



Hong Kong

April 2016

SFC PUBLISHES CONSULTATION CONCLUSIONS ON PRINCIPLES OF RESPONSIBLE OWNERSHIP

Introduction

On 7 March 2016, the Securities and Futures Commission (SFC) published its consultation conclusions regarding its proposals to introduce Principles of Responsible Ownership set out in its Consultation Paper on the Principles of Responsible Ownership published in March 2015. The aim of the Principles of Responsible Ownership (**Principles**) is to describe what the SFC perceives as best practice for shareholders in Hong Kong listed companies.

The key features of the Principles are:

- The Principles apply to investors who invest money, or hold shares, on behalf of clients and other stakeholders and are accountable to such clients or stakeholders. They do not apply to retail and individual investors.
- They are not legally binding on investors and are voluntary for investors to adopt.
- Investors who hold or receive funds from the public that are invested in shares of Hong Kong listed companies are encouraged to adopt the Principles and make disclosures to their stakeholders in accordance with the Principles. If investors do not apply all the Principles, they should disclose why some aspects do not apply to them.

- Investors who consider that the Principles are not relevant or suitable for them at the outset are encouraged to provide their stakeholders with disclosure clearly explaining why the Principles have not been adopted at the outset and, if applicable, explaining any alternative measures in place.

Various changes have been made to the Principles to reflect comments made during the consultation process. The revised version of the Principles is set out in Appendix A to the consultation conclusions. The SFC plans to monitor the Principles' reception to assess whether any amendments or the introduction of obligations or requirements may be necessary in the future.

Background

The current Hong Kong legal framework supports corporate governance for shareholders' protection in the following ways:

1. directors are required by law to act in the interests of the shareholders of a company and their obligations are contained in statute, common law as well as non-statutory provisions such as the Hong Kong Listing Rules;
2. other provisions set out in statute, common law and non-statutory provisions (such as the Corporate Governance Code under the Hong Kong Listing Rules) which stipulate what a listed company can or cannot do; and

3. shareholders rights that can be used to protect themselves which include the right to vote, the right to receive information from the company to monitor the progress of their investments, and the right to communicate any questions or concerns to the company.

The SFC considers that strong corporate governance requires listed companies and their directors to be proactive and shareholders to be reactive and proactive. While the recent reforms to the obligations, liabilities and responsibilities of directors and listed companies have been widely publicised, the SFC considers that shareholders' rights have not been promoted to the same level.

Further, the SFC observed that investors who closely follow their investee companies' performance, decisions and corporate actions and review their disclosures are generally better informed and more able to engage effectively with investee companies. Effective engagement generally leads to better-run companies.

By promoting responsible ownership, the SFC believes the Principles will further strengthen the corporate governance culture in Hong Kong which will benefit the overall health of the Hong Kong financial market.

The Seven Principles of Responsible Ownership

Principle 1 - Investors should establish and report to their stakeholders their policies for discharging their ownership responsibilities

Principle 1 is the guiding principle that investors should establish policies on how they will fulfil their ownership responsibilities identified in Principles 2 to 7 and report these to their stakeholders.

The SFC has not defined "stakeholders" to allow flexibility in the application of the Principles, although the following guidance is included in Principle 1:

- Where a company/entity invests its own funds, its stakeholders are the board of directors or equivalent body and, depending on the size and relevance of the overall holdings to the entity, stakeholders may include its shareholders. If the company/entity is also accountable to the public, then stakeholders may also include the public generally.

- Where an investor manages clients' funds, those clients will be stakeholders. Retirement funds and investors accepting funds from third parties for investment are investors under this category, whether or not they have direct responsibility for investment decisions or appoint third party asset managers to manage their investments.

- An investor's stakeholders will include the beneficiaries of the funds received from the investor's direct clients. Thus where an asset manager is responsible for portfolios of funds on behalf of a retirement fund or a unit trust holder, the asset manager's stakeholders will include the members of the retirement scheme and the holders of such unit trust.

Depending on the number of stakeholders, it may be more effective to report to stakeholders through general disclosure on a website rather than to stakeholders individually. Where investment activities are outsourced, such as where funds are managed by asset managers, the report to stakeholders should disclose what steps are taken to ensure ownership responsibilities are fulfilled in accordance with the policy and the minimum policy requirements that are expected of those discharging ownership responsibilities. Further, an investor should include information provided by the asset managers in its reports or inform its stakeholders how and where its asset managers disclose their policies on discharging ownership responsibility. Finally, it is sufficient for an investor to disclose its ownership responsibility policy when it is established and only update this disclosure when the policy is amended.

Principle 2 - Investors should monitor and engage with their investee companies

Investors' ownership responsibilities extend beyond voting and include monitoring and engaging on matters such as strategy, capital structure, risk, performance and corporate governance. Engagement with investee companies is a process through which shareholders as owners share their views and concerns directly with their investee companies.

Investors should have policies on corporate governance principles and practices and on how they will engage with their investee companies if they have concerns about investee companies' corporate governance practices. They should, in particular, consider any departures from the Listing Rules' Corporate Governance Code and encourage investee companies to have policies on environmental, social and governance (ESG) issues. Investors should additionally

engage with investee companies on significant ESG issues which could potentially impact the companies' goodwill, reputation and performance.

When monitoring their investee companies, Principle 2 provides that investors should:

1. keep abreast of the companies' performance;
2. keep abreast of developments, both internal and external to the companies, that drive the companies' value and risks;
3. satisfy themselves that the companies' leadership is effective;
4. satisfy themselves as to the corporate governance structures and practices adopted by the companies;
5. consider the quality of the companies' reporting; and
6. attend shareholder meetings of companies where appropriate and practicable.

The SFC has also suggested the following engagement mechanisms for investors:

1. direct private communication with the companies such as writing letters to and dialogue with management;
2. more public strategies such as using the media and proposing shareholder resolutions at general meetings;
3. exercise their rights to speak and vote at general meetings;
4. selling their shares; and
5. in extreme cases, litigation.

If the shareholder engagement activities are outsourced, investors should ensure that the activities are carried out in line with their own shareholder engagement policies.

Investors are reminded to tread carefully during engagement to ensure that they do not obtain inside information that has not been disclosed to the market as required under Part XIVA of the Securities and Futures Ordinance (the **SFO**). If an investor considers that material information was obtained during an engagement with the investee company, it must employ sufficient safeguards, such as a temporary ban on trading

in the company's shares or establishing 'Chinese Walls', to ensure that the information is secure and separated from any other activity until appropriate disclosures have been made to the market. The investor should also consider whether it is necessary to warn the company that it may have breached the inside information provisions in the Securities and Futures Ordinance.

Principle 3: Investors should consider and establish clear policies on when to escalate their engagement activities

Investors' engagement policies should prescribe the situations in which they will actively engage and assess the outcomes of such engagements. Examples of such situations include, but are not limited to, when they have concerns over the company's strategy, performance, remuneration or approach to risks.

Initial discussions should take place on a confidential basis between the investor and the investee company. However, if companies do not respond constructively, the SFC recommends that investors should consider whether to escalate their action by:

1. holding additional meetings with management specifically to discuss concerns;
2. expressing concerns through the company's advisers;
3. meeting with the chairman or other board members;
4. collaborating with other investors on particular issues;
5. making a public statement in advance of general meetings;
6. submitting resolutions and speaking at general meetings; and
7. requisitioning a general meeting and, in some cases, proposing to change board membership.

Principle 4 - Investors should have clear policies on voting

Generally, investors should seek to vote all shares held; however, where it is not appropriate to do so, investors should disclose the reasons to their stakeholders. The SFC expects investors to vote on their own initiative rather than automatically support the board. In some situations, the SFC recognises that an investor could vote in favour of and against the same resolution due to shares being held for different purposes.

The SFC's guidance to investors provides that:

- a) If investors are unable to achieve an appropriate outcome through their engagement with an investee company, an investor should abstain or vote against relevant resolutions at shareholder meetings.
- b) Where proxy voting or other voting advisory services are utilised, investors should consider whether the advice reflects their assessments of the issues before voting their shares.

Principle 5 - Investors should be willing to act collectively with other investors when appropriate

In certain situations, collaboration with other investors may be the most effective form of engagement. Situations when collective engagement may be appropriate include times of significant corporate or wider economic stress or where significant value is at stake.

Principle 6 - Investors should report to their stakeholders on how they have discharged their ownership responsibilities

Investors should report to stakeholders annually on how ownership responsibilities were discharged. The SFC has suggested two methods for an investor to inform stakeholders of its voting activities:

1. to give details of its voting on a company by company basis; or
2. to report on the extent to which it complies with its stated policy on voting with details of specific cases where significant departures from its stated policy were appropriate.

Where investment activities are outsourced, such as where funds are placed with asset managers, the report to stakeholders should disclose what steps are taken to ensure ownership responsibilities are fulfilled in accordance with the policy. Further, an investor should include information provided by the asset managers in its reports or inform its stakeholders how and where its asset managers disclose their reports on discharging ownership responsibilities.

Principle 7 - When investing on behalf of clients, investors should have policies on managing conflicts of interests

An investor has a duty to act in the interest of its clients and/or the beneficiaries of the funds provided by the clients when investing funds on behalf of clients. Consequently, conflicts of interests are bound to arise.

Under General Principle 6 of the Code of Conduct for Persons Licensed or Registered with the Securities and Futures Commission, a licensed or registered person is required to try to avoid conflicts of interest and, if a conflict of interest cannot be avoided, to ensure its clients are treated fairly. Institutional investors are thus required to have a policy for identifying and managing conflict of interests in order to ensure that interests of clients, or where applicable the beneficiaries of those funds provided by their clients, are prioritised. This policy should address how matters are handled when the interests of clients differ from those of the beneficiaries of the funds provided by the clients. Institutional investors must also manage material conflicts of interests that may affect the exercise of key ownership rights regarding their investments.

Applicability of the Seven Principles of Responsible Ownership

The SFC has reiterated that the Principles are voluntary and open for investors to adopt. The Principles are geared towards all investors who invest money, or hold shares, on behalf of clients and other stakeholders and are accountable to such clients and other stakeholders. In other words, investors who are accountable only to themselves for their investments, such as individual and retail investors, are exempted from the scope of the Principles. Investors who hold or receive funds from the public that are invested in shares of Hong Kong listed companies are encouraged to adopt the Principles.

Recognising that the Principles are not written with any specific investor groups in mind, at the introductory stage of the Principles:

- a) The SFC aims not to prescribe how investors should adopt the Principles.
- b) Investors are encouraged to adopt the Principles in a way that best fits their institution, business model or business mandate.

- c) While the SFC encourages investors to adopt the Principles that best suit them and their stakeholders, it also recommends that investors adopt standards that exceed the minimum required by laws and regulations.

Investors that adopt the Principles should disclose to their stakeholders that they have done so, and then either apply the Principles in their entirety and disclose how they have done so, or explain why some aspects of the Principles do not apply to them. If investors consider that the Principles are not relevant to or suitable for them at the outset, they are encouraged to disclose this to their stakeholders explaining why the Principles have not been adopted and, if suitable, explain the alternative measures they have adopted instead.

Next Stage

After the introduction of the Principles, the SFC will review the following:

- a) whether there should be requirements for specified institutions to disclose whether they have adopted the Principles and, if not, explain why;
- b) whether the disclosure of a fund manager's engagement policy should be mandated, whether by adoption of the Principles or an equivalent overseas stewardship code and, if so, how it should be disclosed; and
- c) if intermediaries hold investments on behalf of individual investors, whether intermediaries should explain, where appropriate, in writing whether ownership responsibilities rest with the intermediaries or individuals and, if the latter, whether the individuals should be advised on how they can exercise their ownership responsibilities.

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