

## CHAPTER 2

### ENHANCING CORPORATE GOVERNANCE

- 2.1 The SCCLR conducted an overall review of corporate governance in Hong Kong (CGR) in 2000 to 2004.<sup>10</sup> Major recommendations arising from the CGR to enhance shareholders' remedies, including the introduction of a statutory derivative action and enhancement of shareholders' access to company records, were implemented in July 2005 by means of the Companies (Amendment) Ordinance 2004. Some other recommendations of the CGR, such as the proposal to set up a body with authority to investigate financial statements and enforce necessary changes to the companies' financial statements, have been implemented through other legislative initiatives.<sup>11</sup> The remaining recommendations that would require legislative changes are being taken forward in the CO rewrite.
- 2.2 In the course of the rewrite, the SCCLR has further explored a number of corporate governance issues. The key proposals 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) providing greater transparency and improving disclosure of company information, such as new requirements for listed and certain unlisted companies to prepare a directors' remuneration report and business review;
  - (d) strengthening auditors' rights, such as providing auditors with a right to require information from a wider group of persons;
  - (e) 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
  - (f) fostering shareholder protection, such as introducing more effective rules to deal with directors' conflicts of interests and enabling

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<sup>10</sup> Two consultation papers on proposals made in the CGR and the final recommendations are available at <http://www.cr.gov.hk/en/standing/consultation.htm>.

<sup>11</sup> The Financial Reporting Council Ordinance (Cap 588) was enacted in 2006.

shareholders of a company to commence a statutory derivative action on behalf of a related company.

- 2.3 We believe that the above 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.

## **Strengthening Accountability of Directors**

### *Codifying directors' duty of care, skill and diligence*

- 2.4 The issue of whether directors' general duties (including fiduciary duties<sup>12</sup> and duty of care, skill and diligence) should be codified was put to public consultation in the second quarter of 2008. Responses were highly divided. We conclude that it would be premature to go down the route of comprehensive codification at this stage.<sup>13</sup>
- 2.5 Nevertheless, we see some merit in clarifying the directors' standard of care, skill and diligence as proposed by some respondents. The standard in the old case law<sup>14</sup> focusing on the knowledge and experience which a particular director possesses is too lenient nowadays. Other comparable jurisdictions like the UK have developed a so-called "mixed objective/subjective test" with an objective standard of care expected of directors and a subjective test looking at the personal attributes of a particular director on top of the objective standard.<sup>15</sup>
- 2.6 In the absence of a clear authority under the common law in Hong Kong in this respect, there is some uncertainty as to how far the "mixed objective/subjective test" will be applied by the Hong Kong courts. We therefore recommend introducing a statutory statement on the duty of care, skill and diligence in the CB (**Clause 10.13**) to clarify the law and provide guidance to directors.
- 2.7 We believe that the adoption of the statutory statement would be conducive to enhancing corporate governance in Hong Kong. We propose that the statutory statement should replace the corresponding common law rules and equitable principles as the retention of such rules and principles may result in dual standards and hinder the development of the statutory provision.

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<sup>12</sup> Fiduciary duties that apply to directors include: (i) duty to act in good faith in the interests of the company, (ii) duty to exercise powers for proper purpose, (iii) duty to refrain from fettering his own discretion, (iv) duty to avoid conflicts of duty and interest, and (v) duty not to compete with the company. They arise from equitable principles.

<sup>13</sup> See FSTB, *Consultation Conclusions on Company Names, Directors' Duties, Corporate Directorship and Registration of Charges* (December 2008), paragraphs 17 to 20 (available at [http://www.fstb.gov.hk/fsb/co\\_rewrite](http://www.fstb.gov.hk/fsb/co_rewrite)).

<sup>14</sup> The subjective test is based on *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 428.

<sup>15</sup> Section 174 of the UKCA 2006.

## *Restricting the appointment of corporate directors*

- 2.8 Since 1985, all public companies and private companies which are members of a group of companies of which a listed company is a member have been prohibited from appointing a body corporate as their director, whereas other private companies can continue to have corporate directors.
- 2.9 After consulting the public in the second quarter of 2008, we propose to restrict corporate directorship by requiring every company to have at least one natural person as its director after a grace period as in the UK.<sup>16</sup> We believe this will strike an appropriate balance between enhancing corporate governance and transparency and the legitimate commercial need for flexibility. It should also be able to meet the anti-money laundering and counter-terrorist financing concerns of the Financial Action Task Force to a large extent.

## **Improving Transparency and Disclosure of Company Information**

### *Directors' remuneration report*<sup>17</sup>

- 2.10 In recent years, there has been increasing public concern over the remuneration of directors, particularly those of listed companies. The SCCLR has recommended raising the level of transparency in respect of directors' remuneration packages so as to enhance accountability to members.
- 2.11 We propose that a separate directors' remuneration report should be prepared by:
- (a) all listed companies incorporated in Hong Kong; and
  - (b) unlisted companies where holders of not less than 5% of the total voting rights of all the members so request.
- 2.12 The directors' remuneration report should cover various types of benefits given to the individual directors by name, including the basic salary, fees, housing and other allowances, benefits in kind, pension contributions, bonuses, payment for loss of office and long-term incentive schemes including share options. It should be approved by the board of directors and signed on behalf of the board by a director. With the exception of service contracts, the information in the report should be subject to audit requirements.

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<sup>16</sup> See **Clause 10.5** of the CB and paragraphs 2 to 4 of Explanatory Notes on Part 10.

<sup>17</sup> Provisions will be included in Part 9 of the CB to be covered in the second phase consultation paper.

2.13 We propose that detailed provisions on directors' remuneration report should be prescribed in subsidiary legislation so as to facilitate regular updating in the future. The subsidiary legislation will be prepared in due course in consultation with the SFC and SEHK to ensure that the requirements on the directors' remuneration report will be in line with similar rules applicable to all listed companies under the Listing Rules.

*Business review*<sup>18</sup>

2.14 We propose that public companies and those private and guarantee companies that are not eligible for preparing simplified accounts and simplified directors' reports (see paragraphs 4.2 to 4.4 below) should be required to prepare a more analytical and forward-looking business review as part of the directors' report. Specifically, the business review should include, among other things:

- (a) a fair review of the business of the company;
- (b) a description of the principal risks and uncertainties facing the company;
- (c) particulars of any important events affecting the company which have occurred since the end of the financial year;
- (d) an indication of likely future developments in the business of the company; and
- (e) a balanced and comprehensive analysis of the development, performance or position of the business of the company and, to the extent necessary for an understanding thereof, include:
  - (i) analysis using financial key performance indicators; and
  - (ii) if having a significant impact on the company,
    - a discussion on the company's environmental policies and performance, including compliance with the relevant laws and regulations; and
    - an account of the company's key relationships with employees, customers, suppliers and others, on which its success depends.

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<sup>18</sup> Provisions will be included in Part 9 of the CB to be covered in the second phase consultation paper.

- 2.15 The proposed requirement to include in the business review information relating to environmental and employee matters that have a significant impact on the company is in line with international trends to promote corporate social responsibility.
- 2.16 We expect the new requirement to prepare a business review will not impose a significant burden on private companies as only a small number of larger private companies where the shareholders have not opted for the simplified accounts and simplified directors' report would be subject to that requirement. Detailed provisions on the directors' report including business review will be stipulated in subsidiary legislation to be made after the CB is passed by the LegCo, so as to facilitate regular updating in the future.

*Measures to enhance the timeliness and transparency of company information and proceedings*

- 2.17 The CB will introduce a number of measures to enhance the timeliness and transparency of company information and proceedings. For example:
- (a) a comprehensive set of rules for proposing and passing written resolutions will be introduced in Part 12.<sup>19</sup> This is expected to benefit shareholders of SMEs in particular, as SMEs often use written resolutions for their decision-making; and
  - (b) members of a company will be given a right to inspect voting records and documents (including proxies and voting papers) after a general meeting so as to improve the transparency of the voting process.<sup>20</sup>

**Strengthening Auditors' Rights<sup>21</sup>**

- 2.18 In view of the increasingly important functions that auditors are required to perform on the corporate governance front, we propose to strengthen auditors' rights in the following aspects:
- (a) auditors will be provided with qualified privilege for statements made in the course of their duties as auditors and in respect of their ceasing to hold office as auditors under the CO. Auditors will not, in the absence of malice on their part, be liable to any action for defamation at the suit of any person in respect of any oral or written statement which they make in the course of their duties as auditors and in respect of their ceasing to hold office as auditors;

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<sup>19</sup> See paragraphs 4 to 7 of Explanatory Notes on Part 12.

<sup>20</sup> See paragraphs 19 to 20 of Explanatory Notes on Part 12.

<sup>21</sup> Provisions will be included in Part 9 of the CB to be covered in the second phase consultation paper.

- (b) auditors will be empowered to require from a wider range of persons, including, among others, the employees of the company and the officers and employees of its Hong Kong subsidiaries, and any person holding or accountable for any of the company's or subsidiaries' accounting records,<sup>22</sup> to provide them with information, explanations or other assistance as they think necessary for the performance of their duties as auditors;
- (c) where a holding company has a subsidiary undertaking which is not a company incorporated in Hong Kong, the auditor may also require the holding company to obtain from the relevant persons or parties, such as the undertaking concerned or the officer, employee or auditor of the undertaking, such information, explanations or other assistance as the auditor may reasonably require for the purposes of his duties as auditor; and
- (d) an outgoing auditor<sup>23</sup> will be required to provide a statement of any circumstances connected with his ceasing to hold office that he considers should be brought to the attention of the members or creditors of the company or a statement of no such circumstances.

## **Enhancing Shareholders' Engagement in Decision-making Process**

2.19 Shareholders have a key role to play in driving company performance and economic prosperity. We aim to promote wider participation of shareholders and ensure that they are informed and involved. The Bill will introduce a number of measures to enhance shareholders' rights in the decision-making process. These include, among others:

- (a) providing members with a right to propose a resolution to be moved at a meeting which they have requested to be convened;<sup>24</sup>
- (b) requiring companies to circulate at their expense members' statements relating to the business of general meetings and proposed resolutions for AGMs, if they are received in time for sending together with the notice of the meeting;<sup>25</sup>

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<sup>22</sup> The auditors' current rights to information as set out in sections 133(1) and 141(5) of the CO are considered to be too restrictive. For example, under section 133(1), only a Hong Kong subsidiary and its auditor have the duty to give information and explanation. Under section 141(5), the auditor may request only the officers of the company, but not company employees, for information and explanation.

<sup>23</sup> An "outgoing auditor" covers an auditor who ceases to hold office owing to removal from office, resignation or not being reappointed upon expiration of the term of office. The right is broader than the current right of a resigning auditor under section 140A of the CO to make a similar statement.

<sup>24</sup> See paragraphs 8 to 9 of Explanatory Notes on Part 12.

<sup>25</sup> See paragraphs 10 to 13 of Explanatory Notes on Part 12.

- (c) lowering the threshold requirement for the right to demand a poll from 10% to 5% of the total voting rights;<sup>26</sup> and
- (d) clarifying the rights of a proxy and enhancing members' rights to appoint proxies, such as removing the restriction for a proxy to vote on a show of hands unless provided by the articles, and enhancing shareholders' rights to appoint multiple proxies.<sup>27</sup>

2.20 The use of new information technology will facilitate timely access to company information by shareholders and their communications with the company. The CB will introduce rules to facilitate communications between a company and its members in electronic form or by means of a website. All companies, subject to members' approval, will be able to use electronic communications with members as a default position, permitting companies to use email and websites to communicate with their members. Individuals will be able to request communication in paper form if they wish.<sup>28</sup>

2.21 To keep up with technological development, the CB will also permit a company to hold a general meeting at two or more places using any audio-visual technology that enables the members of the company to exercise their right to speak and vote at the meeting.<sup>29</sup>

### **Fostering Shareholder Protection**

2.22 We will reform the rules in the CO on directors' self-dealing and connected transactions involving directors to make them more effective. On the one hand, we will remove restrictions that are excessive or unnecessary. For example, there will be a general members' approval exception permitting all companies to make loans or enter into similar transactions in favour of their directors or connected persons, if those transactions are approved in a general meeting.<sup>30</sup> We will also decriminalise provisions which restrict loans and similar transactions in favour of directors and connected persons (section 157H of the CO) to avoid the danger of over-deterrence as civil remedies are more appropriate for cases involving directors' duties of loyalty.<sup>31</sup>

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<sup>26</sup> See paragraphs 16 to 18 of Explanatory Notes on Part 12.

<sup>27</sup> See paragraphs 21 to 24, 40 to 41 of Explanatory Notes on Part 12.

<sup>28</sup> See paragraphs 36 to 37 of Explanatory Notes on Part 12 and paragraphs 7 to 16 of Explanatory Notes on Part 18.

<sup>29</sup> See paragraphs 14 to 15 of Explanatory Notes on Part 12.

<sup>30</sup> In the case of public companies, disinterested members' approval will be required. We are consulting in Chapter 6 on whether any private companies associated with a public or listed company should be subject to the same requirement.

<sup>31</sup> See paragraphs 6 to 12 of Explanatory Notes on Part 11.

2.23 On the other hand, more stringent rules will be introduced to plug possible loopholes and to safeguard the interests of minority shareholders.<sup>32</sup> These include:

- (a) requiring companies to keep directors' service contracts available for members' inspection and requiring members' approval for director's long-term employment exceeding 3 years;
- (b) extending the loss of office payment provisions to include payment to a connected person and payment by a company to a director of its holding company;
- (c) requiring members' approval for substantial property transactions; and
- (d) widening the ambit of disclosure currently under section 162 of the CO, for example, to cover "transactions" and "arrangements" instead of just "contracts", and to disclose the "nature and extent" of one's interest instead of just disclosing the "nature" of the interest.

2.24 While shareholder remedies under the CO have been substantially enhanced in 2005 as noted in paragraph 2.1 above, there is room for further improvement. In addition to consolidating all existing provisions concerning shareholder remedies into a distinct part (Part 14) of the CB, some changes are proposed to improve the operation of the unfair prejudice remedy and statutory derivative action, including:

- (a) extending the scope of the unfair prejudice remedy to cover "proposed acts and omissions";
- (b) enhancing the court's discretion in granting relief in cases of unfair prejudice; and
- (c) allowing a member of a company to bring a statutory derivative action on behalf of a related company ("multiple derivative action").<sup>33</sup>

2.25 We are consulting in Chapter 9 below whether there is still a need to preserve the common law derivative action as a shareholder remedy.

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<sup>32</sup> See Explanatory Notes on Part 11.

<sup>33</sup> See Explanatory Notes on Part 14.