STANDARD
&POOR'S

Corporate Governance Score

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Hong Kong Exchanges and Clearing Limited

Hong Kong

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Overall Company Score (CGS)	***CGS–8.3 (maximum CGS–10)***
Hong Kong Sovereign Credit Rating*	***A+***
Component Scores:	
Ownership structure and external influence	8.5 (maximum 10)
Shareholder rights and stakeholder relations	8.0 (maximum 10)
Transparency, disclosure & audit	9.0 (maximum 10)
Board structure and effectiveness	7.6 (maximum 10)

Executive Summary

Standard & Poor's affirms Hong Kong Exchanges and Clearing Ltd.'s (HKEx) Corporate Governance Score (CGS) of CGS-8.3. The score and the updated analysis reflect a number of improvements in the areas of shareholder rights and transparency and disclosure of financial and nonfinancial information but also incorporate concerns regarding the balance of power and responsibility on the board of directors. However, recent changes to Standard & Poor's analytical methodology and some tightening of the scoring criteria have also impacted our updated score. The analytical framework now places increased emphasis on external stakeholder relations (Subcomponents 2.3 and 4.2) and board structure and effectiveness (Component 4). These changes to the methodology in turn reflect the rapidly evolving nature of corporate governance global best practices and investor concerns over a broader range of governance issues.

On the other hand, Standard & Poor's analysis continues to recognize the special status of the HKEx given its role as both a publicly listed company as well as the sole exchange controller in Hong Kong with a clear public interest function. While there is a strong correlation between the long-term public interest of HKEx maintaining its leadership role in Asian financial markets and the consequent financial benefits to its shareholders, it is important to be alert to situations where the public's interests may conflict with those of shareholders, particularly given a board structure that suggests a primary accountability to the former.

It is important to note that Standard & Poor's see no evidence of any major conflicts around HKEx's dual accountability to both shareholders and the public at large, nor does Standard & Poor's believe that the HKEx has ever misused its regulatory influence to benefit its own financial performance. On the other hand, the ongoing public debate over the appropriateness of HKEx's regulatory role vis-à-vis listed companies, while being itself a listed company, may eventually lead to changes to both HKEx's regulatory role as well as its overall governance structure. Recent events such

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as the Penny Stock Incident and its aftermath have underscored the difficulties inherent in maintaining total separation of HKEx's regulatory and commercial interests, both in reality and perception. This ongoing issue and the inherent politics associated with it place an additional burden on the board, particularly the chairman and CEO. The ability of the other board members to provide meaningful input regarding the Penny Stock matter and other issuers relating specifically to listings and listed companies was limited given the firewall that exists to separate HKEx's regulatory and commercial activities. This situation merits ongoing monitoring, particularly to the extent it becomes too much of a distraction for senior management and the board. Notwithstanding the unique nature of the HKEx governance structure and the visibility that has been generated by its involvement in shaping the market's listing rules and trading environment, however, the overall assessment of the governance standards at HKEx remains positive. Standard & Poor's assessment of HKEx from the standpoint of ownership structure and external influence remains very strong. Its shares are widely held, with no one beneficial shareholder having an ownership stake greater than 5%, and HKEx provides good public disclosure of the breakdown of its largest shareholders by amount of shareholdings and demographics. However, like all other Hong Kong companies, HKEx under existing laws does not have a regular tracking mechanism to track and disclose information about the shareholdings of individual beneficial shareholders behind nominee accounts. Aside from the government's influence that is inherent in HKEx's public interest role and its board structure, no other stakeholders, including the brokers whose aggregate shareholdings have steadily declined, appear to exert undue influence over the company's affairs.

Shareholder rights and stakeholder relations are deemed strong. HKEx provides shareholders with timely, comprehensive, and accessible information about shareholders meetings and most recently introduced poll voting to replace the traditional "show of hands" methodology. Shareholders are able to vote on most key decisions traditionally reserved for such a forum, including the general mandate to allow the company to issue new shares up to 20% of outstanding shares. This voting right compensates somewhat for the absence of pre-emptive rights for shareholders. On the other hand, as part of HKEx's public interest-oriented governance structure, shareholders are only allowed to elect six out of a total of 13 board directors. Hong Kong's financial secretary appoints the other six public interest directors, while the board elects a chairman among all the board members, and the CEO from outside the elected or appointed members of the board. Furthermore, the new staggered board structure whereby only two director seats are up for election at each shareholders meeting further restricts shareholders' right to elect directors. While HKEx has no explicit takeover defenses incorporated in its company documents, the 5% limitation on share ownership by any one shareholder can be viewed as such, although this limit is subject to the government's discretion. Presumably, the market for corporate control of HKEx is open to the extent strategic opportunities present themselves that are deemed positive from the standpoint of both shareholder value and the public interest. HKEx generally provides good disclosure regarding its dealings with other key stakeholders, including employees, the government, and society at large. It demonstrates evidence of a high level of engagement in looking after the interests of its various constituencies. Its ongoing relationship with the government and its various regulatory bodies, particularly the Securities and Futures Commission (SFC) merits close monitoring in light of some communication and coordination problems between HKEx and SFC that preceded the Penny Stock Incident.

HKEx's standards of transparency, disclosure, and audit remain very strong. Disclosure and accessibility of financial and nonfinancial information continues to improve, and HKEx this year adopted quarterly financial reporting to set a new standard for Hong Kong listed companies. However, HKEx still reports its financials only under Hong Kong GAAP and has no definite plans to report under a global standard such as international accounting standards (IAS) or provide any additional detailed disclosure regarding the possible differences that may result under a different accounting standard. While this is not a major disclosure shortcoming given that Hong Kong GAAP is generally harmonized with IAS, it remains a concern in light of the significant percentage of foreign shareholders (currently 48%). HKEx continues to demonstrate a comprehensive and independent audit process, both internal and external, and the audit committee provides strong oversight over these processes.

HKEx's Board Structure and Effectiveness is deemed strong, although a difficult business and political environment during the past year posed several challenges to the board, and the first election of new board members led to some significant changes to the board's membership. The new board members, including two with asset management experience, bring additional diversity and skills to an already high calibre board. Notwithstanding these positive additions to the board, the fact that shareholders can elect only six out of the 13 directors will become more of a concern over time, particularly as the shareholder base diversifies away from brokers who initially held all of the shares.

From a governance standpoint, the public interest directors initially served as a check and balance against the broker representatives. Although the changing shareholder base and board member composition are moving forward in a positive direction, the existing structure still calls into question whether the current board provides fair representation to all shareholders. Board committees exist for the main control functions (audit, nomination, and remuneration) and are composed of all nonexecutive directors. The CEO is the only executive director on the board, while the 12 non-executive directors, both public interest and elected, are deemed to be independent vis-à-vis HKEx and its management. Generally, the board members are highly engaged in their respective roles, devote a significant amount of time to their jobs compared with their counterparts at other Hong Kong listed companies, and demonstrate the ability and willingness to think and act independently. On the other hand, the balance of power and responsibility had recently tilted more toward the chairman and CEO, particularly during times of crisis. While the Audit Committee demonstrates strong oversight over its areas of responsibility, the Nomination Committee's scope of responsibility is very limited relative to global norms. This is partly due to the HKEx's unique public interest role, which entails significant government involvement in director nominations. The Nomination Committee did not play a significant role in the new CEO search, the election of new nonexecutive directors, or the recent senior management appointments. Likewise, the Remuneration Committee has only recently established itself as the board's focal point for handling executive compensation matters. On the other hand, both of these committees have been in existence for less than two years, and the board as a whole has been involved in all major matters involving executive and board appointments, compensation, and succession. While the limited role of these two board committees does not imply a lack of independent board oversight over recent high level appointments and compensation matters, this structural imbalance is not ideal for purposes of creating appropriate checks and balances on the board.

COMPANY PROFILE

HKEx operates the only exchange-based stock and futures market in Hong Kong. Under the current structure, HKEx consists of three principal wholly owned subsidiaries, The Stock Exchange of Hong Kong Ltd. (SEHK), Hong Kong Futures Exchange Ltd. (HKFE) and Hong Kong Securities Clearing Co. Ltd. (HKSCC). Since its listing on the Hong Kong Main Board on June 27, 2000, HKEx has undertaken dual responsibilities, that is, to create value for its shareholders and to safeguard the integrity of Hong Kong capital market.

HKEx's basic income is derived from trading tariff and trading fees, listing fees, clearing and settlement fees, depository custody and nominee services fees, investment income, and income from sales of information. Therefore, performance of HKEx depends heavily on market sentiment and the level of market activities. At the same time, due to the unique nature of the HKEx, its success also has a direct influence on the success of Hong Kong as a leading international financial center.

Financial Highlights

Results (mil. HK$)	***2003****	***2002§***	***2001*****
Income	2,019	1,808	1,998
Operating expenses	1,222	1,164	1,176
Profit before taxation	805	650	822
Taxation	(114)	(61)@	(82)
Profit attributable to shareholders	692	588@	740
Shareholders' fund	5,603	5,490@	5,235
Total assets	19,802	14,035	13,745
Per share data (HK$)			
Earnings per share	0.66	0.57	0.71
Interim dividend per share	0.18	0.08	0.08
Final dividend proposed and declared per share	0.42	0.43	0.25

*Financial year ended Dec 31, 2003. §Financial year ended Dec. 31, 2002. @Figure restated in 2003 Financial report. **Financial year ended Dec. 31, 2001. ***Source: Hong Kong Exchanges and Clearing Ltd. Annual and Interim Reports.***

Component 1: Ownership Structure and External Influences

Component Score—8.5

1.1 Transparency of Ownership

The individual shareholding limit of 5% exists that ensures a wide spread of ownership and reduces the chance of undue concentration of ownership. A more detailed public disclosure of the shareholding structure, including the identity of beneficial owners behind nominee accounts, would further enhance transparency.

Key Analytical Issues	*Assessment*
HKEx's shareholding structure is highly diversified.	Positive
Single shareholding is limited to 5% unless approval is obtained from the SFC in consultation with the financial secretary of the Hong Kong SAR Government. This reduces the probability of an unwanted concentration of ownership.	Positive
Indirect holdings have been enumerated and explained.	Positive
Overseas institutional investors hold 47.9% of outstanding shares.	Neutral
Currently there is no regular recording mechanism in place to track both the real owners and the percentage of their ownership held in nominee accounts.	Negative. See comments below.

The authorized share capital for HKEx is HK$2,000,000,000. This is divided into 2,000,000,000 shares of HK$1 per share. As of June 30, 2003, the company had 1,046,954, 846 shares in issue. In its Annual and Interim Reports, the company disclosed a detailed shareholdings analysis categorized according to size and types of holdings. As of end June 2003, 89.8% of the shareholders each held 100,000 shares and below, and 98.8% of the issued capital was held by shareholders each holding more than 100,000 shares. The largest shareholding group is the overseas institutional investors who hold 47.9% of the outstanding shares (as of June 30, 2003). The SFC had granted minority controller status to five custodians holding HKEx's shares on behalf of their clients. However, the HKEx also informed Standard & Poor's that none of their customers hold more than 5% of its outstanding shares.

The exchange participants (both the stock exchange's participants and futures exchange participants) make up the second-largest investment group, holding 26.3% of its outstanding shares (as of June 30, 2003). This figure was recorded at 30.4% as of Dec. 31, 2002, and 100% at the time of its initial listing. This constant decrease indicates a further diversification of the HKEx's shareholding structure. The individual shareholding limit of 5% remains unchanged. However, under the waiver granted by the SFC, the Central Clearing and Settlement System (CCASS) participants are allowed to hold more than 5% of the issued capital on behalf of the beneficial shareholders. As of June 30, 2003, the holding of the minority controllers was in aggregate of 48%. The HKEx reports that the SFC's monitoring of its shareholder structure confirms that no individual owner has a beneficial stake in excess of the 5% maximum. This is monitored on a regular basis. However, as is common under international practice, regulators are not usually in a position to provide the underlying detail to the HKEx. Furthermore, as represented by the HKEx, under the current system, it is not possible to establish the exact percentage held by existing shareholders, notably brokers, on the basis of readily available public information.

The holding of shares in nominee accounts is an efficient way for financial institutions to hold their client's shares. However, a problem with such a system is the effect that it has on the transparency of a company's shareholder structure as, generally, these institutional investors hold all the controlling rights, that is, the rights to vote and receive company information.

While the company obtains the addresses of the various shareholders that comprise the nominee group from the HKSCC for the purposes of notification of company events, it does not obtain the individual holdings. If the HKEx ever has cause for concern about the holdings of any individual, the HKEx would inform the SFC. The SFC would then make inquiries to obtain the necessary input from the individuals concerned and inform the HKEx with regard to any irregularities. Although the HKEx could, pursuant to the Security and Future Ordinance, request nominee shareholders to identify individual shareholders and respective holdings behind the nominee account, it has not yet exercised this particular provision in the Ordinance. The HKEx believes that its current practice of communication with shareholders via nominees or custodians is efficient and effective. HKEx does engage an outside firm to track its shareholders on a quarterly basis, but the details of its findings are limited by what is in the public domain.

1.2 Ownership and External Influences

A wide shareholder base limits concerns potentially arising from concentration of ownership. Details of the directors interests in shares and share options are clearly disclosed. However, it is difficult to establish the current holdings of the member brokers.

Key Analytical Issues	***Assessment***
Majority of shares is widely held. This limits concern over concentrated holdings.	Positive
No evidence of a tendency toward greater concentration of shareholdings.	Positive
Managerial holdings are not large enough to confer actual control.	Positive
No evidence of disproportionate exercises of power by any one shareholding group or other stakeholder. See comment below.	Positive
No cross-shareholdings.	Positive

As provided by section 61 of the Securities and Futures Ordinance, and incorporated in the company's Articles of Association, no person, either alone or with any associate, may hold more than 5% of the voting power or shareholding of the HKEx. This ensures that HKEx is one of the few truly widely held public companies in Hong Kong. Comparing the ownership structure between June 30, 2003 and Dec. 31, 2000, the total number of shareholders was 1,533 and 453 respectively. This indicates that HKEx's ownership this year is even more widely spread.

HKEx discloses directors' interests in shares. Directors' interests are not large enough to convey any form of direct or indirect control over the company.

However, it is notable that most of HKEx's initial shareholders were brokers whose interests may be aligned given that they operate in same industry. Therefore, even though they are not a block holder as such, their interests can differ from those of minority shareholders. This, combined with the fact that brokers are well represented on the board (more detail in Section 4.3), creates a situation where, under certain circumstances, potential investors can find it difficult to assess the dynamics between brokers and the minority shareholders. As noted in last year's report, the debate over the minimum brokerage commission issue provided an example where the interests of the brokers may come into conflict with those of shareholders. On the other hand, brokers are not a homogeneous interest group, and the interests of different brokers are not always aligned on all issues.

The fact that the government tries to make sure that no shareholder group exercises undue influence over HKEx's affairs by appointing the public interest directors may help strengthen the HKEx's public policy role. But this does not allow the shareholders to fully exercise their fundamental shareholder rights, which includes having the freedom to elect their own board representatives.

Table 2. Disclosed Directors Holdings

Name	No. of shares held	% of total	Type of interest
Lee Jor Hung, Dannis	1,610,000*	0.15	Corporate
David Michael Webb	10¶	0.00	Personal/family/ corporate
John Estmond Strickland	18,000	0.00	Personal

As of December 31, 2003. *1,610,000 shares were owned by DL Brokerage Ltd., a private company beneficially wholly owned by Mr. Lee Jor Hung, Dannis. ¶Two personal, two family, and six corporate shareholdings. ***Source:*** *Hong Kong Exchanges and Clearing Ltd.* ***2003 Financial Report.***

Component 2: Shareholder Rights and Stakeholder Relations

Component Score—8.0

2.1 Shareholder Meeting and Voting Procedures

Comprehensive information is supplied to shareholders well in advance of company meetings and is also available on the company's Web site and local newspapers. Procedures that are in place for voting at company meetings are of a high standard. A positive change from the previous year is that the chairman demanded a vote by poll at the last annual general meeting (AGM) in response to a shareholder's request. An independent third party validates voting results.

Key Analytical Issues	Assessment
Shareholder meeting notices are sent to individuals by mail and published in the local newspapers.	Positive
The company informs individual shareholders of upcoming annual general meetings at least 21 days in advance.	Positive
Meetings are held in Hong Kong, and therefore, are easily accessible for most shareholders.	Positive
Shareholders are entitled to appoint a proxy to attend and vote at shareholder meetings. See comment below.	Positive
There is a clearly articulated set of voting procedures that is independently verified by external auditor PriceWaterhouseCoopers (PwC).	Positive
Inexpensive, transparent, and simple voting procedures exist for those unable to attend, although electronic voting is not yet available.	Neutral
There is evidence of efforts to ensure all beneficial shareholders have access to meeting information and their voting instructions can be received	Positive
The atmosphere of HKEX's shareholder meetings has become more open with media attendance and active participation from minority shareholders at the last AGM.	Positive
Poll voting was used at the 2003 AGM.	Positive

The HKEx has satisfactory procedures for holding annual general meetings and extraordinary meetings. Notifications of meetings are subject to Section 114 of the Companies Ordinance. This requires that at least 21 clear days' notice of every AGM and at least 14 clear days' notice of every other extraordinary general meeting (EGM) are given to all shareholders (21 clear days' notice of every EGM at which it is proposed to pass a special resolution–subject to Section 116C of the Companies Ordinance). The HKEx notifies its members of meetings by mail and publishes the notice in a Chinese- and English-language newspaper, and on the company's Web site.

Voting arrangements are clearly set out in the company's Articles of Association and members may attend and vote in person or appoint a proxy to represent them. Voting by post is possible where a shareholder is unable to attend or they may complete their proxy form and appoint the chairman as their proxy. Electronic voting is not possible and on a practical level this has not been considered to be essential, as company meetings are held in Hong Kong where the majority of members are residents. This may become a concern in the future, however, given the increasing proportion of foreign shareholders. Shareholders are sent copies of the full financial reports plus accompanying information about the meeting by post, although shareholders may choose to receive summary financial reports instead. A copy of the proxy form is sent with the notice. Furthermore, the company obtains the names and addresses of individual shareholders, whose shares are held in nominee accounts, from the HKSCC and sends all the relevant notices of company meetings with accompanying information upon their request. HKEx's bilingual Web site is informative and contains the report and accounts and all information pertaining to company meetings. Voting procedures are well defined in the Articles of Association and are disclosed to all shareholders. A poll may be called by the chairman of the meeting; at least three members presented in person or by proxy; member (in person or by proxy) if their holding represents, in aggregate, not less than 10% of the total voting rights; or members (in person or by proxy) for which an aggregated sum has been paid up not less than one-tenth of the total sum paid up, can call for a poll under any circumstances.

As stipulated in its Articles of Association, the standard voting procedures of the HKEx are based on a show of hands, unless a poll is demanded. This is in accordance with the Hong Kong Companies Ordinance, and is a common practice in Hong Kong and many other jurisdictions globally. At the

2003 AGM, the chairman of the HKEx called for poll voting on all resolutions in response to a shareholder request. Furthermore, HKEx has advised Standard & Poor's that a poll will be used for all future shareholder meetings. The external auditor, PriceWaterhouseCoopers (PwC), will continue to provide the independent review of the voting procedures and verification of voting results.

At the last AGM, an investor requested a postponement of the shareholders meeting to allow shareholders more time to evaluate two new director candidates from the brokerage community who were added seven days prior to the scheduled meeting. It is required under the company's Articles of Association that a director can only be appointed or reappointed at any general meeting if he/she is recommended by the directors, or he/she is nominated by a voting member and accepted the nomination not less than seven or more than 28 clear days before the date of the general meeting. The investor's concern was that the seven-day time frame did not allow sufficient time for shareholders to evaluate and vote for the candidates, and that the 28-day/seven-day window is disadvantageous to shareholder-elected director candidates. HKEx advised Standard & Poor's that it is currently working with the SFC to look into this issue. Standard & Poor's will continue to monitor how this matter progresses to see whether all shareholders' interests are taken into consideration.

2.2 Ownership Rights and Takeover Defenses

Ownership rights are clearly stated and well protected. Key governance-related matters are reserved for shareholders meetings. The shareholders still do not have full rights in the director election process, as 50% of the nonexecutive directors are still government appointed public interest directors. There are no explicit takeover provisions, although, the 5% share ownership limit may in theory act as a takeover defence.

Key Analytical Issues	Assessment
Secure ownership rights exist via a transparent and independent registrar system.	Positive
The share structure consists of one class of common shares with clearly articulated rights.	Positive
The company's Articles of Association clearly establish a one share, one vote system.	Positive
Shareholders do not have full voting rights since the government appoints the public interest directors.	See Discussion
Following the 2003 shareholders meeting, the number of public interest directors was reduced from eight to six, the same number as the elected directors.	Positive
Shareholders have the right to ask questions at the general meeting, and there is sufficient time for discussion.	Positive
Most key decisions are reserved for the shareholder assembly.	Positive
A dividend policy exists and has been articulated to shareholders. Declared dividend payments have been made.	Positive
Director elections are transparent and all nominations are voted on, although cumulative voting is not utilized.	Positive
As with all other Hong Kong companies, there is no pre-emptive rights clause for HKEx's shareholders, although the 20% general mandate is subject to a shareholder vote.	See comments below.
There are no explicit antitakeover provisions.	Positive
The 5% share ownership limit can present an obstacle to legitimate take over bid. See comments below.	Negative
The now staggered board structure further limits the shareholders' right to nominate and elect directors.	Negative

Rights attached to the HKEx's shares are secure and shares are fully transferable. The company complies with the statutory requirements, which require all companies to keep a register of members in Hong Kong. Through the subscription service provided by the share registrar, Hong Kong Registrars Limited (HKR), the HKEx is able to access the shareholding of each CCASS participant.

There is no evidence of supermajority provisions that are likely to interfere with shareholders' rights. The Articles of Association provide that all business to be decided upon at AGMs should be deemed to be special business with the exception of declaration of dividends; adoption of the Annual Report and Accounts; election of directors; and reappointment and remuneration of the auditors.

The company's Articles of Association clearly stipulate the one share, one vote policy. Shareholders vote on most key decisions including the declaration of dividends, approval of financial statements, election of directors, and appointment and pay of external auditors. In terms of real practice, the director election processes are transparent, and the AGM gives shareholders the opportunity and sufficient time to ask questions. On the other hand, there are still some gaps between the existing HKEx practices and the best global practices. For instance, due to the local laws and common practice amongst the other Hong Kong listed companies, the HKEx does not use cumulative voting for director elections. Given the highly diversified shareholding structure, it is not a major governance issue for HKEx.

The HKEx does not allow its existing shareholders pre-emptive rights. This is in compliance with the Hong Kong Company Law to guarantee free ownership transfer and liquidity. However, the so-called general mandate that gives the company the flexibility to issue new shares up to 20% of outstanding shares is subject to a shareholder vote at each AGM.

There are no explicit antitakeover defenses. However, the 5% ownership limit per single shareholder could, in theory, be used to thwart an otherwise legitimate takeover bid, particularly in cases where the public interest role of the HKEx was not under threat. Standard & Poor's recognizes the political importance of the HKEx to the region and the reasons for the limit. Moreover, the listing document recognizes that a situation could arise whereby an increase of this limit is required. Accordingly, any increase over the 5% limit would require the approval of the SFC, after consultation with the financial secretary. Hence, the 5% limitation is not cast in stone. The SFC and the financial secretary could waive this provision in the event these bodies were satisfied that both public interest and shareholder financial considerations so justify.

Pursuant to the company's Articles of Association, one-third of elected directors shall retire at every AGM after the annual general meeting in 2003. In addition, the director appointed by the board to fill the casual vacancy during the year shall also retire at the next AGM following his appointment. Although the public interest directors are not subject to retirement by rotation, they were appointed, in April 2003, under different terms of service. Messrs. Charles Lee, Tim Freshwater, and Dr. K. S. Lo were appointed under a one-year term, and Messrs. Fong Hup, K. C. Leong, and Liu Jinbao were appointed under a two-year term. Mr. Henry Fan was appointed by the financial secretary in November 2003 to fill the vacancy arisen following the resignation of Dr. Liu Jinbao in May 2003, and Mr. Fan's term of service covers the remaining term of Dr. Liu. The staggered board structure is intended to provide continuity in policies application. However, staggered board terms also limit the shareholders' ability to elect directors and can represent a takeover defense.

While Standard & Poor's views the appointment process for the public interest directors as less than ideal from a governance perspective, we have also not seen any evidence in the past several years that the public interest directors had overruled or dominated the decisions of the elected directors in a way that resulted in the infringement of shareholders' rights or shareholders' interests. HKEx is different from a normal commercial organization in the way that HKEx has to put public interests ahead of shareholders' interests in the case of any conflict. This obligation is stipulated in the Merger Ordinance, which was consolidated into the Securities and Futures Ordinance with effect from April 1, 2003. Although shareholders' rights might seem to have been affected, as they cannot elect all members of the board, HKEx management believes that the presence of the public interest directors is ultimately in shareholders' interests. This is based on the premise that one of their key duties is to ensure a transparent, fair, and orderly market for the trading of securities or futures products in the interests of the investing public, and that a fair and orderly market reinforces investors' confidence and is a key factor contributing to increased market activities which in turn help improve HKEx's revenue and shareholders' value.

2.3 Stakeholder Relations

Given its high profile public policy role, HKEx must address the concerns and needs of a wide range of stakeholders other than its direct shareholders, including the government and various regulators, employees, listed companies, market intermediaries, and the community at large. HKEx has generally maintained a policy of active engagement with these stakeholders, and there are no serious relationship issues that negatively impact shareholder value. The past relationship with the SFC raises some concerns, although the new CEO has made this ongoing relationship a key priority

Key Analytical Issues	Assessment
HKEx provides good public reporting on key areas of market development, product education, and community and environmental activities.	Positive
There is little public disclosure regarding employee relations and employee benefits.	See comments below.
The company maintains an active policy of engagement with a diverse range of investor and stakeholder interests.	Positive
There is no evidence of serious problematic relationships with nonfinancial stakeholde although the relationships with the SFC and the government warrant close monitoring.	See comments below.

Perhaps in part due to the nature of its business and its unique position in the market, HKEx provides an abundance of information on the financial markets and new financial products to the marketplace. Its public reporting on key market information and investment product education is above average comparing to most other listed companies. HKEx holds regular seminars for investors, focusing on background market information, investment knowledge, and new capital markets products. HKEx works closely with the other exchanges and regulators in the region including the China Securities Regulatory Commission (CSRC). HKEx also conducts an annual customer survey that measures customer satisfaction with its services. Investors, investment bankers, and listed companies participated in the 2002 survey.

HKEx, however, does not provide much disclosure about its employee relations and employee benefits in the Annual Report or on the public Web site. On the other hand, HKEx advised Standard & Poor's that comprehensive employment training and benefits programs do exist, and the information is available for its employees via its Intranet. The new CEO who joined in May 2003 firmly believes that effective communication is crucial to foster staff commitment to the group, and therefore delivers and explains key policies and development of the group to executives at a Monthly Executive Forum, and the group's quarterly performance, key policies, and ongoing projects and business and operation initiatives to staff at grade 7 and above at the CEO Quarterly Presentation, where staff are free to raise any questions relating to the group's policies or activities.

One of the other key nonfinancial stakeholders of the HKEx is the government. In the past, there has been evidence of communication and coordination problems between the HKEx and the SFC (see discussion in Section 4.2). In light of the joint responsibility that the HKEx and the SFC share in regulating the listed companies and the ongoing public debate in Hong Kong over whether some or all of the HKEx's regulatory functions should be shifted to the SFC or otherwise relinquished, there is a clear need for the two organizations and other relevant government bodies to maintain an effective working relationship. Both sides are working toward this end. The HKEx, SFC, and the Financial Services and Treasury Bureau (FSTB) jointly hold periodic meetings to discuss market regulatory issues. Top HKEx executives also participate in regular semiannual retreats with the SFC to facilitate better communications and understanding and to review potential projects and initiatives.

HKEx recently faced some challenges when dealing with investors' claims for compensation for losses caused by broker defaults prior to April 1, 2003. In the past, a Compensation Committee at HKEx that was composed entirely of market practitioners handled claims. However, following the effectiveness of the Securities and Futures Ordinance on April 1, 2003, this function has since been transferred to an investor compensation company under the SFC.

Component 3: Transparency, Disclosure, and Audit

Component Score—9.0

3.1. Content of Public Disclosure

Quality and content of public disclosure is high. The company's financials are audited by a reputable accounting firm under Hong Kong GAAP only; however, the auditor confirmed that there would not be any significant differences if the accounts were reported under IAS. Key governance-related items are publicly disclosed.

Key Analytical Issues	*Assessment*
Accounts are disclosed only under Hong Kong GAAP. There is no reconciliation with IAS or other globally recognized accounting standards, or other explanation that compares the treatment under different accounting standards.	Negative
Its financial statement presentation, breadth of coverage, and attention to detail continue to compare favorably with the highest global standards.	Positive
There is adequate disclosure of minority interests, internal, interfirm, and related-party transactions.	Positive
There is detailed disclosure of operating strategy, operations and the competitive environment, both in the Annual Report, and on the public Web site.	Positive
Key governance related information is publicly disclosed	Positive
AGM minutes are now posted on the Web site.	Positive
HKEx's submitted a proposal to disclose details of individual directors' compensation.	See comments below.

The company's financial statements are prepared in accordance with accounting standards generally accepted in Hong Kong and are audited by PwC according to the Statements of Standard Accounting Practices issued by the Hong Kong Society of Accountants (HKSA). The quality of these statements is fairly close to that of accounts prepared in accordance with IAS as, during the past few years, the HKSA has been in the process of harmonizing Hong Kong's accounting standards with IAS.

Standard & Poor's would expect companies with the highest levels of transparency and disclosure to prepare audited financial statements according to IAS or another globally recognized accounting standard or, alternatively, to provide a reconciliation. However, it is important to note that the major differences between HK GAAP and IAS--treatment of investment property and deferred taxation are both not applicable to HKEx's businesses. Moreover, both HKEx and PwC have represented that the accounts would not differ significantly if they were to be restated under IAS. Therefore, while a reconciliation or some other explanatory analysis would be helpful, particularly given that overseas investors own about 48% of HKEx and may not be intimately familiar with Hong Kong GAAP, in practical terms this is not a significant shortcoming.

The Annual Reports and Interim Reports are prepared in compliance with the requirements predetermined by the Companies Ordinance, Listing Rules, and the Standard Statement of Accounting Practice of the HKSA.

Overall standards of financial disclosure are high. Details of investments and indirect holdings in its subsidiaries are disclosed thoroughly and there is adequate disclosure of related-party and internal transactions. Good disclosure here is particularly important due to the special circumstances arising from the fact that some of the directors of the HKEx are directors and/or shareholders of brokers, companies listed on the SEHK, and exchange participants or clearing participants.

The company discloses information about remuneration of company's executive management. This information is presented in bands. This is more transparent than is typical for most Asian companies. However, disclosure of individual remuneration packages is less extensive than that found in other jurisdictions. HKEx discloses aggregated details of director compensation in bands, which effectively provides disclosure of the CEO's remuneration package since the CEO is the only paid executive on the board. Next year, the company is preparing to disclose individual directors' remuneration by name and the remuneration of the top five executives.

From the previous year, the company's Annual Report includes a corporate governance report. This new part of the Annual Report aims at providing clear information to investors about HKEx's corporate governance structure. This is a positive addition to the company's reporting.

3.2. Timing of and Access to Public Disclosure

Timing and access to public disclosure is in line with good corporate governance practice. To set a good example, HKEx adopted quarterly reporting although it is not yet compulsory under the Listing Rules.

Key Analytical Issues	***Assessment***
HKEx submits financial results to regulators on time.	Positive
Public information is sent to shareholders in a timely manner.	Positive
Corporate records of shareholder meetings are well maintained.	Positive
Shareholders have easy access to corporate records of shareholders meetings.	Positive
Leading the market, commencing 2003, the HKEx adopted quarterly reporting.	Positive
The company discloses public information in a continuous and fair manner.	Positive
HKEx extended its communications with shareholders to include electronic distribution of notices and documents.	Positive. See comments below.
Corporate records of shareholders' meetings are available for inspection at the registered office.	Positive
Public announcements and Memorandum and Articles of Association are available on the company's public Web site and hard copies are available upon request by any shareholder at the company's head office.	Positive

There is clear evidence of the company's efforts to provide information in a timely and efficient manner. Notification of the AGM and EGM is sent at least 21 clear days in advance, (14 days clear notice for passing ordinary resolution on EGM) prior to the meeting. All public information is sent on time and via established distribution systems. Shareholders are sent information on shareholders' meetings.

The company's Web site is another good source of information. The Web site is bilingual and easily navigable, and finding information is easy. There is an "Investors Relations Corner" on the site that provides existing and potential investors with relevant information necessary to make an informed decision. Furthermore, the Web site includes news releases, publications, and information products.

Records of all shareholder meetings are properly maintained by the company secretary and are easily accessible at the company's registered office. A number of important documents are available for inspection at the company's registered office and on the HKEx's Web site, including the Memorandum and Articles of Association, material contracts of the company, the rules of the share option scheme, the audited financial statements, and the accountants report prepared by PwC.

The HKEx has introduced a number of ways of notifying its shareholders of all major events: all relevant corporate information is available on the bilingual (Chinese and English) Web site; as of recently, the company affirmed that corporate communications may also be made by electronic means; annual and interim results are published in one English language newspaper and in Chinese newspapers, summary financial information on five other widely circulated newspapers, and press releases are distributed to all newspaper publishers in Hong Kong; press conferences are held from time to time but always after the AGM and during results announcements; the HKEx occasionally issues circulars (in line with the listing requirements) in order to explain certain issues to its shareholders and; and all relevant information about the AGM is included in the Annual Report or a circular to shareholders.

3.3. Audit Process

HKEx's auditors are PriceWaterhouseCoopers (PwC), a well-established international auditing firm. None of the arrangements between the HKEx and PwC suggest that the auditor's independence is compromised.

Key Analytical Issues	***Assessment***
The external auditor is a reputable and experienced audit company.	Positive
There is an explicit, transparent, and accountable process for selecting the auditor.	Positive
The primary relationship of the auditor is with the independent board Audit Committee.	Positive
The relatively low level of nonaudit fees suggest an independent audit process with limited scope for conflicts of interest.	Positive. See comments below.
The Audit Committee is to determine the independence of the external auditor, although there is no explicit definition of independence.	See comments below.
The Audit Committee consists of nonexecutive directors only.	Positive
There is a good skill and experience mix amongst the Audit Committee members.	Positive
There is no formal training designed for the Audit Committee members.	See comments below.
There is a detailed Charter for the Audit Committee	Positive
The Audit Committee conducts an average of six meetings a year.	Positive
The Audit Committee is involved in the internal control process.	Positive
The chairman of the Audit Committee attends the AGMs to answer questions from the shareholders	Positive
The company has no formal audit rotation policy	See comments below.
A separate Risk Management Committee exists and consists of directors from HKEx and market practitioners appointed by the government to formulate policies on risk management matters relating to the activities of HKEx.	Positive

HKEx's auditors, PwC, are recognized as reputable and independent and are a leading international firm. The company's process of selecting the auditor is transparent. An Audit Committee, consisting entirely of independent outside directors, recommends the external auditor for approval and/or reappointment at each AGM.

Total auditors' remuneration is disclosed in the Annual Report but without a detailed breakdown of audit versus nonaudit fees. However, the company informed Standard & Poor's that nonauditing fees paid to PwC in 2002 were negligible compared to the auditing fees. The Audit Committee must approve any nonaudit work provided by the external auditor. Currently, one PwC partner is on an 18-month secondment service contract with the HKEx listing division. The HKEx board had reviewed and approved this assignment.

A positive governance feature is the high level of engagement and independence demonstrated by the five-member Audit Committee, which directly supervises the company's auditors and the audit process. Its duties include overseeing the setting of audit fees and the nomination, appointment, and performance evaluation processes, and, if necessary, dismissal and replacement of the external auditor. The Audit Committee meets at least four times a year and receives monthly updates from the HKEx Internal Audit Unit. Currently, there is no formal training program in place for the Audit Committee members. However, giving the strong background and experiences of the members in their own industry (including one senior accounting professional), this is not a concern.

HKEx informed Standard & Poor's that currently there are no formalized plans or policies relating to auditor rotation or audit partner rotation. However, PwC has its own internal seven-year partner rotation policy. It is also important to note that HKEx was listed approximately three years ago, and it would not be expected that such a "young" company would change its auditors at this point in time.

Over time, however, this issue may warrant reconsideration in the form of a more explicit policy statement.

Component 4: Board Structure and Effectiveness

Component Score—7.6

4.1. Board Structure and Independence

The caliber of the board members is high. Despite a unique board structure whereby the shareholders elect only six out of the 13 members and the government appoints six public interest directors, there is no evidence that the public interest role is working against the specific financial interests of the shareholders. However, this structural characteristic warrants ongoing monitoring. The nonexecutive directors are high caliber professionals who are all independent vis-à-vis HKEx and its management. However ongoing scrutiny is warranted to ensure that the public interest perspective of the government appointed directors and the perspective of directors from the brokerage community do not diverge from the financial interests of individual shareholders.

Key Analytical Issues	*Assessment*
The board size remains manageable following its recent reduction from 15 to 13 members.	Positive
The new board members have further enhanced the board's diversity of backgrounds and skills.	Positive
The CEO and chairman positions are split, and the chairman is a nonexecutive.	Positive
The Nomination Committee has a clear and comprehensive policy for nonexecutive director nominations.	Positive
The CEO and government appointed public interest directors together still comprise the majority of the board, although elected directors and government appointed directors now have equal representation on the board. This unique structural feature raises concerns about whether shareholders have fair representation on the board.	See comments below.
All directors are nonexecutive except for the CEO.	Positive
The Audit Committee is composed of only nonexecutive directors.	Positive
Both the public interest and elected directors are independent vis-à-vis HKEx and its management.	Positive
Board committees exist for the main control functions (audit, nomination, and remuneration) and are composed of all nonexecutive directors. Executive, Risk Management, and Investment Advisory Committees also exist at the board level.	Positive
Two out of the three members of the Nomination Committee are public interest directors (including the committee chairman, who is also the HKEx chairman), even though this committee is responsible only for nominating non-public interest directors. Furthermore, the five-member ad hoc Nomination Committee that handled the search for the new CEO included four public interest directors, including the HKEx chairman.	Negative

The structure of the board is unorthodox for a publicly listed company due to the special nature of the HKEx. The current structure raises concerns that shareholders may not have fair representation on the board. From a governance perspective, the public interest directors initially served as a structural check and balance against the broker representatives. However, the sharp decline in the proportion of broker shareholdings and the recent reduction in directors representing the brokerage community calls into question the need for a disproportionate number of public interest directors. After the conclusion of the annual general meeting in 2003, the number of the public interest directors has been reduced from eight to six, the same number as the elected directors. Currently, six of the 13 directors are appointed by the financial secretary and are not subject to re-election by the shareholders. The board selects the CEO. In addition, the directorship of the CEO is *ex-officio;* although his appointment to the board is not subject to shareholders approval, his appointment is subject to the approval of HKEx's regulator, the SFC. The official term of the initial group of public interest directors ended in 2003, and the financial secretary reappointed four incumbents and appointed two others. The original six elected directors were nominated by the board and elected by the members in March 2000. At that time, the majority of members were brokers of the two exchanges. Accordingly, all elected directors appeared to represent the interests of the former members of the exchanges. With effect from the AGM in 2003, shareholders may nominate candidates to stand for election. Candidates nominated by shareholders do not require the board's approval. The current elected directors now include two members having an investment management background. The biographies of all the public interest appointments and elected directors are detailed and show a wide range of skills and experiences. As the percentage of outstanding shares ultimately held by brokers has declined substantially since the listing, the membership of the board is now starting to reflect a more diverse shareholder constituency. Each year, starting from AGM 2003, one-third of the elected directors will be subject to retirement, but retired members are eligible for re-election.

With the exception of the CEO, all directors are nonexecutives, thus providing a healthy basis of independence vis-à-vis the company's management. While each shareholder-elected director has the responsibility to represent the interests of all HKEx shareholders, there is also a potential conflict between the collective interests of the Hong Kong brokerage community and the interests of the HKEx shareholders from a financial perspective.

The integrity of the board structure depends on the congruence of the interests of the public interest directors with the financial interests of individual shareholders. In principle it would appear that this correlation is tight and thus far there is no reason to suggest that the public interest directors are pursuing an agenda that might potentially work against the interests of the shareholders to realize value in their shareholding. But this existing structure could, in principle, allow for public interest considerations to diverge from financial interests of shareholders in specific cases. As such, this is something that must be monitored on an ongoing basis.

The Merger Ordinance, now replaced by the Securities and Futures Ordinance (starting April 2003), provides that starting in 2003 the number of public interest directors will be no greater in number than the number of directors elected by the shareholders. Following the 2003 shareholders meeting, the board size was reduced from 15 to 13 members, of which public interest and elected directors comprise six members each. This is one step in the direction of a more conventional board structure, where shareholders have a more complete voice in electing the board directors. As the HKEx continues to mature as an institution, and as the shareholding continues to diversify beyond the concentration in the brokerage community, it will be important to monitor the extent to which the role of public interest directors and broker-linked directors continues to reduce.

The existing board and committee structure basically follows the recommendation of a McKinsey & Co. study. The six committees under the HKEx board are Executive Committee, Audit Committee, Investment Advisory Committee, Risk Management Committee, Remuneration Committee, and Nomination Committee. Except for Executive Committee, which has the CEO & COO as members, the other five committees consist only of nonexecutive directors, while the Investment Advisory Committee and the Risk Management Committee also have outside professionals as members. One structural concern relates to the composition of the Nomination Committee. Two out of three of its members are public interest directors including the committee chairman, who is also the HKEx chairman. However, following the appointment of an elected member with an investment management background to the Nomination Committee, HKEx anticipates that more candidates representing institutional investors and asset management companies would be nominated to stand for election.

The financial secretary appoints the six public interest directors. Their primary function is to oversee the public role of the HKEx. With the exception of the CEO, the board (both elected members and government appointees) is distanced from the executive role of the company and is concerned primarily with policy and major operational issues. There are no public documents relating to the recruitment of any of the public interest directors, and Standard & Poor's was informed by a number of these directors that they were contacted informally by the financial secretary's office prior to receiving a formal written proposal.

The Hong Kong Exchanges and Clearing Ltd.'s Board of Directors

	Position held	***Committee position held***
LEE Yeh Kwong Charles GBS, JP	Nonexecutive chairman Public interest director	Chairman of the Executive Committee Chairman of the Risk Management Committee Chairman of the Nomination Committee
CHOW Man Yiu Paul, JP	Chief executive	Member of the Executive Committee Authorized representative of the HKEx
FAN Hung Ling Henry, SBS, JP	Nonexecutive director Public interest director	Deputy chairman of the takeovers and mergers panel of SFC Member of the Risk Management Committee Member of the Audit Committee
FONG Hup	Nonexecutive director Public interest director	Member of the Audit Committee
FRESHWATER Timothy George	Nonexecutive director Public interest director	Chairman of the Investment Advisory Committee
KWOK Chi Piu Bill	Elected nonexecutive director	Member of the Risk Management Committee
LEE Jor Hung Dannis, BBS	Elected nonexecutive director	Member of the Executive Committee Member of the Remuneration Committee
LEE Kwan Ho Vincent Marshall	Elected nonexecutive director	Member of the Audit Committee Member of the Remuneration Committee
LEONG Ka Chai, JP	Nonexecutive director Public interest director	Member of the Executive Committee Member of the Risk Management Committee
LO Ka Shui GBS, JP	Nonexecutive director Public interest director	Chairman of the Remuneration Committee Member of the Nomination Committee
STRICKLAND John Estmond GBS, JP	Board-appointed nonexecutive director	Chairman of the Audit Committee
WEBB David Michael	Elected nonexecutive director	Member of the Audit Committee Member of the Investment Advisory Committee
WONG Sai Hung Oscar	Elected nonexecutive director	Member of the Nomination Committee Member of the Investment Advisory Committee

As of June 30, 2003. ***Source: Hong Kong Exchanges and Clearing Ltd . Interim Report***

4.2. Role and Effectiveness of the Board

The role of the board is well articulated in company documents, and there is clear evidence that its members are highly engaged in their respective roles. However, the nominations process and the management of relationships with key nonfinancial stakeholders have emerged during the past year as areas of concern.

Key Analytical Issues	***Assessment***
The board has articulated for itself a set of matters reserved for its review and decision.	Positive
Board members generally receive quality information on a timely basis prior to the board and committee meetings.	Positive
The board has articulated a clear vision for HKEx and plays a proactive role in overseeing strategic planning, risk management, internal controls, and IT.	Positive
The ““Penny Stock Incident”” and its aftermath raise concerns about how effectively HKEx has managed its relationship with key stakeholders The Hong Kong SAR government and the SFC. However, the firewall between HKEx’s commercial and regulatory activities limits the board’s ability to add value in certain circumstances where the two converge.	See comments below
Neither the public interest nor the elected nonexecutive directors are subject to a formal performance review process.	Negative
The board has an active meeting schedule with good attendance records. External directorships in most cases are not extensive and do not adversely impact the directors’ level of engagement.	Positive
New board members receive extensive informal training and orientation; existing directors do not receive formal ongoing training.	Neutral
The Nomination Committee’s mandate is limited to non-public interest director nominations; it is not responsible for leading the nomination, appointment, and succession planning processes for the chairman, CEO, or senior executives.	Negative

The minutes of the board meetings show evidence that the HKEx board members are highly engaged in carrying out their duties and operate in the interests of all shareholders. There is clear evidence that the individual board members, both the public interest and elected directors, exercise independent thinking and are willing to challenge management on significant issues. Standard & Poor’s expects that the recent addition of two elected directors with investment management backgrounds will further enhance these characteristics regarding director engagement and independence. The board meets monthly and if required, additional meetings are arranged. Board meeting attendance rates averaged 86% during 2002 and 92% during the first eight months of 2003.

The Audit Committee reviews and supervises the financial reporting process and internal control system of the company and its subsidiaries. The Group Internal Audit Functional Unit has the direct responsibility for assuring the effectiveness of internal controls. The head of this unit reports both to the CEO and the chairman of the Audit Committee and is free to consult directly with the latter on any issues that arise as a result of the internal audit function. Additionally, the Risk Management Committee formulates policies on risk management matters relating to the activities of the HKEx, the exchanges and the clearinghouses, and submits such policies to the board for its consideration. The chairman of HKEx chairs this committee, which includes independent board members, complemented by outside advisors. The board approved the Risk Management Charter in June 2002 following a full review of internal risk management policies by an external consultant. During 2003, the Audit Committee chairman also led an extensive review of the state of HKEx’s information technology given the increasingly critical role that IT plays in all facets of the business.

There is a clearly articulated policy regarding related-party transactions. All related-party transactions have to be reviewed by two independent NEDs (of which one is the chairman), and the company secretary maintains a register involving all related-party transactions concerning board members.

One area of concern at the board level relates to the limited role of the Nomination Committee relative to global norms. In the case of HKEx, the committee’s mandate is limited to finding non-public interest director candidates whenever the number of investor nominated and incumbent director candidates is less than the number of open positions. The committee is also responsible for finding candidates to fill “casual vacancies” on the board. However, of the 10 candidates for the six available board seats to be filled at the most recent shareholders meeting, the committee nominated only one candidate who was not an incumbent director. Furthermore, one of the board members, rather than the committee, nominated the one candidate for a casual vacancy (subsequently approved by the board) that remained following the election of directors. The committee’s mandate does not include responsibility for the nomination, appointment, and succession planning processes involving the CEO, and other executive director and key senior executive positions. In fact, an ad hoc committee led by the HKEx chairman along with three other public interest directors and one non-public interest director assumed responsibility for the new CEO search process. The ad hoc committee included two of the original Nomination Committee members; the other member was not included because he is a nonexecutive director of the employer of one of the potential candidates. The board was fully informed of all potential candidates, and the selected candidate had met senior officials of HKEx’s regulator, and of the government, and a majority of board members before the appointment was taken to the board meeting for confirmation. Thus, despite the use of an ad hoc committee, the selection process was transparent, and the full board was involved in the selection process.

The CEO initiated a number of key senior management changes shortly after assuming his new role, including the appointment of a new COO, CFO, Listing Unit Head, and Clearing Business Unit Head. The candidate for the COO position had met with members of the executive committee, senior executives of the SFC, and HKEx before his appointment was taken to the board for formal approval. While some board members indicated that they would have preferred more detailed briefings at the board meetings, the selection process appears to have been open and transparent. The appointments of the chief financial officer and the head of listing were by internal transfer or promotion, and the board was informed of the proposed arrangements in advance.

The board as a group has played a key role in helping guide HKEx through a particularly difficult time over the past 12 months when it faced a number of challenging issues, including the Penny Stock Incident and its aftermath, the resignation of the CEO, the ongoing public controversy over HKEx’s regulatory role that culminated in the Expert Group’s recommendation to transfer that role to the SFC, the subsequent reversal of the government’s decision to immediately implement the Expert Group’s recommendation and instead conduct a public consultation, HKEx’s first public election of new directors, and the recent staff rationalizations and senior personnel changes. During this time, the chairman in particular has assumed a more visible and hands-on role, and most board members have commended his leadership.

Although the composition of both the Nomination Committee as well as the ad hoc committee that handled the CEO search reflects a substantial majority of public interest directors, there is no evidence to suggest that this has actually biased the nominations process against the interests of the non-public interest directors and their constituencies. However, this structural imbalance is not ideal for purposes of creating appropriate checks and balances on the board and allowing shareholders a platform to influence the nominations process.

As previously cited, recent events have raised concerns about how HKEx manages its relationship with the government and the SFC. How these relationships are managed can have direct and indirect implications for HKEx and shareholder value. Several sources internal and external to HKEx suggest that the Penny Stock Incident was partly a failure of coordination and communication between the HKEx, the SFC, and the FTSB. While the HKEx board might have played a positive role in this instance, the firewall between the HKEx’s commercial and regulatory activities usually precludes the board members from having direct knowledge or involvement in such matters, even when the two areas converge. While the firewall serves a necessary function, it does to some extent limit the board’s ability to assist with important matters that straddle the regulatory and commercial interests of HKEx. On the other hand, the new CEO has clearly made extra efforts to maintain a close working relationships with the SFC. Nevertheless, the ongoing relationships between HKEx and its key nonfinancial stakeholders merit close monitoring.

4.3 Director and Senior Executive Compensation

Executive compensation is long-term performance linked, and the board provides strong independent oversight over the setting of compensation packages and overall plans. However, the Remuneration Committee has only recently begun to assume full ownership of the process.

Key Analytical Issues	*Assessment*
Compensation for senior management is both cash and share based and includes long-term performance linked elements.	Positive
The board reviews and approves all senior executive compensation packages and has used outside advisors for this purpose.	Positive
The Remuneration Committee has just established itself as the board's focal point for handling executive compensation matters.	See comments below
The CEO's compensation is disclosed, and the salary and stock option components are broken out.	Positive
Compensation for the five highest paid employees is not disclosed by individual but by number of employees within bands of HK$500,000 increments. HKEx intends to disclose by individual starting next year.	Positive
The share option schemes generally align executives' interests with those of shareholders and are not deemed excessive.	Positive
Nonexecutive directors receive nominal director fees, raising concerns about the board's ability in the future to attract and retain qualified candidates from diverse backgrounds.	See comments below

The board plays an active role in reviewing and approving senior executive compensation packages and establishing overall compensation policies. Last year, the Remuneration Committee was established with a mandate to ensure that the remuneration structures fairly align the interests of company managers and officers with those of the shareholders. Although this committee did not take the lead role in formulating the new CEO's compensation package, the full board considered and decided the CEO's remuneration package. On the other hand, the HKEx informed Standard & Poor's that the Remuneration Committee had met two times toward the end of 2003 to determine compensation and bonuses for top management in 2003, and to develop a more comprehensive compensation policy for 2004. Although the board and top management has revealed a willingness to strengthen the monitoring power of the committee, the effectiveness of the committee merits further surveillance.

Existing compensation policies for senior management are both cash and share based. None of the directors apart from the executive director (the CEO) received any compensation, although HKEx will pay nonexecutive directors annual directors fees starting next year. Advice was taken from outside remuneration consultants for the share option schemes and remuneration policy.

It is important to note that HKEx has an explicit policy in place that prohibits loans or advances to be given to board members or senior management. This is positive corporate governance feature as it prevents board members and senior management from abusing their position and increasing the exposure of the company to them as individuals.

Compensation plans often allow for the potential of excessive share authorizations. According to the recent Amendments to Share Option Scheme, the maximum number of shares in respect of which options may be granted under the Share Option Scheme (when aggregated with the number of shares that may be granted under any other scheme) is equal to 7.4% of the issued share capital as of June 30, 2003. In calculating the shares available for grant, any options that have been exercised are removed from this calculation. In Standard & Poor's experience, companies that set a high standard for their incentive schemes set minimum vesting periods of three years, following a performance period which has to be met. HKEx's vesting period commences after two years and the award is phased over the subsequent three years, thereby entitling the individual to his entire grant after a period of five years. This is a more demanding requirement and provides a greater incentive structure for HKEx senior management to achieve long-term financial performance.

In terms of option awards, the HKEx adopts the use of a performance period prior to the award rather than an award dependent upon performance. The rules of the prelisting scheme (the prelisting option scheme was terminated after the listing of HKEx in June 2000) refer to the formula that is used by the board for the calculation of the subscription price. Here a price/earnings multiple is determined by reference to the price/earning multiples of various financial companies listed on the stock exchange and/or overseas. A comparator group was composed of financial institutions in Hong Kong and overseas. The rules make no reference to any fixed periods of time to be monitored and this has the potential to attract criticism, as they apparently give the company the discretion to select any period within the rules of the scheme (10 years after adoption of the scheme).

The above-mentioned amendments to the share option scheme have removed the setting of a subscription price at 20% discount to the average closing price. The subscription price is now determined by the board and is higher or at least equal to the highest of: the closing price of HKEx shares on the stock exchange on the relevant offer date, the average closing price of HKEx shares on the stock exchange for the five trading days immediately prior to the relevant offer date, and the nominal value of HKEx shares. Further changes include the requirement for independent NED's approval for the options to be granted to connected persons, restrictions on the exercise of options, and limiting the maximum entitlement of shares granted to an employee to 1% in any 12 month period.

The prelisting scheme was established to reward those involved in the merging of the exchanges. However, these are not linked to the performance of the company and, at the time of making such an award, it is difficult to assess whether or not it has been a success. A total of 143 employees of the group benefited under this scheme and 36,423,269 options were awarded at a subscription price of $7.52. It is also possible for these same individuals to benefit under the postlisting scheme. On May 2, 2003, the new CEO was awarded 3,000,000 stock options under the postlisting scheme at an exercise price of $9.05, exercisable from May 2, 2005 to May 1, 2013, in tranches of 25% reaching 100% as of May 2, 2008.

Previously, the nonexecutive directors received no remuneration, but they will now receive annual director fees of HK$100,000. While low director fees are the norm in Hong Kong, this can potentially be a negative feature, as, over time, more substantial remuneration may be necessary to attract top candidates from under-represented backgrounds and to acknowledge the increased workload and potential liability facing today's NEDs and the contracting supply of qualified candidates from more traditional backgrounds. In the case of the HKEx this is partly mitigated by the fact that the visibility of the HKEx and its unique and prominent role in Hong Kong will continue to attract qualified candidates notwithstanding the low remuneration.

Corporate Governance Scores

A Corporate Governance Score (CGS) reflects Standard & Poor's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests. These governance practices and policies are measured against Standard & Poor's corporate governance scoring methodology, which is based on a synthesis of international codes, governance best practices and guidelines of good governance practice.

Companies with the same score have, in the opinion of Standard & Poor's, similar company specific governance processes and practices overall, irrespective of the country of domicile. The scores do not address specific legal, regulatory and market environments, and the extent to which these support or hinder governance at the company level, a factor which may affect the overall assessment of the governance risks associated with an individual company (see Country Factors below).

A CGS is articulated on a scale of CGS 1 (lowest) to CGS 10 (highest).

CGS 10 and CGS 9—A company that, in Standard & Poor's opinion, has ***very strong*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, few weaknesses in any of the major areas of governance analysis.

CGS 8 and CGS 7—A company that, in Standard & Poor's opinion, has ***strong*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, some weaknesses in certain of the major areas of governance analysis.

CGS 6 and CGS 5—A company that, in Standard & Poor's opinion, has ***moderate*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, weaknesses in several of the major areas of governance analysis.

CGS 4 and CGS 3—A company that, in Standard & Poor's opinion, has ***weak*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in a number of the major areas of governance analysis.

CGS 2 and CGS 1—A company that, in Standard & Poor's opinion, has ***very weak*** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in most of the major areas of analysis.

GovernanceWatch

A GovernanceWatch designation may be used to highlight the fact that identifiable governance events and short-term trends have caused a CGS to be placed on review. GovernanceWatch does not mean that a change to the CGS is inevitable. GovernanceWatch is not intended to include all CGS under review, and changes to the CGS may occur without the CGS having first appeared on GovernanceWatch.

Country Factors

Although Standard & Poor's publishes country governance analyses from time to time, it is important to note that Standard & Poor's does not currently score individual countries. However, consideration of a country's legal, regulatory and market environment is an important element in the overall analysis of the risks associated with the governance practices of an individual company. For example two companies with the same Company Scores, but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles should their governance practices deteriorate, i.e., in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations. However, in Standard & Poor's opinion, companies with high corporate governance scores have less governance related risk than companies with low scores, irrespective of the country of domicile.

In the absence of specific country governance scores, the sovereign credit rating can serve in many ways as a proxy.

Important Note

A CGS is based on current information provided to Standard & Poor's by the company, its officers and any other sources Standard & Poor's considers reliable. A CGS is neither an audit nor a forensic investigation of governance practices. Standard & Poor's may rely on audited information and other information provided by the company for the purpose of the governance analysis. A CGS is neither a credit rating nor a recommendation to purchase, sell or hold any interest in a company, as it does not comment on market price or suitability for a particular investor. Scores may also be changed, suspended or withdrawn as a result of changes in, or unavailability of such information.

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