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Hong Kong
Corporate Governance:
a practical guide

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Hong Kong Corporate Governance: a practical guide

Foreword

David Graham, Chief Regulatory Officer and Head of Listing
Hong Kong Exchanges and Clearing Limited

Hong Kong’s financial market has enjoyed tremendous success, and few would disagree with its status as a major international financial centre. Over the past decade, the Stock Exchange of Hong Kong (SEHK) has been consistently within the top five listing markets in the world. The aggregate market capitalisation of the companies listed on the SEHK is the second largest in Asia and the sixth largest in the world, at more than US$2.8 trillion as of the end of 2012. It was also the most active market for initial public offering funds raised globally in 2009, 2010 and 2011. As of December 2013, 1,643 companies were listed on the SEHK, with a growing number coming from mainland China, as well as overseas.

Hong Kong’s stock market is an efficient and preferred capital-raising centre. Hong Kong continues to be the primary capital-raising centre for mainland China companies. From 2008 to the end of 2012, 247 mainland companies were listed, raising around US$84.1 million.

Hong Kong is also a developed and international market that has attracted investors from around the world. Recent SEHK surveys show that local and overseas investors have similar levels of contribution to the total turnover in the Hong Kong securities market. Local institutional and retail investors each account for about 20 per cent of total turnover. Overseas investors, mainly institutional investors, are the largest contributors, representing over 40 per cent of total turnover.

Hong Kong has been ranked first in terms of economic freedom for 18 consecutive years (1995–2012), according to the Heritage Foundation. It has also been ranked first for the second consecutive year in the Financial Development Index released by the World Economic Forum in its Financial Development Report 2012. The rankings are based on more than 120 variables spanning institutional and business environments, financial stability and size and depth of capital markets. Furthermore, the Xinhua-Dow Jones International Financial Centers Development Index (IFCD) has ranked Hong Kong in third place for 2013 (after New York and London) as an international financial hub, surpassing Tokyo. The IFCD ranks the top 10 cities based on their comprehensive competitiveness. This is the first year that Hong Kong has placed in the top three.

Contributing factors to Hong Kong’s strengths
The reasons most cited for Hong Kong’s success are the quality of its corporate governance regime, the transparency and fairness of its regulatory
Settlements in 2010, Hong Kong was the world's sixth-largest foreign exchange market in turnover. In the banking sector, 70 out of the world's 100 largest banks operate in Hong Kong, according to the Hong Kong Monetary Authority. Nearly all sizeable global and regional investment banks have operations in Hong Kong.

**Good corporate governance**

Studies indicate that investors place significant importance on the corporate governance of a market or company when it comes to valuing the market or the company's stock. Hong Kong continues to enjoy good corporate governance ratings in international surveys. The World Bank's *Doing Business 2012* rated Hong Kong third in the world in the category of investor protection. For minority investor protection, Hong Kong achieved a full 10 out of 10 in the same survey.

In the Asian Corporate Governance Association's *CG Watch 2012*, Hong Kong was again in the top spot for enforcement. For corporate governance rules and practices, Hong Kong ranked second in Asia. The newly revised Corporate Governance Code and related Rules Governing the Listing of Securities on the SEHK (Listing Rules) only became effective in 2012. The long-term effect of these changes remains to be assessed.

**Reliable, transparent and fair regulatory and legal system**

Hong Kong has a strong and well-regulated securities sector. The Securities and Futures Commission (SFC) and the SEHK believe in achieving a good balance between regulating the market; upholding the principles of accountability, fairness and transparency; and allowing normal business operations to thrive. The SFC has won praise for its enforcement efforts. The SEHK has been active in reforms, conducting nearly 30 consultations since 2008.

One of the most important considerations for businesses that choose to operate in Hong Kong is its legal system—it is well-founded and has proved dependable and fair. Businesses entering into commercial contracts have the confidence that their rights will be protected under the legal system.

**Free foreign exchange policy and world-class banking system**

Hong Kong's capital account is fully convertible, and there are no restrictions on foreign exchange dealings. According to a triennial global survey conducted by the Bank of International and legal system and its unrestricted foreign exchange policy. These strengths are described in detail in the next sections.
Several key changes to the Listing Rules resulted from the review. One of the most significant of these changes was to upgrade the provision that INEDs should comprise one third of the board from a recommended best practice to a rule. In addition, the code provision on the establishment of a remuneration committee with a majority of INEDs as members and an INED as chair was upgraded to a rule. Other changes included introducing rules to require (1) shareholders’ approval at the general meeting for any proposal to appoint an auditor or remove an auditor before the end of the term of office, (2) disclosure of an issuer’s constitutional documents on the SEHK’s website and the issuer’s website and (3) training of company secretaries. Also, the existing rule describing directors’ duties was strengthened to provide that delegation is permissible but does not absolve directors from their responsibilities. Attending meetings alone is not sufficient; directors must take an active interest in the issuer’s affairs and follow up anything untoward that comes to their attention.

Key changes to the Corporate Governance Code included introducing code provisions to state that (1) the issuer’s management should provide monthly management updates to all directors and (2) the board should be responsible for corporate governance. Training of directors was also introduced as a code provision. In relation to board committees, code provisions were introduced on the terms of reference of the audit, remuneration and nomination committees. In addition, the provisions on the establishment and composition of a nomination committee were upgraded from recommended best practices to code provisions.

The SEHK received strong support for most of its proposals. In particular, important measures such as the upgraded rules requiring (1) INEDs to comprise at least one third of the issuer's board and (2) the issuer’s remuneration committee to be chaired by an INED and to be composed of a majority of INEDs received support from approximately 75 per cent of the respondents to the consultation.

In November 2013, the SEHK published its first review of issuers’ compliance with the Corporate Governance Code since implementation of the revised code on 1 April 2012. The review involved
analysing the disclosures made by 1,083 issuers (representing 70 per cent of all issuers listed as at 31 December 2012) in their 2012 annual reports. The results of the review indicate that issuers have responded positively and swiftly to the changes made in the code. In the first eight months of the implementation of the revised code, full compliance with the new code provisions (30 in total) was reported by 84 per cent of the issuers reviewed. This is a positive sign that issuers recognise the importance of corporate governance and are ready to adopt a higher standard of governance.

Board diversity
In September 2012, the SEHK consulted on board diversity, proposing as a code provision that the issuer should have a policy on diversity and should disclose that policy or a summary of it in its corporate governance report. The proposal met with overwhelming support from the market. The consultation conclusions were published in December 2012 and the revised Corporate Governance Code became effective 1 September 2013.

The strong support for the recent corporate governance reforms is evidence of the Hong Kong market’s maturity. It shows that issuers and stakeholders are keen to embrace changes that will improve the corporate governance standards in Hong Kong.

Periodic implementation reviews
As part of the ongoing effort to ensure a high standard of corporate governance amongst issuers, the SEHK conducts periodic reviews of the following issuer publications:

- annual reports, in which the SEHK not only monitors issuers’ compliance with the Listing Rules, but also examines their additional disclosure of material events and developments that are relevant to investors.

These periodic reviews share a common objective, namely to enhance transparency and improve the quality of disclosure in the various reports that issuers are required to publish.

Other key regulatory developments in Hong Kong supporting corporate governance

Statutory backing for disclosure of price-sensitive information
The new statutory regime for the disclosure of inside information came into effect 1 January 2013. The new regime aims to cultivate and encourage a lasting culture of disclosure by listed issuers. According to the SFC, since implementation of the regime, there has been a significant increase in corporate announcements in relation to inside information. The SFC found that the total number of corporate announcements on inside information increased by 52% in 2013.

Companies Ordinance rewrite
In July 2012, the new Companies Ordinance was passed by the Legislative Council. It came into effect on 3 March 2014, after enactment of subsidiary legislation.

One of the major objectives of the new Companies Ordinance is to enhance corporate governance. In particular, the new Companies Ordinance introduces a statutory provision that clarifies and codifies directors’ duty of care, skill and diligence.

Environmental, Social and Governance Reporting Guide
Noting the growing importance of environmental, social and governance (ESG) performance and reporting globally, in August 2012 the SEHK announced its decision to issue an Environmental, Social and Governance Reporting Guide (ESG Guide) following a public consultation. The ESG Guide focuses on four areas: workplace quality, environmental protection, operating practices and community involvement. It is an easy-to-
use guide that complements international ESG disclosure guidelines. The ESG Guide helps issuers begin reporting and is a first step towards adopting international best practices. Subject to further consultation, the SEHK plans to raise the obligation level of some recommended disclosures in the ESG Guide to ‘comply or explain’ by 2015.

Financial Reporting Council
The Financial Reporting Council (FRC), which commenced operation in 2007, is an independent statutory body set up under the Financial Reporting Council Ordinance. The FRC plays an important role in the oversight of the auditing profession and issuers’ financial reporting. In particular, its role is to (1) conduct independent investigations into possible auditing and reporting irregularities in relation to issuers and (2) enquire into possible non-compliance with accounting requirements. The FRC’s work helps to raise the level of issuers’ corporate governance, particularly in the area of controlling risks associated with financial reporting.

Outlook and future plans
Going forward, the SEHK will continue to update and review the corporate governance framework to ensure that it achieves a good balance between market regulation and accountability, fairness and transparency principles without imposing an undue administrative burden on issuers’ business operations.

In the near term, the SEHK is reviewing the risk management and internal control aspects of the Corporate Governance Code. Internal control did not form part of the 2010 and 2011 corporate governance review because the SEHK considered it a broad, substantive topic that warranted separate review and consultation. The SEHK will also closely monitor the reporting and implementation level of the ESG Guide, with a view towards upgrading some voluntary obligations to ‘comply or explain’.

Conclusion
Although the SEHK has made great strides towards instilling a culture of strong corporate governance amongst its listed issuers, it must not be complacent. The SEHK remains ever mindful of the need to review and adapt its approach to promoting and strengthening corporate governance according to the evolving needs of the market.

The Listing Rules and Corporate Governance Code merely provide a framework within which issuers should operate. It takes the true commitment of issuers, their directors and their senior management to achieve a standard of corporate governance that is in line with international best practices. That said, the SEHK’s commitment to making Hong Kong not only one of the most competitive financial and business markets in the world, but also one that aspires to the highest standards of corporate governance, remains constant and unwavering.
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The development of Hong Kong’s corporate governance regime

Gordon Jones Former Registrar of Companies, Hong Kong, and author of ‘Corporate Governance & Compliance in Hong Kong’ (2012, LexisNexis Butterworths Hong Kong)

Hong Kong’s corporate governance regime essentially started to develop as a distinct integrated system in the early 1990s, although many important elements significantly pre-date this period. Apart from one major overall corporate governance review in the early 2000s, most reform has been issue-specific and incremental. The corporate governance framework is derived from four principal sources, namely: the Companies Ordinance (CO), the Securities and Futures Ordinance (SFO), the Listing Rules of the Stock Exchange of Hong Kong (SEHK) and the Corporate Governance Code (CGC). These sources are the responsibilities of the Hong Kong Government and different regulatory authorities.

A regulatory problem, largely unique to Hong Kong, is that over 80 per cent of companies listed on the SEHK are ‘non-Hong Kong companies’, not formed and registered under the CO. Consequently, they are not subject to the CO’s provisions, with the exception of Part XI and some other provisions, and can be regulated only by the non-statutory Listing Rules and CGC. In addition, they are subject to Parts XIII, XIV, XIVA and XV of the SFO.

Company law reform

Hong Kong’s company law is essentially based on the UK Companies Acts. The Companies Ordinances of 1865, 1911 and 1932 followed parallel company law reforms in the UK. In 1973, the Second Report of the then Company Law Revision Committee recommended major reforms based on the UK Companies Act 1948 which were implemented in Hong Kong by the Companies (Amendment) Ordinance 1984. At the same time, the Government established the Standing Committee on Company Law Reform (SCCLR) to keep the CO up to date.

Increasing pressure for a complete overhaul of the CO led to the Consultancy Report on the Review of the Companies Ordinance (1997) and the SCCLR’s own report on the consultant’s recommendations (2000). The SCCLR’s report contained a number of corporate governance reforms regarding, inter alia, directors, shareholders and financial reporting. These were subsequently subsumed by either the Companies (Amendment) Ordinances of 2003 and 2004 or the Companies Ordinance Rewrite Exercise.

Corporate Governance Review

In 2000, the then Financial Secretary asked the SCCLR to undertake a comprehensive review of Hong Kong’s corporate governance regime in order to identify and plug any gaps. The SCCLR undertook the Corporate
Governance Review (CGR) in two phases and published reports in July 2001 and June 2003. These recommended a very wide spectrum of reforms, both statutory and non-statutory, regarding boards, directors, shareholders, financial reporting, auditing standards and auditing requirements. A number of these reforms, in particular those regarding shareholders’ remedies – including the introduction of a statutory derivative action, empowering shareholders to inspect company records and the use of injunctive powers by the court – were implemented in the Companies (Amendment) Ordinance 2004.

The Securities and Futures Ordinance and the Securities and Futures Commission

In parallel with these company law reforms, a number of important reforms, with a corporate governance dimension, were made to Hong Kong’s securities law and regulation. A new unified Stock Exchange of Hong Kong (SEHK), which absorbed four previous stock exchanges, began operating on 2 April 1986. The unification of a previously fragmented trading structure and the subsequent introduction of computer-assisted trading were key elements in the modernisation of Hong Kong’s financial services infrastructure. Proving successful in attracting international investors, these developments initiated Hong Kong’s transformation into a major international financial centre.

On 19 October 1987, the world’s stock markets crashed. In Hong Kong, suspension of the market only led to further massive losses and, inevitably, government intervention. As well as arranging a rescue package, the Government appointed a Securities Review Committee under Ian Hay-Davison to investigate the underlying structural problems and systemic defects which had so damaged Hong Kong’s reputation as an international market. Three of the most important of the Hay-Davison Report’s recommendations were: the establishment of an independent statutory securities and futures regulator; the establishment of a ‘three-tier’ system of securities regulation; and the consolidation and reform of Hong Kong’s very fragmented securities legislation which was spread over 10 different ordinances.

The Securities and Futures Commission (SFC) was established on 1 May 1989 under the then Securities and Futures Commission Ordinance. Under the three-tier system of regulation, the Government is the first tier, the SFC the second tier and the SEHK the third tier. Subsequent to the demutualisation and listing of the SEHK and the formation of Hong Kong Exchanges and Clearing Ltd (HKEx) in 2001, the relationship between the SFC and SEHK was further clarified. HKEx is the front-line regulator of all listed companies, except itself. The SFC regulates HKEx and is the front-line regulator for takeovers and mergers, regulation of offers of investment products and enforcing market malpractice legislation. On the legislative front, an overall review of securities legislation resulted in the SFO which came into operation on 1 April 2003.

Despite this delineation of the SFC’s and HKEx’s regulatory responsibilities, there continued to be doubts about HKEx’s real and perceived conflict of interest given its dual roles as a market regulator and a market participant. This tension came to a head with the ‘Penny Stocks’ incident in July 2002, which arose over proposals to delist certain companies whose stocks were trading at a negligible value. Proposals by HKEx that the prices of listed companies’ shares quoted at below HK$0.50 should be consolidated, failing which delisting may follow, led to a significant collapse in the value of these stocks and the withdrawal of the proposals. Subsequently, the then Financial Secretary appointed an ‘Expert Group’ to review the regulatory structure of the securities market. One of the Group’s key recommendations was that the listing functions of HKEx should be transferred to a new Hong Kong Listing Authority which would be established within the SFC. In the event, the recommendations encountered significant market opposition and were withdrawn.

The Listing Rules

The Listing Rules for both the Main and Growth Enterprise Market (GEM) Boards issued by the SEHK are, like the CO and SFO, lengthy, highly technical documents that govern the initial listing and continuous compliance requirements of all issuers listed on the Main and GEM Boards. Although the Listing Rules contain many detailed requirements specific to listed companies, they also apply a large number of the CO’s
provisions, particularly those regarding financial disclosure in Appendix 16, to all listed companies. A large number of the Listing Rules, such as those in Chapter 3, are specifically concerned with corporate governance, including the requirements for independent non-executive directors (INEDs); the definition of ‘independence’; and the establishment of audit and remuneration committees. Consequently, the Listing Rules are, to all intents and purposes, a ‘quasi-Companies Ordinance’ for all listed companies, including the overwhelming majority of listed companies which are not Hong Kong companies.

Over the years, the Listing Rules have undergone continuous reviews to ensure that they remain up to date and responsive to market conditions and corporate governance requirements. A major review took place in 2008 when HKEx sought the market’s views on 18 policy issues regarding initial listing and corporate governance requirements. Fifteen of the recommendations, including the requirement that any vote by shareholders at a general meeting should be taken by poll, were implemented on 1 January 2009.

Statutory backing of the Listing Rules
Following the Expert Group’s Report, the Government identified a number of issues regarding the regulation of listed companies, including the enforcement of the Listing Rules and the regulatory roles of the SFC and HKEx. One major option to deal with the enforcement of the Listing Rules was to give statutory backing to certain fundamental requirements in the Rules. This had been partially addressed by the ‘dual-filing’ system introduced on 1 April 2003 under which the SFC has powers to comment on and object to a listing application. The SFC could also exercise its powers under section 384 of the SFO to take action against knowingly or recklessly false or misleading disclosure.

Building on this system, the Government issued a ‘Consultation Paper on Proposals to Enhance the Regulation of Listing’ in October 2003. This sought the public’s views on whether statutory backing should be extended to other fundamental requirements set out in the Listing Rules and, if so, which listing rules should have statutory backing, how they should be given statutory backing and what sanctions should be imposed for breaches. The consultation conclusions, published in March 2004, indicated that statutory backing should be given to the Listing Rules on: (1) financial disclosure and other periodic disclosures by listed companies; (2) disclosure of price-sensitive information by listed companies; and (3) shareholders’ approval for certain notifiable transactions. There was also overwhelming public support for the SFC to become the new statutory regulator of the new statutory listing requirements.

The ‘Consultation Paper on Proposed Amendments to the Securities and Futures Ordinance to give Statutory Backing to Major Listing Requirements’, published in January 2005, set out the details of the new statutory regime. Under this regime, the Market Misconduct Tribunal established under Part XIII of the SFO would have the power to impose a range of civil sanctions on issuers and directors including civil fines, reprimands and disqualification orders. More serious cases would be referred to the Department of Justice which would decide, inter alia, whether or not to institute criminal proceedings under Part XIV of the SFO. It was, however, to be another five years before the Government issued firm proposals on how to deal with the issue of statutory backing.

Corporate Governance Code
Although the CO, SFO and Listing Rules contain a very considerable number of corporate governance requirements, they do not provide any overall coherent guidance on good corporate governance practice. Part of the reason is that this is not their primary legal and regulatory function. However, a more important factor is that a very significant element in good corporate governance is found in non-legal and regulatory requirements, generally characterised as ‘best practice’ and usually found in codes of conduct.

The previous Hong Kong Code issued by the SEHK mandated a number of significant corporate governance measures for listed companies. These included audit committees, which have been a requirement since 1994. This code was replaced by the Hong Kong Code on Corporate Governance Practices (Appendix 14 of the Listing Rules) which was implemented on 1 January
2005. The philosophy of this code was identical to the then Combined Code in the UK: issuers have to comply with ‘code provisions’ or explain why they do not; and may follow ‘recommended best practices’ which are for guidance only. The Code’s structure and contents were also similar to the Combined Code with specific chapters on: directors; remuneration of directors and senior management; accountability and audit; delegation by the board; and communication with shareholders.

In December 2010, HKEx launched a major review of this Code, recommending significant changes to the corporate governance requirements in the Listing Rules and CGC. As a result of the public consultation, most of the changes were accepted, including requirements for a minimum of one third of the board to be INEDs and all listed companies to form remuneration committees in the Listing Rules, along with the inclusion of a new chapter on the role and functions of company secretaries in the CGC. These changes were implemented in phases during 2012.

Since the implementation of the new CGC, HKEx has held separate public consultations on environmental, governance and social (ESG) reporting and board diversity. The requirements regarding ESG reporting will be a recommended best practice applying to all issuers with financial years ending after 31 December 2012 and board diversity will be a code provision with effect from 1 September 2013.

Financial reporting and auditing regulation
The Hong Kong Society of Accountants (HKSA) was established as a statutory body under the Professional Accountants Ordinance (PAO) in 1973. As a self-regulatory professional body, it was initially responsible for registering certified public accountants, conducting examinations, issuing practising certificates for auditors and undertaking, where necessary, disciplinary action. Subsequently, the HKSA assumed responsibility for setting financial reporting and auditing standards (1992), undertaking audit practice reviews (1992) and undertaking investigations (1994).

The corporate scandals in the USA in 2002, which led to the collapse of Enron and WorldCom, attracted significant global public concern about the credibility of financial reporting and auditing practices. In December 2002, the Government discussed ways of improving the existing self-regulatory regime in the PAO with the HKSA. The Society’s proposals in January 2003 recommended expanding lay representation on the HKSA’s Council’s Investigation and Disciplinary Panels and the establishment of an ‘Independent Investigation Board’ to review accounting and auditing irregularities in listed companies. The HKSA also urged the Government to establish a Financial Reporting Review Panel (FRRP) as recommended by the SCCLR in Phase I of the CGR.

Subsequently, the Government issued a consultation paper in September 2003 seeking views on enhancing the public oversight of auditors and establishing a FRRP. In parallel with this, the PAO was amended in 2004 to provide for increased lay representation on the HKSA’s Council and investigation and disciplinary panels. The HKSA’s name was also changed to the Hong Kong Institute of Certified Public Accountants (HKICPA). Given the general public support for the Government’s proposals to enhance the regulation of the accounting profession, the Government issued a ‘Consultation Paper on Legislative Proposals to Establish Financial Reporting Council’ in February 2005.

The Financial Reporting Council Ordinance (FRCO), passed by the Legislative Council on 12 July 2006, established a Financial Reporting Council (FRC) underpinned by an Audit Investigation Board (AIB) and a FRRP. The AIB undertakes investigations into suspected irregularities concerning the auditors of listed companies, whereas the FRRP conducts inquiries into suspected non-compliance of listed companies’ financial reports with the relevant legal and accounting requirements. When the FRC began operating on 16 July 2007, it adopted a primarily reactive role. Since then, however, it has been adopting an increasingly proactive approach.

Since 15 December 2010, Mainland companies listed on the SEHK (‘H’ share companies) have the option to choose Mainland financial reporting standards as the basis for their financial reports and Mainland auditors to audit any financial statements for periods ending on or after that date. On 21 December 2010, the FRC signed a Memorandum of Understanding with the PRC’s
Ministry of Finance (MOF) under which the FRC can seek the MOF’s help to investigate the Mainland auditors of H-share companies. In addition, the FRC, HKEx and the FRC will undertake an annual review of the financial statements of the small number of H-share companies that use Mainland financial reporting standards and auditors.

At present, the HKICPA retains responsibility for standard setting, investigating auditors of unlisted companies, all disciplinary action against auditors and audit practice reviews. However, as independent standard setting and audit oversight are increasingly the global norms, it is possible that some of these functions will, in the future, be transferred to the FRC.

**Initial public offerings**
Over the past few years, there has been growing concern in Hong Kong about the quality of initial public offerings (IPOs) as evidenced by a number of particularly bad cases – such as Hontex International Holdings – and the SFC’s regular reviews of IPO sponsors. In May 2012, the SFC consulted the market on the enhanced regulation of IPO sponsors. Following publication of the consultation conclusions in December 2012, the SFC will be making appropriate changes to, inter alia, the SFC’s code of conduct and recommending amendments to the CO to make clear that the civil and criminal liability provisions apply to sponsors.

**Companies Ordinance rewrite**
Although a number of the SCCLR’s recommendations on reforming the CO were implemented in the context of a number of major companies’ amendment bills in the early 2000s, many of them effectively called for a rewrite of the entire ordinance. During 2005, the Government formulated detailed proposals on the scope of, and process for, undertaking the rewrite exercise, including the staffing implications, which began in 2006. The timing of the rewrite exercise was deliberately synchronised with the availability of the Companies Act 2006 in the UK as, given the close relationship between Hong Kong and UK company law, it was only sensible for Hong Kong to capitalise on this major reform, where appropriate. Five advisory groups provided advice on a wide spectrum of policy and legal issues, while the public’s views were sought on particularly controversial and complex issues in the context of three consultation papers.

In order to provide focus and vision for the rewrite and give practical guidance for the formulation of reform proposals, the SCCLR considered and approved seven guiding principles, one of which was to enhance corporate governance. This stated that any additional corporate governance requirements for listed companies should generally be provided in the SFO and Listing Rules, not the CO (as over 80 per cent of listed companies are incorporated outside Hong Kong). Corporate governance reforms included in the new CO include: strengthening the accountability of directors (eg codifying the duty of care); enhancing shareholder engagement in the decision-making process (eg comprehensive rules for written resolutions); improving the disclosure of business information (eg introduction of a ‘business review’); fostering shareholder protection (eg more effective rules to deal with directors’ conflicts of interest); and strengthening auditors’ rights to access corporate information. The draft Companies Bill was introduced into the Legislative Council on 26 January 2011 and, after very detailed scrutiny by a Bills Committee, was passed on 12 July 2012. Once subsidiary legislation has been finalised, it is intended that the new Companies Ordinance will be implemented during 2014.

**Statutory backing to the Listing Rules on price-sensitive information**
In contrast to the consultation paper published in 2005, the ‘Consultation Paper on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations’, published in March 2010, was far more limited in scope. It was also proposed that criminal sanctions for breaches of the listing rules regarding price-sensitive information should be removed. Subsequently, Securities and Futures (Amendment) Bill 2011 provided for a new Part XIVA in the SFO to give statutory backing only to the listing rules regarding the disclosure of price-sensitive information (PSI). The Bill was passed by the Legislative Council on 29 June 2011 and implemented on 1 January 2013.
The future

With the implementation of the reforms in the CGC in 2012 and 2013, statutory backing of the listing rules regarding PSI in 2013, the proposals regarding IPOs in 2013, and the new CO in 2014, Hong Kong’s corporate governance regime will have been updated in many respects. To date, however, it is not known whether or not the Government intends to proceed with giving statutory backing to other key requirements in the Listing Rules (such as financial disclosure and notifiable transactions). Other important issues which need to be tackled include adoption of a more systematic approach to board recruitment; increased use of board evaluation; expanding directors’ statutory duties; better disclosure and control of directors’ remuneration and conflicts of interest; greater engagement of institutional investors in maintaining corporate governance standards, possibly through the issue of a Stewardship Code; and reforming auditors’ liability, to name but a few. Much still remains to be done.
Significant Values of HKIoD Membership

- Availability of Continuing Professional Development programmes and up-to-date information on director practices.
- Participation in, and contribution to, a collective voice on corporate governance issues in order to help shape the future of Hong Kong.
- Recognition as a member of a progressive premier body representing professional directors.
- Networking opportunities with fellow members and associate bodies in the local community, Mainland China and overseas.
- Friendship in a multi-cultural international environment.
- Enjoyment of various members’ benefits offered by HKIoD and reciprocal entitlements from kindred organisations.

- 獲得持續專業發展培訓及有關董事實務趨勢的最新資訊。
- 參與對有關企業管治重要問題的詳細研究、徵集意見、提交建議，然後向有關當局作出代表性反饋，以協助創建香港的未來。
- 認可為一箇進取精神，代表專業董事的精英組織一份子。
- 伸展網絡至來自各門專業及行業的會友，本地的友好專業團體，及至中國內地和海外的同類組織。
- 在多元文化的國際環境下拓展友誼。
- 分享本會的各種會員福利及世界各地相關組織的互惠服務。
Corporate governance and director professionalism in Hong Kong: initiatives and observations

Dr Carlye Tsui, Chief Executive Officer The Hong Kong Institute of Directors

Hong Kong has for years been rated as the freest economy in the world by the Heritage Foundation’s Index of Economic Freedom. The late Milton Friedman once said, ‘If you want to see capitalism at work, go to Hong Kong’. The economy is characterised by internationalism; the rule of law; free trade; free flow of information; open and fair competition; efficient financial, transport and communication networks; a strong workforce; dynamic entrepreneurs; substantial foreign exchange reserves; a fully convertible and stable currency; and a simple tax system with low tax rates. Against this backdrop, Hong Kong continually strives to enhance its competitiveness as a major international financial centre. A key to success is corporate governance, in which Hong Kong is ranked as one of the top two economies in Asia, according to studies by Credit Lyonnais Securities Asia and the Asian Corporate Governance Association.

The development of corporate governance in Hong Kong is driven by the following four forces: legal and regulatory framework, market pressure, professional disciplines and corporate self-disciplines. Amongst listed companies, drivers of corporate governance include regulatory compliance to limit the threat of penalty, as well as increasing awareness of the board’s responsibilities in implementing good corporate governance practices, which leads to enhancement of corporate image and market price. The stipulations in law, regulations and professional disciplines often provide basic yardsticks, with the Corporate Governance Code (Listing Rules Appendix 14) of Hong Kong Exchanges and Clearing Limited (HKEx) specifying recommended best practices over code provisions (CPs). While regulators pitch compliance and analysts critique compliance and practices, professionals and professional institutions promote excellence.

The Hong Kong Institute of Directors (HKIoD) is a private-sector organisation and Hong Kong’s premier body representing directors. HKIoD’s mission is to be ‘Hong Kong’s premier body representing directors to foster the long-term success of companies through advocacy and standards-setting in corporate governance and professional development for directors.’ HKIoD plays a significant role in society by building a culture for best practices to complement regulatory rules and enforcement. This chapter highlights HKIoD’s initiatives in contributing towards the advancement of corporate governance in Hong Kong through developing director professionalism, particularly amongst listed companies. This chapter also includes observations on the performance of Hong Kong-listed companies in corporate governance, as well as the behaviour and practices of directors in fulfilling their corporate governance responsibilities.
Framework of director professionalism
Originating from the Hong Kong branch of the UK Institute of Directors, HKIoD commenced independent operation in Hong Kong on 1 July 1997. Since then, HKIoD’s membership has expanded more than 10 times to reach over 2,000 members in 2013. This includes directors and senior executives from listed and private companies and diverse industries. In line with its mission, HKIoD defines corporate governance as ‘the system of policies and procedures established by the board of directors to direct and control the company’s behaviour and performance in order to foster the company’s long-term success’.

As directors are ultimately responsible for corporate governance, HKIoD stipulates that a competent director should be able to master five groups of knowledge and skills: corporate functions from a strategic perspective, the role of a director, the development of the board, personal qualities and business ethics. Therefore, HKIoD’s programmes and activities are organised in accordance with its mission, its definition of corporate governance and its expectations of what makes a competent director.

According to HKIoD’s records, about 33 per cent of members serve as executive directors of listed companies, 20 per cent of members serve as independent non-executive directors on the boards of listed companies, approximately 50 per cent of members are current directors of listed companies and, including the retired members, more than 50 per cent of members have director experience in listed companies.

HKIoD members agree to abide by, among other things, a membership accreditation scheme that consists of a code of conduct and a requirement for annual continuing professional development (CPD), to keep themselves up to date in the knowledge and skills necessary for making meaningful contributions to their respective boards and companies.

HKEx has for a long time promoted the pursuit of CPD by directors. In its December 2010 consultation exercise on the review of its Corporate Governance Code and associated Listing Rules, HKEx aimed to introduce an annual CPD requirement in Code Provision (CP) and stated in its consultation paper: ‘We note that HKIoD requires 10 hours of training for its members. A director who meets the HKIoD requirement would also comply with the proposed CP. So, the proposed CP would not place an onerous burden on directors who are HKIoD members’. The proposal was adopted and the new CP came into effect from 1 April 2012.

Listed companies are now required to disclose in their corporate governance reports how the company’s directors complied with their training requirement during the year under review.

Launched in 2006, HKIoD’s membership accreditation scheme through mandatory CPD for all members is a pioneer initiative amongst institutes of directors around the world. As well as setting an international example, it has also served as a reference framework for HKEx in its reform. The impact of HKEx’s reform in this area is seen in the disclosure by companies and demonstrated in the increase of HKIoD training for directors of listed companies, as summarised in Table 1.

<table>
<thead>
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<th>CPD opportunities for directors</th>
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<tr>
<td>With the firm belief that director professionalism is a crucial factor in good corporate governance, HKIoD is focused on providing directors, both members and non-members, with programmes and activities that generate learning outcomes. These include training courses, speaker meetings,</td>
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<table>
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<tr>
<th>Table 1: Increases in training for directors of listed companies</th>
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<tr>
<td>Increase of attendance by directors of listed companies at HKIoD training courses</td>
</tr>
<tr>
<td>Increase of commissioned board training hours organised by HKIoD for listed companies</td>
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<tr>
<td>Increase of commissioned board training hours organised by HKIoD for listed companies</td>
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talks, forums, publications, positions on corporate governance issues, public promotion projects, roadshows and delegations, as summarised in Table 2. The participants in these activities who are directors of listed companies range from 33 to 100 per cent. The most heavily subscribed activities are training courses.

HKIoD publications serve as useful study materials and reference books for directors. In its 2011 consultation conclusions, HKEx amended Listing Rule 3.08 to clarify directors’ responsibilities, giving guidance by referring, in a note to the rule, to HKIoD’s Guidelines for Directors and Guide for Independent Non-Executive Directors. In advising directors on practical aspects of board practices, HKIoD publishes Directors’ Practice Notes on a regular basis. For instance, issues 1 and 2 of the practice notes elaborate, respectively, on approaches for pursuing CPD and on the specification of monthly management updates for the board. The guidelines and practice notes can be downloaded from the HKIoD website, www.hkiod.com.

HKIoD works in tandem with the government and regulators to provide feedback on issues and consulted subject matters. In developing an official position, HKIoD involves its membership in polling and focus groups in order to derive collective views. Such activities generate interest from, active participation by, and greater understanding of the issues for participating directors, particularly directors of listed companies. Recent examples are the in-depth reviews on the rewriting of the Companies Ordinance and the disclosure of price-sensitive information that has been codified in the Securities and Futures Ordinance.

### Training of directors

HKIoD’s structured training programmes are developed for directors by directors. It schedules more than 100 sessions per year, and the programmes are conducted in Cantonese, English and Putonghua. In 2013, the forecast total attendance of HKIoD training from listed-company directors was 930 people.

HKIoD offers the following training courses: (1) a credits programme, for attendees to accumulate credits towards a certificate (eg certificate in finance core) or a diploma (eg diploma in essentials for listed-company directors); (2) fast-track programmes (eg the well-subscribed professional diploma in corporate governance and directorship for listed and to-be-listed companies and a professional diploma in small- to medium-enterprise (SME) directorship), and (3) commissioned board training by client companies. In particular, since launching in 2002, the professional diploma in corporate governance and directorship for listed and to-be-listed companies, jointly organised with the Hong Kong Productivity Council, has been arranged for 16 intakes totalling 960 hours of training. Since the amendment to the Corporate Governance Code on director training which
came into effect in April in 2012, 424 hours of commissioned training have been conducted for listed companies. Private and discreet training is also offered for directors who have been required to undertake remedial training as a result of a sanction by HKEx.

The HKIoD Corporate Governance Score-card
To evaluate corporate governance standards and to help companies, policy makers and the public identify ways to improve corporate governance practices, the HKIoD Corporate Governance Score-card has been conducted regularly over the past 10 years and is expected to continue in the future. Organised by HKIoD and sponsored by the Corporate Governance Development Foundation Fund, the Score-card project was conducted by Professor Stephen Y L Cheung, who led a team of researchers from City University of Hong Kong in 2004 and 2006 and from Hong Kong Baptist University in 2009 and 2012 to work on this project.

The research is implemented by way of a questionnaire, designed in accordance with the Organisation for Economic Co-operation and Development’s Principles on Corporate Governance and the HKEx Corporate Governance Code. Scores are assigned to Hong Kong-listed companies by using information from their annual reports, other financial statements and websites. The sample companies are prevailing constituent stocks of the following four Hang Seng indexes: Hang Seng Index (HSI), Hang Seng China-Affiliated Corporation Index (HSCCI), Hang Seng China Enterprises Index (HSCEI) and Hang Seng Hong Kong Composite Index (HSHKCI) in the first three exercises (HSHKCI was replaced by Hang Seng HK Large Cap Index (HSLI) in 2012).

Corporate governance practices are assessed across five important areas:

- rights of shareholders
- equitable treatment of shareholders
- role of stakeholders
- disclosure and transparency
- board responsibilities.

Scores are expressed on a scale of 0 to 100.

Corporate governance standards of Hong Kong-listed companies have continued to show improvement. Table 3 compares the overall performance.

Comparing the most recent survey from 2012 with the one in 2009, only 82 firms were common to both years. While the average corporate governance index in 2012 increased only 0.02 per cent compared to 2009, the level of corporate governance improved greatly, partly because the 2012 questionnaire contained more questions. Furthermore, these questions were rebalanced in weighting so that the weightings decreased in areas where Hong Kong-listed companies are strong and increased in areas where the companies are weaker. Moreover, the sample in 2012 contained more enterprises from emerging industries and companies that have been publicly traded for a shorter period, noting that young companies and those from emerging industries often lack mature corporate governance regime, especially

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2009</th>
<th>2006</th>
<th>2004</th>
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<tbody>
<tr>
<td>Companies in sample</td>
<td>121</td>
<td>146</td>
<td>174</td>
<td>168</td>
</tr>
<tr>
<td>Questions and subquestions</td>
<td>151</td>
<td>133</td>
<td>121</td>
<td>75</td>
</tr>
<tr>
<td><strong>Overall score: corporate governance index</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum</td>
<td>56.92</td>
<td>56.64</td>
<td>51.33</td>
<td>132.86</td>
</tr>
<tr>
<td>Mean</td>
<td>71.91</td>
<td>71.89</td>
<td>70.87</td>
<td>48.33</td>
</tr>
<tr>
<td>Maximum</td>
<td>87.59</td>
<td>85.21</td>
<td>92.35</td>
<td>76.34</td>
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in the areas of disclosure, transparency and board responsibilities. For these reasons, it is believed that the 2012 level of corporate governance improved significantly compared to 2009.

The 2012 survey is broken down by survey areas A to E, by market index and by industry, respectively, in Figures 1, 2 and 3.

Amongst the five survey areas in Figure 1, the sample Hong Kong-listed companies perform best in rights of shareholders (A), whereas the wide range of scores in role of stakeholders (C) indicates that companies should devote greater effort to their corporate social responsibility activities. Despite the low average score in C, a number of companies earned high marks.

The survey results in Figure 2 show notable differences in scores amongst constituent companies, with HSCEI constituents performing the best, followed by HSI constituents.

In the comparison across industries (Figure 3), companies in the finance sector lead the way, followed by those in the energy sector. The 10

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**Figure 1: Corporate governance index scores by survey section**

![Figure 1](image1.png)

**Figure 2: Corporate governance index scores by market index**

![Figure 2](image2.png)
firms ranking the highest in scores in the 2012 survey are listed in Table 4.

Details of the survey methodology and findings are published in the Report on the HKIoD Corporate Governance Score-card 2012. While previous Score-cards indicate an upward trend, Professor Stephen Y L Cheung’s reflections from the 2012 survey highlighted the following areas for improvement:

• Despite the substantial resources available to them, many of the large companies in the survey did not disclose details of their internal audit system and some did not have (or chose not to disclose) internal staff reporting and control guidelines (e.g., a whistle-blowing policy)
• It is likely that a company could benefit from having more than the mandated minimum of three independent non-executive directors
• Many large-scale enterprises have still not established a clear company culture, with vision and mission statements, to set clear objectives for employees and generate confidence and recognition from shareholders, potential investors, and the public. Companies should integrate corporate social responsibility concepts into their respective company cultures.

Table 4: Top 10 firms

<table>
<thead>
<tr>
<th>Stock code</th>
<th>Company name</th>
<th>HSI</th>
<th>HSLI</th>
<th>HSCCI</th>
<th>HSCEI</th>
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<tbody>
<tr>
<td>0002</td>
<td>CLP Holdings</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0005</td>
<td>HSBC Holdings</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0066</td>
<td>MTR Corporation</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0388</td>
<td>HKEx</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0883</td>
<td>CNOOC</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>0992</td>
<td>Lenovo Group</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1398</td>
<td>ICBC</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td>✓</td>
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<tr>
<td>1919</td>
<td>China COSCO</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td>✓</td>
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<tr>
<td>2628</td>
<td>China Life</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td>✓</td>
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<tr>
<td>3988</td>
<td>Bank of China</td>
<td>✓</td>
<td>✓</td>
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<td>✓</td>
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Directors of the Year awards
Another major initiative of HKIoD to evaluate the performance of directors and boards in corporate governance is its Directors of the Year awards (DYA), organised every year since 2001, and the first such awards in Asia. The objectives of DYA are to recognise outstanding boards and directors, to publicise the significance of corporate governance and to promote good corporate governance and director professionalism.

DYA is a community-wide project. Nomination of candidates is open to the public. The project has more than 80 partners, including HKIoD as organiser; the Financial Services and the Treasury Bureau of the Hong Kong government, the Securities and Futures Commission and HKEx as co-organisers; major firms as lead sponsor, joint sponsors and co-sponsors; chambers of commerce, professional bodies, community groups and other government bureaus as supporting organisations; leading audit firms and search firms as honorary selection consultants; and more than 20 representatives of project partners form the panel of judges. The honorary selection consultants conduct due diligence and interviews to generate their independent reports, and the panel of judges makes independent and final decisions based on the reports and deliberations.

The awards are categorised. The company categories include listed companies on Hang Seng indexes, listed companies on non-Hang Seng indexes, private companies and statutory or non-profit-distributing organisations. The director categories include executive directors, non-executive directors and boards. The evaluation criteria for individual directors cover the following areas:

- contribution towards managing change, risk and succession
- leadership and other attributes and qualities, including CPD for directors
- business ethics
- any other outstanding achievements.

The board evaluation criteria cover the following:

- board composition, skill mix and competencies of directors
- effectiveness in strategic corporate business functions
- development and implementation of strategic plans and monitoring of performance
- managing compliance and accountability
- managing change, risk and succession
- development of the board, including CPD for directors
- effectiveness of board committees
- business ethics
- any other achievements.

One strict principle of DYA is that an award will not be made merely to fill a category if the candidates are not deemed qualified. However, if multiple candidates meet the high benchmark, multiple awards may be granted in a category.

Throughout the past 13 years, DYA has been well received and has gained substantial credibility. Table 5 displays the number of awardees, with a breakdown by category.

Notably in recent years, the number of awardees from mainland China companies listed on HKEx has increased significantly. Some exemplary practices of corporate governance in mainland China companies have emerged and these are recognised through DYA.

<table>
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<th>Table 5: DYA awardees</th>
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<tr>
<td><strong>2001-2013 DYA awardees</strong></td>
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<tr>
<td>Executive directors</td>
</tr>
<tr>
<td>Non-executive directors</td>
</tr>
<tr>
<td>Boards</td>
</tr>
<tr>
<td>Total</td>
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</tbody>
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To illustrate the performance of the awardees, the following are selected citations from the panel of judges:

- ‘Armed with extensive knowledge in corporate finance and operating strategy…[he is] an exemplary executive director in corporate governance. Internally, he has played a pivotal role in [the] company’s development, particularly in strategic human resources…[and is] devoted to fulfilling corporate social responsibility’.
  Dr Yim Fung (Chairman and Chief Executive Officer, Guotai Junan International Holdings Limited), 2012 awardee, listed company executive director.

- ‘[He] has made remarkable contribution to the company with his extensive industry knowledge, experience and international exposure…[and] has led the company through a fundamental change in early 2009, in improving corporate governance, internal controls, risk management, transparency and corporate social sustainability’.
  Nicholas Robert Sallnow-Smith (Chairman and Independent Non-executive Director, The Link Management Limited), 2011 awardee, listed-company non-executive director.

- ‘The board…is well structured with a strong mix of talents and skills. The board members have contributed their expertise to the company’s business growth while leading business transformation with high transparency, due diligence and professionalism. The board is applauded for its dedicated effort in employee development and social and community involvement’.
  Board of directors, COSCO International Holdings Limited, 2010 awardee, listed-company board.

**Building the culture amongst and beyond listed companies**

Non-listed companies should address corporate governance to strengthen their foundation and pave the way for sustainability, expansion and a potential listing in due course. Hence, HKIoD has developed well-supported programmes and activities for private companies, particularly SMEs, such as the following:

- Publications such as *Guidelines on Corporate Governance for SMEs in Hong Kong* and *SME Corporate Governance Toolkit*
- Seminars and regular forums for SMEs.

With regulatory changes and professional disciplines as the driving force, corporate governance and director professionalism are being developed hand-in-hand to contribute towards advancing Hong Kong’s status as a major international financial centre. In pushing forward the standards of corporate governance, HKIoD is pleased to be an advocate, participant, facilitator, catalyst and influencer in this platform.
The management of MTR Corporation Limited (MTR) firmly believe that good corporate governance is fundamental in ensuring that a company is well managed in the interests of all of its stakeholders. The company’s commitment to the highest standards of corporate governance is driven by its board of directors, whose members, led by the chairman, assume overall responsibility for the governance of the company, taking into account the interests of various stakeholders, the development of the company’s business and the changing external environment.

In recent years, there have been changes both in the nature of MTR’s business, which has expanded in Hong Kong and overseas, and in the external environment. Expectations placed on large businesses, whether by shareholders, other stakeholders or the public, have never been higher. In addition, the regulatory environment continues to expand from a coverage perspective and become more complex, particularly for businesses operating internationally. The key challenge from a corporate governance perspective is to stay ahead of these changes and ensure that the company is well prepared for them.

In Hong Kong, the last two years have seen a number of significant regulatory advancements in the corporate field, not least of which were the amendments to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong (Listing Rules) and Corporate Governance Code, which introduced a number of new rules, code provisions and recommended best practices.

A listed company needs to be aware of potential developments in the regulatory environment at an early stage. It should participate (where appropriate) in consultation exercises. It should also consider how new mandatory provisions affect the company and how best to comply with them. Finally, the listed company should determine whether voluntary changes are concepts that it would be desirable to adopt.

Once the company has decided how to proceed, it must obtain buy-in and support from its chairman and board of directors and educate staff as to what the new provisions mean. Where relevant, the company should design systems and procedures to try to ensure compliance from then on.

By way of example, the recent changes to the Corporate Governance Code introduced a new recommended best practice relating to board evaluation. Although board evaluation is still relatively new for Hong Kong compared to jurisdictions such as the UK, MTR decided to explore whether it would add value to the way in which the company was run and ensure a more effective board. Having supported the introduction of this recommended best practice during the consultation exercise, MTR decided to proceed with a board evaluation process. The company first explored the manner in which other companies (in Hong Kong and overseas) had carried out board evaluation exercises, looking at whether the exercises were conducted internally or with external assistance and the types of issues they covered.
With the support of MTR’s chairman, the company designed and conducted its first board evaluation exercise in 2012. The exercise was run internally through means of a simple questionnaire that asked board members to evaluate the performance of the board in a number of areas, including overall performance, composition, conduct of board meetings and the provision of information to the board. The responses to the questionnaire were thoroughly analysed and discussed at a private board meeting (ie attended only by the chairman and non-executive directors of the company), with suggestions made by board members incorporated as further improvements to the company’s overall corporate governance regime.

MTR is considering how to take this forward, with ideas including to undertake an externally facilitated board evaluation exercise, to assess the performance of individual board members, to focus on one or more board committees in the next evaluation, or to try to analyse the performance of the board in the context of a particular transaction. It hopes that this consideration will ensure that feedback received from the exercise is relevant and meaningful.

MTR has approached other regulatory changes in a similar manner. Where they appear to add value to the business, MTR has been keen to adopt these changes early. This is intended to ensure that the company stays ahead of the game as far as corporate governance is concerned.
An efficient board can add real value to a company. The board is responsible for guiding corporate strategy, risk governance, monitoring the performance of management and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the company. Consequently, the composition of the board is fundamental to a company’s governance.

Board effectiveness is more important than ever, given the global economic slowdown and high-profile corporate governance failures. Boards are operating in an increasingly complex environment that demands new levels of commitment and engagement. Therefore, how directors are nominated and elected, the role of the board and shareholder participation in this process are important to optimizing the opportunities to have an effective board that adds real value to companies, shareholders and stakeholders.

That is why following the endorsement of the OECD-Asian Roundtable on Corporate Governance report Reform Priorities in Asia: taking corporate governance to a higher level in 2011, participants decided to advance work on implementation of Priority 4 ‘to enhance a board nomination process that is transparent, with full disclosure about prospective board members, including their qualifications’. A Task Force on Board Nomination and Election was formed, with representatives from securities regulators, stock exchanges, institutes of directors, board secretary associations and others. Hong Kong participated actively in this initiative.

In June 2013, the Asian Roundtable endorsed a report entitled ‘Better Policies for Improved Board Nomination and Election’. The result of extensive consultation, commentary and discussion by the Asian Roundtable and its Task Force members, the report proposes policy options for consideration by Asian Roundtable policy makers and practitioners as they seek to improve the transparency of the board nomination and election process in order to reinforce more effective boards. This chapter attempts to summarise aspects of the report that are relevant to Hong Kong and provide a comparative perspective.

Boards operate behind closed doors

Boards of directors generally operate behind closed doors, and outside of the public eye and the focus of investors. While the nature of confidential board deliberations makes it difficult to demand full transparency of board meetings, there needs to be trust and confidence in the proper functioning of the board. Uncertainty is bad for investment decisions.

Investor reactions during the recent global financial crisis have made the demand for improved boards even stronger. Shareholders rely on boards of directors to ensure that companies are managing their long-term
interests. It is difficult for shareholders to assess the performance of boards, and often, it is only when there are failures that attention is drawn to the fact that the board is not performing.

While the legal and regulatory framework as well as ‘comply or explain’ recommendations in codes can contribute to facilitating good board practices, the effectiveness of actual board behaviour cannot be mandated. The journey to more effective boards is not an easy one, especially in companies with a highly concentrated corporate ownership structure. It requires a concerted effort from many stakeholders to promote the business case that in the longer term, competent and effective boards, rather than compliant ones, are in the best interest of all shareholders, including controlling shareholders. An effective and transparent board nomination and election process is an essential and critical ingredient in this regard.

The election and nomination of board members should facilitate the formation of a board that is capable of performing the key board functions advocated in the OECD Principles of Corporate Governance. However, there is a big difference between de jure and de facto roles of the board. Evidence suggests that boards of controlled companies have little role in strategic functions and in appointing senior management, but they do frequently appear to be used in two key areas: monitoring and managing potential conflicts of interest such as related party transactions and ensuring the integrity of the corporation's accounting and financial reporting systems. These are two areas where board nomination and election is especially important, staffing special board committees supported either by listing requirements or company law that define independence. However, special voting and nomination procedures, as exist in some countries, may need to be considered.

The board as a whole has a fiduciary responsibility to the company and to all shareholders including minority shareholders in fulfilling these duties. Following the recent financial crisis, a marked feature of several jurisdictions is a greater emphasis on minority protection and on objective independent judgment by the board that is related to board nomination and election (OECD, 2012).

**Improving the board nomination and election process in Asia**

While responsible controlling ownership can be a strength, there are also risks. These risks are commonly referred to as ‘private benefits of control’ that may put non-controlling shareholders at a disadvantage. This risk of misappropriation is a particular concern in markets with weak minority shareholder protection. That is why especially in this context, a more transparent and formal board nomination and election system is needed.

Even with ‘controlling owners’ there is a need to improve board quality. Board nomination and election is influenced by both formal processes and by the use of informal networks. This is common around the world. More recently, greater attention is focusing on the qualities of nominated candidates such as skills, independence and diversity that may be supported by the use of advisors and board evaluations.

The traditional approach in Asia essentially revolves around information networks and personal acquaintances, especially of the controlling shareholders. Anecdotal evidence suggests that controlling owners often nominate friends, former colleagues, or relatives to the board regardless of their experience, qualifications or objectivity. Directors elected in this manner are likely to have a sense of loyalty to the controlling shareholder, potentially rubber stamping proposals, disregarding minority shareholder and broader company interests. Even where nomination committees exist, their objectivity and the transparency of the actual nomination and election process could be questionable as they are themselves nominated and elected by the controlling shareholder.

The ownership structure of companies will have an impact on what is expected of the board and its role. Several measures can be suggested to improve board nomination and election in Asia. This report presents some policy options for consideration. While there may be a consensus about the direction of these reforms, policymakers need to adapt implementation to their specific jurisdictions.

1. Ensure a transparent, fair and formal board nomination and election process
2. Empower the nomination committee
3. Facilitate the participation of all shareholders in the board nomination and election process
4. Enhance transparency and accountability of the board evaluation process
5. Increase the pool of qualified candidates to the board

Corporate governance frameworks
Asian economies started their reforms in the area of corporate governance after the 1997 financial crisis and these have continued actively in recent years. Since then, corporate governance has come a long way in the region, particularly with regard to improvement in the legal and regulatory framework, such as updates to company and securities laws, regulations, listing rules and corporate governance codes. Hong Kong, Malaysia, Singapore, and India went through a full review of their Companies Act and proposed significant changes, some still pending approval in Parliament. Codes have been recently revised or are undergoing change, (eg Hong Kong, Singapore, Malaysia, Vietnam, India, and the Philippines).

Investor-led surveys and other corporate governance scorecards show that as a whole, regulators have stepped up their efforts to achieve better corporate governance. Almost all jurisdictions in Asia show a state-driven, top-down style of corporate governance reform but developments at the company level still need to catch up and are underway (CLSA et al., 2011).

Ownership and control structures
Concentrated ownership of publicly traded companies is an economic reality for most emerging economies (Gourevitch, 2005). In Asia, some two-thirds of public corporations have a controlling shareholder (Khan 2003, Morck et al., 2005). Listed companies are typically controlled by shareholders owning the majority of the company’s shares, approximately 50 per cent in Hong Kong, Indonesia and Malaysia (Claessens and Yurtoglu, 2012).

Most controlled entities in Asia are family companies. One measure of their dominance in the region is family businesses as the per cent of total listed companies with market capitalisation above USD 50 million (Table 1).

This concentrated ownership structure presents opportunities and risks. Responsible majority owners, given the degree of their investment, typically have the incentive to monitor the company and/or management closely and carefully. Their voting power can allow them to intervene on a timely basis and forcefully if the company’s performance is not up to standard. Controlling shareholders also have the incentive and power to implement strategic and management changes. Finally, controlling owners usually have a long-term investment horizon and more patience to consider the long-term strategy of the company.

While monitoring may be the strongest tangible advantage of a controlling shareholder, there are perhaps less visible ones. In family companies, anecdotal and empirical evidence suggests that strong value attachments to the long-term success of family companies over several generations can bring rewards. Values may breed trust, which can add to higher performance. Cultural factors are also important, linked to motivating an entrepreneurial spirit and long-term economic incentives, such as reputation. (Hofstetter, 2005)

Although controlling owners can potentially reduce some agency costs compared to companies with dispersed ownership, the same influence also creates other risks. These risks are commonly referred to as ‘private benefits of control’ that may put non-controlling shareholders at a disadvantage. This includes, for example, an insider extracting from the company assets, information

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<th>Family businesses in Asia, 2011</th>
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Source: Credit Suisse, 2011 ‘Asian Family Businesses Report’
and opportunities, at prices or conditions more favourable to them than in an arm’s-length transaction.

Family shareholders tend to dominate the boards of directors and have fewer independent members (Anderson and Reeb, 2004, Yeh and Woidtke in Chen et al. 2010). The nomination and election of board members therefore tends to revolve around personal relationships and acquaintances, often referred to as ‘the old boys’ network’. Given the predominance of controlling shareholders and concentrated ownership throughout Asia, in practice minority shareholders often feel powerless to influence the outcome of board elections (OECD, 2012).

Frameworks for boards

Unitary board structures predominate in Asia; however China and Indonesia have dual board structures while Taiwan allows companies to choose. Board structures are usually defined by company law and/or the individual company’s Articles of Association. Occasionally board structure may be set through the adoption of a mandatory model charter. These instruments set the rules for the size of the board and any required representation on the board. Generally the minimum number of board members is set (mostly 2-3 board members) (OECD, 2011). There is more variation allowed regarding the maximum number of board members.

Laws, regulations and codes also generally set the requirements for a specified number or percentage of independent board members or board members of special institutions such as securities companies and banks. The number of boards an individual director may sit on is limited in some cases and not in others. The maximum number of board seats a director can sit on is often quite high (up to ten board memberships), and in an exceptional case the number of board memberships a director may hold is twenty-five. The number of board memberships for outside or independent board members is much lower than these standard limits.

Role of the board

The expected role of the board and shareholders in the nomination and election of board members is stated in the OECD Principles. Both groups have a part to play and the corporate governance framework should clearly specify key board duties and essential behavioural norms for board members. This is especially important in a controlled ownership environment (OECD, 2012).

In most economies, the board of directors (or supervisory board in the dual board system) may nominate candidates for board members to be elected at the general meetings. In Hong Kong, if there is a nomination committee, then the committee is in charge of selecting and nominating candidates to be proposed to the board. In cases of a vacancy, usually the board can nominate any person eligible to be a board member until he/she is formally elected at the GMS (OECD, 2011).

Nomination committee

The board’s nomination committee plays a key role in identifying potential members for the board with appropriate knowledge, competencies and expertise to complement the existing skills of the board. Its authority should be clearly established and its functions stated in a committee charter. Where there is a controlling shareholder, a nomination committee can help balance the nomination process and help to ensure a transparent and well-established nomination process takes place.

In the presence of controlling shareholders, it may be useful if nomination committees are led by and comprise only independent board members. In Asia, 9 per cent of listed companies have fully independent nomination committees (Grant, 2007), whereas 56 per cent of nomination committees in European companies are composed of independent board members (Heidrick, 2011).

The implementation of the OECD Principles to have a formal and transparent nomination process is a challenge when insiders are selected to the board, and in some cases become members of a nomination committee and are subject to the influence of the controlling shareholders.

Nomination, election and voting by shareholders

Around the world, there is a general practice that permits shareholders to nominate and elect candidates to the board – although it should be noted that such rights are not always exercised.
Nonetheless, the mere right by shareholders to nominate board members can serve as a powerful incentive for boards and shareholders to engage more actively with each other regarding board composition and effectiveness. In Asia, the right of shareholders to nominate and elect board members is often contained in the relevant company law, listing rules and recommended by most codes; the election is conducted at the GMS. Minimum shareholdings are required for shareholders to be able to nominate candidates for the board in China, Hong Kong, Malaysia, South Korea, Singapore, Thailand and Vietnam. Singapore, Hong Kong, Malaysia and Vietnam have thresholds at 5 per cent or above. Perhaps these thresholds could be lowered to enable increased shareholder participation in the nomination process (CFA Institute, 2010).

Some state-owned companies set out the nomination process in the company’s articles of association, guaranteeing to the government a special privilege of nominating one or more board members (OECD, 2012).

However, the prevalence of controlling shareholders in addition to the relatively low participation of minority shareholders at the GMS implies that the controlling shareholders effectively nominate and elect all board members, including those designated to be ‘independent’ board members (OECD, 2012). As mentioned above, there is a perception that independent board members are often essentially figureheads, serving the controlling shareholder rather than representing all shareholders equally (Lee and Pica, CFA Institute, 2010).

Some countries have introduced mechanisms to facilitate equitable treatment of shareholders in the process of board nomination and election. For example, the largest South Korean companies have an outside director nominating committee, Italy and Israel impose special voting arrangements for the appointment of independent directors, see Box 1 (OECD, 2012). Other countries prevent the issuance of shares with differential or multiple voting rights, such as China, Hong Kong and Indonesia (Singhai, 2002 and OECD, 2011).

Another way to enhance minority shareholders participation in the board nomination and election process is to facilitate shareholder cooperation and communication, as specified in the OECD Principles. Importantly such cooperation has to be within ‘acting in concert’ rules. In Asia, to date no such rules to facilitate shareholder cooperation exist, but in several jurisdictions, laws provide for disclosure of voting agreements.

Voting
Practices such as voting by a show of hands are still widely used in the region and viewed as unfair by shareholders. Voting by a show of hands reduces the effectiveness of shareholder participation as it doesn’t indicate the percentage of ownership that hands represent and can dilute the vote of some of the larger shareholders. With improved technology and earlier registration of shares to vote, full voting by poll can be more efficiently introduced. Hong Kong requires mandatory voting by poll, which gives all votes cast their proper weight.

Disclosure of the nomination and election process
The quality of board nomination and election depends to a large extent on establishing a transparent process: transparency about the candidates, the selection process and the elections. Requiring disclosure of the board nomination and election processes as well as the degree of disclosure (the steps in the process) as well as the outlet for the disclosure (eg in the Annual Report and/or on the company website) would go a long way in improving the results. Some countries have started this. For example, in Malaysia the listing rules require mandated disclosure of the board nomination and election process and criteria used by nominating committees in the selection process. Disclosure must be included in all annual reports starting in 2014.

Candidate information
Specific information about board nominee qualifications, published in a timely manner, is essential to ensuring a transparent nomination process and to facilitating effective shareholder participation. In some countries, such as the US, disclosure rules require companies to disclose information about each director and nominee, including specific qualifications (Walter E., 2011). In Asia, disclosure of nominee information is particularly poor.

To enable shareholders to assess the qualifications of board member candidates, it
is important to disclose the background and professional experience of the candidates prior to the GMS (OECD, 2012). While in most jurisdictions information about candidates is required to accompany the GMS notice; in practice this information is often minimal. Quality board election notices need to consist of much more than a list of names, for example information about the education, professional experience, board and committee memberships held, and any significant relationships with management or other shareholders (Lee, 2010). It would also be helpful to disclose the rationale for selecting the candidate(s) and specify what contribution the candidate(s) are expected to make to the board.

Singapore, Malaysia, Hong Kong, China and the Philippines require significant disclosure under their listing rules. However other jurisdictions, such as Indonesia and Vietnam, do not require extensive disclosure of board members’ profiles at the time of/before their election.

The opinions expressed are those of the author and do not necessarily reflect the views of the OECD or of the governments of its member countries.

http://www.oecd.org/corporate/ca/corporategovernanceprinciples/oecd-asianroundtableoncorporategovernance.htm
Shifting focus to shareholders

Michelle Edkins, Chairman International Corporate Governance Network
Head of Corporate Governance and Responsible Investment BlackRock

We are seeing a significant shift in focus in the corporate governance debate in many markets around the world. For more than a decade, the focus has been on companies when making rules for and raising awareness about corporate governance. Listing standards now define more clearly the expectations of investors in listed companies in relation to how companies are governed and the safeguards that should be in place to protect the shareholders and other investors in public companies. But the governance system only works if shareholders meet the responsibilities of share ownership and ensure that the checks and balances enabled by the corporate governance framework are enacted. What we see now in the corporate governance debate is a gradual but steady shift of focus to shareholders and how they fulfil their responsibilities to their clients and the companies in which they invest on their behalf.

A number of markets, most notably the UK, the Netherlands and South Africa (but not yet Hong Kong), have stewardship codes or best-practice guidelines related to the responsibilities of institutional investors. These codes recognise that the majority of investors have a fiduciary duty; that is, they are investing on behalf of others who are entrusting them with their long-term savings. These codes also answer a range of questions:

- What is the appropriate role for institutional, especially fiduciary, investors in overseeing companies?
- What are their policies on voting at shareholder meetings and engaging (communicating with) companies on governance matters, including environmental and social impacts?
- How do institutional investors deal with the conflicts of interest they may face?
- How do they align the interests of their staff with the interests of their clients?
- How do they report on these factors?

Discussions around the points in the codes are increasingly frequent at a global level, particularly as more is understood about the causes of the 21st century financial crisis, the interdependencies inherent in the capital markets and the absence of oversight by shareholders in certain situations. Global organisations such as the International Corporate Governance Network and the Organisation for Economic Co-operation and Development have published guidelines on stewardship or the responsibilities of institutional shareholders. More countries have started to consider developing policies, and we expect to see stewardship codes published in Italy and Japan, amongst others, in the not too distant future.

These changes have several implications for investors. Many institutional investors will find themselves asked more frequently by their clients about
the work they are doing on stewardship. Those without specialist teams will likely start to build resources in the area to meet the objectives of stewardship codes. More thought will go into how governance, environmental and social factors are integrated into investment decision-making, which will require many investors to develop new skills through training. Ultimately, companies should expect to hear more from their investors about governance, shareholder rights and responsibilities and the delivery of sustainable financial returns over time. All of these changes point towards the healthier functioning of capital markets.
Our work for a wide range of listed companies, regulators and stock exchanges means we are ideally placed to advise on best practice and trends in corporate governance.

"Excellent teamwork."
"Spectacular lawyers who are a pleasure to work with."

CHAMBERS ASIA

SLAUGHTER AND MAY
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One of the unusual features of listed companies in Hong Kong compared to other jurisdictions like the United Kingdom, the United States and Canada is the number of family-owned or parent-controlled companies. This gives rise to potential conflicts between the management and the minority shareholders. Corporate governance in Hong Kong, which enshrines the principles of transparency and accountability, plays an important role in addressing this issue. Corporate governance consists of two aspects: putting in place a suitable structure under which a company functions and regulating the behaviour or conduct of the participants under that structure.

The board of directors of an issuer is collectively responsible for its management and operations. The directors, both collectively and individually, must fulfil the fiduciary duties and satisfy the required levels of skill, care and diligence.

The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Main Board Listing Rules) for main board issuers or the Rules Governing the Listing of Securities on the Growth Enterprise Market (GEM) of the Stock Exchange of Hong Kong (GEM Listing Rules) for GEM board issuers (together, Listing Rules) and the Corporate Governance Code (Code) have specific requirements and recommendations regarding the composition of the board of directors and the management structure of an issuer. They include the following requirements:

- The board of directors should contain a balanced composition of executive, non-executive and independent non-executive directors.
- An issuer must appoint at least three independent non-executive directors who should represent at least one third of the board.
- At least one of the independent non-executive directors must have appropriate professional qualifications or accounting or related financial management expertise.
- An issuer must establish an audit committee comprising non-executive directors only and a remuneration committee with a majority comprising independent non-executive directors. Under the code provisions of the Code, an issuer should also establish a nomination committee with a majority comprising independent non-executive directors (or otherwise explain the reason for not doing so). Each of these committees should have specific written terms of reference.
- An issuer must appoint a company secretary with appropriate professional qualifications or relevant experience.

The behaviour or conduct of issuers, directors, shareholders and other stakeholders is regulated by various statutory and non-statutory sources in China.
Hong Kong. These are discussed in more detail in the later sections.

**Regulatory framework for corporate governance in Hong Kong**

The regulatory framework for corporate governance in Hong Kong comprises a number of sources, including (1) legislation, principally the Companies Ordinance (CO), the Securities and Futures Ordinance (SFO) and the Financial Reporting Council Ordinance (FR.CO), and (2) the Main Board Listing Rules and the GEM Listing Rules, both of which include the Code as an appendix.

In addition, there are several useful guidelines on corporate governance issued by various statutory or non-statutory professional organisations, such as *A Guide on Directors’ Duties* published by the Companies Registry, a variety of corporate governance study reports and practice guidance issued by the Hong Kong Institute of Certified Public Accountants and the *Guidelines for Directors and Guide for Independent Non-executive Directors* issued by the Hong Kong Institute of Directors.

**Companies Ordinance**

The CO is the principal piece of legislation that applies to all companies incorporated in Hong Kong. A limited number of provisions are also applicable to companies incorporated outside Hong Kong but that establish a place of business in Hong Kong. Because a majority of the companies listed on the Stock Exchange of Hong Kong (SEHK) are not incorporated in Hong Kong, the CO only has limited influence on the corporate governance practices of these companies.

The main statutory provisions concerning corporate governance under the CO are in Part 12 (company administration and procedure) and Part 14 (remedies for protection of companies’ or members’ interests). Part IVA (disqualification of directors) is also relevant to corporate governance but has remained in the old CO, retitled the Companies (Winding up and Miscellaneous Provisions) Ordinance. Some key provisions are:

- The directors must convene an extraordinary general meeting on the requisition of shareholders holding 5 per cent or more of the paid-up capital of the company carrying voting rights.

- A directors’ report in respect of the profit or loss of the company and the state of the company’s affairs must be attached to every statement of financial position.

- The aggregate amount of the directors’ emoluments, pensions and compensation for loss of office must be included in the accounts to be laid before the general meeting.

- The auditor of the company must be appointed at each annual general meeting of the company.

- The appointment of directors must be voted on individually at a general meeting.

- A director may be removed by an ordinary resolution of shareholders (ie by shareholders present in person or by proxy at a general meeting holding a majority of the votes at that meeting).

- A director must declare material interests in contracts at board meetings.

- A court may make a disqualification order against a director under certain circumstances, for example, where he is convicted of an indictable offence in connection with the promotion, management or liquidation of the company, where he has been in persistent breach of the CO provisions in respect of the filing of return, accounts or other documents with the Companies Registry, where in the course of the winding up of the company, he has been guilty of fraud, etc.

- A member of a company may, with the leave of the court, bring proceedings before the court on behalf of the company or intervene in any proceedings before the court to which the company is a party for the purposes of continuing, discontinuing or defending those proceedings on behalf of the company.

A comprehensive exercise to rewrite the CO was launched in mid-2006 with the aim of modernising Hong Kong’s corporate law, strengthening corporate governance, facilitating businesses and ensuring better regulation. The new CO was passed on 12 July 2012 and commenced operation on 3 March 2014.

Some key measures for enhancing corporate governance under the new CO are:

- The directors’ duty of care, skill and diligence has been codified.
• Shareholders’ involvement in the decision-making process has been enhanced, and their participation facilitated by the introduction of a comprehensive set of rules for proposing and passing written resolutions and reducing the threshold requirement for shareholders to demand a poll.

• Ratification of acts and omissions of directors now requires the approval of disinterested shareholders.

• The directors’ report for public companies and larger private companies will be required to include a more analytical and forward-looking business review section to improve information disclosure.

• Auditors’ rights have been strengthened such that they may obtain information from a wider range of persons for performing the auditors’ duties.

Securities and Futures Ordinance
The SFO applies to companies whose shares are listed on the SEHK, amongst others. In addition to criminal sanctions and civil liabilities for market misconduct which apply to any person including an issuer and its officers, the SFO seeks to promote corporate governance by imposing disclosure obligations on an issuer and its officers to enable investors and other stakeholders to make an informed assessment of the issuer and its position. The core disclosure requirements can be found in Part XIVA (disclosure of inside information) and Part XV (disclosure of interests) of the SFO. Some key requirements are:

• An issuer and its officers must disclose, as soon as reasonably practicable, any inside information. In substance, inside information means specific information about the issuer or any of its shareholders, officers or listed securities that is not generally known in the market but that would, if known, be likely to materially affect the price of the listed securities. Listed companies must take reasonable measures to ensure that proper safeguards are in place to prevent a breach of this disclosure requirement.

• The directors, chief executive and substantial shareholders of an issuer must notify the issuer and the SEHK of interests they have in the issuer’s shares.

Financial Reporting Council Ordinance
The FRCO establishes the Financial Reporting Council (FRC). The FRC is an independent statutory body established to investigate auditing or reporting irregularities and non-compliance with accounting requirements such as those provided under the CO and the Listing Rules in relation to entities listed on the SEHK. The FRC’s role is limited to investigation and enquiry, and it refers any case of irregularities to the Hong Kong Institute of Certified Public Accountants, the SEHK or the Securities and Futures Commission, depending on the nature of the irregularities. In addition, the FRC has the power to direct the Audit Investigation Board, which is also established under the FRCO, to conduct the investigation.

The Listing Rules
The Listing Rules contain a number of disclosure obligations and restrictions on issuers that seek to ensure transparency and accountability to shareholders, thereby enhancing shareholders’ protection and corporate governance.

General obligation of disclosure
In addition to an issuer’s obligation to disclose inside information under the SFO, where in the view of the SEHK there is or is likely to be a false market in an issuer’s securities, the issuer must, as soon as reasonably practicable after consultation with the SEHK, announce the information to avoid a false market in its securities.

Notifiable transactions
Seven categories of transactions may give rise to notification and, depending on the size of the transaction, shareholders’ approval requirements. These transactions include acquisitions and disposals of assets and the provision of financial assistance. The Listing Rules define specific thresholds for transactions that constitute major transactions, very substantial acquisitions, very substantial disposals and reverse takeovers. All of these are conditional on the approval of independent shareholders in a general meeting.
Connected transactions
The purpose of the connected transaction rules is to ensure that the interests of shareholders as a whole are taken into account by an issuer when it enters into a connected transaction (i.e., a transaction between a listed issuer and a connected person). These rules provide certain safeguards against issuers’ directors, chief executives or substantial shareholders (or their associates) taking advantage of their positions. This is achieved through the general requirement for connected transactions to be disclosed and subject to independent shareholders’ approval unless any of the exemptions apply.

Model Code for Securities Transactions by Directors of Listed Issuers
Under the Model Code for Securities Transactions by Directors of Listed Issuers, a director of an issuer must refrain from dealing in the issuer’s securities before obtaining the clearance to deal from the board of directors or as soon as the director becomes aware of inside information until the information has been announced. In addition, a director must not make unauthorised disclosure of confidential information or use such information for personal advantage or the advantage of others. Specifically, a director is prohibited from dealing in the securities of the issuer in the 60 days preceding the publication of annual results and the 30 days preceding the publication of interim results (as well as on the day of publication in each case).

Environmental, Social and Governance Reporting Guide
The SEHK has added Appendix 27 to the Main Board Listing Rules and Appendix 20 to the GEM Listing Rules for the Environmental, Social and Governance Reporting Guide. At present, ESG reporting is only a recommended best practice. The SEHK has indicated that, subject to further consultation, it may raise the obligation level to ‘comply or explain’ by 2015. There are four subject areas in the guide: workplace quality, environmental protection, operating practices and community involvement. The SEHK encourages issuers to identify and disclose additional ESG issues and key performance indicators that are relevant to its business and may refer to international reporting guidance.

The Corporate Governance Code

Development of the Code
The SEHK introduced the Code on Corporate Governance Practices, commonly referred to as the Old Code, in January 2005. It applied to all companies listed on the SEHK. The Old Code was amended following a consultation exercise in 2010. It was renamed the Corporate Governance Code and came into effect on 1 April 2012. The Code sets out a number of principles, followed by code provisions and recommended best practices. In addition to updating the Old Code, there has been another recent development which has led to changes to the Listing Rules in the areas of board diversity with effect from 1 September 2013.

Contents of the Code
Rule 13.89(1) of the Main Board Listing Rules and Rule 17.101(1) of the GEM Listing Rules provide that the Code sets out the principles of good corporate governance. The Code contains two levels of recommendations: (1) code provisions and (2) recommended best practices. Issuers are expected to comply with, but may choose to deviate from, the code provisions, whereas the recommended best practices are for guidance only.

Issuers must include a corporate governance report prepared by the board of directors in their annual reports and, if they prepare one, their summary financial reports. The corporate governance report must contain all information that falls within the scope of mandatory disclosure requirements under paragraphs G to P of the Code.

The comply-or-explain approach to corporate governance
In line with the corporate governance regimes in many other countries, the Code adopts a comply-or-explain approach. Issuers must state in the corporate governance report whether they have complied with the code provisions. The code provisions are not mandatory rules, and the Code provides that deviations from them are acceptable if the issuer considers there are more suitable ways for it to comply with the principles set out in the Code. Each issuer must consider its individual circumstances, the size and complexities of its operations and the nature of
The Hong Kong corporate governance framework

The Hong Kong Corporate Governance Code (the ‘Code’) was introduced on 13 October 2003 for use by issuers; it provides a set of guidelines on corporate governance practices. It is intended to be used to help issuers improve their corporate governance practices and ensure a balance of power and authority between the board of directors and management. The Code sets out the minimum requirements of good corporate governance and serves as a point of reference for issuers to ensure their corporate governance practices are transparent, fair and in the best interest of the issuer. There should be a clear division between the roles of the chairman, who is responsible for leadership of the board, and the chief executive, who is responsible for running the issuer’s business, to ensure a balance of power and authority.

The board should include a balanced composition of executive and non-executive directors, including independent non-executive directors, to enable the board to exercise independent judgment. Directors should be provided with timely and appropriate information to enable them to make informed decisions. There should be a formal and transparent procedure for the appointment of directors, and all directors should be subject to re-election at regular intervals.

From 1 September 2013, a new code provision was introduced in the Code that requires the nomination committee to have a policy concerning board diversity or otherwise explain why no such policy has been adopted. In addition, there is a new mandatory disclosure requirement for the inclusion of such a policy, if one exists, in the corporate governance report.

Remuneration of directors and senior management and board evaluation

An issuer should disclose the remuneration policy of its directors. There should be a formal and transparent procedure for setting all directors’ remuneration packages. No director should be involved in deciding his or her own remuneration. Remuneration levels should be sufficient to attract and retain directors without paying more than necessary.

Accountability and audit

The board of directors should present a balanced, clear and comprehensive assessment of the issuer’s performance, position and prospects. It should also ensure that the issuer maintains sound and effective internal controls to safeguard the shareholders’ investments and the issuer’s assets. It should also establish a formal and transparent arrangement to consider how it applies financial reporting and internal control principles and maintains an appropriate relationship with the issuer’s auditors.

Delegation by the board

There should be a formal schedule of matters specifically reserved for the board to determine, including the nomination of directors and the decision on major corporate issues such as major acquisitions, fund raisings and changes in the issuer’s corporate structure. The board should also consider the risks and challenges it faces. It must provide considered reasons to explain to shareholders why good corporate governance is achieved by means other than strict compliance with the code provisions.

The disclosure or the explanation required under the Code is intended to enable shareholders and other stakeholders to evaluate the issuer’s governance practices. It is a means of communication to facilitate informed decision-making. The SEHK explained in one of its frequently asked questions that it does not judge whether an explanation is acceptable, because the judges of the explanation are the investors and stakeholders who read the corporate governance report. The SEHK also states in the preface to the Code that ‘an informed, constructive dialogue between issuers and shareholders is important to improving corporate governance’.

Accountability to shareholders underpins the corporate governance system in Hong Kong. Shareholders may take action to influence the board of directors using their voting powers. As mentioned earlier, the CO gives shareholders the ability to appoint and remove individual directors and the right to call an extraordinary general meeting of the company. Under the Listing Rules, an issuer must disclose on its website the procedures for its shareholders to propose a person for election as a director. Furthermore, under the Code, an issuer must disclose in its corporate governance report how shareholders can convene an extraordinary general meeting, the procedures by which enquiries may be put to the board and sufficient contact details to enable these enquiries to be properly directed and the procedures and sufficient contact details for putting forward proposals at shareholders’ meetings.

Summary of the main principles

The Code consists of six sections: directors, remuneration of directors and senior management and board evaluation, accountability and audit, delegation by the board, communication with shareholders and company secretary.

Directors

Every issuer should be headed by an effective board of directors, which should assume responsibility for its leadership and control. The board should regularly review the performance of each director, who should act in the best interest of the issuer. There should be a clear division between the roles of the chairman, who is responsible for leadership of the board, and the chief executive, who is responsible for running the issuer’s business, to ensure a balance of power and authority.

The board should include a balanced composition of executive and non-executive directors, including independent non-executive directors, to enable the board to exercise independent judgment. Directors should be provided with timely and appropriate information to enable them to make informed decisions. There should be a formal and transparent procedure for the appointment of directors, and all directors should be subject to re-election at regular intervals.

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Delegation by the board

There should be a formal schedule of matters specifically reserved
for board approval. The board should give clear directions to management on the matters that must be approved by it before decisions are made on the issuer’s behalf. Board committees should be formed with specific written terms of reference.

**Communication with shareholders** There should be an ongoing dialogue with shareholders. The board of directors should use annual general meetings or other general meetings to communicate with the shareholders and encourage their participation. The issuer should ensure that shareholders are familiar with the detailed procedures for conducting a poll.

**Company secretary** The company secretary plays an important role in supporting the board by ensuring good information flow within the board of directors and adherence to board policy and procedures. The company secretary is responsible for advising the board through the chairman, the chief executive or both on governance matters and should facilitate induction and professional development of the directors.

**Mandatory disclosures in the corporate governance report** Paragraphs G to P of the Code set out the mandatory disclosures while paragraphs Q to T set out the recommended disclosures to be included in a corporate governance report. The corporate governance reports of many issuers tend to follow the order and the paragraph headings in the Code. The level of detail included under each area of disclosure varies amongst issuers, and the length of the corporate governance reports ranges from a few to more than 30 pages in some instances.

**Implications of non-compliance with the Code** The corporate governance report must contain all information that is subject to the mandatory disclosure requirements under the Code. Failure to do so is regarded as a breach of the Listing Rules. A number of disciplinary procedures may be taken by the SEHK for a breach of the Listing Rules, and these are set out in Rule 2A.09 of the Main Board Listing Rules or Rule 3.10 of the GEM Listing Rules. These sanctions include issuing a private reprimand, issuing a public statement that involves criticism or public censure or ordering that the facilities of the market be denied to an issuer in wilful or persistent breach.

It is expressly stated in the preface to the Code that shareholders should not consider departures from code provisions and recommended best practices as breaches. Instead, shareholders should carefully consider and evaluate explanations given by issuers in the comply-or-explain process, taking into account the purpose of good corporate governance. As mentioned earlier, shareholders may then take necessary actions to influence the board using their voting rights. As long as issuers comply with the mandatory disclosure requirements by providing details of deviation from the code provisions and considered reasons for the deviation, they will not be in breach of the Listing Rules.

**Deviations from the code provisions of the Code** The SEHK used to publish a paper every year analysing the corporate governance disclosures in the annual reports of main board and GEM board issuers. According to the last paper, published in September 2010, the SEHK reviewed the 2009 annual reports of 132 issuers and analysed their compliance with the code provisions, recommended best practices, internal control and other corporate governance practices.

The review found that 39 per cent of the issuers complied with all code provisions and that 99 per cent of the issuers complied with 41 or more of the 45 code provisions of the Old Code. The top three code provisions from which the issuers deviated were (using the numbering in the Old Code): (1) separation of the roles of chairman and chief executive (A.2.1), (2) non-executive directors to be appointed for a specific term subject to re-election (A.4.1) and (3) all directors appointed to fill a casual vacancy subject to election by shareholders at the first general meeting after their appointment and every director subject to retirement by rotation at least once every three years (A.4.2).

More recent examples of deviations from the code provisions of the Code are discussed in the box.
## Recent deviations from the code provisions

Examples of deviations from the code provisions reflected in the 2012 annual reports of companies listed on the main board

**Roles of chairman and chief executive not performed by different individuals:**

- A Chinese pharmaceutical company stated that it had deviated from code provision A.2.1, which requires that the roles of chairman and chief executive be performed by different individuals. The company explained that the individual who took up both roles was one of the main founders and that he possessed extensive medical and pharmaceutical industry knowledge. According to the company, the board members believed his continued service in both roles would be beneficial to the stable and healthy development of the company. It further explained that the board would review the structure occasionally and would consider adjustments if appropriate.

**Absence of appropriate insurance cover in respect of legal action against directors:**

- A newly listed Chinese company whose principal activities were the design, manufacturing and sale of high-end fabric products stated that it had deviated from code provision A.1.8, which stipulates that an issuer should arrange appropriate insurance cover in respect of legal action against its directors; it had no insurance cover. The company explained that the board would continue to review the arrangements for insurance cover for the directors occasionally and might arrange for insurance cover in the future.

**Independent non-executive directors not appointed for specific terms:**

- A Bermudan incorporated property development and investment company indicated that, contrary to code provision A.4.1, the independent non-executive directors of the company were not appointed for specific terms but in accordance with the by-laws of the company.

**Independent non-executive directors and other non-executive directors failed to attend certain general meetings:**

- A Chinese public utility company stated that it had fully complied with all code provisions except for code provision A.6.7, because certain executive directors, non-executive directors and independent non-executive directors of the company were unable to attend certain extraordinary general meetings due to other business engagements. The attendance record of each director at the general meetings of the company was included in the corporate governance report.
PART II

Pre-IPO Considerations

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An initial public offering (IPO) is a transformational event for any company. Listing on a major stock exchange such as the Stock Exchange of Hong Kong (SEHK) not only confers prestige and provides liquidity to the company’s shareholders but also establishes a transparent relationship between the company, its investors and the wider public.

Hong Kong’s stock exchange is amongst the largest in the world. Raising capital from institutional and retail investors in this world-class market comes with responsibilities for a listed company. These responsibilities include additional reporting and fiduciary requirements, higher levels of transparency and, above all, a commitment to uphold Hong Kong’s standards of corporate governance.

Public companies are accountable to their shareholders, who trust that the company’s management is working actively to promote their interests. To protect this trust, companies must establish a strong corporate governance framework while planning to become a public company. Companies that fail to build a transparent and effective corporate governance regime before their IPO may find it difficult to attract investor interest and risk having their listing application rejected.

Hong Kong has two listing options for companies planning to go public: the main board and the Growth Enterprise Market (GEM). The GEM is generally for early-stage companies that hope to raise capital but do not meet the more rigorous requirements of the main board, as explained at the end of this chapter. However, all firms must embrace the principles of the SEHK’s Corporate Governance Code (www.hkex.com.hk) and meet certain corporate governance criteria to launch a successful IPO.

Although corporate governance standards provide a structural skeleton that can be adopted by listing applicants and fleshed out to protect and reassure investors, certain aspects of corporate governance raise far deeper issues and can in practice become quite controversial. For example, regulators in Hong Kong have for a long time been strict proponents of ‘one share, one vote’ shareholder democracy, under which each share of a company’s common equity possesses the same rights and authority as every other share. Recently, this has become a widely debated topic, because certain companies may take the view that such an absolute form of share equality may not always be in the company’s best interests.

This chapter explains how companies should approach establishing corporate governance standards as they prepare for an IPO in Hong Kong and touches on certain red flag issues companies may wish to consider. It is intended to provide some guidance as to the expectations of Hong Kong’s
regulators and investors and to help companies develop the right approach in formulating their governance infrastructure.

The significance of corporate governance in IPOs

Strong, effective, transparent and consistently applied corporate governance is a defining component of every successful IPO. It is of paramount importance that companies conceive of corporate governance as more than simply complying with minimum standards and a marketing tool. Corporate governance should be regarded as a unified group of management and communication standards required to establish ongoing credibility with investors, the broader public and regulatory bodies.

Corporate governance standards exist to align the interests of management with shareholders and to hold management accountable for poor performance or intentional wrongdoing. For companies that go public but retain a dominant majority shareholder, strong corporate governance is especially important to protect the interests of minority investors. In addition, some companies that pursue IPOs are still at an early stage in the corporate life cycle. Listing candidates should keep in mind that investors, although eager to find new opportunities, look to corporate governance practices to help mitigate concerns of investing in companies that lack lengthy track records.

Every company must overcome significant hurdles during the IPO process. The first of these is meeting all regulatory requirements of the company’s chosen listing destination; the second is effectively communicating the company’s vision and strategy to institutional and retail investors; and the third is convincing those investors that backing the IPO would add real value to their respective portfolios. This is where transparent and consistently applied corporate governance standards are indispensable: they provide investors with assurance that their voices will be heard and their interests protected. At the end of the day, it is unlikely that any company can bring about a highly successful IPO without instilling in investors the belief that the company’s governance structure entails basic fairness to all shareholders. This does not require all shareholders to have equal power and authority or even all shares to have such equality, but it does require that deviations from absolute equality be adequately described and convincingly justified.

Some companies retain a majority shareholder when they go public, and their IPOs involve less than 50 per cent of the company’s issued share capital. This is prevalent in Hong Kong and elsewhere in Asia, where it is not unusual for companies to retain a dominant shareholder – a family, an individual or sometimes a government entity, as is the case with China’s state-owned enterprises. Corporate governance for companies with a dominant shareholder is even more important given the potential concentration of power with the majority shareholder.

Applicants seeking to list in Hong Kong should be aware of these regional practices and realities.

The value investors and regulators place on corporate governance in an IPO

Hong Kong attracts mature companies with well-established corporate governance standards, as well as younger enterprises that are expanding rapidly on the back of Asia’s rapid growth. Several multinational corporations have also looked to Hong Kong as a listing venue for access to the growing and dynamic pools of capital in the region. Although investors and companies are eager to gain exposure to the region’s economic expansion, many investors are hesitant to invest in companies that fail to establish effective corporate governance regimes.

Taking a cue from the UK, the SEHK has adopted a ‘comply or explain’ approach to its Corporate Governance Code. This approach includes two components for listing candidates: mandatory standards (code provisions) for all companies and a list of recommended best practices.

The code’s best practices are recommended but voluntary. However, if a company fails to adopt one of the code’s provisions, it must address the reasons behind the non-compliance and explain how they plan to handle resulting issues going forward. Many investors – especially those from large and international institutions – are likely to prefer full compliance and be wary of companies with too much explaining to do.
One way companies can alleviate investor concerns is to have a well-balanced and independent board of directors in place before the IPO (and particularly a board whose composition is in compliance with SEHK requirements). It is also helpful to make the board accessible to investors before the listing. Companies that fail to take these steps, or that tackle them late, are likely to see potential investors demanding to be compensated for the perceived risks associated with investing in the firm through a lower valuation.

Although it is understandable that some companies may struggle to comply fully and completely with the code, every effort must be made to do so. Experienced investors quickly identify a company that is not serious about corporate governance. Investors may refuse to participate in an IPO if they feel a company is not trustworthy. Low levels of investor interest can often be equated with a lack of confidence in a company’s commitment to establish a rigorous, consistent and transparent corporate governance regime.

Alternative aspects of governing structure
At present, both the SEHK and the independent Securities and Futures Commission (SFC) react strongly and negatively to any proposed feature of a company’s corporate governance that they see as diverging from fair and equal treatment of all of the company’s shareholders. In Hong Kong, the one share, one vote policy has been, for many years, the only structure acceptable for a listing applicant. Not only are dual voting class structures prohibited but so is any other type of structure that would have the practical effect of concentrating power within a particular class or group of shares.

In the US, the regulatory mindset underlying unusual corporate governance features – and most other offering-related matters – is one of ‘disclose and let investors decide’ (note the similarity between this and the comply-or-explain approach adopted in Hong Kong in other contexts). In other words, whether an unusual, and even arguably unfair, aspect of governance is acceptable is a matter to be judged by the market, not by regulators. In Hong Kong, the SFC and, to an even greater extent, the SEHK take a more paternalistic approach, judging what is and is not acceptable.

The view of the Hong Kong regulators is not without reason. Many Hong Kong-listed companies start out as family-owned enterprises, where minority investors are seemingly at a disadvantage to the controlling group. It is also true that the strongest protections available to minority shareholders in the US (such as class actions, shareholder derivative suits and securities fraud claims) are largely absent from Hong Kong. In light of this, Hong Kong regulators are more protective of minority shareholders, and moving away from this model would not be easy.

Who is responsible for corporate governance in an IPO?
There are a number of constituencies involved in the preparations for an IPO, including the company’s management, major shareholders, financial advisers, listing sponsors, legal advisers and financial sponsors. Each of these constituencies plays a role in ensuring the company has the necessary corporate governance framework in place. The details of this governance structure must be explained in the prospectus that is vetted by the SEHK, which evaluates its merits and decides whether the company has met all of the requirements. The SEHK works in conjunction with the SFC, which can make objections to applications that it deems unsatisfactory.

Although companies must take full responsibility for disclosures in their prospectuses, Hong Kong has also adopted new rules to regulate sponsors’ conduct and plans to propose legislative amendments to allocate prospectus responsibility to IPO sponsors. For example, sponsors must now be appointed for a minimum period of two months before a company submits its IPO application, and ‘no deal, no fee’ arrangements are now prohibited in Hong Kong for IPO sponsors. The sponsor must also ensure that its engagement letter is filed with the SEHK and must comply with new due diligence requirements in the revised code of conduct. As of October 2013, sponsors are required to notify the SFC of any matter of material non-compliance during its review of the company’s operations. Regulators also need to be informed of reasons for termination of a sponsor engagement.
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What is best practice in terms of applying the Corporate Governance Code?
As we have seen, the purpose of Hong Kong’s Corporate Governance Code is to ensure that public companies are transparent about their operations and committed to protecting the interests of majority and minority shareholders. Fair-minded investors should be attracted to companies that embrace Hong Kong’s comply-or-explain standard.

The code contains numerous provisions, and a clear understanding of each clause is critical. The code’s key requirements are explained later in further detail.

Chairman and chief executive
The code dictates that there should be a clear division between the chairman’s role and the chief executive’s role. The management of the board of directors and the management of the business must be treated as separate roles and responsibilities to ensure that authority is divided amongst multiple individuals rather than concentrated in a few hands.

There are unique situations in every market. For example, sometimes the chairman is also the company’s dominant shareholder and perhaps previously served as the company’s chief executive. In this scenario, shareholders may prefer to see a clean break with the chairman’s former managerial role, as well as a higher number of independent non-executive directors on the board to ensure objectivity and balance. Most, if not all, independent non-executive directors should be appointed before companies begin the IPO regulatory filing process and before companies start meeting investors.

Historic corporate ties or shared investment interests between the management team and the nominally independent members of the board may also invite investor and regulator scepticism. For companies considering an IPO in Hong Kong, it is best practice to avoid such scenarios to ensure the market retains confidence in the company’s leadership.

The board of directors
The Corporate Governance Code sets out requirements on the make-up of the board of directors that are designed to ensure it contributes to the leadership of the company effectively and independently. Under amendments that took effect in December 2012, there should be at least three independent non-executive directors or these directors should make up at least one third of the positions on the board of a listed firm, whichever is greater. The interests – or lack thereof – of directors in the company and associated firms must be detailed in listing documents.

The code also calls for directors to stand for regular re-election. In addition, the reappointment of any independent non-executive director who has served on the board for more than nine years is subject to the approval of a separate shareholder resolution. Although these provisions play an important role in safeguarding board independence, they also make it all the more vital that companies have clear and transparent succession plans in place for all components of the board (executive directors, non-executive directors and independent non-executive directors).

Most recently, the SEHK has signalled a more active approach to promoting diversity on boards. Amendments to the code that took effect in September 2013 state that every board or nomination committee should have a policy on diversity in place and report regularly on its implementation. The code’s definition of diversity is relatively broad to give each company room to tailor diversity policies according to its needs, taking into account factors including gender, age, cultural background and experience.

Although recent changes to the code may place a greater burden on companies considering an IPO in terms of planning board composition, there are clear indications that a more diverse and independent board improves corporate performance by introducing a wider range of approaches to problem solving. A diverse board can also speak to the progressiveness of a firm undertaking the IPO process, enhancing its value in the eyes of employees, the public and potential investors.

Accountability
Applicants are expected to detail in their listing documents both the roles and the biographical details of existing or proposed members of the board of directors and of senior management, including their history with the company or
affiliates, relevant expertise and experience and any other information that may reassure shareholders as to their ability and integrity. This section of a prospectus can build confidence amongst potential investors regarding the balance of skills on the board and its ability to implement company strategy.

The audit committee plays a vital role in gauging the board’s performance, particularly its ability to meet financial targets and standards. In addition to reviewing the integrity of financial statements, the committee is responsible for ensuring the firm’s external auditors are kept at arm’s length and for evaluating internal control and risk management systems. The code also recommends that the committee ensure arrangements are in place to investigate and act upon possible improprieties flagged by whistle-blowers. Building an independent audit committee (composed of members satisfying requirements set out by the SEHK’s clear mandate to safeguard compliance) can send a powerful, and reassuring, message to potential shareholders.

Remuneration
Although executive compensation overall may not face high levels of scrutiny or constraints in Hong Kong, the code still endorses principles that are generally in line with global best practices. Listed firms must establish a remuneration committee – in compliance with the SEHK’s requirements – tasked with reviewing and making recommendations to the board of directors on remuneration packages for directors and senior management. The code also recommends that a ‘significant’ portion of any compensation package be linked to corporate and individual performance. Firms are also expected to detail the compensation packages of directors and, in particular, their five highest paid executives in listing documents (these individuals do not have to be identified by name).

Delegation
Although the board of directors is responsible for the management of the business of a company, it is necessary and inevitable for the board to delegate aspects of its management and administration functions to management so that the business of the company can be conducted both effectively and efficiently. The code requires a listed company to include in its board’s terms of reference the need to develop and review the company’s policies and practices on corporate governance, as well as the need to review the company’s compliance with the code.

The company should also formalise the functions reserved to its board and those delegated to management, and it should disclose their respective responsibilities, accountabilities and contributions. Where board committees are established to deal with matters, the board should give them sufficiently clear terms of reference to enable them to perform their functions properly and communicate with the board at appropriate times.

It would therefore be advisable for companies preparing for IPOs to formalise and implement an appropriate system of delegation, not only for proper execution of its management function but also as a means of good internal control.

Shareholder communication
As mentioned, Hong Kong – and Asia as a whole – is characterised by a large number of companies controlled by founding families, either as majority shareholders or via holding company structures. The management of such companies is often closely aligned to family interests, and minority shareholders may find they have limited input into decisions on spending, capital allocation or corporate vision and strategy. Conversely, this creates an opportunity for firms that assert the rights of and demonstrate accountability to minority shareholders, because they will stand out to potential investors.

The code has relatively few requirements on communication with shareholders, recommending only that listed companies establish a shareholder communication policy and use regular events, particularly annual general meetings, to consult shareholders on company resolutions and finances. However, this should be viewed as a bare minimum. To attract quality investors, a more involved approach, incorporating ‘real time’ communication with shareholders on key issues, should be adopted. Communication and transparency constitute the bedrock of governance.

In the run-up to a listing, a company’s sponsor takes charge of much of the communication with
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regulators and ultimately the market (even though the company retains final responsibility for such communication). Under changes to listing rules effective October 2013, sponsors must confirm to the SEHK that the listing document contains sufficient information to enable a reasonable person to make an informed assessment of the listing applicant (from April 2014, the draft prospectus will be made public on the Exchange’s website). This draft should be concise, complete and in English. These changes accompany a streamlined application process but also make it vital that a communication strategy is developed early in the pre-listing phase.

Main Board or GEM?
Hong Kong’s GEM offers an alternative for firms seeking to raise capital that may not meet the track record requirements of the SEHK’s main board listing rules. GEM is generally viewed as a ‘stepping stone’ to the main board and accepts only listings in the form of shares, whereas main board listings can consist of shares or depositary receipts.

Listing thresholds for GEM are overall less stringent than those of the main board, including lower market capitalisation, profit, cash flow and management continuity thresholds. However, the rules governing board independence, compliance and financial reporting are broadly identical for GEM and main board firms, and GEM companies are advised to adhere to the Corporate Governance Code, particularly if they are planning an eventual main board listing.

Conclusion
Although compliance with every provision of the code is not mandatory, adopting it to the fullest extent possible provides any company embarking on the listing process with a compliance framework and communications strategy that will pay dividends in terms of satisfying regulators, attracting both top-quality talent and investors and enhancing corporate performance. It is advisable to incorporate the code’s provisions into the earliest stages of listing preparations to ensure a smooth IPO process and to maximise the listing company’s value in the eyes of potential shareholders.

Recent amendments to the code and listing rules suggest regulators will continue to push for greater transparency and board independence at listed firms. Companies preparing for a listing and their sponsors should consider the following:

• communicating the firm’s corporate governance strategies clearly to regulators and potential investors before and during the IPO process through both required documentation and regular meetings
• developing comprehensive strategies on remuneration, diversity and shareholder relations that incorporate the code’s best-practice provisions, and establishing committees to oversee their implementation
• ensuring a diverse and independent board of directors is in place before announcing listing plans
• having well-articulated and transparent succession plans in place for key board positions
• ensuring high standards of governance remain in place after the listing process through regular monitoring and enforcement, including procedures to deal with possible lapses or infractions.

With high-profile governance breaches continuing to concern regulators and the public, the burden of compliance can only increase. Although Hong Kong’s regulatory approach gives companies listing in the territory a degree of flexibility in formulating decisions and policies on governance, by aspiring to the recommendations and best practices set out in the code, companies place themselves ahead of regulatory requirements and on track for better performance. Instead of being solely a matter of compliance, adherence to the code should be viewed as a continuous, evolving process of communication that will benefit the company’s standing amongst investors and the wider community.
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Governance and shareholder rights were front-page news in Hong Kong in the autumn of 2013, with questions being raised not only around how to attract top companies to the market but also how best to protect investors’ interests.

That balance between attracting and protecting investors is also relevant for individual issuers. When a business is coming to market, it needs to consider the way in which it will first entice and later engage with its new base of shareholders. They are owners, but will they feel like owners? Will they have a good, clear perspective on the business? Will they trust management even when things go badly?

“Our own analysis shows that the market prices corporate governance performance into valuation. Companies that score highly across a range of measures for ‘good’ corporate governance may trade at premiums of up to 25%”.

Andrew Swan, Managing Director, Head of Asian Equities, BlackRock

The degree to which a company engages in open dialogue and builds trust with the investment community is directly related to the market and price for its shares. These strategic aspects of corporate governance are less technical than listing rules or compliance standards would indicate, but they are equally important.

Investors attach a premium to good governance and proper engagement – some we spoke to put it as high as 25 per cent. Studies by McKinsey & Company have shown that an overwhelming majority of investors are prepared to pay a premium of roughly 15 to 30 per cent for companies exhibiting high governance standards. But what investors may reward certainly goes beyond what regulators recommend and transcends what lawyers and chief financial officers (CFOs) can put in place. The true evidence that best practice is embedded in a company’s DNA is when potential investors trust that they have been offered deep and honest insights into a business. Trust reduces a company’s cost of capital and improves its valuation. The inverse of this is plainly apparent amongst some of the Chinese companies listed in Hong Kong and elsewhere, where there have been a few instances of fraudulent firms undermining confidence in a range of stocks and sectors in recent years.

Every business competes for share of voice, or the proportion of the total audience, with others in its sector. The best way to increase a company’s
share of voice is to disclose information to investors openly, give them their say in general or private meetings, appoint competent independent directors to look after their interests, and act in ways that build shareholder value. This is not merely an opinion; the investment community has articulated this to Brunswick Group many times over the years. In the most recent annual survey of chief investment officers and senior investment managers, in which Brunswick Group canvassed the opinion of investors who manage approximately US$80 billion worth of assets regionally (Source: IPREO), investors repeatedly brought up corporate governance as a central criterion for judging and evaluating companies. Some of the insights that they shared are included in this chapter in non-attributable form. BlackRock, the largest institutional investor in the world and an active manager of funds across Asia, considers the topic important enough to employ a head of corporate governance in the region. BlackRock has contributed some comments to this chapter, which are highlighted as boxed quotations from department heads.

This chapter elaborates on why investor support is so important; offers suggestions on how, before their initial public offering (IPO), companies can set the foundation for a trusted relationship with minority shareholders; and illustrates with hypothetical case studies how corporate governance affects reputation and valuation.

“We prefer to engage in private dialogue with companies on corporate governance. We communicate our view about issues that may impact performance, but we also listen. Having that ongoing relationship makes it easier when a crisis erupts or a company has to communicate bad news, because there’s already a level of understanding”.

Michelle Edkins, Global Head of Corporate Governance and Responsible Investment
BlackRock

Why investor support matters
For investors, the perceived credibility and competence of the company’s board of directors and its governance rest at the heart of the investment case, particularly in light of today’s unpredictable market conditions. Companies considering an IPO need to understand and internalise this issue of support, because a new company’s lack of track record means that investors may judge it on appearances. If a company is perceived to be lacking in transparency, disrespectful of minority shareholder rights, or controlled by insiders rather than run by a diverse and competent team of outside professionals and directors, not only its reputation but also its valuation can be held back. Quite simply, investors will look elsewhere.

Investors often remind us that corporate governance is a strategic issue, not an exercise in compliance. Good board members monitor the management of the companies whose boards they sit on by asking challenging questions about strategic direction. It follows that when such strategic dialogue is productive and value accretive, valuations rise and the cost of equity is lowered.

Trust around corporate governance becomes more important as a company matures. Investors form a view of a company’s approach to governance over time. Hopefully, this view is based not only on observations and assumptions but also on conversations with the company’s leaders.

Ultimately, good investor support elevates a company’s ability to compete, grow, tap capital markets, potentially move into indexes, attract the best customers and partners and recruit and retain talented staff. In contrast, poor investor support can manifest itself through short-selling and volatility in the company’s stock. There is no question that companies are less vulnerable to short-seller attacks when they have taken the time to build trusted relationships with investors in advance.

Putting aside the extremes of short-seller attacks, many listed companies that appear to be complying both legally and financially with the Corporate Governance Code under the Hong Kong Listing Rules nevertheless develop a reputation for disregarding the Code in spirit, and this is holding back their valuation potential.

Ticking the box versus taking governance seriously
Can a company meet the standards, and ‘tick the boxes’, yet fail to convince stakeholders that it
Another enlightening statement was written by the journalists Prudence Ho and Nisha Goplan for *The Wall Street Journal Asia* on 30 April 2012:

“Investors who bought shares in many of the city’s offerings aren’t cheering. The average initial public offering in Hong Kong since the start of 2009 is down 13 per cent, and more than two-thirds of the offerings have underperformed the Hang Seng Index since their listings”.

Setting the foundations

The time before the IPO should be used to set the foundations for how a company is going to communicate with the investment community. The company should learn as much as possible about investing audiences’ motivations in advance.

In general, we believe that several best practices are key to establishing a good record on corporate governance, which in turn supports both a company’s reputation and its valuation. The following are some guidelines on how to start setting strong foundations:

- **Well-written IPO prospectus**: Early investment of time in a well-written IPO prospectus is invaluable. Companies should strive for short, comprehensible communications documents that read like a strategic plan drafted by the company executives, rather than a document written solely by lawyers and investment bankers, who may be somewhat detached from the company’s day-to-day business. An IPO prospectus should tell a story and should be written by someone who understands the company and its industry; it should also detail board committee structures, recruitment and appointment policies and other corporate governance standards that will be followed after the IPO. All too often, advisers are brought in too late, drafts are rushed and there is an inadequate amount of communication between the regulator and the potential issuer, which may lead to problems with the regulatory review process.

- **Competitive governance framework**: Companies should review the corporate governance practices of peers and compare them to best practice standards to ensure governance that is both strong and competitive. A company

Taking them seriously? The answer, according to investors, is yes, and this happens all too often.

In the rush to comply with the legal and regulatory obligations of being a newly listed company, directors and management teams may not pause long enough to question why the company’s attitude and record on corporate governance matter to investors and what positive or negative consequences may ensue as a result of a good or bad record in these areas. Newly public companies are often caught off guard by how quickly things can go wrong and by how often corporate governance weaknesses reflect badly upon their reputation.

How a company reacts during critical moments (including its debut) is often seen as the barometer of how it behaves in daily life. This window into the company will be remembered, scrutinised, and questioned (not to mention memorialised forever in this digital age). If, during the IPO preparation, the groundwork on governance has been laid down, investors are likely to appreciate this and be more forgiving.

The Hong Kong IPO landscape

Paying mere lip service to corporate governance has not only damaged the reputation of some Hong Kong listed companies, but has also potentially made the road harder for new companies to list, because investor appetite in the recent past has dwindled for new listings. In a difficult IPO climate, a few companies have also circumvented the normal process for going public by pursuing backdoor listings, which are perceived by investors to be an attempt to avoid the higher levels of disclosure associated with a full listing.

Increasingly, newly listed companies are considered unknown quantities. Any hint of weak governance and weak investor protection leads investors to hold back until they know the deeper character of a business and of its leadership. Doubts by investors can dampen a company’s important debut. Consider this remark made in confidence by a chief investment officer:

“Yes we participate in IPOs here, but we are doing so less frequently. Given the stock performance of many of the new listed companies, we are better off waiting six months [and] then investing”.

Hong Kong Corporate Governance: a practical guide
should begin to align its story and internal governance practices, such as the proportion of independent non-executive directors (INEDs) on the board and its director selection criteria, committee structure, disclosure policy, whistle-blower protection, and board evaluation procedures, to those best practices.

- **Pre-IPO investor targeting:** Companies should create an investor universe or shareholder wish-list. They should look tactically at who could potentially invest and start to build a profile of these institutions. This can run alongside the bankers’ and brokers’ lists and could become part of the core investor database after the listing. It is important to take time to think about and understand potential investors and how the corporate story may resonate with them.

“We would prefer to see newly public companies embrace best practices from the very start, such as annual investor roadshows that bring the chairman or lead independent director to meet with investors. This is expected in more mature markets, and if we saw it become common in Hong Kong, I honestly believe markets would reward companies for adopting the practice”.

* Pru Bennett, Head of Corporate Governance for Asia-Pacific BlackRock*

- **Commitment to engagement:** Good companies make an open commitment to communicate transparently about executive and board appointments. They also plan regular roadshows. The chief executive officer (CEO), CFO, chairman and INEDs must devote time to interacting with minority shareholders.

- **Attention to board composition:** Companies that not only meet, but exceed expectations around board composition should see an uplift in their reputations. In Hong Kong, at least one third of the directors on the board must be INEDs. In addition, Hong Kong listed companies are required to have a written diversity policy, which ideally stipulates that a skills matrix is used to identify competent board members with diverse expertise and backgrounds. Rather than doing the mere minimum to meet the requirement, companies should strive to show that they take director nomination and board composition seriously.

- **Consider cornerstone investors with caution:** If cornerstones are going to be a key feature of an IPO, some different investor relations (IR) tactics need to be employed. Cornerstones create different trading dynamics. An IPO that predominantly features cornerstones can have a negative appeal to large traditionally longer-term investors who need allocation and liquidity to own and trade in a stock. If a company goes down the cornerstone route, it needs to manage carefully stock overhang and the potential of a sell-off, post-lockup period.

**Life as a public company: building trust**

One of the things investors like least is to be surprised. On the contrary, investors reward companies that set clear expectations and then deliver according to those expectations. When words are followed up by consistent actions, the market approves, whether the company is going from strength to strength or reacting to setbacks. The act of managing expectations is vital to the long-term health and success of a company.

Many investors lament that pre-IPO companies set the bar too high and then find they cannot deliver results as promised. Investors generally prefer companies to under-promise and over-deliver.

The openness and dialogue that are required to build trust go beyond regular reporting periods. Open communication about the company’s exposure to risks and how they are managed, disclosure of the board director selection process and consideration of investors’ and other stakeholders’ opinions alongside those of controlling shareholders are all critical to a company’s reputation. In short, such practices build trust. Companies that are doing these things right should therefore make sure that investors and stakeholders are aware of their actions.

Nevertheless, when a company falls short in any area, being open about where it stands and how it aims to improve goes a long way towards boosting investor confidence. Counterintuitively, when a company acknowledges its imperfections transparently and then takes tangible steps to
improve disclosure or make an improving change, a positive ‘halo effect’ is often the result.

The boxed section at the end of this chapter offers examples of good and bad corporate governance and the impact on reputation.

Managing minority interests in family businesses
In Hong Kong, where some 60 per cent of all listed companies are family businesses, the status quo and market expectations are changing. Many minority shareholders are frustrated at having little voice or leverage in comparison to controlling shareholders. In the past, even the largest institutional investors have lamented that they are not allocated enough IPO shares to make it worth investing, or that they cannot buy a large enough stake in a mature business to have a say in how it is run.

However, investors increasingly invest in the high-quality businesses that respect their voice at the table. Therefore, the tone a company takes towards their engagement strongly influences investors’ opinions.

“The best family-controlled companies realise that institutional investors are more than providers of capital. When investors feel consulted, respected and confident about how a company is governed, the family will find that its stake in the business is much more valuable”.

Pru Bennett, Head of Corporate Governance for Asia-Pacific BlackRock

Building relationships with investors is a two-way street, but listening to investors is a basic starting point. Even when a company has a small free-float, it would do well to listen to the voices of its minority shareholders. If it does not, valuation and perception can quickly decrease, which in turn hurts the family’s personal wealth and standing amongst all stakeholders.

When family-controlled businesses can prove that they follow international best practices in corporate governance and avoid the typical stereotypes associated with closely-held family businesses, they earn respect. If a company has done a good job of appointing professional, competent managers into the business, or bringing them up through the ranks and genuinely letting them manage alongside family members, it should demonstrate and even be demonstrative about this. This becomes part of a company’s legacy and a major source of goodwill. Since so much of market sentiment is perception, that goodwill often manifests itself in higher valuations.

Another reason why Hong Kong trades on perceptions is the high level of participation by retail investors in the stock market. Retail investors in Hong Kong are more stock savvy than those in many other parts of the world, and they avidly follow the fortunes of the city’s family-controlled businesses. They know stocks by name and number, and they read stock commentary in the papers. Retail investors make a habit of attending annual general meetings, and they are active on social media.

Retail investors in Hong Kong are doing more than buying shares – they are buying into the face of the business (often a family member or the managing director). When retail investors put their hard-earned cash into a business, they trust that business to be a good steward of their money. If something goes wrong, the tide of public opinion can turn quickly against the company.

Conclusion
Actions, as well as words, determine reputation when it comes to corporate governance. Investors, the media and business communities are savvy – they can detect sincerity or the lack thereof, and they can spot true transparency versus mere required disclosure. Authenticity and reputation are critical to achieving a fair share price, and companies should strive to avoid a bad reputation in this area. Market memory of poor governance practices may penalise a company for many years and leave it exposed to additional risk if something goes wrong. Once investors move out of a stock, the analysts quickly follow, and the company may soon have a low valuation and an illiquid stock. Enticing investors back can take years.

Companies should plan ahead and use all of the communication channels open to them to maximise market appreciation. They should devote time to maintaining a website that projects an open and transparent approach to corporate governance and should update it regularly after their listing. And they should be technologically advanced from the start, at a minimum posting
corporate reputation, a higher long-term valuation and a lower cost of capital. Family-controlled businesses have to work extra hard to prove themselves, but they stand to gain from doing so. Although some may choose a tick-box approach to compliance with changing regulations, best-in-class companies have the chance to position themselves ahead of the pack and attract the full value of a strong corporate governance record through effective communications.

webcasts and presentations on the IR website. Best practices include easy-to-find links to the charters of remuneration, audit and nomination committees; the full board diversity policy; and the biographies of all board members. Investors appreciate not having to spend time searching for this information in annual reports.

We believe that communicating a company’s high standards of corporate governance is a strategic imperative that will result in a better
corporate reputation, a higher long-term valuation and a lower cost of capital. Family-controlled businesses have to work extra hard to prove themselves, but they stand to gain from doing so. Although some may choose a tick-box approach to compliance with changing regulations, best-in-class companies have the chance to position themselves ahead of the pack and attract the full value of a strong corporate governance record through effective communications.

Corporate governance examples and reputation

Hypothetical case studies of good corporate governance and effect on reputation

Clear succession planning
A family-owned conglomerate still run by its patriarch discloses its succession plan and board member appointment process in the public domain, not only dividing assets clearly amongst children but also announcing that any successor will be chosen on merit. A board diversity policy is clearly articulated at the same time.

Clear succession planning removes doubt and uncertainty and allows time for investors to get to know the successor before he or she takes over, even if the successor is a family member. Share price remains strong, and analyst and media coverage is positive.

Managing expectations well
A company explains in detail to analysts and investors that it is likely to miss targets in its three-year plan – before the negative results are announced.

When expectations are successfully managed, analysts are able to forecast accurately and investors are not surprised, generating goodwill. Share price rises slightly as the market feels that the worst is over.

Apologising when appropriate
A company that discovers its joint venture partner has covered up a food safety issue comes out immediately and publicly to apologise and recall the product.

Apologising when appropriate generates respect and sympathy; it also limits damage. Investors believe the company has the situation under control and is not hiding anything.

Listening to investors
A company that is concerned about the gap between net asset value and share price engages a third party to probe investor opinion and find out how it is being valued.

Shareholders appreciate it when a company listens to their views, and they are more likely to give frank feedback when they feel their voice counts. Their suggestion to implement a share buy-back programme is shared with the company, which takes the advice to heart and announces such a programme. The share price rallies.

Disclosure of price-sensitive information
A company realises that it has lost money on a complicated financial instrument. The full board of directors is informed right away, and the company issues a statement. Despite a short-term drop in share price, management is respected for coming forward with bad news. Lawsuits are averted.
**Hypothetical examples of poor corporate governance and effect on reputation**

**Minimum public float and minimum independence on the board of directors**
A subsidiary is floated with a minimum public float percentage and a minimum number of INEDs but is unwilling to discuss this issue directly.

An appearance of disregard for minority interests is immediately formed. Investors may decline to buy into the IPO. Liquidity suffers.

**Informal selection process for directors**
A company CEO blatantly ignores the nominating committee’s oversight of board director nominating protocol and promises a position to a close friend and golfing buddy without using a search firm or any formal process.

Rumours float around town about the clubby nature of appointments in this company. Media and stock commentators publish unfavourable gossip.

**Conflicts of interest**
A parent company intervenes on behalf of a listed subsidiary in loan financing negotiations. Any hint of a conflict of interest is kept private, and investors only find out months later in a regulatory filing that this has happened.

Hedge fund investors quietly build up a short position against the company. When asked by industry colleagues, they voice their negative opinions about the company’s corporate governance.

**Selective disclosure**
A newly public company holds private meetings with inquisitive investors and answers their questions openly, but it fails to disclose the information to others.

An analyst publishes the remarks, and a media firestorm results, making the CFO look bad and irritating investors who were out of the loop, yet the company stays silent.

**Static corporate website after listing**
After a company is first listed, it fails to update or change its website for six months, posting only those shareholder notices required under the listing rules or by law.

Investors and media cannot get up-to-date information, and the overall impression is one of non-transparency and arrogance.
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As Asian, particularly Chinese, companies go public and expand across borders, board structure and corporate governance become increasingly crucial to a firm’s overall success. Western firms have had guiding principles and rules regarding what a board is and how it should be run since the collapse of Robert Maxwell’s companies, which led to the first major report on corporate governance, the Cadbury Report, published in the UK in 1992. More recently, the global financial crisis (GFC) highlighted once again that a weak board, despite a strong chief executive officer, will lead to failure – as was the case with Bear Stearns and Lehman Brothers.

These cases highlight the importance for firms to adopt best practices in board formation and board structuring. However, it can be difficult to know where to start with these processes and how to determine accurately what each member’s role should be.

This chapter will outline how to create the robust, resilient and resourceful boards that help companies succeed.

**Defining a board and its membership**

The board of directors is a group of elected or appointed members who collectively oversee the running of a company or organisation. Their responsibilities include, but are not limited to:

- governing the organisation by setting policies and objectives;
- approving strategy, annual budgets and major investments or acquisitions;
- selecting, appointing, supporting and reviewing the performance of the CEO;
- ensuring the availability of adequate financial resources;
- being accountable to shareholders for the organisation’s performance; and
- setting the salary and compensation strategy of the company’s senior management.

The legal responsibilities of boards and board members vary with the nature of the organisation and with the jurisdiction within which it operates. For listed companies, these responsibilities are typically more rigorous and complex than for unlisted companies.

**Who are the key players on a board?**

**Chairman**

The chairman is the most important officer of a board. His or her duties are typically limited to matters related directly to the board, such as

- chairing board meetings;
- organising and coordinating the board’s activities (such as setting its annual agenda);
• reviewing and evaluating the performance of the CEO and the other board members; and
• ensuring proper committees are formed to comply with good corporate governance, such as the Non-Executive Director (NED) Nomination Committee and the Audit Committee.

Executive directors
An executive director is a member of the board of directors who is also a full-time senior employee of the company. Typically, the executive directors include the company’s CEO and chief financial officer (CFO), but often extend further to include other important operating divisions, such as the head of legal or the chief operating officer (COO). The executive directors are the board members who will have the greatest working knowledge of the day-to-day operations and business of the company.

Non-executive directors (NED)
An NED is a board member of a company who does not form part of the executive management team. Unlike the executive directors, they are not employees of the company or affiliated with it in any other way.

NEDs’ responsibilities vary, but according to the Higgs Report, a UK study commissioned on the subject in 2003, they should include:

• contributing to the company’s strategy;
• scrutinising the performance of management;
• monitoring risk; and
• determining appropriate levels of remuneration for the executive directors.

Independent non-executive directors (INED)
An INED has the same role and responsibilities as those of the NED but does not have any other material pecuniary relationship or transactions with the company. This delineation is designed to keep the INED unbiased and independent in judgment, an important aspect of a sound and balanced board.

Under the Listing Rules of the Hong Kong Stock Exchange (HK Listing Rules), an INED is independent of management and does not receive any benefits from the company other than the director’s fee. In addition, an INED’s independence will be questioned if he or she holds more than 1 per cent of the total issued share capital of the listed issuer.

Structuring the board
Guidelines in Hong Kong
One of the main goals of the Hong Kong Stock Exchange (HKEx) is to promote good corporate governance and ensure that listed companies abide by professional standards to protect shareholders.

According to Chapter 3 of the Hong Kong Listing Rules, every board of directors should have at least three INEDs (a minimum of 1/3 of the board – see LR3.10); at least one of the INEDs must have appropriate professional qualifications or related financial management expertise.

The Code on Corporate Governance Practices issued by the HKEx also recommends that the board include a balanced composition of executive and non-executive directors (including INEDs) and a balance of skills, experience and diversity of perspective appropriate to the requirements of the issuer’s business. Section A4 goes on to say that there should be plans in place for the orderly succession of appointments and that all directors should be subject to re-election at regular intervals.

The Hong Kong government operates through many different statutory bodies; although these are not (in most cases) listed entities, the government does have guidelines where it appoints non-official members on boards of statutory bodies. It formulated the ‘six plus six rule,’ which means a non-official member should not serve on the same body in any one capacity for more than six years and should not serve as a non-official member on more than six advisory and statutory bodies at any one time. The rationale is to ensure a reasonable distribution of workload and substantive contribution to the business of these companies. Individuals who are NEDs or INEDs and sit on ten or more boards are bound to dilute their time and resources across these companies, in comparison to those that are more focused.

Structuring your board
Key questions of board structure which must be addressed include:

• size;
• the ratio of non-executives to executives;
• the skills and experience mix within those groups;
• the personality profiles and how those impact the dynamics of the board and the culture of the company;
• how non-executives split their role between addressing governance issues and adding value through their knowledge, contacts and experience; and
• the balance of power, particularly between the chief executive and the rest of the board.

The board must be large enough to carry weight and also be able to function effectively when some of the directors are away. On the other hand, it must be small enough to allow ‘air time’ to directors.

While much has been written on the subject of board composition and structure, in our conversations with the chairmen and NEDs of Hong Kong companies, we have found that the most useful framework for structuring a board is common sense.

The composition and structure of the board will vary according to the type of company it is, its markets, size, growth, culture, and stage of development. As a starting point, a board’s structure and composition should reflect the objectives and issues a company is facing. Its members should have the diversity of skills and experience to meet these objectives and to navigate issues or crises that the company is facing on various fronts.

Companies with little knowledge of financial markets will need input from someone in the banking or finance industry; one expanding across borders will seek a member with international experience; a small, high-growth company values the experience of someone who has already suffered the pain encountered by rapidly growing organisations, and who can foresee problems early and identify their resolution. Boards are fluid, with new members being appointed and existing ones resigning, and the chairman should always be thinking ahead to ensure that the composition of the board does not suddenly drop out of balance.

For example, a company in women’s apparel may be under-served by a board comprised predominantly of men. A company in a highly-regulated industry with significant risk exposure, such as insurance or banking, would be well served by an NED from a regulatory or risk management background; a company with a large unionised workforce might wish to have an industrial relations practitioner on its board.

Perhaps these examples seem like common sense, and indeed they are, but an analysis of the members’ backgrounds and diversity mix of many boards in Hong Kong will find that the reality is rather different.

The next question to ask is: how many people should be on the board? This is normally determined by the size and complexity of the company. Typically, the larger the company, the larger the board. Too small a board and the company will lack the breadth of experience required; too large, and decision-making becomes difficult and getting a decent attendance at meetings problematic. As a general guideline, 10 to 12 members is considered about right.

The G30, in their 2012 report ‘Towards Effective Governance of Financial Institutions’, recommended that smaller boards requiring greater time commitment are a far better approach than having larger boards that require only a modest time commitment.

A formalised process
All listed companies in Hong Kong need to have a clear and well thought-out approach for how they assemble, structure and maintain their board. As a starting point, the company secretary, together with the head of human resources, should be asked to start a formal board appointment process. This should include:

• Establishing a Nomination Committee (NC)
• Having the NC draft guiding principles for the board’s structure, objectives and diversity policies
• Setting terms for the appointment of NEDs
• Keeping a table showing the dates of NED terms and appointments, expiration, and planning for new appointments
• Maintaining a matrix showing who is on the board and highlighting their sector or industry experience, functional expertise, professional qualifications, age and gender. This should be used for gap analysis to show where additional skills or background are required, and ensuring
that the appropriate NEDs chair important committees such as remuneration and audit

- Using clear guidelines on NEDs’ fees and remuneration, ensuring consistency of remuneration that is competitive enough to attract the right people and keeps interests aligned

- Seeking an executive search firm to conduct an independent search for an NED to prevent the ‘group think’ that is, in our experience, commonly found in Hong Kong-listed companies. This ensures independence, a thorough review of the market, a broad mix of candidates and a targeted approach

- Seeking an executive search firm to offer an independent review of the effectiveness of existing board members, giving the chairman assurance that he or she has the right team in place

- The head of human resources should provide considerable input to all of the above, working closely with the chairman

- Making sure INEDs are briefed on the company’s business; often, they will not know much about the industry and details of the business. The executive directors can help the board acquaint itself with the industry

- A training programme or special sessions should be considered for newly-appointed INEDs to bring them up to speed on the company’s businesses and the industry sectors in which they operate

- All NEDs should understand the HK Listing Rules and their fiduciary duties as a director

- There should be adequate directors’ liability insurance in place for all members of the board

How many executive directors and NEDs?

As a general rule, neither executives nor non-executives should dominate. When non-executives constantly harass or eclipse the executive, the latter becomes resentful, withholds information, and does not contribute. This, in turn, prevents the non-executives from getting a proper understanding of the issues facing the business and reduces the effectiveness of executive performance.

Where the executive dominates the non-executive, there is potential for conflicts of interest and withholding of important information. Detrimental to the interests of shareholders, this is relatively common in listed companies dominated by aggressive Asian family entrepreneurs.

NEDs who lack credibility, or do not have an appropriate powerbase, cannot exercise their vital role of governance. They must be independent, courageous, and carry sufficient gravitas and influence together with the means to exercise their will, such that when things do go seriously wrong, they can take appropriate action. Within the board, the axis of the chairman and the CEO is immensely powerful. A strong chairman–CEO combination can move mountains. It is not good for shareholders if that relationship breaks down.

The catastrophic, almost overnight failure of some of the world’s largest banking institutions during the global financial crisis was, in most instances, a direct result of two factors: a bad board and poor corporate governance.

According to one senior executive who has experienced this type of situation, as the toxic exposure spiralled, ‘The board had absolutely no idea how much of this risky stuff was actually on the books…And perhaps worst of all, in the context of this discussion, independent directors did not even turn up for the shareholders’ meeting that approved the sale [of the company].’

So the non-executives have a vital governance role and responsibility to constructively challenge the CEO and executive directors. In addition to this, they should add a significant extra advisory dimension. People who have run businesses, who have been through the trauma of a share-price crash, who understand the problems of restructuring, declining markets, launching new businesses, and making and absorbing acquisitions, can provide valuable insights and a vital steadying hand when needed.

This does not mean that non-executives should only be drawn from the ranks of existing CEOs of other companies; this can lead to an unhealthy concentration on a single type of experience and skill-set. The mix of personalities must be such that positive rather than negative tensions are created, with entrepreneurial zeal and sensible caution being appropriately balanced. The chemistry must allow informed debate, clear thinking, proper evaluation of problems and their resolution, and a clear framework and direction in which the executives can carry out their tasks.
Building a balanced board is complex. Searches for directors need to be undertaken to the highest professional standards, involving extensive discussion with all board members and careful evaluation of candidates to assess not only their personal strengths and weaknesses, but how they will operate in the context of the board, both present and future. The pay-off is a team with the balance, commitment and ‘will to win’ that top sportsmen would understand and admire.

The proper balance between executive and non-executive is important. If the non-executives are not powerful enough, they may be rolled over by the executives, who have the advantage of greater information and control its supply. On the other hand, a board with too few executive directors can be demotivating to the key operational executives ultimately responsible for producing results.

Furthermore, the board cannot scrutinise their performance on an ongoing basis, nor can they grow through participation on that board. This is one of the most frequent causes of top executives defecting to other companies. A well-structured board has the right balance of constructive debate, challenge and ability to make well-informed decisions. It should not be so harmonious or aligned that ‘group think’ takes place, nor so challenging that it becomes acrimonious.

**Diversity**

Board diversity has been a topic of increasing contemporary interest, most recently brought to the public forum by HKEx. On 1 September 2013, HKEx introduced a Code Provision stipulating that all listed issuers must report on board diversity policy on a ‘comply or explain’ basis and publish their board diversity policy, measurable objectives, and progress against these objectives.

As of January 2013, women comprised only 10.7 per cent of directors of all listed issuers in Hong Kong. Forty per cent of listed companies have no women on their board, and there have been no improvements in the last five years. These statistics run directly counter to the growing body of research which demonstrates that more diverse companies outperform their less diverse peers.

What does diversity mean – and what does it encompass? Diversity for the boardroom is expansive across all sectors, covering specifications such as backgrounds, skills and experiences. The most robust boards have a team of members who balance each other in terms of age, gender, professional experience, and cultural background. These competencies allow companies to avoid ‘group think’ on matters of corporate strategy, performance and risk. These are the kinds of boards that enable companies to become more effective and, as studies have shown, economically more successful.

As Su-Mei Thompson, Chairwoman of The Women’s Foundation, has pointed out, greater board diversity also benefits Hong Kong. As a major financial centre with an abundant talent pool of qualified men and women, Hong Kong has a unique opportunity to become a leader in board diversity and assert itself as a modern sophisticated economy that nurtures talent across the workforce.

**The Hong Kong market**

The US and European markets have led the way with many of the directives and recommendations that have been published on board structure and corporate governance. As mentioned earlier, the UK Cadbury report (1992) was the first major review on corporate governance recommendations, and since then, we have seen numerous other codes, mandates, recommendations and academic papers. Some of these have been in response to company failure, others as part of an ongoing evolutionary process.

However, the landscape in Hong Kong and Asia is quite different. Listed companies are often family run, and NEDs are very often family members who are likely to have a significant shareholding in the company. This can weaken corporate governance and create conflicts of interest.

Chinese societal norms teach unity, deference and respect, and challenging the company boss is uncommon. Decisions tend to be deferred upwards, and control is tightly held among the ranks of the top one or two executives. These institutional practices and cultural principles can lead to a challenging corporate governance environment, with ineffective and inherently detrimental decision-making structures. Having a well-structured board is the first step towards the sustainability and profitability of a company.
As the highest elected decision-making body in a company, it is important to remember that the director’s values and culture will determine behaviour across the whole organisation. As such, any company should seek to recruit board members with irreproachable independence of thought and action to create the optimum balance of expertise, skills, experience and perspectives.

Nomination Committees should not be afraid to think creatively when appointing board members. Very often, Hong Kong-listed companies like the safety of a ‘known name’ who is on multiple boards and is well known in the local business community. But there are many talented individuals who have much to contribute who are less well known. Using a good executive search firm can help find these people and more choice and diversity than will be possible by relying solely on the networks of existing company owners and/or board members.

Conclusions
Watch any great sportsman in top form. Their balance is absolute. You cannot deliver the powerful strike, serve, kick, punch or surge of pace unless all parts of your body are working in harmony, each muscle providing the appropriate positive tension for the whole to explode into action at the moment it is needed. No part should sap strength from another or destabilise it. So it is in business. A balanced board, fully focused and working together to achieve its objectives, is a formidable competitor. By contrast, a board that is not properly balanced is less than optimal, while a divided board is unstable and can lead to results that are nothing less than catastrophic for shareholders.
PART III

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Building on Chapter 1, which tells the story of how the current regime for corporate governance came about through legislation and regulations, and Chapter 6, which maps out the key requirements with their sources – statutory or otherwise, this chapter explains in more detail the substantive requirements that companies listed on The Stock Exchange of Hong Kong Limited (SEHK) have to follow.

Most requirements that apply to listed companies are contained in the Rules Governing the Listing of Securities on the SEHK for main board issuers (Main Board Listing Rules) and their counterpart for the Growth Enterprise Market (GEM), the Rules Governing the Listing of Securities on the Growth Enterprise Market of the SEHK (GEM Listing Rules), with their respective guidance and practice notes and appendices. These requirements are supplemented by various guidance letters, listing decisions and frequently asked questions published by the SEHK.

The Corporate Governance Code and the requirements in relation to a listed company’s corporate governance report are contained in Appendix 14 of the Main Board Listing Rules and Appendix 15 of the GEM Listing Rules. The Code sets out the principles of good corporate governance and contains (1) code provisions that impose an obligation to ‘comply or explain’ and (2) recommended best practices that are for guidance only. The main provisions of the Code are summarised in this chapter under the topics to which they relate. Further details about the corporate governance report are described in the annual report section later in this chapter.

The Main Board Listing Rules and the GEM Listing Rules (together, Listing Rules) apply to listed issuers, including those that are not incorporated in Hong Kong, certain requirements in the Hong Kong Companies Ordinance regarding disclosure of financial and other information.

The requirements highlighted in this chapter concern a range of matters that fall within the broad ambit of corporate governance. They have been grouped into four sections according to the way in which they seek to regulate the infrastructure of the issuer, promote transparency and impose checks on the management’s power, being: constitutional and structural requirements, financial reporting, non-financial disclosures and restrictions and approval requirements. All of these requirements serve the ultimate aims of ensuring a fair and orderly market and protecting investors.

### Constitutional and structural requirements

#### Articles of association

The articles of association of a listed issuer must include provisions prescribed by the Listing Rules on matters such as transfer of securities and registration, share certificates, dividends, directors, accounts, shareholders’ rights, notices, capital structure, voting and proxies.
Personnel
There are requirements on the appointment, qualifications and responsibilities of directors, the company secretary, the compliance officer (for GEM only) and authorised representatives. Authorised representatives are the principal channels of communication for the issuer with the SEHK after listing.

Board
The board of directors of an issuer must include at least three independent non-executive directors (INEDs), representing at least one third of the board. At least one INED must have an accounting or a related financial management qualification and expertise. There are detailed factors which may affect an INED’s independence, which is subject to regular review and confirmation.

There are a number of code provisions and recommended best practices in the Corporate Governance Code concerning the board of directors:

- provisions related to directors such as conduct of board meetings; separation of roles between the chairman and the chief executive; responsibilities of the chairman; composition of the board; appointment, re-election and removal of directors; responsibilities of directors; and information to directors
- remuneration of directors and senior management, board evaluation and functioning of remuneration committee
- delegation by the board of directors
- appointment and dismissal of, and other requirements relating to, the company secretary.

Committees
An issuer must establish an audit committee and a remuneration committee, both with a majority of INEDs and chaired by an INED. Only non-executive directors (including INEDs) can be members of the audit committee. There are code provisions (again, requiring an issuer to ‘comply or explain’) on the proceedings of the audit committee and remuneration committee, and on the establishment of a nomination committee.

Share option schemes
Any share option scheme of an issuer involving options over new shares must comply with the procedure for adoption of the scheme; the terms of the scheme (including the maximum number of shares that may be issued; the maximum entitlement of each participant; the exercise period; the exercise price and the maximum duration of the scheme); restrictions on granting options to directors, the chief executive and substantial shareholders; the timing of grants; and announcement and disclosure requirements.

Financial reporting
Periodic reporting
All main board issuers are required to publish annual financial results and half-yearly financial results. Publication of quarterly financial results is required for GEM issuers but is only a recommended best practice for main board issuers – one that is not commonly followed at present.

The Listing Rules provide that the accounts must conform with Hong Kong financial reporting standards (HKFRS), international financial reporting standards (IFRS) or, as an option available to People’s Republic of China (PRC) issuers only, Chinese Accounting Standards for Business Enterprises (CASBE). Main board issuers that have a secondary listing in

New development: board diversity
Two new code provisions (ie ‘comply or explain’ provisions), which became effective from 1 September 2013, state that an issuer’s board of directors should have a diversity of perspectives appropriate to the requirements of the issuer’s business and that the nomination committee should give adequate consideration to diversity. Diversity of board members can be achieved through consideration of factors such as gender, age, cultural and educational background or professional experience. Each issuer should take into account its specific situation and disclose the reasons for applying the relevant factors.
Hong Kong, and GEM issuers that are also listed on the New York Stock Exchange or Nasdaq but are not property development or investment companies, may publish accounts that conform with US generally accepted accounting principles (GAAP).

Other accounting standards not specified in the Listing Rules may also be adopted by overseas companies seeking to list on the main board, subject to approval from the SEHK. The SEHK had, as of December 2013, accepted US GAAP for dual-primary listings and European Union IFRS, Australian GAAP, Canadian GAAP, Japan GAAP, Singapore FRS and UK GAAP for dual-primary or secondary listings. However, all financial statements adopting standards other than HKFRS, IFRS and CASBE must include a statement showing the financial effect of material differences between them and those prepared using HKFRS or IFRS.

Specific line items and segmental information must be included in the income statement and the balance sheet.

The financial statements must include other information, such as:

- details of subsidiaries, their share capitals and debt securities
- details of bank loans and borrowings (except where the listed issuer is a bank) and amount of interest capitalised
- emoluments of each director, with a breakdown into fee, basic salary, housing allowance, other allowances and benefits, contribution to pension, discretionary bonus, inducement to join and compensation for loss of office
- emoluments of the five highest-paid individuals, without names unless they are directors.

The following items, and various others, must also be disclosed by all listed companies. They may be included in the notes to the accounts, as most of them are in practice, or disclosed separately in other parts of the annual report:

- particulars of connected transactions
- convertible securities or options issued or exercised
- redemption of redeemable securities or repurchase of listed securities of the issuer
- securities interests of directors and the chief executive, directors’ service contracts and contracts in which any director is materially interested
- significant contract with any controlling shareholder
- waiver of dividends by any shareholder
- explanation of difference between reported net income and profit forecast previously made
- details of significant properties held for development, sale or both
- the group’s emolument policy
- details of pension schemes
- details of investments
- details of the ultimate holding company
- loans to company officers
- reserves available for distribution to shareholders
- major customers and suppliers and the interests of directors or significant shareholders in them
- sufficiency of public float
- (for GEM issuers only) during at least the first two full financial years after listing, a statement as to the issuer’s achievement of its business objectives, as stated in the listing document.

Banks and financial conglomerates are subject to additional disclosure requirements.

Financial reporting for transactions

Periodic reporting aside, whenever a listed company issues a listing document for a public offer of securities or a circular in connection with certain transactions, an accountants’ report prepared by a qualified accounting firm must be included in the document.

The accountants’ report must include certain prescribed information on the issuer and, where relevant, the business or company to be acquired, together with pro forma financial information on the combined group. The reporting accountants must prepare the report in accordance with the relevant auditing guidelines issued by the Hong Kong Institute of Certified Public Accountants. In this report, they must express an opinion as to whether the information gives a true and fair view of the results and financial position of the reported companies. The report must state whether the accounts have been audited and, if so, by whom; it also must state whether any audited accounts have been made up since the end of the last reported period.
Code on corporate governance
There are code provisions and recommended best practices on the responsibility of the management to provide information and updates to the board of directors, disclosure of information in the corporate governance report concerning accounts, disclosure of long-term strategy in the annual report, presentation of financial disclosures, internal controls and functioning of the audit committee.

Non-financial disclosures

Annual report
In addition to the financial statements, the annual report of a listed issuer must contain a directors’ report, the management’s discussion and analysis of the group’s performance (MD&A) and a corporate governance report.

Directors’ report
The directors’ report should cover, amongst other things, the principal activities of the group, the amount of the proposed dividend, material donations, significant changes in fixed assets, reasons for and details of issuances of equity securities and debentures, the names of the directors, contracts in which any director has a material interest and other matters that are material for the appreciation of the state of the company’s affairs by its members. In all cases, the disclosure of this information should not, in the directors’ opinion, be harmful to the company.

Management’s discussion and analysis
The MD&A should focus on trends and should identify significant events or transactions during the period under review. Specifically, it should cover matters such as liquidity and financial resources, capital structure, the state of the order book, significant investments, material acquisitions and disposals, developments within industry segments, employees’ remuneration and training, charges on assets, gearing ratio, exposure to exchange rate fluctuations and contingent liabilities. It should also include certain forward-looking disclosures such as the prospects for new business including new products and services, future prospects of significant investments held and future plans for material investments or capital assets.

New development: business review
Hong Kong companies are required under the new Companies Ordinance, which came into operation on 3 March 2014, to include a business review in their directors’ reports. The business review will address, among other matters, the likely future development of the company’s business. There will be an exception: no disclosure will need to be made of information about impending developments or matters in the course of negotiation if the disclosure would, in the directors’ opinion, be seriously prejudicial to the company’s interests. The Listing Rules incorporate by reference the requirements in the Companies Ordinance as regards disclosures in directors’ report. The requirement to disclose future developments in the business review is phrased in broader terms (but subject to the ‘seriously prejudicial’ exception) compared to the current requirements to make forward-looking disclosures under the Listing Rules – see the section on management’s discussion and analysis. It will be interesting to see how the practice of issuers will evolve, and whether any guidance will be issued by the SEHK in this area.
**Corporate governance report**

Issuers are required to comply with the mandatory disclosure requirements and are encouraged to make certain recommended disclosures in their corporate governance reports. See Chapter 6 of this book for more details.

The recommended disclosures are provided for issuers’ reference and are not intended to be exhaustive or mandatory. Such disclosures include information related to share interests of senior management, investor relations, internal controls and division of responsibility between the board of directors and the management of the company.

**New development: environmental, social and governance reporting**

The environmental, social and governance (ESG) guide in a newly added Appendix to the Listing Rules applies to issuers for financial years ended after 31 December 2012. It contains a list of non-exhaustive aspects of four subject areas: workplace quality, environmental protection, operating practice and community involvement. Guidance is provided on making general disclosures in annual reports in relation to the aspects relevant to an issuer and key performance indicators for each aspect. Compliance with the ESG guide is a recommended best practice. The SEHK has indicated that, subject to further consultation, it may raise the obligation level to comply and explain by 2015.

**Disclosure of inside information**

Listed companies are required under the Securities and Futures Ordinance to disclose inside information, and they have a duty under the Listing Rules to disclose information to avoid a false market in its securities. This topic is discussed in detail in Chapter 14.

**Other disclosure obligations**

In addition to its general duty to announce price-sensitive information, an issuer must announce or publish on the SEHK’s website certain specific matters whenever they arise:

- matters concerning its business, such as the making of an advance to an entity other than in the ordinary course of business and on normal commercial terms, giving of financial assistance to an affiliate company, pledging of shares by a controlling shareholder to secure the issuer’s debts, loan agreements that impose specific performance obligations on its controlling shareholder, breach of significant loan agreements, notifiable transactions and connected transactions (described later in this chapter)
- matters concerning its securities or their trading, such as material matters that affect profit forecasts, a change in issued share capital, a change in the terms of convertible securities, issues of securities and a change in rights attached to any class of listed securities
- matters concerning its corporate status and management, such as appointment of a receiver or manager; initiation of a winding up or liquidation process; a proposed change of memorandum or articles of association; a change of director, supervisor, chief executive or company secretary; a change of auditors or the end of the financial year; a change in its share registrar or registered address; and a change of compliance adviser.

**Restrictions and approval requirements**

A listed company and its management are subject to various limitations in their actions according to the Listing Rules. Some are outright prohibitions, and others are approval requirements. Most of these restrictions concern dealing in securities, notifiable transactions and connected transactions.

**Dealing in securities**

When offering new securities for subscription, a listed issuer must observe the restrictions against offering securities on a preferential basis to employees (permissible but subject to a maximum limit), directors and existing shareholders (not permissible for main board issuers). Companies must comply with the minimum public float requirement – generally 25 per cent, except for issuers with market capitalisations over HK$10 billion.
A listed issuer with a primary listing on the SEHK may only purchase its own shares on the SEHK with prior approval of shareholders by ordinary resolution. An explanatory statement including all relevant details prescribed by the Listing Rules must be sent to the shareholders, together with the notice of the general meeting. There are restrictions on the maximum purchase price. The shares must be paid for in cash, and the trade must be settled in accordance with the trading rules of the SEHK. The issuer may not knowingly purchase the shares from a connected person. It may not purchase shares when it has knowledge of inside information that has not been announced or during the month before the date of any board meeting for the approval of financial results. Details of share repurchases must be announced before the market opens the next business day. An issuer cannot issue new shares within 30 days of purchasing its own shares.

With limited exceptions, an issuer may not issue new shares or convertible securities within six months of its initial public offering (IPO). Likewise, its controlling shareholders may not sell shares within such a six-month period. In addition, in the second six–month period after the IPO, no controlling shareholder may make disposals that will result in it ceasing to be a controlling shareholder.

The Model Code for Securities Transactions by Directors of Listed Issuers is set out as an Appendix to the Main Board Listing Rules. Its requirements are mandatory, in that any breach of them is regarded as a breach of the Main Board Listing Rules. The equivalent provisions for GEM are set out in Chapter 5 of the GEM Listing Rules.

Under the Model Code and Chapter 5 of the GEM Listing Rules, a director must not deal in the securities of the issuer when in possession of inside information during the 60 days immediately before and on the date of publication of annual results or during the 30 days immediately before and on the date of publication of interim results, other than in exceptional circumstances. Dealing and securities are defined broadly, and the restrictions cover the exercise of convertible securities. In any event, before any dealing, a director must follow a prescribed procedure and obtain clearance from the chairman or another director designated for this purpose. A director must not make unauthorised disclosure of confidential information or use such information for personal advantage or the advantage of others.

There are provisions in the Securities and Futures Ordinance against insider dealing and other market misconduct offences that, although not solely applicable to directors or persons managing or controlling a listed company, are particularly relevant to them because of their positions. In addition, directors, the chief executive and substantial shareholders are required to disclose their equity interests in the listed issuer.

**Notifiable transactions**

Transactions carried out by a listed issuer – mostly acquisitions and disposals but also options to acquire or dispose of assets, certain finance leases and operating leases, indemnities, guarantees and joint ventures – are classified by size, according to percentage ratios comparing the total assets, net profits before tax and revenue attributable to the assets targeted for acquisition or disposal against the corresponding values of the issuer, and by comparing the consideration against the market capitalisation of the issuer and (if relevant) the nominal value of the equity capital issued as consideration by the issuer against its issued equity capital.

Transactions classified as major transactions, very substantial disposals, very substantial acquisitions and reverse takeovers (ie those with the highest of the ratios reaching 25 per cent or higher), require shareholders’ approval by ordinary resolution passed at a general meeting of shareholders (or written shareholders’ approval in limited situations). Shareholders having a material interest in the transaction must abstain from voting. The issuer must send a circular to its shareholders, which contains the information about the transaction, as prescribed by the Listing Rules. It also includes an accountants’ report, as described in the section on financial reporting for transactions, and any expert’s or valuation report that may be relevant.

**Connected transactions**

An issuer’s directors, supervisors (if the issuer is a PRC company), chief executive and substantial shareholders, as well as their respective associates,
are ‘connected persons’ of the issuer. To safeguard against them taking advantage of their positions, the Listing Rules require that any transaction between the issuer and a connected person, and any transaction of a certain type in which a connected person is interested, must be approved by independent shareholders, unless its value is less than certain thresholds or it falls under any other exemption.

The approval is given by ordinary resolution passed at a general meeting, where any connected person (including its associates) with a material interest in the transaction must abstain from voting.

Where a connected transaction is subject to independent shareholders’ approval, the issuer must establish an independent board committee (IBC) comprising only INEDs to advise the independent shareholders on the merits of the transaction and on how to vote. The IBC is advised by an independent financial adviser appointed by the issuer. The IBC and the independent financial adviser each issues a letter to shareholders with their recommendation, both of which are contained in the circular to shareholders.

Some connected transactions involve the provision of goods, services or financial assistance that are carried out continuously or repeatedly over a period. These continuing connected transactions require annual review by the INEDs and auditors and disclosure in the annual report, as well as independent shareholders’ approval, unless otherwise exempted.

**Other requirements**

In addition to the requirements set out earlier, which are generally applicable to all listed issuers, a number of others apply to specific types of companies (eg PRC issuers and other overseas issuers, as described in Chapters 21 and 22 of this book; banks; and mineral companies), specific types of transactions (eg IPOs, as described in Chapter 7; rights issue; and public takeovers) and specific technical matters (eg valuation of properties and expert reports).

**Non-compliance**

The consequence of breach depends on whether the requirement is statutory. Failure to comply with the provisions in the Securities and Futures Ordinance and the Companies Ordinance may give rise to civil or criminal liability on the part of the issuer and its directors and officers.

On the other hand, the Listing Rules do not have the force of law. The SEHK has some discretion to waive or modify their application in practice. If there is a breach, the SEHK may issue a private reprimand, a public statement that involves criticism or a public censure against an offender. In more serious cases, it may state publicly that the retention of office of a director is prejudicial to the interests of investors (and suspend or cancel the listing of the issuer concerned if the director remains in office), order the facilities of the market to be withdrawn from certain parties or take both actions. It may also report the breach to the Securities and Futures Commission or other professional or regulatory bodies, which may lead to disciplinary actions being taken against the sponsor firm, the financial adviser and other professional parties involved in the breach.
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Building effective risk management and internal control

Wee Teong Cheah, Director of Risk Advisory Services RSM Nelson Wheeler Consulting Limited

The number and scale of corporate failures caused by wilful and reckless conduct or malfeasance have resulted in a greater demand for good corporate governance. Major capital markets in the US, UK and Asia have responded by revising and raising their corporate governance requirements. The foreword from the 2008 edition of the Guidebook for Audit Committees in Singapore stated that ‘Good corporate governance is about maximising performance with accountability to shareholders’. Underpinning good corporate governance is a sound system of risk management and internal control, which helps companies to achieve their business objectives and long-term success. This chapter explains how companies can build an effective risk management and internal control system.

Corporate governance requirements

There are common recurring themes of proper governance and oversight of companies. These themes are related to risk management and internal

<table>
<thead>
<tr>
<th>Location</th>
<th>Requirement</th>
<th>Source</th>
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<tbody>
<tr>
<td>Hong Kong</td>
<td>The board should ensure that the issuer maintains sound and effective internal controls to safeguard shareholders’ investment and the issuer’s assets.</td>
<td>Principle, C.2: Internal Controls, Appendix 14 – Corporate Governance Code and Corporate Governance Report, Hong Kong Main Board Listing Rules</td>
</tr>
<tr>
<td>Singapore</td>
<td>The board should ensure that Management maintains a sound system of risk management and internal controls to safeguard shareholders’ interests and the company’s assets, and should determine the nature and extent of the significant risks which the board is willing to take in achieving its strategic objectives.</td>
<td>Principle 11: Risk Management and Internal Controls, Code of Corporate Governance 2012, Monetary Authority of Singapore</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.</td>
<td>Main Principle, C.2: Risk Management and Internal Control, The UK Corporate Governance Code, September 2012, Financial Reporting Council</td>
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</tbody>
</table>
controls in the corporate governance standards and guidance published by listing authorities, regulatory bodies and investor protections committees. In Hong Kong, Singapore and the UK, the principles of corporate governance all require a sound system of risk management and an effective system of internal controls.

More importantly, the standards clearly state the responsibility of the board of directors in ensuring that companies maintain a sound system of risk management and internal controls. However, it is vital to distinguish the board’s oversight role from the management’s role in implementing a sound and effective system of risk management and internal controls. The respective roles of the board and management are summarised in Table 1.

### Review of governance in Hong Kong

In Hong Kong, a review on corporate governance conducted in 2012 revealed some interesting findings. The review covered 241 listed companies in Hong Kong, comprising the large-cap and mid-cap indices of the Hang Seng Composite Index (HSCI).

As shown in Figure 1, while almost all companies performed an annual review on the effectiveness of their risk management and internal control system (87 per cent in 2012), this appears to be trending down (from 92 per cent in 2010). Nonetheless, companies that performed the review covered financial, operational and compliance controls, as well as risk management systems (improving from 70 per cent in 2010 to 74 per cent in 2012).

With an increasing focus on risk awareness and management, more companies are implementing

### Table 1: The roles of the board and management

<table>
<thead>
<tr>
<th>Board</th>
<th>Management</th>
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<tbody>
<tr>
<td>The board:</td>
<td>Management is responsible for:</td>
</tr>
<tr>
<td>• should review and be satisfied with the system of risk management and internal controls designed, operated and monitored by management</td>
<td>• the identification, assessment, management and monitoring of risks</td>
</tr>
<tr>
<td>• may decide to conduct more detailed reviews (with the assistance of independent professional advisers), particularly if the board is of the view that there are serious issues at hand.</td>
<td>• designing, operating and monitoring the system of internal controls</td>
</tr>
<tr>
<td></td>
<td>• providing assurance to the board on risk management and internal controls.</td>
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</tbody>
</table>

### Figure 1: Comparison of corporate governance practices of HSCI-listed companies 2010–2012

Source: Corporate Governance Review 2012, BDO Corporate Governance Academy.
processes to identify, evaluate and manage risks (from 36 per cent in 2010 to 48 per cent in 2012). Thus, it appears that more Hong Kong listed companies are slowly gaining traction in recognising the importance and quality of risk management and internal controls in enhancing their corporate governance.

**The board of directors and the audit committee**

In many companies and jurisdictions, audit committees play a central role in the governance and oversight of companies. While the arrangements for audit committees and delegation of specific board responsibilities may differ, the principle remains that all board members are equally responsible for a company’s affairs. Hong Kong’s Corporate Governance Code clearly states this principle of ‘collective responsibility’:

> “An issuer should be headed by an effective board which should assume responsibility for its leadership and control and be collectively responsible for promoting its success by directing and supervising its affairs…”.

*Source: Section A. Directors, Principle, A.1: The Board, Appendix 14 – Corporate Governance Code and Corporate Governance Report, Hong Kong Main Board Listing Rules*

Regulatory authorities in Hong Kong, such as the Securities and Futures Commission, have reaffirmed this point. In its recent Guidelines on Disclosure of Inside Information, the Commission made the following statement:

> “Given the unitary nature of a board and the indivisible legal duties of all directors, both executive directors and non-executive directors should exercise due care, skill and diligence to fulfil their roles and obligations”.

**Setting up an effective audit committee**

In Hong Kong, Main Board-listed companies are required to have a clear mandate on the audit committee’s roles and responsibilities when setting it up. As stated in the Corporate Governance Code:

> “The board should establish formal and transparent arrangements to consider how it will apply financial reporting and internal control principles and maintain an appropriate relationship with the issuer’s auditors. The audit committee established under the Listing Rules should have clear terms of reference”.

*Source: Principle, C.3: Audit Committee, Appendix 14 – Corporate Governance Code and Corporate Governance Report, Hong Kong Main Board Listing Rules*

The following sections outline good practices for audit committees to adopt, which are also broadly consistent with guidance suggested by the Hong Kong Institute of Certified Public Accountants.

**Mandate and composition**

The core functions of an audit committee include assisting the board of directors with an independent review on the effectiveness of the financial reporting process, risk management and internal control system of the company and overseeing the audit process, as well as other duties and responsibilities assigned by the board. The main roles and responsibilities of the audit committee should be formally documented in clear written terms of reference and should include the following:

- constitution
- membership
- attendance and frequency of meetings
- authority
- duties
- reporting procedures.

As noted earlier, the board of directors may have delegated certain duties to the audit committee, but the board retains full responsibility and authority over a company’s matters.

The audit committee should consist of non-executive directors of the board of directors only. To discharge its responsibilities effectively, some audit committee members should have accounting or related financial management expertise or experience; that is, they should be able to do some or all of the following:

- read and understand financial statements (balance sheet, income statement and cash flow statement)
• understand and assess the general application of local or other generally accepted accounting principles
• ask pertinent questions on the financial reporting process
• challenge management’s assertions and responses on financial matters where appropriate
• understand internal controls and risk factors relevant to the company’s operations, including those relating to complex financial instruments
• have previous experience gained in a finance function or from financial oversight responsibilities
• have experience gained from corporate finance, financial reporting or accounting
• have related educational, professional, or both types of qualifications in accounting or finance.

Roles and responsibilities
The principal responsibilities of the audit committee can be categorised into the following areas:

Financial reporting and disclosure
The responsibility for preparing complete and accurate financial statements and disclosures based on acceptable financial reporting standards and applicable rules and regulations lies with management. The audit committee’s review of financial information and disclosures should focus mainly on its completeness, accuracy and fairness, including the appropriateness of statements made by directors of the company. The audit committee must be satisfied with and endorse the financial statements and disclosures before presenting them to the full board of directors for approval.

This review should typically cover major areas such as:

- **Significant accounting policies**: Considering whether accounting policies are in accordance with current best practices. Considering areas in which the policies are not in accordance with acceptable accounting standards and practices.
- **Judgmental issues and estimates**: Reviewing the reasonableness of management’s bases and judgments. Where appropriate, challenging the relevance of using an alternative basis of calculation.
- **Disclosures**: Considering whether all relevant items have been adequately disclosed and whether disclosures give a fair view of the nature of the transactions reported (e.g., related-party transactions).
- **Unusual items**: Ensuring disclosure of unusual items (e.g., asset acquisitions and disposals, contingent liabilities and litigation) is fair, is not misleading and is given suitable prominence in the financial statements.
- **Significant audit adjustments**: Giving due consideration to the cause of the error that gave rise to the adjustment. Considering whether further investigation is warranted.
- **Auditors’ concerns and significant unadjusted audit differences**: Considering matters raised by auditors, such as material uncertainties that may cast significant doubt on the company’s ability to continue as a going concern, the potential effect of significant risks and exposures that are required to be disclosed in the financial statements, expected modifications to the auditors’ report and significant irregularities, including fraud and non-compliance with law and regulations.
- **Consistency of financial information**: Reviewing interim and annual reports to ensure that there are no inconsistencies. In particular, considering whether the directors’ report, chairman’s statement and management discussion and analysis reflect the company’s performance and whether the financial position is fair and consistent with the picture given by the accounts.

Risk management and internal control
Maintenance of an effective control environment is vital to the company’s operations. The audit committee needs to assess whether there are adequate risk management and internal control procedures in place to ensure:

- adherence to management policies
- safeguarding of assets
- prevention and detection of fraud and error
- accuracy and completeness of accounting records
- timely preparation of reliable financial information.

In addition, the audit committee should obtain assurance that management systematically
identifies key areas of risk and that an appropriate control environment is enforced and maintained to manage the identified risks.

Audits
The audit committee should monitor internal and external audit coverage to ensure all key risk areas are considered. This may involve reviewing and discussing the audit plan and resolving prior-year issues. In addition, the audit committee should assess the effectiveness of the internal audit function, including the adequacy of its resources and its standing within the company.

Resources
The audit committee is effective only if sufficient resources are provided. For example, the audit committee should have access to the company secretary for all related matters, including receiving information and papers in a timely manner to allow full and proper consideration. In addition, management should provide the audit committee with access to external independent accounting, legal or other advice when it is deemed reasonable and necessary to do so.

Reporting to the board of directors
Lines of reporting between the audit committee and the board of directors should be formalised, normally within the audit committee’s terms of reference. The audit committee reports and makes recommendations to the full board on matters related to its work and findings in areas such as:

- financial and other reporting
- internal control and risk management
- audits
- other duties and responsibilities.

Audit committee self-assessment
The audit committee should consider regularly performing a self-assessment on its effectiveness and consider improvements in the following areas:

- terms of reference
- membership and appointments
- meetings
- training and resources
- financial reporting and disclosure
- risk management and internal control systems
- internal and external audit process
- whistle-blowing
- relationship with the board of directors
- communication with shareholders.

Establishing practical and relevant risk management and internal control systems
There are various approaches to building sustainable and effective risk management and internal control systems. We rarely find a one-size-fits-all approach or solution that is suitable for all companies in different industries and jurisdictions. However, companies are able to reference leading sources of material and literature, as well as regulatory guidance.

Leading frameworks
For risk management, references commonly used include the enterprise risk management (ERM) integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2004, and the International Organization for Standardization’s risk management family of standards, which provides principles and guidelines for managing risk. COSO also published an internal control integrated framework in 1992 that is widely recognised as leading guidance for designing, implementing and conducting internal control and assessing its effectiveness. This framework has been adopted by many companies that are subject to the requirements under Section 404 of the US Sarbanes-Oxley Act, which focuses on internal controls over financial reporting.

In 2013, COSO refreshed the internal control framework to (1) address changes in business and operating environments, (2) broaden the application of internal control in addressing operations and reporting objectives and (3) clarify the requirements for determining what constitutes effective internal control. The updated internal control framework sets out principles of effective internal control for each control component, as shown in Figure 2.

Objectives and considerations
According to guidance from the UK Financial Reporting Council, an internal control system
In addition, the UK Financial Reporting Council believes that the internal control system should:

- be embedded in the operations of the company and form part of its culture
- be capable of responding quickly to evolving risks arising due to factors from within and due to external changes
- immediately escalate to appropriate levels of management significant control failings or weaknesses (together with details of corrective action being undertaken).

When the board of directors assesses the internal control system, the following factors should be considered:

- nature and extent of risks
- extent and categories of risk considered acceptable to bear
- likelihood of risks occurring

The system helps ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation.

- The elements help ensure compliance with applicable laws and regulations and with internal policies with respect to the conduct of business.

encompasses the policies, processes, tasks, behaviours and other aspects of a company. Taken together, these elements have the following effects:

- They facilitate a company’s effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieve the company’s objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud and ensuring that liabilities are identified and managed.

- The system helps ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation.

- The elements help ensure compliance with applicable laws and regulations and with internal policies with respect to the conduct of business.

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**Figure 2: Components and principles of effective internal control**

<table>
<thead>
<tr>
<th>Component</th>
<th>Principles</th>
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<tbody>
<tr>
<td>Control Environment</td>
<td>1. Demonstrates commitment to integrity and ethical values</td>
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<tr>
<td></td>
<td>2. Exercises oversight responsibility</td>
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<td></td>
<td>3. Establishes structure, authority and responsibility</td>
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<td></td>
<td>4. Demonstrates commitment to competence</td>
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<td></td>
<td>5. Enforces accountability</td>
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<tr>
<td>Risk Assessment</td>
<td>6. Specifies suitable objectives</td>
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<td></td>
<td>7. Identifies and analyses risk</td>
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<td></td>
<td>8. Assesses fraud risk</td>
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<td></td>
<td>9. Identifies and analyses significant change</td>
</tr>
<tr>
<td>Control Activities</td>
<td>10. Selects and develops control activities</td>
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<tr>
<td></td>
<td>11. Selects and develops general controls over technology</td>
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<td></td>
<td>12. Deploys through policies and procedures</td>
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<tr>
<td>Information and Communication</td>
<td>13. Uses relevant information</td>
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<td></td>
<td>14. Communicates internally</td>
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<tr>
<td></td>
<td>15. Communicates externally</td>
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<tr>
<td>Monitoring Activities</td>
<td>16. Conducts ongoing and/or separate evaluations</td>
</tr>
<tr>
<td></td>
<td>17. Evaluates and communicates deficiencies</td>
</tr>
</tbody>
</table>

*Source: COSO Internal Control – Integrated Framework, 2013*
• ability to reduce and mitigate incidence and impact of risks occurring
• costs of controls relative to benefits in managing the related risks.

The use of a relevant and robust framework helps to provide structure, consistency and a coordinated approach to implement and embed a suitable risk management and internal control system, particularly when the framework defines essential components, suggests a common language and provides clear direction and guidance.

Board of directors and risk oversight
In 2009, COSO published a paper that highlights four areas where the ERM framework contributes to board oversight with regard to enterprise risk management:

(1) Understand the entity’s risk philosophy and concur with the entity’s risk appetite
Risk appetite is the amount of risk, on a broad level, that an organisation is willing to accept in pursuit of stakeholder value. Since boards represent the views and desires of the organisation’s key stakeholders, management should have an active discussion with the board of directors to establish a mutual understanding of the organisation’s overall appetite for risks.

(2) Know the extent to which management has established effective enterprise risk management of the organization
Boards should inquire of management about existing risk management processes and challenge management to demonstrate the effectiveness of those processes in identifying, assessing and managing the organisation’s most significant enterprise-wide risk exposures.

(3) Review the entity’s portfolio of risk and consider it against the entity’s risk appetite
Effective board oversight of risks is contingent on the ability of the board to understand and assess an organization’s strategies with risk exposures. Board agenda time and information packs that integrate strategy and operational initiatives with enterprise-wide risk exposures strengthen the ability of boards to ensure risk exposures are consistent with overall appetite for risk.

(4) Be apprised of the most significant risks and whether management is responding appropriately
Risks are constantly evolving, and the need for robust information is critical. Regular updating by management to boards of key risk indicators is critical to effective board oversight of key risk exposures for the preservation and enhancement of stakeholder value.

Assessing the effectiveness of risk management and internal control
When the board of directors evaluates whether management has adequately fulfilled its responsibilities in designing, operating and monitoring a suitable risk management and internal control system according to board policies, the following questions should be considered.

Risk assessment
• Does the company have clear objectives, and have they been communicated so as to provide effective direction to employees on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?
• Are the significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis? These are likely to include the principal risks identified in the operating and financial review.
• Is there a clear understanding by management and others within the company of what risks are acceptable to the board?

Control environment and control activities
• Does the board have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks?
• Do the company’s culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?
• Does management demonstrate, through its actions, as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the company?
Monitoring

- Do ongoing processes embedded within the company’s overall business operations, and addressed by management, monitor the effective application of the policies, processes and activities related to internal control and risk management? Such processes could include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews and management reviews.

- Do these processes monitor the company’s ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, its business and its external environment?

- Are there effective follow-up procedures to ensure that appropriate change or action occurs in response to changes in risk and control assessments?

- Is there appropriate communication to the board of directors (or the board committees) on the effectiveness of the ongoing monitoring processes on risk and control matters?

- Are there specific arrangements for management monitoring and reporting to the board on risk and control matters of particular importance, such as actual or suspected fraud, other illegal or irregular acts and matters that could adversely affect the company’s reputation or financial position?

Summary

Boards have a duty to ensure an effective risk management and internal control system is in place. This is also a business imperative if their companies are to reap the rewards from successful risk-taking. Adoption of a risk-based approach to establishing a sound system of internal control and reviewing its effectiveness have a key role to play in the management of risks and these are important to the fulfilment of business objectives.
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- Largest consumer IPO in Hong Kong since Chow Tai Fook

Alibaba (2012)
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- The largest privatisation in Hong Kong by market cap; one of the most complex leveraged debt deals in Asia

Bright Food (2012)
- Acquisition of a 60% stake in Weetabix from Lion Capital at an enterprise value of US$1.9bn
- One of the largest ever overseas acquisitions by a Chinese company in the consumer sector

CLP (2012)
- US$982m placing
- Competitive auction process added considerable value in company’s first ECM transaction since 1997

CITIC Securities (2012)
- Acquisition of a 19.9% stake in CLSA for US$310m and granting of a put option for the acquisition of the remaining 80.1% for US$842m
- Largest international acquisition by a Chinese securities firm, set to reshape the industry both in China and globally

Chow Tai Fook (2011)
- US$2bn IPO on Hong Kong Stock Exchange
- One of the largest new consumer listings of 2011; company became the world’s largest listed jewellery retailer

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Image: detail from a silver sycee, Chinese silver bullion, gifted to Anthony de Rothschild in 1910 (The Rothschild Archive)
The adoption and maintenance of high corporate governance standards for publicly listed companies is a key focus for investors, and for the regulators who serve to protect such investors globally. In Hong Kong, however, given that the prevalence of businesses owned and controlled by a founder, family or major shareholder is higher than it is in other jurisdictions, a financial adviser can often play an important role. In many situations, the value of a financial adviser is centred on the proper identification and management of conflicts of interest. Where ownership or control of a company is in the hands of a single or concentrated group of parties, concerns regarding protection of minority investors’ interests may come to the fore, and a financial adviser can play an important role by providing independent advice to ensure that decisions taken are in the best interests of the company and all shareholders, not just a subset of the stakeholders.

In recent years, there have also been mounting concerns about conflicts resulting from the increased range of activities undertaken by many investment firms and banks. This was brought into sharp focus during the fallout from the 2008 financial crisis, which placed the integrated ‘one-stop shop’ investment banking model under particular scrutiny. After the crisis, many companies chose to appoint specialist independent corporate finance advisory firms to work alongside the investment bank both during the initial public offering (IPO) process, and once they had listed.

Financial advisers can offer advice on mergers and acquisitions, debt and equity raising. One of their main responsibilities is the identification and management of conflicts of interest between the market participants involved, such as the issuer, bankers, analysts and investors. They can therefore help a client company maximise value from all parties while acting as an independent sounding board on key decisions.

Failings in governance and the road back

With corporate governance standards and practices continuing to be under scrutiny from regulators and investors alike, some boards have been criticised for failing to fulfil their role of oversight. Directors have a fiduciary duty to act in the best interests of all shareholders, and not on behalf of a significant shareholder or stakeholder interest, or on behalf of themselves. Furthermore, if directors fail to discharge their duties and responsibilities, they may attract civil liability, criminal liability, or both, under Hong Kong law or laws of other jurisdictions. Against this backdrop, boards cannot afford to be seen as compromised and, increasingly, many are turning to financial advisory firms to assist them. This chapter considers some common situations in
which a board may consider it prudent to seek independent financial advice.

The role of a financial adviser in an IPO
Owners of companies seeking an IPO want to maximise the valuation of their business, while institutional investors want to buy those shares at the lowest reasonable price possible. A primary focus of an integrated investment bank appointed as a bookrunner to help sell the shares in an IPO is to achieve the issuer’s objectives. However, because the institutional investors are also clients of the same bank or banks, paying them ongoing fees for their sales and trading services, conflicts may occur despite there being ‘Chinese walls’ in place within the firm.

Financial advisers, who are independent of the bookrunners or underwriting banks, are able to provide much-needed objectivity. This is because they do not cross-sell services, they usually do not lend money, and they typically do not have the same relationship with institutional investors as that of underwriting banks because they have no role in selling the shares to them at or after an IPO. Such an adviser, who is free from the conflicts of interest that the underwriting banks may sometime face, can be perceived as entirely on the side of the issuer and management on every topic. This allows the adviser to work closely with the company, almost becoming a member of the internal team. Furthermore, when the adviser engaged by the company has specific equity capital markets experience (an independent equity adviser), a company can get experienced help with the project management of an IPO process, enabling the management team to continue running the business with the minimum of distraction. Executing an IPO and being a listed company consumes a significant amount of management time, especially because many executives may have had little or no public company experience.

In the past few years, a growing number of transactions, including some of the largest and highest-profile IPOs in Hong Kong and Asia, have used an independent equity adviser.

Valuation
An independent equity adviser’s role includes helping to optimise the valuation not just at the IPO but also in aftermarket trading, given that in most cases the pre-IPO shareholders retain major stakes. Independent equity advisers manage the valuation dialogue so that the issuer has a realistic view of the likely IPO price from the beginning of the process. This view is then refined and updated as the process moves on. They also help the issuer negotiate the valuation with bookrunners and ensure that the valuation feedback received from investors is presented in a clear, frank and accurate manner.

The bookrunner beauty parade
An independent equity adviser can help the management team and shareholders select the bookrunner syndicate by compiling a list of possible candidates based on first-hand knowledge of the market and the research, sales, trading and investment banking capabilities of the major candidate banks. They send out detailed requests for proposals (RFPs) to selected banks and compile detailed reports to compare responses to key selection criteria, as well as drawing up lists of follow-up questions. They advise on putting together an experienced syndicate, drawing up heads of terms and negotiating the fee structure. They analyse the RFP responses and run ‘beauty parades’ in which investment banks pitch to become part of the syndicate.

The logic behind this is that an independent equity adviser is able to provide an objective view. The RFP process is usually viewed by the bookrunning candidates as a fair, transparent and level playing-field on which to compete. It therefore maximises competitive tension and puts the issuer firmly in control of the negotiation of fees and contractual terms in the mandate letter. An independent equity adviser also provides a view to the client as to which lawyers, accountants and third-party experts to appoint. Substantial fee savings can be achieved, with no loss of quality.

Dealing with the documentation
An IPO process is heavily regulated and document intensive, with the prospectus, in particular, often being lengthy and complex. An independent equity adviser helps the issuer to navigate the process and may be asked to assist with management of the prospectus, timetable and certain work streams to alleviate time pressures. When involved
from an early stage of the process, an independent equity adviser can help to identify potential due diligence issues, can help to recognise red flags, and can help the issuer to deal with such issues in a timely and appropriate manner so that they do not affect the overall transaction timetable.

The legal documentation, particularly the underwriting agreement, which is the principal agreement governing the relationship between the issuer and the bookrunners, can be a minefield to negotiate. Given the various competing objectives, there is a risk that the respective parties’ positions become entrenched.

Naturally, bookrunners want to negotiate the most favourable terms and cite market standards and precedent agreements from previous mandates in support of their case. The issuer also wants to negotiate the most favourable terms, but may not have the detailed knowledge of market precedent. Key issues in the underwriting agreement are often not purely legal and require detailed knowledge of the issuer's business and commercial judgement. An experienced independent equity adviser can provide an objective view on current market practice and cite concrete examples from previous deals in which, for example, bookrunners may have agreed to compromise in favour of the issuer.

**Keeping the show on the road**

Once the independent equity adviser has recommended a group of banks to run the process and the syndicate is in place, the adviser works behind the scenes to ensure that the bookrunners remain cohesive and are working together towards the same goal. Some issuers prefer their independent equity adviser to act as the key point of contact with the syndicate to free up the issuer to focus on the flotation. In this way, the adviser keeps the syndicate aligned to solve problems before they reach the client. Other issuers prefer to be fully involved with the adviser at their side.

With the syndicate in place, an independent equity adviser continues to help the issuer by monitoring how banks are marketing the offering, soliciting and evaluating investor feedback, and advising on tactics during the book-building and allocation process.

During the book-building process, an independent equity adviser provides assistance in understanding the full range of pricing options available to the issuer and the implications of each scenario – in particular, the potential impact on aftermarket trading. One of the key objectives of a successful IPO is the formation of a high-quality institutional shareholder base that reacts rationally to developments in terms of trading behaviour.

An independent equity adviser scrutinises the composition of the allocation proposal and analyses the profiles of the investors – requesting changes, if appropriate, and providing colour on the likely composition of the shareholder base.

**Secondary offerings**

After the IPO, a listed company will in certain instances continue to receive independent equity advice. If further sales or issuances of shares are envisaged, vendors or issuers turn to independent equity advisers to manage the process, provide guidance on optimal timing, and manage the syndicate, pricing and allocation. For these types of transactions, independent equity advisers can run confidential competitive auctions amongst bookrunner candidates in order to achieve firm, fixed-price underwriting at an optimal price – and eliminate the risk of leaks.

Issuers wishing to raise further capital by way of a secondary equity offering often turn to an independent equity adviser to recommend the timing and pricing of a placing or rights issue. The independent equity adviser is also consulted on the selection of underwriters, the underwriting fees, and the targeting of specific investors. The adviser can also play an important role in helping to ensure that the fees appropriately reflect the risks that are being run by the underwriters.

Rights issues require bookrunners or underwriters to take firm underwriting risk for a longer period. Banks do not usually welcome this risk unless they are confident that the rights issue will be strongly supported by shareholders, which may have a bearing on pricing and fee levels. An independent equity adviser develops strategies to reduce the probability of this occurring, including techniques such as broadening the underwriting syndicate to include more risk-tolerant banks and spreading the risk into smaller parcels, when conditions suggest this is the best strategy.
The role of the financial adviser  Rothschild

**Mergers and acquisitions (M&A)**

One of the main reasons clients in Hong Kong hire a financial adviser in an M&A deal is to seek unbiased financial advice. Financial advice covers a wide spectrum and has no set formula – it is determined by the parameters of the commercial transaction. Such advice may relate to transaction structure and terms, as well as timing, process, negotiation tactics and financing. It may address, from a financial point of view, whether a transaction is in the best interests of shareholders, and occasionally a client may wish to have an opinion from an adviser on the merits of a particular transaction to support a board decision, or to create an appropriate audit trail.

In addition, independent financial advisers (IFAs) may be required in Hong Kong in certain transactions under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules), such as transactions between a listed issuer and a connected person, and for general offers and privatisation offers under the Code on Takeovers and Mergers (Takeovers Code). In such situations, IFAs are engaged because they are not aligned to a particular interest (be that a board member, shareholder or other stakeholder) or predisposed to any particular outcome.

When an IFA is required by regulation, this adviser is often asked to opine to the independent board committee and the independent shareholders as to whether the terms of a transaction are fair and reasonable, to state whether such a transaction is in the interests of the issuer and its shareholders as a whole, and to make a recommendation as to voting. So as to preserve their independence and ensure no bias in their advice, IFAs are not involved in the structuring of the transaction. However, a separate financial adviser could be, and often is, engaged to assist in planning, structuring, negotiating and guiding clients through every important step and milestone in a transaction.

A separate financial adviser (not the IFA) plays an important role in guiding the offeror or offeree throughout the transaction from both technical and regulatory perspectives. The financial adviser can advise the client on the best way to proceed with an acquisition or a sale process to achieve an optimal outcome, while complying with all relevant legislation and regulations. This adviser could also recommend optimal timing for any announcement or information released in relation to an offer or possible offer, or during an offer period.

**Regulatory environment in Hong Kong**

**The Takeovers Code**

The Takeovers Code, which governs mergers and acquisitions of companies, *inter alia*, listed in Hong Kong and is managed by the Securities and Futures Commission (SFC), imposes certain requirements on the offeror and offeree. The Takeovers Code requires compliance with certain legislation, regulations, rules, and procedures, and a financial adviser who is experienced in such matters helps the offeror or offeree to discharge their duties in relation to these requirements. These may cover, *inter alia*, announcements, formulating an intention to offer, the terms of any such offer, confirming resources to consummate the transaction, participating in discussions and negotiations with relevant parties, compiling and undertaking due diligence on profit forecasts, and conducting due diligence on the financial and business condition of the entities.

The Takeovers Code also requires a board that receives an offer, or is approached with a view to a potential offer, to establish an independent committee of the board and to receive independent advice from an IFA. The IFA’s written advice, including reasons, must also be made known to shareholders by including it in the offeree board circular, along with the recommendations of the independent committee regarding the offer. In such situations, the independence of the IFA is rigorously assessed by the SFC. The onus is on the adviser to establish that it meets the SFC’s criteria.

**The Listing Rules**

When a listed company enters into a transaction with a connected person (as defined in the Listing Rules) or puts forward a spin-off proposal that is subject to independent shareholders’ approval, an IFA must be appointed. Typically, the IFA undertakes the required work and presents conclusions and recommendations to the independent board committee and shareholders.
Conclusions of interest have been a major driver in the global trend towards using independent advisers. Senior executives and boards are demanding higher standards around conflict management, and regulators and the market are turning the spotlight on the record of boards and sometimes singling out non-executives for impartiality and strong oversight.

Some companies feel they can make their own judgements, but they are increasingly choosing to appoint an independent adviser to help steer a course through the twists and turns of a transaction.

Voluntary circumstances
A client may retain a financial adviser to give advice voluntarily. In these circumstances, the adviser undertakes detailed valuation work and analysis and provides the client with its conclusions. These could be delivered in various forms, such as a presentation to the management or board that sets out the principal decisions made regarding the data, methodologies, and analyses, including qualifications or assumptions. Examples of when voluntary financial advice may be sought include the following scenarios involving actual or potential conflicts of interest:

- Chief executive wants to bid for the company
- Controlling shareholder wants to take a company private (delist)
- Controlling shareholder wants to spin off a part, or parts, of the company
- Controlling shareholder wants to restructure the company and its subsidiaries (public and private)
- Private equity firm wants to take a company private and offer roles to management
- Significant shareholder wishes the company to buy a private company that the shareholder owns
- Parent company wishes to demerge a public company subsidiary, after paying a special dividend to the parent company
- Acquirer wants to offer different consideration to different constituencies (not permitted under the Takeovers Code, but potentially applicable to private companies or in different jurisdictions)
- Government is a long-term owner or majority shareholder and is selling its stake or preparing to float.

The circular to shareholders, containing the letter from the IFA, sets out the reasons for the key assumptions made, and the factors taken into consideration in forming the recommendation that the terms of the transaction or proposal are, or are not, fair and reasonable and that such a transaction or proposal is, or is not, in the interests of the company and its shareholders. The recommendation with regards to voting from both the independent board committee and the IFA is also disclosed.
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Directors frequently encounter actual and potential conflicts in performing their roles. Improper handling of conflicts is one of the most common breaches of corporate governance, exposing the company and its directors to potential civil and criminal liabilities. Since most problems arising from directors’ conflicts can be mitigated or rectified if intervention occurs at an early stage, it is in the company’s interest to manage directors’ conflicts proactively.

This chapter focuses on conflicts faced by directors of Hong Kong-listed companies and covers the applicable legal standards, common scenarios in which conflicts arise, and methods to prevent or minimise the adverse impact of conflicts.

Duties of directors
To handle conflicts of interest properly, a director needs to satisfy both the internal and external standards applicable to the matter. Internal standards include the requirements set out in the company’s constitutional documents and corporate governance guidelines and in the director’s service contract. External standards include the requirements of the jurisdiction(s) in which the company is incorporated and where the shares of the company are listed, and the venue and governing law of the matter.

Although the external standards outlined below are centred on the Hong Kong requirements (including the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules)), in most cases the applicable standards are the product of requirements from different jurisdictions. By way of example, when a Cayman Island company with shares listed on the Hong Kong Stock Exchange conducts a share placement in the United States and one of the share places is affiliated with the company’s chairman, the chairman needs to consider his fiduciary duties under the laws of the Cayman Island; his disclosure duties as a controlling person of the company under US securities laws; and the disclosure and procedural requirements under the Listing Rules.

Common law
Under Hong Kong common law, directors’ duties to the company consist of two types: the duty of care, skill and diligence and fiduciary duties. The duty of care, skill and diligence is derived from tort principles and requires directors to satisfy certain standards in performing their roles. In contrast, fiduciary duties are derived from equitable principles and require directors to act in the best interest of the company. Common law does not distinguish between executive directors, non-executive directors and independent non-executive directors.
In the context of directors’ conflicts, fiduciary duties are the most relevant under common law and require a director of a Hong Kong company to:

- avoid putting himself in a situation in which his personal interest conflicts with the interests of the company
- act honestly and in good faith in the best interest of the company and its shareholders
- exercise his power as a director for a proper purpose.

The standard of care, skill and diligence is also relevant because it establishes how disinterested directors should act in identifying and resolving situations in which another director is conflicted. Under Hong Kong common law, the standard of care, skill and diligence is an objective one: a director is required to exercise only such skill as is reasonably expected from a person with similar knowledge and experience.

Statutory law
In the context of directors’ conflicts, the most relevant statutory duties are imposed by the Companies Ordinance and require a director of a Hong Kong company:

- to disclose to the board of directors if he has an interest in a material contract proposed to be entered into by the company
- not to borrow from the company or have the company provide other kinds of financial support, such as acting as a guarantor or providing assets as security for a personal loan, unless the financing support falls within the narrow exceptions in the statute.

The new Companies Ordinance that became effective in Hong Kong on 3 March 2014, has two further implications on directors’ statutory duties in the context of conflicts. First, the objective test for the duty of care, skill and diligence under Hong Kong common law has been replaced by a two-limbed objective/subjective statutory test, such that the objective standard will apply in all cases and will then be subjectively adjusted upward if the director possesses special knowledge, skill and experience. Second, directors have an affirmative statutory obligation to disclose to the company any transaction that they have proposed or entered into if the transaction is significant to the company’s business.

The Listing Rules
In the context of directors’ conflicts, Listing Rule 3.08 is most relevant and requires a director of a Hong Kong-listed company to:

- act honestly and in good faith in the interests of the company as a whole, act for a proper purpose, and avoid actual and potential conflicts of interests and duties (analogous to the fiduciary duties under the Hong Kong common law)
- disclose fully and fairly interests in contracts with the company (analogous to the statutory duty under the Companies Ordinance)
- exercise reasonable care, skill and diligence that would be expected of a reasonably diligent person with general or similar knowledge, skill and experience (analogous to the duty of care, skill and diligence under the Hong Kong common law, except that the objective standard applies, which means the director must exercise the reasonable care, skill and diligence that would be exercised by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same function as the relevant director).

Although the Listing Rules do not have the force of law, a breach of the Listing Rules could result in the forced retirement of the director from the company, the imposition of other sanctions on the director and the company, as well as a cancellation or suspension of the company’s listing.

The Corporate Governance Code contained in Appendix 14 of the Listing Rules provides further guidance on the role, leadership, appointment, responsibilities and remuneration of directors. Under the Corporate Governance Code, non-executive directors are expected to take the lead where potential conflicts of interests arise and to manage conflicts proactively by participating, as members of audit and remuneration committees, in the establishment and implementation of a whistle-blowing policy and a remuneration policy for the company and the conduct of investigations.
on internal control matters. Although non-compliance with the Corporate Governance Code does not constitute a breach of the Listing Rules, any deviation from the code provisions must be disclosed by the company.

Industry guidelines
Directors are expected to be familiar with the general duties outlined in ‘A Guide on Directors’ Duties’ published by the Companies Registry, as well as the ‘Guidelines for Directors’ and the ‘Guide for Independent Non-executive Directors’ published by the Hong Kong Institute of Directors (HKIOD). In the context of directors’ conflicts, these guidelines require a director to refuse any benefit conferred by a third party in reward for his exercise of powers as a director. Although the principles set out in these guidelines are not mandatory, they would be taken into account by the courts in assessing whether a director has met the requisite standard of skill and care in the discharge of his duties.

Comparison with the UK approach
Part 10 of the UK Companies Act of 2006 codifies the standards of directors’ duties, including the duty of care, skill and diligence; the duty to avoid conflicts; and the duty not to exploit the position for personal benefit.

Although the duty of care, skill and due diligence has now been codified in the new Companies Ordinance, two key aspects of the codified fiduciary duties in the UK are not included in the existing Hong Kong requirements (including the Listing Rules) and will not be included in the new Companies Ordinance: corporate opportunities and benefits from third parties. As a result, the standards expected of a director in such circumstances will continue to be governed by common law.

Conflicts typically encountered by directors
Proper identification and handling of conflicts are important from the perspective of directors in their personal capacity. Directors who are in breach of their duties may incur civil and criminal liabilities and be subject to regulatory sanctions, including reprimand, disqualification order, fine and imprisonment. Sometimes a breach of directors’ duties arises not from a flagrant disregard of the requirements but from an inadvertent failure to identify and respond to a conflict scenario promptly. This section describes scenarios in which conflicts are typically encountered and explains how the relevant standards apply to these scenarios.

Connected transactions
The Listing Rules contain detailed procedural and disclosure requirements on transactions between a company and its ‘connected persons’, which are broadly defined as the directors, significant shareholders of the company and their respective affiliated entities, amongst many others. These requirements are determined by reference to specific thresholds and are designed to provide a ‘check and balance’ effect.

A director who structures a connected transaction aiming for a particular outcome under the Listing Rules may be in breach of his duty to act in the best interests of the company and its shareholders. A fellow director who fails to identify the motivation behind the structure may also be in breach of the duty to exercise diligence. The practice also increases the risk of non-compliance with the Listing Rules.

Placement of equity securities
Under the Listing Rules, shareholders may delegate to the board of directors a general mandate to issue additional equity securities on a non-preemptive basis within certain limits, so that the listed company can finance its operations and growth efficiently by capturing market opportunities on a timely basis.

Placement of equity securities under a general mandate is often made to institutional investors through agents. Such placements could offer additional working capital for management and enable an investor who is not a connected person to increase its influence over the management of the company, but it may not be the right business strategy for a company to pursue. A director who supports a placement without the benefit of an independent market assessment and a company-specific evaluation may be in breach of the duty of skill, care and diligence.

Board composition
The constitutional documents of the company often give directors the power to appoint additional or replacement directors to serve on
the board until the next annual shareholders’ meeting. A director may be in breach of the duty to act in good faith for the company’s benefit if the decision to change the board’s composition is motivated by a desire to consolidate power.

In one example, the board of directors of a listed company appointed several new directors less than 24 hours before a special shareholders’ meeting convened for the election of directors. The shareholders refused to recognise the legitimacy of the newly appointed directors and proceeded at the shareholders’ meeting to elect additional directors, thereby exceeding the quota of directors contained in the company’s constitutional documents. This created two purported boards of directors, each in denial of the legitimacy of the other. The operation of the company was crippled, and trading in its shares was suspended. The appointments made by the board of directors were subsequently found to be invalid because they were made for an ulterior motive.

**Director remuneration**

A conflict may arise in relation to director remuneration issues. The conflict can be managed partly through different procedural requirements. First, the Listing Rules require that the board of directors establish a remuneration committee, chaired by an independent non-executive director and comprising a majority of independent non-executive directors, to set or approve directors’ remuneration. Second, the Code of Corporate Governance stipulates that the remuneration committee should establish a formal and transparent procedure for developing the remuneration policy. Third, the Listing Rules require that non-customary arrangements in a director’s service agreement, such as ‘golden parachute’ payments and loans to directors, be approved by disinterested shareholders.

Indemnification of directors and directors’ liability insurance are issues that pose specific concerns. Some of the conflicts in these areas are managed by statute. Section 165 of the old Companies Ordinance provides that a company may not indemnify its directors for liability to the company or its related companies but is otherwise silent on whether liability to third parties may be indemnified, although the company may purchase insurance for its directors to cover any liability owed by them to the company, its related companies and third parties. This means the scope of a director’s indemnification right under such circumstances is often uncertain, with outcomes dependent on the company’s jurisdiction of incorporation, contract provisions and common law. For instance, in a decision of the Hong Kong Court of Appeal, a director of a Bermuda company was prevented from relying on the indemnity provisions contained in the company’s bylaws in an action against her for liability to the company on the basis that she was not privy to the constitutional documents of the company and the indemnity provisions contained in those bylaws could not be construed to be implied in the director’s terms of engagement. Although section 165 was held to be inapplicable, the director was prevented from relying on a separate deed of release and indemnity delivered by the company for her benefit on the basis that the deed covered only liability to third parties.

The new Companies Ordinance expressly allows a company to indemnify its directors for liability owed to third parties and for costs and expenses related thereto, such as legal fees in defending a lawsuit, subject to limited exceptions. The new Companies Ordinance also continues to allow the company to purchase insurance coverage.

**Corporate opportunity**

Directors may encounter business opportunities that might be of interest to the listed company. A director who elects to pursue such an opportunity (either directly or indirectly through other companies in which he is a shareholder, director or officer) without disclosing the opportunity to the board of directors may be in breach of the duty to act honestly for the company’s best interests. The director may also be held accountable to the company for the profits generated from this opportunity.

**Benefits from third parties**

Gifts or other benefits given to directors by third parties as part of their marketing efforts may compromise the director’s ability to exercise impartial judgement in evaluating dealings between the company and such third parties. A director may breach his duty to avoid conflicts
if he knows, or has reason to know, that gifts or benefits bestowed on him are motivated by a desire to do business with the company.

**Confidential information**

In the course of performing their duties, directors frequently have access to confidential information about the listed company, such as acquisition plans. If a director shares such information with any person for pecuniary or other gain, a director may breach his duty to act honestly in the best interest of the company. It may also result in a breach of the director’s service agreement, an infringement of the company’s internal policies and a violation of securities laws (in particular, insider dealing offences).

**Managing conflicts**

It is important that a company properly manage directors’ conflicts for a number of reasons. First, rumours of internal crises could affect the company’s routine operations and trading in its shares. Second, allegations of serious management misconduct may trigger a stock exchange or regulatory investigation, potentially resulting in a trading suspension and other civil and criminal sanctions. Third, although shareholders’ lawsuits are relatively uncommon and class actions are unavailable in Hong Kong, the company has a strong economic incentive to minimise the probability of litigation. Finally, a listed company has a long-term interest in developing and maintaining a reputation in the investment community as a professionally managed company operating with high standards of corporate governance and respectful of minority shareholders’ rights.

This section discusses how directors’ conflicts can be managed through good corporate governance. The goal is to have a transparent framework so that conflicts can be handled impartially with minimal discretion.

**Building a framework**

The company should have a written policy governing the management of directors’ conflicts. The policy could, among other things:

- require directors to disclose and periodically update the company in relation to actual or potential conflicts (such as by completing a director’s questionnaire and affirming the contents contained therein annually)
- consolidate all applicable internal and external requirements (eg those standards contained in the constitutional documents of the company, the Listing Rules, the various industry guidelines mentioned above and the Companies Ordinance) into a single set of guidelines for easy reference
- require an interested director to declare his interests on any relevant transactions before each board meeting and refrain from voting on such transactions
- translate some of the more abstract standards under the common law into well-defined thresholds so that directors need not exercise personal judgment in ambiguous situations. For example, the company could require a director to refuse gifts from third parties with a fair market value in excess of a specified dollar amount and limit the roles a director may assume in other entities unless the director has obtained prior written consent from the disinterested directors.

A clearly worded policy that is well understood and followed by directors should offer certainty and comfort to directors and shareholders alike.

**Identifying conflicts of interest**

Compliance with the written policy must be monitored regularly, and breaches of the policy must be rectified. When allocating resources to a particular matter, the company should be mindful of the likelihood of conflicts arising and the gravity of mishandling them. In situations where the risk is high, the company may want to implement supplemental guidelines or seek specific declarations from directors as to their potential interests. Examples of risky situations include:

- Change of control – conflicts may arise because a director is a significant shareholder of the company or a director, officer or significant shareholder of another company that is capable of exerting significant influence, through voting control or otherwise, over the management of the company.
- Change in business plan – conflicts may arise when the company is evaluating whether to
Managing directors’ conflicts

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develop a new product line or implement extensive cost-cutting measures, but a director is associated with one or more of the company’s suppliers, customers, competitors or distributors.

• Potential acquisition or capital raising – conflicts may arise because a director is associated with one or more of the company’s bankers or professional advisers or is an officer in an investment bank, private equity fund, or hedge fund that takes material positions in securities.

Handling conflicts

Having identified a situation in which a conflict may arise, management must ensure that a director whose independent judgment may be affected by a personal interest in the subject matter does not have the power to decide on the company’s behalf. To mitigate issues arising from directors’ conflicts, the company may have to:

• Delegate the subject matter to an independent committee comprising disinterested directors – examples include a privatisation proposal made by a significant shareholder of the company. The committee should be given the power to retain financial and legal advisors to assist them on the subject matter.

• Defer the subject matter to disinterested shareholders following full disclosure – examples include the company’s purchase of a business from its controlling shareholder. Adequate information, such as valuation reports and fairness opinions, should be provided to enable shareholders to make an informed decision.

• Present an improper exercise of power to shareholders for ratification – examples include a joint venture project in which one or more directors had an indirect interest that was not disclosed initially. Hong Kong courts generally do not interfere with ratification of breaches by shareholders, although ratification cannot cure a regulatory violation caused by the conflict.

Investigating conflicts

Many allegations of directors’ conflicts are made by employees. Others are made in response to queries from the Hong Kong Stock Exchange or the Securities and Futures Commission (which in turn are often prompted by informants linked to the company), or in derivative actions (in common law or under the Companies Ordinance) against the company and the relevant directors.

Disinterested directors should remain vigilant in handling such an allegation. If they do not act appropriately, they may also put themselves in breach of their duties, giving rise to another conflict situation caused by their inability to deal with the earlier conflict.

The company may in response initiate an internal investigation. An investigation into directors’ conflicts is typically conducted by an independent committee whose work is supported by external professional advisers. In this situation, management should:

• act honestly to restore market confidence in the company
• promptly disclose material information uncovered in the investigation as part of the company’s duty to inform shareholders
• adequately address the concerns and inquiries of market regulators
• deal with actual or potential claims against the company
• strengthen the company’s corporate governance so that similar mistakes are not repeated.

Independent investigations are often costly and time consuming. Management should seek to minimise disruption to the company’s normal operations without compromising the principles outlined above. It should also focus on preserving the privileged status of any internal legal memoranda and other analyses with professional third parties, such as forensic accountants.

Conclusion

A failure to identify and resolve directors’ conflicts in a timely manner is a classic scenario for shareholder litigation and regulatory investigations. The number and frequency of such actions have increased in recent years as shareholders and regulators increase their scrutiny on corporate governance and demand more accountability from directors. Shareholder litigation and regulatory investigations are often lengthy, costly and distracting for the company and expose the
company to significant risk of economic and reputational loss.

Most problems associated with directors’ conflicts can be mitigated if the conflict is identified early. It is in the company’s interest to develop an effective internal framework so that directors can understand the fiduciary duties expected of them and tackle conflicts with a clear set of procedural and substantive rules in mind. Such a framework will enable the company to identify potential conflict situations and minimise any problems arising from such situations.
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瑞生致力于在全世界范围内与客户合作，协助他们实现业务目标并克服法律上的挑战。凭借遍布世界各主要金融、商业和监管中心的办事处构建起的全球化平台，瑞生的律师与客户携手迈向成功。在北京、香港、上海、新加坡和东京，我们屡获殊荣的亚洲团队拥有全球化的敏锐触觉和对当地市场的深入了解，长期处理区域内最大型、最复杂的交易。
Relying, timely and readily accessible information for investors has always been the key to a fair and informed market and a benchmark of good corporate governance. On the flipside, a fair market needs to safeguard the listed corporation’s legitimate interests in allowing certain information to be kept confidential to facilitate the corporation’s business and operations. Jurisdictions across the world have taken different regulatory approaches towards striking that fine balance. Hong Kong has adopted a twin approach by imposing a general obligation on listed companies to disclose material information, in addition to the specific disclosure requirements for certain types of events.

Effective from 1 January 2013, the disclosure regime for Hong Kong-listed companies was codified under Part XIVA of the Securities and Futures Ordinance (SFO). The disclosure regime was previously governed by the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (Listing Rules) and did not have the force of law. Hong Kong-listed corporations are now required by law to disclose inside information. Failure to do so may attract civil sanctions.

In light of this situation, new trends relating to the timing and content of disclosure are emerging in the Hong Kong market. To give one example, the total number of corporate announcements about inside information issued by listed companies in 2013 had significantly increased, by 52 per cent, relative to 2012, and the number of profit alerts and warnings increased by 16 per cent in the same period. This occurred even though the number of listed companies only increased by 6.2 per cent that year, from 1,547 to 1,643. One explanation for this is the increased awareness of the requirements for timely disclosure amongst market participants under the new statutory disclosure regime.

In this chapter, we look at the legal framework in Hong Kong governing the disclosure of inside information and provide practical suggestions for listed companies to handle and appropriately disclose information. We also examine past cases in which listed companies have been found to be in breach of the old disclosure regime, analysing what went wrong and the lessons to be learnt.

Legal framework on disclosure of inside information

Previously, the information disclosure requirements for Hong Kong-listed corporations were contained in the Listing Rules and were enforced by the Stock Exchange of Hong Kong (SEHK). Following a legislative consultation process, some material information disclosure requirements were codified and replaced by Part XIVA of the SFO.

Old regime under the Listing Rules

The material information disclosure regime under the old Rule 13.09 of the Listing Rules required listed companies to disclose, as soon as
reasonably practicable, information that (1) is necessary to enable shareholders and the public to appraise its position; (2) is necessary to avoid the establishment of a false market in its securities; or (3) might be reasonably expected to materially affect the price and market activity in its securities. Such information was commonly referred to as price-sensitive information. The requirements under the old regime did not have the force of law and lacked regulatory teeth. The SEHK was responsible for imposing disciplinary sanctions in the event of breaches, which included requiring the relevant listed issuer to undertake remedial action, censuring or reprimanding the issuer publicly or privately or reporting the corporation or any of its offices to a regulatory or professional body, suspending trading of its securities, or cancelling its listing status.

New statutory regime under Part XIVA of the SFO
The new regime was introduced to create formal statutory obligations to disclose ‘inside information’, cultivating a continuous disclosure culture amongst listed corporations, enhancing market transparency and quality and sustaining Hong Kong’s position as China’s global financial centre and premier capital-formation centre. The codification also brings Hong Kong’s regulatory regime more in line with other major overseas jurisdictions.

Inside information, as defined under the SFO, consists of three key elements:

- the information is specific about the listed company, a shareholder, an officer, the listed securities or the derivatives of the listed company
- the information is not generally known to the market, and
- the information is likely to have a material effect on the price of the listed securities.

Specific information
Specific information refers to information that is capable of being identified, defined and unequivocally expressed. In 2004, the Insider Dealing Tribunal (IDT) confirmed in the Firstone International Holdings Limited case that specific information should contain sufficient particulars of an existing or proposed transaction, event or matter, allowing it to be identified and its nature to be coherently understood. For example, contemplation of a forthcoming share placing by a listed company may be specific even if the details are not known, so long as there is substantial commercial reality to it. In the Asia Orient Holdings case in 2006, it was explained that while the information may not necessarily be precise, it must be more than mere rumours, vague hopes or unsubstantiated conjectures.

Information not generally known to the market
According to the Hanny Holdings Limited case, the market refers to persons who are accustomed or would be likely to deal in the listed securities of the listed company and includes professional dealers and investors. It was noted in the Public International Investments Limited case that the market also includes small, unsophisticated investors. The existence of rumours or media speculation as to a set of events does not mean that the information is generally known to the market. Listed companies should consider how widely the information has been disseminated, the accuracy and completeness of the information disseminated and the reliance that the market can place on such information. If the information in the market is materially incomplete or there are doubts as to its legitimacy, such information is considered not generally known and the listed company will not have to make full disclosure. In practice, the only certain way to establish that information relating to an issuer is generally known in the market is the issuance of an announcement by the issuer itself in respect of that information. Therefore, if information is specific and is likely to have a material effect on the share price (the other key elements of the definition of inside information outlined earlier), the listed company is generally urged to disclose such information in compliance with Part XIVA of the SFO.

Information likely to materially affect the listed securities’ price
Companies also need to consider whether the information is more or less likely to cause a material change in the price of the listed securities. According to the Securities and Futures Commission (SFC)’s Guidelines on Disclosure of
Inside Information (SFC Guidelines), published in June 2012, listed companies should take into account the following factors when considering whether the information is sufficiently material: (1) the anticipated magnitude of the event in the context of the totality of the listed company’s activities, (2) the relevance of the information with regard to the main determinants of the price of the listed securities, (3) the reliability of the source and (4) the market variables that affect the price of the listed securities.

Timing of disclosure
Under the new regime, a listed company must disclose to the public as soon as reasonably practicable after inside information has come to its knowledge. Inside information is considered to have come to the listed company’s knowledge if the information has, or should reasonably have, come to the knowledge of an officer of the listed company (i.e., a director, manager, secretary or other high-level individual involved in the management of the listed company) in the course of performing functions as an officer and if a reasonable person, acting as an officer of the listed company, would consider it to be inside information. Listed companies should immediately take all steps necessary to disclose the information to the public unless the information falls within the safe harbours provided in the SFO.

Safe harbours
The SFO has provided five safe harbours that allow companies listed in Hong Kong to delay or withhold the disclosure of inside information: (1) information prohibited from disclosure by a Hong Kong court or under Hong Kong statutes, (2) information concerning an incomplete proposal or negotiation, (3) trade secrets, (4) information concerning the provision of liquidity support from the Exchange Fund or from an institution that performs the functions of a central bank to the listed companies or (5) where the SFC has waived the disclosure requirements. To rely on safe harbours 2 to 5, listed companies must have taken reasonable precautions to preserve and have actually maintained confidentiality. If information is leaked or confidentiality is no longer maintained, the listed company should disclose the information as soon as reasonably practicable after the leak.

Breach
Failure to disclose inside information as required under the SFO, including non-disclosure, late disclosure, false or misleading disclosure or omission of a material fact, can constitute a breach by the listed company. Directors, chief executives and other officers may also be liable if a breach is the result of their intentional, reckless or negligent conduct or if all reasonable measures to ensure that proper safeguards exist to prevent breaches have not been taken.

Consequences of breach
Under the new regime, the SFC is empowered to investigate suspected breaches of the statutory requirements. In addition, the Market Misconduct Tribunal (MMT) has the power to impose a wider range of civil sanctions for any breaches. In addition to the sanctions that could have been imposed under the Listing Rule regime, listed companies, and each of their directors and chief executives, may be fined up to HK$8 million and be required to pay related costs. Officers may also be disqualified from being a director or otherwise involved in the management of listed companies for up to five years. Furthermore, any person who has suffered pecuniary loss as a result of the breach by the officer may, for the first time, be able to claim compensation from the officer in question.

To facilitate the transition into the new regime, in addition to the SFC Guidelines, the SFC also issued a set of frequently asked questions (FAQs) to provide further guidance. Since the concept of inside information is identical to that of ‘relevant information’ for insider dealing under the SFO, past decisions of the MMT and the IDT on the interpretation of the term relevant information may also offer guidance towards understanding the term inside information.

Since 1 December 2012, the SFC has also provided a consultation service, for an initial period of two years, to assist Hong Kong-listed corporations in understanding how to apply the disclosure provisions. The SFC envisaged that most questions would relate to the application of the safe harbours, as opposed to the determination...
of whether certain information may be inside information, for which the listed corporation should be best placed to make a judgment.

**Prohibitions on dealing when in possession of inside information**

The Model Code for Securities Transactions by the Directors of Listed Issuers, which is found in Appendix 10 of the Listing Rules, contains prohibitions on directors dealing in any of the listed companies’ securities when those directors possess related inside information. Directors are also required to obtain clearance from the chairman of the board prior to any dealing.

Under the SFO, a person may commit an offence of insider dealing if that person obtains inside information of a listed company and deals in listed securities of that company, a related company or their derivatives; counsels or procures another person to engage in such dealings; or discloses the inside information to another person while knowing or having reasonable cause to believe that the person will so deal. A person found guilty of insider dealing (or another form of market misconduct, as defined under the SFO) may be subject to both criminal and civil liabilities.

**Practical suggestions for handling and disclosing inside information**

Listed corporations and their officers are encouraged to take proactive roles in protecting themselves and ensuring full compliance with the new disclosure regime. First, they should familiarise themselves with the new Part XIVA of the SFO, which should be read in conjunction with the SFC Guidelines and FAQs. It is also important for the listed corporations to establish an effective and structured internal monitoring, control and reporting system to identify potential inside information and for steps to be taken promptly when such information is identified.

**Day-to-day systems**

A listed company should develop a written compliance manual and provide complementary training to directors, officers and employees. In developing its internal systems and disclosure procedures, the board should take into account the particular needs and circumstances of the corporation. The SFC Guidelines give a non-exhaustive list of examples of reasonable measures that should be considered when establishing systems and procedures, which include:

- establishing controls for monitoring key business and corporate developments
- having controls for monitoring key financial and operating data
- keeping a list of sensitive factors to identify potential inside information
- authorising an officer, officers or an internal committee to be notified of material information and to escalate information to the board
- restricting inside information to employees on a need-to-know basis
- ensuring confidentiality agreements are in place with negotiating parties
- designating executives to handle media questions
- developing procedures for meeting with analysts or the media
- developing procedures to handle rumours, leaks and inadvertent disclosures.

In practice, employees at all levels of the organisation should be aware of and involved in monitoring and handling inside information. Each department should have designated persons to highlight potential inside information, such as finance team members who may notice significant changes in the latest management accounts, or business team members at the outset of a major transaction. Details about this potential inside information should then be passed on to a disclosure committee for further consideration.

The disclosure committee, which may comprise representatives from the business, finance, legal and compliance functions, would be in charge of deciding what constitutes inside information and would liaise with the board to make recommendations regarding details and timing of disclosure. The committee members should also ensure that an updated insider list (a comprehensive list of all company staff who have access to such inside information) is maintained and ensure that persons on the insider list are aware of their confidentiality obligations until such information is disclosed. The board of directors serves as the final approval authority and should
review and approve all announcements before they are released. A compliance officer should be tasked with ensuring that the company and its officers comply with all legal and regulatory requirements, as well as monitoring compliance with the company’s internal policies.

Once certain information has been determined to be inside information that requires disclosure, an announcement should be prepared. This should be reviewed by the disclosure committee for compliance with all relevant disclosure requirements. The corporate communications department should also ensure that the contents of the announcement effectively and clearly communicates the intended message. Third-party advisers, including lawyers, financial advisers or accountants, may also need to be consulted. The announcement should be published through the SEHK’s eSubmission system. This procedure should be sufficiently streamlined so that an announcement can be made swiftly after the initial board decision to disclose.

Listed corporations should also regularly review their existing procedures for dealing with possible SFC investigations. Furthermore, they should check their insurance policies to ensure the policy provides sufficient coverage of the corporations and their officers for the potential liabilities under the new disclosure regime. Finally, listed corporations are encouraged to take advantage of the SFC consultation service while it remains available.

**Additional monitoring systems for transactional activities**

Inside information considerations become particularly relevant when a listed company contemplates an M&A or capital markets transaction. Other parties involved in such transactions also need to be aware of the inside information implications for the listed company. This extends beyond the advisers engaged by the listed company. The practice of pre-sounding, which involves discussions with investors to gauge their interest in a potential transaction, also leads to such investors possessing inside information.

A Hong Kong-listed company should also ensure that its third-party advisers keep all inside information confidential. Such advisers should in turn maintain robust systems to preserve confidentiality for the listed company and limit the sharing of such information unless strictly necessary.

**Recent examples of breaches of disclosure requirements**

Although at the time of writing there have not been any public instances of the SFC taking enforcement action against listed companies for breaches of the new Part XIVA, we summarise below two instances in which listed companies have breached the former Listing Rule disclosure regime and examine the lessons to be learnt from these cases.

**Ausnutria Dairy Corporation Limited**

The first example involves the common question of when a profit warning should be issued. Ausnutria’s financial performance significantly deteriorated in the second half of 2010, which was reflected in the monthly management accounts of its main subsidiary. However, Ausnutria only published a profit warning announcement in February 2011.

The Listing Committee found that Ausnutria was in breach of the old Rule 13.09 of the Listing Rules, determining that the disclosure obligations had arisen as early as the board’s receipt of the August 2010 management accounts. The committee also found that the publication of the profit warning announcement in February 2011 was not disclosure made ‘as soon as reasonably practicable’ or ‘without delay,’ as required under the Listing Rules. As a result, the committee members imposed a range of sanctions, including (1) censure of Ausnutria and its chief executive officer, (2) criticism of the executive directors, (3) resumption of trading in Ausnutria’s shares subject to various conditions (including the publication of outstanding financial results), (4) appointment of a compliance adviser and (5) mandatory training for Ausnutria’s directors.

**The failure to issue profit warnings in a timely manner is one of the most frequent breaches of disclosure obligations and has been one of the most common grounds for enforcement by the regulators.** An entire section within the SFC Guidelines has been dedicated to management accounts to highlight when information in management accounts may constitute inside
information. Typically, some considerations listed companies face when deciding whether a profit warning is necessary include deciding whether the performance reflected by the interim financials is sufficiently poor to merit disclosure and deciding whether management expects performance to improve in the near future (thus smoothing out poor performance of the previous month or months). Both decisions are inherently subjective and speculative. While the new law does not spell out a set formula for when profit warnings should be issued — this remains a matter for listed companies’ discretion — management is advised to be particularly vigilant as to when such disclosure obligations may arise.

**Pearl Oriental Oil Limited**

Pearl Oriental’s shares were suspended on 9 December 2009 pending the release of an announcement regarding a share placing. Between 9 and 11 December 2009, Pearl Oriental entered into a number of agreements regarding the initial placing of 115,680,000 shares. On Friday 11 December 2009, Pearl Oriental approved the announcement regarding the initial placing, which was published on 13 December 2009, and requested for trading to resume the next day, Monday 14 December 2009. However, during the weekend, Pearl Oriental agreed to place a further 115 million shares, yet it only made an announcement regarding the further placing on Monday evening, after the publication of the first announcement the day before and after trading had resumed on the Monday morning.

The SEHK held that the first announcement on Sunday 13 December 2009 was incomplete in a material respect and misleading; that Pearl Oriental was in breach of its disclosure obligations, which arose upon signing of the agreements for the further placing; and that Pearl Oriental should have requested a further suspension in trading before the announcement regarding the further placing. Although the SEHK considered that there had been no evidence of intention by Pearl Oriental and its directors to mislead the market, sanctions were still imposed, including (1) public statements criticising Pearl Oriental and its directors, (2) appointment of a compliance adviser and (3) mandatory training for Pearl Oriental’s directors.

**Conclusion**

Prompt and full disclosure is an area regulators are, and increasingly will be, concerned with in Hong Kong. Listed companies and their officers are strongly advised to familiarise themselves with the new statutory requirements on the disclosure of inside information. They should also review their internal control procedures to ensure prompt identification and handling of inside information and, where necessary, consult with external legal counsel or the SFC. Effective disclosure not only helps keep listed companies in the regulators’ good books but also provides investors with evidence of the company’s good corporate governance practices.
Do you know the rules of this game? We do.

Every move on the chessboard can alter the outcome of the game. You need to know the rules, but more importantly you need experience and knowledge to win the game.

With corporate governance and anti-corruption issues on the rise, you need a team that not only has the legal skills but also an in-depth understanding of the global regulations companies need to comply with. Through the strength of our leading global regulatory network, our team can advise you on all types of corporate governance matters, from bribery to anti-corruption, wherever these issues arise.

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This chapter discusses the anti-bribery and anti-corruption laws in Hong Kong, the US and the UK, and it provides practical advice to ensure compliance with these laws. Since 2004, regulatory investigations and prosecutions have markedly increased, causing major crises for companies whose operations span continents and cross borders. For some well-established institutions, the financial fallout that can occur if the rules are bent – even slightly – can be brutal. It is increasingly clear that global corporations and their employees need to pay particular attention to all anti-corruption laws that may be applicable to their operations if they are to avoid the pitfalls of bribery and corruption and the almost inevitable ensuing financial calamity.

An anti-corruption compliance programme that is comprehensive, accessible and equally applicable to all employees and company representatives is an essential component of a company’s anti-bribery and anti-corruption toolkit. These days, best business practices and the highest standards of corporate governance demand effective compliance with anti-corruption policies on a global scale, as well as constant monitoring of compliance with those policies once implemented. It is foolhardy to ignore the perils of non-compliance with anti-corruption laws.

Effective anti-corruption compliance practices for Asia-Pacific companies
As the global and regulatory focus on corruption, national security threats and financial and corporate fraud intensifies, having an effective anti-corruption compliance and ethics programme has never been more important for companies. The extraterritorial reach of the anti-bribery laws of the US, UK and Hong Kong extends to Asia-Pacific companies and their employees. Recent investigations and prosecutions by US and UK law enforcement authorities also demonstrate that corruption allegations can ruin a company’s reputation, destroy its financial standing and cause great personal concern to individual employees, particularly if criminal charges are filed.

Companies can no longer cling to old business models of compliance and outdated practices related to anti-corruption. The costs of non-compliance with anti-corruption laws may include not only fines and other judicial penalties, but also the expense of internal investigations, the legal defence of the company and its employees and possible collateral consequences such as debarment from public contracts, denial of licensing privileges, avoidance of contracts and loss of business relationships. Although no uniform anti-corruption compliance standard fits all companies, it is crucial that directors and senior management understand that an effective
anti-corruption compliance programme can minimise delays and costs associated with pre-acquisition and investment due diligence, decrease investment risks and avoid the imposition of onerous warranties and indemnity protections. An effective anti-corruption compliance programme must be tailored to the countries in which the company operates and to its industry sectors.

Do’s and don’ts of effective anti-corruption compliance
This section sets out some straightforward do’s and don’ts of effective anti-corruption compliance practices that companies would be well advised to put into place.

Companies should do the following:

• have a commitment from senior management and a clearly articulated policy against corruption
• have a global code of conduct and anti-corruption compliance policies and procedures that apply to all employees and that are clear and accessible (in local languages)
• provide oversight, autonomy and resources; the responsible manager or chief compliance officer must have proper authority, autonomy from management and adequate resources appropriate to the company’s size, complexity, industry, geographical reach and risks associated with the business
• conduct a risk assessment and ongoing third-party due diligence of agents, consultants and distributors, and regularly monitor payments and transactions, especially where the lines between government and industry may be blurred, such as with state-owned companies
• provide company-wide training, with web-based or in-person delivery, on the risks associated with corruption
• provide incentives for compliance and disciplinary measures for non-compliance with anti-corruption and anti-bribery policies and laws
• have a mechanism for confidential reporting and internal investigation
• have periodic testing and review for continuous improvement, and maintain company-smart awareness of the bribery risks associated with mergers and acquisitions

Companies should not do the following:

• ignore the bribery risks facing the organisation
• ignore the triggers for potential misconduct, such as third-party and government relationships
• be motivated by a desire to influence foreign officials, state-owned or state-controlled enterprises, and the like
• permit staff to provide gifts or hospitality to public officials beyond what would be considered reasonable and modest; they must always ensure that those considered acceptable are provided in good faith.

Country-specific anti-corruption and anti-bribery laws
Although there can be similarities among various countries’ anti-corruption and anti-bribery laws, there are notable differences as well. This section considers the essential components and some key facts about the Hong Kong, US and UK laws.

Hong Kong
Table 1 outlines the Hong Kong legislation that applies to corruption and bribery, as well as the primary offences and their penalties.

Five key facts worth noting about Hong Kong’s anti-corruption and anti-bribery laws
1. Hong Kong’s anti-corruption and anti-bribery laws have extraterritorial effect.
   • Hong Kong’s anti-corruption and anti-bribery laws have extraterritorial effect if the bribery involves a Hong Kong public servant. Public servants are subject to offences committed outside Hong Kong. It
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<td></td>
<td>• Bribing for procuring withdrawal of tenders for public contracts: s.6</td>
</tr>
<tr>
<td></td>
<td>• Bribery in relation to auctions: s.7</td>
</tr>
<tr>
<td></td>
<td>• A prescribed officer being in possession of unexplained property: s.10</td>
</tr>
<tr>
<td>Private sector bribery</td>
<td>• Bribery of prescribed officers and public servants by persons dealing with the government or public bodies: s.8</td>
</tr>
<tr>
<td></td>
<td>• An agent soliciting or accepting an advantage: s.9</td>
</tr>
<tr>
<td></td>
<td>• Offering an advantage to an agent: s.9</td>
</tr>
<tr>
<td></td>
<td>• Common law offence of bribery</td>
</tr>
<tr>
<td>Defences or exceptions</td>
<td>• Lawful authority or reasonable excuse: the burden of proof lies with the accused</td>
</tr>
<tr>
<td></td>
<td>• No exemption for facilitating payments</td>
</tr>
<tr>
<td></td>
<td>• No legal defence if a company has an anti-corruption compliance programme in place</td>
</tr>
<tr>
<td></td>
<td>• Cannot invoke privilege against self-incrimination or refuse to answer questions in relation to an ICAC investigation</td>
</tr>
<tr>
<td></td>
<td>• No defence that an advantage is customary in any profession, trade or calling</td>
</tr>
<tr>
<td></td>
<td>• No defence, even if the acceptor of an advantage had no intention to carry out a corrupt act and did not or could not</td>
</tr>
<tr>
<td>Private sector bribery covered</td>
<td>Yes</td>
</tr>
<tr>
<td>Extraterritorial effect</td>
<td>Yes, with limitations. Public servants are subject to offences committed outside Hong Kong (s.4 POBO).</td>
</tr>
<tr>
<td>Gifts and hospitality covered</td>
<td>Yes. ‘Advantage’ is widely drafted; covers any form of bribe, including gifts, loans, commissions, offices, contracts, services, favours, hospitality and discharge of liability in whole or in part. In some circumstances, meals and beverages (‘entertainment’) are not restricted.</td>
</tr>
<tr>
<td>Penalties for individuals (maximum per violation)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Fine HK$100,000</td>
</tr>
<tr>
<td>4, 7, 8 and 9</td>
<td>Imprisonment 1 year</td>
</tr>
<tr>
<td>5 and 6</td>
<td>Imprisonment 7 years</td>
</tr>
<tr>
<td>10</td>
<td>Imprisonment 10 years</td>
</tr>
<tr>
<td></td>
<td>Fine HK$500,000</td>
</tr>
<tr>
<td></td>
<td>Fine HK$100,000</td>
</tr>
</tbody>
</table>
does not matter where the bribe is offered, solicited or accepted, whether in Hong Kong or elsewhere.

- The position is less certain in relation to the other types of bribery offences (ie private sector bribery). A bribe through an intermediary is an offence, in relation to both the bribe giver and the bribe receiver, whether the person is within or outside Hong Kong.

- Hong Kong’s law enforcement agencies have excellent international cooperation with overseas countries, including the US and UK; there are bilateral agreements between Hong Kong and many countries that permit the surrender of wanted persons and provide for the mutual exchange of evidence in criminal matters, including anti-bribery and anti-corruption cases.

| Penalties for companies (maximum per violation) | Under Hong Kong law, a company cannot be charged with bribery or corruption-related criminal offences but may be charged with other offences under other laws, such as the Companies Ordinance or the Securities and Futures Ordinance. However, any natural person who is part of the controlling mind of the company, such as a director or an individual (eg employee or agent), can be charged in a personal capacity with such offences. |
| Collateral consequences | ICAC has enforcement powers of investigation, arrest, detention, search and seizure and granting of bail: |
| - Special powers of investigation: The ICAC can require a suspect to disclose details of assets, income and expenditure, material and other information; powers can be scrutinised by courts if necessary |
| - Search and seizure powers: Wide |
| - Restraint of property (including money): Possible |
| - Surrender of travel documents of a suspect: Possible |
| - Legally privileged information held by a legal adviser: Not required to be disclosed |
| - Confiscation of assets: Probable if convicted |
| - Offence to make false complaint or mislead investigation |
| - Offence to disclose identity of persons being investigated or details of investigation |
| - Informers have statutory protection |
| - Collateral proceeds of a crime can be restrained (without notice) and confiscated under the Organised and Serious Crimes Ordinance (OSCO) or forfeited under the Criminal Procedure Ordinance. |
| - There is equal culpability of the offeror and the acceptor |
| - The burden is on the accused to provide a satisfactory explanation of unexplained property |
| - If a person is convicted of offences under the POBO, imprisonment sentence and a fine are highly likely; community service orders are regarded as exceptional. |
| Useful references | • POBO, OSCO, ICAC and Hong Kong Department of Justice |
| • Financial Action Task Force’s (FATF) recent evaluation report on Hong Kong. FATF is an inter-governmental body of 36 country members promoting effective global implementation of anti-money laundering, anti-terrorist financing laws and anti-corruption-related laws. Hong Kong is a FATF member. |
2. The definition of what is regarded as ‘an advantage’ is extremely wide.
   • An advantage covers money, gifts, loans, commissions, offices, contracts, services, favours, hospitality and discharge of liability in whole or in part, although entertainment (food or drink) is not restricted in some circumstances.
   • Both a direct and an indirect offer are caught under POBO. No maximum specified dollar value would be considered reasonable or customary for a gift to be accepted by a public officer in a public capacity, or by a private sector agent. In general, entertainment (meals and beverages), if provided, should be of modest value and consumed when provided.
   • No money, goods or services need change hands to attract criminal prosecution. An offer to bribe is captured.

3. Confidentiality of those reporting corruption to the authorities is protected.
   • Informers have statutory protection; that is, they are protected by law as long as the complaint is not false or frivolous. It is an offence to make a false complaint or mislead an investigation.
   • It is also an offence to disclose the identity of persons being investigated by the ICAC, or details of an investigation.

4. Enforcement trends in Hong Kong show zero tolerance to corruption.
   • Hong Kong’s authorities are keen to ensure that the community at large and companies doing business in and out of Hong Kong are fully aware that there is zero tolerance for corruption. High-profile criminal cases have been brought against public officials and individuals alike. Prison sentences and heavy fines have been imposed.
   • An effective anti-corruption compliance programme is not a defence under Hong Kong’s laws to avoid corruption or corruption-related charges against individuals in any capacity, but may be considered a mitigating factor by the courts.

5. Hong Kong is ranked at 14th ‘cleanest’ out of 176 countries and territories in a 2012 global Corruption Perceptions Index.

Transparency International’s global 2012 Corruption Perceptions Index ranks countries and territories based on how corrupt (and conversely, how clean) their public sector is perceived to be. Hong Kong is ranked as the 14th cleanest place out of the 176 countries and territories listed. The UK is ranked as the 17th cleanest equal (with Japan), and the US is the 19th cleanest. Two thirds of the countries ranked have a serious corruption problem.

United States
The FCPA is the key US legislation related to anti-corruption and anti-bribery (Table 2).

Five key facts worth noting about the US FCPA
1. Activities outside the US and conducted by non-US individuals and companies may be captured by the FCPA.
   • A foreign company’s bribery occurring mainly outside the US may be captured if an act in furtherance of the bribery (eg a single telephone call or payment of the bribe in US dollars) occurs within the US.
   • A US issuer may be held liable for its non-US subsidiary’s bribery entirely outside the US if it knows about or authorises the prohibited payments.

2. Third-party agents can cause problems, even if a company does not know of their briberies.
   • A company may be held liable for its third-party agent’s bribery if the company consciously disregards or deliberately ignores the agent’s culpable conduct or suspicious circumstances. Actual knowledge of bribery is not required.

3. Facilitating payments are not risk-free.
   • The facilitating payment exception is limited, only applying to relatively insignificant payments made to facilitate or expedite performance of a ‘routine government action’. If facilitating payments are not properly recorded in books, they may still violate the FCPA (accounting provision).

4. Improper gifts, travel and entertainment are treated as bribery.
   • The FCPA does not prohibit gifts, but it does prohibit bribes disguised as gifts, including systematic giving of smaller gifts as a pattern of bribery.
### Table 2: US anti-corruption and anti-bribery law

<table>
<thead>
<tr>
<th>Key legislation</th>
<th>FCPA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enforcement authorities</td>
<td>Department of Justice</td>
</tr>
<tr>
<td>Bribery</td>
<td>Securities and Exchange Commission (SEC)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Primary offences under the anti-bribery provision</th>
<th>• False accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Deficient internal control</td>
</tr>
</tbody>
</table>

| Primary offences under the accounting provision | • Payments permissible under local law |
|------------------------------------------------|• Reasonable and *bona fide* expenditures |
|                                                   |• Facilitating payments |

<table>
<thead>
<tr>
<th>Defences or exceptions</th>
<th>No. However, many states have enacted individual commercial bribery statutes to criminalise private sector bribery.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Extraterritorial effect</th>
<th>Yes</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Penalties for individuals (maximum per violation)</th>
<th><strong>Criminal</strong></th>
<th><strong>Civil</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>anti-bribery provision</td>
<td>Fine: US$100,000</td>
<td>US$16,000</td>
</tr>
<tr>
<td></td>
<td>Imprisonment: 5 years</td>
<td></td>
</tr>
<tr>
<td>accounting provision</td>
<td>Fine: US$5 million</td>
<td>Greater of (a) gross amount of pecuniary gain of the violation, or (b) a specified dollar limitation based on egregiousness of the violation (from US$7,500 to US$150,000)</td>
</tr>
<tr>
<td></td>
<td>Imprisonment: 20 years</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Penalties for companies (maximum per violation)</th>
<th><strong>Criminal</strong></th>
<th><strong>Civil</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>anti-bribery provision</td>
<td>US$2 million</td>
<td>US$16,000</td>
</tr>
<tr>
<td>accounting provision</td>
<td>US$25 million</td>
<td>Greater of (a) gross amount of pecuniary gain of the violation, or (b) a specified dollar limitation based on egregiousness of the violation (from US$7,500 to US$725,000)</td>
</tr>
</tbody>
</table>

| Collateral consequences | • Suspension or debarment from contracting with the US federal government |
|-------------------------|• Cross-debarment by multilateral development banks |
|                         |• Suspension or revocation of export privileges |

<table>
<thead>
<tr>
<th>Useful references</th>
<th>• FCPA</th>
</tr>
</thead>
</table>
5. **Strong anti-corruption compliance programmes help a company minimise liability.**
   - The US Department of Justice and SEC consider the adequacy of a company’s compliance programme when deciding enforcement actions and penalties. Both organisations encourage timely self-reporting, cooperation and remedial efforts, and they take these into account in determining the action to take.
   - The board of directors is always responsible for the oversight and management of the company’s FCPA compliance programme.

**United Kingdom**

The UK passed the Bribery Act in 2010 to set down regulations related to corruption and bribery, as outlined in Table 3.

<table>
<thead>
<tr>
<th>Table 3: UK anti-corruption and anti-bribery law</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key legislation</strong></td>
</tr>
<tr>
<td>Bribery Act 2010 (UK)</td>
</tr>
<tr>
<td><strong>Enforcement authorities</strong></td>
</tr>
<tr>
<td>Serious Fraud Office (SFO)</td>
</tr>
<tr>
<td>Crown Prosecution Service (CPS)</td>
</tr>
<tr>
<td><strong>Primary offences</strong></td>
</tr>
<tr>
<td>• Bribery of a person</td>
</tr>
<tr>
<td>• Accepting or requesting a bribe</td>
</tr>
<tr>
<td>• Bribing a foreign public official</td>
</tr>
<tr>
<td>• Failure of a commercial organisation to prevent bribery by a person ‘associated’ with the organisation (the corporate offence)</td>
</tr>
<tr>
<td><strong>Defences or exceptions</strong></td>
</tr>
<tr>
<td>• Adequate procedures in place within a commercial organisation to prevent bribery by an associated person</td>
</tr>
<tr>
<td>• Necessary for military or intelligence purposes</td>
</tr>
<tr>
<td>• Duress</td>
</tr>
<tr>
<td><strong>Private sector bribery covered</strong></td>
</tr>
<tr>
<td>Yes</td>
</tr>
<tr>
<td><strong>Extraterritorial effect</strong></td>
</tr>
<tr>
<td>Yes; very wide</td>
</tr>
<tr>
<td><strong>Penalties for individuals</strong></td>
</tr>
<tr>
<td>(maximum per violation)</td>
</tr>
<tr>
<td><strong>Criminal</strong></td>
</tr>
<tr>
<td>Fine: Unlimited</td>
</tr>
<tr>
<td><strong>Civil</strong></td>
</tr>
<tr>
<td>N/A</td>
</tr>
<tr>
<td>• Bribery of a person</td>
</tr>
<tr>
<td>• Accepting a bribe</td>
</tr>
<tr>
<td>• Bribing a foreign public official</td>
</tr>
<tr>
<td><strong>Penalties for companies</strong></td>
</tr>
<tr>
<td>(maximum per violation)</td>
</tr>
<tr>
<td><strong>Criminal</strong></td>
</tr>
<tr>
<td>Fine: Unlimited</td>
</tr>
<tr>
<td><strong>Civil</strong></td>
</tr>
<tr>
<td>N/A</td>
</tr>
<tr>
<td>• Bribery of a person</td>
</tr>
<tr>
<td>• Accepting a bribe</td>
</tr>
<tr>
<td>• Bribing a foreign public official</td>
</tr>
<tr>
<td>• The corporate offence</td>
</tr>
<tr>
<td><strong>Collateral consequences</strong></td>
</tr>
<tr>
<td>• Confiscation orders or civil recovery orders under the Proceeds of Crime Act 2002</td>
</tr>
<tr>
<td>• Potential debarment from competing for UK public contracts under the Public Contracts Regulations 2006</td>
</tr>
<tr>
<td><strong>Useful references</strong></td>
</tr>
<tr>
<td>• UK Bribery Act</td>
</tr>
<tr>
<td>• Ministry of Justice guidance about procedures that relevant commercial organisations can put in place to prevent persons associated with them from committing bribery</td>
</tr>
</tbody>
</table>
Five key facts worth noting about the UK Bribery Act

1. Private sector bribery is covered.
   - Unlike the US FCPA, bribes to private individuals and companies are covered. This has ramifications for corporate entertainment and development of business connections, relationships and employee hiring. In addition, excessive corporate hospitality may be viewed as bribery.

2. Facilitating payments are criminally prohibited.
   - The UK Bribery Act has no exception for facilitation payments, which are criminally prohibited. According to the SFO, ‘A facilitation payment is a type of bribe and should be seen as such’. However, offers, promises or gifts that are allowed by written local law (offsets) are excluded.

3. The Bribery Act has an extremely wide territorial reach.
   - Making or receiving bribes anywhere in the world by UK companies or individuals is captured.
   - The corporate offence captures any company that carries on a business, or part of a business, in the UK and fails to prevent bribery anywhere in the world by any person associated with that business.

4. Companies may be liable for failing to prevent bribes made for their benefit by anyone who performs services for or on behalf of them, anywhere in the world.
   - The corporate offence is widely drafted and may include employees, agents, contractors, subsidiaries or members of a joint venture scheme.

5. Strong anti-corruption compliance programmes help protect the company (and its management).
   - It is a complete defence to the corporate offence if the company has put in place ‘adequate procedures’ designed to prevent people from making bribes on its behalf. A company’s compliance programme is a factor taken into account by the SFO and the CPS when deciding whether to prosecute, and it may be a mitigating factor upon sentencing.
   - The SFO and CPS also take into account whether there has been a ‘genuinely proactive approach involving self-reporting and remedial action’ when deciding whether to prosecute.
   - Senior company officers are personally liable (and may be sent to prison) for bribery offences committed by their company with their consent or connivance.
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Executive remuneration

Trey Davis, Asia-Pacific Executive Compensation Practice Leader Towers Watson

“We have seen greater convergence in executive compensation practices around the world as companies continue to expand beyond their domestic shores and investors take more global positions. In an increasingly complex environment of shareholder activism, heightened scrutiny by regulators and an increasingly vocal press, a sound corporate governance framework is vital to set the right foundation to develop an effective executive compensation. Towers Watson is pleased to contribute its thoughts, research and view on these critical topics of governance and executive compensation”.

–Jeffrey Tang
Director of Talent & Rewards and Global Financial Services Leader,
Asia Pacific, Towers Watson

Over the past 20 years, executive pay, particularly for chief executive officers (CEOs), has increased significantly in countries around the world. While many causes have contributed to this pay inflation, there is one undoubted outcome: the number of government agencies, investment advisers and organisations trying to slow the growth of executive pay has increased alongside executive pay itself. Unsurprisingly, the two groups that have had the most impact on executive pay over the past few years are investors and regulators. In Asia, in particular, executive pay continues to increase because of talent-market factors including continued economic growth and a constrained supply of proven, highly experienced executives.

This chapter reviews the influences that have shaped executive pay while expanding and complicating the role of remuneration committees (RemCos) and boards. These changes are summarised in Table 1.

Key executive compensation influences
In response to rising executive pay levels and the perception that executive pay practices played a role in the global financial crises, the world has recently seen a proliferation of new regulations regarding executive pay practices and disclosure. The Stock Exchange of Hong Kong (SEHK) has expanded the requirements for disclosure of director compensation to mandate detailed pay of all directors and the pay range of all senior executives who are not directors. The SEHK has also mandated that RemCos be chaired by and comprise a majority of independent non-executive directors (INEDs).

At the same time, institutional investors and private equity firms are becoming more influential, both globally and in Hong Kong. From 2000 to 2012, SEHK transactions by overseas institutional investors increased from 28 to 42 per cent of trading volume (in contrast, local retail investors’ share of trading volume fell from 49 to 17 per cent). These global firms often have detailed policies on portfolio company pay practices and in the West have been influencing public company pay practices for many years, often from behind the scenes. Some of these institutional investors are increasingly influenced by advisers such as Institutional Shareholder Services. The growing influence
Executive remuneration

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Table 1: Key global executive compensation themes

<table>
<thead>
<tr>
<th>Theme</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>General industry</td>
<td>RemCos displaying more restraint on overall pay opportunities (by capping incentive plan payouts, for instance)</td>
</tr>
<tr>
<td></td>
<td>Little change in overall designs of compensation packages, but many companies fine-tuning approaches</td>
</tr>
<tr>
<td></td>
<td>Focus on performance and actual (realised) pay outcomes</td>
</tr>
<tr>
<td>Financial services</td>
<td>Regulatory framework extending to all financial services sectors</td>
</tr>
<tr>
<td></td>
<td>Ratio of fixed to variable pay proposed for EU banking sector</td>
</tr>
<tr>
<td></td>
<td>Less prescriptive regime for insurance and fund sectors</td>
</tr>
<tr>
<td>Public sector and state-owned enterprises</td>
<td>Pay differentials among key concerns</td>
</tr>
<tr>
<td>Governance</td>
<td>Pay caps introduced in some markets (eg France)</td>
</tr>
<tr>
<td></td>
<td>Challenging environment for ‘commercial’ state-owned organisations</td>
</tr>
<tr>
<td></td>
<td>Increasing pressure on boards and RemCos</td>
</tr>
<tr>
<td></td>
<td>Initiatives for greater disclosure and transparency</td>
</tr>
<tr>
<td></td>
<td>Moves to increase shareholder power (‘say on pay’)</td>
</tr>
</tbody>
</table>

of institutional investors is a long-term trend that will continue to shape executive compensation practices, even in closely held companies.

In addition, regulators around the globe are increasingly moving beyond requiring detailed pay disclosure and adherence to general pay principles to promulgating strict rules on executive compensation, particularly for financial services and state-controlled companies. Examples of these rules include limits on the value of incentives in pay packages (pay ratio limits) in the European Union (EU), required incentive payment clawback policies in a number of countries and outright pay limits in France for commercially focused, state-owned companies. While American and European pay rules may seem far removed from Hong Kong, they often affect local pay practices and alter the expectations of investors as a result of the influence of foreign companies in the local talent market.

The global financial crisis has made Western executives more willing to consider working in Asia, and local managers are becoming more qualified and experienced. Despite this rise in executive talent supply, the demand for executive talent from both local and Western companies in the region is strong and is therefore pushing local executive pay higher. In particular, local companies are expanding their search for proven, multilingual executives with experience working in global organisations and across multiple cultures. For these individuals, who are relatively rare and in high demand, pay is linked less to market practices and norms and more to individual circumstances and the particular need for employers to acquire these skills and experiences. We see large variations in pay levels across and within organisations as companies adjust their pay practices to attract and retain these individuals who are in high demand.

Responses to external influences

There are many important trends in executive compensation practices in Hong Kong, many of which reflect broader, global trends but have a particular local flavor due to the influence of local regulators and investors, as well as talent-market dynamics. The most notable of these Hong Kong pay trends include:

• steadily increasing total remuneration (TR) levels, driven by rising annual incentive awards and especially long-term incentive (LTI) awards
• a sharper focus on the relationship between pay and performance
• more willingness to use multiple LTI plans to meet multiple and sometimes competing remuneration objectives
• increasing use of pay philosophies and guiding principles to shape plan designs and decision-making
• increasing pay for board members due to increasing demand for and heavier workloads on INEDs.

In the following sections, we take a closer look at each of these trends.
Remuneration levels
Figure 1 presents the median CEO compensation for the Hang Seng Hong Kong 35 index companies from 2008 to 2012. During this time, total guaranteed compensation (TGC, which comprises salary, allowances and other fixed components of pay) increased 31 per cent, while TR (which consists of TGC plus annual incentives and LTIs) increased 47 per cent. TGC as a proportion of TR fell from 38 to 33 per cent over this period as the value of annual incentives and LTIs increased faster than the fixed components of pay. From 2008 to 2012, LTIs as a proportion of TR increased from 18 to 26 per cent. Despite these increases, overall TR and the proportion of at-risk remuneration are still well behind US and UK market practices for similar-sized companies.

While pay for other senior executive positions in Hong Kong has also increased over the past few years, pay for CEOs has increased more quickly than for other executives. This is due to CEO compensation being typically more heavily weighted towards LTIs, which are the fastest-growing component of pay. LTI award value for CEOs is often two or three times more than the award values for the next level of executives.

Pay for performance
As pay levels increase and pressure from investors and regulators intensifies, RemCos are putting more effort into ensuring that shareholders’ investment in executive pay programmes earns a proper return with more robust processes and in-depth analysis. There are a number of ways in which Hong Kong companies are doing this, including:

- more reliance on incentives and at-risk compensation
- greater use of performance-vesting equity awards, rather than time-vesting awards
- adopting a more holistic view of company performance by:
  - using multiple LTI plans, including full-value shares such as restricted stock
  - using multiple performance metrics (including non-financial metrics) in annual incentive plans.

Figure 2 shows that most large Hong Kong companies (those with annual revenue above HK$10 billion) have LTI plans in place. From 2008 to 2012, the percentage of large companies offering at least one LTI plan increased from 59 to 73 per cent, and 30 per cent had multiple LTI plans in place as of 2012.

The prevalence of stock options has remained high over this period, and all companies with an LTI plan in place had an option plan. However, options are often used in conjunction with full-value stock awards, such as restricted stock.
Executive remuneration  Towers Watson

and performance-vesting shares. (In some cases, although companies maintain share option plans, they have not recently made grants to employees or directors under those plans.) Figure 3 shows the types of LTI plans in place at large Hong Kong companies (revenues above HK$10 billion) in 2008 and 2012 (the data show the prevalence of LTI plans among companies with LTIs in place). This information is based on publicly disclosed data and possibly understates the prevalence of full-value and cash-based plans, because it does not capture LTIs used in overseas subsidiaries. In particular, cash-based LTIs are increasingly used for mainland China-based employees and executives of Hong Kong-based and other non-Chinese companies.

Although post-employment payments and termination agreements such as ‘golden parachutes’ have not been particularly common in Hong Kong, RemCos are more aware of these issues, especially as they hire western executives who may have had such benefits in their previous service contracts or as the company assumes pre-existing employment agreements through overseas acquisitions. As in the West, the trend is to minimise and, if possible, eliminate post-employment promises or payouts that are unusual in the market, are not aligned with a clear business purpose or are inconsistent with what most other salaried employees receive.

In many countries, a corollary to the greater focus on pay for performance and higher executive pay is higher rates of CEO turnover and shorter average CEO tenures. While shorter CEO tenures have not been widely noted in Hong Kong, it may be a future trend as investors continue to gain leverage in Hong Kong boardrooms and demands for the removal of poorly performing executives become more common. If executive turnover increases, pressure from executives for

Figure 2: Prevalence of LTI plans among large Hong Kong companies, 2008-2012

![Figure 2](image1.png)

Source: Towers Watson Executive and Director Renumeration and Corporate Governance Database, Hong Kong, 2007/08 to 2012/13.

Figure 3: Prevalence of LTIs by type of plan among large Hong Kong companies, 2008 and 2012

![Figure 3](image2.png)

Source: Towers Watson Executive and Director Renumeration and Corporate Governance Database, Hong Kong, 2007/08 to 2012/13.
greater post-employment protection will likely grow despite boards’ desire to avoid such policies.

**Pay philosophies and guiding principles**

As Hong Kong companies expand globally and pay regulations become more pervasive, companies are adopting increasingly complex incentive plans and pay programmes. As a result, the issues confronting RemCos become more complex and involve more moving parts. These issues include:

- cross-border employee tax issues
- complex employment agreements, including expatriate arrangements
- local market pay regulations that limit the usefulness of home-country pay programmes due to tax, currency exchange, or securities issues
- multiple pension and benefit programmes across multiple countries
- increasing regulatory, media and public scrutiny of board pay decisions.

To help manage these issues, RemCos are increasingly developing reward strategies or pay philosophies to help guide their decision-making. Like business strategies, reward strategies can help RemCos ensure their pay designs and pay decisions are aligned with each other and

<table>
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<tr>
<th>Table 2: Typical components of company pay philosophies and strategies</th>
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<tr>
<td><strong>Strategy component</strong></td>
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<tr>
<td>Alignment of interests among executives, shareholders and the corporation</td>
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<tr>
<td>Definition of relevant talent market (ie peer groups)</td>
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<tr>
<td>Target competitiveness</td>
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<tr>
<td>Pay element mix</td>
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<tr>
<td>Performance measurement</td>
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<tr>
<td>Approach to goal setting</td>
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<tr>
<td>Stock ownership</td>
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<td>Executive 'total rewards'</td>
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support the overall human resource and business strategies. Such philosophies create a framework for evaluating pay decisions and typically touch on a number of key issues, as shown in Table 2.

Evolving role of RemCo members
With the adoption of new director compensation disclosure rules and a continuing focus on corporate governance issues from regulators and investors, the role of RemCo members continues to expand. Table 3 outlines the role of Hong Kong RemCos in ensuring officers, directors and employees are compensated in accordance with the company’s compensation philosophy and objectives, as well as the most common RemCo tasks.

The expanding role of the RemCo is significantly increasing the time required of committee members. The time commitment required from most Hong Kong INEDs is increasing. For instance, one prominent Hong Kong company disclosed in its annual report that the total number of hours consumed by all board and committee meetings increased from approximately 55 hours in 2010 to nearly 70 hours in 2012. This figure excludes the many hours of preparation that directors require for each hour of meetings. The company also noted that the volume of materials to be reviewed annually increased by a similar margin – to nearly 6,000 pages of agenda papers and circulars in 2012.

As the demands on RemCo members continue to expand, the SEHK adopted new rules in 2010 concerning the independence of directors. These rules (fully implemented in early 2013) state that at least one third of board members and a majority of RemCo members must be independent. These changes have led to an increase in demand for qualified directors at the same time as workloads have been escalating significantly.

In reaction to these trends, Hong Kong board member remuneration has been increasing rapidly, in most cases as fast as CEO pay. In particular, for Hang Seng HK35 companies, median annual INED remuneration increased from HK$237,000 in 2008 to HK$359,000 in 2012, an increase of 51 per cent (as compared to the 47 per cent increase in CEO pay at these companies over the same

<table>
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<th>Table 3: Role of RemCos</th>
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<tr>
<td><strong>ROLE OF THE REMUNERATION COMMITTEE</strong></td>
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<tr>
<td>Ensuring officers, directors and employees are compensated in accordance with the company’s compensation philosophy and objectives</td>
</tr>
<tr>
<td>Develop and articulate executive compensation philosophy</td>
</tr>
<tr>
<td>Approve (or recommend for board approval) annual and/or periodic actions (eg salary increases and incentive awards) for CEO and other senior executives</td>
</tr>
<tr>
<td>Prepare and/or approve annual pay disclosures and related reports</td>
</tr>
<tr>
<td>Make recommendations to board regarding non-employee director remuneration practices and levels</td>
</tr>
<tr>
<td>Select and calibrate financial and other performance measures</td>
</tr>
<tr>
<td>Design and monitor effective succession planning and talent development programmes for executives</td>
</tr>
<tr>
<td>Approve (or recommend for board or shareholder approval) specific pay plans, including equity-based plans</td>
</tr>
<tr>
<td>Approve (or recommend for board approval) compensation packages and/or contracts for newly hired and terminating executives</td>
</tr>
<tr>
<td>Review and approve performance goals and objectives relevant to CEO and senior executives</td>
</tr>
<tr>
<td>Align compensation arrangements with corporate strategy and objectives</td>
</tr>
<tr>
<td>Monitor legislative and regulatory developments with independent advisers</td>
</tr>
<tr>
<td>Maintain familiarity with key trends and market practices with regard to executive and director compensation</td>
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period). The number of INEDs has also increased: between 2008 and 2012, the average number of INEDs at each of these HK35 companies increased from 5.5 to 6.2.

Nevertheless, Hong Kong INED pay is still well behind typical pay levels in the US and UK for companies of a similar size. Given the increasing pressure on Hong Kong board members, and in particular RemCo members, we expect INED pay to continue to rise in the foreseeable future.

Key challenges and opportunities for Hong Kong companies
The recent changes in Hong Kong pay practices and the greater emphasis on RemCo members are trends that should be considered as positives for the Hong Kong (and global) economy. Greater alignment between executives and shareholders and a focus on shareholder returns help to ensure that Hong Kong remains competitive economically and continues to attract global investors. Executives and outside board members from many countries have appeared less than enthusiastic with the emerging global norms of transparency and accountability. However, because global capital flows ever more quickly to the macroeconomic winners at the country level and the microeconomic winners at the company level, properly designed executive pay programmes and incentives can help to ensure that managers are focused on the key strategies and outcomes needed to compete globally. Institutional investors have repeatedly singled out corporate governance, including executive pay, as one of the most important non-financial factors in deciding whether to invest in a company.

To help ensure that these pay trends are properly managed for the good of the company, Towers Watson has identified 10 critical pay practices that RemCos should follow. These practices are designed to improve the alignment between executives’ and shareholders’ interests and to ensure that pay practices are supportable to investors and other observers:

1. Establish an explicit pay philosophy and ensure it remains relevant over time.
2. Ensure pay decisions are supportable externally, combining market data and considerations of organisation strategy.
3. Minimise (but do not eliminate) fixed aspects of pay.
4. Emphasise realised pay (outcomes at various levels of performance) over target pay (opportunity at a single point of performance).
5. Review pay outcomes over a multi-year timetable to ensure realised pay is consistent with a holistic assessment of performance and is aligned with shareholder outcomes.
6. Use discretion and judgment to override inappropriate pay outcomes.
7. Assess performance (as well as pay) relative to peers.
8. Set challenging but achievable incentive performance targets.
9. Avoid special deals or overpaying to retain talent.
10. Use disclosure to inform rather than confuse.

Outlook
RemCos in Hong Kong need to take an active role in shaping executive pay programmes and ensure these programmes are fair and appropriate. It is an important job — and it is not easy. Executive compensation has become, whether or not justified, a lightning rod for criticism and a tangible symbol of how companies govern themselves and respond to the concerns of various stakeholders. However, properly structured and communicated executive compensation programmes are powerful management tools. They provide a framework by which investors and management can establish expectations and evaluate performance, they help attract and retain great leadership and they serve as a powerful corporate communication device, both internally and externally.

While the ‘new normal’ with regard to executive compensation regulations and the complexity of pay programmes can require more time and attention, any company can formulate an executive remuneration strategy and key pay programmes that are effective in attracting, motivating and retaining top executive talent and are at the same time aligned with shareholder interests and outcomes.
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The value of disclosure and public engagement in investor relations

K W Lam, Managing Director and Head of Financial Communications, Hong Kong,
Claire Koeneman, Executive Vice President, and Robert Ludke, Executive Vice President
Hill+Knowlton Strategies

In today’s world of dynamic capital markets and fast-paced media, effective financial communications and investor relations (IR) play key roles in forging an understanding between a public company’s directors and its stakeholders. In order to succeed over the long term, forward-looking companies should put in place a strategic plan that addresses the following:

- establishing sound corporate governance programmes
- working with trusted communications partners
- managing corporate reputation through disclosure
- integrating business, financial and non-financial reporting
- keeping stakeholders informed and engaged.

Each of these issues is discussed in more detail in this chapter.

The emergence of Hong Kong as a global financial centre alongside London and New York City has led a multitude of companies, old and new, to list their shares on the Hong Kong bourse.

A public listing in Hong Kong, as in other places, requires a company to adopt well-established norms and to abide by a long list of rules and regulations that may seem daunting and onerous at the outset. The companies that list in Hong Kong operate with varying degrees of transparency and have corporate governance standards that often lag behind the world’s longer-established companies. While some newly-listed companies may see the norms and rules placed on publicly-traded companies as burdens or constraints, in the long run, playing by the rules can bring greater gains.

This chapter focuses on the areas of disclosure and public engagement, which are of particular importance as public companies aim to achieve not only further business success but also higher levels of respectability. Improved brand reputation brings these companies closer to expanding their business operations to a global scale, building world-renowned brands and achieving the highest levels of public trust.

Establishing sound corporate governance programmes

The quality of corporate governance is an important driver of shareholder value, and public companies that score highly in this area generally outperform their peers. A thorough governance framework should provide strategic direction for the company and ensure the effective monitoring of management by the board of directors and the accountability of management and directors to shareholders.

Best practices for boards generally include establishing major policies and goals for the organisation, which should involve oversight and guidance
of the company’s strategic plan, annual business plan and budget. Leadership planning – including selection, evaluation and compensation of the top executives – should be taken into account, as should chief executive succession planning. A solid corporate governance programme will also monitor the effectiveness of management decisions, evaluate the company’s quarterly, annual and long-term performance, and include long-range planning.

Public companies should also consider additional steps to ensure that their board functions at a high level. One of these steps may be to recruit directors with expertise in a variety of areas, with a majority being independent but still committed to the company’s strategy and culture. In addition, it is important to establish proper board leadership – for example, by designating a lead director – as well as to maintain the board at a manageable size.

Working with trusted communications partners
In order to achieve long-term success, public companies must give their communications advisers a seat at the table, integrating them into the team along with advisers from the legal, accounting, management consulting and investment banking fields. Experienced communications professionals provide value to a company by ensuring that messages and strategies for financial communications, investor relations and media relations are aligned, giving the company one voice.

Financial communications and investor relations
A high-performing financial communications team helps a company enhance shareholder value by effectively managing its relationships with the investment community and the financial media. This includes providing consistent, accurate information and appropriate access to company management in order to build relationships with the media that influence opinion in the City of London, on Wall Street, in Hong Kong and in other financial communities.

These efforts can bring bottom-line as well as reputational benefits:

“Fundamentally, the remit of investor relations is not only to create an awareness and understanding of your company amongst the investment community … Entering into a dialogue and developing relationships with the investment community over time so that its participants become cognisant with the company and its investment proposition is generally seen as a worthwhile exercise when trying to achieve efficient, cost-effective access to capital”. (‘Investor Relations: A Practical Guide’, London Stock Exchange, March 2010)

A financial communications team will provide support for all of the key elements of an investor relations programme – including message development, issues management and materials development (for example, annual reports and earnings announcements) – and can also lead studies of investor perceptions to establish a benchmark and identify key issues and influence attitudes. Additional tactics include outreach to sell-side and industry analysts, institutional targeting of ‘buy and hold’ investors, and coordination of key investor conferences.

External financial communications professionals should also work closely with senior management and the company’s in-house IR team when organising and preparing for investor relations events, such as earnings announcements, investor days and shareholder meetings. In addition, these external professionals should help ensure that the messages delivered to investors are clear, concise and compelling, while providing execution support in the following ways:

• contacting investors, analysts and the media on behalf of a company
• co-ordinating conference calls, webcasts and investor meetings
• developing the press release, presentation, conference call script, Q&A document and other materials for financial announcements
• carrying out a dry run with company spokespeople to ensure they are comfortable with the script and Q&A
• following up on the event to handle any resulting investor or media inquiries
• providing feedback to the chief executive and senior management.

Media relations
Whether a company is seeking to enhance or preserve its reputation, increase market share, respond to competitors, shape public policy or
The value of disclosure and public engagement in investor relations

The greatest fear among many companies is reporting bad news. This worry often spreads, infecting communications professionals, senior management and members of the board of directors. While we do not want to minimise the risk that is sometimes posed by full and open disclosure, our perspective is somewhat different.

The vast majority of people view the process of financial and non-financial reporting as a journey. As long as they are brought along on the journey in a transparent and genuine manner (and given the opportunity to provide input), they usually accept temporary setbacks and missed opportunities. Companies seen as leaders in stakeholder relations work with their audience in an effort to be more sustainable and transparent in their public disclosures.

Establishing an open dialogue with the public is, in fact, one of the most effective approaches a company can take in improving governance and risk management. Rather than being surprised by the demands of their audience, companies employing a disclosure process that includes measures such as materiality assessments (discussed towards the end of this chapter), an ongoing dialogue and regular reporting will allow the companies to know what is expected of them and what steps must be achieved to meet those expectations. By failing to engage the public regularly, it is likely a company will never learn of reputational risks until the damage is done. Rather, such a company is perpetually doomed to find itself reacting to risk.

Companies must also view reporting on financial and non-financial performance as a process, not a product. An integrated process – one that addresses the concerns of all stakeholders by placing a company's strategy and performance in a social, environmental and economic context – will lead to the production of a report whose:

- predominant value lies in the preparation: the selection of metrics, the scrutiny and analysis
of the business impacts and risks, the resultant insights, and the adjustments to operations and even strategy. Additionally, a properly designed set of performance measures reported on as part of regular financial management gives the incentive and ability to improve performance”.

(Integrated Reporting: A better view?’, Deloitte, 2011)

Beyond risk management, there is a growing body of evidence to show that making and communicating efforts to become a more sustainable company generates a higher rate of return for investors. In May 2012, professors Robert Eccles and George Serafeim of Harvard Business School and Ioannis Ioannou of the London Business School published a working paper entitled ‘The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance’.

The authors looked at 180 companies, evenly divided between ‘high sustainability’ and ‘low sustainability’, and compared the rate of return for investors (Figure 1). They found that a portfolio of firms in the first group – organisations with a long and consistent track record of making and disclosing efforts to operate with environmental, social and governance (ESG) policies in mind – would have far outperformed a portfolio of firms following more traditional corporate policies.

Stephen Dubner, the journalist and author famed for co-writing the book ‘Freakonomics: A Rogue Economist Explores the Hidden Side of Everything’, was quoted on his reaction to the study:

“It may be that being a good corporate citizen is good for business in the long run – or it may be that the kind of company that’s more likely to be a good citizen in the first place is also more likely to be a profitable company. Whichever direction the arrow was pointing, however, which we don’t really know yet, it does look like at least one truism in the business world is actually true, which is that you really can do well by doing good”.

We propose one caveat to his astute observation: if a company wants to do well by doing good, and gain the reputational credit for doing so, it must bring the public along on its journey through an effective and honest communications effort that encompasses both financial and non-financial reporting.

**Integrating business, financial and non-financial reporting**

Corporate reporting practices are in flux now, and new requirements will have lasting implications for how companies disclose performance and communicate with the public. This trend is illustrated by the Johannesburg Stock Exchange’s requirement from 1 March 2010 that all listed companies produce an integrated report in which the companies tie together their financial and non-financial performance, or explain why they have not done so. Such changes in reporting requirements, however, present many opportunities
for strengthening reputation, managing risk and generating a stronger return on investment.

Most publicly traded companies around the world have long placed a premium on communicating with their investors, and with social media’s rapid growth in recent years, those communications techniques have become more sophisticated. Public companies must also actively engage with regulators – both in government and in the various exchanges around the world – as they seek to remain in accordance with applicable rules and laws.

An emerging theme in corporate communications and investor relations is the effort made by companies to demonstrate broad-based value creation that goes beyond profits and losses to encompass the various ESG initiatives that they undertake to act in a more sustainable and responsible manner. Many companies hope that the path they map out to a sustainable future will generate numerous other benefits – including stronger profits, higher returns on investment, increased brand awareness and reputational goodwill.

The importance of demonstrating sustainable value creation is driven by a myriad of public forces. Customers and consumers are holding corporations to an ever-increasing set of expectations that they should act in a responsible and ethical manner, while regulators – most prominently in the EU and UK, increasingly in the US, and to some extent in Asia – are calling for greater disclosure on a variety of ESG performance metrics. For example, the Stock Exchange of Hong Kong Limited (HKEx) implemented the ‘ESG Reporting Guide’, recommending listed companies to begin work on ESG reporting, with a view to raising the level of obligation of some recommended disclosures to ‘comply or explain’ by 2015, subject to consultation. Perhaps the most powerful forces in the move to greater transparency are institutional investors, who want a detailed account of how a company’s ESG efforts affect bottom-line performance and reputational value.

In other words, publicly traded corporations can no longer expect platitudes about corporate citizenship and ‘feel good’ reports on corporate social responsibility (CSR) to be taken at face value. In an article about the importance of integrating financial and non-financial performance when discussing responsible corporate behaviour, Professor Eccles said:

“If you really think that how you’re managing environmental, social and governance [ESG] issues is at the core of what you do, if those things are core to how you create value, you need to explain [those efforts]. It’s not, ‘here’s my financial report and here’s my green strategy’. Or, ‘here’s my financial report and here are my human rights policies’. Integrated means that you’re not thinking of these larger efforts as simply an appendage, but in terms of how they support the company’s value creation strategy”.


Thus, to demonstrate value creation effectively and persuasively, companies must look to expand and enhance their communications and disclosure efforts. They cannot rely on static reports placed on their websites accompanied by a basic press release to satisfy the demands of shareholders or broader public audiences. Moreover, leading companies are raising the bar not only for communicating about their financial and non-financial performance but also for using those communications to establish a dialogue with the public and gain positive reputational credit for doing so.

Keeping stakeholders informed and engaged
Companies listed on stock exchanges are required to disclose their financial performance on an annual basis along with a variety of indicators. But while fulfilling the obligations for financial reporting continues to be a relatively straightforward process – based on a set of accounting standards that define what information needs to be presented – the growing demand for ESG reporting has created a paradox.

As the journalist and environmental writer Eric Roston observed:

“If non-financial data, such as greenhouse gas emissions per dollar of revenue, is included in a financial report for investors, how can it still be called non-financial? Institutional investors and companies aren’t yet making the leap to calling
The value of disclosure and public engagement in investor relations

Perhaps the most significant point is that the mindset around sustainability efforts is gradually changing. Companies are moving away from seeing sustainability communications as a marketing tool primarily used to bolster corporate reputations. Rather, the approach is evolving to one where reports simply lay out the facts with a minimum of interpretation so that, in the words of Jim Nail of the analyst Verdantix: “stakeholders can make their own judgments”. (Jim Nail, ‘Plan Sustainability Communications, Not Green Marketing’, Environmental & Energy Management News, November 16, 2010)

To help companies not only disclose non-financial data but, perhaps more fundamentally, assess what is and what is not material, reporting frameworks such as the Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP) have gained prominence. Although these do not have statutory or regulatory authority, they are additional mechanisms that companies should consider using when reporting on their various activities. Frameworks such as GRI and CDP are also representative of another important trend: the growing inability of country- or region-specific reporting structures to fully account for all of the activities of global corporations. As a result, a market-driven model is coming into greater use, where public audiences such as NGOs are increasingly using social media and the democratisation of information facilitated by the internet to police corporate behaviour.

The outcome is a shift in how companies report on their activities. As the Deloitte paper, ‘Integrated Reporting: A better view?’, asserted:

“By accepting that business sustainability is about how a company creates value, rather than just about how it achieves compliance or avoids harmful effects from its activities, a different perspective of sustainable value creation emerges, along with a different perspective on how companies should report on value creation and protection.”

Regardless of the framework that companies use to assess or disclose financial and non-financial performance, they must solve the paradox of what information is material to the public. And the only way a company can find this out is to talk to the public — and listen to their responses. This means that an internally focused process whose outcome is a static report produced once a year must be replaced with one in which public audiences are given the opportunity to weigh in at any time on what is important.

greenhouse gas emissions, percentage of female executives or other ESG metrics ‘financial’. But they are increasingly considering them to be material”. (Eric Roston, ‘Non-Financial Data Is Material: The Sustainability Paradox’, Bloomberg, April 13, 2012)

In other words, companies are required on a regular basis to disclose information about operations to regulators, policymakers and other audiences. But the process of determining what information must be disclosed, and how, involves communicating with the public. This communication can take many different forms, ranging from an interactive website, to a survey of key audiences asking a series of questions about material issues, to one-on-one meetings. Many companies must also do a better job communicating internally. We often encounter situations where sustainability work remains the purview of a relatively siloed team with little insight into — let alone an ability to influence — decisions affecting global operations.

Effective reporting of financial and non-financial performance requires collaboration among a myriad of departments, including communications, investor relations, legal, accounting, sustainability and those more focused on company operations. Given the sharpening focus of regulatory bodies on nonfinancial reporting, there is a need for some kind of formal validation to be given to the report, and this is most often done through an auditing firm.

Even starting the process to determine what information is material can be daunting. Companies are increasingly turning to a process called a materiality assessment, in which the relevant internal and external audiences are brought together to decide collectively on what issues are relevant and must be disclosed. Such an assessment will help prioritise a company’s attention and resources so that it can be confident it is communicating the information that the public wants.
When businesses succeed, livelihoods flourish.

In 2009, we took the initiative to be first to align with the World Bank Group in boosting global trade flows. Since then, we have continued to be proactive in encouraging growth across our markets. As trade is the lifeblood of the local economy, our commitment does more than protect businesses. It stimulates the communities that depend on them.

Here for good
Corporations use various terms to describe their engagement with society, such as community relations, corporate social responsibility, corporate sustainability and corporate citizenship. Over the past two decades, in response to the changing expectations of their role in society, leading companies have been looking beyond a community engagement strategy based solely on philanthropy and are taking a more integrated approach to corporate sustainability.

Historical context
The rapid development of the corporation following the industrial revolution and into the first half of the twentieth century was narrowly focused on shareholder return, often with a short-term view that did not consider the impact of the enterprise on society and the environment.

In many cases, corporations actively pursued positive shareholder return without addressing the negative consequences of their operations in areas such as human rights, worker safety and pollution. As public criticism grew, many corporations responded to the pressure by providing philanthropy, often in the form of cash donations to community organisations and underprivileged groups. Philanthropy also became a way for individuals who had amassed wealth through the corporate structure to reallocate resources to the community.

However, philanthropic approaches alone were not sufficient, because they were not sustainable over the long term and did not fully address the social and environmental externalities of the company’s operations. External stakeholders began demanding more from companies, and forward-looking companies started to increase their dialogue with community groups and consider the social and environmental implications of their operations.

The trend from philanthropy to a more integrated approach towards sustainability was primarily led by western multinationals responding to the demands of local and international stakeholders. In Hong Kong, the economy is built on the foundations of small and medium enterprises. These companies, often family run, tend to take a more traditional philanthropic approach to responding to community needs. As these charitable donations have been positively received by communities and are seldom challenged, corporations in Hong Kong have accepted the concept of integrating sustainability into their operations later than companies in Europe and North America.

Mark Devadason, Group Head of Sustainability and Regions, Corporate Affairs, and Bill Wang, Head of Group Listings, Asia Standard Chartered Bank
The approach in Hong Kong is starting to change. Over the past two decades, multinational corporations with regional headquarters in Hong Kong have shared best practices of corporate sustainability with the local business community. This information sharing has been matched by many global companies, which expect their business partners and suppliers in Hong Kong and the rest of Asia to meet higher environmental and social standards.

It is encouraging to see growing interest in a more integrated approach to sustainability in Hong Kong. The environmental, social and governance (ESG) reporting guidelines put forward by Hong Kong Exchanges and Clearing Limited (HKEx) are an important step in promoting more transparency and engagement around ESG issues in Hong Kong and throughout Asia.

The role of stakeholders in corporate sustainability
In today’s complex socio-economic environment, corporations need to balance the interests of various stakeholders, not only those of shareholders. These stakeholders include clients and customers, employees, investors, non-governmental organisations, regulators, government and industry bodies.

Global corporations have recognised that they must be accountable for their behaviour to a diverse group of stakeholders. With the growth of social media, companies are being judged increasingly by society at large, and their actions and behaviours are debated through traditional and social media channels. Forward-looking corporations have realised the importance of stakeholder engagement and have proactively maintained ongoing dialogues with internal and external stakeholders to gauge and assess their strategic direction and impact.

Through these dialogues, corporations have come to understand that issues such as the environment, youth opportunities, health, education and diversity are as much business concerns as social concerns. The issues identified by stakeholders may pose business risks, as well as offering opportunities, and must be considered within a company’s overall business strategy.

There are clear incentives for businesses to operate with sustainability as an integrated key business consideration. According to *The Innovation Bottom Line*, a study by MIT Sloan Management Review and Boston Consulting Group released in February 2013, nearly half of the responding corporations have seen their organisation’s business model change as a result of greater awareness of the idea of sustainability. In addition, just over half of the respondents indicated that their business models have evolved as a response to customers preferring sustainable products and services.

This study highlights the value generated for companies that integrate sustainability into their operations. Global corporations are increasingly incorporating the views of external stakeholders into their strategy and thinking more deeply about how they can contribute to sustainable economic development through their core business.

International best practices
Amongst corporations that are driving best practices in sustainability, ESG considerations are incorporated into all aspects of how they do business. These corporations recognise that the most significant contribution they can make to local economies and communities is through responsible and sustainable business practices. With their annual sustainability reporting process, these companies seek to provide transparency around their approach to sustainability, setting out priorities, key performance indicators (KPIs) and reporting on progress.

Within leading corporations, philanthropy continues to play an important role, but it is not the primary way in which corporations seek to give back to communities. Strategies for best practices in sustainability build on a company’s core competencies so that they can share their knowledge and expertise with local communities. For example, construction companies focus their sustainability activities on reconstruction after natural disasters, and financial institutions offer skills-based employee volunteering focused on financial education.

The increasing demand for transparency and sustainability reporting over the past decade has resulted from the changing external expectations of stakeholders, including investors, and in some cases legal and regulatory requirements. Increasingly, investors are making investment
The trend for global initiatives such as the United Nations (UN) Global Compact and competition to be included on leading sustainability indices such as the Dow Jones Sustainability Index and FTSE4Good Index have helped drive more comprehensive reporting amongst international and large local corporations.

Corporations can adopt a number of best practice standards in developing their sustainability reporting, including the following:

- UN Global Compact
- Organisation for Economic Co-operation and Development’s Guidelines for Multinational Enterprises
- Global Reporting Initiative
- International Organization for Standardization’s ISO 26000 Guidance on Social Responsibility
- Equator Principles
- Carbon Disclosure Project.

Another emerging global trend is the rise of reporting on natural capital. There is increasing awareness about the value of natural capital in maintaining sustainable economic growth. The ecosystem provides natural resources or services known as natural capital, which are essential to economic productivity. To maintain sustainable economic growth over the long-term, it is important for governments and companies to value and account for the use of natural capital. More than 40 financial institutions, including Standard Chartered Bank, are signatories to the Natural Capital Declaration, which explores ways to increase the level of transparency, disclosure and external reporting about the use of natural capital within operations and through financing.

Currently, most sustainability reports are designed to complement a company’s annual report and accounts and to balance a corporation’s financial deliverables with its social contribution. However, the ultimate objective of many proponents of sustainability is the shift to integrated reporting in which a company combines its annual financial report with its sustainability review, with all information externally audited. Since 2010, companies listed on the Johannesburg Stock Exchange are required to produce integrated reports. This trend is gaining momentum globally, with the International Integrated Reporting Council encouraging businesses and investors to adopt an integrated approach.

**ESG reporting as recommended by HKEx**

International corporations that are dual listed in Hong Kong and on other exchanges have introduced best practices in sustainability reporting from their experience in meeting disclosure requirements in other jurisdictions. These reports issued by listed international corporations have been a catalyst for local regulators to look into alignment with international governance standards.

The HKEx noted in its 2011 Consultation Paper on Environmental, Social and Governance Reporting Guide (ESG Guide) that, amongst HKEx-listed issuers, those with the largest market capitalisation also demonstrate the highest engagement in and transparency on ESG issues.

It is encouraging that institutional investors are showing interest in receiving more ESG information from HKEx-listed issuers. Acknowledging that it will take many Hong Kong issuers time to fully comply with the emerging international standards for ESG practice and reporting, the HKEx has adopted a step-by-step and awareness-focused approach with significant efforts in training and progress evaluation.

With the *ESG Guide* (Appendix 27 to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong), the HKEx aims to raise ESG awareness and encourage meaningful disclosure on ESG matters. The *ESG Guide* is intended to be a first step towards HKEx-listed issuers adopting best practices, and it complements international disclosure guidelines.

The *ESG Guide* covers four subject areas:

- workplace quality
- environmental protection
- operating practices and
- community involvement.
Each of these areas is divided into three sections:

- ESG aspects under the area
- general disclosure recommendations and
- KPI disclosure that an issuer could make to measure its performance under each aspect.

The *ESG Guide* does not address corporate governance issues, which are dealt with separately in the Corporate Governance Code (Appendix 14 to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong).

For financial years ending after 31 December 2012, the *ESG Guide* applies to HKEx-listed issuers as a recommended best practice, which means voluntary rather than mandatory compliance. Subject to consultation, HKEx plans to upgrade the level of obligation of some recommended disclosures to ‘comply or explain’ status in 2015.

HKEx has allowed greater flexibility at the initial stage of ESG reporting. An issuer with resource constraints could start reporting on a few KPIs that are material and most relevant and include only its major operations, whereas listed issuers with more advanced capabilities are strongly encouraged to adopt international guidelines.

An issuer can include in its annual report ESG information for the same period, or it can offer this information in a separate report. Where the information is included in a separate report, it does not need to be issued at the same time or cover the same period as the annual report. An issuer is free to report on any period, but should consistently report for the same period so that the information can be comparable.

To help listed issuers better understand the key concepts and requirements, HKEx has sponsored various seminars and workshops on ESG reporting. Training for issuers was offered in 2011 based on the *ESG Guide* and again in 2013 in anticipation of listed issuers’ adoption of ESG reporting practices in the coming reporting cycles.

More practical guidance sessions are expected from HKEx in 2014.

Meanwhile, the government of Hong Kong is proposing a carbon footprint repository. Some Hong Kong-listed companies have adopted regular carbon-auditing practices. The proposal intends to facilitate disclosure of their carbon audit findings and sharing of their carbon management experience and practices. The government is proposing that Hong Kong-listed companies provide a summary of their carbon footprint for uploading onto a government web page, which is expected to be launched soon.

**Sustainability governance in the changing landscape**

It is encouraging to see the momentum towards increased ESG reporting amongst listed companies in Hong Kong. However, it is important to recognise that reporting alone is not enough. It must be underpinned by strong corporate governance standards and an open and transparent culture.

The culture at all levels – from the company’s board of directors to its operational teams – must commit to ethical behaviour, trust and open communication. A culture of strong governance must be led from the top down and constantly reinforced through both formal and informal mechanisms, including performance evaluation, remuneration, codes of conducts, training and staff communications.

The corporate governance requirements of today are very different from those of 10 years ago. The socio-political context is far more challenging, and regulators and governments have higher expectations. As corporations in Hong Kong evolve from philanthropy to sustainability, it is important for them to recognise that there is no perfect end-state. During this ongoing evolution, corporations should remain focused on their core competencies and maintain their ability to adapt and respond to the expectations of internal and external stakeholders.
Standard Chartered PLC is listed on the London and Hong Kong stock exchanges, as well as the Bombay and National stock exchanges in India.

The bank is clear about its commitment to society and has a comprehensive approach to promoting sustainability throughout its business. Over the past decade, it has adapted and shaped its business strategy to help drive social and economic development in its markets.

The bank’s approach to sustainability focuses on three priorities: contributing to sustainable economic growth, being a responsible company and investing in communities. Stakeholder engagement is central to this approach, and the bank has ongoing dialogue with external stakeholders, including non-governmental organisations, clients and customers, industry bodies, governments, regulators and investors.

In 2005, Standard Chartered began publishing a separate sustainability review to respond to expectations from external stakeholders for more information on its approach to environmental and social engagement. The bank’s reporting format is informed by the guidelines set out by the Global Reporting Initiative (GRI) and focuses on providing transparent information on the bank’s policies, procedures and progress related to its sustainability commitments. Over the years, the bank’s sustainability review has evolved to keep pace with industry best practices, including more extensive key performance indicators, proof points and case studies.

The bank’s sustainable business practices are grounded in its commitment to upholding high standards of corporate governance, social responsibility, sustainable finance policies and employee diversity. The bank has clear, well-understood governance policies, procedures and practices that apply throughout the organisation. The core aspect of the group’s strategic intent is the delivery of exemplary governance, and it is communicated to employees at all levels. These policies are also shared with external stakeholders through the bank’s annual sustainability review and corporate website.

The bank recognises that, through its core business, it can contribute to sustainable economic growth and have the most significant impact on the economies and communities where it operates. It has commissioned three independent research reports to evaluate its contribution in Ghana, Indonesia and Bangladesh. Through these reports, the bank has been able to demonstrate the core value it provides as a bank in its local market. For example, through its onshore financing in Bangladesh, Standard Chartered contributes – directly, indirectly and through induced effects – to 1.1 per cent of the country’s gross domestic product.

While the bank’s focus is on delivering value through its core business, it also recognises the continued role of philanthropy and it maintains an active employee volunteering programme and supports health and education priorities across its markets. The bank’s ‘Seeing is Believing’ programme to tackle avoidable blindness has raised more than US$60 million since 2003 and reached more than 41 million people.

Standard Chartered’s sustainability performance is evaluated by specialised sustainability trade publications, ratings agencies and indices. In 2012, it was named ‘Sustainable Global Bank of the Year’ by the Financial Times and the International Finance Corporation (IFC), recognising its commitment to embedding sustainability across its business. It is listed in the FTSE4Good Index, which has been designed to measure the performance of companies that meet globally recognised corporate responsibility standards, and in the Dow Jones Sustainability Index’s World Index and European Index, which shows its strong performance in stakeholder engagement, brand management and financial inclusion.

In addition, the bank’s leading approach to corporate governance reporting was recognised by the Institute of Chartered Secretaries and Administrators’ Hermes Transparency in Governance awards; it received the Best FTSE100 Annual Report for its 2010 Annual Report and was shortlisted for the Best FTSE100 Board Disclosure for its 2011 Annual Report.
RSM Nelson Wheeler was established in 1975 and is one of the leading accounting and consulting firms in Hong Kong, offering a wide range of services to local and international clients. Services include Audit and Assurance, Tax, Risk Advisory, Transaction Advisory and Corporate Advisory.

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The guidance from the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited aptly sums up the importance of corporate governance reporting: ‘An informed, constructive dialogue between issuers and shareholders is important to improving corporate governance’. Enhanced corporate governance is futile without appropriate timely and relevant disclosures to all stakeholders that provide assurance and confidence in connection with the stewardship and performance of a company, including its future prospects.

In the last few years, improving corporate governance reporting has been receiving considerable attention in various countries, such as the US, UK, Singapore and Hong Kong, albeit applying different approaches and disclosure requirements. For example, US-listed companies are required to publicly certify the state of their internal controls over financial reporting by key executives – that is, the chief executive officer (CEO) and chief financial officer (CFO) – of the company in accordance with the disclosure requirements in Section 404 of the US Sarbanes-Oxley Act. In other jurisdictions, companies must either report compliance with or provide explanations for deviations from the corporate governance code. Regulators are also requiring additional disclosure by company boards on matters such as strategy, business model, market environment and risks either in the management discussion and analysis (MD&A) or the business review section of the annual or interim (or both) reports released by companies.

The challenge for good corporate governance reporting is not only demonstrating compliance with governance requirements (the checklist approach) but also telling the governance story to stakeholders. This includes the information they want to know on areas viewed as critical to the success of the business and its governance. Such reporting inspires confidence in the company’s performance and in its future.

Warren Buffett, a well-known American investor and one of the world’s wealthiest individuals, offers the following advice on writing financial disclosures and reports:

“One unoriginal but useful tip: Write with a specific person in mind. When writing Berkshire Hathaway’s annual report, I pretend that I’m talking to my sisters. I have no trouble picturing them: Though highly intelligent, they are not experts in accounting or finance. They will understand plain English, but jargon may puzzle them. My goal is simply to give them the information I would wish them to supply me if our positions were reversed. To succeed, I don’t need to be Shakespeare; I must, though, have a sincere desire to inform.

No siblings to write to? Borrow mine: Just begin with ‘Dear Doris and Bertie’.”
Corporate governance reporting requirements

In Hong Kong, companies listed on the main board are required to:

“[I]nclude a Corporate Governance Report prepared by the board of directors in their summary financial reports…. The Corporate Governance Report must contain all the information set out inParagraphs G to P of this Appendix. Any failure to do so will be regarded as a breach of the Exchange Listing Rules”. (Source: Appendix 14 – Corporate Governance Code and Corporate Governance Report, Hong Kong Main Board Listing Rules)

The mandatory disclosures for the Corporate Governance Report cover the areas outlined in Tables 1 and 2.

Table 1: Mandatory disclosures by Hong Kong-listed companies

| Corporate governance practices | • A narrative statement explaining how the issuer has applied the principles in the Corporate Governance Code  
|                              | • A statement as to whether the issuer meets the code provisions and details of any deviation supported by considered reasons  
| Directors’ securities transactions | • Adoption of a code of conduct on terms no less exacting than the Model Code for Securities Transactions by Directors of Listed Issuers  
|                              | • Specific inquiry of all directors on compliance with and breaches of the required standard set out in the Model Code and the code of conduct  
| Board of directors | • Composition of the board (by category of director, including names)  
|                              | • Number of board meetings held during the financial year  
|                              | • Attendance of each director, by name, at the board and general meetings (including meetings attended by alternate directors)  
|                              | • A statement of the respective responsibilities, accountabilities and contributions of the board and management (including how the board operates, types of decisions taken by the board and decisions delegated to management)  
|                              | • Disclose of non-compliance and remedial steps taken in relation to:  
|                              | o Appointing at least three independent non-executive directors (INEDs)  
|                              | o Ensuring at least one INED has appropriate professional qualifications or accounting or related financial management expertise  
|                              | o Ensuring INEDs represent at least one third of the board  
|                              | • Explanation for INEDs who fail to meet one or more of the guidelines for assessing independence (eg has material business dealings with the company, is connected with a director, CEO or a substantial shareholder, etc)  
|                              | • Disclosure of any relationship (including financial, business, family or other material or relevant relationships) between board members and between the chairman and the CEO  
|                              | • Explanation of how each director participates in continuous professional development to expand and refresh their knowledge and skills  
| Chairman and CEO | • Identity of the chairman and the CEO  
| Non-executive directors | • Separation of chairman and CEO roles  
| Board committees | • Term of appointment for non-executive directors  
|                              | • Disclose and report on:  
|                              | o Role and function of each committee  
|                              | o Composition of each committee  
|                              | o Number of meetings held by each committee  
|                              | • A summary of their work during the year  
|                              | • See Table 2 for specific committee disclosure requirements
<table>
<thead>
<tr>
<th>Table 2: Mandatory disclosures for board committees</th>
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</thead>
<tbody>
<tr>
<td><strong>Remuneration committee</strong></td>
</tr>
<tr>
<td>• Determining the policy for the remuneration of executive directors</td>
</tr>
<tr>
<td>• Assessing the performance of executive directors</td>
</tr>
<tr>
<td>• Approving the terms of executive directors’ service contracts</td>
</tr>
<tr>
<td>• Disclosing whether the committee determines or makes recommendations to the board on remuneration packages of individual executive directors and senior management</td>
</tr>
<tr>
<td><strong>Nomination committee</strong></td>
</tr>
<tr>
<td>• Determining the policy for nomination of directors</td>
</tr>
<tr>
<td>• Disclosing nomination procedures, process and criteria to select and recommend candidates for directorship</td>
</tr>
<tr>
<td>• If applicable, including policy on board diversity and progress on achieving those objectives</td>
</tr>
<tr>
<td><strong>Corporate governance</strong></td>
</tr>
<tr>
<td>• Determining the policy for corporate governance</td>
</tr>
<tr>
<td>• Ensuring duties are performed to:</td>
</tr>
<tr>
<td>○ Develop and review corporate governance policies and practices, and make recommendations to the board</td>
</tr>
<tr>
<td>○ Review and monitor training and continuous professional development for directors and senior management</td>
</tr>
<tr>
<td>○ Review and monitor policies and practices on compliance with legal and regulatory requirements</td>
</tr>
<tr>
<td>○ Develop, review and monitor the code of conduct and compliance manual applicable to employees and directors</td>
</tr>
<tr>
<td>○ Review compliance with the Corporate Governance Code and disclosure in the corporate governance report</td>
</tr>
<tr>
<td><strong>Audit committee</strong></td>
</tr>
<tr>
<td>• Reporting on how the audit committee discharges its responsibilities in reviewing the company’s financial results and internal control system</td>
</tr>
<tr>
<td>• Disclosing breaches in establishing an audit committee (see latter requirements) and remedial steps taken to ensure the audit committee:</td>
</tr>
<tr>
<td>○ Comprises non-executive directors only</td>
</tr>
<tr>
<td>○ Comprises a minimum of three members</td>
</tr>
<tr>
<td>○ Has at least one member who is an INED with appropriate professional qualifications or accounting or related financial management expertise</td>
</tr>
<tr>
<td>○ Has a majority of members who are INEDs</td>
</tr>
<tr>
<td>○ Is chaired by an INED</td>
</tr>
</tbody>
</table>
In addition, the corporate governance report must include the following disclosures from the accountability and audit section of the Corporate Governance Code:

- **Financial reporting**: Directors must acknowledge their responsibility for preparing the accounts and provide a statement by the auditors about their reporting responsibilities on the financial statements. Directors should disclose and discuss at length material uncertainties relating to events or conditions that may cast significant doubt on the company’s ability to continue as a going concern.

- **Internal controls**: Directors must have conducted a review on the effectiveness of the company’s internal control system at least annually. The review should cover areas such as financial, operational and compliance controls and risk management.

- **Audit committee**: Should the board disagree with the audit committee’s view on the selection, appointment, resignation or dismissal of the external auditors, the audit committee must explain its recommendation and the reason or reasons the board has taken a different view.

**Corporate governance reporting and its challenges in Hong Kong**

Corporate governance reporting according to the Listing Rules in Hong Kong is often viewed as a minimum standard for information disclosure. Surveys conducted by Hong Kong Exchanges and Clearing Limited (HKEx) and others since 2005 on mandatory corporate governance reporting have uncovered certain trends and insights into Hong Kong-listed companies over the years.

**From 2005 to 2009**

HKEx randomly selected companies based on their market capitalisation (large-cap of more than HK$1 billion, mid-cap of more than HK$400 million to HK$1 billion and small-cap of HK$400 million or less) for a cross-section of listed companies. It then reviewed disclosure of corporate governance practices in company annual reports over several years. The results of this review are shown in Figure 1.

Companies were assessed on whether they fully complied with the code provisions in the Corporate Governance Code. Starting from 2005, only 29 per cent of companies were fully compliant. While trending upwards initially, the results showed that overall compliance by companies seemed to have plateaued at 39 per cent between 2007 and 2009.

However, a closer look reveals that compliance levels were different for companies based on their market capitalisation. See Figure 2.

In both 2007 and 2009, a higher percentage of companies fully complied with all code provisions for large-cap compared with mid-cap companies, and a similar distinction was found between mid-cap and small-cap companies. This appears to

![Figure 1: Overall compliance with all code provisions (CPs) by Hong Kong-listed companies](image)
support the view that strict adherence to a one-size-fits-all standard and approach for corporate governance may not be appropriate, particularly for small-cap companies.

The number one deviation (for 37 per cent of companies reviewed) from the code provisions related to the separation of the chairman and CEO roles. According to the Corporate Governance Code, these roles should not be performed by the same person. In addition, ‘The division of responsibilities between the chairman and the chief executive officer should be clearly established and set out in writing’.

The top-three most frequently quoted reasons by companies for not complying with this requirement were:

1. **Strong leadership**: The same person provides the group with strong and consistent leadership, which allows more effective planning and formulation, as well as execution and implementation, of long-term business strategies.

2. **Size of group**: One person is ideal for both roles because of the size of the group; the scope or nature of its business; a practical necessity arising from the corporate operating structure; or a combination of these reasons.

3. **Directors’ contribution**: Contributions are made by all executive directors and INEDs, who bring different experience and expertise and who meet regularly to discuss issues affecting the issuer’s operations.

**From 2010 to 2012**

A more recent review of listed companies in Hong Kong, encompassing the large-cap and mid-cap indices of the Hang Seng Composite Index, indicated that the level of compliance has continued to improve from 2009 (39 per cent overall compliance), but that it has started to plateau as well. See Figure 3.

At the same time, further analysis of the degree to which companies explained their reason for non-compliance (ie failure to adhere to one or more code provisions) showed a worrying
A downward trend (from 59 per cent in 2010 to 50 per cent in 2012). See Figure 4.

Similar to HKEx’s review, this more recent review by BDO noted that many companies continue to have one person fulfilling the roles of both chairman and CEO.

On a more positive note, the BDO review highlighted that some companies are providing more informative disclosures, such as using tables and charts and even personal comments on governance in their chairman’s statement and in their governance report. At the other extreme, however, some companies simply repeated content from previous years and used information copied directly from the code. Such companies provided stakeholders with only minimal insight into their governance practices and compliance.

**Reporting outlook for Hong Kong**

The most recent reforms to the Hong Kong Corporate Governance Code, which took effect in 2012, were comprehensive. They covered areas such as:

- **Remuneration**: The company must disclose the remuneration of a CEO who is not a director and disclose senior management remuneration by band in the annual report.
- **Committees**: The company must establish a remuneration committee comprising a majority of INED members and establish a nomination committee with a majority of INEDs and chaired by an INED or the board chairman.
- **Board balance**: At least one third of a company’s board must comprise INEDs.
- **Enhanced governance reporting**: The annual report should include an explanation of the basis on which the company generates or preserves value over time and the strategy for delivering the objectives of the company. The company must disclose the corporate governance policy and duties performed in the corporate governance report.

Unfortunately, the reforms did not require an explicit statement that addresses a company’s risk management and internal control system. The Singapore authorities, in their latest governance reforms, require the board of directors and the audit committee to provide an opinion on whether the internal controls are adequate to address financial, operational and compliance risks.

The HKEx also runs a review programme on company annual reports (as part of its ongoing monitoring and compliance activities), because it believes that better disclosure promotes an informed market. Its latest report was released in March 2013. One of its findings noted that the MD&A section should disclose meaningful information, such as:

- a company’s business model and material business developments (by major product lines or business sectors).
- a detailed explanation of material account fluctuations, such as:
  - *Trade receivables*: Debtors’ turnover days, credit period analysis, customer profile and subsequent settlement.
• Tax balances or effective tax rate: Tax rates applicable to major operating subsidiaries, effective period of tax holidays and reduced tax rates
• key performance indicators to measure the company’s performance and their trends, their changes and the reasons for these changes.

Nonetheless, other efforts are underway to improve governance reporting further. Starting from September 2013, companies have been required to disclose measures for board diversity in terms of the gender, age, cultural and educational background and professional experience of directors.

In addition, the new Hong Kong Companies Ordinance (which provides the legal framework for the formation and operation of companies incorporated in Hong Kong) came into operation on 3 March 2014. The changes introduced by this new ordinance are extensive. One of the changes relates to financial reporting and the directors’ report. This requires a public company (listed or unlisted), or a company that does not qualify for simplified financial reporting, to prepare an analytical and forward-looking business review of the company in its directors’ report. The business review must include information on:

• the risks and uncertainties facing the company
• the future development of the company’s business
• environmental concerns, employees, customers and suppliers that have a significant impact on the company
• analysis using key financial performance indicators.

Summary
It is clear that stakeholders, including regulators, are demanding better reporting of corporate governance. The aim is no longer to take a checklist approach with minimal insights from a company and its board of directors. The challenge now is to deliver more integrated, comprehensive and meaningful reporting that tells the governance story starting with the ‘tone from the top’. Stakeholders want to know what good governance means to a company, whether the board’s oversight is effective and how the governance culture is aligned with the company’s policies and procedures, which – in turn – are reinforced by an appropriate measurement and incentive system.

Much work remains to be done, but companies can start by looking at the effectiveness of their reporting on:

• Corporate governance: Putting into context how the company approaches governance and what it means to the company
• Narrative reporting (MD&A or business review): Beyond financial reporting, disclosing the company’s plans, activities and performance starting with areas such as (1) strategy, remuneration and performance; (2) business model and market environment; and (3) risk management and internal controls
• Compliance with rules and regulations: Demonstrating compliance with specific provisions of the Corporate Governance Code (eg board composition and committees and internal controls) by drawing on the reports from the audit, nomination and remuneration committees.

By adopting good practices in corporate governance reporting, Hong Kong companies will assure stakeholders and increase their confidence in a company’s stewardship and future prospects.
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...With Integrity.
Recent legal and regulatory reforms have significantly increased the risks and liabilities faced by Hong Kong company directors. In particular, corporate governance reform has resulted in greater scrutiny of board performance, board practices, and the accountability of directors and officers (D&Os). This chapter will guide companies through the potential risks arising during an initial public offering (IPO) and listing on the Stock Exchange of Hong Kong, as well as identifying the insurance solutions available to counter those risks.

D&O liability
D&Os may be personally liable to any party with an interest in the company, and they can be sued in their individual names. A breach of duty exposes an individual’s personal assets (and even assets in a spouse’s name) to claims. Combined with the doctrine of joint and several liability amongst board members, in which members can be held individually or mutually responsible, this could result in using personal assets to meet the liability of the entire board.

D&Os owe a duty of care to a host of other ‘persons,’ which may include the company itself, shareholders, prospective shareholders, investors, employees, creditors, customers, suppliers, liquidators, regulators, competitors, the government and fellow directors. With such liability well established, and in an increasingly litigious environment, the number of actions against directors is rising.

Furthermore, with a more buoyant IPO market, and renewed growth in new issuers, awareness of litigation risk – and demand for D&O protection – is greater than ever.

Potential risk exposures arising out of an IPO
Raising capital through a listing provides a company and its shareholders with significant opportunities. However, the increased liability risks can be onerous.

Typically, a company going public faces increased risk exposure from:

- the process of listing
- a change of ownership after the listing (ie from being a closely held company to a public limited company).

Heightened exposure may arise from various areas during the IPO process and these are detailed below.
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Increased regulatory risks

Stock exchange requirements when preparing for an IPO: The need to comply with stock exchange rules increases the duties of D&Os.

Enhanced corporate governance responsibility: Regulators have recently imposed more stringent requirements and duties on D&Os of public companies, further exposing them to potential personal liability.

Increased regulatory scrutiny: Public companies owe a duty of care to shareholders and clients, leading to greater scrutiny by regulators than would be the case for a private firm.

New regulation in relation to financial disclosures: Late publication of financial information leads to regulators imposing fines and/or penalties.

Insider trading after an IPO: Share trading by directors could lead to regulatory investigation into alleged insider trading, incurring substantial fines and legal costs.

Counterparty risks

The underwriters on an IB are likely to seek an indemnity against losses incurred as a result of misstatements, and other alleged errors in the offering document. The offering document usually allows for indemnities to be provided to the underwriters, sponsors, or both. If the listing company is sued for misstatement in its prospectus, not only are D&Os potentially liable, but further indemnities may have to be provided to counterparties.

Employee risks

Changes to pension plans following an IPO may cause employees to sue the company or the trustees of the company’s pension scheme.

What is directors’ and officers’ liability insurance?

D&O liability insurance is coverage designed to address the personal liability that company D&Os can incur for acts or omissions arising from their duties as directors or officers, which may or may not be covered by an indemnity from the corporation.

A D&O insurance policy protects D&Os of the parent company and its subsidiary companies. The policy usually protects:

- all past and present D&Os and those appointed during the life of the policy; and
- the company when it reimburses its D&Os.

Who is an officer?

Although the legal definition of an officer of a company will vary according to the jurisdiction of incorporation of a company, in general terms an officer is any employee or director of a company who is involved in the management, supervision or corporate decision-making. Officers are not limited to company directors and may also include the company secretary, chief accounting staff and other members of senior management.

What protection does D&O liability insurance provide?

One major benefit provided by a D&O insurance policy is to protect D&Os from litigation and to provide liability insurance should such litigation arise in the conduct of their duties. Protection...
for D&Os is also compliant with the Hong Kong Listing Corporate Governance Code requirement for the purchase of appropriate insurance coverage. What is ‘appropriate’ insurance cover will depend on the nature of the issuer’s business. Consequently, issuers are encouraged to seek professional advice to assess their needs with respect to insurance for their D&Os.

D&O insurance is a key risk management tool that provides the protection directors need to be able to pursue the strategic objectives of the company without being unduly concerned with the fear of bearing personal financial loss as a result of their actions.

The D&O insurance policy is a three-part contract:

**D&O liability** protects individual D&Os of the company in situations where the company does not indemnify them. From a legal perspective, a company may not be able to indemnify D&Os or it may not be financially capable of doing so. Such coverage is referred to as ‘ground up’, in that generally no deductible or excess applies.

**Company reimbursement** protects the company from claims made against D&Os when it indemnifies them. Such coverage is usually subject to a deductible or excess, which must be absorbed by the company.

**Entity coverage** protects the company with respect to:
- securities claims arising out of the sale or purchase of shares which may be brought by a shareholder or a group of shareholders against directors, or as a derivative action in the name of the company, if permitted by law
- claims arising out of breaches of employment practices by the company, which may include wrongful dismissal, wrongful termination, discrimination, or harassment claims.

D&O insurance also protects D&Os against allegations of wrongful conduct when they are acting as company executives. The policy is intended to cover defence and settlement costs where claims are made against them in their capacity as D&Os of the company. The policy covers claims made against the company and reported to the insurer during the policy period, which is usually 12 months. There is also a maximum liability limit under the policy, which is the maximum amount insurers will pay for each claim during the policy period.

Wrongful act is a key definition in any D&O policy. A broad definition includes errors, misstatements, misleading statements or acts, omissions, neglect, breach of duty, or breach of trust on the part of an insured individual. Wrongful acts can also be defined in the broadest terms to include any matters claimed against insured individuals solely because they are a director or officer of the company.

When choosing protection, the nature of a claim that would trigger coverage under a D&O policy is a key consideration and would usually include:
- civil proceedings brought by a third party for recovery of compensation or damages
- any lawsuit, proceeding, or written demand for monetary damages or other relief
- requests for extradition
- criminal proceedings against an insured person
- formal regulatory or formal administrative proceedings against an insured person alleging a wrongful act
- investigation of an insured person.

A D&O policy offers automatic protection for insured persons, which can be widely defined to include:
- past, present and future D&Os
- non-executive directors and shadow directors
- directors appointed to the board of investee or related entities
- spouses or partners
- other employees who carry out a managerial or supervisory function for the company.

The following losses will generally be covered under a D&O policy: damages, judgments, or settlements and associated costs and expenses, prosecution (criminal or otherwise), defence costs, and all other reasonable costs and expenses.

The insured person needs to obtain the written consent of insurers before incurring costs and expenses. Key protection provided by a D&O
policy would typically include the following extensions:

**Advancement of defence costs:** The D&O policy extends to providing coverage for defence costs before the final settlement of the claim. Allegations of wrongful acts or threats of litigation may lack merit or reasonable grounds for success. Regardless of whether the director or officer is ultimately found liable for allegations of wrongdoing, such actions usually require a defence. Through this extension, the policy advances defence costs. If defence costs are advanced for a matter not covered by the insurance, then the money needs to be repaid to the insurer.

**Investigation costs:** For an insured individual, investigation costs can arise from a need to prepare for, attend or provide documents for an investigation by a regulatory body. An investigation is generally an official investigation of, examination of, or inquiry into the affairs of the company that requires the attendance of the director.

**Outside directorships:** It is common for a company to ask one of its directors to sit on the board of a related, associated or investee company. These positions can be automatically included under the coverage of a D&O policy; however, such coverage would be subject to any underlying insurance or indemnity available to the related, associated, or investee company. Directors will typically ask if such coverage is in force before accepting an outside directorship. Even for small private companies, it would be prudent for D&Os to ask if such insurance is in place.

A D&O policy is also designed to provide automatic coverage to directors for liabilities that may arise out of the following:

**Acquisition of a new subsidiary:** A D&O policy can automatically extend to directors of new subsidiaries subject to certain conditions.

**Secondary offering of securities:** Coverage is provided to an issuer and its directors with respect to D&O claims arising out of a secondary offering of its securities.

**Merger or acquisition:** Specific policy features provide discovery-period or run-off coverage for directors for up to six years from the date of merger or acquisition, or in line with the relevant statue of limitations.

**Extended reporting period:** If the company cancels the policy and does not renew it with another insurer, then the insurer offers an extended reporting period for discovery of claims for a period chosen by the company. However, such coverage only extends to wrongful acts committed before the termination or non-renewal date.

**What are the major exclusions from D&O cover?** All D&O policies are written with specific exclusions. The basic policies of insurers vary, but most do not cover claims arising from:

- **Prior knowledge:** The policy excludes pending or prior litigation, demands, or judgments known to the insured before the inception of the policy. It also excludes circumstances of which the director received notification under a prior insurance policy.
- **Fraudulent, dishonest, and wilful conduct:** An insurer will not cover criminal, dishonest, or fraudulent acts or omissions that are against public policy or are uninsurable as a matter of law. However, to invoke the exclusion, such conduct must generally be established as having occurred by a court or final adjudication, or by admission of the insured.
- **Insured versus insured exclusion:** This exclusion is present in D&O policies to avoid policy abuse or collusive lawsuits. Typically there are write-backs to carve out situations where insured versus insured claims are permitted. In some cases, policies only apply this exclusion to claims brought within the United States or Canada.
- **Bodily injury or property damage exclusion:** This protection is usually afforded by other general liability or property insurance policies.
- **Pollution claims exclusion:** Coverage is provided for shareholder derivative actions alleging environmental damage, along with limited defence cost coverage for insured persons.
- **Major shareholder claims:** Exclusions usually prevent claims brought by shareholders holding and interest in shareholdings of 15 per cent or more of the company.
- **War and terrorism or nuclear risk exclusion.**
**What gives rise to legal proceedings?**

Legal proceedings against D&Os usually arise following certain events, including:

- change in ownership, change of control, acquisition or merger
- issue of financial report or prospectus containing inaccurate or incomplete information
- dishonesty of a director or officer
- dramatic change in share price
- appointment of a receiver
- boardroom disputes.

**Recent regulatory changes**

There has been an increase in demand for and awareness of D&O insurance in Hong Kong following the upgrade of the requirement for main board-listed companies to provide D&O protection for their directors from being a recommended best practice to a code provision.

**When can a company indemnify D&Os?**

For Hong Kong companies, the provisions relating to indemnification of D&Os are set out in section 469 of the new Companies Ordinance (which came into effect on 3 March 2014). Section 469 of the new Companies Ordinance expressly allows a company to indemnify a director against liability incurred by the directors to a third party. Furthermore, section 468(4) of the new Companies Ordinance allows a company to maintain insurance for a director of the company or an associated company against liabilities to third parties (except for fraud). The provision covers defence costs incurred by a director in defending proceedings (whether civil or criminal) taken against a director for negligence, default, breach of duty, or breach of trust (including fraud) in relation to the company or an associated company.

A new disclosure requirement has also been introduced. A company which provides a lawful indemnity to its directors or its associated company’s directors is required to disclose details of the indemnity provisions in the directors’ report, and make them available for the members to inspect upon request. It is believed that this measure will give greater transparency to the shareholders and the public in relation to D&O policies maintained by the company.

**Conclusion**

Certainly, it is better to prevent claims arising in the first place. But even the best controls and governance are not unable to ensure comprehensive protection. This is why D&O liability insurance plays such a vital role in helping individuals and companies manage the increasing range of risks to which they are exposed.

Unlike corporate liability, personal liability for breach of duty is unlimited, and civil and criminal consequences may result. These may expose individual directors to potentially ruinous costs from defending claims and paying any penalties imposed. The global nature of business may also mean needing to secure local legal representation in multiple jurisdictions outside Hong Kong.

In an environment where the number of claims against companies and their directors continues to increase, it is therefore unsurprising to see D&O liability insurance emerging as a key issue in the corporate governance debate.
PART IV
An International Perspective

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The majority of companies whose shares are listed on The Stock Exchange of Hong Kong Limited (SEHK) are not in fact incorporated in Hong Kong. The Rules Governing the Listing of Securities on the SEHK (Listing Rules) recognise four jurisdictions of incorporation from which companies may be eligible for listing (Recognised Jurisdictions): Hong Kong, the People's Republic of China (PRC), Bermuda and the Cayman Islands. Over time, and in particular since 2007, the SEHK’s Listing Committee has accepted other jurisdictions as approved jurisdictions of incorporation (Approved Jurisdictions). As of 1 December 2013, there were 21 Approved Jurisdictions, including Australia, Brazil, Italy, the United Kingdom (UK), Japan, Korea, Canada and certain states of the United States of America (US). This Chapter summarises the main corporate governance challenges that overseas companies face when listing in Hong Kong.

The Hong Kong listing rules applicable to overseas listing applicants

Chapter 19 of the Listing Rules
Chapter 19 of the Listing Rules sets out the additional requirements for overseas listing applicants and the considerations that the SEHK takes into account when assessing whether an overseas company is eligible for listing. If a listing applicant is incorporated in a jurisdiction that is neither a Recognised Jurisdiction nor an Approved Jurisdiction, the listing applicant should first seek guidance on compliance with the relevant requirements. This would normally involve consulting the SEHK on issues that conflict with the Listing Rules and possible waivers or solutions to those issues.

The key consideration from the SEHK’s perspective is whether the jurisdiction has standards of shareholder protection that are at least equivalent to those provided in Hong Kong. If a jurisdiction’s laws and regulations do not offer equivalent protection, the SEHK may accept alternative ways of bringing the level of shareholder protection in those companies in line with the Hong Kong requirements. For example, certain key provisions may instead be added to the constitutional documents of the company.

Chapter 19A of the Listing Rules
There are additional provisions in Chapter 19A of the Listing Rules that apply to PRC-incorporated companies. These obligations include:

- the requirement for at least one independent non-executive director (INED) to be ordinarily resident in Hong Kong
- the requirement to have a supervisor with the necessary character, experience and integrity who is able to demonstrate a standard of competence commensurate with their position as a supervisor (noting that
there is a similar requirement regarding character, experience, integrity and competence for every director of a non-PRC incorporated company)

• the requirement for every director and officer to enter into a contract with the PRC issuer containing certain provisions. These provisions include an undertaking by the director to observe and comply with the company law of the PRC, the Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies, the articles of association of the company, the Takeover Code and Share Repurchase Code and an undertaking by the director to observe and comply with his obligations to shareholders stipulated in the articles of association. There is a similar requirement for supervisors.

The current JPS
The current JPS updates certain requirements from the old JPS and consolidates the old JPS, the 2009 guidance letter and various listing decisions into one document, including individual Country Guides to supplement the basic framework. The SEHK published a Country Guide for each Approved Jurisdiction (except Ontario, Canada) at the end of 2013 with the intention that applicants would be able to adopt the arrangements set out in the Country Guide for its place of incorporation in an Approved Jurisdiction. Subject to applicants demonstrating how their practices conform with the JPS requirements as set out in the applicable Country Guide, the SEHK does not consider the shareholder protection standards in each of those jurisdictions to be materially different from those of Hong Kong. Each Country Guide provides guidance on how the SEHK will consider certain matters under the JPS. Accordingly, an overseas company from an Approved Jurisdiction will not be required to provide a detailed explanation of how it satisfies the key shareholder protection standards in each of those jurisdictions to be materially different from those of Hong Kong. Each Country Guide provides guidance on how the SEHK will consider certain matters under the JPS. Accordingly, an overseas company from an Approved Jurisdiction will not be required to provide a detailed explanation of how it satisfies the key shareholder protection standards. If a Country Guide has not yet been published for an Approved Jurisdiction, an applicant should refer to the published listing decisions for that jurisdiction (which are available on the SEHK’s website).

For an overseas company incorporated in a jurisdiction that is new to listing in Hong Kong, those applicants should refer to the following numbered sections in this chapter. These sections set out the requirements with which the applicants must demonstrate compliance in their listing application to the SEHK. In particular, the listing applicant can refer to the Country Guides as reference for guidance on how to show equivalence in shareholder protection standards. The SEHK encourages overseas companies which wish to seek a listing on the SEHK to consult them at an early stage if they foresee any difficulty in complying with the requirements.

The JPS is divided into five sections:

1. Shareholder protection standards
2. Regulatory cooperation arrangements
3. Accounting and auditing related and other disclosure requirements

The joint policy statement
The first major step by the Hong Kong authorities to encourage more overseas companies to consider Hong Kong as a listing venue was taken in March 2007 when the Securities and Futures Commission (SFC) and the SEHK published a joint policy statement. A new joint policy statement (JPS) was published in September 2013, which superseded the March 2007 version with the aim of encouraging overseas companies to list in Hong Kong by reducing unnecessary regulatory burdens but still preserving high standards of regulation, enforcement and corporate governance.

The old JPS
The old JPS clarified the requirements under the Listing Rules, especially those under Chapter 19, and provided a roadmap to assist overseas companies and their advisers when seeking a primary listing either on the Main Board or the Growth Enterprise Market of the SEHK. It also set out the key requirements that the SEHK considered when determining whether an overseas company was eligible for listing. The old JPS was designed to be read in conjunction with listing decisions published by the SEHK that addressed the procedural requirements for each Approved Jurisdiction. In addition, a guidance letter was published by the SEHK in September 2009 to expand upon certain requirements under the old JPS and to facilitate the process for subsequent overseas listing applicants.
4. Practical and operational matters

5. Suitability for secondary listing

In addition, the JPS contains a table setting out how each Main Board Listing Rule applies to an overseas company that is primary listed, dual primary listed or secondary listed on the SEHK.

1. Shareholder protection standards

An overseas listing applicant which is not incorporated in a Recognised Jurisdiction must demonstrate that it is subject to the following key shareholder protection standards, by reference to its domestic laws, rules and regulations and its constitutional documents:

- **Matters requiring a super majority vote:** The SEHK will accept overseas applicants from a jurisdiction where the following matters are dealt with by way of a super majority vote of shareholders (eg two-thirds as opposed to the three-quarters requirement under Hong Kong law). These matters are (a) changes to the rights attached to any class of shares, (b) material changes to the company’s constitutional documents and (c) voluntary winding up of the company.

- **Individual shareholders to approve increase in shareholder’s liability:** There should not be an ability under the constitutional documents to increase an existing shareholder's liability to the company, unless the increase is agreed in writing by that shareholder.

- **Auditors:** The appointment, removal and remuneration of auditors must be approved by a majority of an overseas company’s shareholders or a body that is independent of the board of directors.

- **Proceedings at general meetings:** A general meeting must be held each year and generally not more than 15 months should elapse between these meetings. Other requirements for general meetings are set out in the JPS in relation to meeting notices, the shareholders’ right to speak and vote at the meeting, the ability of shareholders to convene a general meeting and add resolutions to a meeting agenda and the ability of a recognised Hong Kong clearing house to appoint proxies or corporate representatives.

2. Regulatory cooperation

The statutory securities regulator in an overseas company’s jurisdiction and the place of the company’s central management and control must satisfy one of two requirements:

- be a full signatory of the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information
- have entered into an appropriate bilateral agreement with the SFC, which provides for mutual assistance and exchange of information for the purpose of enforcing and securing compliance with the laws and regulations of that jurisdiction and Hong Kong. Details of the bilateral agreements in place with the SFC can be found on the SFC’s website.

3. Accounting and auditing related and other disclosure requirements

All companies seeking to list on the SEHK must prepare an accountants’ report and the relevant accounts should normally have been audited to a standard comparable to that required in Hong Kong. Where the SEHK allows a report that is not prepared in conformity with Hong Kong Financial Reporting Standards (HKFRS), International Financial Reporting Standards (IFRS) or, as an option available to PRC issues only, Chinese Accounting Standards for Business Enterprises, the accountants’ report will be required to conform with accounting standards acceptable to the SEHK and the financial effect of the material differences (if any) from HKFRS or IFRS must be stated. The SEHK has so far accepted:

- EU-IFRS, the IFRS (as adopted by the European Union (EU)) for use by EU companies
- US Generally Accepted Accounting Principles (GAAP) for use by companies with, or seeking, a dual-primary listing in the US and on the SEHK
- the following financial reporting standards for companies with, or seeking, a listing in the relevant jurisdiction and a dual-primary or secondary listing on the SEHK:
  - Australian GAAP
  - Canadian GAAP
  - Japanese GAAP
  - Singapore Financial Reporting Standards
  - UK GAAP.
The JPS further explains the regulatory approach the SEHK will take when considering whether to allow an accountants’ report and financial statements that are not prepared in accordance with HKFRS or the IFRS by non-Hong Kong qualified auditors.

The JPS sets out additional disclosure requirements for overseas companies, such as a summary of waivers and exemptions that have been granted, a summary of the provisions in the laws and regulations in its home jurisdiction and primary market that are different to those required by Hong Kong law regarding certain areas, and details of any withholding tax. In addition, an overseas company must make certain disclosures in a Company Information Sheet, which is then posted on the website of the SEHK. The Company Information Sheet contains summaries of waivers and exemptions, local law requirements and the constitutional documents of the issuer. The Company Information Sheet must be amended whenever there is a material change to the information disclosed in it.

4. Practical and operational matters
The JPS sets out various notes on practical and operational matters:

- **Compliance**: If overseas companies foresee any practical or operational difficulty in complying with the Listing Rules or The Codes on Takeovers and Mergers and Share Buy-backs (Takeovers Code), they are strongly encouraged to consult with the SEHK and Takeovers Executive at the earliest opportunity. The SEHK allows a variety of methods to enable overseas companies to comply with the Listing Rules and the Takeovers Code, such as providing undertakings to put in place a shareholder protection measure or by demonstrating it has adopted appropriate internal compliance measures.

- **HDRs**: Overseas companies facing operational and legal difficulties listing their shares in Hong Kong may wish to consider listing Hong Kong Depositary Receipts instead. This option is discussed in more detail in the JPS and on the website of the SEHK.

- **Taxation**: An applicant must bring to the attention of the SEHK any withholding tax on dividends or any other tax payable (eg capital gains tax). Details of any taxes payable must be disclosed in the listing document.

5. Entities suitable for a secondary listing
The JPS sets out the criteria for entities seeking a secondary listing in Hong Kong for whom it would be appropriate to grant extensive waivers from compliance with the Main Board Listing Rules; for example, if the applicant:

- is a large company with a long track record of regulatory compliance on its primary market
- has a primary listing on one of the recognised exchanges listed in the JPS (eg London, New York or Singapore, among others)
- has a ‘centre of gravity’ outside Greater China, which will depend on certain factors such as where the company is incorporated, its history and where it is listed.

Moreover, an applicant for a secondary listing seeking waivers should:

- have a market capitalisation in excess of US$400 million
- have been listed in its primary market for at least five years (there are some exceptions)
- demonstrate a good compliance record with the rules and regulations of its home jurisdiction and primary market.

The grant of any waivers will be conditional upon the applicant maintaining its primary listing on the same main market overseas.

Corporate governance considerations
We highlight below, based on our experience with overseas company listings in Hong Kong, some of the key areas where the Hong Kong corporate governance regime may be more onerous than – or at least different to – their local requirements.

It is possible to obtain waivers from strict compliance with certain requirements of the Listing Rules. There is no definitive list of waivers published by the SEHK, but it is useful to cross-reference the listing documents of other overseas companies to see which waivers have been granted to them. In addition, the JPS includes an appendix that sets out how each Main Board Rule applies...
to an overseas company that is primary listed, dual primary listed or secondary listed on the SEHK’s Main Board. It highlights which waivers are automatically granted (upon being identified to the SEHK) and which waivers are commonly granted following a formal application for a waiver.

Management presence
A new applicant for a primary listing must have a sufficient management presence in Hong Kong. This normally means that the issuer must have at least two executive directors who are ordinarily resident in Hong Kong. By 2009, it had become almost invariable practice for overseas companies to seek a waiver from strict compliance with this requirement. Therefore, the SEHK published a guidance letter for new applicants, which sets out the conditions that it would ordinarily expect a waiver application in relation to the management presence requirement to contain, such as appointing an authorised representative who will act as the principal channel of communication with the SEHK and that each director who is not ordinarily resident in Hong Kong should possess or have the ability to apply for a valid travel document to visit Hong Kong and can meet with the SEHK within a reasonable period. The guidance letter emphasises that a waiver will still be granted on a case-by-case basis having regard to all the relevant facts and circumstances.

Minimum number of INEDs
A listed issuer must have at least three INEDs on its board of directors and the number of INEDs must represent at least one third of the board of directors.

The INEDs must satisfy the independence requirements under the Listing Rules. These are the factors that the SEHK will take into account when assessing the independence of a non-executive director, although they are not necessarily conclusive. The factors are non-exhaustive and the SEHK may take into account other factors relevant to a particular case.

The independence requirement for INEDs is an on-going requirement and any changes to their independence must be notified to the SEHK as soon as practicable. Each INED must provide an annual confirmation of their independence to the listed issuer and the listed issuer must confirm in its annual reports that it has received such confirmation and whether it still regards its INEDs as independent.

In our experience with overseas issuers, questions regarding the independence of a director do not often arise and it is usually fairly clear-cut whether a person is or is not independent.

Company secretary
A listed issuer must appoint a company secretary who, by virtue of that individual’s academic or professional qualifications or relevant experience, is, in the opinion of the SEHK, capable of discharging the functions of a company secretary.

The SEHK considers a Hong Kong qualified solicitor, a member of the Hong Kong Institute of Chartered Secretaries or a certified public accountant as acceptable academic or professional qualifications. When assessing ‘relevant experience’, the SEHK will consider factors such as familiarity with the Listing Rules and the securities law regime in Hong Kong, relevant training taken or to be taken, and professional qualifications in other jurisdictions.

The Corporate Governance Code also contains a specific section on the role and responsibilities of the company secretary. As an on-going obligation, a listed issuer’s company secretary must undertake at least 15 hours of relevant professional training in each financial year.

The SEHK has, in the past, granted a waiver to dual-listed companies from strict compliance with the eligibility requirements for a company secretary. This has allowed the listing applicant to appoint a joint or assistant company secretary who possesses the relevant qualifications or experience to ensure compliance with the Hong Kong requirements and enables the existing company secretary to continue its current role in the home jurisdiction. The SEHK has indicated in the JPS that it will grant an automatic waiver from compliance with the company secretary requirement to an applicant applying for a secondary listing.

Split Chairman/CEO role
As a code provision under the Corporate Governance Code (which is to be complied with or otherwise explained in the company’s financial reports), the roles of chairman and chief executive
should be separate and should not be performed by the same individual. The rationale for this split is to ensure there is a division of responsibilities between the management of the board and the day-to-day management of the business, and to ensure a balance of power and authority.

It is not uncommon amongst overseas listing applicants, particularly those from certain European jurisdictions, that the same individual is the chairman and chief executive of a company. Such an overseas company should consider whether it is possible to comply with the above provision and, if not, must explain why this does not represent a concentration of too much power in the hands of one person.

Connected transactions
The main purpose of the connected transaction requirements under the Listing Rules is to ensure that connected persons – such as directors or substantial shareholders – cannot take advantage of their position to the detriment of other shareholders (particularly the minority).

Connected transactions need to be identified in the early stages of the listing process and details must be disclosed in the listing document. Unless an exemption applies, there are also on-going requirements relating to connected transactions, including disclosure, annual reporting and independent shareholders’ approval requirements.

The SEHK has indicated in the JPS that it will grant an automatic waiver from compliance with the connected transaction requirements to an applicant applying for a secondary listing.

The SEHK issued two new consultation papers in relation to connected transactions in April 2013. The main consultation paper reviews the current regime on connected transactions and sets out proposals to simplify the rules. If the proposed amendments to the Listing Rules are implemented in the future, this will lead to a relaxation of certain requirements – but the requirements may still be more onerous than an overseas company is used to in its home jurisdiction. For example, there is no general exemption for revenue transactions in the ordinary course of business of the listed issuer.

Other waivers that may be considered
Some examples of waivers that have been granted to overseas companies seeking primary or secondary listings are set out below. As mentioned above in relation to the JPS, it should be noted that the SEHK may grant extensive waivers from the Main Board Listing Rules to those companies seeking a secondary listing.

- In the secondary listing of Brazilian-incorporated Vale S.A., the SEHK granted waivers from strict compliance with the requirements relating to:
  - the minimum number of INEDs
  - confirming in the annual report that the company has received the annual confirmation of independence from those directors
  - having an audit committee comprising non-executive directors only.

The waivers were mainly granted on the basis that there was no equivalent concept under Brazilian law of a non-executive director. Instead, the company has a fiscal council that assumes the duties and obligations normally performed by INEDs under the Hong Kong Listing Rules. In addition, there are protections under Brazilian law that were deemed by the SEHK to be equivalent to certain Listing Rule requirements – for example, the total remuneration payable to directors and members of the Board of Executive Officers must be approved by shareholders in its annual general meeting.

- In the primary listing of the Germany-incorporated company Schramm Holding A.G. (now de-listed), the SEHK also granted a waiver from strict compliance with the requirement to appoint INEDs. This was on the basis that independent supervisors would carry out the duties and obligations normally performed by INEDs under the Hong Kong Listing Rules. In addition, there are protections under Brazilian law that were deemed by the SEHK to be equivalent to certain Listing Rule requirements – for example, the total remuneration payable to directors and members of the Board of Executive Officers must be approved by shareholders in its annual general meeting.

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• In the secondary listing of Jersey-incorporated Glencore International Plc, the SEHK granted a waiver from strict compliance with the Corporate Governance Code and the content requirements of the Corporate Governance Report that must ordinarily be included in a listed company’s annual report. These waivers were granted on the basis that it would be unduly burdensome and unnecessary for the company to be required to comply with a second level of corporate governance requirements, as it would already be subject to the corporate governance regime in the UK. The same waiver has not been granted to the dual primary UK-HK listed companies, namely HSBC, Prudential and Standard Chartered.

Conclusion
The SEHK has been and remains keen to encourage overseas companies to list in Hong Kong. The JPS, together with recent amendments to the Listing Rules and further amendments under consultation, means that Hong Kong has remained an attractive listing venue for overseas companies – and one in which international standards of best practice are prevalent in the context of corporate governance.
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In July 2013, Tsingtao Brewery, the first company from the People’s Republic of China (PRC) to list on the Stock Exchange of Hong Kong (SEHK), marked the twentieth anniversary of its listing. Tsingtao was one of nine companies in the first group of state-owned enterprises to be approved for listing in Hong Kong by the Chinese government in 1992. Since then, PRC companies (commonly known as H-share companies) have grown to become one of the major constituents of the SEHK, with 158 companies representing 20.52 per cent of total market capitalisation and 37.85 per cent of market turnover on the Main Board of the SEHK as of December 2013.

Initially, the H-share companies listing in Hong Kong were mainly state-owned enterprises in heavy industries, but over time a wider range of companies from sectors including telecommunications, airlines, property and financial services have come to market. H-share companies have been responsible for six of the 10 biggest initial public offerings in Hong Kong’s history and in total have raised more than HK$1.5 trillion in equity funds on the SEHK between July 1993 and December 2013. Today, they are widely seen as an integral part of Hong Kong’s corporate landscape.

When proposals for the listing of PRC companies in Hong Kong were first discussed, compliance and corporate governance issues were both key concerns and drivers behind the Chinese government’s desire to subject PRC companies to the same standards as other companies listed on the SEHK. Corporate law and regulation in the PRC was still relatively undeveloped in the early 1990s, and it was felt that requiring H-share companies to comply with the established standards and practices in Hong Kong would lead to improvements in the management and governance of those companies.

At the same time, there were some significant differences between the legal systems in Hong Kong, which inherited a UK-style common law system, and those in the PRC, which has adopted a civil law system influenced in part by the German legal system. These differences required lawmakers and regulators on both sides to cooperate and introduce a number of modifications to their existing rules when dealing with PRC companies seeking a listing in Hong Kong, including the addition of a new Chapter 19A to the Rules Governing the Listing of Securities on the SEHK.

Applicable laws and regulations in Hong Kong and the PRC
All H-share companies listed in Hong Kong are subject to the laws and regulations of the PRC as the jurisdiction of incorporation, as well as the HK Listing Rules (as modified for H-share companies by Chapter 19A) and other applicable Hong Kong laws. The term H share is used to distinguish the shares of a PRC company listed on the SEHK or another overseas exchange from its domestically owned shares (known as A shares), which can be listed.
on either the Shanghai Stock Exchange (SHSE) or the Shenzhen Stock Exchange (SZSE).

Under PRC law, only PRC citizens and legal persons are permitted to own A shares and only foreign investors (including those from Hong Kong, Taiwan and Macau) are permitted to own H shares. Chapter 19A of the HK Listing Rules notes that although A and H shares are both ordinary shares in a PRC company, they are in effect treated as two separate classes of shares operating in two separate markets.

A PRC company looking to list in Hong Kong can seek either a single listing of all of its shares as H shares on the SEHK or a dual listing of a portion of its shares as domestic A shares on the SHSE or SZSE and a portion as H shares on the SEHK. As of January 2014, a total of 82 companies on the SEHK had a dual A-share and H-share listing. Dual-listed companies are subject to rules and regulations for listed companies in the PRC, including the SHSE and SZSE Listing Rules, as well as the HK Listing Rules.

Given the underlying differences in the development history, regulatory philosophy, level of market liberalisation and structure of the capital markets in Hong Kong and the PRC, there are relatively few conflicts between the corporate governance provisions under the two systems that have not been addressed to some degree. This can be attributed largely to the measures taken to adapt the PRC law and HK Listing Rule requirements applicable to H-share companies and to the developments made in bringing PRC corporate and securities laws and regulations closer to internationally recognised standards in recent years.

Some questions remain about the extent to which rules and principles of corporate governance are implemented by some PRC companies, particularly the smaller and privately owned enterprises that are expected to account for an increasing proportion of new H-share companies listing on the SEHK in the future. Many of the challenges associated with corporate governance standards in PRC companies lie in establishing robust processes, practices and structures for implementing the regulatory requirements; raising awareness of the importance and potential benefits of corporate governance amongst directors and management; and encouraging a culture of ongoing compliance.

**Corporate governance requirements for H-share companies in the PRC**

**Requirements for all H-share companies**

All H-share companies seeking a listing on the SEHK are subject to the following key sources of regulation in the PRC:

- The Company Law of the PRC and its subsidiary rules and regulations
- The Special Regulations of the State Council Concerning Issuing and Listing of Shares Overseas by Joint Stock Limited Companies
- The Mandatory Provisions for Articles of Association of Companies to be Listed Overseas.

The Special Regulations and Mandatory Provisions apply in addition to the PRC Company Law and provide a more extensive set of rights and protections for shareholders, more rigorous procedures for shareholder and board meetings and a higher level of duties and obligations on the directors and management for H-share companies compared to those of purely domestic PRC companies. The key provisions relating to corporate governance are described below.

**PRC Company Law**

The PRC Company Law is the law under which all PRC companies are established. It sets out the general requirements on matters such as corporate structures, shareholder meetings, issue and transfer of shares, mergers and liquidation.

Rather than the unitary board structure under common law systems, the PRC Company Law imposes a dual structure, with a board of directors responsible for management of the company, as well as its business and investment plans, and a board of supervisors responsible for oversight of the board and senior management. This is similar to the dual management and supervisory board structure under German law.

The PRC Company Law also imposes duties of loyalty and diligence to a company on its directors, supervisors and senior management. It
prohibits them from misappropriating company funds, taking advantage of their position to obtain business opportunities for personal benefit or disclosing company secrets.

Special Regulations
The Special Regulations require all PRC companies that wish to list overseas to first obtain the approval of the China Securities Regulatory Commission (CSRC). They impose a number of additional governance obligations for PRC companies seeking a listing overseas.

Under the Special Regulations, a company is required to send its shareholders written notice 45 days in advance of convening any shareholders’ meeting. Shareholders representing more than 5 per cent of the voting rights may raise proposals for resolution at a shareholders’ meeting.

The Special Regulations also establish that the directors, supervisors and senior management owe fiduciary duties to a company. They must abide by the articles of association, carry out their duties faithfully and protect the rights and interests of the company. This is a more extensive duty than the duty of loyalty and diligence imposed under the PRC Company Law.

Mandatory Provisions
The Mandatory Provisions are a set of additional provisions that a PRC company seeking an overseas listing must add to its articles of association. They include enhancements to shareholder rights on voting and dividends, procedures at shareholder and board meetings and qualification requirements for directors and supervisors. The Mandatory Provisions also require the fiduciary duties owed to a PRC company by its directors, supervisors and senior management to be enshrined in its articles.

The Mandatory Provisions require an H-share company to include an arbitration clause in its articles of association that allows any dispute between holders of H shares and the company to be referred to arbitration. The claimant may elect for this arbitration to take place at the China International Economic and Trade Arbitration Commission (CIETAC) in the PRC or the Hong Kong International Arbitration Centre (HKIAC).

Additional requirements for companies with dual A-share and H-share listings
PRC companies with A shares listed in the PRC are subject to additional corporate governance requirements under PRC regulations and the SHSE or SZSE Listing Rules. Some key provisions are set out below.

Code of Corporate Governance for Listed Companies in China
The Code of Corporate Governance for Listed Companies in China was issued by the CSRC and the State Economic and Trade Commission in January 2002. It was designed to align corporate governance practices in China with commonly accepted international standards and is applicable to all companies listed in the PRC. The PRC Code imposes additional governance requirements on companies with listed A shares, including:

• Shareholders, particularly minority shareholders, must have the right to equal treatment, with the ability to claim compensation via the company against directors and management in the event of violations of law or the articles.
• Related party transactions must be on arm’s length terms, and details must be properly disclosed.
• Controlling shareholders owe a duty of good faith towards the company and its other shareholders and must not use their position to damage the company’s interests.
• A company’s business, assets, personnel and finances must be independent of its controlling shareholders, with an independent board and supervisory committee.
• A company must set out in its articles a standardised and transparent process for the election of directors.
• Directors must possess adequate knowledge, skill and professional experience and must dedicate adequate time and energy for the performance of their duties.
• Under the independent director guidelines issued under the PRC Code, a company must appoint independent directors to make up at least one third of its board.
• A company may establish separate board committees to manage corporate strategy, audit,
nomination and remuneration matters. Audit, nomination and remuneration committees should be chaired by, and consist of a majority of, independent directors.

- A company must respect the legal rights of its creditors, employees, consumers, suppliers and other stakeholders and must actively cooperate with its stakeholders to achieve sustainable development.
- A company must disclose in a timely manner information that may materially affect the decisions of shareholders and stakeholders, as well as information on its corporate governance measures and performance.

**SHSE and SZSE Listing Rules**

The rules governing the listing of stocks on the SHSE and the SZSE are broadly similar, and they reinforce many of the requirements set out in the PRC Code. The main governance provisions in these rules include:

- Listed companies must establish and implement a management system for disclosure of information.
- Listed companies are required to publish announcements in the event of unusual price movements or market rumours.
- All directors, supervisors and senior officers of a listed company are required to give an undertaking to the SHSE or SZSE to comply with applicable laws and regulations, listing rules and articles of the company. They also must fulfil their fiduciary duty to the company.
- Listed companies must appoint a secretary to the board of directors, with responsibility for acting as the designated point of contact with the SHSE or SZSE and coordinating disclosure of information by the company.
- Listed companies are required to publish quarterly financial reports.
- If a listed company also has shares listed on an overseas exchange (as is the case with dual-listed A-share and H-share companies), it must simultaneously release information on the overseas exchange and on the SHSE or SZSE. The information releases on the exchanges must be consistent, with an explanation provided for material discrepancies.

**Corporate governance requirements for H-share companies under Hong Kong laws and regulations**

H-share companies are subject to largely the same requirements under the HK Listing Rules as all other issuers and are subject to the applicable provisions under the Securities and Futures Ordinance, including market misconduct, disclosure of inside information, and disclosure of interests. The HK Listing Rules are modified for H-share companies by Chapter 19A, which provides additional requirements, modifications and exceptions to the HK Listing Rules to deal with the different markets in which H and A shares are traded and the differences between the Hong Kong and the PRC legal systems. The key modifications are set out below.

**Independent non-executive directors**

In addition to the requirements under Chapter 3 of the HK Listing Rules, the independent non-executive directors of an H-share company must be able to demonstrate an acceptable standard of competence and experience, and at least one of the independent non-executive directors must be resident in Hong Kong.

**Supervisors**

The members of an H-share company’s board of supervisors, who are responsible for oversight of the board and senior management, must have the character, experience and integrity, and be able to demonstrate a standard of competence, commensurate with their position.

**Shareholders**

An H-share company is required to obtain approval by special resolution from its holders of A shares and holders of H shares as separate classes before issuing shares or convertible securities. This requirement does not apply if the shareholders have granted the directors, by special resolution, a general mandate to issue new shares up to a maximum of 20 per cent of the existing issued shares in each class. Note the HK Listing Rules only require approval for a general mandate to be by ordinary resolution.
Directors and officers
An H-share company must enter into a written contract with every director and officer, providing for:

- An undertaking by the director or officer to comply with relevant PRC laws and regulations, the company’s articles and the Hong Kong Takeovers Code
- An undertaking to the H-share company as agent for each shareholder to comply with obligations to shareholders under the company’s articles
- An arbitration clause providing that in relation to rights and obligations under relevant PRC laws or company articles, disputes between the company and its directors or officers or between a holder of H shares and a director or officer will be resolved through arbitration by either CIETAC in the PRC or HKIAC in Hong Kong, at the choice of the claiming party.

Practical differences between the Hong Kong and PRC requirements for dual-listed companies
Table 1 sets out some of the main areas where differences exist between the corporate governance requirements in Hong Kong and the PRC. It also gives practical points to note for dual-listed companies.

In practice, it is common for dual-listed companies to deal with the conflicts between the SEHK requirements and the SHSE and SZSE requirements by seeking to comply with the more stringent of the two requirements. For most dual-listed companies, this does not give rise to significant practical difficulties.

One way in which dual-listed companies implement the highest standard across both exchanges is by preparing a composite corporate governance manual with input from Hong Kong and PRC legal counsel. This manual sets out the more stringent standard to be followed in each area and is drafted to minimise conflicts between the company’s obligations in Hong Kong and in the PRC.

Table 1: Differences in requirements that affect dual-listed companies

<table>
<thead>
<tr>
<th>(1) Disclosure of connected transactions</th>
<th>SEHK</th>
<th>SHSE and SZSE</th>
<th>Points to Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition of connected person or related party</td>
<td>Includes all family interests, related trust interests and controlled company interests of a director, chief executive or substantial shareholder</td>
<td>Includes a connected legal person and a connected natural person</td>
<td>The definition is broader in the PRC, including individuals holding 5 per cent or more interest and senior managers of the listed issuer and their family members.</td>
</tr>
<tr>
<td>Disclosure and approval thresholds</td>
<td>Announcement is required if any size test is above 0.1 per cent, and shareholder approval is required if any size test is above 5 per cent</td>
<td>Announcement is required if the transaction value is more than 0.5 per cent of net assets, and shareholder approval is required if the transaction value is more than 5 per cent of net assets</td>
<td>Dual-listed companies in practice apply the more stringent rules when evaluating a particular connected transaction.</td>
</tr>
</tbody>
</table>
**Comparison of Hong Kong and PRC corporate governance considerations**  
**Freshfields Bruckhaus Deringer**

<table>
<thead>
<tr>
<th>Points to Note</th>
<th>SHSE and SZSE</th>
<th>SEHK</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Periodic financial reporting</strong></td>
<td>Mandatory</td>
<td>Not mandatory, but stated as a recommended best practice in the SEHK Corporate Governance Code</td>
</tr>
<tr>
<td><strong>Corporate governance structure</strong></td>
<td>Issuers ‘may’ establish audit, nomination and remuneration committees under the SHSE and SZSE Listing Rules</td>
<td>Audit and remuneration committees must be established, and a nomination committee is required under the SEHK Corporate Governance Code</td>
</tr>
</tbody>
</table>
| **Disclosure of information** | Announcements must be published online during a single 3:30 p.m. to 7:00 p.m. window following market close during trading days; no publication on Sundays or public holidays | Announcements must be published during three stipulated windows during trading days:  
  - 6:00 a.m. to 8:30 a.m.  
  - Noon to 12:30 p.m.  
  - 4:15 p.m. to 11:00 p.m.  
  Publication can also be made during a 6.00 p.m. to 8.00 p.m. window on Sundays and public holidays |

**Freshfields Bruckhaus Deringer**
### Bilingual announcements

<table>
<thead>
<tr>
<th>SEHK</th>
<th>SHSE and SZSE</th>
<th>Points to Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Announcements must be published in Chinese and English (except for PRC regulatory announcements)</td>
<td>Announcements may be published in Chinese only</td>
<td>Trading may be suspended on the SEHK if the SHSE or SZSE announcements are published between 3:30 p.m. to 4:15 p.m. before the SEHK closes (e.g., China Unicom in 2013).</td>
</tr>
</tbody>
</table>

### Disclosure of price-sensitive information

<table>
<thead>
<tr>
<th>SEHK</th>
<th>SHSE and SZSE</th>
<th>Points to Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuers must publish price-sensitive information as soon as practicable during a publication window (SEHK plans to introduce release of price-sensitive information during trading hours in 2015)</td>
<td>Issuers must publish price-sensitive information outside of the SHSE and SZSE trading hours, and pre-vetting of announcements may be required before publication</td>
<td>Trading may be suspended on the SEHK in some cases if the English version of an announcement is not published. Dual-listed companies may be required to suspend trading on the SEHK until they are able to publish on the SHSE or SZSE. Dual-listed companies may not be able to benefit from the new SEHK arrangements in 2015, because information must be released on the SHSE or SZSE at the same time.</td>
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</table>

### Suspension of trading

<table>
<thead>
<tr>
<th>SEHK</th>
<th>SHSE and SZSE</th>
<th>Points to Note</th>
</tr>
</thead>
</table>
| Suspensions usually take place when events cause unusual movements in the price or trading volume of the securities | Suspensions are more frequently imposed in the PRC and for longer periods, with regular suspensions for corporate events, e.g.:  
  - Offer period for rights issues  
  - Delay in publishing quarterly results  
  - Certain breaches of SHSE or SZSE Listing Rules  
  - Usually applications for suspension should be made one day in advance | In practice, the SEHK and the SHSE or SZSE seek to impose suspensions across both markets simultaneously when possible, but trading may continue for a time on one market while it is suspended on the other. In some incidents, non-simultaneous suspensions of trading on the SEHK and the SHSE or SZSE occurred (e.g., Sinopec Shanghai Petrochemical in 2006 and China Life Insurance in 2012), revealing the risk of ‘regulatory arbitrage.’ |
<table>
<thead>
<tr>
<th>SEHK</th>
<th>SHSE and SZSE</th>
<th>Points to Note</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(5) Securities transactions by directors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Blackout period for directors</strong></td>
<td>SHSE and SZSE Listing Rules have similar restrictions that prohibit directors, supervisors and senior management from dealing in the issuer’s shares 10 days before the publication of financial results</td>
<td>Directors of dual-listed companies are effectively required to comply with the SEHK Model Code blackout restrictions.</td>
</tr>
<tr>
<td>Under the SEHK Model Code, a director must not deal during the 60 days immediately preceding the publication of annual results or during the 30 days immediately preceding the publication of interim or quarterly results</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(6) Pre-vetting</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Announcements subject to pre-vetting</strong></td>
<td>Only announcements and circulars for significant transactions, such as substantial acquisitions or disposals, are subject to pre-vetting</td>
<td>Pre-vetting by one exchange may present difficulties for making timely announcements on the other exchange.</td>
</tr>
<tr>
<td>SHSE and SZSE</td>
<td>Announcements are commonly subject to pre-vetting, eg announcements on unusual movements in share price or clarification announcements</td>
<td></td>
</tr>
<tr>
<td><strong>(7) Company secretary or board secretary</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Qualification requirements</strong></td>
<td>Qualifications for board secretary are more flexible, and candidates can be certified upon attending SHSE or SZSE training</td>
<td>A candidate qualified under the SHSE or SZSE Listing Rules may not be qualified under the HK Listing Rules. The issuer may need to appoint different candidates to the positions.</td>
</tr>
<tr>
<td>Strict and specific requirements are placed professional qualifications and relevant experience, requiring knowledge and familiarity with the HK Listing Rules; candidates without the required qualifications need to be assisted by a qualified person for a term of three years</td>
<td></td>
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</tr>
</tbody>
</table>
Leading the way.

Supporting clients for 175 years.
As Hong Kong’s legal system originated from the British legal system, it should come as no surprise that the corporate governance regime in Hong Kong (HK) and the United Kingdom (UK) share much common ground. Corporate governance is a multifaceted subject that encompasses a range of issues. This chapter is not intended to present an exhaustive comparison of all corporate governance requirements in HK and in the UK. Instead, it gives an overview of the corporate governance regimes applicable to companies listed on the main board of the Stock Exchange of Hong Kong (SEHK) and to companies with a premium listing on the main market of the London Stock Exchange (LSE). It also sets out a high-level summary of key similarities and differences between the HK Corporate Governance Code (HK Code) and the UK Corporate Governance Code (UK Code), highlights other notable corporate governance measures in HK and in the UK and discusses certain recent corporate governance developments in these two jurisdictions.

HK corporate governance regime
The principal sources of corporate governance requirements applicable to companies listed on the main board of the SEHK comprise the Rules Governing the Listing of Securities on the SEHK (HK Listing Rules) and the HK Code.

HK Listing Rules
The HK Listing Rules set out mandatory requirements regulating corporate processes and actions of listed companies, irrespective of their jurisdiction of incorporation. The HK Listing Rules do not have the force of law, and the SEHK may not impose civil or criminal sanctions (such as fines) for breaches of the HK Listing Rules.

The obligation to comply with the HK Listing Rules is imposed on listed companies through an undertaking that each company is required to sign as part of its listing application. Sanctions that may be imposed by the SEHK on any listed company that fails to comply with the HK Listing Rules include private reprimand, public criticism, public censure, suspension of trading in the company’s shares and cancellation of the company’s listing.

HK Corporate Governance Code
The HK Code is a non-statutory code contained in Appendix 14 of the HK Listing Rules. It sets out principles of good corporate governance and two levels of recommendations: code provisions (CPs) and recommended best practices (RBPs).
Comparison of Hong Kong and UK corporate governance considerations  Linklaters

**Code provisions**

Listed companies are expected to comply with CPs. However, if a listed company chooses to deviate from a CP, this deviation does not constitute a breach of any HK rule. Nevertheless, when deviations occur, listed companies, regardless of whether they are incorporated in HK, are required under the HK Listing Rules to disclose in their annual and interim reports details of, and considered reasons for, the deviations.

**Recommended best practices**

The RBPs are for guidance only. Listed companies are encouraged, but not required, to state in their annual and interim reports whether they have complied with the RBPs and considered reasons for any deviation.

**Other sources**

Other sources of important corporate governance requirements applicable to main board-listed companies in HK include the Securities and Futures Ordinance (SFO), the Model Code for Securities Transactions by Directors of Listed Issuers (HK Model Code) and, for those incorporated in HK, the Companies Ordinance. The new Companies Ordinance (NCO), which came into force on 3 March 2014, is discussed later in this chapter.

**UK corporate governance regime**

Corporate governance requirements applicable to companies with a premium listing on the main market of the LSE are primarily set out in the UK Listing Authority’s Listing Rules (UK Listing Rules), the UK Code and the UK Disclosure and Transparency Rules (DTRs).

**UK Listing Rules and Disclosure and Transparency Rules**

Unlike the HK Listing Rules, the UK Listing Rules and DTRs are statutory rules. The Financial Conduct Authority (FCA) may impose fines on listed companies for breaches of the UK Listing Rules or DTRs. Other possible sanctions include private warnings, public censure, suspension of trading in the company’s shares and cancellation of the company’s listing. In particular, the DTRs require listed companies to publish a statement on their corporate governance practices in their annual reports.

**UK Corporate Governance Code**

In contrast with the HK Code, the UK Code is not included as an appendix to the UK Listing Rules. The UK Code is issued by the Financial Reporting Council and consists of ‘main principles’ (Main Principles), most of which have their own ‘supporting principles’, and more detailed ‘provisions’ (Provisions) which, in most cases, amplify the Main Principles and the supporting principles.

As with the HK Code, the UK Code is non-statutory, and compliance is not mandatory. However, premium-listed companies, regardless of the jurisdiction in which they are incorporated, are required by the UK Listing Rules to state in their annual reports how they have applied the Main Principles and whether they have complied with the Provisions. If a premium-listed company decides not to comply with any Provision, it is required by the UK Listing Rules to identify and explain this non-compliance in its annual report.

There is some overlap between disclosure requirements under the UK Code and those under the DTRs. Although the UK Code is more extensive, compliance with the DTRs is mandatory. Premium-listed companies should therefore ensure that they comply with the disclosure requirements under the DTRs even if they decide not to comply with any disclosure requirement under the UK Code.

**Other sources**

Premium-listed companies are also subject to corporate governance requirements from a number of other sources, including the Model Code contained in Annex 1R to Rule 9 of the UK Listing Rules (UK Model Code) and, for those incorporated in the UK, the Companies Act 2006 (UKCA).

**Key similarities and differences between the HK Code and the UK Code**

**Approach and basis**

The HK Code and the UK Code have both adopted a principles-based approach that operates on a ‘comply or explain’ basis. They set out principles and practices to which listed companies are expected to adhere. These principles and practices do not function as a set of rigid
rules within a one-size-fits-all framework. Listed companies have flexibility to tailor their corporate governance practices to their individual circumstances, provided that deviations from the corporate governance code, and the explanations for such deviations, are disclosed to shareholders.

In the UK, only premium-listed companies are required to comply with, or explain why they do not comply with, the UK Code. Companies with standard listings and those quoted on the LSE’s Alternative Investment Market are not subject to this obligation (although companies with standard listings are still required under the DTRs to publish a corporate governance statement). Unlike the UK Code, the HK Code applies to companies listed on the main board of the SEHK, as well as to those listed on the SEHK’s Growth Enterprise Market.

Certain provisions of the UK Code impose a higher standard on, or apply only to, companies in the FTSE 350 index. In contrast, the HK Code does not differentiate between listed companies of different sizes.

**Board of directors**

**Composition and diversity**
The HK Code adopts a qualitative standard that requires a balanced composition of executive directors and non-executive directors (NEDs), including independent non-executive directors (INEDs), so that there is a strong independent element on a company’s board. This is supplemented by a requirement under the HK Listing Rules that INEDs should constitute at least one-third of the board.

The UK Code includes a quantitative standard, which provides that at least half of the board of FTSE 350 companies should be INEDs. For other listed companies, there should be at least two INEDs on the company’s board.

The HK Code and the UK Code both require the board to have a balance of skills and experience, and both highlight the importance of diversity (including gender) in the boardroom. In particular, listed companies should have a policy on board diversity and disclosure of the policy should be made in the annual report. The HK Code also makes it clear that diversity of board members can be achieved through consideration of a number of factors, including gender, age, cultural and educational background, and professional experience.

**Evaluation**
More emphasis is placed on the evaluation of the board’s performance in the UK Code compared with the HK Code. The UK Code requires an annual evaluation by the board of its own performance; in the case of a FTSE 350 company, external advisers must facilitate board evaluations every three years. The equivalent provision in the HK Code is only an RBP and is therefore not subject to the comply-or-explain obligation. The HK Code also does not require the use of external advisers.

**Directors**

**Non-executive directors and independent non-executive directors**
The roles and responsibilities of NEDs are highlighted in both the HK Code and the UK Code, especially their roles in scrutinising the company’s performance in achieving agreed goals and objectives. The UK Code further indicates that NEDs should offer constructive challenge to the company’s actions and policies in the boardroom. It also states that the board should appoint one of its INEDs as the senior INED to act as a sounding board for the chairman and an intermediary for other directors as necessary. There is no equivalent provision in the HK Code.

**Re-election**
Under the HK Code, all directors are generally subject to re-election once every three years. Under the UK Code, directors of FTSE 350 companies are subject to annual re-election, but directors of other listed companies are subject to re-election once every three years.

**Time commitment**
Directors are required under both the HK Code and the UK Code to commit sufficient time to the company’s affairs. While the UK Code also states that a full-time executive director should not take on more than one NED position in a FTSE 100 company, there is no similar limitation in the HK Code.
Accountability and audit

Internal controls and risk management
The HK Code and the UK Code both require the board to conduct an annual review of the company’s internal controls and risk management functions and to report to shareholders that it has done so. The UK Code places more emphasis on the board’s role in risk management by confirming, in a Main Principle, that the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving strategic objectives.

Financial and business reporting
The HK Code and the UK Code both require the board to present a balanced and understandable assessment of the company’s position and prospects in required disclosures, including annual and interim reports. The UK Code also specifically requires the board to confirm in the company’s annual report that the annual report and accounts, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the company’s performance, business model and strategy.

Whistleblowing policy
The HK Code requires the audit committee to review arrangements for employees to confidentially raise concerns about possible improprieties. It also requires the audit committee to ensure that proper arrangements are in place to investigate and follow up on any concerns raised. There are similar provisions in the UK Code.

External audit
Audit committees are required under both the HK Code and the UK Code. They are primarily responsible for making recommendations on the appointment of external auditors and for assessing the effectiveness of the external audit process. The UK Code, however, requires more extensive disclosures on the work of the audit committee in the annual report. These disclosures include significant issues that the audit committee has considered in relation to the company’s financial statements and how these issues have been addressed.

FTSE 350 companies are required under the UK Code to put their external audit contracts out to tender at least once every 10 years. There is no equivalent requirement under the HK Code.

Remuneration

Remuneration committee
The HK Code and the UK Code both state that no director should be involved in deciding his or her remuneration. The UK Code further requires the board to delegate the responsibility for setting the remuneration of all executive directors and of the chairman to the remuneration committee. In contrast, the HK Code allows the board to retain this responsibility, with the remuneration committee taking an advisory role.

Performance-related elements
Compared with the HK Code, the UK Code places more emphasis on, and is relatively more prescriptive regarding, performance-related remuneration. A Main Principle states that a significant proportion of executive directors’ remuneration should be linked to corporate and individual performance, whereas the equivalent provision in the HK Code is an RBP and is therefore not subject to the comply-or-explain requirement.

The UK Code further states that consideration should be given to arrangements permitting the company to claw-back variable components of remuneration in exceptional circumstances and that remuneration for NEDs should not include performance-related elements (including share options). There are no equivalent provisions in the HK Code.

Bonus caps
When it comes to annual bonuses for directors, the UK Code states that upper limits should be set and disclosed. The HK Code has no equivalent requirement.

Other notable corporate governance measures

Sizable and related party transactions
The HK Listing Rules and the UK Listing Rules both contain provisions that apply when a listed company undertakes certain transactions. These provisions generally require the listed company to make an announcement of the transaction, send a circular to its shareholders containing prescribed
Changes have been made to it since then, the last substantial review was in 1984. The NCO is a comprehensive rewrite. Although many of the changes introduced by the NCO are modelled upon the UKCA, some changes have been influenced by the company laws of Australia, New Zealand or Singapore. As with the previous Companies Ordinance, the NCO applies to companies incorporated in HK and, to a more limited extent, to overseas companies that have established a place of business in HK.

Enhancing corporate governance is one of the major initiatives in the NCO. Key amendments regarding corporate governance include:

- the codification of the duty of a director to exercise reasonable care, skill and diligence
- a new requirement for most public companies and larger private companies to prepare an analytical and forward-looking business review
- the codification of common law requirements for the ratification of a director’s act or omission that amounts to negligence, default, breach of duty or breach of trust. Ratification of such an act or omission requires an ordinary resolution passed by disinterested shareholders.

Codification of inside information disclosure requirements
The SFO has been amended to provide statutory force to certain requirements, previously contained in the HK Listing Rules, for listed companies to disclose inside information. From 1 January 2013, subject to limited exemptions, a listed company and its officers commit a civil offence if they fail to disclose inside information about the company as soon as reasonably practicable. The Securities and Futures Commission has statutory power to investigate suspected breaches and to decide whether to commence civil proceedings. Breach of the statutory inside information disclosure requirements may result in wide-ranging civil sanctions against the company, its directors and other officers of the company. This codification sets more effective sanctions for enforcing one of the most important disclosure obligations of listed companies in HK.

Recent corporate governance developments in HK

New Companies Ordinance
The NCO, which came into force on 3 March 2014, is a significant milestone for the development of HK’s company laws. The previous Companies Ordinance was enacted in 1932. Although changes have been made to it since then, the last substantial review was in 1984. The NCO is a comprehensive rewrite. Although many of the changes introduced by the NCO are modelled upon the UKCA, some changes have been influenced by the company laws of Australia, New Zealand or Singapore. As with the previous Companies Ordinance, the NCO applies to companies incorporated in HK and, to a more limited extent, to overseas companies that have established a place of business in HK.

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Environmental, social and governance reporting
Given the growth of responsible investments, the SEHK has published an Environmental, Social and
**Governance Reporting Guide** to encourage listed companies to disclose environmental, social and governance information in their annual reports. While compliance with the guide is currently a recommended practice in the HK Listing Rules, the SEHK intends to raise the obligation level to ‘comply or explain’ by 2015.

**Board diversity**
Enhancing board diversity has been a key focus of recent corporate governance developments in HK. Amendments to the HK Code in 2013 introduced the provisions on board diversity discussed earlier in this chapter.

**Recent corporate governance developments in the UK**

**Directors’ remuneration**
Certain provisions in the UKCA relating to directors’ remuneration were amended and took effect on 1 October 2013. These provisions apply to UK-incorporated companies listed on the LSE, a European Economic Area exchange, the New York Stock Exchange or NASDAQ. These companies are collectively referred to in this chapter as ‘quoted UK companies’.

Key amendments include:

- the remuneration policy must be approved by an ordinary resolution of shareholders every three years
- remuneration payments and payments for loss of office may not be made outside the terms of the approved remuneration policy unless these payments have also been approved by an ordinary resolution of shareholders
- the remuneration report must be split into two sections. One section is forward-looking, setting out the company's policy on directors’ remuneration in the future. The other section is a report on the implementation of the company’s existing remuneration policy in the relevant reporting year.

**Narrative reporting**
The UKCA was also amended in 2013 to require companies to prepare a separate strategic report. The strategic report replaces the business review that was previously required. Its contents and purpose are largely the same, but quoted UK companies must include information on their business model and strategy. These companies are also required to disclose, to the extent necessary for an understanding of the development, performance or position of their business, information about human rights, alongside environmental, social and community issues, and a numerical breakdown of the persons of each sex who are directors, senior managers and employees. In addition, quoted UK companies are required to disclose in the directors’ report details of their greenhouse gas emissions.

**Controlling shareholders**
Concerns about the corporate governance of listed companies with a controlling shareholder (based on a 30 per cent definition of control) have led the FCA to propose changes to the UK Listing Rules. These include a requirement for a company with a controlling shareholder to have in place an agreement to ensure that any transactions with the controlling shareholder are on arm’s length terms. In addition, the non-controlling shareholders of a company with a controlling shareholder will have a separate vote on the appointment of INEDs.

**European influence**
The UK corporate governance regime develops against the backdrop of European corporate governance and company law initiatives. The European Commission adopted an action plan in December 2012 with concerns and objectives similar to those already being considered in the UK. Depending on the development of these European Union (EU) initiatives, additional requirements may be imposed on listed companies in the UK. For example, the EU gender balance directive may lead to priority being given to female candidates for NED positions with listed companies in the UK over male candidates who are equally qualified.

**Conclusion**
There is a large degree of overlap between the corporate governance regime in HK and that in the UK, particularly in the form of a principles-based corporate governance code that operates on a ‘comply-or-explain’ basis. Recent corporate governance developments in HK and in the UK also share some common themes, such
as enhancing board diversity, strengthening the independent element on the board of directors and promoting non-financial reporting.

Nevertheless, corporate governance developments in HK do not always follow those in the UK. For example, the so-called 'enlightened shareholder value' concept under the UKCA, which requires directors to consider the interests of stakeholders other than shareholders, has not been incorporated into the NCO in HK. There is also no HK equivalent of the UK Stewardship Code.

Apart from watching developments in the UK, HK usually studies experiences and practices in other jurisdictions, such as Australia, New Zealand and Singapore, before implementing corporate governance reforms. In addition, listed companies in the UK are generally widely held by investors. This is in contrast to HK, where a majority of listed companies are owned or controlled by either members of the same family or by the Chinese state. This concentration of ownership and control has played, and will continue to play, a key role in shaping corporate governance practices in HK.

It remains to be seen whether HK will follow any of the recent corporate governance developments in the UK that are mentioned in this chapter and, if it does, how HK will implement them to adapt to the specific circumstances of the HK market.
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Mr McConnell has extensive experience in commercial litigation disputes, particularly in the financial services industry. Apart from contractual disputes, fraud and shareholder disputes, he specialises in regulatory matters and investigations and currently acts for a number of financial-industry and securities-industry clients in confidential regulatory matters in Hong Kong and regionally. This includes acting in regulatory and employment matters for regulated entities and handling contentious ‘team moves’ and restrictive covenants, enforcement and injunctive relief.

Mr McConnell is ranked in Chambers (Hong Kong) in Band 1 of contentious insurance lawyers. Chambers states: ‘Simon McConnell’s top-tier ranking is acknowledged by many sources, with one enthusing: “He’s head and shoulders above the rest for complex claims”’. Simon is also ranked by The Legal 500 (Asia Pacific) as a leading insurance practitioner. It notes that ‘Clyde & Co has a growing reputation for regulatory matters and investigations. Simon McConnell has a fine reputation’.

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Ms Ko was awarded Dealmaker of the Year and Managing Partner of the Year by the ALB Hong Kong Law Awards in 2013, Best Capital Markets Lawyer by the Asia Women in Business Law Awards in 2012 and was selected as one of the 25 Women of Our Time by the South China Morning Post in 2011. She speaks regularly on corporate governance, Chinese securities law matters and issues concerning the development of the Hong Kong securities market.

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Mr Graham took up the newly created role of executive vice president, chief regulatory officer and head of listing (designate) at the Hong Kong Exchanges and Clearing Limited in January 2013. He formally became head of listing on 1 March 2013.

Mr Graham has more than 30 years of experience in legal and financial services. He started his career with Freshfields (now Freshfields Bruckhaus Deringer) in the UK in 1982, was promoted to partner in 1991 and moved to Hong Kong in 1999. Mr Graham joined Morgan Stanley as general counsel (Asia ex-Japan) in 2001 and has been working in the financial services sector since then. He has held several senior roles within UBS, both in Asia and in the UK, including global general counsel of UBS Investment Bank. Before taking up his current role, he was global head of legal and general counsel of the Wholesale Division at Nomura.

Mr Graham has been a member of a number of committees of the Hong Kong Securities and Futures Commission, including serving as a member and then a deputy chairman of the Hong Kong Takeovers Panel from 2001 to 2012. He is a member of the Code Committee of the UK Takeover Panel, a member of the Securities and Futures Commission Advisory Committee and a member of the Standing Committee on Company Law Reform.

Mr Graham graduated from Oxford University in 1981. He is admitted as a solicitor in England and Wales and in Hong Kong.

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Dr Tsui has served on various public councils and authorities. Her current service roles include, inter alia, Justice of the Peace and member of Communications Authority (regulator of broadcasting and telecommunications). She was awarded the Bronze Bauhinia Star of Hong Kong and is a member of the Most Excellent Order of the British Empire.
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He joined the administrative grade of the Hong Kong government in October 1973 and served in directorate positions in a large number of branches in the Government Secretariat and executive departments. On 1 May 1993, he was appointed the Registrar of Companies for Hong Kong. He played a key role in company law and corporate governance reform, including initiating the rewrite of the Companies Ordinance in 2006, and modernising and computerising the Companies Registry’s operations.

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Best in Capital Markets. Highlights of her work include advising Chinalco Mining Corporation, Prada, Prudential, Dong Feng Motor, SMIC and other listed clients on corporate governance and corporate finance/M&A matters after advising on their Hong Kong listings; the underwriters on the Hong Kong IPO of PICC, Alibaba.com, China Pacific Insurance and Fosun International; and the dual/triple listings of Sinopec, China Unicom, China Telecom and Chalco. She also advised on the privatisation proposals of Alibaba.com and Guoco. She is a member of the SFC (HKEC) Listing Committee, the Takeover Panel, the Takeover Appeals Committee and the Standing Committee on Company Law Reform of the HKSAR Government.

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Mr Rudge has worked on a wide range of transactions in the corporate, capital markets and financing fields, advising leading corporates and financial institutions. He is listed as leading lawyer in Capital Markets: Debt (International Firms) – China in Chambers Asia 2014 and in Hong Kong Banking and Finance and Equity Capital Markets (Foreign Firms) in IFLR1000 2014. Mr Rudge joined Slaughter and May’s London office in 1997 and was admitted as a solicitor in England and Wales in 1999 and in Hong Kong in 2003. He has been based in Slaughter and May’s Hong Kong office since 2002. Highlights of his work include advising Prada and Alibaba.com on their IPOs; CIMB Group on the acquisition of RBS’ cash equities, corporate finance and advisory businesses; and Standard Chartered on its two rights issues raising a combined £5 billion. He regularly advises some of the leading Hong Kong listed companies and dual primary listed companies on corporate governance and listing rule compliance matters.

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Mr Devadason is group head of sustainability and regions, corporate affairs. He has global responsibility for the in-country corporate affairs teams, with responsibility for internal communications, media relations, government and regulatory relations, brand, sponsorship and sustainability. He is also in charge of the group’s overall sustainability agenda, a core part of the bank’s strategy to build a sustainable business through contributing to economic growth, leading as a responsible company and investing in the future of communities.

Mr Devadason is a member of the board of Standard Chartered Bank in Thailand and chairman of the fundraising committee for the bank’s charity Seeing Is Believing, which is committed to raising US$100 million by 2020.

Throughout his 28-year career at Standard Chartered, he has had broad-based management experience with wholesale banking, consumer banking and human resources and as a country chief executive officer for Standard Chartered Bank in Thailand (2008–2010) and in Japan (2003–2007).

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Mr Wang is Standard Chartered Group’s listing head for Asia and head of subsidiary governance for greater China and north-east Asia regions. He is the bank’s primary contact with the Hong Kong Stock Exchange on the listing matters of Standard Chartered.
Mr Wang was previously senior group legal counsel and senior Asia legal counsel, covering a range of Standard Chartered’s proprietary merger and acquisition (M&A) and other strategic corporate initiatives and transactions. Between 2008 and 2010, Mr Wang was lead in-house counsel for the bank’s listing in India through the Indian depositary receipts programme.

Before joining Standard Chartered in 2006, Mr Wang practised with major international law firms specialising in international capital markets and cross-border M&A areas, with particular expertise in China-inbound foreign direct investment and private equity work and China-outbound investment and capital-raising projects. Mr Wang is a New York-qualified lawyer and has practised in major international financial centres.

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Mr Tang is Towers Watson’s talent and rewards leader based in Hong Kong. He is also the Asia leader for Towers Watson’s global financial services practice, with close to two decades of experience in the financial services industry in both consulting and corporate capacities. He also serves as an executive compensation adviser to organisations across Hong Kong and South-east Asia, including a number of remuneration committee appointments.

Mr Tang has led numerous long-term incentive and equity engagements for both listed and unlisted companies, and his work includes design of founders’ plans, employee share schemes, carried interest plans and pre- and post-initial public offering situations. His clients span the Asia-Pacific, Europe and US and include large regional corporations, sovereign wealth funds, semi-government-linked companies, family-owned conglomerates and multinationals. He also consults extensively in the financial services, and his clients include universal banks, investment banks, asset management companies and private equity firms.

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Mr Davis is a director in Towers Watson’s executive compensation practice, with more than 15 years of senior executive and board-level consulting experience in North America and the Asia-Pacific region. Mr Davis serves as the practice leader for the firm’s executive compensation consulting practice in the Asia-Pacific. He assists remuneration committees and senior management teams worldwide in optimising their executive remuneration programmes while ensuring compliance with increasingly complex rules and regulations from around the world.

Mr Davis has experience in all areas of executive and board member compensation, including providing cross-border transactional advice during mergers, acquisitions and initial public offerings and designing short-term and long-term incentive plans (including cash, performance unit, phantom share and share option plans). Mr Davis’s clients include companies worldwide, including US-, European- and Hong Kong-based companies. His clients include companies from various industries and range in size from Fortune Global 50 companies to high-technology start-ups.

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Mr Kuan has been an executive director with Willis Hong Kong since September 2010. In this role, he was appointed as a directors and officers (D&O) liability insurance adviser to
handle US shareholder class actions, because he is experienced in resolving complicated coverage and claim issues.

From December 2006 to September 2010, Mr Kuan served as executive director with HSBC Insurance Brokers and was responsible for financial and professional practices for South-east Asia. In that role, Mr Kuan led the largest Hong Kong D&O liability insurance broker, with more than 400 listed-company clients in Hong Kong. Mr Kuan has extensive experience in serving Hang Seng Index companies’ D&O liability insurance and risk management programmes.

From July 2004 to December 2006, Mr Kuan was the chief operating officer for ACE Taiwan, responsible for all lines of insurance (including life, accident, health, property and casualty insurance) operation for Taiwan. Before the Taiwan post, he was the regional underwriting manager for ACE Insurance’s financial lines operation in South-east Asia.

Mr Kuan was a founding member of Taiwan D&O Liability Insurance in 1997. He also set up the American International Underwriters (now Chartis) D&O and financial lines profit centre for Taiwan.