



**GUIDE FOR
COMPANY DIRECTORS**

HONG KONG

Preface



The purpose of this Guide is to assist directors in understanding their roles and responsibilities in managing a company in Hong Kong. Where companies also operate or are listed outside of Hong Kong, additional obligations and responsibilities may apply, which are not dealt with in this publication. Although the Guide is primarily directed at the boards of listed companies, KPMG believes many of the principles and practices covered in this publication will be relevant to those charged with the governance of other corporate entities, including companies not listed on a stock exchange; family-owned and other private companies; state-owned (government) enterprises and agencies; and not-for-profit organisations. The Guide deals with both the private and public sectors, and in particular with companies registered under the Hong Kong Companies Ordinance.

In achieving its purpose the Guide considers issues that affect:

- a director as an individual;
- a director as an integral part of the board of directors;
- a director's role in governing the company's operations; and
- a director's interaction with the company's shareholders and other stakeholders.

In preparing the Guide, KPMG has not attempted to establish a model or pattern for the optimum composition and conduct of a company board. The way in which a board pursues its objectives will be influenced by many factors, including its ownership structure; the places in which it does business; the industry or industries in which the company operates; the legal and regulatory environment; and also the personalities of those in the management. No two boards will function in exactly the same way.

In considering these issues, the Guide covers the director's appointment and resignation, their duties and responsibilities and certain recent developments in corporate governance in Hong Kong. The Guide also considers the topic that binds all of these issues together — corporate governance.

Additional information

If you would like further information about the challenges that directors and in particular audit committees face in meeting demanding responsibilities with respect to corporate governance, please visit the KPMG sponsored Hong Kong Audit Committee Institute (“HKACI”) web site <<http://aci.kpmg.com.hk/HK/home.html>>, or contact the following individuals at our KPMG Hong Kong office. The HKACI’s initiatives include publication of KPMG Corporate Governance White Paper, Guide for Company Directors, Hong Kong Audit Committee Update, periodic roundtables, corporate governance conferences and board presentations, and updates on the latest corporate governance developments.

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KPMG Hong Kong

KPMG is the global network of professional services firms whose aim is to turn knowledge into value for the benefit of its clients, its people and its communities. With more than 100,000 people worldwide, KPMG member firms provide assurance, tax and legal and financial advisory services from more than 750 cities in 152 countries.

In Hong Kong and China, KPMG has more than 2,500 staff in its six offices in Beijing, Shanghai, Guangzhou, Shenzhen, Macau and Hong Kong. Besides providing the traditional skills of audit and accounting, tax, corporate finance, corporate recovery and turnaround, KPMG also has professionals who can advise in executive search, corporate secretarial and accounting services, forensic accounting services, management assurance and information risk management services.

To meet the needs of its clients, KPMG professionals operate in multi-disciplinary groups focusing on clients' industries and their needs. KPMG has established five focused industry groups covering the areas in which we have particular experience, namely Consumer Markets; Financial Services; Industrial Markets; Information, Communications and Entertainment; and Property and Infrastructure.

KPMG's Corporate Services

KPMG's Corporate Services practice can help directors and officers of both private and listed companies in analysing their roles and responsibilities within a given organisation and provide assistance with compliance with legislative and regulatory regimes in Hong Kong. In an area that is constantly developing, KPMG provides up to date guidance for its clients with respect to both Hong Kong and international regulations and practice.

A blurred, blue-tinted photograph of two business professionals in suits walking through a modern office or lobby. One is carrying a briefcase.

KPMG's Management Assurance Services

KPMG's Management Assurance Services professionals can help organisations assess their corporate governance processes. KPMG provides access to established methodologies and tools to help organisations enhance quality and results, ensure that effective and efficient controls are designed and implemented to manage organisational risk, improve the efficiency and effectiveness of key business processes, enhance the internal audit value proposition by driving revenue enhancement and cost containment opportunities, and develop or enhance the enterprise risk management and corporate governance processes within an organisation.

Table of Abbreviations

Throughout this Guide, the abbreviations listed below have the following meanings:

AGM	– annual general meeting
CO	– Hong Kong Companies Ordinance (Chapter 32)
Code	– Code of Best Practice of The Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Limited
GEM	– Growth Enterprise Market
GEM Rules	– The Rules Governing The Listing of Securities on The Growth Enterprise Market of The Stock Exchange of Hong Kong Limited
HKEx	– Hong Kong Exchanges and Clearing Limited
Listing Rules	– The Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Limited
OECD	– The Organisation for Economic Cooperation and Development
PRC	– People’s Republic of China
SCCLR	– Standing Committee on Company Law Reform
SDIO	– Hong Kong Securities (Disclosure of Interests) Ordinance (Chapter 396)
SEHK	– The Stock Exchange of Hong Kong Limited
SFC	– Securities and Futures Commission
SFO	– Hong Kong Securities and Futures Ordinance (Chapter 571)

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Chapter 1

Corporate Governance

Corporate governance is a global term encompassing all the issues facing a board in directing and controlling the company's operations — issues such as its interaction with management and with other stakeholders including shareholders, customers, suppliers, employees, creditors, the community at large and governments.

1.1 Definition

The term corporate governance has many definitions and all reflect the divergent role of companies in society. One such definition, adopted in Paris in 1999, by the Organisation for Economic Cooperation and Development (“OECD”) is set out below.

The OECD definition: “Corporate governance is the system by which business organisations are directed and controlled. The corporate governance structure specifies the rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.”

The recent failure of a number of publicly listed companies overseas has exposed weakness in corporate governance, deficiencies in financial reporting and the alleged abuse of power by directors and “C” level officers, prompting the reform of company law and review of corporate governance rules and practices by the regulators. The following are the main elements of corporate governance:

- sufficient transparency;
- appropriate/adequate disclosure to investors;
- accountability of any controlling shareholder(s);
- fairness between all parties; and
- responsibility of directors.



1.2 Corporate governance at different levels

1.2.1 Investor level

Corporate governance is one of the risk factors that should be assessed when evaluating potential investment opportunities. Shareholders should have access to information and the ability to influence management, through both internal governance procedures and external regulatory mechanisms.

1.2.2 Government level

Emphasis is placed on encouraging the building of an effective regulatory environment that applies and enforces existing laws and regulations as well as maintaining a level of transparency and disclosure required by an efficient and fair market for all investors.

1.2.3 Company level

Managements, in particular those of listed companies, should adopt governance practices that are consistent with accepted prevailing principles of corporate governance in the global markets in which they operate.

1.3 Listing Rules guidelines and GEM Rules regarding board practices and procedures

The Rules Governing The Listing of Securities on The Stock Exchange of Hong Kong Limited (“Listing Rules”) contain a Code of Best Practice (“Code”) (App. 14, Listing Rules), which is a set of guidelines for directors of companies listed on the Main Board to form the framework of their own code of best practice. However, the Rules Governing the Listing of Securities on the Growth Enterprise Market on The Stock Exchange of Hong Kong Limited (“GEM Rules”) contain certain rules regarding board practices and procedures (Rule 5.28 - 5.39, GEM Rules). These rules set out the minimum standards of good practice

concerning the general management responsibilities of the board with which the companies listed on the Growth Enterprise Market (“GEM”) and their directors must comply.

1.3.1 Code of Best Practice of the Listing Rules

The guidelines set out in the Code are not rigid rules, but The Stock Exchange of Hong Kong Limited (“SEHK”) recommends the boards of listed companies to comply with them as a minimum. Companies listed on the Main Board are encouraged to devise their own codes of practice that are suitable not only to their independent non-executive directors, but also to the board as a whole. The main items of the Code are:

- full board meetings, at which the directors are physically present, should be held at least every six months;
- adequate notice of board meetings should be given in order to allow all board members an opportunity to attend, and an agenda and board papers should be circulated at least two days in advance;
- the directors’ fees and any other reimbursement or emolument payable to an independent non-executive director should be disclosed in full in the annual report and accounts of the listed company;
- non-executive directors should be appointed for a specific term, which should be disclosed in the company’s annual report and accounts;
- the SEHK should be informed of the reasons for the resignation or removal of independent non-executive directors;
- the board should establish an audit committee with written terms of reference which clearly set out its authorities and duties; and

- every non-executive director must ensure that he/she can give sufficient time and attention to the affairs of the listed company and should not accept the appointment if he/she cannot.

1.3.2 GEM Rules

The main items of the GEM rules regarding board practices and procedures are:

- full board meetings, at which the directors are physically present, should be held at least every three months;
- adequate notice of board meetings should be given in order to allow all board members an opportunity to attend, and an agenda and board papers should be circulated at least two days in advance; and
- the directors' fees and any other reimbursement or emolument payable to an independent non-executive director should be disclosed in full in the annual report and accounts of the listed company.

The SEHK's requirement for all listed companies to include a statement of compliance with the Code or the GEM Rules in their annual and interim reports serves several important purposes.

These include:

- to encourage directors to regularly focus on and review the policies and procedures governing their boards;
- to provide Main Board listed companies with an opportunity to describe their governance practices in instances where they depart from the Code; and
- to provide investors with a means by which to assess the quality of corporate governance among companies listed in Hong Kong.

1.4 Summary

Being a director of a company can be rewarding, worthwhile and fulfilling. At the same time, it is a demanding and challenging task, even in the best of circumstances. Directors cannot avoid their responsibilities nor completely delegate them. They must answer to their company's shareholders and stakeholders. Directors have become under increasing pressure to be more accountable, transparent and responsive to stakeholder and community interests. In extreme cases, they face the possibility of litigation brought by discontented shareholders and stakeholders. They should therefore aim at improving standards of corporate governance continuously.





Chapter 2

Directors

2.1 A director as an individual

2.1.1 Appointment of directors

The Hong Kong Companies Ordinance (“CO”) currently requires that every company must have at least two directors (s. 153, CO). However, the articles of association may provide for a minimum number of directors in excess of the statutory requirement and also provide for a maximum number of directors.

Before appointment as a director, every proposed appointee is required to give their consent to acting as director of the company and, for natural persons, to state that they have attained the age of 18.

The CO provides for certain restrictions or conditions which must be observed before a new director may be appointed, namely:

- only persons who have attained the age of 18 can be appointed as directors (s. 157C, CO);
- an undischarged bankrupt cannot act as a director except with the permission of the court by which he was adjudged bankrupt (s. 156, CO); and
- a person against whom a disqualification order is made cannot (without the approval of the court) be appointed or continue to act as a director for a specified period (ss. 157E & 157F, CO).

In addition, some companies’ articles of association may disallow persons of unsound mind to be directors. Further, some articles of association may require directors to hold qualification shares in the company. In this case, such shares must be acquired by the directors within two months of the date of their appointment or such shorter time frame as prescribed by the articles of association (s. 155, CO).

Directors of listed companies are subject to the qualifications as specified in the Listing Rules or GEM Rules as appropriate. Pursuant to the Listing Rules and GEM Rules, every director must, in the performance of his/her duties as a director (Rule 3.08, Listing Rules) (Rule 5.01, GEM Rules):

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

Although these principles are codified in the Listing Rules and GEM Rules, it should be noted that these are also fundamental principles of common law and apply to directors of both listed and unlisted companies.

Every director of a listed company must satisfy the SEHK that he/she has the character, experience and integrity and is able to demonstrate a standard of competence commensurate with his/her position as a director of a listed company. If the SEHK is not initially satisfied as to the character, experience and integrity of the director, it may request further information regarding the background, experience, other business interests or character of any director or proposed director of the listed company (Rule 3.09, Listing Rules) (Rule 5.02, GEM Rules).

Further, directors of companies in certain regulated businesses (for example, banking, insurance and stock broking) will have to demonstrate to the appropriate regulator that they have the requisite skills, experience and integrity to become involved in the management of such businesses.

2.1.2 Resignation

A director may, unless otherwise provided in the company's articles of association or by an agreement, resign from his/her office at any time by giving written notice to the company. A resignation is normally effective on the day the letter of resignation is received by the company, unless the letter specifies a later date on which the resignation is to be effective. If the articles of association or any other agreement provide that notice of resignation is required, the resignation is not effective unless the required notice is given in writing to the company.

2.1.3 Retirement/removal

Directors are required to retire at an AGM if so stipulated by the company's articles of association. The number of directors to retire and the method of re-appointment are usually specified in the articles of association. The purpose of mandatory retirement provisions is to allow shareholders the opportunity to discontinue with the services of a director for poor performance. Although the primary reason for not re-appointing a director may be on the grounds of performance, as re-appointment is by way of a majority vote of the shareholders, a director may not be re-elected without having any reason stated.

Notwithstanding anything in the company's articles of association or in any agreement between the company and the director, a company may, by special resolution (that is, a shareholders' resolution that requires 21 days notice and an affirmative vote of at least 75 per cent of the votes cast at a general meeting) remove a director before the expiration of his/her period of office (s. 157B, CO). (This does not apply to a director of a private company who was holding office for life on or before 31 August 1994.) However, a director's right to any compensation or damages in respect of loss of office, if there is a contract providing for such a payment, will not be affected by the passing of a special resolution to remove him/her. Although legislation prescribes for a proper process for removal of a director, he/she has a right to put his/her case and to make representations to the shareholders.

2.2 Composition of the board

In Hong Kong, other than prescribing the statutory minimum number of directors, the CO does not determine requirements for the composition of a company's board of directors. The CO defines a director as a person occupying the position of director, regardless of title. Therefore, a person with a title other than "Director" but has the function of a director, is, in fact, a director for the purposes of the CO.

The main distinction among directors is between executive directors and non-executive directors. The executive directors are generally employees and part of the management staff of the companies of which they are also directors. The term "non-executive director" is commonly used to describe a director who does not hold any salaried appointment with the company but may receive fees laid down in the articles of association or as determined by the board.

The Listing Rules and GEM Rules provide that no listed company shall grant a service contract of 10 years for Main Board listed companies (3 years for GEM), or longer without the approval of the shareholders in a general meeting at which the relevant director cannot vote (App. 7, para. 33, Listing Rules) (Rule 17.90, GEM Rules). The Listing Rules and GEM Rules also provide that every listed company should appoint at least two independent non-executive directors (Rule 3.10, Listing Rules) (Rule 5.05, GEM Rules).

2.2.1 Independent non-executive directors

Non-executive directors are not involved in the daily management of the company. They are generally appointed because they can provide advice in a particular area of expertise to the board of directors. Their duties are to review the overall policies of the company, to contribute to the decision making of the board and to review the company processes. Minority shareholders look upon independent non-executive directors as a check on executive management.

In assessing the independence of a non-executive director, it is necessary to take account of the following matters (Rule 3.11, Listing Rules) (Rule 5.06, GEM Rules):

- an interest in the company of less than 1 per cent of the total issued share capital will not normally operate as a bar to independence, but where the director has received those shares as a gift from or by means of other financial assistance from a connected person¹, this will tend to indicate that he is not independent;

¹ A connected person (a) in relation to a company other than a People's Republic of China ("PRC") company and a company other than a subsidiary of a PRC company means a director, chief executive or substantial shareholder of such a company or any of its subsidiaries or an associate of any of them; and (b) in relation to a PRC company means a promoter, director, supervisor, chief executive or substantial shareholder of the PRC company or any of its subsidiaries or an associate of any of them.

- the director should normally have no past or present financial or other interest in the business of the company and no past or present connection with any connected person of the company other than as a professional adviser, which, in either case, might affect his/her exercise of independent judgement; and
- the director would be expected not to have any management function in the company.

2.2.2 Alternate directors

A director has no power to delegate his/her authority to an alternate director unless so authorised by the company's articles of association. If authorised by the articles of association, the appointment is usually required to be in writing and is subject to the approval of the board. An alternate may be appointed by a director to represent his/her views and vote on decisions to be taken at board meetings at which the principal director cannot be present. An alternate director shall cease to hold office as an alternate automatically upon his/her appointor ceasing to hold office as a director.

2.2.3 Corporate directors

Public and listed companies may not have any corporate body as a director. Private companies may, however, appoint a corporate body as a director provided that the company is not a member of a group of companies of which a Hong Kong listed company is also a member. Corporate directors are occasionally used by some larger groups to ease the management and administration of subsidiaries.

2.2.4 Board size

The size of the board is a function of the size and complexity of the company itself. The smaller the board, the easier it will be to make collective decisions, but the harder it will be to ensure that the directors represent all the skills required to run the company. Larger boards may appoint committees made up of a smaller number of directors to undertake specific functions (see also section 3.5 – Meetings of committees of the board).

2.2.5 Appointment of the board

A company's articles of association would normally provide that the subscribers to the memorandum of association (that is, the first shareholders) have the power to appoint the first directors of the company. The articles of association may, however, provide for certain persons to be the first directors. Whilst such a practice is technically acceptable, there is scope for confusion as the persons named in the articles of association may not give their consent to act as a director once the company has been incorporated.

Subsequent appointments of directors are governed by the provisions contained in the articles of association of the company. Normally, the articles of association would give directors the power to fill vacancies or to appoint additional directors, provided the total number of directors do not exceed the maximum permitted therein. The articles of association may also provide that any persons appointed by the directors shall automatically retire at the next AGM but may offer themselves for re-election. Such a provision provides a mechanism for the shareholders to confirm (or reject) the appointment of the director concerned. The company's general meeting can fill vacancies or appoint new directors, if the company's articles of association so specify.

2.2.6 Vacation of office

Other than resignation and removal by a special resolution, the office of a director is also vacated if the director:

- fails to obtain qualification shares within the stipulated period after appointment, where appropriate (s. 153(3), CO);
- fails to maintain the qualification shares subsequent to appointment, where appropriate (s. 153(3), CO);
- is an undischarged bankrupt (unless he/she has obtained leave from the court to continue his/her office) (s. 156, CO);
- is disqualified by the courts in respect of a conviction involving fraud or dishonesty or in connection with the promotion, formation or management of a company (ss. 168E or 168G, CO);
- is disqualified by the court for persistent default in relation to the delivery of documents to the Companies Registry (s. 168F, CO);
- is disqualified by the court in respect of having acted as director of an insolvent company (s. 168H, CO);
- becomes of unsound mind (if provided for in the articles of association);
- dies;
- retires and does not seek re-election at the AGM (if the articles of association require the directors to retire at an AGM);
- is not re-elected at an AGM;
- ceases to hold office on the expiration of the term fixed for the appointment; or
- any other manner as provided in the articles of association.

Companies may include additional qualifications and may give the board of directors the power of removal (for example, where a director has been absent from board meetings for a specified period).

2.3 Role and function of individual directors


The nature of the duties of a director depends not only on the type of the company's business, but also on the manner in which the responsibilities of the company are distributed between the directors and other officers.

Directors have a general duty to act honestly and diligently. They must act in good faith and in the company's best interests. In other words, directors should:

- act honestly and in a bona fide manner for the benefit of the company as a whole;
- act for a proper purpose; and
- avoid any actual and potential conflicts between their duties and personal interests.

A director is expected to exercise reasonable care, skill and diligence. However, a director need not, in the performance of his/her duties, exhibit a greater degree of skill than may reasonably be expected from a person of his/her knowledge and experience.

A person acting in the sole capacity as director, is not bound to give continuous attention to the affairs of his/her company (although circumstances may exist from time to time where this does not hold true, for example, in emergency situations). His/her duties are of an intermittent nature to be performed at periodic board meetings and at meetings of any committee of the board upon which he/she happens to be placed. He/She is not, however, bound to attend all such meetings, although he/she ought to attend whenever he/she is reasonably able to do so.



In respect of all duties that may properly be left to some other official, having regard to the needs of the business and the articles of association, a director, in the absence of grounds for suspicion, is justified in trusting that official to perform such duties honestly. A director must, however, satisfy himself/herself as to the appropriateness of the official's actions and also the appropriateness and consequences of his/her own actions.



Chapter 3

Managing the board's affairs

Chapter 3**Managing the board's affairs**

3.1 Collective responsibility

In general, directors have collective responsibility for the decisions made by the board which is held to be ultimately responsible for almost every aspect of the company's activities.

3.2 Role of the Chairman

The chairman is the person empowered to control the conduct of board meetings. The chairman is appointed by the board to preside over board meetings. Traditionally, the chairman is also the figurehead of the company. The main functions of the chairman are as follows:

- chair board meetings;
- chair AGMs and general meetings of shareholders (if provided for in the articles of association);
- ensure the orderly conduct of meetings;
- allocate a proper amount of time to the various items on the agenda;
- liaise with the chief executive officer and company secretary on the agenda for board meetings;
- direct discussion towards a consensus view;
- summarise decisions made;
- act as the company's leading representative in its dealings with the outside world;
- play a leading role in determining the composition of the board and any sub-structure of committees, so as to make the board an effective team, working with a high degree of harmony; and
- between meetings of the board, take whatever decisions are delegated to the chairman by the board.



3.3 Board meetings

The basic requirements for a valid meeting are as follows:

- it must be properly called and convened with sufficient authority and notice period;
- it must be properly constituted with the necessary quorum and a chairman to regulate the meeting; and
- it must be properly conducted with appropriate procedures.

Unless the articles of association provide otherwise, board meetings are usually convened by the chairman but may also be convened by a director or by the company secretary upon the instruction of a director of the company. The directors on a committee would normally decide the frequency and method of convening and holding of committee meetings. The agenda of the meeting is usually incorporated into the notice of the meeting. Shorter notice may be given if the written consent of all the directors of the company is obtained, unless the articles of association provide otherwise.

A quorum is the minimum number of members required to be present in order to proceed with or conduct the business of the meeting. In the absence of a quorum, the meeting and any decisions or business transacted will be invalid.

The quorum of the meeting is specified in the company's articles of association. However, subject to certain exceptions, there should be at least two persons physically present at the meeting. A director who also acts as the alternate for all the other directors of the company cannot by himself form the quorum and hold a board meeting.

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The general guidelines for the conduct of board meetings are:

- proper and timely notice should be given;
- the notice should state the date, venue and time, together with the proposed business of the meeting;
- the agenda should have a general business item so that directors who are present at the meeting may raise matters not covered by the formal agenda;
- board papers should be distributed before the meeting, allowing sufficient time for review and access to management;
- the meeting must not commence before the quorum is present and subject to the provisions in the articles of association, the chairman should ensure that a quorum is present throughout the meeting;
- questions and observations should be prepared and communicated clearly and directly, focusing on the issue;
- open questions should be used to encourage discussion; and
- the meeting is usually terminated by the chairman stating that the business of the meeting has been finished and declaring the meeting closed.

Further, typical provisions may also include that where no chairman is elected, or if at any meeting the chairman is not present within a specified time pursuant to the articles of association after the time appointed for holding the meeting, the members present may choose one of their number to be the chairman. Questions arising at any meeting shall be determined by a majority of votes of the members present, and in the case of an equality of votes, the chairman may, subject to the provisions in the articles of association, have a second or casting vote. It would be usual for draft minutes of meetings to be circulated to the participants for comments. Thereafter, minutes of meetings are usually confirmed at the subsequent meeting, and once signed by the chairman are regarded as an authoritative and accurate record of the decisions taken.



3.4 Role of the company secretary

The CO requires every Hong Kong incorporated company to appoint a company secretary. Listing Rules and GEM Rules also requires every company listed in Hong Kong to appoint a person who has the requisite knowledge and experience to discharge the functions of the secretary. The board is responsible for the appointment of the company secretary, who is recognised as an officer of the company under the CO. Appointment or cessation of the company secretary must be notified to the Registrar of Companies in Hong Kong and for listed companies to the SEHK as well.

The company secretary is responsible for making arrangements for the calling and convening of company meetings, assisting and advising the chairman of board or shareholders' meetings in the conduct of these meetings, and thereafter, preparing the minutes of the meetings, assisting with the implementation of resolutions and post meeting requirements. In addition, all directors should have access to the company secretary for advice and information at all reasonable times.

The company secretary must have sufficient knowledge of the laws, regulation and practice to highlight to those present at the meeting if further advice on a particular subject is required. He/She must also be familiar with the business to be transacted at the meeting.

3.5 Meetings of committees of the board

The process of managing and controlling a company is becoming ever more complicated as new legislation and regulations are introduced and stakeholders become increasingly aware of their ability or responsibility to influence companies. Consequently, many boards have established committees to assist them in performing their duties and discharging their responsibilities more efficiently and effectively.

Chapter 3

Managing the board's affairs

A company's articles of association usually provide for delegation by the board of any of their powers to individual directors or committees of the board. However, the power of any director or committee cannot exceed the power of the board. Any committee so formed shall, in exercising the powers delegated, conform to any regulations that may be imposed on it by the directors.

A committee or the board may elect a chairman of the committee who should preside as chairman at the committee meetings. It would be usual for the articles of association to provide that matters relating to quorum, voting and the appointment of chairman of a committee meeting closely follow the provisions that relate to meetings of the board of directors.

3.6 Types of committee

There are generally two types of board committee:

- standing committees that have a continuing role in assisting the board to discharge its responsibilities; and
- ad hoc committees that are formed in response to a specific situation and cease to exist after a given task has been completed.

3.7 Role of committees

The board's overall responsibilities will not be reduced by the creation of a board committee. Although the board is able to delegate some of its function to committees, the ultimate power and responsibility cannot be delegated.

A committee may be constituted to:

- ensure that specified responsibilities receive adequate and appropriate attention;
- act as a filter in discussing and summarising complex issues and recommending courses of action; and
- provide an independent check and balance in an area where some board members might have a conflict of interest; and monitor company activities in specified areas.

Benefits can be brought by a committee if it is properly constituted and organised. These benefits include reinforcing the role of the independent director and providing an independent director with an opportunity to gain a better understanding of the company's activities and issues than would generally be obtained at a full board meeting.

3.8 Establishing committees

The board may create committees for any purpose. The most common committee for listed companies in Hong Kong is the audit committee.

When establishing a committee, the board should consider:

- the need to review the written terms of reference regularly (for example at least annually);
- the appropriate composition of the committee;
- the tenure of the committee's members; and
- the appropriate mechanism for reporting back to the board.

Decisions relating to these matters should be recorded in the minutes of the board meeting. In establishing a committee, it is important to avoid dominance by any director and for formal meeting procedures to be observed.

3.9 Audit committee

The primary function of the audit committee is to assist the board in fulfilling its oversight responsibilities by reviewing auditing, accounting and the financial reporting processes and internal control system of the company.

An effective audit committee can improve board effectiveness, accountability and transparency. It may also:

- help improve the quality of financial reporting;
- create a climate of discipline and control, which may reduce the opportunity for fraud;
- give directors more insight into the company's accounting and control systems;
- enable the non-executive directors to contribute independent judgment and play a positive role;
- help the chief financial officer or finance director, by providing a forum in which he/she can raise issues of concern;
- improve communication between the board and the external auditor;
- provide a mechanism for the external auditor to assert his/her independence in the event of a dispute with management;
- strengthen the internal audit function by giving it greater independence from management; and
- increase public confidence in the credibility and objectivity of the company's financial statements and of the board.

In May 1998, the SEHK formally endorsed the establishment of audit committees by companies listed on the Main Board as set out in the Code. The Code is voluntary, however, any deviation from the Code must be disclosed in the company's annual and interim reports. The GEM Rules also requires every company listed on the GEM to establish an audit committee (Rule 5.23, GEM Rules). The board of a GEM listed company should establish an audit committee with written terms of

reference clearly setting out the audit committee's authority and duties. As recommended by the SEHK through the Code and as required by the GEM Rules, the audit committee should be appointed only from the non-executive directors of the board and consist of a minimum of two members; a majority of the members, including the chairman, should be independent.

Audit committee meetings should be adequately planned and prepared for, held at appropriate times and attended by relevant persons.

3.10 Special purpose committees

Special purpose committees may be established to gather, evaluate and report to the board on any particular issue. These issues may include:

- due diligence;
- the assessment of the merits of a takeover bid for the company;
- the development of strategic plans for consideration by the board;
and
- a review of litigation in respect of actions taken against the company.

Special purpose committees, having been established to consider a specific matter, will sometimes have a limited life. However, a committee's terms of reference should still be approved by the board.



Chapter 4

**Communicating with shareholders
and other stakeholders**

4.1 Shareholders and stakeholders

Listed companies are generally owned by a relatively large number of shareholders. Directors are responsible to all shareholders as a group and not just to some of them. Various mechanisms exist for helping to ensure directors are made accountable to their shareholders and stakeholders, including:

- the preparation of annual financial statements which must be audited;
- listed companies must release half-yearly reports and full year report and financial statements. Companies listed on the GEM are also required to issue quarterly reports;
- companies must hold an AGM and present annual audited financial statements together with directors' and auditors' reports to shareholders;
- under certain circumstances, shareholders can compel directors to call extraordinary general meetings; and
- listed companies are required to advise the SEHK immediately (for release to the public) any information concerning the company or its subsidiaries or associated companies which is necessary to avoid the establishment of a false market in that company's securities or would be likely to materially affect the price or value of its securities.

4.2 Shareholder overview

Shareholders own a package of rights on which a monetary value can be placed. The extent and nature of these rights depend very largely on each company's memorandum and articles of association. Shareholders' rights will normally include the following main elements, although these may be excluded or modified in the case of a particular company or class of shareholder:

- a financial return, normally in the form of a proportion of the company's distributable profits;
- a right to transfer their interest to another person; and
- a right to vote in general meetings, enabling them to participate in decisions on the size, shape and scope of the company and in particular in decisions to:
 - dismiss and appoint the directors;
 - change the company's constitution; and
 - liquidate the company and distribute the value of the net assets among themselves.

Many of the provisions of the CO are designed to protect the interests of shareholders on the assumption that their knowledge of and involvement with the company will be minimal. Shareholders' rights to information about a company are limited to those provided for in the CO, Listing Rules, GEM Rules, other securities disclosure legislation and the company's own articles of association.

4.3 Stakeholder overview

A number of parties or stakeholders will also have an interest in the activities and fortunes of a company. These include customers, suppliers, employees and their families, lenders and other creditors, the general community in which the company geographically operates and governments.

The obligations of the company to its customers, suppliers and employees or its wider public obligations in respect of such issues as the protection of the environment, are not affected by its corporate status. However, the mechanisms for enforcing compliance of the company with these obligations and dealing with conflicts that arise due to the demands of different interest groups are heavily affected by its corporate status, and a great deal of the burden falls on directors personally. For a company to become successful, management must understand what each stakeholder group expects or demands from the company, understand the legal and economic aspects of the company's relationship with these groups and adopt policies for dealing with them.

4.3.1 Customers

A company's income is generated through sales to customers or clients whereas the other parties connected to the company are only likely to produce costs and therefore lower profitability. However, in the production of a product, a company should not only take account of the immediate needs of the customer (that is, the purpose for which the product is bought), but the following should also be considered:

- the product or service should be safe and will not cause danger to customers' health;
- the customers' expectation to receive quality products and services; and
- the customers' economic interests.

4.3.2 Employees

A company must treat their employees fairly and equitably, and in accordance with the Hong Kong Employment Ordinance and other relevant rules and regulations. In addition, an employer should, whenever possible, take into consideration the concerns of its employees. Some of these concerns include:

- job satisfaction, including financial rewards and recognition;
- job security; and
- working conditions.

4.3.3 Creditors

Company and insolvency legislation is designed to protect creditors and, in certain circumstances, to compensate them for the wrongdoing of company directors. The liabilities of the company to creditors may create substantial personal liabilities for its directors if the business of the company has been carried on with intent to defraud creditors and the company becomes insolvent.

4.3.4 Government and the community

The collective conscience of the board may be held to represent the conscience of the company where moral rather than legal issues are at stake. Some companies, in order to demonstrate good corporate citizenship, project an image of being a positive force in the communities in which they operate. This can be done

Chapter 4**Communicating with shareholders and other stakeholders**

by organising or sponsoring community or socially responsible activities such as educational projects with the underprivileged or raising awareness of environmental issues.

However, a proper balance of interests must be maintained. If it is expressly or impliedly empowered to do so, a company may make charitable, political and other similar gifts to the community.

4.4 Communicating with shareholders

If companies are to maximise returns for their shareholders, they must not only create value, but be seen to create value. This is essentially a matter of communicating with shareholders, potential shareholders, and third parties in a position to influence investors' share buying and selling decisions (including stockbrokers, analysts, investment advisers and financial journalists).

Listed companies can utilise formal investor relations programmes to manage the flow of timely, accurate and relevant information to selected target audiences. When delivering investor relations programmes and briefing media, analysts and other interest groups, care needs to be taken that only publicly available information is used. Where market sensitive information is not publicly available, the company should ensure it makes appropriate disclosures in line with the Listing Rules or GEM Rules, as appropriate, and other relevant legislation.

4.5 Reporting to shareholders

Shareholder and investor communication starts with statutory disclosure. For listed companies in Hong Kong, statutory disclosure is primarily provided for by:

- the Companies Ordinance;
- the Securities (Disclosure of Interests) Ordinance (“SDIO”);
- relevant accounting standards and regulations; and
- the Listing Rules and the GEM Rules.

The elements of statutory disclosure for listed companies are:

- financial disclosure;
- continuous disclosure requirements for price-sensitive information; and
- other disclosure requirements, such as connected transactions and notifiable transactions.

4.6 Financial disclosure

The CO requires the directors of every company to present the audited financial statements, directors’ and auditors’ reports to the AGM of the company. The AGM should be held within 6 months of the end of the financial year. However, in the case of a private company (other than a private company which at any time during the period to which the said accounts relate was a member of a group of companies of which a company other than a private company was a member) and a company limited by guarantee, the AGM may be held within 9 months of the end of the financial year.

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Companies with a primary listing on the SEHK are requested to prepare their annual report and audited financial statements to conform to the relevant accounting standards.

Listed companies have to comply with the detailed requirements for financial disclosure contained in the Listing Rules or GEM Rules, as appropriate. The annual report and financial statements must be despatched to shareholders at least 21 days before the AGM and within 4 months (for Main Board) or 3 months (for GEM) of the relevant financial year end.

The annual report and financial statements comprise the following items:

- corporate information;
- chairman's statement;
- management discussion and analysis;
- biographical details of its directors and senior management;
- directors' report for the year;
- financial statements for the year;
- auditors' report on the financial statements;
- general information required by Appendix 16 of the Listing Rules or Chapter 18 of the GEM Rules; and
- other information as prescribed by any relevant regulatory authority (for example the Hong Kong Monetary Authority or the Hong Kong Insurance Authority).

An interim report must be despatched to shareholders within 3 months (for Main Board listed companies) or 45 days (for GEM listed companies) of the end of the first six months of the financial year of the company. For companies listed on GEM, quarterly reports must be despatched to shareholders within 45 days after the end of the relevant financial period. Currently, the Listing Rules for companies listed on the Main Board do not oblige companies to issue quarterly reports.

A listed company's financial results are price-sensitive. Directors should therefore keep this information confidential and also refrain from buying and selling any of the company's shares until the results have been released onto the market (App. 10, Listing Rules) (Rule 5.51, GEM Rules).

External advice should be sought in appropriate circumstances. Boards should also insist that effective systems are in place to ensure that all formal shareholder and investor communications (including financial reports):

- result from a designated approvals process;
- include all the information required by the relevant laws and standards;
- adhere to statutory timing requirements;
- follow the format prescribed by the relevant laws and standards; and
- are accurate and not misleading.

Boards should ensure that the organisation's effective system includes adequate involvement of the internal audit area and the audit committee, and should also ensure that there is sufficient interaction between these and the company's external auditors. The terms of reference of the audit committee should include a role in the review of significant financial disclosures before sign-off by the board.

The above items are some minimum reporting requirements. Some companies choose to provide shareholders and investors with extensive additional information concerning their activities and operations. Many companies also include artwork, photographs and charts in their annual and interim reports. They might also, for example, report on their environmental achievements and compliance records, and/or on various communities, social and "corporate citizenship" initiatives.

4.7 Disclosure of price-sensitive information

Directors must ensure fair and timely public disclosure of information that might reasonably be expected to materially affect market activity in, and the price of, a company's securities (App. 7, para. 2(1)(c), Listing Rules) (Rule 17.10, GEM Rules).

The question of timing of the release of an announcement to the market is crucial, having regard to its possible effect on the market price of the listed company's listed securities. Generally, disclosure should be made as soon as practicable. If the information is expected to be price-sensitive and is the subject of a decision, then the directors are required to ensure that such information is kept strictly confidential until a decision and an announcement thereof is made. Confidentiality of price-sensitive information must be maintained so that no one is able to deal in shares from a more informed position than that available to the market generally. Although companies can discuss ongoing matters with journalists and analysts, they have to be particularly careful not to disclose price-sensitive information which has not been made public.

A listed company must inform the SEHK and holders of the listed securities as soon as practicable of any information relating to the company which:

- is necessary to enable the SEHK and the public to appraise the position of the company;
- is necessary to avoid the establishment of a false market in the company's securities; and
- might reasonably be expected materially to affect market activity in and the price of its securities.

If there are unusual movements in the price or trading volume of a company's shares, the SEHK will usually make enquiries to the company concerned and require an announcement regarding any relevant developments. If an announcement cannot be made in time, trading in the company's shares may be suspended.

In January 2002, the SEHK issued a "Guide on Disclosure of Price-Sensitive Information" which is intended to help directors fulfil their obligations and to judge what price-sensitive information is and when disclosure is required.

4.8 Other disclosure requirements

Certain events are required to be notified to the SEHK. A company must inform the SEHK immediately after approval by the board of any proposed change in the capital structure and any decision to change the general character or nature of the business of the company or the group. A company must inform the SEHK immediately of:

- any changes in its directorate, secretary, auditor or registered office;
- any important change in the holding of an executive office;
- any proposal to change the memorandum or articles of association or equivalent documents; and
- any changes in the rights attaching to any class of a listed security.

The SEHK should be informed immediately after decisions in relation to changes in the composition of the board of directors take effect, and the company should simultaneously make arrangements to notify the public by means of a press release or such other method as the directors consider appropriate. In addition, a draft of any proposed amendment to the company's articles of association must be submitted to the SEHK for review before it is submitted to shareholders for consideration.

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The company must inform the SEHK at least 7 clear business days in advance of board meetings where decisions are to be taken in relation to financial results and dividends. The company must also inform the SEHK immediately after approval by the board of any preliminary announcement of financial results or any decision regarding dividends (App. 7, para.12, 13(1), (2), (3), Listing Rules) (Rule 17.48, 17.49(1), (2), (3), GEM Rules).

4.8.1 Notifiable transactions

A listed company has to comply with the requirements for acquisitions and realisations of assets. Depending upon the results of comparative tests of assets, profits, consideration and the value of equity, the listed company is required to make an announcement, issue a circular or obtain prior shareholders' approval and ensure independent financial advice is provided to shareholders. There are five categories of notifiable transaction:

- very substantial acquisitions;
- major transactions;
- discloseable transactions;
- share transactions; and
- connected transactions.

Directors should note that even if a transaction may not be required to be disclosed under notifiable transactions, disclosure may nevertheless be required under the general obligation to keep the market informed of all price-sensitive information.

4.8.2 Connected transactions

Transactions between a listed company and a “connected person” are subject to disclosure and/or independent shareholders' approval unless the conditions as set out in Chapter 14 of the Listing Rules and Chapter 20 of the GEM Rules are satisfied. Generally, a “connected person” in relation to connected transactions means a director, chief executive or substantial shareholder (that is a holder of 10 per cent or more of the voting rights) of the company (or any of its subsidiaries) or an associate of any of them. More specific definitions of such “connected persons” are set out in Chapter 14 of the Listing Rules and Chapter 20 of the GEM Rules.

The Listing Rules and GEM Rules relating to connected transactions are complex, and, therefore, it is essential that the SEHK be consulted at an early stage so that, in cases of doubt, it may be established whether or not the provisions on connected transactions will apply.

4.8.3 Securities (Disclosure of Interests) Ordinance

The SDIO requires directors of listed companies to disclose all their interests in the shares and debentures of their company or any associated corporations (as defined in the SDIO) and those of their spouse and children under 18. Interests in the context include interests in derivative warrants and the grant and exercise of share options.

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Shareholders who become interested in 10 per cent or more of a listed company's issued and voting capital (a substantial shareholder) must also disclose their holdings.

Disclosure of both directors' and substantial shareholders' interests must be made by those respective persons to the SEHK and to the listed company within 5 days of the duty to notify arising. All listed companies must keep registers of directors' and substantial shareholders' interests.

4.8.4 Dealings in the company's securities

The SDIO states that persons who are "connected with" a listed company must not deal in the listed securities of that company if they have price-sensitive information which has not been disseminated to the market.

The Model Code for Securities Transactions by directors contained in the Listing Rules and GEM Rules contains minimum standards of good practice for a director's dealing in shares of his/her company. It restricts dealings by directors of listed companies when they have access to price-sensitive information. This is during the one month before the preliminary announcement of the company's annual and interim results, and quarterly results for a GEM listed company. The prohibition on dealing in the company's shares is also applicable where any negotiations relating to intended transactions by the company are taking place.

4.9 Annual General Meeting

With the exception of a newly incorporated company, which need only hold its first AGM within 18 months of incorporation, every company must hold an AGM each year and within 15 months of the last AGM. Public and listed companies must hold an AGM each year and within 6 months after the financial year end.

The statutory minimum notice for an AGM is 21 days in writing but may be longer if provided for by the articles of association. A shorter notice period may be given provided all the shareholders entitled to attend and vote at the AGM agree.

For many public companies, the AGM is a major channel of shareholder communication and investor relations. The AGM offers shareholders an opportunity to question the board, express their views on company performance, and suggest changes to company governance and operations. The AGM can be both a positive and a difficult experience for boards, and a source of positive and negative publicity for companies. Thorough preparation lessens the possibility of a negative outcome:

- a hostile AGM is rarely the result of issues first arising at the meeting itself. Boards in touch with shareholder and other stakeholder concerns should be able to anticipate and embrace debate on contentious issues;
- boards and managements should spend time trying to anticipate specific shareholder questions, and developing appropriate responses. Speakers should be identified to respond on specific issues and be well prepared to deal with those issues, thereby avoiding potentially inflammatory or embarrassing remarks;
- likely difficult questions can sometimes be anticipated by raising and answering them in the annual report, or in the formal chairman's address to the AGM; and

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- the chairman — who is normally responsible for the conduct of the AGM — should be thoroughly familiar with the AGM agenda and meeting procedures, and have developed an approach for dealing with difficult or hostile responses from the floor of the meeting. The chairman’s aim should be to adequately address shareholder questions/concerns constructively and courteously and to manage the time effectively. The chairman of an AGM must allow shareholders reasonable opportunity to ask questions about the management and operations of a company.

4.10 Additional shareholder communication mechanisms

Some companies have added additional channels for their shareholder communications and investor relations as follows:

- occasional sampling of shareholder/investor attitudes and concerns to assist the board shape its messages more effectively. To avoid results that could be misleading, sampling should be conducted according to acceptable statistical protocols;
- formal documentation distributed to shareholders in connection with events such as share issues and changes to the company’s constitution accompanied by a letter setting out as clearly as possible what the proposals mean, how they will affect shareholders, and what (if anything) shareholders are expected to do;
- shareholder enquiry lines; and
- corporate web sites that include an “Investor Relations” section giving details of financial reports, announcements, management biographies and share information.





Chapter 5

**Recent developments in
corporate governance in Hong Kong**

Chapter 5**Recent developments in corporate governance in Hong Kong**

Good corporate governance is key to enhancing the attraction of the market and investors' confidence, as well as maintaining the stability of the financial markets. The Government has initiated reviews on Hong Kong's corporate governance regime to upgrade Hong Kong's corporate governance standards. The Standing Committee on Company Law Reform ("SCCLR"), the Securities and Futures Commission ("SFC"), the Hong Kong Exchanges and Clearing Limited ("HKEx") and various professional bodies have worked together to propose and implement reforms to the legislation and rules and bring them up to date.

5.1 Corporate governance review by the Standing Committee on Company Law Reform

A "Consultation Paper on Proposal in Phase I of the Corporate Governance Review" was issued by the SCCLR in July 2001.

This consultation paper covers proposals with respect to directors' duties and responsibilities, shareholders' rights and corporate reporting.

5.2 Companies (Amendment) Bill 2002

The Companies (Amendment) Bill 2002, which seeks to improve corporate governance standards and to modernise the CO, was issued in January 2002. The Bill covers 17 of the recommendations made by the SCCLR in February 2000. These have been grouped into three categories, namely, shareholders' rights, requirements regarding directorships, and technical matters. The Bill also seeks to simplify the filing requirements, to improve the charge registration procedures and to make technical amendments to certain winding-up provisions under the CO.

5.3 Securities and Futures Ordinance

The new Securities and Futures Ordinance (“SFO”) includes amongst other things:

- the establishment of a Market Misconduct Tribunal (“the Tribunal”), to replace the Insider Dealing Tribunal. However, as its name suggests, the Tribunal will have authority over all forms of market wrong-doings rather than just insider dealing;
- the Tribunal only has power to make certain orders but these include extension of powers to disqualify a person from being a director or other senior managerial position of either any company listed in Hong Kong or other company specifically, or an order to pay to the Government any profit derived (which includes losses avoided) from the market misconduct activities;
- the right of the recovery of pecuniary losses resulting from market misconduct, such as insider dealing or price rigging. In bringing such an action it will not be necessary for the complainant to rely upon the results or findings of a criminal case or the Tribunal and also, being a civil action, need only prove misconduct has “probably” occurred. However, the SFO also permits the findings of the Tribunal or a criminal conviction to be admitted as evidence in such an action and should this occur, the door will be open for all persons who have suffered losses to bring an action against those from guilty.

5.4 Consultation Paper on proposed amendments to the Listing Rules and GEM Rules relating to corporate governance issues

On 21 January 2002, the SEHK issued a consultation paper on proposed changes to the Listing Rules and the GEM Rules relating to corporate governance issues. The consultation paper contains a significant number of proposals, some of which may be potentially controversial, and is divided into three main sections:

- protection of shareholders' rights;
- directors and board practices; and
- corporate reporting and disclosure of information.

5.5 Conclusion

Corporate governance has been identified as a priority area in Hong Kong. This is because good governance is key to maintaining Hong Kong as a leading international financial centre.

This is the first edition of the Guide for Company Directors, which summarises the relevant statutory duties and responsibilities of those charged with directing a company. It also emphasises how good corporate governance standards are no longer just a desirable option for the very top tier companies but has become essential for all organisations in both the public and private sectors where managers have been entrusted with stewardship and of the custody of the assets of others. It also incorporates recent statutory and regulatory changes and proposed changes affecting directors' duties and responsibilities. It is clear that rules and regulations shall continue to evolve and directors will find it a challenge to keep pace with these developments.

Please visit the HKACI at <http://aci.kpmg.com.hk/HK/home.html> or contact KPMG if you require any other information or if you wish to discuss any matters regarding corporate governance.