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Dear Sirs,

Exposure of Draft Code on Corporate Governance Practices and Corporate Governance Report

The Legal Committee of the Hong Kong General Chamber of Commerce ("the Committee" or "we") wishes to express certain views and make certain suggestions in respect of the above.

The Chamber, and this Committee, have consistently been strong supporters of corporate governance and for a long time have held the view that generally applied standards of governance in the Hong Kong market needed to be materially improved. Indeed, before it became clear, a year or so ago, that HKEx and the SFC were committed to the preparation and introduction of a Code, a Chamber Working Group was making constructive progress on the draft of a Code specifically tailored to the Hong Kong market, with the involvement of several major issuer members of the Chamber. In principle we therefore wholeheartedly support the introduction of the Code, as soon as practicable.

In those circumstances we propose to limit our specific comments. Additionally we support the proposed "comply or explain" approach, which creates encouragement to comply while providing flexibility, and also in our opinion reduces the need for much of the debate which might have been necessary in respect of provisions with mandatory compliance. We will however qualify that comment below.

On that basis, the points which we wish to make are set out below. Individual members of the Committee do have reservations about a number of other specific items in the draft Code, and our views in paragraph (ix) below are particularly relevant to such concerns. Our points are as follows:-

i) A.1.6 Minutes

It is not normal, and we consider it too broad a requirement, that minutes should record "any concerns raised by directors". It is healthy that concerns

should be raised, since otherwise the board's business would be unlikely to be adequately discussed, but they are only material if the director raising them is not satisfied. We suggest that the first sentence of A.1.6 should end after the words "decisions reached", and that the following sentence, which closely follows the UK Combined Code, should be inserted after that: "Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns, and dissenting votes if applicable, are recorded in the board minutes."

ii) *A.2 Chairman and Chief Executive Officer*

Compliance with the Principle and the proposed Code Provision A.2.1 will clearly represent a major problem for a high percentage of listed issuers in Hong Kong. The prevalence of controlled companies in the Hong Kong market (as in other Asian markets) is of course one of the biggest hurdles, if not the biggest, to a visibly effective governance regime. Inclusion of the word "visibly" is important, since there is no doubt that a significant number of controlled companies is in practice better managed because of a controlling shareholder, who has the greatest motive, by virtue of his stake in the company, to ensure that it performs well, and who may have a better vision of the long term objectives of the company than would many an uncontrolled board. However, there is also no doubt that a significant number of companies is worse managed because of a controlling shareholder, for a variety of reasons.

We expect relevant issuers who can reasonably justify their controlled status and the combination of the offices of chairman and chief executive to find ways of doing so in their governance reports. We are however more concerned about controlled companies who seek to avoid the issue by appointment of a titular chief executive who in practice is wholly subordinate to the wishes of the chairman/principal shareholder. We suggest that consideration should in any case be given to imposing an extra level of "comply or explain" provisions upon controlled companies generally, as well as those which do not separate the roles of chairman and CEO. We attach as Annex One some provisions relevant to that suggestion; they are in fact taken from initial drafting in early 2003 within the Chamber's Working Group as referred to in the introductory paragraphs of this letter, although the comments are added for the purposes of this submission.

However, in the context of our preliminary views, we accept that achieving an early target date for introduction of the Code is of great importance. If full consideration of the issue we raise above, and of the additional provisions we have suggested, or others on the subject, would materially defer the date of introduction of the Code, it would probably be better to hold the topic over for future review. Paragraph (ix) below is further relevant to that. However, on the particular issue of the separation of the roles of chairman and chief executive we would then suggest that such separation might best be introduced as a best practice only.

iii) *A.2.4 Agenda*

We suggest that the last five lines should be simplified to refer to the chairman's responsibility for ensuring compliance with Code Provision A.6.1 (which we refer to below) and the first sentence of Code Provision A.6.2, and that the agenda includes any item which any director has requested to be included. We believe that the five lines as drafted do not represent normal good practice, and that the suggested treatment of matters proposed by other directors may be questionable legally as well as on other grounds.

iv) *A.4 Appointments, re-election and removal*

In paragraph A.4.3, under Recommended Best Practices, we suggest, again in connection with controlled companies, in which the independence of the non-executives is most critical anyway, that the controlling shareholder should be allowed to vote on maintaining the independent status of a long standing non-executive director if he wishes to oppose the relevant resolution, but otherwise should be required to abstain: without that amendment the shareholder approval in the relevant circumstances would be a mere formality. For the avoidance of doubt we make this point only in relation to para A.4.3, and would not support it in respect of the election of independent non-executive directors generally. We suggest that the subject of this paragraph is sufficiently important that it should be a Code Provision rather than a Best Practice.

v) *A.4.4 Nomination Committee*

On a drafting technicality, we suspect that paragraph A.4.4 does not reflect the true intention, that issuers should establish a nomination committee a majority of the members of which are independent non-executive directors.

vi) *A.6.1 Agenda and Board Papers*

We consider that the words "other than in exceptional circumstances" should be deleted and replaced by the words "In respect of normal scheduled board meetings, and in other cases so far as practicable,". A new sentence should then be added at the end of the paragraph: "In other cases all reasonable efforts should be made to deliver the agenda and related board papers to all directors in time that they at least have an opportunity to read them before the board meeting." Reality is not reflected in the existing draft.

vii) *C.3 Audit Committee*

We are uncomfortable with the differences between paragraph C.3.4 of the Exposure Draft, on the situation where the board disagrees with the audit committee on the appointment or removal of the external auditors, and paragraph C.3.6 of the UK Combined Code:

- while the reference to resignation of the auditors is fair in principle, and is not, we observe, covered in the UK Combined Code, we consider that if it is to be included in the Hong Kong Code its proper place is within paragraph C.3.2, as a matter for review by the audit committee of the reasons for the auditor's resignation and submission of such views as it sees fit to the board: this is primarily an internal matter, and we consider it dangerous that it should be arbitrarily ruled to be one where any difference of views between the audit committee and the board should be reported to the shareholders;
- on the other circumstances referred to in the subject paragraph, we consider that the wording of paragraph C.3.6 of the Combined Code, that the annual (corporate governance) report should include "a statement from the audit committee explaining the recommendation" is clearer and better than the wording of the draft Hong Kong Code that the "issuer should include ... a detailed explanation of the audit committee's view".

viii) *Draft Listing Rules on Corporate Governance Report*

Mandatory Disclosure Requirements:- (i) Audit Committee. The wording of sub-paragraph (iii) needs to be reviewed. It may not have been the intention, but as worded the draft suggests that the audit committee has to report to shareholders on its findings on review of the accounts etc. That would of course be against the concept of the role of the audit committee, and quite possibly also contrary to legal principles. The audit committee can report to shareholders that it has reviewed the relevant matters, and has discharged its functions. It should not report on any "findings", or even whether there were any findings: those are matters strictly between the audit committee and the board. See paragraph C.3.3 of the UK Combined Code for a better presentation.

ix) *The need for ongoing review*


We appreciate and agree generally with the reasons expressed in the Introduction to the Exposure Draft as to why some provisions of the UK Combined Code have been omitted. We believe that a higher level of genuine acceptance and compliance is likely to be achieved in Hong Kong if the benchmarks are not immediately set at the recently introduced levels of the UK Combined Code. By "genuine" we mean acceptance of the substance as well as of the form: there is obviously a risk that acceptance will be in form only, and while that may have a short term benefit to claims that can be made of Hong Kong's international benchmarking status, such claims will need to be substantiated over the coming years by visible actual improvements in both business conduct and financial results.

For that purpose we consider that continuous ongoing review is essential. It should however be realistic. Strengthened or additional Code Provisions and Best Practices may become feasible and appropriate: but if it becomes evident

that compliance with some provisions is not practicable for the Hong Kong market generally, we believe that acceptance of that fact may become preferable to continuing with a veneer of imported benchmarks which the corporate and investment community regard as being irrelevant through lack of real observance.

In such circumstances we believe that there is, or will be, an available choice between making compliance with certain provisions obligatory, or making amendments in the Code appropriate to the Hong Kong market. The latter is likely to be the better, or only practicable, choice on some issues. The views which we have expressed in paragraph (ii) above relate to a particular, and very important, topic to which our above comment may be found relevant, and our attached drafting suggestions on that indicate, we believe, that there is scope for tailored provisions to go at least some way to adopt concepts of a code of governance to specific local conditions which may practically and sensibly be measured as long term if not permanent.

Yours faithfully,



Kenneth Ng
Chairman
Legal Committee

ANNEX ONE

Suggested additional Code Provisions for controlled companies and for companies which do not separate the roles of chairman and chief executive (including a situation in which the chairman and chief executive are related)

- i) The board should consider the appointment of a separate and unrelated managing director or a chief operating officer, who should also be a director.
- ii) One of the independent non-executive directors should be recognised as the senior non-executive director, who will generally convene and chair meetings of independent directors as appropriate.
- iii) The independent non-executive directors should be particularly aware of the need for independent judgment and comment, and should consider the need for separate meetings of the independent directors, potentially with the attendance of executive directors unrelated to the chairman, on any issue which might be affected by the lack of separation of and distinction between the posts of chairman and chief executive officer, or by the status of the company as a controlled company.
- iv) There should be a designated senior compliance officer, who should not be a director or the head of the finance function but may be the company secretary, and who is fully accessible to the audit committee and to any meeting of the independent directors.
- v) None of the head of finance, the company secretary or the senior compliance officer should have a relationship with any director, other officer or shareholder of the company which prejudices their independence.
- vi) The individuals holding the offices referred to in paragraph (iv) and (v) should be identified in the annual report.

In relation to (ii) above we consider that companies to which this Annex relates should recognise a senior non-executive director, as issues of compliance are materially more sensitive in these cases.

We note in relation to (iv) above that the present Main Board listing rules require a qualified accountant who will oversee both finance and compliance functions. In view of the fact that many issues, and problems, of compliance involve financial elements, and therefore potentially the finance function, we regard it as essential that there is an identified senior compliance officer who is neither a director nor the head of finance. Indeed we consider that the best practice is that the head of compliance should be neither a director nor the head of finance, and that while the head of finance should be responsible for compliance within the finance function, in respect of the compliance function he should be answerable to a non-director head of compliance. Such arrangements should indeed be generally applicable, but are particularly important for companies to which this Annex applies.

We suggest additionally that in the context of the prevalence of controlled companies in the Hong Kong market, and to correct certain misunderstandings of the common law duties of directors which may also be common, an expanded version of the last

sentence of Principle A.1 should be considered as a Code Provision. We put forward the following version:-

- vii) Each director should acknowledge and act on the basis that the duty of a director is at all times to consider the interests of the company as a whole, and not personal interests of himself or herself or a specific shareholder or group of shareholders. Directors should speak and vote at board meetings according to the same principle, or should abstain if they cannot act independently. This standard may be qualified where non-executive directors are specifically considering the interests of independent shareholders in a connected transaction. Where a director is an interested party, the other directors should be particularly conscious of the need to act impartially.

Members of the Committee suggest from personal experience that greater emphasis than is constituted by the proposed Recommended Best Practice in paragraph A.2.6 would be appropriate in Hong Kong to support a progressive objective that executive directors, as much as non-executive directors, should participate substantively in board meetings, and that chairmen/chief executives should encourage that. Non executive directors who hear nothing but the chairman's presentation and views on each agenda item at a meeting are seriously handicapped in contributing to the best possible effect, and a board which operates in such a manner is likely also to act in a manner which renders the Code of Governance as a whole largely ineffectual. Our above proposal reflects the non-statutory Guidelines on Directors' Duties recently published by the Companies Registry, but introduces two or three practical points.