

Bills Committee on Mass Transit Railway Bill Corporate Governance

PURPOSE

This paper provides information on the following corporate governance issues raised by members at previous meetings of the Bills Committee :-

- (a) how the board of the privatised corporation i.e. MTR Corporation Limited (MTRCL) will be composed;
- (b) whether an employees' representative will be appointed to the board;
- (c) how the Government will participate in the governance of MTRCL; and
- (d) whether the Government will be treated by the Hong Kong Stock Exchange (HKSE) as a connected person for the purpose of the Hong Kong Stock Exchange Listing Rules (the Listing Rules) and will need to abstain from voting at the General Meeting on issues in which it has an interest.

BACKGROUND

Board of Existing MTRC

2. Established by the Mass Transit Railway Corporation Ordinance (Cap. 270) in 1975, MTRC is a statutory corporation wholly owned by the Government. Cap. 270 provides for the following existing corporate governance framework :-

- (a) a Chairman, appointed by the SAR Chief Executive (SARCE), shall be the chief executive of the Corporation;
- (b) a board shall have no fewer than four nor more than eight members appointed by SARCE;

- (c) the board shall exercise the powers, functions and duties conferred or imposed on the Corporation under Cap. 270; and
- (d) the Corporation shall operate on prudent commercial principles.

Board of MTRCL

3. Following privatisation, the Board of MTRCL will need to be constituted in an appropriate manner in a listed company, taking into account good corporate governance practice for a company with public shareholders. Similar to any other listed companies in Hong Kong, the MTRCL will operate within the legal framework of the Companies Ordinance (Cap. 32) and the Listing Rules.

Board of Directors

Responsibilities

4. The principal responsibilities of the board of MTRCL, like those of the boards of companies in the private sector, include the review and making of policy and strategy of the company, appointment of key management, review of business operations and making of major business decisions. All powers of MTRCL will generally be vested in the board.

Composition Requirements

5. Under Cap. 32, the board of an incorporated company must have a minimum of two directors.

6. Rule 3.10 of the Listing Rules requires every listed company to have at least two independent non-executive directors. The criteria adopted by HKSE in determining the independence of directors are set out in 3.11 of the Listing Rules, which is reproduced in **Annex A**.

Committee of the Board

7. The Code of Best Practice in the Listing Rules (**Annex B**) currently requires the establishment of an Audit Committee which is responsible for reviewing and supervising the financial reporting process and internal audit control.

PROPOSALS

(a) How the board of the privatised corporation i.e. MTR Corporation Limited (MTRCL) will be composed

Chairman of the Board

8. The appointment of a competent Chairman is essential to the efficient working of the Board. Our proposal is for MTRCL's Chairman to be appointed by the Government, as the majority shareholder. This effectively will maintain the status quo.

Composition

9. To facilitate a smooth transition from MTRC to MTRCL and to preserve the efficiency of the present operation of the Corporation, we propose that the Members of the board of MTRC, which presently consists of nine directors including the MTRC Chairman and Chief Executive, academic, government officials and professionals will be invited to serve as directors of MTRCL. This will help strengthen investors' confidence that MTRCL will continue to enjoy the leadership provided by the existing board of MTRC which has contributed to the success of the Corporation and will provide a good balance of independent non-executive directors.

10. Pursuant to Section 8 of the Mass Transit Railway Bill (the Bill), the SARCE has the power to appoint up to three additional directors to the board of MTRCL.

11. We will also give consideration to the appointment of other directors on the Board having regard to the practice of best corporate governance in the private sector.

Committee of the Board

12. Our intention is to establish the Audit Committee in MTRCL according to the Code of Best Practice in the Listing Rules. This committee will be made up of non-executive directors, a majority of which should be independent, whose independent judgment is essential in the exercise of this important function of the board.

(b) Whether an employees representative will be appointed to the board

13. We do not think such an appointment is appropriate or necessary. MTRCL is to be established as a listed company with public shareholders charged to operate on prudent commercial principles. The board will have a legal and contractual duty to consider the interest of the company as a whole and it would not be appropriate to have individual directors to represent specific sectorial interests. In fact, as far as we are aware, there are no listed companies in Hong Kong which has staff representation at the board level.

14. MTRC has made clear that its staff are its primary asset and that its management will continue to consult its staff on important issues affecting them through the existing elected MTR Corporation Staff Consultative Committee.

(c) How the Government will participate in the governance of MTRCL

15. The key areas of Government's participation in MTRCL's corporate governance include :-

(i) *Appointment of additional directors*

Up to three additional directors may be appointed by the SARCE pursuant to Section 8 of the Bill;

(ii) *Appointment of Chairman*

As discussed above, the Government will have the right to appoint the Chairman of the board so long as the Government holds more than 50% of the issued share capital of MTRCL;

(iii) *Voting as the Majority Shareholder*

As the majority shareholder, the Government holds the important power of appointment (by ordinary resolution) of all directors in the general meeting; and

(iv) *Exercise of Special Power under the Bill*

Section 13 of the Bill allows the SARCE to give direction to MTRCL in relation to any matter concerning the franchise if public interest so requires.

Articles of Association

16. Within the parameters of Cap. 32 and the Listing Rules, a company's governance structure is embodied in the company's Articles. The Articles of MTRCL will track the provisions of the standard Articles provided by Table A, Schedule 1 of Cap. 32. A number of modifications will be made to provide for the Government's role in the privatised corporation. Set out below are some differences between the MTRCL's Articles and Table A, Schedule 1 Cap. 32 :-

- (i) the SARCE's right to appoint up to three additional directors pursuant to section 8 of the Bill; and
- (ii) the right of the Government, so long as it is a majority shareholder, to appoint the Chairman.

17. A copy of Table A, Schedule 1 Cap. 32 has been deposited with the Clerk to the Bills Committee for inspection by interested members.

(d) Government's Vote in Connected Transactions

18. Discussions will need to take place between the MTRCL, the Government and the HKSE on the issue of whether new railway projects undertaken by MTRCL constitute connected transactions and, if that is the case, whether the Government, as the controlling shareholder, will be subject to restrictions on voting on such issues at the general meeting of the company. Relating to this issue, it should be noted that in April 1999 the HKSE, after six years of experience in dealing with these matters, amended its Listing Rules governing the listing of H shares by PRC state-owned enterprises and indicated that the Exchange would not normally treat a PRC government body as a connected person of a PRC issuer. At an appropriate time, discussions will take place with HKSE on whether the Government will be treated as a connected person for all purposes. Such discussions are likely to include proposals relating to suitable disclosure requirements for connected

transactions with the Government and will take place nearer the time of any decision to proceed with the listing.

19. The Government expects MTRCL to continue to be driven by market competition and the need to achieve commercial return. As we have made it clear on a number of occasions in this Bills Committee, the Government will not compel the Corporation to take on railway projects which do not yield commercial return. In the event that the Government and the MTRCL agree that the Corporation is to undertake railway projects which are commercially unviable, the Government will provide support to MTRCL. Such support must be separately identified and justified publicly, and can take the form of property development rights, contribution to railway infrastructure, etc. The details of such support will be negotiated in the process of preparing the relevant Project Agreement.

CONCLUSION

20. MTRC has provided outstanding service to the community for the past 25 years and is expected to continue to do so after privatisation. The proposed corporate governance structure is in line with the provision of Cap. 32 and the Code of Best Practice of the Listing Rules. The structure combines Government control with a large degree of autonomy found in most commercial enterprises and should provide a suitable framework for the governance of a public utility to adequately look after the interest of shareholders and the public.

ADVICE SOUGHT

21. Members are requested to note the contents of this paper.

Finance Bureau
December 1999

ANNEX A

RULE 3.11 OF THE LISTING RULES

3.11 In assessing the independence of a non-executive director the Exchange will take account of the following matters:—

- (1) the holding of a shareholding interest in the issuer of not more than 1% 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 person, this will tend to indicate that he is not independent;
- (2) as an indication of independence, the director should normally have no past or present financial or other interest in the business of the issuer or its subsidiaries, (other than a shareholding within the parameters set out in sub-paragraph (1) or an interest as a director or professional adviser) and no past or present connection with any connected person of the issuer other than as a professional adviser, which, in either case, might affect his exercise of independent judgment;
- (3) an independent director would not be expected by the Exchange to have any management function in the group.

Note: The factors set out in rule 3.11 are included for guidance only and are not intended to be exhaustive. The Exchange may take account of other factors relevant to a particular case in assessing independence.

Annex B

Hong Kong Stock Exchange Listing Rules (Appendix 14)

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.