
CORPORATE GOVERNANCE

Report on Improving Corporate Governance in Hong Kong

A comparative based study

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Hong Kong Institute of
Certified Public Accountants
香港會計師公會



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"The only part of the conduct of any one, for which he is amenable* to society, is that which concerns others."

John Stuart Mill, *On Liberty*, 2nd ed., 1859
London, John W Parker and Son, page 22

*liable to the legal authority of

PREFACE

Development is synonymous with improved standards. However, what yardstick should be used to agree on standards and assess improvement as compared to merely change depends on where one stands.

The almost eighteen years since the start of this century has witnessed significant changes to the corporate and regulatory landscape globally. The usual triumvirate of corporate misbehaviour, market repercussions and regulatory responses has been predictably played out. Leading global financial centres continue to pursue similar though not identical courses of remediation in the public capital markets that seek to establish better oversight, reduce information asymmetries, install preventative controls and impose greater accountability.

Looking past the process-based methods used to achieve this, the underlying factor being addressed is human behaviour. The minds and deeds of individuals are the drivers of successes and failures, production and disorder, efficiency and waste, gains and losses. Each of these pairs can be and are measured alternatively by private interests and public aspirations. This is no less the case with the relationship between the owners and managers of a publicly listed company, which is the topic of this Report.

Since the mid 20th century, there has been a progressive awareness of the importance of corporate governance to the healthy functioning of the marketplace. A voluminous output of material on the topic has been produced by governments, multilateral organizations, regulatory agencies, commercial parties, interest groups (for both owners and managers), academics and others. The topic has been prodded and explored, and misunderstood, from every angle, commercial, social and political, and has given rise to numerous theories. Some of this has led to developments in the way the business of governance is undertaken in practice, and some has given rise to new expectations, be it commercial, legal, regulatory or social.

Expectations are made of restless stuff that renders development an ongoing task. Change is constantly measured and re-measured against an evolving landscape. This Report represents little more than a snapshot of the five jurisdictions studied. The recommendations made herein are intended to be practical and implementable, and based on a yardstick with a sufficient prospect for finding consensus. At the very least, this Report seeks to create discussion around the topics explored in the hope it will stimulate new ways of thinking about solutions to problems, and that more than a few of the recommendations will survive the test of scrutiny and be implemented.

The Hong Kong Institute of Certified Public Accountants (HKICPA) has been instrumental in commissioning this Report, and the members of its Corporate Governance Working Group have contributed their knowledge and experience as a highly valuable sounding board, and as challengers, for many of the ideas generated by the study. A special thanks of appreciation is due to Peter Tisman and Eric Chiang, both of the HKICPA, for their tireless assistance and invaluable support throughout the duration of the study. Producing a Report of this nature requires the support of many others, including in particular the persons acknowledged further below, whose involvement has been deeply appreciated. As ever, the views expressed herein, and any errors, remain those of the authors.

This Report states the position as at end November 2017.

Syren Johnstone
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Hong Kong, December 2017

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EXECUTIVE SUMMARY

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I	KEY FINDINGS
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Introduction

Hong Kong's emergence as a global financial centre has brought far greater attention to its role in the global market place and the standards it engages as compared to other leading global centres. Markets compete on a range of factors, amongst which the corporate governance (CG) system is of particular importance because it impacts on market integrity, and hence market success. Where the affairs of publicly listed companies are undertaken in a way that fall short of expected CG standards, or where the mechanisms of control and redress are inadequate to curb misbehaviour, confidence in the market may be damaged, and the market becomes less efficient. CG is therefore an integral part of a market that a CG system must serve.

This Report was commissioned by the Hong Kong Institute of Certified Public Accountants (HKICPA) to make recommendations on how Hong Kong's CG system may be further developed to improve the long-term competitiveness of the Hong Kong public market. The recommendations are to be based on an independent, comparative study of shareholder rights, remedies and protections and board processes within the context of public listed companies. As many listed issuers are not incorporated in Hong Kong this presents special issues as regards standard setting and enforcement.

To assess the strengths and weaknesses of Hong Kong's CG system in the global context, this study investigated the CG system in Hong Kong and each of the United Kingdom (UK), the United States, Mainland China and Singapore. The CG system in each of these jurisdictions has undergone developments and experiences, successes and failures that are shaped by its historical, political, legal, market, and social and cultural contexts. The different influences of these factors are important to recognize for the purposes of forming recommendations within a Hong Kong framework – what works, or fails, in one jurisdiction might fail, or work, in another.

The comparative analysis undertaken in this Report has led to a total of 28 recommendations being put forward. Reflecting one of the guiding concepts of this study to produce practical and implementable recommendations, only two require a change to legislation, with another four possibly requiring legislative change subject to the outcome of a further consultative process. All recommendations are consistent with overarching objectives of fostering competition and regulatory efficiency.

The remainder of this Part I of the Executive Summary provides an overview of the study's main findings. Part II outlines each recommendation made and provides a summary Table of all recommendations found in Section 4 of this Report. Part III summarizes the approach taken to the topic of CG and the formation of recommendations. Part IV summarizes the analysis that gives rise to the 28 recommendations via an abridged text of the detailed analysis found in Section 3 of this Report.

Standing of Hong Kong's CG system

In general, Hong Kong's CG system is keeping up with international best practices in most areas. The approach to evolving its CG system has been inclined to follow developments in other markets, particularly the UK and to some degree the United

States.¹ This typically means that changes to Hong Kong's CG system lags rather than leads international best practices. Its evolution in recent times can be broadly captured under three main areas: statutory law, the non-statutory listing rules, and gateway mechanisms for new issuers including those companies not incorporated in Hong Kong, as follows.

The rights of shareholders under statutory law in relation to director misfeasance and mis-disclosure are generally on par with or better than international best practices, as supported by important statutory reforms including the Securities and Futures Ordinance (SFO) (introduced 2003) and the new Companies Ordinance (introduced 2014).² However, as discussed below, the lack of availability of collective redress and the standing of the listing rules remain areas of concern insofar as they have not evolved in line with developments in other markets and so leave shareholders in Hong Kong listed issuers comparatively disadvantaged.

The standards of CG that are expected of listed issuers have developed generally in line with international best practices. Board practices are subject to mandatory listing rule requirements and a "comply or explain" CG code that the SEHK³ subjects to progressive development. While in some areas the CG system is well developed and goes further than other markets, such as the non-statutory regulations governing connected party transactions, the adequacy of enforcement discipline and availability of shareholder remedies remain a concern.

Gateway mechanisms designed to protect and further the interests of shareholders have also been progressively improved, including in respect of non-Hong Kong incorporated companies. This has been a result of the SFC⁴ and the HKEX⁵ working together as regards listing standards, the development of policies for non-Hong Kong incorporated companies tailored to specific jurisdictions, and the regulatory requirements imposed on sponsors.

Overall, the dual responsibilities model has worked well in response to significant developments in the market, including Hong Kong's global position in the IPO market and the highly significant shift to the listing of Mainland enterprises such that these firms now account for the majority of market capitalisation and trading. The correct balance of the role of the SEHK as the frontline regulator and the SFC's oversight role remains subject to intermittent discussion and disagreement as regards how the roles should evolve in response to these developments.

Key areas for reform

There are a number of areas of concern in which Hong Kong must do significantly better to protect its market and the shareholders who invest in it. The weaknesses in Hong Kong's CG system primarily revolve around: the articulation of regulatory responsibilities, particularly between the SFC and the HKEX/SEHK; the role of the board and the quality of disclosure and transparency; and the ability of shareholders to seek redress in respect of an issuer and its directors that fail to meet expected standards. However, factors that influence a CG system are rarely mutually exclusive. For example, the ability of a shareholder to exercise or enforce their rights may depend on what they know (information transparency), their ability to influence decisions (involvement/equality), and the means by which they can hold management responsible (accountability), which together reflect the efficacy of a CG system (effectiveness).

¹ For a discussion, see Section 1.2

² Respectively, Cap. 571 and Cap. 622

³ The Stock Exchange of Hong Kong Limited

⁴ Securities and Futures Commission

⁵ Hong Kong Exchanges and Clearing Limited

For the purposes of this Report, the recommendations have been grouped together under three main divisions: the board and its processes and standards; the enforcement regime (including for both shareholders and regulators); and matters concerning CG system architecture and policy. A number of the recommendations made in each of these divisions intersect with the particular issues presented by non-Hong Kong incorporated companies.

Board processes

Mechanisms that protect shareholders from potential abuses of the board must be improved. This includes important functions expected to be undertaken by the audit committee and independent directors, and CG-related transparency generally. Each jurisdiction studied is dealing with similar types of issues related to the role of board sub-committees and independent directors, board evaluation and refreshment, and executive remuneration. The experience in each jurisdiction is markedly different, with some reforms having a positive effect, others not. In some instances, the market response to reform can be to game it to bring about an alternative outcome from the one intended by regulators, thus producing unexpected consequences – this has been the case in the United States as a result of shareholder activism and incentive-based remuneration for executive directors. Nevertheless, Hong Kong can do more to keep up with best practices internationally.

This Report makes ten recommendations concerning board processes.

Enforcement (shareholders)

While the study indicated that shareholder rights are, as regards strict legal rights, well established in Hong Kong law, it is subject to three important caveats. The first is the ability of a shareholder to acquire information relevant to the identification of the infringement of a right. The second is the ability of the shareholder to pursue that right in practice. The third is in relation to what matters should a shareholder have rights of redress.

These three caveats reveal the areas where Hong Kong is most clearly in need of meaningful reform. While shareholders have been provided with rights under the law, such as derivative actions and civil suits in respect of certain types of information, claims are rarely brought. Unlike some other markets, shareholders have no rights in relation to breaches of listing rule disclosure requirements, despite having (together with regulators) an expectation that directors and issuers will comply with them. While many CG failings currently do not amount to legal causes of action, shareholders cum investors do consider the CG practices of an issuer in the total mix of information available to them, so one would expect this to have some relevance to establishing the scope of their rights and protections.

This Report makes two recommendations concerning shareholders rights.

Enforcement (regulatory agencies)

The position of shareholders is considerably exacerbated by the existence of an enforcement lacuna between the powers of the two regulatory agencies, the SFC and the SEHK. Hong Kong has clearly fallen behind international best practices in this regard as the powers of regulatory agencies are either too weak and ineffective, or too strong and insufficiently graduated in relation to a wrongdoing that does not warrant (or may not give rise to) court action.

This represents a serious shortcoming in regulatory efficiency as compared to all the other markets studied. It leaves many important CG standards set by the listing rules

subject to ineffective enforcement. A number of the recommendations made in this Report are directed to improving regulatory efficiency by enabling earlier behaviour correction via more effective means of consequence management to improve regulatory efficiency but without invoking changes to the fundamental dual responsibilities model of regulatory oversight. For example, it is suggested that various disclosures made by issuers and their directors should be made on forms that bring the disclosure under the potential liability of section 384(3) of the SFO - this section is not fixed to any particular disclosure but is designed to be used by regulatory agencies to safeguard the undertaking of their statutory functions from being supplied with false or misleading information.

This Report makes ten recommendations concerning the enforcement powers of regulatory agencies.

Non-Hong Kong incorporated companies

Despite concerns as to the ability to set and enforce CG standards against non-locally incorporated companies, the system in Hong Kong works reasonably well when compared to other jurisdictions – cross-border enforcement issues and potential conflicts of law is not unique to Hong Kong. However, the preponderance of Mainland enterprises listed in Hong Kong lends a different emphasis to the problem as compared to the other markets studied and establishing more effective means of enforcement against these companies has become essential.

Improving *ex ante* mechanisms of enforcement that provide for more effective early-warning identification and correction mechanisms can work well in this regard. Several of the enforcement recommendations made in this Report would subject non-locally incorporated companies to a more effective system of domestic enforcement, the cross-border problem notwithstanding. The recommendations also propose *ex ante* mechanisms that place greater emphasis on the gateway mechanisms in place for entry to the market.

This Report makes nine recommendations that assist with *ex ante* enforcement concerns in respect of non-Hong Kong incorporated companies. A number of the other recommendations made herein would also serve to improve the overall CG standards of non-Hong Kong incorporated issuers just as they would local issuers.

The Report also makes one additional recommendation that is specific to Mainland enterprises, namely, to consider the possibility of exploring with the Mainland a new cross-border enforcement arrangement specifically tailored to the public capital market. Hong Kong is uniquely positioned to develop this type of solution, which would address some of the drawbacks associated with MoUs, and could give the Hong Kong market a competitive advantage to attract quality listings.

Architecture and policy

The way in which policy is developed in each of the jurisdictions is significantly different. This arises not only out of the political, legal and regulatory architecture of each jurisdiction but also out of fundamental concepts about the nature of the corporate and the circumstances when it is appropriate for public interests to override private rights.

Some of the shortcomings in Hong Kong's CG system identified by this Report arise out of the dual responsibilities model of regulatory oversight of the listed market undertaken by the SFC and HKEX. However, the problems are not exclusive to the model and none of the recommendations made in this Report require a fundamental change to the model. The efficient functioning of the model requires an appropriate balance between market self-discipline and regulatory oversight for it to remain fit for purpose and some

developments of the model are proposed that serve to improve balance. For example, a number of recommendations would create more efficient enforcement powers, including those of the SFC, that are nevertheless consistent with the dual responsibilities model.

The Report observes differences in the way policy is developed and enforced, and notes that the development of the Hong Kong market has in some ways outpaced policies on market development.

This Report makes six recommendations concerning architecture and policy.

Conclusions and way forward

The analysis and recommendations presented in this Report are intended to be helpful and thought provoking for the Government, policymakers, regulators, market participants and investors. The scope of this study, being shareholder rights, remedies and protections, is essentially focused on the relationship between the owners and managers of a company and how effectively the CG system provides for, *inter alia*, transparency, equality and accountability. Accordingly, this Report has not sought to explore a number of areas of CG that nevertheless are of interest, such as board diversity, environmental and social governance, and various aspects of internal governance processes by which the board directs and controls the undertaking of the company's business.

A number of the recommendations made in this Report are relatively straightforward to implement, others require further work to be undertaken as to their more specific details and potential ramifications. A few specifically contemplate a further consultation or enquiry process. To a greater or lesser extent, all the recommendations will be subjected to the test and reaction of the market.

The stated objective of this Report is to make recommendations for improving Hong Kong's CG system so that it better serves the needs of the market and improves its long-term competitiveness. However, an important interim purpose is to generate discussion that will lead to an enhanced recognition and understanding of areas that are in need of reform when Hong Kong is examined against best-practices internationally.

A note on funding: This project was entirely funded by the Hong Kong Institute of Certified Public Accountants (HKICPA), which also established the general scope of the study, as part of its efforts to promote better CG in Hong Kong and to enable the HKICPA and its members to consider how Hong Kong's CG should develop in the future. The mandate given to the authors of this Report was to conduct an independent enquiry and accordingly this study was not constrained by any preset views, preferences or desired outcomes, nor did it include any requirement to have regard to the interests of the HKICPA or its members. The HKICPA's Corporate Governance Working Group monitored progress. While there was a diversity of opinion on various recommendations made herein, the final decision on all aspects of the Report, including the contents of, and whether or not to make, each recommendation rested solely with the authors of this Report.

II	SUMMARY OF RECOMMENDATIONS
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Classification

A total of 28 recommendations have been made. Twenty-two propose changes that can be made by regulatory agencies, two require a change to legislation, and another four may require legislative change subject to the outcome of a further consultative process.

Ten recommendations propose improvements to board processes that will foster transparency and accountability, including in relation to the role of the audit committee and independent directors.

Twelve recommendations address the ability of shareholders and regulators to conduct meaningful, and graded, enforcement where an issuer's practices fall below required CG standards.

Nine recommendations assist with *ex ante* enforcement concerns against non-Hong Kong incorporated companies.

Six recommendations address regulatory architecture and policy development that would work to better serve the interests of shareholders and the market.

Recommendations in this Report vary according to: whether or not they involve a change in legislation or may subsequently require such a change; the strength of evidence that supports it; and whether it is likely to be contentious to the industry.

Based on these variables, each recommendation has been assigned one of the following classifications:

Compelling (C) – Advocate (A) – Support (S) – Explore (E).

These are not "levels" *per se*, meaning that each may be worth developing or implementing for different reasons. Twenty recommendations fall into the "C" and "A" classification, with two and six falling into the "S" and "E" classifications, respectively.

Each recommendation is also denoted as follows:

- * legislative change might be required depending on a subsequent enquiry;
- ** legislative change required;
- + assists in relation to non-Hong Kong incorporated issuers.

The recommendations made by this Report are summarized in the following sections. The references at the right side of each topic identify the recommendation number together with its classification as per above. A summary of all recommendations is provided in the Table at the end of this section.

Section 4 of the Report provides the detail of each recommendation together with a cross reference to the supporting analysis in Section 3 of the Report.

Recommendations that do not require any change to the law

The changes can be made by the HKEX and the SFC working together or by the SFC alone.

The board

Hong Kong's CG standards imposed by non-statutory regulations on the board are broadly in line with international best practices. However, board directors remain insufficiently accountable to shareholders in terms of performance evaluation and executive remuneration. The audit committee's ability to reach its full potential is handicapped because of the limited delegated power they are typically provided by the board. The expected role of non-executive directors (NEDs) that are not independent is not always clear. While the requirement for independent non-executive directors (INEDs) has been introduced as a check on executive power, the existing framework does not sufficiently support and foster the functionality of the intended role.

- *Recommendations that improve the transparency and accountability of the board:*

Topic	Proposed	Ref.
Board evaluation	Require the board, on a comply or explain basis, to undertake an annual self-evaluation based on a disclosed evaluation policy that covers specified matters including high-level terms of reference and the involvement of INEDs or external advisers. The board to report annually on how it has complied with the provision and specified matters including, for example, how the evaluation was undertaken and whether any recommendations are made. This builds on developments in the UK, Mainland China and Singapore. <i>Step required: Amend CG Code (Appendix 14 listing rules).</i>	C4.1.1
Executive remuneration	Require disclosure of the considerations taken into account by the remuneration committee in relation to any performance-linked remuneration. This builds on developments in the UK and the United States. <i>Step required: Amend CG Code (Appendix 14 listing rules).</i>	A4.1.2
Audit committee	Require the audit committee to itself make a disclosure in the annual report including as to its role in relation to the external audit process and the work it has undertaken to discharge its responsibilities. The independence and accountability of the audit committee can be improved through increased visibility. This builds on developments in the UK and the United States.	A4.1.3 ⁺
	Require the board, on a comply or explain basis, to delegate all powers in relation to the appointment, compensation, and oversight of the external auditor to the audit committee. This builds on developments in the United States. <i>Step required: Amend the listing rules & CG Code (Appendix 14 listing rules).</i>	A4.1.4
Non-executive &	Require issuers to develop and disclose, on a comply or explain basis, a code for NEDs (NED Code) that specifies its policies,	A4.2.1 A4.2.2

independent directors	practices and expectations in respect of INEDs and other NEDs that is designed to facilitate the effectiveness of NED roles. The CG Code to provide a Model NED Code that an issuer may choose to comply with or alternatively establish their own NED Code via policies that address the NED’s expected involvement, sufficiency of a NED’s time, basis of remuneration, and knowledge of the business and training, etc. The Code based approach provides a clearer forum for establishing the expectations placed on INEDs and other NEDs. In addition, INEDs are to be required to report annually on their activities and the effectiveness of the NED Code. This builds on requirements in the United States, Mainland China, Singapore and the UK.	A4.2.3 C4.2.4
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Step required: Amend CG Code (Appendix 14 listing rules).

Enforcement

The extent to which the enforcement regime in Hong Kong has fallen behind international practices is significant. Shareholders in issuers listed in Hong Kong are in various ways worse off when compared to their counterparts in other major markets.

It is widely recognized that disclosures made under the listing rules form part of the total mix of information used for exercising voting rights and making investment decisions. Shareholders have a reasonable expectation that issuers should comply with the listing rules. Despite the foregoing, shareholders have no rights where the company and its directors have breached the listing rules, unless it also amounts to a breach of law.

The position of shareholders is made worse by the absence of a world-class regulator-based enforcement regime, a shortcoming that arises out of a significant enforcement lacuna between the disciplinary sanctions imposed by The Stock Exchange of Hong Kong Limited (SEHK) and the powers available to the SFC. This enforcement lacuna is not a product of regulatory architecture *per se*. Regulatory agencies can make better use of extant powers or bring other administrative powers to bear on CG sensitive topics. For example, section 384(3) of the SFO is a provision designed by the legislature to be used by regulatory agencies to safeguard the performance of their statutory functions from being supplied with false or misleading information, but the section has not been extensively utilised.

While much has been written on the HKEX’s potential conflict of interest, there is very little discussion on the other considerations the SFC must take into account when deciding whether to bring an action that would benefit shareholders.

- *Recommendations that improve the ability of shareholders to seek redress against wrongdoing issuers and directors:*

Topic	Proposed	Ref.
Listing rules	Give shareholders rights to enforce any disclosure breach of the listing rules by making them third party beneficiaries of the contract between the issuer and the SEHK. This builds on experiences in the United States and the ability of shareholders in the UK and Singapore to bring actions.	S4.4.1

Step required: Amend the listing rules.

Note: See also recommendation A4.4.2* regarding collective redress.

- *Recommendations that improve the transparency and accountability of an issuer's CG-related disclosures and assist to close out the SEHK-SFC enforcement lacuna:*

Topic	Proposed	Ref.
Listing rule disclosures	<p>Four types of CG-related disclosures to be required to be made on a form that brings the disclosure within section 384(3) of the SFO under which providing false or misleading information to a regulator is an offence: (1) existing required disclosures concerning financial disclosure, notifiable and connected transactions, and those made pursuant to the CG Code; (2) breaches of the listing rules are to be disclosed on an ongoing basis; (3) an annual certification of compliance with the listing rules will be required; and (4) facts pertaining to independence disclosed to the SEHK by a proposed INED. This reflects standards already in place in the United States, the UK, Singapore and Mainland China.</p> <p><i>Step required: Amend listing rules and CG Code (Appendix 14 listing rules).</i></p>	<p>A4.5.1⁺ C4.5.2⁺ C4.5.3⁺</p>
SEHK discipline	<p>The SEHK to make more effective use of its existing powers (1) to require issuers to "take, or refrain from taking, such other action as it thinks fit" and (2) to impose resumption conditions on suspended issuers. In both cases, issuers and/or directors can be required to take steps that address specific CG shortcomings.</p> <p><i>Step required: Better utilization of an existing power.</i></p>	C4.6.1
SMLR ⁶ conditions	<p>The SFC to use its power to impose conditions on listing applicants or issuers that would work to address the underlying CG shortcomings or failures that gave rise to the problem, and that may serve to catalyze change.</p> <p><i>Step required: Better utilization of an existing power.</i></p>	A4.6.2 ⁺

- *Recommendations that improve CG standards from the outset of an issuer's listing on an ex ante basis (gate keeping):*

Topic	Proposed	Ref.
Listing applicant standards	<p>Require a listing applicant to make a statement in the listing document cum prospectus explaining its current CG practices and how these will be developed in the period to its next annual report in view of the standards imposed and expected under the listing rules and the CG Code. Require the sponsor's declaration to encompass the foregoing. This builds on the requirements in the United States.</p> <p><i>Step required: Amend the listing rules.</i></p>	C4.7.1 ⁺

⁶ Securities and Futures (Stock Market Listing) Rules (Cap. 571V)

Compliance adviser	Upgrade the compliance adviser role to make it more active, engaged and responsible. A sponsor to the listing application should undertake the role. Prior to termination, a declaration to be made by the compliance adviser as to the completion of its role on a form subject to section 384(3) of the SFO. This builds on the requirements in Mainland China.	E4.7.2 ⁺
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Step required: Amend the listing rules.

CG standards generally

Apart from standard setting and enforcement, good CG standards require promotion, as do departures from them. The largest issuers in the UK are subject to higher standards, and this forms a positive association between expectations of good CG and successful companies. Many issuers on the Hang Seng Index already adhere to higher standards and this should receive more visible endorsement.

- *Recommendations that promote CG standards generally:*

Topic	Proposed	Ref.
Elevated standards	Impose higher standards on designated issuers such as HSI or HSCEI constituent stocks. Selected recommended best practices become comply or explain provisions, and selected recommended disclosures become required disclosures for those issuers as "Elevated Standards". Consideration to be given to incorporating specified comply or explain provisions as mandatory requirements in the Elevated Standards. This builds on experiences in the UK. <i>Step required: Amend CG Code (Appendix 14 listing rules) and/or listing rules.</i>	C4.3.1
Departure from adopted practices	Issuers may adopt CG practices that are not mandated by the listing rules and although variations from those practices may not amount to a breach of the listing rules, they are nevertheless relevant to an investors' legitimate interest in the CG practices of an issuer. Accordingly, the changes should be disclosed if not merely temporary. (Note this is distinct from recommendations A4.5.1 ⁺ and C4.5.2 ⁺ .) <i>Step required: Amend the listing rules.</i>	S4.3.2

Policy development

Hong Kong needs to do better when compared with its international peers as regards developing CG policy that takes into account shareholder interests. Hong Kong lacks an unconflicted agency that is charged with this responsibility. Transparency of listing rule development as regards the matters considered by the SEHK and SFC is also lacking, and this is something likely to become of greater importance as courts or tribunals may be increasingly faced with the challenge of interpreting listing rules.

▪ *Recommendations that improve policy development:*

Topic	Proposed	Ref.
CG Unit & CG Group	<p>Establish a CG Unit within a regulatory agency charged with CG policy development. It should be advised by an external market-based CG Group. If the proposal to establish an investor protection agency is adopted (see E4.8.2** below), it should be located within that agency. This is based on developments in the United States, and experiences in Hong Kong in relation to other regulatory concerns.</p> <p><i>Step required: Identify agency to establish.</i></p>	E4.8.1
Listing rule development	<p>The SEHK and SFC should provide <i>ex post</i> transparency to the explanations of purpose and likely effect required by the SFO to support listing rule development.</p> <p><i>Step required: Adoption of relevant policy on transparency.</i></p>	A4.9.1
Market development	<p>Undertake a clearer and more specific examination of what overarching objectives should drive the development of the Hong Kong market and the alternative mechanisms for shareholder protection that may need to develop in tandem with change, which may or may not require modification of the one-share-one-vote principle.</p> <p><i>Step required: Undertake policy-led initiative.</i></p>	E4.9.3
Agency response time	<p>Regulatory and government agencies undertaking consultations should voluntarily adopt a performance standard on response times.</p> <p><i>Step required: Adoption of relevant policy on performance.</i></p>	A4.9.4

Recommendations that require a change in the law

The changes can only be made by or with the approval of the Legislative Council, and so require sufficient political support from that body.

As noted above, the major shortcoming of Hong Kong's CG system is the enforcement lacuna. While the dual responsibilities model gives rise to some problems as discussed in this Report, they are not exclusive to that model. Rule making and rule-enforcement are separate matters that can be developed differently while also keeping within the dual responsibilities model. Given the SFC's ultimate powers⁷ under the model, its enforcement powers can be developed within the scope of the model. Other mechanisms of enforcement can also be developed outside the model, and this would include some of the enforcement developments suggested above that do not require any change to legislation.

⁷ I.e. its powers under the SFO and the SMLR

▪ *Recommendations that improve enforcement:*

Topic	Proposed	Ref.
SMLR powers	Calibrate SFC's powers to provide for a fine together with the imposition of conditions that works as a warning-cum-precursor to suspension that is premised on the same grounds as its existing SMLR powers. This can work as a win-win-win for the issuer, its shareholders and the market. The power is exercisable by the SFC directly as a specified decision subject to appeal to the Securities and Futures Appeals Tribunal, subject to prior consultation with the Listing Committee. This reflects powers already given to regulators in the UK, Singapore, Mainland China and, in certain regards, the United States. <i>Step required: Amend SMLR.</i>	A4.6.3**+
Investor protection agency	Establish a new, unconflicted regulatory agency empowered to bring an action for the benefit of shareholders. This is based on developments in the United States. <i>Step required: Amend the SFO or create new primary legislation.</i>	E4.8.2**

Recommendations subject to further enquiry

These are recommendations where any change is contingent on a further consultation or enquiry collecting more detailed evidence. Depending on the outcome, it may require changes that can only be made by the Legislative Council.

There remain a few significant issues Hong Kong's CG system must resolve but which cannot be described as a deficiency since experiences both internationally and locally remain mixed. First, the question of whether all or part of the listing rules should be given statutory backing remains under discussion but there has been little detailed exploration of the issue since 2013 when Hong Kong took a partial step in this direction with the implementation of Part XIVA of the SFO. Second, while the rights of shareholders under the law in relation to director misfeasance and mis-disclosure match or better international best practices, the difficulty of shareholders to act upon those rights is evidenced by the absence of legal actions that are taken and suggests more needs to be done to meaningfully give effect to shareholders' legal rights. Third, Hong Kong's piecemeal approach to whistle-blowing has clearly fallen behind international practices that give legal protections to whistle-blowers, and so represents the absence of a mechanism that might promote the discovery of wrongdoing. Each of these involve significant and far reaching issues on which more evidence would need to be collected for further evaluation.

▪ *Recommendations that require further detailed study:*

Topic	Proposed	Ref.
Statutory backing to listing rules	Re-examine, in view of today's circumstances, the discussion on giving statutory backing to specific provisions of the listing rules - Chapters 4 (periodic financial reporting), 14 (notifiable transactions) and 14A (connected transactions). Undertake a	A4.6.4*

detailed assessment of past problems under these Chapters of the listing rules. This reflects developments in the UK and Singapore.

Step required: Undertake a public enquiry/consultation.

Cross-border enforcement	To consider the feasibility of expanding the existing cross-border enforcement arrangements to create an arrangement with Mainland China specifically tailored to the public capital market within an agreed scope of non-criminal disclosure obligations.	E4.6.5* ⁺
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Step required: HKSAR Government to consider exploring the issue with the Government of China.

Statutory rights	Re-visit, and develop, the Law Commission's 2012 proposal on the implementation of class action rights to widen its approach to collective redress. This builds on a process previously commenced in Hong Kong without conclusion, developments in the UK and Mainland China, and the position in the United States.	A4.4.2*
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Step required: Undertake a public enquiry/consultation.

Whistle-blowing	Commence an enquiry on whether to implement whistle-blowing laws, and whether this should be limited to specific circumstances such as corporate misfeasance. This builds on experiences in the UK, United States and Mainland China.	E4.9.2* ⁺
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Step required: Undertake a public enquiry/consultation.

Summary Table of all recommendations

	Board processes	Enforcement	Architecture & policy			
Compelling	C4.1.1	Board evaluation				
	C4.2.4	NED Code and INED reporting				
	C4.3.1	Relevant issuers to be subject to "Elevated Standards"				
	C4.5.2 ⁺		Status of listing rule compliance and related disclosures (continuing)			
	C4.5.3 ⁺		Facts regarding director independence			
	C4.6.1		SEHK to develop use of existing disciplinary power			
	C4.7.1 ⁺		Disclosure of CG standards in listing document			
Advocate	A4.1.2	Transparency of performance related executive remuneration				
	A4.1.3 ⁺	Disclosures of the audit committee				
	A4.1.4	Status of the audit committee				
	A4.2.1	Sufficient INED time				
	A4.2.2	Basis of INED remuneration				
	A4.2.3	INED training				
	A4.4.2*		Collective redress			
	A4.6.3** ⁺		Calibrate SFC's powers under the SMLR			
	A4.5.1 ⁺		Legal status of CG-related disclosures			
	A4.6.2 ⁺		SFC to develop use of conditions when exercising existing SMLR powers			
	A4.6.4*		Statutory backing of certain Listing Rules			
A4.9.1			Transparency of listing rule development			
A4.9.4			Response time to public enquiries/consultations			
Support	S4.3.2	Disclosure of non-compliance with issuer's disclosed CG practices				
	S4.4.1		Shareholders as beneficiaries of listing rules			
Explore	E4.6.5* ⁺		Explore a narrow-channel cross-border enforcement arrangement			
	E4.7.2 ⁺		Develop role of compliance adviser			
	E4.8.1			Establish a CG Unit and CG Group		
	E4.8.2**			Establish an investor protection agency		
	E4.9.2* ⁺			Whistle-blowing		
	E4.9.3			Market development		
			Compelling	Advocate	Support	Explore
Board	3	6	1	-		
Enforcement	4	5	1	2		
Arch. and policy	-	2	-	4		

III	APPROACH TO THE STUDY
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The topic of CG and its improvement

When the topic of CG is raised in any discussion it is readily apparent that the potential breadth of the topic is only matched by the profusion of applied, conceptual and value-laden variations in what the term “corporate governance” means and implies to different people. It attracts a diverse range of reactions, opinions, beliefs and approaches to it, ranging from the philosophical to the commercial, from the theoretical to the applied, as well as from almost doctrinal insistence to resistance and repudiation. And there are significantly different methodologies claiming to measure it.

The task of this study has to some extent been simplified by the central mandate on which it is based: to undertake a comparative study of shareholder rights, remedies and protections and board processes within the context of public listed companies.

The objective of this study, to derive recommendations that improve the CG system in Hong Kong, requires an interpretation of CG and what constitutes “good CG”. As explained in **Section 2** of this Report, “good CG” is assumed to underpin shareholder rights, remedies and protections, as well as an appropriate level of oversight of the management by the owners of a company. It is further assumed to be desirable as a means of fostering market integrity and market confidence. This requires mechanisms that bring non-locally incorporated companies within a local CG framework supporting good CG in those issuers. Moreover, the viewpoint of a minority shareholder is adopted (as opposed to, for example, board members or other stakeholders in a company's operations). For the purposes of organizing material generated by the study the “good CG” concept is understood as being dependent on five key variables:

Information – Involvement – Equality – Accountability – Effectiveness.

The specific focus on shareholder rights, remedies and protections means that other matters sometimes invoked in the CG debate receive little or no attention herein, including gender and racial diversity, corporate social responsibility, and the relationship between CG and share price performance.

This Report has sought to make recommendations that work to improve regulatory efficiency, and has leaned toward proposals that are balanced, practical and implementable. Accordingly, any temptation to make large-scale headline-grabbing recommendations has been resisted. Recommendations that require fundamental changes to the law or regulatory architecture are resource consuming (time, people and money), and often have an uncertain outcome given the difficulty of getting all stakeholders on board. Wherever possible, this Report has sought to work within the existing regulatory architecture. Larger scale changes have formed part of the recommendations only where this appeared to be necessary or desirable. The Report also recognizes an “acupuncture” value in some improvements that may seem relatively minor but have the capacity of stimulating further development and changed behaviour in due course.

Recommendations have also been considered in view of their overall effectiveness. This is partly determined by the structure of a CG system, and significantly influenced by the degree of mismatch between the different priorities of relevant actors. Right-minded CG principles do need to confront the realities of the market, as they may lead to

unexpected outcomes or box-tick approaches to compliance that does not serve the underlying objectives. Where that happens, a CG rule or principle can become a false validator of the behaviour actually undertaken. It may also operate as a distraction from moving forward on other, more effective, means of achieving the relevant objective.

Promoting change in markets that have a significant element of self-regulation, like Hong Kong, also presents the hurdle that change may be rejected on the basis of short-term self-interest. It is not unusual for a proposal to be rebuffed by citing established corporate and cultural values, or claiming that issuers are not ready for it. In this context, regulatory dicta are unlikely to lead to development. On the other hand, readiness is frequently precipitated by regulatory changes, rather than the other way around. So an important consideration is how to resolve this apparent contradiction. The “acupuncture” approach may be of some value in this context.

While an important orientation of this Report is to identify and explore CG topics that have attracted debate in global CG communities, whether by regulatory agencies or other stakeholders, the Report is not limited to these topics. It can be read as an exploration of ideas intended to create discussion around them. Many of the recommendations represent ideas that will require further consideration as to their detail, and possibly additional investigation. Some may stimulate new ways of thinking about old problems. Some may survive the test of scrutiny and be implemented.

Organization of this Report

This Report comprises five main sections and five Appendices.

Section 1 explains the scope and purposes of this Report as well as its limitations. It sets the Report in the context of developments in Hong Kong over the past two to three decades, as well as the global developments that have had an impact on the development process in Hong Kong.

Section 2 discusses the initial methodological questions that needed to be addressed from the outset of the study.

Section 3 comprises the substantive analysis of this Report. It commences by identifying the thematic topics and trends in regulating CG as well as important overarching considerations including the role of culture, the methodology of assessing CG, the costs and benefits of CG, competitiveness, and what is meant by “effectiveness”. This leads to the analysis of Hong Kong’s CG system in the context of the other jurisdictions studied. The Report considers each jurisdiction’s legal and regulatory system and, where relevant, the other characteristics of its market including political, historical, cultural and social factors. Where relevant, previous proposals to reform the CG system are reviewed. Based on the analysis of the data, Section 3 identifies recommendations for changes in Hong Kong’s CG system. As Section 3 is essential to understanding the considerations giving rise to the recommendations, an abridged text of the analysis is presented in Part IV of this Executive Summary.

Section 4 presents the recommendations of this Report. Each recommendation provides a cross-reference to the relevant analysis in Section 3 from which it has been derived. Recommendations have been developed according to a number of factors: the level of complexity involved to implement it, the support for it, and whether it is likely to be contentious to the industry. This gives rise to a classification that serves as a general indicator of overall support/difficulty for each recommendation: Compelling – Advocate – Support – Explore. These are not “levels” *per se*, meaning that each may be worth developing or implementing for different reasons.

Section 5 concludes.

Reference material concerning the jurisdictions considered is set out in Appendices I to V to this Report. Each Appendix provides a description of the essential structure and characteristics of the CG system in the relevant jurisdiction together with recent developments of interest to this study. This covers the operation of key regulatory agencies, policy development, enforcement mechanisms, the legal and regulatory framework, shareholder rights and protections, and the regulation of non-locally incorporated companies.

IV	ABRIDGED TEXT OF THE ANALYSIS
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This abridgement is provided as a means of enabling a faster and less detailed reading of the main Section 3 "Discussion and analysis of jurisdictions studied" of this Report and the recommendations that it gives rise to, as detailed in Section 4 "Recommendations". As such, this abridgement does not comprise a sufficient analysis to support the recommendations but it does enable the reader to understand the driving forces behind the recommendations. This section assumes a reader with a moderate degree of knowledge of the Hong Kong corporate governance (CG) context. To aid readability, case law descriptions, abbreviated terms, detailed cross-referencing and footnotes found in Section 3 have not been repeated here, and the reader is invited to refer to Section 3 and the "Abbreviations" section at the end of the Report for the relevant details.

Introduction to the analysis in Section 3

Parts I to III of the Executive Summary have outlined the scope and purpose of this Report (discussed in Section 1 of the Report), the methodology and limitations of the study (discussed in Section 2 of the Report), and the recommendations that have been made (presented in Section 4 of the Report).

Section 3 of the Report, which is the subject of this abridgement, comprises a focused and selective discussion that provides a segue between the detail of each jurisdiction described in Appendices I to V and the recommendations made in Section 4. It commences, in Section 3.1, with a discussion of common themes, trends, issues and considerations that weigh on the assessment and development of any recommendation considered or proposed. The bulk of Section 3 (Sections 3.2 to 3.7) contains the comparative analyses that lead to the recommendations in Section 4.

Overarching considerations (Section 3.1)

Thematic topics and trends in regulating CG standards (Sections 3.1.1 and 3.1.2)

Despite the variation across the different jurisdictions' legal and regulatory architecture, and basic concepts about the nature of the corporation and the relative role of managers and owners in relation to it, a number of common topics were identified from the key differences and observations of interest, a subset of which have led to recommendations.

The extent of involvement of regulatory agencies in a CG system is an issue in all jurisdictions to some extent. The mechanisms of enforcement that are effective in deterring undesirable behaviour and procuring desired behaviour have very much been in issue over the past two decades, particularly since the statutory codification of listing rules undertaken in the United Kingdom (UK) and Singapore, and following the 2008 global financial crisis. This also encompasses the question of what persons should be able to bring enforcement actions, be it shareholders seeking remedies, regulatory agencies imposing administrative fines or other forms of sanction, or issuers themselves imposing controls on directors. An interesting theme has been the different approaches the jurisdictions take toward *ex ante* and *ex post* forms of redress.

The role of the board and the execution of its responsibilities has also been a common theme, particularly as regards the role of sub-committees intended to undertake specialized tasks and the role of independent directors. Particular foci include the audit process, executive remuneration, and shareholder involvement in the appointment or

reappointment of directors. Looked as a whole, there is a push in most jurisdictions to open up the black box of board processes to greater scrutiny, through disclosure and accountability mechanisms that empower the shareholder vote. While these are common issues, each jurisdiction has tackled the problem slightly differently.

The developments in the CG system across the jurisdictions are typically driven, and constrained, by the approach to evolving the regulatory design of its securities industry, as well as its legal and regulatory infrastructure, and political, conceptual and cultural factors. This encompasses sectoral, twin peaks and super-regulator models that place regulators and Exchanges in different roles in relation to each other. These differences are important to recognize for the purposes of the present study – what works, or fails, in one jurisdiction might fail, or work, in another. For example, attitudes in the UK toward the proper scope of CG are relatively well aligned among stakeholders as compared to the United States where there is significantly less alignment. Together, these differences have a significant influence on the extent to which CG-relevant behaviour is driven by the perceived risk of legal, regulatory or reputational liability.

The role of culture (**Section 3.1.3**)

Culture is also an emerging topic of interest that has gained considerable attention since the 2008 global financial crisis. Culture can be a highly relevant factor that influences whether compliance with a CG requirement is undertaken on the basis of seeking to achieve the underlying objective of a regulatory requirement, or on the basis of a “box-tick” approach. The latter approach is often synonymous with the validation of an act and a corresponding perceived diminution of culpability. However, there is little consistency or clarity across the jurisdictions as to what culture means or how to influence it. Culture is instead often used as a residual explanation when other modes of explanation are insufficient.

The methodology of assessment (**Section 3.1.4**)

One can also find various forms of assessing or measuring CG standards in each jurisdiction. This Report identifies two different approaches to assessment – a “Framework Approach” based on the percentage of CG rules technically complied with, and an “Empirical Approach” based on canvassing the views of stakeholders. Each comes with various methodological issues - for example, a simple binary measure of whether or not a particular requirement (such as might appear in a CG Code) is met is oblivious to the difference between box-ticking and objective-fulfillment. It is important to appreciate the information provided by, and the limitations of, each of these different approaches to measurement because they are frequently used to inform the policy-making process as regards developing CG standards. They are also used by different interest groups to justify, or resist, changes to a CG system.

Cost-benefit considerations, maintaining competitiveness, and effectiveness (**Sections 3.1.5 to 3.1.7**)

Whatever ideas might emerge from the systems studied, they must be considered in view of their overall effectiveness. Does a proposed change work to close out the potential disjunct between a right-minded principle, the practice that in fact subsequently evolves in response, and the outcome that eventuates? If it does not, a CG rule or principle can become a false validator of the behaviour actually undertaken. It may also operate as a distraction from the objective sought to be achieved. It is important to ask what is the overall cost to a CG system in light of the benefits a proposal is expected to deliver. The actual regulatory costs of different CG systems (however hard to estimate) do impact on regulatory efficiency and the overall success of a market. While the availability of effective mechanisms of enforcement is a recognized issue in all jurisdictions, enforcement costs vary significantly, including the different

costs associated with *ex ante* and *ex post* approaches. Thus, the mere addition of more rules that may give rise to more enforcement actions do not, without clear justification, necessarily represent taking a step forward when compared with other solutions. Maintaining competitiveness in the international context must also be considered. Together, these factors require a more fundamental recognition that CG is ultimately part of a wider market system that a CG system must serve.

Non-locally incorporated companies (Section 3.2)

Application of local laws and regulations, and cross-border enforcement and cooperation (Sections 3.2.1 and 3.2.2)

Section 3.2 considers the question of how to regulate non-locally incorporated companies listed in Hong Kong. Most listed issuers fall into this category. There are two major challenges with the regulation of these companies: setting the appropriate CG standards for these companies in view of the conditions imposed in the jurisdiction of their incorporation, and the enforcement of standards imposed in Hong Kong against the companies and their directors and senior management.

While many requirements may be imposed on a non-locally incorporated issuer, the ability to supervise it and collect evidence will affect the discovery of a breach. The nature of the breach, whether it is breaching a law or a non-statutory code, will be relevant to the available mechanisms of enforcement including, where investors have suffered loss, the possibility for compensation. While the breach of a law in one jurisdiction is generally enforceable in another, this is not the case with non-statutory codes such as the listing rules. Even within the scope of legal breaches, cross-border enforcement may not be possible if a local law provision encroaches on a provision of the foreign law. Mainland China does not have foreign companies listed on its stock exchanges, so does not have to deal with these problems.

Listing rules are often used as a means of closing the gap between the CG standards imposed by the law on companies (and its directors) incorporated in different jurisdictions. Hong Kong and the UK both use listing rules to narrow the gap between the disclosures required to be made by domestically incorporated companies that are subject to local legislative requirements and foreign companies that are not. However, because the listing rules in the UK have statutory backing whereas they do not in Hong Kong, there is a difference in the legal effect where the listing rule provision is breached. For example, a breach of provisions in Hong Kong's listing rules that seek to level the playing field as regards directors' duties and annual reporting requirements has no direct legal consequences *per se* beyond the scope of the listing rules. In contrast, the statutory backing given to the listing rules in the UK and Singapore change the direct consequences of a breach – regulators possess the power to impose fines, and shareholders who suffer loss have a basis for a damages claim where there has been a disclosure breach. Listing rules that have statutory backing thus also serve to close the enforcement gap between laws and what were previously non-statutory codes.

A different approach is taken in the United States where listed issuers are required to make disclosures on Forms that bring the disclosures within the jurisdiction of Federal securities law – while a particular breach of an Exchange requirement is similar to Hong Kong in that it has no direct legal consequences *per se*, a breach of Federal securities law, including mis-disclosure on a Federal Form, is a serious matter giving rise to legal liability.

Another type of approach to the problems presented by non-locally incorporated companies is to require the company to amend its articles/bye-laws on issues of sufficient importance. This approach is taken in Hong Kong where the law of the home jurisdiction of the listing applicant does not provide standards of shareholder protection

at least equivalent to Hong Kong.

Regulatory agencies in each of the jurisdictions studied have entered into one or more MoU (memorandum of understanding) with relevant foreign agencies. However, MoUs are ultimately limited by its scope and the powers and constraints imposed on the regulatory agencies in each jurisdiction, and this has in practice proved to be limiting where cooperation on enforcement has been sought. Cooperation may therefore depend on *de facto* assistance as opposed to *de jure* actions, as illustrated in the *China Sky* case in Singapore.

The residual problem of cross-border enforcement and conflicts of law are not unique to the Hong Kong-Mainland relationship. Rather, the emphasis is different owing to the preponderance of Mainland enterprises listed in Hong Kong. The observations made on the potential problems presented by non-locally incorporated issuers are addressed through a number of the recommendations made in other sections of this Report. Listing rules that seek to subject non-locally incorporated issuers to local CG standards ultimately depend on the effectiveness of listing rule enforcement. This ties in with the discussion in **Sections 3.3.1 and 3.7.3**, which explores means of improving the enforcement of listing rules that would operate equally against both locally and non-locally incorporated issuers. Those sections give rise to several relevant recommendations in this regard. **Recommendation A4.5.1** "Legal status of CG-related disclosures" together with **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)" propose giving legal backing to CG disclosures by bringing them within the provisions of the Securities and Futures Ordinance (Cap. 571) (SFO) that deal with providing false or misleading information to regulatory agencies. **Recommendation A4.6.2** "SFC to develop use of conditions when exercising existing SMLR powers" and **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR" propose that the Securities and Futures Commission (SFC) use alternative powers that sit within the scope of its existing powers in respect of breaches of the listing rules, the relevant powers being derived from the Securities and Futures (Stock Market Listing) Rules (Cap. 571V) (SMLR).

As cross-border enforcement remains problematic, more effective gateway mechanisms that ensure or facilitate that only companies able to comply with CG standards are admitted to listing becomes a relatively more important component of improving Hong Kong's CG system. The discussion in **Section 3.7.8** explores those gateway mechanisms and makes two recommendations. **Recommendation C4.7.1** "Disclosure of CG standards in listing document" proposes that issuers be required to make a statement in the listing document that discusses its CG practices in view of the requirements under the HK CG Code. **Recommendation E4.7.2** "Develop role of compliance adviser" proposes expanding the role of the compliance adviser on the basis that establishing good CG practices from the outset of an issuer's entry to the public market creates better prospects for CG standards following the end of this initial period.

The position of Mainland enterprises that are either incorporated in the Mainland or in offshore jurisdictions requires separate attention due to the significance of their presence in the Hong Kong market both in terms of their relative number and contribution to total market capitalization and trading volume. Hong Kong and the United States have both experienced difficulties in procuring cross border enforcement in respect of Mainland enterprises – the assets of these enterprises may be primarily or solely located in the Mainland, and their directors may be Mainland citizens who have returned to the Mainland. For example, the United States has a number of Mainland enterprises that have "gone dark" and are effectively beyond the reach of effective cross border enforcement. In response, enforcement agencies have sought other means of solving the problem. This includes entering into MoUs, the limitations of which have already been noted, or case-specific solutions, such as the SFC has recently procured in relation to the suspended issuer Hanergy Thin Film Power. Unlike the other markets studied,

Hong Kong already has a reciprocal recognition and enforcement of judgments arrangement in place with Mainland China, however, it is very limited and does not cover the public securities market. Building on that arrangement, the proposal in **Recommendation E4.6.5** "Explore a narrow-channel cross-border enforcement arrangement" suggests taking advantage of Hong Kong's unique position to seek an enforcement arrangement specifically tailored to the public capital market. If able to be achieved, this would contribute to the efficiency of the Hong Kong market and could create a competitive advantage over the United States for quality issuers.

Information (Section 3.3)

Legal status of CG disclosures (Section 3.3.1)

Disclosures related to CG concerns are subject to different types of legal or regulatory liability in each of the jurisdictions studied. Because this impacts on the types of enforcement mechanisms that are available, it will have a general influence on market discipline and, consequently, the quality of information disclosures.

Both the UK and Singapore have moved to the model of giving statutory backing to disclosure requirements, albeit implemented slightly differently. In the UK, information transparency is achieved through a mix of the Companies Act 2006 (Cap. 46) (CA 2006), the Financial Conduct Authority's (FCA) statutorily backed listing rules that incorporate by reference the UK CG Code issued by the Financial Reporting Council (FRC), and the Disclosure Guidance and Transparency Rules (DTR). In Singapore, it is achieved through a mix of the Companies Act (Cap. 50) and the Securities and Futures Act (Cap. 289) (SFA) that create rights of enforcement in relation to breaches of the listing rules including by the Monetary Authority of Singapore (MAS), Singapore Exchange (SGX) and aggrieved investors.

In Mainland China, the China Securities Regulatory Commission (CSRC) can directly enforce the CG requirements in the Securities Law, the CG Code (which is mandatory), the listing rules and a large number of guidelines.

In contrast, the strongly disclosure based system of the United States does not give any legal effect to breaches of listing rules *per se*. However, many standards set by Exchanges on a mandatory or recommended practice basis dovetail with Federal requirements, and such disclosures are required to be made on a Federal form thus bringing disclosures within the Federal law system. This has a significant bearing on the overall quality of disclosures because a false disclosure may amount to a Federal offence. Merely breaching an Exchange requirement would in general be subject to more limited consequences.

In Hong Kong, standards of information transparency are set by both legislative and code based provisions. Part XIVA and sections 277 and 298 of the SFO provide for enforcement by the SFC (through the Market Misconduct Tribunal (MMT) or the criminal courts). Investors who have suffered damage may also bring a civil action under similar provisions. In addition, the SFC has "reserve powers" under the SMLR in relation to false disclosures to suspend or cancel a companies listing. While the foregoing are clear and mostly effective, they are mainly aligned to the preservation of market integrity and investor protection, as compared to many provisions of the listing rules, including the HK CG Code, that prescribe disclosures relating to specific CG concerns. While breaches of the listing rule's disclosure requirements are capable of invoking the foregoing laws, typically they do not.

The enforcement of CG-related disclosure requirements is weak in Hong Kong compared to all the other jurisdictions studied. One of the concerns surrounding CG-related disclosures is that they may represent a box-tick approach to compliance, as opposed to

meeting the objective of the relevant requirement. It is suggested that box-tick approaches to compliance are to a significant extent supported by an ineffective enforcement regime. Several parts of Section 3 address how to improve this situation. The discussion in **Section 3.3.1** leads to **Recommendation A4.5.1** "Legal status of CG-related disclosures", which proposes giving legal backing to specified CG disclosures by bringing them within the existing provisions of the SFO that deal with the provision of false or misleading information to regulatory agencies. This would cover disclosures made pursuant to MBLR Chapters 4 (periodic financial reporting), 14 (notifiable transactions) and 14A (connected transactions), and Appendix 14, each of which have previously been identified by The Stock Exchange of Hong Kong Limited (SEHK) as important parts of the listing rules intended to improve the CG of listed issuers.

Disclosure of listing rule compliance (Section 3.3.2)

Closely following on from the analysis in the previous section, it is a legitimate expectation of shareholders that a listed issuer will comply with the laws and regulations that apply to it – this is further backed by the undertaking directors must give to the SEHK to procure compliance with the listing rules. However, issuers listed in Hong Kong are not required to self-report breaches. This gives rise to anomalies as regards the perceived importance of CG disclosures given that other matters do need to be disclosed, some of which need to be disclosed on an ongoing basis (such as under Chapter 13 of the listing rules or, where there is no applicable safeharbour, under Part XIVA of the SFO). The recent *CITIC* case provides an illustration of one such anomaly (albeit the relevant events took place prior to the introduction of Part XIVA).

Issuers listed on the New York Stock Exchange (NYSE) or Nasdaq are required to report to the Exchange non-compliance with the Exchange's CG standards. Similar rules on disclosing compliance and explaining breaches of listing rules are found in Singapore. While the latter may be relevant to legal action under the SFA, this is not necessarily the case in the United States. Mainland China also imposes on issuers an obligation to report breaches.

The discussion gives rise to recommendations that foster the provision of timely advice to investors of non-compliance. **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)" proposes that breaches must be reported and that an annual certification of compliance is required. The annual certification could encompass assurance that the issuer's procedures, systems and controls are adequate to enable the board to comply with their obligations. This recommendation builds on the suggestion (in **Recommendation A4.5.1** "Legal status of CG-related disclosures") that any report or certification is to be given on a basis that brings it within the provisions of the SFO that deal with the provision of false or misleading information to regulatory agencies. Because issuers may adopt, disclose and subsequently depart from CG practices that are not mandated by the listing rules, **Recommendation S4.3.2** "Disclosure of non-compliance with issuer's disclosed CG practices" proposes that departures from disclosed practices are disclosed to shareholders. Subsequent sections build further recommendations designed to give stronger effect to the listing rules.

Board evaluation (Section 3.3.3)

The proper functioning of the board is a matter of considerable importance. Good CG requires a recognition that directors are appointed by shareholders and on that basis are or should be accountable to them. Board evaluation serves two similar but different purposes. It is a means of generating information for the board's own use in improving the way it works, particularly in view of the duties of directors. When information is disclosed about evaluation, this facilitates shareholders being given insight to the operations, and the effectiveness of the operations, of the board. While this can provide

assurance to shareholders that the board is applying an appropriate check and balance on its own operations, it also assists shareholders in exercising their rights, including in relation to voting on director appointments.

Views on whether board evaluation should be subject to regulatory requirements are mixed across the jurisdictions studied. CG codes in the UK, Mainland China and Singapore all require a formal self-evaluation on an annual basis with the main distinction being the basis of the evaluation and what details needs to be reported on. In the United States, board evaluation is not a feature of CG, which reflects the different nature of the CG system being essentially board-centric and subject to State laws that actively govern a board's fiduciary duties. However, there is commercial support in the United States for evaluation as being a factor in improving CG. In Hong Kong, board evaluation is merely a recommended best practice and is not commonly undertaken and reported on. Previous proposals to develop evaluation had been rejected on the basis that, *inter alia*, Hong Kong issuers are not ready for it. However, readiness is frequently precipitated by regulatory changes, rather than the other way around.

Analysis suggests that bringing evaluation within a stronger regulatory requirement is desirable. It should provide, in general terms, a reference to the values and priorities of the board in terms of its operational processes and how these evolve over time. This should encompass the role and effectiveness of independent non-executive directors (INEDs) in relation to board operations. **Recommendation C4.1.1** "Board evaluation" proposes raising the existing recommended best practice in the HK CG Code to a code provision that incorporates additional requirements including a reporting requirement in the Corporate Governance Report. It also proposes the introduction of a new recommended best practice, modeled on the approach taken in the UK, concerning how the evaluation exercise should be undertaken - however, while defining board performance is an important issue, unlike the evaluation provisions in the UK CG Code, it is not recommended that the factors a board should consider be prescribed by the regulators. This approach is intended to bring focus on disclosure while leaving the commercial aspects of the evaluation to the board.

Audit committee (Section 3.3.4)

The audit committee does, or at least should, play an important role in relation to the quality of financial disclosures. In the UK as in Hong Kong, the essential role of the audit committee is as a subcommittee of the board that reports to the board and possesses limited delegated powers. This is similar to the requirements in Mainland China and Singapore. There are two main consequences of this. First, although the audit committee may have day-to-day influence over the undertaking of the audit work, the primary legal relationship of the external auditor is with the board not the audit committee. Second, although the board will report on the audit committee's work, the audit committee itself makes no disclosures (except where the board and the audit committee have been unable to agree on the recommended appointment, reappointment or removal of the external auditors), although the report on the audit committee in the UK is often regarded as a *de facto* report of the committee.

This is quite different from the position in the United States, where the Sarbanes-Oxley Act of 2002 (SOX) together with the Securities and Exchange Commission's (SEC) implementing rules have empowered the audit committee in relation to the above two factors. First, the audit committee acts as the primary body directly responsible for the appointment, compensation, and oversight of the issuer's external auditor, not as a subcommittee that makes recommendations to the board. Second, the audit committee itself makes disclosures in an audit committee report, which supports transparency of the audit committee undertaking by placing more responsibility on it and making it directly subject to scrutiny.

The discussion leads to two recommendations. **Recommendation A4.1.3** "Disclosures of the audit committee" proposes that the listing rules be amended to require the audit committee itself to make a disclosure in the annual report as to its work undertaken. **Recommendation A4.1.4** "Status of the audit committee" proposes that a new comply or explain provision be inserted into the HK CG Code that the board should fully delegate to its audit committee powers in relation to the appointment, compensation, and oversight of the external auditor and report on how it has subsequently managed that delegation.

Involvement (Section 3.4)

Shareholder stewardship, and shareholder votes (Sections 3.4.1 and 3.4.2)

Shareholder involvement is an overarching theme in a number of the jurisdictions studied. The mechanisms by which shareholders exercise their votes, and in relation to what matters, clearly represents a fundamental involvement of the shareholder in a company's affairs.

The UK, Hong Kong and Singapore have all emphasized some form of shareholder stewardship to encourage investors to proactively get involved. This has been done in the UK and subsequently Hong Kong by the regulator introducing a shareholder stewardship code. This is despite the different makeup of the investor base in the two markets, with the UK having a deeper institutional participation in the market than Hong Kong. However, stewardship codes do not appear to have translated into shared responsibility and enhanced collaboration between the board and shareholders.

The UK has taken some bold steps, including via its introduction of dual voting for issuers with a controlling shareholder, which gives independent shareholders an opportunity to directly vote for independent directors, and the requirement that FTSE350 company directors be put up for election every year. The former is of particular interest as it requires issuers subject to the requirement to make changes to their constitution - as discussed in **Section 3.5.1**, dual voting represents a public law amendment of private rights that interferes with the one-share-one-vote principle.

The United States has experienced a different matrix of problems. Actual in-person meetings of shareholders are now, in effect, only a necessary formality. The SEC's long standing efforts to facilitate shareholder involvement via proxy rules have been unsuccessful - this has led to some suggestions that the United States in this regard has fallen behind standards in other countries, and that it represents an important competitiveness problem for United States issuers. Shareholder involvement also encompasses activist shareholders, which in the United States are aggressive and can exert a dominating effect leading to the appointment of directors that represent specialized interests rather than those of the company as a whole. A few developments over the past decade or so have strengthened the voice of shareholders in companies, including via electronic shareholder forums, the information provided to shareholders on executive compensation, and a move toward amending by-laws to provide shareholders with access to company proxy materials.

There is little evidence of shareholder engagement in Mainland China, and there appear to be no regulatory steps taken that address this, although it has devised means of facilitating beneficial owners to vote via online voting.

There is little to suggest that significant inroads to shareholder participation in a listed issuer will be obtained in Hong Kong through a stewardship approach. Issuers tend to be dominated by controlling shareholders and minority shareholders are relatively passive, a feature that is also found in Mainland China and Singapore. There are two recent interesting shareholder disputes in the market that are exceptions to this (Elliot/BEA and

Aristeia/Sina), although these are unlikely to impact on the cultural bias of Hong Kong shareholders.

There have been proposals in Hong Kong that independent shareholders should appoint independent directors via a special vote. Apart from the conceptual problem special voting rights creates for the one-share-one-vote principle, it is unclear whether having a special vote is desirable - the risk is that such directors may pursue the interests of a minority group to the exclusion of the interests of the company as a whole, as has been observed in the United States. It is suggested that laying the foundation for an appropriate level of empowerment is an important precursor to and facilitator of stewardship in the wider shareholder context. This includes shareholder rights in relation to information and enforcement that are discussed elsewhere in this Report. The introduction of a scripless system helps, but only really once it has been extended to non-Hong Kong incorporated issuers (particularly Mainland China and the primary offshore jurisdictions). Accordingly no recommendations are made in these two sections, although it is suggested that stewardship principles may need to be revisited at some future point in time when ground conditions in the market may be more responsive.

Remuneration (Section 3.4.3)

Much attention has fallen on executive remuneration since the 2008 global financial crisis. This is particularly notable in the UK and the United States, though less so in Singapore and Mainland China where remuneration tends to be subject to closer monitoring and control by the State as the controlling shareholder.

The substantive issues turn on establishing appropriate mechanisms for the transparency, evaluation and approval of executive remuneration. The question of linking executive compensation to corporate performance – which has in some instances given rise to short-termism and unwarranted risk taking – is a subset of the foregoing.

Each of the jurisdictions studied employs some form of remuneration committee, with differing requirements as to its composition (usually requiring some degree of independence of its members) and powers (to review, to make recommendations or to determine remuneration with delegated responsibility), and differing degrees of disclosure as to its operations. As regards the latter, the UK CG Code has specified the provisions the remuneration committee should follow when designing performance-related remuneration. The rules governing remuneration committees also vary as regards their source – in the United States it is largely derived from the Dodd-Frank Act and implementing rules of the SEC, whereas in the UK and Hong Kong it is based on comply or explain provisions of a CG code.

A wider question for present purposes is what measures are appropriate to deal with the risk of remuneration-abuse. There are essentially four approaches that have been taken in the jurisdictions studied. One approach has been through the imposition of mechanisms that claw back or defer remuneration – successfully implemented in the UK though not as yet in the United States. Improving transparency as to the determination of remuneration including the operation of the remuneration committee has been an important development in the UK via changes to the UK CG Code. In the United States, the composition of the remuneration committee is the subject of mandatory requirements imposed on Exchanges by the Dodd-Frank Act, but is merely a comply or explain standard in the UK CG Code. Finally, the ability of shareholders to approve executive compensation is an important component of the Dodd-Frank Act, albeit subject to the primacy of State laws on the matter.

The extent to which these developments have been successful is unclear. Some evidence suggests that neither the role of independent directors nor giving shareholders votes has assisted to stem abuse or change behaviour. This is possibly due to a lack of sufficient

consensus as between shareholders and regulators.

The difficulties encountered in the jurisdictions studied, the absence of a clear mandate from the Hong Kong market that executive compensation needs to be better regulated and the different context of Hong Kong suggests that it may not be appropriate at present to develop a mandatory regime for shareholder votes on executive pay or clawback mechanisms. There also seems little momentum to mandate a greater involvement of INEDs. The Hong Kong context may therefore be better served by leaving remuneration as a commercial matter to be decided by the board and assessed by shareholders upon receiving adequate disclosure - this broadly shifts the discussion to shareholder voting, which is picked up in **Sections 3.6.3 and 3.7.7**.

The foregoing does leave open the question of how to foster adequate disclosure to shareholders as regards remuneration and its determination. The requirements in Hong Kong as regards the remuneration committee, while broadly similar to international best practices, can be improved. **Recommendation A4.1.2** "Transparency of performance related executive remuneration" proposes better disclosure of the considerations taken into account by the remuneration committee in relation to any performance-linked remuneration. **Recommendation A4.2.2** "Basis of INED remuneration" proposes that the board be required to consider the linkage between the level of an INED's remuneration and their expected commitment and responsibilities and make an appropriate disclosure in relation thereto. The latter recommendation also arises out of considerations discussed in **Section 3.7.10**. Both recommendations also tie in with three other recommendations that address the transparency and legal consequences of CG related disclosures: **Recommendation A4.5.1** "Legal status of CG-related disclosures", **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)" and **Recommendation S4.3.2** "Disclosure of non-compliance with issuer's disclosed CG practices".

Changes of control (Section 3.4.4)

A proposed change of control of a company represents a fundamental issue for shareholders. The different approaches of the models in the UK, Hong Kong and Singapore (regulating via a code and an administrative tribunal/takeover panel) and the United States (regulating via the application of law, particularly fiduciary concepts in the State courts) reflect a fundamentally different understanding of the role of the board in relation to managing the affairs of the company. Whereas the UK and Singapore have moved toward a statutory backed code, it is suggested that in the absence of a broader policy change toward statutory regulation and any clear indication that the Hong Kong Code on Takeovers and Mergers is lacking in effectiveness, there is no mandate for recommending any similar change to the legal standing of the Code. Should either one of these factors change, a review may then be warranted.

It is noted that although UK corporate law, and to a lesser extent Hong Kong, is steeped in a rich tradition of fiduciary law, it does not often come to the fore in a takeover scenario, unlike in the United States. That fiduciary law is a tool actively used in the United States courts (e.g. Delaware) but less so in Hong Kong, may be of relevance to the CG debate beyond the borders of the takeover context, as discussed in **Section 3.7.6**.

Equality (Section 3.5)

Voting rights generally, and weighted voting rights (Sections 3.5.1 and 3.5.2)

The principle around which much discussion occurs on the topic of equality is the one-share-one-vote (OSOV) principle. The current protagonist in the debate about OSOV is weighted voting rights (WVR). The UK and Hong Kong traditionally stand on the side of

maintaining OSOV on the basis that it is a cornerstone of investor protection, whereas the United States permits WVR. Hong Kong is currently wavering on the issue, primarily out of a desire to compete with New York to attract new listings, and also being aware that Singapore is already leaning in the direction of allowing WVR structures to list.

There is a notable division of opinion on the topic, which sometimes turns on an incomplete appreciation of issues that are rarely acknowledged in the OSOV versus WVR debate. First, jurisdictions that ostensibly adhere to OSOV in fact do support mechanisms that override OSOV via public regulation-based adjustments to voting rights that are intended to protect minority shareholders from abuse. Second, there is a commonly mistaken, i.e. false, connection made between WVR in the United States and class action rights and technology companies. Third, the degree to which developmental objectives on the basis of which a market seeks to compete with other markets is connected with CG standards.

While OSOV has undoubtedly stemmed much abuse, many different mechanisms impact on shareholder protection. **Recommendation E4.9.3** "Market development" proposes a clearer and more specific examination of what overarching objectives should drive the development of the Hong Kong market and the alternative mechanisms for shareholder protection that may need to develop in tandem with change, which may or may not go outside of OSOV.

Accountability (Section 3.6)

Information disclosures generally and listing rules (Sections 3.6.1 and 3.6.2)

The ability of shareholders to seek redress where disclosures to them are inadequate as regards the nature, content or the timing of a disclosure, is an important applied element of a CG system. Where absent or subject to significant hurdles, it indicates a weakness in the CG system. Each of the UK, the United States, Singapore and Hong Kong provide for mechanisms of legal redress by way of a civil claim for damages in respect of mis-disclosures, albeit through differing mechanisms and with a different scope (**Section 3.6.1**). While Hong Kong law does provide shareholders with actionable rights under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (CWUMPO) and the SFO, there remain no instances of civil litigation being brought under them. This is in part due to the difficulties of bringing litigation – unlike the United States, Hong Kong does not possess class action rights, although this was proposed by the Hong Kong Law Reform Commission in 2012. Nor does Hong Kong possess other means of collective redress as are already operative in the UK and Mainland China.

When the position under the listing rules is considered, significant variation across the jurisdictions is observed (**Section 3.6.2**). The approach in the United States is based on Rule 10b-5 under the Securities Exchange Act of 1934 and State laws governing fiduciary duty, both of which are neutral as to the source obliging the disclosure. In the UK and Singapore, shareholders can sue for breaches of listing rule requirements because of the statutory backing those jurisdictions give to their listing rules. This is not the case in Hong Kong where a civil action cannot be taken in relation to listing rule breaches, unless they also amount to a breach of the law – this is because the listing rules merely operate as a contract between the SEHK and the issuer, as in the United States.

In practice, the burden of establishing a breach of the relevant disclosure laws in Hong Kong is much higher than what is required in the UK to establish a breach under the disclosure requirements of the listing rules, and may also be higher than what is required to establish a claim under 10b-5 in the United States. Two cases that suggest breaches of the listing rules can give rise to legal action are *Wong Shu Wing* and *Styland (2012)*. While both cases acknowledge the importance to shareholders of information

required by the listing rules, both relate to a right that is only exercisable by the SFC, not shareholders, i.e., under section 214 of the SFO.

Breaches of the Hong Kong listing rules are matters only for regulators but discipline, even for serious breaches, is generally weak and does not benefit shareholders. This represents a deficiency in Hong Kong's CG system as compared to other jurisdictions, which in the past has led to some calls to give statutory backing to the Hong Kong listing rules. However, it is possible to improve accountability to shareholders working within the current regulatory architecture. **Sections 3.3.1 and 3.3.2** lead to **Recommendation A4.5.1** "Legal status of CG-related disclosures" and **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)", which proposed that issuers and directors should be subject to disclosure obligations in respect of compliance with the listing rules that would be subject to legal sanctions.

While the foregoing recommendations would improve the quality of CG-relevant information provided to shareholders, it still does not give rise to actionable shareholder rights. Two recommendations are made. In **Section 3.6.1, Recommendation A4.4.2** "Collective redress" proposes to re-open, and develop, the Law Reform Commission's 2012 proposal on the implementation of class action rights as this may serve to more meaningfully give effect to shareholders' legal rights. The recommendation suggests widening the exercise to consider implementing collective redress on a case management basis, i.e. group litigation as opposed to class action, which is considerably easier to implement although it might not solve all problems. In **Section 3.6.2, Recommendation S4.4.1** "Shareholders as beneficiaries of listing rules" proposes making shareholders a third party beneficiary of the contract between the issuer and the SEHK, thus giving shareholders a basis to bring an action in respect of specified provisions of the listing rules.

The several recommendations referred to and made in this section are a part of a larger theme: creating more effective means of legal recourse over the listing rules, whether by creating powers in the hands of the SFC, shareholders, or both. This is returned to in **Section 3.7.3**.

Board refreshment (**Section 3.6.3**)

The frequency with which directors are required to present themselves to shareholders for re-election is closely aligned to the concept of board refreshment, which can be looked at as a means of ensuring skills, knowledge and experience on a board remain appropriate to the evolving challenges faced by a company. The flip side of this is the concern that the interests of entrenched directors may overshadow the interests of the company. Each jurisdiction studied, with the exception of Mainland China, recognizes the importance of director rotation, with the UK and the United States expressly identifying it as important to good CG. The HK CG Code comply or explain provision for retirement by rotation is broadly in alignment with the other jurisdictions, the listing rules in none of which impose mandatory requirements. While the UK has more recently introduced a UK CG Code provision that directors of FTSE350 issuers should be subject to re-election annually, in the absence of a shareholder mandate in Hong Kong to do more, there is little in favour of making a recommendation on board refreshment. In contrast, other Sections of this Report suggest more needs to be done in relation to board evaluation (**Section 3.3.3**) and independent directors (**Sections 3.6.4 and 3.7 Part C**).

Appointment of independent directors (**Section 3.6.4**)

The appointment of independent directors has attracted more discussion following the adoption in the UK of a dual voting system, which is unique to the UK of the jurisdictions studied. It has led to suggestions in Hong Kong that independent shareholders should

appoint independent directors; this however is a misunderstanding of the UK model, which does not provide that only independent shareholders appoint independent directors – the company as a whole must agree as well. The experience in the United States has been notably marked, if not marred, by the actions of activist shareholders that have led to the directors so appointed pursuing selective agendas not in the interests of the company as a whole. These often carry short-term objectives that in some cases have led to anomalies in the development of appropriate executive remuneration packages (as further discussed in **Section 3.4.3**). The more significant problem in the United States arises out of proxy rules that can work to deprive shareholders of their voice in company meetings and promote the voice of the independent activist director. Hong Kong does not have this kind of problem to deal with (the problem of not having a scripless system is discussed in **Section 3.4.2**).

The appointment of independent directors cannot be understood as a panacea to all possible problems. There is no clear argument for introducing special voting arrangements for the appointment of independent directors that would override the rights attaching to shares otherwise enjoyed in the private law context.

While this section does not make any recommendation, it does serve as a staging post for the consideration of more fundamental questions, such as the determination of independence and whose interests does an INED understand themselves as being responsible to further. That discussion is taken up in **Section 3.7 Part C**.

Effectiveness (Section 3.7, Part A - CG system design)

Impact of regulatory design (Section 3.7.1)

Debates about Hong Kong's CG system significantly turns on the position one takes in relation to the question of market self-regulatory models versus statutory regulatory models. As Exchanges internationally have over the past few decades become increasingly commercialized and privatized, the trend internationally has generally shifted toward favouring statutory regulatory models.

The CG system in the UK is elegant, having one regulatory agency responsible for the listing rules with another responsible for the development of specific CG standards in a CG Code, the FCA and FRC respectively. However, the system has also been criticized as overly regulated and overly complex – while the adoption of a statutory approach to listing regulation has created many benefits, it has also created complexities with many changes to the law, via the CA 2006, Financial Services and Markets Act 2000, and the Financial Services Act 2012, statutory instruments made pursuant to the foregoing, and a complex FCA Handbook.

The CG system in the United States is, in its application, in many ways more complicated than in the other jurisdictions studied. Although the relationship between the SEC and the Exchanges are relatively clear cut, there is a complex relationship between Federal and State laws that impacts on the scope of the SEC's powers and which gives rise to a significant body of case law with outcomes that are harder to predict than, for example, the statutory code-based approach in the UK.

Although flawed in various regards, Hong Kong's CG system is in various ways enviable in its relative simplicity, with a frontline regulator for the listed market subject to the oversight of an industry regulator, the Hong Kong Exchanges and Clearing Limited (HKEX)/SEHK and SFC respectively. Hong Kong is the only jurisdiction in this study that still gives the power to make and enforce both listing rules and the CG Code to the HKEX, a market player, rather than an independent regulator, such as the SFC. While a similar power is enjoyed by the Exchanges in the United States, in practice many of their CG requirements arise out of requirements imposed by legislation or the implementing

rules of the SEC. This feature of Hong Kong's CG system arises out of its leaning toward a market self-regulatory model, which is an important underlying reason why the powers available to regulatory agencies in the UK, United States and Singapore in relation to the listed market are in various ways significantly wider than those given to the SFC.

Hong Kong has enjoyed considerable success under the dual responsibilities model. It has also worked well as regards rule making insofar as the content of Hong Kong's CG system in the form of the listing rules (including the HK CG Code) in general compares favourably with international standards. The significant weakness in Hong Kong's system is the lack of meaningful and adequate enforcement in relation to breaches of the listing rules, as already noted above.

Shortcomings in CG standards span a range of seriousness. Between the SEHK's exercise of its disciplinary powers and the SFC's powers lies a significant lacuna that is inadequately covered by appropriate enforcement mechanisms – they are either too weak and so ineffective, or too strong in relation to a wrongdoing that does not warrant (or may not give rise to) court action. Suggestions to give the SFC power have been controversial in the past primarily on the grounds that it interferes with the dual responsibilities model. A change to that model would require the involvement of the legislature.

Rule making and enforcement are two different things, and can be developed along different pathways without disturbing the basic premise of the dual responsibilities model. It is therefore possible to seek to address the enforcement lacuna by working within the dual responsibilities model with suggestions that do not require legislative action but nevertheless create a range of more graded sanctions. Recommendations made in previous sections of this Report work in this manner: **Recommendation A4.5.1** "Legal status of CG-related disclosures" and **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)". Recommendations made in **Section 3.7.3** that work in a similar manner concern the SFC's powers: **Recommendation C4.6.1** "SEHK to develop use of existing disciplinary power", **Recommendation A4.6.2** "SFC to develop use of conditions when exercising existing SMLR power", and **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR".

Recommendations directed to closing out an enforcement lacuna that do not displace the powers of the HKEX or the dual responsibilities model should be more palatable to those who object strongly to moving toward a statutory model of listing governance.

Policy development agencies (Section 3.7.2)

A CG system evolves over time in relation to both market incidents as well as market expectations. Policy development agencies play an essential role in identifying and detailing suggested developments to the CG system. All the jurisdictions studied have a range of bodies in addition to the regulatory agencies that provide input to proposed developments in the CG system. However, numerous voices from a panoply of sometimes competing interests can operate as distraction from real issues needing to be addressed to improve good CG – the greater the number of bodies that do not coordinate with each other may introduce doubts as to the authoritativeness of each.

The governments of both the UK and the United States place a high value on CG. In the UK, Parliament is very active in conducting, either by its own committees or by specially appointed commissions, thoroughgoing enquiries. The FRC performs an important role in relation to the development of CG standards. In the United States, the SEC took the step of establishing the Office of the Investor Advocate, which, *inter alia*, provides a voice for investors on regulatory CG matters. In Mainland China, policy agencies are active in their policy formulation and implementation but there are doubts as to whether the policy is effective in achieving good CG.

Hong Kong, in contrast to the UK, experiences far less certainty as to whether the recommendations of policy development agencies will lead to developments, there being a number of notable instances where touted changes have failed to occur, particularly as regards proposals touching on the role of the SFC in listed company matters. This is in large part due to a high degree of polarization on the topic of regulatory involvement in the market, and in this sense Hong Kong is similar to the United States where the market has a strong, active and influential voice. Broadly speaking, CG-supportive proposals that originate from independent practitioner-based bodies such as the Listing Committee may stand a higher likelihood of finding their way into the CG infrastructure of the listing rules as compared to those originating from the 1st or 2nd tiers (i.e. Financial Services and Treasury Bureau /the Government, and the SFC) that are concerned with statutory changes, which inevitably may carry more complex implications for a wider set of stakeholders. While at one level that is entirely understandable, at another it reflects a fundamental feature of Hong Kong's CG policy development that is rooted in the market's deep suspicion of government and regulatory interference. Given its status as a global financial centre and participation in the International Organization of Securities Commissions, Hong Kong is also lacking in global thought leadership on CG. While Hong Kong's conservative approach to developing CG may have served Hong Kong well in the past, and there is great value in consulting the practices and developments of other jurisdictions when formulating new CG measures, merely following international or UK best practices may not continue to suffice to meet Hong Kong's particular needs. Hong Kong needs to assert itself more in this regard given that it has become a global financial centre.

While the orderliness and public transparency in the consultation process is generally quite good, there are sometimes lengthy delays and some consultations are delayed or even shelved without adequate explanation, the consultation on class action rights being a notable example of the latter. One exception to transparency is some of the policy and listing rule development work undertaken by the SEHK and the SFC pursuant to their statutory obligations, including the somewhat opaque "High Level Group" formed by an MoU between the SFC and SEHK. In particular, while the development of a new listing rule requires the SEHK to provide to the SFC an explanation of its purpose and likely effect, this is not required to be disclosed to the public following a proposal being implemented. **Recommendation A4.9.1** "Transparency of listing rule development" proposes that giving *ex post* transparency to this process would improve the understanding of listing rules – something that may become increasingly important as courts or tribunals come to be faced with the challenge of interpreting listing rules, the recent *CITIC* case being one such example. **Recommendation A4.9.4** "Response time to public enquiries/consultations" proposes the adoption of a performance standard by regulatory agencies.

The absence in Hong Kong of a designated agency that has the development of CG standards and the interests of minority (i.e. non-institutional) shareholders as its primary concern leaves development in the hands of the SEHK and the SFC. The former must deal with conflicts and the latter has a matrix of regulatory obligations to the market as a whole to which the interests of shareholders may be subjugated – the decision to take or not take an enforcement action that may benefit shareholders being one such example. This division of interests and roles may also serve to propagate the enforcement lacuna referred to in **Section 3.7.1**.

In response to the absence of any singular agency charged with policy development having regard primarily to the interests of shareholders (particularly minority shareholders) on CG matters, **Recommendation E4.8.1** "Establish a CG Unit and CG Group" proposes establishing two bodies: one within a regulatory agency, a "CG Unit" that would assist and coordinating CG policy development as well as providing an agency-based contact point for the collection of information; and a "CG Group" of

experts external to the agency that would serve as a useful semaphore post between commercial needs/tolerances and regulatory insights/expectations. Such a CG Unit and CG Group may work to produce solutions in addition to the recommendations in this Report that would assist to close out the enforcement lacuna, which includes: **Recommendation A4.6.2** "SFC to develop use of conditions when exercising existing SMLR power", **Recommendation C4.6.1** "SEHK to develop use of existing disciplinary power", **Recommendation A4.5.1** "Legal status of CG-related disclosures", **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)", **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR", **Recommendation A4.6.4** "Statutory backing of certain listing rules", **Recommendation S4.4.1** "Shareholders as beneficiaries of listing rules" and **Recommendation E4.8.2** "Establish an investor protection agency".

Recommendation E4.8.1 "Establish a CG Unit and CG Group" also connects with the discussion in **Section 3.7.3** that leads to **Recommendation E4.8.2** "Establish an investor protection agency", which proposes the establishment of a separate enforcement agency (see the discussion in **Section 3.7.3**) - if such a new agency were established, it may make sense to place the CG Unit and CG Group within that agency rather than any existing agency.

Enforcement agencies (**Section 3.7.3**)

Section 3.7.1 discussed the enforcement lacuna in Hong Kong's CG system arising out of the different types of oversight and powers given to the SEHK and the SFC in respect of listed issuers. **Section 3.7.2** discussed the problems each of the HKEX and SFC has in putting the interests of minority (i.e. non-institutional) shareholders as its primary concern. This section takes as its concern the effectiveness of a CG system as regards the ability of regulatory agencies to undertake meaningful and corrective enforcement actions.

The potential role of the SFC as an enforcer of the listing rules to improve the enforcement of them has been a hotly debated topic in Hong Kong ever since the UK introduced the UK listing authority (UKLA) concept as a functionality within the industry regulator, the FCA. The primary issue in Hong Kong is the position of the SFC in relation to the HKEX vis-à-vis the dual responsibilities model. Proposals to create a Hong Kong listing authority within the SFC have not been successful, nor has a reduced version in which only Chapters 4 (periodic financial reporting), 14 (notifiable transactions) and 14A (connected transactions) of the listing rules would receive statutory backing.

Since UKLA was introduced, there have been a number of other developments of significance in Hong Kong, in particular, the removal of the disclosure of price sensitive information obligations from the listing rules to Part XIVA of the SFO. This appears to have been successful in improving disclosures and case law has already begun to develop as a result of the SFC bringing successful actions under these provisions. While this study has not derived sufficient evidence to lead to a positive recommendation that other listing rules now be given statutory support, based on what has been observed in the other jurisdictions studied and the Part XIVA experience, it is suggested that the ground conditions have sufficiently changed for this discussion to be re-examined. This leads to **Recommendation A4.6.4** "Statutory backing of certain listing rules", which proposes reviving the discussion on giving statutory backing to certain provisions in view of today's circumstances.

The power that the SFC has been given over listed issuers under the SMLR is a somewhat blunt instrument: suspending dealings in an issuer's securities or directing the cancellation of the listing. While this may be protective to the market and its investors, it also has the effect of shutting investors out from being able to trade risk. Suspension is an all-or-nothing action that lacks gradation and in that sense has a limited ability to

close out the enforcement lacuna discussed in previous sections. The discussion in this section of the Report leads to **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR", which proposes calibrating the SFC's powers under the SMLR to provide for a fine that works as a warning-cum-precursor to suspension that is premised on the same grounds as its existing SMLR powers. This might provide a "win-win-win" for the issuer, its investors and the market as opposed to outright suspension, and might avoid the problems of previous proposals to give the SFC a disciplinary fining power in respect of breaches of the listing rules more generally.

In contrast to the above recommendations, it is also possible to work within the existing regulations to find ways that the regulators could seek to use existing powers more effectively to bring improvements to CG standards. **Recommendation A4.6.2** "SFC to develop use of conditions when exercising existing SMLR power" proposes that the SFC use its power to impose conditions on a suspended issuer that would work to address the CG shortcomings of the issuer that gave rise to the problem - for example, to require changes to a board's processes that reduce the likelihood of a recurrence of the problem and that may serve to catalyze change. However, some care would need to be taken to ensure that such conditions do not result in rewriting the listing rules for some issuers so as to create an uneven playing field. The foregoing recommendation should be read together with others that would help to close out the enforcement gap without requiring any change to legislation including **Recommendation A4.5.1** "Legal status of CG-related disclosures" and **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)".

The SEHK can also better use its existing powers. **Recommendation C4.6.1** "SEHK to develop use of existing disciplinary power" proposes that the SEHK make better use of its existing power to require issuers to "take, or refrain from taking, such other action as it thinks fit", as well as its power to impose on a suspended issuer conditions on permitting the resumption of trading. The Panel on Takeovers and Mergers has used a similarly broad power to considerable effect. For example, the SEHK's power could be used to require an issuer and/or the relevant director(s) to make a statement as to what measures will be undertaken to ensure non-recurrence of this or similar breaches, and to subsequently report on their implementation. Such a statement could also be required to be reiterated in the annual report and/or on the next occasion the shareholders are asked to re-appoint that director. This may be a more effective means of activating reputational liability than a mere censure and could go a long way to introducing discipline that works proactively to bring about improvements in an issuer's CG practices. This is merely one example of how the power could be used - other uses of the power could be set out in a guidance letter on a non-binding basis.

While the foregoing discussions consider the SFC in relation to developments in the UK, structurally, the SFC sits in a similar position of enforcement as does the SEC. Among the SFC's statutory objectives is the protection of members of the public investing in or holding financial products. Although powers of the SFC may be exercised in a way that has a similar effect in protecting investors, this is not the SFC's sole mandate. A similar issue arises in relation to the SEC. An interesting approach to addressing the problem in the United States was to establish the Consumer Financial Protection Bureau (CFPB) as a new regulatory agency in 2008. This agency has a mandate to protect consumers against unfair, deceptive, or abusive practices and take action against companies that break the law. It has extensive regulatory powers including monitoring, investigating, and enforcing the law. The CFPB may therefore take action in relation to breaches of legal requirements that overlap with the powers of the SEC. **Recommendation E4.8.2** "Establish an investor protection agency" proposes a new, unconflicted regulatory agency empowered to bring an action for the benefit of shareholders. For example, Sections 213 and 214 of the SFO could be amended to provide that such agency (and not only the SFC) may bring an action. Introducing a new statutory body is of course complex and requires many things to be considered, including its objectives, powers

(including both investigation and enforcement), accountability, governance, staffing and funding. While market participants may object to the proposal in view of the increased liability risk, the primary question is whether the proposal would operate to further CG standards in Hong Kong in a manner that facilitates long-term market development.

Audits of public companies (Section 3.7.4)

All the jurisdictions studied are members of the International Forum of Independent Audit Regulators (IFIAR), with the exception of Hong Kong and Mainland China. The most recent member is the United States following the creation of the Public Company Accounting Oversight Board by SOX to oversee auditors. Importantly, SOX puts explicit responsibility on the Chief Executive Officer for certifying the soundness of accounting and disclosure procedures and goes beyond a mere certification that generally accepted accounting principles are being followed – in many instances it was the case that adherence to those principles were in any case inadequate.

Hong Kong is in the process of establishing the parameters of the role of the relatively new FRC, with the oversight of financial reporting and auditing in Hong Kong currently remaining subject to a self-regulatory regime overseen by the Hong Kong Institute of Certified Public Accountants. The development of the FRC's independence and the means by which disciplinary power is to be exercised over audit firms will be an important factor in bringing Hong Kong into alignment with international practices such that it is able to become a member of IFIAR. However, what is arguably more important in practice is the ability to effectively oversee audits of Hong Kong listed issuers that are based in Mainland China. The problem of cross-border enforcement and the need for effective co-operation mechanisms, such as MoUs with the regulator in Mainland China, has been discussed in **Section 3.2**.

Duties of directors and role of fiduciary law (Sections 3.7.5 and 3.7.6)

Directors and the fiduciary duties imposed on them by law have historically formed an important basis of the relationship between the board and shareholders. The UK has codified such duties in the CA 2006 and this can be seen as part of a wider trend in the UK toward giving statutory backing to important matters, such as had previously been done in relation to the listing rules. A similar codification of fiduciary duties had been considered but rejected in the rewrite of the Hong Kong Companies Ordinance (Cap. 622) (CO). The common law applying to fiduciaries continues to apply, and this is the case in Hong Kong, the United States and Singapore. The civil legal system Mainland China means that fiduciary duties are found in the Company Law. Given the foregoing mix of approaches and that codification has recently been considered in Hong Kong, this Report makes no recommendation in this regard, however, it does suggest that the situation might need to be reviewed in the future in light of the experience in the UK, for example, upon the development of a sufficient body of case law.

In the United States, fiduciary law is a flexible tool that plays an important role in the regulation of CG. This has given rise to a large number of State (mainly Delaware) court cases that play a significant role in establishing CG principles and how CG is understood and applied. Not only directors but also controlling shareholders can be subject to fiduciary duties where they own a majority interest in the company or exercise some measure of *de facto* managerial control over the company's business affairs, including through the appointment of its agents to the board. Fiduciary law may also be invoked in relation to actions taken by fiduciaries that amount to a purposeful breach of the listing rules or a breach of the SEC's disclosure obligations.

While directors' duties in Hong Kong are also based on fiduciary duties, this is not a route under which directors are typically held to account. Instead, in the post SFO era focus has fallen on misfeasance and misconduct provisions of section 214 of the SFO,

which has forestalled earlier suggestions that the SFC be given a statutory right of derivative action, particularly as the SFC has successfully used section 214. The advantage of this statutory route is that regulatory efficiency is probably greater as fiduciary cases may be more difficult to establish and fiduciary law as applied by the courts may be difficult to predict and are perceived as creating commercial uncertainty – certainly, this has been the experience in the United States. However, the regulatory inefficiency is that only the SFC is able to bring an action under that provision – shareholders need to rely on the derivative action under applicable law. Because the SFC needs to consider a range of matters, such as those related to market integrity, the available resources of the SFC, and policy issues, this can lead to some plausible (from a shareholder’s viewpoint) actions not being taken. This discussion links to the discussion in **Section 3.7.3** and **Recommendation E4.8.2** “Establish an investor protection agency”, which proposes to establish an unconflicted investor protection agency outside the SFC. The introduction of provisions in the CO that allow unfair prejudice proceedings to be brought by way of statutory derivative action, including in respect of non-Hong Kong incorporated issuers, assists to develop the avenues available to bring directors to account.

Effectiveness (Section 3.7, Part B – Specific actions)

Differentiation of CG requirements (Section 3.7.7)

In the UK, a number of provisions of the UK CG Code are expressed only to apply to FTSE350 issuers, with modifications for smaller companies. Compliance with these higher standards is quite good. As requirements that set standards, smaller companies are also free to comply with them. In contrast, the provisions of the HK CG Code apply equally across all issuers listed on the same board irrespective of factors such as size.

Based on the premise, which appears supported by research, that CG matters to investors, particularly institutional investors, there seems some merit in exploring whether there is a case for imposing higher standards on larger issuers in Hong Kong. This could be done by establishing standards that will apply to certain larger issuers, for example, those admitted to a relevant index, such as an HSI or HSCEI constituent stock. **Recommendation C4.3.1** “Relevant issuers to be subject to “Elevated Standards” proposes escalating selected recommended best practices to code provisions, recommended disclosures to required disclosures, and possibly certain comply or explain provisions to mandatory requirements to create “Elevated Standards”. As many of the relevant issuers will already be compliant, the development would serve to send a signal to the market that companies subject to the Elevated Standards are leading examples of good CG practices.

Other means of recognizing companies with higher standards were explored in the study. For example, it might be possible to establish a CG index based on companies that meet specified CG criteria. However, attempts at doing this in various other jurisdictions have not been successful.

Listing regime standards upon entry (Section 3.7.8)

There are several important gateway mechanisms to ensure the quality of companies seeking a listing on an Exchange. Where a company with low CG standards is brought to an Exchange listing, it may be difficult, time consuming or simply unworkable to change their processes and corporate culture.

Every jurisdiction studied places considerable emphasis on the quality of disclosures, with attendant liability where they amount to mis-disclosures. The UK, Singapore and Hong Kong all engage the sponsor concept as part of the gateway controls. Recognising the importance of sponsor work to the listing regime, the UK and Hong Kong have over

recent years increased their regulatory supervision of sponsor work. There is no such concept in the United States beyond the disclosures required in regulatory filings, where significant focus falls, in addition to the company, on the underwriter. However, unlike sponsors in the UK and underwriters in the United States, the prospectus liability attaching to sponsors in Hong Kong is unclear. The quality of sponsor work remains a concern, which suggests that supervisory oversight of their work undertaking needs to be improved.

Compared to the availability of legal enforcement in the UK and the United States, in Hong Kong, where a shareholder is unlikely, unwilling or unable to litigate, setting the tone of an issuer's CG standards from the outset is arguably more critical to ensure. Listing applicants in the United States are required to make extensive CG-specific disclosures in the registration statement and liability will attach to mis-disclosures. In Hong Kong, listing applicants make only basic and limited disclosures concerning their CG practices. The declarations required to be made by sponsors to the SEHK address in general terms the ability of the directors to undertake their responsibilities and the company's internal controls and processes, as well as the disclosures made in the listing document cum prospectus. However, the CG disclosures required of, and that are typically made by, listing applicants fall well short of the standards imposed on listed issuers. **Recommendation C4.7.1** "Disclosure of CG standards in listing document" proposes that the listing applicant be required to make a statement in the listing document cum prospectus that discusses its CG practices in view of the requirements under the HK CG Code. This would serve to bring those statements within the laws on disclosures in public offerings.

While the sponsor role has received much attention over the past few years, the role of the compliance adviser has not. In terms of *ex ante* mechanisms, the compliance adviser role is important in assisting the newly admitted issuer settle in to its new public company status. This is underlined by research that suggests newly admitted issuers may take a few years before they are able to meet the intent of a CG provision, and in the interim rely on a box-tick approach. Considering the changes to the sponsor regime, the compliance adviser regime remains weak in two areas: its role is passive, which contrasts with the active role of the sponsor that was strengthened in the reforms introduced in 2013; the sponsor and compliance adviser roles are completely independent, which means that sponsors that have brought the company to listing and are intimately familiar with it can and often do walk away upon the company being admitted to listing, leaving the compliance adviser role possibly being taken up by a relative outsider. This is unlike the position in Mainland China where a sponsor of a newly listed issuer is required to be involved in supervising the issuer's compliance issues for a period of two to three years after admission to listing. **Recommendation E4.7.2** "Develop role of compliance adviser" proposes a development of the compliance adviser role to make it more actively engaged and to require it to be undertaken by a sponsor on the listing application. The latter requirement has the effect of keeping the sponsor's skin in the game and this might bring greater focus in the sponsor's review of the listing applicant's CG processes and standards pre-listing.

Effectiveness (Section 3.7, Part C – Independent directors)

Determination of independence (Section 3.7.9)

Each of the jurisdictions studied require the board to comprise a minimum number of independent directors: at least one-third in the UK, Singapore and Hong Kong; at least half in the United States. The concept of independence is specified by the Exchanges and is broadly concerned with similar issues in each jurisdiction, with each jurisdiction providing (with the exception of the United States) for a period of appointment after which independence is to be questioned or explained. Where they differ is in the determination of independence. In the UK, Singapore and the United States

independence is for the board to assess. This is different from Hong Kong and Mainland China where it is for the SEHK and CSRC, respectively, to assess and approve.

While the UK is clearer in its empowerment and accountability of INEDs, including through dual voting (discussed in **Sections 3.5.1 and 3.6.4**) and the relationship agreement with controlling shareholders (discussed in **Section 3.7.12**), it may to some degree be weakened by the self-determination by the board of independence, which is only subject to the comply or explain standard.

In this regard Hong Kong appears to be doing well when compared to the other jurisdictions studied. However, in Hong Kong, the written confirmation of independence submitted by directors to the SEHK, which it relies on, is only subject to the limited sanctions available to the SEHK – discipline for providing false or misleading information is therefore weak. In the United States, a filing as to independence is also required but there it is made on a form subjecting the disclosure to Federal law. **Recommendation C4.5.3** “Facts regarding director independence” proposes bringing INED disclosures of facts relevant to the SEHK’s assessment of independence under the SFO provisions dealing with providing false or misleading information to regulators. This is appropriate given the importance attached to the independence of INEDs and their expected role.

Requirements relating to INED performance (Section 3.7.10)

INEDs perform a special role on the board and there is some variation in the jurisdictions studied as regards the parameters that should be placed on INEDs that may affect their performance. A basic concern is ensuring they have sufficient time, qualifications and are sufficiently engaged to properly discharge their duties. Exchanges in the UK, the United States and Singapore touch upon the question of how many non-executive posts at different companies an individual can undertake, and each leave this to the board to decide noting that the board may consider adopting policies to place a cap on the same. In Mainland China, there is strict limit of five, in addition to other prescriptive requirements that mandate attendance at board meetings and training organized by the CSRC.

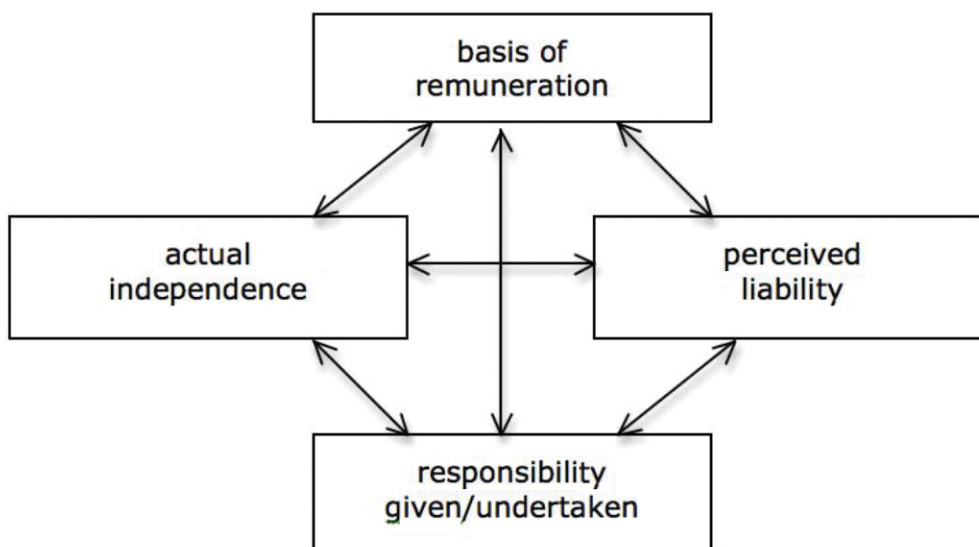
In Hong Kong, the question of an INED’s other posts is left to the board. The obligation on an INED to disclose other commitments as found in the UK CG Code is absent from the HK CG Code. Interviewees felt less concerned about that difference and more concerned about the number of posts some INEDs hold, raising queries over how they could possibly undertake their role meaningfully, particularly during financial reporting seasons. The HKEX is currently consulting on these issues.

Recommendation A4.2.1 “Sufficient INED time” proposes that issuers should at the very minimum adopt a policy that is disclosed to shareholders, with deviations from it also being explained.

Other than time, a variety of factors influence the ability of an INED to be effective. Some of these are unique to the individual, such as their experience, skills and personality. Other influences are driven by the issuer itself, including the extent of active engagement and training about the company’s business, board processes that incorporate or distance INEDs such as practices on board paper briefings, and level and nature of remuneration. Non-executive directors (NED) that are not independent are less frequently discussed but nevertheless present a similar matrix of problems and concerns as discussed in relation to INEDs, albeit without emphasis on their role as an assurance of investor confidence.

Together, these give rise to an inherent *de facto* relationship between independence, the responsibility given and undertaken, remuneration and perceived liability, as shown in the following diagram.

Factors impacting on the INED role



Almost all of the interviewees expressed concern that a number of INEDs of listed issuers in Hong Kong do not fully appreciate their role on the board and take up INED roles as trophy posts.

Enforcement against INEDs is weak in the UK as well as the United States, and Hong Kong is no different in this regard – the regulatory enforcement lacuna is discussed in **Section 3.7.1**. While it is tempting to conclude there should be more enforcement, it is suggested that the public framework of responsibility and accountability of INEDs in Hong Kong could be evolved in a manner that better supports their function. Changes in the UK (see **Section 3.7.12**) and the United States (see **Section 3.3.4**) that give INEDs greater responsibility and visibility support this suggestion, as does the requirement in Mainland China that INEDs must themselves make disclosures in the annual report. Disclosure by INEDs also serves to provide an insight onto the black box of the board and make INEDs more visible and so accountable to shareholders.

Recommendation C4.2.4 “NED Code and INED reporting” proposes the introduction of a mandatory requirement that INEDs make a statement in the Corporate Governance Report as to their activities relating to the undertaking of their role over the course of the year, and a comply or explain provision that the issuer should implement an “NED Code” to support and facilitate the effectiveness of the NED role. A Model NED Code would be set out in the HK CG Code establishing the matters that should be addressed, although it is up to each issuer to determine its policy in relation to each item. Such matters would include, for example, the NED’s expected involvement, sufficiency of a NED’s time, basis of remuneration, knowledge of the business and training, etc. The Code based approach provides a clearer forum for establishing the expectations placed on INEDs and other NEDs.

INED qualifications (**Section 3.7.11**)

The foregoing **Section 3.7.10** is closely connected to a topic that has been a concern in all jurisdictions studied, namely, the precursors to NEDs being able to contribute as effective challengers on the board. Discussion frequently circles around director training and whether undertaking that role should be determined solely by commercial considerations (and the enforcement mechanisms and vested interests of directors to

comply with them), or whether the ability to be appointed to and undertake a director post should be subject to a formal training, qualification or certification requirement imposed by a regulatory body. Where enforcement is weak, as is the case in Hong Kong as a result of an enforcement lacuna (see **Section 3.7.1**), support for the former position is correspondingly weaker.

Not all jurisdictions have meaningfully distinguished between the different demands placed on executive and non-executive directors. The UK's Turner Review and Walker Review (albeit focused on financial institutions) suggested that INEDs should undergo an induction process, receive regular training, and be provided with dedicated support. Neither the UK, Singapore nor Hong Kong distinguishes between the training needs of different directors, although the UK CG Code does provide that NEDs should have access to independent professional advice.

In Hong Kong, it is a comply or explain requirement that directors engage in continuous professional development. While this was elevated from a recommended best practice following the HKEX's 2010/2011 consultation proposals, the proposal did not distinguish INEDs as possibly requiring different types of training. Only where there has been a breach of the listing rules might the SEHK require a director to undertake training. In March 2017 the SEHK began to release training videos for directors. Whether the videos constitute a meaningful learning tool that works to change the behaviour of directors in the marketplace is open to doubt. It is rather predictable that the body of directors that the market is most concerned about – inattentive or inactive INEDs and other directors who have little regard for CG standards – are unlikely to study and learn from the videos such that their behaviour changes. The release of the videos thus may serve as a false validator that something is being done about director training.

Mainland China is the only jurisdiction studied that has a regulatory requirement for certifying director candidates. As regards INEDs, the CSRC and the Exchanges all provide ongoing director training, with the Exchanges requiring certification from INEDs in this regard. This is relevant to note in the Hong Kong context where many issuers, and their directors, are from Mainland China – which for directors individually presents a less regulated environment as compared to if they were listed in the Mainland since they do not need to undertake training or certification in Hong Kong.

Most interviewees supported the idea of mandatory training for INEDs. Those who have received such training found the training to be useful in preparing them for the job as independent directors. INEDs do face a different set of tasks from executive directors that may require, for example, reading outside board papers prepared by management, engaging in site visits to understand the company's operations, conducting one-on-one conversations with management people not on the board, and attending industry and related conferences especially for directors who are not industry experts.

Hong Kong's CG system places some emphasis on the role of INEDs. Concerns over INED involvement and capabilities combined with a weak system of enforcement suggest that Hong Kong needs to do better in this regard. **Recommendation A4.2.3 "INED training"** proposes that INEDs be required to undertake training that is specialized to their role, that this must be subject to a minimum number of certified hours of training experiences that must be disclosed if not met, but that issuers are free to determine what training constitutes an INED CG training experience.

Empowerment of INEDs – controlling shareholders (**Section 3.7.12**)

All the jurisdictions studied recognize the potential risks of controlling shareholders or their connected parties entering into transactions with the issuer and have imposed controls on these types of transactions, either via listing requirements and/or codes that set CG standards, or via fiduciary duties.

The UK has gone further to provide in the listing rules that the controlling shareholder must enter into a “relationship agreement” with the issuer in which it gives undertakings as regards arms’ length transactions and compliance with the listing rules. An important feature of the agreement is that any one independent director can assess whether the controlling shareholder’s undertakings have been breached – if they have, subsequent connected transactions will require the approval of independent shareholders until further requirements are satisfied.

This is interesting to consider in the context of Hong Kong where there are perceived shortcomings in the oversight (by shareholders and regulators) of connected party transactions. The UK’s relationship agreement is in theory an empowering device for INEDs, particularly as a dual voting procedure is used for the election of independent directors (see **Sections 3.4.1 and 3.4.2**). However, in the absence of a special voting procedure for INEDs in Hong Kong, it is suggested that a relationship agreement may be of little use in practice. While it may be tempting to put this forward as a reason for introducing special voting rights for the election of INEDs, this would be the tail wagging the dog. As discussed in **Sections 3.5.1 and 3.6.4**, dual voting represents a public law amendment of private rights that interferes with the one-share-one-vote principle. Moreover, there are other means of addressing that problem, as discussed in **Section 3.7.3** (regarding enforcement agencies) and **Section 3.6.2** (regarding enforcement by shareholders).

Effectiveness (Section 3.7, Part D – Other items)

Whistle-blowing (Section 3.7.13)

Whistle-blowing has been in place in the United States for almost half a century, initially under the umbrella of protecting the labour market. Over the last two decades, both the United States and the UK have introduced whistle-blowing laws that cover, in varying degrees of specificity, CG standards. The UK provisions cover CG matters established in primary legislation and, because the listing rules have statutory effect, potentially also many of the detailed CG requirements in the FCA’s listing rules. The provisions in the United States arise out of the SOX and specifically recognize breaches of regulatory laws promulgated by the SEC. An important distinction is that the UK has considered and rejected financial incentives for whistle-blowers, whereas the United States embraces incentives. There is in reality some uncertainty whether incentives work, or to what degree their effectiveness depends on the characteristics of a particular jurisdiction. Mainland China also provides for whistle-blowing protection, however, this is not targeted but is directed at citizen’s rights more generally.

It appears to be common ground that whistle-blowing plays a potentially important role in increasing transparency and uncovering and possibly preventing fraud and wrongdoing. Hong Kong also recognizes whistle-blowing as a tool, but its implementation is piecemeal and, compared to the steps taken in the UK and the United States, it is also weak in terms of protection from retaliation. There is no overarching law to protect whistle-blowers; some laws do provide limited protections in limited contexts; the HK CG Code merely positions it as a recommended best practice; and the regulators support whistle-blowing, but in principle only.

This raises the question, in the context of this study, whether the implementation of whistle-blowing in relation to CG practices should also adopt a specialized-context approach. While the introduction of requirements in the HK CG Code would be helpful, this does not go far enough given that the potential consequences arising from poor CG may extend beyond non-statutory codes and involve director misfeasance and corporate fraud that have legal and possibly other far reaching consequences on investors and the market more generally. **Recommendation E4.9.2** “Whistle-blowing” proposes that a

consultation or public report should be undertaken that explores whether to implement laws that encourage whistle-blowing from employees by providing protection to whistle-blowers, and whether this should be limited to specific circumstances such as, for the purposes of this Report, corporate misfeasance.

Section 1	INTRODUCTION TO THE STUDY AND ITS PURPOSES
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Introduction

The importance of corporate governance (CG) for Hong Kong as an international financial centre cannot be over-emphasized.

Management of a publicly listed company bears considerable responsibility, both commercially and under the law, as regards the manner in which the affairs of the company are undertaken, and with responsibility also comes the possibility of negligence, recklessness or abuse. Where management failures are isolated to a specific company, the shareholders in that company suffer. Where management failures become more widespread, it becomes a concern for the market as a whole and suggests a structural or systemic failure in the checks, balances and mechanisms of accountability normally imposed by a system of CG on the exercise of management authority.

Hong Kong's emergence as a global financial centre has brought far greater attention to be placed on its role in the global market place and the standards it engages as compared to other leading global markets. This necessarily includes the vast array of topics that sit under the umbrella of CG. The risk of CG failures, whether isolated or recurring, has not escaped the attention of the Government, regulatory agencies, market participants, professional and retail investors, and other stakeholders in the integrity and prosperity of the market. The highest levels of the Hong Kong Special Administrative Region (HKSAR) Government have also emphasized the desire to establish Hong Kong "as a paragon of corporate governance" that better protects the interests of all stakeholders.⁸

Standards are of course relative, expectations do change over time, and views on the appropriate role of CG in the commercial functioning of a company are heterogeneous. Since at least the time of the Great Depression in the 1930s and certainly since the 1980s, there has been a deeper recognition of the fundamental connection between the health of a market and the health of the economy it serves. CG is central to this relationship, and over the course of the 20th century standards and expectations have steadily increased, a trend that is continuing with increasing clarity and scope in the early part of the present century.

⁸ "Hong Kong aims to be a 'paragon of corporate governance'", 1 March 2003: Available at <http://www.info.gov.hk/gia/general/brandhk/0301079.htm> (visited 10 Nov 2017)

1.1	Purpose of this Report
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1.1 Purpose of this Report

The purpose of the present study is to investigate the CG framework in Hong Kong and to make recommendations as to how it may be further developed to improve the long-term competitiveness of the Hong Kong public market.

To this end, the study has researched four overseas jurisdictions – the United Kingdom (UK), the United States, Mainland China and Singapore. Examining the developments and experiences, both successes and failures, in these other markets enables a comparative analysis of Hong Kong’s strengths and weaknesses. A central premise of the analysis is that the broad historical, legal and cultural contexts of each of these five markets are different, which implies that merely supplanting aspects of Hong Kong’s CG system with those from another may not work to produce the same outcomes – what was successful in another jurisdiction may fail in Hong Kong, and *vice versa*.

Of particular interest to this study are shareholder rights, remedies and protections and board processes within the context of public listed companies. The regulatory oversight of listed companies in Hong Kong is therefore relevant to consider, including the many listed companies that are not incorporated in Hong Kong that present special issues as regards the legal standing of CG standards and their enforcement.

1.2**The development context of Hong Kong's CG system****1.2.1 Domestic drivers**

The modern development of CG reform in Hong Kong can be traced to various sources. The last few decades of the 20th century witnessed the inception of the foundations on which today's system of financial market regulation rest. In the period since the 1990s to date, a more specific, targeted and recognizable CG system has evolved within a regulatory framework that continues to develop. The setting of CG standards primarily arises out of complementary developments to corporate and securities legislation as well as the non-statutory listing rules issued by The Stock Exchange of Hong Kong Limited (SEHK). Enforcement of those standards is spread across several agencies with varying degrees of effectiveness.

Prior to the 1970s the market was largely unregulated, depended on a colonial transplant of law, and had no effective financial law or regulation, which only began to develop in from the 1970s. This left CG in Hong Kong primarily a matter of the general fiduciary provisions of English law. It is fair to say that at that time, other concerns were more pressing as Hong Kong was evolving from being a regional entrepôt and merchant city toward becoming a commercial and financial centre.⁹

The first legislative attempts to provide a firm informational basis for the financial market began in 1970 with the introduction of the Companies (Amendment) Ordinance to better govern company prospectuses. In 1971 the First Report of the Companies Law Revision Committee was issued.¹⁰ In 1973, the Stock Exchange Control Ordinance was introduced, representing the first step of Government regulation of stock exchanges.¹¹ In 1988 the Hay Davison report was issued.¹² That report led to the passage of the Securities and Futures Commission Ordinance and the establishment of the Securities and Futures Commission (SFC) in 1989. The overall focus of these developments was to improve the regulatory oversight of the markets. Among the many issues identified by the Hay Davison report, it found that self-regulation and market self-discipline had failed to develop, and that the Commissioner for Securities had lost effective control in its oversight of the market. While the standards of CG were being affected by these changes, it had not significantly evolved.

That began to change as Hong Kong moved toward a modernization of its corporate law, which had seen piecemeal development that left it progressively out of date since its introduction in 1933. The first attempts in the mid 1990s to create "an ordinance for the 21st century"¹³ were largely unsuccessful following the issuance of the Pascutto Report¹⁴ in 1997. In 2006, the Financial Services and Treasury Bureau launched a complete rewrite that led to the present Companies Ordinance¹⁵ coming into effect in 2014.

In tandem with the attention being given to the companies' legislation, CG standards

⁹ Douglas W Arner, Berry Hsu, Say H. Goo, Syren Johnstone, and Paul Lejot, *Financial Markets in Hong Kong: Law and Practice* (Oxford: Oxford University Press, 2nd edn, 2016), para 1.03

¹⁰ "The protection of investors", 24 June 1971. Few of its provisions were implemented.

¹¹ At that time there had been four exchanges in operation. There had previously been effectively no control on the formation of stock exchanges.

¹² "The Operation and Regulation of Hong Kong Securities Industry: Report of the Securities Review Committee", 1988: Available at http://www.sfc.hk/web/doc/EN/speeches/public/consult/Report-Operation_and_Regulation_HK_Industry.pdf (visited 10 Nov 2017)

¹³ Per Sir Hamish Macleod, the HKSAR Financial Secretary, in his budget speech 2 March 1994

¹⁴ "Review of the Hong Kong Companies Ordinance, Consultancy Report", March 1997: Available at <http://www.cr.gov.hk/en/standing/docs/concmpny.pdf> (visited 10 Nov 2017)

¹⁵ Cap. 622

also began to receive more attention, starting with financial disclosures which were expanded notably in 1994, 1998 and 2000. The recognition of the need to enhance CG standards more broadly to keep abreast of global standards was an important theme of the Hong Kong Exchange and Clearing Limited's (HKEX) January 2002 Consultation Paper.¹⁶ In addition to disclosures, its focus was shareholder rights and director and board practices. This led to a raft of CG related developments including the introduction in 2004 of a new Chapter 14A that expanded on the existing connected transactions rules¹⁷ and the requirement that each listed issuer's board possess three independent non-executive directors (INEDs).¹⁸ In 2005, the gateway functions expected to be performed by sponsors, compliance advisers and independent financial advisers were developed.¹⁹ The regulation of the sponsor and compliance adviser undertaking being wholly transferred to the SFC in 2007 under the umbrella of their regulation of intermediaries. The SEHK's first Code of Best Practice for listed issuers had been issued in 1993, then replaced in 2005 by the Code of Corporate Governance Practices and Rules on the Corporate Governance Report,²⁰ which in turn was the precursor to (and later renamed in 2012 to) the Corporate Governance Code.

An important development in the regulatory architecture of the listed market occurred in 2003 with the introduction of the Securities and Futures Ordinance (SFO).²¹ Subsidiary legislation to the SFO, the Securities and Futures (Stock Market Listing) Rules²², established a dual filing regime that also provided the SFC with regulatory oversight of listing applications as well as listed issuers. It also provided the SFC with powers based around disclosures filed with the SFC and the interests of the public market. While such powers were introduced as "reserve powers", the interpretation of this term is now controversial, a point that shall be returned to later in this Report. However, despite this power, and various other developments in the listing rules in the modern era, the issue of the effective enforcement of the listing rules remains a problem the market has been struggling with since at least the 1990s, if not earlier. As a former Chairman of the HKEX succinctly put it in 2001, "The rules must be fair. They must be clear. They must be sensible. And they must be enforced properly. If not enforced properly, rules become meaningless."²³ Subsequent sections of this Report will return to this important issue.

The foregoing is of course merely a brief overview of some of the notable domestic drivers leading to the current CG system in Hong Kong – these, together with more recent developments in Hong Kong, are the subject of later sections of this Report. However, many of the developments reviewed above must also be seen in the context of global processes, a topic that is of particular interest to this study given its comparative element.

1.2.2 Global drivers

The development of CG in Hong Kong did not occur in isolation to the global scene but was often triggered by events and developments elsewhere, in particular the UK and the United States. The collapse of wallpaper group Coloroll and Polly Peck in the UK led to the establishment of the Committee on the Financial Aspects of Corporate Governance

¹⁶ HKEX "Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues" January 2002

¹⁷ These were previously incorporated in LR Chapter 14

¹⁸ HKEX Update No. 80, Available at http://en-rules.hkex.com.hk/en/display/display_main.html?rbid=4476&element_id=48

¹⁹ HKEX Update No. 81, Available at http://en-rules.hkex.com.hk/en/display/display_main.html?rbid=4476&element_id=47

²⁰ HKEX Update No. 82, Available at http://en-rules.hkex.com.hk/en/display/display_main.html?rbid=4476&element_id=46

²¹ Cap. 571

²² Cap. 571V

²³ Per Mr. Charles Lee, Chairman, HKEX, speech at SFC Conference on Corporate Governance in the Pan-Chinese Market, October 2001

chaired by Sir Adrian Cadbury, popularly known as the Cadbury Committee in May 1991. As the Committee got down to business, two further scandals - the collapse of BCCI and Maxwell Communications Corp - heightened the sense of urgency behind the Committee's work. The report of the Committee published in 1992,²⁴ "Financial Aspects of Corporate Governance", usually referred to as the Cadbury Report, has had a profound influence not only in the UK but globally, including Hong Kong.

Many of the recommendations made in the Cadbury Report have found their way to the CG system in Hong Kong. For example, it recommended that the board of directors, as opposed to the Chief Executive Officer, should be the decision-making body for major transactions and that the board should have sufficient number of INEDs to carry significant weight in board decisions. It also recommended that the board should be supported by three committees - the nomination committee, the remuneration committee and the audit committee. These recommendations were later implemented by the London Stock Exchange by way of an appendix to the listing rules on the basis that compliance was not compulsory but non-compliance required explanations, i.e. the "comply or explain" approach. Amongst other influences, these changes led to the recommendation by the Hong Kong Society of Accountants (later renamed as the Hong Kong Institute of Certified Public Accountants) Corporate Governance Committee in 1995 that an audit committee be introduced as part of the SEHK's Code of Best Practice and the formal endorsement of the recommendation by the SEHK in 1998 in the form of Appendix 14 to the listing rules.

Subsequent undertakings of committees in the UK also had significant impacts on Hong Kong. This included: the Greenbury Committee's report in 1995 (on directors' remunerations),²⁵ the Hampel Committee's report in 1998 (to review the Cadbury principles and Greenbury principles which led to the Combined Code),²⁶ the Higg's Review in 2003 (on independent non-executive directors),²⁷ the Smith Report in 2003 (on audit committee) following the collapse of Enron in the US in December 2001,²⁸ and the Walker Report in 2009 (on CG of financial institutions) following the global financial crisis of 2008.²⁹ To this influence can be added: the introduction of the UK Corporate Governance Code 2010 (which replaced the Combined Code), the Stewardship Code 2010, the new Companies Act 2006, the Financial Services and Market Act 2000 and its amendments by the Financial Services Act 2012, and the Bank of England and Financial Services Act 2016. These are further considered in subsequent sections of this Report.

Across the Atlantic, the collapse of Enron, WorldCom and Tyco between 2000-2002 led to the passage of the Sarbanes-Oxley Act of 2002 (SOX) in the United States, which resulted in many significant CG changes. These changes have spurred the CG debate in Hong Kong, sometimes in different directions. For example, whether there should be an independent oversight body of auditors such as the Public Company Accounting Oversight Board in the United States established under SOX, whether auditors who provide auditing service to a listed company should be banned from providing non-auditing services to the company at the same time, and so on. On the other hand, while SOX may have helped improve investor confidence, it also produced unintended consequences as it significantly increased liability and compliance costs for listed

²⁴ It was also published in a draft version in May 1992

²⁵ "Director's Remuneration, Report of a Study Group chaired by Sir Richard Greenbury", 17 July 1995: Available at <http://www.ecgi.org/codes/documents/greenbury.pdf> (visited 10 Nov 2017)

²⁶ "Committee on Corporate Governance, Final Report", January 2008: Available at <http://www.ecgi.org/codes/documents/hampel.pdf> (visited 10 Nov 2017)

²⁷ "Review of the role and effectiveness of non-executive directors", January 2003: Available at <http://www.ecgi.org/codes/documents/higgsreport.pdf> (visited 10 Nov 2017)

²⁸ "Audit Committees Combined Code Guidance", January 2003: Available at http://www.ecgi.org/codes/documents/ac_report.pdf (visited 10 Nov 2017)

²⁹ "A review of corporate governance in UK banks and other financial industry entities, Final recommendations" 26 November 2009: Available at http://webarchive.nationalarchives.gov.uk/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf (visited 10 Nov 2017)

companies. Reflecting the increasing cost of compliance, the annual cost of a public listing in the U.S. increased from around US\$1.2 million in 2004 to around US\$2.8 million in 2005. It also led to an increase in the number of companies delisting (from 48 in 2003 to 80 in 2004) and a significant decrease in the number of foreign issuers seeking a listing on the market.³⁰ One of the authors of SOX, Congressman Oxley, has admitted that SOX may be causing companies to be excessively risk averse, and this concern speaks to the need for balance in a CG system, and to steer clear of the risk of examining companies to death such that they would not have any breathing room to innovate or to take risks.³¹

Similarly, the changes introduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 also provided the foundation for raising numerous CG discussions in Hong Kong. However, few of the requirements have been implemented and many of them may not be progressed under the current United States Government leadership, including relating to executive remuneration and shareholder rights and proxy rules, as discussed in subsequent sections of this Report.

Global trends in CG have also influenced developments in Singapore and Mainland China. This encompasses the use of a code of corporate governance, the appointment of board committees, and the use of independent directors. Experience in these markets not only provides opportunities for Hong Kong to understand how these measures work in different markets under different market and institutional conditions but also the nature and operation of the companies listed in Singapore and Mainland companies listed in Hong Kong and Singapore.

That global trends have also taken hold in developing the CG system in Mainland China is particularly noteworthy in the Hong Kong context. Since the first mainland company, Tsingtao Brewery, listed its H shares in Hong Kong on 15 July 1993, Mainland enterprises have come to dominate the SEHK. Mainland Chinese enterprises³² now account for more than half of the companies listed on the SEHK. For the years ended 2015 and 2016, around 90% of total funds raised in initial public offerings (IPOs) and around 70% of average daily turnover are attributable to Mainland enterprises.³³ This is a dramatic change since the 1990s – from 57 Mainland enterprises accounting for 9% of total turnover in 1994, by end 2004 these figures had respectively risen to 304 and around 50%.³⁴ Milton Friedman has also attributed Hong Kong's free market capitalism as a "major factor in encouraging Mainland China... to move away from centralized control toward greater reliance on private enterprise and the free market".³⁵

This dominance has facilitated Hong Kong's position as a leading global market for IPOs – in this regard being positioned second in the world over a consolidated ten-year period, as shown in the diagram below.³⁶

³⁰ See Syren Johnstone, "Financial markets in Hong Kong – developing regulation", Hong Kong Law Journal, Law Lectures for Practitioners, 2006, pages 101-122, 121

³¹ Comments made by Alan Greenspan, Chairman of the U.S. Federal Reserve in the context of the failure of LTCM, as quoted in Asia Wall Street Journal 22 Nov 2004, page A6

³² This includes H-share companies (incorporated in Mainland China), red chip companies (incorporated outside of Mainland China but controlled by Mainland government entities) and Mainland private enterprises (incorporated outside of Mainland China and controlled by Mainland Chinese individuals)

³³ See HKEX Market Statistics 2016. The exact figures are, respectively, 92%, 94%, 73% and 71%.

³⁴ First Quarter Economic Report 2005, available at <http://www.hkeconomy.gov.hk/en/pdf/box-05q1-4-1.pdf> (visited 10 Nov 2017)

³⁵ Milton Friedman, "The real lesson of Hong Kong" (1997), Magazine of the University of Chicago Booth School of Business, Fall, and "Hong Kong wrong", Wall Street Journal 6 October 2006

³⁶ "Hong Kong remains in pole position for IPOs", 24 June 2017: Available at <http://www.scmp.com/business/companies/article/2099755/hong-kong-remains-pole-position-ipos> (visited 10 Nov 2017)

Top 10 global stock exchanges (1997 - 2017*)

	Proceeds raised (US\$b)	Market share (%)	Number of issues
New York	675.8	19.5	1,334
Hong Kong	388	11.2	1,172
Nasdaq	339.3	9.8	2,952
London	292.6	8.5	638
Shanghai	235.1	6.8	965
Tokyo First Section	116.1	3.4	109
Australia	110.4	3.2	1,367
Frankfurt	86.4	2.5	274
Shenzhen Small and Medium Enterprise	81.6	2.4	837
Madrid	72.6	2.1	86

Source: Thomson Reuters

*As at March 31

SCMP

The trend of Mainland enterprises coming to list on the SEHK is likely to continue as the HKEX continues to target technology startups, Mainland firms looking for expansion overseas, and Belt and Road initiative-related companies for further growth in IPOs.³⁷ This presents huge opportunities for Hong Kong as a fund raising centre. It also presents challenges in regulating CG to maintain and improve standards, transparency, and investor protection, as witnessed by a number of corporate scandals involving Mainland enterprises listed in Hong Kong over the past two decades.

³⁷ Ibid.

1.3	Structure of this Report
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Other than this introductory Section 1 and the concluding remarks in the final Section 5, this report comprises three substantive sections. Section 2 explains the methodology employed in undertaking the study, Section 3 presents a detailed analysis of the data obtained from each of the jurisdictions studied, which leads to the recommendations that are presented in Section 4. Reference material concerning the jurisdictions considered is set out in Appendices I to V to this Report. Each Appendix describes the essential structure and characteristics of the CG system in the relevant jurisdiction, including the operation of key regulatory agencies, policy development, enforcement mechanisms, the legal and regulatory framework, shareholder rights and protections, and the regulation of non-locally incorporated companies.

1.3.1 Methodology

Section 2 discusses the initial methodological questions that needed to be addressed from the outset of the study: defining the scope of CG as a concept, and determining the geographical scope of the comparator jurisdictions.

Given the profusion of applied, conceptual and value-laden variations in how CG can be understood, it was necessary to provide some form of definition for the purposes of this study that strives for neutrality. Section 2 provides a definition of “good CG” around five key variables upon which it is dependent – information, involvement, equality, accountability and effectiveness. Together with the particular problem of dealing with non-locally incorporated companies, these variables form the structure of the analysis in Section 3. Inevitably, some items are excluded although they may in another context merit investigation, for example, gender and racial diversity, corporate social responsibility, and the relationship between CG and share price performance.

Section 2 also explains the process of collecting and organizing the data, and the identification of key differences and observations of interest across each CG system studied. The data collected on each of the five CG systems studied are presented in the five Appendices to this Report.

Concurrent with the data collection and organization process, oral interviews were undertaken, on a candid and confidential basis, with senior individuals from issuers, investment banks and regulators, among others.

1.3.2 Analysis

Section 3, which is the main body of this Report, presents the substantive analysis of the study with a view to identifying potential recommendations for changes in Hong Kong’s CG system that are supported by the analysis of the data. The analysis considers each jurisdiction’s legal and regulatory system and, where relevant, the other characteristics of its market including political, historical, cultural and social factors. These circumstances vary considerably from one jurisdiction to another in ways that fundamentally interact with the likelihood of successful CG reform and the manner in which it might be implementable. The analysis in Section 3 identifies recommendations that are subsequently presented in Section 4.

Section 3.1 sets out in some detail the thematic topics, and trends in regulating CG. It also identifies some of the important background considerations to CG, including the role of culture, assessing the costs and benefits of CG, and the methodology of assessing CG. The section concludes with an exploration of what is meant by “effectiveness” and

discusses the potential disjunct between a right-minded principle, the practice that in fact subsequently evolves in response, and the outcome that eventuates.

Sections 3.2 to 3.7 comprise the substantive analyses that give rise to specific recommendations - where a recommendation is made, a cross reference is provided to each recommendation in Section 4. These sections are intended to serve as largely self-contained discussions of 28 different topics of interest grouped together under six concept-driven headings. Inevitably, no topic on CG is self-contained because each topic interacts with the broader CG system it is located within.

Section 3.2 considers the issue of how to regulate non-locally incorporated companies listed in Hong Kong. Over half of the all listed issuers fall into this category. There are two major challenges with the regulation of these companies: setting the appropriate CG standards for these companies in view of the conditions imposed in the jurisdiction of their incorporation, and the enforcement of standards imposed in Hong Kong against the companies and their directors and senior management. The enforcement of the standards is particularly challenging with Mainland companies as many of them have no meaningful physical presence in Hong Kong - their business operations, assets and directors and officers may all be located in Mainland China. Such non-domestic companies present various difficulties, including investigation and the collection of evidence, and the enforcement of sanctions and other orders such as investor compensation orders.

Section 3.3 discusses the role of information in a CG system. This covers its disclosure and, importantly, the enforcement mechanisms where applicable requirements are not met, some of which arise out of the law and others arising out of non-statutory codes, which gives rise to different levels of enforcement effectiveness. This section, therefore, also explores practical ways in which compliance can be better secured.

Section 3.4 explores the concept of shareholder involvement and the mechanisms by which the voices of shareholders are facilitated in relevant governance concerns of the company. This includes the concept of shareholder stewardship, the rights attaching to shareholder votes, specific issues related to executive compensation, and event driven matters relating to changes of control.

Section 3.5 explores the issue of equality of voting rights, in particular the one-share-one-vote principle, the question of weighted voting rights (or dual class shares), and the relationship between public market concerns and private law rights.

Section 3.6 focuses on the mechanisms by which directors are held accountable to shareholders. An important issue in this regard is board refreshment, as well as whether INEDs should be directly appointed by minority shareholders. Section 3.6 also analyzes the difficulties faced by minority shareholders in Hong Kong in pursuing legal remedies, including the absence of class action rights and contingency fees in Hong Kong, which is sometimes seen as a significant impediment to shareholders law suits.

Section 3.7 explores the question of the effectiveness of the CG system. This is longest of the analysis sections and also leads to the largest number of recommendations. This is no surprise since, ultimately, rules and regulations concerning CG will only achieve their purpose if they are effective. Whether the system is effective depends on a broad spectrum of factors that, as already noted, are interrelated. At the level of CG system design, this concerns matters such as the tools used to develop policy, the effectiveness of enforcement agencies, and the oversight of public auditors. At the more specific level, it concerns matters such as the operation of gateway mechanisms designed to filter out issuers that are not ready for life as a public company, managing the relationship between controlling shareholders and the company, and the characterization of INEDs and the role they are expected to perform. In particular the dual responsibilities model of

oversight of the listed market undertaken by the HKEX and the SFC has been the subject of much discussion. As there is inadequacy in the current system particularly with regard to enforcement, this Report explores a number of mechanisms that improve the effectiveness of the system without disruption to the dual responsibilities model.

1.3.3 Recommendations

Each recommendation in Section 4 is based on the analysis in Section 3 and provides a cross reference to the relevant section(s) in which the analysis leading to the recommendation can be found.

Recommendations are developed according to a number of factors: the level of complexity involved to implement a recommendation, the support obtained for each recommendation, and whether a recommendation is likely to be contentious to the industry. As explained in Section 4, this gives rise to a system that serves to indicate the overall force of each recommendation:

Compelling (C) – Advocate (A) – Support (S) – Explore (E).

Each recommendation provides an outline of the steps suggested to implement it as well as the attendant considerations.

The recommendations are divided into a three main themes that are concerned with board processes, enforcement, and architecture and policy.

A total of 28 recommendations have been made.

1.4	Scope and limitations of this Report
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The evolution of Hong Kong's CG system has historically been largely driven by the UK, which seems appropriate given that Hong Kong's legal system is based on and has developed out the UK's. The regulatory architecture of the UK has since taken directions that have not been followed in Hong Kong. In 2000 it established a statutory listing authority, and in 2013 it moved to a twin peaks model of regulation. While Singapore has broadly followed suit as regards giving statutory effect to listing rules that incorporate many CG standards, the changes in the UK has left Hong Kong in something of a quandary, whether to keep looking to the UK or to look more to the United States, which in various regards shares important structural similarities to Hong Kong's listed market. The United States is also perceived as an important competitor to the Hong Kong market, which has recently driven much discussion as to the handling of key CG concerns, in particular the one-share-one-vote principle. Whether Hong Kong should respond to competitive challenge by adopting the approach of another jurisdiction can easily become the question of whether this is simply giving effect to regulatory arbitrage and, on some topics, the degradation of standards.

It is clear from the present study that Hong Kong has in the past been following developments in the United States and the UK more than anywhere else. As these two jurisdictions are also important market leaders in the field of CG, emphasis has been placed on the developments there in the analysis in Section 3. Of course, other jurisdictions also represent significant voices in the development of the CG debate, amongst which Australia and South Africa are notable, even though these are small and largely domestic markets.

Singapore as a rival and competitor in the East Asia region, has some comparative lessons for Hong Kong, although, not being a market leader, the lessons are somewhat more limited compared to the United States and the UK. It is not possible to undertake a study of CG in Hong Kong without considering Mainland China, despite fundamental differences between the two jurisdictions. As it does not have overseas companies listed in its stock markets, and while there is no shortage of laws and regulations pertaining to CG, the comparative lesson for Hong Kong has obvious limitations. This is complicated by the fact that it is a civil law jurisdiction with a different institutional framework, political system and market ideology. Nevertheless, it is useful if not essential to have a better understanding of the system in Mainland China, so that policy makers, regulators and market participants in Hong Kong can make relevant adjustments to better regulate Mainland enterprises listed in Hong Kong.

1.5	Next steps
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This Report, in particular the recommendations in Section 4, provide suggestions that are intended to be helpful and thought provoking for the Government, policy makers, regulators and investors. While the stated objective of this Report is to make recommendations for improving CG standards in Hong Kong, an important interim purpose is to generate discussion that will lead to a positive evolution of Hong Kong's CG system.

Section 2	METHODOLOGY
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Section 2 - Contents

Introduction

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Introduction

Purpose

This section sets out the scope of work undertaken in furtherance of the purposes of this study discussed in **Section 1**.

There are two primary methodological questions that need to be addressed in a study of Hong Kong corporate governance (CG) that references CG systems in other jurisdictions: defining the scope of CG as a concept, and determining the geographical scope of the comparator jurisdictions.

The topic of CG is clearly open to many different approaches depending on how one defines CG, "good CG" and what values are assigned to its role in relation to the market as a whole, the owners and managers of the company, and the other entities that have a stake in the way the business of a company is organized and run. The parameters of "good CG" for the purposes of this study are set out in **Section 2.1.1** "CG concepts".

The study is in large part driven by considering Hong Kong's CG system in light of the CG systems that have developed in other relevant jurisdictions. The rationale underlying the choice of jurisdictions for the purposes of this study is set out in **Section 2.1.2** "Geographic reach".

Section 2.2 "Work process" explains the approach taken to the undertaking of the study including the collection and organization of data, the preparation of the jurisdiction summaries in the Appendices and the development of the analysis and recommendations in **Sections 3 and 4** of this report.

A note on funding

This project was entirely funded by the Hong Kong Institute of Certified Public Accountants (HKICPA). The general scope of the study was framed by the HKICPA, as discussed in **Section 1**. The mandate given to the authors of this report was to conduct an independent enquiry and accordingly this study was not constrained by any preset views, preferences or desired outcomes, nor did it include any requirement to have regard to the interests of the members of the HKICPA. The HKICPA formed a Working Group³⁸ to monitor progress. While there was a diversity of opinion within the Working Group on various recommendations made herein, the final decision to include or not include a recommendation rested solely with the authors of this report.

³⁸ The members of the working group are listed in the Foreword of this document

2.1	Scope
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2.1.1 CG concepts

The notion of CG is clear enough when discussed in very general terms. However, for the purposes of any study of CG it should be recognized that there is no one all-encompassing agreed definition of CG and its parameters, or what constitutes “good CG” in its detailed implementation. Instead, the approaches of different regulatory agencies, the views of different participants and stakeholders, and the theories put forward by academics reveal a profusion of conceptual and value-laden variations in how CG is to be understood, the variables that are relevant to CG, and the objectives it is seeking to achieve.

The divergent values different parties assign to discrete variables that are recruited to the CG debate ranges from a relatively contained issue, such as quarterly reporting, to commercial questions as to the relative weight that should be given to the voices of short-term investors versus long-term shareholders, to more socially complex issues, such as gender and racial diversity on the board.

The Organisation for Economic Co-operation and Development Principles of Corporate Governance³⁹ discuss CG around six themes, each of which are expanded upon by sub-principles: ensuring the basis for an effective corporate governance framework; the rights and equitable treatment of shareholders and key ownership functions; institutional investors, stock markets, and other intermediaries; the role of stakeholders; disclosure and transparency; and the responsibilities of the board. In general, Hong Kong’s regulatory system addresses each of these themes reasonably well, the notable exceptions being: the articulation of regulatory responsibilities, particularly between the Securities and Futures Commission and the Hong Kong Exchanges and Clearing Limited, the role of the board, the role of broader stakeholder groups that are largely ignored in Hong Kong’s *laissez-faire* economic and legal structure, and the quality of disclosure and transparency.⁴⁰

One may also refer to “good CG” in various prescriptive ways, for example, in terms of behaviour that is considered desirable based on a set of assumed *a priori* values, or to those aspects of a CG system that serve to foster that behaviour and deter undesirable behaviour, or to the ability of a stakeholder (however defined) to perform a role in CG outcomes (whether *ex ante* or *ex post*). Conversations about CG frequently sometimes fail to make such distinctions and often fail to identify the underlying assumed values on which a viewpoint is based.

Accordingly, it is necessary to provide some sort of framework around how this study will, having regard to the overarching purposes of this study as set out in **Section 1** above, approach the concept of CG and how “good CG” is to be understood. As a study directed toward practical suggestions as to how CG can be improved in Hong Kong, this study does not dwell on CG theory, except where to do so is relevant to an explanation as to why a change has been made and why it has worked or failed etc. The comparative aspect of this study requires an approach that is to some extent jurisdiction-neutral.

In view of the foregoing considerations, this study has adopted the following approaches

³⁹ OECD (2015), *G20/OECD Principles of Corporate Governance*, OECD Publishing, Paris: Available at <http://dx.doi.org/10.1787/9789264236882-en> (visited on 10 Nov 2017)

⁴⁰ For a discussion, see: Douglas W Arner, Berry Hsu, Say H. Goo, Syren Johnstone, and Paul Lejot, *Financial Markets in Hong Kong: Law and Practice* (Oxford: Oxford University Press, 2nd edn, 2016), 10.05-10.11

to understanding “good CG”:

good CG is assumed to underpin shareholder rights, remedies and protections;

good CG is assumed to underpin an appropriate level of oversight of the management by the owners of the company;

good CG is assumed to be desirable as a means of fostering market integrity and market confidence;

CG mechanisms (see below) that are designed to bring non-locally incorporated companies within a local CG framework are regarded as supporting good CG;

the viewpoint of a minority shareholder is adopted (as opposed to, for example, board members or other stakeholders in a company's operations);

to the extent possible, the “good CG” concept ignores the reality that different minority shareholders in practice may attach different priorities to their shareholding interest (e.g.: share price performance over a shorter versus longer term; improvements in corporate social responsibility; dividend performance; etc), except where it has been necessary to take into account, for example, in relation to shareholder activism;

to the extent possible, other matters related to the CG debate are in general excluded, such as stakeholder governance, stewardship, gender and racial board diversity, corporate social responsibility, and various aspects of internal governance processes by which the board directs and controls the undertaking of the company's business;⁴¹

no examination is undertaken as to whether there is any relationship between good CG and share price performance or management performance.⁴²

The above list is of course not designed to form any comprehensive definition of what is good CG - as already noted, there are a number of different approaches to the CG question and the foregoing merely serves as a framework around the restricted purposes of this study.

For the purposes of organizing material generated by the study the CG concept is understood as being dependent on five key variables:

Information – Involvement – Equality – Accountability – Effectiveness.

These variables are not mutually exclusive. For example, the ability of a shareholder to exercise or enforce their rights may depend on what they know (information), their ability to influence (involvement/equality), and the means by which they can hold management responsible (accountability), which together reflect the efficacy of a CG system (effectiveness). With this complexity in mind, these five variables also serve as a structure for the discussion and analysis in **Section 3**:

Information – Whether the information flow to shareholders of CG-related

⁴¹ It is recognised that issues such as these are among the forefront of presently active issues in the CG debate. However, it is also observed that some of these topics invoke a great variation of opinion that can turn on expressed or assumed societal values and concerns rather than the more restricted topic of shareholder rights, remedies and protections per se with which this study is concerned.

⁴² This is primarily because this study does not attempt any quantitative analysis, which would be required for an assessment of that relationship. While many studies undertaken by others do suggest a positive relationship between good CG and share price performance, there are many others that do not reach that conclusion.

matters is adequate. For example: the timeliness and adequacy of disclosure and when mandated by laws or regulations; whether information as to the effectiveness of the board including its subcommittees such as the audit committee in undertaking its operations is adequate; whether the mechanisms that support such information are adequate. This is discussed in **Section 3.3**.

Involvement – Whether shareholders are given adequate opportunity for involvement in the affairs of the company. For example: shareholder involvement in decision making generally as well as specific issues of CG concern such as executive compensation; what circumstances trigger shareholder involvement. This is discussed in **Section 3.4**.

Equality – Whether shareholders are treated equally. For example: the principle of one-share-one-vote as compared to weighted voting rights/different share classes; equality of voting power in specific transaction scenarios (such as takeover and other offers); when shareholders are excluded via a disinterested shares concept. This is discussed in **Section 3.5**.

Accountability – The mechanisms that hold the exercise of management power to account. For example: mechanisms of redress in relation to the disclosure of information; compliance with the listing rules; accountability to shareholders individually or as a class or via regulatory agencies; the appointment of directors and board refreshment. This is discussed in **Section 3.6**.

Effectiveness – Whether the CG system is effective with regard to procuring desired behaviours and deterring behaviour considered inconsistent with good CG. For example: the overall adequacy of the CG system design; adequacy of legal remedies; effectiveness of regulatory bodies; whether independent non-executive directors (INEDs) are effective. This is discussed in **Section 3.7**.

The topic of non-locally incorporated companies is discussed in **Section 3.2**.

2.1.2 Geographic reach

While the resources of any study are not unlimited, a number of jurisdictions were considered for inclusion in the study.

As mentioned in Section 1, in addition to Hong Kong this study brings within its consideration the CG conditions in the United Kingdom (UK), the United States, Mainland China and Singapore. These jurisdictions have been selected for the following reasons:

UK – Hong Kong’s legal and regulatory system is based on the UK’s and there are many similarities in the approach sought to be taken to address CG standards in both markets, albeit that there have been important structural changes in the UK that have not been adopted in Hong Kong. The UK can also be regarded as playing an important role in thought leadership in relation to CG globally.

United States – the largest, and in that sense arguably the most successful, listed marketplace in the world, the United States has adopted fundamentally different approaches to regulating CG albeit based around a common law system.

Mainland China – Mainland businesses and business interests account for a significant proportion of new listings on, and total market capitalization of, The Stock Exchange of Hong Kong Limited (SEHK), a proportional representation that has been increasing markedly over the past one to two decades that is expected to continue to increase. Mainland related issuers also represent the single largest source of non-Hong Kong incorporated companies that are listed on the

Exchange.

Singapore – although a much smaller market than Hong Kong, Singapore has traditionally been regarded as Hong Kong’s natural competitor in the Asian time zone. Moreover, while the CG system in Singapore is similar to Hong Kong insofar as both are derived from the UK and its legal and regulatory systems, divergences of approach (from both Hong Kong and the UK) have opened up over the past decade or so that makes Singapore an interesting comparator.

Other jurisdictions that were considered for inclusion in the study were the following: Australia and South Africa (owing to their progressive approach, however, both are relatively small, primarily domestic markets); Germany (as it is a leading member of the European Union with a legal system on which Mainland China’s is largely derived, however, its legal system is very different from Hong Kong’s, its stock market is not notably an international one and there appears to be very little persuasive thought leadership on CG). Some consideration was also given to examining the Cayman Islands, as this is the most common offshore jurisdiction in which SEHK-listed issuers are incorporated. However, its laws are largely similar to those in the UK by virtue of being a British Colony, there is little local jurisprudence with English legal decisions being almost always followed,⁴³ its stock exchange is young⁴⁴ and traditionally focussed on product listings rather than the equity of operating businesses, and the territory does provide any leadership in CG. Although many Mainland enterprises are incorporated in the Cayman Islands, the prevailing cultural attitude of their directors and controlling shareholders are, unsurprisingly, aligned to those in Mainland China not the Cayman Islands. A similar set of arguments can be made out in relation to the second most popular offshore incorporation venue for SEHK-listed issuers, namely, the British Virgin Islands.

2.1.3 CG mechanisms

As this study is essentially directed toward implementation rather than theory, the following are considered to be the primary mechanisms that are capable of influencing CG behaviour in practice:

- applicable law (both primary and secondary legislation as well as case law);
- non-statutory regulations;
- stock exchange listing rules;
- the role of third parties (e.g. independent financial advisers, auditors);
- rules of professional bodies (e.g. HKICPA, Hong Kong Institute of Chartered Secretaries etc);
- voluntary self-imposed issuer practices;
- market practices and expectations; and
- cultural factors.

It is recognized that each of the above has significantly different valencies when considered in the context of a CG system when looked at as a whole. That is, in terms of the power of a mechanism to attract good CG or displace undesirable behaviours. For

⁴³ “Guide to the legal system in the Cayman Islands” Appleby, January 2015

⁴⁴ Established 1996

example, a law (or regulation) may establish a very specific penalty or recourse for a certain act that may be quite effective to that specific extent. However, certain other acts (possibly falling around the borders of that law) may be influenced by a much broader set of cultural behaviours that may, despite being more inconspicuous or vague, nevertheless drives (or attracts) a large number of more diverse and iniquitous practices (or *vice versa*).

Accordingly, the above mechanisms cannot be assigned equal values in their ability to procure good CG, nor can each of them be regarded as having the same valence or directional effect in each of the jurisdictions studied.

While this study discusses these mechanisms in detail at various points, see **Section 3.1** "Overarching considerations" for a further overview discussion.

2.2	Work process
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2.2.1 Data collection

Within the scope of the considerations set out in **Section 2.1** above, the initial primary task of commencing this study was to undertake a review of each of the jurisdictions studied.

This exercise was focused on the present state of affairs in each jurisdiction. Recent developments in each jurisdiction was assessed with a view to garnering a better understanding of the directional shifts that CG systems having been taking since around 2000, as well as understanding the extent to which developments in the CG mechanisms have been more or less effective, or in some instances, counterproductive.

In undertaking that research, the focus was on issues that may be relevant to Hong Kong, and how these issues are addressed in other comparative markets.

An initial sweep of the following materials obtained from online and library sources was undertaken for each to this report:

- laws (statutes and common law or equivalent; case law);
- non-statutory regulations;
- stock exchange listing rules;
- policy papers of the government;
- consultation papers of the regulator;
- academic journal articles;
- market statistics (where available);
- media coverage;
- other sources as appropriate.

In this initial part of the data collection exercise some care was taken to check if the overseas CG system has been accurately described, particularly having regard to sources that may describe the CG system as operating differently in practice from what may appear in the text.

2.2.2 Initial data organization

The above exercise was organized under a set of eight key factors that also form the structure of each of the Appendices to this report on each jurisdictions studied:

- Market overview – structure, characteristics and culture (section 1 of each Appendix);
- CG policy (section 2 of each Appendix);
- Legislation (section 3 of each Appendix);

- Regulation (section 4 of each Appendix);
- Other influences (section 5 of each Appendix);
- Enforcement (section 6 of each Appendix);
- Shareholders' rights and protections (section 7 of each Appendix);
- Regulation of non-local companies (section 8 of each Appendix).

2.2.3 Oral evidence

Concurrent with the data collection and organization process, oral interviews were undertaken with ten persons on a candid, confidential and off-the-record/no-attribution basis. Those interviewed included senior individuals from issuers, investment banks and regulators, among others. No consideration was exchanged for taking part in an interview.

Each interview lasted around 90 minutes. Prior to the interview, broad areas of interest were identified to the interviewee as well as an indication of the research being undertaken in connection with the data collection exercise. This included providing a list of open-ended questions⁴⁵ as well as broad topics of interest.⁴⁶ The purpose of this was to frame the context of the interview rather than to limit its scope and in some interviews new areas of enquiry emerged based on the interviewee's personal experiences, observations and expectations.

The interviews were used primarily as a means to crosscheck and to further stimulate the main directions the study was taking. The interviews provided another avenue to identify and explore areas of CG that were perceived to be problematic, as well as those areas thought to be working well. While each interviewee's profile and experience lent a slightly different emphasis to the discussion, it was not unusual to see areas of common concern identified.

Although the focus of each interview was the CG system in Hong Kong, in several cases the interviews came to discuss developments or differences in other markets. The need to understand the context of Mainland China was a repeating theme.

The opportunity was also taken to discuss the areas most in need of reform as well as testing, in a very preliminary sense, some initial thinking as to what reform proposals might or might not work and/or be acceptable to the Hong Kong market.

2.2.4 Parity check

The CG system of each of the jurisdictions studied was considered in view of the Hong Kong context. Initially, this focused on identifying key differences and observations of interest ("KDOI") across the systems studied – observing points of similarity or difference against the broader context in which each CG system operates. While many differences in the details of each CG system can be observed, the focus was to identify those likely to be of greater relevance to discuss and analyze with a view to identifying recommendations. This exercise encompassed developments elsewhere that might be capable of adoption or adaptation in Hong Kong and which might serve to address

⁴⁵ For example, "What IS/IS NOT working in HK CG standards?", "What is the most commonly abused aspect of CG?", "What is the area of CG with the greatest consequence in practice?"

⁴⁶ This included topics related to the role of non-executive directors and INEDs, the role and function of board committees, the position and role of shareholders and controlling shareholders, the role of regulators and regulations, board processes, the impact of cultural factors in respect of non-local companies, etc.

weaknesses in Hong Kong's CG system and/or improve the long-term competitiveness of the Hong Kong public market.

2.2.5 Analysis

The parity check and identification of KDOI provided a set of data against which the analysis of the jurisdictions studied was undertaken.

Without in any way limiting the scope of the analysis, three themes of the analysis were:

- to identify what already works well or is well developed in Hong Kong's CG system;

- to identify shortcomings in Hong Kong's CG system, particularly in light of developments implemented in the jurisdictions studied;

- to consider experiences, innovations and specific provisions in the jurisdictions studied in the Hong Kong context.

The purpose of the analysis is to build toward identifying and supporting recommendations for changes in Hong Kong's CG system. In that undertaking it was also necessary to consider the wider context of each jurisdiction studied, meaning not just its legal and regulatory system but also the other characteristics of a market. This includes not only matters relating to the legal system but also political, historical, cultural and social factors that may vary considerably from one jurisdiction to another in ways that fundamentally interact with the likelihood of successful CG reform and the manner in which it might be implementable.

While CG standard setting is increasingly subject to a global approach, different markets having different characteristics means that a reform in one jurisdiction may not be suitable in another for a variety of reasons – simple transpositions frequently ignore the realities of those differences and may fail to be effective for that reason. As discussed further in **Section 3.1.7** "Effectiveness", the implementation of and compliance with new CG-oriented rules does not always equate to better CG in practice – a box-ticking approach to compliance being one prevalent example of this that presents a validation problem.

In undertaking the analysis it was also recognized that an important aspect of considering changes to the CG system is that governance is in effect a social science practice in which behaviours can be affected by psychosocial factors spanning matters such as knowledge, conformity, and the acceptance of new expectations and standards. In other words, CG behaviour should not be understood as one that is merely reactive to the imposition of legal and regulatory requirements - it is capable of being driven in new directions by other factors.

The analysis is set out in **Section 3**.

2.2.6 Recommendations

The recommendations of this study were developed in view of the following considerations:

- recommendations are made by reference to the scope and purposes of this study;

- recommendations are derived from the analysis, which also provides the primary support for each recommendation;

recommendations seek to identify options for improving identified shortcomings in Hong Kong's CG condition or that may serve to improve the CG conditions in Hong Kong;

the relevant distinctions between legal and regulatory systems as well as market and cultural differences were taken into consideration;

developed proposals that had been made historically, recently or were currently underway in Hong Kong without further development or implementation were considered;

recommendations are not intended to be all encompassing, present total solutions or deal with all extant problems.

A recommendation is by its nature a proposal that it is suitable to the intended purposes. The process of identifying recommendations was affected by the consideration of not only the strength of support from and relevance of experiences in other jurisdictions but also what is involved in implementing a recommendation. This includes the relative ease or difficulty of realizing a proposal, for example, whether a change to primary law or regulatory architecture is required or if it is merely an adjustment to an existing non-statutory code or practice. The likelihood of a proposed change being contentious was also taken into consideration.

While these factors were weighed in the formulation of the study's final recommendations, it was not the case that recommendations were avoided simply because they were difficult and contentious. Nor were they advanced simply because of actions undertaken in another jurisdiction that was studied. Accordingly, the recommendations presented in this study are accompanied by a system of variables that reflect the above considerations together with a logical weighting of recommendations that range from "strongly recommend" to "consider".

As "practical", "useful" and "implementable" are key themes of this study that underlie the recommendations, a brief indication of what would be required to implement the recommendation has been provided together with an overview of the attendant matters that may need to be considered in connection with a decision to implement a recommendation.

On the other hand, this study considers certain proposals but has reached the conclusion that no recommendation can be made in respect of that proposal. These are also presented in this study on the basis that whereas the specific scope of this study finds insufficient grounds to support it, another study with a different orientation may find otherwise. In other words, these "no recommendation" proposals are not to be read as an outright rejection or assertion that such proposal is unsuitable for any CG-related purpose.

The recommendations are set out in **Section 4**.

Section 3	DISCUSSION AND ANALYSIS OF JURISDICTIONS STUDIED
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Introduction

Purpose

This Section comprises a discussion of the key differences and observations of interest arising out of the study of the four comparative jurisdictions studied.

A considerable amount of detail on each jurisdiction is provided in Appendices I to V. Bearing in mind the primary objectives of this study as described in Section 1, this Section 3 comprises a highly focused and selective discussion that provides a segue between the detail provided in those Appendices and the recommendations made in Section 4. Each of the recommendations in Section 4 provides a cross-reference to the relevant part of this Section 3.

While this Section 3 comprises a discourse on some of the more notable items of interest arising out of the jurisdictions studied, it is not intended that every matter discussed herein is to lead to a recommendation. Many parts of Sections 3.2 to 3.6, serve as groundwork for other Sections, notably Section 3.7, which is concerned with effectiveness and gives rise to the largest number of recommendations in Section 4.

Nor is this Section 3 intended to be a general summary of the Appendices or an overview of the similarities and differences between the jurisdictions studied. Where it is appropriate to do so, a cross-reference to the relevant part of an Appendix is provided for further detail.

As summarized next, this Section 3 first addresses some overarching considerations in Section 3.1 that are relevant to and frame the subsequent Sections 3.2 to 3.7 that provide an analysis of the key observations made by this study.

Overarching considerations

Section 3.1 "Overarching considerations" comprises a discussion of common themes, trends, issues and considerations that are at present highly relevant to the assessment and development of a corporate governance (CG) system.

Section 3.1.1 "Thematic topics" considers a number of common topics that have emerged as themes in the jurisdictions studied, despite the variation across the different jurisdictions' legal and regulatory architecture as well as basic concepts about the nature of the corporation and the relative role of managers and owners in relation to it. This includes the position of CG within the jurisdiction's system, the availability of enforcement and remedies, the role of the board, the role of shareholders, controls on gateways, and the position of non-local companies.

Section 3.1.2 "Trends in regulating CG standards" observes that the different ways in which CG standards are regulated and developed is both driven and constrained by the approach to developing legal and regulatory infrastructure as well as political, conceptual and cultural factors. In addition to the fundamental differences between common law and civil law systems, different jurisdictions also engage different concepts of the nature of the corporation and the role of its managers and owners that impact on the approach to CG.

Section 3.1.3 "The role of culture" introduces the position that culture plays in a CG system. While CG culture has since the 2008 global financial crisis received much more attention, the question of how to measure, assess, regulate or influence CG culture remains under discussion.

Section 3.1.4 "The methodology of assessment" identifies some fundamental issues,

and common though possibly mistaken approaches, in relation to measuring the effectiveness of CG. Whether one is considering measures of corporate performance or formulating policy development it will always be relevant to understand how to differentiate between compliance with a regulatory requirement and achieving a desired outcome or objective - two matters that are commonly conflated by mistaking the rules for the objectives they set out to achieve.

Sections 3.1.5 "Cost-benefit considerations" and **3.1.6** "Maintaining competitiveness" discuss interrelated concerns that consider the topic of CG from macro perspectives. Both Sections recognize that CG is ultimately part of a wider market system that a CG system must serve.

Section 3.1.7 "Effectiveness" follows on from the preceding **Section** to consider the potential disjunct between a right-minded principle, the practice that in fact subsequently evolves in response, and the outcome that eventuates. Closing out such disjuncts should be an objective of any CG system, failing which there is a risk that box-tick compliance with a CG rule or principle can in effect become a false validator of the behaviour actually undertaken. Similarly, CG policy development must be astute to the real as opposed to apparent effectiveness of CG regulations to ensure they do not operate as a distraction from the objective sought to be achieved. In the absence of addressing the foregoing, it is observed that the imposition of additional CG rules or principles can be counterproductive.

Analysis Sections

The question of how best to group together the key observations made by this study is open to different approaches. It goes without saying that the concerns that drive the CG debate do not fit into a neat and mutually exclusive taxonomy but are fundamentally interactive. For example, the transparency of corporate information to shareholders is essential to the ability of a shareholder to meaningfully exercise their voting rights, which in turn depends on the extent to which applicable laws, regulations and practices in a market empower and protect them. The latter includes the ability, both in theory and in practice, to seek legal redress where there has been wrongdoing. How one divides up the CG discussion therefore to some extent depends on the purposes for which the discussion is undertaken. There is no single "correct" taxonomy.

Section 2.1.1 has set out the approach taken, for the purposes of this study, of how "good CG" is to be understood and the five key variables upon which good CG is dependent. Together with the particular problem of dealing with non-locally incorporated companies, this forms the layout of this section, although in many places it would be open to discuss a particular item of interest under one or another of the following headings.

Section 3.2 "Non-locally incorporated companies" considers the application and enforcement of CG standards to companies that are established in a jurisdiction other than the market on which its shares are primarily traded.

Section 3.3 "Information" considers the mechanisms that promote the timely acquisition and disclosure of CG-related information to shareholders, and to the board itself.

Section 3.4 "Involvement" considers shareholder involvement in decision-making and what circumstances enable or trigger their involvement.

Section 3.5 "Equality" considers the basic voting rights of shareholders in a company.

Section 3.6 "Accountability" considers the mechanisms by which management

accountability to shareholders is established.

Section 3.7 "Effectiveness" considers elements of the CG system design relevant to procuring desired behaviour and deterring behaviour considered inconsistent with good CG. Many of the concerns of previous Sections depend on the support of the system in this regard.

The final **Section 3.8** "Coda" serves to wrap up the analysis as a segue to **Section 4** "Recommendations".

3.1	Overarching considerations
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Introduction

The discussion in this Section 3 is necessarily subject to a raft of considerations as regards the wider context in which CG standards are developed, acts are performed (or not performed) and responses and consequences assessed. While it is not a primary purpose of this Report to undertake a detailed examination of this wider context, it is appropriate to provide some commentary as a means of better illuminating the analysis in Sections 3.2 to 3.7. The balance of this Section 3.1 discusses:

- thematic topics that have been identified from the key differences and observations of interest, a subset of which have led to recommendations (Section 3.1.1);
- the trends in regulating CG standards across the jurisdictions studied (Section 3.1.2);
- the role of culture in putting CG standards into effect (Section 3.1.3);
- assessing the costs and benefits of regulation (Section 3.1.5);
- the importance of maintaining competitiveness (Section 3.1.6);
- the methodology by which good CG is measured and how this feeds into the development process (Section 3.1.6);
- how effectiveness should be approached (Section 3.1.7).

3.1.1 Thematic topics

The topic of shareholder rights, remedies and protections, and the position of overseas companies listed in Hong Kong naturally brings within the reach of a comparative study of CG a number of considerations that range from the regulatory architecture of the jurisdiction, to the specific provisions of the system, to the cultural context against which the foregoing must be read. The 3 C's of the investor base in each jurisdiction - composition, CG culture and characteristics - is a relevant factor in relation to each of the foregoing.

Thematic topics that have been identified from the key differences and observations of interest, a subset of which have informed the discussion in Sections 3.2 to 3.7 and the recommendations in Section 4, are as follows.

The CG system:

The fundamental design of the CG systems studied vary in important ways that have an impact on the more specific tools used to implement good CG, as further discussed in **Section 3.1.2** "Trends in regulating CG standards". This includes factors such as:

- the presence or absence of a dedicated CG standards body;
- the basis of the model being shareholder-centric as compared to board-centric;
- and

the extent of gaps and overlaps in the oversight and development of CG.

The comparative roles of the exchanges, the industry regulator and oversight and review bodies, and their structural position within the regulatory architecture and legal system, are notably different, and this has an impact on the means by which CG standards are developed as well as the available mechanisms of enforcement. A good example of this can be seen when one compares the systems in the United Kingdom (UK) and the United States. Although the UK's Financial Reporting Council (FRC) performs an important CG standard-setting role that is entirely non-statutory, decision of the Financial Conduct Authority (FCA) to incorporate, by reference, FRC CG standards into the listing rules serves to create potential legal consequences for certain types of breaches of those standards - while the architecture does not itself provide for CG standards, the regulator is sufficiently empowered to bring about that consequence. In contrast, in the United States (which does not possess any CG-standard setter equivalent to the FRC) CG standards are primarily developed and enforced by Federal and State mechanisms that include legislative bodies, courts and the statutory regulator the Securities and Exchange Commission (SEC) - while the listing requirements set by the exchanges do impose CG standards, they are only introduced with the approval of the SEC and are typically dovetailed with other requirements that bring them within the scope of Federal liability. Hong Kong is different yet again - unlike the UK the listing rules in Hong Kong themselves set out CG standards, the Securities and Futures Commission (SFC) as statutory regulator has powers over the listing rules similar to the SEC, but unlike either the SEC or the FCA the SFC's powers in relation to breaches of the CG standards are relatively limited. Development is also particularly prone to the characteristics the 3 C's of the investor base and the influence they are able to exercise on the development process, and at what stage of the process their influence bites.

Enforcement / remedies

The degree and types of power given to regulators and the presence or absence of laws and regulations that can be and are actively enforced varies considerably across the jurisdictions. The prospective liabilities vary considerably, ranging from relatively less severe sanctions such as private or public censures, to director disqualification, fines in limited or unlimited amounts, trading suspension, shareholder compensation, and criminal offences. The body that is empowered to impose the same also varies, from regulatory agencies, to administrative tribunals, to the courts. The SFC has less power than some of its leading international counterparts, certainly less than either the FCA or SEC, for example, as regards the power to make regulatory law and to impose administrative sanctions. The powers of the regulatory bodies also vary in relation to the origination and enforcement of listing rules, as shown in the following Table:

	Issues CG Code	Issues listing rules	Approve listing rules	Enforces listing rules
SFC	No	Can, though not in practice	Yes	Only indirectly
FCA	No ⁴⁷	Yes	N/a	Yes
SEC	No	No	Yes	No
CSRC	Yes	No	Yes	Yes
MAS	Yes	No	Yes	No ⁴⁸

One might expect that where an enforcement agency has weaker powers this is compensated by shareholders having greater powers, however, this is not the case. The ability of shareholders to bring an action, and the basis on which an action can be

⁴⁷ The UK CG Code is instead issued by the UK's Financial Reporting Council

⁴⁸ Except continuing disclosure covered by s 213 Securities and Futures Act (Cap. 289) (SFA))

brought vary considerably – here some emphasis must be lent to the ability to bring an action in practice, not merely the enabling laws. An important distinction in this regard is the availability of some form of collective redress. The class action lawsuit in the United States is regarded by the Organisation for Economic Co-operation and Development (OECD) as an effective “ex-post means of redress”.⁴⁹ The UK has also has introduced, since 2000, group litigation orders, although they operate as a case management tool rather than as a class action right *per se*. Mainland China has introduced very similar joint litigation adjudication procedures. Shareholders in Hong Kong have a range of remedies available under the law but do not have access to any means of collective redress. The Table below provides a brief comparison of the jurisdictions studied:

	Collective redress for breach of securities law	Civil action for damages for breach of securities law	Derivative action - foreign companies	Derivative action - domestic companies
HK	No	Yes	Yes	Yes
UK	Yes ⁵⁰	Yes	Yes	Yes
United States	Yes	Yes	Yes	Yes
Mainland China	Yes ⁵¹	Yes	N/a	Yes
Singapore	No	Yes	No	Yes

From the point of view of an issuer and its directors, the foregoing considerations provide a form of risk map in different jurisdictions of not engaging in good CG practices. This profile also may evolve over time as regulators shift their enforcement priorities. It also appears to evolve in response to the perception of imminent danger, that is, whether an enforcement action is likely to be meted out swiftly or subject to lengthy procedures that may take some years before it is finalized. Timeliness (and to some extent the inevitability) of enforcement actions varies significantly across the jurisdictions according to a number of factors including the mechanism of enforcement (for example, a fine swiftly imposed by a regulator as opposed to a tribunal or court after a more lengthy process) and the CG culture and accessibility to legal representation.

Board processes

While all the jurisdictions studied give considerable importance to the processes by which the board undertakes its responsibilities, the particular means by which this is managed toward improved CG standards varies. This includes matters such as: the degree to which executive remuneration is managed by processes internal to the board or by shareholders; the requirements attaching to director education and induction; the frequency of director re-election; whether the board should be subject to self-evaluation and, if so, whether this should be an internal or externally facilitated process; the other mechanisms of internal control required to be implemented by the board.

The role expected to be undertaken by the board member has always been subject to progressive change. Over recent years it has become more clearly understood that the directors need to interrogate the business and ask the difficult questions. However, the operations of the boardroom remain something of a black box. The increasing frequency

⁴⁹ Lack of Proportionality Between Ownership and Control, OECD, December 2007, 42

⁵⁰ Group litigation orders

⁵¹ Joint litigation – as discussed in Section 3.6.1, a pre-condition imposed by the rules of the court in respect of a securities civil compensation suit is that the CSRC must have issued a relevant sanction or the court a relevant judgment

of boardroom matters becoming items of front page news is causing a wider range of shareholders (and regulators) to ask who appoints and removes the board, and what transparency over board functions stakeholders are to be provided with.

A feature of all jurisdictions is the recognition that independent directors are an important component to board effectiveness. However, the details of their role and by what means they are to be empowered or held accountable is an area of considerable variance across the jurisdictions, including: how independent directors are appointed; how their independence is to be assessed; what roles they are expected to perform on sub-committees of the board; and whether or not their function is restricted to be an internal one that solely reports to the board. Of these issues, independence and competence of independent directors are of considerable interest, particularly as they directly impact on the ability of the individual to properly perform the role expected of them. An important differentiator is the extent to which independent directors are appointed and undertake their functions pursuant to mandatory requirements (at law or non-statutory regulation) or non-mandatory recommendations, and this has a consequential knock-on effect as to their liabilities where they do not properly undertake their role.

Shareholders

Closely connected to the foregoing topic, all jurisdictions are evolving new approaches to bringing better mechanisms of board accountability to shareholders. The means by which this is pursued on an ongoing basis is primarily through two mechanisms: the disclosures required to be made to shareholders, and the occasions on which shareholders are able to exercise their voice and their vote. A notable distinction across the jurisdictions is the attitude toward the voting rights attaching to shares, including what rights are permitted to be created and sold into the market as well as the circumstances in which public regulatory considerations are permitted to override the private rights that may otherwise be created and attach to shares.

A third mechanism, relevant on an event-driven basis, is the ability to bring a legal action against directors engaging in poor CG practices and whether or not breaches of non-statutory regulations amounts to some form of misfeasance relevant to legal remedies.

In each case, it is recognized in all jurisdictions that information disclosure through appropriate shareholder communication is essential to shareholder protection and the exercise of shareholder rights.

Gateway controls

While the different jurisdictions recognize that the CG practices of an issuer may (legitimately) vary considerably, different approaches are taken to the controls placed on issuers being admitted to the market, and the controls placed on information being released into the market. *Ex ante* controls are generally regarded as more cost effective than relying on *ex post* actions, however, the nature of the regulator's role in *ex ante* controls vary widely, in part reflecting their position in the legal and regulatory architecture as well as their preparedness to exercise their incumbent powers. There is also an apparent relationship between *ex ante* and *ex post* actions – where steps taken in relation to the former have failed to be effective, increased recourse may need to be had to the latter.

Non-local companies

The position of non-local companies in each jurisdiction varies across a number of dimensions including: what listing rules are to apply (or be disapplied); the means by

which directors are brought under responsibilities on par with directors of local issuers; the protections afforded to shareholders, including in particular the exercise of their voting rights; and the enforcement mechanisms in practice available in respect of each of the foregoing.

3.1.2 Trends in regulating CG standards

The specific means by which CG standards are regulated has developed in quite different ways in the jurisdictions studied. This is both driven and constrained by the approach to developing legal and regulatory infrastructure as well as political, conceptual and cultural factors. This includes the ability as well as the likelihood of enforcement whether by an enforcement agency or by a shareholder and, consequently, the extent to which CG standards are in their application established by the law courts (or statutory tribunals) and behaviour is driven by the perceived risk of liability.

Significant differences arise when considering the approach in the UK compared with that of the United States. In the UK the guiding consideration has been an across the board move in the area of financial regulation toward a statutory basis of regulation. Indicia of this includes the creation of the U.K. Listing Authority (UKLA), which moved regulation of listed issuers from the exchange to a statutory body, and the introduction of a twin peaks model of regulation. The regulator in the UK has significant powers of enforcement that are in general backed by a clear mandate of Parliament and the industry generally.

Whereas in the UK a strong shareholder-centric model drives the approach to CG standard setting, the United States is driven by a different concept of the relationship between company and shareholder that is far more board-centric. A guiding consideration in the United States is the likelihood of challenge in the law courts. This applies not only to shareholders seeking redress but also to the regulators, primarily the SEC, in the exercise of its statutory powers. This will involve both State law/courts and Federal law/courts, respectively. Viewed through the lens of the court, there appears to be significantly less alignment of attitudes toward the proper scope of CG between lawmakers, regulators and the market. This means that while the SEC has considerable power to create regulatory law, often as a result of a direct mandate from Congress in the form of primary legislation, it may encounter difficulties in implementing new rules that the FCA is unlikely to experience owing to the different cultural climate. However, the mandate of the SEC under the 1933 and 1934 Acts in relation to securities offerings and disclosures and its power over the stock exchanges in general remains a more robust source of regulating the disclosure element of CG. The critical intersection in this regard is standards set by the exchanges that are required to be reported on thereby bringing disclosures within the framework of Federal securities law.

In Hong Kong, the CG model is based on a shareholder-centric approach inherited from the UK during its period as a British colony. Development of CG standards revolves around the relationship between The Stock Exchange of Hong Kong Limited (SEHK) and the SFC, the powers of the SFC, and the position of shareholders both culturally and as regards their empowerment under the law. Dealing these in reverse order, although Hong Kong law creates a number of avenues through which shareholders can seek redress, court action is rare as a result of both cultural factors as well as the practical difficulties of bringing cases. Unlike the UK, breaches of disclosure requirements under the listing rules in Hong Kong are incapable of giving shareholders the right to a damages claim, unless some other breach of law is involved. The SFC's enabling legislation gives it the power to introduce subsidiary legislation,⁵² however, that power is not used in relation to CG standard setting. This reflects, in comparison to the position in the UK and in some ways more similar to position in the United States, a degree of non-

⁵² Subject to the negative vetting of the Legislative Council

alignment of attitudes between lawmakers, regulators and the market. The dual responsibilities model of regulatory oversight of listed issuers in fact positions the SEHK as the primary setter of CG standards, subject to the SFC's oversight. However, disclosures in the securities market that may pertain to CG standards are not subject to the same reach of the regulator, as compared to the United States, unless it amounts to an abuse of the market⁵³ or is relevant to the SFC's powers to suspend, impose conditions on, or cancel a listing under the Securities and Futures (Stock Market Listing) Rules (Cap. 571V) (SMLR).⁵⁴ Together, this currently leaves much of the detailed CG standards set by the SEHK subject to the comparatively weak enforcement mechanisms under its listing rules.

While the SFC has over the last several years gradually repositioned itself in the regulatory architecture in relation to the regulation of listed issuers, something that is largely supported by the Government, this has not been successful, again owing to the mis-alignment of attitudes toward CG already referred to. Consequently, the SFC has sought alternative means to impose themselves on the CG standards of listed issuers based on their more general regulatory objectives relating to market integrity and the protection of investors. It has taken as its cue suspicious corporate behaviour such as deep-discounted, highly dilutive rights issues, questionable placings on Growth Enterprise Market (GEM), and over-valued acquisitions. One mechanism is through the SFC's direct regulatory oversight of intermediaries that service the needs of issuers. Here the focus has been on raising the standards of and scope of duties imposed on sponsor work in relation to new listing applications. This includes a significant revision to the sponsor regime in 2013, addressing concerns in relation to new listings, and the duties of financial advisers in relation to valuation matters. A second mechanism is through their investigative and enforcement powers in relation to listed issuers under the Securities and Futures Ordinance (Cap. 571) (SFO). Here the focus is on bringing actions in respect of, for example, corporate fraud, misleading financial statements, conflict of interests, or failure to disclose inside information. However, as compared to its direct administrative powers over licensed intermediaries to impose discipline including fines, the exercise of its powers in relation to listed issuers is resource intensive as an action will need to be brought before an administrative tribunal or the court. In contrast to these derivative approaches to regulating CG standards, the powers of the FCA are much more direct and resource-efficient.

Although Singapore's system may also be described as shareholder-centric and similarly based on the common law tradition, the political dominance of the PAP in Singapore means that it can exercise considerable control over the standards setting and enforcement powers of the industry regulator. Similarly, the dominance of the Chinese Communist Party (CCP) in Mainland China means that there is significant political influence on the regulator. Ironically, even though Mainland China has a civil law tradition, which is very different from the common law tradition, the design of the power structure within its CG regulation is remarkably similar to that of Singapore. In both Singapore and Mainland China, enforcement of CG standards, either by shareholders undertaking shareholder activism in general meeting, by private or regulator-driven litigation is very rare. Thus, in both jurisdictions, regulation of CG has been largely a matter for the regulators in their paternalistic oversight role, rather than a private affair for shareholders to take up with directors - this trend is likely to continue for the time. These features are absent from the UK and the United States, although Hong Kong shareholders largely remain within a framework of regulator paternalism.

In terms of the regulatory design of its securities industry, each of the jurisdictions studied engage different approaches to its overall regulatory architecture including sectoral, twin peaks and super-regulator models. While each of these models has in

⁵³ Under sections 277 and 298 of the SFO

⁵⁴ Sections 6, 8 and 9 SMLR

practice been accompanied by a different means of CG standard-setting and enforcement, it is open to debate to what extent these different models influence the success of CG in a particular market. This is to be distinguished from the debates on whether some or all listing regulatory functions should be transferred to a statutory regulator and to what extent listing rules should themselves have statutory effect, versions of which have been implemented in the UK and Singapore.

3.1.3 The role of culture

It is not possible in the post 2008 era to discuss CG processes without also giving some consideration to the topic of CG culture. While CG culture has always been recognized as a fundamental issue in corporate processes, it has only been given scant attention by regulators and has largely been overlooked by the processes of regulatory oversight until more recently. This is possibly due to the twin difficulties of defining culture while at the same time avoiding the risk that “culture” is used as a residual explanation when other modes of explanation are insufficient.⁵⁵

The FRC defines culture in a corporate context as “a combination of the values, attitudes and behaviours manifested by a company in its operations and relations with its stakeholders”.⁵⁶ In other words, it is how a company behaves in its daily operation and how it deals with its stakeholders as influenced by the values it in practice subscribes to. Specific discussions of “CG culture” can be undertaken either (1) at the specific level of the corporation and the values and practices of the owners and managers of the company, or (2) at the wider social or market context in which a company operates and the generally accepted values and practices of all persons considered to be legitimate stakeholders in the market, possibly encompassing not only owners and managers but also employees, creditors, business partners, and so on. As explained in **Section 2 Methodology**, the scope of the present study is confined to the former more narrow definition of CG culture.

Any assessment of CG processes must also be astute to the fundamental difference between the bare fact of complying with a regulatory requirement, and complying with the objective that a regulatory requirement is intended to achieve. The former is consistent with a “box-tick” approach to compliance that in some cases can only be discernable from the latter according to whether or not the relevant behaviour is underwritten by an appropriate CG cultural attitude toward the objective of the relevant regulatory requirement. Regrettably, box-ticking is often synonymous with the validation of an act and a corresponding perceived diminution of culpability.

There is no shortage of reading material on the question of what businesses should be doing to succeed. However, the things that go wrong with companies frequently represent implosions where the board wasn’t doing enough and the shareholders weren’t challenging them. These are things that are going wrong inside the business, not external factors. Examples include Volkswagen, the SONY hacking, FIFA and Wells Fargo.

The recent issues arising out of the Wells Fargo incident – which have given rise to its Chief Executive Officer (CEO) facing a Congressional hearing - has redoubled attention to the importance of “tone at the top”. Commenting on the board’s response to the incident, a former chairwoman of the Federal Deposit Insurance Corporation stated:

“Unfortunately, it appears that the bank’s response was to view the problem as employee misconduct and to fire people as opposed to looking at the supervisory

⁵⁵ Sally Engle Merry “What is legal culture? An anthropological perspective”, 5 J. Comp. L. 40 2010, 41

⁵⁶ “Corporate culture and the role of boards”, FRC, July 2016, 6

chain and culture...Culture and tone at the top is exactly what the board should be looking at.”⁵⁷

Corporate values and culture do appear to be subject to more discussions in the boardrooms of FTSE 350 Index (FTSE350) companies.⁵⁸ The FRC are taking an active interest in understanding corporate culture and the components relevant for boards to consider.⁵⁹ However, based on the quality and profile of strategic reporting in 2015, only one fifth of FTSE350 chairmen gave culture prominence and provided insight into the topic with only half of these using their primary statement to emphasize the importance of culture.⁶⁰ In 2016, although 86% of FTSE350 companies’ annual reports mention corporate culture, only 20% provide a meaningful discussion, and 48% do not clearly communicate their organizational values. Fragmented commentaries may give the impression that culture and values are neither embedded in nor drive CG behaviour within a significant number of issuers, and it has been suggested that companies failing to adequately explain their CG related objectives may indicate a possible box-tick mentality.⁶¹

It is of interest to note that the connection between legal liability and culture has been recognized in the United States Federal Sentencing Guidelines for Organizations (FSG)⁶² issued by the United States Department of Justice. The FSG expressly deal with, *inter alia*, the compliance obligations of directors and establish criteria as to what is expected of a director in relation to organizational culture and the promotion of ethical conduct and a commitment to compliance with the law. This is important in view of the steady expansion of director liability that require directors to exercise greater – and effective – oversight of the company’s affairs. While the FSG substantively acts as sentencing guidelines, because the laws are actively enforced, they also serve proactive purposes. Key criteria of the FSG deal with matters such as the exercise of senior management oversight, undertaking effective communication to employees, installing appropriate compliance systems in relation to wrongdoing within the corporation, the consistent application of enforcing compliance standards through appropriate disciplinary mechanisms, and taking appropriate steps to prevent recurrence of compliance breaches. Put together, this recognizes the reality of effective governance, namely, that successful governance reflects a firm-wide approach – it is not something that merely happens in the boardroom.

The conversation on culture in fact has already moved beyond “tone from the top”. “Tone from the middle” and even “tone from everywhere” reflects the reality that achieving cultural objectives of a company requires recognition that this is not someone else’s responsibility.

The importance of culture is also gathering increasing attention in Hong Kong. There have been significant developments in senior management accountability at law, notably following the introduction of the SFO in 2003 and including, as a result of amendments to the SFO in 2013, responsibility for systems that enable compliance with statutory

⁵⁷ Gretchen Morgenston, “By Taking Back Money, Well’s Fargo Board Seems to Recall Its Role,” (27 September 2016) *New York Times, Business Day*

⁵⁸ “Boardroom Bellwether survey of FTSE 350 company secretaries”, The Financial Times and ICSA: The Governance Institute; Dec. 2016

⁵⁹ FRC, “Corporate Culture and the Role of Boards: A report of observations” 2016

⁶⁰ Grant Thornton, “Trust and integrity – loud and clear?,” (2015) *Corporate Governance Review*, 4: Available at <http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/2015/uk-corporate-governance-review-and-trends-2015.pdf> (visited on 27 November 2016)

⁶¹ Grant Thornton, “The future of governance: one small step...,” (2016) *Corporate Governance Review*, 3: Available at <http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/2016/2016-corporate-governance-review.pdf> (visited on 27 November 2016)

⁶² See United States Sentencing Commission, Guidelines Manual, and Chapter 8 –Sentencing of Organizations (Nov. 2010)

disclosure obligations.⁶³ The SFC also appears to increasingly recognize that merely approaching CG via standard setting that is enforced when the standards are breached is not sufficient and that it is “essential that a culture of robust corporate governance is developed to safeguard the interests of the investing public.”⁶⁴

The importance of culture in the CG context is that in the absence of an appropriate CG culture a company’s compliance with CG regulations may be reduced to a box-tick approach. Where a culture of non-compliance is caused by existing shortcomings in the value system that has been adopted, the question is how to get companies to change the CG culture. Simply imposing another rule is not enough.

There needs to be other supporting mechanisms that work to promote change. This might encompass externally-imposed mechanisms (such as more effectual enforcement mechanisms), ones that are generated from within the company (such as whistle-blowing) as well as from the market itself (such as an active and vocal institutional investor base). It is trite to point out that changing a CG culture that leans in the wrong direction requires considerable effort and involvement of many parties over a period of time.

Perceived shortcomings in establishing an appropriate CG culture has in many jurisdictions brought increased attention to mechanisms that affect the ability, willingness and accountability of directors to prevent or deal with malpractice. This includes boardroom practices including the roles expected of independent directors and board sub-committees, shareholder engagement and the role of stewardship, and the means of bringing greater accountability to executive remuneration, whether through shareholder accountability or the imposition of clawback arrangements. These mechanisms are discussed in subsequent Sections.

The topic of CG culture requires special consideration in relation to the abundance of Mainland China businesses in both new and existing listings on the Hong Kong market. Given the very different political, economic and social history of Mainland China – which affects both management and controlling shareholders – from that experienced in Hong Kong (or the other jurisdictions studied) it would be unremarkable to state that their management and investor makeup is quite different, and their experiences different. For example, a mainland unlisted business would not be accustomed to the same type of pre-listing reporting as would be a UK unlisted company. To some extent this needs to be qualified by observing that state-owned enterprises (SOEs) are subject to the oversight of, and corresponding reporting to, various Government ministries. Nevertheless, the reporting requirements of a UK unlisted company (to private equity investors) and a UK listed company (to the public market) is significantly similar, as compared to an SOE reporting to government ministries as compared to a public market.

The foregoing distinction is in some ways underlined in bold by comments of President Xi Jinping that positions SOEs as primarily serving the interests of the Communist Party in the economic realm and that they are, or should be, “party organs in leadership and political affairs.”⁶⁵ Those comments represent a significant schism from traditional Western approaches to the role of the company and the position of CG in that regard. Rather, the incorporation of “Western” CG board processes over the past three decades may instead be perceived as undermining the leadership of the Communist Party.⁶⁶ The extent to which such comments interact with the realities of SOEs listed in Hong Kong (or elsewhere) is hard to estimate. However, it has been suggested that as many as 19 SOEs listed in Hong Kong have established Communist Party committees, with powers

⁶³ I.e. section 307G of the SFO

⁶⁴ Brian Ho, SFC Corporate Finance Division Executive Director, “Recent trends in corporate conduct – an SFC angle”, presentation at Companies Registry Corporate Governance Roundtable, 13 March 2017

⁶⁵ As reported in SCMP.com 12 October 2016. Xi Jinping is the President of the People's Republic of China

⁶⁶ Per Zhang Xixian, a professor at the Central Party School, as reported in SCMP.com 12 October 2016

enshrined in new amendments to the articles of the companies, whose function includes advising and/or instructing the board on, *inter alia*, operational and strategic matters as well as board appointments and remuneration.⁶⁷ SOEs do of course remain subject to CG requirements in the markets they are listed on. However, it is notable that the United States-China Economic and Security Review Commission in its annual report to the United States Congress in 2016 expressed concerns as to the nature and purposes of state-backed enterprises.⁶⁸

3.1.4 The methodology of assessment

*"The concept of governance is abstract and latent rather than concrete and observable, and we are not sure how to proxy for this vague concept using observable measures."*⁶⁹

There are a number of ways that effectiveness of CG and a CG regime may be assessed. The discussions of the jurisdictions studied in the Appendices refer to many assessments that have been made of CG performance, or CG improvements in a given market over time. Many of these are undertaken on an annual basis, for example, as typically seen by the UK FRC and the SEHK in relation to the UK CG Code and HK CG Code, respectively.

Broadly speaking, the assessments tend to fall into two categories – those that measure the percentage of CG rules (such as the CG Code) that are complied with (a "Framework Approach"), and those that seek to measure effectiveness by canvassing the views of stakeholders (an "Empirical Approach"). Each of these approaches is based on an observable construct that is used as a proxy to measure the underlying concept of governance. However, as suggested by the above quotation, this requires an assessment of how well the construct in fact measures CG.

These measures are frequently used to inform the policy making process as regards developing standards, as well as assessing the uptake of CG standards and the effectiveness of measures, including but not limited to enforcement, that work to promote improved governance. Accordingly, it is important to understand the information provided by and the limitations of each of these different approaches to measurement.

The Framework Approach measures how many rule-based requirements have been complied with, where each rule is accorded an equal value. For example, this has been done in relation to the HK CG Code as well as the UK CG Code. There are two primary problems with this approach.

First, it glosses over the problem of box-tick compliance. This tends to make a better-looking story than what is the reality. The UK Institute of Directors (IoD) has suggested that such a measure of CG is "naïve",⁷⁰ because focusing solely on how companies report compliance with a framework does not consider underlying behaviour.⁷¹ The FRC has

⁶⁷ Per SCMP.com article dated 30 May 2017, "The hammer and sickle are making their way into some Hong Kong public companies" by Shirley Yam

⁶⁸ "Panel urges ban on Chinese state firms buying US companies", SCMP.com 17 Nov 2016: Available at <http://www.scmp.com/news/china/economy/article/2046785/panelurges-ban-chinese-state-firms-buying-us-companies?edition=hong-kong>

⁶⁹ B Black, A Gledson de Carvalho, V Khanna, W Kim and B Yurtoglu "Corporate governance indices and construct validity". European Corporate Governance Institute Working Paper Series in Finance, Working Paper N° 483/2016, September 2016, page 2

⁷⁰ Institute of Directors, "The 2016 Good Governance Report: The great governance debate continued," (September 2016), 9

⁷¹ Per Simon Walker, IoD Director General, as reported in CCH Daily, "IoD to establish corporate governance index," (June 2015): Available at <https://www.cchdaily.co.uk/iod-establish-corporate-governance-index> (visited on 21 Nov 2016)

also observed the problem of companies paying lip service to CG and so have started to take an active interest in understanding corporate culture and the components relevant for boards to consider as mentioned in **Section 3.1.3** "The role of corporate governance culture".⁷²

Second, it fails to take account of the relative importance of different CG factors to stakeholders. A high score achieved by complying with a large number of less-significant contributors to good CG may mask non-compliance with requirements that have an important bearing on governance.

The upshot is that the robustness of measures of improvements in CG standards based on an existing framework of rules is subject to significant qualifications. Accordingly, more should not be read into them than are presented, i.e., a measure that indicates more companies are complying with a specific requirement should not be read as implying that this results in the company achieving the desired outcome of the requirement, no matter how propitious that may appear.

It does of course make some basic sense to assess the relative importance of different, measurable CG factors to stakeholders. Particularly so given the premise that good CG is for the benefit of stakeholders. In other words, the question is to what extent has compliance with a rule been effectively translated into practices that benefit stakeholders.

The Empirical Approach is based on stakeholder feedback and involves a more complex process of extracting from responses the relevant factors and assigning a weighting to each factor. An example of this is the approach taken by the IoD, as discussed in see Appendix II.1.1.

While it is tempting to suggest that an approach founded in an assessment of stakeholder views yields a better measure of CG performance or, when assessed over time, improvements in CG standards, a confounding issue is that a factor could attract a lower score not because it is unimportant *per se* but because it is already sufficiently well implemented in the culture and practices of the market.

To this one must add the problem that the results of an Empirical Approach will be significantly dependent on the profile of the stakeholder population that participates in the study, and this will typically lean toward institutions and away from the retail viewpoint. This bias will be material where retail investors are either significant participants in a market (whether by trading volume or share ownership) or are in need of greater protection.

Underlying this discussion therefore is a more fundamental one: to what extent should CG standards be developed based on a Framework Approach or Empirical Approach, or some combination of the two? In Hong Kong, public consultation, as well as consultation by proxy with different stakeholder groups, tends to be the normal approach to the development of regulations, including in relation to CG. The content of consultations are frequently though not exclusively developed by reference to developments and discussions in other jurisdictions. Standards are often introduced because they appear to make sense in principle. It is trite to point out that a fundamental flaw of an approach based on right-minded concepts being laid down by right-minded individuals, is that it can fail to deal with the reality of persons who do not share the same views. While the drawbacks of the Empirical Approach have already been noted above, it does make some sense to subject rules to empirical *ex post* verification as to how well companies are performing on them in the eyes of stakeholders – i.e. not just measure whether the company appears to be complying because it has complied with a rule. To fail to look

⁷² FRC, "Corporate Culture and the Role of Boards: A report of observations" 2016

beyond mere rule-based compliance is to mistake the rules for the objectives they set out to achieve.⁷³

It is suggested that obtaining weightings through an assessment of stakeholder views are of informational value in relation to regulatory development and enforcement priorities since the weightings can be used as pointers to areas where stakeholders feel more needs to be done.

In Hong Kong, the regulators do not issue any specific assessments of CG performance or developments, although they may do so on an ad hoc basis. Material published by the SFC (such as its Annual Report or other research material published on an ad hoc basis) or the SEHK may include information on CG, such as rates of compliance with HK CG Code.

How often should measures of CG standards be undertaken, and on what basis should they be undertaken to serve as useful guidance for further policy development? Should a body be specifically charged with undertaking such a task and, if so, should it be independent of the apparatus of CG policy development? As regards the latter, the success of the market-practitioner approach to regulatory development in Hong Kong cannot be ignored, whether or not one considers this to be the best “theoretical” approach. Certainly, a body that is independent of the rule makers, one that was established with a view to providing information to the rule makers, may give the review greater weight in the market by avoiding potential conflicts of interest that arise where a rule maker is reviewing the success of its own rules.

An issue that is fundamentally tied up in this question is the issue of corporate culture, as already discussed in **Section 3.1.3** “The role of Corporate Governance culture” above. While giving lip service, or taking a box-tick approach, to compliance with CG rules is recognized as a problem, there is little or nothing in the way of formal guidance on CG culture in Hong Kong, it remaining to regulators a somewhat elusive topic that remains embedded in now well-worn catch-phrases such as “tone from the top”, more recently to “tone from the middle”, or “tone from every layer”. CG Culture nevertheless is identifiable and, importantly for regulators, it is increasingly being recognized that wrong CG culture is able to be punished if the correct ground conditions for good CG are clearly laid out. For example, the increasing attention on hard-to-justify executive remuneration packages coupled with greater rights being given to shareholders has resulted in the curtailing of some corporate excesses, as discussed in the remainder of this **Section 3** and the Appendices.

3.1.5 Cost-benefit considerations

Any system of regulatory controls on a market can be considered from various angles according to the standpoint one assumes and the interests that one wishes to prioritize over others. One possibly neutral⁷⁴ standpoint is the question of the overall cost/benefit assessment of a regulatory system or any changes proposed to be made to a regulatory system. This certainly includes questions related to CG standards.

Although somewhat dated, estimates (in 2005) of the “adjusted regulatory costs” in terms of the cost of securities regulation per billion dollars of stock market capitalization put Hong Kong and the United States on a roughly equal footing (\$73,317 and \$83,943, respectively) compared with other jurisdictions – for example, the UK stood at \$138,159, Singapore at \$95,406).⁷⁵ On the basis of those numbers, Hong Kong is doing well,

⁷³ For example, as pointed out by Max Weber, “The Protestant Ethic and the Spirit of Capitalism” (1904)

⁷⁴ This is only “possibly neutral” since, in its application, the assessment of cost/benefit inevitably must assign relative values to qualitatively different variables

⁷⁵ John Coffee, “Law and the Market: The Impact of Enforcement” (2007) *Columbia Law and Economics Working Paper*, No. 304, p 29-30. No data was provided for China

however, the estimate predates a number of significant changes. In Hong Kong, the SFO had only just been introduced and the period since has witnessed a significant growth in the size of the SFC workforce, an increased level of surveillance and enforcement activity of the SFC in part in response to a significant growth of the stock exchange and the composition of companies listed on it. In the UK, the listing function had only been transferred away from the exchange to the UK Listing Authority in May 2000, and a twin peaks model of regulation later came into effect in April 2013. In Singapore, many initiatives have been taken since 2012 that may have increased the regulatory compliance cost. It may also be noted in Mainland China, where there have been many legislative and regulatory changes since 2005, e.g. the Company Law 2014.

As noted, the above figures are somewhat out of date and it is not one of the purposes of the present study to undertake an update of the same. However, the point is that any system of CG operates within a wider regulatory framework such that proposing changes to CG regulation will bring with it a greater or lesser impact on the overall regulatory costs of a system.

The SEC have for a long time been subject to requirements to provide cost-benefit analyses. However, there are different views on the overall utility of the requirement given the delays and costs involved in undertaking the analysis as well as the selection of the appropriate metric used to measure cost-benefit. Whether or not it is correct to regard it as a burdensome obstacle to implementing productive change, rules implemented by the SEC are sometimes challenged on the basis of the analysis the SEC has undertaken. For example, the SEC's Rule 14a-11 that was designed to facilitate the rights of shareholders to nominate directors to a company's board was successfully overturned on this basis, as discussed in **Section 3.4** and Appendix III.7.2.

The SFC has in the past year or so been increasingly bringing focus to listed companies-related issues such as the risks posed by corporate fraud and misfeasance, and has cited a figure of HK\$200 billion as the cost to market capitalization.⁷⁶ This is not merely about the setting or enforcement of CG standards but is very much concerned with the establishment of effective mechanisms that enable the identification and rectification of CG shortcomings.

When considered in terms of cost/benefit to the system, enforcement is resource intensive and ultimately expensive, particularly when assessed against the potential damage already done to the integrity of the market. This is perhaps one reason why regulatory agencies, including the SFC, have increasingly been turning their attention to gatekeeping or *ex ante* mechanisms, which are systemically more cost effective than enforcement. There are a number of potential gatekeepers. For example, the SEC regards outside directors as gatekeepers that are important links in the preservation of quality information in the market.⁷⁷ The SFC has utilized its role as an overseer of intermediaries to increase its regulatory focus on sponsors of new listing applicants as well as the roles performed by financial advisers to listed issuers.⁷⁸ A focus of these efforts is the quality of information and management's role in relation to the same.⁷⁹

There are many possible approaches to improving CG standards that are consistent with the protection of shareholders and the integrity of a marketplace. This may involve changes to laws or regulatory requirements that impact on board processes, the transparency, quality and timeliness of information, shareholder involvement,

⁷⁶ Thomas Atkinson, SFC Executive Director, Enforcement, at the 7th Pan Asian Regulatory Summit (9 November 2016)

⁷⁷ Stephen Joyce, "SEC Will Only Target Directors in Egregious Cases," (February 2016) *Bloomberg BNA, News*.

⁷⁸ "Circular to Financial Advisers in relation to their Advisory Work on Valuations in Corporate Transactions", SFC, 15 May 2017.

⁷⁹ For example, see "Guidance note on directors' duties in the context of valuations in corporate transactions", SFC, 15 May 2017

shareholder rights, or any of the other matters discussed in **Section 3.1.1** "Thematic topics". An important consideration in any of these alternative approaches must be: what is the likelihood that the change will facilitate the objectives sought (for example, as compared to box-ticking), and what is the overall cost to the system in light of the benefits it is expected to deliver. Certainly, the mere addition of more rules does not, without clear justification, represent taking a step forward.

3.1.6 Maintaining competitiveness

It is well accepted that the burdens and consequential liabilities imposed by regulation is a general factor considered by a company in deciding where to list. This appears to be no different when the specific topic is CG regulation, as confirmed by research undertaken by the UK Government's Department of Business, Innovation & Skills (BIS) in 2013, as discussed in Appendix II.1.1. The BIS research suggested there is a general desire among companies to maintain the status quo, rather than continually increasing the regulatory burden. Nevertheless, there was widespread acceptance that CG regulation and reporting is necessary and desirable for maintaining market standards and providing investors with the required levels of transparency to generate confidence.

One of the essential metrics of assessing a CG system is therefore how well the balance of market standards and an issuer's regulatory burdens is established and maintained.

Where it is proposed to increase the CG regulatory burden, it is therefore appropriate to ask what is the underlying mandate of doing so, or, to put it another way, what further CG regulations are justifiable in view of the standards expected of the market by each of capital users, capital providers, and the providers of liquidity to the market?

The experience of the United States post the introduction of Sarbanes-Oxley Act of 2002 (SOX) is in some ways a relevant case study that testifies to the often mistakenly held belief that a more extensive regulatory system goes hand-in-hand with the concept of a developed market. Introduced in 2002, SOX was an Act intended "To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."⁸⁰ It introduced a number of important provisions relating to financial disclosures including establishing the Public Accounting Oversight Board (PCAOB), and regarding auditor independence and audit committee governance.

However, SOX also had its consequences for the market, the most significant of which being that it acted as a deterrent to foreign companies seeking a listing in the United States, as well as causing others to withdraw their listing. Research suggests that while SOX may have increased the reliability of financial disclosures, less information is available as a result of SOX.⁸¹ It has also been suggested that business agility and responsiveness in responding to the market has been lost, "So when directors are now asked to do something, they respond that they have to make sure they are doing the required certifications. Response and time go out the window."⁸² Congressman Oxley, one of the authors of the Act, has expressed concern that the Act may be causing companies to be excessively risk averse for fear of breaching the Act, and that this in turn is damaging economic growth prospects. Finally, it must be pointed out that while SOX toughened audit and disclosure requirements, SOX "did not avert the problems that

⁸⁰ Preamble to SOX, 116 STAT. 745

⁸¹ J Begley, Q Cheng, and Y Gao, "The Impact of the Sarbanes-Oxley Act on Information Quality in Capital Markets", 22 August 2007: Available at <http://ssrn.com/abstract=1008986>

⁸² Comments made by Professor Douglas Branson, W Edward Sell professor of business law at the University of Pittsburgh, as reported by The National Business Review (New Zealand), July 22, 2005

have taken place in investment banks and other financial institutions, including excessive leverage and other reckless governance practices.”⁸³

Another way to look at this is: what problem is affecting the conditions for free market (e.g. agency cost, investor rationality, etc) and what rule can be designed to remove or address this?

Any consideration of the balancing of market standards and an issuer’s regulatory burdens must additionally consider the types of company (in other words, its management and governance profile) that are seeking a listing (or are already listed) on a particular market, or the types of company that a particular stock exchange seeks to attract. The BIS research cited above also found that where companies were already accountable through reporting to private equity shareholders, parent companies, and industry regulators, they were not overly concerned by the additional CG burdens of listing. Nonetheless, such companies still viewed the additional time and cost involved as a burden.

3.1.7 Effectiveness

Distinctions between principle and practice render measuring and identifying CG effectiveness problematic. Infrastructure (such as laws, regulations and voluntary corporate requirements) designed to secure desired CG objectives does not, for a variety of reasons, always result in effective implementation in practice. Effectiveness is, in some ways, a retroactive measure of the disjunct between a right-minded principle, the practice that in fact subsequently evolves in response, and the outcome that eventuates.

Improving effectiveness can be approached from a principles-based or empirical-based approach. The former seeks to establish means of closing the disjunct by driving the infrastructure toward identified problem areas. The latter seeks to identify perceived problem areas. In this sense the two approaches are symbiotic: principles-based approaches should strive to understand the empirical dynamics and seek appropriate developments in light thereof. The utility of a development can subsequently be assessed by later empirical studies and/or through argument by analogy taking specific companies or jurisdictions that have already adopted requirements or practices that equate to the developments.

A key hurdle in understanding CG effectiveness is what might be called the “black-box problem”. The actual operations of a governance team (the board, its committees and other functionalities that report to the board) are to outsiders largely a black-box into which only partial glimpses are available. Those glimpses are in general provided by two primary mechanisms: where disclosure of black-box events or black-box knowledge are mandated by a law or regulation or are undertaken voluntarily; and where disclosure emerges as evidence in proceedings before a court, tribunal or regulatory body. Both mechanisms suffer from data issues. The former is more abundant than the latter but there is a risk that data quality is impaired as a result of the disclosure being partial, limited, tailored, or falsified to respond to the relevant law or regulation or other objective sought. The latter, while providing a higher degree of certainty of being complete and accurate, by its nature is biased to malfunctioning corporate situations that might give a misleading picture of the entire corporate landscape – forming views on effectiveness based on this data might suggest developments that amount to over-regulation of healthy companies that may be unjustifiable on a cost-benefit basis. Survey-based evidence and anecdotal evidence is available as a means of seeking to

⁸³ S Davis, J Lukomnik and D Pitt-Watson, “Creating Responsible Financial Markets”, United Nations conference on trade and development, “Corporate Governance in the wake of the financial crisis” New York and Geneva, 2010, page 134

bridge between the former and the latter, although such evidence, particularly anecdotal evidence, is subject to limitations.

The effectiveness of rules can also be counterproductive where they operate as a distraction from the objective sought to be achieved. This may occur as a result of directing attention to ensuring all the boxes are ticked rather than addressing the substantive matter. The rule can in effect become a false validator of the behaviour undertaken. Accordingly, effectiveness should also take into account whether the objectives of a law or regulation (or one that is proposed) is able to be effectively monitored and enforced – where this is absent, there is a clear risk that compliance with the requirement gives a sense that something is being done to achieve a public objective when the objective is not necessarily being achieved. In this sense, such rules may work to remove or lessen sense of personal/corporate culpability.

The comparative approach to understanding the effectiveness of Hong Kong's CG regime, as undertaken in this study, is primarily driven by evidence from other jurisdictions in view of the themes and trends and other matters discussed above.

3.2**Non-locally incorporated companies****Introduction**

An international financial market requires an environment that attracts the involvement of foreign players. From a CG perspective, this presents the issue of how to conform the CG standards of a non-locally incorporated issuer to meet or exceed local standards. Fundamentally, a non-locally incorporated company is primarily governed by the laws of the place of its incorporation, which may provide for obligations on directors and shareholder rights and remedies that differ from the local market. Each of the jurisdictions studied engage different methods of bringing a foreign issuer under its own CG system (**Section 3.2.1**), and dealing with the enforcement of those standards across jurisdictional borders (**Section 3.2.2**).

3.2.1 Application of local laws and regulations

Different jurisdictions approach differently the question of what local laws and regulations apply to companies incorporated in another jurisdiction (“foreign companies” or “foreign issuers”) and how to effectively bring foreign companies within an acceptable enforcement regime in respect of the same. As regards specific CG standard-setting, much will depend on the legal nature of the standard, i.e. whether it is a statutory requirement, a regulatory requirement with statutory enforcement options, or a purely regulatory requirement with consequences for breach restricted to regulatory sanctions). In the Sections that follow, it is necessary to remain alert to these distinctions, which will impact on the type and effectiveness of enforcement options.

Companies legislation and related requirements

In the UK, the disclosures required of listed issuers had previously depended on their place of incorporation. UK incorporated issuers are subject to the Companies Act 2006 (Cap. 46) (CA 2006) and to the UK CG Code. The CA 2006 introduced the requirement for business reviews, which was later to be replaced in 2013 with the annual strategic report, as discussed in Appendices II.3.2 and II.7.2. However, at that time foreign companies did not have to comply with the UK CG Code⁸⁴ and only 45 out of 171 overseas companies that had a primary listing had voluntarily to comply.⁸⁵ These gaps were significantly reduced as a result of changes to the listing rules in April 2010.⁸⁶ Provisions of the FCA’s listing rules and Disclosure and Transparency Rules (DTR) when read together with the requirement of the UK CG Code Main Principle C.2 represent important, though partial, extensions of the foregoing disclosure requirements to foreign companies, albeit only those with a Premium Listing.

The UK listing rules, LR 9.8.7 R, requires foreign incorporated issuers with a Premium Listing to state how they have applied the Main Principles of the UK CG Code and whether or not they have complied with the provisions of the UK CG Code throughout the reporting period. The Main Principle in C.2 states “The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.” This is a lesser requirement than that applying to UK incorporated

⁸⁴ LR 9.8.6 R, which requires compliance with the UK CG Code, previously only applied to UK incorporated companies. See Appendix C.4.

⁸⁵ Andrew Chambers, *Chambers’ Corporate Governance Handbook* (Haywards Heath: Bloomsbury Professional Ltd, 2014), p488.p 488

⁸⁶ On 6 April 2010 issuers that previously had a primary listing on the London Stock Exchange became known as a Premium Listing and those with a secondary listing became known as a Standard Listing

issuers, which are subject to the CA 2006 requirement to produce an annual directors' report and strategic report, and if they have a premium listing they will additionally be subject to LR 9.8.6(3) R, which requires the annual report to include a statement by directors as to the current prospects of the company, including identifying the principal risks, and as to whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment.⁸⁷

Requiring a foreign company to explain how they have complied with Main Principle C.2, in a manner that would enable shareholders to evaluate how the principles have been applied,⁸⁸ does serve to reduce, although not eliminate, the disclosure gap between UK and foreign companies with a Premium Listing. Whereas the provisions of the CA 2006 are mandatory law, the provisions of the UK CG Code are only subject to a lesser comply or explain standard. However, FCA Rule DTR 7.2.5 R requires companies to describe the main features of the internal control and risk management systems in relation to the financial reporting process. Breaches of the disclosure requirements are actionable by the FCA and investors may seek damages.

While this development in the listing rules served to reduce the different standards expected of Premium Listing issuers according to their place of incorporation, the required standards remain different across Premium and Standard Listings, the latter category representing issuers with a secondary listing in the UK. Furthermore, other provisions in the CA 2006 such as the provisions on statutory derivative action and unfair prejudice still do not apply to foreign companies that are listed on the London Stock Exchange. However, the listing rules do give investors the right to bring an action for damages where there have been mis-disclosures by the issuer, irrespective of their place of incorporation.

In Singapore, the SFA gives statutory backing to the listing rules, which gives enforcement powers to the MAS and Singapore Exchange (SGX) and standing to bring a legal action to any person aggrieved by a breach of the listing rules (see Appendix V.2.1). On the other hand, the Companies Act (Cap. 50) (CA) only applies to locally incorporated companies. This means that derivative action and unfair prejudice remedies are only available to shareholders of overseas companies under the common law (see Appendix V.7.1).

In the United States, Federal legislation and regulatory law will generally apply to foreign companies unless it is regarded as a foreign private issuer (FPI). As discussed in Appendices III.3.2, III.3.4, and III.8.2, a company will be regarded as an FPI according to the degree of its connection with the United States including the ownership of shares by United States residents and the location of its officers and assets. These tests are not dissimilar in nature from those used when determining whether a SEHK listed issuer is subject to, and hence whether its shareholders receive the protection of, the Hong Kong Code on Takeovers and Mergers. Where a United States issuer is regarded as an FPI, certain registration and disclosure requirements will not apply, including, for example, Regulation FD (Fair Disclosure). The situation is more complex for the application of Dodd-Frank and which CG provisions of the Exchange listing rules are to be applied or disapplied. In general, both New York Stock Exchange LLC (NYSE) and National Association of Securities Dealers Automatic Quotation System LLC (Nasdaq) allow FPIs the flexibility to follow their home country CG practices, though they may choose to voluntarily comply with the domestic CG standards. However, in each case the issuer

⁸⁷ Provision C.2.2

⁸⁸ 9.8.6(5) R

must give a disclosure notice that sets out the significant differences⁸⁹ and remain subject to the audit committee requirements.⁹⁰

All issuers in Hong Kong are generally subject to the same CG standards under the listing rules, including the HK CG Code, irrespective of their place of incorporation. However, the position of domestic and foreign issuers under the Companies Ordinance (Cap. 622) (CO) and certain other regulations that impact on CG is not the same. As discussed in Appendix I.4.1, although a non-Hong Kong incorporated issuer is not subject to the statutory directors duties under the CO, the listing rules provide that directors of non-Hong Kong incorporated issuers are expected to meet the same directors' duties of skill, care and diligence to a standard commensurate with that established under Hong Kong law.⁹¹ In furtherance of this requirement, directors are required to give an undertaking to the SEHK to comply with the listing rules and the Hong Kong Code on Takeovers and Mergers (and certain provisions of the SFO) to the best of their ability.⁹² Other provisions of Hong Kong law and regulations that impact on director responsibilities need to be considered separately, for example, the CG protections afforded by the Code on Takeovers and Mergers depends on whether an issuer (and so its directors) is determined as subject to the Code according to a set of non-exhaustive tests,⁹³ which may yield a different determination at different points in time.⁹⁴

As regards annual reporting obligations of the issuer, the Hong Kong regime bridges the gap via two routes under the listing rules. Locally incorporated issuers are subject to the CO, which requires a directors' report.⁹⁵ Although this only applies to Hong Kong incorporated companies, both domestic and non-Hong Kong incorporated issuers are subject to the mandatory financial disclosure requirements of Appendix 16 of the listing rules, which specifies that annual reports must include, *inter alia*, a directors' report that complies with the CO.⁹⁶ This requires a description of the principal risks and uncertainties facing the company and an indication of likely future development in the company's business.⁹⁷ In this regard, Hong Kong does a better job than the UK at levelling the financial disclosure obligations of issuers as regards the requirements of domestic companies legislation subject to the caveat that a breach by a non-locally incorporated issuer of the Appendix 16 requirement is merely a breach of the listing rules and as such would not carry the same consequences as a breach of the DTR requirement concerning internal control and risk management systems. This reflects a difference in the UK and Hong Kong systems as regards the enforceability of the listing rules (see further below).

As compared to other jurisdictions, Hong Kong law provides strong shareholder protections against director mismanagement insofar as the CO provisions on statutory derivative actions apply to non-Hong Kong companies that have a place of business in Hong Kong – because this includes having a share transfer or registered office in Hong Kong this will cover all listed issuers in Hong Kong. Section 732 of the CO provides that shareholders can, with leave of the court in Hong Kong, bring unfair prejudice

⁸⁹ NYSE section 303A.11 statement of significant differences disclosure and section 303A. 12; Nasdaq Rule 5625 Notification of Noncompliance. See Latham & Watkins LLP, "The Latham FPI Guide: Accessing the US Capital Markets From Outside the United States," (2015) *2015 Edition*, 133-134

⁹⁰ Rule 10A-3 under the Securities Exchange Act of 1934; NYSE Rule 303A.06; Nasdaq Rules 5605 (c) (3) and 5605 (c)90. See Daniel Bushner, Richard W. Kosnik, and J Eric Maki, "Foreign Private Issuers of Equity Securities in the United States," (2012) *JonesDay*, 33-34

⁹¹ Main Board Listing Rules (MBLR) 3.08

⁹² MBLR Appendix 5 Form B Part 2

⁹³ Introduction, para 4.2

⁹⁴ For example, see the decision of the Takeovers and Mergers Panel in relation to SouthGobi Resources Limited, 24 June 2014

⁹⁵ s. 388 and Schedule 5 CO

⁹⁶ MBLR Appendix 16, para 28. The report must comply with the Companies (Directors' Report) Regulation (cap 622D)

⁹⁷ Schedule 5, CO

proceedings against directors in the name of the company by way of statutory derivative action, including in respect of non-Hong Kong incorporated listed issuers. One case has already been successfully commenced under this provision against a listed issuer incorporated in the Cayman Islands.⁹⁸

Interests of directors

Under the Hong Kong CO, sections 536(2) and 540 require directors and shadow directors of public companies to disclose the interests of any entity connected with the director or any shadow director. This facilitates the oversight of director interests in company transactions, arrangements and contracts. This requirement is higher than the corresponding provision of section 182 of the CA 2006 in the UK. This reflects a particular feature of Hong Kong, which is characterized by considerable interconnectedness, often complex and convoluted, among family-controlled and other dominant shareholders of listed companies. However, these requirements do not apply to non-locally incorporated companies. Instead, the gap is managed by listing rule requirements. This brings the discussion back to a point already touched on, namely, the standing of the listing rules and the consequences of breaching them. The sanctions associated with breaches of the SEHK's listing rules are weaker than those available in the UK, in particular as regards the right of a shareholder to bring a claim for damages. The relevance of an effective enforcement regime is discussed below.

Disclosures generally

The two boards operated by the SEHK, and the issuers listed on them, whether by way of primary or secondary listing, and wherever incorporated, are subject to the HK CG Code that applies to the relevant board on which they are listed. While, for regulatory purposes, this approach equalizes the disclosure position across all issuers, the consequences for breach by non-Hong Kong incorporated issuers is in general limited to the disciplinary sanctions available to the SEHK (for a discussion see Appendix II.7.2), which are regarded as somewhat toothless. There are nevertheless two important differences between the approaches in the UK and Hong Kong. First, breaches of the HK CG Code can only be committed in respect of disclosure requirements, not with regards to the substantive provisions of the Code. In the UK issuers with a Premium Listing will breach the Code if they fail to apply the Main Principles and report to shareholders how they have done so (issuers with a Standard Listing are subject to the same requirements unless they choose to opt out). Second, in contrast to the limited sanctions for breaches able to be imposed by the SEHK, because non-compliance in the UK amounts to a breach of listing rules that have statutory backing, the sanctions able to be applied by the FCA include the power to fine, and investors may have a civil right for damages where there has been a disclosure problem.

Although Singapore's Securities and Futures Act does not apply to companies not incorporated in Singapore, it does apply to companies listed on the SGX, whether incorporated locally or otherwise. Most CG provisions, e.g. disclosure of shareholding interest by substantial shareholders, directors and CEO, disclosure by corporations, insider dealing, compliance with listing rules etc apply to corporations see Appendix V.8.1). Furthermore, the listing rules apply to all listed companies regardless of their place of incorporation. This is similar to Hong Kong, except in Singapore the provisions on continuing disclosure obligations (s 203 SFA) in the listing rules can be enforced by the MAS under s 232 SFA (see Appendix V.1.6). This contrasts with the position in Hong Kong where the continuing disclosure obligations regarding inside information have only been able to be enforced by the SFC directly following their removal from the listing rules to Part XIVA SFO in 2013. However, the residual continuing obligations in the Hong

⁹⁸ See *Yu Yuchuan & Ors v China Shanshui Investment Company Limited (HCMP) 360/2015*, which involves China Shanshui Cement Group Ltd (0691.HK)

Kong listing rules remain enforceable only by the Hong Kong Exchanges and Clearing Limited (HKEX), unless they amount to, for example, director misfeasance.⁹⁹

Enforcement of listing rules

One of the issues that must be touched on in relation to the foregoing is the question of the legal status of the listing rules and how this affects their application to locally and non-locally incorporated issuers. The relevance of an effective enforcement regime was discussed in **Section 3.1.7** "Effectiveness". Where listing rules have been given statutory effect, as has been done in the UK and Singapore, it means that the closure of any gap between laws and the listing rules will be more effective insofar as the mechanisms of enforceability will be established in the law. It may also create rights for shareholders affected by wrongdoing. The question of statutory backing is an important topic, and this is returned to in **Section 3.7.3** "Enforcement agencies".

Reference is also made to **Section 3.3.1** "Legal status of CG disclosures" which considers the enforceability of listing rules by regulatory agencies and alternatives for supplying a measure of legal backing to requirements of the listing rules.

Reconciling foreign laws and domestic regulations

Domestic, non-statutory codes are in general neutral as to the place of incorporation of the issuer, subject to the caveat that complying with a domestic regulation must not be in breach of the law of the place of incorporation of the issuer. In the UK, a listed overseas company must comply with disclosure requirements only in so far as (1) information available to it enables it to do so, and (2) compliance is not contrary to the law in its country of incorporation.¹⁰⁰ Where applicable, a listed overseas company must, if required by the FCA, provide a letter from an independent legal adviser explaining why compliance with LR 1.4.2 is contrary to the law of its country of incorporation.¹⁰¹ Whereas DTR 7.2 only requires UK incorporated companies to provide corporate governance statements, LR 9.8.7A R extends this to foreign issuers, save for companies that are required to comply with similar provisions imposed by a European Economic Area country.¹⁰²

In Hong Kong, the problem of incompatible laws and listing rule requirements is primarily addressed by the SFC/HKEX "Joint policy statement regarding the listing of overseas companies",¹⁰³ the objective of which is to preserve high standards of regulation, enforcement and corporate governance, and the related country guides. Overall, this approach appears to have served its purposes well.

Very few issuers listed in Hong Kong are incorporated in Hong Kong, and this means that the law of the relevant foreign jurisdiction will govern the calling of shareholder meetings. While historically this was dealt with by only allowing listing applications from companies incorporated in jurisdictions with equivalence in this regard, since 2007 the SEHK has allowed a wider range of jurisdictions as being acceptable. LR 19.05(1)(b) of the SEHK's listing rules require overseas issuers to provide standards of shareholder protection at least equivalent to Hong Kong. Where the applicable home jurisdiction law does not provide such protections, then the company will need to amend its articles to provide equivalence to the Hong Kong CO in this regard.¹⁰⁴

⁹⁹ Such as is provided for in s. 214 SFO

¹⁰⁰ LR, 1.4.2. R

¹⁰¹ LR, 1.4.3. R

¹⁰² DTR, 1B.1.5A

¹⁰³ The most recent version being issued 27 September 2013

¹⁰⁴ SFC/HKEX "Joint policy statement regarding the listing of overseas companies" 27 September 2013, para 39

As further discussed in **Section 3.4.2 "Shareholder votes"**, the ability of shareholders of companies in the United States to meaningfully exercise their rights is subject to some complication due to the proxy statement process. Delaware is an interesting case study for the purposes of equivalence to standards in Hong Kong (in connection with applications for listing on the SEHK) given that it is an acceptable jurisdiction for the purposes of listing on the SEHK. Although the SFC and HKEX regard Delaware shareholder protection standards as not materially different from Hong Kong's, before a Delaware incorporated company could be regarded as giving shareholders rights equivalent to those in Hong Kong it remains necessary for it to establish that members have the right (1) to convene general meetings and add resolutions to the agenda and (2) to speak and vote at meetings, and this may require amendments to the company's articles.¹⁰⁵ This requirement overcomes a problem that shareholders of many Delaware companies have yet been able to bridge - in that sense, should a Delaware-incorporated company list in Hong Kong it would operate to a higher level of CG standards than do many other Delaware companies. This reflects a higher expected standard in Hong Kong.

Mainland China does not have foreign companies listed on its stock exchanges, so does not have to deal with these problems. However, many of its companies, whether incorporated in Mainland China or off-shore jurisdictions, are listed in Hong Kong, Singapore, London and New York, and there have been some serious concerns as to the CG standards of certain of these companies.¹⁰⁶ As a result, Mainland China does need to consider ways in which the regulators in Mainland China can assist foreign regulators to enforce foreign standards. Where the Mainland companies are also listed in the stock exchanges in Mainland China, CSRC will have jurisdiction over these companies and can assist foreign regulators through mutual assistance arrangements. However, where the Mainland companies are not also listed in Mainland China, CSRC will have no jurisdiction over them and may have a limited ability to render assistance to the foreign regulators. It is suggested that Mainland China needs to develop ways to ensure that a Mainland China regulator can render assistance to foreign regulators, including Hong Kong.

3.2.2 Cross border enforcement and cooperation

With many foreign companies listed on the Exchanges in each of the jurisdictions studied, cross border enforcement becomes an important issue. The regulators in these jurisdictions all have to deal with the challenges of cross-border enforcement of securities law, listing rules and CG standards against overseas companies. The problem of directors of failed or fraudulent issuers disappearing across borders to avoid enforcement is not unique to Hong Kong. For example, as discussed in Appendix III.8.3, the United States, another frequent destination for Mainland enterprises to list and which HKEX regards as a competitor in this regard, has also experienced cross border enforcement problems - a number of Mainland enterprises there have "gone dark" by simply disappearing and ceasing, in breach of Federal securities laws, to make any further regulatory filings leaving regulatory agencies with no effective means to pursue legal recourse.

Regulators from one jurisdiction have no right to enter another jurisdiction to carry out investigation and obtain evidence without the consent and assistance of the other jurisdiction. Thus, a common arrangement is for one regulator to sign a memorandum of understanding (MoU) with another regulator to facilitate mutual co-operation and assistance. Mainland China has signed MoUs with all four jurisdiction studied: HK (19 June 1993),¹⁰⁷ United States (28 April 1994), Singapore (30 Nov 1995) and the UK (7

¹⁰⁵ See HKEX's "country guide - The State of Delaware, the United States of America" (20 December 2013, updated April 2014), section 4

¹⁰⁶ For example, see: Moody's report issued 11 July 2011 "Red Flags for Emerging-Market Companies: A Focus on China"; Floyd Norris, "The Audacity of Chinese Frauds" *New York Times* (26 May 2011)

¹⁰⁷ For details of the MoU, see "Regulatory cooperation memorandum", 19 June 1993: Available at <http://fgcx.bjcourt.gov.cn:4601/law?fn=chl092s167.txt>

Oct 1996).¹⁰⁸ At the international level, there is the International Organization of Securities Commission (IOSCO) multi-lateral MoU (MMoU) for mutual assistance.¹⁰⁹ Industry regulators in each of the five jurisdictions studied are signatories to the MMoU: SEC (19 Nov 2002), SFC (3 March 2003), FCA (10 March 2003), MAS (17 November 2005) and CSRC (29 May 2007).

Whether a regulator is able to provide assistance under an MoU or MMoU to another regulator will depend on whether the assistance sought is covered by the MoU or MMoU and it is lawfully able to provide such assistance. So, for example, if there is a client confidentiality agreement between a bank in the requested regulator's jurisdiction and its client, the requested regulator may not be able to force the bank to provide confidential document to the requested regulator for forwarding to the requesting regulator, unless there is legislation in the requested jurisdiction giving the requested regulator power to obtain such document in connection with the request of the requesting regulator. This was what happened in the 1998 *Crownhampton* case.¹¹⁰ However, so far as Hong Kong law is concerned, this gap has been addressed through the introduction section 179 of the SFO, which empowers the SFC to appoint an authorized person to obtain records from bankers, auditors and others (failure to comply being an offence), and more recent changes to sections 186 and 186A of the SFO that facilitate the provision of assistance by the SFC and Hong Kong Monetary Authority (HKMA) to foreign regulators.

Many jurisdictions often have laws corresponding to these powers under the SFO. For example, Switzerland has legislation to provide for the Swiss Federal Banking Commission to provide such assistance even in the absence of an MoU. Singapore has section 172 of the SFA. In contrast, Mainland China lacks a similar enabling provision for the CSRC. Thus, the CSRC was unable to provide any assistance to the SFC in relation to it seeking access to the bank records of a controlling shareholder based in Mainland China of Hanergy Thin Film Power Group, a Hong Kong listed issuer that had been suspended from trading pending investigation of suspected anomalies. Article 179(8) of Mainland China's Securities Law merely provides that CSRC "may establish co-operative mechanism of supervision and administration in collaboration with the securities regulatory bodies of any other country or region and apply a cross-border supervision and administration."

In the absence of MoU's being a panacea to legal hurdles, or domestic laws providing avenues for foreign regulatory investigations, foreign regulators have had to develop their own ways of getting evidence. For example, in the United States, the PCAOB has used its power under the SOX and PCAOB rules to require registered audit firms and their associated persons to cooperate with requests for information in Board investigations, and have sanctioned audit firms and their employees for failure to cooperate.¹¹¹ However, this has only been partially effective in that the firms refusing to co-operate have been sanctioned, without this leading to the sought after co-operation.

¹⁰⁸ See "List of memoranda signed between China Securities Regulatory Commission and overseas regulators", 4 March 2003: Available at http://www.csrc.gov.cn/pub/newsite/gjb/jghz/200403/t20040304_79407.html (visited on 12 Nov 2017)

¹⁰⁹ For details see "Multilateral Memorandum of Understanding Concerning Consultation And Cooperation and the Exchange Of Information", May 2002: Available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD386.pdf> (visited on 12 Nov 2017)

¹¹⁰ See Report on an Investigation into Possible Contraventions of Securities (Insider Dealing) Ordinance and Securities (Disclosure of Interests) Ordinance in relation to the Trading of Shares in Crownhampton International Limited Hong Kong February 1998) : Available at <http://www.sfc.hk/web/EN/published-resources/reports/one-off-reports/report-on-an-investigation-into-possible-contraventions-of-securities.html>

¹¹¹ PCAOB Sanctions Hong Kong Audit Firm and Three Individuals For Failing to Cooperate with Board Investigation, 13 January 2016: Available at <https://pcaobus.org/News/Releases/Pages/PKF-Hong-Kong-enforcement-1-13-16.aspx> (visited on 12 Nov 2017)

In 2012 the SEC sued the China affiliates of the top five accounting firms¹¹² for refusing to produce, contrary to the SOX and the 1934 Act, audit work papers relating to United States listed Mainland Chinese issuers that were under SEC investigation for fraud.¹¹³ The CSRC had earlier refused to provide assistance arguing that it would be against Mainland China's national sovereignty and breach of Mainland Chinese law to allow a foreign regulator to oversee domestic companies regardless of where they are listed. The year prior, a Federal judge ruled in favour of the SEC against Deloitte in a case concerning fraud investigation into Longtop Financial Technologies Ltd (see Appendix IV.5.2). Deloitte had resigned as auditor over alleged false reporting yet had initially refused to cooperate with the SEC stating that it was prohibited by Mainland Chinese law to do so. The CSRC has since been more cooperative by providing a substantial volume of audit work papers and other documents to the SEC. These cases demonstrate the potential cross-border enforcement difficulties that regulators face when seeking cooperation from the CSRC, a problem that is well recognized by Hong Kong's regulatory bodies. These actions have assisted to procure better cooperation. In 2013 the PCAOB entered into an enforcement cooperation MoU with the CSRC and the Chinese Ministry of Finance with a view to progressing better arrangements on cross-border inspections of audit firms under the PCAOB's oversight. This has encompassed seeking joint inspections of relevant audit firms based in China.

Cooperation may depend on *de facto* assistance as opposed to *de jure* actions. In the recent China Sky case,¹¹⁴ the MAS website said that the success of the case was partly through "assistance rendered by the authorities and regulators in the People's Republic of China". However, the website does not explain how the Mainland Chinese authorities were able to render assistance. Given China Sky is an S-chip incorporated in Cayman Islands not also listed in Mainland China, the CSRC or other Mainland Chinese authorities technically does not have jurisdiction over it. One might therefore speculate that the only kind of assistance the CSRC could render is to persuade the controlling shareholder to cooperate with the Singapore authorities.

In 2013 Singapore introduced a direct listing framework¹¹⁵ to address the problem of lack of regulatory reach and to enhance the quality of its market. Under the framework, Mainland Chinese companies must be incorporated in Mainland China and have obtained the approval of CSRC in order to seek a listing on SGX.¹¹⁶ The Mainland companies have to go through the regulatory processes and due diligence conducted by the relevant regulatory organisations in both countries. This measure, which appears in many ways to be similar to the H-share listing scheme in HK, provides a measure of assurance to the marketplace. It also provides the basis for mutual co-operation and assistance. Before this scheme, many Mainland companies listed in Singapore were red-chip stocks that

¹¹² Deloitte Touche Tohmatsu, Ernst & Young Hua Ming, KPMG Huazhen, Pricewaterhouse Coopers Zhong Tian, and BDO China Dahua

¹¹³ Securities Exchange Act Of 1934 Release No. 68335/ December 3, 2012; Accounting And Auditing Enforcement Release No. 3426 / December 3, 2012; Administrative Proceeding File No. 3-15116

¹¹⁴ Discussed in Appendix D.3.2.1.1, D.3.2.6.1 and H.3.4.4.1. See Wan, Chen, Xia and Goo, "Managing the risks of corporate fraud: the evidence from Hong Kong and Singapore," (2017), forthcoming; Monetary Authority of Singapore, Opinion Editorial on Achieving a Robust and Vibrant Securities Market, Business Times, 26 June 2015: Available at <http://www.mas.gov.sg/news-and-publications/letters-to-editor/2015/opinion-editorial-on-achieving-a-robust-and-vibrant-securities-market.aspx>; MAS, Former China Sky CEO Huang Zhong Xuan pays civil penalty of \$2.5 million and offers to surrender 10% of his shareholdings in China Sky (12 February 2015) : Available at <http://www.mas.gov.sg/news-and-publications/enforcement-actions/2015/china-sky.aspx>

¹¹⁵ SGX, "SGX and China Securities Regulatory Commission establishing direct listing framework" (2013) : Available at

http://www.sgx.com/wps/wcm/connect/sgx_en/home/highlights/news_releases/SGX+and+China+Securities+Regulatory+Commission+establishing+direct+listing+framework;

<http://www.straitstimes.com/business/singapore-exchange-to-co-operate-with-china-regulators-in-vetting-new-s-chip-listings>

¹¹⁶ For details on how the scheme works see "SGX and China Securities Regulatory Commission Establish Direct Listing Framework" November 2013: Available at

<http://www.wongpartnership.com/index.php/files/download/1134>

were merely shells incorporated in a tax-free or low tax jurisdiction, while the revenue generating operations and businesses remained onshore in Mainland China.¹¹⁷ This gave the owners of those companies significant insulation from Singapore regulatory actions and accountability. A string of events with red-chip companies¹¹⁸ had led to many being suspended from trading, giving rise to a loss of confidence from foreign investors. Any attempt to impose sanctions or regulatory penalties on the listed vehicle affected the minority shareholders adversely while the majority shareholders/original owners remained free to continue business as usual in Mainland China (whether by transferring the businesses out or by simply moving on). Furthermore, the authorities in Mainland China regularly took the view that no action could be taken against the responsible persons despite a breach of Singapore law because no offence had been committed under Mainland China's domestic laws. The lack of accountability and regulatory reach were systemic flaws in corporate governance and regulatory oversight, and also hindered rescue and restructuring efforts. However, it remains to be seen whether the scheme will prove successful in terms of actual cross-border enforcement.

In practice, cross-border enforcement can also be limited by differences between the legal systems of domestic and foreign jurisdictions. For example, the recent United States Court of Appeals case *United States v Allen*¹¹⁹ held that testimony obtained in a foreign jurisdiction (by the FCA in this case) was inadmissible under the Fifth Amendment (because of the potential use of compelled testimony in criminal proceedings).

Mainland China's 2010 amendments to its State Secrets Law, generally regarded as capable of wide application, have given rise to other problems. Under sections 179 and 183 of the SFO, a person who receives a notice from SFC to disclose document must generally comply unless there is "reasonable excuse". In *SFC v Ernst & Young, Standard Water*, a company based in Mainland China, applied to SEHK for listing but later withdrew its application after E&Y, its reporting accountants and auditors, informed the SEHK of its resignation upon discovery of certain inconsistencies in documentation provided by the company. SFC requested Ernst & Young's Hong Kong office to provide audit work papers but was met with the claim that the papers were kept in the Mainland by their partners, and that production of such papers would be against Mainland China's secrecy law. The court ordered Ernst & Young to co-operate as foreign illegality is not a "reasonable excuse". This has indeed been the approach taken by the courts in many other jurisdictions.¹²⁰

Hong Kong

Non-Hong Kong incorporated companies listed in Hong Kong are subject to the jurisdiction of the SFC under the SFO, which has extensive powers of investigation and enforcement, and shareholders can enforce their rights via civil actions for damages or derivative suits. However, an important hurdle is to obtain evidence. The SFC needs co-operation from overseas jurisdictions. As regards Mainland enterprises, its avenues via the CSRC are limited. The SFC has pointed out that the MMoU has limitations as it does not require regulators to provide information nor does it require cooperation where misconduct occurs in one jurisdiction that affects another.¹²¹ To address this limitation,

¹¹⁷ see Morgan Lewis & Bockius, LLP Making SGX attractive to S-Chips, 18 August 2014: Available at <https://www.lexology.com/library/detail.aspx?g=0db983fc-6c21-4e52-b1c3-9e3c7c08266a>.

¹¹⁸ Including the default on loans by steelmaker FerroChina just weeks after announcing that its quarterly earnings tripled in 2008; the spectacular accounting intrigues in Sino Techfibre (an office fire); and missing assets of China Sun Bio-Chem (stolen trucks)

¹¹⁹ 864 F.3d 63 2d Cir. 2017

¹²⁰ Disclosure and Foreign Illegality: Striking a Balance, June 2013: Available at <http://www.hk-lawyer.org/content/disclosure-and-foreign-illegality-striking-balance> (visited on 12 Nov 2017)

¹²¹ Speech by Mark Steward, SFC Executive Director of Enforcement "Fighting On the Frontline: An Update" 3rd Annual US-China Legal Summit, 2 March 2015, available on the SFC's website. See also "Civil action against Hanergy shows SFC is just a chained lion" 24 January 2017: Available at

the SFC signed a further MoU in 2014 with CSRC to strengthen enforcement cooperation under the Shanghai-Hong Kong Stock Connect and in 2016 for the Shenzhen-Hong Kong Stock Connect scheme. Among other things, this complements practices in relation to: enforcement cooperation, alerts and the exchange of investigatory information, joint investigations, service of documents, executions, investor compensation, and the publication of information. The stock connect MoU's aim is to fight against cross-border market abuse and misconduct, reinforce cross-border enforcement cooperation, maintain market order in Hong Kong and Shanghai, and to protect the legal rights of investors in both markets.¹²² However, it remains to be seen whether the arrangements will result in effective cross-border enforcement.

That the CSRC does not have investigative powers similar to the SFC represents a significant disjunct across the two jurisdictions that is important to consider in view of the predominance of Mainland issuers listed on the Hong Kong market. It means that the effectiveness of any cooperation between the SFC and the CSRC agreement will ultimately be limited. Clearly, if the CSRC were to be given powers similar to those enjoyed by the SFC, this would go a long way to giving greater effect to the MoU. The recent MoU entered into between the SFC and the Hong Kong Police Force (HKPF)¹²³ may become relevant in this regard if it enables the SFC, via the police, to obtain investigative cooperation from the HKPF's counterparts in Mainland China.

A problem for Hong Kong is the CG standards of Mainland enterprises listed in Hong Kong that are not also listed or incorporated in Mainland China, as there is no effective regulatory nexus for the CSRC to regulate these companies.¹²⁴ Despite the CSRC-SFC MoU on cross-border enforcement and co-operation, the SFC and the HKEX have no real reach over wrongdoing directors located in the Mainland. This is exacerbated where the business operations are physically in Mainland China with little presence in Hong Kong. Any form of assistance CSRC is able to provide is likely to be informal pressure. Alternatively, where the Mainland enterprises or their directors have assets or bank accounts in Hong Kong, or their auditors are in Hong Kong, SFC can take legal action against the assets or auditors bringing pressure to bear on the wrongdoing directors to co-operate. Despite the difficulties and challenges the SFC faces, it has successfully investigated a number of cases, sometimes with the help of CSRC.

As a result of the problem of cross-border enforcement, gateway mechanisms that ensure, or facilitate, that only companies able to comply with CG standards are admitted to listing becomes a relatively more important component of improving the CG standards in Hong Kong (see further below under **Section 3.7.8** "Listing regime standards upon entry"). An *ex ante* approach would seek an early stage means of identifying, preventing or reducing the likelihood of wrongdoing - *ex ante* mechanisms of enforcement that provide for more effective early-warning identification and correction mechanisms can work better in this regard.

Five of the enforcement recommendations made elsewhere in this Report would subject non-locally incorporated companies to a more effective and ongoing system of enforcement, the cross-border problem notwithstanding. This includes **Recommendations A4.5.1** "Legal status of annual CG disclosures", **C4.5.2** "Status of listing rule compliance and related disclosures (continuing)", **C4.5.3** "Facts regarding

<http://www.scmp.com/business/article/2065049/civil-action-against-hanergy-shows-sfc-just-chained-lion> (visited on 12 Nov 2017)

¹²² CSRC successful crackdown on the first cross-border manipulation case under Shanghai-Hong Kong Stock Connect, 21 November 2016: Available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201611/t20161123_306416.html (visited on 12 Nov 2017)

¹²³ MoU to strengthen co-operation in combating financial crime, 25 August 2017

¹²⁴ See the discussion in Appendix IV.8.3

director independence”, **A4.6.2** “SFC to develop use of conditions when exercising existing SMLR powers”, **and A4.6.3** “Calibrate SFC’s powers under the SMLR”.

Four other recommendations are particularly germane to some of the important CG standards of non-Hong Kong incorporated issuers (as they are to local issuers), namely **Recommendations A4.1.3** “Disclosures of the audit committee”, **C4.7.1** “Disclosure of CG standards in listing document”, **E4.7.2** “Develop role of compliance adviser”, **and E4.9.2** “Whistle-blowing”. Each of these recommendations is developed in subsequent sections of this Report.

Mainland enterprises

Given the nature of the Hong Kong market and the significant number of non-Hong Kong listings, in particular listings of Mainland enterprises, there is increased concern about the difficulty of cross-border regulation and enforcement.

To the extent a Mainland enterprise maintains a *de minimis* presence in the market on which the company is listed, meaningful domestic enforcement is correspondingly limited. Assets or relevant individuals located in Mainland China require a mechanism for seeking enforcement in the Mainland. The issuer’s actual place of incorporation (e.g. Cayman Islands or the Mainland itself) is often irrelevant¹²⁵ as what is sought is to enforce the ruling of a Hong Kong court through the courts of Mainland China.

While a market could in theory adopt requirements that imposed a minimum local presence of substance, this may be difficult to render consistent with the commercial requirements of a free market and is likely to impact negatively on a market’s competitiveness. Regulatory agencies have instead sought other levers to procure enforcement where cross-border enforcement is problematic. A recent example of this is the means by which the SFC has procured remedies in respect of Hanergy Thin Film Power Group (a Mainland enterprise issuer listed on the SEHK that has had its trading suspended since May 2015) - the SFC was able to obtain an order from the Hong Kong court that the controlling shareholder and chairman of Hanergy procure the payment of outstanding receivables from its parent company within two years from the date of the order.¹²⁶ The ability of the SFC to obtain the order, and have a reasonable expectation of compliance with the order, to a not insignificant extent relied on the agreement of the controlling shareholder to the order.¹²⁷ Such alternative means are not always (or typically) available.

Ultimately, cross-border enforcement is not a problem that can be solved unilaterally. On a case-by-case basis it requires the cooperation of the wrongdoer. To address the problem on a universal basis would require the support of relevant authorities in Mainland China. As regards the latter, it is suggested that the present environment could present a fertile context in which to progress the issue. During the steadily increasing participation of Mainland enterprises in the international marketplace since the mid-1990s, Mainland enterprises and the destination markets have undergone significant, and at times difficult, learning experiences that have sometimes not worked in China’s favour. Instances of Mainland enterprises failing have tended to attract considerable attention that has led to closer regulatory scrutiny as well as increased commercial concerns that may impact on the risk premium. This has been the experience for outbound acquisitions by Mainland enterprises internationally where transactions are now subject to increased regulatory checks,¹²⁸ and sellers have become increasingly

¹²⁵The place of incorporation will be relevant where the cause of action is established under the law of the place of incorporation of the issuer, and in relation to insolvency proceedings

¹²⁶ See *SFC v Li Hejun* [2017] 4 HKLRD 785

¹²⁷ The case was heard under a *Carecraft* procedure, which is based on an agreed statement of facts

¹²⁸ E.g., in the United States by the Committee on Foreign Investment. There are also increased regulatory hurdles being imposed by Mainland China on outbound acquisitions.

wary of the commercial risks of failed negotiations, which has in turn given rise to increased deposit or break-up fee requirements.¹²⁹ This has created a disadvantageous environment for Chinese acquirers.¹³⁰

That a Mainland (or other non-Hong Kong) enterprise, including its founding shareholders and officers, are based across the border out of reach of the Hong Kong regulatory authorities is an extension of these issues. Indeed, it is a grave public concern that exposes investors to increased risk and challenges a market's integrity. At the same time, defaulting or fraudulent issuers may create a knock-on effect for subsequent listing applicants in the form of heightened sensitivity about risk. One can also consider the extent to which the reputation of Chinese enterprises abroad has been negatively affected, notwithstanding the many successful Mainland enterprises in many sectors of the international economy.

It is suggested that the time might be right for the Hong Kong SAR Government to consider exploring with the relevant authorities in Mainland China the possibility of creating a narrow-channel avenue (see below) for cross-border enforcement in the context of the public capital markets. While the MoUs in place between the CSRC and the SFC are important tools of cooperation, the scope of co-operation between the CSRC and SFC on enforcement matters is quite limited, as already discussed above.¹³¹

Unlike the other markets studied, Hong Kong already has a reciprocal recognition and enforcement of judgments arrangement in place with Mainland China,¹³² however, it only applies to money payments arising out of civil and commercial cases pursuant to a choice of court agreement.¹³³ The narrow channel avenue proposed above would be one that represents a gradualistic development of the arrangements already in place, is consistent with the promotion of agreed standards in capital raising exercises, and steers clear of the more difficult considerations concerning offences of a criminal nature.

A narrow-channel arrangement for the capital markets might be restricted to, for example, the enforcement of financial penalties and compensation orders by a court in respect of an agreed scope of disclosure obligations (including financial mis-disclosure) and directors' duties. In this regard, some very limited¹³⁴ reference can be made to the mutual recognition of funds (MRF) between the Mainland and Hong Kong¹³⁵ in which each regulator recognizes the other's authorisation of investment funds for public distribution in the home market, while also accepting the ability of the host market to impose its own disclosure requirements. A narrow-channel solution may also be consistent with developing cooperation and cross-border trust, and the progressive integration of markets, including via the Stock Connect programmes (and the MRF already mentioned). A suitable cross-border enforcement mechanism might also be regarded as a highly desirable precursor to the proposed IPO Connect.

¹²⁹ For example, as per Huang Min, deputy general manager, merger and acquisition office, Guotai Junan Securities, as reported at SCMP.com, 19 October 2017

¹³⁰ A number of good examples being cited by Julie Steinberg, "Sellers grow sceptical of China's insatiable M&A appetite", Wall Street Journal, 10 Sept 2017

¹³¹ See also Appendix IV.8.3

¹³² Arrangement for Mutual Service of Judicial Documents in Civil and Commercial Proceedings and the Arrangement Concerning Mutual Enforcement of Arbitral Award in 1999; Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region Pursuant to Choice of Court Agreements between Parties Concerned (the "2006 Arrangement"); and Mainland Judgments (Reciprocal Enforcement) Ordinance (Cap. 597)

¹³³ Article 1 of the 2006 Arrangement

¹³⁴ The reference is limited as the Memorandum is focussed on the regulation of the product by the home jurisdiction and the regulated activity by the host jurisdiction, and does not delve into cross-border enforcement of sanctions for serious breaches, the primary sanction contemplated being suspension of new subscriptions or withdrawal of authorisation.

¹³⁵ Memorandum of Regulatory Cooperation concerning Mutual Recognition of Funds between the Mainland and Hong Kong, 22 May 2015

Establishing an appropriate cross-border enforcement mechanism seems necessary in order to go beyond the inherent constraints of the MoU approach. Such a development would be beneficial to the integrity of Hong Kong's market as well as to the reputation and standing of Mainland enterprises listed in Hong Kong because it provides a measure of assurance to the commercial concerns of investors. It would not alter compliance costs as no new legal or regulatory requirement is being introduced, nor does it represent a new source of liability. Rather, improved accountability would foster market efficiency.

The narrow-channel proposal thus has the potential of creating a competitive advantage for Hong Kong. Hong Kong's unique position, of being a separate legal jurisdiction from the Mainland yet co-existing with the Mainland under the sovereign state of China, gives it a unique advantage to take the lead on developing cross-border enforcement solutions that go beyond the inherent constraints of the MoU approach.

The foregoing leads to **Recommendation A4.6.5** "Explore a narrow-channel cross-border enforcement arrangement".

3.3	Information
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Introduction

A discussion of “information” as a topic of relevance to CG requires a recognition that while CG related information is frequently not going to amount to information that is subject to Hong Kong’s statutory disclosure laws, because it may not be likely to have an impact on the market in the issuer’s securities, shareholders cum investors do consider the CG standards of an issuer in the total mix of available information. Many of the current requirements affecting CG disclosures in Hong Kong are instead subject to non-statutory codes that carry with them concerns as to how effectively they can be enforced.

This Section takes as its primary concern the mechanisms that promote the timely disclosure of important CG-related information to shareholders (**Sections 3.3.1 and 3.3.2**). Board processes that should operate to identify or acquire information relevant to CG concerns are considered in relation to board evaluation (**Section 3.3.3**) and audit committee work (**Section 3.3.4**). Other board processes, such as executive compensation, changes of control, etc. are discussed in the Sections that follow. The means of identifying, preparing and disseminating the information, the assurance of quality, and the means by which this is mandated and enforced are central to each of these concerns.

3.3.1 Legal status of CG disclosures

In the jurisdictions studied, required CG disclosures are scattered in at least three places with varying degree of enforceability or legal backing as the table in **Section 3.1.1** above shows: legislative provisions in relating to securities or corporate law, listing requirements enforceable only by the exchange except where they have some measure of statutory backing United States, and codes that may merely promote disclosure without mandating it, which are themselves unenforceable unless non-disclosure also happens to fall under either of the foregoing two categories.

Specific CG disclosures required to be made in the UK arise out of the listing rules that incorporate by reference the UK CG Code. While the code is non-statutory, the listing rules have statutory backing and breaches of them are subject to enforcement by the FCA and, where there has been a breach of the disclosure requirements, may also subject to a claim for damages by investors. In the latter regard it is important to recognize that the relevant nexus for liability is not the UK CG Code *per se* but the fact that certain of its requirements align with the FCA’s DTR, which do have statutory backing, as discussed in Appendix II.7.2. This system shares some similarities with Hong Kong, as discussed in Appendices II.3.3 and II.6.3, the notable difference being that the HK CG Code together with the listing rules does not have any statutory backing. In other regards, that statutory effect is achieved in the UK through the alignment of non-statutory provisions with disclosure obligations having statutory effect shares some similarities with the United States.

As discussed in Appendix III.1.1, the United States is a strongly disclosure based system, and this holds true of the approach to specific disclosures listed issuers are expected to provide to shareholders in relation to the CG standards they have adopted. CG standard-setting and the means by which those standards are enforced extends across each level of the regulatory architecture of the United States. This includes State and Federal law, regulatory law made by the SEC, and the requirements of the Exchanges. The alignment of these obligations are important to appreciate to gain an

understanding of the means by which CG standards are reinforced or developed, and the respective roles of the SEC and the Exchanges.

Unlike the UK, important CG standards are set by the Exchanges, however, as noted in Appendix III.4.1, Exchange requirements do not carry statutory force and are not generally regarded as enforceable by shareholders (subject as discussed in Appendix III.6.6). The important caveat to the foregoing statement is that an issuer, in breaching a listing requirement, may also happen to violate a relevant disclosure or anti-fraud provision of the securities laws. This is an important nexus to appreciate because the Exchange's CG rules incorporate information disclosure requirements that are broadly aligned with or tied to disclosures mandated by the SEC under Regulation S-K, made pursuant to the 1933 Securities Act, which sets out the reporting requirements for listed companies in the United States.

Some of the Exchange's requirements go some way to covering areas of CG regulation that are not – or are presently unable to be – addressed by State or Federal laws. The SEC could in theory start adopting some of the Exchange CG rules if they wanted to – after all, they approve each and every one of them before adopted by the Exchange – but that is not the primary purpose of the SEC in the overall CG system of the United States. For example, in Appendix III.3.2 it was observed that Item 407 of Regulation S-K¹³⁶ requires disclosures in relation to a similar group of topics with which the HK CG Code is concerned, namely: director independence, board meetings and committees, annual meeting attendance, nominating committee, audit committee, audit committee financial expert, compensation committee, shareholder communications and board leadership structure and role in risk oversight. However, this is not accompanied by any expectation of meeting a specific CG standard – the setting of specific standards is instead taken up by rules of the Exchanges¹³⁷ that impose corresponding requirements on issuers, which fall into either mandatory compliance requirements (i.e. must do/have, or must disclose), or recommended practices (i.e. should) – see further Appendix III.4.1.

This alignment has a significant bearing on the overall quality of disclosures that are made – because compliance with the Exchange's standards to some extent become the subject of material required to be reported pursuant to Regulation S-K, securities law becomes relevant to consider in relation to an Exchange's CG requirements. This is important since a false disclosure amounts to a Federal offence, whereas merely breaching an Exchange requirement would otherwise be subject to rather more limited sanctions.

In Singapore, MAS can enforce the SFA, which contains some CG requirements. The CG Code issued by the MAS is enforced by SGX. The Code, as in Hong Kong, operates on a "comply or explain", not mandatory, basis. The listing rules are issued by the SGX subject to approval by MAS, and enforced by SGX on a contractual basis. However, as the listing rules on continuing disclosure has statutory backing under s 203 SFA – this creates a statutory obligation on an issuer and others to comply with SGX's continuing disclosure obligations under its listing rules – intentional or reckless breaches is a criminal offence under s 203 of SFA. MAS could impose civil penalty on offender, or transfer the case to CAD for criminal prosecution. A recent example of MAS's power under s 203 was the high profile China Sky Chemical Fibre Co Ltd case (see Appendices V.4.1 and V.8.3).

The position in Mainland China is more straightforward. CSRC can enforce the CG requirements in the Securities Law, the CG Code and listing rules and a large number of guidelines. The CG Code is issued by the CSRC and is not on a "comply or explain" basis but is mandatory.

¹³⁶ 17 CFR 229.407 – (Item 407)

¹³⁷ NYSE Rules section 3 Corporate Responsibility; Nasdaq Series 5600 Corporate Governance Requirements

Hong Kong

In Hong Kong, the specific CG related disclosures required by the listing rules and the HK CG Code are generally regarded as being matters of concern only for the listing rules. This includes, for example, Chapter 4 dealing with periodic financial reporting, Chapters 14 and 14A respectively concerned with notifiable and connected transactions, and the many specific comply or explain provisions of the HK CG Code. In general, the disciplinary sanctions able to be imposed in respect of listing rule breaches are limited and generally regarded as lacking teeth. However, this is also potentially subject to similar caveats as already discussed in the context of the United States since mis-disclosure is nevertheless subject to overarching information laws applying to the market. However, these laws in practice maybe unlikely to be relevant as CG disclosures are in normal circumstances unlikely to relate to inside information for the purposes of Part XIVA of the SFO, and are similarly unlikely to be information that may affect market activity for the purposes of the market misconduct provisions of sections 277 and 298 of the SFO. Accordingly, a false or misleading CG disclosure is, based on the foregoing, merely a matter subject to the relatively weak disciplinary mechanisms of the SEHK, which do not include any power to fine. One caveat to the foregoing is the SFC's powers under the SMLR to suspend trading in an issuer's securities or cancel an issuer's listing where, *inter alia*, information is false or misleading.

On the other hand, there is some case law that supports the position that breaches of listing rule requirements pertaining to required disclosures can give rise to an actionable claim under section 214 of the SFO (see **Section 3.6.2** "Listing rules").¹³⁸ However, such claims only seem capable of arising in respect of more egregious cases amounting to misfeasance etc., and can only be brought by the SFC. Logically, one might extend this concept to suggest a right of shareholders to bring a derivative action on the basis that the directors owe a fiduciary duty to the company as regards sufficient compliance with the listing rules (as has been argued in the United States – see Appendix III.6.3), however, no such action has to date emerged.

Discussion

Hong Kong does not have any equivalent of Regulation S-K *per se*. However, it does have a more general provision in section 384(3) of the SFO that submitting a record or document containing false or misleading information to the SEHK or the SFC (a "specified recipient") is an offence that potentially attracts criminal liability including fines. The application of that section is subject to two important components set out in section 384(4) of the SFO. First, the person providing the document must have received prior written warning from the specified recipient that the provision of the document would constitute an offence if it contains false or misleading information.¹³⁹ Second, either the specified recipient must reasonably rely on the document or the provider must intend the recipient to rely on it.¹⁴⁰ By way of example, this provision has been used by the SEHK in relation to various forms required to be submitted in connection with new listing applications.¹⁴¹ It has not been used in relation to the annual disclosures made by an issuer as required by the HK CG Code.

Based on the general premise that weaker enforcement mechanisms are less capable of bringing about desired behaviours, there is an argument that the quality of CG disclosures could be enhanced if a mechanism of enforcement were put in place that was

¹³⁸ *SFC v Kenneth Cheung Chi Shing* [2012] HKCFI 312; [2012] 2 HKLRD 325; HCMP 1702/2008 (7 March 2012) HCMP 1702/2008; *SFC v Wong Shu Wing* [2013] HKCU 1008

¹³⁹ s. 384(3)(b)(ii) SFO

¹⁴⁰ s. 384(4) SFO

¹⁴¹ Under MBLR Appendices 5 Forms B, H & I, 17, 19 and 21. Similar provisions are made in the GEM Listing Rules (GEMLR)

more effective than the existing sanctions available to the SEHK or the SFC. Requiring CG disclosures to be submitted on a section 384(3) based form would bring the disclosures within the SFC's powers to bring an enforcement action against individuals. If undertaken before a magistrate summarily the SFC can seek a fine of up to level 5 (currently being HK\$50,000).¹⁴² It is suggested that this provides a relatively quick means of exerting influence on the undertaking of directors without imposing excessive penalties and as such represents a step toward a more effective mechanism of enforcement.¹⁴³ More egregious breaches can be pursued on indictment, which carries fines of up to HK\$500,000. In both cases, the fines would give rise to disclosure requirements thus interacting with reputational liability, particularly if the offence is repeated. The presence of these risks would be another factor bringing focus to quality and completeness of the disclosure. While shareholders do not gain any direct rights under this approach, they may benefit from such an increased focus.

Bringing CG-related disclosures within the scope of section 384(3) is a convenient mechanism of underwriting the importance of the quality of disclosures because it would give CG disclosures a measure of statutory support, and because it could be implemented by a relatively simple amendment to the listing rules that would not involve any changes to the law. The relevant disclosures covered would be those made pursuant to MBLR Chapters 4 (periodic financial reporting), 14 (notifiable transactions) and 14A (connected transactions) and Appendix 14, each of which have been previously identified by the SEHK as important parts of the listing rules intended to improve the CG of listed issuers.

The implementation can be effected through the use of a declarative form.¹⁴⁴ The two requisite components of section 384(4) are easily satisfied by the incorporation of an appropriate notice into the form, as has been done with other forms, and it would be reasonable for the SEHK to rely on it in furtherance of its regulatory objectives as established by statute.

The form would need to be submitted by or on behalf of the directors and address compliance with the relevant obligations. An advantage of using a form-based approach is that, as has been done with other forms, the declaration could include a statement that the directors have undertaken all reasonable enquiries etc.

The foregoing leads to **Recommendation A4.5.1** "Legal status of CG-related disclosures".

One of the recognized problems of compliance with CG requirements, including with regard to disclosures, is that compliance can be undertaken on a box-tick basis, meaning that there is an apparent satisfaction of the relevant requirement without the objective of that requirement being met. It is suggested that box-tick approaches to compliance are to a significant extent supported by an ineffective enforcement regime. This is complicated by the tendency of the HKEX (and other standard-setting bodies such as the UK's FRC) – currently the primary and largely sole enforcer of the listing rules – to count box-tick compliance as evidence of a functioning CG system. (For a discussion of the methodological problems of measuring good CG, see **Section 3.1.4**.) This may bring a less acute enforcement eye to the adequacy of a disclosure and whether it is in fact misleading. For example, disclosures made pursuant to Chapters 4, 14 or 14A may constitute incomplete disclosure of relevant facts. While mis-disclosure under the comply or explain provisions of the CG Code may require a more subtle examination, box-tick explanations of, for example, how an issuer has applied code principles or met code

¹⁴² s. 384(7) SFO and s. 113B and schedule 8, Criminal Procedure Ordinance (cap 221)

¹⁴³ s. 384(7) also provides for imprisonment for up to 6 months

¹⁴⁴ Although it may also be noted that section 384(3) is not limited to forms *per se* but is capable of applying to any record or document

provisions may nevertheless be prone to being incomplete explanations of the facts. By bringing the disclosures under the SFO, the above recommendation brings them under the SFC's jurisdiction, which may bring greater responsibility to making the disclosures, particularly if enforcement is more actively applied.

3.3.2 Disclosure of listing rule compliance

Since 2009/2010, both NYSE and Nasdaq have imposed requirements on the CEO (NYSE) or the issuer (Nasdaq) of listed issuers to notify the Exchange in writing of any non-compliance with the Exchange's CG standards; NYSE additionally imposes an annual certification requirement and a requirement to make an affirmation as and when required.¹⁴⁵ Per the commentary in the NYSE rules, the intention of the requirement is to bring greater focus of the senior management on compliance with the CG listing standards. In Singapore, there is an obligation to explain non-compliance of the CG Code in the annual report, and for companies with a secondary listing in SGX, an obligation, since November 2014, to provide an annual certification that it has complied with the applicable continuing listing obligations in the SGX Listing Manual (see Appendix V.4.1); rather similar to the NYSE's certification requirement. In Mainland China, all CG provisions and listing rules must be complied with. There is an obligation to report "any breaches of laws and regulations" to the CSRC under rule 17.1(6) of the Shanghai Stock Exchange listing rules. There is no annual certification or self-declaration requirement.

Hong Kong

An issuer is required to comply with the listing rules and the responsibility for ensuring full compliance falls to the directors individually and collectively.¹⁴⁶ It is also required to provide to the SEHK any other information or explanation that the SEHK might require for the purpose of investigating a suspected breach of or verifying compliance with the listing rules.¹⁴⁷

That these obligations are widely expected to be fulfilled is consistent with the desirability of fostering investor confidence and market integrity. In particular, the disclosures expected to be made in compliance with the listing rules are relevant to the total mix of information in a market and constitutes information that a shareholder might reasonably expect to receive for statutory purposes.¹⁴⁸ Given these considerations, it is somewhat surprising that there is no corresponding obligation to report a breach.

Discussion

It is a legitimate expectation of shareholders of a listed issuer that the company will comply with the laws and regulations that apply to it, including the listing rules. This includes many provisions that are not enforceable at law by shareholders but which nevertheless impact on CG standards and the legitimate rights of shareholders. Directors already do give an undertaking to the SEHK (LR Appendix 5B, H or I) to use best endeavours to procure compliance with the listing rules. However, that issuers are not required to self-report breaches can give rise to anomalies.

A recent example of such an anomaly was the case brought by the SFC in the Market Misconduct Tribunal (MMT) against CITIC Limited under section 277 of the SFO.¹⁴⁹ In the

¹⁴⁵ NYSE Listed Company Manual Rule 303A.12; Nasdaq Rule 5625

¹⁴⁶ LR 13.01 and 13.04

¹⁴⁷ MBLR 2.12A(2)

¹⁴⁸ I.e., s. 214 of SFO as recognized by the court in *SFC v Kenneth Cheung Chi Shing* [2012] op. cit. and *SFC v. Wong Shu Wing and Another* [2013] op. cit. See also *TSC Industries v Northway* 426 US 438 (1976), which has been judicially approved in the Singapore Court of Appeal in *Lew Chee Fai Kevin v Monetary Authority of Singapore*, [2012] 2 SLR 913 at [95]

¹⁴⁹ See the report of the MMT dated 7 April 2017, available on the MMT's website

established facts of that case, which occurred prior to the introduction of Part XIVA of the SFO, the directors of CITIC were able to issue, without attracting any legal liability, a “no material adverse change” (no-MAC) statement in compliance with Chapter 14A, despite its directors being aware of price sensitive information (PSI) that had not been disclosed to the market in accordance with MBLR 13.09. Had the market been aware of the breach of the 13.09 requirement – that the directors possessed undisclosed PSI – the reception of the no-MAC statement would likely have been entirely different.

The foregoing considerations give rise to the suggestion that an obligation be placed on an issuer and its directors to self-report breaches of the listing rules. The requirement to impose an obligation to disclose a breach is not without precedent in the listing rules: an issuer is already required to disclose in its annual report whether its directors have or have not complied with the Model Code for directors’ dealings.¹⁵⁰

As observed in many places in the present Report, providing shareholders with access to relevant information is a central concern of CG. A self-reporting obligation combined with a disclosure requirement not only facilitates information to shareholders, it also emphasizes the legitimate expectations of shareholders as regards compliance with the listing rules and the CG standards comprised therein. At the same time, it facilitates the SEHK and the SFC gaining an appreciation of the nature of the breach so that appropriate action may be undertaken. However, as also observed elsewhere in this Report, information disclosure must be timely for disclosure to be meaningful and effective. If disclosure of listing rule breaches were left to disclosure on an annual basis, one must query whether the foregoing objectives are truly achieved or are relegated to what amounts to a box-tick approach.

To give practical effect to the proposal it would therefore be necessary to impose a continuing obligation as well as an annual declaration of compliance.

To give teeth to the disclosure, it should be made subject to section 384(3) of the SFO on the same basis, and for the same reasons, as already discussed in **Section 3.3.1** “Legal status of CG disclosures”. Because this includes the ability of the SFC to seek the imposition of fines where the form is false or misleading, it means that where there has been a breach that has not been self-reported during the year, failure to disclose it on the annual declaration would expose the directors to a section 384 sanction. A failure to disclose a breach possibly may also work to create a failure of properly undertaking the directors’ fiduciary duty that gives rise to a cause of action. So as to differentiate the breach itself from the self-reporting of the breach, self-reporting should be encouraged by an appropriate amelioration of the sanction that might otherwise be applied in respect of the breach, much the same way that the SFC will consider to reduce a proposed disciplinary sanction where a licensed corporation has self-reported and admits fault. One possible difficulty is when the directors have reasonable grounds to believe that they have not breached the listing rules, where for example whether the conduct of directors or the behaviour of the company constitutes a breach is debatable. Thus, any imposition of a duty to disclose breaches must be qualified by a defence that directors have reasonable grounds to believe and did believe that no breach has been committed. The NYSE rule allows this possibility as it requires director to certify that he/she “is not aware of any violation by the listed company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary”. The wording in Singapore which says that the director certifies “to the Exchange that after making due and careful enquiry, and at the time of this certification, the Company has complied with the applicable continuing listing obligations in the SGX Listing Manual on a continuing basis” is less clear.

¹⁵⁰ LR Appendix 10, Part D, para 15(b)

The form could additionally be used to generate an annual renewal of the sponsor's declaration – albeit now given by the directors – made on the issuer's admission to listing that the company's procedures, systems and controls are adequate to enable the board to comply with their obligations and that the directors possess adequate experience and qualifications etc.¹⁵¹ These matters as addressed in the sponsor declaration are of crucial importance as without the sponsor's declaration the company cannot be admitted to listing. They are also matters that go to the ability of an issuer to effectuate CG standards. However, it appears to be a material shortcoming of the listing rules that once a company is listed, these matters become of significantly less consequence insofar as they are broadly dealt with to some extent by MBLR Chapter 3 and the comparatively lighter and more flexible hand of the HK CG Code, neither of which are currently accompanied by effective mechanisms of enforcement where the management falls short of the relevant expectations. This disjunct reflects an aspect of the broader laws and regulatory approach in Hong Kong that is in various ways misaligned as regards the matters to which the primary market is subjected as compared to the secondary market.

The foregoing leads to **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)".

Issuers may adopt and disclose CG practices that are not mandated by the listing rules and, although variations from those practices may not amount to a breach of the listing rules, they are no less important to investors' legitimate interest in the CG practices of an issuer.

The foregoing leads to **Recommendation S4.3.2** "Disclosure of non-compliance with issuer's disclosed CG practices".

Unlike **Recommendation A4.5.1** and **Recommendation C4.5.2** (see above) it is not proposed to require this disclosure to be made on a form subjecting the issuer and its directors to liability under the SFO – it would be inappropriate to do so as **Recommendation S4.3.2** addresses practices that have been voluntarily adopted and so imposing liability may discourage issuers from adopting higher standards.

While these recommendations improve the transparency of CG-related information to shareholders, it does not directly change their standing to take any action in respect of breaches. However, breaches of the recommended disclosure requirements will be relevant to consider again in **Section 3.6.4** "Legal standing of listing rules" where the discussion leads to **Recommendation S4.4.1** "Shareholders as beneficiaries of listing rules".

3.3.3 Board evaluation

Following the UK Walker Review¹⁵² in 2009, which recommended that the board should undertake a formal evaluation of its performance, the UK CG Code subsequently introduced a provision that the company should undertake an evaluation of its own performance and disclose the findings of the evaluation annually.¹⁵³ The evaluation is to be undertaken by non-executive directors and led by the senior independent director and should bring within its consideration certain other matters imposed on the board under the UK CG Code including as regards (1) the skills, experience, independence and knowledge of the company on the board, (2) how the board works together as a unit, and (3) other factors relevant to its effectiveness. For FTSE350 issuers, not less than

¹⁵¹ See paragraphs (b)(v)&(vi) of the sponsors declaration set out in Appendix 19

¹⁵² "A review of corporate governance in UK banks and other financial industry entities" 26 November 2009: Available at http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

¹⁵³ Section B.6

every 3 years, the board should obtain external assistance for the evaluation. Board self-evaluation provides an important nexus for the board to consider its own processes with a view to identifying and improving on weaknesses. While the Code does not provide that the results are made known to shareholders, the board is required to state how the evaluation was conducted.

Board evaluation is not a feature of CG in the United States. However, as noted in **Section 3.1** and in Appendices III.1.1 and III.7.2, the CG system is essentially board-centric with specific State and Federal laws protecting the interests of shareholders who are more properly described as beneficiaries of the fiduciary powers exercised by directors, without possessing the power to direct them.¹⁵⁴

In Mainland China, board evaluation is compulsory under the Code of CG for listed Companies (see Appendix IV.7.3). Such evaluation must cover the performance and evaluation of the board of directors, the supervisory board and the independent directors, including their attendance at board of directors' meetings, their issuance of independent opinions and their opinions regarding related party transactions and appointment and removal of directors and senior management personnel, as well as the composition and work of the specialized committees of the board of directors.

In Singapore, the Code of CG requires that there should be a formal annual assessment of the effectiveness of the Board as a whole and its board committees and the contribution by each director see Appendix V.7.3).¹⁵⁵ In practice, board evaluations are often compromised in Government-Linked Companies (GLCs) and family-owned companies (as the SingPost case shows (see Appendix V.7.3), when the members of nomination committee in charge of board evaluation are not independent, and the committee is assessing its own performance. Although the CG Code recommends that performance criteria should be consistent from year to year, and that where circumstances deem change necessary the onus should be on the board to justify the decision, the lack of independence of the nomination committee makes it difficult for the evaluation process to be effective and changes to be made. The adoption of a code of conduct and ethics in SingPost case has only come about because the director had been inadvertently exposed. The engagement of an outside unconnected party beyond the board's control should facilitate a more objective evaluation process. Policies governing conflicts of interest are undermined by the structure of the nomination committee and its relationship to the board. Finally, the committee that evaluates board performance should not consist of directors or connected parties to ensure objective and impartial board evaluations. Another weakness in Singapore's system is that the requirement for board evaluation is only a comply or explain provision which makes real meaningful and effective evaluation difficult.

Hong Kong

In contrast, in Hong Kong board evaluation is merely a recommended best practice. It is not accompanied by any guidance as to what factors should be considered, there is no disclosure requirement, and there is no element providing for external assistance.

The HKEX consulted on this in 2010 to 2011 with a view to moving evaluation to a code provision and bringing within its scope the evaluation of individual directors as well as the board as a whole.¹⁵⁶ However, neither proposal proceeded despite many respondents recognizing that it would align Hong Kong with international best practice. Among the responses the HKEX considered to have merit in deciding not to proceed was the view

¹⁵⁴ Christopher M Bruner, "Corporate governance in the common-law world", Cambridge University Press 2013, section 3B

¹⁵⁵ 2012 CG Code rule 5 Principle

¹⁵⁶ HKEX, "Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules", December 2010 and the "Consultation Conclusions", October 2011, Chapter 5

that “Hong Kong issuers are not ready for board evaluation ... because established corporate and cultural values would reduce individual performance evaluation to a mere box-ticking exercise”.¹⁵⁷ This is an example of using “culture” as a residual explanation when other modes of explanation are insufficient, as discussed in **Section 3.1.3** “The role of culture”. It is a peculiar, if not irrelevant response that essentially places an important aspect of board function in a black box and ignores the concept that directors are appointed by shareholders and on that basis are or should be accountable to them. Readiness is frequently precipitated by regulatory changes, rather than the other way around. Moreover, there are other mechanisms that, over time, can seek to address the box-tick concern.

Discussion

Formal board evaluation does not appear to be a common practice that is undertaken or reported on in Hong Kong.

An event-driven instance of this being done in recent years (in 2014) was the report produced by an independent board committee, comprised solely of independent non-executive directors (INEDs), of the MTR Corporation in response to “intense public concern and criticism” in relation to certain revelations concerning delays in the Guangzhou-Shenzhen-Hong Kong Express Rail Link project.¹⁵⁸ External experts were also engaged for the purposes of certain elements of the review. While it does not serve the present purposes to review the report in any detail, it is notable that the report made observations concerning the operations of the board as well as internal control processes, in particular in relation to the means by which information is communicated and made available to relevant persons, as well as the timeliness of making public statements. It is also of interest to note that the report commented on the effect of the failings on the credibility of the company, which is in some ways a reminder of the reputation-based liability of CG shortcomings discussed elsewhere in the present Report. The MTR report made a series of recommendations designed to address the relevant shortcomings.

A number of the interviewees expressed support for some form of board evaluation, however queried who will be watching the reviewers and whether it will in fact lead to a change in behaviour. A primary source of concern, should some form of evaluation requirement be introduced, was what basis or what metrics would be appropriate to use or recommend, and what details should be reported on. Because for commercial reasons it would be unwise to provide too much information to the market, there was a concern that the exercise could become another box-tick exercise and there was some uncertainty as to what use board evaluation might serve. In the absence of information being given to shareholders, board evaluation would not be a means of opening to shareholders the black box of the boardroom and its decision-making processes. A secondary concern was the question of how to effectively measure the long-term performance of the board and to avoid the risk that an evaluation of board performance be appropriated by short-termism. These concerns may in part explain why results of evaluation are not reported in the UK and why there is no formal requirement of board evaluation in the United States.

How to define board performance is an important issue. This affects the scope of the exercise as well as what metrics are used to assess performance. It is suggested that this should be regarded as a primarily commercial matter for the board to decide – if appropriate in consultation with external advisers – and that it will suffice if the board

¹⁵⁷ HKEX, “Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules”, December 2010 and the “Consultation Conclusions”, October 2011, 192 and 195

¹⁵⁸ “First report by the Independent Board Committee on the Express Rail Link Project”, MTR Corp., July 2014, page 7

makes the disclosures as set out in the required code provision. Based on feedback from interviewees and having regard to important differences between the nature of the UK and Hong Kong markets, it is not recommended that the factors a board should consider be prescribed, unlike the evaluation provisions in the UK CG Code. While this would not preclude a list of factors being provided for reference with guidance notes, as some interviewees had countenanced, there is a concern that such factors could come to take on more weight than originally intended. Some interviewees considered that to require this might be infringing on commercially sensitive matters. Thus, in the context of the Hong Kong market the definition of performance should be regarded as a commercial matter to be decided by the board and its adequacy assessed by shareholders.

Given the two primary purposes of board evaluation – encouraging the board to improve its processes and assisting shareholders to understand whether the board as a whole is operating effectively – it also does not seem necessary to specify what a board is required to do in a self-evaluation but merely to require it to advise shareholders what its policy is toward self-evaluation.

It is suggested that a board evaluation provide to shareholders, at the minimum, a reference in high-level terms as to the values and priorities of the board in terms of its operational processes and how these evolve over time. This should encompass the role and effectiveness of INEDs in relation to board operations. Such policy disclosure should indicate the board's approach to the evaluation of individual directors.

Where board evaluations amount to cut and paste exercises from previous years (or other issuers) this might send a signal to investors that the board is not undertaking a penetrating consideration of how effectively it operates.

The foregoing leads to **Recommendation C4.1.1** "Board evaluation".

3.3.4 Audit committee

In the UK there are two main sources that govern the audit committee: the FRC's UK CG Code and the FCA's DTR. As noted in Appendix II.4.3, a number of the provisions overlap, however, only the DTR provisions create binding obligations and breaches of them may give rise to enforcement action and/or an action for damages. Whereas the DTR sets out minimum requirements, the UK CG Code sets out recommendations, and the FCA has given guidance that compliance with certain provisions of the UK CG Code will entail compliance with the corresponding DTR requirement. This includes the composition and functions of the audit committee and the annual disclosures required in relation thereto. The FRC also issues guidance on certain sections of the CG Code including its Guidance on Audit Committees 2016.

The UK CG Code's approach to the audit committee is based on its function as a sub-committee of the board. Thus, the UK CG Code provides that the audit committee's responsibility in relation to the appointment, reappointment and removal of the external auditors is to make recommendations to the board.¹⁵⁹ Since 2012 the issuer is required to explain in the annual report to shareholders how the audit committee has carried out their responsibilities,¹⁶⁰ and the FRC's Guidance on Audit Committees recommends that the relevant section should include specified matters (generally covering the role and work of the audit committee) and be signed by the chairman of the audit committee.¹⁶¹ In practice, this is often regarded in the UK as equivalent to a report prepared by the audit committee. Where the board and the audit committee have been unable to agree on the recommended appointment, reappointment or removal of the external auditors,

¹⁵⁹ UK CG Code C.3.7

¹⁶⁰ UK CG Code C.3.8

¹⁶¹ Section 4, Paras 80 - 84

the Code requires the annual report to contain a statement from the audit committee explaining the recommendation and why the board has taken a different position.¹⁶² The same approach is undertaken in Hong Kong in relation to disagreements,¹⁶³ however, in the absence of such a disagreement, the audit committee does not make any disclosure. The HKICPA's "A guide for effective audit committees" issued in 2002 does recommend that the annual report should contain disclosures concerning the role and work of the audit committee.¹⁶⁴

In the United States, disclosures are not only required to be made about the audit committee, but are also required to be made by the audit committee itself (see Appendix III.3.2). The composition and workings of the audit committee, as well as the disclosures required to be made in the audit committee report presented in the issuer's annual proxy statements, are subject to SEC rules effective 2003 that implement SOX. Many issuers are already providing audit committee disclosures that go beyond the SEC's requirements.¹⁶⁵ Nevertheless, the disclosures of the audit committee in the audit committee report, and the usefulness of those disclosures, remains a continuing focus of the SEC and the PCAOB (although the PCAOB does not have regulatory jurisdiction over the audit committee).

Unlike the position in the UK, where the audit committee operates as a sub-committee subject to the board's usual powers, SOX and the SEC implementing rules position the audit committee as the primary body directly responsible for the appointment, compensation, and oversight of the issuer's external auditor, and it is the audit committee to whom the external auditor must report. These requirements, together with issues surrounding audit firm tenure, audit firm fee determinations, and audit committee involvement in the selection of the audit engagement partner, continue to be scrutinized.¹⁶⁶

In addition, the audit committee will need to be cognizant of the code of ethics an issuer is required to establish and apply to senior financial officers in compliance with the requirements of section 406(c) of the SOX.¹⁶⁷ This covers, *inter alia*, conflicts of interest, disclosure standards, and compliance with applicable rules and regulations. In addition to the code of ethics requirements reviewed above, the PCAOB issues auditing standards that outline the responsibilities and functions of auditors, internal and external, much as the FRC do in the UK and the Hong Kong Institute of Certified Public Accountants (HKICPA) do in Hong Kong despite the somewhat differing nature of each of these bodies in the regulatory architecture of each jurisdiction. The PCAOB's standards have been reviewed recently.¹⁶⁸

The NYSE rules also specifically require prospective audit committee members to consider and evaluate carefully the existing demands on his or her time before accepting this assignment¹⁶⁹ and, if a committee member serves on more than 3 public companies

¹⁶² UK CG Code C.3.7

¹⁶³ HK CG Code C.3.5

¹⁶⁴ Para 61

¹⁶⁵ James Schnurr, Chief Accountant, Office of the Chief Accountant, SEC, Remarks at the 34th Annual SEC and Financial Reporting Institute Conference (June 5, 2015) : Available at <https://www.sec.gov/news/speech/remarks-34th-sec-financial-reporting-institute-conference.html>

¹⁶⁶ See Audit Committee Collaboration, *Enhancing the Audit Committee Report, A Call to Action* (Nov. 20, 2013), Available at <http://www.thecaq.org/reports-andpublications/enhancing-the-audit-committee-report-acall-to-action>.

¹⁶⁷ 17 CFR 229.406 – (Item 406)

¹⁶⁸ On 31 March 2015, the PCAOB adopted amendments to reorganise its auditing standards, which were approved by the SEC on 17 September 2015, and shall be effective as of 31 December 2016. See PCAOB, "Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules," (31 March 2015) *PCAOB Release No. 2015-002*

¹⁶⁹ NYSE Company Manual Commentary to rule 303A.07(a)

then the board must consider whether this impairs the ability of the person to serve and must disclose such determination.¹⁷⁰

In Mainland China, an audit committee is not compulsory except for firms controlled or owned by the central government (see Appendix IV.7.3). Otherwise, the requirements for an audit committee are very similar to those in Hong Kong, UK and United States. Thus, whilst audit committees are increasingly playing a positive role, their effectiveness remains a work in progress. This to some extent depends on the effectiveness of independent directors who are the key members of the committees.

In Singapore, the Audit Committee is compulsory for all locally incorporated listed companies (s 201B(1), CA). The requirements are quite similar to the other jurisdictions examined. Listed companies incorporated outside Singapore are subject to similar requirements under the Singapore CG Code.¹⁷¹ However, unlike Hong Kong, the requirements in the Code are only comply or explain provisions. Surveys conducted in Singapore and Hong Kong found that fraudulent companies have a lower proportion of finance experts (as distinct from accounting experts) in their audit committees.¹⁷² Thus, it was suggested that there might be merit in emphasizing the monitoring role by finance experts in audit committee.¹⁷³

Hong Kong

The position of audit committees in Hong Kong overall is very similar to the position in the UK, but considerably different from the arrangements in the United States in three main regards.

First, in Hong Kong, the provisions governing the establishment and operation of the audit committee do not arise out of primary or regulatory law, as they do in the United States or Singapore (for locally incorporated companies), but are established in the non-statutory listing rules. Core requirements concerning composition of the committee are mandatory, as is the requirement for the board to establish the terms of reference of the committee, although the parameters of such terms are not specified in the listing rules, which instead reference the (non-mandatory) HKICPA's "A guide for effective audit committees" issued in 2002. Many of the detailed operational provisions are not mandatory but are instead laid out in the HK CG Code making them only subject to the comply or explain standard.

Second, in Hong Kong, although the audit committee may have day-to-day influence over the undertaking of the audit work, the primary relationship of the external auditor with the issuer is with the board, whereas in the United States it is with the audit committee independently of the board's usual functioning.

Third, the HK CG Code positions the audit committee's responsibilities around its role as a sub-committee of the board that reports to the board; accordingly, while the code requires the board to make disclosures about the audit committee,¹⁷⁴ the audit committee itself does not make any disclosures, subject to one exception (below). While guidelines issued by the HKICPA¹⁷⁵ do recommend the disclosure of the composition, activity and various functions of the audit committee in the annual report, the guidelines stop short of suggesting the audit committee itself make a disclosure in the annual report. Moreover, for the purposes of the HK CG Code the guidelines only constitute

¹⁷⁰ NYSE Company Manual Disclosure Requirement rule 303A.07(a)

¹⁷¹ 2012 CG Code Rule 12.1

¹⁷² Wan et al., *op. cit.*

¹⁷³ *Ibid.* See Appendix V.7.2

¹⁷⁴ CG Code C.3.5

¹⁷⁵ "A Guide for Effective Audit Committees", Hong Kong Institute of Certified Public Accountants, February 2002, para 61

suggestions. Section L(iv) of the HK CG Code contemplates – somewhat indirectly – that an audit committee might itself report on its functioning, however, the board may also do this.

The one exception to the silence of the audit committee’s voice reflects a similar provision in the UK: the HK CG Code requires – again on a comply or explain basis only – the audit committee to make a disclosure in the annual report in circumstances where it has been unable to agree with the board on the selection, appointment, resignation or dismissal of the external auditors.¹⁷⁶

Given the importance to CG standards of the role played by a properly engaged audit committee, it is in some ways surprising that the role performed by the audit committee is open to being determined by the board with no legal constraints thereupon. Together with the relative invisibility of the audit committee’s voice in communications with shareholders this suggests that Hong Kong can do significantly better in this regard. This is supported by the greater concern that has been identified over auditors and the quality of financial statements of Mainland Chinese issuers, as already mentioned in **Section 3.1** “Overarching considerations”, concerns that should not be taken lightly given the increasing predominance of Mainland Chinese enterprises being listed on the SEHK.

However, it is recognized that a number of factors weigh in on this discussion. Not least being the current discussions about the correct positioning and powers of the FRC in Hong Kong’s regulatory architecture. Accordingly, two levels of suggestions are made, both of which would require changes at the level of the listing rules.

The relatively simpler one is to expand on developments in the UK and the United States to improve the transparency and voice of the audit committee to shareholders by requiring it to make a disclosure in the annual report. This is often the *de facto* position in the UK and is required in the United States. Given the concerns expressed in relation to INEDs (see **Section 3.7** Part C “Independent directors”), increased visibility of the audit committee through mandated disclosures is one mechanism by which responsibility may be brought more directly to bear on INEDs – under the current listing rules the audit committee must be chaired by an INED, be comprised of a majority of INEDs, and include at least one INED with appropriate professional qualifications or accounting or related financial management expertise.¹⁷⁷ It may include NEDs but excludes executive directors.

A more complex suggestion would be to reposition the function of the audit committee as one that is managed by legal requirements, as has been done in the United States. While this requirement in the United States has been implemented via primary and regulatory law, it is suggested the equivalent action in Hong Kong – making primary or subsidiary legislation – may be difficult to implement, and would likely be premature in the absence of a clear mandate from the market that this is needed. Accordingly, it is suggested that a more suitable approach for Hong Kong would be to impose a comply or explain requirement on boards that the authority in relation to the appointment, compensation, and oversight of the external auditor be fully delegated to the audit committee. Such a delegation would not, at law, diminish the ultimate legal authority of the board, or alter the board’s legal obligations to oversee the execution of any delegated function of the board. However, where full delegation is made, this places greater emphasis on the primary role and authority of the audit committee – i.e., not merely to make recommendations to the board but to itself make binding determinations. This would considerably strengthen the intended function of an audit committee as a safeguard against financial manipulation.

¹⁷⁶ CG Code Provision C.3.5

¹⁷⁷ MBLR 3.21

The foregoing leads to **Recommendation A4.1.3** "Disclosures of the audit committee" and **Recommendation A4.1.4** "Status of the audit committee".

The ability to achieve the intended objectives of these two recommendations depends significantly on the INEDs and the other NEDs comprised in an audit committee. In this regard, reference should be made to other recommendations in this Report that are directed toward improving the quality, independence and accountability of INEDs (and other NEDs): **Recommendation A4.2.1** "Sufficient INED time", **Recommendation A4.2.2** "Basis of INED remuneration", **Recommendation A4.2.3** "INED training", **Recommendation C4.2.4** "NED Code and INED reporting", and **Recommendation C4.5.3** "Facts regarding director independence".

3.4	Involvement
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Introduction

The quest of improving the involvement of shareholders in the affairs of a company, and thereby developing a more informed relationship and communication between management and shareholders, has been a multi-pronged approach in most of the jurisdictions studied. Traditionally, this effort has focused on the disclosure obligations of the company and its management, which was the topic of **Section 3.3 "Information"**. As noted in that section, this occurs against a backdrop of facilitating the real ability of a shareholder not only to receive timely and adequate information but also to exercise their votes in shareholders meetings.

This Section takes as its primary concern shareholder involvement in decision-making and what circumstances trigger their involvement. This includes the concept of shareholder stewardship (**Section 3.4.1**), the rights attaching to shareholder votes and specific issues related to executive compensation (**Sections 3.4.2 and 3.4.3**), and event driven matters relating to changes of control (**Section 3.4.4**).

3.4.1 Shareholder stewardship

In the UK, the drive to encourage shareholders to become more actively interested in the affairs of the company has taken various forms. One example of the broader initiative undertaken is the FRC's introduction of the first version of the Stewardship Code in 2010. This Code comprises a voluntary set of principles to assist institutional investors in the exercise of their shareholder responsibilities towards UK listed issuers.¹⁷⁸ It is backed by the requirement of the FCA, in its role as the regulator of financial firms, that UK authorized asset managers report on whether they comply with the Stewardship Code.¹⁷⁹

However, the Stewardship Code has not translated into shared responsibility and enhanced collaboration between the board and shareholders. As discussed in Appendix II.4.3, shareholder engagement has declined over the 2016 period,¹⁸⁰ this is despite additional shareholder powers in relation to the board, in particular dual-voting, being made available to shareholders. UK institutional investors tend to be non-confrontational and passive and activist shareholders are uncommon.

In the United States, by contrast, there is a clear profile of activist shareholders that are taking an aggressive and confrontational approach, demanding that boards implement their strategies and insert their board appointments. This has not always led to productive outcomes, as discussed in **Section 3.4.3 "Remuneration"** (see also Appendix III.1.2). As discussed in Appendix III.7.2, the SEC has been trying to facilitate the role of shareholders more widely via, *inter alia*, federal proxy rules to remove various impediments to shareholder involvement. However, the rules were successfully challenged in court and rejected.

The current extremities of acquiescence and friction between professional shareholders and boards of directors in a context of government and regulatory intervention in the

¹⁷⁸ FRC, "UK Stewardship Code": Available at <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx> (visited on the 30 Nov 2016); FRC, "The UK Stewardship Code," (2012), 1

¹⁷⁹ FRC, "Corporate Governance and Stewardship," Available at <https://www.frc.org.uk/Our-Work/Corporate-Governance-Reporting/Corporate-governance.aspx> (visited on 2 Nov 2016)

¹⁸⁰ Grant Thornton, "The future of governance: one small step...," (2016) op. cit.

roles and rights of shareholders as well as remuneration mechanisms are evidence that a regulatory-commercial grey area has developed. Developments in the specific roles, powers, and enforcement scope of the regulators have occurred because an environment whereby market participants are active and consistent in promoting the principles of the responsible investing has failed to develop. However, regulatory intervention in traditionally commercial matters has not always been successful.

Hong Kong

The SFC introduced the “2016 Principles of Responsible Ownership”, which largely follows the lead established by the FRC’s Stewardship Code. However, there is little evidence that it is having an impact. As noted in Appendix I.2, Hong Kong has few activist shareholders and, despite an increase in institutional shareholders in Hong Kong in recent decades,¹⁸¹ a relatively larger participation of retail investors in the public market, who tend to be relatively inactive. Media reports of activist and institutional shareholders in Hong Kong are quite rare. Institutional interaction with listed issuers does occur, although this tends to be on a more informal and private basis with the board. This stands in contrast to the United States where shareholder activism is apparent, and the UK where activism is on the rise. However, there have been two recent high-profile examples of activism being imported to Hong Kong. In the first, a United States based fund manager (Elliot International) holding shares in a Hong Kong listed issuer (Bank of East Asia), has petitioned the Hong Kong court alleging that the affairs of the issuer have been conducted in a manner unfairly prejudicial to the interests of its shareholders.¹⁸² In the second, a dispute between a Nasdaq listed issuer (Sina Corp) and a United States investment manager (Aristeia Capital) concerning the appointment of two directors nominated by Aristeia was played out in an annual general meeting held in Hong Kong in November 2017. Both cases represent somewhat unique instances of exposing Hong Kong shareholders to activism.

Perhaps similar to the UK, some institutional shareholders are implementing their own approaches, e.g. Blackrock’s “Corporate governance and proxy voting guidelines for Hong Kong securities”. However, in both the UK and Hong Kong markets retail investors in general tend to be relatively uninvolved as shareholders with rights and behave more like investors with the power to sell.

In Singapore, the Securities Investors Association Singapore is the body that represents shareholders – it is active in promoting shareholder rights through boardroom activism rather than the courtroom, although it is prepared to do so in appropriate cases (see Appendix V.5.1). In November 2016, the Stewardship Asia Centre on behalf of the Singapore Stewardship Principles Working Group¹⁸³ issued the “Singapore Stewardship Principles for Responsible Investors.”¹⁸⁴ Despite the adoption of the Stewardship Principles, there is no evidence of a rise in shareholder involvement or activism.

In Mainland China, although institutional investors have an increased presence, they are still smaller compared to the controlling shareholder of SOEs, the State. Thus, activism by institutional investors remains low (see Appendix IV.5.4). There is no Stewardship Code. In a survey by Institutional Shareholder Services in November 2014, it was found that (1) the level of engagement between Mainland Chinese companies and foreign investors is low compared to United States companies, and engagement is usually initiated by investors; (2) philosophical, cultural, and language differences are significant

¹⁸¹ Kieran Colvert, “Where were the Investors?,” (7 April 2015) *Chartered Securities Journal*

¹⁸² Under s. 724 CO. See also <http://fairdealforbea.com/>

¹⁸³ Consisting of Stewardship Asia Centre, the Singapore Institute of Directors, the Investment Management Association of Singapore and the Securities Investors Association of Singapore, supported by the MAS and SGX

¹⁸⁴ Stewardship Asia, “Singapore Stewardship Principles For Responsible Investors”, November 2016: Available at http://www.stewardshipasia.com.sg/principles/singapore_stewardship_principles.pdf

barriers to constructive dialogue between Mainland Chinese issuers and investors; (3) voter turnout at mainland-listed Chinese companies is approximately 55 percent, the lowest among the markets studied; (4) investors of mainland-listed companies are more concerned with related-party transactions and share issuances without preemptive rights than other common voting agendas, and are more vocal about these issues through their votes; (5) nearly half of all proposals at mainland-listed companies are approved unanimously, while such unanimous consent is much less frequent in other markets studied; and (6) while shareholder proposals are not uncommon in Mainland China, nearly all are presented by controlling shareholders, and typically receive more than 95 percent support.¹⁸⁵

Discussion

Based on the lack of traction the Stewardship Code has had in the UK to date and the particular characteristics of the Hong Kong market at present, there is little to suggest that significant inroads to shareholder participation in a listed issuer will be obtained through a stewardship approach, at least at the present time. However, this is not to suggest that stewardship is an unworthy idea in principle. Rather, it is suggested that stewardship is not a concept that should be expected to be integrated into a market within a short period of time. It is more likely to be part of a generational cum cultural shift as shareholders come to feel increasingly empowered in the exercise – and enforcement – of their rights. Instances such as the Elliot and Aristeia actions may serve to promote change more than regulatory dicta might. Accordingly, for the purposes of this study, it is considered that laying the foundation for an appropriate level of empowerment is an important precursor to and facilitator of stewardship in the wider shareholder context. The scope of the present study being to identify recommendations that are likely to be more resource-effective in that they should be supported by a mandate from the market and/or have a high expectation of achieving measurable improvements in CG standards, it is suggested that stewardship principles may need to be revisited at some future point in time when ground conditions in the market may be more responsive.

3.4.2 Shareholder votes

A more specific measure taken in relation to shareholder votes in the UK was the introduction of a requirement that independent directors be appointed by independent shareholders under a dual voting arrangement, and that this would require, for issuers with a controlling shareholder, appropriate changes in their constitutional documents – discussed in **Section 3.6.4** “Appointment of independent directors” and Appendix II.1.2. This serves two purposes: it gives shareholders a stronger incentive to attend meetings and to exercise their vote, and it establishes a clear line of accountability of independent directors to independent shareholders – the argument being that it is those shareholders they should be taking into account when exercising their role. Another example of shareholder empowerment, particularly when considered in light of the foregoing development, is the introduction of paragraph B.7 to the UK CG Code, to the effect that FTSE350 company directors should be put up for election every year. According to oral testimony before a Parliamentary Committee, “most companies have adopted this”.¹⁸⁶ The Department of Business, Innovation & Skills (BEIS) also have a strong shareholder-driven mandate in view of some recent high-profile shareholder actions in relation to executive remuneration, as discussed in Appendix II.2.1.

¹⁸⁵ Jun Frank, Rui Deng, Faye Mo, Investor Stewardship: An examination of voting and engagement activities in China: Available at <https://www.issgovernance.com/file/publications/china-investor-stewardship.pdf>

¹⁸⁶ Per Sarah Hogg (non-executive Board member of the FCA and former Chair of the FRC), oral evidence given at BEIS enquiry into CG, see Tuesday 24 Jan 2017: Available at <http://parliamentlive.tv/Event/Index/1f833dfc-c5d9-4a46-896c-f18e237928c1>

These requirements have all been introduced within the last few years, indicating an active engagement of the regulators in developing mechanisms that put more power into the hands of shareholders.

However, there are nuances to the question of the appropriate level of shareholder involvement in the affairs of a company. The experience in the United States presents a somewhat different matrix of problems than the UK but which are nevertheless informative as regards the context in Hong Kong. The specific question of the appointment of INEDs is discussed in **Section 3.6.4** "Appointment of independent directors".

In the United States, it has been a long-standing fundamental right of shareholders under State law to participate in meetings. This encompasses not only the right to vote but also the right to make proposals to be voted on by members. However, as discussed in Appendix III.7.2, the SEC's view is that the proxy statement process impedes those rights and the SEC has been struggling for over half a century to facilitate shareholders exercising their rights. Different State laws provide for different shareholder rights, for example, neither Delaware nor New York guarantees that shareholders have any right to call a meeting, whereas California does. However, as noted elsewhere, since most listed issuers are incorporated in Delaware that is the State law of reference for present purposes.

Actual in-person meetings of shareholders are now, in effect, only a necessary formality. The primary means by which shareholders are in practice able to express their views is now by way of proxy exercised either in response to an issuer's proxy statement that explains to shareholders the matters for discussion at the meeting, or through the solicitation of proxies by initiating a proxy contest.

The question of giving shareholders appropriate access to the contents of the proxy statement, i.e. to give them the right to insert proposals on it, has been a significant battleground. A fundamental CG concern in this regard is that in the absence of an effective means for shareholders to nominate and elect or remove directors to or from the board, accountability of the board to shareholders is diminished. There is a wider set of arguments that the United States in this regard has fallen behind standards in other countries and that this ultimately represents an important competitiveness problem for United States issuers.¹⁸⁷ Some academic literature also suggests a relationship between board accountability and effectiveness.¹⁸⁸

Conversely, a concern that has been expressed over shareholder-nominated appointments¹⁸⁹ is that directors so appointed may represent the interests of select shareholders rather than the interests of the company as a whole. Shareholder activism via proxy contests can lead to undesirable outcomes, a feature that is also beginning to appear in the UK markets. This issue is discussed further under **Section 3.6.4** "Appointment of independent directors".

This issue was a concern of Dodd-Frank, which empowered the SEC to make rules addressing shareholder access to company proxy materials. The authority was an important means of overcoming a previous court ruling in 1990¹⁹⁰ that the SEC lacked the authority to regulate corporate governance through the proxy rules. In 2010 the SEC introduced a new proxy access rule – Rule 14a-11 – designed to facilitate the rights of

¹⁸⁷ Committee on Capital Markets Regulation, *Interim Report* (November 30, 2006) at 109: Available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf

¹⁸⁸ See, e.g., Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors—A Decision-Making Analysis*, 5 Berkeley Bus. L.J. 131 (2008)

¹⁸⁹ For example by the United States Chamber of Commerce and the Business Roundtable Corporate Governance Task Force

¹⁹⁰ *Business Roundtable v. SEC* 905 F.2d 406 (D.C. Cir. 1990)

shareholders to nominate directors to a company's board. In a rule that sought to address the perceived problem of short-term shareholders pursuing short-term interests at the cost of longer term corporate prosperity, an issuer was required to include the nominees of long-term shareholders in their proxy materials together with the nominees of management. However, the rule was again successfully challenged in court, this time on the basis that the SEC had failed to adequately assess the economic effects of the rule.

Nevertheless, developments over the past decade or so have strengthened the voice of shareholders in companies. This includes SEC rules that facilitate the use of electronic shareholder forums,¹⁹¹ enhanced disclosure requirements concerning the nominating committee of the board,¹⁹² the information required to be included in proxy statements which includes matters such as appointment of directors and executive compensation,¹⁹³ many larger companies moving to majority voting in place of plurality voting in director elections,¹⁹⁴ and that many State laws – including Delaware where most listed issuers are incorporated - now clearly allow constitutional documents of companies to set out shareholder rights to nominate directors.¹⁹⁵ Indeed, there have been ever growing waves of shareholder-initiated proposals to amend bylaws to allow proxy access and a significant number of United States companies have amended bylaws in one form or another.

Hong Kong

In contrast, the discussion surrounding shareholder involvement in Hong Kong is relatively inactive. Shareholders in Hong Kong incorporated issuers have clear powers under section 566 of the CO to call meetings and to propose matters to be discussed and voted on. Given that most issuers are not incorporated in Hong Kong, significant reliance is placed on the SFC/HKEX Joint Policy Statement together with MBLR 19.05(1)(b), which, as discussed in **Section 3.2.1** "Application of local laws and regulations", work to ensure that shareholders receive equivalent standards of investor protection including as to their rights to call meetings, propose resolutions and to vote.

The HK CG Code has not as yet followed the approach in the UK as regards the frequency of director re-election. The HK CG Code instead provides for retirement by rotation every three years.¹⁹⁶ The election of directors is closely tied to the interrelated topics of board refreshment as a mechanism of management accountability to shareholders (see **Section 3.6.3** "Board refreshment"), as well as the information made available to shareholders in relation to the performance evaluation of directors and the board as a whole (see **Section 3.3.3** "Board evaluation", which led to **Recommendation C4.1.1** "Board evaluation"). The question of whether the HK CG Code should develop higher CG standards for certain larger companies is discussed in **Section 3.7.7** "Differentiation of CG requirements".

¹⁹¹ *Electronic Shareholder Forums*, Release No. 34-57172 (January 18, 2008) [73 FR 4450]

¹⁹² *Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors*, Release No. 33-8340 (December 11, 2003) [68 FR 69204]

¹⁹³ 17 CFR 240.14a-101 Schedule 14A. Information required in proxy statement

¹⁹⁴ Around half of S&P 500 companies had changed over by the end of 2008. However, plurality voting remains the standard at the majority of smaller companies. See The Corporate Library Analyst Alert, December 2008, and the Broadridge letter dated March 27, 2009 and attached analysis in response to File No. SR-NYSE-2006-92.

¹⁹⁵ Effective August 1, 2009 Delaware General Corporation Law included a new section 112 allowing that the bylaws of a Delaware corporation may provide that, if the corporation solicits proxies with respect to an election of directors, the corporation may be required to include in its solicitation materials one or more individuals nominated by a stockholder in addition to the individuals nominated by the board of directors. Similar changes may be made to the Model Business Corporation Act maintained by the American Bar Association.

¹⁹⁶ Code Provision A.4.2

Other changes made in the UK, such as dual voting, are regarded in the Hong Kong context as almost radical, and this likely arises out of the significantly different makeup of investors in the Hong Kong market, in which around half of companies possess a controlling (>30%) shareholder and around a third possess a majority (>50%) shareholder (see Appendix II.1.2).

However, Hong Kong is not without its structural problems as regards shareholder voting. Most publicly-owned shares in Hong Kong are held through a nominee arrangement (HKSCC Nominees Ltd, a subsidiary of the SEHK) and this does create proxy issues in practice. This does not challenge shareholders exercising their rights to the same extent as in the United States where the problems are more fundamentally legally systemic in nature – Hong Kong’s problem is more operational in nature. This system has often been criticized as a deterrent to shareholders attending or casting their votes at general meetings of listed issuers. To attend, the shareholder must instruct the nominee to appoint them as its proxy (or corporate representative). To vote, the shareholder must give the nominee its voting instructions. These instructions must be given to the nominee in sufficient time for it to process the instruction in time. Together with the delays in shareholders receiving corporate communications, which need to be processed through the nominee, this materially shortens the amount of time provided by statute that a shareholder has to form its views. These arrangements clearly add meaningful hurdles to the concept of shareholder participation. Indeed, it was a key observation of the Kay Review,¹⁹⁷ undertaken in the UK (see Appendix II.2.1), that shareholder engagement is diminished by shareholders holding through a custodial system, which creates barriers and uncertainty, rather than directly. Based on the Kay Review’s recommendation, BEIS is exploring a cost effective means of implementing an electronic shareholder register.

The Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Ordinance gazetted in March 2015 provides a framework for the introduction of a securities market that will enable shareholders to hold, transfer and vote shares under a paperless system. However, this Ordinance is not yet in force pending the preparation of detailed subsidiary legislation.

In Singapore, some shares are also held by nominees (e.g. banks or other intermediaries), and only registered legal owners can vote. However, the 2013 amendment to the CA allows intermediaries to appoint more than two proxies to vote by show of hands. The CG Code also has similar rules (see Appendix V.7.1).

Mainland China has also devised means of facilitating beneficial owners to vote via online voting.

However, the main problem for investors in each of Singapore, Mainland China and Hong Kong is that they are minority shareholders, and most listed companies are subject to the influence of majority or controlling shareholders. So, while having the right to vote assists minority shareholders express their voice, it has a limited ability to solve many of the problems minority shareholders face. Something else is needed to protect minority shareholders.

Like Hong Kong and the UK, the Exchanges in Singapore and Mainland China also do not allow companies with dual class share structure to be listed. This is ostensibly for the protection of minority shareholders based on the one-share-one-vote principle. However, some voices in the market argue that this principle stifles the development of an alternative public market for innovative companies seeking to raise funds. Thus, the Hong Kong and Singapore Exchanges have been actively considering the issue, as has

¹⁹⁷ John Kay, “The Kay Review of UK Equity Markets and Long-Term Decision Making,” (2012), 9

the corresponding industry regulators in each jurisdiction (see discussion at **Section 3.5.2** "Weighted voting rights" below).

Discussion

As discussed in **Section 3.5.1** "Voting rights generally", dual voting represents a public law amendment of private rights. While the SFC has in the past expressed strong disapproval of the introduction of dual class voting shares, it is expected that any suggestion of dual voting rights imposed by the regulator would be met with similarly strong resistance by the controlling shareholders that dominate ownership of listed issuers. Interviewees were quite divided on the question of whether dual voting would be desirable in Hong Kong. The cultural background together with the traditional predominance of family controlled issuers suggested to some that an "outside" director may simply introduce disruption in the operations of the board. Similarly, there was concern that if independent directors were to be appointed by independent shareholders then there would be a risk that those directors would pursue the interests of a minority group to the exclusion of the interests of the company as a whole. However, the makeup of the market is changing very considerably, and it is arguable that the expectations of investors are evolving together with the market and international practices. Nevertheless, there is some doubt as to whether the introduction of dual voting would be supported by the requisite regulatory mandate.

A more significant opportunity to engage shareholders rests in the reform of the means by which shareholders hold their shares. As already discussed above, the framework for a scripless system is in progress that will enable more direct contact between issuer and shareholder both as regards the timeliness of notifications and the ability to vote as legal owners of the shares. Note however that while the new law will apply to Hong Kong companies, it will only apply to non-Hong Kong companies as and when the necessary approvals or laws of their home jurisdictions are in place and the Government is currently initiating discussion on this with Mainland China, the United Kingdom, Cayman Islands and Bermuda.¹⁹⁸

3.4.3 Remuneration

Since the 2008 global financial crisis a significantly greater focus of attention has fallen on executive remuneration. This is particularly notable in the UK and United States. The central concerns are the reference points for setting remuneration and how decisions are made to set them.

Any discussion of the transparency, evaluation and approval of executive remuneration must be distinguished from the question of whether executive remuneration should be linked to corporate performance. Whereas the former is firmly within the scope of this study's approach to the mechanisms of "good CG" (as discussed in **Section 2** "Methodology"), the latter is essentially value-laden as it makes certain assumptions about the effect of establishing such a link - as such, for the purposes of this study it is regarded as a subset of the former concerns.

In common with the approach advocated in many markets, Hong Kong has adopted a regulatory policy, set out in the HK CG Code, that an executive director's remuneration should be linked to corporate and individual performance.¹⁹⁹ While establishing the link may appear to make sense in spirit, it has nevertheless been subject to abuse, particularly in the United States, much less so in Hong Kong and the other jurisdictions studied. In some instances, the link has led (possibly quite predictably) to unintended

¹⁹⁸ Legislative Council Brief, 2014: Available at http://www.legco.gov.hk/yr13-14/english/bills/brief/b201406132_brf.pdf (visited on 12 Nov 2017)

¹⁹⁹ B.1.7

consequences, namely, short-termism and unwarranted risk taking. This has been exacerbated by changes to board composition in the form of activist directors, and changes in shareholder composition including the formation of temporary majorities being formed through “wolf packs”.²⁰⁰ There are clear instances where activist shareholders have driven executive remuneration structures toward short-term growth and management reward objectives without regard to longer-term strategies or benefits to the company and its shareholders. This has particularly been the case with hedge fund investors that stand to gain from share price fluctuations over the short term. The problem is not limited to hedge fund managers - executives have also observed the opportunity to make personal gains from share price performance irrespective of whether it is in the long term interests of the company, for example, via excessive risk taking (as seen in the global financial crisis) or, in extreme cases, committing fraud (as in Enron). Where remuneration is linked to corporate performance, there must be separate safeguards as regards the decision to establish a link, and if so, vetting the nature of the link and submitting it to shareholder approval.

The wider question for present purposes is what measures are appropriate to deal with the risk of remuneration-abuse (whether or not it is linked to corporate performance). As discussed in **Section 3.6.4** “Appointment of independent directors”, the increased representation of independent directors has not alleviated the problem, possibly with the exception of Singapore where other factors are at play (see below). Instead, there has been a general drive internationally to give shareholders more say on executive remuneration and to improve the functioning of the remuneration committee. Proposals to impose “clawback” rights on executive remuneration have been mixed.

In the UK, the FRC has been active in introducing new provisions to the UK CG Code, including provisions dealing with the design of performance related remuneration (2008), remuneration (2010) and policies to defer, recover, or withhold variable pay (2014), as discussed in Appendix II.4.1.

The FCA’s DTR mandates disclosure of the composition and operation of the issuer’s administrative, management and supervisory bodies and their committees, and this will encompass the remuneration committee where one has been established.²⁰¹ A description of the work of the remuneration committee is also required under the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2013, although this is applicable only to UK incorporated companies. This requirement is supplemented by provisions of the UK CG Code that specify the remuneration committee should be comprised of at least three independent non-executive directors,²⁰² and that its terms of reference, including its role and the authority delegated to it by the board, should be disclosed. FTSE350 issuers should establish their remuneration committee with delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments.²⁰³ Many FTSE350 companies have taken up suggestions of the FRC to implement clawback arrangements on executive pay.²⁰⁴ The UK CG Code also provides that shareholders should be “invited” to approve all new long-term incentive schemes (as defined in the listing rules²⁰⁵) and significant changes to existing schemes, save in the circumstances permitted by the listing rules.²⁰⁶

²⁰⁰ See JC Coffee, “The wolf at the door: the impact of hedge fund activism on corporate governance.” Working Paper No. 521, 2015: Available at <http://ssrn.com/abstract=2656325>

²⁰¹ FCA Rule DTR 7.2.7 R

²⁰² Provision D.2.1

²⁰³ Per Section D of the UK CG Code, Provision D.2.2; the committee should also recommend and monitor the level and structure of remuneration for senior management

²⁰⁴ 91% of FTSE350 issuers in respect of the annual bonus and by 78% in respect of long term plans. See FRC’s 2016 annual review “Developments in Corporate Governance and Stewardship”

²⁰⁵ Listing rules, LR 9.4

²⁰⁶ Code Provision D.2.4

The link between remuneration and corporate performance and the attendant safeguards against abuse was an important focus of the Dodd-Frank reforms. The Dodd-Frank Act mandated three different types of non-binding shareholder votes on compensation matters that encompass enhanced compensation structure reporting and shareholder voting on executive compensation (see Appendix III.3.1). Although the votes are non-binding due to the primacy of directors under State laws to determine the company's affairs, it does serve as an important barometer of shareholder views of a company's compensation practices. In consequence, directors do tend to be quite focused on receiving a favorable outcome as poor results have the potential to trigger significant investor pressure and possibly litigation. Dodd-Frank also required the SEC to implement rules for compensation committee independence, and many of these have been implemented by way of mandatory requirements being incorporated into the listing rules of the Exchanges²⁰⁷ that will need to be reported on under Item 407 of Regulation S-K, which brings the disclosure within the reach of Federal securities laws (see **Section 3.3.1** "Legal status of CG disclosures").

The SEC has proposed rules, also pursuant to Dodd-Frank, directing the Exchanges to establish listing standards requiring companies to adopt policies to recover or claw back executive incentive-based compensation (i.e. tied to accounting-related metrics, stock price, or total shareholder returns) that were awarded erroneously.²⁰⁸ However, the draft implementing rules proposed by the SEC have not yet been finalized as this has been a more controversial issue and remains in a state of uncertainty following the most recent change of government, which is seeking to roll back some of the Dodd-Frank reforms.

While the SEC has also sought to implement proxy rules to bring greater power to long-term shareholders, this has been successfully challenged in court, as discussed in **Section 3.4.2** "Shareholder votes" above.

Notwithstanding the foregoing efforts to develop safeguards on executive remuneration, it has been observed that clawback provisions²⁰⁹ or say on pay²¹⁰ are not particularly effective and have little effect on reducing CEO compensation levels in the United States. What appears to be essential for it to work, and which appears to be lacking, is consensus:

"In order to determine the effectiveness of say-on-pay, there must be some consensus on the nature of the problem and the desired outcome. There also has to be some consensus on what led to say-on-pay. Moreover, say-on-pay cannot be understood in a vacuum. Instead, it must be analyzed as a part of corporate governance. As long as the corporate governance system as a whole does not serve shareholders' interests properly, there is little that say-on-pay can achieve... Without the threat of say-on-pay, excess executive compensation might have been even higher, but that is impossible to measure."²¹¹

²⁰⁷ Section 952 of Dodd Frank requires the adoption of NYSE and Nasdaq compensation committee listing standards

²⁰⁸ U.S. Securities and Exchange Commission, "SEC Proposes Rules requiring Companies to Adopt Clawback Policies on Executive Compensation," (1 July 2015) *Press Release*: Available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/2015-136.html> (visited on 9 Sept 2016).

²⁰⁹ Executive Pay Clawbacks Are Gratifying, but Not Particularly Effective, 30 September 2016: Available at <https://www.nytimes.com/2016/10/02/business/exclawbacks-are-gratifying-but-not-particularly-effective.html?mcubz=3>. Since 2011, the SEC has brought 40 cases against top executives and clawbacks under voluntary corporate programs are even rarer. In the Wells Fargo case, the SEC could recover only a portion of pay from chief executives or chief financial officers if their companies were found to have manipulated their books.

²¹⁰ Dan Palmon "Say-on-Pay: Is Anybody Listening?", 4 August 2017: Available at <https://corp.gov.law.harvard.edu/2017/08/04/say-on-pay-is-anybody-listening/> (visited on 12 Nov 2017)

²¹¹ *ibid*

This reflects a position arrived at in other parts of this study that specific CG mechanisms intended to operate as safeguards can only be assessed and implemented having regard to all other surrounding mechanisms that provide, or fail to provide, appropriate support for a proposed CG mechanism.

In Singapore, there are also requirements for remuneration practices and disclosures (see Appendices V.1.3, V.4.1, V.7.3) although a review by the SGX reveals that remuneration matters receive the lowest score (see Appendix V.1.3). The idea is that with independent directors as members, executive directors would not get to set their pay, and abuse can be avoided. The Remuneration Committee's responsibilities are to review and recommend to the Board a general framework of remuneration for the Board and key management personnel and review and recommend to the Board the specific remuneration packages for each director as well as for the key management personnel. While excessive executive compensation continues to be an issue in the United States and UK, raising the question whether the remuneration committee is an effective mechanism, this does not appear to be a problem in Singapore – although possible exceptions could be Mainland China state-owned enterprises (S-Chips) which are not well-monitored by State-owned Assets Supervision and Administration Commission of the State Council (there have been some instances of abuse taking various forms with S-Chips (see Appendices V.1.4 and V.7.3) or private firms where the controlling shareholders are also the executive directors. However, it is likely that with GLCs being majority-owned by the Singapore government, and other private firms owned by controlling shareholders, there is informal – and arguably effective – control on executive compensation imposed by the government or the controlling shareholders. What may be of relevance to note in this regard is that INEDs are much better paid in Singapore than their counterparts in Hong Kong (see Appendix V.1.3). Whether this signals that INEDs have a greater influence or whether this is merely part of the consensus package that comes with government and controlling shareholder influence is open to debate.

In Mainland China, as in Singapore, executive remuneration does not appear to be an issue as it is frequently subject to close monitoring and control by the State as the controlling shareholder. However, following Western concepts, Mainland China employs a committee – the remuneration and appraisal committee – with similar functions to its counterparts elsewhere, including a requirement for disclosure of information concerning remuneration policy and director remuneration (see Appendix IV.7.3). Pay for independent directors, as in Hong Kong, is also on the low side.

Hong Kong

The focus in Hong Kong is primarily concerned with the formation and functioning of the remuneration committee under the HK CG Code. As indicated in the comparison Table of the UK and HK CG codes in Annex 1 to Appendix I.4, the arrangements in both Hong Kong and the UK cover similar principles regarding the level and make-up of remuneration and disclosure. For example, both codes require the remuneration committee to consider salaries paid by comparable companies.

A notable difference is that whereas the UK CG Code provides that the remuneration should have delegated responsibility for setting remuneration²¹² the HK CG Code only requires disclosure of whether the remuneration committee determines remuneration with delegated responsibility or merely makes recommendations to the board.²¹³ The UK CG Code also provides considerably greater detail, and emphasis, on the provisions the remuneration committee should follow when designing performance-related remuneration for executive directors,²¹⁴ which in Hong Kong receives only a brief

²¹² UK CG Code Provision D.2.1 and D.2.2

²¹³ HK CG Code Provisions L and B.1.2(c)

²¹⁴ See Schedule A of the UK CG Code

mention as a recommended best practice.²¹⁵ Unlike the UK CG Code,²¹⁶ the basis on which INEDs should be remunerated is not addressed by the HK CG Code. Taken together, the HK CG Code in its provisions represents a relatively diluted detailing of the principle²¹⁷ that issuers should disclose their remuneration policy and other remuneration related matters, the latter of which is potentially quite encompassing.

As regards developing shareholder voting on executive pay, there appears to be relatively little momentum in Hong Kong on the issue, or for imposing clawback mechanisms. At the present point in time, that may be appropriate given the issues encountered in the other jurisdictions studied.

Discussion

Executive compensation has been most widely discussed in the United States and the UK, with no definitive solutions. In the UK, the Government has been trying to solve the problem for more than 25 years, first through the CG Code as a result of the Report of the Greenbury Committee in 1995, without noticeable impact. Critics have doubted whether it is any more likely to be successful in the current environment.²¹⁸

The difficulties encountered in the jurisdictions studied, the absence of a clear mandate from the market that executive compensation needs to be better regulated and the different context of Hong Kong suggests that it may not be appropriate at present to develop a mandatory regime for shareholder votes on executive pay or clawback mechanisms. Similarly, there seems little momentum to mandate a greater involvement of INEDs, first because of the weak effectiveness of doing so elsewhere (see above and **Section 3.6.4** "Appointment of independent directors"), and second because in Hong Kong this appears to cut too deeply into the mandate of the board to determine such matters as it considers commercially desirable. Even if some form of regulations were introduced, a necessary consensus to make them effective may not form – in which case the regulations run the risk of serving to validate remuneration without actually influencing it. The Hong Kong context may therefore be better served by leaving remuneration as a commercial matter to be decided by the board and assessed by shareholders upon receiving adequate disclosure. That implies shareholders need to be able to vote a director out if, for example, they feel the performance of the director is not commensurate with the remuneration received. As discussed in **Section 3.4.2** "Shareholder votes" and more particularly in **Section 3.7.7** "Differentiation of CG requirements", there may be some value in discussing further the frequency with which shareholders are able to exercise this right. The discussion on board refreshment also supports such an approach (see **Section 3.6.3** "Board refreshment").

The foregoing does leave open the question of how to foster adequate disclosure to shareholders as regards remuneration and its determination. The UK, via the UK CG Code, sets out the provisions the remuneration committee should follow when designing performance-related executive remuneration,²¹⁹ whereas in Hong Kong this receives only a brief mention as a recommended best practice.²²⁰ The United States, via Exchange rules, requires the independence of the compensation committee to be reported on²²¹ in a manner that brings the disclosure within the reach of Federal securities laws – in Hong Kong while the terms of reference of the remuneration committee and whether or not it

²¹⁵ Provision B.1.7

²¹⁶ Provision D.1.3

²¹⁷ HK CG Code B.1

²¹⁸ Corporate Governance Reform: UK Government Green Paper, 2 December 2016: Available at <https://www.law.ox.ac.uk/business-law-blog/blog/2016/12/department-business-energy-and-industrial-strategy-corporate> (visited on 12 Nov 2017)

²¹⁹ See Schedule A of the UK CG Code

²²⁰ Code Provision B.1.7 HK CG Code

²²¹ s. 952 of Dodd Frank requires the adoption of NYSE and Nasdaq compensation committee listing standards. See also (see Section 3.3.1 "Legal status of CG disclosures")

comprises INEDs is required to be disclosed,²²² this has limited consequences if it amounts to a mis-disclosure. If the functions of the remuneration committee are subject to higher disclosure standards, this will improve transparency of executive remuneration to shareholders and accordingly their opportunity for exercising meaningful involvement. For the above reasons, there is some justification for better disclosure of performance-linked remuneration.

The foregoing leads to **Recommendation A4.1.2** "Transparency of performance related executive remuneration".

As the above recommendation provides for mandated disclosure, it should be read together with the recommendations that would attach legal consequences to mis-disclosure or failure to disclose: **Recommendation A4.5.1** "Legal status of CG-related disclosures", **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)" and **Recommendation S4.3.2** "Disclosure of non-compliance with issuer's disclosed CG practices".

As regards the remuneration of INEDs, there is a plausible case for suggesting that the basis on which INEDs are remunerated should be given further consideration. Almost all of the interviewees expressed concern that many INEDs of listed issuers in Hong Kong do not fully appreciate their role on the board and take up INED roles as trophy posts without regard to their responsibilities or their liabilities. A number of interviewees expressed the concern that if an INED is being paid a token fee what message does this send to them in terms of their responsibilities and liabilities? It is probable that they are not expected to do very much save as is sufficient to ensure the INED requirements are met on a box-tick basis.

In the UK, it is recognized that the remuneration for non-executive directors should reflect their expected commitment and responsibilities, and that this should in general not include performance-linked remuneration.²²³ As already noted above, the HK CG Code provides very little detailing on the requirement to disclose remuneration related matters – on the topic of the remuneration of non-executive directors, it only provides that the remuneration committee's terms of reference should include making recommendations to the board.²²⁴

The foregoing leads to **Recommendation A4.2.2** "Basis of INED remuneration".

The role of remuneration in the overall matrix affecting an INED's performance is further discussed in **Section 3.7.10** "Requirements relating to INED performance", which also discusses the other findings of this study as regards the requirements that should be imposed in relation to INEDs.

3.4.4 Changes of control

The regulation of takeovers represents an important event-based test of CG practices. The board of the target company will normally²²⁵ be placed in a position of special knowledge, raising the question of how they exercise their powers, particularly as regards decision-making, the extent to which shareholders have a voice in decisions, and the transparency of information afforded to their shareholders. The position of a controlling shareholder or shareholders or directors that are connected to the offeror will also be relevant to consider as regards similar concerns where the acquisition is

²²² Code Provision B.1.3 HK CG Code and L(b) & (d)(i)

²²³ UK CG Code Provision D.1.3

²²⁴ HK CG Code Provision B.1.2(d)

²²⁵ I.e. in a friendly bid context, which is by far the norm in Hong Kong

significant relevant to the offeror. Conflicts of interest among the key actors may also represent an issue of concern.

The company seeking to acquire control is also a matter of interest in takeover regulation as regards the protection of shareholders in the target company, primarily because shareholders may receive unequal treatment in terms of information sharing and the offer made for their shares – however, strictly speaking, this is not a CG concern as traditionally conceived as it involves the relationship between a shareholder and a third party. The topic more properly falls under the broader topic of protection of investors and will not be further considered here.

Takeovers of public companies in the UK have long been subject to the Takeovers Code, a code widely regarded as being successful in balancing commercial interests with regulatory objectives. As a result of the introduction of the CA 2006, the Takeovers Code, together with the powers of the Takeovers Panel provided for therein, was given statutory effect. For the purposes of the present CG discussion, the essential principle of that Code is that the function of the board is to act as a conduit of information to enable the shareholders to decide whether or not to accept the offer. To implement this principle, once an offer has been received the board is required to form an independent board committee who will manage the offer and who will also appoint an independent financial adviser to advise the minority shareholders whether the offer is fair and reasonable.

Hong Kong

This position in Hong Kong is set out in the Code on Takeovers and Mergers, which is historically based on the UK Takeovers Code. As with the UK code, the role of the target board is to facilitate shareholders reaching an informed decision as to whether they wish to accept or reject an offer. As with many other pieces of law and regulation in the territory that have been imported during Hong Kong's period as a British colony, the details of the Code have over time evolved in different ways from its UK origins. The most notable distinction is that the code in Hong Kong does not possess statutory backing. However, this lack does not appear to impact on the effectiveness of the Code on Takeovers and Mergers in practice.

The strong-shareholder model in Hong Kong as based on the UK approach can be contrasted with the strong board model adopted in the United States. Notwithstanding the recent changes in the UK, the former approach (in both jurisdictions) is essentially based on an industry-supported code enforced by a practitioner-based panel as an accepted check-and-balance on takeover activity. In the latter case it is backed by laws based around fiduciary duties – the United States does not have a specific takeovers code.

The approach taken in the United States may seem adverse to shareholder rights insofar as it permits the concentration of power in a takeover scenario to reside in the board rather than mandating decision making to be passed to the shareholders. In a takeover scenario in the United States the board will have considerable power to determine the progress and outcome of the takeover as compared to the shareholder-based model in Hong Kong and the UK.

However, there is a counterpoint to the fundamental distinction between Hong Kong and the United States that is not to be underestimated, namely, the strength of oversight and accountability able to be applied under each system. For example, whereas a takeover in the United States is undertaken in view of judicial enforcements of directors'

duties in takeover situations (primarily under State law),²²⁶ in Hong Kong it is in practice undertaken in view of the Takeovers Code and the rulings, decisions and powers of the Executive and the Panel. Hong Kong does have laws governing director duties but they are less commonly in the forefront of considerations. While in both cases the regulator has tools at its disposal to correct or punish bad CG, the tools differ in their approach and their consequences – this impacts on their effectiveness, as discussed in Appendix III.6.6. Moreover, each system puts the investor in a different relationship to the question of corporate behaviour and the exercise of shareholder rights, as discussed in Appendix III.7.3.

Singapore also adopts the UK model of the Takeovers Code, being also a former British colony. Hostile takeovers are basically absent (see Appendix V.1.1). The Code on Takeovers and Mergers is issued by the Ministry of Finance (MoF) under the Companies Act and applies to listed corporations including corporations incorporated outside Singapore. The Securities Industry Council administers and enforces the Code independently of the MAS (see Appendices V.2.1 and V.4.1) and its decision is final without possibility of appeal to the court, though judicial review is possible.

In Mainland China, there are not many hostile takeover activities due to the state controlled ownership in the listed SOEs. The Recent failed attempt by Baoneng to takeover China Vanke is a rarity.

Discussion

The different legal standing of the UK and Hong Kong takeover regulations offers up the question whether the Hong Kong code should also be given statutory backing. The changes to the legal standing of the UK code cannot be understood in isolation. As discussed in Appendices II.3 and II.4.1, significant changes to the regulatory architecture of UK have taken place since 2000. This includes the creation of a statutory regulator for the listed market in the form of the UKLA, and the adoption of a twin peaks model in the creation of the Prudential Regulation Authority (PRA) and FCA. The change to the legal standing of the UK Takeovers Code is therefore part of a general policy shift in the UK toward statutory regulation. These more fundamental changes to regulatory architecture have not been followed in Hong Kong, as discussed in Appendices I.1.1 and I.4.1. The takeovers code in Singapore being issued by the MoF and the measures in Mainland China being issued and administered by the CSRC have a strong element of government regulation, even though the code is administered in Singapore by the Securities Industry Council, an independent body. In that sense, the position in Singapore and Mainland China is quite different from Hong Kong and in certain regards similar to the UK, which has moved away from self-regulation and toward statutory regulation.

Nevertheless, it is suggested that in the absence of (1) a broader policy change toward statutory regulation and (2) any clear indication that the Hong Kong Code on Takeovers and Mergers is lacking in effectiveness, there is no mandate for recommending any similar change to the legal standing of the Code. Should either one of these factors change, a review may then be warranted.

The different approaches of the UK/Hong Kong model (regulating via a code and an administrative tribunal, i.e. the takeover panels) and the United States model (regulating via the application of law, particularly fiduciary concepts, in the State courts) are not merely superficial. Rather, they arise out of a fundamentally different understanding of the role of the board in relation to managing the affairs of the company. Whereas the United States places the reins firmly in the hands of the board

²²⁶ Gregory Jackson, "Understanding Corporate Governance in the United States," (October 2010) *Arbeitspapier 223, Hans Böckler Stiftung*, 9

and its directors – but always subject to their fiduciary duties - Hong Kong instead follows the UK model of requiring the board at critical times to step aside to allow shareholders to decide matters of importance.²²⁷ What is of interest to note is that UK corporate law is steeped in a rich tradition of fiduciary law yet this does not often come to the fore in a takeover scenario - this is perhaps in large part due to the effectiveness of the UK Takeovers Code. Being based on the same UK common law system, the same could be said of Hong Kong. However, as discussed in **Section 3.7.6** "Role of fiduciary law", that fiduciary law is a tool actively used in the United States courts (i.e. Delaware) but less so in Hong Kong, may be of relevance to the CG debate beyond the borders of the takeover context.

²²⁷ For the further discussion, see Christopher M Bruner, op. cit.

3.5	Equality
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Introduction

This section considers the basic voting rights of shareholders in a company. While at one level the question is relatively straightforward, it is necessary to consider in what manner and for what reason equality is established. This begins with the tenets of attaching rights to the securities being issued and, subsequently, the ability to exercise those rights *pari passu* with another shareholder that holds the same right (**Section 3.5.1**). In recent years, Hong Kong has wrestled with the question of weighted voting rights (WVR), that is, where a company issues different classes of equity shares possessing different rights attached to them (**Section 3.5.2**). These topics require a careful consideration of the relationship between rights exercisable under private law and the means by which those rights may be subject to other considerations arising out of the public nature of the listed market, as well as the relationship between market development and CG standards.

3.5.1 Voting rights generally

Probably one of the most striking differences across the jurisdictions studied is the issue of the equality of voting rights that attach to shares. While the United States permits companies to list with WVR, both the FCA in the UK and the SFC in Hong Kong have expressed, quite strongly, that the one-share-one-vote (OSOV) principle is a cornerstone of investor protection, as discussed in Appendix I.4.1. Singapore has amended its CA: section 64A now allows public companies to issue shares of different classes. However, the question of allowing WVR structures to list remains under discussion. Notwithstanding Hong Kong's continued adherence to the OSOV principle, companies can be incorporated under the Hong Kong CO with different classes of shares having different rights attached – they just cannot obtain a listing on the SEHK. The position in Hong Kong then must be understood as an issue only of concern to public companies, presumably given the considerable degree of anonymity associated with freely tradable shares, and the impact of any abuse of a supervoting right on members of the public.

While this distinction is clear cut in terms of the powers of and limitations imposed on the issuers setting the rights attached to shares, and the approach to regulating such rights, the distinction is far less clear when shareholder voting rights are examined from the point of the ability to exercise them. Regulators have imposed on issuers requirements that in effect either disenfranchise a shareholder of a right to exercise a vote attaching to share, or give additional rights to some shareholders not others. This is usually imposed as a means of creating a separate vote on a relevant matter. For example, the SEHK's listing rules require shareholders with an interest in certain notifiable and connected transactions to abstain from voting on a resolution to approve the transaction²²⁸ and the Code on Takeovers and Mergers requires both delistings and takeovers executed by way of schemes of arrangement to be approved by shareholders not connected with the offeror.²²⁹ In the UK, as part of the broader requirement that an issuer should be capable of acting independently, the listing rules require that companies with a controlling shareholder must make the appointment of independent directors subject to a dual voting procedure that gives independent shareholders a special vote. While this can be implemented purely as a regulatory measure – leaving the legal rights of shareholders intact, in the UK it has been implemented by the FCA's listing rules requiring listed issuers with controlling shareholders to make appropriate amendments

²²⁸ MBLR Chapters 14 and 14A

²²⁹ Rules 2.2 and 2.10

to their constitutional documents (see Appendix II.1.2). The position in the UK is further discussed in **Section 3.4** "Involvement". In Hong Kong, the SEHK may require changes to the articles of foreign companies to provide for similar provisions as apply under the CO in respect of the rights of shareholders but this is only set out as a precondition to a listing applicant being regarded as suitable, as discussed in **Section 3.2.1** "Application of local laws and regulations".

Where such changes have the effect of curbing the equality of rights of all shareholders, whether via changes to the articles of the company or via regulatory requirements, it must be recognized this represents a deviation from the OSOV principle. This is an example of the concerns of public regulation overriding rights attaching to shares otherwise enjoyed in the private law context. To be a justifiable exercise of public regulation, there must be an important principle at stake – in these cases it is the wish to protect minority shareholders from abuse in a context where conflicted shareholders may exercise their votes to benefit themselves at the expense of their interests as shareholders in the company. Accordingly, where that risk may be dealt with via other means, there is a lesser argument for such public regulation-based adjustments to voting rights.

3.5.2 Weighted voting rights

The foregoing discussion focuses on circumstances where conflicted shareholders are not allowed to vote in order to protect other minority shareholders. In contrast, that WVR structures allow certain shareholders to have more votes than others is a different factual matrix. In both cases the fundamental issue remains the same, namely, whether altered voting rights should be allowed in view of concerns about minority shareholder protection. As mentioned above, Hong Kong, UK and Mainland China (and presently Singapore) do not allow companies with a WVR structure to be listed in their Exchanges on the basis that such a structure is against the OSOV principle. However, since the rejection of Alibaba's application for listing in Hong Kong, HKEX has been actively seeking views on the relaxation of the restriction, first in its two papers on WVR in 2014 and 2015,²³⁰ and more recently in its paper on a new board which envisages the possibility of allowing companies with WVR structures to list.²³¹

Singapore appears to have decided as early as 2014 in favour of moving towards the direction of allowing WVR, however, there is some resistance to the proposal, predictably from among institutional investors such as fund managers.²³²

The proportion of United States companies that employ dual-class structures has increased from 6.8 per cent of the Russell 3000 index two years ago to 8.9 per cent now.²³³ It has been suggested recently that the rise in hedge fund activism has led to an increased concentrated ownership by fortifying the incentives of entrepreneurs to retain control in order to insulate themselves from the market for corporate influence, and that recent evidence shows that there is a general upward trend in the adoption of dual-class stock, and this structure is becoming "the current flavor."²³⁴ This is not dissimilar to the context in the mid 1980s when companies were seeking to make themselves takeover proof and commercial pressure from General Motors led to WVR being accepted on the

²³⁰ "Weighted Voting Rights Concept Paper", HKEX, 29 August 2014; "Consultation Conclusions", HKEX, June 2015

²³¹ "Concept paper. New Board", HKEX, June 2017

²³² For example, see the response from BlackRock dated 13 April 2017 to the Singapore Exchange's consultation paper "Possible Listing Framework for Dual Class Share Structures", 16 February 2017

²³³ According to Institutional Shareholder Services: Available at <https://www.ft.com/content/6b5f1726-fb99-11e3-aa19-00144feab7de>

²³⁴ Kobi Kastiel, "Against all odds: hedge fund activism in controlled companies" (2016) Columbia Business Law Review, 130-131

NYSE, despite efforts of the SEC to prevent it.²³⁵ However, as a result of the market's distaste for Snap's dual class listing which was regarded as "frankly an insulting display of indifference and greed, even for Wall Street,"²³⁶ as the ordinary shares do not carry any voting rights at all, the Standard & Poor's 500 Index has banned dual class companies from joining the index.²³⁷ This ban does not apply to existing companies such as Facebook, Alphabet, Berkshire Hathaway etc., which are grandfathered in.

Discussion

In Hong Kong, one way of examining this issue is whether allowing companies with WVR structures to list on the SEHK would be a good thing for Hong Kong's development as a fund raising and international financial centre. While an important focus of the HKEX's push for WVR has been to compete against New York, markets also compete on a range of other issues, such as the transparency, efficiency and predictability of the listing process. They also compete on the costs and potential liability of being listed in a particular venue. Moreover, there are developmental objectives beyond competitiveness, and this includes the ability of a market to provide channels for raising capital to support the development of innovation and the real economy.²³⁸ If permitting WVR would facilitate small growth companies to innovate there is a case that the OSOV principle may not always need to be adhered to. However, because the CG systems in each of the jurisdictions studied are subject to very different political, commercial, social and philosophical influences, market development in its application is driven by different forces in each jurisdiction.

The main concern is that, in the absence of the OSOV principle, the founders who have control through WVR may more easily abuse their position and act for their own personal gain at the expense of the minority investors who do not have such voting powers. As mentioned earlier, the OSOV principle has in other instances been overridden by public regulation-based adjustments, e.g. conflicted shareholders being not allowed to vote. In the United States, where WVR is permitted, the same concern about a controlling shareholder abusing of the minority may instead be addressed by the application of fiduciary law in the courts (see Appendix III.7.3).

There is no clear evidence that WVR structures lead to poor corporate performance. The evidence from international literature²³⁹ shows that investors apply a discount to the ordinary shares to reflect the risk of private benefit extraction by controlling shareholders, but does not show that WVR structures lead to poor performance; on the contrary, empirical evidence shows that WVR structures are beneficial for small growth companies and provides incentives to controlling shareholders to innovate and grow the company. The issue is whether, if there is a market for such listed companies, should the exchange as a market facilitator and the industry regulator endeavor to allow such listings. There is nothing wrong in principle for the HKEX to propose allowing WVR companies to list. However, given that minority shareholder protection is a legitimate

²³⁵ See Syren Johnstone, Nigel Davis and Douglas W. Arner "Moving forward on listing reform", AIIFL Working Paper No. 22, October 2017, section 3.2. Available on SSRN at: <http://ssrn.com/abstract=3057959>

²³⁶ Karma for SNAP Stock: S&P 500 Bans Dual-Class Shares, 1 August 2017: Available at <https://money.usnews.com/investing/stock-market-news/articles/2017-08-01/snap-stock-s-p-500-bans-dual-class-shares> (visited on 12 Nov 2017)

²³⁷ Karma for SNAP Stock, op. cit.

²³⁸ See Syren Johnstone et al., "Moving forward on listing reform", op. cit., section 3.3

²³⁹ Renee Adams and Daniel Ferreira, One Share-One Vote: The Empirical Evidence, *Review of Finance* (2008) 12: 51-91; Anete Pajuste, Determinants and Consequences of the Unification of Dual-Class Shares, *European Central Bank Working Paper* 465 / MARCH 2005; Thomas J. Chemmanur and Yawen Jiao, Dual class IPOs: A theoretical analysis, *Journal of Banking & Finance* 36 (2012) 305-319; Douglas Ashton, Revisiting Dual-Class Stock, *St. John's Law Review* Volume 68 Issue 4 (1994); Piet Sercu and Tom Vinaimont, Double bids for dual-class shares, *Leuven Economic Working Paper* AFI 0613

Ting Xu, Excess Control Rights Benefit Debtholders? Evidence from Dual-Class Firms, SSRN paper

concern, the SEHK and SFC should work together to consider how minority shareholder protection could be fostered within a WVR listed issuer.

The United States has relied on fiduciary law, class action lawsuits and contingency fees as mechanisms that empower shareholders and enable them to seek redress in respect of misconduct by directors and controlling shareholders. However, the connection between WVR and class action rights is often misunderstood and overstated.²⁴⁰ While class action rights are available for matters involving individual rights²⁴¹ such as “suits to compel the payment of a dividend, to protest the issuance of shares impermissibly diluting a shareholder’s interest, to protect voting rights or to obtain inspection of corporate books”,²⁴² a breach by a director of fiduciary duty to the company is primarily a matter for a derivative action taken on behalf of the company. Most shareholder class action suits in the United States are brought in respect of either misrepresentation in financial documents or securities fraud under section 10(b) of the Exchange Act of 1934 and Rule 10b-5 (respectively accounting for 97% and 84% of all class action suits in 2013)²⁴³ – they are not brought in respect of abuse of power, although it remains open to question to what extent disclosure breaches and fraud occur as a consequence of some form of abuse of power.

The topic of permitting companies with WVR structures to list in a public market is clearly a highly complex one that has deeply divided the market in Hong Kong as to its benefits and drawbacks. While allowing such companies to list would undoubtedly lead to growth in the total market capitalization of the SEHK, the question is really whether such growth will foster the underlying strategic objectives of Hong Kong’s capital market over the long term.²⁴⁴ For the purposes of the present study, there is no clear evidence from the jurisdictions studied suggesting that WVR structures would promote good CG. Accordingly, no recommendation can be made in that regard.

Peeling away the ostensible considerations in the OSOV vs. WVR debate, there are really only two underlying issues: on the basis of what developmental objectives should the Hong Kong market be competing with other markets; and what mechanisms should the market employ to protect minority shareholders from the risk of abuse by a controlling shareholder? Although the first of these may seem not relevant to the CG debate, policy objectives may be implemented in ways that give rise to different types of CG issue, such as the risk of abuse mentioned above. On the premise that CG is important for Hong Kong as an international financial centre, the above two issues are in fact intimately connected. For example, if WVR structures are subsequently permitted in Hong Kong, it will be essential to consider the mechanisms that foster standards of good CG that are equivalent to or better than what is currently expected of Hong Kong listed issuers. As discussed in other sections of this Report, the effectiveness of different mechanisms impacts on shareholder protection, in particular the efficacy of enforcement and the real availability of remedies. While OSOV has undoubtedly stemmed abuse, there nevertheless remain many issues arising out of the predominance of controlling shareholders in the Hong Kong market.

The foregoing leads to **Recommendation E4.9.3** “Market development”.

²⁴⁰ See Syren Johnstone et al., “Moving forward on listing reform”, op. cit. section 3.3

²⁴¹ See *Kahn v. Kaskel*, 367 F. Supp. 784 (S.D.N.Y. 1973) (a class action by shareholders is based upon individual rights belonging to each member of the class) and *Behrens v. Aerial Comm., Inc.* Del. Ch., No. 17436 (May 18, 2001) (“The distinction between a direct and derivative claim . . . turns on the existence of direct or ‘special’ injury to the plaintiff stockholder.”)

²⁴² In *re Worldcom, Inc.*, 323 B.R. 844, 850 (Bankr. S.D.N.Y. 2005)

²⁴³ “Securities Class Action Filings 2013 Year in Review”, Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse, at 7

²⁴⁴ See Syren Johnstone et. al., “Moving forward on listing reform”, op. cit., Section 3.2

3.6	Accountability
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Introduction

A premise of good CG is that the behaviour and performance of management is ultimately subject to an appropriate level of oversight of the owners of the company. In practice, the ability to engage in oversight depends on information transparency via timely and adequate disclosures and the ability of shareholders to be involved in decision-making on matters of significance – both of which have been discussed in **Sections 3.3 and 3.4.**

This section takes as its primary concern certain mechanisms by which the accountability of management to shareholders is directly established, including the ability of shareholders to seek redress in respect of inadequate disclosures (**Section 3.6.1**), the ability of shareholders to hold management to account where it has failed to adhere to standards expected of them as a publicly listed company (**Section 3.6.2**), board refreshment via the rotation of directors (**Section 3.6.3**), and the role and appointment of INEDs (**Section 3.6.4**; this topic is again taken up in **Section 3.7** Part C where the effectiveness of INEDs is considered).

3.6.1 Information disclosures generally

A fundamental mechanism of the accountability of management to shareholders is the ability of shareholders to seek legal recourse where they have been given false or misleading information about a company's affairs, or have not been provided with material information in a timely manner. To the extent a CG system does not adequately provide for such recourse, then to that extent it may be deficient. The ability of a shareholder bringing a private action against a company or its management must be distinguished from the ability of a regulatory agency to bring an enforcement action – this and the following section is concerned with the former, the latter topic is discussed in **Section 3.7.3** "Enforcement agencies".

In the UK, the Financial Services and Markets Act 2000 (FSMA) contains important provisions that attach civil liability to information required to be disclosed either by specific provisions in FSMA²⁴⁵ or by rules made by the FCA pursuant to FSMA. This covers disclosures in the primary market, e.g. a prospectus issued in connection with an initial public offering (IPO), as well as the secondary market.

As regards the issue of listing documents, section 90 of the FSMA provides that a person who suffers loss as a result of the omission of information required to be disclosed in a listing document by the listing rules made by the FCA under section 80(2) of the FSMA may bring a claim for compensation against "any person responsible" for the listing document.

Section 90A and Schedule 10A of the FSMA extend that liability in respect of misleading statements, dishonest omissions or dishonest delays in publishing such information – it being notable that this covers "(i) any untrue or misleading statement in that published information, or (ii) the omission from that published information of any matter required to be included in it."²⁴⁶ This can encompass mandatory disclosure requirements set by the FCA that are concerned with CG standards. In particular, listing rule 9.8.6 R requires a statement to be made in the annual report how the issuer has applied the Main

²⁴⁵ For example, section 80(1) of the FSMA

²⁴⁶ Section 3(1)(b) of Schedule 10A of the FSMA

Principles in the UK CG Code, and whether the issuer has complied with all relevant provisions in that code – where it has not complied it must give reasons. While this does not mandate compliance with the UK CG Code, a failure to make proper disclosure as required by the listing rules may constitute an untrue or misleading statement or an omission of a “matter required to be included” and accordingly could give rise to a civil damages claim (as well as enforcement by the FCA). However, the foregoing does not mean that an investor can seek damages for a breach of the listing rules *per se* or in respect of non-compliance with the UK CG Code – there must be a problem with the issuer’s compliance with its disclosure obligations under the FCA’s Disclosure and Transparency Rules.

Where a listing applicant or issuer has breached a relevant provision, civil liability may arise in respect of a class of persons – all shareholders who have a damages claim in respect of the breach. While the UK does not possess class action rights, the group litigation order does facilitate collective redress, and this may be utilized in relation to shareholder suits, although to date it has not been used in this context (see Appendix II.7.1). Where shareholders cum litigants can be bundled together by the court, this will reduce the costs of litigation, possibly significantly.

In the United States, disclosure by listed issuers is driven by section 10(b) of the 1934 Securities Exchange Act and the SEC’s Rule 10b-5, Regulation FD, and the disclosures required pursuant to Regulation S-K required annually by the SEC the contents of which align with certain CG provisions of the listing requirements of the Exchanges (see the discussion in **Section 3.3.1** “Legal status of CG disclosures” and **Section 3.7.3** “Enforcement agencies”). While breaches of any of these Federal securities laws are enforceable by the SEC, a breach does not automatically give rise to private causes of action for a shareholder – there must be a direct right of action. However, breaches of the Federal laws often do involve either misrepresentation in financial documents or securities fraud under section 10(b) of the 1934 Act and Rule 10b-5, which does give rise to direct rights of action by investors. Class action rights are available for matters involving individual rights²⁴⁷ and most shareholder class action suits are brought in respect of either misrepresentation in financial documents or securities fraud (respectively accounting for 97% and 84% of all class action suits in 2013).²⁴⁸ Shareholders receiving inadequate disclosure may also look to applicable State law and seek fiduciary remedies, and this is discussed in **Section 3.7.1** “Impact of regulatory design” and **Section 3.7.6** “Role of fiduciary law”.

In Singapore, there is a private right of action for any loss or damage sustained by reason of any untrue statement or misrepresentation in prospectuses.²⁴⁹ For non-disclosure, under section 203 of the Securities and Futures Act intentional, reckless or negligent non-disclosure of information to the Exchange for forwarding to the securities market attracts both civil and criminal liability, depending on the state of mind of the disclosing entity (see Appendix V.6.5). Hence, intentional or reckless breach of section 203 or Part VII may give rise to an offence under the SFA.

In Mainland China, the accuracy of statements in a prospectus is subject to laws and administrative measures²⁵⁰ that provide the CSRC with enforcement powers (see Appendices IV.2.2 and IV.3.4). Continuing disclosure requirements, including disclosure of related party transactions, is part of the CG Code and is mandatory (see Appendix IV.4.5). The CSRC can enforce the Code against any breach, although in practice enforcement may sometimes be wanting. Where breaches of company or securities laws give rise to private causes of action, and where shareholders have a sufficiently similar

²⁴⁷ See *Kahn v. Kaskel*, op. cit. and *Behrens v. Aerial Comm.*, op. cit.

²⁴⁸ “Securities Class Acting Filings 2013 Year in Review”, op. cit., at 7

²⁴⁹ s. 254 and 282O of the SFA

²⁵⁰ Securities Law, Company Law, and the Administration Measures for Initial Public Offering and Listing of Stocks (2015) issued by the CSRC - see Appendix IV.4.5

claim, the action may with the approval of the court be conducted under a joint litigation adjudication process – however, in the case of a securities civil compensation suit, this is subject to a pre-condition that there must have been a relevant administrative sanction imposed by the CSRC or court judgment.²⁵¹ While this is not the same as a class action right, and is more of a case management tool similar to the UK’s group litigation order, the ability of shareholders with similar claims to be bundled together by the court may be highly advantageous to them *qua* litigants, particularly as regards sharing the costs of litigation.

Hong Kong

The position in Hong Kong is both similar and different in respect of primary and secondary market disclosures.

As regards the primary market - where listing documents are issued as a prospectus - investors have civil rights for damages under s. 40 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (CWUMPO), broadly similar to s. 90 of the FSMA, subject to two important differences.

First, an IPO prospectus will comprise disclosures required by both CWUMPO and the listing rules, however, the test for the purposes of civil liability in Hong Kong is whether the disclosures as made constitute an “untrue statement”, referring to false or misleading statements or material omissions.²⁵² Although the scope of these CWUMPO provisions have never been tested in court, it is expected that mere non-compliance with the disclosures required by CWUMPO²⁵³ would not, without an element of untruth and materiality, give rise to a cause of action. As the disclosures required by the listing rules are not necessary for a valid prospectus to be issued, there would appear to be no grounds for a case based solely on the mere omission of those requirements. In contrast, FSMA allows private actions to be brought where loss has been suffered as a result of the omission of any matter (1) reasonably required to be included to enable an informed investment decision to be made, or (2) required to be included by the listing rules or by the FCA.²⁵⁴ These FSMA provisions address similar concepts as does section 3 of the SMLR, although under the SMLR the power to act is only extended to the SFC and the power only encompasses matters related to the admission, suspension or cancellation of the company’s listing. While the SMLR provisions establish the dual filing regime, the question that may be asked is why the situation is different in Hong Kong as compared to the UK. Part of this answer rests in the legal nature of the listing rules in the two jurisdictions – as already noted, the listing rules in the UK have statutory backing. This distinction is important, particularly as regards item (2) above, which clearly attaches potential liability to breaches of disclosure requirements imposed by the FCA including the listing rules. The topic of the SMLR is returned to in **Section 3.7.3** “Enforcement agencies”, which leads to a recommendation in respect of the SFC’s powers under the SMLR.

²⁵¹ The pre-condition is imposed by the Provisions of the Supreme Court on the trial of Cases of Civil Compensation Arising out of False Presentation in the security market. Where joint litigation is available, the subject matter of an action is under the same category and one of the sides has numerous litigants but the exact number of the litigants is uncertain when the lawsuit is filed, the court may issue a public notice to explain the nature of the case and the claims of the litigation and informing those interested persons who are entitled to the claim to register their rights with the court within a fixed period of time. The judgments or written orders rendered by the court shall bind all those interested persons who have registered their rights with the court. Such judgments or written orders shall apply to those who have not registered their rights but have instituted legal proceedings during the time of the statute of limitation. See National Civil Procedure Law of the PRC (amended 2012), Chapter V Primary Litigation Participants; the Interpretations of the Supreme People’s Court on Applicability of the Civil Procedure Law of the PRC (2015)

²⁵² s. 41A of the CWUMPO

²⁵³ Including those specified in the Third Schedule thereof

²⁵⁴ section 90 of the FSMA refers to section 80 of the FSMA

Second, the scope of persons subject to civil liability in the UK encompasses any person “responsible for listing particulars”. In Hong Kong, prospectus liability is more specifically limited to directors, promoters and persons who have authorized the issue of the prospectus.²⁵⁵

The position is also quite different when considering shareholder rights in relation to disclosures made in the context of the secondary market. Shareholders who have suffered loss in consequence of market misconduct have a statutory right to claim for damages under sections 281 or 305 of the SFO – for present purposes this includes where an issuer distributes false or misleading information likely to induce transactions (sections 277 or 298 of the SFO). Where information constitutes a false or misleading public communication, shareholders may also have a claim under section 391 of the SFO.

Where no information has been provided but has been withheld, it would need to be shown that it amounts to inside information that was not disclosed in accordance with the statutory requirement to disclose it (under Part XIVA of the SFO) thus giving rise to a potential shareholder claim under section 307Z of the SFO – non-disclosure of what was required by the listing rules to be disclosed would not assist in this regard.

Discussion

As regards disclosures in the primary market, all jurisdictions studied have a broadly similar approach to providing to causes of action to investors. A notable difference is that omissions of disclosures required by the listing rules can give rise to a cause of action in the UK and Singapore, whereas in Hong Kong omissions of information required by the listing rules is ostensibly irrelevant.

A shareholder wishing to bring an action under the SFO’s provisions in relation to secondary market disclosures, including Parts XIII to XIVA of the SFO, would need to prove, amongst other things,²⁵⁶ that the information concerned is likely to have a material effect on trading in the issuer’s shares. This may amount to a significantly more difficult task than in the UK where a breach of a disclosure requirement is concerned, or establishing a claim under Rule 10b-5.²⁵⁷ It also implicitly positions secondary market information that falls short of that standard as relatively unimportant to ongoing investment decisions, at least insofar as statutory legal remedies for damages are concerned.²⁵⁸ This reflects the basis of the Hong Kong provisions as primarily serving the needs of market integrity as opposed to the private rights of shareholders in a public company.

In certain regards, Part XIVA of the SFO is broadly equivalent to Regulation FD in that both are significantly directed toward the reduction of the risk of insider dealing. However, a breach of Part XIVA enables affected investors to pursue a legal cause of action against the wrongdoer whereas a breach of Regulation FD does not, and in this regard Hong Kong gives a wider right to shareholders, albeit subject to the caveat discussed in the preceding paragraph above.

Unlike the UK, breaches of disclosure requirements under the listing rules in Hong Kong are incapable of giving shareholders the right to a damages claim, unless some other

²⁵⁵ Whereas the UK provision could apply to sponsors, the Hong Kong regime does not appear to catch sponsors, despite the unexplained assertion by the SFC that it does. See Syren Johnstone, Antonio M Da Roza and Nigel Davis “Deconstructing sponsor prospectus liability”, *Hong Kong Law Journal* Vol 46(1) 2016, 255-285

²⁵⁶ In addition to the other requirements of Part XIVA, such as no safe harbour being relevant, etc.

²⁵⁷ In the United States, the theory of “fraud on the market” has already been established

²⁵⁸ For example, see the discussion of the MMT’s report on CITIC Limited (7 April 2017) in Syren Johnstone and Nigel Davis “Transparency of information in the market: the CITIC case before the Market Misconduct Tribunal”, *Hong Kong Lawyer*, July 2017

breach of law is involved. This difference arises out of the different legal standing of the listing rules. (The accountability of directors and issuers to shareholders in relation to listing rule disclosures is discussed next, in **Section 3.6.2** "Listing rules".)

While Hong Kong law does provide shareholders with actionable rights under CWUMPO and the SFO, as described above, there remain no instances of civil litigation being brought under them. This is in part due to the difficulties of bringing litigation, including costs and the ability to obtain evidence. Moreover, since these provisions have not been tested in court in a civil claim, there is no case law available to guide a future potential claimant on the application of these provisions. Taken together, rights of shareholders may work well on paper but in practice they are in some ways rendered a lame duck.

The absence of shareholder law suits, despite the availability of rights and numerous potentially actionable cases, may be attributable to the fact that Hong Kong does not possess any effective mechanism of collective redress.²⁵⁹ This stands in contrast to the availability of class action rights in the United States (see Appendix III.7.1), and case management tools in the UK (group litigation - see Appendix II.7.1) and Mainland China (joint litigation - see above), all of which work to alleviate one of the major hurdles of bringing litigation, namely, costs. The issue of costs being economically viable is an important aspect of providing meaningful access to justice, as was recognized in the considerations leading to the introduction of the group litigation order in the UK.²⁶⁰ In the absence of collective redress mechanisms, shareholders in Hong Kong instead rely on the SFC as their *de facto* proxy to take actions that can bring about class-like remedies.²⁶¹ However, as discussed in **Section 3.7.3** "Enforcement agencies" and **Section 3.7.6** "Role of fiduciary law", the SFC is not an unconflicted agency insofar as it needs to take into account a range of matters before deciding whether to commence an action that may benefit shareholders.

In 2007 the OECD stated that it regards class action rights as an effective "ex-post means of redress".²⁶² In May 2012 the LRC proposed the adoption of class actions for consumer cases (see Appendix I.2.1).²⁶³ However, there is no further action on the part of the Department of Justice (DoJ) in response to the LRC's proposal, and no adequate explanation has been offered for the delay. Recommendation 1 of the LRC's 2009 consultation paper had proposed a regime "for multi-party litigation so as to enable efficient, well-defined and workable access to justice",²⁶⁴ effectively the same premise of Lord Woolf in his Final Report.²⁶⁵ While the LRC considered the approach taken in the UK and recognized it is capable of achieving the objectives of the class action, it instead elected to recommend the adoption of a class action rather than the group/joint litigation cum case management approach as seen in the UK and Mainland China.²⁶⁶ This was a result of the LRC's concern with flexibility versus predictability of procedural outcomes.²⁶⁷ However, enacting class action rights is a significantly more complex task as compared to what would be required to allow the court to adopt new rules of procedure. In the interim, shareholders are left with no development, leaving the horse in some ways behind the cart. Facilitating any form of joint litigation does begin to

²⁵⁹ As discussed in Appendix I.7.1, Hong Kong only possesses the "representative action", which is an inadequate framework in the present context

²⁶⁰ See Lord Woolf, "Access to Justice - Final Report to the Lord Chancellor on the Civil Justice System in England and Wales" July 1996, at 223, para 2

²⁶¹ See Syren Johnstone "A flawed debate" International Financial Law Review, May 2015 pp38-39. See also SSRN: <https://ssrn.com/abstract=2811028>

²⁶² Lack of Proportionality Between Ownership and Control, OECD, December 2007, at page 42

²⁶³ The Law Reform Commission of Hong Kong, Class Actions Sub-committee (HKLRC) "Report - Class Actions", May 2012

²⁶⁴ HKLRC "Consultation Paper - Class actions", Nov 2009, page 22

²⁶⁵ Lord Woolf, "Access to Justice - Final Report to the Lord Chancellor on the Civil Justice System in England and Wales", op. cit.

²⁶⁶ HKLRC "Report - Class Actions", op. cit., at para 4.22

²⁶⁷ Ibid.

address the cost issue as a fundamental hurdle to access shareholder rights. The question of the specific funding model – for example, whether contingency fees should be permitted as are allowed in class actions in the United States – is clearly important to consider in this regard but should not operate to forestall reform on the availability of collective redress. Other funding solutions may emerge, for example, if two or more larger institutional shareholders institute actions, this may serve to significantly reduce costs proportionately for smaller shareholders that tag along on the litigation. Or other developments in the law may subsequently be built on a successful implementation of joint litigation. In short, developments in the UK and Mainland China support the case for collective redress to be reconsidered.

The foregoing leads to **Recommendation A4.4.2** “Collective redress”.

3.6.2 Listing rules

As already noted, the listing rules in the UK has since 2002 been a matter to be issued by a statutory regulator that has statutory powers to enforce the rules. Although shareholders cannot enforce the listing rules directly, they may bring an action for damages against the issuer where a breach of the listing rules has involved a breach of an issuer’s disclosure obligations under the DTR.

The position is broadly the same in Singapore. Enforceability of the listing rules concerning continuing disclosure obligations under section 203 of the SFA is a major difference from the position in Hong Kong - reckless or negligent non-disclosure of information to the Exchange for forwarding to the securities market does attract civil (and potential criminal) liability (See Appendix V.6.4). Moreover, section 25 of the SFA provides that a person aggrieved by a failure to observe the listing rules may apply to the High Court for an order to direct compliance (see Appendix 4.1).

In the United States the listing rules of the Exchanges operate on a contractual basis as between the issuer and the Exchange. The rights of shareholders in relation to disclosures made by issuers are established by Federal laws, as discussed in **Section 3.6.1** “Information disclosures generally”. Of interest are discussions in the United States courts concerning whether shareholders possess standing to enforce Exchange listing rules against issuers in which they have invested. Several cases have noted that the 1934 Act does not preclude the private enforcement of Exchange rules in court, and that, while a legislative intent to permit a Federal claim for violation of Exchange rules regarding disclosures cannot be inferred, civil liability for a breach of such rules is potentially justified. It has been noted by the Court that certain requirements of the Exchanges serve an important function of protecting investors.²⁶⁸ The Court in *Norlin Corp v Rooney, Pace, Inc.*²⁶⁹ recognized that a derivative action seeking an injunction could be brought where the alleged damage to be avoided was a delisting by the NYSE. Academic literature also supports the possibility that shareholders could be regarded as third-party beneficiaries to the listing contract between the issuer and the Exchange.²⁷⁰ These cases and lines of thinking are important for CG purposes as they may provide an important avenue for shareholders to redress corporate wrongdoing. This is capable of extending not only to mis-disclosure issues but also to breaches of listing requirements that mandate shareholder involvement (as was in issue in the *Norlin* case), however, there is no definitive case that establishes this with certainty.

²⁶⁸ For a discussion, see *State Teachers Retirement Board v Fluor Corp.* 654 F.2d 843 (2d Cir. 1981)

²⁶⁹ *Norlin Corp v Rooney, Pace, Inc.*, 744 F.2d 255, 267-269 (2d Cir. 1984)

²⁷⁰ Choper, Coffee, and Gilson, “Cases and Materials on Corporations”, 7th Edn, Wolters Kluwer, 2008, 307

Hong Kong

As in the United States, the listing rules in Hong Kong operate on a contractual basis as between the issuer and the SEHK. While they are issued by the SEHK pursuant to powers given to it by the SFO, and are overseen and approved by the SFC, the rules do not have statutory force and do not have statutory backing. Breaches of the Hong Kong listing rules are subject only to the disciplinary sanctions available to the SEHK, as set out in MBLR 2A.09, and the limited “reserve powers” of the SFC under the SMLR. However, enforcement action taken by the SEHK or the SFC does not provide any remedies to investors. By way of illustration, over the period 1 January 2016 to end 31 October 2017²⁷¹ 48 directors of Main Board issuers were subject to censure or criticism for breaching their Director’s Undertakings to the SEHK.²⁷¹ Of these, only 6 directors received a higher sanction from the SEHK, which stated that the directors remaining in their post would be prejudicial to the interests of investors²⁷² - however, in each case the relevant individuals had already ceased to act as directors by the time such announcement was made. Some of the other 42 directors were required to undertake compulsory training. Granted that 48 individuals represents a small portion of the total number of directors of listed issuers, but what is particularly worth noting in these cases is that most of these breaches involved disclosure breaches, and some involved breaches of the notifiable and connected transaction provisions of the listing rules²⁷³ - for example, failing to obtain shareholder approval when required or provide the required disclosures. In the period 1 January 2015 to 31 October 2017, 14 companies had breached one or more of these requirements. These provisions represent important aspects of the SEHK’s mandatory listing rules that seek to improve the CG standards of listed issuers and protect the interest of shareholders as a whole. Given that such breaches are regarded by the SEHK as “serious” and represent directors falling short of the degree of skill, care and diligence required and expected of directors, the sanctions seems weak. This goes to the effectiveness of the CG standards enforcement system, a topic that is returned to in **Section 3.7.3** “Enforcement agencies”.

Unless a breach of the listing rules gives rise to a statutory basis for a claim (see **Section 3.6.1**. “Information disclosures generally”), a breach does not give rise to any civil cause of action, subject to two caveats, neither of which is well bedded into Hong Kong law.

First, two cases of interest to the question of the listing rules and the rights of shareholders: *SFC v. Wong Shu Wing and Another*²⁷⁴ and *SFC V. Kenneth Cheung Chi Shing And Others*²⁷⁵ (the *Stylant (2012)* case), both discussed in Appendix I.7.1. In *Wong Shu Wing* it was held that information required by the listing rules to be given to shareholders is, for the purposes of section 214(1)(c) of the SFO, information a shareholder might reasonably expect (which is not dissimilar to certain concerns of FSMA).²⁷⁶ In that case, the failure to provide such information was part of the issuer’s unfair prejudice toward shareholders. A similar point concerning section 214(1)(c) was made in *Stylant (2012)* in relation to frequent breaches of the listing rule obligations regarding disclosure and shareholder approval. The former case was under a *Carecraft* procedure and the latter point was made *obiter dicta*,²⁷⁷ which weakens the strength of these precedents.

²⁷¹ LR Appendix 5B sets out the form of the Declaration and Undertaking with regard to Directors given to the Exchange

²⁷² Under LR 2A.09(7) this requires “wilful or persistent failure by a director ... to discharge his responsibilities under the Exchange Listing Rules”

²⁷³ MBLR Chapters 14 and 14A respectively, and GEMLR Chapters 19 and 20 respectively

²⁷⁴ [2013] HKCFI 2302; HCMP 1831/2010 (20 March 2013)

²⁷⁵ [2012] HKCFI 312; [2012] 2 HKLRD 325; HCMP 1702/2008 (7 March 2012) HCMP 1702/2008

²⁷⁶ This in concept is similar to the provision under section 3(1)(b)(ii) of Schedule 10A of the FSMA, as described in Section 3.6.1 above

²⁷⁷ *Obiter dicta* was based on defalcation, misfeasance and unfair prejudice thus invoking s. 214 SFO

These cases do indicate the direction of the court's attitude to egregious breaches of the listing rules, i.e. that breaches are capable of being relevant to investor remedies even in the absence of any effect on trading in the issuer's shares. However, an investor cannot bring an action under section 214 - only the SFC can. This means that the opportunity for an investor remedy being obtained via this route is contingent on the SFC deciding to bring an action, the SFC having other matters to consider that are not always aligned with the interests of shareholders.²⁷⁸ This in practice relegates the question of private rights in public companies to the collective interests of the public market as a whole.

Second, it is arguable that breaches of the listing rules might be actionable by the SFC under section 213(1)(a)(i)(B) of the SFO on the basis that the listing rules are "requirements given or made pursuant to" section 23 of the SFO.²⁷⁹ In the UK, section 382 of the FSMA allows the FCA to apply to the court for various orders if a "relevant requirement" is contravened, and Teare J held in *Hall v Cable & Wireless plc*²⁸⁰ that "relevant requirement" includes listing rules. However, this has not been tested in court in Hong Kong²⁸¹ and in the UK such rules have a different standing in law. The conservative and widely held view is that section 213 is not intended to work in this manner. In any event, for the purposes of this study, while section 213 can provide remedies to shareholders, only the SFC may bring an action under it.

Although in Hong Kong shareholders can bring common law or statutory derivative action (and multiple derivative action) against defaulting directors, the usual problems of cost and free riding apply. Furthermore, it is not certain whether breach of listing rules would be actionable under a derivative suit.

Discussion

One of the main problems with the Hong Kong listing rules vis-à-vis accountability to shareholders is that they do not give shareholders any means of enforcing the listing rules against a company in which they invest or its directors. Breaches that do not give rise to statutory claims can only be dealt with by the regulators, but their enforcement is relatively weak and does not provide remedies to investors. To the extent one regards the listing rules as important in establishing minimum acceptable CG standards, this represents a serious deficiency in shareholder protection.

The discussion in **Section 3.3.1** "Legal status of CG disclosures" and **Section 3.3.2** "Disclosure of listing rule compliance" led to two recommendations that directors should be subject to disclosure obligations in respect of compliance with the listing rules as a means of providing shareholders with information as to their standing in this regard – the point being made that shareholders have a legitimate expectation that an issuer and its directors should comply with the listing rules. Under those recommendations (**A4.5.1** "Legal status of CG-related disclosures" and **C4.5.2** "Status of listing rule compliance and related disclosures (continuing)"), such disclosures would be brought within the scope of section 384(3) of the SFO – however, for the purposes of the present section it should be noted that shareholders do not have any right to enforce **Section 384**, which means that shareholders would need to establish a claim on some other basis, as discussed in **Section 3.6.1** "Information disclosures generally". For the reasons explained in that section, it would not be a simple task for a shareholder to show that

²⁷⁸ For example, the need to make efficient use of its resources per section 6(2)(e) of the SFO and in view of its various regulatory objectives

²⁷⁹ T. Ng, "Judicial enforcement of the listing rules in Hong Kong" *Hong Kong Law Journal* (2015) Vol 45 Part 2 389-404

²⁸⁰ [2009] EWHC 1793 (Comm); [2011] BCC 543

²⁸¹ Douglas W Arner, Berry Hsu, Say H Goo, Syren Johnstone and Paul Lejot, "Financial Markets in Hong Kong: Law and practice", OUP, 2016, para 10.50

mis-disclosure of an issuer's compliance with the listing rules gave rise to an actionable claim.

In summary, shareholders in Hong Kong appear to have no clear basis on which they can bring directors to account where they or the issuer have breached the listing rules and the disclosure obligations imposed on them. Developments in the UK and Singapore have resolved this gap by giving shareholders a right to enforce the listing rules directly. Because that was done by giving statutory backing to the listing rules, there have been some calls for Hong Kong to do likewise. Doing so would involve a complex change to Hong Kong's regulatory architecture, it being noted that previous attempts to implement such a change have been highly controversial and have failed. (The topic of a revised regulatory architecture is also discussed in relation to the SFC's power to enforce the listing rules in **Section 3.7.3** "Enforcement agencies", which does make recommendations on this issue.)

In the context of the present discussion, the changes in the UK and Singapore can also be understood as merely a means by which the objective of giving shareholders rights has been achieved. However, it is possible to ameliorate these deficiencies in Hong Kong and improve accountability to shareholders at different levels of the Hong Kong system.

A different route for giving *locus standi* to shareholders to bring an action for breaches of the listing rules would be through the contractual basis of the relationship between the SEHK and the issuer. Namely, to establish shareholders of an issuer as third party beneficiaries of that contract via the Contracts (Rights of Third parties) Ordinance²⁸² with a right to enforce terms of the contract. Doing so would be consistent with academic literature in the United States, as discussed above. According to the Hong Kong Department of Justice, the beneficiaries of a contract under the Ordinance can be expressed as any member of a class.²⁸³ This could be put into effect without involving any changes to the regulatory architecture as it would only require the introduction of changes to the listing rules, which can be made by the SEHK subject to the approval of the SFC. This could be implemented with some specificity, indicating which provisions of the listing rules are intended to benefit shareholders. For example, following the approach taken in the UK, this could be limited to disclosure obligations. However, *prima facie*, such a benefit may only apply in respect of companies being admitted to listing after the relevant change to the listing rules, and extending the rights to shareholders of existing issuers would need to be explored further.

The foregoing leads to **Recommendation S4.4.1** "Shareholders as beneficiaries of listing rules".

The above discussion and recommendation is really a part of a larger theme: creating more effective means of legal recourse over the listing rules, whether by creating powers in the hands of the SFC, or shareholders individually or collectively. The recommendations made and referred to in this section may be considered as counterpoints to the recommendations arising out of the discussion in **Section 3.7.3** "Enforcement agencies", which leads to **Recommendation A4.6.4** "Statutory backing of certain listing rules".

3.6.3 Board refreshment

For the purposes of this section, which is concerned with mechanisms of management accountability to shareholders, board refreshment provides shareholders with a more frequent and direct means of exercising their oversight of the board's effectiveness and

²⁸² Cap. 623, in force as from 1 January 2016

²⁸³ See the examples provided by the Department of Justice: Available at <http://www.doj.gov.hk/eng/public/rightsofThirdParties.html>

capabilities. Refreshment helps to address concerns that boards become “clubby”. This could be defined as being where the entrenchment of directors overshadows the interests of the company, or is founded on a belief that long-standing board memberships constitute the essential fabric of the company. The recent Wells Fargo scandal has been cited as an example of the need to refresh clubby boards and the dangers of not doing so to the perspicacity of the board and its sub-committees.²⁸⁴

Looked at more positively, refreshment of the board is concerned with ensuring the spread of skills, knowledge and experience on a board remain appropriate to the evolving challenges faced by a company. The agility required to deal with these challenges may be hampered by a board that was formed at a different stage of the company’s development. Indeed, as discussed in Appendix III.7.2, research undertaken in the United States suggests that while many directors regard board refreshment as important to CG standards, some regard it as critical. It works to avoid “group-think” and complacency, or boards that are out-of-touch with new realities. Arguments against board refreshment are usually raised by management linked to the board (e.g. chairman and CEO) or controlling shareholders. Nonetheless, the overriding consensus is that board refreshment is a core principle that serves to foster good CG via increased accountability.

A number of approaches have been undertaken to address mechanisms of refreshment. The research cited above returned a significant finding, namely that over 84% of respondents²⁸⁵ regarded board assessment/evaluation as the most effective tool. The 2009 Walker Review in the UK, discussed in Appendix II.2.1, also suggested that a formal board evaluation was a desirable contributor to good CG. Board evaluation was discussed in **Section 3.3.3** “Board evaluation” and led to **Recommendation C4.1.1** “Board evaluation”.

Board refreshment is recognized as a core principle of good CG in the UK.²⁸⁶ The approach there has been to focus on the power of shareholders to exercise their votes. The UK CG Code has recently introduced a provision that directors should be subject to re-election by the shareholders at regular intervals, that this should be an annual exercise in respect of directors of FTSE350 issuers, and that relevant information should be provided to shareholders to facilitate their decision-making.²⁸⁷ Most FTSE350 issuers have implemented this provision, as discussed in **Section 3.4.2** “Shareholder votes”. This brings directors to account before shareholders on a regular basis. As regards INEDs, the Code suggests that terms of more than six years should be subject to rigorous review.²⁸⁸ Together with the other changes made in the UK to the appointment of independent directors (discussed in **Section 3.6.4** “Appointment of independent directors” below) this helps to address concerns that boards can become “clubby”.²⁸⁹

In the United States, the National Association of Corporate Directors (NACD) runs programs to help directors improve, *inter alia*, board diversity and director recruitment, its aim being to “help directors move beyond the traditional approaches to board refreshment and develop a continuous-improvement plan that keeps board skill sets and processes in tune with the company’s strategic needs.”²⁹⁰ Staggered boards in the United States are used to entrench the board and is a major problem and prevents board refreshment. In a staggered board, the board is divided into three classes. Each year,

²⁸⁴ Stephen Foley and Alister Gray, “Activist pushes for shake-up at Wells Fargo,” (15 September 2016) *Financial Times*

²⁸⁵ Over 77% of respondents on the survey were outside directors based on the largest company on which they serve

²⁸⁶ Principle B.2

²⁸⁷ Provision B.7.1

²⁸⁸ Provision B.2.3

²⁸⁹ One might also add to this the developments happening in relation to board diversity

²⁹⁰ NACD, “NACD to Help Directors Move Beyond Traditional Approaches to Board Refreshment,” (7 April 2016) *Globe Newswire*

only one class (i.e. one third of the board) is up for election. So it would take longer to refresh the board composition. Empirical evidence suggests that staggered boards are bad for value-creating takeovers.²⁹¹

In Singapore, the SGX listing rules mandate that all listed companies have articles providing that where a managing director or a person holding an equivalent position is appointed for a fixed term, the term shall not exceed five years. This provides an opportunity for the company to review the suitability of the director at intervals. Otherwise, there is no other general legal requirement governing the length of a director's tenure or the number of terms that a director may hold office.²⁹² The Singapore Code of Corporate Governance has nevertheless suggested that all directors submit themselves for re-nomination and re-election at regular intervals, and at least once every three years.²⁹³ The Singapore Institute of Directors recommends in its Statement of Good Practice that all companies should have articles that require at least one-third of the board to retire from office at each general meeting. This is said to be a usual provision in the articles of many companies and a matter of good practice, though there is no further elaboration as to why (see Appendix V.7.3).

The Code of CG in Mainland China does not contain any provision for board refreshment, only their appointment (see Appendix IV.7.3). As the appointment of directors of many SOEs are often subject to the control of the CCP, board refreshment may be less important in Mainland China as directors are likely to be replaced with individuals holding comparatively similar views as regards the implementation of State policy in the operations of the SOE. For mainland companies listed in Hong Kong, they are subject to the HK CG Code. However, whether such requirement is likely to be meaningful in practice is not certain given the controlling stake of the State in many of the companies listed in Hong Kong. For a similar reason, nor is there certainty that the requirement in Singapore will be meaningful, i.e. due to the influence of the Singapore Government via its investment vehicles.

Hong Kong

The HK CG Code does provide for board refreshment insofar as it states that directors should be subject to retirement by rotation at least once every three years.²⁹⁴ However, as a code provision, this is not mandatory and an issuer is free to deviate from it provided an explanation for the deviation is given in its annual report.

Discussion

The obvious if bland question the foregoing considerations raise is whether a higher refreshment frequency should be imposed under the HK CG Code. However, there must be a clear shareholder mandate to warrant it. For example, in the UK there have been a number of high profile examples where shareholders have taken action, a recent case being the shareholder pressure placed on HSBC to replace the Chairman because the lack of pace of change within the bank, which led to the bank announcing a change on 12 March 2017. BP, WPP, and Smith & Nephew represent other high profile instances of shareholder action leading to boardroom changes, as discussed in Appendix II.1.2, although these had been driven by concerns over executive compensation.

²⁹¹ The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, March 2002: Available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/353.pdf (visited on 12 Nov 2012)

²⁹² Other than age-related: Section 153 of the Companies Act requires that directors of public companies who are of or over the age of 70 may only be appointed or re-appointed by an ordinary resolution passed at an annual general meeting of the company

²⁹³ See Tenure And Termination Of Board Appointments: Available at <http://www.sid.org.sg/images/PDFs/Codes/SGP06.pdf>

²⁹⁴ Code Provision A.4.2

In the absence of such a shareholder mandate in Hong Kong, there seems little in favour of making a recommendation, bearing in mind the context of the present Report.

Topics that are more supportable to explore in this regard concern (1) board evaluation as a mechanism - discussed in **Section 3.3.3 "Board evaluation"** (which led to **Recommendation C4.1.1 "Board evaluation"**) and (2) the role and appointment of independent directors and the assessment of their independence - discussed in **Section 3.6.4 "Appointment of independent directors"** and **Section 3.7 Part C "Independent directors"**. Indeed, both these topics gave rise to considerable discussion in all the interviews.

3.6.4 Appointment of independent directors

A basic mechanism that establishes accountability for all directors is the ability of shareholders to vote on their appointment or reappointment. An issue that has attracted particular significance in the jurisdictions studied has been the accountability of INEDs to the shareholders they are intended to represent - the interests of shareholders as a whole as opposed to controlling interests.

The position of independent shareholders underwent a significant development in the UK in 2014 when the FCA established dual voting for independent directors. This requires that the appointment of independent directors is subject to the approval of both (1) the shareholders and (2) independent shareholders.²⁹⁵ Issuers with a controlling shareholder are required to change their constitutional documents to provide for this, as discussed in Appendix II.1.2. The development in the UK is set against the more sweeping UK CG Code provision that terms of INEDs that are more than six years should be subject to rigorous review.²⁹⁶

Neither the United States nor the other jurisdictions studied have implemented a similar approach. The United States has instead been dealing with a different and to some extent unique problem of director appointments arising out of issues attendant on their proxy rules that can work to deprive shareholders of their voice in company meetings (discussed in **Section 3.4.2 "Shareholder votes"**). One of the particular problems arising out of the proxy rules, germane to the current discussion, is the rise of the independent activist director.

The experience of appointing independent directors in the United States has been notably marked, if not marred, by the actions of activist shareholders. While there is some evidence that shareholder activism is on the rise in the UK, it has not come close to the levels experienced in the United States. The rise of institutional and activist shareholders and proxy advisers as dominant shareholder voices in United States listed issuers has become an important factor associated with a number of current problematic issues with CG culture in the United States, as discussed in Appendix III.1.2. The primary issue is that the interests of such voices, which wield considerable influence, may not align with the strategic or longer-term goals of an issuer or the shareholders as a whole. This has led to some significant anomalies in the development of appropriate executive remuneration packages, as discussed in **Section 3.4.3 "Remuneration"**.

The increased representation of independent directors (see Table 3 in Appendix II.1) has not alleviated the problem owing to the problem that directors independent of management may not be independent of blockholders and may represent shareholder activists seeking short term profits - in one study, over 40% of shareholder activist

²⁹⁵ LR 9.2.2E R and 9.2.2F R. See FCA, "Response to CP13/15 - Enhancing the effectiveness of the Listing Regime," (May 2014) *Policy Statement, PS14/8*, 6. See FCA 2014/33 Listing Rules (Listing Regime Enhancements) Instrument 2014

²⁹⁶ Provision B.2.3

interventions between 2004-2012 resulted in the appointment of activist directors, and 43% of those appointments were directly employed by a hedge fund activist.²⁹⁷ As a result, Congress has considered the influence of proxy advisory firms over shareholder voting and the potential conflict of interest that arises because proxy advisory firms also provide consulting services for listed companies and advise on their proxy ballots.²⁹⁸ The Corporate Governance Reform and Transparency Act of 2017, not yet passed into law,²⁹⁹ seeks to protect investors by improving the quality of proxy advisory firms by fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry. However, this at present looks unlikely to pass into law under the new administration.

In Singapore, although independent directors are now required to be independent of controlling shareholders as well as the company, there is still no requirement that independent directors must be appointed by independent shareholders.

The position is the same in Mainland China. Recent research reveals that independent directors are not effective in preventing frauds - since they are appointed by controlling shareholders they have incentive to side with controlling shareholders (see Appendix V.7.2). This would suggest that being independent from controlling shareholders itself is not enough; they need to be independently appointed too.

Hong Kong

Procuring the proper undertaking of an INED of its role was a topic of concern in every interview undertaken, and this is more broadly discussed in **Section 3.7 Part C** "Independent directors".

As regards specific appointment issues, the HK CG Code falls short of the UK CG Code in two regards as regards INEDs. First, in place of a six-year period the HK CG Code provides that serving for a period of nine years "could be relevant to the determination of a non-executive director's independence" and so re-appointment should be made subject to shareholder approval.³⁰⁰ This also contrasts with the approach taken by the UK CG Code that an independent director serving for more than nine years should be subject to annual review.³⁰¹ Second, unlike the UK CG Code, the HK CG Code does not suggest that re-appointment be subject to a "rigorous" review, but merely that the papers sent so shareholders explain why the board considers the INED to remain independent. The question of determining independence is further discussed in **Section 3.7.9** "Determination of independence".

The means by which an independent director is appointed was a subject of discussion in a number of our interviews, with mixed reactions. Central to the discussion was whether independent shareholders should appoint independent directors to guarantee their independence, as this has been a topic circulating in the market for some time.³⁰²

On one hand, the argument made out was that a director couldn't be regarded as truly independent if they are, notwithstanding any independence tests that may be applied, ultimately subject to appointment or removal by a controlling shareholder casting their vote. On the other, concern was expressed that having independent shareholders

²⁹⁷ Gow, Ian D., Sa-Pyung Sean Shin, and Suraj Srinivasan. "Activist Directors: Determinants and Consequences." Harvard Business School Working Paper, No. 14-120, June 2014

²⁹⁸ Mara Lemos Stein, "The Morning Risk Report: U.S. Lawmakers Target Proxy Advisory Firms," (20 September 2016) *The Wall Street Journal*

²⁹⁹ The House Financial Services Committee approved the bill in September 2016

³⁰⁰ Provision A.4.3

³⁰¹ Provision B.2.3

³⁰² For example, see "The three wise monkeys of HK boards" 15 Feb 2011: Available at <https://webb-site.com/articles/3wisemonkeys.asp>

directly appoint a director may lead to directors on the board that selectively pursue “an agenda” that does not align with the interests of the company as a whole. Neither argument is particularly persuasive. For example, logically, the latter view requires one to put in abeyance the argument that a director subject to appointment by a controlling shareholder may selectively pursue “an agenda” that primarily aligns with the interests of the controlling shareholder rather than the shareholders as a whole.

The UK dual voting model does not provide that only independent shareholders appoint independent directors – the company as a whole must agree as well. There are fewer companies in the UK with controlling shareholders, so the chances of a candidate that is acceptable to shareholders as a whole but not accepted by independent shareholders are smaller, although there have been instances of this happening.³⁰³ However, this may not be the case if the system was adopted in Hong Kong, which could lead to difficulties.

Discussion

As the experience in the United States demonstrates, independent directors cannot be understood as a panacea to all possible problems. At the heart of the question is, amongst other things, who are they independent of and whose interests do they understand themselves as being responsible to further. Of course, the profile of shareholders in the UK and the United States stands in high contrast to that seen in Hong Kong in terms of institutional/retail makeup, the frequently seen characteristic of Hong Kong listed issuers possessing a controlling or dominant shareholder or shareholder group and, arising out of that different makeup, the level of shareholder activism, which is rare. These differences should be taken into account when considering the question of the appointment of independent directors.

Based on the foregoing, the arguments for and against introducing special voting arrangements for the appointment of independent directors are largely equivocal. As noted in **Section 3.5.1** “Voting rights generally”, imposing regulations that establish a different set of voting rights for shareholders based on their independence represents public law overriding rights attaching to shares otherwise enjoyed in the private law context. On balance, it is suggested that in the absence of a clear mandate to impose such an override, no such regulation should be imposed.

³⁰³ Independent shareholders voted against the Sports Direct chairman in September 2016, as discussed in the UK Appendix

3.7	Effectiveness
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Introduction

This Section takes as its primary concern elements of the CG system design that are relevant to procuring desired behaviour, and deterring behaviour considered inconsistent with good CG. Whether a CG system is effective depends on a number of interrelated factors, and many of the issues discussed in previous sections depend on the effectiveness and support of the system in this regard.

The main observations of interest are grouped under four main parts, as follows.

Part A considers the particular tools of policy development and enforcement;

Part B considers some specific mechanisms that may be engaged to improve effectiveness;

Part C considers specific issues surrounding the role of independent directors; and

Part D concludes with other matters not falling under the above headings.

PART A – CG system design

3.7.1 Impact of regulatory design

At one level, the UK's CG system is straightforward in its overall design and functioning. The FCA is empowered by statute to make rules that have statutory backing, and it has incorporated in its listing rules and the DTR many rules that pertain to CG standards, as discussed in Appendices II.3.3 and II.4.1. This includes the listing rule requirement to make disclosures based on the non-statutory UK CG Code published by the FRC, thus giving that code a measure of statutory backing.

Nevertheless, the number of fundamental changes cum developments in the system since 2000, particularly post 2008, currently render the system in its operational details prone to complexity and a degree of overlap insofar as a requirement in one set of laws or regulations may refer to another, which itself maybe supported by another law, regulation or guidance, each level of which will have a different legal standing and different legal consequences upon breaching them. For example, it has been said that a print-out of the FCA Handbook stands over a metre tall and that the introduction of a twin peaks model effectively created two such stacks of similar but not identical regulations. To this of course could be added the various instruments and so on made pursuant to the CA 2006, FSMA 2000, and the FSA 2012. As a result, at present there is no one consolidated text of financial services law in the UK.

Despite the elegance of the overall system structure, for example, as compared to the overlapping regulatory agencies in the United States, the system has been criticized as overly complex and overly regulated, the FSA having once been characterized by the then Prime Minister Tony Blair as "hugely inhibiting of efficient business by perfectly respectable companies that have never defrauded anyone".³⁰⁴ It is more than of merely historical interest to note that Callum McCarthy, the Chairman of the FSA in 2005,

³⁰⁴ Per a leaked letter as cited in a disclosed letter to Prime Minister Tony Blair, dated 31 May 2005 from Callum McCarthy in his capacity as Chairman of the FSA

commented in support of the UK system that whereas Citibank in the United States had about 30 regulators in full-time residence representing multiple regulatory agencies, HSBC in the UK has only one regulator overseen by a team of six staff who are not on-site, a situation that has dramatically changed in recent years.³⁰⁵

While the status of the UK CG Code is in general a highly valued component of the UK system, the means of its derivative support is not as strong as it could be, and indeed compliance with the code is wanting, as discussed in Appendix II.1.1. Although very differently implemented in terms of the code's legal standing, there is a significant similarity in approach taken in the content of the UK CG Code and the HK CG Code, as summarized in Annex 1 to Appendix I.4.

The CG system in the United States is, in its application, in many ways more complicated than in the other jurisdictions studied. As a matter of regulatory architecture, the powers given to the SEC are clear, although the exercise of those powers in relation to CG concerns is not infrequently subjected to challenge in the courts.

At one level the division between the scope of authority between the SEC and the Exchanges is clear-cut: the former is only concerned with disclosures in the context of public securities laws whereas the latter is only concerned with information pertaining to the eligibility and the continuing obligations under the listing requirements, with many of the detailed CG-specific requirements being laid down in the Exchange's listing requirements. However, these two levels of the system dovetail in important ways to bring Exchange requirements into a Federal disclosure regime, as discussed in **Section 3.3.1** "Legal status of CG disclosures", it being noted that all listing requirements are approved by the SEC – similar to Hong Kong where all the SEHK's listing requirements are approved by the SFC.

The powers of the SEC are significantly wider than the SFC, the SEC being empowered to, *inter alia*, make regulatory law (effectively the equivalent of subsidiary legislation) and to impose fines – while the SFC is also empowered to make subsidiary legislation, including in relation to the SEHK,³⁰⁶ this is subject to the negative vetting of the Legislative Council and this aspect has in practice led to the power not being used except where the Legislative Council has already agreed in principle to the proposal. As discussed below, where attempts have been made to use this power to widen the arc of the SFC's regulatory oversight of the SEHK, this has not proceeded.

A significant factor in the complexity of CG regulation in the United States is the many cases brought in the State courts that are called upon to adjudicate disputes. These cases are frequently decided around a combination of State law and fiduciary law, which in some ways makes outcomes possibly harder to predict than, for example, the statutory code-based approach in the UK. Certainly, the depth of cases and the occasional development of law in higher courts present a challenge to directors to keep abreast of, often leading to directors taking a conservative approach that tends toward safer more established mechanisms of good CG, as has been discussed in Appendix III.7.2.

In Singapore, the system gives a lot of powers to the MAS, including the power to approve listing rules made by the SGX, which is similar to the power enjoyed by SFC. However what is different is that the MAS also has power to issue CG Code and to enforce the listing rules and the Code which is not the case with SFC. This has meant that MAS working together with the CCB and the AG office have been able to enforce the standards more effectively, the China Sky case being the case in point.

³⁰⁵ Ibid.

³⁰⁶ section 36(1)(h) of the SFO

Similarly in Mainland China, the CSRC has power to issue and amend Code of Corporate Governance and enforce it. Again, this means that where CSRC is willing to enforce the standards, it has been able to do so effectively.³⁰⁷ As discussed, the UK also gives the power to issue and enforce listing rules and the CG Code to one independent regulator, namely the FRC in the case of the Code and FCA in the case of listing rules.

Hong Kong

Hong Kong is the only jurisdiction in this study that still gives the power to make and enforce both listing rules and the CG Code to the HKEX, a market player, rather than an independent regulator, such as the SFC – while a similar power appears to be enjoyed by the Exchanges in the United States, in practice many of their CG requirements arise out of requirements imposed by legislation or the implementing rules of the SEC.

The regulatory oversight of listed issuers including the setting of standards to which they are expected to comply operates under a dual responsibilities model, as discussed in Appendix I.3.2. This arrangement of dual responsibility, which is one type of competitive self-regulation,³⁰⁸ is to preserve the advantages of self-regulation, which is that a stock exchange (i.e. for the SEHK via the functionality of its Listing Committee) as the participant and facilitator of the market knows the problems in the market and how to fix them better than government or statutory regulatory agencies such as the SFC.

The powers that have been given to the SFC in relation to the listed market, its primary means of oversight being the “reserve power” given to it by the SMLR, are not as extensive as their counterparts in the UK, United States or Singapore. The SFC can make rules that operate as subsidiary legislation, subject to public consultation and to the negative vetting of the Legislative Council. Those powers encompass making rules in the form of listing requirements.³⁰⁹ While the SFC has exercised its general rule-making power, previous attempts to allow the SFC to exercise this power in relation to listing requirements have been strongly rejected. As noted in Appendix I.2.1, the Financial Services and Treasury Bureau (FSTB) has consulted on the execution of these powers to encompass civil fining and other powers, without success.

The nature of the SFC’s “reserve power”³¹⁰ is currently a subject of particular interest as a result of the SFC recently having signaled to the market it intends to place greater emphasis on earlier, more targeted intervention.³¹¹ While its powers under section 6 of the SMLR have been rarely used in the past, it has used this power twice in 2017, one of which was appealed (although the appeal was subsequently withdrawn).³¹² This appears to be part of the SFC seeking to move from goalkeeper into the playing field.³¹³ From the outset of the power being given to the SFC it was envisaged that the power “would not normally be necessary” because the SFC and HKEX would be working together to identify

³⁰⁷ For example, enforcement actions against Qingdao Evercontaining Electric Co Ltd 2012 for non-disclosure of related party available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201311/t20131120_238600.html; Henan Tianfon Energy-Saving Panel Science and Technology Co Ltd 2013 for disguising related-party transactions available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201307/t20130722_231554.html.

³⁰⁸ See Antony Ogas, “Rethinking Self-Regulation”, (1995) OJLS 97, at 103

³⁰⁹ section 36 of the SFO

³¹⁰ See paragraph 28 of the SFC’s A Consultation Paper on the Securities and Futures (Stock Market Listing) Rules and the Securities and Futures (Transfer of Functions – Stock Exchange Company) Order, May 2002

³¹¹ Per Ashley Alder, SFC CEO, “Front-loaded, transparent and direct: A new approach to regulation for changing markets”, speech given at the HKSI Institute Roundtable Luncheon Series”, 13 July 2017. Available on the SFC’s website. See also “SFC Regulatory Bulletin: listed corporations” Issue No. 1 July 2017

³¹² It has used the power in relation to the listing applications of Alpha Era International Holdings Limited in July 2017, and Soar Group Holdings Limited in June 2017 (the latter of these was appealed but the appeal was subsequently withdrawn – see www.sfat.gov.hk). It had last been used in relation to the listing application of China Nonferrous Gold Limited in January 2015.

³¹³ Per the analogy suggested by Carlson Tong, Chairman of the SFC, as quoted in the South China Morning Post, 3rd July, 2016

serious issues from the beginning of the listing application process.³¹⁴ The SFC's present stance has therefore led to concern among some market participants that the SFC's new use of the power may be exceeding its original purposes as a reserve power, however, the power does not cease to be reserve in nature simply because it is used more actively, although there may be other concerns as to the way it is being used.³¹⁵

Discussion

Debates about Hong Kong's CG system significantly turns on the position one takes in relation to the question of market self-regulatory models versus regulator-driven models.

The development of CG-specific requirements of the listing rules currently remains vested primarily with the SEHK, subject to the role of the SFC under the dual responsibilities model. Suggestions that the SFC play a larger role in this regard tend to be met with considerable resistance, both by the HKEX and by some market participants. The strong backlash against the SFC/HKEX Joint Consultation on listing reform (2016) is the most recent case in point.

The argument primarily relied on by those who object to a larger involvement of the SFC tend to refer to the desirability of a degree of self-regulation in the form of a practitioner-based system subject to reserve powers given to the SFC. This is consistent with the foundations of the SFC as contemplated by the Hay-Davison Report. It is also conducive to preserving the advantages of self-regulation as indicated above. Some argue that although the current structure is somewhat unique to Hong Kong it has managed to balance market practitioner and regulatory roles, as highlighted in a second major IMF review in 2014. It has also been sufficient to support the emergence of Hong Kong as a leading market for IPOs including occupying the leading global IPO position from 2009 to 2011 and again in 2015 to 2016.³¹⁶

Those in favour of a stronger statutory regulator tend to point to the developments in the UK, first with the creation of the UKLA, and subsequently with the post 2008 reforms that created the FCA (and PRA), which absorbed the UKLA function. The experience in the UK is in many ways a part of a general shift towards a greater role for public regulatory agencies, beginning with the enactment of the 1933 and 1934 securities acts in the United States in the wake of the 1929 crash. This has been facilitated by the increasing commercialization and privatization of exchange services across many financial markets.³¹⁷

As regards those aspects of the CG system that fall within the remit of the HKEX, there is a fundamental distinction between two separate roles.

The first role is the rule-making power that is managed subject to the oversight of the SFC under the dual responsibilities model. On the whole, this model has worked well insofar as the content of the HK CG Code compares favourably with the UK CG Code and the listing rules contain some of most comprehensive rules on related party transactions in the world.

³¹⁴ "Smooth implementation of dual filing", SFC, 29 May 2003

³¹⁵ Syren Johnstone et al., "Moving forward on listing reform", op. cit., section 3.3

³¹⁶ Syren Johnstone, Nigel Davis and Douglas W. Arner, "A Principles-Based Response to the Proposed Reform of the Governance Structure for Listing Regulation in Hong Kong" (November 11, 2016), 13. University of Hong Kong Faculty of Law Research Paper No. 2016/036. Available at SSRN: Available at <https://ssrn.com/abstract=2867895> or <http://dx.doi.org/10.2139/ssrn.2867895>.

³¹⁷ Syren Johnstone et al., "A Principles-Based Response to the Proposed Reform of the Governance Structure for Listing Regulation in Hong Kong", op. cit., 9

The second role is the enforcement of the rules such that behaviour deviating from expected standards is subjected to consequences that make it less likely to occur or recur. Here the dual responsibilities model has not worked well. Hong Kong's CG system fails to attach the same risk to breaches of expected CG standards as the other jurisdictions considered in this Report - the personal or commercial consequences in practice are comparatively limited and weak both as regards the powers of regulators and as regards accountability to shareholders. Thus, the significant weakness in Hong Kong's CG system is the lack of meaningful and adequate enforcement in relation to breaches of the listing rules, which reflects a typical weakness of self-regulation.³¹⁸

Addressing the enforcement issue does not necessitate taking away the HKEX's rule making power - HKEX can retain the power to make listing rules subject to SFC's approval, but there is some sense in having standards able to be enforced through other mechanisms.

Creating avenues of enforcement outside the agency of the HKEX will also resolve the conflict of interests perceived to be suffered by the HKEX in term of its lack of incentive for enforcement. This is not a novel suggestion as it is after all how the constitutional system in many democratic and developed nations is designed: the law is made by legislature but enforced by an independent prosecutorial and judicial system. Although the SFC is vetting and approving every listing rule, this in itself does not affect SFC's independence in the enforcement of the rules, as SFC has no commercial interest in not enforcing those rules.

One such avenue was discussed in **Section 3.6.2 "Listing rules" – Recommendation S4.4.1 "Shareholders as beneficiaries of listing rules"** proposes giving shareholders the right to enforce certain rules.

Another mechanism is to give the power to the SFC to directly enforce the listing rules – which does not necessitate removing the power of the SEHK to do so. There is some sense in this suggestion insofar as the SFC's enforcement power works together with the surveillance of listed issuer disclosures it undertakes pursuant to its powers under the SFO, including under section 214 and Part XIVA. The SFC has already taken numerous actions under both sections (see Appendix I.6.5). These kinds of problems in listed issuers represent significant CG failings and the head of the SFC's enforcement division has stated that the more serious corporate abuses are now a priority of the SFC's enforcement policy, effectively putting the preservation of minimum CG standards squarely on the SFC's enforcement radar.³¹⁹

However, shortcomings in CG standards span a range of seriousness. Between the SEHK's exercise of its disciplinary powers and the SFC's powers lies a significant lacuna that is inadequately covered by appropriate enforcement mechanisms – they are either too weak and so ineffective, or too strong in relation to a wrongdoing that does not warrant court action. While suggestions to give the SFC power have been controversial in the past because it interferes with the dual responsibilities model it is possible to close out the enforcement lacuna by creating a range of more graded sanctions that fit within the dual responsibilities model. Some of the recommendations made in previous sections are relevant to this: **Recommendation C4.6.1 "SEHK to develop use of existing disciplinary power"**, which proposes that the HKEX could develop its use of its existing disciplinary powers (see **Section 3.7.3 "Enforcement agencies"**); **Recommendation A4.5.1 "Legal status of CG-related disclosures"** and **Recommendation C4.5.2 "Status of listing rule compliance and related disclosures (continuing)"**, which propose to make

³¹⁸ For advantages and disadvantages of self-regulation see Anthony Ogus, "Rethinking Self-Regulation", (1995) OJLS 97OJLS

³¹⁹ Thomas Atkinson, SFC Executive Director, Enforcement, at the 7th Pan Asian Regulatory Summit (9 November 2016)

listing rule disclosures subject to legal sanctions that are more easily able to be applied (see **Section 3.3.1** "Legal status of CG disclosures" and **Section 3.3.2** "Disclosure of listing rule compliance"; and **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR", which proposes to give the SFC a graded power under the SMLR that would modulate its all or nothing power under the SMLR to suspend trading in a company's securities (see **Section 3.7.3** "Enforcement agencies").

Adopting these proposals would contribute to regulatory efficiency, however, none of them suggest a full-blown reconstruction of the powers of the SFC (which would be necessary if one wished to bring the SFC's powers into full alignment with the FCA, SEC, CSRC and MAS, which would involve a complex and controversial change to primary legislation).

As discussed in Appendix I.1.1, emphasis has been traditionally placed on reputational enforcement mechanisms rather than judicial regulation. That emphasis was established at a time when locally incorporated family-controlled companies dominated the market. However, increasingly over the past two decades, Mainland China SOEs and Mainland China privately held businesses have come to dominate the market. This period has also witnessed a steadily increasing reliance on regulatory enforcement mechanisms operated by the SEHK or the SFC, including *ex ante* mechanisms. The SFC is already using its position as a regulator overseeing licensed corporations and registered institutions to fortify the standards of professionals in the market that service the needs of companies. This includes developments to the sponsor regime including the burden of sponsors who must, *inter alia*, provide declarations as to a listing applicant's management capabilities, as discussed in Appendix I.3.2, and, more recently, its triad of guidelines and circulars concerning the duties and responsibilities of directors and advisers in relation to the valuation of company assets in corporate transactions.³²⁰ This directly impacts on the CG standards of issuers to the extent that professionals increasingly bear responsibility to advise and remind the directors of their responsibilities, and are subject to liability if they knowingly, recklessly or negligently assist the directors breach the relevant legal requirements – such liability can include being required to compensate investors under section 213 of the SFO. At this juncture it is worth noting a point that has been made elsewhere in this Report: that despite investors possessing rights exercisable in court, they are rarely exercised and investors in Hong Kong instead look to the regulators to control corporate behaviour and for a remedy where there has been wrongdoing.

Returning to the overall complexity of the system, Hong Kong's system, although somewhat unique, benefits from a level of simplicity not enjoyed by other jurisdictions. There is a perception in the market (including among some of those interviewed for the purposes of this Report) that increasing either the complexity of the system or the regulatory burden could be counterproductive. However, complexity/simplicity and the regulatory burden are two distinct issues, and there is considerable value in maintaining simplicity in terms of the system being readily comprehensible by the targets of concern they are directed toward. Milton Friedman had praised Hong Kong as an example of capitalism in action and possibly the leading example of a free market economy, and regarded this as a "major factor in encouraging Mainland China... to move away from centralized control toward greater reliance on private enterprise and the free market".³²¹ The importance and consequences of Hong Kong setting and enforcing CG standards therefore should not be underestimated.

³²⁰ "Circular to Financial Advisers in relation to their Advisory Work on Valuations in Corporate Transactions", "Guidance note on directors' duties in the context of valuations in corporate transactions", and "Statement on the liability of valuers for disclosure of false or misleading information", all issued on 15 May 2017

³²¹ Milton Friedman, "The real lesson of Hong Kong" (1997), Magazine of the University of Chicago Booth School of Business, Fall, and "Hong Kong wrong", Wall Street Journal 6 October 2006

3.7.2 Policy development agencies

Reflecting the high value the UK Government places on CG, it has been active in conducting enquiries into key concerns of CG. A characteristic of these enquiries is that they are frequent, openly conducted, forward looking, and tend to result in developments in the infrastructure of CG, either through changes in primary legislation or in applicable regulations, notably the FRC's UK CG Code. The primary point of impact of these developments tends to be on the requirements imposed on a company and its management although less frequently, if at all, on the rights of shareholders *per se*. Appendix II.2.1 discusses a number of such examples. While the scope of these enquiry-driven developments are often the consequence of market incidents, many are based on thought leadership, a notable characteristic of which is that the enquiry is not constrained by merely following what is happening in other countries.

In the United States, policy is developed at different levels of the regulatory architecture according to the nature of the problem being addressed. As discussed in Appendices III.1.1 and III.5, there is an active range of voices on the question of CG standards. In 2014 the SEC took the step of establishing the Office of the Investor Advocate,³²² which, *inter alia*, provides a voice for investors as regards decisions and development of proposed changes to rules made by the SEC or SROs, i.e. the Exchanges. It also studies investor behaviour and provides data that feed into policy choices including assessments of the economic analyses of proposed rule changes. Disclosure reform, shareholder rights, and financial reporting are among its list of top priorities for 2016, as discussed in Appendix III.4.1.³²³

Outside of the statutory agencies, both the UK and the United States possess a panoply of bodies that weigh in on the topic of CG standards. However, as discussed in Appendices II.5 and III.5 there appears to be little coordination between them toward establishing common goals with each instead pursuing selective and sometimes specialized agendas.

While there is an obvious utility in seeing a range of views expressed, the greater the number of bodies that do not coordinate with each other may introduce doubts as to the authoritativeness of each - each body frequently tends to claim to reflect balanced views supported more widely in the market. There are attendant concerns over the lack of accountability of the views expressed. Against this context there is much to be said for an agency such as the UK's FRC, which has a very clear mandate supported by the FCA, to drive the setting of CG standards that reflect a broader cross-section of stakeholders in the betterment of market standards. In this regard the United States lacks such a singularly clear voice, other than that intermittently expressed by Congress. While the SEC's efforts are of course significant in this regard, their voice is often subject to challenge in court as regards the more detailed processes associate with good CG.

In Singapore, not unlike Hong Kong, CG policy is developed at different levels by a number of government agencies and industry players, as discussed in Appendices V.1 and V.5. At the highest level, the MoF is the single shareholder of Temasek Holding that holds stakes in local listed companies and GLCs providing direct influence by the government on the CG of these companies and CG culture generally. At the frontline level, there is a clear line of division of responsibilities between MAS and SGX and a clear hierarchy with MAS clearly on top of SGX with power to formulate CG policy and implement it through the issuance and enforcement of CG Code.

In Mainland China, the administrative structure for the implementation of corporate governance policy is remarkably similar to that seen in Singapore with a clear line of

³²² <https://www.sec.gov/investorad> (last accessed Dec 2016)

³²³ Report on Objectives: Fiscal Year 2016, Office of the Investor Advocate, SEC

authority on policy matters coming from the CCP through to the State Council and its MoF and CSRC for implementation. While the policy agencies are active in their policy formulation and implementation, there are doubts as to whether the policy is effective in achieving good CG. The MoF and CSRC do regularly conduct consultation with market participants, and undertake reviews and assessments (Appendix IV.2.2). On the whole, in 2012 the IMF has been fairly positive about the effectiveness of CSRC (see Appendix IV.1.2).

Hong Kong

The experience in Hong Kong is rather divided in this regard, depending on the nature of the body making the proposals and of course the type of proposal. There is a mixed picture at the highest levels of policy-making, i.e. the first tier of Hong Kong's three-tier system of regulation, namely the Financial Services and the Treasury Bureau, the Companies Registry and Standing Committee on Company Law Reform (SCCLR) and expert groups appointed by the Government. In contrast to the UK, it is far less certain as to whether the recommendations of these bodies will lead to developments in Hong Kong's CG infrastructure, with the exception of the SCCLR³²⁴ whose recommendations have led to a number of amendments to the Companies Ordinance before 2014 and the major rewrite of the Companies Ordinance which came into force from 2014. For example, the Report on the Penny Stocks in September 2002³²⁵ and the report of the Expert Group on listing reform in 2003, which was not pursued. Recommendations for reform by other government agencies, such as the Law Reform Commission's report on class actions in 2012,³²⁶ remains with the Department of Justice and the Hong Kong Special Administrative Region (HKSAR) Government and is no longer listed by the LRC as a current project.³²⁷ This reflects the particular political dynamics of Hong Kong.

Whether the Hong Kong government should learn from Singapore's and Mainland China's style of top-down policy formulation as a means to be more assertive in formulating guiding policy for the SFC and HKEX turns on the fundamental differences between these political systems. While a firmer top-down policy direction may be beneficial, or even necessary, to move Hong Kong forward from a repeating cycle of many unchanged and un-progressed issues, it remains a question of whether the social needs of Hong Kong are sufficient to warrant intervention by the government through, for example, the introduction of new legislation if the SFC and HKEX are insufficiently enabled to resolve the issues within the existing framework.³²⁸ Nonetheless, in the absence of government intervention, a style of regulatory-driven governance moving away from the status quo would be strongly objected to by many market participants, as was the case recently with the overwhelming rejection of the proposal for the SFC gaining more powers over the listed market.

The position at the second and third tiers of Hong Kong's regulatory architecture is clearer. As a general rule of thumb, proposals made by the HKEX that promote CG standards tend to find their way, with the support of the SFC, into the CG infrastructure of the listing rules. There are many examples of this, notably with regard to the continued development of the HK CG Code, which is a centrepiece of the HKEX's CG standard setting for listed issuers. Conversely, HKEX proposals that may challenge accepted standards of CG may experience substantial push-back from either or both of the SFC as well as institutional shareholders and shareholder interest groups. The push-back works both ways. For example, the issue of WVR or dual class shares, discussed in

³²⁴ By way of disclosure, the co-author of this Report, Goo, served as a member for six years during which the bulk of the rewrite was undertaken.

³²⁵ Report of the Panel of Inquiry on the Penny Stocks Incident, September 2002: Available at <http://www.info.gov.hk/info/pennystock/report-full.pdf> (visited on 12 Nov 2017)

³²⁶ The Law Commission of Hong Kong, "Report – Class Actions, (May 2012)", Annex I, page 275

³²⁷ As per its website www.hkreform.gov.hk, as of August 2017

³²⁸ See Syren Johnstone et al., "Moving forward on listing reform", op. cit.

Appendix I.2.1 (see also **Section 3.5.2** "Weighted voting rights"), was an example of many in the market claiming this presented a risk to the minimum standards of good CG; in contrast, many of the proposals made by the HKEX in its 2010 to 2011 consultation on the HK CG Code that would foster good CG were rejected by the market.³²⁹ Another example is the FSTB and SFC's joint consultation paper proposing to empower the SFC to bring derivative actions on behalf of a company in May 2003. The consultation conclusions issued in November 2003 announced the decision to keep the proposal in abeyance in view of the limited support and numerous reservations.³³⁰

There are some success stories even where proposals were controversial at time. For example, the proposal for giving statutory backing to the price sensitive disclosure requirements of the listing rules, which led to the implementation of Part XIVA of the SFO.

The transparency of policy development is mixed across the three tiers. Although Legco panel discussions are generally open to public scrutiny, many of the formative responses to policy development proposals suffer from a greater or lesser degree of translucency as compared to transparency. For example, the response time to consultation paper responses by the LRC tends to be long. The LRC issued a consultation paper on class action in Hong Kong in November 2009.³³¹ It did not publish a final report which takes into account all responses to the consultation paper until May 2012, over two years later proposing the adoption of class action for consumer cases (see Appendix I.2.1).³³² However, until today, there is no further action on the part of the DoJ, and no adequate explanation has been offered for the delay.

The SFC normally goes above and beyond the public consultation requirements imposed on it under the SFO, pursuant to a policy it has voluntarily adopted and which has been vetted and approved, in 2002-2003, by the Process Review Panel. Nevertheless, part of that policy involves engaging in a proxy form of public consultation that involves a focused consultation of interested parties whose identity remain undisclosed. A recent case in point was the SFC's "Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management" issued 16 December 2016, which involved a proxy consultation yet took many industry participants by surprise.

Where the SEHK proposes changes to the listing rules, the SFO requires it to submit to the SFC explanations of their purpose and likely effect, including their effect on the investing public. However, this material is not publicly disclosed, even if the rule change is eventually implemented. In practice, much of the ongoing policy development is undertaken either by the Listing Committee or the somewhat opaque "High Level Group" established pursuant to the SFC/HKEX "Memorandum of Understanding Governing Listing Matters"(the "Listing MOU").³³³ This group is comprised of senior representatives from the SFC and SEHK with the function to review "systemic and policy issues" relating to listing matters. However, transparency in these agencies of the regulators also falls short, this being one of the driving objectives underlying the SFC/HKEX Joint Consultation Paper on listing reform³³⁴ – namely, to increase transparency and accountability for regulatory decision-making, including important listing decisions and

³²⁹ HKEX, "Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules", December 2010 and the "Consultation Conclusions", October 2011, Chapter 3 Part I

³³⁰ FSTB and SFC, "Consultation Paper on the Proposal to Empower the Securities and Futures Commission to Initiate a Derivative Action on Behalf of a Company", 18 November 2003: Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/enforcement/conclusion?refNo=03CP7> (visited on 12 Nov 2017)

³³¹ HKLRC "Class Actions", op. cit.,

³³² Ibid.

³³³ Dated 28th January 2003, this is a non-binding memorandum per Clause 3.1(c) of the Listing MOU

³³⁴ SFC and HKEX, "Proposed enhancements to The Stock Exchange of Hong Kong Limited's decision-making and governance structure for listing regulation" June 2016

the reasons for those decisions.³³⁵ However, that consultation met with significant problems that resulted in it not proceeding, in part due to unaddressed legal problems inherent in the proposals,³³⁶ a concern that had been raised in the Financial Affairs Panel of the Legislative Council.³³⁷ The follow-up Conclusions Paper issued in 2017 followed a similarly problematic path.³³⁸

What does this say about the effectiveness of policy development agencies in Hong Kong? While it is not possible to draw too definitive a conclusion on the point, the experience does tend to suggest that where CG-supportive proposals originate from independent practitioner-based bodies, i.e. the Listing Committee, there is a significantly stronger likelihood of it being accepted. The recent SFC/HKEX Joint Consultation on Listing Reform (2016) serves as an interesting litmus test for this hypothesis - following the release of the consultation paper, the Listing Committee of the SEHK³³⁹ came out in strong opposition to the proposal, which coincided with the negative views expressed by many of the respondents to the proposals.³⁴⁰ At one level this might be due to the greater complexity and reach of certain types of proposal, at another it reflects a fundamental feature of Hong Kong's CG policy development that is rooted in the market's deep suspicion of government and regulatory interference.

Hong Kong is often characterized as a laissez-faire system of capitalism, which might tend to suggest that centralized directives from the Government or its agencies would find less traction in a market that has traditionally been dominated by a family controlled companies and a large number of small stockbrokers that service a significant retail participation in the market. Reflecting this, businesses in Hong Kong have, historically, assumed a degree of self-regulatory responsibility. However, the laissez-faire characterization of Hong Kong is arguably no longer entirely correct and, while dominant economic entities continue to exert influence, over the past two decades the financial system is becoming increasingly rule based and transparent.³⁴¹

As with other leading financial centres over the span of the 20th century, Hong Kong's regulatory architecture has evolved a system of public regulatory agencies. Nevertheless, the appropriate balance of responsibilities between those agencies and the involvement of the market remains very much under discussion, as evidenced by the Joint Consultation paper. This was an important issue in the Hay Davison Report,³⁴² which set the framework underlying Hong Kong's subsequent regulatory evolution following its release in 1988. Like the Gower Report in the UK in 1984, the Hay Davison Report came down in favour of continued market involvement and that market participants are the best judges of specific issues relating to listed companies: "practitioner regulation should continue but that safeguards will have to be introduced at every level."³⁴³ Accordingly, primacy in setting CG standards of listed issuers remains with the exchange, its regulatory functions operated through the Listing Committee, and subject to the reserve powers of the SFC.

³³⁵ Ibid., para 31 and 33

³³⁶ For a discussion, see Syren Johnstone et al., "A Principles-Based Response to the Proposed Reform of the Governance Structure for Listing Regulation in Hong Kong", op. cit., 9

³³⁷ Policy briefing cum meeting of Panel on Financial Affairs on 6 February 2017

³³⁸ See Syren Johnstone et al., "Moving forward on listing reform", op. cit., section 1

³³⁹ Listing Committee submission 2016 (undated), other than 4 members (out of a total of 28) who made a submission dated 16 November 2016 in favour of the proposal

³⁴⁰ A total of 8,793 submissions were sent in (per Ashley Alder, CEO of the SFC, "Front-loaded, transparent and direct: A new approach to regulation for changing markets", op. cit. According to one media source, 94% came down against the proposed changes - per Enoch Yiu, "How past reforms have come, failed and gone", 6 May 2017, SCMP.com. The proposal, at least in its presented form, currently looks unlikely to proceed.

³⁴¹ Douglas W Arner et al., "Financial Markets in Hong Kong: Law and Practice", op. cit., 2.20

³⁴² "The operation and regulation of the Hong Kong Securities Industry", Report of the Securities Review Committee, May 1988

³⁴³ Ibid., para 1.8

This then begs the question, from which point of Hong Kong's regulatory architecture should policy development emerge? One might also frame the question another way: which bodies should be involved in the development and assessment of policy?

Discussion

As to the issue of thought leadership, by comparison to the UK and the United States, Hong Kong in general appears to fare poorly. Whether for better or worse, Hong Kong tends to follow a more conservative route of following international practices than leading them, with very few exceptions to this rule. Many reasons might be suggested for this - perhaps it is rooted in Hong Kong's relatively more recent emergence as an international capital centre, its *laissez-faire* leaning, the lesser powers of the SFC (as compared to the FCA and the SEC) to impose and enforce legal requirements, the misalignment of values of the functional constituencies represented in the Legislative Council from those of the Government and the statutory regulators, a belief that the only way to progress is to emulate the West,³⁴⁴ or possibly even in the city's transitional political state from being a British colony following the resumption of Chinese sovereignty under a one country two systems structure that is still being expressed and developed in its implementation. In some ways this is surprising given the emergence of Hong Kong as a global financial centre and the high-level participation Hong Kong has in international regulatory bodies - notably, the SFC has been strongly represented on IOCSO for many years, with the CEO of the SFC currently holding the IOSCO Chairmanship. In the UK, Members of the House of Commons and the House of Lords have established a somewhat unique body, the All-Party Parliamentary Corporate Governance Group ("APPCGG").³⁴⁵ The purpose of this informal group is to develop and enhance the understanding of CG at Westminster and to influence policy making in this context. It regularly holds networking events where key CG issues are discussed with its members and the government. While there does not appear to be anything similar to that in Hong Kong, the newly formed Financial Leaders Forum was established to facilitate the Government playing a more active and leading role in relation to policymaking and matters relating to, *inter alia*, financial safety and regulation. The HKSAR Chief Executive and Financial Secretary, and the Chairman and CEO of the SFC are among its members, although the HKEX/SEHK is not represented.³⁴⁶ This body does not have a CG focus, however, it is hoped that developments that may spring from the Forum may serve to facilitate thought leadership on CG.

While the historical perspective may explain the lack of thought leadership, Hong Kong needs to assert itself more in this regard given that it has become a global financial centre. It needs to develop measures that would be effective bearing in mind the CG culture, legal and regulatory and political circumstances and state of economic development in Asia, while striving also to meet if not surpass the international benchmarks and best practices. Merely following international or UK best practices may not suffice, though there is great value in consulting those practices in formulating its own effective measures.

Another possible hindrance to the CG discussion in Hong Kong is that it tends to be overly polarized. As with the other jurisdictions studied, Hong Kong possesses proportionately as many bodies that are charged with promoting the perceived values of good CG as it does interests that are aligned toward the hegemony of the commercial voice.

³⁴⁴ K Mahbubani, "Can Asians think?", Times Books International, 1998, 23

³⁴⁵ All Party Parliamentary Corporate Governance Group, "Influencing the policy agenda for business, economic and social prosperity - About the group": Available at <http://www.appcgg.co.uk/> (visited on 21 Nov 2016)

³⁴⁶ Appointments to Financial Leaders Forum, 18 August 2017: Available at <http://www.info.gov.hk/gia/general/201708/18/P2017081800677.htm> (visited on 20 Oct 2017)

While Hong Kong's conservative policy approach to CG development may have served Hong Kong well in the past, this may no longer be inappropriate to the extent that the circumstances of Hong Kong's market is different in significant ways from either the UK or the United States. In particular, the prevalence of businesses being listed in Hong Kong that originates from an emerging and centrally controlled economy, namely, Mainland China, where the CG culture is still embryonic. Hong Kong may need to consider the wisdom of adopting a stronger regulatory interventionist approach and move away from the traditional *laissez-faire* approach. Singapore has been more proactive in developing ways to regulate Mainland companies, for example, it has changed its definition of independent directors to ensure they are independent from the controlling shareholders precisely because of the increasing number of Mainland SOEs listed in SGX (see Appendix V.7.2). As CG culture is still weak in Mainland China, Hong Kong cannot rely on the changes in Mainland CG standards to improve the quality of Mainland companies listed in Hong Kong, some of which are not listed in Mainland China and therefore not subject to the CG standards there. There is very little influence Hong Kong can bring to the reform and enforcement of CG standards in Mainland China (i.e. other than through persuasive diplomacy) where CG policies are being formulated from the very top leadership in the ruling CCP. What Hong Kong can do is to lead by way of example by raising the standards and enforcing them against all companies listed in Hong Kong, including the Mainland issuers. Thus, Hong Kong needs to continue to work on finding and implementing effective measures.

The foregoing leads to different possible lines of thinking as regards proposals for the purposes of this study, the first two being process driven to improve transparency, the third and fourth relating to the operation of regulatory agencies to improve thought leadership and policy development.

First, as regards the development of the listing rules by regulatory agencies and the transparency of the process, it is suggested that explanations for the purpose and effect of a rule that has been implemented should, within a short period thereafter, be made public. Section 24(2)(a) of the SFO requires the SEHK when proposing a new listing rule to explain to the SFC the purpose and likely effect of the rule. Despite the public nature of the market, these explanations are not public documents. Nevertheless, the intended purpose of a listing rule requirement may be important in the context of enforcing it and courts and regulatory tribunals are increasingly being asked to consider the intended purpose of a regulatory provision. For example, in the recent case brought by the SFC in the MMT against CITIC under section 277 of the SFO, the interpretation of a requirement in Chapter 14 of the listing rules was central to the case yet the Tribunal failed to consider a number of highly relevant considerations within the environment of the listing rules, including the origin and intended purposes of the relevant provision in the listing rules.³⁴⁷ Were a shareholder to seek access to the purpose and effect of a rule because it was relevant to a private action, the primary hurdle would likely be that the SFC may regard the material as being secret pursuant to section 378 of the SFO; in such case the shareholder's remaining recourse would be to seek to issue a summons for discovery of the relevant documents.³⁴⁸ Accordingly, it is suggested that making the materials publicly available would bring about greater transparency and, importantly, accountability. To be clear, this is not a suggestion that the materials be subject to a public consultation, merely that once the rule has been approved that the explanation of its purposes and effect, as finalized following the SFC's response to it, should be published. While it is recognized that the provisions of section 378 of the SFO will need to be addressed, it is also noted that the SFC has powers under the SFO³⁴⁹ to make disclosures to the public regarding the performance of its functions. Neither the HKEX

³⁴⁷ Syren Johnstone and Nigel Davis, "Transparency of information in the market: the CITIC case before the Market Misconduct Tribunal", *op. cit.*

³⁴⁸ For example, as was done in *SFC v Wong Yuen Yee & others* [2017] HKCU 23

³⁴⁹ Specifically, sections 5(1)(a) and (g), and 5(4)(e) of the SFO

nor the SEHK are subject to secrecy provisions in relation to their statement of intended purpose and effect. Anecdotally, regulators seem reluctant to disclose such inner workings, possibly out of a concern that they may affect the way the rule is understood and applied. However, while the suggestion is in fact a lesser degree of transparency than as found via Hansard,³⁵⁰ Courts and Tribunals that may be required to consider regulatory rules apply well-established procedures of interpretation.³⁵¹

The foregoing leads to **Recommendation A4.9.1** "Transparency of listing rule development".

Second, given the considerable delays sometimes experienced in the publication of consultation conclusions and turnaround times of responding to the recommendations of expert groups or responses by regulatory agencies to consultation conclusions, it is suggested that a code be proposed for voluntary adoption by the relevant agency initiating or responding to the recommendation or consultation. There is also some anecdotal evidence that the response times are lengthening, or becoming unpredictable possibly owing to the involvement of vested interest groups. For example, many of the Expert Group's recommendations made in the report published in March 2003, such as removing the listing function from the HKEX to a division within SFC to be known as Hong Kong Listing Authority, remain neither implemented nor firmly rebutted, leaving the debate on the issue continuing, as recently observed in relation to the SFC/HKEX's June 2016 Joint Consultation Paper on listing reform. It is fair to say that the Government, the SFC and the HKEX are responding to the Expert Group's recommendations in different ways, albeit via a circuitous and uncertain route.

Insofar as responding to consultation conclusions are concerned, where the conclusions are not in favour of the recommendations proposed, the Government has tended to shelve the matter for a future open-ended date. The FSTB and SFC's proposal to give SFC power to bring derivative action is an example. There seems to be no periodic review to see if such a proposal should be reconsidered in light of changing circumstances, for example the need to enhance investor protection in preparation for allowing WVR structures in Hong Kong.

Such a code would provide for an obligation to publish consultation conclusions and to respond to recommendations or consultation conclusions within a specified minimum period of time. In the case of publishing consultation conclusions, a maximum of three to six months should be adequate. In the case of responding to recommendations or consultation conclusions, a maximum of one year would appear reasonable as implementation issues often take longer to resolve. Where the date cannot be met, a detailed reason must be provided explaining the scope of work undertaken and the steps put in place to respond or provide a further update by a subsequent date (for example, which would be not more than half of the previous period). The code could be incorporated by reference into the relevant appointment or consultation.

The foregoing leads to **Recommendation A4.9.4** "Response time to public enquiries/consultations".

Third, in the absence of any agency that has the development of CG standards and the interests of minority (i.e. non-institutional) shareholders as its primary concern, it is noted that the UK's FRC performs an important role in relation to the former and the SEC's Office of the Investor Advocate and the Investor Advisory Committee performs a role in relation to the latter. The UK has moved from *ex post* remedies toward *ex ante* prevention through the CG Code. The United States remains reliant on *ex post* enforcement, rather than any *ex ante* CG Code, though this is changing as a result of

³⁵⁰ Published transcripts of Legislative Council meetings

³⁵¹ For example, as done in the Moody's case in the MMT and the Court of Appeal

Enron and GFC as Congress has enacted more proactively oriented laws in response to those crises.

The dual responsibilities model of the oversight of listed issuers in Hong Kong places the development of CG standards primarily in the hands of the SEHK and the enforcement of more serious corporate wrongdoings primarily in the hands of the SFC. As discussed in **Section 3.7.1** above, while the content of the SEHK's listing rules fares reasonably well when compared with international standards, weak self-regulation of CG standards leaves an enforcement lacuna that means rules are not necessarily embodied by good standards in practice. Enforcement of the more serious corporate wrongdoings are handled by the SFC that involve standards set not by the SEHK but by legislators..

The SFC is increasingly concerned about CG standards and the costs to the market both as regards its long-standing concern with the protection of investors and its effect on market integrity. However, it is notable that the current divisional structure of the SFC does not contain any discrete functionality that deals with CG *per se*. The review of corporate disclosures and the development and approval of listing rules is primarily a matter handled by the Corporate Finance Division whereas it is the Enforcement Division that has more recently been vocal as to the enforcement of corporate wrongdoings; and the SFC have formed a new operational team between these two divisions and the Intermediaries Division – named “ICE” – that collaborates to deal with difficult issues related to listed companies.³⁵² It is unclear where in this matrix the interests of shareholders are particularly advocated. The recent *CITIC* case before the MMT has already been mentioned and the effect of the SFC deciding not to appeal the MMT's finding (that no market misconduct occurred) is of interest in this context: although there appears to be grounds on which the MMT's finding might be challenged³⁵³ the SFC's decision not to appeal affects the ability of investors to obtain a remedy since the compensation claim sought by the SFC against CITIC and its directors under section 213 of the SFO would no longer be able to proceed. Certainly, a decision to appeal is affected by many considerations, not least the SFC's statutory obligation to make efficient use of its resources.³⁵⁴

It is suggested that concerns about CG standards, and the corresponding question of when to bring an enforcement action and when not to, provide a context that a more specialized focus group on CG should be formed. The SFC has used specialized focus groups to address specific issues. For example, a Risk & Strategy Unit had been established in response to the post 2008 crisis a to facilitate a centralized approach to identifying and evaluating significant risks facing the financial sector and to help the SFC to more effectively coordinate its overall strategy in this regard.³⁵⁵ In response to the emergence of Fintech and the challenges it presents, the SFC established the SFC Contact Point and the Fintech Advisory Group in March 2016.³⁵⁶ The former is a unit within the SFC whereas the latter is comprised of external members whose function is to facilitate the former, in particular as regards understanding the opportunities, risks and regulatory perimeter implications of Fintech. In that function, the latter vehicle appears to serve as a useful semaphore post between commercial needs/tolerances and regulatory insights/expectations without having the burdens (or stigma) of being a think-tank or being formed within a regulatory body.

³⁵² Speech at the 8th Pan Asian Regulatory Summit given by T. Atkinson, Head of Enforcement at the SFC, 11 October, 2017, available on the SFC's website

³⁵³ Syren Johnstone and Nigel Davis “Transparency of information in the market: the CITIC case before the Market Misconduct Tribunal”, *op. cit.*

³⁵⁴ Section 6(2)(e) of the SFO

³⁵⁵ SFC sets up centralised unit on risk management, 2 March 2012: Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=12PR22> (visited on 12 Nov 2017). The Unit has since ceased to operate.

³⁵⁶ By way of disclosure, the lead author of this Report, Syren Johnstone, has been a member of the Fintech Advisory Group since its inception in May 2016. See: <http://www.sfc.hk/web/EN/sfc-fintech-contact-point/fintech-advisory-committee.html> (visited on 12 Nov 2017)

Developments in the other jurisdictions studied has seen the development of CG standards being moved away from Exchanges to regulators and even the legislature, so the natural question that may be asked is whether it would be appropriate that a CG-focused group should be formed within the SFC. It is suggested that doing so would be hard to implement credibly as it would disrupt the balance of the dual responsibilities model - similar attempts by the SFC to establish bodies that interact with the development of HKEX's policy and rule making role have met with significant problems (as discussed in this section above as regards the SFC/HKEX Joint Consultation).

However, this does not prevent the SFC from itself establishing a clearer voice on CG concerns that should encompass resolving the enforcement lacuna. It is suggested that as an immediately implementable step, the SFC establish an internal unit - the CG Unit - that is advised by an external working group comprised of external experts and industry participants from different sectors of the market - the CG Group. While one might consider giving representation to the SEHK's Listing Committee on the CG Group, it is suggested that this may complicate the free sharing of ideas, involve a vested interest in a process that it would eventually be involved in if a policy proposal advances sufficiently, and invoke concerns similar to the SFC/HKEX Joint Consultation already discussed. Such a CG Unit and CG Group may work to produce solutions in addition to the recommendations in this Report - which operate within the dual responsibilities model - that would assist to close out the enforcement lacuna, which includes: **Recommendation A4.6.2** "SFC to develop use of conditions when exercising existing SMLR powers", **Recommendation C4.6.1** "SEHK to develop use of existing disciplinary power", **Recommendation A4.5.1** "Legal status of CG-related disclosures", **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)", **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR", **Recommendation A4.6.4** "Statutory backing of certain listing rules", **Recommendation S4.4.1** "Shareholders as beneficiaries of listing rules" and **Recommendation E4.8.2** "Establish an investor protection agency".

Establishing such groups would also be consistent with the SFC's statutory obligation to recommend law reforms.³⁵⁷ The CG Unit and the CG Group would take as its focus CG and the interests of shareholders (particularly minority shareholders) with a view to promoting CG standards and policy development. The CG Unit would also provide an agency-based contact point for the collection of information relating to problems faced by minority shareholders in relation to shortcomings of CG standards and so would be a meaningful furtherance of the SFC's statutory objectives concerning investor protection. While HKEX still has responsibility for making the rules (subject to SFC approval), the two bodies suggested are able to consider the minority shareholder position from a different perspective - while the SFC's Corporate Finance Division may already do this, it is not as focused as it needs to have regard to both protecting the market interests as well as protecting the interests of minority shareholders, which are sometimes in competition.

The above discussion also connects with the discussion in **Section 3.7.3** "Enforcement agencies" that goes further to consider the establishment of a separate enforcement agency, as proposed in **Recommendation E4.8.2** "Establish an investor protection agency". If such a new agency were established, it may make sense to place the CG Unit and CG Group within it rather than the SFC.

The foregoing leads to **Recommendation E4.8.1** "Establish a CG Unit and CG Group".

³⁵⁷ Section 5(1)(p) of the SFO

3.7.3 Enforcement agencies

The effectiveness of a CG system within a public regulatory framework relies in important ways on the ability of regulatory agencies to impose timely and effective mechanisms that serve not only to punish undesirable behaviour but that also work to correct it going forward and to send a clear signal to other persons in the market.

This section is concerned with the question of how regulatory agencies go about exercising their powers of enforcement in relation to instances of a failure in CG standards. Clearly there are two quite different levels to be considered: what one might for the purposes of this section call “discipline” where CG standards have been breached but which have not resulted in material damage to shareholders or market integrity, and “enforcement” where the failure to adhere to CG standards has been egregious and resulted in material damage to investors and/or the market. One might also add to that list the effectiveness of discipline or punishment serving to direct an issuer and its directors toward desired behaviour, i.e. by adopting and implementing better CG standards.

As regards discipline, the Exchanges in the United States and the SEHK have limited effective power over issuers, as discussed in Appendices I.1 and III.1. In the UK, disciplinary power rests with the FCA, not the Exchange, and is generally regarded as effective, not least because it has the power to impose fines in an unlimited amount in respect of breaches of the listing rules, which enables the FCA to transition between discipline and enforcement, as those terms are distinguished above.

The FCA and the MAS both have the ability to directly enforce the listing rules as a result of both jurisdictions giving statutory effect to the listing rules (for a discussion, see **Section 3.6.1** “Information disclosures generally”). The FCA also has the power to direct an issuer to appoint a sponsor to advise the issuer on the application of listing rule requirements that the issuer is or may be in breach of (see Appendix II.6.4).

In contrast, the broad equivalent to listing rule enforcement in the United States is not driven by the listing rules *per se* but are brought within the scope of Federal securities law as a result of the Form S-K required annually by the SEC, the contents of which align with certain CG provisions of the listing requirements of the Exchanges. This, in effect, makes disclosure pursuant to the listing rules subject to section 10(b) of the 1934 Act and the SEC’s Rule 10b-5, and Regulation FD. Bringing listing rules disclosures within these provisions are effective because they are actively enforced (see Appendices III.3.1 and III.6.4) and, consequently, the risk of liability drives the behaviour of persons responsible for making disclosures. Indeed, Rule 10b-5, which may be relied on by both the SEC and private litigants, has become one of the cornerstones of disclosure standards - and liability - for listed issuers and companies seeking to be listed.

While enforcement in the United States has traditionally rested with the SEC, in 2008 a new regulatory agency was established – the Consumer Financial Protection Bureau (CFPB). The mandate of the CFPB is to protect consumers against unfair, deceptive, or abusive practices and take action against companies that break the law.³⁵⁸ Regulatory powers include monitoring, investigating, and enforcing the law. The CFPB may therefore take action in relation to breaches of legal requirements that overlap with the powers of the SEC.

In Singapore, enforcement of listing rules and the CG code rests primarily with the MAS, although the Exchanges in Mainland China also have the power to discipline (see Appendix IV.6.4). Similar to Hong Kong’s comply and explain regime, prior to 2012,

³⁵⁸ CFPB, “The Bureau” Available at <http://www.consumerfinance.gov/about-us/the-bureau> (visited on 18 July 2016)

breaches of Singapore's CG Code were subject to lighter sanctions, such as reprimand and disqualifying directors, in comparison to the civil and criminal sanctions discussed above. Some questions had been raised concerning the effectiveness of the SGX's enforcement powers. The Asian Corporate Governance Association (ACGA) CG Watch 2014 asserted that Singapore had "less impressive progress on enforcement" (see Appendix V.1.3).³⁵⁹ This had been particularly evident with the CG Code's "comply or explain" regime with continued criticism in the media, acknowledged by the government (also in the media and in parliament) and the SGX through the announcement of a CG review into the matter (see Appendix V.1.3). However, since 2012 MAS has been given the power to make rules, and is probably more efficient in setting and enforcing standards than in Hong Kong. In 2015, after extensive consultation, the SGX established Listing Disciplinary and Listing Appeals Committees.³⁶⁰ The consultation also resulted in strengthening the listing enforcement framework with Chapter 14 of SGX listing rules added on 7 Oct 2015. The SGX's enforcement powers were also strengthened. The MAS also has administrative penalty powers (see Appendix V.6.5). Sanctions are mainly confined to administrative actions because of a fragmented regulatory structure, and enforcement by way of criminal proceedings is rare - criminal proceedings can only be undertaken by Commercial Affairs Department (CAD)³⁶¹ with MAS and the SGX being constrained to administrative-sanctioning powers and limited powers of investigation.

In Mainland China, enforcement of listing rules and the CG code rests primarily with the CSRC. While CSRC has the power of enforcement, political interference and lack of resources have meant that CG standards in Mainland China remain strong on paper but weak in practice. There are a number of key differences between the enforcement of CG standards in Mainland China and Hong Kong. First, the CG Code and standards in Mainland China are enforced by the CSRC, not the exchanges. Second, the requirements in the CG Code in Mainland China are mandatory, whereas in Hong Kong the CG Code is subject to a "comply or explain" regime. Third, the sanctions imposed by CSRC are more extensive than those of the HKEX. This gives the CSRC a wider range of options to ensure that the Code is effective in its operation and therefore maintain CG standards. In terms of system design, this is perhaps a stronger enforcement system than found in Hong Kong.

The MAS and CSRC have the power to enforce but due to heavy government influence have been unable to do so. There is no such government influence in Hong Kong, however, the SFC is unable to directly enforce listing rules and the HK CG Code - its powers of oversight of the listed market are limited to those given to it under the SMLR. The lesson from Singapore and Mainland China is that, to be effective, SFC may need to be given similar powers to enforce CG standards.

Hong Kong

No one regulatory body is charged with the enforcement of CG standards in Hong Kong, although each of the relevant regulatory bodies do undertake enforcement actions within their scope of authority. As discussed in **Section 3.1.2** "Trends in regulating CG standards", and Appendices I.6 and II.6, the powers of the SFC are in important ways limited in respect of the setting and enforcement of CG standards as compared to the FCA. Neither the SFC nor the SEHK have any power to fine in relation to breaches of the listing rules including its disclosure requirements. The disciplinary powers of the SEHK are widely regarded as toothless. Only if the breaches are egregious and amount to oppression, defalcation, fraud, misfeasance or unfair prejudice for the purposes of

³⁵⁹ Amar Gill, Jamie Allen, Charles Yonts, and Irina Bevza, "Dark Shades of Grey: Corporate Governance and Sustainability in Asia" (September 2014) *CLSA and ACGA, CG Watch 2014, Special Report*, 5: Available at [http://www.acga-asia.org/upload/files/CG%20Watch%202014%20\(Cover%20and%20Overview\).pdf](http://www.acga-asia.org/upload/files/CG%20Watch%202014%20(Cover%20and%20Overview).pdf) (visited on 26 Nov 2016)

³⁶⁰ SGX, "Reinforcing the SGX Listings and Enforcement Framework" (17 September 2014)

³⁶¹ Amar Gill et al. "Dark Shades of Grey: Corporate Governance and Sustainability in Asia", op. cit

section 214 of the SFO does the SFC have the power to seek a more severe enforcement mechanism. The SFC does have specific powers under SMLR, which may also be invoked in respect of more egregious breaches.

Specific CG standards established by the listing rules are enforced by the SEHK, or the SFC if the breach involves provisions in the SFO, the former giving way to the latter where the SFC proposes to take legal action.³⁶² The SFC has no disciplinary powers over listed issuer's CG standards *per se* but is empowered to take action where the issuer has breached a provision of the SFO, such as sections 277 or 298, or CWUMPO, however, the relative lack of enforcement actions under these provisions (there have been none under CWUMPO) means that the perceived risk of liability does little to affect behaviour. Instead, the system in Hong Kong that traditionally has brought consequences to mis-disclosure tends to be commercial in nature (e.g. de-listing followed by winding up), or the application of sanctions either by the SEHK under the listing rules, which is comparatively weak, or by the SFC against the persons (such as sponsors) it regulates. There is some sign that this is changing as the SFC have started to become active in relation to items sections 277/298 and Part XIVA of the SFO. As already noted in **Section 3.6.1** "Information disclosures generally", the SFO does provide for civil liability but there have been no actions taken under the relevant sections.

Standards of financial disclosure are subject to the same considerations, although the situation is currently in a state of flux as regards the split of functions between the HKICPA and the FRC and how the powers of the latter will be finally defined.

A positive development in this regard was the removal of the price-sensitive information provisions of MBLR 13.09 (as it was) and the introduction of Part XIVA of the SFO in 2013. This empowered the SFC to seek fines through the MMT, and extended the powers of enforcement to officers of the issuer and not just the company. It also enabled a person who has suffered loss as a result of the breach to bring a civil action for damages through the courts.³⁶³ While this in some ways is similar to UK, an enforcement action by the SFC must be undertaken through the MMT, not by the regulator directly as in the UK, thus introducing not only a significant delay in the timeliness of enforcement but also the cost of doing so. Moreover, the fining power of the MMT is limited to HK\$8 million in contrast to the FCA's power to impose a fine in an unlimited amount. In Hong Kong the enforcement of information disclosures in the markets, an important feature of an effective CG system, in important ways does not rest primarily with the regulators, their role instead being restricted to oversight and the commencement of enforcement actions undertaken in the MMT. The dissemination of false or misleading information by an issuer might also fall to be treated as market abuse³⁶⁴ - whereas the FCA has similar fining powers³⁶⁵ the SFC would need to make an application to the MMT or the court depending on which provision of the SFO is being relied on.

Discussion

As the powers given to regulators in Hong Kong are generally inferior to their international counterparts, this gives rise to a fairly obvious suggestion that these powers should be increased to be on par with international norms. What has been done in relation to the removal of parts of listing rule 13.09 to create Part XIVA of the SFO could be regarded as a step in that direction but only a partial one since the change represents only a subset of other important disclosures (and rights) that are to be provided to shareholders under the listing rules, and because the SFC did not acquire the administrative power to fine (it has to apply to the MMT).

³⁶² See the "Enforcement of the listing rules – policy statement", first issued by HEX on 13 September 2013, revised 17 February 2017

³⁶³ section 307Z of the SFO

³⁶⁴ section 118(7) of the FSMA in the UK, and sections 277 or 298 of the SFO in Hong Kong

³⁶⁵ section 123 of the FSMA

The foregoing considerations give rise to two separate topics: (1) the potential role of the SFC as an enforcer of the listing rules, and (2) whether the SFC is the only entity that should be regarded as an enforcement body. These will be dealt with in turn below, and each give rise to recommendations. The final part of this section turns to a third topic related to this discussion: (3) the existing powers of the SEHK.

(1) The potential role of the SFC as an enforcer of the listing rules

The enforcement of the listing rules in Hong Kong stands in high contrast to the powers of regulators in the other jurisdictions studied. It would not be a new idea to suggest that the SFC be given the power to fine listed issuers for breaches of the listing rules, nor that certain parts of the listing rules (such as Chapters 4, 14 and 14A) be removed to statute. This has been proposed before, notably in the FSTB and SFC consultations on proposals to give statutory backing to major listing requirements issued between 2003 and 2005, as discussed in Appendix I.2.1. However, the proposals were rejected. HKEX at that time was supportive of statutory backing for the more important listing rule requirements as proposed in the Consultation Conclusions on Proposals to Enhance the Regulation of Listing, however, it disagreed with the details of the implementation of the same as proposed by the FSTB and the SFC. The proposals have also given rise to considerable controversy and pushback from the industry. Contemporary discussion in relation to listing reform remains positioned around and to a large extent pinioned by these consultations.³⁶⁶

The fining powers of the SFC are broadly similar to those possessed by the SEC, which also does not enjoy the outright power to fine possessed by the FCA. (The SFC only has a power to directly fine in respect of persons who are subject to its regulatory oversight under the SFO.) This reflects the fundamental nature of the developments in the UK toward a statutory basis for listing regulation. Accordingly, any discussion that suggests the SFC be given a power to fine would need to be based on a more fundamental discussion of regulatory architecture of the oversight of listed issuers, and would need to be properly embedded in a wider legal framework. Certainly, giving the SFC the power to fine listed issuers – or, more pointedly, their directors – would require significant consideration and any proposal would be controversial. Any proposal in this regard would need to be established on a basis that better addresses the concerns expressed in the previous consultation exercise. This might incorporate, for example, mechanisms for regulatory collaboration as to the imposition of fines that involves not only the SFC but also the practitioner-driven Listing Committee of the SEHK in order to ensure appropriate checks and balances in relation to the imposition of fines, subject to appropriate appeal mechanisms such as are already in place in relation to the specified decisions of the SFC that may be appealed to the Securities and Futures Appeals Tribunal. It would need to be measured against an assessment of whether the powers under the current system of enforcement are adequate to its purposes. This would need to take into account not only factors related to the effectiveness of deterrence, such as the consequences of delayed sanctions, but also the resource based capability of the enforcement mechanisms, such as the resources of the MMT and the regulators. Accordingly, further investigation would be needed before a clear proposal could be made that the SFC be given administrative fining power over listed issuers and their directors.

Since the UK introduced a listing authority, there have been intermittent calls for Hong Kong to create a listing authority, as was proposed in the report of the Expert Group in 2003.³⁶⁷ However, it is suggested that in the absence of a review of the significant

³⁶⁶ For a further discussion, see Syren Johnstone et al., "Moving forward on listing reform", op. cit.

³⁶⁷ Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure, March 2003

changes to the Hong Kong market since 2003, repeating such a call appears premature. Moreover, it is far from certain whether an alternative statutory model would have worked better than the current model under which Hong Kong has enjoyed a considerable measure of prosperity. As noted elsewhere,³⁶⁸ the introduction of the statutory model in the UK was paired with significant structural changes that had a clear mandate from Parliament and was accepted by the market, but also generated a series of complex and ongoing changes that has left the UK system being regarded by some as overly complex.

Given the recent difficulties in progressing listing reform as proposed by the SFC and HKEX, and the lack of direction from the government on the question,³⁶⁹ it is difficult to recommend, given the purposes and orientation of the present study, that a sweeping change to regulatory architecture be undertaken. However, within this study's scope it is nevertheless possible to make three different types of suggestion, the first working entirely within existing regulations, the second representing a modification to the SMLR that may benefit issuers and shareholders, and the third is based on relevant developments since 2003.

First, working within existing regulations:

The SFC and the SEHK have powers they do not appear to fully utilize (the position of the SEHK's powers in this regard are discussed under (3) below). There is some parsimony in a suggestion that the regulators could seek to use existing powers more effectively to bring improvements to CG standards. While this may not amount to a significant-looking suggestion, for example as compared to suggesting that the SFC be given the administrative power to fine, it is one that has the considerable benefit of being able to be immediately implemented and one that allows another enforcement focus to be shone on the topic of CG standards.

The SFC already has regulatory oversight of the listing application process and the ongoing disclosures and listed status of listed issuers – this is provided for by the dual filing regime and the powers given to the SFC under the SMLR. However, those powers are somewhat blunt instruments, being: to object to a listing or to indicate it does not object subject to the satisfaction of conditions it specifies, to direct the SEHK to suspend all dealings in an issuer's securities and to impose conditions on the suspension being lifted, or direct the cancellation of an issuer's listing.³⁷⁰ These powers only arise in specific circumstances (as discussed in Appendix I.3.2) that do not cover breaches of the listing rules *per se* save in relation to listing applications.

Once the SFC has directed a suspension under one of the routes provided for, the SFC has corresponding powers under section 9(4) of the SMLR to direct dealings to recommence subject to conditions that it might impose (the power of the SEHK to impose resumption conditions is discussed under (3) below). Where the suspension has been invoked on the grounds of maintaining an orderly and fair market or protecting investors,³⁷¹ the SFC has the discretion to impose such conditions it considers appropriate to address the relevant issue.³⁷² While the SFC is required to consider any representations made by the SEHK or the issuer, where no representations are made it

³⁶⁸ See Sections 3.1.2 "Trends in regulating CG standards", 3.4.4 Changes of control" and 3.7.1 "Impact of regulatory design"

³⁶⁹ See Syren Johnstone et al., "Moving forward on listing reform", op. cit.

³⁷⁰ Sections 3, 8 and 9 of the SMLR, respectively

³⁷¹ Sections 8(1)(b)&(c) of the SMLR, respectively, the latter subsection also contemplates the interests of the investing public or the public interest

³⁷² Sections 9(4)(b)&(c) of the SMLR, respectively

may nevertheless exercise the power to direct resumption of trading subject to conditions being met.³⁷³

Here it seems possible that, if the problem has arisen out of the issuer's CG standards or processes, such conditions could be used to address those CG shortcomings. For example, the SFC could require changes to a board's processes, including the functioning of the board's sub-committees, that reduce the likelihood of a recurrence of the problem and that may serve to catalyze change. Bringing a focus to an issuer's CG standards, systems and processes (particularly those that relate to internal controls and disclosure cum transparency) would be consistent with a more progressive approach to regulation that looks to solving underlying problems as opposed to merely addressing instances. The use of such catalyzing conditions recognizes, and must be premised on, the reality that certain shortcomings of listed issuers arise out of a CG culture that is not in keeping with the minimum standards expected by the market. However, some care would need to be taken to ensure that such conditions do not result in rewriting the listing rules for some issuers so as to create an uneven playing field. Where this concern arises, it may be able to be addressed by way of placing a time limit on compliance with the condition that gives an opportunity for catalysis to take hold. Catalyzing conditions might also be paired with requiring the appointment of a compliance adviser for the relevant period. The potential range and use of such catalyzing conditions would require further detailed examination, as does the precursors required before the SFC might use them. If correctly developed, catalyzing conditions can work toward two ends: (1) to direct an issuer toward better CG standards, and (2) to more openly promote the SFC's policy attitudes toward good CG. Item (2) is an important alternative to negotiations that might otherwise take place in private.

In relation to listing applications, such conditions conceivably could address CG shortcomings in the listing applicant's governance arrangements.

The foregoing leads to **Recommendation A4.6.2** "SFC to develop use of conditions when exercising existing SMLR powers".

The foregoing recommendation can be read together with recommendations made elsewhere in this study that propose giving a degree of power to the SFC in a manner that does not require changes to legislation or the dual responsibilities model, namely, **Recommendation A4.5.1** "Legal status of CG disclosures", and **Recommendation C4.5.2** "Status of listing rule compliance and related disclosures (continuing)", both of which bring certain CG disclosures made by listed issuers pursuant to the listing rules within the scope of the existing provisions of the SFO.

A problem in practice with imposing conditions on suspended issuers arises where its directors may be content to leave the company in a suspended status despite the potential prejudice to minority shareholders. This problem is addressed by **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR", discussed next.

Second, modifying the SMLR:

To deal with the enforcement gap, the SFC has increasingly looked to *ex post* enforcement mechanisms through the courts. This is expensive and time consuming, and

³⁷³ There is an alternative view that where no representations have been made the power to impose conditions does not arise. This is ultimately a question of statutory interpretation. It is suggested that the purpose of the requirement imposed on the SFC to "consider any ... representations" (section 9(3)(b) of the SMLR) is to ensure consistency with well established principles of administrative justice rather than being intended as a means by which an issuer (or the SEHK) can effectively block the SFC's use of the power to impose conditions. Nevertheless, if Recommendation A4.6.3 is implemented it would be a simple matter to clarify this provision to provide for "representations ... if any".

it is not certain that such actions will always benefit investors who have suffered loss.³⁷⁴ The exercise of the SFC's power under the SMLR to suspend an issuer's listing, while striving to protect the market and its investors, nevertheless has the effect of shutting shareholders out from being able to trade risk. Suspension is an all-or-nothing action that lacks gradation. The SEHK's Listing Committee has noted its concerns regarding the number and duration of suspended companies, including some of which remain suspended for long periods.³⁷⁵ During the period of suspension, in the absence of correcting the fault and seeking readmission to listing, the issuer sits in limbo that leaves the SEHK with only one option – delisting – or the SFC may decide to devote resources to investigating for evidence of wrongdoing sufficiently egregious that would warrant bringing a matter before the MMT or a court.

The SFC's oversight powers under the SMLR can also be developed within the existing regulatory framework by giving the SFC more nuanced powers that sit within the scope of – and in that sense do not extend – its existing powers under the SMLR. Providing the SFC with limited alternative powers that serve as a warning-cum-precursor to suspension and that redirect errant behaviour may create a preferential outcome for the issuer, its investors, and the market. As an alternative to suspension, providing for a fine that works as a warning-cum-precursor to suspension might provide a “win-win-win” for the issuer, its investors and the market as opposed to outright suspension. The power would need to be premised on the same grounds as its existing SMLR powers and provide for a fine together with the imposition of conditions on the issuer and/or its officers in lieu of suspension but without prejudice to the SFC's power to suspend where the conditions are not satisfied. More mundane breaches of listing rules that do not impact on the public market *per se* should not give rise to the SFC's power to fine. In keeping with the dual responsibilities model, it would be appropriate to require the SFC to consult with the Listing Committee prior to imposing a fine. To maintain regulatory efficiency, the power should be exercisable by the SFC directly, and be classified as a specified decision appealable to the SFAT. This proposal might avoid the problems of previous proposals to give the SFC a disciplinary fining power in respect of breaches of the listing rules more generally.

The power to fine could also be supplemented by giving the SFC power to issue a formal caution where the SFC is of the opinion that there have been material breaches of the listing rules that, if left unchecked, could lead to it exercising its power to fine and/or direct a suspension of trading.

Imposing a fine with conditions in lieu of directing a suspension is analogous to section 201(3) of the SFO, which contemplates (in the context of intermediary discipline) the SFC reaching an agreement with the intermediary as to what power or other action it will exercise. This provides the intermediary and the SFC with alternative means of discipline that represents a preferred win-win outcome. It would be possible to adjust the SMLR to also provide for such a negotiated enforcement action.

However, the imposition of conditions or seeking negotiated enforcement might not work where directors of an issuer may be content to leave the issuer in a suspended status indefinitely despite the possible prejudice to minority shareholders. Accordingly, where the directors do not take steps to meet the conditions or negotiate an enforcement penalty, it may be appropriate to devise a mechanism whereby shareholders get to decide. Given the company's basic premise that it is a publicly traded company, and that a suspension fundamentally affects that premise, it would be appropriate for the conditions and/or the proposed enforcement to be put to shareholders in a general meeting. Directors and any controlling shareholder and their associates would need to be prohibited from voting. It is suggested that the imposition of a cold shoulder order on

³⁷⁴ The SFC would also need to bring an action under section 213 of the SFO to seek a compensation order

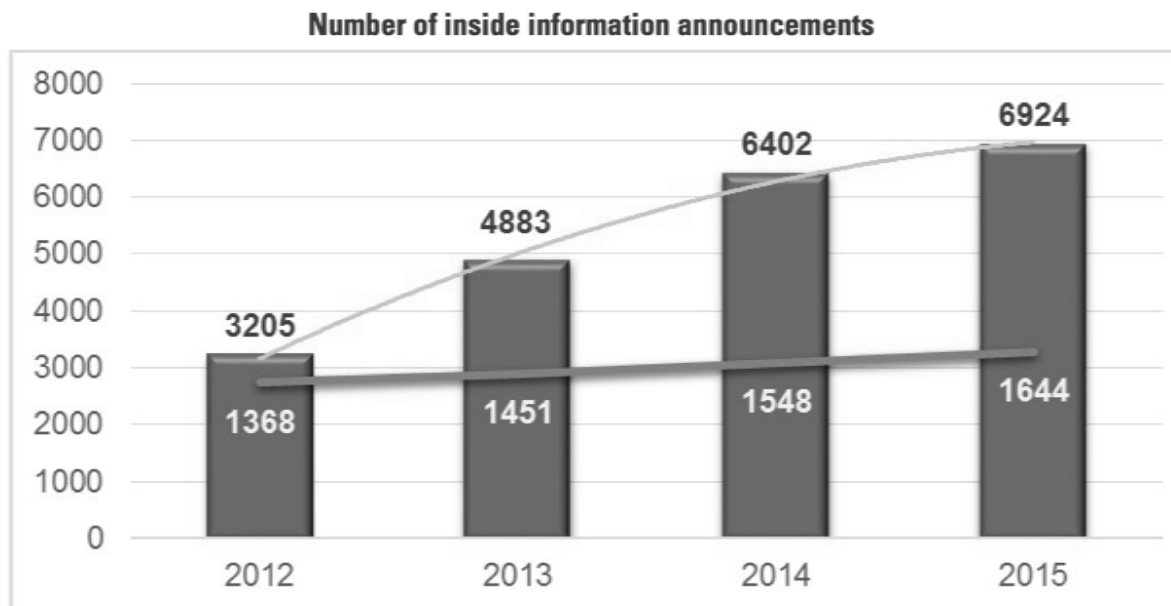
³⁷⁵ HKEX “Listing Committee report” 2015, para 49

the directors and any controlling shareholder and their associates until such time as the shareholders have voted would be an effective mechanism of procuring the matter being brought to the shareholders.

The foregoing leads to **Recommendation A4.6.3** "Calibrate SFC's powers under the SMLR".

Third, as regards relevant developments since 2003:

The major evolution of the SFC's oversight of the listed market has been the powers given to by the introduction of Part XIVA of the SFO in 2013, which deals with the disclosure of inside information. This was a statutory codification of the previous provisions of MBLR 13.09 concerning the disclosure of price sensitive information. This appears to have been successful in promoting overall transparency in the market despite its relatively short track record. Evidence suggests that the number of inside information disclosures being made has increased following Part XIVA coming into effect, by 52.4% and 31.1% in 2013 and 2014 respectively, as shown in the Diagram below.³⁷⁶



In addition, the SFC have to date brought three successful actions under Part XIVA concerning late disclosure, which have resulted in fines against the issuer and its senior executives, cost orders and director disqualification orders.³⁷⁷ It is also possible that, in serious cases, the SFC may consider taking action under section 213 of the SFO.

The generally successful experience with Part XIVA is relevant to note in relation to earlier, failed, proposals to give other parts of the listing rules statutory effect, namely MBLR Chapter 4³⁷⁸ concerning periodic financial reporting, and those aspects of MBLR Chapters 14 and 14A concerned with shareholder approval of notifiable and connected transactions.³⁷⁹

³⁷⁶ SFC Corporate Regulation Newsletter, Issue No. 4, December 2016, page 4

³⁷⁷ The relevant issuers were AcrossAsia Limited (Nov 2016), Yorkey Optical (Feb 2017) and Mayer Holdings Ltd (Apr 2017), all available on the MMT's website

³⁷⁸ See also LR Appendices 15 and 16

³⁷⁹ "Consultation Conclusions on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules", SFC, January 2005; "Consultation Conclusions on Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules", SFC, February 2007

Hong Kong has not been without its share of problematic listings that have involved financial mis-disclosure. The increasing predominance of Mainland Chinese businesses on the SEHK is of particular relevance in view of investigations undertaken by the SEC around the time of cautionary reports were issued by Moody's and the New York Times - in each case relating to Mainland issuers³⁸⁰ - and a number of cases where that concern has materialized.³⁸¹

The difficulty experienced by the MMT in the *CITIC* case (see the discussion of it in **Section 3.7.2** "Policy development agencies") perhaps also highlights the need to provide clearer, law-based provisions to govern transactions that otherwise provide to wrongdoers avenues of shareholder abuse - as the events in *CITIC* occurred prior to the introduction of Part XIVA it can be noted that the case would have been decided differently had Part XIVA been in place at the time and, if so, this may have led to the compensation of investor losses.³⁸²

Some further support for a statutory approach may be found from the experience in the United States, where significant and/or connected transactions have been the subject of many court cases (Delaware), and this has led to a higher level of caution being exercised by directors. On this basis it might be argued that statutory codification would not be necessary if an adequate body of case law was developed in Hong Kong.³⁸³ However, the experience in Delaware has also been the complexity of ever-developing case law and the consequential difficulty of forecasting the attitude of the court in relation to new cases. By way illustrating this, in a note to clients in 2014, Gibson Dunn listed out eleven different non-definitive scenarios expected to be relevant to the likely standard of review applicable in a Delaware M&A transaction to determine whether directors have complied with their fiduciary duties.³⁸⁴ This complexity gives rise to an increased uncertainty and so too the cost of doing business.

This positions statutory development as an option that may better serve to foster corporate transparency, shareholder involvement and director accountability insofar as it may provide greater certainty to both managers and owners alike.

While this study has not derived sufficient evidence to lead to a recommendation that certain listing rules now be given statutory support, based on what has been observed in the other jurisdictions studied and the Part XIVA experience, it is suggested that the ground conditions have sufficiently changed for this discussion to be re-examined. In doing so, the dangers of treading over old issues must be in the forefront of considerations, in particular, as to whether there is sufficient market consensus³⁸⁵ to warrant undertaking a new public consultation.

The foregoing leads to **Recommendation A4.6.4** "Statutory backing of certain listing rules".

As already noted in **Section 3.6.2** "Listing rules" the above recommendation may be contrasted with the proposal to make shareholders third party beneficiaries of the

³⁸⁰ Moody's Investors Service Hong Kong Limited, "Red Flags for Emerging-Market Companies: A Focus on China", July 2011; Floyd Norris, "The Audacity of Chinese Frauds" *New York Times* (26 May 2011)

³⁸¹ For example, Hontex, Greencool, China Metal Recycling, Hanergy, Huishan Dairy

³⁸² Syren Johnstone and Nigel Davis "Transparency of information in the market: the CITIC case before the Market Misconduct Tribunal", op. cit.

³⁸³ For example, in consequence of actions taken by the SFC under section 214 of the SFO or by shareholders by way of derivative action

³⁸⁴ Gibson Dunn & Crutcher, "M&A report - determining the likely standard of review applicable to board decisions in Delaware M&A transactions", 18 November 2014

³⁸⁵ See the "Consensus Proposition" asserted in Syren Johnstone et al., "Moving forward on listing reform", op. cit., section 3

contract between the SEHK and the issuer,³⁸⁶ which would not require any change to legislation and which could be more simply implemented with the involvement of the SEHK and the SFC. Both recommendations address a main theme of creating more effective means of legal recourse over the listing rules, whether by creating powers in the hands of the SFC, shareholders, or both.

For a discussion of issues related to the above, see also **Section 3.3.4** "Audit committee" and **Section 3.7.5** "Duties of directors".

(2) Whether the SFC is the only entity that should be regarded as an enforcement body

As the CFPB's mandate has no equivalent in Hong Kong, is there a case for proposing one albeit limited to CG related concerns?

Structurally, the SFC sits in a similar position of enforcement as does the SEC. Among the SFC's statutory objectives is the protection of members of the public investing in or holding financial products.³⁸⁷ Although powers of the SFC may be exercised in a way that has a similar effect in protecting investors, this is not the SFC's sole mandate (see Appendix I.4.1). As already mentioned in **Section 3.7.1** "Impact of regulatory design", the SFC is now increasing its focus on corporate fraud and misfeasance in its enforcement. While this is hoped to raise the risk of liability, and hence standards, it will directly benefit shareholders where the SFC is able to obtain compensation orders under section 213 of the SFO, and indirectly benefit them where similar orders are obtained against directors in favour of the company under section 214 of the SFO. The SFC has also sought to bring greater focus to the role of the sponsor in bringing new companies to the listed market, though has demurred from recommending changes to the law that would be necessary to enable investors to bring a civil claim against sponsors.³⁸⁸ Following the Lehman Brothers Minibond crisis, the SFC was able to negotiate substantial recoveries for investors who had suffered loss.³⁸⁹

However, the SFC has other obligations and considerations that may in its detail compete with specific instances of consumer interests, including in relation to market integrity, facilitating innovation and competitiveness, and the duty to make efficient use of its resources.³⁹⁰ The SFC's decision not to appeal the MMT's finding in the *CITIC* case, discussed in **Section 3.7.2** "Policy development agencies", may be an example of this. The SFC was designed to regulate the public markets, not to act as an advocate for shareholders. The SFC does not operate any department or division that is solely concerned with the interests of investors, it being notable that its Enforcement Division when taken as a whole deals with a variety of matters. As such, when considering the interests of shareholder's in specific situations, the SFC is not an unconflicted agency.

In 2012 the Financial Dispute Resolution Centre (FDRC) was established. Though the FDRC is not concerned with issues related to CG (its terms of reference are disputes with licensed corporations and authorized institutions) it is relevant to note as it does represent an attempt to establish a better means of enabling consumers to seek redress. However, the FDRC has not been successful.

One other consideration of relevance to this discussion is the absence of collective redress in Hong Kong. Although the SFO creates rights to bring civil actions for damages in respect of corporate mis-disclosure, it is very expensive for an individual to do so, and

³⁸⁶ Recommendation S4.4.1 "Shareholders as beneficiaries of listing rules"

³⁸⁷ section 4(c) of the SFO

³⁸⁸ For a discussion, see Syren Johnstone et al., "Deconstructing Sponsor Liability" *HKLJ* Vol 46(1) 2016 op. cit.

³⁸⁹ For a review, see Douglas W Arner, Berry FC Hsu, Antonio M Da Roza, FA Da Roza, Syren Johnstone and Paul Lejot "The Global Financial Crisis and the Future of Financial Regulation in Hong Kong" (February 1, 2009). AIIFL Working Paper No. 4. Available at SSRN: <https://ssrn.com/abstract=1349625>

³⁹⁰ Section 6(2)(e) of the SFO

no claims under these provisions are in fact brought, rendering the provisions in some ways a lame duck. The absence of collective redress, the cultural leaning toward the regulator to take action, and the range of considerations that the SFC needs to take into account before commencing any action within its power, are in fact highly interrelated.

This suggests there may be value in exploring whether some form of agency equivalent to the CFPB might be established with a specific mandate to enforce shareholder rights. Creating a new statutory body is complex and requires careful consideration of, *inter alia*, its objectives, powers, accountability, governance, staffing and funding. Such an agency would need to be empowered to bring an action for the benefit of shareholders, for example, by amending sections 213 and 214 of the SFO to provide that such agency, and not only the SFC, may bring an action. Powers of investigation and evidence collection would also need to be provided for.

It would be neither necessary nor desirable that the powers of the SFC would be affected by such an agency – they would remain unchanged, although the new agency might reduce the enforcement burden of the SFC. Nevertheless, creating an agency with powers that overlap those of the SFC might be perceived by the SFC as a challenge to their authority in relation to certain powers they presently enjoy exclusively, although this would seem an inappropriate reaction if both agencies were working toward the same objectives of market integrity and investor protection. It may also be perceived by the market as an overlap with the SFC’s function, causing confusion in the market as to who is responsible for enforcement. These considerations may be addressed by MoUs, as already utilized by the SFC and other regulatory bodies with overlapping responsibilities, such as the Hong Kong Monetary Authority, that makes it clear that the SFC remains the industry regulator and details how the two agencies are to coordinate enforcement actions in which both have an interest.

The proposal to establish a new enforcement agency is likely to be met with resistance from the market as it represents an increased liability risk. The absence of a very clear mandate from the market will present implementation challenges.³⁹¹ However, as discussed in **Section 3.5** “Equality” and **Recommendation E4.9.3** “Market development”, the longer-term priorities of market development should be repositioned around more fundamental objectives. While potential resistance to the proposal from market participants is a material consideration, the primary question is whether the proposal, if correctly implemented, would operate to further CG standards in Hong Kong in a manner that facilitates long-term market development.

The foregoing leads to **Recommendation E4.8.2** “Establish an investor protection agency”.

Alternatively, the suggestion was made in **Section 3.7.2** “Policy development agencies” that the SFC establish a new division or functionality that has as its focus CG and the interests of shareholders – that led to **Recommendation E4.8.1** “Establish a CG Unit and CG Group”. While not directly concerning enforcement *per se*, such a functionality may assist in the development of more effective enforcement choices that benefit consumers in relation to failings of CG standards.

(3) *The existing powers of the SEHK*

The SEHK has the power under MBLR 2A.09(10) to require issuers to “take, or refrain from taking, such other action as it thinks fit”. A similar provision has been used by

³⁹¹ One is reminded of the failed attempt by David Webb to form a Hong Kong Association of Minority Shareholders (HAMS), which did not receive market support at the time. HAMS is an entirely different concept from the proposal made in this Report. For details on HAMS see <https://webb-site.com/articles/hams.asp#HAMS>

powers of the Takeovers and Mergers Panel under the Code on Takeovers and Mergers, which provides that the Panel may impose sanctions “requiring further action to be taken as the Panel thinks fit”.³⁹² This power has been used to require a person who breached the Code to compensate investors.³⁹³ Although the Panel’s ruling had been subjected to an application for judicial review, eventually leading to the Privy Council,³⁹⁴ the Panel’s use of its power in this regard stood.

In addition, where an issuer has been suspended, the SEHK has the power “to impose such conditions as it considers appropriate” on the resumption of trading.³⁹⁵

There are various ways the SEHK could use such powers to direct an issuer or its directors toward improved CG standards. Whereas the leverage available to the Panel that gave its order effect in practice was its ability to issue a cold shoulder order, the primary leverage available to the SEHK would be its power, exercised via its Listing Committee, to suspend or continue the suspension of trading, or cancel a listing. These powers could also be used with effect, for example, to require an issuer and/or the relevant director(s) to make a statement as to what measures will be undertaken to ensure non-recurrence of this or similar breaches, and to subsequently report on implementation. This would be consistent with the approach proposed by the HKEX in its current proposal for suspended issuers to give quarterly updates on satisfying resumption conditions³⁹⁶ - the primary issue is what conditions are appropriate to impose. Such statements could also be required to be reiterated in the annual report and/or on the next occasion the shareholders are asked to re-appoint the relevant director. This may be a more effective means of activating reputational liability than a mere censure and could go a long way to introducing discipline that works proactively to bring about improvements in an issuer’s CG practices. Given there is no self-reporting requirement in the listing rules (although see the discussion in **Section 3.3.2** “Disclosure of listing rule compliance” which leads to **Recommendation C4.5.2** “Status of listing rule compliance and related disclosures (continuing)”), the SEHK could adopt a policy via a guidance letter that if a breach of the listing rules is self-reported upon it coming to knowledge of a director, then the SEHK would not impose such a sanction. It is further suggested that the imposition of such a sanction may be well attuned to the Asian culture, including as regards the large number of Mainland enterprises listed on the exchange who may place a high value on their personal reputation. In this regard it might also be noted that directors of issuers listed on the Mainland China Exchanges are subject to annual self-critiques, albeit those are frequently little more than cut and paste exercises. The foregoing is merely one example of how the power could be used more effectively – other such uses of the power could be set out in a guidance letter on a non-binding basis.

While these powers are ostensibly quite wide, it would be important to ensure that the use of the powers remains within the scope of the contractual relationship between the issuer and the SEHK.

The foregoing leads to **Recommendation C4.6.1** “SEHK to develop use of existing disciplinary power”.

³⁹² Para rule 12.2(e) of the Introduction

³⁹³ See the statement of the Takeovers Panel and Mr William Cheng Kai Man in 1995. The amount of compensation involved was in the order of HK\$49 million

³⁹⁴ *Panel on Takeovers & Mergers and Another v Cheng Kai-man*, Privy Council, October 1995

³⁹⁵ MBLR 6.04

³⁹⁶ HEX Consultation Paper on “Delisting and other rule amendments” Sept 2017, para 50

3.7.4 Audits of public companies

The UK is a member of International Forum of Independent Audit Regulators (IFIAR) with the FRC established as a statutory body to establish, oversee and enforce audit standards.

In contrast, the United States has only more recently become a member of IFIAR following the establishment of the Public Company Accounting Oversight Board (PCAOB), which was created by SOX to oversee auditors.³⁹⁷ Importantly, SOX puts explicit responsibility on the CEO for certifying the soundness of accounting and disclosure procedures and goes beyond a mere certification that generally accepted accounting principles are being followed – in many instances it was the case that adherence to those principles were in any case inadequate. While both the SEC and the Exchanges have a measure of oversight of financial reporting vis-à-vis their roles in relation to ongoing disclosures generally, the PCAOB is empowered under section 101 of the SOX to oversee the audits of public companies. This encompasses monitoring, inspecting and disciplining public accounting firms and associated persons for non-compliance with SOX, the rules of the PCAOB, and the SEC. Membership of IFIAR has aligned the United States with the typical structure seen in the other jurisdictions reviewed, other than Mainland China.

In Singapore, with the enactment of the Accounting Standards Act (Chapter 2B) in 2007, the Accounting Standards Council (funded by the MoF) was formed to formulate financial reporting standards for companies. On the other hand, ACRA monitors and enforces compliance with accounting standards including the financial reporting standards for companies. Singapore is a member of IFIAR as the majority of ACRA board is non-practitioners so is independent of the audit profession.³⁹⁸

Similar to the UK, Mainland China has placed the standards setting and enforcement power in one body, namely the MOF, which is the policy maker of the Accounting Rules of Enterprises, and enforces the Accounting Law (1999) and is in charge of supervising the implementation of accounting rules and regulating registered accountants and accounting firms. The China Accounting Standards Committee (the “Committee”), established in October 1998, under the Ministry of Finance (MOF) is the advisory body for setting Mainland Chinese accounting standards providing advice and recommendations on setting and improving Mainland Chinese accounting standards. These standards substantially converge with the IFRS issued by the IASB. MOF also regulates companies’ financial reports. All companies must issue annual financial reports that are audited by a registered accounting firm. MOF is also responsible for the financial matters concerning SOEs. One major difference between the UK and the Mainland Chinese system is that MOF is under the authority of state council therefore liable to political influence or interference by the government, whereas FRC in UK is a more independent body from the government. This may explain why Mainland China is not a member of IFIAR.

Hong Kong

In contrast, Hong Kong currently operates a self-regulatory regime and is not a member of the IFIAR, although plans to establish an independent audit body are in place. At present, the oversight of financial reporting and auditing in Hong Kong is instead subject to a self-regulatory regime undertaken by the HKICPA, which undertakes registration, inspection, and enforcement or discipline of audit firms, as supplemented by the FRC.

³⁹⁷ United States Securities and Exchange Commission, “The Laws That Govern the Securities Industry,” Available at <https://www.sec.gov/about/laws.shtml#invcoact1940> (visited on 4 July 2016)

³⁹⁸ IFIAR 2017 Member Profile – ACRA: Available at https://www.ifiar.org/download/singapore-2017-member-profile-website-pdf/?wpdmdl=1779&ind=uYSc6mzet07DnKxMn3ja4NOzunuPvYNJx_n_9Vy2NwiAyACJ4M8P8jL30ncn9aTIwCaJz-6rvYYuKR0kFACMrA (visited on 12 Nov 2017)

The FRC's role is presently limited, and includes conducting investigations into possible auditing and reporting irregularities of listed issuers³⁹⁹ but, importantly, not the disciplinary powers as the PCAOB possess. There are proposals to develop the FRC's role into an independent audit regulator with more responsibilities, and powers, and this will require new legislation to be passed.

Discussion

Hong Kong has not been without its share of problematic listings that have involved financial mis-disclosure that have caused some concern over the audit process and the quality of financial statements – this includes issues surrounding the audit firm as well as the means by which the issuer interacts with it, a particular focus of the interaction being the role of the audit committee, as discussed in **Section 3.3.4** "Audit committee" below. By 2012, 13 listed companies had been put on watch by FRC for alleged auditing problems.⁴⁰⁰ The Number of complaints received by FRC in the last two years has increased but the number of investigation and enquiry initiated remains low.⁴⁰¹ The increasing predominance of Mainland Chinese businesses on the SEHK is of particular relevance in view of investigations undertaken by the SEC around the time cautionary reports were issued by Moody's and the New York Times - in each case relating to Mainland issuers⁴⁰² - and a number of cases where that concern has materialized.⁴⁰³

Participation in IFIAR is an important step to bring Hong Kong into alignment with international practices, particularly following the United States accession to IFIAR membership subsequent to the establishment of the PCAOB in 2002. The key to this is the basis on which the FRC is developed, in particular as regards its independence and the means by which disciplinary power is to be exercised over audit firms. However, what is arguably more important in practice is the ability to effectively oversee audits of Hong Kong listed issuers that are based in Mainland China. The problem of cross border enforcement and the need for effective co-operation mechanisms, such as MoUs with the regulator in Mainland China, has been discussed in **Section 3.2** "Non-locally incorporated companies".

³⁹⁹ Under sections 25 and 26 of the FRCO. See generally Process Review Panel for the Financial Reporting Council, "2015 Annual Report," 1.2. FRCO, s9. See also Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (2nd edn, LexisNexis 2015) [7.1]

⁴⁰⁰ See IFIAR 2017 Member Profile – ACRA: Available at https://www.ifiar.org/download/singapore-2017-member-profile-website-pdf/?wpdmdl=1779&ind=uYSc6mzet07DnKxMn3ja4NOzunuPvYNJx_n_9Vy2NwiAyACJ4M8P8jL30ncn9aTIwCaJz-6rvYYuKRoKfACMrA. (visited on 12 Nov 2017)

⁴⁰¹ Operations statistics: Available at <http://www.frc.org.hk/en/os.php> (visited on Nov 12 2017)

⁴⁰² Moody's Investors Service Hong Kong Limited, "Red Flags for Emerging-Market Companies: A Focus on China", July 2011; Floyd Norris, "The Audacity of Chinese Frauds" *New York Times* (26 May 2011).

⁴⁰³ For example, Hontex, Greencool, China Metal Recycling, Hanergy Thin Film Power, Huishan Dairy

3.7.5 Duties of directors

In the United Kingdom, the CA 2006 codified directors' fiduciary duties – such as avoiding conflicts of interest and not accepting benefits from third parties.⁴⁰⁴ In contrast, shareholders in Hong Kong companies have the benefit of the same duties albeit under the common law rather than statute. While a basic argument for codification is that it is intended to facilitate certainty and accessibility to the law, this is not clearly the case where duties are expressed at a general level.⁴⁰⁵ The question of the codification of directors duties is of limited interest given that both boards of the SEHK are significantly dominated by non-Hong Kong incorporated issuers and Hong Kong's CO provisions in this regard only apply to Hong Kong incorporated companies.

However, the provisions of the CO are not entirely irrelevant because the SEHK's listing rules require directors of all listed issuers, wherever incorporated, to fulfill fiduciary standards and duties of care to a standard at least commensurate with the standard of Hong Kong law. As noted in Appendix I.4.1, the listing rules do not have statutory effect and so a breach of these standards merely gives rise to the SEHK's disciplinary sanctions (although behaviour comprised in the breach may entail other considerations arising under the SFO or the law of the place of the issuer's incorporation).

In the United States, fiduciary law is actively developed and applied in the State courts. The relevance of this to the present study is discussed next in **Section 3.7.6** "Role of fiduciary law".

In Mainland China, directors' fiduciary duties and duty of care are stated in the Company Law, elaborated by the CG Code.

In Singapore, fiduciary duty and duty of care remains in case law (see Appendix V.7.2).

Discussion

The question of reforming the companies' legislation on fiduciary duties has already been the subject of careful, and recent, scrutiny. While there are arguments both for and against it, for the purposes of the present study, this is not a priority issue to pursue further at the present point in time. This is not to rule out the desirability of reviewing the matter in the future, particularly in light of the experience in the UK, for example, upon the development of a sufficient body of case law, and also in view of any case law that may emerge in Hong Kong should the suggestions made in **Section 3.7.6** "Role of fiduciary law" lead to developments.

3.7.6 Role of fiduciary law

It is well established in the UK that directors owe fiduciary duties, however, insofar as the regulation and enforcement of specific CG standards are concerned, it is frequently the regulations of the FCA (including the UK CG Code issued by the FRC) that are the primary matter of interest, not fiduciary law. This reflects the development in the UK of a codified system of law, as discussed in **Section 3.1.2** "Trends in regulating CG standards".

In contrast, a notable feature of CG regulation in the United States is the extent to which CG standards are established, developed and enforced under State law through the State courts, as discussed in Appendix III.7.1. This is less a result of specific standards being set down in legislation but rather is a consequence of the emphasis placed on the

⁴⁰⁴ Sections 175 and 176 respectively

⁴⁰⁵ For a fuller discussion, see Stefan HC Lo, "Corporate governance and the new companies ordinance in Hong Kong", (2013) 21 *Asia Pacific Law Review* 267

fiduciary duties of directors, together with a cultural preparedness in the United States to seek redress through the courts. The vast number of State (mainly Delaware) court cases play a significant role in establishing CG principles and how CG is understood and applied in the United States, particularly as regards director fiduciary duties. Because of the depth of that case law, CG in the United States imposes many specific obligations on boards in particular circumstances such that it is often the case that Delaware companies are subject to a much higher standards than the board of a Hong Kong listed issuer.

While directors in the United States are generally protected by the business judgment rule, where shareholders are dissatisfied with board decisions they may consider whether any cause of action arises as a result of a breach of fiduciary duty. For example, the highly influential *Revlon*⁴⁰⁶ case examined the role of the board in a hostile takeover scenario and narrowly construed its fiduciary obligations as requiring the board to maximize value for the shareholders in the short term, as opposed to the longer-term preservation of the company. However, subsequent cases have moved toward imposing on directors a more general obligation of good faith and exercising reasonable judgment that require the directors to achieve the best value for shareholders that is reasonably available.⁴⁰⁷ As noted in **Section 3.7.3** "Enforcement agencies", this has resulted in considerable complexity of an ever-developing body of case law and a consequential difficulty of forecasting the attitude of the court. Because this can create commercial uncertainty, to that extent it also creates regulatory inefficiency.

Not only directors but also controlling shareholders may be regarded as owing fiduciary duties to other shareholders where they own a majority interest in the company or exercises some measure of de facto managerial control over the company's business affairs, including through the appointment of its agents to the board.⁴⁰⁸ In addition, where directors take actions that amount to a purposeful breach of the listing rules, or a breach of the SEC's disclosure obligations, shareholders may have rights for breach of fiduciary duties. Appendix III.7.2 has discussed both of these in the context of relevant state laws that focus on fiduciary law - the powers and duties of directors and other *de facto* controllers and the rights of shareholders to seek judicial relief for breaches of their duties.⁴⁰⁹ This broadly aligns with the position in Hong Kong as regards disclosure - the SFO allows both the SFC and individuals to bring an action for breach of the statutory disclosure requirements⁴¹⁰ - and as regards the rights of individual shareholders more generally in respect of misfeasance and the fiduciary duties of directors - see further Appendices I.7 and III.7.

Hong Kong

While fiduciary law establishes the foundations of director liability, this is not a route under which directors are typically held to account. This is partly a result of the availability of codified causes of action in statute, particularly the SFO. For example, the SFC has successfully brought a number of cases against the directors of listed companies under the misfeasance and misconduct provisions of section 214 of the SFO, which are heavily reliant on the concept of fiduciary responsibility of directors.⁴¹¹ However, only the SFC is able to bring an action under section 214 - shareholders would instead need to

⁴⁰⁶ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)

⁴⁰⁷ See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994), and *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) as discussed in *LA Cunningham and CM Yablon*, "Delaware Fiduciary Duty Law after QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)" *The Business Lawyer*, 49(4): 1593-1628, Aug. 1994

⁴⁰⁸ *Kahn v Lynch* (1994); *Ivanhoe Partners v. Newmont Mining Corp.*, Del.Supr., 535 A.2d 1334, 1344 (1987). See also Webb Hecker, "Controlling Shareholder Duty of Loyalty" (2014)

⁴⁰⁹ OECD, "Supervision and Enforcement in Corporate Governance," (2013), 101

⁴¹⁰ For example, Part XIVA Division 4

⁴¹¹ For example, the *Styland (2012)* case, op. cit., *SFC v Yin Yingneng Richard* HCMP 2502/2012, *Freeman Fintech Corp Ltd* (Oct 2016), *First Natural Food Holdings* (Feb 2017)

undertake a derivative action under applicable law.⁴¹² A recent, and high profile, example of this is the action brought by Elliott, a hedge fund, and others against The Bank of East Asia under section 724 of the CO.⁴¹³ That claim alleges the directors of the bank have breached their fiduciary duties when entering into certain arrangements without due regard to the interests of all shareholders. The case is particularly notable as it involves an American hedge fund bringing an action against directors comprising some of Hong Kong's most well known family names in a manner that is reminiscent of fiduciary actions brought in the United States. In addition, under section 732 of the CO shareholders can, with leave of the Hong Kong courts, bring unfair prejudice proceedings against directors in the name of the company by way of derivative action, including non-Hong Kong incorporated listed issuers.⁴¹⁴

Discussion

It is of interest to note that a finding of the Kay Review (see Appendix II.2.1) was that the Law Commission should review the concept of fiduciary duty as applied to investments.

In 2003 the FSTB, following a recommendation of the SCCLR as part of its Review of Corporate Governance, consulted the market on giving the SFC a statutory right of derivative action but found limited support for the proposal and held it in abeyance. Possibly the most insightful of the responses was provided by the HKEX in its response, which noted that, although it has no objection to the SFC having such a power such a statutory remedy "may prove superfluous and/or less effective than SFC actions under section 214" and that "there are reasons to be optimistic about the potential efficacy of section 214."⁴¹⁵ At present there remains little active discussion in relation to the topic and it is suggested that is appropriate in view of the development of case law in relation to section 214, which has borne out its efficacy in bringing remedies to companies that ultimately benefit shareholders.

This consideration would appear to outweigh the complexities of changing primary legislation to provide the SFC with statutory derivative powers. Actions under section 214 have served as a proxy for fiduciary concerns, for example, *dicta* in the *Styland (2012)* case is based on defalcation, misfeasance and unfair prejudice.

Action through the courts, whether undertaken by the SFC or shareholders, sends clear signals to directors as to the standards expected of them. The drawback rests in the issue of regulatory efficiency as fiduciary cases may be more difficult to establish and will take longer to reach a conclusion. Moreover, one of the problems in relying on fiduciary law as applied by the courts is that it may be perceived as creating commercial uncertainty.

However, the SFC has numerous statutory obligations and considerations imposed on it in addition to its shareholder protection mandate that must be weighed into any decision to bring an action under section 214. For example, a decision to bring or not bring an action under section 214 could also be subject to considerations related to market integrity, the available resources of the SFC, or policy issues. These considerations may or may not align with the interests of a particular set of shareholders.⁴¹⁶ Although the SFC should be praised on its engagement of section 214 and the consequent successes it

⁴¹² Part 14, Division 4 of the Companies Ordinance (Cap. 622) in the case of companies incorporated in Hong Kong

⁴¹³ HCMP 1812/2016. The petition is also Available at <http://fairdealforbea.com/>

⁴¹⁴ See *Yu Yuchuan & Ors v China Shanshui Investment Company Limited (HCMP) 360/2015*, which concerns China Shanshui Cement Group Ltd (0691.HK), a company incorporated in the Cayman Islands

⁴¹⁵ HKEX letter addressed to the FTSB and SFC dated 29 July 2003, pages 4 and 3 respectively.

⁴¹⁶ Syren Johnstone, "A flawed debate", *International Financial Law Review*, May 2015, 38-39, page 39. Also Available at SSRN: <https://ssrn.com/abstract=2811028>

has secured, it should also be recognized that the other matters it is required to take into consideration might lead to some plausible (from a shareholder's viewpoint) actions not being taken. The proposal made in **Recommendation E4.8.2** "Establish an investor protection agency" would serve to address this potential conflict by creating an enforcement agency with a more singular and unconflicted mandate. What is also relevant to note in this regard is that if such an agency were created, its powers of investigation, if similar to those enjoyed by the SFC, would also benefit shareholders in that they exceed the powers of shareholders under the usual rules of discovery.⁴¹⁷ Such an agency would also address the cultural tendency of shareholders in Hong Kong, discussed in Appendix I.1.1, to look to the regulator for solutions rather than undertake court action themselves. While the extent to which it is appropriate for a public agency to undertake what are effectively private causes of action may be regarded by some as moot, the establishment of the CFPB in the United States is a recognition of the need for public enforcement bodies to address socially important issues in the public financial sector. See also the discussion under **Section 3.7.3** "Enforcement agencies".

Part B - Specific actions

3.7.7 Differentiation of CG requirements

In the UK, some CG requirements only apply to FTSE350 companies. This includes: the requirement that FTSE350 issuers have a board of which at least half excluding the chairman are INEDs;⁴¹⁸ a recommendation that directors of FTSE350 issuers should be subject to annual re-election;⁴¹⁹ and the requirement that FTSE350 issuers establish a remuneration committee with delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments.⁴²⁰

The response to the higher requirements for FTSE350 issuers is in general quite good. For example, compliance with the minimum number of INEDs requirement is high, with only 26 FTSE350 issuers being non-compliant in 2016.⁴²¹ The FRC has also reported that its suggestion to implement clawback arrangements on executive pay have been taken up by 91% of FTSE350 issuers in respect of the annual bonus and by 78% in respect of long term plans.⁴²² This is perhaps not surprising given the market's general expectations of the standards of these larger companies.

Hong Kong

In contrast, the HK CG Code applies equally across all issuers listed on the same board irrespective of factors such as size or, as discussed earlier, place of incorporation. Nevertheless, larger or better known/established issuers frequently adopt standards higher than what is required by the applicable regulations.

⁴¹⁷ Ibid, page 38

⁴¹⁸ Per B.1.2 of the UK CG Code, whereas smaller issuers are only required to have at least two INEDs

⁴¹⁹ Per Provision B.7.1, whereas the requirement for smaller companies is only that it be at regular intervals and not less than every three years

⁴²⁰ Per section D of the UK CG Code; the committee should also recommend and monitor the level and structure of remuneration for senior management

⁴²¹ In 2014, 324/350 issuers complied, and in 2015 308/350 issuers complied with over half of those not in compliance returning to compliance by the time their annual reports were published. Non-compliant FTSE350 issuers had reduced to 26 in 2016. FRC "Developments in Corporate Governance and Stewardship", 2016 and FRC "Developments in Corporate Governance and Stewardship", 2015. Available at [https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-(1).pdf)

⁴²² FRC, *ibid.*, 2016

Discussion

As discussed in Appendix I.1.1, Hong Kong has traditionally relied on reputational rather than jurisprudential means of liability as regards CG standards, with some of the larger issuers leading CG standards. Based on the premise, which appears supported by research,⁴²³ that CG matters to investors, particularly institutional investors, there seems some merit in exploring whether there is a case for imposing higher standards on larger issuers. Based on the UK data, compliance may be forthcoming provided the requirements are established with the mandate of the market.

Three mechanisms by which this could be introduced are as follows.

First, changes could be made to the HK CG Code and/or the listing rules that only apply to certain larger issuers, for example, those that have been admitted to a relevant index, such as an HSI or HSCEI constituent stock. A simple means of doing this is to focus the changes on the escalation of recommended best practices to code provisions and selected recommended disclosures to become required disclosures for the relevant companies to establish "Elevated Standards". However, as there are relatively few recommended best practices in the HK CG Code following the HKEX's review in 2012, consideration should be given to incorporating specified comply or explain provisions as mandatory requirements in the Elevated Standards for the relevant issuers. A benefit of this approach is that many of the relevant issuers will already be compliant, so the development would serve to entrench those voluntary practices. At the same time it would send a signal to the market that companies subject to the Elevated Standards are leading examples of good CG practices.

Second, changes could be made to the criteria by which an issuer may be admitted to a relevant index. However, admission to indices is, with good reason, primarily quantitatively based on objective criteria. In contrast, compliance with some measure of CG is likely to be open to less objective considerations – for example, even a quantitative requirement such as a majority of INEDs on the board contains an embedded qualitative factor, namely, the assessment of independence. This approach is therefore untenable.

Third, it would be possible to establish a CG index based on companies that meet specified CG criteria. Such indices have been established in eight jurisdictions,⁴²⁴ however, they have not been successful and the concept is still evolving. A fundamental problem is, as already alluded to, the problem of developing objective and measurable CG benchmarks, and dealing with embedded non-objective criteria. A more significant problem is that the CG indices are not sufficiently differentiated in performance from the main benchmark index of their markets due to a significant overlap in the constituent stocks. In consequence of this, investment products such as exchange-trade funds tailored to the indices have not developed.⁴²⁵

Accordingly, only the first of the above three approaches would appear to be tenable.

The foregoing leads to **Recommendation R C4.3.1** "Relevant issuers to be subject to 'Elevated Standards'".

⁴²³ For example, McKinsey & Co, "Investor Opinion Survey on Corporate Governance" June 2000

⁴²⁴ Brazil (2001), China (2008), Italy (2001), Mexico (2011), Peru (2008), South Africa (2004), South Korea (2003) and Turkey (2007)

⁴²⁵ *P Di Benedetta and A Grimminger*, "Raising the Bar on Corporate Governance – A Study of Eight Stock Exchanges Indices", World Bank/IFC, 2013

3.7.8 Listing regime standards upon entry

The ability of a company to adopt good CG standards depends on a number of factors including the skills and experience of the directors, the systems and procedures they implement, and the CG culture of the company as a whole. It is relatively clear that many of these factors will be set from the outset of a company's admission to listed status, and that where they are set to relatively low standards it will be a significant task to move the company toward the standards expected of a public company. One may make the analogy that it is difficult to repair a badly constructed boat when it is already at sea –not always impossible, but difficult nonetheless.

In the UK the FCA has increased the intensity of its supervision of sponsors of listing applicants to ensure that CG structures cannot undermine the UK listing regime. The liability of a sponsor to fines not limited in amount imposed by the FCA is clear.

In the United States, there is no sponsor concept, however, the underwriter has a clear statutory liability in the United States under the 1933 Securities Act. This means it has a greater interest to ensure disclosures in an offering document, including as to a company's actual CG practices, are accurate, complete and not misleading. Extensive CG-specific disclosures are required in the registration statement and liability will attach to mis-disclosures.⁴²⁶

While the above distinctions reflect differences arising out of the strongly disclosure-based approach in the United States, it has also been characterized as reflecting the *ex post* approach in the United States compared with the relatively more proactive regulatory approach in the UK, which tends toward *ex ante* mechanisms - *ex ante* means of regulating corporate behaviour are an important alternative means of improving shareholder rights.⁴²⁷

In Mainland China, the exchanges can enforce listing rules and trading rules against sponsors (see Appendix IV.3.4). CSRC can enforce the Administration Measures for Initial Public Offering and Listing of Stocks (2015) against sponsors.⁴²⁸ In Singapore, the SFA (sections 253(4)(d) and 254(3)(d)) has imposed criminal and civil liability on sponsors.

Hong Kong

Like the UK, the SFC has also increased its focus on the quality of sponsor work in recent years, recognizing that the quality of sponsor work is an important gateway mechanism for ensuring an adequate quality of companies listed on the SEHK. As part of the sponsors role, before a listing applicant can be admitted to listing its sponsor (each of them if there is more than one) will be required to submit a declaration to the SEHK as to the adequacy of the company's procedures, systems and controls as well as the experience, qualifications and competence of the directors.⁴²⁹

However, unlike sponsors in the UK and underwriters in the United States, the prospectus liability attaching to sponsors is unclear. According to the SFC, sponsors are under CWUMPO potentially liable to primary (though not secondary) market investors as persons who have authorized the issue of the prospectus. However, as discussed in Appendix I.3.1, there appears to be no legal grounds for the SFC's position, which

⁴²⁶ E.g., items 402, 406 and 407 of Regulation S-K

⁴²⁷ John Coffee, "Law and the Market: The Impact of Enforcement" (2007) *Columbia Law and Economics Working Paper*, No. 304, p 33

⁴²⁸ New China rules for botched IPOs spooking underwriters, 14 January 2016: Available at <http://www.reuters.com/article/china-ipo-regulations-idUSL3N14W25S20160114> (visited on 12 Nov 2017)

⁴²⁹ MBLR Appendix 19, para (b)(v)&(vi)

remains untested in court.⁴³⁰ This might suggest a need to make proposals to reform a sponsor's prospectus liability as a means of improving the quality of sponsor work. However that suggestion seems unnecessary in the present context as sponsors are already potentially liable under sections 277 and 298 of the SFO in respect of mis-disclosures in the prospectus, and under section 384(3) of the SFO if their declaration to the SEHK is found to be false or misleading. In addition, the SFC has significant leverage over sponsor firms under sections 193 and 194 of the SFO to procure compliance with expected standards of conduct.

Despite the increased regulatory attention on sponsor work, there have been no legal actions brought against sponsors to date, the SFC instead relying on its administrative powers to discipline under section 194 of the SFO, for example, as was engaged in relation to Mega Capital (Asia).⁴³¹ Moreover, anecdotal reports suggest that the quality of sponsor work remains a real concern. The SFC has stated it is currently investigating 15 sponsor firms whose sub-standard work is connected to billions of dollars in investment losses,⁴³² including against well-known firms such as UBS Group, Standard Chartered, Morgan Stanley, Bank of America and KPMG.⁴³³

Discussion

Ex post means of redress is weak in Hong Kong for shareholders - it is of interest to note that whereas in the United States private litigation is greater than actions undertaken by the SEC,⁴³⁴ the reverse is true in Hong Kong where CG related actions are primarily undertaken by the SFC. Setting the tone of an issuer's CG standards from the outset is arguably more critical to shareholder in such a context as they are unlikely, unwilling or unable to litigate. More recently, the SFC has also re-emphasized the importance of a multi-dimensional approach that includes gatekeeping and supervision (while also bringing greater focus on corporate wrongdoing).⁴³⁵

As regards gatekeeping, while sponsors are required to make a declaration generally covering the company's procedures, systems and controls, listing applicants are not themselves currently required to make any disclosures in their listing documents as to their CG practices or standards, except as regards their CG measures to resolve actual or potential conflicts of interests between the applicant and its controlling shareholder/director.⁴³⁶ In practice, listing applicants do typically elect to make statements pertaining to their CG processes, for example, as regards the establishment of sub-committees of the board, such as the audit committee mandated by the listing rules. If the listing rules were amended to require statements as to the listing applicant's CG processes, including what provisions of the HK CG Code it intends to comply with and which not, this would give rise to disclosures that would be subject to liability under CWUMPO and the SFO as well as the SFC's powers under the SMLR.

The foregoing leads to **Recommendation C4.7.1** "Disclosure of CG standards in listing document".

In the immediate period post-listing, an issuer is normally making adjustments as it becomes accustomed to its new status. As discussed in Appendix II.1.1, GT has

⁴³⁰ For a discussion, see Syren Johnstone et al., "Deconstructing Sponsor Liability" *HKLJ* Vol 46(1) 2016 op. cit.

⁴³¹ Mega Capital (Asia) was stripped of its license and fined HK\$42 million. For a further discussion of sponsor failings generally, see the SFC's "Report on Sponsor Theme Inspection Findings", March 2011

⁴³² Per Thomas Atkinson, Head of Enforcement at the SFC, speech given at the 8th Pan Asian Regulatory Summit, 11 October, 2017, available on the SFC's website

⁴³³ "Hong Kong Regulator Probes Financial Firms for Shoddy IPOs", Wall Street Journal, 11 October 2017. A case that had been brought against UBS has since been dropped owing to a statutory limitation problem.

⁴³⁴ The SEC is nevertheless very active in enforcement

⁴³⁵ Per Thomas Atkinson, Head of Enforcement at the SFC, speech given at the 7th Pan Asian Regulatory Summit, 9 November 2016, available on the SFC's website

⁴³⁶ See HKEX GL56-13, page 18

suggested that when a company first lists there is a four-year move from box-ticking to meeting the intent of provision. In Hong Kong, the listing rules require the appointment of a compliance adviser for not less than a full financial period, and this period may be extended. However, it must be noted that the compliance adviser role is essentially passive as the responsibility to consult rests with the issuer. In addition, the entity appointed as the compliance adviser does not need to be drawn from among the sponsors of the listing, and most commonly it is not. Taken together, these characteristics weaken the compliance adviser role. First, because it is passive. Second, because the sponsors who undertook the regulatory responsibilities in the listing application and are intimately familiar with the workings of the company in essence walk away from having an ongoing regulatory function leaving it to an outsider. This contrasts with the position in Mainland China where a sponsor of a newly listed issuer is required to be involved in supervising the issuer's compliance issues for a period of two to three years after admission to listing.⁴³⁷ While not identical to the compliance adviser role used in Hong Kong, it has a similar purpose, namely, assisting the issuer in relation to new regulatory requirements imposed on it by securities laws and regulations. This facilitates issuer's to develop their approach to compliance during this initial period.

Given the role of the compliance adviser to advise on matters such as regulatory announcements and notifiable and connected transactions, their function can impact on the development of the initial CG standards of an issuer. This presents a case to explore, whether the compliance adviser role would be strengthened by (1) giving it a more active engagement and responsibility, possibly on a wider range of CG-related concerns, and (2) requiring the role to be undertaken by one of the sponsors to the listing application. As regards the former, the changes made to the sponsor regime in 2013 introduced obligations on the listing applicant that ensured the sponsor had proper access to records, third parties and material changes that enable it to fulfill its regulatory responsibilities.⁴³⁸ The latter, which has the effect of keeping the sponsors skin in the game, connects with the concerns already discussed as regards the quality of sponsor work – if the sponsor's regulatory liability continued post-listing as compliance adviser this might bring greater focus in their review of the listing applicant's CG processes and standards pre-listing.

As an expanded compliance adviser role would effectively then become an extension of the sponsor's regulatory purpose, consideration should also be given to requiring the compliance adviser to provide a declaration as to CG matters in a manner similar to that given by sponsors in their Appendix 19 declaration.

The foregoing leads to **Recommendation E4.7.2** "Develop role of compliance adviser".

Part C - Independent directors

3.7.9 Determination of independence

Both the UK and the Hong Kong regimes impose requirements on issuers as regards the number of INEDs that should be on the board. While the number of INEDs required differ, unlike the UK, the requirement to have at least one-third of the board comprised of INEDs is a mandatory requirement of the Hong Kong listing rules. Singapore and Mainland China also have the one-third rule (in Singapore this requirement is raised to half of the board where the independence of the chairman is compromised⁴³⁹).

⁴³⁷ 证券发行上市保荐业务管理办法 (2009) The Administrative Measures for the Sponsorship Business of the Issuance and Listing of Securities)

⁴³⁸ MBLR 3A.02, 3A.05

⁴³⁹ As discussed in Appendix V.7.2, where: the chairman of the board (CoB) and CEO are the same person; CoB and CEO are immediate family members to each other; CoB is part of the management team; and CoB is not an independent director.

Further, in the UK it is the board that determines independence whereas in Hong Kong this is determined by the SEHK⁴⁴⁰ (although the HK CG Code does require the nomination committee of the board to consider independence in connection with proposed new INED appointments⁴⁴¹). While the considerations relevant to a determination of independence address broadly similar considerations, in Hong Kong these are in the listing rules whereas in the UK they are comply or explain provisions in the UK CG Code.⁴⁴² An important consequence arising out of this difference is that in Hong Kong an INED is required to submit to the SEHK a written confirmation of independence that requires the approval of the SEHK before the INED is appointed.

The requirement for independent directors is also a feature in the United States. The NYSE Listed Companies Manual require boards to have a majority of independent directors,⁴⁴³ adopt and disclose corporate governance guidelines that address director qualification standards which should, at minimum, reflect the NYSE's independence requirements. Here, it is again the board that is required to determine independence against a set of considerations specified in the listing requirements that provide both general and specific situations where a director is to be regarded as not independent.⁴⁴⁴ This carries with it a disclosure obligation that is subject to Federal securities law.⁴⁴⁵

While both the UK CG Code and the HK CG Code (although not the NYSE Rules) consider that independence may be questionable after a long period of service on the board, the approaches differ. In the UK, after six years of service the re-appointment should be subject to a rigorous review, and after nine years the director should be subject to annual review.⁴⁴⁶ In Hong Kong, it is only after a period of nine years service that an INED should be subject to reappointment by the shareholders, with the board to set out the reasons why they consider the INED to remain independent.⁴⁴⁷ The HKEX is currently reviewing the factors that may affect independence.⁴⁴⁸

Mainland China has a more rigid regime requiring independent directors not to hold the position for more than 6 years consecutively. In addition, the requirements for independence are set out by the CSRC and, while all directors need to apply to the CSRC to be confirmed as a director, a director seeking to be treated as an independent director must make the appropriate disclosures to the CSRC to be approved as an independent director.⁴⁴⁹ Where false or misleading information has been used in the application, the director's approval can be withdrawn and the individual subjected to a fine imposed by the CSRC.⁴⁵⁰

The determination of independence is therefore essentially a board process in the UK, Singapore and the United States that is subject to a comply or explain standard in the former two and a mandatory requirement in the United States. However, in Hong Kong and Mainland China independence is a matter for a regulatory agency, the SEHK or CSRC, to determine.

⁴⁴⁰ While the independence of an INED serving on the board for nine years is relevant to the question of independence in both regimes, in Hong Kong this consideration is relegated to a provision of the HK CG Code - A.4.3

⁴⁴¹ Provision A.5.2(d)

⁴⁴² Respectively MBLR 3.13 and B.1.

⁴⁴³ This only applies to listed companies that are not foreign private issuers

⁴⁴⁴ NYSE Rule 303A.02 (a) & (b)

⁴⁴⁵ Item 407(a) of Regulation S-K

⁴⁴⁶ Provision B.2.3

⁴⁴⁷ Provision A.4.3

⁴⁴⁸ HKEX, "Consultation Paper – Review of the corporate governance code and related listing rules", November 2017

⁴⁴⁹ Pursuant to Article 34 of the 證券公司董事、監事和高級管理人員任職資格兼管辦法 ("Rules of the CRSC Governing the Supervision of the Qualification for the Directors, Supervisors and Senior Managers in the Listed Companies")

⁴⁵⁰ Ibid., Articles 63 and 65

Discussion

As noted in Appendix II.1.2, the UK has placed a greater emphasis on the role and powers of INEDs through the creation of the dual-voting mechanism⁴⁵¹ as well as the powers of INEDs as regards the relationship agreement with the controlling shareholder (discussed in **Section 3.7.12** "Empowerment of INEDs - controlling shareholders"). In view of the different mechanisms by which independence is assessed, it might be said that while the UK system is clearer in its empowerment and accountability of INEDs, it may to some degree be weakened by the self-determination by the board of independence itself.

The question of independence is subject to a negative test since it is confirmed by the absence of any identified fact that would cause a director to be not independent. It is ultimately subject to both measurable fact-based and non-measurable considerations. It is suggested that the approach of leaving this to the regulator, i.e. the SEHK, to determine removes the possibility of manipulation (or laxity) by the board – it may be easy to not look too hard. On this basis, Hong Kong appears to be doing well when compared to the other jurisdictions studied. Nevertheless, the SEHK in reaching its determination relies on the facts that have been represented to it, and it should be entitled to assume that the representations made are true, complete and not misleading. However, unlike the United States where false or misleading disclosures of facts pertaining to a director's independence can give rise to breaches of Federal securities laws, or Mainland China where false information can lead to disqualification or the imposition of a fine, in Hong Kong the same act is merely a breach of the listing rules with limited consequences. This is surprising given the importance attributed to director independence in many aspects of the listing rules (as well as other regulatory contexts in Hong Kong, including the Code on Takeovers and Mergers). This stands in high contrast to the approach taken to the declaration and undertaking given by directors, and the declarations of independence for the purposes of the listing rules required to be given by sponsors and independent financial advisers,⁴⁵² each of which is provided on a form that is made subject to section 384(3) of the SFO thus creating an additional layer of liability – breach of section 384 is an offence. It is appropriate to bring the facts stated by a director in a written confirmation to the SEHK under section 384(3) liability because this provides the SEHK with greater certainty as to the veracity of the facts when it assesses a director's independence, and brings an appropriate degree of accountability to the individuals that are making the relevant representations.

The foregoing leads to **Recommendation C4.5.3** "Facts regarding director independence".

3.7.10 Requirements relating to INED performance

The UK CG Code requires that INEDs have sufficient time to devote to their responsibilities, disclose to the board their other significant commitments, and keep the board updated of any changes thereto.⁴⁵³ Although the UK CG Code suggests that the number of non-executive posts at other companies a full time executive director can take on be capped at one, there is no cap suggested for the number of posts that can be taken on by INEDs. A survey undertaken by the UK's Institute of Directors in 2016 suggests that stakeholders are not especially concerned with the average number of boards a director sits on (see Appendix II.1.1).

⁴⁵¹ LR 9.2.2E R. FCA, "Response to CP13/15 – Enhancing the effectiveness of the Listing Regime," (May 2014) *Policy Statement, PS14/8*, 6. See FCA 2014/33 Listing Rules (Listing Regime Enhancements) Instrument 2014

⁴⁵² Respectively, in MBLR Appendices 5 (B, H and I), 17 and 21

⁴⁵³ Principle B3 and Code provision B.3.2

In the United States, the NYSE Listed Companies Manual also does not impose any limits on the number of boards on which an independent director may sit, although it does state that companies may choose to address other substantive qualification requirements of independent directors, including policies limiting the number of boards on which a director may sit.⁴⁵⁴

In Mainland China, independent directors are not allowed to hold more than 5 such positions at any given time and must ensure that they have sufficient time and energy to discharge their duties.⁴⁵⁵ There are prescriptive requirements on attendance too. If INEDs fail to attend the meeting of the board of directors for three times consecutively, the board of directors may request the shareholders general meeting to replace the INEDs.⁴⁵⁶ Directors are also required to attend training. Independent directors and newly appointed independent directors should participate in training organized by the CSRC and its authorized institutions according to the requirements of the CSRC.⁴⁵⁷ This is more prescriptive than Hong Kong.

Singapore does not impose any restriction on multiple directorship in Singapore, the Code merely providing that when nominating directors, the Nominating Committee should consider if a director is able to, and has been adequately carrying out his/her duties as a director, taking into consideration the director's number of listed company board representations, and other principal commitments, and the board should determine the maximum number of listed company board representations any director may hold, and disclose this in the annual report.⁴⁵⁸

Hong Kong

Following a consultation exercise undertaken by the HKEX in 2010 to 2011,⁴⁵⁹ the HK CG Code contains a general requirement, applicable to all directors, that they should devote sufficient time and attention to undertaking their role, and a specific requirement that INEDs should give the board and its committees their regular attendance.⁴⁶⁰ Like the UK CG Code, there is no cap suggested for the number of posts that can be taken on by INEDs, although the HKEX's 2017 consultation on the CG Code does, as discussed below, does touch upon this issue. However, unlike the UK CG Code, there is no express requirement that other commitments be disclosed to the board.

Discussion

While most of the interviewees expressed some consternation surrounding the role of INEDs, none appeared to be concerned as to the issue of the disclosure of other significant interests to the board upon appointment or thereafter. The general sense is that issuers will normally take this into consideration as a matter of prudent commercial practice - indeed, it is likely to be their fiduciary duty to do so insofar as ensuring that any potential conflicts of interest are known through disclosure, such as an individual also occupying a position as a director on another company perceived as a competitor. Apart from this commercial common sense, it should also be pointed out that, as discussed in Appendix I.4.1, directors of all Hong Kong listed issuers, including INEDs, are in general subject to the same fiduciary duties - i.e. being those of the director of

⁴⁵⁴ Commentary to rule 303A.09, NYSE Manual

⁴⁵⁵ See Note 3, Article 1 of the CG Code

⁴⁵⁶ See Note 3, Article 4(5) of the CG Code

⁴⁵⁷ Ibid., Article 1(5)

⁴⁵⁸ Rule 4.4

⁴⁵⁹ HKEX, "Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules", December 2010 and the "Consultation Conclusions", October 2011, Chapter 3 Part I

⁴⁶⁰ A.6.3 & A.6.7

Hong Kong incorporated company. Among those duties is the duty to avoid conflicts of interest.

It was also understood from the interviews that the issuer would be sufficiently familiar with the INED to be aware of developments in the interests of the INED as time passes by. This is a characteristic boon and burden to the INED situation in Hong Kong – familiarity brings with it a more intimate relationship between an INED and the board while at the same time casting doubts as to the quality of an INED's independence.

The identification of a difference between different regulations across jurisdictions presents a continuing temptation to suggest that a new rule be made to close out the gap. However, given the foregoing considerations, there seems little to be gained through the addition of a rule dealing with the formal disclosure of an INED's other interests. Rather, it is suggested that the addition of such a rule would only need to be considered contingent upon other more fundamental changes to the responsibilities and accountability of INEDs.

Almost all interviewees expressed considerable concern as to the phenomenon of INEDs holding a sufficiently large number of INED posts in multiple issuers that it raises the practical question of whether they are able to fulfill their basic responsibilities since there is a logical point beyond which the INED will have insufficient time to undertake their responsibilities properly. This is particularly the case during the usual financial reporting seasons, particularly as the functions of the audit committee are undertaken by non-executive directors only, at least one of whom must be an INED.⁴⁶¹ Almost all interviewees agreed that imposing a cap on the number of posts that could be held would be a sensible mechanism to control this problem, however, by what means should that cap be set was entirely unclear. This sits at odds with the "overwhelming majority" of responses to the HKEX's 2010/2011 market consultation opposing such a cap.⁴⁶² However, the consultation responses require some clarification, which was lacking in the HKEX's conclusions paper and remains unquantified in their most recent consultation.⁴⁶³ First, the suggestion that multiple directorships in Hong Kong are uncommon can be quantified: as discussed in Appendix I.7.2, 65 INEDs hold six or more seats, which represents only 1.25% of all INEDs (increasing to 3.83% for INEDs who hold 4 or more seats). Second, the 2011 consultation response that not imposing a limit may encourage a culture of professional directorships in Hong Kong, where more qualified and experienced individuals could build careers providing independent advice to board members⁴⁶⁴ would, based on the statistics cited above, appear to be only relevant to a small though not insignificant number of individuals. Moreover, as discussed below, there is very little evidence this is developing – instead, career INEDs appear to be taking trophy posts with very little professionalism exhibited. This is reflected by anecdotal descriptions of some INEDs, when queried by the regulator regarding a possible corporate wrongdoing, denying they have any responsibility on the grounds that they are only an INED and don't know anything about the company's affairs. In this context, one must query whether there is any sense in the SEHK relying on the responses of a majority that may be self-serving and not in the best interests of the market.

HKEX's most recent (November 2017) consultation suggests placing a soft cap of six other posts held by INEDs such that where seven or more posts are held an explanation is required from the board why the person would still be able to devote sufficient time to

⁴⁶¹ MBLR 3.21

⁴⁶² HKEX, "Consultation Conclusions", October 2011, Chapter 3 Para 74-75

⁴⁶³ HKEX, "Consultation Paper – Review of the corporate governance code and related listing rules", November 2017

⁴⁶⁴ HKEX, "Consultation Conclusions", October 2011, Chapter 3 Para 74(ii)&(v)

the board, i.e. to be able to fulfill their duties as directors.⁴⁶⁵ While the HKEX does not state from where the number “six” was derived, it is suggested that the proposed requirement effectively sanctions as acceptable, and so not in need of any explanation, an INED holding posts at multiple issuers, up to and including six. The HKEX’s proposal therefore runs the risk of validating multiple appointments at least up to six, without addressing the underlying concern about a director having sufficient time and attention to devote to their duties. Under the research already referenced above, the HKEX’s proposal would affect 0.85% of all INEDs,⁴⁶⁶ which suggests that the consultation proposal also serves little purpose in practice. There are a wide variety of circumstances affecting INEDs, including not only their other obligations but also their personal skills, capabilities and sense of responsibility.

There is an active discussion in Hong Kong about the role of INEDs and to what extent they can properly undertake the role to serve the underlying purpose of having INEDs on the board, which is in part to assure investor confidence by acting as a check and balance on the powers of the executive directors engaged in running the day to day business of the company. While the context of Hong Kong is very different from Mainland China, which has imposed strict caps, it is suggested that issuers in Hong Kong should adopt a policy that is disclosed to shareholders, with deviations from it also being explained. This leaves it to issuers to decide and shareholders to assess, in each case in view of the circumstances of each company.

The foregoing leads to **Recommendation A4.2.1** “Sufficient INED time”.

Almost all of the interviewees expressed concern that there are too many INEDs of listed issuers in Hong Kong who do not fully appreciate their role on the board and take up INED roles as trophy posts – as illustrated by the above anecdotal evidence. A variety of factors were discussed that influence the ability of an INED to be effective including:

the experience and skill set of the individual;

their personality, as an independent thinker or challenger as compared to someone that perceives themselves to be performing a confirmation role;

the individual’s technical understanding of their role and potential liabilities as an INED (whether on the board or in specific sub-committees of the board), the extent to which they have received training on this, and the extent to which board processes support and confirm that role;

the willingness of the individual to become involved;

their ability to become involved (assuming willingness) being affected by board processes, an example being given, apparently not uncommon, of receiving lengthy briefing papers only just prior to the board meeting at which they will be discussed;

the degree of information asymmetry between executive and non-executive directors;

the amount of time they are expected to devote to undertaking their role and to what extent this is or is not confirmed by board practices (such as late delivery of briefing papers as mentioned above);

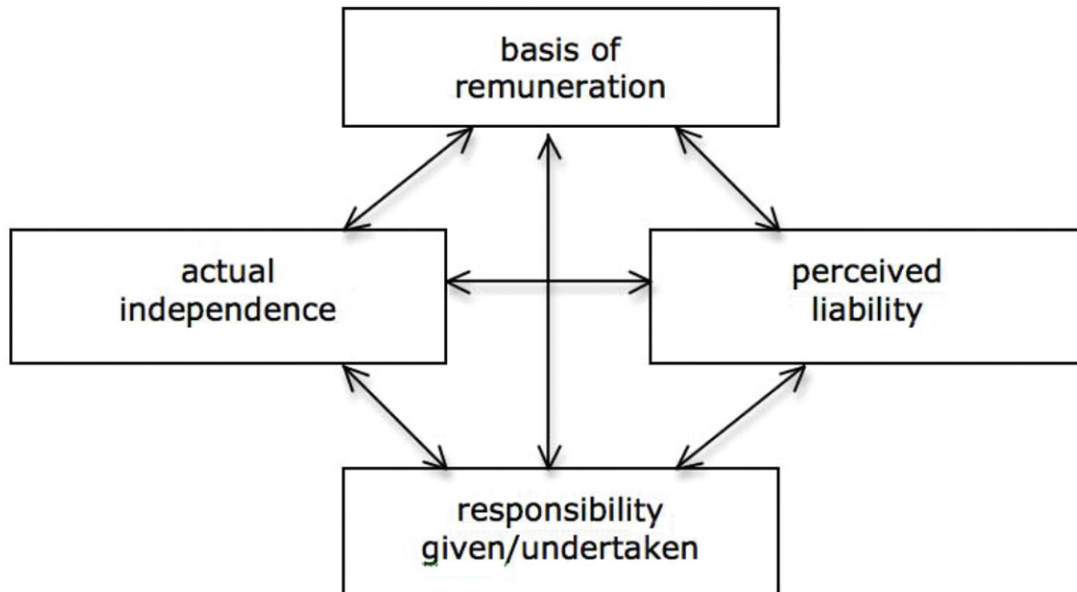
⁴⁶⁵ HKEX, “Consultation Paper – Review of the corporate governance code and related listing rules”, November 2017, para 36

⁴⁶⁶ Or 44 individuals (data as at 28 November 2017)

the level of remuneration received, which can be (wrongly) perceived as a proxy for how much effort they should put in or alternatively as a compensation to receive their confirmation, or for their liability.

Together, these give rise to an inherent *de facto* relationship between independence, the responsibility given and undertaken, remuneration and perceived liability, as shown in the diagram below.

Factors impacting on the INED role



Solving this problem is not a simple one. Considering each of the boxes in Diagram 1, it might be asked which can best be manipulated to bring about improved INED standards to the market more generally?

Actual independence: Independence has already been discussed in **Section 3.7.9** "Determination of independence" above.

Basis of remuneration: The point has already been made in **Section 3.4.3** "Remuneration" that where an INED's remuneration amounts to a token fee little is likely to be expected of them in terms of their actual responsibilities, and this supports a (mis)understanding of reduced liability. It is probable that a low remuneration indicates they are not expected to do very much save as is sufficient to ensure the INED requirements are met on a box-tick basis – anecdotally, the current market rate for INEDs is typically around HK\$10,000 to HK\$20,000 a month (Main Board and GEM issuers). The disclosure proposed by **Recommendation A4.2.2** "Basis of INED remuneration" is a step toward more openly discussing why an INED is receiving a certain level of remuneration, and by implication what is expected of them.

Responsibility given/undertaken: As regards expected requirements, the HK CG Code does indicate a number of roles required to be undertaken by INEDs in relation to sub-committees of the board. However, the extent to which an INED actively engages in the relevant role remains open to doubt and can vary from company to company.

Perceived liability: While actual liability is a matter of law, perceived liability is a product of the foregoing two factors as well as what an INED thinks they are expected or required to do and the individual's perceived risk of liability in performing or not performing the relevant requirement.

What INEDs see in the market in terms of the frequency and severity of enforcement activity, and how clearly they regard it as potentially concerning themselves, is relevant to consider as a factor influencing the relationship between these boxes. Research in the UK⁴⁶⁷ and Singapore⁴⁶⁸ found that independent directors face little threat of civil liability and disqualification orders are hardly made against independent directors of publicly traded companies. Even in the United States where shareholder actions are more common, independent directors are exposed to very little personal liability risks in civil trials as they are often covered by a directors' and officers' insurance, unless civil proceedings are brought by government regulators against them.⁴⁶⁹

While it is tempting to conclude this suggests there should be more enforcement, it is suggested that the basis for enforcement should more specifically express what is expected of an INED. In other words, to bring INEDs more clearly into the public framework of responsibility and accountability in a manner that supports their function. Relevant examples of this are provided from both the UK and the United States. In the UK, an independent director has special powers in relation to the question of whether a controlling shareholder has complied with its undertakings under the "relationship agreement" (see **Section 3.7.12** "Empowerment of INEDs - controlling shareholders", and Appendices II.1.2 and II.7.3). In the United States, greater significance and responsibility was brought to bear on the audit committee by requiring them to make a disclosure in the annual report (see **Section 3.3.4** "Audit committee").

Such examples give rise to a suggestion that the public framework of responsibility and accountability of INEDs in Hong Kong could be evolved by requiring them to make disclosures, for example by way of an INED report in the annual report, as has been implemented in Mainland China as discussed below. Doing so places INEDs in a much more visible position that demonstrably supports the importance of the role they are expected to undertake. However, it would also be desirable, or perhaps necessary, to provide appropriate support for INEDs – for example, to avoid situations where they are placed in an information-deprived position that hampers them in the performance of their role, such as receiving board papers with insufficient time to review them before a board or committee meeting.

In terms of disclosure on INED's work, Mainland China has adopted guidelines that require a lot of disclosure. If the independent directors disagree themselves and are not able to reach the consensus, the board of directors shall disclose the independent directors' respective opinions separately. The requirement of disclosure gives the public an insight into the black box of the board and make independent directors more visible and so accountable to shareholders. However, it has been pointed that the independent director system in Mainland China still has its limitation, despite their powers and the above mentioned disclosure requirements, because they are nominated by the manager and appointed by controlling shareholders so they are not truly independent, and they have limited access to corporate information in practice and rely on the manager for the

⁴⁶⁷ Armour, J., Black, B., Cheffins, B., & Nolan, R. "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States", *Journal of Empirical Legal Studies*, 2009, 6(4), 687-722, at 716 (only one outside director of a publicly listed company was the subject of disqualification proceedings over 2004-2006 period)

⁴⁶⁸ Wan et al., op. cit. p.33

⁴⁶⁹ Black, B., Cheffins, B., & Klausner, M.) "Outside Director Liability", *Stanford Law Review*, 2006, 58(4), 1055-1159

information.⁴⁷⁰

One way of bringing these themes together is to suggest that the listing rules be amended in two ways.

First, to introduce a mandatory requirement that INEDs make a statement in the Corporate Governance Report as to their activities relating to the undertaking of their role over the course of the year. Some of the interviewees concurred in the view that independent directors should report annually on their work, in particular, how they review and approve connected transactions. The concept of introducing formal board evaluation has been discussed in **Section 3.3.3** "Board evaluation" and an annual INED report could encompass the evaluation process.

Second, issuers could be required to adopt a code that addressed specified matters concerning all non-executive directors (NEDs) including INEDs. NEDs are less frequently discussed but nevertheless present a similar matrix of problems and concerns as discussed in relation to INEDs, albeit without less emphasis on their role as an assurance of investor confidence. Some of the interviewees agreed that such a Code would be a meaningful companion to facilitate the effectiveness of the INED role, and could also serve to clarify the role of NEDs. The minimum range of matters that require coverage would need to be studied further but could be set out in a Model NED Code that an issuer may choose to comply with or alternatively establish their own NED Code. Such a code would cover matters such as the issuer's policies and practices in relation to: the selection and appointment of INEDs and other NEDs including in relation to matters such as skills and diversity; the board's expectations of INEDs and other NEDs; the minimum time for circulation of board papers prior to board meetings; conducting INED and other NED pre-board meeting briefings; steps taken to minimize executive/non-executive information asymmetries; facilitating the familiarity of INEDs and other NEDs with the business through site visits and regular training, etc.; requiring a resigning INED or NED to make a statement setting out reasons for their resignation; and the other appointments of INEDs and other NEDs (including whether it applies any cap on the number of other appointments – for the reasons discussed above, sanctioning a certain number of multiple directors as acceptable may be less progressive than requiring a board to form and to follow a disclosed policy). Some of these matters reflect concerns expressed in the UK's Turner Review and Walker Review as well as in other jurisdictions, as discussed next.

The foregoing leads to **Recommendation C4.2.4** "NED Code and INED reporting".

3.7.11 INED qualifications

The UK Walker Review (2009),⁴⁷¹ recognizing a problem identified in the Turner Review (2009),⁴⁷² suggested that non-executive directors ("NEDs") be required to undergo an induction process, receive regular training, and be provided with dedicated support to put them in a position they can contribute as effective challengers on the board. Although the review was focused on banks and financial institutions, its findings and recommendations are nevertheless of wider interest to the CG topic. However, the UK CG Code does not distinguish between the training needs of different directors, although

⁴⁷⁰ Wang Jianguy, "Company law in China: Regulation of Business Organization in Socialist Market economy", 2014 p.175-187

⁴⁷¹ "A review of corporate governance in UK banks and other financial industry entities. Final recommendations", 26 November 2009: Available at

http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

⁴⁷² Financial Services Authority, "Turner Review—A Regulatory Response to the Global Banking Crisis," (March 2009), 5: Available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf (visited on 19 November 2016)

it does provide that non-executive directors should have access to independent professional advice where relevant to the execution of their responsibilities.⁴⁷³

In the United States, the Independent Directors Council (“IDC”)⁴⁷⁴ was founded to focus primarily on the education of directors, particularly on independent directors. However, this body and the training provided by it do not carry with it any specific status for legal or regulatory purposes.

Directors in Mainland China are required to attend training (see Appendix IV.7.2). The CG Code requires directors to “earnestly attend relevant training to learn about the rights, obligations and duties of a director, to familiarize themselves with relevant laws and regulations and to master relevant knowledge necessary for acting as directors”.⁴⁷⁵ Directors must sign a declaration as to whether he has participated in any securities business training programme organized or acknowledged by the CSRC and the Exchanges and undertake to participate in professional training programme organized by the CSRC or the relevant Exchange.⁴⁷⁶ The Exchanges have guidelines on the requirement of training,⁴⁷⁷ for example the SSE’s guidelines require that INEDs must participate in not less than 30 hours of classes to obtain qualification to be an INED and obtain the certificate for such qualification (guideline 18, section 3), and must attend not less than 30 hours of continuing training once every 2 years (guideline 19). Training typically last for a few days with an examination at the end. According to the guidelines, the training program should be recognized by the CSRC; the guidelines also contain a detailed list of training topics and requirements issued by the SSE.

Mainland China is the only market that has a regulatory requirement for certifying director candidates. This may be a consequence of its relatively recent transformation to a market driven economy following on from the reforms introduced by Deng Xiaoping, something that the other jurisdictions have not had to grapple with. While director training may in spirit be a worthy undertaking, it is highly debatable whether such training is effective in changing a director’s understanding of their role and their behaviour in the boardroom so as to improve the quality of directors and corporate governance (see Appendix IV.7.2). Doubtless there will be a population of individuals who will learn and change in consequence of the experience as much as there will be a population that regard the training as a necessary box-tick exercise. Establishing the relative size of these populations would be a relevant measure of the success of the training, however, no such research appears to have been undertaken to date.

In Singapore, the CG Code requires the provision of director training and a professional development programme albeit on a comply or explain basis (see Appendix V.7.2). The Singapore Institute of Directors, like the Hong Kong Institute of Directors (HKIoD), provides regular training (see Appendix V.7.2). Director training is the responsibility of the nomination committee.⁴⁷⁸ With the nomination committee being responsible for board and director evaluation, companies characterized by a corporate board and director/s which are not objective or impartial (e.g. SingPost – see discussion in Appendices V.1.3 and V.7.3) will likely be indicative of ineffective director training. The vague recommendations in the CG Code are of little assistance. In SingPost’s case, the disclosure of induction and training in the 2014/2015 Annual Report was a boilerplate

⁴⁷³ Code Provision B.5.1

⁴⁷⁴ Founded in 1995 by the Investment Company Institute (“ICI”), a funds industry association. See ICI, “About ICI”: Available at https://www.ici.org/about_ici (visited on 28 July 2016)

⁴⁷⁵ Article 37, CG Code

⁴⁷⁶ See Appendix 1 to the SSE listing rules: <http://english.sse.com.cn/laws/framework/c/3978488.pdf>.

⁴⁷⁷ 上海证券交易所关于发布《上海证券交易所上市公司独立董事备案及培训工作指引》的通知 上证公字[2010]60号 effective from 28 October 2010 (Guideline of Shanghai Stock Exchange for Independent Director Registration and Training for Listed Companies. English version not available): Available at <http://fgcx.bjcourt.gov.cn:4601/law?fn=chl453s298.txt>.

⁴⁷⁸ Based on a number of annual reports

response that essentially mirrored the CG Code's recommendations.⁴⁷⁹ The annual report stated that training focused on commercial risks, business operations, industry developments, and changes in regulations and guidelines.⁴⁸⁰ Furthermore, SingPost's 2014/2015 annual report provided no indication of how often director training takes place, who supervised the training, what the training covered, nor who participated in the training. Boilerplate explanations are essentially a non-response to the comply requirement of director training pursuant to the CG Code and provide no assistance in evaluating the effectiveness of director training. When comparing disclosures of director training in annual reports (2014), there is no discernible difference between companies' characterized as having effective and ineffective CG. Thus the disclosures made under the CG Code provide no basis to evaluate the effectiveness of director training. The 2014 Association of Southeast Asian Nations (ASEAN) Corporate Governance Scorecard stated that companies should provide more details on continuing education programs and training of directors in their annual reports.⁴⁸¹

The flexibility of the comply or explain regime potentially increases the range of effective and ineffective examples of director training while at the same time obscuring which companies have effective or ineffective CG. This amounts to the creation of a false validator. Such a regime facilitates, in addition to genuine compliance, an option not to comply or engage in poor compliance. The effectiveness of director training is not easily gauged under a comply or explain regime.

One approach to quantitatively evaluate the effectiveness of director training might be to analyze the disclosures in the Corporate Governance Report contained in the Annual Report, and company disclosures and any directives on the SGX website. The first aspect involves searches for any voluntary disclosures and if so, how detailed are the explanations given? Were any directors at fault, and if so why? Secondly, has the company been given any directives by the SGX, why were they given, did they involve a director/s, and how did the company manage these directives? Analyzing the behaviour of the company and its directors will provide some insights to the CG culture of the company and mind-set of directors when addressing breaches of the CG Code. This may be a more accurate gauge of the effectiveness of director training and how well it addresses CG issues, although it is essentially subject to the culture of the board overall.

Hong Kong

In Hong Kong there is no regulatory agency of directors per se, other than the normal laws and regulations under which they are accountable. In an IPO context they are subject to vetting by the sponsor and the SEHK as to their suitability. It has long been regarded as an anomaly that such pre-IPO vetting falls away once an issuer is listed, meaning that a person that might not satisfy the pre-IPO vetting may nevertheless be appointed in the post-IPO context.

Following a consultation over 2010 to 2011,⁴⁸² the HKEX upgraded a recommended best practice that directors should participate in continuous professional development to a code provision together with a requirement to report in the Corporate Governance Report on how each director met the requirement.⁴⁸³ The proposal did not distinguish INEDs as possibly requiring different types of training from other directors. The SEHK decided not to impose a mandatory requirement of 8 hours training per year because many respondents did not agree to the proposal even though members of HKIoD are

⁴⁷⁹ SingPost, "Annual Report 2014/15," 39 and 58

⁴⁸⁰ SingPost, "Annual Report 2014/15," 39 and 58

⁴⁸¹ ASEAN, "ASEAN corporate governance scorecard country reports and assessments 2014: joint initiative of the ASEAN capital markets forum and the Asian Development Bank," 61

⁴⁸² HKEX, "Consultation Paper on Review of the Code on Corporate Governance

Practices and Associated Listing Rules", December 2010 and the "Consultation Conclusions", October 2011

⁴⁸³ Code Provision A.6.5 and I(i)

already required to undertake 10 hours of training to remain a member.⁴⁸⁴ Currently, only where a director breaches the listing rules might the SEHK require the director to undergo mandatory training, by the HKIoD, the Hong Institute of Chartered Secretaries or another body approved by HKEX.

In March 2017 the HKEX launched a series of directors training videos with the ostensible purpose of providing practical advice and tips with a view to helping improve board performance - all directors are encouraged to “complete the training” but watching the videos is not mandatory.⁴⁸⁵ The first series, which dealt with matters such as conflicts of interest, complex transactions and the role and functions of board committees, was subsequently further extended to cover risk management and internal control, and environmental and social governance reporting.⁴⁸⁶

While the content of the videos are right-minded and uncontentious as regards delivering useful guidance on important governance matters, it is an entirely separate question whether they constitute a learning environment that works to change the behaviour of directors in the marketplace. It is noted that there is no means of independently tracking which directors have watched the videos and whether it has brought any influence upon them. Moreover, it is rather predictable that the body of directors that the market is most concerned about – those who have little regard for CG standards – are unlikely to study and learn from the videos such that they change their behaviour. To the extent the webcasts may not represent effective means of training they operate as a false validator that the HKEX is doing something about the standards of directors. Nevertheless, they do serve as a signal to the market that the need to improve director knowledge of CG is on the regulatory agenda.

Discussion

The essential question that underlies the debate on director training is whether undertaking the role of a director in a listed company should be determined solely by commercial considerations subject to legal and regulatory enforcement mechanisms and the vested interests of directors to comply with them, or whether the ability to be appointed to undertake a director post should be subject to a formal training, qualification or certification requirement imposed by a regulatory or similar body. The market is replete with examples of persons subject to the latter approach, such as financial intermediaries, lawyers and accountants, all of whom are subject to continuous professional training (CPT) requirements imposed by a regulator of the relevant activity.

Most interviewees supported the idea of mandatory training for INEDs, especially pre-IPO training – although it is noted that pre-IPO director preparation is often undertaken by the sponsor and its and/or the issuer’s solicitors. INEDs do face a different set of tasks from executive directors. Some interviewees have found the training to be very useful in preparing them for the job as independent directors and expose them to various items of knowledge. Site visits are also found to be very useful for independent directors to speak to people below management level and to understand the company’s business and operation. Directors should also read widely outside board papers prepared by management, conduct one-on-one conversation with management people who are not on the board, and attend industry and related conferences especially for directors who are not industry experts. In Hong Kong the HKIoD already offers training courses on a regular basis leading to certificates and diplomas.⁴⁸⁷ There is however no formal requirement that a director must receive training or be a member of HKIoD.

⁴⁸⁴ Consultation Conclusions, para 83-84: Available at <https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2010124cc.pdf>.

⁴⁸⁵ “Exchange launches director training webcasts”, HKEX News Release 31 March 2017

⁴⁸⁶ See HKEX News Release 21 July 2017

Some interviewees had suggested that Mainland issuers listed in Hong Kong are accustomed to rule-based culture, and so experience difficulties knowing how to comply with the principle-based approach in Hong Kong. If so, it would be desirable to educate mainland company directors and compliance officers on the meaning and importance of principle-based regulation as part of their required training (see Appendix IV.7.2). Another possibility would be to review the HK CG Code to provide more guidance notes that elaborate the principles in the HK CG Code and listing rules. However, other interviewees felt this distinction was exaggerated, citing the increasingly rule-based nature of CG requirements in Hong Kong and the reality that senior management in Mainland issuers have considerable experience in interpreting policy guidance from the Mainland Chinese Government or its regulatory agencies covering a range of matters.

The issue of director training cannot be wholly segregated from the issue of director qualification. A “strong” model might propose that directors are only eligible to serve as such if they pass required qualification tests. This appears to be the basis of the approach in Mainland China. However, concerns over this approach include the body empowered to provide training and set tests, the effectiveness of such a regime in improving standards, and whether the commercial forces of the market are unduly interfered with. In the absence of the first two features, and given Hong Kong’s open commercial culture, a strong model is not supported. A “weak” model might propose voluntary training that is not subject to testing, and this is effectively the HKEX’s current approach and, as discussed above, the effectiveness of a weak model is highly questionable where enforcement is also weak. There would be several variants of an “intermediate” model, such as proposing mandatory director training but not requiring any testing beyond attendance certification – this follows the model with other professional CPT programmes under which training can be provided through a number of recognized avenues. The intermediate model might also incorporate an appropriate level of disclosure to shareholders.

Finally, given the concerns surrounding INEDs (for example as expressed in the Walker Review and Turner Review discussed above), it might also be asked whether INEDs should be subject to a distinct form of training requirement. While they are subject to the same directors duties and liabilities as all other directors, their role in relation to the topic of CG is of particular significance.

The foregoing leads to **Recommendation A4.2.3** “INED training”.

3.7.12 Empowerment of INEDs - controlling shareholders

As already noted above, an important feature of CG in the UK is that a controlling shareholder is required to enter into a “relationship agreement” with the issuer – this contains undertakings given by the shareholder to the issuer concerning arms’ length transactions and compliance with the listing rules.⁴⁸⁸ A central element of this regulation is that any independent director may disagree with the board’s assessment of whether the undertakings have been complied with, and where they have not, then any subsequent transaction with the controlling shareholder (irrespective of size of transaction) will require independent shareholder approval. This sanction remains in place until the next annual report in which the board makes a compliance statement without any disagreement from any of the independent directors. This is a powerful tool given to independent directors. Coupled with the requirement that independent directors must have the support of independent shareholders as a result of dual voting, the relationship agreement brings a significant check and balance on the powers of controlling shareholders.

⁴⁸⁸ LR 6.1.4D R

Conversely, it may be queried whether the relationship agreement would carry the same weight and effect if the appointment of the independent director was subject to the voting power of the controlling shareholders and its associates. Without it, the “relationship agreement” may represent little more than another tick-box requirement. That is not to suggest that INEDs in Hong Kong are not subject to fiduciary duties that may require them to raise a red flag where a breach of an agreement between the controlling shareholder and the issuer is suspected. That duty applies to all directors of the issuer.

All the jurisdictions under study impose, via listing requirements and/or codes that set CG standards, restrictions on connected party transactions. This is contained in Chapter 14A of the MBLR. In the United States, the Delaware courts have also imposed restrictions, albeit under the heading of fiduciary law, In Mainland China, the CG Code and the Exchanges’ listing rules as well as the company law contain provisions on related party transactions, and in Singapore it is in the listing rules.

However, the UK is the only jurisdiction that has imposed a requirement for an undertaking to be entered into. Notwithstanding the duties of directors under the common law, and under Chapter 3 of the listing rules, it suggested that the question of whether a relationship agreement would bring any benefits to the Hong Kong market hinges on the outcome of the debate on whether or not INEDs should be appointed by independent shareholders. That debate is discussed in **Section 3.6.4** “Appointment of independent directors”, where it is concluded that, on balance, in the absence of a clear mandate, special voting arrangements for the appointment of independent directors is not warranted. Accordingly, the conclusion as regards the relationship agreement is that it would currently serve no real purpose.

One might alternatively seek to tackle this problem in reverse order – if there is sufficient justification for introducing a relationship agreement requirement, and achieving that depends on the independent appointment of INEDs, then special voting rights should be introduced to achieve that objective. While this is tempting to suggest as a means of addressing perceived shortcomings in the oversight (by shareholders and regulators) of connected party transactions, it is the tail wagging the dog; there are other means of addressing that problem (as set out in **Section 3.7.3** “Enforcement agencies”) that would not necessitate a public administrative law override of rights attaching to shares otherwise enjoyed in the private law context (for a discussion see **Section 3.6.4** “Appointment of independent directors”).

Part D - Other items

3.7.13 Whistle-blowing

Both the UK and the United States have made provisions for whistle-blowing. In both jurisdictions, the provisions have initially been driven by protective labour laws and subsequently extended into a wider range of issues that cover, *inter alia*, CG concerns.

In the UK, CG issues will be covered by the Public Interest Disclosure Act 1998 (PIDA) if it involves a failure to comply with a legal obligation to which the person is subject⁴⁸⁹ – this will therefore cover not only CG matters established under primary legislation, but potentially also many of the detailed CG requirements established by regulatory bodies, as discussed in Appendix II.4.1.

As discussed in Appendix III.6.7, whistle-blowing has been in place in the United States for almost half a century. Initially introduced as a means of protecting the labour market, it is increasingly being recognized as a mechanism that can provide an

⁴⁸⁹ Section 43B(1)(b) of the PIDA

important source of information on breaches of CG-related concerns, such as relate to disclosure, misfeasance, and so on that may facilitate actions undertaken by the SEC, PCAOB or privately.

Whistle-blowing in relation to breaches of securities laws by publicly traded companies, including breaches of regulatory laws promulgated by the SEC, is specifically recognized in SOX.⁴⁹⁰ There were problems with s 806 of SOX, e.g. it does not apply to extraterritorially to employees of Mainland Chinese companies listed in the United States,⁴⁹¹ and it has been narrowly interpreted by the Department of Labour.⁴⁹² The provisions of section 922 of the Dodd-Frank developed whistle-blowing further by introducing monetary rewards for whistleblowers that provide original information that leads to successful enforcement actions involving monetary sanctions of over US\$1 million. The SEC implemented the relevant rules that became effective in August 2011.⁴⁹³ The SEC has also established the Office of the Whistleblower to administer the SEC's whistleblower program.

A significant difference between the jurisdictions is that the United States but not the UK provides financial incentives, although the UK does allow for a compensation order to be made. Some research in the United States has shown that whistle-blowing detects far more fraud than regulatory agencies like the SEC,⁴⁹⁴ and increases firm value by reducing self-dealing, providing companies with strong incentives to detect and prevent self-dealing among corporate executives, owners and directors.⁴⁹⁵ This is also the case in the international level as reported by the Global Economic Crime Survey and Transparency International.⁴⁹⁶ Providing employees and others with whistle-blowing mechanisms before they use external channels (like regulatory agencies and the media) also allows companies to tackle self-dealing.⁴⁹⁷ The merits of introducing financial incentives were considered by the PRA and FCA in 2014 for the Treasury Select Committee, which concluded that it would not encourage whistle-blowing or increase the integrity and transparency in financial markets.⁴⁹⁸ Given the UK FCA had collected evidence through visits to SEC and Federal Trade Commission in fall 2013 only two years after the measures came into effect in the United States, it may be premature to reach a conclusion. Nevertheless, the FCA does see the benefit in having internal whistle-blowing mechanism and considers it to be the responsibility of senior management to put the mechanism in place.⁴⁹⁹

⁴⁹⁰ 18 U.S.C. §1514A; section 806 of the SOX

⁴⁹¹ See Federal appellate court case of *Carnero v Boston Scientific Corp* No Civ A 04-10031, 2004 WL 1922132, at *2 (D Mass Aug 27, 2004), *affd* 433 F 3d 1 (1st Cir 2006)

⁴⁹² See Rachel Beller, *Whistleblower Protection Legislation of the East and West: Can It Really Reduce Corporate Fraud and Improve Corporate Governance - A Study of the Successes and Failures of Whistleblower Protection Legislation in the US and China*, (2010-11) volume 7, *NYU Journal of Law and Business*, 873: Available at

http://heinonline.org/HOL/Page?handle=hein.journals/nyujolbu7&div=24&g_sent=1&collection=journals.

⁴⁹³ 17 CFR Parts 240 and 249

⁴⁹⁴ See Alexander Dyck, Adair Morse, and Luigi Zingales, "Who Blows the Whistle on Corporate Fraud?", 65 *J. of Fin.* 6, 2010; see also See Rachel Beller, "Whistleblower Protection Legislation of the East and West: Can It Really Reduce Corporate Fraud and Improve Corporate Governance - A Study of the Successes and Failures of Whistleblower Protection Legislation in the US and China", 2010-11, volume 7, *NYU Journal of Law and Business*, 873: Available at

http://heinonline.org/HOL/Page?handle=hein.journals/nyujolbu7&div=24&g_sent=1&collection=journals

⁴⁹⁵ See Robert Bowen, Andrew Call, and Shiva Rajgopal, *Whistle-Blowing: Target Firm Characteristics and Economic Consequences*, 85 *ACCOUNT. REV.* 4, 2010

⁴⁹⁶ See Rachel Beller, *op. cit.*

⁴⁹⁷ See Gladys Lee and Neil Fargher, "Companies' Use of Whistle-Blowing to Detect Fraud: An Examination of Corporate Whistle-Blowing Policies", 114 *J. of Bus. Ethics* 2, 2013

⁴⁹⁸ "Financial incentives for whistleblowers", Note by the Financial Conduct Authority and the Prudential Regulation Authority for the Treasury Select Committee, July 2014: Available at

<https://www.fca.org.uk/publication/financial-incentives-for-whistleblowers.pdf>

⁴⁹⁹ *Ibid.*

As mentioned in Appendix IV.4.6, Mainland China has a body of law, including its Constitution that protects citizens' right to whistle-blow. This is recently further enhanced by new regulations, which are a strong signal that whistle-blowing continues to play an important role in the Mainland Chinese government's anti-corruption campaign against government officials which may include managers and directors of SOEs. Singapore, in this regard, is rather behind the curve (see Appendices V.1.3, V.3.1 and V.4.1), like Hong Kong.

Hong Kong

Hong Kong does not have any specific whistle-blowing law, however, certain statutes do provide limited protections in relation to persons reporting suspected wrongdoing, as discussed in Appendices I.3.1 and I.4.1. For example, section 381 of the SFO provides immunity to auditors of listed issuers for whistle-blowing disclosures to the SFC in good faith and various anti-money-laundering laws provide some protection in those contexts.⁵⁰⁰ The Prevention of Bribery Ordinance (Cap. 201) also guarantees whistle-blowers (private and public sector) anonymity in relation to offences committed under the ordinance. However, there is no statutory protection against retaliation in Hong Kong.

Whistle-blowing is the subject of the HK CG Code that is addressed to audit anomalies but as that is merely a non-mandatory recommended best practice limited in scope it represents a very light touch approach to regulation.⁵⁰¹ While more companies are introducing audit whistle-blowing policies and procedures,⁵⁰² less than half of listed companies in Hong Kong do not comply with that recommended practice.⁵⁰³ The HKMA's Supervisory Policy Manual mentions the concept of whistle-blowing but this is couched in language that an authorized institution should have a well communicated policy allowing staff "to communicate, in confidence and without risk of reprisal" observations of any violations.⁵⁰⁴

The SFC appear to support whistle-blowing as a key step that directors of listed issuers should take to protect their company from corporate misconduct and to foster a culture of good CG.⁵⁰⁵

Discussion

While all global systemically important financial institutions have set up whistle-blowing hotlines, whistle-blowing hotlines do not appear to be an effective means to identify breaches of law or regulation. Globally, there is a lower number of whistle-blowing events in Asia, possibly due to a cultural reluctance to speak up against persons in a position of seniority or power. To the extent complaints are made, they often pertain to human resources matters rather than to breaches of regulatory compliance violations. Nevertheless, whistle-blowing hotlines were considered relevant to creating a proper risk culture of "doing the right thing" across the institution.⁵⁰⁶

It appears to be common ground that whistle-blowing plays an important role in uncovering and possibly preventing fraud and wrongdoing. Some even argue that without whistle-blowing from employees, independent directors and auditors cannot do

⁵⁰⁰ Drug Trafficking (Recovery of Proceeds) Ordinance (Cap. 405), the Organised and Serious Crimes Ordinance (Cap. 455), the United Nations (Anti-Terrorism Measures) Ordinance (Cap. 575), the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615)

⁵⁰¹ MBLR Appendix 14, para C 3.8

⁵⁰² "Best corporate governance awards 2016, Judges Report", HKICPA, page 13

⁵⁰³ "Corporate governance update", BDO Limited, 2016, page 5

⁵⁰⁴ At CG-1, para 2.6.7

⁵⁰⁵ SFC "Enforcement reporter" No. 2 May 2017, page 3

⁵⁰⁶ SFC "Risk-focused industry meeting series: G-SIFI trends in risk and risk mitigation" December 2013, page

their job properly, which is why despite the best corporate governance practices, companies continue to fail, and shareholders continue to wonder why independent directors and auditors could not prevent corporate failures.⁵⁰⁷ The main reason for lack of whistle-blowing from employee is the fear of retaliation from the wrongdoers who are often in position of power, and the feeling that they have nothing to gain but everything to lose by whistle-blowing. Thus, protection against retaliation is crucial in order for the system to work, and financial incentives may encourage some employees to take the risk and trouble to whistle-blow.

It has been suggested that effective compliance programs and culture are key to preventing corporate abuses and fraud, and that an effective whistle-blowing programme is an important component to a successful compliance program.⁵⁰⁸ The collapse of Enron, WorldCom, and Tyco in the United States revealed massive corporate fraud that was exposed through the reports of whistle-blowing employees concerning internal accounting fraud and other abuses.⁵⁰⁹ What was more alarming was that employees were well aware of the fraudulent activities well before the onset of the companies' collapse.⁵¹⁰ Employees were reluctant to come forward because of fear of retaliation, or in other words, a lack of whistleblower statutory protection from retaliation.⁵¹¹ It has been suggested that if whistleblower legislation had been in place prior to these companies' collapse that compelled disclosure while at the same time protecting employees from retaliation and liability, these insolvencies may have been avoided.⁵¹² As already noted, Hong Kong has no overarching law to protect whistle-blowers. There is no requirement under the Main Board listing rules, only a recommended best practice in the CG Code, similar to the UK CG Code,⁵¹³ that listed companies put in place arrangements for employees to report, in confidence, concerns about possible improprieties.⁵¹⁴ A number of well-established companies have implemented a whistle-blower system, for example, HSBC Confidential received more than 1,100 cases in 2016.⁵¹⁵ Smaller companies have not established such systems.

Hong Kong's approach to whistle-blowing can be characterized as piecemeal because it provides for whistle-blowing in specialized contexts and because the framework of protection varies across each of those contexts. This raises the question, in the context of this study, whether the implementation of whistle-blowing in relation to CG practices should also adopt a specialized-context approach. Given that many of the CG standards that apply in Hong Kong do not have legal standing, there is little justification for introducing whistle-blowing requirements beyond what the HKEX might propose in relation to, for example, the CG Code. On the other hand, the topic of CG and the potential consequences arising from poor CG extend far beyond non-statutory codes relating as they do to serious legal matters such as director misfeasance and corporate fraud that can have far reaching consequences on investors and the market more generally. The latter concern does provide some basis on which to ask whether whistle-blowing protection in Hong Kong should be placed on a basis that is not limited to a highly specialized context. Such a question invokes a much wider range of social issues.

The foregoing leads to **Recommendation E4.9.2** "Whistle-blowing".

⁵⁰⁷ Frederick D. Lipman, "Why corporate governance failures continue", 17 April 2017: Available at <http://tcblogs.org/governance/2017/04/17/why-corporate-governance-still-continues-to-fail/> (visited on 12 Nov 2017)

⁵⁰⁸ : Mini vandePol, Vivian Wu and Simon Hui, "New Rules Offer Greater Protection and Incentives to Whistleblowers in China", 4 May 2016: Available at <https://globalcompliancenews.com/new-rules-offer-greater-protection-and-incentives-to-whistleblowers-in-china-20160504/> (visited on 12 Nov 2017)

⁵⁰⁹ See Rachel Beller, *op. cit.*

⁵¹⁰ *Ibid.*

⁵¹¹ *Ibid.*

⁵¹² *Ibid.*

⁵¹³ HKICS, "Guidance Note: A practical guide to good governance – Whistleblowing Toolkit," 2010, 3

⁵¹⁴ See also HKICS, "Guidance Note: A practical guide to good governance – Whistleblowing Toolkit," 2010

⁵¹⁵ See HSBC's 2016 Annual Report, p 24

3.8	Coda
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The analysis in this Section 3 has given rise to a total of 28 recommendations. Ten recommendations propose improvements to board processes that will foster transparency and accountability, including in relation to the undertaking of the INED role. Twelve recommendations are concerned with the ability of shareholders and regulators to conduct meaningful, and graded, enforcement where CG standards fall below the requirements. Six recommendations address regulatory architecture and policy development that would work better to serve the interests of shareholders and the market.

As per the objective of the study to make recommendations that are practical implementable, as stated in Section 2, only two of the recommendations require a change to legislation, and another four may require legislative change subject to the outcome of a further consultative process.

All recommendations, and the Sections from which they are derived, are listed in the Tables at the end of this section.

The area where Hong Kong is most clearly in need of reform when compared with the other jurisdictions studied is the enforcement lacuna in respect of issuers in breach of CG standards set by the listing rules. Regulatory powers are either too weak and ineffective, or too strong (if available at all) – this amounts to regulatory inefficiency. Adding to this problem is the reality that shareholders are unable to seek redress where issuers and directors have fallen short of expected standards, either *de jure*, because shareholders have no standing to enforce the listing rules, or *de facto*, because although shareholders may possess rights under the law these rights are rarely exercised. In the UK and Singapore, regulators have graded powers over breaches of the listing rules including the power to fine, and shareholders have the right to bring an action for damages in relation to disclosure breaches. While the United States is similar to Hong Kong as regards the listing rules not having any legal standing, it does better than Hong Kong for two reasons. First, many listing rule disclosures are subject to Federal laws that are actionable by regulators, and possibly shareholders. Second, there is an active engagement of shareholder rights that is fostered by a number of factors including active development of fiduciary standards through State courts, efforts undertaken by the SEC (though not always successfully), and the presence of class action rights. Together these give shareholders a measure of meaningful oversight of CG standards, some of which may involve breaches of the listing rules.

Some of these problems arise out of the dual responsibilities model, but not exclusively so. The Section 3 analysis and Appendix I noted that the idea of replacing the dual responsibilities model with a statutory model has been discussed intermittently ever since the adoption of the model in the UK in 2000. A change to a statutory model would represent a significant change to Hong Kong's regulatory architecture - while it is clear that it would resolve certain issues, it is not a panacea for all issues and it is far from clear as to whether it may create other issues that do not sit well with Hong Kong's market-led system. In the course of that debate, two other approaches have been suggested that seek to ameliorate the issues, with varying degrees of success.

The first of these proposed bringing only the most important listing rules into statutory effect. This has been partially, and successfully, implemented – replacing the price sensitive information disclosure requirements of the listing rules with Part XIVA of the SFO appears to have led to some improvements in transparency, case law has developed

and, importantly, the change has occurred without disturbance to the market's commercial business undertaking. The second of these approaches proposed giving the SFC fining powers over the listing rules, similar to what the FCA in the UK possesses. In contrast to the partial success of the former case, this approach has met with no success. It is tempting to suggest that the first approach succeeded and the second failed because the latter more fundamentally disrupts the dual responsibilities model in which the SEHK is the frontline regulator and the SFC has reserve powers of oversight. But it would be conceptually wrong to do so since both approaches fundamentally reassign the power of enforcement – the former shifts enforcement to the MMT at the initiative of the SFC, the latter would place power directly in the hands of the SFC.

Recommendation A4.6.4 “Statutory backing of certain listing rules” builds on the Part XIVA experience to suggest that it may now be time to expand this approach and again consider the other listing rules that had previously been suggested for statutory backing. This would help address the breaches of the relevant sections that currently carry insufficient deterrent force, as discussed in **Section 3.6.2** “Listing rules”.

There are a number of ways that more effective regulatory oversight can be achieved while staying within the intent of the existing dual responsibilities model. Seven recommendations of this Report are relevant to consider. Six of them do not require legislative change (**Recommendation A4.5.1** “Legal status of CG-related disclosures”, **Recommendation C4.5.2** “Status of listing rule compliance and related disclosures (continuing)”, **C4.6.1** “SEHK to develop use of existing disciplinary power”, **Recommendation A4.6.2** “SFC to develop use of conditions when exercising existing SMLR powers”, **Recommendation C4.7.1** “Disclosure of CG standards in listing document” and **Recommendation E4.7.2** “Develop role of compliance adviser”). The seventh (**Recommendation A4.6.3** “Calibrate SFC’s powers under the SMLR”) might be perceived as a change to the dual responsibilities model because it gives the SFC fining powers, however, that recommendation proposes fine-tuning sub-legislation such that fining powers are limited to operate within the SFC’s existing SMLR power (to suspend trading in an issuer’s shares) in a manner that may work better for both the issuer and investors as compared to outright suspension to create a win-win situation.

Not all problems can be connected back to the dual responsibilities model. While the enforcement lacuna discussed in **Section 3.7.1** arises partly out the model, it also arises out of problems, as noted above, with shareholders rights in relation to the listing rules and the law. This has given rise to two recommendations, one that does not require a change in the law (**Recommendation S4.4.1** “Shareholders as beneficiaries of listing rules”), the other that would (**Recommendation A4.4.2** “Collective redress”). In addition to the lacuna between the powers of the SEHK and the SFC, **Section 3.7.3** (see also **Section 3.7.6**) discussed the problem that the SFC is not unconflicted when considering whether or not to bring an action that would benefit shareholders, and this led to a proposal for a new regulatory body that sits outside the dual responsibilities model (**Recommendation E4.8.2** “Establish an investor protection agency”).

To this list may be added three other recommendations of relevance to the enforcement lacuna: two that address the position of shareholders’ rights collectively (**Recommendation A4.4.2** “Collective redress”) as well as in relation to the listing rules (**Recommendation S4.4.1** “Shareholders as beneficiaries of listing rules”) and one that proposes a new regulatory body that sits outside the dual responsibilities model and has a specific focus on shareholder rights (**Recommendation E4.8.2** “Establish an investor protection agency”).

Finally, policy development is also complicated by a number of factors. The SFC is an advocate of high CG standards but in practice is constrained to exercising its voice in *ante* or *ex post* enforcement actions, the former of these also encompassing the expectations it and the HKEX place on sponsors to serve as effective gateway

mechanisms. The HKEX is also an advocate of high CG standards but is subject to potential commercial considerations that may work to soften standards or the enforcement of them – to some this is a means of establishing an appropriate balance whereby the CG system serves the needs of the market, whereas to others it represents a common feature cum problem of self-regulatory models that lean toward lighter-touch regulation. That both these agencies have issues has led to the suggestion that a new CG-focussed Unit and Group be established (**Recommendation E4.8.1** “Establish a CG Unit and CG Group”) within an appropriate agency. The proposed new investor protection agency (**Recommendation E4.8.2** “Establish an investor protection agency”) would be an ideal venue for the CG Unit, and could serve to facilitate Hong Kong moving forward on CG with a clearer set of objectives.

In the absence of policy development that addresses enforcement issues, the rules themselves become meaningless. The Hay-Davison report had noted that self-regulation and market self-discipline had failed to develop. This was not an assertion having an absolute value but one of appropriate balance between the market and the regulatory agencies having charge of the market (at that time being the Commissioner for Securities). The SFC was born out of that report as a means of remediation, yet, in various regards Section 3 has observed important instances of the SFC having very limited oversight of a listed market which has grown considerably since the Hay-Davison report when it was issued in 1988. This does bring the discussion to the dual responsibilities model and whether the balance between the market and regulatory oversight remains fit for purpose.

It is clear that the fundamental developments of the market and its makeup since the Hay-Davison report have in general been responded to in ways that are consistent with international best practices. However, given that the Hong Kong market is more dependent on non-locally incorporated companies than the other markets studied, Hong Kong may need to develop other solutions. A number of the recommendations made herein will improve the efficiency, and prospect, of enforcement actions against non-local companies as they would locally incorporated companies. However, more may be needed to move forward in respect of significant cases of wrongdoing or fraud and **Recommendation 4.6.5** “Explore a narrow-channel cross-border enforcement arrangement” proposed that Hong Kong is in a unique position to develop cross border enforcement solutions that may be beneficial to the integrity of Hong Kong’s market as well as to the reputation and standing of Mainland enterprises listed in Hong Kong.

SUMMARY OF ALL RECOMMENDATIONS – BY SECTION 3.2-3.7

		3.2 Non-HK companies	3.3 Information	3.4 Involvement	3.5 Equality	3.6 Accountability	3.7 Effectiveness
The board	Processes		Board evaluation (C4.1.1) Audit committee (A4.1.3 ⁺ , A4.1.4)	Executive remuneration (A4.1.2)			
	INEDs			INED Remuneration (A4.2.2)			INED time (A4.2.1) INED training (A4.2.3) NED Code (C4.2.4)
	Standard		LR non-compliance disclosures (S4.3.2)				Elevated standards (C4.3.1)
Enforcement	Sh'holders					Shareholders to enforce listing rules (S4.4.1) Collective redress (A4.4.2*)	
	Disclosures		Legal status of disclosures (A4.5.1 ⁺) Continuing disclosure obligation (C4.5.2 ⁺)				Facts regarding director independence (C4.5.3)
	Regulators	Cross-border enforcement (E4.6.5* ⁺)					SEHK use of power (C4.6.1) SFC's SMLR powers (A4.6.2 ⁺ , A4.6.3** ⁺) Statutory backing of certain listing rules (A4.6.4*)
	Ex ante						Disclosure of CG standards (C4.7.1 ⁺) Compliance officer role (E4.7.2 ⁺)
Policy and architecture	Arch.						CG Unit/Group (E4.8.1) Investor protection agency (E4.8.2**)
	Policy				Market development (E4.9.3)		LR development (A4.9.1) Whistle-blowing (E4.9.2* ⁺) Voluntary performance code (A4.9.4)

	Compelling	Advocate	Support	Explore
Board	3	6	1	-
Enforcement	4	5	1	2
Arch. and policy	-	2	-	4

Section 4	RECOMMENDATIONS
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Introduction and approach to the recommendations

This Section 4 sets out the primary recommendations of this study that arise out of the discussion and analysis in Section 3. It is divided into two main divisions, this Introduction and the detailed recommendations set out in Sections 4.1 to 4.9. The final section 4.10 provides summary tables of all recommendations.

Given the scope and methodology of the study as set out in Section 2, the recommendations set out in Sections 4.1 to 4.9 have been developed against the backdrop of each jurisdiction studied, the wider considerations discussed in Section 3.1, and in view of the particular circumstances prevailing in Hong Kong. Over the past 20 years or so there have been innumerable discussions as to what aspects of the corporate governance (CG) system in Hong Kong are in need of development, particularly in response to the changing characteristics of the market and its makeup over that period of time. Accordingly, it is not the purpose of these recommendations to review and provide perspectives on those long-standing debates, except where they have again come to the fore in the course of the study. In some instances, revisiting a long-standing debate has been necessary, such as where there have been relevant changes in the underlying texture of CG concerns in the market, however, this has not always led to a recommendation being formed.

Formation of recommendations

A study that is essentially rooted in a comparison of the practices of other jurisdictions naturally gives rise to a variety of observations ranging from noting significant similarities of approach to fundamental differences. While differences are of course a source of considerable interest in the formation of recommendations, they must be measured or graded against a variety of factors. The balance and fit within one CG system as compared to another is clearly critical to assess. More difficult to measure, but nonetheless critical to take account of, is a consideration of what would be required to translate a practice in another jurisdiction to Hong Kong. This is not merely a theoretical exercise but one that requires an assessment of the ground conditions in the market itself, in brief, the difficulty or ease, or receptiveness or otherwise in an active and vocal market filled with a variety of commercial considerations and, consequently, viewpoints.

In deciding whether to propose a recommendation, the essential litmus test that has been adopted in this study is the probable utility, effectiveness and benefits of a potential recommendation under consideration. Subject to meeting that requirement, the recommendations as finally presented in this section of the Report have been formed with reference to the three sets of variables that are used as a framework for classifying recommendations, as explained in the Table on the next page.

Table: Classification of recommendations

Variables

1. the level of complexity involved to implement a recommendation, ranging from:
 - a. relatively straightforward (e.g. changes to regulatory rules or practices) to
 - b. wide ranging and complex (e.g. changes in regulatory architecture or primary legislation)
2. the nature of support for a recommendation, being either:
 - a. from experiences in other markets
 - b. from principles (which may be based in experiences in other markets)
3. whether a recommendation is likely to be contentious to the industry, either:
 - a. unlikely to be contentious
 - b. may be contentious

(these two categories must be read relatively, given that any proposed change from the status quo may be met with objections from one or more segments of the industry)

Classification of recommendations

Assembling these variables into a framework, the four types of recommendation indicated below have been adopted to apply to each recommendation made in this Report. Each is merely a general indicator of overall support/difficulty. They are to be read more as a guide, not strictly. Certainly, just because something is more difficult to implement does not mean that it cannot be actively progressed and implemented.

<i>Classification</i>	<i>Codifier</i>	<i>Variables satisfied</i>
Compelling	C	1a+2a+3a
Advocate	A	1a AND either 2a+3b OR 2b+3a
Support	S	1b+2a+3a/b
Explore	E	Not falling within the foregoing, this represents a matter that is subject to further research being undertaken and/or one that is worth considering in the future when relevant circumstances permit
<i>Additional codifiers</i>	*	The recommendation proposes a further consultation that could lead to legislative changes.
	**	The recommendation requires a legislative change.
	+	The recommendation assists re non-Hong Kong incorporated issuers.

Format of presentation

Where a specific matter has been considered and the investigation has led to a recommendation, these are summarized in following format:

[Codifier+Reference number]	[Statement of the issue]
Step required	[Very brief statement of what step required]
Recommendation level	[Compelling / Advocate / Support / Explore]
Topic addressed	[Brief explanation of the topic context]
Details of recommendation	[Itemized details listed out]
Attendant considerations	[Surrounding considerations, such as further details needed etc.]
Jurisdiction references	[Brief pointer to reference in another jurisdiction]
Section 3 reference	3.[]

References to the Main Board listing rules are intended to be addressed also to corresponding provisions of the GEM listing rules.

Where a specific matter has been considered, possibly with a view to making a recommendation, but the investigation has led to the conclusion that there are insufficient grounds to make a recommendation, these items are summarized in following format:

No recommendation	[Statement of the issue]
<i>Issue considered</i>	<i>[Brief description of the topic context]</i>
<i>Reasoning</i>	<i>[Brief explanation]</i>
<i>Section 3 reference</i>	3.[]

Main themes of the recommendations

A total of 28 recommendations have been made, including 20 falling within the “Compelling” and “Advocate” levels. These have been grouped in the sections that follow under four main divisions:

- Part A – The board
- Part B – Enforcement
- Part C – Architecture and policy

Many of the recommendations can be linked together by some key threads that run through them. This includes, for example, seeking alternative or more effective enforcement mechanisms, finding solutions through use of existing powers as opposed to creating new ones, improving policy development and the marketing of good CG,

exploring more effective empowerment mechanisms (shareholders, non-executive directors (NEDs), independent non-executive directors (INEDs)), improving transparency and accountability themes, and so on.

Much consideration was given to the specific question of shareholder rights and protections, this being a core purpose of the present study. Overall, the study indicated that shareholder rights are, insofar as strict legal rights are concerned, well established in Hong Kong law subject to three important caveats. The first is the ability of a shareholder to acquire information relevant to the identification of the infringement of a right. The second is the ability of the shareholder to pursue that right in practice. The third is in relation to what matters should a shareholder have rights of redress. Many of the recommendations made in the sections that follow are concerned with this issue.

PART A	THE BOARD
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Summary of main recommendations made

C4.1.1 addresses board evaluation. It proposes raising the existing recommended best practice in the CG Code to a code provision that incorporates additional requirements including a reporting requirement in the Corporate Governance Report. It also proposes the introduction of a new recommended best practice, modelled on the approach taken in the United Kingdom (UK), concerning how the evaluation exercise should be undertaken - however, while defining board performance is an important issue, unlike the evaluation provisions in the UK CG Code, it is not recommended that the factors a board should consider be prescribed by the regulations.

A4.1.2 proposes better disclosure of the considerations taken into account by the remuneration committee in relation to performance-linked remuneration.

A4.1.3 proposes that the listing rules be amended to require the audit committee itself to make a disclosure in the annual report as to its work undertaken.

A4.1.4 proposes that a new comply or explain provision be inserted into the CG Code that the board should delegate to its audit committee powers in relation to the appointment, compensation, and oversight of the external auditor.

A4.2.1 proposes that issuers should at the very minimum adopt a policy on the number of INED posts that can be held by an individual at any one time, and that the policy is disclosed to shareholders, with deviations from it also being explained.

A4.2.2 proposes that the board be required to consider the linkage between the level of an INED's remuneration and their expected commitment and responsibilities and make an appropriate disclosure in relation thereto.

A4.2.3 proposes that INEDs be required to undertake training that is specialized to their role, that this must be subject to a minimum number of certified hours of training experiences that must be disclosed if not met, but that issuers are free to determine what training constitutes an INED CG training experience.

C4.2.4 proposes the introduction of a mandatory requirement that INEDs make a statement in the Corporate Governance Report as to their activities relating to the undertaking of their role over the course of the year, and a comply or explain provision that the issuer should implement an "NED Code" to support and facilitate the effectiveness of the NED and INED roles.

C4.3.1 proposes escalating certain recommended best practices to code provisions to create "Elevated Standards".

S4.3.2 proposes that an issuer and its directors be subject to an ongoing requirement to disclose any variation from previously disclosed CG practices. This is distinct from disclosures required to be made by the listing rules or applicable laws (see A4.5.1 and C4.5.2 below).

4.1	Processes
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C4.1.1	Board evaluation
Step required	Amend section B of the CG Code and the Corporate Governance Report.
Recommendation level	Compelling.
Topic addressed	Mechanisms that facilitate shareholders being given insight to the operations, and the effectiveness of the operations, of the board to assist shareholders in exercising their rights, including in relation to voting on director appointments.
Details of recommendation	<p>1. The existing Recommended Best Practice (RBP) B.1.9 to be escalated into a code provision that specifies:</p> <ul style="list-style-type: none"> - the board should undertake an annual evaluation; - the evaluation should be based on a policy adopted by the board as to the terms of reference for the evaluation; - the policy should include a policy on the involvement of INEDs or external advisers in the evaluation; - the policy and any adjustments to it to be published not less than annually and/or made available on the issuer’s website. <p>2. The Corporate Governance Report to be amended to require an annual disclosure as to how the issuer has complied with the new code provision. The following matters will need to be stated or explained:</p> <ul style="list-style-type: none"> - the scope of evaluation including the high-level (i.e. non-commercial) metrics used to assess or define performance; - the manner in which the evaluation was undertaken; - whether any recommendations have been made to improve board performance; - whether INEDs or external advisers were involved in the evaluation exercise. <p>3. A new RBP to be introduced that suggests:</p> <ul style="list-style-type: none"> - a board consider appointing a committee comprised of a majority of INEDs to undertake the evaluation exercise; - a board consider appointing external assistance not less than every three years. <p>4. The above RBP should be reviewed after a suitable settling in period to determine if it should be elevated to a code provision.</p>
Attendant considerations	<p>How much detail should be imposed on, or required in relation to, a board evaluation.</p> <p>Setting the level such that compliance with the requirement provides an opportunity for catalyzing change as opposed to being merely another item for disclosure.</p>

	The required disclosure would be subject to section 384(3) of the SFO if recommendation A4.5.1 "Legal status of CG-related disclosures" were implemented.
Jurisdiction references	UK (CG Code B.6). Singapore (CG Code). China (CG Code). HK (MTR).
Section 3 reference	3.3.3 Board evaluation.

A4.1.2	Transparency of performance related executive remuneration
Step required	Amend CG Code section B.1 / L.
Recommendation level	Advocate.
Topic addressed	Performance-linked executive remuneration.
Details of recommendation	<p>1. Amend CG Code section B.1 / L to require disclosure in the Corporate Governance Report of the considerations taken into account by the remuneration committee where performance-linked remuneration is proposed.</p> <p>2. The CG Code to incorporate, for reference only to assist in the report suggested above, a schedule with alternative approaches to designing performance-linked pay similar to that found in the UK CG Code Schedule A "The design of performance-related remuneration for executive directors".</p>
Attendant considerations	The required disclosure would be subject to section 384(3) of the SFO if recommendation A4.5.1 "Legal status of CG-related disclosures" were implemented.
Jurisdiction references	UK. United States.
Section 3 reference	3.4.3 Remuneration

A4.1.3	Disclosures of the audit committee
Step required	Amend the listing rules (MBLR 13.49(1)-(3)) and CG Code (Corporate Governance Report).
Recommendation level	Advocate.
Topic addressed	The scope of disclosures made by the audit committee in respect of the issuer's financial reports (as opposed to the board reporting on the audit committee).
Details of recommendation	<p>1. The listing rules to require the audit committee to itself make a disclosure in relation to the issuer's financial reports, including as to its role in relation to the external audit process and the work it has undertaken to discharge its responsibilities.</p> <p>2. The audit committee to report annually on all items currently provided for in CG Code C.3.3.</p>
Attendant considerations	The scope of matters to be covered in the report need to be considered further – reference should be made to the disclosures required to be made by the audit committee in the United States post SOX.
Jurisdiction references	UK (FRC's Guidance on Audit Committees 2016). United States (Securities and Exchange Commission (SEC) rules implementing Sarbanes-Oxley Act of 2002 (SOX)).
Section 3 reference	3.3.4 Audit committee

A4.1.4	Status of the audit committee
Step required	Amend the CG Code (C.3).
Recommendation level	Advocate.
Topic addressed	The independence from the full board of the relationship between the audit committee and the auditor as regards the appointment, compensation, and oversight of the auditor.
Details of recommendation	<p>1. The CG Code to include a comply or explain Code Provision that a board should fully delegate to its audit committee powers that make the audit committee primarily and directly responsible in relation to the appointment, compensation, and oversight of the external auditor.</p> <p>2. As the board technically retains its legal obligations in respect of any delegated authority, the board should be required to separately explain (1) how it has exercised its power to delegate, (2) how it has exercised its legal obligations to oversee the authority it has delegated and (3) whether it has revoked any aspect of the delegated authority and, if so, why.</p> <p>3. Where the board has not followed this Code Provision, it must explain the factors that it considers relevant to the decision not to delegate full authority to the audit committee.</p> <p>4. The possibility of making this a mandatory listing rule requirement should be kept under review.</p>
Attendant considerations	<p>While full delegation to the audit committee is intended to improve the committee's independence and accountability, it also places more importance on the quality, independence and accountability of the INEDs (and other NEDs) comprised in it. In this regard, see recommendations A4.2.1 "Sufficient INED time", A4.2.2 "Basis of INED remuneration", A4.2.3 "INED training", C4.2.4 "NED Code and INED reporting", and C4.5.3 "Facts regarding director independence".</p> <p>The required disclosure of the board would be subject to section 384(3) of the SFO if recommendation A4.5.1 "Legal status of CG-related disclosures" were implemented.</p> <p>An alternative would be to make this a recommended best practice, however, this would substantially weaken the effect of the recommendation as deviation from it would no longer need to be disclosed.</p>
Jurisdiction references	United States (SEC rules implementing SOX).
Section 3 reference	3.3.4 Audit committee.

No recommendation	Board refreshment
<i>Issue considered</i>	<i>Whether boards should be subject to additional requirements as regards the refreshment of the board.</i>
<i>Reasoning</i>	<i>Despite interviewees providing limited positive support, developments in the UK in favour of board refreshment, and to a mixed extent the United States, there does not appear to be a sufficient shareholder mandate for changing the present position in Hong Kong. There is no such requirement in Singapore or China either.</i>
<i>Section 3 reference</i>	<i>3.6.3 Board refreshment.</i>

4.2	Independent directors
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A4.2.1	Sufficient INED time
Recommendation	Amend the CG Code.
Recommendation level	Advocate.
Topic addressed	The proper undertaking of INED duties requires a recognition of the time required to undertake the same.
Details of recommendation	<p>1. The CG Code to include a comply or explain provision that issuers should adopt a policy on the number of INED posts that can be held by an individual at any one time.</p> <p>2. The policy to be made publicly available, such as on the issuer's website.</p> <p>3. Deviations from the policy, where one has been adopted, are to be explained in the Corporate Governance Report, including as to why the INED's other posts will not affect the ability to properly and fully undertake the INED responsibilities.</p> <p>4. The other posts of each INED must be disclosed in the Corporate Governance Report.</p>
Attendant considerations	<p>The Hong Kong Exchanges and Clearing Limited (HKEX) did a market consultation on this in 2010-2011, however, evidence suggests that the responses may be self-serving and not in the best interests of the market.</p> <p>The recent HKEX consultation (2017) proposes that only posts in excess of six require further disclosures (see the discussion in Section 3).</p>
Jurisdiction references	United States (New York Stock Exchange LLC (NYSE)). Mainland China. Singapore. UK.
Section 3 reference	3.7.11 Requirements relating to INEDs.

A4.2.2	Basis of INED remuneration
Step required	Amend CG Code B.1.2(d) and L.
Recommendation level	Advocate.
Topic addressed	Promoting transparency and disclosure of the basis on which INEDs are remunerated.
Details of recommendation	<p>1. CG Code B.1.2(d) to require the board to consider the linkage between the level of an INED’s remuneration and their expected commitment and responsibilities.</p> <p>2. CG Code L to require an appropriate disclosure cum explanation in relation to the foregoing (1 above) to be made in the Corporate Governance Report.</p>
Attendant considerations	The required disclosure would be subject section 384(3) of the SFO if recommendation A4.5.1 “Legal status of CG-related disclosures” were implemented.
Jurisdiction references	UK.
Section 3 reference	<p>3.4.3 Remuneration.</p> <p>See also: 3.7.10 Requirements relating to INED performance.</p>

A4.2.3	INED training
Step required	Amend CG Code.
Recommendation level	Advocate.
Topic addressed	To enhance INEDs' capability and performance.
Details of recommendation	<ol style="list-style-type: none"> 1. CG Code to impose continuous professional training requirements based on certification of attendance, not exam based. 2. INEDs should be exposed to CG training that is specialized to their role. 3. The SEHK to set out examples of the types of CG training or experiences it regards as acceptable. 4. Issuers will be free to commercially determine what training constitutes an INED CG training experience. (With reference to C4.2.4 "NED Code and INED reporting", this should be incorporated within the issuer's NED Code.) 5. CPT must be satisfied on an annual basis and reported to the SEHK. Issuers should be encouraged to disclose the same details on their websites. 6. Issuers only need to make disclosure to shareholders if a director has not satisfied the CPT requirement.
Attendant considerations	<p>The new requirement should be reviewed after 2 years with a view to further development.</p> <p>To determine the number of hours required – based on the HKEX 2010/2011 consultation 8 hours is suggested.</p>
Jurisdiction references	UK (Walker and Turner Reviews). Mainland China.
Section 3 reference	3.7.11 INED qualifications.

C4.2.4	NED Code and INED reporting
Step required	Amend the CG Code.
Recommendation level	Compelling.
Topic addressed	<p>The public framework of responsibility and accountability of NEDs including INEDs.</p> <p>To improve the responsibility of NEDs, particularly INEDs.</p> <p>To improve the perception of legal responsibilities for INEDs through the increased visibility resulting from mandated disclosures.</p>
Details of recommendation	<p>1. CG Code to include a comply or explain Code Provision that an issuer should adopt an NED Code that specifies its policies, practices and expectations in respect of INEDs and other NEDs that is designed to facilitate the effectiveness of these NED roles.</p> <p>2. A Model NED Code to be annexed to the CG Code that an issuer may choose to comply with, or alternatively establish their own NED Code. The Model NED Code to address, <i>inter alia</i>, the NED's expected involvement, sufficiency of a NED's time, basis of remuneration, and knowledge of the business and training, etc.</p> <p>3. CG Code to impose mandatory reporting by INEDs in the Corporate Governance Report.</p> <p>4. The matters to be reported to be specified but should include</p> <ul style="list-style-type: none"> - a summary of the INEDs' activities relating to the undertaking of their role over the course of the year; - a statement as to the effectiveness of the issuer's INED Code and any changes that have been made to it over the year to improve its effectiveness (where a code has been adopted). <p>5. The listing rules will set out a model INED Code that establish the minimum set of topics required and/or recommended to be covered (see suggested details in Section 3.7.10).</p>
Attendant considerations	<p>The scope of matters to be reported on to be explored further.</p> <p>Requirements in relation to the preparation and drafting of the INED report, particularly as regards its submission to the board for inclusion in the annual report, to be explored further.</p> <p>The scope of matters that should be covered by the INED Code to be explored further.</p>
Jurisdiction references	Mainland China. UK.

	United States.
Section 3 reference	3.7.10 Requirements relating to INEDs. See also: 3.3.4 Audit committee and A4.1.3 "Disclosures of the audit committee"

No recommendation	Special appointment mechanism for independent directors
<i>Issue considered</i>	<i>Whether independent shareholders should appoint independent directors to guarantee their independence.</i>
<i>Reasoning</i>	<i>Based on a review of the experiences in the jurisdictions studied, particularly the quite divergent experiences and approaches in the UK and the United States when considered in view of the circumstances in Hong Kong, the arguments for and against introducing special voting arrangements for the appointment of independent directors are largely equivocal. Because imposing regulations that establish a different set of voting rights for shareholders based on their independence represents a public law override of the private law rights that would otherwise attach to the shares, it is suggested that in the absence of a clear mandate to impose such an override no such regulation should be imposed.</i>
<i>Section 3 reference</i>	<i>3.5.1 Voting rights generally.</i>

4.3	CG standards
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C4.3.1	Relevant issuers to be subject to “Elevated Standards”
Step required	Amend CG Code and listing rules to specify selected CG requirements as Elevated Standards for designated issuers.
Recommendation level	Compelling.
Topic addressed	<p>Larger or more well-known/established issuers are frequently expected by the market to adhere to higher CG standards. Many of these companies often lead CG standards by voluntarily adopting requirements that go beyond the provisions of the CG Code.</p> <p>The primary benefits of the recommendation, which is to establish a set of Elevated Standards for these types of issuers, would be (1) to entrench those voluntary practices, and (2) to send a signal to the market that companies subject to the Elevated Standards are leading examples of good CG practices.</p> <p>Establishing Elevated Standards will also assist issuers that voluntarily elect to comply with them to identify/label themselves as adhering to higher CG standards.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. Review existing RBPs and Recommended Disclosures to select which are to be treated as “Elevated Standards”. Such Elevated Standards to be specified as code provisions subject to the comply or explain regime and required disclosures for relevant issuers. 2. Consideration to be given to incorporating specified comply or explain provisions as mandatory requirements in the Elevated Standards. 3. Specify criteria for identifying the issuers that will be subject to the Elevated Standards. It is suggested this is based on the status of being a constituent stock in a relevant index and that this would include constituent stocks of the HSI, and probably the HSCEI. 4. Make a provision for other issuers that elect to be subject to the Elevated Standards.
Attendant considerations	It is expected that this development will not cause significant change or disruption to issuers that will become subject to it.
Jurisdiction references	UK (CG Code higher standards on FTSE350 issuers).
Section 3 reference	3.7.7 Differentiation of CG requirements.

S4.3.2	Disclosure of non-compliance with issuer's disclosed CG practices
Step required	Amend the listing rules to require early disclosure of variance from previously disclosed practices.
Recommendation level	Support.
Topic addressed	<p>At present, shareholders are only required to be informed once a year of the issuer's CG practices in view of the CG Code.</p> <p>On the premise that CG practices concern matters of importance, and that this is of relevance to shareholders to know, there is a case that an annual disclosure may be insufficient to capture changes in an issuer's practices during the year.</p>
Details of recommendation	<p>1. An issuer should inform shareholders if disclosed CG practices change and this is expected to last for more than a specified period, e.g., 3 months.</p> <p>2. Unlike C4.5.2 "Status of listing rule compliance and related disclosures (continuing)", it is not suggested to bring this disclosure within the scope of section 384(3) of the SFO. However, a failure to disclose a change of practices would constitute a breach of the above requirement and so would be reportable under C4.5.2.</p> <p>3. While this disclosure obligation could be limited to changes to a lower standard of CG practice, there is a risk that this may permit different views as to what constitutes a lower standard.</p>
Attendant considerations	Nil.
Jurisdiction references	Nil.
Section 3 reference	<p>3.3.3 Disclosure of listing rule compliance. 3.6.1 Information disclosures generally.</p> <p>See also: 3.7.3 Enforcement agencies.</p>

PART B	ENFORCEMENT
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Summary of main recommendations made

S4.4.1 proposes making shareholders a third party beneficiary of the contract between the issuer and the SEHK thus giving shareholders a basis to bring an action in respect of specified provisions of the listing rules.

A4.4.2* proposes to re-visit the Law Commission’s 2012 proposal on the implementation of class action rights and to widen its approach to collective redress as this may serve to more meaningfully give effect to shareholders’ legal rights.

A4.5.1 proposes giving legal backing to specific CG related disclosures under the listing rules, including those required under the CG Code, by bringing them within the provisions of the SFO that deal with the provision of false or misleading information to regulatory agencies.

C4.5.2 proposes a continuing requirement to disclose breaches of the listing rules and an annual certification requirement as to the correctness of disclosures already required by and made under the listing rules, the disclosures to be brought within the provisions of the SFO that deal with the provision of false or misleading information to regulatory agencies.

C4.5.3 proposes making the facts stated in an INED’s written confirmation of independence subject to the provisions of the SFO that deal with the provision of false or misleading information to regulatory agencies.

C4.6.1 proposes that the SEHK make more effective use of its existing power to require issuers to “take, or refrain from taking, such other action as it thinks fit”.

A4.6.2 proposes that the SFC use its power to impose conditions on listing applicants and listed issuers that would work to address the CG shortcomings or failures that gave rise to the problem - for example, to require changes to a board’s processes that reduce the likelihood of a recurrence of the problem and that may serve to catalyze change.

A4.6.3** proposes calibrating the SFC’s powers under the Securities and Futures (Stock Market Listing) Rules (Cap. 571V) (SMLR) to provide for a fine that works as a warning cum precursor to suspension that is premised on the same grounds as its existing SMLR powers and works as a win-win-win for the issuer, its shareholders and the market.

A4.6.4* proposes re-examining the discussion on giving statutory backing to a limited number of provisions of the listing rules in view of today’s circumstances.

C4.7.1 proposes that the listing applicant be required to make a statement in the listing document cum prospectus that complies with the reporting requirements under the CG Code.

E4.7.2 proposes a development of the compliance adviser role to make it more actively engaged and to require it to be undertaken by a sponsor to the listing application.

4.4	Shareholders
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S4.4.1	Shareholders as beneficiaries of listing rules
Step required	Establish a legal mechanism that gives shareholders <i>locus standi</i> .
Recommendation level	Support.
Topic addressed	Shareholders to have a personal right to seek an action for damages for loss suffered as a result of breaches of certain listing rules.
Details of recommendation	<p>1. Amend the listing rules to express shareholders as third party beneficiaries of the contract between the issuer and the SEHK.</p> <p>2. The SEHK could do this with the approval of the SFC, or the SFC could use its existing SFO powers to direct the exchange to do so.</p> <p>3. The provisions over which shareholders have the right to take action to include all mandatory disclosure provisions of the listing rules.</p>
Attendant considerations	<p>The mechanism of assessing damages would need to be considered further – likely this will need to be referenced to the UK position where shareholders can sue for damages for disclosure breaches.</p> <p>The position of issuers already listed on the SEHK would need to be addressed.</p>
Jurisdiction references	<p>United States.</p> <p>UK.</p> <p>Singapore.</p>
Section 3 reference	<p>3.6.2 Listing rules</p> <p>See also: 3.3.2 Disclosure of listing rule compliance.</p>

A4.4.2*	Collective redress
Step required	Re-visit the Law Commission's 2012 proposal on the implementation of class action rights and to widen its approach to collective redress.
Recommendation level	Advocate.
Topic addressed	The ability in practice of shareholders to give effect to their legal rights.
Details of recommendation	<p>1. Undertake a review of the original proposal with a view to identifying aspects of the proposal able to be adjusted to make this more acceptable in the Hong Kong context.</p> <p>2. To widen the scope to reconsider implementing collective redress on a case management basis, i.e. group litigation as opposed to class action.</p> <p>3. To consider removal of any contingency fee requirement associated with collective redress (since deep pocket institutional investors may still be prepared to commence an action that proportionally reduces the cost burden for smaller tag-along shareholders).</p>
Attendant considerations	<p>To identify the parameters of the review, its objectives and timeframe, and who should be undertaking the review.</p> <p>The objectives of the review should be such that, if met, they are consistent with the political will to implement.</p> <p>Implementing a case management based form of collective redress</p>
Jurisdiction references	<p>Hong Kong (LRC 2012 proposal).</p> <p>United States (class action rights).</p> <p>UK (group litigation order).</p> <p>Mainland China (joint litigation).</p>
Section 3 reference	<p>3.6.1.</p> <p>See also: 3.7.2 Policy development agencies.</p>

4.5	CG disclosures
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A4.5.1	Legal status of CG-related disclosures
Step required	Amend the listing rules and CG Code to bring specific CG-related disclosures made pursuant to it within section 384(3) of the SFO.
Recommendation level	Advocate.
Topic addressed	<p>Disclosures made pursuant to but in breach of the listing rules and CG Code in general are only enforceable by the SEHK, however, the sanctions available to the SEHK are weak and do not include the ability to impose a fine.</p> <p>Bringing a disclosure within section 384(3) creates an avenue for enforcement by the SFC in respect of false or misleading information.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. Disclosures made pursuant to Chapters 4 (periodic financial reporting), 14 (notifiable transactions) and 14A (connected transactions) or Appendix 14 of the listing rules to be made to the SEHK and SFC under a new declarative form. 2. The form will contain declarations confirming the correctness of the disclosures (this does not require any change in any required disclosure). 3. The form to contain declarations consistent with the declarations required to be made by sponsors on an initial listing application regarding the issuer's management (paragraphs (b)(v)&(vi) of MBLR Appendix 19) and so will include a statement that reasonable efforts having been undertaken etc. 4. The form to contain the warning notice required by section 384(3)(b)(ii) SFO to bring it within the provisions of that section.
Attendant considerations	<p>Under this approach, a relatively quick enforcement action can be taken by the SFC summarily before a magistrate, more egregious matters can be pursued under indictment.</p> <p>It is important the declarations are also made by the directors, not merely the issuer, to ensure that any enforcement action taken under section 384(3) is able to be applied to the directors individually.</p> <p>Some resistance may be expected from some quarters of the director community as it represents an increase in their personal liability.</p>
Jurisdiction references	United States (Regulation S-K and Federal securities laws).

	UK (Financial Conduct Authority listing rule 9.8.6 R). Singapore (Securities and Futures Act (Cap. 289) (SFA)). Mainland China Securities Regulatory Commission.
Section 3 reference	3.3.1 Legal status of CG disclosures. See also: 3.7.1 Impact of regulatory design; 3.7.3 Enforcement agencies.

C4.5.2	Status of listing rule compliance and related disclosures (continuing)
Step required	Amend listing rules to require disclosure of breaches. Disclosure to be made subject to section 384(3) of the SFO.
Recommendation level	Compelling.
Topic addressed	<p>Directors already give an undertaking to the SEHK (Appendix 5B) to use best endeavours to procure compliance with the listing rules.</p> <p>Shareholders and the market have a legitimate expectation to know whether or not an issuer is complying with the listing rules.</p> <p>Where the listing rules are breached, the sanctions available to the SEHK are weak and do not include the ability to impose a fine.</p> <p>Bringing a disclosure within section 384(3) creates an avenue for enforcement by the SFC in respect of false or misleading information.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. An issuer and each of its directors to be subject to (1) a continuing obligation to promptly report breaches of the listing rules and (2) an annual obligation to certify compliance with the listing rules over the year, subject to any disclosure of breaches made during the year. 2. New declarative forms to be added to the listing rules in respect of the foregoing self-reporting and annual obligations. 3. The form to contain appropriate declarations pertaining to the compliance by the issuer with the listing rules, and the relevant director with their director's undertaking, including, e.g. reasonable belief having made reasonable enquiries etc. 4. The form to contain the warning notice required by section 384(3)(b)(ii) SFO to bring it within the provisions of that section. 5. The listing rules to be amended to require the relevant issuer or director form to be submitted upon a breach of the listing rules or director's undertaking, and annually in respect of each annual reporting period together with the issuer's annual reports. 6. To consider expanding the annual certification to include a statement that the company's procedures, systems and controls are adequate to enable the board to comply with their obligations and that the directors possess adequate experience and qualifications etc. (reflecting the certification requirement imposed at the time a listing applicant is admitted to listing).

<p>Attendant considerations</p>	<p>Under this approach, a relatively quick enforcement action can be taken by the SFC summarily before a magistrate, more egregious matters can be pursued under indictment.</p> <p>It is important the declarations are made by the directors, not the company, to ensure that any enforcement action taken under section 384(3) is able to be applied to the directors individually, not the company.</p> <p>It is suggested that the details of the new rules and form require directors to set out: (1) the details of the breach, (2) how it was identified and rectified, (3) the steps taken to avoid a recurrence, and (4) the estimated costs or other consequences to the company, if any.</p> <p>It is suggested that consideration be given to making the initial disclosure of a breach reportable only to the SEHK/SFC. This would enable the SEHK/SFC to determine/confirm that the listing rules have been breached, and to make an appropriate decision as to what steps are warranted, such as requiring the issuer to correct the breach and/or to make an announcement, granting a waiver, or to consider imposing a sanction. The grounds on which the SEHK/SFC would exercise the foregoing should be clearly set out and be based on a premise of fostering good CG through appropriate transparency and regulatory discipline.</p> <p>As this recommendation proposes an annual declaration by directors, it can be combined with the annual declaration proposed in recommendation A4.5.1 "Legal status of CG-related disclosures".</p> <p>Some resistance may be expected from some quarters of the director community as it represents an increase in their personal liability.</p>
<p>Jurisdiction references</p>	<p>United States (Rules of NYSE and Nasdaq; Form S-K and Federal securities laws). Singapore. Mainland China. Hong Kong (director's dealing).</p>
<p>Section 3 reference</p>	<p>3.3.2 Disclosure of listing rule compliance. 3.6.1 Information disclosures generally.</p> <p>See also: 3.7.1 Impact of regulatory design; 3.7.3 Enforcement agencies.</p>

C4.5.3	Facts regarding director independence
Step required	Amend the listing rules to bring INED disclosures regarding independence within section 384 SFO.
Recommendation level	Compelling.
Topic addressed	<p>Independence is important and assessed by the SEHK based on facts provided in the "written confirmation" of the INED.</p> <p>However, the sanctions available to the SEHK for INEDs who provide misleading information are weak and do not include the ability to impose a fine.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. A new declarative form to be added to the listing rules for directors to use when stating the facts relevant to a determination of their independence. 2. The form will contain declarations confirming the correctness of the facts stated (but not any inference as to independence the SEHK may draw from those facts). 3. The form to contain the warning notice required by section 384(3)(b)(ii) SFO to bring it within the provisions of that section. 4. The form will be required to be submitted by INEDs annually together with the issuer's annual reports, i.e. by way of update that no relevant circumstances have changed.
Attendant considerations	<p>Under this approach, a relatively quick enforcement action can be taken by the SFC summarily before a magistrate, more egregious matters can be pursued under indictment.</p> <p>The SEHK's powers to sanction the director for a false disclosure remain intact.</p>
Jurisdiction references	<p>Hong Kong. United States. Mainland China.</p>
Section 3 reference	3.7.9 Determination of independence.

4.6	Regulators
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C4.6.1	SEHK to develop use of existing disciplinary power
Step required	SEHK to develop use of existing disciplinary powers. under MBLR 2A.09(10) and MBLR 6.04.
Recommendation level	Compelling.
Topic addressed	The SEHK's disciplinary powers are considered to have problems as regards their real effectiveness.
Details of recommendation	<p>1. The SEHK use its power under LR2A.09(10) to require issuers to "take, or refrain from taking, such other action as it thinks fit" to establish more effective disciplinary solutions that can work proactively.</p> <p>2. The SEHK use its power to impose resumption conditions on suspended issuers to establish more effective disciplinary solutions that can work proactively.</p> <p>3. In both cases, issuers can be required to take steps that address specific CG shortcomings. This can be combined with the SEHK's power under MBLR2A.09(6), which enables it to specify remedial action for breaches.</p> <p>4. For example, a more immediate reputational liability could be imposed on issuers and individual directors by requiring a statement as to what measures will be undertaken to ensure non-recurrence of a breach, or similar breaches, and to again report on their implementation within a defined period.</p>
Attendant considerations	<p>As these powers are ostensibly quite wide, their scope of use is open to further investigation.</p> <p>The use of the powers must remain within the scope of the contractual relationship between the issuer and the SEHK.</p>
Jurisdiction references	Hong Kong (Panel on Takeovers and Mergers).
Section 3 reference	<p>3.7.3 Enforcement agencies.</p> <p>See also: 3.7.1 Impact of regulatory design.</p>

A4.6.2	SFC to develop use of conditions when exercising existing SMLR powers
Step required	The SFC to expand use of existing powers under sections 6(3)(b) and 9(4) of the SMLR to impose conditions.
Recommendation level	Advocate.
Topic addressed	The topic of increasing the powers of the SFC in relation to listed companies is not a new one, and has attracted a high level of resistance in the past in part due to the legislative changes required.
Details of recommendation	<p>1. The SFC to use its existing powers under the SMLR to impose conditions on listing applicants and listed issuers that address specific CG shortcomings.</p> <p>2. The conditions to be more aligned with catalyzing improvements to CG standards – referred hereafter as “Catalyzing Conditions”.</p>
Attendant considerations	<p>The use of a Catalyzing Condition must be premised on a CG shortcoming or failure and be consistent with the empowering SMLR section.</p> <p>The potential range and use of Catalyzing Conditions requires further detailed examination.</p> <p>What precursors might be required before the SFC might use Catalyzing Conditions requires further detailed examination.</p> <p>Caution required to ensure Catalyzing Conditions do not result in rewriting the listing rules for some issuers so as to create a uneven playing field</p>
Jurisdiction references	<p>UK (LR 1.4.1 R).</p> <p>(However, see Recommendation C4.6.1 “SEHK to develop use of existing disciplinary power” reference to Hong Kong Takeovers Panel.)</p>
Section 3 reference	3.7.3 Enforcement agencies.

A4.6.3**	Calibrate SFC's powers under the SMLR
Step required	Amend SMLR.
Recommendation level	Support.
Topic addressed	<p>Breach of the listing rules (and CG Code) in general are only enforceable by the SEHK, however, the sanctions available to the SEHK are weak and do not include the ability to impose a fine.</p> <p>On the other hand, the SFC's enforcement powers only arise if there has been serious corporate wrongdoing. This leaves an enforcement gap.</p> <p>Previous attempts to give SFC an administrative fining power over issuers has failed.</p> <p>To explore the alternative kinds of power that could be given to the SFC by the legislature that may be more commercially acceptable.</p> <p>To propose a power that sits within its existing powers that may be a commercial "win-win-win" for the issuer, its shareholders and the market as compared to suspension.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. The SMLR is amended to give the SFC the power to impose, in lieu of suspension and subject to prior consultation with the Listing Committee, a fine. More mundane breaches of listing rules that do not impact on the public market <i>per se</i> would not give rise to the SFC's power to fine. 2. The SFC would be empowered to pair the fine with conditions that are to be met within a defined timeframe to avoid either a further fine or suspension. 3. The amount of the fine would be determined according to fining guidelines that are to be published by the SFC and could be referenced, for example, to market capitalization or share trading turnover. 4. Prior to imposing any fine, the SFC would need to provide the issuer with a warning notice that gives the issuer a specified brief period to make representations. 5. The issuer would be required to disclose any fine or conditions imposed by the SFC (but not any warning notice) together with the steps it is taking to resolve the same (save in exceptional circumstances). 6. The amendment to the SMLR could also provide for the SFC to issue a formal caution where the SFC is of the opinion that there have been sufficiently material breaches of the listing rules that, if left unchecked, could lead to it exercising its power to fine and/or direct a suspension of trading.

	<p>7. No change proposed is to alter the SFC's current powers under the SMLR to order suspension at any time.</p> <p>8. The SMLR may also be supplemented with a provision equivalent to section 201(3) of the SFO that allows the SFC to reach an agreed penalty with the issuer.</p> <p>9. Where directors do not take steps to meet conditions or reach a negotiated penalty, the SFC is empowered to impose a cold shoulder order (directors, controlling shareholder, their associates) until such time as shareholders have voted on the matter (excluding votes of directors, controlling shareholder, and their associates).</p>
Attendant considerations	<p>The design ensures a much more limited power than what has been previously proposed.</p> <p>Whether the fine can be applied to directors individually, for example, where they have breached the Directors' Undertaking.</p> <p>Other benefits of this limited scope of enforcement include:</p> <ul style="list-style-type: none"> - it provides the SFC intermediate options to impose discipline not as severe as suspension; - it may serve a corrective function without requiring recourse to the courts; - unlike suspensions, investors can continue to trade; - it could in practice operate as a precursor to suspension if corrective steps not undertaken; - it can assist publicize the SFC's expectations that issuers should comply with the listing rules as a matter of good CG.
Jurisdiction references	<p>UK. Singapore. China. United States (while SEC powers are not directed at the listing rules <i>per se</i> its powers broadly align with the foregoing jurisdictions as regards disclosure and fraud).</p>
Section 3 reference	<p>3.7.3 Enforcement agencies</p> <p>See also: 3.6.1 Information disclosures generally; 3.7.1 Impact of regulatory design.</p>

A4.6.4*	Statutory backing of certain listing rules
Step required	Undertake a public enquiry/consultation that re-examines the discussion on giving statutory backing to LR Chapters 4 (periodic financial reporting), 14 (notifiable transactions) and 14A (connected transactions).
Recommendation level	Advocate.
Topic addressed	<p>The proposal to give statutory backing to these provisions has been suggested in the past as a counter to the relatively weak disciplinary powers of the SEHK that stand in contrast to the degree of abuse that shareholders can be subjected to where they are breached.</p> <p>In the interim, the experience following the amendment of LR13.09 and the introduction of Part XIVA of the SFO has been conducive to improving transparency.</p> <p>While legal remedies for egregious breaches may be available in the courts, this is prone to uncertainty and complexity that create market inefficiency.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. The Financial Services and Treasury Bureau (FSTB), SFC and HKEX should reconnoitre the landscape, including detailed assessments of past problems under these Chapters of the listing rules. 2. Consideration to be given as to whether there is sufficient market consensus to undertake a new public consultation. 3. If there is unlikely to be sufficient consensus, consideration to be given as to whether the issue is important enough to Hong Kong's prosperity to seek guidance from the Government.
Attendant considerations	<p>Likely to be predictable negative reactions to the proposal.</p> <p>It will be important to distinguish the present exercise from the previous one based on an evolution of underlying conditions in the interim period.</p> <p>Going forward, it may be appropriate to review whether the civil liability under Part XIVA of the SFO has sufficiently encouraged listed companies to observe the disclosure requirement, and whether it would be necessary to introduce criminal liability (<i>cf.</i> Singapore under s 203 SFA) which was the original plan, dropped eventually due to fear of increased liability and resistance.</p>
Jurisdiction references	UK. Singapore.
Section 3 reference	3.7.3 Enforcement agencies.

E4.6.5*	Explore a narrow-channel cross-border enforcement arrangement
Step required	Policy-led initiative.
Recommendation level	Explore.
Topic addressed	<p>Cross-border enforcement against listed Mainland enterprises and their directors that breach applicable Hong Kong laws and regulations.</p> <p>Instances of non-enforcement has a negative effect on enterprises emerging from the Mainland as well as existing listed Mainland enterprises.</p>
Details of recommendation	<p>1. The HKSAR Government to explore the attitude of the relevant authorities in Mainland China to expanding the existing arrangements for reciprocal recognition and enforcement of judgments to create an arrangement specifically tailored to the public capital market.</p> <p>2. Ambit of arrangement to be considered, for example, breaches of an agreed scope of disclosure obligations (including financial mis-disclosure) and the enforcement of financial penalties and compensation orders by a court.</p> <p>3. Not to encompass criminal penalties.</p>
Attendant considerations	<p>There is no prospect for reciprocity under current conditions as Mainland China does not accept listings of foreign companies.</p> <p>Establishing a narrow-channel arrangement as proposed above may be a highly desirable precursor to the proposed IPO Connect.</p> <p>Requires long term planning and coordination at high levels of Government.</p>
Jurisdiction references	Hong Kong.
Section 3 reference	3.2.2 Non-locally incorporated companies.

No recommendation	Changes of control
<i>Issue considered</i>	<i>Whether statutory backing should be given to the Code on Takeovers and Mergers as has been done in the UK.</i>
<i>Reasoning</i>	<i>In the absence of (1) a broader policy change toward statutory regulation and (2) any clear indication that the Code on Takeovers and Mergers is lacking in effectiveness, there is no mandate for recommending any similar change to the legal standing of the Code on Takeovers and Mergers. Should either one of these factors appear to change, then a review of the legal nature of the code may be warranted.</i>
<i>Section 3 reference</i>	<i>3.4.4 Changes of control</i>

4.7	Ex ante mechanisms
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C4.7.1	Disclosure of CG standards in listing document
Step required	Amend Appendices 1 and 19 of the listing rules.
Recommendation level	Compelling.
Topic addressed	The listing applicant to be required to make a statement in the listing document cum prospectus as to its CG practices.
Details of recommendation	<p>1. Amend Appendix 1 to require a statement that aligns with the comply or explain disclosures required by CG Code.</p> <p>2. As the listing applicant has not previously been subject to the Code, some modification of the required disclosures will be appropriate.</p> <p>3. The required disclosures are to focus on explaining its current CG practices and how these will be developed in the period to its next annual report in view of the standards imposed and expected under the listing rules and the CG Code.</p> <p>4. The statement should indicate which provisions of the CG Code the listing applicant intends to comply with and which it does not intend to comply with.</p> <p>5. Appendix 19 (the sponsor declaration) should be amended to encompass an appropriate declaration in relation to the above matters.</p>
Attendant considerations	Nil.
Jurisdiction references	United States (Item 407 of Regulation S-K).
Section 3 reference	<p>3.7.8 Listing regime standards upon entry.</p> <p>See also: 3.6.1 Information disclosures generally; 3.2.2 Cross border enforcement and cooperation.</p>

E4.7.2	Develop role of compliance adviser
Step required	Amend listing rules (MBLR 3A.19-3A.24).
Recommendation level	Explore.
Topic addressed	Establishing good CG practices from the outset of an issuer's entry to the public market creates better prospects for CG standards post the end of this initial period.
Details of recommendation	<p>1. Requirements similar to those imposed on the sponsor-issuer appointment to be imposed on the compliance adviser appointment to make the role more active and engaged. For example, the compliance adviser could be required to undertake a quarterly audit on the internal reporting mechanisms and board processes.</p> <p>2. The scope of the compliance adviser's role should be reviewed with a view to expanding it to cover a wider range of CG-related processes. For example, this could cover board processes and shareholder communication.</p> <p>3. To require the compliance adviser role to be undertaken by one of the sponsors on the listing application.</p> <p>4. To introduce a compliance adviser declaration required to be submitted in advance of termination of the role, along similar lines as the sponsor's LR Appendix 19 declaration. The declaration to be subject to section 384(3) of the SFO.</p> <p>5. Where the declaration cannot be given: the role to be extended; to consider issuer consequences, e.g. announcement or whether could give rise to SMLR powers.</p>
Attendant considerations	<p>The sponsor market may not like this to the extent that the business model of the sponsor would not encompass a continuing engagement – e.g. where the sponsor is also the underwriter, accordingly, this may affect the selection of sponsors.</p> <p>To consider the appropriate liability attaching to an expanded compliance adviser role.</p>
Jurisdiction references	Mainland China.
Section 3 reference	<p>3.7.8 Listing regime standards upon entry.</p> <p>See also: 3.2.2 Cross border enforcement and cooperation.</p>

PART C	ARCHITECTURE AND POLICY
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Summary of main recommendations made

E4.8.1 proposes establishing a “CG Unit” based within a regulatory agency that would assist and coordinate CG policy development as well as providing an agency-based contact point for the collection of information; and an external “CG Group” of experts that would serve as a useful semaphore post between commercial needs/tolerances and regulatory insights/expectations. The location of the Unit and the Group could be the SFC, or the body suggested in E4.8.2**.

E4.8.2** proposes a new, unconflicted, regulatory agency empowered to bring an action for the benefit of shareholders.

A4.9.1 proposes that giving *ex post* transparency to the process of listing rule development between the SFC and SEHK would improve the understanding of listing rules – something that may become increasingly important as courts or tribunals come to be faced with the challenge of interpreting listing rules, the recent CITIC case being one such example.

E4.9.2* proposes that a consultation or public report should be undertaken that explores whether to implement laws that encourage whistle-blowing by providing protection to whistle-blowers, and whether this should be limited to specific circumstances such as, for the purposes of this Report, corporate misfeasance.

E4.9.3 proposes a clearer and more specific examination of what overarching objectives should drive the development of the Hong Kong market and the alternative mechanisms for shareholder protection that may need to develop in tandem with change, which may or may not go outside of the one-share-one-vote principle.

A4.9.4 proposes the voluntary adoption of a performance standard on response times by regulatory agencies.

4.8	Architecture
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E4.8.1	Establish a CG Unit and CG Group
Step required	Establish a regulatory agency based CG cum shareholder interest unit and an external industry group.
Recommendation level	Explore.
Topic addressed	Whether a specialized body that is concerned solely with CG policy development in view of minority shareholder concerns would facilitate CG policy development.
Details of recommendation	<p>1. The CG Unit to be charged with CG policy development based on information as to, for example, enforcement hurdles presented to individual investors that wish to bring a damages claim, with a view to better policy development on the problem.</p> <p>2. If established within the SFC, the CG Unit would coordinate across Divisions where specific issues such as listing rule development or CG enforcement affects the interests of shareholders.</p> <p>3. The CG Group to be comprised of external experts and industry participants from different sectors of the market with a view to exploring the commercial, legal and regulatory boundaries of important CG issues.</p> <p>4. The CG Group is to operate on an informal basis, providing input to the CG Unit as and when requested to do so.</p>
Attendant considerations	<p>To explore the parameters of such a CG Unit and how it would be funded.</p> <p>To identify the composition and operation of the CG Group.</p> <p>Location of group contingent on implementation of A4.8.2** "Establish an investor protection agency".</p>
Jurisdiction references	<p>United States (SEC's Office of the Investor Advocate and the Investor Advisory Committee).</p> <p>Hong Kong (SFC's Risk and Strategy Unit, and the Fintech Advisory Group).</p>
Section 3 reference	3.7.2 Policy development agencies.

E4.8.2**	Establish an investor protection agency
Step required	Policy-led initiative.
Recommendation level	Explore.
Topic addressed	An unconflicted representation of shareholder rights by a body not presented with the same constraints and considerations as the SFC.
Details of recommendation	<ol style="list-style-type: none"> 1. An expert group to be appointed by the Government and mandated to consider the benefits and drawbacks of establishing an investor protection agency. 2. To consider the primary legislation needed. 3. The agency would need to be empowered to bring actions under sections 213 and 214 of the SFO. 4. The agency would need to possess appropriate powers of investigation that are aligned with those possessed by the SFC. 5. The agency would need to have appropriate access to information held by other regulatory agencies including the SFC and the HKMA. 6. The agency would need to enter into MoUs with other regulatory agencies for appropriate coordination on matters of common interest. 7. To explore details of the agency's objectives, powers, accountability, governance, staffing and funding.
Attendant considerations	<p>Dealing with likely resistance from the SFC and the market.</p> <p>The SFC's existing powers remain intact.</p>
Jurisdiction references	United States (Consumer Financial Protection Bureau).
Section 3 reference	<p>3.7.3 Enforcement agencies</p> <p>See also: 3.7.2 Policy development agencies; 3.7.6 Role of fiduciary law.</p>

4.9	Policy
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A4.9.1	Transparency of listing rule development
Step required	Adoption by SFC and SEHK of transparency policy on listing rule development.
Recommendation level	Advocate.
Topic addressed	<p>Courts and tribunals are increasingly being required to consider the intended purpose of regulatory requirements.</p> <p>Explanations of purpose and likely effect of proposed new listing rules are not, following its implementation, currently made publicly available.</p> <p>Enforcement of listing rule requirements is expected to develop toward a more effective system.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. Once a new listing rule has been approved, the SEHK's explanation of its purposes and effect, as finalized following the SFC's response to it, must be made public. 2. Publication would be made after a defined short period following the announcement of the new rule. 3. The new requirement to be implemented by the SFC and SEHK adopting a transparency policy. 4. The policy to address scope of permissible redactions.
Attendant considerations	<p>Ensuring that the secrecy provisions of section 378 of the SFO applying to the SFC are not triggered.</p> <p>To consider whether previous materials should be publicly released.</p> <p>Alternatively, the obligation to publicly disclose could be imposed via subsidiary legislation under the SFO.</p>
Jurisdiction references	Nil.
Section 3 reference	3.7.2 Policy development agencies.

E4.9.2*	Whistle-blowing
Step required	Public enquiry/consultation.
Recommendation level	Explore.
Topic addressed	Introduction of whistle-blowing laws that encourage whistle-blowing by providing protection to whistle-blowers.
Details of recommendation	1. Financial Secretary/FSTB to initiate a public consultation or commission an expert group to undertake a report on whistle-blowing.
Attendant considerations	Whether the consultation should be limited to specific circumstances such as, for the purposes of this Report, corporate misfeasance etc. The role of financial incentives in whistle-blowing.
Jurisdiction references	UK. United States. Mainland China.
Section 3 reference	3.7.13 Whistle-blowing.

E4.9.3	Market development
Step required	Policy-led initiative.
Recommendation level	Explore.
Topic addressed	<p>Proposals to develop the market (such as allowing weighted voting rights, etc) should be repositioned around more fundamental market objectives.</p> <p>Given Hong Kong’s growth over the last three decades, there is a need to identify the overarching objectives that should drive the development of the Hong Kong market and how might this impact on shareholder protection.</p> <p>What mechanisms for shareholder protection may need to develop in tandem with change need to be more openly addressed.</p>
Details of recommendation	<ol style="list-style-type: none"> 1. An expert group to be appointed by the Government and mandated to establish the key factors relevant to the development of Hong Kong’s capital market over the next stage of its evolution. 2. The overarching market objectives to be based on the constitutionally-defined role of Hong Kong as an international financial centre. 3. The relevance of CG in market development should be clearly established from the outset and what changes may need to be made in Hong Kong’s CG system to maintain or improve current standards be considered accordingly. 4. Based on the expert report, Government to undertake appropriate policy-led initiatives.
Attendant considerations	The identification and inclusion of relevant stakeholders.
Jurisdiction references	Nil.
Section 3 reference	3.5 Equality.

A4.9.4	Response time to public enquiries/consultations
Step required	Voluntary adoption of performance standard by regulatory agencies.
Recommendation level	Advocate.
Topic addressed	That regulatory agencies be encouraged to adopt a voluntary code to respond in a timely manner to public enquiries and consultations undertaken by them as there have been some instances of long delays for undisclosed reasons.
Details of recommendation	<p>1. The adopted standard to require the agency to respond to the recommendation or consultation responses within a specified minimum period of time (for example, which would be not more than one year).</p> <p>2. Where that date cannot be met then a detailed reason must be provided explaining the scope of work undertaken and the steps put in place to respond or provide a further update by a subsequent date (for example, which would be not more than half of the initial period).</p>
Attendant considerations	As the code is voluntary and could be adopted by a variety of agencies, there is a question of who should issue it - the Office of the Ombudsman is a possible suggestion.
Jurisdiction references	Nil.
Section 3 reference	3.7.2 Policy development agencies.

4.10	Summary tables
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This section presents two summary tables.

Table 1 lists out all the recommendations made by part, i.e. according to their order discussed in the above sections concerning board processes, enforcement, and architecture & policy.

Table 2 groups the recommendations according to their classification, i.e. Compelling, Advocate, Support, Explore. The total number of types of recommendations in each category is shown at the foot of Table 2.

TABLE 1 - SUMMARY OF ALL RECOMMENDATIONS – BY PART**PART A – THE BOARD****4.1 Processes**

C4.1.1	Board evaluation
A4.1.2	Transparency of performance related executive remuneration
A4.1.3 ⁺	Disclosures of the audit committee
A4.1.4	Status of the audit committee

4.2 Independent directors

A4.2.1	Sufficient INED time
A4.2.2	Basis of INED remuneration
A4.2.3	INED training
C4.2.4	NED Code and INED reporting

4.3 CG standards

C4.3.1	Relevant issuers to be subject to “Elevated Standards”
S4.3.2	Disclosure of non-compliance with issuer’s disclosed CG practices

PART B – ENFORCEMENT**4.4 Shareholders**

S4.4.1	Shareholders as beneficiaries of listing rules
A4.4.2*	Collective redress

4.5 CG disclosures

A4.5.1 ⁺	Legal status of CG-related disclosures
C4.5.2 ⁺	Status of listing rule compliance and related disclosures (continuing)
C4.5.3	Facts regarding director independence

4.6 Regulators

C4.6.1	SEHK to develop use of existing disciplinary power
A4.6.2 ⁺	SFC to develop use of conditions when exercising existing SMLR powers
A4.6.3** ⁺	Calibrate SFC’s powers under the SMLR
A4.6.4*	Statutory backing of certain listing rules
E4.6.5* ⁺	Explore a narrow-channel cross-border enforcement arrangement

4.7 Ex ante mechanisms

C4.7.1 ⁺	Disclosure of CG standards in listing document
E4.7.2 ⁺	Develop role of compliance adviser

PART C – POLICY AND ARCHITECTURE**4.8 Architecture**

E4.8.1	Establish a CG Unit and CG Group
E4.8.2**	Establish an investor protection agency

4.9 Policy

A4.9.1	Transparency of listing rule development
E4.9.2* ⁺	Whistle-blowing
E4.9.3	Market development
A4.9.4	Response time to public enquiries/consultations

TABLE 2 – SUMMARY OF ALL RECOMMENDATIONS – BY TYPE

	Board processes	Enforcement	Architecture & policy	
Compelling	C4.1.1	Board evaluation		
	C4.2.4	NED Code and INED reporting		
	C4.3.1	Relevant issuers to be subject to “Elevated Standards”		
	C4.5.2 ⁺	Status of listing rule compliance and related disclosures (continuing)		
	C4.5.3		Facts regarding director independence	
	C4.6.1		SEHK to develop use of existing disciplinary power	
	C4.7.1 ⁺		Disclosure of CG standards in listing document	
Advocate	A4.1.2	Transparency of performance related executive remuneration		
	A4.1.3 ⁺	Disclosures of the audit committee		
	A4.1.4	Status of the audit committee		
	A4.2.1	Sufficient INED time		
	A4.2.2	Basis of INED remuneration		
	A4.2.3	INED training		
	A4.4.2*		Collective redress	
	A4.6.3** ⁺		Calibrate SFC’s powers under the SMLR	
	A4.5.1 ⁺		Legal status of CG-related disclosures	
	A4.6.2 ⁺		SFC to develop use of conditions when exercising existing SMLR powers	
	A4.6.4*		Statutory backing of certain listing rules	
A4.9.1		Transparency of listing rule development		
A4.9.4		Response time to public enquiries/consultations		
Support	S4.3.2	Disclosure of non-compliance with issuer’s disclosed CG practices		
	S4.4.1		Shareholders as beneficiaries of listing rules	
Explore	E4.6.5* ⁺		Explore a narrow-channel cross-border enforcement arrangement	
	E4.7.2 ⁺		Develop role of compliance adviser	
	E4.8.1		Establish a CG Unit and CG Group	
	E4.8.2**		Establish an investor protection agency	
	E4.9.2* ⁺		Whistle-blowing	
E4.9.3		Market development		
	Compelling	Advocate	Support	Explore
Board	3	6	1	-
Enforcement	4	5	1	2
Arch. and policy	-	2	-	4

Section 5	CONCLUDING REMARKS
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5.1	The recommendations
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Introduction

The make-up and rapid evolution of the Hong Kong market raises complex issues, many of which were discussed in Section 3 in the context of the practices and experiences in the other jurisdictions studied. The recommendations presented in Section 4 have addressed the board and its processes and standards, the enforcement regime (including for both shareholders and regulators), the regulatory oversight of non-Hong Kong incorporated companies, and matters concerning system architecture and policy.

5.1.1 The board

Ten recommendations propose improvements to board processes that will foster transparency and accountability, including in relation to the undertaking of the independent director role.

The findings of the Cadbury Committee pointed to the importance of the board and its role in a company's decision-making. While attention has focused on the effectiveness of the board and its processes, all too often it remains the case that the boardroom remains a black box to shareholders. This Report has considered board evaluation and board refreshment as important mechanisms that underpin accountability to shareholders. It has also considered the one-share-one-vote (OSOV) principle, in particular, its relationship to proposals to allow companies with weighted voting right share structures to list, as well as to existing public regulatory provisions that override the equality implicit in the OSOV principle, including dual voting in the UK.

The idea of independent directors bringing in expertise, improving the quality of board oversight and acting as a guard against potentially damaging conflicts of interest is intuitively a good one. However, despite reform over the years, the independent director system has not worked well in Hong Kong. One possible explanation could be that the independent director concept is a product of an "outsider" system and does not fit well into the "insider" system that dominates the Hong Kong market. The problems include their appointment by controlling shareholders, low compensation, uneven quality and insufficient contribution to their companies. What is more difficult is the culture of not trusting an "outsider" in an "insider" system. Thus, independent directors are often chosen by controlling shareholders from a circle of friends and are not expected to ask difficult questions. There is not a lot one can do to change this culture overnight. However, some changes can help make the system of independent directors work better and more transparently. This requires a holistic approach to the undertaking of independent non-executive directors (INEDs) that encompasses their skills, their responsibilities, their remuneration, and the liability that attaches to their role.

There has been a lot of attention on the requirements and effectiveness of the audit committee since its introduction by the Cadbury Code in the UK in 1992. This intensified after the Sarbanes-Oxley Act mandated in 2002 the creation of audit committees in the United States – the requirements having been further developed by Dodd-Frank and the Securities and Exchange Commission's implementing rules in 2011. Unlike the United States, the audit committee in Hong Kong is only compulsory under the listing rules, not a legal requirement, and it undertakes its work within the confines of their sub-committee status with relatively little independence from the board. Hong Kong needs to do more to fortify the role of the audit committee.

Good corporate governance (CG) standards in the present era are significantly set according to listing rules that may include non-mandatory standards. Many of the largest issuers in each of the jurisdictions studied choose to comply with non-mandatory standards, including many recommended best practices. These issuers can be seen as vanguards that set standards others should follow. This presents opportunities to create stronger associations between successful companies and the adoption of higher CG standards to which others may aspire.

Other listing rule requirements are mandatory, which raises the question of shareholder expectations and what rights if any should be derived from those expectations, particularly where they are not met. This is discussed in the context of enforcement.

5.1.2 Enforcement

Twelve recommendations are concerned with the ability of shareholders and regulators to conduct meaningful, and graded, enforcement where CG standards fall below standards. The presence of a significant enforcement lacuna in respect of issuers in breach of CG standards set by the listing rules is an area where Hong Kong is clearly in need of reform.

Shareholders have been provided with rights in relation to various types of corporate and insider wrongdoing, however, they have a diminished ability to exercise those rights as compared to shareholders in the other jurisdictions studied. On the other hand, they are given no rights in relation to the listing rules, despite it being acknowledged that disclosures required by the listing rules are important in relation to investment decisions. The UK and Singapore both provide for shareholder actions for damages in respect of disclosure breaches of the listing rules. In the United States, shareholders may have claims either under Federal or State fiduciary law. The United States also provides for class action rights and contingency fees. This Report has made recommendations pertaining to each of these issues, one in respect of the listing rules that does not require legislative change, the other concerning improving the means of collective redress.

Shareholders in Hong Kong have generally come to rely on the regulatory agencies to pursue the wrongdoing company on their behalf, more so than in the other jurisdictions studied. To the extent that The Stock Exchange of Hong Kong Limited (SEHK) is effectively enforcing the listing rules and the CG Code is being meaningfully implemented, it may be less urgent to give shareholders the right to enforce listing rules. However, regulatory effectiveness is lacking. Regulatory agencies have been provided with a range of powers but they are not sufficiently comprehensive to create regulatory efficiency and avoid a gap between powers that are either too weak and ineffective, or powers that are too strong and resource consuming. Although the Securities and Futures Ordinance (SFO)⁵¹⁶ covers some areas (such as disclosure of inside information, disclosure of directors' shareholding interest, etc.), the listing rules and the CG Code are important sources of standards. More than three-quarters of listed issuers are incorporated in a jurisdiction outside of Hong Kong⁵¹⁷ and so are not subject to the standards in the Companies Ordinance (CO).⁵¹⁸ The adequacy of the listing rules and their enforcement in these circumstances become of crucial importance, yet this is perhaps the weakest link in Hong Kong's CG system.

The debate as to whether certain powers to set standards and enforce them should be removed from Hong Kong Exchanges and Clearing Limited (HKEX) remains controversial.

⁵¹⁶ Cap. 571

⁵¹⁷ As at 16 October 2016 based on the address of incorporation of all listed issuers. Data sourced from the Osiris database.

⁵¹⁸ Cap. 622

This Report has made recommendations on how to close the enforcement lacuna and improve regulatory efficiency without invoking changes to the fundamental dual responsibilities model of regulatory oversight. A number of the recommendations seek to either activate extant powers of the Securities and Futures Commission (SFC) or SEHK that are not well utilised, or to bring other administrative powers to bear on CG sensitive topics. An example of the latter is the suggestion that various disclosures made by issuers and their directors should be made on forms that bring the disclosure within section 384(3) of the SFO. This section is concerned with the provision of false or misleading information to regulatory agencies in the performance of their statutory functions. Section 384(3) is not fixed to any particular disclosure but is designed to be used by regulatory agencies to safeguard their undertaking. Although applying the section to a new use does not require any legislative change, it has not been extensively utilised. This Report recommends that both the SFC and the SEHK can and should use this legislative facility more actively.

This Report has also considered the roles of the sponsor and the compliance adviser in relation to listing applicants and newly listed issuers as part of a set of *ex ante* mechanisms, including the listing rule requirements applying to listing applicants, which can be strengthened to support a better CG system.

5.1.3 Architecture and policy

Six recommendations address regulatory architecture and policy development that would work better to serve the interests of shareholders and the market.

Hong Kong's three-tier regulatory structure, which has operated since 1989, has been a subject of regular reviews and criticisms. This includes the report of the Panel of Inquiry on the Penny Stocks Incident in 2002, the report of the Expert Group in 2003, attempts by the Financial Services and Treasury Bureau and the SFC over 2003 to 2005 to remove parts of the listing rules from the oversight of the SEHK to the SFO where they would be subject to the oversight of the SFC and, most recently, following the SFC/HKEX joint consultations on listing governance in 2016 and 2017. At each of these junctures, suggestions to alter the existing oversight of the listed market are highly controversial.

While some of the shortcomings identified by this Report arise out of the dual responsibilities model of regulatory oversight of the listed market, the problems are not exclusive to the model. This Report has explored other more practical ways in which the current system can be improved without a major overhaul, including a number of enforcement-related recommendations that sit within the existing dual filing regime. None of the recommendations made require fundamental changes to the model. However, the suggestion is made that for the model to function efficiently there must be an appropriate balance between market self-discipline and regulatory oversight that is not static but is dynamic and responsive to market developments.

5.1.4 Non-Hong Kong incorporated companies

A major residual challenge is how to regulate companies that are not incorporated in Hong Kong. Given the substantial presence of Mainland enterprises listed on the SEHK, the relationship between Hong Kong and the Mainland is of particular interest. Although there is a memorandum of understanding (MoU) between the SFC and the China Securities Regulatory Commission (CSRC) that facilitates cross-border cooperation, where criminal investigation is involved the CSRC does not have power to conduct investigations - only the Mainland police have such power but there is no MoU between the SFC and the Mainland police. Mainland enterprises that are not also listed or incorporated in Mainland China are not subject to the oversight of Mainland agencies including the CSRC. While the use of MoUs between the CSRC and the SFC have been helpful in building important relationships that foster mutual understanding and

cooperation, they are fundamentally limited by the scope of the MoU and the powers possessed by the parties to the MoU.

The problem of cross-border cooperation is not unique to Hong Kong – regulatory agencies in the United States have experienced similar difficulties both before and after MoUs have been established. However, Hong Kong possesses a unique advantage by virtue of being a separate legal jurisdiction from the Mainland yet co-existing with the Mainland under the sovereign state of China. It already has one arrangement in place with the Mainland regarding the reciprocal recognition and enforcement of judgments, and this may provide a basis on which to develop a further arrangement that specifically covers the public capital market – indeed, this seems necessary in order to go beyond the inherent constraints of the MoU approach

Although there is nothing Hong Kong can do unilaterally to resolve the cross border enforcement difficulties non-Hong Kong incorporated companies present, other measures can and have been taken locally that apply to issuers wherever incorporated. Gateway mechanisms in the listing rules include requiring companies to, where necessary, amend their articles to provide for minimum standards of shareholder protection, and providing for a higher level of responsibility on sponsors of listing applicants incorporated in Mainland China. The listing rules, and the provisions of the CO concerning statutory derivative action and unfair prejudice also apply to all issuers wherever incorporated. These arrangements already go further in certain regards than other markets, such as the United States, where foreign private issuers are subject to reduced disclosure requirements and where an important base of many shareholder lawsuits – State laws – is absent. Nine of the recommendations in this Report assist with *ex ante* enforcement concerns against non-Hong Kong incorporated companies. One additional recommendation is specific to cross border enforcement in the context of Mainland enterprises.

5.2**The Hong Kong market****5.2.1 Characteristics**

The SEHK is now the third largest stock exchange in Asia, the sixth largest in the world in term of its market capitalisation, and it is often the largest initial public offering marketplace. However, this growth has been relatively recent when compared to well-established markets such as the United Kingdom (UK) and the United States. Hong Kong's CG system can today be characterized as having significantly caught up with, and in some cases exceeded, international best practices. Nevertheless, it remains subject to distinct features. Its regulatory architecture of listed company oversight via the dual responsibilities model is somewhat unique, requiring some caution when considering developments in the UK and the United States, each of which possess regulatory architectures different from the other in important ways. While Hong Kong has in the past lacked depth in its corporate and securities laws and court rulings that develop them, this can no longer be said to be the case. Statutory laws and the rulings or determinations of the courts and the Market Misconduct Tribunal, as well as non-statutory codes and the activity of regulatory agencies, have developed at a pace that has in general been adequate to keep abreast of the growth of the market, although some intractable difficulties remain in relation to enforcement against non-Hong Kong incorporated issuers that have engaged in egregious wrongdoing. The specific issue of shareholder rights and protections is also subject to characteristics of the Hong Kong market that are distinct from other markets, including the following.

First, as already noted above, over three-quarters of listed issuers are incorporated in a jurisdiction outside of Hong Kong. The CG standards of listed companies established under the laws of another jurisdiction will be partly set by those other laws, and partly by Hong Kong's laws and regulations. This includes the listing rules (and its CG Code), the relevant provisions of the SFO, and the parts of the CO concerning derivative actions and unfair prejudice. The SEHK is active in enforcing the listing rule requirements, though is subject to regular criticism from different segments of the market that its approach is too light handed, possibly as a result of inadequate conflict management by HKEX. The SFC has been active in bringing many successful actions under the SFO against non-Hong Kong incorporated issuers, for example, in relation to disclosures and director misfeasance. To date, there has already been one case successfully commenced by way of statutory derivative action under the CO unfair prejudice provisions against a listed issuer incorporated in the Cayman Islands.⁵¹⁹ While in general Hong Kong has adopted approaches to non-local companies equivalent or better than international best practices, the question remains as to whether the approach in Hong Kong is adequate to ensure Hong Kong and non-Hong Kong incorporated companies are subject to minimum acceptable CG standards.

Second, it is significantly dominated by Mainland enterprises in terms of number of issuers and their contribution to turnover and total market capitalization. Mainland enterprises are coming from a jurisdiction where the market ideology, political system and political economy, legal institutions and legal system, CG culture, and regulatory system are very different from Hong Kong. This presents challenges in understanding how these companies will respond to the CG standards of Hong Kong. For example, Hong Kong law requires directors to act in the best interest of the shareholders but in state-owned enterprises (SOEs) the Chinese Communist Party can exercise influence over them through the state council and State-owned Assets Supervision and Administration Commission of the State Council by appointing and removing them –

⁵¹⁹ See Section 3.2.1

accordingly there is likely to be political interference in the board's decision-making process that may not be in the interests of the shareholders as a whole. Indeed, SOEs are now primarily regarded by the central Government as "party organs in leadership and political affairs."⁵²⁰

Third, many non-Hong Kong incorporated issuers do not have a physical presence in Hong Kong, which presents additional hurdles in enforcing Hong Kong standards against these companies without the co-operation of relevant overseas agencies – such co-operation is needed if relevant individuals or assets are located in another jurisdiction. Enforcement in the Mainland is difficult in this regard owing to the absence of an applicable cross border enforcement arrangement.

Fourth, the majority of listed issuers in Hong Kong are characterised by dominant majority shareholders who are either the founders of the companies, or the State. This is commonly known as an "insider" system. Yet, as discussed in Sections 1 and 3 of this Report, Hong Kong has in the past adopted many of the CG practices from the UK and the United States where many of the listed companies in their respective traded stock markets do not have dominant shareholders – they are markets commonly described as an "outsider" system. In the outsider system, there is more likely to be managerial abuses given that there is no dominant shareholder to watch over the managers. Whereas in the insider system, managerial abuse is unlikely to occur where the dominant shareholders are the individual founders, what tends to happen instead is the diversion of company assets to the hands of dominant shareholders through related party transactions. Where the dominant shareholder fails to monitor the managers, managerial abuse may be more likely to occur. This raises interesting questions whether the practices from an outsider system can fit in well with the insider system and be effective to achieve the regulatory objectives. For example, is an independent director system transplanted from an outsider system likely to work in an insider system? UK and United States practices may work in companies that are dominated by a controlling shareholder that fails to monitor but may not work well in enterprises with controlling shareholders that control the enterprises.

Finally, many shareholders in Hong Kong listed issuers who are in need of the greatest protection have very little interest in CG standards and instead regard their shareholding as an investment in the business acumen of the founding shareholder and/or the directors. A not insignificant portion of these trade on the basis of rumour and gossip. In both cases they implicitly rely to some extent on transparency in order to exercise their investment decision. To a large extent they expect that regulators are keeping the market in check to make it fair. In short, they do in fact rely on an effective CG system. However, corporate wrongdoing is unlikely to be met with shareholder lawsuits seeking redress. Many investors either consider that regulators are acting as their proxy to identify and deal with wrongdoing, or instead appear to have become accustomed to treating CG failings that impact on share price as a bad investment that needs to be sold. Larger institutional investors are of course different, and to the smaller investor they may represent a different proxy for shareholder interests more generally.

These characteristics lead to complex questions that directly and indirectly affect shareholder rights and protections. Are board processes of issuers (wherever incorporated) sufficiently subject to shareholder oversight? In what ways are directors of issuers accountable to shareholders, and is this effective and operational? What other checks on a board's powers are required and effective? Is the dual responsibilities model of regulatory oversight fit for purpose? Are the regulatory agencies appropriately empowered and effective? Are the standards in the listing rules adequate and subject to effective mechanisms of enforcement? Is the comply or explain approach appropriate in the East Asian context? How well, or poorly is cross border cooperation working to

⁵²⁰ Per Xi Jinping (President of the People's Republic of China), as reported in SCMP.com 12 October 2016

achieve shared objectives? Many of these questions have been considered by this Report, which has led to recommendations intended to improve Hong Kong's CG system.

The trend of admitting Mainland and other non-Hong Kong incorporated enterprises to listed status in Hong Kong will continue as HKEX seeks to tap into technology and new economy businesses, Mainland enterprises look for expansion overseas, and Belt and Road Initiative-related companies seek capital. Thus, it will be an ongoing priority for Hong Kong as an international financial and fund raising centre to examine and develop its CG system in tandem with the continued evolution of the market.

5.2.2 Work in progress

While this Report has considered many issues in the areas of shareholder rights, remedies and protections and regulation of non-Hong Kong incorporated companies, it has not been possible to provide an answer or recommendation for all the issues discussed. It has also not been possible to render this Report as a complete treatise on all issues of relevance to the CG discussion. The study has focused on key differences and observations of interest between Hong Kong's CG system and the systems in four other jurisdictions. The scope of this Report has also meant that other matters which to greater or lesser degrees directly or indirectly affect shareholders have not been discussed, such as board diversity, environmental and social governance and the relationship between CG standards and share price performance.

As this Report has engaged in a comparative analysis focused on the current regulatory position and recent developments, it has not touched on all the factors required for change to occur. Instead, the classification of each recommendation incorporates concepts of market reaction and complexity of implementation in recognition of the reality that some of the changes proposed will require more political will and a greater degree of market support than others.

Going forward, while no major overhaul of the system has been recommended, the 28 recommendations in Section 4 would, if implemented, go some distance to improving the standards and effectiveness of Hong Kong's CG system. While no amount of reform can prevent corporate scandals altogether, one can strive to make them less likely, less damaging and subject to more effective means of redress. Agreeing on acceptable standards of good CG and developing an effective CG system that supports them remains, as ever, a work in progress.

LIST OF ABBREVIATIONS

Abbreviations used in relation to specific jurisdictions are included in separate sections further below.

1933 Act	Securities Act of 1933
1934 Act	Securities Exchange Act of 1934
ACCA	Association of Chartered Certified Accountants
ACGA	The Asian Corporate Governance Association
ACGS	ASEAN Corporate Governance Scorecard
AGM	Annual General Meeting
CCASS	Central Clearing and Settlement System
CCP	Chinese Communist Party
CEO	chief executive officer
CFO	chief financial officer
CFPB	Consumer Financial Protection Bureau
CG	corporate governance
CG Code	the code on corporate governance adopted by the relevant jurisdiction (see the specific definition given for each jurisdiction)
CO	Hong Kong's Companies Ordinance (cap. 622)
CSRC	China Securities Regulatory Commission
CWUMPO	Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)
Dodd Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
DTR	Disclosure Guidance and Transparency Rules
ESG	Environmental, Social and Governance
EU	European Union
Exchange	a stock exchange in the relevant jurisdiction
FAQs	Frequently asked questions
FCA	Financial Conduct Authority (UK)
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSB	Financial Stability Board
FTSE	FTSE Index series
FTSE350	FTSE 350 Index
GAAP	Generally Accepted Accounting Principles
GEM	Growth Enterprise Market
GFC	global financial crisis
HKD	Hong Kong dollar
HKEX	Hong Kong Exchange and Clearing Limited
HKICPA	Hong Kong Institute of Certified Public Accountants
HKMA	Hong Kong Monetary Authority
HKSAR	Hong Kong Special Administrative Region
HSCEI	Hang Seng China Enterprises Index
HSI	Hang Seng Index
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
INED	independent non-executive director
IOSCO	International Organization of Securities Commission
IOSCO MMoU	IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information
IPO	initial public offering
KPIs	Key performance indicators
LegCo	Legislative Council (Hong Kong)

listing rules	refers to the listing rules or requirements that govern the listing of an issuer's securities on the relevant Exchange
LR	listing rules
LRC	Law Reform Commission
LSE	London Stock Exchange
Mainland	Mainland China
Mainland China	People's Republic of China excluding the HKSAR
MAS	Monetary Authority of Singapore
MBLR	Main Board Listing Rules
MMoU	Multilateral Memorandum of Understanding
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MMT	Market Misconduct Tribunal
Nasdaq	National Association of Securities Dealers Automated Quotations
NED	Non-executive director
NYSE	New York Stock Exchange LLC
OECD	Organisation for Economic Co-operation and Development
PCAOB	Public Company Accounting Oversight Board in the United States
PRC	People's Republic of China
RBP	Recommended Best Practice
RMB	Renminbi
SCCLR	Standing Committee on Company Law Reform
SEC	Securities and Exchange Commission
SEHK	The Stock Exchange of Hong Kong Limited
SFAT	Securities and Futures Appeals Tribunal
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571)
SGX	Singapore Exchange Limited
SIFI	systemically important financial institution
SME	Small and Medium Enterprise
SMLR	Securities and Futures (Stock Market Listing) Rules (Cap. 571V)
SOE	state-owned enterprise
SOX	Sarbanes-Oxley Act of 2002
SRO	Self-Regulatory Organisation
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
UK	United Kingdom
UKLA	UK Listing Authority
USD	United States dollar
WVR	weighted voting rights

LIST OF ABBREVIATIONS – Hong Kong

AI	Authorised Institution
AIMA	Alternative Investment Management Association
ASIFMA	Asian Securities Industry and Financial Markets Association
BO	Banking Ordinance (Cap. 155)
CA/CA 2006	Company Act 2006
CE	Chief Executive
CG-1	Corporate Governance of Locally Incorporated Authorised Institutions (HKMA)
CG Code	Corporate Governance Code and Corporate Governance Report
CG Report	Corporate Governance Report
CHKLC	Chamber of Hong Kong Listed Companies
CMT	Compliance and Monitoring Team

CP	Corporate Governance Code Provision
CPERS	City-Parish Employees' Retirement System
CR	Companies Registry
DFR	dual filing regime
FRCO	Financial Reporting Council Ordinance (Cap. 588)
FS	Financial Secretary
FSDC	Financial Services Development Council
FSTB	Financial Services and Treasury Bureau
GEMLR	GEM Listing Rules
GEM Listing Rules	Rules Governing the Listing of Securities on the Growth Enterprise Market on the Stock Exchange of Hong Kong Limited
HK CG Code	Corporate Governance Code and Corporate Governance Report
HKFE	Hong Kong Futures Exchange Limited
HKFRS	Hong Kong Financial Reporting Standards
HKGCC	Hong Kong General Chamber of Commerce
HKICS	Hong Kong Institute of Chartered Secretaries
HKIoD	Hong Kong Institute of Directors
HKIRA	Hong Kong Investor Relations Association
HKSA	Hong Kong Standards on Auditing/Hong Kong Securities Association
HKSII	Hong Kong Securities and Investment Institute
H-share companies	Chinese incorporated companies listed on the SEHK
IA	Insurance Authority
ICGN	International Corporate Governance Network
IO	Insurance Companies Ordinance (Cap. 41)
Judge's Report	The Best Corporate Governance Awards 2016 – Judges Report (HKICPA)
JPS	Joint Policy Statement
LEAs	auditors of listed issuers
LET	Listing Enforcement Team
Listing MoU	"Memorandum of Understanding Governing Listing Matters" between the SFC and SEHK
LPP	Listing Policy Panel
Main Board Listing Rules	Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited
MCA Guideline	Guideline on "Minimum Criteria for Authorization" (HKMA)
Model Code	Model Code for Securities Transactions by Directors of Listed Issuers
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
MPFSO	Mandatory Provident Fund Schemes Ordinance
New JPS	Joint Policy Statement Regarding the Listing of Overseas Companies
ORO	Official Receivers Office
PAO	Professional Accountants Ordinance (Cap. 50)
PRP	Process Review Panel
PwC	PricewaterhouseCoopers
regulated persons	licensed or registered firms and licensed persons
SEHK Policy Statement	"The Enforcement of the Listing Rules – Policy Statement" published by the SEHK in 2013 and revised in February 2017
SPM	Supervisory Policy Manual (HKMA)
the CR Guide	non-statutory "A Guide on Directors' Duties" published by the CR
the ESG Guide	the Environmental, Social and Governance Reporting Guide
the Scheme	Scheme of Arrangement or Compromise that shareholders or creditors can apply to reorganize the company's share capital by consolidating or dividing different share classes

the SEHK review annual reviews of disclosure compliance with the CG Code conducted by SEHK

LIST OF ABBREVIATIONS – United Kingdom

ABI	Association of British Insurers
AIM	Alternative Investment Market
AIMA	Alternative Investment Management Association
Alliance	Alliance Trust
APPCGG	All-Party Parliamentary Corporate Governance Group
BEIS	Department of Business Energy & Industry Strategy
BIS	Department of Business, Innovation & Skills
BoE	Bank of England
CA/CA 2006	Companies Act 2006 (Cap. 46)
CIIA	Chartered Institute of Internal Auditors
CIMA	Chartered Institute of Management Accountants
CRR Committee	Corporate Reporting Review Committee
DEPP	Decision Procedure and Penalties manual
ECGI	European Corporate Governance Institute
ENRC	Eurasian Natural Resources Corporation plc
EY	Ernst & Young
FOS	Financial Ombudsman Service
FSA (BR)	Financial Services (Banking Reform) Act 2013
FSMA	Financial Services and Markets Act 2000
IA	Investment Association
IBE	Institute of Business Ethics
ICAEW	Institute of Chartered Accountants for England and Wales
ICGN	International Corporate Governance Network
ICSA	Institute of Chartered Secretaries and Administrators
IFoA	Institute and Faculty of Actuaries
IIA Global	Institute of Internal Auditors
IMA	Investment Management Association
IoD	Institute of Directors
ISS	Institutional Shareholder Services
LMCG Regulations	Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008
NAPF	The National Association of Pension Funds
PE	Private equity
PIDA	Public Interest Disclosure Act 1998
PIRC	Pensions and Investment Research Consultants Ltd
Plc	Public limited company
PLSA	Pensions and Lifetime Savings Association
PR	Prospectus rules
PRA	Prudential Regulation Authority
PSM	Professional Securities Market
QCA	Quoted Companies Alliance
QCA CG Code	Corporate Governance Code for Small and Mid-Size Quoted Companies
QCA Guidelines	Corporate Governance Guidelines for Smaller Quoted Companies
Rolls-Royce	Rolls-Royce Holdings Plc
ShareSoc	UK Individual Shareholders Society
SFS	Special Fund Segment
SYSC	Systems and Controls
the GT Reviews	CG reviews conducted by Grant Thornton in 2015 and 2016 in the context of the quality and profile of reporting on corporate culture

	and values in view of the requirements of the UK CG Code and strategic and director's reporting introduced by the CA 2006
the Official List	FCA's list of company securities officially listed in the U.K.
tPA	The Pensions Regulator
TUC	Trade Union Centre
UK CG Code	UK Corporate Governance Code published by the FRC
UKSA	UK Shareholders' Association
UK TC	UK Takeovers Code
ValueAct	ValueAct Capital Partners

LIST OF ABBREVIATIONS – United States

ABA	American Bar Association
AFL-CIO	American Federation of Labor and Congress of Industrial Organizations
BIS	Bank for International Settlements
BRT	The Business Roundtable
CalPERS	California Public Employees' Retirement System
CEC	Center on Executive Compensation
CFTC	Commodities Futures Trading Commission
CGADM Act	Corporate Governance Annual Disclosure Model Act
CGRT Act	Corporate Governance Reform and Transparency Act of 2016
CII	The Council of Institutional Investors
CIRCA	Council for Investor Rights and Corporate Accountability
DCF	Division of Corporate Finance
DGCL	Delaware General Corporations Law
DoJ	United States Department of Justice
FDIC	Federal Deposit Insurance Corporation
FINRA	Financial Regulatory Authority
foreign firms	foreign private issuers whose shares are traded on the NYSE or Nasdaq
FPI	foreign private issuer
FSG	United States Federal Sentencing Guidelines for Organizations
GM	General Motors
golden parachute say-on-pay vote	a nonbinding shareholder vote on the golden parachute arrangements covering any of its NEOs
Guidelines on Risk Governance	Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches in 2014
ICI	The Investment Company Institute
IDC	Independent Directors Council
ISS	Institutional Shareholders Services
NACD	National Association of Corporate Directors
NACD BRCDP	NACD 1996 Report of the National Association of Corporate Directors Blue Ribbon Commission on Director Professionalism
NACD Key Principles	NACD Key Agreed Principles to Strengthen Corporate Governance for US Publicly Traded Companies
NAIC	National Association of Insurance Commissioners
NAIFA	National Association of Insurance and Financial Advisers
NASD	National Association of Securities Dealers
Nasdaq Rules	National Association of Securities Dealers Automatic Quotation System Marketplace Rules
NASRA	National Association of State Retirement Administrators
NEO	named executive officer
NFA	National Futures Association
NYSE CGC	NYSE: Corporate Governance Guide (2014)

NYSE Manual	NYSE Listed Company Manual
OCC	Office of the Comptroller of the Currency
OSHA	Occupational Safety & Health Administration
RMBC Act	Revised Model Business Corporation Act
say-on-pay vote	a nonbinding shareholder vote
say-when-on-pay vote	a nonbinding shareholder vote regarding the question of whether the say-on-pay vote should be held annually, biennially or triennially
TCH	The Clearing House Association
TCH CG Guiding Principles	The Clearing House Association's Guiding Principles for Enhancing U.S. Banking Organization Corporate Governance
TIAA-CREF	Teachers Insurance and Annuity Association—College Retirement Equities Fund
USCC	The United States Chamber of Commerce

LIST OF ABBREVIATIONS – Mainland China

Accounting Law	Accounting Law of the People's Republic of China
AIC	Administration of Industry and Commerce
A-shares	Mainland incorporated companies listed on the SSE and SZSE
Basic Standard	Basic Standard for Enterprise Internal Controls
B-shares	Mainland incorporated companies listed on the SSE and SZSE and traded in non-local currency—USD (SSE) and HKD (SZSE)
CAO	China Aviation Oil
CBRC	China Banking Regulatory Commission
CCGI	China Corporate Governance Index
CCP	Chinese Communist Party
Central Government	Central People's Government of the People's Republic of China
CFA Institute Centre	CFA Institute Centre for Financial Market Integrity
CG	corporate governance
CG Code	Code of Corporate Governance
CGAAP	Chinese Generally Accepted Accounting Principles
China Sky	China Sky Chemical Fibre Company Co Ltd
CIRC	China Insurance Regulatory Commission
CNAO	China National Auditing Office
CNY	Chinese Yuan
Company Law	Company Law of the People's Republic of China
Companies Ordinance	Companies Ordinance (Cap. 622) (Hong Kong)
Constitution	Constitution of the People's Republic of China
CPCs	Communist Party committees
CSRC	China Securities Regulatory Commission
FRC	Financial Reporting Council (Hong Kong)
GEM	Growth Enterprise Market
Hanergy Group	Hanergy Holding Group Ltd
HK	Hong Kong
HKD	Hong Kong dollar
HKEX	Hong Kong Exchange and Clearing Limited
HKICPA	Hong Kong Institute of Certified Public Accountants
Hontex	Hontex International Holdings Co Ltd
H-shares	Mainland incorporated companies listed on the SEHK
HTF	Hanergy Thin Film Power Group Ltd
IAD	Internal Audit Department (MAS)
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
INED	independent non-executive director
IOSCO	International Organization of Securities Commission

IPO	initial public offering
listing rules	refers to the listing rules or requirements that govern the listing of an issuer's securities on the relevant Exchange
MAS	Monetary Authority of Singapore
Material Asset Restructurings Measures	Measures for the Administration of the Material Asset Restructurings of Listed Companies
MMOU	multi-lateral MOU
MOF	Ministry of Finance
MoU	Memorandum of Understanding
MSCI	Morgan Stanley Capital International
Nan Kai CG Centre	the Research Centre of Corporate Governance of Nan Kai University
NASDAQ	National Association of Securities Dealers Automated Quotations
NPC	National People's Congress
NPCSC	NPC Standing Committee
NYSE	New York Stock Exchange
OECD	The Organization for Economic Co-operation and Development
Pilot Scheme	Guiding Opinions on Pilot Implementation of Employee Stock Option Plans of Listed Companies (2014)
PRC	People's Republic of China
private companies	companies incorporated in Mainland China which are not owned or controlled by the government, wholly or partially
public companies	companies listed on a Mainland exchange and incorporated in Mainland China
QFII	Qualified Foreign Institutional Investor
RBP	Recommended Best Practice
Red Chips	Companies listed on the SEHK and incorporated outside the Mainland which have primary business interests in the Mainland
RMB	Renminbi
RQFII	Qualified Foreign Institutional Investor
SAFE	State Administration of Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission of the State Council
Securities Law	Securities Law of the People's Republic of China
SEHK	Hong Kong Stock Exchange
SFC	Securities and Futures Commission
SGX	Singapore Exchange Limited
SMEs	Small and Medium Enterprises
SOEs	state-owned enterprises
SPP	Supreme People's Procuratorate
SPP Rules	Rules of the People's Procuratorates on Whistleblowing Work
SSE	Shanghai Stock Exchange
State Council	State Council of the People's Republic of China
Stock Connect	Shanghai-Hong Kong Stock Connect and/or Shenzhen-Hong Kong Stock Connect
SZSE	Shenzhen Stock Exchange
the Exchanges	SSE and SZSE
U.K.	United Kingdom
unlisted companies	companies incorporated in the Mainland which are not listed on a Mainland exchange
USD	United States dollar
Working Group	the Working Group of the Standard Operation of Listed Companies
Working Guidelines	Working Guidelines for Dealing with the Relationship Between Listed Companies and Investors

LIST OF ABBREVIATIONS - Singapore

AAC	Appeal Advisory Committee
ACGA	The Asian Corporate Governance Association
ACGC	Audit Committee Guidance Committee
ACGS	ASEAN Corporate Governance Scorecard
ACRA	Accounting and Corporate Regulatory Authority
ACRA Act	Accounting and Corporate Regulatory Authority Act (Cap. 2A)
AGC	Attorney-General's Chambers
AGM	Annual General Meeting
ASC	Accounting Standards Council
ASEAN	Association of Southeast Asian Nations
CA	Companies Act (Cap. 50)
CAD	Commercial Affairs Department
Cap	capitalisation
CCASS	Central Clearing and Settlement System (Hong Kong)
CCP	Chinese Communist Party
CEO	Chief Executive Officer
CG	Corporate governance
CGC	Corporate Governance Council
CG Code	Code of Corporate Governance (Singapore)
CGIO	Center for Governance, Institutions & Organisations
China Sky	China Sky Chemical Fibre Co Ltd
CLSA	Credit Lyonnais Securities Asia
CPF	Central Provident Fund
CPIB	Corrupt Practices Investigation Bureau
CSRC	China Securities Regulatory Commission
ESG	Environmental, Social, and Governance
FCA	Financial Conduct Authority (United Kingdom)
FRC	Financial Reporting Council (Hong Kong)
GAAP	Generally Accepted Accounting Principles
GEM	Growth Enterprise Market (Hong Kong)
GLCs	Government-Linked Companies
GSD	Government Surveillance Division
GTI	Governance and Transparency Index
HKD	Hong Kong dollar
HKEX	Hong Kong Exchange Limited
HKICPA	Hong Kong Institute of Certified Public Accountants
HKSCC	Hong Kong Securities and Clearing Company Limited
H-share companies	Mainland incorporated companies listed on the SEHK
IAD	Internal Audit Department (MAS)
IASB	International Accounting Standards Board
IDs	Independent Directors
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
IMF	International Money Fund
INEDs	Independent Non-executive Directors
IOSCO	International Organization of Securities Commissions
IPO	Initial public offering
ISCA	Institute of Singaporean Chartered Accountants
LR	Listing Rules
MAS	Monetary Authority of Singapore
MAS Act	Monetary Authority of Singapore Act (Cap. 186)
MMoU	Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (IOSCO)
MoF	Ministry of Finance

MoU	Memorandum of Understanding
NEDs	Non-executive Directors
NUS	National University of Singapore
OCBC	Oversea-Chinese Banking Corporation Limited
OECD	Organisation for Economic Co-operation and Development
PAOC	Public Accountants Oversight Committee
PAP	People's Action Party
RCC	Regulatory Conflict Committee (SGX)
Red-chips	Companies listed on the SEHK and incorporated outside China which have primary business interests in the Mainland
S-chip	Mainland Chinese companies listed on the SGX
SEC	Securities Exchange Commission (United States)
SEHK	Hong Kong Stock Exchange
SFC	Securities and Futures Commission (Hong Kong)
SG	Singapore
SG\$	Singapore dollar
SGX	Singapore Exchange Limited
SGX-DT	Singapore Exchange Derivatives Trading Limited
SGX-ST	Singapore Exchange Securities Trading Limited
SIAS	Securities Investors Association Singapore
SIC	Securities Industry Council
SID	Singapore Institute of Directors
SOEs	State-owned enterprises
SPH	Singapore Press Holdings
Steering Committee	Steering Committee to Review the Companies Act
Temasek Holdings	Temasek Holding Private Limited
the Framework	Streamlined Review Framework for the ASEAN Common Prospectus
U.K.	United Kingdom
UOB	United Overseas Bank Limited
USD	United States dollar

JURISDICTION APPENDICES

Appendices to

**REPORT ON IMPROVING
CORPORATE GOVERNANCE IN HONG KONG**

~ A comparative based study ~

for the

Hong Kong Institute of Certified Public Accountants

15 December 2017

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Note:

Each Appendix provides a description of the essential structure and characteristics of the CG system in the relevant jurisdiction across the eight topics listed below. The analysis of Hong Kong's CG system in view of the other four jurisdictions is undertaken in the body of the Report in Section 3 "Discussion and analysis of jurisdictions studied".

1. Market overview
2. Policy
3. Legislation
4. Regulation
5. Other influences
6. Enforcement
7. Shareholders' rights and protections
8. Regulation of non-local companies

Appendix I	HONG KONG
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Introduction

Historically a small regional market with a corporate governance (CG) system implanted from the UK, the Hong Kong market has evolved from being dominated by family-controlled companies to one that is dominated by Mainland enterprises. Its regulatory architecture remains a mixed sectoral (banking, securities and insurance) and institutional (banks) structure,¹ with an overall regulatory approach characterised by attempts of regulators to strike a balance between a merit-based and a disclosure-based system.

While good CG standards are an expressed value of the regulators, and Hong Kong does rank highly in regional rankings, CG culture in practice tends to be weak except among some of the largest and predominantly locally incorporated Hong Kong companies. The boards of many listed companies fail to understand, value or act on key CG principles such as shareholder communication. Directors who do not understand and are inactive in relation to their CG responsibilities is not an uncommon problem. Reliance on a comply or explain compliance regime does not appear to have fostered fundamental and widespread changes in attitudes toward CG standards. Instead, compliance with the non-statutory requirements often appears to remain, in many instances, box tick exercises undertaken in an environment of limited consequences for non-compliance, although the consequence management of non-compliance has in recent years been evolving toward judicial remedies in respect of egregious CG failings. Processing significant CG failings through the courts implicitly recognises the costs of poor CG to investors and the reputation of the market, although the regulatory cost of doing so is high as compared to *ex ante* approaches including the imposition of regulatory discipline that serves as an earlier behaviour correction mechanism.

I.1.1 Corporate governance system

Hong Kong's CG system is historically based on the approach taken under UK law, which was transplanted to Hong Kong during the British colonial era and can be characterised as an outsider-dominated system or Anglo-American system.² However, the Hong Kong market is distinct in its composition, particularly as regards a large number of locally incorporated family-controlled companies and, increasingly over the past two decades, Mainland state-owned enterprises and Mainland privately held companies. While emphasis has been traditionally placed on reputational enforcement mechanisms rather than by the judiciary, as in the UK, the past two decades or so has also witnessed a steadily increasing reliance on regulatory enforcement mechanisms operated by The Stock Exchange of Hong Kong Limited (SEHK) or the Securities and Futures Commission (SFC). Most recently, there has been an increased focus on, and a perceived need for, using judicial remedies for more serious corporate abuses.³

¹ For a discussion, see: Douglas W Arner, Berry Hsu, Say H. Goo, Syren Johnstone, and Paul Lejot, *Financial Markets in Hong Kong: Law and Practice* (Oxford: Oxford University Press, 2nd edn, 2016), Chapter 2

² John Armour and Jeffrey N. Gordon, "The Berle-Means Corporation in the 21st Century," (2016) *Preliminary and incomplete draft*, Yale University, 3. Demetra Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Oxon and New York: Routledge, 2016), p 202.

³ For example, as outlined in the speech of Thomas Atkinson, "Speech at 7th Pan Asian Regulatory Summit", SFC 9 November 2016: Available at http://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Atkinson_20161109.pdf (visited 19 Oct 2017)

The CG system is founded on a matrix of law and non-statutory regulations, as further discussed in Appendices I.3 and I.4. Primary legislation provides for the creation of both subsidiary legislation and non-statutory regulations. The latter has given rise to the listing rules that do not enjoy statutory support, unlike the position in the UK – see Appendix II.3. The system is distinct from the United States where regulators may be empowered by statute to make regulations that amount to regulatory law (having a similar standing as subsidiary legislation in Hong Kong), breaches of which the regulator may specify as being actionable by shareholders – see Appendix III.3.

Significant reliance is placed on non-statutory self-regulatory mechanisms. This comprises the mandatory requirements of the listing rules designed to foster good CG standards (including in particular provisions of Chapters 3, 13, 14 and 14A as well as Appendix 10) and the comply or explain requirements of the CG Code set out in Appendix 14 of the listing rules. While the underlying statutory framework provides for shareholder enforcement of directors duties (see Appendix I.3 and I.7), shareholders are in practice largely passive and complacent, with extensive reliance being placed on the regulators responsible for listed issuers, namely the SEHK and the SFC. (The regulatory approach and relevant regulations is discussed further in Appendix I.4 below.)

CG regulation in Hong Kong is affected by the attempts of regulators to strike a balance between a merit-based and a disclosure-based system. Regulators take an active role in approving initial public offers (IPOs) but there are trade-offs in doing so. One is that remedies available to minority shareholders are infrequently exercised, partly owing to the expectation that regulators have assumed responsibility (and also partly owing to the difficulties of commencing litigation). Another is that companies seeking to list in Hong Kong may perceive the process as less predictable than other markets as a result of a different level of regulatory judgement being applied. As Hong Kong’s regulators take a more proactive and parental approach with IPOs, for example, as compared to the strongly disclosure-based system in the United States, the CG system does not unequivocally embrace the concept of *caveat emptor* based on disclosure. The secondary market’s CG system is based around statutory and non-statutory directors’ duties and disclosure obligations, with particular CG standards being more self-regulatory and based on the comply or explain standard under the CG Code.⁴ Such an approach leaves the specifics of CG provisions to be resolved by commercial forces between a company’s management, its shareholders, and the marketplace.⁵ However, a not insignificant number of listed issuers approach the CG Code as a box-ticking exercise.

Corporate culture

Hong Kong’s CG culture appears good in principle but is less convincing in practice. A number of high-profile reviews tend to rank Hong Kong highly in terms of good CG yet fail to appreciate the box-ticking and minimalist compliance culture often adopted in response to the regulatory requirements. This is revealed by local reviews that focus on specific CG compliance issues. Board composition, director duties/responsibilities, and shareholder disclosure/communication are the areas in need of the most attention, in terms of both the CG Code and the listing rules generally. The availability and quality of directors is also a major concern. Only the largest and predominantly locally incorporated Hong Kong companies appear to appreciate the importance of good CG by exceeding minimum requirements and, among other things, adopting many of the CG Code’s non-mandatory recommended best practices (RBPs). CG culture among the majority of listed companies is weak, tends not to be compliance focused, often fails to appreciate the importance of disclosure communications, and neither do they routinely monitor their shareholder base.

⁴ Douglas W. Arner, Berry Hsu, Say H. Goo, Syren Johnstone, and Paul Lejot, *Financial Markets in Hong Kong* (Oxford: Oxford University Press, 2nd edn, 2016), [10.58]

⁵ Arner et al., [10.58]

The SEHK conducts annual reviews of disclosure compliance with the CG Code, the most recent being published in October 2017 in respect of the period 1 January to 31 December 2016. There are 78 CG Code code provisions (CPs) that are subject to the comply or explain regime (discussed in Appendix I.4). In December 2016, 34% of 1,428 (1,271 Main Board and 157 GEM⁶) listed companies had complied with all 78, 94% with 75 or more, and 99.6% complied with 70 or more.⁷ This can be compared with 2014 where 35% had complied with all CPs, 35% with 75 or more, and 98% with 70 or more.⁸ An independent survey on Hong Kong CG compliance mirrored these results.⁹ Compliance rates were higher on average for large-cap companies in comparison to medium and small-cap companies.

In December 2016, PricewaterhouseCoopers (PwC) released a report on compliance with the Hong Kong CG Code's internal control and risk management requirements. The survey of over 200 listed issuers' annual CG reports found that only 45% disclosed their risk management processes while 82% disclosed their internal audit function.¹⁰

Very few issuers have adopted the recommended best practices, which are not mandatory, and non-compliance does not incur reporting obligations - as of December 2015 only 12% of listed issuers had adopted them.¹¹

Furthermore, although the listing rules require that an explanation of deviations from code provisions should be informative and clear,¹² it has been observed that issuers "need to make more effort to increase the quality of their CG beyond the level of mere compliance."¹³

This is indicative of a minimum compliance culture, where the comply or explain regime facilitates a level of compliance that does not always operate to serve the end objectives, and recommended best practices are largely ignored, possibly because doing so attracts no consequences.

A joint 2016 report by Credit Lyonnais Securities Asia (CLSA) and the Asian Corporate Governance Association (ACGA) across 12 Asia-Pacific countries on CG standards found that Hong Kong ranked third highest in the region.¹⁴ Results were based on scores to evaluate accounting and auditing, CG culture, enforcement and regulatory environment, and CG rules. However, the results of the survey reflect the views of fund managers and institutional investors and do not take into account the views of other shareholders or stakeholders.

⁶ This is almost two thirds of Main Board companies and less than half of all GEM companies

⁷ HKEX, "Analysis of Corporate Governance Practice Disclosures in June Year-End 2016 Annual Reports," (October 2017), 2

⁸ Ibid.

⁹ BDO Corporate Governance Academy, "Corporate Governance Update," (2016): Available at <https://www.bdo.com.hk/getattachment/Insights/Research/Corporate-Governance-Review/cg-review-2015final.pdf.aspx?lang=en-GB cmstree.GetCmsAsset.do?cmsAssetType=2&fileName=cg%20review-2015final.pdf> (visited 19 Oct 2017)

¹⁰ PwC China, "Cracking the Corporate Governance Code – How ready are Hong Kong listed companies in meeting new requirements?," (December 2016), p. 2: Available at <http://www.pwccn/en/risk-assurance/ra-corporate-whitepaper-dec2016.pdf> (visited 19 Oct 2017)

¹¹ HKEX, "Analysis of Corporate Governance Practice Disclosures in June Year-End 2015 Annual Reports," (September 2016), 3

¹² HKEX, "Exchange Reports on its Review of Listed Issuers' Corporate Governance Practice Disclosure," 13 May 2016: Available at <https://www.hkex.com.hk/eng/newsconsul/hkexnews/2016/160513news.htm> (visited 16 Dec 2016)

¹³ HKICPA, "The Best Corporate Governance Awards 2016 – Judges Report," (2016), 10

¹⁴ Enoch Yiu, "Hong Kong loses out to Singapore in corporate governance survey", *South China Morning Post*, 29 Sept 2016

Hong Kong topped the previous CLSA/ACGA survey in 2014 but was penalised in the 2016 survey because, like Mainland China, it does not have an independent body to regulate auditors. Hong Kong is currently addressing this issue via the introduction of an independent audit regulator, the Financial Reporting Council (FRC). John Poon, Chief Executive Officer (CEO) of the FRC said: "Assuming that the future Council will comprise of non-practitioners only, the regime will enable Hong Kong to be eligible for membership of IFIAR [the International Forum of Independent Audit Regulators] and be recognised for regulatory equivalence with the EC [European Community]."¹⁵

I.1.2 Market characteristics

Stock Exchange

The Hong Kong Exchanges and Clearing Limited (HKEX) is a recognised exchange controller that owns and operates three exchanges and four clearing houses. These include the SEHK, the Hong Kong Futures Exchange Limited, and the London Metal Exchange. It operates the Hong Kong Securities Clearing Company Limited, the HKFE Clearing Corporation Limited, the SEHK Options Clearing House Limited, and OTC Clearing Hong Kong Limited. The HKEX is the result of a demutualisation and merger of the former stock and futures exchanges and clearing houses in 2000, at which point in time the HKEX became listed on the SEHK.¹⁶

The SEHK consists of the Main Board and the Growth Enterprise Market (GEM). The Main Board comprises of generally larger listed companies which at the time of admission to listing have satisfied the three year track record period requirement and have an adequate profit record or satisfy alternative financial tests.¹⁷ In contrast, the GEM provides capital formation opportunities for growth companies in all industries that are unable to meet the requirements of the Main Board. Companies listed on GEM may seek a listing on the Main Board once the relevant requirements are met – among the reduced requirements are the track record period, which is reduced to two years and the absence of any profit requirement. On 16 June 2017, the HKEX issued a concept paper on behalf of the SEHK inviting comments on establishing a new board in addition to the Main Board and GEM. The proposed new board will accommodate (1) pre-profit companies, (2) companies with non-standard governance features, and (3) Mainland Chinese enterprises that wish a secondary listing in Hong Kong.¹⁸ Two segments are proposed: New Board PRO (for earlier stage companies that do not meet the financial or track record criteria for GEM or the Main Board), and New Board PREMIUM (for companies that meet existing financial and track record requirements of the Main Board that are ineligible to list because of non-standard governance structures).¹⁹ The proposal to include companies with non-standard governance structures is controversial because it would allow companies with weighted voting right (WVR), i.e. dual-class shares, to be publicly listed.

As at 31 October 2016, there were 1,955 companies listed on the SEHK (Main Board and GEM). In the year to July 2017, there were 51 new listings – 29 on the Main Board and 22 on GEM.²⁰ According to the HKEX's classification of enterprises, 989 were Mainland enterprises²¹, 856 were Hong Kong enterprises, and 110 overseas enterprises.²² On this

¹⁵ Laura He, "Hong Kong's new audit regulator should exclude industry practitioners for international recognition, says FRC", *South China Morning Post*, 27 Oct 2016

¹⁶ HKEX, "History of the HKEX and its Market": Available at http://www.hkexgroup.com/About-HKEX/Company-Information/About-HKEX/History-of-HKEX-and-its-Market?sc_lang=en (visited 14 Dec 2016)

¹⁷ Rules Governing The Listing of Securities on the Stock Exchange of Hong Kong Limited 2016, Chapter 8

¹⁸ HKEX, "Concept Paper - New Board," (June 2017), 6 [1.3. (4)]: Available at <https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2017061.pdf> (visited 19 Oct 2017)

¹⁹ *Ibid.* [1.3. (8)]

²⁰ HKEX, "Report on Initial Public Offering Applications, Delisting and Suspensions," 31 July 2017: Available at <http://www.hkex.com.hk/eng/newsconsul/hkexnews/2017/170731news.htm> (visited 6 October 2017)

²¹ 236 H share and 153 Red Chip, the others being mainland private enterprises

basis, non-Hong Kong enterprises represent 56.21% of the SEHK. However, when one looks solely at the place of incorporation of the issuer, only 223 companies (Main Board and GEM) are incorporated in Hong Kong, representing less than 12% of all listed issuers.²³

Average daily turnover of the SEHK (Main Board and GEM) in November 2016 was HK\$67,677 million, and for 2016 was HK\$66,448 million.²⁴ Following the HKEX's classification given above, Mainland enterprises represent 50.59% of the SEHK, Hong Kong companies 43.79%, and overseas companies 5.62% of the SEHK.

An important development in recent years was the introduction of the cross-border trading "stock connect" programme with two-way links in eligible stocks between the SEHK and each of the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE). The stock connect programme provides access to 1,450 companies listed in the Mainland, 569 on the SSE and 881 on the SZSE.²⁵ In percentage terms, the SSE represents 39.24% and the SZSE represents 60.76% of the Mainland companies that can be accessed via the stock connect programme. The combined market capitalisation of the three exchanges – SEHK, SSE and SZSE - is US\$10.6 trillion, which positions it only after the New York Stock Exchange.²⁶ However, each issuer whose stock can be traded via stock connect remains solely regulated by the exchange on which it is listed. In 2016 the total southbound average daily turnover for the Shanghai-Hong Kong Stock Connect was HK\$826,776 and HK\$9,164 for the Shenzhen-Hong Kong Stock Connect.²⁷

Shareholder ownership

The SEHK is dominated by family and state-controlled public companies.²⁸ Thus the majority of listed companies are characterised by dominant majority shareholders. This creates an environment of potential conflicts between management and minority shareholders.²⁹ There are no current statistics on the proportion of family companies on the SEHK - this can be difficult to establish in practice owing to complex family holding structures that are a characteristic of the Hong Kong market. A 2008 study by the Hong Kong Institute of Certified Practising Accountants (HKICPA) suggested that 90% of listed companies in Hong Kong were family controlled, owning more than 25% of share capital.³⁰ This figure has been substantively diluted from the surge of Mainland listings since that time. Nonetheless, family ownership remains prevalent and ownership in the overall market can be defined as concentrated consisting of large blockholders. Companies that are not family-owned tend to be dominated by a small number of majority shareholders, which are typically also the management.³¹

Research undertaken in the present study shows a significant number of issuers being controlled by a single largest shareholder. Around half of all listed issuers possess at least one shareholder holding between 30% and 50% of the listed capital, with over a

²² HKEX, "Our Markets": Available at https://www.hkex.com.hk/eng/listing/listhk/our_markets.htm (visited 13 Dec 2016)

²³ Figures derived from the Osiris database, as of 16 October 2016

²⁴ HKEX, "HKEX Monthly Market Highlights for November 2016 Highlights": Available at <https://www.hkex.com.hk/eng/stat/statrpt/mkthl/mkthl201611.htm> (visited 13 Dec 2016)

²⁵ Goldman Sachs Research, "China in Transition," *Goldman Sachs, What is Stock Connect*, September 2016: Available at Twitter: Goldman Sachs, 7 December 2016 (visited 13 Dec 2016)

²⁶ Ibid.

²⁷ HKEX, "Cash Market Transaction Survey 2016," (July 2017), 1

²⁸ Hong Kong Institute of Chartered Secretaries, "Shareholder Communications for Listed Issuers: Five Imperatives to Break the Monologue," (September 2016), 3

²⁹ Benita Yu and Laurence Rudge, "Hong Kong Corporate Governance: a practical guide," (May 2014) *Slaughter and May*, 41

³⁰ Cally Jordan, "Family resemblances: the family-controlled company in Asia," (2008) *Legal Study Research Paper No. 334*, 3

³¹ Kieran Colvert, "Where were the Investors?," (7 April 2015) *Chartered Securities Journal*

third of Main Board issuers having a single majority shareholder. This is shown in the Table below, which shows the percentage of companies with the single largest shareholder holding more than X% of the issued share capital.³²

	X ≥ 50%	X ≥ 30%	X ≥ 5%
Main Board	37.32%	61.94%	88.88%
GEM	0.00%	44.67%	85.66%
All SEHK	32.48%	59.70%	88.46%

The level of shareholder engagement in Hong Kong has been described as “stubbornly low”.³³ In 2015 it was observed that “While attendance at AGMs has been going up, the number of attendees who participate in votes has been declining for four consecutive years.”³⁴

Share trading turnover is roughly equally divided between local and overseas investors. In 2016,³⁵ institutional investors (local and overseas) contributed to 53% of total market turnover (up from 51% the year prior) and retail investors (local and overseas) contributed 23%, with exchange participants’ principal trading making up the balance. Of this, local retail and local institutional shareholders account for around 15% and 20% respectively. The single largest contributor to turnover was overseas institutional investors, which accounted for approximately one-third of trading, most of which are asset managers. Overseas institutional investors contributed to 33% and overseas retail investors contributed 6.9%. In recent decades there has been a steady increase in institutional shareholders in Hong Kong, namely by retirement funds, insurance companies, and mutual funds.³⁶

Shareholder communication

In contrast to the positive results of the HKEX’s “Analysis of Corporate Governance Practice Disclosures” and the CSLA/ACGA Corporate Governance Watch 2016, a 2013 CG study had found that Hong Kong issuers lacked board balance and failed to adequately communicate with minority shareholders.³⁷

In July 2017, the HKEX suggested that disclosures in financial reports could be improved by: (1) issuers providing adequate discussions of performance and identifying causes for fluctuations in profit or loss; (2) assessing materiality of disclosures and commenting on the nature, size, or incidence of unusual or material items and transactions; (3) discuss operational and financial factors, and entity-specific risks; and (4) ensuring that key-performance indicators and non-HKFRS financial measures are unbiased, harmonious with local reporting requirements, unambiguous, and reconciled consistently over time.³⁸

HKEX 2016 studies revealed that chairpersons and directors do not always attend annual general meetings (AGMs). Weak CG reports repeat content from previous years and contained cut and pasted provisions directly from the CG Code.³⁹ This “boilerplate” approach to the comply or explain regime provides minority shareholders with minimal insight into the company’s actual CG practices and their attitude toward CG. It signals the lack of an adequate CG culture, apart from a box-ticking mentality.⁴⁰

³² Figures derived from the Osiris database, as of 16 October 2016

³³ Kieran Colvert, “Where were the Investors?,” (7 April 2015) *Chartered Securities Journal*

³⁴ Per by Lucy Newcombe, corporate Communications director at Computershare, as quoted in Kieran Colvert, “Where were the Investors?,” (7 April 2015) *Chartered Securities Journal*

³⁵ Data from HKEX, “Cash Market Transaction Survey 2016,” (July 2017)

³⁶ Kieran Colvert, “Where were the Investors?,” (7 April 2015) *Chartered Securities Journal*

³⁷ BDO Corporate Governance Academy, “Corporate Governance Review 2013,” (2014), 7

³⁸ HKEX, “Exchange Publishes Results of its Latest Review of Listed Issuers’ Financial Reports,” (14 July 2017)

³⁹ BDO Corporate Governance Academy, “Corporate Governance Review 2013,” (2014), 7

⁴⁰ BDO Corporate Governance Academy, “Corporate Governance Review 2013,” (2014), 7

It has been observed that, because issuers “only need to explain non-compliance to shareholders, and they would not face any penalty”,⁴¹ the nature of Hong Kong’s comply or explain regime may have a propensity to propagate a minimalist compliance culture due to non-compliance having no meaningful regulatory down-side.

Nonetheless, rectifying the deficiencies in the comply or explain and disclosure regimes may not enhance shareholder insight to a company’s CG culture. A 2016 shareholder communication survey by the Hong Kong Institute of Chartered Secretaries (HKICS) suggested that a majority of listed companies lacked a shareholder communication strategy and had very little accountability for shareholder communication at the CEO or board level.⁴² Over half of the companies surveyed stated that the company secretary is responsible for profiling the shareholder base.⁴³ The survey argues that:

“The actual value and quality of that regulatory communication must be undermined if listed companies do not actually know who are the shareholders with whom they are communicating; and are not committed to engaging with those shareholders to understand the effectiveness and relevance of their communication i.e. improvement through feedback. If you do not know your audience or what they want, how can you frame your message?”⁴⁴

There is a disconnect between regulators striving for enhanced communication disclosures and listed issuers’ CG culture as to what is required or important.⁴⁵ The HKICS survey revealed that a sizable portion of listed companies neither knew their shareholders nor routinely monitor their shareholder base.⁴⁶ Listed issuers’ comply or explain culture has infiltrated shareholder communications, which are viewed as a matter of minimalist compliance and non-committal.⁴⁷

The Judge’s Report in the HKICPA’s annual CG awards observed that the best CG compliance performers achieved high scores on the strength of their voluntary additional disclosures and practices.⁴⁸ It noted that early adopters of CG reform were large-cap companies listed on multiple exchanges worldwide.⁴⁹ H-share companies provide a “responsibility notice” at the front of their annual reports, stating that the board, its supervisors, and senior management warrant that the information in the report contains no false or misleading statement or material omission, and that they, jointly and severally, accept full responsibility for the information.⁵⁰ An approach whereby the board and its members accept full responsibility by issuing a clear and obvious notice of their intent, may enhance shareholder confidence.⁵¹

A December 2016 PwC China study of over 200 SEHK issuers’ CG reports found that 69% were early adopters of disclosure requirements relating to internal control and risk management - 86% of these were Hang Seng Index (HSI) companies that, on average, had better disclosure practices than H-share companies.⁵²

⁴¹ Enoch Yiu, “Hong Kong companies failing to protect rights of small investors,” (4 February 2014) *South China Morning Post*, quoting Patrick Rozario, Director and Head of Risk Advisory Services at BDO.

⁴² HKICS, “Shareholder Communications for Listed Issuers: Five Imperatives to Break the Monologue,” (September 2016), 4

⁴³ *Ibid.*, 4

⁴⁴ *Ibid.*, 5

⁴⁵ *Ibid.*, 5

⁴⁶ *Ibid.*, 4

⁴⁷ *Ibid.*, 4

⁴⁸ HKICPA, “The Best Corporate Governance Awards 2016 – Judges Report,” (2016), 11

⁴⁹ *Ibid.*, 12

⁵⁰ *Ibid.*, 12 and 13

⁵¹ *Ibid.*, 13

⁵² PwC China, “Cracking the Corporate Governance Code – How ready are Hong Kong listed companies in meeting new requirements?,” (Dec 2016), p. 5

A further factor that contributes to the comply or explain and disclosure culture in Hong Kong is the fact that retail shareholders are not active and rarely attend shareholder meetings, let alone vote on important CG issues. International regulatory developments have prompted the SFC to release a non-mandatory guidance for shareholders: “2016 Principles of Responsible Ownership” – see Appendix I.4. Although the guidance is targeted at institutional shareholders, the principles outline the role of all shareholders in holding boards accountable and discharging their ownership responsibilities.

Activist shareholders

Media reports of activist and institutional shareholders are quite rare. Recent examples reported in the media include Elliott Management re Bank of East Asia (2015-2017); BlackRock Inc. re G-Resources (2016); the failure of Cheung Kong Infrastructure’s power asset merger (2015); Sina/Aristeia (2017) and GOME Electrical Appliances’ connected transaction (2015).

The outcome of such actions are mixed. For example, the dispute between Elliott Management and Bank of East Asia (BEA) involved the planned private placement of new shares together with restrictive covenants on the places. After an open letter was sent to all shareholders and litigation had commenced opposing the move, the Bank of East Asia responded by instigating board changes and a strategic review of a subsidiary. Elliott proceeded with litigation. In 2015 the Court of First Instance held that a shareholder is entitled to be concerned about the way that the board makes business judgements and whether this has involved a breach of fiduciary duty by the directors. A professional investor with a sizable interest in a company (i.e. Elliott) will want to investigate the way in which major decisions affect its economic interest. Justice Harris concluded that he did not think that Bank of East Asia dealt with the matter properly nor was it fully resolved.⁵³ Litigation is continuing, with Elliott arguing that the arrangements constituted unfair prejudicial conduct covered by section 724 of the Companies Ordinance⁵⁴ (CO) and that BEA’s directors have breached their fiduciary duties.⁵⁵

Another recent example is the proxy battle between Sina, a Chinese company listed on Nasdaq and a United States investment manager, Aristeia Capital. This example is relevant because the shareholder dispute is taking place in Hong Kong. The proxy battle is interesting because it is developing along the same lines as those in the United States.⁵⁶ Aristeia has nominated two directors and is proposing that Sina spin off all or part of its stake in Weibo. A reverse merger is also proposed whereby Weibo would acquire Sina for cash and stock realising \$162 million in share value. Aristeia argues that Sina’s CG policies deviate radically from standard practices and have consistently eroded shareholder value.⁵⁷ Sina argues that Aristeia’s proposals might actually destroy shareholder value. At the AGM, shareholders rejected Aristeia’s proposals.

Only a small fraction of the actual number activist shareholder and institutional shareholder activity is reported by the media, with the majority comprising of private engagements isolated from the media. Further, Part XV of the Securities and Futures Ordinance⁵⁸ (SFO) provides far less information on activist shareholders to the public in comparison to the United States (cf. Schedule 13D of the Securities Exchange Act of 1934).

⁵³ See: *Elliott v Bank of East Asia & Ors* HCMP 125/2015 at 74

⁵⁴ Cap. 622

⁵⁵ HCMP 1812/2016. The petition is also available at <http://fairdealforbea.com/>

⁵⁶ Alun John, “Chinese internet giant Sina digs in over proxy battle with US shareholder Aristeia,” (9 October 2017) South China Morning Post

⁵⁷ Scott Deveau, “Aristeia Capital says Weibo backer Sina could fetch 67% premium in share sale,” 13 October 2017 *Deal Street Asia*: Available at <https://www.dealstreetasia.com/stories/activist-says-weibo-backer-sina-fetch190-share-sale-84124/> (visited 17 Oct 2017)

⁵⁸ Cap. 571

Activist shareholders in Hong Kong can be broadly grouped into four classes: (1) international asset managers that seek informal and private discussions with the board (e.g. BlackRock); (2) local activist investors (typically non-confrontational); (3) local activist investors (confrontational); and (4) international activist investors (such as Elliott Management). The media tends to only report on the last two categories. Since 2003 these categories have only witnessed a handful of activist shareholders capturing media attention. However, the first category above does appear to be active, albeit less visible. For example, BlackRock has invested in 900 public companies in Hong Kong and is privately engaged with 100.

Overall, the activism of shareholders is far less visible in Hong Kong as compared with, for example, the United States where shareholder activism is apparent, and the UK where activism is on the rise.

Directors and the board

Reviews of compliance with provisions of the CG Code suggest that board composition and director duties and responsibilities are areas that require the most attention. The SEHK's 2016 review of compliance with the provisions of the CG Code indicated the following as being the least complied with: (1) board diversity, (2) the separation of the roles of chairman and CEO; (3) non-executive directors (NEDs) being appointed for a specific term, subject to re-election; (4) NEDs attendance at general meetings; (5) chairman's attendance at general meetings; and (6) establishment of a nomination committee.⁵⁹ These were, in general, recurring issues across the past three reviews, June 2014 to December 2015.⁶⁰

The foregoing reflects a wider problem with directors' understanding of and compliance with the listing rules.⁶¹ The HKEX has acknowledged these problems by noting that recent investigatory and disciplinary actions against a number of company directors who have failed in their duties indicate they are not being proactive in fulfilling their responsibilities either due to a lack of understanding of the listing rules, or they did not give compliance obligations the necessary attention required.⁶² To address these problems, the HKEX launched a training programme for company directors in 2017. David Graham, HKEX's Chief Regulatory Officer, commenting on the programme, stated that the HKEX's "continued efforts to provide guidance and training to directors along with our periodic reviews of the Corporate Governance Code and related Rules, [seeks] to improve the quality of directors and consequently, the effectiveness of boards."⁶³

In contrast, there has been some media criticism⁶⁴ that the SEHK routinely grants waivers in respect of company secretaries, who lack the relevant professional qualifications or relevant experience.⁶⁵ The practice is not limited to small or medium-sized companies. One of the largest listed companies in Hong Kong, Bank of China (Hong Kong), appointed a company secretary in 2016 who failed to qualify under the listing rules, yet was granted a waiver.⁶⁶ This is a not infrequent practice of Mainland

⁵⁹ HKEX, "Analysis of Corporate Governance Practice Disclosures in June Year-End 2015 Annual Reports," (September 2016), 2

⁶⁰ Ibid.

⁶¹ HKEX, "Exchange Launches Training for Company Directors," (9 December 2016) *HKEX News Release*, 9 December 2016: Available at <https://www.hkex.com.hk/eng/newsconsul/hkexnews/2016/161209news.htm> (visited 16 Dec 2016)

⁶² Ibid.

⁶³ Ibid.

⁶⁴ Shirley Yam, "HKSE's waiver for BoC Hong Kong corporate secretary sets a bad precedent," (28 October 2016) *South China Morning Post*

⁶⁵ As required by Main Board LR 3.28

⁶⁶ HKEX, "HKEX Listing Decision – LD47-2013," (April 2015); BOC, "Change of Company Secretary," 26 October 2016: Available at http://www.bochk.com/dam/bochk/an/2016/20161026a_en.pdf (visited on 16

enterprises listed in Hong Kong.⁶⁷ Where company secretaries lack professional qualifications and/or relevant experience, and do not live in Hong Kong, they may be less capable of contributing to the quality of the company's CG performance.⁶⁸ However, this is to some extent ameliorated by making the waiver contingent on the issuer appointing a qualified and/or experienced person as an assistant company secretary or joint company secretary who is based in Hong Kong to work with the Mainland company secretary for the term of their appointment.⁶⁹

December 2016); Shirley Yam, "HKSE's waiver for BoC Hong Kong corporate secretary sets a bad precedent," (28 October 2016) *South China Morning Post*

⁶⁷ Examples include China Galaxy Securities; China Taiping Insurance Holdings; Automated Systems Holdings

⁶⁸ HKEX, "HKEX Listing Decision – LD47-2013," (April 2015); Shirley Yam, "HKSE's waiver for BoC Hong Kong corporate secretary sets a bad precedent," (28 October 2016) *South China Morning Post*

⁶⁹ Ibid.

Appendix I	2. Policy	I.2 Hong Kong
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Introduction

The principal CG policy-making bodies in Hong Kong are the Government via the Financial Services and Treasury Bureau (FSTB), the Standing Committee on Company Law Reform (SCCLR) and ad hoc Expert Groups, the SFC and the HKEX, with the HKICPA and the FRC undertaking specific roles in relation to audits and financial disclosures. The Government has also formed two bodies that may have an impact on policy thinking - the Financial Services Development Council (FSDC) in 2013, and the Financial Leaders Forum in 2017.

The introduction of the new CO in 2014 was successful in developing a modernised legal structure for companies. However, its relevance to Hong Kong's listed issuers is limited as most issuers are not incorporated in Hong Kong and the provisions of the Ordinance concerned with CG matters only apply to Hong Kong incorporated issuers with the exception of statutory derivative actions and unfair prejudice which apply to all companies having a place of business in Hong Kong. The non-statutory listing rules have sought to create a bridge that brings non-Hong Kong incorporated issuers under those requirements, in addition to imposing other CG-specific rules.

An ongoing policy debate on the correct structure for the supervision of the listed market has been active at regular intervals since a 2002 report recommended the creation of a statutory listing authority, as had recently been done in the UK. This centres on the structural and functional relationship between the HKEX/SEHK and the SFC. In the period running through to the latest consultations in 2016/2017, the SFC has evolved its focus from an active intermediary regulator to one that is increasingly active as a corporate regulator. The development of an independent regulator of auditors (the FRC) has also given rise to a current policy debate about the composition and powers of the FRC.

Overall, despite there being no agency specifically charged with CG policy development, there is an active debate on a number of CG related themes in the Hong Kong market. While there is broad agreement as regards overarching CG principles, progress is constrained by widely differing views on the question of implementation in view of the current regulatory architecture, the needs of the market, and, on occasions, the readiness cum commercial willingness of issuers and their directors to move to higher standards.

I.2.1 Stakeholder engagement in regulatory development

Government related

CG policy at the highest level is set by the Government's Chief Executive (CE) who is advised by the Executive Council.⁷⁰ The Financial Secretary (FS) has responsibility for legislation and policy on CG matters. These roles are in principle as the responsibility is delegated to government committees or groups to issue a report before being considered by the Legislative Council (LegCo).⁷¹ For example, the FS is supported by the Panel of Financial Affairs, which may hold sessions on, *inter alia*, pertinent CG issues and international developments.

⁷⁰ HKICPA, "Hong Kong – Market Information," (2015), 4

⁷¹ Ibid.

More complex areas of CG policy are delegated to standing committees that advise the FS on their findings.⁷² For example, addressing issues in the extensive rewrite of the CO was delegated to the SCCLR, a non-statutory advisory committee to the government, as discussed below.⁷³

Devising specific CG policies is managed by the FSTB, which undertakes CG reviews or delegates responsibility to the relevant government departments, bureaus, or regulators. For example, the FSTB holds public consultations into CG matters affecting the Companies Registry (CR), establishing the independent auditor regulatory regime or rewriting the CO, and may then make recommendations. The FSTB is also responsible for standing committees which report annually through the Secretary of the FSTB to the CE.⁷⁴

In contrast, the SFC is responsible for CG policy formulation within the regulatory ambit of the SFO. It undertakes public consultations and has the power to approve recommendations cum rule changes proposed by the HKEX. It is accountable to the FS for any proposed legislative amendments. A specific statutory function of the SFC is to recommend law reforms and advise the FS on the securities and futures industry.⁷⁵

Companies Ordinance:

The most significant undertaking of the FSTB in recent years has been the rewriting of the CO with the overall aim of making Hong Kong's company law more user-friendly and to provide a modernized legal infrastructure commensurate with its status as an international financial centre.⁷⁶ The rewrite was a long and drawn out process which took seven years to complete. The FSTB undertook two phases of public consultation as part of the process and subsequently issued recommendations.

A first phase consultation of the draft Companies Bill highlighted a number of CG issues: (1) more detailed identification of directors and company secretaries; (2) whether private companies associated with listed companies should be more stringently regulated; (3) whether the common law derivative action should be abolished;⁷⁷ (4) codification of directors' duty of care, skill, diligence (mixed objective/subjective test) in place of the common law position of an objective test; and (5) introducing a business judgement rule instead of relying on the common law.⁷⁸ Strengthening the safeguards on the interests of minority shareholders was also considered because of the dominance of majority shareholders in the market.⁷⁹ The FSTB decided, after public consultation, to enhance shareholder engagement in the decision-making process.⁸⁰ For example, reducing the threshold requirement to demand a poll from ten to five percent of total voting rights and fostering shareholder protections, such as introducing more effective rules to deal with directors' conflicts of interest.⁸¹

⁷² Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), 30 [fn 6]

⁷³ *Ibid.*, [2.12]

⁷⁴ *Ibid.*, 30 [fn 6]

⁷⁵ s. 5(1)(p) & (q) SFO

⁷⁶ FSTB, "Consultation Paper: Accounting and Auditing Provisions," (March 2007) *Rewrite of the Companies Ordinance*, 2

⁷⁷ FSTB, "Rewrite of the Companies Ordinance First Phase Consultation on the Draft Companies Bill, Consultation Conclusions," (27 August 2010), 1 and 2

⁷⁸ *Ibid.* 13 to 16

⁷⁹ *Ibid.*, 2

⁸⁰ FSTB, "Rewrite of the Companies Ordinance Second Phase Consultation on the Draft Companies Bill, Consultation Conclusions," (25 October 2010), 1 and 2

⁸¹ *Ibid.*, 1 and 2

An assessment of other comparable jurisdictions is a part of the FSTB's approach when considering issues (e.g. UK, Australia, and Singapore) as well as others that have listed companies on the SEHK (e.g. British Virgin Islands, Cayman Islands and Bermuda).⁸²

The second phase consultation draft was issued on 25 October 2010 and canvassed a number of CG issues: (1) introducing statutory directors' remuneration reports for all listed companies incorporated in Hong Kong and unlisted companies incorporated in Hong Kong where members holding not less than five per cent have so requested; (2) providing the FS with powers of investigation and enquiry into a company's affairs; (3) introducing new powers for the CR to obtain documents, records, and information; (4) statutory obligations for a company to give reasons to refuse or affirm a transfer of shares; (5) imposing a more streamlined statutory prohibition on a Hong Kong company (and its subsidiaries) giving financial assistance to a third party for the purpose of acquiring shares in that company.⁸³

The FSTB considered that the disclosure of remuneration reports would be better served by the listing rules and/or the SFO and that the burden would be too onerous for unlisted companies.⁸⁴ Accordingly, the FSTB invited the SFC and HKEX to review the matter in relation to listed companies.⁸⁵ The FS's power to appoint inspectors was extended to members of non-Hong Kong companies that have a place of business in Hong Kong to align with the existing powers over Hong Kong incorporated companies.⁸⁶ Further, the FSTB accepted that it would be impossible to extend this power to overseas companies that do not have a place of business in Hong Kong.⁸⁷ By extending the information-gathering powers of the CR, the FSTB argued that this would facilitate the enforcement effort and help safeguard the integrity of the register.⁸⁸ In particular, the CR would focus on misconduct of false or misleading information relating to the delisting of a company and misleading and deceptive statements.⁸⁹

During the second phase consultation, a number of amendments were also considered in respect of Part 9 (Accounts and Audits) of the CO. These included: simplified reporting for small private companies, and that a "group of small companies" can prepare simplified financial and directors' reports.⁹⁰ A reason for not extending these provisions to capture other private companies/groups of any size was that Hong Kong Financial Reporting Standards (HKFRS) had already been developed for small and medium enterprises (SMEs), which applied simplified accounting requirements.⁹¹ The HKICPA and major accounting firms argued that having a supplementary statutory requirement may cause regulatory frictions in terms of compatibility and the degree of transparency.⁹² This position was accepted by the FSTB. A number of additional accounting and auditing requirements were adopted for bringing Hong Kong in line with international standards.

Accounting and Auditing Provisions:

A second major consultation undertaking driven by the FSTB, also in connection with the rewrite of the CO, was the accounting and auditing provisions of the CO. Views were

⁸² FSTB, "Rewrite of the Companies Ordinance First Phase Consultation on the Draft Companies Bill, Consultation Conclusions," (27 August 2010), 6

⁸³ FSTB, "Rewrite of the Companies Ordinance Second Phase Consultation on the Draft Companies Bill, Consultation Conclusions," (25 October 2010), 2 and 4

⁸⁴ *Ibid.*, 10

⁸⁵ *Ibid.*, 10

⁸⁶ *Ibid.*, 11

⁸⁷ *Ibid.*, 11

⁸⁸ *Ibid.*, 12

⁸⁹ *Ibid.*, 25

⁹⁰ *Ibid.*, 15

⁹¹ *Ibid.*, 16

⁹² *Ibid.*, 16

considered primarily from the HKICPA's "Working Group to Review the Accounting and Auditing Provisions of the CO" and the SCCLR.

The consultation concluded on 28 March 2008 and included the following modifications: (1) when restructuring a company just prior to an IPO, the first accounting period is prior to the date of incorporation to immediately before the IPO; (2) first set of accounts can be prepared within a few days of incorporation, and the annual accounts thereafter; (3) a company can alter its accounting reference date within five years from the last extension, if approved by members at a general meeting; (4) prepare a business review, applicable to all public companies and large private companies where shareholders have indicated support; (5) companies opting for simplified accounts and directors' reports are not to be given the option of dispensing with a more analytical and forward-looking business review; (6) making directors criminally liable if aware of information that the auditor considers necessary for the performance of their duties but which has not been disclosed to the auditor; and (7) for large guarantee companies to adopt full reporting requirements.⁹³ Amendments to the old CO were given effect in 2009.

In June 2014 the FSTB commenced a consultation on the regulation of listed company auditors and published its conclusions on 26 June 2015. A key objective of the consultation was to "enhance the independence of the existing auditor regulatory regime from the audit profession with a view to ensuring that the regime is benchmarked against international standards and practices".⁹⁴ This requires auditors of listed issuers (listed entity auditors, or LEAs) to be registered with the FRC under a new statutory regime. The primary concerns of the consultation were as follows:

LEAs will need to be registered with the FRC;

the FRC will have oversight of registration and setting of auditing and ethics standards. The FRC will receive periodic reports from the HKICPA although it will have no reserve power to act;

the FRC will assume the inspection of LEAs, non-compliance with these requirements being a criminal offence;

the FRC will be vested with disciplinary powers, including the power to fine according to published guidelines, and subject to a right of appeal and other appropriate checks and balances;

the FRC to be funded equally by the auditing profession, transaction levies and listed entities; and

the majority of the FRC board to be non-practitioners, and non-executive, with seven members appointed by the Hong Kong Special Administrative Region CE plus the CEO of the FRC ex officio.

The HKICPA in a press release dated 31 October 2016 added further considerations in relation to several of these proposals including concerns as to checks and balances on powers of inspection/investigation and enforcement. Unlike the equivalent powers of the SFC, the HKICPA considers these functions should be segregated and subject to guidelines on regulatory actions or sanctions that are proportionate to the identified audit deficiency.

Securities and Futures Ordinance:

⁹³ See generally, CR, "Consultation Conclusions on the Accounting and Auditing Provisions of the Companies Ordinance," (26 March 2008)

⁹⁴ "Consultation on Proposals to Improve the Regulatory Regime for Listed Entity Auditors", p. 1

The FSTB has undertaken a number of related consultations in relation to the SFC's role in the regulatory architecture of Hong Kong following the implementation of the SFO in 2003.

On 7 January 2005, the FSTB commenced a public consultation the primary objective of which was to expand the existing dual filing regime by giving statutory backing to major requirements of the listing rules and making the SFC responsible for the statutory listing rules. The SEHK would remain the frontline listing regulator and companies would only be admitted to listing with the approval of the SEHK's Listing Committee. The consultation represented a response to the recommendation of the 2003 Expert Group (discussed below) to put in place a statutory listing regime but which had not been implemented (as discussed in Appendix II, the UK moved to a statutory listing regime in 2000). The FSTB sought to extend the market misconduct regime in Parts XIII and XIV of the SFO to cover breaches of new statutory listing rules that would be made by the SFC. The Market Misconduct Tribunal (MMT) would be given new powers to impose, where there had been a breach of the statutory listing rules, administrative sanctions including public reprimands and fines on the primary targets, i.e. issuers, directors and officers. In addition, the SFC's powers under Part IX of the SFO would be expanded to the imposition of sanctions that include public reprimands, disqualification orders, disgorgement orders and fines.

However, the changes proposed by the FSTB did not proceed. The HKEX in its response suggested the only requirements that should be incorporated into the SFO are "the key requirements for the protection of investors and the reputation of the market", which would include the general obligation to disclose price sensitive information, the requirements as to the publication and contents of periodic financial reports and the provisions on connected transactions.⁹⁵ The HKEX also expressed concern that the proposed rules lacked the clarity and certainty required of legislative provisions. It stated that the principle underlying the division between the HKEX and the SFC should be that it "administers and interprets the listing rules and the SFC enforces those requirements which receive statutory backing". While it did support the SFC having the power to impose limited fines (of up to HK\$8 million), the HKEX considered that it was the role of the legislature, not the SFC, to set out the main requirements and subsidiary legislation set by the SFC should be restricted to filling out the details.⁹⁶

The FSTB again consulted the market in 2010. In February 2011 the FSTB's conclusions,⁹⁷ which excluded connected and notifiable transactions and periodic reporting, led to the implementation of Part XIVA of the SFO and the SFC's Guidelines on the Disclosure of Price Sensitive Information, discussed in Appendices I.3 and I.4 respectively.

Law Reform Commission of Hong Kong (LRC):

The LRC has studied the question of whether class rights of action should be introduced, and has published a recommendation that some form of class action mechanism should be adopted.⁹⁸ Cases related to interests in securities that were provided for under the investor protection provisions of the SFO was one of the scenarios contemplated by the LRC.⁹⁹ Although the LRC's recommendation has been submitted to the Department of Justice and the HKSAR Government, there has been no response or further progress. In

⁹⁵ "Combined Submission of HKEX in Response To The FSTB and SFC Consultation Papers On Proposals to Give Statutory Backing To Major Listing Requirements" 24 March 2005, para 1.4-1.5

⁹⁶ *Ibid.*, para 1.5(a)

⁹⁷ "Proposed statutory codification of certain requirements to disclose price sensitive information by listed corporations – Consultation conclusions"

⁹⁸ The Law Reform Commission of Hong Kong, "Report – Class Actions", May 2012, Annex I, page 275

⁹⁹ *Ibid.*, [1.34]

the interim, it has been suggested that the SFC's powers under the SFO may in certain regards act as a meaningful alternative to class action rights, though does not fully replace class action rights as the SFC has a number of statutory obligations that may affect its decision to bring an action.¹⁰⁰

Standing Committee on Company Law Reform:

The first Company Law Revision Committee was established in 1962. Its first report, published in 1971, mainly dealt with prospectus requirements.¹⁰¹ Origins of the current SCCLR stem from 1984 when the committee was created to ensure that the old CO remained responsive to the day-to-day needs of the business sector and community at large.¹⁰² Composition of the SCCLR's membership was essentially settled at this time to include members of relevant government departments/bureaus (e.g. FSTB and CR), CG regulator representatives (e.g. SFC and HKEX) and leading industry individuals (e.g. accounting, legal, academic, and company secretarial).¹⁰³ Members are appointed by the FS to advise the government.

The comprehensive rewrite of the CO launched in mid-2006 required policy issues to be considered by the SCCLR. One problem cited by Gordon Jones, the former Registrar of Companies, was that the SCCLR as a government department is primarily reactive: it does not initiate amendments, seek to review the CO as a whole or address the fundamental problems with the CO.¹⁰⁴ The SCCLR's role is to consider, *inter alia*, CG issues and initiate company law amendment bills in LegCo.¹⁰⁵ Issues raised by the SCCLR are progressively released for public consultation by the FSTB, before being presented to FS and ultimately LegCo. Thus the SCCLR's CG policy recommendations are exposed to public consultation prior to LegCo's decision as to whether the policies will be legislated. On 3 March 2014, this policy and legislative process resulted in the promulgation of the new CO, which contained many new CG provisions, as reviewed above.

Expert groups:

The government will, on occasion, appoint non-statutory expert groups or consultants to produce ad-hoc reports on high-profile CG issues. Expert groups are similar to the SCCLR, except that the terms of reference are more focused on a particular issue.

The FS appointed a panel of inquiry to examine a substantial fall of HK\$10.9 billion in the value of penny stocks on the SEHK Main Board following the release of a consultation paper by the HKEX that recommended their delisting.¹⁰⁶ The report on the panel's findings submitted to the FS identified numerous problems including: (1) poor communication within the first tier, (2) HKEX and SFC underestimated market reaction, (3) HKEX staff was not experienced enough, (4) HKEX had not devoted adequate resources to reform proposals, (5) lack of communication between HKEX and market players, (6) lack of co-ordination between SFC and HKEX, and (7) HKEX was bureaucratic.¹⁰⁷ As a consequence of the report, a recommendation was made to the

¹⁰⁰ Syren Johnstone, "A flawed debate", *International Financial Law Review*, May 2015, pages 38-39

¹⁰¹ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [2.12]

¹⁰² Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [2.12]

¹⁰³ CR, "Consultation Conclusions on the Accounting and Auditing Provisions of the Companies Ordinance," (26 March 2008), 2 [fn 3]

¹⁰⁴ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [2.13]

¹⁰⁵ *Ibid.*, [2.14]

¹⁰⁶ Robert Kotewall and Gordon Kwong, "Report of the Panel of Inquiry on the Penny Stocks Incident," (September 2002), 1

¹⁰⁷ *Ibid.*

government that a study be undertaken to review the regulatory structure relating to listing matters.¹⁰⁸ At this stage, the SFO was still under discussion, although largely final in terms of content.

On 26 September 2002, the FS appointed a three member Expert Group to review the operation of the securities and market regulatory structure.¹⁰⁹ Two important considerations at the time were the changes that had taken place in the UK and the demutualization and listing of the Exchange in Hong Kong in 1999. On 1 May 2000, regulatory responsibility for companies listed on the London Stock Exchange (LSE) was transferred from the LSE to the UK Listing Authority (UKLA) - the UKLA was part of the now defunct Financial Services Authority and is now a function of the Financial Conduct Authority. The reorganization in the UK was viewed as appropriate given the commercialization of Exchange business. At this time, the HKEX had only recently been formed and newly listed on the Main Board of the SEHK. This brought considerable attention to the potential conflicts of interest in listing matters, including CG standards, given that HKEX itself was now listed on a board operated by its subsidiary. Following a public consultation, the report of the expert group identified the main issues to be: (1) quality of listings, or lack thereof; (2) the HKEX's conflict of interest being both the controller of the SEHK and having a business model that promotes IPOs; (3) an absence of a lead corporate regulator; (4) the need for stronger regulation and enforcement of intermediaries; and (5) the roles and responsibilities of the three tiers of regulators.¹¹⁰

The recommendation of the expert group, to support a similar regulatory model, was supported by a major review by the International Monetary Fund likewise in the same year. However, the recommended adoption was subsequently dropped, apparently after political opposition.

Financial Services Development Council:

The FSDC was established in January 2013 with a mission to formulate proposals to promote the further development of Hong Kong as an international financial centre.¹¹¹ It issues papers on specific topics of relevance to their mission. Although none of its papers issued to date specifically touch on CG, it did offer a submission that was critical of the SFC/HKEX Joint Consultation on Listing Reform,¹¹² as well as a paper proposing reforms to Part XV of the SFO.¹¹³

Securities and Futures Commission

The SFC is very active in undertaking a range of policy initiatives. It has a statutory function to advise the FS on matters relating to the securities industry¹¹⁴ and to provide the FS with, *inter alia*, details of the policies it is pursuing or proposing to adopt, many of which encompass CG concerns.¹¹⁵

While the SFC does not normally propose specific CG regulatory measures, it does perform an important function in relation to any proposed changes to the listing rules of the SEHK, which require the approval of the SFC. The SFC also has the power to direct

¹⁰⁸ Hong Kong Government, "Report by the Expert Group to Review the Operation of the Securities and Market Regulatory Structure," (2003), 1

¹⁰⁹ Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure, March 2003

¹¹⁰ Hong Kong Government, "Report by the Expert Group to Review the Operation of the Securities and Market Regulatory Structure," (2003), 4 to 12

¹¹¹ "Mission": Available at <http://www.fsd.org.hk/en/about/mission> (visited 3 Dec 2016)

¹¹² Available on the FSDC website

¹¹³ "Disclosure of interests regime in Hong Kong", Paper No. 12 December 2014

¹¹⁴ S. 5(1)(q) SFO

¹¹⁵ s. 12 SFO

the SEHK to make rules, although it has to date not used this power.¹¹⁶ As already noted above, there is considerable sensitivity around the exercise of the SFC's powers to make subsidiary legislation. In addition, the relationship between the SFC and HKEX, while in general constructive, often enters uncomfortable territory when it comes to structural matters concerning their respective roles, responsibilities and powers in relation to the listed market.

The SFC and the HKEX have established, pursuant to "Memorandum of Understanding Governing Listing Matters" (the "Listing MoU"),¹¹⁷ a "High Level Group" composed of senior representatives from the SFC and SEHK, which reviews policy issues relating to listing matters and which may propose amendments to the listing rules.¹¹⁸ This group consists of: Chair of the HKEX, Chair of the Listing Committee, Chair of the GEM Listing Committee, Chair of the Takeovers Panel, Chair of the SFC, Executive Director of the Corporate Finance Division of the SFC, CE of the HKEX, and the Head of "Listing, Regulation and Risk Management", HKEX.¹¹⁹ The HKEX's Listing Division is guided by the High-Level Group and the Listing Committee, which will, from time-to-time, review and propose amendments to the listing rules.¹²⁰ In addition, the Listing MoU requires the SFC and SEHK to hold "Listing Matters Liaison Meetings" on a monthly basis to discuss issues arising from specific cases and more general policy issues.

Important recent consultations and publications impacting on CG standards include the following.

"Guidelines on Disclosure of Inside Information" (2012) – these are non-statutory guidelines issued by the SFC to assist listed issuers comply with their obligations to disclose inside information under Part XIVA of the SFO¹²¹ - discussed in Appendix I.4.

"Consultation on the Regulation of IPO Sponsors" (May 2012) - which led to substantial changes in the regulatory requirements imposed on sponsors and (listing applicants) during the listing process – this is expected to improve the quality of listing applicant, including the quality of management and the systems and procedures adopted by the board of the issuer upon being admitted to listing.

"Principles of Responsible Ownership" (2016) (published following the Consultation on the Principles of Responsible Ownership (May 2015)) – the principles outline the role of shareholders in holding boards accountable and discharging their ownership responsibilities - discussed in Appendix I.4.

"Joint Consultation on Proposed Enhancements to The Stock Exchange of Hong Kong Decision-Making and Governance Structure for Listing Regulations" (SFC/HKEX, June 2016) - this proposed structural and procedural changes to the way listing regulation is carried out - however, the consultation was highly controversial, attracting a large number of submissions both in support of and against the proposal. The Financial Affairs Panel of the LegCo has expressed concern that the proposal may be *ultra vires*, citing a submission to the consultation by the University of Hong Kong.¹²²

¹¹⁶ ss. 24 and 23(3) SFO respectively

¹¹⁷ Dated 28th January 2003, this is a non-binding memorandum per Clause 3.1(c)

¹¹⁹ SFC and SEHK, "Memorandum of Understanding Governing Listing Matters," (January 2003), Appendix II

¹²⁰ *Ibid.*, [6.2]

¹²¹ Paul Westover and Yolanda Chung, "Corporate Governance and Directors' Duties in Hong Kong: Overview," *Practical Law, A Thomson Reuters Legal Solution*: Available at <http://uk.practicallaw.com/7-506-8920#> [THIS LINK IS NOT WORKING] (visited 4 Dec 2016)

¹²² HKSAR Legislative Council Panel on Financial Affairs 6 Feb 2017 citing Syren Johnstone, Nigel Davis & Douglas W Arner "A principles-based response to the proposed reform of the governance structure for listing regulation in Hong Kong", AIFL Working Paper No. 19, November 2016). Available at

"Joint Consultation Conclusions. Proposed enhancements to The Stock Exchange of Hong Kong Limited's decision-making and governance structure for listing regulation" (SFC/HKEX, September 2017) – this dropped the proposals in the above consultation and instead proposed a "Listing Policy Panel", which is yet to be implemented and may yet face further *vires* problems.¹²³

Hong Kong Institute of Certified Public Accountants

As the body that is empowered to register and grant practising certificates to public accountants in Hong Kong, the HKICPA also issues the HKFRS and the Hong Kong Standards on Auditing (HKSA) pursuant to section 18A of the Professional Accountants Ordinance (Cap. 50) (PAO),¹²⁴ and the Hong Kong Accounting Standards (pursuant to section 380 (4) (b) of the CO).¹²⁵ The HKFRS set out recognition, measurement, presentation, and disclosure requirements for dealing with transactions and events.¹²⁶

The HKSA deals with an auditor's responsibilities to consider laws and regulations in the audit of financial statements.¹²⁷ Many of the Sarbanes-Oxley Act 2002 (SOX) provisions concerning auditor independence are absent.¹²⁸ Certain auditing requirements are mandated in the listing rules. Therefore, non-compliance with overlapping listing rules/HKSA requirements are referred to the SFC or HKEX for follow up action. The HKICPA also issues various non-statutory auditing guidelines.

Other guidance issued by the HKICPA:

"A Guide on Better Corporate Governance Disclosure", issued by HKICPA in February 2014, is a non-statutory guide that focuses on the provisions of the CG Code involving the board, internal controls, the audit committee and communication with shareholders.¹²⁹ To prepare the guide, feedback was sought from annual report preparers, investors, independent directors, listed company management, auditors, and other consultants. The guide was designed to provide an explanation of the areas of the CG Code that are not self-explanatory. The CG Code is discussed in Appendix I.4.

Financial Reporting Council

The FRC is active in its current role to maintain the quality of financial reporting. At present it is in a transitional state - the FSTB has recommended that steps should be taken with the FRC to facilitate Hong Kong's membership of IFIAR. The FRC's own policy position, as discussed in Appendix I.4 below, is that it should become the independent auditor oversight body vested with powers of inspection, investigation, and discipline with regard to auditors of listed companies.

HKEX/SEHK

Pursuant to the Listing MoU, the SFC has delegated its policy making powers in relation to the listing rules to the SEHK.¹³⁰ SEHK policy formulation is handled by the Listing

<https://ssrn.com/abstract=2867895>. The recording of the Panel meeting can be viewed at <http://webcast.legco.gov.hk/public/en-us>

¹²³ Syren Johnstone, Nigel Davis and Douglas W. Arner, "Moving Forward on Listing Reform", AIIFL Working Paper No. 22, October 2017: Available at <http://ssrn.com/abstract=3057959>

¹²⁴ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.259]

¹²⁵ HKICPA, "Financial reporting"

¹²⁶ HKICPA, "Financial reporting"

¹²⁷ HKICPA, "Consideration of Laws and Regulations in an Audit of Financial Statements," (2010) *HKSA 250*, [1]

¹²⁸ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.259]

¹²⁹ HKICPA, "A Guide on Better Corporate Governance Disclosure," (February 2014), 4

¹³⁰ SFC and SEHK, "Memorandum Of Understanding Governing Listing Matters," (January 2003), [6], And [4.3 (D)] And [4.7].

Committee, which advises the HKEX's Listing and Regulatory Affairs Division on reviews of the listing rules, and approves public consultation papers and recommended consultation conclusions it may issue.¹³¹ The Listing and Regulatory Affairs Division may seek policy advice from the SFC.¹³² However, the Listing MoU states that any changes to the listing rules must be approved by the SFC,¹³³ which reflects the statutory provision in section 24 of the SFO.

Important recent consultations impacting on CG standards include the following.

"Consultation Paper. Review of the Corporate Governance Code and related listing rules" (November 2017), which builds on a number of the consultations undertaken in 2010/2011 (discussed below) and focuses on, *inter alia*, independent non-executive directors (INEDs), nomination policy, and directors' attendance at meetings.

The Joint Consultation on governance structure of the listed market (June 2016 and September 2017) – discussed above.

"Concept Paper. New Board" (June 2017), which proposes a New Board with two segments, New Board Premium and New Board Pro, the latter of which would permit companies with WVR structures to list (discussed in Appendix I.1).

"Consultation on Weighted Voting Rights Concept" (August 2014), which was issued to seek views on whether governance structures that give certain persons voting power or related rights that are disproportionate to their shareholding should be permissible for companies seeking to list on the SEHK.¹³⁴ This was followed, on 18 June 2015, with a draft proposal for a second stage consultation on WVR as the SEHK concluded that there was some support for the concept but had not formed any views itself.¹³⁵ However, on 25 June 2015 the SFC announced its board had unanimously concluded that it "does not support the draft proposal for primary listings with WVR structures." While the HKEX did not further progress the concept, the SFC has since qualified its position by stating that "the SFC at no point decided that some form of weighted voting rights is totally impossible for Hong Kong".¹³⁶ The topic may be resurrected following the HKEX's proposal for a New Board (discussed above and in Appendix I.1).

"Consultation on Review of Listing Rules on Disclosure of Financial Information" (August 2014), which proposed amendments to the listing rules (Main Board and GEM), with reference to the CO and Hong Kong Reporting Standards, to align the requirements for the disclosure of financial information.¹³⁷ The amendments to the listing rules were subsequently approved by the SFC to revise Main Board listing rules (MBLR) Appendix 16 and GEM listing rules (GEMLR) Chapter 18, applicable to the preliminary announcements of quarterly reports (GEM only), interim and annual reports.¹³⁸ The listing rules¹³⁹ require an issuer's summary financial report to comply with the relevant provisions set out in the Companies (Summary Financial Reports of Listed Companies) Regulation.¹⁴⁰

¹³¹ Ibid., [6.2] And [6.3]

¹³² Ibid., [6.2]

¹³³ Ibid., [6.1]

¹³⁴ HKEX, "Consultation Conclusions To Concept Paper on Weighted Voting Rights," (June 2015), 3

¹³⁵ See generally, HKEX, "Consultation Conclusions To Concept Paper on Weighted Voting Rights," (June 2015)

¹³⁶ Remarks made by SFC CEO Ashley Alder at the 7th Pan Asian Regulatory Summit, 8 November 2016

¹³⁷ HKEX, "Consultation Conclusions on Review of Listing Rules on Disclosure of Financial Information," (February 2015), 1

¹³⁸ Ibid., 4

¹³⁹ MBLR 13.46

¹⁴⁰ Cap. 32M

"Consultation on Risk Management and Internal Control" (June 2014), which proposed to amend the CG Code with respect to risk management and internal controls. Major changes proposed include: (1) incorporating risk management into the CG Code; (2) revising Principal C.2 to define the roles and responsibilities of the board and management; (3) clarifying that the board has an ongoing responsibility to oversee the issuer's risk management and internal control systems; (4) upgrading to CPs the recommendations in relation to the annual review and disclosures in the Corporate Governance Report (CG Report); and (5) upgrading to CP the recommendation that issuers should have an internal audit function (where that is not adopted, the issuer should review the need for one on an annual basis.¹⁴¹ The amendments to the CG Code took effect from 1 January 2016.

"Consultation on Connected Transaction Rules" (April 2013), which proposed to exempt connected transactions below the monetary limits of HK\$3 million from the announcement requirement and HK\$10 million from the shareholder approval requirement. The announcement requirement was originally proposed at HK\$1 million, which respondents deemed too low in comparison with other neighbouring jurisdictions, namely Singapore, Shanghai, and Malaysia.¹⁴² Revisions were made to the MBLR, Chapter 14A and GEMLR, Chapter 20 that took effect on 1 July 2014.

"Consultation on Proposed Changes to Align the Definitions of Connected Persons and Associates in the Listing Rules" (April 2013), which proposed aligning the definitions of "connected person" and "associate" in the MBLRs in relation to Chapters 1 and 14A and GEMLR Chapter 20. This proposal gained majority support from the 47 respondents. The HKEX renamed the definition in Chapter 1 as "core connected person" and "close associate" as the original definitions might have connoted other unintended meanings.¹⁴³ The changes took effect from 1 July 2014.

"Consultation on Board Diversity" (September 2012), which sought views on board diversity. Submissions were received from 139 respondents consisting of issuers, market practitioners, professional bodies and industry groups, non-governmental/non-profit-making organisations, institutional investors, individuals, and others.¹⁴⁴ Amendments to the listing rules introduced on 1 September 2013 included introducing a code provision whereby the issuer should have a board diversity policy and disclose it, or a summary of it, in the CG Report.¹⁴⁵ The amendments extended to: (1) CP Board composition; (2) CP Appointments, re-election, and removal; (3) CP Nomination Committee; and (4) Board Committees.¹⁴⁶

"Consultation on Statutory Backing to Listed Corporations' Continuing Obligation to Disclose Inside Information" (August 2012), which proposed changes to the listing rules (Main Board and GEM) as a consequence of amending Part XIVA of the SFO to give statutory backing to listed corporations' continuing obligation to disclose inside information.¹⁴⁷ The listing rules concerned were MBLR 1.01 and

¹⁴¹ HKEX, "Consultation Conclusions On Risk Management and Internal Control: Review of the Corporate Governance Code and Corporate Governance Report," (December 2014), 1 and 2

¹⁴² HKEX, "Consultation Conclusions On Review Of Connected Transaction Rules," (March 2014), 27

¹⁴³ HKEX, "Consultation Conclusions On Proposed Changes To Align The Definitions of Connected Persons and Associate In The Listing Rules," (March 2014), 4

¹⁴⁴ HKEX, "Consultation Conclusions Board Diversity," (December 2012), 1

¹⁴⁵ *Ibid.*, 3

¹⁴⁶ *Ibid.*, 19 and 20

¹⁴⁷ HKEX, "Consultation Conclusions Rule Changes Consequential On The Enactment of the Securities and Futures (Amendment) Ordinance 2012 To Provide Statutory Backing To Listed Corporations' Continuing Obligation To Disclose Inside Information," (November 2012), 1

GEMLR 1.01 to enable the SEHK to discharge its duty under section 21 of the SFO – as far as reasonably practicable, ensure an orderly, informed, and fair market for the trading of securities listed on its exchange.¹⁴⁸ The SFC subsequently issued the Guidelines on Disclosure of Inside Information. New inside information provisions imposed statutory obligations on issuers and officers to disclose inside information as soon as reasonably practicable subject to applicable safe harbours. Part XIVA gives the SFC the power to enforce those provisions. Amendments to the listing rules and the SFO came into effect on 1 January 2013.

“Consultation on Review of the Corporate Governance Code and Associated Listing Rules” (December 2010) and the “Consultation Conclusions” (October 2011), which adopted a combination of rules, CPs, and RBPs.¹⁴⁹ Specific changes related to, *inter alia*: (1) directors’ duties and time commitments; (2) directors’ training and INEDs; (3) board committees; (4) remuneration of directors, CEOs, and senior management; (5) board evaluation; (6) board meetings; (7) chairman and CEO; (8) notifying of director change and disclosure of director information; (9) shareholders’ general meetings; (10) shareholders’ rights; (11) communications with shareholders; and (12) company secretary requirements. These changes were rolled out progressively between 1 January and 31 December 2012.

I.2.2 Periodic reviews

While the regulators do not issue any specific assessments of CG performance or developments, they do issue periodic reports on regulatory performance that may encompass the development of CG. Material published by the SFC (such as its Annual Report or other research material published on an *ad hoc* basis) or the SEHK may include information on CG, such as rates of compliance with the CG Code (as discussed in Appendix I.1.1).

Standing Committee on Company Law Reform

The SCCLR reports annually to the FS, through the FSTB, on amendments to the CO and Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (CWUMPO) that are under consideration.¹⁵⁰ However, the SCCLR can only provide policy recommendations or directives to initiate CO amendments. The SCCLR advises the FS on SFO matters relating to CG and shareholder protection.¹⁵¹ The SCCLR may receive information or discussion papers from the Government (e.g. FSTB) on legislative proposals and will be required to provide policy advice or directives after consulting with the Government.¹⁵²

Securities and Futures Commission

The SFC issues annual reviews of the HKEX’s and SEHK’s performance in its regulation of listing matters.¹⁵³ This is a statutory duty of the SFC in accordance with section 5(1) of the SFO and as agreed in the Listing MoU.¹⁵⁴ The annual review can make recommendations that the SEHK conduct a general review of its rules to ensure that the

¹⁴⁸ HKEX, “Rule Changes Consequential on Statutory Backing to Issuers’ Continuing Obligations to Disclose Inside Information,” (1 January 2013), 5

¹⁴⁹ HKEX, “Consultation Conclusions On Review Of The Corporate Governance Code And Associated Listing Rules,” (October 2011), 2

¹⁵⁰ SCCLR, “The Thirty-Second Annual Report 2015/2016,” (November 2016), 1

¹⁵¹ *Ibid.*, 1

¹⁵² *Ibid.*, 5

¹⁵³ SFC, “Periodic reports,”: available at <http://www.sfc.hk/web/EN/published-resources/reports/periodic-reports.html> (visited 20 Dec 2016)

¹⁵⁴ SFC and SEHK, “Memorandum of Understanding Governing Listing Matters,” (January 2003), [4.2 (d)]

policy intention behind the rules is preserved.¹⁵⁵ Commentary is also provided in relation to the HKEX Listing Department's discussion papers' policy proposals during the review period.¹⁵⁶ The performance of the Listing Department's is ranked annually. For example, an issue on which the Listing Department was ranked during 2015 was its experience and knowledge of the listing rules with regards to its understanding of the policy issues behind the listing rules – it was ranked 4.3 on a scale of 1 to 5, with 5 being the highest ranking.¹⁵⁷

A function and responsibility of the SFC is to provide policy advice on any potential amendments to the listing rules that the SEHK might propose.¹⁵⁸ General policy advice is provided to the SFC by the Advisory Committee, which meets periodically at least once every three months or when requested by the SFC.¹⁵⁹

The SFC is itself subject to an annual review undertaken by the Process Review Panel (PRP), an independent, non-statutory panel established by the CE of the HKSAR in November 2000, comprising of representatives from different stakeholders in the industry. Its membership also includes the SFC's Chairman as an *ex-officio* member. The PRP's terms of reference are, *inter alia*, to "review and advise the[SFC] upon the adequacy of the [SFC's] internal procedures and operational guidelines governing the action taken and operational decisions made by the [SFC] and its staff in the performance of the [SFC's] regulatory functions".¹⁶⁰ Reviews undertaken since 2001 are available on the SFC's website and have focused on the SFC's operations and the proper and consistent exercise of its regulatory powers. The reports cannot be characterized as particularly incisive challenges to the SFC's undertaking of its role, and instead tend toward being constructive assessments that support the better development of the SFC's execution of its regulatory mandate.

¹⁵⁵ SFC, "Report on the Securities and Futures Commission's 2015 annual review of the Exchange's performance in its regulation of listing matters," (June 2016), [56]

¹⁵⁶ *Ibid.*, [58]

¹⁵⁷ *Ibid.*, Appendix A, 17

¹⁵⁸ SFC and SEHK, "Memorandum Of Understanding Governing Listing Matters," (January 2003), [4.2 (e)]

¹⁵⁹ SFO, ss 7 (3) and 7 (4)

¹⁶⁰ Annex A, para 1, "Process Review Panel for the Securities and Futures Commission. First Annual Report for 2001": Available on the SFC's website

Appendix I	3. Legislation	I.3 Hong Kong
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Introduction

Historically, Hong Kong’s statutory framework for CG follows the UK system, with both jurisdictions operating under comparable regulatory architectures. While remaining largely similar in spirit, Hong Kong’s architecture has not adopted the fundamental structural changes in the UK since the early 2000’s (see Appendix II.3) in three important regards. First, the regulatory oversight of the listed market remains based on the Exchange (HKEX and the SEHK) acting as the frontline regulator subject to the oversight of the industry regulator (the SFC) – in contrast to the UK’s statutory based listing model. Second, as noted in Appendix I.1, Hong Kong’s regulatory architecture remains a mixed sectoral and institutional approach, with prudential and conduct regulation being spread across different regulatory agencies – in contrast to the twin peaks model adopted by the UK. Third, the SFC’s powers to make subsidiary legislation and to impose administrative penalties remain constrained in that the former remains subject to legislative negative vetting (the SFC has not to date exercised those powers in relation to specific CG concerns), and the latter power is restricted to the SFC’s role as a regulator of intermediaries in the financial services sector – in contrast to the more direct powers that have been provided to the UK’s FCA.

Legislative support for and enforcement of CG standards is found in a number of ordinances, which tend to address CG processes at a higher level rather than the specifics of day-to-day operational and procedural matters. The setting of specific CG requirements remains an important function of the HKEX/SEHK subject to the oversight of the SFC. However, such requirements do not have statutory force. While the CO does contain clear statements as to the duties of directors, they only apply to locally incorporated companies whereas most companies listed on the SEHK are incorporated elsewhere. Accordingly, many of the more targeted CG requirements lack statutory backing as regards the consequences of breaching them – instead, only a narrow range of penalties, often regarded as weak, are typically available in all but the more egregious cases that breach the law. This problem is to some extent ameliorated by measures taken by the SFC and HKEX in relation to the acceptability of non-Hong Kong incorporated companies for listing, as discussed in Appendix I.4.

I.3.1 Primary legislation

There is no overarching statutory framework for CG in HK. The legislative framework addressing CG concerns is primarily established by the CO, SFO, CWUMPO and the Financial Reporting Council Ordinance¹⁶¹ (FRCO).

The legislative enforcement of CG standards of listed companies tends to operate under the wider ambit of the SFO and, to a lesser extent in practice, the CO and the CWUMPO. Unlike the CO, the SFO applies to all companies listed on the SEHK regardless of their place of incorporation. Parts of the CO do apply to non-Hong Kong incorporated companies, and the CWUMPO is limited to primary market disclosures.

The oversight of financial reporting is subject to specific legislative provisions and industry regulators as well as non-statutory requirements set by the HKEX/SEHK.

¹⁶¹ Cap. 588

Companies Ordinance

Hong Kong's governing companies legislation, first introduced in 1932 and closely based on the equivalent UK legislation, underwent gradualistic and piecemeal evolution over most of the 20th century, often following developments in the UK albeit at a lag. For example, the statutory derivative action – discussed in Appendix I.7 – was not introduced until 2010.¹⁶²

The current CO, which came into effect on 3 March 2014, replaced the old companies legislation, most of which was repealed, the remaining provisions of which continuing to deal with director disqualification, share offerings, prospectuses, and disciplinary powers against non-Hong Kong companies – discussed below.

Among the issues the new CO address that impact on CG are: (1) identification of directors and company secretaries; (2) enhanced private company regulation; (3) codification of directors' duty of care, skill and diligence; (4) introducing a business judgement rule; (5) introducing directors' remuneration reports; and (6) new Companies Registry information-gathering powers. Accounts and audit amendments were also made to the CO, including criminal liability for directors who fail to disclose relevant information to auditors. Supporting the CO is the Companies (Non-Hong Kong Companies) Regulation¹⁶³ – discussed in Appendix I.8.

The CO covers both public and private companies that are incorporated in Hong Kong. The main operative provisions of the CO that may have a bearing on the topic of CG are:

Part 5: Transactions in relation to Share Capital;

Part 9: Accounts and Audit;

Part 10: Directors and Company Secretaries – Division 2 of which sets out the directors' duty of care, skill and diligence;

Part 11: Fair Dealing by Directors;

Part 12: Company Administration and Procedure;

Part 13: Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back;

Part 14: Remedies for Protection of Companies' or Members' Interests – which includes remedies in where there has been to unfair prejudice and derivative actions both of which, importantly, are available in relation to Hong Kong incorporated and non-Hong Kong incorporated companies – discussed further in Appendix I.7; and

Part 19: Investigations and Enquiries.

Many of the CO's provisions are straightforward, for example, the requirement that a public company has at least two directors, that a register of directors be kept, and that directors be of at least eighteen years of age.¹⁶⁴ Other provisions regulate directors' actions, for example that the notice for a shareholder meeting must contain: "such

¹⁶² See generally, Companies (Amendment) Ordinance 2010

¹⁶³ Cap. 622J

¹⁶⁴ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.46]: referring to the CO, ss 453(2), 644(1), and 459(1), respectively

information and explanation ... as is reasonably necessary to indicate the purpose of the resolution".¹⁶⁵

Prior to the rewrite of the legislation leading to the present CO, the question of the codification of directors' duties had been discussed, as had been done elsewhere, notably the UK¹⁶⁶ (see Appendix II.3) and Australia.¹⁶⁷ Codification would address not only the duty of care, skill and diligence but also other duties of a fiduciary nature. However, the conclusion of the SCCLR in its 2001 Corporate Governance Review¹⁶⁸ was that this is unnecessary and accordingly only the duty of care, skill and diligence of directors is codified in section 465 of the CO, which is modeled on section 174 of the UK Company Act 2006 (CA 2006).¹⁶⁹ This duty applies to both executive directors and NEDs equally. However, what is required of different directors will vary according to the functions carried out by a director, what is reasonably expected in relation thereto,¹⁷⁰ and the particular individual's knowledge, skill and experience.¹⁷¹

The CR has published the non-statutory "A Guide on Directors' Duties" ("the CR Guide") to assist with an understanding of the law. However, the CR Guide is non-statutory, it is not enforceable, and a breach of it may or may not constitute a breach of the common law duties of directors - this may only be determined by the court applying the law.

The CO is not directly relevant to most listed companies in Hong Kong as most are not incorporated in Hong Kong. While the law of the place of incorporation will generally govern matters such as directors' duties and shareholder rights, some provisions of the CO will apply: those providing for statutory derivative action and unfair prejudice (Part 14 of the CO),¹⁷² as well as those dealing with the annual return and accounts and various administrative matters such as the provision of a list of directors (Part 16 of the CO),¹⁷³ the registration of the company, and its authorized representative. The CO is also relevant as a result of the following three mechanisms employed by the SEHK.

As a basic gateway for acceptability to be listed, the SFC/HKEX "Joint policy statement regarding the listing of overseas companies"¹⁷⁴ sets out minimum requirements for listing applicants that are concerned with CG and shareholder protection. While not directly imposing the legislative requirements on overseas issuers, it does incorporate certain basic requirements, for example, in relation to convening and voting at shareholder meetings that may require the listing applicant to change its constitutional documents before being regarded as acceptable for listing.

The listing rules contain a general requirement to provide standards of shareholder protection at least equivalent to Hong Kong.¹⁷⁵ Where the applicable home jurisdiction law does not provide such protections, then the company will need to amend its constitutional documents to provide equivalence to the Hong Kong legislation in this regard.¹⁷⁶

¹⁶⁵ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.46]: referring to the CO s 576(1)

¹⁶⁶ ss 170-181 CA 2006

¹⁶⁷ Corporations Act 2001 (Cth of Aust), ss 180-183

¹⁶⁸ SCCLR, *Corporate Governance Review: Consultation Paper on Proposals Made in Phase I of the Review* (2001) at paras 6.13-6.14

¹⁶⁹ FSTB, *Rewrite of the Companies Ordinance – Company Names, Directors' Duties, Corporate Directorship, Registration of Charges: Consultation Paper* (2008)

¹⁷⁰ Per s. 465(2)(a) CO

¹⁷¹ Per s. 465(2)(b) CO

¹⁷² CO ss. 724 and 732

¹⁷³ Respectively: CO, ss 786, 788, 789, 802

¹⁷⁴ The most recent version being issued 27 September 2013

¹⁷⁵ LR 19.05(1)(b)

¹⁷⁶ SFC/HKEX "Joint policy statement regarding the listing of overseas companies" 27 September 2013, para 4

The listing rules require that all directors of listed issuers adhere to standards commensurate with standards established by Hong Kong law.¹⁷⁷ Therefore directors of non-Hong Kong incorporated companies are required to exercise fiduciary duties under Hong Kong common law and the duties of skill, care, and diligence as required by section 465 of the CO, i.e. as applicable to directors of a Hong Kong incorporated company. The listing rules reference the CR Guide as summarizing the relevant duties.

Appendix I.4 discusses the above provisions together with a number of other listing rule requirements that specifically address CG matters. Non-locally incorporated companies issuers are discussed in Appendix I.8.

Securities and Futures Ordinance

The SFO, introduced in April 2003, consolidated, replaced, and significantly developed and modernized the securities laws that had previously been in force. The powers of the SFC are derived from the SFO including administrative, civil and criminal enforcement provisions.

All companies listed on the SEHK (regardless of the place of incorporation) are subject to the provisions of the SFO. This includes important market protection provisions under Parts XIII, XIV and, since 1 January 2013, XIVA, and ownership transparency obligations under Part XV of the SFO.

Two sets of provisions of Parts XIII and XIV are of particular relevance to the CG topic because they concern transparency of information and abuse by corporate insiders. First, sections 277 and 298 of the SFO are concerned with the disclosure of false or misleading information likely to induce transactions. Second, sections 270 and 291 of the SFO prohibit insider dealing. The primary difference between Parts XIII and XIV is that the forum in which a wrongdoing is heard. Part XIII provides for administrative hearings before the MMT, which is empowered to, *inter alia*, impose director disqualification and disgorgement orders. Hearings under Part XIV are conducted in a criminal court with wide powers including the power to fine and imprison.

Section 277 of the SFO has come under the scrutiny of the MMT on two occasions in the past two years.¹⁷⁸ In one of these cases, the CITIC case, the events occurred in 2008 – because this was prior to the introduction of Part XIVA of the SFO, CITIC was only subject to the non-statutory obligations under the listing rules to disclose price sensitive information. While CITIC was found not to have engaged in market misconduct, the general view is that had the events occurred after the introduction of Part XIVA, it would have been in breach of the obligations under that Part.¹⁷⁹

Part XIVA was introduced to the SFO after a lengthy consultation commencing in 2005 that considered the removal of certain parts of the listing rules into statute, as discussed in Appendix I.2. While it had been proposed to give statutory effect to various provisions of the listing rules, only the obligation under MBLR 13.09 to disclose price sensitive information was moved to become Part XIVA – this Part imposes obligations on listed issuers and their officers to, *inter alia*, disclose inside information subject to applicable safe harbours. At the same time, the SFC issued the “Guidelines on Disclosure of Inside Information”.

¹⁷⁷ LR 3.08 and GEM LR 5.01

¹⁷⁸ The report issued 26 August 2016 in relation to dealings in the shares of Evergrande Real Estate Group Limited (regarding research distributed by Andrew Left/Citron); the report issued on 7 April 2017 in relation to CITIC Ltd (formerly known as CITIC Pacific Ltd) regarding announcements made by CITIC. Both reports are available on the MMT’s website.

¹⁷⁹ For a discussion, see Syren Johnstone and Nigel Davis “Transparency of information in the market: the CITIC case before the Market Misconduct Tribunal” Hong Kong Lawyer, July 2017

Part VIII of the SFO gives the SFC power to inspect records and investigate listed companies and certain related parties where it suspects a listed company may have acted, *inter alia*, in a manner oppressive to its members or any part of its members, or the management has engaged in defalcation, fraud, misfeasance or other misconduct towards it or its members or any part of its members, or shareholders have not been given all the information with respect to its affairs that they might reasonably expect.¹⁸⁰ The SFC also has effective powers to conduct reasonable cause investigations in relation to, *inter alia*, breaches of the SFO including Part XIVA.¹⁸¹ Where there has been wrongdoing in these regards, the SFC has various remedial powers,¹⁸² which it has used to effect in the Courts (see Appendix I.6).

The power of the SEHK to make rules governing the admission to listing is also derived from the SFO, and this is discussed in Appendix I.4.¹⁸³

Companies (Winding-up and Miscellaneous Provisions) Ordinance

Hong Kong's prospectus law, i.e. the requirements attaching to public offers of shares or debentures, is set out in the CWUMPO. This regulates the contents of a prospectus, the filing requirements for its authorization,¹⁸⁴ and the persons liable for any material misstatements in it. The company issuing a prospectus and its directors are subject to both civil and criminal liability for material misstatements.¹⁸⁵ A long running debate, since at least the early 2000's and involving several rounds of public consultation, has been whether a sponsor of an IPO is, or should be, subject to liability under CWUMPO. Although the SFC has suggested that they are, there appears to be no legal support for their position, which remains untested in court.¹⁸⁶

Under Part IVA of CWUMPO, section 168D a court may, or pursuant to section 168H a court shall, *inter alia*, make against a person a disqualification order to be a director.¹⁸⁷ The effect of such an order is that the relevant person may not be a director of, or be involved in anyway, directly or indirectly, or be concerned or take part in the management of a company for a specified period, without leave of the court.¹⁸⁸

Many other parts of CWUMPO have been repealed following the introduction of the CO, with the remaining parts dealing with certain aspects of insolvency and winding-up.

Financial Reporting Council Ordinance

The FRCO establishes and empowers the FRC in respect of the accounts of listed companies.¹⁸⁹ This applies to the preparation of prospectuses or other listing documents, and non-compliance with legal, accounting, and other regulatory requirements in the financial reports of SEHK listed companies.¹⁹⁰ Auditing/reporting and accounting requirements are those pursuant to the CO and the listing rules.¹⁹¹ Irregularities are to be reported to HKICPA or the SFC as the FRC's powers are currently limited to

¹⁸⁰ S. 179 SFO

¹⁸¹ ss. 182 – 184 SFO

¹⁸² ss. 213 and 214 SFO

¹⁸³ s. 23 SFO

¹⁸⁴ By the SFC or, where the prospectus is produced in connection with a listing, the SEHK

¹⁸⁵ ss. 40 & 40A CWUMPO

¹⁸⁶ Syren Johnstone, Antonio Da Roza and Nigel Davis "Deconstructing sponsor prospectus liability", Hong Kong Law Journal, 46(1) 2016

¹⁸⁷ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.169]

¹⁸⁸ *Ibid.*, [10.169] referring to ss 168D (1)(a) and 168D(1)(d)

¹⁸⁹ FRCO, Long title

¹⁹⁰ FRCO, Long title

¹⁹¹ HKICPA, "Hong Kong – Market Information," (2015), 9

investigation and enquiry.¹⁹² The FRC can direct the Audit Investigation Board, also established under the FRCO, to conduct an investigation.¹⁹³

Industry-specific ordinances

Banking Ordinance (Cap. 155) (BO):

Authorised Institutions (AIs) are subject to the BO.¹⁹⁴ Part X of the BO, "Powers of Control over Authorized Institutions", contains CG provisions relevant to AIs, including: (1) audits and meetings; (2) disclosure of general information; (3) information on shareholdings; (4) disciplinary action with respect to relevant individuals; (5) publication of audited balance sheet; and (6) alterations to the constitution. "Ownership and Management of Authorised Institutions" (Part XIII of the BO) consists of CG provisions concerning: (1) controllers; (2) restriction on and sale of shares; (3) circumstances requiring regulatory consent by directors and CEOs; (4) appointment of CEOs; (5) specified persons to submit information; (6) notification of appointment of manager; (7) prohibitions of and consent for certain persons acting as employees; (8) appointment of executive officers; (9) limitations on advances to directors; (10) limitation on shareholdings; and (11) limitations on aggregate holdings. Schedule 9 of the BO also outlines the powers of managers.

The Hong Kong Monetary Authority (HKMA) issues a guideline on the CG of AIs in its Supervisory Policy Manual (SPM), viz. "Corporate Governance of Locally Incorporated Authorised Institutions" (CG-1) pursuant to the section 7(3) of the BO.¹⁹⁵ The purpose of CG-1 is to set out the minimum standards the HKMA expects locally incorporated AIs to adopt in respect of their CG practices.¹⁹⁶ The HKMA has also issued a guideline on "Minimum Criteria for Authorization" (MCA Guideline), pursuant to section 16 (10) of the BO.¹⁹⁷ It sets out the manner in which the HKMA will interpret the licensing criteria set out in the Seventh Schedule of the BO and exercise related functions.¹⁹⁸ The HKMA expects that one-third of the board's directors, or three of its members, whichever is higher, are INEDs.¹⁹⁹ To ensure independence, INEDs should not be involved in the management of the bank and should be free from any business or other relationship that could materially interfere with the exercise of their independent judgment.²⁰⁰

Insurance Ordinance (Cap. 41) (IO):²⁰¹

The IO contains CG provisions for a person carrying on an insurance business, and deals with financial reporting and auditing matters²⁰², as well as matters including directors and controllers.²⁰³ The Insurance Authority has issued a "Guidance Note on the Corporate Governance of Authorised Insurers,"²⁰⁴ that covers matters such as (1)

¹⁹² Ibid., 9

¹⁹³ Ibid., 9

¹⁹⁴ Section 2 BO defines an AI as a bank, restricted-licence bank, or a deposit-taking company

¹⁹⁵ HKMA, "Supervisory Policy Manual – Corporate Governance of Locally Incorporated Authorized Institutions," (Revised) CG-1

¹⁹⁶ Ibid.

¹⁹⁷ HKMA, "Minimum Criteria for Authorization – A Guideline issued by the Monetary Authority under section 16(10)," (2015), [1]: Available at <http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/guideline/g15.pdf> (visited 9 Dec 2016)

¹⁹⁸ Ibid., [1]

¹⁹⁹ HKMA, "Minimum Criteria for Authorization – A Guideline issued by the Monetary Authority under section 16(10)," (2015), [14]: available at <http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/guideline/g15.pdf> (visited on 9 December 2016)

²⁰⁰ Ibid., [14]

²⁰¹ Formerly known as the Insurance Companies Ordinance

²⁰² Part III "Accounts and Statements" and Schedule 3

²⁰³ Schedule 2

²⁰⁴ Office of the Commissioner of Insurance, "Guidance Note on the Corporate Governance of Authorised Insurers," (2014), 21 and 22: Available at <http://www.oci.gov.hk/download/gn10-eng.pdf> [THIS DOCUMENT IS NO LONGER AVAILABLE AT THIS LINK](visited 6 Dec 2016) referring to the ICO

structure of senior management; (2) role and responsibilities of the board; (3) board matters; (4) committees; (5) internal controls; (6) compliance with laws and regulations; and (7) servicing of clients.²⁰⁵

Mandatory Provident Fund Schemes Ordinance (Cap. 485) (MPFSO):

Mandatory Provident Funds (MPFs) and their approved trustees are subject to certain CG requirements, namely: (1) lodging annual statements with the Authority; (2) duties of officers of corporate trustees; (3) restrictions on investments; (4) auditor reports; (5) information and documents; and (6) inspections.²⁰⁶ Responsible officers have, in accordance with the MPFSO: (1) specified responsibilities; (2) can be assigned a frontline regulator; and (3) conduct requirements.²⁰⁷

Whistle-blowing

Hong Kong does not have any specific whistle-blowing law. However, certain statutes do provide limited protections to persons reporting suspected wrongdoing, including employees making reports in relation to labour laws under the Employment Ordinance, discrimination under the Discrimination Ordinances,²⁰⁸ disclosures under the Anti-money Laundering Ordinance,²⁰⁹ or disclosures to the SFC by auditors of listed companies.²¹⁰ The Competition Commission of Hong Kong issued a leniency policy in November 2015 that serves to encourage whistle-blowing. Some non-statutory measures are in place as regards whistle-blowing – see Appendix I.4.

I.3.2 Subsidiary legislation

Companies Ordinance

A number of statutory rules have been made under the CO and relate to CG, including:²¹¹

Companies (Accounting Standards (Prescribed Body) Regulation;

Companies (Directors' Report) Regulation;

Companies (Summary Financial Reports) Regulation;

Companies (Revision of Financial Statements and Reports) Regulation;

Companies (Disclosure of Information about Benefits of Directors) Regulation;

Company Records (Inspection and Provision of Copies) Regulation;

Companies (Non-Hong Kong Companies) Regulation – discussed in Appendix I.8; and

²⁰⁵ Office of the Commissioner of Insurance, "Guidance Note on the Corporate Governance of Authorised Insurers," (2014), 2: available at <http://www.oci.gov.hk/download/gn10-eng.pdf>
<http://www.oci.gov.hk/download/gn10-eng.pdf> [THIS DOCUMENT IS NO LONGER AVAILABLE AT THIS LINK] (visited 6 Dec 2016)

²⁰⁶ See generally, MPFSO, Part 4

²⁰⁷ See generally, MPFSO, Part 4A

²⁰⁸ Disability Discrimination Ordinance, the Sex Discrimination Ordinance, the Family Status Discrimination Ordinance and the Race Discrimination Ordinance

²⁰⁹ Drug Trafficking (Recovery of Proceeds) Ordinance, the United Nations (Anti-Terrorism Measures) Ordinance and the Organised and Serious Crimes Ordinance

²¹⁰ SFO, s. 380

²¹¹ Respectively, Caps. 622 C, D, E, F, G, I, J, L

Companies (Unfair Prejudice Petitions) Proceedings Rules – discussed in Appendix I.7.

Only the last two of the foregoing apply to non-Hong Kong incorporated companies.

Stock Market Listing Rules

The Securities and Futures (Stock Market Listing) Rules²¹² (SMLR) have been made pursuant to section 36(1) of the SFO.²¹³ While not directly dealing with CG, the SMLR is relevant to CG as it provides a measure of statutory backing to the provisions of the listing rules as regards the disclosure obligations of listing applicants and listed issuers. The SMLR creates a dual filing regime (DFR) that requires all disclosures – both listing applications and ongoing listing disclosures – to be provided to the SFC.²¹⁴ This is part of the oversight mechanism for ensuring the quality of information provided by listing applicants and listed issuers.²¹⁵

The SMLR gives the SFC the power to object to a listing application or to impose on a listing applicant such conditions it may consider fit to impose.²¹⁶ This is an important part of the overall set of gateway mechanisms for allowing new companies to list on the SEHK, which includes roles performed by the SEHK and the sponsor(s) to the listing applicant. Grounds on which the SFC can object include: the application does not comply with the listing rules or an applicable law (such as CWUMPO), the information provided in the application is inadequate to enable an investor to make an informed assessment, is materially false or misleading, or it is not in the interest of the investing public or the public interest for the securities to be listed.²¹⁷ The conditions imposed by the SFC conceivably could address CG shortcomings in the listing applicant's governance arrangements. However, these powers have only rarely been used since, in practice, listing applicants would typically prefer to withdraw their application than face a possible objection – once an objection has been made, even if they were able to successfully appeal it, the capital raising exercise may nevertheless have been prejudiced commercially.

As regards listed issuers, the SFC is also empowered to direct the suspension of dealing in an issuer's securities on similar grounds as above,²¹⁸ primarily where materially false, incomplete, or misleading information has been filed with the SFC and the SEHK or where it is in the public interest, subject to the right of an aggrieved issuer, and the SEHK, to make representations to the SFC. This power does not arise in relation to breaches of the listing rules *per se* as they are instead focused on disclosures, but may nevertheless arise out of disclosures made pursuant to listing rule obligations. The SFC also has the power to impose on a suspended issuer conditions to the suspension being lifted.²¹⁹ Such conditions conceivably could, where the relevant shortcomings arise out of CG shortcomings, address the listing applicant's CG arrangements, although they do not appear to be used in this way. Once an issuer has been suspended, the SFC can also direct the SEHK to cancel an issuer's listing where it is in the public interest or is necessary for the protection of investors, or to maintain a fair and orderly market.²²⁰

The listing rules are discussed in Appendix I.4.

²¹² Cap. 571V

²¹³ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.50]

²¹⁴ s. 7, SMLR

²¹⁵ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.203].

²¹⁶ ss. 6(2) and 6(3)(b) respectively. Where the SFC exercises either power, it is subject to appeal and review by the Securities and Futures Appeals Tribunal under Part XI of the SFO.

²¹⁷ SMLR, s.6(2)

²¹⁸ s. 8 SMLR

²¹⁹ ss. 9(3)(c) and & (4) SMLR

²²⁰ SMLR, s9(3)(d)

I.3.3 Non-locally incorporated companies

As already noted above, non-Hong Kong incorporated companies are subject to Parts 14 and 16 of the CO. Supporting the CO is Companies (Non-Hong Kong Companies) Regulation.²²¹

Section 360N of the CWUMPO gives the Chief Executive-in-Council the power to have a non-Hong Kong company's registration or exemption from registration cancelled or its operation or continued operation prohibited. Furthermore the Chief Executive-in-Council may order the non-Hong Kong company to cease to carry on business in Hong Kong.²²²

Disclosure requirements

Since the introduction of Part XIVA of the SFO in January 2013 – discussed above - non-Hong Kong issuers are subject to statutory laws concerning the quality and timeliness of the disclosure of inside information. This is important as prior to 2013 they were only subject to the non-statutory sanctions applicable to breaches of the continuing obligations of the listing rules, or the market misconduct provisions of Parts XIII and XIV.

Non-Hong Kong companies are further discussed in Appendix I.8.

²²¹ Cap. 622J

²²² CWUMPO, s 360N, (b)

Appendix I	4. Regulation	I.4 Hong Kong
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Introduction

Hong Kong's three-tier system of regulation provides for relatively clear powers of the regulatory agencies. As the frontline regulator of listed issuers, the HKEX and the SEHK play an important role in setting general and specific CG standards. This is subject to oversight by the SFC as regards policy formation, the contents of and developments to the listing rules and, under the DFR, the disclosures of companies listed or seeking a listing on the SEHK. The SFC and the HKEX/SEHK are accordingly the two agencies holding general regulatory mandates that pertain to a wide range of CG concerns. Other regulatory agencies have more specific and targeted areas - the HKICPA and FRC as regards financial reporting and auditing, and the CR (a government department) as regards compliance with the CO.

These regulatory agencies are active in developing CG standards in Hong Kong, through public consultations and high-level inter-agency discussions, many of which occur through formalized forums. Detailed coordination often occurs pursuant to non-binding memoranda of understanding (MoU).

When considered at the non-statutory level, the CG system is subject to subtle complexities as a result of the relationship between the non-statutory regulations (including codes and guidelines) issued by the regulatory agencies, their heterogeneous relevance to the law, and the statutory powers of agencies, particularly the SFC which has a wide remit under the SFO including in relation to matters of central importance to CG concerns.

I.4.1 Regulatory agencies

The three-tier system of regulation, which formalises the roles, responsibilities, and inter-relationships of the government and the regulatory agencies²²³, is derived from the Securities Review Committee's 1988 "Hay-Davison Report".²²⁴

As the top layer of the hierarchy, the FSTB reflects the Government's "broad policy interest and concern in the development of Hong Kong's financial markets as part of Hong Kong's economy."²²⁵ The FSTB plays an important role in relation to policy setting, as discussed in Appendix I.2, and the accountability of agencies.

Founded on the notion that the operation of the market should be practitioner based subject to the oversight of an independent regulator, under the three-tier structure the FSTB oversees the SFC, the SFC regulates the HKEX/SEHK, and the HKEX/SEHK is given the power under the SFO to act as the front line regulator of listed companies. Together, these are the primary bodies responsible for determining CG policy and regulation.

²²³ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [5.6]

²²⁴ "The operation and regulation of the Hong Kong Securities Industry", Report of the Securities Review Committee, May 1988

²²⁵ Robert G Kotewall and Gordon CK Kwong, "Report of the Panel of Inquiry on the Penny Stocks Incident," (September 2002): Available at <http://www.info.gov.hk/info/pennystock/report-e-full.pdf> (visited 7 Nov 2016) [3.4]

The SFC and the HKEX/SEHK each possess independent though overlapping powers related to listing matters. The primary obligation to develop non-statutory listing requirements rests with the SEHK, which exercises this function through the Listing Committee (an independent sub-committee of the board of the SEHK). The SEHK's powers are subject to checks and balances in the form of powers given to the SFC as the statutory regulator for the securities industry. Each agency has disciplinary powers to enforce the framework in different ways.²²⁶

Securities and Futures Commission

The SFC was formed in 1989 as a consequence of the Hay-Davison Report. Its regulatory objectives, functions and powers, and duties are set out in the SFO.²²⁷ A broad description of the SFC's role is provided by the mission statement it has adopted: "...the SFC strives to strengthen and protect the integrity and soundness of Hong Kong's securities and futures markets for the benefit of investors and the industry."²²⁸ As noted in Appendix I.2, the Government has on a number of occasions sought to bolster the SFC's role in Hong Kong's regulatory architecture as regards the regulatory oversight of listed companies, albeit with very limited success. While the powers of the SFC have not essentially altered since the introduction of the SFO,²²⁹ its exercise of powers has increased noticeably over the past decade or so – see Appendix I.6.

The SFC performs several important roles that impact on CG concerns as a result of its supervisory role in relation to the listed market, including in relation to regulating the takeover of public companies (discussed below), share repurchases, monitoring corporate disclosures under the SFO's inside information disclosure regime (discussed in Appendix I.3), and vetting listing applications alongside the SEHK under the (DFR) (discussed below).²³⁰ It has a number of other regulatory roles, including intermediary licensing and conduct supervision, the authorization of investment products for sale to the public,²³¹ the oversight of market infrastructure, automated trading services, securities and futures market activity, including position reporting, market misconduct, and enforcement.

The SFC's specific CG related roles arise out of its regulatory objectives and duties, and by virtue of its functions and powers under the SFO and CWUMPO as well as the SMLR, which creates the DFR. Together, these give the SFC ultimate power²³² over many listed company matters, including the following.

All listing rules and any changes to them must be approved by the SFC, and the SFC has the power to direct the SEHK in relation to the listing rules.²³³ Together with its powers under the SMLR (discussed in Appendix I.3), this means that the SFC has an important role as regards the requirements to be met when seeking admission to the listed market as well as the continuing requirements to remain listed, both of which contain important disclosure requirements. The SFC also has powers under section 36(1)(h) of the SFO to make subsidiary legislation on "any

²²⁶ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [5.5]

²²⁷ ss. 4-6 SFO respectively

²²⁸ SFC, "Annual Report 2015-16," (June 2016), 6: Available at http://www.sfc.hk/web/EN/files/ER/Annual%20Report/SFC_AR2015-16_Eng_r.pdf (visited 7 Dec 2016)

²²⁹ It has acquired additional powers under new sections added to the SFO, particularly Part XIVA SFO, however, this is not different in nature from the powers it already possessed

²³⁰ SFC, "Annual Report 2015-16," (June 2016), 6: Available at http://www.sfc.hk/web/EN/files/ER/Annual%20Report/SFC_AR2015-16_Eng_r.pdf (visited 7 Dec 2016)

²³¹ i.e. collective investment schemes and structured products, as defined in the SFO

²³² Syren Johnstone, Nigel Davis and Douglas W. Arner, "A Principles-Based Response to the Proposed Reform of the Governance Structure for Listing Regulation in Hong Kong" (November 11, 2016), page 5 and section 5 University of Hong Kong Faculty of Law Research Paper No. 2016/036. Available at SSRN: <https://ssrn.com/abstract=2867895> or <http://dx.doi.org/10.2139/ssrn.2867895>

²³³ ss. 23(3) and (5) and 24(1) SFO

matter which is to be or may be prescribed by rules made under section 23 [of the SFO]" (those rules being the non-statutory listing rules made by the SEHK). The SFC has not to date exercised its powers under this subsection. As noted in Appendix I.2, the FSTB has consulted on the execution of these powers to give the SFC administrative fining and other powers but without success.

The power to authorize prospectuses for the purposes of the CWUMPO has been given to the SFC.²³⁴ However, this power has been transferred to the SEHK where the prospectus is to be issued in connection with a listing application.²³⁵ The transfer supports the SEHK's role as the frontline regulator of listed companies although it is subject to the caveat that the SFC is to perform the functions "concurrently with" the SEHK, which it does under the DFR.²³⁶

The SFC has a statutory function under section 5(1)(b) of the SFO to supervise, monitor and regulate the activities carried on by HKEX/SEHK. The SFC and SEHK have entered into the Listing MoU, which further provides that the SFC will periodically review the SEHK's performance in its regulation of listing-related matters.²³⁷

The SMLR gives the SFC powers in relation to both listing applicants and listed issuers that establishes an important link to the SFC's oversight of the listed market, and this has been discussed in Appendix I.3. Although the SEHK remains the frontline regulator of all listing-related matters, this arrangement gives the SFC a wide remit to enforce against certain misconduct breaches.

In Appendix I.3.1 the powers of the SFC under Part VIII were discussed in relation to misfeasance of directors etc. Part VIII includes important provisions concerning conduct that is unfairly prejudicial to its members, or where members have not been given all the information with respect to an issuer's business affairs that they might reasonably expect.²³⁸ As regards the latter, two court cases have held that information required by the listing rules to be given to shareholders is, for the purposes section 214(1)(c) of the SFO, information they might reasonably expect - accordingly, a failure to provide it may amount to unfair prejudice - both cases are discussed in Appendix I.7.1.²³⁹ This does not amount to giving legal effect to the listing rules but it does indicate that failure to comply with the listing rules may be taken into account when adjudging the application of certain statutory provisions.

The SFC's powers in relation to listed issuers and their officers under Parts XIII, XIV and XIVA of the SFO have been discussed in Appendix I.3.1.

The SFC also issues and oversees the Code on Takeovers and Mergers - discussed below.

Key non-statutory regulations issued by the SFC:

²³⁴ ss. 38(D)(3) and (5) and 342C(3) and (5), CWUMPO

²³⁵ s. (a), Securities and Futures (Transfer of Functions-Stock Exchange Company) Order (cap 571AE)

²³⁶ S. 3(b), Securities and Futures (Transfer of Functions-Stock

Exchange Company) Order (cap 571AE) pursuant to s 25(3)(a), SFO, however, the power to grant certificates of exemption from the CWUMPO requirements has not been transferred to the SFC. Under the Proposal the SFC will no longer "routinely" issue a separate set of comments on the draft prospectus.

²³⁷ These reviews are published on the SFC's website

²³⁸ s. 214(1)(c) and (d) SFO

²³⁹ *SFC v. Wong Shu Wing and Another* [2013] HKCFI 2302; HCMP1831/2010 (20 March 2013) and *SFC v Kenneth Cheung Chi Shing* [2010] HKCU 2560

Although the SFC has not issued any rules, codes or guidelines that specifically address CG of listed issuers, some non-statutory codes and guidelines issued by the SFC do have an impact on CG issues including transparency, shareholder rights and shareholder involvement, as follows. However, with the exception of takeover-related requirements, they do not address board processes.

“Guidance note of directors’ duties in the context of valuations in corporate transactions” (2017) – it is based on the obligations that the law already imposes on directors generally, the guidance sets out the SFC’s expectations of the conduct of directors when considering or approving a corporate transaction that involves the valuation of an asset or a target company. The guidance is directed at the circumstances in which it is appropriate for a director to rely on a valuation to justify a transaction.

“Principles of Responsible Ownership” (2016) – these Principles are non-statutory²⁴⁰ and premised on a view that shareholders should be encouraged, and have a responsibility, to engage with companies, and that this will improve CG and promote the company’s long-term success. Although targeted at institutional shareholders, it sets out seven principals designed as guidance to assist all shareholders how to best meet their ownership responsibilities:²⁴¹ (1) establish and report to their stakeholders their policies for discharging their ownership responsibilities; (2) monitor and engage with their investee companies; (3) establish clear policies on when to escalate their engagement activities; (4) have clear policies on voting; (5) be willing to act collectively with other shareholders when appropriate; (6) report to their stakeholders on how they have discharged their ownership responsibilities; and (7) when investing on behalf of clients, have policies on managing conflicts of interest.²⁴² There are no regulatory enforcement consequences associated with the Principles.

“Guidelines on Disclosure of Inside Information” (2012) – these are non-statutory guidelines²⁴³ intended to assist listed issuers comply with their obligations to disclose inside information under Part XIVA of the SFO.²⁴⁴ The guidelines are based on decisions of courts and tribunals, and set out the views of the SFC on the operation of Part XIVA.²⁴⁵ As the guidelines are non-statutory, they do not have the force of law nor can they be relied upon as an authoritative legal opinion;²⁴⁶ however, they are nevertheless important to consider given that the SFC is empowered to bring an action in respect of a breach of Part XIVA.

“Code on Takeovers and Mergers” – issued by the SFC after consultation with the Panel (see below) pursuant to its power under the SFO.²⁴⁷ This Code regulates changes in the control of listed and public companies in Hong Kong. Historically, it is closely based on the UK’s City Code on Takeovers and Mergers. It is administered by the Executive Director of the Corporate Finance Division of the SFC and overseen by the Panel on Takeovers and Mergers, a sub-committee of the SFC.²⁴⁸ Reflecting the view of the Hay-Davison Report already discussed above, the Panel is comprised of market practitioners drawn from the financial

²⁴⁰ And arguably non-regulatory insofar as they are not codes or guidelines issued pursuant to the SFO

²⁴¹ SFC, “Principles of Responsible Ownership” (2016): Available at <http://www.sfc.hk/web/EN/rule-book/principles-of-responsible-ownership.html> (visited 15 Dec 2016)

²⁴² SFC, “Principles of Responsible Ownership” (2016), 1 and 2

²⁴³ Issued pursuant to its general powers under s. 399 of the SFO

²⁴⁴ Paul Westover and Yolanda Chung, “Corporate Governance and Directors’ Duties in Hong Kong: Overview,” *Practical Law, A Thomson Reuters Legal Solution*: Available at <http://uk.practicallaw.com/7-506-8920#> [THIS LINK IS NOT WORKING] (visited 4 Dec 2016)

²⁴⁵ SFC, “Guidelines on Disclosure of Inside Information,” (2012), [3] and [4]

²⁴⁶ SFC, “Guidelines on Disclosure of Inside Information,” (2012), [2] and [3]

²⁴⁷ s. 399(2)(a) SFO

²⁴⁸ Introduction to the Code, s 11

and investment community. The Code contains important provisions that govern the disclosure and quality of information before, during and after an offer,²⁴⁹ as well as mechanisms that protect shareholders including: the imposition of a mandatory bid obligation where there has been a change of control,²⁵⁰ restrictions on the offer price and consideration,²⁵¹ as well as shareholder approval, board involvement and the appointment of an independent committee of the board and an independent financial adviser.²⁵² Although the Code is non-statutory, it is generally regarded as effective as a result of its commercial acceptance by the majority of practitioners, the listing rules requiring listed issuers to comply with it,²⁵³ and its enforcement mechanisms²⁵⁴ being effective against SFC licensed or registered intermediaries by virtue of the SFC's disciplinary powers over them²⁵⁵ and commercially effective against others. These mechanisms include private reprimand, public criticism or censure, reporting offender's conduct to regulator, cold shoulder orders, and taking such further action as the Panel thinks fit.²⁵⁶ The Code is discussed further in Appendix I.7.

Hong Kong Exchanges and Clearing Limited

The HKEX is a recognised exchange controller pursuant to section 59 of the SFO and, together with the SEHK, is the front-line regulator of listed companies in Hong Kong. Six directors (out of a maximum of 13) are appointed to the HKEX board by the FS.²⁵⁷ It is subject to statutory duties to maintain an orderly, informed and fair market²⁵⁸ and to act in the public interest ahead of its own interests.²⁵⁹ Section 23 of the SFO gives it the power to make non-statutory rules concerning qualification for and admission to listing – i.e. the listing rules – but that power is subject to the foregoing duties.

An important issue for the HKEX, and one that has been the subject of various consultations on the regulatory oversight of listed issuers (see Appendix I.2.1 for a discussion) is that it regulates the exchange which it is listed on, the SEHK. This is managed by way of, *inter alia*, arrangements in respect of the execution of its regulatory functions, as discussed next.

The Stock Exchange of Hong Kong Limited:

The SEHK is a recognised stock exchange pursuant to section 19 of the SFO and a wholly owned subsidiary of the HKEX. The SEHK board, which consists of senior employees of the HKEX and appointments by the HKEX board, has the power to make and amend the listing rules subject to approval by the SFC.²⁶⁰

It is the frontline regulator in relation to all listing matters – both the Main Board and GEM. Listing-related powers and functions are discharged by the Listing Committee or delegated to the Listing Department.²⁶¹ SEHK staff, under the ultimate supervision of the

²⁴⁹ Particularly Rules 3, 6, 8, 9, 10, 12, 18, 19 and 22

²⁵⁰ I.e. under Rule 26

²⁵¹ Rules 4, 23-25

²⁵² Rule 2

²⁵³ LR 13.23(2) and 14.78

²⁵⁴ Introduction s 12

²⁵⁵ Under s 194 SFO

²⁵⁶ For example, see *Panel on Takeovers & Mergers and Another v Cheng Kai-man (Privy Council, 1995)*, and Panel statement of 29 November 1995

²⁵⁷ HKEX, "Terms of Reference and Modus Operandi of the Board ("Board") of Hong Kong Exchanges and Clearing Limited ("HKEX")," (July 2014), [1]

²⁵⁸ s 21(1), SFO

²⁵⁹ s 21(2), SFO

²⁶⁰ HKEX, "Role and Mode of Operation of the Committee," [5]: Available at https://www.hkex.com.hk/eng/listing/listcomrpt/Documents/LCRole_Mode.pdf (visited 7 Dec 2016)

²⁶¹ Main Board Listing Rules, 2A.01, 2A.02, and GEM LR, 3.01. HKEX, "Role and Mode of Operation of the Committee," [5]: Available at https://www.hkex.com.hk/eng/listing/listcomrpt/Documents/LCRole_Mode.pdf

Listing Committee, make all day-to-day decisions in relation to the vetting of listing applications and the application of the listing rules to listed issuers. This structure reflects the conclusion of the Hay Davison Report that market participants are the best judges of specific issues relating to listed companies and the application of the listing rules.

Listing Committee:

The SEHK's statutorily defined powers and obligations to regulate the listing market are performed by or under the supervision of its Listing Committee, including disciplinary matters.²⁶² These arrangements have been entered into pursuant to the Listing MoU.²⁶³ The Listing Committee is established as a sub-committee of the SEHK board of directors to which the board's functions have been delegated, and therefore the Listing Committee operates within the SEHK's governance structure. By this arrangement, the HKEX's regulatory responsibilities are carried out by the Listing Committee, which acts as the gatekeeper for all listing matters²⁶⁴ subject to the overarching powers of the SFC discussed above. The only power the SEHK board retains is to make rule changes recommended by the Listing Committee and to revoke the delegation of power. As a practical matter, it is not possible for formal decision making to be taken by the Listing Committee on a substantial number of matters arising from the day-to-day administration of the listing rules, and this is instead undertaken by the Listing Division, an operating division of the HKEX.²⁶⁵

The Listing Committee is composed of independent individuals (practitioners in Hong Kong's financial markets) appointed jointly by the SFC and SEHK. The 28 members of the Listing Committee (except the CEO of the SEHK who is *ex-officio*) are chosen by the Listing Nomination Committee, which is composed of an equal number of HKEX directors and SFC representatives.

The Listing Committee's role, to act as an independent decision-maker and an advisory body for the HKEX,²⁶⁶ comprises four principal functions: (1) to oversee the Listing Division of the HKEX; (2) to provide policy advice to the Listing Division on listing matters and to approve proposed amendments to the listing rules; (3) to take decisions of material significance for listing applicants, listed issuers, and individuals, including approvals and cancellations of listing and disciplinary matters; and (4) to act as a review body, in its role as the Listing (Review) Committee, for decisions made by the Listing Division and by the Listing Committee.²⁶⁷ Materially significant decisions include: (1) granting approval for listing of new equity applicants; (2) approval of the cancellation of listing; (3) the determination of a breach of the listing rules and the imposition of disciplinary sanctions or remedial conditions; (4) the endorsement, variation or modification of decisions made by the Listing Division and in some circumstances the Listing Committee on application for a review; (5) the approval of a specified category of waiver; and (6) approval of significant policies and listing rules amendments.²⁶⁸

Key consultations undertaken by the HKEX:

(visited 7 Dec 2016). See also Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [5.176]

²⁶² LR 2A.01

²⁶³ The Listing MOU, dated 28th January 2003, is a non-binding memorandum per Clause 3.1(c) of the Listing MOU. See Clause 4.6 concerning the Listing Committee.

²⁶⁴ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [5.176]

²⁶⁵ HKEX, "Role and Mode of Operation of the Committee," [6]: Available at https://www.hkex.com.hk/eng/listing/listcomrpt/Documents/LCRole_Mode.pdf (visited 7 Dec 2016)

²⁶⁶ HKEX, "Listing Committee Report," (2015), 26

²⁶⁷ HKEX, "Listing Committee Report," (2015), 26

²⁶⁸ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [5.184]

The HKEX is very active in undertaking consultations as to developments of the listing rules and these have been discussed in Appendix I.2.

Key non-statutory regulations issued by the HKEX/SEHK:

The listing rules, made pursuant to section 23 SFO, sets the requirements for all companies seeking to obtain a listing on the SEHK as well as the continuing requirements to remain listed. There are two separate sets of rules, namely the "Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited" and the "Rules Governing the Listing of Securities on the Growth Enterprise Market on the Stock Exchange of Hong Kong Limited", which apply to companies listed on the Main Board and GEM, respectively. The two sets of rules address similar matters, subject to variances reflecting the different nature of each market. To support the listing rules, the SEHK issues interpretations, practice notes, guidance letters and rejection letters.

The listing rules apply to all companies listed on the SEHK whether or not incorporated in Hong Kong. With a few exceptions, as noted below, most listing rules are mandatory. Failure to comply with the listing rules is a serious matter - the SEHK has a general right to cancel or suspend an issuer's listing and breaches are subject to the disciplinary powers of the SEHK set out in MBLR 2A.09. Consequences for breach centre on issuers, directors, senior management, substantial shareholders and professional advisers, among others. A number of CG-related listing rules address or reiterate issues embodied in the common law, equity, and/or statute — this should not be seen as a redundancy in view of the relatively swift disciplinary action that can be taken by the SEHK as compared to a lengthy court process, albeit the SEHK's discipline is typically weak.²⁶⁹

The listing rules operate in conjunction with the disclosure and market misconduct provisions of the SFO that, together with oversight by the SFC, constitute an important means by which a local Hong Kong framework for CG standards is established that applies to all issuers, wherever incorporated.

Non-Hong Kong incorporated issuers are additionally subject to the SFC/HKEX "Joint policy statement regarding the listing of overseas companies".²⁷⁰ This policy sets out minimum requirements intended to preserve "high standards of regulation, enforcement and corporate governance."²⁷¹ The policy requires overseas applicants to satisfy the SEHK that its domestic laws and constitutional documents satisfy specified shareholder protection standards, including:

certain matters that require a two-thirds majority vote (for example, changes to the rights attaching to shares);

the appointment, removal and remuneration of auditors; and

proceedings at general meetings including the right to speak and vote, the right for shareholders to convene a meeting with at least 10% shareholder support, and that a shareholder must abstain from voting where it has a material interest in a transaction or arrangement that is subject to shareholder approval.

Where those standards are not met, the SEHK may require the listing applicant to amend its constitutional documents to provide for them before it will be considered

²⁶⁹ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.55]

²⁷⁰ The most recent version being issued 27 September 2013

²⁷¹ SFC/HKEX "Joint policy statement regarding the listing of overseas companies" 27 September 2013, para 1

acceptable for listing.²⁷² The SEHK has created a number of “country guides” which, if an applicant complies with, enables the applicant to avoid the necessity of explaining to the SEHK its domestic circumstances.

The listing rules are non-statutory and operate by way of contract between the SEHK and the issuer. They have a measure of statutory backing by virtue of the SMLR, as discussed above and in Appendix I.3.2. It has been suggested that breaches of the listing rules might be actionable by the SFC bringing an action before the Court of First Instance pursuant to section 213(1)(a)(i)(B) of the SFO on the basis that the listing rules are “requirements given or made pursuant to” section 23 of the SFO. However, this has not been judicially tested and the usual view is that they are not actionable in this way.²⁷³ As already noted above, a failure to provide to shareholders information required by the listing rules to be provided to them may nevertheless be relevant for the purposes of judicial proceedings under s. 214(1)(c) of the SFO.

At the broadest level, the listing rules oblige issuers to keep shareholders and the market informed and “to ensure the maintenance of a fair and orderly market in securities and that all users of the market have simultaneous access to the same information.”²⁷⁴ This is important as the disclosure standards and other requirements of the listing rules are relevant to the SFC’s exercise of its SMLR powers.

Listing rules of particular relevance to CG include the following Chapters.²⁷⁵

Chapter 3: this chapter is concerned with directors and the board. MBLR 3.08²⁷⁶ requires directors of all issuers to exercise their duties to a standard commensurate with the fiduciary duties under common law and the duties of skill, care, and diligence, as required by section 465 of the CO that apply to directors of a Hong Kong incorporated company. The CR Guide is referenced as summarising the relevant duties. In addition, the HKEX has issued guidance emphasising that directors are expected to comply with the CR Guide and that failure to do so may constitute a breach of the listing rules.²⁷⁷ MBLR 3.10 and 3.10A requires at least one-third of an issuer’s board to be comprised of INEDs and to have appointed at least three INEDs. Issuers are also required to establish an audit committee and a remuneration committee.²⁷⁸

Chapter 3A: this chapter is concerned with the roles, functions and obligations of sponsors and compliance advisers. Sponsors represent an important gateway mechanism intended to ensure the eligibility of a listing applicant, full disclosure in its listing application, and the capability of an issuer’s management. Compliance advisers represent an important mechanism that assists newly admitted issuers during the initial period of their listing.

Chapter 8: sets out the qualifications for listing. MBLR 8.11: imposes a “one share one vote” concept on all Hong Kong listed issuers. This concept is regarded by the SFC as a cornerstone of shareholders’ protection under the common

²⁷² Footnote 9 to para 38 notes that the restriction of shareholder voting rights may not be possible under some foreign laws and in that case requires other measures or arrangements to be put in place to achieve the same result.

²⁷³ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.50]

²⁷⁴ MBLR, 13.03

²⁷⁵ References are to the Main Board Listing Rules; the GEMLR contain similar provisions

²⁷⁶ See also GEM LR 5.01

²⁷⁷ HKEX, “HKEX Guidance Letter - HKEX-GL62-13,” (January 2015), [2.2] and [2.8]: Available at https://www.hkex.com.hk/eng/rulesreg/listrules/listarchive/listarc_listguid/Documents/gl62-13.pdf (visited 5 Dec 2016)

²⁷⁸ MBLR 3.21-3.27

law.²⁷⁹ For a class of securities to be listed, the voting powers attached to such securities must bear a reasonable relationship to the equity interest in those shares when fully paid. This predisposes the market against listed companies with WVRs and other more esoteric control and/or governance structures.²⁸⁰ The question on WVRs has been raised several times over recent years, most recently in the HKEX's 2017 concept paper, as discussed in Appendix I.2.1.

Chapter 13: imposes on listed issuers a general ongoing obligation to disclose information, for example, to avoid a false market in its securities, as well as detailing specific matters that the issuer must disclose, including relating to financial information, breaches of a loan agreement and financial assistance to affiliates. Chapter 13 also imposes disclosure obligations on the controlling shareholder where it has pledged its shares in certain circumstances.²⁸¹

Chapter 14: depending on the relative size of a proposed transaction of the issuer, this chapter imposes obligations on the issuer to, *inter alia*, disclose information and obtain prior shareholder approval.

Chapter 14A: is concerned with transactions between an issuer and a person who is connected with the issuer and their associates. It imposes obligations on the issuer to, depending on the size and nature of the transaction, *inter alia*, disclose information, appoint an independent financial adviser and obtain prior shareholder approval.

Chapter 19: sets out additional requirements for overseas listing applicants, with a key consideration being that the standards of shareholder protection must be at least equivalent to those in Hong Kong.²⁸² If this is not the case, the SEHK may accept alternative means to bring the level of shareholder protection to an acceptable standard.²⁸³ The SFC/HKEX "Joint policy statement regarding the listing of overseas companies" will be relevant to consider and this has been discussed above.

Chapter 19A: specifies additional requirements applying to issuers incorporated in Mainland China, including: at least one INED that is an ordinary resident in Hong Kong; the supervisor must be of necessary character, experience, and integrity; and strict contractual requirements between every director and officer with the issuer.²⁸⁴

Appendix 10: contains the "Model Code for Securities Transactions by Directors of Listed Issuers" ("Model Code"). It provides basic principles and rules that set the required standards for directors transacting in securities of their listed company.²⁸⁵ This is important as the SEHK regards it as highly desirable that directors of listed companies hold their company's securities.²⁸⁶ The Model Code requires directors must have regard to the market misconduct provisions of Parts XIII and XIV SFO (i.e. regarding insider dealing).²⁸⁷

²⁷⁹ Financial Services Development Council, "Positioning Hong Kong as an International IPO Centre of Choice," (June 2014) *FSDC Paper No.09*, [4.9.1]

²⁸⁰ Financial Services Development Council, "Positioning Hong Kong as an International IPO Centre of Choice," (June 2014) *FSDC Paper No.09*, [4.9.1]

²⁸¹ LR 13.17 and 13.18

²⁸² HKICPA, "Hong Kong – Market Information," (2015), 18

²⁸³ *Ibid.*, 18

²⁸⁴ *Ibid.*, 18

²⁸⁵ Main Board LR, Appendix 10 [1]

²⁸⁶ Main Board LR, Appendix 10 [3]

²⁸⁷ Main Board LR, Appendix 10 [4]

Appendix 14: contains the “Corporate Governance Code and Corporate Governance Report”, discussed below.²⁸⁸ Although the CG Code is part of the listing rules, it requires separate attention as it is specifically directed to CG standards. Moreover, there are comparisons of interest that can be drawn between it and the equivalent code in the UK (discussed in Appendix II.4).

CG Code:

Unlike most provisions of the listing rules, which are mandatory, the CG Code operates on a comply or explain basis. This means that an issuer can choose to comply or not comply with the Code but the reporting element is mandatory. So, non-compliance with the reporting requirement is a breach of the listing rules whereas non-compliance with a provision of the Code is not.²⁸⁹

The CG Code sets out Principles and two levels of recommendations: CPs and RBPs. Issuers are expected to comply with the CPs but not the RBPs. When considering whether to comply or explain, an issuer is required to consider the company’s individual circumstances, the size and complexities of the company’s operations, and the nature of the risks and challenges facing the company.²⁹⁰

When opting to explain rather than comply, the issuer must provide considered reasons to explain to shareholders “why good CG is achieved by means other than strict compliance with a CP”.²⁹¹ Issuers must state in the CG Report, annual report, and interim reports (and summary financial reports where necessary) whether or not they have complied with the CPs. As RBPs are for guidance only, issuers are encouraged but not required to state whether they have complied with the RBPs.

While the comply or explain approach leaves the specific CG standards to be resolved by commercial forces (i.e. between a company’s management, its shareholders, and the wider marketplace), it sends a signal to shareholders and the marketplace of what the SEHK regards as acceptable minimum CG standards, which amounts to “anticipatory compliance”.²⁹²

The SEHK amended the CG Code in 2012 to promote a higher standard of CG among listed companies by upgrading CPs to listing rules and RBPs to CPs.²⁹³ The reporting requirements were also revised. Further amendments were made to the CG Code in December 2014, effective for the accounting period beginning 1 January 2016, that include: improving risk management and internal control; defining the roles and responsibilities of management; CP and RBP upgrades in relation to the annual review; and disclosures in the annual report regarding an internal audit function.²⁹⁴

By way of broad overview, the CG Code currently addresses matters including:

board processes including appointment, re-election and removal as well as the composition of board committees;

²⁸⁸ Appendix 15 of the GEM LR

²⁸⁹ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.9] and [10.58].

²⁹⁰ HKICPA, “Hong Kong – Market Information,” (2015), 12; CG Code, “What is “comply or explain”?”

²⁹¹ Preamble to the CG Code, page A14-2

²⁹² Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.58]

²⁹³ Paul Westover and Yolanda Chung, “Corporate Governance and Directors’ Duties in Hong Kong: Overview,” *Practical Law, A Thomson Reuters Legal Solution*

²⁹⁴ *Ibid.*

director responsibilities and requirements including level of participation, continuous professional development, disclosure, INEDs and supply and access to information;

the remuneration of directors and senior management;

financial reporting and audit matters (i.e. audit committee);

risk management and internal controls;

board delegation and committees;

corporate governance functions; and

communications with shareholders including voting.

It is important to recognise the connections between the evolution of the CG Code and the equivalent code issued by the UK's FRC (the UK CG Code is discussed in Appendix II.4). The similarities and differences between the two codes are summarized in the Table in Annex 1 set out at the end of this Appendix I.4.

Companies Registry

The CR is established by Part 2 Division 2 of the CO and Division 3 sets out its functions. It is responsible for administering and enforcing the provisions of the CO, including for listed and non-listed companies, as well as local and non-local Hong Kong companies. It is responsible for maintaining the register of companies.²⁹⁵ The Registrar of Companies, acting on behalf of the CR, is responsible for enforcing the CO and is delegated with the authority to prosecute non-compliance.²⁹⁶ This includes applying to Magistrates Courts to impose fines against directors, company executives, and companies who breach the CO,²⁹⁷ and enforcing the disclosure obligations under the CO, such as where a director knowingly or recklessly gives false or misleading information. There are approximately 200 offences provided for by the CO, which could be prosecuted by way of indictment or summarily.²⁹⁸

CR Guide on Directors' Duties:

As discussed in Appendix I.3, the non-statutory CR Guide provides an important nexus for the incorporation into the listing rules of the standards that are expected of directors of Hong Kong incorporated companies that will apply to all listed issuers irrespective of their place of incorporation. The CR Guide is referred to in a note to MBLR 3.08,²⁹⁹ which is referenced as summarising the relevant duties. However, this does not raise the standards to statutory requirements as regards directors of non-Hong Kong incorporated companies - the standards instead remain to be enforced by the SEHK on the same contractual basis as other mandatory listing rules.

The first version of the CR Guide was published by the CR in 2004, it was updated and re-titled in July 2009 by the SCCLR, and again updated and revised on 3 March 2014 to

²⁹⁵ CR, "Companies Registration and Insolvency Administration," (June 2016) *Hong Kong: The Facts*, 1

²⁹⁶ CR, "Our Enforcement": Available at <http://www.cr.gov.hk/en/compliance/enforcement.htm> (visited 8 Dec 2016)

²⁹⁷ Ibid.

²⁹⁸ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [6.81]. The maximum penalty for most of the offences ranges from levels 1 to 6. (i.e. HK \$2,000 to HK \$100,000).

²⁹⁹ and GEMLR 5.01

coincide with the introduction of the new CO.³⁰⁰ The CR Guide outlines 11 general principles for a director of a company in the performance of their functions and the exercise of their powers.³⁰¹ These duties are: (1) to act in good faith for the benefit of the company as a whole; (2) to use powers for a proper purpose for the benefit of members as a whole; (3) not to delegate powers except with proper authorisation and duty to exercise independent judgement; (4) to exercise, care, skill and diligence; (5) to avoid conflicts between personal interests and interests of the company; (6) not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law; (7) not to gain an advantage from use of position as a director; (8) not to make unauthorised use of company's property or information; (9) not to accept personal benefits from third parties conferred because of position as a director; (10) to observe the company's constitution and resolutions; and (11) to keep accounting records.³⁰²

Hong Kong Institute of Certified Practising Accountants

Hong Kong's accounting and auditing profession is subject to a self-regulatory regime in which the HKICPA plays a critically important role.³⁰³ The HKICPA is an industry body that registers and grants practicing certificates to certified practicing accountants in Hong Kong.³⁰⁴ Legislatively backed by the PAO, the HKICPA has statutory powers over the registration and control of the accountancy profession, and has the power to make by-laws.³⁰⁵

The HKICPA administers statutory backed financial reporting and auditing standards, and codes of ethics. Hong Kong is unique among major international financial centres as financial reporting and auditing regulation is presently undertaken by an accounting industry body rather than an independent regulator.³⁰⁶ However, this is due to change, as discussed in Appendix I.1.

Statutory panels and committees within the HKICPA's organisational structure include Disciplinary Panels, Investigatory Panels, a Practice Review Committee, and a Disciplinary Committee. The HKICPA has enforcement powers with regards to auditors and accountants.³⁰⁷ It regulates the professional conduct of its members, with formal complaints against its members for misconduct dealt with by a Disciplinary Committee.³⁰⁸ The HKICPA regulates in tandem with the FRC.

The HKICPA is active in seeking developments to the regulation of listed issuer's auditors – discussed in Appendix I.2.

Financial Reporting Council

Financial reporting is administered mostly by the HKICPA, which is supplemented by the FRC.³⁰⁹ The key role of the FRC is to maintain the quality of financial reporting,

³⁰⁰ Companies Registry, "The New Companies Ordinance (Cap. 622) – A Guide on Directors Duties," (6 January 2014) *Companies Registry External Circular No.3 / 2014*, [1] and [2]

³⁰¹ Companies Registry, "A Guide on Directors' Duties," (March 2014)

³⁰² Ibid.

³⁰³ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [7.1]

³⁰⁴ HKICPA, "Overview": Available at <http://www.hkicpa.org.hk/en/about-us/organization/overview/> (visited 8 Dec 2016)

³⁰⁵ PAO, Long Title and s 8

³⁰⁶ HKICPA, "Overview": Available at <http://www.hkicpa.org.hk/en/about-us/organization/overview/> (visited 8 Dec 2016)

³⁰⁷ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.259]

³⁰⁸ HKICPA, "Information Sheet," (October 2015), 1; HKICPA, "Disciplinary": Available at <http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/disciplinary/> (visited 8 Dec 2016)

³⁰⁹ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [7.1]

promoting the integrity of the accounting profession, enhancing CG, and protecting investors.³¹⁰

Following the establishment of the FRC in 2007 as a statutory body,³¹¹ responsibility for the investigation of listed companies was assumed by the FRC from the HKICPA.³¹² The FRC has statutory powers and functions to enquire, investigate, to make decisions, approve and oversee policies, refer complaints, and provide assistance to specified bodies.³¹³

More specifically, the FRC is statutorily empowered to conduct independent investigations into auditing and reporting irregularities of listed companies and enquire into non-compliance and accounting irregularities.³¹⁴ Pursuant to powers granted by the FRCO, the FRC conducts independent investigations in relation to listed companies with assistance from the Audit Investigation Board.³¹⁵ Non-compliance investigations are carried out in collaboration with the Financial Reporting Review Committees.³¹⁶ Auditing and reporting irregularities are referred to the HKICPA and non-compliance with the listing rules is referred to either the SFC or HKEX.³¹⁷ This is because the FRC does not have any enforcement or sanctioning powers to discipline or prosecute offenders.³¹⁸ The FRC also has statutory powers to issue guidelines.³¹⁹

In 2013, the FRC commissioned Deloitte LLP to prepare a report on independent audit oversight in Hong Kong.³²⁰ The report provided a comparative analysis of Hong Kong with international standards and noted that Hong Kong did not meet the membership requirements of the IFIAR and regulatory equivalence requirements of the European Commission.³²¹ Audit oversight is currently undertaken by the accountancy industry body, the HKICPA.

On 26 June 2015 the FSTB published its conclusions to a public consultation commenced in 2014 when it released its consultation paper "Proposals to Improve the Regulatory Regime for Listed Entity Auditors." One of the key factors behind the consultation was that Hong Kong did not comply with international auditor standards with regards to IFIAR membership or the regulatory equivalence requirements of the European Commission.³²² In particular, the Consultation Paper emphasised the concern of the International Monetary Fund (IMF), in its 2014 assessment of Hong Kong's financial regulatory system, of the current auditor regulatory regime's lack of independence.³²³

Under the FSTB's proposed reforms, the FRC would become the independent oversight body of listed company auditors vested with powers of inspection, investigation, and discipline.³²⁴ The HKICPA will perform the statutory functions of registration, setting continuous professional development requirements, and standards of professional ethics,

³¹⁰ Process Review Panel for the Financial Reporting Council, "2015 Annual Report," 1.2

³¹¹ Under the FRCO

³¹² HKICPA, "Investigations": Available at <http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/investigations/> (visited 8 Dec 2016)

³¹³ FRCO, ss 9 and 12

³¹⁴ Process Review Panel for the Financial Reporting Council, "2015 Annual Report," 1.2. FRCO, s 9

³¹⁵ *Ibid.*, 1.3

³¹⁶ *Ibid.*, 1.3

³¹⁷ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.259]

³¹⁸ *Ibid.*, [10.259]

³¹⁹ FRCO, s 13

³²⁰ FRC, "Update on Independent Audit Oversight Report Q & As," (27 October 2016), 1

³²¹ *Ibid.*, 1

³²² FSTB, "Proposals to Improve the Regulatory Regime for Listed Entity Auditors – Consultation Paper," (June 2014), 2

³²³ *Ibid.*, 2

³²⁴ FSTB, "Consultation conclusions on improving regulatory regime for listed entity auditors released," (26 June 2015), *Press Release*, 1

and auditing and assurance with regard to listed company auditors.³²⁵ Oversight of the HKICPA in this role will be the responsibility of the FRC.³²⁶

In October 2016 an FRC update reiterated that audit regulators in countries with the most preeminent international financial centres, namely the UK and United States, are independent of the profession with authority over auditors of listed companies, are members of IFIAR, and are in compliance with the European Commission requirements.³²⁷

The independent auditor regulatory regime is yet to be implemented.

Others

Official Receiver's Office (ORO): responsible for director disqualifications in relation to director's unfit conduct under the Part IVA of the CWUMPO.³²⁸ If the Office decides that it is in the public interest, they can make an application to the courts for a disqualification order against a person who is or has been a director of an insolvent company.³²⁹ A register of disqualification orders is kept by the Registrar of Companies.³³⁰

HKMA: derives important powers over authorized institutions from the BO. It has published the Supervisory Policy Manual, which includes provisions for various CG related matters under part CG-1 of the manual, including risk governance, the responsibilities of senior management, board structure and board committee, the appointment and remuneration of directors, communication, competence and ethical behaviour. The oversight of authorized institutions that engage in activities regulated by the SFO is shared with the SFC although the HKMA remains the frontline regulator.

Other financial regulators, namely the Insurance Authority and the Mandatory Provident Fund Schemes Authority (MPFA) enforce statutory CG requirements pertaining to a designated financial institution, which they supervise as the lead regulator.

Whistle-blowing

As noted in Appendix I.3, Hong Kong does not have any specific whistle-blowing law, although some statutes do provide limited protection.

Whistle-blowing is the subject of a non-mandatory recommended practice in the CG Code addressed to audit anomalies.³³¹ While more companies are introducing audit whistle-blowing policies and procedures,³³² less than half of listed companies in Hong Kong do not comply with that recommended practice.³³³ The HKMA's Supervisory Policy Manual mentions the concept of whistle-blowing but this is couched in language that an authorized institution should have a well communicated policy allowing staff "to communicate, in confidence and without risk of reprisal" observations of any violations.³³⁴

³²⁵ Ibid., 1

³²⁶ Ibid., 1

³²⁷ FRC, "FRC releases Update on Independent Audit Oversight Report," (27 October 2016), 1

³²⁸ ORO, "Disqualification of Directors," (2014) *Official Receiver's Office Circular No. 7/2014*, Appendix I, (B) (ii)

³²⁹ Ibid., [2]

³³⁰ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [6.104]

³³¹ Listing Rules, Appendix 14, para C 3.8

³³² "Best corporate governance awards 2016, Judges Report", HKICPA, page 13

³³³ "Corporate governance update", BDO Limited, 2016, page 5

³³⁴ At CG-1, para 2.6.7

I.4.2 Accountability

Public sector regulatory bodies are generally subject to governance provisions in the Ordinance from which they derive their statutory powers.

Securities and Futures Commission

The SFC is subject to Part II Division 2 of the SFO, which provides for: accounting and financial arrangements, accounts and annual reports, and audit and auditors. Specific SFC governance requirements are set out in Schedule 2 of the SFO, which address: Chairman, CEO, and members of the SFC; vacancy in the office of CEO; functions of the office and its members; meetings; written resolutions; seal and regulation of administration; and advisory committee. The SFC has an extensive governance framework consisting of: audit committee, remuneration committee, budget committee, a process review tribunal, and external committees, among other mechanisms.³³⁵

The FS has the power to require the SFC to explain, and give reasons for, the principles, practices and policy it is pursuing or adopting, or proposing to pursue or adopt, in furtherance of any of its regulatory objectives or performing any of its functions.³³⁶

The SFC is also subject to an annual review undertaken by the PRP, as discussed in Appendix I.2.

HKEX/SEHK

As a listed company incorporated in Hong Kong, the HKEX is subject to the same CG requirements of Hong Kong local companies.

Furthermore, because the HKEX is a recognised exchange controller and the SEHK is a recognised exchange company, these bodies also have governance requirements pursuant to Part III of the SFO, including: the SEHK's statutory duties (section 21); requirement to produce records to the SFC (section 27); provisions limiting minority controllers (section 61); HKEX's statutory duties (section 63); establishing a risk management committee (section 65); the election of its Chairman (section 69); appointments of CEO and Chief Operating Officer (section 70); the production of records (section 71) and FS HKEX board appointments (section 77).

As discussed in Appendix I.2.2, the HKEX is subject to an annual review of its performance in its regulation of listing matters,³³⁷ which is undertaken by the SFC pursuant to section 5(1) of the SFO and as provided for in the Listing MoU.³³⁸

Financial Reporting Council

The FRC has CG requirements pursuant to Part 2 of the FRCO. These requirements include: composition of the FRC, CEO, FRC to furnish information, accounts, audit, and reports and statements for the LegCo.

Companies Registry

The CR is an exception to other government bodies as it is not subject to governance requirements under the CO. Nonetheless the CR has issued a governance Policy Statement on its website that highlights, among other things, the importance of the

³³⁵ SFC, "Corporate governance": Available at the SFC's website

³³⁶ S. 12 SFO

³³⁷ SFC, "Periodic reports,": Available at <http://www.sfc.hk/web/EN/published-resources/reports/periodic-reports.html> (visited 20 Dec 2016)

³³⁸ SFC and SEHK, "Memorandum of Understanding Governing Listing Matters," (January 2003), [4.2 (d)]

accountability of its board, transparent and timely reporting systems, and robust internal controls and risk management.³³⁹

Other agencies

The HKMA has statutory governance requirements under Part II of the BO. Governance issues are handled by the HKMA's Exchange Fund Advisory Committee Governance Sub-Committee which monitors the performance of the HKMA, and makes recommendations on remuneration, human resources policy, and on governance issues.³⁴⁰ Its Internal Audit Division is responsible for an effective system of internal controls.³⁴¹

Similarly, the Insurance Authority and the MPFA are subject to CG provisions under Part IA of the IO, and Part 2 of the MPFSO respectively, which are somewhat more extensive than those of the HKMA and SFC.

A voluntary basic framework for corporate governance of public sector organisations is also issued by the HKICPA.³⁴²

1.4.3 Inter-regulator relationships and effectiveness

Hong Kong's mixed sectoral and institutional architecture of regulatory oversight gives rise to a number of regulatory overlaps, grey areas, and gaps across the primary regulatory agencies that have an impact on CG standards. Whereas coordination is to a large extent facilitated through the use of MoU, this adds complexity, and occasionally a degree of obscurity, to the system and fails to fully resolve the gaps and overlaps inherent in the regulatory architecture.

Coordination

Coordination is normally an important topic of an inter-regulator MoU. The Listing MoU already discussed above between the SFC and the SEHK governs all listing matters including the operation of the DFR as well as the exercise of the HKEX's authorisation function in respect of prospectuses under the CWUMPO that has been transferred to it from the SFC.³⁴³ It confirms that the SEHK is the front-line regulator responsible for listed companies, their directors, their controlling shareholders, and market uses in relation to listing matters. Notwithstanding these arrangements, the SFC/HKEX Joint Consultation on Listing Reform (discussed in Appendix I.2) suggests that a deeper level of coordination is desired and/or necessary in relation to both policy development as well as day-to-day matters concerning listed issuers.

An MoU has been entered into between the SFC and the HKEX regarding matters relating to the SFC's oversight of exchange participants and market surveillance in February 2001 (amended in 2007). The SFC has also entered into a number of MoUs concerning regulated businesses that are subject to multiple regulatory supervision (e.g. Registered Institutions, which are regulated by the HKMA as the frontline regulator and the SFC as the industry regulator).

³³⁹ CR, "Corporate Governance Policy Statement": Available at <http://www.cr.gov.hk/en/about/governance.htm> (visited 10 Dec 2016)

³⁴⁰ HKMA, "Internal Audit": Available at the HKMA website

³⁴¹ Ibid.

³⁴² HKICPA, "Corporate Governance for Public Bodies: A Basic Framework," (May 2004): Available at <http://www.hkicpa.org.hk/en/membership-and-benefits/professional-representation/corporate-governance/publications/gov-publications/basic-framework/> (visited 13 Dec 2016)

³⁴³ SFC and SEHK, "Memorandum of Understanding Governing Listing Matters," (January 2003)

The SFC has also entered into an MoU with the FRC in view of the importance of auditing and reporting obligations of listed issuers,³⁴⁴ and the fact that the SFC's mandate under the SFO encompasses auditing and reporting related concerns. The MoU aims to reduce duplication.

The FRC has entered into several other MoUs: with the SEHK to reduce regulatory duplication and to facilitate the SEHK in referring to the FRC reporting and auditing irregularities; with the HKICPA in relation to their respective regulatory functions for overseeing the accounting and auditing professions; and with other financial business regulators, namely the HKMA and the Insurance Authority.

There does not appear to be any MoUs entered into by the CR with either the SFC or HKEX. Nor are there any MoUs pertaining to the ORO. Coordination with the CR or the ORO, and other government departments/bureaus and/or regulators is managed via protocol.³⁴⁵

Finally, the SFC has statutory authority to assist international regulators under section 186 of the SFO (and the HKMA under section 186A). This power was expanded in November 2015 to enable the SFC to provide overseas regulators with information in connection with that regulator's supervisory functions (it had previously been limited to enforcement actions under the SFO).

Overlaps

Significant overlaps in regulatory oversight and the applicable requirements exist in relation to the oversight of the listing regime, the disclosures required to be made by listed issuers, and the standards expected of directors. Overlaps are not a necessarily bad aspect of the system as redundancies provide for multiple observation points as well as alternative means of imposing and enforcing standards requirements. For example, although many of the listing rules' CG requirements overlap with the common law and statute, it may be swifter and more efficient to deal with a matter at the level of the Listing Committee rather than escalate it to a legal case brought under the law.

Listing regime:

Supervision of the listing regime is undertaken by the SEHK through the Listing Committee and the SFC as a result of the DFR. This includes the prospectus regime for companies seeking a listing as well as ongoing disclosures. Investigations into listed companies are the responsibility of the HKEX and the SFC, although the HKEX will as a matter of policy defer to the SFC where the matter concerns a potential breach of the SFO.

Listed issuers that engage in specified financial services are additionally subject to prudential and conduct regulation imposed by the relevant law and regulator. This includes intermediaries licensed by the SFC, and institutions authorised under the BO, the latter also being regulated by the SFC if they are also registered with the SFC to engage in regulated activities under the SFO.

Disclosures:

Disclosure requirements are provided under Listing Rules, SFO, CO and CWUMPO, and therefore, subject to supervision by the Listing Committee, SFC, and the CR. Guidance on the disclosure requirements is also issued by the SFC and the HKICPA.

³⁴⁴ SFC and FRC, "Memorandum Of Understanding between the Securities and Futures Commission and the Financial Reporting Council," (November 2007), [11]

³⁴⁵ Companies Registrar (14 December 2016)

Financial reporting is subject to supervision by the FRC and HKICPA, which currently share regulatory functions. Auditing and reporting requirements are also provided under the SFO, creating overlap between the FRC, HKICPA, and the SFC. Similarly there are reporting requirements under the listing rules thereby creating another layer of regulatory overlap with the Listing Committee. Reporting requirements are also required by specific financial institutions, such as by the HKMA in respect of AIs. Although this creates a further layer of regulatory requirements, this kind of overlap is subject to the fact that the requirements are imposed with differing objectives. The HKMA's requirements, for example, are based in prudential regulatory concerns.

False and misleading information is regulated under the listing rules and the SFO. Disclosures in the primary capital market are additionally subject to the CWUMPO.

Directors:

Directors of listed companies are regulated and disciplined at multiple levels according to the nature of their activity: the SEHK under the listing rules, the SFC under the SFO, ORO under the CWUMPO, and the CR under the CO. Guidance on director duties is issued by the CR. Directors of licensed or registered intermediaries or AIs will be further subject to regulatory guidance/requirements pertaining to CG issued by the SFC and HKMA, respectively.

Grey areas

The regulation of auditors is handled by the HKICPA, which may give rise to a potential conflict of interest. Standards for auditors and certified practicing accountants are issued by the HKICPA, pursuant to the PAO. These and related issues are currently being addressed by the introduction of the FRC as an independent audit regulator consistent with international standards. Furthermore, enforcement of financial reporting is handled by the HKICPA, the accounting industry body, rather than the independent statutory FRC.

HKEX is responsible for investigating and reporting breaches to the Listing Committee involving disciplinary matters on its exchange, creating a possible conflict of interest with its IPO-promoting business model. However, a number of factors ameliorate this concern including the statutory duties imposed on the HKEX/SEHK, the status of the Listing Committee as an independent body comprised of practitioners, and the ultimate powers of oversight possessed by the SFC.

Mainland-based company secretaries, who lack the requisite qualification and/or experience, who are supported by local company secretaries remains an unresolved issue. Disagreements between the company secretaries may tend to be resolved in the Mainland company secretary's favour. The incentive for the local company secretary to object is diminished by the fact they are paid employees of the company.

The supervision of non-Hong Kong incorporated companies whereby the standards of the foreign jurisdiction are deemed acceptable in Hong Kong is a potential grey area. While the SFC/HKEX policy discussed above go a long way to ameliorating differences between the foreign and the Hong Kong jurisdiction, there remain questions as to the compatibility with specific CG matters, which may create gaps or loopholes, notably with respect to shareholder rights and protections.

A grey area exists as to which regulator should assume responsibility for policing unlisted and private companies.³⁴⁶

Gaps

No overarching CG regulator exists in Hong Kong. Although this is not a regulatory gap *per se*, the fact that CG regulation is subject to a multitude of regulators creates an environment not only conducive to regulatory overlaps but also to regulatory gaps or uncertainties.

There is no designated Hong Kong companies regulator *per se*, as the CR is primarily constituted and resourced as a “registry”, as opposed to a regulator. This has implications on its ability to effectively enforce the CO.³⁴⁷ The CR has statutory investigatory powers under the CO yet they have never been used – see Appendix I.6. The absence of a designated companies’ regulator also has implications for company CG policy formulation as this is usually managed by the FSTB and the SCCLR, not the CR.

Private companies do not fall under the supervisory ambit of the SFC.³⁴⁸ The reforms to the CO are inadequate to provide CG guidance to private SMEs.³⁴⁹ Furthermore, unincorporated companies, namely partnerships and sole proprietorships, are not subject to the CO but are subject to other ordinances.

There is a gap in the disclosure requirements between companies seeking minimalist or standardised compliance with the CG Code’s comply or explain regime as compared to those seeking to comply with higher CG standards. One of the core reasons for this is the voluntary aspects of the comply or explain approach - boilerplate explanations for non-compliance are adequate to avoid disciplinary measures. When enforcement is not effective, compliance tends to suffer, for example, compliance with the disclosure of the internal audit function is less than 50%. The issue of waivers being granted by the SEHK also facilitates gaps in the regulatory framework, diluting good CG.

The FRC’s primary statutory role is to maintain the quality of financial reporting, promoting the integrity of the accounting profession, enhance CG, and protect investors, yet it does not have any financial reporting enforcement or disciplinary powers.³⁵⁰

The HKICPA issues the Hong Kong Standards on Auditing, which deal with auditor responsibilities to consider laws and regulations in the audit of financial statements,³⁵¹ nonetheless omit many of the SOX provisions concerning auditor independence.³⁵²

Effectiveness of enforcement across the Hong Kong and Mainland border represents a significant problem. Challenges include a different system of laws, including as to the concept of State secrecy laws, and the absence of an extradition treaty, the latter being difficult to implement under current social concerns in Hong Kong as regards the operation of the one country-two systems model. A lack of enforcement powers against Mainland directors of Hong Kong listed companies who commit corporate offences and then leave Hong Kong is a substantial regulatory gap in the CG enforcement fabric. Recent problematic cases involving listed Mainland enterprises that have emerged in recent years includes the cases of Hontex, China Metal Recycling, Hanergy and Standard

³⁴⁶ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [6.3]

³⁴⁷ *Ibid.*, [6.3]

³⁴⁸ For example, see *HKSAR v IPFUND Asset Management Ltd* [2016] CHKEC 524

³⁴⁹ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [28.69]

³⁵⁰ Process Review Panel for the Financial Reporting Council, “2015 Annual Report,” 1.2

³⁵¹ HKICPA, “Consideration of Laws and Regulations in an Audit of Financial Statements,” (2010) *HKSA 250*, [1]

³⁵² Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.259]

Water. As a result of the legal lacuna, cross-border enforcement relies heavily on co-operation between the SFC and the China Securities Regulatory Commission (CSRC). The SFC and CSRC entered in a Memorandum of Regulatory Co-operation in 1993 and most recently have entered into an MoU in relation to co-operation in relation to the Stock Connect programme.³⁵³

³⁵³ “Memorandum of Understanding between the CSRC and the SFC on Strengthening of Regulatory and Enforcement Cooperation under the Mutual Access between the Mainland and Hong Kong Stock Markets” , per announcement of the SFC and CSRC on 16 August 2016

Annex 1 to Appendix I.4: HK CG Code and the UK CG Code compared

Appendix 14 MBLR	UK CG Code	Same/similar/different
<p>PRINCIPLES OF GOOD GOVERNANCE, CODE PROVISIONS AND RECOMMENDED BEST PRACTICES</p>	<p>The Main Principles of the Code</p>	
<p>A. DIRECTORS</p>		
<p>A.1 The board</p>	<p>A.1(exl. A.1.1, A.1.2), B.5.1</p>	<p><i>Same:</i> principle regarding role and responsibilities of the board; Directors should have access to independent professional advice.</p> <p><i>Similar:</i> code provisions. HK Code imposes more responsibilities on the company to aid board meetings.</p> <p><i>Different:</i> In Hong Kong director conflicts of interest are to dealt with by a board meeting (A.1.7) whereas in the UK director conflicts are dealt with by the remuneration committee (D.2).</p>
<p>A.2 Chairman and chief executive</p>	<p>A.2, A.3, A.4.2,</p>	<p><i>Same:</i> principle re division of responsibilities between management of the board by the chairman and day-to-day management of business by chief executive; meeting with NEDs without the presence of executives.</p> <p><i>Similar:</i> responsibilities of the chairman. HK Code sets out more detailed responsibilities in the code provisions.</p> <p><i>Different:</i> UK code requires chairman to meet independence criteria (A.3.1) while HK code does not.</p>
<p>A.3 Board composition</p> <p>HK MBLR Chapter 3: 3.10,3.10A</p>	<p>B.1 (exl. B.1.1)</p>	<p><i>Same:</i> principle regarding composition of the board; require the disclosure of the board identities (including INEDs) in the annual report.</p> <p><i>Similar:</i> HK LR 3.10A requires 1/3 of the board to be INEDs; UK CG Code requires 1/2 (except for smaller companies).</p> <p><i>Different:</i> HK LR 3.10 requires ≥ 3 INEDs and at least 1 of which holds professional qualification.</p>
<p>A.4 Appointments, re-election and removal</p>	<p>B.2(2.3) and B.7</p>	<p><i>Same:</i> principles re appointment and re-election; specified term for NEDs.</p> <p><i>Similar:</i> HK code – further appointment of INED serving > 9 years requires shareholders’ approval; UK code – NED serving > 9 years should be subject to annual re-election.</p> <p><i>Different:</i> HK code recommends retirement of directors by rotation at least once every 3 years; UK code recommends review of a NED with term > 6 years. UK code recommends directors of FTSE 350 companies be subject to annual election by</p>

			shareholders.
A.5	Nomination Committee	B.2 (2.1,2.2,2.3, 2.4)	<p><i>Same:</i> recommendation of a majority of INEDs on nomination committee; policy concerning diversity of board members; provide for external advice/consultancy.</p> <p><i>Similar:</i> code provisions. HK code more detailed, setting out duties of nomination committee (e.g. annual review of the composition of the board, which is not shown in UK code); UK CG Code requires a disclosure in the annual report to describe the nomination committees work including the process for board appointments, whereas the HK CG Code requires a circular and/or explanatory statement at the general meeting.</p> <p><i>Different:</i> HK code, issuer should provide sufficient resources to nomination committee, UK code, has no such recommendation; UK CG Code specifies terms of appointment for the nomination committee and that after six years appointments are to be subject to rigorous review, HK has no such recommendation.</p>
A.6	Responsibilities of directors	A.4 (exl. A4.2.), B.3 (exl. B3.2) and B.4	<p><i>Same:</i> Newly appointed directors should receive induction; NEDs should scrutinise performance of directors and monitor performance; Directors should allocate sufficient time; Directors should have continuous professional development.</p> <p><i>Similar:</i> HK code - Each director should disclose significant commitment in public companies/organisations; UK code - Chairman should disclose his other significant commitment.</p> <p><i>Different:</i> UK code - one senior independent director should be appointed; board should not agree to a full-time executive director taking on more than 1 NED job or the chairman of a FTSE 100 company. There is not a similar recommendation in the HK CG Code.</p>
A.7	Supply of and access to information	B.5	<p><i>Same:</i> principle - directors should be provided with info in a timely manner.</p> <p><i>Similar:</i> code provisions. HK code more detailed (e.g. management has obligation to supply info). UK CG Code – directors should have access to the company secretary.</p>

<p>B. REMUNERATION OF DIRECTORS AND SENIOR MANAGEMENT AND BOARD EVALUATION</p>		<p><i>Different: -</i></p>
<p>B.1 The level and make-up of remuneration and disclosure</p>	<p>D1, D2, B6 and Schedule A</p>	<p><i>Same:</i> Performance-linked remuneration for EDs (HK in recommended best practices, UK in code provisions); Formal and transparent procedure for developing exec director remuneration.</p> <p><i>Similar:</i> In general, UK code much more detailed. Composition of the committee: HK LR 3.25 recommends majority to be INEDs and chairman be INED; UK code recommends at least 3 (2 for small Cos) INEDs in the committee.</p> <p><i>Different:</i> Evaluation: HK code –RBP that board should evaluate performance regularly; UK code – much more detailed (e.g. Evaluation of the board of FTSE 350 companies should be externally facilitated at least every 3 years).</p>
<p>C. ACCOUNTABILITY AND AUDIT</p>		
<p>C.1 Financial reporting</p>	<p>C1</p>	<p><i>Same:</i> principle. fair, balanced and understandable assessment. Long-term financial prospects of the company.</p> <p><i>Similar:</i> code provisions. HK code more detailed.</p> <p><i>Different:</i> HK code recommends management to give monthly update and sufficient info to the board; UK code recommends directors to provide necessary info to shareholders in the annual report; HK Code has the recommended best practice for company to publish quarterly results. HK Code recommends that management provide board members with monthly updates concerning financial performance; directors are to acknowledge in the Corporate Governance Report their responsibility for preparing accounts.</p>
<p>C.2 Risk management and internal control</p>	<p>C2</p>	<p><i>Same:</i> principle. Board is responsible for risk identification and should maintain risk management. HK more detailed.</p> <p><i>Similar:</i> code provisions on annual review. HK code includes details of annual review considerations; HK code - disclosure in CG report of management's confirmation on effectiveness of the system as (recommended best practices); UK code - directors' confirmation in annual report that robust assessment of risks has been performed (required in code provisions).</p> <p><i>Different:</i> -</p>
<p>C.3 Audit Committee</p>	<p>C3</p>	<p><i>Same:</i> principle. Formal and transparent arrangements and appropriate relationship with</p>

			<p>auditor, determines independence of the auditor, responsible for appointing external auditors; and most code provisions.</p> <p><i>Similar:</i> code provisions. HK code more detailed. Composition of committee: HK LR 3.21 requires > 3 and NED only, at least 1 which is INED and holds professional qualifications; UK code recommends majority to be independent, >3 INEDs, at least 1 with relevant financial experience. Whistle-blowing policy: HK code sets out in recommended best practices while UK code in code provisions. HK CG Code – terms of reference and responsibilities on the SEHK and its website; UK CG Code – in the annual report.</p> <p><i>Different:</i> HK CG Code recommends that the committee be chaired by an INED HK code recommends that former partner of the issuer’s existing audit firm not be appointed to the committee for 1 year. HK code recommends full minutes of audit committee meetings be kept. HK code recommends the committee to meet at least twice a year with auditors.</p>
D.	DELEGATION BY THE BOARD		
D.1	Management functions	A (Code Provisions A.1.1)	<p><i>Same:</i> An issuer should have a formal schedule of matters specifically reserved for board approval.</p> <p><i>Similar:</i> HK code more detailed.</p> <p><i>Different:</i> -</p>
D.2	Board Committees	N/A- part of board recommendations	
D.3	Corporate Governance Functions	N/A	
E.	COMMUNICATION WITH SHAREHOLDERS		
E.1	Effective communication	E1 and E2	<p><i>Same:</i> principles regarding dialogue with shareholders.</p> <p><i>Similar:</i> code provisions. UK Code more detailed and emphasize usage of general meetings to communicate with shareholders.</p> <p><i>Different:</i> HK CG Code – Board should establish a communication policy.</p>
E.2	Voting by Poll	N/A	

F. COMPANY SECRETARY	B5 (Supporting Principle)	<p><i>Same:</i> principle. Secretary's role. Board responsible for appointment and removal</p> <p><i>Similar:</i> -</p> <p><i>Different:</i> HK code imposes detailed requirement in code provisions.</p>
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CORPORATE GOVERNANCE REPORT MANDATORY DISCLOSURE REQUIREMENTS	Schedule B Disclosure of corporate governance arrangements	
G. CORPORATE GOVERNANCE PRACTICES	Schedule B	<p><i>Same:</i> UK more detailed.</p> <p><i>Different:</i> Incorporates DTRs in relation to audit committees although this is generally part of the CG Code.</p>
H. DIRECTORS' SECURITIES TRANSACTIONS	Schedule B	<p><i>Different:</i> UK code does not have such requirement.</p>
I. BOARD OF DIRECTORS	DTR 7.2.7 R	<p><i>Same:</i> most terms.</p>
	CG code Schedule B	<p><i>Similar:</i> -</p>
		<p><i>Different:</i> HK code requires relationship between board members be disclosed. UK code requires more – (1) Statements (how performance evaluation is conducted, going-concern basis, how prospects are assessed); (2) Explanations (fair, balanced and understandable accounts, long-term value generation basis); (3) Confirmation (robust assessment of principle risks) from directors.</p>
J. CHAIRMAN AND CHIEF EXECUTIVE	DTR 7.2.7 R	<p><i>Same:</i> disclosure of identity</p>
	CG code Schedule B	<p><i>Similar:</i> -</p>
		<p><i>Different:</i> UK code requires disclosure in the annual report of: the impact of any changes to the other significant commitments of the chairman; and where a chief executive is appointed chairman, the reasons.</p>
K. NON-EXECUTIVE DIRECTORS	Schedule B	<p><i>Same:</i> terms of appointment.</p>
		<p><i>Different:</i> UK CG Code – names of whom the board determines are independent and reasons where necessary.</p>
L. BOARD COMMITTEES	DTR 7.2.7 R	<p><i>Same:</i> most terms.</p>
	CG code Schedule B	<p><i>Similar:</i> -</p>
		<p><i>Different:</i> UK code recommends a statement of how performance evaluation is conducted.</p>
M. AUDITOR'S REMUNERATION	Schedule B	<p><i>Different:</i> HK CG Code – remuneration in respect of auditor and non-audit services. UK CG Code – approach taken to appoint the external auditor,</p>

		when a tender was last conducted, if the auditor provides non-audit services.
N. COMPANY SECRETARY	N/A	
O. SHAREHOLDERS' RIGHTS	N/A	
P. INVESTOR RELATIONS	N/A	
Q. RISK MANAGEMENT AND INTERNAL CONTROL	DTR DTR 7.2.5 R	<p><i>Same:</i> disclosure of whether it has an internal audit function.</p> <p><i>Similar:</i> disclosure of main concerns. HK code – as recommended practices.</p> <p><i>Different:</i> - HK Code recommends a statement of review.</p>

Appendix I	5. Other influences	I.5 Hong Kong
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Introduction

Many interest groups and bodies other than the regulators have been active in influencing the development of CG in Hong Kong. They come with different perspectives according to their constituent representation. Their activities include: publication of principles, policy documents, guidelines, model codes; making submissions during public consultations and hearings of LegCo committees; lobbying the government and the regulators; submitting research to regulatory agencies; submitting comment letters on proposed CG changes to listing requirements; and engagement of the media etc.

They can be broadly divided into several categories, as follows:

international and regional bodies (e.g. International Corporate Governance Network (ICGN), Alternative Investment Management Association (AIMA), ACGA, Asian Securities Industry and Financial Markets Association (ASIFMA));

self-regulatory statutory bodies (HKICPA);

management interest groups (Hong Kong Institute of Directors (HKIoD), HKICS);

business/commerce associations (Hong Kong General Chamber of Commerce (HKGCC), Chamber of Hong Kong Listed Companies (CHKLC));

securities industry groups (Hong Kong Securities and Investment Institute (HKSII), (HKSA));

shareholder interest groups (Hong Kong Investor Relations Association (HKIRA));

shareholder activism (Elliott Management, BlackRock, David Webb); and

institutional shareholders (City-Parish Employees' Retirement System (CPERS)).

A number of these groups make written submissions to public consultations such as the FSTB Proposal to Improve the Regulatory Regime for Listed Entity Auditors (2014), SFC Consultation Paper on Proposed Amendments to the SFO for Providing Assistance to Overseas Regulators in Certain Situations (2015), SFC Principles of Responsible Ownership (June 2015), SFC Consultation Paper on Review of Connected Transaction Rules (2013), HKEX Concept Paper on Weighted Voting Rights (2014), and the HKEX Consultation Paper on Board Diversity (2012) (see Appendix I.2). Such submissions have influenced the development of CG rules and changes in Hong Kong as they are often taken into account by the regulators in forming their consultation conclusions. The media also plays a key role in reporting and uncovering some stories, which put pressure on the government or the regulators to make CG changes or take enforcement actions.

I.5.1 International and regional bodies

The ICGN is an investor-led organisation that promotes effective standards of CG and investor stewardship to advance efficient markets and sustainable economies worldwide. CG policy positions are guided by the ICGN Global Governance Principles and the Global Stewardship Principles, which are implemented by:

influencing policy by providing a reliable source of investor opinion on CG and stewardship;

connecting peers at global events to enhance dialogue between companies, investors to facilitate long-term value creation; and

inform dialogue through knowledge and education to stimulate the professionalism of CG and stewardship practices.³⁵⁴

In response to public consultations addressing Hong Kong CG reforms, the ICGN has commented on, for example, the SFC's "Principles of Responsible Ownership" (June 2015); the "Consultation on the Regulation of Sponsors" (2012); and the HKEX's "Consultation Paper on Board Diversity" (2012).

The AIMA is a private organization representing hedge funds located in London. It promotes the activities of hedge funds by *inter alia* publishing and advocating on their behalf on a range of issues, including CG. AIMA issues responses to public consultations on CG reforms, for example, to the SFC on the "Consultation Paper on Proposed Amendments to the SFO for Providing Assistance to Overseas Regulators in Certain Situations" (2015); the "Principles of Responsible Ownership" (June 2015); the "Consultation Paper on Proposed Amendments to the Professional Investor Regime and Client Agreement Requirements" (2013); and the HKEX's "Concept Paper on Weighted Voting Rights" (2014).

The ACGA is an independent, non-profit membership organisation which works with investors, companies, and regulators to implement effective CG practices in the Asia-Pacific. ACGA was founded from the belief that CG is fundamental to the long-term development of Asian-Pacific economies and capital markets.

In terms of the scope of ACGA's CG work, three areas are covered: research, advocacy, and education. Research involves tracking CG developments across 12 markets and producing independent analyses of laws and regulations, investor activism, and corporate practices. Advocacy is undertaken by engaging in constructive dialogue with regulators, stock exchanges, institutional investors, and companies on the regulatory environment and CG practices. Education is through the organising of conferences and seminars to understand the benefits of CG and foster effective CG implementation.³⁵⁵ ACGA issues a biennial joint report with CLSA, a latest edition being "CG Watch 2016".³⁵⁶

ACGA responds to public consultations addressing Hong Kong CG reforms, for example, the SFC's "Principles of Responsible Ownership" (June 2015); the "Consultation on the Regulation of Sponsors" (2012); the HKEX's "Concept Paper on Weighted Voting Rights" (2014); and the "Consultation Paper on Board Diversity" (2012).

The ASIFMA is an independent regional trade association which represents banks, asset managers, law firms, and market infrastructure service providers. ASIFMA's initiatives include consultations with regulators and exchanges, the development of uniform industry standards, and advocacy for enhanced markets through policy papers.³⁵⁷ Part of ASIFMA's advocacy platform is to drive consensus of CG issues. ASIFMA participates and responds to public consultations addressing Hong Kong CG reforms, for example the HKEX's "Concept Paper on Weighted Voting Rights" (2014).

³⁵⁴ International Corporate Governance Network, "About": Available at <https://www.icgn.org/about> (visited on 21 November 2016)

³⁵⁵ ACGA, "About ACGA": Available at: www.acga-asia.org/who-we-are.php (visited on 20 November 2017)

³⁵⁶ For details, see: CLSA, "CG Watch 2016 Ecosystems matter: Asia's path to better home-grown governance," (30 September 2016), Media Coverage Summary," Available at: <http://www.acga-asia.org/research.php> (visited on 20 November 2017)

³⁵⁷ ASIFMA, "About ASIFMA": Available at <http://www.asifma.org/about/> (visited on 22 December 2016)

I.5.2 Self-regulatory statutory organisations

The HKICPA is an industry body that registers and grants practicing certificates to certified practicing accountants in Hong Kong. It is the prescribed body for the general requirements of financial statements, incorporated under section 3 of the PAO, for the purposes of section 380(8)(a) of the CO.³⁵⁸ The HKICPA also has statutory powers to make by-laws including issuing financial reporting and auditing standards, and codes of ethics.³⁵⁹ These by-laws are an essential element of the effective CG framework. In the HKICPA's view:

"...in order for Hong Kong to remain successful in an increasingly competitive global market and to maintain its status amongst the world's leading financial and commercial centres, it must continue to promote and aspire to achieve international best practice in CG, both in terms of regulations and prevailing practices."³⁶⁰

Various initiatives are undertaken by the HKICPA to promote and enhance Hong Kong's CG standards, including:³⁶¹

Best practice guidance: Producing study reports and practice guidance;

Promotional events and activities: Organising the "Best Corporate Governance Disclosure Awards";

Representation and advocacy: Commenting on consultation documents and proposals relating to CG; and

External and international involvement: Participating in events and activities and collaborating with professional and regulatory bodies to promote CG in Hong Kong.

In relation to commenting on consultation documents and proposals, the HKICPA actively participates in CG policy formulation and issues responses to public consultations on CG reforms, for example, to the FSTB's CO rewrite (2012), "Proposal to Improve the Regulatory Regime for Listed Entity Auditors" (2014), the HKEX's "Concept Paper on Weighted Voting Rights" (2014), the "Consultation Paper on Review of Connected Transaction Rules" (2013), and the "Consultation Paper on Board Diversity" (2012). (For more details on the HKICPA, also see Appendix I.4.5).

I.5.3 Associations and interest groups

Management interest groups

The HKIoD is a non-profit organisation representing directors working to promote good CG and contribute towards advancing the status of Hong Kong, both in Mainland China and internationally.³⁶² Membership consists of directors from listed and non-listed companies. The HKIoD is committed to providing directors with educational programmes, information services, and an influential voice in representation. Reflecting international perspectives and Hong Kong's multi-cultural environment, the HKIoD

³⁵⁸ Companies (Accounting Standards and Prescribed Body) Regulation (Cap. 622C), s 2

³⁵⁹ PAO, Long Title and s 8

³⁶⁰ HKICPA, "Corporate Governance": Available at <http://www.hkicpa.org.hk/en/membership-and-benefits/professional-representation/corporate-governance/> (visited on 22 December 2016)

³⁶¹ Ibid.

³⁶² HKIoD, "About Us – Vision, Mission & Values,": Available at <http://www.hkiod.com/mission.html> (visited on 22 December 2016)

conducts its business in biliteracy and trilingualism.³⁶³

The HKIoD is committed to enhancing CG standards by, *inter alia*, assisting companies, policy makers, and the public to identify ways to improve CG policies.³⁶⁴ A CG Scorecard is compiled regularly by the HKIoD to assess major SEHK listed companies' CG practices. To acknowledge directors for excellence in CG practice, the HKIoD holds annual "Directors Of The Year Awards", which stimulate industry-wide influence and establish role models for benchmarking.

CG policies and director practices are developed by the HKIoD with the aim of influencing public policy makers and opinion formers. Regular consultations are conducted with HKIoD members, followed by reviews to assert consolidated opinions.³⁶⁵ For example, the HKIoD has issued responses to public consultations on CG reforms to, *inter alia*, the FSTB's "Proposal to Improve the Regulatory Regime for Listed Entity Auditors" (2014), the HKEX's "Concept Paper on Weighted Voting Rights" (2014), the "Consultation Paper on Review of Connected Transaction Rules" (2013), and the "Consultation Paper on Board Diversity" (2012).

The HKICS is an independent institute that promotes its members' role in the formation of effective implementation of good CG policies and the development of the profession of a "Chartered Secretary" in Hong Kong and Mainland China. Members of the HKICS represent a body of CG expertise. Professional development and educational CG programmes are regularly run by the institute. For example, the HKICS' "Enhanced Continuing Professional Development" programme keeps members up to date with relevant areas of CG. A "Corporate Governance Paper Competition" engages university undergraduates in Hong Kong frontier CG issues. A CG programme in collaboration with the Open University of Hong Kong is run for Mainland postgraduate students to obtain a Masters of Corporate Governance degree. Furthermore, the institute provides scholarships for people pursuing studies in corporate secretarial and CG-related subjects. The HKICS also holds biennial CG conferences.³⁶⁶

Members are represented by the HKICS by issuing responses to public consultations on CG reforms, for example, the FSTB's "Proposal to Improve the Regulatory Regime for Listed Entity Auditors" (2014), the HKEX's "Concept Paper on Weighted Voting Rights" (2014), the "Consultation Paper on Review of Connected Transaction Rules" (2013), the "Consultation Paper on Board Diversity" (2012), the SFC's "Consultation on the Regulation of Sponsors" (2012), and the "Consultation Paper on the Draft Guidelines on Disclosure of Inside Information" (2010).

Business/commerce associations and lobby groups

The HKGCC is the oldest business organization in Hong Kong representing local, Mainland, and international businesses. Half of the corporations listed on the Hang Seng Index (i.e. approximately 25 of the 50 largest listed companies on the Main Board) are its members. Representatives of the HKGCC are on over 40 government and non-government advisory boards.³⁶⁷ The HKGCC regularly provides responses to public consultations concerning Hong Kong CG issues, for example, the SFC's "Principles of

³⁶³ HKIoD, "The Hong Kong Institute of Directors Announces Winners of Directors Of The Year Awards 2014": Available at http://www.hkiod.com/document/DYA/DYA2016_result_pr_eng.pdf (visited on 20 November 2017)

³⁶⁴ HKIoD, "About Us – Services": Available at <http://www.hkiod.com/services.html> (visited on 22 December 2016)

³⁶⁵ Ibid

³⁶⁶ See generally, HKICS, "Annual Report 2016, Building Professional Influence," (2016)

³⁶⁷ HKGCC, "Overview": Available at http://www.chamber.org.hk/en/about/hkgcc_welcome.aspx (visited on 22 December 2016)

Responsible Ownership” (June 2015), FSTB’s CO rewrite (2012); and the HKMA’s “Guidelines on a Sound Remuneration System” (December 2009).

The CHKLC is a non-profit organization serving listed companies and other industry bodies in Hong Kong. It strives to, *inter alia*, promote sound CG and function as an effective communication channel between listed companies and regulatory authorities.³⁶⁸ The CHKLC issues the “Hong Kong Corporate Governance Charter” for its members, responds to public consultations on CG reforms regularly, including the SFC’s “Consultation of the Principles of Responsible Ownership” (June 2015), the “Consultation Paper on the Draft Guidelines on Disclosure of Inside Information” (2010), the FSTB’s “Proposal to Improve the Regulatory Regime for Listed Entity Auditors” (2014), the HKEX’s “Consultation Paper on Review of Connected Transaction Rules” (2013), and the “Consultation Paper on Board Diversity” (2012).

I.5.4 Securities industry groups

The HKSII offers professional recognized training courses, through examinations and qualifications, to meet the licensing requirements of the SFC. Membership of the HKSII provides access to a network platform which operates across the financial services industry. The HKSII provides responses to public consultations addressing CG reforms, for example, the SFC’s “Principles of Responsible Ownership” (June 2015) and the HKEX’s “Concept Paper on Weighted Voting Rights” (2014).

The HKSA is a non-profit association which works closely with the government, the SFC, and the HKEX. It is accredited by the SFC to conduct Continuous Professional Training applicable to persons registered under the SFO.³⁶⁹ The HKSA issues responses to public consultations on CG reforms, for example, the SFC’s “Consultation Paper on Proposed Amendments to the Professional Investor Regime and Client Agreement Requirements” (2013), the “Consultation on the Regulation of Sponsors” (2012), and the HKEX’s “Concept Paper on Weighted Voting Rights” (2014).

I.5.5 Shareholder interest groups

The HKIRA comprises of investor relations practitioners and officers responsible for corporate communication between management and the investor community. Objectives of the HKIRA include, *inter alia*: (1) providing a platform for investor relations practitioners to exchange views; (2) offering education and training to support professional and ethical standards; and (3) representing the views of the investor community, as well as regulatory and government bodies.³⁷⁰ In terms of the education and training, the HKIRA offers a “HKU Space IR Executive Certificate Program” which includes a module on CG. The HKIRA also issues responses to public consultations on CG reforms, for example, the HKEX’s “Concept Paper on Weighted Voting Rights” (2014), and the “Consultation Paper on Board Diversity” (2012).

I.5.6 Shareholder activism

Shareholder activism in Hong Kong is dominated by a small group. Most activism takes place in private and therefore does not gain media attention. The few high-profile activists, including United States firms Elliott Management and BlackRock, which engage in public media events seek to pressure management to increase shareholder value or otherwise improve CG. These examples are quite rare. Activist investors do, however, respond to public consultations concerning CG regulatory reforms, for example, the

³⁶⁸ CHKLC, “About the Chamber – Mission”: Available at <http://www.chkcl.org/web/eng/index.htm> (visited on 22 December 2016)

³⁶⁹ HKSA, “Introduction About HKSA”: Available at <http://www.hksa.com.hk> (visited on 22 December 2016)

³⁷⁰ HKIRA, “Mission and Vision”: Available at <http://www.hkira.com/en/about/mission.php> (visited on 22 December 2016)

SFC's "Principles of Responsible Ownership" (June 2015) - BlackRock, Aberdeen Asset Management, APG Asset Management Asia, and David Webb; the HKEX's "Concept Paper on Weighted Voting Rights" (2014) - BlackRock, David Webb (on behalf of 349 individuals), Avant Capital Management (Hong Kong) Limited, Fidelity Worldwide Investment, and USS Investment Management Limited; and the "Consultation Paper on Board Diversity" (2012) - BlackRock.³⁷¹ Responses by activist shareholders to HKEX consultations are not obvious because they are classed as "market practitioners", whereas institutional investors are classed as such.

One of the most high-profile local activist investors in Hong Kong is David Webb. The activist approach taken by Mr. Webb is that of public engagement through a variety of forums, not merely constrained to board engagements. For example, Mr. Webb operates "Webb-site.com" a public online website where the public can access "Webb-site Reports", which offer opinions focusing on, *inter alia*, corporate and economic governance, and legal and regulatory affairs.³⁷² Mr. Webb is the Deputy Chairman of Hong Kong's Takeovers and Mergers Panel, a past INED of the HKEX, and an associate member of the Hong Kong Journalists Association.

I.5.7 Institutional shareholders

Hong Kong institutional shareholders range from local to some of the largest international institutional shareholders (e.g. California Public Employees' Retirement System). Institutional shareholders rarely pressurise management to improve CG. On the whole, institutional shareholders take a passive approach to CG in Hong Kong. The preferred method of engagement is to make carefully detailed responses to public consultations involving CG reforms, for example, the HKEX's "Concept Paper on Weighted Voting Rights" (2014); and the "Consultation Paper on Board Diversity" (2012). (For more details on institutional shareholders, see section A above.)

I.5.8 Other groups

"Practising Governance" is a platform for CG practitioners involved in Hong Kong-listed companies — including company secretaries, legal counsels, and Chief Financial Officers. Importantly, Practice Governance advocates that good CG must not be limited to the largest companies. The approach of Practising Governance is to help companies build capacity for good CG by supporting the work of CG practitioners. Focal areas include CG, risk management, and the listing rules (and related regulatory) compliance. The approach taken by Practising Governance is to develop "soft skills" which it argues is "crucial in getting organisation buy-in". Practising Governance is a new independent organisation that provides regulatory updates and interactive training for practitioners to learn and exchange views. The aim of Practising Governance is to combine insights, the expertise of practitioners and leading companies.³⁷³

I.5.9 Public media

There is a free media that reports on CG issues. The results of CG reviews gain extensive media attention, especially those that are favourable to Hong Kong. However, incidences of misconduct and other CG breaches are not widely reported, apart from media releases on the regulators' websites. Of the press releases issued, there are two journalists that regularly report on CG - Enoch Yiu and Shirley Yam. Market participants rarely offer their views or comments in media reports. The only critical comments on CG misconduct are by regulators, institutional shareholders, and activist shareholders. This may be

³⁷¹ The activist shareholders listed are merely a sample of a larger group.

³⁷² See generally, Webb-site, "About us": Available at <https://webb-site.com/pages/aboutus.asp> (visited on 23 December 2016)

³⁷³ Practising Governance, "ABOUT US": Available at <http://practisingov.com/about-us/> (visited on 20 November 2017)

explained by the passive and non-confrontational character of retail investors who only tend to be vocal when facing financial losses from misconduct (e.g. Lehman Brothers Minibonds). The government responds more readily to incidents with the subsequent enquiries gaining widespread media attention. Outside of these incidents, media attention centres on board composition, directors, and aspects of the CG framework which may affect Hong Kong's competitiveness as an international financial centre. Confrontational activist shareholders attract widespread CG publicity from proactive engagement with the media. This is more a result of their business model rather than that of the media *per se*. Nonetheless, most shareholder activism is conducted privately and does not gain media attention. Media and press releases are an important tool in the regulators' CG enforcement arsenal, for example, public censures and seeking public comments on proposed regulatory or statutory CG changes.

Appendix I	6. Enforcement	I.6 Hong Kong
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Introduction

Enforcement has been mainly in the form of public enforcement by the regulators, particularly the HKEX and SFC. HKEX is mainly in charge of enforcing the Listing Rules whereas the SFC is in charge of the relevant provisions in the SFO. HKEX has less investigatory power than the SFC and the sanctions it can impose are far less onerous than those that SFC can seek through either civil or criminal proceedings. Thus, HKEX has often been criticised for weak enforcement, which has prompted calls for statutory backing to the listing rules. However, in recent past the SFC has been more pro-active in using its powers under sections 213 and 214 SFO to obtain remedies for various breaches of listing rules. Although private enforcements by shareholders are available (see Appendix I.7), for example, by unfair prejudice or derivative actions, such actions by shareholders in listed companies are extremely rare.

CR is in charge of enforcing the CO against all locally incorporated companies. Enforcement of accounting standards is done by HKICPA whilst the FRC is responsible for investigation into accounting and reporting irregularities, before such cases are heard and sanctioned by the HKICPA.

I.6.1 Laws and regulations

See Appendices I.3 and I.4 for a discussion of the legislation and regulations on which enforcement action through the courts or by administrative means is undertaken.

I.6.2 Offences

A number of bodies are able to prosecute offences, including the Department of Justice, SFC, Hong Kong Police Force, CR, the HKICPA, HKMA, and the ORO.

Powers to obtain evidence

The SFC can impose a positive requirement to answer, including by way of statutory declaration applicable to licensed intermediaries³⁷⁴ and listed issuers - which can be applied to the issuer, their banker and auditor, and any other person including the issuer's directors and staff.³⁷⁵ Where an SFC appointed investigator requires a person to give an answer to any question under sections 179 and 183 of the SFO, and the answer might incriminate the person and the person so claims before providing the answer, then the requirement as well as the answer shall not be admissible in evidence against the person in criminal proceedings in a court of law (with exceptions).³⁷⁶

Pursuant to the CO, if a CR inspector or delegate of an inspector requires a person to give an answer to any question or provide any information or explanation in respect of a document or record produced, there are limitations on the admissibility of that evidence in legal proceedings.³⁷⁷ Limitations apply to criminal proceedings where the answer, information, or explanation might tend to incriminate the person and that person so

³⁷⁴ SFO, s 180

³⁷⁵ SFO, ss 179(3) and 183(2)

³⁷⁶ Not cooperating with investigations... s179(13), (14) or (15) or s184, s219(2)(a), 253(2)(a) or 254(6)(a) or (b), Part V of the Crimes Ordinance (Cap 200), or for perjury. For the privilege against self-incriminating testimony or answers, see SFO, s 187

³⁷⁷ s 865

claims before giving the answer, or providing the information or explanation (with exceptions).³⁷⁸

Liability of officers

In general, statutes that provide for offences committed by corporations also provide for liability of relevant officers.

Under the CO, officers have a duty to prepare financial statements,³⁷⁹ a directors' report,³⁸⁰ and maintain adequate accounting records.³⁸¹ Officers who fail to take all reasonable steps to secure compliance in the preparation commit an offence.³⁸² A director has a duty to exercise reasonable care, skill and diligence.³⁸³ A breach of a director's statutory duties have civil consequences the same as common law rules or equitable principles.³⁸⁴

Pursuant to the SFO, issuers and their officers have a duty to take steps as soon as reasonably practicable to disclose inside information, subject to applicable safe harbours. A statutory offence is committed by an officer which is intentional, reckless or negligent and who has not taken all reasonable measures to ensure proper safeguards exist to prevent a breach of the disclosure requirements.³⁸⁵

I.6.3 Private actions

Section 40 of CWUMPO provides for civil liability in relation to false or misleading information in prospectuses. Civil actions only arise in relation to disclosure matters – based on inside information requirements in the statutory provisions of the SFO. Persons who suffer loss as a result of misstatements or material omissions in a prospectus may claim damages. The scope of the provision is limited to directors, promoters and persons who have authorised the issue of the prospectus. "Material omissions" is unspecified as to whether a failure to disclose information required by the listing rules would amount to a material omission.

Section 40A of CWUMPO imposes criminal liability for misstatements in prospectus.

A breach of the disclosure requirements under Part XIVA of the SFO give rise to a civil liability by way of compensation for damages.³⁸⁶

I.6.4 Listing rules

The listing rules operate as a contract between the issuer and the exchange and investors have no rights of private action in respect of breaches of listing rule requirements..

Monitoring of compliance with the listing rules is handled by the HKEX³⁸⁷ and indirectly by the SFC, which monitors the disclosures made by issuers.

The HKEX has powers for monitoring, investigating, and enforcing the listing rules, many

³⁷⁸ s 865

³⁷⁹ s379

³⁸⁰ s388

³⁸¹ s373

³⁸² ss373, 379, and 388

³⁸³ s465

³⁸⁴ ss 465 and 466

³⁸⁵ s307G

³⁸⁶ s307Z

³⁸⁷ Main Board LR 13.06 (3)

of which have a significant CG dimension.³⁸⁸ Two principal HKEX departments which enforce the listing rules are the Compliance and Monitoring Team (CMT) and the Listing Enforcement Team (LET). CMT is responsible for monitoring listed companies' continuous obligations with the listing rules, including continuous disclosures and their CG practices. The LET is responsible for investigating possible breaches of the listing rules, including handling complaints alleging breaches of the LRs, and initiating and conducting disciplinary proceedings before the Listing (Disciplinary) Committee.³⁸⁹ However, the HKEX does not have statutory investigatory powers. In practice, the CMT is responsible for the day-to-day administration of the listing rules and is the first to identify breaches.³⁹⁰ The HKEX conducts spot checks of listed companies' compliance with the CG Code as part of its ongoing monitoring activities.³⁹¹

To address potential conflicts of interest with the HKEX being listed on the SEHK, the HKEX/SEHK delegated its regulatory listing functions to the SEHK's "Listing Committee". Breaches of the listing rules are subject to the disciplinary powers exercised by the Listing (Disciplinary) Committee. The Listing Committee can be reconvened as the Listing (Disciplinary) Committee, Listing (Review) Committee, or Listing Appeals Committee, depending on the role required.

Investigations concerning conduct that possibly breaches the listing rules can arise during monitoring compliance, referrals from other regulatory or law enforcement bodies, or complaints from the public.³⁹² For example, monitoring compliance can trigger an investigation pursuant to LR 13.09(1) when there is unusual trading activity relating to a company's shares:

"where in the view of the SEHK there is or likely to be a false market in an issuer's securities, the issuer must, as soon as reasonably practicable after consultation with the SEHK, announce the information necessary to avoid a false market in its securities."

The Enforcement Statement titled "The Enforcement of the Listing Rules – Policy Statement" ("SEHK Policy Statement") published by the SEHK in 2013 and revised in February 2017 states:

"Under section 21 of the Securities and Futures Ordinance, the Exchange has a statutory duty to ensure, as far as reasonably practicable, an orderly, informed and fair market for the trading of securities listed on the Exchange...In discharging this statutory obligation, the Exchange enforces the Listing Rules, and cooperates with the statutory regulator (the SFC) and other law enforcement authorities in their enforcement work which concern listed companies."³⁹³

The SEHK Policy Statement emphasises that enforcement of the law (e.g. SFO and CO) takes priority over the SEHK Listing Rules. When the SEHK becomes aware of (1) conduct which breaches the law, and/or (2) conduct which may amount to a possible

³⁸⁸ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [6.1]

³⁸⁹ HKEX, "Listing": Available at http://www.hkexgroup.com/About-HKEX/Organisation/Management/Management-Functions/Listing-and-Regulatory-Affairs/Listing?sc_lang=en (visited on 12 December 2016)

³⁹⁰ Ibid [5.191]

³⁹¹ David Graham, "Comply or explain: a guide to compliance with Hong Kong's Corporate Governance Code," (September 2014) CSJ: Available at <http://csj.hkics.org.hk/site/2014/09/comply-or-explain-a-guide-to-compliance-with-hong-kongs-corporate-governance-code/> (visited on 20 November 2017)

³⁹² HKEX, "The Enforcement of the Listing Rules – Policy Statement," (13 September 2013 revised 17 February 2017), 1: Available at https://www.hkex.com.hk/eng/rulesreg/listdisenf/Documents/enf_state_201702.pdf (visited on 27 October 2017)

³⁹³ HKEX, "The Enforcement of the Listing Rules – Policy Statement," (13 September 2013 revised 17 February 2017), 1: Available at https://www.hkex.com.hk/eng/rulesreg/listdisenf/Documents/enf_state_201702.pdf (visited on 27 October 2017)

breach of the law, the appropriate law enforcement authority is notified. In the majority of cases the SEHK will continue its investigation simultaneously with the law enforcement authority, except in circumstances where there is possible prejudice of the law enforcement authority's investigation or enforcement action, in which circumstances, the SEHK will temporarily suspend its investigation or action.³⁹⁴

Enforcement of the listing rules by the SEHK serves a number of policy objectives: (1) deterring future rule breaches; (2) educating the market; and (3) influencing the corporate compliance culture and attitude. Importantly, the SEHK' listing rules enforcement policy seeks to enhance CG.³⁹⁵

Sanctions

Breaches involving a disciplinary matter revealed during a CMT investigation are referred to the LET. The LET then refers the matter to a Discipline Coordination Meeting to decide whether further action will be taken.³⁹⁶

If disciplinary action is decided upon, the matter will be referred to the Listing (Disciplinary) Committee.³⁹⁷ Disciplinary powers are conferred upon the Listing (Disciplinary) Committee, by the listing rules pursuant to section 23 of the SFO.

Admissions of breaches are taken into account when determining sanctions. If the breach admitted is not considered to be sufficiently egregious to require disciplinary action, a warning letter may be issued. If there is a failure to admit guilt, a caution may be issued as, although a breach is suspected, this is not sufficient to warrant disciplinary action.³⁹⁸

The listing rules require information contained in listing documents to be clearly presented, plain language, and sets page limits for specific sections.³⁹⁹ For example, the SEHK has recently been drawing attention to the quality of disclosures in GEM listing documents (August 2017). If these requirements are not satisfied, the SEHK has the discretion to suspend vetting. To resume vetting, the applicant must redraft the relevant sections of the listing document. Guidance letters have been issued by the SEHK to assist applicants meet these requirements. GEM applications may be returned if fundamental issues in a GEM listing application (e.g. business model or operations) are not clearly understandable after two rounds of comments by the SEHK.

Sponsors have a duty to conduct proper due diligence of listing documents and assist applicants prepare replies to SEHK comments and be prepared to properly answer questions. Unresponsive or unclear answers to comments or questions will result in the return or rejection of the listing application.⁴⁰⁰

Regulatory responses depend on the facts and circumstances and whether the listing rules breach is major or minor. Major breaches incur disciplinary action against issuers and their officers. Minor breaches or conduct that does not meet SEHK expectations (i.e. no breach) are managed by issuing a warning or caution letter. Caution and warning letters are issued by the LET. The SEHK can direct issuers to appoint compliance advisers to improve listing rules compliance or conduct an internal control review, direct

³⁹⁴ Ibid

³⁹⁵ Ibid.

³⁹⁶ Jones, op. cit, [5.200] and [5.201]

³⁹⁷ Ibid, [5.202]

³⁹⁸ Jones, op. cit., [5.201]

³⁹⁹ For example, a limit of 10 pages for "Summary and Highlights" and "Industry Overview" sections and 20 pages for the "History and Development" and "Applicable Laws and Regulations" sections

⁴⁰⁰ HKEX, "Exchange Updates Guidance to Help Improve Listing Document Quality and Clarity," (11 August 2017) *HKEX News Release*

a trading suspension, and in exceptional cases, cancel the issuer's listing.⁴⁰¹ The SMLR gives the SFC power to direct the SEHK to suspend dealing in securities in specified circumstances.⁴⁰²

Specific sanctions are set-out in MBLR 2A.09 and GEMLR 3.10 for parties identified in MBLR 2A.10 and GEMLR 3.11. Focusing on the MBLRs, the sanctions imposed by the Disciplinary Committee are: (1) private reprimand; (2) public statement including criticism; (3) public censure; (4) report the offenders conduct to the SFC or regulatory authority (including overseas regulators); (5) ban a professional advisor or named individual employed by a professional advisor for a period from representing a party in stipulated matters before the Listing and Regulatory Affairs Division (HKEX) or Listing Committee; (6) rectifying a breach or remedial action for a stipulated period, including appointing an independent advisor to minority shareholders; (7) a director's wilful or persistent failure to discharge their responsibilities under the listing rules, state publicly that in the SEHK's opinion the retention of the director is prejudicial to shareholders' interests; (8) if a director remains in office following a public statement mentioned in (7) suspend or cancel the listing of the company's securities or any class of security; (9) for wilful or persistent failure to discharge their responsibilities under the listing rules, order that market facilities be denied for a specified period to that company and prohibit dealers and financial advisers from acting for the company; and (10) take or refrain other action as the SEHK thinks fit, including public actions pursuant to (4), (5), (6), (8), and (9). These sanctions can be imposed on a listed company, its directors, any member of its senior management, any substantial shareholder, professional advisors, authorised representative, supervisor of a Mainland China company, and any independent financial advisor.⁴⁰³

To allocate the SEHK's resources with the best regulatory effect, only the most blatant and serious conduct offences are pursued. This usually involves public sanctions against parties responsible for conduct breaches.⁴⁰⁴

For example, the GEM Listing Committee censured a former executive director of Inno-Tech Holdings Limited for breaching obligations under the Declaration and Undertaking of Directors provided to the SEHK (Appendix 6A of the GEMLRs). The director was suspected of dissipating a significant amount of cash withdrawn from the company without supporting documents. Later, he admitted to owing the company \$33 million and repaid this amount to the company. The company asked the director to voluntarily resign, which he did. Enquiry letters and telephone calls to the director from the Listing Department went unanswered. The director was censured by the GEM Listing Committee for failing to cooperate with the Listing Department's investigation.⁴⁰⁵

The following two examples demonstrate the SEHK disciplinary approach to companies that radically change their business plans/operations. Within two years of an IPO a company underwent a complete change in control and management, undertaking a series of transactions that fundamentally changed its business. The SEHK was of the view that the rationale for the transactions was substantially different from the business plan disclosed in the prospectus issued for the IPO. Applying the principles-based test,

⁴⁰¹ HKEX, "The Enforcement of the Listing Rules – Policy Statement," (13 September 2013 revised 17 February 2017), 1 and 3: Available at https://www.hkex.com.hk/eng/rulesreg/listdisenf/Documents/enf_state_201702.pdf (visited on 27 October 2017)

⁴⁰² Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.17]: referring to SMLR, s 8

⁴⁰³ Main Board LR 2A.10

⁴⁰⁴ HKEX, "The Enforcement of the Listing Rules – Policy Statement," (13 September 2013 revised 17 February 2017), 1: Available at https://www.hkex.com.hk/eng/rulesreg/listdisenf/Documents/enf_state_201702.pdf (visited on 27 October 2017)

⁴⁰⁵ HKEX, "The Gem Listing Committee censures Mr Ang Wing Fung, a former executive director of Inno-Tech," (27 July 2017) *HKEX News Release*

the transactions and disposal of the original business would amount to a reverse take-over. In such circumstances, the company would be treated as a new listing applicant and required to reapply. Additional conditions were imposed by the SEHK on the proposed disposal of the original IPO business pursuant to LR 2.04.⁴⁰⁶

In another example, LR 13.24 requires issuers to maintain sufficient assets to support continued listing of their securities. This is a qualitative test assessed on a case-by-case basis. The SEHK questioned the viability and sustainability of an advisory business after a disposal based on: (1) the history of its operation and management was formed for less than six months; (2) had only begun making substantial revenues and net profits in recent months; (3) relying on a very small number of clients with the majority of revenue derived from one client sourced by the previous substantial shareholder; and (4) the company failed to demonstrate the viability and sustainability of the business by not providing the SEHK with a business plan. The SEHK concluded that the company would not comply with LR 13.24 if it proceeded with the disposal.⁴⁰⁷

Publication

“Disciplinary Hearing Procedures” are published on the SEHK website which are formulated by the Listing Committee in accordance with MBLR 2A.15 and GEMLR 3.16.⁴⁰⁸ A “Statement on Principles and Factors In Determining Sanctions and Directions Imposed By the Disciplinary Committee and Review Committee” and a “Settlement of Stock Exchange Disciplinary Matters involving Listing Rule Breaches” are published on the HKEX website. The HKEX annually issues a report: “Analysis of Corporate Governance Practice Disclosure” which is a review of listed companies CG disclosures.

An enforcement newsletter and director training webcasts have been issued by the SEHK since 2017. There are currently three webcasts: (1) Duties of Directors and Role and Function of Board Committees; (2) Director and Company Secretary Roles; and (3) Risk Management and Internal Control, and Environmental, Social and Governance (ESG) Reporting.

Accountability and appeals

The SEHK Listing (Disciplinary) Committee consists of at least five members with its Chairman usually being the Listing Committee Chairman, failing which a Deputy Chairmen. Listing (Disciplinary) Committee Chairs should have no professional or personal interest in the disciplinary matter.⁴⁰⁹ The FS is responsible for appointing directors to the HKEX’s board pursuant to section 77 of the SFO.⁴¹⁰

An annual Listing Committee Report is publicly available on the HKEX website that outlines policy developments and analysis in relation to, inter alia, disciplinary matters, and contains related qualitative and quantitative data. This report is prepared by the Listing Committee for the board of the SEHK and the HKEX, which in turn is forwarded to the FSTB and the SFC.⁴¹¹ The Listing Committee is accountable to the SEHK which is in turn accountable to the HKEX. As the HKEX is a publicly listed company, it is accountable to its shareholders and issues an annual CG report.

The Listing (Disciplinary) Committee will, if requested by any party, give reasons in

⁴⁰⁶ HKEX Listing Decision “LD113-2017,” (October 2017)

⁴⁰⁷ HKEX Listing Decision, “LD112-2017,” (October 2017)

⁴⁰⁸ SEHK, “Disciplinary Hearing Procedures,” [3]: Available at https://www.hkex.com.hk/eng/rulesreg/listrules/listdisciplinarypro/documents/dis_0913.pdf (visited on 13 December 2016)

⁴⁰⁹ Ibid, [5.1]: (visited 27 Oct 2017)

⁴¹⁰ HKEX, “Board”: Available at http://www.hkexgroup.com/About-HKEX/Organisation/Board-and-Committees/Board?sc_lang=en (visited on 13 December 2013)

⁴¹¹ HKEX, “Listing Committee Report,” (2015), 1

writing for the decision made against that appellant pursuant to MBLRs 2A.09 and 2A.10.⁴¹² This disciplinary process is multi-stage with each stage being a re-hearing on the merits to ensure that the parties are given a reasonable opportunity to be heard. Reviews and appeals of decisions by the Listing (Disciplinary) Committee are initially made before the Listing (Review) Committee with a final conclusive and binding review available before the Listing (Appeals) Committee.⁴¹³ Written reasons of reviews can be requested.⁴¹⁴

I.6.5 Securities and Futures Commission

The SFC has surveillance, investigative, and disciplinary roles. Where appropriate, SFC takes action to remedy market misconduct by applying to the courts for injunctive and remedial orders.⁴¹⁵ Investigations are conducted with other law enforcement agencies and overseas regulatory bodies.

In the context of listed companies, the SFC oversees the dual filing regime (for details, see Appendix I.4 above) for listing applicants, disclosure requirements, corporate conduct and the listing-related functions of the SEHK. The SFC's CG oversight of listed companies centres on corporate misconduct and disclosure irregularities.⁴¹⁶

The regulation of IPO sponsors is an essential role of the SFC in the dual filing regime and as a tool for preventing fraud. In October 2017, the SFC stated it was investigating 15 sponsor firms. A common problem for sponsors is the failure to verify critical business data such as material customers and revenue information. A nexus has been established between sub-standard sponsor verifications and corporate fraud. Sponsors have a duty to make reasonable inquiries to verify listing applicant disclosures.⁴¹⁷ For example, UBS, Standard Chartered and KPMG were investigated for mishandling the IPO of China Forestry Holdings in 2009. China Forestry's shares were suspended one year after its IPO when the company's auditors found accounting irregularities. This led to the 2011 arrest of the CEO by Chinese authorities for alleged embezzlement. Shares of China Forestry were delisted in early 2017 and it is currently in liquidation (October 2017).

Listed company announcements are monitored by the SFC on a daily basis. This is to ensure that inside information is disclosed in accordance with the SFO. Pursuant to section 307B of the SFO, a listed corporation must publicly disclose inside information, as soon as reasonably practicable after any inside information has come to its knowledge. The SFC has issued Guidelines on Disclosure of Inside Information in 2012. The SFC raises enquiries with listed companies to explore potential disclosure and CG failures.⁴¹⁸ Part VIII, Division 2 and in particular section 179 of the SFO empowers the SFC to compel persons related to listed companies to produce records and documents.

Investigatory powers of the SFC are pursuant to Part VIII, Division 3 of the SFO. The

⁴¹² Main Board LR 2A.11

⁴¹³ SEHK, "Disciplinary Hearing Procedures," [5]: Available at https://www.hkex.com.hk/eng/rulesreg/listrules/listdisciplinarypro/documents/dis_0913.pdf (visited on 13 December 2016)

⁴¹⁴ If the Listing (Review) Committee modifies or varies the ruling of an earlier meeting, it will, if requested by the appellant, give written reasons in respect of decisions pursuant to Main Board LRs 2A.09 (2), (3), (5), (7), (8) or (9): Main Board LR 2A.11

⁴¹⁵ SFC, "SFC Annual Report 2016-17," 12: Available at http://www.sfc.hk/web/EN/files/ER/Annual%20Report/SFC_Annual_Report_20164-175_Eng.pdf (visited 20 on October 2017)

⁴¹⁶ SFC, "Annual Report 2015-16," (June 2016), 49 and 50: Available at http://www.sfc.hk/web/EN/files/ER/Annual%20Report/SFC_AR2015-16_Eng_r.pdf (visited on 12 December 2016)

⁴¹⁷ Thomas Atkinson, "Keynote speech at 8th Pan Asian Regulatory Summit," (11 October 2017) *SFC, Executive Director, Enforcement Division*, 3

⁴¹⁸ SFC, "Annual Report 2015-16," (June 2016), 9: Available at http://www.sfc.hk/web/EN/files/ER/Annual%20Report/SFC_AR2015-16_Eng_r.pdf (visited on 12 December 2016)

SFC can commence an investigation where there is “reasonable cause” to believe that an SFO breach has been committed, involving misconduct or a breach of a disclosure requirement.⁴¹⁹ The SFC’s investigatory powers are pursuant to section 182 with the conduct of investigations governed by section 183 of the SFO. An investigator has powers require from any person under investigation or person believed to be in possession of any record or document containing information relevant to an investigation to produce such record and to provide such explanations as the investigator might require.⁴²⁰ This includes information kept in information systems.⁴²¹ Furthermore, the investigator has the power to make such persons: (1) produce any record or document specified by the investigator; (2) give an explanation or further particulars of any record or document; (3) answer any questions before the investigator; and (4) give the investigator all reasonable assistance.⁴²² In the context of listing-related functions of the SEHK, the SFC reviews listing applications received by the SEHK. The SFC’s powers on listing-related matters are partially derived from Parts II (i.e. prospectus requirements) and XII (i.e. restriction on shares for sale or offered to the public) of the CWUMPO.

The SFC is responsible for market misconduct involving listed companies, with the Enforcement Division being responsible for conducting market surveillance to identify market misconduct for further investigation.⁴²³ Enforcement proceedings are undertaken by the SFC by making a court application or by bringing a matter before the MMT. Market misconduct may be committed under Parts XIII and XIV of the SFO with CG-related offences including insider dealing and disclosure of false or misleading information likely to induce transactions.

A curious application of section 277 involved the company, CITIC. Directors were aware, although did not disclose to the market, that significant mark-to-market losses on foreign currency derivative contracts had been incurred. Surprisingly, the MMT held that a “no material adverse change” statement issued by the company did not constitute a breach of section 277 because the statement was unlikely to influence the share price. However, when the losses were subsequently disclosed to the market, CITIC’s shares fell by 66% of its market capitalisation.⁴²⁴

The SFC has recently revised its approach to the market regulation of IPOs. In the first issue of the SFC Regulatory Bulletin (July 2017), a new approach was outlined for early intervention (e.g. IPO) to execute its statutory objectives under the SFO and. The approach is described as “real time” or “front-loaded” regulation where an objection to an IPO (based on section 6(2) of the SMLR) may be raised by the SFC when a view is formed that:

“it is more likely than not, given the known facts and circumstances, that an objection would be raised under section 6 the SMLR, it will promptly issue a “letter of mindedness to object”⁴²⁵

Operational collaboration between the internal divisions of the SFC is a key enforcement platform. Termed “ICE”, the intermediaries, corporate finance and enforcement divisions particularly focus on the price volatility of GEM companies. Another area of focus is inter-related companies which enter into opaque transactions to extract value from investors. These are transactions designed to achieve a number of illegal profit-making objectives

⁴¹⁹SFO, s182.

⁴²⁰ SFO, s183 (1)

⁴²¹ SFO, s189

⁴²² SFO, s183, (1)

⁴²³ HKEX, “Introduction to Regulatory Framework: Available at <https://www.hkex.com/hk/eng/rulesregs/regintro/introreg.htm> (visited on 12 December 2016)

⁴²⁴ For more details, see Syren Johnstone and Nigel Davis, “Transparency of information in the market: the CITIC case before the Market Misconduct Tribunal,” (July 2017) *Hong Kong Lawyer, Official Journal of the Hong Kong Law Society*, available at SSRN <https://papers.ssrn.com/abstract=3006477>

⁴²⁵ SFC, “SFC Regulatory Bulletin: Listed Corporations,” (July 2017) *Issue No. 1, 2*

from manipulating markets to defrauding investors. ICE is executing a complex strategy to overcome these regulatory blind spots and uncover camouflaged transactions. A recent ICE operation was the largest in the SFC history - involving 136 officers from the three ICE divisions.⁴²⁶

An MoU was entered into between the SFC and the Hong Kong Police in August 2017 to elevate the level of cooperation beyond operational matters to policy-making and training to further deter financial crimes in Hong Kong.⁴²⁷

There is an ongoing effort to reduce the SFC Enforcement Division's caseload by culling low-priority cases and filtering out new cases that do not meet the regulatory threshold. Enforcement focuses on serious breaches of the SFO and the SMLR and is designed to ensure compliance with the law/rules and penalise breaches. This involves deterring behaviours - general deterrence and specific deterrence. General deterrence is concerned with deterring future behaviour by the totality of sanctions. Specific deterrence is tailored to deter future recurrence of misbehaviour by sanctioning an appropriate penalty.⁴²⁸

For example, in the *Wong Shu Wing* case (see Appendix I.7.1) the former chairman and executive director of Sunlink was disqualified by the courts for five years after agreeing to a *Carecraft* procedure - agreeing to a statement of facts whereby the court consequently assesses the appropriate order. Pursuant to section 214, Wong Shu Wing was disqualified subject to the following orders: (1) not being or continuing to be a director, liquidator, receiver or manager of property or business of a listed company in Hong Kong, including Sunlink which is incorporated in the Cayman Islands, or any affiliates or subsidiaries; and (2) not in any way being directly or indirectly concerned, or taking part in the management of any listed company in Hong Kong, including Sunlink, or any subsidiaries and affiliates.⁴²⁹ Similarly, in *SFC v Li Hejun and others*,⁴³⁰ the former chairman and executive director of Hanergy, Li Hejun and independent directors were disqualified, after agreeing to a *Carecraft* procedure, for eight, four and three years respectively on an application by the SFC under section 214 of the SFO.

In October 2017, the SFC had 136 active corporate fraud and misfeasance investigations, with 28 deemed particularly serious. A significant number of serious cases involve gross overstatement of revenue and circular financing - facilitated by related parties and false customers.⁴³¹

Sanctions

When overseeing IPOs, the SFC can issue a Letter of Mindedness to Object which sets out substantive concerns and detailed reasons for those concerns. Discussions are held with the SFC, the issuer, and their advisors to address the issues. If the issuer fails to address the concerns, then the SFC will issue a Final Decision Notice under section 6 of the SMLR.⁴³²

⁴²⁶ Thomas Atkinson, "Keynote speech at 8th Pan Asian Regulatory Summit," (11 October 2017) *SFC, Executive Director, Enforcement Division*, 4 and 5

⁴²⁷ *Ibid*, 6

⁴²⁸ *Ibid*, 2 and 5

⁴²⁹ See *Securities and Futures Commission v Wong Shu Wing & Anor* [2013] HKCU 1008; SFC, "SFC's Allegations Against Respondents (an extract from the SFC's Petition filed with the Court," (20 January 2011): Available at https://www.sfc.hk/web/doc/EN/general/general/press_release/11/11pr6_summary.pdf (visited on 13 October 2017)

⁴³⁰ [2017] HKCU 2235. See also *SFC v Fan Di & Ors* [2011] HKCU 961 (1 year disqualification order); *SFC v Kenneth Cheung Chi Shing (Styland case)* [2010] HKCU 2560 (12, 6 and 7 years respectively); *SFC v Cheung Keng Ching & Ors* [2010] HKCU 622 (4 years)

⁴³¹ Thomas Atkinson, "Keynote speech at 8th Pan Asian Regulatory Summit," (11 October 2017) *SFC, Executive Director, Enforcement Division*, 3

⁴³² SFC, "SFC Regulatory Bulletin: Listed Corporations," (July 2017) *Issue No. 1, 2*

As regards listed issuers, pursuant to section 8 of the SMLR the SFC can suspend trading in an issuers shares. Prior to the suspension a "show cause" letter is issued explaining detailed concerns and the company is given an opportunity to respond.⁴³³

A person who fails to comply with an investigator exercising their powers under sections 182 and 183 without a reasonable excuse, commits an offence under the SFO punishable by indictment (fine of HKD 1,000,000 and imprisonment for two years) or summary conviction (level six fine and six months imprisonment).⁴³⁴

When exercising enforcement powers, the SFC can take action against directors of listed companies for non-compliance and apply to the court for injunctive relief, remedial orders, or a disqualification order/s pursuant to sections 213 and 214 of the SFO. Injunctive and remedial orders are available under section 213 to redress shareholders' rights, where there is a breach of the SFO or other relevant provisions, or a notice or requirement made under SFO.⁴³⁵ Section 214 deals with directors where the affairs of the company have been conducted in a manner oppressive to its members, or involving defalcation, fraud or misfeasance or other misconduct towards its members, or resulting in its members not being given information about its business or affairs which they might reasonably expect or which is unfairly prejudicial to its members.⁴³⁶ Over the past few years, shareholders of a number of listed companies have benefitted from the SFC's actions under s. 214 including against including First China Financial Network, China Asean Resources, Styland, Tack Fiori and Pearl Oriental Oil.⁴³⁷

The court can make an order restraining the commission of the act or conduct; and make any other order it thinks fit, whether for regulating the conduct in the future or the purchase of shares in the company.⁴³⁸ This section also provides a nexus with Parts II (share capital and debentures) and XII (restrictions on sale of shares and offers of shares for sale) of the CWUMPO and Part 5 of the CO (transactions in relation to share capital), allowing the SFC to enforce outside of its ambit as a securities regulator in conduct areas that have a profound CG dimension under above provisions. In practice, section 214 is used by the SFC to enforce the non-statutory listing rules through civil actions in the courts.⁴³⁹ Further, the SFC can instigate proceedings before the MMT and criminal proceedings before the Magistrates' Court.

The following two Tables detail the most common enforcement infringements and sanctions in 2015. The first shows investigations by nature, the second shows subject to ongoing or concluded enforcement proceedings.⁴⁴⁰

⁴³³ Ibid

⁴³⁴ SFO, s 184 (2)

⁴³⁵ See also SFC, "Annual Report 2015-16," (June 2016), 54: Available at http://www.sfc.hk/web/EN/files/ER/Annual%20Report/SFC_AR2015-16_Eng_r.pdf (visited on 12 December 2016)

⁴³⁶ See also Arner et al, op. cit, [10.173].

⁴³⁷ See: SFC v. Yin Yingneng Richard and Others [2015] HKCFI 56; SFC v. Kwok Wing and Others [2014] HKCFI 2191; SFC v Kenneth Cheung Chi Shing and Others [2012] HKCFI 312; SFC v. Li Wo Hng and Others [2012] HKCFI 1604; SFC v. Fan Di and Others [2011] HKCFI 322).

⁴³⁸ Arner et al, op. cit, [10.180]

⁴³⁹ Jones, op. cit, [5.54]

⁴⁴⁰ Source: SFC, "Persons subject to ongoing or concluded enforcement proceedings,": Available at <http://www.sfc.hk/web/EN/regulatory-functions/enforcement/enforcement-statistics/people-subject-to-ongoing-or-concluded-enforcement-proceedings.html> (visited on 20 November 2017)

	Quarter ended 31/12/2015	Quarter ended 30/09/2015	Quarter ended 30/6/2015	Quarter ended 31/3/2015
Corporate disclosure	64	60	67	65
Corporate misgovernance	54	52	55	53
Insider dealing	120	117	117	111
Intermediary misconduct	221	209	196	187
Market manipulation	134	125	129	123
Unlicensed activities	129	109	128	107
Total	722	672	692	646

	Quarter ended 31/12/2015	Quarter ended 30/09/2015	Quarter ended 30/6/2015	Quarter ended 31/3/2015
Prosecutions	22	17	17	27
Civil proceedings	104	93	93	108
Disciplinary proceedings	73	62	42	88
MMT proceedings	30	30	27	30
Total	229	202	179	253

Enforcement proceedings for misconduct (e.g. insider dealing) are instituted by the SFC in the MMT.⁴⁴¹ The MMT has the power to consolidate proceedings or order that proceedings be held together.⁴⁴² Orders can be made by the MMT pursuant to section 257 of the SFO (Part XIII), to *inter alia*: (1) disqualify a director of a listed company, whether directly or indirectly involved in its management for a period not exceeding five years; (2) ban the right to acquire, dispose, or deal in securities, directly or indirectly for a period not exceeding five years; (3) ban on perpetrating any conduct; (4) pay the Government any profit gained or loss avoided; (5) pay the Government's costs and expenses incurred; (6) pay the SFC's costs and expenses incurred; (7) pay the FRC's costs and expenses incurred; (8) order that anybody may take disciplinary action against the person.⁴⁴³ Under Part XIVA of SFO, the MMT can make orders pursuant to section 307N similar to those under Part XIII and additionally can fine up to HK8,000,000, appoint an independent professional advisor approved by the SFC to review the companies compliance, and any order necessary to ensure that an officer of a listed corporation does not perpetrate another breach and undergo training, approved by the SFC, on compliance with Part XIVA directors' duties and CG.

If a person has committed misconduct in relation to Part XIV of the SFO they are liable for, on conviction of indictment, a fine of up to HK10,000,000 and imprisonment for up to 10 years, on conviction summarily, a fine of up to HK1,000,000 and imprisonment for

⁴⁴¹ SFO, s252

⁴⁴² SFO, Schedule 9, 40

⁴⁴³ SFO, s 257

up to three years. The court can also make orders under Part XIV to *inter alia*: (1) disqualify directors; (2) ban the right to acquire, dispose, or deal in securities, directly or indirectly for a period not exceeding five years; (3) order that anybody may take disciplinary action against the person; and/or (4) pay the Government a fine equal to any profit gained or loss avoided.⁴⁴⁴

Publication

Circulars and “frequently asked questions” (FAQs) are posted on the SFC’s website to better understand enforcement policy issues.⁴⁴⁵ All the SFC’s sanctions, other than a private reprimand, are published by means of a press release. A summary of the SFC’s enforcement activity is available in each quarterly report and annual report, which outline certain pertinent regulatory actions. Enforcement philosophy, disciplinary proceedings, and enforcement actions are published on the SFC’s website.

Accountability and appeals

The SFC’s Board is appointed by the CE of Hong Kong or the FS and is accountable to the FS under the SFO.⁴⁴⁶ An advisory committee advises the SFC on policy issues. Section 15 of the SFO requires the SFC to present its annual report to the FS who will in turn present it to LegCo. The SFC’s annual report contains qualitative and quantitative enforcement data, and the Enforcement Reporter is regularly issued on its website. An annual budget must be submitted to LegCo pursuant to section 13 of the SFO. Internal procedures of the SFC are reviewed by the PRP, which produces annual reports to the FS.⁴⁴⁷ Regular meetings are held with LegCo to explain policy initiatives including meetings with the Panel on Financial Affairs.⁴⁴⁸

Orders made in the Court of First Instance, can be appealed to the Court of Appeal. A person can appeal findings made by the MMT, pursuant to section 252 of the SFO, on a point of law, or with Leave of the Court of Appeal on a question of fact, to the Court of Appeal.⁴⁴⁹

I.6.6 Companies Registry and Companies Registrar

The CR is responsible for administering and enforcing the provisions of the CO. Investigatory powers under the CO are split with the FS. The FS’s investigatory powers, and power to appoint an independent investigator, are exercised pursuant to sections 840 and 841 of the CO. Investigatory powers of the CR, on behalf of the FS, are exercised pursuant to sections 867 to 872 of the CO.⁴⁵⁰ Power to require information in relation to sections 869 to 873 of the CO are exercised pursuant to section 888 of the CO. However, neither investigatory powers have ever been used under both the current and former COs because of the belief that the SFC has sufficient powers to investigate listed companies. The Registrar of Companies, acting on behalf of the CR, is responsible for enforcing the CO and is delegated with the authority to prosecute non-compliance.⁴⁵¹

⁴⁴⁴ SFO, s303 (2)

⁴⁴⁵ SFC, “Annual Report 2015-16,” (June 2016), 66: Available at http://www.sfc.hk/web/EN/files/ER/Annual%20Report/SFC_AR2015-16_Eng_r.pdf (visited on 12 December 2016)

⁴⁴⁶ SFO, s 5

⁴⁴⁷ SFC, “Process Review Panel reports”; Available at <http://www.sfc.hk/web/EN/published-resources/reports/process-review-panel-reports.html> (visited on 13 December 2016)

⁴⁴⁸ SFC, “Annual Report 2012-13, Corporate Governance”: Available at <http://www.sfc.hk/web/annualreport2012-13/EN/corporate-governance/accountancy-and-transparency/> (visited on 20 November 2017)

⁴⁴⁹ SFO, s266

⁴⁵¹ CR, “Our Enforcement”: Available at <http://www.cr.gov.hk/en/compliance/enforcement.htm> (visited 11 Dec 2016) and Jones, op. cit, [6.98]

The CR's powers over private companies, includes incorporation, information collecting, disciplinary, and enforcement. There is no regulatory mechanism to investigate non-listed and large private companies pursuant to the CO, other than the FS or CR invoking the dormant investigatory powers under the CO.⁴⁵²

Sanctions

Section 899 of the CO explains the notification powers of the Registrar of Companies, including compoundable offences, and when an offence has been committed pursuant to Schedule 7 of the CO. Offences under the CO are either "filing" or "non-filing" offences. Filing offences carry minor penalties namely filing obligations of statutory forms, for example, submitting an annual return within the prescribed time limit. Notice compliance periods can be extended for minor filing-related offences.⁴⁵³ Non-filing offences are more serious and involve proof of the mental element (i.e. *mens rea*) of an offence as these can involve criminal sanctions. For example, directors failing to take reasonable steps to ensure that proper books of account are kept (section 379(4)) and officers recklessly or knowingly making false statement to auditors (section 408(1)). CG offences under the CO tend to be concerned with disclosure obligations. The CO also imposes sanctions on company officers for misconduct, such as fraudulent trading.⁴⁵⁴

For minor offences, the CR can apply to Magistrates Courts to impose fines against directors, company executives, and companies who breach the CO. More serious offences under the CO carry not only civil penalties—fines, but also criminal penalties—imprisonment.⁴⁵⁵ These offences can attract penalties up to HK\$1million and seven years imprisonment. The authority to prosecute serious offences under the CO rests with the Department of Justice.⁴⁵⁶

Publication

A "Prosecution Policy" is published on the CR's website. The CR's website provides FAQs on company compliance and links to recent prosecution case highlights involving court proceedings. An inspector's report can be published from an investigation undertaken by the FS pursuant to section 861 of the CO. However, this provision has never been used.

Accountability and appeals

The CR is accountable to the FSTB. This accountability falls under CR policy responsibility which is supported by clear reporting lines.⁴⁵⁷ Public lists of enforcement matters are available on the CR website.

Certain minor filing offences can be appealed to the Administrative Appeals Board in accordance with Part 3 of the CO. (e.g. in relation to company names). Section 37 provides for appeals involving filing offences: "If a person is aggrieved by a decision of the Registrar to refuse to register a document under section 35(3), the person may, within 42 days after the decision, appeal to the Court against the decision." Appeals against a decision of the Magistrates Court (i.e. minor filing offence) are heard by the Court of First Instance. Appeals against non-filing offences are heard by the courts — the particular court hearing the appeal will depend on the nature of the offence and sanction/s imposed.

⁴⁵² Ibid.

⁴⁵³ Referring to CO, s 899 (3)

⁴⁵⁴ Jones, op.cit, [6.31], [6.69], [6.81], and [6.82]

⁴⁵⁵ CR, "Our Enforcement": Available at <http://www.cr.gov.hk/en/compliance/enforcement.htm> (visited on 11 December 2016)

⁴⁵⁶ Jones, op. cit, [6.81] and [6.82]

⁴⁵⁷ Jones, op. cit, [6.2]

I.6.7 Financial Reporting Council

Information-gathering powers are conferred on the FRC under sections 25 and 26 of the FRCO. The FRC is statutorily empowered under the FRCO to enquire and conduct independent investigations into auditing, reporting, non-compliance and accounting irregularities of listed companies.⁴⁵⁸ Further, the FRC can direct the Audit Investigation Board, also established under the FRCO, to conduct an investigation into auditing irregularities of listed companies.⁴⁵⁹ Non-compliance investigations are carried out in collaboration with the Financial Reporting Review Committees.⁴⁶⁰ Statutory powers of investigation are sourced from Part 3, Division 2 of the FRCO.

The FRC can refer complaints and provide assistance to specified bodies. As the FRC does not have enforcement or disciplinary powers, referrals and assistance concerning auditing and reporting irregularities are referred to the HKICPA and listing rules non-compliance is referred to either the SFC or HKEX.⁴⁶¹ When a referral is made to the HKICPA, the FRC continues to be involved in the enforcement process and makes the ultimate determination on whether to refer a matter to the HKICPA's Disciplinary Panels, after considering the report from the HKICPA's Investigation Committee.⁴⁶²

Briefings are provided by the FRC to legislators and an annual meeting is held with LegCo's panel on Financial Affairs.⁴⁶³ A PRP annually reviews cases handled by the FRC and to decide whether the actions taken by the FRC are consistent with its internal procedures and guidelines.⁴⁶⁴ An annual report is publicly available on the FRC's website which contains qualitative and quantitative data on enforcement actions. It should be noted that the FRC is funded, in part, by the HKICPA (one quarter of its annual budget), along with the CR, HKEX and SFC.⁴⁶⁵

I.6.8 Hong Kong Institute of Certified Public Accountants

If the HKICPA becomes aware that there are auditing or reporting irregularities or non-compliance by its members, it must inform the FRC in accordance with section 42CA of the PAO. In the course of the FRC's independent investigations, it may refer auditing and reporting irregularities to the HKICPA. The HKICPA will in turn appoint an Investigation Committee which investigates the conduct of a member and reports to the FRC whether there has been a breach of professional standards issued by the HKICPA or of section 34 (1) of the PAO.⁴⁶⁶ Disciplinary Committees hear the complaint and issue sanctions.

The HKICPA also investigates auditing and reporting irregularities of non-listed companies.

Sanctions

The HKICPA's Disciplinary Committee can make orders against its members: (1) temporary or permanent removal from membership; (2) temporary or permanent cancellation of a practicing certificate issued by the HKICPA; (3) reprimand; (4) penalties

⁴⁵⁸ Process Review Panel for the Financial Reporting Council, "2015 Annual Report," 1.2. FRCO, s9

⁴⁵⁹ HKICPA, "Hong Kong – Market Information," (2015), 9. FRCO, s 23

⁴⁶⁰ Process Review Panel for the Financial Reporting Council, "2015 Annual Report," 1.3

⁴⁶¹ Arner et al, op. cit, [10.259]

⁴⁶² HKICPA, "Investigations": Available at <http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/investigations/> (visited on 11 December 2016)

⁴⁶³ FRC, "Annual Report," (2015), 6

⁴⁶⁴ Process Review Panel for the FRC, "Annual Report 2015," (2015), [1.1]

⁴⁶⁵ HKICPA, "Annual Report 2016: Fashioning A Future For Hong Kong," (2016), 75

⁴⁶⁶ HKICPA, "Investigations": Available at <http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/investigations/> (visited on 11 December 2016)

less than HK500,000; (5) and payment of costs and expenses of proceedings.⁴⁶⁷

Publication

Disciplinary policy is published on the HKICPA website which includes a link of “cases referred to the Disciplinary Panel”. Guidelines and guidance notes on the Disciplinary Committee Proceedings Rules are also available online. A Compliance Operation Report is published annually that explains disciplinary proceedings and investigations, and outlines disciplinary orders. The order of the Disciplinary Committee is published in the HKICPA Journal “APLUS”, HKICPA press release, Gazette (for removal orders only) and on the HKICPA website. Disciplinary and regulatory findings are published by the HKICPA on its website for five years from the date of issue.

Accountability and appeals

As the HKICPA is an industry body, it is not directly accountable to the government by means of a hierarchy. The HKICPA’s Council, its governing body, consists of 22 members, two of which are ex-officio members from the government and four lay members appointed by the government.⁴⁶⁸ Regular meetings are held with Hong Kong Government regulators.⁴⁶⁹ A Regulatory Accountability Board was established to ensure that regulatory functions, including enforcement, are carried out in accordance with the strategies and policies determined by the Council and in the public interest.⁴⁷⁰ The publicly issued annual Compliance Operations Report contains both qualitative and quantitative data on enforcement actions by the HKICPA.

Pursuant to section 41 of the PAO a certified public accountant can appeal an order, or under section 35 (1) of the PAO, a Certified Public Accountant can give notice to appeal a decision of the Disciplinary Committee, to the Court of Appeal.⁴⁷¹

I.6.9 Office of Official Receiver

The ORO has statutory functions to investigate the affairs of directors and officers of insolvent companies and monitors the conduct of investment funds, private insolvency practitioners, and auditing accounts.⁴⁷² In terms of CG enforcement, director can face disqualification for unfit conduct under the Part IVA of the CWUMPO. The ORO is accountable to the FSTB.⁴⁷³

I.6.10 Whistle-blowing

Hong Kong does not have any specific whistle-blowing law, however, certain statutes do provide limited protections in relation to persons reporting suspected wrongdoing, including employees making reports in relation to labour laws under the Employment Ordinance, auditors of listed issuers alerting the SFC under the SFO as to anomalies,⁴⁷⁴ discrimination under the Discrimination Ordinances,⁴⁷⁵ or disclosures under the Anti-

⁴⁶⁷ HKICPA, “Disciplinary”: Available at <http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/disciplinary/> (visited on 11 December 2016); PAO, s35

⁴⁶⁸ HKICPA, “Annual Report 2016: Fashioning A Future For Hong Kong,” (2016), 8; Part III, PAO

⁴⁶⁹ Ibid, 18

⁴⁷⁰ HKICPA, “Compliance Operational Report,” (2015), 13

⁴⁷¹ HKICPA, “Disciplinary”: Available at <http://www.hkicpa.org.hk/en/standards-and-regulations/compliance/disciplinary/> (visited on 11 December 2016)

⁴⁷² Jones, op. cit, [6.102]

⁴⁷³ Jones, op. cit, [6.2]

⁴⁷⁴ SFO, s. 380

⁴⁷⁵ Disability Discrimination Ordinance, the Sex Discrimination Ordinance, the Family Status Discrimination Ordinance and the Race Discrimination Ordinance

money Laundering Ordinance.⁴⁷⁶ The Competition Commission of Hong Kong issued a leniency policy in November 2015 that serves to encourage whistle-blowing. As regards listed issuers, whistle-blowing is the subject of a non-mandatory recommended practice in the Corporate Governance Code of the listing rules that is only addressed to audit anomalies.⁴⁷⁷ However, while more companies are introducing audit whistle-blowing policies and procedures⁴⁷⁸ less than half of listed companies in Hong Kong do not comply with that recommended practice.⁴⁷⁹ The HKMA's Supervisory Policy Manual mentions the concept of whistle-blowing but this is couched in language that an authorized institution should have a well communicated policy allowing staff "to communicate, in confidence and without risk of reprisal" observations of any violations.⁴⁸⁰

⁴⁷⁶ Drug Trafficking (Recovery of Proceeds) Ordinance, the United Nations (Anti-Terrorism Measures) Ordinance and the Organised and Serious Crimes Ordinance

⁴⁷⁷ Main Board LR, Appendix 14, para C 3.8

⁴⁷⁸ HKICPA "Best corporate governance awards 2016, Judges Report", 13: Available at http://www.hkicpa.org.hk/file/media/section1_about_us/best-corporate/Judges_Report%202016_final.pdf (visited on 20 November 2017)

⁴⁷⁹ BDO Limited "Corporate governance update Report", (2016), 5

⁴⁸⁰ HKMA, "Supervisory Policy Manual - Corporate Governance of Locally Incorporated Authorised Institutions," CG-1, para 2.6.7

Appendix I	7. Shareholder rights and protections	I.7 Hong Kong
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Introduction

Shareholders rights in Hong Kong are generally weak. Although there are many provisions in the CO, SFO and listing rules that give shareholders rights, they are rarely enforced by shareholders. This is partly due to the general shareholder passivity, especially with retail investors. Even institutional investors are traditionally quite passive, even after the SFC issued its Principles of Responsible Ownership. Activism by institutional investors such as BlackRock and Elliot are rare examples. While there are legal remedies for shareholders, such as the unfair prejudice action and derivative suit, such cases are very rare. Cost is a major deterrence for shareholders, especially retail investors. A lot depends, therefore, on public enforcement by regulators, principally the SFC and, to a lesser extent, the HKEX as discussed in Appendix I.6 above.

Apart from shareholder rights and remedies, Hong Kong's CG system also uses other mechanisms to prevent abuses by management or controlling shareholders, such as directors duties, the use of independent directors, board committees, board evaluation, and rules on related party transaction discussed in this section.

I.7.1 Shareholder rights

Minimum rights

Shareholders have a right to company information in the form of reports and results as prescribed by the CO and the listing rules. For example, Hong Kong incorporated companies are required to provide to shareholders a copy of their annual report (including annual accounts and consolidated financial statements where applicable) or a summary financial report not less than 21 days before the date of the issuer's AGM or not more than four months after the end of the financial year.⁴⁸¹ For non-Hong Kong incorporated companies, an issuer shall send to shareholders either its annual report including annual accounts, group accounts (where prepared), and the auditor's report not less than 21 days before the date of the issuer's AGM or not more than four months after the end of the financial year.⁴⁸² In addition, directors are statutorily obliged to prepare statements that the financial reports represent a "true and fair" view of the company (for details, see below).⁴⁸³

The listing rules require an issuer to provide shareholders with an interim report or summary interim report for the first six months of the financial year, within three months of the end of the relevant period.⁴⁸⁴ Preliminary results for the financial year are to be published as soon as possible with board approval, not later than three months after the end of the financial year.⁴⁸⁵ For preliminary interim period results, the issuer must publish the results not later than two months after the end of the first six-month reporting period.⁴⁸⁶

A listed issuer is primarily concerned with the registered legal shareholders (hence only the registered legal shareholders have the right to inspect corporate information beyond continuous disclosure requirements), the board, senior management, and regulators.

⁴⁸¹ LR 13.46 (1) (a) (ii). This is other than non-Hong Kong incorporated companies

⁴⁸² LR 13.46 (2) (a) (ii)

⁴⁸³ CO (Cap. 622), s379 (2)

⁴⁸⁴ LR 13.48 (1)

⁴⁸⁵ LR 13.49 (1)

⁴⁸⁶ LR 13.49 (6)

Minority shareholders in Hong Kong are generally retail shareholders who have little incentive or means to monitor a company's CG practices. Hence, minority shareholders are often not active in protecting their interests.

Shareholder meetings:

Shareholders are statutorily entitled to request directors to call general meetings and/or call general meetings if requested by at least 5% of the shareholders with total voting rights.⁴⁸⁷ If the company does not have any director or sufficient directors to form a quorum, two or more shareholders representing at least 10% of the total voting rights have a right to vote for a general meeting.⁴⁸⁸

Voting rights:

Section 588 of the CO provides for resolution votes at a general meeting - every member present in person or by proxy has one vote. Proxy voting rights are given effect pursuant to section 596 of the CO whereby a shareholder is entitled to appoint another person (whether a shareholder or not) as a proxy to exercise all or any of the shareholder's rights to attend, speak, and vote at a general meeting. A notice of appointment of a proxy is required to be sent to the listed issuer at least 48 hours prior to a general meeting.⁴⁸⁹ The listing rules also give shareholders the right to attend and vote at AGMs or other general meetings and the ability to outsource these rights by way of proxy.⁴⁹⁰

The listing rules prohibits new applicants from including shares whereby the proposed voting power does not bear a reasonable relationship to the equity interest of such shares when fully paid. These shares are referred to as "B Shares" and their issuance would amount to an issuer engaging a WVR structure. The SEHK will not list B Shares except in exceptional circumstances or, where companies already have B Shares in issue, and issue identical B Shares to the same proportion as the total number of issued voting shares.⁴⁹¹ However, no companies with a WVR structure have been allowed to be listed in SEHK since December 1989 when the prohibition was introduced,⁴⁹² as evidenced by the recent example of Alibaba's request to list on the SEHK with a WVR structure, which was rejected by the SEHK. Eventually, Alibaba turned to and listed on the NYSE. With intense competition for IPOs and the availability of WVR on a number of other Exchanges, the FS has recently decided to consider the introduction of WVR on the HKEX Main Board, balanced with more extensive shareholder protections (October 2017).

Rights of pre-emption:

Section 160 of the CO gives shareholders the right of pre-emption. The right only arises when the company's articles of association provide for the right of pre-emption to a shareholder or class of shareholder. The listing rules also provide for pre-emptive rights, which will apply to all issuers wherever incorporated.⁴⁹³

Controlling shareholders

⁴⁸⁷ CO (Cap. 622), s566

⁴⁸⁸ CO (Cap. 622), s569

⁴⁸⁹ CO (Cap. 622), s598

⁴⁹⁰ LR 13.38

⁴⁹¹ LR 8.11. Identical refers to scrip dividend or capitalisation issue

⁴⁹² For a brief history see, Charltonslaw, "Hong Kong Stock Exchange's Weighted Voting Rights Concept Paper," (2014): Available at <https://www.charltonslaw.com/hong-kong-law/hong-kong-weighted-voting-rights-concept-paper/> (visited on 20 November 2017)

⁴⁹³ Main Board LR 13.36

Controlling shareholders are defined in the listing rules as a person or group of persons who are entitled to exercise or control 30% or more of the voting power at general meetings of the issuer.⁴⁹⁴ The listing rules have sections on “Restrictions on disposal of shares by controlling shareholders following a new listing”; “Pledging of shares by the controlling shareholders”; and “Loan agreements with covenants relating to specific performance of the controlling shareholder”. Certain transactions of the company involving a controlling shareholder or its associates require independent shareholder approval pursuant to the listing rules, and this is discussed in Appendix I.7.3 below.

Remedies

Under the existing legal regime, there are few options available to protect shareholders’ rights⁴⁹⁵:

unfair prejudice petition: where a minority shareholder’s interest has suffered prejudice, the shareholder (under section 724 of CO) or the SFC (under section 214 SFO) can ask for remedial reliefs from the court such as a buy-out order or disqualification order;

just and equitable winding up: where a buy-out offer is not feasible, or there is a breakdown of trust and confidence in quasi-partnership, it is appropriate to petition for just and equitable winding up;

derivative action: where the minority shareholders do not suffer personally but the company suffers losses, shareholders can bring an action against the wrongdoers – usually the directors – in the name of the company.

Shareholders or creditors can apply for a Scheme of Arrangement or Compromise (Scheme) to reorganise the company’s share capital by consolidating or dividing different share classes (also see discussion of B Shares in Voting rights).⁴⁹⁶ The Scheme has to be approved by a majority representing at least 75% of the votes cast by shareholders present and voting or by proxy at a meeting convened by the court.⁴⁹⁷ Votes cast against the Scheme must not account for more than 10% of the votes attaching to all disinterested shares.⁴⁹⁸

Unfair prejudice:

Unfair prejudice under section 724 of the CO⁴⁹⁹ tends to be used by shareholders in private companies, but rarely in listed companies. However, unfair prejudice under section 214 of the SFO has been used more frequently by the SFC. There are five such cases; two examples are *Wong Shu Wing* and *Styland*.⁵⁰⁰ In 2008 the SFC obtained section 214 orders in the High Court to disqualify the chairman and executive director of Sunlink, Wong Shu Wing, for failing to make timely disclosures of price sensitive information. Wong Shu Wing agreed to a statement of facts that he had failed to manage Sunlink with the necessary degree of skill, care, diligence and competence reasonably

⁴⁹⁴ LR 1.01

⁴⁹⁵ Richard Leung and Kerby Lau, “Protecting Minority Shareholders – Different Actions For Different Wrongs,” (9 September 2013): Available at <http://csj.hkics.org.hk/2013/09/protecting-minority-shareholders-different-actions-for-different-wrongs/> (visited on 24 May 2016)

⁴⁹⁶ CO (Cap. 622), ss668 and 673

⁴⁹⁷ CO (Cap. 622), ss670 and 674(1)

⁴⁹⁸ CO (Cap. 622), ss670 and 674(2)

⁴⁹⁹ This was section 168A under the old companies ordinance – now CWUMPO (Cap. 32)

⁵⁰⁰ *SFC v Wong Shu Wing & Anor* [2013] HKCU 1008 (5 years disqualification); *SFC v Kenneth Cheung Chi Shing* [2010] HKCU 2560 (6 years disqualification); The other three cases are *SFC v Li Hejun and others* [2017] HKCU 2235; *SFC v Fan Di & Ors* [2011] HKCU 961 (1 year disqualification order); and *SFC v Cheung Keng Ching & Ors* [2010] HKCU 622 (4 years disqualification).

expected of persons of their knowledge and experience holding their offices and functions within Sunlink and failed on a number of occasions to ensure Sunlink complies with the listed rules and provide to shareholders information that they might reasonably expect. The breach of disclosure obligations pursuant to the listing rules (the events in this case occurred prior to the introduction of Part XIVA of the SFO), included: (1) MBLR 13.09 – failure to disclose material or price sensitive information that clearly demonstrated that the company was in serious financial difficulties; (2) MBLR 13.10 – the company failed to respond truthfully to an enquiry by the SEHK concerning the unusual movement of the company’s share price (i.e. stated being unaware of the reasons for the unusual share price drop of 13% after the closing price); and (3) MBLR 13.19 – the failure to disclose that bank loans were significant to the operation of the company, the failure to repay bank loans and statutory demands issued on behalf of bank creditors.⁵⁰¹

In *Styland* disqualification orders were sought against four directors including the chairman for receiving direct and indirect financial benefits from company transactions. The transactions were not properly disclosed and caused loss or damage to the company and its shareholders. Following proceedings by the SFC, *Styland* appointed an independent committee to investigate. Results of the independent committee were reported at a general meeting and independent shareholders approved the transactions and ratified the directors’ conduct. However, the SFC contended that the committee’s report was defective because shareholders were given misleading information about the nature and extent of the directors’ benefits. The Court of First Instance held that the transactions amounted to defalcation of *Styland*’s assets and misfeasance causing unfair prejudice to shareholders. Mark Steward, the Executive Director of Enforcement of the SFC said: “These directors flouted their responsibilities, abused shareholders’ funds and then sought to prevent steps being taken to make them accountable.”⁵⁰²

Styland was the first case where a compensation order was assigned by the court in proceedings brought by the SFC under section 214 of the SFO. Directors had persistently failed to comply with the director duty to act with reasonable care, skill, and diligence pursuant to the listing rules and had failed to make proper disclosures. *Styland*’s shareholders were not provided with all information in respect of its business or affairs that they might reasonably expect, within the definition of section 214(1)(c) of the SFO.⁵⁰³ Mark Steward commented: “The compensation order means they must account for those shareholders’ funds that were misappropriated and the lengthy disqualification periods send a deterrent message.”⁵⁰⁴ The court disqualified the former chairman and an executive director (the chairman’s wife) for 12 years, the longest disqualification order ever imposed at the time (2012). Two other directors were disqualified for six and seven years. Another executive director had orders brought by a way of the *Carecraft* procedure and did not take part in the trial. This was because the director had admitted to all the facts in the SFC petition and that he was at least partially responsible for the conduct of *Styland*.⁵⁰⁵

⁵⁰¹ SFC, “SFC’s Allegations Against Respondents (an extract from the SFC’s Petition filed with the Court,” (20 January 2011): Available at https://www.sfc.hk/web/doc/EN/general/general/press_release/11/11pr6_summary.pdf (visited on 13 October 2017)

⁵⁰² SFC, “Former *Styland* chairman and executive director ordered to pay \$85 million compensation to company,” (7 March 2012): Available at <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=12PR23> (visited on 13 October 2017)

⁵⁰³ *Securities and Futures Commission v Kenneth Cheung Chi Shibg, Yvonne Yeaung Han Yi, Steven Li Wang Tai, Miranda Chan Chi Mei, and Styland Holdings* HCMP 1702/2008 at 105

⁵⁰⁴ SFC, “Former *Styland* chairman and executive director ordered to pay \$85 million compensation to company,” (7 March 2012): Available at <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=12PR23> (visited on 13 October 2017)

⁵⁰⁵ *Securities and Futures Commission v Kenneth Cheung Chi Shibg, Yvonne Yeaung Han Yi, Steven Li Wang Tai, Miranda Chan Chi Mei, and Styland Holdings* HCMP 1702/2008 at 11

The *Wong Shu Wing* and *Styland* cases are precedents (for the purposes of section 214 (1) (c) of the SFO) whereby directors have a duty to provide information to shareholders which they might reasonably expect. A failure to provide this information may amount to unfair prejudice. *Styland* involved frequent breaches of the listing rules obligations regarding disclosure and shareholder approval. However, the former case was under a *Carecraft* procedure and the latter point was made *obiter dicta*.⁵⁰⁶ While this weakens the strength of these precedents, this does indicate the direction of the court's attitude to egregious breaches of the listing rules.

Derivative action:

Protections afforded to shareholders by common law and equity are those provided by the director's fiduciary duties and the duty of care, skill, and diligence, as has been reviewed above. This is broadly the same in Hong Kong as in other English law-based jurisdictions. However, the shareholders cannot enforce the common law by personal direct action for the director's fiduciary duties and duty of care and skill are owed to the company. Under the proper plaintiff rule, only the company can enforce these duties against any wrongdoing directors, unless the shareholders can show fraud on the minority and wrongdoer in control at common law to bring a derivative suit in the name of the company. It has been notoriously difficult to bring derivative suits under common law in many common law jurisdictions, including Hong Kong. Thus, many countries including Hong Kong have introduced statutory derivative suits to simplify the grounds and procedure for derivative suits.⁵⁰⁷ As explained in Part 14, Division 4 of the new CO, a shareholder can bring a derivative suit against a director or a third party for any fraud, negligence, breach of duty, or default in compliance with any ordinance or rule of law provided he obtains leave of the court. Leave may be granted if it appears to be in the interest of the company, there is a serious question to be tried, the company has not itself brought the proceedings, and the shareholder has served a notice on the company of his intention to apply for leave. The courts have so far adopted a fairly low threshold.⁵⁰⁸ It is also possible to bring multiple derivative actions under the CO. A shareholder of a parent company can bring a derivative suit in the name of a subsidiary or associated company of the parent company against anyone who commits a wrong against the subsidiary or associated company. A shareholder who brings a derivative suit can apply to the court for costs to be indemnified out of the company's assets if the suit is brought in good faith and on reasonable grounds. The courts have so far been willing to grant such indemnity orders especially where leave for the suit has been granted. While in many jurisdictions statutory derivative suits have been adopted to replace common law derivative actions, in Hong Kong common law derivative actions are kept in parallel with the statutory procedure. However, such law affords shareholders only limited rights in practice, especially shareholders in listed companies. In the few successful cases, none of them involved shareholders in a listed company. The reality is that most shareholders in a listed company would prefer to sell their shares than to bring a derivative suit.

Collective redress / class actions:

Class actions are not available in Hong Kong. As discussed in Appendix I.2.1, in 2012 the Law Reform Commission has proposed the adoption of class action rights but no further development or response to the proposal has occurred since. Hong Kong courts do allow for multi-party proceedings⁵⁰⁹ via representative actions, however they are "inadequate

⁵⁰⁶ *Dicta* in was based on defalcation, misfeasance and unfair prejudice thus invoking s. 214, SFO.

⁵⁰⁷ See P von Nessen, S H Goo, and C K Low, "A Parallel Path to Shareholder Remedies: Hong Kong's Derivative Actions" in D W Puchniak (ed.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge: Cambridge University Press, 2012) p. 296

⁵⁰⁸ See e.g. *Re F & S Express Ltd* [2005] 4 HKLRD 743; *Re Lucky Money Ltd* [2006] HKEC 1379, CFI; *Re Myway Ltd* [2008] 3 HKLRD 614; *Re Gen 2 Partners Inc* [2012] 4 HKLRD 511

⁵⁰⁹ Order 15, rule 12 of the Rules of the High Court (Cap. 4A)

as a framework for dealing with large-scale multi-party situations”.⁵¹⁰

Listing requirements:

Breaches of the SEHK’s listing rules are not per se actionable by investors.

I.7.2 Board processes

Legislation

Director interests:

Directors are subject to a statutory obligation to declare material interests that in any way directly or indirectly involve an actual or proposed transaction, arrangement, or contract with the company that is significant in relation to company’s business.⁵¹¹ The nature and extent of the interest must be declared by the director including interests with other directors.⁵¹² Interests of persons connected to directors needs to be disclosed, as further discussed below.

Director duties:

Section 465 of the CO prescribes directors’ duties of care and skill. Directors of a company must exercise reasonable care, duty, and skill that would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director (an objective standard) and (b) the general knowledge, skill and experience that the director has (a subjective standard).⁵¹³ Shadow directors are captured by section 465 of the CO. This statutory duty overrides the common law rules and equitable principles as regards the duty to exercise reasonable care, skill, and diligence required of company directors.⁵¹⁴ However, breaches of section 465 of the CO have the same consequences as the common law rules and equitable principles that the section replaces.⁵¹⁵

It is possible for the shareholders in general meeting to ratify the breach. It used to be unclear when this remedy would be available - the courts in some cases permitting ratification by majority vote⁵¹⁶ but not in other cases.⁵¹⁷ It was suggested that ratification might be permitted where directors were making a secret profit but not where it concerned misappropriation of the company’s property.⁵¹⁸ Section 473 of the CO now provides that a company may ratify conduct of a director involving negligence, default, breach of duty, or breach of trust in relation to the company by resolution of the members of the company. If such a resolution is proposed at a meeting, every vote in favour of the resolution by a member who (1) is a director in respect of whose conduct the ratification is sought; (2) is an entity connected with that director; or (3) holds any shares in the company in trust for that director or entity, is to be disregarded.⁵¹⁹ It is essential that ratification is based on full and adequate disclosure of the material circumstances – where it is not, the court may regard any approval of shareholders as not based on informed consent, and so not amounting to a ratification that serves to

⁵¹⁰ *Chief Justice’s Working Party on Civil Justice Reform*, Civil Justice Reform Interim Report and Consultative Paper (2001), [385] at 148

⁵¹¹ CO (Cap. 622), s536

⁵¹² CO (Cap. 622), s536

⁵¹³ CO (Cap. 622), s465 (2)

⁵¹⁴ CO (Cap. 622), s465 (4)

⁵¹⁵ CO (Cap. 622), s466

⁵¹⁶ *Regal Hastings Ltd v Gulliver* [1942] 1 All ER 378

⁵¹⁷ *Cook v Deeks* [1916] 1 AC 554 PC

⁵¹⁸ P Davies (ed), *Gower’s Principles of Modern Company Law* (London: Sweet & Maxwell, 1997, 6th edn), p.

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⁵¹⁹ CO (Cap. 622), s473 (3)

absolve directors from their breaches of duty.⁵²⁰ However, any ratification properly obtained does not bar a derivative action against a director who has engaged in misconduct against the company.⁵²¹

Pursuant to MBLR 3.08, the SEHK expects directors, as a board and individually, to fulfil fiduciary duties and duties of skill, care and diligence to at least a standard commensurate with Hong Kong law (see CO above). Every director must, in the performance of his duties:⁵²²

act honestly and in good faith in the interests of the company as a whole;

act for the proper purpose;

be answerable to the issuer for the application or misapplication of the issuer's assets;

avoid actual and potential conflicts of interest and duty;

fully and fairly disclose contractual interests with the issuer; and

apply a degree of skill, care, and diligence as may reasonably be expected of a person of his knowledge and experience and holding his office within the issuer.

A note to MBLR 3.08 states that these duties are summarised in "A Guide on Directors' Duties", a non-binding publication by the CR. Further, the SEHK generally expects directors to be guided by the Guidelines for Directors and the Guide for INEDs issued by the HKIoD (see below).

MBLR 3.08 is drafted to ensure that non-Hong Kong incorporated companies comply with Hong Kong law on directors' duties. Note however that (f) has not been amended since section 465 of the CO came into force - so arguably, it does not reflect the new law and should therefore be amended to correspond with the new CO.

Directors must prepare for each financial year, a Director Report, and ensure that the annual financial statements and annual consolidated financial statements give a true and fair view of the financial position and performance of the company, and all subsidiary undertakings.⁵²³ Pursuant to MBLR 2.03 (5), the board of directors have to act in the best interests of the shareholders as a whole. This would include providing accurate financial statement, adequate information to investor and adequate internal control. For example, a 2017 HKEX Listing Decision⁵²⁴ found that (1) a company's financial statements and/or records were not accurate and complete in material respects or were materially misleading; (2) its investors had not been given the necessary information to make an informed assessment of the Company; (3) there was problem with the integrity of the company's management; and (4) there was a lack of adequate internal controls to safeguard the company's assets and protect shareholders' interests. The company was given six months to remedy the issues or face delisting.

As discussed above, the CO imposes a duty of directors to call a general meeting.⁵²⁵ Directors have a duty to disclose their particulars in the register of directors.⁵²⁶

⁵²⁰ *Securities and Futures Commission v Kenneth Cheung Chi Shing and Others* [2012] HKCFI 312

⁵²¹ CO (Cap. 622), ss732 and 734

⁵²² LR 3.08

⁵²³ CO (Cap. 622), ss 380 and 388

⁵²⁴ HKEX Listing Decision, "LD114-2017," (October 2017)

⁵²⁵ CO, s567

⁵²⁶ CO, s646

Narrative reporting:

Directors must prepare a Directors' Report pursuant to the CO which contains, *inter alia*, the principle activities of the company, matters material for shareholders' appreciation of the state of the company's affairs, and disclosures which in the directors' opinion are not harmful to the business of the company.⁵²⁷ Paragraph 28(2)(d) of Appendix 16 of the listing rules require issuers to disclose in the directors' report a business review, and an Environmental, Social, and Governance discussion that complies with Schedule 5 of the CO.⁵²⁸ In this context, the business review must include a discussion of the issuer's policies and performance - for example, compliance with laws and regulations that have a significant impact on the issuer.⁵²⁹

Non-statutory regulation

CG Code:

Under the CG Code in Appendix 14 of the listing rules (the Corporate Governance Code and Corporate Governance Report), CPs and RBPs are not mandatory rules. CG Code deviations are acceptable if the issuer has more suitable ways to comply with the Code's principles. Accordingly, the SEHK does not envisage a "one size fits all" approach.⁵³⁰

Board effectiveness:

Principle A.1. of the CG Code states that an issuer should be headed by an effective board which assumes responsibility for its leadership and control which is collectively responsible for promoting the company's success by directing and supervising its affairs. The board should meet regularly with meeting held at least four times a year. Meetings should involve active participation and majority representation by directors. Arrangements should ensure that directors are given an opportunity to include matters in the agenda for regular board meetings.⁵³¹ A procedure should allow directors to seek independent professional advice at the issuer's expense, to perform their duties.⁵³² Conflicts of interest should be dealt with in a physical board meeting.⁵³³

All directors should participate in continuous professional development to progress their knowledge and skills.⁵³⁴ Listed issuers are responsible for arranging and funding suitable training.

Directors:

The board should have a balance of skills, experience and diversity of perspectives appropriate to an issuer's business requirements. Executive directors and NEDs should be balanced so there is a strong independent element which can effectively exercise independent judgement.⁵³⁵

Directors should be provided with appropriate information to enable informed decisions and perform their duties and responsibilities. An agenda and related information should be sent to directors at least three days before a board or committee meeting.⁵³⁶

⁵²⁷ CO, s390

⁵²⁸ LR, Appendix 27, [12]

⁵²⁹ Ibid

⁵³⁰ HKEX, "What is "comply or explain"?": Available at http://en-rules.hkex.com.hk/en/display/display_main.html?rbid=4476&element_id=4647 (visited 20 November 2017)

⁵³¹ CG Code, A.1.2

⁵³² Ibid, A.1.6

⁵³³ Ibid, A.1.7

⁵³⁴ Ibid, A.6.5

⁵³⁵ Ibid, A.3

⁵³⁶ Ibid, A.7.1

Management is obliged to supply the board and committees with adequate information. Directors must not solely rely on this information and may need to make further enquiries.⁵³⁷ All directors are entitled to have access to board papers and any other related materials to make informed decisions.⁵³⁸

The roles of chairman and CE should be separate and not performed by the same individual. A division of responsibilities between the chairman and CE should be clearly established and set out in writing.⁵³⁹

Functions of NEDs include:⁵⁴⁰

- participating in board meetings to bring an independent judgement relating to strategy, policy, performance, accountability, resources, key appointments and standards of conduct;

- taking the lead when potential conflicts of interests arise;

- when invited, serving on audit, remuneration, nomination and governance committees; and

- scrutinising an issuer's performance to achieve corporate goals and objectives, and monitor performance reporting.

NEDs have the same duties of care and skill and fiduciary duties as executive directors.⁵⁴¹

The HKIoD issues the "Guidelines for Directors", which are non-statutory and non-regulatory guidelines. The publication reflects attempts to summarise the common law and where possible, recommend good practice for directors where the law is yet to reach. References also reflect certain provisions of the new CO and the CWUMPO.⁵⁴² Part I deals with "The Company and Its Board", Part II with "Directors' Legal Status, Powers and Duties", and Part III "The Directors as an Individuals".

Reference is also made to the Main Board and GEM listing rules, and the CG Code. The HKIoD's "Guidelines for Directors" is cited in the same note to MBLR 3.08 and GEMLR 5.01 as CR's "A Guide on Directors' Duties" (see above). As with "A Guide on Directors' Duties", no agency is designated to investigate the conduct of a director for a breach of a duty.⁵⁴³ It is mentioned in the reference note that directors are generally expected by the HKEX to be guided by the "Guidelines for Directors". Disciplinary arrangements that may be enforced by the HKEX, in accordance with the listing rules, relate to the overlapping director duties and responsibilities, in terms of the "expected standard of care, skill, and diligence", with the "Guidelines for Directors", for example: (1) conflicts of interest; (2) standard of skill and care; (3) duty to act honestly for the benefit of the company; (4) duty to act for proper purpose; and (5) the director's fiduciary duty to the company (i.e. a responsibility). As with "A Guide on Directors' Duties", any HKEX discipline would fall under the listing rules, not the "Guidelines for Directors".

Independent directors:

⁵³⁷ Ibid, A.7.2

⁵³⁸ Ibid, A.7.3

⁵³⁹ CG Code, A.2.1

⁵⁴⁰ Ibid, A.6.2

⁵⁴¹ Ibid, A.6

⁵⁴² HKIoD, "Guidelines For Directors," (2014) *Foreword and Preface*, iv

⁵⁴³ Thomas Mok, "Should the Hong Kong Code on Corporate Governance Practices be Given Statutory Backing? (Part II)," (December 2014) *Hong Kong Lawyer*: Available at <http://www.hk-lawyer.org/content/should-hong-kong-code-corporate-governance-practices-be-given-statutory-backing-part-ii> (visited on 4 December 2016)

MBLR 3.10 states that every board of directors of a listed issuer must include at least three INEDs; and (since December 2012) at least one of them must have appropriate professional qualifications or accounting or related financial management expertise. MBLR 3.10A states that an issuer must appoint INEDs representing at least one-third of the board. Every INED must satisfy the SEHK that she/he has the character, integrity, independence and experience to fulfil her/his role effectively (MBLR 3.12). In assessing the independence of an NED, the SEHK will take into account the following factors: (1) shareholding in the listed issuer; (2) interest in any securities of the listed issuer; (3) whether she/he is a director, partner or principal of a professional adviser which currently provides or has within one year immediately prior to the date of his proposed appointment provided services to the listed issuer or its directors or controlling shareholder (i.e. 30% of shareholding) or CE.

There is no requirement for the chairman/president to be an INED or NED under the listing rules.

The CG Code recommends that INEDs should be identified in all corporate communications.⁵⁴⁴ If an INED serves more than nine years, any further appointment should be subject to a separate resolution approved by the shareholders. Papers accompanying the resolution should include the reasons why the board believes the INED is independent and should be re-elected.⁵⁴⁵ INEDs are required to submit to the SEHK a written confirmation of independence in a specified form that will render the submitter subject to prosecution for a statutory offence if the information provided is not true, complete, and accurate.⁵⁴⁶

According to the "Guide for Independent Non-executive Directors" published by the HKIoD (i.e. a non-statutory and non-regulatory guide), INEDs are to acquire a realistic appreciation of the time that will be necessary to devote to board matters and then decide whether the INED will have sufficient time to meet new responsibilities before accepting an appointment.⁵⁴⁷ INEDs are to supervise management, participate in the direction of the company's business and affairs and speak out firmly and objectively on these and other issues that may come before the board.⁵⁴⁸ The guide does not aim to establish rules or best practice or provide a road map through legislative or regulatory provisions for directors. It is a concise guide to help directors understand their role as an independent voice on the board, their responsibilities, authority, and limitations.⁵⁴⁹ Reference is made to the listing rules, with respect to the subjective test of "independence" and "board committees". The HKIoD's "Guide for Independent Non-Executive Directors" is cited in the same note to MBLR 3.08 and GEMLR 5.01 as the CR's "Guidelines for Directors". Similarly, directors are generally expected by the HKEX to be guided by the "Guide for Independent Non-Executive Directors" which is enforced indirectly under the listing rules to the extent that there is overlap with director duties and responsibilities in terms of the "expected standard of care, skill and diligence".

There is currently no restriction on the number of INED positions one may hold. Although the HKEX has consulted on this issue, no consensus has been reached. 44 INEDs hold seven or more seats, and 65 hold six or more seats, as shown in the Table below.⁵⁵⁰ Survey evidence suggests that a director's effectiveness declines once he/she

⁵⁴⁴ CG Code, A.3.1

⁵⁴⁵ Ibid, A.4.3

⁵⁴⁶ Liability under s384, SFO

⁵⁴⁷ HKIoD, "Guide for Independent Non-Executive directors," (2012), [2]

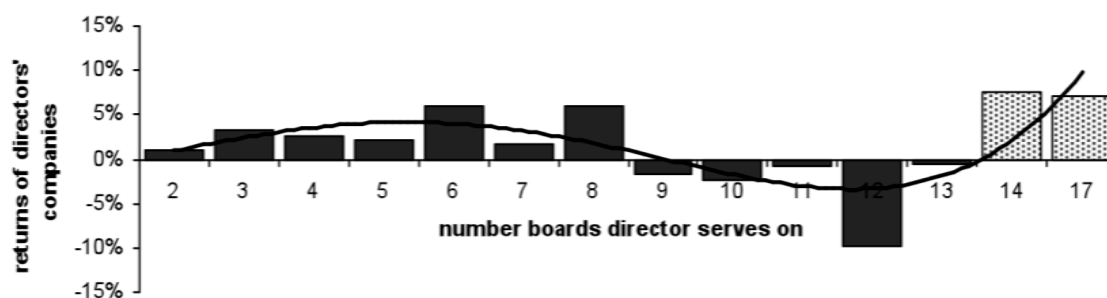
⁵⁴⁸ Ibid, [7] and [8]

⁵⁴⁹ Ibid, 2

⁵⁵⁰ Source: "webb-site.com": Available at <https://webb-site.com/dbpub/INEDHKDistnPeople.asp> (visited on 28 November 2017). Figures in the Table are stated as at 28 November 2017

holds more than six seats.⁵⁵¹

No. of INED seats	No. of people	Fem.	Cumulative people	Cumulative female	Cumulative seats	Cumulative female seats
15	2	0	2	0	30	0
13	2	0	4	0	56	0
11	5	0	9	0	111	0
10	1	0	10	0	121	0
9	5	0	15	0	166	0
8	10	1	25	1	246	8
7	19	0	44	1	379	8
6	21	1	65	2	505	14
5	45	0	110	2	730	14
4	89	8	199	10	1086	46
3	203	16	402	26	1695	94
2	580	46	982	72	2855	186
1	4208	551	5190	623	7063	737



The data in the figure show the returns of the companies various Hong Kong directors serve on (presumably over their tenure). For example, directors with 6 board seats led their companies to a roughly 5% compound annual average rate of return. Authors like Lei and Jie (2011) argue these data reflect the desire boards to get the best talent but such talent becomes overwhelmed if taking up too many board positions.

Source: webb-site.com

Board performance:

The CG Code's RBP states that the board should conduct a regular evaluation of its performance.⁵⁵² Furthermore, RBP B.1.7 states that a significant proportion of executive directors' remuneration should link rewards to corporate and individual performance. The remuneration committee should assess the performance of executive directors.

Accountability:

Under MBLR 3.21, every listed issuer must establish an audit committee comprising NEDs. The audit committee must comprise a minimum of three members, at least one of

⁵⁵¹ Ibid.

⁵⁵² CG Code, B.1.9

whom is an INED with appropriate professional qualifications or accounting or related financial management expertise as required under MBLR 3.10(2). The majority of the audit committee members must be INEDs. The audit committee must be chaired by an INED.

The CG Code recommends that the roles of the audit committee are to include making recommendations to the board, the appointment/removal and the remuneration of the external auditors, reviewing and monitoring external auditors' independence and objectivity and effectiveness of the audit process, and monitoring the integrity of the listed issuer's financial statements and reports.⁵⁵³ The CG Code also contains recommendations on risk management and internal control .

An issuer must report on the provisions of the ESG Guide. The ESG Guide has two levels of disclosure obligations similar to the CG Code: "comply or explain" provisions; and recommended disclosures. Paragraph 8 of the ESG Guide states that the board has overall responsibility for the ESG strategy and reporting. This involves identifying and disclosing ESG issues and key performance indicators that reflect the issuer's significant environmental and social impacts, or substantially influence stakeholders.⁵⁵⁴ ESG reports must be published on an annual basis for the same period covered by the issuer's annual reports.⁵⁵⁵

Appointment and removal of directors:

The CG Code recommends that an issuer establish a nomination committee comprising of a majority of INEDs.⁵⁵⁶ Terms of reference should explain the nomination committee's role and the authority delegated by the board should be made publicly available on the company's and SEHK website.⁵⁵⁷

Issuers should annually disclose in its CG report the procedures, processes, and criteria adopted by the nomination committee to select and recommend the appointment of directors.⁵⁵⁸

Directors appointed to fill a casual vacancy should be subject to a shareholder election at the first general meeting following their appointment.⁵⁵⁹ Serving more than nine years may be relevant to the determination of independence, as discussed above.⁵⁶⁰

Remuneration:

A listed company must establish a remuneration committee chaired by an INED and comprising of a majority of INEDs.⁵⁶¹ The board of directors must approve and provide written terms of reference that clearly establishes the remuneration committee's authority and duties.⁵⁶² Failure of the above two listing rules stipulations necessitates an immediate announcement detailing reasons and the establishment of a remuneration committee that satisfies the requirements within three months.⁵⁶³

The CG Code suggests that the remuneration committee should make recommendations to the board on the policy and structure of directors' and senior management

⁵⁵³ CG Code, C.3.3

⁵⁵⁴ LRs, Appendix 27, [6]

⁵⁵⁵ LR 13.91

⁵⁵⁶ CG Code, A.5.1

⁵⁵⁷ Ibid, A.5.3

⁵⁵⁸ Ibid, L (d) (ii)

⁵⁵⁹ Ibid, A.4.2

⁵⁶⁰ Ibid, A.4.3

⁵⁶¹ LR 3.25

⁵⁶² LR 3.26

⁵⁶³ LR 3.27

remuneration and a formal and transparent procedure for developing remuneration policy.⁵⁶⁴ Remuneration committees should have access to independent professional advice.⁵⁶⁵ Terms of reference should explain the nomination committee's role and the authority delegated by the board should be made publicly available on the company's and SEHK website.⁵⁶⁶ Issuers should disclose details of remuneration in the annual report.⁵⁶⁷

In principle, remuneration needs to be approved by shareholders in general meeting. However, in practice, shareholders, especially minority shareholders do not have enough voting power to veto a proposed pay package.

Internal controls, risk management, and discussion of principal risks:

The CG Code recommends the board to oversee the issuer's risk management and internal control systems. This involves ensuring that a review of the effectiveness of the issuer's and its subsidiaries' risk management and internal control systems have been conducted at least annually and reported to shareholders in the CG Report. The review should cover all material controls, including financial, operational and compliance controls.⁵⁶⁸ The board's annual review should ensure the adequacy of resources, staff qualifications and experience, training programmes, and budgets pertaining to accounting, internal audit, and financial reporting functions.⁵⁶⁹

The SEHK recently issued a Risk Management and Internal Control, ESG Reporting webcast to train directors (July 2017).

Shareholder engagement:

A key principle of the CG Code is that the board should maintain on-going dialogue, communication, and encourage shareholder participation in AGMs and other general meetings.⁵⁷⁰ The CG Code recommends that the board establish a shareholders' communication policy to be reviewed regularly to maintain its effectiveness.⁵⁷¹

I.7.3 Specific transaction contexts

Notifiable transactions and connected transactions

Notifiable transactions covered by MBLR Chapter 14 and connected transactions covered by MBLR Chapter 14A have been introduced in Appendix I.4, and where triggered both may involve additional disclosures and possibly require prior shareholder approval. While the former is concerned with the overall size of a transaction relative to the issuer, connected party transactions are of particular interest as they represent a clear opportunity for abuse of minority shareholders.

Pursuant to MBLR 14A.36, connected transactions must be conditional on shareholder approval at a general meeting unless they are exempt. The purpose of the connected transaction rules is to guard against the transfer of benefits by persons who are able to exercise significant influence over the issuer.⁵⁷²

⁵⁶⁴ CG Code, B.1.2

⁵⁶⁵ Ibid, B.1.1

⁵⁶⁶ Ibid, B.1.3

⁵⁶⁷ Ibid, B.1.5

⁵⁶⁸ Ibid, C.2.1

⁵⁶⁹ Ibid, C.2.2

⁵⁷⁰ Ibid, E.1

⁵⁷¹ Ibid, E.1.4

⁵⁷² HKEX Listing Decision, "LD111-2017," (October 2017)

The SEHK has the power to deem any person a connected person.⁵⁷³ MBLRs 14A.20 and 14A.21 provide circumstances where the SEHK may apply a non-exhaustive deeming provision. For example, in one listing decision⁵⁷⁴ the SEHK deemed that a parent company was a connected person with its subsidiary company. The reason for the decision was based on: (1) the parent company being a controlling shareholder of the subsidiary company and therefore in a position to exercise significant influence over the subsidiary's transactions with parent; and (2) a profit sharing arrangement between the parent and subsidiary would enable the parent to benefit from the subsidiary's transactions with the parent which was in effect a transfer of benefits from the subsidiary to the parent. The transaction would constitute a connected transaction.

Transactions involving a potential change in control

The Code on Takeovers and Mergers (TC) was introduced in Appendix I.4. It provides for safeguards important to the protection of shareholders rights of the offeree (or target) company and is based on the premise that it is the shareholders (not the board, as in some other jurisdictions) who have the right to decide on the offer. This means that the board is prohibited from engaging in action that may frustrate a bona fide offer. Upon being approached with a bona fide offer, the board is required to establish an independent committee of the board (ICB) responsible for the conduct of the offer – this committee is to act as a conduit for all information to shareholders. An independent financial adviser (IFA) is required to be appointed who will be responsible for advising shareholders as a whole on the fairness and reasonableness of the offer. Where no ICB can be formed because there are no directors independent of the offeror, the IFA will undertake the ICB's functions on behalf of the board. The TC contains extensive provisions as to the independence of the IFA and its particular responsibilities.

A central concern of the TC is to ensure that all shareholders are treated fairly and equally (General Principle 1) and this has several implications. Information must be available to all shareholders not to some only, and must be prepared to prospectus standard. All shareholders must all receive the same price for their shares, and this includes look-back periods of up to 6 months that set the minimum price payable according to the highest price that has been paid by the offeror or its concert parties during the relevant period. The TC also prohibits low-ball offers. The TC prevents the provisions on price being avoided by prohibiting special deals that seek to provide benefits to some shareholders and not others.

A central provision of the TC is the Rule 26 mandatory offer, which arises out of General Principle 2. This requires a general offer to be made to all shareholders where there has been a change of control, which is defined by reference to the 30% shareholding level. A mandatory bid obligation is imposed on persons holding less than 30% and coming to acquire 30% or more, and on persons holding 30% or more who increase their holding by more than 2% in any 12 month period.

Where the offer is to be undertaken by way of a scheme of arrangement, which will be governed by the law of the place of incorporation of the company, the TC requires the scheme to be approved by a 75% majority of disinterested shareholders with not more than 10% dissenting. Where the scheme is not approved, the costs associated with proposing the scheme to shareholders are to be borne by the offeror.

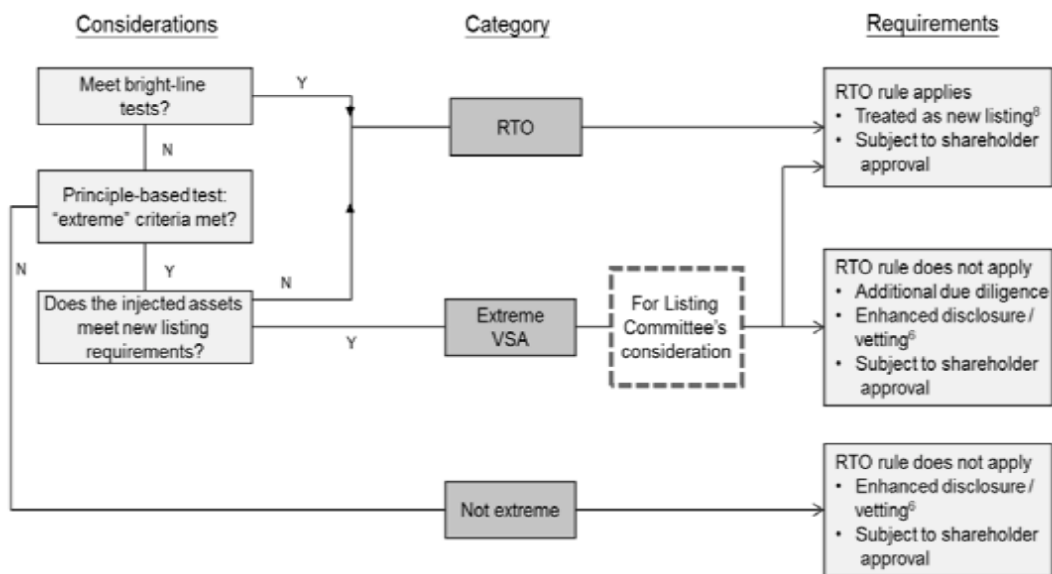
Reverse takeovers

Reverse takeovers (RTO) are subject to the provisions of the listing rules and the Takeovers Code that protect the rights of shareholders of listed issuers that are the

⁵⁷³ LR 14A.19

⁵⁷⁴ HKEX Listing Decision, "LD111-2017," (October 2017).

subject of a RTO – in a RTO the control of the company changes, and frequently its principle business does as well, which puts shareholders at risk of having insufficient information and insufficient say in such a significant transaction. The TC requires directors to obtain independent financial advice on a proposed RTO. The listing rules go further and contain extensive anti-avoidance provisions.⁵⁷⁵ This includes bright line tests (including whether the transaction would constitute a very substantial acquisition for the purposes of MBLR Chapter 14), a principles based test,⁵⁷⁶ and cash company rules.⁵⁷⁷ Where a transaction is determined to be an RTO a trading halt/suspension will be required, the issuer will be treated as a new listing applicant, a new listing document will need to be prepared, and a shareholders vote will be required in which shareholders and associates with an interest in the transaction must abstain from voting. The process determining if a transaction would constitute an RTO is shown in the following diagram.⁵⁷⁸



I.7.4 Role of regulators

See Appendices I.4 and I.6.

⁵⁷⁵ See, HKEX Guidance Letter, "Guidance on application of the reverse takeover requirements," (May 2014) *HKEX-GL78-14*

⁵⁷⁶ Main Board LR 14.06(6)

⁵⁷⁷ HKEX Guidance Letter, "Guidance on Cash Company Rules," (December 2015) *GL84-15*

⁵⁷⁸ Source: HKEX Guidance Letter, "Guidance on application of the reverse takeover requirements," (May 2014) *GL78-14*

Appendix I	8. Regulation of non-local companies	I.8 Hong Kong
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Introduction

There are many non-local companies listed in Hong Kong (see Appendix I.1), particularly from Mainland, and the number is expanding. As they are not incorporated in Hong Kong, they are generally not subject to the CO, except some provisions such as the unfair prejudice remedies and statutory derivative suits; they are instead primarily governed by the law of their place of incorporation. However, they are also subject to the listing rules and the SFO. The former is however only enforceable by the HKEX, although the SFC has in recent years tried to enforce them via its powers under section 8 of the SMLR. Egregious breaches of the disclosure provisions of the listing rules may also give rise to breaches of section 214 of the SFO (discussed in Appendix I.7). Many non-Hong Kong incorporated companies have their business operation and assets as well as their directors and management outside Hong Kong, making it difficult for regulatory agencies in Hong Kong to undertake effective enforcement when there is a default. Whilst there are bilateral and multilateral memorandums of understanding between Hong Kong and other countries for mutual assistance and co-operation, there are gaps in cross-border assistance.

I.8.1 Legislation

The CO governs Hong Kong incorporated companies, except for Part 16 and 17 which cover non-Hong Kong companies or those not formed, but registerable, under the CO. Part 14 of the CO provides that derivative actions, unfair prejudice remedies and winding up orders apply to Hong Kong companies as well as non-Hong Kong incorporated companies (for a discussion of these remedies, see Appendix I.7).⁵⁷⁹ A member of a company includes a representative of a shareholder/member, trustee, or a person with beneficial interests in the company.⁵⁸⁰

Non-Hong Kong incorporated companies that have a place of business in Hong Kong must be registered with the CR, deliver an annual return and accounts for registration, and provide the registrar with an index of directors.⁵⁸¹ A "place of business" for a non-Hong Kong company is described in section 774 of the CO to include a share transfer office and a share registration office but excludes an office pursuant to section 774 (3) of the CO, namely, a local representative office established by a bank with the approval of HKMA.⁵⁸² Under the listing rules, a listed company is required to have a share register office in Hong Kong, thus all listed issuers will have a place of business in Hong Kong for the purposes of the CO.

Section 360N of the CWUMPO gives the CE in Council the power to have a non-Hong Kong incorporated company's registration or exemption from registration cancelled or its operation or continued operation prohibited. Furthermore, the CE in Council may order a non-Hong Kong incorporated company to cease to carry on business in Hong Kong.⁵⁸³ Supporting the CO is Companies (Non-Hong Kong Companies) Regulation (Cap. 622J).

⁵⁷⁹ CO (Cap. 622), s722

⁵⁸⁰ CO (Cap. 622), s723

⁵⁸¹ Respectively: Companies Ordinance (Cap. 622), ss 786, 788, 789, 802

⁵⁸² The exclusion under subsection 3 refers to representative offices approved by the HKMA in accordance with section 46 of the Banking Ordinance (Cap. 155)

⁵⁸³ CWUMPO, s360N, (b)

I.8.2 Non-statutory regulation

The listing rules are applicable to all listed issuers on the SEHK, irrespective of their place of incorporation, subject to waivers granted by the SEHK. The SFC/SEHK "Joint policy statement regarding the listing of overseas companies" (27 September 2013) (JPS) sets out the waivers that are automatically or commonly granted for issuers of equity securities that are not incorporated in Hong Kong. Application for discretionary waivers of the listing rules is considered on its own facts and circumstances, and is subject to the overall discretion of the SFC. For example, a waiver may be granted regarding the compliance obligations of connected and notifiable transactions on the basis that their home jurisdiction rules take precedence, subject to Part XIVA of the SFO (i.e. all listed companies including secondary listings must comply with Part XIVA). Shareholder protections are at least equivalent to Hong Kong, and if not, overseas companies can achieve equivalent standard by varying their constitutional documents. The Model Code (MBLR Appendix 10) is not applicable to issuers with a secondary listing in Hong Kong if it is subject to similar rules in their home jurisdiction (i.e. automatic waiver).⁵⁸⁴

The SEHK has published a Country Guide for each Acceptable Jurisdiction setting out guidance on how companies can meet equivalent shareholder protection standards in the listing rules, and guidance for new applicants from the same jurisdiction.

Where an applicant adopts the arrangements set out in the Country Guide in an Acceptable Jurisdiction, the company will not need to provide detailed explanations concerning key shareholder protection standards.

Main Board LR 19.12 requires financial statements in accountants' reports of overseas companies be audited to a standard comparable to Hong Kong - that is required by the HKICPA or the International Auditing and Assurance Standards Board.⁵⁸⁵

I.8.3 Cross-border considerations

The JPS sets out the regulatory cooperation framework with the jurisdiction of incorporation. A regulator in an overseas company's jurisdiction must:⁵⁸⁶

be a full signatory of the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information; or

have entered into an appropriate bi-lateral agreement with the SFC which provides for mutual assistance and the SEHK for the purpose of enforcing and securing compliance with the laws and regulations of that jurisdiction and Hong Kong.

This enables the SFC to seek regulatory assistance and information from the overseas regulators to facilitate investigations and enforcement

The scope of the JPS includes: (1) shareholder protection standards; (2) regulatory cooperation arrangements; (3) accounting and auditing related and other disclosure requirements; (4) practical and operational matters; and (5) suitability for secondary listing. In addition, the JPS sets out how each listing rule applies to a non-Hong Kong incorporated company listed on the SEHK.

In the context of the Hong Kong market, the most critical cross-border regulatory relationship is with Mainland because of the large number of Mainland enterprises listed

⁵⁸⁴ For details, see: HKEX, "Joint Policy Statement Regarding the Listing of Overseas Companies," (2013)

⁵⁸⁵ Ibid [48] and [49]

⁵⁸⁶ Ibid]

on the SEHK. Because of the different regulatory structure in Hong Kong and the Mainland, this regulatory relationship hinges on cooperation between the SFC and the CSRC. Cross-border evidence gathering is a key regulatory challenge. To overcome this challenge, regular high-level meetings are held between the senior enforcement teams of the SFC and CSRC. Soft cooperative measures are important to develop reciprocity and overcome regulatory frictions. For example, a training exercise on market manipulation was attended by over 100 delegates of the SFC and CSRC in Xi'an in 2016. Similar exercises are planned in the future. An active secondment program enables each regulator's staff to understand the counterpart's culture and business practices.⁵⁸⁷

However, an important source of concern is red-chips issuers, which are Mainland enterprises incorporated in an off-shore jurisdiction, i.e. outside Hong Kong and the Mainland. Unless these companies commit some wrong according to the law of Mainland China, they are outside the jurisdiction of the CSRC, and therefore CSRC will be unable to render much assistance to the SFC.

⁵⁸⁷ Thomas Atkinson, "Keynote speech at 8th Pan Asian Regulatory Summit," (11 October 2017) *SFC, Executive Director, Enforcement Division*, 2 and 3

Appendix II	UNITED KINGDOM
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prepared by:
Syren Johnstone

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Appendix II	1. Market overview – Structure, characteristics and culture	II.1 United Kingdom
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Introduction

Good corporate governance (CG) has long been an important topic for corporate regulation in the United Kingdom (UK) and this has resulted in the UK having today amongst the highest standards in the world designed to protect shareholder interests and hold management to account. These standards are embedded in a mix of legal provisions and non-statutory regulations, some of which enjoy a measure of statutory support (see Appendices II.3 and II.4).

UK shareholders, including institutional shareholders, tend to be passive and non-confrontational, for example in comparison to the United States, although they tend to be more visible in the CG debate than shareholders in Hong Kong. A degree of relative complacency towards CG is witnessed by low levels of shareholder engagement. Nevertheless, the government places a high value on CG and is active in conducting enquiries, particularly in response to larger scale corporate problems, which in some ways can be characterised as acting on the shareholders' behalf to provide a framework that facilitates CG objectives. The recommendations of such enquiries do frequently lead to developments in the CG system.

Significant reliance is placed on self-regulatory mechanisms. However, there is evidence that the progressive-thinking standards established by, for example, the UK Corporate Governance Code (UK CG Code), strategic reporting and the Stewardship Code are, in the case of a not insubstantial number of companies, presently being approached with a "box-tick" approach rather than substantively.

Many of these characteristics are similar to that seen in Hong Kong. It is of interest to observe that this is so despite notable cultural and political differences and influences in present-day Hong Kong. These similarities may be underpinned by the development of Hong Kong's legal and regulatory system being fundamentally rooted in its colonial history.

II.1.1 Corporate governance system

CG in the UK operates on a market-based system that is characterised as an outsider-dominated system or Anglo-American system.¹ It is governance-oriented with a significant focus on the provision of control rights to shareholders, in particular institutional shareholders.² Theoretically, this leads to greater shareholder control over matters including meetings, removal of directors, controlling defensive tactics during hostile takeovers, and veto rights of self-dealing.³ Greater emphasis has been traditionally placed on reputational enforcement mechanisms, rather than judicial regulation, consistent with repeated interaction by a smaller community of significant (i.e. institutional) shareholders.⁴ There is less emphasis on issuer disclosure and, at least compared to the United States, lower rates of court enforcement.⁵

¹ John Armour and Jeffrey Gordon, "The Berle-Means Corporation in the 21st Century," (2016) *Preliminary Draft*, 3

² Demetra Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Oxon and New York: Routledge, 2016), p 202

³ Armour and Gordon, op. cit.

⁴ Ibid

⁵ Ibid

The UK CG system is provided for via a matrix of law and non-statutory regulations, some of which have a measure of derivative statutory support, as discussed in Appendix II.3. In this regard, the derivative support provided in the UK to some regulations and codes is quite distinct from Hong Kong, which does not provide for such support. It is also distinct from the United States where regulators may be empowered by statute to make regulations that amount to regulatory law (having a similar standing as subsidiary legislation in the UK), breaches of which the regulator may specify as being actionable by shareholders – see Appendix III.3.⁶

The governance-oriented focus means that shareholders are regarded as an important component to CG, including as regards the appointment of the board and satisfying themselves as to the presence of appropriate governance structures. Equally, it is central to the UK model that the Board's actions are subject to laws, regulations and the voice of shareholders in general meeting.⁷ This reflects core definitions of the UK system of CG laid down by the Cadbury Report almost 25 years ago – the Cadbury definition of CG is still included in the preamble to the 2016 UK CG Code, first issued by the Financial Reporting Council (FRC) in 1992.

Significant reliance is placed on self-regulatory mechanisms to maintain a balance between market participants, for example, comply or explain under the UK CG Code, strategic reporting, and the Stewardship Code. Strong shareholder protections in the underlying statutory framework and the active involvement of the government and its agencies tend to mask the fact that compliance rates are less than satisfactory insofar as companies tend to adopt a minimum compliance culture towards CG, and shareholders are largely passive and complacent. This is of particular concern with many companies failing to appoint independent directors and chairs. This leads to an impression of the system in which the government and its agencies appreciate the importance of good CG, often driven by the concerns of the global community of supervisory authorities, and that this is undertaken on behalf of the shareholders and/or market integrity.

Recent corporate scandals have highlighted the concern that poor CG can lead to corporate problems regardless of whether or not the company is listed. BHS was a large private company that failed following problems arising out of its controlling shareholder. Sports Direct was a Premium Listing company where it was found that the Chairman was controlled by the majority shareholder to the detriment of the company's CG culture. The Sports Direct incident led to the Department for Business, Energy & Industrial Strategy (BEIS) undertaking an enquiry into CG (see Appendix II.2). Company size does appear to influence the appreciation of good CG - smaller companies generally lack awareness of the statutory director's duties towards the success of the company.

Corporate culture

Corporate culture is a topic that has been attracting increasing interest in the UK over recent years as seen through more surveys and regulatory interest being expressed in how to identify and manage cultural influences on CG practices. A focus of empirical research in this area has been the UK CG Code, where compliance (see Appendices II.4 and II.7 for a discussion of the contents of the Code) has been found to be mixed, possibly reflecting the foregoing discussion.

⁶ Gregory Jackson, "Understanding Corporate Governance in the United States," (October 2010) *Arbeitspapier 223, Hans Böckler Stiftung*, 9

⁷ Andrew Chambers, *Chambers' Corporate Governance Handbook* (Haywards Heath: Bloomsbury Professional Ltd, 2014), pp 360-361

In 2015⁸ and 2016⁹ Grant Thornton analysed (GT Reviews) CG in the context of the quality and profile of reporting on corporate culture and values (based on annual reports published in each year) in view of the requirements of the UK CG Code (discussed in Appendices II.4 and II.6) and strategic and director's reporting introduced by the Companies Act 2006 (Cap. 46) (CA 2006) (see Appendix II.6).

The GT Reviews revealed that, based on the quality and profile of strategic reporting in 2015, chairmen of only one-fifth of FTSE 350 Index (FTSE350) gave culture prominence and provided insight into the topic, with only half of these using their primary statement to emphasise the importance of culture. In 2016, although 86% of FTSE350 companies' annual reports mentioned corporate culture, only 20% provided a meaningful discussion, and 48% do not clearly communicate their organisational values - only 16 companies were regarded as having provided high quality reporting on strategic matters. The prevalence of fragmented commentaries may suggest that culture and values are neither embedded in nor drive CG behaviour within a significant number of issuers. The 2016 GT Review also suggested that failure of companies to adequately explain their CG related objectives might indicate a possible "box-ticking" mentality.

The FRC (based on annual reports published in 2016)¹⁰ found that 90% of issuers complied with either all or all but one or two of the UK CG Code's provisions - however, the GT Reviews had found that only 62% of issuers were in full compliance with the Code in 2016, up from 57% in 2015. The quality of explanations under the Code's comply or explain regime continued to strengthen, from 70% of issuers in 2015 to 79% in 2016 providing good or detailed explanations of non-compliance - such as explaining reasons for non-compliance, alternative arrangements, time frames for ad hoc provisions, and why the board thinks this is appropriate.

Notwithstanding the shortfalls already mentioned above in relation to cultural values, the level of compliance with the UK CG Code represents relatively high levels of apparent compliance practices. However, this is not indicative of Standard Listing issuers, which are not subject to the comply or explain requirement.

GT's observation regarding "box-ticking" is that it may to some extent be a transitional issue in respect of newly introduced provisions - GT suggested that it takes around four years for a majority of companies to begin to address the underlying intent of the new provision. The UK CG Code was first introduced in 1992 and has been updated several times since (as discussed in Appendix II.4), including in 2014 when narrative reporting requiring discussion of strategic concerns was introduced in the CA 2006 (see Appendix II.7). This may, in the alternative, suggest that while good CG culture is compelling, practices may or may not reflect the expected standards that underlie and drive developments in the UK CG Code and narrative reporting. The Table in the Annex to this Appendix II.1 shows the findings of the GT Reviews of the UK CG Code provisions that are the most commonly not complied with. It is notable that among the top items are issues in relation to the board independence requirements (discussed further below), and the membership of the audit, remuneration and nomination committees.

The topic of culture and its relationship to CG is not, of course, new - the importance of "tone from the top" (and subsequently "tone from the middle" and, more recently, "tone

⁸ Grant Thornton, "Trust and integrity – loud and clear?," (2015) *Corporate Governance Review*, 4: Available at <http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/2015/uk-corporate-governance-review-and-trends-2015.pdf> (visited 27 Nov 2016)

⁹ Grant Thornton, "The future of governance: one small step...," (2016) *Corporate Governance Review*, 3: Available at <http://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/2016/2016-corporate-governance-review.pdf> (visited 27 Nov 2016):

¹⁰ FRC (Jan 2016). *Developments in Corporate Governance and Stewardship 2015*: Available at [https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-(1).pdf) (visited 25 Nov 2017)

from everywhere”) has long been a subject of discussion. However, it has been slow to translate into actual CG practices. Nevertheless, corporate values and culture do appear to be subject to more discussions in the boardrooms of FTSE350 companies.¹¹ The FRC is also taking an active interest in understanding corporate culture and the components relevant for boards to consider.¹² Among the factors under consideration are shareholder engagement and the role of stewardship (discussed in Appendix II.4), and the influence this has on encouraging desirable behaviours in companies.

More recently, the Institute of Directors (IoD) has suggested that using compliance with the UK CG Code as a measure of CG is “naïve”.¹³ They consider the provisions of the UK CG Code to be, to some extent, reactive measures that amount to “fighting the last battle”¹⁴ and that “focusing solely on how companies report compliance with a framework, while not looking at underlying behaviour, will simply not do the job”.¹⁵ The IoD instead regard it as more meaningful to assess the relative importance of different, measurable CG factors to stakeholders. This makes some basic sense insofar as it is connected to the premise that good CG is for the benefit of stakeholders. While, ostensibly, the IoD’s approach appears to raise the question as to whether theoretical or empirical approaches to understanding CG work best, this is more apparent than real as the views of stakeholder groups canvassed in the lead up to regulatory developments already represent a condensation of stakeholder experiences and concerns. Nevertheless, the IoD’s approach may represent an interesting empirical *ex post* verification of the factors that have been implemented into CG regulation and how well companies are performing on them in the eyes of stakeholders.

The IoD constructed a model based around this concept. The model assesses 34 factors across five general areas to assess CG: (1) board effectiveness; (2) audit and risk; (3) remuneration and reward; (4) shareholder relations; and (5) stakeholder relations.¹⁶ Using a regression analysis of survey results,¹⁷ they found that respondents placed the greatest weight on audit and risk, and gave little or no weight to board effectiveness (which encompasses, for example, separation of the Chairman and Chief Executive Officer (CEO) roles, the number of audit committee meetings held, the percentage of non-executive directors (NEDs), and the average number of boards a director sits on). The IoD then used the weighting given to each factor to generate an overall model score for individual companies.

The IoD’s weightings – to the extent they are reliable¹⁸ – might also be capable of use in deciding which areas of CG should be a focus of greater attention, both in terms of regulatory development as well as enforcement. While a possible confounding factor in the IoD’s model might be that a particular factor could attract a lower score not because it is unimportant per se but because it is already sufficiently well implemented in the culture of the market. However, this would not affect the utility of the weightings in relation to regulatory development and enforcement priorities since such factors can still be used as pointers to areas where stakeholders feel more needs to be done.

¹¹ “Boardroom Bellwether survey of FTSE350 company secretaries”, The Financial Times and ICSA: The Governance Institute; Dec. 2016

¹² FRC, “Corporate Culture and the Role of Boards: A report of observations” 2016

¹³ IoD, “The 2016 Good Governance Report: The great governance debate continued,” (September 2016), 9

¹⁴ Per Ken Olisa, the chairman of the advisory panel for the Report, as quoted in CCH Daily, “IoD to establish corporate governance index,” (June 2015): Available at <https://www.cchdaily.co.uk/iod-establish-corporate-governance-index> (visited 21 Nov 2016)

¹⁵ Per Simon Walker, IoD Director General, as reported in CCH Daily *op. cit.*

¹⁶ IoD, “The 2016 Good Governance Report”, *op. cit.* 10

¹⁷ The survey was conducted from February to June 2016 and attracted 744 participants who provided 1,977 ratings on a sample of 100 FTSE companies

¹⁸ The Report notes on page 15 that the robustness of the findings may need to be taken into consideration as the heterogeneity across respondents was large

As regards CG regulatory development, in 2013, the UK Government's Department of Business, Innovation and Skills (BIS) (replaced by the BEIS in 2016) researched the motivations for listing decisions of UK companies and the degree to which CG regulation affected the decision to list.¹⁹ While there is a widespread acceptance that CG regulation and reporting is necessary and desirable for maintaining market standards and providing investors with the required levels of transparency to generate confidence, there is also a general desire to maintain the status quo, rather than continually increasing the regulatory burden. When surveying listed companies for possible CG changes, less than half (i.e. seven out of 17 cases) made suggestions to change the current CG regime. The BIS research also found that when companies listed on an Exchange, it led to increased CG activities in respect of (1) board oversight by committees (e.g. audit, remuneration, and nomination) and (2) reporting requirements, both of which are widely understood as necessary forms of accountability to the providers of capital and to instil shareholder confidence. However, there was mixed feedback on the role of CG and the extent to which this acts as a deterrent to unlisted companies considering a future listing. Companies that were already accountable through reporting to private equity (PE) shareholders, parent companies, and industry regulators were not overly concerned by the additional CG burdens of listing. Nonetheless, companies that had previously experienced such reporting standards viewed the additional time and cost involved as a burden.

II.1.2 Market characteristics

Stock Exchange

In general, the structure and operation of the securities markets in the UK, operated by the London Stock Exchange (LSE), is broadly similar to those operated by the Hong Kong Exchange and Clearing Limited (HKEX). Both are operated by companies that, following a process of demutualisation,²⁰ are listed²¹ on a stock market it operates, both operate different boards with particular characteristics, and both allow a variety of securities to be listed. In contrast to the two boards operated by the HKEX, the LSE operates three, and the HKEX has a larger proportion of foreign incorporated issuers. Importantly, as discussed in Appendices II.3 and II.4, the listing rules governing the admission and continued listing of securities are promulgated by the Financial Conduct Authority (FCA) and carry a measure of statutory support, unlike Hong Kong where they are promulgated by the HKEX and operate primarily as a contract between the issuer and the Exchange, breaches of which do not directly give rise to shareholder rights of civil action.

The LSE is the largest stock market by market capitalisation outside of the United States. The London Stock Exchange Group plc (LSEG) is listed with a Premium Listing. Share indices such as the FTSE²² are jointly owned by the LSEG and the Financial Times as the FTSE Group. The LSE operates several markets for listing of securities.²³ As of 31

¹⁹ BIS, "Investigation into the motivations behind the listing decision of U.K. companies," (2013) *BIS Research Paper Number 126*, 56: Available at

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/232087/bis-13-1130-investigation-into-the-motivations-behind-the-listing-decisions-of-uk-companies.pdf (visited 27 Nov 2016)

²⁰ Laura Padilla Angulo, Faten Ben Silmane, and Djaoudath Alidou, "The London Stock Exchange: Strategic Corporate Governance Restructuring After Demutualisation," (2014) 30 *The Journal of Applied Business Research* 1, 214

²¹ LSE, "LSE London Stock Exchange Group PLC Ord SHS 6 79/86P": Available at <http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary/GB00B0SWJX34GBGBXSET1.html> (visited 26 Nov 2016). London Stock Exchange Group, "History of London Stock Exchange Group": Available at <http://www.lseg.com/about-london-stock-exchange-group/history> (visited 26 Nov 2016)

²² LSE, "FTSE": Available at <https://www.gov.uk/government/news/ftse-100-executive-pipeline-needs-more-women-say-top-business-bosses> (visited 26 Nov 2016)

²³ LSE, "A guide to listing on the London Stock Exchange," (2010), 6

October 2017,²⁴ there were 2,022 companies with equity shares listed having a total market capitalization of £4,185,550 million. Of these, approximately 25% are incorporated outside the UK, with just under 10% incorporated outside Europe. Only 3 were incorporated in China.

For the LSE's Main Market, the flagship market for larger, more established companies, as of 31 October 2017 there were 1,067 listed companies of which approximately 24% are incorporated outside the UK. The Main market has two listing alternatives - Premium Listing and Standard Listing - each with different admission and continuing requirements (see further Appendices II.3 and II.4).

For the LSE's Alternative Investment Market (AIM), the LSE's market for smaller growing companies,²⁵ as of 31 October 2017 there were 955 listed companies of which approximately 25% are incorporated outside the UK.

Shareholder ownership

Nonetheless, share ownership of listed companies in the UK is generally considered to be dispersed,²⁶ although many are family-controlled - around 30% in 2010.²⁷

The listed market is historically characterised by high levels of institutional shareholders that underpin a diversity of ownership.²⁸ Institutional investors in the UK are mainly insurance companies, pensions firms, unit trusts, and investment firms. In 2014, insurance companies held 6% of public shares by value, pension funds held 3%, unit trusts held 9%, and other financial institutions held 7% - together with other institutions beneficial ownership held by institutional investors was about 28%.²⁹ Block ownership in the UK is relatively low, at about 25%, in comparison to other jurisdictions.³⁰ Individual retail investors make up 12% of all public shares by value in 2014.³¹ Foreign ownership of UK listed companies is relatively high at 54% in 2014.³²

Activist shareholders

With relatively strong shareholder protections, the passive and non-confrontational nature of UK shareholders reflects a degree of complacency towards good CG. This is reflected by levels of shareholder engagement that vary considerably with the listing status of the company³³ and is an increasing topic of concern for regulators, with companies being asked to explain voting outcomes on resolutions involving significant issues while at the same time encouraging dialogue.³⁴ In 2016, only 36% of FTSE350 companies clearly explained how they engage with shareholders, a significant drop from 55% in 2015.³⁵

²⁴ All data at 31 October 2017 is derived from LSE statistics available at <http://www.londonstockexchange.com/statistics/home/statistics.htm> (visited 28 Nov 2017)

²⁵ A wide range of businesses seeking access to capital growth - including early stage, venture capital backed, and established companies - join AIM, see LSE, "AIM": Available at <http://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm> (visited the 26 Nov 2017)

²⁶ Alison L Dempsey, *Evolutions In Corporate Governance* (Sheffield: Greenleaf Publishing Limited, 2013), p 46.

²⁷ Julian Franks, Colin Mayer, Paolo Volpin, and Hannes Wagner, "The Life Cycle of Family Ownership: International Evidence," (June 2012) 25 *Oxford Journals* 6, 2.

²⁸ Alison L Dempsey, *op. cit.*

²⁹ Office for National Statistics, "Ownership of U.K. Quoted Shares: 2014": Available at <http://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofquotedshares/2015-09-02#insurance-companies-holdings-of-uk-shares-by-value> (visited 30 Nov 2016)

³⁰ Clifford G. Holderness, "The Myth of Diffuse Ownership in the United States," (2009) 22 *Review of Financial Studies* 4, 1394

³¹ Office for National Statistics, *op. cit.*

³² *Ibid*

³³ BIS, *Research Paper Number 126*, *op. cit.* 47

³⁴ Grant Thornton, "The future of governance: one small step...", *op. cit.*

³⁵ *Ibid*

Institutional investors tend to be more passive and favour a softer approach in comparison to their United States counterparts. Shareholder directors are rare in the UK with only a very small number of institutional investors having NED status, although listed companies tend to keep institutional investors well informed.³⁶ Institutional investors in the UK rarely have a direct impact on activity or policy.³⁷

Shareholder activism is a fraction of that in the United States even though the UK is one of the largest markets outside the United States. In 2015, the Alternative Investment Management Association (AIMA) and Simmons & Simmons undertook a joint research initiative to assess the development of shareholder activism, focusing on, *inter alia*, the UK. The research found that activism in the UK was less aggressive and more collaborative than that of the United States and long-only institutional investors tended to favour a softer approach.³⁸ These findings were explained, in part, by the fact that the UK has a more shareholder-oriented legal and regulatory framework. Furthermore, shareholder activism in the UK appears to be primarily driven by CG issues.

Although confrontational activist shareholders are rare in the UK, in contrast to the United States,³⁹ this is starting to change as confrontational United States activist shareholders have become more active and visible in the UK market. According to Linklaters, there were 32 activism interventions in the UK in 2015.⁴⁰ A case study of this change in the UK is Alliance Trust (Alliance). Alliance had been under attack in past few years with its CEO, Katherine Garrett-Cox, seeing off two attempts in 2012 by an activist shareholder, Laxey Partners.⁴¹ Subsequently, Elliott Advisors (the UK arm of United States hedge fund and activist shareholder Elliott Management) built a sizable stake in Alliance before aggressively pushing the board to accept two new NEDs. Alliance's CEO has expressed the concern that such activist shareholders "have a different agenda..." from the board's collective responsibility to manage the company.⁴² The CEO stood down from Alliance's board six months after the annual general meeting (AGM). A similar unfolding of events occurred in relation to the United States activist shareholder Sherborne acquiring a stake in Electra, a PE company, in advance of launching a confrontation with the board that led to the appointment of new directors and the resignation of the CEO.

There are views that these developments may have a positive impact on the market, prompting listed company directors to increase their appreciation of good CG. ValueAct Capital Partners is one United States activist shareholder that has taken a more collaborative approach to its stake in Rolls-Royce Holdings Plc, it being understood that there is a good alignment of the long-term views of the company. It has been argued by the IoD that confrontational activist shareholders could be a boon for stewardship of UK public listed companies as it might work to bolster CG, comprise better advocates for long-termism than passive institutional shareholders, address a lack of shareholder interest and shift the balance of power towards investors.⁴³

The advent of activist shareholders does, however, bring with it the risk that they are pursuing their own short-term objectives that puts at risk the longer-term objectives of

³⁶ BIS, *Research Paper Number 126*, op. cit. 47

³⁷ Ibid

³⁸ AIMA and Simmons & Simmons, "Unlocking value: the role of activist alternative investment managers," (2015), 37, 38, and 49

³⁹ Kate Burgess, "Confrontational activism rare in the U.K.," (3 January 2016) *Financial Times, Investor activism*

⁴⁰ Simon Walker, "Ignore activist investors and risk imperilling your long-term future," (7 February 2016) *The Telegraph, Finance*

⁴¹ Jamie Dunkley, "Alliance Trust shareholders angry at board compromise with Elliott Advisors," (30 April 2015) *The Independent*

⁴² Sarah Jones, "Alliance Trust Says Elliot Fund 'Wants Out at All Costs,'" (20 March 2015) *Bloomberg*.

⁴³ Simon Walker, *The Telegraph, Finance* op. cit.

the company (see Appendix III.1 for a discussion of the problems this has created in the United States context).

Company size

More controversial proposals include providing for a workers representative on the board and for large private companies to adopt a CG code (see further Appendix II.2). In terms of large private companies adopting a CG code, the view of the Institute of Chartered Secretaries (ICSA) is that unlisted companies should be encouraged to comply with existing codes, without drafting new codes. While more companies appear to be recognising the commercial imperative of maintaining effective CG practices, this frequently amounts to only minimal compliance with the UK CG Code.⁴⁴

Directors and the board

CG processes at listed issuers are in general more developed when compared with unlisted firms, and this is in part due to the CG expectations placed on listed issuers.

Most companies have monthly board meetings, with little difference between listed and PE companies.⁴⁵ However, listed companies are more likely to take on collective board responsibility for CG and to have separate oversight boards.⁴⁶ This contrasts with non-listed companies' boards, which are more likely to have a single person being responsible, such as the Chairman or Company Secretary,⁴⁷ and family companies where the owners are in day-to-day contact with the business and so have markedly fewer board meetings.⁴⁸

Listed issuers having a dominant and controlling shareholder – such as Bumi plc and Eurasian Natural Resources Corporation plc (ENRC) (both of which were Premium Listings) - that have had serious problems were found to have deficient CG. ENRC was subject to a criminal investigation by the Serious Fraud Office and Bumi suspending trading of its shares after it was unable to meet auditing deadlines. Incompetent directors were blamed in both cases. These events led to the FCA seeking consultation on measures to improve minority shareholders rights and protections where they are at risk of being abused in the context of Premium Listing Regime. The FCA consequently amended the listing rules, in 2014, to improve minority shareholder rights and protections. An important component of this is the requirement that where an issuer possesses a controlling shareholder (i.e. a person who, together with their concert parties, controls 30% of the votes),⁴⁹ it must include in their constitutional documents a dual voting structure that applies to the appointment of independent directors and requires the approval of both (1) the shareholders and (2) independent shareholders.⁵⁰ This requirement is part of the broader requirement that a listed company must be able to carry on business independently.

Compensation:

Shareholders and shareholder representative groups have both been active in relation to executive compensation, and the government is considering a number of CG changes such as giving shareholders more powers to reject executive remuneration packages.

⁴⁴ Sarah Gordon, "Third of U.K. businesses do not meet corporate governance requirements," (14 Nov 2016) *Financial Times, Corporate governance*

⁴⁵ BIS, *Research Paper Number 126*, op. cit. 47

⁴⁶ Ibid

⁴⁷ Ibid

⁴⁸ Ibid

⁴⁹ LR 6.1.2A R

⁵⁰ LR 9.2.2A R, 9.2.2E R and 9.2.2F R. See FCA, "Response to CP13/15 – Enhancing the effectiveness of the Listing Regime," (May 2014) *Policy Statement, PS14/8*, 6. See FCA 2014/33 Listing Rules (Listing Regime Enhancements) Instrument 2014

Examples of shareholder action have been seen in the case of BP shareholders rejecting the CEO's pay package at its AGM, and the UK's highest-paid executive, WPP's Sir Martin Sorrell, faced a shareholder revolt when they voted against his excessive executive compensation.⁵¹ Similar shareholder rebellions recently occurred at Smith & Nephew and Reckitt Benckiser.⁵² Both the IoD and the UK Individual Shareholders Society Ltd (ShareSoc), a representative of individual shareholders, have weighed in on these debates, which have notably been carried on in public under the eye of the media, to express concern as to what is perceived as excessive remuneration. Their comments circle around questioning whether the level of remuneration is necessary to motivate or help retain the relevant directors, whether the pay is aligned with performance, and transparency.^{53,54,55}

Reporting on remuneration has been rated as "high quality" in 93% of FTSE350 companies, with a little under two-thirds including non-financial metrics in 2016 performance-based remuneration.⁵⁶

The FRC's 2016 annual review "Developments in Corporate Governance and Stewardship" reports that the FRC's suggestion to implement clawback arrangements on executive pay have been taken up by 91% of FTSE350 issuers in respect of the annual bonus and by 78% in respect of long-term plans.

Appointment and retention:

As noted above, dual shareholding has been introduced in relation to independent directors where the issuer possesses a controlling shareholder.

Independence:

As noted above in the discussion of the GT Reviews, the most common item of non-compliance with the UK CG Code was board independence, with 48% of new entrants failing to comply and many issuers failing to appoint independent directors and chairpersons.⁵⁷ ⁵⁸ However, this is changing. Whereas in 2015 42 FTSE350 issuers failed to meet the UK CG Code provision that at least half of the board (excluding the chairperson) be Independent non-executive directors (INEDs), this had reduced to 26 in 2016.⁵⁹ The diversity of boards has at the same time expanded, with 76% of companies mentioning race, cultural background and gender, as well as focusing on skills and experience.⁶⁰

The FCA's 2014 amendment to the listing rules⁶¹ also widened the concept of the controlling shareholder and its associates, bringing it into alignment with the definitions already in place in Hong Kong, as part of an effort to improve the ability of a Premium Listing issuer with a controlling shareholder to act independently of its controlling shareholder and its associates. However, the changes go further to require, which is not a requirement in Hong Kong, that the controlling shareholder and the issuer enter into a "relationship agreement" containing undertakings concerning arms' length transactions

⁵¹ Roger Baird, "Executive pay: Big and getting bigger thanks to the big boys club," (9 August 2016) *IB Times*

⁵² *Ibid*

⁵³ Sarah Meddings, "Shareholder backlash at Berkeley Group over boss's bumper pay package," (23 August 2016) *This is Money, Daily Mail*

⁵⁴ Baird, *op. cit.*

⁵⁵ Dan Cancian, "MPs launch investigation into executive pay after investors' revolt," (16 Sept 2016) *IB Times*

⁵⁶ Grant Thornton, "The future of governance: one small step..." *op. cit.*

⁵⁷ *Ibid*

⁵⁸ Grant Thornton, "Trust and integrity – loud and clear?," *op. cit.*

⁵⁹ FRC "Developments in Corporate Governance and Stewardship", *op. cit.* 2016

⁶⁰ Grant Thornton, "The future of governance: one small step..." *op. cit.*

⁶¹ FCA, Response to CP13/15, *op. cit.* and FCA 2014/33 *op. cit.*

and compliance with the listing rules⁶² – where the relationship agreement has been breached (or one has not been entered into), the sanction applied is that any transaction with the controlling shareholder (irrespective of size of transaction) will require independent shareholder approval. Importantly, this sanction may be triggered by any independent director who disagrees with the board’s assessment of whether the undertakings have been complied with. The sanctions will remain in place until the next annual report in which the board makes a compliance statement without any disagreement from any of the independent directors.

⁶² LR 6.1.4D R

Annex 1 to Appendix II.1: Most common parts of the UK CG Code that are not complied with.⁶³

Areas companies list as non-compliant

Code provision	Requirement	% of non-compliant FTSE 350 companies only	% of all FTSE 350		
			2016	2015	2014
B.1.2	At least half the board should be independent non-executive directors	28.7	10.7	12.8	9.8
C.3.1	Failure to meet audit committee membership criteria	25.2	9.4	8	7.5
D.2.1	Failure to meet remuneration committee membership criteria	21.7	8.1	8	9.1
A.3.1	The chair should be independent on appointment	17.4	6.5	4.8	3.3
B.2.1	Failure to meet nomination committee membership criteria	14.8	5.5	4.5	3.6
E.1.1	The chair should discuss governance and strategy with major shareholders; the senior independent director should attend a sufficient number of meetings with a range of major shareholders	11.3	4.2	3.8	1.6
D.1.1	Failure to include clawback or other specific provisions to the schemes of performance-related remuneration for executive directors	11.3	4.2	2.9	N/A
C.3.7	FTSE 350 companies should put the external audit contract out to tender at least every 10 years	10.4	3.9	5.8	4.6
B.6.2	The board evaluation should be externally facilitated at least every three years	8.7	3.2	7.4	5.5
A.2.1	The roles of chair and chief executive should not be held by the same individual	7.8	2.9	4.5	3.6

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⁶³ Grant Thornton, "The future of governance: one small step..." op. cit.

Appendix II	2. Policy	II.2 United Kingdom
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Introduction

The principal CG policy-making bodies in the UK are:

Parliament – which has the ability to make statutory law as well as to hold parliamentary investigations, often through Select Committees comprising groups of House of Commons’ members,⁶⁴ and receive evidence as to the future direction of policy-making;

Government departments – such as the BEIS (which replaced the BIS in July 2016), which leads the government’s relationship with business enterprises, is involved in reviews of proposed legislation as well as proposing new laws, and undertakes reviews of specific issues including impacting on CG concerns;

Government-backed commissions – ad hoc commissions appointed by the government to investigate specific issues;

Regulatory bodies – the FCA and the FRC (and the Prudential Regulation Authority (PRA) in relation to certain financial institutions), each of which have the power to make regulations that implement provisions of the law, albeit such regulations do not themselves have the standing of being either primary or secondary legislation (or, as it is termed in the United States, regulatory law).

These arrangements contrast with the system in Hong Kong in two important ways. First, in contrast to the many commissions that have been used in the UK, the Hong Kong government far less frequently uses ad hoc commissions, and instead looks to either standing law commissions, the regulators, or the relatively new (since 2013) Financial Services Development Council to investigate and further policy objectives. Second, as discussed in Appendix II.3, many of the rules made by regulators in the UK have a degree of statutory backing whereas those made by regulators in Hong Kong generally do not.

II.2.1 Stakeholder engagement in regulatory development

Government related

The government is active in relation to the development of CG both via the work undertaken by the BEIS, a ministerial department, as well as a number of important government-backed commissions.

Select Committees carry out enquiries on areas ranging from the work of government departments to economic affairs.⁶⁵ Terms of reference are issued to guide the enquiry. Contributions may be sought by industry experts. Written and oral evidence may be sought from specialist advisors.⁶⁶ Research from market participants and publicly available information may be pursued and analysed. A detailed report is then published with recommendations - a policy directive of the committee that the government may or may not adopt. The results of these enquiries are public and normally require a response

⁶⁴ UK Parliament, “Select Committees,” Available at <https://www.parliament.uk/documents/commons-information-office/Brief-Guides/Select-Committees.pdf> (visited 15 Oct 2016)

⁶⁵ Ibid

⁶⁶ Ibid

from the government.⁶⁷ Replies are usually undertaken by the government within a two-month timeframe.⁶⁸ In this regard, high-level CG policy-making is not periodic but *ad hoc*.

Since the 2008 crisis there have been no less than seven commissions of interest and a BEIS Strategy Committee enquiry on CG is currently ongoing. These reviews frequently give rise to high-level inspirational directions in thinking. Importantly, they do not appear to be constrained by merely following what is happening in other countries and rely heavily on receiving both written and oral evidence from a range of concerned parties. There is an increasing tendency to make the gathering of evidence as public as possible. For example, the oral evidence gathering under the BEIS Strategy Committee enquiry on CG (discussed below) is broadcast via the government's website parliamentlive.tv.

These two features – leading high-level inspirational thinking and transparency – may be contrasted with the approach in Hong Kong, which in many ways remains in a transitional state post its exit from a British colony and resumption of Chinese sovereignty in July 1997. In important ways, Hong Kong still references the UK for leadership and confirmation on critical issues of importance, an example being the issue of maintaining the “one-share, one-vote” principle in which the Securities and Futures Commission (SFC) found staunch support from the FCA. This, of course, is more than merely cultural as the Hong Kong legal and regulatory system is borne out of the UK. As regards openness, the Legislative Council's panel discussions are generally open to public scrutiny.⁶⁹ Unlike legislative bodies, the regulators (the FCA and the SFC) do not open their discussions to the public. However, because of the different level of engagement of the government, detailed and formative discussions relating to policy development in Hong Kong are not undertaken with the same level of openness as in the UK. Both the FCA and the SFC regularly consults the market on various proposed changes that gives rise to, after a delay,⁷⁰ publicly available written responses, and both often engage in “soft consultation” with unidentified persons. The Listing Committee of The Stock Exchange of Hong Kong Limited (SEHK) in its regulatory policy development capacity operates similarly.

The key undertakings of the reviews are summarised in the following paragraphs. It may be observed that many of the findings and recommendations are precursors to developments subsequently undertaken in the UK, some of which have after a delay been adapted into Hong Kong's context.

Turner Review 2009⁷¹ - undertaken to review the causes of the global financial crisis (GFC), the Turner Review acknowledged that risk management operations and CG within banks required review. The Turner Review highlighted the issues of technical capability of NEDs (in particular their ability to perform an effective oversight of risks and provide a challenge to executive strategies) and addressed the relationship between CG and effective risk management. Importantly, the Turner Review observed that regulation and supervision was a critical component in controlling bank risk-taking, in some ways paving the way to many of the regulatory oversights put in place post the GFC. Following the Turner Review's recommendations, the government issued a white paper entitled “Reforming financial markets” in July 2009.

⁶⁷ Ibid

⁶⁸ Ibid

⁶⁹ See <http://webcast.legco.gov.hk/public> (visited 25 Nov 2017)

⁷⁰ For example, public responses to the SFC/SEHK joint consultation on listing reform were not available for some months following the closing of the consultation period

⁷¹ FSA, “Turner Review—A Regulatory Response to the Global Banking Crisis,” (March 2009), 5: Available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf (visited 19 Nov 2016)

Walker Review 2009⁷² - also undertaken in response to the GFC, the review was focussed on banks and financial institutions. However, its findings and recommendations are nevertheless of wider interest to the CG topic. Recognising a problem identified in the Turner Review, it suggested that NEDs be required to undergo an induction process, receive regular training, and be provided with dedicated support to put them in a position where they can contribute as effective challengers on the board. The board should also undertake a formal evaluation of its performance. While the review suggested that the chairperson should be subject to annual election, the UK CG Code later introduced the concept of director re-election at regular intervals, requiring this to be an annual process for FTSE350 issuers. The review also proposed rules on the setting and structure of executive remuneration as well as clawback arrangements in circumstances of misstatement or misconduct.

Davies Review 2010⁷³ - introduced in 2010 to examine the underrepresentation of women on boards, led by Lord Davies of Abersoch, Minister of State for Trade, Investment and Small Business. The review was primarily based on quantitative research over a five-year period, analysing the board composition of FTSE companies.

Vickers Report 2011⁷⁴ - undertaken by the Independent Commission on Banking, the report touched on the issue of remuneration, citing weaknesses in capital and accounting frameworks prior to the GFC - however, this was marred by extensive disagreement between the parties on virtually all of the issues and subject to criticism from non-banking industry participants (e.g. academics).

Kay Review 2012⁷⁵ - the Kay review made a number of CG-related recommendations, based on its terms of reference, that included, inter alia: (1) the Stewardship code be developed to be more expansive focusing on strategic issues and CG; (2) directors, asset managers, and asset holders adopt Good Practice Statements that promote stewardship and long-term decision making; (3) an investors forum to be established to facilitate collective engagement with investors; (4) the scale and effectiveness of mergers to be carefully reviewed by the BIS and the companies themselves; (5) companies should consult with major long-term investors over board appointments; (6) companies should disengage from short-term earnings expectations and announcements; (7) regulators should apply fiduciary standards to all relationships in the investment chain, namely institutional investors and investment advisors; (8) the Law Commission should review the concept of fiduciary duty as applied to investments; (9) mandatory quarterly reporting obligations; (10) high quality and succinct narrative reporting⁷⁶; and (11) directors' remuneration to be structures to relate to long-term business performance.⁷⁷ These suggestions were broadly accepted by the government.⁷⁸ One of the recommendations, which is currently being explored by the BEIS (see below), is to establish a cost-effective means for individual investors to hold shares directly on an electronic share register, most likely via an automatic opt-in arrangement. Professor Kay expressed concerns that the

⁷² A review of corporate governance in UK banks and other financial industry entities, Final recommendations 26 Nov 2009: Available at http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf (visited 25 Nov 2017)

⁷³ UK Government, "Women on Boards: 5 Year Summary (Davies Review)," (October 2015), 27: Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/482059/BIS-15-585-women-on-boards-davies-review-5-year-summary-october-2015.pdf (visited 19 Nov 2016)

⁷⁴ Timothy Edwards, "The Independent Commission on Banking: The Vickers Report," (December 2013) *House of Commons Library*, 4

⁷⁵ John Kay, "The Kay Review of UK Equity Markets and Long-Term Decision Making," (2012), 9

⁷⁶ Also see: Davey Report (2010), a consultation on the future of narrative reporting for BIS

⁷⁷ Kay, op. cit. 13

⁷⁸ For the suggested principles, see Kay op. cit.

electronic intermediated shareholding model creates barriers to shareholder engagement and uncertainty for individual investors.

Hampton-Alexander Review 2016 - building on the Davies Review this review sought to increase representation of women in the executive level of FTSE350 companies focussing on building the pipeline for female executives and emerging non-directors, a key recommendation of Lord Davies.⁷⁹ The review recommended that companies listed on the FTSE 100 should have at least 33% of their executive pipeline positions filled by women by 2020.⁸⁰

Parker Review 2016⁸¹ – focussing on the ethnic diversity of boards of FTSE100 and FTSE250 companies, including reasons for including ethnic diversity on boards, business drivers, and the responsibilities of nomination committees. Proposed recommendations include FTSE100 companies having at least one ethnically diverse director by 2021 and FTSE250 by 2024.⁸² Nomination committees should require their human resource teams to identify and present qualified people of diverse ethnicity to be considered for board appointments.⁸³

The BEIS Strategy Committee enquiry on CG commenced in September 2016⁸⁴ focuses on three core CG concerns:

director duties – whether there is an effective voice to challenge boardroom decisions, whether boardroom and advisor duties should be expanded to provide greater transparency, and whether the provisions of the Cadbury Review (see below) have been embedded into British business practice and culture;

executive compensation - whether executive pay should reflect the value added by executives relative to junior employees, whether recent high-profile shareholder actions (see Appendix II.1) suggest the current framework is working or whether shareholders need a greater role; and

the composition of boardrooms – following the Davies Review (see below), whether more should be done to increase the number of women in executive positions, to explore proposals on worker representation on boards and remuneration committees, and how to achieve greater diversity of board membership, including representation and gender balance in executive positions.

The first and third of these policy concerns (except worker representation) reflect similar concerns in the Hong Kong market as indicated by recent regulatory developments. However, there is at present no serious undertaking in Hong Kong to impose further parameters around executive compensation beyond the non-mandatory guidelines that are already in place in Appendix 14 of the Main Board Listing Rules (MBLR).

Written evidence was accepted online by the enquiry and oral evidence is being called for by expert witnesses. The enquiry publishes all submissions and makes oral evidence available online.⁸⁵ The enquiry is ongoing.

⁷⁹ UK Government, "FTSE 100 executive pipeline needs more women, say top business bosses, (28 Nov 2016) Press Release: Available at <https://www.gov.uk/government/news/ftse-100-executive-pipeline-needs-more-women-say-top-business-bosses> (visited 28 Nov 2016)

⁸⁰ Ibid

⁸¹ John Parker, "A Report into the Ethic Diversity of UK Boards," (Nov 2016) *Consultation Version*, 8.

⁸² Ibid

⁸³ Ibid

⁸⁴ UK Parliament, "Corporate Governance inquiry launched,": Available at <http://www.parliament.uk/business/committees/committees-a-z/commons-select/business-innovation-and-skills/news-parliament-2015/corporate-governance-inquiry-launch-16-17/> (visited 19 Nov 2016)

Industry regulator

FCA:

It is a general function of the FCA, as a competent regulatory agency, to determine the general policy and principles when performing particular statutory functions in relation to official listings.⁸⁶ The power to make listing rules, disclosure rules and prospectus rules is conferred on the FCA under section 73A of the Financial Services and Markets Act 2000 (FSMA) and section 890 confers powers to make CG rules. The Treasury may arrange independent enquiries into matters considered to be in the public interest.⁸⁷ Appointment of a person to hold an enquiry is conferred under section 15 of the FSMA. For example, the FCA published the Davis Review in 2014 and issued a response on its internal CG. Reviews conducted by the FCA are sourced from review and information gathering powers pursuant to the FSMA.⁸⁸

FRC:

The CA 2006 delegates power from the Secretary of State to the FRC under Part 42 (audits) and Schedules 10 and 11. In terms of CG, the FRC does not have the statutory power to make CG regulations, and so its powers are limited – its UK CG Code gains some backing from the FCA’s listing rules.⁸⁹

The FRC makes proposals to issue, review, and change codes, standards, statements of practice, or guidance. Procedures to carry out such functions are approved at the discretion of the FRC Board or the Codes and Standards Committee.⁹⁰ Its Codes and Standards Committee is responsible for maintaining an effective framework of UK codes and standards for, *inter alia*, CG, stewardship, accounting, and auditing.⁹¹ A topic may be identified that warrants amendment to part of the FRC regulatory framework.⁹² In such circumstances, the FRC obtains formal and informal feedback on its proposals.⁹³ The form and length of a consultation depends on the nature and status of the material, which is determined in accordance with the FRC’s “Framework for the Development of Codes, Standards, Statements of Practice and Guidance”.⁹⁴ Formal consultation, including written consultation, usually lasts for 12 weeks.⁹⁵ Informal consultation involves stakeholder outreach.⁹⁶ When an issue requires debate, an exposure draft is prepared by the FRC Executive that takes into account the results of any stakeholder outreach before being released for public consultation.⁹⁷ The views of interested parties are considered and weighed, with the FRC making the ultimate decision on the proposal based on a cost/benefit analysis.⁹⁸ For example, the FRC recommendations in “The impact and implementation of the UK Corporate Governance and Stewardship Codes” in 2012 were based on the findings of the Kay Review (see above) and Lord Sharman’s review of how companies assess their going-concern status. Considerations of the review

⁸⁵ As of 15 November 2016: UK Parliament, “Corporate Governance inquiry - publications”: Available at <https://www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/inquiries/parliament-2015/corporate-governance-inquiry/publications/> (visited 19 Nov 2016)

⁸⁶ FSMA, s73(2)(c)

⁸⁷ FSMA, s14(4)

⁸⁸ Information gathering powers, Part XI

⁸⁹ FRC, “The FRC and its Regulatory Approach,” (January 2014), 10

⁹⁰ FRC, “Codes & Standards Committee: procedures”: Available at <https://www.frc.org.uk/About-the-FRC/Procedures/FRC-Codes-and-Standards-procedures.aspx> (visited 18 Nov 2016)

⁹¹ *Ibid*

⁹² *Ibid*

⁹³ *Ibid*

⁹⁴ *Ibid*

⁹⁵ *Ibid*

⁹⁶ *Ibid*

⁹⁷ *Ibid*

⁹⁸ *Ibid*

covered remuneration and wider concerns of CG in the banking sector. The FRC undertook analysis of overall compliance rates with code requirements, diversity on boards, reporting by listed companies, stewardship and engagement take-up rates, voting levels, and barriers to engagement.

Exchanges

Following the creation of the UK Listing Authority (UKLA) (now subsumed by the FCA), the LSE does not perform a significant role in policy development as regards CG.

Other bodies

Institutional investors in the UK include investment firms, pension funds, and insurers such as the Association of British Insurers (ABI). The ABI has published "Improving Corporate Governance and Shareholder Engagement" (July 2013) which focuses on areas such as, *inter alia*, INEDs, voting, AGMs, resolutions, and shareholder rights. It was part of a working group with the Investment Management Association (IMA) and the National Association of Pension Funds (NAPF), which published "Collective Engagement Investor Exchange" in February 2014 that covered, among other things, board composition, remuneration, accounting, and audit. In response to perceived shortcomings in shareholder engagement (see Appendix II.1), the ICSA has issued the "Consultation paper on improving engagement practices between companies and institutional investors".

A wide range of persons respond to requests for evidence in connection with commission enquiries, including regulatory agencies (such as the FCA, PRA and FRC), accounting firms, law firms, pension funds, ABI, Association of Chartered Certified Accountants (ACCA), Association of Corporate Treasurers, Association of Private Client Investment Managers and Stockbrokers, hedge funds, investment banks, Financial Services Consumer Panel, Institute of Business Ethics (IBE), IoDs, Institute of Chartered Accountants for England and Wales, ICSA, International Securities Lending Association, IMA, LSEG, NAPF, Network for Sustainable Financial Markets, the Takeover Panel, UK ShareSoc, UK Shareholders Association, UK Sustainable Investment and Finance and academics.

II.2.2 Periodic reviews

When the House of Commons' Select Committees conduct CG reviews in an *ad hoc* manner, usually in response to public incidence or issue, a review of the proposed changes may be undertaken by relevant regulatory agencies.

The FRC releases an annual review that reports on "Developments in Corporate Governance and Stewardship" which assesses and identifies CG and stewardship matters requiring improvement. It evaluates compliance rates, looks to explanations under the comply or explain regime, analyses the development of CG issues, and outlines future directions. The Annual report is also useful in providing a snapshot of important features, developments or shortfalls of CG in the UK at different periods. For example, the inclusion of stewardship as a major development in the annual report has only occurred since 2014. The 2015 report focused on the quality of compliance with UK CG Code and the Stewardship Code as well as engagement between companies and shareholders, and indicated to the market where the FRC would like to see changes in CG behaviour or reporting.⁹⁹ The 2016 report draws a direct link between CG standards in the UK and the ability of the UK market to attract capital. It also illustrates the feedback between the FRC and the government. For example, noting that there is less support for resolutions on remuneration and a lack of transparency on executive pay and its link with corporate performance, the FRC has invited the government to bring greater focus to this issue.

⁹⁹ FRC, (Jan 2016) op. cit.

Also in 2016, the FRC published "Corporate culture and the role of boards: A report of observations" and this has been discussed in Appendix II.1.

In contrast, the FCA reviews CG on an *ad hoc* basis.

In Hong Kong, the regulators do not issue any specific assessments of CG performance or developments, although they may do so on an *ad hoc* basis. Material published by the SFC (such as its Annual Report or other research material published on an *ad hoc* basis) or the SEHK may include information on CG, such as rates of compliance with CG Code in appendix 14 of the MBLR.

Appendix II	3. Legislation	II.3 United Kingdom
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Introduction

A number of major milestones in recent times have impacted on the UK's CG system. In 2000, FSMA created the Financial Services Authority (FSA), which was later replaced by the FCA as a result of changes made pursuant to the Financial Services Act 2012 that introduced, in 2013, a twin peaks model of regulation. The function of listing regulation that had at first been moved to the UKLA within the FSA, has since been absorbed into the FCA. The CA 2006 introduced a number of changes including the codification of the general duties of directors including those of a fiduciary nature, and laid the groundwork for the introduction of the strategic report and narrative reporting that was later introduced in 2013. These developments represent significant changes to the legal and regulatory infrastructure that impact on the establishment, monitoring and enforcement of CG standards in the UK. While in recent times the UK has been subject to European Union (EU) directives¹⁰⁰ that explicitly bind the UK to the EU's CG framework, the UK is presently in the midst of exiting the EU. This is not expected to have any notable negative impact on the importance attributed to CG in the UK.

Historically, Hong Kong's framework for CG has substantially followed that of the UK, with a similar regulatory architecture. However, the structural changes in the UK since the early 2000's have given rise to important differences, notably, the UK's adoption of a twin peaks model of regulatory architecture, and the creation of regulatory bodies, the FCA and the FRC, with powers to make rules that, while not amounting to legislation, nevertheless have a clear statutory backing as regards the rights, remedies and sanctions where such rules are breached that extend beyond merely administrative orders. This is distinct from the Hong Kong model where breaches of non-statutory regulatory codes such as those issued by the HKEX or SFC are not regarded as having statutory backing resulting in a narrower range of sanctions being available in respect of breaches. For this reason, the rules having statutory backing are discussed in Appendix II.3.3 below (rather than Appendix II.4 which deals with regulations not having statutory backing). It may also be noted here that the UK model is also distinct from that seen in the United States where rules made by the Securities and Exchange Commission (SEC) do have the standing of regulatory law, the United States equivalent of subordinate legislation in the UK (see Appendix III.3). Similar to UK statutory-backed rules, regulatory law may or may not provide rights to persons to bring an action in respect of breaches of the same.

Notable changes to CG requirements were also made on 6 April 2010 when issuers that previously had a primary listing on the LSE became known as a Premium Listing and those with a secondary listing became known as a Standard Listing.

II.3.1 Primary legislation

There are two main pieces of primary legislation that are of importance to CG in the UK: the CA 2006 and the FSMA, as amended by the Financial Services Act 2012 and the Bank of England and Financial Services Act 2016. Whereas the CA 2006 sets, *inter alia*, an overarching CG framework for all companies operating in the UK, the FSMA makes provision for regulatory agencies to promulgate CG rules that apply to the issue and listing of securities.

¹⁰⁰ Article 288, Consolidated Version of the Treaty on the Functioning of the European Union 2012

Breaches of CG standards and expectations can also involve a number of different types of offences sourced from an array of statutes (which are not discussed further herein), for example:

fraud - Fraud Act 2006 and Theft Act 1968;

bribery - Bribery Act 2010;

insider dealing and market abuse - section 52 of the Criminal Justice Act 1993, Part 7 of the Financial Services Act 2012 (see the discussion of section 89 misleading statements below), (the civil market abuse regime is governed by Part 8 of the FSMA);

financial record keeping – CA 2006 (e.g. sections 386, 388, 485, 499) and Theft Act 1968.

It may also be noted that, following publication of the so-called Panama Papers in April 2016, the Ministry of Justice in January 2017 launched a public consultation in respect of proposals for the strict liability offence, under section 7 of the Bribery Act 2010, to be extended to other acts of financial crime, such as fraud and money laundering.

Companies Act 2006

The CA 2006 provides an overarching legislative framework for CG in the UK. All companies, both private and public,¹⁰¹ formed and registered under the CA 2006, are subject to the CA 2006.¹⁰² Overseas companies, i.e., those incorporated outside of the UK but registered in the UK are subject to certain provisions of the CA 2006,¹⁰³ including provisions dealing with CG. Part 34 of the CA 2006 explicitly deals with overseas companies.

Parts of the CA 2006 that are highly pertinent to CG are:

Part 3 "A Company's Constitution";

Part 8 "A Company's Members";

Part 9 "Exercise of Members' Rights";

Part 10 "A Company's Directors";

Part 13 "Resolutions and Meetings";

Part 15 "Accounts and Reports";

Part 16 "Audit"; and

Part 42 "Statutory Auditors".

The contents of the Directors' Report is specified in section 417 of the CA 2006 and the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 discussed under Secondary Legislation below.

¹⁰¹ Sections 58 and 59 of the CA

¹⁰² Section 1 (1) of the CA

¹⁰³ Section 1(2) of the CA

Criminal liability can arise in a number of CG-related situations under the CA 2006. For example, a director would be committing an offence where he or she either failed to declare an interest in an existing transaction with the company (section 183), or failed to take reasonable steps to ensure that a directors' report was prepared, and one was not prepared, in respect of a relevant financial period (section 415).

Overall, the CA 2006 bears significant similarities to Hong Kong's Companies Ordinance¹⁰⁴ (CO), the latter historically being derived from the CA 2006 and its antecedents. Hong Kong's first companies ordinance was introduced in 1932 based on the UK Companies Act 1929, with subsequent development in Hong Kong broadly following developments in the UK, albeit subject to a lag.

Nevertheless, there are some interesting divergences between the CA 2006 and the CO as regards CG concerns. A notable variance is the codification of directors' duties. In the UK, sections 170-181 of the CA 2006 have codified the "general duties of directors", which covers not only the duty of care, skill and diligence but also other duties of a fiduciary nature (an approach already adopted in Australia¹⁰⁵). The latter includes the duty to:

- act within powers (section 171);
- promote the success of the company (section 172);
- exercise independent judgment (section 173);
- avoid conflicts of interest (section 175);
- not to accept benefits from third parties (section 176); and
- declare an interest in a proposed transaction or arrangement (section 177).

In Hong Kong, the Standing Committee on Company Law Reform's (SCCLR) conclusion in its 2001 Corporate Governance Review¹⁰⁶ that codification was unnecessary largely prevailed during the rewrite of the legislation leading to the present CO with the exception that the duty of care, skill and diligence of directors is now codified in section 465 of the CO, which has been modeled on section 174 of the CA 2006.¹⁰⁷ This duty applies to both executive directors and NEDs equally. However, what is required of different directors will vary according to both the functions carried out by a director and what is reasonably expected in relation thereto¹⁰⁸ as well as the particular individual's knowledge, skill and experience.¹⁰⁹

On the other hand, the CA 2006 is less stringent than the CO as regards director disclosures of a material interest in company transactions, arrangements and contracts – whereas both the CA 2006 and the CO require disclosure of the director's direct and indirect interests, the CO but not the CA 2006 requires directors and shadow directors of public companies to disclose the interests of any entity connected with the director or any shadow director.¹¹⁰ This reflects particular cultural and market characteristics of Hong Kong, namely considerable interconnectedness, often complex and convoluted,

¹⁰⁴ Cap. 622

¹⁰⁵ Corporations Act 2001 (Cth of Aust), sections 180-183

¹⁰⁶ SCCLR, *Corporate Governance Review: Consultation Paper on Proposals Made in Phase I of the Review* (2001) at paras 6.13-6.14

¹⁰⁷ FSTB, *Rewrite of the Companies Ordinance – Company Names, Directors' Duties, Corporate Directorship, Registration of Charges: Consultation Paper* (2008)

¹⁰⁸ Per section 465(2)(a) of the CO

¹⁰⁹ Per section 465(2)(b) of the CO

¹¹⁰ Cf sections 536(2) and 540 of the CO with sections 177 and 182 of the CA

among family controlled and other dominant shareholders of listed companies. However, as discussed in Appendix II.1.2, changes made to the UK listing rules in 2014 have sought to capture connectedness by widening the definition of the controlling shareholder and their associates.

It is also notable that section 172 of the CA 2006 requires directors to promote the success of the company. This is absent in Hong Kong's CO, although the directors' report is required to explain in the business review the key relationships (such as employees, customers and suppliers) on which the company's success depends.

The CA 2006 also contains a number of provisions that reduce the filing and reporting requirements for smaller and medium-sized firms.¹¹¹ The FRC also adjusts the requirements for smaller companies. Many of these provisions are to be found in subsidiary legislation that are made pursuant to the CA 2006 and enforced by the FRC.¹¹²

Financial Services and Markets Act 2000

FSMA covers any share listing or issue of securities by public and private companies to shareholders and investors.

Following the GFC, FSMA was amended by the Financial Services Act 2012 to create the PRA and the FCA, implementing a so-called "twin peaks" model of financial regulation that organised regulation not along sectoral business lines but along the axes of conduct, for which the FCA is responsible, and prudential regulation or systemic risk, for which the PRA – the BoE - is responsible. This is fundamentally different from the regulatory architecture of Hong Kong, which remains a mix of sectoral (banking, securities and insurance) and institutional (banks) structure.¹¹³

Part VI of the FSMA empowers the FCA to make listing rules that apply to all listed companies unless a waiver for a rule is obtained from the FCA.¹¹⁴ Because the FSMA provides for, inter alia, compensation for affected persons¹¹⁵ and penalties that may be imposed by the FCA¹¹⁶ where an issuer has breached the listing rules, it is said that the listing rules have statutory backing. However, this does not give the listing rules themselves the status of legislation or subsidiary legislation. The listing rules are discussed in Appendix II.3.3.

The amendments to FSMA made by the Financial Services Act 2012 also strengthened the investigatory, disciplinary, and enforcement powers given to the FCA in respect of listed issuers (the FCA also absorbing the UKLA previously under the now defunct FSA). It also introduced to FSMA section 890 "Corporate Governance Rules" which empowers the FCA to make CG rules relating to any EU obligations for issuers admitted to listing in the UK.

FSMA makes provision for the regulation of financial services and markets including rule-making powers under Part X. Sections 96A and 96B cover disclosure requirements and rules, with Part XXIII explaining the regulatory authorities' disclosure powers. Part XI provides authorities with information gathering and investigative powers, Part XXV provides for injunctions and restitution, and Part XXVII lists offences. Part VIII stipulates

¹¹¹ See for example sections 382, 384, 444, 445, 465(3) and 467 of the CA

¹¹² LMCG Regulations; Small Companies and Groups (Accounts and Directors' Report) Regulations 2008

¹¹³ For a discussion, See DW Arner et al "Financial Markets in Hong Kong: Law and practice", OUP, 2016, Chapter 2

¹¹⁴ FCA, "Waivers and modifications": Available at <https://www.fca.org.uk/firms/waivers-modifications> (visited 18 Oct 2016)

¹¹⁵ Section 90 of the FSMA

¹¹⁶ Section 91 FSMA

penalties for market abuse and Part XIV lists disciplinary measures. Auditors' powers are provided for in Part XXII.

The Financial Services (Banking Reform) Act 2013 also amended the FSMA by providing additional conduct provisions, enforcement and investigation powers, disclosure of information requirements, and specifying enforcement and appeals mechanisms. Subsidiary legislation, the Financial Services and Market Act 2000 Regulations, provide additional regulatory detail. For example, the Financial Services and Market Act 2000 (Liability of Issuers) Regulations 2010 elucidates issuers' liability in damages when making disclosures. The Bank of England and Financial Services Act 2016 further strengthens conduct requirements for persons working in the financial services sector.

Whistle-blowing

The Public Interest Disclosure Act 1998 (PIDA) constitutes the UK's whistle-blowing legislation. It makes amendments to the Employment rights Act 1996 that protects employees who make a "qualifying disclosure" in the public interest. CG issues will be covered by PIDA if it involves a failure to comply with a legal obligation to which the person is subject¹¹⁷ – this will therefore cover not only CG matters established under primary legislation, but potentially also many of the detailed CG requirements established by regulatory bodies such as the FCA that have statutory backing. Hong Kong does not have any specific whistle-blowing law, although certain statutes do provide limited protections in relation to persons reporting suspected wrongdoing. Whistle-blowing is further discussed in II.6.8.

II.3.2 Secondary legislation

The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 created separate Directors' Report and Strategic Report in the annual report to replace the existing requirements of the business review, removed some reporting obligations, and required quoted companies to make additional disclosures.¹¹⁸ The Regulations became effective on 1 October 2013. The Strategic Report must contain, *inter alia*, a description of the principal risks and uncertainties facing the company. This is to be a "fair review" and "balanced and comprehensive".¹¹⁹ An important element of the narrative reporting introduced by these Regulations was removing complexity and textual clutter to simplify the reports with a view to giving shareholders the information they need in a clear and effective way.¹²⁰ This has been described as giving shareholders "a holistic and meaningful picture of an entity's business model, strategy, development, performance, position and future prospects".¹²¹ The FRC has issued detailed, albeit non-mandatory and principles-based, guidance on the preparation of the strategic report.¹²²

As noted above, the CA 2006 makes different reporting provisions according to the size of the company. Large and medium-sized companies are subject to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (LMCG Regulations), which mandates the issuing of a CG statement.¹²³ The main requirements of the LMCG Regulations are the Directors' Report and the Directors' Remuneration Report. These requirements are optional for statutorily designated small-sized companies. Directors' Reports are mandatory for medium-sized companies, large-sized companies, and public companies.

¹¹⁷ Section 43B(1)(b) of the PIDA

¹¹⁸ BIS, "Explanatory Memorandum To The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013," (2013), 2.1

¹¹⁹ Sections 417 (3) (a) and (4) of the CA

¹²⁰ BIS Explanatory Memorandum, *op. cit.* section 7

¹²¹ "Guidance on the strategic report", FRC, June 2014, page 3

¹²² *Ibid*

¹²³ The information in the CG statement must conform with Schedule 7

The FRC also issues subsidiary legislation pertaining to reporting requirements: (1) FRS 102 – the Financial Reporting Standard applicable in the UK and Republic of Ireland (September 2015); (2) Financial Reporting Standards for Smaller Entities (January 2015); and (3) FRS 105 - the Financial Reporting Standard applicable to the Micro-entities Regime (July 2015).

II.3.3 Rules with statutory backing

This section takes as its focus regulatory rules that do not amount to either primary or secondary legislation but do have statutory backing. The regulatory bodies holding the powers to make such rules, and the scope and accountability of such powers, are discussed in Appendix II.4, together with Rules or codes that do not have statutory backing.

The FCA has a wide range of powers under FSMA. The FCA Handbook, which contains the listing rules, sets out the relevant provisions the FCA has made. Rules made by the FCA under the FSMA are marked with an “R” icon and are binding – breaches can give rise to an enforcement action (the imposition by the FCA of administrative penalties) and/or a claim for damages (by way of a private civil action).¹²⁴ For this reason, such rules are said to have statutory backing.

Three important sections of the Handbook that impact on CG are:

- the listing rules, which are concerned with admission to the official list and applies to all listed companies unless a waiver for a rule is obtained from the FCA;¹²⁵

- the prospectus rules, which are concerned with public offers of securities; and

- the Disclosure Guidance and Transparency Rules (DTR), which are concerned with aspects of disclosures required by issuers under EU directives and include:

 - the transparency rules,¹²⁶ which are to ensure adequate transparency of and access to information through a regular flow of information to the markets, including financial information, information on major holdings of voting rights and information pursuant to the Market Abuse Directive;¹²⁷ and

 - the corporate governance rules,¹²⁸ which implement matters arising out of or related to any EU law obligation relating to the CG of listed issuers, in particular regarding audit committees, the content of management reports, CG statements¹²⁹ respectively required under the EU Audit Directive¹³⁰ and Accounting Directive.¹³¹

Together, these rules arise from the FCA’s powers under statute and comprise requirements marked with an “R” supported by rules that are for guidance only (marked “G”).

¹²⁴ Civil claims do not affect the penalties that the FCA may separately impose on the issuer or its management

¹²⁵ FCA, Waivers and modifications, op. cit.

¹²⁶ Under sections 73A(1) and 89A of the FSMA pursuant to the Transparency Directive

¹²⁷ (2003/6/EC) (OJ No L 96, 12.4.2003, p. 16). See also DTR 1A.1.3 G

¹²⁸ In accordance with sections 73A(1) and 89O(1) of the FSMA and contained in DTR ch. 1B, 4 and 7

¹²⁹ All listed companies are required to include a CG statement in the directors report - 7.2 R, DTR

¹³⁰ Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts

¹³¹ Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings

The FSMA contains important provisions that attach civil liability to information required to be disclosed either by specific provisions in FSMA¹³² or by rules made by the FCA pursuant to FSMA. The latter is of particular importance as regards CG concerns and is the focus of this section. Section 90 of the FSMA provides that a person who suffers loss as a result of the omission of information required to be disclosed in a listing document by the listing rules made by the FCA under section 80(2) of the FSMA may bring a claim for compensation against “any person responsible” for the listing document. Section 90A of the FSMA extends that liability in respect of misleading statements or dishonest omissions or dishonest delays in publishing such information. This covers “(i) any untrue or misleading statement in that published information, or (ii) the omission from that published information of any matter required to be included in it”¹³³ and can encompass mandatory disclosure requirements set by FCA that are concerned with CG standards. In particular, listing rule 9.8.6 R requires a statement to be made in the annual report how the issuer has applied the Main Principles in the UK CG Code published by the FRC, and whether the issuer has complied with all relevant provisions in that code – where it has not complied it must give reasons. While this does not mandate compliance with the UK CG Code, a failure to make proper disclosure as required by the listing rules may constitute an untrue or misleading statement or an omission of a “matter required to be included” and accordingly could give rise to enforcement or a damages claim.

This may be contrasted with the position in Hong Kong despite having similar regulations as regards both disclosures generally and specific disclosures concerned with CG.

As regards disclosure generally, section 3(c) of the Securities and Futures (Stock Market Listing) Rules¹³⁴ (SMLR) is modelled on section 80(1) of the FSMA, both requiring information enabling an informed investment decision to be made by stipulating that a listing document must:

Section 80 FSMA: “contain all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment of—(a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities; and (b) the rights attaching to the securities”;

Section 3(c) SMLR: “contain such particulars and information which, having regard to the particular nature of the applicant and the securities, is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities and financial position, of the applicant at the time of the application and its profits and losses and of the rights attaching to the securities”.

As regards specific disclosures concerned with CG, listing rule (LR) 9.8.6 R imposes a comply or explain annual disclosure requirement in respect of the UK CG Code¹³⁵ – this is broadly similar to the “comply or explain” requirement in the CG Code in Appendix 14 of the Hong Kong listing rules. However, the UK and Hong Kong CG Codes have been implemented in a different manner and with different effect. The UK CG Code is discussed further in Appendices II.4 and II.7.

The additional disclosures required by LR 9.8.6 R to be provided in the annual report are:

a statement setting out all director interests;

¹³² For example, section 80(1) of the FSMA

¹³³ Section 3(1)(b) of Schedule 10A of the FSMA, as amended by the Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2010

¹³⁴ Cap. 571V

¹³⁵ Chambers, *op. cit.* p 488

- all interests disclosed to the listed company;
- a statement by the directors of the appropriateness of adopting the going concern basis of accounting;
- a statement by the directors of the appropriateness of meeting C.2.2. of the CG Code—sound risk management and internal controls;
- a statement how the company has adopted the main principles of the CG Code;
- a statement to shareholders concerning the company buying its own shares;
- a statement of how the company has complied with all the provisions of the CG Code; and
- a report to the shareholders setting out compliance with LR 9.8.8. R — directors term of tenure.

Despite the apparent similarity of the foregoing UK and Hong Kong disclosure requirements, their legal standing is quite different.

In the UK, because the comply or explain provision has been implemented in the listing rules, a breach thereof can give rise to enforcement and/or a compensation claim under FSMA – but only in respect of the DTR and not for any breach of the UK CG Code itself. The different standing of the SEHK’s listing rules gives an investor no rights to seek compensation in relation to a breach of the comply or explain requirement (or any other provision of the listing rules). In Hong Kong, investors’ statutory rights in respect of disclosure arises in relation to Part XIVA of the Securities and Futures Ordinance¹³⁶ (SFO), but this only concerns a much narrower range of disclosure obligations limited to inside information. There is some case law¹³⁷ in Hong Kong that supports the argument that where investors have not been given the information they would normally expect to receive under the listing rule requirements, then the responsible persons may be liable under section 214 of the SFO, although only the SFC can bring a claim under that section.

The scope of companies required to comply with the UK and Hong Kong CG Codes also differs. In Hong Kong, all issuers, whether listed on the Main Board or on the Growth Enterprise Market, are subject to the CG Code.¹³⁸ However, since the introduction on 6 April 2010 of the UK’s new listing regime, compliance with LR 9.8.6 R depends on whether the issuer has a Premium or Standard listing. Issuers with a Premium Listing, whether incorporated in the UK or overseas,¹³⁹ are required to meet the UK’s “super-equivalent” requirements by adopting the UK’s highest standards of CG.¹⁴⁰ They will need to comply with LR 9.8.6 R and this requires issuers to apply the UK CG Code’s Main Principles and to report to shareholders how they have done so, and to adopt a comply or explain approach as regards all the provisions of the UK CG Code. Issuers with Standard Listings can opt out of LR 9.8.6 R, but nevertheless must prepare a CG

¹³⁶ Cap. 571

¹³⁷ *Wong Shu Wing and Another* [2013] HKCFI 2302; HCMP 1831/2010 (20 March 2013); *SFC v. Kenneth Cheung Chi Shing And Others* [2012] HKCFI 312; [2012] 2 HKLRD 325; HCMP 1702/2008 (7 March 2012) HCMP 1702/2008

¹³⁸ MBLR Appendix 14 and GEMLR Appendix 15, respectively

¹³⁹ LR, 9.8.7

¹⁴⁰ LSE, “Listing Regime”: Available at <http://www.londonstockexchange.com/companies-and-advisors/main-market/companies/primary-and-secondary-listing/listing-categories.htm> (visited 22 Oct 2016)

statement (this does not have to comply with the CG Code).¹⁴¹ Both Premium and Standard Listings are required to comply with EU minimum requirements.

II.3.4 Non-locally incorporated companies

Part 34 of the CA 2006 explicitly deals with overseas companies, defined as those companies incorporated outside of the UK,¹⁴² and contains specific provisions for: (1) accounts and reports; (2) trading disclosures; (3) offences; (4) and general disclosures required to be made under subordinate legislation made by the Secretary of State.

Section 195 of the FSMA empowers the FCA to exercise power in support of an overseas regulator. The exercise of this power is described in section 55Q of the Financial Services Act 2012, which includes the FCA acting on its own initiative or in accordance with a request of the overseas regulator.

Overseas companies that wish to list in the UK must apply to the FCA to be included on its list of company securities officially listed in the UK (the Official List). The Official List consists of Standard Listings and Premium Listings, which have different CG requirements.

If a listing rule applies to a UK incorporated company, then in accordance with LR 1.4.2. R, a listed overseas company must also comply with the requirement in so far as information available to it enables it to do so, and compliance is not contrary to the law in its country of incorporation.¹⁴³ Where applicable, a listed overseas company must, if required by the FCA, provide a letter from an independent legal adviser explaining why compliance with LR 1.4.2 R is contrary to the law of its country of incorporation.¹⁴⁴ Whereas DTR 7.2 only requires UK incorporated companies to provide CG statements, LR 9.8.7A R extends this to overseas companies that have securities admitted to the official list, save for companies that are required to comply with similar provisions imposed by a European Economic Area country.¹⁴⁵

Different CG disclosure requirements

As noted above, since the new listing regime was introduced in April 2010, the rules that apply to overseas companies vary according to which type of listing they have. LR 9.8.6 R now imposes a comply or explain annual disclosure requirement in respect of the UK CG Code according to the type of listing (Premium or Standard¹⁴⁶) and irrespective of whether the company is incorporated in the UK or overseas.¹⁴⁷ Prior to the change, overseas companies did not have to comply with LR 9.8.6 R as the rule only applied to UK incorporated companies.¹⁴⁸ At that time, only 45 out of 171 overseas companies that had a primary listing opted to voluntarily comply with the UK CG Code.¹⁴⁹ This contrasts with the SEHK CG Code, which applies to all companies irrespective of place of incorporation, although breaches of the comply or explain requirement do not give rise to damages claims or administrative fines.

¹⁴¹ Chambers, op. cit. p 489

¹⁴² Section 1044 of the CA

¹⁴³ LR, 1.4.2. R

¹⁴⁴ LR, 1.4.3. R

¹⁴⁵ DTR, 1B.1.5 A

¹⁴⁶ Premium and Standard Listings are available for both UK and overseas incorporated companies

¹⁴⁷ Chambers, op. cit. p 488

¹⁴⁸ Ibid

¹⁴⁹ Ibid

Appendix II	4. Regulation	II.4 United Kingdom
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Introduction

As discussed in Appendix II.3, the UK is characterised by a system in which laws give powers to regulatory agencies to make rules that have a measure of statutory support, notably the FCA and, to a lesser extent as regards specific CG requirements other than as related to financial disclosure, the FRC. Both bodies are central to the furtherance of CG standards in the UK and both issue guidance on matters of importance, often expressed on a high-level principles basis. While regulatory coordination and clarity is reasonably good, the system is nevertheless prone to complexity and suffers from a degree of regulatory overlap insofar as a requirement in one set of regulations may refer to another, which itself may be supported by guidance, each level of which may have a different legal standing, and different legal consequences upon breaching them. The forthcoming exit from the UK will undoubtedly add, at least during an interim period, further complexity owing to the large number of requirements that are imposed by, or cross-referenced to, EU directives or regulations.

II.4.1 Regulatory agencies

Financial Conduct Authority

The FCA's regulatory powers are sourced from FSMA, as amended by the section 16 of the Financial Services Act 2012 following the devolution of powers from the now defunct FSA. Treasury can also delegate powers to the FCA under Part VI to the FCA.¹⁵⁰

The FCA is an independent public body that regulates financial services markets, stock exchanges, and it is the supervisor and prudential regulator of securities issuers.¹⁵¹ As the regulator for all financial services providers, it regulates approximately 56,000 firms.¹⁵² It has extensive powers under Part 5 of the FSMA in relation to intermediary conduct, similar in breadth and scope as the SFC has under part VII of the SFO in respect of intermediaries. As an independent public body, the FCA is funded by the firms it regulates and is accountable to the Treasury.¹⁵³

The FCA's role in regulating initial public offerings (IPOs) and listed companies is primarily sourced from Part VI of the FSMA. Statutory powers to make listing rules are conferred on the FCA under section 74(4) of the FSMA. FSMA also empowers the FCA to make: rules (section 73A), statements and codes (sections 64 and 119), and guidance (section 139B (5)). The FCA's statutory role is to: (1) make listing rules;¹⁵⁴ (2) review and approve prospectuses and monitor market disclosures; (3) maintain an official list of companies listed on the Exchange;¹⁵⁵ (4) appoint a competent person to conduct an investigation on its behalf for breaches of the listing rules;¹⁵⁶ (5) take action for non-compliance of the listing rules;¹⁵⁷ (6) issue penalties for breaches of the listing rules;¹⁵⁸

¹⁵⁰ FSMA, Schedule 8, s 2(2)

¹⁵¹ FCA, "Markets,": Available at <https://www.fca.org.uk/about/the-fca> (visited 4 Nov 2016)9

¹⁵² FCA, "About the FCA,": Available at <https://www.fca.org.uk/about/the-fca> (visited 5 Nov 2016)

¹⁵³ Ibid

¹⁵⁴ Section 73A of the FSMA

¹⁵⁵ Sections 74 and 75 of the FSM

¹⁵⁶ Section 97(2) of the FSMA

¹⁵⁷ Section 96 (1) (b) of the FSMA

¹⁵⁸ Section 91 of the FSMA

(7) have the power to discontinue or suspend a listing,¹⁵⁹ and (8) provide written notice of a suspension or delisting.¹⁶⁰

Supervision, monitoring, and enforcement powers (subject to Part XIV of the FSMA) are provided under the Financial Services Act 2012, section 1L. Information gathering and investigatory powers are in Part XI and section 97 (in relation to Part VI function) of the FSMA and Part 5 of the Financial Services Act 2012. Offences such as misleading statements are listed in Parts 6 and 7 of the Financial Services Act 2012 and section 397 of the FSMA. The FCA's disciplinary powers are sourced from Part XIV of the FSMA. Penalties for market abuse are provided for in Part VIII of the FSMA. The FCA's conduct powers and functions also encompass the codes, for example, the FCA requires UK authorised asset managers to report on whether they comply with the Stewardship Code.¹⁶¹

Under Part VI of the FSMA, the FCA's regulatory objectives are the protection of investors, access to capital, and investor confidence.¹⁶² The FCA's operational objectives include the consumer protection objective, the integrity objective, and the competition objective.¹⁶³ The integrity objective includes, *inter alia*, protecting and enhancing the integrity of the UK financial system by not being affected by behaviour that amounts to market abuse.¹⁶⁴ This is supported by the consumer protection objective, which, among other things, ensures that consumers have timely provision of information and advice that is accurate and fit for the purpose.¹⁶⁵

The FCA operates a number of committees. These include a non-statutory Listing Authority Advisory Panel, which consists predominantly of industry practitioners. Its role is to advise the FCA on policy issues that affect the issuers of securities, and on policy and regulatory proposals attributable to the FCA's listing functions.¹⁶⁶

These arrangements are broadly similar to the statutory creation of and powers given to the SFC. A notable difference is the roles of the two regulators in relation to listed companies. Whereas the FCA's powers encompass the promulgation of the listing rules and applying administrative sanctions (including fines) in respect of breaches thereof, in Hong Kong the listing rules are prepared by the SEHK, albeit subject to the approval of the SFC and the SFC's statutory power to direct the SEHK to amend or insert listing rules – a power not used by the SFC. In contrast to the FCA's enforcement rights over listed issuers, the SFC does not have powers over listed issuers in respect of breaches of the listing rules, and is instead, limited to powers provided under the SMLR concerning, *inter alia*, false or misleading disclosures and taking action under the SFO in relation to matters such as director misfeasance or misconduct, or statutory disclosure irregularities.

Reflecting the above distinction, the SFC does not operate any equivalent to the FCA's Listing Authority Advisory Panel – that practitioner-led regulatory role is instead undertaken by the Listing Committee which is an independent sub-committee of the SEHK board comprised of market practitioners.

Significant investment banks are regulated by the PRA (see below).

¹⁵⁹ Sections 77 and 78 of the FSMA

¹⁶⁰ Section 78 of the FSMA

¹⁶¹ FRC, "Corporate Governance and Stewardship," Available at <https://www.frc.org.uk/Our-Work/Corporate-Governance-Reporting/Corporate-governance.aspx> (visited 2 Nov 2016)

¹⁶² FCA, "The Enforcement Guide," (2014) *Appendix to the Guidelines on Investigation of Cases of Interest or Concern to the Financial Conduct Authority and Other Prosecuting and Investigating Agencies*, 1.1.

¹⁶³ Financial Services Act 2012, section 1B (3)

¹⁶⁴ Financial Services Act 2012, section 1D (2) (c)

¹⁶⁵ Financial Services Act 2012, section 1C (2) (c)

¹⁶⁶ FCA, "Listing Authority Advisory Panel," Available at <https://www.fca.org.uk/about/uk-regulators-government-other-bodies/listing-authority-advisory-panel> (visited 4 Nov 2016)

Financial Reporting Council

The FRC is the audit, accounting, and financial reporting regulator, deriving substantial powers to regulate auditors primarily from the CA 2006 but also from the FSMA. In this role the SFC sets (1) financial reporting and auditing standards and regulations; (2) supervises, monitors and enforces corporate reporting;¹⁶⁷ and (3) enforces suspension orders and compliance notices, and determines sanctions.¹⁶⁸

In addition to the FRC's responsibilities in relation to audit regulation,¹⁶⁹ the FRC's Conduct Committee has issued the Operating Procedure for reviewing corporate reporting (2014). It also identifies and assesses CG and reporting risks (current, emerging and potential) and approves action to mitigate those risks.¹⁷⁰

Importantly for CG purposes, these functions include ensuring that the provision of financial information, including directors' reports by public and large private companies and their accounts are not defective, and monitoring compliance with accounting requirements of the listing rules by issuers and listed securities.¹⁷¹

In terms of wider CG issues, the FRC's mission is to promote high standards of behaviour for boards and reporting to foster investment,¹⁷² however, its powers in this regard are limited.¹⁷³ It publishes and monitors the implementation of the UK CG Code and Stewardship Code (and associated guidance¹⁷⁴), neither of which have statutory backing and are purely voluntary. However, as noted in Appendix II.3, the UK CG Code does have a measure of support via the mandatory disclosure obligations imposed upon Premium Listings (but not Standard Listings) in the listing rules that cover the UK CG Code.

The FRC broadly describes its core functions and powers in terms of promoting trusted behaviour and information by:

"monitoring the quality of accounts published by public companies in line with the legal framework including accounting standards and the overriding requirement to give a true and fair view; making clear our expectations of how companies and other entities should approach financial reporting and regularly highlighting the matters we regard as particularly important;

"monitoring and reporting publicly on the quality of the audit of listed and other major public interest entities and the policies and procedures supporting audit quality at the major audit firms in the UK and determining proportionate sanctions where necessary; and highlighting key messages on audit quality for audit firms and audit committees; and

"oversight of the regulatory activities of the accountancy and actuarial professional bodies and through our own independent disciplinary arrangements for public interest cases involving accountants and actuaries, as well as by cooperating with other bodies – such as the PRA, the FCA and the Pensions Regulator – which rely on the professionalism of their work."¹⁷⁵

¹⁶⁷ FRC, "About the FRC,": Available at <https://frc.org.uk/About-the-FRC.aspx> (visited 1 Nov 2016)

¹⁶⁸ See generally: CA, Chapter 3; and Companies (Audit, Investigations and Community Enterprise) Act 2004

¹⁶⁹ FRC, "The FRC and its Regulatory Approach," (2014), op. cit. 6

¹⁷⁰ Ibid

¹⁷¹ CA, sections 456 and 457. See also FRC, (2014) op. cit. 12

¹⁷² FRC, (2014) op. cit. 1

¹⁷³ Chambers op. cit. p 497

¹⁷⁴ FRC, (2014), op. cit 13

¹⁷⁵ See generally: FRC, (2014) op. cit. 2

The FRC's specific functions¹⁷⁶ include: (1) issuing accounting standards and provisions,¹⁷⁷ external auditing standards,¹⁷⁸ reporting provisions,¹⁷⁹ and external auditing guidance;¹⁸⁰ (2) providing independent oversight of the regulation of the auditing and accounting professions by recognised supervisory and qualifying bodies;¹⁸¹ (3) monitoring the quality of audits of economically significant entities;¹⁸² (4) regulating and registering third country auditors;¹⁸³ (5) determining auditor sanctions;¹⁸⁴ (6) monitoring compliance with accounting requirements of the listing rules;¹⁸⁵ (7) ensuring that company accounts are not defective;¹⁸⁶ and (8) providing an independent and disciplinary scheme for matters relating to accountancy professional bodies.¹⁸⁷ Some of the FRC's powers have no statutory backing but derive their authority from voluntary arrangements via Memoranda of Understanding (MoU) with stakeholders.¹⁸⁸

UK Corporate Governance Code:

The FRC first issued the UK CG Code in 1992. As noted in Appendix II.3, since 2011 the FRC has been publishing an annual report on the implementation of the UK CG Code and Stewardship Code and related developments. The FRC also publishes guidance to boards to assist them in considering how to apply the Codes to their particular circumstances. There are different items of guidance addressing board effectiveness, the role of audit committees and risk management, internal control, the going concern basis of accounting and the board's longer-term viability statement.

Non-compliance with the UK CG Code does not directly give rise to any legal consequences – only if a company with a Premium Listing does not properly disclose its compliance or non-compliance with the Code can there be consequences under the FCA's listing rules including enforcement action or claim for damages.

Since 2008 the CG Code has been revised five times, with the latest being in 2016. Over this period a number of important revisions have been developed in the Code including the following:

- provisions on the design of performance related remuneration (2008);
- guidance on liability of NEDs: care, skill, and diligence (2008);
- disclosure of CG arrangements (2008);
- frequency of director re-elections (2010);
- boardroom diversity (2010);
- external facilitation of board effectiveness reviews (2010);

¹⁷⁶ See generally: FRC, (2014) op. cit. Annex A

¹⁷⁷ Financial reporting or accounting standards: CA, sections 464 and 468

¹⁷⁸ In accordance with its powers in the CA, Schedule 10

¹⁷⁹ Section 468 of the CA

¹⁸⁰ CA, Schedule 10 op. cit.

¹⁸¹ The auditing profession: see generally, CA, Chapter 6; and the accounting profession: see generally, CA, Schedule 10

¹⁸² See generally, CA, Schedule 10

¹⁸³ See generally, CA, Chapter 5

¹⁸⁴ See generally, CA, Schedule 10

¹⁸⁵ Companies (Audit, Investigations and Community Enterprise) Act 2004, section 14

¹⁸⁶ FRC, (2014) op. cit. 12. This refers to sections 456 and 457 of the CA

¹⁸⁷ See generally, CA, Schedule 10

¹⁸⁸ See generally: FRC, (2014) op. cit. 3

report on the company's business model (2010);

board's responsibility for risk (2010);

remuneration (2010);

use of company websites (2010);

FTSE350 companies are to tender external audits (2012);

audit committees to explain to shareholders how they have carried out their responsibilities (2012);

boards to confirm that the annual report and accounts are fair, balanced, and understandable (2012);¹⁸⁹

companies to explain and report on policies of boardroom diversity (2012);

full explanations to shareholders if the company does not follow the CG Code (2012);

designing remuneration policies for the long-term success of the company (2014);

policies to defer, recover, or withhold variable pay (2014);

when a significant percentage of shareholders have voted against a resolution, companies should give an explanation when publishing AGM results (2014);

state whether it is appropriate to adopt going concern accounting and identify material uncertainties to their ability to continue doing so (2014);

assess principle risks and explain how they are being managed and mitigated (2014);

state whether the company believes that they will be able to continue in operation and meet their liabilities over a period greater than 12 months (2014);

monitor risk management and internal control systems at least annually and carry out reviews of effectiveness that are included in the annual report (2014); and

incorporating new statutory auditing standards, including ethical standards, monitoring and enforcement.¹⁹⁰

In 2016 the FRC stated that, with the exception of minor changes to reflect the EU Audit Regulation, it does not plan to amend the UK CG Code until 2019.¹⁹¹

¹⁸⁹ FRC, "FRC Publishes updates to UK Corporate Governance Code and Stewardship Code,": Available at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-publishes-updates-to-UK-Corporate-Governance-C.aspx> (visited 30 Nov 2016)

¹⁹⁰ Ibid. See also FRC, "Consultation on the UK Corporate Governance Code published,": Available at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/Aprilr/Consultation-on-the-UK-Corporate-Governance-Code-p.aspx> (visited 30 Nov 2016)

¹⁹¹ FRC, "Quality of corporate governance in the UK remains high" PN 03/16, 14 January 2016: Available at <https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/January/Quality-of-corporate-governance-in-the-UK-remains.aspx> (last visited 18 March 2017)

Overall, the UK CG Code and the equivalent code in Hong Kong, set out in Appendix 14 of the SEHK's LR, largely deal with the same issues. Appendix II.7 discusses the main provisions of the UK CG Code relevant to the present study, with a focus on some of the differences of interest.

The FRC also issues guidance on certain sections of the CG Code including, *inter alia*:

Guidance on Audit Committees 2016;

Guidance on risk management, internal control and related financial and business reporting 2014 – this is expressly referred to in 9.8.6(3) R dealing with director statements, again giving the relevant provisions a measure of support;

Guidance on the Strategic Report 2014; and

Guidance on Board Effectiveness 2011.

Stewardship Code:

The UK Stewardship Code, first published in July 2010, is a voluntary set of principles to assist institutional investors in the exercise of their stewardship responsibilities towards UK listed companies.¹⁹² It was revised in 2012 and included the following changes:

clarification of responsibilities of asset managers and asset owners and for stewardship activities that they outsource (2012);¹⁹³

investors to explain more clearly how conflicts of interest are managed, circumstances of collective engagement, and the use of proxy voting agencies (2012);¹⁹⁴ and

asset managers are encouraged to have the processes of their stewardship activities independently verified (2012).¹⁹⁵

Exchange

The LSE (for more details on the LSE's status, see Appendix II.1 above) is a recognised investment exchange pursuant to Part XVIII of the FSMA, which ensures that securities admitted to trading on its markets, and all dealings in those securities, are conducted in accordance with primary and secondary market obligations (i.e. FCA Sourcebook for Recognised Exchanges).¹⁹⁶ It regulates listed companies' compliance with, *inter alia*, the Admissions and Disclosure Standards (2016). The LSE administers official listing status, Exchange rules and standards, issues notices for: (1) rule updates, (2) consultations, and (3) proposed rule changes; and (4) issues compliance guidance.¹⁹⁷ The LSE is regulated by the FCA.

On 6 April 2010, the UK introduced a new listing regime categorised as Premium and Standard Listings. Companies that previously had a primary listing on the LSE became known as a Premium Listing and those with a secondary listing became known as a Standard Listing.

¹⁹² FRC, "UK Stewardship Code" (2012), 1: Available at <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx> (visited the 30 Nov 2016)

¹⁹³ FRC, Publishes updates op. cit.

¹⁹⁴ Ibid

¹⁹⁵ Ibid

¹⁹⁶ LSE, "Admissions and Disclosure Standards," (July 2016), 10

¹⁹⁷ LSE, "Stock Exchange Notices and Guidance": Available at <http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/updatesguidance.htm> (visited 22 Nov 2016)

A Premium Listing is a prerequisite for listing on the Financial Times Stock Exchange (FTSE) indices and is, therefore, mandatory for both UK and overseas incorporated FTSE listed companies.¹⁹⁸

Under the new regime the Standard Listing designation is open to all companies, including UK incorporated companies, regardless of domicile.¹⁹⁹ LR Chapter 14 applies to all Standard Listing shares.

Overall, a company with a Standard Listing bears a lighter compliance burden. The table²⁰⁰ below shows some key differences between a Premium and Standard Listing:

Key continuing obligations	Premium Listing – Equity Shares	Standard Listing – Shares
UK CG Code	Comply or explain	N/A, voluntary
Pre-emption rights	Required	As required by relevant company law
Significant transactions	Rules apply	N/A
Related-party transactions	Rules apply	N/A

Smaller size companies:

Smaller and growing companies can apply for listing on the AIM. The CG Code does not apply to companies listed on AIM. CG guidance is provided nonetheless by the Quoted Companies Alliance’s (QCA) “Corporate Governance Code for Small and Mid-Size Quoted Companies” (QCA CG Code) and “Corporate Governance Guidelines for Smaller Quoted Companies” which both apply key elements from the CG Code.²⁰¹

PRA

The PRA is a part of the BoE, created by the Financial Services Act 2012, which is responsible for the prudential regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms.²⁰² The PRA’s specific regulatory objectives are (1) market confidence, (2) financial stability, (3) the protection of consumers, and (4) the reduction of financial crime.²⁰³ While its primary focus is on prudential concerns not specifically CG, poor CG can of course give rise to prudential concerns. Accordingly, its PRA Rulebook is concerned with audit committee and auditor requirements and specific CG requirements are set out in the PRA’s Remuneration Code.

Powers and functions of PRA are set out in the Financial Services Act 2012 and the FSMA. Its general objective is to promote the safety and soundness of PRA-authorized persons²⁰⁴ through setting and supervising standards and policies that influence the firm’s CG.²⁰⁵ For example, the PRA’s Remuneration Code describe the standards that banks, building societies, and major investment firms must comply with when setting

¹⁹⁸ Chambers, op.cit. p 489

¹⁹⁹ LSE, “Listing Regime” op. cit.

²⁰⁰ LSE, “A guide to listing on the London Stock Exchange” (2010), op. cit. 18

²⁰¹ LSE, “Corporate Governance for Main Market and AIM Companies,” (2012): Available at <http://www.londonstockexchange.com/companies-and-advisors/aim/publications/documents/corpgov.pdf> (visited 24 Oct 2016)

²⁰² BoE, “Prudential Regulatory Authority,”: Available at <http://www.bankofengland.co.uk/pr/Pages/default.aspx> (visited 7 Oct 2016)

²⁰³ Section 2(2) of the FSMA

²⁰⁴ PRA, “Supervisory activities”: Available at <http://www.bankofengland.co.uk/pr/Pages/supervision/activities/default.aspx> (visited 25 Nov 2016)

²⁰⁵ Financial Services Act 2012, s 2B (2)

staffs' pay and bonus awards.²⁰⁶ Furthermore, the firms' planning and risk management processes are shaped by stress and scenario testing, and PRA-related policy, which help identify, analyse, and manage risks.²⁰⁷ Where a firm's activities are a cause for concern, the PRA has the power to commission reports by skilled persons.

The PRA, in collaboration with the FCA, is responsible for financial firm authorisation under the FSMA.²⁰⁸

Unlisted companies

Non-listed or private or limited companies are registered with Companies House, subject to the relevant provisions of the CA 2006, and thus related supervision by the FRC. The IoD publishes the "Corporate Governance Guidance and Principles for Unlisted Companies in the UK" which has set 14 principles that provide guidance on CG to directors and company secretaries of non-listed companies.²⁰⁹ This constitutes non-statutory, voluntary guidance and, therefore, is not subject to investigation or enforcement.

Whistle-blowing

As mentioned in Appendix II.3.1, listed companies that breach the FCA's statutorily backed listing requirements may be subject to PIDA. Firms authorised by the FCA or subject to the oversight of the PRA are, therefore, subject to rules on PIDA issued by those bodies, implemented in stages during 2016.

The PRA and FCA have put in place rules and guidance regarding whistle-blowing but neither apply to listed issuers. They only extend to authorised firms, certain UK deposit takers, PRA-designated investment firms, and certain insurance and reinsurance firms. Other authorised firms are to read the rules merely as non-binding guidance - however, the FCA has indicated an intent to extend the rules to other authorised firms in the future.

The rules require firms to put in place whistle-blowing policies and procedures that are overseen by a senior manager and to inform UK-based employees about the PRA and FCA whistle-blowing services. In addition, a whistle-blowing report must be provided annually to the board. Systems and Controls (SYSC) chapter 18 of the FCA Handbook provides guidance on the PIDA and includes suggested internal controls that may be undertaken by different size firms. An important underlying element in the guidance is culture: setting a tone that the firm takes failures seriously due to its consequences to the organisation and adopting appropriate consequence management measures. The FCA has also indicated that the fitness and properness of authorised firms would be called into question where it was established they had acted to the detriment of a worker who had blown the whistle.

The whistle-blowing services put in place by the FCA and the PRA are active. The FCA reported 1,340 whistle-blowing cases in its 2014-2015 annual report, an increase of 28% from the prior year.

The Chartered Institute of Internal Auditors (CIIA) has drawn to their members' attention the role of internal auditors in whistle-blowing as providing a valuable source of

²⁰⁶ PRA, Supervisory activities, op. cit.

²⁰⁷ PRA, ibid

²⁰⁸ Memorandum of Understanding (MoU) between the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA), 5

²⁰⁹ Steptoe & Johnson LLP, *Corporate governance for UK private and unlisted companies*; Available at <http://www.lexology.com/library/detail.aspx?g=a9de981a-1fbc-49bd-b783-99e283aeb381> (visited on 29 July 2016).

intelligence about the effectiveness of internal controls and the provision of assurance to audit committees and boards.²¹⁰

Whistle-blowing is further discussed in II.6.8.

Other

The CIIA is a professional association for internal auditors in the UK. It is part of Institute of Internal Auditors (IIA Global), a global network of professional bodies that sets standards and guidance for its members, which includes the Institute of Internal Auditors Hong Kong.

Companies House is the UK's registrar of companies sponsored by the BEIS. Its powers and functions are sourced from Part 35 of the CA 2006 which includes (1) making registrar rules; (2) ensuring the procedures and all relevant documents for admission to the register are received; (3) certify and verify information contained in the documents; (4) maintaining the register; (5) keeping records of the information contained in the documents; (6) annotating the register; and (7) removing information from the register. All companies are incorporated and registered with Companies House in accordance with the CA 2006. Furthermore, the FCA issue an official list of all listed companies.²¹¹ Companies House also issues two registers of disqualified company directors.

Limited companies are required to file annual financial statements and company returns with Companies House. The BEIS is responsible for most investigations and prosecutions under the CA 2006.²¹²

CG guidance and guidelines are issued by various industry bodies representing institutional investor issues, namely, the Investment Association (IA), the Pensions and Lifetime Savings Association (PLSA), Pensions and Investment Research Consultants Ltd (PIRC), and Institutional Shareholder Services (ISS). Their guidance include: (1) The Investment Association Principles of Executive Remuneration 2016; (2) Company Act and Articles of Association Guidance 2009; (3) The Investment Association Guidelines on Responsible Investment Disclosure 2007; (4) PIRC UK Shareholder Voting Guidelines 2016; (5) ISS, UK and Ireland Proxy Voting Guidelines 2016; and (6) PLSA Corporate Governance Policy and Voting Guidelines 2015/16. Proxy advisory firms, such as Glass Lewis also issue guidelines (e.g. Glass Lewis 2016 Proxy Season Guidelines).

II.4.2 Accountability

The FCA and PRA are both accountable to HM Treasury, the UK government's economic and finance ministry, and to Parliament. The FCA submits an annual report to the Treasury, which then reports on the FCA's performance of its statutory objectives to Parliament. Twice a year the FCA is subject a general accountability hearing before the Parliament's Treasury Select Committee. Section 12 of the FSMA, which empowers the Treasury to appoint a person independent of the FCA and PRA²¹³ to conduct a review of the economy, efficiency and effectiveness with which the FCA or PRA has used its resources in discharging its functions.²¹⁴

Appeals of certain decisions made by the FCA, PRA, the Pensions Regulator, BoE, and HM Treasury are heard by the Upper Tribunal (Tax and Chancery Chamber) – this broadly covers decisions concerning permission to provide financial services, fines for market

²¹⁰ "Whistleblowing and corporate governance", CIIA, January 2014

²¹¹ Sections 74 and 75 of the FSMA

²¹² FCA, "UK regulators, government and other bodies,": Available at <https://www.fca.org.uk/about/uk-regulators-government-other-bodies> (visited 7 Nov 2016)

²¹³ Section 12(7) of the FSMA

²¹⁴ Section 12(1) of the FSMA

abuse, the imposition of disciplinary measures, and winding up or freezing a pension scheme.²¹⁵

Appeals against decisions of the FRC are heard by an Appeals Tribunal – discussed further in Appendix II.6.

Public sector bodies have statutory duties to adhere to CG principles, for example, the FCA and PRA in accordance with section 7 of the FSMA (as amended by the Financial Services Act 2012), and the BoE/PRA in accordance with sections 1 to 8 of the Bank of England and Financial Services Act 2016.

The Financial Ombudsman Service (FOS), set up by Parliament, is an independent body that aims to settle complaints between consumers and businesses providing financial services regulated by the FCA.²¹⁶ It is the statutory dispute-resolution scheme set up under the provisions of Part XVI and Schedule 17 of the FSMA.²¹⁷ In carrying out its functions, the FOS cooperates and communicates with a number of organisations, including regulators and other official bodies.²¹⁸ The FOS has agreed MoUs with a number of organisations, including the FCA,²¹⁹ that provide an operational framework for the relationship between FOS and the subject organisations.²²⁰

II.4.3 Inter-regulator relationships and effectiveness

CG coordination and cooperation arrangements between the regulators is primarily managed through the use of MoUs that set out high level frameworks to coordinate and cooperate their respective statutory responsibilities, including under the CA 2006, FSMA and the Financial Services Act 2012. This includes MoUs between (1) FRC and FCA,²²¹ (2) FRC and PRA,²²² and (3) the FCA and PRA.²²³

Internationally, financial regulation and cooperation of international organisations is also provided for in a MoU²²⁴ pursuant to section 66 of the Financial Services Act 2012. The MoU establishes an International Coordination Committee, between the BoE, PRA, HM Treasury, and the FCA, that ensures the regulators act in accordance with eight key principles. A number of MoUs have been entered into independently by the PRA and the FCA with overseas financial regulators. Furthermore, the FRC actively engages with EU and international regulators.²²⁵

Important examples of the FRC's international cooperation and coordination arrangements include the FRC:²²⁶

²¹⁵ HM Courts and Tribunal Service, "Refer a financial services regulator or Ofgem to a tribunal," *Guidance*: Available at <https://www.gov.uk/guidance/refer-a-financial-service-regulator-or-energy-market-decision-to-a-tribunal#financial-services-decisions> (visited 15 Nov 2016)

²¹⁶ FOS, "About the Financial Ombudsman Service,": Available at <http://www.financial-ombudsman.org.uk/about/index.html> (visited 15 Nov 2016)

²¹⁷ FOS, "underpinning our statutory functions and powers,": Available at <http://www.financial-ombudsman.org.uk/about/official-documents.html> (visited 15 Nov 2016)

²¹⁸ FOS, "Our work with other official bodies,": Available at <http://www.financial-ombudsman.org.uk/about/oother-bodies.html> (visited 15 Nov 2016)

²¹⁹ *Ibid*

²²⁰ *Ibid*

²²¹ ; FRC and FCA, "Memorandum of Understanding (MoU) between the Financial Reporting Council (FRC) and the Financial Conduct Authority (FCA)," (2013), 1

²²² FCA and PRA, MoU op. cit.

²²³ MoU between the FCA and the PRA, 18

²²⁴ BoE, "Memorandum of Understanding: International Organisations," (2013)

²²⁵ FRC, "International activity": Available at <https://www.frc.org.uk/Our-Work/International-activity.aspx> (visited the 16 Nov 2016)

²²⁶ *Ibid*

chairing meetings of the European Corporate Governance Codes Network, a grouping of European national owners of CG codes;

working closely with the European Commission on CG issues;

assisting the World Bank to complete their Report on the Observance of Standards and Codes – CG; and

working with the Organisation for Economic Co-operation and Development (OECD) and the UK Government in developing the OECD CG Principles.

While the regulatory bodies appear to be well coordinated, the multiple levels of laws, regulations, rules and guidance that are issued by the various bodies, and their legal standing, can be complex to work through. The Appendix of the 2016 UK CG Code shows the overlaps between the DTRs and the UK CG Code with respect to audit committees and the CG statements required on internal control and risk management systems, the board, and board committees (see further Appendix II.7).

Overlaps also occur in regulatory oversight, such as between the FRC and PRA in respect of financial firms generally, and between the FCA and FRC’s Conduct Committee with respect to financial firms’ CG.

There are a few FRC enforcement grey areas with respect to the self-regulatory aspects of the CG framework. For example, as discussed in Appendix II.1, compliance with the CG Code’s comply or explain regime has been decreasing recently, with board independence being an ongoing problem. The introduction of the strategic reporting requirements in the past two years has not produced the expected quality of detail, with almost half of directors failing to be accountable for the strategic report. This questions the effectiveness of the FRC as the CG regulator, and whether the FCA with its wider supervisory ambit and enforcement powers would be better suited to the role of CG regulator.

Similarly, the voluntary nature of the 2012 Stewardship Code has not translated into shared responsibility and enhanced collaboration between the board and shareholders. Shareholder engagement has in fact declined over the past year.²²⁷ That decline has occurred notwithstanding additional shareholder powers in relation to the board, in particular, dual voting, being made available to shareholders (see Appendix II.1). However, UK institutional and activist investors tend to be non-confrontational and passive, failing to meaningfully engage with boards. UK activist shareholders are rare. In contrast, certain activist shareholders in the United States are taking an aggressive and confrontational approach, demanding that boards implement their strategies and insert their board appointments - see the discussion in Appendix II.1. The current extremities of acquiescence and friction between professional shareholders and boards are evidence that a regulatory grey area has developed. The exact roles, powers, and enforcement scope of the regulators within the existing regulatory framework and with the influence of market forces are oblique because there has been a failure to nurture an environment whereby market participants are consistent and active in promoting the principles of the Stewardship Code.

The government and regulators have expressed frustration from the lack of enforcement mechanisms to hold board members to account and the absence of powers to scrutinise annual reports beyond financial statements and the strategic report. Section 172 of the CA 2006 (i.e. directors’ duty to promote the success of the company) is not enforced,

²²⁷ Grant Thornton, “The future of governance: one small step...,” *op. cit.*

especially in the case of non-listed companies and lower-end listed companies.²²⁸ Recent CG scandals have also highlighted the need for the CG Code or similar regulations to apply to large private firms, Standard Listing companies, and small listed companies.

²²⁸ Tara Hounslea, "Call for more prosecution powers after BHS and Sports Direct failings," (16 Nov 2016) *Drapers*

Appendix II	5. Other influences	II.5 United Kingdom
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Introduction

A wide range of bodies actively pursues stances on CG from different perspectives according to the nature and function of their formation. The means engaged for these purposes include:

- publication of principles, policy documents, guidelines, model codes and similar;
- making submissions during public consultations and hearings of parliamentary committees;
- lobbying the government and the regulators;
- submitting research to regulatory bodies;
- submitting comment letters on proposed CG changes to listing requirements; and engagement with the media.

Interest groups can be broadly divided into several categories, as summarised below, and each of the sections that follow briefly explain the activities of each:

- government and international bodies (All-Party Parliamentary Corporate Governance Group (APPCGG), International Corporate Governance Network (ICGN), European Corporate Governance Institute (ECGI));
- self-regulatory organisations (Chartered Institute of Management Accountants (CIMA), ACCA)
- management interest groups (IoD, ICSA);
- business associations (QCA);
- industry interest groups (Institute of Chartered Accountants for England and Wales (ICAEW), ABI, PLSA, Institute and Faculty of Actuaries (IFoA)); and
- shareholder interest groups and others (UK Shareholders' Association (UKSA), PIRC, IA, IBE, ISS, Trade Union Centre (TUC)).

A number of these bodies actively participate in giving oral evidence or making written submissions to consultation exercises such as the Walker Review (2009), the Kay Review (2012), and the current Business Innovation and Skills Committee of Parliament into Corporate Governance 2016 consultation (see Appendix II.2).

II.5.1 Government bodies

APPCGG²²⁹ is an informal group of Members of the House of Commons and the House of Lords that aim to develop and enhance the understanding of CG at Westminster and to influence policy-making in this context. Its primary focus is to promote "responsible leadership of business so that the interest of shareholders and other stakeholders are

²²⁹ All Party Parliamentary Corporate Governance Group, "Influencing the policy agenda for business, economic and social prosperity – About the group": Available at <http://www.appcgg.co.uk/> (visited 21 Nov 2016)

properly protected". The APPCGG is committed to support business growth and promoting CG best practice. Acknowledgement is given that there is no universal CG template for every business, but the APPCGG does promote "the recognition that there are many ways for companies to create prosperity for their employees and shareholders". The APPCGG holds networking events regularly where key CG issues are discussed with its members and the government.

II.5.2 International and European bodies

ICGN²³⁰ is an investor-led organisation that promotes effective standards of CG and investor stewardship to advance efficient markets and sustainable economies worldwide. CG policy positions are guided by the ICGN Global Governance Principles and the Global Stewardship Principles, which are implemented by:

influencing policy by providing a reliable source of investor opinion on CG and stewardship;

connecting peers at global events to enhance dialogue between companies, investors to facilitate long-term value creation; and

informing dialogue through knowledge and education to stimulate the professionalism of CG and stewardship practices.

ECGI²³¹ is an international non-profit association that provides a forum for debate and dialogue between academics, legislators, and practitioners. It focuses on major corporate CG issues and promotes CG best practice. The primary role of the ECGI is to "undertake, commission and disseminate leading research on corporate governance". Advice can be given on CG policy formulation, developing best practice, or undertaking any other activity that will improve the understanding and exercise of CG.

II.5.3 Self-regulatory organisations

CIMA²³² is the world's largest professional body of Management Accountants with 150,000 members and students operating in 168 countries. CIMA teaches the fundamentals of ethics, CG, and business law. It issues CG guides and reports for members and students. CIMA has stated that it will participate in the Business Innovation and Skills Committee of Parliament into Corporate Governance 2016 consultation.

ACCA²³³ is a global body for accountants with 188,000 members, 480,000 students in 178 countries. It publishes on CG topics, such as "The Report on creating value through governance" (July 2014) and has made submissions to CG reviews on behalf of its members, including to the Walker Review and the Kay Review (2012).

II.5.4 Associations and interest groups

Management interest groups

IoD²³⁴ is an organisation that seeks to promote high standards of excellence and professionalism in the boardroom including "responsible business practice for the benefit

²³⁰ ICGN, "About": Available at <https://www.icgn.org/about> (visited 21 Nov 2016)

²³¹ ECGI, "Leading Research with Global Impact": Available at <http://www.ecgi.org/organisation/overview.htm> (visited 21 Nov 2016)

²³² CIMA, "About Us": Available at <http://www.cimaglobal.com/About-us/> (visited 20 Nov 2016)

²³³ ACCA, "Discover ACCA": Available at <http://www.accaglobal.com/hk/en/discover/about.html> (visited 20 Nov 2016)

²³⁴ IoD, "About": Available at <https://www.iod.com/about> (visited 21 Nov 2016)

of the business community and society as a whole". The IoD provided oral evidence to the Business Innovation and Skills Committee of Parliament into Corporate Governance 2016 and made submissions to both the Walker Review (2009) and the Kay Review (2012). The IoD has 34,500 members and 48 regional branches in the UK.

ICSA²³⁵ is the professional qualifying body for Chartered Secretaries and operates the Governance Group, which advocates on CG issues, provides CG training courses, and has published a range of guidance materials promoting CG best practice. In February 2015, the ICSA joined a steering group to survey companies on investor engagement. A report was issued by the ICSA in October 2012 titled: "Consultation paper on improving engagement practices between companies and institutional investors". The ICSA has also made submissions on behalf of its members to the Walker Review (2009) and the Kay Review (2012).

Business associations and lobby groups

QCA²³⁶ is an independent organisation that represents small- and mid-sized listed companies and issues the QCA CG Code. It makes submissions to consultations including the enquiry by the Business Innovation and Skills Committee of Parliament into Corporate Governance 2016 supporting the codification of directors duties into the CA 2006. The QCA commented on, among other things, director remuneration, shareholder participation, and board diversity.

Industry interest groups

ICAEW²³⁷ is an important part of the ICAEW's role is to shape CG government policy and regulation. It has published "A dialogue in corporate governance" in July 2013. The ICAEW was made submissions to the Walker Review (2009) and the Kay Review (2012). has over 147,000 members providing guidance to meet ethical and technical standards.

There are a number of institutional investor groups in the UK including investment firms, pension funds, and insurers such as ABI. The ABI has published "Improving Corporate Governance and Shareholder Engagement" (July 2013) which focuses on areas such as independent NEDs, voting, AGMs, resolutions, and shareholder rights. It was part of a working group with the IMA and the NAPF, which published "Collective Engagement Investor Exchange" in February 2014 that covered, among other things, board composition, remuneration, accounting, and audit.

PLSA²³⁸ (formally the NAPF) is a body with a primary role to help pension professionals run pension schemes but it also engages with government and regulators in a range of matters including CG. In this context submissions were made by the NAPF, on behalf of its members, to the Walker Review (2009) and the Kay Review (2012). Membership includes over 1300 pension schemes managing £1 trillion in assets.

IFoA²³⁹ is a chartered body that educates and regulates actuaries in the UK. Oversight of the IFoA's regulatory activities is conducted by the FCA. The IFoA comments on CG changes that may affect its members by making submissions to reviews, for example, the Walker Review (2009).

²³⁵ ICSA, "About Us": Available at <https://www.icsa.org.uk/about-us> (visited 20 Nov 2016)

²³⁶ QCA, "QCA Response to BIS Committee Inquiry on Corporate Governance": Available at <http://www.theqca.com/about-us/responses/122851/qca-response-to-bis-committee-inquiry-on-corporate-governance.thtml> (visited 20 Nov 2016)

²³⁷ ICAEW, "About ICAEW": Available at <http://www.icaew.com/en/about-icaew> (visited 20 Nov 2016)

²³⁸ PLSA, "About Us": Available at <http://www.plsa.co.uk/About-us.aspx> (visited 20 Nov 2016)

²³⁹ IFoA, "About us": Available at <https://www.actuaries.org.uk/about-us> (visited 20 Nov 2016)

II.5.5 Shareholder interest groups

UKSA²⁴⁰ is a non-profit company formed to provide private shareholders with a forum to express views and to be influential. An elected Chairman and Board of Directors monitor regional organisations or chapters, each region benefitting from oversight by an elected regional Chairman and Committee. Members can set up their own regular meetings for any defined purpose connected to the aims of the Association. The Croydon and Purley Group, for example, has met on a monthly basis for the past ten years. There are two main interests of UKSA: (1) maintaining a relationship with selected listed companies such as attending company presentations similar to those provided to City analysts and institutional investors; and (2) examination of, and action on, policy issues particularly where impending legislation might affect investors. The UKSA examines selected AIM companies' annual reports, with the objective of exposing directors' reporting practices to public scrutiny by publishing findings. Good practice is highlighted when found, but attention particularly focuses on company reports that are inadequate or flawed, including whether they are confusing or difficult to read. It publishes a member magazine, "The Private Investor", with CG being an important topic.²⁴¹ It has also published "Responsible Investing – for the individual and society" (2010)²⁴², a publication that outlines the UKSA's role in promoting the interests of private shareholders. From time to time, UKSA organises campaigns on particular issues, for example, on "Voting Rights" and "Directors' Pay". The UKSA made a submission on behalf of its members to the Kay Review (2012).

PIRC²⁴³ is Europe's largest independent CG and shareholder advisory consultancy that provides proxy research services to institutional investors. PIRC provides services for asset owners and asset managers focusing on capital stewardship for the long-term investor, based on data, research, and analysis.²⁴⁴ Its core business is monitoring companies for institutional shareholders, and providing voting and engagement services.

IA²⁴⁵ (previously known as the IMA) is a body that represents UK investment managers and produces circulars and guidelines on, inter alia, CG-relevant legal and regulatory developments. It actively engages with policymakers and stakeholders. On 13 April 2015, the IA and Ernst & Young produced a report "Board Effectiveness: continuing the journey", which discussed leading practices and means of improving and demonstrating board effectiveness.²⁴⁶ The IA also makes submissions to reviews concerning CG, such as the Walker Review (2009) and the Kay Review (2012).

II.5.6 Other groups

IBE²⁴⁷ is a body that promotes high standards of business behaviour including CG based on ethics. It issues a Code of Ethics and conducts related surveys. The IBE gave oral evidence to the Business Innovation and Skills Committee of Parliament into Corporate Governance and has made submissions to the Walker Review (2009) and the Kay Review (2012).

²⁴⁰ UKSA, "About the UKSA": Available at <http://www.uksa.org.uk/about> (visited 21 Nov 2016)

²⁴¹ See, Issues 197 (November 2015) and 180 (January 2016): UKSA, "The Private Investor"

²⁴² Available at http://www.uksa.org.uk/sites/default/files/responsible_investing_2010_members.pdf (visited 21 Nov 2016)

²⁴³ PIRC, "About us"; Available at <http://pirc.co.uk/about-us-1>. "What we do"; Available at <http://pirc.co.uk/about-us-1/what-we-do> (visited 20 Nov 2016)

²⁴⁴ PIRC

²⁴⁵ The IA, "About": Available at <http://www.theinvestmentassociation.org/about-the-investment-association> (visited 20 Nov 2016)

²⁴⁶ For more details, see: EY and The IA, "Board Effectiveness – continuing the journey," (April 2015), 1.

²⁴⁷ IBE, "About IBE & Supporting Us,": Available at <http://www.ibe.org.uk/about-ibe-and-supporting-us/54/54> (visited 20 Nov 2016)

There are two major proxy advisory firms in the UK, as is the case in the United States (see Appendix III.5): ISS and Glass Lewis.

TUC²⁴⁸ is a body that advocates trade union-related activities representing 5.8 million workers in 51 unions. It has given oral evidence to the Business Innovation and Skills Committee of Parliament into Corporate Governance 2016 concerning legislating for the inclusion of workers on boards.

II.5.7 Public media

There is a free media that exposes CG misconduct in the UK. Nonetheless, media reporting of incidences of corporate misconduct is not as widely available as is the case in the U.S. This may be due to the relatively underdeveloped and non-confrontational manner of institutional and activist shareholders in the UK. Media attention also tends to centre on related social issues, such as workers losing entitlements following director misconduct. Governments tend to respond more readily to these incidences and the resultant enquiries do gain widespread media attention. Confrontational U.S. activist shareholders are gaining more widespread media attention to CG issues. This is more a result of their business model rather than that of the media *per se*. Media and press releases are an important tool in the regulators' CG enforcement arsenal, for example, public censures, and a means to open for public comment any proposed regulatory or statutory CG changes.

²⁴⁸ TUC, "About the TUC": Available at <https://www.tuc.org.uk/about-tuc> (visited 20 Nov 2016)

Appendix II	6. Enforcement	II.6 United Kingdom
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Introduction

The enforcement of CG standards in the UK is a mix of primary law, regulations made pursuant to primary law that have statutory backing (including the listing rules), and non-statutory regulations that have a measure of statutory support to the extent they are incorporated by reference in the listing rules made by the FCA – see Appendices II.3 and II.4. It operates as a highly codified system within a common law jurisdiction.

Enforcement in the UK is spread across a number of agencies specifically concerned with CG including the FCA and the FRC, as well as the PRA. Shareholders are also provided with rights of civil action, including in relation to certain breaches of the listing rules concerning disclosure. The FCA possesses meaningful powers of investigation that enable it to obtain evidence and its enforcement powers are graduated, ranging from censure, to imposing administrative fines, to prosecuting criminal offences under the FSMA as well as other offences relevant to its functions. These powers it may undertake directly, for example, it may directly impose a fine subject to rights of appeal to an administrative Tribunal system. The statutory backing that has been given to the listing rules and to the takeovers code add significantly to the scope of the FCA’s enforcement powers, as well as the range of remedies available to shareholders. The FRC also has powers of investigation and enforcement, albeit not as extensive as the FCA’s – they operate disciplinary schemes for the accountancy profession and since June 2016 possess enforcement powers in relation to statutory audits.

The UK has also sought to facilitate the discovery of wrongdoing, and hence the opportunity to undertake enforcement action, by implementing whistle-blowing laws.

II.6.1 Laws and regulations

See Appendices II.3 and II.4 for a discussion of the legislation and regulations, respectively, on which enforcement action through the courts or by administrative means is undertaken.

II.6.2 Offences

A number of bodies are able to prosecute offences, including the Crown Prosecution Service, the Serious Fraud Office, the BoE/PRA, the FCA, and Companies House. Companies House enforces a number of specific matters under the CA 2006. The FCA is also relevant to consider for the purposes of offences related to CG. The FCA has a wide power to both investigate and prosecute offences under FSMA as well as other offences where to do so would be consistent with meeting any of its statutory objectives.²⁴⁹

An important change made by the Financial Services Act 2012 relevant to CG is the repeal of the criminal offence of misleading statements and practices under section 397 of the FSMA and the introduction of section 89 of the Financial Services Act 2012 on misleading statements, which is capable of application to a company’s statements to its shareholders. The offence, punishable by up to seven years imprisonment, would be committed if a person makes a statement or conceal facts with the intention of inducing, or is reckless as to whether making or concealing them may induce a person, to enter

²⁴⁹ See the Supreme Court case of *Rollins* [2010] UKSC 39, [2010] All ER (D) 289 (Jul) where it was confirmed that the FSA (the precursor of the FCA) could prosecute offences contrary to sections 327 and 328 of the Proceeds of Crime Act 2002

into/or offer to enter into/or to refrain from entering or offering to enter into a relevant agreement or to exercise, or refrain from exercising, any rights conferred by a relevant investment.

Powers to obtain evidence

The Serious Fraud Office has the power to require a person to provide evidence and failure to comply without a reasonable excuse is a criminal offence.²⁵⁰ A person being interviewed retains the right against self-incrimination insofar as the contents of the interview cannot be used in evidence against that person in any subsequent criminal trial, except in very limited circumstances. However, where the person remains silent or fails to answer questions this can lead to adverse inferences being drawn at trial.

The FCA and the PRA also have powers to require documents and information²⁵¹ and failure to comply with which is an offence.²⁵² However, these powers appear to be limited to authorised persons it regulates pursuant to functions the regulator performs under FSMA including, for example, recognised Exchanges, as well as certain other persons relevant to the stability of the UK financial system. This power does not appear to cover listed issuers or their officers.

In Hong Kong, the powers of the SFC are in this context wider than that of the FCA/PRA. The positive requirement to answer, including by way of statutory declaration arises not only in relation to licensed intermediaries²⁵³ but also in respect of listed issuers and so can be applied to the issuer, its bankers and auditor and indeed to any other person which will encompass the issuer's directors as well as its staff.²⁵⁴ As regards the privilege against self-incriminating testimony or answers,²⁵⁵ where an SFC appointed investigator requires a person to give an answer to any question under sections 179 or 183 of the SFO, and the answer might incriminate the person and the person so claims before providing the answer, then the requirement as well as the answer shall not be admissible in evidence against the person in criminal proceedings in a court of law (with certain exceptions).²⁵⁶

It may also be noted that where the FCA is investigating a criminal offence it has the power to grant statutory immunities under the Serious Organised Crime and Police Act 2005, a power the FCA regards as important to their enforcement process and which strengthens their ability to achieve "credible deterrence in the financial services industry."²⁵⁷ The SFC does not possess this power.

Liability of officers

In general, statutes that provide for offences committed by corporations also provide for liability of relevant officers.

Under the CA 2006, officers are under a direct duty to maintain adequate accounting records²⁵⁸ and knowingly or recklessly making a misleading, false or materially deceptive

²⁵⁰ Section 2 of the Criminal Justice Act 1987. There is no statutory right to legal representation for those being interviewed under a section 2 notice.

²⁵¹ Sections 165 and 165A of the FSMA

²⁵² Section 177 of the FSMA

²⁵³ Section 180 of the SFO

²⁵⁴ Sections 179(3) and 183(2) of the SFO

²⁵⁵ SFO, section 187

²⁵⁶ Not cooperating with investigations... sections 179(13), (14) or (15) or 184, 219(2)(a), 253(2)(a) or 254(6)(a) or (b), Part V of the Crimes Ordinance (Cap 200), or for perjury

²⁵⁷ FSA "FSA welcomes proposed new 'immunity notices' power", 14 Jan 2009, available at <http://www.fsa.gov.uk/pages/Library/Communication/Statements/2009/immunity.shtml>, last visited 28 Nov 2017

²⁵⁸ Section 387 of the CA

statement to a company's auditor requesting information they are statutorily entitled to is also an offence.²⁵⁹ Offences in relation to records may also arise under the Theft Act 1968.²⁶⁰

Under the FSMA, where an offence is committed by a corporate with the consent or connivance of, or is attributable to any neglect on the part of, an officer (including director, member of the committee of management, chief executive, manager, secretary or other similar officer of the body), then the officer is also guilty of the offence.²⁶¹

II.6.3 Private actions

Section 90 of the FSMA provides that persons who suffer loss as a result of misstatements or material omissions in listing particulars may claim damages. This arrangement is similar to the Hong Kong provision in section 40 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance²⁶² (CWUMPO) for civil liability in relation to false or misleading information in prospectuses. However, there are two notable differences. The first concerns the scope of persons subject to liability. In the UK, that scope encompasses any person "responsible for listing particulars". In Hong Kong this is more specifically limited to directors, promoters and persons who have authorised the issue of the prospectus. Whereas the UK provision could apply to sponsors, the Hong Kong regime does not appear to catch sponsors.²⁶³ The second concerns what omissions can give rise to liability. The FSMA allows private actions to be brought where loss has been suffered as a result of the omission of any matter (1) reasonably required to be included to enable an informed investment decision to be made, or (2) required to be included by the listing rules or by the FCA.²⁶⁴ In contrast, the CWUMPO only refers to "a material omission". This distinction is important, particularly as regards item (2) above, which clearly attaches potential liability to breaches of disclosure requirements imposed by the FCA including the listing rules whereas in Hong Kong it remains unspecified in the statutory provisions whether a failure to disclose information required by the listing rules would amount to a material omission. Two cases of relevance in this regard are *SFC v. Wong Shu Wing and Another*²⁶⁵ and *SFC v. Kenneth Cheung Chi Shing And Others (the Styland (2012) case)*²⁶⁶ - both were brought under section 214 of the SFO in which non-compliance with listing rule disclosure requirements was successfully used to support a case of misfeasance, inadequate information to shareholders, and unfair prejudice.

What is similar in both jurisdictions is that civil action only arises in relation to disclosure matters - based on listing rule requirements in the UK and inside information requirements in the statutory provisions of the SFO (the *Wong Shu Wing* and *Styland (2012)* cases aside). It is of interest to note that in the UK general breaches of the listing rules other than relating to disclosure do not give rise to any right of civil action. However, such breaches are subject to the enforcement powers of the FCA including the power to impose a fine (see below).

DTR 7.2 requires an issuer to publish a CG statement in its directors' report regarding the CG code to which it is subject or has voluntarily decided to apply, or any CG practices it has applied over and above the requirements of national law. Where the statement is misleading, false or deceptive, DTR 1A.3.2 R will be relevant to consider,

²⁵⁹ Section 501 of the CA

²⁶⁰ Section 17

²⁶¹ Section 400 of the FSMA

²⁶² Cap. 32

²⁶³ See Syren Johnstone, Antonio M Da Roza and Nigel Davis "Deconstructing sponsor prospectus liability", HKLJ Vol 46(1) 2016, 255-285

²⁶⁴ FSMA section 90 refers to section 80

²⁶⁵ [2013] HKCFI 2302; HCMP 1831/2010 (20 March 2013)

²⁶⁶ [2012] HKCFI 312; [2012] 2 HKLRD 325; HCMP 1702/2008 (7 March 2012) HCMP 1702/2008

which requires that an issuer must take “all reasonable care” in relation to any information provided to a primary information provider. A breach of this requirement can give rise to an enforcement action and/or an action for damages.

The above provisions in relation to disclosures made in the primary market were extended by the CA 2006, and subsequently further amended in 2010,²⁶⁷ to cover disclosures made in the secondary market. This extension, provided for in section 90A and Schedule 10A of the FSMA, covers misleading statements, dishonest omissions, and delays in publishing information. Section 90B provides that the Treasury can make further provisions as regards secondary market disclosures.

As regards specific CG concerns of the listing rules, the new secondary market provisions mean that a breach of mandatory provisions of the listing rules is only capable of triggering potential liability where there has been a disclosure problem. This might come about, for example, in relation to significant and related party transactions, or the comply or explain provisions that cover the UK CG Code (although non-compliance with the UK CG Code itself does not attract liability). However, general breaches of the listing rules do not *per se* attract such liability. This is a significant difference from the position in Hong Kong where the listing rules operate as a contract between the issuer and the Exchange and investors have no rights of private action in respect of breaches of listing rule requirements – they must instead look to the disclosure obligations of listed issuers under Part XIVA of the SFO, which is only concerned with the narrower category of inside information.

II.6.4 Financial Conduct Authority

Statutory investigatory and enforcement powers of the FCA include appointing a competent person to conduct an investigation on its behalf for breaches of the listing rules²⁶⁸ and taking enforcement action for breaches of the listing rules, the DTR, the CG rules, or the prospectus rules or any provision made under Part VI of the FSMA.

Section 96 of the FSMA further provides that the listing rules may make provisions for the actions the FCA may take in the event of non-compliance. LR 1.4.1 R provides that where a Premium Listing issuer is or may be in breach of the listing rules or the DTR the FCA may direct the issuer to appoint a sponsor to advise the applicant on the application of those requirements. The equivalent power in Hong Kong, where the role of a sponsor is restricted to the application for listing of securities, is that the SEHK may direct an issuer to appoint a compliance adviser for advice on future listing rule compliance matters.²⁶⁹

An important distinction between the FCA and SFC in this regard is that the SFC does not have any direct power to enforce the SEHK’s listing rules – although breaches of the listing rules may give rise to other matters (such as a breach of the law) that would trigger powers of the SFC. Under the dual filing regime established by the SMLR the SFC can object to or impose conditions on a listing of securities.²⁷⁰ The SMLR also requires ongoing disclosure materials to be provided to the SFC²⁷¹ and this provides an important link to the SFC’s continuing powers over listed issuers in relation to its power to direct the suspension of dealings and cancellation of listings.²⁷² Beyond those powers, the remit of the SFC over listed companies relies on breaches of the law, primarily the SFO provisions dealing with disclosure and misfeasance.²⁷³

²⁶⁷ By the Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2010 (S.I. 2010/1192)

²⁶⁸ Section 97(2) of the FSMA

²⁶⁹ MBLR 3A.20

²⁷⁰ Sections 6(2) and 6(3)(b) respectively

²⁷¹ Section 7 of the SMLR

²⁷² Sections 8 and 9 of the SMLR

²⁷³ In particular, sections 213, 214, 277, 298 and Part XIVA of the SFO

In addition, the FCA has a number of enforcement powers as the conduct regulator of Authorised Persons – broadly equivalent to the SFC’s functions and powers in relation to licensed intermediaries and registered institutions.

Sanctions

The FCA’s statutory powers to impose administrative sanctions in respect of breaches of various CG related provisions – namely the listing rules, the DTR and the prospectus rules - is established in Part VI of the FSMA. The FCA has a general power to discontinue or suspend a listing,²⁷⁴ as well as the power to censure²⁷⁵ and the power to impose a financial penalty in such amount as it considers appropriate.²⁷⁶ The power to fine under section 91 of the FSMA is defined according to the rules breached and applies to different persons, as shown in the table below. Section 91(7) of the FSMA also provides for a two-year limitation period, commencing when the FCA first knew of the breach, on imposing a fine.

Requirement breached:	Persons subject to fine* include:
Listing rules	Issuer. Applicant (i.e. the company).
Disclosure rules	Issuer. Individuals undertaking management. **
Any provision of Part VI of the FSMA or prospectus rules	Issuer. Offeror of the securities. Individuals who are directors of the issuer. ***
Transparency rules (or provision made under the transparency obligations directive)	Individual who is a director knowingly concerned in the contravention. Any person engaged in the contravention.
Corporate governance rules	Individual who is a director knowingly concerned in the contravention. Any person engaged in the contravention.

* *The FCA may instead publish a statement censuring the person.*

** *A person discharging managerial responsibilities or a person connected with such person.*

*** *Being a person to whom a provision of the prospectus directive applies (see PR 5.5.3 R)*

The foregoing power of the FCA to fine stands in sharp contrast to the position in Hong Kong where neither the SFC nor the SEHK have any power to fine in relation to breaches of the listing rules including the disclosure requirements thereunder - the powers of the Hong Kong regulators are quite restricted by comparison, for example, making public statements or taking action in relation to the continued trading and listing of the issuer’s securities. Breaches of the statutory disclosure requirements under Part XIVA of the SFO or the transparency and disclosure of interests requirements under Part XV of the SFO also do not give rise to any power to regulators to impose fines or indeed any sanctions – these are instead actionable by the SFC through the Market Misconduct Tribunal (MMT), or through the courts as an offence, respectively. As already noted above, breaches of Part XIVA are actionable through a civil action by a person who has suffered loss as a result of the breach.²⁷⁷ Thus in Hong Kong the enforcement of disclosure and

²⁷⁴ Sections 77 and 78 of the FSMA

²⁷⁵ Sections 87M and 89K of the FSMA

²⁷⁶ Section 91 of the FSMA

²⁷⁷ Section 307Z of the SFO

transparency in the markets, both important features of a CG system, in important ways does not rest with the regulators, their role instead being restricted to oversight and the commencement of enforcement actions undertaken in the MMT or the courts.

The power of the FCA to impose fines in relation to a range of CG related concerns is subject to the appeal oversight of the Upper Tribunal, whereas in Hong Kong the ability to fine only arises in relation to the Part XIVA disclosure regime and this requires the SFC to apply to the MMT to seek an order. Compared to the UK, the Hong Kong model undoubtedly adds significant cost and delays in seeking to impose fines on wrongdoers. This reflects a different structure and functioning of the two tribunals. In the UK the Upper Tribunal is part of the administrative system of justice that allows aggrieved persons to appeal an administrative fine of the FCA – the Tribunal does not itself originate any fine. In contrast, in Hong Kong the MMT is itself the body that is able to originate and impose the administrative fine, subject to appeal to the Court of Appeal. Where the SFC is itself empowered to impose an administrative fine – namely, on persons engaged in licensed regulated activities – the route of appeal is instead to the Securities and Futures Appeals Tribunal which is part of the checks and balances on the exercise of the SFC’s powers under the SFO.

The dissemination of false or misleading information by an issuer might also fall to be treated as market abuse,²⁷⁸ in which case similar fining penalties also arise.²⁷⁹ This is again distinct from Hong Kong where the SFC would need to make an application to the MMT or the courts.

Where the FCA intends to impose any such sanctions it must first give the person a warning notice and an opportunity to make representations.²⁸⁰

Section 18 of the Financial Services Act 2012 lists the FCA’s IPO disciplinary powers in relation to sponsors. Actions the FCA may take action against a sponsor include imposing penalties, suspending sponsor approvals, limiting or restricting sponsor services, and publishing statements of contravention.²⁸¹ Furthermore, a sponsor may be subject to public censure if they have contravened the listing rules imposed by the requirements of section 88 (3)(c) of the FSMA (i.e. the provision of services).²⁸²

As already noted, the significant difference in the FCA’s powers is the ability to impose fines on issuers that breach the listing rules. This would include in relation to a breach of the comply or explain requirement in relation to the UK CG Code. Neither the SFC nor the SEHK have the power to impose fines in respect of breaches of the listing rules.

Publication

The power of the FCA to publicly censure an issuer is subject to due process requirements. The FSMA requires a warning notice to be given if the FCA is contemplating taking action against a person and specify a period within which the person may make representations, and thereafter decide within a reasonable period whether to give a decision notice.²⁸³ Warning notices may not be published and decision notices may only be published by the FCA.²⁸⁴ However, following amendments made by the FSA 2012 to the FSMA, the FCA can publish details of certain warning notices, provided it has first consulted the persons to whom the warning notice is given or copied

²⁷⁸ Section 118(7) of the FSMA

²⁷⁹ Section 123 of the FSMA

²⁸⁰ Section 78(2) of the FSMA in respect of suspension or discontinuation, sections 87M(2) or 89K(2) in respect of censure, and section 92 in respect of fines

²⁸¹ Section 88A of the Financial Services Act 2012

²⁸² Section 89 of the FSMA

²⁸³ Sections 92, 387 and 388 of the FSMA

²⁸⁴ Section 391 of the FSMA

and provided it would not be unfair to the person to do so or be prejudicial to the interests of consumers or financial stability. The policy of the FCA remains that they would not normally make public any investigation until the warning notice stage is reached.²⁸⁵ Furthermore, supervisory notices, requirement notices, cancellation notices and other publications are published online.²⁸⁶ However, the FCA will not normally publish details of the information found or conclusions reached during investigations.²⁸⁷ Outcomes of civil and criminal prosecutions will normally be publicised by the FCA.²⁸⁸

Accountability and appeals

HM Treasury has the power to review the FCA's functions under section 1S of the Financial Services Act 2012. The FCA is accountable to the Parliament and HM Treasury. Each year HM Treasury monitors the performance of the FCA from its annual report.²⁸⁹ The FCA's Annual Report contains information and statistics in relation to its enforcement actions.

The FCA is required to set out a policy statement as to how it intends to exercise its fining powers.²⁹⁰ The FCA has set this out in the Decision Procedure and Penalties manual (DEPP), which is contained in the FCA Handbook - DEPP 6.4 (Financial penalty or public censure) and DEPP 6.5 to DEPP 6.5D (on the amount of a financial penalty). The FCA's policy statement was most recently updated on 31 January 2017 and 1 March 2017.

Where a sanction has been imposed by the FCA, the relevant person may refer the matter (by way of appeal under a judicial review process) to the Upper Tribunal (Tax and Chancery Chamber), which is part of the UK's system of ensuring administrative justice.²⁹¹ A breach of an order of the Upper Tribunal is an offence.²⁹²

II.6.5 Financial Reporting Council

The Corporate Reporting Review Committee (CRR Committee) is a sub-committee of the Conduct Committee that ensures consistency and quality of the FRC's monitoring work.²⁹³ Reports are initially reviewed by FRC staff for indications of potential breach of accounting or reporting requirements (including reporting against the CG Code in companies' annual reports), which then provides to the CRR Committee a preliminary analysis with a recommended course of action. If the CRR Committee decides that there is a question whether the reports comply with the relevant accounting or reporting requirements, a member of the CRR team may write to the company's Chairman seeking further information. Where the CRR Committee determines that there is a potential breach, a monitoring Committee appoints a Review Group to open an enquiry. The Chairman of the Review Group can request further information, documents or explanations from the companies. If the Review Group is in the opinion that there is a breach of the relevant accounting or reporting requirements, it will refer the matter to

²⁸⁵ "FCA transparency framework" FCA, 2013

²⁸⁶ FCA, "Enforcement": Available at <https://www.fca.org.uk/about/enforcement> (visited 23 Nov 2016)

²⁸⁷ FCA, "The Enforcement Guide," (2014) op. cit, 6.7

²⁸⁸ Ibid

²⁸⁹ FCA, "Reporting to Treasury and Parliament": Available at <https://www.fca.org.uk/about/reporting-treasury-parliament> (visited 23 Nov 2016)

²⁹⁰ FSMA, sections 93 and 94

²⁹¹ FCA, "UKLA decision making and individual guidance processes," (2014) *UKLA/PN/908.2*. See also the Tribunal Courts and Enforcement Act 2007

²⁹² Section 133B of the FSMA

²⁹³ FRC, "Conduct Committee,": Available at <https://www.frc.org.uk/About-the-FRC/FRC-structure/Conduct-Committee.aspx> (visited 2 Nov 2016)

the Conduct Committee which can make an application to the court requiring the directors of the company to prepare revised accounts or a revised report.²⁹⁴

Under section 456 of the CA 2006, the Conduct Committee is empowered to apply to the court that the annual accounts of a company do not comply with the requirements of that Act and for an order requiring the directors of the company to prepare revised accounts. On application to the court, the Conduct Committee informs other authorities as appropriate, such as HM Treasury, BoE, the FCA, the PRA, the Secretary of State,²⁹⁵ and the LSE, and will ordinarily make a public announcement.²⁹⁶

In some cases, the CRR Committee or the Review Group may accept alternative corrective or clarificatory action by the directors – for example, a corrective statement published by the entity either separately or in the next interim or annual report (where appropriate), with an adjustment of the relevant comparative figures and notes.²⁹⁷

A Case Management Committee advises on the handling of each case.²⁹⁸ In this role, its function is to monitor the conduct of any investigation and/or disciplinary proceeding and the merits of the Executive Counsel.²⁹⁹

The FRC, being the independent disciplinary body for accountants, accountancy firms, and actuaries in the UK, also operates disciplinary schemes for the accountancy profession and the actuarial profession in public interest cases.³⁰⁰ Discipline includes investigation (and preliminary investigations), deciding whether to commence a disciplinary proceeding, referral to the Disciplinary Tribunal, Tribunal hearing, and determination and imposition of sanctions.³⁰¹

Audit enforcement powers of the FRC became effective from 17 June 2016 pursuant to the Audit Enforcement Procedure, which provides for the investigation of allegations in relation to statutory audit matters that have not been delegated to the private-sector responsible supervisory body.³⁰² An Enforcement Committee Panel is required under Parts 4 and 6 of the Audit Enforcement Procedure to undertake functions pursuant to Part 3 of the Auditor Regulatory Sanctions Procedure.³⁰³

Accountability and appeals³⁰⁴

The FRC is accountable to Secretary of the BEIS (formally BIS). An FRC Annual Report and Accounts is presented to the UK Parliament, pursuant to section 1252 of the CA 2006, which contains some information and statistics concerning the FRC's disciplinary actions through the year. In addition the FRC issues the "Developments in Corporate Governance and Stewardship" annually, which provides a qualitative and statistical assessment of overall compliance rates with the CG Code.

²⁹⁴ FRC, "How we review reports and accounts": Available at <https://frc.org.uk/Our-Work/Corporate-Governance-Reporting/Corporate-Reporting-Review/How-we-review-reports-and-accounts.aspx> (visited 22 Nov 2016)

²⁹⁵ Section 461 (3) of the CA pursuant to the restrictions on disclosure in section 460

²⁹⁶ FRC, "The Conduct Committee: Operating procedures for reviewing corporate reporting," (April 2016), 6

²⁹⁷ Ibid, 7. As appropriate and required by legislation

²⁹⁸ FRC, "Case Management Committee": Available at <https://www.frc.org.uk/About-the-FRC/FRC-structure/Case-Management-Committee.aspx> (visited 23 Nov 2016)

²⁹⁹ Ibid

³⁰⁰ FRC, "Enforcement": Available at <https://www.frc.org.uk/Our-Work/Enforcement/Enforcement.aspx> (visited 22 Nov 2016)

³⁰¹ Ibid

³⁰² Ibid

³⁰³ FRC, "Enforcement Committee Panel": Available at [https://www.frc.org.uk/About-the-FRC/FRC-structure/FRC-Board-\(1\).aspx](https://www.frc.org.uk/About-the-FRC/FRC-structure/FRC-Board-(1).aspx) (visited 23 Nov 2016)

³⁰⁴ See generally: FRC, "Tribunals": Available at <https://frc.org.uk/Our-Work/Enforcement/Enforcement/Tribunals.aspx> (visited 22 Nov 2016)

Under the disciplinary scheme operated by the FRC, an actuary, accountant, or accountancy firm can seek leave to appeal against a finding of misconduct and/or sanction imposed by the Disciplinary Tribunal. Leave to appeal is only granted on certain grounds and, if granted, an Appeal Tribunal will be appointed. An appeal under the disciplinary schemes is a review, not a rehearing.

Tribunal hearings are normally be open to the public except in exceptional circumstances when it's determined not to be in the interests of justice. For example, under the Accountancy Scheme if the Disciplinary Tribunals finds that misconduct has been committed, sanctions or a combination of sanctions can be imposed, such as reprimand, order to comply with certain conditions, fine, suspension of license, withdrawal of authorisation³⁰⁵.

If the complaint is dismissed by the Discipline Tribunal, it can order the FRC to pay all or part of the legal costs but only if the Tribunal is satisfied that the FRC behaved unreasonably in bringing or pursuing the complaint. However, FRC Tribunals cannot order compensation to be paid to victims of misconduct.

Complaints against the FRC are made to the Chief Executive of the FRC. The Case Management Committee advises the Executive Counsel on the factors it should consider when deciding whether to proceed with a Formal Complaint.³⁰⁶ If the complaint proceeds and is decided upon, a decision of the Chief Executive or their appointee is final and the complaint will be deemed closed.³⁰⁷

Publication

This may involve a summary of the details of a case that has led to corrective or clarificatory action, the press notice concerned, or a requested Committee Reference. When a company makes a change to a significant aspect of its reporting in its next report in response to intervention by the Conduct Committee, it may ask the company to refer to its exchanges with the Conduct Committee. Companies that publish a Committee Reference should request the Conduct Committee to comment on the reference prior to publication.³⁰⁸

The FRC Disciplinary Tribunal also publishes Tribunal reports online that cover the proceedings, the issues, and recommendations in detail.³⁰⁹

A "Developments in Corporate Governance and Stewardship" is issued annually and provides a report on quality of compliance with and against the CG code and the Stewardship Code.³¹⁰

II.6.6 Prudential regulation

As discussed in Appendix II.3.1, under the twin peaks model prudential regulation is primarily undertaken by the PRA, although firms not regulated by the PRA are subject to the prudential regulation of the FCA.

³⁰⁵ FRC, "The Accountancy Scheme," (July 2013), 47

³⁰⁶ FRC, Case Management Committee, op. cit.

³⁰⁷ FRC; "Making a complaint about the FRC": Available at <https://frc.org.uk/Footer-Quick-Links/Quick-Links-3/Making-a-Complaint/Making-a-complaint-about-the-FRC.aspx> (visited 22 Nov 2016)

³⁰⁸ FRC, The Conduct Committee, (April 2016) op. cit. 10

³⁰⁹ FRC, Tribunals, op. cit.

³¹⁰ FRC, (Jan 2016) op. cit.

Prudential Regulatory Authority

Part XI of the FSMA and Part 5 of the Financial Services Act 2012 provides the PRA with statutory information gathering and investigative powers. Investigations may be undertaken on its own or utilise third parties³¹¹, including the FCA.³¹²

Part XIV of the FSMA empowers the PRA with general statutory disciplinary measures. Regulated activity disciplinary measures are sourced from Part V of the FSMA. Sections 66 and 67 of the FSMA provide statutory disciplinary powers and measures, respectively, in relation to codes (e.g. Remuneration Code). Disciplinary measures with respect to codes are undertaken by the PRA or may be referred by the PRA to the Upper Tribunal (Tax and Chancery Chamber).

Under the FSMA, the PRA has a number of statutory sanctioning powers that reflect those provided to the FCA including: (1) vary PRA-authorized person's permissions³¹³ or impose a requirement; (2) refusal to authorise a firm; (3) refusal to approve an individual to carry out a controlled function; (4) object to a change of control or to approve it subject to conditions; (4) direct an unregulated parent undertaking; (5) investigate a matter under Part XI of the FSMA; (6) impose a penalty; (7) public censure; (8) suspension; or (9) issue a restriction.³¹⁴

When proposing to exercise certain statutory powers (including disciplinary measures with respect to the Remuneration Code and codes in general³¹⁵), the PRA must give written notice to whom the power is exercised, in accordance with the following categories:³¹⁶

Notice	Description	FSMA (as amended)
Warning Notice	States the action the PRA proposes to take giving reasons for the proposed action and giving the opportunity for representations.	Section 387
Decision Notice	States the reasons for the action that the PRA has decided to take. The PRA may also give a further decision notice that relates to a different action in respect of the same matter if the recipient consents. The notice also gives an indication of any right to have the matter referred to the Upper Tribunal (Tax and Chancery Chamber) and the procedure for such a reference.	Section 388
Notice of Discontinuance	Identifies the proceedings set out in a warning or decision notice and which are not being taken or being	Section 389

³¹¹ Sections 167-169 of the FSMA

³¹² PRA, "The PRA's enforcement policies": Available at <http://www.bankofengland.co.uk/pr/Pages/supervision/regulatoryaction/enforcement.aspx> (visited 25 Nov 2016)

³¹³ This includes to undertake certain regulated activities to the extent that it may require a change to the firm's business model or future strategy

³¹⁴ PRA, "Regulatory Action," (January 2016): Available at <http://www.bankofengland.co.uk/pr/Pages/supervision/regulatoryaction/default.aspx> (visited 24 Nov 2016).

³¹⁵ Section 67 of the FSMA

³¹⁶ PRA, "The Prudential Regulatory Authority's approach to enforcement: statutory statements of policy and procedure," (January 2016), 6 and 7

	discontinued.	
Final Notice	Sets out the terms of the action that the PRA is taking.	Section 390
Supervisory Notice	Details action that the PRA has taken or proposes to take.	Section 395(13)

Warning notices or first supervisory notices given by the PRA will specify a time within which the recipient is required to make oral representations, subject to extension of time.³¹⁷ The recipient of the warning notice or supervisory notice may choose to be legally represented at the meeting.³¹⁸

Appeals against the decisions of the PRA can be made to the Upper Tribunal under Part IX of the FSMA and section 23 of the Financial Services Act 2012, which in turn can be appealed to the Court of Appeal on a point of law (FSMA, s137).

Publication:

Enforcement policy statements in general are published by the PRA in "The Prudential Regulatory Authority's approach to enforcement: statutory statements of policy and procedure". However, the PRA will not normally publicise the fact that it is or is not investigating an individual or matter, identities of those under investigation, or findings or conclusions of an investigation.³¹⁹ Information concerning a statutory notice may be published pursuant to sections 391 and 395 (2) of the FSMA. The PRA takes into account various factors in making the decision on publicity such as any potential prejudice risk of unfairness and/or disproportionate damage that it believes may be caused to any persons under investigation, and whether publicity advances its statutory objectives, assisting the investigation (e.g. by way of bringing forward witnesses), or deterring more widespread breaches of its regulatory requirements.³²⁰

Accountability:

The PRA is accountable to HM Treasury and issues an annual report that canvasses some general enforcement information and statistics.

Financial Conduct Authority

When acting in the role as prudential regulator (i.e. those firms not regulated by the PRA) the FCA can utilise the following enforcement actions: (1) discipline authorised firms in accordance with Part XIV of the FSMA and approved persons under section 66 of the FSMA; (2) withdraw a firm's authorisation;³²¹ (3) prohibit individuals from carrying out regulated activities;³²² (4) suspend firms or individuals from undertaking regulated activities;³²³ (5) prohibit an individual to be employed in connection with a regulated activity (section 56 of the FSMA); (6) petition the court for the winding up or administration of companies, and the bankruptcy of individuals carrying on regulated activities; (7) impose civil penalties (section 123 of the FSMA) or impose restitution orders (sections 382, 383, and 384 of the FSMA) in relation to market abuse; and (8) apply for injunctions (sections 380 and 381 of the FSMA). Prosecutions may be initiated by the FCA in instances involving, *inter alia*, carrying on a regulated activity without

³¹⁷ Ibid 13

³¹⁸ Ibid 14

³¹⁹ Ibid 43

³²⁰ Ibid 43 and 44

³²¹ FCA, "Enforcement Information Guide,": Available at <https://www.fca.org.uk/publication/documents/enforcement-information-guide.pdf> (visited 24 Nov 2016)

³²² Ibid

³²³ Ibid

authorisation or exemption, making false claims to be authorised or exempt (section 24 of the FSMA), promoting an investment activity without authorisation (section 25 of the FSMA), failing to cooperate or giving false information to FCA investigators (section 25 of the FSMA), and failing to comply with provisions about influence over authorised persons (section 191 of the FSMA).³²⁴ The FCA has powers to prosecute a range of criminal offences under sections 401 and 402 of the FSMA.³²⁵

A person who contravenes the general prohibition—no person may carry on a regulated activity in the UK, or purport to do so, unless they are an authorised person or an exempt person (section 19(1) of the FSMA)—is guilty of an offence on summary conviction, indictment, imprisonment, and/or fine (section 23(1) of the FSMA).

II.6.7 Companies House

Documentation and company information is lodged with Companies House as part of the incorporation process and ongoing registration requirements. Monitoring of companies on the public register is conducted by Companies House to ensure that companies meet the requirements under the CA 2006, which is complemented by the public having online access to that information. Companies House applies fair and appropriate enforcement.³²⁶ The BEIS is responsible for most investigations and prosecutions under the CA 2006.³²⁷

Companies House monitoring of compliance with the CA 2006 such as filing of financial statements is equally applicable to non-listed companies. Companies House does not have any investigatory powers but does have some enforcement powers.³²⁸ Non-listed companies are nonetheless required to comply with the relevant financial reporting provisions of the CA 2006, and are thus regulated (monitoring, investigation, and enforcement) by the FRC (see above).

Under the CA 2006, Companies House can take actions such as removing a company from the registrar or prosecuting directors.³²⁹ Companies House works with various law enforcement authorities to provide assistance with their enquiries.³³⁰

Companies House is accountable to the BEIS and issues an “annual report and accounts” to Parliament which contains some enforcement information and statistics.

II.6.8 Whistle-blowing

As discussed in Appendix II.3.1, PIDA constitutes the UK’s whistle-blowing legislation. It makes amendments to the Employment rights Act 1996 that protects employees who make a “qualifying disclosure” in the public interest. CG issues will be covered by PIDA if it involves a failure to comply with a legal obligation to which the person is subject³³¹ – this will therefore cover not only CG matters established under primary legislation, but potentially also many of the detailed CG requirements established by regulatory bodies such as the FCA that have statutory backing.

³²⁴ FCA, “The Enforcement Guide,” (2014) *Appendix* op. cit. 1.4

³²⁵ FCA, “Enforcement Guide,” (Nov 2016), 12.1.1

³²⁶ “Companies House, Companies House enforcement strategy”: Available at <https://www.gov.uk/government/publications/enforcement-strategy-at-companies-house/companies-house-strategy> (visited 25 Nov 2016)

³²⁷ FCA, UK regulators, government and other bodies, op. cit.

³²⁸ Companies House, “What Companies House can and can’t do”: Available at <https://www.gov.uk/government/publications/reporting-fraud-about-a-company-to-companies-house/reporting-fraud-to-companies-house> (visited 25 Nov 2016)

³²⁹ *Ibid*

³³⁰ *Ibid*

³³¹ Section 43B(1)(b) of the PIDA.

While the Act does not require companies to institute internal whistle-blowing procedures, and has been criticised as not going far enough to encourage and protect whistle-blowers, both the FCA and the PRA have issued rules on PIDA that apply to limited types of financial institutions but not to listed issuers *per se*, as discussed in Appendix II.4.1.

Unlike the whistle-blowing laws in the United States, PIDA does not contain any mechanisms of reward (financial incentives) but only compensation – this reflects fundamental differences in the UK and United States legal systems and culture, the UK Government having stated that it does not believe that financial incentives should form an integral part of the whistle-blowing framework. However, in 2014 the PRA and FCA for the Treasury Select Committee considered the merits of introducing financial incentives and concluded that it would not encourage whistle-blowing or increase the integrity and transparency in financial markets.³³²

Hong Kong does not have any specific whistle-blowing law. However, certain statutes do provide limited protections in relation to persons reporting suspected wrongdoing, including employees making reports in relation to labour laws under the Employment Ordinance, discrimination under the Discrimination Ordinances,³³³ disclosures under the Anti-money Laundering Ordinance,³³⁴ or disclosures to the SFC by auditors of listed companies.³³⁵ The Competition Commission of Hong Kong issued a leniency policy in November 2015 that serves to encourage whistle-blowing. As regards listed issuers, whistle-blowing is the subject of a non-mandatory recommended practice in the Corporate Governance Code of the listing rules that is only addressed to audit anomalies.³³⁶ However, while more companies are introducing audit whistle-blowing policies and procedures³³⁷ less than half of listed companies in Hong Kong do not comply with that recommended practice.³³⁸ The Hong Kong Monetary Authority (HKMA)'s Supervisory Policy Manual mentions the concept of whistle-blowing but this is couched in language that an authorised institution should have a well-communicated policy allowing staff "to communicate, in confidence and without risk of reprisal" observations of any violations.³³⁹

³³² "Financial incentives for whistleblowers", Note by the Financial Conduct Authority and the Prudential Regulation Authority for the Treasury Select Committee, July 2014:, availableAvailable at <https://www.fca.org.uk/publication/financial-incentives-for-whistleblowers.pdf> (visited 25 Nov 2017)

³³³ Disability Discrimination Ordinance, the Sex Discrimination Ordinance, the Family Status Discrimination Ordinance and the Race Discrimination Ordinance

³³⁴ Drug Trafficking (Recovery of Proceeds) Ordinance, the United Nations (Anti-Terrorism Measures) Ordinance and the Organised and Serious Crimes Ordinance

³³⁵ SFO, s. 380

³³⁶ Listing Rules, Appendix 14, para C 3.8

³³⁷ "Best corporate governance awards 2016, Judges Report", HKICPA, page 13

³³⁸ "Corporate governance update", BDO Limited, 2016, page 5

³³⁹ At CG-1, para 2.6.7

Appendix II	7. Shareholders' rights and protections	II.7 United Kingdom
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Introduction

The UK represents a strongly shareholder-centric approach to CG. It is supported by a statutory regime under the CA 2006 based on a concept of enlightened shareholder value that emphasises long-term sustainable growth in which the interests of a wider group of stakeholders are brought into the field of management's consideration.

The CA 2006 provides clear and meaningful powers to shareholders. The FCA is active in improving minority shareholder rights, in particular in respect of Premium Listing issuers, including through requiring foreign companies seeking a listing to adjust their constitutive documents, and through regulating adjustments to voting power in certain circumstances. The FRC is also active in relation to the development and monitoring of the UK CG Code.

Access to information concerning material information of the company in general, and disclosures of governance arrangements in particular, are an important part of giving a degree of transparency to a number of matters of interest to investors. The UK provides for a range of disclosure obligations in relation to the financial situation and performance of the company, for example, through timely disclosure of material events as well as through strategic and directors' report. The disclosure of governance processes that have been adopted, as measured against the standards set by the UK CG Code, is an important means of allowing investors to understand how the company intends to conduct itself with regard to a range of governance issues including board processes and shareholder engagement. Together, these facilitate a measure of transparency on how the board operates, in the absence of which shareholders are faced with a black box operation providing limited insight into the company's prospects.

II.7.1 Shareholder rights

Minimum rights

Shareholder meetings:

Shareholders are entitled under section 303 of CA 2006 to require directors to call a general meeting and the directors are required to do so once the company has received requests from members representing at least 5% of the paid-up voting share capital of the company.³⁴⁰ Shareholders calling a meeting need to state the general purpose of the meeting and may include one or more proposed resolutions, which will need to be included in the notice of the meeting given to all shareholders.

Where the directors fail to call a meeting, section 305 of the CA 2006 provides that the requesting members may call the meeting at the company's expense. The members calling the meeting can claim any reasonable expenses they have incurred, and section 305(7) provides that the company must deduct the amount of any expenses so paid out from remuneration due to the directors who were in default of calling the meeting.

Voting rights:

³⁴⁰ The figure was reduced from 10% to 5% by the Companies (Shareholders' Rights) Regulations 2009 (S.I. 2009/1632), reg. 4(2)

The CA 2006 provides that rights held by a person in a fiduciary or nominee capacity on behalf of another shall be treated as held by the other, not by him. Rights shall be regarded as held as nominee for another if they are exercisable only on his instructions or with his consent or concurrence.³⁴¹ Under the CA 2006, nominee shareholders are not automatically entitled to receive information relating to the companies in which they have invested nor to attend or vote at relevant general meetings.³⁴² Section 324 of the CA 2006 allows a member of a company to appoint another person as his proxy to exercise all or any of his rights to attend and to speak and vote at a meeting of the company. The appointment of a proxy to vote on a matter at a meeting of a company authorises the proxy to demand, or join in demanding, a poll on that matter.

As noted in Appendix II.2, a finding of the Kay Review was that intermediated shareholding arrangements create barriers to shareholder engagement, and that the BEIS is exploring solutions to this.

The position as regards weighted voting rights is effectively the same as in Hong Kong in that the CA 2006, like the CO, permits the creation of different classes of shares with different rights attaching to them. The listing rules contemplate the listing of different classes of shares, however, the listing is not as a regulatory matter allowed in practice based on a "one-share, one-vote" principle. Premium Listing Principle 4 provides:

"Where a listed company has more than one class of equity shares admitted to premium listing, the aggregate voting rights of the shares in each class should be broadly proportionate to the relative interests of those classes in the equity of the listed company".

The UK tightened its listing principles in 2015 to prevent super voting shares or any share structures of primary listed companies that lead to voting power being kept within a small group of shareholders.³⁴³

Rights of pre-emption:

Chapter 3 of the CA 2006 gives shareholders a right of pre-emption. While overseas companies are not subject to this provision, LR 9.3.11 R imposes pre-emption rights (as qualified by LR 9.3.12. R) on listed issuers. For overseas companies seeking a Premium Listing, LR 6.1.25 R requires the issuer to ensure its constitution provides for rights at least equivalent to the rights provided for in LR 9.3.11 R and that such rights are not incompatible with the laws of its place of incorporation.

Controlling shareholders

As noted in Appendix II.1, in 2014 the FCA introduced important amendments to the listing rules to improve minority shareholder rights and protections where they are at risk of being abused by a controlling shareholder.

LR 9.2.2A R and 9.2.2E R now requires that, where an issuer possesses a controlling shareholder (i.e. a person together with their concert parties controls 30% of the votes),³⁴⁴ it must amend its constitution to provide for dual voting such that the

³⁴¹ Paragraphs 5 and 6, Schedule 6, CA

³⁴² Working For The Investment Community & Their Clients, "Nominee shareholders should have the same rights as registered shareholders," (25 March 2015), Press Release: Available at <http://www.thewma.co.uk/news/press-releases/nominee-shareholders-should-have-the-same-rights-as-registered-shareholders> (visited 25 Nov 2017)

³⁴³ LegCo of the HKSAR, "Understanding 'weighted voting right structures'". Available at <http://www.legco.gov.hk/research-publications/english/essentials-1415ise03-understanding-weighted-voting-right-structures.htm> (visited 5 Sept 2016)

³⁴⁴ LR 6.1.2A R

appointment of independent directors requires the approval of both the shareholders and independent shareholders.³⁴⁵

LR 9.2.2A R and 9.2.2B R require the controlling shareholder and the issuer enter into a "relationship agreement" containing undertakings concerning arms' length transactions and compliance with the listing rules – where the relationship agreement has been breached (or one has not been entered into), the sanction applied is that any transaction with the controlling shareholder (irrespective of size of transaction) will require independent shareholder approval. This sanction may be triggered by any independent director who disagrees with the board's assessment of whether the undertakings have been complied with. It is not able to be directly triggered by minority shareholders who would need to pursue redress through other means, for example, by seeking a general meeting or by bringing a derivative action where misfeasance is involved.

Remedies

Unfair prejudice:

Sections 994 to 996 of the CA 2006 allows a shareholder to bring a claim against a company where its affairs have been conducted in a manner "unfairly prejudicial" to its shareholders or some part of the shareholders, including the person bring the claim. The Secretary of State may also bring such a claim, and this may follow on as a consequence of the FCA exercising its information gathering and investigative powers under the FSMA. The Court has wide discretion as the remedy to grant, including as to the future regulation of the company's affairs, requiring the company to bring an action against another person (such as a malfeasant director), and ordering the company to repurchase shares from the petitioners.

Derivative action:

Part 11 of the CA 2006 allows a shareholder to bring a derivative action, i.e. on behalf of the company, in respect of "an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company".³⁴⁶ A claim will not be permitted where the action complained of has been validly ratified by shareholders in general meeting – this will require all necessary and relevant information to have been given to the shareholders in order for them to exercise an informed vote.

Listing requirements:

As noted in Appendix II.4, breaches of requirements of the listing rules or other requirements of the FCA's Handbook can give rise to a civil action for damages by affected persons. This is different from the situation in Hong Kong where breaches of the SEHK's LR are not *per se* actionable by investors.

Collective redress / class actions:

In 2000 the group litigation order (GLO) was introduced in the UK to bring together related cases. The GLO is an order made by the court that provides for the case management of claims that give rise to common or related issues of fact or law.³⁴⁷

Granting a GLO is at the court's discretion to allow related cases to be dealt with by the court together, to save time and costs. As such, it is not a collective action nor a class

³⁴⁵ FCA, Response to CP13/15, op. cit. and FCA 2014/33 op. cit.

³⁴⁶ Section 260(3) of the CA

³⁴⁷ Civil Procedure Rules Part 19 section III, see <http://www.justice.gov.uk/courts/procedure-rules/civil/rules/part19#III>

action right *per se*. However, there are some similarities worth noting for the present purposes - given that claimants can appoint one solicitor to conduct their claims, and the court makes a register onto which the claims of other individuals can subsequently be added, this introduces a significant cost saving for litigants that may serve to facilitate litigation by a group of similarly affected persons.

Although introduced with a focus on consumer rights, including financial services, a GLO can be set up in any civil claim. Accordingly, it seems possible in principle that a group of shareholders might be able to use it, although there has to date been no use made in the GLO in this context.

Class actions are not available in the UK.

II.7.2 Board processes

Legislation

Director interests:

As noted in Appendix II.3, the essential operation of the CA 2006 as regards directors is broadly similar as that seen in Hong Kong under the CO. An important difference that was noted is that interests of persons connected to directors would need to be disclosed under the HK regime but would appear to only be subject to disclosure requirements in the UK if it was regarded as a direct or indirect interest of the director. While this may reflect the interconnectedness and culture of Hong Kong, it does mean that additional information is statutorily required under the Hong Kong provisions.

Fiduciary duties:

The CA 2006 has codified directors' fiduciary duties – such as avoiding conflicts of interest and not accepting benefits from third parties.³⁴⁸ In contrast, shareholders in Hong Kong companies have the benefit of the same duties, albeit under the common law rather than statute. While a basic argument for codification is that it is intended to facilitate certainty and accessibility to the law, this is not clearly the case where duties are expressed at a general level.³⁴⁹ The above debate is of limited interest given that both boards of the SEHK is significantly dominated by non-Hong Kong incorporated issuers and Hong Kong's CO provisions in this regard only apply to Hong Kong incorporated companies. The SEHK's listing rules require directors of all listed issuers to fulfil fiduciary standards and duties of care to a standard at least commensurate with the standard of Hong Kong law, however, as noted in Appendices I.1 and I.4, the listing rules do not have statutory effect and so a breach of these standards merely gives rise to the SEHK's disciplinary sanctions (although behaviour comprised in the breach may entail other considerations arising under the SFO or the law of the place of the issuer's incorporation).

Narrative reporting:

The CA 2006 also introduced important disclosure obligations on UK incorporated issuers in the form of the strategic report³⁵⁰ and the directors' report.³⁵¹

³⁴⁸ Sections 175 and 176 respectively

³⁴⁹ For a fuller discussion, see Stefan HC Lo, "Corporate governance and the new companies ordinance in Hong Kong", (2013) 21 *Asia Pacific Law Review* 267

³⁵⁰ Section 414A CA 2006 as amended by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013

³⁵¹ Section 416 CA 2006 as amended by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013

Directors of a company must prepare a strategic report for each financial year of the company. The strategic report must contain a fair review of the company's business, and a description of the principal risks and uncertainties facing the company. The review must provide a balanced and comprehensive analysis of the development and performance of the company's business during the financial year as well as the position of the company's business at the end of the year. The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include an analysis using financial key performance indicators, i.e. the factors that effectively measure the development, performance or position of the company's business. It must also include, where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

In the case of a listed company with a Premium Listing they will additionally be subject to LR 9.8.6(3) R, which requires the annual report to include a statement by directors as to the current prospects of the company, including identifying the principal risks, and as to whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment.³⁵²

These disclosure obligations provide important information to shareholders. They can be compared to the directors' report required under section 388 of the CO (see also Schedule 5 of the CO). However, in the case of both the CA 2006 and the CO, the requirement only applies to companies incorporated under the CA 2006 or CO, respectively. However, in the UK, provisions of the FCA's listing rules and DTR, when read together with the requirement of the UK CG Code Main Principle C.2 discussed below, represent important, albeit partial, extensions of these disclosure requirements to non-UK incorporated issuers with a Premium Listing, as discussed below.

UK CG Code

Appendices II.3 and II.4 have discussed the standing and relevance of the UK CG Code in this regard, and it will be noted in the following discussion that certain provisions of the UK CG Code overlap with rules made by the FCA (such as the listing rules or the DTR), in some cases the FCA's guidance stating that compliance with a certain provision of the UK CG Code will be regarded as compliance with a particular FCA rule.

While listed issuers are not required to comply with the UK CG Code, they are required to make disclosures in relation to governance. The FCA's DTR 7.2.2 R and 7.2.3 R together require an issuer to disclose in its annual CG statement the CG code to which it is subject, or has voluntarily decided to apply, and to explain the reasons for any departures from that code; alternatively, if it has elected not to refer to any CG code it must explain the reasons why. More specifically, listing rule 9.8.6 R requires a statement to be made in the annual report how the issuer has applied the Main Principles in the UK CG Code and whether it has complied with all relevant provisions therein code – where it has not complied it must give the reasons therefor. While these provisions do not mandate compliance with the UK CG Code, a failure to make proper disclosure as required may constitute an untrue or misleading statement or an omission of a "matter required to be included" and accordingly could give rise to an enforcement action or a damages claim.

Overall, the UK CG Code places an emphasis on the responsibilities of the board that is not dissimilar to Hong Kong – see the discussion in Appendix I.4.1 and the comparison Table of the two CG codes at the end of Appendix I.4. Important examples of how the

³⁵² Provision C.2.2

UK CG Code impact on board processes that directly or indirectly benefit shareholders are as follows (references are to the UK CG Code).

Board effectiveness:

Principle A1 states that every company should be headed by an effective board that is collectively responsible for the long-term success of the company, that strategic aims should be appropriately set, and systems and procedures established that enable risks to be identified and managed. The collective nature of the undertaking of the board is underlined by Principle A.2, which states that no one individual should have unfettered powers of decision making.

Directors:

Principle B.1 requires the board and its committees to have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. The board should be of sufficient size that the requirements of the business can be met and that changes to the board's composition and that of its committees can be managed without undue disruption, and should not be so large as to be unwieldy. Code provision B.5.1 requires committees to be provided with sufficient resources to undertake their duties and directors, including INEDs, are to have access to independent professional advice at the company's expense – it is up to the directors to determine where advice is required.

Independent directors:

Principle B.1 of the CG Code requires that the board should include an appropriate combination of executive and NEDs (and, in particular, INEDs) such that no individual or small group of individuals can dominate the board's decision taking. B.1.2 of the Code requires FTSE350 issuers to have a board of which at least half (excluding the chairman) are INEDs. Other, smaller issuers, should have at least two INEDs. Compliance with this requirement is high: in 2014, 324/350 issuers complied, and in 2015 308/350 issuers complied in 2015 with over half of those not in compliance returning to compliance by the time their annual reports were published.³⁵³

There are three important differences in the way the UK and Hong Kong regimes operate in relation to the above requirement. First, in Hong Kong, it is a mandatory requirement for all issuers (LR 3.10A) that INEDs must comprise at least a third of the board (and no less than three), meaning that non-compliance with the requirement will be a breach of the listing rules and necessitate an announcement. Second, in the UK the board determines independence whereas in Hong Kong this is determined by the SEHK³⁵⁴ (although the Hong Kong CG Code requires the nomination committee of the board to consider independence in connection with proposed new INED appointments³⁵⁵). While the considerations relevant to a determination of independence address broadly similar considerations, in Hong Kong these are set out in the listing rules whereas in the UK they are provisions in the non-mandatory UK CG Code.³⁵⁶ An interesting exception to this division is that the independence of an INED serving on the board for nine years is relevant to the question of independence in both regimes but in Hong Kong this consideration is relegated to a provision of the HK CG Code.³⁵⁷ Third, in Hong Kong an INED is required to submit to the SEHK a written confirmation of independence.³⁵⁸

³⁵³ FRC (Jan 2016) op. cit.

³⁵⁴ LR 3.13

³⁵⁵ Provision A.5.2(d)

³⁵⁶ Respectively LR 3.13 and B.1.1

³⁵⁷ A.4.3

³⁵⁸ LR 3.13

The UK CG Code also requires that INEDs have sufficient time to devote to their responsibilities, requiring them to disclose to the board their other significant commitments, and keeping the board updated of any changes thereto.³⁵⁹ While the UK CG Code suggests that the number of NED posts at other companies a full time executive director can take on should be capped at one,³⁶⁰ there is no cap suggested for INEDs, although the HKEX is currently consulting on this question. While the Hong Kong CG Code also contains a requirement for sufficient time and attention, there is no express requirement that other commitments be disclosed to the board.

Board performance:

An important provision of the UK CG Code that goes further than seen in Hong Kong is Section B.6, which was introduced in 2010 and requires the board to undertake an annual evaluation of its own performance that brings within its consideration certain other matters imposed on the board under the UK CG Code. This includes the skills, experience, independence and knowledge of the company on the board, how the board works together as a unit, and other factors relevant to its effectiveness. The evaluation must be externally assisted at least every three years. The evaluation must be disclosed annually. In contrast, in Hong Kong board evaluation is a recommended best practice³⁶¹ that is not accompanied by any guidance as to what should be considered nor any disclosure requirement.

Accountability:

Accountability of the board is provided for in a range of provisions in Section C covering financial and business reporting, risk management and internal control, and audit and audit committees. Some of these provisions overlap with the FCA's Disclosure and Transparency Rules sourcebook, DTR 7.1 and 7.2 as regards the composition and functions of the audit committee and the annual disclosures requires in relation thereto – because these are established as DTR rules, unlike the provisions of the UK CG Code, the provisions create binding obligations and breaches may give rise to enforcement action and/or an action for damages. This includes the requirement that a majority of the committee is comprised of INEDs, that at least one member has accounting or audit competence, and that the body as a whole has competence relevant to the sector in which the issuer operates.³⁶² The FCA has given guidance³⁶³ that compliance with A.1.2, C.3.1, C.3.2, C.3.3 and C.3.8 of the UK CG Code will result in compliance with DTR 7.1.1 R to DTR 7.1.5 R.

The UK CG Code's approach to the audit committee is based on its primary function as a sub-committee of the board, and accordingly the findings of the audit committee are only reportable to the board. The one exception to this is where the board and the audit committee have been unable to agree on the recommended appointment, reappointment or removal of the external auditors – here the Code requires the annual report to contain a statement from the audit committee explaining the recommendation and why the board has taken a different position.³⁶⁴ The same approach is undertaken in Hong Kong.

Appointment and removal of directors:

The process for recommending board appointments should be led by a nomination committee, chaired by an INED and a majority of which should be INEDs.³⁶⁵ The terms of

³⁵⁹ Principle B3 and Code provision B.3.2

³⁶⁰ B.3.3 refers to NED roles in FTSE100 companies

³⁶¹ B.1.9

³⁶² DTR 7.1.1A R and 7.1.2A R

³⁶³ DTR 7.1.7 G

³⁶⁴ UK CG Code C.3.7

³⁶⁵ Provision B.2.1

reference explaining the role and authority delegated to the committee should be disclosed. The nomination committee should evaluate the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.³⁶⁶

The UK CG Code also requires the annual report to describe the work of the nomination committee,³⁶⁷ including the process it has used in relation to board appointments. This section should include a description of the board's policy on diversity, including gender, any measurable objectives that it has set for implementing the policy, and progress on achieving the objectives. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or an NED. Where an external search consultancy has been used, it should be identified in the annual report and a statement made as to whether it has any other connection with the company.³⁶⁸

Principle B.2 of the Code recognises the value of board refreshment, specifically as regards INEDs, suggesting that terms of more than six years should be subject to rigorous review.³⁶⁹

The UK CG Code recommends directors should be subject to re-election by the shareholders at regular intervals, that this should be annually in respect of FTSE350 directors, and that relevant information should be provided to shareholders to facilitate their decision-making.³⁷⁰

These provisions are broadly the same as the Hong Kong CG Code, save for the issue of board refreshment on which the Hong Kong regime is silent.

Remuneration:

Section D requires FTSE350 issuers to establish a remuneration committee with delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments; the committee should also recommend and monitor the level and structure of remuneration for senior management.

The remuneration committee should be comprised of at least three INEDs³⁷¹ and its terms of reference, explaining its role and the authority delegated to it by the board, are to be disclosed. The remuneration of NEDs is handled separately, the UK CG Code requiring this to be determined by the board or, where required by the Articles of Association, the shareholders or, where permitted by the Articles, to a committee of the board that may include the CEO.³⁷²

The DTR mandates disclosure of the composition and operation of the issuer's administrative, management and supervisory bodies and their committees, and this will encompass the remuneration committee where one has been established.³⁷³ A description of the work of the remuneration committee is also required under the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2013.

³⁶⁶ Provision B.2.2

³⁶⁷ This provision overlaps with FCA Rule DTR 7.2.7 R (see Schedule B)

³⁶⁸ Provision B.2.4

³⁶⁹ Provision B.2.3

³⁷⁰ Provision B.7.1

³⁷¹ Provision D.2.1

³⁷² Provision D.2.3

³⁷³ FCA Rule DTR 7.2.7 R

As regards shareholder involvement in remuneration, the Code also provides that shareholders should be invited to approve all new long-term incentive schemes (as defined in the listing rules³⁷⁴) and significant changes to existing schemes, save in the circumstances permitted by the listing rules.³⁷⁵

Together, these arrangements cover principles regarding the level and make-up of remuneration and disclosure that are similar to Hong Kong, as indicated in the comparison Table of the UK and HK CG codes set out at the end of Appendix I.4. A notable difference is that the UK CG Code provides greater detail, and emphasis, on the provisions the remuneration committee should follow when designing performance-related remuneration for executive directors,³⁷⁶ which in Hong Kong receives only a brief mention as a recommended best practice,³⁷⁷ and as regards the basis on which INEDs should be remunerated, which is not addressed by the HK CG Code.

Internal controls, risk management, and discussion of principal risks:

The Code requires the board should be responsible for, and maintain sound risk management and internal control systems.³⁷⁸ This includes carrying out reviews of the effectiveness of those systems, including financial, operational and compliance controls and the principal risks facing the company, and reporting on the review in the annual report.³⁷⁹ The directors should also describe those risks and explain how they are being managed or mitigated.³⁸⁰ In addition FCA Rule DTR 7.2.5 R requires companies to describe the main features of the internal control and risk management systems in relation to the financial reporting process.

As noted above, the strategic report that has been introduced into the CA 2006 only applies to UK incorporated companies. This is to some extent ameliorated by the FCA's rules LR 9.8.6(3) R and LR 9.8.7 R, which respectively apply to UK and non-UK incorporated issuers.

LR 9.8.6(3) R requires a UK incorporated listed issuer to include in its annual financial report a statement of the prospects of the company, which must contain the information required by Provision C.2.2 of the UK CG Code. Provision C.2.2 requires the directors to make a statement as to the current prospects of the company, including identifying the principal risks, and as to whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment. (Provision C.2.1, which requires a confirmation that a robust assessment has been carried out, is not subject to this LR requirement.)

LR 9.8.7 R requires non-UK incorporated issuers with a premium listing to state how they have applied the Main Principles of the UK CG Code and whether or not they have complied with the provisions of the UK CG Code throughout the reporting period. The Main Principle in C.2 states "The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems." While this is a lesser requirement than applies to UK incorporated issuers as discussed above, requiring a foreign issuer to explain how they have complied with that Main Principle, in a manner that would enable shareholders to evaluate how the principles have been

³⁷⁴ Listing Rules LR 9.4

³⁷⁵ Code Provision D.2.4

³⁷⁶ See Schedule A of the UK CG Code

³⁷⁷ Provision B.1.7

³⁷⁸ Principle C2

³⁷⁹ Provision C.2.3

³⁸⁰ Provision C.2.1

applied,³⁸¹ does serve to reduce – although not eliminate – the disclosure gap between UK and non-UK incorporated Premium Listing issuers.

The Hong Kong CG Code is similar to the foregoing as regards the general responsibility of the board in relation to risk, the need to undertake reviews, and the need to disclose various aspects of the features of risk management and the process used to review effectiveness of the systems.³⁸² However, in the absence of potential insolvency concerns,³⁸³ the Hong Kong regime does not expressly require any statement of prospects and principal risks and only suggests, as a recommended best practice, that the board may disclose the effectiveness of the risk management and internal control systems and any significant areas of concern.³⁸⁴ This is a subtle but nevertheless significant distinction. In contrast to the arrangements in the UK, which go some way to narrowing the disclosure gap between locally and foreign incorporated issuers as regards the identification of principal risks, the Hong Kong regime does not contain provisions that work to narrow that disclosure gap in this way.

Shareholder engagement:

Beyond the foregoing disclosure mechanisms of accountability, the UK CG Code requires the board as a whole to be responsible for ensuring dialogue with shareholders takes place, that this should be based on a mutual understanding of objectives, and that all directors should be made aware of shareholders' issues and concerns. Provision E.1.1 specifically requires the chairman to discuss governance and strategy with major shareholders – while this is not provided for in Hong Kong, it is arguably less relevant given the tendency toward controlling shareholder blocks. The chairman should also arrange the persons who chair the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.³⁸⁵ This broadly aligns with the requirement of the Hong Kong CG Code.³⁸⁶

II.7.3 Specific transaction contexts

Transactions significant in size

Chapter 10 of the listing rules applies to Premium Listing companies and is concerned with giving shareholders enhanced information and the right to vote on larger proposed transactions. Broadly similar in purpose to SEHK's LR Chapter 14, the UK provisions contemplate two classes of transaction:

Class 1 where any percentage ratio is greater than 25% (the equivalent of a major disposal/acquisition transaction (or above) under the Hong Kong rules); and

Class 2 where any percentage ratio is greater than 5% but all are less than 25% (the equivalent of a discloseable transaction under the Hong Kong rules).

The percentage ratio tests are similar in nature and purpose to those engaged in Hong Kong, although the UK regime does not employ a revenue test.

³⁸¹ 9.8.6(5) R

³⁸² Provision C.2.4

³⁸³ Provision C.1.3 refers to the disclosure in the Corporate Governance Report of "material uncertainties relating to events or conditions that may cast significant doubt on the issuer's ability to continue as a going concern"

³⁸⁴ Provisions C.2.6 and C.2.7

³⁸⁵ Provision E.2.3

³⁸⁶ Provision E.1.2

Whereas Class 2 transactions only required enhanced disclosures to be made, Class 1 transactions require the transaction to be made subject to shareholder approval – this corresponds to the same arrangements under the Hong Kong listing rules for the same sized transactions.

Related party transactions

Chapter 11 of the listing rules applies to Premium Listing companies and is concerned with providing safeguards to shareholders in relation to transactions involving a controlling shareholder or their associates.

As noted in Appendix II.1.2, controlling shareholders are required to be subject to independence requirements set out in a relationship agreement with the company.³⁸⁷ Where a controlling shareholder is not in compliance with those requirements, any transaction with the controlling shareholder (irrespective of size of transaction) will require independent shareholder approval. Importantly, this sanction may be triggered by any independent director who disagrees with the board's assessment of whether the undertakings have been complied with. The sanctions will remain in place until the next annual report in which the board makes a compliance statement without any disagreement from any of the independent directors. The sanctions will also apply where an independent director declines to make a statement of compliance in the annual report³⁸⁸ as regards the independence requirements under the relationship agreement.³⁸⁹

Other than the foregoing relationship agreement considerations, the Chapter 11 rules are similar in nature and purpose to that found in the SEHK's LR Chapter 14A. Subject to *de minimis* exemptions that dis-apply Chapter 11, a related party transaction gives rise to enhanced disclosures and, if one of the percentage ratios is 5% or more, then the transaction must be subject to approval of the shareholders (at which the related party and its associates do not vote), the shareholders having been provided with the requisite information.³⁹⁰ Both the UK and the Hong Kong rules make provision for the aggregation of transactions.

Director as connected party:

As noted above and in Appendix II.3, the CA 2006 requires direct or indirect interests of the director to be disclosed, and this is in some ways less encompassing than the Hong Kong regime applying to director disclosures.

Transactions involving potential change in control

All issuers listed on the LSE, including both Premium Listings and Standard Listings, are subject to the Takeovers Code. While the Hong Kong Code on Takeovers and Mergers is historically based on the UK Takeovers Code, and both remain primarily concerned with the equal treatment of shareholders, the two codes have evolved in different ways, particularly over the last decade or so. The most notable distinction is that the CA 2006 gave statutory effect to the UK Takeovers Code and the powers of the Takeover Panel, whereas the Hong Kong code remains non-statutory, although nevertheless effective.

³⁸⁷ See LR 9.2.2B R and 6.1.4D R

³⁸⁸ As required by LR 9.8.4R (12)(c)

³⁸⁹ LR 11.1.1A R

³⁹⁰ LR 11.1.7R

II.7.4 Role of regulators

Financial Conduct Authority

The powers of the FCA have been reviewed in Appendix II.6.

Prudential Regulatory Authority

The powers of the PRA have been reviewed in Appendix II.6.

Financial Reporting Council

The powers of the FRC have been reviewed in Appendix II.6.

Appendix II	8. Regulation of non-local companies	II.8 United Kingdom
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Introduction

In general, listed companies in the UK are subject to the same requirements of, and powers exercised by, the FCA. However, the application of the UK's primary corporate legislation, the CA 2006, applies primarily to UK incorporated companies with limited provisions covering foreign issuers. The FCA's requirements represent important means by which foreign firms come under regulatory oversight that work to facilitate a level playing field by imposing similar expected standards and providing for shareholder rights. The UK's present membership of the EU brings many non-UK companies established in the EU within the oversight of enforcement authorities, however, as the UK has commenced the process of leaving the EU it remains to be seen how cross-border enforcement will operate in a post-EU environment.

II.8.1 Legislation

As noted in appendix II.3.4, overseas companies are subject to Part 34 of the CA 2006 (sections 1044 to 1059 inclusive) and to the Overseas Companies Regulations 2009, which have been made pursuant to the CA 2006. These provisions primarily address matters related to registration, filings with Companies House and the requirements attaching to the preparation of accounts and disclosures.

As already noted, companies incorporated under the CA 2006 are required to prepare directors' reports and, since 1 October 2013, strategic reports.³⁹¹ Section 1049 of the CA 2006 empowers the Secretary of State to make regulations that require overseas companies also to prepare these reports, however, no such regulations have been made to date.

II.8.2 Non-statutory regulation

The FCA's requirements applying to issuers with a Premium Listing comprise some important provisions that bring overseas issuers into closer, though not always full, alignment with requirements that apply to companies incorporated in the UK³⁹²

First, although overseas issuers are not subject to Chapter 3 of the CA 2006, which gives shareholders a right of pre-emption, they are nonetheless subject to LR 9.3.11 R, which imposes pre-emption rights on all issuers. Where the issuer is an overseas company seeking a Premium Listing, it will need to make corresponding changes to its constitutional documents, as discussed in Appendix II.7.

Second, although overseas issuers are not subject to the requirement to produce strategic reports and directors' reports (discussed in Appendix II.7), which gives shareholders important additional information about, *inter alia*, the prospects of the company, overseas companies with a Premium Listing are nonetheless subject to LR 9.8.7 R, which requires them to state how they have applied the Main Principles of the UK CG Code and whether or not they have complied with the Main Principles set out in

³⁹¹ CA was amended by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013

³⁹² The FCA's requirements, including its listing rules and the disclosure guidance, in general apply to all companies wherever incorporated, subject to the proviso that an overseas company is only required to comply insofar as information available to it enables it to do so, and compliance is not contrary to the law in its country of incorporation. Where an issuer wishes to rely on the latter of these provisions, it will need to provide the FCA with a letter from an independent legal adviser explaining the situation (see LR 1.4.2 R, LR 1.4.3 R and DTR 1.1.1 G).

the UK CG Code throughout the reporting period. This is important because Main Principle in C.2 states: "The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems." Accordingly, requiring a foreign issuer to explain how they have complied with that Main Principle, in a manner that would enable shareholders to evaluate how the principles have been applied,³⁹³ serves to reduce – although not eliminate – the disclosure gap between UK and non-UK incorporated Premium Listing issuers in this regard.

As noted in Appendix II.7, the Hong Kong CG Code does not operate to narrow the disclosure gap in this regard between a locally and overseas incorporated issuer. A locally incorporated issuer will be subject to the CO reporting requirements (as well as those arising under the CG Code), whereas an overseas company will only be subject to a much more general recommended best practice, namely, that the board may disclose the effectiveness of the risk management and internal control systems and any significant areas of concern.³⁹⁴ Non-compliance with this recommended best practice is not a matter subject to reporting requirements.

II.8.3 Cross-border considerations

The ability to share non-public information across borders is an important tool to effective regulatory oversight. Post the 2008 financial crisis, there has been an increased awareness on the ability of national regulators to regulate effectively where firms within their jurisdiction operate globally. Relevant information held in one jurisdiction that is not available to another regulator represents a segmented set of information that impedes the ability of a regulator to observe, and react to, the bigger picture. However, cooperation generally does not involve cooperation in the enforcement context, such as to instigate a joint-name legal action or joint investigation.

The UK is a party to a number of important arrangements that work to reduce the cross-border segmentation of information.

The FCA is a party to the International Organisation of Securities Commissions' multi-lateral MoU (MMoU), which provides for assistance to other signatories to the MMoU – signatories include Hong Kong as well as the other jurisdictions the subject of this study. The MMoU is reactive rather than proactive. For example, it does not require regulators to actively provide information that comes into their possession nor does it require regulators to cooperate where misconduct occurs in one jurisdiction and affects another. In that sense, the MMoU has been described as successful, albeit subject to limitations.³⁹⁵

The FCA and FRC have agreed with the SEC a protocol for the sharing of information, on a confidential basis, on each regulator's reviews of the application of International Financial Reporting Standards (IFRS) by issuers listed in their respective jurisdictions.³⁹⁶ The protocol is intended to further the quality and consistency of the application of IFRS.

As a member of the International Forum of Independent Audit Regulators (IFIAR), the FRC is involved in the International Cooperation Working Group, which is concerned with how to improve the regulatory oversight of firms that operate across borders. This

³⁹³ 9.8.6(5) R

³⁹⁴ Provisions C.2.6 and C.2.7

³⁹⁵ Speech by Mark Steward, SFC Executive Director of Enforcement "Fighting On the Frontline: An Update" 3rd Annual US-China Legal Summit, 2 March 2015

³⁹⁶ SEC, "SEC, UK FSA, and UK FRC Sign Protocol for Sharing Information on Application of IFRS": Available at <https://www.sec.gov/news/press/2007/2007-73.htm> (visited 6 Sep 2016)

encompasses the cooperation of IFIAR members as regards the exchange of information including inspection reports.³⁹⁷ Hong Kong is not a member of the IFIAR.

In addition, the FRC is also a party to a protocol with the Public Company Accounting Oversight Board in the United States as regards the sharing of information, on a confidential basis, of information related to auditors. The protocol is intended to improve the accuracy and reliability of audit reports and by that means to facilitate investor confidence as well as to better protect investors.³⁹⁸

In 2014 the Chairman of the FCA stated the case for further cross-border cooperation:

“National silos are expensive, burdensome and provide opportunities for regulatory arbitrage. We have come far closer to the ideal on international co-operation than before the crisis.”³⁹⁹

In Hong Kong, the SFC have been active in engaging and extending its cooperation with the China Securities Regulatory Commission, important to the Hong Kong market in the present environment in which Mainland China businesses dominate the IPO market and increasingly dominate the makeup of companies listed on the SEHK.

³⁹⁷ Other members of the group are Australia, Canada, France, Italy, Japan, Korea, Switzerland, the UK and the United States. The European Commission is an Observer to the working group. International Forum of Independent Audit Regulators, “International Cooperation Working Group”: Available at [https://www.ifiar.org/Working-Groups/International-Cooperation-Working-Group-\(1\).aspx](https://www.ifiar.org/Working-Groups/International-Cooperation-Working-Group-(1).aspx) (visited 6 Sept 2016).

³⁹⁸ “Statement of Protocol Between the Public Company Accounting Oversight Board in the United States and the Financial Reporting Council of the United Kingdom on Cooperation and the Exchange of Information Related to the Oversight of Auditors”: Available at https://pcaobus.org/International/Documents/Cooperative_Agreement_UKpdf (visited 6 Sept 2016)

³⁹⁹ Terry Flanagan (2014), “FCA Pushes for International Cooperation”. Available at <http://marketsmedia.com/fca-pushes-international-cooperation/> (visited 5 Sept 2016)

Appendix III	UNITED STATES
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Appendix III	1. Market overview - Structure, characteristics and culture	III.1 United States
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Introduction

The importance of good corporate governance (CG) is widely recognised in the United States through several channels: a system of laws that are continually updated with a view to improving CG, the implementation of primary law by the many implementing rules and statements made by the Securities and Exchange Commission (SEC) as the main regulator of the securities markets, and rules of the Exchanges that are specifically concerned with CG that often reinforce, complement or add to the rules of the SEC. Institutional and activist shareholders and proxy advisory firms that hold companies to account, and the companies themselves by undertaking various measures including in particular the rise of independent directors on boards, together support a cultural emphasis on the importance of good CG and the responsibilities of management. It is clear that the United States government places high importance on CG not only through the enactment of legislation but also by holding Congressional hearings when market participants abuse expected core standards. Overall, CG culture is strong among listed firms, most notably large-cap companies, the Exchanges having introduced, in 2004 (New York Stock Exchange LLC (NYSE)) and 2009 (National Association of Securities Dealers Automatic Quotation System LLC (Nasdaq)), listing requirements specifically dealing with CG matters not otherwise addressed in United States laws (see Appendix III.7 for a discussion).

Nevertheless, there is no overarching theory of CG in the United States that explains CG in terms of shareholder interests - the United States CG system being overall more consistent with the interests of stakeholders and being ambivalent as to the ultimate locus of power and the beneficiaries of decision making power in corporations.¹ This stands in clear contrast to the position in Hong Kong, which is strongly shareholder-centric in ways that the United States CG system does not tolerate.

There are also a number of current problematic issues with the United States CG culture, two important drivers of recent developments being (1) the rise of institutional and activist shareholders and proxy advisers as dominant voices whose interests may not align with the strategic goals of an issuer or the shareholders as a whole, and (2) the widespread public recognition of the need to develop a more robust CG regime in the aftermath of the 2008 global financial crisis (GFC). The willingness of directors to promote CG cultural change beyond mere lip service also remains problematic, a particularly sensitive issue being director compensation and clawback arrangements that the government and the SEC will likely continue to grapple with for some time, something that is widely expected to be exacerbated following the election of President Donald Trump.

These problems overlap with certain problems perceived in the Hong Kong market only to a limited extent, due in part to a substantially different makeup of the shareholder base for Hong Kong listed issuers and, as discussed further in Appendix III.3, the relative lack of development of laws on the aforesaid matters. Hong Kong is in a different stage of development from the United States in terms of its maturity as an international financial market and the composition of its investor base, and possibly in terms of the extent to which good CG is or should be underpinned by laws as opposed to non-statutory regulations.

¹ Bainbridge, Stephen M., Director Primacy (May 25, 2010). UCLA School of Law, Law-Econ Research Paper No. 10-06: Available at SSRN: <https://ssrn.com/abstract=1615838>.

The United States capital market has long been among the leading centres in the world for the raising of equity capital, and is by far the largest as regards the number of firms listed as well as total market capitalisation. This has been facilitated not only by the size and leadership of the United States economy as the world's largest but also by a set of well-established and understood securities and exchange laws dating back to the early 1930s that continue to be subject to evolutionary updating in response to the market.

In contrast, the emergence of Hong Kong as an international financial centre is relatively recent. In the late 1980s it was a small regional market that accounted for less than 1% of world market capitalisation.² By 2002 to 2006 the Hong Kong market accounted for 12.9% of the total capital raised through initial public offerings (IPOs) worldwide. A combination of factors, including the economic emergence of Mainland China and the costs and risks associated with registered offerings in the United States post the Sarbanes-Oxley Act of 2002 (SOX) (see Appendices I.3 and III.3), resulted in the United States markets losing their position as the leading capital raising centre (based on funds raised) in IPOs to Hong Kong from 2009 to 2011 and 2015 to 2016.³ In contrast to the domination of non-Hong Kong incorporated companies that are listed on The Stock Exchange of Hong Kong Limited (SEHK), more than 50% of the listed companies in the United States are incorporated in the state of Delaware⁴ with 33% (NYSE) and 47% (Nasdaq) being incorporated in other domestic states.⁵

III.1.1 Corporate governance system

The United States CG system operates on a market-based model that is referred to as an outsider-dominated system or Anglo-American system.⁶ This is based on a law-oriented approach to CG that relies on shareholders and investors as the regulatory heuristic.⁷ While the United States comprises elements of a shareholder-oriented model,⁸ in important ways shareholders are more properly described as beneficiaries of the fiduciary powers exercised by directors, without possessing the power to direct them.⁹ Indeed, it has been suggested that any attempt to give shareholders the power to specifically direct the directors by making provisions in the company's charter, for example, in the manner enjoyed by Hong Kong shareholders or those under the United Kingdom (UK) system from which the Hong Kong system is derived, would be invalid.¹⁰

Three key features of the CG system in the United States are:

² Hay-Davison Report

³ See: Market Capitalisation of the World's Top Stock Exchanges (As at end September 2017): Available at <http://www.sfc.hk/web/EN/files/SOM/MarketStatistics/a01.pdf> (visited 20 Nov 2017); IPO insights Comparing global stock exchanges: Available at [http://www.ey.com/Publication/vwLUAssets/IPO_Insights:_Comparing_global_stock_exchanges/\\$FILE/IPO_comparingglobalstockexchanges.pdf](http://www.ey.com/Publication/vwLUAssets/IPO_Insights:_Comparing_global_stock_exchanges/$FILE/IPO_comparingglobalstockexchanges.pdf) (visited 20 Nov 2017); China IPO Markets Update, December 2015: Available at <https://home.kpmg.com/content/dam/kpmg/pdf/2016/03/China-IPO-Markets-Update-1512-v1.pdf> (visited 20 Nov 2017)

⁴ State of Delaware, "About the Agency,": Available at <https://corp.delaware.gov/aboutagency.shtml> (visited 20 Sep 2016)

⁵ NYSE, "Current List of All Non-U.S. Issuers,": Available at https://www.nyse.com/publicdocs/nyse/data/CurListofallStocks_12-31-15.pdf (visited 21 Sept 2016). Nasdaq, "NASDAQ – Non US companies,": Available at <http://www.nasdaq.com/screening/companies-by-industry.aspx?exchange=NASDAQ&market=ADR> (visited 21 Sept 2016)

⁶ Demetra Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Oxon and New York: Routledge, 2016), p 202

⁷ John Armour and Jeffrey Gordon, "The Berle-Means Corporation in the 21st Century," (2016) *Preliminary Draft*, 3

⁸ Gregory Jackson, "Understanding Corporate Governance in the United States" (October 2010) *Arbeitspapier 223, Hans Böckler Stiftung*, 9

⁹ C.M. Bruner, "Corporate governance in the common-law world", 2013 [PAGE REF]

¹⁰ Bebchuk, Lucian A., The Case for Increasing Shareholder Power. Harvard Law Review, Vol. 118, No. 3, pp 833-914, January 2005; Harvard Law and Economics Discussion Paper No. 500: Available at SSRN: <https://ssrn.com/abstract=387940>. WT Allen, HR Kraakman, G Subramanian, "Commentaries and Cases on the Law of Business Organization" (2007) (2 ed.) 107

A disclosure-based system of obligations imposed on issuers backed by primary legislation (see Appendix III.3) and regulatory law (see Appendix III.4) designed to overcome information asymmetries between corporations and shareholders.¹¹ Disclosure is also the cornerstone of the SEC's mission to protect investors, and maintain fair, orderly, and efficient markets.¹² When the disclosure regime was first implemented in the early 1930s, it was designed to extend the rule of caveat emptor by adding the doctrine of "let the seller also beware".¹³

Concentration of power in the board with a limited set of control rights for shareholders (see Appendix III.7). This has been rationalised as an efficient division of labour explained by the fact – common to all jurisdictions the subject of this study if not a universal phenomenon – that retail shareholders are numerous, highly dispersed with high coordination costs, tend toward passivity as regards the exercise of rights given to them arising from the separation of ownership and control,¹⁴ and are frequently ill-informed contributors to CG.¹⁵

Aggressive court enforcement of rules regulating CG-sensitive matters such as self-dealing transactions and mandating disclosures (see Appendix III.6).¹⁶

This system differs from the Hong Kong system in important ways. Although the Hong Kong system is also strongly disclosure oriented, important aspects of the system, particularly in relation to the admission of issuers to listed status, are effectively merit based. While there is a body of disclosure-based law, the ordinance that governs primary market offerings – the Companies (Winding Up and Miscellaneous Provisions) Ordinance¹⁷ (CWUMPO) – is largely out of date and has never been enforced or tested in court. On the other hand, the law that mandates disclosures of listed issuers in the secondary market – Part XIVA of the Securities and Futures Ordinance¹⁸ (SFO) – is relatively new but is being actively enforced by the Securities and Futures Commission (SFC) though not by shareholders. Many of the regulations in Hong Kong that more specifically interact with CG are not backed by statute and attract disciplinary sanctions of a regulatory nature that have been criticised as being insufficiently deterrent in nature (see Appendices III.3, III.4 and I.1). These differences lead to a notable difference in how good CG is fostered and enforced.

Whereas CG in the United States is firmly rooted in legislation, regulatory law and case law that arises out of enforcement actions or judicial review, the Hong Kong model has, with few exceptions, adopted non-statutory codes. The United States may seem adverse to shareholder rights in its approach to allowing the concentration of power in boards. For example, in a takeover scenario, the board will have considerable power to determine the progress and outcome of the takeover as compared to the shareholder-based model in Hong Kong, which has followed the model of the UK (see Appendix III.7). However, the counterpoint to that is the strength of oversight and accountability then able to be applied under each system. For example, whereas a takeover in the United States is undertaken in view of judicial enforcements of directors' duties in takeover situations under State law, in Hong Kong it is undertaken in view of the Code on Takeovers and Mergers and the rulings, decisions and powers of the Executive and the

¹¹ Armour and Gordon, op. cit.

¹² Daniel M Gallagher, "The Importance of the SEC Disclosure Regime," (2013): Available at <https://corpgov.law.harvard.edu/2013/07/16/the-importance-of-the-sec-disclosure-regime/> (visited 23 Sept 2016)

¹³ Ibid.

¹⁴ Adolf Berle and Gardiner Means, *The Modern Corporation & Private Property* (New York: The Macmillan Company, 1932)

¹⁵ Armour and Gordon, op. cit.

¹⁶ Ibid.

¹⁷ Cap. 32

¹⁸ Cap. 571

Panel thereunder – Hong Kong does have clear laws governing director duties but they are rarely in the forefront of considerations.¹⁹ While in both cases the regulator has tools at its disposal to correct or punish bad CG, the tools differ in their consequences and hence effectiveness (see Appendix III.6). Each system puts the investor in a different relationship to the question of corporate behaviour – see Appendix III.7 for a discussion of shareholder rights. These distinctions in part arise out of a fundamentally different understanding of the role of the board in relation to managing the affairs of the company, the United States placing the reins firmly in the hands of the board and its directors subject to their fiduciary duties, Hong Kong instead following the UK model of requiring the board at critical times to step aside to allow shareholders to decide matters of importance.²⁰

The recent issues arising out of the Wells Fargo incident – which has given rise to its chief executive officer (CEO) facing a Congressional hearing - has redoubled attention to the importance of “tone at the top”. Commenting on the board’s response to the incident, a former chairwoman of the Federal Deposit Insurance Corporation (FDIC) stated, “Unfortunately, it appears that the bank’s response was to view the problem as employee misconduct and to fire people as opposed to looking at the supervisory chain and culture... Culture and tone at the top is exactly what the board should be looking at.”²¹ The ability, willingness and accountability of directors to deal with malpractice has fortified calls for the clawback of bonuses from senior executives.²² It has also been observed that part of the problem underlying the Wells Fargo incident was the structure of the executive compensation scheme that was heavily incentive-based and likely led to pressure on lower operational levels to “perform”.²³

Closely connected to this discussion is the role executive compensation has played in the dynamics of CG and this is discussed further below. The importance of “tone at the top” is also gathering increasing attention in Hong Kong. However, while there has been significant developments in senior management accountability at law, notably following the introduction of the SFO in 2003, including responsibility for systems that enable compliance with statutory disclosure obligations following amendments to the SFO in 2013 that introduced Part XIVA, executive clawback is not currently under discussion for implementation. Regulatory influence as regards tone from the top is mainly left to non-statutory codes in the listing rules.

III.1.2 Market characteristics

Exchanges

An important distinction to make between the United States and Hong Kong is that the effective monopoly enjoyed by the Hong Kong Exchanges and Clearing Limited (HKEX) is missing in the United States where a large number of Exchanges and electronic securities markets operate.²⁴ For this reason, only the NYSE and Nasdaq, by far the largest stock exchange and electronic securities market, respectively, are considered in

¹⁹ Jackson, op. cit.

²⁰ For the further discussion, see Bruner op. cit. section 3B

²¹ Gretchen Morgenstern, “By Taking Back Money, Well’s Fargo Board Seems to Recall Its Role,” (27 Sept 2016) *New York Times, Business Day*

²² Stephen Foley and Alister Gray, “Activist pushes for shake-up at Wells Fargo,” (15 Sept 2016) *Financial Times*

²³ JC Coffee, “Preserving the corporate superego in a time of activism”, speech delivered University of Hong Kong, 14 December 2016: Available at <http://ssrn.com/abstract=2839388>

²⁴ Around 20 Exchanges operate, although not all are strictly speaking trading in equity shares. For an up to date list see <https://www.sec.gov/divisions/marketreg/mrexchanges.shtml>. There are a number of other distinctions, for example, the securities of companies that are not listed may if they have filed registration statements with the SEC be traded on the OTC Bulletin Board operated by the Nasdaq, and companies that are neither listed nor registered with the SEC can be traded through the Pink Sheets quotation dissemination service. In addition, stocks listed on one Exchange may be traded through other Exchanges subject to specific exceptions.

the present study. A further distinction to note is that whereas the SEHK requires all of an issuer's equity capital to be listed, this is not a requirement of the NYSE and Nasdaq, however, the listing of a portion of a company's equity is nevertheless effective in bring CG, and hence corporate behaviour and accountability, within the regulatory oversight discussed in this section.

While the character of NYSE and Nasdaq differ as regards their trading mechanisms²⁵ and nature of issuers traded,²⁶ their approach to CG follows a similar pattern under a common umbrella of legislative requirements and regulatory oversight (see Appendices III.3 and III.4). Both NYSE and Nasdaq are demutualised (i.e. for profit, investor owned) Exchanges. Intercontinental Exchange Inc owns NYSE and Nasdaq Inc owns Nasdaq. In 2007 NYSE merged with Euronext. NYSE and Nasdaq are listed companies on their own Exchanges. Each of NYSE and Nasdaq have around 3,000 companies listed on their trading boards.

Company size

The particular characteristics of CG culture in companies listed in the United States is also influenced by size. Small-cap companies, i.e. with a market-capitalisation of less than US\$500 million, comprise over 80% of listed companies.²⁷ With different resources available, small-cap companies often spend less on their entire CG infrastructure than large-caps spend on one director, and board talent is often attracted to large-cap companies.²⁸ This may filter down into reduced management and board experience and additional burdens being placed on directors.²⁹

However, the percentage of independent directors on a company board does not differ significantly: 84% of the board in large companies, 80% in mid-cap companies, and 77% in small-cap companies.³⁰ In other regards, small-cap companies' CG culture include: (1) more than 60% elect directors at annual elections as opposed to holding staggered board elections; (2) majority voting in director elections is used by 19% of small-caps; (3) they are more likely to have an independent board chair than in comparison to mid- or large-caps; (4) directors are less likely to serve on multiple listed company boards; (5) smaller board sizes and key committees that tend to meet less often; and (6) CEO compensation is less likely to include use of options, pension programs, or deferred compensation plans.³¹

²⁵ NYSE operates on a physical trading floor located in New York and employs an auction market structure where designated market makers facilitate price discovery and brokers execute trades (i.e. participate in auctions) on behalf of firm's clients, both manually and electronically whereas Nasdaq operates under a dealer market structure—an electronic based structure where member firms become market makers, matching buyers and sellers electronically. It has servers located across the U.S. and does not have a physical central trading floor. See NYSE, "Trading Information": Available at <https://www.nyse.com/markets/nyse/trading-info> (visited 20 Sept 2016) and Nasdaq, "Market Mechanics: An Educator's Guide to U.S. Stock Markets," 11: Available at http://www.nasdaq.com/reference/market_mechanics.pdf (visited 20 Sept 2016)

²⁶ NYSE has more established companies, including many blue chip firms, on the NYSE in comparison to Nasdaq. NYSE stocks are considered to be more stable and established than those listed on the Nasdaq. Nasdaq is known as a high-tech market, attracting many internet, technology, or electronic oriented companies. Stocks listed on Nasdaq are considered to be more volatile and growth oriented than those listed on the NYSE. See Roger D. Huang and Hans R. Stall, "Dealer versus auction markets: A paired comparison of execution costs on NASDAQ and the NYSE," (1996) *Journal of Financial Economics* 41, 313-357 and Mark Ingebretsen, *Nasdaq: A History of the Market That Changed the World* (Roseville: Prima Lifestyles, 2002); Nasdaq, Market Mechanics, op. cit.

²⁷ James McRitchie, "A Big Reason Small-Caps Undertake Bad Financings: Board Composition," (5 February 2014) *CorpGov.net*

²⁸ Ibid.

²⁹ Adam J Epstein, "Corporate governance is not one-size-fits-all," (May 2016) *Financier Worldwide, Special Report: Operating An Effective Board*

³⁰ Ernst & Young, "Governance Trends and Practices at US Companies: a review of small- and mid-sized companies," (May 2013), 6: Available at [http://www.ey.com/Publication/vwLUAssets/Governance_trends_practices_at_US_companies/\\$FILE/Governance_trends_practices_at_US_companies.pdf](http://www.ey.com/Publication/vwLUAssets/Governance_trends_practices_at_US_companies/$FILE/Governance_trends_practices_at_US_companies.pdf) (visited 28 Sept 2016)

³¹ Ibid.

Shareholder ownership

Numerous surveys undertaken in the United States indicate market participants appreciate the value of good CG. For example, the 2015 Spencer Stuart Board Index found that investor attention to board performance had escalated in the past several years, notably in the areas of board composition, disclosure, and shareholder engagement.³² The 2008 GFC has redoubled concerns that a robust CG regime be developed.³³ Changes to shareholder ownership represent one challenge in this regard.

The widely accepted view of shareholder ownership in the United States, reflecting the Berle and Means dispersed ownership structure recognised since the 1930s, is that the ownership of listed companies is characterised by dispersed shareholdings.³⁴ While one reason advocated for the dispersed ownership structure in the United States is the separation of ownership and management,³⁵ there are suggestions that the trend is toward more concentrated ownership structures and that the dispersed ownership characterisation of the United States markets is empirically incorrect.³⁶ Research done for the present study shows that over 90% of issuers listed on NYSE and Nasdaq had one or more shareholders that held 5% or more of the company's traded shares, with over 20% having one or more shareholders that held 30% or more, as shown in the Table below.³⁷ These statistics undoubtedly underestimate the extent of concentrated ownership structures as Exchanges in the United States do not require all issued shares to be listed – this means that companies can register for admission to trading only a portion of the issued share capital, so these statistics would not capture shareholding blocks that have not been registered with the SEC.

	X ≥ 50%	50% > X ≥ 30%	30% > X ≥ 5%	5% > X ≥ 0%
NYSE	10.23%	7.29%	72.32%	10.16%
Nasdaq	15.01%	12.34%	67.20%	5.45%
<i>Cumulative (NYSE & Nasdaq)</i>	<i>12.88%</i>	<i>22.98%</i>	<i>92.45%</i>	<i>100.00%</i>
HKEX Main board	37.32%	24.62%	26.94%	11.12%
<i>Cumulative</i>	<i>37.32%</i>	<i>61.94%</i>	<i>88.88%</i>	<i>100.00%</i>
HKEX GEM	0.00%	44.67%	40.98%	14.34%
<i>Cumulative</i>	<i>0.00%</i>	<i>44.67%</i>	<i>85.66%</i>	<i>100.00%</i>

³² Spencer Stuart, "2015 Spencer Stuart Board Index," 1

³³ Commissioner Luis A. Aguilar, "Looking at Corporate Governance from the Investor's Perspective," (21 April 2014) *U.S. Securities and Exchange Commission, speech at the Emory University School of Law, Atlanta, Georgia*: Available at https://www..sec.gov/News/Speech/Detail/Speech/1370541547078#_edn10 (visited 24 Sept 2016)

³⁴ OECD, "OECD Corporate Governance Factbook," (2015), 14

³⁵ Clifford G. Holderness, "The Myth of Diffuse Ownership in the United States," (2009) 22 *Review of Financial Studies* 4, 1377-1378

³⁶ *Ibid.*

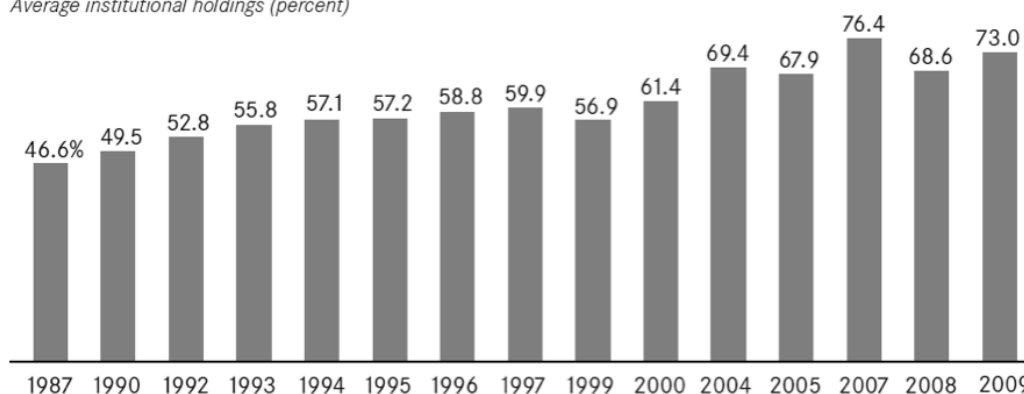
³⁷ Figures derived from the Osiris database, as of 16 October 2016

Put in the perspective of the Hong Kong market, share ownership in the United States public market remains comparatively well dispersed as regards controlling ($\geq 30\%$) interests. Of issuers listed on the Main Board of the SEHK, the research showed that 37.32% of issuers possess majority shareholders and 61.94% possess controlling shareholders (i.e. hold 30% or more). Many issuers in Hong Kong also have a limited public float (the listing rules require a minimum of 25% and for issuers with a larger market capitalisation this can be reduced down to 15% and, informally, 10%), meaning that if the statistics were able to capture shareholdings of persons not part of the public float,³⁸ such as persons connected to the issuer and its directors, the dispersal of interest would be less than what the above statistics suggest.

Ownership concentration in both the United States and Hong Kong markets tend toward institutional shareholders³⁹ with family ownership an additional factor in the Hong Kong market. Institutional shareholders are a mix of international funds (e.g. mutual funds and exchange traded funds)⁴⁰, activist shareholders, private equity, pension funds, and sovereign wealth funds.⁴¹ Institutional shareholders have dominated the ownership of stocks in United States listed companies at least since the 1990s.⁴² Public stocks owned by institutional shareholders has risen from about 7.5% in 1950,⁴³ to around 50% in the late 1980s to around 70% in the current era, as shown in the Table below.⁴⁴

Institutional ownership concentration in the top 1,000 U.S. corporations, 1987–2009

Average institutional holdings (percent)



Source: The Conference Board, 2010.

As already discussed above, this change together with the advent of hedge fund activism may introduce new dynamics in the level of influence shareholders may exercise over board appointments, such as might result from temporary formation of wolf packs. In Hong Kong, institutional ownership is facilitated from the point of admission to listing via IPOs by splitting the offering into an international placing and a retail tranche in which the latter is normally set at only 10% of the entire offering.

³⁸ See MBLR 8.24

³⁹ See Ronald J. Gilson & Jeffrey N. Gordon, "The Agency Costs of Agency Capitalism," 113 *Columbia Law Review* 863 (2013)

⁴⁰ Aguilar op. cit.

⁴¹ Armour and Gordon, op. cit. *Preliminary Draft*, 4; Jackson, op. cit. *Hans Böckler Stiftung*, 10

⁴² Armour and Gordon, op. cit. *Preliminary Draft*, 4

⁴³ Aguilar, op. cit.; referring to Marshall E Blume and Donald B Keim, "Institutional Investors and Stock Market Liquidity: Trends and Relationships," (21 August 2012) *Working Paper, The Wharton School*, 4; The Conference Board, "Institutional Investor Report: Trends in Asset Allocation and Portfolio Composition," (November 2010)

⁴⁴ *Ibid.*

The rise of institutional and activist shareholders as the dominant shareholders in the United States is an important factor that has given new emphasis and greater resources to law and shareholder oriented approaches to CG.

A second important factor, discussed next, is the advent of proxy advisory firms (such as Institutional Shareholders Services (ISS)) that wield considerable influence, sufficient to attract the attention of regulators, and tend to be supportive of entities pushing for CG cultural change, at least in name - the alternative view is that they are not pushing for good CG *per se* but are merely pushing the interests of activist shareholders that may be different from the interests of shareholders at large.

Activist shareholders and proxy advisory firms

As already noted, the profile of shareholders in the United States stands in high contrast to that seen in Hong Kong, in terms of institutional/retail makeup, the frequently seen characteristic of Hong Kong listed issuers possessing a controlling or dominant shareholder or shareholder group and, arising out of that different makeup, the level of shareholder activism, which is rare. According to Thomson Reuters data, activist shareholders launched 508 campaigns against issuers in the United States in 2015.⁴⁵ In an effort to strengthen their position in challenging board decisions, activist shareholders formed a new lobby group in May 2016 - The Council for Investor Rights and Corporate Accountability (CIRCA). CIRCA's principles *prima facie* align with CG values insofar as it stands for corporate accountability, monitoring of boards, between investors and boards, and advocating regulatory changes that foster these principles within a framework of regulatory balance and transparency.⁴⁶ However, while CIRCA argues it represents the interests of all investors, including institutional shareholders, this is not always clearly the case. For example, many activist shareholders involved in CIRCA are hedge funds, which are primarily incentivised by value creation over the shorter term. This has not escaped the attention of politicians, with one of the backers of CIRCA being required to appear before a Congressional committee to address matters relating to short-term value creation.⁴⁷

Proxy advisory firms' influence over shareholder voting has also recently become the target of Congress, which is has been considering the Corporate Governance Reform and Transparency Bill (see further Appendices III.2 and III.5). If passed into law, which is expected to happen,⁴⁸ the Act will address the potential conflict of interest the proxy advisory firms have by providing consulting services for listed companies and advising on their proxy ballots.⁴⁹

Directors

Concerns surrounding directors at present circulate around three primary issues: compensation, appointment and retention, and independence. The notable difference in the United States when compared to Hong Kong's system is a strong and vocal presence of activist and institutional shareholders, as well as senior directors, that often have the effect of actively breaking inertia on problematic topics that instigate governmental, SEC or public debate on an issue.

Compensation:

⁴⁵ Michael Flaherty, "Activist investor heavyweights form new lobbying arm," (4 May 2015) *Reuters, Money*

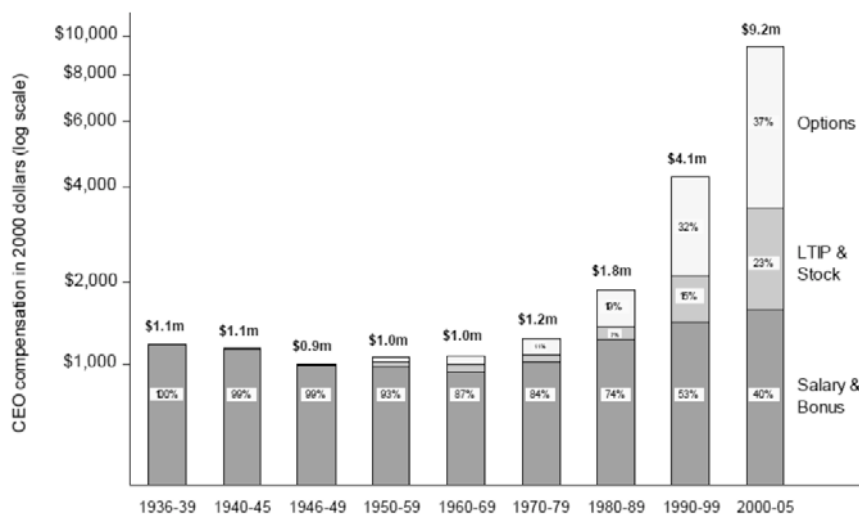
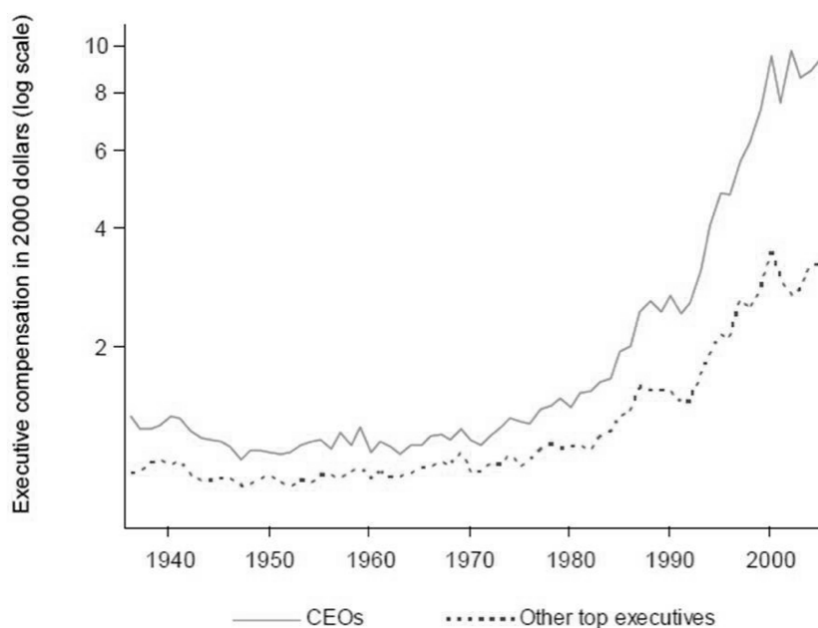
⁴⁶ CIRCA, "About Circa,"; Available at <http://www.investorrights.org/about/> (visited 27 Sept 2016)

⁴⁷ Flaherty, *op. cit.*

⁴⁸ The House Financial Services Committee approved the bill in September 2016

⁴⁹ Mara Lemos Stein, "The Morning Risk Report: U.S. Lawmakers Target Proxy Advisory Firms," (20 September 2016) *The Wall Street Journal*

The significant rise of executive compensation over the last two to three decades, in terms of overall quantum and the degree to which compensation is connected to share price performance, as shown in the two Tables⁵⁰ below, has played an important role in the changing dynamics of CG in the United States.



Three important forces that have driven this are:

activist shareholders that may drive compensation mechanisms toward short-term growth and reward objectives;

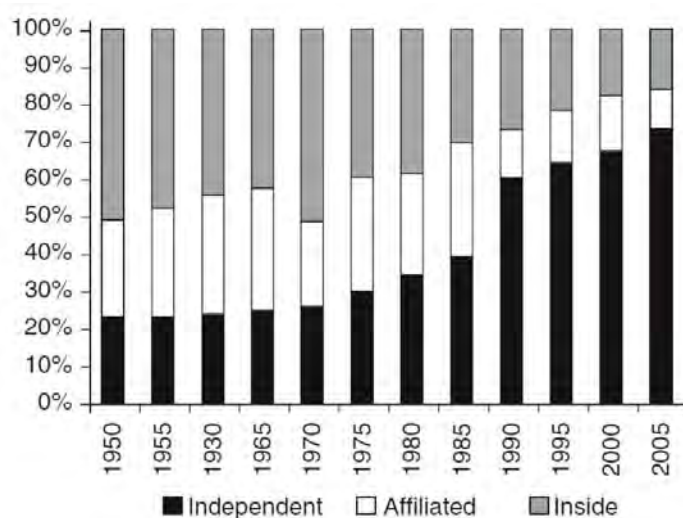
increasing responsibilities of directors owing to a growing body of legislation and regulatory law that require an increasing amount of time⁵¹ devoted to undertaking the role;

increasing exposure to liability, particularly since SOX (see Appendix III.3) and growing shareholder activism.⁵²

⁵⁰ C. Frydman and D Jenter, "CEO compensation", 2 Annu. Rev. Fin. Econ. 2:75-102, 2010

⁵¹ Olivia Oran, "Fearing lawsuits, U.S. banks set sky-high limits for director pay," (1 September 2016) *Reuters, Legal*

While linking executive remuneration to corporate performance has been actively encouraged as a means of aligning performance measures, both in the United States and in Hong Kong⁵³, this has in some instances led to short-termism via remuneration structures that drive executive management to generate short-term performance that feeds into their own compensation without regard to the longer term strategies or benefits to the company and its shareholders. It has been argued that this has been exacerbated by changes to board composition in the form of activist directors, and changes in shareholder composition including the formation of temporary majorities being formed through “wolf packs”.⁵⁴ The increased representation of independent directors, as shown in the Table⁵⁵ below, has not alleviated the problem owing to the problem that directors independent of management may not be independent of blockholders and may represent shareholder activists seeking short-term profits – in one study, over 40% of shareholder activist interventions studied between 2004-2012 resulted in the appointment of activist directors, and 43% of those appointments were directly employed by a hedge fund activist.⁵⁶



This involvement is changing the CG behaviour/culture in listed issuers in the United States, notably in the area of director related issues. Higher compensation is needed to lure more qualified directors into these positions⁵⁷, most notably in the finance sector.⁵⁸ Conversely, one may look at compensation from the reverse end of the problem, namely, if directors are undercompensated, problems may arise⁵⁹ in part owing to the directors having little incentive to challenge executives.⁶⁰

The Shearman & Sterling 2015 Corporate Governance and Executive Compensation Survey of the 100 largest listed companies indicated that there is a clear correlation

⁵² Sacha Pfeiffer and Todd Wallack, “Few hours, soaring pay for corporate board members,” (2 December 2015) *Boston Globe, Board Game*

⁵³ LR Appendix 14 para B.1.7 recommends as a best practice that “A significant proportion of executive directors’ remuneration should link rewards to corporate and individual performance.”

⁵⁴ See JC Coffee, “The wolf at the door: the impact of hedge fund activism on corporate governance.” Working Paper No. 521, 2015: Available at <http://ssrn.com/abstract=2656325>

⁵⁵ J Gordon, “The rise of independent directors in the United States” 59 *Stan. L. Rev.* 2007, 1465, 1474

⁵⁶ Gow, Ian D., Sa-Pyung Sean Shin, and Suraj Srinivasan. “Activist Directors: Determinants and Consequences.” Harvard Business School Working Paper, No. 14-120, June 2014

⁵⁷ Pfeiffer and Wallack, op. cit.

⁵⁸ Oran, op. cit.

⁵⁹ Pfeiffer and Wallack, op. cit.

⁶⁰ Ibid.

between the level of shareholder engagement disclosures in proxy statements and “say-on-pay” results (see Appendix III.7.2).⁶¹

In Hong Kong, director remuneration is subject to consideration by a remuneration committee – while the formation of the committee is mandatory, its detailed functioning is not and only certain director service contracts are subject to shareholder approval – discussed further in Appendices III.3 and I.1.

Appointment and retention:

The extent to which shareholders have a say over appointments to the board is an important aspect of shareholder rights and there remains considerable struggles between boards and institutional shareholders in relation to board appointments including the question of the separation of the chairman and CEO roles, the appointment of independent directors, and board diversity.

A number of prominent CEOs have exposure to, or are, activist shareholders, many of whom advocate truly independent corporate boards and recognise that they are vital to effective governance, that boards should be diverse in terms of skills, backgrounds, and experiences, and that the leader should be independent of management.⁶² Some shareholders have been active in this regard. For example, the California Public Employees’ Retirement System (CalPERS), a pension fund and institutional shareholder, announced in September 2016 that it waged a successful proxy campaign to advance the majority vote standard (over the existing plurality standard) in board of director elections at listed companies - out of 106 companies, 94 adopted the standard before it went to vote.⁶³

While splitting the role of chairman and CEO is a common CG cultural change objective of institutional and activist shareholders, there is much resistance and quite a number of large listed company boards (e.g. Bank of America, Wells Fargo, and General Motors (GM) to name but a few) combine the roles, despite the challenges from institutional and activist shareholders, and proxy advisory firms. In Hong Kong, it is not mandatory to separate the roles, however, if they do not, then they are required to report to shareholders on why they have not done so.⁶⁴

Commenting on the Wells Fargo incident, one of most vocal shareholder activists in the United States, Gerald Armstrong, has argued that the scandal shows the need for Wells to refresh its “clubby board” and stated an intent to submit a proposal to install an independent chairman at the next annual general meeting.⁶⁵ Armstrong also commented, “Where is the board? Where is the audit committee of the board? It appears they go to their meetings, they pick up their cheques and they go home.”⁶⁶

The National Association of Corporate Directors (NACD) runs programs to help directors improve, *inter alia*, board diversity and director recruitment, its aim being to “help directors move beyond the traditional approaches to board refreshment and develop a continuous-improvement plan that keeps board skill sets and processes in tune with the company’s strategic needs.”⁶⁷

⁶¹ Shearman & Sterling LLP, “About the Survey,” Available at <http://www.corpgov.shearman.com/about-the-survey> (visited 24 Sept 2016)

⁶² Buffet, Fink, Dimon, et al, “Open Letter: Common sense Principles of Corporate Governance,” (July 2016)

⁶³ CalSTRS, “CalSTRS Corporate Governance Advances Majority Vote Standard,” (8 September 2016) *Market Wired*

⁶⁴ LR Appendix 14

⁶⁵ Foley and Gray, op. cit.

⁶⁶ Ibid.

⁶⁷ NACD, “NACD to Help Directors Move Beyond Traditional Approaches to Board Refreshment,” (7 April 2016) *Globe Newswire*

Independence:

One of the principal means advocated for good CG to overcome conflicts of interest, is the number, diversity, and appropriateness of independent directors on the board. To overcome short-term value creation and conflicts of interest, independent directors need to represent all of the company's shareholders, not merely one particular interest group, and be actively involved in the long-term strategy of the company.

In 2015 ISS examined annual board practices and found that independent board leadership is steadily increasing (see the Table above) while the combined CEO/chairman position is declining.⁶⁸ Proxy advisory firms play an important role in filtering or raising issues of independence when appointing or re-electing independent directors, although, unsurprisingly, they are not always effective in doing so.⁶⁹

⁶⁸ ISS, "Prevalence of Independent Chairs Continues to Climb," (16 March 2015): Available at <https://www.issgovernance.com/iss-releases-2015-board-practices-study/> (visited 28 Sept 2016)

⁶⁹ Jessica Toonkel, "Viacom's new lead independent director pledges close eye on strategy," (17 March 2016) *Reuters, Top News*; Theo Francis and Joann S Lublin, "Boards Get More Independent, but Ties Endure," (19 January 2016) *Wall Street Journal, Business*

Appendix III	2. Policy	III.2 United States
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Introduction

The principal federal CG policy-makers in the United States are:

Congress – Both houses of Congress hold hearings into proposed Federal law changes, notably the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act), SOX and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act);

States - Corporations are subject to corporation law provisions of the State in which it is incorporated. For example, most United States companies are incorporated in Delaware and are therefore subject to the Delaware General Corporation Law (DGCL) CG provisions;

SEC – the SEC is the national securities regulator, and securities regulators or a body with similar functions are present in all states. CG regulations, rules, and guidance and promulgated by the SEC which also approves rule changes of the national Exchanges;

the national Exchanges (e.g. NYSE and Nasdaq) – listing rules are issued by the Exchanges.

While this hierarchical system, backed by a common law system that interprets statutory CG provisions, is structurally similar to Hong Kong the legal standing of the regulations issued by the SEC is different from those issued by the SFC - as noted in Appendices III.1 and III.3.

Unlike the statutory oversight of financial reporting and auditing standards, overseen in the United States by the Public Company Accounting Oversight Board (PCAOB) established by SOX with powers to establish auditing standards, in Hong Kong this is overseen by the Hong Kong Institute of Certified Public Accountants (HKICPA), a self-regulatory industry body that has powers of registration, inspection and enforcement with regards to auditors and accountants.⁷⁰ Unlike the PCAOB, Hong Kong does not meet the membership requirements of the International Forum of Independent Audit Regulators (IFIAR) and regulatory equivalence requirements of the European Commission.⁷¹

III.2.1 Stakeholder engagement in regulatory development

In general, the desirability of seeking the engagement of relevant stakeholders and other interested persons is recognised in the United States in ways that are similar to that undertaken in Hong Kong.

Law making body

Congress consists of the House of Representatives and the Senate.⁷² Both operate committees responsible for a specific policy area and help to decide which bills and resolutions will be passed into law. This may involve receiving the testimony of expert

⁷⁰ Arner et al, *Financial Markets in Hong Kong* (Hong Kong: Oxford University Press, 2016), [10.259]

⁷¹ FRC, "Update on Independent Audit Oversight Report Q & As," (27 October 2016), 1

⁷² Article I, Section 1, U.S. Constitution

witnesses and/or comment letters, of which the following are some notable recent examples.

Prior to the introduction of Dodd-Frank Act, testimony was received by the Senate Committee on Banking, Housing, and Urban Affairs – including from, *inter alia*, representatives from the SEC, Office of the Comptroller of the Currency (OCC), FDIC, Council of Institutional Investors (CII), Business Roundtable (BRT), CalPERS, and a number of university professors. CalPERS (see Appendix III.5) testified in support of the disclosures required in respect of a person who occupies the dual roles of CEO and chairman of the board.⁷³ In contrast, the SEC dissented by arguing that activist shareholders could exploit proposed new shareholder powers.

The Corporate Governance Reform and Transparency Act of 2016 being considered by Congress has received comment letters from, *inter alia*, the BRT supporting the bill and the CIIs opposing the bill.

This is broadly equivalent to Hong Kong where CG policy at the highest level is set by the Government's Chief Executive who is advised by the Executive Council.⁷⁴ The Financial Secretary (FS) has responsibility for legislation and policy on CG matters and may require the SFC to provide policy information in accordance with the SFC's regulatory objectives and functions pursuant to the SFO.⁷⁵ These roles are in principle as the responsibility is delegated to government committees or groups to issue a report before being considered by the Legislative Council.⁷⁶ The FS is supported by the Panel of Financial Affairs, which holds sessions on, *inter alia*, pertinent CG issues and international developments. More complex CG policy formulation is delegated by the government to standing committees. For example, addressing issues in the extensive rewrite of the Companies Ordinance (CO) was delegated to the Standing Committee on Company Law Reform, a non-statutory advisory committee to the government.⁷⁷

Industry regulator

In general, the SEC seeks public comment in advance of rule changes. For example, prior to implementing various rule changes under Dodd-Frank Act, comment letters were received from various lobby groups.⁷⁸ As discussed in Appendix III.4, the SEC's rule making powers may be accompanied by guidance provided by the SEC Division of Corporation Finance (DCF) for the assistance of concerned persons.

Similarly, the SFC when exercising its power under the SFO to introduce subsidiary legislation is required to seek public comment⁷⁹ and the SFC will normally publish a response, in the form of a consultation conclusion that sets out its responses to the substantive responses received. The SFC's exercise of these powers is subject to overarching regulatory objectives, functions, powers and duties established by the SFO.⁸⁰

Exchanges

The Exchanges are required to submit to the SEC any proposed rules together with a statement concerning the purpose and basis of the rule together with any comments

⁷³ Dodd-Frank Act, sections 951-953, and 972

⁷⁴ HKICPA, "Hong Kong – Market Information," (2015), 4

⁷⁵ SFO, section 12

⁷⁶ HKICPA, Market Information op. cit.

⁷⁷ Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis, 2015 2nd edn), [2.12]

⁷⁸ AFL-CIO, CIIs, CEC, BRT, Financial Services Roundtable, and USCC (see section E.5)

⁷⁹ Section 398(1) SFO

⁸⁰ Sections 4, 5 and 6, SFO

received on the proposed rule. The SEC then publishes the proposed rule for public comment then approves or declines the rule change.⁸¹

However, that approach appears not to be required for guides that are not made pursuant to the 1934 Act. In 2014 the NYSE issued its Corporate Governance Guide without prior public consultation. Specific chapters were authored by a range of interested persons including: academics, private sector financial institutions (e.g. Vanguard), shareholder associations (e.g. Institutional Shareholder Services or ISS), board and management associations (e.g. CamberView, Booz Allen Hamilton, and Spencer Stuart), credit rating agencies (e.g. Moody's Investors Service), law firms, and governance consulting firms, among others.

Similarly, where the SEHK proposed a new rule, it must provide to the SFC explanations of the purpose and likely effect of the rule, including its effect on the investing public,⁸² and no rule will take effect until approved by the SFC.⁸³ Policy development in practice primarily rests with the Listing Committee of the SEHK, which is guided by a high-level group established by the SFC and SEHK, which meets periodically to review, *inter alia*, policy issues concerning listing related matters.⁸⁴ The SFC can also direct the SEHK to make a rule or to amend a rule the SEHK has previously made,⁸⁵ provided it has first consulted with both the FS of the Hong Kong Special Administrative Region (HKSAR) and the SEHK.⁸⁶ Should the SEHK not comply with the request, the SFC may itself make or amend the listing rules.⁸⁷

Other bodies

A similar process of consulting with interested persons is undertaken by other bodies when issuing sector-specific guidelines, including the Federal Reserve, OCC, FDIC, Office of Thrift Supervision and the Commodities Futures Trading Commission (CFTC).

State laws

Unlike Hong Kong, in the United States both Federal and State laws are relevant to consider. Delaware's DGCL is the dominant State law on CG for publicly listed companies as most listed corporations are Delaware incorporated.⁸⁸ The Corporate Laws Committee of the Business Law Section of the American Bar Association drafts the Revised Model Business Corporation Act (RMBC Act) which guides a large number of States. Delaware's legislature and judiciary have initiated important elements of corporations law, including relating to CG, which have been transplanted into the RMBC Act.⁸⁹ Arguably, the RMBC Act is better suited to companies that are incorporated in States other than Delaware, as the effectiveness of the DGCL is contingent on Delaware's highly developed judicial system and corporate case law.⁹⁰

III.2.2 Periodic reviews

The SEC conducts formal and informal reviews of regulations. Formal reviews can involve the passing of legislation or amending legislation by Congress, for example, CG standards imposed by the Dodd-Frank Act and SOX. These types of reviews are not

⁸¹ 1934 Act, section 19

⁸² Section 24(2), SFO, subject as provided in section 24(7), SFO

⁸³ Section 24(1), SFO

⁸⁴ SFC and SEHK, "Memorandum of Understanding Governing Listing Matters," (January 2003), [5.1]

⁸⁵ Section 23(3), SFO

⁸⁶ Section 23(4), SFO

⁸⁷ Section 23(5), SFO

⁸⁸ Arsalidou, *op. cit.*

⁸⁹ Jeffrey M Gorris, Lawrence A Hamermesh, and Leo E Strine Jr, "Delaware Corporate Law and The Model Business Corporation Act: A Study in Symbiosis," (2011) 74 *Law and Contemporary Problems* 107, 107

⁹⁰ *Ibid.*

periodic but are typically initiated in response to CG failures. An example of a formal periodic review is the SEC's annual review under section 610(a) of the Regulatory Flexibility Act that assess rules pertaining to small entities which have been made final within the past 10 years.⁹¹ The informal review process is enforced by the SEC DCF, which selectively reviews company filings under the 1933 Act and 1934 Act to monitor compliance with disclosure and accounting standards. These reviews are primarily concerned with identifying disclosures that are materially deficient.⁹² Concept releases are issued by the SEC from time-to-time to better evaluate the public's view on future rulemaking.⁹³

In Hong Kong, the review of laws and regulations falls within the ambit of the statutory duties of the SFC.⁹⁴ The SFC is very active in terms of developing regulations through the issuance of public consultations, codes, guidelines, circulars and frequently asked questions. However, it has in the past several years appeared to be less involved in law reform and has demonstrated a clear preference for dealing with recurrent and emerging issues by way of regulatory measures or regulatory posturing. Examples of recent issues arising out of the law as currently drafted that the SFC have sought to manage in this way includes the lack of clarity on the liability of sponsors under Hong Kong's prospectus law,⁹⁵ the oversight arrangements of the stock exchange,⁹⁶ the introduction of senior management responsibility amongst regulated firms,⁹⁷ and the respective roles of gatekeeping and enforcement as regards the standards of CG among listed issuers.⁹⁸ As discussed in Appendix I.2, the SFC undertakes an annual review of the SEHK's performance in undertaking its statutory regulatory function and the SFC is itself subject to an annual review undertaken by the Process Review Panel (PRP), an independent non-statutory panel. The PRP reviews the adequacy of the SFC's internal procedures and operational decisions with a view to ensuring the exercise of its regulatory power is consistent and fair, however, the PRP reviews are not particularly incisive as regards how the SFC's statutory duties are undertaken as regard law reform and is regarded by many as more of a box-ticking exercise.

⁹¹ SEC, "Retrospective Review of Existing Regulations," (6 September 2011) *17 CFR Chapter II*: Available at <https://www.sec.gov/rules/other/2011/33-9257.pdf> (visited 4 Sept 2016)

⁹² SEC, "Division of Corporation Finance," Available at <https://www.sec.gov/corpfin/Article/filing-review-process---corp-fin.html> (visited 4 Sept 2016)

⁹³ SEC, "SEC Concept Releases": Available at <https://www.sec.gov/rules/concept.shtml> (visited 4 Sept 2016)

⁹⁴ Section 5(1)(q) SFO

⁹⁵ See Syren Johnstone, Antonio Da Roze and Nigel Davis "Deconstructing sponsor prospectus liability", HKLJ 46(1) 2013, 255-285

⁹⁶ See Syren Johnstone, Nigel Davis and Douglas W. Arner "A principles-based response to the proposed reform of the governance structure for listing regulation in Hong kong" AIIFL Working Paper No. 19, November 2016: Available at <https://ssrn.com/abstract=2867895> or <http://dx.doi.org/10.2139/ssrn.2867895>

⁹⁷ The approach taken in the UK to substantively the same concern involved a public consultation followed by the introduction of legislation, whereas the SFC issued a circular with no prior public consultation – see "Circular to licensed corporations regarding measures augmenting the accountability of senior management" SFC 16 December 2016

⁹⁸ For example, see "Speech at 7th pan Asian regulatory summit" by Thomas Atkinson, Executive Director of Enforcement, 9 November 2016: Available at www.sfc.com [THIS SOURCE IS GIVEN IN LATER FOOT NOTE CITATION - <http://www.sfc.hk/web/EN/published-resources/executive-speech/>]

Appendix III	3. Legislation	III.3 United States
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Introduction

There is no overarching CG legislation in the United States. Nevertheless, CG standards are effectuated via elements of primary legislation or by empowering regulatory agencies to create rules that implement primary legislation and which have the force of law.

A long-standing focus of primary legislation in the United States is disclosure, although more recent developments, as reviewed below, have turned toward specific targets intended to promote good CG. This shares some structural similarities to Hong Kong. The disclosure requirements found in primary legislation are not in concept dissimilar from those imposed upon issuers in Hong Kong under the SFO, and by CWUMPO in respect of primary market offerings.

Similarity can also be seen insofar as the SFO empowers the SFC to create rules (i.e. subsidiary legislation). However, the SFC's rule making power has not to date encompassed matters concerning CG or listing requirements including relating to disclosure obligations. See further Appendix III.4.

III.3.1 Primary legislation

At the Federal level, the principal pieces of legislation affecting listed companies are: the 1933 Act, the 1934 Act, the SOX, and the Dodd-Frank Act. Specific financial company CG legislation includes the Investment Company Act of 1940.

Federal law is largely focussed on:

disclosure liability – for which the SEC may seek criminal or administrative penalties against the company and its directors and officers; in some cases private parties may rely on these laws to claim damages;

anti-fraud provisions - such as Rule 10b-5, which may be relied on by both the SEC and private litigants;

books and records requirements - for which the SEC may seek criminal or administrative penalties against the company and its directors and officers; and

market manipulation provisions.

State law is primarily concerned with the imposition of fiduciary duties on directors and officers of companies organised under the relevant State law – the duty of care and the duty of loyalty, to act in good faith and in the best interests of the company, subject to the business judgement rule. Private litigants can bring shareholder derivative suits to enforce duties on behalf of the company. See further Appendix III.6.

Disclosure

An important characteristic of the United States legislation is its strongly disclosure-based approach, though interestingly securities laws do not actually impose a general duty to disclose information – rather, disclosure is required when there is a legal duty and this duty arises in connection with the sale and purchase of securities (both primary and secondary market). Disclosure is a focus of the SOX and the Dodd-Frank Act, both of which were introduced in response to failures perceived as threatening the well-being

of the American economy, namely, large-scale corporate failures (such as Enron) and the sub-prime/GFC respectively. As reviewed below, while an important focus of both is disclosure they also address matters that pertain directly to widely accepted CG, such as director conflicts of interest, the role of board committees and mandating shareholder participation in certain matters.

It may be observed that a number of the topics reviewed below are also addressed in Hong Kong's regulatory framework, with notable distinctions. Disclosure in Hong Kong is driven by different requirements applicable to the primary (CWUMPO and the listing rules, and certain provisions of the SFO) and secondary markets (SFO and listing rules), it being noted that the many specific disclosure requirements of the listing rules do not have statutory force, and accordingly lack effective means of enforcement by affected stakeholders. Indeed, some of the requirements of the listing rules fall short of being mandatory, and although they may be backed by disclosure requirements, disclosure is merely on an annual basis, breaches of which carry penalties having limited deterrent effect, and dissatisfied shareholders have no means of acting on such listing rule breaches other than selling their shares, save where it amounts to market misconduct, misfeasance or fraud which are covered by statute.

The 1933 Act contains a number of provisions concerning disclosure that applies to all listed companies and companies seeking to list (subject to specific exemptions that do not directly impact on the topic of CG). This includes:

- section 7 - information required in a registration statement;

- section 10 - information required in a prospectus; and

- sections 11 and 12 - civil liabilities for false registrations statements and in connection with prospectuses and communications, respectively.

Disclosure is also an important concern of the 1934 Act, which applies to listed companies, their officers, and directors that transact securities. This includes:

- section 14A - the disclosure of executive compensation (this was added by section 951 of the Dodd-Frank Act – see below), which requires a shareholder resolution subject to a shareholder vote to approve executive compensation – not less frequently than once every three years and at least every six years there must be a vote to determine whether such approval is required every one, two or three years;

- section 13 - the continuous disclosure of periodic and other reports;

- section 14 - disclosure during proxy contests;

- section 14B - specifically covers CG requiring an issuer to disclose in an annual proxy to shareholders the reasons why the same person shall act as chairman and CEO or different individuals serve as chairman and CEO.

Section 10(b) of the 1934 Act is an example of a provision that allows the SEC to create rules to protect investors from manipulative or deceptive practices and this has given rise to the SEC's Rule 10b-5, sub-paragraph (c) of which is directed specifically at untrue statements of a material fact or omitting to state a material fact etc. As such, Rule 10b-5 has become one of the cornerstones of disclosure standards, and liability, for listed issuers and companies seeking to be listed.

In contrast, Hong Kong's combination of the CWUMPO and SFO disclosure requirements do not have a record of being actively enforced – no action has ever been taken under

the relevant CWUMPO provisions. However, this is starting to change as regards the SFC's willingness to enforce disclosure provisions of the SFO. The SEHK listing rules contain extensive disclosure requirements for new issuers but a breach of them merely amounts to a breach of the listing rules with limited sanctions available to the HKEX.

Accounting and auditing

SOX mandates enhanced corporate responsibility, financial disclosures to combat corporate and accounting fraud, and created the PCAOB to oversee auditors.⁹⁹ Importantly, SOX puts explicit responsibility on the CEO for certifying the soundness of accounting and disclosure procedures and goes beyond a mere certification that generally accepted accounting principles are being followed – in many instances it was the case that adherence to those principles were in any case inadequate. The Titles of the SOX deal with:

Title I, sections 101 to 109 creates the PCAOB. Section 105 provides for investigations and disciplinary proceedings and section 108 contains provisions concerning accounting standards;

Title II, sections 201 to 209 set out auditor independence requirements including dealing with conflicts of interest in section 206;

Title III, sections 301 to 308 deal with corporate responsibility. This is particularly important for audit committees (section 301), financial reports (section 302), compensation (i.e. bonuses) (section 304), and officer and director bars and penalties (section 305);

Title IV sections 401 to 409 deal with enhanced financial disclosures including disclosures in periodic reports (section 401), enhanced conflict of interest provisions (section 402), disclosures of transactions involving management and principal stock holders (section 403), a requirement that listed companies must perform extensive internal control tests including an internal control report to accompany annual audits (section 404), and provides a code of ethics for senior financial officials (section 406); and

Titles VIII, IX, and XI are criminal provisions in relation to fraud.

As noted elsewhere (see Appendix III.4), Hong Kong has not followed international practice to appoint an independent statutory body to oversee auditors although this may soon change. Other aspects of SOX have not been replicated in Hong Kong and this may for the time being be a sensible approach as, while SOX initially helped improve investor confidence, it has been widely criticised as have unintended consequences, in particular, that the burden of complying with SOX has affected the pockets of companies and affected the success of the market.

Executive compensation

The Dodd-Frank Act took as a primary objective improvement in accountability and transparency of the United States financial system and all listed companies whose failure could affect the financial system (i.e. companies "too-big-to-fail"). An important focus of the Dodd-Frank Act is executive compensation, including in particular:

sections 951 to 955 - accountability and executive compensation as complemented by the disclosure obligations in sections 955 and 956;

⁹⁹ SEC, "The Laws That Govern the Securities Industry,": Available at <https://www.sec.gov/about/laws.shtml#invcoact1940> (visited 4 July 2016)

section 951 - shareholder voting on executive compensation disclosures, section 951(a)(1) of which requires a separate shareholder resolution;

section 951(1) - disclosure and shareholder approval of golden parachute compensation;¹⁰⁰

section 952 - rules for compensation committee independence (the adoption by national stock exchanges of mandatory requirements in relation to compensation committees);¹⁰¹

section 953 - executive compensation disclosures relating to pay and performance (the disclosure of CEO compensation as a ratio of various metrics);¹⁰²

section 954 - the recovery of erroneously awarded compensation (the so called "clawback" provisions);

section 955 - disclosure regarding employee and director hedging;¹⁰³ and

section 956 - enhanced compensation structure reporting.

More controversially, in July 2015 the SEC proposed rules directing national Exchanges to establish listing standards requiring companies to adopt policies to recover or clawback executive incentive-based compensation that were awarded erroneously.¹⁰⁴ The newly added section 10D "Recovery of Erroneously Awarded Compensation Policy" of the 1934 Act has been inserted in accordance with section 954 of Dodd-Frank Act. The rule applies to incentive-based compensation tied to accounting-related metrics, stock price, or total shareholder returns.¹⁰⁵ Section 954 was designed to require the SEC to direct the Exchanges to prohibit the listing of securities of issuers that have not developed and implemented incentive-based compensation clawback policies that comply with the new listing standard.¹⁰⁶ However, the implementing rules have not yet been put into effect and it is widely expected that this may not occur anytime soon in view of the recent change of government.¹⁰⁷

III.3.2 Regulatory law

As noted above, primary legislation gives powers to specified executive agencies to make rules and adjudicate matters. The rules made, or "regulatory law", is structurally equivalent to what is called "subsidiary legislation" in Hong Kong.¹⁰⁸ The regulatory bodies holding such powers, and the scope and accountability of such powers, are discussed in Appendix III.4. The present section takes as its focus the content of such regulatory law.

¹⁰⁰ See section 14A of the 1934 Act; section 229.402 of the Code of Federal Regulations

¹⁰¹ See SEC, "SEC Adopts Rule Requiring Listing Standards for Compensation Committees and Compensation Advisors," (20 June 2012) *Press Release*: Available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171482648> (visited 9 Sept 2016)

¹⁰² The SEC has proposed a par ratio rule effective 1 January 2017

¹⁰³ Section 14 of the 1934 Act

¹⁰⁴ SEC, "SEC Proposes Rules requiring Companies to Adopt Clawback Policies on Executive Compensation," (1 July 2015) *Press Release*: Available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/2015-136.html> (visited 9 Sept 2016)

¹⁰⁵ *Ibid.*

¹⁰⁶ *Ibid.*

¹⁰⁷ John Coffee, speech op. cit.

¹⁰⁸ The differences between the terms "secondary legislation", "subsidiary legislation", "subordinate legislation" and "delegated legislation" on the one hand and "regulatory law" on the other arise partly out of different legal systems and partly out of preferred usage but all share a common relationship of arising in consequence of primary legislation.

Title 17 of the Code of Federal Regulations (CFR) contains a number of rules that are relevant to CG including:

Part 202 - Informal and Other Procedures;

Part 203 - Rules Relating to Investigations;

Part 210 - Forms and Content of and Requirements for Financial Statements;

Part 229 – Standard instructions for filing forms under, *inter alia*, the 1933 Act and 1934 Act (Regulation S-K);

Part 240 - General Rules and Regulations, Securities and Exchange Act of 1934; and

Part 270 - Rules and Regulations, Investment Company Act of 1940 (i.e. 2a3-1 Investment company partners not deemed affiliated persons; and 32a-4 Independent audit committees).

As mentioned in Appendix III.4, the scope of these Rules is sometimes subject to interpretation and challenge in their precise application. Rule 240.14a-8, made under the 1934 Act, is one such rule that has been subject to some uncertainty. The Rule gives certain shareholders the ability to submit a proposal for a vote of the other shareholders that, if approved, would recommend or require that the company take a certain course of action.¹⁰⁹ However, that rule is subject to exceptions, including allowing a company to exclude a shareholder proposal that directly conflicts with its own, which has been subjected to the SEC's review as the scope of this exception.¹¹⁰

Disclosure

A rule of particular importance to matters of disclosure is Regulation Fair Disclosure (Regulation FD), introduced by the SEC in August 2000, which prohibits selective disclosure of material non-public information to persons that will foreseeably trade on that information.¹¹¹ Where material non-public information has been disclosed to some investors or analysts, Regulation FD requires the information to be made available publicly as soon as reasonably practicable. The requirement is significantly directed toward the reduction of the risk of insider dealing. Breaches of Regulation FD are subject to SEC enforcement actions – and the SEC have been aggressive in taking action under this regulation - but do not give rise to private causes of action, although a breach of the regulation might give rise to a claim under other laws such as Rule 10b-5. In certain regards, Regulation FD has a broad equivalence in Hong Kong in the form of Part XIVA SFO – a purpose of which is also concerned with insider dealing - however, a breach of Part XIVA enables affected investors to pursue a legal cause of action against the wrongdoer.¹¹²

Regulation S-K requires that disclosures made by an issuer are to be promptly filed with the SEC on a specific form – Form 6-K for foreign private issuers (FPIs) otherwise Form 8-K. This includes information that is material, such as changes in management or control or material legal proceedings, disclosures made to an Exchange that the Exchange subsequently makes public, any information it distributes to holders of its

¹⁰⁹ Exchange Act Rule 14a-8, 17 CFR 240.14a-8 (2015)

¹¹⁰ Statement from Chair White Directing Staff to Review Commission Rule for Excluding Conflicting Proxy Proposals (January 16, 2015): Available at <http://www.sec.gov/news/statement/statement-on-conflicting-proxy-proposals.html>

¹¹¹ 17 CFR Parts 240, 243, and 249

¹¹² Section 307Z SFO

securities requirements as well as, for FPIs, any public disclosure made pursuant to the law of the place of its incorporation. Form 8-K is far more detailed and prescriptive. Both forms are subject to Federal securities laws.

Item 407 of Regulation S-K¹¹³ requires disclosures in relation to a similar group of topics with which the Corporate Governance Code and Corporate Governance Report (HK CG Code) is concerned, namely: director independence, board meetings and committees, annual meeting attendance, nominating committee, audit committee, audit committee financial expert, compensation committee, shareholder communications and board leadership structure and role in risk oversight. Rules of the NYSE¹¹⁴ and Nasdaq¹¹⁵ impose corresponding requirements on issuers that fall into either mandatory compliance requirements (i.e. must do/have or must disclose), or recommended practices (i.e. should) – see further Appendix III.4. While, as noted, this is a disclosure-based regime, it does not appear to carry with it the same expectation of compliance with CG standards as is explicit in the HK CG Code and this reflects important elements of the United States context that are materially different despite both systems giving rise to not dissimilar disclosures.¹¹⁶ As discussed in section III.7 delisting and the possibility of investor suits is a material concern of directors of listed issuers in the United States.

Financial integrity

In addition, issuers are required to have a code of conduct for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions - the code must meet the definition of the “code of ethics” set forth in section 406(c) of SOX.¹¹⁷ The code of ethics requires standard setting necessary to promote ethical conduct including conflicts of interest, disclosure standards, and compliance with applicable rules and regulations. While this requirement appears to have no direct equivalent in Hong Kong, aspects of the SEHK’s listing rules can be seen to overlap when the SEC’s implementing rules¹¹⁸ are considered.

A company must disclose whether it has at least one “audit committee financial expert” serving on its audit committee, and if so, the name of the expert and whether the expert is independent of management. Where this requirement is not satisfied, this must be disclosed together with an explanation – this can be compared with SEHK listing rules 3.21-3.23 which impose a mandatory requirement regarding audit committees, as supplemented by the non-mandatory guidelines set out in the HKICPA’s “A Guide for Effective Audit Committees”. The SEC’s final rules under section 407 of SOX set out the attributes an audit committee financial expert is required to possess, and indicates the means by which those attributes can be acquired. Main Board Listing Rules (MBLR) 3.10(2) and the accompanying note sets out the HKEX’s requirements for at least one member of the audit committee to possess “appropriate professional qualifications or accounting or related financial management expertise”. While in both cases the board determines the adequacy of the qualifications of the expert, the requirements in the United States emphasises the functionality of the role – as compared to a “financial expert”, an “audit committee financial expert” must additionally possess an understanding of the audit committee's oversight role and the ability to ask insightful questions as regards the accuracy and completeness

¹¹³ 17 CFR 229.407 – (Item 407)

¹¹⁴ Section 3 Corporate Responsibility [SEEMS LIKE INCOMPLETE CITATION OF STATUTE OR REGULATION]

¹¹⁵ Series 5600 Corporate Governance Requirements

¹¹⁶ Of course, a Hong Kong listed issuer is only required to explain instances of non-compliance with the CG Code.

¹¹⁷ 17 CFR 229.406 – (Item 406)

¹¹⁸ Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 24 January 2003: Available at <http://www.sec.gov/rules/final/33-8177.htm> as updated by Disclosure Required by Sections 406 And 407 of the Sarbanes-Oxley Act of 2002; Correction, 31 March 31: Available at <http://www.sec.gov/rules/final/33-8177a.htm>

of the company's financial statements.

A company must disclose whether it has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. Where this requirement is not satisfied, or where it is but waivers are granted, this must be disclosed together with an explanation – the SEHK listing rules do contain overarching requirements in LR 3.08-3.09 that apply to directors as well as requirements addressing director dealing (MBLR Appendix 10) and board and directors practices (MBLR Appendix 14), although the latter operates on a “comply or explain” not mandatory compliance basis.

A notable distinction is that the SOX requirements apply to senior financial officers, which is a different set of management who are subjected to the SEHK listing rules, primarily being directors, with a wider class of management – “officers” - only being subjected to laws concerning the disclosure of inside information under Part XIVA of the SFO, i.e. a director, manager or secretary of, or any other person involved in the management of, the listed issuer.

In addition to the code of ethics requirements reviewed above, the PCAOB issues auditing standards that outline the responsibilities and functions of auditors, internal and external. These have been reviewed recently.¹¹⁹

Audit committee:

The audit committee has long been regarded as playing a critical role in the overall reporting framework of issuers. The SEC has implemented rules, effective from 2003, in relation to both the composition and workings of the audit committee as well as the disclosures it is required to make. The requirements include disclosures to be made about the audit committee and by the audit committee in the issuer's annual proxy statements.

Disclosures about the audit committee include:

the independence of audit committee members (all are required to be independent);¹²⁰

the audit committee's responsibility to select and oversee the issuer's independent accountant;

procedures for handling complaints regarding the issuer's accounting practices;

the authority of the audit committee to engage advisors - section 301 of SOX and the SEC's implementing rules¹²¹ require that audit committees be “directly responsible for the appointment, compensation, and oversight” of the outside auditor and that it is the audit committee to whom the external auditor must report;¹²² and

¹¹⁹ On 31 March 2015, the PCAOB adopted amendments to reorganise its auditing standards, which were approved by the SEC on 17 September 2015, and shall be effective as of 31 December 2016. See PCAOB, “Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules,” (31 March 2015) *PCAOB Release No. 2015-002*.

¹²⁰ For example, see NYSE rule 303A.06, 303A.07 and 303A.02

¹²¹ See 17 CFR PARTS 228, 229, 240, 249 and 274; SEC [Release Nos. 33-8220; 34-47654; IC-26001; File No. S7-02-03]

¹²² For a further discussion, see S Tsacoumis, SR Bess and BA Sappington, “The Sarbanes–Oxley Act: Rewriting Audit Committee Governance” [2003] *B.L.I. Issue*, pp 212-225

funding for the independent auditor and any outside advisors engaged by the audit committee.

Disclosures by the audit committee include:¹²³

whether the audit committee has reviewed and discussed the audited financial statements with management;

whether the audit committee has discussed with the independent auditors certain matters related to accounting standards;

whether the audit committee has received from the auditors disclosures regarding the auditors' independence;¹²⁴ and

whether, based on the foregoing, the audit committee recommended to the board that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB (as applicable) for the last fiscal year for filing with the SEC.

Following a call in 2013 by several governance organisations, the transparency of the audit committee's work has come under further scrutiny. This includes matters related to the appointment and oversight of the external auditor, audit firm tenure, audit firm fee determinations, and audit committee involvement in the selection of the audit engagement partner, as well as the usefulness of the information contained in the report to investors.¹²⁵ The attention of the SEC and the PCAOB (although the PCAOB does not have regulatory jurisdiction over audit committee) has been increasingly focussing on the disclosures of the audit committee in the audit committee report, and it has been noted that many issuers are already providing audit committee disclosures that go beyond the SEC's requirements.¹²⁶

The position of audit committees in Hong Kong is considerably different from these arrangements, particularly as regards the primacy of the relationship with the external auditor, and the requirement for the audit committee to make disclosures. First, in Hong Kong, the audit committee is a mandatory requirement of the listing rules, not law, with some of the operational provisions being laid out in the HK CG Code making them only subject to the "comply or explain" approach. Second, the CG Code positions the audit committee's responsibilities around its role as a sub-committee of the board that reports to the board; accordingly, while the HK CG Code requires the board to make disclosures about the audit committee,¹²⁷ the audit committee itself does not make any disclosures. In addition, guidelines issued by the HKICPA,¹²⁸ which for the purposes of the HK CG Code only constitute suggestions, do recommend the disclosure of the composition, activity and various functions of the audit committee to be disclosed in the annual report, however, those guidelines stop short of suggesting the audit committee make a disclosure in the annual report. The one exception to the silence of the audit committee's voice is that the HK CG Code does require – again on a comply or explain basis only – the audit committee to make a disclosure in the annual report in circumstances where it

¹²³ See SEC [Release No. 34-42266; File No. S7-22-99]

¹²⁴ The applicable standards are set out in "Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees": Available at www.cpaindependence.org

¹²⁵ See Audit Committee Collaboration, *Enhancing the Audit Committee Report, A Call to Action* (Nov. 20, 2013): Available at <http://www.theqaq.org/reports-andpublications/enhancing-the-audit-committee-report-acall-to-action>

¹²⁶ James Schnurr, Chief Accountant, Office of the Chief Accountant, SEC, Remarks at the 34th Annual SEC and Financial Reporting Institute Conference 5 June, 2015: Available at <https://www.sec.gov/news/speech/remarks-34th-sec-financial-reporting-institute-conference.html>

¹²⁷ CG Code C.3.3

¹²⁸ "A Guide for Effective Audit Committees", Hong Kong Institute of Certified Public Accountants, February 2002, para 61

has been unable to agree with the board on the selection, appointment, resignation or dismissal of the external auditors.¹²⁹ Section L(iv) of the HK CG Code contemplates – somewhat indirectly – that an audit committee might itself report on its functioning, however, the board may also do this.

Proxy voting

A number of developments have been underway in recent years in respect of shareholder voting arrangements, many of which concern proxy voting arrangements.¹³⁰ To some extent, the proxy issues arising in the United States are somewhat unique to its system and bear little relevance to the regulations in Hong Kong, which have had only two notable changes in recent years – concerning the show of hands rule and the administrative arrangements for proxy voting as conducted by HKSCC Nominees Limited.

III.3.3 Exchange requirements

While not having the standing of regulatory law, requirements of the Exchanges facilitate disclosure of matters that cover CG standards, and these requirements can be enforced by the relevant Exchange under section 19(b)(3)(C) of the 1934 Act to the extent it is not inconsistent with primary legislation or regulatory law. See Appendix III.6 for a discussion of the Exchange’s enforcement powers.

The NYSE has issued the Listed Company Manual (NYSE Manual) with provisions that include the following:

section 303A - describes NYSE’s policies and requirements with respect to independent directors, shareholder’s voting rights, and other matters affecting CG;

section 402 - concerns shareholders meeting and proxies with subsection 2 providing practices and procedures for the disclosure and reporting of information; and

the more general NYSE Rules also contains a number of CG provisions (see Appendix III.6 for details).

Nasdaq has issued the National Association of Securities Dealers Automatic Quotation System Marketplace Rules (Nasdaq Rules). The requirements of the Nasdaq Rules 5600 Series cover a wide range of CG matters including the distribution of annual or interim reports, independent directors, audit committees, compensation of executive officers, nomination of directors, company code of conduct, annual meetings, solicitation of proxies, quorum, shareholder approval and voting rights.

The Exchanges may also be directed to make rules by the SEC pursuant to its power under section 19 of the 1934 Act. One such example, arising as a result of requirements imposed on the SEC by SOX, is requiring the Exchanges to make a rule that prohibits the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by section 301 of SOX – already mentioned above – and to require listed issuers to come into compliance with that requirement.¹³¹

In broad overview, the arrangements as between the SEC and the self-regulatory organisation (SRO) Exchanges are not dissimilar from that which exists between the SFC

¹²⁹ CG Code Provision C.3.5

¹³⁰ Under the 1933 Act and the Dodd-Frank Act, including proxy solicitation, broker discretionary voting, proxy disclosure enhancements, shareholder proxy access, and proxy advisory firms

¹³¹ 17 CFR PARTS 210, 228, 229, 240, 249 and 274. Section 10A(m)(1) of the 1934 Act, as added by Section 301 of the Sarbanes-Oxley Act of 2002. See the SEC [Release No. 34-42266; File No. S7-22-99]

and HKEX. Both require, as a matter of primary law, that Exchange listing requirements are approved by the industry regulator, that the industry regulator may direct the Exchange to implement new rules, and that enforcement of the listing requirements falls to the Exchange. Whereas in the United States primary law states that the Exchange has the power to enforce the listing requirements, in Hong Kong primary law merely states that the Exchange may make rules that provide for the sanctions it may apply. This in practice is not a substantive difference. Breaches of listing requirements do not thereby amount to a breach of primary law but may involve a breach of primary law in other regards – a primary example of the latter would be where the issuer’s failure to disclose material non-public price sensitive information gives rise to liability under Regulation FD or possibly rule 10b-5 (in the United States) or Part XIVA SFO (in Hong Kong). See further Appendix III.4 and Annex 1 to Appendix III.4. As regards enforcement, see Appendix III.6.

III.3.4 Non-locally incorporated companies

In general, legislation and regulatory law will apply to non-locally incorporated companies unless it is regarded as an FPI, in which case certain registration and disclosure requirements will not apply, although the three basic federal securities laws (the 1933 Act, the 1934 Act and SOX) will continue to apply (see Appendix III.8). The determination of a company’s status is made prior to its filing with the SEC and reviewed by the FPI and assessed by the SEC six months apart, once a year.¹³² The Exchange rules also apply to FPIs subject to some relaxations as to its CG practices (discussed in Appendix III.8).

The approach to FPIs stands in contrast to the situation in Hong Kong. All issuers will be equally subject to the provisions of the SFO concerning disclosures and the CO provisions concerning statutory derivative action and unfair prejudice. All issuers are also subject to the non-statutory SEHK listing rules, the only minor caveats being related to issuers with a primary listing on another recognised Exchange. In contrast, a test similar in concept to the FPI test is undertaken when determining whether a SEHK listed issuer is subject to the Hong Kong Code on Takeovers and Mergers.¹³³ This is relevant to note as the Takeovers Code contains a number of provisions that, although not specifically directed at CG, do serve to protect the interests of shareholders vis-à-vis management practices.

Issuer’s qualifying as FPIs are subject to, *inter alia*, less burdensome financial and other disclosure requirements imposed under the 1933 Act and the 1934 Act including those related to detailed disclosure of executive compensation and director/officer shareholdings.¹³⁴ If FPIs satisfy a number of conditions they will also be exempt from SOX-enforced Regulation G – the United States accounting standards (i.e. financial statements need only comply with International Financial Reporting Standards (IFRS) not Generally Accepted Accounting Principles (GAAP)). However, SOX continues to require compliance with the SEC’s independent audit committee rules.¹³⁵ Further provisions include enforcement of an FPIs’ CEO or chief financial officer (CFO) to forfeit certain bonus if there is an accounting material non-compliance as a result of misconduct.¹³⁶

¹³² SEC, “Accessing the U.S. Capital Markets – A Brief Overview for Foreign Private Issuers,” Available at <https://www.sec.gov/divisions/corpfin/internatl/foreign-private-issuers-overview.shtml#II> (visited 6 July 2016)

¹³³ See para 4.2 of the Introduction to the Takeovers Code

¹³⁴ SEC, Accessing the U.S. Capital Markets op. cit.

¹³⁵ Kevin W Kelley, “The Sarbanes-Oxley Act and Foreign Private Issuers,” *Chapter 7, Gibson, Dunn & Crutcher LLP*, 214: Available at <http://www.gibsondunn.com/publications/Documetns/Kelley-Sarbanes-OxleyActForeignPrivateIssuers.pdf> (visited 6 July 2016)

¹³⁶ Ibid.

The situation is more abstract for the application of the Dodd-Frank Act. FPIs may have to make certain Form 20-F disclosures if they are required to be registered under the 1934 Act. Specifically, section 952 of the Dodd-Frank Act requires the adoption of NYSE and Nasdaq compensation committee listing standards. FPIs are subject to an exemption if the FPI discloses in its annual report on Form 20-F: (1) (NYSE listed FPI) the "significant ways" in which its CG practices differ from NYSE domestic listed companies; or (2) (Nasdaq listed FPI) the reasons why it does not have an independent compensation committee and a brief statement of the home country practice as to why it does not follow certain CG provisions.¹³⁷

It is at present unclear whether the SEC will provide for exemptions for FPIs if it establishes executive clawback requirements as required by the Dodd-Frank Act. The "say on pay" rules that require shareholder approval of executive compensation do not apply to FPIs.

In the context of the NYSE Manual's CG provisions (i.e. Rule 303A) the compulsory FPI CG provisions are: section 303A.06 (Rule 10A-3 under the 1934 Act — audit committee); section 303A.11 (statement of significant differences disclosure); section 303A.12(b) (noncompliance notification); and section 303A.12(c) (written affirmations). The requirement is that FPIs should provide a brief general summary of the significant differences between the practices the company follows in its home country and the section 303A CG requirements applicable to NYSE domestically listed companies.

In general, both NYSE and Nasdaq allow FPIs the flexibility to follow their home country CG practices, though they may choose to voluntarily comply with the NYSE Manual's domestic CG standards. However, in each case the issuer must give a disclosure notice that sets out the significant differences¹³⁸ and remain subject to the audit committee requirements.¹³⁹

III.3.5 Guidelines

In addition to legislation and regulatory law, a number of organisations issue guidelines for best practices in complying with applicable requirements that are intended to influence board and company behaviour. This includes:

NYSE – "NYSE: Corporate Governance Guide (2014)";¹⁴⁰

OCC – "Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches in 2014";

FDIC – "Pocket Guide for Directors";

NACD – among the many publications it issues two are of particular interest, the "1996 Report of the National Association of Corporate Directors Blue Ribbon Commission on Director Professionalism" (NACD BRCDP), and the "Key Agreed

¹³⁷ Latham and Watkins LLP, "The Latham FPI Guide: Accessing the US Capital Markets From Outside the United States," (2015) *2015 Edition*, 133-134

¹³⁸ NYSE section 303A.11 statement of significant differences disclosure and section 303A.12; Nasdaq Rule 5625 Notification of Noncompliance. See Latham and Watkins op. cit.

¹³⁹ Rule 10A-3 under the 1934 Act; NYSE Rule 303A.06; Nasdaq Rules 5605 (c) (3) and 5605 (c)139. See Daniel Bushner, Richard W. Kosnik, and J Eric Maki, "Foreign Private Issuers of Equity Securities in the United States," (2012) JonesDay, 33-34.

¹⁴⁰ Steven A Rosenblum, Karessa L Cain, Sebastian V Niles, Watchtell, Lipton, Rosen and Katz (cons. Eds.), 'NYSE: Corporate Governance Guide,' (2014), iii: Available at https://www.nyse.com/publicdocs/nyse/listing/NYSE_Corporate_Governance_Guide.pdf (visited 5 July 2016)

Principles to Strengthen Corporate Governance for US Publicly Traded Companies” (NACD Key Principles);

BRT¹⁴¹ - “Principles of Corporate Governance”;

American Law Institute – “Principles of Corporate Governance”;

CalPERS – “The Global Principles of Accountable Corporate Governance”;

American Federation of Labor and Congress of Industrial Organisations (AFL-CIO)
– “Proxy Voting Guidelines”;

ISS – “2013 U.S. Proxy Voting Guidelines”.¹⁴²

The concept of “professionalism” in the board room developed by the NACD BRCDP has been built on by the 2008 released NACD Key Principles which address:

- board responsibility for governance;
- CG transparency;
- director competency and commitment;
- board accountability and objectivity;
- independent board leadership;
- integrity, ethics, and responsibility;
- attention to information;
- protection against board entrenchment;
- shareholder input in director selection; and
- shareholder communications.

While guidelines do operate as a means of discussing standards, they may or may not be effective in changing behaviour and run the risk of comprising self-serving purposes that deter motivation to impose requirements backed by laws. However the guidelines in the United States do in general reflect aspects of the common law and this is the approach taken by guidelines in Hong Kong, such as the somewhat generic Company Registry’s “A Guide to Directors’ Duties”, and the more detailed “Guidelines for Directors” issued by the Hong Kong Institute of Directors. It may also be noted that sponsors of IPOs have responsibilities to confirm the ability of the board to fulfil their responsibilities and in this regard sponsors will typically provide to directors tailored guidelines setting out the responsibilities of directors of listed issuers both at law and under applicable regulations.

¹⁴¹ A business association that represents company CEOs

¹⁴² Weil, Gotshal & Manges LLP, “Comparison of Corporate Governance Principles and Guidelines: United States,” (November 2013), 1 and 2

Appendix III	4. Regulation	III.4 United States
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Introduction

The United States does not have a regulator specifically mandated as the overarching regulator for CG purposes. However, ongoing CG standards are monitored, and enforced (see Appendix III.6), by regulators with a wider remit over the securities market with expected standards of CG arising out of primary law, regulations that implement Federal law (both of which have been discussed in Appendix III.3), and the Exchanges' listing standards.

As noted in Appendix III.3, the primary points of regulatory oversight of listed companies in the United States is structurally similar to Hong Kong: a securities regulator that has regulatory oversight of stock exchanges, the Exchanges which operate as SROs subject to regulatory oversight that create and enforce rules for companies admitted to listing, supplemented by a body that oversees financial reporting standards. Each of these bodies are involved in setting and monitoring standards relevant to CG. In contrast to Hong Kong's dual responsibilities model of the SFC and SEHK, the division in the United States is more clear cut, with the eligibility of issuers for listing being determined by the Exchanges (in accordance with listing requirements approved by the SEC) and the information disclosed by issuers being assessed by the SEC (in accordance with securities laws). The Exchanges also impose disclosure requirements, including matters directly concerned with expected CG standards, and these are also subject to Federal requirements to file them with the SEC pursuant to Regulation S-K.

As regards disclosure and director conduct generally, the requirements imposed in Hong Kong under the regulatory oversight of the SFC and SEHK can be broadly mapped against their United States equivalents, the SEC and various Exchanges, subject to differences in the specific details of their scope of power and operation.

III.4.1 Regulatory agencies

SEC

The SEC was established in the aftermath of the 1929 market crash and ensuing depression as an agency of the Federal government by section 4 of the 1934 Act. Its primary functions are to protect investors, maintain fair orderly and efficient markets and to facilitate capital formation. It is an independent administrative agency primarily responsible for regulating the securities industry and this includes enforcing federal securities laws and oversight of stock exchanges and electronic securities markets. It has expansive powers to make rules that amount to regulatory law (see Appendix III.3) and to adjudicate and enforce federal securities laws – of relevance to the topic of this study, this includes the 1933 Act, the 1934 Act, SOX and, most recently, the Dodd-Frank Act.

Its rule making powers are subject to the Administrative Procedure Act and judicial review through the court system which has the power to override a rule of the SEC. The precise scope of its powers is subject to interpretation and has frequently been the subject of actions before the courts including the Supreme Court.¹⁴³ Before implementing any rule, the SEC is also required, by the Administrative Procedure Act, to evaluate the

¹⁴³ For example, see A. C. Pritchard, "Justice Lewis F. Powell, Jr. and the Counterrevolution in the Federal Securities Laws," 52 Duke Law Journal 841 (2003)

cost/benefit of the rule. The SEC is also subject to the oversight of Congress to which it is required to report.

The SEC is authorised under the 1934 Act to interpret Federal laws, issue regulations and rules, and discuss regulatory issues with the public.¹⁴⁴ Regulations are published in a daily periodical called the Federal Register. The CFR annual edition codifies regulations and rules, which are listed in the Federal Register. Proposed rules are published in the Federal Register and posted on the SEC website to encourage public comments and feedback.¹⁴⁵ The SEC's DCF provides administrative interpretations of the 1933 Act and the 1934 Act as well as recommending regulations to implement these statutes.¹⁴⁶ Guidance is provided by the SEC DCF to registrants, potential registrants and the public to help comply with the law.¹⁴⁷ Interpretations by the SEC DCF are shared with securities regulators to advise on compliance of disclosure issues.¹⁴⁸ Formal guidance is provided by the SEC DCF through the issue of no-action letters.¹⁴⁹ No-action letters are sought by companies engaging in unchartered activities.¹⁵⁰ The SEC also issues concept releases to solicit the public's view on securities issues.¹⁵¹ In these regards it is notable that the SFC does not issue no-action letters, it being open to debate as to whether the SFO permits them to do so.

The SEC's powers are extensive and covers a range of CG matters including misconduct and disclosure obligations of listed issuers. For these purposes the SEC operates the DCF and Division of Trading and Markets. The SEC's powers accordingly cover disclosure requirements in relation to initial securities offerings (principally regulated by the 1933 Act) as well as the continuous reporting requirements that arise out of the 1934 Act.

The foregoing divisions are not dissimilar from divisions operated for like purposes by the SFC. However, in recent years the SEC has established new functions that are specifically concerned with the interests of the investor and which have no equivalent in Hong Kong. In 2014 the SEC established the Office of the Investor Advocate. The Investor Advocate has four core functions:¹⁵² (1) to provide a voice for investors as regards decisions of and development of proposed changes to rules made by the SEC or SROs; (2) to assist retail investors resolve problems with the SEC or SROs; (3) to study investor behaviour and provide data that feed into policy choices including assessments of the economic analyses of proposed rule changes; (4) and to support the SEC's Investor Advisory Committee. The latter Committee was established pursuant to section 911 of the Dodd-Frank Act to

“to advise the [SEC] on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace”.¹⁵³

The Committee is comprised of individuals representing a variety of investor interests.

Amongst matters the Investor Advocate short-listed as being a top policy priority for 2016, three directly concern CG:¹⁵⁴

¹⁴⁴ SEC, “What We Do,”: Available at <https://www.sec.gov/about/whatwedo.shtml> (visited 4 Sept 2016)

¹⁴⁵ Ibid.

¹⁴⁶ Ibid.

¹⁴⁷ Ibid.

¹⁴⁸ Ibid.

¹⁴⁹ Ibid.

¹⁵⁰ Ibid.

¹⁵¹ “SEC Concept Releases” op. cit.

¹⁵² Office of the Investor Advocate: Available at <https://www.sec.gov/investorad> (last accessed Dec 2016)

¹⁵³ Investor Advisory Committee: Available at <https://www.sec.gov/spotlight/investor-advisory-committee.shtml> (last accessed Dec 2016)

¹⁵⁴ Report on Objectives: Fiscal Year 2016, Office of the Investor Advocate, SEC

Disclosure – improving the effectiveness of disclosures both as to means of disclosure and as to content having regard Regulation S-K, which governs public company disclosure, and the SEC’s 2013 Report¹⁵⁵ on Review of Disclosure Requirements in Regulation S-K which “provides a framework for disclosure reform”¹⁵⁶;

Shareholder rights and CG – as discussed further in Appendix III.7, the rights of shareholders to vote on issues concerning the management of the company encompassing the election of directors, the right to direct the company’s actions under Rule 14-8 made under the 1934 Act (see Appendix III.3), and rules governing proxy voting; and

Financial reporting and auditing – in particular, the convergence of global accounting standards in general, and of United States GAAP and IFRS, and proposed new disclosures by audit committees and auditors.

The SEC also operates an electronic company data registry - electronic data gathering, analysis and retrieval system (EDGAR). Each State operates a company registry of all companies that are incorporated or domiciled in that State (i.e. listed and non-listed)—for example, the Delaware Company Registry.

In Hong Kong, the SFC is given the power to make subsidiary legislation to the SFO, however, none of the subsidiary legislation it has created to date deals with CG, although the Securities and Futures (Stock Market Listing) Rules¹⁵⁷ (SMLR) are relevant to disclosures. As regards the listing rules, the SFC also has powers under section 36(1)(h) of the SFO to make subsidiary legislation on “any matter which is to be or may be prescribed by [non-statutory] rules made under section 23” of the SFO, however, the SFC has not to date exercised its powers under this section. Taken together with its power to approve proposed listing rules or require changes to them (see Appendix III.2), the SFC has considerable power over the content of the listing rules, including giving them a measure of statutory backing via the creation of subsidiary legislation.

Exchanges

Like the SFC, the SEC also has the power, under section 6 of the 1934 Act, to register and subsequently regulate the Exchanges, which are regarded for United States securities purposes as SROs. As such, the NYSE and Nasdaq are required to conduct their operations in compliance with the SEC rules.

NYSE and Nasdaq regulate the admission and conduct of companies whose securities are listed on the Exchange by issuing their own listing rules (e.g. NYSE Manual; Nasdaq listing rules). Similar to the Hong Kong system, listing requirements and changes thereto must be filed with the regulator, being the SEC.

Many of the listing rules are concerned with similar CG concerns and cover matters such as independent director membership on boards, the establishment of subcommittees of the board to deal with specific issues (such as audit, director compensation and nomination), the thresholds for transactions that are considered material and which require shareholder approval, and shareholders’ voting rights. In brief overview, it can be said that the listing requirements of NYSE and Nasdaq are broadly concerned with similar concerns as those issued by the SEHK – see Annex 1 to this Appendix III.4 –

¹⁵⁵ A report mandated by Congress under the Jumpstart Our Business Startups Act

¹⁵⁶ Per SEC Chair Mary Jo White, 20 December 2013: Available at

https://www.sec.gov/news/pressrelease/copy-of-2013-269_45351.html (last accessed Dec 2016)

¹⁵⁷ Cap. 571V

albeit in other matters of detail they can be quite different, a notable example being the matter of different classes of shares bearing different voting rights (i.e. weighted voting rights (WVRs)) being acceptable in the United States but being not acceptable in Hong Kong.¹⁵⁸

The NYSE/Nasdaq provisions are a mix of mandatory compliance requirements (i.e. must do/have or must disclose), or recommended practices (i.e. should). For example, NYSE rule 303A.04 specifies that an issuer “must” have a nominating/CG committee composed of only independent directors governed by a written charter, that the charter for this committee “should” consider various matters such as member qualifications, and that the charter “must” be disclosed. The NYSE’s “Corporate responsibility”¹⁵⁹ provisions are broadly similar to Nasdaq’s “Corporate governance requirements” in series 5600. Annex 2 attached to this Appendix III.4 compares the corresponding provisions of the SEHK’s MBLR and HK CG Code with those of the NYSE’s “Corporate responsibility” provisions – very similar ground is covered by these provisions. One can compare the mandatory provisions of the NYSE relating to the nomination committee, CG committee, compensation committee and audit committee, which are mandatory, to their treatment in Hong Kong which is a mix of mandatory and comply or explain requirements. This appears to suggest a lower standard is imposed on, and possibly expected of, issuers in the Hong Kong market or, alternatively, that the Hong Kong market reflects a more liberal “investor decides” approach. However, the reality is that the HK CG Code, first introduced in 2005¹⁶⁰ (the year after NYSE introduced its section 303A Corporate Governance Standards – see Appendix III.1), has been used by the regulators to make headway into CG matters by advancing provisions along a route from recommendations, to disclosure, to mandating behaviour. For example, in 2005, listing rule 3.10 mandated that at least three directors on a board should be independent non-executive directors (INEDs) whereas Appendix 14 in that year contained a recommended best practice (RBP) that INEDs should comprise at least a third of the board.¹⁶¹ In 2012 the RBP was dropped and a mandatory requirement introduced as listing rule 3.10A that at least a third of the board be INEDs.

A number of the NYSE/Nasdaq rules also mandate disclosure of specified information where this has not already been done in the annual proxy statement or the SEC’s Form 10-K required to be submitted annually. For example, NYSE rule 303A.03 mandates that a company must disclose in its annual proxy statement or Form 10-K a method for interested parties (not just shareholders) to make their concerns known to independent directors, and rule 303A.05 similarly deals with disclosure of the charter of issuer’s compensation committee.

A further distinction is that staff of the relevant Exchange undertakes the administration of the listing requirements in the United States whereas in Hong Kong, while the Listing Division are employees of the SEHK and make many decisions in respect of listing matters, their work is overseen by a sub-committee of the SEHK board known as the Listing Committee, which is comprised of industry participants. A number of Memorandum of Understanding have been signed by the SEHK/HKEX with the SFC as regards the operation of their regulatory functions – something which appears unnecessary in the United States in view of the more limited regulatory role of the Exchanges and the deeper cleft between public securities law and the administration of an Exchange listing.

The NYSE periodically issues interpretative guidance relating to SEC and Exchange rules. This guidance includes: information memoranda, weekly bulletins, rule adoption notices,

¹⁵⁸ The only listed issuers with dual class shares in Hong Kong being Swire Group and HKEX.

¹⁵⁹ Section 3 of the NYSE Company Manual

¹⁶⁰ Originally divided into two parts as the Code on Corporate Governance Practices (Appendix 14) and the Corporate Governance Report (Appendix 23)

¹⁶¹ In section A.3.2. That section has since been amended.

rule interpretations, rules changes, education bulletins, regulatory bulletins, instructions, and comparisons.¹⁶² These policy guidance documents are available on the NYSE website.

Public Company Accounting Oversight Board

While both the SEC and the Exchanges have a measure of oversight of financial reporting vis-à-vis their roles in relation to ongoing disclosures generally, the PCAOB was established under the SOX to oversee the audits of public companies subject to securities laws and related matters.¹⁶³ This has brought the United States into membership of the IFIAR and aligns it with the structure seen in the other jurisdictions reviewed, UK and Singapore, but not Hong Kong and Mainland China.

PCAOB's main role is to provide investor protection by promoting informative, accurate, and independent audit reports.¹⁶⁴ Section 101 of SOX empowers the PCAOB to supervise the audit of public companies and related reports. It has the power to monitor, inspect, and discipline public accounting firms and associated persons for non-compliance with SOX, the rules of the PCAOB, and the SEC, among others.¹⁶⁵

In contrast, Hong Kong currently operates a self-regulatory regime and is not a member of the IFIAR, although plans to establish an independent audit body are in place. At present, the oversight of financial reporting and auditing in Hong Kong is instead subject to a self-regulatory regime undertaken by the HKICPA, which undertakes registration, inspection, and enforcement or discipline of audit firms, as supplemented by the Financial Reporting Council (FRC). The FRC's role is presently limited, and includes conducting investigations into possible auditing and reporting irregularities of listed issuers¹⁶⁶ but, importantly, not the disciplinary powers as the PCAOB possess. There are proposals to develop the FRC's role into an independent audit regulator with more responsibilities, and powers, and this will require new legislation to be passed.

Consumer Financial Protection Bureau

In 2008 a new regulatory agency was established – the Consumer Financial Protection Bureau (CFPB). The mandate of the CFPB is to protect consumers against unfair, deceptive, or abusive practices and take action against companies that break the law.¹⁶⁷ Regulatory powers include monitoring, investigating, and enforcing the law. The CFPB may, therefore, take action in relation to breaches of legal requirements that overlap with the powers of the SEC. The CFPB's somewhat broad mandate has no equivalent in Hong Kong. Although powers of the SFC may be exercised in a way that has a similar effect in protecting investors, this is not the SFC's sole mandate (see Appendix I.4).

Other

As in Hong Kong, specific types of issuers are subject to additional regulatory oversight by specialised bodies that may impose additional requirements that address CG issues.

¹⁶² NYSE, "NYSE MKT, RULES,": Available at <https://www.nyse.com/regulations/nyse-mkt/rules-and-disciplinary-actions> (visited 4 Sept 2016); and NYSE, "NYSE MKT, GUIDANCE AND INTERPRETIVE MATERIALS,": Available at <https://www.nyse.com/regulations/nyse-mkt> (visited 4 Sept 2016)

¹⁶³ Section 101

¹⁶⁴ PCAOB, "About the PCAOB": Available at <https://pcaobus.org/About/Pages/default.aspx> (visited 18 July 2016)

¹⁶⁵ PCAOB, "Enforcement": Available at <https://pcaobus.org/enforcement/Pages/default.aspx> (visited 25 July 2016)

¹⁶⁶ Under sections 25 and 26 of the Financial Reporting Council Ordinance (FRCO). See generally Process Review Panel for the Financial Reporting Council, "2015 Annual Report," 1.2. FRCO, s 9. See also Jones, *op. cit.* [7.1].

¹⁶⁷ CFPB, "The Bureau,": Available at <http://www.consumerfinance.gov/about-us/the-bureau> (visited 18 July 2016)

This includes issuers that are:

financial services providers, which are subject to the oversight of the Financial Regulatory Authority (FINRA). As with the SFC in Hong Kong, the extent to which the ambit of the regulator in this sector touches on CG matters is primarily restricted to operational issues such as risk management, however, due to the licensing requirement the ambit of regulatory oversight may also extend to suitability of directors and certain other senior management of regulated firms;

banks, which are subject to CG conduct regulation by the OCC, the FDIC and the Federal Reserve¹⁶⁸ with powers that include the ability to remove officers and directors.¹⁶⁹ The Federal Reserve's CG regulatory roles encapsulate formulating incentive-based compensation practices policy and overseeing supervision of its practices. In this context the Federal Reserve's role is in relation to bank holding companies, foreign banking organisations, and state-chartered member banks that are members of the Federal Reserve System.¹⁷⁰ Regulation of incentive-based compensation practices is exercised in conjunction with the FDIC, OCC and SEC, among others, in accordance with section 956, Dodd-Frank Act that empowers these regulatory agencies to prescribe regulations or guidelines. The Federal Reserve has the power to monitor, investigate, and enforce incentive-based compensation practices. This range of powers goes considerably beyond the regulation of banks in Hong Kong by the Hong Kong Monetary Authority (HKMA) that are also listed on the SEHK;

insurers, which are subject to the oversight of state insurance commissioners in accordance with the Corporate Governance Annual Disclosure Model Act (CGADM Act) (primarily disclosure-based, as the title suggests).

Finally, private companies are subject to the law of the State where they are incorporated and are therefore subject to that State's corporate law/code, as discussed in Appendix III.3.

III.4.2 Inter-regulator relationships

In general, these bodies operate independently of each other and accordingly formal coordination between them appears to be limited, subject as mentioned in relation to the Exchanges' rule making power being subject to the SEC's powers.

Overlaps of regulatory oversight operate at a number of different levels including as regards the following.

Disclosure requirements - regulated by the SEC¹⁷¹ and the NYSE.¹⁷² Insurance companies are also subject to state insurance regulators disclosure requirements pursuant to the CGADM Act;

¹⁶⁸ While state banks are not captured by the OCC's Risk Governance Guidelines, the Federal Reserve and FDIC impose analogous OCC CG requirements on large state banks. Federally insured state-chartered banks that are not members of the Federal Reserve System¹⁶⁸ are subject to CG supervision by the FDIC. See: FDIC, 'The FDIC and the Banking Industry: Perspective and Outlook,' Available at <https://www.fdic.gov/about/strategic/strategic/bankingindustry.html> (visited 22 July 2016).

¹⁶⁹ OCC, 'About the OCC,' Available at <http://www.occ.treas.gov/about/what-we-do/mission/index-about.html> (visited 22 July 2016)

¹⁷⁰ Board of Governors of the Federal Reserve System, 'Banking Supervision and Regulation,' Available at <https://www.federalreserve.gov/econresdata/bsrstaff.htm> (visited 23 July 2016)

¹⁷¹ Sections 13 and 18, 1934 Act; and sections 401 to 409, SOX

¹⁷² Section 2, NYSE Manual and Nasdaq 5250(d)

Financial reporting - regulated by the SEC,¹⁷³ and the NYSE and Nasdaq as per the supervision of disclosure requirements above. For example, the NYSE has requirements for the reporting of material information (i.e. disclosure). PCAOB regulates reporting of audits of financial statements;¹⁷⁴

Audit requirements - regulated by the SEC¹⁷⁵ and PCAOB.¹⁷⁶ Audit committees are subject to oversight by the PCAOB¹⁷⁷, NYSE and Nasdaq.¹⁷⁸

Compensation committees - subject to oversight by the SEC,¹⁷⁹ NYSE and Nasdaq.¹⁸⁰ Executive compensation is regulated by SEC,¹⁸¹ the PCAOB,¹⁸² NYSE and Nasdaq, with the Federal Reserve, OCC, FDIC and the Office of Thrift Supervision jointly issuing guidance for financial institutions.

Company directors - subject to supervision of the SEC,¹⁸³ while independent directors are subject to supervision by the NYSE¹⁸⁴ and Nasdaq.¹⁸⁵ Companies that are regulated as banks are additionally subject to the oversight of the OCC, FDIC and the Federal Reserve.

Use of proxies - subject to supervision by the SEC,¹⁸⁶ the NYSE¹⁸⁷ and Nasdaq.¹⁸⁸

The CFPB may also undertake supervision of any of the above areas where it considers a relevant matter falls within its mandate.

These overlaps do not seem problematic insofar as each regulatory agency has a clear mandate it is pursuing: the Exchanges in view of their own market integrity and business model, the SEC in view of applicable securities laws, the PCAOB as regards audit standards and the CFPB in view of consumer interests. Importantly, there does not seem to be any concern that has been identified in the study that the overlaps are causing one agency to rely on the other taking action.

In contrast to these overlaps, the supervision and enforcement director conflicts of interest is comparatively weak. Both the SOX¹⁸⁹ and the NYSE and Nasdaq listing rules¹⁹⁰ provide for codes that address director conflicts but neither provide guidance on enforcement if the self-regulatory enforcement mechanism fails. Gauging by the media coverage of this issue (see Appendix III.5), the enforcement mechanism is either ignored or rarely applied.

As mentioned in Appendix III.1, some concern has been expressed in relation to the misalignment of the values and strategies between market participants raising the question as to whether this constitutes a shortcoming, or gap, in regulatory oversight. The particular focus of concern is activist and institutional shareholder activities that fall

¹⁷³ Sections 14 and 14A, 1934 Act; section 302, SOX

¹⁷⁴ Section 3100, Auditing Standards.

¹⁷⁵ Section 10A of the 1934 Act

¹⁷⁶ Sections 103 and 204, SOX; and PCAOB Auditing Standards

¹⁷⁷ Section 301, SOX

¹⁷⁸ Listing Rule 5605-3

¹⁷⁹ Section 952, Dodd-Frank Act

¹⁸⁰ Listing Rule 5605(d)

¹⁸¹ Sections 951 to 956, Dodd-Frank Act; and section 304, SOX

¹⁸² Auditing Standards

¹⁸³ Section 16, 1934 Act; and SOX, notably section 1105

¹⁸⁴ Section 3, NYSE Manual

¹⁸⁵ Listing Rule 5605(e): nominations

¹⁸⁶ Sections 14 and 14A, 1934 Act

¹⁸⁷ Section 4, NYSE Manual

¹⁸⁸ Listing Rule 5620 (b)

¹⁸⁹ Section 406, SOX: disclosure of a Code of Ethics

¹⁹⁰ Listing Rule 5610 provides for a Code of Conduct that complies with section 406 SOX

outside the supervisory remit of the SEC. While such shareholders may owe specific fiduciary duties where they manage funds or are directors of listed issuers, they do not owe duties to the companies in which they invest. The concern centres on shareholders seeking short-term value creation at the expense of the long-term strategies of companies. Provisions of SOX addressing Enhanced Conflict of Interest Provisions¹⁹¹ and Code of Ethics¹⁹² attaches to directors but not block shareholders *per se* and accordingly this group of influential persons fall outside the supervisory ambit of the SEC. They also fall outside the scope of the NYSE Manual and the Nasdaq listing rules and therefore are not subject to the supervision of the Exchanges. While such concerns are outside the scope of this study it may be noted that, in Hong Kong, the SFC has issued the Principles of Responsible Ownership which are a set of non-binding and voluntary principles and guidance to assist investors to determine how best to meet their ownership responsibilities.

¹⁹¹ Section 402, SOX

¹⁹² Section 406, SOX

ANNEX 1 – COMPARISON OF SEHK LISTING RULES WITH NYSE/NASDAQ

SEHK Rule	Concept/issue addressed	NYSE Rule	Concept/issue addressed	Nasdaq Rule	Concept/issue addressed
Exchange					
2.01	function of exchange	101.00	function of the exchange	0130 0150 1001	Regulation of Nasdaq and Its Members Function of the exchange
2A.09-2A.10	Disciplinary procedures	801.00	Suspension and delisting		
				8300 1120(a) (3) 9110(a) &(b)	Sanctions Disciplinary Actions Proceedings; Rights, Duties, and Obligations of Members and Associated Person
To qualify					
PN 1& 2A & 2B	Procedures regarding the delivery of information and documents	107.04	Exchange Information Requests - IPO	5205 5305	The Applications and Qualifications Process General Information for the Nasdaq Global Select Market
8.04	Suitability for listing - Qualitative			5315 5600	CG Requirements Initial Listing Requirements for Primary Equity Securities Corporate Governance Requirements
8.05	Suitability for listing - Quantitative tests	102.01	Minimum numerical standards-domestic equity listings	5405	Quantitative tests - Income/equity/market value/assets/revenue
		103.01	FPIs – minimum numerical standards (Non U.S Companies)		
19.05	Overseas Issuers	103.00	Foreign private issuers	5615(3)	Foreign private issuers
18.03	Mineral Companies				
21.04	Investment companies	102.04	Investment companies (Minimum Numerical Standards)		
Sponsor					
Ch. 3A	SPONSORS AND COMPLIANCE ADVISERS		No equivalent		No equivalent
Underwriter					
7.03; 8.22	Offer for subscription must be fully underwritten	102.01B	Written commitment from the underwriter to represent the anticipated value of the company's offering	4120 (c)(8)(A)) 4619(1) (A)	Nasdaq receives notice from the underwriter that the security is ready to trade-IPO.
Directors					
3.08-3.09	Basic duties and character	303A.10 303A.09	Code of Business Conduct and Ethics for directors CG Guidelines- director qualifications and responsibilities	3000 IM-5610	Responsibilities of Associated Persons (includes directors) Code of Conduct
3.10-3.13	>= 3 INEDs; character; what independence means	303A.01 303A.02	Independent Directors Independence tests for directors	IM-5605 (b)(1)	Majority independent board
13.67 + Appendix 10	Directors' dealings Restrictions on Directors' Purchase and	309.00	Purchases of company stock by directors and officers		

10.03; 10.05	Subscription				
Board					
3.21- 3.24	Audit committee required	303A.06 303A.07	Audit Committee Audit Committee – additional requirements	IM-5605-5	The Audit committee responsibilities and authority
3.25- 3.27	Remuneration committee required	303A.05	Compensation Committee (composed entirely of independent directors)	IM-5605-6	Independent director oversight of executive compensation
Appendix 14 A.5	Nomination committee	303A.04	Nominating/Corporate Governance Committee (composed entirely of independent directors)	IM-5605-7	Independent director oversight of director nomination
13.43- 13.45	Board meetings	302.00	AGMs	IM-5620	Meetings of shareholders
3.08	Board of Directors	303A.03	Executive Sessions – regular meetings for non-management directors	5605	Board of Directors and Committees
Disclosures					
13.09 2.07 & 2.13	False market Corporate communication	202.03	Dealing with rumours and unusual market activity	2210 3351(e)	Communications with the public Trading Practices
13.10	Exchange enquiries + announcement	202.05 107.04	Timely disclosure of material news developments Exchange Information Requests	5250 (a)	Obligation to provide information to Nasdaq
13.10A 6.02~6 .08	Trading halts and suspensions Trading halt or suspension	202.04 202.06/0 7 801.00	Exchange market surveillance Trading halts + procedures Suspension and delisting (if not meet listing criteria)	4120 5800 3350 IM-5210-1(f)	Trading halts due to extraordinary market volatility Failure to meet listing standards Suspension of trading Disclosure of Material Information-Trading Halts-events regarding a company's securities
13.13	Advances to a single entity	204.11	Disposition of Assets	1017(C)	Application for Approval of Change in Ownership, Control, or Business Operations
13.16	Giving financial assistance and guarantees	303A.10 204.07	Code of BCE – conflicts of interest; fair dealing; proper use Collateral removed or changed	IM-5610	Code of Conduct (para 3)
13.17	Controlling shareholder pledging shares	204.07 204.23	Collateral removed or changed Rights or privileges of listed security changed	1017	Application for Approval of Change in Ownership, Control, or Business Operations
13.18	Certain loan agreements	204.05 204.07	Capital surplus charges Collateral removed or changed	IM-5605	Definition of Independence – (para 5).
13.19	Breach of a loan by issuer		GAP		
13.25A	Changes in issued shares	311.03 311 204.22	Tender Offers Redemption of Listed Securities	2269	Disclosure or Participation or Interest in Primary or Secondary Distribution
13.28	Issue of securities	204.20	Increase in outstanding amount of securities	2269	As above
8.08 + 13.32	Public float	102.01B	Domestic companies - Aggregate market value of public-held shares of \$40m at IPO	5415	Initial Listing Requirements for Preferred Stock and Secondary Classes of Common Stock
13.51	Various changes to	204.10	Directors or Executive	1010	Material change in business

	articles, directors, and other material matters generally	202.05 312.03 204.40	Officers changed Disclosure of Material News Shareholder approval Business purpose changed	(g) 5250(b) (1) IM-5210-1	operations Disclosure of Material Information As above
Ch. 14 13.23 13.20~ 13.22	Notifiable transactions Notifiable transactions, connected transactions, takeovers and share repurchases Continuing disclosure requirements	s.2 202.01	Disclosure and reporting material information Internal handling of confidential corporate matters	IM-5250-1 IM-5610	Disclosure of material information Code of Conduct
Ch. 14A Appendix 14	Connected transactions Corporate Governance Code and Corporate Governance Report	s.3 303A.00 314.0	Corporate Responsibility Corporate Governance Standards Related party transaction	5600 5615 5630	Corporate Governance Requirements Exemptions from certain corporate governance requirements Review of Related Party Transactions
Financial matters					
13.46- 13.48	Financial reports generally	203.00 203.01	Reporting financial information to shareholders Annual financial statement requirement	5250 (c) 5250 (d)	Obligation to file periodic reports Distribution of Annual and Interim Reports
13.88 Appendix 14- C.3	Auditor appointment Audit Committee	204.03 303A.06 ~07	Auditors changed Audit Committee	IM-5605- 3~5 9557	Audit Committee Charter Financial or Operational Difficulties
Shareholder types					
1.01 + 14A.06	Associate + close associate	312.03(2))& (3) 202.02(B)) 314.00	Shareholder approval Relationship between company officials and others Related party transactions	0115 1011(b)	Applicability Associated Person
1.01	Substantial shareholder (10%)	312.03(1))	Shareholder approval – substantial security holder of the company – definition depends on the share issue or transaction involved (e.g. dilutive transactions – 20%; related party- 5%)	5635(e) (3)	Substantial Shareholder (>5%)
1.01	Controlling shareholder (30%)	303A.00	Controlled companies (>50% voting power for the election of directors is held by an individual)	1017(a) (4)	Controlling shareholder (>25%)
10.07	Restrictions on controlling shareholders	312.03	Shareholder approval for related party transactions and dilutive transactions (i.e. share issues)- see substantial shareholder above		
Shareholder involvement					
Ch. 14	Notifiable transactions	312.00	Shareholder Approval Policy	5635	Shareholder approval
Ch. 14A	Connected transactions	312.00	Shareholder Approval Policy	5630	Related party transactions
13.36	Issue of new shares / shareholder pre-emptive rights	204.23	Rights of privileges of listed security changed	5635 (b) 5635 (d)	Change of control Private placements

13.39 fol	Meetings of shareholders generally	s.4 204.17	Shareholder's meeting and proxies Meetings of shareholders(Notice)	5620 IM-5620	Meetings of Shareholders
6.11- 6.12	Withdrawal of listing	807.00 808.00	Voluntary transfer to another exchange by company that falls below criteria for continued listing Withdrawal from listing	5840(j)	Voluntary Delisting
		401.00 313	Shareholders' meeting Voting Rights		
Independent financial adviser					
13.80	Required in certain circumstances	102.01C(I)(b)	Independent accountants report by auditor for certain acquisitions and dispositions	4370(b) (2)	Engage an independent accounting firm once a year for review
Share capital					
10.08	No new shares within 6 months of listing			11310(d) (2)(B)	No new shares within 3 months of listing
10.05	Restrictions on share repurchases (share buy-back)	204.09	Decrease in floating supply of stock		SEC Rule10b-18
		Others:			
		303A	Domestic Company: Annual written affirmation		
		303A.08	Shareholder Approval of Equity Compensation Plans		

ANNEX 2 – COMPARISON OF NYSE CG REQUIREMENTS AND HKEX MBLR

NYSE Company Manual Section 3 Corporate Responsibility	Provision	HK Listing Rules and CG Code	Same/similar/different
301.00 Introduction		N/A	
302.00 Annual Meetings		s.610 of Companies Ordinance, Cap.622	Same
303A.00 Corporate Governance Standard			
303A.01	Independent Directors	LR 3.10 and 3.10A	Different: The NYSE requires a listed company to have majority of independent directors on the board (Compulsory); as opposed to at least one-third with the minimum of three independent directors, provided that at least one of them with appropriate professional qualifications, as stipulated in the HK Listing Rules (Compulsory).
303A.02	Independence Tests	LR 3.13 and 3.14	Different: The NYSE has very different requirements towards independence of directors. The NYSE focuses on the directors' independence from management, and does not view ownership of even a significant amount of stock, by itself, as bar to an independence finding. The NYSE also emphasizes on the source of compensation received by directors serving on the compensation committee (Compulsory). On the other hand, HK views securities holding by directors as an important factor on independence; where a director holding an interest of 5% or more will normally not be considered independent (Compulsory).
303A.03	Executive Sessions	N/A	
303A.04	Nominating/Corporate Governance Committee	CG Code A.5	Similar: The NYSE has similar provisions as to the nomination committee compare to HK. However, the NYSE requires the nomination committee to be composed entirely of independent directors (Compulsory); whilst the HK CG Code requires merely the nomination committee to be chaired and composed of majority of independent directors (Comply or explain). Also, the NYSE entrusted the task of setting corporate governance guidelines on the committee (Compulsory).
303A.05	Compensation Committee	LR 3.25, 3.26, and 3.27; CG Code B.1	Similar: The NYSE requires the compensation committee to be composed entirely of independent directors (Compulsory); whilst the HK requires merely the similar remuneration committee to be chaired by and composed of majority of independent directors (Compulsory). The NYSE's compensation committee is tasked only with fixing the executive management's compensation; whilst the HK's remuneration committee is tasked also with fixing the directors' remuneration (Comply or explain).
303A.06 and 303A.07	Audit Committee	LR 3.21, 3.22, and 3.23; CG Code C3	Similar: The audit committee under NYSE and HK rules share similar functions. As to the composition requirements, both NYSE and HK require the audit committee to comprise with a minimum of three

303A.08	Shareholder Approval of Equity Compensation Plans	LR Ch.17	members, where at least one must be independent directors and have accounting or related financial management expertise (Compulsory). However, the NYSE requires all members to be independent directors; whilst HK merely requires all members to be non-executive directors, except the one with accounting or related financial management expertise who must be an independent director. Different: Both NYSE and HK require shareholders' approval on share option schemes offer to employees and directors (Compulsory). The NYSE sets out in detail the exceptions to this general rule. The HK focuses on the disclosure and transparency ambit of share options schemes; and further requires the approval of independent non-executive directors (Compulsory).
303A.09	Corporate Governance Guidelines		
303A.10	Code of Business Conduct and Ethics		
303A.11	Foreign Private Issuer Disclosure Requirements	LR Ch.19	
303A.12	Certification Requirements	N/A	
303A.13	Public Reprimand Letter	LR 2A.09	Same
304.00 Classified Boards of Directors		N/A	
306.00 Consent			
307.00 Website Requirements		LR 2.07(6)	Same
309.00 Purchases of Company Stock by Directors and Officers		LR 10.01, 10.02, 10.03, and Appendix 10; CG Code H	Different: The NYSE and HK have different approach towards the subject matter. The NYSE emphasizes on the timing of directors and officers dealing in securities of their own listed company and, without setting out hard-and-fast rule for such best timing, allows the directors and officers to make decision with a sense of fairness to the investing public. It also recommends circumstances where such transactions may be appropriate and encourages companies to adopt policies and guidance (Recommended). On the other hand, the HK has a stricter approach. The Listing Rules restricts preferential treatment when offering securities to directors and employees. Furthermore, it sets out the Model Code for directors to follow as a minimum bottom-line and companies are free to adopt higher standard. The Model Code provides circumstances of absolute prohibition for directors to deal in securities of own listed company, blackout-periods, notification and disclosure requirements. Failure in complying the Model Code would be a breach of the Listing Rules (Compulsory).
310.00 Quorums		N/A	

311.00 Redemption of Listed Securities, Tender Offers		
311.01	Publicity and Notice to the Exchange of Redemption	LR 10.05 and 10.06
311.02	Trading in Securities Called for Redemption	
311.03	Tender Offers	
312.00 Shareholder Approval Policy		
312.01	Shareholders' Interest	
312.02	Companies Are Urged	
312.03	Shareholder Approval	LR Ch.14 and 14A
312.04	For the Purpose of Section 312.03	
312.05	Exceptions	
312.06	In the Event	
312.07	Where Shareholder	
313.00 Voting Rights		
314.00 Related Party Transactions		
315.00 Regulatory Review		

Appendix III	5. Other influences	III.5 United States
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Introduction

A wide range of bodies actively pursues stances on CG from different perspectives according to the nature and function of their formation. The means engaged for these purposes include:

- publication of principles, policy documents, guidelines, model codes and similar;
- making submissions during public consultations and hearings of congressional committees;
- engaging in legal challenges against decisions of the Government of SEC rule making;
- submission of amicus curiae to the Courts;
- testifying before government enquiries;
- lobbying the United States Congress and the SEC;
- submitting research to regulatory bodies;
- submitting comment letters on proposed CG changes to listing rules, SEC regulations;
- waging proxy contests; and
- engagement of the media.

Where some form of CG principles, standards or codes have been prepared, they specifically reflect the concerns of the relevant organisation and do not appear to have been written with a view to coordinating with the other organisations. Moreover, such codes etc. also largely appear to be reactive, reflecting the experience of a particular group in dealing with a particular set of governance issues and disputes. Accordingly, to that extent they do not appear to exhibit any quality of universality.¹⁹³ This stands in clear contrast to the position in Hong Kong, with strong links to the UK CG Code and, in some regards, to the Organisation for Economic Co-operation and Development (OECD) Principles and reports issued by the International Organisation of Securities Commission (IOSCO).¹⁹⁴ The most widely known codes are:

- the American Law Institute recommendations;
- the BRT's Principles;
- the NACDs' Governance Guidelines;
- the Conference Board's Recommendations;

¹⁹³ Nolan Haskovec, "Codes of Corporate Governance – A Review", A Working Paper published by the Millstein Center for Corporate Governance and Performance, June 2012

¹⁹⁴ In particular, "Board independence of listed companies" (March 2007) and "Protection of minority shareholders in listed issuers" (March 2009)

the CII's Policies;

the CalPERS's Corporate Governance Principles;

Teachers Insurance and Annuity Association—College Retirement Equities Fund's Policy Statement;

the AFL-CIO Voting Guidelines; and

Institutional Shareholder Services' Best Practices User Guide and Glossary.

Interest groups can be broadly divided into several categories, as summarised below, and each of the sections that follow briefly explain the activities of each:

SROs (FINRA, National Futures Association (NFA), National Association of Insurance Commissioners (NAIC), National Association of State Retirement Administrators (NASRA))

management interest groups (NACD, Independent Directors Council (IDC));

business associations (BRT, United States Chamber of Commerce (USCC));

industry interest groups (The Clearing House Association (TCH), National Association of Insurance and Financial Advisers (NAIFA)); and

shareholder interest groups (CalPERS; CIRCA, CII, Center on Executive Compensation (CEC), AFL-CIO).

III.5.1 Self-regulatory organisations

FINRA - established in 2007 by merging the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration operations of the NYSE in relation to securities dealers and brokers. It is an independent, non-profit, SRO authorised by Congress to protect security investors/shareholders by, *inter alia*, writing and enforcing rules and federal securities laws governing securities firms and brokers.¹⁹⁵ It regulates virtually every aspect of the securities business.¹⁹⁶

NFA - a SRO for the United States derivatives industry that regulates on-Exchange traded futures, retail off-Exchange foreign currency and over-the-counter derivatives.¹⁹⁷ Its role is to develop and enforce rules, provide programs and offer services that safeguard market integrity, protect investors and help its members meet their regulatory responsibilities.¹⁹⁸ NFA's CG rules concern NFA Forex Dealer Members to adopt and implement risk management programs and to provide additional market disclosures and firm specific information. The NFA is consulted by the SEC in conjunction with the CFTC and others to improve the business conduct standards of the United States swap dealers, pursuant to the Dodd-Frank Act.¹⁹⁹

¹⁹⁵ FINRA, "About FINRA,": Available at <https://www.finra.org/about> (visited 27 July 2016)

¹⁹⁶ FINRA, "NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority," (30 July 2007): Available at <https://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority> (visited 27 July 2016)

¹⁹⁷ NFA, "Who We Are": Available at <http://www.nfa.futures.org/nfa-about-nfa/index.HTML> (27 July 2016). The NFA is established under section 17 of the Commodity Exchange Act.

¹⁹⁸ Ibid.

¹⁹⁹ CFTC, "Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties," (2012) *Federal Register, Rules and Regulations*, 17 CFR Parts 4 and 23, 9739

NAIC - the United States standard-setting and regulatory support organisation for state chief insurance regulators. It has issued the CGADM Act, which is adopted by each state. Insurers must provide a summary of their CG structure, policies and practices so that a state insurance commissioner can understand its CG framework.²⁰⁰ Furthermore, under the CGADM Act, insurers must disclose in accordance with the NAIC's Financial Analysis Handbook.²⁰¹

NASRA - a non-profit association whose members are the directors of the United States state public retirement systems. CG principles are contained in a number of resolutions issued by NASRA, including ethics policies, reporting and disclosure, accounting standards, and risk management. The largest state pension fund is the CalPERS. CalPERS has adopted Global Governance Principles which cover, *inter alia*, independent directors, board access to management, director accountability proxies, disclosure, board responsibilities, and compensation policies. Furthermore, CalPERS uses its proxy votes to ensure that its interests are aligned with the companies in which it invests.²⁰² CalPERS engages in litigation against companies that it invests in which breach their CG responsibilities and issues comment letters to regulators (i.e. SEC, PCAOB) on CG regulatory matters.²⁰³

III.5.2 Associations and interest groups

Management interest groups

NACD - an independent, non-profit association that operates at both the Federal and State level to improve leadership by supporting and educating public and private company boards and directors. In terms of CG, the NACD offers services such as governance reviews to provide an analysis of board oversight and drivers—governance documents, agendas, committee roles, selection criteria, roles, and key risks.²⁰⁴ Furthermore, the NACD has issued CG Guidelines, bylaws, a Code of Ethics, a record retention policy, Key Principles, and a Whistleblower protection policy. In the late 1990's the NACD's Blue Ribbon Commission released a report on director professionalism, which set an important standard for the roles and responsibilities of corporate directors and how to effectively execute their duties.²⁰⁵ The NACD actively lobbies Congress and the SEC to promote its policies, including submitting NACD research and comment letters. For example, in February 2002, Roger Raber, former CEO of NACD, was called to testify before the House Energy and Commerce Committee regarding the failure of Enron.²⁰⁶ A number of more recent regulatory submissions include: (1) in December 2010 the NACD sent a comment letter to the SEC on the "Proposed Rules for Implementing the Whistleblower Provisions of Section 21 F of the 1934 Act";²⁰⁷ (2) a February 2013 comment letter was sent to the Secretary of the SEC commenting on the proposed rule for "Pay Ratio Disclosure";²⁰⁸ and (3) in February 2014 the NACD sent a comment letter

²⁰⁰ CGADM Act, section 1.A.1

²⁰¹ Section 3

²⁰² CalPERS, "Governance,": Available at <https://www.calpers.ca.gov/page/investments/governance> (visited 28 July 2016)

²⁰³ CalPERS, "Governance Research Library,": Available at <https://www.calpers.ca.gov/page/investments/governance/governance-research-library> (visited 28 July 2016)

²⁰⁴ NACD, "How do your stakeholders view your governance practices?,": Available at <https://www.nacdonline.org/BoardDevelopment/content.cfm?ItemNumber=196748&navItemNumber=5318> (visited 30 July 2016)

²⁰⁵ NACD, "NACD Library,": Available at <https://www.nacdonline.org/Store/ProductDetail.cfm?ItemNumber=3721> (visited 30 July 2016)

²⁰⁶ Roger W Raber, "Developments Relating to Enron Corp,": Available at <http://web.archive.org/web/20071129124130/http://energycommerce.house.gov/reparchives/107/hearings/02062002Hearing483/Raber783.htm> (visited 22 May 2016)

²⁰⁷ NACD: Available at <https://www.sec.gov/comments/s7-33-10/s73310-135.pdf> (visited 22 May 2016)

²⁰⁸ NACD: Available at <https://www.sec.gov/comments/s7-07-13/s70713-500.pdf> (visited 22 May 2016)

to the PCAOB on the proposed amendments to auditing standards in relation to disclosure provisions in auditors' reports.²⁰⁹

IDC – founded in 1995 by the Investment Company Institute (ICI),²¹⁰ a funds industry association, to focus primarily on the education of directors, particularly on independent directors. IDC also communicates the views of fund independent directors to policymakers, including the SEC and Congress.²¹¹ In 2003 the ICI recommended a series of CG best practices to investment company boards of directors to enhance board independence and effectiveness, and management investment companies implement similar practices.²¹² Best practices for fund directors include the representation of independent directors, independent director qualifications, training, and ongoing development.²¹³ The ICI and IDC issue comment letters on proposed CG changes to listing rules (NYSE and Nasdaq), SEC regulations, NASD proposals, the United States court cases, and international developments.²¹⁴

Business associations and lobby groups

BRT - an association of CEOs of leading the United States companies working to promote pro-business public policy and economic growth. It consists of a number of committees including a CG committee which issued a "2016 Principles of Corporate Governance" that covers a number of broad objectives including: director duties and the appointment of the CEO; management to be ethical, promote a culture of compliance, and develop corporate strategies; oversight of the audit committee; CG committee to oversee compensation policies; engaging with shareholders; and dealing with related parties in an ethical manner.²¹⁵ The BRT issues comment letters to regulators (i.e. SEC, NYSE, and Nasdaq) concerning proposed CG policy and regulatory changes.²¹⁶ It should be noted that the BRT has in the past actively opposed pro-shareholder CG changes, such as proxy changes in 2010.²¹⁷

USCC - a pro-business lobby group. CG matters are handled by the USCC's Center For Capital Markets Competitiveness which holds CG conferences, issues best practice in specific areas of CG – such as receiving proxy advice, and issues comment letters to the United States government, regulators (i.e. SEC, OCC, FDIC, etc.), and international bodies (i.e. Bank for International Settlements, International Accounting Standards Board (IASB), Financial Stability Board, and IOSCO) on proposed CG changes.²¹⁸

Industry interest groups

TCH - a banking association that advocates regulatory, legislative, and legal public policy issues, including CG, on behalf of commercial banks before policymakers, courts, and the

²⁰⁹ NACD, "Proposed Auditing Standards on Improving the Transparency of Audits,": Available at http://pcaobus.org/Rules/Rulemaking/Docket029/038c_NACD.pdf (visited 22 May 2016)

²¹⁰ ICI, "About ICI,": Available at https://www.ici.org/about_ici (visited 28 July 2016)

²¹¹ IDC, "About IDC,": Available at https://www.idc.org/idc/about_idc (visited 28 July 2016)

²¹² ICI, "Resolution of the Board of Governors of the Investment Company Institute,": Available at https://www.ici.org/policy/governance/corporate/03_fund-gov-best.stmt (visited 28 July 2016)

²¹³ ICI, "ICI Board Adopts Resolution Urging Fund Industry to Strengthen Governance,": Available at https://www.ici.org/pressrooms/news/NEWS_99_BEST_PRACTICES_ADOPT (visited 28 July 2016)

²¹⁴ ICI, "Corporate Governance,": Available at <https://www.ici.org/policy/governance/corporate> (visited 28 July 2016)

²¹⁵ BRT, "2012 Principles of Corporate Governance,": Available at <http://www.businessroundtable.org/resources/business-roundtable-principles-of-corporate-governance-2012> (visited 29 July 2016)

²¹⁶ BRT, "Recent Activities in Corporate Governance,": Available at <http://www.businessroundtable.org/issues/corporate-governance/committee> (visited 29 July 2016)

²¹⁷ The Washington Post, "CEOs from far and wide band against financial bill provision,": Available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/05/13/AR2010051305288.html> (visited 29 July 2016)

²¹⁸ Center of Capital Markets Competitiveness, "Letters – old,": Available at <http://www.centerforcapitalmarkets.com/comment-letters> (visited 29 July 2016)

United States standards setters.²¹⁹ In June 2015, the TCH released its updated Guiding Principles for Enhancing U.S. Banking Organization Corporate Governance (TCH CG Guiding Principles), which aim to provide a framework to facilitate more effective board oversight, enhanced safety, promote confidence, and encourage consistent supervisory guidance.²²⁰ The TCH CG Guiding Principles cover board responsibilities, board size, board duties, audit committees, nominating committees, CG committees, director qualifications, compensation committees, risk committees, independent directors, board compensation, director elections, shareholder rights, and shareholder engagement.²²¹

NAIFA²²² - one of the nation's largest associations representing the interests of the insurance industry from every Congressional district in the United States. These include insurance agents, financial advisors, multiline agents, health insurance and employee benefit specialists, and captive and independent advisors. The NAIFA advocates on legislative and regulatory issues to promote ethical conduct of its members. Accordingly, NAIFA has issued a Code of Ethics, regularly submits comments and statements on certain CG related issues (e.g. fiduciary duty)²²³, and engages in legal challenges against government decisions.²²⁴

III.5.3 Shareholder interest groups

Nasdaq defines activist shareholders as:

"A minority shareholder who seeks to influence the decision making at a company by voicing concerns, engaging in dialogue with management, or lobbying other shareholders for support. The demands could relate to changes in management, representation on the board, acquisitions or divestitures, salaries, bonus payments, use of retained earnings etc."²²⁵

Companies that exhibit poor CG are sometimes the target of activist shareholders, although as noted in Appendix III.1 activist shareholders target companies for a variety of reasons. Activists that focus on a company's CG profile will typically examine how directors perform and how companies perform in areas such as "say on pay" votes or executive remuneration and, if CG problems are found to exist, activists will seek to remove directors and gain board representation. These activist shareholders are firmly of the belief that poor CG is correlated with poor company performance and value.²²⁶

One of the most prominent types of entity that act as activist shareholders are hedge funds. Institutional shareholders have also been known to actively support and

²¹⁹ The Clearing House, "The Association: Addressing Issues in an Independent, Measured and Intellectually Rigorous Way," Available at <https://www.theclearinghouse.org/about-tch/the-association> (visited 28 July 2016)

²²⁰ The Clearing House, "TCH Publishes Updated Guiding Principles on Enhancing U.S. Banks' Corporate Governance," Available at <https://www.theclearinghouse.org/issues/articles/2015/06/20150624-tch-revises-guiding-principles-on-corporate-governance> (visited 28 July 2016)

²²¹ The Clearing House, "Guiding Principles on Enhancing U.S. Banks' Corporate Governance," (2015 Edition), 2

²²² NAIFA, "Mission & Vision," Available at <http://www.naifa.org/about-naifa/mission-vision> (visited 28 July 2016)

²²³ NAIFA, "NAIFA Submits Comments on DOL's Proposed Fiduciary Rule," Available at <http://www.naifa.org/news-publications/press-room/news-releases/naifa-submits-comments-on-dol-s-proposed-fiduciary> (visited 28 July 2016)

²²⁴ NAIFA, "Press Room," Available at <http://www.naifa.org/news-publications/press-room> (visited 28 July 2016)

²²⁵ Nasdaq, "Activist Investors," Available at <http://www.nasdaq.com/investing/glossary/a/activist-investor> (visited 1 Sept 2016)

²²⁶ Josh Black, "Corporate governance the focus for a new type of activist investor," *Activist Insight*: Available at <http://www.activistinsight.com/press/Activist%20approaches%20to%20Corporate%20Governance.pdf> (visited 1 Sept 2016)

participate in shareholder activism.²²⁷ Shareholder activism has also been taken up by some pension funds (e.g. CalPERS).²²⁸

CIRCA - formed in May 2016, is an activist investor/shareholder lobbying group. CIRCA promotes the actions of shareholder activists to influence CG and business policies. Located in Washington D.C., CIRCA seeks to influence government policy, including CG, by "educating policy makers and the American public."²²⁹ An important aim of CIRCA is to act as a system of checks and balances between boards or directors and shareholders and to hold boards accountable.²³⁰ CIRCA will lobby politicians, regulators, the media, directors of listed companies, and legal and finance professionals to advance its principles and to further dialogue between shareholders and listed company boards.

CII - a non-profit, nonpartisan, association of employee benefit funds and endowments that promotes the interests of institutional shareholders.²³¹ Its goal is to promote strong CG standards at public companies and strong CG rights.²³² The CII publishes CG guides for members, including proxy voting guidelines for institutional shareholders. Furthermore, the CII has also issued policies on federal and state legal compliance, disclosure governance policies and ethics code, shareholder accountability, business practices and corporate citizenship, and CG best practices.²³³ The CII's CG policies specifically cover the board of directors, shareholder voting rights, shareholder meetings, executive compensation, director compensation, and an independent director definition.²³⁴ Finally, the CII writes comment letters on proposed CG statutory and regulatory changes (Federal and State).²³⁵

CEC - develops and promotes principled pay practices and advocates for compensation policies that serve the interests of shareholders and stakeholders.²³⁶ It comments on proposed reforms (e.g. comment letter to the SEC on proposed listing standards for compensation committees) and provides analysis to members on the effects of regulatory and legal changes to executive compensation practices.

AFL-CIO - a trade union organisation that advocates shareholder reforms to promote pro-worker CG practices in the areas of executive pay and stock buybacks, government service golden parachutes, and corporate lobbying disclosure.²³⁷ The AFL-CIO petitions the SEC and testifies before Congress on CG failures and to advocate for pro-worker CG reforms. For example, after the Enron collapse, the AFL-CIO filed petitions with the SEC calling for greater independence of auditors and company boards and testified before Congress.²³⁸ After the GFC, the AFL-CIO was vocal in advocating that boards of directors failed in their proxy access responsibilities.²³⁹

²²⁷ David Benoit, "Activist Investors Have New Target: Washington," (18 May 2016) *Wall Street Journal, Markets*: Available at <http://www.wsj.com/articles/activist-investorsally-to-form-lobby-group-1463604738> (visited 1 Sept 2016)

²²⁸ Black, op. cit.

²²⁹ Benoit, op. cit.

²³⁰ CIRCA, op. cit.

²³¹ CII, "About Us,": Available at http://www.cii.org/about_us (visited 27 July 2016)

²³² CII, "History,": Available at http://www.cii.org/cii_history (visited 27 July 2016)

²³³ CII, "Policies for Corporate Governance,": Available at <http://www.cii.org/content.asp?pl=73&sl=50&contentid=76> (visited 27 July 2016)

²³⁴ Ibid.

²³⁵ See generally: CII, "CII Correspondence & Testimony,": Available at <http://www.cii.org/correspondence> (visited 27 July 2016)

²³⁶ CEC, "Principles,": Available at <http://www.excecomp.org/About/Principles> (visited 2 Sept 2016)

²³⁷ AFL-CIO, "Why Shareholder Reforms Are Vital for All Working People,": Available at <http://www.aflcio.org/Corporate-Watch/Why-Shareholder-Reforms-Are-Vital-for-All-Working-People> (visited 29 July 2016)

²³⁸ AFL-CIO, "Retirement Security and Corporate Governance in the Wake of ENRON,": Available at <http://www.aflcio.org/About/Exec-Council/EC-Statements/Retirement-Security-and-Corporate-Governance-in-the-Wake-of-ENRON> (visited 29 July 2016)

²³⁹ The Washington Post, op. cit.

III.5.4 Public media

There is a free and active media that exposes corporate and public sector misconduct. Media and press releases are regarded as an important aspect of the disclosure-based system that works to reduce or remove information asymmetries in the marketplace.²⁴⁰ The media is vigorously used by institutional and activist shareholders, and proxy advisory firms – while this is frequently driven by grievances or disagreements with management or the board, it may also serve to spotlight any CG concerns in an issuer. This also acts as a form of lobbying to Congress. Media and press releases are an important tool in the regulators' CG enforcement arsenal and a means to open for public comment any proposed regulatory or statutory CG changes.

As noted in Appendix I.5, the freedom of the media in Hong Kong is not significantly different from the United States, however, it does tend to be less critical and plays a lesser role in addressing information asymmetries.

²⁴⁰ Gallagher, op. cit.

Appendix III	6. Enforcement	III.6 United States
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Introduction

The sources of CG regulation in the United States include Federal and State securities laws, implementing regulations of the SEC, State corporate law, stock exchange listing rules, and court cases – see Appendices III.3 and III.4. Proceedings may arise as a result of civil action taken by private parties or government agencies, administrative actions undertaken by government agencies, or criminal charges being laid by the United States Department of Justice (DoJ). The SEC is the most active government agency in this regard, both as regards civil and administrative actions as well as bringing criminal matters to the DoJ for prosecution.

Federal law enforcement relies principally on reporting and disclosure requirements that arise under the 1933 Act or 1934 Act, SOX or the Dodd-Frank Act, and may generally be enforced by the SEC or by private litigation.²⁴¹ The relevant State laws focus on fiduciary law - the powers and duties of directors and the rights of shareholders to seek judicial relief for breaches of their duties.²⁴² This broadly aligns with the position in Hong Kong as regards disclosure - the SFO allows both the SFC and individuals to bring an action for breach of the statutory disclosure requirements²⁴³ - and as regards the rights of individual shareholders in respect of misfeasance and the fiduciary duties of directors – see further Appendix III.7.

The vast number of Federal and State (mainly Delaware) court cases play a significant role in establishing CG principles and how CG is understood and applied in the United States, particularly as regards director fiduciary duties. Because of the depth of that case law, CG in the United States imposes many specific obligations on boards in particular circumstances such that it is often the case that Delaware companies are subject to a much higher standard than the board of a Hong Kong listed issuer. For example, the common law *Revlon* duties (see Appendix III.7) when a Delaware company might be subject to a change of control, which doesn't exist in other jurisdictions.

The role of court cases as an important driver of CG also means that CG in the United States is much more changeable and fluid over time compared to other jurisdictions. For example, in a recent case it was decided that the entire fairness doctrine (discussed in Appendix III.7) applies not only to squeeze-out mergers – as had long been understood - but also to contracts between the company and a controlling shareholder.²⁴⁴ Case law thus causes the law to evolve fairly quickly in response to current shareholder views and changes in the types of corporate activity happening.

Class action rights, which allow a single court action to seek a remedy for a class of persons affected in a similar way by a wrongdoing, are also recognised by the court system. This right is further facilitated by the United States legal system allowing lawyers to undertake litigation on the basis they will share in any award given in successful litigation. As noted in Appendix I.6, class action rights are not recognised in Hong Kong and the legal profession may not engage in contingency fee arrangements.

Monitoring and investigation of companies that have securities listed on the Exchanges, for example the NYSE and Nasdaq, rely upon continuous information reporting and the

²⁴¹ OECD, "Supervision and Enforcement in Corporate Governance," (2013), 100

²⁴² *Ibid.* at 101

²⁴³ For example, Part XIVA Division 4

²⁴⁴ *Re EZCorp Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245 (Del. Ch. Jan. 25, 2016)

disclosure of material information.²⁴⁵ The disclosure requirements facilitate the identification of wrongdoing and hence enforcement. The disciplinary powers possessed by the Exchanges in respect of breaches of their rules do not comprise legal sanctions, however, such breaches may give rise to legal actions as described above.

Whistle-blowing has been in place in the United States for almost half a century, initially as a means of protecting the labour market, and is increasingly being used as a mechanism for obtaining information on breaches of securities laws including matters concerning CG.

III.6.1 Laws and regulations

See Appendix III.3 for a discussion of the legislation and regulatory law on which enforcement action through the courts or by administrative means is based.

III.6.2 Department of Justice

A knowing or reckless violation of securities laws can lead to criminal liability under United States law including a fine and/or imprisonment amongst other possible orders. The DoJ undertakes criminal prosecutions for breaches of Federal Laws. The United States Federal Sentencing Guidelines for Organisations (FSG) issued by the DoJ²⁴⁶ are relevant to CG insofar as they deal with the compliance obligations of directors and establish criteria that, taken together, amount to a “good citizen” model which promotes “an organisational culture that encourages ethical conduct and a commitment to compliance with the law.” This is important in view of the steady expansion of director liability that require them to exercise greater – and effective – oversight of the company’s affairs. While the FSG substantively acts as sentencing guidelines they also serve proactive purposes. The FSG’s key criteria are:

oversight by high-level personnel;

due care in delegating substantial discretionary authority;

effective communication to all levels of employees;

reasonable steps to achieve compliance, which include systems for monitoring, auditing, and reporting suspected wrongdoing without fear of reprisal;

consistent enforcement of compliance standards including disciplinary mechanisms;

reasonable steps to respond to and prevent further similar offenses upon detection of a violation.²⁴⁷

III.6.3 Private actions

Private enforcement by way of civil actions is regarded by the regulators as an important supplement, and complementary to, achieving compliance with the Federal securities laws.²⁴⁸ The two main private enforcement suits to enforce statutory (i.e. federal or state

²⁴⁵ OECD, op. cit. (2013), 101.

²⁴⁶ See United States Sentencing Commission, Guidelines Manual, and Chapter 8 –Sentencing of Organizations (Nov. 2010)

²⁴⁷ An Overview of the Organisational Guidelines Paula Desio, Deputy General Counsel, United States Sentencing Commission: Available at <http://www.ussc.gov/sites/default/files/pdf/training/organizational-guidelines/ORGOVERVIEW.pdf> (visited on 20 Nov 2017)

²⁴⁸ OECD, op. cit. (2013), 101.

law), contractual, or fiduciary duties are class actions and derivative actions. Class actions brought in the Federal courts on behalf of a large number of similarly situated shareholders or investors are subject to the requirements of section 27 of the 1933 Act and section 21D of the 1934 Act. Derivative actions are brought by a shareholder or investor to pursue the company's claim for relief on account of harm to the company itself.²⁴⁹ Both forms of private litigation centre on the incentive that the court will make an award to the shareholders based on monetary damages or other benefit to facilitate restitution.²⁵⁰ Shareholder rights are further discussed in Appendix III.7.

Of interest are discussions in the United States courts concerning whether shareholders possess standing to enforce Exchange listing rules against issuers in which they have invested. Several cases have noted that the 1934 Act does not preclude the private enforcement of Exchange rules in court, and that, while a legislative intent to permit a Federal claim for violation of Exchange rules regarding disclosures cannot be inferred, civil liability for a breach of such rules was potentially justified – it being noted by the Court that certain requirements of the Exchange served an important function of protecting investors.²⁵¹ The Courts have also recognised that a derivative action seeking an injunction could be brought where the alleged damage to be avoided was a delisting by the NYSE.²⁵² Academic literature also supports the possibility that shareholders could be regarded as third-party beneficiaries to the listing contract between the issuer and the Exchange.²⁵³ These cases and lines of thinking are important for CG purposes as they may provide another avenue for shareholders to redress corporate wrongdoing, including in relation to breaches of listing requirements that mandate shareholder involvement (as was in issue in the *Norlin* case), however, there is no definitive case that establishes this with certainty.

In this regard it is of interest to note that the Courts in Hong Kong have been willing to give some legal effect to breaches of the SEHK listing rules concerning disclosure requirements, positioning this as a breach of a requirement under the provisions of the SFO to provide shareholders with information reasonably expected to be provided.²⁵⁴ However, this was an action brought under section 214, a provision that is only actionable by the SFC, not by an investor.

III.6.4 Securities and Exchange Commission

The SEC is empowered by the 1933 Act and the 1934 Act to conduct investigations into breaches of both Acts and rules and regulations made under them, rules of a national securities exchange or registered securities association, rules of a registered clearing agency, rules of the PCAOB, and rules of the Municipal Securities Rulemaking Board.²⁵⁵ Enforcement is the responsibility of the SEC's Division of Enforcement. It has overlapping roles in surveillance, to conduct investigations, and to impose discipline – this is similar to the SFC and appears to work effectively notwithstanding occasional criticisms of acting as judge and jury. As noted in Appendix III.3 rulings of the SEC are increasingly subject to challenge in the courts. Overall, the SEC's Division of Enforcement is very active in conducting public securities actions as compared to other markets, whether measured by the number of actions taken or the monetary sanctions imposed, even when adjusted for market size.²⁵⁶

²⁴⁹ OECD, *op. cit.* (2013), 102.

²⁵⁰ *Ibid.*

²⁵¹ For a discussion, see *State Teachers Retirement Board v. Fluor Corp.* 654 F.2d 843 (2d Cir. 1981)

²⁵² *Norlin Corp v. Rooney, Pace, Inc.*, 744 F.2d 255, 267-269 (2d Cir. 1984)

²⁵³ Choper, Coffee, and Gilson, *Cases and Materials on Corporations* (7th Edn, Wolters Kluwer, 2008) (p.307)

²⁵⁴ *SFC v. Wong Shu Wing and Another* [2013] HKCFI 2302; HCMP 1831/2010 (20 March 2013)

²⁵⁵ Section 21(a)(1), 1934 Act

²⁵⁶ John Coffee, "Law and the Market: The Impact of Enforcement" (2007) *Columbia Law and Economics Working Paper*, No. 304, p 33-35

The SEC has the power to require or permit any person to file with it a statement in writing, under oath or otherwise as the SEC shall determine.²⁵⁷ The SEC Rules Relating to Investigations (Part 203) specifically address transcripts obtained by the SEC, rights of witnesses, and the service of subpoenas.

These powers are broadly similar to those possessed by the SFC, which encompass powers of investigation as well as the ability to require testimony, powers that extend over not only listed issuers but also persons related to them, such as associates, financial institutions, auditors and professional advisers, as well as persons who are a party to any transaction. The mechanism is slightly different in that certain of the SFC's powers, particularly as regards enforcement, need to be registered with the court in order for them to have legal force. In the sections that follow, it may be observed that the sanctions available to the SEC, their ability to publish the same, and the accountability and appeal mechanisms that are in place broadly correspond to that seen in respect of the SFC.

Estimates (in 2005) of the "adjusted regulatory costs" in terms of the cost of securities regulation per billion dollars of stock market capitalisation put the United States and Hong Kong on a roughly equal footing (US\$83,943 and US\$73,317, respectively) compared with other jurisdictions – for example, the UK stood at US\$138,159, Singapore at US\$95,406).²⁵⁸ However, this estimate predates a significant growth in the size of the SFC workforce following the introduction of the SFO in 2003 as well as the increased surveillance and enforcement activity of the SFC.

Sanctions

In civil suits undertaken by the SEC, it has the power to seek: (1) injunctions; (2) monetary penalties; (3) the disgorgement of illegal profits; and (4) a bar or suspension of individuals from acting as corporate officers or directors.²⁵⁹

Administrative enforcement actions undertaken by the SEC are heard by the administrative law judges (ALJ) or the SEC. Administrative proceedings can result in: (1) a cease and desist order against a person who violates the federal securities laws; or (2) ordering the respondent to disgorge ill-gotten funds in these proceedings.²⁶⁰ Violations relating to regulated activities (e.g. brokers and dealers) can result in the revocation or suspension of registration, or the imposition of bars or suspensions from employment.²⁶¹ Furthermore, the SEC is authorised to order the payment of civil penalties and disgorgements.²⁶²

While the SEC (like other government agencies) does not have authority to bring criminal prosecutions, it may refer such cases to the DoJ and cooperate with them.

The range of sanctions available to the SEC are highly similar to those available to the SFC in Hong Kong.

Publication

The SEC is authorised under section 21(a)(1) of the 1934 Act to publish information at its discretion concerning any violations of the Act and rules and regulations made under or pursuant to the Act. Civil law suits and trading suspension decisions are published on

²⁵⁷ Section 21(a)(1), 1934 Act

²⁵⁸ Coffee, op. cit. *Working Paper*, No. 304, p 29-30

²⁵⁹ SEC, "About the Division of Enforcement,": Available at <https://www.sec.gov/divisions/enforce/about.htm> (visited 18 Sept 2016)

²⁶⁰ Ibid.

²⁶¹ Ibid.

²⁶² Ibid.

its website. ALJ's initial decisions and SEC administrative proceedings that have been recently instituted or settled are posted on its website.²⁶³

The SEC Publishes a list of civil lawsuits brought by SEC in Federal court,²⁶⁴ a list of administrative proceedings notices and orders,²⁶⁵ a list of ALJs initial decisions,²⁶⁶ and a list of trading suspensions decisions.²⁶⁷

Although the SEC has been criticised for being too "tentative and fearful" in confronting wrongdoing on Wall Street, and for doing "an especially poor job of holding executives accountable",²⁶⁸ a 2013 study found that the SEC names individuals in 93% of its cases and 96% of its fraud cases. Nor are those cases limited to junior employees. The same study found that the Commission named CEOs in 56% of its cases, CFOs in 58% of cases, and lower level executives in 71% of its cases. Among cases naming a top executive, "93 percent of cases result in such an executive receiving a severe penalty."²⁶⁹

In Hong Kong, the SFC has since the introduction of the SFO in 2003 been increasing the number and visibility of enforcement actions it undertakes. During the tenure of Mark Steward as the Executive Director of Enforcement (2006 to 2015), enforcement was regarded in some quarters as "aggressive".²⁷⁰ It is of interest to note that the SFC's approach to publicly naming wrongdoers has, post the Lehman Minibonds crisis in 2008, had an influence on the willingness of the HKMA to disclose its enforcement actions more publicly.

Accountability and appeals

As discussed in Appendix III.4, the SEC is accountable to the President, the Senate, and the Congress under the 1934 Act.²⁷¹ Its decisions are subject to judicial review by the courts of the decisions and orders of the SEC.²⁷² Administrative decisions made by ALJs can be appealed to the SEC.²⁷³ Appeals from decisions of the SEC are heard by a United States Court of Appeals.²⁷⁴

The SEC's investor-related activities are accountable to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.²⁷⁵ On 12 March 2013, the SEC Regulatory Accountability Act was introduced to amend the 1934 Act. The Act made the SEC more accountable to

²⁶³ Ibid.; SEC, "ALJ Initial Decisions: Administrative Law Judges," Available at <https://www.sec.gov/litigation/aljdec.shtml> (visited 26 May 2016)

²⁶⁴ SEC, "Litigation Releases": Available at <https://www.sec.gov/litigation/litreleases.shtml> (visited 26 May 2016)

²⁶⁵ SEC, "Administrative Proceedings": Available at <https://www.sec.gov/litigation/admin.shtml> (visited 26 May 2016)

²⁶⁶ SEC, ALJ Initial Decisions op. cit.

²⁶⁷ SEC, "Trading Suspensions": Available at <https://www.sec.gov/litigation/suspensions.shtml> (visited 26 May 2016)

²⁶⁸ Frontline, "Is SEC 'Fearful of Wall Street?': Available at <http://www.pbs.org/wgbh/frontline/article/is-sec-fearful-of-wall-street-agency-insider-says-yes/> (visited 6 Jun 2016); Bloomberg, "SEC Goldman Lawyer Says Agency Too Timid on Wall Street Misdeeds": Available at <http://www.bloomberg.com/news/articles/2014-04-08/sec-goldman-lawyer-says-agency-too-timid-on-wall-street-misdeeds> (visited 6 Jun 2016)

²⁶⁹ Harvard Law School Forum on Corporate Governance and Financial Regulation, "Recent Criticism of the SEC: Fair or Unfair?": Available at <https://corpgov.law.harvard.edu/2016/05/25/recent-criticism-of-the-sec-fair-or-unfair/> (visited 6 Jun 2016)

²⁷⁰ "SFC's outgoing crime fighter Steward warns successor to beware of nice people", South China Morning Post, 21 August 2015

²⁷¹ Section 4 (a), 1934 Act

²⁷² SEC Rules and Regulations, Part 200-Organization; Conduct and Ethics; and Information and Requests, 200.64

²⁷³ SEC, "Office of Administrative Law Judges," Available at <https://sec.gov/alj> (visited 18 Sept 2016)

²⁷⁴ Section 25, 1934 Act

²⁷⁵ See generally: Section 4, 1934 Act

shareholders, investors (i.e. freedom of choice), markets (i.e. in terms of liquidity), and small businesses.

This appeal process is distinct from that undertaken in respect of actions taken by the SFC, which broadly fall into three types: those brought before a court of law under primary legislation, those brought before a statutory tribunal – the Market Misconduct Tribunal - established by the SFO, and those decisions that are within its own power to make. The former two involve an appeal routes into the court system. However, so far as the SFC’s own decisions, this is very limited in relation to matters of CG and concern the CG of entities licensed or registered by it to engage in specified regulated activities, and the ability to refuse a listing application or order a suspension or withdrawal of listing under powers given to it by the SMLR. These powers are subject to appeal as they are “specified decisions” and may be appealed to the Securities and Future Appeals Tribunal (SFAT), a body established by the SFO. Appealing a determination or finding of the SFAT brings the matter before the Court of Appeal.

III.6.5 Public Company Accounting Oversight Board

The PCAOB conducts inspections of firms for assessing compliance with the requirements applicable to auditing listed issuers. The findings of the inspections are published on the PCAOB website and this includes identified auditing deficiencies, although certain matters, such as criticisms that require remediation, will be redacted from the report as required by SOX and may only be made public if they are not addressed satisfactorily within 12 months of the issuance of the report.

As noted in Appendix III.4 the PCAOB enforcement actions include censure, monetary penalties, revocation of a firm's registration, and a bar on an individual's association with registered accounting firms. Matters that proceed to enforcement are published on the website but only after completion of an SEC review procedure – i.e., the audit firm appeals the matter to the SEC, the SEC elects to review the matter, or the time allowed for appeal or the SEC’s review has passed. Sanctions are similarly stayed in the interim. Where the SEC undertakes review proceedings, they are normally made public.²⁷⁶

Importantly, the PCAOB’s powers attach to the audit of listed issuers in the United States and accordingly cover non-United States audit firms. For example, in May 2016 the PCAOB announced sanctions in respect of a Hong Kong firm’s violations of rules and standards in respect of a Mainland enterprise listed on Nasdaq.²⁷⁷ The violations of the Hong Kong firm, which included “improperly relying on management representations, ignoring red flags indicating possible fraud, impaired independence and other violations,”²⁷⁸ resulted in the firm’s PCAOB registration being revoked for a period of two years and a monetary penalty.

III.6.6 Exchanges

Issuers listed on the NYSE or Nasdaq are expected to comply with the listing standards upon admission to listing and at all times thereafter.

At the point of seeking admission to listing, the company must satisfy the Exchange’s quantitative listing standards – conceptually similar in nature to the quantitative qualification requirements of Chapter 8 of the SEHK listing rules - and submit a registration statement to the SEC and deal with the SEC’s comments thereon. Enforcement at this stage is primarily one of denying access to listed status, either by

²⁷⁶ Per Rule 301 of the SEC’s Rules of Practice

²⁷⁷ AWC (CPA) Limited, its New York affiliate and four individuals.

<https://pcaobus.org/News/Releases/Pages/PCAOB-sanctions-hong-kong-audit-firm-new-york-affiliate-four-individuals.aspx>

²⁷⁸ Ibid.

the Exchange in respect of a failure to meet the quantitative listing standards, or by the SEC in respect of the registration statement required by the 1933 Act in respect of the public offer of securities. This is both similar and different from Hong Kong where the vetting of a company's listing application is primarily undertaken by the Listing Committee and/or the Listing Division of the HKEX – who also has the power to authorise the document as a prospectus for the purposes of the public offer prospectus regime - with the SFC involved in the review process as a result of the dual filing regime. Both bodies exercise considerable judgement on matters that go well beyond the quantitative requirements, such as suitability and sustainability. Both the SEHK and SFC are also increasingly expecting sponsors – a regulatory function not present in the United States - to be satisfied as to the ability of a listing applicant to meet expected standards of CG, sponsors being required to sign off on the ability of the board as a whole and directors individually to fulfil their obligations under the listing rules. With overlapping responsibilities – albeit the SFC having the final word - in relation to both satisfying the listing rules and approval of the prospectus for the purposes of the law relating to public offerings, the structure has been proposed to be revised in a June 2016 consultation paper issued jointly by the SFC and the SEHK, however, the proposal had a number of inherent problems and was met with considerable resistance,²⁷⁹ including from the Listing Committee and its proposals have subsequently been dropped.

Where materially false or misleading statements have been made in connection with a securities offering, including as to an issuer's CG practices, civil liability in the United States falls on, *inter alia*, the directors and the underwriters (a statutorily defined term²⁸⁰) under sections 11(a)(5) and 12(a)(2) of the 1933 Act and criminal liability may arise out of a breach of the disclosure obligations under sections 10 and 20(b) of the 1933 Act. Section 11 civil liability is similar to section 40 of the CWUMPO, with the exceptions that underwriter is not a term of law in Hong Kong and any liability to an underwriter in Hong Kong arises under laws that are applicable generally to anyone who offers or sells securities, as with section 12 liability. As in Hong Kong (section 384 of the SFO) it is also an offence to make a false statement to a regulator, which will become relevant in connection with the filing of the registration statement, although this liability only catches the company (as registrant in the United States, as applicant in Hong Kong). The SFC has sought to assert both civil and criminal liability over sponsors in view of their important role in prospectus disclosures, however, the legal basis for such a view remains unexplained, untested in court and subject to doubt upon close analysis.²⁸¹

Following admission to listing, failure to comply with the ongoing listing standards is primarily a matter for the Exchange which has power to either issue a public reprimand letter (NYSE) or issue a letter advising the issuer of the deficiency that gives rise to a disclosure obligation on the part of the issuer (Nasdaq) and, if such failure continues, then to suspend trading and, ultimately, delist the company. While those powers are aligned with the powers of the HKEX, the HKEX's powers in fact go further, enabling the HKEX to comment on the suitability of a director and the consequences should he remain in office, as well as a broad power to take "such action as it thinks fit"²⁸² – while the latter broader power has been used²⁸³ it has not been used as aggressively as the Takeovers and Mergers Panel has in a similar power²⁸⁴ given to them.²⁸⁵

²⁷⁹ See Johnstone, Davis and Arner, *op. cit.*

²⁸⁰ Section 2(11) 1933 Act

²⁸¹ See Johnstone, Roza and Davis, *op. cit.* The working paper is available at <https://ssrn.com/abstract=2803793>

²⁸² LR 2A.09

²⁸³ For example, to require directors in breach of the listing rules to undertake specified training, as was done in a recent action by the Listing Committee against directors of Natural Dairy (NZ) Holdings Ltd, see HKEx news release of 13 January 2017: Available at <http://www.hkex.com.hk/eng/newsconsul/hkexnews/2017/170113news.htm>

²⁸⁴ Takeovers Code, Introduction para 12.2(e)

²⁸⁵ Panel statement in the William Cheng Kai Man case, November 1995

The NYSE and Nasdaq are SROs that are accountable to and regulated by the SEC, and which depend on the SEC's continued approval of them to operate an Exchange.²⁸⁶ The SFC has effectively the same powers of regulatory oversight of the Exchanges operated by the HKEX. See also the discussion on this point in Appendix III.4.

Decisions of the NYSE can be appealed to the Committee of the Board of Directors of the NYSE, and those of Nasdaq to the Nasdaq Listing and Hearing Review Council. These appeal routes are broadly similar to the independent practitioner based composition of the Listing Committee's appellate bodies.

As in Hong Kong, disciplinary matters are published on the website of the Exchanges.

III.6.7 Whistle-blowing

Whistle-blowing can provide an important source of violation information that facilitates actions such as those undertaken by the SEC, PCAOB or privately that may relate to breaches of CG-related concerns, such as relate to disclosure, misfeasance, and so on. Whistle-blowing has been recognised and been subject to protection at least since the Occupational Safety and Health Administration Act 1970. The Occupational Safety and Health Administration (OSHA) is the federal agency under the United States Department of Labour that investigates and handles "whistleblower" complaints. Under the authority of the 1970 Act OSHA operates a Whistleblower Protection Program that enforces more than twenty whistleblower statutes, and this encompasses SOX and the Dodd-Frank Act.

Whistle-blowing in relation to breaches of securities laws by publicly traded companies, including breaches of regulatory laws promulgated by the SEC, is specifically recognised in SOX.²⁸⁷ The provisions of section 922 the Dodd-Frank Act developed whistle-blowing further by introducing monetary rewards for whistleblowers that provide original information that leads to successful enforcement actions involving monetary sanctions of over US\$1 million. The SEC implemented the relevant rules that became effective in August 2011.²⁸⁸ The SEC has also established the Office of the Whistleblower to administer the SEC's whistleblower program.

Hong Kong does not have any specific whistle-blowing law, however, certain statutes do provide limited protections in relation to persons reporting suspected wrongdoing, including employees making reports in relation to labour laws under the Employment Ordinance, auditors of listed issuers alerting the SFC under the SFO as to anomalies, discrimination under the Discrimination Ordinances,²⁸⁹ or disclosures under the Anti-money Laundering Ordinance.²⁹⁰ The Competition Commission of Hong Kong issued a leniency policy in November 2015 that serves to encourage whistle-blowing. As regards listed issuers, whistle-blowing is the subject of a non-mandatory recommended practice in the CG Code of the listing rules that is only addressed to audit anomalies.²⁹¹ However, while more companies are introducing audit whistle-blowing policies and procedures²⁹² less than half of listed companies in Hong Kong do not comply with that recommended practice.²⁹³ The HKMA's Supervisory Policy Manual mentions the concept of whistle-blowing but this is couched in language that an authorised institution should have a well

²⁸⁶ Section 19, 1934 Act

²⁸⁷ 18 U.S.C. §1514A

²⁸⁸ 17 CFR Parts 240 and 249

²⁸⁹ Disability Discrimination Ordinance, the Sex Discrimination Ordinance, the Family Status Discrimination Ordinance and the Race Discrimination Ordinance

²⁹⁰ Drug Trafficking (Recovery of Proceeds) Ordinance, the United Nations (Anti-Terrorism Measures) Ordinance and the Organised and Serious Crimes Ordinance

²⁹¹ MBLR, Appendix 14, para C 3.8

²⁹² "Best corporate governance awards 2016, Judges Report", HKICPA, p 13

²⁹³ "Corporate governance update", BDO Limited, 2016, p 5

communicated policy allowing staff “to communicate, in confidence and without risk of reprisal” observations of any violations.²⁹⁴

²⁹⁴ At Corporate Governance of Locally Incorporated Authorised Institutions, para 2.6.7

Appendix III	7. Shareholders' rights and protections	III.7 United States
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Introduction

In general, the position of the shareholder in the United States system is fundamentally different from that seen in jurisdictions, including Hong Kong, that have been derived from the UK system, which implements a strong shareholder-centric model of CG. Fundamental to any discussion of shareholder rights in the United States is the interplay, and sometimes tension, between State and Federal laws and regulations, which take different points of focus – respectively the corporation and the public securities market – that sometimes leads to very different approaches to the question of the position and attendant rights of shareholders/investors.

State laws place a significant amount of power in the board, the primary mechanism by which directors are accountable to shareholders being their position as fiduciaries. In general, directors are protected by the business judgement rule, meaning that where shareholders are dissatisfied with board decisions they will need to consider whether any cause of action arises as a result of a breach of fiduciary duty. Traditionally, Federal law is primarily concerned with disclosure and anti-fraud provisions, although more recent approaches, as witnessed by SOX and the Dodd-Frank Act, reflect a shift of lawmakers' interest toward corporate mechanisms broadly within the sphere of CG. The SEC have since the mid-20th century been proponents of shareholder involvement, however, rules they have implemented in this context have not always been successful when tested in the Courts, as discussed in Appendix III.4 and as illustrated below. The role or ability of shareholders to influence the composition of the board is a particularly important point of tension between State and Federal law. A characteristic example of the different approaches undertaken at State and Federal level is the treatment of related party transactions - whereas all companies, whether public or private, can have interested directors approve transactions, if the company is an SEC reporting company, it is subject to an additional disclosure obligation that requires it to report material transactions. As noted below and in Appendix III.8, the CG requirements applicable to domestic and foreign companies listed in the United States is somewhat different.

On the other hand, listed issuers are subject to requirements imposed by the Exchanges that facilitate CG standards and go some way to covering areas of CG regulation that are not – or presently unable to be – addressed by State or Federal laws. For example, in Appendix III.3 it was observed that while Item 407 of Regulation S-K mandates disclosures to be made on a range of concerns similar to the HK CG Code, it is not accompanied by any expectation of meeting a specific CG standard – this is instead taken up by the listing standards imposed on listed issuers by the Exchanges that broadly reflect the same concerns. The Exchanges' requirements for independence were discussed in Appendix III.4 and, as discussed below, Exchange rules recommend that issuer's decisions on related party transactions should be undertaken by an appropriate body. While these examples demonstrate the ability of the Exchanges to regulate, Exchange rules do not, as noted in Appendix III.4, carry statutory force and are not generally regarded as enforceable by shareholders (subject as discussed in Appendix III.6) unless an issuer, in breaching a listing requirement, also happens to violate a relevant disclosure or anti-fraud provision of the securities laws. The SEC could in theory start adopting some of the Exchanges' CG rules if they wanted to - after all, they approve each and every one of them before adopted by the Exchange – but that is not the primary purpose of the SEC in the overall CG system of the United States. Moreover, shareholders do not usually need to enforce the listing rules as companies tend to obey

the rules to avoid delisting – something that is not uncommon in the United States²⁹⁵ – and because where directors take actions that amount to a purposeful breach of the listing rules, shareholders may have rights for breach of fiduciary duties and disclosure violations. Aside from investors, the SEC will also normally scrutinise a delisted issuer as to whether the issuer may have breached its disclosure obligations.

The strongly disclosure-based philosophy of the CG system and its reliance on the fiduciary role of the director, also gives rise to an interesting incongruity when considered in view of Hong Kong's CG system. While the DGCL accepts shares being listed where there is a dual-class structure (i.e. WVRs), it also attaches primacy to the votes so attached insofar as shareholders are not disenfranchised of votes on the basis they may be interested in a transaction (i.e. as a related party) – such as where shareholders are asked to approve a merger²⁹⁶ – although in practice directors often seek the approval of a “majority of the minority”, such as in a takeover by connected parties, owing to the risks of litigation and developing case law. In contrast, the system in Hong Kong, at least so far as listed issuers are concerned, adheres to the “one share one vote” principle, eschewing WVRs,²⁹⁷ while at the same time regulations issued by the SEHK²⁹⁸ or the SFC²⁹⁹ disenfranchise shareholders of voting power in relation to transactions in which they have a relevant interest. Notably, while directors in Hong Kong do owe fiduciary duties to the company, they are required to step aside where they have a conflicting interest and in specific transaction scenarios such as where a change of shareholder control is being proposed. In contrast, case law and the risk of litigation in the United States often lead to boards establishing special committees of independent directors where a transaction involves a related party, even though the DGCL does not require them to do so. Whereas in the United States votes attaching to shares remain exercisable always, in Hong Kong they are not. These features serve to highlight fundamental distinctions between the two systems that encompass the relationship between owners and managers as overseen by the law and non-statutory codes issued by regulatory agencies. It has been argued that these differences arise out of fundamentally different social and political contexts, the United States traditionally being a right-leaning employee welfare state (i.e. in which corporate employers are responsible for workers' social welfare) in contrast to the UK (which has influenced Hong Kong) which has traditionally been a left-leaning social welfare state (in which reliance is placed on state based welfare structures).³⁰⁰ To the extent that is a correct underpinning of the two approaches, further development in Hong Kong may require due consideration being given to the social circumstances prevailing in Hong Kong as well as the inherited legal and regulatory structure.

III.7.1 Shareholder rights

Minimum rights

It has long been regarded as a fundamental right of shareholders under United States state law “to appear at the meeting [of shareholders]; to make a proposal; to speak on that proposal at appropriate length; and to have his proposal voted on.”³⁰¹ However, actual in-person meetings of shareholders are now, in effect, only a necessary formality,

²⁹⁵ For example, between January and July 2014 30 companies were delisted from NYSE or Nasdaq

²⁹⁶ Although, as discussed below, where a director is a party to a transaction he may still vote, however, if the transaction is approved by a majority of disinterested shares this will normally work to take the transaction out of the review of the Court

²⁹⁷ With the notable exceptions of Swire, which was grandfathered in, and HKEX itself, in which the HKSAR government has a special class of shares

²⁹⁸ Listing rules, particularly Chapter 14A of the MBLR

²⁹⁹ The Code on Takeovers and Mergers

³⁰⁰ See generally, Bruner op. cit. e.g. section 5.B

³⁰¹ SEC Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 before the House Committee on Interstate and Foreign Commerce, 78th Cong., 1st Sess. 172 (1943) (statement of SEC Chairman Ganson Purcell)

the primary means by which shareholders are in practice able to express their views instead being by way of proxy – exercised in response to an issuer’s proxy statement or through the solicitation of proxies, i.e. by initiating a proxy contest.³⁰² Important issues decided by proxy include director nomination (discussed below) as well as other shareholder proposals.

Considerable discussion has revolved around the content and access to the proxy statements required, pursuant to section 14(a) of the 1934 Act, to be sent to shareholders prior to shareholder meetings. The purpose of the statement is to explain to shareholders the matters for discussion at the meeting. Rules made by the SEC specify the information required to be included – this will cover matters such as appointment of directors and executive compensation.³⁰³ Proxy statements are also filed with the SEC (Form DEF 14A) and maintained on the SEC’s EDGAR.

The SEC has long been of the view, including based on research it has undertaken in recent times,³⁰⁴ that the proxy process represents an impediment on those fundamental shareholder rights, which have been

“rendered largely meaningless through the process of dispersion of security ownership through[out] the country ... whereas formerly ... a stockholder might appear at the meeting and address his fellow stockholders [, t]oday he can only address the assembled proxies which are lying at the head of the table. The only opportunity that the stockholder has today of expressing his judgment comes at the time he considers the execution of his proxy form, and we believe ... that this is the time when he should have the full information before him and ability to take action as he sees fit.”³⁰⁵

As discussed below in connection with the appointment and removal of directors, the SEC has sought to implement proxy rules that address this perceived problem by replicating, as nearly as possible, an in-person meeting, however, it has done so without success. Despite the roll-back of the SEC proxy access rules, there have been ever growing waves of shareholder initiated proposals to amend bylaws to allow proxy access. A significant number of listed issuers now have amended bylaws in one form or another. This is a good example of how shareholders can change the CG landscape in a meaningful way.

The fundamental CG concern in this regard is straightforward: in the absence of an effective means for shareholders to nominate and elect or remove directors to or from the board, accountability of the board to shareholders is diminished. There is a wider set of arguments that the United States in this regard has fallen behind standards in other countries and that this ultimately represents an important competitiveness problem for United States issuers.³⁰⁶ Some academic literature also suggests a relationship between board accountability and effectiveness.³⁰⁷

Conversely, a concern that has been expressed over shareholder-nominated appointments³⁰⁸ is that directors so appointed may represent the interests of select shareholders rather than the interests of the company as a whole. Shareholder activism

³⁰² 5 Fletcher Cyclopedia of Corporations § 2049.10 (Perm. Ed.)

³⁰³ 17 CFR 240.14a-101 Schedule 14A. Information required in proxy statement

³⁰⁴ See Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,025–26 (2009)

³⁰⁵ SEC Proxy Rules op. cit.

³⁰⁶ Committee on Capital Markets Regulation, *Interim Report* (November 30, 2006) at 109: Available at http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf

³⁰⁷ See, e.g., Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors—A Decision-Making Analysis*, 5 Berkeley Bus. L.J. 131 (2008)

³⁰⁸ For example, by the USCC and the BRT Corporate Governance Task Force

via proxy contests can lead to undesirable outcomes (as discussed in Appendix III.1), a feature that is also beginning to appear in the UK markets.

Developments over the past decade or so have strengthened the voice of shareholders in companies. This includes SEC rules that facilitate the use of electronic shareholder forums,³⁰⁹ enhanced disclosure requirements concerning the nominating committee of the board,³¹⁰ many larger companies moving to majority voting in place of plurality voting in director elections,³¹¹ and that many State laws – including Delaware where most listed issuers are incorporated – now clearly allow constitutional documents of companies to set out shareholder rights to nominate directors.³¹²

Nevertheless, for the purposes of equivalence to standards in Hong Kong (in connection with applications for listing on the SEHK), although the SFC and HKEX regard Delaware shareholder protection standards as not materially different from Hong Kong's, before a Delaware incorporated company could be regarded as giving shareholders rights equivalent to those in Hong Kong it remains necessary for it to establish that members have the right (1) to convene general meetings and add resolutions to the agenda and (2) to speak and vote at meetings. These may require amendments to the company's articles.³¹³

Staggered boards and WVRs remain issues that appear to conflict with the traditional rights of shareholders mentioned above. In March 2017 Snap Inc (the parent company of Snapchat) became the first company to list shares on the NYSE that possess no voting rights. This has caused some negative reactions in the market as pushing the WVRs concept too far.

Calling shareholder meetings:

The ability to call meetings is primarily a matter of State law and the articles of the company. Section 211(d) of the DGCL provides that special meetings (i.e. extraordinary general meetings) may be called by the board of directors or by such person or persons as may be authorised by the certificate of incorporation or by the bylaws. Some states, such as New York, follow this law, others are more permissive, such as California, which requires its corporations to allow shareholders to call a special meeting (10% of shareholders may requisition a meeting).

In contrast, Hong Kong primary legislation (part 12, Division 1 of the CO) provides a clear right that shareholders holding at least 5% of the total voting rights may require directors to convene a general meeting of shareholders, and to apply to Court if the directors do not then call the meeting. However, only very few listed companies in Hong Kong are incorporated in Hong Kong meaning that the law of their place of incorporation will govern the calling of shareholder meetings. While historically this was dealt with by only allowing listing applications from companies incorporated in jurisdictions with equivalence in this regard, since 2007 the SEHK has allowed a wider range of jurisdictions as being acceptable. LR 19.05(1)(b) of the SEHK's listing rules requires

³⁰⁹ Electronic Shareholder Forums, Release No. 34-57172 (January 18, 2008) [73 FR 4450]

³¹⁰ Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Release No. 33-8340 (December 11, 2003) [68 FR 69204]

³¹¹ Around half of S&P 500 companies had changed over by the end of 2008. However, plurality voting remains the standard at the majority of smaller companies. The Corporate Library Analyst Alert, December 2008. See also Broadridge letter dated March 27, 2009 and attached analysis in response to File No. SR-NYSE-2006-92.

³¹² Effective August 1, 2009 DGCL included a new Section 112 allowing that the bylaws of a Delaware corporation may provide that, if the corporation solicits proxies with respect to an election of directors, the corporation may be required to include in its solicitation materials one or more individuals nominated by a stockholder in addition to the individuals nominated by the board of directors. Similar changes may be made to the Model Business Corporation Act maintained by the American Bar Association.

³¹³ See HKEX's "Country guide – The State of Delaware, the United States of America" (20 December 2013, updated April 2014), section 4

overseas issuers to provide standards of shareholder protection at least equivalent to Hong Kong. Where the applicable home jurisdiction law does not provide such protections, then the company will need to amend its articles to provide equivalence to the Hong Kong CO in this regard.³¹⁴ Overseas issuers are further discussed in Appendix III.8.

Information and engagement:

In general, Federal securities law, i.e. the 1933 Act or the 1934 Act, require listed issuers to disclose information on a periodic basis, i.e. at prescribed moments in time, such as when a 10-Q or 10-K is due. Around these requirements the Courts have developed a duty to update and a duty to correct.³¹⁵ The SOX also requires CEOs and CFOs of public companies to certify the annual and quarterly reports as fair presentations of companies' financial conditions. Rules made by the SEC pursuant to those Acts determine the specific details of the disclosures and filings are made by way of submitting forms designed by the SEC for these purposes. This includes annual reports (Form 10-K), quarterly reports (Form 10-Q) and current reports for a number of specified events (Form 8-K) – however, these forms only apply to issuers that don't qualify as FPIs (for which Form 6-K applies, as discussed in Appendix III.3). For the annual and quarterly reports, the amount of time allowed for filing following the end of the relevant period varies according to the size of the issuer. Companies with public floats of US\$700 million or more are known as "large accelerated filers" and are subject to shorter deadlines (for example, 60 days and 40 days for annual and quarterly reports respectively). Quarterly reports compare the issuer's performance in the current quarter and year to date to the same periods in the previous year.

On the other hand, NYSE and Nasdaq listing rules require disclosure of material information on a continuous basis - listed issuers must release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities.³¹⁶ News released during trading hours is not accompanied by a halt in trading while the news is released and digested, unlike the SEHK where a trading halt is required. However, the Exchanges do require submission of material releases in advance and they do on occasion impose trading halts to allow the market time to digest the news, although this is relatively infrequent and, where a halt is imposed, is of very limited duration.

In addition, NYSE Rule 303A.03 requires issuers to establish for all interested parties (not just shareholders) a means of making their concerns known to the non-management or independent directors. This may be undertaken through the issuer's annual proxy statement or by other means. Some companies have taken a more expansive approach, creating email addresses for shareholders to use in communicating with the whole board, independent directors, non-management directors and individual directors, with the caveat that communications will be reviewed by the company and forwarded to the board only if they require a response.³¹⁷

An increasing number of issuers in the United States have in recent years, at least in appearance, been placing an increased emphasis on soliciting feedback from shareholders to understand their concerns, in particular as regards governance and

³¹⁴ SFC/HKEX "Joint policy statement regarding the listing of overseas companies" 27 September 2013, para 39

³¹⁵ For a more detailed discussion, see B Mendelsohn and J Brush, "The Duties to Correct and Update: A Web of Conflicting Case Law and Principles", *Securities Regulation Law Journal*, Volume 43, Issue 1, Spring 2015.

³¹⁶ § 202.05, NYSE Company Manual, Nasdaq rule 5600

³¹⁷ Harvard Law School Forum on Corporate Governance and Financial Regulation, "Building Relationships with Your Shareholders Through Effective Communication": Available at <https://corpgov.law.harvard.edu/2012/11/13/building-relationships-with-your-shareholders-through-effective-communication/> (visited 7 Jun 2016)

executive compensation. This is witnessed by the increasing number of proxy statements that refer to these concerns.

Exchange requirements and comply/explain:

The listing standards of the Exchanges set out the practices an issuer is expected to maintain as regards standards of corporate responsibility, integrity and accountability to shareholders.³¹⁸ They represent important requirements in the context of a CG system that in other regards cannot be characterised as shareholder-oriented by comparison with Commonwealth models of CG as seen in Hong Kong, the UK and Singapore. These are discussed below under board processes. Appendix III.6 has discussed the enforcement of the listing standards.

Since 2009/2010, both NYSE and Nasdaq have imposed requirements on the CEO (NYSE) or the issuer (Nasdaq) of listed issuers to notify the Exchange in writing of any non-compliance with the Exchange's CG standards; NYSE additionally imposes an annual certification requirement and a requirement to make an affirmation as and when required.³¹⁹ According to the commentary in the NYSE rules, the intention of the requirement is to bring greater focus of the senior management on compliance with the CG listing standards. This requirement is not present in the SEHK's listing rules.

Controlling shareholders

United States laws and regulations do not provide for special rules that apply to persons holding 30% or more (or any other threshold) of the voting capital of a company, unlike Hong Kong where the SEHK has imposed special rules on controlling shareholders. However, controlling shareholders is nevertheless recognised as a concept in United States law, as discussed below.

Remedies

Two important remedies for shareholders affected by bad CG, both of which are frequently exercised in the United States, are the derivative action and the class action. These actions are facilitated by the availability of lawyer contingency fees,³²⁰ which are not permitted in Hong Kong for similar kinds of action. Overall, the United States is characterised by a significantly greater level of activity of private shareholder lawsuits as compared to Hong Kong where most CG-related actions are instead undertaken by the regulatory agencies. Nevertheless, Hong Kong was ranked closely behind the United States in a report published by the World Bank that assessed the ability of shareholders to seek redress for damages, scoring 8/10 as compared the United States' 9/10, well ahead of the 5/10 average for OECD rich economies.³²¹

Derivative action:

Derivative actions are available to shareholders to take action on behalf of the company in respect of breaches of duties owed by managers to the corporation under State law and Federal law.³²² Potential litigants are required to first ask the board to litigate by serving a demand on the board, although the need to do so is frequently excused under Delaware law on the basis that the board is conflicted and the board's subsequent decision as to whether to litigate may enjoy the protection of the business judgement rule. Hence, at the first stage, the Courts have to consider whether the requirement of

³¹⁸ NYSE Company Manual rule 301.00

³¹⁹ NYSE Company Manual Rule 303A.12; Nasdaq Rule 5625

³²⁰ Rules 1.5 (c) and(d) of the Model Rules of Professional Conduct of the American Bar Association

³²¹ The World Bank and International Finance Corporation, "Doing Business 2014 – United States", page 62 and "Doing Business 2014 – Hong Kong SAR, China", p 58

³²² Delaware Code, Title 6, §18-1001; Rule 23.1 Federal Rules of Civil Procedure

making a demand to the board can be excused (the *Levine* test³²³). A demand can be excused when it is "futile", when: (1) evidence casts doubt on the board's independence from those who engage in the challenged transaction, or (2) evidence casts reasonable doubt on the board's business judgement in relation to the challenged transaction.

These rights are to be compared to the twin rights in Hong Kong for shareholders to bring actions in relation to unfair prejudice and derivative actions under Part 14 of the CO. Both remedies are available in relation to Hong Kong incorporated and non-Hong Kong incorporated companies.³²⁴ However, there appears to be no direct equivalent in the United States for the unfair prejudice remedy, the class action instead being the remedy in relation to breaches of director responsibilities, as discussed next.

Collective redress / class actions:

The primary means of collective redress in the United States is the class action. Where the management of a company has abridged a statutory, contractual, or other common law duty owed directly to the shareholders as individuals and the alleged misconduct similarly affects the rights of a number of other shareholders, their suit may be brought together as a class action.³²⁵ This covers matters involving individual rights³²⁶ such as "suits to compel the payment of a dividend, to protest the issuance of shares impermissibly diluting a shareholder's interest, to protect voting rights or to obtain inspection of corporate books".³²⁷ In contrast, a breach by a director of fiduciary duty to the company is primarily a matter for a derivative action taken on behalf of the company. Direct actions can be filed individually or in a class under either State corporate law or Federal securities law. Class actions brought in the Federal courts are subject to the requirements of section 27 of the 1933 Act and section 21D of the 1934 Act.

Most shareholder class action suits in the United States are brought in respect of either misrepresentation in financial documents or securities fraud under section 10(b) of the Exchange Act of 1934 and Rule 10b-5 (respectively accounting for 97% and 84% of all class action suits in 2013)³²⁸ – they are not brought in respect of abuse of power, although it remains open to question to what extent disclosure breaches and fraud occur as a consequence of some form of abuse of power. Class actions are frequent in the United States, one study indicating an average of 193 suits per year being brought on this basis over the period 1997 to 2012³²⁹ and another indicating that over US\$64 billion in settlements of class action suits have been obtained between 2000 and 2011.³³⁰ While some view the availability of class action suits as important mechanisms of control and redress, it is not without other burdens to companies and the market. This includes the significantly increased cost of directors' insurance and the deterrent effect that the higher risk of class action lawsuits may have on the United States as a listing venue.³³¹ One study estimated that the average public company has a 10% chance of facing at

³²³ *Levine v. Smith* 591 A.2d 194 (1991)

³²⁴ Section 722(1), CO

³²⁵ Rule 23, Federal Rules of Civil Procedure; Rule 23, Rules of Civil Procedure for the Superior Court of the State of Delaware (and the applicable laws of other States)

³²⁶ See *Kahn v. Kaskel*, 367 F. Supp. 784 (S.D.N.Y. 1973) (a class action by shareholders is based upon individual rights belonging to each member of the class) and *Behrens v. Aerial Comm., Inc.* Del. Ch., No. 17436 (May 18, 2001) ("The distinction between a direct and derivative claim . . . turns on the existence of direct or 'special' injury to the plaintiff stockholder.")

³²⁷ In *re Worldcom, Inc.*, 323 B.R. 844, 850 (Bankr. S.D.N.Y. 2005)

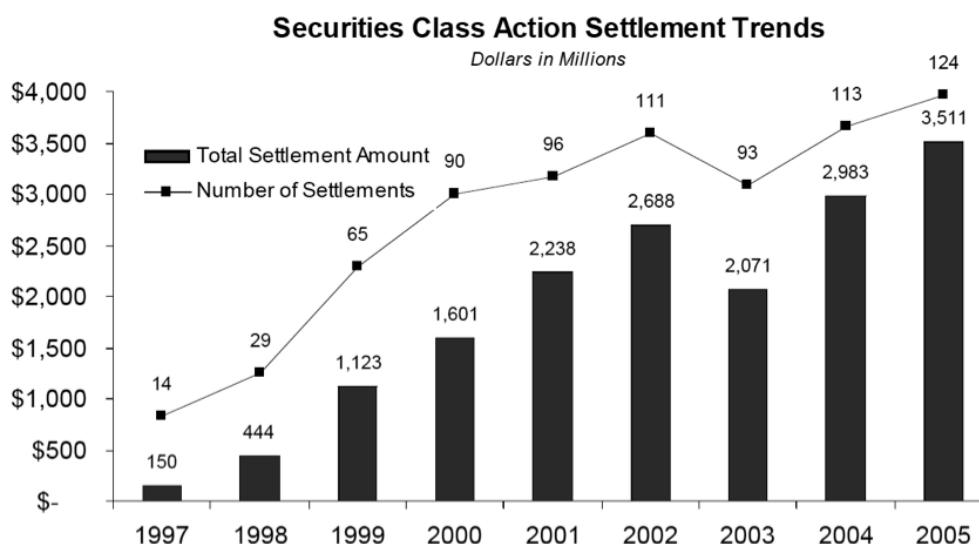
³²⁸ "Securities Class Acting Filings 2013 Year in Review", Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse, at p 7

³²⁹ Cornerstone Research, "*Securities Class Action Filings – 2012 Year in Review*", p 3

³³⁰ According to NERA Economic Consulting as cited by the Committee on Capital Markets Regulation, Available at <http://www.capmksreg.org/2012/04/01/the-alternative-to-shareholder-class-actions/>, (visited 22 Feb 2017)

³³¹ Interim Report of the Committee on Capital Markets Regulation, November 30, 2006, section III

least one lawsuit over a five-year period,³³² possibly including frivolous ones. The Table³³³ below shows a marked trend in class action rights, both in terms of number of settlements as well as the total settlement amount. Moreover, these settlements may do little to accomplish the class action's traditional goals of compensation and deterrence since most actions are settled with attorney fees accounting for up to 35% of the total settlement.³³⁴



Class action rights are not available in Hong Kong. The Law Reform Commission (LRC) has studied the question of whether such rights should be introduced, and has published a recommendation that some form of class rights mechanism should be adopted, identifying cases related to interests in securities being a particular area of relevance.³³⁵ While the LRC's recommendation has been submitted to the DoJ and the HKSAR Government, there has been no further action or response to it. In the interim, it has been suggested that the SFC's powers under the SFO, may in some regards, act as a meaningful alternative to class action rights in view of the particular characteristics of Hong Kong culture and the drawbacks of class action rights, albeit subject to the inherent conflicts of the SFC as regards the other matters it needs to take into account.³³⁶

Listing requirements:

In addition, as discussed in Appendix III.6, there is some indication that the Courts are willing to entertain private civil suits as well as derivative actions in respect of issuer's that breach requirements of the Exchange on which they are listed. To date, there have only been two cases in Hong Kong that provide a link between the SEHK's disclosure requirements and a shareholder's expectations as regards information it should be provided with – however, those cases were concerned with a provision of the SFO, section 214, that is only actionable by the SFC, not by an investor.³³⁷ This may be seen

³³² Buckberg, Elaine, Todd Foster, and Ronald Miller. 2006. "Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, is Stabilization Ahead?" Worldwide: NERA Economic Consulting

³³³ Interim Report of the Committee on Capital Markets Regulation *op. cit.* p 75

³³⁴ This is the view of the Committee on Capital Markets Regulation: Available at <http://www.capmktreg.org/2012/04/01/the-alternative-to-shareholder-class-actions/> (visited 22 Feb 2017)

³³⁵ The Law Commission of Hong Kong, "Report – Class Actions, (May 2012)", Annex I, p 275

³³⁶ Syren Johnstone, "A flawed debate", International Financial Law Review, May 2015, pp 38-39

³³⁷ *SFC V. Kenneth Cheung Chi Shing And Others* [2012] HKCFI 312; [2012] 2 HKLRD 325; HCMP 1702/2008 (7 March 2012) HCMP 1702/2008, and *Wong Shu Wing op. cit.*

as another instance where shareholders in Hong Kong in some instances must, or in practice do, rely on the regulator taking an action to redress corporate wrongdoing where they themselves cannot or would face considerable difficulties in doing so.

Other considerations:

Given the wider costs to the United States markets created by litigation risks, there has been some discussion, and attempts, in the United States as regards mandating arbitration as the means of dealing with shareholder disputes. The SEC has rejected these proposals citing securities laws.³³⁸ The Committee on Capital Markets Regulation is a strong advocate for the arbitration approach.

The foregoing discussion is focussed on *ex post* means of redress. For completeness, it should be noted that *ex ante* means of regulating corporate behaviour is an important alternative means of improving shareholder rights. John Coffee has characterised this distinction as reflecting the *ex post* approach in the United States compared with the regulatory approach in the UK, which tends toward *ex ante* mechanisms.³³⁹ As regards Hong Kong, it is notable that, in contradistinction to the United States where private litigation is greater than actions undertaken by the SEC,³⁴⁰ the reverse is true in Hong Kong where CG related actions are primarily undertaken by the SFC. More recently, the SFC, while stating they will bring greater focus on corporate wrongdoing, has also re-emphasised the importance of a multi-dimensional approach that includes gatekeeping and supervision.³⁴¹

Market abuse

As discussed in Appendix III.3, Regulation FD, which is actively enforced by the SEC, provides that when an issuer discloses material non-public information to certain individuals or entities - generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information - the issuer must make public disclosure of that information.³⁴² It was noted in Appendix III.3 that Regulation FD is broadly similar to Part XIVA of the SFO, but that the SFO goes further than Regulation FD insofar as a breach of Part XIVA enables affected investors to pursue a legal cause of action against the wrongdoer, whereas a breach of Regulation FD does not directly give rise to private cause of action. Nevertheless, selective disclosure in breach of Regulation FD may still subject an issuer to liability under certain circumstances, including in relation to the duty to correct and the duty to update (discussed above), where selective disclosure is made for a "personal benefit",³⁴³ or, importantly, liability under Rule 10b-5 where the disclosure contained false or misleading information.

III.7.2 Board processes

As mentioned above, State law places considerable emphasis on the fiduciary duties of directors and many elements that regulate matters such as decision making and shareholder involvement are dependent on fiduciary law as interpreted and applied by the Courts.

Subject to those requirements at law, the processes in which a board and its directors engage in, is supplemented in important ways by disclosure requirements (in particular the filings required under Regulation S-K, as discussed in section III.3) and non-

³³⁸ Proposals made by the Carlyle Group and shareholders of Pfizer and Gannett

³³⁹ Coffee, *op. cit.* *Working Paper*, No. 304, p 33

³⁴⁰ The SEC is nevertheless very active in enforcement.

³⁴¹ Thomas Atkinson Speech *op. cit.*

³⁴² 17 CFR 243

³⁴³ *Dirks v. SEC*, 463 U.S. 646 (1983)

statutory requirements imposed by the Exchanges. For example, the NYSE Listed Companies Manual require boards to have a majority of independent directors³⁴⁴ adopt and disclose CG guidelines that address director qualification standards which should, at a minimum, reflect the NYSE's independence requirements, and establish an audit committee that must report regularly to the board of directors.³⁴⁵ Companies may also choose to address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.³⁴⁶ The rules also indicate that committees such as the nominating/CG committee and the compensation committee should be supported by charters that deal with their reporting obligations to the board.³⁴⁷

Nasdaq has similar requirements relating to a Company's board of directors, that address audit committees and oversight by independent directors of executive compensation and the director nomination process. A code of conduct is also required. Other matters covered include shareholder meetings, proxy solicitation and quorum, the review of related party transactions, and shareholder approval, including voting rights.³⁴⁸

Appointment and removal of directors

Although shareholders elect the board of directors in general meetings, candidates for director posts are usually nominated not by shareholders but by incumbent directors. NYSE and Nasdaq rules require issuers to have in place arrangements whereby independent directors oversee appointments to the board, although the two Exchanges do this in differing ways.³⁴⁹

The issue of the appointment and removal of directors partners with the question of board refreshment. According to the 2014 NYSE/Spencer Stuart survey³⁵⁰ while around half of those surveyed thought board refreshment was "important" for good CG, around 16% regarded it as "critically important". In terms of mechanisms for refreshment, over 84% regarded "board assessment/evaluation" as the most effective tool, with around half responding that setting an age ceiling was effective and only a quarter regarding setting of term limits as effective. Over 77% of respondents on the survey were outside directors.³⁵¹ It is of interest to note that the 2009 Walker Review in the UK (albeit focused on banks and financial institutions) also suggested that a formal board evaluation was a desirable contributor to good CG (see Appendix II.2).

The question of shareholder participation in the nomination process has been under consideration for over half a century.³⁵² Currently, shareholders have three typical routes to seek changes to the board (or in relation to other matters): mount a proxy contest (see above), submit a shareholder proposal under SEC Rule 14a-8, or conduct a "vote no" campaign. Additionally, they may either decide to sell their shares, seek dialogue with management (in practice only open to a few larger shareholders of significance), or propose their own nominee at the shareholder meeting. In practice, such moves are

³⁴⁴ This only applies to listed companies that are non-foreign private issuers

³⁴⁵ NYSE Listed Companies Manual Rules 303A.01, 303A.02, 303A.09 and 303A.07(b)(iii)(H)

³⁴⁶ Commentary to rule 303A.09, NYSE Manual

³⁴⁷ Commentary to sections 303A.04 and 303A.05 of the NYSE Company Manual

³⁴⁸ Nasdaq rule 5601

³⁴⁹ NYSE Listed Companies Manual Rule 303A.04(b)(i); Nasdaq Rule 5605(e)

³⁵⁰ The 2014 Corporate Board Member/Spencer Stuart What Directors Think survey, see https://www.nyse.com/publicdocs/nyse/listing/What_Directors_Think_2014.pdf

³⁵¹ Based on the largest company on which they serve

³⁵² In 1942 the SEC had proposed a rule that would give shareholders a right to nominate directors but the proposal was subsequently dropped. See Securities Act Release No. 2887, Exchange Act Release No. 3347, Holding Company Act Release No. 3988, Investment Company Act Release No. 417, 1942 WL 34864 (Dec. 18, 1942)

typically fought by management using shareholders' money – one commentator has referred to this as “not a level playing field. It is close to perpendicular.”³⁵³

As already noted above, the device of the proxy has created some impediments to the due exercise of shareholders' traditional rights and the SEC has in response been seeking improvements through, *inter alia*, Federal proxy rules to remove those impediments, particularly in relation to the nomination and election of directors.³⁵⁴ However, Federal and State systems, and indeed the regulatory impetus and the market, are not always well-aligned and sought after changes remain subject to challenge in the Courts. A particular example of this occurred in relation to the empowerment of the SEC by the Dodd-Frank Act to make rules addressing shareholder access to company proxy materials. In 2010 the SEC introduced a new proxy access rule – Rule 14a-11 - designed to facilitate the rights of shareholders to nominate directors to a company's board. The rule sought to facilitate the views of long-term shareholders – specifically, those who have held at least 3% of the company's shares continuously for at least the prior three years – by requiring the company to include the nominees of long-term shareholders in their proxy materials, together with the nominees of management. The measure sought to address the perceived problem of short-term shareholders, such as hedge fund activists – discussed in Appendix III.1 – pursuing short-term interests at the cost of longer-term corporate prosperity.

The SEC's proxy access rules were subsequently successfully challenged in Court - the Court found the new rule to be arbitrary and capricious, and stated that the SEC had failed “adequately to assess the economic effects of a new rule [...and...] inconsistently and opportunistically framed the costs and benefits of the rule.”³⁵⁵

It has been argued that the SEC is not suited for regulating CG.³⁵⁶ Part of the argument is that existing State laws provide a more flexible framework and that SEC rules can operate to impede, rather than facilitate, shareholder participation. This might arise out of the different objectives and concerns that rest with a regulator as compared to the corporate context. For example, in a 2014 survey of directors³⁵⁷ “quite a few” directors observed that while the survey focused on topical issues such as board structure and effectiveness, this should not be a distraction from the primary responsibility of the board to generate sustainable profits for shareholders. For example: “A board's obligation is to further and enhance a company's revenue growth, profit potential, and shareholder benefit” rather than to be overly concerned with “political correctness”.³⁵⁸ In contrast, the regulator has different overarching priorities arising out of its statutory duties, investor protection being primary among them, as well as its own corporate culture and external pressures placed upon it to act or refrain from acting in relation to a particular matter. It is critical that a regulator has a relatively clear and directional mandate, supported by the market, in order for regulations it implements to be effective in practice – absent this, regulations may be perceived as merely undue interference, give rise to widespread non-compliance that weakens the mandate of the regulator, and invite challenges. It is arguable that such a market mandate is equally as important as having a legislative basis for acting. For example, on the proxy access rules discussed above, one of the problems that the Dodd-Frank Act empowerment of the SEC sought to overcome was the 1990 decision of the United States Court of Appeals for the District of Columbia – responsible for reviewing rules made by the SEC - that the SEC lacked the

³⁵³ 2003 Proposal to the SEC from The Corporate Library (December 22, 2003)

³⁵⁴ See Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024, 29,025–26 (2009)

³⁵⁵ *Business Roundtable And Chamber Of Commerce Of The United States Of America v. SEC*, United States Court of Appeals, For The District Of Columbia Circuit, Decided July 22, 2011, No. 10-1305, p 7

³⁵⁶ J.E. Fisch, “The Destructive Ambiguity of Federal Proxy Access”, *Emory Law Journal*, Vol. 61, Pg. 435, 2012

³⁵⁷ Spencer Stuart op. cit.

³⁵⁸ What Directors Think 2014: Available at <https://www.nyse.com/corporate-services/nysegs/hot-topics/governance-nominating-committee/what-directors-think> (visited 20 Nov 2017)

authority to regulate CG through the proxy rules.³⁵⁹ Nevertheless, when challenged again in the same court forum in 2011, the SEC again lost, for reasons already described.

Ultimately, the argument of regulator involvement in CG concerns is in some ways a deeply structural one not only as regards its *vires* to decide on the appropriate allocation of power between shareholders and management but also the proper role of regulatory agencies in the markets *per se*.

Remuneration

Under both the NYSE and Nasdaq requirements, issuers must have in place arrangements whereby independent directors oversee executive compensation, although the Exchanges require this in differing ways.³⁶⁰ Under both sets of Rules, compensation committee members are subject to additional independence tests,³⁶¹ and an issuer must also include a Compensation Committee Report in its proxy statement and its annual report on Form 10-K.

The Dodd-Frank Act mandated three different types of nonbinding shareholder votes on compensation matters. First, not less frequently than once every three calendar years, each public company must submit the compensation of its named executive officers (NEOs) to a nonbinding shareholder vote (the "say-on-pay vote").³⁶² Second, not less frequently than once every six calendar years, each public company must submit for a nonbinding shareholder vote the question of whether the say-on-pay vote should be held annually, biennially or triennially (the "say-when-on-pay vote") - all companies being required to hold such a vote at their first or other shareholder meeting occurring after January 21, 2011.³⁶³ Third, in any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets, a public company must submit all golden parachute arrangements covering any of its NEOs to a separate nonbinding shareholder vote, unless the arrangements have already been subjected to a say-on-pay vote (the "golden parachute say-on-pay vote").³⁶⁴

Technically, due to the primacy of directors under State laws to determine the company's affairs, the say-on-pay vote is nonbinding. However, as it does serve as an important barometer of shareholder views of a company's compensation practices, directors do tend to be quite focused on receiving a favorable outcome as poor results have the potential to trigger significant investor pressure and possibly litigation.

Independent directors

In contrast to the requirements of the SEHK, which requires at least one-third of the board to be comprised of INEDs,³⁶⁵ Exchange listing standards require listed issuers to have a majority of independent directors³⁶⁶ with a view to increasing the quality of board oversight and lessening the possibility of damaging conflicts of interest.³⁶⁷ NYSE and Nasdaq both have tests of independence that are broadly aligned with the concepts of independence as required under the SEHK's listing rules, although they differ in their detail.

³⁵⁹ *Business Roundtable v. SEC* 905 F.2d 406 (D.C. Cir. 1990)

³⁶⁰ NYSE Listed Companies Manual Rule 303A.05; Nasdaq Rule IM-5605-6

³⁶¹ NYSE Listed Companies Manual Rule 303A.02(a)(ii); Nasdaq Rule 5605(d)(2)(A)

³⁶² §240.14a-21(a), CFR

³⁶³ §240.14a-21(b), CFR

³⁶⁴ 2011 (§240.14a-21(c), CFR

³⁶⁵ MBLR 3.10A

³⁶⁶ NYSE Company Manual rule 303A.01

³⁶⁷ NYSE Company Manual Commentary to rule 303A.01

As in Hong Kong, independent directors are required to take charge of nomination, compensation and audit committees.

Audit committee:

SEC rules adopted as part of SOX also require that the audit committee members cannot be affiliates of the company (for example, a principal of a 10% or greater shareholder of the company) or receive any compensation from the company except for board and board committee service. Audit committees are also expected to have at least one member qualify as an audit committee financial expert (see Appendix III.3). In addition, the NYSE rules specifically require prospective committee members to evaluate carefully the existing demands on his or her time before accepting this assignment³⁶⁸ and, if a committee member serves on more than three public companies then the board must consider whether this impairs the ability of the person to serve and must disclose such determination.³⁶⁹

III.7.3 Specific transaction contexts

Related party transactions

Unlike Hong Kong, which lays down specific listing rule requirements³⁷⁰ for related party transactions that listed issuers propose to enter into, issuers in the United States are primarily subject to the general consideration of overall materiality. There is heightened sensitivity about related party transactions that may make a company more likely to disclose it in view of potential 10b-5 liabilities under Federal law (State laws are concerned with different matters, as discussed below). Disclosures would need to be made pursuant to the relevant SEC filing requirements (Regulation S-K in the context of ongoing reporting requirements or an offering under the 1933 Act, and Item 7.B of the 20-F instructions in the context of a 1934 Act annual report filing). Item 404 of Regulation S-K covers transactions in an amount that exceeds US\$120,000 with directors, executive officers, or shareholders holding more than 5% of the companies stock, and their respective relatives and requires disclosure of all information that is material to investors in light of the circumstances of the transaction.³⁷¹ FPI's are subject to the same overall considerations of materiality, and Form 6-K specifically requires FPI's to disclose material transactions with directors, officers or principal security holders.

Consistent with the disclosure-based approach of the United States (and prevailing laws, discussed below), filings with the SEC do not give rise to specific approval requirements but instead requires a disclosure of the issuer's policies and procedures for reviewing and approving or ratifying any reportable related party transaction. While this requires an indication of the types of persons who may be involved in that process, there is no specific requirement that independence be a factor.

The legal requirements are supplemented by the listing requirements of both NYSE³⁷² and Nasdaq,³⁷³ which require that an "appropriate" review be undertaken - Nasdaq requiring this to be the issuer's audit committee or another independent body of the board of directors, NYSE merely noting that the audit committee or another comparable body might be considered as an appropriate forum for this task.

³⁶⁸ NYSE Company Manual Commentary to rule 303A.07(a)

³⁶⁹ NYSE Company Manual Disclosure Requirement rule 303A.07(a)

³⁷⁰ I.e. MBLR Chapter 14A

³⁷¹ 17 CFR 229.404 (Item 404)

³⁷² NYSE Company Manual Rule 314.00

³⁷³ Nasdaq Rule 5630(a)

The law applying to connected parties of listed issuers fall into two sets of requirements, those applying to directors and those to controlling shareholders, discussed below.

Director as connected party:

Under Delaware law, transactions of the company in which a director has an interest is subject to section 144 of the DGCL and case law concerning the application of the business judgment rule.

Under the business judgment rule, directors when making business decision are presumed to have acted on "an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."³⁷⁴ In general, this rule prevents the decisions of directors being second-guessed by shareholders and the Courts.³⁷⁵ However, where directors have a self-dealing interest in the subject matter of their decision, the transaction may not be protected by the business judgment rule depending on the circumstances.³⁷⁶ In such cases, the substantive merits of the transaction are subject to judicial scrutiny on an "entire fairness standard", with the burden of proof shifting to the interested director(s) to establish good faith and fairness.³⁷⁷ "Entire fairness" requires both procedural (fair dealing) and substantive (fair deal) fairness.³⁷⁸ "Fair dealing" includes when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the board, and how the director and shareholder approvals were obtained. "Fair deal" relates to price and includes assets, market value, earnings, future prospects, and any other relevant factors.

The DGCL provides that transactions of the company in which a director has an interest will not be void or voidable provided it has been approved or ratified, in good faith, by a majority of independent directors of the board or a committee of the board³⁷⁹ or by shareholders,³⁸⁰ in each case following the material facts having been properly provided as to (1) the director's relationship or interest and (2) the transaction. A transaction may also be given the same protection under the DGCL if approved by directors (or shareholders) without regard to any director independence requirement if the transaction is fair to the company at the time of authorisation.³⁸¹

Under these provisions, disinterestedness means that, where the independent director's option has been satisfied, the business judgment rule can be applied and the burden of proof would then be on a plaintiff to prove waste.³⁸² As regards shareholders exercising voting rights, while there is no concept as in Hong Kong of "disinterested" votes *per se*, the Delaware courts nevertheless do consider whether a "majority of the minority" have approved the transaction based on a full-set of information.³⁸³ Accordingly, independence of the board and voting shareholders will affect who has the burden of proof in relation to the business judgment and entire fairness rules.³⁸⁴

³⁷⁴ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)

³⁷⁵ "Controlling Shareholder Duty of Loyalty: Entire Fairness or Business Judgment?" by Edwin Webb Hecker, Jr (May 2014)

³⁷⁶ *Fliegler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976). In practice, the case law on this topic is extensive and somewhat complicated to summarise briefly and accurately

³⁷⁷ *Newton v. Hornblower*, 582 P.2d 1136, 1145-47 (Kan. 1978)

³⁷⁸ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983)

³⁷⁹ Section 144(a)(1) of the DGCL

³⁸⁰ Section 144(a)(2) of the DGCL

³⁸¹ Section 144(a)(3) of the DGCL

³⁸² *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114, 120 (Del. 2006)

³⁸³ *Gottlieb v. Heyden Chemical Corp.*, 91 A.2d 57, 58-59 (Del. 1952)

³⁸⁴ For a more detailed breakdown of the possible alternatives and the likely standard of review see "M&A report – determining the likely standard of review applicable to board decisions in Delaware M&A transactions", Gibson Dunn, November 19, 2014: Available at <http://www.gibsondunn.com/publications/Documents/MAReport-Determining-Likely-Standard-of-Review-Applicable-to-Board-Decisions-in-Delaware-MA-Transactions.pdf> (visited 21 Mar 2017)

These arrangements are somewhat different from the fair dealing requirements applying to directors under Part 11 of the Hong Kong CO and the restrictions imposed by Chapter 14A of the MBLR.

Part 11 of the CO provides for fair dealing by directors by subjecting them to a requirement to disclose to the board whether they or their related parties have an interest in a transaction of the company. There is no specific independence requirement applied to the meetings and votes of directors, and while failure to make a required disclosure may be an offence, it does not render transactions voidable unless it falls into one of the specified prohibited types of transaction, such as loans to directors, that require shareholder approval and where the votes of interested shares must be disregarded.³⁸⁵

Unlike Part 14 of the CO (shareholder remedies – discussed above), Part 11 does not apply to non-Hong Kong companies operating in Hong Kong. Here it is relevant to consider the requirements of the HKEX and the SEHK's listing rules. The SFC/HKEX joint policy statement on the acceptability of non-Hong Kong companies for listing refers to the listing rule requirements that shareholders must abstain from voting where they have a material interest in the transaction or arrangement,³⁸⁶ and this may necessitate a change in the issuer's constitutional documents for it to be acceptable for listed status in Hong Kong.³⁸⁷ This does not refer to or appear to cover directors, so it would appear that only directors who are also shareholders are covered – however, executive directors will normally hold shares in the issuer. In any case, all directors are subject to MBLR 3.08, which requires that all directors adhere to standards commensurate with standards established by Hong Kong law. Notwithstanding that, MBLR 3.08 requires directors to avoid conflicts and disclose their interests in transactions of the issuer, and Chapter 14A the listing rules contains detailed disclosure and shareholder approval requirements that apply to transactions with directors. While a mere breach of the listing rules does not give rise to a legal cause of action (see the discussion above concerning remedies), it may be noted that if transactions with directors were undertaken in a manner that amounted to unfair prejudice, then remedies under Part 14 of the CO may become available, or the SFC may pursue an action under section 214 of the SFO.

Controlling shareholder as connected party:

It is of interest to note that controlling shareholders may be regarded as owing fiduciary duties to other shareholders where they own a majority interest in the company or exercise some measure of *de facto* managerial control over the company's business affairs, including through the appointment of their agents to the board.³⁸⁸

This position in the United States is both similar and different from the situation in Hong Kong where a controlling shareholder would need to be established to be acting as a shadow director,³⁸⁹ and if they were, then they would owe the usual duties that a director owes to the company as a whole.³⁹⁰ As noted above, the SFC/HKEX joint policy statement on the acceptability of non-Hong Kong companies for listing refers to the listing rules requirements that shareholders must abstain from voting where they have a material interest in the transaction or arrangement, and this will capture controlling

³⁸⁵ CO, section 496

³⁸⁶ SFC/HKEX, Joint policy statement op. cit. para 38

³⁸⁷ Ibid. para 27

³⁸⁸ *Kahn v. Lynch* (1994); *Ivanhoe Partners v. Newmont Mining Corp.*, Del.Supr., 535 A.2d 1334, 1344 (1987) See also Webb Hecker op. cit.

³⁸⁹ Section 2(1) of the CO defines shadow director as being "a person in accordance with whose directions or instructions (excluding advice given in a professional capacity) the directors, or a majority of the directors, of the body corporate are accustomed to act". See also section 456(4)(b) of the CO which confirms the liability of a body corporate notwithstanding that it could not be appointed as a director of a private company that is a member of a listed group.

³⁹⁰ Unisoft Group Ltd (No 2) [1994] BCC 766

shareholders.³⁹¹ Chapter 14A the listing rules contains detailed disclosure and shareholder approval requirements that apply to transactions with controlling shareholders - however, the Chapter 14A rules do not carry legal weight, meaning that a breach of them only gives rise to regulatory sanctions, unless a wider legal cause of action is established (see discussion under remedies above).

In a report published by the World Bank that assessed the ability of local systems to regulate connected transactions that pose a risk to shareholders, the United States ranked sixth, behind Hong Kong's score of 9/10, which ranked third overall and well ahead of the 7/10 average for OECD high income economies.³⁹²

Transactions significant in size

United States CG regulation does not make special provisions for transactions of a certain size, for example, as found in Chapter 14 of the SEHK's listing rules. Instead, where there is an extraordinary transaction, i.e. one not part of the normal course of the company's business, the focus of shareholders and the attention of the courts will fall on the fiduciary obligations of directors arising under State law. Thus, transactions significant in size and transactions involving a change in control (discussed next) fall to be treated under the same principles.

The business judgment and entire fairness rules, already discussed, are therefore applicable, and cases that develop this area of law frequently arise in the context of a change of control. For example, the highly influential *Revlon*³⁹³ case examined the role of the board in a hostile takeover scenario and narrowly construed its fiduciary obligations as requiring the board to maximise value for the shareholders in the short-term, as opposed to the longer-term preservation of the company. However, subsequent cases have moved toward imposing on directors a more general obligation of good faith and exercising reasonable judgment that require the directors to achieve the best value for shareholders that is reasonably available.³⁹⁴

Transactions involving potential change in control

Merger and acquisition (M&A) activity is subject to State laws, based on the place of incorporation of the target, and Federal laws. State laws are primarily concerned with the fiduciary obligations of directors of the issuer, as enforced by the Courts upon a suit being brought by a shareholder alleging a breach of those duties. Federal laws, primarily sections 13(d) and 14(d)(1) of the 1934 Act, are primarily concerned with regulating the public securities market via disclosures and certain procedural requirements and, related to that, the conduct of companies involved in M&A transactions, and this is regulated and enforced by the SEC. NYSE and Nasdaq listing requirements also both contain provisions concerning M&A activity.

Where a statutory merger is proposed, a merger plan is agreed between the boards and is put before a meeting of shareholders for approval. Under Delaware law, a simple majority is sufficient to approve the plan. The merger must also be approved by the board of each company. Where a tender offer (or exchange offer³⁹⁵) is involved, the offeror may, in theory, offer different prices to different shareholders, quite unlike the

³⁹¹ SFC/HKEX, Joint policy statement op. cit. para 38

³⁹² World Bank Doing Business 2014 op. cit., as reported by the HKEX in its "Concept paper weighted voting rights" August 2014, para 68

³⁹³ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)

³⁹⁴ See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994), and *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) as discussed in *LA Cunningham and CM Yablon*, "Delaware Fiduciary Duty Law after QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)" *The Business Lawyer*, 49(4): 1593-1628, Aug. 1994

³⁹⁵ A tender offer involves cash, in an exchange offer shares of the offeror are used as consideration

position under the Hong Kong Code on Takeovers and Mergers where equality of treatment of shareholders is one of the general principles of the code that affects many of the specific obligations the Code places on the offeror. However, the price offered in the United States context is nevertheless subject to Federal anti-fraud provisions, discussed below.

Under neither scenario is a target board required by any law to obtain independent advice on the transaction. However, such advice is normally obtained as a means of fulfilling the directors' statutory duties.

One other significant way in which CG regulation differs between the United States and Hong Kong is that poison pills and other anti-takeover devices are used in the United States to significant effect, whereas they would generally be regarded as frustrating action in violation of Rule 4 of the Hong Kong Code on Takeovers and Mergers. The different States also have differing anti-takeover statutes.³⁹⁶

The DGCL offers two routes by which minority shareholders can be squeezed out where the acquirer seeks 100% control. The first, similar to the provisions in Hong Kong, is where the offeror acquires 90% of the shares.³⁹⁷ The second arises by virtue of the merger rules summarised above - where the acquirer obtains more than 50% of the target company's shares, it may proceed to acquire the balance, either by way of a merger which requires only a majority vote, or under the DGCL without a further meeting of shareholders.³⁹⁸

Rule 14d-10 made under the 1934 Act requires tender and exchange offers to be made to all the shareholders of a target issuer. While this must be made at the same price to all shareholders, this does not prevent shares from being transacted at higher prices, for example, those of controlling shareholders, at a higher price prior to the tender offer. However, where that happens, there is a possibility of litigation arising out of alleged fiduciary duties of the controlling shareholder (see discussion above under related party transactions).

These arrangements stand in high contrast to the strongly shareholder oriented model on which the Hong Kong Code on Takeovers and Mergers is based which requires, *inter alia*, (1) an offer to be extended to all shareholders where there has been a change in control;³⁹⁹ (2) equality of price to all shareholders encompassing share purchases up to six months prior to the commencement of the offer period;⁴⁰⁰ (3) the board to establish an independent committee for the purposes of the conduct of the transaction; (4) the appointment of an independent financial adviser to advise the shareholders; and (5) where the offer is undertaken by way of a scheme of arrangement, that only disinterested shareholders⁴⁰¹ may vote on the proposal with a special majority (75%) being required in addition to not more than 10% of disinterested shareholders voting against the proposal.

³⁹⁶ While the number of companies with pills in place has declined over the last decade, a high number of companies have pills on the shelf, meaning that they have all the documentation ready to go in case an unwanted activist shareholder suddenly appears

³⁹⁷ DGCL, section 253

³⁹⁸ DGCL, section 251(h)

³⁹⁹ I.e. the mandatory offer obligation under Rule 26 of the Takeovers Code

⁴⁰⁰ Although that period can be extended by the Executive

⁴⁰¹ The disinterested shareholder concept excludes the votes to shares in the issuer held by persons by the offeror or persons acting in concert with it. (Note 6 to Rule 2 of the Takeovers Code).

III.7.4 Role of regulators

Securities and Exchange Commission

The powers of the SEC have been reviewed in Appendix III.6.

Public Company Accounting Oversight Board

The powers of the PCAOB have been reviewed in Appendix III.6.

Appendix III	8. Regulation of non-local companies	III.8 United States
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Introduction

A company that is not incorporated in the United States but is listed and traded in the United States will be subject to three basic federal securities laws: the 1933 Act, the 1934 Act and the SOX. Section 3b-4 of the 1934 Act provides that a company will be regarded as a "foreign issuer" if it is organised under the laws of a country other than the United States. A foreign issuer will also be regarded as a FPI except if more than 50% of its voting shares are held by residents of the United States and any of the following apply: (a) the majority of its executive officers or directors are United States citizens or residents, (b) more than 50% of its assets are located in the United States or (c) its business is administered principally in the United States.⁴⁰² Any of these will form a sufficient nexus to the United States such that it will not be regarded as an FPI. This is important for the purposes of what disclosures an issuer is required to make. If one were to apply the a similar FPI test to issuers listed in Hong Kong (using Hong Kong instead of the United States as the reference jurisdiction), many companies, and possibly the majority of Mainland enterprises, would qualify as an FPI.

III.8.1 Applicable laws

FPIs are subject to all the SEC rules, with limited exemptions – the SEC's proxy rules do not apply to FPIs nor does the quarterly reporting requirement under form 10-Q - and, as discussed in Appendix III.3, are subject to the less prescriptive requirements of Form 6-K compared to Form 8-K.

Being a disclosure-based system, there are no special arrangements in place concerning the rights of shareholders, who in general rely on the remedies provided by applicable Federal securities laws in respect of disclosure and anti-fraud provisions.

The size and importance of the United States market, the punitive financial penalties that can be imposed (generally regarded as the highest in the world), and the extraterritorial reach sought by United States laws, traditionally has meant that foreign companies are reluctant to flout United States laws where they might apply – nevertheless, there have been numerous instances of issuers "going dark", as discussed below.

FPIs registered with the SEC must comply with the applicable securities laws and SEC rules, including the obligation to make filings with the SEC, maintain certain books and records, and to submit to examinations conducted by SEC staff. The SEC actively monitors activities of FPIs undertaken both within and outside the United States for compliance with Federal securities laws, and will take enforcement action as necessary. This will involve co-operation with foreign regulators including information sharing arrangements, and inspections are sometimes jointly undertaken in respect of dual listed firms.⁴⁰³ In general, where the regulator in the home jurisdiction is perceived by the SEC as having robust monitoring backed by effective public and private enforcement, the SEC will reduce the intensity of its monitoring of those foreign companies as compared to

⁴⁰² 17 CFR 240.3b-4

⁴⁰³ SEC, "Supervisory Cooperation: The Next Frontier for International Securities Regulation": Available at <https://www.sec.gov/news/speech/2010/spch070610ebw.htm> (visited 19 Jun 2016)

companies from jurisdictions where regulation is weak, or there are perceived to be higher levels of information asymmetry.⁴⁰⁴

Other than the annual report required to be filed with the SEC, FPIs must disclose (on Form 6-K) the material information it makes or is required to make public pursuant to the law of its home jurisdiction or is required to file with a stock exchange on which its securities are traded and which was made public by that Exchange, or distributes or is required to distribute to its security holders. Form 6-K refers to general areas of disclosure, including:

- changes in business;
- changes in management or control;
- acquisitions or dispositions of assets;
- bankruptcy or receivership;
- changes in registrant's certifying accountants;
- the financial condition and results of operations;
- material legal proceedings;
- changes in securities or in the security for registered securities;
- defaults upon senior securities;
- material increases or decreases in the amount outstanding of securities or indebtedness;
- the results of the submission of matters to a vote of security holders;
- transactions with directors, officers or principal security holders;
- the granting of options or payment of other compensation to directors or officers; and
- any other information which the FPI deems of material importance to security holders.⁴⁰⁵

However, an FPI is subject to relaxed disclosure burdens as compared to domestic companies. They are exempt from the disclosure requirements of Regulation FD and all of the SEC's proxy rules. They may present financial statements pursuant to United States GAAP, IFRS as issued by the IASB, or home country accounting standards with reconciliation to United States GAAP.⁴⁰⁶

Auditors of FPIs that operate from the firm's home jurisdiction are subject to inspection by the PCAOB, and are required to assess the audit firm's compliance with United States requirements applying to audits of United States public companies, including SOX and the rules of the SEC. Inspections may be carried out either by the PCAOB only, or jointly

⁴⁰⁴ Naughton et al., "SEC Monitoring of Foreign Firms' Disclosures" (2016): Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2760743 (visited 11 Jun 2016)

⁴⁰⁵ SEC, Accessing the U.S. Capital Markets op. cit.

⁴⁰⁶ Ibid.

with the home regulator. Where there is a co-operation agreement in place, the PCAOB may rely on inspection work performed by the home country regulator.⁴⁰⁷

In 2013 the PCAOB entered into an enforcement cooperation MoU with the China Securities Regulatory Commission (CSRC) and the Ministry of Finance of China.

III.8.2 Exchange requirements and CG standards

FPIs will in general have to comply with the same quantitative listing standards as domestic firms, subject to some relaxations. The NYSE provides that FPIs may seek to qualify to list under the Alternative Listing Standards for FPIs – this is only available to issuers that already have a broad, liquid market for the company's shares in its country of origin.⁴⁰⁸

As regards the CG standards imposed by Exchange listing standards, both NYSE and Nasdaq in general permit FPIs to follow their home jurisdiction practices subject to the requirement that they must disclose any significant differences in which their CG practices differ from domestic companies under the listing standards of the relevant Exchange (i.e. NYSE or Nasdaq) – such reports are expected to be a brief and general summary of significant differences, not detailed item-by-item analyses; these differences will also need to be disclosed in an annual report filed with the SEC. However, FPIs continue to remain subject to the requirements concerning the audit committee and the certification and notification requirements in respect of non-compliance with the CG listing standards (discussed in Appendix III.7).⁴⁰⁹ Additionally, FPIs are permitted to disclose executive compensation on an aggregate basis and need not supply a “Compensation Discussion & Analysis”, as is required for domestic companies. To the extent an FPI discloses more extensive executive compensation information in accordance with home market requirements or voluntarily, such information must also be disclosed under Form 20-F.

The foregoing arrangements are somewhat different than those in Hong Kong, where there is a greater focus on shareholder protection via the imposition of requirements on issuers by regulatory agencies. As noted in Appendices III.6 and III.7, the Hong Kong CO provides that certain remedies available to shareholders of domestic companies (i.e. unfair prejudice and derivative actions) are also available in respect of non-Hong Kong companies. As regards listing matters, the continuing obligations set out in Chapter 13 (which includes the comply or explain requirements of the HK CG Code⁴¹⁰) and the accounting and audit matters set out in Appendix 16 apply to non-Hong Kong incorporated issuers as they do to domestic issuers – the SEHK may allow modifications on a case-by-case basis but may also impose additional requirements to ensure investors have the same protection to them as afforded to them in Hong Kong.⁴¹¹ The position is similar in relation to non-Hong Kong incorporated companies with a secondary listing in Hong Kong.⁴¹²

III.8.3 Enforcement

While enforcement against an FPI presents no special issues *per se* as regards laws in the United States, it can be problematic where the wrongdoer wishes to evade enforcement by withdrawing itself from the United States completely. This presents the problem of cross-border enforcement, which requires appropriate conventions to be in

⁴⁰⁷ PACOB, “Non-US Firm Inspections”: Available at <https://pcaobus.org/International/Inspections/Pages/default.aspx> (19 Jun 2016)

⁴⁰⁸ NYSE Company Manual Rule 103.00

⁴⁰⁹ NYSE Company Manual 303A.00, 303A.11; Nasdaq Rule 5605, 5615(3)

⁴¹⁰ MBLR 13.89

⁴¹¹ MBLR 19.17, 19.18

⁴¹² MBLR 19.44, 19.45

place between the two jurisdictions, which normally require reciprocity, and a degree of cooperation from the relevant foreign jurisdiction.

Following a wave of smaller Mainland reverse mergers prior to and around 2010 – many of which involved alleged financial and accounting fraud – many issuers were either delisted or have “gone dark”,⁴¹³ many of them illegally. Rather than deregister their shares by applying to the SEC, companies that go dark illegally simply disappear by ceasing to fulfill their reporting obligations and being subsequently uncontactable. As at October 2012 a total of 28 Mainland enterprises listed in the United States had gone dark illegally.⁴¹⁴ A particularly well known case was Longtop Financial Technologies Ltd., which had been exposed by the media in 2011 for having fraudulent financial statements. This problem, in the case of Mainland enterprises, is not dissimilar to the problems faced by Hong Kong when it comes to enforcement. Unlike the United States, Hong Kong does have the benefit of reciprocity arrangements.⁴¹⁵

⁴¹³ Per the PCAOB, 126 issuers have gone dark at this time, see “Investor protection through audit oversight” 21 September 2012: Available at https://pcaobus.org/News/Speech/Pages/09212012_FergusonCalState.aspx (visited 17 Nov 2017)

⁴¹⁴ “Chinese Companies ‘Going Dark’”, *The Traveller* on Sunday, October 14, 2012: Available at <http://china.fixyou.co.uk/2012/10/chinese-companies-going-dark.html> (visited 17 Nov 2017)

⁴¹⁵ Mainland and Hong Kong entered into the Arrangement on Reciprocal Enforcement of Judgments in Civil and Commercial Matters with Hong Kong in 2006, which provides for recognition and enforcement of judgments in civil and commercial matters

Appendix IV	MAINLAND CHINA
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prepared by:
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Introduction

Mainland China's corporate governance (CG) development coincided with the transition from a planned economy to a socialist market-oriented economy. Following the opening-up of the Chinese economy, many state-owned enterprises (SOEs) faced bankruptcy which was not viewed as a politically viable option.

In an effort to reform SOEs to become more efficient, the original purpose of Shanghai Stock Exchange (SSE) was to provide a listing venue for companies to raise funds and be subject to market discipline.¹ This was followed by a significant number of listings on exchanges in other jurisdictions. These SOE reforms were integral to strengthening CG because:

"It has been viewed that the process of getting listed, particularly on the Hong Kong Exchange or other foreign stock exchange, has the potential of enhancing the quality of CG in Chinese companies. As such, this initiative has been proclaimed as one of the more successful vehicles for China's SOE reform."²

This efficiency-driven process has been supported by a body of law, regulations, and rules which embrace Western market corporate forms and business practices.³ However, China's economy is not a pure market economy as the government plays a central role in allocating resources.⁴ SOEs dominate many industries and enjoy monopolies created by the government.

The concept of CG in China was first examined by the "Research and Development Centre of the Shanghai Stock Exchange" in 1997.⁵ This early research was predominantly influenced by the developments in the United States, the Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance (1999), and the World Bank.⁶

In 2009, Yao Gang, deputy chairman of the China Securities Regulatory Commission (CSRC) stated that: "China's capital market is still an emerging and transitional market" with imperfect market regulatory mechanisms, immature investors, and a unique shareholding structure.⁷ Accordingly, CG in the Mainland has been undergoing constant change. The phases of change include: the system of administrative governance before 1978 (the first phase); the planned and market-based two-track governance system from 1978 to 1992 (the second phase); and the evolving modern CG practice from 1992 (the third phase).⁸ The third phase can be further divided into three periods: from 1992-

¹ See Chen, Ruoying, "From Legal Capital to Subscribed Capital Rule in China and its Economic Background" in Holger Fleischer (ed), *German and Asian Perspectives on Company Law: Law and Policy Perspectives*, (Tubingen: Mohr Siebeck, 2016), p. 184

² CFA Institute, "China Corporate Governance Survey," (April 2007), 3: Available at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n3.4563> (visited 11 November 2017)

³ Chao Xi, *Corporate Governance and Legal Reform in China*, (London: Wildy, Simmonds & Hill Publishing, 2009), p. 34

⁴ Chen, op. cit, pp. 183-184

⁵ Jane Fu, *Corporate Disclosure and Corporate Governance in China*, (Wolters Kluwer, 2010), p. 5

⁶ Hu Ruyin, "The Concept and Importance of Corporate Governance" in Tu Guangshao & Zhu Congjiu (ed), *Corporate Governance: International Experience and China Practice*, (Beijing: People's Press, 2001) pp. 15-18; Fu, op. cit, p. 6

⁷ Cited in *ibid*, p. 12

⁸ SSE, *China Corporate Governance Report 2003* (Shanghai: Fudan University Press, 2003), p. 33

1999, which focused on corporatisation and securitisation reform; from 2000-2003 with the development of a capital market; and from 2004 when universal CG practices were implemented.⁹

Although the emergence of the SSE and the Shenzhen Stock Exchange (SZSE) have been a relatively recent development in comparison to Hong Kong, both exchanges combined are the third largest in the world in terms of market capitalisation, behind only the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ), slightly ahead of the London Stock Exchange, and almost twice the size of the Hong Kong Stock Exchange (SEHK) which ranks sixth globally. Most companies listed on the SSE and the SZSE Main Board, and some listed on the SZSE SME Board, SZSE ChiNext, and SEHK are SOEs.

IV.1.1 Corporate governance system

Developing the socialist market system

The Mainland's CG system is dominated by the State and the Chinese Communist Party (CCP) which is best described as an insider-dominated system, as opposed to the Anglo-American system. Being a country with a unitary system of government, the controlling and dominant status of the CCP is made clear in the preamble of the Constitution of the People's Republic of China (the Constitution). Other factors that are intertwined with, and have shaped the Mainland's CG regime include:

(1) the prevailing pattern of company ownership structures; (2) the corporate finance system; (3) the level of economic development; (4) Mainland China's position in the global economy; (5) institutional capacity; and (6) local interest group politics.¹⁰

Mainland China's economic development encapsulates socialist ideology with Chinese characteristics.

The CG system was developed by a combination of top-down and bottom-up approaches.¹¹ This was a result of enterprise reform to improve efficiency in the country's transition from a planned economy to a socialist market economy. The top-down approach has been taken by the State, or more precisely the CCP, which has led the process to improve CG. This is the same approach taken to reform China's economic system and establish a capital market:¹²

"Every major corporate governance plan had to be first endorsed by the CCP before it could be written into law by the NPC or its Standing Committee (NPCSC)... The establishment of a modern corporate system within state-owned companies was first written into the CCP's Resolution before it was written into the PRC Company Law of 1993."¹³

Mainland China's bottom-up approach takes CG philosophy and ideas from Western economies (e.g. executive remuneration scheme), which are trialled and then adopted or rejected by the CCP. The top-down approach is more widely used than the bottom-up approach because of the CCP's absolute leadership and determination to build a socialist market economy.¹⁴

⁹ Fu, op. cit, p. 12

¹⁰ Fu, op. cit, p. 35

¹¹ Ibid, p. 6

¹² 胡汝银,《中国公司治理:当代视角》,上海人民出版社,(2010),p. 30

¹³ Fu, op. cit, p. 6

¹⁴ Ibid, p. 6

Developing the regulatory system

There are a large number of laws, rules, and regulations which extensively cover listed companies' (including SOEs) and financial entities' CG (see Appendix IV.3 and IV.4). Being a socialist market economy with Chinese characteristics, the philosophy of corporate law is to foster internal unity and company performance. The CG debate focuses on the relationship between management, shareholders, and stakeholders. Under the law, shareholder meetings are superior to the board of directors. As the State is the largest shareholder of many SOEs, the State controls SOEs through shareholder meetings. This is very different from the Anglo-American system. The board of directors formulates policy and plans which the shareholders approve or reject, with the board and managers carrying out the plans. Influenced by the German and Japanese systems, the Mainland Chinese system relies on the supervisory board to monitor the legitimacy of the board of directors, senior management performance, and protects shareholders' legal rights and interests.¹⁵ This, however, has been ineffective in practice. Although employees have representatives on the supervisory board, they do not have the German system's power of co-determination.

Mainland China's development of a securities law and CG standards (including a disclosure-based system) have also been shaped by the systems in the United States and Europe. The securities market is often called a "policy market" because it is controlled by the State and is directly affected by government policies rather than free market principles. As a result CG practices and information disclosure (see Appendices IV.2, IV.3, and IV.4) that are important for the proper functioning of a free securities market are often ignored or neglected.¹⁶

Increasingly Mainland China is adopting the Anglo-American style of CG. For example, the CSRC is the principal CG regulator, the presence of independent directors on boards, and the audit committee requirement. Although the regulation of information disclosure is rules-based, there has been a gradual move towards principles-based regulation. More attention has been given to on-going monitoring and enforcement rather than administrative control (such as licensing).¹⁷

The Code of Corporate Governance

The Code of Corporate Governance (CG Code), which was first issued in 2002 by the CSRC, is based on the OECD Corporate Governance Principles, with the revised 2004 version being the primary standard for evaluating the CG of companies listed on the SSE and SZSE. The Preface to the CG Code states:

"Listed companies are required to act in the spirit of the Code in their efforts to improve CG. The securities supervision and regulation authorities may instruct a company to make corrections in accordance with the Code."¹⁸

The CSRC has since issued a number of related rules and regulatory documents, and the SSE and SZSE (the Exchanges) have issued guidelines on standard operation of listed companies to implement the CG Code (see Appendix IV.4).

Listed companies are required to establish a governance structure in accordance with the CG Code and subordinated regulatory documents covering:

- (1) equal treatment of shareholders, particularly minority shareholders;

¹⁵ See, Chapter 4, CG Code

¹⁶ Fu, op. cit, p. 26

¹⁷ 胡汝银, op. cit, p. 188

¹⁸ CG Code, Preface, "Securities supervision and regulation authorities" is not defined

- (2) rules for shareholders' meetings;
- (3) restrictions on related-party transactions require proper disclosure in the form of written agreements which must observe the principles of equality, voluntariness, and making compensation of equal value; (4) controlling shareholders owe duty of good faith to the company and other shareholders, and the company should be independent from its controlling shareholder;
- (5) the company should have a fair and transparent process for selecting directors, its directors should perform their duties in the best interests of the company, have independent directors (i.e. at least 1/3 of the board must be independent directors subject to CSRC's Guiding Opinions on Establishment of Independent Director of Listed Companies), and can have special board committees of corporate strategy, audit, nomination, and remuneration;
- (6) the board of supervisors is accountable to all shareholders (see above for details);
- (7) performance assessments, incentives, and a disciplinary system are applicable to directors, supervisors, and management;
- (8) respect the legal rights of its creditors, employees, consumers, suppliers, and other stakeholders and actively cooperate with stakeholders to achieve sustainable development; and
- (9) publish an annual report, semi-annual report, and quarterly report, and disclose in a timely manner information that can materially affect the decisions of shareholders and stakeholders, as well as information on its CG measures and performance (i.e. information disclosure).

The financial regulators, i.e. CSRC, China Banking Regulatory Commission (CBRC) and China Insurance Regulatory Commission (CIRC), issue extra requirements for the CG structure of securities companies, banks, and insurance companies—mainly for the purpose of risk management. Financial institutions are also required to set up special board committees.

IV.1.2 Corporate governance approach: strengths and weaknesses

There are a number of problems within the Mainland's CG framework.¹⁹ Most prominently there is widespread insider dealing and initial public offering (IPO) packaging.²⁰

These problems are not confined to Mainland's borders because a large number of Hong Kong's IPOs involve companies incorporated in the Mainland. For example, of 1739 companies listed on the SEHK Main Board, Chinese companies comprise of 224 H-shares and 152 Red Chips (as at 31 August 2017), and of the 287 companies listed on SEHK Growth Enterprise Market (GEM) there are 24 H-shares and six Red Chips (as at 31 August 2017).²¹

Mainland companies seeking an IPO on the SEHK or that is linked to the SEHK via the SSE or SZSE Stock Connect Schemes will be accountable to Hong Kong's regulators. Companies incorporated in the Mainland listed on the SEHK (i.e. H-shares) are subject to certain provisions of the Hong Kong's Companies Ordinance (Cap. 622) (Companies Ordinance), the Security and Futures Ordinance, and the SEHK Listing Rules (LRs). In

¹⁹ See Fu, *op. cit.*, pp. 14-15; 208-210

²⁰ For example, false disclosure by directors and senior officers for their personal benefit is common with civil actions for CG breaches being rare

²¹ Hong Kong Exchange and Clearing Limited, "Mutual Market – Market Highlights": Available at <https://www.hkex.com.hk/eng/csm/highlight.htm> (visited 21 September 2017). As at 31 October 2016, there were 1,955 companies listed on the SEHK (Main Board and GEM). According to the HKEX's classification of enterprises, 989 were Mainland enterprises (236 H share and 153 Red Chips, the others being Mainland private enterprises), 856 were HK enterprises, and 110 overseas enterprises: see HKEX, "Our Markets": Available at https://www.hkex.com.hk/eng/listing/listhk/our_markets.htm (visited 13 December 2016).

the past Hong Kong investors could not exercise shareholder rights provided by the Companies Ordinance, such as derivative suits or unfair prejudice remedies, unless the company had a share registration or transfer office in Hong Kong. Hong Kong's LRs now require every listed company to have a share register office in Hong Kong. This requirement facilitates the use of shareholders' remedies provided in the Companies Ordinance. However, if wrongdoers are in the Mainland, bringing such legal action in Hong Kong can be difficult as there is no extradition treaty between the Mainland and Hong Kong and the Memorandum of Understanding (MoU) between CSRC and Securities and Futures Commission (SFC) is limited, being "soft law". Compounding the Hong Kong Exchange and Clearing Limited (HKEX) regulatory dilemma is the SSE - and SZSE-Hong Kong Stock Connect Schemes which allow Hong Kong investors to buy shares in companies listed on the SSE and SZSE, respectively. An understanding of the Mainland's CG regime and standards is crucial for Hong Kong's regulators and policymakers to formulate effective CG regulation for Mainland companies listed on the SEHK and to protect Hong Kong investors participating in the Stock Connect Schemes.

The 2002 McKinsey's Global Investor Opinion Survey found that an overwhelming majority of investors are prepared to pay a premium of up to 25% for Mainland companies with high CG standards.²² This suggests that global market participants appreciate the importance of good CG in the Mainland.

In 2007 the CFA Institute Centre for Financial Market Integrity (CFA Institute Centre) conducted a survey of members²³ investing in, or having interests in Mainland Chinese companies. Members' opinions and views were surveyed on:

- (1) CG issues among Mainland Chinese companies; (2) the effectiveness of recent Mainland Chinese reforms to improve CG practices; and (3) suggestions on how to further improve CG practices in Mainland China.

Among the respondents, 59% were investment managers, 45% analysts, 29% service providers, and 30% officers of Mainland companies.²⁴ Respondents were asked 16 questions covering:

- (1) board composition, structure, and mechanisms; (2) relationships with stakeholders and shareholders; and (3) disclosure and transparency—to rate how important each issue was to the initial investment decision and how each issue has changed over the past three years.²⁵

Survey respondents felt that implementation of the four pre-2007 CG reforms were "somewhat effective". Of the four reform measures, the conversion of non-tradable shares to freely tradable shares was viewed as being more positive to the development of the Mainland's capital market compared with the directive on quarterly reporting. The CFA Institute Centre survey found that a growing number of Mainland managers and entrepreneurs have a predisposition towards improving CG and an awareness that this makes a company more attractive to both domestic and international investors and lenders which ultimately improves profitability. Developing a sound CG framework enhances creditability, confidence, and trust in the Mainland's capital markets and removes growth constraints.²⁶

²² CFA Institute Centre, op. cit.; and McKinsey & Company, "Global Investor Opinion Survey: Key Findings," (July 2002), Exhibit 4: Available at <http://www.eiod.org/uploads/Publications/Pdf/II-Rp-4-1.pdf> (visited 11 November 2017). 21% for Singapore, 14% for US, 12% for UK markets. Surprisingly, no information for the Hong Kong market from the survey.

²³ By e-mail invitation, containing a link to a web-based survey, to 3,780 CFA charterholders and CFA Institute Centre members in Hong Kong and China. Analysis of the survey findings was based on the responses of 475 charterholders and members who completed the survey.

²⁴ CFA Institute Centre, op. cit

²⁵ Ibid, 2

²⁶ Ibid, 1 and 5

In 2012, the International Monetary Fund (IMF) and the World Bank produced a "Detailed Assessment Report: IOSCO Objectives and Principles of Securities Regulation" (Detailed Assessment Report). Some issues raised were:

(1) the CSRC not having an adequate budget to exercise its powers; (2) actions against insider trading and market manipulation is disproportionately low; (3) greater legal certainty required for the CSRC's enforcement role; (4) consideration should be given to co-operation arrangements between the CSRC, domestic regulators, and the Exchanges to avoid potential regulatory arbitrage; (5) review the obligation to report substantial shareholdings; and (6) develop the accounting and auditing profession in Mainland China.

Some positives from the Detailed Assessment Report include:

(1) considerable attention has been given by the CSRC to investor education; (2) the CSRC staff avoid conflicts of interest; (3) the Exchanges are subject to appropriate authorisation and oversight by the CSRC; (4) the CSRC has comprehensive enforcement powers; (5) the CSRC oversees credible and active inspection, surveillance, and investigation; (6) the regulatory regime adequately addresses the rights and equitable treatment of shareholders; (7) the accounting and auditing standards are converging with the International Financial Reporting Standards (IFRS); and (8) considerable resources have been allocated towards detecting and deterring insider trading and market manipulation.

The OECD conducted a CG survey of Asia in 2017 which included China. A brief description of the ownership structure was provided:

"Listed companies in [Mainland] China are characterised by concentrated ownership. Only a small portion of shares of listed companies are held by individual or foreign investors, with average ownership equalling 2.38% and 2.66%, respectively. Government and institutional investors hold large portions of shares, with 31.27% and 19.86%, respectively. The Shanghai Stock Exchange and the Shenzhen Stock Exchange have 2887 listed companies (1781 and 1106 respectively) with a total market capitalisation of USD 6.966 trillion (WFE, 2016)."²⁷

IV.1.3 Corporate culture

Corporate culture is described by the UK's Financial Reporting Council (FRC) as: "a combination of the values, attitudes, and behaviour manifested by a company in its operations and relations with its stakeholders".²⁸ This is how people in a company behave in their daily operations, influenced by the company values, represented by the company's relationship with its stakeholders. Observing corporate culture helps to understand types of behaviour that influence non-compliance and how such behaviour can be changed.

Culture in the context of CG can be described as the culture of complying with good CG values and practices. This is a new concept in the Mainland which is still developing and is thus weaker than developed or Western markets because of the transition from a planned economy. The CCP has a different conception of a corporation and CG in

²⁷ OECD, "OECD Survey of Corporate Governance Frameworks in Asia," (2017), 5: Available at <https://www.oecd.org/daf/ca/OECD-Survey-Corporate-Governance-Frameworks-Asia.pdf> (visited 22 May 2017)

²⁸ FRC, "Corporate Culture and the Role of Boards: Report of Observations," (July 2016), 6: Available at <https://www.frc.org.uk/getattachment/3851b9c5-92d3-4695-aeb2-87c9052dc8c1/Corporate-Culture-and-the-Role-of-Boards-Report-of-Observations.pdf> (visited 29 September 2017)

comparison with Western economies (e.g. United States, Hong Kong, and Europe) which has led to, at best, a compliance-focused, box-ticking approach, and at worst non-compliance characterised by, for example, fraud, market manipulation, and misleading disclosures.

CG culture remains weak in the Mainland, although efforts have been made by regulators to emphasise its importance. Box-ticking, especially for small listed companies and SOEs, remains the norm. This is worsened by a culture of influence and interference from government and CCP members over corporate appointments and decisions. Thus, although there is no comply or explain approach in the Mainland - all rules are to be complied with - political interference affects compliance which becomes difficult in practice. Lack of CG culture can be observed in many listed companies in the Mainland as State interference in the appointment of management, the board, and supervisors creates obstacles for ethical CG reform. For example, the appointment of senior managers, directors, and supervisors is determined by party politics rather than market principles, which can result in suboptimal behaviour and a culture resistant to change.

The socialist ideology of the CCP CG policy reforms have been described as:

"... simply [a] means to bolster socialism and its economic foundation, and [the] law has long been used as an instrument to implement the Party's enterprise reform policies."²⁹

"...the Party's organization remains an organ that plays an important part in the governance of Chinese companies."³⁰

In President Xi Jinping's words, SOEs should be serving the interests of the CCP in the economic realm and that they are, or should be, "party organs in leadership and political affairs."³¹ Those comments represent a significant schism from traditional Western approaches to the role of the company and the position of CG. Rather, the incorporation of "Western" CG board processes over the past three decades can instead be perceived as undermining the leadership of the CCP.³² The extent to which such comments interact with the realities of SOEs listed in Hong Kong (or elsewhere) is hard to estimate. SOEs do, of course, remain subject to CG requirements in the markets they are listed on. However, it is notable that the United States-China Economic and Security Review Commission in its annual report to the United States Congress in 2016 expressed concerns as to the nature and purpose of Mainland SOEs.³³

At least 19 Mainland SOEs listed on the SEHK have established Communist Party Committees (CPCs) to advise the board of directors on operational, personnel, and strategic matters.³⁴ These Committees occupy a superior position than the existing corporate hierarchy. For example, in the China Construction Bank, which is listed on SEHK, the CPC instructs and promotes senior management to implement the decisions of the shareholder's annual general meeting and the board. With the state being the controlling shareholder and the board consisting of state appointments, instilling the CCP

²⁹ Chao, op. cit, p. 34

³⁰ Ibid, p. 35

³¹ Zhou Xin, "Communist Party the top boss of China's state firms, Xi Jinping asserts in rare meeting," (12 October 2016) *South China Morning Post*: Available at <http://www.scmp.com/news/china/economy/article/2027407/communist-party-top-boss-chinas-state-firms-xi-jinping-asserts> (visited 28 September 2017). Xi Jinping is the President of the People's Republic of China

³² Ibid, per Zhang Xixian, a professor at the Central Party School

³³ David Lawder and Denny Thomas, "Panel urges ban on Chinese state firms buying United States companies", (16 November 2016) *Reuters*: Available at <https://www.reuters.com/article/us-usa-china/u-s-panel-urges-ban-on-china-state-firms-buying-u-s-companies-idUSKBN13B1WO> (visited 11 November 2017)

³⁴ Shirley Yam, "The hammer and sickle are making their way into some Hong Kong Public companies," (30 May 2017) *South China Morning Post*

as the ultimate decision-maker further centralises power. CPC powers can extend to the power to vet senior management candidates nominated by the board and propose its own candidates. Furthermore, the CPC can make decisions concerning operations and production, asset restructuring, capital management, mergers, the opening and closing of branches, performance appraisals of senior management, and remuneration. In fact, the Bank of Chongqing's (listed on SEHK) CPC will deliberate on material matters and communicate their opinion to the board and senior management. Management boards will make decisions according to the CPC's opinion on major operational and management matters (e.g. macroeconomic control, development, and security).³⁵ This effectively nullifies the decision-making powers of independent directors and the independence of the board as a whole.

The CPCs theoretically wield supreme power over the board and can make non-commercial deliberations on material matters. In contrast to supervisors, CPC members sign no undertaking to abide by Hong Kong's regulations and laws. The SFC's response to these developments is one of acquiescence:

"The Commission will perform our regulatory function under the Securities and Futures Ordinance and the Exchange has to discharge its duty under the Listing Rules"³⁶

In the non-SOE sector, the position is somewhat mixed. There are enterprises that fully embrace the western style of CG. However, many companies do not recognise or embrace western CG nor its value. These companies tend to adopt a box-ticking approach to CG. Numerous cultural CG characteristics are evident in the Mainland's system:

(1) The CG regulatory regime is characterised by preferential treatment towards SOEs—such as government financial subsidies and services not otherwise available to the wider market. SOEs' preferential status not only increases costs for private investors and competing companies (i.e. non-SOEs) which makes SOEs less competitive and inefficient, but also creates social resentment, dissatisfaction, and deep instability. Consequently, maintaining social stability, preventing conflicts, and mitigating confrontation between entities is an ongoing priority in policy formulation (i.e. economic, legal, and government),³⁷ which results in SOEs being less competitive and inefficient.

(2) Supervisory boards are weak and more a matter of form rather than function when compared to the supervisory board system in Germany.

(3) Accounting standards and supervision lack credibility. The falsification and fabrication of financial data constitute a common problem with listed Mainland companies, including those listed on overseas exchanges, for example, the Singapore Exchange Limited (SGX) and NYSE. Creative accounting is also an issue. SOEs have no strict budget constraints, which is driven more by State policy than shareholder value.³⁸ Private companies - those companies incorporated in the Mainland which are not owned or controlled by the government (wholly or partially) - do not share this characteristic.

(4) Retail investor rights are subject to a system of enforcement which is underdeveloped, for example, private actions through the courts, and thus

³⁵ Ibid

³⁶ Ibid

³⁷ Ibid

³⁸ James Kynge, "Corporate governance minefield awaits China A-share buyers," (22 June 2017) *Financial Times*: Available at <https://www.ft.com/content/fa75c8f4-5719-11e7-9fed-c19e2700005f> (visited 11 November 2017)

responsibility falls on the regulator (e.g. CSRC).³⁹ In listed SOEs, minority shareholders are subordinate to the decisions of the CCP and the State.

(5) Institutional investor rights are subject to the same limitations as retail investors. Activist shareholding is becoming more prevalent and has been instrumental in exposing corruption and fraud. With China's acceptance to the Morgan Stanley Capital International or MSCI, this trend should continue.

(6) The appointment of independent directors in most high-level SOE board appointments are political, rather than a commercial appointment. An SOE independent director is constricted by the dynamics of senior management, the supervisory board, and the CPC, resulting in difficulties when discharging their duties without making mistakes, politically or legally.⁴⁰ Independent directors nonetheless require certification by the SSE or SZSE which is unique to China.

(7) Disclosure of remuneration is required for directors, supervisors, and senior management in accordance with the 2012 CSRC Regulations. However, the regulations do not require the disclosure of compensation philosophy, principle, nor stipulate a disclosure framework.⁴¹

(8) Whistle-blowing in the Mainland has traditionally been subject to widespread retaliation with suspected informants being sacked, assaulted, or harassed. For example, GlaxoSmithKline consistently ignored warnings from a whistle-blower, claiming that the allegations were a smear campaign, resulting in the whistle-blower's eventual sacking.⁴² Similar instances led to the introduction of specific regulations, Several Provisions on Protecting and Rewarding Whistleblowers for Reporting Duty Crimes (2016), which give rise to a criminal offence when whistle-blowers in the Mainland are subject to retaliation, including retaliation by government officials. However, there are a lot of recent incidents of retaliation against whistle-blowers from local and foreign companies which can serve to preclude people from coming forth with information on corruption and/or bribery.⁴³ The introduction of cash rewards, the slowdown in the Mainland's economy, and restructuring has led to disgruntled employees, suppliers, and distributors becoming more willing to report corruption and even use this information to extort employers.⁴⁴

(9) Private interest groups promoting good CG are virtually non-existent in the Mainland. Good CG is policy-driven by the government and non-government companies' pursuit to increase shareholder value. However, the Chinese Government and regulators understand that good CG is an important factor in

³⁹ IMF, "People's Republic of China: Detailed Assessment Report: IOSCO Objectives and Principles of Securities Regulation," (2012), 7 and 20: Available at <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Peoples-Republic-of-China-Detailed-Assessment-Report-IOSCO-Objectives-and-Principles-of-25830> (visited 11 November 2017)

⁴⁰ CSLA and ACGA, "CG Watch 2014: Darker Shades of Grey: Corporate Governance and Sustainability in Asia," (September 2014), 84 and 87: Available at <https://www.acga-asia.org/research-detail.php?id=2> (visited 11 November 2017)

⁴¹ Mercer, "Executive Remuneration Disclosures in Asia," (2014), 4: Available at https://www.mercer.com/content/dam/mercer/attachments/asia-pacific/asia/Mercer_Executive_Remuneration_Disclosures_in_Asia_12588B-TL.pdf (visited 11 November 2017)

⁴² The whistle-blower was reappointed three years later in 2016

⁴³ See Rachel Beller, "Whistleblower Protection Legislation of the East and West: Can It Really Reduce Corporate Fraud and Improve Corporate Governance - A Study of the Successes and Failures of Whistleblower Protection Legislation in the US and China", (2010-11) 7 *NYU Journal of Law and Business* 873: Available at http://heinonline.org/HOL/Page?handle=hein.journals/nyujolbu7&div=24&g_sent=1&collection=journals (visited on 11 November 2017)

⁴⁴ Kent Kedl, "Behind China's Corruption Crackdown: Whistleblowers," (12 February 2015) *Forbes*: Available at <https://www.forbes.com/sites/riskmap/2015/02/12/behind-chinas-corruption-crackdown-whistleblowers/#7e25f48b2e89> (visited 11 November 2017)

reforming SOEs and have made concerted efforts to improve standards, and promulgate laws and regulations. However, enforcement still remains a pertinent issue and State supervision of management's compliance is an ongoing problem.

IV.1.4 Market characteristics

Listed companies

At present all companies listed on SSE and SZSE are domestically incorporated. To be listed on the SSE and SZSE, a company must be incorporated in the Mainland and is, therefore, subject to the Company Law of the People's Republic of China (Company Law).⁴⁵ Mainland listed companies are predominantly SOEs with the State exercising control through shareholder meetings. It has been argued that Article 2 of the Company Law does not preclude the possibility of listing a foreign company in the Mainland.⁴⁶ Since permission is required from the CSRC before a company can be listed in the Mainland, the CSRC is unlikely to grant permission to list a foreign company—this argument is academic.

Stock exchanges

The Mainland's current Exchanges are relatively new, with the Main Boards of the SSE and SZSE being established in 1990.⁴⁷ In the beginning, the SSE and SZSE served two different functions, fundamentally differentiated by company size.

In comparison to the SEHK which operates two boards - the Main Board and GEM, in the Mainland the SSE operates one board (the Main Board) and the SZSE operate three boards (the Main Board, SME Board (2004) and ChiNext (2009)). The SSE Main Board has historically catered for large companies—SOEs, banks, and energy companies—collectively known as “old China”.⁴⁸ Small and Medium Enterprises (SMEs) and “new economy” (e.g. technology) companies—consisting predominantly of private companies—are listed on the SZSE. The SZSEs boards are designed for companies at different stages of growth, quality, and risk profiles.⁴⁹ Similar to the SSE Main Board, the SZSE Main Board was designed for SOEs, albeit smaller subsidiaries of SOEs.

The SME Board's function is self-explanatory - 75% of listings are manufacturing companies⁵⁰ and has the same capital requirements as the SZSE Main Board. ChiNext is for small fast-growing innovative technology companies, 93% of all companies on ChiNext are technology companies⁵¹, which have lower capital and regulatory requirements. Thus the SZSE SME Board and ChiNext are integral to the economy's evolution to one shaped by market forces. Hong Kong's GEM is analogous to ChiNext, yet the CG requirements for companies listed on the GEM Board are, in some aspects, more stringent than those for companies listed on the Main Board.

SSE Main Board listed companies' minimum share capital requirement has been increased from Renminbi (RMB) 30 million to RMB 50 million. In Hong Kong, the Main Board requires at least HK\$ 200 million (RMB 175 million) at the time of listing and GEM requires a market cap of at least HK\$ 100 million (RMB 88 million).⁵² On the SZSE, the Main Board and the SME Board has a pre-IPO share capital requirement of not less than

⁴⁵ The Company Law, art 2

⁴⁶ 徐明, 外国公司在我国[] ([] 2009)(2), p. 76

⁴⁷ The SSE was first established in the late 1800s but was disbanded under Mao Zedong

⁴⁸ CSOP Asset Management, “China's Equity Market”: Available at <https://csoassetmanagement.us/markets/equity-market> (visited 25 May 2017)

⁴⁹ SZSE, “Listing Q & A”: Available at <https://www.szse.cn/main/en/ListingatSZSE/ListingQA/> (visited 25 May 2017)

⁵⁰ Ibid

⁵¹ SZSE, “About ChiNext”: Available at <https://www.szse.cn/main/en/chinext/> (visited 25 May 2017)

⁵² As at May 2017. Exchange rate calculated at 1 CNY = 1.14 HK\$ and are approximations

RMB 30 million and a post-IPO of not less than RMB 50 million (the same as the SSE Main Board) with ChiNext having a post-IPO share capital requirement of not less than RMB 30 million.

The levels of turnover on the SZSE Main Board and SME Board are similar. Privately-owned companies, as opposed to SOEs, dominate IPOs and listings.⁵³

As of June 2016, there were 478 companies listed on the main board of SZSE, 791 companies listed on SME Board and 512 companies on ChiNext.⁵⁴ There were 1103 companies listed at SSE.⁵⁵ According to the 2015 Fact Book of SSE, the daily average stock turnover value of SSE in 2015 is RMB 543.3 billion⁵⁶ while the SZSE is RMB 557.8 billion.⁵⁷

Comparison with Hong Kong

There are several important structural distinctions between the stock markets in Hong Kong and in Mainland. Firstly, the SEHK operates as a stock market monopoly, whereas the SSE and SZSE operate as a stock market duopoly intended to compete against each other. There was strong pressure from provincial governments to establish more exchanges, but the Central People's Government of the People's Republic of China (Central Government) preferred to limit the number of bourses to two in order to maintain good CG.⁵⁸

Secondly, the SEHK is operated by the Stock Exchange of Hong Kong Ltd, a wholly owned subsidiary of the HKEX Ltd which is a profit-making entity listed on its own exchange which it regulates. This is in contrast to the SSE and the SZSE which are not demutualised and are statutory non-profit legal entities⁵⁹ operating a membership system. Thus, the perceived conflict of interest that SEHK faces (i.e. deriving profits from IPOs and regulating companies on its exchange) does not exist in Mainland.

Thirdly, the SSE and SZSE are regulated by CSRC,⁶⁰ unlike the HKEX and SEHK which are self-regulatory organizations, albeit with oversight by the SFC.

Fourthly, in contrast to Hong Kong, there is a large number of SOEs listed on the SSE and SZSE Main Boards where the State owns shares which are not freely transferable by way of voluntary lock-up agreements. This ensures that the government is intimately involved in the management of listed companies which leads to potential conflicts and inefficiencies.

⁵³ SMEs have become the backbone of the Chinese economy. By the end of 2013, the private sector contributed more than 60% of the GDP nationwide and more than 80% of the GDP in Guangdong province, one of the top 3 largest provincial economies in China and provided more than 200 million jobs: See Chen , op. cit, p. 183; citing Xinhua News Agency on 28 February 2014

⁵⁴ SZSE, "市场数据-交易统计-基本指标" "Market Statistics – Trading Statistics – Basic Index": Available at <http://www.szse.cn/main/marketdata/tjsj/jbzb/> (visited 30 October 2017)

⁵⁵ SSE, "数据-股票数据-统计" "Statistics – Stock Statistics – Overview": Available at <http://www.sse.com.cn/market/stockdata/statistic/> (visited 7 June 2016)

⁵⁶ SSE, "2016年市场资料" "2016 Fact Book": Available at <http://www.sse.com.cn/aboutus/publication/factbook/documents/c/4062036.pdf> (visited 13 July 2016)

⁵⁷ SZSE, "2015深圳市场统计-基本指标" "Fact Book 2015": Available at <http://www.szse.cn/UpFiles/largepdf/20160323094430.pdf> (visited 30 October 2017)

⁵⁸ Fu, op. cit, p. 119

⁵⁹ Securities Law of the People's Republic of China, art 102

⁶⁰ SSE, "交易所介绍" "Introduction to SSE": Available at <http://www.sse.com.cn/aboutus/sseintroduction/introduction/> (visited 7 June 2016); and SZSE, "本所简介" "Introduction to SZSE": Available at <http://www.szse.cn/main/aboutus/bsjs/bsjj/index.shtml> (visited 7 June 2016)

These last two points create a perceived conflict of interest with Mainland companies that is not present in Hong Kong companies—listed SOEs and the regulator are entities/bodies which do not operate independently of the government.

The cultural characteristics of the Mainland's and Hong Kong's exchanges are compared below.

A stock exchange in the Mainland can only be established or dissolved upon a decision of the State Council of the People's Republic of China (State Council).⁶¹ The formulation and amendment of the articles of association of an exchange must be approved by the CSRC.⁶² An exchange can formulate rules on listing, trading, and membership administration as well as any other relevant rules which must be approved by the CSRC.⁶³ This is similar to Hong Kong, where LRs formulated by the HKEX require SFC approval. Although the Mainland's exchanges can apply "a self-regulating administration" in accordance with the Securities Law of the People's Republic of China (Securities Law),⁶⁴ the Exchanges have been seen as subordinate or close affiliates of the CSRC (e.g. the CSRC appoints the Chair of an exchange, a CSRC vice chair-level leader).⁶⁵ This affiliation has been said to "affect their ability to provide a fair and competitive trading market"⁶⁶ because the CSRC issues extensive exchange rules and guidelines in contrast to the SFC which only issues exchange guidelines with the HKEX issuing the LRs. In comparison with Hong Kong, the Mainland has a control-centric regulatory culture. The Mainland's regulatory culture is characterised by a hierarchy whereby lower level agencies (e.g. the SSE and SZSE) respect or are subservient to the higher authority, such as the CSRC (contrast this with the turf wars between the SFC and HKEX). Consequently, there is a failure of exchange self-regulation, poor enforcement and supervision by the Exchanges which has created a fertile environment for securities companies to provide false information.⁶⁷ This highlights the limitations of the Mainland's system and questions whether the Exchanges should be given more self-regulatory powers or whether oversight by the CSRC should be retained. The issue is not unique to the Mainland. However, this issue in the context of Hong Kong centres on whether the HKEX should cede some or all of its self-regulatory powers to the SFC because of the HKEX's perceived conflict of interest.

IV.1.5 Different types of shares

China: A-shares and B-shares

A-shares are Mainland incorporated companies listed on the SSE and SZSE. They are traded in CNY and are available to Mainland investors and foreign investors approved by the government as a Qualified Foreign Institutional Investor (QFII), a Renminbi Qualified Foreign Institutional Investor (RQFII), or via the Stock Connect programs (see below). QFII have been permitted to trade A-shares since 2002, with quotas granted by State Administration of Foreign Exchange (SAFE) and RQFII permitted since December 2011.

B-shares are Mainland incorporated companies listed on the SSE and SZSE which differ from A-shares as these are traded in non-local currency—USD (SSE) and HKD (SZSE). The purpose of B-shares was initially to encourage foreign investment at a time when RMB was not freely convertible.⁶⁸ From 19 February 2001, the CSRC opened the B-share market to Mainland investors who had foreign currency deposited in a bank located

⁶¹ Securities Law, art 102

⁶² Securities Law, art 103

⁶³ Securities Law, art 118

⁶⁴ Securities Law, art 102

⁶⁵ IMF, op. cit.

⁶⁶ Fu, op. cit, p. 120

⁶⁷ Ibid, p. 124

⁶⁸ Fu, op. cit, p. 184

within the Mainland. On 1 June 2001, the CSRC opened the B-share market to all Mainland investors without restrictions—in order to deflate the black foreign currency market.⁶⁹ B-shares have been available to foreign investors since their inception.

A joint stock company can issue A-shares, B-shares, or cross-list A- and B-shares on the SSE or SZSE, but cannot list on both Exchanges simultaneously.⁷⁰

There are three differences between A-shares and B-shares: (1) B-shares are calculated in USD (SSE) and HKD (SZSE) with A-shares calculated in CNY; (2) B-share trading must be done through designated brokers, while investors can directly trade in A-shares; and (3) A-shares are subject to strict foreign investor restrictions.⁷¹

Hong Kong: H-shares and Red Chips

H-shares are Mainland incorporated companies listed on the SEHK.⁷² The face value of H-shares is marked in CNY but subscribed and traded in HKD. H-shares can only be subscribed and traded by Hong Kong residents and foreign investors. The listing of H-shares requires the approval of the CSRC and must meet SEHK listing requirements. On the 19 June 1993, the SEHK and the SFC entered into a Memorandum of Regulatory Cooperation with CSRC (as well as the SSE and SZSE) to regulate H-share companies.

Red Chips are those SEHK listed companies incorporated outside the Mainland which have primary business interests in the Mainland. This group of companies is not covered by the 1993 mutual co-operation agreement between CSRC and SFC, but are subject to the International Organization of Securities Commissions' (IOSCO) multi-lateral MOU (MMOU). Red-chips are the most challenging companies to effect cross-border enforcement (see Appendices IV.6.4 and IV.8.3).

The Hong Kong Chinese Enterprise Index is derived from SEHK listed companies incorporated in the Mainland.

IV.1.6 Shareholder ownership

Listed state-owned enterprises

Shares in SOEs can be classified as state shares, legal entity shares, employee shares, and public individual shares. State shares and legal entity shares⁷³ are owned by the state and are not freely transferrable. The percentage of state shares and legal entity shares in an SOE is decided by the government which normally ranges between 40-80%. Consequently, the government has influence over listed companies' management which infringes upon public shareholders' rights (i.e. because the State is the controlling shareholder).⁷⁴ The transferability of state-owned shares has been a controversial issue. After ten years of debate, the CCP decided in September 1999, in the fourth meeting of the fifteenth Congress of the CCP, to start the reform and development of SOEs. The State's controlling position is slowly changing as a result of the shareholding division system experiment introduced from 29 April 2005.⁷⁵

⁶⁹ Fu, op. cit, p. 186

⁷⁰ For details on joint stock companies, also see: the Company Law, Chapter III

⁷¹ Fu, op. cit, p. 186

⁷² There are also N-shares that are listed in NYSE by Chinese incorporated companies that are for foreigners marked in RMB but traded in USD. The CSRC and the SEC signed a Memorandum of Regulatory Cooperation on 28 April 1994. L-Shares are issued on the London Stock Exchange and S-shares on the SGX

⁷³ In a non-SOE, legal entity shares are shares issued to legal entities other than the issuing company itself

⁷⁴ Fu, op. cit, p. 186

⁷⁵ CSRC, "Circular on Experiment in Shareholding Division in Listed Companies"

Employee shares are issued at a price lower than the market trading price, realising arbitrage profits despite restrictions on such transfers.⁷⁶

As a controlling shareholder of SOEs, the government is extensively involved in CG from two perspectives: firstly, the regulator influences the management in areas such as business decision making, election and appointment of directors and managers, compensation of top managers, and the supervision of directors. For example, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) not only supervises the management of SOEs' state-owned assets, but is also involved in the SOE's management (also see Appendix IV.4). These two roles can create a conflict because when the SASAC is involved with management, the effectiveness of its supervisory role is questionable. Secondly, SOEs, including listed SOEs, can be controlled by managers who are former employees appointed by the government. The holding company of listed SOEs is managed and controlled by government appointed managers who are not nominated by the shareholders, board of directors, nor the board of supervisors. Because the parent company managers also control the listed SOE, small and medium shareholders have negligible CG influence.⁷⁷

Family-owned listed companies

Mainland family enterprises account for around one-third of listed companies. In family enterprises influenced by Confucianism, the founder or founder's family members exercise control. High-level managers are typically family members, for example, owners and managers are the same person. This reduces the Berle and Means type agency cost but can create dictatorships characterised by unfair treatment of non-family shareholders (i.e. a different type of agency cost). This characteristic is very similar to that of Hong Kong's family-controlled companies. Decisions are made informally by the family and, therefore, lack the transparency of a formalised process, for example, a shareholders' meeting or a meeting of the board of directors.⁷⁸

According to the 2015 *Forbes*'s "Survey Report of Chinese Modern Family Enterprises", for the period 2012-2014, there were 884 listed family enterprises in the Mainland, which accounts for 31.8% of all the listed companies.⁷⁹

Over 67.5% of listed companies are controlled either by the state or families. This is important because another survey revealed that SOEs and family-controlled companies use intermediate companies to exercise control and overcome legal constraints.⁸⁰ While the adoption of a pyramid of companies was originally for practical considerations, such control has resulted in agency problems, viz. managerial abuses and expropriation of minority shareholders by controlling shareholders.

Institutional and retail shareholders

The mix of shareholders consist of institutional and retail investors, originally restricted to different classes of shares which is gradually being removed. Domestic institutional

⁷⁶ Fu, op. cit, p. 187

⁷⁷ 胡汝银, "中国公司治理: 当代视角, 上海人民出版社," (2010), pp.35-36, and 85-86

⁷⁸ 田田田, 公司治理的中国模式[M]. 社会科学文献出版社, (2009), pp.79-92

⁷⁹ *Forbes*, "福布斯2015年中国家族企业调查报告: 家族管理层亲属关系趋向简单化": Available at http://www.cbdi.com/BigData/2015-09/08/content_3778442_2.htm (visited 7 June 2016). Family enterprises refer to enterprises owned or controlled by family members and at the same time at least two family members take part in management of the enterprises

⁸⁰ In the case of SOEs to decentralise the decisions making power to firm management without selling off the state ownership (which they could not do), and in the case of private company to overcome the problem of lack of access to external funds. See: Joseph P.H. Fan, T.J. Wong, and Tianyu Zhang, "The Emergence of Corporate Pyramids in China," (2005) *Chinese University of Hong Kong*: Available at http://www.rieti.go.jp/users/peng-xu/project/asia/pdf/fan_wong_zhang.pdf (visited 21 November 2017)

and retail investors as well as QFIIs are permitted to participate in the A-share and B-share markets on both Exchanges.

The approximate proportion of shareholdings of institutional investors is 19.86% as of 2017.⁸¹

Foreign investors

The SZSE 2016 Fact Book states that on 31 December 2016, there were 7.98 million local investors (7.93 million individuals and 51,100 companies) and 199.92 million non-local investors (199.43 million individuals and 494,400 companies) in A-shares. For B-shares, there were 1.04 million individual investors, 6216 companies, and 9533 funds.⁸²

The SSE 2016 Fact Book does not contain information on investors in this context.

The QFII scheme allows foreign institutional investors, who meet certain qualifications, to invest in SSE and SZSE listed shares. QFII is limited because of foreign exchange controls. The RFQII allows RMB funds raised in Hong Kong by subsidiaries of Mainland fund management companies and securities companies located in Hong Kong to invest in SSE and SZSE listed shares. Approval must be sought from the CSRC and an investment quota must be obtained from SAFE.⁸³

Foreign investors are allowed to invest in the B-share market on both Exchanges and, since the establishment of Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, eligible A-shares on the SSE and SZSE.

The Shanghai Stock Connect and Shenzhen Stock Connect are open to all SEHK participants (institutional and retail investors) who satisfy eligibility requirements of the SEHK LRs to participate in the SSE and SZSE. However, SZSE ChiNext will be initially limited to international institutional investors. Trading of north-bound shares under the connect programs (i.e. SSE and SZSE) is subject to a daily quota of RMB 13 billion each. Mainland investors in SEHK eligible shares have a daily quota under each of the stock connect programs of RMB 10.5 billion.⁸⁴

The Shanghai-Hong Kong Stock Connect commenced in November 2014 providing access to 939 eligible A-shares listed on the SSE (as at 2 May 2017) for foreign investors.⁸⁵ Mainland investors are able to trade 315 eligible shares listed on the SEHK.

The Shenzhen-Hong Kong Stock Connect began operations on 5 December 2016. International investors can buy and sell in 901 Shenzhen-listed companies (as at 26 May

⁸¹ OECD, op. cit, 5

⁸² Figures sourced from: SZSE, "Shenzhen Stock Exchange Factbook 2016", p. 430: Available at: <https://www.szse.cn/UpFiles/largepdf/20170321091732.pdf> (visited 10 November 2017)

⁸³ SSE, "Briefing on QFII Scheme and Its Development": Available at <http://english.sse.com.cn/investors/qfii/what/> (visited May 2017)

⁸⁴ HKEX, "Stock Connect Another Milestone – FAQ," (10 April 2017), [1.2], [1.3], and [1.6]

⁸⁵ According to the Interim Measures of SSE on Shanghai-Hong Kong Stock Connect, Mainland investors can trade shares of Hang Seng Composite LargeCap Index, shares of Hang Seng Composite MidCap Index and H shares of the A+H dual listed companies. Foreign investors can trade A shares of SSE 180 Index, A shares of SSE 380 Index and A shares of the A+H dual listed companies; HKEX, "Shanghai and Shenzhen Connect – Eligible Stocks": Available at https://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Eligiblestock.htm (visited 30 May 2017)

2017) and 12 Hong Kong-listed stocks.⁸⁶ Eligible SZSE A-share companies must have a minimum market capitalisation of not less than RMB 6 billion.⁸⁷

Eligible Mainland companies can seek a listing on the SSE (A-shares) and the SEHK (H-shares) as part of the stock-connect program.

The rise of foreign investors in Mainland stock markets could provide new impetus for further reform of CG standards to harmonise with international best practices. This is supported by Mainland capital markets continually easing restrictions on foreign investment.

⁸⁶ Enoch Yiu, "Stock connect debut will link the Mainland's southern bourse Shenzhen and Hong Kong for first time," (4 December 2016) *SCMP*: Available at <http://www.scmp.com/business/companies/article/2051614/shenzhen-hong-kong-stock-connect-poised-historic-debut-monday>; HKEX, "Shanghai and Shenzhen Connect – Eligible Stocks": Available at https://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Eligiblestock.htm (visited 30 May 2017)

⁸⁷ HKEX, "Shanghai Connect Shenzhen Connect – Information Book For Investors," (9 March 2017), 7

Appendix IV	2. Policy	IV.2 Mainland China
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Introduction

The securities market in the Mainland is largely influenced by the United States and Hong Kong. In particular, the market was modelled on the United States because this was viewed as the world's most developed market.⁸⁸ Accordingly, many of the CSRC senior staff were trained in the United States⁸⁹ with others gaining experience in Hong Kong. Hong Kong's regulatory system is similar to the United Kingdom (UK), yet geographically and culturally aligned with the Mainland.⁹⁰ Thus, the United States and Hong Kong were the main models that shaped the establishment of the Mainland's regulatory regime.⁹¹

The Exchanges were established by local governments with the approval of the Central Government. By the end of 1992, the Central Government took full control of the regulatory regime by establishing the State Securities Commission, including its operational arm—the CSRC. The CSRC's regulatory role was solidified in 1998 with the enactment of the first Securities Law, which centralised authority and made it accountable to the State Council (art 7); the Exchanges' articles of association requiring approval by the CSRC (art 96); the general managers of the Exchanges being appointed by CSRC (art 100); and each exchange adopting the same LRs, approved by CSRC.⁹²

Until 1999 a quota system was operated by central and the local governments to facilitate approved companies (mostly SOEs) to list shares on an exchange. To meet exchange requirements, SOEs and local government officials often made false operational disclosures.⁹³ Since the abolition of the quota system, any company can apply to CSRC for listing approval.

When formulating CG policy prior to drafting laws, regulations, and rules, the legislature or regulator/s will carry out research and implement procedures to solicit a broad scope of opinions from the public and market participants through discussion, debate, consultation, and comments.

IV.2.1 Parties responsible for regulatory development

Communist Party of China

As mentioned earlier, the CCP sets CG policy at the highest level. However, a large number of regulators set policy for various aspects of CG, albeit with the approval of the CCP.

⁸⁸ Zhou Yousu (ed) *General Theories on Securities Law* (in Chinese) (Chengdu: Sichuan People's Press, 1999) , p. 12

⁸⁹ Fu, op. cit, pp.19-20

⁹⁰ For example, Anthony Neoh and Laura Cha both worked for the SFC

⁹¹ Foreign experts invited by the CSRC on the drafting of the Securities Law were mostly from the United States and Hong Kong, though a few were from Japan and the UK. The drafters also visited United States, Hong Kong, Japan and the UK during the drafting of the Company Law 1993: see Fu, op. cit, p. 20. It has also been noted that the Australian experience has also influenced the Hong Kong model as many Australians worked in the SFC, including its second chairman, Robert Nottle (1992-1994), and therefore, indirectly influencing the Mainland model and some Australian academic and professionals were also involved in the drafting of the Securities Law: *ibid* at 22

⁹² *Ibid*, p. 19

⁹³ *Ibid*, p. 25

Ministry of Finance

The Ministry of Finance (MOF) is the accounting regulator that formulates financial and accounting policy, enforces the Accounting Law of the People's Republic of China (Accounting Law), is responsible for supervising the implementation of accounting rules, regulates registered accountants and accounting firms, and regulates companies' financial reports.

This is in contrast to Hong Kong's three-tier regulatory system where the Financial Services and Treasury Bureau is responsible for the Companies Ordinance and the Securities and Futures Ordinance (Cap. 571), with the exchange operator—the HKEX—exercising a degree of self-regulation under the supervision of the securities regulator—the SFC. Further, the Hong Kong Institute of Certified Public Accountants (HKICPA) is responsible for self-regulation of accounting matters.

According to Article 163 of the Company Law, financial and auditing reports must comply with MOF laws, regulations, and rules. For example, the Accounting Standards for Business Enterprises were issued by the MOF in 2006 and revised in 2014. These standards substantially converge with the IFRS issued by the International Accounting Standards Board. The MOF and four CG regulators (e.g. CSRC, China National Auditing Office (CNAO), CBRC, and CIRC) issued the Basic Standard for Enterprise Internal Controls (Basic Standards) and related guidelines (i.e. application, evaluation, and auditing) in 2008, commonly known as the China Sarbanes-Oxley (i.e. Sarbanes-Oxley is a United States Act), which came into effect on 1 July 2009. All listed companies are required to comply with the internal control requirements from 2011, and unlisted (i.e. companies incorporated in the Mainland which are not listed on a Mainland exchange) large and medium-sized companies, are encouraged to comply. In 2015, the MOF announced a plan to start researching and formulating rules for the internal control of small enterprises.

All companies must issue annual financial reports that are audited by a registered accounting firm.⁹⁴

The MOF is also responsible for SOE financial matters. This creates a conflict of interest because the MOF drafts and distributes policy between the Central Government and SOEs, manages the Central Government's budget which provides financial support to SOEs, supervises the financial affairs of SOEs reporting directly to the Central Government, and manages the returns from state-owned assets.⁹⁵ Since 2015, the MOF has published Briefs of Enterprise Internal Control, providing information on MOF's recent studies and research, international practices, and shares experience garnered from large enterprises.

All companies listed on the main boards of SSE and SZSE are required (large and medium-sized unlisted enterprises are encouraged) to evaluate and disclose internal controls, subject to the rule and guidelines issued by the MOF and the CG regulators.

Corporate governance regulators

There are a number of regulators responsible for CG. All listed companies on the Exchanges are supervised by the CSRC. The finance industry is regulated according to different sectors – the CSRC for securities of listed companies, CBRC for commercial banks, and the CIRC for insurance companies. Each is responsible for CG in their respective financial sector. The SASAC supervises SOEs and the CNAO is the auditor of

⁹⁴ Company Law, art 165

⁹⁵ 中国证券监督管理委员会,中国上市公司治理发展报告[M], 中国金融出版社, (2010), p. 122

state-owned assets. SOEs also have to be registered with, and submit annual financial reports to, the Administration of Industry and Commerce (AIC).

China Securities Regulatory Commission:

As the regulator for all listed companies, the CSRC enforces the Securities Law, has oversight of the Exchanges, and issues and enforces a substantial volume of rules and regulatory documents on different aspects of CG (including, inter alia, information disclosure, shareholders' protection, risk control, restrictions on directors, supervisors, and senior managers).

Securities Law enforcement is similar to the SFC except that the CSRC has a wider regulatory scope. For example, the SFC's rule making powers do not cover CG matters or listing requirements such as disclosure obligations. In Hong Kong, these powers are exercised by the SEHK. The CSRC can make orders to correct any CG non-compliance. If a securities firm is a listed company, the CG Code will apply, which also falls within the CSRC's regulatory ambit.

The CSRC issued the CG Code in 2002, which is the principal CG regulation for listed companies and is mandatory (c/f Hong Kong, Singapore, and the UK where the CG Code is anticipatory). This was followed by the CSRC issuing a substantial number of CG rules and regulatory documents viz:

information disclosure (2007), takeovers (2006, amended in 2015), material asset restructuring (2008, amended in 2014), shareholders' meetings (2006, amended in 2014), articles of associations (2007), protection of public investors (2004), independent directors (2001), management of shares held by directors, supervisors, and senior managers (2007), equity incentive plans (2005), employee stock ownership plans (2014) and internal controls (2008 together with the MOF, CSRC, CNAO, CBRC, and CIRC).

In 2005 the State Council issued a Notice on Approving and Forwarding the Opinions of CSRC on Improving the Quality of Listed Companies that required bureaus to implement CSRC opinions.

Listed companies were required to improve CG structures, set up internal control systems, increase transparency, strengthen senior management and employee incentives and restrictions, and restrict the conduct of controlling shareholders (e.g. related-party transactions).

The CSRC has built a comprehensive regulatory framework to promote standard practices among listed companies. In 2005 the "Working Group of the Standard Operation of Listed Companies" (Working Group) was established which is coordinated by CSRC with 11 ministries of the State Council participating (see Appendix IV.4.4). The Working Group has strengthened coordination among CG regulators, promotes non-tradable share reform, prevents the misappropriation of capital by controlling shareholders, and promotes the standardisation of listed companies.⁹⁶

In a 2007 survey, respondents concurred that the implementation of four pre-2007 CG reforms were "somewhat effective."⁹⁷ One problem identified by the IMF (2012) is that CSRC is under-staffed. Listed SOEs and regulators are all government entities which do not operate independently of the Central Government. This can result in prompt and effective formulation and implementation of policy, yet may be obscured by the government's political objectives rendering CG improvements ineffective.

⁹⁶ 中国证券监督管理委员会,中国上市公司治理发展报告[M], 中国金融出版社 (2010) p. 14

⁹⁷ Referring to: CFA Institute, op. cit, 5

Major inhibitors of the CSRC fulfilling its regulatory functions include:

(1) seriously inadequate resources allocated for investigations into breaches of the Securities Law; (2) not having wide-ranging enforcement powers as, for example, the SEC in the United States (e.g. no power of subpoena and the need to apply for a court order to freeze bank accounts, except in narrowly prescribed circumstances); and (3) suffers from internal corruption and fraud.⁹⁸

Administration of Industry and Commerce:

All listed and unlisted companies are required to register at the AIC and issue annual financial reports which are audited by an MOF regulated accounting firm.

The AIC enforces the Company Law similar to the Companies Registry in Hong Kong. Companies' CG structure (including shareholders' meetings, board of directors, and board of supervisors) must be included in the Articles of Association, which is submitted to the AIC for company registration and approval to obtain a business license. Before 2014 a capital verification report, prepared by an accounting firm, was required for a business license. Following a company's incorporation, all annual financial reports (prepared by accounting firms) must be submitted to the AIC for inspection. Since March 2014, the capital verification report and annual inspection of financial reports requirement has been removed following an amendment of the Company Law and the Regulation on Administration of Company Registration. Companies are now required to publish their annual reports on the AIC's website, which the AIC checks randomly.⁹⁹

State-owned Assets Supervision and Administration Commission of the State Council:

The SASAC is responsible for SOE shareholder matters pursuant to the Company Law, Law of the State-owned Assets of Enterprises, related laws and administrative regulations, and supervises and manages the state-owned assets of SOEs under the supervision of the Central Government (excluding financial enterprises). Managing state-owned assets involves preserving and increasing value. The SASAC guides and advances SOE reforms and restructurings, improves SOE CG through establishing a modern SOE enterprise system, drafts and implements the remuneration policy of senior managers, and appoints and removes top executives in accordance with regulations and articles of association.¹⁰⁰

IV.2.2 Periodic reviews

Prior to 2007 regulators did not publish reviews of CG compliance. Non-compliance with the CG Code was regulated and sanctioned by CSRC. Sanctions included administrative penalty (e.g. fines), license revocation, and public disclosure of breaches. In March 2007 the CSRC launched a campaign—issuing a notice comprising of 100 questions to improve CG. By the end of October 2007 all listed companies were required to self-assess their CG against the Company Law 2005 CG Code, regulatory documents, and publish a self-assessment report.¹⁰¹ In June 2008, the CSRC ordered all listed companies to make an announcement—published on the exchange website—before 20 July 2008 that explained how CG reforms were being implemented in comparison to the planned reforms. All reforms and self-assessments had to be completed by 30 November 2008. Spot examinations were conducted by CSRC branches—if any listed company was unable to

⁹⁸ Beller, op. cit; and papers cited therein

⁹⁹ AIC, “《注册[REDACTED]》” (24 February 2014): Available at http://www.gov.cn/zhuanti/2014-02/24/content_2726423.htm (visited 27 July 2016)

¹⁰⁰ 中国证券监督管理委员会, 中国上市公司治理发展报告[M], 中国金融出版社 (2010), pp. 123-124

¹⁰¹ CSRC, 关于开展加[REDACTED]: Available at http://www.csrc.gov.cn/pub/newsite/ssb/gzdt/200703/t20070320_72564.html (visited 28 July 2016)

comply with the reforms by 30 November 2008, applications for equity incentive plans and the issuance of new securities was rejected.¹⁰² There does not appear to be any publications on the CSRC's analysis or evaluation of the reforms, or listed companies' CG self-assessments and results.

Following these reforms, the CSRC launched a 2009 CG assessment program with the OECD. The CSRC published the "China Listed Company Corporate Governance Report" in 2010. This report compared the Mainland's CG system with the relevant OECD principles, namely: shareholder rights, equal treatment of shareholders, information disclosure, responsibility and supervision of the board of directors and supervisory board, stakeholders, and corporate social responsibility.¹⁰³

In contrast to the government, CG evaluations have been undertaken by Chinese academics since 2003. The research of greatest influence is conducted by the Research Centre of Corporate Governance of Nan Kai University¹⁰⁴ (Nan Kai CG Centre), which is supported by the CSRC and the Development Research Centre of the State Council. From 2003, this research developed into the China Corporate Governance Index (CCGI). The CCGI was the first CG evaluation system in the Mainland.¹⁰⁵ Several CCGI reports have been published periodically since 2004.

The SASAC authorised the Nan Kai CG Centre to evaluate how large SOEs were governed.¹⁰⁶ Based on empirical studies of listed companies on the SSE and SZSE, the CCGI evaluates six aspects:

- (1) shareholders' rights, (2) board of directors, (3) board of supervisors, (4) senior managers, (5) information disclosure, and (6) stakeholders.

There are six first-class indicators and nineteen second-class indicators. In the 2007 report, the CCGI average score based on 1162 listed companies was 56.85 out of 100 (55.02 in 2004; 55.33 in 2005; 56.08 in 2006), with the highest score being 70.50 and the lowest being 43.66.¹⁰⁷

According to the CCGI, listed companies' CG improved from 2004 to 2007. This is attributed to:

- (1) the regulation of shareholder conduct; (2) improvements to boards of directors, boards of supervisors, and senior managers; and (3) a slight improvement in stakeholders.

There was no substantial change in information disclosures.¹⁰⁸ Since that time listed companies have improved gradually, except in 2009, when there was a slight drop from the 2008 score (57.86 to 57.62).¹⁰⁹

CCGI research is on-going with the latest publication (2014 statistics) based on 2467 listed companies—the average score was 61.46, the highest score was 72.09, the lowest score was 48.20, with 17 companies scoring over 70 (three in 2013), and 64.69% scoring between 60-70 (59.72% in 2013). Companies with a score below 50 accounted

¹⁰² CSRC, 证监发[2008]27号: Available at

http://www.csrc.gov.cn/pub/zjhpublic/G00306207/200806/t20080625_25485.htm (visited 28 July 2016)

¹⁰³ 中国证券监督管理委员会, 中国上市公司治理发展报告[M], 中国金融出版社 (2010), pp. 4-5

¹⁰⁴ Nan Kai University is a leading university in management in China

¹⁰⁵ 南开大学公司治理研究中心公司治理评价课题组, 2007中国上市公司治理评价研究报告[M], 商务印书馆, (2014), p. II

¹⁰⁶ 南开大学公司治理研究中心公司治理评价课题组, "2004中国上市公司治理评价研究报告" "2004 China Research Report on Evaluation of Corporate Governance of Listed Companies", 商务印书馆 (2007), p. 230

¹⁰⁷ 南开大学公司治理研究中心公司治理评价课题组, 2007中国上市公司治理评价研究报告[M], 商务印书馆 (2014), pp.13-14

¹⁰⁸ Ibid, p. 28-29

¹⁰⁹ 李国, 中国公司治理与评价2014[M], 北京大学出版社(2016) p. 192

for 0.12% in comparison to 0.16% (2013), 0.21% (2012), 0.67% (2011), and 3.33% (2010). Companies listed on different boards had an average 2014 score of 60.15 (Main Board), 63.05 (SME Board), and 63.03 (ChiNext).¹¹⁰ This suggests that the companies with good CG are not all large SOEs, and companies with weak CG are not always small companies or non-SOEs.

In recent years there has been an increase in CG information disclosed to the public because listed companies are required to issue an annual internal control evaluation report. From 2011 dual listed companies have been required to comply with the internal control requirements, with companies listed on the main board of SSE or SZSE being required to comply since 2012.¹¹¹

Periodic reviews have been undertaken by the regulators since 2007. The CSRC reviews listed companies' financial reports, analyses compliance with the 2006 Accounting Standards for Business Enterprises and publishes annual accounting reports, which are available on the MOF's website.

Since 2012, the MOF and CSRC have jointly reviewed the internal control reports of listed companies annually, which are publicly available. In 2012, the MOF and CSRC reviewed the internal controls of 67 dual listed companies.¹¹² All 67 companies issued a 2011 financial report, internal control evaluation report, and internal control auditing report by 30 April 2012. Only one out of the 67 listed companies in 2011 was deemed to have ineffective internal controls, however 49 listed companies had problems with internal control systems. The MOF and CSRC highlighted some of the problems revealed by the evaluation and made suggestions for improvements, namely:

- (1) strengthening enforcement and punishment, (2) unifying the rules among different regulators, (3) providing more detailed guidelines and practices, and (4) providing training.

Subsequent listed company reviews and analysis were published by the MOF and CSRC in 2012, 2013, and 2014 in their internal control evaluation reports.¹¹³ This has led to more companies evaluating the effectiveness of their internal control measures. The majority¹¹⁴ of listed companies disclosed internal control information in the 2014 annual reporting season (issued by 30 April 2015). Companies listed on SZSE SME Board and ChiNext are not required to follow the internal control requirements. Listed company reports that followed regulatory guidelines numbered 2088 out of 2586.¹¹⁵ There were 37 listed companies or 1.43% that had ineffective internal control systems.¹¹⁶ From 2015, the MOF Committee of Internal Control Standards began publishing the Briefs of

¹¹⁰ Figures sourced from: *ibid* pp. 165, 173, 174, and 188

¹¹¹ MOF, CSRC, CNAO, CBRC, and CIRC, *Guidelines for Application of Enterprise Internal Controls (2011)*; MOF, CSRC, CNAO, CBRC, and CIRC, *Guidelines for Evaluation of Enterprise Internal Controls (2011)*; and MOF, CSRC, CNAO, CBRC, and CIRC, *Guidelines for Auditing of Enterprise Internal Controls (2011)*

¹¹² 财政部会计司, 证监会会计部, <我国境内外同时上市公司2011年执行企业内控规范体系情况分析报告>: Available at http://kjs.mof.gov.cn/zhengwuxinxi/diaochayanjiu/201209/t20120918_683441.html (visited 5 June 2016)

¹¹³ MOF and CSRC, 2012年上市公司内控: Available at <http://www.kuaiji.com/news/1428086> (visited 29 July 2016); MOF and CSRC, 我国上市公司2013年: Available at http://kjs.mof.gov.cn/zhengwuxinxi/diaochayanjiu/201410/t20141009_1147429.html (visited 29 July 2016); and MOF and CSRC, 我国上市公司 2014 年: Available at <http://www.mof.gov.cn/pub/kjs/zhengwuxinxi/kuaijiguanlidongtai/201512/P020151229379651517494.pdf> (visited 29 July 2016)

¹¹⁴ Total: 2,586 out of 2,631; SSE Main Board: 96.12%; SZSE Main Board: 99.15%; SZSE SME Board: 99.73%; and ChiNext: 100%

¹¹⁵ Total: 80.74%; SSE Main Board: 94.09%; SZSE Main Board: 91.16%; SZSE SME Board: 73.85%; and ChiNext: 50.60%

¹¹⁶ 蔡宗琦, "中国上市公司2015年内部控制白皮书发布" "China White Paper of the Internal Control of Listed Companies in 2015", 中国证券报 (9 June 2015): Available at <http://www.iaudit.cn/News/ShowArticle.asp?ArticleID=188458&Page=2> (visited 2 June 2016)

Enterprise Internal Control, information on MOF studies and research, and international practice and experience from large foreign corporations.¹¹⁷

The Working Group has periodic meetings to facilitate communication and coordination. However, there is little information released on the meetings frequency and content.

IV.2.3 On-going monitoring

The CSRC is responsible for the on-going monitoring of listed companies. In the role as the financial reporting regulator, the MOF monitors companies' CG by regulating accounting firms and registered accountants that audit annual financial reports. The MOF reviews companies' internal control reports (see Appendix IV.2.1). Financial regulators are responsible for on-going monitoring of their financial regulated ambit – the CBRC for commercial banks, the CSRC for securities industry, and the CIRC for insurance companies. Monitoring by these regulators includes spot inspections and interviewing relevant personnel. More specifically, the CBRC's on-going CG monitoring of commercial banks is carried out through risk disclosure, spot inspections, interviews with relevant personnel and auditors, and sending CBRC officers to attend meetings of the board of directors and supervisory boards. If a bank fails to comply with the Guidelines for Corporate Governance of Commercial Banks (2014), the CBRC can require correction plans from the bank or take other regulatory measures. In the role of securities sector regulator, the Rules for Corporate Governance of Securities Companies (2012) allow the CSRC to consider securities companies' CG to determine whether market access is warranted and the grounds for evaluating daily supervision (article 75). The CIRC monitors insurance companies through:

- (1) examining the qualification of directors, supervisors, and senior managers;
- (2) spot inspections; (3) non-spot inspections (i.e. reviews annual reports of insurance companies), and (4) can send CIRC officers to attend board meetings.

¹¹⁷ At the time of writing, there were six 2015 publications on the MOF website

Appendix IV	3. Legislation	IV.3 Mainland China
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Introduction

The CCP sets the tone on CG reform at the top - the Central Government is able to make CG changes through the CSRC very rapidly and effectively in terms of implementation and enforcement.

There is no overarching CG legislative framework. The CG framework comprises of four levels: primary legislation, State Council administrative regulations, government bureau regulations, and self-disciplinary rules. The exact designation of laws and regulations is nonetheless subject to a degree of ambiguity as there is no uniform naming convention.

IV.3.1 Primary legislation

Primary legislation includes “basic laws” (基本法) and “departmental laws” (部門法) that are formulated by the National People’s Congress (NPC) or the NPCSC. In the context of CG, the relevant primary legislations are:

- (1) the Company Law, (2) the Securities Law; (3) the Criminal Law Amendment Act (6); (4) the Law of the People’s Republic of China on State-Owned Assets of Enterprises; and (5) the Accounting Law.

Introduced in 2006, the Company Law and the Securities Law form the legislative foundation of the Mainland’s CG framework. In terms of naming conventions, it should be noted that a law passed by the NPC may take the form of a law, regulation, rule, measures, decision, or resolution.

Unlike the common law tradition, civil law powers of Mainland lower courts to interpret legislation are limited:

“People’s courts do not have the power to interpret laws: this power belongs to the NPC’s Standing Committee” (sometimes called legislative interpretation)¹¹⁸

Similarities between the common law and Mainland civil law courts’ enforcement and interpretative functions include:

“The function of Chinese courts is to enforce laws”.¹¹⁹

“In the process of dealing with cases, the Supreme People’s Court has the power to interpret questions concerning specific applications of laws and rules”¹²⁰ (sometimes called judicial interpretation).

The Company Law

The Company Law (amended in 2013 with effect from 1 March 2014), promulgated by the NPCSC, only applies to two types of companies: limited liability companies and companies limited by shares incorporated in the Mainland (Article 2 of the Company Law).

¹¹⁸ Fu, op. cit, p. 46, citing the Constitution, art 67

¹¹⁹ Ibid, p. 46 citing article 123, the Constitution, art 123

¹²⁰ Ibid, p. 46, citing the Organic Law of People’s Courts of 1983, art 33

The revised Company Law provided the following CG changes:

(1) the decision-making process of the company's investment and guarantee was regulated (Article 16); (2) companies were required to sign a labour contract with employees and provide employee insurance (Article 17); (3) piercing the corporate veil was introduced (Article 20); (4) shareholder rights - shareholder litigation pertaining to decisions stemming from shareholder meetings and the board of directors (Article 22), derivative actions by minority shareholders (Article 152), access to corporate information (Article 34), company purchases of shares - notably from minority shareholders (Articles 75 and 153); (5) one-person companies (Articles 58-64)—before 2006 a company required two or more shareholders; (6) cumulative voting for the election of directors and supervisors (Article 105); and (7) listed companies were required to have independent directors (Article 123).

The 2013 Amendment to the Company Law principally removed the registered capital requirement to establish a company, changed the paid-up capital registration system to a subscribed capital registration system, and removed the minimum cash requirement for capital contributions.

The Securities Law

Promulgated by the NPCSC, the Securities Law (amended in 2014) applies to the issuance and trading in the Mainland of stocks, corporate bonds and other securities, trading of listed treasury bonds and securities investment fund units, and the issuance and trading of securities derivatives (Article 2: regulated activities related to securities industry).

The Law of the People's Republic of China on State-Owned Assets of Enterprises

The Law of the People's Republic of China on State-owned Assets of Enterprises was promulgated by the NPCSC in 2008. This applies to "state-invested enterprises" which includes wholly SOEs, state-controlled companies, and partly state-owned companies to which the state contributes capital.¹²¹

IV.3.2 State Council administrative regulations

State Council administrative regulations (行政法規) are below "laws" in the regulatory hierarchy which can take the form of measures, rules, regulations, decisions, orders, opinions, and circulars. For example, CG regulations and related opinions or measures. The State Council's authority to issue regulations comes from the Constitution or is delegated by the NPC or the NPCSC.

Regulations are designed to provide detailed rules for implementing laws. Laws are designed with generalised drafting and require further elaboration. These types of regulations have the same status as laws, although in practice can be more important than the source law.¹²²

For example, Administrative Regulations of the People's Republic of China on Administration of Company Registration (2016 Revision) were promulgated by the State Council, pursuant to the Company Law. Under the regulations, companies are confirmed as having a legal person status and company registration is standardised. The regulations apply to companies incorporated in the Mainland, as defined by Article 2 of the Company Law.

¹²¹ Law of the People's Republic of China on State-owned Assets of Enterprises 2008, art 5

¹²² Fu, op. cit, p. 53

However, not all regulations elaborate on the generalised drafting of laws. For example, “Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets (2009)”. Although this “opinion” has the status of law, and is supposed to provide details for implementing the law, the wording is generalised (see Part V and a related notice is discussed in Appendix IV.3.2).

Some opinions of the State Council on Promoting the Reform, Opening up and Steady Growth of Capital Market (2004)

These regulations upgraded the quality of listed companies. The quality of listed companies is defined as its investment value in the securities market. Directors and senior management of listed companies were initially required to optimise shareholders’ interests and provide sustained improvements in profitability. The long-term goal was to:

- (1) hone the management system of share issuance; (2) advocate a sponsor system for securities issuance and listings; (3) support companies with strong competitiveness; (4) standardise operations—companies producing satisfactory returns were listed; (5) and focus on improving business quality.

Listed companies were encouraged to conduct market-oriented mergers, acquisitions, or restructuring propitious to the company’s sustainable development and consummate with the re-financing policy. Support for companies deemed “superior” in this regard included accelerating their development and growth through the capital market.

The standardisation of listed companies’ operations and legal-person governance structure was improved. This involved a check-and-balance system regulated by an authority, decision-making agency, and a supervisory agency. Management was required to comply with the modern enterprise system. Moreover, directors and senior management had to strengthen their credibility and the responsibility of directors widened. Additional improvements included an independent director system, standardising the behaviour of controlling shareholders, and prosecuting controlling shareholders who damaged a listed company’s interests or minority shareholders’ interests. The responsibilities of listed companies were reinforced. Information disclosure was made obligatory, ensuring the trueness, accuracy, completeness, and timeliness of information. Incentive and restraint mechanisms were established for listed companies’ senior management.¹²³

Notice of the State Council on Approving and Forwarding CSRC’s Opinions on Improving the Quality of Listed Companies (2009)

To implement “Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Market”, the State Council promulgated the Notice of the State Council on Approving and Forwarding the Opinions of CSRC on Improving the Quality of Listed Companies. The notice applies to all listed companies.¹²⁴ For the purpose of promoting the quality of listed companies, the notice states that:

“great efforts should be made to let the listed companies’ corporate governance structure complete, internal control system reasonable and sound, incentive and

¹²³ CSRC, “Some Opinions of the State Council on Promoting the Reform, Opening up and Steady Growth of Capital Market,” (2009): Available at http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/AdministrativeLaws/200907/t20090729_119391.html (visited 11 November 2017)

¹²⁴ CSRC, Notice of the State Council on Approving and Forwarding CSRC’s Opinions on Improving Quality of Listed Companies (2008)

restraint mechanisms normative and effective, and companies' transparency, competitiveness and profitability improved prominently." (Article 1(2))

The notice focuses on:

(1) solving practical problems, such as safeguarding the independence of listed companies, standardising the usage of raised funds, prohibiting the misappropriation of listed companies' capital, curbing illegal guarantees, regulating connected transactions, and prohibiting false financial and accounting information (Article 3); (2) taking effective measures, such as supporting high-quality enterprises, elevating refinancing efficiency, establishing a multi-level market system, and promoting equity division reform, to strengthen listed companies (Article 4); (3) improving the supervision and management mechanism for listed companies to reinforce supervisory collaboration via building enhanced credibility, regulating the behaviour of controlling shareholders or actual controllers, supervising senior management and securities intermediaries, and taking advantage of self-regulation (Article 5); and (4) the government's role being primarily concerned with consolidating the organisation and leadership to create a favourable environment for the healthy development of listed companies (Article 6).

The notice is extremely general, leaving many questions of how, who, when, and where unanswered.

IV.3.3 Government bureau regulations

Below administrative regulations in the hierarchy are government bureau regulations (部門行政規章) which are made by the ministries (e.g. the MOF or other CG-related ministries) and regulatory commissions (e.g. CSRC, CBRC, and CIRC) of the State Council, the People's Bank of China, the Auditing Administration, and other government bureaus/departments directly within the State Council's remit.¹²⁵ These can take the form of orders, directives, regulations, measures, codes, guidelines, and guiding opinions. For example, the rules promulgated by the CSRC.

In theory the CSRC rules are not binding on the courts because government bureau regulations do not have the force of law. In practice judges apply government bureau regulations subject to their discretion.

Another example is the internal control requirements introduced after the 2008 global financial crisis.

IV.3.4 Self-disciplinary rules

At the base of the hierarchy are self-disciplinary listing and trading rules issued by the Exchanges and subject to the CSRC's guidelines for LRs. Under the guidelines, the LR requirements have only minor differences. Listing and trading rules require CSRC approval.¹²⁶ The Exchanges can enforce these rules by imposing sanctions on companies and their directors, supervisors, sponsors, and board secretaries.¹²⁷

¹²⁵ OECD, *op. cit.*, [1.2]

¹²⁶ Securities Law, art 118

¹²⁷ For example, SZSE LR, 16.2-16.5

Appendix IV	4. Regulation	IV.4 Mainland China
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Introduction

Mainland China's listed companies' CG is primarily regulated by the CSRC, MOF, and the AIC. The CSRC issues the CG Code while the Exchanges issue and enforce LRs under the CSRC's oversight. Other regulators play some role, for example, the MOF, AIC, and SASAC.

IV.4.1 Corporate governance regulatory structure

China Securities Regulatory Commission

The CSRC is the securities regulator which provides oversight of the Exchanges and listed companies. This role is similar to the SFC in Hong Kong, except that the CSRC has more power. For example, the CG Code is the main standard for evaluating CG of listed companies, where compliance is mandatory, and which is issued and enforced by CSRC. In Hong Kong the CG Code is a "comply or explain" regime issued and enforced by the HKEX as part of the LRs.

The CSRC's responsibilities and powers are set-out in the Securities Law, analogous to the SFC's responsibilities under the Securities and Futures Ordinance (Cap. 571), which include:

- (1) administration, supervision, and rule-making powers;¹²⁸
- (2) investigatory powers;¹²⁹ and
- (3) powers to impose disciplinary sanctions¹³⁰ (for more details, see Appendix IV.6).

The CSRC is a ministerial-level public institution directly under the State Council, performing a unified regulatory function over the securities and futures market in Mainland China.¹³¹ Therefore, the CSRC is not as independent as the SFC.

With the CSRC being the principal regulator of CG, regulatory changes have sought to further improve CG standards and compliance, the ownership structure of the market, and encourage foreign shareholdings. For example, the preference share pilot program launched in 2013 and the draft Foreign Investment Law bring all foreign-invested entities within the Company Law regulatory framework.¹³² There is an ongoing effort to explore best CG practice and implementation methods by the government in areas such as minority shareholder protection, regulation of controlling shareholders or actual controllers, and transparency and disclosure obligations. For example, the recent launch of a pilot scheme of Minority Shareholder Service Centre (see Appendix IV.5), and the State Council's opinion asking listed companies to disclose their dividend policy. Enforcement efforts by the CSRC centre on breaches of good faith, unlawful conduct by listed companies and responsible persons, and compliance with disclosure obligations. A pilot employee share scheme was launched recently (see Appendix IV.4.5). There is strong drive by regulators to improve listed companies' self-discipline regime in relation to these issues. The recent attempted hostile takeover of China Vanke by its largest

¹²⁸ Securities Law, art 179

¹²⁹ Securities Law, art 180

¹³⁰ Securities Law, Part XI

¹³¹ CSRC, "Introducing the CSRC": Available at

http://www.csrc.gov.cn/pub/csrc_en/about/intro/200811/t20081130_67718.html (visited 5 May 2016)

¹³² Fang Jian and Grace Yu, "China Corporate Governance 2017," *ICLG*: Available at <https://iclg.com/practice-areas/corporate-governance/corporate-governance-2017/china> (visited 29 September 2017)

shareholder, Baoneng, and the consequential board resolution for a restructuring plan to fend off the takeover (see Appendix IV.6) raises regulatory concerns pertaining to the role, effectiveness, and independence of independent directors, legality of takeovers, and the exact nature of the role of SASAC and the State in listed companies.

Shanghai Stock Exchange and Shenzhen Stock Exchange

Exchange supervision involves real-time surveillance to detect unusual trading activities and market misconduct. The Exchanges have been erroneously described as performing self-regulatory governance of the Mainland's securities markets.¹³³ Despite this description of "self-regulatory governance", the Exchanges come under the control of the CSRC. For example, guidelines issued by the Exchanges on the standard operation of listed companies to implement the CG Code have to be approved by the CSRC. The SZSE has issued three comprehensive guidelines regulating the CG of companies listed on the Main Board, SME Board, and ChiNext. In comparison, the SSE has issued regulations pertaining to different aspects of CG such as the board of directors, the board of supervisors, secretaries of the board of directors, auditing committees, and controlling shareholders.

The Exchanges have the power to suspend trading or temporarily halt trading when an "unexpected incident occurs due to force majeure", which must be reported in a timely manner to the CSRC.¹³⁴ Trading of a securities account can be restricted by the Exchanges which display "significantly suspicious trading situations".¹³⁵ Such action taken by the Exchanges must be reported to the CSRC.¹³⁶ The Exchanges also have the power to impose disciplinary sanctions on listed companies and relevant personnel who breach the Exchanges' trading rules¹³⁷ (for more details, see Appendix IV.6).

Administration for Industry and Commerce

The AIC is responsible for companies/enterprise registration (including foreign-invested enterprises), competition, consumer protection, trademark protection, and combating economic illegalities.

All companies (whether listed or unlisted) register with the AIC in accordance with the Company Law (2013) and the Measures of the Administration of Company Registration (2014). The CG structure of a company (i.e. shareholders' meetings, board of directors, and board of supervisors) is written in the Articles of Association, which is submitted to AIC for company registration and approval in order to obtain a business licence. All licensed companies are required to publish annual reports (including a financial report) (also see Appendix IV.2).

Powers of the AIC include rule-making, compliance, investigation, and enforcement.¹³⁸

IV.4.2 Financial reporting and auditing oversight

All companies' financial and accounting reports must comply with the laws, administrative regulations, and rules issued by the Financial Department of the State Council (i.e. MOF and CNAO).¹³⁹ Companies must prepare financial reports annually which must be audited by an accounting firm recognised under the law.¹⁴⁰ Large and

¹³³ Securities Law, art 102

¹³⁴ Securities Law, art 114

¹³⁵ Securities Law, art 115

¹³⁶ Ibid

¹³⁷ Securities Law, art 121

¹³⁸ AIC, "Mission": Available at <http://www.saic.gov.cn/english/aboutus/Mission/> (visited 25 May 2016)

¹³⁹ Company Law, art 163

¹⁴⁰ Company Law, art 164

medium-sized companies must set-up an internal control system in order to improve CG and control risks in accordance with the Basic Internal Control Norms for Enterprises 2008 issued by MOF, CSRC, CNAO, CBRC, and CIRC.

Ministry of Finance

The MOF enforces the Accounting Law (1999), is in charge of supervising the implementation of accounting rules, and regulates registered accountants and accounting firms. Established in October 1998 under the MOF, the China Accounting Standards Committee is the advisory body for setting Chinese accounting standards. A review of compliance with accounting rules of listed companies is undertaken by CSRC and MOF, with a report published on the CSRC website.

The MOF is a government ministry whereas in Hong Kong the HKICPA is a statutorily-backed private body responsible for statutory-backed financial reporting and auditing standards, and registering Certified Public Accountants. Hong Kong's FRC is an independent statutory body that enquires into possible accounting standard non-compliance. Auditing and reporting irregularities are referred to the HKICPA by the FRC. Therefore, Mainland's financial reporting oversight design is more efficient and gives the government more direct control over the regulation of the profession and financial reporting in comparison to Hong Kong.

China Auditing Standards Board

The China Auditing Standards Board is a specialised board under the Chinese Institute of Certified Public Accountants that is responsible for developing Certified Public Accountant practice standards. This is similar to the role and structural design of the HKICPA.

National Audit Office of the People's Republic of China

The CNAO is the audit regulator of the government, government officers, and public institutions with funding provided by the Central Government, enterprises, and financial institutions directly owned by the Central Government, or which the Central Government has a controlling or dominant position. Established pursuant to Article 91 of the Constitution, the CNAO comes under the direction of the Premier of the State Council.¹⁴¹ Article 91 stipulates that the CNAO's powers of supervision are "subject to no interference by any other administrative organ or any public organisation or individual". Despite this statutory stipulation, as with other regulators in the Mainland, this stipulation is more form rather than substance as there have been incidents of financial fraud and reporting irregularities.

IV.4.3 Accountability of agencies

For the accountability hierarchy, see each regulatory agency in Appendix IV.6.

IV.4.4 Inter-regulator relationships and effectiveness

Working Group of the Standard Operation of Listed Companies

The CSRC has built a comprehensive regulatory framework whereby government departments jointly promote standard practices among listed companies. To enhance supervision and improve the CG of listed companies, the Working Group was established in 2005, led by CSRC in collaboration with 11 ministries of the State Council. Its members include:

¹⁴¹ CNAO, "About us": Available at <http://www.audit.gov.cn/en/n744/c68261/content.html> (visited 25 May 2016)

National Development and Reform Commission, Ministry of Public Security, MOF, Ministry of Commerce, People's Bank of China, SASAC, General Administration of Customs, State Administration of Taxation, AIC, CBRC, and the CIRC.¹⁴²

There is no available information on the frequency and content of the Working Group's meetings.

Since being established the Working Group has achieved a number of regulatory improvements to enhance the Mainland's CG framework. For example, strengthening coordination among regulators, promoting non-tradable share reform, preventing the misappropriation of capital by controlling shareholders, and promoting the standardisation of listed companies.¹⁴³

Basic Standard for Enterprise Internal Controls

To improve management and CG while mitigating risks, the MOF with the CSRC, CNAO, CBRC, and CIRC issued the Basic Standard. These regulatory bodies have also issued Guidelines for Application of Enterprise Internal Controls, Guidelines for Evaluation of Enterprise Internal Controls, and Guidelines for Auditing of Enterprise (2011). This is discussed in more detail in Appendix IV.4.6.

Regulatory overlaps

Auditing of financial reports is subject to regulatory overlap. The MOF and CSRC undertake annual random examinations of accounting firms. Further, provincial branches of the MOF and CSRC undertake examinations of accounting firms and listed companies within their provincial jurisdiction. The dual filing regime operated by the MOF and CSRC requires accounting firms to submit nine information forms and, if accounting firms have a securities qualification, nine additional information forms. Moreover, the CSRC requires accounting firms with securities qualifications to provide information on their accountants. Accordingly, different regulators require the same information in different formats. This is inefficient as listed company compliance costs are significantly increased and statistical comparisons obscured.¹⁴⁴

Listed SOE financial institutions must comply with securities regulations, SOE regulations, and relevant financial institution regulations.

Regulatory gaps

All companies are required to have an annual audit in accordance with the Company Law. Since 2014, Mainland companies (including listed companies)¹⁴⁵ do not have to submit an auditing report to the AIC.¹⁴⁶ The MOF, which is the regulator of registered accountants and accounting firms, does not supervise annual company audits. In addition, companies which authorise accounting firms to perform audits, pay their fees. This creates a conflict of interest between the company and accounting firm and lacks procedural independence.

¹⁴² 中国证券监督管理委员会,中国上市公司治理发展报告[M],中国金融出版社,(2010),p.14

¹⁴³ Ibid

¹⁴⁴ 中国上市公司治理,中国上市公司治理[M],(2014),pp.46-47.

¹⁴⁵ But listed companies need to publish their financial report in their annual report and this is under the supervision of CSRC. See IV.2.1

¹⁴⁶ Before 2014, all companies are required to hand in annual auditing report by an accounting firm, to AIC for annual inspection in order to renew its business license. But after the new amendment of the Company Law, AIC removed this requirement. Now Chinese companies can update their company information online and do not need to submit an auditing report. However, foreign-invested companies still have annual inspections and auditing reports of foreign currency are submitted by the accounting firms rather than the foreign-invested companies themselves

The problems with the auditing profession in the Mainland, including internal auditing, include the lack of auditor independence, shortage of well-qualified auditors, and corruption within the Mainland's audit market.¹⁴⁷

IV.4.5 Standing of listing requirements

Regulatory structure

CG legislation pertaining to listed companies, including laws (drafted by NPC and the NPCSC), administrative regulations (drafted by the State Council) and rules (drafted by the bureaus of the State Council, e.g. MOF, AIC, CNAO, etc.), are mandatory. (for details, see IV.3). Non-statutory regulatory documents issued and enforced by the bureaus of the State Council and self-regulations issued by the Exchanges (e.g. LRs) are mandatory.

Code of Corporate Governance

The CG Code is a non-statutory regulatory document, promulgated in 2002 by the CSRC and the State Economic and Trade Commission. It is the major standard for evaluating listed companies' CG by setting out the basic principles. For example:

(1) rights of shareholders; (2) rules for shareholders' meetings; (3) related-party transactions; (4) behavioural rules for controlling shareholders; (5) independence of listed companies; (6) director nominations; (7) duties and responsibilities of directors; (8) duties and composition of the board of directors; (9) rules and procedures of the board of directors; (10) independent directors; (11) specialised committees of the board of directors; (12) duties and responsibilities of supervisory board; (13) composition and steering of the supervisory board; (14) performance assessment of directors, supervisors, and management personnel; (15) selection of management personnel; (16) incentive and disciplinary systems for management; (17) stakeholders; (18) ongoing information disclosure; (19) disclosure of information regarding CG; and (20) disclosure of controlling shareholder's interests.

In comparison to Hong Kong's CG Code, the CSRC's CG Code is mandatory and is not subject to a "comply or explain" regime. Therefore, the CSRC CG Code carries greater legal weight, especially the enforcement of compliance with its principles. The HKEX CG Code, which is part of the LRs, is structurally different in two ways: (1) the CSRC CG Code is not part of the LRs - it is a standalone regulation; and (2) the CG Code is issued by the CSRC, not by an exchange. The CSRC is not subject to the conflict of the interest inherent to the HKEX (i.e. not regulating the Exchanges on which it is listed and having a business model based on promoting IPOs) and lacks independence from the government by being under State Council control. Amendments made to the CG Code or the process to promulgate a rule or regulation is more efficient and transparent than in Hong Kong (i.e. the HKEX must have the will and should have a legitimate regulatory reason to amend the LRs (CG Code) and then has to seek approval from the SFC). This raises some Byzantine issues for Hong Kong to strengthen listed companies' CG, and in doing so, become more aligned with the Mainland's CG model: Should the SFC be given sole power to amend the CG Code and by extension, the LRs? Should Hong Kong abandon the CG Code's "comply or explain" regime?

Internal controls

¹⁴⁷ See Beller, op. cit

The Basic Standards (2008) were issued collectively by the MOF, CSRC, CNAO, CBRC and CIRC, and became effective for listed companies in 2011. It applies to all listed companies incorporated in the Mainland except for those companies listed on the SZSE SME Board and ChiNext. SZSE SME Board and ChiNext companies are required to adopt the implementation guidelines (see below) when appropriate. Non-listed large and medium-sized enterprises are encouraged to adopt the Basic Standards.

The Basic Standards outlines how to establish, evaluate, and assess companies' effectiveness of their internal controls and for accounting firms to audit their effectiveness.¹⁴⁸ "Internal control" is defined as the process implemented by the board of directors, the board of supervisors, the management, and all employees of enterprises for realisation of the "control elements".

The five control elements are:

(1) internal environment (e.g. governance structure, organisational structure and distribution of powers and responsibilities, internal audit, human resource policies, and corporate culture, etc); (2) risk assessment (i.e. target setting, risk identification, risk analysis, and response); (3) control activities (i.e. segregated control of incompatible duties, control of authorisation, examination and approval, control of accounting system, control of assets protection, budgetary control, control of operational analysis, and performance appraisal); (4) information and communication (i.e. information quality, communication mechanism, information system, and anti-corruption mechanism); and (5) internal monitoring (i.e. day-to-day supervision and special supervision).

This is supported by three implementation guidelines:

(1) Application Guidelines for Enterprise Internal Control; (2) Guidelines for Assessment of Enterprise Internal Control; and (3) Guidelines for Audit of Enterprise Internal Control issued collectively by the MOF, CSRC, CNAO, CBRC, and CIRC (2011).

The Application Guidelines for Enterprise Internal Control contains detailed requirements on 18 aspects for establishing an internal control system, including:

(1) corporate structure; (2) development strategy; (3) human resources; (4) social responsibility; (5) enterprise culture; (6) capital activity; (7) purchase; (8) asset management; (9) sales; (10) research and development; (11) engineering project; (12) mortgage; (13) outsourcing; (14) financial report; (15) comprehensive budgeting; (16) contract management; (17) transmitting information inside the enterprise; and (18) information systems.

The Guidelines for Evaluation of Enterprise Internal Control provides assessments for the design and operation of internal controls. An internal control evaluation report is required to record the company's internal control position on 31st December every year, which is to be published by the end of April of the following year.

The Exchanges issue guidelines for the internal control of listed companies. (see Appendix IV.4.5)

Corporate governance rules and regulations (CSRC)

¹⁴⁸ KPMG, "The Basic Standard for Enterprise Internal Control," Available at <https://home.kpmg.com/cn/en/home/services/advisory/risk-consulting/international-audit-risk/the-basic-standard-for-enterprise-internal-control.html> (visited on 9 June 2017)

In contrast to the SFC, the CSRC issues and enforces a substantial number of CG rules and regulations. For example:

Measures for the Administration of Disclosure of Information of Listed Companies (2007);
Disclosure of Enterprise Information Regulations (2014);
Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders (2004);
Working Guidelines for Dealing with the Relationship Between Listed Companies and Investors (2005);
Rules of the General Meeting of Listed Companies (2006, amended in 2014);
Guidelines for the Establishment of Independent Directors System by Listed Companies (2001);
Rules of Equity Shares of a Listed Company Held by its Directors, Supervisors and Senior Management Personnel and Related Changes (2007);
Measures for the Administration of the Material Asset Restructurings of Listed Companies (2008, amended in 2014, revised in 2016);
Administration Measures for Initial Public Offering and Listing of Stocks (2006 revised 2015);
Administrative Measures for the Issuance of Securities by Listed Companies (2006); Administrative Measures for the Takeover of Listed Companies (2006, revised in 2014);
No. 3 Guideline for the Supervision of Listed Companies – Cash Dividends of Listed Companies (2013);
Administration Measures of Equity Incentives of Listed Companies (2016);
Guiding Opinions on Pilot Implementation of Employee Stock Option Plans of Listed Companies (2014); and
Guidelines on Information Disclosure Related to the Issuance of Preferred Shares by Listed Companies (2014).

This list is not exhaustive. These rules and regulations will be discussed briefly below.

Administrative Measures for the Disclosure of Information of Listed Companies (2007):

It regulates the disclosure of information by issuers, listed companies, and other information obligors. The information should not contain any false records, misleading statements, or serious omissions. An information disclosure obligor must simultaneously and openly disclose information to all investors. The issuer, directors, supervisors, and senior managers must perform their duties faithfully and diligently, and ensure that information will be disclosed truthfully, accurately, completely, fairly, and timely. Insider information disclosures and disclosure documents are covered by the measures.

Disclosure of Enterprise Information Regulations (2014):

It created a disclosure system - the publicly available AIC company information database. Companies input data in accordance with ongoing disclosures or following regulatory inspections and penalties.¹⁴⁹

Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders (2004):

¹⁴⁹ Hong Kong Lawyer, "China's New Company Information Disclosure System": Available at <http://www.hk-lawyer.org/content/china's-new-company-information-disclosure-system> (visited 9 June 2017)

It applies to listed companies to prevent the abuse of controlling shareholder rights and to establish legal protection of the lawful rights and interests of minority investors, especially public shareholders. Mechanisms include:

(1) implementing on trial a system for voting on major company decisions by general public shareholders; (2) establishing an independent director system and independent directors given full accessibility to information available to the other directors; (3) strengthening investor relation management and enhancing the quality of information disclosure; (4) implementing a proactive profit distribution policy; and (5) strengthening the supervision of listed companies and senior management personnel.

Working Guidelines for Dealing with the Relationship Between Listed Companies and Investors (2005):

Otherwise referred to as the "Working Guidelines", they are designed:

(1) to strengthen guidance in relation to listed companies' investor relations; (2) regulate the relevant behaviour; (3) enhancing investor relationships and information communication; (4) improving the CG structure; and (5) protect the lawful rights and interests of the investors (especially the general public investors).¹⁵⁰

The CSRC issued the Working Guidelines in accordance with the Company Law, the Securities Law, and Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of the Capital Market.

The main content of communication between a company and its investors must include:

(1) a development strategy for the company, including direction and plans, competition strategies, and business policies; (2) statutory information disclosure and corresponding explanations, including periodic reports and interim announcements; (3) information on business administration that can be disclosed according to law, including production and business operating status, financial status, research and development of new products and new technology, business performance, and profit distribution; (4) major events that can be disclosed according to law, such as major investments, asset restructurings, mergers and acquisitions, the provision of security to outside parties, affiliated transactions, etc.; (5) company culture; and (6) other relevant company information.¹⁵¹

Companies must set up a dedicated investor consultation hotline and facsimile number for investors.¹⁵² A company can hold, when necessary, a business performance session after the completion of a periodic report or conduct one-to-one communication with investors, fund managers, and analysts on the company's business and financial status. Companies cannot publish any unpublished material company information at the business performance session or during one-to-one communication sessions (i.e. disclosure must be publicly available to all shareholders simultaneously).¹⁵³

A company must appoint the secretary of the board of directors to be responsible for investor relations.¹⁵⁴ Major responsibilities of investor relations include:

¹⁵⁰ Art 1

¹⁵¹ Art 6

¹⁵² Art 12

¹⁵³ Art 15

¹⁵⁴ Art 19

(1) analysis and research of the number and composition of investors and potential investors; (2) communication and liaison with investors, analysts, and the media; (3) establishing public relations with the Exchanges, industry associations, media, and other listed companies, which includes maintaining the company's public image; and (4) other enhancement to investor relations.¹⁵⁵

Companies must establish a sound internal coordination mechanism/s and information gathering system/s.¹⁵⁶ Unless specifically authorised, senior management personnel or company staff cannot speak on behalf of the company in any investor relations activity.¹⁵⁷

Rules of the General Meetings of Listed Companies (2006, 2014):

These are prescribed pursuant to the Company Law and the Securities Law. The board of directors must perform its duties pragmatically and organise shareholder general meetings prudentially and timely. All directors must act diligently and responsibly to ensure that shareholders' general meetings are convened normally and must exercise their powers pursuant to the law.¹⁵⁸

Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001):

These are designed to improve CG structures and promote standardised operations. The Guidelines establish an independent director system and specifies the definition, fiduciary duties, obligation of diligence, required qualifications and basic conditions, the nomination, election, and replacement of directors, as well as advocating the advantages of such a system.

Rules of Equity Shares of a Listed Company Held by its Directors, Supervisors and Senior Management Personnel and Related Changes (2007):

These are designed to strengthen the management of shares and the shares held by the directors, supervisors, and senior management officers,¹⁵⁹ and set strict conditions on their share trading activities, including those likely to have a material effect on the share price.¹⁶⁰ (Also see: Rules of the SSE for the Sale of Shares by Shareholders, Directors, Supervisors and Senior Management of Listed Companies 2017 - implemented to standardise the transfer of shares by influential stakeholders).

Measures for the Administration of the Material Asset Restructurings of Listed Companies (2007):

Otherwise referred to as the "Material Asset Restructurings Measures", they are similar to the "Administrative Measures for the Takeover of Listed Companies (2014)" (see below) and apply to asset trading behaviours of a listed company or any company held or controlled by the listed company beyond its daily operating activities. For example, the purchase, sale, or otherwise trading of assets, which result in material changes in the principal business, assets, or revenues of the listed company (i.e. material asset restructurings). They apply to purchasing assets through the offering of shares by listed companies. However, they do not apply to the use of funds raised for the acquisition of

¹⁵⁵ Art 22

¹⁵⁶ Art 23

¹⁵⁷ Art 24

¹⁵⁸ Art 2

¹⁵⁹ Art 1

¹⁶⁰ Art 5

assets or for foreign investments in accordance with the purposes of funds raised as disclosed in a securities offering document approved by the CSRC.¹⁶¹

When conducting a material asset restructuring, the directors, supervisors, and senior management of a listed company must act in good faith, diligently perform their duties and safeguard the company's assets, and protect the legitimate rights and interests of the company and its shareholders.¹⁶²

The company must sufficiently explain material asset restructuring transactions' compliance with the following requirements and disclose any relevant information:

- (1) comply with the State's industry policies and the environmental protection, land management, and anti-monopoly laws and administrative requirements;
- (2) will not cause the company to be non-compliant with the listing requirements;
- (3) the price of assets involved is fair, and there is no damage to the legitimate rights and interests of the listed company and its shareholders;
- (4) the ownership of the assets involved is clear, and there are no legal obstacles for the transfer of the assets' title or transfer of the assets, and the relevant creditor's rights and debts are dealt with legitimately;
- (5) beneficial for the listed company's operations, and will not result in major assets being liquidated or the listed company having no specific business after the restructuring;
- (6) beneficial to maintaining independence between the listed company's business, assets, finance, staffing, organisation, and its actual controlling shareholder and related parties, and is compliant with the relevant CSRC provisions on independence of listed companies; and
- (7) beneficial for listed company to maintain a healthy and efficient CG structure.¹⁶³

Significant asset restructurings require approval by way of resolution at a shareholders' general meeting.¹⁶⁴ There are specific requirements for information disclosure and related-party transactions involving significant asset restructurings.¹⁶⁵ Directors, supervisors, and senior management are expected to act honestly and with integrity.¹⁶⁶ The CSRC enforces breaches of this duty, including the reporting of significant asset restructurings, which carry criminal and civil penalties, and can result in the restructuring being suspended or terminated.¹⁶⁷

Administration Measures for Initial Public Offering and Listing of Stocks (2015):

These measures complement the Securities Law and Company Law for IPOs. Areas covered include information disclosure, sponsors and their representatives, issuer qualifications, prospectus requirements, supervision, administration, and penalties. These measures do not apply to the subscription and trading of shares in domestic companies denominated in foreign currencies.¹⁶⁸

¹⁶¹ Art 2

¹⁶² Art 5

¹⁶³ Art 11

¹⁶⁴ Art 21. For the shareholders' general meeting to approve such a resolution, certain legal requirements shall also be strictly followed — such as two-thirds or more of voting rights represented by the shareholders who are present at the meeting, related parties shall abstain from voting, etc (Article 24)

¹⁶⁵ See, Arts 39 to 41

¹⁶⁶ Art 57

¹⁶⁷ See, Arts 54 and 193

¹⁶⁸ Art 2

Administrative Measures for the Issuance of Securities by Listed Companies (2006):

It requires that listed companies must establish a CG structure encapsulating requirements for:

- (1) information disclosure; (2) articles of association; (3) shareholders' meetings;
- (4) board of directors; (5) board of supervisors; (6) independent directors; (7) an efficient and lawful internal control system; and (8) reliable financial reports.

"Sustainable profit making abilities" is also a requirement defined as, inter alia, the company maintaining a favourable balance for the past three consecutive years, calculated on the basis of net profit after specified deductions.¹⁶⁹ The listed company must have no false records in the past 36 months and has not committed any illegal acts.¹⁷⁰ Article 11 specifies circumstances when a listed company will be prohibited from issuing shares. Allotments of shares to original shareholders must not exceed 30% of the total capital stock.¹⁷¹ Other issues covered include:

- (1) publicly raising shares against unspecified objects; (2) issuance of convertible corporate bonds, bondholder meetings, changes of guarantors or collateral; (3) prospectus requirements for sell-back clauses, (4) conditions for private offerings of stocks; and (5) issuance procedures and determinations.

Administrative Measures for the Takeover of Listed Companies (2014):

This standardises takeovers of listed companies and related issues, including:

- (1) shareholding interests; (2) protecting the legitimate rights and interests of listed companies and investors; (3) safeguarding the order of the securities market and public interest; and (4) promoting the optimum allocation of resources in the securities market.¹⁷²

Directors, supervisors, and senior management of a target company bear the duties of loyalty and diligence to the bidder company and must treat all acquirers who take over the company fairly.¹⁷³ Where a director of a listed company fails to perform his/her duty of loyalty and diligence and makes use of the takeover to seek improper gains, the CSRC must adopt regulatory measures such as holding a regulatory talk, issuing a warning letter, and may deem the director as an inappropriate candidate.¹⁷⁴ Takeovers are also subject to the Measures for the Administration of the Material Asset Restructurings of Listed Companies (see above).

No. 3 Guideline for the Supervision of Listed Companies – Cash Dividends of Listed Companies (2013):

This guideline standardises:

- (1) cash dividend distributions by listed companies; (2) enhances transparency of cash dividend distributions; (3) protects the legitimate rights and interests of investors; (4) strengthens the awareness of returns to shareholders; (5) improves the cash dividend distribution system; and (6) maintains consistency, reasonableness, and stability of the cash dividend distribution policy.

¹⁶⁹ Art 7 (1)

¹⁷⁰ Art 9

¹⁷¹ Art 12 (1)

¹⁷² Art 1

¹⁷³ Art 8

¹⁷⁴ Art 80

It ensures that the veracity of information disclosure for cash dividend distributions strictly follow the Company Law, the Securities Law, and the company's articles of association. The CSRC sets guidelines on, for example, the contents of companies' articles of association in the formulation of profit distribution policies and decision-making procedures.¹⁷⁵

The board of directors must conduct specialised research on shareholders' returns, prepare definite and clear plans on shareholders' returns, and elaborate on the reasons for planning and arrangements in other circumstances.¹⁷⁶ When deliberating over a detailed plan of cash dividend distributions at the shareholders' meeting, the board must communicate and discuss the plan with shareholders (especially to express different perspectives to minority shareholders), listen to shareholder opinions and demands, and answer questions in a timely manner.¹⁷⁷ (Also see: CSRC Circular, 2012; and CSRC, Guidelines of the Shanghai Stock Exchange on Cash Dividends of Listed Companies, 2013).

Administration Measures of Equity Incentives of Listed Companies (2016):

Equity incentives are long-term incentives granted in the form of the company's stock allocation to directors, senior executives, and other employees. This applies to the granting of restricted stock or stock options.¹⁷⁸ Directors, supervisors, and senior management must act in good faith, with due diligence, and safeguard the interests of the company and all shareholders during the implementation of equity incentive plans.¹⁷⁹ Article 7 outlines a substantial list of qualifications that prohibit the implementation of equity incentive plans.

Guiding Opinions on Pilot Implementation of Employee Stock Option Plans of Listed Companies (2014):

Otherwise known as "the Pilot Scheme", it is voluntary for employees of listed companies to participate. It lists basic principles, key contents, implementation procedures, information disclosure, and supervision. This includes:

- (1) implementation of an employee share option plan; (2) establishing and improving a benefit-sharing mechanism for employees and business owners; (3) improving CG levels; (4) enhancing employee cohesion and corporate competitiveness; and (5) achieving optimised allocation of social capital through the capital market.

Guidelines on Information Disclosure Related to the Issuance of Preferred Shares by Listed Companies (2014):

This is another pilot scheme. It requires that the preferred shares issued to the public must not contain provisions that allow their conversion to common equity.

Exchange requirements:

The Exchanges have responsibilities and powers to supervise listed companies.¹⁸⁰ Disciplinary procedures are handled by the Disciplinary Committee of the SSE or SZSE and appeals are heard by the Appeal Committee of the SSE or SZSE – these are handled in accordance with the "Measures of Implementation of Disciplinary Sanction and

¹⁷⁵ Arts 1 and 2

¹⁷⁶ Art 3

¹⁷⁷ CSRC Circular (2012), Paragraph III

¹⁷⁸ Art 2

¹⁷⁹ Art 3

¹⁸⁰ Art 11 and Measures of Administration of Exchanges, Part VII

Supervisory Measures of SSE” and the “Detailed Rules of Implementation of Disciplinary Sanction and Supervisory Measures of SZSE”. Further CG regulations pertaining to the Exchanges are discussed below.

Exchange rules

Rules Governing the Listing of Stocks on Shanghai Stock Exchange (revised 2012):

These rules apply to companies listed on the SSE Main Board. The SSE LRs regulate:

- (1) information disclosure; (2) responsibilities and restrictions of directors; (3) supervisors and senior managers; (4) related-party transactions; (5) listing requirements; (6) listing suspensions and delistings; and (7) supervisory measures and disciplinary sanctions.

To implement the “Notice of the State Council on Approving and Forwarding the Opinions of CSRC on Improving the Quality of Listed Companies”, the SSE issued the “Guidelines of Shanghai Stock Exchange for the Internal Control of Listed Companies” in 2006.

In 2005 the SSE issued the “Guidelines of Shanghai Stock Exchange for the Information Disclosure Management Bylaws of Listed Companies” and self-regulations for the:

- (1) board of directors; (2) the board of supervisors; (3) secretaries of the board of directors; (4) auditing committees; and (5) controlling shareholders of listed companies.

Stock Listing Rules of Shenzhen Stock Exchange (revised in 2014):

These rules apply to the companies listed on the Main Board and SME Board of SZSE and the Stock Listing Rules of ChiNext of SZSE (revised in 2014) apply to the companies listed on ChiNext. Both sets of rules contain regulations on:

- (1) information disclosure; (2) responsibilities and restrictions of directors; (3) supervisors and senior managers; (4) related-party transactions; (5) listing requirements; (6) listing suspensions and delisting; and (7) supervisory measures and disciplinary sanctions.

These are similar to LRs of SSE. Companies listed on ChiNext have lower minimum corporate capital requirements of 30 million CNY, as compared with companies listed on the Main Board and SME board (50 million CNY). The SZSE also issues the SSE Guide to Internal Control of Listed Companies (2006).

The SZSE issues self-regulations pertaining to the CG and operation of the companies listed on its boards. These include:

- (1) Guidelines of Shenzhen Stock Exchange for the Standard Operation of Listed Companies on the Main Board (2015); (2) Guidelines of Shenzhen Stock Exchange for the Standard Operation of Listed Companies on the Small and Medium-sized Enterprise Board (2015); (3) Stock Listing Rules of the Growth Enterprise Market of Shenzhen Stock Exchange (2014); and (4) Guidelines of Shenzhen Stock Exchange for the Standard Operation of Listed Companies on ChiNext (2015).

These guidelines provide general requirements for the:

- (1) CG structure; (2) conduct regulation of directors, supervisors, senior managers, controlling shareholders and actual controllers; (3) information

disclosure; (4) fund management; (5) internal controls; (6) relationships with investors; and (7) social responsibility.

Furthermore, the SZSE has issued the Memorandum on Main Board Information Disclosure, the Memorandum on Growth Enterprise Market Information Disclosure, and the Memorandum on Small and Medium-sized Enterprise Board Information Disclosure.

IV.4.6 Other observations

State-owned enterprises and state-owned assets

The SASAC, MOF, and CNAO are responsible for the CG of SOEs. In particular, the MOF is responsible for supervising state-owned assets in conjunction with the SASAC which is responsible for SOEs' assets (excluding financial enterprises) in accordance with the Company Law. Shareholder responsibilities on behalf of the state are exercised by the SASAC in accordance with the Company Law and the Law of State-owned Assets of Enterprises (2008). This covers non-financial enterprises structured as wholly SOEs, wholly state-owned companies and companies in which the State has a stake, whether controlling or non-controlling.

Furthermore the SASAC is responsible for:¹⁸¹

- (1) Enhancing the management of state-owned assets;
- (2) Preserving the value of state-owned assets;
- (3) Reforming and restructuring SOEs, the establishment of the modern enterprise system in SOEs, and improving SOE CG;
- (4) Appointing and removing top executives of supervised enterprises, evaluating executive performance; establishing a corporate executive selection system, and to improve the corporate management incentives and restraint system;
- (5) Dispatching supervisory panels to SOEs on behalf of the State Council and takes charge of the daily management of the supervisory panels;
- (6) Organising supervised enterprises to repatriate state-owned capital gains, participating in formulating management system and methods of the state-owned capital operational budget, and formulating and implementing the state-owned capital operational budget and final account; and
- (7) Formulating draft laws and regulations to manage state-owned assets.

The SASAC supervisory and disciplinary powers encompass, inter alia, civil servant disciplinary sanctions and the recovery of the illegal gains procured by directors, supervisors, and/or senior managers (for more details, see Appendix IV.6).

The MOF exercises shareholder responsibilities on behalf of the State in state-owned financial institutions.¹⁸² The MOF:

- (1) examines and summarises the drafts of budgets and financial accounts of state-owned assets;
- (2) makes rules and measures of management and prepares budgets of state-owned assets;
- (3) collects state-owned assets' profits;
- (4) establishes and implements the financial system of enterprises;
- (5) is responsible for the management of state-owned financial assets;
- (6) participates in establishing the management system of state-owned assets of enterprises; and
- (7) is responsible for the evaluation of state-owned assets.

¹⁸¹ SASAC, "About SASAC": Available at <http://en.sasac.gov.cn/n1408028/n1408521/index.html> (visited 25 May 2016)

¹⁸² The MOF is also responsible for: China National Tobacco Company, China Railway Company, China Publishing Group Corporation and China Arts & Entertainment Group, and supervises the state-owned assets in these enterprises

Further, the MOF supervises the financial affairs of SOEs which report directly to the central government.

The CNAO is responsible for auditing SOEs (for more details, see Appendix IV.4.1).

Financial industry regulators

As in Hong Kong, there is no single financial markets conduct regulator in the Mainland. Market conduct is regulated according to the different financial sectors. The financial regulators are not only gate-keepers but also responsible for the on-going conduct regulation of specific regulated industries. For example, the People's Bank of China for financial holding companies and credit organisations, CBRC for commercial banks, CSRC for securities and listed companies, and CIRC for insurance companies. The central bank and three financial regulators take a similar approach to regulation and enforcement. Special board committees are constituted primarily for the purpose of risk management.

The CBRC, CSRC, and CIRC issue additional CG requirements focusing on corporate structures and internal controls. There are numerous rules on CG standards both generally and specifically for securities and listed companies, insurance companies, and banking institutions. A brief summary of each regulatory ambit is provided below.

China Securities Regulatory Commission:

The CSRC is the regulator for:

- (1) listed companies;
- (2) securities companies;
- (3) futures companies;
- (4) investment fund management;
- (5) securities depository and clearing corporations;
- (6) futures clearing institutions;
- (7) securities and futures investment consulting institutions;
- (8) securities credit institutions; and
- (9) private equity companies.

This regulatory ambit encapsulates the issuance, listing, trading, custody, and settlement of stocks, bonds, and futures.¹⁸³

In terms of CG in the securities and futures industry, the CSRC enforces the Securities Law (revised 2014), the Code of Corporate Governance for Securities Companies (CSRC, 2012), and Guidance on Internal Control of Securities Investment Fund Management Companies (CSRC, 2002).

Under the "Code of Corporate Governance for Securities Companies", securities companies are required to comply with CG requirements pertaining to:

- (1) shareholders;
- (2) shareholders' meetings;
- (3) directors;
- (4) the board of directors;
- (5) special committees of the board of directors;
- (6) external professionals such as independent directors;
- (7) senior management personnel;
- (8) supervisors;
- (9) board of supervisors;
- (10) customer relations;
- (11) incentive and disciplinary mechanisms; and
- (12) articles of association.

Further, securities companies must establish internal control systems beyond those required of other listed companies in accordance with the Guidance on Internal Control of Securities Investment Fund Management Companies (CSRC, 2002). The CSRC has rule-making, investigatory, supervisory and disciplinary powers (for more details, see Appendix IV.6). These powers extend to authorising an accounting firm or an asset appraisal institution to audit or appraise a securities company with respect to its financial position, internal controls, and asset values.¹⁸⁴

¹⁸³ CSRC, op. cit, note 134

¹⁸⁴ Securities Law, art 149

China Banking Regulatory Commission:

The CBRC supervises:

(1) commercial banks; (2) urban credit cooperatives; (3) rural credit cooperatives; (4) policy banks; (5) financial asset management companies; (6) trust and investment corporations; (7) financial companies; and (8) financial leasing companies.¹⁸⁵

In terms of CG, the CBRC enforces the Law of the People's Republic of China on Commercial Banks, Guidelines on the Corporate Governance of Commercial Banks (CBRC, 2013), and Guidelines on Internal Control of Commercial Banks (CBRC, 2014).

Commercial banks must comply with additional CG requirements pertaining to:

(1) a sound organisational structure; (2) clear responsibility boundaries; (3) effective risk management and internal controls; (4) shareholders; (5) shareholders' meetings; (6) duties of the board of directors; (7) senior management; (8) responsibilities of the supervisory board; (9) appropriate incentive and disciplinary mechanisms; (10) good value criterion and social responsibility; (11) strategic planning; and (12) asset management.¹⁸⁶

Further, commercial banks must establish internal control systems beyond other listed companies in accordance with the Guidelines on Internal Control of Commercial Banks (CBRC, 2014). The CBRC has rule-making, investigatory, supervisory, and disciplinary powers.

China Insurance Regulatory Commission:

The CIRC supervises insurance activities in Mainland which includes:

(1) commercial insurance companies; (2) insurance groups; (3) insurance holding companies; and (4) insurance asset management companies.

In the context of CG, the CIRC enforces the:

(1) Insurance Law of the People's Republic of China (2009); (2) Guiding Opinions on Regulating Governance Structure of Insurance Companies (CIRC, 2006); (3) Basic Rules for the Internal Control of Insurance Companies (CIRC, 2010); (4) Measures on Evaluation of Insurance Company Corporate Governance (CIRC, 2015); and (5) Administrative Rules on the Qualification of Director, Supervisor and Senior Management Personnel of Insurance Companies (CIRC, 2014).

In the context of CG, insurance companies, insurance group (holding), and insurance asset management companies must comply with governance requirements of shareholders, shareholders' meetings, directors, board of directors, independent directors, special committees, senior management, board of supervisors, related-party transactions, information disclosure, and regulation of the governance structure.¹⁸⁷ Furthermore, insurance companies require internal control systems beyond those of other listed companies in accordance with the Basic Rules for the Internal Control of Insurance Companies (CIRC, 2010). The CIRC has rule-making, investigatory, supervisory, and disciplinary powers.

¹⁸⁵ Law of the People's Republic of China on Regulation of and Supervision over the Banking Industry, art 2

¹⁸⁶ CBRC, "Guidelines on the Corporate Governance of Commercial Banks," (2013)

¹⁸⁷ CIRC, "Guiding Opinions on Regulating Governance Structure of Insurance Companies," (2006)

Private companies

Private companies need to register with the AIC and comply with financial reporting requirements pursuant to the Company Law and the Measures of the Administration of Company Registration (2014).

There is no CG regulation of private companies, other than the Company Law provisions. Private companies have to set-up a CG structure (three bodies within the company: shareholders' meeting, board of directors, board of supervisors), which is written into the articles of association, and they must submit documents to the AIC for company registration.

Whistle-blowing

The Constitution grants Chinese citizens the right to whistle-blow and provides protection against retaliation.¹⁸⁸ China's Anti-Corruption Bureau was established in 1995 under the supervision of the Supreme People's Procuratorate (SPP) which subsequently issued the "Rules of the People's Procuratorates on Whistle-blowing Work" (SPP Rules) in 1996 (amended in 2009 and 2014). The aim of SPP Rules is to "guarantee the smooth progress of whistle-blowing work".¹⁸⁹

The Mainland passed the Basic Standards in 2008, which contains whistle-blowing provisions (Article 43) and requires companies to set up mechanisms to detect fraud. Although critics in the regulatory and business sectors were sceptical about the Basic Standards' effectiveness, citing reasons such as vagueness of the text, the inadequacy of the legal system, and an ingrained culture of not causing trouble for superiors, it has been argued that the vagueness of the provision also allows companies to experiment with different channels of whistle-blowing reporting that are best suited to their needs. As for culture, the events that took place during the cultural revolution and more recent examples of residents and employees taking action to monitor local industries for violation of the environmental law, suggest that Mainland people are capable of overcoming the traditional culture of not wanting to cause trouble for superiors. Furthermore, two crucial factors could contribute to the success of Mainland's whistle-blower protection:

- (1) the success of the Mainland's Labour Contract Law and Labour Dispute Resolution Law, and the ability of these laws' arbitration procedures to effectively enforce the Mainland's whistle-blowing rules against employer retaliation; and (2) the Mainland's ability to learn from the United States experience of private sector whistle-blower protection and thereby avoiding its pitfalls, although much depends on whether the Mainland is willing to take the necessary steps to implement such protections in practice.¹⁹⁰

The Basic Rules for Enterprise Internal Control requires listed companies to have a whistle-blowing policy by setting up a whistle-blowing hotline. Large and medium-sized unlisted companies are encouraged to follow the Basic Rules.

More recently, the Mainland has backed whistle-blowing in the fight against corruption involving government officials. The SPP, Ministry of Public Security, and MOF have jointly released new regulations offering greater protection and incentives for whistle-

¹⁸⁸ Art 41(2)

¹⁸⁹ Susan Munro, Lucinda Low, Bo Yue, and Yongli Xu, "China Supreme People's Procuratorate Strengthens Protection for Whistleblowers," (4 November 2014) *Steptoe & Johnson LLP*

¹⁹⁰ See Beller, *op. cit*

blowers.¹⁹¹ This is likely to have a significant impact on SOE CG standards. The regulations provide comprehensive and confidentiality protection measures to handle whistle-blower reports and protect whistle-blowers who provide tips about government officials committing crimes such as corruption, official bribery, embezzlement, and malfeasance. Rewards are provided to encourage whistle-blowing. There are regulations against retaliation which include threats to the safety or property of whistle-blowers and their close relatives, and also other covert measures such as terminating employment, demotion, or withholding approval of applications without proper justification. Increased safety and protection is provided for whistle-blowers, their close relatives, and their property. Rectification measures are coordinated by the whistle-blowing authorities with other relevant authorities in the form of assistance or subsidies.

Although the new regulations target Mainland officials, whistle-blower complaints involving multi-national corporations may attract an investigation by Mainland authorities or the attention of foreign enforcement bodies such as the United States Department of Justice, SEC, or the UK Serious Fraud Office.

¹⁹¹ SPP, Ministry of Public Security, and MoF, "Several Provisions of the Supreme People's Procuratorate, The Ministry of Public Security and the MoF on Protecting and Rewarding Whistleblowers of Occupational Crimes," (30 March 2016): Available at <http://en.pkulaw.cn/display.aspx?cgid=267857&lib=law> (visited 11 November 2017)

Appendix IV	5. Other influences	IV.5 Mainland China
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Introduction

There are a number of other influences which shape the Mainland's CG system. These influences include the CCP's organisation control of SOEs (also discussed in Appendix IV.1), the media, controlling shareholders, and institutional shareholders. Each influence will be discussed.

IV.5.1 Chinese Communist Party

The CCP plays a crucial role in many aspects of CG, including reducing state shareholding, establishing stock exchanges, and introducing every major CG plan. A CCP organisation must be established in a company (i.e. limited liability and limited by shares) to carry out the activities of the CCP in accordance with the Charter of the CCP.¹⁹² Companies must provide necessary conditions for the activities of CCP.¹⁹³ In an SOE, the CCP organisation undertakes a key role in politics. The CCP organisation oversees the implementation of the principles of the CPP and the political direction of the State in SOEs. This includes making active contributions to promoting the sustainable and sound development of the Mainland economy and society.¹⁹⁴

The CCP organisation influences the CG of SOEs through its active participation on the board of directors. For example, the CCP organisation of SOEs has the power to reduce senior management's executive compensation.¹⁹⁵ Proposals are usually discussed by CCP organisation before the board makes a formal decision. If the members of the board and CCP organisation are the same, arguably this process produces efficiencies as time and resources can be reduced. A 2012 empirical study revealed that SOEs perform better when the vice-secretary of the CCP organisation is also the chair of the board of directors, the chair of board of supervisors, or the general manager. SOEs were found to have better CG, as the Chief Secretary of the CCP acts as a "check" of the vice-Secretary's decisions. However, if the Chief Secretary of the CCP organisation is also the chair of board of directors—which is allowed according to the Decision of 4th Plenary Session of the 15th Central Committee of the CCP—this will have a negative impact on an SOE's CG because power is concentrated in one person who is not subject to checks by a higher authority.¹⁹⁶

SOEs listed in Hong Kong have recently established CCP committees. The HKEX and SFC have taken a benign attitude towards this change. However, as the influence of the committee is likely to be real, and yet uncertain and unaccountable to shareholders, this may affect foreign investor confidence.¹⁹⁷

IV.5.2 Media

The media consists of a combination of state-run and independent outlets. State-run

¹⁹² Company Law, arts 2 and 19. Charter is also termed the "constitution"

¹⁹³ Ibid, art 19

¹⁹⁴ See, Guiding Opinions of the Central Committee of the Communist Party of China and the State Council on Deepening State-Owned Enterprise Reform (2015)

¹⁹⁵ 马连福, "王元芳, 沈小秀: 国有企业党组织治理、冗余雇员与高管薪酬契约" "Governance of CCP Organization, Redundant Employees and Executive Compensation of SOEs," 管理世界 (2013)(5), pp.100-115

¹⁹⁶ 马连福, "王元芳, 沈小秀: 中国国有企业党组织治理效应研究——基于"内部控制人"的视角" "Research on Governance Effects of China's State-owned Companies' Party Organization – A Perspective Based on "Insiders Control"," 管理世界, (2012)(8), pp.82-95

¹⁹⁷ Yam, op. cit

outlets are the largest and most influential.

Chinese media influences CG by investigating and exposing the misconduct of large companies and improving information disclosure. For example, the January 2012 China Securities Journal reported that Susino (梅花伞, 002174) acquired a mining company which had no mining license. On 31 January 2012, Susino immediately made a public announcement concerning the acquisition.¹⁹⁸ Online media also plays an important role. For example, news posted in online discussion forums and websites reported that Zixin Pharmaceutical Industrial Co. Ltd (紫鑫药业, 002118) had fraudulent financial statistics. Consequently, Zixin made a public announcement addressing the matter.¹⁹⁹ In another example, media reported that a branch of Sinopec spent millions of CNY to purchase wine for personal use. This led to an investigation by Sinopec and a public disclosure in relation to the issue.

The media is not always successful in coercing companies to address misconduct. In these instances government regulation is required to correct misconduct. A study of a famous traditional Mainland liquor provider, Wuliangye, revealed the controlling shareholder's misconduct, and the share price fell following news reports. The controlling shareholder's misconduct continued, highlighting a CSRC supervisory failure.²⁰⁰

According to a 2003-2004 empirical analysis of 50 listed companies having board of directors with the weakest CG, a company is more likely to correct misconduct if it is reported by the media (i.e. 79% of cases of misconduct are corrected when reported; 38% if unreported). This is primarily due to a government regulator becoming involved following media exposure.²⁰¹ For example, the media reported that Sanlu, a large dairy producer, sold melamine-tainted milk powder in 2008. The State Council issued an I Level Response of Nation Food Safety (i.e. I Level being the highest). Following an investigation by regulators, Sanlu was ordered to halt its operations and help affected persons. Sanlu entered bankruptcy in 2009 and the Chair of the board was sentenced to life imprisonment.

Foreign media also plays a role when Chinese companies are listed on overseas exchanges. For example, Longtop Financial Technologies, a company listed on the NYSE, was exposed for having fraudulent financial statements in 2011. The United States media investigations were extensive and critical, which helped expose the extent of the fraud and highlighted the problem of over-reliance on written reports without physically examining operations in the Mainland.

IV.5.3 Controlling shareholders

Most listed companies in the Mainland have one large shareholder (i.e. 一股独大, 30% of the shares or more) which may give rise to "tunnelling" (i.e. the diversion of corporate resources from the corporation or minority shareholders to the controlling shareholder).²⁰² The majority of the companies listed on the SSE Main Board are SOEs. From 2008 to 2012, shareholdings in listed SOEs consisted of the State, holding approximately 39% of shares, while the second to tenth largest shareholders held 15% combined.²⁰³

Around one-third of all the listed companies are family businesses according to Forbes

¹⁹⁸ 施如海, 黄, "梅花伞:媒体[新闻]," 中国[新闻](3 February 2012). 梅花伞, 梅花伞[新闻] (2012-006), (31 January 2012)

¹⁹⁹ 紫鑫药业, "吉林紫鑫[新闻](2011-029)," (29 July 2011)

²⁰⁰ [新闻], "魏明海, 刘峰, 利益[新闻] (2008)(10)

²⁰¹ 李培功, "沈[新闻], 媒体的公司治理作用: 中国的[新闻] (2010)(4)

²⁰² 胡汝银, "中国公司治理: 当代视角[M], 上海人民出版社," (2010), pp. 95-101

²⁰³ 李[新闻], "刘小元, 国有控股上市企业[新闻]: 2007—2012 年的一个[新闻] (2015)(7)

(2012-2014) (see Appendix IV.1) In companies characterised by one controlling shareholder, the controlling shareholder plays a dominant role in decision-making, the election of directors, information disclosure, and daily operations.

The main problems of having one controlling shareholder includes:²⁰⁴

(1) misappropriation of corporate funds (e.g. in 2009, re Lawton Development Co., Ltd (罗顿发展, 600209) received an order from the Hainan Branch of CSRC due to the misappropriation of funds by its controlling shareholder between 1999 to 2008); (2) control over the shareholders' meeting, the board of directors, and the supervisory board (according to an SSE survey, more than half of all boards of directors are appointed by the largest shareholder); and (3) manipulation of financial reporting.

The controlling shareholder is tempted to fraudulently misappropriate corporate profits because of the conflict of interest and information asymmetries between the controlling shareholder and minority shareholders.

Scholars have studied potential reforms to the ownership structure of SOEs and how this would affect corporate performance. One opinion suggests that a diversified ownership structure can improve corporate performance.²⁰⁵ Others argue that CG is not improved merely through the sale of shares to non-state shareholders. In comparison to SOEs where the state is the sole shareholder, companies which have a non-state controlling shareholder and where the state is the second largest shareholder heightens the problem of tunnelling.²⁰⁶

IV.5.4 Institutional investors

Activism

In recent years, institutional investors, such as securities investment funds, insurance companies, pension funds, securities companies, commercial banks, and QFIIs have become more influential on CG practices because of significantly increased shareholdings. Some institutional investors, particularly securities investment funds, have abandoned their speculative trading role and become more actively involved in the CG of the companies in their portfolios. In securities investment funds' role as a speculative trader, protesting against poor CG by selling a company's shares drives down the share price resulting in losses. This is why securities investment funds have become the most active investors—their holdings are so large that engaging with portfolio companies is a better way to reduce governance risks arising from low levels of disclosure and transparency. Activist investors have compelled the promulgation of CG rules designed to protect minority shareholders which in turn has shaped CG standards. However the level of activism remains low due to ownership structures, self-interest, conflicts of interest, collective action problems, and legal and regulatory rules that raise CG participation costs.²⁰⁷ A rare example is the recent attempt by majority shareholder of China Vanke, Baoneng Group, to remove the founder and chairman of China Vanke, Mr Wang Shi.²⁰⁸ Wang Shi agreed to step down after his term as Chairman ended and he

²⁰⁴ 胡汝银, "中国公司治理: 当代视角[M], 上海人民出版社," 2010, p.103-112

²⁰⁵ 李国, "刘小元, 国有控股上市企业治理: 2007—2012 年的一个案例[N], 中央财经大学," (2015)(7)

²⁰⁶ 涂国前, "刘峰, 制衡股——来自中国民营企业的启示[N], 管理世界," 2010(11)

²⁰⁷ Chao, op. cit, p. 108

²⁰⁸ Ryan McMorro, "Vanke Founder Wang Shi, Chinese Property Developer, Steps Down," (21 June 2017) *New York Times*: Available at <https://www.nytimes.com/2017/06/21/business/wang-shi-china-vanke-group.html?mcubz=3> (visited 29 September 2017)

managed to fend off Baoneng's hostile takeover attempt with the help of two other substantial shareholders - Shenzhen Metro Group and China Evergrande.²⁰⁹

Foreign investors

Foreign investors under the QFII scheme:

"have not, as a group, demonstrated a strong interest in corporate governance matters. Over time, however, it is anticipated that the QFII scheme will lead to more market-driven improvements in corporate governance practices."²¹⁰

Investors have generally taken two forms of activism in Mainland by voting and by presenting a shareholder's proposal at a shareholders' meeting.

Shareholder voting

As key corporate decisions are made by shareholders in the general meeting, controlling shareholders (e.g. the state which owns non-tradable shares in SOEs) can vote in their interest (and which shareholders can do as owners of proprietary rights). Institutional investors do not, on their own, have enough votes to challenge controlling shareholders. However, institutional investors have been successful in pushing for regulations whereby companies have to adopt rules that require minority shareholder approval for controlling shareholder transactions. For example, under CSRC regulations (2002), if new shares are issued for a cash offer that exceeds 20% of the company's outstanding shares, the cash offer must be approved by a majority of the tradable shareholders, voting at the shareholder's meeting. In 2004, following institutional investors voting against cash offers²¹¹ and convertible bond issues²¹² on numerous occasions, the CSRC extended its regulation on cash offers to all major corporate transactions affecting tradable shareholders. Furthermore, the share structure reform compensation scheme requires approval by at least two-thirds of the votes of tradable shareholders.

Institutional investors have been able to assert significant influence on portfolio companies' proposals for share structure reform, through private meetings with portfolio companies, controlling shareholders, and by voting.²¹³ The adoption of a cumulative voting system for the election of directors and supervisors—under the CG Code,²¹⁴ Minority Shareholder Protection Provisions 2004,²¹⁵ and Company Law 2005²¹⁶—has provided activist investors power to appoint their preferred candidates to the board. As of 2005, there were no reported cases of institutional investors exercising their voting powers. This may be explained by the then low level of shareholdings held by institutional investors, restricting their ability to exercise effective voting power. Many fund managers have pledged (in fund contracts) not to invest with a view of exercising control or management over a portfolio company.²¹⁷ Recently, a pilot scheme of Minority Shareholder Service Centre (see above for details) has been launched, composed of professionals entitled to hold up to 100 A-class shares of listed companies in pilot

²⁰⁹ Summer Zhen, "Shenzhen's shield around Vanke should ward off hostile takeovers," (29 March 2017) *SCMP*: Available at <http://www.scmp.com/business/companies/article/2083119/shenzhens-shield-around-vanke-should-ward-hostile-takeovers> (visited 29 September 2017)

²¹⁰ CFA Institute, *op. cit.*

²¹¹ For example, the ZTE's proposal plan to dual list and issue cash offer in SEHK in 2002, and Foton Motor's cash offer plan in 2003

²¹² China Merchant Bank's convertible bond issues proposal in 2003

²¹³ For example, Shenzhen Yantian Port Co, Shanghai Airport Co, Shanghai 3F New Materials Co, Xishan Coal and Electricity Power Co and Hailuo Cement Co's compensation schemes

²¹⁴ Art 31

²¹⁵ Art 1(4)

²¹⁶ Art 106

²¹⁷ Chao, *op. cit.*, pp. 146-147

regions and to exercise rights as ordinary shareholders on behalf of minority shareholders.²¹⁸

Shareholder proposals

The Opinion on the Standards for Shareholders' Meetings of Listed Companies (2000) provides shareholders, representing not less than five percent of the total voting rights, with the power to make a proposal for a resolution at the shareholders' meeting. Institutional investors involved with China Vanke were able to put forward an alternative proposal - the threshold triggering the shareholder approval requirement for the provision of a guarantee by the company to related parties must be based on the company's net assets - not the company's total assets, as was proposed by China Vanke's board.²¹⁹

²¹⁸ Jian and Yu, op. cit

²¹⁹ Chao, op. cit, pp. 121-122

Appendix IV	6. Enforcement	IV.6 Mainland China
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Introduction

Enforcement is perhaps the weakest link in the Mainland's CG system. Although there are routine enforcement actions more can be done (as in other jurisdictions). The main enforcement regulator is the CSRC. In terms of system design, the Mainland's system gives regulators, in particular the CSRC, sufficient powers to enforce CG standards. An obstacle to effective enforcement is political interference by the State regarding enforcement actions against certain companies or individuals and, as identified by the IMF, a lack of resources (see Appendices IV.1.2 and IV.2.1).

The main problem for Hong Kong, however, is not whether there is adequate enforcement of CG standards in the Mainland, rather the enforcement of HK CG standards against Mainland companies listed in Hong Kong that are not listed in the Mainland (i.e. Red Chips or H-shares). These companies fall between two regulatory stools; the CSRC has no incentive and no jurisdiction to regulate these companies, and the SFC and the HKEX have no reach over directors and business operations that are physically in the Mainland. The SFC or foreign regulators often have to resort to other means for successful enforcement when dealing with the CSRC. For example, Hanergy Holding Group Ltd (Hanergy Group) is a private company with a head office in Beijing, that is incorporated but not listed in the Mainland. Hanergy Group holds shares in Hanergy Thin Film Power Group Ltd (HTF), a SEHK listed company, incorporated in Bermuda (i.e. a Red Chip company), that is not listed in the Mainland. When the SFC investigated into the trading of HTF and asked the CSRC for co-operation in accessing Hanergy Group's bank records in the Mainland, the CSRC could not provide assistance as Hanergy Group is not listed in the Mainland and, therefore, outside of the CSRC's regulatory jurisdiction. The SFC was able to sanction the chairman of HTF because the Chief Executive Officer (CEO) did not contest the civil action brought by the SFC against the chairman. However, this was more based on lifting of the ban on the company's share trading by the SFC.

Another example is Standard Water Ltd, a private company incorporated in the Mainland which has a head office in Beijing, but is not listed in the Mainland. Standard Water applied to the SEHK for listing in 2009 but withdrew its application when its accountant, EY Hong Kong, resigned in March 2010. The case centres on the issue of the SFC lacking jurisdiction to access company accounting records in the Mainland held by a company or its auditors. Assistance was sought from the CSRC without success and the accountant (EY) refused to hand over the accounts. To obtain access to the company's accounts in the Mainland, the SFC had to resort to legal proceedings against EY in Hong Kong under section 185 of the Securities and Futures Ordinance. EY lost in the Court of First Instance (Hong Kong) and sought an appeal, which was eventually dropped almost three years after the SFC began legal proceedings (2015) when the relevant accounting records from the Mainland were produced by EY in compliance with the original court order.

Another example involved Hontex International Holdings Co Ltd (Hontex), a company with a head office in Fujian Province China, incorporated in the Cayman Islands (i.e. a Red Chips), and listed on the SEHK. Hontex is not listed in the Mainland. Although the SFC sought assistance from the CSRC, the assistance provided by the CSRC is unclear (i.e. especially since Hontex is not a listed company in the Mainland and, therefore, not directly within the CSRC's jurisdiction). The case was the first legal proceeding brought by the SFC pursuant to section 213 of the Securities and Futures Ordinance that allows the court to grant a range of court-based orders upon application by the SFC. The SFC

sought evidence regarding the disclosure of false and misleading information in Hontex's prospectus (2009). Orders were granted by the Court of First Instance (Hong Kong) which included, inter alia, a repurchase offer to investors who had subscribed to Hontex shares in the IPO (2012). The success of this case was probably due to Hontex's own admission of making false statements in the prospectus.

Turning to some examples from Singapore, China Sky Chemical Fibre Company Co Ltd (China Sky) is listed on the SGX, a Cayman Islands incorporated company that has a principle place of business in Quanzhou City, Fujian Province, China. China Sky is not listed in the Mainland. Although the Monetary Authority of Singapore (MAS) acknowledged the CSRC's assistance in the case, there is some ambiguity as to what kind of assistance the CSRC was able to provide and under which regulatory jurisdiction. The MAS was successful in an enforcement action against China Sky probably because it obtained a court order to freeze the CEO's US\$3.7 million bank account in Singapore which eventually led to his admission of making misleading statements in relation to China Sky's purchase of land in Fujian (2015).

A final example involves China Aviation Oil (CAO), a SGX listed company headquartered and incorporated in Singapore. CAO is not listed in the Mainland. Extensive losses were incurred by the company which triggered an MAS/SGX investigation. The company refused to cooperate fully with MAS/SGX as did the Chinese authorities. MAS imposed a S\$8 million civil penalty on the Beijing parent of China Aviation Oil—China National Aviation Fuel Group Corporation (a large Chinese SOE). After the parent sold a 15% stake in CAO following some losses but prior to disclosure, MAS concluded that the parent had admitted to insider trading. Co-operation was eventually obtained from CAO's parent, probably because of strong media coverage and public interest, as CAO wanted to resume operations in Singapore and, therefore, backed a restructuring plan for CAO. CAO's parent voluntarily sent CAO and CAO's parent's ex-CEO to Singapore to face court proceedings. The CEO was subsequently jailed, the first person in Singapore for insider trading (2006).

IV.6.1 Laws and regulations

See Appendices IV.3 and IV.4 for a discussion of legislation and regulations respectively, pertaining to enforcement actions in the courts and by administrative action.

IV.6.2 Offences

People's Procuratorate

The People's Procuratorate initiates criminal procurations, investigates bribery, corruption, and malpractice of state functionaries.²²⁰ In Hong Kong this function is performed by the Department of Justice.

Ministry of Public Security

The Ministry of Public Security investigates crimes.²²¹ A number of functional departments constitute the Ministry. These include, inter alia, the Department of Securities Criminal Investigation which has three branches— Beijing, Shanghai and Shenzhen—and is in charge of investigating securities industry crimes. The Department of Economic Criminal Investigation, which has branches in every province and municipal city, is in charge of investigating economic or commercial crimes other than the securities industry. This is similar to the Hong Kong Police Force and its Commercial Crime Bureau.

²²⁰ Criminal Procedure Law of the People's Republic of China, art 3

²²¹ Ibid

The People's Court

The People's Court hears criminal and civil cases. For criminal cases, the Ministry of Public Security, People's Procuratorate, and People's Court can ask the CSRC to assist with their investigations in accordance with judicial opinions of the Supreme People's Court. When a civil claim is made involving false statements, the court will not hear a case unless the CSRC makes a decision to impose an administrative sanction. There are no judicial opinions relating to other securities industry misconduct. In Hong Kong the courts do not have the power to ask the CSRC or the HKEX to assist with investigations because of the common law legal system, which is in contrast to the civil legal system in the Mainland.

IV.6.3 Administrative sanctions

Administrative sanctions are sourced from legislation enacted by the NPC and administrative regulations promulgated by the State Council.

There are seven administrative sanctions pursuant to the Law of the People's Republic of China on Administrative Penalty:

(1) disciplinary warning; (2) fine; (3) confiscating illegal gains or unlawful property; (4) an order to suspend production or business; (5) suspension or revocation of permit or licence; (6) detention; (7) other administrative sanctions provided by laws; and (8) administrative rules and regulations.²²²

The regulators (discussed below) enforce administrative sanctions with decisions being published.

IV.6.4 Listed companies

China Securities Regulatory Commission

The CSRC is the principal securities industry regulator (also see Appendix IV.4). Its powers include rule-making, investigatory, supervisory, and disciplinary. Laws and regulations enforced by the CSRC are the Securities Law, the Rules for Corporate Governance of Securities Companies, and related regulations. The CG Code issued by CSRC is the primary standard for evaluating the CG of listed companies.

Listed company sanctions:

There are a range of powers that the CSRC can exercise. The CSRC can order a listed company to make a correction and issue the following sanctions:

(1) confiscate illegal gains; (2) fine; (3) issue warnings; (4) order a halt on offerings or transactions; and (5) temporarily or permanently ban its directors, supervisors, or senior managers.²²³

The CSRC has taken a strong stance against manipulative behaviour and takes firm action against any attempts to disrupt the market. Habitual offenders are recorded in the Market Integrity File and monitored closely. Repeat offenders are subject to zero tolerance.²²⁴ In 2013 a detailed statement was issued that explains how the CSRC

²²² Art 8

²²³ Securities Law, arts 188-235

²²⁴ CSRC, "CSRC Successful crackdown on the first cross-border manipulation case under Shanghai-Hong Kong Stock Connect", (21 November 2016) *News Release*: Available at

intends to strengthen enforcement with its supervisory departments and regional offices.²²⁵ This includes:

- (1) boosting the capability in detecting and processing that leads to violations;
- (2) improving case investigations and management mechanisms;
- (3) contributing to optimising the separation of investigations and sanctions;
- (4) reinforcing enforcement coordination within and outside the regulatory system;
- (5) adopt stronger enforcement monitoring and accountability assessments; and
- (6) bolster enforcement institution safeguards.

Publications:

The CSRC publishes and reviews the decisions of administrative sanctions, and from 2008 onwards has released an annual regulatory information disclosure report. Since 2004 the CSRC has been issuing a monthly White Paper (including CSRC regulatory documents, administrative approvals, news, and market statistics). According to the 2015 regulatory information disclosure report, the CSRC has imposed 63 administrative sanctions, nine prohibitions on entry to the securities market (including bans on directors, supervisors, and senior managers of listed companies, and prohibitions on securities market practices), and 36 administrative sanction decisions were reviewed and published.²²⁶

Accountability:

The CSRC is accountable to the State Council (vice-premier in charge).

Co-operation with the Securities and Futures Commission (Hong Kong):

In 1993, the CSRC signed an MoU with the SFC on cross-border enforcement and co-operation to regulate H-shares. The regulators have successfully investigated and dealt with a cross-border market manipulation of shares incident involving a Shanghai-Hong Kong Stock Connect scheme listed company. On 17 October 2014, the CSRC and SFC signed an MoU on "Strengthening of Regulatory and Enforcement Co-operation under Shanghai-Hong Kong Stock Connect", which complements practices in relation to, among other things:

- (1) enforcement co-operation;
- (2) alerts and the exchange of investigatory information;
- (3) joint investigations
- (4) service of documents
- (5) executions
- (6) investor compensation; and
- (7) the publication of information.

The Stock Connect MoU's aim is to:

- (1) fight against cross-border market abuse and misconduct;
- (2) reinforce cross-border enforcement co-operation;
- (3) maintain market order in Hong Kong and Shanghai; and
- (4) to protect the legal rights of investors in both markets.²²⁷

For example, an investigation by the CSRC found out that Tang Moubo and others were suspected of manipulating the shares of Zhejiang China Commodities City Group Co. Ltd.

http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201611/t20161123_306416.html (visited 11 November 2017)

²²⁵ CSRC, "The CSRC Opinions on Further Strengthening Enforcement," (19 August 2013): Available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201310/t20131009_235763.html (visited 11 November 2017)

²²⁶ CSRC, 中国证监2015年年报: Available at http://www.csrc.gov.cn/pub/zjhpublic/G00306201/ndbg/201603/t20160331_295253.htm (visited 7 August 2016)

²²⁷ CSRC, op. cit, note 227

(a stock-connect company in the Northbound Trading Link) to realise an illegal gain of over RMB 40 million. During the investigation, the CSRC discovered further evidence which implicated Tang Moubo and others in the manipulation of shares involving five other Mainland companies, which realised RMB 250 million.²²⁸

Comparison with Hong Kong:

There are a number of key differences between the enforcement of CG standards in the Mainland and Hong Kong. Firstly, the CG Code and standards in the Mainland are enforced by the CSRC, not the Exchanges, whereas the CG Code in Hong Kong is enforced by the exchange (HKEX) not the SFC. Secondly, the CSRC is not perceived to have a conflict of interest as is the case for the HKEX being a regulator and a for-profit exchange operator. Thirdly, the requirements in the Mainland's CG Code are mandatory whereas in Hong Kong the CG Code is subject to an anticipatory "comply or explain" regime. In the Mainland, listed companies must comply or will be sanctioned and, therefore, will improve CG more readily, whereas in Hong Kong the CG Code's non-mandatory compliance results in a longer time-frame for listed companies to improve CG. Fourthly, sanctions imposed by CSRC are more extensive than those of the HKEX. This gives the CSRC a wider range of options to ensure that the CG Code is effective in its operation and, therefore, maintain high CG standards.

Shanghai Stock Exchange and Shenzhen Stock Exchange

The Exchanges apply self-regulating administration of the securities market.²²⁹ Both exchanges have powers to impose disciplinary sanctions for breaches of the exchange rules.²³⁰ The Exchanges have responsibilities and powers to supervise listed companies in accordance with Article 11 and Part VII of the "Measures of Administration of Exchanges". Guidelines on the standard operation of listed companies to implement the CG Code are issued and enforced by the Exchanges.

Disciplinary actions:

Disciplinary procedures are handled by the Disciplinary Committee of each exchange with appeals heard by an Appeal Committee.

The Exchanges impose disciplinary sanctions on listed companies, including:

- (1) oral warnings;
- (2) written warnings;
- (3) inquiries and reprimand;
- (4) correction within a time limit;
- (5) public clarification or explanation;
- (6) public apology;
- (7) appointing industry professionals to give comments;
- (8) impose training or examination requirements which must be completed within a limited time;
- (9) holding an investor presentation within a time limit; and/or
- (10) trade restrictions.

The SSE has additional disciplinary powers which include:

- (1) circulating a notice of criticism;
- (2) public censure;
- (3) publicly identifying the incapacity of a director, supervisor, or senior manager; and/or
- (4) entering a motion with the court to change the trustee of bankruptcy.

SZSE's additional disciplinary powers include:

- (1) a temporary refusal to accept any documents from a related-party, (2)

²²⁸ Ibid

²²⁹ Securities Law, art 102

²³⁰ Securities Law, art 121

temporary refusal to accept any business; (3) suspension of information disclosure express services; and/or (4) reporting to the CSRC.²³¹

Publications:

The Exchanges publish decisions arising from disciplinary sanctions and annual self-regulation reports. Additionally, the SZSE reports weekly on self-regulation and enforcement. According to the 2014 Self-regulation Report, the SSE circulated 151 notices of criticism, imposed 65 public censures, restricted one company from trading, and publicly identified five cases involving incapacity of a director, supervisor, or senior manager.²³² In 2014 the SZSE circulated 23 notices of criticism to listed companies and 146 to individuals, imposed six public censures on listed companies and 39 on individuals, and restricted 53 companies from trading.²³³

According to the 2016 Fact Book by the SSE, 24 companies were given a delisting warning, one was subject to an “other risk” warning, and one to a suspension warning. In 2015, five companies were delisted and one was suspended on the SZSE.²³⁴

Accountability:

The SSE and SZSE are accountable to the CSRC.

Comparison with Hong Kong:

The sanctions the Exchanges can impose are slightly wider than those of the HKEX. This is in addition to sanctions imposed by the CSRC. Mainland CG standards are subject to two levels of enforcement with the matters covered by each level not always overlapping. In terms of system design, this is perhaps a stronger enforcement system than in Hong Kong.

Ministry of Finance

The MOF has rule-making, investigatory, supervisory, and disciplinary powers. Investigations encompass listed companies’ financial reporting (including the internal control report). Furthermore, the MOF regulates registered accountants and accounting firms, and enforces the Accounting Law.

Disciplinary powers:

In terms of sanctions, the MOF can order rectification and/or fine companies for misconduct involving accounting, financial reporting, or statutory common reserves.²³⁵

As the regulator of accounting firms and registered accountants, the MOF can issue an

²³¹ SSE, “Measures of Implementation of Disciplinary Sanction and Supervisory Measures of SSE”: Available at http://www.sse.com.cn/lawandrules/sserules/organization/c/c_20150906_3976222.shtml (visited 25 May 2016). SZSE, “Detailed Rules of Implementation of Disciplinary Sanction and Supervisory Measures of SZSE”: Available at

<http://www.szse.cn/main/files/2016/02/29/%E3%80%8A%E6%B7%B1%E5%9C%B3%E8%AF%81%E5%88%B8%E4%BA%A4%E6%98%93%E6%89%80%E8%87%AA%E5%BE%8B%E7%9B%91%E7%AE%A1%E6%8E%AA%E6%96%BD%E5%92%8C%E7%BA%AA%E5%BE%8B%E5%A4%84%E5%88%86.pdf> (visited 25 May 2016)

²³² SSE, “上海2014年自律报告”: Available at <http://www.sse.com.cn/disclosure/credibility/whitepaper/c/4118097.pdf> (visited 5 Aug 2016)

²³³ 深圳证券交易所, 深圳2014年度自律报告: Available at <http://kuaixun.stcn.com/2015/0118/11974041.shtml> (visited 5 August 2016)

²³⁴ SZSE, “Shenzhen Stock Exchange Factbook 2015,”: Available at <http://www.szse.cn/UpFiles/largepdf/20160323094430.pdf> (visited 11 November 2017)

²³⁵ Company Law, arts 201 and 203

order to correct within a time limit and impose the following administrative sanctions:

- (1) fine; (2) make corrections; (3) revoke the accountant qualification; (4) make disciplinary sanctions against any civil servants involved, including removal from the public function; and/or (5) impose administrative sanctions.²³⁶

Publications:

The MOF publishes announcements on the examination of accounting information quality on its website. Currently there are 34 announcements available and three new announcements were made in 2014 (No.32 – No.34 Announcements). According to No. 32 and No. 34 Announcements, the MOF randomly examined the quality of accounting information of 78 companies (including SOEs, listed companies, private companies, and foreign-invested enterprises), 25 accounting firms with securities qualifications, commercial banks, and published the results of the examination.²³⁷ According to the No. 33 Announcement, the MOF reviewed and published the examination of accounting information from its branches in different provinces and cities.²³⁸

Accountability:

The MOF is accountable to the State Council (vice-premier in charge).

Comparison with Hong Kong:

In Hong Kong accounting and auditing rules are issued and enforced by the HKICPA, with the FRC investigating possible auditing or reporting irregularities, and non-compliance with the accounting rules. In comparison with the Mainland, the powers of the MOF are more extensive than the FRC which gives the appearance of having independent oversight of the accounting, auditing, and reporting standards. This regulatory function is absent in Hong Kong.

Administration for Industry and Commerce

The AIC is the body responsible for company registration in the Mainland with powers for:

- (1) rule-making; (2) enforcement; (3) investigatory; and (4) disciplinary powers, including enforcing the Company Law and Measures of the Administration of Company Registration.

The AIC is accountable to the State Council (vice-premier in charge).

Administrative sanctions:

The AIC can order companies to correct and impose administrative sanctions, including:

- (1) revoking business licenses; (2) confiscating illegal gains; (3) fines; (4) warnings; and/or (5) impose administrative sanctions on a company's

²³⁶ Accounting Law, arts 42 and 49

²³⁷ MOF, “中 国 公 司 登 记 年 报 公 告 第 32 号”: Available at http://jdc.mof.gov.cn/zhengwuxinxi/jianchagonggao/201509/t20150909_1455175.html (visited 7 August 2016); and MOF, “中 国 公 司 登 记 年 报 公 告 第 34 号”: Available at http://jdc.mof.gov.cn/zhengwuxinxi/jianchagonggao/201509/t20150909_1455171.html (visited 7 August 2016)

²³⁸ MOF, “中 国 公 司 登 记 年 报 公 告 第 33 号”: Available at http://jdc.mof.gov.cn/zhengwuxinxi/jianchagonggao/201509/t20150909_1455173.html (visited 7 August 2016)

personnel.²³⁹

Comparison with Hong Kong:

Powers and functions of the AIC are similar to the Companies Registry in Hong Kong.

IV.6.5 State-owned enterprises

Ministry of Finance

The MOF performs shareholder's responsibilities on behalf of the State in state-owned financial institutions, China National Tobacco Company, China Railway Company, China Publishing Group Corporation, and China Arts & Entertainment Group, and supervises the state-owned assets of these enterprises.

State-owned Assets Supervision and Administration Commission

The SASAC performs shareholder's responsibilities on behalf of the State in non-financial SOEs and supervises state-owned assets of these enterprises. The SASAC is accountable to the State Council (vice-premier in charge).

National Audit Office of the People's Republic of China

The CNAO is the audit regulator of publicly funded institutions, enterprises, and financial institutions directly owned by the Central Government or which the Central Government has a controlling or dominant position.²⁴⁰ The CNAO is accountable directly to the Premier of the State Council.

IV.6.6 Financial sector

China Securities Regulatory Commission

The CSRC can impose the following administrative sanctions on a securities company:

- (1) suspend or revoke the securities license of a securities company or an individual (i.e. post-holding qualification or securities practice qualification); (2) confiscate illegal gains; (3) fine; (4) warning; and/or (5) order a halt on the offering or transaction.²⁴¹

The CSRC can order a securities company to make a correction and undertake the following measures if the net capital or other indicator of risk control fails to satisfy the relevant provisions:

- (1) restrict the business operations, suspend part of the business operations, or halt an approval for a new business; (2) halt an approval to establish or for the acquisition of new branches; (3) restrict the allocation of bonuses or restrict the salaries of directors, supervisors, and senior managers; (4) restrict the transfer of property; (5) order a change of directors, supervisors, or senior managers, or restrict their rights; (6) order to change the controlling shareholder or restrict their rights; and/or (7) revoke the relevant business license.²⁴²

In addition, the CSRC can authorise an accounting firm or an asset valuation company to audit or appraise the financial status, internal controls, and asset values of a securities

²³⁹ State Council, "Measures of the Administration of Company Registration": Available at http://www.saic.gov.cn/zcfg/xzfgfxwj/xxb/201402/t20140227_142236.html (visited 26 May 2016)

²⁴⁰ CNAO, op. cit

²⁴¹ Securities Law, arts 188-235

²⁴² Securities Law, art 150

company.²⁴³

China Banking Regulatory Commission

In terms of CG, the CBRC enforces the Law of the People's Republic of China on Commercial Banks and the Guidelines on Corporate Governance of Commercial Banks. The CBRC can impose the following administrative sanctions:

(1) warnings; (2) fines; (3) confiscate illegal gains; (4) order to suspend operations for correction, (5) revoke the financial license of banking institutions; and/or (6) revoke the qualification of directors and senior managers.²⁴⁴

In comparison, the Hong Kong Monetary Authority issues and enforces the Guideline on Corporate Governance of Locally Incorporated Authorised Institutions, which forms part of its non-statutory Supervisory Policy Manual.

The CBRC is accountable to the State Council (vice-premier in charge).

China Insurance Regulatory Commission

The CIRC enforces the Insurance Law and the Guiding Opinion on Regulating the Insurance Company Corporate Governance Structure.

Administrative sanctions imposed by the CIRC include:

(1) an order to correct; (2) confiscate illegal gains; (3) fines; (4) restrict part of the insurance business (5) order to halt the approval of a new business; and (6) revoke insurance licenses.²⁴⁵

When an insurance company is insolvent, the CIRC can restrict the level of salaries to directors, supervisors, and senior managers²⁴⁶ The CIRC can make an order for a rectification and take-over and control an insurance company if it is insolvent or the company is in violation of the law and impairs the public interest.²⁴⁷

In Hong Kong, the Insurance Authority is an independent body responsible for the regulation of insurance companies and issues the Guideline on the Corporate Governance of Authorised Insurers. Hong Kong's Insurance Authority has weaker enforcement powers in comparison to the CIRC.

The CIRC is accountable to the State Council (vice-premier in charge).

IV.6.7 Non-listed companies

Non-listed public company

Non-listed public companies fall under the supervision of CSRC which exercises enforcement powers pursuant to the Measures for the Supervision and Administration of Unlisted Public Companies. Non-listed public companies are also supervised by the MOF (financial reporting) and the AIC for company registration, and are subject to enforcement powers under the Company Law (see above).

²⁴³ Securities Law, art 149

²⁴⁴ The Banking Supervision Law of the People's Republic of China, art 7

²⁴⁵ Insurance Law of the People's Republic of China, arts 159-181

²⁴⁶ Insurance Law of the People's Republic of China, art 139

²⁴⁷ Insurance Law of the People's Republic of China, arts 141-148

Private companies

Private companies are supervised by the MOF (financial reporting) and the AIC for company registration. Enforcement powers are sourced from the Company Law (see above).

IV.6.8 Appeals

Administrative review

If any individual or company disagrees with an administrative sanction, an application can be made for an administrative review, except for administrative sanctions imposed on civil servants.²⁴⁸ If the applicant is still unsatisfied with the decision of the administrative review, the next step is to appeal the decision by taking the matter to court or by applying to the State Council for a final decision.²⁴⁹ The following table highlights which regulator reviews a lower-level decision, and critically, that the regulator that made the decision in the first instance is also the reviewer. This arrangement raises concerns over the impartiality of the review.

Relevant industry / field	If the disciplinary administrative sanction is made by	Reviewer
Company registration	AIC	AIC
	Local AIC (at county level or above)	AIC or local government
Financial reporting	MOF	MOF
	Local MOF (at county level or above)	MOF or local government
Securities industry	CSRC or its subsidiaries	CSRC
Banking industry	CBRC or its subsidiaries	CBRC
Insurance industry	CIRC or its subsidiaries	CIRC

Court appeals

If any individual or company disagrees with the disciplinary administrative sanction, court action can be taken against the regulator. If the appellant is unsatisfied with the judgment of the court, an appeal can be made to a higher court which will make a final decision.²⁵⁰ For example, in July 2016 Shanghai DZH CO., Ltd (大智慧, 601519) sued the CSRC to revoke an administrative sanction in the Beijing Intermediate People's Court. If the company was unsatisfied with the judgment of Beijing Intermediate People's Court, an appeal could have been lodged with the Beijing High People's Court for a final decision.

²⁴⁸ Administrative Review Law of the People's Republic of China, arts 9-13

²⁴⁹ Administrative Review Law of the People's Republic of China, art 14

²⁵⁰ Administrative Litigation Law of the People's Republic of China, art 2

Appendix IV	7. Shareholder rights and protections	IV.7 Mainland China
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Introduction

Shareholder rights and protections are one of the weakest areas of CG in the Mainland. This is due to a number of problems:

(1) the supervisory board/supervisors' and independent directors' role do not significantly strengthen CG; (2) the CSRC and the other CG regulators have a poor enforcement record; (3) a lack of participation by shareholders in general meetings and a poor record of enforcing their rights through the courts; and (4) the passive approach undertaken by institutional shareholders.

Nonetheless, according to a survey conducted by Nankai University, the performance of listed companies' CG in the Mainland has increased substantially from 2003-2016. In particular, since the turnaround in 2009 following the global financial crisis, CG performance has improved every year.²⁵¹

IV.7.1 Shareholder rights

Minimum rights

Shareholder meetings:

The CG Code provides that a listed company must state in its articles of association the principles for shareholder meetings and establish a CG structure sufficient for ensuring the full exercise of shareholder rights.²⁵² The functions and powers of the shareholders meeting are outlined in section 2 of the Company Law. Furthermore, a general meeting has to be held once a year,²⁵³ with all shareholders being notified of the time, venue, and matters to be considered 20 days prior to the meeting.²⁵⁴

Voting rights:

The CG Codes states that listed companies must set-out convening and voting procedures for shareholder meetings in its articles of association, including rules governing such matters as:

(1) notification; (2) registration; (3) review of proposals; (4) voting; (5) counting of votes; (6) announcement of voting results (7) formulation of resolutions; (8) recording of minutes and signatories; and (9) public announcements.²⁵⁵

Shareholders can either be present in person at the shareholders' meeting or they can appoint a proxy to vote on their behalf, both means having the same legal effect.²⁵⁶ The

²⁵¹ See, 报告：2016年中国公司治理指数达到62.49 创2003年以来新高， (27 October 2016): Available at http://www.cssn.cn/jjx/jjx_bg/201610/t20161027_3253019.shtml (visited 11 November 2017). According to this survey, the composition of CG in China in 2016 includes shareholders governance index, board of directors governance index, board of supervisors governance index, management governance index, information disclosure index and stakeholders governance index, all of which are at showing increasing trend. Inter alia, shareholders governance and board of directors' governance have increased most significantly. CG index of China's listed companies is the index published earliest about CG in China. Over years, it has become a key indication for the evaluation of CG in China

²⁵² CG Code, arts 1 and 7

²⁵³ Article 101, Company Law, art 101

²⁵⁴ Article 103, Company Law, art 103

²⁵⁵ CG Code, art 5

Company Law stipulates that if a proxy is solicited by the shareholder, voting rights must be within the scope of the authorisation.²⁵⁷ A proxy should submit a shareholders' authorisation letter to the company. Article 41 of the Opinion on Shareholders Limited Company, Article 65 of the Interim Regulations on the Administration of Stock Issuance and Transactions, and the Guidelines on the Articles of Association of Listed Companies also set out relevant rules for the proxy voting system.

The CG Code allows the board of directors, independent directors, and qualified shareholders, to solicit for the shareholder's right to vote in a shareholders' meeting. No payments must be made to the shareholders for such solicitation and adequate information must be provided to persons whose voting rights are being solicited.²⁵⁸ For example, detailed information regarding the candidates for directorship must be disclosed prior to the convening of the shareholders' meeting to ensure adequate understanding of the candidates by the shareholders at the time of voting.²⁵⁹

Article 43 of the Company Law states that shareholders must exercise their voting rights at the shareholders' meeting in proportion to their capital contributions unless otherwise stipulated by the company's articles of association.

Pursuant to article 34 of the Securities Depository and Clearing Rules, the China Securities Depository and Clearing Corporation established a depository of securities which are registered either in the name of the securities companies or their clients. The Mainland has scriptless shares and voting can be conducted online.²⁶⁰

Weighted voting is discussed in Article 104 of the Company Law. Shareholders attending a shareholders' general meeting must have the right to one vote for each share held. This is the application of the one-share one-vote principle in the Mainland which is currently consistent with Hong Kong. Accordingly, there are no weighted voting rights in the Mainland.

Cumulative voting is provided for in the CG Code which refers to a mechanism where each share carries the same voting weight. Shareholders can cast all their votes through a single nominee when there are multiple vacancies. For example, cumulative voting is to be advanced for the election of directors and for companies owned by controlling shareholders (see below for details).²⁶¹ Cumulative voting may also be implemented for the election of supervisors. The cumulative voting system needs to be implemented in accordance with the articles of association or by resolution at the shareholders' general meeting.²⁶²

Controlling shareholders

Controlling shareholders owe a duty of good faith towards the listed company and other shareholders.²⁶³ The controlling shareholders may not use their affiliation with directors, supervisors, and senior officers to harm the interests of the company.²⁶⁴ Important decisions of a listed company must be made through a shareholders' meeting or board of directors' meeting in accordance with the law. Controlling shareholders cannot directly or indirectly interfere with the company's decisions or business activities conducted in accordance with the law; nor can they impair the listed company's other shareholders'

²⁵⁶ CG Code, art 9

²⁵⁷ Company Law, art 107

²⁵⁸ CG Code, art 10

²⁵⁹ CG Code, art 29

²⁶⁰ CSDC, "About CSDC (China Securities Depository and Clearing Corporation Ltd), Company Profile": Available at http://www.chinaclear.cn/english/comp/about_lmmtt.shtml (visited 19 September 2017)

²⁶¹ CG Code, art 31

²⁶² Company Law, art 105

²⁶³ CG Code, art 19

²⁶⁴ Company Law, art 21

rights and interests.²⁶⁵

Listed companies that are more than 30% owned by a controlling shareholder must adopt a cumulative voting system, with implementing rules stipulated in the company's articles of association.²⁶⁶

Independent directors must bear the duties of good faith and due diligence toward the listed company and all shareholders. The independent directors should earnestly perform their duties independently, in accordance with laws, regulations and the company's articles of association, and must protect the interests of minority shareholders from being infringed. Independent shareholders must carry out their duties independently and not subject themselves to influence by the company's major shareholders, actual controllers, or other entities or persons who are interested parties of the listed company.²⁶⁷

Remedies

Legal rights:

The CG Code provides shareholders with the right to protect their interests and rights through civil litigation or other legal means in accordance with laws and administrative regulations. If the resolutions of shareholders' meetings or the resolutions of the board of directors are in breach of laws and administrative regulations or infringe on shareholders' legal interests and rights, the shareholders have the right to initiate litigation to preclude the breach or infringement.²⁶⁸

Derivative actions:

Pursuant to the CG Code, shareholders have the right to request the company to sue the directors, supervisors, and managers for compensation, who violate the laws, administrative regulations, or articles of association and cause damage to the company during the performance of their duties.²⁶⁹

Article 152 of Company Law provides general rights for minority shareholders to bring an action in the People's Court against the board of directors to preclude illegal activities or actions that infringe on their rights. There is ambiguity concerning whether this would include bringing an action on the company's behalf and, therefore, a derivative action.

Although minority shareholders can protect their rights by instigating litigation, in practice, judicial statistics reveal that there are few cases involving minority shareholders against major shareholders which have been granted standing; and of the few cases which have, even less have been successful. Although procedural issues may be the foremost explanation as to why minority shareholders have been unsuccessful, defective law is probably the principal cause. Furthermore, shareholders cannot take action until the CSRC has completed any investigations, and the court will usually require parties to settle.²⁷⁰

Class actions:

"Representative actions" are recognised under the Civil Procedure Law of the People's Republic of China, yet they are uncommon in the Mainland.

²⁶⁵ CG Code, art 21

²⁶⁶ CG Code, art 31

²⁶⁷ Ibid

²⁶⁸ Article 4, Code of Corporate Governance for Listed Companies

²⁶⁹ Ibid

²⁷⁰ See Beller, *op. cit* and papers cited therein

IV.7.2 Director duties and requirements

Director interests

The Company Law has adopted many of the common law fiduciary duties (see discussion, below). Thus, directors, supervisors and senior managers cannot take advantage of their positions and powers to collect or accept bribes or other illegal incomes, nor can they encroach upon the property of the company.²⁷¹

In addition, directors and senior managers are not allowed to²⁷²:

- (1) misappropriate the company's funds;
- (2) deposit the company's funds in an account opened in his/her personal name or in the name of another individual;
- (3) in violation of the articles of association of the company, lend the company's funds to other persons or use the company's property to provide security for other persons without shareholder consent;
- (4) enter into a contract or transaction with the company in violation of the articles of association of the company or without the consent of the shareholders;
- (5) take advantage of the convenience of his/her position to seek for himself/herself or other persons commercial opportunities that belong to the company or to operate by himself/herself or for another person the same type of business as that of his/her company without consent of the shareholders;
- (6) accept as his/her own the commissions of a transaction between another person and the company;
- (7) disclose the secrets of the company without authorisation; or
- (8) other acts that violate fiduciary obligations to the company.

The income derived by a director or senior managers from violating the provisions of the preceding paragraph belongs to the company.²⁷³

In contrast to Hong Kong, there does not appear to be any provision in the Company Law that requires directors to disclose connected parties. This is, however, required under the CG Code.

Directors' fiduciary duty and duty of care

The Mainland has adopted the common law fiduciary duty and duty of care in the Company Law and CG Code. As stated above and in Article 148 of the Company Law, directors, supervisors, and senior managers assume duties of loyalty and diligence to the company (i.e. fiduciary duty). This is similar to directors' fiduciary duty and duty of care and skills in Hong Kong, except the duty of care and skills in Hong Kong is at common law rather than an explicit statutory requirement. There are a list of prohibited acts in article 149 of the Company Law which leave a lot of scope for interpretation of how the law is applied (see above). Given that the Mainland does not have a binding case law system and the power of the NPCSC to interpret laws, this can create undesirable uncertainty, though there is now a trend for Mainland courts to use higher court decisions as guidelines, if not precedents.

The CG Code elaborates directors' duties and responsibilities which have to be performed faithfully, honestly, and diligently for the best interests of the company.²⁷⁴ This includes,

²⁷¹ Company Law, art 148

²⁷² Company Law, art 149

²⁷³ Company Law, art 149

²⁷⁴ Art 33

but not limited to, attending board meetings of the board of directors in a diligent and responsible manner, and the expression of clear opinions on topics discussed.²⁷⁵ Directors must abide by laws, regulations, rules, articles of association, and must acknowledge these undertakings publicly.²⁷⁶ When absent for any reason, another director must be authorised in writing to vote as a proxy, yet the absent director must be responsible for the vote.²⁷⁷

Independent directors owe a duty of good faith and due diligence to the listed company and all shareholders. Independent directors must, according to relevant laws and regulations, (including the Guiding Opinions on the Establishment of Independent Director System in Listed Companies) and articles of association, protect the overall interests of the company, and protect the interests of minority shareholders from being infringed.²⁷⁸

Generally, directors' fiduciary duties mirror that of Hong Kong (and internationally) which involves:

(1) carefully reading all business and financial reports of the listed company and any significant media coverage on the company; (2) keeping informed of and paying continuous attention to the company's operations and management; (3) material matters that have occurred or are likely to occur and the impact of such material matters; (4) reporting in a timely manner to the board of directors any problems concerning the company's operations; and (5) not shirking this responsibility by offering the excuse that he/she is not engaged directly in the operation and management of the company or has no knowledge of the matter or situation.

Neither the Company Law nor the CG Code impose an explicit fiduciary duty on employee representatives who sit on the company's board of directors. However, they can owe a fiduciary duty to the company implicitly under Article 148 of the Company Law and the CG Code.

Comparison with Hong Kong

The Mainland's CG Code differs from Hong Kong's CG Code as emphasis is placed not only on the board of directors, but also the supervisory board. Furthermore, a number of provisions are absent in the Company Law, when compared to the Companies Ordinance, which are present in the mandatory CG Code enforced by the CSRC.

Director qualifications

The board must have a professional background. Directors must possess adequate knowledge, skill, and quality to perform their duties.²⁷⁹ Directors must ensure adequate time and energy for the performance of their duties.²⁸⁰ This is analogous to Hong Kong.

Director training

Regulatory framework:

The CG Code does not provide a lot of guidance on director training. However, there are a number of guidelines and regulations issued by the CSRC and the Exchanges. Directors

²⁷⁵ CG Code, art 35

²⁷⁶ CG Code, art 36

²⁷⁷ CG Code, art 35

²⁷⁸ CG Code, art 50

²⁷⁹ CG Code, art 41

²⁸⁰ CG Code, art 34

in the Mainland are required to attend training. The CG Code states that directors must earnestly attend training to learn about:

- (1) their rights; (2) obligations and duties; (3) become familiar with relevant laws and regulation; and (4) master the knowledge necessary for a director.²⁸¹

The SSE LRs require the board secretary, who is accountable to the company and the board, to organise training for directors on laws, administrative regulations, and provide assistance in understanding directors' disclosure obligations.²⁸² When being first inducted, a director must make an undertaking to the SSE (in the prescribed form provided at the back of the LRs), which includes, inter alia, acknowledging participation in professional training programs organised by the CSRC and the SSE, pursuant to the relevant regulations.²⁸³

The CSRC issued Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001) require independent directors to take part in training organised by the CSRC and its authorised institutions.²⁸⁴ Guidelines are also issued by the Exchanges on independent non-executive director (INED) registration and training.

CSRC issued guidance includes:

- (1) Guidance for the Training of Senior Managerial Personnel in a Listed Company; (2) Implementing Regulations on the Training of the Board Chairman and General Manager in a Listed Company; (3) Implementing Regulations on the Training of Directors and Supervisors in a Listed Company; and (4) Implementing Regulations on the Training of Board Secretaries in a Listed Company.²⁸⁵

Article 4 of Guidance for the Training of Senior Managerial Personnel in a Listed Company stipulates that directors must accept ongoing education and training and obtain a training certificate. The CSRC provides training in collaboration with CSRC agencies and the Exchanges. Training is provided for, inter alia, the chairman of the board, directors, and independent directors. The training is designed to:

- (1) gain an understanding of laws and regulations; (2) the securities market, improve business knowledge; (3) strengthen awareness of self-discipline and standard operations; and (4) improve company CG.

Trainers are sourced from the CSRC, stock exchanges, higher education institutions, and professional institutions. The CSRC records the training for directors, including examination results.²⁸⁶

Training of financial company directors is provided in specific guidelines.

Directors must sign a declaration of participation in a securities business training programme organised or acknowledged by the CSRC and the exchange, and undertake to participate in a professional training programme organised by the CSRC or the exchange.²⁸⁷

²⁸¹ CG Code, art 37

²⁸² SSE LR, [3.2.2. (6)]

²⁸³ SSE LR, Appendix 1, Part II [7]

²⁸⁴ At [1.5]

²⁸⁵ OECD, op. cit, 90

²⁸⁶ Ibid, 91

²⁸⁷ SSE LR, Appendix 1

Effectiveness of director training:

The Mainland has some of the most extensive director training and certification requirements in the world. Training typically last for a few days with an examination held at the end of the training course.

A number of annual reports of SSE listed companies were examined to provide examples of director training in practice. The Shanghai Pudong Development Bank Co Ltd 2016 Annual Report did not disclose anything on director training (SSE); Sinopec which is listed on the SSE, SEHK, and the NYSE did not contain any information on director training in its 2016 Annual Report; and Baosteel's (SSE) 2015 Annual Report disclosed one paragraph on a "Training Scheme", which consisted of a boilerplate explanation.²⁸⁸

In contrast Anhui Expressway Company Limited (a company listed on the SSE and SEHK) stated that training sessions were held and complied with the Hong Kong CG Code; these sessions were held by the Anhui Securities Bureau (a local securities agency of the CSRC) and the Hong Kong Institute of Chartered Secretaries provided the company with training records.²⁸⁹ A director's attendance list was provided which divided the attendance into CG law and regulatory changes lectures/training and accounting, financial, management and professional skills lectures/training. Interestingly only four directors (out of 12) attended both sessions, with all directors having perused the related materials. The training sessions were said to be reviewed annually. Two independent directors attended one-off SSE independent director training.²⁹⁰

Disclosure statements in the SSE annual reports are not indicative of whether director training is effective. To review the effectiveness of director training across the market, an examination of director behaviour is required. This will be based on the two types of director training outlined in the Anhui Expressway Company Limited 2014 Annual Report: legal/regulatory and accounting/financial. The number of recent corruption cases involving chairmen, for example PetroChina, China Resources, GOME Electrical Appliances, and China Telecom, highlight a failure of legal/regulatory director training. It should be noted that a number of these incidents of corruption occurred over the past 10 to 15 years, prior to the release of detailed director training regulations and guidance. However, instances of director corruption have persisted since the introduction of detailed regulations and guidelines. For example, as late as 2015, the Chairman of China Telecom (an SOE and H-share company listed on SEHK) and former Chairman of China Unicom (an SOE listed on the SEHK and SSE) sold a state-owned office building below market value for the benefit of an associate.²⁹¹ Considering the Chairman was appointed to China Telecom for four months prior to arrest, there would have been sufficient exposure to Mainland director training. This demonstrates that director legal/regulatory training was ineffective. The Chairman may have been aware of the legal and regulatory changes, yet persisted in breaking the law. This highlights an underlying CG culture and director mind-set beyond merely educating directors of changes in law/regulations. Director training needs to address CG culture and director mind-set to firmly establish ethical behavioural standards that enhance shareholder value, not the personal wealth of directors.

Outside of the legal/regulatory failures, there are few reported incidents of companies listed solely on the SSE or SZSE experiencing accounting/financial fraud. However, where the Mainland/China differs from other large economies is that a substantial number of state companies list outside the home jurisdiction. These companies are subject to the legal and regulatory requirements pertaining to the jurisdiction where they

²⁸⁸ Baosteel, "2015 Annual Report," (2015), 48

²⁸⁹ Anhui Expressway Company Limited, "Annual Report 2014," (2014), 87

²⁹⁰ Ibid, 93

²⁹¹ South China Morning Post, "Former China Telecom boss Chang Xiaobing sentenced to six years for corruption," (31 May 2017)

are listed, and not to the Mainland/Chinese regulatory regime, unless dual-listed on the SSE or SZSE. Some of the most prominent markets for capital formation are the SEHK, NYSE, and SGX. There has been an unusually high frequency of Chinese companies listed on these exchanges experiencing accounting fraud.

For example, China Huishan Dairy Holdings (listed on the SEHK) was exposed for misappropriating funds to speculate in real estate and overstating spending to support the company's income statement.²⁹² Within a month of the share price falling over 90% on the SEHK and a suspension of trading in March 2017, all directors had resigned, except for the chairman who was also the controlling shareholder. Problematically, the director responsible for overseeing the company's finances had disappeared. Huishan represents a complete failure of director accounting/financial training and the audit committee in a Mainland company listed on the SEHK.

A number of other prominent examples of Mainland/Chinese companies committing accounting fraud include LongTop Financial (NYSE); Credit China Fintech Holdings (SEHK); China Resources (SEHK); and SinoTech Energy (Nasdaq).

Independent directors

Regulatory framework:

According to Article 49 of the CG Code, listed companies should introduce independent directors to the board according with the relevant regulations. Independent directors must be independent from the company and major shareholders. An independent director cannot hold any other position apart from that of an independent director in the listed company.²⁹³

There is no direct requirement for INED minimum time commitment. However, under Article IV (5) of the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001), where INEDs fail to attend a board meeting for three consecutive times, the board can request the shareholders' general meeting to replace the INED. In other words, the minimum time commitment for INEDs to attend board meetings is once in every three meetings held.

Under Article I (2) of the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001), INEDs must, in principle, serve as independent directors in a maximum of five listed companies and they must ensure that they have sufficient time and energy to discharge their duties.

According to Article I (5) Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001), independent directors and nominated independent directors should participate in training organised by the CSRC and its authorised institutions according to CSRC requirements.

The Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001) paragraph IV (5) states that if an independent director is dismissed by the listed company before the term of his/her office expires, the listed company must make a special disclosure. Independent directors' standard allowance must be disclosed in the company's annual report.²⁹⁴

²⁹² Sofia Horta e Costa, "Carson Block Is Up All Night Watching Huishan Rout He Called," (24 March 2017) *Bloomberg*

²⁹³ CSRC, 上市公司治理准则 "Code of Corporate Governance for Listed Companies in China", (证监发[2002]1号): Available at http://www.csrc.gov.cn/pub/shanxi/xxfw/gfxwj/200712/t20071221_69334.htm (visited 25 December 2016); Article 49

²⁹⁴ Paragraph VII (5)

Pursuant to paragraph VI (3), independent directors are required to express their independent opinion which must be disclosed in the following matters:

(1) nomination, appointment, or replacement of directors; (2) appointment or dismissal of senior managers; (3) remuneration for directors and senior managers; (4) any existing or new loan borrowed from the listed company by or other funds transfer made by the company's shareholders, actual controllers, or affiliated enterprises that exceeds RMB three million or 5% of the company's net assets audited recently, and whether the company has taken effective measures to collect the amount due; (5) events that the independent director considers to be detrimental to the interests of minority shareholders; and (6) other matters stipulated by the articles of association.

Independent directors have special powers to make a number of specific proposals other than those stipulated in the Company Law, other relevant laws, and regulations. These include:

(1) approving major related-party transactions before being submitted to the board for discussion; (2) appointment and removal of accounting firms; (3) calling interim shareholders' meeting; (4) call a meeting of the board of directors; (5) appointing outside auditing and consulting organisations independently; and (6) solicit proxies before convening the shareholders' meeting.²⁹⁵

Where a proposal by independent directors is not accepted or their power to approve a related-party transaction, or to propose the appointment or removal of accounting firm cannot be exercised, the company must disclose the relevant information.²⁹⁶

Effectiveness of Independent directors:

There has been a lot of literature written which suggests an inadequacy and ineffectiveness of the independent director system. The recent board resolution to approve China Vanke's restructuring plan to fend off a hostile takeover by its largest shareholder, Baoneng, has raised some doubt about the effectiveness of the independent director system - one of the independent directors abstained in the crucial vote, citing a conflict of interest, which made it possible for Vanke board to obtain 2/3 majority for the resolution.²⁹⁷

IV.7.3 Board processes

Board effectiveness

A listed company must formulate rules of procedure for the board in the articles of association to ensure the efficient functionality and rational decision-making.²⁹⁸ The number of directors and the structure of the board must be in compliance with laws and regulations to ensure effective discussion and efficient, timely, and prudent decision-making processes of the board.²⁹⁹

A listed company's CG framework must ensure that the board can exercise its power in accordance with laws, administrative regulations, and the articles of association.³⁰⁰

²⁹⁵ Paragraph V (1)

²⁹⁶ Paragraph V (3)

²⁹⁷ Liping Zhang, "Vanke: the Battle of Five Armies," (30 June 2016) *Glass Lewis*: Available at <http://www.glasslewis.com/vanke-the-battle-of-five-armies/> (visited 29 September 2017)

²⁹⁸ CG Code, art 44

²⁹⁹ CG Code, art 40

³⁰⁰ CG Code, art 42

The board must meet periodically and convene interim meetings in a timely manner when necessary. Each board meeting must have a pre-decided agenda.³⁰¹

Board performance

The CG Code states that listed companies must establish a fair and transparent system for the criteria of evaluation of the performance and procedure of directors, supervisors, and management personnel.³⁰² Evaluation of directors (and management) must be conducted by the board or the remuneration and appraisal committee. Independent director and supervisor performance evaluation must be conducted through a combination of self-review and peer review.³⁰³

In accordance with laws, regulations and other relevant rules, a listed company must disclose information regarding its CG, including inter alia:

(1) the members and structure of the board of directors and the supervisory board; (2) the performance and evaluation of the board of directors and the supervisory board; (3) the performance and evaluation of the independent directors, including their attendance at board meetings, their issuance of independent opinions and their opinions regarding related-party transactions, and the appointment and removal of directors and senior management; (4) the composition and work of the specialised committees ; (5) the actual state of the company's CG, the gap between the company's CG and the CG Code, and the reasons for the gap; and (6) specific plans and measures to improve CG.³⁰⁴

The board of directors and supervisory board must report to the shareholder meetings the performance of the directors (and supervisors), the results of the assessment of their work and their compensation, which must be disclosed.³⁰⁵

The supervisory board must make a record to be used for the performance assessment of directors (and managers and other senior personnel) and can report to the board of directors at the shareholders' meeting when there has been a violation of the laws, regulations, rules, or articles of association by directors.³⁰⁶

Where the resolutions of board violate laws, regulations, or the articles of association which causes a company loss, directors responsible for making such resolutions are liable for compensation, except those proved to have objected and the objections have been recorded in the minutes.³⁰⁷

Thus board evaluation and disclosure is mandatory under China's CG Code which contrasts to the Hong Kong CG Code where board evaluation is a recommended best practice (RBP) and there is no disclosure requirements.

Accountability

Listed companies are internally accountable to a number of board committees. However, the wording of the CG Code suggests that the establishment of committees is optional.

The board "may" establish a corporate strategy committee, an audit committee, a nomination committee, a remuneration and appraisal committee, and other special

³⁰¹ CG Code, art 40

³⁰² CG Code, art 69

³⁰³ CG Code, art 70

³⁰⁴ CG Code, art 91

³⁰⁵ CG Code, art 72

³⁰⁶ CG Code, arts 62 and 63

³⁰⁷ CG Code, art 38

committees in accordance with shareholder meetings' resolutions. All committees are composed solely of directors. The audit, nomination, and remuneration and appraisal committees must be chaired by an independent director, and independent directors must constitute the majority of the committees. Each committee is accountable to the board and all proposals by a committee must be submitted to the board for review and approval.³⁰⁸ Committees can engage intermediary institutions to provide professional opinions, with the company incurring the expense.³⁰⁹

At least one independent director from the audit committee must be an accounting professional.³¹⁰

Under Article 54 of the CG Code, the main duties of the audit committee are to:

- (1) recommend the recruitment or replacement of the company's external auditors;
- (2) review and implement the internal auditing system;
- (3) be responsible for interaction between internal and external auditors;
- (4) inspect and disclose the company's financial information; and
- (5) monitor the company's internal control system.

In contrast to Hong Kong, the Mainland's CG Code does not recommend a statement in the annual report to explain why the board has selected a different external auditor to one recommended by the audit committee.

The main duties of the nomination, and the remuneration and appraisal committees are discussed below.

Appointment and removal of directors

The election of directors must reflect the opinions of minority shareholders by way of cumulative voting (see discussion in Appendix IV.7.1).³¹¹ Directors who breach laws, regulations, or the articles of association, must be removed.³¹² The CG Code does not discuss the re-election of directors, only their election. This is different from Hong Kong's CG Code which recommends that directors should be subject to retirement by rotation at least once every three years.³¹³

A listed company's board of directors can establish a nomination committee.³¹⁴ The main duties of the nomination committee are to:

- (1) formulate standards and procedures for the election of directors and make recommendations;
- (2) extensively seek qualified director candidates; and
- (3) review the director candidates and make recommendations.³¹⁵

There is no requirement for the disclosure of the committee's work and nomination policies and processes.

Remuneration

The main duties of the remuneration and appraisal committee are to:

³⁰⁸ CG Code, art 58

³⁰⁹ CG Code, art 57

³¹⁰ CG Code, art 52

³¹¹ CG Code, art 31

³¹² CG Code, art 32

³¹³ A.4.2, CG Code (Hong Kong)

³¹⁴ CG Code, art 52

³¹⁵ CG Code, art 55

(1) study the appraisal standard for directors and management personnel; (2) conduct appraisal and to make recommendations; and (3) study and review the remuneration policies and schemes for directors.³¹⁶

The board must propose a scheme for the amount and method of director compensation to be approved at the shareholders' meeting. Directors must not participate in their own compensation arrangements at board meetings.³¹⁷

To attract qualified personnel and maintain stable management, a listed company must establish reward systems that link management compensation with the performance of the company and individual.³¹⁸

The performance assessment for management must form the basis for determining compensation and reward mechanisms.³¹⁹ Results of performance assessments must be approved by the board, explained at the shareholders' meeting, and disclosed.³²⁰ Article 72 of the CG Code requires the assessment and disclosure of directors' remuneration.

Although matters on remuneration are to be approved by shareholders in the general meeting, in practice minority shareholders have little or no influence over such matters as they are often out-voted by controlling shareholders, which are either the State or founding members. This is similar to Hong Kong and other jurisdictions.

In comparison to Hong Kong, the Mainland's CG Code has some details on the remuneration and appraisal committee's role in calculating performance-based pay which is mandatory, and not merely a RBP. As is the case in Hong Kong, the CG Code is silent on the calculation of independent directors' remuneration.

IV.7.4 Internal controls, the audit committee, and risk management

Internal control and the audit committee

As stated above, one of the main duties of the audit committee is to review the company's internal control system and its execution.³²¹ Compliance with internal control requirements is high although there is room for improvement (see, Appendix IV.2).

A study in 2008 revealed:

"...that various groups of stakeholders had generally accepted the ceremonial roles and responsibilities of audit committees in terms of lifting the image of good CG, enhancing communication between board of directors and auditors, and mediating conflict between management and auditors. However, the more concrete audit committee oversight roles and responsibilities for improving internal control, rules compliance, sound corporate financial reporting and auditing processes had not been fully recognized ... particularly by company management and independent directors. In addition...actual audit committee operations in practice were ineffective even though a large portion of Chinese listed companies had set up audit committees."³²²

³¹⁶ CG Code, art 56

³¹⁷ CG Code, art 71

³¹⁸ CG Code, art 77

³¹⁹ CG Code, art 78

³²⁰ CG Code, art 79

³²¹ CG Code, art 54

³²² Z Jun Lin, Jason Z Xiao, and Qingliang Tang, "The roles, responsibilities, and characteristics of audit committee in China," (2008) 21 *Accounting, Auditing & Accountability Journal* 5, 721-751: Available at <http://www.emeraldinsight.com/doi/pdfplus/10.1108/09513570810872987> (visited 29 September 2017)

This was supported by a more recent survey in 2015 which revealed that the institutional environment in the Mainland is yet to fully support the concept of an audit committee, and the implementation of audit committees and independent directors is largely symbolic because concepts are rarely applied as mechanisms to improve the quality of financial reporting in the Mainland.³²³

In contrast, a survey in 2014 was more positive about the role and effectiveness of audit committees in the Mainland. The 2014 survey found that:

(1) 95% of audit committees act as an overseer by monitoring and auditing the company's major information disclosure; (2) 92% of audit committees supervise matters related to transactions by providing professional opinions on related transactions, which is the extended function of audit committees included in the broad definition of this role; (3) 60% of audit committees act as consultants to provide added value to the company by diagnosing and providing solutions to problems during the company's developmental phase; (4) 49% of audit committees act as decision makers by being involved in developing important company policies—this appears to be a conflict with the independence of the audit committee; and (5) a total of 23% of audit committees fulfil a training role by providing professional training to the middle and senior level management.³²⁴

These findings are supported by a 2013 survey which found that:

"...firms with independent director accounting expertise, more paid supervisors, large chairman ownership, greater total assets, and Big 4 auditors are more likely to have effective audit committees; firms with a significant presence of the largest shareholder and diverse share ownership are less likely to have effective audit committees."³²⁵

Risk management

The LRs require a listed company to inform the exchange of matters that expose the company to heightened risks.³²⁶ There are additional requirements for specific entities, for example, financial companies such as banks, in the form of LRs and guidelines (see Appendix IV.4). At the regulatory level, the MOF and CSRC monitor and review compliance with these internal control requirements. The MOF and CSRC have recently highlighted some problems with the evaluation of internal control systems and have recommended:

(1) strengthening enforcement and sanctions; (2) synchronising internal control regulations and rules across regulators; (3) issuing more detailed guidelines and practices; and (4) providing training (see Appendix IV.2).

The corporate strategy committee conducts research and makes recommendations on

³²³ Huiying Wu, Chris Patel, and Hector Perera, "Implementation of 'audit committee' and 'independent director' for financial reporting in China," (December 2015) 31 *Advances in Accounting 2*: Available at <http://www.sciencedirect.com/science/article/pii/S0882611015000346> (visited 29 September 2017)

³²⁴ Pao-Chen Lee, "A Theoretical Analysis of the Audit Committee's Role in China," (2014) 14 *Global Journal of Management and Business Research 5*: Available at http://www.google.com.hk/url?q=https://journalofbusiness.org/index.php/GJMBR/article/download/1541/1444/&sa=U&ved=0ahUKewiF4b_99sPVAhXDkZQKHRHxD-8QFggIMAM&usg=AFQjCNF14RCXRYH-LqfZNul8T9fBQD7hVg (visited 29 September 2017)

³²⁵ Hsihui Chang, Xin Chen, and Nan Zhou, "Determinants and Consequences of Audit Committee Effectiveness: Evidence from China," (2013) *MIT Sloan, 2013 MIT Asia Conference in Accounting, Shanghai, China*: Available at

http://mitsloan.mit.edu/events/2013-asia-conference-in-accounting/pdf/Determinants_and_Consequences_of_Audit_Committee_Effect.pdf (visited 29 September 2017)

³²⁶ LR 11.7.2

the long-term strategic development plans and major investment decisions of the company.³²⁷

In contrast, the Hong Kong CG Code contains comply or explain provisions and RBP on risk management.

IV.7.5 Shareholder engagement

Disclosure requirements

The CG Code stipulates a number of shareholder information disclosure requirements. Shareholders have the right to know and participate in major company matters in the laws, administrative regulations, and the articles of association. Efficient channels of communication have to be established with shareholders.³²⁸

Listed companies must truthfully, accurately, completely and timely disclose information as required by laws, regulations, and the company's articles of association,³²⁹ - notably information that can have a material effect on the decisions of shareholders.³³⁰

Information disclosed must be easily comprehensible, with economical, convenient, and timely access provided through various forums (e.g. the internet).³³¹

Every effort, including utilising information technology, must be employed to increase the number of shareholders attending shareholders' meetings. The time and location of shareholders' meetings must be set to maximise shareholder participation.³³² The board must arrange the agenda for shareholders' meeting and allow a reasonable amount of time to discuss each agenda item.³³³

The CG Code states that each specialised committee must be accountable to the board,³³⁴ and not to the shareholders at the shareholder meeting. Technically, this contrasts with the CG Code in Hong Kong, but in practice the dominance of controlling shareholders in both jurisdictions makes such a requirement redundant.

Narrative reporting

There does not appear to be legal requirements for narrative reporting under the Company Law. However, there are narrative CG disclosure provisions in the CG Code.³³⁵ For example, in addition to disclosing mandatory information, a company must disclose, voluntarily and timely, all other information that can have a material effect on the decisions of shareholders and stakeholders.³³⁶

IV.7.6 Specific transaction contexts

Transactions significant in size

The CG Code regulates specific transactions. Controlling shareholders must not damage other shareholders' legal rights and interests, by, for example, asset restructuring or

³²⁷ CG Code, art 53

³²⁸ CG Code, art 3

³²⁹ CG Code, art 87

³³⁰ CG Code, art 88

³³¹ CG Code, art 89

³³² CG Code, art 8

³³³ CG Code, art 6

³³⁴ CG Code, art 58

³³⁵ CG Code, art 91

³³⁶ CG Code, art 88

taking advantage of their position to obtain a benefit.³³⁷

Assets, including non-cash assets, invested by a controlling shareholder must be independent of the company's assets, independently registered, and subject to independent accounting and management procedures. Controlling shareholders are prohibited from misappropriating or controlling such assets.³³⁸

The CG Code does not specify quantitative measures to regulate large transactions. Implicitly, large transactions would be considered "important decisions of a listed company" which can be disclosed at the shareholders' meeting or at a board meeting.³³⁹ Information that "may have a material effect on shareholders' decision" is subject to voluntary disclosure.³⁴⁰ Therefore, there is no explicit or implicit mandatory requirements for companies to disclose large transactions. These transactions are covered by Hong Kong's CG Code which provides quantitative measures to determine large transactions. However, the "comply or explain" regime renders disclosure of large transactions voluntary in Hong Kong.

Related-party transactions

Related-party transactions must be recorded in unambiguous written agreements, which observe principles of voluntariness, commercial and fair compensation, and must be disclosed pursuant to regulations.³⁴¹ Compensation must be determined by an independent third party and the calculations disclosed.³⁴² Measures must be adopted to prevent connected parties from interfering and damaging the company. Assets and capital must be protected from misappropriation and the company cannot provide financial guarantees to its shareholders or affiliates.³⁴³

Related-party transaction disclosure requirements are extensive, which is similar to the position in Hong Kong.

Director as a connected party

The CG Code does not appear to contain provisions which restrain directors from engaging with connected parties. Broad provisions are contained in the Company Law which prohibit directors' affiliation with controlling shareholders, supervisors, and senior officers who endeavour to harm the interests of the company³⁴⁴ and not take advantage of their position.³⁴⁵ Hong Kong has stricter and explicit director disclosure requirements.

Transactions involving a potential change in control

Controlling shareholders (including those acting in concert), changes in shareholdings (including related matters), and shareholders who own a relatively large block of shares are subject to timely disclosure requirements pursuant to the CG Code.³⁴⁶

These requirements have greater legal force to those pursuant to Hong Kong's Code on Takeovers and Mergers.

³³⁷ CG Code, art 19

³³⁸ CG Code, art 24

³³⁹ CG Code, art 21

³⁴⁰ CG Code, art 88

³⁴¹ CG Code, art 12

³⁴² CG Code, art 13

³⁴³ CG Code, art 14

³⁴⁴ Company Law, art 21

³⁴⁵ Company Law, art 148

³⁴⁶ CG Code, arts 92, 93, and 94

IV.7.7 Role of regulators

See Appendices IV.4 and IV.6.

Appendix IV	8. Regulation of non-local companies	IV.8 Mainland China
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Introduction

There are no foreign companies listed on the Exchanges in the Mainland (see Appendix IV.1). A number of Mainland companies are incorporated in foreign jurisdictions or are dual-listed on local and foreign exchanges. Many Mainland companies are cross-listed on the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect which provides access to international shareholders. The SSE and SZSE LRs cover cross-listed companies' disclosure, financial reports, and trading suspensions (see Appendix IV.8.2)

IV.8.1 Legislation

The Company Law has relatively few provisions on non-local or foreign companies. Chapter XI of the Company Law covers branches of foreign companies which are unlisted companies. This Chapter refers to companies incorporated outside of the Mainland and addresses the legal status of foreign companies, administrative matters to establish a company in the Mainland, and designating a representative/agent to be responsible for the branch. Article 212 outlines sanctions for foreign branches which violate the Company Law.

IV.8.2 Non-statutory regulations

Chapter XVI of the SSE LRs discusses "Coordination between domestic and overseas listings".

The SSE must be informed simultaneously when information is released on an overseas exchange by a domestically listed company.³⁴⁷ Reports and announcements should be consistent between exchanges.³⁴⁸ Trading suspensions on overseas exchanges must be reported to the SSE in a timely manner.³⁴⁹ Any matter not covered by the LRs must be subject to other Mainland laws and regulations, and co-operation MoUs signed with other exchanges.³⁵⁰ Similar provisions are found in the SZSE LRs.

IV.8.3 Cross-border considerations

International co-operation

The CSRC is a signatory to the IOSCOs' multi-lateral MoU or MMOU, which provides assistance to other signatories, including Hong Kong. However, the MMOU has limitations as it does not require regulators to provide information nor does it require co-operation where misconduct occurs in one jurisdiction that affects another.³⁵¹

Co-operation with Hong Kong

The CSRC and the SFC signed a MoU in 2014 to strengthen enforcement co-operation under the Shanghai-Hong Kong Stock Connect and a similar agreement with the SZSE in

³⁴⁷ SSE LR 16.1

³⁴⁸ SSE LR 16.2

³⁴⁹ SSE LR 16.3

³⁵⁰ SSE LR 16.4

³⁵¹ Mark Steward, "Fighting On the Frontline: An Update" 3rd Annual US-China Legal Summit," (2 March 2015) *Speech*

2016³⁵². Areas of co-operation include information sharing, investigative assistance, joint investigations, taking complementary enforcement actions when there is a wrongdoing in both jurisdictions, and taking enforcement actions in both jurisdictions to protect the investing public in the Mainland and Hong Kong, including the provision for compensation.³⁵³

Stock Connect investors can lodge complaints directly with the CSRC, the Exchanges, the listed companies concerned, and the stock trading and settlement service providers under Stock Connect.

According to the territorial monitoring principle under this arrangement, complaints by Mainland and Hong Kong investors within the span of control of the CSRC, will be given unified treatment according to the relevant rules and regulations of the Mainland. Hong Kong investors can also lodge complaints with the SFC. Upon receipt of a complaint, the SFC would refer it to the CSRC for handling. After the CSRC has handled the complaint, it will reply directly to the complainant and the reply will be forwarded to the SFC.³⁵⁴

The SFC organises training sessions for executives from the CSRC and Mainland financial institutions to better understand Hong Kong's securities market and regulatory regime.³⁵⁵

Thomas Atkinson, SFC Executive Director of Enforcement, states:

"We have an active executive staff exchange programme with the CSRC to enhance our mutual understanding of each other's work. We also hold regular joint training initiatives. At a recent 'Market Manipulation Conference' jointly held with the CSRC in Xi'an, we had the benefit of listening to some of the world's leading experts on how to tackle cross-jurisdictional market manipulation investigations. In appropriate cases, we also conduct joint investigations which provide excellent opportunities for officers of both organisations to build trust and establish long-term working relationships."³⁵⁶

The MoUs for the Stock Connect programs addresses the limitations of the IOSCO MMOU which focus on coordination rather than assistance. This has been described as a greater challenge for regulators, but one which should produce stronger outcomes.³⁵⁷ These arrangements are important as there have been a number of recent cases where Mainland directors of Hong Kong listed companies have absconded to the Mainland to escape the enforcement reach of the SFC. However, the main problem is that CSRC does not have jurisdiction for foreign incorporated Mainland companies listed in Hong Kong that are not also listed in the Mainland (i.e. Red Chips). For example, in the Hanergy case (for a discussion, see Appendix IV.6), the SFC had sought assistance from the CSRC, which was unable to provide assistance because the parent was outside its jurisdiction (i.e. private company).³⁵⁸ A well-known fact is that Mainland regional banks are hostile towards foreign regulators and are insubordinate to domestic regulators as— their loyalty is with their key borrowers whose survival matters to maintaining a

³⁵² Legco, "Hansard," (10 December 2014), p 3439: Available at <http://www.legco.gov.hk/yr14-15/english/counmtg/hansard/cm20141210-translate-e.pdf> (visited 9 November 2017)

³⁵³ SFC, "SFC signs MoU with CSRC to strengthen enforcement co-operation under Shanghai-Hong Kong Stock Connect" (17 October 2014) *News*

³⁵⁴ Legco, *op. cit*

³⁵⁵ SFC, "Quarterly Report, July-September 2012," (2013), 7: Available at http://www.sfc.hk/web/EN/files/ER/PDF/Full_20130122.pdf (visited 26 September 2017)

³⁵⁶ Thomas Atkinson, "Enforcement Focus," (February 2017) *CSJ*: Available at <http://csj.hkics.org.hk/2017/02/enforcement-focus/> (visited 26 September 2017)

³⁵⁷ Steward, *op. cit*

³⁵⁸ Shirley Yam, "Civil action against Hanergy shows SFC in just a chained lion," (24 January 2017) *SCMP*: Available at <http://www.scmp.com/business/article/2065049/civil-action-against-hanergy-shows-sfc-just-chained-lion> (visited 26 September 2017)

manageable bad-debt level.³⁵⁹ These customers take precedent over the CSRC which has no regulatory jurisdiction.³⁶⁰

Accounting standards

The Mainland does not rigidly follow international accounting conventions. The MOF has issued the Chinese Generally Accepted Accounting Principles (CGAAP) developed from the Accounting Standards for Business Enterprises and the Accounting Standards for Small Business Enterprises. However, CGAAP does correspond with most of the provisions of IFRS. Foreign invested enterprises in the Mainland are required under the Company Law to comply with annual audit and compliance processes in accordance with CGAAP. Mainland companies which are listed on the SEHK can use for their annual reports either IFRS, Hong Kong Financial Reporting Standards, or China Accounting Standards for Business Enterprises.

³⁵⁹ Ibid

³⁶⁰ Ibid

Appendix V	SINGAPORE
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prepared by:
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Appendix V	1. Market overview – structure, characteristics and culture	V.1 Singapore
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Introduction

Singapore has a unique corporate governance (CG) system despite being a common law country with a similar legal system to the United States, United Kingdom (UK), and Hong Kong. Similar to Hong Kong, the market is dominated by majority shareholders, and similar to China, the government is a dominant majority shareholder or controlling shareholder in a large number of listed companies. Despite these market characteristics, Singapore has high CG awareness and the market performs strongly with low volatility.

The legislative and regulatory structure is analogous to Hong Kong with a strong reliance on self-regulatory mechanisms, namely the Code of Corporate Governance (CG Code) comply or explain regime. However, the regulators' powers differ in scope as does the statutory backing of specific CG rules and enforcement sanctions.

It is of particular interest to observe the cultural and structural CG similarities with not only Hong Kong but also China. Singapore provides an incubator for the development of CG in Hong Kong and China, which is extremely important as competition for future foreign company listings is imperative for the growth of these three large Asian markets.

V.1.1 Corporate governance system

Theoretical underpinnings

The CG system is based on the Anglo-American model, otherwise known as the outsider system¹, which originated in the United States. This CG system is characterised by dispersed ownership among many shareholders who are outsiders or external to the company, and as such, generally do not exercise control, giving rise to the separation of ownership and control.² Being a former British colony, Singapore has a shareholder-centric model of CG, with shared responsibility between the securities regulator, the Monetary Authority of Singapore (MAS), and Singapore Exchange Limited (SGX) which issues LRs subject to MAS approval.

Despite Singapore's economic success and competitiveness,³ the corporate landscape is largely devoid of the hallmark features of the United States CG system:

- (1) corporate control is weak even though it is often regarded as critical to the success of the United States model;⁴

¹ Tan Lay Hong, Long Hsueh Ching, and Tan Chong Huat (ed.), *Corporate Governance of Listed Companies in Singapore* (Singapore: Thomson Reuters, 2013), p. 24

² Adolf Berle and Gardiner Means, *The Modern Corporation & Private Property* (New York: The Macmillan Company, 1932)

³ In 2010, Singapore was ranked first in the world by IMD World Competitiveness Centre in terms of economic competitiveness and by Newsweek in terms of economic dynamism. Despite dropping to fourth place in 2016 (Hong Kong being ranked first, United States third, UK 18th, and China was in 25th place): Available at <http://www.imd.org/uupload/imd.website/wcc/scoreboard.pdf> (visited 15 November 2017)

⁴ Wee Meng Seng & Dan W. Puchniak, "Singapore Derivative Actions: Mundanely Non-Asian, Intriguingly Non-American and at the Forefront of the Commonwealth," in Dan W. Puchniak, H. Baum, & M. Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach*, (Cambridge: Cambridge University Press, 2012), p. 367, citing Martin Conyon, "Corporate Governance in Singapore: a case study in international corporate governance", in Christine Mallin (ed), *International Corporate Governance: A Case Study Approach* (Cheltenham: Edward Elgar, 2006), pp. 187-217; and Puchniak, "Singapore (Chapter 8)" in Bruce Aronson and Joongi Kim (ed), *Corporate Governance in Asia*, (forthcoming)

- (2) shareholdings are not dispersed, even though it is often viewed by legal origin theorists as a critical element to the success of United States economic performance;⁵
- (3) the market is dominated by block shareholders,⁶ which is similar to the Hong Kong market, although the degree of dominance and type of block shareholders differ;
- (4) external market discipline (e.g. hostile takeover) is fundamentally absent in Singapore; and
- (5) the independence of independent directors (IDs) is doubtful.⁷

The success of Singapore's system despite the market lacking dispersed shareholdings, private-sector corporate control, and genuine IDs, has effectively rewritten the legal origin theory. Singapore provides extensive shareholder protections and enjoys economic prosperity which suggests that there is another avenue to CG success which is not dependent on the United States' model path.⁸

Design elements

Similar to Hong Kong's CG system, Singapore has adopted a CG Code that applies a "comply or explain" approach. However, the CG Code is issued by MAS, and not by the SGX, whereas in Hong Kong the exchange, Hong Kong Exchange Limited (HKEx), is responsible for formulating the CG Code's rules, albeit with approval by the securities regulator, the Securities and Futures Commission (SFC). This is one significant difference between the CG systems. The listing rules (LR) of the Mainboard and Catalist contain the CG Code - they are interpreted, administered, and enforced by the SGX, whose decisions and requirements are conclusive and binding on an issuer. This is analogous to Hong Kong where the HKEx exercises these responsibilities.

Singapore and Hong Kong operate under a continuous listing and disclosure regime, as opposed to the merit-based approach where the regulator judges the suitability of securities offered to the public. There is a greater reliance on disclosure and the CG Code's "comply or explain" reporting requirements.

However, SGX Mainboard LR 105(2) requires all listed companies, including foreign companies, to comply with the LRs in accordance with the spirit, intention, and purpose, and by looking beyond form to substance. Hong Kong's Main Board LRs do not have such a requirement. Further, Singapore's LRs state that an issuer must describe its CG practices with specific reference to the principles of the CG Code in its annual report. A listed company must disclose any deviation from any guideline of the CG Code together with an appropriate explanation for such deviation in the annual report. Singapore's LRs, including the CG Code, apply to all listed companies, including foreign issuers. However, as is emphasised in Appendix V.1.3, the "comply or explain" requirement has resulted in poor explanations for non-compliance.

V.1.2 Corporate governance: formal and informal approach

Singapore's formal regulation of listed companies is similar to Hong Kong, being based on two elements of a sound legal framework and an effective supervisory and enforcement regime. A three-pronged approach of detecting, investigating market misconduct, and enforcing sanctions is implemented through a fragmented regulatory

⁵ La Porta et al, "Law and Finance," (1998) 106 *Journal of Political Economy* 1113-1155, 1151

⁶ Isabel Sim, Steen Thomsen, and Gerard Yeong, "The State as Shareholder: The Case of Singapore," (June 2014) *Chartered Institute of Management Accountants and Centre for Governance, Institutions and Organisations-NUS Business School*, 6: Available at http://bschool.nus.edu/Portals/0/docs/FinalReport_SOE_1July2014.pdf (visited 26 May 2016)

⁷ Wee Meng Seng & Dan W. Puchniak, op. cit, p. 367

⁸ Ibid

structure involving the SGX and the Commercial Affairs Department (CAD) of the Singapore Police force (i.e. white-collar crime). The company regulator, the Accounting and Corporate Regulatory Authority (ACRA), is also responsible for monitoring corporate compliance with the disclosure requirements.

Legal innovation and foresight by law-makers in the formulation of Singapore's CG policy has prevented some of the legal problems at the technical level which have arisen in the UK and Hong Kong. For example, Singapore adopted a statutory derivative action which overcame the problems inherent with the common law derivative action and the rule in *Foss v Harbottle*, and the unfair prejudice and oppression remedy available in Hong Kong and the UK.⁹

The formal approach of Singapore's CG and investor protection requirements are predominantly sourced from the CG Code "comply or explain" regime which places greater reliance on disclosure and legal avenues for redress (e.g. derivative actions).

Government controlled companies or sometimes called Government-Linked Companies (GLCs) and family-controlled companies form a closely connected community that facilitates government regulation of listed companies through informal mechanisms. Informal mechanisms are the cultural elements, such as networks (e.g. political and/or family), customs, traditions (e.g. family and political), norms, and religion. Board composition can be influenced by family and/or government networks which affects their relationship. History and development also influenced these informal mechanisms, for example, Singapore and Hong Kong being former British colonies.

A further market characteristic is the presence of S-chip companies—Chinese companies listed on the SGX—which are either locally incorporated or incorporated offshore (e.g. Cayman Islands, British Virgin Islands, or Bermuda). They have business operations in Mainland China and are often Chinese state-owned enterprises. An inundation of Chinese company listings on the SGX (S-chips) occurred in the late 1990s and early 2000s. Towards the end of the 2000s, a number of corporate scandals were exposed involving S-chips incorporated off-shore. The motivation to list outside of China's strict regulatory regime and the structure of S-chips, being incorporated overseas, were seen as two driving factors in these scandals.¹⁰ Singapore's lack of off-shore regulatory reach and corporate accountability preceded the delisting of many S-chips. These scandals provided the impetus for significant changes in Singapore's CG framework.

Informal networks may be influenced by government policies which can take a protectionist position (e.g. GLCs and S-chips). In this way, informal networks and law enforcement can influence the formal regulatory mechanisms. This is evident from some of the examples discussed in Appendix V.1.6.¹¹

Informal mechanisms give rise to informal contracts that are important to influence, for example, the relationship between management and non-controlling shareholders. However, as retail investors tend to be passive in Singapore, the informal CG approach is principally dependent on monitoring by controlling shareholders. The composition of controlling shareholders and the informal mechanisms in Singapore, like Hong Kong and China, give rise to a potential conflict of interest. For example, in practice the control mechanisms inherent to GLCs, S-chips, and family-controlled companies undermine the monitoring role of IDs.

⁹ See, Wee Meng Seng & Dan W. Puchniak, op. cit, p. 366

¹⁰ Zu Hao Peh, "Dealing with Perception, A Look at Overseas-Listed Chinese Firms in Singapore," (6 February 2014) *NUS Centre for Banking & Finance Law, Working Paper*, 8-9

¹¹ Andreas Hogberg, "Formal and Informal Institutions in Asia: A Survey of Asian Corporate Governance," (2009) *Jonkoping International Business School, Sweden*, 9, 10, and 19

V.1.3 Corporate culture

The following Singaporean CG cultural characteristics have been observed:

(1) Although the CG Code expects listed companies to comply with the spirit and not merely the letter of the CG Code, this has subsequently proved to be problematic. Satisfying the CG Code's "comply or explain" regime has been described as a "box-ticking" exercise which has been criticised publicly by a number listed company Chief Executive Officers (CEO), representing the market view.¹² They argued that this approach would not assist in building sustainable global businesses. A number of media articles (notably in the Business Times) over five years (i.e. 2011-2016) tended to criticise the "box-ticking" or rules-based approach as this leads to a minimalist CG compliance and low-quality generic explanations. For example, when Singapore Post (SingPost) failed to meet its disclosure requirements (2015):

"SingPost shareholder Mak Yuen Teen...raised questions about public disclosures relating to Mr Tay's possible interest in three of SingPost's recent acquisitions ...Adrian Chan, head of corporate at law firm Lee & Lee, hopes...that the company will agree to share with the public the identified shortcomings and the steps taken to rectify and remedy any lapses."¹³

This culture has been blamed on the SGX's lack of clarity to set the parameters of what should be "explained":

"...many companies feel that it would be more helpful if the SGX clearly communicates to companies precisely what are acceptable or unacceptable explanations for deviations from the Code, instead of leaving them to make their own judgment calls."¹⁴

The SGX launched a review in 2015 on how listed companies abide by the "comply or explain" requirements under the revised CG Code in 2012. In this context, the CG initiatives undertaken by Hong Kong since 1997 have preceded those of Singapore.

The Asian Corporate Governance Association (ACGA) 2014 report states that some companies have a culture of "refusal to comply" which is evenly distributed among Mainboard and Catalist companies (25 apiece).¹⁵ A majority of listed companies also treat certain provisions of the CG Code as subject to their own discretion in deciding whether to comply or not. For example, a 2014 survey by the Singapore Institute of Directors (SID) and the SGX among others, found that 69% of companies (uniformly across all industries) had a low level of director remuneration disclosure.¹⁶

A MAS review of 550 out of 593 Mainboard listed companies' "comply or explain" approach, which is clearly set-out in LR 710, illustrates a general market

¹² Business Times, "Statement of Support: 92 companies have backed it so far," (23 October 2014)

¹³ Melissa Tan, "SingPost set for special audit of its corporate governance," (24 December 2015) *Business Times*

¹⁴ Joyce Koh, "Making comply or explain work," (23 November 2015) *Business Times*

¹⁵ Amar Gill, Jamie Allen, Charles Yonts, and Irina Bevza, "Dark Shades of Grey: Corporate Governance and Sustainability in Asia," (September 2014) *CLSA and ACGA, CG Watch 2014, Special Report*, 179: Available at <https://www.clsa.com/about-clsa/media-centre/2014-media-releases/corporate-governance-watch-2014-eng.php> (visited 26 May 2016)

¹⁶ SID and ISCA, "The Singapore Directorship Report 2014," 31 referring to note 7: Available at <http://www.isca.org.sg/tkc/cogov/general/general/2015/april/sid-isca-singapore-directorship-report-2014> (visited 7 June 2016)

disregard for good CG. The media reports that the typical market analogy of the approach to the “comply or explain” regime is likened to:

““stop” signs on our roads are now treated as “give way” signs at best, and “give way” signs are treated as “get out of my way” signs by many motorists. It has to do with the lack of monitoring and enforcement.”¹⁷

The SGX has acknowledged, and is taking steps to, remedy Singapore’s current CG culture:

“... conscious of the misconceptions or lack of awareness” about the Code, which “may have led to inadvertent failures to adhere to our rules”.¹⁸

A number of “comply or explain” CG strengthening measures, including director independence, board composition, director training, multiple directorships, alternative directors, remuneration practices and disclosures, risk management, and shareholder rights and roles, are currently being implemented by the MAS and SGX to address this issue (see Appendix V.2.1).

CG culture remains weak in Singapore, although efforts have been made by regulators to emphasise the importance of good CG. Box-ticking and weak explanations for non-compliance, notably small listed companies and S-chip SOEs, remain the norm. One argument suggests that the “comply or explain” approach does not work well as a result of a weak CG culture. Others have expressed a similar sentiment in relation to the “comply or explain” approach in Hong Kong and posit that compulsory rules work better to promote good CG. Compulsory rules do not necessarily improve CG (e.g. China). These examples highlight instances where culture has a fundamental influence on the ability or willingness to comply with non-statutory CG requirements or recommendations.

(2) Media articles from 2011-2016 suggest that it is common knowledge that the CG model is not supporting minority shareholders (i.e. retail investors), despite the early adoption of a statutory derivative action and an unfair prejudice and oppression remedy. The media argues that this has prompted the Singaporean government to accept that the CG system has serious shortcomings and there is a need for major structural reforms (representing the media perception). For example, the 2013 penny stock crash¹⁹ resulted in a number of media reports calling for CG reforms, such as “whether regulators could have done more to avert the disaster and to bring any perpetrators to justice.”²⁰

(3) At the annual 2014 Securities Investors Association Singapore (SIAS) CG week, 92 listed companies demonstrated their appreciation of good CG by joining a Statement of Support.²¹ Placed in the context of total listed companies, however, (2016 statistics–770 listed companies), this only represents about 12%.

¹⁷ Mak Yuen Teen, “Enforcing the Comply or Explain Requirement,” (20 October 2015) *Business Times*

¹⁸ Melissa Tan, “SGX to inspect over 550 listed firms on governance code,” (13 October 2015) *Business Times*

¹⁹ Three companies: Asiasons Capital, Blumont Group, and LionGold Corp; were subject to share price manipulation by three individuals to trigger steep increases in these companies’ share prices followed by precipitous falls resulting in an SG\$8 billion loss of market value over less than two trading days. Two brokerage firms were also scammed into extending more than SG\$170 million of margin financing. This consequently resulted in tighter enforcement of Singapore’s securities markets

²⁰ Business Times, “Enforcement takes centre stage in outlook 2016,” (1 January 2016)

²¹ “As a Company, we are committed to upholding high standards of corporate governance to enhance shareholder value. We believe practising good corporate governance is central to the health and stability of our financial markets and economy.”

(4) In 2016 Singapore's CG standards were ranked second by ACGA, ahead of Hong Kong which was ranked third out of 12 Asia-Pacific markets.²² A number of areas for improvement were identified,²³ for example, shareholder rights lag behind international standards because they are subject to outdated rules. These rules include:

(a) shareholders being prohibited from appointing more than two proxies²⁴; (b) brief or no explanation notes for key resolutions; (c) no clear or appropriate reasons to be provided for delaying results announcements or holding annual general meetings (AGMs)²⁵; and (d) the 14 day deadline for releasing AGM agendas.²⁶

(5) Certain types of listed companies do not have an appreciation of the importance of good CG. For example, the 2015 Singapore Governance and Transparency Index (GTI) suggests that CG culture is weaker in smaller companies. In particular, the GTI found that large companies have superior board processes and more resources to meet disclosure requirements. The GTI does not provide a definition of large or small firms. However, the ACGA CG Watch 2014 lists only three Singaporean companies (including the SGX as a listed company) with market caps under United States dollar (USD) 10 billion as having high CG ratings. In the context of Asia this is a poor result.²⁷ Research also tends to support SGX-listed GLCs having better CG than non-GLCs.²⁸ Weak results for listed small companies and non-GLCs may explain why CG culture in Singapore has consistently been rated poorly in the annual ACGA CG Watch reports, despite Singapore topping the overall CG Watch ratings in 2012 and 2014. For example, prior to 2014, the scandals involving large S-chip companies severely eroded market confidence.

In the Asia-Pacific, two Singaporean banks (i.e. United Overseas Bank Limited (UOB) and Oversea-Chinese Banking Corporation Limited (OCBC)) were in the top-20 large-capitalisation (i.e. over USD 10 billion) CG listed companies.²⁹ When examining the companies in Asia-Pacific's top-two CG quartiles (as surveyed by the Credit Lyonnais Securities Asia (CLSA) in 2014) the Singaporean industries with the highest CG scores were real estate and transportation/logistics, followed by telecommunications and financial services. The total number of Singaporean listed companies in this group was 23, not an outstandingly high number in comparison to other Asia-Pacific jurisdictions surveyed by the Centre for Governance, Institutions & Organisations (CGIO). Moreover, S-chips constituted the lower half of rankings in the 2011 GTI.

(6) Few companies provide limits on the number of directorships their board appointments hold. Some companies retain IDs for long periods of time (i.e.

²² Australia was ranked first, and Mainland China 10th. See, Enoch Yiu, "Hong Kong loses to Singapore in corporate governance survey," (29 September 2016): Available at <http://www.scmp.com/business/companies/article/2023697/hong-kong-loses-out-singapore-corporate-governance-survey> (visited 15 November 2017)

²³ See, for example: Tan Lay Hong, "Recent Case Study on corporate governance in Singapore: The "Good", the "Bad", and the "Ugly","(2009): Available at <http://www.clta.edu.au/professional/papers/conference2009/TanCLTA09.pdf> (visited 15 November 2017)

²⁴ CA, s 181(1A)

²⁵ Quah Michelle, "Shareholder Activism, engagement improve, but not enough: study," (12 April 2016) *Business Times*

²⁶ Gill et. al, op. cit, 172

²⁷ Ibid, 17-Figure 11

²⁸ See: Sim et. al, op. cit

²⁹ Gill et. al, op. cit, 16

greater than nine years) which questions their independence. Decisions in family firms and GLCs are characterised by a lack of director independence and connections with families or the government.

(7) In family firms, IDs are typically appointed on the basis of trust - those who do not upset the status quo rather than those who challenge management. This can be explained by an underlying culture which does not trust outsiders. With GLCs, government control can compromise the independence of directors (i.e. as in China). The definition of an ID, which differs from the American model, is related to share ownership (i.e. having more than 10% voting rights), immediate family members, or someone who has been associated with a significant shareholder (i.e. having more than 10% voting) in the past financial year. This definition does not preclude the appointment of family associates or persons connected with the government. A 2016 review of annual reports since the introduction of the 2012CG Code revealed a number government-linked appointments, despite there being no mention of this in the relevant report. For family firms, a friend or associate holding less than 10% of the company's voting shares can be appointed and deemed an ID. Empirical evidence suggests that a large percentage of IDs are family friends.³⁰

(8) ACRA's 2013 practice monitoring program revealed a number of deficiencies involving accounting standards—cashflow forecasts, revenue recognition, accounting estimates and fair value measurement, and group audits.

(9) Remuneration rules are weak (i.e. comply or explain) and disclosure is poor. A 2014 survey revealed that 68% would refuse to comply with the CG Code on director and CEO disclosure.³¹ Nonetheless, the CG Code has one of the most advanced remuneration disclosure designs in Asia, in terms of underlying policy, level and mix of remuneration, and procedure for calculation, which has to be disclosed in the company's annual report.

(10) A general consensus among investors, managers, and analysts (2014) is that disclosure of price-sensitive information in Singapore, even among large caps, is weaker than in Hong Kong.³²

(11) Singapore's informal CG approach is principally dependent on monitoring by block shareholders, not retail investors who tend to be passive.

(12) Singaporean institutional investors are passive and do not have an active role in CG.

(13) Regulatory enforcement of serious securities crimes, such as insider trading and market manipulation, is noticeably lower-profile in Singapore compared with Hong Kong. In contrast to Hong Kong, where SFC enforcement actions have resulted in prison sentences and large fines, Singaporean enforcement involves a fine or a fine and director disqualification. MAS settles most cases of insider trading without going to court.

(14) Singapore has no overarching whistle-blowing legislation (i.e. similar to Hong Kong but converse to China). There are provisions for whistle-blowing against corruption, for example, section 36 of the Prevention of Corruption Act provides anonymity to whistle-blowers. However, anonymity can be revoked in certain circumstances. Whistle-blowers are protected against retaliation under the

³⁰ Dan W. Puchniak and Luh Luh Lan, *op. cit.*, 25

³¹ Amar Gill, *et. al*, *op. cit.*, 180

³² *Ibid*, 173

Penal Code. However, incidents of whistle-blowing are rare, which may be attributed to the market culture based on a lack of whistle-blower protection, no rewards for whistle-blowers (c/f China), the dominance of GLCs and family firms, connected “independent” (i.e. not independent) directors, and strong censorship laws.

(15) Private interest groups promoting good CG are well developed. These groups include, inter alia, the SIAS; SID; Institute of Certified Public Accountants of Singapore; Certified Financial Analyst Society Singapore; and Chartered Secretaries Institute of Singapore.

V.1.4 Market characteristics

Stock exchange

Regulatory structure:

The SGX exhibits similar structural characteristics as the HKEx: there is only one stock exchange which operates as a monopoly. It is a self-regulatory organisation - a listed investment holding company on the SGX and a profit-making entity. Prima facie, this might suggest that the HKEx and SGX are less interested in high standards of CG. This could deter companies from seeking an initial public offering (IPO). Conversely, because there is competition for investors at the international and regional level, the exchange’s monopoly and lack of competition within each jurisdiction does not per se preclude each exchange from raising their CG standards. The SGX is approved by the MAS under the Securities and Futures Act (Cap. 289) (SFA). Analogous to Hong Kong’s Main Board and Growth Enterprise Market (GEM)³³, the SGX also has two boards; the Mainboard and Catalist. The Mainboard caters to the needs of established enterprises, while the Catalist caters to the needs of fast-growing enterprises. Each board has their own LRs and are subject to different regulatory regimes. However, in contrast to Hong Kong’s system, the Catalist company regulatory regime is far less onerous—for example, Catalist companies do not have to conform with the prospectus requirements in the Securities and Futures Regulations, and they are not overseen by MAS. This is different from Hong Kong where, although the entry requirement for the GEM is lower, other regulatory requirements are more onerous. This raises the question of whether Hong Kong’s GEM rules should be relaxed to encourage more fast growing companies to be listed in Hong Kong. This question has been partially addressed recently, although not by relaxing GEM listing requirements. To encourage more listings of fast growing companies (i.e. technology), weighted voting rights (WVRs) has been proposed for these types of companies to list on the Main Board. Singapore has made a similar proposal.

Potential conflict of interest:

The SGX actively monitors and sets standards for listed companies. However, the structure and regulatory role of the SGX creates potential conflicts of interest:

“This has led to comments from corporate governance commentators and the media as to whether SGX can be fully effective in both roles, given the inherent conflicts of interest that may arise.”³⁴

³³ GEM is for growth companies that do not meet the requirements of profitability or track record required by the Main Board. Although it is easier to get listed on GEM, there are more stringent rules for greater, more frequent, and timely disclosure, and CG arrangements. For details see, Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (Hong Kong: LexisNexis 1st edn, 2012), pp. 85-88

³⁴ Annabelle Yip and Joy Tan, “Singapore,” in Willem J L Calkoen (ed), “The Corporate Governance Review,” (2013) *Third Edition, Law Business Research Ltd*, 291: Available at <http://www.wongpartnership.com/files/download/761> (visited 15 November 2017)

To address this conflict “Guiding Principle Six” was issued. The SFA places a legal obligation on the SGX’s board and management to maintain effective governance arrangements for managing conflicts, such as, ensuring access to its facilities, are subject to fair and objective criteria and that the exchange does not act contrary to the public interest while discharging its obligations.³⁵ Being a company listed on its own exchange, enhanced disclosure strengthens the SGX’s credibility. When potential conflicts of interests arise, notably the reasons for admitting companies to list on the exchange, enhanced disclosure of the SGX’s reasons should be publicly available which supports the admission decision based on objective predetermined criteria. This is designed to enhance the SGX’s reputation by dismissing any perceptions of conflict that admission decisions are not essentially based on commercial gain.

Structural arrangements support Guiding Principle Six, namely establishing a Regulatory Conflict Committee (RCC) of the board to identify and regulate conflicts. The RCC must consist of at least three IDs from SGX, with the majority of the committee being independent from the SGX’s substantial shareholders. MAS oversees the SGX and its management of regulatory conflicts. Appointment of RCC members, and the chairman, CEO, and directors of the SGX board are subject to MAS approval. The SGX board, supported by RCC members, reports to MAS annually on the basis of the adequacy of SGX’s self-regulatory organisation conflicts management framework and practices. MAS is empowered by the SFA to remove officers who have wilfully contravened or failed to ensure SGX compliance with the SFA or LRs. Thus, the SGX has to balance the conflicts of being a regulator with the role of a standards setter. This is different from Hong Kong, where regulatory conflict is handled by the SFC overseeing the HKEx’s compliance with its own LRs.³⁶

Listed company composition and statistics

As of March 2016 there were 770 listed companies on the SGX—593 on the Mainboard and 177 on the Catalist. Of the 770 listed companies, 484 were Singapore companies (62.85%), 166 foreign companies (21.55%), and 120 Chinese companies (15.58%).³⁷ Foreign companies (including S-chips) made up 37.14% of total listed companies in 2016.

In comparison, Hong Kong had 1866 listed companies, a much larger number than the SGX at 770. According to the World Federation of Exchanges Statistics, there are 1770 domestics³⁸ and 96 foreign companies listed on the HKEx. This would appear to suggest that foreign companies (excluding from the Mainland) prefer Singapore to Hong Kong as a destination for listing. How can Hong Kong attract more foreign companies to establish the HKEx as a desirable international bourse? Being a gateway and conduit to Chinese markets is one advantage. Corporate scandals involving Chinese companies listed on the SGX, the HKEX, and other foreign exchanges is however, a deterrent. Strengthening CG, including investor protections while relaxing other regulatory requirements (e.g. WVRs) to attract more technologies companies, are two steps to encourage more foreign companies to list on the HKEx.

While there are more “foreign companies” listed in Singapore than Hong Kong, the market capitalisation of Hong Kong is almost five times the size of the Singaporean

³⁵ SFA, s 16

³⁶ For details see, Jones, op. cit, pp. 129-138

³⁷ This excludes global deposit receipts, Hedge Funds and Debt Securities. See SGX, “Market Statistics Report,” (March 2016), 1, 23 and 24: Available at <http://www.sgx.com/wps/wcm/connect/5f2a9e47-875a-47cc-bc96-49faf607c92c/SGX+Monthly+Market+Statistics+Report+-+Mar+2016.pdf?MOD=AJPERES&CACHEID=5f2a9e47-875a-47cc-bc96-49faf607c92c> (visited 26 May 2016).

³⁸ Domestic companies are defined as companies that are incorporated in the same country as where the exchange is located. The only exception is the case of foreign companies which are exclusively listed on an exchange, which is also counted as domestic. This explains the small number of “foreign companies” in Hong Kong market as many companies listed in Hong Kong are incorporated overseas

market (USD3,184,874 million in Hong Kong compared to USD639,955 million in Singapore).³⁹ The Securities Daily Average Value of the SGX for 2015 was SG\$1083.5 million⁴⁰ and average daily number of trades in the second half of 2015 was 216,000.⁴¹ In comparison, average daily turnover of the Hong Kong Stock Exchange (SEHK), Main Board and GEM, in November 2016 was Hong Kong dollar (HKD) 67,677 million. Thus, Singapore's daily turnover is only about 10% of the SEHK. Hong Kong is a much bigger market than Singapore which is an advantage in attracting foreign listings.

S-chips

Most S-chips are incorporated in overseas jurisdictions. A lack of regulation and accountability of non-SOE controlled S-chips was viewed as the cause of a number of accounting scandals and subsequent de-listings over the past decade, and severely undermined S-chip CG creditability. Consequently, the popularity of S-chips listed on the SGX among investors has markedly declined since the 2000s.

In 2013 there were no S-chip IPOs in Singapore, compared with 65 listed in Hong Kong and eight in the United States. This creates a strong incentive for Singapore to improve its CG system to maintain the high level of foreign company listings and increase S-chip IPOs in order to compete with Hong Kong and other international financial centres. Hong Kong cannot be complacent regarding its CG system and competition from the SGX and other regional bourses for S-chips and foreign company IPOs.

V.1.5 Shareholder ownership

Block shareholders

Over 90% of SGX listed companies have block shareholders exercising controlling power⁴²—controlling 15% or more of total listed shares which are either family-firms, GLCs (where the government is the controlling shareholder),⁴³ or the Chinese government. According to the Organisation for Economic Co-operation and Development (OECD) 2015 Corporate Governance Fact Book, ownership concentration by family and government-linked majority shareholders has historically been high. Family-firms⁴⁴

³⁹ As of 15 December 2015, Market for Shanghai Stock Exchange is USD4,549,288 million, Shenzhen Stock Exchange is USD3 638,731 million. The combined market capitalisation of the two exchanges is about 2.5 times the size of the Hong Kong market

⁴⁰ Securities daily average value among SGX ordinary shares for the period from 1 January 2015 to 30 June 2015 was SGD 1, 131 million, and was SG\$1, 036 million between 1 July 2015 and 31 December 2015: SGX, "Securities Market Quality Indicators," (July 2015 – December 2015), 2: Available at <http://www.sgx.com/wps/wcm/connect/bc9fd2e7-90fc-4f71-83a4-a69b30b3dc52/Securities+Market+Quality+Report+2015+H1.pdf?MOD=AJPERES&CACHEID=bc9fd2e7-90fc-4f71-83a4-a69b30b3dc52> (visited 26 May 2016)

⁴¹ Ibid

⁴² Tan Cheng-Han, Dan W.Puchniak, and Umakanth Varottil, "Historical Insights Into a Potential Model For Reform," (March 2015) *NUS Law Working Paper 2015/003*, 6: referring to Luh Luh Lan and Varottil 2015: Available at http://law.nus.edu.sg/wps/pdfs/003_2015_Dan_ChengHan_Umakanth.pdf (visited 26 May 2016)

"Controlling power" is defined as a person who: (1) holds directly or indirectly 15% or more of the total number of issued shares excluding treasury shares in the company. The exchange may determine that a person who satisfies this paragraph is not a controlling shareholder; or (2) in fact exercises control over a company: See SGX Main Board Rules/Catalist Rules Definitions and Interpretation of "controlling shareholders"

⁴³ Singaporean companies in which Temasek Holdings has invested (i.e. government investment) are generally known as GLCs. GLCs have a high industry concentration in transport, storage, communications, and multi-industry sectors: Sim, et. al, op. cit, 29

⁴⁴ "Family firms" can be defined as those companies where there is wither family ownership, involvement in, or influence over, a firm: Marleen Dieleman, Jungwook Shim, and Muhammad Ibrahim, "Success and Succession: A Study of SGX-listed Family Firms," (May 2013) *NUS Centre for Governance, Institutions & Organisation and DBS*, 7: Available at <https://bschool.nus.edu/Portals/0/images/CGIO/Report/Asian%20Family%20Business%20Report.pdf> (visited 16 November 2017)

comprise 60.8% of all listed SGX firms (2013), representing 33% of total market capitalisation.⁴⁵

Government-linked companies

Singapore's government, through shareholdings in the sovereign wealth fund Temasek Holdings (Private) Limited (Temasek Holdings) and other GLCs control a substantial portion of the market.⁴⁶ The Singaporean government holds 23.4% of the SGX through Temasek Holdings. Based on 2008-2013 Bloomberg data, GLCs account for 37% of total SGX market capitalisation. Therefore, the Singaporean Government is the most powerful block shareholder in Singapore. In Hong Kong, there are very few government controlled listed firms. Most listed companies in Hong Kong are either family controlled or subject to Chinese Government control (e.g. SOEs). Therefore, in comparison to Hong Kong, the Singaporean government has greater influence over informal mechanisms to regulate listed companies and enforcing CG measures. This comes at a cost because director independence in many of Singapore's GLCs is doubtful.⁴⁷

Singapore's GLCs are nonetheless seen as a good model for reforming China's SOEs with the Chinese Government recently resolving to replicate Singapore's GLC model 30 times over in the Mainland by 2020. However, the Singaporean GLC model is so closely intertwined with Singapore's idiosyncratic history and unique regulatory culture that transplanting the model to China or elsewhere could prove problematic.⁴⁸

One notable feature for Singapore's GLC's success, which could be a lesson for many countries including China, is that there is limited government interference. Another feature is that the ideology of public governance in Singapore is transposed to its GLCs, which has resulted in professionalism in management and governance, executive compensation practices to attract the best talent, and zero-tolerance towards corruption. These features are hallmarks of good governance in the public sector and GLCs. The Singaporean government needs to ensure that GLCs are successful because the ruling political party's (People's Action Party (PAP)) future, which has formed government since the country's independence, depends on the economic performance of Singapore and, therefore, its GLCs. Hong Kong's government does not have this level of political accountability, except so far as the performance of the property market from which the government derives much of its revenues. However, the Chinese Communist Party (CCP) is in a similar situation as the PAP in terms of political accountability—the CCP's mandate and legitimacy is sourced from a pledge to look after the people of China.

Institutional investors

Apart from Temasek Holdings which has a good CG record based on data collected from the 2014 GTI, there is very limited information on institutional investors.⁴⁹ Tan and Long assert that Singaporean institutional investors are passive and do not play an active role in CG.⁵⁰

⁴⁵ The distribution of SGX-listed family-firms, that is the proportion of family-firms to total firms, by industry is: construction (81.3%); hotels/restaurants (72.2%); property (70.7%); manufacturing (64.3%); commerce (58.2%); financial services (42.3%); and transport, storage, and communication (37.1%): Dieleman, et. al, op. cit, 11. This distribution demonstrates family-firms dominance across a number of Singaporean industries, notably those involving the real estate sector

⁴⁶ Wee Meng Seng & Dan W. Puchniak, op. cit, p. 367. See also Sim et. al, op. cit

⁴⁷ Ibid

⁴⁸ Dan W. Puchniak and Cheng H. Tan, "Company Law," (2015) *Singapore Academy of Law Review of Cases* 255

⁴⁹ Sim et. al, op. cit, 8

⁵⁰ Hong et. al, op. cit, p. 24

Retail investors

Retail investors account for 30% of market turnover (2012).⁵¹ In Hong Kong and Mainland China retail investors account for approximately 20% of market turnover. This might suggest that stronger protections are needed in the form of CG.

V.1.6 Enforcement

Securities and Futures Act - criminal proceedings

Enforcement is weak and sanctions are mainly confined to civil actions because of a fragmented regulatory structure. For example, criminal proceedings can only be undertaken by CAD, with MAS and the SGX being constrained to civil sanctioning and investigatory powers. Criminal proceedings are, therefore, rare. Another reason is the higher standard of proof in criminal proceedings—prosecutors have to prove the criminal elements beyond a reasonable doubt. Part XII of the SFA deals with misconduct offences⁵² (see Appendix V.6.5).

Securities and Futures Act - civil proceedings

Civil enforcement actions undertaken by the MAS and SGX overwhelmingly focus on financial services. However, CG offences in the financial services sector are rare. Part XII of the SFA also covers civil liabilities for misconduct offences.⁵³

Continuous disclosure (s 203) imposes civil liability (Division 4) to complement criminal sanctions (s 204). This provides a nuanced approach to combat market misconduct.⁵⁴

Under section 232(1) of the SFA, whenever any person apparently contravenes any provision in Part XII of the SFA, MAS can, with the consent of the Public Prosecutor, bring an action in a court against that person—seeking an order for a civil penalty in respect of the contravention. This is similar to Hong Kong's Parts XIII and XIV of the Securities and Futures Ordinance⁵⁵ which also imposes both civil and criminal liability, except for continuous disclosure which is part of the Hong Kong LRs. However, disclosure of inside information has been moved from Hong Kong's LRs to Part XIVA (ss 307A-307G) of the Securities and Futures Ordinance which only attracts civil liability. Thus, Hong Kong's continuous disclosure regime is weaker than Singapore. It is, therefore, recommended that continuous disclosure in Hong Kong be subject to statutory market misconduct offences which carry civil and criminal liabilities as is in Singapore.

⁵¹ Ansuya Harjani, "Why Asia's Retail Investors Are Ditching the Market," (26 July 2016) *CNBC, Asia Economy*: Available at <http://www.cnbc.com/id/48331749> (visited 6 June 2016)

⁵² For example: market misconduct such as false trading and market rigging (s 197), market manipulation (s.198), false and misleading statement (s 199), fraudulently inducing person to deal (s 200), employing manipulative and deceptive devices (s 201), dissemination of information about illegal transactions (s 202), and continuous disclosure (s 203)), criminal liability (s 204)

⁵³ For example, sections 203 (2) and (3) cover continuous disclosure which carry both criminal and civil liability: "(2) The persons specified in subsection (1)(a), (b) or (c) shall not intentionally, recklessly or negligently fail to notify the securities exchange of such information as is required to be disclosed by the securities exchange under the listing rules or any other requirement of the securities exchange; and (3) Notwithstanding section 204, a contravention of subsection (2) shall not be an offence unless the failure to notify is intentional or reckless"

⁵⁴ This came into operation from 2004

⁵⁵ Securities and Futures Ordinance (Hong Kong), Parts XIII and XIV cover: insider dealing (ss 270-273 and ss 291-294), false trading (s 274 and 295), Price rigging (s 275 and 296), disclosure of information about prohibited transactions (s 276 and 297), disclosure of false or misleading information inducing transactions (s 277 and 298), stock market manipulation (s 278 and 299)), Division 4 of Part XIV which covers fraudulent or deceptive devices (s 300), and disclosure of false or misleading information inducing contracts (s 301)

Corporate Governance Code - comply or explain

Similar to Hong Kong's comply and explain regime, breaches of Singapore's CG Code are subject to lighter sanctions, such as reprimand and disqualification of directors, in comparison to the civil and criminal sanctions discussed above. Some questions have been raised concerning the effectiveness of the SGX's enforcement powers. For example, SingPost failed to disclose a related party transaction involving one of its directors. The SGX's subsequent investigation recommended a special audit which made market observers question whether full disclosure would result:

"SingPost's special audit would probably not be able to establish how Stirling Coleman came to be a financial adviser to the seller for a few of SingPost's acquisitions because that would require an audit of the seller or of Stirling Coleman, 'which won't be done', said corporate governance specialist and SingPost shareholder Mak Yuen Teen."⁵⁶

The ACGA CG Watch 2014 asserts that Singapore has "less impressive progress on enforcement". This has been particularly evident with the CG Code's "comply or explain" regime with continued criticism in the media, acknowledged by the government (in the media and in parliament) and the SGX through an announcement of a CG review into the matter (see Appendix V.2.1).

⁵⁶ Melissa Tan, SingPost set for special audit, op. cit

Appendix V	2. Policy	V.2 Singapore
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Introduction

The principal CG policy-makers are:

Ministry of Finance (MoF) - The MoF has the responsibility of enacting and amending CG statutes. Prior to the establishment of Temasek Holdings in 1974, the Singaporean government's stake in local companies was held by the MoF. Since 1984, Temasek Holdings has taken over the government's stake in those companies and the added CG responsibility. The MoF is the only shareholder of Temasek Holdings thus providing a government-link to its corporate investments and CG responsibilities.

Monetary Authority of Singapore - The MAS is an integrated supervisor and regulator overseeing and regulating the CG of all financial institutions in Singapore - banks, insurers, capital market intermediaries, financial advisors, and the SGX. In the context of Hong Kong, MAS combines the regulatory functions and responsibilities of the Hong Kong Monetary Authority, the Insurance Authority, and the SFC. The MAS has less oversight of an SGX's disciplinary procedures, LR changes, and the day-to-day supervision of the market, which are the responsibilities of the SGX.

Accounting and Company Regulatory Authority - ACRA is the regulator of business entities, public accountants, and corporate service providers in Singapore. ACRA's role is to achieve synergies between the monitoring of CG compliance, disclosure requirements, and the CG regulation of public accountants performing statutory audit. In the context of Hong Kong, ACRA is a combination of the Company Registry and Financial Reporting Council (FRC).

Accounting Standards Council - The broad policy intention of the Accounting Standards Council (ASC) is to issue Financial Reporting Standards based on International Financial Reporting Standards (IFRS) and the International Accounting Standards Board (IASB). This role is analogous to the Hong Kong Institute of Certified Public Accountants (HKICPA).

The Securities Industry Council (SIC) - SIC administers and enforces the Code on Takeovers and Mergers independently of the MAS. In Hong Kong, the Code on Takeovers is administered by the SFC's Takeovers Panel, which is not independent of the SFC.

SGX - Similar to the HKEx, the SGX is an investment-holding company that provides listing, trading, clearing, settlement, depository, and data services. The SGX regulates and oversees the CG of all the listed companies on the SGX in accordance with the LRs.

A number of statutes (e.g. Banking Act and Insurance Act) empower the MAS to issue CG regulations, written directives (Monetary Authority of Singapore Act (Cap. 186) (MAS Act) s 27), codes, and guidelines for regulated financial companies. Guidance can be provided by the MAS, SGX, and ACRA at the regulator's discretion.

V.2.1 Parties responsible for regulatory development

Government related

The MoF is Singapore's highest level CG policymaker. In its CG policymaker role, the MoF is:

"To establish Singapore as an international business and financial centre...to maintain international standards and best practices in areas such as Company law, Accounting standards, and Corporate governance principles".⁵⁷

Principal regulatory statutes are: Accountants Act, Accounting Standards Act, Business Registration Act, and Companies Act (Cap. 50)(CA).

The role of the MoF is more than "in principle" – its CG policymaking function is firmly established in its Mission Statement—to maintain international standards, best practices, and reviews CG-related statutes (e.g. CA). This has been supported by the MoF exercising CG policy making functions by setting up a "Steering Committee" in 2007, and the public CG review in 2011-2012. The Steering Committee (Steering Committee to Review the Companies Act) undertook the most comprehensive review since 1999 and made recommendations for amending the CA.

In 2013, the MoF and ACRA launched an extensive industry/public consultation to implement the Steering Committee's recommendations on draft amendments to the CA. The Steering Committee made 217 recommendations, covering areas such as directors, shareholders' rights and meetings, and general company administration. A review of the feedback from two rounds of industry/public consultation was completed in 2014 with the MoF accepting 192 and modifying 17 Steering Committee recommendations. Amendments to the CA were subsequently passed by Parliament in 2014 (see Companies (Amendment) Bill No. 25 of 2014) and implemented in two phases beginning in 2015 and 2016 (see Companies (Amendment) Act 2014).

Industry Regulators

Monetary Authority of Singapore:

The MAS is Singapore's central bank and integrated financial sector regulator which:

"...helps shape Singapore's financial industry by promoting a strong corporate governance framework and close adherence to international accounting standards."⁵⁸

This structure is different from Hong Kong where the Hong Kong Monetary Authority is the de facto central bank and banking sector regulator. The MAS is more similar to UK's 2001-2013 regulator, the Financial Services Authority, which regulated all financial sectors albeit was not a central bank.

MAS has established committees and councils to issue, review, and make recommendations to amend the CG Code which was first published in 2001. The CG Code came under MAS and SGX purview in 2007 and was subject to a 2012 revision by the MAS in accordance with its general powers under section 23 (8) of the MAS Act and regulatory-making powers pertaining to specific Acts (e.g. Banking Act, s 78). Amendments to the CG Code included changes relating to:

⁵⁷ MAS, "About MAS": Available at <http://www.mas.gov.sg/about-mas.aspx>; and MAS, "Overview - Our Mission": Available at <http://www.mas.gov.sg/about-mas/overview.aspx> (visited 16 November 2017)

⁵⁸ Ibid

(1) director independence; (2) board composition; (3) multiple directorships; (4) alternate directors; (5) remuneration practices and disclosures; (6) risk management; and (7) shareholders' rights and roles.

This is an interesting development considering the CG Code is part of the LRs which are administered by the SGX. This is similar to Hong Kong where the CG Code is part of the LRs.

MAS is a statutory CG regulator in accordance with the statutes which empower it to make CG regulations, codes, rules, and guidance. (e.g. SFA, Banking Act, Insurance Act, etc). This is different from Hong Kong where the LRs, which include the CG Code, are formulated by the HKEx subject to SFC approval. However, neither the MAS nor the SFC enforce the LRs and CG Code (this is the role of the exchange, c/f China), although some argue that the SFC can enforce the LRs through section 213, of the Securities and Futures Ordinance. The recent "front-loaded" approach by the SFC to fully utilise the powers under the statutory Stock Market LRs are an indirect way of enforcing good CG in Hong Kong. Arguably, the SFC should be responsible for the provisions of the CG Code which overlap with its statutory regulatory perimeter.

Part of the CG revision process involved MAS establishing a temporary Corporate Governance Council (CGC) in 2010 to conduct a formal and industry/public review of the CG Code on its behalf. The CGC was established by MAS to review the CG Code and issue the Risk Governance Guidance for Listed Boards 2012. After taking into consideration these recommendations, MAS issues a revised CG Code.

MAS issues CG guidelines and regulations for the banking and insurance sectors. In Hong Kong the Hong Kong Monetary Authority issues the Supervisory Policy Manual which contains guidelines on CG for banks and guidance notes for insurance companies have, in the past, been issued by the Office of Commissioner for Insurance. The recently established independent Insurance Authority will assume this role in Hong Kong (see Appendix V.3).

MAS has independently sought public consultation when reviewing companies that fall directly within its regulatory perimeter (i.e. regulated financial entities). For example, MAS established a Corporate Governance Committee to review CG in Singapore and issued the first CG Code in March 2001. The Council of Corporate Disclosure and Governance established in August 2002, which replaced the Corporate Governance Committee, prescribed accounting standards and made recommendations to the MoF for revision to the CG Code. In September 2007 the Council of Corporate Disclosure and Governance was dissolved with oversight of listed companies' CG transferred to the MAS and the SGX. The move was to clarify and streamline responsibilities for listed companies' CG.⁵⁹ In 2012 the CGC reviewed and issued the revised CG Code, though the SGX continues to retain the power to enforce the CG Code. Thus, there has been a trend towards greater power given to the MAS for CG reviews and consequent regulation. This review process has been more frequent recently (i.e. from 2010).

Accounting and Company Regulatory Authority:

ACRA is established under the Accounting and Corporate Regulatory Authority Act (Cap. 2A) (ACRA Act) and is under the purview of the MoF. As a statutory board, ACRA is subject to the directions of the MoF and is required to implement policies and policy

⁵⁹ MAS, "MAS and SGX to oversee corporate governance for listed companies from 1 September 2017," (29 May 2007): Available at <http://www.mas.gov.sg/news-and-publications/media-releases/2007/mas-and-sgx-to-oversee-corporate-governance-for-listed-companies-from-01sep2007.aspx> (visited 16 November 2017)

changes as determined by the MoF and other government ministries. ACRA has a statutory duty to advise the government of its CG functions.⁶⁰

CG responsibility is delegated to ACRA under the CA and the ACRA Act which can be described as:

“...to promote public awareness about new business structures, compliance requirements, corporate governance practice and any matter under the purview of the Authority.”⁶¹

The regulatory perimeter of ACRA encapsulates business entities, public accountants, and corporate service providers. ACRA monitors corporate compliance with disclosure requirements and public accountants performing statutory audit. ACRA’s Strategic Planning & Policy Committee provides guidance to strengthen the CG framework and disclosure standards, and ensuring that policies formulated by ACRA are responsive, sound, and effective. The powers of ARCA include prescribing measures and standards on any matters relating to its functions.⁶² In comparison to Hong Kong, audit oversight is the responsibility of the statutory accountancy industry body, the HKICPA. The FRC is an independent statutory body responsible for maintaining the quality of financial reports in Hong Kong although it does not have the power to issue guidelines. In contrast the HKICPA has the power to make by-laws, administers financial reporting and auditing standards, and codes of ethics. The FRC has powers to approve and oversee policies to enhance CG. Currently, the roles of the HKICPA and FRC are under review.

In ACRA’s 2012 review of the CA and regulatory framework with the MoF (see Government related above), a number of amendments were proposed, including CG provisions, which were passed by the government in the Companies (Amendment) Bill 2014. These amendments apply to all Singapore incorporated companies. Hong Kong’s Company Registry was extensively involved in the 2014 rewrite of the Companies Ordinance (CO) (Cap. 622) which strengthened CG. However, there are a number of differences with those introduced in Singapore (for details, see Appendix V.3.1).

Accounting Standards Council:

When the IASB proposes amendments to existing IFRS or a draft interpretation to an existing interpretation, the ASC will invite public comments on its website. To gather feedback, the ASC hosts public meetings between the IASB and constituents or sets up key industry working groups. The ASC monitors IASB publications and provides comments to the IASB on proposed IASB standards or interpretations. The standards prescribed by the ASC are published on its website and email alerts are sent to subscribers when standards are issued.

The Securities Industry Council:

The SIC issues rulings on the interpretation of the Code on Take-overs and Mergers and sets out the practices to be followed by parties engaging in take-overs or mergers.

Singapore Exchange Limited

The SGX issues, interprets, and enforces the LRs. The revised CG Code (2012) was amended by MAS following a public consultation (see Appendix V.2.1) yet is enforced by the SGX. Listed companies are required by the SGX, under LR 710, to comply with the CG Code, or explain deviations in their annual report. The CG Code is part of the

⁶⁰ ACRA Act, s6

⁶¹ ACRA, “About ACRA”: Available at https://www.acra.gov.sg/about_Acra/ (visited 16 November 2017)

⁶² ACRA Act, s7

Mainboard and Catalist LRs in Singapore, which is similar to Hong Kong where the CG Code is part of the Mainboard and GEM LRs.

SGX continuous disclosure obligations in the LRs are statutorily enforced under the SFA. This is similar in substance rather than form with Hong Kong, where the disclosure of inside information has been moved from Hong Kong's LRs to Part XIVA of the Securities and Futures Ordinance (see Appendix V.1.6 Enforcement – SFA civil proceedings). The two regimes differ insofar that the SGX issues the LRs and therefore formulates the continuous disclosure obligations, whereas in Hong Kong the SFC is responsible for the Securities and Futures Ordinance and, therefore, formulating the disclosure of inside information statutory rules.

A disclosure guide is issued by the SGX to assist companies' compliance with the CG Code and investors to assess information disclosed by companies. The guide does not have statutory backing. In contrast, Hong Kong's SFC issues non-statutory guidelines on the disclosure of inside information, not the HKEx.

The SGX issues ad-hoc consultation papers and reviews regarding CG development in Singapore. Some of the reform issues covered by the consultation papers are:

- (1) sustainable reporting and the "comply or explain" regime; (2) the LRs, enforcement; (3) general meetings; (4) shareholder engagement; and (5) strengthening CG practice.

Three of the more notable consultations are discussed below.

In May 2006 the MAS and the SGX commissioned Associate Professor Mak Yuen Teen to undertake a project to assess and propose measures to improve CG practices in Singapore. Subsequently in January 2008, MAS, ACRA, and the SGX established the Audit Committee Guidance Committee (ACGC) to develop practical guidance for audit committees to better appreciate their responsibilities and enhanced effectiveness. In the same year, the ACGC submitted a Guidebook for Audit Committees to provide assistance to audit committee members.

In 2015, the SGX launched a review on how listed companies abide by the "comply or explain" requirement for principles and guidelines of the CG Code". This was undertaken:

"...to raise governance standards of listed companies and following the introduction of a Disclosure Guidance document in January 2015 to help companies comply with key aspects of governance."⁶³

The SGX commissioned KPMG (Singapore) to examine the state of CG disclosures among Mainboard listed companies. The study reviewed the extent of companies' compliance with the CG requirements under the CG Code, the SGX Disclosure Guideline Document, and LR 1207 (10). A total of 545 Mainboard companies' annual reports were reviewed for the study. Its key findings include:

- (1) disclosures could be improved; (2) companies achieved an average score of 60%; (3) large-cap companies outperformed small-cap companies; (4)

⁶³ SGX, "SGX reviewing companies' compliance with Corporate Governance Code," (12 October 2015): Available at http://www.sgx.com/wps/wcm/connect/sgx_en/home/highlights/news_releases/SGX-reviewing-companies-compliance-with-Corporate-Governance-Code (visited 8 June 2016)

accountability and audit achieved the highest score; and (5) remuneration matters received the lowest score.⁶⁴

Key areas of deficiency identified by the report include:

(1) board diversity; (2) remuneration; (3) board and executive performance criteria; (4) adequacy and effectiveness of risk management and internal controls; (5) internal audit; and (6) investor relations.

The 2016 GTI survey highlighted some disclosure weaknesses, for example, disclosure of multiple board memberships and details of whistle-blowing policy. These surveys are expected to guide the current trend in regulating CG standards in Singapore.

V.2.2 Periodic reviews

CG reviews are not periodically scheduled. Reviews are transparent public consultations that take heed of international developments. Government appointed CG committees/councils have been deployed in the past by the MoF and MAS to formulate CG recommendations. These committees/councils comprise of the business community, stakeholder groups, and representatives of government regulators. In contrast, the SGX did not appoint a committee of stakeholders for the 2016 CG review - it appointed an accounting/audit firm—KPMG. ACRA collaborates with the MoF when conducting CG reviews.

Consultation papers on CG policy are issued ad hoc by MAS⁶⁵ which invite industry and the public for comment. MAS promotes and monitors compliance with CG standards, notably by banks, insurers, and financial holding companies. Therefore, MAS is an active CG regulator empowered to review and give directions on CG matters that fall within its regulatory perimeter. Appendix V.1.3 “CG Culture” suggests that there is room for improvement, especially in the area of enforcement, which may be due to Singapore embracing stronger CG standards later than Hong Kong. However, since MAS has now been given the power to make rules, it will probably be more efficient in reviewing and setting standards in comparison to Hong Kong.

Recent CG policy consultation papers released by MAS include:

(1) Consultation Paper on Amendments to Corporate Governance Regulations (20 September 2013); (2) Proposed Revisions to the Code of Corporate Governance (14 June 2011); and (3) Corporate Governance Regulations and Guidelines. (18 March 2010).

⁶⁴ KPMG, “Review of Mainboard Companies’ Code of Corporate governance disclosures”: Available at <https://home.kpmg.com/sg/en/home/insights/2016/07/review-of-corporate-governance-disclosures-in-singapore.html> (visited 28 June 2017)

⁶⁵ Consultations papers to amend the CG regulations and guidelines pertaining to regulated financial entities include: Consultation Paper on Related Party Transaction Requirements for Banks (25 January 2016); Review of the Securities Market Structure and Practice (with SGX) (7 February 2014); Consultation Paper on Related Party Transaction Requirements for Banks (5 December 2013); Consultation Paper on Enterprise Risk Management for Insurers (23 January 2013); Consultation Paper on Draft Corporate Governance Regulations and Guidelines for Insurers (4 January 2013); Consultation Paper on Related Party Transaction Requirements for Banks (2 April 2013); and Consultation Paper On Corporate Governance for Insurers (22 February 2012)

Appendix V	3. Legislation	V.3 Singapore
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Introduction

Historically, Singapore’s CG framework has substantially followed the UK, operating under a similar regulatory structure until the global financial crisis prompted a redesign in the UK. In 2013, the UK moved to a “twin peaks” regulatory model which is substantially different to Singapore’s “integrated” model. Significantly, financial conduct is the remit of a separate body in the UK—the Financial Conduct Authority (FCA). In contrast, Hong Kong’s regulatory structure has a sectoral design, whereby the SFC regulates the securities sector. This design is analogous to the UK pre-2001, yet has parallels with the FCA as the SFC is fundamentally a market conduct regulator. Alternatively, the MAS performs prudential and market conduct regulatory roles over multiple financial sectors. Regulatory structure is discussed in more detail in Appendix V.4.1.

Singapore’s CG legislative framework is similar to Hong Kong comprising of a Companies Act (Hong Kong – Companies Ordinance), a SFA (Hong Kong – Securities and Futures Ordinance), and non-statutory LRs which contain a CG Code subject to a “complain or explain” regulatory regime. Nuances nonetheless exist, in particular the legislative framework’s design pertaining to specific CG issues. For example, Singapore’s continuous disclosure obligations are contained in the LRs whereas in Hong Kong the disclosure of inside information has been moved from the LRs to the Securities and Futures Ordinance. However, as discussed in Appendix V.2.1, Singapore’s disclosure obligations in the LRs are given statutory backing by the SFA.

A further similarity between the legislative frameworks of Singapore and Hong Kong is that the CG Codes do not have statutory backing. This is different to the UK and China where rights, remedies, and sanctions under such rules are statutory and thus extend beyond administrative orders. For this reason, rules with statutory backing are discussed in Appendix V.3.3, and regulations without statutory backing are discussed in Appendix V.4.1. Statutory backed disclosure obligations in the LRs are discussed in Appendix V.3.3, with the non-statutory provisions discussed in Appendix V.4.1.

Notable recent changes to Singapore’s CG legislative requirements are the amendments made to the CA in 2013 and the SFA in 2016. CA amendments included enhanced CEO disclosures and the availability of multiple proxies for indirect investors (see Appendix V.6 for details). Amendments to the SFA centre on investor protection and enforcement.

V.3.1 Primary legislation

As eluded to above, there is no single piece of overarching legislation for Singapore’s CG framework. This legislative design is similar to Hong Kong. The primary pieces of legislation which contain CG-related provisions are the CA and the SFA. Whereas the CA sets, inter alia, an overarching CG framework for all companies operating in Singapore, the SFA makes provision for the promulgation of CG rules that apply to the issue and listing of securities.

Companies Act

All locally incorporated companies, private and public, are subject to the CG provisions of the CA. Section 17(3) of the CA requires businesses with more than 20 members to incorporate. The CG provisions are limited to disclosure.

A foreign company (i.e. incorporated outside of Singapore and which has a place of business or carries on a business in Singapore⁶⁶) is governed by Part IX and Part XI (Division 2). The main CG provisions are: Part III – Constitution of Companies; Part V – Management and Administration; and Part VI – Financial Statements and Audit. Part V covers directors and shareholder meetings.

The CA was subject to a number of amendments (i.e. Companies (Amendment) Act 2014) which came into force in 2015-2016. These amendments included:

- (1) removing the requirement for a directors report (in contrast, the UK requires a directors' report), however, directors must disclose shareholdings;
- (2) recognising shadow directors;
- (3) relaxing conditions for the nominee directors to disclose information;
- (4) shareholders' approval not required for executive director compensation following their termination;
- (5) expansion of the statutory derivative action;
- (6) partial codification of directors' fiduciary duty and duty of care;
- (7) all companies to send financial statement summaries to members;
- (8) merging memorandum and articles into the constitution;
- (9) extension of disclosure requirements for CEOs;
- (10) new debarment regime (directors and company secretaries);
- (11) removal of one-share one-vote for public companies (i.e. introduction of WVRs or dual-class shares);
- (12) multiple proxy regime to enfranchise indirect investors;
- (13) companies can expressly indemnify directors against claims from third parties and potential liability;
- (14) extending the prohibition on loans to directors or their relatives;
- (15) aligning foreign and local company reporting arrangements;
- (16) reducing the number of agents for a foreign company from two to one; and
- (17) expanding the grounds to strike-off a foreign company.

Criminal liability can arise in a number of CG-related situations under the CA. For example, a director or CEO would be committing an offence where he/she failed to declare a direct or indirect interest in a transaction or proposed transaction with the company.⁶⁷ Furthermore, in relation to disclosures, a director can face criminal prosecution if he/she does not discharge their duties honestly or use reasonable diligence to discharge their duties.⁶⁸

In contrast to the UK and as stated above, director fiduciary duties in Singapore are partially codified. This is different from Hong Kong, where these duties are not codified. Conversely, the director's duty of care is codified in Hong Kong and Singapore. In summary, although Singapore's CA was originally modelled on the UK Companies Act, the recent amendments diverge from the UK, notably by eliminating the requirement for a directors' report.

Singapore amended the CA to allow public companies to have dual-class shares with WVRs in the future (ss 64A and 74). Similarly, Hong Kong's Companies Ordinance does not prohibit dual-class shares for non-listed companies and has proposed introducing WVRs for certain Mainboard listings. In February 2017, the SGX issued a consultation paper on allowing dual-class companies to be listed. The amendments to Singapore's CA may be viewed as paving the way for companies with WVRs to be listed on the SGX in order to attract more foreign listings, including S-chips. As competition for foreign

⁶⁶ CA, s365. This also includes businesses intending to have a place of business or carries on a business in Singapore

⁶⁷ CA, ss 156 (15) and 165 (9)

⁶⁸ CA, ss 157 and 165 (9)

listings builds between Hong Kong and Singapore, CG concessions and strengthening measures will be a consequence. This competition has already begun to influence Singapore's and Hong Kong's CG frameworks—Hong Kong's proposal to allow WVRs is to be offset by increasing other shareholder protections. Singapore has also strengthened its CG regime by implicitly recognising shadow directors.⁶⁹ This follows Hong Kong's 2011 amendment to the Companies Ordinance and symbolises both jurisdictions moving away from the UK system.

As in Hong Kong, small companies in Singapore have reduced filing and reporting requirements. For example, small companies are exempt from audit requirements.

Securities and Futures Act

The SFA encapsulates primary and secondary listings of securities by companies. Private placement of securities is exempt. Pertinent CG provisions in the SFA include:

Part II – Markets; Part VII – Disclosure of Interests; Part IX - Supervision and Investigation; Part X – Assistance to Foreign Regulatory Authorities; Part XII - Market Conduct; Part XIII – Offers of Investments; Part XIV – Appeals; and XV - Miscellaneous.

The SFA empowers the SGX to make, maintain, and enforce compliance with the LRs. Amendments to the LRs are subject to MAS approval. In addition, the SFA empowers MAS to modify the LRs after providing notice to the SGX. Where any person who is under an obligation to comply with, observe, enforce, or give effect to the LRs fails to do so, the High Court may, on the application by MAS, make an order for that person to comply with, observe, enforce, or give effect to the LRs.⁷⁰

Amendments were made to SFA in 2016 stemming from the aftermath of the global financial crisis. In the context of CG, safeguards for retail investors were enhanced, the classification of non-retail investors refined, and the enforcement regime for market misconduct strengthened. For example:

(1) enhanced safeguards for retail investors because the prospectus must contain all material information and be registered with MAS; (2) non-retail investors are defined as accredited investors (i.e. based on wealth or income) and institutional investors; (3) strengthening enforcement actions pertaining to disclosing statements which are false or misleading; and (4) strengthening the civil penalty enforcement regime.

Whistle-blowing

In Singapore, as in Hong Kong, there is no exclusive whistle-blower legislation. However, section 36 of the Prevention of Corruption Act allows for whistle-blower anonymity in Singapore, although this can be revoked in certain circumstances. In contrast, the UK has exclusive legislation, Public Interest Disclosure Act 1998; and China has exclusive rules, Rules of the People's Procuratorates on Whistle-blowing Work.

V.3.2 Secondary legislation

The primary legislation facilitates CG regulators to issue secondary legislation, usually in the form of regulations. CG regulations are extensive for listed companies with specific sectors, especially the finance sector being subject to additional secondary legislation. This regulatory design is commonplace, for example, the design of Hong Kong's and the

⁶⁹ CA, s4

⁷⁰ SFA, s 25(1)

UK's regulatory frameworks are analogous to Singapore in this regard. This appendix will discuss statutory regulations issued pursuant to the CA and the SFA, with codes (i.e. non-statutory) being discussed in Appendix V.4.1.

Companies regulations

The Companies (Amendment) Act 2014 amended the CA and a number of related regulations. For example, these regulations include:

Companies Regulations, and Companies (Filing of Documents) Regulations; Companies (Model Constitutions) Regulations; Companies (Register of Controllers and Nominee Directors) Regulations; Companies (Summary Financial Statement) Regulations; and Companies (Accounting Standards) Regulations.

Each of these regulations is briefly outlined below:

Companies Regulations (Rg 1) (revised 1990) stipulates, inter alia, publicity requirements for information, particulars prescribed by forms, verification and certification of documents, auditors' remuneration, judicial management orders, and proofs (e.g. verification). Under section 411 of the CA, the Companies (Amendment) Regulations 2015 were issued to include provisions for, among other things, secretary requirements, circumstances where a company is deemed to be carrying on a business, and safeguards for the use of electronic communications.

Companies (Summary Financial Statement) Regulations (Rg 4) (revised 1996) provide detailed conditions of when a company is allowed to send to its shareholders summary financial statement in place of a full financial statement and the content of summary financial statement.

The Companies (Accounting Standards) Regulations (Rg 6) (revised 2004) sets out the requirements for companies' Accounting Standards (known as the Financial Reporting Standards) including the International Accounting Standards or IFRS and the Interpretations of the Standing Interpretations Committee or Interpretations of the International Financial Reporting Interpretations Committee. The Companies (Accounting Standards for Listed Companies) Order (revised 2004) allows a company listed on the SGX that is also listed outside Singapore and required by an exchange outside Singapore to comply with its accounting standards by applying those foreign accounting standards instead of applying the Accounting Standards prescribed under section 200A(1)(a) of the CA. This is provided the foreign accounting standards are approved by SGX, and the company has notified the Companies Registrar of its intention to apply the foreign accounting standards.

Companies (Filing of Documents) Regulations (Rg 7) (revised 2005) stipulate requirements for documents attached to forms for locally and foreign incorporated companies. This includes the details of annual returns, reductions of share capital, and amalgamations. The 2015 amendments impose requirements for the lodgement of documents by way of electronic transactions.

Companies (Model Constitutions) Regulations 2015 prescribe details for company constitutions for private companies and companies limited by guarantee.

Companies (Register of Controllers and Nominee Directors) Regulations 2017 specify the particulars and structure of registers for a company's or a foreign company's individual or corporate controllers, nominee directors, and members.

Securities and futures regulations

MAS issued regulations pursuant to the SFA which include, inter alia: Securities and Futures (Corporate Governance of Approved Exchanges, Approved Clearing Houses and Approved Holding Companies) Regulations 2005; Securities and Futures (Appeals) Regulation 2005; Securities and Futures (Prescribed Specific Classes of Investors) Regulations 2005; Securities and Futures (Markets) Regulations 2005; and Securities and Futures (Disclosure of Interests) Regulations 2012.

Each regulation is briefly outlined below:

Securities and Futures (Corporate Governance of Approved Exchanges, Approved Clearing Houses and Approved Holding Companies) Regulations 2005 contains regulations on the CG of the exchange and clearing house, and provides that the board of the exchange and the clearing house must have at least a majority of directors who are independent from management and business relationships with the exchange or clearing house, at least one-third of directors who are IDs; and at least a majority of directors who are independent from any single substantial shareholder of the exchange or clearing house.

Securities and Futures (Appeals) Regulation 2005 sets out the constituents of the Appeal Advisory Committee, meetings and hearings of the Appeal Advisory Committee, procedures for appeals to the Minister, and the submission of information for an appeal.

Securities and Futures (Prescribed Specific Classes of Investors) Regulations 2005 identifies persons who are accredited investors and institutional investors for the purposes of the SFA. For example, institutional investors include, but are not limited to, a designated market-maker or a person who undertakes fund management activity in Singapore on behalf of not more than 30 qualified investors.

Securities and Futures (Markets) Regulations 2005 contains provisions on the power of the MAS to approve an exchange and the regulation of an approved exchange. For example, obligations and matters relating to approved exchanges, rules of approved exchange, matters requiring approval by MAS, regulation of recognised market operators, criteria for MAS to determine a failure to discharge duties or functions by exchange officers, and offences.

Securities and Futures (Disclosure of Interests) Regulations 2012 contain provisions on persons and entities exempt from the "disclosure of interests" requirements.

Banking and insurance companies

There is additional secondary legislation which imposes mandatory CG requirements on banks and insurance companies, namely Banking (Corporate Governance) Regulations 2005—enforced under section 78 of the Banking Act⁷¹; and Insurance (Corporate Governance) Regulations 2013—enforced under section 64 of the Insurance Act⁷².

These CG requirements for banks focus on the board of directors, directors, committees

⁷¹ In accordance with the Banking Act, the Banking Regulations apply to banks licensed to carry out banking business in Singapore

⁷² The Insurance Act and Insurance Regulations apply to licensed and registered insurers carrying out insurance business (life business and general business). The Regulations apply to licensed insurers incorporated in Singapore

(i.e. nomination, remuneration, audit, and risk management), and the independence of directors. The CG requirements for insurance companies centre on board responsibilities, notably in relation to committees.

V.3.3 Rules with statutory backing

Continuous disclosure obligations in Chapter 7 of the LRs have the statutory backing of section 203, SFA. (also see Appendix V.2.1) This covers, inter alia, material information, specific information, and periodic reports. From this perspective the LRs are statutorily backed (e.g. civil proceeding enforcement and continuous disclosure) although the LRs per se are non-statutory rules. In comparison with Hong Kong, the HKEx also has the power to make LRs, however, these are non-statutory. If a LR requires statutory effect, Hong Kong prefers to transfer the LR to the Securities and Futures Ordinance rather than give statutory backing to the LRs (e.g. disclosure of inside information). This contrasts with the UK where the FCA issues LRs which are statutorily backed. Non-statutory provisions of the SGX LRs are discussed in Appendix V.4.1.

The ASC is responsible for formulating and promulgating the Financial Reporting Standards in accordance with the Accounting Standards Act. Section 8 of the Accounting Standards Act expressly applies the Financial Reporting Standards to all companies incorporated under the CA, including foreign companies registered under Division 2 of Part XI. More details on the ASC are discussed in Appendix V.4.1. Hong Kong's financial reporting standards are statutorily backed.

V.3.4 Non-locally incorporated companies

Companies Act

Foreign companies which establish a place of business or carry on business in Singapore or intend to establish a place of business or carry on business in Singapore are required by Division 2 Part XI to register and lodge financial statements with ACRA. Part XI Division 2 of the CA applies to foreign companies, which includes provisions on, inter alia:

- (1) documents to be lodged; (2) duty of directors and authorised representatives to provide information to the foreign company; (3) registered office and authorised representatives; and (4) financial statement.

A number of CA exemptions and waivers are available to foreign companies. In Hong Kong, Part 16 of the Companies Ordinance applies to non-Hong Kong incorporated companies which encapsulates, inter alia: registration; regulation of names; authorised representatives; and returns and accounts. Foreign company legislative CG requirements in both jurisdictions is basically the same. However, there are some differences pertaining to shareholder remedies.

In *Petroships Investment Pte Ltd v Wealthplus Pte Ltd and others* [2016] SGCA 17 the Court of Appeal clarified that, following the CA amendments, statutory derivative actions under section 216A apply to private companies and publicly-listed companies incorporated in Singapore, thereby exempting foreign companies.⁷³ The section 216A (1) definition of a "company", which included a company listed on the SGX, was deleted.⁷⁴ Foreign companies are nonetheless subject to derivative actions under the common law. Oppression remedies (i.e. unfair prejudice) are available under section 216 by way of a personal action.

⁷³ At [67]

⁷⁴ At [67]

Hong Kong's Companies Ordinance has provisions for derivative actions and unfair prejudice actions against Hong Kong incorporated companies and non-Hong Kong companies that have a place of business in Hong Kong. In *Yu Yuchuan & Ors v China Shanshui Investment Company Limited* (HCMP) 360/2015 the Court of First Instance granted leave to minority shareholders, under sections 732 and 733 of the Companies Ordinance, to bring unfair prejudice proceedings by way of statutory derivative action against a Cayman Island incorporated company. Common law derivative actions were available. However, section 736 of the Companies Ordinance allows the court to dismiss a common law derivative proceeding. In the *Shanshui* case, minority shareholders also brought a common law derivative action. Leave was granted to pursue the statutory derivative action on the condition to withdraw the common law action. Hong Kong thus provides additional statutory remedies to shareholders of foreign companies compared with Singapore.

In the Hong Kong Court of Final Appeal *Yung Kee* Case (2015), a petitioner brought an unfair prejudice proceeding against a British Virgin Island incorporated company under the former Companies Ordinance (Cap. 32). The current and former legislation applies to non-Hong Kong companies. However, the company did not have "a place of business" as there was no evidence that the company had an office in Hong Kong, did not keep a share transfer or share registration office in Hong Kong, and no board or general meetings had been held prior to 2009. The Court of Final Appeal concluded that *Yung Kee* was not a non-Hong Kong company that did not have a place of business in Hong Kong under the ordinance and therefore standing for an unfair prejudice claim was unavailable under section 168A Companies Ordinance (Cap. 32). Similarly, a derivative action would be unavailable in such circumstances. This finding applies to the current Companies Ordinance (Cap. 622) as the relevant definitions are carried over. Thus a foreign company is required to have a "place of business" in Hong Kong, otherwise, shareholders have the same legal rights with regard to unfair prejudice and derivative actions as shareholders in Singapore (i.e. common law). Singapore does not statutorily define a "place of business" in the CA.

Foreign companies listed on the SGX must abide by the SFA, certain provisions of the CA, Singapore Code of Takeovers and Mergers, LRs, and the CG Code. It should be noted that a number of exemptions apply. For example, foreign companies with a secondary listing on the SGX are not required to observe the continuing listing requirements provided that they release information at the same time in English as that required for release from their home exchange. HKEx Mainboard LR 19.36 provides a similar exemption for foreign incorporated companies.

S-chips

In 2014 the SGX and the China Securities Regulatory Commission (CSRC) established a "direct listing framework" whereby companies from China can list on the SGX without the need for foreign incorporation. Applicants approved by the CSRC must comply with the laws and regulations of China and Singapore (for details, see Appendix V.8.3).

Association of South East Asian Nations harmonisation

Singapore, the United States, Malaysia, and Thailand entered into the Association of South East Asian Nations (ASEAN) Disclosure Standards Scheme (the Scheme) in 2013. Under the Scheme issuers offering equity and plain debt securities within ASEAN only need to comply with the ASEAN Disclosure Standards. Among other things, the Scheme requires issuers to obtain approvals from the home and host jurisdiction for cross-border offerings (for details, see Appendix V.8.3).

Appendix V	4. Regulation	V.4 Singapore
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Introduction

In Singapore, similar to the UK and Hong Kong, regulatory powers are sourced from primary legislation, supported by secondary legislation (e.g. regulations), codes, rules, and guidance. The CG of listed companies is shared among several regulators, principally the MAS, the SGX, and ACRA. This is analogous yet simpler to Hong Kong’s regulatory design—the roles of the SFC, HKEx, the Companies Registry, and the HKICPA respectively.

While regulatory coordination and clarity is satisfactory, Singapore’s regulatory architecture is prone to complexity and suffers from regulatory overlap leading to multiple regulators being responsible for one particular breach and/or one company. Singapore’s regulatory architecture is very similar to Hong Kong and, therefore, provides further insight into the strengths and weaknesses of CG in Hong Kong. Analysis and comparisons between the systems also emphasise the relative comparative advantages of each jurisdiction to, inter alia, attract foreign listings.

V.4.1 Corporate governance regulatory structure

Monetary Authority of Singapore

MAS is Singapore’s capital markets regulator, de-facto central bank, and “integrated” financial sector regulator. This regulatory role encapsulates oversight of the SGX, listed companies that breach the SFA, and the banking, securities, and insurance sectors.

Corporate governance regulator:

The overarching statutory objects, functions, powers, and duties of MAS are sourced from the MAS Act. However, the principal objects and functions of MAS and the powers, duties, and functions of MAS stipulate CG oversight of listed companies. MAS exercises CG powers over listed companies, in collaboration with the SGX, which are sourced primarily from the SFA and secondary legislation (discussed here and in Appendix V.3).

The CG regulatory role of MAS pertains to listed companies and financial institutions within its regulatory perimeter. This appendix focuses on listed companies generally.

MAS’ CG powers under the SFA extend to disclosure of interests and market conduct. Exemptions and extensions of the scope of the disclosure of interests provisions can be granted by MAS. MAS has powers of supervision and investigation in this context, provided under Part IX of the SFA. Disclosure of interests are canvassed in Part VII of the SFA which include, inter alia, disclosures by directors, CEOs, and substantial shareholders of listed companies (see Appendix V.3.1 for more details). MAS may impose civil penalties against any person who intentionally or recklessly contravenes these provisions (s 134, SFA). Market conduct provisions cover, among other things:

- (1) false trading and market rigging transactions (s197, SFA);
- (2) false or misleading statements (s199, SFA);
- and (3) insider trading (ss213-231, SFA).

MAS can issue civil and criminal penalties for contravention of these provisions (ss 204 and 221, SFA). In this role MAS performs similar regulatory functions as Hong Kong’s SFC under the Securities and Futures Ordinance.

An example of SFA market conduct contraventions and MAS' CG regulatory role are elucidated in the high-profile China Sky Chemical Fibre Co Ltd (China Sky) case. Mr Huang, the former CEO of China Sky, was investigated for purported contraventions of the SFA. Huang's Singaporean bank account held USD 3.7m which had been frozen following a High Court injunction obtained by MAS in 2013. Huang admitted to making misleading statements and market announcements relating to China Sky's aborted acquisition of land in Fujian, China, contravening the SFA (s199(c)). This included misleading disclosures relating to the use of the land in Fujian, incorrectly depicting the transaction counterparty as an independent third party when it was a related company, and providing a false reason for delaying the transfer of the land's use rights to China Sky's subsidiary. Huang also admitted to contravening the SFA (s203) relating to China Sky's failure to make a prompt and proper disclosure relating to attempted acquisition of the land. In the civil case brought by MAS, Huang agreed to:

- (1) pay a penalty of \$2.5 million to MAS (for misleading public disclosures and failing to make market disclosures);
- (2) surrendering 10% of his shareholding in China Sky; and
- (3) made an undertaking not to assume the role of a company director or be involved in the management of any entity listed on the SGX for three years.⁷⁵

The subsequent withdrawal of the SGX and CAD from pursuing sanctions, emphasises the dominant regulatory role of MAS. MAS has the power to enforce SFA and is not reluctant in taking the lead when collaborating with the CAD and SGX on corporate misconduct matters involving breaches of SFA, as the high-profile case of China Sky demonstrates.

Corporate Governance Code 2012:

MAS has been assertive in setting CG standards by revising the CG Code despite the SGX enforcing the CG Code. The CG Code is non-statutory and part of the LRs. As a condition of listing, companies are required under the LRs to disclose in their annual reports any deviations from their published CG practices.⁷⁶ Compliance with the CG Code is, therefore, anticipatory rather than mandatory. Hong Kong's CG Code is also part of the HKEx LRs and operates under a similar anticipatory "comply or explain" regime.

LR 710 provides that:

"An issuer must describe its corporate governance practices with specific reference to the principles of the Code in its annual report. It must disclose any deviation from any guideline of the Code together with an appropriate explanation for such deviation in the annual report."

LR 751 requires:

"An issuer with a secondary listing on the SGX Main Board must: (1) maintain its primary listing on the home exchange; (2) be subject to all the applicable listing rules of the home exchange (unless a waiver has been obtained for any non-compliance); and (3) provide an annual certification in the form prescribed at Appendix 7.6 that it has complied with the applicable continuing listing obligations in the SGX Listing Manual; on a continuing basis."

Non-compliance with the CG Code does not directly give rise to legal discipline—if a company does not properly disclose its compliance or non-compliance, section 25 of the

⁷⁵ MAS, "Publications" (12 February 2015): Available at <http://www.mas.gov.sg/news-and-publications/media-releases/2015/former-china-sky-ceo.aspx> (visited 10 July 2017)

⁷⁶ LR 710

SFA provides for a High Court application to obtain a court order to direct compliance. As the Code is “comply or explain”, all that is required where there is non-compliance is to explain. Thus, companies can easily circumvent section 25 which results in many weak explanations.

The 2012 amendments recommended by CGC and adopted by MAS included, inter alia:

director independence—circumstances when a director is deemed non-independent;

director training—Guideline 1.6 of the CG Code requires that a listed company should provide training for first-time directors in areas such as accounting, legal, and industry-specific knowledge as appropriate, and all directors should receive regular training, particularly on relevant new laws, regulations and changing commercial risks, from time to time. The company should be responsible for arranging and funding the training of directors and the board should disclose in the company’s annual report the induction, orientation, and training provided to new and existing directors.⁷⁷ Under Guideline 4.2, the Nomination Committee should make recommendations to the board on the review of training and professional development programs for the board;

board composition—IDs are to constitute at least half of the board in circumstances where the CEO is the Chair, CEO and Chair are family members, Chair is part of the management, and the Chair is not independent;

multiple directorships—the nominating committee is to decide if a director can adequately discharge their duties;

remuneration practices and disclosures—disclose remuneration of five key management personnel who are not directors or the CEO nor immediate family members of a director or CEO;

risk management—as a minimum requirement, a review of the adequacy and effectiveness of internal control systems in the annual report is required;

audit committee—the chair and at least one member is to have recent and relevant accounting or related management expertise and experience; and

shareholder rights—implement an investor relations policy to facilitate adequate communications with shareholders; ensure shareholders have the opportunity to effectively participate and vote at the general meeting; and allow for the nomination of two proxies and, in the case of nominee, more than two proxies.

Overall, Singapore’s CG Code and the equivalent CG Code in Hong Kong, set out in Appendix 14 of the SEHK LRs, largely deal with the same issues. A discussion in Appendix V.7 canvasses the main provisions of Singapore’s CG Code relevant to the present study, with a focus on some differences of interest.

Guides on certain sections of the CG Code are issued by MAS including, inter alia, Audit Committees 2014 (in collaboration with the SGX and ACRA) and Listed Boards 2012 (from recommendations by the CGC).

Financial sector regulator:

Sections 4 (2) (b) and 23 (8) of the MAS Act states that MAS is responsible for

⁷⁷ CG Code, 1.6

conducting integrated supervision of financial services, including administering the SFA. This includes supervision and issuing regulations for, inter alia, financial holding companies, banks, insurers, and the securities industry. MAS is also responsible for supervising the SGX (see below).

As the capital markets services regulator (i.e. securities sector), MAS' responsibilities, powers, and authority over capital market activities and supervision of capital market services license holders are exercised in accordance with the SFA. Pursuant to the SFA, MAS has the power to issue capital market regulations and directions. For example, the Securities and Futures (Licensing and Conduct of Business) Regulations (2016) apply to MAS licensed institutions in Singapore's securities, futures, and derivatives industry as well as non-listed companies that offer securities to the public. In terms of CG concerning capital market companies which are licensed, MAS has the power to remove any officer and effect control of the company.

MAS is responsible for the CG of financial sector companies that it supervises, namely banks and insurance companies. Powers of supervision, issuing regulations, inspection, and enforcement over these financial companies are sourced from, for example, the Banking Act and Insurance Act. Statutory-backed CG regulations issued include: Banking (Corporate Governance) Regulations 2005 and the Insurance (Corporate Governance) Regulations 2013 (see Appendix V.3.2 for more details). Guidelines pertinent to strengthening the CG of financial institutions supervised by MAS include, for example, the "Guidelines on Risk Management 2013" which apply to all financial institutions, and the "Guidelines on Corporate Governance 2013" which apply to financial holding companies, banks, and insurers.

This regulatory architecture is significantly different to Hong Kong's sectoral design where capital markets (including licensing) are supervised by the SFC, the banking sector by the Hong Kong Monetary Authority, and the insurance sector by the Insurance Authority. Each regulator is responsible for supervising, investigating, issuing regulations and guidance, and enforcing CG within their statutory regulatory perimeter. As in Singapore, Hong Kong's regulatory powers are sourced from the relevant ordinances, for example, the Securities and Futures Ordinance (i.e. capital markets and licensing) and the Banking Ordinance (i.e. deposit-taking institutions).

Accounting and Corporate Regulatory Authority

ACRA is responsible for administering the CA, Business Registration Act, Accounting and Corporate Regulatory Authority Act; Accountants Act; Limited Liability Partnerships Act, and the Limited Partnerships Act. The regulatory roles of ACRA are fundamentally as the companies' regulator and registry, and the regulator of accountants and auditors.

Companies' regulator and registry:

ACRA is responsible for the registration of companies and administering the CA and the Companies Regulations in relation to monitoring, compliance, investigation, and enforcement. In the role of the companies' regulator, ACRA monitors corporate compliance with disclosure requirements. Disciplinary actions are rare—four since 2010—and these actions did not directly relate to CG. In this context Hong Kong's Companies Registry regulatory role is analogous with ACRA, with comparable enforcement success.

Accountants and auditors:

ACRA is an independent government body which is the regulator for public accountants in Singapore. In Hong Kong, the HKICPA is an industry body that regulates accountants and auditors in collaboration with the FRC, a statutory independent body. Pursuant to the section 3 of the Accountants Act, ACRA is responsible for, inter alia, the registration

of public accountants, the approval of accounting corporations, and the control and regulation of the profession, including the regulation of public accountants who act as auditors of companies. Auditors are required to obtain ACRA's consent and publicly disclose reasons for resignation to provide greater transparency.

ACRA inspects public accountants that audit listed companies. To discharge these functions in accordance with the Accountants Act (s4), ACRA established the Public Accountants Oversight Committee (PAOC) from its members. In Hong Kong the HKICPA is responsible for the registration, regulation, and supervision of public accountants.

ACRA's CG responsibility for accountants is sourced from the 4th Schedule of the Accountants (Public Accountants) Rules which contains the Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities 2015 and the Guidebook for Audit Committees which it issues. In comparison, the HKICPA issues the Code of Ethics for Professional Accountants and the Guide for Effective Audit Committees.

The PAOC undertakes investigations into public accountant's audits to check compliance with the Singaporean Standards on Auditing. In Hong Kong the FRC is statutorily empowered to conduct independent investigations into auditing and reporting irregularities of listed companies and enquires into non-compliance and accounting irregularities. Auditing and reporting irregularities are referred to the HKICPA.

Compliance with accounting standards:

In accordance with the CA, ACRA monitors and enforces compliance with accounting standards including the Financial Reporting Standards for companies incorporated in Singapore. (for details on the Financial Reporting Standards, see Appendix V.3.2). ACRA commenced a Financial Reporting Surveillance Program in 2011. Under section 201 of the CA, directors of every Singaporean incorporated company (including unlisted companies) are required to present a set of audited financial statements that comply with the Financial Reporting Standards. In Hong Kong, the HKICPA administers financial reporting and auditing standards and the FRC maintains the quality of financial reporting by listed companies.

Unlisted companies:

ACRA is responsible for regulating unlisted companies in accordance with the CA which contains provisions on specific disclosure requirements and that all incorporated companies must issue financial statements in compliance with the Financial Reporting Standards.

In 2013 the International Monetary Fund (IMF) reviewed ACRA's supervision of non-listed public companies. The IMF recommended that ACRA's policy of moral suasion over non-listed public companies regarding timely disclosure should be replaced with a statutory requirement. Overall, the IMF recommended that non-listed public companies' disclosure requirements and reporting timeframes should be more stringent.⁷⁸

Accounting Standards Council

The ASC' mandate is to develop, review, amend, and approve financial reporting standards for entities that are under its purview. Pursuant to section 3 of the Accounting Standards Act, the ASC has to formulate accounting standards (i.e. Financial Reporting Standards) for companies. In Hong Kong, financial reporting standards are formulated by the HKICPA, a private industry body, with the quality of financial reporting being the

⁷⁸ IMF, "Singapore: Report on the Observance of Standards and Codes," (November 2013) *IMF Country Report No. 13/326*, 37

responsibility of the FRC. Members and the chair of the ASC are appointed by the MoF to represent the public interest—namely representatives from stakeholder groups such as the accounting profession, the users and preparers of financial information, academia, and the government.

Foreign issuers seeking an IPO in Singapore must prepare their financial statements in accordance with the Financial Reporting Standards, IFRS in accordance with the IASB, or United States Generally Accepted Accounting Principles (GAAP). Foreign companies that are not incorporated under the CA, and where they are listed on SGX may adopt IFRS or United States GAAP. Hong Kong has similar financial reporting arrangements.

Securities Industry Council

Role:

The SIC is statutorily backed by the SFA (Part VIII) and consists of business representatives, the government, and MAS. MoF and MAS, on advice of the SIC, issues the Code on Take-overs and Mergers which is neither statutory nor classified as secondary legislation. The SIC's main function is to administer and enforce the Code on Take-overs and Mergers. Further, the SIC issues Practice Notes on the interpretation of principles, and the rules and practices to be followed.

In Hong Kong, the (SFC) Takeovers and Mergers Panel regulates the non-statutory "Codes on Takeovers and Mergers and Share Buy-backs" and related rules. The codes are issued by the SFC in consultation with the Takeovers and Mergers Panel. Members of the Takeovers and Mergers Panel are appointed and reappointed by the SFC.

Code on Take-overs and Mergers:

The Code on Take-overs and Mergers is enforced by the SIC which, on an apparent breach of the code, will summon the alleged offender for a hearing. Enforcement powers of the SIC include issuing private reprimands or public censures, and depriving the offender temporarily or permanently of the ability to enjoy the facilities of the securities market. The SIC can make a ruling which are final or recommend to the Attorney-General that the alleged offender be prosecuted under the CA, the Securities Industry Act (Cap. 289) or the criminal law. Compliance with the Code on Take-overs and Mergers is the responsibility of the parties to a take-over or merger and their advisers.⁷⁹ In Hong Kong, the Takeovers and Mergers Panel hears disciplinary matters in the first instance and has the power to issue public censures, public criticisms, and "cold-shoulder" orders (i.e. temporary or permanent deprivation of the ability to enjoy the facilities of the securities market).

The Code on Take-overs and Mergers is intended to supplement and expand on the statutory provisions dealing with take-overs in sections 213 and 214 of, and the Tenth Schedule to, the CA. However, the Code on Take-overs and Mergers and the CA do not cover everything as there are further provisions in the Listing Manual of the Stock Exchange. Similar to the Hong Kong Code of Takeovers, its purpose is to ensure that sufficient information is provided to shareholders, set-out the procedures to be followed by parties to a take-over or merger transaction, and to ensure that shareholders are treated equally. The Code on Take-overs and Mergers, like the provisions in the CA, also applies to offeror companies incorporated outside Singapore (i.e. foreign companies).

Hong Kong's "Codes on Takeovers and Mergers and Share Buy-backs" applies to public

⁷⁹ Code on Takeovers and Mergers, "Introduction": Available at <http://statutes.agc.gov.sg/aol/search/display/view.w3p?page=0;query=CompId%3Adeeb5cb-3cc9-4215-9a63-fdd2528b477e%20ValidTime%3A20170524000000%20TransactionTime%3A20170524000000;rec=0> (visited 7 July 2017)

companies in Hong Kong and companies with a primary listing of their equity securities in Hong Kong. Therefore, foreign offeror companies incorporated outside Hong Kong can be subject to the code. Companies incorporated outside of Hong Kong with a secondary listing in Hong Kong are exempt from the Codes on Takeovers and Mergers and Share Buy-backs.

Singapore Exchange Limited

Exchange operator:

In Singapore, market operators are approved by MAS which can be either an approved exchange or a recognised market operator (s.6, SFA), unless granted an exemption (s.14 (2), SFA). Singapore has three approved exchanges which operate as self-regulatory organisations: the Singapore Exchange Securities Trading Limited (SGX-ST); Singapore Exchange Derivatives Trading Limited (SGX-DT); and Singapore Mercantile Exchange Pte. Ltd. MAS regulates the exchanges subject to the Securities and Futures (Corporate Governance of Approved Exchanges, Approved Clearing Houses and Approved Holding Companies) Regulations 2005 (see Appendix V.3.2). This is similar to Hong Kong where the SFC regulates the HKEx.

The SGX-ST and SGX-DT are wholly-owned subsidiaries of the SGX. There are two boards on the SGX-ST: the Mainboard and Catalist. Mainboard listings are for large companies satisfying quantitative requirements whereas Catalist listings are for small companies which do not satisfy Mainboard requirements.⁸⁰ The SGX is listed on the SGX-ST Mainboard and is the approved exchange regulator by MAS to supervise trading and clearing activities in Singapore's securities and derivatives markets (Part II, SFA). Again, this is similar to Hong Kong, where the HKEx is listed on the SEHK (i.e. a wholly-owned subsidiary of the HKEx) and is the approved exchange regulator.

SGX regulation is based on six principles:

(1) disclosure-based regime⁸¹; (2) comprehensive risk management; (3) risk-based targeting regulatory activities; (4) balanced approach to international best practice; (5) transparency; and (6) frontline regulator and managing regulatory conflict,⁸² (conflict of interest is discussed in Appendix V.4.2 Accountability).

Market regulator:

The SGX is responsible for approving new listings, (except with respect to its own shares) although MAS must review and register IPO prospectuses. For example, an issuer seeking an IPO to list on the SGX-ST must submit a listing application (including the prospectus) to SGX-ST for review, and lodge the prospectus with MAS for registration. The issuer has the choice of submitting the listing application to SGX-ST and the prospectus to MAS for a Concurrent Review (the most popular scenario), or submitting the listing application to SGX-ST first and lodging the prospectus with MAS after it receives the eligibility-to-list letter from SGX. The SGX-ST approves or rejects the listing application. MAS is responsible for ensuring that the prospectus complies with the SFA disclosure requirements but has no involvement in the listing process. This is analogous to Hong Kong which has a dual-filing regime—the SFC is responsible for the

⁸⁰ The Mainboard quantitative requirements are satisfying either: (1) consolidated pre-tax profit of at least SG\$30 million for the latest financial year and an operational record for at least three years; (2) being profitable in the latest financial year, an operational record for at least three years, and an IPO capitalisation of not less than SG\$150 million; or (3) having operating revenue in that latest financial year and IPO capitalisation of not less than SG\$300 million

⁸¹ Continuous disclosure: SFA, s 203

⁸² SGX, "How we regulate": Available at <http://www.sgx.com/wps/portal/sgxweb/home/regulation/howwereg> (visited 5 July 2017)

prospectus requirements in the Companies (Winding Up and Miscellaneous Provisions) Ordinance and the disclosure requirements of the Securities and Futures Ordinance, with the HKEx overseeing the listing process pursuant to the LRs.

The SGX Markets Surveillance Committee is responsible for real-time surveillance to detect unusual trading activities and possible market misconduct. This surveillance involves monitoring the compliance of listed issuers, their directors, executive officers, sponsors, and registered professionals with the LRs and compliance of SGX trading and clearing members. Any suspected breaches are investigated by the SGX. If an investigation reveals a breach of the LRs, the SGX may issue:

- (1) a warning letter;
- (2) make an offer of composition to Relevant Persons;
- (3) take other forms of enforcement actions;
- or (4) charge the Relevant Persons before the Disciplinary Committee.⁸³

If a breach of the SFA, or suspicious market activity that could breach the SFA is detected, MAS is notified. Similarly, the HKEx notifies the SFC, as soon as reasonably practical, when the HKEx becomes aware of serious matters (e.g. conduct breaches which require SFC intervention).

SGX disciplinary matters to enforce the LRs are handled by the Disciplinary Committee and appeals from the Disciplinary Committee are heard by the Appeals Committee. No director, officer, or employee of the SGX or its related corporations may be appointed to either committee. Members of both committees are appointed by the SGX board in consultation with MAS.⁸⁴

The SGX-ST undertakes reviews of interim and annual financial statements of listed companies and can raise questions about the entities' application of accounting principles. Similarly, the HKEx reviews listed companies' financial reports.

Listing rules:

Pursuant to section 16 of the SFA, the SGX issues, maintains, and enforces compliance with the LRs (e.g. Mainboard Rules and Catalist Rules). The SGX is also responsible for enforcing the "anticipatory requirements" of the CG Code, which is part of the LRs (discussed above).

Each exchange issues rules for the admission of members, trading, business conduct and qualification, conduct disciplinary actions, and administer investor compensation arrangements.⁸⁵ In the context of the SGX-ST, the Mainboard Rules and Catalist Rules provide the SGX with regulatory powers including:

- (1) administrative;
- (2) investigatory;
- (3) disciplinary;
- (4) enforcement; and
- (5) appealing Disciplinary Committee rulings.

This is similar to Hong Kong's SEHK Mainboard and GEM.

An example of the SGX taking disciplinary action under the LRs is the China Sky case. The SGX sued China Sky (2012) in the High Court (a separate legal action to that undertaken by MAS) to compel the company to appoint a special auditor, after the company had ignored the SGX's initial requests. Three reasons were given for demanding the appointment:

⁸³ SGX, "Disciplinary Framework": Available at http://www.sgx.com/wps/portal/sgxweb/home/regulation/market/market_disciplinary (visited 5 July 2017)

⁸⁴ LRs 7.5.1 and 7.9.1

⁸⁵ IMF, *op. cit.*, 63

(1) the exchange's concerns over the "interested person transactions" between the audit committee chairman, Lai Seng Kwoon, and the company; (2) the aborted acquisition and development of land in China; and (3) the significant repairs and maintenance costs incurred.

The case demonstrated the SGX's limited powers to enforce its LRs under section 25 of the SFA—powers of the courts to order observance or enforce the LRs. Unfortunately, the SGX withdrew the action 22 days later, with no reason given. However, nine days after the withdrawal, a joint announcement was made by the Singapore Police and the MAS which revealed that SGX submitted a report detailing possible breaches of the SFA by China Sky and its directors.⁸⁶ MAS and CAD were successful in sanctioning China Sky in 2013. Despite the withdrawal of its lawsuit, the SGX was entitled under section 25 of the SFA to seek an order of compliance from the court. The withdrawal of the SGX might be explained by the strong case that MAS and CAD had against China Sky and its directors.

Commercial Affairs Department

Not technically a regulatory agency, the CAD, being part of the Singapore Police Force, is integral in complementing the regulators' investigatory and enforcement powers in relation to criminal offences.

CAD is a commercial and financial crime investigative agency that does not issue any CG rules but works closely with the regulators. For example, the MAS entered into a civil settlement with former China Sky CEO Huang following breaches of the SFA while CAD commenced criminal actions (2012). Later, the CAD agreed to discontinue the criminal actions so that the civil penalty settlement with MAS could take place (for details, see "Listing rules").

Smaller sized companies

Smaller sized companies are subject to lower regulatory standards and specific regulations. For example, the Catalist LRs are less onerous than the Mainboard LRs of the SGX-ST. Nonetheless, Catalist companies are subject to the CG Code and its "comply or explain" regime. The ASC also issues a Financial Reporting Standard for Small Entities.

Hong Kong's GEM operates under a regulatory regime similar to that of the Catalist, except GEM compliance rules are more onerous. Small and Medium Enterprise Financial Reporting Standards are issued by the HKICPA which are less onerous than those for large companies.

Whistle-blowing

As discussed in Appendix V.3.1, Singapore has no formal whistle-blowing legislation, and accordingly, no designated whistle-blowing regulator. This is similar to Hong Kong. Nonetheless the CG Code recommends that the company's whistle-blowing policy be disclosed in the annual report with reference to Guideline 12.6. The 2016 GTI survey shows that 94.6% of 631 listed companies surveyed have a whistle-blowing policy, but only 33.1% provide details on their policy or anonymous reporting.⁸⁷ Furthermore, the

⁸⁶ Mak Yuen Teen (ed), "Corporate Governance Case Studies, Volume 2," (May 2013) *CPA Australia*, 7: See <http://governanceforstakeholders.com/wp-content/uploads/2013/05/CPA-CG-Case-Studies-Vol2-0410.pdf> (visited 10 July 2017)

⁸⁷ Lawrence Loh, Muhammad Ibrahim, Linh Nguyen, Huong Nguyen, "Corporate Governance Highlights," (December 2016) *CPA Australia, NUS Centre for Governance, Institutions & Organisation, and SID*, 11: Available at

audit committee should review any arrangements and raise any concerns relating to financial reporting improprieties. Arrangements should be in place for independent investigations and follow-up action to be taken.⁸⁸ Hong Kong's CG Code requires companies to introduce whistle-blowing policies that are overseen by the audit committee.

V.4.2 Accountability of agencies

Singapore Exchange Limited

Conflicts of interest may arise from the SGX being the approved exchange regulator that is listed on the exchange that it regulates—the SGX-ST. Section 30 (1) (a) of the SFA imposes a statutory obligation on the SGX to deal with possible conflicts of interest that may arise from being a listed company. MAS' exchange approval process requires an exchange to describe and demonstrate how it adequately deals with any conflicts of interest. A "Deed of Undertaking" (2007) between the SGX and SGX-ST addresses conflicts of interests whereby MAS makes decisions and takes action in relation to the administration of the LRs in respect of the SGX being a listed company.⁸⁹

Under the Securities and Futures (Corporate Governance of Approved Exchanges, Designated Clearing Houses and Approved Holding Companies) Regulations 2005, approved exchanges are required to establish a board-level "Regulatory Conflicts Committee" (for more details, see Appendix V.1.4). The Deed of Undertaking sets out the listing arrangements, Market Surveillance responsibilities and composition, and "terms of reference" of the RCC. The RCC is responsible for reviewing and reporting to the SGX Board and MAS on the adequacy of the arrangements for dealing with any perceived or actual conflict between its commercial interests and regulatory role.⁹⁰ In Hong Kong, the HKEx has established a Conflict Committee, which is answerable to the SFC, to handle comparable issues in accordance with the Exchanges and Clearing Houses (Merger) Ordinance.

Accountability of the SGX regulatory role involves mandatory public disclosures when a waiver of the LRs is granted or when an enforcement action leads to a Disciplinary Committee proceeding. Overall, MAS exercises supervision of the SGX and the management of regulatory conflicts. This is similar to Hong Kong.

Monetary Authority of Singapore

MAS' board of directors has a statutory responsibility to periodically inform the government of its regulatory and supervisory policies and furnish the Minister with such information as the Minister may require in respect of the duties and functions of MAS. Further, the Minister may appoint inspectors to investigate matters which are the responsibility of MAS. The accounts of MAS are subject to audit by the Attorney-General.⁹¹

The IMF 2013 "Singapore Detailed Assessment of Implementation – International Organisation of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation" found that the composition of the MAS board is potentially exposed to political interference. Technically, MAS is statutorily independent of the government. However, the board is appointed by the President and composed of current members of the government. To limit the possibility of political interference or any other conflicts, a

http://bschool.nus.edu/Portals/0/images/CGIO/Report/CGIO_SGTI_2016_Corporate%20Governance%20Highlights.pdf (visited 26 September 2017)

⁸⁸ CG Code, 12.7

⁸⁹ IMF, op. cit, 67. Referring to SFA, s30

⁹⁰ Ibid

⁹¹ See generally, MAS Act

Code of Conduct for Board members and an operational policy manual have been issued. In contrast to the SGX commercial interests, MAS does not endorse commercial activities, products, or members of private organisations.⁹²

Pursuant to the MAS Act, MAS is required to publish a report on the performance of MAS' functions and duties in its annual report, which must be presented to the President and the Parliament within six months of the end of the financial year. MAS is accountable to the Parliament through the Minister-in-charge.⁹³

MAS provides written reasons to licensees when a decision affects their license. Regulatory decisions and significant regulatory actions for market conduct breaches are made publicly available on the MAS website.⁹⁴

Accounting and Company Regulatory Authority

ACRA is accountable to the Minister-in-charge. In accordance with the ACRA Act, ACRA must furnish the Minister with such information in respect of its property and activities as the Minister requires. With approval of the Minister, the Registrar of Companies and Registrar of Public Accountants must appoint the Chief Executive. The board of ACRA is far more diverse than that of MAS, and consists of 15 members—two practicing public accountants, directors, lawyers, academics and senior public servants, including members from MAS. With the approval of the Minister, ACRA prescribes auditing standards.

Accounting Standards Council

Members of the ASC are appointed by the MoF comprising representatives from stakeholder groups such as the accounting profession, the users and preparers of financial information, academia, and the government. The Minister may give the ASC directions consistent with the Accounting Standards Act, as to the performance of the functions and powers of the ASC, and how the ASC complies with such directions.

Other bodies and mechanisms

Similar to the Independent Commission Against Corruption in Hong Kong, the Corrupt Practices Investigation Bureau's (CPIB) role is to investigate into any act of corruption in Singapore's public and private sectors and any other offence under the Prevention of Corruption Act. The CPIB has the power to review government departments (including regulators), identify weaknesses, and recommend changes in their procedures.

The courts provide recourse against the decision of public sector bodies by way of judicial review and administrative law.

V.4.3 Inter-regulator relationships and effectiveness

An absence of coordination mechanisms is a common feature across all CG regulators (i.e. MAS, SGX, ACRA, and CAD). MAS stated in 2013 that it believed that formal coordination and cooperation memorandums of understanding (MoUs) among the self-regulatory organisations were not necessary as the functions of the approved exchanges are set by law.⁹⁵ For example, section 20 of the SFA obliges approved exchanges to provide assistance to MAS for the performance of its functions. There is interaction and ongoing dialogue between each exchange and MAS. The CEO of the SGX, Mr Loh Boon Chye states that the scope of regulatory responsibilities of the MAS and the SGX will be

⁹² IMF, op. cit, 42

⁹³ Ibid, 44

⁹⁴ Ibid, 45

⁹⁵ IMF, op. cit, 66

redefined to minimise overlap.⁹⁶ In essence, the SGX is responsible for enforcing the LRs and conduct disciplinary action, any breaches involving suspicious market activity is forwarded to MAS. MAS and the SGX can refer CG commercial and financial cases to CAD for further investigation.

Meetings are held every quarter between MAS, SGX, ACRA, and CAD to exchange CG information and discuss CG enforcement actions. MAS shares information mainly with the CAD and CIPB. Information sharing between MAS and the other CG regulators is subject to principles espoused in the common law, MAS' statutory duties, and the recipient regulator fulfilling its statutory duties. Despite the lack of any formal co-ordination mechanisms, in 2013 the IMF found that MAS had a reasonable record prosecuting civil cases in cooperation with CAD and the Attorney General's Chambers.⁹⁷ However, the IMF also stated that there are weaknesses in the timeliness of corporate disclosures (in the context of emerging global standards),⁹⁸ implicating MAS and the SGX.

With a number of regulators involved in different aspects of the regulation of listed companies, there are inevitable overlaps and gaps. MAS and the SGX overlap in relation to market conduct and enforcement when a listed company fails to comply with the LRs (e.g. s25, SFA). The SGX overlaps with ACRA when regulating the market conduct of listed accounting firms. MAS and CAD overlap in relation to joint investigations (post-2015) and enforcement (civil and criminal sanctions respectively) of misconduct offences.

⁹⁶ Loh Boon Chye, "Regulatory Landscape for 2016: Positioning for a Dynamic, Trusted and Vibrant Market" – Keynote Address by Mr. Ong Chong Tee, Deputy Managing Director, Monetary Authority of Singapore, at the SGX Equities Dialogue 2016 on 28 January 2016," *Monetary Authority of Singapore, News and Publications*: Available at <http://www.mas.gov.sg/News-and-Publications/Speeches-and-Monetary-Policy-Statements/Speeches/2016/Regulatory-Landscape-for-2016.aspx> (visited 10 June 2016)

⁹⁷ IMF, *op. cit.*, 57. Information sharing in this context is facilities by SFA, s168B

⁹⁸ *Ibid*

Appendix V	5. Other influences	V.5 Singapore
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Introduction

Compliance is not the sole responsibility of the government and the regulators. Boards (i.e. directors), management, employees, investors, interest groups, the media, and industry watchers (e.g. academics and commentators) all have a role in promoting compliance and fostering good CG. Of these influences, two interest groups/associations, namely the SID and the SIAS, have a profound effect on shaping CG policy in Singapore. Regional and local CG surveys provide additional qualitative and quantitative data to assess, rate, and/or rank listed companies' CG. Public media also plays an important role in strengthening CG in Singapore.

V.5.1 Interest groups and associations

Management interest groups

The SID is the Singapore national association of company directors, which is similar to the Hong Kong Institute of Directors. SID promotes the professional development of directors and corporate leaders. The institute claims to work closely with authorities, regulators, and a network of members and professionals such as accountants and lawyers, to identify ways to uphold and enhance the highest standards of CG and ethical conduct in Singapore.⁹⁹ There is no independent survey, academic review, or media report of SID's effectiveness. The stated mission of the SID is to foster good governance and ethics in corporate leadership. SID organises and conducts professional training courses and seminars for its members and regularly issues publications. For example, SID has published a SID Code of Governance and a Directors Code of Professional Conduct. These codes set out standards to ensure directors discharge their duties and responsibilities effectively—the Directors Code of Professional Conduct is designed to complement the CG Code by amplifying its ethical standards.

In November 2014, SID and the Institute of Singaporean Chartered Accountants (ISCA) issued a Singaporean Directorship Report that analysed 3,670 directors on the boards of 717 listed companies (2013) (for details, see Appendices V.7.2 and V.7.3).

SID is also involved with two benchmarking initiatives: the ASEAN Corporate Governance Scorecard (ACGS), and from 2016, the Singapore GTI (discussed in Appendix V.5.2).

Shareholder interest groups

The SIAS represents minority retail investors. It was established (1999) in response to the Central Limit Order Book—a secondary market in Singapore that traded mainly Malaysian shares—being frozen from September 1998 by the Malaysian Government. At the time USD 3.7 billion worth of shares were affected. SIAS represented affected minority shareholders (almost 50, 000) banding together, under the leadership of David Gerald, to resolve the incident. Technically, the SIAS is a charity and an institution of public charter which acts as a retail investor lobby group to promote investor rights. There is no similar association in Hong Kong that represents the interests of retail investors.

⁹⁹ SID, "About SID": Available at http://www.sid.org.sg/Web/About_Us?Web/About/SID_Singaporeo.aspx?hkey=a1df14c6-e940-495e-b851-f04b460f22c6 (visited 10 July 2017)

The SIAS's mission is to:

(1) advocate sustainable and stable stakeholder relationships in the investment community; (2) safeguard and protect shareholder rights; (3) empower investors through education and timely information; and (4) promote fair and transparent CG standards, regulations, and practices.¹⁰⁰

Traditionally, the SIAS relied on identifying CG improprieties, lobbying, and moral suasion to improve CG practices. For example, calling on the takeovers regulator, the SIC, to examine OSIM founder Ron Sims "unintentional purchase" of shares above his offer price to examine whether a false market had been created and, therefore, whether shareholders had suffered a loss. Mr Sim consequently agreed to compensate shareholders who had suffered a loss. Recently (2016) the SIAS has raised the prospect of engaging in United States' style class actions on behalf of its members.

A number of boards and management actively support the SIAS' initiatives, notably 92 listed companies which have joined its Statement of Support to uphold and advance good CG standards. This demonstrates at least a symbolic gesture of investors and management working together to improve CG.

In November 2016, the SIAS issued the "Singapore Stewardship Principles for Responsible Investors" in collaboration with the Stewardship Asia Centre and on behalf of Singapore Stewardship Principles Working Group consisting of, inter alia, Stewardship Asia Centre, the SID, the Investment Management Association of Singapore, and the SIAS—supported by the MAS and SGX.

The SIAS conducts research on Singaporean listed companies on their CG practices and transparency. There is also a CG index, based on OECD principles and Singapore's CG Code, that rates and ranks companies' CG practices and awards those with high CG standards. Results are publicly available on the SIAS' website.

To educate and support investors' appreciation of CG, public educational activities are hosted by the SIAS which include conferences, forums, and workshops supported by the ACRA, the ISCA, and the SGX. The SIAS offers investor education programmes and an extensive shareholder communication programme. The investor education programme is targeted at helping investors analyse companies, for example, interpreting annual reports. One of the aims of the shareholder communication programme is to, inter alia, improve good CG and transparency. Publicly available handbooks issued by the SIAS include, inter alia, the Shareholders' Rights Handbook, Understanding Annual Reports Handbook, Enhanced Auditor's Report Handbook, and the Code of Conduct Handbook.

Further comments

Both the SIAS and SID express support for the improvement of CG standards in Singapore in relation to the interest groups they represent. Nonetheless, as one group represents the owners (SIAS) and the other management (SID), this creates a potential conflict between principal and agent and, therefore, the interpretation of "good CG".

In practice the SIAS and SID are often consulted for their views before implementation of key regulatory changes. For example, the SIAS' President and SID's Governing Council's Chair were involved in major CG policy reviews, the former as a CGC member

¹⁰⁰ SIAS, "Annual Report 2015/2016," (2016), 16

(MAS), and the latter sat on the MoF's Steering Committee¹⁰¹ (for details of these bodies' role in shaping CG policy, see Appendix V.2.1).

Singapore typically adopts a collaborative regulatory approach to ensure that views from industry are taken into account before implementation, to educate the market on the reasons and objectives for CG changes, and to mitigate any adverse market effects from legislative or regulatory changes.

V.5.2 Other groups

The ACGS is a joint initiative of the ASEAN Capital Markets Forum and the Asian Development Bank—involving Singapore, Malaysia, Indonesia, Vietnam, the Philippines, and Thailand—to raise CG standards of ASEAN publicly listed companies.

SID and the CGIO have been appointed by MAS to rank Singapore listed companies based on the following assessment criteria:

- (1) rights of shareholders; (2) equitable treatment of shareholders; (3) role of shareholders; (4) disclosure and transparency; and (5) responsibilities of the board.

Ranking is based primarily on the OECD's Principles of Corporate Governance 2004.

The key goal of the ACGS is to assess the CG practices of the top 100 publicly listed companies by market capitalisation across six ASEAN countries.¹⁰² In April 2015, the first list of Singaporean companies was released, with the top 10 in decreasing rank being:

Singtel, SGX, DBS Group, SMRT Corp, Singapore Press Holdings (SPH), CapitaLand, Keppel Land, SIA Engineering Co, OCBC Bank, and Keppel Corp. The Singaporean ACGS top 10 consists of a mix of GLCs and public companies.

The GTI is an initiative of the Business Times and CGIO to assess the financial transparency of publicly listed companies based on their annual announcements (i.e. CG disclosures). In 2015, 639 SGX listed companies were ranked based closely on the CG Code. The 2015 results were similar but not the same as the ACGS, with Singtel and SGX topping the GTI. Listed companies are ranked under the GTI based on a CG section (i.e. board matters; remuneration matters; and accountability and audit) and a transparency section that focuses on shareholder communication. From 2016, the GTI expanded to include the SID alongside the Business Times and CGIO to develop a new Singapore GTI, leveraged from the current GTI and the ACGS.¹⁰³

Additional GTI factors include how companies handle a broader range of stakeholders (i.e. employees, customers, suppliers, regulators, and the community). The 2016 GTI survey shows a slight improvement in the average score of 49.7. Much progress was made in the area of board matters, including disclosure of director attendance in board and committee meetings, and reporting on the exact remuneration of CEOs. However, fewer companies satisfied the requirement for multiple board memberships. There has been improvements in voting by poll, but stakeholder engagement remains weak.

¹⁰¹ MoF, "Report of the Steering Committee for Review of the Companies Act," (June 2011) *Consultation Paper*: Available at

<http://www.mof.gov.sg/cmsresource/public%20consultation/2011/Review/%200f%20Companies%20Act%20and%20Foreign%20Entities%20Act/Anx%20A%20SC%20Report%20Complete.pdf> (visited 11 July 2017)

¹⁰² SID, "ASEAN Corporate Governance Scorecard: Briefing on new Methodology," (2017), 1: Available at http://www.sid.org.sg/images/PDFS?PD_pdfs/ASEANfScorecardBrief_4May2017.pdf (visited 11 July 2017)

¹⁰³ CPA Australia and National University of Singapore, "Singapore corporate governance standards hit new high ahead of index revamp," (18 August 2016), 2 and 3: Available at <http://www.cpaustralia.com.au/-/media/corporate/allfiles/document/professional-resources/financial-planning/singapore-gti-2015-media-release.pdf> (visited 11 July 2017)

Whistle-blowing policies were strong, though disclosure of the policies is weak (for details, see Appendix V.4.1). There was slight improvement in the disclosure of processes, and the framework for evaluating risk management and internal controls. Disclosure by directors in the areas of concurrent directorships was strong at 84.5% and 65% of companies issued their latest financial results and annual reports on time.¹⁰⁴

The National University of Singapore's (NUS) CGIO issues research publications, with the law faculty publishing CG-related journal articles. In recent years, the CGIO has issued research relating to listed GLCs and family-firms (see Appendix V.1.4). Journal articles published by the law faculty tend to focus on more specific CG issues.¹⁰⁵ In the past the government has sought academics' views (e.g. Mak Yuen Teen of NUS on behalf of the MAS and SGX in 2007) when undertaking regulatory reforms. Thus, the CG research routinely carried out by NUS feeds back into the CG review process. Following the AGSC, the CGIO (and SID) stated that the rights of shareholders, equitable treatment of shareholders, and the role of stakeholders are areas requiring improvement.¹⁰⁶

V.5.3 Media

Singapore's media is subject to political censorship under Article 14 of the Constitution, the Newspapers and Printing Presses Act, the Defamation Act, and the Internal Securities Act, which is enforced pursuant to the Sedition Act and the Penal Code.¹⁰⁷ The largest media company (i.e. TV and radio) in Singapore is Mediacorp Pte Ltd, which is wholly owned by the government through Temasek Holdings. This may manifest reporting anomalies as GLCs have a significant presence in the market. The Straits Times, the newspaper with the largest circulation along with a number of other major publications (i.e. Business Times) are owned by a private listed company—SPH. Our research has revealed that SPH's publications tend to actively and relatively freely report CG issues pertaining to GLCs. For example, that GLC SingPost decided to bring in "special auditors" after media commentators (about seven articles) and shareholders criticised its CG following revelations that three directors had conflicting interests.¹⁰⁸

CG reporting in Singapore reflects the media landscape with virtually no reports from Mediacorp of government misconduct. In contrast, the Straits Times and Business Times have recently reported a number of public sector misconduct articles. Overall the media is very active in reporting CG issues that involve private sector companies. Listed private sector companies by far receive the most media attention. For example, China Sky and Daka Design each had in excess of 200 articles published over a five year period in relation to their CG failures. The most prominent CG failures in Singapore involves company announcements and disclosures (e.g. China Sky; Daka Designs); independence of auditors (e.g. China Sky; China Hongxing Sports Limited); and board composition and remuneration (e.g. OCBC; UOB).¹⁰⁹

Media executives are involved in formulating CG policy. For example, the Chairman of the CGC was the CEO of SPH with another SPH executive being a member of CGC when the CGC undertook a review of the CG Code for MAS.

Social media is also a useful CG instrument. As reported in one media article written by an SID Governing Council member, it places pressure on directors and management to

¹⁰⁴ Loh et. al, op. cit

¹⁰⁵ For example: Dan W. Puchniak and Luh Luh Lan, op. cit

¹⁰⁶ Phyllis Lo, "Top 10 Singapore companies in Asean corporate governance scorecard unveiled," (30 April 2015) *Straits Times*

¹⁰⁷ Freedom House, "Freedom of the Press: Singapore," (2013): Available at <https://freedomhouse.org/report/freedom-press/2013/singapore> (visited 11 July 2017)

¹⁰⁸ Melissa Tan, "Chance for SingPost board to further cement confidence," (24 February 2016) *Business Times*

¹⁰⁹ See: Mak Yuen Teen op. cit

uphold good CG because of ease in which it can garner instantaneous and widespread reporting of any corporate indiscretion.¹¹⁰

Webpages are actively employed by regulators, SIAS, and SID to publicly air regulatory changes and views, with the former also engaging in infringement and enforcement notices, to keep the market informed and up to date, and the latter to generate debate and interest.

¹¹⁰ Poh Mui Hoon, "Social media: better 'friend' than unfriend'," (12 October 2015) *Business Times*

Appendix V	6. Enforcement	V.6 Singapore
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Introduction

The primary enforcement CG regulators in Singapore are the SGX, MAS, ACRA, and CAD. Enforcement powers are sourced from legislation and non-statutory secondary legislation. For example, the SGX enforces administrative sanctions under the LRs, the MAS can enforce civil and administrative sanctions pursuant to the SFA, and can initiate criminal sanctions which are enforced by CAD. ACRA and the SIC operate under a similar civil and criminal enforcement regime (i.e. CAD pursues criminal investigations and prosecutions) pursuant to the CA and the SFA respectively.

According to the ACGA and CLSA's CG Watch 2012, 2014, and 2016, Singapore ranked consistently behind Hong Kong in enforcement, despite recent efforts to strengthen the enforcement powers of the SGX.

This appendix will begin with a general overview before examining Singapore's CG regulators' enforcement powers in detail.

V.6.1 Laws and regulations

See Appendix V.3 for legislation and statutorily-backed regulations, and Appendix V.4.1 for non-statutory regulations, codes, and rules.

V.6.2 Financial statement obligations of directors and officers

The CA stipulates civil and criminal penalties pertaining to directors and relevant officers who fail to satisfy their financial statement legislative obligations.

Pursuant to Part VI of the CA, officers are under a direct duty to maintain adequate accounting and other records, failing which attracts civil and criminal penalties. Financial statements must give a true and fair view of the financial position and performance of the company or group which must be accompanied by a director's statement acknowledging the fact. Financial statements are to include a statement of compliance with these requirements by the company's auditors. Failure to comply renders directors' liable for civil and criminal penalties.

V.6.3 Private actions

There is a private right of action for anyone who suffers a loss as a result of market misconduct and an action for any loss or damage sustained by reason of any untrue statement or misrepresentation in a prospectus. There are rights of action under the common law, for example, contract or tort, subject to the usual limitations. There is no United States style class action, although a limited form of class action in the form of representative action, is permissible wherein all plaintiffs have to be identified in the action. There is also an expedited "coat-tail action" whereby multiple plaintiffs can claim for a loss suffered as a result of a criminal act of a convicted person or a person who has been ordered to pay a civil penalty.

V.6.4 Singapore Exchange Limited

Scope of powers

The SGX monitors, investigates, and enforces the LRs (Mainboard and Catalist) and the

CG Code. There are a wide range of administrative powers available to the SGX it can pose queries to an issuer where it is of the opinion that queries are in the interests of ensuring the market is fair, orderly, and transparent. Circumstances where queries may be raised include where the SGX:

(1) is of the opinion that information provided is either incomplete or unclear; (2) has reason to believe that an issuer has failed to disclose information as required by the Exchange's LRs; (3) has reason to believe that there is a possibility that the Exchange's LRs has not been complied with; or (4) is of the opinion that it is appropriate to do so.¹¹¹

Prior to 2015, unless an offence had been committed and referred to the MAS or another authority for follow-up action, the SGX could only:

(1) issue private or public censures or warnings; (2) object to the appointment of certain directors of SGX-listed corporations; (3) suspend trading; or, (4) in extreme cases, delist the corporation—which inadvertently punished innocent shareholders.¹¹²

Prior to 2015, the SGX suffered from a lack of effective sanctions and enforcement powers. After extensive consultation, the listed company enforcement framework was strengthened with the addition of Chapter 14 of LRs on 7 October 2015. SGX enforcement powers were strengthened through the:

(1) formalisation of the SGX's powers to investigate breaches of the LRs; (2) a greater range of sanctions, notably deterrents; and (3) publishing enforcement actions.¹¹³

The consultation also led to the SGX establishing the Listing Disciplinary and Listing Appeals Committees.¹¹⁴

Sanctions

The 2015 Mainboard LR amendments, pursuant to LR 1405(3), expanded the SGX's disciplinary powers to take enforcement actions against a Relevant Person, including:

- (1) issuing a private warning;
- (2) offering a composition sum to an issuer;
- (3) requiring an issuer to implement an effective education or compliance programme;
- (4) requiring an issuer's directors or executive officers to undertake a mandatory education or training programme;
- (5) requiring an issuer to undertake an independent review of internal controls and processes;
- (6) requiring an issuer to obtain the prior approval of the SGX for a period not exceeding three years, for the appointment of a director or an executive officer;
- (7) objecting to the appointments of individual directors or executive officers in any issuer for a period not exceeding three years;

¹¹¹ LR 1406

¹¹² Annabelle Yip, "Reinforcing SGX Listings and Enforcement Framework," (6 March 2015) *BT Invest*

¹¹³ SGX, "Past Disciplinary Actions": Available at

http://www.sgx.com/wps/portal/sgxweb/home/regulation/consult_pub/past_dis_action (visited 12 July 2017); and SGX, "Responses to Comments on Consultation Paper: Reinforcing the SGX Listings and Enforcement Frameworks," (15 September 2015), 7-8

¹¹⁴ SGX, "Reinforcing the SGX Listings and Enforcement Framework," (17 September 2014): Available at

<http://www.sgx.com/wps/wcm/connect/4f659a93-81b5-4081-9393-047de90878c7/Consultation+Paper+on+Reinforcing+the+SGX+Listings+and+Enforcement+Framework.pdf?MID=AJPRES> (visited 16 November 2017)

- (8) requiring an issuer to appoint independent advisers to minority shareholders;
- (9) requiring an issuer to appoint special auditors, compliance advisers, legal advisers, or other independent professionals for specified purposes;
- (10) perform other remedial actions to rectify the consequences of contraventions;
- (11) imposing conditions on the accreditation of an issue manager;
- (12) suspending or restricting the activities of an issue manager if the integrity of the market may be adversely affected or if the SGX thinks it necessary in the interests of the public or for the protection of investors. The SGX will refer the matter to the Disciplinary Committee within 14 days from the date of suspension or restriction, whereupon the Disciplinary Committee will determine if the suspension or restriction should be lifted or should be continued for a specified period not exceeding three years;
- (13) halting or suspending trading of listed securities of an issuer;
- (14) removing an issuer from the Official List; and
- (15) imposing any other requirements which the SGX considers appropriate.

The increased scope of the SGX's enforcement powers and sanctions is something HKEx should consider.

Disciplinary Committee

Pursuant to LR 1403 (1), the Disciplinary Committee must, as a tribunal of first instance, hear and determine charges brought by the SGX against a Relevant Person for contravention of any relevant rule. Under LR 1404 (1), the Appeals Committee must hear and decide appeals arising from decisions of the Disciplinary Committee and decisions of the SGX relating to list of specified matters (for details, see below).

The Listings Disciplinary Committee can take the following disciplinary actions under the SGX-ST Trading Rules:¹¹⁵

- (1) expulsion or suspension from membership or registration;
- (2) imposing an administrative fine not exceeding Singapore (SG)\$250k;
- (3) issuing a public or private reprimand;
- (4) require education (individual) or compliance (entity) programs;
- (5) imposing restrictions on conditions on the activities of the individual or entity;
- (6) requiring an individual or entity to pay penalties; or
- (7) requiring a director to step down from the day-to-day conduct of the business of a trading member.

The Disciplinary Committee is able to impose a wider range of sanctions than the SGX for breaches of the LRs (Rule 1417) (for more details, see Disciplinary Committee and Appeals Committee, below) These additional sanctions which are not available to the SGX, include:¹¹⁶

- (1) imposition of a monetary penalty in excess of SG\$10,000 but not more than SG\$250,000 per breach;
- (2) imposition of a monetary penalty in excess of SG\$100,000 but not more than SG\$1,000,000 in aggregate for multiple breaches;
- (3) issuance of a public reprimand; and
- (4) issuing an order for the denial of facilities of the market.

¹¹⁵ MAS, "Capital Markets Enforcement," (January 2016), 24-25: Available at <http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Monographs%20and%20Information%20Papers/MAS%20Capital%20Markets%20Enforcement.pdf> (visited 12 July 2017). Note: the SGX-ST Trading Rules are different to the LRs

¹¹⁶ LR 1417; and SGX, "SGX Enforcement Handbook," 10-11 (para 4.5.2): Available at <http://www.sgx.com/wps/wcm/connect/4b5f3dc3-babd-4200-acd4-5f0675418e67/Enforcement+Handbook.pdf?MOD=AJPERES> (visited 11 July 2017)

These powers are more extensive than the HKEx's powers.

Publications

The SGX only publishes an anonymous list (i.e. does not reveal the name of the offending party) of its rulings on private disciplinary actions.

Accountability and appeals

Accountability:

The SGX is accountable to MAS (for more details, see Appendix V.4.2.) Under the business rules of the SGX-ST, members of the Disciplinary Committee and Appeal Committee are appointed by the SGX board of directors. If the appointments were made by, for instance MAS, this would better address the SGX's perceived conflict of interest. Nonetheless, the rules set out the independence requirement of committees, their powers, prescribe the proceedings for disciplinary actions, and hearing appeals.¹¹⁷ For example, the Disciplinary/Appeals Committee must not have a member who is, or who within three years of the proposed appointment date was, a director, officer or employee of the SGX or a related corporation of the SGX.¹¹⁸

Disciplinary Committee and Appeals Committee:

A Disciplinary/Appeals Committee hearing must have an initial quorum of five members, including the chairman or deputy chairman of the Disciplinary/Appeals Committee, which may be concluded with a quorum of three members.¹¹⁹ The quorum of a Disciplinary/Appeals Committee hearing must comprise at least one member with legal experience and the remaining members with any of the following experience: (1) corporate finance experience; (2) directorship experience with an issuer listed on the SGX; and (3) accounting experience.

No member of the Disciplinary Committee is to participate in a hearing if he/she has a conflict of interest.

In comparison to Hong Kong, there is no requirement of expertise which applies to HKEx Disciplinary Committee members. The chairman of the HKEx Disciplinary Committee will usually be the chairman of the Listing Committee. If the chair cannot accept this role, then one of the deputy chairs of the HKEx Listing Committee may do so. Before agreeing to act as Chairman (HKEx), the member concerned will do their best to satisfy themselves that there is no professional or personal interest in the case. After accepting the role the Chairman (HKEx) will arrange for at least four other members of the Listing Committee to be members. Interestingly, HKEx Disciplinary Members with a possible conflict of interest must raise the issue with the Secretary.¹²⁰ In contrast to Singapore, there is no explicit requirement for the member to withdraw from the hearing. Thus, the onus for determining a conflict of interest is on the Secretary of the Disciplinary Committee in Hong Kong, whereas the onus is on the member of the Disciplinary Committee in Singapore.

Upon conclusion of a SGX hearing, the Disciplinary/Appeals Committee must, within a specified period of no more than six weeks, determine if the charges have been made

¹¹⁷ SGX-ST Rules 14.4–14.9

¹¹⁸ LRs 1403(2) and 1404 (2)

¹¹⁹ LRs 1403

¹²⁰ HKEx, "The Stock Exchange of Hong Kong Limited Disciplinary Hearings Procedures," (2013), [5.2] and [5.3] to [5.5]

out and provide reasons for the decision in writing.¹²¹

Where the SGX Disciplinary/Appeals Committee makes a finding that the proceeded charges are made out, the Disciplinary/Appeals Committee must include the sanctions imposed against the relevant person.¹²² The Disciplinary/Appeals Committee's reasons for the decision must be published by the SGX, unless the sanction imposed involves the issuance of a private warning. Where a private warning is issued by the Disciplinary/Appeals Committee, the Disciplinary/Appeals Committee must determine whether the reasons for the decision will be published, and if so, whether the reasons are to be partially published or published in full.¹²³

The SGX Appeals Committee handles appeals against the decisions of the Disciplinary Committee and SGX's decisions on both the Mainboard and the Catalist under their respective LRs. A party may appeal against the decision of the Disciplinary Committee, or a decision of the SGX specified under LR 1404(1)(b), by filing a notice of appeal with the Appeals Committee within 14 business days of the decision. An appellant other than the SGX must pay a non-refundable administrative fee of SG\$1,500 when filing a notice of appeal.¹²⁴

Appeals against a decision by the SGX that can be brought before the Appeals Committee, include:

- (1) rejection of an application for the extension of time to allow an issuer to restore its percentage of securities in public hands to at least 10% under LR 724;
- (2) rejection of a proposal by a cash company to meet requirements for a new listing under LR 1018;
- (3) rejection of an application for extension of time to meet requirements for a new listing under LR 1018;
- (4) rejection of a resumption proposal under LR 1304;
- (5) rejection of an application for extension of time to submit or implement a resumption proposal under LR 1304;
- (6) removal of an issuer from the official list under LR 1305;
- (7) rejection of a proposal by an issuer to voluntarily delist under LR 1307;
- (8) rejection of an application to exit from the watch-list under LR 1314; and
- (9) rejection of an application for extension of time to submit an application to exit from the watch-list under LR 1315.

Pursuant to LR 1419 (4), an appeal against a decision by the Disciplinary Committee can only be heard if the chairman is of the opinion that:

- (1) the Disciplinary Committee had acted in bad faith;
- (2) there was procedural unfairness in the Disciplinary Committee's determination of the charges;
- (3) there is fresh evidence, not previously available, which would likely have affected the decision of the Disciplinary Committee;
- (4) the Disciplinary Committee had made a gross error in respect of a finding of fact;
- (5) the Disciplinary Committee had made an error in respect of the interpretation of the LRs; or
- (4) the sanctions imposed are manifestly excessive or inadequate.

Where the SGX Appeals Committee is of the opinion that the charge is defective, the Appeals Committee may invite the SGX to amend the charge, or directly amend the charge.¹²⁵

¹²¹ LRs 1417 (1) and 1422 (1)

¹²² LRs 1417 (3) and 1422 (2)

¹²³ LRs 1418 (1) and 1423 (1)

¹²⁴ LR 1419 (1)

¹²⁵ LR 1421 (3)

Subject to LR 1424 and the continuing disclosure obligations in Chapter 7 of the LRs, the parties to SGX Disciplinary Committee proceedings or Appeals Committee proceedings, their representatives and their advisors must at all times treat all matters and documents relating to the proceedings as confidential, subject to a few exceptions (e.g. parties consent, required under the law). The IMF (2013) has raised some concerns regarding the overall transparency of this process.

V.6.5 Monetary Authority of Singapore¹²⁶

Scope of powers

MAS monitors, investigates, and enforces the CG requirements in the SFA, industry specific regulations (see banking and insurance regulations, Appendix V.4.1), and is responsible for issuing the CG Code. Pursuant to the SFA Part XII market misconduct offences, MAS monitors capital markets. Investigations and reviews are carried out in conjunction with CAD and enforcement is undertaken by the Attorney-General's Chambers (AGC) (civil and criminal). An order of observance or enforcement of LRs from the court can be sought by MAS pursuant to section 25 (1) of the SFA.

Criminal powers

MAS has regulatory and investigative powers to obtain data, information, documents, statements, and records from persons (whether regulated or unregulated) who may have information relevant to an inquiry or investigation. Officers of the MAS can take part in joint investigations with the CAD, having the same powers of investigation as CAD officers. However, MAS does not have criminal enforcement powers and must refer suspected criminal offenses to the CAD for investigation and subsequent prosecution by the AGC. Thus, the CAD is the primary enforcement agency for the criminal investigation and prosecution in relation to corporate and securities laws. The SFA sets out criminal penalties for contraventions of the provisions prohibiting market misconduct, with a maximum fine of SG\$250,000 or imprisonment of up to seven years or both.¹²⁷ Any person who does not comply with producing information for MAS (s 163, SFA) or produce books relating to any matter under investigation by MAS, is liable on conviction to a fine not exceeding SG\$50,000 or to imprisonment for a term not exceeding two years or both.¹²⁸ Destruction or removal of books from Singapore can increase the fine to SG\$100,000.¹²⁹ The CAD also has the full range of investigative powers to obtain information, documents, statements, and records from any person.¹³⁰

Civil powers

Civil penalty actions may be enforced by MAS pursuant to market conduct provisions in Part XII of the SFA and disclosure obligations in Part VII of the SFA. Any contraventions must be proven on a balance of probabilities. This is similar to Hong Kong's market misconduct provisions and disclosure obligations in the Securities and Futures Ordinance. Consent of the Public Prosecutor, the AGC, is required which is necessary to ensure that the AGC's powers to press criminal charges are not fettered by a MAS decision to press for a civil penalty as there is ambiguity surrounding double jeopardy in Singapore.¹³¹ The MAS and the CAD have agreed to a protocol which sets out their understanding of the type of cases that would be appropriate for civil charges. This is to ensure that the CAD does not have to review the evidence, make an initial decision, and

¹²⁶ This section sourced from: IMF, op. cit

¹²⁷ SFA, ss 204, 213, and 221

¹²⁸ SFA, s 168 (1)

¹²⁹ SFA, s168 (4)

¹³⁰ IMF, op. cit, 72

¹³¹ Note: section 244, Criminal Procedure Code and Article 112 of the Constitution of the Republic of Singapore. Also see: *Kho Jabing v Public Prosecutor* [2016] SGCA 21

whether the appropriate sanction is a civil penalty or criminal prosecution¹³² (e.g. see China Sky, Appendix V.4.1). Civil actions that are initially investigated by MAS may subsequently be transferred to CAD for criminal prosecution, or vice versa, to produce more effective enforcement outcomes.

The maximum civil penalty is three times the amount of the profit gained or loss avoided as a result of the contravention, subject to a minimum of either SG\$50,000 (natural person) or SG\$100,000 (corporation).¹³³ Where there is no profit gained or loss avoided, a penalty of not less than SG\$50,000 and not more than SG\$2 million may be imposed.¹³⁴

MAS can obtain an injunction from the court to freeze a person's assets, if there is a risk that the person will remove assets from the jurisdiction before MAS can initiate a civil action.¹³⁵ This power was applied to listed company, China Sky (2013). Being an S-chip company solely listed on the SGX, the CSRC does not have jurisdiction over such companies. However, the SGX can file complaints with Chinese authorities if alleged offences have been perpetrated in China under the Chinese Penal Code. For example, in March 2017 the SGX filed a complaint with Chinese authorities against Wu Xinhua, Executive Chairman and CEO of China Fibretech Ltd.

Administrative sanctions¹³⁶

MAS has the power to:

(1) make prohibition orders (notice in writing) against regulated persons; (2) issue written directions; (3) refuse entry, suspend, or revoke the license or status of regulated persons; (4) revoke, suspend, or withdraw exemptions, authorisations or recognitions in respect of offers of investments; (5) withdraw exemptions from holding a license; (6) reprimand for misconduct; (7) offer for composition on non-custodial offenses, and (8) warnings.¹³⁷

Composition is akin to settlement, although liability must be admitted. The penalty is usually measured with reference to the stipulated fine. As with civil proceedings, the consent of the AGC is required because of the possibility that the AGC may wish to bring a criminal prosecution. Except for minor breaches, compositions are published. MAS does not have a power to issue administrative fines or financial penalties except late filing fees.

The SGX-ST can issue a private or public reprimand against a listed issuer and/or its directors, or suspend or delist the listed issuer for breaches of the LRs. If MAS is of the opinion that the prohibition of trading in certain securities is necessary, MAS can give notice in writing (including email) to the SGX stating its opinion and its reasons. Other aggrieved parties can appeal the decision but the SGX cannot. MAS' decision stands while the appeal process proceeds. If the SGX fails to take any action, MAS can prohibit trading in those securities for a period not exceeding 14 days. MAS must issue notice in writing to the SGX.¹³⁸

MAS has comprehensive powers to obtain all data, information, documents, statements, and records from persons (whether regulated or unregulated) who might have

¹³² MAS, "MAS and CAD to Jointly Investigate Market Misconduct Offences," (17 March 2015): Available at <http://www.mas.gov.sg/news-and-publications/media-releases/2015/mas-and-cad-to-jointly-investigate-market-misconduct-offences.aspx> (visited 14 July 2017)

¹³³ SFA, ss 236B (4) and 236H

¹³⁴ SFA, s236B (5)

¹³⁵ SFA, ss325 and 326

¹³⁶ This section is sourced from: IMF, op. cit, 73

¹³⁷ MAS, "Capital Markets Enforcement," op. cit

¹³⁸ SFA, s 32

information relevant to an inquiry or investigation. This enables MAS to reconstruct any securities and derivatives transaction and the identities of the licensee and the individual employee(s) who handled the trade. MAS may obtain information including documents and bank records, exercise the power to obtain information from individuals or entities located in Singapore, or who beneficially own or control a non-natural person organised in Singapore.

MAS has the statutory power to take statements or testimonies under oath. The excuse that a disclosure of information might lead to incrimination is unavailable, although statements made under MAS oath are generally not admissible as evidence in criminal proceedings (c/f proceedings for making false or misleading statements). However, such statements are admissible as evidence in civil proceedings under the SFA, Part XII (Market Conduct). Refusal to provide a statement or furnishing false or misleading information may, on conviction, result in a fine not exceeding SG\$50,000 or imprisonment for a term not exceeding two years or both.¹³⁹

International Monetary Fund: securities market regulation assessment

In 2013 the IMF assessed MAS securities market regulatory function as:

“The MAS operates to a high standard overall. There are concerns regarding its independence from government, most notably in the composition of the Board, and the transparency of some elements of regulatory decision making and appeals therefrom. The Code of Conduct for staff imposes high standards of personal conduct. On other matters, systemic risk, policing of the perimeter of regulation and conflicts of interest, the Capital Markets Group (CMG) of MAS, which has supervisory responsibility for capital markets and capital market intermediaries, meets IOSCO requirements...MAS has a reasonable record in prosecuting cases of breaches of securities law in the civil courts and, in cooperation with the CAD and the AGC, its success rate in the criminal cases it brings is high. It has an extensive suite of supervision, inspection, surveillance, and sanctioning powers and its enforcement philosophy is thoughtful and coherent. MAS has made a considerable investment in investor education...”¹⁴⁰

¹³⁹ SFA, s 154

¹⁴⁰ IMF, op. cit, 19-20 [38] and [40]

Enforcement statistics were compiled by the IMF in December 2013:¹⁴¹

Enforcement Actions Between 2008-12						
Year	No. of Criminal Enforcement Prosecution/ Convictions	No. of Civil Penalty Enforcement Actions (Settlement/ Court Actions)	Number of Administrative/Regulatory Enforcement Actions			
			Composition	Prohibition Order, Suspension/ Revocation of License	Reprimands, Letters of Warnings	Specific Directions, Others
2012	4/2	5/0	29	6	301	1
2011	4/4	3/3	50	7/0	219	16
2010	10/10	1/0	41	18/0	9/28	6/0
2009	15/15	3/0	34	8/0	1/189	13/0
2008	4/2	2/0	5/	21/0	4/72	25/0

Source: MAS.

Notes:
 All criminal prosecutions are considered material.
 All settlements are entered into with admission of liability and agreement to pay civil penalty. All civil penalty actions settlements have to-date been published on the MAS website.
 MAS had the power and discretion to compound non-custodial offenses under the SFA and the FAA by collecting from a person reasonably suspected of having committed the offense a sum of money not exceeding the maximum fine prescribed for that offense.

Reprimands and warning letters have the highest frequency, with civil and criminal court actions having the lowest.

The IMF (2013) commented on the MAS' lack of an administrative power to issue fines for breaches of provisions, and the inability to pursue court proceedings to enforce civil penalties being a noticeable gap in the regulatory framework when compared internationally. While there is a lack of a full suite of sanctions:

"MAS argues that the use of its composition powers, which are not necessarily limited to cases for which a civil penalty is available, can be as small as S\$500 and which require an admission of liability, is a more effective mechanism for penalizing low significance breaches than a specific power to fine under administrative procedures which would entail providing provisions for appeals...Furthermore, Singapore may be a culture where a public reprimand from an important public authority is more damaging to the person because it has a negative impact on his reputation, than paying a fine that he can easily afford. However, the lack of an administrative power of MAS to issue fines should be kept under review and change sought if the current arrangements prove inadequate for effective and proportional enforcement."¹⁴²

¹⁴¹ Ibid, 83

¹⁴² IMF, op. cit, relating to Principle 11: Comprehensive enforcement powers

Publication¹⁴³

MAS publishes enforcement actions taken against financial institutions and representatives on its website. However, not all actions are published. The publication policy is not to disclose dealings with institutions where MAS is of the opinion that they are best dealt with in confidence or if the disclosure of regulatory actions is unfair or unduly prejudicial. Reprimands are not subject to mandatory publication. However, reprimands for breaches of market conduct requirements are published, including the circumstances justifying reprimands. Market conduct compositions and prohibition orders are also published.

The IMF (2013) commented that

“Given the wide scope of power that MAS may exercise against an intermediary and the range of sanctions available, MAS should consider reviewing its policy regarding publication of actions taken against intermediaries. IOSCO expectations support full transparency of regulatory actions, particularly on enforcement matters. Investors should know about problems with the behavior of intermediaries in the marketplace. Private sanctions should not be applied except in extraordinary cases. The normal process should be to publicly disclose all actions.”

Accountability and appeals¹⁴⁴

Accountability:

MAS is accountable to the Finance Minister and is statutorily required to include a performance report in its annual report, which must be presented to the President and to the Parliament. MAS’ board is required to inform the Government of its regulatory, supervisory, and monetary policies and furnish the Finance Minister with information as required.

Financial statements must be presented and audited by the Auditor-General which are published in the Gazette and presented to the President. The MAS annual report and financial statements are published on MAS’ website. Key regulatory policies are listed in the annual report which have been introduced during the financial year. Capital market statistics are disclosed, for example, the number of licensees and the net funds raised in domestic capital markets.

The financial resources of MAS are the responsibility of the Finance Department which includes controlling of payments, receipts, budgeting, and accounting for MAS’ overall income, expenditure, assets, and liabilities. MAS has an Internal Audit Department (IAD) which is responsible for providing an independent, objective, and effective internal control. The IAD reports to the Audit Committee and administratively to the managing director, and is not involved in any activities that may jeopardise or appear to jeopardise its independence and objectivity. An Audit Committee independently assesses MAS’ internal controls, financial reporting processes, and reviews the reports of MAS’ internal and external auditors. Accountability of the use of funds is monitored through internal management accounting and audits by the Auditor-General.

Before making a decision affecting applicants or holders of licenses or an enforcement decision, MAS provides an opportunity to be heard. Submissions may be in writing and legally supported. A list of enforcement actions is published on MAS’ website which provides reasons for each action.

¹⁴³ Sourced from: Ibid

¹⁴⁴ Sourced from: IMF, op. cit

Appeals: ¹⁴⁵

Appeals against certain MAS decisions (e.g. a refusal to grant a license or the issuance of a prohibition order) can be made to the Finance Minister, which is currently the MAS Chairman. Within 28 days of receipt of the appeal application, the Minister must constitute an Appeal Advisory Committee (AAC) consisting of non-governmental persons. A hearing must be conducted within 28 days from the AAC formation date which must give MAS and the appellant a reasonable opportunity to appear and be heard. A written report must be submitted to the Minister by the AAC within 14 days of the conclusion of the hearing which may contain recommendations. The Minister must consider the report when making a decision but is not bound by the report's recommendations. A MAS appeal decision may be confirmed, varied, reversed, or directions can be given by the Minister whose decision is final. High Court judicial reviews of MAS decisions are available to aggrieved persons pursuant to section 310 of the SFA.

The IMF commented (2013) that:

"...an appeal to the minister-in-charge of MAS, in the case, for example, of a decision by MAS staff to refuse or revoke a license, does not appear to be an appeal to a decision-maker who is independent of the entity whose decision is being appealed, as this person is also, currently, the Chairman of the MAS Board (although he does not have to be)...the administrative change required, in the view of the assessors, is either that the minister surrenders his right to reject the advice of the Appeal Advisory Committee or, preferably, that the committee is brought "in house" to MAS, its decisions are final (subject to judicial review), and the minister is no longer involved in making these decisions, as is good global practice."

V.6.6 Accounting and Corporate Regulatory Authority

Scope of enforcement

ACRA monitors and enforces compliance with the CA by locally incorporated companies including listed and non-listed companies. Criminal investigations are handled by CAD and enforced by the AGC through the court system.

Sanctions and publication

ACRA can issue fines to directors, and as of 2016, has the power to debar¹⁴⁶ directors and secretaries from taking new appointments if they are in default of a statutory filing requirements under the CA for a continuous period of three months.¹⁴⁷ Pursuant to the CA, ACRA can:

(1) remove directors (s152); (2) disqualify directors (s154); (3) issue fines (ss173H; 204); (4) commence civil proceedings (s242); and (5) commence criminal proceedings (s242).

Pursuant to the Accountants Act, ACRA can:

(1) suspend an accountant (s52(2)(b)); (2) make a public censure (s52(2)(e)); (3) order an undertaking (i.e. reviewed by another accountant) (s52(2)(f)); (4) cancel

¹⁴⁵ Ibid

¹⁴⁶ A debarred person can, however, continue with existing appointments. ACRA will lift the debarment when the default has been rectified or on other prescribed grounds

¹⁴⁷ CA, s 155B. See, ACRA, "ACRA Annual Report 2014-2015," 19: Available at https://www.acra.gov.sg/uploadedFiles/Content/Publications/ACRA_Annual_Reports/ACRAAR2014-15.pdf (visited 15 July 2017)

registration (s52(2)(a); or (5) make an order for costs (of the disciplinary proceeding) (s52(2)(g)).

ACRA gazettes disciplinary proceedings.

Accountability and appeals

ACRA is accountable to the Finance Minister. From 2013 onwards, companies can appeal to the Finance Minister under the ACRA Act. Prior to 2013, the Governance Surveillance Division (GSD) handled all forms of complaints, including governance-related matters and breaches under the legislation administered by ACRA. The GSD worked closely with other government agencies to ensure that appropriate enforcement steps were taken against offenders. Judicial reviews against ACRA decisions can be sought in the High Court.

V.6.7 Others government bodies

The Code on Take-overs and Mergers is administered and enforced by the SIC. However, the code does not contain enforcement provisions. Pursuant to section 138 (4) of the SFA, the SIC has the power to enquire into any matter or thing related to the securities industry and summon any person to give evidence on oath or affirmation, or produce any document or material necessary for the purpose of the enquiry. The SFA provides for offences relating to a take-over offer where a person has no intention to make an offer but gives notice of intent, and where notice has been given but the person does not have reasonable grounds to make the offer—the person and, where the person is a corporation, every officer of the corporation who is in default is guilty of an offence and is liable on conviction to a fine not exceeding SG\$250,000 or to imprisonment for a term not exceeding seven years or to both.¹⁴⁸ Enforcement is undertaken by the AGC.

No appeals are permitted for SIC decisions—a ruling that so far has been unchallenged in the courts (2013). In a notable case in 2008 involving a failed take-over offer (Jade Technologies Holdings Ltd) the SIC declared that a director was not suitable to be a director of a listed company.¹⁴⁹

The CPIB enforces the Prevention of Corruption Act (Cap. 241) in relation to a “public body” which is interpreted as any corporation, board, council, commissioners, or other body which has the power to act under and for the purposes of any written law relating to public health or to undertakings or public utility or otherwise to administer money levied or raised by rates or charges in pursuance of any written law.¹⁵⁰ Enforcement is undertaken by CAD or the AGC through the court system. The CPIB publishes its enforcement actions. It is unclear whether the scope of “a public body” captures GLCs.

CAD does not appear to publish its enforcement or criminal prosecutions. This may be explained by the fact that CAD is not a regulator per se, and because the media is actively involved in reporting CG offences, particularly providing extensive coverage of criminal proceedings.

¹⁴⁸ SFA, s 140 (3)

¹⁴⁹ IMF, *op. cit.*, 106

¹⁵⁰ Prevention of Corruption Act (Cap. 241), s2

Appendix V	7. Shareholders' rights and protections	V.7 Singapore
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Introduction

Singapore represents a market where controlling shareholders dominate which is reflected in the CG system. The CA principally governs Singapore-incorporated listed companies and the rights of shareholders. This is supported by the CG Code, the SGX-ST LRs, which recommend companies:

(1) treat all shareholders fairly and equitably; (2) should recognise, protect, and facilitate the exercise of shareholders' rights; and (3) continually review and update such governance arrangements.

ACRA and the SGX are active in regulating the CA and the LRs respectively.

Access to material company information in general, and disclosures of governance arrangements in particular, are important for transparency in matters of interest to shareholders. Mandatory disclosure obligations include financial information, the soon to be introduced sustainability reporting requirements, and a number of narrative "comply or explain" requirements in the CG Code. The introduction of sustainable reporting in particular provides shareholders with more transparent information on, inter alia, CG policies and practice which is useful in evaluating the board's priorities, objectives, and strategies, as well as shareholders gaining a deeper understanding of their rights.

V.7.1 Shareholder rights

Minimum rights

Shareholder meetings:

Section 180 of the CA mandates that a shareholder has the right to attend any general meeting of the company, pursuant to a company's constitution. At least 14 days notice (a special resolution requires 21 days) must be given for shareholder meetings unless a longer period is specified in the articles of association. Shareholders holding at least 10% of shares are entitled to request the directors to convene an extraordinary general meeting.¹⁵¹

Appendix 2.2. (8) of the LRs requires the articles of association to include a provision whereby holders of ordinary shares are entitled to be present at general meetings. In 2013, the SGX amended the LRs for Mainboard and Catalist companies to hold their general meetings in Singapore.

Principal 16 of the CG Code recommends companies to encourage greater shareholder participation at general meetings to allow shareholders the opportunity to communicate their views on matters affecting the company. Shareholders should have the opportunity to participate effectively in general meetings.¹⁵²

Voting rights:

The CA provides every member with the right to speak and vote on a resolution before a meeting, notwithstanding any contrary provision in a company's constitution.

¹⁵¹ CA, s 176

¹⁵² CG Code, 16.1

Proxy voting is permitted pursuant to the CA—a shareholder of a company entitled to attend and vote at a meeting of a company must be entitled to appoint another person as his/her proxy to attend and vote instead of the shareholder and must have the same right to speak at the meeting. However, the right to appoint a proxy is subject to the company’s constitution which can revoke or vary the right. A shareholder (except a nominee) is restricted to appointing no more than two proxies, pursuant to the company’s constitution revoking this right. An objection raised to these arrangements is that this prevents institutional and retail investors from exercising their rights as shareholders.¹⁵³

The “multiple proxies regime” allows specified intermediaries, such as banks and capital market services license holders that provide custodial services, to appoint more than two proxies to attend and vote at general meetings. The proxies have the same rights as shareholders, such as raising queries at meetings for the board to answer. Companies cannot opt out of the multiple proxies regime. This improves CG and transparency by making the company accountable to all shareholders.

Similar arrangements are now available in Hong Kong where, if shares owned by an investor are registered in the name of Hong Kong Securities and Clearing Company Limited (HKSCC) Nominees Limited, a shareholder can exercise the right to vote at the AGM by giving instructions to HKSCC through their brokers. If an investor has opened an Investor Account in the Central Clearing and Settlement System (CCASS) and has deposited shares into the CCASS Depository, he/she may vote on corporate actions and activities by giving instructions directly to the HKSCC. The HKSCC sends its representatives to the AGM and votes according to the instructions received. If an investor wants to vote in person or appoint a proxy to attend the AGM to vote, a request must be made through their brokers to the HKSCC. Investors who have opened an Investor Account in the CCASS can make this request to HKSCC directly.

In the first quarter of 2016, the CA was amended to allow public companies to issue ordinary shares with different voting rights or dual-class shares. Though these amendments have not taken effect in practice, this is the first step in accepting companies with dual-class shares to be listed on the SGX. The second step in the process was by the SGX issuing of a consultation paper in February 2017 on dual-class share structures. Hong Kong has similarly proposed (October 2017) allowing dual-class shares on the HKEx Mainboard for technology and growth companies.

The SGX-ST Listing Manual requires the articles of association of listed issuers to include a provision that holders of ordinary shares must be entitled to vote at any general meeting.¹⁵⁴ Issuers are required to disclose information (e.g. circulars) to assist shareholders’ voting decisions. Rule 1206 of the SGX-ST Listing Manual requires any circular sent to shareholders to contain all information necessary for shareholders to make a properly informed decision.

Indirect shareholders, including overseas shareholders, have no impediments to exercising their voting rights as instructions can be given to Custodial Firms or central provident fund (CPF) agent banks. The CG Code recommends that companies allow Custodial Firms to appoint more than two proxies so that shareholders can personally attend meetings. A shareholder whose shares are held through a nominee company or custodian bank will not have any rights to vote directly in a general meeting. While registered “members” are effectively bare trustees holding shares for the collective benefit of beneficial shareholders, a company will only recognise the rights of the

¹⁵³ CA, s181

¹⁵⁴ Appendix 2.2. (8)

persons registered as holders of the shares who attend and vote at a general meeting.¹⁵⁵ Few have acted on this recommendation and the MoF has recently decided to make this a statutory requirement.¹⁵⁶

The CG Code recommends that companies are required to ensure that shareholders have the opportunity to participate effectively in, and vote at, general meetings.¹⁵⁷ Principle 16.1 recommends that companies make appropriate provisions in their articles of association or constitutive documents to allow for *absentia* voting at general meetings.

The common law imposes a duty on company directors to inform shareholders fully and fairly on matters which they have the right to vote on. A notice of a meeting should include sufficient information for a shareholder to decide whether or not to attend and vote for or against a proposed resolution.

Rights of pre-emption:

In contrast to the UK, in Singapore the CA does not mention rights of pre-emption. However, the Listing Manual requires the constitution to provide pre-emption rights to existing shareholders, subject to a contrary direction by shareholders at the general meeting.¹⁵⁸

Controlling shareholders

Most listed companies in Singapore are subject to a controlling shareholder (e.g. families or government-linked). Empowering shareholders generally could have the perverse effect of further strengthening the position of controlling shareholders, rather than empowering minority shareholders.¹⁵⁹ Hong Kong shares this predicament with its proliferation of family-owned companies. This is why the statutory and LR requirements for controlling shareholders are relatively limited in Singapore (and in Hong Kong), the exception being interested person transactions (see Director interests, below). Instead, an alternative voting mechanism and statutory duties could be considered. For example, cumulative voting for the appointment of directors and placing a fiduciary duty on controlling shareholders.

A controlling shareholder is defined in the LRs as a person who holds, directly or indirectly, 15% or more of the total number of shares issued or in fact exercises control over the company. In accordance with LR 803, an issuer must not issue securities that transfer a controlling interest without the approval of shareholders in a general meeting.

The CA does not mention controlling shareholders, but does regulate substantial shareholders. Part IV, Division 4 of the CA defines substantial shareholders as a person who holds more than 5% of the total votes attached to all voting shares of the company. This includes persons who have an interest in voting shares. The definition could encapsulate controlling shareholders as defined by the LRs. The introduction of dual-

¹⁵⁵ Morgan Lewis, "Can I still exercise my voting rights as a shareholder of a company if my shares are kept in a nominee account?" (2013) *Lexology*: Available at: <http://www.lexology.com/library/detail.aspx?g=fb3dbe3e-f730-4630-b0ec-49ef98364eea> (visited 20 June 2016)

¹⁵⁶ IMF, *op. cit.*, 105. CPF shareholders are local shareholders that had used their pension money to invest in listed securities which are held in the name of the CPF agent banks

¹⁵⁷ Provision 14.2

¹⁵⁸ Stephanie Keen, Adrian Chan, Matthew Bousfield, and Lucy Harrison, "Private mergers and acquisitions in Singapore: overview," (1 October 2016) *Hogal Lovells Lee & Lee*: Available at [https://content.next.westlaw.com/9-543-1146?transitionType=Default&contextData=\(sc.Default\)&_IrTS=20170503230240995&firstPage=true&bhcp=1](https://content.next.westlaw.com/9-543-1146?transitionType=Default&contextData=(sc.Default)&_IrTS=20170503230240995&firstPage=true&bhcp=1) (visited 18 July 2017)

¹⁵⁹ Luh Luh Lan and Umakanth Varottil, "Shareholder Empowerment in Controlled Companies: The Case of Singapore," in Jennifer G Hill and Randall S Thomas (ed), *Research Handbook on Shareholder Power* (Cheltenham: Edward Elgar, 2015)

class shares emphasises the definition of a substantial shareholder being centred on those who hold voting shares. A person who is a substantial shareholder and who changes the percentage level of interest or ceases to be a substantial shareholder in a company must give notice in writing to the company.¹⁶⁰

Section 91 of the CA empowers the court to make an order, on application of the Minister, with regards to:

(1) restraining a substantial shareholder or person entitled from disposing of any interest in shares; (2) restraining the exercise of any voting or other rights attached to any shares; (3) directing the company not to make payment, or to defer making payment; (4) directing the sale of all or any of the shares; (5) directing the company not to register the transfer or transmission of specified shares; (6) any exercise of the voting or other rights attached to specified shares; and (7) securing compliance with any other order to do or refrain from doing a specified act.

Any person who contravenes or fails to comply with an order made under section 91 of the CA is liable on conviction to a fine.

Remedies

Representative actions, a limited form of class action, dissimilar to the United States style of class action, are possible but not common.¹⁶¹ Notably, the preclusion of contingency fees for contentious matters (e.g. representative actions against companies) limit incentives for lawyers or shareholders to pursue a representative action.

Unfair prejudice:

Shareholders can apply to the court for an unfair prejudice or oppression remedy pursuant to section 216 of the CA—a shareholder can apply to court for an order on the grounds that:

(1) the affairs of the company are being conducted or the powers of the directors are being exercised in a manner oppressive to one or more shareholders, or in disregard of their interests as shareholders; or (2) some act of the company has been done, is threatened, a resolution by the shareholders has been passed, is proposed which unfairly discriminates against, or is otherwise prejudicial to one or more of the shareholders (including the shareholder making the application).

The court has wide powers in this regard. For example, the court may direct, prohibit any act, cancel, or vary any transaction or resolution. The court may also make orders to regulate the conduct of the company in the future. Other remedies include a buy-out order or a winding up order. This is essentially similar to Hong Kong's unfair prejudice remedy under section 168A of the Companies Ordinance (Cap 32) which now is Part 14, Division 2, Companies Ordinance (Cap 622) (for a detailed comparison with Hong Kong, see Appendix V.3.4 Non-locally incorporated companies).

Section 216 of the CA was initially enacted in 1967. A search at "LawNet" on 10 June 2016 revealed 504 results for "Companies Act section 216" and 34 reported cases of minority shareholder/s taking a court action on the grounds that the company's or majority shareholder's action was oppressive or unfairly discriminatory or prejudicial. Approximately half of the cases brought before the courts between 2011 and 2016 show

¹⁶⁰ CA, ss 82, 83, and 84

¹⁶¹ IMF, op. cit, 109

an increased awareness and willingness to exercise shareholders' rights.¹⁶²

Derivative action:

At common law, a shareholder can bring derivative action on behalf of the company if certain conditions are satisfied, namely "fraud on minority" and "wrongdoer in control". Where a case of unfair prejudice or oppression can be made out pursuant to section 216(2)(c) of the CA, the court may grant leave for an action in the name of the company (i.e. a derivative action) to obtain corporate relief on such terms as the court directs.

Section 216 of the CA was complemented with the addition of section 216A following the 2014 amendments to the CA. Section 216A goes further than the common law and section 216, as a complainant can bring an arbitration or an intervention in the name of, or on behalf of, the company. The scope of statutory derivative actions in Singapore is wider than Hong Kong's Part 14, Division 4, Companies Ordinance (Cap 622), which only apply to "misconduct"¹⁶³ (there is no such requirement in Singapore, in practice the same conclusion can be reached), and does not provide for a complainant to bring an arbitration action.

In *Petroships Investment Pte Ltd v Wealthplus Pte Ltd* [2016] SGCA 17, the Court of Appeal clarified the application of section 216A. The statutory derivative action is only available to Singapore incorporated companies (i.e. private, public, and/or listed companies), and does not apply to foreign incorporated companies which must rely on the common law derivative action¹⁶⁴ (for more details, see Appendix V.3.4 Non-locally incorporated companies). In Hong Kong, section 733 (3) (b) of the Companies Ordinance (Cap. 622) provides leave to commence a derivative action involving certain companies incorporated outside of Hong Kong that have a place of business in Hong Kong.¹⁶⁵ This is wider in scope than Singapore's section 216A of the CA.¹⁶⁶

Listing requirements:

A breach of the LRs are not actionable by shareholders in Singapore, as is the case in Hong Kong. This is different to a breach of the LRs in the UK where a civil action is available to "affected persons".

V.7.2 Director duties and requirements

Singapore adopts the same statutory definition of a director as in Hong Kong which treats a director as any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors or the majority of the directors of a corporation are accustomed to act, which includes an alternate or substitute director.¹⁶⁷

¹⁶² Hong, Ching and Huat (ed) op. cit. p. 25

¹⁶³ CO, s731: misconduct is defined as fraud, negligence, breach of duty, or default

¹⁶⁴ Chandra Mohan Rethnam, Khelvin Xu, and Tan Ruo Yu, "Singapore Court of Appeal: Derivative Actions by Shareholders not Available for Companies in Liquidation," (24 March 2016): Available at <http://www.lexology.com/library/detail.aspx?g=78afb0ba-bc65-463b-8b72-63a4ece16e9b> (visited 19 July 2017)

¹⁶⁵ Hong Kong derivative actions are restricted to Hong Kong companies or non-Hong Kong companies that have a place of business in Hong Kong. Place of business is defined as having a share register or share transfer office in Hong Kong. Under the LRs 19.05(3)(a) and (4) all listed companies must have a share register in Hong Kong. Thus shareholders of foreign companies listed in Hong Kong can bring a derivative action in Hong Kong

¹⁶⁶ Pursuant to the old Companies Ordinance (Cap. 32) foreign companies required leave from the court in their place of incorporation to bring a derivative action in Hong Kong: *Wong Ming Bun v Wang Ming Fan* [2014] 1 HKLRD 1108 as per the Hong Kong Court of First Instance

¹⁶⁷ CA, 4; Companies Ordinance, s2

Directors' interests

Part VII of the SFA imposes an obligation on a director or CEO of a listed company to notify the company of his/her interest or change in interest in the securities of the company. The company is required to notify the market via an SGXNET announcement within one business day of notification from the director/CEO.

In terms of statutory-backed secondary legislation (see Appendix V.3.2), the Securities and Futures (Offers of Investments) (Shares and Debentures) Regulations require that the interests (whether direct or deemed) of directors and the CEO be disclosed in the prospectus. Rule 1207(7) of the SGX-ST Listing Manual (which is statutorily backed by s 203, SFA) imposes the same disclosure requirement on directors in the annual report.

The Companies (Amendment) Act 2014 extends the obligation to disclose interests in transactions to CEOs, in addition to directors, including interests of the CEO and their immediate family members (i.e. spouses and minors) in the securities of the company. This improves CG and transparency. Again, Hong Kong has similar requirements in the Securities and Futures Ordinance.¹⁶⁸

Section 156 of the CA requires every director or CEO, directly or indirectly, interested in a transaction or proposed transaction with the company to, as soon as is practicable, declare the nature of the interest and issue a notice to the company. This extends to persons whose interests the director represents (s 158(2)(a), CA). Chapter 9 of the LRs require an issuer to disclose the aggregate value of interested person transactions (an interested person includes a director, CEO, controlling shareholder, or their associates).¹⁶⁹ Hong Kong is subject to similar requirements in the Company Ordinance (Cap. 622) which include the disclosure of interested persons connected to the director. The extensive disclosure requirements of director interests in Singapore and Hong Kong reflect the increased risks from the prevalence of controlling shareholders and market culture.

Director duty of care and fiduciary duty

Singapore has taken a middling approach with the partial codification of duty of care and fiduciary duty coming into force on 1 July 2015.¹⁷⁰ This is different to Hong Kong. Unlike the duty of care in Hong Kong now codified under section 465 of Companies Ordinance (Cap. 622), which imposes both a minimum objective and higher subjective standard, the duty of care (or duty of honesty and reasonable diligence as stated in the CA) in Singapore is objective under section 157(1) of the CA.

While Hong Kong has codified the directors' duty of care and introduced a minimum objective standard subject to a higher subjective standard, Singapore's codification of the directors' duty of care states that the objective standard as requiring:

"A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office."¹⁷¹

This is different from the duty of care in common law which imposes a subjective standard which is higher than the minimum objective standard. However, section

¹⁶⁸ See generally, Securities and Futures Ordinance (Cap. 571), Part XV, Division 7. Spouses and minors, see: section 316, Securities and Futures Ordinance (Cap. 571)

¹⁶⁹ LR 904

¹⁷⁰ For a description of directors' duties in Singapore, see: Robson Lee, "Directors' Duties & Responsibilities (Singapore)," (2015) *Gibson Dunn*: Available at <http://www.gibsondunn.com/publications/Documents/Directors-Duties-and-Responsibilities-in-Singapore08-2015.pdf> (visited 16 November 2017)

¹⁷¹ CA, s157(1)

157(4) of the CA says that the duty imposed by section 157 is: "...in addition to and not in derogation of any other written law or rule of law relating to the duty or liability of directors or officers of a company."

Therefore, Singapore's position is fundamentally the same as Hong Kong, albeit expressed in different terms. Section 157 of the CA clearly imposes a minimum objective standard while retaining the higher subjective standards imposed on a director at common law. Thus, the standard of a directors' duty of care at common law remains relevant.

The fiduciary duty has been partially codified under section 157(2) regarding only the no-conflict rule and no-profit rule, leaving the fiduciary duty at common law intact by section 157(4) of the CA. Section 157 (2) states:

"An officer or agent of a company shall not make improper use of his position as an officer or agent of the company or any information acquired by virtue of his position as an officer or agent of the company to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the company."

This provides a statement of directors' fiduciary duty which is not as extensive as the UK codification (ss 170-177 of the Companies Act 2006 UK). Section 157(3) retains the consequence of a breach at common law—liability to account "to the company for any profit made by him or for any damage suffered by the company". Section 157 (3) criminalises breaches and imposes a fine not exceeding SG\$5,000 or imprisonment for a term not exceeding 12 months.

The LRs address a director's conflict of interest in relation to "interested parties" (see Related party transactions, below). Furthermore, the CG Code recommends that all directors to objectively discharge their duties and responsibilities at all times as fiduciaries in the interest of the company.¹⁷²

Director qualifications

The CG Code recommends that the board of directors and its committees, as a group, should provide the appropriate balance and diversity of skills, experience, gender, and knowledge of the company.¹⁷³ Directors should have the core competencies of accounting or finance, business or management experience, industry knowledge, strategic planning experience, and customer-based experience or knowledge.¹⁷⁴

Singapore's board diversity is similar to the board composition recommendations in Hong Kong's CG Code. Hong Kong's core competencies focus on committees, notably accounting and financial experience for the audit committee.

Director training

The CG Code recommends that the nomination committee is responsible for making recommendations to the board on relevant matters relating to the review of training and professional development programs for the board.¹⁷⁵

The company should be responsible for arranging and funding director training.¹⁷⁶

¹⁷² Guideline, 1.2

¹⁷³ CG Code, Guideline 2.6

¹⁷⁴ Ibid

¹⁷⁵ CG Code, Guideline 4.2 (c)

¹⁷⁶ CG Code, Guideline 1.6

Incoming directors should receive a comprehensive and tailored induction, which should include an orientation program to ensure familiarity with the company's business and CG practices.¹⁷⁷ Upon the appointment of each director, a formal letter should set out the director's duties and obligations.¹⁷⁸ All directors should receive regular training.¹⁷⁹

In the annual report, the board should disclose induction, orientation, and training provided to new and existing directors.¹⁸⁰ There is no indication in the CG Code of the exact nature of the training nor how often the training should take place.

Director training is provided by the SID—which organises seminars for its members and regularly issues publications. For example, SID has published a Code of Governance and a Directors Code of Professional Conduct to assist directors discharge their duties and responsibilities.

Independent directors

With the powers resting with MAS, the Singaporean government has the discretion to raise CG standards promptly and effectively. For example, Singapore adopted the United States style of ID system (which is independent from management as opposed to controlling shareholders) promptly in 2002 to reassure international investors of its CG standards after the Asian financial crisis. This suited the Singapore CG culture at the time because most listed companies had controlling shareholders. However, with an increasing number of Chinese SOEs (where the companies are controlled by the Chinese government) listing in Singapore, and in order to reign in the misconduct by SOE controlling shareholders, the Singaporean government changed the independence definition in 2012 to require independence from controlling shareholders.

Principle 2 of the CG Code recommends that the board of directors should be able to exercise objective judgment on corporate affairs independently. In particular, directors should be independent from management and shareholders who control 10% or more of the voting shares (i.e. 10% shareholders). An ID is defined as a person who has no relationship with the company, related corporations¹⁸¹, 10% shareholders, or the company's officers that could interfere, or reasonably perceived to interfere, with the exercise of the director's independent business judgment (i.e. a view based on acting in the best interests of the company).¹⁸²

At a minimum, the CG Code recommends that IDs should make-up at least one-third of the board of directors.¹⁸³ IDs should comprise at least half of the board of directors where:

- (1) the chair and CEO is the same person;
- (2) the chair and CEO are immediate family members;
- (3) the chair is part of the management team; or
- (4) the chair is not an ID.¹⁸⁴

Hong Kong's CG Code does not specify the proportion of IDs on the board because this has been made mandatory in the LRs, notably that one-third (or at least three members) of the board should consist of independent non-executive directors (INEDs).¹⁸⁵ Furthermore, the SEHK may specify a higher number of INEDs than the minimum

¹⁷⁷ Ibid

¹⁷⁸ CG Code, Guideline 1.7

¹⁷⁹ CG Code, Guideline 1.6

¹⁸⁰ Ibid

¹⁸¹ The term "related corporation", in relation to the company, has the same meaning as currently defined in the CA, i.e. a corporation that is the company's holding company, subsidiary or fellow subsidiary

¹⁸² CG Code, Guideline 2.3

¹⁸³ CG Code, Guideline 2.1

¹⁸⁴ CG Code, Guideline 2.2

¹⁸⁵ LR 3.10A (HKEx)

requirement, if the size of the board or other circumstances justify an increase in INEDs.¹⁸⁶

In Singapore, the board determines the independence of directors in accordance with the recommendations in the CG Code.¹⁸⁷ This is different to Hong Kong where INEDs must satisfy the SEHK of their independence to fulfil the role effectively.¹⁸⁸ (Note that the Hong Kong CG Code does recommend that the nomination committee assess the independence of INEDs¹⁸⁹). INEDs in Hong Kong are required to submit to the SEHK a written confirmation of their independence in a specified form that will render the submitter subject to prosecution for an offence if the information provided is not true, complete, and accurate.¹⁹⁰ This is not an SGX requirement.

In Singapore and Hong Kong the CG Code recommends that the independence of any director who has served on the board of directors for more than nine years from the date of his/her first appointment should be subject to scrutiny.¹⁹¹ Singapore recommends that the INED be rigorously reviewed by the board whereas in Hong Kong any further appointment should be subject to a shareholder resolution. Prima facie, the scrutiny in Hong Kong appears to be of a higher standard, but the fact that both markets are dominated by controlling shareholders and that the process is subject to “comply or explain” undermine the principle behind the process.

IDs attendance at board meetings (2014) is relatively high with 85.5% having attendance rates of more than 75% of the total number of board meetings held. This is comparable to executive directors (86.6%), while being higher than non-executive directors (NEDs), who like IDs, do not have a daily executive role.¹⁹²

Scholars have argued of the problems in drawing comparative lessons from Singapore’s system because of the idiosyncratic factors that obscure the development and function of the ID system. These factors include the ability of Singapore’s regulators to use informal mechanisms to effectively mitigate control benefits in well-connected local companies, the small pool of IDs, the need to attract foreign capital, and compliance with international CG standards. This is broadly similar to Hong Kong except that the regulators do not use informal mechanisms to effectively mitigate control benefits in local companies. Although the United States system has been successfully applied to the GLC governance model, the model is difficult to replicate because of Singapore’s efficient and meritocratic government. The precise identity of a shareholder (who they are and their motivations) is important to understand how the ID system functions when developing an effective regulatory strategy. CG advisory firms have erroneously assumed that United States style ID systems can be universally transplanted into any jurisdiction without looking to the precise definition of “independence” in the context of each jurisdiction. Literature and international organisations commonly cited (e.g. World Bank) have failed to take into account the scope of the definition of “independence”. Despite Singapore adopting the United States style of IDs, a façade of an effective CG system had been created. For example, prior to 2012, S-chips could not be effectively regulated through informal mechanisms because IDs were not independent from controlling shareholders. An increasing number of scandals involving S-chips led to the United States system being abandoned, notably with the introduction of the CG Code in 2012. New “independence” requirements were carefully crafted not to affect the

¹⁸⁶ LR 3.2 (HKEx)

¹⁸⁷ Guideline 2.3

¹⁸⁸ LRs 3.2 and 5.09 (HKEx)

¹⁸⁹ CG Code, A.5.2 (c) (Hong Kong)

¹⁹⁰ LR 5.09 (8) (HKEx)

¹⁹¹ CG Code, Guideline 2.4; CG Code, A.4.3 (Hong Kong)

¹⁹² SID and ISCA, op. cit

governance of GLCs and family controlled companies.¹⁹³

V.7.3 Board processes

Board effectiveness

Principle 1 of the CG Code states that every company should be headed by an effective board of directors to lead and control the company. The board is collectively responsible for the long-term success of the company which works with management to achieve this objective, and management being accountable to the board. Guideline 1.5 of the CG Code recommends that every company should prepare a document with guidelines setting forth the matters reserved for the board's decision and clear directions to management on matters that must be approved by the board. To be effective, incoming directors should receive comprehensive and tailored induction which should include director duties, how to discharge those duties, and an orientation program to ensure familiarity with the company's business and governance practices. All directors should receive regular training, particularly on relevant new laws, regulations, and changing commercial risks.¹⁹⁴

Hong Kong's CG Code includes more extensive recommendations to enhance board effectiveness. For example, arrangements should be in place to ensure that all directors are given an opportunity to include matters in the agenda for regular board meetings¹⁹⁵ and there should be a procedure agreed by the board to enable directors, upon reasonable request, to seek independent professional advice.¹⁹⁶

Singapore's CG Code also recommends that the board examine its size to determine the impact upon effectiveness, decide on what it considers an appropriate size which facilitates effective decision making.¹⁹⁷

Board evaluation of performance

The CG Code states that there should be a formal annual assessment of the effectiveness of the board as a whole, its committees, and the contribution by each director to the effectiveness of the board. The nominating committee should assess the contribution of the chair and each director to the effectiveness of the board. An assessment of the board, the committees, and each director should be stated in the company's annual report by the board. The annual report should state how this assessment has been conducted, if an external facilitator was used, whether there is any connection with the company or its directors, and the assessment process should be disclosed.¹⁹⁸

Specifically, the CG Code states that the nomination committee is responsible for making recommendations to the board on relevant matters relating to the development of a process for evaluation of the performance of the board, its committees, and directors.¹⁹⁹ The nomination committee should decide how to evaluate the board's performance and propose objective performance criteria. This performance criteria should be approved by the board and address how the board has enhanced long-term shareholder value. Performance criteria should also allow for comparisons with industry peers. These

¹⁹³ See, Dan W. Puchniak and Luh Luh Lan, op. cit

¹⁹⁴ CG Code, Guideline 1.6

¹⁹⁵ CG Code, A.1.2 (Hong Kong)

¹⁹⁶ CG Code, A.1.6 (Hong Kong)

¹⁹⁷ CG Code, Guideline 2.5

¹⁹⁸ CG Code, Guideline 5.1

¹⁹⁹ CG Code, Guideline 4.2 (b)

performance criteria should be consistent from year to year, and where circumstances deem change is necessary, the onus should be on the board to justify the change.²⁰⁰

Individual evaluation should assess whether each director continues to contribute effectively and demonstrate commitment to the role (e.g. time commitment). The chair should act on the results of the evaluation in consultation with the nominating committee proposing the appointment or resignation of members to the board.²⁰¹

Guideline 4.4 of the CG Code recommends that when directors have multiple board representations, they must ensure sufficient time and attention given to each company. The nomination committee should decide if a director is able to carry out their duties as a director, taking into consideration the number of listed company board representations and other principal commitments. The following table is provided by the SID and the ISCA (2014) which reveals the number of board seats held by directors on SGX listed companies:²⁰²

	Full sample	Main Board	Catalist	REITS	Business Trusts
No. of directors with 1 board seat	3,016 (82.2%)	2,369 (79.0%)	495 (69.5%)	89 (56.7%)	63 (63.6%)
No. of directors with 2 board seats	391 (10.7%)	364 (12.1%)	111 (15.6%)	29 (18.5%)	20 (20.2%)
No. of directors with 3 board seats	132 (3.6%)	131 (4.4%)	43 (6.0%)	18 (11.5%)	8 (8.1%)
No. of directors with 4 board seats	63 (1.7%)	64 (2.1%)	34 (4.8%)	11 (7.0%)	5 (5.1%)
No. of directors with 5 board seats	37 (1.0%)	37 (1.2%)	18 (2.5%)	4 (2.5%)	1 (1.0%)
No. of directors with 6 board seats	21 (0.6%)	23 (0.8%)	7 (1.0%)	6 (3.8%)	1 (1.0%)
No. of directors with 7 board seats	2 (0.1%)	2 (0.1%)	1 (0.1%)	0 (0.0%)	0 (0.0%)
No. of directors with 8 board seats	5 (0.1%)	5 (0.2%)	1 (0.1%)	0 (0.0%)	0 (0.0%)
No. of directors with 9 board seats	2 (0.1%)	2 (0.1%)	1 (0.1%)	0 (0.0%)	1 (1.0%)
No. of directors with 10 board seats	1 (0.0%)	1 (0.0%)	1 (0.1%)	0 (0.0%)	0 (0.0%)
Total number of directors	3,670 (100.0%)	2,998 (100.0%)	712 (100.0%)	157 (100.0%)	99 (100.0%)

Table G1 – Multiple Directorships – Number (%) of total number of directors of Board Seats Held by Individual Directors

Further research (SID and ISCA, 2014) revealed that most directors hold one board seat, with 17.8% of all directors holding multiple directorships (2014). The highest number of board seats held by a single individual is 10 with the highest number of ID seats held by a single individual being nine. Surprisingly, the findings show that directors holding multiple directorships attended more board meetings than directors holding one seat, while 81.4% of directors holding one seat attended over 75% of board meetings, over 90% of directors holding multiple directorships had a mean attendance of over 75%.²⁰³

In practice, GLCs and family-owned companies tend to be characterised by a lack of director independence as connections with family or the government are prevalent.²⁰⁴

²⁰⁰ CG Code, Guideline 5.2

²⁰¹ CG Code, Guideline 5.3

²⁰² SID and ISCA, op. cit

²⁰³ SID and ISCA, op. cit, 40-46

²⁰⁴ Dan W. Puchniak and Luh Luh Lan, op. cit, 25

When nomination committees consist of directors, including IDs, that are not independent and which are responsible for assessing board effectiveness, this will compromise the objectivity and impartiality of the board to evaluate board decisions. Furthermore, the nomination committee evaluates its own performance, which is a conflict of interest. For example, SingPost, a large GLC, had a nomination committee consisting of the Chairman of the board and three INEDs. In 2015 SingPost had not properly disclosed a director's interest in a 2014 acquisition made by the company. SingPost's nomination committee was responsible for assisting the board to fulfil its CG responsibilities and evaluate the effectiveness of individual directors in meeting performance objectives.²⁰⁵ The failure to disclose related-party transactions represents a failure of the directors to commit to their role, and shows that the board and directors do not meet objective performance criteria. The nomination committee had failed to properly evaluate the performance of the board and the director in question. Compounding this revelation was the fact that the director in question was also the Chairman of the nomination committee and an INED. This highlights the conflict of interest in the structural design of the nomination committee consisting of directors who evaluate their own performance and the nomination committee's performance criteria being approved by the board. Board evaluation can be severely compromised in these circumstances. The failure to properly disclose a related-party transaction made by the Chairman of the nomination committee and where the Chairman of the Board is a member of the nomination committee, represents a lack of independence and objectivity of the nomination committee and a break-down of the CG Code mechanisms to evaluate the performance of the board and its directors.

Since the revelations, all members of the nomination committee had been replaced and the Chairman of the board has resigned. In 2016, SingPost publicly announced that it would voluntarily adopt a new directors' code of business conduct and ethics, and policies governing directors' conflicts of interest, board renewal, and tenure.

In Hong Kong, board performance is a CG Code recommended best practice and lacks the detail of assessment in comparison to Singapore. Hong Kong's CG Code focuses on the role of the remuneration committee in relation to an individual director's performance.

Accountability

Accountability of the board is discussed in Appendices V.2.1 and V.3.1 which focus on the 2014 CA amendments. The Hong Kong and Singapore CG Codes recognise the importance of having a clear division of responsibilities between the leadership of the board and the executives responsible for managing the company's business—that the Chairman and the CEO be separate persons to ensure an appropriate balance of power, increased accountability, and greater capacity of the board for independent decision making. The division of responsibilities between the chairman and CEO should be clearly established, set out in writing, and agreed by the board. In addition, the board should disclose the relationship between the chairman and the CEO if they are immediate family members.²⁰⁶

Singapore's approach to the audit committee is similar to Hong Kong being based on a sub-committee of the board, which is reportable only to the board. Both jurisdictions require the audit committee to comprise of at least three directors, the majority of whom, including the audit committee chairman, should be independent.²⁰⁷ All members of the audit committee should be NEDs. Singapore requires two (including the chair)

²⁰⁵ SingPost, "Annual Report 2014/15," (2015), 10, 13, and 37

²⁰⁶ CG Code, Guidance 3.1; CG Code, Provision 2.1, (Hong Kong)

²⁰⁷ CA, s 201B(2)

directors and Hong Kong requires one director with relevant qualifications or accounting related experience.²⁰⁸

Despite the adoption of audit committees since the Asian financial crisis and subsequent changes largely influenced by the UK Code of Corporate Governance and the United States Sarbanes-Oxley Act, including the promotion of greater independent board representation and the increase in demands on audit committees, there continues to be cases of fraud involving listed companies on the HKEx and SGX. These case of fraud have prompted Wan et al to conduct a survey²⁰⁹ on the following key questions to assess the effectiveness of audit committees in both jurisdictions: firstly, does greater ID representation on boards or audit committees reduce the likelihood of the occurrence of fraud in these two jurisdictions where concentrated shareholding is the norm? Secondly, what are the reasons why IDs and audit committees have not been effective in deterring fraud in the two jurisdictions? In addressing the first question, Wan et al examined a sample of 62 listed companies in Hong Kong and Singapore which had committed fraud or were under investigation for fraud between 2008 and 2014. Comparisons of company CG characteristics in the sample were matched with a sample of 62 non-fraudulent companies.²¹⁰ They found some evidence that the fraudulent companies tended to combine the roles of chairman and CEO.²¹¹ It was, therefore, suggested that there might be some merit to separate the roles of the chair and CEO.²¹² This suggestion has been considered in Hong Kong before and is consistent with developments in the UK since the 1990s which is the norm among the FTSE 350 boards.²¹³ Hong Kong should consider elevating the CG Code provision A.2.1 to a LR given the survey evidence. The survey also found that fraud companies have a lower proportion of finance experts (as distinct from accounting experts) in audit committees. A suggestion was made that there might be merit in emphasising the monitoring role by finance experts in audit committees. LR 3.21 (HKEx) requires the audit committee to comprise of a minimum three members, at least one of whom is an INED with appropriate professional qualifications, accounting, or related financial management expertise. However, Wan et al found that there was no difference in the proportion of IDs on boards or audit committees between fraudulent and non-fraudulent companies.²¹⁴ One consideration is to amend this rule as to require a director having accounting expertise and another with financial expertise.

On the second question, the authors found that the ability of IDs to provide effective monitoring of executive directors or management is limited because IDs are ultimately elected and removed by controlling shareholders, who sometimes serve as executive directors or appoint executives who blindly follow their instructions. The authors observed that IDs and audit committees remain dependent of management and controlling shareholders in uncovering information, such as related-party transactions. This echoes the observations made elsewhere in this report and supports the proposal for the appointment of IDs and access to information by IDs and audit committees. These findings suggest that IDs (or independent audit committees) have relatively narrower roles to perform in preventing fraud by issuers, although IDs with finance expertise are valuable in providing oversight of financial reporting and material disclosures. Notwithstanding the negative press coverage surrounding Mainland companies listed in Hong Kong and Singapore, Wan et al did not observe that there was a higher likelihood to commit fraud in these companies.²¹⁵ In Singapore, the CG Code

²⁰⁸ CG Code, Guidance 12.2; LR 3.21 (HKEx)

²⁰⁹ Wan, Chen, Xia and Goo, "Managing the risks of corporate fraud: the evidence from Hong Kong and Singapore," (2017), paper available in research file

²¹⁰ Ibid

²¹¹ Ibid

²¹² Ibid

²¹³ Marc Moore, "United Kingdom: The Scope and Dynamics of Corporate Governance Regulation," (2010) in Andreas M. Fleckner and Klaus J. Hopt (eds), *Comparative Corporate Governance: A Functional and International Analysis*, (Cambridge: Cambridge University Press, 2013), pp. 913-956

²¹⁴ Wan et. al, op. cit

²¹⁵ Ibid

recommends that the majority of members, including the Chair, should be independent²¹⁶ whereas in Hong Kong at least one member should be an INED.²¹⁷ Hong Kong has a requirement that the annual report has to contain a statement from the audit committee explaining a recommendation by the board when it takes a different position. Singapore's CG Code is silent on this point. The critical distinction between jurisdictions is that Singaporean audit committees are subject to the non-binding CG Code whereas in Hong Kong audit committees are subject to both the compulsory LRs and the non-binding CG Code. Thus, the formal Hong Kong requirement is stronger than Singapore in this regard.

Appointment and removal of directors

Tenure of a director's appointment is generally governed by a company's articles of association. The LRs mandate that all new listing applicant companies have articles which provide that where a managing director or a person holding an equivalent position is appointed for a fixed term, the term does not exceed five years.²¹⁸

There is no legal requirement governing the length of a director's tenure nor the number of terms. The Singaporean CG Code recommends that all directors submit for re-nomination and re-election at regular intervals—at least once every three years.²¹⁹ The SID recommends in its Board Guide that all companies should have articles which require at least one-third of the board retire from office at each general meeting.²²⁰

Rule 210(7) of the SGX-ST Listing Manual provides for the election of directors which must be stated in the constitution of a listed issuer. The nominating committee, which is responsible for the appointment of directors,²²¹ should comprise of at least three directors with the chair being independent. The requirement of an independent chair is similar to Hong Kong and the UK. In Singapore and Hong Kong, the remuneration committee is subject to the CG Code.

Principle (4) of the CG Code states that there should be a formal and transparent process for director appointments and reappointments. Important issues to be considered as part of the process for director selection, appointment, and re-appointment include:

- (1) composition; (2) progressive board renewal; (3) director's particular competencies; (4) commitment; (5) contribution; and (6) performance.²²²

In contrast to the UK, Singapore does not recommend policies based on physiological diversity. A description of the director selection process, appointment, and re-appointment should be disclosed in the company's annual report, including a disclosure on the search and nomination process.²²³ Key information which should be disclosed in the company's annual report regarding directors includes:

- (1) academic and professional qualifications; (2) company shareholding and related corporations; (3) board committees served on; (4) date of first director appointment; (5) date of last re-appointment; (6) directorships or chairmanships in the past (preceding three years) and present in other listed companies; and

²¹⁶ CG Code, Guidance 12.1

²¹⁷ LR 3.21

²¹⁸ LR Appendix 2.2. (9) (i)

²¹⁹ CG Code, Guideline 4.2

²²⁰ Tenure and Termination of Board Appointments, SGP No. 6/2006

²²¹ CG Code, Guideline 4.2

²²² Ibid

²²³ CG Code, Guideline 4.6

(7) other principal commitments.²²⁴

The CG Code recommends that the nominating committee determines annually, or as and when circumstances require, a director's independence.²²⁵ Furthermore, the nominating committee should decide if a director can carry out his/her duties, taking into consideration the number of listed company board representations and other principal commitments.²²⁶

These provisions are broadly the same as Hong Kong's CG Code, except that in Hong Kong there is no recommendation to take into consideration the number of board memberships or other principal commitments. Singapore's recommendation for selection, appointment, and reappointment in the annual report is not included in Hong Kong's CG Code, although it does recommend that a circular be made available to the shareholders and/or an explanatory statement accompanying the notice explaining the reasons in the relevant general meeting.

Remuneration

Remuneration committee:

As with the audit committee in Singapore, the remuneration committee is subject to the CG Code. In Hong Kong remuneration is regulated by the LRs and the CG Code. The establishment of the remuneration committee in Singapore is merely a recommendation rather than a requirement as in Hong Kong. Again, the formal requirement in Hong Kong is stronger.

The recommended remuneration committee responsibilities are to review and make recommendations to the board of directors concerning a general framework of remuneration and specific remuneration packages for the board and key management personnel.²²⁷

A remuneration committee should comprise of at least three directors, the majority being independent, including the chair.²²⁸ The board of directors should disclose in the annual report the remuneration committee members and the remuneration committee's key terms of reference, explaining its role, and delegated authority.²²⁹

If necessary, the remuneration committee should seek expert advice on director remuneration. The existing relationships between the company and its appointed remuneration consultants should not affect the independence and objectivity of the remuneration consultants.²³⁰

Disclosure of remuneration:

Companies should clearly disclosure remuneration policies, level and mix of remuneration, and the procedure for setting remuneration in the annual report.²³¹ A company should report to the shareholders annually on the remuneration of each director and the CEO on a named basis to the nearest thousand dollars and at least the top five key management personnel in aggregate.²³²

²²⁴ CG Code, Guideline 4.7

²²⁵ CG Code, Guideline, 4.3

²²⁶ CG Code, Guideline 4.4

²²⁷ CG Code, Guideline 7.2

²²⁸ CG Code, Guideline 7.1

²²⁹ CG Code, Guideline 7.1

²³⁰ CG Code, Guidelines 7.3

²³¹ CG Code, Principle 9

²³² CG Code, Guidelines 9.1, 9.2, and 9.3

Full disclosure is encouraged for the remuneration of employees who are immediate family members of a director or the CEO and whose remuneration exceeds SG\$50,000 (instead of SG\$150,000 recommended in the 2005 Code) and, for greater transparency, more extensive information on the nexus between performance and remuneration paid to the executive directors and key management personnel.²³³

Hong Kong's CG Code and LRs are not as comprehensive as Singapore's CG Code. In particular the recommendation for disclosing the break-down of remuneration policies and packages is not as stringent as Singapore.

In 2014, 31% of companies disclosed the remuneration of individual directors on a named basis in compliance with Guideline 9.2 of the CG Code. The size of directors' fees and remuneration appears to be positively correlated to the size of the company. A significantly higher percentage of IDs and NEDs in large-cap companies have remuneration in the SG\$100,001 to SG\$250,000 range compared with those in mid- and small-cap companies. This appears to be significantly higher than the remuneration of INEDs in Hong Kong. IDs and NEDs in the financial sector received higher remuneration than those in other sectors. There is a clustering of remuneration at the SG\$100,000-S\$250,000 range for IDs (17.3%) and NEDs (25.0%). In the SG\$250,000 range, 9.1% of IDs were remunerated compared with 5.7% of NEDs.²³⁴

Excessive Executive Pay:

In 2015, the SGX and SID conducted a board of directors survey which revealed that 55% of listed companies do not disclose director remuneration. The ISCA put the figure at a 34% compliance rate in 2016.²³⁵ This is because the disclosure of executive pay is subject to the CG Code's "comply or explain" regime making disclosure optional rather than mandatory. Principle 8 of the CG Code states:

"The level and structure of remuneration should be aligned with the long-term interest and risk policies of the company, and should be appropriate to attract, retain and motivate (1) the directors to provide good stewardship of the company, and (2) key management personnel to successfully manage the company. However, companies should avoid paying more than is necessary for this purpose."

The definition of director remuneration, compensation, or pay is not limited to monetary consideration; it encompasses all benefits that directors receive by virtue of their position. For example, litigation brought against directors for fraudulent or unauthorised use of a company's resources can indirectly reveal private benefits which constitute directors' pay.

For example, the S-chip company China Sky's legal action in October 2016 against a NED for allegedly fraudulent and/or unauthorised use of the group's funds and the fraudulent and/or unauthorised use of the groups assets as collateral for securing loans (the loan amounted to SG\$219.6 million)²³⁶ clearly revealed an excessive director benefit.

Another example involved the liquidation of S-chip Celestial Nutrifoods. In 2009 the liquidator took legal action against two former INEDs for a range of alleged fraudulent and/or unauthorised transactions. Among these transactions was a payment of SG\$5.79 million of company funds for directors' fees, performance bonuses, and expense

²³³ CG Code, Guidelines 9.4 and 9.6

²³⁴ SID and ISCA, op. cit

²³⁵ ISCA, "SID-ISCA Singapore Directorship Report 2016: More boards have Greater Proportion of Independent Directors (IDs) and Increase in Lead IDs," (18 October 2016) *Media Release*

²³⁶ Melissa Tan, "China Sky sues director Zheng Kai Su in High Court," (25 October 2016) *Business Times*

reimbursements at the expense of the company's creditors.²³⁷ The payments were in keeping with the upper range of CEO pay in Singapore and well in excess of average director pay (e.g. in 2015 the average annual pay for NEDs was SG\$60,000).²³⁸ Related-party transactions were also made to the two-former INEDs' personal businesses.²³⁹

In Singapore, the CG Code only recommends that companies consider the use of contractual provisions to allow clawback in exceptional circumstances of misstatement of financial results, or of misconduct that results in financial loss to the listed companies,²⁴⁰ but not in instances of excessive compensation/remuneration.

V.7.4 Internal controls, the audit committee, and risk management

Since 2012 there has been a greater emphasis on risk management, a clearer definition of director's duties, greater transparency, and director independence.²⁴¹ For example, LR 1207(10) requires the board to report, with the concurrence of the audit committee, on the adequacy of the company's internal controls in addressing financial, operational, and compliance risk. The CG Code was revised in 2012 with a new definition of IDs, changed the requirement of IDs in board committees, and board refreshment.

The CG Code states that the board of directors role is to establish a framework of prudent and effective controls which enables risks to be assessed and managed, including safeguarding of shareholders' interests and the company's assets: and it should also determine the nature and extent of significant risks.²⁴² This includes reviewing, at least annually, the adequacy and effectiveness of the company's risk management and internal control systems, including financial, operational, compliance, and information technology controls.²⁴³

The board should comment in the annual report on whether the CEO and Chief Financial Officer have made an assurance that the financial records have been properly maintained, financial statements give a true and fair view of the company's operations and finances, and the effectiveness of risk management and internal control systems.²⁴⁴

A separate board risk committee or alternative means to assess the oversight of the company's risk management framework and policies may be established by the board.²⁴⁵

According to the Singapore Accountancy Commission, based on a sample of 25 Straits Times Index companies' 2012 annual reports, most companies do not disclose their risk appetite.²⁴⁶

The Hong Kong CG Code is similar regarding the responsibility of the board in relation to risk and the need to undertake reviews. However, Hong Kong goes further than Singapore by recommending issuers should disclose, in the Corporate Governance Report, a narrative statement on how the board of directors have complied with the risk

²³⁷ Grace Leong, "Ex-directors of Celestial Nutrifoods being sued," (16 March 2016) *The Strait Times*

²³⁸ Korn Ferry, "Singapore non-executive directors receive fee hike of 7.1% for last financial year," (2015) *Hay Group*. INEDs are usually paid substantially less than non-executive directors

²³⁹ Grace Leong, op. cit

²⁴⁰ CG Code, Guidelines 8.2 and 8.4

²⁴¹ ISCA, "Corporate Governance: What's Changed, What Remains 2013/2014," (2013): Available at <http://iscadirectory.isca.org.sg/media/uploads/pdf/Corporate%20Governance.pdf> (visited 16 November 2017)

²⁴² CG Code, Guideline, 1.1 (b) and Principle 11

²⁴³ CG Code, Guideline 11.2

²⁴⁴ CG Code, Guideline 11.3

²⁴⁵ CG Code, Guideline 11.4

²⁴⁶ Singapore Accountancy Commission, "Risks & Opportunity Practice Guide and Rating Methodology," (2014): Available at http://www.integratedreporting.org/wp-content/uploads/2014/04/SAC-NUS-Research-Summary_Apr29_2014.pdf (visited 21 July 2017)

management and internal control code provisions during the reporting period.²⁴⁷

V.7.5 Shareholder engagement

Disclosure requirements

Beyond the continuous disclosure mechanisms, shareholder communication and engagement is recommended in the CG Code. Guideline 15.1 recommends that companies devise an effective investor relations policy to regularly convey pertinent information to shareholders. When disclosing information, companies should be as descriptive, detailed, and forthcoming as possible, avoiding boilerplate disclosures. The board should establish and maintain regular dialogue with shareholders to gather views and address their concerns.²⁴⁸ The board should state in the annual report steps taken to solicit and understand shareholders' views.²⁴⁹ Shareholders have the right to be sufficiently informed of changes in the company or its business which would likely materially affect the price or value of the company's shares.²⁵⁰ This is broadly similar to the recommendations in Hong Kong's CG Code.

Narrative reporting

Singaporean incorporated company information (including unlisted public companies) is available electronically to the public through the ACRA website. For example, "Corporate Compliance" and "Financial Profile" provides key information about a company's business profile (e.g. principal activities, capital structure, particulars of officers and shareholders). The Mainboard LRs require the annual report to include a chairman's statement which must provide a balanced and readable summary of the issuer's performance and prospects, and should represent the collective view of the board.²⁵¹ An issuer must describe in the annual report its CG practices with specific reference to the principles of the CG Code.²⁵² In Hong Kong the mandatory CG Report contains the company's CG practices. Issuers must release a sustainability report (for the year ending 31 December 2017) which describes sustainability practices with reference to:

- (1) material environmental, social, and governance factors; (2) policies, practices, and performance; (3) targets; (4) sustainability reporting framework; and (5) a board statement.²⁵³

For example, the issuer's responsibility on disclosure should cover stakeholder engagement, risk management, business model, business cycle, strategy, and qualitative perspectives including regulatory.²⁵⁴

In Hong Kong, Environmental, Social, and Governance (ESG) reporting is required on a "comply or explain" basis.²⁵⁵ Hong Kong's ESG recommendations are not as extensive as Singapore. However, Hong Kong does include a "community investment" and consideration aspect which is not part of Singapore's sustainability practices.

²⁴⁷ CG Code, C.2.4, CG Code (Hong Kong)

²⁴⁸ CG Code, Guideline 15.3

²⁴⁹ CG Code, Guideline 15.4

²⁵⁰ CG Code, Guideline 14.1

²⁵¹ LR 708

²⁵² LR 710

²⁵³ LRs 711A and 711B

²⁵⁴ SGX-ST LRs, Practice Note 7.6, Sustainability Reporting Guide

²⁵⁵ See: LR Appendix 27 (HKEx)

V.7.6 Specific transaction contexts

Transactions significant in size

Chapter 10 of the LRs covers “Acquisitions and Realisations” by issuers with Part VII covering “Major Transactions”. LR 1014 defines “Major Transactions”, as transactions that exceed 20% of the figure as computed based on: (1) the net value of assets to be disposed; (2) net profits attributable to assets acquired or disposed compared with group assets; (3) aggregate value of consideration compared with the issuer’s market capitalisation; (4) the number of equity securities issued by the issuer as consideration for an acquisition, compared with the number of equity securities on issue; or (5) the aggregate value or amount of proved or provable reserves to be disposed compared with the group.²⁵⁶

A major transaction must be made conditional on the approval of shareholders in the general meeting.²⁵⁷

The percentage/ratio test is similar to that in Hong Kong.

Related-party transactions

Chapter 9 of the LRs covers “Interested person transactions”. Shareholders’ approval is required when the value of an interested person transaction that is equal or greater than five percent of the group’s latest audited net tangible assets, above SG\$100,000.²⁵⁸ If the value is equal to or above three percent, yet below five percent and is greater than SG\$100,000, the issuer must make an immediate announcement to the market.²⁵⁹ The issuer must disclose the aggregate value of interested party transactions during the financial year in the annual report.²⁶⁰

Where a transaction requires shareholder approval, this must be obtained prior to entering into the transaction.²⁶¹ An issuer may seek a general mandate from shareholders for recurrent interested person transactions. In these circumstances, LR 920 requires, inter alia, disclosure of:

(1) the nature of the transactions; (2) the rationale for, and benefit to, the entity at risk, the methods or procedures for determining transaction prices; and (3) the independent financial adviser’s opinion on whether the transactions will be carried out on normal commercial terms and will not be prejudicial to the interests of the issuer and its minority shareholders.

In Hong Kong LR Chapter 14A specifies that a connected transaction gives rise to enhanced disclosures and, if one of the percentage ratios is five percent or more, then the transaction must be subject to approval of the shareholders (at which the connected party and its associates do not vote). Allowances are also made for aggregated connected transactions.

Director as connected party:

See discussion in “Directors’ interests” above.

²⁵⁶ Referring to LR 1006

²⁵⁷ LR 1014

²⁵⁸ LR 906

²⁵⁹ LR 905

²⁶⁰ LR 907

²⁶¹ LR 918

Transactions involving potential change in control

Chapter 10 "Acquisitions and Realisations" of the LRs involve transactions which may lead to a change in control, in particular Part VIII, which is titled as "Very Substantial Acquisitions and Reverse Takeovers". A transaction exceeding 20 percent of the listed issuer's net assets or net profit before tax requires disclosure and shareholder approval. An acquisition of assets exceeding 100 percent of the listed issuer's net assets or net profit before tax or which would result in a change in control in the listed issuer is also subject to shareholder approval.²⁶²

Chapter 11 "Takeovers" of the LRs specify procedures that must be followed in the event that the issuer is subject to a takeover offer. Where notice is received by the issuer from an offeror of an intention to make a takeover offer, the issuer must request a suspension of trading in its listed securities, and make an immediate announcement to the market.²⁶³ When this is made, upon the announcement by the offeror that the acceptances have been received which bring the holdings owned and parties acting in concert above 90% of the total number of issued shares, the SGX can suspend trading until satisfied that at least 10% of the total shares are held by at least 500 shareholders who are members of the public.²⁶⁴

The Code on Take-overs and Mergers is issued and enforced by the SIC (for details, see Appendix V.4.1) and is primarily concerned with the fair and equal treatment of shareholders. This is similar to Hong Kong's "Code on Takeovers and Mergers and Share Buy-backs" with both codes being non-statutory regulations.

V.7.7 Role of regulators

See, Appendices V.4.1 and V.6.

²⁶² LRs 1006 and 1015

²⁶³ LR 1102

²⁶⁴ LR 1105

Appendix V	8. Regulation of non-local companies	V.8 Singapore
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Introduction

Listed companies in Singapore are subject to the registration and filing requirements of ACRA. The CA applies primarily to Singapore incorporated companies with limited provisions covering non-local or foreign issuers. Foreign company requirements represent an important application of the corporate oversight framework which attempts to equalise CG among all companies, notably expected standards (i.e. directors' duties) and shareholder rights. Like the CA, the SFA applies primarily to Singaporean incorporated companies with some provisions applying to foreign companies.

V.8.1 Legislation

Foreign companies are subject to the CA, specifically Part XI, sections 365 to 386, and the Business Registrations Act. Part XI applies to a foreign company that establishes (or intends to establish) a place of business or carries on business in Singapore.²⁶⁵ Primary matters covered under Part XI are registration and filings with ACRA, director duties, and penalties. Section 4(1) of the CA defines a foreign company as:

“(a) a company, corporation, society, association or other body incorporated outside Singapore; or

(b) an unincorporated society, association or other body which under the law of its place of origin may sue or be sued, or hold property in the name of the secretary or other officer of the body or association duly appointed for that purpose and which does not have its head office or principal place of business in Singapore.”

The application of the CA is quite wide as the definition of a “corporation” includes foreign companies.²⁶⁶ For example, Part IX “Investigations” applies to foreign companies.²⁶⁷ Furthermore, accounting standards made by the ASC under Part III of the Accounting Standards Act 2007 are applicable to foreign companies with respect to their operations in Singapore.²⁶⁸ There are a few notable exceptions, the statutory derivative action under section 216A does not apply to foreign companies.

SGX primary listed foreign companies have to comply with the SFA, notably the “Disclosure of Interests” and extra-territorial provisions regulated by MAS. The SFA has extra-territorial application where a person does an act partly in and partly outside Singapore which, if done wholly in Singapore, would constitute an offence against any provision of the SFA. Accordingly, that person is guilty of an offence as if the act was committed wholly in Singapore.²⁶⁹

V.8.2 Non-statutory regulation

SGX primary listed foreign companies are regulated by the SGX. Primary listed foreign companies have to comply with the LRs and the CG Code. Secondary listings of foreign companies on the SGX have been subject to a more streamlined regulatory framework since 3 November 2014. The SGX will not impose additional regulatory requirements on

²⁶⁵ CA, s 365

²⁶⁶ CA, s 4

²⁶⁷ CA, s 229

²⁶⁸ CA, s 4

²⁶⁹ SFA, s 339

foreign companies which are from a deemed “developed jurisdiction” that have a secondary listing on the SGX Mainboard or Catalist.²⁷⁰

Amendments to the LRs in 2006 required foreign issuers to have two IDs resident in Singapore.²⁷¹ This gives the SGX access to the company’s IDs where there is a need for regulatory enforcement. However, if IDs are not wrongdoers, this is likely to be of little assistance. In Hong Kong, the LRs require each issuer to have two representatives (directors or director and company secretary) to be in Hong Kong and when not in Hong Kong to provide details of alternates to the HKEx.²⁷²

V.8.3 Cross-border considerations

Background

The ability to share non-public information across borders is important for effective regulatory oversight. Following the 2008 global financial crisis there has been increased awareness to regulate local firms which operate globally. Regulatory information that is unavailable across jurisdictions represents fragmented and disjointed regulatory oversight. However, cross-border cooperation does not usually involve joint investigations nor enforcement.

International arrangements

Any cross-border enforcement action is reliant on MoUs and similar agreements between jurisdictions. The overarching MoU is the IOSCO Multilateral MoU (MMoU). More specifically, bilateral MoUs provide protocols for regulatory cooperation and the exchange of information (notably non-public). The MMoU provides for mutual assistance between signatories. Signatories include, inter alia, Singapore, Hong Kong, China, UK, United States, Malaysia, Thailand, and Indonesia. Regulatory authorities are to provide each other with the fullest of assistance permissible to ensure compliance with the respective laws and regulations.²⁷³ This includes enforcing and securing compliance with respective jurisdictions laws and regulations.²⁷⁴ For example, the Securities Commission of Malaysia states that the MMoU creates a valuable cross-border network to combat international financial fraud and market manipulation.²⁷⁵ The OECD has assessed that the Securities Commission of Malaysia, upon receiving a written request from a foreign supervisor (such as MAS) for assistance to investigate into an alleged breach of a legal or regulatory requirement, would offer assistance by carrying out an investigation of the alleged breach, or provide other such assistance as it sees fit.²⁷⁶ However, the SFC noted that the MMoU has regulatory limitations as it does not require regulators to provide information nor require cooperation where misconduct occurs in one jurisdiction that affects another.²⁷⁷ In Hong Kong, the SFC commenced legal action against the auditors of a Mainland issuer (Standard Water), which had made an application for listing on the SEHK, to compel the production of certain accounting records. Standard Water’s auditors refused to provide information requested by SFC without the consent of the relevant

²⁷⁰ SGX, “SGX welcomes secondary listings with streamlined rules,” (30 October 2014) News Release: Available at http://www.infopub.sg.com/FileOpen/20141030_SGX-welcomes_secondary-listings.ashx?App=Announcement&FileID=321046 (visited 24 July 2017)

²⁷¹ LR 221

²⁷² LRs 3.06 and 8.12 (HKEx)

²⁷³ MMoU, [7(a)]

²⁷⁴ MMoU, [6(a)]

²⁷⁵ Securities Commission of Malaysia, “Kuala Lumpur, 12 April 2007,” *Media Release*

²⁷⁶ OECD, “Public Enforcement and Corporate Governance in Asia,” (2014), 49

²⁷⁷ Mark Steward, “Fighting On the Frontline: An Update,” (2 March 2015) *SFC, SFC Executive Director of Enforcement, Speech at 3rd Annual US-China Legal Summit*

Mainland authorities on the grounds of state secrecy under Chinese law. The SFC was successful in Hong Kong's Court of First Instance.²⁷⁸

Regional arrangements

On 3 March 2015 MAS and the SGX jointly signed a MoU with the Securities Commission Malaysia and the Securities and Exchange Commission, Thailand to establish a Streamlined Review Framework for the ASEAN Common Prospectus (the Framework). The Framework, which is an initiative under the ASEAN Capital Market Forum Implementation Plan endorsed by the ASEAN finance ministers, will facilitate cross-border offerings of equity securities and plain debt securities in ASEAN. The three countries will apply the common disclosure standards for the review of prospectuses. There is no information on mutual assistance and co-operation at this stage. However, such a framework could provide the basis for mutual assistance in the future.

Bilateral arrangements

Direct listing framework with China:

In 2013, the SGX and the CSRC set up a direct listing framework allowing Chinese-incorporated companies that have obtained approvals from CSRC and SGX to list directly on SGX. The rationale behind the scheme is for MAS and SGX to have greater regulatory reach with assistance from the CSRC for cross-border enforcement. These companies are required to comply with the laws and regulation in China and Singapore, and are subject to the regulatory processes in both jurisdictions, providing greater assurance for the investors.²⁷⁹ This is similar to the current system in Hong Kong where Mainland incorporated firms are approved by CSRC for listing in Hong Kong.

As the applicants have to comply with laws in China and Singapore. If a listed issuer or director commits fraud in relation to the company's affairs or financial statement in China, the company may breach Singaporean and Chinese laws.²⁸⁰ The breach gives Singapore regulatory power to enforce Singaporean law, and CSRC power under Chinese Law to require the Mainland issuer to produce documentary evidence which will be forwarded to the Singaporean regulator or to co-operate in an investigation.

The framework also requires potential issuers to file applications with the CSRC and the SGX, and financial statements must be audited by certified practicing accountants in accordance with Singaporean auditing standards, International Standards on Auditing, or United States Generally Accepted Auditing Standards.

When seeking a listing, the CSRC reviews the application before granting administrative licensing approval for the issuer's listing on the SGX. The SGX then reviews the application, and if successful, an "eligibility-to-list" will be issued. This formal mechanism provides a much-needed structure for cross-border investigation. Furthermore, with the CSRC and the SGX having a role in vetting listing applications, the listing process is designed to improve the gate-keeping and selection of companies which qualify for the framework. However, to qualify for the framework, like H-share companies (Mainland incorporated companies listed on the SEHK) in Hong Kong, an S-chip has to be incorporated in China. If the S-chip is incorporated outside China (like the red-chips in Hong Kong – red-chips are companies listed on the SEHK and incorporated outside the Mainland which have primary business interests in the Mainland), the CSRC will not have

²⁷⁸ *Securities and Futures Commission v Ernest & Young* [2014] HKCFI 931; [2015] 5 HKLRD 293; [2014] 3 HKC 406; HCMP 1818/2012 (23 May 2014)

²⁷⁹ Cai Haoxiang, "New, direct route for China firms seeking Singapore listing," (26 November 2013) *Business Times*

²⁸⁰ LR 217 only applies to companies with a secondary listing and foreign companies do not have to comply with the LR under certain circumstances

jurisdiction as the company would not be admitted under the framework.

The direct listing framework applies to all subsequent S-chip listings incorporated in China. However, until recently there has been uncertainty as to whether the dual regulatory requirements applied to S-chips listed prior to the framework's establishment.

Recent action (March 2017) taken by the SGX to notify Chinese authorities—concerning the Executive Chairman and CEO of China Fibretech Ltd of potential breaches of Chinese law—suggests that the framework does in fact extend to S-chips listed prior to 2013.²⁸¹ (Fibretech's SGX IPO was held on 30 June 2008). The approach taken is similar to that adopted by CAD against China Sky, which was incorporated in the Cayman Islands. Assistance from Chinese authorities and regulators forced China Sky to agree to a civil settlement. The exact nature of assistance rendered by Chinese authorities/regulators is unclear. However, assistance would appear to be one of moral suasion at the request of the Singaporean authorities/regulators.

Memorandum of Understanding with the Securities and Futures Commission:

An MoU was signed by the SFC and MAS in 1997 to strengthen protection of investors and to promote the integrity of the securities and futures markets. The MoU provides for exchange of information, including market manipulation, insider dealing, enforcement of laws and regulatory requirements in securities and futures contracts, and promoting and securing the fitness and properness of persons authorised.

In the early 1990s, there was an investigation into possible contraventions of the Securities (Insider Dealing) Ordinance and Securities (Disclosure of Interests) Ordinance in relation to the Trading of Shares in Crownhampton International Limited Hong Kong. The SFC sought assistance from MAS in February 1994. Despite the absence at the time of a MoU on regulatory cooperation between the two regulators, MAS offered full information and assistance but could only do so to the extent permitted by Singaporean law. The investigation was limited because of the brokers' client confidentiality obligations. Available assistance was insufficient to enable the SFC to pursue the investigation. MAS had no power to compel the clients concerned to give written consent to their brokers to make a disclosure to the SFC. The SFC strengthened its cooperation with the MAS with the signing of the MoU. However, the MoU does not impose any legally binding obligations to modify or supersede any laws, regulatory requirements, rules, or by-laws by the relevant exchange, nor modify the common law for parties contracted to a securities or futures transaction.²⁸²

Memorandum of Understanding with the Securities Exchange Commission:

A MoU between the Securities Exchange Commission (United States) (SEC) and MAS allows for cooperation with foreign securities and futures authorities by conducting investigations on behalf of listed entities. The MoU is broad in scope, providing for the "fullest mutual assistance" permitted by law. Mutual assistance is contemplated through the provision of information currently held by an authority, taking statements, and obtaining further information and documents. The MOU states that information provided pursuant to the agreement may be used in civil and administrative enforcement matters, as well as for investigation and prosecution of criminal matters. There is also an allowance for unsolicited assistance. Similar to the MoU between MAS and the SFC, the MoU between MAS and the SEC does not take precedence over the laws, regulations, and rules of either jurisdiction.

²⁸¹ David Gerald, "Press Statement on SGX Complaint Against Wu Xinhua, China Fibretech Ltd," (30 March 2017) *SIAS*: Available at https://sias.org.sg/index.php?option=com_content&view=article&id=760%3Apress-statement-on-sgx--complaint-against-wu-xinhua-china-fibretech-ltd&catid=20%3Apress-releases&Itemid=43&lang=en (visited 4 September 2017)

²⁸² At [2]

International accounting and auditing standards:

ACRA is a founding member and active participant of the International Forum of Independent Audit Regulators (IFIAR). The IFIAR core purpose is to share knowledge of the audit market environment and practical experience, promoting collaboration and consistency in regulatory activity, and providing a platform for dialogue with other organisations. In addition, ACRA has confirmed a co-operative arrangement with the Public Company Accounting Oversight Board in the United States (2008) for the oversight of audit firms.

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