RESPONSE BY THE LAW SOCIETY OF HONG KONG TO THE CONSULTATION PAPER ON PROPOSED AMENDMENTS TO THE LISTING RULES RELATING TO CORPORATE GOVERNANCE ISSUES

PART B PROTECTION OF SHAREHOLDERS' RIGHTS

VOTING BY SHAREHOLDERS

Voting by poll

Paragraph 1.4 of Part B of the Consultation Paper

Q1 Agree

We agree with the proposal to require voting by way of poll, particularly having regard to the role of CCASS and the fact that a vote on a show of hands effectively disenfranchises those shareholders holding shares through CCASS.

Paragraph 1.5 of Part B of the Consultation Paper

Q2 Disagree

The requirement to publish the results of the poll will result in additional administrative expense. We would prefer that the results are disclosed on the company/Stock Exchange web site and by notice to the Stock Exchange.

Paragraph 1.6 of Part B of the Consultation Paper

Q3 Agree

Voting of "interested shareholders" in relation to very substantial acquisitions, very substantial disposals and major transactions

Paragraph 2.4 of Part B of the Consultation Paper

Q4 Disagree

We agree that the test should be the same for both the Main Board Rules and the GEM Rules. We also agree with the general principle (as stated in paragraph 2.1 of the Consultation Paper) that where a shareholder has a *different interest*, they should be debarred from voting on the relevant resolution.

However, we do not believe that the proposed amendment captures the spirit of paragraph 2.1. Deletion of the word "material" would not, in our opinion, achieve the desired result. Instead, abolition of the "material interest" test may produce unfair or unduly harsh results for a controlling shareholder (which, after all, has purchased control of a company and so should be entitled to vote, provided the transaction is not a connected transaction). If this amendment is intended to catch situations such as the Hong Kong Chinese Bank transaction, then we would consider that more substantive changes than those proposed would be required.

Q5 The Stock Exchange should provide some guidance in the Listing Rules as to what factors would be taken into account in determining whether a shareholder has a material interest.

In addition, the Listing Rules should clarify that the interest referred to in the Listing Rules is an interest not only in the transaction itself, but an interest in the resolution in question being passed.

We are conscious of the danger that defining materiality too broadly would result in a controlling shareholder being unable to properly exercise their rights of control.

Finally, the Listing Rules should confirm that "material interest" is a material interest in the resolution other than by holding shares in the company in question.

Voting of controlling shareholders

Paragraph 3.9 of Part B of the Consultation Paper

Q6 Agree

Q7 Agree

However, we observe that in practice it is difficult to envisage how such circumstances would arise.

Paragraph 3.10 of Part B of the Consultation Paper

Q8 Agree

We agree that the 30% test is suitable. However, we note that the assumption underlying the proposal is that all directors' interests are aligned – this may not be accurate, and accordingly, the Stock Exchange may wish to consider requiring the relevant persons to abstain from voting for any proposed resolution, but may be permitted to vote against any proposed resolution.

Paragraph 3.11 of Part B of the Consultation Paper

Q9 Agree

Waiver of requirement to hold general meetings

Paragraph 4.7 of Part B of the Consultation Paper

Q10 Disagree

We believe that only condition (c) in paragraph 4.7 should be met.

We cannot see the rationale for condition (a). Issue of securities by an issuer or its subsidiaries should not require special treatment. Accepting certificate of shareholders' approval is a matter of administrative convenience, and we note that this would have no effect on the outcome of the resolution in any event.

We also disagree with condition (b). It is difficult to understand why if any other shareholder is required to abstain from voting (not being one of the shareholders providing the written approval), then the written approval should be disallowed. Where the holding is extremely low and insignificant and there is 50% shareholder approval anyway, the fact that one shareholder would be required to abstain from voting does not change the result and convening a meeting is a waste of the company's money. Indeed, if certain shareholders are required to abstain, the written approval would represent an even larger percentage majority.

Of course, if any of the shareholders providing the written approval is required to abstain from voting if the issuer convenes a general meeting, then his approval should not be counted.

Q11 Agree

We agree provided that condition (c) is satisfied and other disclosure requirements continue to apply.

Paragraph 4.8 of Part B of the Consultation Paper

Q12 Agree

DILUTION OF SHAREHOLDERS' INTERESTS

Placing of shares using the general mandate

Paragraph 5.8 of Part B of the Consultation Paper

Q13 Agree

Q14 Unlimited

Q15 Agree

Q16 Disagree

Paragraph 5.9 of Part B of the Consultation Paper

Q17 Disagree

We believe the alternative benchmarked price should be the average closing price in the 10 trading days prior – we believe that 5 days is too short a period.

We note also that the time period used to determine the benchmarked price is related to the maximum permitted discount level, i.e. the longer the benchmarking period, the deeper the acceptable discount.

Q18 Disagree

We believe the trigger discount level should be set at a discount of 15% or more to the benchmarked price.

We note that there is a need to strike a balance between the protection of investors and the legitimate needs of the company to raise funds.

Q19 Agree

We consider that it is prudent to make provision for exceptional cases. However, exercise of the Listing Division's discretion as regards what constitutes "severe financial difficulties … or … other exceptional circumstances" may be problematic. As regards "severe financial difficulties", an alternative approach might be to require some form of directors' certificate. Guidance notes might be drafted as to what factors might be considered for the purposes of determining whether such difficulties exist (it would not be practical to try to draft factors for determining other exceptional circumstances).

Paragraph 5.10 of Part B of the Consultation Paper

Q20 Agree, but the following information should also be disclosed in the announcement: If any single placee takes an equivalent of 5% (or such amount as may be prescribed by the Securities (Disclosure of Interests) Ordinance / Securities and Futures Ordinance) or more of the enlarged share capital of the company, then such placee should be identified, *irrespective* of the discount.

Placing and top-up subscription

Paragraph 6.3 of Part B of the Consultation Paper

Q21 Agree

Paragraph 6.4 of Part B of the Consultation Paper

Q22 Agree

Rights issues and open offers

Paragraph 7.7 of Part B of the Consultation Paper

Q23 Agree

Q24 N/A

Paragraph 7.8 of Part B of the Consultation Paper

Q25 Agree

Paragraph 7.9 of Part B of the Consultation Paper

Q26 Agree

Paragraph 7.10 of Part B of the Consultation Paper

Q27 Agree

Exclusion of overseas shareholders from share offers

Paragraph 8.2 of Part B of the Consultation Paper

Q28 Agree

We agree with the proposed changes in (a), but do not agree with the additional conditions laid down in (b) and (c).

We consider that the proposal in (a) should go a step further and facilitate dispensing with the need to make enquiry. The intention seems to be to permit expediency where an offer could be extended to overseas shareholders but it might be troublesome to do so. However a relevant question seems to be whether the issuer should actually have to make any enquiry as to what overseas laws and regulations actually require. We suspect that much local practice is simply to exclude overseas shareholders without making enquiry (even though this gives rise to questions as to whether directors have had "regard to" relevant laws and regulations, as envisaged in most general mandate definitions of rights issues). Under the proposal, issuers would have to have "account" of overseas legal problems or regulatory requirements (in the same way as they ought to do under typical general mandate wording). This would require enquiry and therefore does not seem to go far enough (similar to the wording of most general mandates).

We would take the view that the Rules (and general mandates) should be further extended to cover situations where directors of the issuers consider it expedient to exclude overseas shareholders from the offer, without any implication that actual enquiry is needed. This would assist cases where the number of overseas shareholders are so small that the time and cost involved in obtaining legal advice on local laws and regulations would outweigh

the benefit. If paragraph 19(2)(a) of Appendix 7A and 7B of the Main Board Listing Rules and Rule 7.41 of the GEM Rules are revised to reflect the above and general mandates are suitably worded, companies would be able to legitimately take advantage of those provisions to carry out rights issues or other pre-emptive share issues.

If the view is taken that, because Hong Kong is trying to attract international investors, issuers should make enquiry and should only disenfranchise overseas shareholders on the basis, having made enquiry, that it would be necessary or expedient to do so, we suggest it might be useful to have a footnote in the Listing Rules clarifying that issuers are expected to make enquiry.

We do not think that it is necessary to require issuers to include explanations for the exclusion of overseas shareholders from the share offers in the relevant offer document as suggested in (b).

With respect to (c), we believe that the requirement to send the offer documents to overseas shareholders should not be mandated, but that issuers should make the documents available to the shareholders upon request. We assume that the intention of 8.2(c) is to provide offer documents "for information only".

We note that this proposal may raise concerns, at least in theory, as to the potential impact on the interests of Hong Kong as an international marketplace, however we also observe that the majority of large international institutional investors generally hold securities through local custodians/nominees, so the impact upon their activities should be negligible.

OTHER MATTERS AFFECTING SHAREHOLDERS

Material changes in nature of business

Paragraph 9.6 of Part B of the Consultation Paper

Q29 Agree

Share repurchases

Restrictions on pricing and bidding

Paragraph 10.4 of Part B of the Consultation Paper

Q30 Agree

Q31 Agree

We note that this approach follows that adopted in the UK.

Dealing restrictions

Paragraph 11.2 of Part B of the Consultation Paper

Q32 Agree

It is sensible to ensure these dealing restriction periods are consistent.

25% monthly share repurchase restriction

Paragraph 12.3 of Part B of the Consultation Paper

Q33 Agree

We would agree, provided that the proposed 5% pricing restriction referred to in Paragraph 10.4 of Part B of the Consultation Paper is also introduced.

Withdrawal of primary listing on the Exchange

Paragraph 13.5 of Part B of the Consultation Paper

Q34 Agree

Although we agree with the proposal, we note that the test as to who may vote under the Listing Rules (which refer to directors, substantial shareholders, etc.) is different to that under the Takeovers Code (which refers to the offeror and its concert parties). We are of the view that the tests for independence under the Listing Rules and the Takeovers Code should be consistent.

In particular, we are concerned about the situation that may arise where a takeover bid results in the offeror holding between 75% and 90% of the outstanding shares of a company. In such circumstances, the offeror is unable to implement a compulsory buy-out under the provisions of the Companies Ordinance, may not be in a position to have the delisting proposal approved, yet at the same time may not be able to maintain the public float requirements under the Listing Rules.

We would urge the Stock Exchange to clarify this position, perhaps by introducing separate rules for delisting following a takeover offer.

In addition, we would query whether this voting procedure would always be required by the Exchange where an offer is made subject to the compulsory acquisition level being met and compulsory acquisition is actually carried out (in this regard we note that Rule 2.2 of the Code refers to a meeting "if any" convened in accordance with the Listing Rules). This might be of particular relevance in cases (albeit rare in Hong Kong) where an offer was not recommended, in which case it might be more difficult for an offeror actually to convene a meeting for the purposes of Rule 6.12 on the same timing (or, possibly, at all, given potential circularity of conditions) than would be the case in a typical privatisation. In such circumstances it might make sense for an offeror simply to have a condition of acceptances sufficient for compulsory acquisition.

Withdrawal of secondary listing on the Exchange

Paragraph 14.2 of Part B of the Consultation Paper

Q35 Disagree

We take the view that three months prior notice is too long for the withdrawal of secondary listing on the Exchange. We do not think that the notice period should be the same as that of a withdrawal of primary listing on the Exchange where the issuer has also maintained an alternative listing on another exchange (see Rule 6.11(1) of the Main Board Listing Rules). We agree that notice should be given to shareholders on the withdrawal of secondary listing on the Exchange, but the notice period should not be longer than what is required to be given by the issuer under the rules of the exchange where it maintains a primary listing.

NOTIFIABLE TRANSACTIONS OTHER THAN CONNECTED TRANSACTIONS

Very substantial acquisitions

Paragraph 15.6 of Part B of the Consultation Paper

Q36 Agree

Paragraph 15.7 of Part B of the Consultation Paper

Q37 Agree

However, we do not believe the proposed relaxation should apply in such a way as to prejudice the minority shareholders in an offeror company, or to diminish the rights of a target company.
In addition, it may be necessary to spell out some guidelines for the grant of a waiver rather than simply to state that it may be granted in exceptional circumstances, given the need to maintain confidentiality in a hostile takeover situation.

Paragraph 15.8 of Part B of the Consultation Paper

Q38 Agree

We believe it would be helpful if the Stock Exchange could provide examples of such "different interests", or examples of when an interest would not be regarded as a "different interest".

Paragraph 15.9 of Part B of the Consultation Paper

Q39 Disagree

The written certificate of shareholders' approval should be accepted for very substantial acquisitions. This is a matter of administrative convenience, and we note that this would have no effect on the outcome of the resolution in any event. This would also reduce the time period
of uncertainty for the market.

Introduction of "very substantial disposals"

Paragraph 16.4 of Part B of the Consultation Paper

Q40 Disagree

We do not understand the rationale behind this proposal. If a very substantial disposal falls within the 50% level on the various tests for classification of the transaction, it will be classified as a "major transaction", and shareholder approval will be required in any event. If it is envisaged that similar requirements as those that apply to "very substantial acquisitions" would be applied to "very substantial disposals", including suspension of shares and a reapplication for listing, we are of the view that the minority shareholders would be unfairly penalised in such circumstances, in that they would lose a liquid market for the disposal of their shares in the company.

Paragraph 16.5 of Part B of the Consultation Paper

Q41 Agree

Although we disagree with the general proposal in Paragraph 16.4 of Part B of the Consultation Paper, if a category of "very substantial disposals" is introduced, we agree that the "different interest" test should apply.

Paragraph 16.6 of Part B of the Consultation Paper

Q42 Disagree

The written certificate of shareholders' approval should be accepted (refer to our response to Paragraph 15.9 of Part B of the Consultation Paper, above).

Reverse takeovers

Paragraph 17.6 of Part B of the Consultation Paper

Q43 Agree

By way of supplemental comment, the relevant rules should give some guidance as to what might constitute a "fundamental change of business". For example, would this apply if the issuer continued to carry on its original business? What would the parameters be?

Paragraph 17.7 of Part B of the Consultation Paper

Q44 Agree

Paragraph 17.8 of Part B of the Consultation Paper

Q45 Disagree

The written certificate of shareholders' approval should be accepted (refer to our response to Paragraph 15.9 of Part B of the Consultation Paper, above).

Paragraph 17.9 of Part B of the Consultation Paper

Q46 Agree

Introduction of "total assets test" and "turnover test"

Paragraph 18.4 of Part B of the Consultation Paper

Q47 Agree

Paragraph 18.5 of Part B of the Consultation Paper

Q48 Agree

However, the Exchange should clarify what is meant by "exceptional circumstances" where the profits test will be substituted by the turnover test.

Paragraph 18.6 of Part B of the Consultation Paper

Q49 Agree

New thresholds for notifiable transactions

Paragraph 19.6 of Part B of the Consultation Paper

General comments on Q50 – Q54: We agree that the introduction of the "total assets" concept requires that the threshold be lowered for the "consideration test".

We are unsure whether the use of "total assets" will affect the "assets test" – will "total assets" also be used as the basis for calculating the numerator of the assets test? If so, then the threshold should not be reduced. However, if there are circumstances where the adoption of "total assets" concept will not affect calculation of the value of the assets being acquired (e.g. where a tangible asset is being acquired), then the assets test may be affected by the adoption of "total assets" as the denominator, and the threshold should be adjusted accordingly.

The "total assets" concept is not relevant for the calculation of the "profits test" and "equity test". The thresholds for the profits and equity tests should not be similarly reduced. We disagree with the Exchange's argument that the thresholds for the "profits test" and "equity test" should be reduced merely for reasons of "ease of application of the Rules", particularly when to do so would lead to anomalous results.

(a) Share transaction

Q50 Agree, but see general comment above.

(b) Discloseable transaction

Q51 Agree, but see general comment above.

(c) Major transaction

Q52 Agree, but see general comment above.

(d) Very substantial acquisition

Q53 Agree, but see general comment above.

(e) Very substantial disposal

Q54 Disagree

As noted above, we disagree with the proposal to introduce a category of transactions for "very substantial disposals".

Valuation of properties

Paragraph 20.4 of Part B of the Consultation Paper

Q55 Agree

However we note that the workability of this proposal will depend very much on the manner in which the Stock Exchange proposes to exercise its right to require such additional valuation reports. It would be preferable to have some specific indication of the situations where valuation reports would be required; otherwise too much uncertainty would exist.

Paragraph 20.5 of Part B of the Consultation Paper

Q56 Agree

However, we disagree, to the extent that the book value of the assets is not relevant (and may be unrealistically high if not written down to reflect the valuation), and the value of outstanding mortgages should not be included (unless the issuer acquiring the property company is providing a guarantee on such mortgages).

Paragraph 20.6 of Part B of the Consultation Paper

Q57 Agree

Asset valuation

Paragraph 21.2 of Part B of the Consultation Paper

Q58 Agree

We agree with the proposal, although this requirement should only be disclosed in circulars to shareholders where the shareholders are required to vote to approve the transaction. It is not clear whether the Stock Exchange also intends this disclosure requirement to apply to discloseable transactions that are not major transactions / very substantial acquisitions.

In addition, the requirement in the Takeovers Code Consultation Paper of April 2001 has been modified and the new provisions provide for consultation and waivers in exceptional circumstances or where the predictability of cash flows is reasonably assured.

Options granted by issuers

Paragraph 22.4 of Part B of the Consultation Paper

Q59 Agree

Paragraph 22.5 of Part B of the Consultation Paper

Q60 Agree

We agree that it is desirable for the Exchange to codify existing practice. However, the new rules should not apply to exercise of options granted/obtained before the rule change.

Dilution of interest in subsidiaries resulting in deemed disposals

Paragraph 23.2 of Part B of the Consultation Paper

Q61 Agree

CONNECTED TRANSACTIONS

Definition of "connected person"

Paragraph 24.7 of Part B of the Consultation Paper

Q62 Agree

We agree that the broader Main Board rule should apply (and that the GEM Rules should be amended accordingly), however, we believe that the exception in rule 14.25 of the Main Board Rules should be extended such that shareholder approval would not be required in circumstances where the connected person is only connected by virtue of the relationship at the subsidiary level (i.e. the relationship not currently caught by the GEM Rules).

Paragraph 24.8 of Part B of the Consultation Paper

Q63 Disagree

We disagree with such proposal because (i) we disagree with the proposal set out in Q65 and (ii) the proposal would substantially widen the scope of "connected persons".

Paragraph 25.6 of Part B of the Consultation Paper

Q64 Agree

Transactions between connected persons and associated companies

Paragraph 26.9 of Part B of the Consultation Paper

Q65 Disagree

It is not practicable to require issuers to regulate the activities of companies not wholly controlled by the issuer. The issuer would be in breach even without being at fault.

Transactions with non wholly owned subsidiaries

Paragraph 27.4 of Part B of the Consultation Paper

Q66 Agree

We agree with the principle of the proposal. However, we believe that the proposal may not be necessary. The second and third sentences in paragraph 27.1 of the Consultation Paper are incorrect. This proposal arises from a misunderstanding of the purpose of paragraph 14.24(4) Listing Rules (the misunderstanding presumably arises because the introductory wording of Rule 14.24 is badly drafted). Aside from the commonly accepted anomaly of 14.25(2) (which is justifiable on the basis that it would be wrong for a connected person effectively not to have to contribute financial assistance proportionately) the key provision of the Listing Rules for determining what is a connected transaction is 14.23; 14.24 is intended to contain relaxations. A non-wholly owned subsidiary is typically therefore only a connected person if it is an "associate" of another connected person, i.e. a minority shareholder holding a 30% plus stake. The Listing (Review) Committee has recently accepted that this is the correct interpretation of the present Listing Rules, which were never intended to imply that non-wholly owned subsidiaries are always connected persons.

Listing Rule 14.24(4) already effectively provides the relief suggested by paragraph 27.4 of the Consultation Paper - but is only relevant if the non-wholly owned subsidiary is a "connected person" in the first place. The proposed amendment would therefore extend the connected transaction provisions rather than providing relief. Is such an extension necessary? On balance we consider not, and that the existing rule looking to a 30% interest (for "associate" status) is sufficient, in cases other than financial assistance.

A better course of action would be to amend the introductory wording of 14.24 to read, in effect, "The following transactions, if otherwise falling to be treated as connected transactions, are not normally subject …. [etc.]".

Finally, we would add that granting of financial assistance which is governed by rule 14.25(2) should still be excluded in any event, whether or not connected person(s) of the issuer (excluding connected person(s) at the subsidiary level) are together a substantial shareholder in such non wholly owned subsidiaries.

De minimis thresholds for connected transactions

Paragraph 28.2 of Part B of the Consultation Paper

(a)

Q67 Agree

Although the adoption of the "total assets" concept may require that the de minimis thresholds be reduced, we are concerned that reduced thresholds may prejudice companies with lower intangible assets. Accordingly, we would suggest that the Exchange also retain the existing threshold as an additional threshold (iii), for cases where companies do not have large total assets (for which the relevant percentage level is adjusted to 0.01%), and accordingly where net assets (for which the relevant percentage level is 0.03%) may be a more appropriate test.

(b)

Q68 Agree

See comments on Q67, above. We would but suggest that the Exchange retain the existing threshold as an additional threshold (iii), to cover companies which do not have large total assets (for which the relevant percentage level is adjusted to 1%), and accordingly where net assets (for which the relevant percentage level is 3%) may be a more appropriate test.

Continuing connected transactions

Paragraph 29.4 of Part B of the Consultation Paper

Q69 Agree

A clearly defined category of "continuing connected transactions" is preferable to the ad hoc system of waivers currently in place for Main Board issuers.

Paragraph 29.5 of Part B of the Consultation Paper

(a)

Q70 Agree, subject to our comments on Q67, above.

(b)

Q71 Agree, subject to our comments on Q68, above.

(c)

Q72 Agree

Paragraph 29.6 of Part B of the Consultation Paper

Q73 Disagree

We do not agree that the relevant continuing connected transactions be subject to maximum time or maximum aggregate annual value restrictions set out in (a) and (b) of paragraph 29.6. Issuers should be free to enter into such transactions on such terms as they see fit, subject to proper disclosure and (where relevant) obtaining independent shareholder approval.

Paragraph 29.7 of Part B of the Consultation Paper

Q74 Agree

Paragraph 29.8 of Part B of the Consultation Paper

Q75 Agree

It is desirable for the Main Board Rules and GEM Rules to be consistent, and we agree with the approach proposed for the Main Board Rules in relation to this issue.

Paragraph 29.9 of Part B of the Consultation Paper

Q76 Agree

We agree, provided this is limited to the provision of goods or services, which one would expect to be terminable on notice, and where theoretically the contract could be stopped with an opportunity to renegotiate (as opposed to, say, a construction contract). Query what the position should be as regards fixed term contracts for goods and services entered into in good faith before any connected relationship was contemplated.

MEANING OF "SUBSIDIARY"

Paragraph 30.10 of Part B of the Consultation Paper

Q77 Agree

DISPOSAL OF CONTROLLING SHAREHOLDERS' INTERESTS

Commencement of lock-up period

Paragraph 31.3 of Part B of the Consultation Paper

Q78 Agree

It is desirable to codify the Exchange's existing view.

Agreement for disposal of shares

Paragraph 32.2 of Part B of the Consultation Paper

Q79 Agree

Paragraph 32.3 of Part B of the Consultation Paper

Q80 Agree

Deemed disposal of controlling shareholders' interests

Paragraph 33.5 of Part B of the Consultation Paper

Q81 Agree

PART C DIRECTORS AND BOARD PRACTICES

INDEPENDENT NON-EXECUTIVE BOARD DIRECTORS ("INEDs")

Further guidance regarding independence

Paragraph 1.4 of Part C of the Consultation Paper

(a)

Q82 Disagree

We take the view that the proposed 5% limit on shareholding for INEDs is too high especially in light of the reduction of the disclosure limit from 10% to 5% for substantial shareholders under the Securities (Disclosure of Interests) Ordinance (see Part XV of the Securities and Futures Ordinance). A shareholding of up to 5% constitutes a high percentage of the public float. It does not sound logical that an INED could own as much as up to 5% interest if he is expected to provide independent judgement and take into account minority shareholders' interests.

We would suggest that the percentage limit on shareholding in the issuer should be 3%. We believe that this guideline should also operate to prevent a director of a company with a 3% shareholding in an issuer from becoming an independent director of that issuer.

As a general comment, it is important that these guidelines should not unnecessarily restrict the pool of candidates from which INEDs can be selected.

(b)

Q83 Disagree.

The receipt of securities by way of gift may well compromise the independence of a director. We support the exception where the securities are received as part of the normal remuneration package of the director or pursuant to share option schemes. However we believe the limit of issued shares should be 3%.

(c)

Q84 Disagree

We disagree with the notion that partners / principals / directors of professional advisers should be identified as having more questionable independence – it may well be possible for the issuer to appoint a friendly party (who may appear totally unrelated) as a director, who may have more questionable independence than the partners, directors or principals mentioned above. The latter group may be more conscious of the need to be independent and be seen clearly to be independent, by virtue of their known relationship with the issuer. In any event as a director, an INED will owe fiduciary duties to the issuer and to the shareholders as a whole.

If the underlying rationale for this proposal is that the financial interest of professional advisers may prejudice independence, we are not sure that this is consistent with the liberal proposals regarding permitted shareholdings, and more particularly share options, of INEDs.

In addition we note that the proposed prohibition would restrict unnecessarily the pool of able candidates to act as INEDs.

(d)

Q85 Agree

(e)

Q86 Agree

Although we agree with the principle behind the guideline, the wording of the guideline is imprecise and may be difficult to enforce. We suggest that the guideline should be drafted so that the independence of the director may be questioned if they represent a major shareholder, or act in accordance with the instructions of a particular shareholder or shareholders.

(f)

Q87 Agree.

Presumably this is aimed at circumstances where a person is effectively a "board representative" of a particular shareholder or shareholders, which could arise, for example, as a condition of subscribing for a stake in a listed company, possibly by a party which has a commercial relationship with the Issuer.

(g)

Q88 Agree, although the Exchange should clarify what is meant by "connected" in this context.

(h)

Q89 Agree

The proposal recognises a valid risk to the independence of an INED. A two year limit properly balances the need not to restrict the pool of candidates with ensuring independence.

(i)

Q90 Agree

Although we understand the reason behind this guideline, it is not always the case that there is a risk to an INED's independence on the basis that their principal income source would be jeopardised by loss of the position. Where the INED is a candidate of high calibre finding another position would present a difficulty, especially given the reported shortage in Hong Kong. There is a view in the market that it would be helpful to build up a body of individuals who only act as independent directors and this guideline may not assist this process.
In addition, it might be helpful to define what is meant by "principal" – what percentage of a person's income would be regarded as a "principal" source of income?

Paragraph 1.5 of Part C of the Consultation Paper

Q91 Agree

The confirmation should be given by the INED by reference to each guideline and any other factors that affect his independence. The requirement to inform the Exchange should also be expressed by reference to the guidelines, as well as any other factors not covered by the guidelines that would jeopardise independence. We recommend that the confirmation should also be given to the Board.

Qualifications of INEDs

Paragraph 2.3 of Part C of the Consultation Paper

Q92 Agree

However as a drafting point the Rule amendment should require specific professional qualifications, or "experience in accountancy, banking or commerce", as "experience in financial matters" is imprecise.

Minimum number of INEDs

Paragraph 3.5 of Part C of the Consultation Paper

Q93 Disagree

The existing minimum requirement of 2 INEDs under the Rules should be retained.

We do not agree that one-third of the Board is required to be made up of INEDs in order for independent views to carry significant weight. In the UK the Combined Code provides that non-executive directors should comprise not less than one-third of the board (and that the majority of non-executive directors should be independent). Two INEDs are sufficient to put forward independent views, regardless of the size of the Board. It is also worth bearing in mind that the INEDs on a Board will have different views on different issues, and will not necessarily reach a consensus. An issuer should not be required to employ an INED simply to make up the numbers; the calibre of the INEDs is more important than the number.

Q94 Other period: We think that the company should be given sufficient time until the next AGM to appoint the required number of INEDs.

Paragraph 3.6 of Part C of the Consultation Paper

Q95 Agree

We recommend that the announcement should state what action the issuer is taking and when it expects to appoint a replacement.

Paragraph 3.7 of Part C of the Consultation Paper

Q96 Disagree

We believe that the 3 month period is too short. The company should be given sufficient time until the next AGM to appoint the INED.

Independent board committees

Paragraph 4.4 of Part C of the Consultation Paper

Q97 Agree

It is sensible to codify this practice in the Rules. However, it should be made clear that there would only be a need for an "independent board committee" if some of the directors have an interest in the transaction. If the concept of persons connected only at subsidiary level is retained, there may often be occasions when the entire board of the Issuer is "independent" as regards the particular transaction.

Paragraph 4.5 of Part C of the Consultation Paper

Q98 Agree

We agree, except to the extent (if at all) that this implies that all directors other than INEDs will never be able to be members of an independent board committee – it should depend *inter alia* on their respective interests in the transaction.

We recommend that an INED should only be disqualified from sitting on the independent board committee if they have an interest different to other shareholders that is material.

Paragraph 4.6 of Part C of the Consultation Paper

Q99 Agree

In circumstances where the independent board committee does not adopt the recommendation of the independent expert, it should explain its reasons for this departure in the letter included in the circular. The Exchange should also consider requiring the independent board committee to declare how many independent experts were consulted as

part of the process so that shareholders will be aware whether any "opinion-shopping" has taken place.

BOARD PRACTICES

Code of Best Practice

Paragraph 5.3 of Part C of the Consultation Paper

Q100 Agree

We support disclosure to shareholders and investors of any deviation from the Code of Best Practice. We note the general policy of the Exchange to move to a disclosure based regime which aims to ensure that investors have all relevant information with which to value properly a security. We agree that the provisions of the Code of Best Practice are not suitable to be mandated.

Paragraph 5.4 of Part C of the Consultation Paper

Q101 Agree

This will assist in increasing the regularity of disclosure to the market.

Report on corporate governance

Paragraph 6.3 of Part C of the Consultation Paper

Q102 Agree

Is the disclosure in paragraph (a) intended to include corporate governance practices required by the corporate law applicable in the jurisdiction of incorporation or by the rules of any other exchange on which the securities of an issuer are listed?

To what extent will an auditor be required to sign off on these disclosures?

Establishment of corporate governance committees

Audit committee

Paragraph 7.3 of Part C of the Consultation Paper

Q103 Agree

Paragraph 7.4 of Part C of the Consultation Paper

Q104 Disagree

It is important to ensure that the audit committee is made up of a majority of non-executive directors, and that there should be at least one INED. We do not believe that it is sensible to prescribe a minimum number of non-executive directors provided that they are in the majority. We also note that the number of non-executive directors on the board should not be over-emphasised as in most cases it is the calibre rather than the number of directors that is important.

Q105 Disagree

The chairman should be a non-executive director but does not necessarily need to be an INED. It is important that the issuer retains the flexibility to appoint the most appropriate non-executive director for the position.

Paragraph 7.5 of Part C of the Consultation Paper

Q106 Agree

It may be too restrictive to require experience in financial reporting. Again we would suggest that the Rule be drafted to require an INED to have sufficient experience in accountancy, banking or commerce and in reviewing financial statements.

Paragraph 7.6 of Part C of the Consultation Paper

Q107 Agree

We recommend that the announcement should give reasons as to the failure to comply with this requirement.

Paragraph 7.7 of Part C of the Consultation Paper

Q108 Agree

The list of duties and responsibilities is comprehensive. However, perhaps clarification should be provided as to what is envisaged by a review of the group's "operating" policies and practices, as opposed to financial and accounting policies and practices.

Paragraph 7.8 of Part C of the Consultation Paper

Q109 Agree

We agree that the matters referred to in paragraphs (a), (b), and (c) of the Consultation Paper, the principal work performed by the audit committee during the year, significant problems identified by the committee and the overall effectiveness of the issuer's internal control system should be included in annual reports. As to other details such as the committee's findings on review of the financial results, we believe that it would be more appropriate if they are not mandated as part of the annual reports but are included as recommended disclosures under the Code of Best Practice.

Remuneration committee

Paragraph 8.4 of Part C of the Consultation Paper

Q110 Agree

Q111 Disagree

The majority of the committee should be non-executive directors, with a minimum of one INED. We believe it is appropriate for executive directors to be members of any remuneration committee given their views as to the availability of candidates of high calibre candidates in the market and the cost of recruitment.

Paragraph 8.5 of Part C of the Consultation Paper

Q112 Agree

Paragraph 8.6 of Part C of the Consultation Paper

Q113 Disagree

We believe that issuers should only be required to disclose the matters in paragraphs (a) and (b).

The market will not benefit from disclosure of the particular issues addressed by the remuneration committee or a summary of the work carried out. Shareholders' concern will focus on whether there is a remuneration committee, its membership and its responsibilities.

Nomination committee

Paragraph 9.6 of Part C of the Consultation Paper

Q114 Agree

Q115 Disagree

The majority of the committee should be non-executive directors, with a minimum of one INED. We believe it is appropriate for executive directors to be members of the nomination committee.

Paragraph 9.7 of Part C of the Consultation Paper

Q116 Agree

Paragraph 9.8 of Part C of the Consultation Paper

Q117 Disagree

We believe that issuers should only be required to disclose the matters in paragraph (a). The market will not benefit from disclosure of the particular issues addressed by the nomination committee or a summary of the work carried out. Shareholders' concern will focus on the existence of the nomination committee, its membership and its responsibilities.

DIRECTORS' DUTIES AND RESPONSIBILITIES

Duties and responsibilities of non-executive directors

Paragraph 10.3 of Part C of the Consultation Paper

Q118 Agree

In addition there should be an obligation on issuers to take reasonable efforts to ensure that non-executive directors have timely access to all relevant information to ensure that they can properly carry out their duties. This of course includes providing board packs sufficiently in advance of board meetings to allow non-executive directors to digest their contents and also to allow directors to retain board papers after board meetings.

Chairman and chief executive officer

Paragraph 11.4 of Part C of the Consultation Paper

Q119 Agree

We agree that this proposal to segregate the role of chairman and chief executive officer should not be mandated to allow an issuer to retain flexibility over the conduct of its business. We note that in the United Kingdom the Financial Services Authority allows a single individual to fill both roles.

Paragraph 11.5 of Part C of the Consultation Paper

Q120 Agree

Internal controls

Paragraph 12.3 of Part C of the Consultation Paper

Q121 Agree

In addition we would recommend that a rule be introduced requiring issuers to conduct a review of the effectiveness of its system of internal controls at least once in each financial year.

Paragraph 12.4 of Part C of the Consultation Paper

Q122 Agree

However, we do not believe that it is appropriate for an issuer to disclose in the report item (b) "details of any significant areas of concern that may affect shareholders". The purpose of the review is to ensure that any weaknesses are identified so that they can be corrected. It may mislead to identify these weaknesses when the issuer may already have resolved the matter. A requirement to disclose the results of the review may also undermine its effectiveness. The key point for shareholders and investors is to know that the review is being undertaken and that its conclusions will be or have been acted upon.

Voting by interested directors

Paragraph 13.3 of Part C of the Consultation Paper

Q123 Agree

SECURITIES TRANSACTIONS BY DIRECTORS

Disclosure of breaches

Paragraph 14.3 of Part C of the Consultation Paper

Q124 Agree

Breaches of the Model Code or the issuer's own code would currently represent a breach of Listing Rule 3.13. We agree that the Exchange should not seek to enforce a provision in an issuer's code that is imposed over and above the minimum standard. We recommend that a Listing Rule be introduced requiring issuers to take reasonable steps to ensure that directors comply with the Model Code or the issuer's own code.

Paragraph 14.4 of Part C of the Consultation Paper

Q125 Agree

In principle we agree that it is helpful to the market to promote transparency by requiring issuers to give disclosure in respect of the code of conduct governing securities transactions undertaken by directors. We support the disclosure set out in paragraph (a).

However, we agree with paragraphs (b) and (c) only on the basis that the non-compliance is one which the Exchange has found to be a breach of the Rules (see Exchange proposals as set out in paragraph 14.3 of Part C of the Consultation Paper). There are certain issues that arise in connection with the disclosure suggested in paragraphs (b) and (c). A director and the issuer may not agree as to whether the director has acted in compliance with the code of conduct. In the event of a dispute, who does the Exchange intend will resolve it? An issuer will be understandably reluctant to include information in its annual or interim accounts that may lead to proceedings being brought against it by the director for defamation.

The Exchange may consider requiring issuers to disclose the fact of a potential breach of the code of conduct to the Exchange. The Exchange should then investigate the

circumstances of the suspected breach. If the Exchange finds that a director is in breach of the code of conduct, it may take disciplinary action and inform the issuer of its findings. In circumstances where the SFC is investigating the director under its powers in relation to market misconduct, the Exchange would presumably rely on any subsequent determination of the Market Misconduct Tribunal (once the Securities and Futures Ordinance has come into force.

Definition of "dealing"

Paragraph 15.2 of Part C of the Consultation Paper

Q126 Agree

We support the inclusion of a definition of dealing in the Rules for application to the Model Code. However, we would raise the following issues with regard to the proposed definition (which we note follows that in the FSA's UK Listing Rules):

(i) It seems to us that the definition of "dealing" under the Listing Rules should not be inconsistent with that of the Securities (Insider Dealing) Ordinance or the relevant part of the Securities and Futures Ordinance.

(ii) We note that the definition of dealing has included "any interest in securities" of the issuer. One abuse which the rules do not cover is the dealing in interests in a special purpose vehicle holding solely shares in the listed company. These are not dealings in securities of the listed issuer. We suggest that the rules should be extended to cover expressly this situation.

(iii) Finally, at the moment, the Exchange considers that an acceptance of a general offer to be dealing within the ambit of Rule A2 of the Code of Best Practice. This is unfair to the directors of an issuer which is the subject of an uninvited offer. A hostile offeror might take advantage of this prohibition and time the offer so as to prevent directors from accepting the offer. This is wrong. The Code should specifically carve out acceptance of general offers as dealing. The Takeovers Code Schedule 2 para. 2(vi) already requires directors to state their intentions as to acceptance. This kind of "dealing" is not dealing in exceptional circumstances.

Paragraph 15.3 of Part C of the Consultation Paper

Q127 Agree

The UKLA's Model Code included in the Appendix to chapter 16 details certain transactions that are *not* considered as dealings even though they would otherwise fall within the definition. We recommend that the Exchange consider this list of transactions, given the proposal to adopt a definition of "dealing" in substantially the same form as that employed in the UKLA's Model Code. The relevant circumstances are set out below:

- The grant of options under an employees' share scheme during a prohibited dealing period;

- Exercising options where the final exercise date falls within a prohibited dealing period;
- Purchase of securities under a saving scheme;
- Taking up or allowing to lapse entitlements under a rights issue;
- Undertakings to accept or acceptance of a takeover offer;
- Cancellation or surrender of an option under an employees' share scheme.

Dealings by directors in exceptional circumstances

Paragraph 16.3 of Part C of the Consultation Paper

Q128 Agree, on the basis that the Exchange should issue guidance as to what it regards as "exceptional circumstances". This is because the question of what amounts to "exceptional circumstances" may vary from issuer to issuer. We believe that this guidance should be tightly drawn to prevent dealing except in cases of dire financial need. See our response to question 129 below.

Paragraph 16.4 of Part C of the Consultation Paper

Q129 Agree to requiring the issuer to provide notification to the Exchange.

However, we disagree with the suggestion that listed companies have to issue an announcement with respect to dealings carried out by directors in exceptional circumstances. This is because the relevant dealings should have been disclosed by directors as required by the Securities (Disclosure of Interests) Ordinance within 5 days anyway (and within 3 business days under Part XV of the Securities and Futures Ordinance). We think that it would be sufficient if the issuer is required to inform the Exchange of the relevant dealing, the exceptional circumstances under which it was allowed to take place and the reasons why the listed issuer considered it reasonable to allow the dealing. The Rules should state clearly when the issuer should inform the Exchange of the dealing.

In particular, the Exchange should clarify that this permission to deal in exceptional circumstances only applies during the blackout period and not when the director is otherwise in possession of unpublished price-sensitive information in relation to the securities. This requirement reinforces the need for guidance from the Exchange as to what can properly be considered exceptional circumstances.

Directors as trustees or beneficiaries

Paragraph 17.4 of Part C of the Consultation Paper

Q130 Agree, only on the basis that the Rules would also state as one of the conditions that the trust deeds do not require the director, as co-trustee, to participate in forming any judgement or making any decision in relation to the relevant dealing to be carried out on behalf of the trust.

Securities transactions by "relevant employees"

Paragraph 18.3 of Part C of the Consultation Paper

Q131 Disagree

We agree that the Code of Best Practice should recommend listed companies to establish guidelines for their employees in relation to dealings so as to ensure that there are sufficient internal guidance given to employees to prevent insider dealing – see section 13 of the Securities (Insider Dealing) Ordinance.

We believe that it is appropriate for the code of conduct (whether the Model Code or the issuer's own code) to apply to employees who are likely to be in possession of unpublished price-sensitive information.

We are of the view that this application of the code should be (a) mandatory; and (b) applicable to all employees of the issuer. It is not sensible for the certain employees of certain issuers to be subject to the code of conduct and others not to be. However, we do not think that the Code of Best Practice should recommend that the guidelines applicable to employees should be in no less exacting terms than the minimum standards applicable to directors. In the event of a breach of the code by an employee, it would be open to the issuer to take action under its own disciplinary proceedings or to refer the matter to the SFC for investigation under market misconduct provisions.

Q132 Disagree. It should be reasonable if the guidelines apply to all employees of a listed issuer.

"Black out" period of directors' securities transactions

Paragraph 19.7 of Part C of the Consultation Paper

Q133 Agree

Q134 Disagree

DIRECTORS' CONTRACTS, REMUNERATION AND APPOINTMENTS

Directors' service contracts

Paragraph 20.7 of Part C of the Consultation Paper

(a)

Q135 Agree

We believe that three years is an appropriate threshold. We assume this means a fixed duration rather than a contract with rolling notice provisions which might extend beyond 3

years. It might be worth referring to "fixed duration" in the revised Listing Rules, for the sake of clarity.

(b)

Q136 Agree

Paragraph 20.8 of Part C of the Consultation Paper

Q137 Agree

Presumably the remuneration committee would have approved the remuneration package in any event and would therefore recommend the shareholders to vote for the resolution.

Disclosure of directors' remuneration

Paragraph 21.3 of Part C of the Consultation Paper

Q138 Agree

Appointment, reappointment and removal of directors

Paragraph 22.4 of Part C of the Consultation Paper

Q139 Disagree

An amendment to the rules to require rotation of directors will in effect be a requirement for issuers to introduce such a provision into their constitutional documents. Although the Listing Rules currently require the inclusion of provisions in the constitutional documents of issuers, we do not favour this approach. We believe that rotation of directors should not be mandated by the Listing Rules but encouraged as best practice.

Q140 Disagree

We understand the rationale behind the Exchange's proposal. However, as INEDs ultimately owe their duties to the company as a whole, we think that it is not appropriate if only minority shareholders can vote on their appointment, reappointment and removal. We would agree if the Listing Rules require that before the appointment of INEDs is put forward for approval in general meeting, issuers should ensure that the selection of candidates have gone through a formal assessment process based on their competence, experience and independence.

PART D CORPORATE REPORTING AND DISCLOSURE OF INFORMATION QUARTERLY REPORTING

Quarterly reports

Paragraph 1.11 of Part D of the Consultation Paper

Q141 Agree but subject to comments relating to disclosure content and/or timeliness of reporting in questions 142 and 144 to 146 below.

Q142 Disagree

The reporting deadline for quarterly reporting should be two months.

We believe that 45 days may be too short a period for quarterly reporting and believe that 2 months is more appropriate. The amount of work required to produce a quarterly report should not be under-estimated. We agree that there should be consistency between the GEM Rules and Main Board Rules and propose that the GEM Rules be amended accordingly.

Q143 Agree

Paragraph 1.12 of Part D of the Consultation Paper

Q144 Agree

The scope and subject of the disclosures seem sensible.

Q145 Agree

Both comparative statements are required to give shareholders and investors a complete picture of the profitability (or otherwise) of a listed issuer.

Q146 Agree

Paragraph 1.13 of Part D of the Consultation Paper

Q147 Agree

Quarterly results announcements

Paragraph 2.4 of Part D of the Consultation Paper

Q148 Agree

The quarterly results announcement should be published on the next business day following their approval by the board of directors and within two months of the quarter end, consistent with our response to question 142 above.

Paragraph 2.5 of Part D of the Consultation Paper

Q149 Agree

Paragraph 2.6 of Part D of the Consultation Paper

Q150 Agree

HALF-YEAR REPORTING

Half-year reports

Paragraph 3.7 of Part D of the Consultation Paper

Q151 Agree

Q152 Agree

Paragraph 3.8 of Part D of the Consultation Paper

Q153 Disagree

The reporting deadline for half-year reporting should be three months.

We believe that a deadline of two months is too short and may in practice discriminate against smaller issuers with less resources. We agree that the deadline in the Main Board Rules should be consistent with the GEM Rules. The three-month deadline is consistent with the UK Listing Rules.

Half-year results announcements

Paragraph 4.9 of Part D of the Consultation Paper

Q154 Agree

We understand the importance to investors and shareholders of the inclusion of a consolidated balance sheet in the half-year results announcements.

Paragraph 4.10 of Part D of the Consultation Paper

Q155 Agree

Q156 N/A

FULL YEAR REPORTING

Annual reports

Paragraph 5.6 of Part D of the Consultation Paper

Q157 Disagree

We believe that the deadline should be four months from the financial year end. A deadline of 3 months is impractical and would be likely to lead to a significant number of requests for waivers. We note that the requirement under the UK Listing Rules is for the annual report and accounts to be published within six months of the end of the financial period.

Paragraph 5.7 of Part D of the Consultation Paper

Q158 Agree

It would be helpful for the Exchange to indicate whether it considers these reference disclosures to represent best practice in the market.

Summary financial reports

Paragraph 6.2 of Part D of the Consultation Paper

Q159 Agree

The disclosure should be given in summary form.

Annual results announcements

Paragraph 7.9 of Part D of the Consultation Paper

Q160 Agree

Paragraph 7.10 of Part D of the Consultation Paper

Q161 Agree

Q162 N/A

CONTENTS OF CIRCULARS AND ANNOUNCEMENTS RELATING TO NOTIFIABLE TRANSACTIONS

Very substantial acquisitions

Paragraph 8.3 of Part D of the Consultation Paper

Q163 Agree

Q164 Agree

However, clarification is need in respect of paragraph 9.2(e): Does the Exchange intend to require that a business valuation report be provided in all cases, or only that it should be disclosed if it exists.

Q165 Agree

Where there are valid reasons for the identity of the third party not to be disclosed, this can be dealt with by a request for a waiver from the Exchange.

OTHERS

Changes in directorship

Paragraph 10.3 of Part D of the Consultation Paper

Q166 Agree

Paragraph 10.4 of Part D of the Consultation Paper

Q167 Agree

The key disclosure for shareholders of biographical details is prior to appointment of the director at the issuer's general meeting.

Despatch of notice of general meeting and circular

Paragraph 11.5 of Part D of the Consultation Paper

Q168 Agree

Paragraph 11.6 of Part D of the Consultation Paper

Q169 Agree

The Law Society of Hong Kong
Securities Law Committee and
The Companies and Financial Law Committee
22 April 2002

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