



Recent developments in Corporate Governance in Hong Kong

“... involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance...”

Preamble, OECD Principles of Corporate Governance, 1999

Since the 1997 Asian financial crisis and the spectacular collapses of Enron, Andersen, WorldCom and Parmalat, the unremitting focus of stakeholders on corporate governance, transparency, and accountability continues to shape and define boardroom and corporate activities worldwide.

The pace of corporate governance reform is quickening. Regulators and lawmakers throughout the world, who have previously only been talking about changes, have been forced into a frenzy of activity and Hong Kong has been no different. Even the roles of relevant regulators have been examined and proposed changes made.

There have been numerous recent changes in Hong Kong in relation to corporate governance matters, extending well beyond legislation and non-binding codes. It is not only directors of companies who need to be aware of these recent changes. Rather every employee who acts as an “Officer” of a company must be aware of and comply with the relevant regulatory changes. As Directors and Officers they are liable and potentially subject to legal action in relation to the performance of their duties.

In Hong Kong, the duties and obligations on Directors and Officers are covered primarily by three sets of ordinances and rules:

- the Securities and Futures Ordinance (“SFO”);
- the Companies Ordinance; and
- the Hong Kong Listing Rules.

Of recent legislative changes, the most significant is the introduction of the SFO, which came into force on 1 April 2003. Here, important additions that relate to companies registered in Hong Kong include:

- introducing a new licensing regime which makes insider dealing a criminal offence (a person who commits an offence under the SFO is liable on conviction to a maximum fine of HK\$10 million and 10 years imprisonment);

- introducing detailed provisions on securities misconduct; and
- imposing new disclosure requirements, which are probably more extensive than those in many international markets.

There have also been various changes and proposed changes to the Companies Ordinance concerning issues such as the regulation of foreign companies, prospectus liability and enhancement of shareholders' remedies.

Legislation aside, significant changes have also been made to the Hong Kong Listing Rules, most of which came into force on 31 March 2004. These changes:

- modernise and rationalise the entry requirements for listing applicants;
- modernise and rationalise the continuing requirements of listed companies, particularly with respect to connected transactions and notifiable transactions;
- require qualitative and quantitative disclosure in relation to accounting and other matters;
- provide increased guidance and requirements on directors and their independence; and
- extensively amend the Model Code, which governs when directors may deal in the securities of a listed company.

The following section presents an overview of key changes and issues of which Directors and Officers need to be aware and with which they will need to comply.

Key areas of reform

Disclosure

General obligations

Hong Kong has one of the world's most complicated disclosure regimes and apart from the periodic reporting of financial results the following must be announced:

- any price-sensitive developments which are the subject of a decision (some companies have begun to issue profit warning statements, but this is not yet an established practice);
- the conclusion of notifiable transactions (i.e. issuance of shares for non-cash consideration,

certain acquisitions and disposals of companies, assets and businesses), or any transaction with a connected person;

- where there has been a significant increase in trading volume or price, confirmation of whether there are any price-sensitive developments;
- any material change after relevant circulars have been issued, in which case supplementary disclosure is required; and
- any changes to the directorate or to the constitution of the company.

Disclosure Interests

Hong Kong requires disclosure of interests in shares and short positions as follows:

- Subject to specific exceptions, all interests in issued or unissued shares must be disclosed.
- "Interests in shares" means interests in 5% or more of the voting shares of a listed company. Certain interests - such as family interests, certain trusts interests, controlled company interests and interests of "concert parties" - are aggregated.
- A person who has disclosable interests in shares (i.e. long positions) must also disclose short positions of 1% or more.
- Interests in derivatives must also be disclosed, including any cash-settled derivatives (even though such derivatives do not involve any creation or transfer of voting rights or interest in shares).
- Notifiable interest must be disclosed within three business days to the listed company and The Stock Exchange of Hong Kong (SEHK).

Management structure and the role of directors

Board Structure

There is no limit on the size of the board, although a listed company must have at least three independent directors. There are extensive guidelines on the factors to be taken into account in determining whether a director is independent.

The following persons may not be regarded as independent:

- persons who have any material business relationship with the listed company or its

connected persons (including partners or employees of a firm providing professional services to the listed company);

- persons holding more than 1% of the issued shares of the listed company;
- persons who have acquired securities by way of financial assistance or gift from the listed company or its connected persons;
- persons appointed to the board to protect the interests of a specific person or persons, rather than the interests of the shareholders as a whole.

Accounts and audits

Reporting periods and standards

Hong Kong listed companies are required to perform an annual audit and announce annual audited results.

They are also required to announce their unaudited half-yearly results.

Voting requirements

Most matters presented to shareholders only require a simple majority vote. However, independent shareholders must approve certain matters. Examples include:

- connected transactions, meaning transactions or arrangements between a listed group or any of its directors, chief executive officers (CEOs) or substantial shareholders and their respective associates. "Associates" is widely defined to include all sorts of family interests, related trust interests and controlled company interests (meaning that the board of such companies or more than 30% of the voting rights of such companies are controlled by such persons, their family interests or trust interests);
- any transactions in which a shareholder has a material interest. This may include situations where the interest of that shareholder are different from those of the other shareholders; and
- certain specific types of transactions which may have a significant impact on the company or its shareholders. Examples include reverse takeovers, very substantial acquisitions or disposals, very significant rights issues or open offers, or a delisting or privatisation where the company has no alternative listing.

Other areas of reform

Special circumstances affecting corporate governance

As in other Asian markets, many Hong Kong issuers are family controlled and it is common to have a controlling shareholder or a group of controlling shareholders in a listed company. For this reason, the regulation of connected transactions is of utmost importance in Hong Kong. Indeed, this was one of the focal areas in the recent changes to the Listing Rules.

Another feature is the predominance of the use of foreign incorporated companies. Companies incorporated in Bermuda or the Cayman Islands are often used as listing vehicles, and the SEHK also permits enterprises incorporated in the People's Republic of China (PRC) to be listed. One focus of corporate governance reform in Hong Kong is to apply standards across the board on a uniform basis, irrespective (to the extent possible) of the place of incorporation of such companies.

Right to call meetings and propose resolutions

Shareholders of a Hong Kong company holding not less than 5% of its issued share capital may request that meetings be convened. In relation to foreign companies, domestic law governs the position. The Listing Rules do not give further rights to shareholders or impose obligations on listed companies in this regard.

Nomination and election of directors

Directors of listing companies must rotate every three years.

Enforcement powers

The constitution of a Hong Kong company is a statutory contract between the shareholders and the company. The Companies Ordinance has been recently amended to allow a shareholder directly to enforce provisions contained in the constitutions.

A bill has been issued which, if passed, will significantly enhance shareholders' rights in the following ways:

- Shareholders will be allowed to pursue directly the enforcement of any breach of duties by directors, without obtaining prior court approval;

- They will be granted enlarged statutory inspection rights and a right to obtain an injunction against any contravention of the Companies Ordinance or any breach of fiduciary duties; and
- The Court will be given a more general power to award costs for shareholder actions in respect of corporate injury or unfair prejudice actions

Managing risk

Directors & Officers Insurance (“D&O”) provides financial protection for the Directors and Officers of a company in the event that they are sued in relation to the performance of their duties as a Director or Officer.

This document presents an overview, not an exhaustive list of the regulatory and legal changes that have come to pass in Hong Kong and which impact the individuals who accept positions as Directors and Officers of companies in Hong Kong.

Failure to comply with some or all of the above and to meet those obligations may expose a Company and its Directors and Officers personally, to litigation. Moreover, the potential for actions emanating from shareholders, employees, regulators and clients is now even greater given the increased awareness and expectation of adherence to good Corporate Governance standards. Those who agree to become Directors and Officers (including non-executive positions) will, and should be demanding the protection that properly structured D&O insurance affords.



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