

## Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below on the proposed change discussed in the Consultation Paper downloadable from the HKEx website at: <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201406.pdf>

Where there is insufficient space provided for your comments, please attach additional pages.

1. Do you agree with our proposal to amend the title of Section C.2 of the Code to “Risk management and internal control”?

Yes

No

Please give reasons for your views.

*Yes, since this is consistent with the practice of other countries.*

2. Do you agree with the proposed amendments to Principle C.2 to define the roles of the board and the management, and state that the management should provide assurance to the board on the effectiveness of the risk management systems? Is the intention of the proposed wording sufficiently clear?

Yes, subject to the recommendations provided below

No

Please give reasons for your views.

*We agree with the direction taken by the Exchange in amending the Principle. We believe that it is important that issuers clearly delineate the roles of the Board and management with respect to these systems. However, we would recommend that the Exchange also includes some clarification to the effect that the Principle is not implying that the Board is able to delegate its responsibility for the systems to management.*

*Further, we do not think that, when translating the Principle into the Code Provisions and Recommended Best Practices, the wording used is sufficiently clear. This is further explained below and in our answers to the other questions that follow. We agree with the new wording that sets out that the Board is responsible for "evaluating the nature and extent of the risks it is willing to take in achieving the issuer's strategic objectives...". However, it is not clear to us how this expectation then becomes a required action in a CP. The only directly applicable action appears to be C.2.3 (a) which simply requires a consideration of the changes since the last review in the nature and extent of significant risks and the issuer's ability to respond to changes in its business and the external environment. We would recommend that the CP is more closely aligned with the wording and spirit of the new Principle wording.*

*We also agree with the concept that management should provide the Board with some level of formal assurance or comfort as to the outcome of its review and monitoring of the systems in question. However, in order to avoid confusion and to promote a common understanding of what this means in practice, we recommend that the code provides further detail on what is meant by assurance and how it should be delivered (as the concept is normally reserved for assurance by an independent party). For instance, applying the concepts used in auditing literature, assurance could encompass either reasonable or limited levels of assurance. It is also not clear (when reporting under C.2.6) whether the issuer should report the fact that management has only been able to provide qualified assurance due to control deficiencies identified during the period, where this situation arises.*

3. Do you agree with our proposal to introduce an amended RBP (C.2.6) to provide that the board may disclose in the Corporate Governance Report that it has received assurance from management on the effectiveness of the issuer's risk management and internal control systems? Is the intention of the proposed wording sufficiently clear?

Yes

No

Please give reasons for your views.

*As stated in our answer to question 2 above, we agree with the newly worded Principle, including the concept that management should provide assurance to the Board on the effectiveness of risk management systems. However, it would therefore appear to us to be more appropriate that the requirement for the board to receive assurance from management as to the effectiveness of the issuer's risk management and internal controls systems should be a "comply or explain" CP. Including a disclosure requirement in a Recommended Best Practice is, in our view, an insufficiently direct approach to implementing this principle. Including the action in a "comply or explain" CP would have the desired effect of requiring disclosure if an issuer does not implement this action.*

4. Do you agree with the proposed amendments to CP C.2.1 to state that the board should oversee the issuer's risk management and internal control systems on an ongoing basis? Is the intention of the proposed wording sufficiently clear?

Yes, subject to the recommendations below

No

Please give reasons for your views.

*In general, we agree with the concept that the Board has the responsibility to oversee the systems on an ongoing basis. However, we do not believe that the wording used in respect of the review (to be conducted at least annually) is sufficiently clear. The original wording made it clear that the Board itself is responsible for conducting this review. However, by using the passive voice ("the board should...ensure that a review...has been conducted at least annually") gives the reader the impression that this review is not the Board's direct responsibility and was the ultimate responsibility of management instead. We do not believe this is the intention as C.2.3 states "The board's annual review...". We would recommend that the wording in C.2.1 be made clearer to avoid any misunderstandings.*

5. Do you agree with our proposal to upgrade to a CP the existing RBP C.2.3, which sets out the matters that the board's annual review should consider?

Yes

No

Please give reasons for your views.

***We agree with the upgrading of this RBP as we feel that these are all important actions that issuers should be implementing. However, we think that there is a need for a requirement for issuers to disclose risks themselves in their annual reports, together with information on how they are being addressed, similar to a prospectus for an IPO or to the annual reporting requirements in other jurisdictions. Issuers face a number of key risks that readers of their annual reports are interested in seeing identified and mitigated i.e. cyber security, data privacy, bribery and corruption, etc..***

6. Do you agree with our proposal to upgrade to a CP the existing RBP C.2.4, which sets out the particular disclosures that issuers should make in their Corporate Governance Reports in relation to how they have complied with the internal control CPs during the reporting period?

Yes

No

Please give reasons for your views.

***Yes, in general, but this should not be a requirement to disclose information on individual internal controls as this would be too detailed.***

7. Do you agree with our proposal to amend the wording of proposed CP C.2.4 to simplify the requirements and remove ambiguous language, and to make clear that the risk management and internal control systems are designed to manage rather than eliminate risks? Is the intention of the proposed wording sufficiently clear?

Yes

No

Please give reasons for your views.

*Yes, the changes and simplifications are appropriate.*

*The additional wording in C.2.4 (c) is appropriate as it is a generally accepted view in professional literature and guidance that risk management and internal controls systems do not have the purpose of, or capability to, eliminate risk.*

8. In relation to proposed CP C.2.4, do you agree with our proposal to upgrade the existing recommendation that issuers disclose their procedures and internal controls for handling and disseminating inside information (Section S., paragraph (a)(ii)), and amend it to include the handling of “other regulatory compliance risks”?

Yes

No

Please give reasons for your views.

*In our view, there is insufficient explanation in the consultation paper to understand why the specific issue of handling and dissemination of inside information has been specifically identified for disclosure. This is one of the many risks that an issuer faces, and systems for handling it could be quite difficult to describe on a stand-alone basis (as it is an area that is integral to the financial reporting process as a whole but also relates to many aspects of an issuer's systems and operations). Rather, we would recommend for the Exchange to perform a separate and more detailed analysis of the need for issuers to explain the significant risks they face in relation to inside information and on how these are being addressed. If it is determined that such disclosure is required, this could be provided for elsewhere in the corporate governance report.*

*Disclosure of how "other regulatory compliance risks" are handled is valid provided this information relates to overall compliance systems, as opposed to individual compliance risks. However, the requirement is arguably already covered by C.2.4 (a).*

9. Do you agree with our proposal to upgrade to Mandatory Disclosures the following existing Recommended Disclosures in relation to internal controls (Section S.):

- (a) whether the issuer has an internal audit function;
- (b) how often the risk management and internal control systems are reviewed, the period covered, and where an issuer has not conducted a review during the year, an explanation why not;
- (c) a statement that a review of the effectiveness of the risk management and internal control systems has been conducted and whether the issuer considers them effective and adequate; and
- (d) significant views or proposals put forward by the audit committee?

Yes, partly

No

Please give reasons for your views.

- a) *We agree with this. We are also in agreement with the Exchange's views expressed in the consultation paper that the internal audit function could be outsourced. However, we would suggest that this clarification is inserted into the notes to the Mandatory Disclosure for the avoidance of doubt.*
- b) *Whilst we agree that it is useful to disclose "how often the risk management and internal control systems are reviewed", we do not believe that it is meaningful to require a disclosure of the period under review as this is required to be on at least an annual basis anyway. In practice, most issuers will either perform one review annually or spread the work over the year and adopt some form of rotation plan so that material risks are covered over a longer period). We further believe that it is not necessary to require a specific Mandatory Disclosure as to why a review has not been performed as this is already a CP which requires an issuer to make this disclosure in the event that they have not implemented the CP.*
- c) *A statement that a review of the effectiveness of the risk management and internal control systems has been conducted – this overlaps with the general CP requirement (as mentioned in b) above). The statement whether the issuer considers the systems to be effective and adequate – inclusion of this requirement is, in our view, a favourable development but leads to a number of issues which is not clear that the Exchange has considered in detail – what is the basis for "effective" and "adequate"? Does the Exchange envisage some form of attestation process similar to Sarbanes-Oxley Section 404 in the US, especially given that the term "assurance" is used in the revised CP, as discussed in question 2 above? Even if this requirement is included in the finally-issued CP as it stands, with the Exchange expecting issuers to define "effective" and "adequate" for themselves, issuers may still resist the requirement on the basis that no framework has been provided.*
- d) *We suggest not to include this on the basis that it may have the unintended consequence of discouraging free exchange of views between the audit committee and the rest of the Board. It is also difficult to define which of the proposals or views put forward would be "significant".*

10. Do you agree with our proposal to move the existing recommendation that issuers disclose details of any significant areas of concern (Section S., paragraph (a)(ix)) to a new RBP C.2.7, and to amend the provision to widen its application by removing the reference to areas of concern “which may affect shareholders”?

Yes

No

Please give reasons for your views.

*No, we do not believe it is necessary to include reference to significant areas of concerns as this concept appears to overlap with the concept of significant risks.*

*Please see our earlier reply (in Question 5) suggesting expanded disclosures in respect of risks.*

11. Do you agree with our proposal to remove RBP C.2.5, which states that issuers should ensure their disclosures provide meaningful information and do not give a misleading impression?

Yes

No

Please give reasons for your views.

*We agree with the comments in paragraph 76 of the consultation paper, as this disclosure is redundant. If this issue requires emphasis and clarification, it should be set out as a requirement or principle of the entire Code on Corporate Governance and not in the amended C section.*

12. Do you agree with our proposals to remove the recommendations that issuers include in their Corporate Governance Reports:

(a) an explanation of how the internal control system has been defined for them (Section S., paragraph (a)(i)); and

(b) the directors' criteria for assessing the effectiveness of the internal control system (Section S., paragraph (a)(vii))?

Yes

No

Please give reasons for your views.

*Yes, we agree to remove these as they have been superseded by C.2.4(b) and (d).*

13. Do you agree with our proposal to upgrade RBP C.2.6 to a CP (re-numbered C.2.5) and amend it to state that an issuer should have an internal audit function, and issuers without an internal audit function should review the need for one on an annual basis and disclose the reasons for the absence of such function in the Corporate Governance Report? Is the intention of the proposed wording sufficiently clear?

Yes, partly

No

Please give reasons for your views.

*We would suggest that the Exchange considers making the IA function a mandatory requirement. The consultation paper explains the importance of the IA function as a fundamental part of the issuer's internal controls structure through being the third line of defence. A mandatory requirement would reflect this view more appropriately.*

*Again, as mentioned under question 9, the fact that an IA function can be outsourced, in full or in part, should be made clearer.*

14. Do you agree with our proposal to introduce new Notes to the proposed CP C.2.5 to clarify that:

- (a) the role of the internal audit function is to carry out the analysis and independent appraisal of the adequacy and effectiveness of an issuer's risk management and internal control systems; and
- (b) a group with multiple listed issuers may share group resources of the holding company to carry out the internal audit function for members of the group?

Yes

No

Is the intention of the proposed wording sufficiently clear? Please give reasons for your views.

***Yes, but we think in (a) the wording should be 'assurance' rather than 'appraisal' as this is more in line with the accepted understanding of IA and its report in professional literature.***

15. Do you agree with our proposal to amend the existing CP C.2.2 to state that the board's annual review should ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the issuer's internal audit function (in addition to its accounting and financial reporting functions)?

Yes

No

Please give reasons for your views.

***Yes, and we also suggest there should be a CP or Mandatory Disclosure requirement to explain the reporting lines of the IA function as we believe this is a critical factor in determining the effectiveness and objectivity of the IA function. For example, we would expect that an issuer's IA function reports to the Chairman of Audit Committee, as opposed to executive management.***

16. Do you agree with our proposal to amend Principle C.3 in respect of audit committees and CP C.3.3 in respect of their terms of reference to incorporate “risk management” where appropriate?

Yes, partly

No

Please give reasons for your views.

*We suggest revisiting the Principle as it is not easy to understand why it refers to the "Board" when the Principle applies specifically to the Audit Committee ("AC").*

*We would also suggest the Exchange revisits the Principle in general as the requirements currently stated are only operational (i.e. putting in place terms of reference). The Principle should cover more high-level and strategic matters addressing the fundamental role and purpose of the AC.*

*Moreover, in the CP, we suggest whenever the term 'oversight' is mentioned, it should be changed to 'independent oversight' to express clearly that this is the role of the AC as an independent body, and to distinguish it from the general oversight role of the Board as a whole.*

17. Do you agree that the matter of establishing a separate board risk committee should be left to issuers to decide in accordance with their own circumstances?

Yes

No

Please give reasons for your views.

*Company structures vary and, in principle, issuers should be allowed to decide their own governance systems and structures.*

18. What would be an appropriate period of time between the publication of the consultation conclusions and the implementation of the amendments set out in the Consultation Paper?

Six months

Nine months

12 months

Others (please specify: *please see below*)

Please give reasons for your views.

*We suggest the Exchange should not make the date too early as the changes suggested in the consultation paper are substantial and may take issuers some time to implement properly. We also suggest that the required implementation date should be expressed in terms of issuers' accounting periods (as they should be aiming to achieve compliance by the start of that accounting period in order to be able to report their compliance properly and in full). We would therefore recommend a period of not less than 6 months from the date of publication of the final requirements before the start of the first relevant accounting period.*

*For example, we would suggest the date for implementation to be applicable to accounting periods ending on or after 1 June 2016, to allow companies sufficient time to implement the new rules. This would enable issuers with June 30 year ends to have the time between finalisation of the requirements (perhaps by the end of 2014) and June 30, 2015 to prepare themselves properly.*

- End -