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# HKCGI Note – Governance-related matters for Hong Kong start-ups

This guidance note is directed at governance-related matters for a start-up. Most start-ups have an incubation period where the focus would be on developing their business case. However, investors are increasingly concerned with the governance of start-ups. Accordingly, a start-up with an ambition to grow should aspire to be well-governed at inception to attract investors' interest and for sustainable growth.

## Introduction

The idea of 'governance' revolves around 'systems of internal controls' to 'manage risks'.<sup>1</sup>

For example, standard good 'governance practice' requires two persons to authorise payments beyond a nominal amount. Such a requirement is part of a system of controls to reduce 'operational risks' such as unauthorised or fraudulent payments, which could possibly threaten a start-up's existence and well-being. This control process assumes that two persons are more likely to keep each other in check. If this requirement is published, it becomes a 'policy' for the company.

Understanding this example allows us to introduce the idea of a company's 'three lines of defence'. As part of operational risk management, the business practices, the first line, must reduce operational risks. This is

achieved through front-line staff training in accordance with policies and procedures under the second line of defence. The audit functions, the third line, will keep the other two lines.

<sup>1</sup> Risks are any matters that can bring about uncertainties in the desired outcomes of a company.

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A start-up is involved in the sales of novel software. The employee selling the software gets a commission and additional bonuses when specific sales targets are met. To boost sales, an employee provides rebates to purchasers and also buys some software himself. These practices amount to corrupt business practices. If the start-up did not train its employees that such practices are corrupt and not acceptable, nor are the policies in place, these would probably spell the end of the start-up should there emerge regulatory investigations or a social media expose.

Designing operational risk management and the related three lines of defence will invariably require professional support. A company must adopt various policies, and its directors, management and employees should be appropriately trained. The governance professional can assist in these matters<sup>2</sup>. The main idea is that good governance practices, including the three lines of defence, should be set by the 'tone on the top' by senior management and subscribed by all persons holistically across the organisation to avoid a 'tick-the-box' mentality. Good governance should be embedded as part of the 'culture' of the start-up.

A shareholders' meeting must be held periodically to comply with legal requirements and shareholders' agreements, if any. It is easy to treat this as a mere compliance matter with proposing a meeting with minimum agenda items. During the meeting day, the lowest number of shareholders constituting the quorum or required under shareholders' agreements meet for 5-10 minutes to pass standard resolutions under a 'tick-the-box' approach. However, the better-governed start-up would reach out to different stakeholders and identify governance-related issues from 'stakeholders' engagement'. Shaping the start-up's strategy from the stakeholders' engagement will undoubtedly be appreciated by investors.

In addition to 'legal and compliance risks', other risks include privacy and reputational risks. Fallouts from data breach leaks, a privacy risk, are daily occurrences. On more than one occasion, we have also seen business leaders saying something misleading or inaccurate on social media, affecting their businesses. The scope of governance is ever-increasing. For example, ten years ago, environmental, social, and governance (ESG) risks were in their infancy and are now of prime importance. Climate change-related transition and physical risks, as part of ESG, are fast becoming the main governance topics.

A start-up which has the purpose of helping society to reduce its carbon footprint would be most concerned with reducing climate change, an ESG risk. Conversely, a start-up intending to give people stress-free payment options may be less concerned with climate risks but more with cyber-risks. Thus, a start-up needs to clearly articulate what it wants to achieve and work out from there its main governance concerns.

### Purposeful governance

The Institute promotes the concept of 'purposeful governance', a powerful tool for start-ups to assess risks under governance controls. Under this approach, a start-up can shape its strategy and related governance by identifying its purpose and aligning with its vision and mission. In most cases, it will be necessary to talk to stakeholders to determine its strategy. Once the strategy is determined, relevant risks can be identified and addressed under governance controls. Over time, the start-up might eventually adopt an 'enterprise risk management' (ERM) system with the help of consultants<sup>3</sup>.

<sup>2</sup> Suppose the start-up does not have a professional company secretary, for example, a member of our Institute, it should consider outsourcing the function initially to professional corporate service providers as it builds its internal expertise.

<sup>3</sup> For reference, the Treadway Commission's COSO framework is a robust ERM framework in which consultants work with companies to develop their ERM systems.

A start-up that hopes to address the pressing needs of the aged may well want to speak to stakeholders about the significant problems and risks involved in achieving the desired outcome. These could include talking to nursing homes, relatives, and government authorities. It could also address the possible issue of physical abuse of the elderly. Thus, as good governance practices, a start-up may design its hiring process to ensure adequate training (first line of defence). There should also be mandatory reporting to police authority of all suspected elderly abuse cases. Moreover, policies and procedures should stipulate zero tolerance for any physical abuse of the elderly (second line of defence).

Thus, far from being a down-the-line matter, strategy and governance must be addressed up-front under purposeful governance to support the business case and desired strategic outcomes.

### Essential legal and compliance matters

We do not want to leave the reader with the impression that strict legal and compliance matters are unnecessary. They are essential, but start-ups are encouraged to look beyond the 'tick-the-box' approach under purposeful governance. In any event, legal and compliance matters, including keeping proper books and records, and protecting intellectual property (IP) rights and security procedures, remain essential.

#### Keeping books and records

If the start-up is a Hong Kong company, it must comply with the Companies Ordinance. It will have to keep complete statutory books and records and attend to the related filings with the Companies Registry. It also has to file information of the ultimate beneficial ownership for holders of more than 25% shareholding or voting rights, individually or as a voting block, within the books and records. We have seen start-ups

that have not even issued their shares nor made up the books for the directors, members and company secretaries. When a transaction comes about, they struggle to retrieve the missing information.

Under Hong Kong law, there is no requirement to use a qualified company secretary for keeping books and records for private companies. However, there is more than meets the eye in making up books and records, for example, the information entries, filings, and record-keeping durations. We suggest that the start-up initially engage a professional service provider and eventually hire its own internal experienced practising company secretary, meaning a member of our Institute, or a legal or accounting professional.

#### IP rights

Protecting IP rights is critical if the start-up is developing a brand or using an innovation.

There may, in many cases, be a need to register a trade or service mark for the start-up's supply of goods or services. The start-up must consider what activities it intends to engage in and in what jurisdictions. After these are identified, it is not difficult to register the trade or service marks in the appropriate classes in various jurisdictions using trade mark and service agents. The design of the mark should be distinctive, and there are reference materials in the Intellectual Property Department to study<sup>4</sup>. In Hong Kong, the protection for trademarks is renewable ten years from the registration date. Usually, there will be the availability of use of treaty provisions for cross-jurisdictional protections.

If the start-up is involved in an invention, it may need to register a patent to prevent others from manufacturing, using, selling or importing the invention. It is exceedingly important to keep confidentiality, and legal professionals and patent agents should be consulted at the inception of the

4 <https://www.ipd.gov.hk/eng/trademarks.htm>

invention. There will be a need to preserve secrecy for the patent registration. There is typically 20-year protection in most cases, and treaty provisions can be relied on for cross-jurisdictional protections.

There are also registered designs to protect the appearance and general copyright laws for any original work that does not need registration. This copyright protection can exist in literary works including books and computer software, musical works (such as musical compositions), dramatic works (such as plays), artistic works (such as drawings, paintings and sculptures), sound recordings, films, broadcasts, cable programmes and the typographical arrangement of published editions of literary, dramatic or musical works, as well as performers' performances<sup>5</sup>.

### Security procedures

There is a multitude of governance concerns that revolve around the design of appropriate security procedures. A prime matter is for keeping safe personal data. In this connection, the Privacy Commissioner for Personal Data, Hong Kong, has provided a sample of the Privacy Management Programme (PMP) Manual<sup>6</sup>. Furthermore, depending on the start-up's business, there may also be a need to devise business practices and related policies for matters including safekeeping and storage of inventions, patents, and formulae.

These are apart from other usual risks that the start-up will need to address with legal support, where appropriate. For example, a start-up should implement proper human resources (HR) policies and procedures. Matters regarding remuneration, incentives, preservation of confidentiality, and ownership of IP rights developed during employment should also be addressed. There is also a need to review material contracts with counterparties to reduce hidden legal risks and to ensure a proper contract management system to deal with contract implementation.

### Summary

The discussions highlight that governance takes time. There is a need to communicate with stakeholders, determine strategy, and address the governance concerns consistent with the purposeful approach to governance. While we cannot exhaust all the governance issues for the start-up, we have identified some basic ones. We often see start-ups so focused on business growth that attention to governance is ignored. Therefore, governance needs to start at inception and not be abruptly enforced nearer to a funding transaction or initial public offering (IPO). It is hard to unlearn things done wrong insofar as governance is concerned.

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5 [https://www.ipd.gov.hk/eng/pub\\_press/publications/hk.htm](https://www.ipd.gov.hk/eng/pub_press/publications/hk.htm)

6 [https://www.pcpd.org.hk/misc/files/grg\\_private\\_sector.pdf](https://www.pcpd.org.hk/misc/files/grg_private_sector.pdf)