

Hong Kong, China

Corporate Governance Institutions, Practices and Developments

1. Key Institutional Features of Corporate Governance and Company Profile in Hong Kong, China

1.1 Background

The main laws, rules and regulations concerning corporate governance-related matters are:

The Companies Ordinance (Cap. 32) (CO)—The CO is one of the main legislations that contain provisions relating to corporate governance. It provides the legal framework which enables the business community to form and operate companies. It also sets out the parameters within which companies must operate, so as to safeguard the interests of those parties who have dealings with them, such as shareholders and creditors. The CO governs, inter alia, the incorporation of companies; management and administration of companies, disclosure by companies of their operations and financial condition; dealing by directors; shareholder remedies and winding up of companies.

A significant proportion of companies listed in Hong Kong, China (HKC) are incorporated outside Hong Kong, in places like Bermuda, the Cayman Islands and the People's Republic of China. These companies are not subject to the CO, but must comply with the relevant company law of their economy of incorporation;⁷⁹

The Securities and Futures Ordinance (Cap. 571) (SFO)—The SFO provides the regulatory and legal framework for the regulation of securities and futures market in Hong Kong. It provides, amongst others, the legal requirements relating to disclosure of interest in listed corporations' securities and offers of securities to the public;

The Rules governing the listing of securities on The Stock Exchange of Hong Kong Limited (Listing Rules) and the Rules governing the listing of securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited (GEM Rules)—All listed companies are required to comply with the Listing Rules or the GEM Rules. The Listing Rules and GEM Rules are the principal source of regulation relating to corporate governance of listed companies, irrespective of their place of incorporation; and

⁷⁹ The Bermudan and the Cayman Islands company laws are based on the English common law. As such their company laws should provide similar levels of protection as that afforded under the Hong Kong Companies Ordinance. Companies incorporated in the People's Republic of China must comply with certain additional requirements under the Listing Rules. Companies incorporated in other jurisdictions have to demonstrate to the Stock Exchange of Hong Kong Limited that they are subject to appropriate standards of shareholder protection which are at least equivalent to those required under Hong Kong law.

The Codes on Takeovers and Mergers and Share Repurchases (the Takeovers Code)—The Takeovers Code applies to takeovers, mergers and share repurchases affecting public companies in Hong Kong, China and companies with a primary listing of their equity securities in Hong Kong, China.

The Listing Rules

The corporate governance requirements in the Listing Rules and GEM Rules are divided into:

- Listing Rules and GEM Rules that listed entities (issuers) must comply with; and
- The Code of Corporate Governance Practices (CG Code), divided into:
 - Principles;
 - Code Provisions (CPs) that issuers are expected to comply with but may choose to deviate from; and
 - Recommended Best Practices (RBPs) that are for guidance only;
 - An issuer must state whether it has complied with the CPs in the CG Code for the relevant accounting period in its interim report and annual report. Where an issuer has deviated from the CPs set out in the CG Code, it must give considered reasons. For annual reports, these reasons must be set out in the form of a Corporate Governance Report that is in accordance with Appendix 23 of the Listing Rules.

1.2 Trends

The tables below show the number of companies that are listed on The Stock Exchange of Hong Kong Limited (Exchange) and the total market capitalization as at the end of each year from 2005 to 2009.

Number of Hong Kong listed companies 2005-2009

	Dec 2005	Dec 2006	Dec 2007	Dec 2008	Dec 2009
No. of Main Board listed companies	934	975	1,048	1,087	1,145
No. of GEM listed companies	201	198	193	174	174
Total no. of listed companies	1,135	1,173	1,241	1,261	1,319

Total Market Capitalisation of Hong Kong issuers 2005-2009

	Dec 2005	Dec 2006	Dec 2007	Dec 2008	Dec 2009
Market Capitalisation for Main Board (HK\$ billion)	8,113	13,249	20,536	10,254	17,769
Market Capitalisation for GEM (HK\$ billion)	67	89	161	45	105
Total Market Capitalisation (HK\$ billion)	8,180	13,338	20,697	10,229	17,874

2. Development, Enforcement and Assessment of Implementation of Corporate Governance Rules

2.1 Development of Corporate Governance Rules

Relevant Regulatory Bodies

The principal regulator of Hong Kong, China's securities and futures markets is the Securities and Futures Commission (SFC). The SFC is responsible for administering the SFO, the ordinance governing the securities and futures markets in HKC and other statutory ordinances. Two of the regulatory objectives of the SFC are to:

- Maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry; and
- Provide protection for members of the public investing in or holding financial products.

Hong Kong Exchanges and Clearing Limited (HKEx) is regulated by the SFC. The Stock Exchange of Hong Kong (SEHK) is a wholly-owned subsidiary of HKEx. The SEHK is the frontline regulator of all listing related matters including corporate governance for issuers.

The SFC has a statutory duty to supervise, monitor and regulate the SEHK's performance of its listing-related functions and responsibilities. The staff of the SEHK and the SFC meet regularly to discuss listing-related matters. The SFC also conducts a periodic audit of the SEHK's performance in its regulation of listing-related matters.

The SEHK's Listing Committee is an independent body which administers the Listing Rules on matters that are of material significance for issuers, their directors and authorised representatives. Day-to-day administration of the Listing Rules is delegated to the SEHK's Listing Division. The work of the Listing Division is subject to review by the Listing Committee with the reservation of specific matters to the Listing Committee by the Listing Rules.

The Listing Division, guided by the Listing Committee, will review and from time to time propose amendments to the Exchange Listing Rules. The Listing Division will seek the SFC's policy advice and comments on any proposals for potential amendments to the Exchange Listing Rules.

The Listing Division will seek the endorsement of the Exchange Board for any final proposals as decided by the Listing Committee and submit them to the SFC for approval. Section 24 of the SFO requires the Exchange Listing Rules to be approved by the SFC.

Standing Committee on Company Law Reform (SCCLR)

The SCCLR is a non-statutory advisory body formed in 1984 to review the CO on a regular basis to ensure that the company law meets with the changing needs of the local business environment. The Companies Registry provides secretarial support to the SCCLR. The SCCLR is one of the main proponents of reforms for modernizing the company law and upgrading its corporate governance regime.

As the Registrar of Companies is the administrator of, inter alia, the CO, the Companies Registry collaborates, from time to time, with the Financial Services and the Treasury Bureau of the government of the Hong Kong Special Administrative Region in implementing the SCCLR's recommendations by means of amendment bills. With a view to updating and

modernizing the CO, the government launched a comprehensive rewrite of the CO in mid-2006. The rewrite also covers amendments to the corporate governance rules.

2.2 Enforcement of Corporate Governance Rules

The SEHK works to both enforce the Listing Rules and promote compliance.

Potential rule breaches are uncovered through a range of activities, including primarily the Listing Division's surveillance activities and research and data analysis, and also from many sources including tip-offs and complaints received from the public and media commentary. Each year the SEHK makes enquiries and investigates several hundred potential rule breaches. Depending on the type of conduct involved the SEHK is able to deploy a variety of graduated responses for non-compliance.

Disciplinary sanctions are one of the regulatory responses available to the SEHK but they are not the only response available and it may be possible to address instances of non-compliance without resorting to disciplinary action. The SEHK also sends warning letters, caution letters and guidance letters where appropriate to deal with behaviour which is not sufficiently egregious to justify disciplinary action. Directions (hence not just sanctions) are also imposed in appropriate cases by the Listing Committee to improve or enhance future compliance with the Listing Rules, e.g. compliance review of the issuers' internal control systems; appointment of a compliance adviser for consultation on Listing Rules compliance; and training for directors who are made parties to the disciplinary action (see 3.1 below).

Other non-disciplinary measures available where the SEHK considers it necessary to take protective or remedial action include suspension or, in exceptional circumstances, delisting.

The SEHK may suspend trading in an issuer's securities where there is inadequate disclosure or an issuer fails to comply with the continuing obligations of listing in a manner severe enough to justify suspension.

Regulatory Enforcement Actions

The table below shows the disciplinary cases in 2008 and 2009. These cases involved investigations of both the company and its directors.

Nature of alleged breach of the Listing Rules	2008 Cases	2009 Cases
Misstatement or misleading information in prospectus or announcement	2	2
Failure to publish annual accounts and interim accounts within prescribed deadlines	3	0
Failure to disclose price sensitive information, significant advances to entities or discloseable transactions	4	4
Failure to obtain shareholder approval for connected or other transactions	7	3
Failure to respond to enquiries	1	0
TOTAL:	17	9

The outcome for the vast majority of these 26 cases was a public sanction by the Listing Committee. A private sanction was given for one of these cases. When a public sanction is imposed, the Listing Committee may also impose a public sanction on the directors (Executive and Non-Executive) whom it found to be in breach of their Directors' Undertakings to procure the companies' compliance.

One of the objectives behind enforcement action is to improve corporate governance. The Main Board (MB) Listing Rules enforced by disciplinary action address strong corporate governance

concerns. This is particularly so for actions brought because of failure to obtain prior independent shareholder approval.

De-listed Companies

MB Listing Rule 13.24 requires an issuer to carry out a sufficient level of operations or have tangible assets of sufficient value or intangible assets for which sufficient value can be demonstrated to warrant the continued listing of the issuer's securities on the Exchange. If an issuer cannot meet these requirements, MB Listing Rule Practice Note 17 sets out the delisting procedures that the SEHK will follow to de-list the issuer.

The issuers that are required to follow these delisting procedures are often those that have suffered corporate governance failings. The table below shows the number of these de-listings in the last two years.

Year	De-listings under Practice Note 17
2008	7 [Main Board issuers: 4; and GEM issuers 3]
2009	1 [Main Board issuers: 1; GEM issuers: 0]
TOTAL	8 [Main Board issuers: 5; GEM issuers: 3]

2.3 Assessment of Corporate Governance Practices

Report on the Observance of Standards and Codes

In 2002, HKC participated in the Financial Stability Assessment Programme (FSAP). As part of the FSAP assessment, HKC was also assessed on its observance of the OECD Principles of Corporate Governance. The table below shows the results of the assessment.

Observed	Largely observed	Partially observed	Materially observed	Not observed	Not applicable
4	13	4	2	0	0

Review of compliance with the CG Code

Since the SEHK introduced the CG Code in 2004 (the Code became effective in 2005), it has reviewed issuers' compliance with the Code and published the results of its review.

On 20 February 2009 the SEHK published its report on the findings from its third review of issuers' corporate governance practices on the HKEx website.

The review found that:

- All 1,213 issuers met the requirement to comply or explain, i.e. all issuers either said in their annual reports that they had complied with the 45 code provisions or explained their deviation from one or more code provisions;
- About 98% of the issuers (up from 96% in the second review) complied with at least 41 of the 45 code provisions;
- Same as the second review, larger issuers complied with more code provisions than smaller issuers (based on market capitalisation); and
- The recommended best practices on quarterly reporting continued to have the lowest compliance rate.

3. Awareness and Advocacy for Good Corporate Governance

3.1 Company Directors

The Hong Kong Institute of Directors (HKIoD) was incorporated in 1996. It is a non-statutory body representing professional directors working together to promote corporate governance and to contribute towards advancing the status of Hong Kong, China, both in China and internationally.

HKIoD currently has over 1,400 members, consisting of directors from listed, public and private companies and statutory/non-profit-distributing organisations. The profile of its membership can be found at <http://www.hkiod.com/profile.html>.

CG Code Provision A.5.1 states that every newly appointed director should receive a comprehensive, formal and tailored induction and subsequently such briefing and professional development as necessary. This is to ensure that the director is fully aware of his responsibilities under statute and common law, the Exchange Listing Rules, applicable legal requirements and other regulatory requirements and the business and governance policies of the issuer.

Listed issuers are given the following guidance as to recommended best practice:

Recommended Best Practice A.5.5—All directors should participate in a programme of continuous professional development to develop and refresh their knowledge and skills to help ensure that their contribution to the board remains informed and relevant. The issuer should be responsible for arranging and funding a suitable development programme.

Remedial training

As part of a disciplinary action taken by the SEHK, a director may be required to take remedial training. For previous disciplinary cases, this has meant training on Listing Rule compliance and directors' duties to be given by the Hong Kong Institute of Directors, Hong Kong Institute of Chartered Secretaries or any other recognised professional organisation satisfactory to the Listing Committee and/or the Listing Division within a specified time period.

Educational System

Higher education institutions in HKC enjoy a high degree of autonomy in managing their internal affairs including academic development. That said, electives related to corporate governance are common in our institutions, notably MBA programmes.

Hong Kong, China's judges and judicial officers do receive training in corporate governance. The Judicial Studies Board, set up under the chairmanship of a Vice President of the Court of Appeal of the High Court, is responsible for arranging such training.

Stock Exchange

The SEHK will offer training on changes to the Listing rules to issuers but it is not compulsory for directors to attend. In 2009, the Exchange organised two series of seminars (14 sessions) on listing rule amendments and notifiable transactions, which attracted an overall attendance of 3,000 participants.

HKEx does not support, endorse or accredit anybody that provides directors' training. However, in the past, the SEHK has required directors to attend remedial training if they have found to have breached the Listing Rules.

In 2009 and up to mid-May 2010, the Listing Division ran an outreach programme with issuers and market practitioners to learn their needs and to facilitate mutual understanding of regulatory issues through continuing dialogue.

4. Recent Developments in Corporate Governance

4.1 Corporate Governance Developments

Listed Companies

Amendment to the Law

The government supports the cultivation of a continuous disclosure culture among listed corporations. A way to achieve this is to oblige timely disclosure of price sensitive information (PSI) under the statute.

The government commenced on 29 March 2010 a three-month consultation on the proposed statutory codification of certain requirements to disclose PSI by listed corporations. The proposed statutory regime will specify the requirements clearly in the law, with safe harbours, to facilitate compliance; enhance the effectiveness of investigation and enforcement; and ensure that all suspected breaches would be dealt with independently via statutory proceedings.

Through continuous improvement of the regulatory regime in respect of listing, the government is enhancing market transparency and quality, and promoting good corporate governance in HKC.

Changes to the Listing Rules

Over the last three years the Exchange Listing Rules, including the CG Code have been amended. Changes include:

- Shortening the publication deadlines for annual and half-year results announcements, effective for accounting periods ending 30 June 2010;
- Making voting by poll mandatory on all resolutions at general meetings of issuers. In addition, CG Code Provision E.1.3 was introduced that requires an issuer to send a notice to shareholders for an annual general meeting at least 20 clear business days before the meeting and at least 10 clear business days for all other general meetings;
- Requiring updates of previously disclosed directors' information by way of announcements; and
- Extending the "black-out" periods set out in the Model Code.

Corporate Governance Review

The Listing Committee has formed a sub-Committee to review the CG Code. The objective is to make possible enhancements to the CG Code benchmarked against international standards.

Consultation on Connected Transaction Rules

On 2 October 2009, the SEHK published a consultation paper on proposed changes to its connected transaction rules. In SEHK's conclusions, it addressed issues about some specific connected transaction requirements that are burdensome, restrictive or have unintended effects. The Rule amendments became effective from 3 June 2010.

Unlisted Companies

In the course of the rewrite of the CO, the SCCLR has further explored a number of corporate governance issues. The key proposals of the SCCLR include:

- (a) codifying the standard of directors' duty of care, skill and diligence with a view to clarifying the duty under the law and providing guidance to directors;
- (b) restricting the appointment of corporate directors by requiring every private company to have at least one natural person as director so as to enhance transparency and accountability;
- (c) strengthening rules on fair dealings by directors and disclosure of material interests in transactions;
- (d) providing greater transparency and improving disclosure of company information, such as new requirements for a business review;
- (e) strengthening auditors' rights, such as providing auditors with a right to require information from a wider group of persons;
- (f) enhancing shareholders' engagement in the decision-making process, such as reducing the threshold requirement for shareholders to demand a poll from 10% to 5% of the total voting rights; and
- (g) fostering shareholder protection, such as introducing more effective rules to deal with directors' conflicts of interests and enabling shareholders of a company to commence a statutory derivative action on behalf of a related company.

The proposals will ensure greater transparency and accountability within the company's operations and greater opportunity for all shareholders to engage in company business in an informed way.

4.2 Enforcement of Corporate Governance Rules

Shareholder remedies provisions were substantially revised by the Companies (Amendment) Ordinance 2004 with a view to enhancing legal remedies available to members of a company. One of the amendments that relates to the enforcement of corporate governance rules is the provision for a statutory derivative action (SDA) that may be taken on behalf of a company by a member of the company. Unlike some comparable jurisdictions, only members of the company (*vis-à-vis* members of a related company of the company) have standing under the CO to seek leave to commence a SDA. In other words, only "simple" derivative actions, as opposed to "multiple" derivative actions, can be brought under the SDA provisions.

However, in a recent case, *Waddington Ltd v Chan Chun Hoo and Others* (2008) 11 HKCFAR 370, the Court of Final Appeal (CFA) ruled that an action by a shareholder of a parent company on behalf of a subsidiary or second or lower tier subsidiary is maintainable under the common law.

The concerns of the CFA were discussed in the context of shareholders in a holding company taking action on behalf of a subsidiary or sub-subsidiary. However, the Administration is of the view that there is a strong argument for extending the CFA's reasoning to justify giving standing to members of related companies, since this situation concerns a wrongdoer controlling the corporate group to the detriment of a shareholder in the group.

The proposals on enabling multiple statutory derivative actions has been incorporated into a Companies (Amendment) Bill introduced into the LegCo in early 2010. The Bill was passed by the LegCo on 7 July 2010.

In addition to the company law, the securities regulations (the Securities and Futures Ordinance) have provisions for the securities regulator (the Securities and Futures Commission (SFC)) to take action against listed companies and their directors in cases where there has been oppression against the minority shareholders, fraud, misfeasance, defalcation and other misconduct perpetrated against minority shareholders. The SFC in recent years has taken a more robust enforcement approach leading to more prosecutions for corporate governance failures.

Prosecutions for CG	2004	2005	2006	2007	2008	2009
No. of successful legal actions in court*	1	1	3	0	1	7

*Some of these cases took years to conclude particularly when there were numerous parties involved. The case is only determined to be completed on the date it is resolved against all parties.

For instance, the SFC successfully applied to the court to freeze the assets of a newly listed company when it transpired that the company may have made false or misleading statements in its prospectus thus inducing investors to subscribe for its shares.

The SFC also obtained a court order directing a company to take legal action against its directors for breaches of their fiduciary duties. In another couple of cases, the SFC obtained court orders to disqualify a number of directors of two companies for providing misleading information in their companies' documents.

Recent Disciplinary Cases involving breach of Main Board Listing Rules

Three significant cases⁸⁰ involving a breach of Main Board Listing Rules regarding connected transactions or an advance to an entity resulted in a public sanction in 2009. The Listing Rules breached for these cases were: MB Listing Rules 13.13, 13.20, 14.34, 14.37, 14.38, 14A.45, 14A.47, 14A.52.

4.3 Current Issues and Challenges for Corporate Governance

4.3.1 Challenges

A few challenges are:

- Directors often do not see the benefits (e.g., higher share valuations and easier access to capital markets) out of improving their behavior. Education is needed.
- Even if they realize the benefits out of improving their behavior, they often focus on short term and not long term results. The rewards of good corporate governance are often long term.

There is always a group of constituents (e.g., start-ups, companies in financial difficulties) that do not have the resources to bring about better corporate governance.

⁸⁰ These include: (i) Pearl Oriental Innovation Limited (23/03/2009): <http://www.hkexnews.hk/reports/enforcement/090323.htm>; (ii) China Solar Energy Holdings Limited (9/07/2009): <http://www.hkexnews.hk/reports/enforcement/090709.htm>, and (iii) Travelsky Technology Limited (28/09/2009): <http://www.hkexnews.hk/reports/enforcement/090928.htm>

4.3.2 Priorities for Reform

As the CO is undergoing a comprehensive review and public consultation on the rewrite, one of the top priorities for corporate governance reform is the introduction of a strengthened legal and regulatory framework taking into account the public's views expressed in the consultation. An effective implementation of the corporate governance provisions is also a main concern. Therefore, education of the public including the companies, directors, shareholders and creditors about the corporate governance reforms under the rewrite is one of the top ranking priorities.

In addition, as stated under 6.1 above, the Listing Committee has recently formed a sub-committee to review the CG Code and corporate governance issues that have arisen in the course of the Listing Committee's administration of the Listing Rules in recent years.

4.3.3 Financial Crisis

A summary of HKC's responses in financial services to the Global Financial Crisis is given below.

Banking Sector

The Hong Kong Monetary Authority (HKMA) has implemented a number of measures to help maintain the stability and confidence in the monetary and banking sectors, and facilitate banks to better perform their function of financial intermediation. For example,

HKMA introduced five temporary measures to provide liquidity assistance to licensed banks in Hong Kong. The measures involve expansion of the scope of eligible collateral for access to, and the duration of, liquidity assistance through the Discount Window, and conduct of foreign exchange swaps and term repos by HKMA. These measures were in place until the end of March 2009. Following a review, two of the measures, foreign exchange swaps and term repos, have been incorporated into the ongoing market operations while others were terminated on 31 March 2009 as planned.

On 9 October 2008, HKMA adjusted the formula in determining the Base Rate to further ease tensions in the money market. Prior to the adjustment, the Base Rate was set at the higher rate of: (a) 150 basis points above the prevailing US Fed Funds Target Rate (FFTR); or (b) the average of the five-day moving averages of the overnight and one-month HIBORs. After the adjustment, the HIBOR leg was removed and the spread of the Base Rate over the FFTR was reduced to 50 basis points. These changes effectively lowered the cost of discount window borrowing. At end March 2009, the HKMA, after a review, decided to maintain the smaller spread of 50 basis points, but restated the HIBOR leg so as to allow the functioning of the interest adjustment mechanism under the Currency Board system.

On 14 October 2008, the Financial Secretary announced two pre-emptive measures, namely, the use of Exchange Fund to provide full guarantee for deposits held with all authorized institutions in Hong Kong in accordance with the principles of the Deposit Protection Scheme, and the establishment of a Contingent Bank Capital Facility for the purpose of making available additional capital to locally incorporated licensed banks. These measures will be in force till end 2010. The HKMA, Bank Negara Malaysia and the Monetary Authority of Singapore formed a tripartite working group in July 2009 with a view to mapping out a coordinated strategy for the scheduled exit from the full deposit guarantee by the end of 2010 in their respective jurisdictions.

On 29 October 2008, HKMA issued a circular urging banks to be more accommodating in lending to SMEs within the bounds of prudent credit assessment.

On 19 November 2008, HKMA issued a circular on “Hong Kong Approach to Corporate Difficulties” to remind banks that when dealing with corporate borrowers in financial difficulties, banks should remain supportive and not hastily put them into receivership or issue writs demanding repayment if they have a reasonable chance of survival.

On 21 November 2008, HKMA announced a temporary measure about a flexible approach towards the premium on capital adequacy ratio of individual banks and introduced a new arrangement for the provision of liquidity to Hong Kong, China banks operating on the Mainland. Local authorised institutions (AIs) remained well capitalised without the need for HKMA to lower their minimum capital adequacy ratio requirements. In order to promote financial stability and support renminbi-denominated trade transactions between Hong Kong and the Mainland, the HKMA and the People’s Bank of China established a RMB-HK\$ currency swap agreement in January 2009. With the establishment of this currency swap arrangement, short-term liquidity support (up to RMB200 billion or HK\$227 billion) can be provided to the Mainland operations of Hong Kong banks and the Hong Kong operations of Mainland banks in case of need.

On 26 March 2009, the HKMA announced the strengthening of the lender of last resort (LOLR) framework by expanding the types of assets and facilities eligible for obtaining LOLR support. Specifically, foreign exchange swaps have been included among the basic instruments to be used by the HKMA to provide LOLR support, and the definition of eligible securities for repos has been expanded to include securities in foreign currencies with acceptable ratings.

After consulting the industry in late 2009, the HKMA is in the process of implementing in Hong Kong the enhancements to the Basel II capital framework issued by the BCBS in July 2009. Implementation of enhancements on capital and disclosure requirements (i.e., Pillars 1 and 3) will be effected through legislative process which is currently underway, and those on supervisory review process to strengthen risk management standards (i.e., Pillar 2) through an updated supervisory guideline issued on 4 June 2010.

The HKMA will shortly issue for industry consultation a draft guideline to implement the systems and controls standards set out in the latest BCBS Liquidity Sound Principles. The guideline takes account of results of a self-assessment by AIs to evaluate their compliance with the Sound Principles and the responses of banks selected subsequently for an information consultation on the draft guideline.

As a member of the Basel Committee, the HKMA has contributed to, and relayed local issues and concerns during, the development of the consultative proposals on new capital and liquidity standards released by the BCBS on 17 December 2009 to strengthen the resilience of the banking sector. Public consultation on the proposals ended on 16 April. The HKMA has provided further comments arising from its discussions with the banking sector and various stakeholders to the Committee. Meanwhile, the HKMA is participating in a comprehensive quantitative impact study (QIS) launched by the BCBS as an important part of the latter’s process for calibrating the standards. With a view to better understanding the likely impact of the standards on the local banking sector, and formulating an appropriate plan for implementing these standards in Hong Kong, the HKMA is also conducting its own QIS on a broader range of AIs.

The HKMA, as a member of the BCBS and its various sub-groups, has been actively participating in the BCBS’s development of proposals for further enhancing the capital and liquidity regimes and the resilience of the banking sector.

In the course of 2009 and 2010 so far, the HKMA has also issued new guidelines on “Counterparty Credit Risk Management” and “Internal Audit Function”. Guidelines under development/revision to reflect latest international standards and best practices include market risk management (new), valuation practices (new), general risk management controls (revised), strategic risk management (revised), and reputation risk management (revised).

Securities Sector

The Securities and Futures Commission (SFC) has taken a number of measures to ensure the financial and operational integrity of licensed corporations, including stepping up market surveillance and more stress testing of the liquid capital level to assess their sensitivity to extreme market conditions. The Hong Kong Securities Clearing Company Limited also doubled the default fee for failed settlement of short selling transactions.

SFC has been closely monitoring short selling activities in the Hong Kong, China market, and has made the preparatory work to facilitate the introduction of market-wide control measures during contingencies or when there is evidence of abusive short selling activities. While the short selling regulations in Hong Kong, China are stricter than those in place in many of the overseas markets, SFC is working towards increasing short position transparency. Following market consultation, SFC intends to introduce a short position reporting regime, whereby short sellers will have to furnish weekly reports to the Securities and Futures Commission if their short position in shares reaches 0.02% of the issued share capital of that particular listed company or the value of the short position reach HK\$30 million, whichever is lower. SFC prepares to conduct a follow-up consultation on the proposed legislative amendments required to implement the reporting mechanism.

Pursuant to EU’s Regulation on Credit Rating Agencies, if credit ratings made by CRAs based in Hong Kong (currently Fitch, Moody’s and Standard & Poor’s) are to continue to be serviceable in the EU, it will be necessary for Hong Kong, China to develop a compatible regulatory regime and have it operational by 7 June 2011. Working with SFC the aim is to introduce the legislative amendments within the latter half of 2010 so that the new legislative framework can be in place before end January 2011.

Insurance

It was reported in the press that the American International Group, Inc. (AIG) had been badly hit by more than US\$25 billion in write-downs on credit default swaps (CDS) it wrote to guarantee mortgage-linked securities against default. AIG’s shares have tumbled sharply since end 2007.

A revolving loan facility of up to US\$85 billion provided by the Federal Reserve Board (Fed) in September 2008 has relieved the short-term funding pressure faced by AIG and is seen as a gesture of support by the US government to its restructuring exercise. The Fed and the US Treasury announced in November 2008 a revised financial assistance programme for AIG replacing the previous package with a larger and longer term US\$152 billion program, including a US\$60 billion 5-year loan and US\$52.5 billion to buy up distressed securities.

AIG has two composite insurance subsidiaries and four wholly owned general insurance subsidiaries in Hong Kong, China.⁸¹ In response to the crisis of AIG, Insurance Authority (IA)

⁸¹ The six subsidiaries include (i) American International Assurance Company (Bermuda) Limited, (ii) American International Assurance Company Limited, (iii) American Home Assurance Company, (iv) National Union Fire Insurance Company of Pittsburgh, Pa, (v) New Hampshire Insurance Company and (vi) AIG United Guaranty Insurance (Asia) Limited.

exercised statutory power to safeguard the interests of policyholders by requiring insurance subsidiaries of AIG operating in Hong Kong, China to seek prior approval on all transactions involving movement of assets or funds to related entities within the same group. In addition, IA had stepped up monitoring the financial and solvency position of all other authorized insurers in Hong Kong, China.

The IA sanctioned a corporate restructuring that grouped American International Assurance Company (Bermuda) Limited into a subsidiary of AIA(HK) with effect from 28 February 2009, which aimed to position AIA(HK) as an independent entity for public listing.

On 1 March 2010, AIG announced an agreement for the sale of the AIA Group Limited which holds AIA to Prudential plc for US\$35.5 billion. On 2 June 2010, AIG and Prudential plc separately announced that the aforesaid agreement has been terminated. The IA is closely monitoring the possible strategic options available to AIG for the disposal of AIA Group to repay its outstanding debt due under the Fed's credit facility.

In parallel, Hong Kong, China is preparing proposals for the proposed establishment of a Policyholders' Protection Fund in Hong Kong, China to improve market stability and to safeguard the interest of policyholders in the event of insolvency of an insurer. The plan is to consult Legislative Council Panel on Financial Affairs on the detailed proposals in Q4 2010.

Mandatory Provident Fund (MPF)

Exposure of MPF assets to products that might be affected in the recent financial turmoil was insignificant as compared with the total net asset value of the whole MPF System. In the event that an MPF approved trustee experiences financial difficulties or even closes down, the MPF scheme assets will be protected by the multilayered safety net of the MPF scheme. First, MPF scheme assets are segregated from the assets of the employers, trustees and other service providers. Furthermore, in addition to capital adequacy requirements, the MPF legislation requires the trustees to obtain indemnity insurance as a safety net for the MPF schemes. The insurance is used for compensating losses to scheme assets attributable to fraudulent or illegal acts committed by the trustees, service providers and others. Finally, the Mandatory Provident Fund Schemes Authority (MPFA) can apply to the court for the use of the Compensation Fund as a last resort to compensate scheme members.

In the unlikely event that an approved trustee is placed into liquidation, the MPFA would revoke the approval of the trustee and appoint another entity to replace the trustee concerned in order to maintain the normal operation of the MPF schemes as much as possible.

MPFA stepped up the supervision of MPF trustees by requiring them to increase reporting on operational matters and financial positions. The MPFA also requested the trustees to provide their contingency plans in case the business viability of their own or their related entities is in doubt.

MPFA is satisfied that the businesses of all MPF trustees are viable and their operations have not been affected to any material extent.

The MPF legislation set out stringent requirements on the permissibility of investments into which the MPF constituent funds may invest in order to reduce risk as far as possible for the protection of MPF scheme members' interests. The MPF legislation imposes an investment spread requirement to reduce risk and restricts MPF funds from carrying out relatively high-risk activities such as those relating to borrowing and leveraging. The MPFA ensures compliance with the investment regulations by the approved trustees of MPF schemes through

different means, including examining the statutory returns and reports, conducting on-site inspections and investigating into complaints received, etc. The investment of all the constituent funds is managed by investment managers who are authorized by SFC.

The MPFA will continue to monitor the investment compliance of MPF investment funds.

Key Corporate Governance Rules and Practices in Hong Kong, China

Rules Regarding Listed Companies

Element	Yes	No	Source(s) of Rule	Comments
RIGHTS OF SHAREHOLDERS				
1. Do shareholders add items to the agenda for shareholders' meetings?	X		Schedule 1 to the Companies Ordinance (CO)(Cap.32)	Shareholders' rights to propose a resolution for shareholders' meeting are governed by issuers' articles of association. Schedule 1 to the CO sets out the model articles of association that companies can adopt.
			Rules of the Listing of Securities on the Stock Exchange of Hong Kong Ltd (MBLR) 13.70 Rules of the Listing of Securities on the Growth Enterprise Market (GEM LR) 17.46B	Under the Listing Rules, an issuer must publish an announcement or issue a supplementary circular upon receipt of a notice from a shareholder to propose a person for election as a director at the general meeting.
			Section 115A CO	Companies must circulate members' resolution to all members of the company.
2. Do shareholders ask questions of directors at shareholders' meetings and do they receive answers?	X		CG Code Provision E.1.2	The CG Code Provision E.1.2 states that the chairman should attend the annual general meeting and arrange for the chairmen of the audit, remuneration and nomination committees to attend and be available to answer questions. The chairman of the independent board committee (if any) should also be available to answer questions at any general meeting to approve a connected transaction or any other transaction that is subject to independent shareholders' approval. The SEHK's review of 2007 annual accounts found that about 93% of issuers comply with CG Code Provision E.1.2. This is a rise from 91.4% for the 2006 annual accounts review.
3. Must company transactions with its insiders be on a non-preferential basis?	X		MB LR 14A.11 MB LR 14A.18 MB LR 14A.31 GEM LR 20.11 GEM LR 20.18 GEM LR 20.31	All transactions with "connected persons" (as defined in the Listing Rules) are subject to the connected transaction rules. Connected transactions should be conducted on normal commercial terms. The SEHK will require that connected transactions and continuing connected transactions are made conditional on prior approval by shareholders of the listed issuer in a general meeting. A circular for the transaction must be dispatched to shareholders. "Intra-group transactions" and "de minimis transactions" (as defined in the Listing Rules) are exempt from these requirements.
			Guidelines on Directors' Duties	Under common law, directors have a fiduciary duty to act in the best interests of the company and not to allow personal interests to conflict with the company's interests.
4. Is a super majority vote required for major company acts affecting shareholder rights?	X		MB LR 6.12(2) (3) GEM LR 9.20(2) (3) Appendix 13a and 13b, paragraph 2	An approval of withdrawal of listing must be given by at least 75% of the votes attaching to any class of listed securities held by holders voting at the meeting and not more than 10% of votes cast against. An approval of variation of class rights must be given by members holding at least 75% of the votes attaching to that class.

Element	Yes	No	Source(s) of Rule	Comments
			Section 63A of the CO	Variation of rights attached to a class of shares requires approval by 75% of the shareholders in that class.
			Rule 2.10 of the Takeovers Code	Takeover and privatization of a public company by scheme of arrangement or capital reorganization must be approved by at least 75% of the votes attaching to the disinterested shares that are cast either in person or by proxy; and the number of votes cast against the resolution to approve the scheme or capital reorganization must not be more than 10% of the votes attaching to all disinterested shares.
COMPOSITION AND ROLE OF BOARDS OF DIRECTORS				
5. Must boards have independent directors? What percentage?	X		MB LR 3.10, GEM LR 5.05	Boards must have three independent non-executive directors (INED), at least one of which must have appropriate professional qualifications in accounting or related financial management expertise.
			CP RBP A.3.2	The CG Code (RBP) states that an issuer should appoint INEDs representing at least one-third of the board.
6. Do independent directors have significant influence over (a) internal and external audit and (b) executive compensation?	X		Internal and external audit MB LR 3.21 & 3.22 GEM LR 5.28 & 5.29 CG Code Provisions C.3.1 to C.3.6 and RBP C.3.7	<p>Internal and external audit</p> <p>The audit committee must comprise non-executive directors only. The majority of the audit committee must be INEDs and must be chaired by an INED. The board of directors of the listed issuer must approve and provide written terms of reference for the audit committee which clearly establishes its authority and duties.</p> <p>The CG Code states that the terms of reference of the audit committee should include at least the following duties:</p> <p><u>External audit</u></p> <p>Primary responsibility for making recommendation to the board on the appointment, reappointment and removal of the external auditor, approve remuneration and terms of engagement for the external auditor and any questions of resignation or dismissal of that auditor;</p> <p>to review and monitor the external auditor's independence, objectivity and effectiveness of the audit process including discussion of the scope of the audit and reporting obligations;</p> <p>to develop and implement policy on the engagement of an external auditor to supply non-audit services; and</p> <p>to monitor integrity of financial statements of an issuer and the issuer's annual report and accounts, half-year report and, if prepared, quarterly reports.</p> <p>The audit committee must liaise with the issuer's board of directors and senior management and must meet at least once a year with the issuer's auditors.</p> <p><u>Internal audit</u></p> <p>The audit committee's duties also include:</p> <p>Reviewing the issuer's financial controls, internal control and risk management systems;</p> <p>ensure that management has discharged its duty to have an effective internal control system;</p> <p>consider any findings of major investigations of internal control matters as delegated by the board or on its own initiative; and</p> <p>where an internal audit function exists, to ensure coordination between the internal and external auditors, to ensure that the internal audit function is adequately resourced and has appropriate standing within the issuer and to review and monitor the effectiveness of the internal audit function.</p> <p>The Exchange's review of 2007 annual accounts found that, on average, 99.5% of issuers comply with CG Code Provisions C.3.1 to C.3.6. This is a rise from 99.1% for the 2006 annual accounts review.</p>

Element	Yes	No	Source(s) of Rule	Comments
			Executive compensation CG Code Provisions B.1.1 to B.1.5 and RBP's B.1.6 to B.1.8	Executive compensation The CG Code states that issuers should establish a remuneration committee that has a majority of INEDs as members. The Exchange's review of 2007 annual accounts found that, on average 97.9% of issuers comply with CG Code Provisions B.1.1 to B.1.5 This is a rise from 97.5% for the 2006 annual accounts review.
7. Do independent directors decide what information the board receives from management?	X		CG Code Provisions A.6.1 to A.6.3	The CG Code states that management has an obligation to supply the board and its committees with adequate information in a timely manner to enable it to make informed decisions.
			CG Code Provision A.1.7	The CG Code also states that issuers should have a procedure agreed by the board to enable directors to seek independent professional advice in appropriate circumstances at the issuer's expense.
8. Are the chairman of the board and CEO different persons in the majority of listed companies?	X		CG Code Provision A.2.1	The CG Code states that the roles of the chairman and CEO should be separate. The Exchange's review of 2007 and 2006 annual report and accounts both found that about 63% of issuers comply with CG Code Provision A.2.1 to separate the role of chairman and CEO.
9. Are all board members elected annually?		X	CG Code Provision A.4.2	The CG Code states that every director, including those appointed for a specific term, should be subject to retirement by rotation at least once every three years.
			Article 91 of Schedule 1 to the CO	One third of the board of directors should retire by rotation every year. The directors to retire in every year shall be those who have been longest in office since their last election.
10. Does the board oversee enforcement of a company code of conduct?	X		Note to LR3.25(1) and Preamble to CG Code	The Listing Rules and the CG Code state that issuers may devise their own code on corporate governance practices on such terms as they may consider appropriate.
			MB LR 3.17, 13.67 and Appendix 10	The Listing Rules require that every director comply with the Model Code, or the issuers' own code on no less exacting terms. The Model Code sets out the required standards against which directors must measure their conduct regarding transactions in securities in their own company.
TRANSPARENCY AND DISCLOSURE OF INFORMATION				
11. Do financial statements comply with International Financial Reporting Standards (IFRS)?	X		MB LR Appendix 16.2(6) GEM Listing Rule 18.04 & 18.05	All financial statements of a listed issuer must conform with either: Hong Kong Financial Reporting Standards; or IFRS. A MB overseas issuer that has a secondary listing on the Exchange may use US GAAP. A GEM issuer also listed on NYSE or NASDAQ may use US GAAP subject to various conditions.
12. Are the identities of the five largest shareholders disclosed?	X		MB LR Appendix 16.13(3) GEM LR 18.17B	A statement must be included in the annual accounts as at the balance sheet data showing the interests or short positions of every person, other than a director or chief executive of the listed issuer, in the shares and underlying shares of the listed issuer as recorded in the register required to be kept under section 336 of the SFO and the amount of such interests and short positions.
			Sections 310 and 336 of the SFO and Part XV of the SFO generally	Every person who holds 5% or more interest in shares of a listed corporation (notifiable interest) must disclose his interests by filling and submitting the relevant form to the Exchange and the listed issuer. He must also notify the listed issuer and Exchange of changes of more than a prescribed percentage to his interest. Every issuer must keep a register of interests in shares and short positions once it receives such notification of acquisition and changes in notifiable interest.
13. Is compensation of	X		MB LR Appendix	A listed issuer shall disclose in its financial statements

Element	Yes	No	Source(s) of Rule	Comments
company executive officers disclosed?			16.24 & 16.25 GEM LR 18.28 CG Code RBP B.1.7	information of directors' remuneration on a named basis and of the five highest paid individuals during the financial year. The CG Code recommends that issuers disclose details of any remuneration payable to members of senior management, on an individual and named basis, in their annual reports and accounts.
14. Are extraordinary corporate events disclosed?	X		MB LR 13.09 GEM LR 17.10	An issuer must publish as reasonably practicable any information relating to the group which is necessary to enable an appraisal of the position of the group, or is necessary to avoid the establishment of a false market in the group's securities or might reasonably be expected to materially affect market activity in and the price of its securities.
			Chapter 14	Chapter 14 requires disclosure of notifiable transactions, including mergers and acquisitions.
15. Are risk factors disclosed in securities offering materials?	X		MB LR 19A.42 MB LR Appendix 1a.34(1)(b) MB LR Appendix 1b.29(1)(b) GEM LR Appendix 1a.66 & 67 GEM LR Appendix 1b.29(1)(b)	The contents of a listing document must include a statement as to the financial and trading prospects of the group for at least the current financial year, together with any material information which may be relevant thereto, including all special trade factors or risks (if any) which are not mentioned elsewhere in the listing document and which are unlikely to be known or anticipated by the general public, and which could materially affect the profits. Additionally, a risk factor section is required for PRC listing applicants
16. Are transactions of a company with its insiders disclosed?	X		MB LR 14A.11 MB LR 14A.18 MB LR 14A.31 GEM LR 20.11 GEM LR 20.18 GEM LR 20.31	All transactions with "connected persons" (as defined in the Listing Rules) are subject to the connected transaction rules. Connected transactions should be conducted on normal commercial terms. The Exchange will require that connected transactions and continuing connected transactions are made conditional on prior approval by shareholders of the listed issuer in a general meeting. A circular for the transaction must be dispatched to shareholders. "Intra-group transactions" and "de minimis transactions" (as defined in the Listing Rules) are exempt from these requirements.

Note: CL – company law; SL – securities law; CGC – corporate governance code; SLR – stock exchange listing requirement, GP – general practice but not obligatory

Rules Regarding Unlisted Companies

Element	Yes	No	Source(s) of Rule	Comments
RIGHTS OF SHAREHOLDERS				
1. Do shareholders add items to the agenda for shareholders' meetings?	X		Section 116B CO	Members may propose a written resolution which directors are required to circulate to all members for unanimous approval.
			Section 113 CO	Members may requisition an extraordinary general meeting or may convene a meeting if the directors fail to do so.
			Section 115A CO	Members may request for circulation of a resolution intended to be moved at an annual general meeting.
2. Do shareholders ask questions of directors at shareholders' meetings and do they receive answers?				This may happen in practice. There are no specific provisions on this matter.
3. Must company transactions with its insiders be on a non-preferential basis?	X		Section 157H and 162 CO	There are various CO provisions which regulate a company's dealings with directors. For example, section 157H which prohibits a company from entering into any direct or indirect related party transactions with its directors and section 162 which requires disclosure by directors to the board of material interests in contracts with the company.
4. Is a super majority vote	X		Section 114(3)	Consent for calling a general meeting or AGM by shorter

Element	Yes	No	Source(s) of Rule	Comments
required for major company acts affecting shareholder rights?			CO	notice.
			Section 166 CO	Section 166 – approval for a compromise or arrangement with members.
COMPOSITION AND ROLE OF BOARDS OF DIRECTORS				
5. Must boards have independent directors? What percentage?		X		
6. Do independent directors have significant influence over (a) internal and external audit and (b) executive compensation?				Not applicable.
7. Do independent directors decide what information the board receives from management?				Not applicable.
8. Are the chairman of the board and CEO different persons in the majority of listed companies?				Not applicable.
9. Are all board members elected annually?		X		The rotation and election of directors are usually provided for in a company's constitution.
10. Does the board oversee enforcement of a company code of conduct?				No specific provisions in the CO to so provide for.
TRANSPARENCY AND DISCLOSURE OF INFORMATION				
11. Do financial statements comply with International Financial Reporting Standards (IFRS)?		X	Section 123 and 126 CO	While company directors are required to give a true and fair view of the state of affairs and profit or loss of the company, there is no explicit provision in the CO which requires them to prepare accounts in compliance with the requirements of the HKFRSs (which have fully converged with IFRS since 1 January 2005) or IFRSs. However, under the Professional Accountants Ordinance, Cap. 50 of the laws of Hong Kong, certified public accountants (including auditors) are required to observe the Hong Kong Institute of Certified Public Accountants' (HKICPA) professional standards which include, inter alia, the HKFRSs.
			Section 141D CO	Eligible private companies with unanimous members' consent can prepare simplified financial and directors' reports based on the Small and Medium-sized Entities Financial Reporting Framework and Small and Medium-sized Entities Financial Reporting Standard issued by the HKICPA.
12. Are the identities of the five largest shareholders disclosed?	X			There is no such specific requirement but such information are available from the following sources:
			Section 95(1)(a), 96, 98 CO	The register or index of members of a company which gives particulars of the names of members and shares held is open to inspection by members and non-members.
			Section 107(2)(f), (g) CO	The particulars relating to members and share capital of a company are required to be given in the company's annual return which is required to be filed with the Registrar and is available for public inspection.
			Section 129A(1) CO	A subsidiary's accounts must contain in the notes or statement annexed to it the particulars of its ultimate parent undertaking.
13. Is compensation of company executive officers disclosed?	X		Section 161(1)(c), 161A, 161C CO	Compensation to directors for loss of office is required to be disclosed in the accounts or in a statement annexed to it.
14. Are extraordinary corporate events	X		Section 129D(3)(a),(l)	A directors' report is required to state any significant change in the principal activities of the company and its subsidiaries in

Element	Yes	No	Source(s) of Rule	Comments
disclosed?			CO	the course of the financial year and of particulars of matters so far as they are material for the appreciation of the state of the company's affairs (unless harmful to its business).
15. Are risk factors disclosed in securities offering materials?	X		Section 38 CO	Section 38 CO requires every prospectus issued by or on behalf of a company to state the specific matters and reports as listed in the Third Schedule to the CO which require, inter alia, that sufficient particulars and information should be set out in the prospectus to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus.
16. Are transactions of a company with its insiders disclosed?	X		Section 161, 161A, 161C CO	Directors' emoluments and pensions are required to be disclosed in the accounts of the company or in a statement annexed to it.
			Section 161B, 161BA, 161BB, 161C CO	Loans, quasi-loans and credit transactions in favor of directors, managers and secretaries are required to be disclosed in the accounts of the company.
			Section 155B(1) CO	Notices of resolution are required to contain disclosure of directors' material interest in the matter dealt with by the resolution.
			Section 129D(3)(ia), (j), (k), 162A CO	The following information is required to be disclosed in a directors' report: The directors' material interests in any contract of significance in relation to the company's business with the company, its subsidiary or holding company or a subsidiary of the company's holding company. The management contracts entered into by the company and the name of any director interested therein. A statement explaining the effect of any arrangement whose objects are to enable directors to acquire benefits by means of share acquisition in, or debentures of, the company or any other body corporate, and the names of directors (and nominees) who acquired such debentures.
			Tenth Schedule para 9(1)(c), 47C(4)(b), (c) CO	Outstanding loans to employees for the purchase of shares in employee share schemes are required to be disclosed in the balance sheet of a company.

Note: CL – company law; SL – securities law; CGC – corporate governance code; SLR – stock exchange listing requirement, GP – general practice but not obligatory