Corporate Governance – Hong Kong Prospective

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Corporate governance - definition

Corporate governance is, in simple terms, concerned with the governance or control of companies (i.e. Corporations)

Corporate governance can be described as the rules and regulations concerning the governance of companies to:

1. protect shareholders, employees and other stakeholders; and
2. help the company to operate more competitively and effectively.
Corporate governance - definition

Cadbury Report defines corporate governance as "the system by which companies are directed and controlled". (December 1992)

1. Agency problems between investors and management (Public companies - ownership v control)

Central to almost all corporate governance issues is the separation between the management and ownership of companies. A company is owned by its shareholders (who have invested capital in it and are looking for a fair return on their investment) while it is managed by its board of directors (or, as is usually the case in larger companies, a subsection of them: the executive directors).

Good corporate governance requires that a public listed company be managed to an optimal level and its directors are accountable for their actions to the shareholders.

2. Shareholder versus stakeholder – questions of for whose benefit the corporation should be run (Relationship between management, board of directors, shareholders and stakeholders)
Corporate Governance – Infrastructure

Shareholder Meeting

Board of Directors

Management

Employee
Corporate Governance – Infrastructure

Regulations

Legislation + Common Law

Board of Directors

Shareholders
Corporate Governance – Infrastructure

- Regulators
- Stakeholders
- Shareholders
- Auditors
- Audit committee
- Remuneration + Nomination committees
- Company secretary
- B. Ethics
- CSR
- Other committees
Hong Kong Regulatory Framework

Legislation

- Companies Ordinance
- Companies (Winding Up and Miscellaneous Provisions) Ordinance
- Securities and Futures Ordinance
- Other Ordinances
Hong Kong Regulatory Framework

Common Law

Rules & Codes

- The Listing Rules
  - HKEx concept paper on Weighted Voting Rights
- The Hong Kong Code on Takeovers and Mergers and Share Buy-backs
- Guidelines for the Exemption of Listed Corporations and Other Persons from Part XV of the Securities and Futures Ordinance (Disclosure of Interest)
- Guidelines on Disclosure of Inside Information
Hong Kong Regulatory Framework

The Companies Registry (CR)

The Official Receiver (OR)

The Hong Kong Stock Exchange (SEHK)

The Securities and Futures Commission (SFC)

The Financial Secretary (FS)

Courts and Tribunals
Corporate governance failure

Common features of successful companies that fail

- dominant leader - combined roles
- limited presence of independent non-executive directors
- over-riding internal controls by chief executive officer
- Irregular board meetings
- inadequate management information systems
Shareholdings concentrated in small group of people in listed companies and no distinction between owners and management

Hong Kong is unique among major financial centers as almost all of the companies listed on the SEHK have a controlling shareholder holding a majority of the shares (or at least a very large stake giving de facto control of the issuer). This is because almost all Hong Kong listed issuers originated and remain as either family controlled businesses or as enterprises controlled by the PRC state.

Overseas, the focus is often on the accountability of the managers to shareholders and ensuring that there are enough “checks and balances” in place to ensure that the managers act in the best interests of the shareholders.

In Hong Kong, corporate governance issues tend to relate more to the oppression of minority shareholders than to agency problems. This difference is reflected in the specific corporate governance rules in place in Hong Kong (such as the role of INEDs and the extensive connected transaction rules).
Hong Kong Situation

World Competitiveness Forum (2012) – looking at the business system in general, Hong Kong ranks second only behind Singapore (corporate practices in relation to its comparator jurisdictions – using a survey of business executives)


A recent assessment of Hong Kong corporate governance designed to measure it against its real, economic risks – rather than international best practices – found Hong Kong corporate generally governance good, yet still wanting in protection against dominant shareholders. (Donald)
Hong Kong Situation

Research data suggest that improvements in corporate governance lead to higher market valuations and investment in Hong Kong companies.

The relationship between equity returns, risk (as measured by the standard deviation of those returns) and corporate governance scores.

In 2005, high corporate governance score companies earned an average abnormal stock return of about 8%. Their low score colleague companies lost about 4% over the course of 2005. Moreover, investors in the low corporate governance companies took on slightly more risk (about 1% standard deviation in returns) for their poor returns.
## Hong Kong Situation

### Asian Corporate Governance Association CG Watch market scores: 2010 to 2014 (%)

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<tbody>
<tr>
<td>1. Hong Kong</td>
<td>65</td>
<td>66</td>
<td>65</td>
<td>(-1) Weak leadership, tough enforcement</td>
</tr>
<tr>
<td>1. Singapore</td>
<td>67</td>
<td>69</td>
<td>64</td>
<td>(-5) International vs local contrast Continues</td>
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<tr>
<td>3. Japan</td>
<td>57</td>
<td>55</td>
<td>60</td>
<td>(+5) Landmark changes, can they be sustained?</td>
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<tr>
<td>4. Thailand</td>
<td>55</td>
<td>58</td>
<td>58</td>
<td>Improving, but new legislation needed</td>
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<tr>
<td>4. Malaysia</td>
<td>52</td>
<td>55</td>
<td>58</td>
<td>(+3) Improving, but still too top-down</td>
</tr>
<tr>
<td>6. Taiwan</td>
<td>55</td>
<td>53</td>
<td>56</td>
<td>(+3) Bold policy moves, can they be sustained?</td>
</tr>
<tr>
<td>7. India</td>
<td>48</td>
<td>51</td>
<td>54</td>
<td>(+3) Bouncing back, Delhi more supportive</td>
</tr>
<tr>
<td>8. Korea</td>
<td>45</td>
<td>49</td>
<td>49</td>
<td>Indifferent leader, more active regulators</td>
</tr>
<tr>
<td>9. China</td>
<td>49</td>
<td>45</td>
<td>45</td>
<td>Focus on SOE reform, enforcement</td>
</tr>
<tr>
<td>10.Philippines</td>
<td>37</td>
<td>41</td>
<td>40</td>
<td>(-1) Slow reform, improved company reporting</td>
</tr>
<tr>
<td>10.Indonesia</td>
<td>40</td>
<td>37</td>
<td>39</td>
<td>(+2) Big ambitions, can they be achieved?</td>
</tr>
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</table>
Hong Kong Situation

Hong Kong and Singapore: Equal first, but on lower scores. Regulatory conflicts of interest, out-of-date institutional structures, opposition to reform, and many other factors.

Hong Kong Situation

Hong Kong rated better on:
Disclosure of price-sensitive information

The legal regime governing insider trading and market manipulation

Voting by poll at shareholder meetings

Disclosure of the exact remuneration of directors and senior executives

Release of annual general meeting (AGM) agendas at least 28 days before AGMs
Types of management frauds

Non-disclosure of connected transactions
Frequent rights issue with price of the rights shares at a big discount to the net asset value
Theft of company's assets by directors
Privatisation below net asset value
Insider dealing
False accounting
Unauthorised loans to directors or substantial shareholders
People’s Republic of China

Two-tier board

- Board of directors
- Supervisory board (employees + shareholders)

State-owned companies
- lack of checks + balances
People’s Republic of China

Obstacles to CG

- Shareholding structure
- Management
- Minority protection
- Disclosure of information
- Internal control
- Audit committee
- INEDs
- Supervisory committee
- Legislation and penalty
- Institutional shareholders
PRC Company Law and Corporate Governance

PRC registered companies are governed by PRC law (law of domicile). If they are listed in HK, then HK company law does not apply to them though HKEx rules do as do SFO rules.

PRC company law first enacted in 1993

Subsequently amended in 1999 and 2004 and 2005

Recent major amendment in March 2014
Structural Issues – Role of the two boards

The PRC Company Law requires listed companies to adopt a two-tiered board system

- **Board of Supervisors**
  - Consists of independent shareholders and employees (cannot be less than 1/3)
  - In theory, an independent board that provides independent views and monitors the executive management and the BoD
  - Mostly connected to major shareholder(s), they may only represent a single interest group (the government) but not all stakeholders

- **Board of Directors**
  - consists of 2/3 top executives and 1/3 independent directors
  - accountable directly to shareholders
  - core board works closely with the management
  - operates company’s daily business
Structural Issues – Role of the Government & the Communist Party

Government essentially owns…. everything!

- Enterprises
- Brokerages
- Banks
- Stock Exchange Markets in Shenzhen and Shanghai
  Private system almost non-existent
- Courts
- It is really a Government system, not a private enterprise system.
Corporate Structures and Corporate Governance

Companies registered in China
• governed by PRC Company Law

Wholly-owned subsidiary

Might be registered in “other countries” such as BVI or Cayman Islands.
• Subsidiary is governed by the company law in its place of incorporation

Might be *listed* in Hong Kong should adhere to the:
• HKEx Listing Rules
• Code of Corporate Governance
• Part 17 of the Companies Ordinance

Possible problems:
Controlling power still resides with government officials in China
• PRC management style may be inconsistent with the corporate governance in Hong Kong
• Minority shareholders have no idea about PRC or BVI or Cayman Islands law and inherent risk!
Causes of conflict

Different corporate governance systems in mainland China, Hong Kong, BVI, Cayman

Different requirements by exchanges and regulatory authorities

- e.g. China Securities Regulatory Commission vs. Securities and Future Commission
- Shenzhen/Shanghai Stock exchange vs. HKEx
The new Companies Ordinance (CAP 622)

The new Companies Ordinance came into effect on 3 March 2014. The new legislation is part of a comprehensive exercise to rewrite the company law of Hong Kong.

It has over 900 sections and 10 schedules. The new Companies ordinance did not completely repeal the old Companies Ordinance. The provisions of the old Companies Ordinance relating to corporate insolvency and prospectus liability remain in force (in the re-titled Companies (Winding Up and Miscellaneous Provisions) Ordinance).
New Companies Ordinance – Enhancing Corporate Governance

Strengthening the accountability of directors

1. Requiring a private company to have at least one individual director.

2. Clarifying directors’ duty of Care, Skill and Diligence.
   both objective and subjective elements will be taken into account, and what is required of directors will vary between different types of directors and between different types and sizes of companies

Enhancing shareholder engagement in the decision-making process

3. Requiring a company to bear the expenses of circulating members’ statements.

4. Reducing the threshold requirements for members to demand a poll from 10% to 5% of the total voting rights.
New Companies Ordinance – Enhancing Corporate Governance

Improving the disclosure of company information

5. Requiring large companies to prepare Business Review, but large private companies can opt out with members’ approval.

6. Directors to disclose material interest in transaction, arrangement or contract of significance, and for public companies, material interest of connected entities as well. Disclose the nature and extent of the director’s interest. And cover shadow directors.
Fostering shareholder protection

7. Introducing more effective rules to deal with directors’ or members’ conflicts of interests.

a.) Ratifying breaches

Under the new Companies Ordinance (s473), disinterested members may ratify the conduct of a director involving negligence, default, breach of duty or breach of trust in relation to the company.

If there are no disinterested members, ratification will require all members.
New Companies Ordinance – Enhancing Corporate Governance

b.) Director loans
Prohibits loans or other similar transactions with a director, persons connected with the director holds a controlling interest.

i) Extends the categories of persons/companies affected as following:-
   - adult children;
   - children under the age of 18 who live with the director;
   - a cohabitee;
   - a parent;
   - an associated body corporate (s 488);
   - non Hong Kong companies controlled by the director.

ii) Extension of quasi-loans and credit transaction prohibitions.
   - cover private companies that are subsidiaries of a public or listed company.
   - cover companies controlled and connected with such directors.
New Companies Ordinance – Enhancing Corporate Governance

c.) Payments for loss of office
Without member approval, prohibit payments to directors as compensation for loss of office or retirement.

Extended loss of office payment prohibition to include payments to:

- an entity connected with the director;
- a person made at the direction of, or for the benefit of, the director;
- directors of a holding company.

There is a de minimis exception for payments under HK$100,000.

d.) Long term service contracts
Approvals of shareholders are required for employment of a director which exceeds or may exceed 3 years.
New Companies Ordinance – Enhancing Corporate Governance

e.) Unfair prejudice

New scope of the unfair prejudice remedy:-

- the company’s affairs are being conducted in a manner unfairly prejudicial to the interests of the members; or
- the conduct involves an actual or proposed act and omission of the company (including one done or made on behalf of the company) that is or would be prejudicial.

The provision is intended to cover threatened or proposed conduct which has not yet taken place. As such, the remedies that may be granted by the court are extended to cover an order restraining the proposed act or requiring the doing of an act that the company has omitted to do.
New Companies Ordinance – Enhancing Corporate Governance

8. Strengthening auditors’ powers while introducing a new offence.

a.) Auditors now have a right to any information or an explanation that the auditor reasonably requires for the performance of its duties, from:
   - a person holding or accountable for any accounting records of the company;
   - a person that is a related entity of the company, or was a related entity of the company at the time to which the information or explanation relates; and
   - any officer or auditor, or former officer or former auditor of non-Hong Kong incorporated subsidiary undertaking at the time to which the information and explanation relates.

b.) Offences
   i) Providers accountability: failure to provide requested information or explanation to auditors – criminal fine (s.413(1))

   A person who contravenes the section commits an offence and is liable to a fine at level 4 and, in the case of a continuing offence, to a further fine of $700 for each day during which the offence continues.
New Companies Ordinance – Enhancing Corporate Governance

ii) Auditor’s accountability: An auditor commits an offence if knowingly or recklessly cause a statement required to be contained in an auditor’s report to be omitted from it – criminal fine of HK$150,000 (s.408(1))

iii) Qualified privileges against defamation actions apply to statements made by auditors when performing their duties, absent malice (s.410). According to s.410(1), in the absence of malice, an auditor of a company is not liable to any action for defamation at the suit of any person in respect of any statement made by the auditor in the course of performing duties as auditor of the company.

iv) According to s.413(3), a person commits an offence (HK$150,000 and 2 years imprisonment) if –
   (A) the person makes a statement to an auditor of a company that conveys or purports to convey any information or explanation that the auditor requires, or is entitled to require, under s.412(2) or (4);
   (B) the statement is misleading, false or deceptive in a material particular; and
   (C) the person knows that, or is reckless as to whether or not, the statements is misleading, false or deceptive in a material particular.
Creating a culture of risk awareness

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