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APERCU

CONTENTS

DISCLOSURES OF INSIDE INFORMATION

A few months before its financial year-end, ABC Limited's Financial Controller purchased one million shares in the company. "Why?" you might ask. Well, he had the following inside information when he made the purchase:

- The interim results showed a profit of approximately HK$20 million;
- By the third quarter, the profits had increased by 140% to HK$48 million; and
- On the 11th month, the profits surged to HK$75 million, by 275% from the interim results.

Similarly across Victoria Harbour, a Kowloon-based company has another inside information story. XYZ Limited reported an interim profit of HK$80 million, compared to HK$45 million for the same period previous year. The public reacted positively to this announcement, not knowing that XYZ actually faced significant losses from the third quarter onwards. These were due to the non-continuity of three major debtors. The Board was aware of this information before it made the interim announcement.

These two scenarios are nothing new in the business world. Hence, the questions remain: how should the disclosure of inside information be managed; and how should equal, timely and effective disclosures be made to the public?

Part XIVA of the Securities and Futures Ordinance (SFO) was introduced to answer these issues. It took effect on 1 January 2013, and it requires listed companies to disclose price-sensitive inside information to the public as soon as reasonably practicable after it becomes aware of it.

Basically, since this new requirement came into force, the officers of listed corporations have been required to take reasonable measures from time to time to ensure that proper safeguards exist and to prevent non-compliance concerning "disclosure of inside information".

In this article, we will explore several broad topics, namely "what is inside information?", "when and how should it be disclosed?", "what are the responsibilities and 'safe harbours' for companies", "what needs to be done?", and "what will be the consequences if the issue is not attended to?"

What is inside information?

According to Section 307A (1) of Part XIVA of the SFO, "inside information" basically means **specific information** about a corporation, its relevant stakeholders and its listed securities. Such information must **not be generally known** to those who are accustomed to dealing in the company's listed securities. If the information is generally known, it would be likely to **materially affect** the price of the listed securities. So the concept of "inside Information" have several key elements:

- ***It must be specific.*** Inside information must be capable of being identified, defined and unequivocally expressed. In other words, if the inside information carries sufficient particulars – such as details of a transaction, event or matter, or a proposed transaction – it can be regarded as specific information. However, specific information must not be confused with mere rumours, vague hopes or worries, or with unsubstantiated conjecture, eg "fishing expeditions".
- ***It must not be generally known to the public.*** Information is inside information if it is known only to a few and not generally known to the public. Hence, press speculation, reports and rumours in the markets cannot automatically be categorised as information generally known to the public. To qualify as "generally known", the information must be disclosed via a proper disclosure channel on the HKEx website.
- ***It must materially affect the price of the listed securities.*** The information must have the potential to change the price of securities materially. There are several things to consider when determining whether this might occur. These are the anticipated magnitude of the event (compared to a corporation's entire activities), the relevance of the information, the reliability of its source, and market variables that might affect the price of the securities.

Management accounts. Generally, ordinary information contained in management accounts is not classified as specific information.

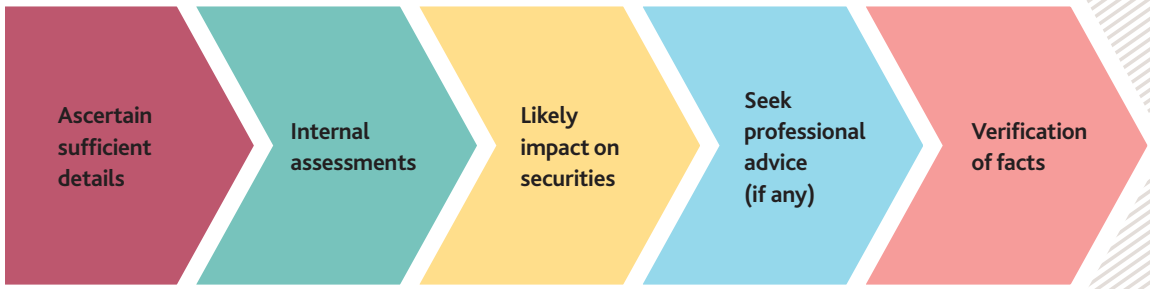
However, knowledge of significant events, such as substantial losses or profits, may be inside information, even if their precise magnitude is not yet clear.

Examples of possible inside information. Common examples of when disclosure obligations may arise include changes in business performance, financial conditions, directors, auditors, restructuring, expected earnings or losses, the solvency of major debtors or suppliers, legal disputes, new licences or patents, etc.

When and how should inside information be disclosed?

Under Section 307B (1) of Part XIVA of the SFO, a listed company must disclose information to the public **as soon as reasonably practicable** after it has come to its knowledge. In essence, "as soon as reasonably practicable" means the company should disclose the inside information to the public (in a full or holding announcement), immediately after the following necessary steps have been taken (**figure 1**).

Figure 1



If a full or holding announcement cannot be made, the company should apply for a suspension of trading of its securities until disclosure is possible. The disclosure must be made via an electronic publication system operated by a recognised exchange company, ie the HKEx website. Therefore, issuing a press release through news and wire services, an announcement on the company's websites or a press conference in Hong Kong might not be sufficient.

Who's responsible for compliance and management controls?

Basically, the officers of a company are responsible for compliance with Part XIVA of the SFO. They must take all **reasonable measures** from time to time to ensure that proper safeguards exist to prevent a breach of this disclosure requirement.

As implied in Section 307B (2) of Part XIVA of the SFO, an officer can be defined as a director, manager or secretary involved in the company's management. The definition of director also includes non-executive directors and independent non-executive directors, as they are responsible for establishing and monitoring key internal control procedures.

Safe harbours

To strike a proper balance between "requiring timely disclosures of inside information" and "preventing premature disclosure" that might tarnish a corporation's business interests, Section 307D of Part XIVA of the SFO provides for safe harbours. These allow the company to withhold disclosure under the following specific circumstances:

- The disclosure is prohibited under an enactment or a court order;
- The company has taken reasonable precautions to preserve the confidentiality of the inside information;
- Its confidentiality has been preserved; and
- Other specific circumstances, such as:
  - An incomplete proposal or negotiation;
  - A trade secret;
  - Liquidity support from the Exchange Fund; and
  - A waiver by the SFC.

What needs to be done?

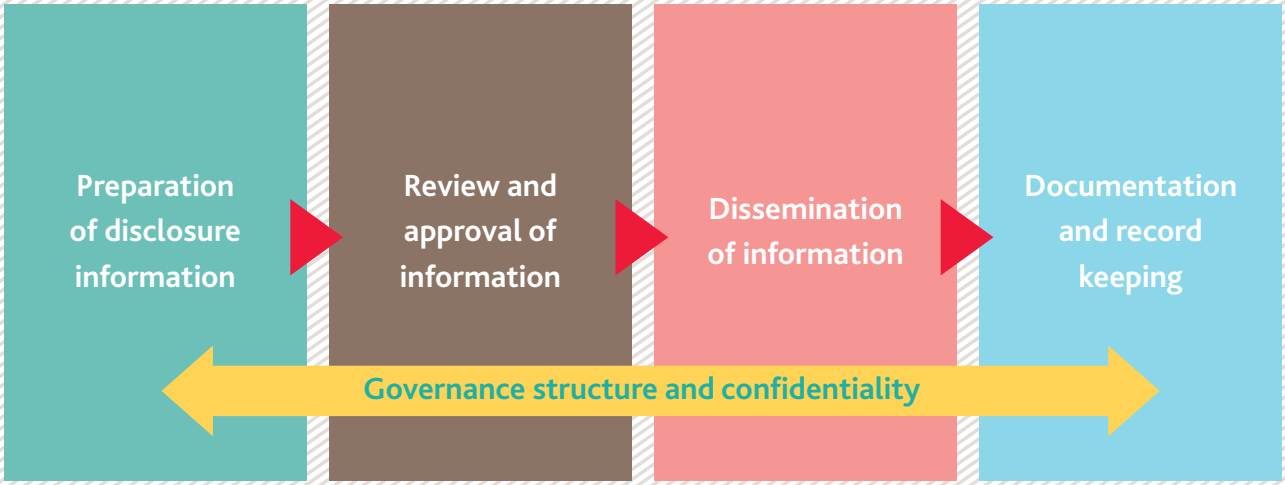
With Part XIVA of the SFO now in effect, a company's officers should take reasonable measures to ensure compliance with the disclosure of inside information. This may include establishing policies, guidelines, reporting channels and procedures, committees, a sensitivity list, record-keeping criteria, etc.

To achieve the above, its officers should implement the "Disclosure Model" (**figure 2**) on the next page.

First of all, a governance structure should be put in place to govern the disclosure process. Ideally, it should consist of the following committees and members:

- ***Board of directors (BOD).*** The final approval authority must rest with the board, which should review and approve all the relevant documents before they are disclosed.
- ***A disclosure committee*** to evaluate and review the relevant information and documents before submitting them to the BOD for its review. It should organise regular meetings with the BOD, finance and operational functions in order to identify and update an inside information checklist.

Figure 2: The Disclosure Model



- *Compliance officer.* This should be a person with adequate knowledge of the relevant rules and regulations. The compliance officer plays an important role in disclosure, especially in terms of ensuring compliance with various disclosure and regulatory requirements.

Second, once the governance structure has been established, the company should proceed to set the tone from the top, ie by preparing a set of policies and guidelines, such as:

- A sensitivity checklist of disclosure requirements, which can be sourced from management accounts, price-sensitive information, connected transactions, corporate governance, etc;
- A definition of disclosure responsibilities and an approval matrix;
- A definition of the materiality of disclosures; and
- An effective mechanism to ensure that the information to be disclosed is timely, accurate and complete.

Third, the listed corporation must ensure that the inside information is properly scrutinised. Once such piece of information has been identified, it should be subject to monitoring, review and approval by one or more of the following:

- The board of directors and audit committee;
- The corporate governance committee;
- Senior officers;
- The group controller/ chief financial officer;
- The disclosure committee or advisors;
- Legal counsel; and
- The company secretary

Fourth, during each disclosure, the company must establish procedures for defining authorised channels for disseminating information. Some suggested procedures are:

- Procedures for releasing information to external stakeholders, such as the HKEx website;
- Procedures for responding to market rumours, leaks or false market information;
- Maintaining an approved list of printers, media and contact persons;
- Procuring external consultants to provide public speaking training to key authorised personnel, in order to ensure that the outcome is consistent with the company's expectations;
- Preparation of an investor relations policy, under which only a limited number of authorised personnel may respond to the public's enquiries on the basis of information that has been carefully prepared and reviewed by the compliance officer; and
- A policy concerning responsibility for electronic communications.

Last but not least, the disclosure model must stress the importance of record keeping. Good record-keeping about disclosures can determine whether proper evidence of safeguards to prevent non-compliance exists. Its key principles include:

- Ensuring security and controlled access to information;
- Formal policies and procedures to provide evidence of "reasonable measures";
- Availability of information on a need-to-know basis only;
- Documentation of internal assessments or meetings concerning inside information;
- A complete record of communication with external parties, as far as is practicable;
- A well-maintained and constantly updated inside information events list; and
- A record of how confidentiality has been monitored.

What are the consequences, if an issue is left unattended?

In summary, the new legislation requires listed companies to perform a self-governing process. This includes implementing checks and balances and striking an appropriate balance between "reporting inside information" and "preventing premature disclosures". The Market Misconduct Tribunal may impose the following measures, among others, for any breach of the regulations:

- A regulatory fine of up to HK$8 million on the director or chief executive of a listed company;
- Disqualification of a director or officer from being a director or otherwise involved in the management of a listed company for up to five years;
- An order depriving a director or officer of access to market facilities for up to five years;
- An order for a listed corporation, director or officer not to breach the statutory disclosure requirements again;
- An order for a company officer to undergo training;
- An order for a company to appoint an independent professional adviser to review its compliance procedures; and
- An order for a company to appoint an independent professional adviser to advise on compliance matters.

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CAN LABOUR DISPUTES BE AVOIDED?

The recent strike by HK container terminal workers is a prominent example that illustrates how labour disputes could be detrimental to a business and simultaneously highlights the importance of maintaining amicable employment relationships between employers and employees.

Labour disputes can have many causes. They include situations that employers could avoid if they clearly and unambiguously lay down the terms of employment in their employment contracts.

Apart from basic remuneration and other general matters, the following are important elements when constructing an employment contract:

i) Whether or not a person is employed under a continuous contract. An employee is deemed to have been continuously employed if he or she has worked under a contract of employment for not less than 18 hours each week over a period of four or more weeks. An employee under a continuous contract is entitled to receive employment benefits and protection, such as rest days, statutory holidays, annual leave, sickness allowances, maternity leave, end-of-year payments, severance pay and long-service payments.
ii) Whether meal breaks and rest days are paid or unpaid.
iii) Whether the average wages payable to an employee for the hours he or she works are at least equal to the statutory minimum wage. Since 1 May 2013, this has been HK$30 per hour (it was previously HK$28 per hour).

An employment contract with unambiguous terms can protect the rights of both employers and employees during the course of their employment, as well as when the employment relationship ceases.

It is important for employers to make correct termination payments to employees in order to avoid labour disputes. The following illustrates the most controversial areas that can affect the correctness of termination payments:

Should bonuses be included when calculating average wages?

The items to be taken into account in termination payments may differ according to the employee's length of service and the reason for termination. They usually include:

- Outstanding wages;
- Notice, or any wages in lieu of notice;
- Untaken annual leave to be converted into annual leave pay;
- Any outstanding and/or pro-rated end-of-year payments or annual bonuses;
- Severance payments or long-service payments (if appropriate); and
- Any other payments under the employment contract, such as gratuities, termination compensation, etc.

Employers and employees may have different ideas about whether end-of-year payments should be included when termination payments are computed. It depends on the agreed terms of end-of-year payments and annual bonuses, as stated in the employment contract. An end-of-year payment may refer to:

a) A thirteenth month's salary payable to an employee on the basis of his or her current monthly base salary or average wages, either at the end of each calendar year or before Chinese New Year;
b) An annual guaranteed bonus payable to an employee that is based on a percentage of his or her current monthly base salary or an agreed amount;
c) An annual bonus payable to an employee on the basis of his or her individual performance or the employer's performance (which may for example be subject to the achievement of an annual sales target and target margins by both the employee and employer); or
d) An annual bonus payable to an employee at the sole discretion of the employer.

The correctness of termination payments may be affected if an employer fails to set out clearly in an employment contract how end-of-year payments will be paid to the employee; or whether the employer has previously made such payments to the employee at its sole discretion.

According to the Employment Ordinance, end-of-year payments or annual bonuses that are of a gratuitous nature or that are payable at the sole discretion of the employer need not be included as wages when calculating the six statutory entitlements (end-of-year payments, holiday pay, sickness allowances, maternity leave pay, wages in lieu of notice, or severance or long-service payments). On that basis, discretionary end-of-year payments should be excluded when calculating average wages for the purposes of statutory entitlements in termination payments.

How do you determine whether a payment is a discretionary end-of-year payment or a fixed-term payment, such as a thirteenth-month salary or guaranteed bonus? Besides looking at the agreed terms of employment, the employer also needs to refer to its past payment practices. If an employment contract states that end-of-year payments are gratuitous in nature but the employer has previously paid them to employees within a regular time frame, such payments will be regarded as a fixed term of payment instead of a discretionary one. Their exclusion from a termination payment may therefore amount to an underpayment that employees may dispute, especially if it involves a significant end-of-year payment.

A real life example

An employer terminated an employee due to the company's restructuring. It excluded end-of-year payments from the calculation of wages in lieu of notice and end-of-year payments on the basis that such payments were subject to the joint achievement of a budgeted profit margin and sales target by the company and employee. The employee disputed the termination payment and claimed an additional amount with the Labour Department on the grounds that the employer had consistently made end-of-year payments to him of an amount equal to one month of his base salary every December. Following a conciliation meeting arranged by the Labour Department, the employer had to agree to a compromised amount based on the figure claimed by the employee.

How does commission impact the calculation of termination payments?

The entitlement of an employee to commission is usually based on his or her performance (for example, an employee would be entitled to a certain percentage of commission on sales revenue if he or she meets quarterly or yearly sales targets). According to the Employment Ordinance, commission calculated on the basis of work performed by an employee comes within the definition of wages for the purpose of calculating the six statutory entitlements. However, it excludes any commission of a gratuitous nature or which is payable at the sole discretion of the employer.

A real life example

An employer regarded the commission paid to its employees as discretionary, since it was not stated in the employment contract. When it terminated an employee, it excluded commission from his wages for the purpose of calculating annual leave pay, end-of-year payment and wages in lieu of notice in the termination payment. The employee disputed the termination payment, due to the fact that the employer had set a sales revenue target for the employee each year, and had subsequently paid a certain percentage of commission to the employee. Although the basis of the employee's commission entitlement was not written into the employment contract, the substance and past practice of commission payments to him overruled the employer's claim that the commission was discretionary in nature. Following the Labour Department's intervention, the employer finally settled the claim with the employee.

Can an employer's failure to keep verbal promises to its employee cause a labour dispute?

The Employment Ordinance provides a clear definition and basis for the calculation of severance payments and long-service payments. Employers are allowed to offset these against accrued Mandatory Provident Fund (MPF) benefits for employees (ie the employer's portion of the accrued benefits). There should be no argument concerning this.

A real life example

An employer verbally promised not to offset long-service payments against the employee's MPF accrued benefits, but eventually it broke this promise and asked the MPF service provider to refund the amount paid as a long-service payment.

The employee asked the Labour Department for assistance, and he eventually received the offset long-service payment amount from his employer.

Other issues that may cause labour disputes

The Employment Ordinance sets out the following restrictions and prohibitions. Failure to comply with these may result in labour disputes.

- A prohibition on making deductions from wages calculated in accordance with the Ordinance.
- Failure to serve sufficient notice of termination or wages in lieu of notice to an employee during or after the employee's probationary period. In particular, a person employed under a prolonged probationary period should receive the same notice of termination or wages in lieu of notice as if he or she had completed the probationary period.
- Unilateral changes of terms of employment by the employer.
- The termination of an employee under the following unlawful circumstances:
  - A female employee who is on maternity leave or has served a notice of pregnancy to the employer;
  - An employee on sick leave or suffering from an injury sustained at work that is being assessed under employees' compensation insurance cover;
  - Membership of a trade union;
  - An employee who has previously been convicted of an offence but has not been sentenced to imprisonment or fine as provided under the Ordinance; and
  - Summary dismissal of an employee without valid reasons, as provided for by the Ordinance.

The chance of a labour dispute occurring is low, provided both employers and employees maintain an amicable employment relationship and the employees are happy with their current terms of employment. The Employment Ordinance, Statutory Minimum Wage Ordinance and other labour-related legislation are updated by the government from time to time. Employers should keep themselves abreast of any relevant changes and ensure that the terms of employment they offer their employees comply with these.

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ASSESSING THE VALUE OF MAINLAND AUTOMOBILE COMPANY MANAGEMENTS

A company's management and business processes can play a decisive role in its financial performance and ultimately its success. Companies with high-quality governance and processes tend to perform better, and their stock valuations outperform the market average as a result.

BDO has partnered with the European consulting firm Management and Excellence (M&E) in formulating the M&E BDO Sustainable Management Assessment & Rating to quantify the management performance of companies. This is based on four major areas:

- Compliance with norms and good business practices;
- Financial and business performance;
- Business strategy; and
- Risk management.

In 2012, this rating approach was used to assess between 300 and 350 data points based on historical and publicly available information about leading Hong Kong-listed companies in 11 sectors in order to create the M&E BDO Asiamoney Hong Kong Stars Index (also known as the "HK STARS Index").

In summary, the Index tracks companies that have been determined to possess consistently good management and strong operations by evaluating comprehensive corporate data rather than market capitalisation and share prices. It focuses on the best and most sustainably managed large-cap companies in Hong Kong.

Furthermore, we recently used the same assessment method to conduct a derivative study focusing on the performance of mainland automobile companies, mainly those listed in Hong Kong, and we benchmarked this against the performance of Volkswagen. The results of the study were published in the June issue of *Asiamoney*.

The study results were calculated by assessing around 300 data points for compliance with good management practices, financial performance, and the volatility within that performance. The method used was the same as the one for rating and ranking companies in the HK STARS Index.

The study showed that mainland automobile companies lag behind the standards set by international benchmarks, such as Volkswagen. The managements of these mainland companies seem to create less value for their companies. According to the study, Volkswagen's management processes and operations effectively contribute 0.745 of management value to market capitalisation, meaning that 74.5% of the German company's listed market value is due to its management operations (see **figure 1**).

The company that came closest to this in the study was Geely Automobile Holdings, whose management structure and processes accounted for 51.4% of its market value (see **figure 1**). Volkswagen made informative disclosures about topics such as its investment in research and development, corporate governance efforts and financial returns on investments. These suggest that the company is doing reasonably well. The study indicates that Geely is moving in the right direction and has effective management systems and processes in place. Geely builds four-door sedans at low prices to cater to the mid to low-end market, which is a growth segment. It uses older technology that is stable and predictable, and it has developed good distribution channels that ensure the sustainability of its earnings. On the other hand, Geely may not be as innovative as some of its competitors; it could face a volatile future as the automobile market evolves in China and more people begin to demand higher quality.

BYD is apparently an outlier. Its relative management value of RMB3.88 billion (US$630 million) is only 19.8% of its total market capitalisation (see **figure 1**). Nevertheless, BYD focuses on building electric cars, and is one of China's more innovative auto companies. Even so, its very volatile revenues and earnings reduced its score. That was largely because it occupies a niche segment, whereas other companies operate within the traditionally more stable standard car market. That said, BYD is receiving a lot of interest from investors as it devotes more resources to several interesting projects; and the strong demand for cars means that the country may well have to start considering alternatives, such as electric vehicles.

Figure 1: Ranking of auto companies according to management value

Rank	Auto company***	Stock code	Market cap (RMB)*	Relative management value (RMB)**	Percent of mgt value to market cap
1	Volkswagen Group	VOW.DE	€ 68,204,029,038.8	€ 50,783,947,736.0	0.745
2	Geely Automobile Holdings	175 :HK	30,408,131,029.0	15,628,258,942.0	0.514
3	Great Wall Motors Company	2333 :HK	27,172,633,212.0	10,590,669,658.0	0.390
4	Guangzhou Automobile Group	2238 :HK	14,541,382,812.0	5,425,971,582.0	0.373
5	Qingling Motor Company	1122 :HK	2,588,782,292.0	929,450,506.0	0.359
6	SAIC Motor Corp	600104 :CH	167,919,431,100.0	57,561,101,787.0	0.343
7	Brilliance China Automotive Holdings	1114 :HK	45,835,016,243.0	14,899,305,149.0	0.325
8	DongFeng Motor Group	0489 :HK	31,127,477,711.0	9,994,721,818.0	0.321
9	BYD	1211 :HK	19,629,255,000.0	3,878,722,352.0	0.198

* Market cap on 28 March 2013, according to Bloomberg. Volkswagen's market cap is quoted in Euros.
** Total value of all management and business processes, but excluding strategy. Volkswagen's value is quoted in Euros.
*** All companies are listed on the Hong Kong Stock Exchange, except SAIC Motor Co. Ltd, which is on the Shanghai Stock Exchange, and the Volkswagen Group, which is on the Frankfurt Stock Exchange.

Figure 2: Ranking of risk factors

Rank	Auto company	Risk score (lower is better)*	Greatest risk
1	Guangzhou Automobile Group	0.116	Net income
2	Volkswagen Group	0.12	EPS
3	Geely Automobile Holdings	0.16	Results from financing activities
4	SAIC Motor Corp	0.33	Cash position
5	Qingling Motor Company	0.38	Results from financing activities
6	DongFeng Motor Group	0.39	Cash position
7	Brilliance China Automotive Holdings	0.40	Results from investments
8	Great Wall Motors Company	0.45	Results from financing activities
9	BYD	0.53	Cash position

* Measures the volatility of the financial performance figures for the past 2-3 years

Figure 3: Ranking for compliance with good practices

Rank	Auto company	Compliance with governance, transparency, good practices standards	Areas of greatest strength
1	Volkswagen Group	87%	Sustainable management
2	DongFeng Motor Group	50%	Corporate governance
3	Geely Automobile Holdings	48%	Corporate governance
4	BYD	47%	Sustainable management
5	Qingling Motor Company	42%	Corporate governance
6	Great Wall Motors Company	39%	Corporate governance
7	SAIC Motor Corp	37%	Corporate governance
8	Brilliance China Automotive Holdings	37%	Corporate governance
9	Guangzhou Automobile Group	36%	Corporate governance

Figure 2 summarises the automobile companies' risk factors (the lower the better). The cash positions of many of these companies, including Geely Automobile and DongFeng Motor, were assessed as being of some concern, while the results of their financing activities were also a common risk.

The study also revealed that the DongFeng Motor Group has the highest ranking for good practices among the mainland automobile companies. Volkswagen's greatest strength is its sustainable management (see **figure 3**).

The rapid growth of China's automobile market is benefiting all its players because it still faces minimal direct competition. But, as the market becomes saturated, these companies will inevitably have to face competition and adapt to changing conditions. The currently low management scores of Chinese automobile companies work to their advantage; it means there is room for them to improve the reliability and security of their business. Those that can achieve this will become less risky to invest in, and they will most likely succeed domestically and beyond.

The auto industry study was the first sector analysis we have conducted using the HK STARS Index method. We will be carrying out further reviews on sectors such as Asian REITs, and the results will appear in forthcoming issues of APERCU.

For more information about the M&E BDO Asiamoney Hong Kong Stars Index, please contact patrickrozario@bdo.com.hk or vivianchow@bdo.com.hk .

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BDO EXECUTIVE FORUM 2013 - PART 1

Updates for senior business and finance executives: risk management and compliance amid rapid regulatory and technological changes

The first of this year's two BDO Executive Forums will be held on Tuesday, 23 July 2013 at the BDO office, 25/F Wing On Centre, 111 Connaught Road Central, Hong Kong. This event aims to provide senior business and finance executives with the latest updates concerning risk management and compliance, thus helping them to face the ever-increasing challenges in today's evolving business environment.

This year, three speakers from BDO will share their knowledge and expertise and offer insights about the **new companies ordinance**, **anti-money laundering**, **anti-corruption and anti-trust**, as well as **data security and privacy management**, in order to help executives stay alert to their implications and the potential impact on their business.

BDO Director and Head of Corporate Secretarial Teresa Lau will give an overview of the new Hong Kong Companies Ordinance and highlight the key changes.

BDO Director and Head of Risk Advisory Services Patrick Rozario will discuss the latest technology trends and cyber risk management, and he will touch on privacy law in Hong Kong. Patrick will also offer advice on data security and assessment.

BDO Principal of Specialist Advisory Services Gabriel Wong will elaborate on recent developments concerning anti-money laundering and anti-corruption, and the introduction of anti-trust as the latest enforcement weapon in Hong Kong.

TOPIC HIGHLIGHTS

- **An overview of the new companies ordinance**
  - Highlights of key changes
- **Anti-money laundering, anti-corruption and anti-trust**
  - Anti-money laundering: the Hong Kong version and recent developments
  - Anti-corruption: current issues and a recap of FCPA, UKBA and POBO
  - Anti-trust: the latest enforcement weapon in Hong Kong
- **Managing data security and privacy**
  - New technology trends and cyber risk management
  - Privacy and data protection law in Hong Kong
  - Safeguarding data security, with a case study
  - Privacy impact assessment

For more details, please visit BDO's website at www.bdo.com.hk

BDO 50TH ANNIVERSARY

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