

## **CORPORATE GOVERNANCE REPORT**

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*(Financial figures in this report are expressed in Hong Kong Dollar)*

### **CORPORATE GOVERNANCE**

*As a listed company as well as an exchange controller, HKEx has both public and corporate responsibilities on corporate governance front. The observance of good governance by the market as a whole as well as by an organisation became an important element in the perspective of investors, both local and overseas. We will continue to play a pivotal role in promoting and enhancing corporate governance standards in Hong Kong.*

### **PUBLIC RESPONSIBILITY**

*Investor confidence is vital to the success of Hong Kong as a leading international financial centre. HKEx acknowledges the importance of raising the corporate governance profile of Hong Kong amid the increasingly competition from other marketplaces, and aims at promoting and enhancing the corporate governance standards on a par with the evolving international standards.*

HKEx is the recognised exchange controller, and has the duty under the SFO to ensure the provision of orderly, informed, and fair markets or arrangements for the trading, clearing, and settlement of securities or futures contracts on the Stock Exchange and the Futures Exchange and their related clearing houses in Hong Kong.

### **Fostering Corporate Governance Culture**

To help maintain Hong Kong's preeminent position as an international financial centre and develop it as a world-class asset management centre, HKEx has continued to take further steps to raise the corporate governance standards and improve the quality of disclosures in Hong Kong.

Certain of these improvement initiatives include:

- revising the Listing Rules by introducing the CG Code and CG Report which came into effect in January 2005. HKEx also invited HKICPA to issue further guidance to help listed issuers understand and implement the CG Code requirements relating to internal control, which took effect for accounting periods commencing on or after 1 July 2005;
- organising regular corporate governance training seminars and programmes for listed issuers, both in Hong Kong and overseas, including those from the Mainland, for raising their awareness of the good corporate governance and the reporting standards;
- working closely with the FSTB and the SFC on further developing the Government proposals for giving statutory backing to major listing requirements to further enhance the regulation of listed companies in Hong Kong; and
- revising the Listing Rules to improve the Stock Exchange's listing decision-making structure. The objective of the proposed new structure is to put in place a simpler administrative framework for listing decision-making whilst retaining the checks and balances for minimising and managing regulatory risk including potential conflicts of interest within the Group.

### **Conflict Management**

In discharging its obligations as the recognised exchange controller, HKEx has to act in the interests of the public, having particular regard to the interests of the investing public, and ensure that where the interests of the public are in conflict with any other interests, the former shall prevail.

The listing of HKEx is governed by the Memorandum of Understanding (“MOU”) entered into between HKEx, the Stock Exchange, and the SFC, and the Chapter 38 in the Main Board Listing Rules. Unlike other listed companies in Hong Kong, the SFC is, pursuant to the MOU, the regulator of HKEx, and shall take all actions and make all decisions in relation to HKEx as a listed company that would normally be taken by the Stock Exchange in respect of other listed companies, including but not limited to the suspension or removal from listing on the Stock Exchange and the application for waivers in complying with the Listing Rules.

In addition, HKEx is required, under the MOU, to use its best endeavours to ensure that whenever a conflict or potential conflict of interest exists, the subject matter would be referred to a Conflict Committee comprising the Chief Executive, the Chief Operating Officer, and the Chief Executive of the Stock Exchange or their alternates for consideration. If the Conflict Committee determines that a conflict or potential conflict of interest does or may arise, the case would be referred to the SFC’s representatives who would consider if the Stock Exchange’s regulatory function could be discharged without its intervention. Any disagreement between the Conflict Committee and the SFC’s representatives will be referred to the SFC for resolution.

### **CORPORATE RESPONSIBILITY**

*Being a listed company, HKEx is committed to achieving the best corporate governance practices, and is pleased to accept a leadership role in setting and articulating corporate governance standards in Hong Kong.*

The Board and the management consider that transparency, fairness and integrity are the cornerstones for good corporate governance and believe that high standards and appropriately rigorous corporate governance practices are essential for HKEx to improve its accountability and transparency, and achieve a balance of the interests of the public and the interests of its stakeholders, inter alia, the Shareholders, EPs, the Government, customers, creditors, and employees.

### **Ongoing Improvements on Corporate Governance Practices**

HKEx regularly reviews its corporate governance practices and aims at standing at the forefront of good governance. During 2005, the following improvement measures have been taken:

#### *Audit and Internal control*

- The policy of rotating the engagement partner of the external auditors every five years was adopted, and the first rotation took effect from the audit for 2005.
- A globally recognised framework was adopted for the evaluation of the internal control system of the Group.

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- The whistle-blowing policy was formalised, and procedures for reporting malpractices directly to the chairman of the Audit Committee had been laid down.

### *Remuneration Policy*

- The remuneration of the non-executive Directors was revised from \$100,000 to \$240,000 after being approved by the Shareholders at the 2005 AGM. The revision was aimed at remunerating fairly the non-executive Directors for their public accountability and time and effort spent on the Board and various committees and/or panels' meetings.
- Guidelines for recruitment of the Chief Executive and senior management staff were established, as part of the succession policy.
- Performance-based evaluation mechanism was adopted for determining the annual salary adjustment and performance bonus.
- An Employees' Share Award Scheme was adopted to replace the Share Option Scheme for rewarding good performers as well as retaining talented staff for the continual operation and development of the Group.
- The Board has retained an independent consultancy firm to carry out an overall review of the Group's remuneration policy and structure, which is scheduled to be completed in the third quarter of 2006.

### *Compliance*

- Approval from the Shareholders was obtained to revise the Articles of Association for fixing the term of office of the non-executive Directors to not more than approximately three years but retiring non-executive Directors are eligible for re-appointment.

### *Organisation Structure*

- As part of the succession plan, a number of senior executives have been assigned new responsibilities since August 2005 to further enrich their exposures and management experience.
- The corporate structure was fine-tuned in August 2005 by transferring the Investor Services Department (previously under the Business Development and Investor Services Division) to the Corporate Communications Department in order to centralise the public communication functions.

### *Transparency*

- The newly designed quarterly newsletter – “*Exchange*” was released in October 2005 which demonstrated HKEx's continued effort to strengthen its communication with various stakeholders.
- A Listing Committee report on the work of the Listing Committees during the financial year of HKEx will be sent to the Shareholders together with the 2005 Annual Report in order to improve the transparency of the operation of the Listing Committees.

## CORPORATE GOVERNANCE REPORT

### PUBLIC RECOGNITION OF HKEx CORPORATE GOVERNANCE PERFORMANCE

Over the past few years, a number of local and overseas professional institutions have granted awards to, or highly rated, HKEx, in recognition of its achievements in corporate governance.

### INTERNATIONAL CORPORATE GOVERNANCE ASSESSMENTS

Rating agencies or bodies	Assessments / Ratings
<b>FTSE International Limited and Institutional Shareholder Services, Inc</b>	<b>FTSE ISS Corporate Governance Index Series (April 2005)</b>  HKEx was mentioned as one of the five companies in Asia, which exhibited highly ranked corporate governance practices.
<b>GovernanceMetrics International Inc</b>	<b>Corporate Governance Rating (July 2005)</b>  Global: 6.5 (2004: 6.0); Home Market: 9.5 (2004: 9.0) out of the full score of 10.00
<b>CLSA Asia-Pacific Markets and Asian Corporate Governance Association</b>	<b>CG Watch 2005 (October 2005)</b> <i>Corporate governance in Asia</i>  HKEx was ranked first among mid-cap stocks listed in Hong Kong.

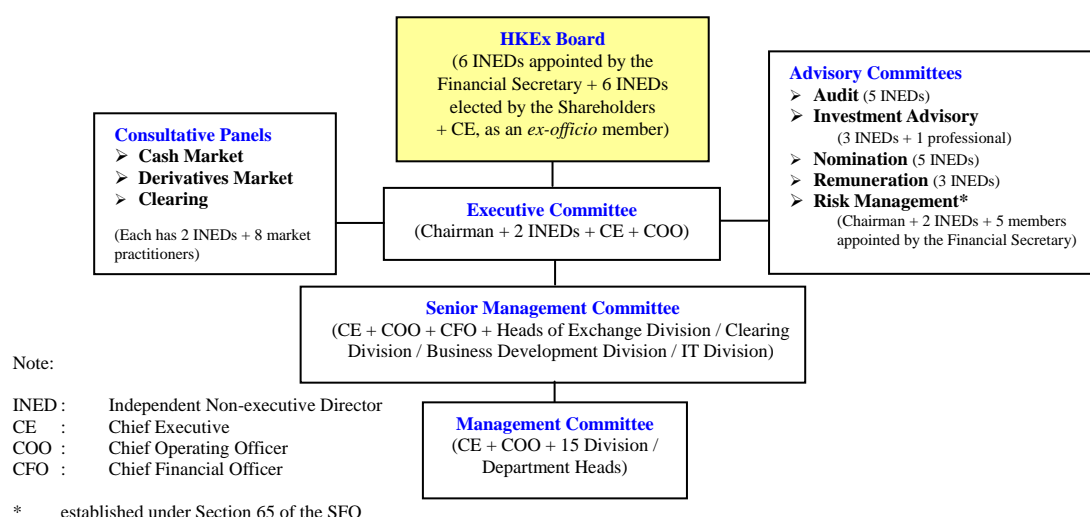
### AWARDS / RECOGNITIONS

Awarding Association	Awards / Recognition
<b>FTSE4Good Policy Committee</b>	<b>FTSE4Good Index Series (September 2005)</b>  HKEx has been selected a member of the FTSE4Good Index Series effective September 2005.
<b>HKICPA</b>	<b>2005 Best Corporate Governance Disclosure Awards (November 2005)</b> <i>Non-Hang Seng Index category</i>  2004 Annual Report – Diamond Award (top honour) – for the third consecutive year
<b>The Hong Kong Management Association</b>	<b>2005 HKMA Best Annual Reports Awards (November 2005)</b> <i>General Category</i>  2004 Annual Report – Bronze Award
<b>The Hong Kong Institute of Directors</b>	<b>Directors Of The Year Awards 2005 (November 2005)</b> <i>Listed Company (SEHK Main Board - Constituents of Hang Seng Indices)</i>  Board : HKEx Board Non-executive Director : Mr Charles Y K Lee Executive Director : Mr Paul M Y Chow

### GOVERNANCE STRUCTURE

*To balance both commercial and public interests of HKEx, the primary consideration in designing its corporate governance structure is to ensure that these interests are properly balanced.*

The overall governance structure of HKEx is set out below:



### REPORT ON CORPORATE GOVERNANCE PRACTICES

*The Board acknowledges the importance and benefits of fostering a high ethical and responsible culture at all levels within the organisation and its responsibility in ensuring that good corporate governance practices and procedures are laid down.*

### COMPLIANCE WITH THE CG CODE

HKEx applied the principles and complied with all requirements set out in the CG Code contained in Appendix 14 of the Main Board Listing Rules, throughout the review period with certain deviations from code provisions A.4.1 and A.4.2 in respect of the service term and rotation of Directors, which were duly rectified after amendments to the Articles of Association were approved by the Shareholders in April 2005. Since then, HKEx has fully complied with the CG Code.

The amendments to Articles of Association included: (a) to specify that all Directors, other than the Chief Executive who shall be subject to the term established under his employment contract with HKEx, will have a specific term of no more than approximately three years, but be eligible for re-appointment upon retirement, and (b) to require that any Director appointed by the Board to fill casual vacancy should be subject to election by the Shareholders at the first general meeting of HKEx after such Director's appointment.

### KEY CORPORATE GOVERNANCE PRINCIPLES AND HKEx'S PRACTICES

#### **The Board**

##### **Roles of Directors**

The Board assumes responsibility for leadership and control of HKEx and is collectively responsible for promoting the success of HKEx. The principal roles of the Board are:

- to lay down the Group's objectives, strategies, policies and business plan;
- to monitor and control operating and financial performance through the determination of the annual budget in particular the capital expenditure budget; and
- to set appropriate policies to manage risks in pursuit of the Group's strategic objectives.

The Board has delegated the day-to-day responsibility to the executive management under the instruction/supervision of Chief Executive and various Board committees.

##### **Composition**

As at the date of this report, the Board consists of 13 members who are all conversant with the Hong Kong financial market. Four of them are qualified accountants with substantial experience in accounting and financial matters. With the exception of the Chief Executive (an *ex-officio* member of the Board), all Board members are INEDs.

The Chairman (an INED) and the Chief Executive positions are split and each of them plays a distinctive role.

- The **Chairman** is responsible for the leadership and effective running of the Board, and ensuring that all key and appropriate issues are discussed by the Board in a timely and constructive manner.
- The **Chief Executive** is delegated with the authority and responsible for running the Group's business, and the implementation of the approved strategies in achieving the overall commercial objectives.

The Nomination Committee is mandated to assess annually the independence of all non-executive Directors, and affirms that all non-executive Directors satisfy the criteria of independence, as set out in the Listing Rules. Board members are totally unrelated in every aspect including financial, business, or family.

The Board structure is defined in the SFO to ensure a balance of the public and commercial interests.

Biographies of the Directors, and their respective roles in the Board and committees will be set out in the Annual Report. The information is also available on HKEx's corporate website.

### **Appointment and Re-election of Directors**

Other than the rules governing the appointment, re-election and removal of Directors laid down in the Articles of Association, details of the procedures for nominating candidates to stand for election at the 2006 AGM are set out in the circular to the Shareholders to be sent together with the Annual Report.

#### *Elected Directors*

The Nomination Committee, comprising all INEDs, is mandated to formulate the nomination policy and be responsible for identifying and nominating suitable candidates for the Board's consideration and recommendation to the Shareholders for election at annual general meetings, or where necessary, nominating candidates to fill casual vacancy of Elected Director.

In the selection process, the Nomination Committee makes reference to criteria including, inter alia, reputation for integrity, accomplishment and experience in the financial service industry, in particular, in the securities and futures markets, professional and educational background, and commitment in respect of available time and relevant interest.

#### *Government Appointed Directors*

Pursuant to section 77 of the SFO, the Financial Secretary may appoint any person as a Director but the number of such shall not exceed the number of Elected Directors, excluding the Chief Executive who is an ex-officio member of the Board.

#### *Chairman*

The Chairman is an INED appointed by the Board, and whose appointment is subject to the approval of the Chief Executive of the Government.

#### *Chief Executive (ex-officio)*

The Selection Committee (an ad hoc committee), comprising the Chairman of the Board, Chairman of the Remuneration Committee, Chairman of the Nomination Committee and two other Directors appointed by the Board, will be formed (as appropriate) for selecting candidates for making recommendation for the Board's approval. The appointment of the Chief Executive is subject to the SFC's approval.

#### *Changes in 2005*

The Nomination Committee met twice in 2005. At the meeting held in February 2005, the Nomination Committee nominated and the Board recommended Dr Bill C P Kwok and Mr Vincent K H Lee to stand for re-election at the 2005 AGM, and both of them were successfully re-elected by the Shareholders thereat for a service term of approximately three years from 12 April 2005 until the conclusion of the annual general meeting to be held in 2008.

On 12 April 2005, the Financial Secretary appointed Dr Marvin K T Cheung and re-appointed Messrs Henry H L Fan and Fong Hup as Government Appointed Directors each for a term of approximately two years from 12 April 2005 until the conclusion of the annual general meeting to be held in 2007. Mr Leong Ka Chai, a Government Appointed Director, retired after the conclusion of the 2005 AGM.

### **Board Process**

The proceedings of the Board are well defined and follow all the recommended best practices of the CG Code.

Regular Board meetings are held normally once a month, with additional meetings arranged, if and when required. Thirteen Board meetings were held in 2005 and the average attendance rate was 92 per cent. Individual attendance records are set out on page 11. Other than regular Board meetings, Directors also meet periodically without management to discuss matters of particular interest.

The Chief Operating Officer and the Deputy Chief Operating Officer are invited to attend Board meetings, and other senior executives will from time to time be invited to attend Board meetings to make presentations or answer the Board's enquires.

Regular Board/committee meeting schedules of each year are normally available to all Directors/committee members before the start of the year. Comprehensive Board/committees papers are distributed to the Directors/committee members, normally four days in advance of the meeting.

Directors are free to contribute alternative views at meetings and major decisions would only be taken after deliberation at Board meetings. Directors who are considered having conflict of interests or material interests in the proposed transactions or issues to be discussed, would not be counted in the quorum of meeting and would abstain from voting on the relevant resolution. According to the Articles of Association, interests of five per cent or more is considered material. Minutes of the Board/committee meetings are kept by the Company Secretary and are open for inspection by Directors.

All Directors have access to the Company Secretary who is responsible for ensuring that the Board procedures are complied with, and advising the Board on compliance matters.

### **Directors' Duties**

Every Director is kept abreast of his responsibilities as a director of the Company and of the conduct, business activities and development of the Company:

- A comprehensive Director's Handbook is issued to every Director, which sets out guidelines on conduct by making reference to the relevant sections of the statutes or the Listing Rules, and reminds Directors of their responsibilities in making disclosure of their interests and potential conflict of interests, and informing HKEx of the changes in personal particulars in a timely manner. The Director's Handbook is updated periodically and posted on HKEx's corporate website.
- Orientation programmes are organised for providing induction to new Directors to help them familiarise with HKEx management, business and governance practices.
- Management provides appropriate and sufficient information to Directors and the committee members in a timely manner to keep them apprised of the latest development of the Group and enable them to discharge their responsibilities. Directors also have independent access to senior executives in respect of operating issues.



- Directors are encouraged to participate in continuous professional development programmes to develop and upkeep their skills and knowledge on the latest development or changes in statutes, Listing Rules, corporate governance practices etc. that are required for discharging their responsibilities. Related expenses are fully reimbursable.

Directors, committee members and Company's officers are fully indemnified against all costs, charges, losses, expenses and liabilities that may be incurred by them in the execution and discharge of their duties or in relation thereto. A Director's and Officers' Liability Insurance policy has been arranged for providing the indemnity.

### **Conduct on Share Dealings**

All Directors are obliged to observe the requirements stipulated in the Model Code, as set out in Appendix 10 to the Main Board Listing Rules. All Directors have confirmed, following specific enquiry by HKEx, that they fully complied with the Model Code throughout the year 2005.

As for employees' conduct on share dealings, the Board has laid down stringent reporting requirements for making disclosures on their securities and derivatives dealings. The code of conduct for securities and derivatives transactions (with no less exacting terms than the Model Code), is set out in the Human Resources Manual which is available on HKEx's corporate website.

### **Board Committees and Consultative Panels**

The Board is supported by five committees, a statutory committee, and three consultative panels. Each of them has defined terms of reference covering its duties, powers and functions. The terms of reference of each of these committees and panels are available on HKEx's corporate website. Hard copies are also available free of charge on request.

The Board and the committees are provided with sufficient resources to discharge their duties including, retention of outside advisers, if necessary, at the cost of HKEx, to provide advice on any specific matter.

Save for the Executive Committee and the Investment Advisory Committee, all committees comprised solely INEDs. The chairmen of the respective committees report regularly to the Board, and, as appropriate, make recommendations on matters discussed. The governance structure and meetings attendance record of the Committees are set out on page 5 and page 11 respectively.

The Listing Committees of the Stock Exchange operate independently under no influence of the Board. A separate Listing Committee Report for 2005 is prepared and will be despatched together with the Annual Report.

# CORPORATE GOVERNANCE REPORT

## Board Committees

Major roles and functions (Full terms of reference are posted on HKEx's corporate website)		Composition during 2005 A – appointed during 2005 R – retired or resigned during 2005	Operating mode
<b>Board committees</b>			
<b>Executive Committee</b>	<ul style="list-style-type: none"> <li>To formulate policies for the Board's consideration and to implement laid down policies</li> <li>To oversee the Group's compliance with all statutory duties</li> <li>To review and recommend amendments to rules and regulations which do not involve policy matters for respective subsidiary boards' approval, and as appropriate, for submission to the SFC for its approval</li> </ul>	<b>INED</b> Charles Y K Lee ( <i>Chairman</i> ) Bill C P Kwok <sup>A</sup> Dannis J H Lee Leong Ka Chai <sup>R</sup> <b>Executive Director</b> Paul M Y Chow ( <i>Chief Executive</i> ) <b>Chief Operating Officer</b> Patrick K Conroy	Normally twice a month
<b>Audit Committee</b>	<ul style="list-style-type: none"> <li>To serve as a focal point for communication between Directors, the external auditors and internal auditors</li> <li>To assist the Board in fulfilling its responsibilities by providing an independent review and supervision of financial reporting, and the effectiveness of the Group's internal control system</li> <li>To review the appointment of external auditors on an annual basis as well as to ensure continuing auditor independence</li> </ul>	<b>INED</b> John E Strickland ( <i>Chairman</i> ) Fong Hup * ( <i>Deputy Chairman</i> ) Marvin K T Cheung * <sup>A</sup> Henry H L Fan Vincent K H Lee * David M Webb <sup>R</sup>  * Qualified Accountants and none of them are members of the former or existing auditors of HKEx	At least 4 times a year
<b>Investment Advisory Committee</b>	<ul style="list-style-type: none"> <li>To provide market expertise and advice to the Board on the Group's investments, including advice on: <ul style="list-style-type: none"> <li>- investment policies;</li> <li>- asset allocation; and</li> <li>- selection of fund managers and custodians.</li> </ul> </li> </ul>	<b>INED</b> Tim Freshwater ( <i>Chairman</i> ) Oscar S H Wong ( <i>Deputy Chairman</i> ) David M Webb  <b>Market Professional</b> David Sun	At least 4 times a year
<b>Nomination Committee</b>	<ul style="list-style-type: none"> <li>To formulate nomination policy and lead the process for identifying and nominating suitable candidates to stand for election by the Shareholders</li> <li>To assess the independence of non-executive Directors</li> <li>To make recommendations to the Board on succession planning of the Chairman and the Chief Executive</li> </ul>	<b>INED</b> Charles Y K Lee ( <i>Chairman</i> ) Fong Hup <sup>A</sup> Vincent K H Lee <sup>A</sup> David M Webb <sup>A</sup> Oscar S H Wong Bill C P Kwok <sup>R</sup>	At least once a year
<b>Remuneration Committee</b>	<ul style="list-style-type: none"> <li>To formulate remuneration policy and make recommendations on the annual remuneration review</li> <li>To determine the remuneration of Executive Director and members of the Senior Management</li> </ul>	<b>INED</b> Lo Ka Shui ( <i>Chairman</i> ) Marvin K T Cheung <sup>A</sup> Dannis J H Lee Vincent K H Lee <sup>R</sup>	At least once a year
<b>Statutory Committee</b>			
<b>Risk Management Committee</b> (established under Section 65 of the SFO)	<ul style="list-style-type: none"> <li>To formulate policies on risk management matters relating to the activities of HKEx, the Stock Exchange and the Futures Exchange and their respective clearing houses, and to submit such policies to the Board for consideration</li> </ul>	<b>INED</b> Charles Y K Lee ( <i>Chairman</i> ) Henry H L Fan Bill C P Kwok  <b>Members Appointed by the Financial Secretary</b> Chan Ka-lok <sup>A</sup> Fong Hup <sup>A</sup> Martin Wheatley <sup>A</sup> Peter T S Wong <sup>A</sup> Eddie W M Yue Mark Dickens <sup>R</sup> Lam Kin <sup>R</sup> Leong Ka Chai <sup>R</sup> Raymond C F Or <sup>R</sup>	Normally once a month

## CORPORATE GOVERNANCE REPORT

### Consultative Panels

There are three consultative panels, namely, *Cash Market Consultative Panel*, *Clearing Consultative Panel* and *Derivatives Market Consultative Panel*. They provide market expertise and advice to the Board on international trends, the needs of intermediaries, issuers, investors, and other market participants, technological challenges and new product opportunities relating to the Cash Market, Clearing business and Derivatives Market respectively.

Each panel consists of two INEDs and eight members who are respective market participants or industry experts. Executives are invited to attend the panel meetings.

### Directors'/Committee Members' Attendance

	Meetings Attended / Held in 2005							
	Board	Executive Committee	Audit Committee	Investment Advisory Committee	Nomination Committee	Remuneration Committee	Risk Management Committee	2005 AGM
<b>No of meetings held during the year</b>	13	20	6	4	2	4	10	1
<b>INED</b>								
Charles Y K Lee ( <i>Chairman</i> )	13/13	20/20			2/2		10/10	1/1
Marvin K T Cheung <sup>1</sup>	8/10		4/4			3/3		
Henry H L Fan	10/13		6/6				8/10	0/1
Fong Hup <sup>2, 7</sup>	12/13		6/6		-/-		5/5	1/1
Tim Freshwater	9/13			4/4				0/1
Bill C P Kwok <sup>3</sup>	13/13	15/15			2/2		10/10	1/1
Dannis J H Lee	13/13	20/20				4/4		1/1
Vincent K H Lee <sup>4</sup>	12/13		6/6		-/-	1/1		1/1
Leong Ka Chai <sup>5, 9</sup>	3/3	5/5					4/5	1/1
Lo Ka Shui	12/13					4/4		0/1
John E Strickland	12/13		6/6					1/1
David M Webb <sup>2, 6</sup>	13/13		2/2	4/4	-/-			1/1
Oscar S H Wong	13/13			4/4	2/2			1/1
<b>Executive Director</b>								
Paul M Y Chow ( <i>Chief Executive</i> )	13/13	20/20						1/1
<b>Others</b>								
Patrick K Conroy ( <i>Chief Operating Officer</i> )		20/20						
<b>Market Professionals</b>								
Chan Ka-lok <sup>7</sup>							4/5	
Mark Dickens <sup>8</sup>							3/4	
Lam Kin <sup>9</sup>							4/5	
Raymond C F Or <sup>8</sup>							3/3	
David Sun				4/4				
Martin Wheatley <sup>7</sup>							5/5	
Peter T S Wong <sup>10</sup>							4/7	
Eddie W M Yue							9/10	
<b>Average attendance rate</b>	92%	100%	100%	100%	100%	100%	87%	77%

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*Notes:*

1. *Dr Marvin K T Cheung was appointed as a Director and a member of the respective Board Committees on 12 April 2005 and 13 April 2005 respectively.*
2. *Messrs Fong Hup and David M Webb were appointed as members of the Nomination Committee on 20 April 2005. No meeting had been held since then.*
3. *Dr Bill C P Kwok retired from the Nomination Committee on 12 April 2005. He was then appointed as a member of the Executive Committee on 13 April 2005.*
4. *Mr Vincent K H Lee retired from the Remuneration Committee on 12 April 2005. He was then appointed as a member of the Nomination Committee on 13 April 2005.*
5. *Mr Leong Ka Chai retired from the Board and the Executive Committee on 12 April 2005.*
6. *Mr David M Webb resigned from the Audit Committee on 13 April 2005.*
7. *Messrs Chan Ka-lok, Fong Hup and Martin Wheatley were appointed as members of the Risk Management Committee on 1 July 2005.*
8. *Messrs Mark Dickens and Raymond C F Or retired from the Risk Management Committee on 31 March 2005.*
9. *Messrs Lam Kin and Leong Ka Chai retired from the Risk Management Committee on 30 June 2005.*
10. *Mr Peter T S Wong was appointed as a member of the Risk Management Committee on 1 April 2005.*

### **Remuneration of Directors and Senior Management**

The Remuneration Committee determines the Group's remuneration policy and reviews, in particular, the remuneration packages of the Chief Executive and the Senior Management. It also makes recommendations to the Board on the annual salary adjustment and provision of the performance bonus.

The Remuneration Committee has prepared a separate report which summarises its work performed during 2005, and also sets out details of the Group's remuneration policy, and the remuneration, including the share option and awarded share benefits, of Directors and the Senior Management for the year ended 31 December 2005, on an individual named basis. The report will be included in the Annual Report.

### **Accountability and Audit**

#### **Financial reporting**

The Directors are responsible for overseeing the preparation of the annual accounts which give a true and fair view of the Group's state of affairs of the results and cash flow for the year. In preparing the accounts for the year ended 31 December 2005, the Directors have:

- approved adoption of all HKFRSs which are in conformity to the International Financial Reporting Standards;
- selected suitable accounting policies and applied them consistently; and
- made judgements and estimates that are prudent and reasonable; and ensured the accounts are prepared on the going concern basis.

HKEx recognises that high quality corporate reporting is important in reinforcing the trustworthy relationship with the Company's stakeholders and aims at presenting a balanced, clear and comprehensible assessment of the Company's performance, position and prospects in all corporate communications. The annual, interim, and quarterly results of HKEx are announced in a timely manner within the limits of 3 months, 2 months, and 45 days respectively after the end of the relevant periods.

### Internal control

#### *System and procedures*

The Board acknowledges its responsibility to ensure that HKEx maintains sound and effective internal control to safeguard the Shareholder's investment and HKEx's assets at all times.

The internal control system, which includes a defined management structure with specified limits of authority, is designed to:

- achieve business objectives and safeguard assets against unauthorised use or disposition;
- ensure maintenance of proper accounting records for the provision of reliable financial information for internal use or for publication; and
- ensure compliance with the relevant legislation and regulations.

The system is designed to provide reasonable, but not absolute, assurance against material misstatement or loss and manage rather than eliminate risks of failure in operational systems, and to ensure achievement of the Group's objectives.

The key procedures that the Board established to provide effective internal controls are as follows:

- A distinct organisational structure exists with defined lines of authority and control responsibilities. Division/Departments Heads are involved in preparing the strategic plan which laid down the corporate strategies to be pursued in the next three years for achieving the annual operating plan and the annual operational and financial targets. Both the strategic plan and the annual operating plan laid down the foundation for the preparation of the annual budget by which resources are allocated in accordance with identified and prioritised business opportunities. Other than the strategic plan which was approved by the Board for a three-year period but subject to annual review, the annual operating plan and the annual budget are approved by the Board annually.
- A comprehensive management accounting system is in place to provide financial and operational performance indicators to the management and the relevant financial information for reporting and disclosure purpose. Variances against budgets are analysed and explained, and appropriate actions are taken, if necessary, to rectify deficiencies noted.
- System and procedures are in place to identify, measure, manage and control risks including legal, credit, market, concentration, operational, environmental, behavioural and systematic risks that may have an impact on the securities and derivatives markets in Hong Kong. Exposure to these risks is monitored by the Senior Management Committee, the Executive Committee, and the Risk Management Committee on a continuous basis.
- Reporting to the Audit Committee functionally, Internal Audit Department ("IA") performs independent reviews of the risks associated with and controls over principal operations and critical applications. These risks and controls were cautiously identified and adequately addressed.

### *Annual assessment*

In 2005, the Board, through the Audit Committee, has reviewed the effectiveness of HKEx's system of internal control over financial, operational and compliance issues, broad-based risk management processes, and physical and information systems security. To formalise the annual review of internal control system, the Audit Committee has made reference to the globally recognised framework with modifications to include some control evaluation on data controls and areas which are specific to HKEx operation. No suspected frauds and irregularities, internal control deficiencies or suspected infringement of laws, rules and regulations have come to the Committee's attention. The Audit Committee concluded that, in general, HKEx has set up a sound control environment and installed necessary control mechanisms to monitor and correct non-compliance. The Board, through the review of the Audit Committee, is satisfied that the Group in 2005, fully complied with the code provisions on internal controls as set forth in the CG Code.

### *Grievances and whistle-blowing policies*

HKEx has established defined procedures for handling employees' complaints and grievances and alerts of wrongdoings. Recommendations on improvements can be channelled to the respective Division/Department Heads of the concern or escalated, as the case may be, to the Chief Operating Officers or the Chief Executive. If the concern involves the Chief Executive or a Director, the employee can report directly to the Chairman.

To encourage employees to raise concerns about internal malpractice without hesitation, HKEx has also established the *whistle-blowing policy* during the year which embedded procedures for reporting such matters internally direct to the chairman of the Audit Committee, who will review the complaint and decide how the investigation should be conducted.

### **Internal Audit Department**

The internal audit methodology and process adopted by IA include:

- *Understand and analyse the business*

IA plays an important role in monitoring HKEx's internal governance and strives to provide objective assurance to the Board that a sound internal control system is maintained and operated by the management in compliance with agreed processes and standards. In accomplishing the objectives, IA has unrestricted access to all corporate operations, records, data files, computer programs, property, and personnel. To preserve the independence of the internal audit function, the Head of IA reports directly to the Audit Committee on audit matters and to the Chief Executive on administrative matters, and is authorised to communicate directly with the Chairman and other Board members. For this reason, he attends the Management Committee meetings as an independent observer.

- *Determine risk areas*

A five-year audit plan is formulated to ensure a systematic coverage of all auditable areas. The plan is revised annually to replace organisational changes as well as new services and operations since last year. Using a risk ranking methodology, IA schedules its internal audit programmes annually based on the five-year plan and submits the audit plan to the Audit Committee for approval. Independent reviews of different financial, business and functional operations and activities will be conducted

## **CORPORATE GOVERNANCE REPORT**

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with resources being focused on higher risk areas. Ad hoc reviews will also be made on areas of concern identified by the Audit Committee and the management.

- *Analyse the process and assess controls*

To help detect frauds, IA designs audit programs to incorporate procedures such as examination of documents, analysis of trend data and verification of assets for certain audit assignments. With the help of the self developed computer-assisted-audit-techniques, IA conducts interrogation tests for trade data processed by mission critical applications in order to verify the integrity and security of such data not being compromised.

As HKEx places heavy reliance on Information Technology (“IT”) to support its business operations, apart from financial and operational compliance audits, IA also applies specialised IT audit skills to conduct regular reviews over major application system, developmental processes, and information system operations to evaluate the effectiveness of the IT controls, security and the related governance processes. IA, in particular, emphasises on the internal control adequacy prior to the system becomes operational.

- *Communicate results and follow up*

At the end of each audit, IA issues an audit report addressing identified control deficiencies. The respective Division/Department Heads is notified of the findings observed together with recommendations for immediate rectification. On a regular basis, IA follows up on the implementation status of all audit recommendations agreed. Significant internal control weaknesses are brought to the attention of the Audit Committee in the form of monthly updates and if necessary to the Board, and to the Senior Management Committee for remedial action. IA summarises audit activities and reports audit progress to the Audit Committee every six months in July and January.

To promote corporate governance and provide the Shareholders with timely information about HKEx’s financial performance, IA conducts quality assurance reviews of the quarterly, interim and final financial reports. These quality assurance reviews provide an additional level of assurance on the overall quality of the financial statements. The quality assurance reports conclude the accuracy and reliability of the financial information prepared by management, and are circulated to the Audit Committee to facilitate its review prior to making recommendations to the Board for its approval.

### **External Auditors**

The Group’s external auditors are PricewaterhouseCoopers. The Audit Committee is mandated to ensure continuing auditors’ objectivity and safeguard independence of the auditors, and it has:

- determined the framework for the type and authorisation of non-audit services for which the external auditors may provide. In general, the engagement of the external auditors to perform non-audit services is prohibited except for tax-related services; and
- agreed with the Board on the policy relating to the hiring of employees or former employees of the external auditors and monitored the applications of such policy.

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During 2005, the fees paid to HKEx's external auditors for non-audit related activities amounted to \$1,333,943 (2004: \$3,202,696) comprising taxation services fees of \$1,181,993 (2004: \$1,202,696), executive secondment to the Listing Division of \$300,000 (2004: \$1,800,000), and write back of provision of other miscellaneous items of \$148,050 (2004: charge of \$200,000).

HKEx has adopted a 5-year rotation policy of the engagement partner of its external auditors and the first rotation commenced in 2005.

The Group has not employed any staff who was formerly involved in the Group's statutory audit.

### **Audit Committee**

A separate report prepared by the Audit Committee which summarised its works performed during 2005 will be set out in the Annual Report.

### **Corporate Communication**

HKEx has in place an effective corporate communication system which provides transparent, regular and timely public disclosures to its stakeholders, including the general public, analysts, and the institutional and individual Shareholders.

- HKEx maintains a website on which comprehensive information about HKEx, its services and news as well as that of the listed issuers on the Stock Exchange, are provided.
- HKEx establishes and maintains different communication channels with its Shareholders through the publication of annual, interim and quarterly reports and press release. A newsletter – *Exchange* is also published on quarterly basis to provide an update on HKEx's latest development. To promote effective communication, the Shareholders may choose to receive shareholder corporate communication electronically. Shareholders' communications are also available on HKEx's corporate website.
- The annual general meeting provides a useful forum for the Shareholders to exchange views with the Board. The Chairman as well as chairmen of the Audit, Nomination, and Remuneration Committees, or in their absence, members of the Committees are available to answer the Shareholders' questions.
- Separate resolutions are proposed at general meetings on each substantial issue, including the election of individual Directors.
- Details of the poll voting procedures and the rights of shareholders to demand a poll are included in the circular to the Shareholders to be despatched together with the Annual Report. The circular also includes details of the procedures and the timetable of proposing appropriate candidates to stand for election as Directors at annual general meetings, relevant details of proposed resolutions, including biographies of each candidates standing for re-election, and whether such candidates are considered to be independent.



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- The poll results are published in newspapers and on HKEx's corporate website.
- A summary of the Shareholders with the top 10 holdings, including an analysis of shareholding by type, and the public float capitalisation of HKEx as at 31 December 2005 will be set out in the Annual Report.
- Shareholders may refer to the Financial Calendar for important dates in 2005 will be set out in the Annual Report.

Financial and other information such as Articles of Association, minutes of annual general meetings, and all shareholders corporate communications are made available on HKEx's corporate website which is updated regularly.

## INTERESTS OF DIRECTORS AND SENIOR MANAGEMENT

### INTERESTS AND SHORT POSITIONS

As at 31 December 2005, the Directors, including the Chief Executive, and their respective associates had the following interests in the shares and underlying shares of HKEx, as recorded in the register maintained by HKEx pursuant to Section 352 of the SFO:

#### Directors' and Chief Executive's Interests in the shares and underlying shares of HKEx

Name of Director	Number of shares / underlying shares held					% of the issued share capital
	Personal Interests	Family Interests	Corporate Interests	Other Interests	Total	
Paul M Y Chow	3,280,000 (note 1)	-	-	-	3,280,000	0.31
Dannis J H Lee	-	-	1,610,000 (note 2)	-	1,610,000	0.15
Vincent K H Lee	-	-	3,640,000 (note 3)	-	3,640,000	0.34
John E Strickland	18,000 (note 4)	-	-	-	18,000	0.00
David M Webb	2 (note 5)	2 (note 6)	6 (note 7)	-	10	0.00

#### Notes:

1. Mr Chow, who is also Chief Executive of HKEx, has beneficial interests in 820,000 shares, and 2,460,000 underlying shares in respect of the share option granted to him pursuant to the Post-Listing Scheme on 2 May 2003. The said option is exercisable between 2 May 2005 and 1 May 2013 at an exercise price of \$8.28 per share. The number of shares issuable under the option granted and the exercise price had been adjusted in accordance with the resolution passed by the Shareholders at the 2004 AGM.
2. 1,610,000 shares were owned by DL Brokerage Limited, a private company beneficially wholly-owned by Mr Lee.
3. Mr Lee has interest in 460,000 shares, and 3,180,000 underlying shares through listed derivatives (physically settled options) held by Pacific Trust Company Limited, in which Mr Lee holds 33.33 per cent beneficial interests.
4. The shares were held by Mr Strickland as beneficial owner.
5. The shares were held by Mr Webb as beneficial owner.
6. The shares were owned by the spouse of Mr Webb.
7. The shares were owned by Fundamental Consultants Limited, Member One Limited and Member Two Limited which are under the control of Mr Webb.

**Short positions in the shares and underlying shares of HKEx**

As at 31 December 2005, Mr Vincent K H Lee was, under the SFO, interested in an aggregate short positions of 460,000 underlying shares in HKEx, representing 0.04 per cent of the total issued share capital of HKEx, which arose through certain listed equity derivatives (physically settled options) held by a corporation in which Mr Lee holds 33.33 per cent beneficial interests.

Save for those disclosed above, no interests and short positions were held or deemed or taken to be held under Part XV of the SFO by any Director or the Chief Executive of HKEx or their respective associates in the shares, underlying shares and debentures of HKEx or any of its associated corporations (within the meaning of Part XV of the SFO) which were required to be notified to HKEx and the Stock Exchange pursuant to Part XV of the SFO or pursuant to the Model Code or which are required pursuant to Section 352 of the SFO to be entered into the register referred to therein. Nor any of the Directors and the Chief Executive (including their spouses and children under the age of 18) had, as at 31 December 2005, any interest in, or had been granted any right to subscribe for the securities and options of HKEx and its associated corporations within the meaning of the SFO, or had exercised any such rights.

**SENIOR MANAGEMENT'S INTERESTS AND SHORT POSITIONS**

As at 31 December 2005, the Senior Management had the following interests in the shares and underlying shares of HKEx:

<b>Name of Employee</b>	<b>Number of shares held</b>	<b>Number of shares issuable under staff option granted</b>	<b>Number of awarded shares</b>
Patrick K Conroy	-	1,476,000	-
Gerald D Greiner	-	400,000	40,600
Lawrence K M Fok	500,000	478,000	24,600
Mary M L Kao	654,000	220,000	28,700
Henry M W Law	-	180,000	22,900
Stewart S C Shing	-	1,094,000	-
Archie T C Tsim	-	164,000	32,700
Richard G Williams	-	844,000	-
Alfred K K Wong	190,000	200,000	32,100

**DIRECTORS' INTERESTS IN CONTRACTS OF SIGNIFICANCE**

No contracts of significance in relation to the Group's business to which HKEx or any of its subsidiaries was a party, and in which a Director had a material interest, whether directly or indirectly subsisted at the year-end or at any time during the year.

**CONTINUING CONNECTED TRANSACTIONS**

During the year ended 31 December 2005, the Group had the following continuing connected transactions, details of which are set out below:

- (A) For the year ended 31 December 2005, transactions between the following connected persons and HKEx or its subsidiaries arising from or in connection with

## **CORPORATE GOVERNANCE REPORT**

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the use of (i) the facilities provided by HKEx or its subsidiaries for the trading, clearing and/or settlement of securities and futures products and transactions; and (ii) all services offered by HKEx or its subsidiaries which are ancillary, incidental or otherwise related to the foregoing:

- (1) Dr Bill C P Kwok, an INED, was interested in the transactions entered into by Wocom Securities Limited and Wocom Limited, EPs and Clearing Participants, which are associates of Dr Kwok by virtue of the Listing Rules.
- (2) Mr Dannis J H Lee, an INED, was interested in the transactions entered into by DL Brokerage Limited, an EP and a Clearing Participant, which is beneficially wholly-owned by Mr Lee.
- (3) Mr Vincent K H Lee, an INED, was interested in the transactions entered into by Tung Tai Securities Company Limited and Tung Tai Futures Limited, EPs and Clearing Participants, which are associates of Mr Lee by virtue of the Listing Rules.
- (4) Mr K C Leong, an INED who retired on 12 April 2005, was interested in the transactions entered into by Roctec Securities Company Limited and Roctec Futures Trading Company Limited, EPs and Clearing Participants, which are associates of Mr Leong by virtue of the Listing Rules.

All the above continuing connected transactions were entered into in the ordinary course of business and on normal commercial terms.

- (B) For the year ended 31 December 2005, transactions between the following connected persons and HKEx or its subsidiaries arising from or in connection with the listing of securities on the Stock Exchange and all services offered by the Group which are ancillary, incidental or otherwise related to the foregoing:

- (1) Dr Bill C P Kwok, an INED, was interested in the transactions entered into by Wing On Company International Limited, a listed company on the Stock Exchange, which is an associate of Dr Kwok by virtue of the Listing Rules.
- (2) Dr Lo Ka Shui, an INED, was interested in the transactions entered into by Great Eagle Holdings Limited (“Great Eagle”), a listed company on the Stock Exchange, which is an associate of Dr Lo by virtue of the Listing Rules.

All the above transactions were entered into in the ordinary course of business and on normal commercial terms.

- (C) For the year ended 31 December 2005, transactions between the following connected persons and HKEx or its subsidiaries arising from or in connection with HKSCC arrangement on behalf of Clearing Participants of Buy-in Transactions:

- (1) Dr Bill C P Kwok, an INED, was interested in the Buy-in Transactions entered into by Wocom Securities Limited which is an associate of Dr Kwok by virtue of the Listing Rules. For the year ended 31 December 2005, the total consideration of such transactions, which were transacted on normal commercial terms, was \$7,197,527.44.

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- (2) Mr Dannis J H Lee, an INED, was interested in the Buy-in Transactions entered into by DL Brokerage Limited beneficially wholly-owned by Mr Lee. For the year ended 31 December 2005, the total consideration of such transactions, which were transacted on normal commercial terms, was \$1,558,101.09.
  - (3) Mr Vincent K H Lee, an INED, was interested in the Buy-in Transactions entered into by Tung Tai Securities Company Limited which is an associate of Mr Lee by virtue of the Listing Rules. For the year ended 31 December 2005, the total consideration of such transactions, which were transacted on normal commercial terms, was \$7,838,440.74.
  - (4) Mr K C Leong, an INED who retired on 12 April 2005, was interested in the Buy-in Transactions entered into by Roctec Securities Company Limited which is an associate of Mr Leong by virtue of the Listing Rules. For the year ended 31 December 2005, the total consideration of such transactions, which were transacted on normal commercial terms, was \$21,955,552.49.
- (D) On 16 February 2005, HKFE, as the tenant renewed the lease with Shine Hill Development Limited (“Shine Hill”), the landlord, in respect of the tenancy (“Tenancy”) of premises of Suites 501-3 and Storeroom on 5th Floor and Suites 1101 & 1109-11 on 11th Floor, ICBC Tower, Citibank Plaza, 3 Garden Road, Central, Hong Kong (“Premises”) for a further term of 2 years commencing 1 January 2005 at a monthly rental of \$310,440, exclusive of management charges, rates and operating expenses. Shine Hill is a subsidiary of Great Eagle and is a connected person of HKEx for being an associate of Dr Lo Ka Shui, an INED. For the year ended 31 December 2005, the total rent, management charges and operating expenses paid in respect of the Tenancy was \$5,326,986.73. The Tenancy constituted a continuing connected transaction of HKEx, and details of which were announced on 14 December 2004.

In respect of the above continuing connected transactions, two INEDs who have not entered into any connected transactions with the Group, have reviewed the transactions and confirmed that the continuing connected transactions entered into by the Group were in compliance with the conditions of the waiver granted by the SFC and with the requirements of the Listing Rules in such a way that:

- (a) the continuing connected transactions disclosed above were entered into in the ordinary and usual course of business of the relevant Group company and conducted on an arm's length basis;
- (b) in respect of transactions other than Buy-in Transactions and the Tenancy, they were in accordance with the rules and regulations of the relevant Group company governing such transactions and where the rules and regulations do not govern those transactions in full, in accordance with the standard terms and conditions of the relevant Group company relating to such transactions;
- (c) in respect of Buy-in Transactions, they were in accordance with the standard terms and conditions of HKSCC applicable generally to all Buy-in Brokers in such transactions for and on behalf of HKSCC and at the standard commission rate payable by HKSCC in respect of all such Buy-in Transactions; and

## **CORPORATE GOVERNANCE REPORT**

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- (d) in respect of the Tenancy, it was entered into in the ordinary and usual course of business of HKFE, and the terms as contained therein, were normal commercial ones.

Based on the opinion of the two INEDs, the Board considered and decided that the continuing connected transactions were fair and reasonable so far as the Shareholders are concerned.

The external auditors of HKEx have also confirmed that:

- (a) the continuing connected transactions disclosed above had been approved by the Directors;
- (b) the continuing connected transactions, other than the Tenancy, were in accordance with the relevant rules and regulations of the relevant Group company governing fees for the applicable facilities, services or goods provided by, or to, the Group and where the rules and regulations do not govern the transaction in full, were in accordance with the standard terms and conditions of the relevant Group company relating to the applicable facilities, services or goods provided by, or to, the Group; and
- (c) the Tenancy had been entered into in accordance with the relevant agreement governing the transaction, and the annual rental had not exceeded the cap disclosed in the announcement of HKEx made on 14 December 2004.

### **RELATED PARTY TRANSACTION**

The Group also entered into certain transactions with parties regarded as “related parties” under the applicable accounting principles. Details of these transactions are set out in note 43 to the accounts.

On behalf of the Board  
**Mau Kam Shing, Joseph**  
*Company Secretary*  
Hong Kong, 8 March 2006

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### **GLOSSARY**

2004 AGM	Annual general meeting held on 31 March 2004
2005 AGM	Annual general meeting held on 12 April 2005
2006 AGM	Annual general meeting to be held on 26 April 2006
CG Code	Code on Corporate Governance Practices as set out in the Listing Rules
CG Report	Corporate Governance Report as set out in the Listing Rules
Elected Directors	Directors elected by the Shareholders at general meetings
EP	Exchange Participant
FSTB	Financial Services and the Treasury Bureau
Financial Secretary	Financial Secretary of Hong Kong
GEM	Growth Enterprise Market
GEM Listing Rules	Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited
Government	The Government of the Hong Kong Special Administrative Region of People's Republic of China
Government Appointed Directors	Directors appointed by the Financial Secretary of Hong Kong pursuant to section 77 of the SFO
Group	HKEx and its subsidiaries
HKEx or the Company	Hong Kong Exchanges and Clearing Limited
HKFRS	Hong Kong Financial Reporting Standards
HKFE or the Futures Exchange	Hong Kong Futures Exchange Limited
HKICPA	Hong Kong Institute of Certified Public Accountants
HKSCC	Hong Kong Securities Clearing Company Limited
Hong Kong or HKSAR	Hong Kong Special Administrative Region of People's Republic of China
INED	Independent Non-executive Director of HKEx
Listing Committees	Listing Committee and the GEM Listing Committee
Listing Rules	Main Board Listing Rules and GEM Listing Rules
Main Board Listing Rules	Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited
Model Code	Model Code for Securities Transactions by Directors of Listed Issuers
Post-Listing Scheme	Post-Listing Share Option Scheme approved by Shareholders on 31 May 2000 which was subsequently amended by Shareholders on 17 April 2002 so as to comply with the new Listing Rules which came into effect on 1 September 2001
SEHK or the Stock Exchange or the Exchange	The Stock Exchange of Hong Kong Limited
Senior Management	Senior executives of HKEx as referred to in the section "Senior Management" as set out in the Annual Report
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
Shareholders	Shareholders of HKEx