The Directors' Toolkit

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Foreword

"Directors have a more challenging task, that is to ensure that the corporate governance is effectively put in place and that staff at all levels, from the top to the bottom of the company, understand the need for good corporate governance and are involved in the process."

Mr Martin Wheatle

Former Hong Kong Securities and Futures Commission ("SFC") Chairman

All around the developed world a great deal of attention has been paid to corporate governance over the last two decades. Competitive pressures are growing, community expectations are increasing, and the standards required for success are rising. In response, many new techniques have been developed which, if applied appropriately, can be of real practical assistance to individual enterprises and can make a substantial contribution to the health of the economy.

Following its *Consultation Conclusions on Review of the Corporate Governance Code and Related Listing Rules* released in Dec 2021, Hong Kong Exchanges and Clearing ("HKEX") rolled out The rule and code amendment which takes effect from 1 January 2022 to introduce a series of new measures:

– emphasize company's alignment on the purpose, values and strategy with its culture
– strengthen risk management policies
– enhance board independence
– promote board diversity
– enhance communication with shareholders
– shortening the ESG reporting deadline

FOREWORD

There is no single right way in which companies should be governed but there are fundamental principles which will assist all enterprises to survive and succeed. Good corporate governance, with an appropriate balance between conformance and performance, is the only response to the difficult and demanding business environment in which organisations now operate. It is clear that the way boards operate will need to change and that even the purpose of companies may need to be re-evaluated to break away from profit orientation and focus on one that incorporates broader ethics and community needs.

Boards of high-performing organisations usually:

- understand the board's role in governance
- discharge their duties
- ensure accountability to shareholders
- understand stakeholder expectations
- structure an effective board
- effectively use board committees to enhance governance
- build a talented management team
- champion a productive and ethical culture
- make informed decisions
- actively contribute to strategy, and closely monitor strategic effectiveness
- ensure a disciplined approach to risk governance
- receive independent assurance
- actively engage externally on current and emerging issues relevant to their organisation and the political, social and economic environment in which it operates.

In preparing this toolkit, KPMG has not attempted to establish a model or pattern for the optimum composition and conduct of a company board. The way in which a board and its management pursue organisational objectives is influenced by many factors, including:

- the industry or industries in which the company operates
- its stage in the typical corporate life cycle
- its business strategy
- its ownership structure
- the places in which it does business
- the legal and regulatory environments
- economic conditions
- society's expectations of ethical or responsible behaviour and conduct
- its willingness to adapt and respond to a rapidly changing and more digitally connected world
- importantly, the personalities of those who comprise the board and executive.
- the board should be alert to the red flags or risk indicators that may affect the organisation.

For guidance, on the first page of each chapter, we have provided a number of red flags or organisational risk indicators, plus a list of pertinent questions that directors may ask.

This *Directors' Toolkit* is intended to provide the information that boards need in a form that is easily digestible. It is designed primarily for directors of listed public companies and major private entities. Nevertheless, much of its content is relevant to those vested with governance responsibilities for a range of organisations, including small private companies, non-profits, statutory bodies and community-based organisations.

We hope you find this practical guide helpful to improve board performance, and we are looking forward to hearing your feedback.

Board Leadership Centre China

The Role of Boards and Directors

1. Directors' Duties

It is critical to understand these duties, maintain compliance and keep up to date on any relevant changes to legislation.

In this chapter

– Company's constitution
– Companies Ordinance
– HKEX's Listing requirements
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– Insolvent trading
– Continuous disclosure
– Insider trading
– Competing interest of directors
– Record keeping
– Share trading by directors
– Enforcements, penalties and remedies

Questions that company directors should ask

1. Do I have a good working knowledge of the company's constitution, laws, regulations and the HKEX Listing Rules relevant to the company?
2. Do the directors have access to company records, reports from management and updates about material changes to the relevant laws and regulations? Are they provided quality information in a timely manner sufficient to discharge their duties?
3. Has the board adequately considered its responsibilities under the relevant Occupational Health and Safety Ordinance and other legislation relevant to the company and its industry?
4. Does the company secretary monitor compliance with the company's constitution or the Corporate Governance Code?
5. Do I understand the scope and limitations of the directors' and officers' liability insurance policy?
6. Is the board immediately advised of queries received from the HKEX, SFC or other regulators?
7. Is there a system in place for regulatory breaches to be reported to the directors?
8. Am I fully aware of my duties and responsibilities regarding conflicts of interest? Are directors' interests properly disclosed in the financial statements and directors' report?
9. Is there an effective procedure for identifying and disclosing connected party transactions?
10. Does the company have effective monitoring mechanisms in place to ensure that market sensitive information is not leaked to the public before it is provided to the HKEX?
11. Am I fully exercise reasonable care, skill and diligence as a director?
12. Am I fully aware of my responsibilities under continuous disclosure requirements?

Red flags

1. The company's constitution is never, or rarely, referred to in board discussions/documentation.
2. Certain directors are perceived to have conflicts of interest.
3. There is concern that a director has close personal ties with a major supplier or contractor.
4. The directors fail to act in the best interests of the company as a whole (e.g. by having undue regard to the interests of a special interest group or major shareholder).
5. A director lets price sensitive information slip at a social gathering or on social media.
6. Insider trading by an employee is discovered, but no action is taken.
7. The board ignores a solvency problem and does not develop and implement an appropriate plan to restructure the entity and/or to allow it to trade out of its difficulties, or fails to seek further information in relation to the accounts when a reasonable director would do so.
8. There are concerns about certain directors or officers trading in company securities immediately before public announcements.
9. Insufficient time is paid to major decisions/ proposals or the annual financial statements.
10. Directors have difficulty accessing company information in a timely manner.
11. The board does not receive updates on changes to the Occupational Health and Safety Ordinance and other legislation relevant to the company and its industry.
12. No reporting on regulatory compliance and breaches are provided to the directors.

Directors' Duties

Company directors' responsibilities are derived from the company's constitution, case law and statute law and a range of other legislative and regulatory regimes. This includes obligations of maintaining health and safety of employees and consumers, environmental obligations and data privacy requirements. Company directors should also be familiar with the laws, regulations and rules relevant to the entities that they govern.

Whilst this chapter contains an overview of some of the key duties, it is not intended as a comprehensive summation of all company officer and director duties. Boards of directors should always seek legal advice if they are uncertain about their legal position.

Circumstances can arise where directors of a company can be held responsible for breaching certain laws, even when they did not specifically authorise such a breach.

Directors have the power to control the management of a company's property and affairs and, as such, are subject to special duties and responsibilities, including among others: [1]

- duty to act in good faith for the benefit of the company as a whole
- duty to use powers for a proper purpose for the benefit of members as a whole
- duty not to delegate powers except with proper authorisation and duty to exercise independent judgment
- duty to exercise care, skill and diligence
- duty to avoid conflicts between personal interests and interests of the company
- duty not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law
- duty not to gain advantage from use of position as a director
- duty not to make unauthorised use of company's property or information
- duty not to accept personal benefit from third parties conferred because of position as a director
- duty to observe the company's constitution and resolutions
- duty to keep accounting records.

Directors need to be vigilant to ensure that they do not expose themselves to civil or criminal liabilities by failing to properly discharge their duties. In practice, directors should take particular care when:

- making connected party transactions
- considering if they have sufficient information (including independent expert advice) and reviewing that information when making decisions
- a company is at risk of trading while insolvent
- a company is involved in a takeover, either as an offeror or offeree
- a company raises money from shareholders or the general public by issuing shares or other securities

1. Refer to *A Guide on Directors' Duties* (March 2014), Companies Registry

- Individual directors should request further information from the company's management and/or seek independent professional advice or otherwise they will be alleged as breach of his or her directors' duties. [2]

In addition to their individual duties, the key responsibilities of the board include: [3]

- to determine the company's objectives, missions, strategies, policies and business plans and monitor their implementation.
- to set appropriate policies to manage risks in pursuit of the company's strategic objectives.
- to ensure the integrity of the company's accounting, financial reporting and internal control systems and compliance with the relevant laws and standards.
- to appoint key senior executives and oversee succession planning.
- to approve annual budgets and funding decisions
- to ensure timely and accurate disclosure to and communications with stakeholders.

Furthermore, the recent technological and digital innovation, increasing public awareness on environmental and social issues and scrutiny of corporate culture have driven up the investor and regulator expectations for board engagement.

2. *Guidelines for Directors* (4th edition), the Hong Kong Institute of Directors ("HKIoD"), Section 65
3. Refer to *Major Roles and Functions of the Board* (11 March 2016), HKEX Group (https://www.hkexgroup.com/Corporate-Governance/Corporate-Governance-Framework/Corporate-Governance-Practices/Board-of-Directors/Major-roles-and-functions-of-the-Board?sc_lang=en)

Drawing on insights from our conversations with board directors and business leaders, KPMG highlights 8 items that boards should keep in mind as they approach and execute their 2022 agendas: [4]

- Deepen the board's engagement in strategy and envisioning the future.
- Embed ESG, including climate risk and Diversity, Equity and Inclusion (DEI), into risk and strategy discussions.
- Engage proactively with shareholders, activists, and other stakeholders.
- Make talent, human capital management, and CEO succession a priority.
- Approach cybersecurity and data privacy holistically as data governance.
- Reassess the company's crisis prevention and readiness efforts.
- Help set the tone and closely monitor the culture of the organisation.
- Think strategically about talent and diversity in the boardroom.

Under the impact of coronavirus attack, trade war between the United States ("US") and China, and the depressed financial market, the boards need to carefully plan for near-term focus, mid-term agility, and long-term thinking to meet the stakeholders' expectations.

4. Refer to *On the 2022 Board agenda*, KPMG Board Leadership Center

Restrictions on being a director

An individual cannot be a director if he/she:

- is under 18 years old [5]
- is an undischarged bankrupt [6]
- has been convicted for any malpractices, such as a breach of duties as a director, insolvent trading, bribery charges or misappropriate of company's assets.

Memorandum and Article of Association

The power to control the affairs of the company is typically vested in the directors by the company's Memorandum and Article of Association. The power and duties of the directors, proceedings of directors meeting and appointment of a managing director are specified in the "Officer" section of the Article of Association. For companies seeking a listing on the HKEX, the Listing Rules make it mandatory for those companies to adopt the requirements set out in Appendix 3 Article of Association.

The provisions of the Article of Association are a key component of a company's governance framework. Directors should be familiar with the constitution and take the necessary steps to ensure it is understood, complied with, and that it provides the appropriate framework for the operation of the company.

5. Companies Ordinance (Cap. 622), Section 459
6. Companies Ordinance (Cap. 622), Section 480

Terms of reference of the board committees

The Listing Rules and the Corporate Governance Code provide that listed companies must establish various board committees such as an audit committee and remuneration committee, with specific written terms of reference.

HKEX's listing requirements

Companies and directors of companies listed on the HKEX must comply with the **Listing Rules**. The Listing Rules are additional obligations imposed only on listed companies and govern the admission of companies to the HKEX's 'Securities List', the quotation of companies' securities, continuous disclosure obligations, directors' disclosures, suspension of securities from quotation, and the removal of companies from the Securities List.

The Listing Rules are contractually binding between each listed company and the HKEX and are enforceable against listed companies and their associates under the Companies Ordinance. Most notably, the continuous disclosure requirements under the Listing Rules are also enforceable under the Companies Ordinance. Refer to the 'Listing Rules, Interpretation & Guidance' [7] to see the principles upon which they are based.

7. https://en-rules.hkex.com.hk

Comply or Explain Principal

The Corporate Governance Code under the listing rule has set out (a) the mandatory requirements for disclosure in the listed company's Corporate Governance Report; and (b) the principles of good corporate governance, the code provisions on a "comply or explain" basis and certain recommended best practices.

While listed companies are encouraged to adopt the recommended best practices on a voluntary basis, they must state whether they have complied with the code provisions for the relevant accounting period in their annual reports and interim reports. If the company choose to deviate from the code provisions, it has to provide the considered reason and explain how good corporate governance was achieved by means other than strict compliance with the code provision in the interim reports and annual reports. Listed companies are also required to include a Corporate Governance Report in their annual reports.

Non-listed entities

Non-listed entities are not subject to the Listing Rules, however, the expectations and requirements of the Companies Ordinance still apply.

Many organisations choose to adopt the corporate governance guidance developed by the HKEX as a means of ensuring that they align with better practice.

The Companies Ordinance is applicable to any company formed in Hong Kong, including the registered charities (non-profit) organisations.

No specific accounting or financial reporting requirements is imposed on charitable organisations. However, statutory accounts should be prepared for tax purpose. Failure to provide financial report within the specified time can result in the withdrawal of the organisation's charitable status. Refer to chapter titled *Non-Profit Organisations* for more information.

Government entities are required to meet the statutory financial reporting requirements under the Company Ordinance. [8]

Key duties and responsibilities

Whether a director of a listed, private, non-profit or government entity, a director's key duties are his/her fiduciary duties, whereby directors are expected **to exercise reasonable care, skill and diligence** [9] **and in good faith, to exercise power for a proper purpose and avoid conflicts of interest**. In addition, the key statutory duties under the Companies Ordinance are that directors must act with care and diligence and in good faith, in the best interests of the corporation and for a proper purpose, and not use position or information obtained through their position to gain an advantage for themselves or others, or cause detriment to the company. When the individual director breaches his/her fiduciary duties to the company,

8. Companies Ordinance (Cap. 622), Section 379
9. Companies Ordinance (Cap. 622), Section 465

a member or members of the company may commence civil proceedings against the concerned director for the misconduct.[10]

The Companies Ordinance provides that a director's duty is owed to 'the company', and the courts have typically characterised the company as being the sum of the shareholders. Whilst directors' duties are narrowly defined in this sense, there is a growing public expectation that directors should play an active role in "exercise duty of care, skill and diligence" by taking account of the interests of broader stakeholder groups.[11]

The commentary of the *A Guide on Better Corporate Governance Disclosure* (February 2014) by the Hong Kong Institute of Certified Public Accountants ("HKICPA")[12] states that "A strong disclosure regime is a pivotal feature of market-based monitoring of corporate conduct and is central to the ability of shareholders to exercise their voting rights effectively. Experience in countries with large and active equity markets shows that disclosure can also be a powerful tool for influencing the behaviour of companies and for protecting investors. A strong disclosure regime can help to attract capital and maintain confidence in capital markets. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management and make informed decisions about the valuation, ownership and voting of shares. Insufficient or unclear information may hamper the ability of markets to function, may increase the cost of capital and result in a poor allocation of resources."

However, any decisions must ultimately be in the best interests of the company's shareholders collectively for directors to discharge their duties under the Companies Ordinance (as set out below).

The new Companies Ordinance does not go down the route of comprehensive codification of directors' duties, but merely codifies one aspect by writing into statute the general duty of care, skill and diligence.[13] The Companies Ordinance outlines the duties and liabilities of directors and other "officers" of a company. The duties apply not only to validly appointed directors (including alternate directors), but also to 'de facto directors' and 'shadow directors'.[14]

Acting in good faith

Directors and other officers of a company are under a common law and fiduciary duty to act in good faith and in the best interests of the company as a whole and for a proper purpose. This duty recognises that a director's primary responsibility is to the company and that this responsibility must ordinarily take precedence over the

10. Companies Ordinance (Cap. 622), Section 732
11. Refer to *A Guide on Directors' Duties* (March 2014), Companies Registry, "The general principles of directors' duties"
12. https://www.hkicpa.org.hk/en/About-us/Advocacy-and-representation/Best-practice-guidance/Publications/Improving-CG-disclose-practices
13. Refer to *Coping with the New Companies Ordinance: Tools to Perform and Shields to Protect*, HKIoD
14. Companies Ordinance (Cap. 622), Section 3, 461

personal interests of the director or the interests of a third party. The duty to act in good faith is a broad duty that requires directors to:

– exercise their powers only for proper corporate purposes
– avoid actual, potential and perceived conflicts of interest
– account to the company for business opportunities that arise.

Use of position and information

Directors and other officers and employees of a company must not improperly use their position or information they receive to gain an advantage for themselves or someone else, or to cause a detriment to the company.

This duty would, for example, prohibit a director from obtaining a personal benefit through the misuse of the company's client or supplier list.

An offence is committed under both statute and common law if it can be shown that the conduct was undertaken with the intention of gaining an advantage. It is not necessary to establish that the advantage was actually obtained.

Duty of care, skill and diligence

The Companies Ordinance codifies director's duties to exercise reasonable care, skill and diligence, which were found mainly in common law. It provides that a director must exercise reasonable care, skill and diligence that would be exercised by a reasonably diligent person with general knowledge, skill and experience:

– that may reasonably be expected of a person carrying out the functions of that particular director; and
– that the director has. [15]

Existing civil consequences of breach of duties under common law continue to apply. However, other fiduciary duties of directors remain uncodified and will continue to be governed by common law rules and equitable principles.

Directors and other officers must exercise their duties with the degree of care and diligence that a reasonable person would exercise if they were a director or officer in the circumstances of the company and occupied the same responsibilities within the company as the director.[16] Matters to consider include the director's position and responsibilities within the company, the company's circumstances and any special expertise of the director.

Business judgment rule

Common law courts have all recognised the business judgment rule, and have integrated it into their formulation of the standard of care that governs directors' conduct.

15. Companies Ordinance (Cap. 622), Section 465
16. Refer to *Regal (Hastings) Ltd v Gulliver (1942)*

A director who makes a 'business judgment' is taken to satisfy their duty of care and diligence in respect of the judgment if they:

– make the 'business judgment' in good faith and for a proper purpose (a 'business judgment' being any decision to take or not take action in respect of a matter relevant to the operations of the corporation)
– do not have a material personal interest in the subject matter of the judgment
– inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate
– rationally believe that the judgment is in the best interests of the company.

The business judgment rule does not protect a cavalier attitude to business risk. Directors are expected to make informed business judgments and they must have a rational belief that their decisions are in the best interests of the company. The director's belief that the judgment is in the best interests of the company is a rational one, unless the belief is one that no reasonable person in their position would hold. This means that directors should exercise their powers and discharge their duties with the degree of care and diligence expected of any reasonable person in their position.

Directors making a 'business judgment' are regarded as having discharged their duty of care and diligence under the Companies Ordinance and their equivalent duties at common law or in equity (including the duty of care that arises under the common law principles governing the liability for negligence). The business judgment rule does not apply to defend statutory duties imposed under the Companies Ordinance.

Courts do not, in general, second-guess the business judgment of directors. However, this statutory codification emphasises that directors are supposed to make business judgments and that the legal test is for these to be made rationally and on an informed basis.

Other legal obligations

Company directors are also subject to a range of legal obligations, including those under various local and global tax and revenue laws, workers' compensation laws, consumer protection laws, equal opportunity laws, sexual harassment laws, environmental laws and industrial agreements. Directors can be held personally liable under many of these laws and should seek legal advice if unsure of their obligations.

More recent legislation and bills that will potentially impact directors' responsibilities include the introduction of the General Data Protection Regulation (EU) 2016/679 ("GDPR') requirements on 25 May 2018. An example of state statute is the California Consumer Privacy Act ("CCPA") which intended to enhance privacy rights and consumer protection for residents of California, United States, and became effective on 1 January 2020.

Directors' indemnities and insurance

Directors must understand the extent of their potential personal liabilities, and the extent to which they can be indemnified for these liabilities through indemnities granted by the company and the provision of directors' and officers' liability insurance.

Under the Companies Ordinance, a company is prohibited from indemnifying its directors or director of its associated companies against any liability that would otherwise attach to the director in connection with any negligence, default, breach of duty or trust in relation to the company or associated company.

Such indemnities against liability incurred by the director to third parties is permitted as long as such indemnities are not in connection with any negligence, default and breach of duty or trust in relation to the company for: [17]

– criminal penalties/penalties imposed by regulatory bodies
– defending costs in criminal proceedings in which the director is convicted
– defending costs in successful civil actions brought by the company/associated companies or derivative actions brought by the shareholders on behalf of the company/associated company
– costs of the director's unsuccessful applications for relief for misconduct/in proceedings for misconduct.

17. Companies Ordinance (Cap. 622), Section 469(2)

Insurance for the Directors

Though a company is not permitted to exempt or indemnify its directors against certain liabilities as mentioned above, it could take out insurance for its directors or directors of its associated companies against such liabilities (except fraud) and the directors' legal costs in defending any civil and criminal proceedings taken against them (including fraud) in relation to the company or its associated companies.

In fact, for listed companies, the Listing Rules expressly provide that a listed company should arrange appropriate insurance cover in respect of legal actions against its directors. [18]

Although the indemnity and insurance provisions under the Companies (Model Articles) Notice (Cap. 622H) ("Model Articles") allow indemnification of a director and empower the directors to purchase and maintain, at the expenses of the company, insurance for a director of the company or a director of the associated company, the company is not obliged to offer the same to the directors. Thus, a director should be minded to bargain for equivalent express terms in his service contract with the company in order to better protect his interest.

A company is prohibited from obtaining insurance to cover officers (including directors) against liabilities arising out of a wilful breach of duty or a contravention of the duties of officers.

18. Corporate Governance Code, Part 2, Section C.1.8

Conflict and disclosure of interests

Conflicts of interest

A director must not take personal advantage of the company's opportunities and allow their personal interests to conflict with those of the company nor misapply the company's assets. The court expects a very high standard of honesty from all fiduciaries and will apply very stringent tests as to what constitutes impropriety, personal advantage or misapplication. This aspect of a director's fiduciary duty demands a more detailed explanation.

A director should avoid being in a position where other interests or duties conflict with their duty to the company. Conflicts of interest can arise in several ways including:

– director contracts with the company (e.g. for the supply of services)
– related party loans, guarantees and other securities
– profiting from a business opportunity that belongs to the company.

Sometimes a conflict is unavoidable. In such a case, the directors are obliged to disclose their conflict of interest or duty and take appropriate action to avoid any adverse consequences.

Directors should tread cautiously when considering an actual, potential or perceived conflict of interest. Any actual or potential conflicts of interest are best dealt with by way of full disclosure to the board – this is a legal and ethical imperative.

Moreover, company stakeholders and the media can be highly critical of director conduct that can be perceived as self-serving. The reputations of both individual directors and their companies can suffer dramatically.

Some instances in which there are perceptions that directors and managers have been too closely involved in private equity bids for their companies have attracted criticism. Directors need to exercise caution where the potential for personal gain is, or could be seen to be, in conflict with the best interests of the company and its shareholders.

Material personal interests

Section 536 of the Companies Ordinance stipulates that director must declare material interests. Director has a fiduciary duty to avoid conflicts between his personal interests and interests of the company. The Companies Ordinance requires that if a director of a company has a material interest in a transaction, arrangement or contract, or a proposed transaction, arrangement or contract, with the company that is significant in relation to the company's business, the director must declare the nature and extent of his interest to the other directors.[19]

Part 11 of the Companies Ordinance contains provisions relating to fair dealing by directors, particularly in situations in which a director is perceived to have a conflict of interest. It governs transactions involving directors or their connected entities which require members' approval (namely loans and similar transactions, payments for loss of office and directors'

19. Refer to *Corporate governance and directors' duties in Hong Kong: overview*, Thomson Reuters Practical Law (https://uk.practicallaw.thomsonreuters.com/7-506-8920?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1)

long-term employment), and covers disclosure by directors of material interests in transactions, arrangements or contracts.

The Model Articles also provide that a director who is appointed as an alternate by another director and who does not have a material interest, can still vote and be counted as part of the quorum for that director. For listed companies, the Listing Rules require that any director who has a material interest in a transaction must not be counted in the quorum of, and must not vote on the related resolution at, the relevant board meeting.[20]

However, the other directors may pass a resolution which identifies the nature and extent of that director's interest and its relation to the affairs of the company, and permit the director to vote, notwithstanding the interest. This approval must be recorded in the minutes of the meeting.

Depending on the extent of the conflict of interest, disclosure and abstaining from voting may not fully discharge a director's duty. There could be circumstances where a director needs to take further actions to protect the company's interests. For example, a director who has not yet made a formal notification in respect of a conflict could instruct the company secretary to withhold relevant information, such as board papers pertaining to the conflict.

In extreme cases, a director's resignation may be the only effective means of avoiding a serious conflict of interest.

Many conflict of interest problems can be avoided if boards regularly discuss conflict of interest issues, and where individual directors are encouraged to bring any possible conflicts to the board table so they can be fully and frankly discussed.

Connected party transactions

Hong Kong has its fair share of concentrated ownership companies, including family and state-owned companies. Chapter 14A of the Main Board Listing Rules (or Chapter 20 of the GEM Listing Rules) applies to connected party transactions. Connected party transactions involving public companies will continue to be one of the SFC's focus areas for investigation.[21] Restrictions on related party transactions apply to a wide range of entities, including public companies, or entities controlled by a public company, and there are significant procedural steps involved in managing such transactions, which are designed to protect shareholders' interests. For the purposes of the Companies Ordinance, a 'connected party transaction' is any transaction through which a public company or controlled entity provides a financial benefit to a 'connected party' (which includes directors, their spouses, parents and children), and which by their nature raise a risk of a conflict of interest.[22]

Connected transactions and continuing connected transactions must be approved by the issuer's independent shareholders. Voting on the resolution approving the connected transaction must be by way of poll. Any shareholder with a material interest in the transaction(s) must abstain from voting.[23]

20. Chapter 13 of the Main Board Listing Rules, Rule 13.10A and Chapter 17 of the GEM Listing Rules, Rule 17.11A

21. Refer to *Hong Kong Regulatory Update - January 2020*, JD Supra (https://www.jdsupra.com/legalnews/hong-kong-regulatory-update-january-2020-61131/)
22. Chapter 14A of the Main Board Listing Rules, Rule 14A.24 and Chapter 20 of the GEM Listing Rules, Rule 20.22 for definition of 'connected party' and 'connected party transactions'
23. Chapter 14A of the Main Board Listing Rules, Rules14A.36, 14A.70(12) and Chapter 20 of the GEM Listing Rules, Rules 20.34, 20.68(12)

In the case of continuing connected transactions, the agreement governing the transaction must be on normal commercial terms and must be for a fixed period. It must not exceed 3 years except in special circumstances where the nature of the transaction requires a longer period. In this case, the issuer must appoint an independent financial adviser to explain why the agreement requires a longer period and that it is normal business practice for agreements of this type to be of a longer duration.[24] The reporting requirements must be followed for each subsequent financial year during which the listed issuer undertakes the continuing connected transaction.

The listed issuer must set a maximum aggregate annual cap expressed in monetary terms, the basis of which must be disclosed. The annual cap must be determined by reference to previous transactions and figures in the group's published information or be based on reasonable assumptions if no previous transaction exists. The annual cap must be approved by shareholders if the continuing connected transaction requires shareholder approval.[25] Each year, the listed issuer's INEDs must review the continuing connected transactions and confirm in the annual report and accounts. The listed issuer must notify the HKEX and the annual report and accounts must include the details of the transactions.[26]

Accounting standards have a broader definition of 'related party' and require disclosure of related party transactions. Some of these related party disclosures are now required to be disclosed in the remuneration report for listed companies.[27]

Safeguards against connected persons taking advantage of their positions include:

- shareholders are informed
- independent directors and independent financial adviser opine on significant transactions
- independent shareholders can vote on significant transactions.

Insolvent trading

Directors also have a positive duty to ensure that the company does not trade while it is insolvent. Directors who permit a company to incur a debt, where there are reasonable grounds for suspecting that the company is already insolvent or that incurring the debt will cause insolvency, may contravene the solvency test in Section 205 of the Companies Ordinance. In certain circumstances, directors may be held personally liable for the debts incurred if the company trades while being insolvent. A company will be deemed to be insolvent if it is not able to pay its debts as and when they become due and payable.[28]

Some practical implications for directors

Developing and undertaking a course of action to achieve a better outcome is no mean feat. In examining a selected course of action directors should have regard as to whether:

24. Chapter 14A of the Main Board Listing Rules, Rule 14A.52, and Chapter 20 of GEM Listing Rules, Rule 20.50
25. Chapter 14A of the Main Board Listing Rules, Rule 14A.53, and Chapter 20 of GEM Listing Rules, Rules 20.51
26. Chapter 14A of the Main Board Listing Rules, Rules 14A.35, 14A.68, 14A.71 and Chapter 20 of GEM Listing Rules, Rules 20.33, 20.66, 20.69
27. Refer to the Hong Kong Accounting Standard ("HKAS") 24 (Revised): Related Party Disclosures, HKICPA
28. Companies Ordinance (Cap 622), Section 207.

- appropriate steps are being taken to ensure a company is keeping appropriate financial records consistent with the size and nature of the company, and to prevent the officers or employees of the company from engaging in misconduct that could limit the entity's ability to pay its debts
- they are always keeping themselves properly informed of the company's financial position
- they are developing or implementing a plan to restructure the company to improve its financial position
- an appropriate level and extent of advice is being sought from an appropriately qualified professional, and whether sufficient information has been provided to the professional to facilitate the giving of sound advice.
- it should be noted that regard may be had to the above factors in formal proceedings as part of the assessment of whether a course of action was 'reasonably likely' to result in a better outcome for the company.

Ultimately recognising the early signs of distress and taking early action remains the best way for directors to improve their chances of achieving a better outcome for the company and its stakeholders.

Insolvent trading 'red flags'

Directors should constantly be on the lookout for signals that may suggest their company's financial reporting is misleading or disguising a serious deterioration in its financial stability. An understanding of the company's financial position at the time of sign-off of the yearly financial reports is insufficient. Insolvent trading 'red flags' that raise concerns for directors include:

- irregular financial reporting
- lack of management focus on key ratios
- insufficient and immature liquidity analysis of the company's debt profile
- lack of budgets or in-depth analysis of failure to meet budgets.

Directors' responsibilities during insolvency

Potential personal liability will depend on the impact of the civil or criminal liability on the company. Directors must take prompt action to reduce exposure to potential claims.

Insolvency, or the threat of insolvency, requires directors to act in the interest of creditors. It is a situation in which directors must subordinate the interests of shareholders to those of the company's creditors. In this context, directors should note that the company must not pay a dividend unless:

- the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend
- the payment of the dividend is fair and reasonable to the company's shareholders as a whole
- does not materially prejudice the company's ability to pay its creditors.

The issue of insolvent trading is accentuated as corporate structures become more complex and parent companies become responsible for the affairs of numerous 'controlled entities'. From a Companies Ordinance perspective, the concept of a controlled entity is not confined to a wholly owned subsidiary. A company can be said to control another if it has the capacity to dominate the decision-making of the other entity, or to impose its interests on the other entity. Boards should seek professional advice if there is any doubt as to whether an entity is a 'controlled entity'.[29]

Continuous disclosure

The Listing Rules and the Securities and Futures Ordinance (Cap. 571) ("SFO") impose duties on the officers and employees of listed and unlisted disclosing entities to make immediate disclosures to markets about inside information.[30]

The board has general oversight of an entity's disclosure obligations. The board will often delegate its powers to a disclosure committee or other senior executives within the organisation for the day-to-day management of disclosure issues. However, the board cannot delegate its responsibility for disclosure in a number of circumstances, for example, financial reporting. The SFC suggests that it may be useful to include a continuous disclosure confirmation as the final item of business on listed entity board agendas and to appoint a disclosure officer who can report to the board on continuous disclosure. Consideration of disclosure issues should form part of the board and executive considerations, and should be part of team discussions and culture within an organisation.[31]

29. Companies Ordinance (Cap. 622), Section 492
30. Securities and Futures Ordinance (Cap. 571), Section 307B
31. Refer to *Guidelines on Disclosure of Inside Information* (June 2012), SFC

The provisions under Part XIVA under the SFO impose a general obligation of disclosure of price sensitive, or "inside" information by listed corporations.

This is designed to ensure that the market is fully informed at all times and that all investors have access to material information.

Sustainable investment indices rely either wholly or in part on the public disclosure of relevant information by listed entities. It is widely recognised that there are significant financial and reputational benefits to companies whose practices are recognised through favourable ratings from such indices. Those ratings can be significantly enhanced by good governance practices in connection with continuous and periodic disclosure or, conversely, damaged by poor practices.

Share price and media monitoring

The HKEX strongly encourages an entity that is relying on the exemptions to disclosure about a market sensitive transaction it is negotiating, or that otherwise chooses not to request a trading halt or voluntary suspension in advance of its market sensitive announcement, to monitor "blogs, chat-sites and other social media that regularly post comments about the entity" for any signs the information has been leaked.

Monitoring the share price of an entity is necessary to ensure that any suspected leaks of confidential information can be quickly identified and dealt with. Monitoring media, including social media, is also useful in identifying whether the market may be operating on the basis of false information. Reporting services are available to assist with collating media reports.

Consequences of non-compliance

Where an entity has contravened the continuous disclosure obligations, the SFC can institute criminal proceedings or civil penalty proceedings, or take administrative action, such as issuing infringement notices or accepting enforceable undertakings. Individuals (including company officers and employees) involved in an entity's contravention of the continuous disclosure provisions will also have contravened the inside information disclosure provisions.

Competing interests of directors

The HKEX Listing Rules [32] imposes obligations on the directors of listed entities for making disclosures to market regarding the competing interest of directors.

Where any of the directors of the listed entity is interested in any business apart from the entity business, which competes or is likely to compete, either directly or indirectly, the directors, including any director appointed after listing, must prominently disclose details of such interest in the entity's annual report. The directors must also prominently disclose in the entity's annual reports any change in details previously so disclosed in the entity's listing document or annual report.

In the annual report, the director must disclose the description of the competing business and its management, to enable investors to assess the nature, scope and size of such business, with an explanation as to how such business may compete with the entity's business. The director must also disclose facts that the entity is capable of carrying on business independently of, and at arms length from the competing business.

32. Chapter 8 of the Main Board Listing Rules, Rule 8.10(1)(a), 8.10(2)(b)(c)

Insider trading

Under the SFO [33], it is an offence if a person with 'inside information' applies for, acquires or disposes of securities, or enters into an agreement to do any of those things. A person with inside information is also prohibited from procuring another party to do any of those things.

The purpose of the insider trading regime is to ensure that the securities market operates freely and fairly with all participants having equal access to relevant information so that no party has an unfair advantage over another. Refer to the 'Share trading by directors' section of this chapter for further information.

Importantly, an 'insider' can be a natural person or a corporation, and need not be directly associated with the company. The Companies Ordinance prohibits any person in possession of inside information from:

- dealing – applying for, acquiring or disposing of the relevant financial products or entering into an agreement to do any of these things (trade)
- procuring – enabling another person to trade in those financial products
- tipping – communicating the information, or causing the information to be communicated, to another person who is likely to trade in those financial products, or procure someone else to so trade.

The SFO also makes a number of activities based on the use of inside information offences which may lead to penalties being imposed by the Insider Dealing Tribunal.

33. Securities and Futures Ordinance (Cap. 571), Section 307G

Briefly, certain persons (being companies, partnerships or individuals including employees, whether directors or not), must not deal on their own account on a recognised stock exchange, or off-market, in securities of a company if, by virtue of their connection with the company, they have confidential, unpublished price sensitive information relating to those securities. The prohibition covers persons who are connected with the company in question, and all persons who have knowingly obtained, directly or indirectly, information from such individuals. If an offence is committed by a company with the consent or by the neglect of its officers, both the officers and the company are guilty of the offence.

Insider dealing is not the only securities related offence which is provided for under the SFO. The SFO regards as offences several types of market misconduct, namely: insider dealing; false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transactions, or stock market manipulation. The possible penalties for such offences include varying degrees of fitness and imprisonment.

By virtue of their roles, directors and officers of companies will be privy to inside information and should, therefore, take particular care to ensure they observe the prohibition against insider trading in the SFO.

Insider trading is a serious offence attracting substantial fines and potential imprisonment. Civil liability may also attach to the offence.

Examples of insider trading offences

AcrossAsia Limited

AcrossAsia Limited ("AAL") is an investment holding company listed in Hong Kong. Mr. Cheok is its Chairman and Mr. Ang is its Chief Executive Officer ("CEO").

A winding-up petition was presented against AAL by PT First Media Tbk in Indonesia on 20 December 2012. The petition sought a temporary freezing order on AAL's debts in order for a composition plan to be drawn up, and for an Indonesian judge and administrators to be appointed to manage AAL's assets.

Mr. Cheok and Mr. Ang and other officers of AAL received the English translation of the court documents on 4 Jan 2013. Petition was granted on 15 Jan 2013. However, no announcement was made until 17 Jan 2013. On 22 July 2015, the SFC commenced proceedings in the Market Misconduct Tribunal ("MMT") against AAL, its chairman and its CEO for non-disclosure of inside information under the SFO.

The MMT found that:

- AAL failed to disclose inside information as soon as reasonably practicable as required under section 307B(1) of the SFO
- Mr. Cheok and Mr. Ang breached the disclosure requirement under section 307G of the SFO.

The MMT fined AAL $600,000, Mr. Cheok $800,000, and Mr. Ang $600,000.

PME Group Limited

In August 2013, the SFC prosecuted PME Group Limited ("PME"), a Hong Kong-listed company, in relation to the allegations that PME had made false or misleading stock exchange announcements, in contravention of Section 384 of the SFO.

It was alleged that:

- in 2008, PME made three announcements respectively in response to the inquiries made by the Stock Exchange in the light of the substantial movement of the share price of PME.
- in each announcement, PME stated that it knew of no negotiations or agreements which were disclosable to the market nor were its directors aware of any price sensitive matter.

However, it was later uncovered that PME was at that time taking steps to acquire 50% of another Hong Kong-listed company, with a market value of about $145 million. The SFC argued that PME ought to have disclosed the transaction in the announcements, and its failure to do so constituted a breach of Section 384 herein.

SFC also prosecuted PME's director, Ms. Ivy Chan Shui Sheung, for her alleged involvement in the offences by PME, pursuant to Section 390 of the SFO.

Record keeping

The Companies Ordinance also requires that directors are personally responsible for preparing and maintaining key documents and reports. A company's accounts must normally comprise a profit and loss account, balance sheet, an auditors' report, a directors' report and any notes required to explain the accounts. In addition, where a company is listed, it must comply with the financial disclosure requirements set out in the HKEX Listing Rules, which also include:

- directors' emoluments on a named basis and senior management compensation
- details of directors and senior management
- pension schemes and costs
- major customers and suppliers
- management discussion and analysis
- details of reserves available for distribution to shareholders.

Financial records must be kept by all entities covered by the Companies Ordinance, however "reporting exemption" is available to private or guarantee companies (other than certain companies specifically excluded) that are qualified to prepare simplified accounts and directors' reports. [34] Financial statements may be prepared in compliance with the *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* published by the HKICPA.

Share trading by directors

Subject to the general prohibition against insider trading, the HKEX Listing Rules, and the restrictions applying to directors under the share trading policy of a listed company, directors can, in certain circumstances, buy and sell shares and other securities in their companies.

34. Companies Ordinance (Cap. 622), Sections 380(3), 380(7), 381(2), 388(3)(a), 406(1)(b), Schedule 4 Part 1;
Companies (Directors' Report) Regulation (Cap. 622D), Sections 3(3A), 4(3), 8(3) and 10(7) ;
Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G), Section 23

HKEX listed companies are required to disclose dealing in the company's securities by its directors and other key management personnel.[35] Under such guidelines, the directors and other key management personnel should disclose in certain listing documents and annual and interim reports, details of substantial shareholders' and certain other persons' interests and short positions in the shares.

The Companies Ordinance requires directors of listed companies to notify the HKEX of any interests they have in the securities of their listed company (or a related body corporate), and of any contracts to which they are a party, or from which they are entitled to a benefit. The HKEX Listing Rules also contain similar notification requirements, although the notification obligation rests with the listed entity, rather than the director.[36]

Enforcement, penalties and remedies

Directors who breach their legal responsibilities face a range of criminal and civil penalties, and can also expect to suffer damage to their reputations and their professional or commercial careers. Moreover, it can also affect the company's reputation.

Enforcement

The SFC has wide enforcement powers under the SFO to ensure that directors and senior executives are held accountable for their actions.[37]

35. Appendix 1 to the Listing Rules, Part A Paragraph 45, Part B Paragraph 38, Part C Paragraph 49; Appendix 16 to the Listing Rules, Paragraph 13
36. Registers required to be kept under Sections 336 and 352 of the Securities and Futures Ordinance (Cap. 571)
37. Securities and Futures Ordinance (Cap. 571), Sections 213, 214, 279, 258, 307N, 390

The SFC intends to continue to work with government on the tightening of listing requirements, extra rules surrounding capital raisings, making delisting of long-suspended companies easier, and the robust use of statutory powers to halt listings that are considered problematic and to force the suspension of trading of the stocks of listed companies where misconduct is suspected.

Accelerating the SFC's enforcement and capacity to pursue actions for serious misconduct through greater use of external expertise and resources is one of the SFC's key regulatory strategic priorities.

Criminal penalties

In certain circumstances, directors can be charged with criminal offences. Criminal penalties can be imposed for a number of actions including:

– if a director is reckless or dishonest, and fails to act in good faith, in the best interests of the company or for a proper purpose
– breach of other statutory duties, such as the duty not to make improper use of a director's position or of information received as a director
– contravention of the prohibition against insider trading.

Directors found guilty of these criminal breaches can be fined and/or imprisoned.

Civil penalties

Civil penalties can apply to a range of breaches of statutory duty, including:

– the duty to exercise reasonable care and diligence
– the duty to act in good faith in the best interests of the company and for a proper purpose

– connected party rules
– market manipulation
– the duty to prevent insolvent trading.

Minority shareholders may petition unfair prejudice against the directors/majority shareholders. The court may order winding-up of the company, make a buy-out order and/or other relief the court thinks fit. Minority shareholders may also bring derivative action on behalf of the company against the delinquent directors.

Directors who have benefited from a breach of duty may also be ordered to account for any profits received. Penalties can include fines, a disqualification order or a compensation order. In civil proceedings, the burden of proof is on the balance of probabilities, rather than beyond the reasonable doubt demanded in criminal proceedings.

Remedies

A cause of action may also arise under general law against directors for breach of:

– the duty of care and diligence arising from common law negligence
– contractual obligations
– the equitable duty to exercise reasonable care and skill.

In addition, if a director breaches the fiduciary duties owed to the company and it suffers a consequential loss, the company may pursue compensation by way of equitable remedy. This is similar to the common law remedy of damages.

Useful references

– *Companies Ordinance (Cap. 622)*
– *Companies (Directors' Report) Regulation (Cap. 622D)*
– *Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G)*
– *Companies (Model Articles) Notice (Cap. 622H)*
– *Securities and Futures Ordinance (Cap. 571)*
– *The HKEX's Listing Rules*
– *Corporate Governance Code, as set out in Appendix 14 to the Main Board Listing Rules and Appendix 15 to the GEM Listing Rules*
– *Takeovers Code and Share Buy-backs Code*
– *Guidelines for Directors (4th edition), HKIoD* *https://www.hkiod.com/guidelines-for-directors.html*
– *A Guide on Directors' Duties (March 2014), Companies Registry* *https://www.cr.gov.hk/en/companies_ordinance/docs/Guide_DirDuties-e.pdf*
– *Major Roles and Functions of the Board (11 March 2016), HKEX Group* *https://www.hkexgroup.com/Corporate-Governance/Corporate-Governance-Framework/Corporate-Governance-Practices/Board-of-Directors/Major-roles-and-functions-of-the-Board?sc_lang=en*
– *On the 2022 Board agenda, KPMG Board Leadership Center* *https://boardleadership.kpmg.us/content/dam/boardleadership/en/pdf/2022/on-the-2022-board-agenda.pdf*

- *A Guide on Better Corporate Governance Disclosure (February 2014), HKICPA*
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- *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard, HKICPA*
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- *Guidelines on Corporate Governance for SMEs in Hong Kong (3rd edition), HKIoD*
  https://www.hkiod.com/document/corporateguide/sme_guidelines_3rd_edition_eng_final.pdf
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2. Governance Roles

There are many instruments, roles and responsibilities required for a board to deliver its governance function effectively. Key factors such as independence, board composition and skills play a critical role in board performance.

In this chapter

- Governance scope
- Board charter
- Annual board agenda
- Retained authorities
- Delegated authorities
- Accountabilities framework
- Types of directors
- Chairman's role
- Senior independent director
- Company secretary's role
- Induction and professional development

Questions that company directors should ask

1. Is the composition of the board appropriately diverse for it to perform effectively?
2. Is the board sufficiently independent of management to enable it to make tough decisions?
3. Is a regular assessment of each director's independence made by the board?
4. Does the board periodically review the board's and chairman's performance, and if so, is the review done by an external body?
5. Does the board tailor its charter to the organisation's circumstances and is the charter periodically reviewed?
6. Is there an annual agenda approved by the board that is linked to the board's key responsibilities, as detailed in the board charter?
7. Are matters that must be referred to the board for approval clearly articulated to management?
8. Does the board clearly set out the roles and authority of the CEO and directors in writing?
9. Are delegations to management, including the delegations policy, set out in a single document?
10. Is the board monitoring that directors allocate sufficient time to discharge their responsibilities?

Red flags

1. The board spends too much time on operational matters with limited time for strategic discussions.
2. Policies and procedures are not updated regularly.
3. The board is heavily weighted towards a certain skill set, background, or gender.
4. Some directors have family ties or cross-directorships that have not been discussed or are overlooked.
5. Assessments of director independence are informal and infrequent.
6. The board's charter is outdated with the last date of review unknown.
7. A statement of 'matters reserved for the board' does not exist, or is not explicit and clear.
8. There are no board approved instruments, such as codes of conduct and delegations of authority.
9. Assessments of the board's performance are only done internally (or not at all) and are routinely positive.
10. The director induction process is procedure-based only.

Governance scope

At its very centre, the role of the board is governance of the organisation. Governance is a unique concept and very different to management, which is the role and function of the executive team. Governance requires a balance between a 'hands-off' approach to implementation, and a greater focus on **oversight**, **insight** and **foresight** in the context of stewardship, direction setting and monitoring performance of the management team against the approved strategic objectives.

The board's governance scope refers to the key roles and responsibilities of the board and includes the following key functions:

- developing, along with senior management, the company's vision, purpose, core values, strategic direction and objectives
- evaluating and challenging management's recommendations on important strategic and operational matters
- holding management to account for its performance and decisions
- scrutinising key financial and non-financial risks to which the enterprise is exposed and ensuring the implementation of an effective risk management, compliance and internal control framework
- ensuring the adequacy of internal regulatory and policy compliance systems
- setting and demonstrating the corporate culture of the organisation
- adopting appropriate ethical standards, codes of conduct and appropriate behaviours, and ensuring that these are adhered to at all times
- communicating and reporting to shareholders and other stakeholders in a transparent and insightful manner
- overseeing management succession plans
- evaluating the board's own practice and performance and the contribution of individual directors.

The board's governance scope should be clearly documented in the board charter.

Board charter

A listed entity should have and disclose a board charter, setting out:

- the respective roles and responsibilities of its board and management; and
- those matters expressly reserved to the board and those delegated to management.

The purpose of a board charter is to document the board's terms of reference, and to articulate the board's approach to important governance practices. The charter should contain a statement clarifying the division of responsibilities between the board and management. Many boards define the roles, powers and responsibilities that it specifically reserves for itself, and those which it delegates to management.

All entities, whether private, public, listed, non-listed, non-profit or government, should have a document that clearly outlines the board's purpose, functions and key operating mechanisms. The document could be called a charter, by-laws (in the case of government entities) or terms of reference. For the purposes of this discussion, we will use the term 'charter'.

While the content of the board charter will vary from company to company, the board charter of a listed company (which can be used as better practice guidance for non-listed entities) will typically cover the following matters:

- overview of board roles, functions and responsibilities
- board structure and composition
- the chairman's role
- the role of the company secretary
- the board's policy for assessing independence
- retained authorities
- board delegations
- board meeting procedures
- oversight of strategy, financial and risk management, and remuneration frameworks.

The board should periodically review its terms of reference to ensure it remains relevant to the circumstances of the company. The charter should be available to directors, management, staff, auditors and shareholders.

Annual board agenda

Boards commonly formulate an annual board agenda as an effective planning tool. The chairman should refer to the annual agenda before approving the agendas for individual board meetings.

An effective annual agenda will:

- provide coverage of all the board's key activities
- provide adequate time for discussion
- ensure all the obligations included in the charter will be addressed
- provide opportunities for the continuous development of directors.

The annual agenda can also be used as an evaluation tool to assess whether the board has achieved the activities planned in the agenda.

See Appendix 2 'Annual agenda' for an example.

Retained authorities

The HKEX's Listing Rules encourage all companies (both listed and non-listed) to disclose the respective roles of its board and management and adopt a formal statement of matters reserved for the board's decision or a formal board charter that specifies its functions and responsibilities.

Some of the responsibilities that boards normally reserve for themselves include:

- demonstrating leadership, defining the entity's purpose and setting its strategic objectives
- appointing the chairman and appointing and replacing the CEO
- approving the appointment and replacement of other senior executives
- overseeing the integrity of the entity's accounting and corporate reporting systems
- ensuring that the entity has in place an appropriate risk management framework (for both financial and non-financial risk)
- ensuring that the entity's remuneration framework is aligned with the entity's purpose, values, strategic objectives and risk appetite
- monitoring the effectiveness of the company's governance practices.

Some boards adopt a formal delegation of authority policy, delineating respective board and management authorities, while setting financial limits on decisions that can be made without specific board approval. Ensuring that the CEO and the board itself understand their respective roles and responsibilities is a priority of every board.

Delegated authorities

Given the complexity and size of the typical large business enterprise, it is not possible, nor is it desirable, for a board to exercise all of its possible powers and functions. A director must refrain from delegating power without proper authorisation. Unless it is specifically mentioned in the articles of association and company memorandum that a director can delegate some of his powers in specific matters, he/she is required by the law to exercise independent judgment. [38]

Directors are entitled to rely on others, where they believe, on reasonable grounds at all times the delegate would exercise the power in conformity with the duties imposed on directors of the company under the Companies Ordinance and the company's constitution, and the director believed on reasonable grounds, in good faith and after making proper enquiries that the delegate was reliable and competent in relation to the power delegated. If these conditions are not met, the directors will be responsible for the exercise of power by the delegate as if the directors themselves had exercised the power.

38. Refer to *A Guide on Directors' Duties* (March 2014), Companies Registry, Principle 3

This provision implies that boards must take responsibility not only for the appointment of a reliable and competent CEO, but must also make a judgment about the competence of the entire senior management team, as well as being satisfied that the company has established proper processes for the hiring of competent employees.

In delegating their powers to committees or management, boards must:

- ensure the delegation is consistent with and in accordance with the entity's risk appetite
- demonstrate and maintain rigorous oversight over the exercise of those powers
- ensure that management and committee reporting back to the board strikes the right balance between summary and detailed information
- ensure seamless communication between board committees.

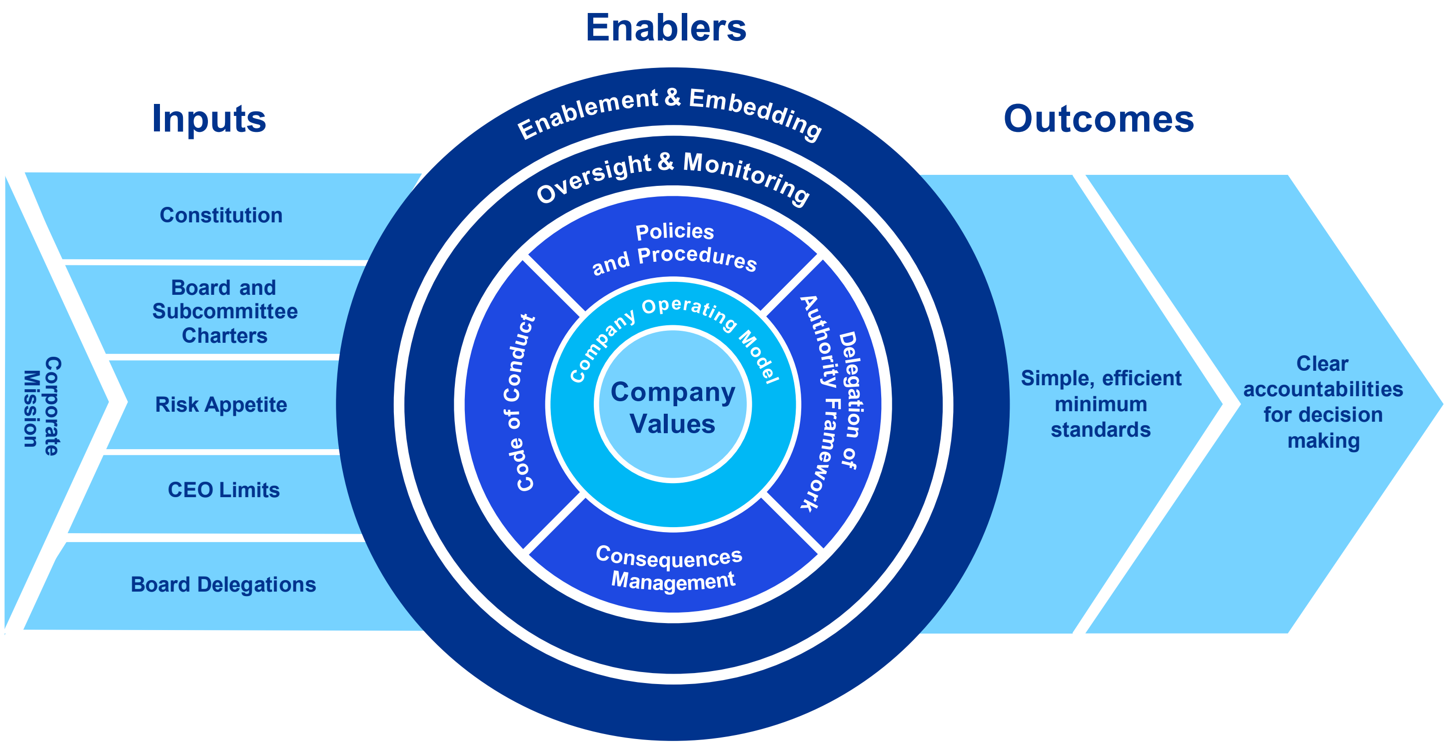
It is important that directors review materials and financial reports presented by management and auditors with a critical eye, and not accept or approve materials without question, to ensure that reasonable grounds exist to rely on the work of management. Case law makes it clear that directors cannot substitute reliance upon the advice of management for their own attention and examination of an important matter that falls within the board's responsibilities (such as, for example, reporting obligations).

The delegations policy, which is approved by the board, should specify the limits of authority to take action and/ or make financial and non-financial decisions for all individuals, including the delegations from the CEO to senior management and from senior management to staff. This will assist the board in fulfilling its duty of care and be a useful reference to all company personnel as to who has responsibility for decision-making.

Accountabilities framework

The KPMG accountabilities framework outlines below the inputs and enablers to deliver simple, efficient minimum standards and clear accountabilities for decision-making across the organisation.

To achieve an effective accountabilities framework requires the board to endorse these instruments, oversee their implementation and regularly consider their compliance and currency.



Types of directors

There are two principal types of directors: executive directors and non-executive directors. However, the Companies Ordinance also defines a range of other types of directors that share the same overall fiduciary responsibilities, but with some slight differences. It is important to understand what type of director you are and how this impacts on your ability to effectively and lawfully fulfil the requirements of the role.

Non-executive directors

A non-executive director is someone who is not employed by the company in a management position but is involved in policy and planning exercises.

Being independent of the management of the organisation, non-executive directors have key responsibilities to deliver. Although written over a decade ago, the *Higgs Report* [39], looking at the role and effectiveness of non-executive directors, is still relevant, suggesting that the main responsibilities are to:

- constructively challenge and contribute to the development of strategy
- scrutinise the performance of management in meeting agreed goals and objectives, and monitor the reporting of performance
- satisfy themselves that financial information is accurate and that risk management systems are robust and defensible
- appoint, evaluate and remove senior management personnel in line with succession plans
- determine appropriate levels of remuneration for executive directors.

This report also suggests that, in order to discharge their responsibilities, effective non-executive directors should possess key personal attributes, including:

- integrity and high ethical standards
- sound judgment
- ability and willingness to challenge and probe
- strong interpersonal skills.[40]

An important characteristic of a non-executive director is the willingness to confront management and raise difficult issues. Non-executive directors must have "sufficient strength of character to seek and obtain full and satisfactory answers within the collegiate environment of the board. [41]

Independent directors

Independent directors play an important role in the separation of power between the management of the company, including executive directors, and can offer new perspectives and challenge old paradigms.

Directors, whether they are executive or non-executive directors or independent non-executive directors, they are subject to the same legal duty under the law [42] and the Listing Rules.

39. Derek Higgs (January 2003). *Review of the role and effectiveness of non-executive directors*. Department of Trade and Industry of the United Kingdom ("UK"), Annex A Part 2 Paragraph A.1.4

40. Ibid P.29 Paragraph 6.12
41. Ibid P.29 Paragraph 6.15
42. Companies Ordinance (Cap. 622), Section 465

Governance Roles

The HKEX Principles go on to provide examples of interests, positions, affiliations and relationships that might raise issues about the independence of a director.[43] Independence is generally regarded as the key to fair and integrity. Given the unique nature of the HKEX's dual roles, INEDs serve the major purpose of striking a balance between public and corporate interests. In addition, due to the complexity and breadth of the financial markets in which it operates, INEDs with diverse backgrounds bring wider spectrum of experience and broader views to the board.

In assessing the independence of a non-executive director, the SFC takes into account the criteria affecting independence as set out in the Listing Rules.[44] Every INED is required to confirm in writing to the SFC his/her independence upon his/her appointment as director and to the HKEX on an annual basis with reference to such criteria. Where an INED fails to meet any of such criteria, the HKEX will disclose the reasons why such director is still considered to be independent in the annual reports.

Each INED is also required to inform the HKEX as soon as practicable if there is any change in his/her own personal particulars that may affect his/her independence. Moreover, each has to declare his/her past or present financial or other interests in the Group's business, or his/her connection with any of the HKEX's connected persons (as defined in the Listing Rules), if any.

Directors considered by the board to be independent should fulfill the interdependence criteria.[45] In each case, the materiality of the interest, position or relationship needs to be assessed by the board to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgment to bear on issues before the board, and to act in the best interests of the entity as a whole, rather than in the interests of an individual security holder or other party.

Since its listing, the HKEX has been steering by a board comprised by a majority of INEDs. The Chief Executive is the only executive director on the board.

For some entities, having a majority of board members as independent directors may not be possible or appropriate. The size of the board, the nature of the business and the skills required, may limit the number of independent appointments. In this situation, it is important to ensure that the organisation has at least one independent director to provide challenge and perspective that only someone from outside the organisation can bring.

According to the Corporate Governance Code, a mechanism(s) should be established to ensure independent views are available to the board. The board should review the implementation and effectiveness of such mechanism(s) on an annual basis.
(effective from 1 January 2022)

43. Corporate Governance Code, Part 2, Section C.1
44. Chapter 3 of the Main Board Listing Rules, Rule 3.13, and Chapter 5 of the GEM Listing Rules, Rule 5.09
45. Corporate Governance Code, Section, Part 2, Section B.1.4

For INEDs serving more than nine years (Long Serving INEDs):

– A new INED should be appointed if all INEDs on board are Long Serving INEDs (effective for the financial year commencing on or after 1 January 2023);
– Additional disclosures should be made on factors considered, process and the board's discussion on why the Long Serving INED is still independent and should be re-elected (effective from 1 January 2022); and
– Disclosure on the length of tenure of the Long Serving INEDs on a named basis in the papers to shareholders for the AGM (effective from 1 January 2022)

Executive directors

Executive directors are paid employees of the company. They are often members of the company's senior management team. The CEO may also be an executive director and in some cases other senior executives may also be appointed to the board.

The HKEX's Listing Rules and Corporate Governance Code recommend the one-tier board structure, with a separation of CEO and chairman and INED representing at least as one-third of the board.[46] The Nomination Committee also composites a majority of INEDs. In some small and medium enterprises ("SMEs"), a CEO may also be the chairman of the board. Whilst there is no empirical evidence to suggest which model is better, this can see the lines between the board and management being blurred, requiring the individual to have a strong understanding of where and when they take on the relevant role. (Note that the practice of having a CEO appointed as chairman is more common in other countries such as the United States).

The argument in favour of executive directors is that they add value to a board's decision-making process through their technical expertise and knowledge of the business and its industry.

The presence of executives on the board can be beneficial to the extent that they can inform non- executive directors by providing their relevant expertise and current working knowledge. Executives might also offer a valuable second opinion to the statements and recommendations of the CEO. A risk exists that their loyalty to the CEO could conflict with their statutory duty as directors to act in the best interests of the company.

Nominee directors

A nominee director is a director appointed by a shareholder, creditor or interest group. Nominee directors have the same overriding duty as other directors. However, they are often thought to have an ongoing allegiance to the nominator responsible for their appointment.

Whilst a nominee cannot favour the nominator's interests over that of the company, they can have regard to the interests of the nominator, provided that the nominee director ultimately acts for a proper purpose and in the best interests of the company. Where the interests of the nominator and the company diverge, the nominee should not participate in the decision.

46. Chapter 3 of the Main Board Listing Rules, Rule 3.10A, and Chapter 5 of the GEM Listing Rules, Rule 5.05A

A nominee director must not divulge to the nominator information obtained from the company in the nominee's capacity as a director if there is a conflict between the interests of the company and the nominator. In the event of a conflict, the nominee must either discharge their duty to the company and not to the nominator, or resign from the company's board.

The Companies Ordinance provides that directors appointed to the board of a wholly owned subsidiary may act in the best interests of the holding company if certain conditions are satisfied and the constitution of the wholly owned subsidiary expressly allows it.

Alternate directors

Where directors find themselves unable to attend all board meetings or otherwise fulfil their board commitments, if the company constitution allows, then an 'alternate' director may be appointed. Depending on the scope of the appointment, the alternate director may exercise some or all of the appointing director's powers for a specified period. However, the appointment of alternate directors is becoming less common now that technology allows for participation in board meetings from a distance.

When an alternate director exercises the appointing director's powers, the exercise of powers is just as effective as if the power were exercised by the appointing director. The appointment process for alternate directors is typically governed by a company's constitution and is usually conditional upon board approval.

In the event that the appointing director has a conflict, the alternate (if exercising the appointing director's powers at that time) may still vote on the matter before the board. However, if the alternate also has a conflict then they must declare the conflict and refrain from voting.

The board should ensure that the terms of the appointment of an alternate director clearly set out:

- the scope of appointment (including any right to vote) and duration of the appointment
- the conditions under which the directorship may be revoked
- if the alternate director is permitted to attend all board meetings
- if there is an entitlement to receive all board papers and other communications.

De facto directors

A de facto director is a person not validly appointed as a director, but who by their actions is considered to in effect act in the position of a director. An example is where a person holds himself/herself out as a director by signing deeds as a director, despite not having a confirmation of appointment as a director, or not having been appointed in accordance with applicable procedures.

In practice, whether or not someone is deemed a de facto director will depend on the circumstances of each case, having regard to such factors as the size of the company, its internal structures and practices, and how the alleged director's position is perceived by outsiders who deal with the company.

Anyone deemed to be a de facto director is subject to the same duties and obligations as those applying to formally appointed directors, including the duty to prevent insolvent trading.

Shadow directors

A shadow director is a person who is not formally appointed as a director, but on whose instructions or wishes a company's directors are 'accustomed to act' as a matter of regular practice rather than as a one-off or isolated event.

A shadow director is subject to the same duties and obligations as those applying to formally appointed directors, including the duty to avoid insolvent trading.

A person will not be construed as a shadow director merely because the directors act on advice given by that person, due to their professional capacity or their business relationship with the directors. This is designed to protect lawyers, accountants, merchant bankers and others providing high-level advisory services to companies.

Chairman's role

Just as the board sets the tone for the entire company, the chairman sets the tone for the board. The chairman is first among equals, leading by example, displaying the utmost professionalism and engaging in conduct that is beyond reproach. In this sense, it is difficult to imagine a well- performing board without an effective chairman.

At its core, the chairman's leadership role involves facilitating the effective contribution of all directors and promoting constructive and respectful relations between all directors and management.

An effective chairman:

- demonstrates personal integrity through ethical behaviour and exercises power in the appropriate manner
- provides leadership by empowering and motivating board colleagues
- develops a positive relationship with the CEO and senior management
- commands respect by winning the confidence of fellow directors
- demonstrates strong communication skills, both verbal and written
- understands and demonstrates a commitment to corporate governance principles and practices
- operates as a team player, respecting, acknowledging and building on the views and perspectives of others
- promotes a suitable vision and strategy, offering strategic insight and direction
- oversees the development of a sound risk management framework.

The duties of the role and the personal characteristics and competencies required should be embodied in a chairman's position description or Board Charter that is reviewed by the board on a regular basis.

To ensure a clear division of responsibilities at the head of the company, the HKEX Principles recommend that the chairman should be an independent director and that the respective roles of the chairman and CEO should not be exercised by the same individual.[47]

47. Corporate Governance Code, Part 2, Section C.2.1

Similarly, the HKEX also acknowledges the demanding and time-consuming nature of the chairman's role.[48] This means that other commitments must not be allowed to detract from the chairman's role.

The chairman may be exposed to 'additional liability' where circumstances may arise that they are a recipient and 'gatekeeper' of information that may not be available to other directors. It is paramount to ensure that any significant performance shortcomings attributed to the CEO are brought to the board's attention and that the chairman resists any complicity with the CEO to hold back information.

In addition, the chairman must not prevent the CEO from raising issues with the board, nor should the chairman fail to raise any matter that would reasonably be judged worthy of the board's consideration.

Given the significance of the chairman's role, boards should give careful attention to the election of a chairman. The common practice of electing a chairman according to a notion of seniority should not be the default position. The role should be filled by the candidate best able to fulfil the duties referred to above.

The Companies Ordinance does not prescribe for any mechanism for appointing directors, therefore it is the articles of association that determine how a director should be appointed. For instance, Schedule 2 of the articles of association provides that a person may be appointed as a director by ordinary resolution for an unlimited period unless otherwise stated in the appointment. If a person is appointed to the board by the directors to fill up a causal vacancy, this director must retire from office at the next annual general meeting but can seek appointment.[49]

This arrangement is based on the premise that members should have the final say on who should be running the company for them. But this arrangement does not preclude the articles from prescribing other ways of appointing directors.

Company secretary's role

Hong Kong laws[50] require every company incorporated in Hong Kong to have a company secretary. The company secretary plays an important role in supporting the effectiveness of the board and its committees, including advising on governance matters.[51] As directors require more information, both in terms of quantity and quality, the company secretary fulfils an increasingly valued role, becoming a senior governance adviser to the board.

48. Refer to *Responsibilities and Conduct of Directors* (9 August 2018), HKEX Group, Time commitment and external appointments (https://www.hkexgroup.com/Corporate-Governance/Corporate-Governance-Framework/Corporate-Governance-Practices/Board-of-Directors/Responsibilities-and-Conduct-of-Directors?sc_lang=en)

49. Companies (Model Articles) Notice (Cap. 622H) , Schedule 2 Sections 22, 23
50. Companies Ordinance (Cap. 622), Section 154
51. Corporate Governance Code, Part 2, Section C.6

Company secretaries fall within the definition of a 'company officer' and essentially have the same legal duties and obligations as directors. It is increasingly common for company secretaries to perform a dual role (e.g. company secretary and general counsel), which has raised interesting issues regarding the extent of the application of the duty of care and diligence in Section 465 of the Companies Ordinance.

The role of the company secretary may include:

– advising the board on corporate governance issues
– correspondence with shareholders and regulatory bodies
– ensuring that the company is in compliance with the regulations
– present at all meetings of the company and the directors and make proper minutes of the meeting
– countersign every document to which the seal of the company is affixed
– share transfers, keep the books of the company and will deliver documents
– make necessary returns to the Hong Kong Companies Registry.

Induction and professional development

Induction training and ongoing professional development for directors are critical to enable directors to effectively discharge their obligations.

The HKEX's Listing Rules indicate that a listed entity should have a programme for inducting new directors and for periodically reviewing whether there is a need for existing directors to undertake professional development to maintain the skills and knowledge needed to perform their role as directors effectively.[52]

It is important, that induction training be comprehensive and commence immediately upon (if not prior to) the directors' appointment, as the directors' liability and remuneration commences immediately.

Induction training should provide directors with an understanding of the entity's structure, operations, history and culture and involve appropriate site visits to key operations. Where gaps in directors' knowledge exist, induction training should be provided on key matters such as directors' duties and responsibilities under the relevant legislation governing the entity, and on key accounting matters and the responsibilities of directors in relation to the entity's financial statements.

Further, the Corporate Governance Code recommends that companies should have and disclose the board composition setting out the mix of skills the board currently has or is looking to achieve. A structured professional development programme should be implemented that addresses gaps in directors' knowledge and skills, and provides training in relation to emerging issues.

52. Corporate Governance Code, Part 2, Section C.1.1, C.1.4

Useful references

- *Companies Ordinance (Cap. 622)*
- *Companies (Model Articles) Notice (Cap. 622H)*
- *The HKEX's Listing Rules*
- *Corporate Governance Code, as set out in Appendix 14 to the Main Board Listing Rules and Appendix 15 to the GEM Listing Rules*
- *A Guide on Directors' Duties (March 2014), Companies Registry* *https://www.cr.gov.hk/en/companies_ordinance/docs/Guide_DirDuties-e.pdf*
- *Derek Higgs (January 2003). Review of the role and effectiveness of non-executive directors. Department of Trade and Industry (UK)* *http://www.ecgi.org/codes/documents/higgsreport.pdf*
- *Responsibilities and Conduct of Directors (11 January 2021), HKEX Group* *https://www.hkexgroup.com/Corporate-Governance/Corporate-Governance-Framework/Corporate-Governance-Practices/Board-of-Directors/Responsibilities-and-Conduct-of-Directors?sc_lang=en*
- *Factsheets: The role of the company secretary (4 October 2018), the Institute of Directors (UK)* *https://www.iod.com/news/news/articles/The-role-of-the-company-secretary*
- *Corporate Governance Guide for Boards and Directors (December 2021), HKEX* *https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Corporate-Governance-Practices/guide_board_dir.pdf?la=en*

3. Non-Profit Organisations

The roles, responsibilities and expectations of directors of non-profit organisations are inherently the same as those of their corporate and government counterparts. Key differences exist however, with respect to aspects of legal compliance, tax obligations, strategic and operational areas of focus, and accountability to members.

In this chapter

- Directors' legal responsibilities
- Structuring an effective non-profit board
- Non-profit leadership
- Strategic priorities
- Stakeholder engagement
- Identification, management and mitigation of risk
- Receiving assurance

Questions that an non-profit organisation director should ask

1. Am I well versed with the constitution and rules for my board?
2. Do I understand my responsibilities relating to the constitution, related government legislation and compliance?
3. Does each board member display strong working knowledge of the strategic priorities?
4. Am I taking steps to engage with members and understand expectations?
5. Is the board aware of its duty to meet the objectives and vision of the organisation?
6. Am I fully aware of my duties and responsibilities regarding conflicts of interest?
7. Is there an effective framework for membership/ constituent engagement?
8. Are there strong working relationships across the organisation with members and stakeholders?
9. Do I understand the board's role with members and the services provided to members?
10. Do I recognise the importance of ethical conduct in the non-profit sector?

Red flags

1. The mission or purpose of the organisation is ambiguous, and never, or rarely, referred to in board discussions/documentation.
2. There is no discussion of risk.
3. There is no regular and/or accurate presentation of results or forecast cashflows.
4. Certain directors are perceived to have conflicts of interest.
5. There is concern that participation and engagement with members is poor.
6. The directors fail to act in accordance with the objectives/purpose of the organisation.
7. A director is demonstrating strong bias towards lobby groups within its membership.
8. The board ignores its strategic priorities in its decision-making framework.
9. Directors display a lack of understanding of non-profit organisations' funding and budget processes.
10. Some directors may have been on the board for many years.

By definition, non-profit entities are organisations that exist for 'public benefit', whereby their key objective is to provide a range of community services or advocacy activities (such as health, education, counselling or spiritual guidance, lobbying or improving the environment) for the communities they serve. Ensuring the ability to deliver these services to their communities over time means that being financially viable is important. The key difference between a corporation and an non-profit entity is that any profits are applied by the non-profit entity to fulfil its overall purpose, rather than generating gains or benefits for distribution to a particular person or people.

Setting and understanding the overall objective, vision, mission and values of an non-profit entity is critical to establishing the context of its operations and the strategic focus of the board.

This section focuses on key differences that directors of non-profit entities need to be cognisant of, and be able to manage effectively.

Directors' legal responsibilities

Non-profit legal structures

It is important to recognise that there are many different types of non-profit organisations, each one with a unique set of legal obligations, tax obligations, regulators and reporting requirements. In developing this chapter, we have focused on general observations applicable to non-profit entities more broadly, however there may be specific considerations that are applicable to your non-profit entity.

As a director of an non-profit entity, you must pay careful attention to the legal structures under which the non-profit entity operates and ensure that independent professional advice is sought with respect to your duties and responsibilities within your organisation.

Non-profits may be referred to as an 'association', 'college', 'club', 'company', 'foundation', fund', 'institute', 'league, or 'society'. The classification is determined largely by the legal structure under which the organisation is established and whether the organisation is a registered charity, which in turn, will impact on its tax status. Throughout this chapter, we will refer to the non-profit organisation as 'the non-profit entity' and the governance representation as the 'non-profit entity board'. You may be called a director, member, councilor or committee member and we will refer to you as a 'director' through this chapter.

The legal structure used to establish the non-profit entity will determine the various financial, operational and compliance functions of the board. In addition to the duties outlined in the chapter titled *Directors' Duties*, different legal structures applicable to non-profit entities means that directors must invest time in understanding the relevant laws and the associated legal, operational, financial (e.g. tax-exemptions) and reporting requirements in order to effectively fulfil their duties.

Some of the more common legal structures include:

- companies limited by guarantee
- incorporated associations
- unincorporated associations

- co-operatives
- indigenous corporations
- gift funds
- trusts
- trade unions
- entities created by laws.

A significant number of non-profit entities are established as either an incorporated association or a company limited by guarantee.

Incorporated associations are legal entities separate from their individual members and are subject to the relevant state or territory legislation in which they operate. This means that the majority of their operations tend to be restricted to that jurisdiction. The liabilities and financial protections of the entity are limited.

Companies limited by guarantee are governed by Section 662 of the Companies Ordinance. Non-profit entities established under this legal structure are public companies, and the liabilities of the company members are also limited to the extent of the guarantee.

Some key considerations for non-profit entities in determining the most appropriate legal structure are:

- Where will the non-profit operate?
- Will there be a changing membership?
- What is nature of the activities?
- How will the organisation raise money?

As noted above, non-profit entities and individual directors should seek specific advice from a professional advisor with respect to legal, tax or accounting matters, prior to implementing or affecting changes to the non-profit entity's legal structure.

Charitable non-profits

Not all non-profits are charities, however under Hong Kong laws, all charities must be an non-profit. A qualified 'Charity' organisation is a specific form of organisation which must be registered in Welfare Department of Hong Kong and list in "Charitable Donations and Tax-Exempt Charities" of the Hong Kong Inland Revenue Department ("IRD").

With respect to discharging their duties, directors of charitable non-profits have an additional duty to ensure that they dutifully oversee how members' funds, assets, and products and services are managed to meet their community's needs. Therefore, the support of the charitable non-profit entity in the maintenance of 'public benefit', or its mission, is key.

As such, in the duty of public benefit, directors should give consideration to the following:

- compliance with the relevant non-profit ethical frameworks
- compliance with the defined values and standards generally outlined in the non-profit's code of conduct
- ensuring a full understanding of the organisation's legal obligations and director's individual responsibilities

- acting with integrity and ensuring ethical decision-making occurs across delegated powers in favour of public benefit
- compliance with non-profit, financial, asset management and procurement requirements, in addition to conscientious expenditure of membership funds
- awareness and declarations of all conflicts of interest
- escalation of identified or suspected corruption
- attentiveness to the illegality of acceptance or offering of gifts or rewards.

Tax exemptions for charity

A charity, subject to the approval of the IRD, is exempted from profits tax under Section 88 of the Inland Revenue Ordinance and is also exempted from obtaining a Business Registration Certificate (unless a trade or business is carried on).

To be accorded its legal status as a charity, an institution or trust must be established "for purposes which are exclusively charitable and these purposes of the organisation are charitable in the strict legal sense”. [53]

Regulation of charitable non-profits

Unlike many other advanced jurisdictions, Hong Kong does not currently have a dedicated charities regulator. The IRD operates a de facto registration system by approving charities for inclusion in a list maintained on its internet site.[54] As a technical matter, however, this is not a regulatory function: the IRD merely acknowledges certain entities as being charitable. It is, however, important to note that merely because an entity is not on the IRD's list does not mean that it is not a charity and, similarly, merely because an entity is on the IRD's list does not necessarily make it charitable at law. Although the IRD carries out random spot-checks on registered charities to determine whether they are still eligible for inclusion on the list, this is not a systematic process and most such inquiries are, in our experience, relatively superficial.

Directors must ensure that they are aware of all of the requirements of legislation governing charitable non-profits, remembering that in essence the obligations are the same as a “for profit” entity, with the addition of ensuring (and demonstrating) that the “public benefit” continues to be met.

53. *Tax Guide for Charitable Institutions and Trusts of a Public Character* (April 2020), IRD, Paragraph 6
54. https://www.ird.gov.hk/eng/tax/ach_search.htm

What is a charity?

Charity must be established exclusively for charitable purposes. For an institution or a trust to be a charity, it must be established for purposes which are exclusively charitable as defined in law.

The definition of "charity" was given in the judgment of Lord MacNaghten in the case of *Income Tax Special Purposes Commissioners v. Pemsel (1891-1894) All ER Rep 28*.

In the judgment, it was held that the following purposes may be accepted as "charitable":

- relief of poverty
- advancement of education
- advancement of religion
- other purposes of a charitable nature beneficial to the community not falling under any of the preceding heads.

For the purpose of obtaining profits tax exemption under Section 88 of the Inland Revenue Ordinance only, while the purposes under the first three heads may apply to activities carried on in any part of the world, those under the fourth head will only be regarded as charitable if they are of benefit to the Hong Kong community.[55]

Other legislation

Whilst this chapter contains an overview of key principles relevant to directors of non-profit entities and charitable non-profits, it is important to note that every jurisdiction has different requirements, guidelines and legislation.

Other regulators include the Companies Registry and the IRD. Apart from "Company", most of the less-formal industry associations and social/recreational groups opt for the register as a Society under the Societies Ordinance. To register as a Society, an organisation must register with the Societies Office of the Societies Office of Hong Kong Police Force.

Similarly, overarching legislation and regulations such as privacy, equal opportunity, freedom of information, environmental protection, occupational health and safety and fair-trading laws apply equally to non-profits as they do to 'for profit' entities. These are discussed in more detail in the chapter titled *Directors' Duties*.

Each director must invest time in understanding the relevant laws that bind their specific association and the impact on their obligations.

55. Refer to *Setting up a charity in Hong Kong*, Charltons (https://www.charltonslaw.com/hong-kong-law/setting-up-a-charity-in-hong-kong/)

Structuring an effective non-profit board

Depending on the constitution of the entity, boards may be elected by members, or appointed through a competitive selection process. For membership-based associations, boards are frequently elected by members, with the appointment of 'community members' to ensure balanced and comprehensive capability and views. Community members are appointed after advertising public the expressions of interests with interviews typically conducted by the board chairman and CEO. The board chairman can delegate the interviewing of public members to a board sub-committee; e.g. governance committee, with recommendations for appointment referred to the chairman for the board's endorsement.

Challenges of finding and retaining non-profit directors

Finding candidates who are willing to invest the time and effort in a 'volunteer' role with such high levels of responsibility and accountability can often be challenging. Conversely, some non-profits find that directors join with great passion and intent for the purpose, but do not have strong governance skills, especially when non-profit boards are often the first governance role for individuals looking to gain governance experience in an unlisted and 'less high profile' environment. The reality is that the expectations, accountabilities and obligations are inherently the same for non-profits as 'for profit' entities.

Appointment process

Members generally vote to make appointments to non-profit boards for a fixed term. While not always the case, the appointments are generally advertised to members via public media and outline the core skills and competencies required. The board chairman, CEO and non-profit entity members may in some cases select 'public members' to the board, or there may be a nomination committee as part of the board governance structure, that has been established specifically to address board appointments. Public members are selected to address board skills deficits or to balance elected board member composition (gender, experience and qualifications, geographical) through an expression of interest. Existing directors and the chairman can help to create a pool of potential candidates through continuous networking as a form of succession planning. In some cases, there may be a combination of member elected board members and board appointed directors, to achieve a balance between member representation and ensuring the appropriate skills are in place. Further entity appointments can occur via elections, ex-officio 'requirements', expressions of interest, nominations for improved non-profit entity composition, and reappointments.

Criteria for selection

The selection criteria used by non-profit entities to elect and/or appoint board members and a chairman may include, but is not limited to:

- the status and integrity of the individual within the community (membership) in which they work
- adherence to the duties of a non-executive director, if applicable
- any other legislative requirements applicable to that board (e.g. mandatory governance requirements of other commissions)
- working knowledge and understanding of accountability relationships
- relevant experience within the sector and their elected field(s) of excellence
- ability to think and act strategically
- understanding of the non-profit organisation and sector operations
- understanding of the objectives and role requirements of their position
- existing relationships and connectivity
- understanding of the key risks and challenges present in the non-profit sector
- governance standards understanding
- capacity to contribute (in time and often financially) and attend board and sub-committee meetings.

To achieve a 'balance of expertise' on an non-profit board, there may be a greater need to consider, and give heavier weight to, the candidate's corporate business and financial expertise, advocacy or stakeholder engagement.

Sourcing

Strategic workforce planning at a board level should be informed by board evaluation and completion of skills matrices to highlight gaps and drive selection based on 'public member' candidate expertise. Embedded in this is the management of talent identification and due diligence.

Probity considerations that should be taken into account when sourcing and selecting candidates may include, but are not limited to:

- proof of identity checks
- verification of qualifications
- registration/disqualification check
- working with children check
- police/criminal record check
- declaration of private interests/conflict of interests
- personal reference checks.

Depending on the jurisdiction in which the non-profit entity operates, these requirements may differ.

Director resignation, retirement and removal

Director involvement on non-profit boards can often be driven by personal values or connections to the organisation. Sometimes, however, despite this passion and commitment, the director does not have the skills or experience required to operate effectively on the board. Other issues associated with board renewal in the non-profit sector include board members who – due to constitutional limitations – have remained on the board for many years, thereby limiting options for new members to join and bring a fresh perspective. This can create significant issues with respect to the ability of the board to fulfil its legal and governance duties. This is where a clearly defined board governance framework, including clearly documented appointment processes, tenure, skills requirements and performance measures of directors, is critical.

Removing a director in these types of sensitive situations can be challenging. The options available will depend on the legal structure of the non-profit entity. For example, an non-profit entity may be able to move the director to a sub-committee (e.g. fundraising), to focus their effort on a specific function to which they feel strongly connected and to which they can make a more significant contribution, but they cannot do this if they are a company limited by guarantee. Directors of non-profit entities operating as companies limited by guarantee can often only be removed by a member vote.

Non-profit leadership

The relationship between CEO and the board is a critical one for non-profits. Unlike other organisations where the CEO reports to the board, often in non-profits the CEO is a key resource for directors – providing assistance in:

– assisting directors (who are often volunteers) to understand their duties
– making recommendations for board recruitment that align with the non-profit entity's culture and skill needs
– increasing the awareness of directors about the organisation's objectives and programs
– participating in strategy development and board committees.

It is critical that the CEO and non-profit directors have an effective working relationship that is based on shared objectives, open communication and a strong understanding and respect for each other's role and skills.

Within non-profits, the line between board and management can be less clear than in private organisations (especially listed companies). Resource constraints can often mean that directors are required to get more involved in operational issues, thereby stepping out of their oversight role and into implementation – i.e. less 'steering' of the boat and more 'rowing'.

Again, in these instances, it is critical for the board to recognise and clearly define when it is required to move into operational matters. Whilst the Board Charter is an important document to define the role of the board (and all non-profits should have a clearly documented Board

Charter), the Delegations of Authority is critical to explicitly define how board and management interact, and the levels of responsibility for decision-making with respect to implementation of the non-profit's mission and strategy.

Strategic priorities

Like corporate boards, the overall strategic framework, direction and priorities for an non-profit entity are set by the board. non-profit entities should set their strategic priorities within this framework and be consistent with the board's direction. It is the duty of a director to ensure that they are familiar with the mission and strategic priorities of the entity. The non-profit's CEO should oversee the alignment of the mission with its strategic direction and operational activities.

Part of the development of strategic priorities requires a clear understanding and agreement on the mission or objectives of the non-profit entity. Membership-based associations may be motivated by public benefit, prestige and advocacy within the industry, and the relationships between members and stakeholders. In contrast, other non-profits (health and education services) may be motivated by achieving the best possible health, education and/ or wellbeing outcomes for the communities that they support.

Types of issues specific to non-profits and the development of strategic priorities are detailed below.

The importance of purpose

The foundation of the non-profit entity's governance framework is its Constitution. This legal instrument defines the organisation's mission, purpose, objectives, general powers, functions and duties, and the responsibilities of its directors. The Constitution should clearly outline the entity's legal structure, charitable/non-for-profit status and governing laws.

The directors should be well versed with the Constitution and review all non-profit entity instruments, processes and functions against it.

A key component of the Constitution is to define the organisation's mission and purpose. Critically, for non-profit entities, the alignment of activities with its mission can be challenging. In some instances, social drivers (such as increasing demand for diversified services), resource/ skills constraints and funding pressures can move organisations away from their mission, thereby creating unique risk and strategy issues for directors.

For example, non-profits often generate 'revenue' through donations or grants. In the case of grant funding, money is often provided to meet specific government policy objectives. In some cases, these objectives will broadly align with the organisation's mission, however, may require the non-profit to direct some of the resources into other related – but non-core – services. Over time, these 'new' services can move the organisation into areas that do not fully align with the non-profit's mission.

In this instance, risk and strategy issues can arise that might put the organisation into conflict with itself. For example, an non-profit established to provide assistance to low income households may receive funding to retrofit households with energy efficient light bulbs (reducing energy bills for low income earners). Whilst in alignment with the non-profit's mission, it may require specialist skills with respect to installation of equipment or electrical modifications within a home. Whilst the funding would no doubt assist the non-profit in achieving its mission, it comes with a range of legal, operational and reputational risks that need to be considered. Pursuing this service offering could distract the organisation from its core purpose and further constrain the use of scarce resources.

Directors, therefore, need to understand the range of risks that these opportunities can present (particularly in a competitive funding environment). This requires a thorough understanding and oversight of risk management practices within the organisation.

Governance roles are also characterised by the size and nature of the organisation and its scope of operations. For example, larger non-profit entities operating multi-million dollar budgets and operating at a national scale will have vastly different governance requirements than a community sporting club.

Managing funding constraints

Non-profits reinvest any profit generated back into the entity in order to fulfil its purpose. All non-profits have a responsibility to remain solvent, generate sufficient profit for the long-term sustainability of the organisation through diverse funding streams (i.e. apart from membership contributions alone), and the judicious management of funds to benefit the ongoing viability of the organisation.

As noted above, there are important considerations for directors when seeking and obtaining funding from grants and donors that have specific objectives. Competition for funding can lead non-profits to move into the provision of services that are related to, but misaligned with, the non-profit's overall mission and strategy. This is where a strong governance framework for managing risk and opportunity is critical – and it is the duty of the board to ensure that these frameworks are in place, and that member interests are being met through the achievement of the organisation's purpose.

Stakeholder engagement

As highlighted in the chapter titled *Accountability to Shareholders*, all boards have an accountability to their stakeholders. An non-profit director's individual role is to represent its members and communities. Part of this responsibility includes providing stakeholders with adequate channels for raising concerns and reporting back to stakeholders on a transparent and regular basis. In the discharge of their duties, an non-profit director should recognise the diversity of the membership, be aware of the members' needs and balance the varying demands, and incorporate these into the strategic priorities of the non-profit entity.

As a collective, an non-profit entity's board must also engage across the membership. This often facilitates the individual director and overall board's understanding of the different needs and challenges facing the members and informs their oversight role.

Member engagement can take many forms; both informal and formal. It can include representation or participation in member forums, attendance at related events, visitation plans and liaising with membership groups. Members have wide and varied expectations that the non-profit entity will fulfil most/all relevant needs. Obtaining value for money and the cost of membership are often critical issues for members.

Outputs of the engagement process should inform strategy development and priority setting. This will keep the non-profit's thinking fresh and ensure that member needs and the non-profit's overall mission are being met.

Directors should also be aware of the importance of stakeholder engagement and the approach taken to engage stakeholders on decisions and strategy. Stakeholders can, in this instance, include relevant government departments, funders and sponsors, industrial bodies, education providers, research institutes and collaborators and community interest groups.

Non-profit entities should have a policy in place for communicating and engaging with stakeholders to ensure a consistent approach is taken across the non-profit entity and that discussions with the relevant key and critical stakeholders (government departments) are not approached on an 'ad hoc' individual basis.

Identification, management and mitigation of risk

Risk management is a critical function for any organisation, particularly the board. non-profit boards have some unique risks that require additional consideration, including ensuring the health and safety of staff and volunteers – who can often be placed in dangerous situations. For example, non-profits that provide health and support services to mental health patients may have volunteers who assist in delivering these services. The volatile nature of members may place these volunteers at risk of injury or stress. To adequately fulfil their duties, directors need to ensure that they are cognisant of the unique circumstances and potential legal, reputational and physical risks that exist within their operations.

Resilience to long-term and emerging risks

Long-term strategic initiatives with a focus on sustainable functionality, and the non-profit entity's ability/agility to respond to varying external impacts/challenges, are critical for both corporate and non-profit boards.

However, the ability of an non-profit entity to continue to deliver community services in the face of long-term social and environmental challenges needs to be understood and scenario tested within the non-profit entity's risk tolerance and risk appetite frameworks. For example, the World Economic Forum lists issues such as ageing population, growing income disparity, natural resources shortages, increasing urbanisation, climate change and cyber disruption as key long-term global risks. non-profit entities providing community services to support, for example, 'at risk' communities (e.g. elderly, disadvantaged), protection of the environment, provision of health services etc. need to understand the potential risks and impacts on their ability to provide services. This includes identifying potential opportunities associated with these emerging risks, for example, new funding opportunities may eventuate in research and innovation around new areas of community need and support.

The chapter titled *Corporate Sustainability* provides more insight into the role of boards in managing sustainability risks and developing response strategies.

Similarly, it is critical that non-profits are aware of both the risks and opportunities generated by social media. The nature and volume of (mis)information spread through social media (and the speed at which this can occur) creates enormous reputational risk that can significantly impact any organisation's 'social licence to operate'. This is a particularly high risk for non-profits that are often in highly competitive funding environments. Conversely, the opportunities that social media can create for non-profits is also large and somewhat untapped. Awareness, support and even fundraising activities can be more quickly and effectively achieved through the reach and power of social media.

As for all organisations, directors need to ensure that the non-profit entity has in place a detailed risk management plan that is reviewed regularly. The board or sub-committee will often have responsibility for identifying risks and mitigation strategies, and endorsing actions when issues emerge.

Efficient and effective ability to monitor progress using agreed key performance indicators

In many non-profit entities, the expectation of transparent and timely disclosure of performance is critical to ensuring ongoing viability, by demonstrating progress towards ongoing positive contributions to member/constituent and public benefit.

Measuring progress against objectives via sound planning and governance processes is therefore critical for any non-profit entity to maximise the opportunities for ongoing funding and support from stakeholders.

Receiving assurance

Assurance over non-profit entities sits with different assurance and investigative bodies within the regulators that apply to the non-profit entity.

Incorporated associations in Hong Kong are governed by the Companies Ordinance. As per the Companies Ordinance, all incorporated companies in Hong Kong are required to have an annual audit of their financial statements performed by a Hong Kong practicing Certified Public Accounts.

Approximately 18 months after the incorporation of the company in Hong Kong, organisations will receive the first tax return form, issued by the IRD. Once done with the completion of the Profits Tax Returns form, it is required to submit along with the audit report and tax computation.

Useful resources:

– *Tax Guide for Charitable Institutions and Trusts of a Public Character (April 2020), IRD*
  https://www.ird.gov.hk/eng/pdf/tax_guide_for_charities.pdf

– *Search for Tax-Exempt Charities, IRD*
  https://www.ird.gov.hk/eng/tax/ach_search.htm

– *Setting up a charity in Hong Kong, Charltons*
  https://www.charltonslaw.com/hong-kong-law/setting-up-a-charity-in-hong-kong/

4. Private Limited Companies

Private limited companies are the most common company type in Hong Kong. This Chapter outlines the key differences between private companies and other company types.

In this chapter

– Key differences between public companies and private companies
– Approaches to governance
– Financial statements requirements
– Crowd-sourced funding

Questions that company directors should ask

1. Has the company adopted a constitution or is it governed by the Companies Ordinance?
2. Is there an overarching shareholders' agreement or trust deed (for those private limited companies that act as trustee of a trust) to be considered in conjunction with the company constitution/Replaceable Rules?
3. If the company pre-dates the mid-1990s, has the board considered proposing the adoption of a new constitution to the company member(s)?
4. If the company is a wholly owned subsidiary, does the company's constitution include the relevant clause to support this?
5. If the company is a family enterprise, does the company's share capital structure adequately facilitate the long-term succession of the company to the next generation?
6. If the company intends to avail itself of crowd-sourced funding, is it correctly structured to do so?
7. If the company is part of a larger group structure, is an up-to-date group structure chart maintained and readily available/accessible?
8. Has the company adequately maintained its financial records, minute book and statutory registers?
9. Is the company required to prepare, audit and/or lodge annual financial statements?
10. If the company is availing itself of relief from the requirement to prepare, audit and/or lodge annual financial statements, does the company adhere to the ongoing relief requirements?

Red flags

1. The board has not given adequate consideration to (or review of) the insurance of the company and its officers against possible liabilities.
2. The family enterprise has not given due consideration to the governance of the family versus the governance of the business.
3. Multiple subsidiaries exist in the group, but there is no up-to-date group structure readily available (and it is unclear who is responsible for maintaining it).
4. Financial records and/or inter-group transactions are not properly documented.
5. A directorship search reveals multiple out-of-date and/or inconsistent details for a director.
6. The company's memorandum and articles of association pre-date the mid-1990s and no consideration has been given to their review and/or adoption of a new constitution.
7. The directors are unaware of (and/or do not refer to) the existence of an overarching shareholders' agreement or trust deed.
8. The company is not adequately structured for the long-term strategic goals or succession planning of the enterprise.
9. If the company is availing itself of relief from the requirement to prepare, audit and/or lodge annual financial statements, the directors do not ensure that the company continues to satisfy the ongoing relief requirements.

Key differences between public companies and private companies

The majority of registered companies in Hong Kong are private limited companies. Like public companies, private companies offer a limited liability to its members. However, there are a number of key differences between public and private limited companies, including:

- Private companies are limited by shares (or by an unlimited company with a share capital) and are 'for profit' in nature (i.e. they cannot be used for non-profit purposes, unlike public companies that can be limited by guarantee and registered as not-for-profit organisations).
- They are not permitted to offer/sell shares directly to the public that would require disclosure under Chapter 6D of the Companies Ordinance.
- They are limited to a maximum of 50 (non-employee) shareholders.
- They are not able to list on the HKEX and, therefore, are not subject to the HKEX's Listing Rules.
- A minimum of one individual director and unlimited maximum number of directors allowed for private companies.
- There are no restrictions as to the place at which board meetings can be held.
- Directors may be permitted to vote on matters where there is a personal material interest being considered at a directors' meeting. [56]
- Private or guarantee companies meeting the qualifying criteria for 'reporting exemption' (such as a small private company with total revenue not exceeding $100 million) are permitted to prepare simplified financial reports and directors' reports. [57]

The majority of these reforms were made to the corporations legislation. Therefore, companies whose memorandum and articles of association ("M&As") refer to pre-1990s corporate legislation may not be able to avail of these reduced requirements. In such instances, the company's M&As may need to be amended or repealed and replaced by the adoption of a modern constitution document.

It is important to note that the reduced requirements under the Companies Ordinance do not lessen the company and directors' exposure under other legislation, and should consider insuring against liabilities, where possible and appropriate.

56. Companies Ordinance (Cap. 622), Section 536
57. Refer to *FAQ on Companies Ordinance: Accounts and Audit*, Companies Registry, Questions 3 to 10 (https://www.cr.gov.hk/en/faq/companies-ordinance/co-account-audit.htm)

Approaches to governance

The governance of a private company can vary immensely depending on its structure and purpose. Regardless of the simplicity of the company structure, all directors are still subject to their fiduciary duties, including but not limited to:

– the duty to act in good faith and exercise power for a proper purpose

– the duty to exercise skill and care.

They are also subject to other statutory duties, including the duty not to trade while insolvent.

In respect to directors' remuneration, the constitution should set out the mechanisms for the approval and reporting of directors' remuneration. Constitutions may contain more specificity concerning the approval and reporting mechanisms.

Sole director/member

A sole director/member company is the simplest of company structures. The Companies Ordinance includes a number of clauses that relate specifically to these companies.

Trustee companies

It is common for trusts to appoint a corporate trustee, rather than individual trustees. This applies to private family trusts and unit trusts. The management of the trustee company's affairs will typically parallel those of the underlying trust, however, the assets of the entity will lie in the trust rather than the company.

Family enterprises

Family enterprises can often take the form of a private company. The governance of the family is distinct from the governance of the family enterprise. Good family governance is a framework within which the family and the family enterprise can work together for mutual benefit and for the benefit of the individuals. Clarity and alignment within the family enables the family to work cohesively towards its collective aspirations, and balance the needs and goals of individuals with the needs and goals of the collective family and the family enterprise.

It is important to clearly differentiate between the roles of owners, managers and other stakeholders in a family enterprise. A family enterprise's constitution is often complemented by a shareholders' agreement and/or a family constitution document. These additional layers of governance support the long-term strategy and succession planning for the family enterprise.

The classic pitfalls of nepotism, inequality and blurred boundaries commonly arise as the family enterprise matures, and can become more pronounced at times when the family enterprise is going through a significant change, such as a transition to the next generation. It is important that advisers to the family enterprise recognise these pitfalls and work with the family and the family enterprise to educate and guide decision-making.

Wholly-owned subsidiaries

Wholly-owned subsidiaries differ in nature by virtue of being owned and controlled by a parent company. The parent company can be another Hong Kong company or a foreign-registered company.

Directors of large groups should ensure that an up-to- date group structure is maintained and readily available, and assign responsibility for it to an appropriate director or member of management.

The directors of a wholly-owned subsidiary can be taken to be acting in good faith in the best interests of the subsidiary, if:

- the constitution of the subsidiary company expressly authorises the director to act in the best interests of the parent company; and
- the director acts in good faith in the best interests of the parent company; and
- the subsidiary is not insolvent at the time of the director's acts and does not become insolvent because of the director's acts.

Details of delegated authorities are usually captured in the corporate group's delegations policy. However, a group's delegations of authority may not provide clarity on whether the directors of a subsidiary company have a right to approve major transactions. In such cases, directors should seek clarification from the owner of the group delegations policy. A failure to consider important transactions undertaken by the subsidiary company could potentially place directors in breach of their duty to exercise skill and care. Directors should also take care that loan agreements and debt forgiveness between group entities is also adequately documented.

Financial statements requirements

Section 286 of the Companies Ordinance requires all companies' financial records to be kept for at least seven years after the transactions covered by the records are complete. They must correctly record and explain the company's transactions, financial position and performance, and allow true and fair financial statements to be prepared. This obligation exists regardless of whether the company's books and records are maintained in-house or outsourced to a third party, and whether they are electronic or not. Even if the company's records are held by someone else (e.g. an accountant), the directors, as company officeholders, are still responsible for providing copies to auditors or anyone entitled to inspect the records.

It is mandatory for companies to prepare and maintain accounts. Accounts must be audited annually by Certified Public Accounts in Hong Kong. The audited accounts together with tax return must be filed annually with the IRD. Every company is required to file annual returns with the Companies Registry.

Sections 397 and 388 of the Companies Ordinance outlines which companies must prepare annual financial reports and directors' reports. The annual report must also contain information on the risks and challenges that the company faces and any other issues which may impact on the performance of the company in the future. In circumstances where the disclosure of information about impending developments or matters still under negotiation would, in the directors' opinion, be seriously prejudicial to the company's interests, disclosure may be excused.

Small and medium enterprise

The Hong Kong government generally defines SMEs as any manufacturing business which employs fewer than 100 persons in Hong Kong or any non-manufacturing business which employs fewer than 50 persons in Hong Kong. This covers a variety of types of business; sole traders, partnerships, listed and unlisted, family and closely held companies. Listed companies are subject to more rules including the HKEX's Listing Rules for the Main Board or GEM and the systems of corporate governance mandated by them.

If a company satisfies the 'reporting exemption' criteria as set out in Section 359 of the Companies Ordinance, it will qualify for reporting under the Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard. Effective from financial year beginning on or after 1 February 2019, the 'reporting exemption' extends to the groups that may consist of Hong Kong and non-Hong Kong incorporated body corporates and mixed groups (i.e. groups comprising a mix of small private companies, eligible private companies and small guarantee companies). Such criteria are highlighted in Paragraphs 22 to 43 of *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* (Revised March 2020) by HKICPA.

Crowd-sourced funding

Crowd-sourced funding is a financial service where start-ups and small businesses raise funds, generally from a large number of investors that invest small amounts of money.

Hong Kong has not introduced specific laws or regulations in relation to crowd-funding. Crowd-funding activities such as peer-to-peer lending in Hong Kong and equity crowd-funding are potentially subject to the following Hong Kong regulatory provisions: [58]

- restrictions on offers of shares or debentures to the public under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)
- prohibition on the issue of unauthorised invitations to the public under Section 103(1) of the SFO
- prohibition on carrying on a 'regulated activity' under the SFO without being licensed/registered to do so by the SFC
- prohibition on carrying on a money lending business without a money lender's licence under Section 7 of the Money Lenders Ordinance (Cap. 163).

58. Refer to *Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities* (May 2014), SFC (https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc%3FrefNo%3D14PR53)

Useful references

- *Companies Ordinance (Cap. 622)*
- *Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)*
- *Securities and Futures Ordinance (Cap. 571)*
- *Money Lenders Ordinance (Cap. 163)*
- *FAQ on Companies Ordinance: Accounts and Audit, Companies Registry, Questions 3 to 10*
  https://www.cr.gov.hk/en/faq/companies-ordinance/co-account-audit.htm
- *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (Revised March 2020), HKICPA*
  https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Members-Handbook-and-Due-Process/HandBook/Volume-II--Financial-Reporting-Standards/SMEFRF--SMEFRS-Revised-February-2019-Small-and-Mediumsized-Entity-Financial-Reporting-Framework-and
- *Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities (May 2014), SFC*
  https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc%3FrefNo%3D14PR53
- *Guidelines on Corporate Governance for SMEs in Hong Kong (3rd edition), HKIoD*
  https://www.hkiod.com/document/corporateguide/sme_guidelines_3rd_edition_eng_final.pdf

Governance Accountability

5. Accountability to Shareholders

Listed public companies are often jointly owned by a relatively large number of separate shareholders, including both individual and institutional shareholders. Individual shareholders (and potential shareholders) have different investment objectives, which are based on varying degrees of financial and commercial understanding, literacy, competency and market intelligence.

In this chapter

Questions that company directors should ask

1. Do the chairman and directors play an active role in the investor relations programme?
2. Are mechanisms in place to capture market intelligence and investor feedback? This may include social media as a dynamic new data source.
3. Is the chairman always well prepared for questions from the floor at the AGM?
4. Are there sufficient skills and experience amongst audit committee members to effectively review statutory reporting obligations?
5. Does the board have a process to ensure that all statutory reporting obligations are met in a timely manner?
6. Is there a continuous disclosure policy approved by the board and linked to the spokesperson policy?
7. Does the board regularly review the effectiveness of its business reporting and communication in assisting investor decision-making?
8. Is the reporting and communication strategy/ investor relations strategy part of the annual strategy development programme?
9. Does the board hold the responsible individuals, committees or functional teams to account where misalignment is observed?

Red flags

1. The board is not aware of the identity or views of major investors.
2. Major marketplace concern regarding executive remuneration incentives.
3. The AGM is a major public relations challenge.
4. There is no social media policy, monitoring or escalation procedures for unfavourable events.
5. The investor relations manager has no contact with the board.
6. There is no strategy of how to handle private equity approaches.
7. Institutional investors publicly voice concerns regarding some of the organisation's governance practices.
8. The regulator expresses concern regarding the timeliness of the organisation's market disclosures.
9. The organisation's business model is not clearly articulated in external communications.
10. The linkage between financial and non-financial reporting is not evident in external communications.
11. A significant protest vote against the company's remuneration report.

The notion of accountability to shareholders is at the core of any corporate governance framework. Shareholders are certainly becoming more active in asserting their rights and many boards are responding by trying to engage with their shareholders more effectively. Nevertheless, boards must balance the equitable treatment of shareholders and the protection of their rights against the need to create sustainable shareholder value.

Protecting shareholders' rights

A basic principle of corporate governance is that it should protect shareholders' rights. These rights typically relate to, but are not limited to:

– declaring dividends in the best interests of shareholders
– receiving information pursuant to the company's continuous disclosure obligations
– approving changes to the company's constitution, articles of association or similar governing documents
– nominating and appointing directors
– receiving continuous disclosure of material developments in the company's affairs
– calling a general meeting of shareholders, and/or proposing a resolution to be considered at a general meeting
– voting at the AGM
– obtaining an independent valuation of their securities
– inspecting the minute books for members' meetings
– suing the corporation for wrongful acts.
– ensuring the fullest communication with shareholders and the company's recognition of their interest.

The board's role

Governance authorities suggest there are some key board roles in protecting shareholder rights. These include:

– maintaining a detailed understanding of shareholders' rights that are set out in the Companies Ordinance, the HKEX's Listing Rules and other relevant legislation, together with the company's constitution and board policies
– maintaining up-to-date knowledge of the company's nominee shareholders and, to the extent possible, their underlying beneficial shareholders
– ensuring shareholder communication is open and transparent
– ensuring debate on contentious issues is embraced and prepared for
– implementation of shareholder proposals approved by a majority of votes/proxies cast at a general meeting.
– being accountable – the directors should be held accountable for their actions or inactions, and where appropriate, take the shareholders' and stakeholders' views into account in their decisions [59]

59. Paragraph B(e) of the Mandatory Disclosure Requirements of the Corporate Governance Code

Enhancing communications with shareholders

Dialogues and two-way engagement with the shareholders are highly appreciated in an effective board. The CG Code has required listed companies to disclose their shareholder communication policy[60]. Listed companies should:

- Set out the communication channels available for the shareholders to express their view;
- Disclose the steps taken by the issuer to solicit and understand the views of the shareholders and the stakeholders, and;
- Disclose actions taken (or to be taken) following the review of the policy and the metrics for measuring the outcome.

In addition, to enhance communications with the shareholders, the board of a company can also:

- Appoint a suitably qualified senior investor relations officer who has access to the board;
- Formalise periodic meetings with the shareholders;
- Enhance disclosure in respect of INEDs' contribution or work done during the year in the annual report;
- Disclose quantitative metrics of INEDs' engagement with the independent shareholders, such as the number of meetings held directly with the independent shareholders;
- Make themselves available for direct communication with the shareholders, where appropriate;
- Conduct board evaluations and disclosing a summary of it in the annual report and/or the corporate governance report; and
- Appointing one of the INEDs to be the lead or senior INED to provide a sounding board for the chairman in situations where the chairman is conflicted or unavailable to act, and to serve as an intermediary for the other directors and the shareholders (where contact through the normal communication channels are inappropriate or inadequate)

Further information for shareholders

Shareholders are always keen to know more about the actions taken by the company to assess whether the company can create financial and non-financial values to them over the longer-term. Set out below are some scenarios where the company can provide further information to the shareholders (in addition to the information required under the Rules):

Director's appointment

- Succession plan of the company
- Remuneration package of a newly appointed director

Notifiable and connected transactions

- Rationale and the commercial benefits
- Material risks of the transaction;

Business outlook

- The company's purpose, values and strategy
- The company's business strategies going forward
- The company's plans to cope with an economic downturn or a global pandemic

60. Paragraph L of the Mandatory Disclosure Requirements of the Corporate Governance Code

Shareholders' responsibilities

Shareholders have different investment objectives; some invest for short-term gain, some for long-term value and others for socially responsible reasons. Companies with an effective approach to investor relations will understand the objectives of different investor groups and key individual investors. Communication and active engagement with shareholders generates feedback on investor concerns. Certain shareholders, particularly some institutional shareholders, are becoming more assertive in protecting their own rights and are taking various measures to influence the companies in which they invest. These measures include:

- communicating with the company openly and transparently.
- adopting a clear, comprehensive and pragmatic view of what constitutes good corporate governance.
- understanding and monitoring company performance and providing feedback to the company.
- teaming with like-minded shareholders to exert a collective influence.
- lobbying and targeted activism.
- engaging with the company's board in times of crisis, or with regard to major transactions, such as takeovers, mergers and private equity approaches, and capital raisings.
- adopting consistent positions, where appropriate, on particular issues and voting accordingly.
- publishing governance guidelines.

Below are two case studies which have illustrated the importance of accountability to shareholders.

PAH Case Study

Power Assets Holdings Ltd. and Cheung Kong Infrastructure Holdings Limited (2015)

In 2015, the minority shareholders of Power Assets Holdings Ltd. ("PAH") campaigned against the proposed merger of Cheung Kong Infrastructure Holdings Limited ("CKI") and PAH which involved a Scheme of cancellation of all PAH shares in exchange for new CKI shares. The campaign was based on the grounds that he proposed share exchange ratio and the proposed special dividend for all CKI shareholders post-merger were too low.

A PAH Court Meeting was held on Tuesday, 24 November 2015. A vote was casted in the Court Meeting where the Scheme was not approved by the disinterested PAH shareholders which represented at least 75% of the voting rights of disinterested PAH shareholders. As a result, the Scheme was not implemented and has therefore lapsed.

BlackRock Case Study

BlackRock and G-Resources Group Limited (2016)

BlackRock, a minority shareholder in G-Resources Group Limited, launched a campaign against G-Resources Group Limited's proposed disposal of its main asset, an Indonesian goldmine. BlackRock created a website and published a letter to urge other shareholders to vote against the proposed disposal at the special general meeting. The campaign failed as the majority of the shareholders voted in favour of the transaction.

Useful tools

SMARTS Market Surveillance Solution

The HKEX was the first customer of NASDAQ to successfully deploy the SMARTS Market Surveillance Solution in 2018. By implementing the machine learning technology, SMARTS analyses unusual trading activities and suggest categorisation to surveillance analysts.

Shareholders convening meetings

Section 566(2) of the Companies Ordinance requires directors of a company to call and arrange to hold a general meeting at the request of members with at least five percent of the votes that may be cast at a general meeting. If the directors fail to call a meeting within 21 days from the date when the board receives the requisition, the shareholders representing over 50% of the total voting rights may call a meeting by themselves In addition, any reasonable expenses incurred by the members requesting the meeting by reason of the failure of the directors duly to call a meeting must be reimbursed by the company.[61]

Shareholders have used the calling of general meetings as a platform to help promote political and social responsibility, notwithstanding that the proposed resolutions might have a very low prospect of success or do not seek to maximise shareholder returns.

61. Companies Ordinance (Cap. 622), Section 566

Shareholders participating in decision-making

For both private and public companies, minority shareholders may not have an effective involvement in or control over decision-making or management.

Subject to the Companies Ordinance and the articles of association of the company, the business and affairs of the company are generally managed by the directors unless otherwise specified in the articles of association or shareholders' agreement (in the case of private companies) or required to be approved by shareholders at general meetings (in the case of listed companies).

Subject to the foregoing, shareholders cannot by ordinary resolution give directions to the board of directors in respect of the matters entrusted to them under the articles of association. In pursuance of the model articles of association for private companies limited by shares, residual power is conferred upon the shareholders with the majority of voting power to direct, by special resolution, the directors to take or refrain from taking a specified action.

If the board is ineffective, the power which in effect has been delegated by the articles of association to the directors reverts to the shareholders who delegated such powers in the general meetings. [62]

Subject to the articles of association, the quorum for a general meeting is two and every shareholder has the right to vote by show of hands unless a poll is demanded. If voting on poll is demanded, each shareholder has one vote for each share such member is holding. Important decisions such as alteration of the articles of association, dispensing with the requirement to hold an AGM and reduction of the share capital must be passed by the majority of 75% or more of votes or by a special resolution at a general meeting. The articles of association may also specify a list of matters which require the unanimous consent of all shareholders, whereby protecting the interests of the minority shareholders with 25% or lower of voting rights.

For listed companies, the procedures for general meetings are provided in the constitutional documents of the company. Listed Companies must also comply with the Main Board Listing Rules relating to meetings of shareholders. Generally, an AGM of a listed company shall be called by at least 21 days' notice in writing and an extraordinary general meeting ("EGM") shall be called by at least 14 days' notice in writing (in each case exclusive of the day on which the notice is served or deemed to be served and of the day for which it is given). The notice shall specify the place, the day and the hour of meeting and, in the case of special business, the general nature of that business. Rule 13.39(4) of the Main Board Listing Rules provides that any vote of shareholders at a general meeting must be taken by poll except where the chairman, in good faith, decides to allow a resolution which relates purely to a procedural or administrative matter to be voted on by a show of hands.

62. Refer to *Miracle Chance Ltd v Ho Yuk Wah, David (1999)*

To ensure the effective participation of all shareholders, every shareholder of the company is entitled to receive notice at least 21 days prior to an AGM and at least 14 days prior to an EGM in the case of a limited company and at least 7 days prior to an EGM in the case of an unlimited company. If the company's articles of association require a longer period of notice than specified above, a general meeting of a company (other than an adjourned meeting) must be called by notice of that longer period. It is possible for the shareholders to accept a shorter notice if the notice is in writing and that the shorter notice is agreed by all shareholders in the case of AGM or by shareholders representing 95% or more of voting rights in the case of EGM. [63]

A notice of meeting must state the place and time of the meeting and the nature of matters to be discussed at the meeting. [64] The discretion of the directors to determine the particulars of a meeting must be exercised in the best interest of the company as a whole. An invalid notice or a notice that does not adequately describe the nature of business of the meeting may render the meeting invalid. [65]

63. Companies Ordinance (Cap. 622), Section 571
64. Companies Ordinance (Cap. 622), Sections 574, 575, 576
65. Cannon v Trask (1875) 20 Eq 669;
Byng v London Life Association (1990) Ch 170, CA;
Kaye v Croydon Tramways Co (1898) 1 Ch 358

The directors' role in investor relations

The board's role in formal investor relations continues to evolve. Many non-executive directors are now seeking to become more active in their companies' investor relations programmes.

The investor relations function continues to increase in strategic importance. Investor relations teams have increasingly become responsible for communications, not only with the investment community, but also with internal stakeholders such as the board of directors, management and employees, by becoming responsible for, or at least influencing, coherent company messaging.

Boards are exposed to a number of risks if their organisation has inadequate investor relations expertise: regulatory risk (continuous disclosure and class actions), poor/lack of communication of strategy and performance to investors, and expectation for information to be publicly available in liquid markets for accuracy of share price valuation. Large companies operate in multiple dynamic, volatile markets and jurisdictions, with diverse investors with different goals requiring different communication strategies. Additionally, the risk of misleading and deceptive information being publicised on social media heightens companies' obligations to meticulously inspect their sources of information and make proper corrections. Boards need to understand their shareholders and shareholder segments, communicate their strategy, performance and ESG activities appropriately, and ensure the strategy is aligned to the company's best interests (being the interests of their shareholders as a whole).

At a minimum, and in conjunction with the board chairman's traditional investor relations responsibilities, the board should approve any policies that control investor relations engagement risks. The board should also provide input into, and approve, the investor relations strategy as well as regularly monitoring investor relations activities. This strategy typically addresses an organisation's approach, performance targets and accountabilities for:

- shareholder and key stakeholder analysis and engagement planning
- shareholder services (including share registry and transactional support)
- investor targeting initiatives
- shareholder and key stakeholder communications
- media and public relations initiatives (including brand and reputation management)
- market intelligence and feedback mechanisms.

Directors should pay attention to the latest developments in areas, including laws and regulations, the Rules, as well as industry-specific and innovative changes to enable them to discharge their duties and responsibilities. Induction training should be provided to the company's new directors and continuous professional developments should be provided to the current directors by the company.

Institutional shareholders' role in governance

Several sets of best practice principles have been published, addressing the responsibilities of institutional investors. One such example includes the International Corporate Governance Network's *ICGN Statement of Principles on Institutional Investor Responsibilities* (30 November 2013), which sets out its view of the responsibilities of institutional investors in relation to their external role as shareholders and also in relation to internal governance. With respect to voting responsibilities, the statement suggests that institutional investors should:

- disclose an annual summary of their voting records, together with their full voting records in important cases
- seek to reach a clear decision, in favour or against, for each resolution on which they are expected to vote
- disclose details of any outsourcing of ownership responsibilities (including the names of agents to whom they have outsourced, together with a description of the nature and extent of outsourcing and how it is regularly monitored).

Effective annual general meeting ("AGM")

AGMs are governed by the Companies Ordinance[66], the company's constitution and common law. In the case of meetings of listed companies, public companies must hold an AGM of shareholders.

For many public companies the AGM is a major exercise in shareholder communication and investor relations. The AGM offers shareholders a unique opportunity to question the board, express their views on company performance and suggest changes to company governance and operations.

As well as a forum for communication and discussion, the business of the AGM primarily considers the financial report and auditor's report, together with resolutions to approve the directors' report, and a resolution for adoption of the remuneration report, and may include consideration of the appointment and remuneration of the auditor and the election of directors. Where the business of the meeting relates to the election (or re-election) of directors, shareholders will expect those directors to address them at the meeting.

The Corporate Governance Code states that an issuer's management should ensure the external auditor attend the AGM to answer questions about the conduct of the audit, the preparation and content of the auditor's report, the accounting policies and auditor independence.[67]

The following are some key considerations for AGMs:

- A hostile AGM is rarely the result of spontaneous combustion. Boards in touch with shareholder concerns will anticipate and embrace debate on contentious issues.
- Boards and management should spend time trying to anticipate specific shareholder questions and develop appropriate responses. Speakers should be identified in advance to respond to specific issues.
- Difficult or contentious questions can sometimes be short-circuited by raising and answering them in the annual report, or in the formal chairman's address to the meeting.
- Shareholders can be invited to submit questions prior to the AGM.
- Shareholders should be able to access a webcast of the meeting.
- The chairman should be thoroughly familiar with the AGM agenda and meeting procedures, and have developed an approach for dealing with difficult or hostile 'responses' from the floor of the meeting.
- The chairman must allow a reasonable opportunity for members to ask questions about, or make comments on, the management of the company.

66. Companies Ordinance (Cap. 622), Section 610
67. Corporate Governance Code, Part 2, Section F.2.2

Statutory reporting

Shareholder and investor communication starts with statutory reporting. For HKEX listed companies, statutory reporting is based on:

- the Companies Ordinance Regulations
- the Hong Kong Financial Reporting Standards ("HKFRS") and Hong Kong Accounting Standards (HKAS), including interpretations issued by the HKICPA
- the SFC Legislative Instruments that apply to the organisation
- the HKEX's Listing Rules
- the HKEX's Corporate Governance Code.

The key elements of the statutory reporting portfolio for listed companies include:

- an interim report, a preliminary final report and an annual audited financial report and directors' report (including the remuneration report)
- an annual Corporate Governance Statement and accompanying disclosure requirements as per the Corporate Governance Code
- notices for AGM
- additional disclosure requirements involving takeovers and new share issues.

Whilst it is common practice for the board to allocate the oversight of statutory reporting to its audit committee or equivalent, it is unable to abrogate its ultimate responsibility for the accurate and thorough preparation and timely release of statutory reports. Consequently, all directors need to understand not only the content of the reports, but what reports are required and by which authorities.

The HKEX guidance suggests if directors take on a role with special responsibilities, such as the chairman of an audit committee or the role of an executive director, they must discharge the increased responsibilities expected of directors in such positions with appropriate care and diligence.

Boards need to exercise appropriate due diligence in matters of financial disclosure. False or misleading statements could leave directors personally liable under the Companies Ordinance and SFC regulations.

Boards should also insist that effective systems are in place to ensure all formal shareholder and investor communications (including financial reports):

- result from a designated approvals process
- include all the information required by the relevant laws and standards
- adhere to statutory timing requirements
- follow the format prescribed by the relevant laws and standards
- produce information that is accurate and not false or misleading (including by way of omission).

Some companies may also have reporting requirements to overseas regulators. For example, the US Securities and Exchange Commission ("SEC") requires foreign registrants to file a number of reports and documents, including the comprehensive Form 20-F Annual Report of a Foreign Private Issuer.

In Hong Kong, Section 441 of the Companies Ordinance provides companies (other than those falling within the reporting exemption) with a choice of sending a copy of the summary financial report instead of a copy of the full reporting documents[68] to their members.

Corporate Governance Report

HKEX listed companies must include a Corporate Governance Report prepared by the board of directors in their summary financial reports (if any) and annual reports under the HKEX Listing Rules. The issuers must include the following information for the accounting period covered by the annual report and significant subsequent events for the period up to the date of publication of the annual report, to the extent possible:

- Corporate governance practices
- Board of directors
- Non-executive directors
- Board Diversity
- Board committees
- Chairman and chief executive
- Company secretary
- Directors' securities transactions
- Shareholder's rights
- Risk management and internal control
- Auditor's remuneration and auditor related matters
- Investor relations

68. Section 357(2) of the Companies Ordinance interprets the reporting documents as the financial statements, directors' report and auditor's report

Statutory reporting content

Detailed guidance on the contents of the financial statements and notes to the financial statements can be obtained from KPMG's *Guides to HKFRS financial statements*[69] series of publications.

Annual report

Depending on the entity's structure and jurisdiction, there are varying reporting requirements that must be adhered to. Directors should be aware of the reporting requirements and obligations applicable to the jurisdiction in which they operate. For example, an HKEX listed entity is required to adhere to the statutory reporting requirements outlined in the previous section and any other applicable legislation relating to the entity type. For this reason, the contents of an annual report should include, at a minimum:

- full set of financial statements, as defined by HKAS 1, including the statement of financial position, statement of profit and loss and other comprehensive income, statement of cash flows, statement of changes in equity and explanatory notes
- directors' report (including the remuneration report)
- directors' declaration
- auditor's report and independence declaration
- corporate governance statement.

69. https://home.kpmg/cn/en/home/insights/2010/12/illustrative-financial-statements.html

Increasingly, however, companies are choosing to include additional material in their annual reports. Emerging areas of optional reporting include sustainability, diversity, corporate citizenship and global taxation summaries, which are being used to not only satisfy stakeholder demands for extra information, but also as a proactive step in the stakeholder management process.

Directors' report

The directors must prepare a directors' report made in accordance with a resolution of the directors, which is signed by a director.[70] The directors' report requirements are dependent on the nature of the company.[71] The required reporting obligations will vary for companies which are listed, limited by guarantee, large private companies and listed or unlisted registered schemes.

Directors' remuneration report

Section 383 of the Companies Ordinance requires that the financial statements of a company incorporated in Hong Kong must contain, in the notes to the financial statements, the information prescribed by the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G) in relation to the following:

- directors' emoluments
- directors' retirement benefits
- payments made or benefit provided in respect of the termination of the service of directors
- consideration provided to or receivable by third parties for making available the services of a person as director.

The HKICPA's Accounting Bulletin 3 (Revised) Guidance on Disclosure of Directors' Remuneration issued in November 2017 sets out the guidelines on financial reporting requirements that companies should observe.

All listed companies in Hong Kong are required under the Listing Rules[72] to disclose in its financial statements, on a named basis, details of directors' and past directors' emoluments. Such details include the directors' fees for the financial year, their basic salaries as well as other allowances (e.g. housing allowances) and benefits in kind, contributions to pension schemes and bonuses paid for directors, etc.

70. Companies Ordinance (Cap. 622), Sections 388, 391
71. Companies Ordinance (Cap. 622), Section 390
72. Chapter 17 of the Listing Rules, Rule 17.07; Appendix 16 to the Listing Rules, Paragraphs 24, 28

Directors' declaration

The directors should acknowledge in the Corporate Governance Report their responsibility for preparing the accounts. [73].

For listed entities, a resolution must be passed by the directors on approving the annual report. In accordance with Part 2, Section D.2 of the Corporate Governance Code, directors confirm that in their opinion it has been formed on the basis of a sound system of risk management and internal control which is operating effectively[74].

The Companies Ordinance[75] establishes a uniform solvency test for buy backs, financial assistance and reductions of share capital. When making a solvency statement, directors are not required to obtain an auditor's report or rely on audited accounts, but they shall still have reasonable grounds in forming their opinion. Directors must make due enquiries on the company's state of affairs and prospects. The appropriateness of engaging professional assistance should also be considered. Apart from causing additional expenses and delays, third party advisers (such as auditors or financial advisers) may not be in a better position than the directors in ascertaining the company's solvency, which involves forward-looking business judgments.

When forming its opinion for the purpose of making a solvency statement, a board is obliged to consider the debts of the company as at the date of the statement, not merely those debts included in the balance sheet as at balance date. The solvency statement should contain a prospective element encompassing expected future debts that will compete for payment with existing debts. For this reason, directors should obtain all relevant information so that they can form an opinion about the company's solvency.[76]

The basis of a board's resolution on solvency should be minuted. If all directors do not support the resolution, the resolution should indicate this fact. Those dissenting from the resolution should be identified and their reasons stated. A board may qualify its statement. This could occur, for example, if there is a material uncertainty about the company's ability to renegotiate loans for repayment. A qualified statement will not of itself limit the liability of directors, nor will it operate as a substitute for the proper discharge of their duties.

When a holding company wants to take advantage of the legislative instrument giving accounts and audit relief to wholly-owned subsidiaries, the directors of the holding company must consider the solvency of the entire group of companies subject to the class order, not just that of the holding company.

73. Corporate Governance Code, Part 2, Section D.1
74. Corporate Governance Code, Part 2, Section D.2
75. Refer to *New Companies Ordinance: Key Considerations for Directors*, HKIoD
76. Companies Ordinance (Cap. 622), Section 206.2(b)

Auditor's report

An auditor must report to members on whether the auditor is of the opinion that the financial report is in accordance with the Companies Ordinance, including compliance with Hong Kong Accounting Standards and International Financial Reporting Standards, and that the financial report provides a true and fair view of the financial position and performance for the financial year.[77]

The auditor's report must also describe any defect or irregularity in the financial report and any deficiency, failure or shortcoming relating to:

- obtaining all information, explanations and assistance necessary for the conduct of the audit
- keeping sufficient financial records to enable a financial report to be prepared and audited
- keeping other records and registers required by law.[78]

The auditor must also provide the directors with a written declaration as to the auditor's independence.[82] Most commonly, this declaration is carried over to the annual report for inclusion within the directors' report.

Other disclosures in the annual report

The HKEX's Listing Rules require listed entities to produce a corporate governance statement which describes the extent to which an entity has followed the recommendations set out in the HKEX Principles during the relevant reporting period.[79] The HKEX Principles are not prescriptive, but a company that does not follow the recommendations must explain why, on an "if not, why not" (or "report or explain") basis. A company can publish its corporate governance statement in its annual report or provide a link to where the statement is located, or otherwise provide a separate copy of its corporate governance statement to the HKEX at the same time that it provides its annual report.[80]

Further disclosures are also required, for examples, the number of board meetings held during the year, attendance by directors at board and general meetings and a statement of the board's and management's respective responsibilities and accountabilities.

77. Companies Ordinance (Cap. 622), Sections 123, 126
78. Companies Ordinance (Cap. 622), Section 407
79. Refer to Appendix 21 to the Listing Rules
80. Refer to Corporate Governance Code

In addition to statutory disclosures, some companies include additional information in their annual reports, such as overviews of business strategies and key drivers, and non-financial performance measures, and they convey these areas using snapshots, charts, artwork and photographs. Whilst often published under a separate report, many organisations are moving towards using the annual report to disclose their environmental achievements and compliance record, and to report on various community, social and 'corporate citizenship' initiatives.

In approving the content and format of annual reports, boards should keep in mind the following points:

– as far as directors are concerned, the annual financial reporting parts of annual reports are legal documents - compliance with the legal requirements remains a key consideration for any board

– awareness of annual reporting 'best practice' for the nature and extent of disclosure, and for the presentation of information

– good reports usually incorporate a straightforward, logical and accurate account of the company's performance, together with a simple explanation of how the company intends to tackle the opportunities and problems confronting it

– whether it is more suitable to make the annual report readily available online or to distribute hard copies to shareholders.

In considering what additional disclosures may be appropriate, directors should refer to HKEX's *Guidance for applicants on the presentation of the non-GAAP financial measures in a listing document and any relevant documents pursuant to the Exchange's Listing Rules* published in April 2019.

Simplified Financial Reporting

The Companies Ordinance now permits qualified companies to prepare simplified financial reporting to cut down on compliance costs. However, management should carefully consider all pros and cons of switching to simplified reporting. Contractual obligations to third parties, such as banks, investors or suppliers, may require financial statements to be prepared according to certain standards. If the company is part of a listed group that has to prepare consolidated HKFRS or International Financial Reporting Standards ("IFRS") financial statements, it may increase time and costs to consolidate simplified financial statements.

Interim reports

A disclosing entity must prepare a financial report and directors' report for each half-year and have the financial report audited or reviewed. [81] More detailed guidance on interim reports can be obtained from KPMG's *Guides to HKFRS financial statements*.

81. Companies Ordinance (Cap. 622), Section 302

The interim report may be either reviewed or audited, although in Hong Kong an interim report would only be audited in exceptional circumstances. Accordingly, the level of assurance provided by the auditor is dependent on the directors' choice.

Recent examples – Hong Kong insider trading convictions against directors

	Interim review	Interim audit
Level of assurance	Limited	Reasonable
Scope of work completed	Lower	Higher
Type of work completed	Generally extends only to inquiry of management and analytical procedures on financial information.	Extensive. Includes evaluating accounting systems, testing and obtaining third party evidence.
Risk of not detecting errors	Greater	Lower

Audit

An audit (as opposed to a review) is an examination of financial information. As per HKAS 700, it is designed to obtain sufficient, appropriate evidence so the auditor can express a positive opinion that the financial report provides a 'true and fair' view of the company's financial position and performance. The auditor draws on evidence from company and external sources, using where appropriate the company's internal controls and results obtained from substantive procedures. An audit provides a high, but not absolute, level of assurance on the financial information. [82]

A review (as opposed to an audit) indicates that, based on the limited procedures performed, nothing has come to the attention of the auditor that indicates the financial report does not comply with the law. A review adds some degree of assurance to the financial statements, although considerably less than the level achieved by an audit.

The auditor must also describe any defect or irregularity in the financial report and any deficiency, failure or shortcoming relating to:

– obtaining all information, explanations and assistance necessary for the conduct of the audit

– the keeping of financial records sufficient to enable a financial report to be prepared and audited

– the keeping of other records and registers required by the law. [83]

82. Refer to *Practice Note 740: Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules*, HKICPA
83. Companies Ordinance (Cap. 622), Section 406

Where applicable, the auditor must provide details of why the financial report does not comply. The auditor may also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

Audit committee

Rule 3.21 of the HKEX's Listing Rules requires HKEX listed companies to have an audit committee. The audit committee is chaired by an INED and comprises a majority of INEDs. [84]

Boards should ensure that the internal governance systems include adequate involvement of the external auditor, internal audit and the board audit committee. The terms of reference of the audit committee should include a role in the review of significant corporate reporting, including financial disclosures before sign-off by the full board.

While the existence of an audit committee does not alter the need for directors to take responsibility for the financial reports, with the ultimate responsibility for a company's financial statements resting with the board, audit committees can play an important role in the financial reporting process and in supporting and promoting audit quality. A separate audit committee can be an efficient and effective mechanism to bring the transparency, focus and independent judgment needed to the corporate reporting process.

The audit committee typically focuses on a limited range of key issues for statutory reporting purposes. It should review:

– any significant accounting and reporting issues, including professional and regulatory announcements, and understand their effect on the company's financial statements
– all interim and annual financial statements of the company, and any other periodic disclosures, that require approval of the board (the process typically culminates in a detailed page-by-page review by the audit committee of these reports with the external auditor and management present)
– the processes, policies and procedures for compliance with the company's continuous disclosure obligations
– the competency, independence and objectivity of the external auditors

The Code Provisions of the Corporate Governance Code require that an audit committee must meet the issuer's auditor at least twice a year. [85]

In addition, the audit committee is also charged with the responsibility to ensure that the internal audit function (where such function exists) is adequately resourced and has appropriate standing within the issuer, and to review and monitor its effectiveness[86].

84. HKEX Main Board Listing Rules, Rule 3.21 / GEM Rule 5.28

85. Corporate Governance Code, Part 2, Section D.3.3(e)(i)

86. Corporate Governance Code, Part 2, Section D.(d)(i) and D.3.3(i)

Continuous disclosure

Disclosing entities (both listed and unlisted) are subject to continuous disclosure requirements. Unlisted and listed disclosing entities should refer to Schedule 4 of the Companies Ordinance for guidance on complying with their accounting disclosure requirements and also Sections 358, 380 and 911 of the Companies Ordinance. The continuous disclosure requirements of HKEX listed entities are governed by the HKEX's Listing Rules and also Part XIVA of the SFO.

Pursuant to Part XIVA of the SFO, a listed entity must immediately notify the HKEX once it becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, subject to the carve-outs to safe harbours. [87]

Under Rules 31.05 and 31.05A of the Listing Rules, if the HKEX considers that there is, or is likely to be, a false market in the company's securities, then the HKEX may require the company to give the HKEX any information it asks for to correct or prevent that false market. The term "false market" refers to a situation where there is material misinformation or materially incomplete information in the market which is compromising proper price discovery. This may arise, for example, where there is false or misleading information circulating in the market, including a specific rumour or media comment affecting the company's share price. [88]

The HKEX Principles recommend that companies establish and disclose written policies and procedures designed to ensure compliance with the HKEX's Listing Rules disclosure requirements and to ensure accountability at a senior executive level for that compliance. [89]

Each board should establish and approve policies and procedures to ensure the company complies with continuous disclosure requirements and that this is linked with the spokesperson policy. The Corporate Governance Code contains useful information for consideration when formulating a continuous disclosure policy. The policies and procedures for meeting the continuous disclosure requirements should be made publicly available, ideally by posting them on the company's website. A 'balanced' approach to disclosure in reporting both positive and negative information should also be considered.

There are other channels aside from the HKEX company announcements platform that facilitate reporting to the market. These include the company's investor presentations, road shows, annual reports and the company's website. However, it is important to note that where any market-sensitive information is proposed to be released to a section of the market (for instance, at an investor or analysts' briefing), such information must first be announced on the HKEX website in accordance with Section 307C(1) of the SFO before it can be released via any other channel. [90]

Information is considered to be 'generally available' if: it consists of readily observable matter, or; it has been

87. Securities and Futures Ordinance (Cap. 571), Section 307D
88. Main Board Listing Rules, Rule 13.09(1); GEM Listing Rules, Rule 17.10
89. Corporate Governance Code, Part 2, Section C.2.5 and D.2
90. Main Board Listing Rules, Rule 13.09(2)(a); GEM Listing Rules, Rule 17.10(2)(a)

made known in a manner that would, or would be likely to, bring it to the attention of people who would commonly invest in the relevant securities and, since it was made known, a reasonable period for it to be disseminated among such people has elapsed; or it otherwise consists of deductions, conclusions or inferences made or drawn from such matters.[91] The SFC carefully monitors the interaction between disclosure and movements in either volume or the price of shares to identify aberrations that suggest either manipulation or deficient information to the market.

The SFC's *Guidelines on Disclosure of Inside Information* (June 2012) clarify the approach of the SFC to interpreting and enforcing the continuous disclosure requirements under Part XIVA of the SFO, and when the HKEX may refer a possible breach of that rule to the SFC. In addition, the guidelines clarify, among other things, the meaning of 'immediately', the 'reasonable person' test, earnings guidance and surprises, and the use of trading halts to manage disclosure issues.

Under the Guidelines, the meaning of 'immediately' is defined as meaning 'as soon as reasonably practicable', that is doing something as quickly as it can be done in the circumstances (acting promptly) and not deferring, postponing or putting it off to a later time (acting without delay).

There are criminal and civil penalties for breach of the continuous disclosure requirements. Directors may also contravene their duty of care and diligence[92] by not complying with the continuous disclosure obligations.

Investor decision-making

If companies are to maximise returns to their shareholders, they must not only create value, but be seen to have created value and provide prospects for value creation in the future. This is essentially a matter of communicating with shareholders, potential shareholders and third parties in a position to influence investors' share buying, retention and selling decisions.

Regular and effective reporting and communications between the company and these parties influences the decision-making of shareholders and potential investors.

It is, however, widely acknowledged that traditional information flows (e.g. general purpose statutory financial reporting) and engagement practices (e.g. AGMs) do not typically address the broad range of issues of concern to individuals and entities seeking to make timely, accurate and precise decisions on their investments, or potential investments, in the company. Therefore, companies need to address the limitations of traditional reporting to fulfil their intended purpose and seek ways to better inform investors.

A more contemporary model of business reporting and communication that creates reports based on what the company wants to communicate – and on what investors want and need to know – can ensure that shareholders

91. Securities and Futures Ordinance (Cap. 571), Section 307A(1)

92. Securities and Futures Ordinance (Cap. 571), Section 307Y, 307Z. Also refer to Chapter 1 for more information about directors' duties and obligations.

will make the right decisions, at the right time, about the things that matter to the company, particularly investment opportunities. Reporting and communication strategies should be directed to balancing the performance/reward equation and aligning business rewards – capital, licences to operate (including social licence) and reputation – with company performance.

Integrated reporting of this kind takes a more forward-looking and holistic approach to articulate the organisation's:

- business strategy
- performance in executing the strategy
- insights about the drivers and risks threatening the successful execution of the strategy
- outlook for future performance if the strategy is well executed.

This model implies specific reporting on performance drivers, such as infrastructure, people, business processes, strategic management, risk management and governance performance, and the dynamic interplay between all of these factors.

Through integrated reporting, shareholders can gain an appreciation of the strength of the business model in terms of its:

- velocity (speed of business processes)
- vulnerability (to shocks from business risks)
- versatility (flexibility and agility in the face of changing external forces and market conditions)
- volatility (consistency of business processes in the face of change).

With integrated reporting, companies can also provide more detail and clarity over the broader health of the organisation and the challenges and opportunities it faces in the future, rather than just a summary and discussion on historic financial results. Integrated reports provide a clearer understanding of how the organisation creates and preserves sustainable value by focusing on governance, resource use and exposure, short-, medium- and longer-term risk to value, and how they are being addressed, as well as strategic performance and future outlook.

In contrast to this, in traditional reports, the reader is not given sufficient information to assess a company's ability to execute its strategy in the future and whether past earnings are likely to be sustainable in the medium to long term.

The International Integrated Reporting Council holds the principle that: "An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term."[93]

Reporting and communication must be underpinned by rigorous business modelling and measurement methodologies. The business modelling methodology is required to support clear and precise reporting of the business strategy and model in a form

93. *The International <IR> Framework* (December 2013), International Integrated Reporting Council

that can be easily understood and acted upon by key shareholders and investors.

Business reporting and communication methodologies and tools help organisations decide what to report, in what format, to whom and when. Among other things, the process requires a filtering mechanism centred on balancing the measurement power of particular key performance indicators, including those relating to risk management (an information supply perspective), and how and when key shareholders and investors can and should build strategy, performance insights and outlook into their decision-making models (an information demand perspective).

The reporting and communications strategy needs to detail how and when the organisation can enhance investment decision-making models and influence investment decision-making behaviours.

The changing tide with integrated reporting

In recent years, Hong Kong was marked by the kind of large-scale change that only happens every few decades. Not only was the economy dramatically affected by the global COVID-19 pandemic; digital transformation also accelerated and people are adjusting to an entirely new way of life. The pandemic also drove a greater emphasis on the social aspect of ESG, where more and more companies recognised the need for full-fledged ESG management, rather than working merely on environmental issues.

As we see it, the dramatic changes to the business environment and the explosion of uncertainties about the future forced many companies to consider the purpose of their organisation, reassess their medium- to long-term business models, and undertake bold reforms. Now that social issues and management issues are so directly linked, stakeholder accountability is of great importance to companies. Discussions and engagement based not only on financial information, but also on pre-financial information related to corporate value, are now essential for ensuring mutual understanding.

The move to enhance narrative information in reports required by regulations is a global trend. In the UK, the Financial Reporting Council (FRC) encourages reporting in line with the recommendations made by the Task Force on Climate-related Financial Disclosures (TCFD) and the use of Sustainability Accounting Standards Board (SASB) standards. In the US, the Securities and Exchange Commission (SEC) has revised Regulation S-K on the narrative information in securities reports. Moreover, the International Accounting Standards Board (IAS) Advisory Council, which deliberates and sets international standards, is currently discussing revisions to IFRS Practice Statement 1, Management Commentary.

These trends are consistent with the truth that corporate value cannot be explained by financial statements alone. They also reflect an evolution in corporate purpose, away from an emphasis on maximising short-erm returns for shareholders and toward a medium- and long-term perspective rooted in providing social value. Companies are being asked not merely to disclose information to meet legal requirements, but to communicate in a succinct manner how they will achieve their purpose.

Trends

New ESG reporting regime

The Hong Kong Stock Exchange has adopted a number of enhancements to the existing Environmental, Social and Governance ("ESG") reporting regime, which take effect for financial years commencing on or after 1 July 2020.

The new rules seek to strengthen board involvement in managing ESG issues, including by mandating disclosure of a statement setting out the board's consideration of ESG issues. This statement should include details of the board's oversight of ESG issues, its approach and strategy to manage them, and how progress on relevant ESG-related goals and targets is reviewed.

Mandatory and "comply or explain" approach – As mentioned above, certain ESG disclosures will become mandatory, with other disclosures elevated from "recommended" to being required on a "comply or explain" basis. There will no longer be any recommended disclosures as the current recommended key performance indicator ("KPI") disclosures on social aspects to ESG reporting, such as employment and labour practices, will be elevated to "comply or explain" disclosures.

The mandatory disclosures – Mandatory disclosures will be required on the following:

- a **statement from the board** covering the board's oversight of ESG issues and its ESG management approach and strategy (including the process used to evaluate, prioritise and manage material ESG issues and the business risks), together with an explanation on how the board reviews progress against its ESG-related goals and targets and how they relate to its business
- a **description** or **explanation** on how the reporting principles (materiality, quantitative and consistency) are applied in preparing the ESG report
- an **explanation** of the reporting boundaries, the process used to identify entities included in the report, and any change in scope.

Timing – ESG reports must be published at the same time as annual reports. (effective from 1 January 2022)[94]

94. Environmental, Social and Governance Reporting Guide, Part A: Introduction, Section 4 (2) (d)

The board's role in business reporting

Business reporting should accurately reflect and communicate the real corporate picture. Boards are in a unique position to step back from the day-to-day perspective of management and view the organisation from all perspectives. Boards should be able to assist in improving the quality of reporting by identifying any major gaps between what is being reported to shareholders and investors by management and what should be reported, whilst having regard to stakeholder needs, concerns, influences and decision-making behaviour.

Thus, boards are actively seeking a new reporting framework to help them decide on what to report, when, to whom, in what format and why. However, there are many impediments to change including:

- the risk of litigation if forward-looking statements are not met
- the release of competitively sensitive information or information that may be subject to rapid change or volatility
- a lack of willingness on the part of competitors and industry participants to be more forthcoming with voluntary disclosures
- no agreed industry reporting standards
- concern that capital markets will not cope with/ synthesise the extra information
- markets being only interested in short-term performance.

There are a number of ways to improve business reporting, including:

- encouraging more direct involvement by the board
- aligning internal reporting with external reporting (statutory reporting, results announcements and investor presentations, corporate social responsibility reporting, and other more frequent reporting, such as:
  - pro-forma/non-GAAP earnings guidance, production reports or balanced scorecards looking at the performance of non-financial KPIs)
  - improving consistency and clarity in the company's message (strategic goals/objectives) and the linkages between financial and non-financial reporting
  - streamlining reporting and creating a balanced portfolio of reports
  - educating shareholders on the implications and value of reporting changes
  - using technology for reporting automation and diffusion (e.g. XBRL, web-based and real-time reporting, enterprise and data modelling).

The HKEX Principles require disclosure of the process to validate corporate reports and to provide investors with appropriate information to make informed investment decisions. Some entities use the principles of integrated reporting as a useful framework for preparing operating and financial reviews in directors' reports.

Whistleblowing Policy

The CG Code has required all listed companies to establish (i) whistleblowing policy and system [95] for their employees and those who deal with the company to raise concerns, in confidence and anonymity, with the audit committee (or a designated committee comprising a majority of INEDs) about possible improprieties in matters related to the company. An effective whistleblowing system can help detect and deter misconduct or malpractice in a company.

Scope of the whistleblowing policy includes:

- Types of breaches and conduct issues to which the policy applies, with examples of the major and minor misconduct [96]
- Personnel to which the policy applies (including implicated parties and the reporting parties).
- Relevant committee/department/personnel responsible for the day-to-day implementation and oversight of the policy

What may be included in the Policy:

- Statement of intent/pledge
- Reporting channels
- Protection against retaliation[97]
- Handling of reports
- Consequence of false reports
- Disclosure of policy
- Frequency of periodic review

Anti-Corruption Policy

The CG Code also requires listed companies to have in place a clear set of policies and systems that supports anti-corruption laws and regulations[98]. Scope of anti-corruption Policy includes:

- Types of breaches and conduct issues to which the policy applies.
- Personnel to which the policy applies.

What may be included in the Policy

- Culture Top-level commitment
- Conflicts of interest
- Acceptance of advantages
- Customer due diligence measures
- Breaches of the policy
- Integrity requirement for issuer's personnel
- Anti-corruption programme
- Disclosure of policy
- Periodic review

95. Corporate Governance Code, Part 2, Section D.2.6

96. For example, persons who victimize or retaliate against whistleblowers who have genuinely raised concerns will be subject to disciplinary actions

97. For example, failure to comply with legal or regulatory requirements, malpractice, impropriety or fraud relating to internal controls, accounting, auditing and financial matters, danger to the health and safety of any individual, bribery or corruption

98. Corporate Governance Code, Part 2, Section D.2.7 and paragraph 3.1 of the Integrity and Corruption Prevention Guide on Managing Relationship with Public Servants published by the ICAC ("ICAC Corruption Prevention Guide")

Useful references

– *Companies Ordinance (Cap. 622)*

– *Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G)*

– *Securities and Futures Ordinance (Cap. 571)*

– *The HKEX's Listing Rules*

– *Corporate Governance Code, as set out in Appendix 14 to the Main Board Listing Rules and Appendix 15 to GEM Listing Rules*

– *Miracle Chance Ltd v Ho Yuk Wah, David (1999)*

– *Cannon v Trask (1875) 20 Eq 669*

– *Byng v London Life Association (1990) Ch 170, CA*

– *Kaye v Croydon Tramways Co (1898) 1 Ch 358*

– *ICGN Statement of Principles on Institutional Investor Responsibilities (30 November 2013), International Corporate Governance Network* *https://ecgi.global/code/icgn-statement-principles-institutional-investor-responsibilities*

– *Consultation Conclusions on Review of the Corporate Governance Code and Related Listing Rules (July 2018), HKEX* *https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2017-Review-of-the-CG-code-and-Related-LRs/Conclusions-(July-2018)/cp2017111cc.pdf*

– *Guides to HKFRS financial statements, KPMG* *https://home.kpmg/cn/en/home/insights/2010/12/illustrative-financial-statements.html*

– *Accounting Bulletin 3 (Revised) Guidance on Disclosure of Directors' Remuneration (November 2017), HKICPA* *http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeII/ab3.pdf*

– *New Companies Ordinance: Key Considerations for Directors, HKIoD* *https://www.hkiod.com/document/21century/issue_14/14th_Issue_The_NCO_key_considerations_for_directors.pdf*

– *Guidance for applicants on the presentation of the non-GAAP financial measures in a listing document and any relevant documents pursuant to the Exchange's Listing Rules (April 2019), HKEX* *https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/GL103-19.pdf*

– *Practice Note 740: Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules, HKICPA* *https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Members-Handbook-and-Due-Process/HandBook/Volume-III--Auditing-and-Assurance-Standards/PN740-Auditor-s-Letter-on-Continuing-Connected-Transactn-under-the-HK-Listing-Rules*

- *Guidelines on Disclosure of Inside Information (June 2012), SFC*
  http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openConclusionAppendix?refNo=10CP2&appendix=4
- *The International <IR> Framework (December 2013), International Integrated Reporting Council*
  https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf
- *Guide on General Meetings (30 August 2019), HKEX*
  https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Practices-and-Procedures-for-Handling-Listing-related-Matters/gm_guide.pdf?la=en
- *Policy on Share Trading Suspension (30 June 2011), HKEX*
  https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Archive/Other-Guidance-Materials-for-Listed-Issuers/20110630.pdf?la=en
- *Guide on Practices and Procedures for Post-vetting Announcements of Listed Issuers and Handling Matters Involving Trading Arrangements prior to Publication of Announcements (1 October 2019), HKEX*
  https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Practices-and-Procedures-for-Handling-Listing-related-Matters/ai_postvet.pdf?la=en
- *Environmental, Social and Governance Reporting Guide as set out in Appendix 27 of the Main Board Listing Rules and Appendix 20 of the GEM Listing Rules*
- *Consultation Conclusions on Review of the Environmental, Social and Governance Guide and Related Listing Rules (December 2019), HKEX*
  https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/May-2019-Review-of-ESG-Guide/Conclusions-(December-2019)/cp201905cc.pdf?la=en
- *Mandatory Disclosure Requirements (01 Jan 2022), HKEX*
  https://en-rules.hkex.com.hk/rulebook/part-1-mandatory-disclosure-requirements
- *Integrity and Corruption Prevention Guide on Managing Relationship with Public Servants ("ICAC Corruption Prevention Guide") (December 2015), ICAC*
  https://cpas.icac.hk/UPloadImages/InfoFile/cate_43/2016/0de0c4d3-f817-4607-9c30-a85e8d294007.pdf
- *Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (September 2021), SFC*
  https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/guidelines/guideline-on-anti-money-laundering-and-counter-financing-of-terrorism-for-licensed-corporations/AML-Guideline-for-LCs_Eng_30-Sep-2021.pdf

6. Stakeholder Expectations

Evolving community expectations of the corporate sector are resulting in effective stakeholder engagement emerging as a critical success factor for the long-term sustainability of an organisation. Boards and directors need to effectively engage with stakeholders to understand their issues and leverage their perspectives on the organisation's performance and direction.

In this chapter

- Stakeholder engagement
- Scope of disclosure
- Why focus on engaging stakeholders
- Stakeholder engagement at a board level
- Stakeholder engagement and strategy development
- Establishing an effective stakeholder engagement framework
- Reputational advantages of effective stakeholder management
- Stakeholder engagement beyond ownership

Questions that company directors should ask

1. Is the board comfortable that it knows who its key stakeholders are?
2. Have stakeholders with the ability to affect strategic and business objectives been effectively engaged?
3. Have the risks of not engaging key stakeholders (financial and reputational) been considered and, if applicable, quantified?
4. Is stakeholder engagement embedded into the company's vision, mission and strategy statements?
5. Does the company have a stakeholder engagement framework aligned with best practice?
6. Do relationship effectiveness measures exist for key stakeholders?
7. Is the board seeking and maintaining relationships with its key stakeholders at the leadership level?
8. Has the company considered making a public disclosure about stakeholder management and corporate social responsibility?
9. Is effective stakeholder management used as a strategic, preventive mechanism, rather than a responsive tool?
10. Is there an anonymous feedback mechanism beyond whistleblowing for stakeholders who frequently interact with the entity?
11. Is there a forum for stakeholders, including employees, to share ideas, feedback and concerns? Has the board taken these into consideration?

Red flags

1. The company maintains no stakeholder mapping, tiering or profiling information.
2. Stakeholders are defined narrowly as clients and customers.
3. In most decisions, stakeholders are not considered or consulted.
4. The risk of not engaging stakeholders is not discussed or is often dismissed quickly by some board members.
5. Dialogue with stakeholders mostly occurs in the event of disputes and negative media coverage.
6. Online coverage of the company is mostly negative.
7. The executive and board accountabilities for stakeholder engagement is unclear.
8. The company is unaware or unprepared for the impact of social media activism.
9. Board members do not hold strong or effective relationships with key stakeholders.

Stakeholder engagement

Stakeholder engagement is the process of identifying and involving the key groups of people and organisations who are affected by, or have the capacity to influence, the company's activities and operations.

Ordinarily, a board's direct involvement with its key stakeholder groups may be limited to the chairman or the respective chairmen of committees such as the audit committee or the sustainability committee (if established). In extraordinary circumstances (e.g. crisis mode) the wider board may become involved in engagement activities and communication.

However, management is now turning to directors to tap into expertise and relationships to facilitate engagement, advocacy and lobbying with key stakeholders. Directors who possess 'change agent' competencies can be influential in championing particular courses of action.

Relevantly, the UK's corporate governance reform has introduced requirements for boards to understand and report on how stakeholders' interests have been considered in board discussions and decision-making.[99] While not a requirement in Hong Kong, the UK corporate governance regime is influential in Hong Kong[100] and may provide useful insight on the future of directors' duties with respect to stakeholders in Hong Kong.

99. *The UK Corporate Governance Code* (July 2018), Financial Reporting Council, Section 1 Provision 5
100. For example, the introduction of Hong Kong's Manager-In-Charge regime in 2017 is referenced from the UK's Senior Managers Regime

Scope of disclosure

The following disclosures related to culture are expected by the stakeholders. These disclosures should be presented precisely and succinctly, which in general, should be no more than one page.

- The vision, values and strategy of the company, alongside its culture, and how all these affect the business model, the purpose and the board evaluation;
- The success measurements of the company (e.g. key performance indicators in terms of revenue growth, profit margins, return on equity, and market share), and how its desired culture affects or contributes to the organisation's performance;
- The measures used for assessing and monitoring culture (e.g. specific indicators, such as staff turnover rate, whistleblowing data, employee surveys, breaches of code of conduct, and regulatory breaches);
- The measures in place to ensure that the desired culture and expected behaviours are clearly communicated to all employees, e.g. through hosting town halls and developing a code of conduct;
- The forum(s) available for sharing ideas and concerns on any misconduct or misalignment identified, and how they are being dealt with
- The company's financial and non-financial incentives which support the desired culture; and
- Summary of board evaluations, if any.

Why focus on engaging stakeholders

Companies exist within an environment where there is increasing scrutiny over the sustainability and integrity of their operations. In the same way that companies perceived as acting in a detrimental fashion can suffer loss, companies that collaborate with and mobilise their stakeholder base are able to present a positive public image and reap the rewards of the reputational and financial benefits that follow.

Other than reputational and public perception implications, for some companies certain revenue (i.e. government contracts) can be dependent on the fulfilment of sustainability, community relations and other stakeholder engagement criteria. For such arrangements, effective stakeholder engagement processes are essential in providing companies with the ability to compete with their industry rivals.

Stakeholder engagement at a board level

Companies with effective stakeholder engagement possess a common theme of a strong 'tone at the top'. Boards are responsible for setting the general policies and direction of the organisation. They shape the organisation's framework for accountability, and they should lead by example in fostering an outward-looking approach.

At board level, stakeholder engagement should be defined as a core organisational value. Directors should identify the key risks associated with evolving societal expectations and set expectations with their executive management group around effectively engaging the stakeholder base. Further, the board should also consider their own interface with their stakeholders, including the integration of stakeholder issues into the AGM and public reporting.

Stakeholder engagement and strategy development

Stakeholders can provide a unique perspective on an organisation's performance, challenges and opportunities. Strong and effective stakeholder engagement provides boards with a range of views that might otherwise be missed in the strategy development and risk assessment processes.

A robust strategy development process involves exploring the macro and micro environment for current and emerging issues that could impact on the organisation's operating model. Management and the board tend to have a good grasp of the local/ micro influences. However, having the perspective of a stakeholder's 'external lens' can provide the organisation with a unique input to inform strategy development and identification of risks and opportunities.

Stakeholders have their own agendas and issues, and will view an organisation through this lens, providing the opportunity to bring enormous value to the business. Effectively engaging with stakeholders can provide management and the board with the ability to see issues affecting the business in a different context and can often provide a different interpretation of what these issues could mean for the business.

Establishing an effective stakeholder engagement framework

In establishing a stakeholder management function, companies are increasingly formalising the arrangements and processes, including developing stakeholder engagement plans.

Common themes of sound stakeholder engagement frameworks include:

- stakeholder maps and tiering
- responsibilities for developing relationships with agreed accountabilities (board and management)
- defined methods for gathering information on stakeholders (i.e. surveys, research, etc.)
- methods and accountabilities for monitoring stakeholder concerns, influences and sensitivities
- established positions on relevant public or industry specific policies
- a variety of methods of communication, including forums, meetings, site visits, etc.

The AA1000 Stakeholder Engagement Standard provides an internationally recognised framework to help organisations ensure stakeholder engagement processes are purpose driven, robust and deliver results, and form a basis for designing and implementing effective stakeholder engagement in a credible way. [101]

Reputational advantages of effective stakeholder management

A good corporate reputation is a prized asset that is earned over time. It can be a source of competitive advantage, influencing the level of engagement with the company by employees, customers, suppliers and other stakeholders. By way of contrast, failure to manage reputation can have a deleterious and prolonged effect on a business. Reputation damage affects directors' personal reputations, employee morale, investor confidence and company performance. Reputation risk has been identified as one of the most important risks a company faces. Loss of reputation, however, is usually the result of poor risk management processes across all risk areas, including compliance, finance, environmental considerations and operations. A robust and systematic enterprise-wide risk management strategy is essential to maintain a company's reputation.

In turn, a company's reputation is directly linked to the board's role in both strategy and risk. The board's starting point in developing a positive corporate reputation is the right 'tone at the top', fostering appropriate organisational values that drive organisational culture. A reputation management system, underpinned by straightforward and open communications, protects this intangible but vital

101. Refer to *AA1000 Stakeholder Engagement Standard 2015*, AccountAbility

asset. Some companies are going further, defining and measuring their reputation and benchmarking it against other participants in the market.

Warren Buffett: *"It takes 20 years to build a reputation and 5 minutes to ruin it."*

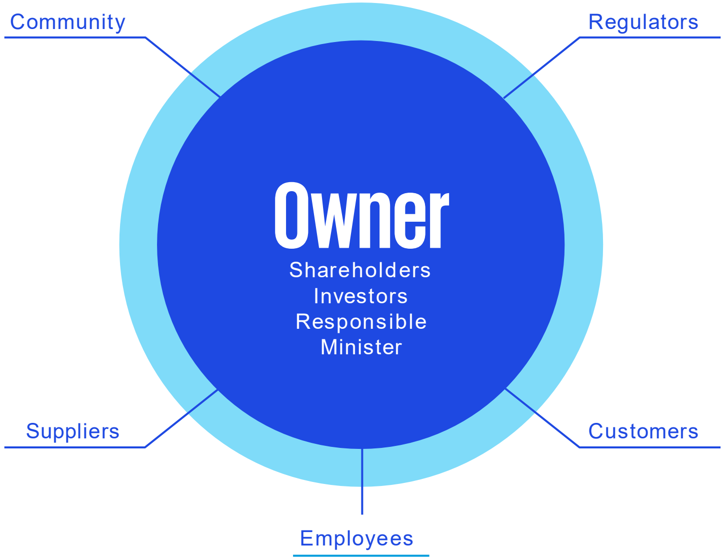
Despite the best risk-mitigation program, when things go wrong, a period of reputational volatility can ensue. Reputation is affected by the way an accident/incident is managed and/or the company's ability to react to and handle such a crisis. The company needs to prepare itself for potential crises. The media is a critical influencer of public opinion, especially in a crisis.

Stakeholder engagement beyond ownership

Stakeholders of organisations will differ depending on the nature, size and complexity of the organisation. However, stakeholders common to most organisations include:

i. Community
ii. Regulators
iii. Suppliers
iv. Employees
v. Customers

The concerns of these stakeholders are not just financial and extend to environmental, social and governance considerations and objectives.



i) Community stakeholder engagement

Identifying, understanding and engaging with community groups interested in or impacted by an organisation is increasingly seen as a minimum requirement in today's landscape. The rise of social media has provided a platform for community members to instantly and publicly share feedback with organisations. Accordingly, having a clear and direct approach to engaging with community groups has never been more important.

Some actions that directors can undertake to help their organisation manage and excel with their community stakeholders include:

- requesting a report from management on the organisation's key community groups
- assigning accountability for directors to engage and own the relationship between key community groups
- developing a community stakeholder engagement plan
- ensuring community stakeholders are engaged as part of the organisation's product/service/project development process
- ensuring feedback from community stakeholders is incorporated within board reporting.

ii) Regulator stakeholder engagement

The reputational and financial repercussions of regulatory scrutiny and action can be far reaching. The SFC provides a clear example of this, where intense regulatory scrutiny and enforcement actions have had significant impact on the reputation of many large financial organisations.

Building a constructive and trusting relationship with regulators is, therefore, clearly in the best interests of an organisation's shareholders or owners. However, building and maintaining such a relationship is no small feat. Given the potential impact that mismanagement of regulatory stakeholders can have, directors are increasingly seen as an important part of an organisation's regulatory stakeholder engagement strategy.

Directors can have bearing on this relationship in several key ways:

Role of directors with respect to regulatory stakeholders	Questions to ask
Ensuring a firm understanding of the organisation's key regulators.	– What are the key regulators for the organisation / industry? – Do I understand the role and remit of each key regulator? – Am I familiar with each key regulator's objectives or stated focus areas? (e.g. 'crackdowns' on certain areas of compliance).
Understanding the key regulatory issues facing the organisation at any given time.	– If approached by a regulator, do I have the requisite knowledge and understanding of the key regulatory issues facing the organisation to adequately respond? – Am I satisfied with management's reporting of regulatory issues? – Do I know who the key relationship managers are within the organisation for each key regulator?
Setting and maintaining a culture of compliance throughout the organisation.	– Am I familiar with the measures in place to manage compliance issues throughout the organisation? – Have directors or management recently interacted with front-line staff to understand the prevailing attitude towards compliance at the coal-face of the organisation? – Do employee engagement surveys highlight any cultural issues?
Establishing and demonstrating requirements for clear, open, transparent and truthful communications with regulators.	– Am I role-modelling the behaviour I would expect from employees in my interactions and communications with regulators? – Have I witnessed (and corrected) any undesired behaviour or attitudes towards regulators?

iii) Supplier stakeholder engagement

Suppliers play a key role in enabling organisations to meet the needs of other key stakeholder groups, in particular customers and the broader community. This is especially so in competitive business environments, where there will be increased pressure to reduce costs while maintaining or improving the quality of the organisation's products and services.

Suppliers can be highly influential in the success (or otherwise) of an organisation. For example, an organisation that maintains a high profit margin at the expense of a key supplier that is struggling to maintain solvency may find itself in trouble in the long run. Similarly, any compliance, regulatory, legal and/or ESG issues that plague a supplier will often have a negative reputational impact upon the procuring organisation. It is, therefore, clear that a holistic approach must be taken when considering the needs of an organisation and its suppliers.

Some practical measures that directors may undertake to ensure the organisation is appropriately engaging and managing its suppliers include:

– having visibility over suppliers' business practices and understanding how the organisation's business model may influence supplier behaviour or incentives
– ensuring the organisation maintains robust procurement processes that incorporate not only value for money factors, but also long-term sustainability, corporate reputation and any history of involvement with business practises below the standard expected by the organisation
– ensuring the organisation establishes mechanisms to measure and monitor suppliers adherence to ESG policies and standards.

Case Study

Software Implementation Errors Causing MTR Incident on 18 March 2019 [102]

The MTR Corporation ("MTR") conducted a drill on a new signaling system provided by the contractor Alstom-Thales DUAT Joint Venture ("ATDJV") on a rail line. However, a non-passenger train heading to a platform station collided with another non-passenger train departing from the same station through the same crossover. Both trains were damaged and both train captains were sent to hospital for medical checks.

After incident investigation, it was concluded that ATDJV had created a software issue due to software implementation errors made during the process of performing a software change, which led to the missing of conflict zone protection at the crossover.

102. Refer to *Press Release: MTR Strengthens Monitoring over Contractor of New Signalling System as Software Implementation Errors were Identified as Causes of Tsuen Wan Line Incident on 18 March 2019* (5 July 2019), MTR (https://www.mtr.com.hk/archive/corporate/en/press_release/PR-19-044-E.pdf)

A list of recommendations were given to ATDJV regarding the software development, quality assurance and risk assessment processes. For instances:

- to replace the corresponding software design and development team
- to enhance the software coding and testing practices to avoid future programming errors
- to introduce effective and traceable measures to detect any programming errors.

Apart from improving the quality of software provided by ATDJV, the investigation panel also recommended the operations projects team of MTR to exercise extra vigilance and strengthen the monitoring on ATDJV's deliverables. For examples:

- to expand the scope of the Independent Safety Assessor to include on-site train-related testing certification
- to establish a joint safety Test & Commissioning Panel to manage on-site testing.

This case study serves as a clear example of the impact that a unreliable supplier can have on the company and the public interest. The insufficiency in managing the supplies could exacerbate the issue and increase the risk of further harm.

iv) Employee stakeholder engagement

Unlike customer stakeholder groups, employee stakeholders' needs remain fairly universal across most organisations. To ensure job satisfaction, employees require:

- fair remuneration and compensation
- job security
- respect, recognition and acknowledgement
- open and honest communication.

Through corporate governance, boards have often had a fairly direct bearing on many of this stakeholder group's key interests. For example, boards will help establish, review and approve the management and employee remuneration structure. Similarly, boards help set and maintain an organisation's culture, which will necessarily influence key job satisfaction factors such as transparency of communication with employees and reward and recognition. Finally, risky decision-making at the board level may impact on the overall level of job security that an organisation can offer employees.

Case Study

Cathay Pacific Labour Dispute during May 2015

In mid-May 2015, around 1,000 cabin crew of Cathay Pacific Airways staged a 41-hour sit-in protest at Hong Kong International Airport in protest over a series of proposed unfavourable terms of employment, including unequal hourly pay rates, reduction in meal allowances for attendants in Melbourne, and cancelation of legal protection for employees. [103]

The Cathay Pacific Airways Flight Attendants Union ("Cathay Union") requested the company to respond to the following three matters to avoid a sizable summer strike in Hong Kong: [104]

- to pay the same hourly rate for all the employees who had recently finished their initial 3-year training contracts and signed the "permanent" employment contracts
- to retain the original meal allowance for attendants in Melbourne
- to retain the legal protection clause in the employee's manual to ensure protection and assistance by the company in case of legal issues arisen when on duty.

After few days of negotiations with the assistance of the Labour Department, management of Cathay Pacific Airways and leaders of the Cathay Union has come to consensus and finally signed a agreement with legal implications to restore the pays and benefits on 1 June 2015.

As a lesson learnt from this labour dispute, in revision of any material terms of employment, senior management shall always maintain adequate communication with their employees to ensure employee stakeholders' interests are reasonably satisfied.

103. Refer to *Cathay Pacific deal ends threat of summer strike in Hong Kong* (2 June 2015), South China Morning Post (https://www.scmp.com/news/hong-kong/education-community/article/1814635/cathay-pacific-deal-ends-threat-summer-strike)
104. Refer to *Is a Strike Unavoidable? The Legal Issues Behind the Cathay Pacific Labour Dispute*, ONC Lawyers (http://www.onc.hk/en_US/is-a-strike-unavoidable-the-legal-issues-behind-the-cathay-pacific-labour-dispute/)

v) Customer stakeholder engagement

Customers are a vital stakeholder group for any organisation and will play a key role in the financial and reputational success of an organisation. Increasingly, organisations are taking a 'customer-first' approach. This approach ensures the organisation's strategy and values, through to end products and services, are aligned to the expectations and requirements of this important stakeholder group.

Customer stakeholder group interests are unique and will differ from industry to industry and organisation to organisation. However, several underlying interests will apply to most companies, including:

- value
- quality
- customer care
- ethical products and services.

Useful references

- *The UK Corporate Governance Code (July 2018), Financial Reporting Council* https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf
- *SFC fully implements Manager-In-Charge regime (17 October 2017), SFC* https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR131
- *AA1000 Stakeholder Engagement Standard 2015, AccountAbility* https://www.accountability.org/wp-content/uploads/2016/10/AA1000SES_2015.pdf
- *Press Release: MTR Strengthens Monitoring over Contractor of New Signalling System as Software Implementation Errors were Identified as Causes of Tsuen Wan Line Incident on 18 March 2019 (5 July 2019), MTR* https://www.mtr.com.hk/archive/corporate/en/press_release/PR-19-044-E.pdf
- *Cathay Pacific deal ends threat of summer strike in Hong Kong (2 June 2015), South China Morning Post* https://www.scmp.com/news/hong-kong/education-community/article/1814635/cathay-pacific-deal-ends-threat-summer-strike
- *Is a Strike Unavoidable? The Legal Issues Behind the Cathay Pacific Labour Dispute, ONC Laywers* http://www.onc.hk/en_US/is-a-strike-unavoidable-the-legal-issues-behind-the-cathay-pacific-labour-dispute/

Governance Leadership

7. Structuring an Effective Board

Whether it be starting a new company or changing organisational structures, structuring an effective board is a challenging undertaking. The structure, composition and internal dynamics of boards can affect the performance of individuals and the board collectively.

In this chapter

- Governance framework
- Code of conduct
- Skills and expertise
- Boardroom diversity
- Board size
- Finding and appointing new directors
- Appointment process
- Director due diligence
- Director induction
- Director professional development
- The first 100 days framework
- Board evaluation
- Director remuneration
- Re-election and rotation of directors
- Board succession planning
- Director tenure
- Access to company records

Questions that company directors should ask

1. Do we have a structured plan, with timeframes and accountabilities, on how to establish the board?
2. Are candidates able to commit sufficient time to discharge board duties?
3. Are the directors sufficiently familiar with the company's operations, performance, values and aspirations?
4. Is there a nomination committee charged with the responsibility of director succession planning, or alternatively, does the board have a robust process to enable orderly board succession?
5. Is a contingency plan established in the event that the chairman has to step down unexpectedly?
6. Has the board adequately considered its approach to diversity, including, where appropriate, the formulation of relevant policies?
7. Beyond having the right mix of skills, experience and background present on the board, does the composition complement the culture, engagement and style of the board?
8. Has the board properly considered the overarching strategy of the organisation and taken account of changes that are likely to occur in the short to medium term (for example changes to strategy, changes in the external environment) when determining its desired size and mix of skills/experience/backgrounds?
9. To the extent there are gaps in desired skills and experience that reside on the board, has the board adequately considered whether and how the board might benefit from the professional development of current board members?
10. Is there an appropriate induction programme (including committee induction) for new directors?
11. Has the board considered the frameworks for communication with stakeholders within the first 100 days?
12. Is the board setting the tone at the top and the culture for the new organisation?
13. Does the board regularly review its own performance and the effectiveness of its governance processes?

Red flags

1. Not everyone agrees on the initial priorities.
2. There is limited understanding of what is required in the establishment phase.
3. The board comprises mainly inexperienced directors and limited induction programmes are in place.
4. No advice is being sought from experts or directors who have experience in establishing a new board.
5. No time has been planned for discussing alignment with 'risk appetite' and strategy.
6. Accountabilities and delegations are unclear and not documented.
7. No board instruments have been presented for endorsement.
8. The board is too large or small compared with similar organisations.
9. The board does not periodically review its skills and competencies or align its skills matrix to the company strategy.
10. Board appointments are decided by the chairman with little input from other directors.
11. Limited consideration is given to the diversity of the board in its structure/composition and thought-process/decision-making processes.
12. No consideration is given to fixed-term directorships.
13. No consideration is given to the composition of, delegation to and reporting from board committees.
14. Directors do not receive a letter setting out the terms and conditions of their appointment.
15. No formal (or an insufficient) board induction is provided to new board members.
16. Board discussions are dominated by one or two directors.
17. The board finds it difficult to make decisions with consistent carry-over of agenda items from one meeting to the next.
18. Directors appear to be overstretched and unable to dedicate sufficient time to their roles.
19. Overuse of external advisers occurs due to skill gaps on the board.
20. Directors are not provided with, or fail to engage with, professional development opportunities.
21. There is no board evaluation/review process (or it is not documented or known to the board).
22. There is a failure to appreciate the implications of the two-strike rule on the directors' remuneration report or to anticipate members' reaction to the remuneration report.
23. No consideration is given to the enforcement of accountability for non-paid directors.
24. There is a lack of ongoing board succession planning.
25. Directors have difficulty accessing company information in a timely manner.

Governance framework

The global regulatory landscape is changing rapidly, with an increased emphasis on the quality of governance. Investors and minority shareholders value how companies report their governance structure, including how the overall governance contributes to the companies' long-term success. [105] The Corporate Governance Code further adds that an effective board should be collectively responsible for its leadership and promoting its success by directing and supervising its affairs, and directors should take decisions objectively in the best interests of the listed issuer. [106]

In practice, the company's governance embodies a complex range of structures (frameworks, policies and processes) balanced against the appropriate mix of skills, behaviours and practices.

A well-designed governance framework will help the board to be effective and fulfil its role by:

- instilling the desired behaviours that underpin the company's core values and drive the cultural 'tone from the top'
- giving an audience to 'the customer voice' and the voice of other key stakeholders
- instilling confidence in shareholders and the public that the company is well governed
- ensuring that directors' competencies and skills are appropriate given the company's current and future strategic requirements
- empowering the board to act to its best capability by having the appropriate mix of skills, expertise, experience and diversity of thought
- clarifying the roles, responsibilities and delegation of powers of individual directors, the board, its committees and management
- matching the skills and expertise of individual directors with board and committee responsibilities
- ensuring that directors have access to an induction programme and ongoing professional development
- implementing sound risk management practices and controls in line with the organisation's risk appetite
- facilitating the evaluation and review of the board, chairman, CEO and management
- embedding processes that facilitate the board's oversight and constructive challenge of management
- including transparent mechanisms for the enforcement of accountability by the board and management
- aligning the remuneration strategy with the shareholders' expectations, rather than encouraging short-term profits and self-interest, thereby safeguarding the shareholders' interests
- enabling the efficient and effective reporting of quality information on a timely basis between directors, the board and its committees, the company executives, the organisation as a whole, and wider stakeholders.

105. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX
106. Corporate Governance Code, Part 2 Section A.1

The Corporate Governance Code requires that there should be a formal, considered and transparent procedure for the appointment of new directors and plans in place for orderly succession for appointments. As a result, the listed entity should establish a nomination committee which is chaired by the chairman of the board or an INED and comprises a majority of INEDs. The nomination committee should have specific written terms of reference which "deal clearly with its authority and duties". The nomination committee should disclose the policy for the nomination of directors during the year, including the nomination procedures, the process and criteria adopted and the board's policy on board diversity. Further information on committees can be found in Chapter 9. [107]

As governance practices continue to come under the spotlight, the Stock Exchange of Hong Kong (the Exchange) has amended the Corporate Governance Code (CG Code) and the related Listing Rules with the aims to ensure that the Listing Rules and the CG Code remain fit for purpose, continue to promote market quality and align with stakeholder expectations and international best practice. The HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021) was also published to help directors carry out their role more effectively. [108]

107. Corporate Governance Code, Part 2 Sections B.2, B.3
108. Refer to *Consultation Conclusions on Review of the Corporate Governance Code and Related Listing Rules, and Housekeeping Rule Amendments (December 2021), HKEX*

Code of Conduct

The Corporate Governance Code suggests that the board should develop, review and monitor the code of conduct and compliance manual (if any) applicable to employees and directors, and every director must always know his responsibilities as a director and its conduct, business activities and development. [109]

The listed issuer should ensure all directors have complied with its code of conduct regarding directors' securities transactions, where the Listing Rules sets a required standard for directors regarding transactions in securities of their listed issuers. [110]

The *HKIoD Code of Conduct* (2nd edition) has been developed to facilitate directors in meeting high standards of professionalism and ethics and lay down the expected standards on directors in fulfilling their roles and responsibilities. The *HKIoD Code of Conduct* contributes to develop a culture of accountability and greater confidence in the organisation.

In particular, the HKIoD suggests to embrace a variety of values, such as becoming conduct, honesty, legality, diligence, accountability, integrity, leadership in enterprise, participation, discipline, etc. [111]

109. *Corporate Governance Code*, Part 2 Section C.1
110. Model Code for Securities Transactions by Directors of Listed Issuers, as set out in *Appendix 10 of the Main Board Listing Rules*
111. Refer to *HKIoD Code of Conduct*

Skills and expertise

The board should collectively possess a sufficient range of competencies to effectively deal with the issues and opportunities the company faces. It should comprise individuals who bring to the boardroom a range of skills and know-how in relevant areas. Their individual strengths should complement each other.

The competencies required for any particular board will vary considerably, depending on the company's industry, strategy, development stage and the environment in which it operates. The types of generic technical skills and competencies required on a board might include:

– accounting and finance
– business judgment
– industry knowledge
– government knowledge
– legal knowledge
– employment/industrial relations knowledge
– environment/sustainability knowledge
– leadership
– strategy/vision
– risk management.

These new areas of focus increase the onus on directors to possess the appropriate behavioural competencies, as well as the traditional technical skills. Behavioural attributes include:

– emotional intelligence
– curiosity
– an appreciation for diversity of thought, backgrounds, expertise and experience
– authenticity
– transparency in decision-making and communication
– self-awareness and accountability
– willingness to reflect, learn and adapt
– ability to challenge and question in a constructive manner
– sense of rigour and ability to enforce accountability in an appropriate manner
– humility to know that they will not have all the answers.

Board skills matrix

The Corporate Governance Code states that the board should have a balance of skills, experience and diversity of perspectives appropriate to the requirements of the issuer's business. [112]

While there is no prescribed format, the HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021) suggests that companies should have and disclose a "board skills matrix", showing the directors' attributes, competencies and diversity. [113]

112. Corporate Governance Code, Part 2 Section B.1
113. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Diversity and Policy

It will show the directors' attributes and competencies and how they contribute to the issuer's strategic direction and succession planning as well as diversity. It also helps the board to assess the current mix of competencies and diversity on the board and identify any gaps that may exist.

In addition to a technical competency assessment, the skills matrix should ideally also include an analysis of the current or desired behaviours to help the board function as an effective decision-making body.

The skills matrix is a useful tool to identify gaps in the collective board's skills (which should be addressed by appointing new members or providing professional development to existing directors) as well as succession planning.

Disclosing the board skills matrix is a good practice as it demonstrates a transparent process for board's selection and appointment of directors. [114]

Boardroom diversity

The HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021) has focused on the importance of board diversity and policy as it is believed that greater diversity of directors is good for corporate governance as it promotes board effectiveness and enables better decisions to be made.[115] The Corporate Governance Code requires a balanced composition of executive and non-executive directors (including INEDs) so that there is a strong independent element on the board. [116]

114. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Diversity and Policy
115. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Diversity and Policy
116. Corporate Governance Code, Part 2 Section B.1

Whilst the appointment of a majority of independent directors to the board of a non-listed company may be impractical, the importance of the board's diversity as a whole should not be overlooked.

In structuring the board to add value from diversity, a company should consider the mix of skills, backgrounds, experience, expertise, age, gender and perspectives of its directors that would be necessary to meet the unique requirements of the company. An emphasis on director diversity should yield a number of key benefits, including:

- an increase in the intellectual resources of the board and less reliance on the authority of key individuals
- deriving value from previously unrecognised or overlooked opportunities
- an enhancement of the board's ability for reflection and decision-making capabilities, thus lessening the risk of 'group-think', 'dulling of the senses'
- a stronger sense of board authenticity and connection with customers, employees and other stakeholders, helping to set the cultural 'tone from the top' and critical to the company's 'social-licence to operate'
- an improvement in skills to constructively challenge and hold management to account, reducing the chance of over-confidence in management and the company's performance as a whole, particularly with regard to risk management.

To encourage companies to foster a governance culture that embraces diversity, the HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021) [117] require listed entities to:

– have and disclose a diversity policy or a summary of the policy in the corporate governance report

– include measurable objectives that the issuer has set for implementing the diversity policy (for example, those related to gender) and progress on achieving those objectives.

Listed entities are also encouraged to consider:

– articulate the benefits of diversity, including gender diversity, and the importance of being able to attract, retain and motivate employees from the widest possible pool of available talent

– express the issuers' commitment to diversity at all levels, including gender, age, cultural and educational background, and professional experience

– assess annually on diversity profile including gender balance of the directors and senior management and their direct reports, and its progress on achieving its diversity objectives

– ensure that recruitment and selection practices at all levels are appropriately structured so that a diverse range of candidates are considered

– state any identified and implemented programmes to assist in the development of a broader and more diverse pool of skilled and experienced employees and that, in time, for future senior management and board positions.

117. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Diversity and Policy

The HKEX also stresses the importance of gender diversity which enables the board to better understand their customers' and stakeholders' needs and is positively associated with the issuer's financial performance, more effective board and better risk management. According to a leading not-for-profit organisation in Hong Kong that tracks "women on boards", women make up of 14.3% of the Hang Seng Index boards as of 1 July 2021. [118]

Diversity is a key cornerstone to a dynamic, effective board. The economic arguments for more board diversity have been identified in various widely publicised studies, which demonstrate a correlation between increased diversity at higher levels of the organisation and stronger organisational and financial performance. [119] A board should be able to illicit the skills required to adapt, embrace change, co-operate with key stakeholders to proactively respond to challenges, identify and exploit opportunities, harness its 'social licence to operate' and build long-term sustainable success. Boards and directors that fail to embrace diversity (in all its forms) will become less relevant and influential.

118. Refer to *Women on Boards Hong Kong 2021 (1 July 2021)*, Community Business (https://www.communitybusiness.org/women-on-boards)

119. See for example – *Gender Diversity and Corporate Performance* (August 2012), Credit Suisse Research Institute; *The Bottom Line: Corporate Performance and Women's Representation on boards* (October 2007), Catalyst; *Australia's Hidden Resource: The economic case for increasing female participation* (November 2009), Goldman Sachs JB Were

Board size

The Companies Ordinance specifies that public company boards must have at least two directors. [120] While the board should have a balance of skills, experience and diversity of perspectives appropriate to the requirements of business to discharge its duties effectively and to add value, the Corporate Governance Code further reminds that the board should ensure changes to its composition can be managed without undue disruption. [121]

In practice, the optimum size for any particular board will reflect several factors, including the:

- size and complexity of the company and its operations
- range of competencies and behavioural skills needed to handle the evolving circumstances and needs of the board and company as a whole
- need, if required, to achieve an appropriate mix of executive and non-executive directors
- need, if required, to allow for the appointment of nominee directors by institutional investors
- number and nature of board committees (audit committee, nomination committee, etc.)
- need to raise a quorum.

120. Companies Ordinance (Cap. 622), Section 453
121. Corporate Governance Code, Part 2 Section B.1

Finding and appointing new directors

The Corporate Governance Code set out that there should be a formal, considered and transparent procedure for the appointment of new directors. There should be plans in place for orderly succession for appointments. [122]

The HKEX's *Corporate Governance Guidance for Boards and Directors (December 2021)* states that the key role for nomination committee is board recruitment. It must evaluate and assess the optimal composition of the board, taking into account the issuer's culture, strategies and objectives. [123] When searching for a new director, the nomination committee should thoroughly review the existing board's strengths and weaknesses, skills and experience gaps, current age range and gender composition, and its ambitions for the future. The outcome of this process will be a brief containing detailed selection criteria approved by the board. There should be an established policy on how to identify directors and the selection process should be transparent and fair and develop a succession plan. The nomination committee should have specific responsibility for identifying suitable candidates and developing a list of desirable skills, perspectives and experience at the outset of the selection process for a new director is a good way to focus the search effort.

122. Corporate Governance Code, Part 2 Section B.2
123. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Committees' Roles and Functions

The Companies Ordinance [124] imposes no educational or specific qualification requirements for directors, although as mentioned the following people are excluded from holding office as a director:

- is under 18 years old
- is an undischarged bankrupt
- has been convicted for any malpractices, such as a breach of duties as a director, insolvent trading, bribery charges or misappropriate of company's assets.

Appointment process

For new appointments, a director must consent in writing to holding the position of director. The company must send the consent together with notice of appointment to the Companies Registrar, which include the following details: [125]

- personal particulars
- directorships or alternate directorships currently held
- consent to act as director

For listed entities, the Corporate Governance Code [126] stipulates that all directors should be subject to re-election at regular intervals.

When a new director has consented to the appointment, they should receive a letter of appointment setting out the key terms and conditions of the appointment.

A company may by an ordinary resolution passed at a general meeting remove a director before the end of the director's term of office, despite anything in its articles or in any agreement between it and the director. [127] For listed entities, an issuer must also explain the reasons for the resignation or removal of any director. [128]

Director due diligence

The role of the company director has become increasingly onerous and time consuming with directors bearing increased responsibility and liability. Prospective directors are advised to undertake their own due diligence on the companies they are invited to join, to ensure they can make a useful contribution and effectively discharge their duties.

Prior to accepting a board appointment, an individual may consider:

- investigate the particular company and the industry in which it operates
- gather information about the people in leadership roles and arrange to speak with key directors and senior management
- review documentation supplied by the company, such as company policies and strategy

124. Companies Ordinance (Cap. 622), Sections 459, 480
125. Refer to *Notice of Change of Company Secretary and Director (Appointment/Cessation)*, Companies Registry
126. Corporate Governance Code, Part 2 Section B.2
127. Companies Ordinance (Cap. 622), Section 462
128. Corporate Governance Code, Part 2 Section B.2

– be satisfied that they are equipped with the requisite skills and knowledge to properly discharge the responsibilities of a director

– assess their ability to contribute the requisite technical and interpersonal skills to enable them to build effective working relationships with the rest of the board and the executive team.

Director induction

The need to get new directors 'up to speed' as quickly as possible relates not only to directors' due diligence, but also to the induction provided by entities, as induction programs make it more likely that new directors can make an immediate contribution.

Director induction programs are designed to make the most out of a director's existing knowledge base by filling any knowledge gaps – typically concerning the company's industry, the competitive landscape and technical issues – as well as familiarising the director with all aspects of the company, including risk management. Increasingly, induction is also recognised as a key tool in a company's ethical framework, used to instil the desired cultural values and behaviours of the organisation. Professional development aids the reinforcement of those values and principles.

There is no prescriptive formula for what should be included in an induction program. The elements of the programme should be tailored to take account of the appointee's knowledge and experience, and will vary depending on company structure, processes and the major issues it faces.

The Corporate Governance Code [129] states that every newly appointed director of an issuer should receive a comprehensive, formal and tailored induction on appointment and it is the responsibility of the company secretary to facilitate the induction and professional development of directors. It is also the responsibilities of all directors to ensure that they keep abreast with the latest development areas. [130]

An induction programme for a new director may include:

– *Corporate information* – mission statement, values and code of conduct, strategic and business plans, financial accounts, legal and regulatory frameworks, major shareholders, corporate communications, overview of the company's competitors and industry information, risk profile and appetite, company history and product information

– *Governance framework* – board charter/governance statement, annual agenda, selected board packs, full details of directors, committee structures, board process, assurance providers, resources available, key stakeholders, procedures for sign-off of financial statements and items requiring approval outside of board meetings

– *Management information* – names and background of senior management, organisational and management structure outline, etc.

– *Legal and accounting training* – if a new director is not familiar with the legal framework that governs the entity and/or if the director does not have accounting skills or knowledge

129. Corporate Governance Code, Part 2 Sections C1.1, C.6

130. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Directors' Duties and Board Effectiveness

– *Technology training* – to optimise the use of dashboards and other technology in the boardroom. Technology training at the induction stage may also facilitate the directors' adoption of new technology in the future.

The Hong Kong Institute of Chartered Secretaries ("HKICS") provides free guidance on their website regarding the typical matters covered in an induction pack. [131]

Typically, a combination of written materials coupled with presentations and activities, such as meetings and site visits, will provide the appointee with a realistic picture of the company's position and the challenges it faces. It will also serve to foster a constructive relationship between the new director and their fellow directors and senior management.

An induction to board committees, with particular emphasis on those board committees which the new director will join, should not be overlooked. An induction pack containing relevant documents, such as committee charters, annual agendas and copies of minutes, plus a full briefing by the relevant committee chairman, will help the new director gain an appreciation of the major issues.

Director professional development

As well as providing induction programs for new directors, boards should also encourage and finance continuing director education.

Through the board evaluation process, areas will be identified where further education may enhance board and individual director effectiveness. The board should ensure that resources are budgeted to provide appropriate educational opportunities for directors. The chairman should address the developmental needs of the board as a whole, plus those of individual directors, with the company secretary playing a key role in facilitating the process.

The Corporate Governance Code states that briefing and professional development are necessary to ensure that the director has a proper understanding of the issuer's operations and business and is fully aware of the responsibilities under statute and common law, the HKEX's Listing Rules, legal and other regulatory requirements and the issuer's business and governance policy. It further states that the terms of reference of the board should include to review and monitor the training and continuous professional development of directors and senior management. [132]

As the need to interpret and critique non-financial reports becomes increasingly relevant, boards would also be wise to broaden the scope of such briefings and director training programs to include integrated reporting. The development of behavioural skills to help embed the cultural 'tone from the top' is also likely to become increasingly important.

Furthermore, the Exchange has made amendments to the ESG Guide and the related Listing Rules on July 2020 to improve ESG governance and disclosure, including introducing mandatory disclosure requirements where board's consideration of ESG matters is required. [133]

131. Refer to *Guide – Directors' Induction: An Overview*, HKICS
132. Corporate Governance Code, Part 2 Sections A.2.1, C.1.1
133. Refer to *Exchange publishes ESG Guide Consultation Conclusions and its ESG Disclosure Findings* (18 December 2019), HKEX (https://www.hkex.com.hk/news/regulatory-announcements/2019/191218news?sc_lang=en)

Professional development requires ongoing commitment from individual directors to continually reflect, learn, challenge and adapt. Directors with long tenures can often feel that they know the business and their role well enough to not require ongoing education, however the reverse is often the case. Such complacency and over-confidence can quickly make directors – and their organisations – irrelevant. Directors who do not value and engage in professional development are red flags for any board.

The first 100 days framework

Directors appointed to newly formed boards are required to oversee the challenging task of establishing a functioning boardroom and effective corporate governance structure. The first 100 days framework provides a high-level roadmap of the key activities and deliverables needed to establish an effective board within a target timeframe of 100 days. It can be applied for new boards or used as a checklist for existing boards.

The framework begins by establishing a direction and clear set of priorities for the newly established board. During this stage, the board should document its plan, and establish timelines and accountabilities around achieving its milestones.

Importantly, the board should then consider its risk management, setting its overall 'risk appetite' and documenting what it considers are the critical risks facing the organisation. With these considerations in mind, the board should then define its target operating model, appoint its key management personnel and endorse policies to guide the organisation.

While this is occurring, the board should be engaging shareholders and key stakeholders and overseeing the development of an accountability and compliance framework.

Governance priorities	Risk profile	Operating model	Stakeholder framework	Compliance

– Terms of reference
– Charter and annual Agenda
– Financial compliance
– Legal and compliance duties
– Retained authorities
– Delegations/CEO limits
– Code of conduct
– Strategic plan
	– Risk management policy
	– Risk workshop
	– Agree and validate critical risks
	– Risk register
	– Risk monitoring and mitigation
	– Risk reporting framework
		– Policies:
		  – Conflicts of interest
		  – Regulatory compliance
		  – Privacy
		  – Whistleblower & Fraud
		  – Media/crisis/incident
		  – Continuous disclosure
		– Target Operating model
		– Key appointments CEO / Chief Financial Officer ("CFO")
			– Communication policy
			– Internal/shareholders/ community/government
			– Shareholder relations
			– Mapping & Tiering
			– Engagement plan
			– Consultation model
			– Shareholder and consumer participation forums
				– Compliance framework
				– Internal and external auditor appointment
				– Audit and risk committee
				– Consequence and breach policy
				– Reporting & oversight
				– Board performance assessments

Leadership & strategy	Risk management	Performance & monitoring	Stakeholder engagement	Accountability & audit
Informed discussions and decisions, not an endless stream of suprises.	*Proactive, strategic, not a reactive function.*	*Healthy culture supported by strong policies, not an inconsistent 'tone at the top'.*	*Active stakeholder consultation, not disengagement from the process.*	*Tailored assurance and reporting, not a 'one size fits all' approach.*

Board evaluation

As previously stated in the 'Finding and appointing new directors' section of this chapter, the Corporate Governance Code [134] states that "there should be a formal, considered and transparent procedure for the appointment of new directors". The reappointment of directors is inextricably linked to the evaluation of the board.

Board evaluation is also a useful process in identifying the critical success factors for improving the effectiveness and efficiency of the board and its committees. It encourages directors to examine their own contribution and, when expertly facilitated, can improve working relationships between directors. The HKIoD's *Guidelines for Directors* (4th edition) [135] further stress the importance of conducting an evaluation of the board to assess how the board can do better in the way forward and serve to present to shareholders upon re-election the individual directors' effectiveness and commitment to the role.

For listed entities, the Corporate Governance Code [136] recommends as a best practice that the board of a listed entity should conduct a regular evaluation of its performance.

For authorised institution, the Hong Kong Monetary Authority ("HKMA") [137] states they should conduct evaluations of the performance of the board and individual directors at least once a year, which may be done by themselves (especially peer reviews), by engaging professional advisers, or a combination of the two.

The HKICS [138] suggests 6 best practices for board evaluation:

- agree on a well-planned, systematic process for evaluations
- allow for anonymous feedback
- secure board evaluations
- value board directors' feedback, time and effort
- make evaluations easy
- automate where possible

In addition, the HKICPA [139] proposes annual evaluations to be undertaken based on publicly agreed terms of reference and involving INEDs or third-party evaluators.

The evaluation process

Some of the issues to consider when designing an evaluation include:

- the type of assessment and evaluation process to

  be used (e.g. qualitative, quantitative or a combination of both)
- the scope of assessment and evaluation
- who should perform the assessment and evaluation process (in-house, chairman, external independent facilitator)
- the timing and frequency of the assessment and evaluation.

134. Corporate Governance Code, Section B.2
135. *Guidelines for Directors* (4th edition), HKIoD, Section 77A
136. Corporate Governance Code, Section B.1.5
137. Refer to *Empowerment of Independent Non-Executive Directors (INEDs) in the Banking Industry in Hong Kong* (14 December 2016), HKMA
138. Refer to *Board evaluations: getting directors on Board* (11 February 2019), HKICS (http://csj.hkics.org.hk/site/2019/02/11/board-evaluations-getting-directors-on-board/)
139. Refer to *Report on Improving Corporate Governance in Hong Kong* (15 December 2017), HKICPA

A gap analysis between how the board or committee actually works and good board practice is a useful starting point for any evaluation. Conducting regular board and committee evaluations also sends a signal to the marketplace that the company is serious about governance and enhancing its performance. Shareholders and proxy voters are beginning to take more notice of whether companies engage in this practice.

Furthermore, engaging an external expert facilitator can help to shine a light on previously unthought-of aspects of the evaluation process that will glean further opportunities for board development and succession planning.

The board or nomination committee can also address gaps identified during the evaluation process through professional development and/or succession planning (both of which are covered separately in this chapter).

Director remuneration

Directors are not entitled to payment for services unless this is provided for in the constitution of the organisation or approved in a resolution of shareholders.

The process for determining levels of remuneration for directors is complex and involves balancing the interests of a number of stakeholders. A balance needs to be struck between attracting, motivating and retaining highly skilled directors, and paying an appropriate level of fees that properly reflects the responsibilities of the directors, the size and complexity of the company and its operations, the industry sector, the shareholders' vote on the remuneration at the AGM, the time commitment required of the director, the director's qualifications and experience, and any other duties to be carried out within the role (e.g. chairman of certain board committees).

It is important to ensure that a director is being paid fairly and appropriately in light of the specific responsibilities and risks associated with the role, their memberships on particular committees, the time required to discharge their duties to the company and the size and complexity of the business as a whole. This should involve reviewing the director's remuneration annually, and can include a peer group benchmarking review, if warranted.

Listed companies remuneration

An issuer should disclose its directors' remuneration policy and other remuneration related matters. The procedure for setting policy on executive directors' remuneration and all directors' remuneration packages should be formal and transparent. Remuneration levels should be sufficient to attract and retain directors to run the company successfully without paying more than necessary. No director should be involved in deciding that director's own remuneration.[140]

Non-executive director compensation should be:

- determined by the board and disclosed completely to shareholders
- aligned with the long-term interests of shareholders
- at a level to adequately compensate directors for their time and effort.

In general, compared with executives, non-executive directors should not receive options or bonus payments which are dependent on the satisfaction of performance

140. Corporate Governance Code, Part 2 Section E.1

conditions, as this can bias their judgment in favour of short-term performance. Non-executive directors should not be provided with retirement benefits, as entitlements to benefits that accrue over time may discourage directors from retiring or resigning from the board at the most appropriate time.

The Corporate Governance Code recommends that issuers generally should not grant equity-based remuneration (e.g. share options or grants) with performance-related elements to INED as this may lead to bias in their decision-making and compromise their objectivity and independence.[141]

Some further issues to take into account when setting fees are the number of sub-committees in which the director participates and whether as the chairman or member, the company's current policy with regard to board fees, the experience and knowledge of the potential director, the indicative level of remuneration being paid to directors in comparative companies (of size and industry) and the size and complexity of the business.

In some circumstances, such as takeovers and mergers, directors may be required to spend considerably more time reviewing proposals or responding to the situation. In these circumstances, it has become more common for directors to receive additional remuneration to take account of the extra time.

Executive director remuneration

Remuneration for executive directors (and other executives) should include an appropriate balance of fixed remuneration and short- and long-term performance-based incentives.

141. Corporate Governance Code, Part 2 Section E.1.9

The Corporate Governance Code recommends that a significant proportion of executive directors' remuneration should link rewards to corporate and individual performance.[142]

Re-election and rotation of directors

For non-listed companies, the requirement and terms of the re-election of directors is dependent on the company's constitution.

For listed companies, the Corporate Governance Code requires all directors should be subject to re-election at regular intervals. Every director, including those appointed for a specific term, should be subject to retirement by rotation at least once every three years.[143]

Serving more than 9 years could be relevant to the determination of a non-executive director's independence. Such director's further appointment should be subject to a separate resolution with documented reasons why the board or the nomination committee believes the director is still independent and should be re-elected, including the factors considered, the process and the discussion in arriving at such determination, to be approved by shareholders. Also, where all the INEDs of an issuer have served more than 9 year on the board, the issuer should appoint a new INED.[144]

Board succession planning

Board succession planning challenges boards to anticipate and plan for their future needs. It should be a continuous process that is regularly considered by the board so that changes in the board composition can be anticipated and planned for in advance.

142. Corporate Governance Code, Part 2 Section E.1.7
143. Corporate Governance Code, Part 2 Sections B.2, B.2.2
144. Corporate Governance Code, Part 2 Section B.2.3, B.2.4

The Corporate Governance Code [145] states that one of the duties the nomination committee should perform is making recommendations to the board on the succession planning for directors, in particular the chairman and the chief executive.

Board succession planning is built on:

– an assessment of the challenges and opportunities facing the company, now and in the future (and therefore strongly aligned to the strategy development process)

– an analysis of the core skills, competencies and behaviours that are required, both immediately and in the future, for both the board and its committees

– an evaluation of the skills, competencies and behaviours of existing directors, including their strengths and weaknesses, skills and experience gaps, current age range and gender composition, and length of tenure

– assessments of existing directors' performance

– assessments of non-executive directors' independence.

The HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021)[146] states that a board skill matrix shows the directors' attributes and competencies and how each director contributes to a critical function of the board and the issuer's succession planning.

Succession planning for chairperson

In developing a succession plan, the chairman's role needs to be considered by the board or nomination committee. In instances where the current chairman's retirement date is known, plans can be set in place to identify a new chairman, either internally or externally.

Companies should also have a contingency plan for the chairman's role in the case of some unexpected event. Previous cases of simultaneous vacancies in the roles of both the chairman and managing director are a reminder to all boards of the consequences of such unplanned disruptions to a board's succession.

Director tenure

As stated in the HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021) [147], the nomination committee must also consider succession planning to ensure the long term success of the issuer. There is a danger that long-standing directors become entrenched and lose their ability to consider issues from an impartial and objective standpoint. Tenure has been cited as one of the key criteria for evaluating the independence of non-executive directors in the Corporate Governance Code. [148] For this reason, many listed companies adopt a director tenure policy providing for a maximum term of office (e.g. nine years), with any extension being subject to annual approval. A company's constitution can also provide for situations in which a director's office is to be vacated at any given point in time (e.g. unsoundness of mind).

145. Corporate Governance Code, Part 2 Section B.3.1
146. Corporate Governance *Guidance for Boards and Directors* (December 2021), HKEX, Board Diversity and Policy
147. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Committees' Role and Functions
148. Corporate Governance Code, Part 2 Section B.2.4

A director of a company may, unless it is otherwise provided in the articles of the company or by any agreement with the company, resign as director at any time. The company must deliver a notice of resignation to the Companies Registry within 15 days after the cessation or change of director. [149]

Removing a director who is unwilling to leave is a difficult situation. According to the Companies Ordinance, a company may by an ordinary resolution passed at a general meeting remove a director before the end of the director's term of office, despite anything in its articles or in any agreement between it and the director. Special notice is required of a resolution to remove the director. [150]

Access to company records

The Companies Ordinance set out that the company's accounting records must be open to inspection by the directors at all times without charge. The company must also allow a director to make a copy of its accounting records in the course of inspection. [151]

The board could consider adopting an information policy which provides that the company secretary holds a complete set of board and committee papers. Under this policy, directors should be entitled, on request, to access board papers for the period during which they were a director, even if they have ceased to be a director. Increasingly such papers are being held electronically, with approval granted to directors, enabling easy access and avoiding the need for the retention of papers by individual directors.

149. Companies Ordinance (Cap. 622), Sections 464, 645
150. Companies Ordinance (Cap. 622), Section 462
151. Companies Ordinance (Cap. 622), Sections 374, 375

Useful references

- *Companies Ordinance (Cap 622)*
- *The HKEX's Listing Rules*
- *Corporate Governance Code, as set out in Appendix 14 to the Main Board Listing Rules and Appendix 15 to the GEM Listing Rules*
- *Corporate Governance Guidance for Boards and Directors (December 2021), HKEX*
  https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Corporate-Governance-Practices/guide_board_dir.pdf?la=en
- *Consultation Conclusions on Review of the Corporate Governance Code and Related Listing Rules, and Housekeeping Rule Amendments (December 2021), HKEX*
  https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/April-2021-Review-of-CG-Code-and-LR/Conclusions-(Dec-2021)/cp202104cc.pdf
- *HKIoD Code of Conduct*
  https://www.hkiod.com/document/code_of_conduct_eng.pdf

– *Refer to Women on Boards Hong Kong 2021 (02 January 2021), Community Business* (https://www.communitybusiness.org/women-on-boards)

– *Notice of Change of Company Secretary and Director (Appointment/Cessation), Companies Registry* *https://www.cr.gov.hk/tc/companies_ordinance/docs/ND2A_fillable.pdf?formref=COR-F011*

– *Guide – Directors' Induction: An Overview, HKICS* *https://www.hkics.org.hk/media/publication/attachment/PUBLICATION_A_2343_Guide%20to%20Directors'%20Induction%202013.pdf*

– *Exchange publishes ESG Guide Consultation Conclusions and its ESG Disclosure Findings (18 December 2019), HKEX* *https://www.hkex.com.hk/news/regulatory-announcements/2019/191218news?sc_lang=en*

– *Guidelines for Directors (4th edition), HKIoD* *https://www.hkiod.com/guidelines-for-directors.html*

– *Empowerment of Independent Non-Executive Directors (INEDs) in the Banking Industry in Hong Kong (14 December 2016), HKMA* *https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2016/20161214e1.pdf*

– *Board evaluations: getting directors on Board (11 February 2019), HKICS* *http://csj.hkics.org.hk/site/2019/02/11/board-evaluations-getting-directors-on-board/*

– *Report on Improving Corporate Governance in Hong Kong (15 December 2017), HKICPA* *https://www.hkicpa.org.hk/-/media/HKICPA-Website/HKICPA/section5_membership/Professional-Representation/corporate-governance/HKICPA_CG_Report_on_Improving_Corporate_Governance_in_Hong_Kong.pdf*

8. Company Leadership

Most boards would agree that one of their most important governance roles is hiring and possibly managing out the CEO. After all, the CEO is responsible for the day-to-day operations of the organisation and is instrumental in both the development and execution of corporate strategy.

In this chapter

- CEO and executive management
- Role of the CEO
- Executive remuneration
- Executive service agreements

Questions that company directors should ask

1. Does the board have confidence in the skills and capabilities of the CEO and the senior management team? What process or approach is in place to help to objectively validate this view?
2. How does the CEO encourage and support the development of a fit-for-purpose talent pipeline that establishes suitable talent bench strength?
3. What is the 'tone at the top', as understood and experienced by layers below?
4. Does the board have in place a robust and fit-for-purpose succession readiness programme that is ready to support a CEO replacement process at any time and is supported by internal executive talent development?
5. Prior to the appointment of a new CEO, does the board (through the chairman or nomination committee) conduct a rigorous succession evaluation process?
6. Is the CEO's view regarding senior management team members and other talented people with strong leadership qualities considered?
7. Does the board have a CEO and senior management succession plan that is regularly (e.g. semi-annually) considered and reviewed for relevance, given the operating environment of the organisation at the time of review (such that talent is considered in the context of the current and prospective operating environment)?
8. Do the CEO's responsibilities include supporting the attracting, developing and retaining of high-performing talents in the organisation?
9. Are concerns about the CEO's performance discussed with the CEO and appropriately documented?
10. Does the board have a transparent process for determining management remuneration?

Red flags

1. The CEO selection process was conducted largely in-house within a pool of board members' friends and business associates.
2. Support and confidence in the CEO is divided amongst board members.
3. The CEO does not have KPIs or they are often not being met.
4. Remuneration setting is discussed mostly privately.
5. CEO performance appraisal is conducted infrequently and informally.
6. No contingency plan or succession plan exists for the current leadership structure; or the plans that do exist lack substance and meaningful engagement (i.e. box checking).
7. The CEO seems focused mostly on achieving his/her own remuneration targets.
8. There is no senior executive development plan in place.
9. There is no regular review or external assessment of senior executive talent.
10. The board has restricted or no access to senior management.

CEO and executive management

The CEO should be involved in nearly all board discussions and input into decisions, where appropriate. They should also have meaningful delegated authority to enable the execution of the enterprise's strategy.
The CEO is pivotal to establishing and reinforcing to all stakeholders the 'tone' of what is expected of the enterprise to all stakeholders; they play a key role in representing the organisation to external parties.

It is usual practice for a CEO to establish an executive management team (or similar) which will:

- provide support to the CEO
- exchange information and ideas
- constructively develop and implement strategies and management frameworks
- provide input on the organisation's direction
- influence the organisation at all levels.

Building a strong executive management team is essential for organisational success. Factors associated with strong organisational leadership include:

- respective board and management roles and responsibilities clearly delineated and articulated in writing
- board protocols covering directors' access to executive managers outside of board meetings
- a CEO that provides appropriate direction, mentoring, support and guidance to executive management team members
- executive management team members who are empowered to share leadership responsibilities
- executive management team members who are rewarded for organisational, business unit and individual performance, based on behavioural standards displayed and value creation outcomes
- management succession and development plans that cover all key positions, based on competencies, behaviours and experience to achieve the strategic vision
- full disclosure of conflicts of interest.

"Leaders establish the vision for the future and set the strategy for getting there; they cause change. They motivate and inspire others to go in the right direction and they, along with everyone else, sacrifice to get there."

Dr John Kotter, Konosuke Matsushita Professor of Leadership, Emeritus (Harvard Business School)

Role of the CEO

It goes without saying that, as a company's most senior officer, the CEO is critical to the performance of the enterprise. The scope of activities and responsibilities assigned to the CEO are broad and far-reaching. Through their attitudes and behaviours CEOs are instrumental in reinforcing the 'tone' of their organisations.

An effective CEO:

- leads with clear purpose, and actions this purpose through providing clarity to the organisation
- actively develops direct reports and sponsors organisation-wide people development
- is consultative, as well as courageous, in making the decisions needed
- always acts with integrity
- drives strategic vision and innovation
- is resilient in the face of setbacks
- successfully adapts to the company's ever changing circumstances
- demonstrates high-level business acumen
- meets immediate performance targets without neglecting longer-term growth opportunities.

The titles CEO and managing director are often used interchangeably. In theory, a CEO does not necessarily have a seat on the company's board, whilst the managing director is, by definition, a director.

Delegated authority

In putting its relationship with the CEO on a sound footing, a board needs to formulate a CEO's job description and define the criteria for the CEO's performance-based remuneration (usually led by the chairman). There should also be a formal statement delineating the boundaries between board and management responsibilities, including the board's retained authorities and those delegated to management (which is usually set out in the board charter). A high-performing board will invest time and effort in constructing an active partnership with the CEO and senior management. It will not be a relationship based mainly on supervision but one in which the board engages with the CEO and senior management to achieve outstanding results.

Outside directorships

Traditionally, the CEOs of many of Hong Kong's leading companies were invited onto the boards of other public companies. The only real restriction on this practice was the avoidance of overt conflicts of interest. This practice was not considered exceptional and was seen as a good training ground for public company directors. In recent times, the size of current CEO remuneration packages and the scope of their responsibilities has often made outside directorships untenable.

Recent trends show examples of CEOs who are coming to the end of their management tenure and holding one other non-executive directorship. Proxy advisors appear to be comfortable with this approach for transitioning the CEOs.

Former CEOs can make excellent non-executive directors in other companies. However, many who have made the move report that there is a considerable transition from being a CEO wielding considerable power and influence, to the collegiate and consensus-based role of the non-executive director. This is where having a clear understanding of the role of a director (versus being part of the executive team) is crucial for both the board and management to effectively do their jobs.

It is no longer common practice for retiring CEOs to remain on their boards in a non-executive capacity, or for retiring CEOs to assume the chairman's role, as it then raises issues of independence. According to the HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021) [152], the board or nomination committee should be aware of whether the INED candidate is a CEO or full time executive director at another listed issuer when assessing the INED candidate's time commitment to the issuer. In addition, suers should explain whether a proposed INED would be able to devote sufficient time to the board if the person will be holding his seventh (or more) listed issuer directorship.

CEO succession planning

The purpose of succession planning is to ensure the board always has available a number of successor candidates in the event that the incumbent CEO departs suddenly and unexpectedly. Ideally, succession planning should start from day one of a new CEO's appointment.

152. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Directors' Duties and Board Effectiveness

Each company's needs are unique and change over time, as does the available pool of talent from which a new CEO may be drawn. The board should ask the CEO to provide an assessment of the key internal contenders and what is being done to develop their strengths and overcome any limitations in order to prepare them for being succession-ready.

Some companies approach succession planning by considering different contingencies, ranging from crisis management (e.g. if something untoward were to happen to the CEO, could the company continue to operate successfully?) to long-term issues such as attraction, development and retention of individuals to be future leaders.

At the heart of CEO succession planning is the notion that the board and the CEO work in cooperation to attract, develop and retain high performers who can be tried and tested prior to possibly being offered the CEO role in the future.

Selecting a CEO

The selection of a CEO is the most important task a board can undertake. It is also probably the most difficult. Boards should drive the succession process, although normally in collaboration with the incumbent CEO. Boards sometimes select a CEO heir-apparent well in advance of the incumbent CEO's planned departure.

For organisations with good succession planning, the selection of a CEO may appear almost automatic with a suitable successor long identified. However, as executives become more mobile and the typical CEO's job tenure continues to shrink, conventional succession planning may not identify an unequivocally acceptable internal candidate. Many boards will feel they have an obligation to look beyond a company's own executive ranks if they are to find the best available CEO.

The board must ensure that robust processes are adhered to in the lead-up to the appointment. Experience suggests that the probability of a successful outcome is enhanced if boards follow a structured appointment process.

Confidentiality is critical throughout the appointment process. Any breach will deter potential candidates and reflect poorly on directors and the company as a whole.

CEO tenure

CEOs are increasingly under the spotlight with boards being prepared to replace them if they consider that their CEO is not performing, or believe that future performance may not be up to the level expected.

A study on CEO succession [153] found that planned turnovers are increasingly common in the world's top 2,500 companies. The study also found a clear correlation between companies with planned turnovers and companies in the top quartile of performance during turnover periods and good governance. Similarly, companies that were able to hire the CEO from inside the company also performed better, highlighting the value of succession planning.

153. Refer to *What happens after a legendary CEO departs?*, Strategy& (https://www.strategyand.pwc.com/gx/en/insights/ceo-success.html)

Investment in the CEO and management team is crucial for the creation of sustained shareholder wealth. For this reason, directors need to commit considerable time and effort to selecting a new CEO. This should be supplemented by appropriate mentoring, development, encouragement and support; a role often fulfilled by the chairman of the board.

When CEO performance concerns arise, these should be discussed and addressed promptly. If it is clear that the CEO is not delivering and needs to be replaced, then the board should act without delay. Whilst the cost of replacing a CEO is considerable, the cost of not acting can be devastating.

CEO appraisal

The CEO performance appraisal is an important board responsibility and should take place on an annual basis. This appraisal provides:

- important feedback to the CEO about his/her performance
- increased understanding of the CEO's concerns and views on the achievement of corporate objectives
- a forum to build a healthy relationship between the board, especially the chairman, and the CEO
- a framework for the CEO to further develop capabilities
- a forum to reinforce accountability, transparency and the responsibilities of the CEO
- an opportunity to identify and address early warning signs of possible difficulties
- an opportunity to discuss any future plans the CEO may have (e.g. retirement).

A robust appraisal process should be established that reflects the company's unique circumstances. This work is generally the responsibility of the remuneration committee, which will make recommendations to the entire board.

A more accurate picture of CEO performance can be gained by incorporating the views of several groups. For example, directors, senior executives, institutional shareholders, customers, suppliers and other key stakeholders will all have a view on the CEO's performance. This must be handled sensitively and all comments treated confidentially to uphold the integrity of the appraisal process.

Both quantitative and qualitative indicators may be included to assess the CEO's leadership behaviour and performance goals, which are fundamental to sustained organisational performance. Using financial and company performance measures alone are inherently problematic. There is an array of factors outside the direct control of the CEO that can affect company performance. A CEO may be performing strongly when the company is not and vice versa. Also, shareholder value can be measured from a number of perspectives, with startlingly different end results. In any event, CEO performance should be measured not only against short-term company financial performance, but also on the CEO's own performance, especially against agreed key performance indicators and corporate strategic objectives.

Executive remuneration

Executive remuneration is a topic that usually elicits much discussion and controversy. The Corporate Governance Code [154] states that the remuneration levels should be sufficient to attract and retain directors to run the company successfully without paying more than necessary. In determining a remuneration policy, the board needs to:

- ensure that remuneration is set at levels that appropriately reward, motivate and incentivise management to execute company strategy
- demonstrate a clear relationship between senior executives' performance and remuneration
- ensure that the remuneration policy is understood by investors.

Executive remuneration should include an appropriate balance of fixed and variable remuneration. The Corporate Governance Code [155] recommends that a significant proportion of executive directors' remuneration should link rewards to corporate and individual performance. The HKEX's *Guidance for Boards and Directors* (July 2018) [156] sets out the factors to be considered by the remuneration committee for executive remuneration, including:

- salaries paid by comparable issuers, time commitment and responsibilities, employment conditions in the group
- appointment and termination terms for directors and senior management to ensure they are fair
- compensation arrangements relating to dismissal or removal of directors for misconduct to ensure they are reasonable and appropriate
- company culture and other non-financial key performance indicators, such as climate related performance indicators
- whether the remuneration package for an INED may affect the INED's objectivity and independence.

Listed companies are subject to a strict disclosure regime. The Corporate Governance Code [157] requires the issuers to disclose details of any remuneration payable to members of senior management by band and other remuneration related matters in the annual reports. It further recommends that the issuers should disclose details of any remuneration payable to members of senior management, on an individual and named basis, in the annual reports.

In addition, the remuneration committee should disclose a summary of work during the year, including determining the policy for the remuneration of executive directors, assessing performance of executive directors and approving the terms of executive directors' service contracts, performed by the committee.

154. Corporate Governance Code, Part 2 Section E.1
155. Corporate Governance Code, Part 2 Section E.1.7
156. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Committees' Role and Functions

157. Corporate Governance Code, Part 2 Sections E.1.5, E.1.8, E (d) (ii)

Executive service agreements

With more rigorous disclosure requirements, the board's approach to negotiating the terms of CEO and senior executive service contracts is more open to challenge by the media and shareholders.

The board has the difficult task of striking a balance between the need to attract and retain senior executives with protecting company interests by not paying excessive remuneration. Most importantly, the process by which executive service agreements are set up must be transparent and beyond reproach.

The remuneration committee is usually vested with the responsibility of providing recommendations to the board in relation to the key terms of executive service agreements and remuneration arrangements on appointment. It is important that there is sufficient expertise within the ranks of the remuneration committee to effectively advise the board on these matters. The board is ultimately responsible for ratifying the appointment of the CEO, and thus it should retain sign-off authority.

It is important that the process adopted ensures the executives for whom contracts are being negotiated remain at arm's length (i.e. instructions on the preparation of the contract should be given directly to solicitors or consultants by the remuneration committee). This does not preclude the CEO and other senior executives from making submissions to the remuneration committee about their own contracts or making recommendations on the remuneration of their direct reports.

The preparation of an executive service agreement is complex. Professional advisers should be engaged who can ensure that the contract reflects what has been agreed and that the contract accords with the law. Any drafting of contracts needs to consider the regulatory framework and the company's governing documents, including the:

- Companies Ordinance (Cap. 622)
- Employment Ordinance (Cap. 57)
- HKEX's Listing Rules
- Company's constitution
- company remuneration policies
- company strategy.

Useful references

- *Corporate Governance Code and Corporate Governance Report, as set out in Appendix 14 to the Main Board Listing Rules and Appendix 15 to the GEM Listing Rules*
- *Corporate Governance Guidance for Boards and Directors (December 2021), HKEX* *https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Corporate-Governance-Practices/guide_board_dir.pdf?la=en*
- *What happens after a legendary CEO departs?, Strategy&* *https://www.strategyand.pwc.com/gx/en/insights/ceo-success.html*

9. Board Committees

Board committees can enhance the oversight provided for companies. As managing and controlling companies becomes more complex, boards are making more use of committees to help all directors better perform their duties and discharge their responsibilities.

In this chapter

- Types of committees
- Benefits of committees
- Terms of reference
- Committee annual agenda
- Committee induction framework
- Committee meeting agenda and minutes
- Committee size and composition
- Committee/board interaction and reporting
- Committee evaluation
- Audit committee
- Risk Committee
- Remuneration committee
- Nomination committee
- Other common committees
- Special purpose committees

Questions that company directors should ask

1. Do the committees in place help the board focus on the key risks and issues facing the organisation?
2. Are board committee charters approved by the board and reviewed annually?
3. Are board committees comprised of a majority of independent directors?
4. Are the offices of the chairman of the board and the chairman of the audit committee exercised by different people?
5. Are the offices of the chairman of the board and the chairman of the remuneration committee exercised by different people?
6. Does each board committee have the expertise and experience to properly advise the full board?
7. Are there an appropriate number of directors with accounting or financial expertise on the audit committee?
8. Does the audit committee meet without management present in order to question the external and internal auditors?
9. Does the board critically scrutinise and question the information provided, and recommendations made, by a board committee, even when endorsed by 'experts'?
10. Is the board informed of any issue upon which committee members are not in full agreement?

Red flags

1. Board committees lack terms of reference or charters.
2. Certain committees are not resourced with appropriately skilled people.
3. The audit committee meets only when required by internal or external auditors.
4. Minutes are not taken at committee meetings or the minutes are not distributed regularly to members.
5. The audit, nomination or remuneration committee involve mostly executive directors due to the unavailability of independent directors.
6. The audit committee has little to do with assessing internal control systems and coordinating with the internal audit function.
7. Similar sized companies or competitors have established additional committees that the company is yet to establish.
8. There is irregular reporting to the board from the chairpersons of the committees.
9. There is insufficient detail provided by the committee chairman for the issues to be appropriately considered.

Types of committees

The most common board committees are the:

– audit (and risk) committees
– nomination committee
– remuneration committee.

Depending on circumstances, additional committees, including ad hoc committees, may be established to deal with other pertinent matters, oversee specific projects or focus on key risk areas for the organisation.

Types of additional committees can include sustainability, information technology, research and development and special purpose (e.g. takeover and merger). However, in general terms, the number and scope of board committees will depend upon the size and complexity of the organisation.

Benefits of committees

Board committees can produce a number of benefits, such as:

- allowing directors to use their limited time more efficiently and effectively to do board work
- acting as a filter in summarising complex issues and recommending courses of action
- sending a positive signal to investors that major issues are being dealt with by the company
- allowing independent directors to gain a comprehensive understanding of the business.

The HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021)[158] states that the board is responsible for performing the corporate governance duties and it may delegate the responsibilities to board committees. Where committees are separated, it is important that there are common members.

Directors have the power to delegate any of their powers to a committee but should not delegate matters to a board committee to an extent that would significantly hinder or reduce the ability of the board as a whole to perform its function.[159] Such delegations are generally set out in the terms of reference (however, to the extent they are not, these should be documented in the board minutes). Any such delegations must also be documented in the board minutes.

158. *Corporate Governance Guidance for Boards and Directors (December 2021)*), HKEX, Board Committees' Role and Functions
159. Corporate Governance Code, Part 2 Section C.3.1

It is imperative that all board committees adopt the same type of systematic planning and processes as the full board, including having:

- a written terms of reference
- an annual agenda
- meeting papers and minutes prepared.

Committees should report regularly to the board through a verbal report by the committee chairman, as well as through a detailed report and/or committee minutes in the board papers. Committees should also review their charters and membership at least annually, with any recommend changes reported back to the full board.

Some of the challenges associated with board committees include:

- ensuring that the committee is comprised of directors with the appropriate expertise and resources to provide the full board with high quality advice
- the legal question of whether a higher standard of care will apply to directors, who are vested with the responsibility of investigating particular issues and making recommendations to the full board.

Terms of reference

The starting point for any board committee is a formal terms of reference. The terms of reference helps committee members understand their duties and responsibilities and how these can be reconciled with the expectations of the full board and the organisation's stakeholders.

A typical terms of reference covers:

- the committee's purpose, responsibilities and duties
- the authority of the committee (including delegations by the board)
- the committee structure and terms of appointment for the chairman and members
- meeting requirements and procedures (e.g. frequency of meetings, quorum, voting and minutes)
- access to company personnel and independent external advisers
- members' skills and experience requirements
- board reporting requirements
- committee assessment process.

For an example of an audit committee terms of reference (including further detail on the types of key matters which are typically covered), refer to example Appendix 3 Audit committee terms of reference.

The terms of reference, explaining committee roles and the authority delegated to it by the Board should be included on the Exchange's website and issuer's website.[160]

Committee annual agenda

An annual agenda provides the framework to manage the committee's time, resources, meeting frequency and the matters considered by the committee.

An effective annual agenda:

- reflects a complete picture of the committee's roles and responsibilities
- is aligned with the board annual agenda to ensure integration of the board and its committees
- provides a summary of the committee's key activities
- prevents meetings being 'crowded-out' by peripheral issues
- ensures the committee's insights and expertise are fully utilised.

The annual agenda brings the committee terms of reference to 'life' as it drives the committee's:

- activities
- meeting agendas
- information requirements.

For more information, refer to the example audit committee annual agenda set out in Appendix 5 Audit committee annual agenda.

Discussion on the annual agenda solicits the involvement of committee members concerning the nature and timing of agenda topics. The committee's annual agenda also helps to determine non-committee members who should be invited (including management and external advisers) to meetings and identifies potential conflicts of interest.

160. Corporate Governance Code, Part 2 Sections B.1.2, B.3.2, D.3.4, E.1.3

Committee induction framework

Audit and other board committees have significant responsibilities. It is not sufficient for committee members to have only a rudimentary knowledge of the specific matters under consideration. Committees cannot provide meaningful protection for shareholders unless their committee members are in a position to challenge management. To do this effectively they must have the skills, knowledge and expertise, and be supported by access to independent advisers. A formal induction framework for new committee members is essential. Induction should comprise the provision of an information package with key business documentation, training sessions and meetings with key business executives. Appendix 4 Audit committee induction framework provides a detailed listing of inclusions in the audit committee induction framework.

Committee meeting agenda and minutes

Each committee meeting agenda should be prepared with reference to the committee's terms of reference and annual agenda. The committee chairman and company secretary should take responsibility for the content of the agenda, seeking input from committee members, the CEO and senior management, where practicable.

The process of setting the agenda should involve:

- consideration of content
- ordering of items
- allocation of time for each item
- deciding on invitees.

Careful preparation of the agenda will enhance the committee's productivity by focusing the committee's attention on the critical matters requiring examination and discussion. Committee minutes must be a complete and accurate record of the resolutions adopted and recommendations made by a committee, evidencing that the committee has acted with due care.

The company secretary, or delegate, is responsible for maintaining a complete set of committee papers, including minutes of meetings, meeting agendas and supporting papers.

Committee draft minutes should be circulated to members after meetings and to all directors for information.

Approval of minutes should coincide with the next meeting of the committee.

Committee size and composition

While the size of a committee varies according to the organisation, a sufficient number of members with the necessary knowledge and expertise should be present in any committee. KPMG suggests that for large organisations, audit committees should be made up of at least four members to allow sufficient diversity of skills and experience.

In determining the appropriate size for each committee, the board should take into account the:

– complexity and geographic diversity of the organisation
– nature and extent of its responsibilities
– knowledge and experience required of committee members
– minimum number of members to allow a workable quorum
– numbers needed to encourage robust and insightful debate.

The HKEX's *Corporate Governance Guidance for Boards and Directors* (December 2021) [161] indicates that the audit, nomination and remuneration committees should comprise of a majority of independent non-executive directors (and in the case of the audit committee, should consist only of non-executive directors and be chaired by an independent director (who must not be chairman of the board)).

Committees usually deal with technical matters, such as financial reporting standards, risk management and executive remuneration. Therefore, ensuring committee members have the relevant skills and experience, as well as access to expert advice, is paramount.

Committee/board interaction and reporting

Board committees are an effective forum for investigating and reviewing important issues in more detail than the full board's agenda normally allows for.

The board should expect the reports it receives from its committees will be:

– complete, but concise
– timely
– accurate
– compiled with integrity.

Whilst the committee may complete background work and make recommendations to the board, or act where the delegation to the committee permits, the overall responsibility for decisions always remains with the full board.

It is, therefore, essential for directors to:

– question the committee chairman and members when the committee report is being presented
– not blindly rely on any information or advice provided (even 'expert' recommendations)
– challenge whether the organisation's culture is appropriate, including the 'tone at the top', from a control perspective
– be informed of any issues on which committee members were not in total agreement
– confirm that any external parties (e.g. auditors) have been effective in providing the required assurance.

161. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Board Committees' Role and Functions

Committee evaluation

Board committees, like their parent boards, should be evaluated on a regular basis to improve their effectiveness. The Corporate Governance Code [162] recommends that the board should conduct a regular evaluation of its performance.

The focus of the evaluation assessment should include looking at the committee's:

- structure, role-clarity and authority
- composition, skill-sets and development
- leadership, relationships and processes
- nature and scope of work.

A typical assessment process includes:

- a self-assessment survey
- interviews with committee members, as well as management and assurance providers
- a review of the quality, quantity and relevance of information coming to, and emanating from, the committee.

The assessment's outcome should be a report providing an objective, balanced evaluation of the committee's effectiveness, highlighting specific areas for improvement.

As a good governance measure, committee evaluations should be performed on an annual basis (even if only informal). Individual assessments of committee chairman should be undertaken regularly by the chairman of the board and by the committee chairman for individual committee members.

162. Corporate Governance Code, Part 2 Section B.1.5

Audit committee

The Corporate Governance Code [163] requires the Board to establish formal and transparent arrangements to consider how it will apply financial reporting, risk management and internal control principles and maintain an appropriate relationship with auditors.

Stakeholder expectations of audit committees have increased significantly, both in Hong Kong and internationally.

According to the 2019 KPMG Audit Committee Pulse Survey, maintaining internal control over financial reporting and disclosure controls and procedures, and helping ensure the finance function has the talent and resources to maintain quality financial reporting and implementing new accounting standards were areas of oversight that posed the greatest concern and drove the top priorities for audit committees in China and Hong Kong. [164]

The Corporate Governance Code [165] states that the following functions must be included in the terms of reference of audit committee:

- reviewing the issuer's financial and accounting policies and practices

163. Corporate Governance Code, Part 2 Section D.3
164. *2019 KPMG Audit Committee Pulse Survey*, P.4 (https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2019/09/2019-audit-committee-pulse-survey.pdf)
165. Corporate Governance Code, Part 2 Section D.3.3

- reviewing company financial information to monitor the integrity of the issuer's financial statements and annual report
- reviewing and monitoring external auditor's independence and objectivity
- making recommendations relating to the appointment and removal of external and internal auditors
- overseeing the financial reporting system, risk management and internal control systems
- reviewing and monitoring the effectiveness of internal audit function.

Additionally, the Corporate Governance Code provided suggestions to issuers the procedures for reviewing and monitoring the independence and objectivity and effectiveness of the audit process of external auditors. [166]

It is fundamental that the audit committee has the technical skills and expertise to discharge its responsibilities and the members exercise independent judgment. Above all, audit committee members must act with integrity and honesty.

The Corporate Governance Code states that a former partner of the issuer's existing auditing firm should be prohibited from acting as a member of its audit committee for a period of two years from the date of the person ceasing to be a partner of the firm or to have any financial interest in the firm, whichever is later. [167]

In addition, some members should have an understanding of the industry in which the entity operates. [168]

The external auditor performance evaluation must be based on the committee's view of the external audit process and should include assessments from management and internal audit.

The external auditor should also be given the opportunity to discuss the findings of the committee's evaluation.

Where an audit committee is not established, it is crucial the company put in place an alternative means of scrutinising the financial reporting system and the board allocates appropriate time to this function.

Audit committees should continually seek to improve their effectiveness through improving and updating committee agendas. Greater focus should be given to material issues rather than 'checklists' that add little or no value. Audit committees should always be seeking better information flow through high quality resources and greater internal transparency.

As economic uncertainty, globalisation and geopolitical turbulence continues, KPMG have identified audit committee priorities, as outlined below.

- risk management is a top concern for audit committees, with the complexity and interconnectivity of risk creating a need for multi-dimensional risk analysis and treatment, rather than the traditional two-dimensional, linear approach most organisations currently apply

166. Corporate Governance Code, Part 2 Section D.3.3
167. Corporate Governance Code, Part 2 Section D.3.2
168. Refer to *2019 Priorities for Boards and Audit Committees,* KPMG (https://home.kpmg/us/en/home/insights/2019/02/2019-issue1-article2.html)

- internal audit can maximise its value to the organisation by focusing on key areas of risk and the adequacy of the company's risk management processes generally
- 'tone at the top', culture and short-termism are major challenges – and may need more attention
- CFO succession planning and bench strength in the organisation continue to be weak spots
- audit committee effectiveness hinges on understanding the business
- consider how the company's disclosures can better tell the company's story – and that of the audit committee.

Risk governance

The role of overseeing the risk management and internal control systems mentioned in previous page, by the Listing Rules [169], may be addressed by the audit committee, a separate board risk committee, or the board itself. If the responsibilities are assigned to the board committee, its terms of reference should specify clearly relevant authority and duties.

Nonetheless, the ultimate responsibility for risk oversight rests with the full board. The board should ensure that a review of the effectiveness of risk management and internal control systems is conducted at least annually.

Issuers should disclose, in the Corporate Governance Report, a narrative statement on how they have complied with the risk management and internal control code provisions during the reporting period.

To achieve better risk governance, KPMG's model suggests risk considerations from two angles – risk content and risk process.

Risk content involves the identification of specific enterprise-level risks that threaten the company's existence, strategy and business model. Risk process refers to how the organisation identifies, evaluates, assigns responsibility and reports on risk content.

In general, the following responsibilities should be performed when overseeing the risk management system:

- endorsing the risk management policy for approval by the board
- overseeing the establishment and implementation of the risk management framework
- reviewing management's plans for mitigation of the material risks faced by the company
- monitoring emerging risks and changes in the risk profile
- promoting awareness of a risk-based culture.

Section D.2 of the Corporate Governance Code outlines the matters that should be covered by the board/committees/management oversight of risk management and internal control.

169. Corporate Governance Code, Part 2 Sections D.2.1, D.3.3 (f)

Remuneration committee

The Listing Rules requires the issuer to establish a remuneration committee chaired by an INED and comprising a majority of INEDs. [170]

A remuneration committee provides support and advice to the board on:

– determining the policy for the remuneration of executive directors
– assessing performance of executive directors
– approving the terms of executive directors' service contracts.

The Corporate Governance Code outlines the matters for which the remuneration committee should make recommendations to the board.

The remuneration committee should consult the chairman and/or chief executive about their remuneration proposals for other executive directors, and have access to independent professional advice if necessary. But no director should be involved in deciding his own remuneration. [171]

A key task of the remuneration committee is to monitor levels of remuneration across relevant industries, and the economy as a whole, in order to ensure the company's remuneration policies are effective in attracting, retaining and motivating the people integral to its success.

Issuers should disclose details of any remuneration payable to members of senior management by band and other remuneration related matters in their annual reports. It is further recommended to disclose the details on an individual and named basis. [172]

Nomination committee

The Corporate Governance Code requires the issuer to establish a nomination committee which is chaired by the chairman of the board or an INED and comprises a majority of INEDs. [173] In smaller companies, this function may be performed by the full board or combined with the remuneration committee.

Nomination committees are generally responsible for:

– devising criteria for directorship (including membership of board committees)
– identifying suitable candidates for appointment to the board
– undertaking appropriate succession planning for the board
– developing and managing the process for the performance evaluation of the board, committees and directors.

The Corporate Governance Code outlines the matters for which the nomination committee should make recommendations to the board. [174]

Prior to recruiting new directors, the committee would typically undertake a formal process of reviewing the balance and effectiveness of the existing board, identifying the skills and experience needed, and considering board candidates who might best provide them.

170. Chapter 3 of the Main Board Listing Rules, Rule 3.25 and Chapter 5 of the GEM Listing Rules, Rule 5.34
171. Corporate Governance Code, Part 2 Sections E.1, E.1.1.
172. Corporate Governance Code, Part 2 Sections E.1.5, E.1.8
173. Chapter 3 of the Main Board Listing Rules, Rule 3.27A and Chapter 5 of the GEM Listing Rules, Rule 5.36A
174. Corporate Governance Code, Part 2 Section B.3.1

Ensuring robust board and committee succession plans are in place and that these plans are effective in delivering directors with the required expertise is another key role of the nomination committee.

Developing a pipeline of future potential board candidates meeting certain criteria, and making contact with such individuals in advance, is an effective method to ensure robust board and committee succession. Although the CEO should be involved in the work of the committee, they should not be involved in its decision-making processes.

Other common committees

A number of other committees often exist and are frequently chaired by directors of the board to provide additional oversight on key risk areas, for example:

- Sustainability committee – assist the board in handling specific matters with high relevance to the business, such as occupational safety and health, environmental and social matters, and preparing sustainability report.
- Information technology steering committee – in place where there is a significant reliance on information technology, such as call centres, emergency response services and technology service providers.
- Research and development committee – often found where revenue generation is dependent on ongoing research activity, such as in the pharmaceutical and mining industries.

Special purpose committees

Special purpose committees are usually established to consider a specific matter and tend to have a limited life span. Nevertheless, the committee's charter or terms of reference should be approved by the full board and the committee should follow the same operating principles as other board committees.

Special purpose committees are often formed to deal with one-off events including:

- takeovers, mergers, acquisitions or divestments
- major builds, capital projects or system upgrades
- reputation matters
- first-time adoption of significant laws, regulations, industry codes and organisational standards.

Useful references

- *The HKEX's Listing Rules*
- *Corporate Governance Code, as set out in Appendix 14 to the Main Board Listing Rules and Appendix 15 to the GEM Listing Rules*
- *Corporate Governance Guidance for Boards and Directors (December 2021), HKEX* *https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Corporate-Governance-Practices/guide_board_dir.pdf?la=en*
- *2019 KPMG Audit Committee Pulse Survey* *https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2019/09/2019-audit-committee-pulse-survey.pdf*
- *2019 Priorities for Boards and Audit Committees, KPMG* *https://home.kpmg/us/en/home/insights/2019/02/2019-issue1-article2.html*
- *Appendix 3 Audit committee terms of reference*
- *Appendix 4 Audit committee induction framework*
- *Appendix 5 Audit committee annual agenda*

10. Investment Management

Entities such as asset and wealth managers (investment managers and banks), insurers, health funds and organisations which invest funds to meet both short- and long-term obligations, have the task of prudently investing funds whilst balancing the need to obtain a reasonable return with managing the portfolio so that it operates within the agreed risk appetite and tolerance.

This must be achieved within a robust risk and reporting framework to achieve compliance with applicable regulatory requirements.

This chapter of the Directors' Toolkit provides guidance to directors who are responsible for overseeing investment governance, operations and processes. Due to the need for brevity, as well as the complexity of various regulatory environments, this chapter covers the general issues associated with better practice investment governance, rather than specific regulatory requirements. Further references that provide more detail are provided at the end of the chapter.

In this chapter

- The role of the board
- Investment committees
- Investment framework
- Risk appetite
- Risk tolerance
- Investment strategy
- Asset allocation
- Financial risk management
- Investment Policy
- Investment performance and risk management reporting
- Outsourcing – fund managers and external providers

Questions that directors of government entities should ask

1. Are we, as directors, convinced that our risk appetite is aligned with management's risk appetite for each investment/financial risk?
2. Does the Investment Policy make sense intuitively, including articulating the rationale for a particular investment strategy?
3. Do the investment mandates given to service providers, such as fund managers, align to the Investment Policy?
4. Is there a process to monitor compliance with the Investment Policy – including by outsourced service providers?
5. Is the investment selection process documented and undertaken by appropriately qualified investment management staff?
6. Would it be useful to employ an external specialist advisor to provide advice on asset allocation strategies?
7. Is there separation of duties between the custodian, fund manager and asset consultant (e.g. it is preferable for the asset consultant not to be providing investment products)?
8. Is investment management performance regularly reviewed and critically examined?
9. Is investment management performance exceeding index-based performance – because if it is not then why is the organisation paying additional fees for 'active management'?
10. Are investment management fees and custodian fees regularly reviewed and periodically tested to the market?
11. What information is available in relation to investment risk (e.g. investment risk ratios, value at risk, stress testing, counterparty risk)?

Red flags

1. Lack of a formal, documented and comprehensible Investment Policy. It should be easily understood by a competent, but non-technical director.
2. An investment performance benchmark is either deemed not appropriate or is not established.
3. The performance of external managers is not measured or reviewed.
4. There appears to be inadequate segregation of duties and inadequate controls, and breach reporting is either not formalised or is inadequate.
5. There are large variances in reported performance over periods.
6. There is a lack of independent verification of performance or compliance with the Investment Policy.
7. Non-compliance with Investment Policy – which may be consistent in nature or not be detected in a timely manner.
8. Management is very defensive when asked logical questions or becomes aggressive towards third parties, such as auditors, when reasonably challenged.
9. There is a high dependence on one key individual in terms of the management of funds.
10. There is confusion at the investment committee in terms of interpreting various reports or advice received from parties, such as an asset consultant.

The role of the board

Ultimately the board is responsible for investment management, including the overall investment beliefs and philosophy, the investment strategy, Investment Policy and associated risk appetite and tolerance.

Even though the board may delegate these responsibilities, either in whole or in part, to a board committee, such as the investment committee, or rely on the advice of an asset consultant, the board is still ultimately responsible for investment management.

Investment committees

The investment committee traditionally tends to be a board committee rather than a management committee, and is responsible for the investment strategy as delegated by the board. The investment committee would also be responsible for the monitoring of investment performance and either approving investment decisions or recommending investment strategies to the board in line with its terms of reference and delegations. Further details regarding board committee composition and structures are provided in the chapter titled *Board Committees*.

Investment framework

The investment framework supports the organisation's process for formulating an investment strategy. An investment framework includes the governance, policies, systems, processes and people to operate and oversee the management of investments, including the management of the investment and financial risks.

Risk appetite

The collective risk appetite of the organisation is a key determinant in the construction of the investment portfolio. It is important that the risk appetite of the board and management are aligned (which is often not the case) and, ultimately, it is the board's risk appetite which is paramount.

Risk appetite is driven by a number of factors, including:

- the values of the organisation and the types of investments it is, and is not, willing to make
- the amount of funds available for investment (i.e. the greater the amount the more diverse and sophisticated the investment choices)
- the period of time over which funds are available (i.e. generally, short term equates to a lower risk, longer term enables greater risk. Exceptions to this include long-term bank deposits where the longer term risk is generally low)
- what the uses for the funds are (e.g. capital expenditure, supporting financial liabilities)
- the ability to withstand volatility in the investment portfolio (i.e. less than one in X years chance of negative returns)
- capital requirements (i.e. for insurance companies, higher risk investments require higher levels of capital)
- the complexity of investments
- the capability and experience of the investment framework, including personnel
- the requirement to make regular dividends/distributions to share/unit holders
- restrictions on certain types of asset class, based on ethical, social or environmental risks (e.g. the tobacco industry)
- investment diversity guidelines for the portfolio, including minimum credit ratings of investment counterparties.

Once the 'risk appetite' has been agreed then the investment selection/asset allocation process can commence.

Risk tolerance

Risk tolerance sits hand in glove with the risk appetite of the organisation. Risk appetite focuses on defining the boundaries within which investments are made. It is a higher-level statement that defines the amount of risk the organisation is willing to take in order to meet its investment objectives. Risk tolerance is the degree of volatility that the organisation is willing to accept within the parameters of its risk appetite.

For example, an organisation's risk appetite statement may state that it does not accept risks that could result in a "significant loss in revenue". A risk tolerance statement would then go on to define the specific levels of acceptable variation within that risk (e.g. the organisation may only accept a 10 percent loss in revenue from a particular asset class in any given period, e.g. a year).

The questions to consider in the development of the organisation's risk tolerance statement are, therefore, inherently linked to those used to develop the risk appetite.

Investment strategy

The investment strategy is the key document defining the strategic investment objectives, and the guiding framework and principles determined by the board to be appropriate for the organisation's broader operating strategy. Its key components include:

– investment purpose and the alignment of organisational values to the investment strategy (e.g. 'ethical' investment principles)
– asset allocation principles, such as how the portfolio will be constructed in order to meet the desired risk/return outcome
– risk management guidelines, including clear risk appetite and risk tolerance targets
– high-level policy statements, including the monitoring framework that details what will be monitored and the specific measures in place to track performance.

Asset allocation

To implement the investment strategy, the organisation should have an asset allocation process in place which includes robust due diligence. Asset allocation involves dividing an investment portfolio among different asset categories/classes. This is a crucial step to ensure that investments selected are aligned to the organisation's investment objectives, including risk appetite and tolerance.

The due diligence process should consider historical returns for particular asset classes and the volatility of return/value of the instrument (i.e. risk) over various time periods. Considering these factors can be insightful and assist in identifying correlations between assets, while helping to dispel common preconceptions about various assets. For example, some assets may be considered to have low returns, but when looked at over the long term, they perform well with low volatility, providing a form of capital protection.

Another relevant example in asset allocation is where funds are needed in the short term and a loss cannot be tolerated. Therefore, the logical asset allocation would be to defensive assets such as cash, term deposits and short-dated fixed-interest securities, all of which impacts the return that can be achieved.

Many research and academic articles indicate that asset allocation is a key driver of returns, rather than stock or security selection – hence the importance of having a robust framework and process in place to determine asset allocation.

Having allocated assets, an organisation should also have arrangements in place for the ongoing management and monitoring of its investment strategy. Depending upon the value of funds invested, this may include asset allocation rebalancing processes, exposure management arrangements (i.e. derivatives and currency), investment transition arrangements, processes to monitor investments and valuation procedures. It is critical that the reporting framework to monitor investments provides directors with meaningful information in a timely manner.

Financial risk management

When directors are overseeing the investment process, they need to be mindful of the financial risks associated with the investment process and not just the asset allocation decision.

A robust risk management framework needs to be established and implemented to address the risks arising from the investment of funds. These risks would include:

- liquidity risk (ensuring that investments can be readily converted to cash, if required, without suffering a significant loss, or that sufficient cash is held as part of the investment portfolio)
- credit risk (the risk of loss resulting from counterparty default)
- market risk (the risk of loss in value of investments due to the adverse effects of movements in interest rates, equity prices, foreign exchange rates, commodity prices, etc)
- operational risk (the risk of loss resulting from errors in the processing of transactions, a breakdown in the control environment, or errors or failures in systems)
- reputational risk (the risk of damage to the reputation of the organisation due to the nature of the investment or loss in value of the investment - particularly important for Government and widely owned organisations)
- social and environmental risk (the risk associated with failing to meet ethical, social and environmental expectations that generate a loss of business value through stakeholder activism, and perceptions of the organisation's misalignment of its business to the broader societal values).

Financial risk management arrangements would typically comprise a range of tools for risk measurement and analysis that are commensurate with the investments of the organisation. One very good example of this is the use of stress testing and scenario analysis, which can assist the organisation to identify and assess potential risk exposures that may threaten the likelihood of achieving investment objectives. Stress testing should be a forward-looking assessment of possible risk factors. Importantly, the outputs from stress testing should enable directors to make informed decisions on the management of the portfolio to enhance returns and reduce financial risk.

Investment Policy

Having determined the investment beliefs and philosophy, objectives, strategy, risk appetite, risk tolerance and approach to financial risk management, it is important that this is documented in the Investment Policy.

The fundamental importance of an Investment Policy is that it provides the framework for an organisation to achieve its investment objectives (as defined in the investment strategy) and seeks to avoid unacceptable outcomes. The policy ensures that the risk appetite and philosophy of the organisation are reflected in its investment activities.

The purpose of the policy is to provide general guidance regarding the investment objectives, specific guidance on strategies to achieve the investment objectives, and to provide a mechanism to control management behaviour and reduce bias and potential errors arising from decision-making.

The Investment Policy should address the key areas of:

– the investment objectives, philosophy, risk appetite and risk tolerance, including an explicit mandate for values-led/ethical investment strategies (e.g. not investing in gaming, tobacco)
– the asset allocation strategy and the rationale by which those objectives are to be pursued
– guidelines on investment exposures and maturity periods
– guidelines on counterparty exposure limits
– liquidity requirements
– the mandates with which underlying investments must comply and, in the case of pooled investments, the guidelines in place for the selection and contracting of managers and how they align to the organisation's investment mandate
– any socially responsible investments and prohibited investments
– the benchmarks against which the performance of investments and managers are to be assessed
– the valuation approach and methodology for unlisted or illiquid investments
– the methodology for deciding and disclosing proxy voting decisions
– the reporting required to be provided to the investment committee and the board
– the responsibilities of various stakeholders, including the board, investment committee and management.

Case study: Responsible investment

Responsible investment, defined as a strategy and practice to incorporate environmental, social and governance ("ESG") factors in investment decisions and active ownership, is becoming a hot topic in investment management over the world. It is recognised that ESG factors can affect risk and return, and clients are demanding greater transparency about how their money is invested.[175]

An irresponsible investment could result in adverse investment return. In February 2014, an Australian and New Zealand company that provides infrastructure maintenance services made a commercial decision to broaden its services and invest in the management of detention centres. With large government contracts on offer for the management of controversial detention centres, both in Australia and offshore, the board saw the potential for large, stable returns. These contracts eventually were estimated to contribute up to 15–20 percent of the company's revenue (in the wake of lost revenue from the declining resources sector), and saw an increase in the company stock price of up to 140 percent.

However, only 18 months after the investment decision, the company was facing a major issue, with many of its shareholders withdrawing their investment in the company due to claims of abuse within the detention centres. Under the confidentiality clauses of the government contracts, the company was unable to answer questions from investors about the abuse claims, making it difficult to transparently disclose how the company undertook the operation of the centres.

As a result of the perceived lack of transparency, together with the instigation of hearings in the Senate to investigate the claims on the back of public and political pressure, the company's stock dropped in value by 45 percent.

Whilst commercially the investment decision was sound, aligned with the board's investment metrics and had a short term positive impact on shareholder value, ultimately, a lack of consideration of social, political and contractual drivers undermined the return and potentially caused significant financial and reputational damage through divestment of the company stock by key shareholders.

175. Refer to *What is responsible investment?,* Principles for Responsible Investment (https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-is-responsible-investment)

Investment performance and risk management reporting

Having executed the investment strategy, the investment performance and risk management reporting will need to be undertaken to measure the performance of investment activities against the investment objectives and benchmarks. At a detailed level, this will involve comparing the performance of investments and managers to agreed benchmark indices. Other considerations include:

- frequency (usually a minimum of monthly reporting)
- documentation – the reporting process should be documented in procedures
- detail/content (e.g. manager performance, compliance, portfolio values, credit risk and other risks)
- format, such as the use of an 'investment report dashboard'
- distribution (i.e. executive management, middle office/compliance function, investment committee, etc.).

Outsourcing – fund managers and external providers

Depending upon the size of the funds available for investment, the outsourcing of various activities may be appropriate. This could include the outsourcing of investment activity to fund managers, the use of asset consultants to determine asset allocation and the use of a custodian for the settlement and recording of investment transactions. However, there are also risks arising from the outsourcing of activities which need to be recognised and managed.

Outsourcing and the use of external providers should also take into account:

- the benefits of outsourced investment management given the capabilities of in-house staff and the complexity of investments
- the nature of asset classes invested in
- the scale and size of investments
- system requirements to support outsourced arrangements
- the use of index funds versus active investment manager funds
- external manager assessment, selection and monitoring processes
- the custody and investment administration requirements.

It is also important that the 'mandates' given to investment service providers, particularly fund managers, are consistent with the Investment Policy. It is not uncommon for an Investment Policy to prohibit the use of derivatives, only to find a fund manager using derivatives – because it is not prohibited in the mandate provided to the fund manager.

Critically, an organisation can outsource its investment activities, however, it cannot outsource its legal accountabilities and responsibilities. Directors and investment committee members should also consider the International Organization of Securities Commissions' *Principles on Outsourcing of Financial Services for Market Intermediaries* (for SFC-licensed firms) or Insurance Authority's *Guideline on Outsourcing* (GL14) (for authorized insurers) in relation to outsourcing for more specific guidance.

Useful references

- *Certain industries are subject to various regulatory requirements relating to the management of investment funds. For example, insurance entities are regulated by Insurance Authority and fund managers are regulated by SFC.*
- *Principles on Outsourcing of Financial Services for Market Intermediaries (2005), published by the International Organization of Securities Commissions and endorsed by SFC* *https://www.sfc.hk/web/doc/EN/general/general/press_release/05/05pr31_iosco_pr.pdf*
- *Guideline on Outsourcing (GL14), Insurance Authority* *https://www.ia.org.hk/en/legislative_framework/files/GL14.pdf*
- *What is responsible investment?, Principles for Responsible Investment* *https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-is-responsible-investment*

11. Productive Meetings

Meetings of directors should be forums of informed discussion and decisions – not an endless stream of surprises.

In this chapter

- Duties related to board and committee meetings
- Meeting papers
- Meeting procedures
- Decision-making process
- Decision-making outside the boardroom
- In-camera sessions
- Boardroom conduct
- Technology
- Confidentiality
- Independent professional advice
- Board minutes
- Meeting evaluation
- Board self-assessment

Questions that company directors should ask

1. Is the number and length of board meetings sufficient to allow the board to effectively discharge its duties and responsibilities?
2. Are board members able to access the previous meeting's board minutes with ease and review these prior to the next board meeting?
3. Are all board members provided sufficient time to review the board papers prior to entering the meeting?
4. Is the chairman clearly accountable for the agenda's content, with all directors and committee chairmen having the opportunity to contribute?
5. Are communication channels used by the board to conduct its business secure and confidential?
6. Is the size of the meeting group appropriate, having regard to the purpose of the meeting, and are all attendees directly relevant?
7. Is regular feedback and evaluation of the effectiveness of meetings provided to board members?
8. Does the board manage actions arising from board minutes, with outstanding actions being reviewed at each board meeting?
9. Is the board undertaking critical self-assessment to identify opportunities for improvement?
10. Has the board allowed sufficient time for committee reporting such that they are satisfied delegated authorities are being executed appropriately?

Red flags

1. Board or sub-committee meetings are not scheduled on a regular basis.
2. Meeting agendas and materials are sent out with little time for review or director contribution.
3. Board members do not read board papers prior to attending the meeting.
4. Board papers are voluminous and don't always relate to the key agenda items.
5. The company secretary provides incomplete or untimely distribution of board meeting minutes after meetings.
6. Directors attend less than 50–75 percent of meetings held (depending on the nature of the organisation).
7. Many issues discussed carry over to the next meeting.
8. Attendee and absentee lists are kept irregularly and sometimes are not noted in the minutes.
9. There is no information-sharing portal set up for the board, and directors rely on emails and handouts to communicate and store information.
10. Often meetings are closed without an agreed set of actions.
11. There are very few or no non-executive director/'in-camera' sessions.
12. At the end of each meeting a review of the effectiveness of that meeting is not undertaken before closing.

Duties related to board and committee meetings

Directors are expected to prepare for, attend and contribute meaningfully to board meetings in order to discharge their director duties. A director's meeting attendance record is often taken into consideration by proxy advisers when determining whether to make a recommendation to shareholders supporting a director's re-election to the board.

The quorum for directors' meeting may be fixed from time to time by a decision of the directors, but it must be two, and unless otherwise fixed.[176]

Boards need to be aware of the requirements relating to the conduct of board meetings imposed by formal documents such as the board charter and company constitution.

176. Companies (Model Articles) Notice (Cap. 622H), Section 9

Chairman

The chairman plays a central role in providing leadership for the board and maintaining effective functioning of the board. The chairman should be primarily responsible for:[177]

- drawing up and approving the agenda for each board meeting
- ensuring that good corporate governance practices and procedures are established
- encouraging all directors to make a full and active contribution to the board's affairs
- allowing sufficient time for discussion of issues and ensuring that board decisions fairly reflect board consensus
- holding meetings with the independent non-executive directors without the presence of other directors at least annually
- promoting a culture of openness and debate by facilitating the effective contribution of non-executive directors in particular and ensuring constructive relations between executive and non-executive directors.

The role of a strong chairman includes encouraging all directors to

- identify and challenge their biases
- engage in active debate
- listen to internal alarm bells and give them a voice
- have the courage to speak up
- challenge management, where appropriate
- not to back away when a difficult issue arises
- promote clarity of purpose.

Company secretary

The company secretary is instrumental in ensuring meetings run smoothly. An efficient company secretary is proactive and will anticipate the needs of directors.

With respect to board meetings, the company secretary should ensure:

- the board agenda and briefing materials are completed and distributed in a timely manner
- appropriate personnel have been invited to the meeting
- presentations are concise and highlight significant issues
- the chairman is appropriately briefed and supported
- the meeting venue and location is appropriate and secure
- audio-visual and other equipment is operational
- expert advice is available when required.

In boards where no company secretary exists, these duties often reside with management and the chairman. Many organisations appoint administrative staff members to assist with the preparation and distribution of board documents, however, the responsibility for ensuring that this occurs remains with the chairman.

Board committees

Board committees provide an effective way of distributing work between directors and allow for more detailed consideration of important issues than would be possible

177. Corporate Governance Code, Part 2 Sections C.2, C.2.4 to C.2.9

during scheduled board meetings. Committees allow directors sufficient opportunity to focus on relevant matters without having to compromise the limited time available during full board meetings.

Meeting attendance

As a part of their duties and responsibilities, directors should be present for board and appropriate committee meetings. Absenteeism will never excuse a director from their duties to the company. To facilitate participation, directors may attend in person, via teleconference or videoconference.

Directors who are unable to attend a meeting should ensure their apology is given in advance and noted in the minutes. In the case of public companies, attendance is measured and documented in the annual directors' report. If there are repeated absences on the part of a director, the chairman may need to meet with the director to ascertain their future availability and commitment. In some circumstances it may be in the company's interest for the director to resign.

To facilitate the effective conduct of the meeting, it is important to:

- establish and circulate a clear and appropriately detailed agenda in advance
- consult with any independent advisers or members of management whose participation is required, and limit attendance at board or board committee meetings to the extent necessary
- establish an appropriate meeting environment (including style, location, room size and seating)
- ensure the meeting begins and ends promptly at the scheduled times
- be aware of particular customs, rules and etiquette for the meeting.

Meeting frequency and duration

The Companies Ordinance does not prescribe the number of directors' meetings that must be convened unless required by a shareholders' agreement or articles of association. For listed entities, the Corporate Governance Code [178] requires the board to meet regularly and board meetings should be held at least four times a year at approximately quarterly intervals. Both the frequency and duration of meetings are factors which influence the quality of board output. The board must agree on the frequency and duration of meetings required for it to effectively address all matters listed in its annual agenda.

As the business environment is constantly evolving, and information and issues arise more quickly, the more traditional frequency and structure of meetings may need to be reconsidered. Board agility is an important factor in enabling issues to be considered when they arise, rather than waiting for the next board meeting. In these instances, mechanisms for formally considering board matters may need to be developed, such as teleconferencing/videoconferencing, circular resolutions or ad hoc meetings. This level of agility can be challenging.

Public companies are required to include in their annual report the number of board and committee meetings held each year and the attendance of each director at these meetings. [179]

178. Corporate Governance Code, Part 2 Section C.5.1
179. Corporate Governance Code, Part 1 Section E

The length of the meeting should be sufficient to give appropriate attention to all issues at hand. When planning the agenda for a long meeting, it may be useful to consider whether splitting the meeting into two shorter meetings would be more appropriate. If the meeting must be kept to a single session, scheduling breaks is vital to keep participants focused, attentive and productive.

A meeting should only be held if it is necessary. If the same information could be covered in an email or report, for example where all agenda items are information sharing, a meeting should be avoided. As meetings are costly, the outcome must be valuable enough to justify holding the meeting.

Under common law, directors must give reasonable notice of board meetings.[180] For listed entities, notice of at least 14 days must be given of a regular board meeting while reasonable notice should be given for all other board meetings.[181] It is crucial that board members have sufficient notice of forthcoming meetings. Circulation of a list of prearranged dates is sufficient notice and typically a convenient practice.

Meeting preparation

Careful preparation of the agenda enhances the board's productivity and supports its strategic and oversight role.

The purpose of the meeting should be communicated amongst members in advance, allowing sufficient time to become familiar with the proposed agenda and undertake any research required. In order for a meeting to be productive, a strategically defined purpose should be linked to specific plans and outcomes.

The chairman must also review the board papers prior to any meeting to identify any potential conflicts of interests for board members and raise these with the individual prior to the meeting. This relies on ongoing, open dialogue between the chairman and other board members regarding potential conflicts of interest.

Agenda

A board meeting agenda enables directors to be fully informed of issues to be proposed and discussed at the meeting, reducing the time required on briefing at the beginning of a meeting. It should be referenced to the annual agenda, which identifies matters to be periodically included on the board agenda.

The chairman, working with the company secretary, should be accountable for the agenda's content. Input should be sought from directors, the CEO and senior management, and the chairmen of board committees. Setting the agenda should involve a consideration of content, the ordering of items, the allocation of time for each item and deciding on invitees. High-priority items should be scheduled first and it is essential to clarify which items are for decision, discussion, noting or information purposes. A timed agenda will assist directors in recognising the relative significance of each issue and ensure the meeting finishes on time.

180. Refer to *Corporate governance and directors' duties in Hong Kong: overview* (1 June 2019), Thomson Reuters (https://uk.practicallaw.thomsonreuters.com/7-506-8920?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1)
181. Corporate Governance Code, Part 2 Section C.5.3

Meeting papers

Review of papers prior to the board meeting

Board meetings are a place for discussion and decision-making. To make effective use of the often limited time available, all board papers should be read prior to the meeting with questions and comments noted and ready to be raised. A well-functioning board will distribute a complete set of board papers at least one week prior to the meeting. This pack will include:

- an agenda with all items for discussion, noting and decision clearly noted, together with the timing allocated for each item (as in indication of importance)
- a copy of the prior meeting minutes for approval
- a list of outstanding action items
- copies of any committee reports being tabled
- copies of all regular reports (e.g. financial reports, performance reports, compliance reports and risk reports). These should be in a consistent, succinct and clear format with content that directly aligns to the organisation's strategic and operational KPIs
- relevant information to support specific agenda items.

Many boards are often inundated with volumes of reading prior to board meetings, making it almost impossible for directors to do the required pre-reading and digest the relevant information. High volumes of board papers are symptomatic of:

- management being unaware of what information the board requires. If there is no clarity regarding matters requiring board consideration, issues that need to be escalated or how the information requested relates to strategic objectives and KPIs, there is a tendency for management to 'give them everything' in the hope of meeting expectations
- management attempting to overwhelm the board with irrelevant information in the hope of distracting time and discussion away from known problem areas
- the board being unable to articulate to management the key information that they need to support their decision-making processes. Directors and boards that request large amounts of supporting data can often be lacking clarity in direction or confidence in their decision-making.

In each scenario, it is up to the board to set the criteria and basis of information to be provided. Board papers should strike an appropriate balance between quality and quantity, and should be concise documents that fully present the information the board will require to comprehend all issues and make appropriately informed decisions (where a decision is required). They should be prepared to strict standards in terms of presentation and content, share a consistent format, and include the date, version reference, author and reviewer's name and title. The purpose of each paper should also be clearly indicated. Directors should establish clear criteria for what matters should be raised at board level and why.

Once that has been established, directors should then be willing to challenge the quantity and quality of papers provided by management. Poor papers are a major cause of bad board decision-making and create a difficulty in reaching a consensus.

Specifically, the Corporate Governance Code[182] states that the chairman should ensure that all directors are properly briefed on issues arising at board meetings and should be responsible for ensuring that directors receive, in a timely manner, adequate information which must be accurate, clear, complete and reliable.

Access to meeting papers

Technology is rapidly moving into boardrooms, with the digital distribution of board papers becoming increasingly widespread. Electronic communication methods may facilitate the exchange of timely and accurate information between board members. The adequacy of the security of data sharing and storage technology (email, iPad and Dropbox-type applications) should be carefully considered when exchanging highly sensitive and confidential company information. The use of online portals for hosting board papers and other company materials is growing substantially as a secure and efficient way of facilitating the board process. Electronic delivery allows relevant information required for decision-making to be delivered rapidly and economically.

Electronic portals are now commonly used by boards to securely post and retain materials, including board minutes, policy documents, agendas and other core documentation. Further uses include providing updates on the activities of board committees, enabling real-time communication and collaboration between board members, and facilitating information sharing between directors and management. Uploading, organising and editing materials online is typically much more time efficient than sorting, printing, stapling and distributing papers.

The way in which directors access such information has changed. Most boardrooms now have board members using a digital device (tablet or laptop) and accessing a portal for board documentation. Digital devices can include multiple layers of authentication and encryption to offer a considerable security improvement over traditional hard copy distribution. However, professional advice may be warranted regarding security and document retention concerns.

Meeting procedures

It is the role of the chairman to ensure that meetings are run to time and that all matters are discussed and actioned appropriately. It is the responsibility of directors to ensure that they work with the chairman to achieve these objectives.

Agendas should include time for ensuring a quorum is present, declaration of any conflicts of interest before opening the meeting, discussion of specific agenda items, approval of prior meeting minutes and a review of outstanding action items.

182. Corporate Governance Code, Part 2 Sections C.2.2, C.2.3

Decision-making process

The emphasis in the boardroom is on consensus decision-making, which focuses on securing the agreement of the full board. If unable to reach a consensus, the board should state the reasons for this and endeavour to solve the issues or find further information required to make a decision.

The board and management should agree on having a number of predetermined elements included in all material proposals for board decision. It is important these elements are seen as guidance, and that management exercises common-sense and business acumen in deciding what information to provide to the board.

The following elements at a minimum should be considered in material proposals for informed decision-making:

- alignment with strategic direction
- values and behaviours
- financial and reputational impact and considerations
- economic and financial assumptions
- key risks and dependencies
- legal and regulatory obligations
- availability of resources (internal and/or external)
- ethical and environmental dimensions (e.g. directors should consider "should we", not just "can we")
- shareholder and stakeholder perspectives
- description of due diligence completed
- benefits or outcomes are measurable and can later be tested
- contingencies to deal with unexpected developments
- monitoring and accountability mechanisms
- in particular, whether actions are being addressed in a timely manner.

Decision-making outside the boardroom

In some situations, decisions need to be taken before the next scheduled directors' meeting. It is usually permissible to circulate a resolution for approval by directors without the need to convene a meeting (known as "paper meetings"), though this process should be reserved for urgent matters or more procedural matters. Best practice requires that a written resolution of the directors is passed unanimously (that is, it must be signed by all directors and not just a majority), as a written resolution of directors does not otherwise provide an adequate forum for further discussion on the issues at hand should one or more directors be inclined to vote against the resolution.

Once the resolution has been passed, it must be entered into the minute book and noted at the next meeting of directors.

In-camera sessions

Non-executive directors should consider the benefits of meeting without the presence of management. These meetings are known as 'in-camera' sessions and can be held when non-executive directors consider it appropriate to convene without the presence of the other directors. Most often this is at the start or the end of each board meeting, so as to allow free-flowing and candid discussion. Directors tend to find that in having the in-camera session as standard on the agenda, any angst from management is reduced. Further, starting each meeting with an in-camera session allows the chairman to identify any key concerns that directors may be seeking to gain an understanding of in the board meeting.

The types of subjects that could be usefully discussed at an in-camera session include:

- CEO performance and remuneration
- relationships between directors
- relationships with management and assurance providers
- director performance issues
- 'tone at the top' concerns
- whistle-blower issues relating to senior management
- confidentiality issues
- potential conflicts of interest
- independence concerns relating to assurance providers
- sensitive matters affecting management and/or assurance providers.

Whether there should be minutes of an 'in-camera' meeting is up to the board and will depend on the nature of the discussion. Some organisations allow their minutes to simply state that an 'in-camera' meeting took place, while others may be more descriptive. Any formal actions that arise from an 'in-camera' session should be documented, allowing outcomes to be tracked in subsequent meetings.

Boardroom conduct

While each board will have its own particular boardroom style, there are basic principles of good boardroom practice and etiquette, such as:

- punctuality and attendance for the full meeting
- full attention should be given to listening and contributing to the discussion
- well-timed and adequate breaks should be scheduled, and catering provided, especially for long meetings.

Boardroom conduct and behaviour has a significant impact on board effectiveness, yet it is one of the most difficult things for boards to deal with. Negative behaviours such as lack of engagement, aggression, dominance, bullying and exclusiveness entering the boardroom can distract directors from their responsibilities, creating rifts, factions or divisions that can take considerable time and effort to resolve. In particular, the non-essential use of mobile phones should be discouraged during board meetings.

It is in the best interests of individuals – and the organisation – for boards to engage in collegiate, constructive and respectful behaviours.

Technology

A directors meeting using any technology is obviously useful when a director cannot physically participate in a meeting. Emergency meetings called at short notice are a case in point. Whilst the use of meeting technology, such as teleconferences or videoconferences, can eliminate many hours of travel time for directors located interstate or overseas, face-to-face meetings are often preferred, especially where contentious matters are to be discussed. It is fundamental where technology is used that it is secure (particularly given the commercially sensitive nature of discussions), reliable and fully functional.

Confidentiality

Consistent with their fiduciary duties, directors are expected to maintain the confidentiality of the deliberations of the board and its committees. Confidential company papers must remain secure. It is recognised as best practice for directors to return meeting papers to the company secretary after the meeting, who will then arrange for the secure destruction of surplus copies.

Several fundamental security recommendations include:

- encrypting documents
- installing password-protection mechanisms for all electronic equipment
- activating automatic locking after periods of inactivity on electronic devices
- careful use of PINs for conference calls.

Independent professional advice

The Corporate Governance Code [183] states that there should be a procedure agreed by the board to enable directors, upon reasonable request, to seek independent professional request in appropriate circumstances, at the issuer's expense. The board should resolve to provide separate independent professional advice to directors to assist them perform their duties to the issuer. Controls should be in place to ensure the process is properly managed.

183. Corporate Governance Code, Part 2 Section C.5.7

Board minutes

The Companies Ordinance states that a company must keep a minutes of all proceedings at meetings of its directors and all resolutions passed by its directors without a meeting. The company must also keep records of all resolutions of members passed otherwise than at general meetings and minutes of all proceedings of general meetings. [184]

The company secretary will normally be responsible for the initial draft of the minutes of all company meetings, including annual general meetings or any extraordinary general meetings and also for the initial drafting of the board meeting minutes. The chairman of the meeting will be responsible for the final version of the minutes. [185]

Minutes should be compiled very carefully and with appropriate detail, with due regard to the fact that minutes provide evidence of what has occurred in meetings and can be used as documents with legal significance in instances of litigation. With an increasing responsibility on directors to be able to show they have properly undertaken their duties, proper minutes can protect directors in this respect.

It is therefore essential that directors give the process of reviewing and approving the minutes the level of attention it warrants, rather than simply treating it as an administrative exercise. Minutes, if purporting to be signed by the chairperson of the meeting or by the chairperson of the next directors' meeting, are evidence of the proceedings at the meeting. Criminal penalties can be imposed for the falsification of records. [1786]Minutes may be used in court to prove or disprove that directors have fulfilled their duties.

If errors are subsequently detected in signed minutes, directors may pass a resolution at a future meeting to correct them. The directors may agree not to proceed with an agreed course of action as set out in the signed minutes. In these circumstances, it will be necessary for the directors to pass a resolution to rescind previous resolutions.

The minutes should always be formally approved at the next meeting if they have not previously been formally approved by all the members of the board. If the minutes are amended at the next board meeting, this should be reflected in the minutes of the subsequent meeting.

The level of detail included in the minutes will vary from company to company. General inclusions would be:

- company name
- meeting location, date and commencement time
- chairman and attendee names, including those physically present and those participating through the use of technology (e.g. teleconference)
- apologies
- presence of a quorum
- minutes of the previous meeting
- directors' declarations of personal interest

184. Companies Ordinance (Cap. 622), Sections 481, 618
185. Refer to *Concise and precise: the art of taking minutes* (11 March 2016), HKICS (http://csj.hkics.org.hk/site/2016/03/11/concise-and-precise-the-art-of-taking-minutes/)
186. Companies Ordinance (Cap. 622), Sections 482, 890

– proceedings and resolutions (including a brief outline of material factors in reaching a decision)
– title, version reference and date of all papers tabled
– directors' disclaimers or objections
– action plans, timelines and responsibilities for implementation
– closure time
– signature of the chairman (at the subsequent meeting).

Meeting evaluation

The meeting should conclude with a review of decisions reached and the related actions, in order to increase accountability among directors. All participants should be fully aware of what is expected of them. Following the meeting, the company secretary should ensure the minutes are circulated quickly in order to allow directors to promptly respond.

Requesting feedback on the meeting will provide valuable insights into how future meetings may be made more productive.

Board self-assessment

A useful tool for obtaining feedback to further enhance the board's performance, including meeting productivity, is to obtain an independent assessment. Such assessment can be conducted internally or externally. [187] This can include surveys, questionnaires and observations of the board members and meetings, combined with benchmarking to high-performing boards. This process usually provides the board with a comprehensive report on performance, including strengths and potential opportunities for improvement. This also provides a statement to shareholders and company staff that the board is proactively seeking feedback to drive continuous improvement.

For more information about the board evaluation process refer to the chapter titled *Structuring an Effective Board*.

Useful references

– *Companies Ordinance (Cap. 622)*
– *Companies (Model Articles) Notice (Cap. 622H)*
– *Corporate Governance Code, as set out in Appendix 14 to the Main Board Listing Rules and Appendix 15 to the GEM Listing Rules*
– *Corporate Governance Guidance for Boards and Directors (December 2021), HKEX* *https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Corporate-Governance-Practices/guide_board_dir.pdf?la=en*
– *Concise and precise: the art of taking minutes (11 March 2016), HKICS* *http://csj.hkics.org.hk/site/2016/03/11/concise-and-precise-the-art-of-taking-minutes/*

187. *Corporate Governance Guidance for Boards and Directors* (December 2021), HKEX, Company Structure

12. Global Governance

The number of regulatory requirements for many geographies and industry segments means that companies are increasingly taking an integrated approach, rather than reacting to a specific regulation in isolation.

In this chapter

- Governance and regulation around the world
- Trends in global corporate governance
- People's Republic of China
- Hong Kong
- Organisation for Economic Cooperation and Development ("OECD")
- United States ("US")
- United Kingdom ("UK")
- Australia
- Asia
- South Africa
- Industry standards

Questions that company directors should ask

1. In which markets is the company listed? What regulations must you follow in those markets?
2. Is there the potential for the company to improve investor confidence by meeting stricter corporate governance standards of markets that it is not listed in?
3. What are current shareholders' expectations of corporate governance?
4. Is the board aware of the recent changes to the regulations?
5. Who is in charge of making sure corporate governance standards are being met?
6. Is the company in a position where it will be able to meet increasingly strict standards?
7. Is management kept abreast of changes in corporate governance standards?
8. Is management aware of the corporate governance expectations of some of the larger institutional investors?
9. How does the board keep abreast of emerging governance trends?
10. Is management aware of the diversity of corporate governance standards in Asia, Europe, the US and the Middle East?

Red flags

1. The company is dual-listed or multi-listed, but only follows the governance code of its primary listing.
2. The board does not receive timely and relevant updates on legal and governance issues.
3. Corporate governance rarely features on board meeting agendas.
4. The accountability for maintenance of the board instruments is not clear.
5. The company's annual report does not include all the disclosures required by company legislation.
6. The directors are unfamiliar with best-practice standards for corporate governance and risk management.

Companies face an expensive and confusing regulatory landscape with changing laws and tougher enforcement. Given the number and the respective mandates of regulators, it is no longer enough to adopt a reactive, episodic approach to compliance.

Governance and regulation around the world

The first code of good governance was established in the US in the late 1970s, however, it was not until the UK's 1992 Cadbury Report that codes of good governance began to proliferate. Governance codes that followed included South Africa's King Report in 1994, Australia's IFSA Guidelines in 1995, the US' California Public Employees' Retirement System Principles in 1998, Hong Kong's Corporate Governance Review subsumed in the Companies (Amendment) Ordinance between 2001 and 2004, etc. More recently, better practice recommendations have been incorporated into the listing rules of stock exchanges around the world, including in Australia, Toronto, New York, and London. Multi-lateral organisations, such as the OECD, the International Monetary Fund, the World Bank and the International Corporate Governance Network are leading the charge for global standards of good governance.

Trends in global corporate governance

A 2018 report by the Harvard Law School Forum,[188] found that the changing landscape in governance we are seeing in Hong Kong is echoing global trends. Many countries are updating their corporate governance standards regarding better practice expectations and disclosure requirements.

The report details trends across the globe that see increasing focus on the following:

- **board composition** (including increasing board diversity)
- heightened **oversight of risk**, especially non-financial risks, such as sexual harassment, cyber risk and technology
- **compensation and remuneration** with respect to incentives; performance pay (including claw-backs for non-performance) and pay inequity
- **environmental and social issues** such as climate change risk, employee welfare and engagement, community welfare and engagement and political contributions
- **workforce and culture** emphasising greater representation of workforce interests at board level and clearer public disclosure of organisational values and adherence to these values.

188. Refer to *The Corporate Governance World in 2018: A Global Review* (28 January 2018), Harvard Law School Forum (https://corpgov.law.harvard.edu/2018/01/28/the-corporate-governance-world-in-2018-a-global-review/)

Consideration should be given to a specific governance code being adopted and reviewed in its entirety, seeking professional advice, in advance, where necessary. This chapter references some of the key principles and governance codes from other jurisdictions for awareness.

High level details of the corporate governance codes of major countries are detailed in the following sections.

People's Republic of China

The China Securities Regulatory Commission and the State Economic and Trade Commission issued the Code of Corporate Governance for Listed Companies in China in 2002. The preface to the Code states that it is formulated to promote the establishment and improvement of a modern enterprise system by listed companies, to standardise the operation of listed companies and to bring forward the healthy development of the securities market of the country. The Code is applicable to all listed companies within the boundary of the People's Republic of China; and is used as a benchmark to assess whether a listed entity has a satisfactory governance structure. The Code was updated in 2018 in order to adapt to more recent developments in the market and to increase the effectiveness of corporate governance of listed companies in China. Some key changes under the new Code include: [189]

- requiring companies to establish Party organisations (representative units of the Communist Party intended to play a political role in the company and ensure implementation of state objectives and policies) and incorporating Party building work into the articles of association of state-controlled firms
- establishing ESG requirements, such as green development and targeted poverty alleviation. Companies are encouraged to develop concepts of "innovation, coordination, green development, openness, sharing" and social responsibilities
- encouraging cash dividend distribution
- promoting board diversity
- strengthening audit committee functions
- restricting powers of controlling shareholders.

Hong Kong

In December 2021, the Hong Kong Stock Exchange published a Consultation Conclusions on the Review of Corporate Governance Code & Related Listing Rules, and Housekeeping Rule Amendments to outline the adopted proposals.

Major changes adopted set out in the Consultation Conclusions include: [190]

- a requirement to align the issuer's culture with its established purpose, values and strategy
- a requirement to establish policy and system that promote and support anti-corruption laws and regulation
- a disclosure requirement to ensure independent views and input are available to the board

189. Refer to *Code of Corporate Governance for Listed Companies 2018, China*
190. Refer to *Consultation Conclusions on the Review of Corporate Governance Code & Related Listing Rules, and Housekeeping Rule Amendments* (December2021), HKEX

– a disclosure requirement on factors considered, process and the discussion arriving at the determination that long serving INED is independent and should be re-elected

– new requirement to disclose the length of the tenure of the long serving INEDs on the board on a named basis in the shareholders' circular

– a recommendation to not grant equity-based remuneration with performance-related elements to INED

– new requirements to have achieve non-single gender board (transitional period until 31 December 2024 for issuers with a single gender board to appoint at least a director of a different gender on the board)

– a requirement to review the implementation and effectiveness of the issuer's policy on board diversity on an annual basis

– a requirement that the nomination committee should be chaired by the board chairman or an INED and comprise of a majority of INEDs

– a requirement to publish the ESG report at the same time as the publication of isser's annual report

Organisation for Economic Cooperation and Development ("OECD")

The OECD Principles have been described as an international benchmark for corporate governance, a summary of which is included in this toolkit.

Summary of the OECD Principles

– Ensuring the basis for an effective corporate governance framework:
  - The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

– The rights of shareholders and key ownership functions:
  - The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

– The equitable treatment of shareholders:
  - The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

– The role of stakeholders in corporate governance:
  - The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

– Disclosure and transparency:
  - The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
– The responsibilities of the board:
  - The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

For more information about the OECD Corporate Governance Principles, visit http://www.oecd.org/

United States ("US")

US Securities and Exchange Commission ("SEC")

The SEC regulates the US securities industry and enforces US federal securities laws. The SEC describes its mission as:

"… to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation… The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it..."

http://www.sec.gov/about/whatwedo.shtml

The SEC website outlines all the relevant legislation for listed entities within the US. These include the:

– Securities Act of 1933
– Securities Exchange Act of 1934
– Trust Indenture Act of 1939
– Investment Company Act of 1940
– Investment Advisers Act of 1940
– Sarbanes Oxley Act of 2002
– Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
– Jumpstart Our Business Startups Act of 2012.

For more information about the relevant US laws, visit https://www.sec.gov/answers/about-lawsshtml.html

Sarbanes-Oxley Act ("SOX")

The introduction of the SOX in the US was a direct result of a number of major corporate collapses in late 2001. With the credibility of financial reporting falling sharply, the US congress responded with what George W. Bush described as, "The most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt." As a result of the introduction of the SOX compliance, management is now required to both assess and report on the effectiveness of internal control over financial reporting. As a result, auditors test and evaluate a company's internal control in a different light and in greater depth. The overall goals of the SOX compliance are to strengthen internal control over financial reporting, provide more reliable information to investors, and renew investor confidence in the US capital markets.

For more information on the SOX, visit https://www.sec.gov/spotlight/sarbanes-oxley.htm

Dodd-Frank Wall Street Reform and Consumer Protection Act

Following the global recession of the late 2000s, the Dodd-Frank Act was introduced in the US (July 2010) to increase consumer protection, reduce or even eliminate 'too big to fail' corporate bailouts, and increase the transparency of credit-rating agencies and exotic financial instruments, along with many other changes. The Act has been described as, "A rewrite of rules touching every corner of finance … the biggest expansion of government power over banking and markets since the Depression." [191]

Notably for corporate governance, shareholders were given a non-binding vote on golden parachutes and executive compensation, thereby increasing their input on remuneration and corporate affairs. [192]

191. Refer to *Law Remakes U.S Financial Landscape* (July 2010), The Wall Street Journal (https://www.wsj.com/articles/SB10001424052748704682604575369030061839958)

192. Refer to *Executive Comp and Governance Provisions of Dodd-Frank Act* (22 July 2010), Business Ethics (https://business-ethics.com/2010/07/22/1640-executive-compensation-and-corporate-governance-provisions-of-the-dodd-frank-act/)

"Among other things, the SEC will require disclosure of any links, between executive compensation actually paid and the company's financial performance, taking into account any change in the value of the company's shares and dividends and any distributions."

Chairman Sullivan and Cromwell, H. Rodgin Cohen.

Shareholders were also given the power to approve compensation of executive officers every one, two or three years. For more information on the changes implemented by the Dodd-Frank Act, visit http://www.sec.gov/spotlight/dodd-frank.shtml

For more information about the SEC, visit http://www.sec.gov/

United Kingdom ("UK")

The UK Corporate Governance Code

The Financial Reporting Council ("FRC") is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance. The FRC suggests that the UK's principles-based system of business regulation should reduce cost to businesses of compliance previously required by detailed regulation, which was unnecessarily constraining business practice and innovation.

In that regard, the FRC has developed the Corporate Governance Code. The FRC notes that whilst it is expected that listed companies will apply the Code's provision most of the time, it is recognised that departure from the provisions of the Code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the code provisions. The Code was quite substantially revised in 2018 to be more succinct and put "the relationships between companies, shareholders and stakeholders at the heart of long-term sustainable growth in the UK economy".[193] The code emphasises the importance of relationships between companies, shareholders and stakeholders. It has underlined the building of trust by enforcing strong relationships with key stakeholders and aligning corporate culture with the company purpose and business strategy.

The FRC has created changes in the area of workforce and stakeholders, culture, succession planning and diversity, and remuneration. Specifically, new principles and provisions have been introduced to drive increased board engagement with the workforce and improved reporting by boards on how they have considered the interests of stakeholders. There is now a greater responsibility for boards to align their company culture with their company values and strategy.

The board should also implement regular board refresh and succession planning that includes a mix of skills and experience to provide better capability. Finally, new principles and provisions have been introduced to take into account workforce remuneration and related policies in generating director remuneration.

For more information about the FRC, visit: https://www.frc.org.uk/directors

193. A UK Corporate Governance Code that is fit for the future (16 July 2018), FRC (https://www.frc.org.uk/news/july-2018/a-uk-corporate-governance-code-that-is-fit-for-the)

Australia

The Australian Securities Exchange ("ASX") Corporate Governance Principles and Recommendations

The ASX Corporate Governance Council's Corporate Governance Principles and Recommendations provide a set of corporate governance guidelines for ASX listed entities, which are designed to promote investor confidence and to assist listed entities to meet stakeholder expectations. The ASX Listing Rules require listed entities to report against the council's recommendations and, where they do not conform, to disclose that fact and the reasons why. Whilst targeting listed entities, many unlisted Australian entities refer to the ASX Principles for guidance and benchmarking on better-practice governance.

The Principles are:

1. lay solid foundations for management and oversight
2. structure the board to be effective and add value
3. instil a culture of acting lawfully, ethically and responsibly
4. safeguard the integrity of corporate reports
5. make timely and balanced disclosures
6. respect the rights of security holders
7. recognise and manage risk
8. remunerate fairly and responsibly.

Global Governance

The ASX Corporate Governance Council released the fourth edition of the Principles and Recommendations in February 2019.

The 4th edition retains the eight key Principles but has seen an increase in the number of overall recommendations from 29 to 38 (being 35 specific recommendations of general application intended to give effect to the principles, as well as three additional recommendations that only apply in certain limited cases), covering all aspects of governance from board composition and committee structures to risk management disclosures and, now, organisational culture and values.

Key changes include:

Principle 3 – moving from, "Act ethically and responsibly", to, "A listed entity should instil a culture of acting lawfully, ethically and responsibly." The focus is now on the board's role in driving and shaping organisational culture as much as it is around being lawful and ethical in its operations. In other words, the focus is not just on 'what' the organisation does, it is 'how' the organisation does it.

In particular, a key change is the focus on ensuring and disclosing how the organisation and its officers and employees behave, so as to ensure its reputation and standing and to protect long-term shareholder value.

In formulating its values, a listed entity should consider what behaviours are needed from its officers and employees to build long term sustainable value for its security holders. This includes the need for the entity to preserve and protect its reputation and standing in the community and with key stakeholders, such as customers, employees, suppliers, creditors, law makers and regulators.

Principle 7 – has seen an emphasis in the importance of risk oversight, including emerging risks such as climate change and environmental risk, cyber-risk and conduct risk.

For more information about the ASX Principles, visit http://www.asx.com.au/

Asia

Japan

'J-SOX' is an unofficial term for the Financial Instruments and Exchange Act that refers to Japanese requirements, similar to the US Sarbanes-Oxley Act, Section 302 (management certification) and Section 404 (management evaluation and report on internal controls). J-SOX requires all public companies listed on stock exchanges in Japan to conduct management's assessment and reporting of internal control over financial reporting on a consolidated basis. As such, overseas subsidiaries and affiliates should also fall within the scope of such assessment and reporting.

India

The Securities and Exchange Board of India ("SEBI") published a report on corporate governance in 2003 from the Narayan Murthy Committee evaluating the adequacy of existing corporate governance practices. After a number of updates, the SEBI formed a committee on corporate governance in June 2017 to further enhance the standards of corporate governance of listed entities in India. The terms of reference of the Kotak Committee on Corporate Governance were that recommendations were required in relation to the following: [194]

- ensuring independence in spirit of Independent Directors and their active participation in functioning of the company
- improving safeguards and disclosures pertaining to Related Party Transactions
- issues in accounting and auditing practices by listed companies
- improving effectiveness of Board Evaluation practices
- addressing issues faced by investors on voting and participation in general meetings
- disclosure and transparency related issues, if any
- any other matter, as the Committee deemed fit pertaining to corporate governance in India.

The committee submitted its report in October 2017. The SEBI approved many of the recommendations made which came into effect on 1 April 2019. The amendments focused primarily on:

- the board to enhance independence, diversity and transparency
- shareholder rights to information
- greater requirements for corporate reporting
- expansion of the term "related parties" to encompass promoters and guidance on fees/remuneration for executive directors who are part of a promoter.

For more information about the SEBI, visit https://www.sebi.gov.in/index.html

194. Refer to *Report submitted by the Committee on Corporate Governance* (5 October 2017), SEBI

Singapore

In 2007, the oversight of the corporate governance of listed companies in Singapore was transferred from the Council on Corporate Disclosure and Governance to the Monetary Authority of Singapore ("MAS") and the Singapore Exchange Ltd. In 2010, the MAS announced the composition of the newly established Corporate Governance Council, which conducted a review of the code in 2011. In response to the recommendations made by the council, the MAS issued a revised code in 2012, which focuses on director independence, board composition, and risk management, amongst other topics.

The Code of Corporate Governance is similar to that for Hong Kong in that it requires listed companies to either follow the code or disclose why they are deviating from it in their AGM annual reports ("comply or explain").

A further review was performed in 2017 which resulted in a revised Code of Corporate Governance being issued in 2018, together with accompanying Practice Guidance. Major changes included:

– the requirement of independent directors to make up a majority of the board to ensure decisions are made in the best interests of the company
– the board to be diverse in age and gender to facilitate constructive debate
– companies to generate an investor relations policy to ensure that effective and regular communication is conducted with their investors.

In 2019, the MAS established the Corporate Governance Advisory Committee as a permanent, industry-led body to advocate good corporate governance practices among listed companies in Singapore. The committee does not carry regulatory or enforcement powers but rather acts as an advisor to identify when local and international trends may suggest that an update to the Code may be required.

For more information the MAS Code, visit https://www.mas.gov.sg/regulation/codes/code-of-corporate-governance

South Africa

South Africa's corporate governance standards are known as the King Code of Governance for South Africa. It is based on the work of the King Committee (led by Mervyn King), and sets high standards of governance and transparency, particularly in relation to non-financial performance.

The most recent iteration is the King IV Code of Governance ("King IV"). Published in 2016, it provides enhancements to the 2009 King III Code of Governance. The changes included reducing the principles from 75 to 17 to provide an easier interpretation. Highlights of King IV include:

– a focus on integrated reporting to reflect integrated organisational governance and thinking (Part 5.2)
– 'independence' of non-executive directors should consider an assessment against the specified criteria (Principle 7)

- increasing disclosure requirements to aid transparency by moving from an "apply or explain" to an "apply and explain" regime
- encouraging the importance of a social and ethics committee, even when it is not legally required (Principle 8).

King IV also indicates the need for governing bodies to oversee both information and technology as separate components. Organisational ethics needs to be governed by the governing body to ensure a code of conduct is met by all employees. The report has created responsibility to ensure that the governing body increases its level of engagement with shareholders.

For more information about King IV, visit https://www.iodsa.co.za/page/KingIVReport

Industry standards

To be able to effectively exercise their duties, directors must have an understanding of the company's business and the industry in which it operates, including a general awareness of any applicable industry standards or codes.

A high-level summary providing an example of these standards is included below.

ISO 9000 and 9001

ISO 9000 is a set of quality management standards that provide a framework for processes and systems required for organisations to meet the needs of customers and other stakeholders. The standards are published by the International Organization for Standardization ("ISO"). ISO 9000 deals with the fundamentals of quality management systems, whilst ISO 9001 deals with the requirements that organisations wishing to meet the standards have to fulfil.

There is widespread use of these standards across many companies and industry segments.

For more information ISO 9000 and 9001, visit https://www.iso.org/home.html

Corporate Acquisitions or Disposals

The SFC is the statutory body of Hong Kong's securities and futures markets. It supervises both licensed intermediaries and market operators (including exchanges, clearing houses, share registrars and alternative trading platforms) in Hong Kong.

Commencing in 2017, to intervene at an early stage in serious cases of corporate misconduct, SFC issued letters of concern to more than 46 listed issuers about proposed corporate transactions and published a *Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals* in 2019 to remind directors and their advisors to comply with their statutory and legal duties during transaction evaluation and approval.

For more information about the SFC statement, visit https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-the-conduct-and-duties-of-directors.html

Useful references

- *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, US SEC*
  https://www.sec.gov/Article/whatwedo.html
- *Balancing Rules and Flexibility, A study of corporate governance requirements across 25 markets (2014), the Association of Chartered Certified Accountants and KPMG*
  https://assets.kpmg/content/dam/kpmg/pdf/2014/12/corporate-governance-balancing-rules-and-flexibility-main-report.pdf
- *The Corporate Governance World in 2018: A Global Review (28 January 2018), Harvard Law School Forum*
  https://corpgov.law.harvard.edu/2018/01/28/the-corporate-governance-world-in-2018-a-global-review/
- *Code of Corporate Governance for Listed Companies 2018, China*
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- *Consultation Conclusions on Review of the Corporate Governance Code and Related Listing Rules, and Housekeeping Rule Amendments (December 2021), HKEX*
  https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/April-2021-Review-of-CG-Code-and-LR/Conclusions-(Dec-2021)/cp202104cc.pdf
- *The Laws That Govern the Securities Industry, SEC*
  https://www.sec.gov/answers/about-lawsshtml.html
- *Law Remakes U.S Financial Landscape (July 2010), The Wall Street Journal*
  https://www.wsj.com/articles/SB10001424052748704682604575369030061839958
- *Executive Comp and Governance Provisions of Dodd-Frank Act (22 July 2010), Business Ethics*
  https://business-ethics.com/2010/07/22/1640-executive-compensation-and-corporate-governance-provisions-of-the-dodd-frank-act/
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- *Report submitted by the Committee on Corporate Governance (5 October 2017), SEBI*
  http://www.nfcg.in/KOTAKCOMMITTEREPORT.pdf
- *Guidance note on directors' duties in the context of valuations in corporate transactions (15 May 2017), SFC*
  https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/guidance-note-on-directors-duties-in-the-conte/guidance-note-on-directors-duties-in-the-context-of-valuations-in-corporate-transactions.pdf

Governance Oversight

Coming soon

Glossary

AAL	AcrossAsia Limited
AGM	Annual general meeting
AI	Artificial intelligence
ASX	Australian Securities Exchange
ATDJV	Alstom-Thales DUAT Joint Venture
Cathay Union	Cathay Pacific Airways Flight Attendants Union
CCPA	California Consumer Privacy Act
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CG Code	Corporate Governance Code
CKI	Cheung Kong Infrastructure Holdings Limited
COP	Conference of Parties
CRO	Chief risk officer
DPP	Data Protection Principle
EGM	Extraordinary general meeting
ERM	Enterprise risk management
ESG	Environmental, Social and Governance
EU	European Union
FRC	Financial Reporting Council
G250	Global Fortune 250
GDPR	General Data Protection Regulation (EU) 2016/679
GEM	Growth Enterprise Market
HKAS	Hong Kong Accounting Standard
HKEX	Hong Kong Exchanges and Clearing
HKFRS	Hong Kong Financial Reporting Standards
HKICPA	Hong Kong Institute of Certified Public Accountants
HKCGI	Hong Kong Chartered Governance Institute
HKIoD	Hong Kong Institute of Directors
HKMA	Hong Kong Monetary Authority
HKVCA	Hong Kong Venture Capital and Private Equity Association
IFRS	International Financial Reporting Standards
INED	independent non-executive director
IOSCO	International Organization of Securities Commissions
IRD	Inland Revenue Department
ISO	International Organization for Standardisation
IT	Information technology
King IV	King IV Code of Governance
KPI	Key performance indicator
LPI	Leading Performance Indicator
LTI	Lost time injury
M&As	Memorandum and articles of association
MAS	Monetary Authority of Singapore
MMT	Market Misconduct Tribunal
Model Articles	Companies (Model Articles) Notice (Cap. 622H)
MTR	MTR Corporation
OECD	Organisation for Economic Cooperation and Development
PAH	Power Assets Holdings Ltd.
PCPD	Privacy Commissioner for Personal Data
PE	Private equity
PEC	Private equity committee
PME	PME Group Limited
SEBI	Securities and Exchange Board of India
SEC	US Securities and Exchange Commission
SFC	Hong Kong Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571)
SMEs	Small and medium enterprises
SOX	Sarbanes-Oxley Act
TCFD	Task Force on Climate-related Financial Disclosures
Transfield	Transfield Services
UK	United Kingdom
UN-FCCC	United Nations Framework Convention on Climate Change
US	United States
VC	Venture capital
WEF	World Economic Forum

Appendix 1: Annual agenda

The board and annual agenda should be designed as a practical work plan where the board's staple business items are allocated to a particular meeting. The example annual agenda attached is one approach to the categorisation of business items and their allocation to specific meetings. In this example, it is assumed there will be 12 meetings of the board including an annual strategy day. An underlying objective of the annual agenda is to achieve balance in the board's workload through the year and ensure all board responsibilities are attended to. The items of business have been categorised as follows:

- matters that the board has resolved for its decision (reserved authorities)
- matters which have been delegated (e.g. to the CEO or a board committee) (delegated authorities)
- matters that are purely for information and do not require a board decision (reporting)
- procedural matters that may arise at any or every board meeting (matters that may be applicable to all meetings).

The matters listed in the annual agenda and the scheduling of such matters will vary from company to company. Each board should identify the core matters for inclusion in the annual agenda. As well as the anticipated board business, there will be other matters which arise that require the board's attention such as a merger or acquisition or major capital expenditure. An annual agenda may be set out in many different ways.

	Reserved authorities	Delegated authorities	Reporting	Matters that may be applicable to all meetings
Meeting 1	– Board charter – Annual agenda – Retained authorities – Delegated authorities – Chairman, individual director and committee roles – Company secretary's role – Advisory boards – Full-year or interim financial reporting – CEO's position description and goal setting	– Investor relations strategy – Management delegations, accountability and approval levels – Board and management information system – Strategic plan (actions and accountabilities)	– Regulatory and compliance report – CEO/CFO report	– Conflict and disclosure of interests – Litigation and non- compliance issues – Insider trading – Share trading – Continuous disclosure – Access to company records – Meeting agenda/ papers/ preparation/ procedures/ decision-making processes – Independent professional advice

	Reserved authorities	Delegated authorities	Reporting	Matters that may be applicable to all meetings
Meeting 2	– Board and committee succession planning – Risk appetite and risk management policy	– Risk management strategy – Risk profile and – assessment – Management accountability for risk – Internal control environment	– Audit committee report – CEO/CFO report – Major project reports – Risk management report	– Protocols for board/ management interaction between board/ committee meetings – Decision-making outside the boardroom (circular resolutions) – Board minutes – Board member induction and education
Meeting 3	– CEO succession planning – Board training plan – Corporate planning and budgeting	– Reporting and communications strategy – Review of key policies and procedures	– Investor relations report – Remuneration committee report – CEO/CFO report	
Meeting 4	– Director appointments/re- election – Director remuneration policy – Non-executive director remuneration – Director independence – Review of constitution	– Code of conduct – Corporate budgeting and planning	– Regulatory and compliance report – CEO/CFO report	
Meeting 5	– Directors' and officers' indemnity and insurance – Internal audit plan – External audit plan	– Whistleblower policy – IS strategy/policy – Director induction program	– Audit committee report – CEO/CFO report – Major project reports – Risk management report – Analyst and institutional presentations	
Meeting 6	– Assurance map – Half-year strategy review	– Crisis management and continuity plan – CSR strategy	– Investor relations report – Nominations committee report – CEO/CFO report	

	Reserved authorities	Delegated authorities	Reporting	Matters that may be applicable to all meetings
Meeting 7	– Related party transactions – CEO/CFO attestations	– Management attestations	– Regulatory and compliance report – Audit committee report – CEO/CFO report	
Meeting 8	– Director retirement/ removal – Statutory reporting – Meeting with external auditor	– Capital management strategy	– Remuneration committee report – Whistleblower report – CEO/CFO report – Major project reports – Risk management report – External audit report	
Meeting 9	– CEO appraisal – Executive remuneration – CEO and senior executive service agreements – Annual report and accounts, including directors' report, solvency declaration and corporate governance statement	– Management and staff remuneration and Human Resources policy	– Investor relations report – Audit committee report – CEO/CFO report	– Protocols for board/ management interaction between board/ committee meetings – Decision-making outside the boardroom (circular resolutions) – Board minutes – Board member induction and education
Meeting 10	– Dividend policy – AGM documentation – Shareholder profiling – External audit independence, appraisal, retention, appointment and remuneration	– Compliance program	– CEO/CFO report	
Meeting 11	– Board and individual director evaluation – Committee evaluation	– Tax strategy	– Regulatory and compliance report – Audit committee report – CEO/CFO report – Major project reports – Risk management report – Analyst and institutional presentations	

Appendix 2: Audit Committee Terms of Reference

Purpose

The audit committee (the committee), appointed by the board of directors (the board), assists the Board to fulfil its oversight responsibilities relating to:

- financial statement preparation and integrity
- risk management and internal controls (in relation to financial, operational and compliance controls)
- external audit (qualifications, independence, engagement, fees and performance)
- annual audit of the financial statements
- internal audit (resources, performance and scope of work)
- company compliance with legal, regulatory requirements and compliance policies.

Effective corporate governance depends on the active and collaborative participation of the committee, board of directors, external auditors, internal auditors, other assurance providers and management. Ensuring that this collaboration occurs effectively and efficiently is fundamental to the committee's success.

The existence of the committee does not diminish the board's responsibility to ensure the integrity of the financial reporting.

Authority

The board has authorised the committee, within the scope of its duties and responsibilities set out in this charter, to:

- investigate any activities within this Terms of Reference to address its responsibilities and make recommendations to the board
- seek any information it requires from any employees in order to perform its duties
- obtain external professional advice and invite outsides with relevant experience and expertise if deemed necessary
- have separate and independent access to senior management and information to make informed decisions
- meet with the external auditor, at least annually, in the absence of management to discuss specific audit-related matters
- invite executive directors and external auditors to attend a particular committee meeting in order to answer specific points or concerns.

Membership

The Board shall appoint an audit committee that has sufficient and relevant expertise to fulfil its role effectively.

The committee shall consist of the following:

- at least three members
- be composed exclusively of non-executive directors
- have a majority of its members, including the chairman appointed by the full board, as independent.

As good practice the members should possess necessary skills and experience to tackle complex financial, operating and other issues. At least one member shall have financial or accounting expertise.

The members shall also have a clear understanding of the company's business, its internal environment and the external environment.

Committee member rotation is encouraged. Wherever possible, the board ensures that changes in committee membership are staggered to maintain continuity.

The company secretary shall be the committee secretary.

Education

The company will assist the committee in maintaining appropriate financial literacy. The company is responsible for providing new members with an appropriate induction programme and educational opportunities, and the full committee with educational resources relating to accounting principles and procedures, current accounting topics pertinent to the company, and other resources, as reasonable requested by the committee.

Meetings

It is recommended by HKICPA that a typical audit committee shall meet at least three or four times per year and whenever deemed necessary. If a member is unable to be physically present, they may participate by video or tele-conference.

A reasonable notice should be given of a regular meeting to each committee member confirming the date, time and venue. The agenda and accompanying board papers should be sent at least 3 days before each meeting.

The Finance Director, the Head of Internal Audit, and a representative of the external auditors shall normally attend meetings. At least once a year the committee shall meet with the external and internal auditor without executive board members present.

The external auditor or internal auditor may request a meeting if considered necessary. The committee chairman, the board chairman or any other committee members may also call a meeting of the committee.

The committee may invite members of management (e.g. CEO, executive directors), any employees, internal and external auditors or other non-executive directors to attend meetings of the committee. A standing invitation shall be issued.

Two independent non-executive directors will constitute a quorum.

Minutes

The committee secretary or delegate should prepare the minutes of the committee meeting within a reasonable time after the meeting. Draft and final versions of the minutes should be sent to all committee members for their comment and records, and shall lastly be circulated to the other board directors.

Full minutes should be kept by the secretary and open for inspection at any reasonable time on reasonable notice by any director.

Communication

The committee is expected to maintain free and open communication with the external auditor, the internal auditor and management.

Duties and responsibilities

In assisting the board to fulfil its responsibilities, the duties of the committee are as follows.

Assessment of financial information

Review all published interim and annual financial statements of the company, which require the approval of the board, based on the recommendation of the committee, and hold discussions regarding the financial statements with the external auditor and management before submission to the board.

Assess and challenge, where necessary, the accuracy, completeness, fairness and consistency of financial information and disclosures, focusing particularly on:

- any changes in accounting policies and practices
- major judgmental areas
- significant adjustments resulting from the audit
- the going concern assumption
- compliance with accounting standards
- compliance with stock exchange and legal requirements.

External auditors

Recommend to the board the appointment, evaluation and removal of the external auditor, and consider any questions of resignation or dismissal.

Review and approve the external auditors' proposed audit plan and audit approach, including materiality levels.

Review and agree the terms of engagement and the audit fees for the external auditors prior to the commencement of each audit.

Review the independence and objectivity of the external auditors and their compliance with all relevant independence requirements including:

- relationships between the company and the audit firm
- hiring employees or former employees of the external auditors
- the level of non-audit services provided
- the rotation of audit partners.

Review the external auditor's management letter detailing the results and significant findings from the audit and management responses.

Meet with the external auditor, at least annually, in the absence of management, to discuss issues arising from the audit and any matters the auditor may wish to raise.

Obtain from the audit firm annually, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including those for rotation of audit partners and staff.

Internal auditors (if any)

Approve the appointment, remuneration and removal of the head of internal audit.

Review the internal audit charter to ensure the appropriate organisational structure, authority, access and reporting arrangements are in place. Ensure appropriate resourcing of the internal audit function.

Approve and review progress against the internal audit work plan:

- review the internal audit coverage and annual work plan, and monitor progress of the work plan
- advise the board on the adequacy of internal audit resources to carry out its responsibilities, including completion of the approved internal audit plan
- oversee the co-ordination of audit programs conducted by internal and external audit respectively
- review significant internal audit reports and findings.

Review progress on management actions. Monitor progress against the annual work plan, including any significant changes to it, any difficulties or restrictions on the scope of activities and any significant disagreements with management.

Discuss issues with internal audit in the absence of management.

Consider the major findings of the internal audit reports and review management's response in terms of content and timeliness. Monitor management's implementation of internal audit recommendations. Periodically review the performance of internal audit.

Risk management and internal controls

Approve the company's risk management and internal control policies and oversee the risk management and internal control systems, including the risk management and internal audit functions and their resourcing.

Approve and monitor the company's risk profile developed by management, covering the principal enterprise-wide risks, including strategic, operational, legal and financial.

Review the operational effectiveness of the policies and procedures relating to risk and the company's internal control environment.

Consider major investigation findings on risk management and internal control matters as delegated by the board and management's response to these findings.

Compliance

Review the effectiveness of the company's approach to achieving compliance with laws, regulations, industry codes and company policies.

Review compliance with the company's values and related behaviours and the code of conduct. Review and monitor the effectiveness of policies, procedures and processes for complying with continuous disclosure requirements.

Obtain regular updates from management, legal counsel and the company secretary regarding compliance matters that may have a material impact on the company's activities. Review any correspondence from regulatory bodies regarding significant issues.

Other responsibilities

Ensure that there is a process in place for the board chairman and committee chairman to be immediately informed of any issue of significant non-compliance or litigation. Oversee the process for the receipt, retention and treatment of information received from the internal whistleblower policy and procedures, and also from external complainants regarding matters relating to audit, the financial statements, internal controls or possible fraud.

Review any fraud reports. Review and discuss any reports concern any breach of fiduciary duty. Hold regular executive sessions with the CEO, CFO and other senior management to discuss private matters with the committee.

Act as a forum for communication between the board and senior management and internal and external audit. Review the effectiveness and level of cooperation between management, the internal auditor (if any), the risk management function (if any) and the external auditors. Review reports to the shareholders on the role and responsibilities of the committee. Conduct special investigations (if required). Perform any other duty of undertaking that the board may request from time to time.

Review, for potential conflict of interest situations, and pre-approve related party transactions on an ongoing basis.

Reporting

In addition to providing the board with a copy of the minutes of its meetings, the committee will ensure that:

- the committee chairman reports to the board on committee meetings, regarding all relevant matters and appropriate recommendations, in a written report (with supporting material) for noting or approval by the board
- the committee addresses any other reporting responsibilities.

Reviews

To ensure that the committee is fulfilling its stewardship duties to the board, the committee will:

- review, at least annually, the Terms of Reference and recommend to the board any appropriate amendments for approval
- review the annual agenda incorporating any changes in the Terms of Reference
- conduct an annual assessment of its performance against its Terms of Reference duties and responsibilities and provide a report of the findings to the board
- conduct an annual assessment of each committee member (the committee chairman should provide a report of the findings to the board chairman).

Appendix 3: Audit Committee Induction Framework

Over the last few years the responsibilities of audit committees have increased significantly. It is no longer sufficient for audit committee members to have only a rudimentary knowledge of financial and regulatory matters. Committees cannot provide meaningful protection for shareholders unless their committee members are in a position to challenge management. To do this effectively, they must have the skills, knowledge and expertise, and be supported by access to independent advisors.

A formal induction programme for new committee members is highly recommended. A comprehensive committee induction programme could include an information package, training sessions and meetings with key executive. The following outlines suggested inclusions in an induction framework.

Information package

An information package could include:

- committee charter
- committee annual agenda
- committee papers and minutes for the previous 12 months
- outline of the resources used by the committee to undertake its duties
- external auditor relationship
- accounting policies and approved practices
- regulatory and compliance framework for the company's business
- risk management policies
- risk management and control framework

- internal auditor's work plan
- details of the compliance framework, together with background on the key compliance obligations, both internal and external
- last annual report to the board on how the committee has discharged its duties.

Training sessions

Training sessions could be facilitated to guide audit committee members on:

- protocols
- effective meetings
- roles and accountabilities
- conflict of interest
- financial report review
- internal audit planning
- risk reporting review and attestation
- internal audit report review
- compliance reporting review
- external audit reporting.

Meetings

Meetings to discuss the committee terms of reference, how the committee operates, the main business and financial dynamics and other matters of significant could be held with the:

- committee chairman
- CEO
- CFO
- internal auditor
- compliance officer
- company secretary and general counsel
- external auditor.

In addition, it may be useful to schedule discussions with other senior management regarding key operations and hold a follow-up meeting with the committee chairman to discuss any issues arising from the induction program.

Appendix 4: Audit Committee Annual Agenda

This example annual agenda is linked to the example audit committee terms of reference. In this example there are four scheduled committee meetings planned for the year.

Scheduled meetings	Dec	Mar	Jul	Sep
Foundation				
Review audit committee terms of reference and annual agenda				
Assess committee's independence, financial literacy, skills and experience				
Determine number of meetings for forthcoming financial year				
Committee chairman to determine meeting agenda and required attendees, including management and assurance providers				
Enhance financial literacy – update on current financial events				
Review of ongoing audit committee member education plans				
Conduct an assessment of the committee's performance against its terms of reference and provide a report to the board				
Conduct an assessment of the individual member's performance				
Consider committee member rotation and succession planning				
Assessment of financial information				
Review significant accounting and reporting issues				
Review financial matter affecting the half year				
Review and approve half year financial statements				
Review financial matters affecting the year end				
Review and approve annual financial statements				

Key: Recommended timing As required

Scheduled meetings				
	Dec	Mar	Jul	Sep
Review with management its evaluation of internal control structure and procedures for financial reporting, including any significant deficiencies or material weaknesses				
Annually review and discuss with management and the external auditors, management's assessment of the effectiveness of internal control structure and procedures for financial reporting				
Review and discuss any reports concerning evidence of material violation or breaches of fiduciary duty				
Review and discuss any reports submitted by the external auditor detailing any instances of fraud or possible illegal acts on the part of senior management				
Review process, policies and procedures for continuous disclosure obligations				
Review conflicts of interest and related party transactions				
External auditors				
Recommend appointment, evaluation and removal of the external auditors				
Review audit plan and scope of audit work and any changes thereto				
Recommend terms of engagement and audit fees				
Consider policy in relation to non-audit services				
Review and pre-approve non-audit services				
Consider objectivity/independence and obtain independence declaration from external auditor				
Review external auditors' report and findings and progress on management actions				
Discuss implications of any significant changes in accounting standards				
Discuss appropriateness of accounting policies, estimates and judgments				
Discuss external auditors' view on control environment, including fraud and risk management				
Resolve any disagreement between management and the external auditor in the financial reporting and report any significant issues to the board				
Discuss issues with auditor in the absence of management				
Ongoing communication (written/oral) between the external auditor with the committee				
Review report from external auditor on quality control procedures				
Review the external auditors process for rotation and approach for managing transition				

Key: Recommended timing As required

Scheduled meetings	Dec	Mar	Jul	Sep
Internal auditors				
Approve appointment and review performance				●
Review internal audit charter	●			
Review internal audit plan and any changes required to the plan including any resource issues		●		
Review progress against the audit plan	●	●	●	●
Review significant internal audit reports and findings	●	●	●	●
Review progress on management actions	●	●	●	●
Discuss issues with the internal auditor in the absence of management	●	●	●	●
Review the performance of internal audit1, including organisational structure, qualifications and independence.				●
Risk management and internal controls				
Review risk management policy and risk management system	●	◆	●	◆
Review risk profile	●	◆	●	◆
Review internal controls and report to the board	●	◆	●	◆
Review operational effectiveness of risk policies and procedures and internal control environment	◆	●	◆	◆
Review the effectiveness of the company's insurance activities	●	◆	●	◆
Ensure effective remuneration risk and controls are linked to the overall risk profile	●	◆	●	◆
Compliance				
Review legal and regulatory matters that may have a material impact on the company	◆	◆	◆	◆
Review compliance report from management, and correspondence (if any) from regulatory bodies	●	◆	●	◆
Review any correspondence from regulatory bodies	◆	◆	◆	◆
Review compliance with company values and related behaviours, and the code of conduct	◆	◆	◆	◆
Review compliance with continuous disclosure requirements	◆	◆	◆	◆

Key: Recommended timing As required

Scheduled meetings				
	Dec	Mar	Jul	Sep
Other responsibilities				
Review whistleblowing arrangements and reports				
Review fraud report				
Hold regular executive sessions with senior management				
Review level of cooperation between management, internal auditor and external auditor				
Review report to the shareholders on the role and responsibility of the committee				
Conduct special investigations and perform other activities, as appropriate				
Reporting				
Maintain minutes and report to the board				

Key: Recommended timing   As required

Contact us

Shanghai:

Joyce Ge
Partner
Tel: +86 (21) 2212 3295
joyce.ge@ kpm g.com

Sabrina Fang
Partner
Tel: +86 (21) 2212 4197
sabrina.hl.fang@kpm g.com

Stephanie Chew
Partner
Tel: +86 (21) 2212 3080
stephanie.chew@kpmg.com

Effeir Li
Director
Tel: +86 (21) 2212 2347
effeir.li@kpmg.com

Ivy Ye
Director
Tel: +86 (21) 2212 3327
iy.ye@kpmg.com

Beijing:

Frank Mei
Partner
Tel: +86 (10) 8508 7188
frank.m ei@kpmg.com

Haoyu Liu
Partner
Tel: +86 (10) 8553 3343
haoyu.liu@ kpm g.com

Jessica Xu
Partner
Tel: +86 (10) 8508 5952
jessica.xu@kpmg.com

Johnson Li
Partner
Tel: +86 (10) 8508 5975
johnson.li@ kpmg.com

Peter Yu
Partner
Tel: +86 (10) 8553 3479
pz.yu@kpmg.com

Vera Li
Partner
Tel: +86 (10) 8508 5870
vd.li@kpm g.com

Aaron Ren
Director
Tel: +86 (10) 85085454
aaron.ren@kpmg.com

May Gao
Director
Tel: +86 (10) 8508 5390
may.gao@kpmg.com

Medivh Luo
Director
Tel: +86 (10) 8508 5016
medivh.luo@ kpmg.com

Hong Kong:

Alva Lee
Partner
Tel: +852 2143 8764
alva.lee@kpmg.com

David Lonergan
Partner
Tel: +852 2826 7195
david.lonergan@kpmg.co
m

Edna Wong
Partner
Tel: +852 2143 8693
edna.wong@kpmg.com

Jeffrey Hau
Partner
Tel: +852 2685 7780
jeffrey.hau@kpmg.com

Jia Ning Song
Partner
Tel: +852 2978 8101
jianing.n.song@ kpm g.com

Claudia Yu
Director
Tel: +852 2685 7898
claudia.yu@kpmg.com

Gianfran Liu
Director
Tel: +852 2847 5164
gianfran.liu@kpmg.com

Jens Kessler
Director
Tel: +852 2143 8584
jens.kessler@kpmg.com

Safa Sadigh-Mostowfi
Director
Tel: +852 2826 7263
safa.mostowfi@kpmg.com

Guangzhou/Shenzhen

Eric Chang
Partner
Tel: +86 (20) 3813 7088
eric.chang@ kpm g.com

Kelvin Leung
Partner
Tel: +86 (755) 2547 3338
kelvin.oc.leung@ kpm g.com

Joyce Xie
Partner
Tel: +86 (755) 2547 1261
joyce.xie@ kpm g.com

Mona He
Director
Tel: +86 (755) 3813 8239
mona.he@kpmg.com

Sandy Wang
Director
Tel: +86 (755) 2547 1159
sandy.k.wang@kpmg.com

Season Wu
Director
Tel: +86 (755) 3813 7505
season.wu@kpmg.com

kpmg.com/cn