

Corporate Governance In Hong Kong



January 22, 2002

Research:

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Publication Date: January 22, 2002

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Executive Summary

Standard & Poor's regards the overall support environment in Hong Kong for corporate governance to be at a good level in a global context, although day-to-day practices at the company level continue to be subject to further improvements.

The positive assessment of the support environment is reflected by a sound legal and regulatory foundation, as well as recent efforts by governmental authorities, and non-governmental organizations (NGOs) to improve levels of corporate governance in Hong Kong. Recent years have shown that attention is being given to identifying and addressing gaps between Hong Kong governance practices and governance standards that are increasingly recognized as best practice on a global level. As such, the trend is positive and relative to other Asian countries in particular, Hong Kong is a leader in the domain of corporate governance.

While it is important to recognize this positive dynamic and support environment at the macro level, it is also essential to highlight that there remain areas for improvement. Many of these are explicitly acknowledged and recognized by local market participants and authorities. For example, the July 2001 review on corporate governance by the Standing Committee for Corporate Law Reform (SCCLR) in Hong Kong highlights numerous areas where Hong Kong standards and practices would benefit from further change. The prime examples quoted by the SCCLR deal with the predominance of controlling shareholder groups in Hong Kong's corporate landscape, the lack of shareholder activism, and the fact that numerous listed companies are not even domiciled in Hong Kong. It is realistic to expect continued leadership in improving corporate governance standards at the macro level in the years to come. However it will be important to link this top down leadership to changes in attitudes and practices at the company level. This is particularly the case for family controlled firms, which comprise a significant proportion of the Hong Kong economy. Many reviews of corporate governance in Hong Kong highlight the relative lack of a strong governance culture, which in part stems from this prevailing ownership structure.

To summarize the key components of Standard & Poor's country environment analysis, Hong Kong has a well-developed **market infrastructure**. The political environment is stable, and its macro-economy demonstrated general resilience from the Asian financial crisis of the late 1990s. As a Special Administrative Region (SAR) of the People's Republic of China (PRC), Hong Kong is also linked closely with the increasing integration of the PRC in the global economy. Hong Kong's banking system is sophisticated and well supervised, and the government rarely intervenes in the market or protects individual sectors. Moreover, access to public exchanges is relatively high. Hong Kong has also made improvements to the required **informational infrastructure** in recent years. Local accounting standards are being harmonized with international standards. Transparency and disclosure is a focus of the SCCLR, the Hong Kong Society of Accountants (HKSA), the Securities and Futures Commission (SFC), and the Companies Registry. Gaps can still be identified, however, with regard to the content of annual and interim reports, operational analysis, and executive remuneration. The **regulatory framework** is well

established, encouraging good practices and providing a supportive environment. One criticism, though, frequently voiced by local market observers is that the regulatory powers of investigation and their ability to enforce regulations fall short of some more pro-active regimes. The English-based **legal system**, also provides the judicial protection of key elements of shareholders' interests and guides the conduct of boards of directors. While this fundamental legal and regulatory infrastructure is sound, local advocates of corporate governance voice the concern that grassroots improvements in governance practices may be limited if the quality of written law and regulation is not matched with a similar quality of aggressive enforcement.

As suggested above, the main weaknesses in the Hong Kong corporate governance environment are less at the legal and regulatory levels than at the individual firm level. Standard & Poor's recognises that family domination of companies' ownership structure and the limited (though growing) shareholder activism culture present particular challenges. While family ownership does not intrinsically suggest a poor governance structure, other models of corporate governance that rely more heavily on market mechanisms to perform checks and balances might not be as effective in the Hong Kong environment, given the historical success of these family-owned companies, and the less formal approach to corporate governance in general. The introduction of a voluntary *Code of Best Practice* is a positive step, but it remains to be seen if this voluntary approach will be successful in promoting the true culture of good corporate governance.

Nevertheless, the overall governance environment is sound and the trend is positive. Improvements in corporate governance practices can be expected going forward to reflect increasing market pressures for transparency and accountability. Moreover, the important need for Hong Kong to maintain or improve upon its status as a regional and global financial centre implies an additional incentive for local authorities to push for Hong Kong to be recognized as a progressive force in the area of corporate governance.

Introduction

As a former British dependent territory, Hong Kong is in an unusual situation, as its regulatory system is based on English common law, but its business practices and corporate governance carry both Asian and UK influences. Historically, the British had dominated the ownership and control of major banks, corporations, and local institutions. However, the past three decades have seen the emergence of highly successful local entrepreneurs. Today, family-owned businesses represent the predominant form of listed companies in Hong Kong, resembling prevailing ownership structures in many other Asian countries.

The family ownership structure that prevails in Hong Kong implies the strong influence of dominant shareholders and a limited voice for minority shareholders. Compared to the Anglo-American environment, for example, where ownership blocks are less concentrated and where institutional investors are more prevalent, there is less of a culture for non-executive directors or minority shareholder activists to challenge

powerful CEOs or directors representing large ownership blocks. The Stock Exchange of Hong Kong published its own *Code of Best Practice* in 1993 to enshrine good corporate governance practice. This was a positive step forward. However, until the Asian financial crisis, corporate governance was not treated as a matter of urgency by the majority of Hong Kong companies.

The financial crisis in 1997 exposed the structural weaknesses of many Asian economies, and it was certainly a wake-up call for Hong Kong as well. Regulators and policy makers realized that corporate governance had become an essential and overriding element necessary for Hong Kong companies to continue to attract investment and to stimulate economic growth. To regain Hong Kong's competitiveness in the global market, reform was needed.

Since then, many improvements have been made, led at the macro level. Corporate governance is increasingly focused upon by government authorities, regulators and NGOs. There is a clear intent to adopt governance standards at the highest level. However, unless this is embraced by the companies that are operating in Hong Kong, the journey will not be a short one. Hong Kong's history as a former British dependent territory, the concentration of its company ownership at the family level, the long tradition of laissez-faire government policy, and the region's strong desire to maintain its status as a major financial centre in Asia, have shaped the environment of corporate governance today, and will continue to impact its evolution in the future.

Market Infrastructure

POLITICAL ENVIRONMENT

The Joint Declaration between the Chinese and British Governments set out the basic policies of the PRC regarding Hong Kong. Under the principle of 'One Country, Two Systems', the PRC's socialist system and policies will not be practised in the Hong Kong SAR, and Hong Kong's previous capitalist system and life-style will remain unchanged for 50 years. *The Basic Law* of HK SAR came into effect on July 1, 1997. Among other things, it rules that:

- *'The HK SAR has a high degree of autonomy and enjoys executive, legislative and independent judicial power, including that of final adjudication'* (BL Article 2)
- *'The HK SAR remains a free port, a separate customs territory and an international financial centre. Its markets for foreign exchange, gold, securities and futures shall continue. There shall be free flow of capital'* (BL Articles 109/112/114/116).

The government's vision of Hong Kong as a leading centre for business has remained unchanged after 1997. Hong Kong's economy is built on free enterprise, free trade, and a free market open to all. There are no barriers to trade, no restrictions on investments, and no foreign exchange controls. The government is committed to maintaining a level playing field for foreign and local investors - both in law and business practice. There are no special approval procedures for foreign investments,

nor any specific regulations governing the management of investment in Hong Kong. Unlike many regions, the HK SAR Government does not make local ownership/control a condition for establishing, maintaining or expanding foreign local staff. To sustain the favourable business environment, the government's approach remains one of minimum interference and maximum support.

In summary, Hong Kong's political environment is unique, yet it has demonstrated signs of political stability and the region continues to prosper economically. Since the hand-over in 1997, Hong Kong has maintained one of the world's most transparent investment regimes, particularly for inward investments. These are favourable factors to the development of corporate governance practice.

MACROECONOMIC STABILITY

Standard & Poor's assigns to Hong Kong a local currency sovereign credit rating of 'AA-' and a foreign currency credit rating of 'A+'. The outlooks for both sovereign ratings are stable. Both ratings represent a strong level of sovereign credit quality in a global context. It should be noted that the sovereign foreign currency credit rating assigned to the PRC is somewhat lower, at 'BBB', also with a stable outlook.

The discussion presented below is an excerpt of the Country Report written by Joydeep Mukherji of the Sovereign group of Standard and Poor's dated March 15, 2001:

The hybrid nature of Hong Kong is reflected in more than just economic values that contradict its political practices. Hong Kong has maintained a strong commitment to market-oriented policies combined with a public sector that owns or subsidizes more than half the dwellings in the territory. Its activist government strictly controls the use of land, invests in huge infrastructure projects, and is heavily involved in providing housing, education, and health services to its population while keeping taxes low and allowing the private sector to make most business decisions. It is an open port city with private-sector cartels dominating many areas of the economy. It is administered largely by competent technocrats and led by a powerful conservative business community, but faces increasing pressures for more public accountability from an educated population. The sharp rebound in economic performance following the strains caused by the 1997 Asian financial crisis indicates the flexibility of Hong Kong's economy. The adjustment to massive currency depreciation and capital outflows from neighbouring countries took place as envisaged, mostly through market means (with the exception of a major purchase of stocks by the government in August 1998 to deter speculation against the linked exchange rate). A rapid adjustment in costs, salaries, and asset prices allowed Hong Kong to regain external competitiveness without devaluation or government-mandated wage cuts, as was the case in Singapore. Wages adjusted with a lag of about one to one-and-one-half years, faster than in most economies, as nominal payroll costs declined from early 1999 through the first quarter of 2000. Prices fell in 1999 and 2000. Total employment may have risen during the recession due to an increase in the labour force and in participation rates, even as unemployment rose. Relatively few firms closed or went into bankruptcy, compared to other Asian countries, and the banking system showed its resilience. Profitability declined, but firms managed to sustain their liquidity.

Accumulated fiscal surpluses allowed the government to incur manageable budget deficits to sustain economic activity during the downturn without weakening public finances. The HKMA estimates that the government's fiscal stimulus in 1998 and 1999 contributed about 1.5% to GDP growth. This included a US\$30 billion program of rail and road infrastructure, as well as investment in infrastructure for information technology. Perhaps more important, the social consensus behind market-oriented policies and institutions was sustained throughout the period, despite rising unemployment.

GDP is estimated to have grown around 10% in 2000, decelerating from an explosive 14% growth rate in the first quarter as the economy emerged from recession. Exports grew nearly 20% compared to stagnation in the previous year. Growth was led by an upsurge in domestic demand, especially capital investment, with rising real investment complemented by recovering private consumption. As a result, unemployment fell to just above 4% from a peak of 6.3 in mid 1999 (but is not likely to return to 2%-3% pre-crisis levels for some time yet). Slowing exports, in line with global trends, could decelerate GDP growth to a more manageable 4% in 2001. Also, the introduction of a compulsory retirement scheme (see Fiscal Flexibility) may dampen the growth of private consumption by reducing disposable income. GDP growth may stabilize around 4%-5% over the medium term, similar to the pace in the previous decade prior to the recession. Long-term growth prospects depend increasingly upon growth in China, as well as upon Hong Kong's ability to develop its financial and knowledge-based industries to service the Mainland and the region. Hong Kong stands to benefit from being the source of equity and debt for Chinese enterprises, a base for regional headquarters for multinationals as well as mainland companies expanding outwards, a logistics hub, and a provider of professional services to China. Investments booked through Hong Kong, either by local or foreign firms, as well as Chinese capital re-entering the Mainland to take advantage of tax breaks, account for about 40% of China's foreign direct investment (FDI). The Mainland's own financial markets will likely develop rapidly in the coming years, but the persistence of capital account controls, as well as a weaker regulatory and supervisory environment, should increase Hong Kong's importance for investors seeking to better manage their Mainland risks. Recent changes in the financial sector and the lowering of telecommunications costs thanks to liberalization augur well for long-term growth.

The government estimates that China's WTO membership could boost Hong Kong's GDP growth by 0.5% on average over the coming decade. The gradual shift of Hong Kong's manufacturing sector into China over the last two decades will be followed by a similar shift in supporting service industries, such as distribution and logistics, into the Pearl River Delta in the coming years. Since 1980, Hong Kong's service sector has grown to 85% of GDP, employing about 80% of the workforce, while manufacturing has shrunk to 6% from 24% of GDP and construction has remained at 6% GDP. Recent investment in the supply chain connecting raw material inputs to Chinese factories and to overseas buyers, much of it passing through Hong Kong's own port and airport facilities, should bolster Hong Kong as the logistical hub for the region. A new marine cargo terminal next to the new airport and more container ports should increase Hong Kong's ability to service the booming economy of southern China.

Long-term growth prospects depend upon raising labour skills. Shortcomings in the education system may become more apparent in the coming years, raising pressure for more public spending and education reform. Competitiveness may be enhanced through telecommunications deregulation, but the absence of a competition law is likely to constrain competition in many service sectors (including retail and distribution). IMF studies indicate that Hong Kong is broadly as competitive as member countries of the Organization for Economic Cooperation and Development (OECD), but raise the question of whether this is sufficient in light of the importance of its fixed exchange rate and greater external dependence.

Most recent economic indicators show that Hong Kong's economy also will be impacted by the global slowdown. As a result, the GDP forecast, which originally had been set at 4%, was reduced to 1% or lower in September of 2001.

Overall, Hong Kong's economy has recovered well from the Asian financial crisis. However, the current slowdown in the global economy will focus attention on perceived weaknesses in the management of companies and the commitment shown to improving corporate governance practices should continue.

OWNERSHIP STRUCTURE

Private ownership is the predominant form of ownership in Hong Kong. The private sector makes up around 80% of Hong Kong's GDP and provides over 90 percent of all jobs. Over the years, the free trade and free market economic environment has nurtured a population famous for its entrepreneurship. The HK SAR Government also encourages private sector participation in the provision of public services wherever suitable, to go forward with incorporation of government activities, and to privatise certain public corporations where market conditions are appropriate.

The partial privatisation of the Mass Transit Railway Corporation (MTRC) through a public offering in 2000 was Hong Kong's first privatisation exercise. After eighteen months of preparation, MTRC was listed on the Hong Kong Stock Exchange in October 2000, and the state's ownership was reduced to 77%. The government has pledged to continue to hold at least a 50% shareholding in the company for at least 20 years from the date of the listing, and to provide the same support as before privatisation. Despite its majority ownership by the government, MTRC is independently managed on commercial principles. It is financially independent and does not rely on any subsidy from the government.

Compared to mature markets where the institutional investor-led companies dominate the corporate horizon, the Hong Kong market remains largely family-based. Studies show that in Asia, family-controlled cross shareholding is common. Family-led firms hold more than 20% of the equity of listed companies in Asia, and more than 60% of the region's listed companies have links to family-owned groups. Offshore registry is common, which makes ownership structure further complicated. For outsiders, understanding the myriad of pyramid structures and cross-shareholdings can prove challenging. Transparency of the ownership structure is therefore considered low.

A report of the Corporate Governance Working Group of the Hong Kong Society of Accountants in December 1995 indicated that *'almost 90 per cent of listed companies have a major shareholder who by himself or with family members owns 25 per cent or more of the share capital'*. These founders/families are highly entrepreneurial and opportunistic in their business strategies but, for the most part, lack the resources and corporate culture to maintain the type of internal corporate control found in other developed markets.

The minimum public float for listed companies in Hong Kong is only 25%. Hong Kong is not unique in this context; this also reflects market norms in other jurisdictions such as the UK and Singapore. In any jurisdiction, this low level of flotation can inhibit the ability of minority of shareholders to exercise their voices. While there are certain market liquidity considerations that speak to the logic of low flotation levels in specific cases, it should also be recognized, that in an environment like that in Hong Kong-- where families and individuals account for a large share of market ownership-- this minimum level can also result in a more limited distribution of share ownership.

Having said that, there are signs of gradual change. In Hong Kong, the make-up of the market's capitalization and ownership structure has evolved significantly over the last fourteen years. As of May 2001, institutional-led corporations accounted for a total market cap share of 26%, a significant increase from the 12% figure recorded in 1987. In contrast, the share of family-led corporations shrank from 37% to 24%. The share of institution-led companies will continue to rise with the introduction of Hong Kong's Mandatory Provident Fund Scheme (which will also further enhance the power of the fund managers in affecting the affairs of the corporations) and the more broad-based IPOs of Mainland Chinese enterprises.

In summary, the predominance of family owned companies in Hong Kong creates concerns about ownership transparency and the influence of dominant shareholders. While family owned companies are fully capable of strong governance practices, this prevailing ownership structure is not as conducive to a robust corporate governance culture, as compared with markets where there is wider institutional ownership.

EASE OF ACCESS TO PUBLIC EXCHANGES

The Main Board of the Stock Exchange of Hong Kong requires issuers to have an operating record of at least three financial years under substantially the same management. The profit for the most recent year may not be less than HK\$20 million, and for the two preceding years, aggregate profits should not be less than HK\$30 million. For new applicants, the expected market capitalisation must be at least HK\$100 million at the time of listing; and the expected market capitalisation of securities held by the public must be at least HK\$50 million. Normally, 25% of any class of listed securities has to be held by the public. The listing process is clearly stated in the *Listing Rules*, and is generally regarded as transparent and closely followed.

The Growth Enterprise Market (GEM), the second Board of Hong Kong serves predominantly small and medium sized companies, and as such has different listing and disclosure requirements—tighter with regard to disclosure levels, more flexible with regard to past operating performance. The GEM’s liquidity is comparable with that of other secondary markets. The United States Security Exchange Commission recognised the GEM as a designated offshore securities market in August 2000. As a result, all GEM-listed shares may generally be resold both in and outside the US without restriction, to US and non-US persons.

It is also worth noting that the *Main Board Listing Rules* are currently being reviewed, and at the same time, amendments to the *GEM Listing Rules* are to be completed. It is the Exchange’s intention that the two be combined into a single set of rules with market specific chapters for the two markets. This will make it easier for market practitioners to understand and apply the rules while maintaining the Main Board and the GEM as separate markets. The increasing integration of the financial markets will also influence the move toward a common standard of best corporate governance practice.

Overall, access to the Exchange is good, given the establishment of two Boards, the clarity of the listing requirements, and the generally adequate market liquidity.

BANKING SYSTEM

Hong Kong is the world's 10th largest international banking center in terms of the volume of external transactions, and the 3rd largest in Asia. As of December 2000, there were 154 licensed banks, 48 restricted licensed banks and 61 deposit-taking companies in Hong Kong (see table below). There were 118 representative offices of

Number of Reported Institutions (Dec 2000)	
Licensed banks	154
Restricted licensed banks	48
Deposit-taking companies	61
Representative offices of foreign banks	118
Total employment (June 2000)	73,850

Sources: Census & Statistics Department

overseas banks from over 30 countries. 79 of the world's top 100 banks also have a presence in Hong Kong. Together these authorized institutions operated a comprehensive network of some 1,555 branches.

Hong Kong’s banking system plays the major fund-raising role in the region serving well beyond Hong Kong's boundaries. The sector operates in more than 25 countries. Local banks in Hong Kong were also among the first to expand into Mainland China.

Banking supervision is carried out by the Hong Kong Monetary Authority (HKMA)¹. The HKMA follows international standards laid out by the Basle Committee in supervising banks. It practices "continuous supervision", through on-site examinations, off-site reviews, prudential meetings, co-operation with external auditors and sharing information with other supervisors. The aim is to identify any problems at an early stage and to ensure compliance with laws and regulations.

Thanks to the overhaul of the prudential framework of the banking sector since the 1980s, the impact of the Asian turmoil on Hong Kong's banking sector has been relatively minor. Although large provisions have been made by most banks to cover the growing volume of non-performing loans, the average capital adequacy ratio remained high at about 17 per cent, more than twice the Basle Committee's recommended minimum of 8 per cent.

In 1999, the HKMA embarked on a three-year reform and further liberalization program. The last interest cap on Hong Kong dollar time deposits has since been removed. The only other remaining cap -- on Hong Kong dollar savings accounts -- was abolished in July 2001. Banks will also be permitted to pay interest on current accounts after the deregulation. In September 1999, the HKMA also relaxed the one-building restriction attached to the licenses of foreign banks. Foreign banks, from that date, were allowed to maintain offices in a maximum of three separate buildings. This has enhanced Hong Kong's reputation as a free and open international financial center.

Banks in Hong Kong do not commonly hold significant equity stakes in industrial companies. They tend to invest only in financial-related companies, such as insurance and finance companies. Financial-industrial groups are not prevalent.

Hong Kong's banking system possesses key elements, which support good governance: the banking sector is mature and sophisticated, cross shareholdings among financial and industrial companies are not common, and banking supervision is adequate and follows international standards.

MARKET DISTORTIONS AND GOVERNMENT PROTECTION

Beyond the standard legal framework, there is minimal government protection of individual companies or sectors. The Hong Kong's government understands very well that business decisions are best left to businessmen and it is not inclined to intervene in or second-guess markets. Essentially, Hong Kong's economy is nurtured by the '*maximum support and minimum intervention*' government policy.

A notable exception occurred in August 1998 during the Asian financial crisis, when the HKMA intervened in the stock and futures markets, arguing that the markets were being manipulated. Although the authorities have not explicitly ruled out the possibility of further intervention if manipulation re-emerges, they have emphasized in public statements that this was a one-time measure taken as a result of exceptional circumstances. Subsequently, details on the government's holdings of shares, as well as the amount spent on each stock, were published, and an independent investment

¹ -Hong Kong Monetary Authority website – <http://www.info.gov.hk/hkma/eng/bank/regulatory>

company was established to manage and dispose of the share holdings in an orderly and transparent manner. The investment company has been licensed by the Securities and Futures Commission (SFC) as an investment adviser and is subject to SFC supervision.

One other area where the government is involved in a significant manner is housing. The government not only supplies home ownership loans, but also develops and sells property, and as a result owns or subsidizes more than half of all the dwellings in the territory.

In general, industries and companies in Hong Kong are well protected from government intervention and market distortions. 'Free Trade, Free Market' has become a part of the spirit of Hong Kong, which is very healthy for the promotion of shareholder interests and good corporate governance.

Informational Infrastructure

The Hong Kong Society of Accountants (HKSA) was incorporated by the *Professional Accountants Ordinance* in 1973 and is the only statutory licensing body of professional accountants in HK SAR. Among others, the HKSA is empowered under the *Ordinance* to formulate accounting and auditing standards. It is a member body of the International Accounting Standards Committee (IASC).

Prior to 1993, the body of Hong Kong's accounting and auditing standards and guidelines was primarily equivalent to U.K. standards. Since 1993, the HKSA has modeled its *Statements of Standard Accounting Practice* (SSAP) on International Accounting Standards (IAS) and its *Statements of Auditing Standards* (SAS) on the International Standards on Auditing (ISA), with the long-term objective of achieving full harmonization with IAS and ISA.

- ***Statements of Standard Accounting Practice (SSAP)*** – The HKSA has completed its work on the development of core standards and has obtained endorsement for these by the International Organization of Securities Commissions. In 2000 alone, the HKSA issued five final SSAPs (closely modeled on the equivalent IAS), nine Exposure Drafts and four other Statements.² Six new standards, based on the equivalent IAS standards, are now effective for accounting periods beginning on or after 1st January 2001:
 - SSAP 26 *Segment Reporting*
 - SSAP 28 *Provisions, Contingent Liabilities and Contingent Assets*
 - SSAP 29 *Intangible Assets*
 - SSAP 30 *Business Combinations*
 - SSAP 31 *Impairment of Assets*
 - SSAP 32 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*

² Hong Kong Society of Accountants, "Report of the Council for 2000", pp 21

The harmonization process is still ongoing. Legacy standards that were promulgated before 1993 and that are not consistent with current IAS are being revised. The following IAS standards have yet to be introduced in Hong Kong:

- IAS 12 *Income Taxes* - Under HK SSAP 12 *Accounting for Deferred Tax*, a deferred taxation provision is only made when it is probable that a liability will crystallise rather than the full provision balance sheet approach as required under IAS12.
-
- IAS 39 *Financial instruments* - HK SSAP 24 *Accounting for Investment Securities* is in line with the 'Accounting for Debt and Equity Securities' under IAS 39, but it does not tackle the more complicated accounting for derivatives and hedging.
- IAS 40 *Investment Property* - In HK, all land is held on leases from the HK government. These are actually operating leases and would not meet the definition of investment properties under IAS 40 although they do under the HK SSAP 13 *Accounting for Investment Properties*.

In certain areas, Hong Kong's accounting standards are more specific than IAS, including on retirement schemes and accounting for investments in securities not held for trading purposes.

The HKSA considers that harmonization with IAS over the treatment of financial derivatives should proceed cautiously in light of the ongoing international debate over the most appropriate treatment.

- ***Statements of Auditing Standards (SAS)*** - HKSA has finalized 22 new *Statements of Auditing Standards (SAS)* that are consistent with the equivalent ISA. In a number of cases, the HKSA standards are more prescriptive than the equivalent ISA. For instance, SAS 600 '*Auditors Reports on Financial Statements*' is based principally on the equivalent UK SAS, which is longer and more exacting than ISA700.

While the *Professional Accountants Ordinance* does not specifically make the HKSA accountable to any public body, in practice the HKSA engages in a broadly based consultative process in its regulatory activities. The Stock Exchange of Hong Kong and the SFC are represented on the HKSA's Financial Accounting Standards Committee and Accounting Standards Advisory Panel. Other market regulators are involved in certain special projects.

The HKSA established a Corporate Governance committee, and in March 2001, published '*Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement*'. In this document, the HKSA recommends that, in addition to a high degree of compliance with mandatory corporate governance rules and regulations, companies should be encouraged to make more voluntary disclosures.

PUBLIC AUDITORS AND REQUIREMENTS FOR INDEPENDENT AUDITS

As of April 2001, the HKSA had a registered membership of 18,512. Among those, 2,952 hold practicing certificates (i.e., Certified Public Accountants), the others are non-practicing members.

All the Big Five international accounting firms have an active presence in Hong Kong. Local firms are relatively small. About 95 per cent of the 1,040 accounting firms registered with the HKSA are firms with one or two partners.

Independent audits are required for companies incorporated in Hong Kong. The *Companies Ordinance* requires that a balance sheet and profit and loss statement, prepared by the company in accordance with approved accounting standards, ‘*be audited by a qualified and registered auditor, whose function is to carry out an audit and present a reliable and independent report on the accounts and financial position of the company*’. This report must state the opinion of the auditor as to the truth and fairness of the financial position as shown in the accounts, and whether any material errors, omissions, or fraud have been detected.

Overall, the auditing practice in Hong Kong is independent and its quality is comparable to international practice.

REQUIRED TIMING OF DISCLOSURE

Statutory reports are required annually for companies incorporated in HKSAR under the *Companies Ordinance* and for overseas companies listed on the SEHK. The reports must contain audited financial statements for the current year, with corresponding amounts for the preceding year, including a balance sheet, profit and loss account, notes and a cash flow statement.

The *Companies Ordinance* requires private companies to lay their accounts at their annual general meetings. Mandatory filing of audited statements with the Registrar of Companies is being considered.

Public companies are required to file their reports with the Registrar of Companies. For companies listed on the Main Board, the requirement is to publish interim results within three months of the period end and the annual results within four months of the financial yearend. Companies listed on the GEM are required to announce their quarterly results within forty-five days of the period end and to announce their annual results and to publish their annual reports within three months of the financial year-end.

Special accounting requirements are in place for regulated entities, such as banks, securities dealers, and insurance companies.

Overall, the required timing of disclosure is comparable to international practice.

EASE OF ACCESS TO INDEPENDENTLY AUDITED FINANCIAL STATEMENTS

Hong Kong incorporated listed companies are required to file the audited financial statements with the Companies Registry for public inspection. The Companies Registry has just announced a \$232 million four-year project to computerize its operation. Public companies' key financial information is also available on the Hong Kong Exchange's web site (www.hkex.com.hk).

In addition to the authoritative channels, there are other resources where investors can access public companies' financial information, thanks primarily to the popularity of the Internet. Below are a few examples of local websites that provide investors with current and historical financial statements:

- **AnnualReport.com.hk** (www.annualreport.com.hk) - The site distributes searchable annual reports, interim reports, quarterly reports and IPO prospectuses of the listed companies in Hong Kong in PDF format.
- **Investor Relations Asia Pacific** (www.irasia.com) - Launched in September 1996, **irasia.com** is the online source of primary investor relation information for Asian Pacific listed companies. The site was rated by TIME Magazine as one of the best sites for "Research to make Investment Decisions". Presently, it profiles over 2,500 listed companies in the region.
- **Electronic Investor Resource Center** - As part of Hong Kong SFC's efforts in Investor Education, eIRC – Electronic Investor Resource Center (www.hkeirc.org) was launched in July 2000 to provide investors round-the-clock access to a one-stop site for education information on investments and regulations, and comprehensive research materials.

Generally speaking, access to independently audited financial statements is good.

COMPARISON BETWEEN THE LOCAL ACCOUNTING STANDARDS AND INTERNATIONAL ACCOUNTING STANDARDS

Basis of Consolidation

With regard to consolidation parameters there is no major difference from IAS. However, with regard to mergers and acquisitions, HK SSAP 30 does take the view that an acquirer can always be identified and does not discuss merger accounting. Although IAS does discuss pooling of interests (merger accounting), SIC 9 makes it clear that only in the very rarest of circumstances would an acquirer not be identified. Consequently, in practice there is no significant difference between the HK SSAP and IAS. In addition, the HK SSAP 27 *Accounting for Group Reconstructions* allows merger accounting for group reconstructions as long as the shareholders' relative rights remain the same before and after the reconstruction. This is not a "full blown" standard on accounting for transactions under common control and was introduced by

the HKSA at the request of the Government when it changed the *HK Companies Ordinance* to allow merger relief.

Operating Data In Addition To Financial Data

A ‘Management Discussion and Analysis’ section is required by *the Listing Rules*, including:

- A description of the significant features of operating performance during the period commenting on segmental information, the environment in which the business operates, material acquisitions and disposals and any special features that have affected the results for the period
- Discussions on prospects of new business, including new products and services and future plans for material investments and their expected sources of financing

In addition, further disclosure of relevant information in the annual report is required if the following circumstances exist:

- The controlling shareholder has pledged its interest in shares to secure debts of the company or other support of obligations of the company
- The company enters into a loan agreement that imposes specific performance obligations on any controlling shareholder and a breach of such obligation will cause a default that is significant
- A breach of the terms of loan agreements by the company

For private companies, there are no mandatory rules to include a ‘Management Discussion and Analysis’ section in their annual reports. There is also nothing in the HK SSAPs that prescribes that accounts or annual reports should include operating data in addition to financial data. While this is not an accounting issue *per se*, this is an important area of disclosure. From Standard & Poor’s experience in reviewing annual reports of Hong Kong companies, it is our view that operating detail often does not meet the highest of international standards.

Financial Position of Subsidiaries Whose Health Is Material To The Interest Of The Company And Individual Shareholders

There is no specific requirement in HK SSAP for separate disclosure.

Segment Data

No difference from IAS.

Methods Of Asset Valuation

HK SSAP 13 *Accounting for Investment Properties*, requires certain investment properties be valued on the open market value basis by persons holding a recognized professional qualification in valuing properties and having recent post-qualification experience in valuing properties in the location and in the category of the properties

concerned. SSAP 17 on *Property, Plant and Equipment* is largely in line with IAS 16 and discusses valuation methods when the revaluation approach is taken. SSAP 24 *Accounting for Investment Securities*, requires FV accounting for investments in debt/equity which are not held to maturity investments.

Definitions Of Revenues, Expenses, Profits And Losses

No difference from IAS.

Cash Flow: Sources And Uses Of Funds

No material difference from IAS.

All Real And Contingent Liabilities

No difference from IAS.

Disclosure Of Transfer Pricing, Hidden Transfers, Subsidies Or Arrears With Related Companies

HK SSAP 20 *Related Party Disclosure* governs the disclosure requirements for related parties transactions. The only difference between SSAP 20 and IAS 24 is that under IAS 24, disclosure of all related party relationships irrespective of whether there have been transactions between related parties is required, while SSAP 20 only requires disclosure where transactions have taken place.

Under the *Listing Rules*, Directors' reports have to disclose the following information in respect of certain connected party transactions:

- The date of the transaction, the parties thereto and a description of their connected relationship
- A brief description of the transaction and the purpose of the transaction
- The total consideration and the terms
- The nature and extent of the interest of the connected person in the transaction



Regulatory Framework

The key regulatory bodies relevant to corporate governance in Hong Kong are:

The Securities and Futures Commission – The SFC (www.hksfc.org.hk) is the statutory regulator of Hong Kong's securities and futures markets. It was established in 1989 under the *Securities and Futures Commission Ordinance*, and is divided into four operating divisions:

- The *Supervision of Markets Division*
- The *Corporate Finance Division*
- The *Intermediaries and Investment Products Division*
- The *Enforcement Division*

The SFC is a leading advocate towards improving corporate governance standards in Hong Kong. “Transparency, Accountability and Corporate Governance” was chosen as the theme of its 2000-2001 Annual Report. In our discussions with the SFC, their mission to underscore the importance of high corporate governance standards was made clear.

Hong Kong Exchanges and Clearing Limited - HKEx (www.hkex.com.hk) is the holding company of the Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited and Hong Kong Securities Clearing Company Limited.

HKEx went public in June 2000 following the integration of the securities and futures market. As a listed company, answerable to its shareholders, HKEx competes vigorously for opportunities in the region and around the world. It is a market-driven business, operating business-driven markets.

As a listed company, HKEx is regulated by the SFC. Under the Memorandum of Understanding between the SFC and the HKEx dated February 2001, except in relation to management of business risk, and the enforcement of their own trading and clearing rules, HKEx, the Exchange Companies and clearing houses are no longer responsible for front-line prudential and conduct regulation of market participants, which is the responsibility of the SFC.

The Hong Kong Monetary Authority - The Hong Kong Monetary Authority (www.hkma.gov.hk) is the government authority in Hong Kong responsible for maintaining monetary and banking stability. Established in 1993, its functions and responsibilities are governed by the *Exchange Fund Ordinance* and the *Banking Ordinance* and it reports to the Financial Secretary.

The Stock Exchange of Hong Kong - The SEHK (www.sehk.com.hk) has the exclusive right, under the *Stock Exchange Unification Ordinance*, to establish, operate and maintain a stock market in Hong Kong. It is also the primary regulator of companies listed on the Main Board of the Stock Exchange and the Growth Enterprise Market, Hong Kong’s second board.

The HK Society of Accountants – Incorporated by the *Professional Accountants Ordinance* in 1973, the Hong Kong Society of Accountants (www.hksa.org.hk) is the only statutory licensing body of accountants in Hong Kong responsible for regulation of the accountancy profession.

RELATIONSHIP BETWEEN THE REGULATORY BODIES

Different regulatory bodies work in co-operation. Over the past few years, the SFC has emphasized its commitment to co-operation and partnership with the exchanges and the intermediaries.

Regulatory responsibilities among various bodies are fairly transparent and clear. There have been a number of memoranda of understanding published to clarify their roles and responsibilities. Unnecessary duplication is minimized. For example, the Memorandum of Understanding between the SFC and the SEHK dated March 2000 focuses on listing related matters. It recognizes the SEHK as the front-line regulatory organization responsible for the day-to-day administration of all listing related matters. The SFC becomes involved in novel, complex or controversial matters or if the exercise of statutory powers, including powers of investigation, is necessary or desirable in a particular case.

Similarly, there is a Memorandum of Understanding between the SFC and the HKMA, which provides in broad terms for the appointment of a coordinator for each institution or financial group in which both the SFC and HKMA have an interest, and the consultation on staff training, issuance of guidelines, and formulation of policy in multiple areas. Regularly scheduled as well as ad hoc meetings are arranged between the SFC and the HKMA. Each party has agreed to inform the other prior to taking any disciplinary or regulatory action in relation to an institution in which both have an interest.

The SFC also works closely with the China Securities Regulatory Commission of Mainland China on market development and listing matters.

In summary, Hong Kong's regulatory bodies are well structured. Their roles and responsibilities are clearly defined. They work with each other in a co-operative manner.

NEW LEGISLATION ON THE REGULATORY AGENDA

New legislation has been put on the agenda reflecting the goal to bring about improving standards of corporate governance. For example:

- The SFC and the HKSA are working together to move to IAS and IOSCO 2000 standards
- The Stock Exchange, working closely with the SFC, is revising its *Listing Rules* to expedite disclosure and access to corporate information and is taking steps to require listed companies to release quarterly reports
- The *Listing Rules* of the Main Board and the GEM are to be brought together, and the revised rules are expected to be released for public consultation in late 2001. The distinct features of each market will be retained, but the changes will simplify the application of the rules

- The SFC is also looking for ways to upgrade the protection of minority shareholders' rights through its Advisory Committee
- The Standing Committee on Company Law Reform (SCCLR) is reviewing and making recommendations on changes in the *Companies Ordinance*. The Government plans to submit a major Companies (Amendment) Bill to the Legislative Council (Legco) within this Legco session

The SCCLR published its overall review of the *Companies Ordinance* in February 2000. Sixty-two recommendations have been categorized into four phases for follow-up actions:

Phase I - Amendments will be made to specific sections of the Ordinance, many of which have a corporate governance dimension. These include:

- Abolishing corporate directors;
- Removing directors by ordinary resolution, notwithstanding the lack of any provisions in the company's constitution;
- Making a director vicariously liable for the acts and omissions of his alternates;
- Extending the statutory provisions to cover in generic terms the provision of financial assistance to directors;
- Extending the statutory definition of shadow directors;
- Reducing the threshold for circulating shareholders' proposals to 2.5 % of the voting rights or 50 shareholders;
- Giving every shareholder a personal right to sue to enforce the terms of a company's Memorandum and Articles of Association; and
- Not requiring court approval for the reduction of a company's capital in certain specified circumstances.

Phase II - Covers corporate governance items requiring further study, which will be undertaken by the SCCLR. These include:

- The appropriate board structure for public companies;
- The appointment of directors;
- A statement of directors duties;
- Self-dealing by directors;
- Empowering the beneficial holders of shares whose legal title is held by the nominees of the Hong Kong Securities Clearing Company Ltd;
- Controlling shareholders' conflicts of interests;
- Reforming the financial disclosure provisions in the 10th Schedule to the *Companies Ordinance*; and
- Development of appropriate accounting standards for small private companies.

Phase III – Includes items requiring further study and not related to corporate governance.

Phase IV - A longer-term project that covers items involving restructuring and rewriting the existing Ordinance. One of the items is to create a separate part of the Ordinance dedicated to shareholders' rights and remedies.

The Financial Secretary announced the *Corporate Governance Review* (CGR) in April 2000, and three sub-committees have been formed:

- The Directors Sub-Committee (DSC) has discussed the roles of executive, non-executive and independent non-executive directors; a statement of directors' duties; self-dealing by directors; and the nomination and election of directors. The DSC will also be considering other issues such as directors entering into joint ventures with a company; a register of directors' interests; directors' remuneration; and the possible development of appropriate training programs and qualifications for directors.
- The Shareholders Sub-Committee (SSC) has considered empowering beneficial shareholders so that they can play a more active role in corporate governance. The SSC will also be considering shareholder remedies, in particular minority shareholder protection; the organization and conduct of company general meetings; the possible development of institutional investors as a force for promoting shareholder democracy and good corporate governance; restraints on controlling shareholders' voting; and improved accessibility to corporate records by shareholders.
- The Corporate Reporting Sub-Committee (CRSC) is liaising with the HKSA regarding the Society's work to harmonize Hong Kong SSAP with IAS; the review of the financial disclosure provisions in the 10th Schedule to the *Companies Ordinance*; and the development of appropriate accounting standards for small private companies. The CRSC will also be considering the categorization of Hong Kong companies for financial reporting purposes; non-financial disclosure by companies; strengthening companies' internal audit functions; the responsibilities, liabilities and independence of external auditors; and the regulatory regime of the accountancy profession.

The three sub-committees' recommendations will be the subject of further public consultation before specific legislative and non-legislative proposals are formulated.

In July 2001, the SCCLR published a consultation paper on its proposals in **Phase I**.

As shown by the above actions taken and plans laid out, Hong Kong's regulatory bodies are taking a proactive approach to the promotion of good corporate governance through various legislative reforms and revisions.

ENFORCEMENT OF THE REGULATIONS

Enforcement of regulations is showing signs of improvement in Hong Kong. For example, in year 2000-2001, the SFC

- Concluded 352 investigations, 237 within 12 months (compared with 198 out of 283 investigations in 1999-2000)
- Successfully prosecuted four cases of market manipulation (three in 1999-2000)

- Referred four cases of suspected insider dealing to the Financial Secretary for hearing by the Insider Dealing Tribunal (one in 1999-2000)
- Successfully prosecuted 38 entities for unregistered activities and breaches of investment and trading ordinances (37 in 1999-2000)
- Concluded 82 disciplinary inquiries and censured 117 registrants or concerned persons (54 inquiries with 83 registrants disciplined in 1999-2000)

For the twelve months ended December 2000, the SEHK also issued 7 Public Censures and 5 Public Statements of Criticism, and enforcement is further strengthened 2001, with 6 Public Censures, 5 Public Statements of Criticism and 2 Public Statements as of September 2001. .

Having said that, it should be noted that there are a number of issues regarding enforcement of regulations that have received criticism. Firstly, the SFC's powers of investigation and regulation enforcement fall short of overseas regulators such as the U.S. Securities and Exchange Commission, whose powers of investigation are protected by the constitution. Currently, the SFC is waiting for the *Securities and Futures Bill* to be approved by the Legislative Council, Hong Kong's de facto parliament. Among other changes, the bill will empower the SFC to conduct fuller probes into companies it suspects of wrongdoing. This will include allowing it to crosscheck transactions with third parties, auditors and bank records.

Secondly, the Stock Exchange, the primary regulator of listed companies, also faces constraints that severely limits its regulatory power. The highest penalty it can impose on a company in breach of the *Listing Rules* is suspension or de-listing. It does not have the power to directly remove a person as director of other listed companies, or investigate suspicious activities, but can stipulate criminal and civil sanctions against persons who have committed offences under the various Securities Ordinances (Disclosure of Interest and Insider Dealing) and Companies Ordinance.

There has also been criticism of the levels of enforcement. Practically, where there are cases of enforcement, the punitive measures are viewed as "affordable".²

In summary, regulatory enforcement is of a reasonable standard but not considered to be on par with other markets that enjoy greater regulatory power and stronger enforcement. Improvements are required if regulation is to match the strongest of regulatory environments globally.

Legal Infrastructure

BACKGROUND

As a former British dependent territory, Hong Kong's legal system is based on English common law. Under the 'One Country, Two Systems' principle, the Hong Kong Special Administrative Region continues to adopt social, economic and political systems distinct from those on the Mainland following the reunification in July 1997. The Basic Law, as the constitutional law of HK SAR, gives a firm protection to this principle. The HK SAR shall continue to uphold the rule of law, maintain an effective

executive-led government, sustain an efficient civil service, practice free enterprise and free trade, follow prudent financial management policies, and keep a simple and predictable tax system with a low tax rate.

PRIMARY LEGISLATION

The primary legislation relevant to companies and which addresses corporate governance issues are:

- The *Companies Ordinance* (Cap 32), originally derived from the *United Kingdom Companies Act 1948*
- The *Securities Ordinance* (Cap 24)
- The *Securities (Insider Dealing) Ordinance* (Cap 395)
- The *Securities (Disclosure of Interests) Ordinance* (Cap 396)
- The Hong Kong *Codes on Takeovers and Mergers and Share Repurchases*

The *Companies Ordinance* provides the basic regulatory infrastructure, which applies to all companies in Hong Kong, both public and private. By the end of 2000, the total number of locally incorporated companies registered under the *Companies Ordinance* was 511,503, showing an increase of almost 68 per cent in ten years. The total number of overseas companies registered under Part XI of the *Companies Ordinance* was 6,093, more than double from 2,828 in 1991. The Company Registry is responsible for the administration and enforcement of the *Companies Ordinance*, and oversees the other related legislation.

Listed companies, though not exempted from the applicable provisions of the *Companies Ordinance*, are obliged to comply with additional requirements imposed upon them by the various securities legislation as well as by administrative rules such as:

- The *Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Ltd.* (the '*Listing Rules*')
- The *Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Ltd.*

As of end 2000, there were 736 companies listed on the Main Board and 54 companies listed on the GEM in Hong Kong. More than half of these are domiciled overseas, mostly in tax havens such as Bermuda and the Cayman Islands. In principle, these companies are governed by the corporate laws of their home jurisdiction instead of the Hong Kong *Companies Ordinance*. Though the common law of these offshore countries is similar to these of Hong Kong, the SEHK has accepted these jurisdictions as the remedies to shareholder and requires companies listed (or to be listed) in Hong Kong to include specific provisions as set out in the *Listing Rules* in their articles. From a legal perspective, SEHK-listed companies from differing jurisdictions have a different level of obligations toward their shareholders. The *Listing Rules* become an important source of authority. Although parity between the laws in different domiciles is not a problem for Hong Kong *per se*, the fact that more than half of the listed companies in Hong Kong are incorporated offshore does make the issue of transparency significant.

LAWS / RULINGS ON CORPORATE GOVERNANCE PRACTICE

Duties And Composition Of The Boards Of Directors

On Appointment of Directors: The *Companies Ordinance* specifies that the minimum number of directors for a company should be two.

On Powers of Directors: The directors may exercise all powers of the company not required by the *Company Ordinance* or the articles to be exercised by the company in general meetings.

On Duties of Directors: The *Listing Rules* re-emphasize directors' duties under common law and require a director of a listed company to fulfill fiduciary duties of skill, care and diligence to a standard at least commensurate with the standards established by Hong Kong law (which is very similar to those in the UK). In particular, a director's duties include the following:

- To act honestly and in good faith in the interest of the company or its assets
- To act for proper purposes
- To be answerable to the company for the application or misapplication of its assets
- To avoid actual and potential conflicts of interest and duties
- To disclose fully and fairly their interest in contracts with the company
- To apply a degree of skill, care and diligence as may be reasonably be expected of people of their knowledge and experience, and holding their position in the company

The Exchange requires directors to be able to demonstrate a standard of competence commensurate with their position within the company and this requirement must be satisfied on a continuing basis. Further, they must undertake that in the performance of their duties as a director they will comply with the *Listing Rules* and ensure to their best endeavour that the company will also comply.

Requirement for Outside Directors

A listed company is required to have a minimum of two independent non-executive directors. Every non-executive director must satisfy the Exchange that he has the character, integrity, independence and experience to fulfil his role effectively.

Certain tests for independence are included in the *Listing Rules* and the *Hong Kong Code on Takeovers & Mergers*. These identify certain personal and professional relationships, any direct or indirect interests in businesses related to the company on whose board the director sits. Each company has a responsibility to interpret these guidelines. Notwithstanding these Listing Rules criteria, it has been argued by local commentators that there are only a limited number of independent directors, as in

many cases it is the controlling shareholders who appoint these directors, which could raise the question as to how many can be considered truly independent..³

In addition, the Hong Kong Institute for Directors published *The Guide For Independent Non-Executive Directors*, which contains the following basic guidelines:

- Act towards the company and the members of the company as a whole at all times with honesty and integrity, and use due care, skill and diligence at all times in the consideration of any courses of action affecting the company;
- Understand the composition of the board and the diverse role they play as non-executive directors;
- Be able to devote a sufficient amount of time to fulfil this role as well as to learn generally about the company, the business, any competitors and the environment in which the company operates; and
- Actively participate in board decisions and help to determine the direction and strategy of the company, as well as supervise the management and act as a soundboard where necessary.

Shareholder Registry And Share Depository

Hong Kong seems to require fairly standard registry requirements, in which all companies have to maintain minimum information on their shareholders, such as their names, addresses, and occupations, an account of the shares held, and other share-specific details.

With the operation of the *Companies (Amendment) Ordinance 1995* in 1997, the register may be kept in English or in Chinese.

A shareholder must be registered in order to be a member of the company or a contributory and to exercise the rights attached to that status under the articles and the *Companies Ordinance*.

The *Central Clearing And Settlement System* (CCASS) was created by Hong Kong Securities Clearing Company Ltd. in 1992, and became the central counter party for all CCASS participants. There is no central depository, but most of the share certificates are immobilized with several large custodians. Share settlement is on a continuous net settlement basis by electronic book entry to participants' stock accounts in CCASS. Transactions between CCASS participants are settled on T+2, the second trading day following the transaction. The company also offers nominee and company registrar services.

Proxy Rights

A member of a company which has a share capital, is entitled to attend and vote at a meeting, whether a general meeting or a class meeting, and is entitled to appoint another person, whether a member or not, as his proxy to attend and vote instead of him. The proxy also has the same right to speak at the meeting as the member who appoints him.

³ David Webb: *Hong Kong's not so Independent Directors*, www.webb-site.com/articles

Voting Procedure

The *Companies Ordinances* has specific rulings on ‘Voting on a show of hands’ and ‘Voting on a poll’. It also states that in the case of an equality of votes, whether on a show of hands or on a poll, the chairman of the meeting is entitled to a second or casting vote.

The *Companies Ordinances* also has separate rulings on:

- Voting on a listed company’s general offer to buy back its shares
- Voting on an unlisted company’s proposed contract to buy back its own shares
- Voting on a private company’s proposal to finance a redemption or buy-back out of capital

Minority Shareholder Rights

Statutory Protection of the Minority Shareholders

Minority shareholders are provided some statutory protection by specific requirements build into the *Companies*. These include, but are not limited to: 1. the right of a minority shareholder to demand that his/her shares be bought out in the case of a successful take-over, 2. the need for court approval in the case of negotiations with creditors as part of restructuring schemes, 3. the need for special resolutions instead of a simple majority vote for actions affecting a company’s capital, 4. the right for dissenting shareholders to direct their grievances to a court, etc.

Rights Of Foreign Creditors And Shareholders

Not specifically defined in the *Companies Ordinance*.

Insider Trading

Insider dealing was formally governed by the *Securities Ordinance*. There was a great deal of criticism of those provisions, especially of the fact that anyone found culpable was not subject to any form of penalty or punishment. Proposals were made on the basis that the sanctions against insider dealing were required to bring Hong Kong’s security market up to international standards. The *Securities (Insider Dealing) Ordinance* became effective on September 1, 1991 and was amended in 1994 and 1995.

The *Securities (Insider Dealing) Ordinance* applies to all companies whose securities are listed on the SEHK irrespective of the company’s place of incorporation. As is the case for many securities markets around the world, the ordinance also prohibits an insider of a company listed in Hong Kong who has knowledge of specific and/or

privileged information about this company (particularly information that could have an impact on the share price) from trading in the securities of that company or any of its subsidiaries or affiliates. An individual is subjective to the *Ordinance* if he was a person connected with the company at any time in the six months prior to the insider dealing.

The *Ordinance* provides the Financial Secretary with the power to require a tribunal to inquire into any apparent insider dealing. In case a person is proven to involved in insider trading, such tribunal can remove such person from all their company positions, and impose monetary sanctions.

The *Ordinance* does not provide any civil remedy in the event of insider dealing.

Reporting And Disclosure

In principal, the Exchange requires a company to keep itself, the members of the company, and other holders of its listed securities informed as soon as is reasonably practicable, of any information relating to the company and its group which:

- Is necessary to enable them and the public to appraise the position of the group;
- Is necessary to avoid the establishment of a false market in its securities; and
- Might be reasonably expected to materially affect market activity in and the price of its securities.

The *Securities (Disclosure of Interests) Ordinance*, which became effective on September 1 1991, requires the disclosure of substantial shareholdings (10 per cent or more) in listed companies and disclosure of all dealings by directors and chief executives in shares or debentures of listed and associated companies.

The rule of law is strong in Hong Kong. The company law review continues as Hong Kong seeks to establish standards that are internationally recognized.

LAW ENFORCEMENT

One of the functions of the Companies Registry (“Registry”) has been enforcing the provisions of the *Companies Ordinance*. The Registry has been active and its prosecution policy was increased to improve the compliance rate for companies filing their annual returns as mandated under the *Ordinance*. This has led directly to an increase in the timely submissions of annual returns by companies. In the financial year ending March 1999, approximately 300 summonses were issued for non-compliance, with obligations under the *Ordinance*.⁴

⁴ Chee-Keong Low (ed), “Financial Markets in Hong Kong” pp 36 (Springer 2000)

EXAMPLES OF JUDICIAL SUCCESS OR FAILURE

The *Ordinance* does not make any specific provisions regarding the powers and duties of the Registrar of Companies. Consequently, the Registrar lacks definitive powers and duties. The Registry reviewed its prosecution policy with the aim of increasing the compliance rate for companies filing their annual returns. Examples of prosecution do show the punitive measures used by the courts to be both inadequate as a punishment and inadequate as a deterrent.⁵

The Standing Committee on Company Law Reform (“SCCLR”) was formed in 1984 to advise the Financial Secretary of Hong Kong on amendments to the Companies Ordinance and other related ordinances. Its most recent consultative paper on company law review was published in July 2000. Its remit was to consider the following areas:

- The predominance of controlling shareholder groups and rights and interests of controlling shareholders;
- The lack of shareholder activism as a natural force for improving corporate governance;
- The domiciling of a significant proportion of listed companies outside Hong Kong,

To review the current statute law, administrative rules and regulations and codes of practice relevant to the directors, boards and shareholders regarding improving genuine accountability, disclosure, transparency and corporate governance standards of companies. Furthermore, improving shareholder democracy and communications. In addition, the SCCLR undertook to review:

- The existing level and nature of information, both financial and non-financial, which all companies registered in Hong Kong need to disclose to their shareholders; and
- The existing processes by which this information is prepared and vetted and approved.

The issue of corporate regulation is to be subject to review of the second phase of the Corporate Governance Review, however, the SCCLR does propose that the SFC would be allowed to conduct civil proceedings on behalf of any public company or individual in the following circumstances:

- In matters arising out of investigation or examination of any regulatory body;
- On request by any person⁶

⁵ Chee-Keong Low (ed), “Financial Markets in Hong Kong” pp 255-259, (Springer 2000),

⁶ “A Consultation Paper on Proposals Made in Phase 1 of the Review”, July 2001, www.info.gov.hk/cr/notice/Rpt_e.htm

Code of Best Practice

The *Code of Best Practice* was introduced in 1993 as an appendix to the *Listing Rules*. The *Code* is aimed to increase the accountability of directors and its guidelines are considered by the Exchange to be the minimum standard that all listed companies should meet to achieve good corporate governance.

Hong Kong's *Code of Best Practice* is short and gives general guidelines only (see Appendix I, *Code of Best Practice*). It covers some essential attributes, such as the importance of having frequent and quality board meetings, and emphasizing the role and power of non-executive directors. In 1998, the establishment of an audit committee was introduced as a voluntary best practice (similar to the UK and Australian approach) for companies listed on the Main Board. For those listed on the GEM, since the *Code of Best Practice* has been incorporated as part of the *GEM Listing Rules*, audit committees are mandatory.

Essentially, for the Main Board, Hong Kong's *Code of Best Practice* remains as a set of voluntary guidelines. The *Listing Rules* expressly provide that the *Code* is not intended to be a set of rules that are to be rigidly adhered to. Instead, companies are encouraged to devise their own code of practice in the interests of the board as a whole.

Under the *Listing Rules*, the Main Board-listed companies may choose not to follow the *Code's* guidelines as long as they disclose reasons for non-compliance in their interim and annual reports. Even in situation where compliance is represented, it is not always possible to establish from the report and accounts whether this is indeed the case.

Given the historical family domination of the corporate landscape and the general lack of culture of minority shareholder activism, it could be contended that Hong Kong's *Code* has not been as effective as it could have been in promoting good corporate governance since its publication. If the intention was to promote the spirit of good corporate governance, then the insertion of a short comment in the annual report, stating that the company complies with the *Code*, certainly does not serve the purpose.

Current Corporate Governance Issues

The development of corporate governance in the UK has influenced the approach to corporate governance in Hong Kong. The continuing development of corporate governance appears to be influenced by the Anglo-American model that relies on market mechanisms to perform necessary 'checks and balances'. A number of issues remain areas of ongoing scrutiny:

- Ownership structure
- Independence (and quality) of non-executive directors
- The relative lack of shareholder activism
- Levels of disclosure
- Perceived weaknesses in the current legal/regulatory system, particularly with regard to enforcement

Firstly, the family concentration in Hong Kong's corporate ownership structure has presented challenges for the minority shareholder. The Anglo-American style requires a high level of stock liquidity so that the market force of a takeover can achieve its role as a mechanism driving the performance of the directors. In Hong Kong, the shareholder structure found in the majority of companies has made the market for corporate control very limited. The minimum public float for a listed company is only 25%, exacerbating the problem.

Secondly, under the Anglo-American model, independent non-executive directors on a board are expected to act as a check on the executive and management of a company and to safeguard the interests of minority shareholders. Although Hong Kong's *Listing Rules* require independent non-executives on the boards, in reality, the independence of these directors is problematic as the supply of high calibre candidates to fulfil the role is inadequate, and their appointment is strongly influenced by the founder or CEO. There is also little evidence or precedent that they challenge the powerful CEOs.

Thirdly, with the exception of a few isolated cases, shareholder activism is not prevalent in the region. The business environment has changed dramatically in the past twenty years and has developed a business culture that is Asian. Institutional shareholders are relatively limited and minority shareholders rarely ask probing questions. Small shareholders back the family rather than the business when investing in a company, and instead of 'voting their shares', they 'vote with their feet'⁹. The ownership structure has obviously contributed to impede the progress of increasing the rights of minority shareholders.

Another feature of the Anglo-American model is adequate and timely disclosure of company information. Currently, information provided in the interim and annual reports only meets the minimum regulatory requirements. There are only cursory references to matters dealing with corporate governance issues and generally it is not possible for an outsider to assess the corporate governance within the company. In comparison, companies in the UK and US volunteer a lot more information. Hong Kong is now undergoing a review of its disclosure standards.

The regulatory system still follows the British model. As discussed in the previous chapters, there are a couple of legal and regulatory areas that need to be reviewed and revised, such as the power of enforcement of the regulatory bodies, the contractual relationship between listed companies and the Stock Exchange, and the need for parity between different laws of domiciles.

Jamie Allen, the Secretary General of the Asian Corporate Governance Association describes the situation in Hong Kong very accurately:

‘... Most governments in Asia have shown little interest in addressing the fundamental contradiction between new corporate governance principles they are espousing and the deeply entrenched ownership structure of Asian companies. In essence, they are trying to graft a system of checks and balances onto an autocratic corporate framework, while leaving real power in the hands of existing owners and ignoring the cultural context in which countries operate...’⁷

Having said that, it should be recognized that in many ways, Hong Kong is unique compared to other Asian countries and Hong Kong’s has good foundations with which to build a strong corporate governance culture. Local entrepreneurs focus on value, which, in many ways, has benefited shareholders, as Hong Kong has not been affected from the Asian syndrome of relationship lending. Hong Kong’s government has recognised the value of good corporate governance as they are taking practical steps to encourage better governance practices. Government agencies are lean and efficient. Regulations are generally well enforced. Hong Kong is consistently rated by international surveys as one of the ‘least-corrupt’ places in Asia.

It is clear that Hong Kong’s authority is committed to enshrine good corporate governance. Since the Asian financial crisis, Hong Kong has demonstrated its commitment to the improvement of corporate governance to regain investor confidence and maintain its status as one of the region’s leading financial centres. Going forward, the real challenge will be to provide the incentives necessary for companies in Hong Kong to embrace the spirit of good governance.

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8. Hong Kong SAR Government information site, <http://www.info.gov.hk/>

APPENDIX I

Appendix 14 of The Listing Rules in Hong Kong

CODE OF BEST PRACTICE

The following guidelines are intended to form the skeleton of a code of best practice to which listed issuers should aim. The following items are not intended to be rules, which are to be rigidly adhered to. All issuers are encouraged to devise their own codes of practice in the interests not only of their independent non-executive directors, but of the board of directors as a whole.

1. Full board meetings shall be held no less frequently than every six months. “Full” board meetings means meetings at which directors are physically present and not “paper” meetings or meetings by circulation.
2. Except in emergencies an agenda and accompanying board papers should be sent in full to all directors at least 2 days before the intended date of a board meeting (or such other period as the board agrees).
3. Except in emergencies adequate notice should be given of a board meeting to give all directors an opportunity to attend.
4. All directors, executive and non-executive, are entitled to have access to board papers and materials. Where queries are raised by non-executive directors, steps must be taken to respond as promptly and fully as possible.
5. Full minutes shall be kept by a duly appointed secretary of the meeting, and such minutes shall be open for inspection at any time in office hours on reasonable notice by any director.
6. The directors' fees and any other reimbursement or emolument payable to an independent non-executive director shall be disclosed in full in the annual report and accounts of the issuer.
7. Non-executive directors should be appointed for a specific term and that term should be disclosed in the annual report and accounts of the issuer.
8. If, in respect of any matter discussed at a board meeting, the independent non-executive directors hold views contrary to those of the executive directors, the minutes should clearly reflect this.
9. Arrangements shall be made in appropriate circumstances to enable the independent non-executive directors of the board, at their request, to seek separate professional advice at the expense of the issuer.
10. Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the issuer and should not accept the appointment if he cannot.
11. If a matter to be considered by the board involves a conflict of interest for a substantial shareholder or a director, a full board meeting should be held and the matter should not be dealt with by circulation or by committee.
12. If an independent non-executive director resigns or is removed from office, the Exchange should be notified of the reasons why.
13. Every director on the board is required to keep abreast of his responsibilities as a director of a listed issuer. Newly appointed board members should receive an appropriate briefing on the issuer's affairs and be provided by the issuer's company secretary with relevant corporate governance materials currently published by the Exchange on an ongoing basis.
14. This board should establish an audit committee with written terms of reference which deal clearly with its authority and duties. Amongst the committee's principal duties should be the review and supervision of the issuer's financial reporting process and internal controls. For further guidance on establishing an audit committee listed issuers may refer to “*A Guide For The Formation Of An Audit Committee*” published by the Hong Kong Society of Accountants in December 1997. Listed issuers may adopt the terms of reference set out in that guide, except that the committee may have a minimum of two members, or they may adopt any other comparable terms of reference for the implementation of audit committees. The committee should be appointed from amongst the non-executive directors and a majority of the non-executive directors should be independent.

APPENDIX II

Doing Business in Hong Kong

Situated at the southeastern tip of China, Hong Kong is ideally positioned at the centre of rapidly growing East Asia. Local companies have established extensive networks of contacts throughout the region and beyond, while Hong Kong's entrepreneurs are noted for their considerable business acumen and ability to 'strike a good deal'.

Hong Kong has an industrious population of 6.8 million with invaluable connections to China. A flexible and well-educated workforce, coupled with entrepreneurial flair, is the bedrock of Hong Kong's productivity and creativity.

Hong Kong is a global service centre. It draws more than 80 per cent of its GDP from the service sector. Services ranging from extensive air transport and shipping to contract manufacturing and software design are easily available and meet international standards. Due to fierce competition, the prices of many services are among the lowest in the world.

Hong Kong is an international corporation base. There were 840 regional headquarters in Hong Kong in 1999. The United States had the largest number of regional headquarters in Hong Kong (205), followed by Japan (114) and the United Kingdom (82). In addition, some 1,650 countries use Hong Kong as a regional office. The major lines of business of the regional headquarters included the wholesale/retail and import/export trades, other business services (e.g. accounting, advertising and legal services), finance and banking, manufacturing and transport and related services.

Hong Kong has a small, efficient government that is well known for its efficiency, transparency and fairness. The government's primary role is to provide the most business-friendly conditions possible. It rarely interferes in the marketplace.

For the past six consecutive years, Hong Kong has been ranked by the Heritage Foundation as the world's freest economy.

Legal system - The Rule of Law

Hong Kong is an ideal place to invest - a free and liberal investment regime, absence of trade barriers, non-discrimination against overseas investors, complete freedom of capital movement, well established rule of law, transparent regulations, low and predictable taxation. Hong Kong is fully committed to the protection of human rights. It is an open and free society. The rights and freedoms in the city are founded on the rule of law, an independent judiciary, a comprehensive system of legal aid, an independent Ombudsman, and a free and active press. The Government adheres to no less than 14 international human rights treaties.

Hong Kong law is based on the British Common Law System. Sitting at the pinnacle of Hong Kong's legal system is its own final appellate court, the Court of Final Appeal (CFA), which was established on July 1, 1997. The CFA is the ultimate arbiter of the development of the common law in Hong Kong.

Free Trade & Free Market

Hong Kong advocates and practices free trade. Its economy is nurtured by a government policy of '*maximum support and minimum intervention*'. Its taxes are very low and simple. There are no hidden "extras" like Medicare and sales taxes and certainly no "province" or "city" taxes.

Hong Kong has an efficient legal system with a minimum of regulation. Hong Kong became a Special Administrative Region of the People's Republic of China on July 1, 1997, after a

century and a half of British administration. The existing economic system will be maintained until at least 2047.

Hong Kong was the world's 9th largest trading economy, in spite of being essentially a large city. In 1999, Hong Kong's port was one of the largest and most efficient in the world in terms of container throughput. Hong Kong's airport was the busiest in the world in terms of international cargo throughput and international passenger. With the new airport on Lantau Island having some four times the capacity of the old airport, Hong Kong has been consolidating its position as a center for trade, transport and transshipment in the region.

Hong Kong is one of the world's leading financial centers - nearly all major international banks have a presence here. Foreign exchange transactions are no problem and there are active capital and asset markets.

Corruption-free & Stable Society

Hong Kong is a very safe city. The crime rate is about the same as Singapore's, much lower than that of London and major cities of the US.

Hong Kong is consistently rated by international surveys as one of the "least-corrupt" places in Asia. In addition, the Independent Commission Against Corruption (ICAC) watches to ensure that government and firms deal fairly and honestly. The Customs and Excise Department takes vigorous enforcement against copyright piracy and trademark counterfeiting, and Hong Kong is leading the fight in the region against pirated goods.

The government is open in its operations and an independent avenue for public appeals and complaints against the government is provided by the Ombudsman who has jurisdiction over practically all Government departments and many major public bodies. He also has the power to initiate investigations against government abuse.

Low & Predictable Taxes

Hong Kong's tax system is the most business-friendly in the world - simple and low. Taxes are levied on three types of income only, - on profits, salaries and property. There is no value-added or sales tax or capital gains tax. Only income sourced in Hong Kong is taxable. Education takes up the largest share of the Government's Budget - over one-fifth in terms of recurrent expenditure.

Source: www.business.gov.hk