under-resourced while its staff comprised civil servants as opposed to financial services professionals. In short, there was minimal capital market regulation in Hong Kong and virtually no way of anticipating and taking remedial action to prevent an accident. The accident duly took place on 19 October 1987 when the world's stock markets crashed.

'Black Friday', 19 October 1987

2.55 On 20 October 1987, the SEHK Management Committee held an emergency meeting and unilaterally decided to suspend trading for four days in the hope that this would prevent further market losses and the international situation would have stabilised by the time that the market re-opened. In addition, the Hong Kong Futures Exchange ('HKFE') also suspended the trading of Hang Seng Futures. Hong Kong was, however, the only international financial market to stop trading as a result of the crash and the closure caused considerable damage to Hong Kong's image. When the SEHK and HKFE opened again on 26 October 1987, the market fell again by another 33 per cent. At this stage, Government intervention became inevitable and, on the advice of the Hambros Bank, the Hong Kong Government arranged a $2 billion rescue package to save the futures markets from bankruptcy and to minimise the effects of major defaults by futures traders.

The Hay Davison Report

2.56 As well as arranging a rescue package, the Government also appointed the Securities Review Committee to investigate the underlying structural problems and systemic defects that had so damaged Hong Kong's reputation as an international market. Subsequently, the 'Report of the Securities Review Committee on the Operation and Regulation of the Hong Kong Securities Industry' ('The Hay Davison Report' after its Chairman, Ian Hay Davison) was presented to the Government on 28 May 1988. The Hay Davison Report recommended major reforms consisting of a fundamental revision of the internal constitutions of the exchanges and the establishment of an independent statutory body outside the civil service to supervise and regulate the securities industry. The Government accepted the recommendations and took action to draft the necessary enabling legislation.

The establishment of the Securities and Futures Commission

2.57 The new Securities and Futures Ordinance (Cap 571) was enacted in 1989 and the SFC was established on 1 May 1989 as the front-line regulator of the securities and futures markets in the interests of investors. The Commission was responsible for enforcing, supervising and monitoring the then relevant legislation relating to the trading of securities, futures and foreign exchange contracts within Hong Kong; monitoring the Exchanges (Special Levy) Ordinance (Cap 351); and ensuring that the relevant Hong Kong legislation met international standards. Subsequently, the Listing Rules were amended in October 1989, followed by the

enactment of the Securities (Insider Dealing) Ordinance (Cap 395) and Securities (Disclosure of Interests) Ordinance (Cap 396) in 1991 and the Securities and Futures (Clearing Houses) Ordinance (Cap 420) in 1992.

The three tier system of securities regulation

2.58 One of the key recommendations of the Hay Davison Report was that Hong Kong should establish a 'three-tier' system of securities regulation comprising the Government (the first tier), the SFC (the second tier) and the SEHK (the third tier). As one of the SFC's main functions was to regulate the securities market and, by implication, certain aspects of listed companies, this created the potential for duplication with the SEHK's existing regulatory function. In order to resolve this issue, on 24 November 1989, the SFC transferred to the SEHK the sole responsibility of regulating various kinds of notifiable transactions. This process of rationalising regulatory responsibility was taken further on 25 November 1991 when the SFC signed a formal Memorandum of Understanding ('MoU') with the SEHK, which came into force on 31 December 1991, under which the SFC devolved responsibility for the day-to-day administration of all listing matters to the SEHK. As a consequence, the SEHK became the front-line regulator for all listed companies in Hong Kong although the SFC had final regulatory control as any changes to the Listing Rules had to be approved by the SFC.

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The Securities and Futures Ordinance

2.59 Another key recommendation in the Hay Davison Report was the rationalisation of Hong Kong's very fragmented securities legislation which was then spread over 10 different ordinances. By 1994, the SFC had prepared the first draft of the Bill but subsequent progress was slow due to criticisms and complaints from the securities and banking industry, the need to consider concurrent reforms in the UK and the US and finally the Asian economic crisis of 1998. However, on 13 March 2002, the long-awaited Securities and Futures Ordinance (Cap 571) ('SFO') was eventually enacted and subsequently came into force on 1 April 2003.

The demutualisation of the Stock Exchange of Hong Kong

2.60 A further major reform of the securities markets took place prior to the enactment of the SFO. In his budget speech in March 1999, the FS announced a comprehensive reform of Hong Kong's stock and futures markets. In order to rationalise the existing structure and increase international competitiveness, the SEHK would be merged with the HKFE and the Hong Kong Securities Clearing Company ('HKSCC') to become a single holding company, Hong Kong Exchanges and Clearing Ltd ('HKEx'), which would be listed on its subsidiary, the SEHK. Subsequently, the merger and demutualisation of Hong Kong's stock market took place on 20 February 2001. The previous MoU between the SFC and the SEHK signed in 1991 was replaced by a new MoU between the SFC and the HKEx on 6 March 2000.

SEHK would not in itself imply that it has failed to meet the disclosure obligation for inside information. If a company wishes to respond to rumours, it should do so by making a formal announcement rather than making a remark to a single publication or by way of a press release. This will ensure that the whole market is equally and properly informed (paragraph 80 of the SFC Guidelines).

Internal matters

3.153 The Guidelines make clear that internal issues relating to the day-to-day operations of the company which involve matters of supposition, or are indefinite in nature, will not be generally seen as 'specific' information. These might include, for example, the development of a new technology, the planning of a major redundancy programme or the possibility of a substantial price cut in its products. However, the Guidelines add a caveat that, where these matters become specific or definite, they constitute inside information (paragraph 84 of the SFC Guidelines).

3.154 Similarly, a company may from time to time generate internal reports for management purposes. The Guidelines cite the example of an internal marketing research report which indicates that a new product to be launched by a competitor may pose a significant challenge that the company needs to address as one possible outcome would be a significant loss of sales. The mere possibility that without a successful response the company would face a serious decline in profits does not automatically trigger an obligation to disclose. However, if after time the competitor's new product has significantly reduced sales, then the fact of the change in trading performance, shown by regular performance monitoring, may constitute inside information (paragraph 85 of the SFC Guidelines).

Companies listed on more than one exchange

3.155 If the securities of a company are listed on more than one stock exchange, the Guidelines state that the company should synchronise the disclosure of inside information as closely as possible in all markets in which the securities are listed. In general, the company should ensure that inside information is released to the public in Hong Kong at the same time it is given to the overseas markets. If inside information is released to another market when the market in Hong Kong is closed, the company should issue an announcement in Hong Kong before the Hong Kong market opens for trading (paragraph 86 of the SFC Guidelines). If necessary, the company may request a suspension of trading in its securities pending the issue of the announcement in Hong Kong (paragraph 87 of the SFC Guidelines).

Publications by third parties

3.156 Publications by industry regulators, government departments, rating agencies or other bodies may affect the price of, or market activity in, the company's securities of the company. The Guidelines clarify that, if such events when they become public knowledge are expected to have significant consequences directly affecting the corporation, this may be inside information that should be disclosed by the corporation with an assessment of the likely impact of those events (paragraph 88 of the SFC Guidelines).

External developments

3.157 The Guidelines clarify that companies are not expected to disclose general external developments, such as foreign currency rates, the market price of commodities or changes in a taxation regime. However, if the information has a particular impact on the company this may be inside information that should be disclosed by the company with an assessment of the likely impact of those events (paragraph 89 of the SFC Guidelines).

In the course of preparing periodic and other structured disclosures

3.158 A company may be required in a number of circumstances to prepare disclosure in certain prescribed structured formats pursuant to the relevant laws and listing rules, for example, regular periodic financial reports, circulars and listing documents. In the course of preparing these prescribed disclosure documents, a company may become aware of inside information previously unknown to the directors and officers, or information in respect of a matter or financial trend which may have crystallised into inside information (paragraph 90 of the SFC Guidelines).

3.159 The Guidelines state that a company should be aware that inside information which requires disclosure may emerge during the preparation of these disclosures, in particular periodic financial information, and that the company cannot defer releasing inside information until the prescribed structured document is issued. Consequently, separate immediate disclosure of the information is necessary (paragraph 91 of the SFC Guidelines).

The CITIC Pacific case

Background

3.160 The issue of statutory backing for PSI is relevant to the case of one of Hong Kong's recent major corporate scandals. In October 2008, the then Chairman of CITIC Pacific, Larry Yung, disclosed that the company had lost HK$15 billion (US$2 billion) due to 'unauthorised trades'. The unauthorised trades were hedges with a contract value of A$9 billion against the Australian dollar, taken out to cover against an A$1.6 billion prospective acquisition and capital expenditure. Subsequently, losses were incurred on the contracts when the currency declined from 98.5% against the US dollar to less than 70%. CITIC Pacific's parent company, CITIC pledged its support to its subsidiary. The board became aware of this on 7 September 2008. Under listing rule 13.09(1), 'an issuer shall keep the Exchange, members of the issuer and other holders of its listed securities informed as soon as reasonably practicable of any information relating to the group (including information on any major new developments in the group's sphere of activity which is not public knowledge) which: … (c) might be reasonably expected materially to affect market activity in and the price of its securities.'

3.161 In the event, disclosure was made to the financial markets only after trading in its shares was suspended on 20 October 2008. The company and the

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(section 182). These may be exercised in a variety of circumstances, including the following:

(a) First, where the SFC has reasonable cause to believe that an offence under the 'relevant provisions' may have been committed (section 182(1)(a)).

(b) Secondly, where, inter alia, the SFC has reasonable cause to believe that a person may have engaged in defalcation, fraud, misfeasance or any other misconduct in connection with: dealing in any securities or futures contract or leveraged foreign exchange contract (section 182(1)(b)(i)); the management of investment in any securities, futures contract or leveraged foreign exchange contract (section 182(1)(b)(ii)); offering or making any leveraged foreign exchange contract or collective investment scheme (section 182(1)(b)(iii)); giving advice in relation to the allotment of securities etc. (section 182(1)(b)(iv)); and any transaction involving securities margin financing (section 182(1)(b)(v)).

(c) Thirdly, the SFC has reasonable cause to believe that market misconduct may have taken place (section 182(1)(c)).

(d) Fourthly, the SFC has reasonable cause to believe that the conduct of a person in any of the activities mentioned in section 182(1)(b) is not in the interest of the investing public or the general public (section 182(1)(d)).

Conduct of investigations

5.42 Section 183 sets out the process for conducting investigations. A person under investigation or a person whom the investigator has reasonable cause to believe has in his possession any record or document relevant to the investigation is required to:

(a) produce to the investigator at a specified time and place any record or document required by the investigator (section 183(1)(a));

(b) if required by the investigator, give an explanation of these records and documents (section 183(1)(b));

(c) attend before the investigator at the time and place specified in writing to answer questions; (section 183(1)(c));

(d) give the investigator all reasonable assistance with the investigation, including responses to written questions (section 183(1)(d)).

5.43 In addition, an investigator may require in writing a person giving an explanation to verify the explanation within a reasonable period by a statutory declaration which may be taken by the investigator (section 183(2)). Furthermore, if a person does not give or make an explanation for the reason that the explanation was not within his knowledge or explanation, an investigator may require in writing the person to verify within a specified period by statutory declaration which may be taken by the investigator that he was unable to comply or fully comply with the requirement (section 183(3)).

Regulatory action by the SFC under sections 179 and 182

5.44 The numbers of investigations under sections 179 and 182 of the SFO inevitably involve a certain degree of overlap. Frequently, investigations will be opened under both provisions and, very often, investigations into listed companies will be opened under section 182 without any need to use section 179: much will depend on the issues being investigated. However, over the past five years, the SFC has been very proactive in this area and the number of investigations commenced under either or both sections 179 and 182 was as follows:[20]

2010–11: 262 investigations commenced and 251 completed
2011–12: 303 investigations commenced and 202 completed
2012–13: 300 investigations commenced and 306 completed
2013–14: 352 investigations commenced and 319 completed
2014–15: 553 investigations commenced and 362 completed

Part X — Powers of Intervention and Proceedings

5.45 In addition to the core enquiry and investigatory powers in sections 179 and 182, the SFC has important powers under Part X of the SFO to intervene in a company's affairs.

Winding-up orders and bankruptcy orders

5.46 Section 212 of the SFO permits the SFC to initiate winding-up proceedings under the CO against companies if it considers that it is desirable in the public interest to do so, and on the ground that the making of a winding-up order would be just and equitable. The conditions are as follows:

212. Winding up and bankruptcy orders

(a) If–

(a) a corporation, other than an authorized financial institution, is of a class of corporations which the Court of First Instance has jurisdiction to wind up under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32); and

(b) it appears to the Commission that it is desirable in the public interest that the corporation should be wound up,

the Commission may present a petition for the corporation to be wound up under that Ordinance on the ground that it is just and equitable that the corporation should be so wound up, and that Ordinance shall apply to such petition as it applies in relation to a petition presented under that Ordinance (section 212(1)).

If–

(a) grounds exist for the presentation of a petition for a bankruptcy order against a licensed representative by his creditor in accordance with the Bankruptcy Ordinance (Cap 6); and

(b) it appears to the Commission that it is desirable in the public interest to present a petition for a bankruptcy order against the licensed representative in accordance with that Ordinance,

20 Information obtained from Mark Steward, Executive Director, Enforcement, SFC.

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Settlement proposals and appeals

5.207 Subsequently, a settlement proposal, as agreed between the Listing and Regulatory Affairs Department and the relevant parties is tabled before the Listing Committee at a meeting for the Committee to consider and where appropriate, to endorse. All settlements are subject to the Committee's approval. To further enhance transparency and to ensure procedural fairness, all the parties to the disciplinary action are invited to attend the meeting at which the settlement proposal is considered, and the Committee may ask questions of the parties present regarding the proposed settlement. Subsequently, if the parties are dissatisfied with the Listing Committee's decision(s), they have the ability to appeal to the Listing Review Committee which comprises those members of the Listing Committee who did not participate in the original hearing.

Limitations to HKEx's enforcement action

Lack of statutory powers

5.208 HKEx does not have any statutory investigatory powers and the Listing Rules are a non-statutory code without the force of law. As over 80% of listed companies are not subject to most of the provisions of the CO, HKEx must rely on the terms of the listing agreement with listed issuers if it is to take any enforcement action. In practice, this means that HKEx's enforcement action is limited to issuing either public censures, statements and criticisms or private reprimands of conduct by listed issuers leaving it to market pressure and sentiment to take any corrective action against the listed issuer in question. These sanctions are largely shaming and reputational in character with a major distinction between those with publicity attached and those which remain in the private domain.

5.209 This must be contrasted with the range of behaviour and conduct and differing roles of individuals who are the subject of disciplinary action. The narrow compass of sanctions available gives rise to considerable challenges in their fair application between the sometimes large number of individuals involved with their differing levels of culpability and an outcome which reflects the expectations of the Exchange and the market. The Listing Committee is aware of possible shortcomings in the current regime and is actively conducting a review of the disciplinary structure and sanctions.[182] As an ultimate sanction, HKEx can always delist a listed company deemed to be in serious breach of the Listing Rules. However, this is also a 'nuclear' option and, as such, the circumstances in which it would be used are so remote that they can be discounted to all intents and purposes. Furthermore, delisting is a very blunt and inadequate instrument to deal with any market misconduct as it does not just punish those whose conduct should be penalised but everyone involved with the company including those minority shareholders who are particularly vulnerable to market misconduct — in short, the innocent suffer just as much as the guilty.

182 Ibid para 68, p 15.

Mitigating factors

5.210 It should, however, be noted that the problems outlined above are mitigated, to some extent, by a number of factors. First, as HKEx plays a very active role in monitoring the market, the Exchange is able to identify and deal with a significant number of issues before they become problems requiring possible enforcement action.

5.211 Secondly, running parallel to the non-statutory enforcement regime operated by HKEx is the statutory enforcement regime operated by the SFC and the threshold for referring cases from HKEx to the SFC is 'very low'. Subsequently, the SFC may or may not take action on cases referred by HKEx.[183] This statutory enforcement regime has been further strengthened by the recent amendments to the SFO which give statutory backing to the listing rule requirements regarding the disclosure of inside information.

5.212 Thirdly, HKEx also interacts closely and regularly with other law enforcement agencies such as the Commercial Crime Bureau of the Hong Kong Police and the ICAC who can take action, if necessary, under the relevant ordinances.[184]

Listing Committee's review of Chapters 2 and 2A of the Listing Rules

5.213 In the 2013 Listing Committee Report, it was reported that the Listing and Regulatory Affairs Department was to conduct further study, seek further legal advice and report back on the review of disciplinary sanctions available to the Listing Committee in exercise of its disciplinary power under Chapter 2A of the Listing Rules. At the May 2014 policy meeting, the Committee also considered the Listing and Regulatory Affairs Department's proposal to proceed with the review of various issues and Rules relating to corporate finance review hearings of the Exchange set out in Chapter 2B of the Listing Rules with a view to streamlining the review process.[185]

5.214 Subsequently, the Committee agreed that the Listing and Regulatory Affairs Department should carry out a consolidated review of the issues identified in Chapter 2B as well as the disciplinary powers and sanctions under Chapter 2A. The scope of the review shall include:

(a) the parties against whom the Exchange may exercise its disciplinary powers;

(b) the current range of sanctions under the Listing Rules and the feasibility of introducing other sanctions into our disciplinary regime;

(c) the structure and composition of the decision making bodies and the levels of review; and

(d) the issues relating to the procedures for Listing Committee review hearings.

183 Comments made by Mark Dickens, the former Head of Listing, HKEx to the author on 14 April 2011.

184 Ibid.

185 Listing Committee Report for 2014, para. 45, p 9.

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Public reaction

7.31 The overall public reaction to the proposals in the Consultation Paper was generally supportive. During the course of 2005 and the first half of 2006, the Financial Reporting Council Bill was considered by a Bills Committee of LegCo. Subsequently, the Financial Reporting Council Ordinance (Cap 588) ('FRCO')[20] was passed by LegCo on 12 July 2006.

The Financial Reporting Council

Establishment and composition

7.32 The FRC is a statutory body established under the FRCO (section 6(1)). It has perpetual succession under its corporate name and is capable of suing and being sued (section 6(2)). As outlined in the Consultation Paper, the membership would comprise not more than 11 members, including the R of C (as an ex officio member), the CEO of the FRC, representatives of the SFC, HKEx and HKICPA and not fewer than four but not more than six other members, all appointed by the CE (section 7(1)).

7.33 In order to ensure the FRCO's independence, the majority of the members must be lay persons while, additionally, a public officer is not eligible for appointment as a representative of the three regulatory and professional bodies (sections 7(2) and (3)). Furthermore, the Chairman of the FRCO must be appointed by the CE from among the lay members, other than the R of C or his representative and the CEO, even if they are lay persons (section 7(4)).

7.34 Appointments to the FRC are for a term not exceeding three years, although members can be reappointed (Schedule 2, paras 2–3). Furthermore, the terms and conditions of appointments shall be determined by the CE.[21] The appointments are to be made from amongst persons who either because of their experience in accounting, auditing, finance, banking, law, administration or management, or because of their professional or occupational experience, appear to the CE to be suitable for such appointment (section 7(1)(c)(iv)).

7.35 The FRCO also contains reserve provisions to empower the CE:

(a) to appoint a lay member of the FRC to be the acting Chairman, and any other persons to be the acting CEO or acting member of the FRC, in the event that the Chairman, the CEO or any other members of the FRC is for any reason unable to perform the functions of his office (Schedule 2, para 3 and Schedule 3, para 2);

(b) to remove any member of the FRC, who for reasons such as bankruptcy, incapacity caused by physical or mental illness, or conviction of an offence, is unable to or unfit to perform his functions as a FRC member, from his office (Schedule 2, para 5).[22]

20 Ordinance No 18 of 2006.
21 Ibid para 4.
22 Ibid para 5.

Operation

7.36 In general, the detailed procedures for convening meetings or conducting business are the FRC's responsibility. Consequently, the FRCO only sets out the broad framework and key provisions in respect of the FRC's operational structure. The provisions regarding the meetings and proceedings of the FRC, the transaction of business by the circulation of papers and the formation of committees are set out in Schedule 2 to the FRCO (paras 6–8). At least two-thirds of the members constitute a quorum of any meeting of the FRC.[23]

7.37 Every question for decision shall be determined by a majority of votes of the members present at the meetings, subject to a minimum of four votes (Schedule 2, paras 6(9)–6(10)). The minimum threshold ensures that no FRC's decisions will be passed by a thin minority of members. Furthermore, in case of an equality of votes, the Chairman should have a casting vote which should not be double-counted for the purpose of satisfying the minimum threshold of four votes in passing a decision.

7.38 The intention is that the FRC should function more like a governing body and play the role of an overseer. Accordingly, the FRCO gives the FRC the powers to, inter alia, employ staff, and appoint persons as consultants, agents or advisers (sections 10(2)(a) and (b)). In addition, the FRC may delegate any functions to a member of the Council, a committee established by the Council, or an employee of the Council, with the exception of the functions listed in section 11(2), eg, the provisions regarding investigations or enquiries (section 11(1)). In order to enhance the transparency of the FRC's operations, it has the power to issue non-statutory guidelines from time to time. The purpose of these guidelines, which must not be inconsistent with the provisions of the FRCO, is to either indicate the manner in which the FRC proposes to perform its functions or provide guidance on the operation of any provision of the FRCO (section 13(1)).

Chief Executive

7.39 The CE appoints the CEO of the FRC who may hold office for a term not exceeding three years although, on the expiry of the period of his appointment, he is eligible for reappointment (section 8(1) and Schedule 3, paras 1(1) and 1(2)). The CEO is the administrative head of the FRC and is responsible, subject to the direction of the Council, for administering the FRC's affairs (section 8(4)). While the CEO does not necessarily have to be a qualified accountant, it is preferable for the occupant of the post to have had some background in the financial services sector given the nature of cases considered by the FRC. Provisions regarding the appointment of an acting CEO, the appointment of the CEO, his terms and conditions of appointment and removal of the CEO are set out in Schedule 3, paras 2–4.

23 By way of illustration, if the FRC consists of 11 members, the quorum will be eight members. If the FRC consists of ten or nine members, the quorum will be seven or six members respectively.

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regulatory regimes of other financial regulators in Hong Kong, under which non-compliances with the requirements in relation to the regulators' inspections are criminal offences. However, to address the concern raised by some respondents, the amendment bill will make it clear that the Court will take into account whether the person concerned has any reasonable excuse for the non-compliance before it makes a decision on the case.[185]

7.253 The Consultation Paper also invited views on whether the FRC should be allowed to delegate to the HKICPA its inspection functions and powers. Most of the respondents who commented on this question considered that such delegation was not in line with the practice of most overseas independent auditor oversight bodies and might jeopardise the independence and consistency of the inspection process. In light of the comments received, the FSTB will not provide for the delegation route in the amendment bill.[186]

Disciplinary mechanism

7.254 The Consultation Paper proposed that the FRC should be vested with direct disciplinary powers, including the powers to make decisions on disciplinary cases concerning LEAs in respect of listed entity audit and reporting accountants in respect of assurance engagements under the new regulatory regime. A number of respondents supported the proposal while others suggested that the FRC's disciplinary function should be performed by a body or committee which was either independent of the FRC or consisting of persons independent of the FRC so as to ensure the separation of disciplinary power and inspection/investigation powers.[187]

7.255 The FSTB has reviewed the proposed disciplinary mechanism, with particular reference to the relevant international standards and practices as they apply to the disciplinary system governing auditors. It is noted that the Statutory Audit Directive of the European Union ('EU') requires that the oversight of the disciplinary system for auditors should be governed by non-practitioners, ie independent of the audit profession. However, there is no parallel requirement in the EU or any comparable overseas jurisdictions that the disciplinary powers must be vested with a body or committee independent of the independent auditor regulator, or that any such body or committee should consist of persons independent of the regulator. In fact, in some major overseas jurisdictions (eg US and Canada), the inspection, investigation and disciplinary powers are all vested with their independent auditor regulators. In view of these considerations, there is no question that, for the purpose of ensuring fairness in the disciplinary mechanism, the FRC must not be vested with direct disciplinary powers under the new regime.[188]

185 Ibid para 17.
186 Ibid para 18.
187 Ibid para 19.
188 Ibid para 20.

7.256 To ensure fairness and due process in the disciplinary mechanism, the consultation paper has proposed a system which is being practised and has been well-tested in auditor regulation in major overseas jurisdictions as well as in Hong Kong's financial market. The FSTB has also committed in the consultation paper to put in place a number of checks and balances[189] on the FRC's exercise of the disciplinary powers. To elaborate further, under the new regime, the person subject to disciplinary proceedings will be given a fair hearing, in which he will be allowed to make written or oral representations before a disciplinary decision against him is made.[190]

7.257 The FSTB will work out the details of the disciplinary mechanism within this framework in drawing up the amendment bill. During this process, the FSTB will consider whether it would be desirable and appropriate for persons independent of the FRC to be given any formal role in the disciplinary mechanism under the auspices of the FRC, and if so, the arrangements for the FRC to engage such persons in making disciplinary decisions.[191]

Maximum level of pecuniary penalty

7.258 The Consultation Paper proposed to cap the amount of pecuniary penalty at $10 million or three times the amount of the profit gained or loss avoided by the LEA as a result of the irregularity, whichever was higher. Some respondents expressed concerns that the proposed maximum level of pecuniary penalty was too high which might drive smaller audit firms out of business.

7.259 However, the Consultation Conclusions be noted that, in some major overseas jurisdictions (eg the UK), there is indeed no statutory limit on the amount of pecuniary penalty the auditor regulator may impose on the auditors. In making this proposal, the FSRB has emphasised that it is not the intention that the imposition of a pecuniary penalty be used as a tool to put LEAs into financial jeopardy. Under the proposal, the FRC would be required by law to publish guidelines on how it may impose a pecuniary penalty, which should include, inter alia, the following factors:

(a) the nature and seriousness of the irregularity;

189 The checks and balances include:
(a) giving the person concerned a reasonable opportunity of being heard before exercising such disciplinary powers;
(b) a power to establish an expert panel to provide advice to the FRC in respect of the disciplinary cases on the application of audit standards, related practices of the audit profession or experiences in previous cases of similar nature;
(c) arrangements to ensure that the FRC's investigation and inspection staff will not be involved in the disciplinary process and the determination of disciplinary sanctions;
(d) a statutory requirement for the FRC to issue guidelines to indicate the manner in which it exercises the power to impose pecuniary penalty, and to have regard to the guidelines when exercising the power; and
(e) a channel for any person who is aggrieved by a disciplinary decision made by the FRC to appeal against the decision through an independent appeals mechanism, etc.

190 Ibid para 21.
191 Ibid para 22.

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HKEx's recommendations

8.136 In parallel with the SCCLR, HKEx was also considering the issue of board committees and, in a separate consultation paper recommended that:[98]

(a) the Main Board Listing Rules should be amended to follow the GEM Listing Rules so that the establishment of an audit committee would become a mandatory requirement;

(b) the Main Board Listing Rules should be amended to require an audit committee to comprise at least three NEDs with a majority of INEDs;

(c) the Main Board Listing Rules should be amended to require an audit committee to have at least one INED with appropriate financial qualifications or experience in financial matters.

The issue of risk

8.137 Undoubtedly, the financial crisis has had implications for the way in which a company's board does business. In the UK, the Walker and Financial Reporting Council Reports lay particular emphasis on the board's attitude towards risk. The Walker Report said that NEDs should, inter alia, have greater access to critical information about the company's present and future risks. As a consequence, audit committees are going to be increasingly pre-occupied with the issue of risk. External auditors are also much more concerned about cash flows and receivables, whether companies can recover their assets and whether there are hidden and undisclosed liabilities.

8.138 In order to improve risk monitoring, HSBC is following a recommendation of the Walker Report in setting up a Risk Committee which will take over risk monitoring from the audit committee. However, according to Carlson Tong, the then Chairman of KPMG China and Asia Pacific, the most important role for an audit committee was to urge management to get past the bottom line: 'If you look at the past and assume that it will be okay, that's wrong because every time that there is a crisis, it's never based on what has already happened, it's something you don't expect'.[99]

The need for boards to challenge management

8.139 In a KPMG survey of 1,300 US directors and senior executives in May and June 2009, 27% of the respondents said the ability and willingness of boards to challenge management is the weakest area in corporate governance. The Walker Report also ranked 'effectiveness of challenge' at the board level as an area of concern, particularly regarding the determination and approval of strategy, risk appetite and risk management.[100] The absence of a culture to critically challenge

98 HKEx's Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues, January 2002, paras 7.1–7.8.

99 'Guardians of Governance', article by Helen Luk and Heda Bayron, A Plus, April 2010. Please see: http://isca.org.sg/media/207977/guardians-of-governance-original.pdf

100 Ibid.

management is, according to the late Mervyn Cheung, a former Chairman of HKEx's Listing Committee, a particular weakness in Hong Kong's corporate governance regime as a company's management tends to regard INEDs as persons imposed on the company by the law and do not really try to get them involved in corporate discussions unless there is a regulatory requirement to involve them.[101] There are, however, exceptions to this as, according to Eric Li, the senior partner of Li, Tang, Chen & Co, dissent can spur change. He said: 'Companies change their practice all the time on my advice as long as you are respected and are able to positively contribute with persuasion.'[102]

8.140 There is also a tendency for the families, which still control a large percentage of Hong Kong listed companies, to appoint family friends as INEDs, irrespective of their competence. However, according to Carlson Tong, this is changing as the major listed companies (although not all of them) are now appointing high quality INEDs who are prepared to ask searching questions.[103] However, Aloysius Tse, who chairs the audit committee of four state-owned enterprises listed in Hong Kong, namely, CNOOC, China Construction Bank, China Telecom and Sinofert, considered that an Audit Committee can be successful only if there is strong management support. He said: 'If the board cares about corporate governance, they would give you a lot of support and it filters all the way down.' He also considered it is important for the audit committee to maintain constant communications with the company's external auditor who should also listen to the internal auditor's report and present their findings to the audit committee without the management present.[104]

The need to improve internal controls

8.141 There is also a need for Hong Kong companies to improve their internal controls to provide a more effective monitoring risk mechanism. According to Stephen Law, the Chairman of the HKICPA's Best Corporate Governance Disclosure Awards' Organising Committee, the audit committees of Hong Kong listed companies should spend more time reviewing internal controls as it is impossible for the INEDs on a company's audit committee to gauge whether a company's internal controls are working effectively by just attending a few meetings of the audit committee. Listed companies should strengthen their internal audit function and ensure that a company's internal auditor reports directly to the audit committee. With the exception of banks and big financial institutions, many Hong Kong listed companies do not have an internal audit function. However, in the absence of an internal auditing department, companies should, at least, engage an external auditor to undertake a more detailed internal control review that goes beyond the scope of a statutory audit and report the findings to the audit committee.[105]

101 Ibid.

102 Ibid.

103 Ibid.

104 Ibid.

105 Ibid.

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(e) A broad statement of principles is unlikely to be of any additional assistance to shareholders.

(f) There is no intention to create criminal penalties for breach of directors' duties.

The SCCLR's recommendations

9.134 In view of these considerations, the SCCLR did not recommend any changes to the law but believed that there was merit in having a Code of Best Practice that would serve as a guide to directors as to their duties. Such a code could be more readily amended, if necessary, to reflect any future developments in case law.[105] It was also noted that the HKIoD had published such guidelines in the past.[106] When, however, the results of the consultation were analysed, it was discovered that the views of respondents were almost equally balanced as to whether such guidelines should take a statutory or non-statutory form. In view of this, the SCCLR suggested that the issue be revisited after observing the practical application of the statutory approach in those jurisdictions where such an approach was likely to be adopted such as the UK. In the meantime, the SCCLR proposed the adoption of guidelines, which had been drafted by the CR, on a non-statutory basis.[107]

Non-statutory Guidelines

9.135 Subsequently, the CR published non-statutory Guidelines in January 2004. The introduction to these Guidelines stressed that: 'Although case law sets out and elaborates on most of these significant principles, it tends to be complex and inaccessible. The objective of these guidelines is to outline the general principles for a director in the performance of his functions and exercise of his powers.' The Guidelines contained 11 principles (one more than the Ten Commandments). It is interesting to note that, in addition to the common law duties, the Guidelines also included other duties in the 'hierarchy' of duties including the need for a director to observe his company's memorandum and articles and the key statutory duty to keep proper books of account. The Guidelines were last revised in March 2014 to coincide with the implementation of the new CO on 3 March 2014. The Guidelines are reproduced at Appendix 5.

The Listing Rules

9.136 In addition to case law, the CO and the Non-Statutory Guidelines, the Main Board Listing Rules and GEM Listing Rules of the SEHK set out certain standards of conduct and the duties of directors of listed companies. In January 2003, at around the same time as Phase II of the SCCLR's Corporate Governance Review, the SEHK completed a consultation on proposed amendments to the Listing Rules

105 CGR Phase I, para 6.15.

106 Guidelines for Directors (1995) and Guidelines for Independent Directors (2000).

107 CGR Phase II, para 7.02.

relating to corporate governance issues including a major review of the Code of Best Practice.[108] The amendments to both sets of listing rules came into effect in March 2004 and the revised Code (the Code on Corporate Governance Practices) became effective on 1 January 2005.

9.137 Rule 3.08 of the Main Board Listing Rules and rule 5.01 of the GEM Listing Rules set out a broad summary of the basic duties of directors as follows:

> The board of directors of an issuer is collectively responsible for the management and operations of an issuer. The Exchange expects the directors, both collectively and individually to fulfil fiduciary duties and duties of care, skill and diligence to a standard at least commensurate with the standard established by Hong Kong law. This means that every director must, in the performance of his duties as a director:
>
> (a) Act honestly and in good faith in the interests of the company as a whole;
>
> (b) Act for proper purposes;
>
> (c) Be answerable to the listed issuer for the application or misapplication of assets;
>
> (d) Avoid actual and potential conflicts of interest;
>
> (e) Disclose fully and fairly his interests in contracts with the listed issuer; and
>
> (f) Apply such degree of skill, care and diligence as may be reasonably expected of a person of his knowledge and experience and holding his office within the listed issuer.

9.138 In addition, rule 3.09 of the Main Board Listing Rules and rule 5.02 of the GEM Listing Rules provide that:

> Every director of a listed issuer must satisfy the Exchange that he has the character, experience and integrity and is able to demonstrate a standard of competence commensurate with his position as a director of a listed issuer. The Exchange may request further information regarding the background, experience, other business interests or character of any director or proposed director of a listed issuer.

9.139 However, the GEM Listing Rules stipulate additional requirements as rule 5.02 also provides that:

> ... The Exchange expects every director of an issuer:–
>
> (1) to be cognisant of the GEM Listing Rules and reasonably familiar with the obligations and duties imposed upon him and the issuer pursuant to the GEM Listing Rules, the Securities and Futures Ordinance, the Companies Ordinance, the Takeovers Code and the Code on Share Repurchases. The Exchange reserves a right to require directors to demonstrate their knowledge and understanding of the same; and

108 The Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues was issued by the SEHK in January 2002.

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12.24 At the outset, it is accepted that the CO provides a legal framework which applies to all Hong Kong companies, irrespective of whether they are listed or unlisted. Additional requirements for listed companies, of which the majority are non-Hong Kong companies, are set out in the SFO and the non-statutory Listing Rules. This means that listed Hong Kong companies are subject to both statutory and non-statutory requirements. However, to argue that the idea of a statutory directors' remuneration report should be abandoned because it would impose a new statutory obligation on Hong Kong listed companies but not non-Hong Kong listed companies is simply not logical. If this argument was taken *reductio ad absurdum*, it would mean that none of the CO's provisions could apply to Hong Kong listed companies as this would mean that they were subject to statutory as well as non-statutory requirements. Clearly, this would be absurd and is self-evidently not the case. Furthermore, all listed companies, irrespective of whether they are Hong Kong or non-Hong Kong companies, are already subject to 'two sets of rules' as they are subject to the company laws of their jurisdictions of domicile as well as the Listing Rules.

12.25 It is also not understood why the introduction of a statutory directors' remuneration report in the CO would cause a legal and regulatory mismatch. The Listing Rules contain numerous cross references to provisions in the CO which listed companies are required to follow in addition to the non-statutory listing rules. In particular, paragraph 28 of Appendix 16 to the Main Board Listing Rules (Disclosure of Financial Information) states that: 'A listed issuer (whether or not it is incorporated in Hong Kong) shall include disclosures required under the following provisions of the Companies Ordinance.' These include: section 161 (directors' remuneration); section 161A (corresponding figures); section 161B (loans to company officers); section 162 (directors' interests in contracts); and section 162A (management contracts). If it has been agreed on policy grounds that companies should prepare a directors' remuneration report, the Listing Rules can be amended quite easily to require all listed companies to prepare a directors' remuneration report on the lines of the directors' remuneration report in the CO.

12.26 The idea that the production of directors' remuneration reports may be 'too onerous' for unlisted companies is an inaccurate over-generalisation. In the first place, the term 'unlisted company' covers a very wide spectrum of companies, including unlisted public and large private companies which are in a very different category from small SMEs, even though the latter comprise the overwhelming majority of unlisted companies. On corporate governance grounds, the shareholders of unlisted public and large private companies must have the ability and power to request the directors of such companies to prepare a directors' remuneration report if they consider this to be necessary. The statement that 'this could impose an extra burden on the directors or management in the case of shareholder disputes' suggests an absence of any real understanding of corporate governance. The whole point of having these disclosures is precisely to ensure that the directors and management are subject to shareholder scrutiny and appropriate questions can be asked.

12.27 Furthermore, the proposed statutory requirement already contains a control mechanism as the trigger point for requesting the preparation of a directors' remuneration report is a request by members holding not less than 5% of the issued shares/voting rights of a company, ie, the request will have to be made by a not insignificant number of shareholders. In practice, the overwhelming majority of unlisted companies, ie, SMEs, would not need to use this provision as the shareholders in these companies would be more than adequately protected by the disclosures to be made under clause 9.27 of the then Companies Bill. However, it is very important on corporate governance grounds that the proposed requirement is retained to protect the interests of shareholders in unlisted public and large private companies.

The reasons for a change of policy

12.28 Despite the very compelling reasons for the CO to contain a statutory provision requiring the mandatory disclosure of an individual director's remuneration, the Companies Bill did not contain such a provision. Part of the reason may have been that 26 out of the 35 submissions on this particular issue supported the Government's views as set out in the Consultation Paper.[28] However, as pointed out above, these views do not stand up to much scrutiny, and it would be have been interesting to see how respondents would have reacted if the issue had been portrayed more accurately. The only explanation for this volte-face is that the Government was not prepared to stand-up to vested interests who did not wish any changes to the current unsatisfactory status-quo and made their views known only at the eleventh hour.

12.29 The 'reasons' for this back-down, set out in the Consultation Conclusions, should be allowed to speak for themselves:

> It is considered that any improvements to the disclosure of the remuneration of directors of listed companies should be better considered under the Listing Rules and/or the Securities and Futures Ordinance (Cap 571). In this regard, we [the FSTB] have invited the SFC and the Hong Kong Exchanges and Clearing Limited (HKEx) to keep under review the compliance and effectiveness of the relevant Listing Rules. The requirement of directors' remuneration reports would also be too onerous for unlisted companies.[29] With the majority of the respondents supporting not to introduce the requirement of separate directors' remuneration reports in the CB, after consulting the SCCLR, we will proceed accordingly.[30]

12.30 As a consequence, the previous clauses 9.34 and 9.35 were not repeated in the Companies Bill.[31] By any standards, this decision by the Government to suddenly renege on long-established proposals, which it had previously supported, is a backward step for corporate governance in Hong Kong.

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28 Second Phase Consultation Conclusions, October 2010, para 27.
29 Does this mean that major unlisted public companies such as Hong Kong Land and Hong Kong Electric would find such a requirement too onerous?
30 Second Phase Consultation Conclusions, October 2010, para 28.
31 Companies Bill, Legal Supplement No 3, Government Gazette, 14 January 2011, Part 9.

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Chapter 13 — Continuing obligations (Chapter 5 — Directors, secretary and corporate governance matters)

Directors' dealings (securities dealings by directors)

14.71 Rule 13.67 of the Main Board Listing Rules stipulates that an issuer shall adopt rules governing dealings by directors in listed securities of the issuer on terms no less exacting than those of the Model Code set out in Appendix 10 issued by the SEHK. The Model Code sets out the standard which the Exchange requires the issuer and its directors to meet and any breach of such required standard will be a breach of the Listing Rules. The issuer may adopt its own code on terms no less exacting than those set out in the Model Code. Any breach of its own code will not be a breach of the Exchange Rules unless it is also a breach of the required standard under the Model Code. The key elements of Appendix 10 are covered in the body of the GEM Listing Rules as outlined below.

The required standard of dealings

14.72 Rules 5.48 to 5.67 of the GEM Board Listing Rules set out the required standard against which issuers and their directors must measure their conduct regarding transactions in securities of their issuers (the 'required standard of dealings'). Any breach of the required standard of dealings will be regarded as a breach of the GEM Listing Rules. A director must seek to secure that all dealings in which he is or is deemed to be interested are conducted in accordance with the required standard of dealings.

Requirements regarding dealings in price-sensitive information

14.73 Rule 5.50 makes clear that the single most important thrust of the required standard of dealings is that directors who are aware of or privy to any negotiations or agreements related to intended acquisitions or disposals which are notifiable transactions under Chapter 19 or connected transactions under Chapter 20 of the GEM Listing Rules or any price-sensitive information must refrain from dealing in the issuer's securities as soon as they become aware of them or privy to them until proper disclosure of the information in accordance with the requirements of Chapter 16. Directors who are privy to relevant negotiations or agreements or any price-sensitive information should caution those directors who are not so privy that there may be unpublished price-sensitive information and that they must not deal in the issuer's securities for a similar period.

Requirements regarding disclosure of confidential information

14.74 Rule 5.51 provides that a director must not make any unauthorised disclosure of confidential information, whether to co-trustees or to any other person (even those to whom he owes a fiduciary duty) or make any use of such information for the advantage of himself or others.

Chapter 13 — Continuing obligations (Chapter 17 — Continuing obligations)

Voting of directors at board meetings

14.75 Rule 13.44 of the Main Board Listing Rules states that a director of the issuer shall not vote on any board resolution approving any contract or arrangement or any other proposal in which he or any of his associates has a material interest nor shall he be counted in the quorum present at the meeting. Appendix 3 of the Rules sets out the required form and contents of an issuer's articles of association. Paragraph 4(1) of Appendix 3 prohibits a director from voting on a board resolution for the approval of a proposed transaction in which he is interested.

14.76 Previously, paragraph (3) of note 1 in Appendix 3 exempted a director from this requirement in certain situations. For example it allowed issuers' articles to state that a director may vote on a board resolution for a proposed transaction with a company in which he is beneficially interested in no more than 5% of that company's issued shares or voting rights. As a result of amendments to the Listing Rules consequent to the Consultation Paper on Review of the Code of Corporate Governance Practices and Associated Listing Rules (December 2010), this exemption has now been removed.

Directors' service contracts

14.77 Rule 13.68 of the Main Board Listing Rules (rule 17.90 of the GEM Listing Rules) requires an issuer shall obtain the prior approval of the shareholders of the issuer in a general meeting (at which the relevant director and his associates shall not vote on the matter) for any service contract to be granted by the issuer or any of its subsidiaries to any director or proposed director of the issuer or to any director or proposed director of any of its subsidiaries which: (a) is for a duration that may exceed three years; or (b) in order to entitle the issuer to terminate the contract, expressly requires the issuer to give a period of notice of more than one year or to pay compensation or make other payments equivalent to more than one year's emoluments.

14.78 The remuneration committee of the issuer (if any and provided that this committee has a majority of independent non-executive directors) or an independent board committee shall form a view in respect of service contracts that require shareholders' approval and advise shareholders (other than shareholders who are directors with a material interest in the service contracts and their associates) as to whether the terms are fair and reasonable, advise whether such contracts are in the interests of the issuer and its shareholders as a whole and advise shareholders on how to vote. An INED who has a material interest in any such contracts shall not sit on the independent board committee.

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equality of voting either by one vote per share (on a written resolution or a poll) or one vote per person (on a show of hands).

Votes of joint holders of shares

17.43 Section 589 of the CO makes the votes of joint shareholders, previously in paragraph 65 of Table A, a statutory default rule subject to any provision of the company's articles. In the case of joint holders of shares, the vote of the senior (ie, the first name in the register of members) shall be accepted to the exclusion of the votes of the other joint holders, unless otherwise provided in a company's constitution.

Admissibility of votes

17.44 Under the relevant articles regarding errors and disputes in the Model Articles, any objection to the qualification of any person voting at a general meeting may only be raised at the meeting or adjourned meeting at which the vote objected to is tendered, and a vote not disallowed at the meeting is valid; and any objection must be referred to the chairperson of the meeting whose decision is final.

Declaration of chairman on show of hands

17.45 Section 590 of the CO makes the declaration of the chairperson on a show of hands,[33] a statutory default rule. The declaration by the chairperson as to the passing or otherwise of a resolution on a show of hands or an entry in the minutes of the meeting of the declared result should be conclusive evidence of that fact without such proof. If a demand for a poll follows but is subsequently withdrawn, the declaration of that show of hands should stand.[34]

Right to demand a poll

17.46 Under section 591 of the CO, members have the right to demand a poll and such right cannot be excluded by a company's articles. It may be exercised on any question except the election of the chairman of the meeting or the adjournment of the meeting (section 591(1)). Under section 591(2), the right to demand a poll is effectively demanded by: not less than five members having the right to vote at the meeting; members representing not less than 5% of the total voting rights; or the chairman of the meeting. Section 591 lowers the threshold requirement for the right to demand a poll from 10% under the former CO to 5% of the voting rights. This ensures compatibility with the statutory requirement that shareholders holding not less than 5% of the voting rights are able to requisition an extraordinary general meeting (section 566). However, apart from this amendment, the section basically repeats the provisions regarding a poll in section 114D of the former CO.

17.47 In 'CG Watch 2007', the Asian Corporate Governance Association acknowledged that the current voting regime at company general meetings in

33 Previously in paragraph 60 of Table A of the former CO.
34 See *R v Wimbledon Local Board* (1882) 8 QBD 459 (CA(Eng)).

Hong Kong was stronger than most jurisdictions in the region in several areas.[35] Nevertheless, certain weaknesses including voting by show of hands were noted. Previously, in 'ACGA Asian Proxy Voting Survey 2006', the Association made a submission against the practice of voting by a show of hands and in favour of requiring voting by poll on every resolution at a general meeting. Subsequently, HKEx consulted on this proposal.[36]

17.48 As a result of this consultation, the Main Board and GEM Listing Rules were amended by the repeal of, respectively, rules 13.39(3) and 17.47(3), which set out the previous practice regarding polls at the general meetings of listed companies, and the revision of rules 13.39(4) and 17.47(4) to read as follows: 'Any vote of shareholders at a general meeting must be taken by poll and the issuer must announce the results of the poll in the manner prescribed under rule 13.39(5) (rule 17.47(5))'.[37] This amendment, along with the most of the other amendments proposed in the Consultation Paper, came into effect on 1 January 2009. As a result of this amendment, votes by a show of hands at the general meetings of listed companies will become a thing of the past but will still feature at the general meetings of unlisted public and private companies.

17.49 The introduction of mandatory voting by poll at the general meetings of listed companies with effect from 1 January 2009 predates the recently introduced reforms regarding voting on a poll in the CO as far as listed companies are concerned. However, they will improve the statutory position regarding voting by poll for unlisted public and private companies.

17.50 More recently,[38] HKEx proposed amending rule 13.39(4) to allow the chairman to decide whether a resolution on a procedural and administrative matter should be excluded from the requirement for voting by poll. It was proposed to add a note to rule 13.39(4) stating that procedural and administrative matters are those which:

(a) do not appear on the agenda of the notice of general meeting or any supplementary circular to shareholders; and

(b) relate to the chairman's duties to maintain the orderly conduct of the meeting and/or allow the business of the meeting to be properly and effectively dealt with, whilst allowing all shareholders a reasonable opportunity to express their views.[39]

17.51 Examples of procedural and administrative resolutions are those which are required to adjourn the meeting to ensure the orderly conduct of the meeting; to maintain discipline at the meeting; to respond to an emergency; and announce

35 The Combined Consultation Paper on Proposed Changes to the Listing Rules, January 2008, para 12.32.
36 Ibid paras 12.51–12.53.
37 Also see Consultation Conclusions, Part B, November 2008, para 13.
38 Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules, December 2010.
39 Ibid para 274.

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Code will apply in addition to the rules of the Share Repurchases Code. The more important rules in the codes are outlined below.

Mandatory offer

18.61 The Codes regulate acquisitions of shares in an offeree company which changes its control, currently defined as a holding, or aggregate holdings, of 30% or more of the voting rights of a company. The mandatory offer rule comes under Rule 26 which is one of the key rules of the Codes. The rule requires the making of a mandatory general offer to all shareholders of the offeree company, where a person or a group of persons acting in concert: (a) acquires control of a company (meaning 30% or more of the voting rights), whether by a series of transactions over a period of time or not; or (b) when already holding between 30% and 50% of the voting rights of a company, acquires more than 2% of the voting rights in the offeree company in a 12 month period from the date of the relevant acquisition (the 'creeper provision'). In either case, an offer must be made to the shareholders for the balance of the shares of the offeree company. The offer must be in cash or accompanied by a cash alternative at not less than the highest price paid by the purchaser or persons acting in concert with it within the preceding six months.

Persons acting in concert

18.62 The Codes apply not only to the offeror and offeree companies but also to those persons acting in concert with the offeror. A group of persons acting in concert is, in general terms, regarded as being the equivalent to a single holder of voting rights. Under the Codes, persons acting in concert are defined as persons who 'pursuant to an agreement or understanding, actively co-operate to obtain or consolidate control of a company through the acquisition by any one of them of voting rights of the company.'[30] The Codes also presume various classes of persons to be acting in concert with others in the same class unless the contrary is established.[31]

Waivers from the Codes

18.63 The SFC has wide discretion to grant waivers in respect of Rule 26, subject to the adherence to the general principles of the Codes. In particular, when the issue of new securities as a consideration for an acquisition, a cash subscription,

30 Ibid, 'Definitions'.

31 For example, persons falling within the following classes will be presumed to be acting in concert with others in the same class: (1) a company, its parent, its subsidiaries, its fellow subsidiaries, associated companies of any of the foregoing, and companies of which such companies are associated companies; (2) a company with any directors (together with their close relatives, related trusts and companies controlled (by reference to holding 30% or more of the voting rights of a company) by any of the directors, their close relatives or related trusts) of it or of its parent; (3) a company with any of its pension funds, provident funds and employee share schemes; (4) directors of a company (together with their close relatives, related trusts and companies controlled (by reference to holding 30% or more of the voting rights of a company) by such directors, their close relatives and related trusts) which is subject to an offer or where the directors have reason to believe a bona fide offer for their company may be imminent; (5) partners etc.

or the taking of a cash dividend would otherwise result in an obligation to make a general offer under Rule 26, the SFC will normally waive the obligation if there is an independent vote, on a poll, at a shareholders' meeting (the 'whitewash' procedure). If the whitewash is obtained, the person or persons, who otherwise would have been required to make the mandatory offer, are deemed to have a lowest percentage holding equal to the percentage holding of such person or groups of persons immediately after the whitewash transaction. Any acquisition of additional voting rights by such person or group of persons subsequent to the whitewashed transaction is subject to the 2% creeper under Rule 26.1 by reference to the lowest percentage holding in the following 12 months.

Voluntary offer

18.64 A takeover may also be made by making a voluntary general offer where there is no obligation to make an offer under the Codes. However, if it is proposed to incur an obligation under Rule 26 during the course of a voluntary offer by the acquisition of voting rights, the SFC must be consulted in advance. Once such an obligation is incurred, an offer in compliance with Rule 26 must be announced immediately.

Sanctions for breach of the Codes

18.65 As the Codes are not legally enforceable, it is not possible to impose fines and imprisonment for breaches. However, as the Listing Rules expressly require public companies listed on the SEHK to comply with the codes, any breach of the Codes will be deemed to be a breach of the Listing Rules. In addition, if the Takeovers and Mergers Panel[32] finds that there has been a breach of the Codes, it may impose a variety of sanctions including a private reprimand, issuance of a public statement involving criticism, public censure and requiring licensed corporations or representatives etc. not to act or continue to act in any or a stated capacity for any person who is in breach of the Codes.

Further issues

The relationship between the Companies Ordinance and the non-statutory Codes on Takeovers and Mergers and Share Repurchases

18.66 While these reforms will improve the statutory provisions in the CO regarding takeovers, they do not address the relationship of these provisions with the non-statutory codes. In this respect, the CO does not contain any reference to the codes although they are fundamentally important documents in the context of any corporate takeover. In this respect, further consideration needs to be given as to whether the CO should specifically recognise the codes in order to clarify and rationalise the relationship between the statutory and non-statutory provisions regarding takeovers and share repurchases.

32 The Takeovers and Mergers Panel is a non-statutory committee established by the SFC under section 8(1) of the SFO.

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21.10 The main difference between full and overseas members is that a full member must be a company incorporated in Hong Kong or, if it is incorporated outside Hong Kong, it has established a place of business in Hong Kong whereas an overseas member must be a company incorporated in any part of the world other than Hong Kong.

21.11 As at 17 August 2015, the HKIFA had 63 fund management companies as full and overseas members.[11]

21.12 An affiliate member is a company that has obtained a licence from the SFC for type 9 regulated activities[12] or is a fund company incorporated in the People's Republic of China. The primary business is fund management including the management of discretionary accounts, segregated portfolios or providing investment management services for non-collective investment schemes or the manager. In addition, an investment adviser of any fund investment company or arrangement not included as an Investment Fund is also eligible to apply as an affiliate member. An associate member is a company conducting or providing any service of accounting, legal, trustee, custodian, administration, banking, distribution, and technological support to the fund management industry or any related professional services.

21.13 As at 31 March 2015, the HKIFA had 19 affiliate members and 42 associate members.[13]

The Hong Kong Retirement Schemes Association

21.14 The Hong Kong Retirement Schemes Association ('HKRSA') is a not-for-profit body which was formed in 1996 with a view to safeguard the best interests of schemes such as the occupational retirement and mandatory provident schemes and their members. The Association's mission is to be the authoritative body in the retirement protection industry, increase awareness of retirement issues and build our services and contacts within Greater China. This is achieved by pursuing the following objectives:

(a) To retain as members 50% or above of large retirement schemes formed under the Occupational Retirement Schemes Ordinance (Cap 426) and Mandatory Provident Fund representing one million plus members.

(b) To act as a thought leader to research and Government policy in the area of retirement protection.

(c) To promote best practice in management of retirement protection, including communication and corporate governance issues.

(d) To promote professional education and training in retirement protection.

11 See the HKIFA's website at 'Different types of membership', available at http://www.hkifa.org.hk/eng/membership-types.aspx.

12 A 'type 9 regulated activity' is 'asset management' under Part 1 of Schedule 5 to the SFO.

13 Information taken from the HKIFA's website, available at http://www.hkifa.org.hk/eng/membership-types.aspx.

(e) To build partnership with retirement organisations and align strategically with Greater China and other national pension scheme associations, to increase our knowledge and thereby our influence.

(f) Go in partnership with the MPFA and other organisations to promote investment education in secondary education/education institutes.[14]

21.15 As at 31 March 2015, the HKRSA had about 150 corporate members, including a significant number of prominent public bodies.[15]

The Hong Kong Trustees' Association

21.16 The Hong Kong Trustees' Association ('HKTA'), which is a company limited by guarantee, was established in 1991. It is the premier independent body representing the trust and fiduciary services industry in Hong Kong. The HKTA's mission is to represent the trust industry in promoting high standards of professionalism and contribute towards advancing the status of Hong Kong trust professionals and the industry in Hong Kong, the People's Republic of China and internationally through Government lobbying and the creation of professional standards. In this respect, the HKTA develops codes of conduct for private trusts, corporate trusts and charitable trusts as well as specific guidance notes.

21.17 As at 30 September 2015, the HKTA had 123 members, including 116 corporate members and seven individual members, covering a wide spectrum of accountancy firms, banks, law firms and corporate and trustee service providers.[16]

Disincentives to shareholder activism

21.18 There are, however, not insignificant problems regarding and disincentives to shareholder activism by institutional investors. These may be summarised as follows:[17]

14 Information taken from the HKRSA's website at 'Mission & Objectives', available at http://www.hkrsa.org.hk/index.php?option=com_content&view=article&id=6&Itemid=20&lang=en.

15 It has not proved possible to obtain definitive numbers from the HKRSA's website. However, it is understood that the Association's current membership includes: universities, eg, the Chinese, City and Polytechnic Universities; banks, eg, HSBC and Standard Chartered; companies, eg, CLP Holdings, Hutchinson Whampoa, Jardine Matheson and Swire; professional firms, eg, Baker & McKenzie, Clifford Chance, Deloitte Touche Tohmatsu and Pricewaterhouse Coopers; and major public bodies, eg, Hong Kong Jockey Club, Hong Kong Trade Development Council and Hospital Authority Provident Fund Scheme.

16 According to the HKTA's website, these include: AXA China Region Trustees Ltd, Bank of China (Hong Kong) Ltd, Citi Private Bank, Clifford Chance, The Hong Kong Trust Company Ltd, HSBC Institutional Trust Services (Asia) Ltd, KCS Hong Kong Ltd, KPMG, Manulife Provident Funds Trust Company Ltd, and Tricor Services Ltd.

17 Goo & Carver, *Corporate Governance – The Hong Kong Debate* (Sweet and Maxwell, 2003), sections 23–7 and 23–14, pp 431 and 434.

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circumstances or not in relation to his resignation that he considers should be brought to the notice of the members or creditors of the company. The Working Group proposes that the requirement should be extended to outgoing auditors (in addition to the resigning ones) to provide a statement of any circumstances connected with his ceasing to hold office[26] that he considered should be brought to the attention of the members or creditors of the company or a statement of no such circumstances.

6.8 The company must within 14 days either circulate the statement to every entitled person, or apply to the court for an order that the statement should not be sent out. If the outgoing auditor is not informed within 21 days of giving the statement that the company is applying to court, he must send a copy of the statement to the Registrar of Companies within a further 7 days.[27] The existing rights of outgoing auditors to attend, speak at and receive communications about company meetings in respect of their cessation of office would remain essentially unchanged.[28]

Public consultation

23.15 The proposals were circulated for consultation in the context of the Companies Ordinance Rewrite Exercise[29] and received the support of the majority of respondents.[30]

Auditors to report on inconsistencies between the audited accounts and financial information in other parts of the annual report

23.16 The JWG proposed that auditors should be required to report on any inconsistencies between the audited accounts and financial information contained in other parts of the annual report, such as the directors' report. The proposals were circulated for consultation in the context of the Companies Ordinance Rewrite Exercise[31] and received the support of the majority of respondents.[32]

Auditors to report on the auditable part of the directors' remuneration report

23.17 The JWG proposed that auditors should be required to report on the auditable part of the directors' remuneration report, if such a report is prepared. Typically, this report covers various types of benefits given to the individual directors, including the basic salary, fees, housing and other allowances, benefits in kind, pension contributions, bonuses, compensation for loss of office and long-

26 It should cover an auditor who ceases to hold office for any reasons and not just a resigning auditor.

27 Under section 140A of the former CO, it was the duty of the company to send a copy of the statement to the R of C and members of the company. Under the new provision, the auditor would have a duty to send a copy of the statement to the R of C.

28 Consultation Paper, Accounting and Auditing Provisions, Chapter 6, March 2007, paras 6.6–6.8.

29 Ibid.

30 Consultation Conclusions on the Accounting and Auditing Provisions in the Companies Ordinance, 26 March 2008, Appendix III.

31 Consultation Paper, Accounting and Auditing Provisions, March 2007, para 6.9(a).

32 Consultation Conclusions on the Accounting and Auditing Provisions in the Companies Ordinance, 26 March 2008, Appendix III.

term incentive schemes including share options. The report should be approved by the board of directors and signed on behalf of the board by a director. Similar disclosure requirements applicable to all listed companies have been incorporated into the Listing Rules.[33]

23.18 The proposals were circulated for consultation in the context of the Companies Ordinance Rewrite Exercise[34] and received the support of all the respondents.[35]

Cessation of an auditor's term of appointment

23.19 The JWG proposed clarifying that an auditor's term of appointment ceased when a liquidator was appointed.[36] The proposal was circulated for consultation in the context of the Companies Ordinance Rewrite Exercise[37] and received the support of the majority of the respondents.[38]

Auditors' remuneration: approval

23.20 Following the SCCLR's recommendation made in the Corporate Governance Review,[39] the JWG proposed removing the existing provision in section 131(8)(b) of the former CO, which required the company in a general meeting to fix the auditors' remuneration, and allow the directors to fix the auditors' remuneration. It was considered that such a change would reflect the actual situation as the shareholders' resolution concerning the appointment of auditors and their remuneration almost invariably authorises the directors to determine the remuneration. In reality, once the shareholders had agreed to the appointment of the auditors at the AGM, there was little, if any, room for subsequently negotiating the remuneration with them although any dissatisfaction with the level of remuneration would probably lead to the auditors not being reappointed during the following year.

23.21 While giving the directors the power to fix the auditors' remuneration might give rise to a perception of a very close relationship between the directors and auditors, it should be noted that:

(a) once the auditors' remuneration had been fixed, the shareholders were powerless to take any further action until the following AGM;

33 Appendix 16 to the Main Board Listing Rules, para 24 and Chapter 17 of the Main Board Listing Rules, para 17.07.

34 Consultation Paper, Accounting and Auditing Provisions, Chapter 6, March 2007, para 6.9(b).

35 Consultation Conclusions on the Accounting and Auditing Provisions in the Companies Ordinance, 26 March 2008, Appendix III.

36 The expression 'liquidator' for the purpose of determining an auditor's term of appointment should exclude a provisional liquidator. Although, sections 131 and 132 of the former CO contain provisions on the termination of an auditor's office, there was no reference to the termination of an auditor's office upon the appointment of a liquidator who will be responsible for ensuring that the company's accounts are properly preserved and checked.

37 Consultation Paper, Accounting and Auditing Provisions, Chapter 6, March 2007, para 6.9(c).

38 Consultation Conclusions on the Accounting and Auditing Provisions in the Companies Ordinance, 26 March 2008, Appendix III.

39 CGR Phase II, para 22.15.

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(c) increase in specialisation and the coming together of different professions in the partnership;

(d) the risk to a partner's personal assets when a claim exceeded the sum of the assets and insurance cover of the partnership.[50]

Limited liability partnerships help to mitigate the unreasonably high risks

24.48 In comparison, LLPs go part of the way to redressing some of the unreasonably high risks which operating in a traditional partnership structure brings. They combine organisational flexibility and the status of the traditional partnership structure with limited liability. LLPs would perpetuate many of the elements of the traditional partnership structure such as:

(a) the trust that comes from the partner's duty of good faith towards each other;

(b) willingness to share clients and resources;

(c) common involvement in developing the firm's business and its people;

(d) sharing financial rewards.[51]

24.49 However, the LLP, not its members, would be liable to third parties, but the negligent member's personal assets would still be at risk.[52] In addition, the tax advantages of an LLP would be the same as that of a partnership.[53] While a change in the membership of a LLP would have the same effect as the change in membership of a partnership.[54] In short, LLPs would address the inequity of the unlimited personal liability of a partner for the actions of his fellow partners. At the same time, it would not substantially affect the rights of a claimant as limited liability of the partners did not prevent recovery against the firm and the wrong doing partners. It merely prevented access to the assets of the innocent partners, other than their interest in the LLP.[55]

The report of the Law Society's working group on limited liability partnerships

24.50 The Report of the Law Society's Working Party on Limited Liability Partnerships considered in detail the various types of models for a LLP; the arguments for and against having a legal personality for an LLP; the partnership model of an LLP versus a corporate model; the impact on consumer interests; and the liquidation of a LLP.[56] The HKICPA fully supported the Law Society's recommendation that a partnership model (with full liability shield) based on elements from the LLP legislation in the Canadian Province on Ontario and the US State of New York should be adopted in Hong Kong.[57]

24.51 The Legal Practitioners (Amendment) Ordinance 2012 (Ord No 22 of 2012) introduced a new Part IIAAA 'Limited Liability Partnerships' in the Legal Practitioners Ordinance (Cap 159). As a consequence, it is now possible for law firms to become LLPs. However, it is understood that the number of legal practices opting to become LLPs has been low due to some 'compromise' elements in the legislation which have limited the benefits of LLP status.

50 Ibid para 3.3.
51 Ibid para 3.2.
52 Ibid para 3.4.
53 Ibid para 3.6.
54 Ibid para 3.7.
55 Ibid para 3.9.
56 Ibid para 5.1.

Statutory Capping

Proportionate liability does not provide a complete solution

24.52 The fourth major proposal by the HKICPA regarding liability reform, namely statutory capping, was one which did not feature in the submission to the Government dated 14 March 2005, but is now the Institute's favoured approach. While the adoption of proportionate liability would help auditing firms faced with a massive claim, it would not mitigate the risks faced by a firm in the case of a mega law suit. In the words of Richard George, a partner at Deloitte China: 'The resources even of large audit firms with captive insurance are tiny in comparison to the market capitalisation of their largest clients. A firm that is held 30% liable on a very large claim will still go out of business.'[58] Paul Winkelmann, a Past President of the HKICPA considered that: 'The cap must be set at a high enough level so that the firm will be hurt and accountable, but it will still save the firm from going out of business and hurting the financial markets.'[59] A recent example of the huge potential liabilities faced by auditors, where capping would be beneficial, was the claim of US$1 billion against Ernst & Young in relation to the collapse of the electronics firm, Akai.

Problems with setting a level for the cap

24.53 However, a major difficulty with capping is how to set the level for the cap. According to Peter Tisman, the HKICPA's Director of Advocacy and Practice Development: 'In some cases, the cap has been set following discussions with the insurance market and the government about what is insurable. In other situations, they have made a judgment based on reasonable past histories of claims. So there isn't one single answer to how you establish your cap.'[60] Another issue is whether capping can protect middle-tier auditing firms. At present, the Big Four firms audit 80% of Hong Kong's listed companies, while the balance is split up

57 Ibid para 5.2 and the Law Society's Paper, Section 6.
58 Martig, 'Containing Liability', A Plus, October 2009 at p 20, available at http://app1.hkicpa.org.hk/APLUS/0910/Aplus_liability.pdf.
59 Ibid p 20.
60 Ibid p 21.