LexisNexis

The Importance of Corporate Governance for Private Companies in Hong Kong

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In 2021, Slotine co-authored an article on corporate governance for private companies with LexisNexis and posted an extract from it on Slotine's blog (10 February 2021). The original article has since been updated and republished, as reflected in the following up-to-date extract below.

According to the OECD, corporate governance involves "a set of relationships between a company's management, its board, its shareholders, and other stakeholders". It also provides "the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined".

Simply put, corporate governance is about ensuring that all the interests of the stakeholders in a company are aligned through a system of rules and practices for control and accountability. Although it is typically enforced by listed companies, private companies in Hong Kong also stand to benefit from embracing it to perpetuate good business decisions.

Private companies vary greatly in size and activity, but their importance to the Hong Kong economy is evidenced by many statistics. In particular, small and medium enterprises (**SMEs**) in the form of manufacturing enterprises with fewer than 100 employees or non-manufacturing enterprises with fewer than 50 employees, account for more than 98% of the total business units in the city. As of 2 August 2022, the Hong Kong Census and Statistics Department estimated that there are over 340,000 SMEs in Hong Kong, constituting more than 98% of business establishments and employing more than 45% of the workforce in the private sector.

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If you were wondering what constitutes a private company for which greater corporate governance is likely to be relevant, there are three possible criteria to consider:

- Companies that fall within the definition of "Category 3" and "Category 4" SMEs as defined by the Hong Kong Institute of Directors (**HKIOD**), with:
  – Category 3 being a medium-sized company with several shareholders or an unincorporated partnership; and
  – Category 4 being a larger medium-sized company with a substantial number of shareholders and a representative board
- Private companies that do not fall within the reporting exemption
- Private companies whose shareholders are considering entering into a shareholders' agreement

It is good practice to amend a company's articles of association to include the corporate governance provisions of the shareholders' agreement, so as to incorporate third parties' information and ensure uniform and transparent corporate governance measures.

UNDERSTANDING THE RULES AND PRINCIPLES OF CORPORATE GOVERNANCE

According to the HKIOD, corporate governance systems set out rules aiming at:

- defining governance roles, such as:
– the role of a board of directors
– the relationship of the board of directors to the general meeting
– the relationship of the board of directors to the shareholders
– the relationship of the board of directors to the management
– the role of the chair of the board of directors
– the role of the individual directors
– the role of the CEO
– board meetings
– board committees
– general meetings
– best practices that supplement the legal requirements, and

- improving the governance process by:
– determining appropriate responsibilities for strategy;
– delegating;
– monitoring;
– ensuring compliance; and
– managing risk.

While there is no single approach, the HKIOD acknowledges that there are basic governing principles that are likely to increase a company's chances of survival and success when applied – the most fundamental being that all companies must:

- comply with the law;
- earn the respect, or at least the tolerance, of their stakeholders, customers, creditors, employees, suppliers, and the communities within which they operate;
- lower the cost of capital by establishing and maintaining a sound reputation;
- identify and manage the risks facing them; and
- adopt and develop systems which enhance the quality of decision making.

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The benefits of better governance are that it helps companies achieve their chosen objectives more effectively and at a lower cost, while reducing the risk of insolvency and other disasters which can prevent them from achieving their objectives – as explained by the HKIOD.

CORPORATE GOVERNANCE BEST PRACTICES AND GUIDANCE BEYOND HONG KONG

To help foster corporate governance in Hong Kong companies, the HKIOD has created two complementary reference tools for SMEs so far, namely:

- The "*Guidelines on Corporate Governance for SMEs in Hong Kong*", which addresses the 'what-to-do' aspects of corporate governance practices; and
- The "*SME Corporate Governance Toolkit – From Guidelines to Implementation*", which covers the 'how-to-do' steps of implementation.

In addition to the HKIOD, Hong Kong private companies should also look to international organisations and other common law jurisdictions for best practices and guidance, such as:

- The Organisation for Economic Co-operation and Development (**OECD**), an intergovernmental economic organisation to which Hong Kong SAR is a participant of their Trade Committee and Committee on Financial Markets. It believes in the global purpose of good corporate governance as a method to help build an environment of trust, transparency, and accountability necessary for fostering long-term investment, financial stability, and business integrity, thereby supporting stronger growth and more inclusive companies.
- The European Confederation of Directors' Associations (**EcoDa**), a not-for-profit association founded in December 2004 under the laws of Belgium to represent the views of company directors from EU member states to corporate governance policy makers at the EU level.
- The National Association of Corporate Directors (**NACD**), an independent, not-for-profit organisation based in the United States that annually surveys its membership community to identify the latest governance trends. They publish their findings and insights on key practices in their "Private Company Governance Survey" as well as their "Blue Ribbon Commission Report" to propose new principles and practices for private companies to address the most critical boardroom issues.
- The Australian Institute of Company Directors (**AICD**), a not-for-profit membership organisation for directors founded in 1990 with more than 45,000 directors and senior leaders from business, government, and not-for-profit sectors as members.

Ultimately, corporate governance and Environmental, Social and Governance (ESG) are complementary, with an enhanced corporate governance structure linked to a company's good governance of environmental and social issues. As explained by the Hong Kong Exchanges and Clearing Limited, one of the world's largest and most respected exchange groups, good corporate governance practices "provide the bedrock for managing environmental and social risk" and ensure that there is accountability at the highest levels of business.

If you have any questions or feedback – or want to find out more – please do not hesitate to reach out to us.