



**CONSULTATION PAPER ON
RISK MANAGEMENT AND INTERNAL CONTROL:
REVIEW OF THE CORPORATE GOVERNANCE CODE
AND CORPORATE GOVERNANCE REPORT**

The Law Society's Submissions

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

Law Society's response:

Yes. We agree that internal control is an integrated part of risk management and the amended title is appropriate.

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

Law Society's response:

We agree with defining the roles of the board and the management. The responsibility of the board may, however, go further than risk evaluation. In line with the UK and Singapore approach, the board's responsibility should include determination of risk tolerance level. We suggest that the words "and determining" should be added after "evaluating" at line 1 of Principle C.2.

Further, the suggested amendments presuppose an internal structure in which "the board" will supervise "management" and "management" will provide specific assurances to "the board". "Management" is not a defined term in the Listing Rules. In practice, the precise application of revised C.2 may be uncertain where an issuer's "board" substantially overlaps with its "management" and there is no clear hierarchy or reporting lines as the draft new rule anticipates.

The Australian Code provides that an issuer should establish a "sound risk management framework". We consider that C.2 can go further to require an issuer to establish a risk management hierarchy. Alternatively, the relevant provision may include wording on how management is defined (for example, under paragraph 12.1 Appendix 16, it is the

directors' responsibility to determine the persons who constitute "senior management").

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

Law Society's response:

No. The management assurance should be a Code provision rather than a RBP. Disclosure on compliance with Principle C.2 is not complete without a statement on whether the board has received management assurance on the effectiveness of the issuer's risk management and internal control systems.

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

Law Society's response: Yes.

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

Law Society's response: Yes.

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

Law Society's response: Yes.

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

Law Society's response: Yes.

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

Law Society's response:

Yes, except that reference should be to "other significant regulatory compliance risks".

***Question 9:** Do you agree with our proposal to upgrade to Mandatory Disclosures most of the existing Recommended Disclosures in relation to internal controls (Section S.), as described in paragraph 71 of this paper?*

Law Society's response: Yes

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

Law Society's response: Yes.

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

Law Society's response: Yes.

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

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

Law Society's response: Yes.

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

Law Society's response: Yes.

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

Law Society's response: Yes.

Question 14: *Do you agree with our proposal to introduce the new Notes as described in paragraph 89 of this paper? Is the intention of the proposed wording sufficiently clear?*

Law Society's response:

Yes. We suggest adding a further note to CP C.2.5 to state that an issuer will be deemed to have an internal audit function for the purposes of CP C.2.5 if it engages an external service provider to perform the internal audit function. This reflects the position as stated at paragraph 88 of the Consultation Paper.

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

Law Society's response:

No. CP C.2.2 should not be expanded to include internal audit function since it is not obligatory for an issuer to have an internal audit function.

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

Law Society's response: Yes.

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

Law Society's response: Yes.

Question 18: *What would be an appropriate period of time between the publication of the consultation conclusions and the implementation of the amendments set out in this paper?*

- (a) Six months;*
- (b) nine months;*
- (c) 12 months; or*
- (d) others (please specify).*

Law Society's response:

We consider that 12 months is appropriate as this would allow sufficient time for issuers to evaluate and determine their risk tolerance level, to formulate risk management policy and to adopt and implement their own risk management system.

The Law Society of Hong Kong
20 August 2014