

# CORPORATE GOVERNANCE REPORT

## CORPORATE GOVERNANCE PRACTICES

The Company firmly believes that good corporate governance is fundamental in ensuring that the Company is well managed in the interests of all of its stakeholders. Continuous efforts are therefore taken to identify and formalise best practices and to ensure that the Company continues to exceed a number of the requirements of the Code on Corporate Governance Practices (the "Code") contained in Appendix 14 of the Listing Rules. The Company's efforts in this regard were recently recognised by the Hong Kong Institute of Certified Public Accountants, who awarded the 2010 Annual Report the Gold Award (Hang Seng Index Category) in the 2011 Best Corporate Governance Disclosure Awards.

The Company's commitment to the highest standards of corporate governance is driven by the Board who, led by the Chairman, assume overall responsibility for the governance of the Company, taking into account the interests of the Company's stakeholders, the development of its business, and the changing external environment.

This Report describes the corporate governance best practices that the Company has adopted and specifically highlights how the Company has applied the principles of the Code and, in accordance with the commitment of the Board referred to above, adopted a number of the requirements of the new Corporate Governance Code (the "new CG Code") and the associated Listing Rules announced by Stock Exchange on 28 October 2011 in advance of their formal dates for implementation.

The Company has complied with the Code throughout the year ended 31 December 2011, except for Code Provision A.4.2 (which exception was already disclosed in advance in the Company's 2010 Annual Report, and then in the 2011 Interim Results Announcement and the 2011 Interim Report). The reason for such exception is restated below for ease of reference.

In relation to the retirement by rotation of directors, the Company continued to comply with its Articles of Association (available on both the websites of the Company ([www.mtr.com.hk](http://www.mtr.com.hk)) and the Stock Exchange) which require that one

third of the then Directors who are subject to Articles 87 and 88 must retire as Directors (i.e. three out of the nine Directors (excluding two Directors appointed pursuant to Section 8 of the MTR Ordinance)). The re-organisation in the Government and the Rail Merger of the Company with KCRC brought an increase in the number of Directors last elected/re-elected in the 2008 Annual General Meeting. For this reason, the Company, for the first time, did not meet Code Provision A.4.2, which requires every director to be subject to retirement by rotation at least once every three years, in 2011.

The composition of the Board, with 11 non-executive Directors out of the 12-member Board, of whom 7 are independent non-executive Directors (the "INED(s)"), well exceeds both the requirements of the current Listing Rule (every board of directors of a listed issuer has to have at least 3 INEDs), as well as the new Listing Rule (to have INEDs representing at least one-third of the board by not later than 31 December 2012).

Further, and as an integral part of good corporate governance, the Company has, for some time, had a number of Board Committees with written terms of reference to oversee particular aspects of the Company's affairs, and these include the Remuneration Committee (this new Listing Rule requirement will take effect on 1 April 2012) and the Nominations Committee (this new CG Code provision will become effective on 1 April 2012). In advance of the new CG Code implementation, the Board has, at the January 2012 Board Meeting, adopted revised Terms of Reference for the Remuneration Committee, the Nominations Committee and the Audit Committee (the new CG Code provision for audit committees will be effective on 1 April 2012) in order to meet the requirements of the new CG Code. All these Terms of Reference are available on both the MTR and the Stock Exchange websites.

As mentioned earlier, the Board recognises that corporate governance should be the collective responsibility of all Members of the Board. In light of the new CG Code provision on corporate governance functions (to take effect from 1 April 2012) and alongside the adoption of both the relevant Terms of Reference for the Board (available on both the MTR and the

Stock Exchange websites), and the revised "Protocol: Matters Reserved for the Board" (the "Protocol"), the Board confirmed at the January 2012 Board Meeting, that a separate corporate governance board committee would not be established by the Company.

## THE BOARD OF DIRECTORS

The overall management of the Company's business is vested in the Board. Pursuant to the Articles of Association and the Protocol adopted by the Board, the Board has delegated the day-to-day management of the Company's business to the Executive Committee, and focuses its attention on matters affecting the Company's overall strategic policies, finances and shareholders. These include financial statements, dividend policy, significant changes in accounting policy, annual operating budget, certain material contracts, strategies for future growth, major financing arrangements and major investments, corporate governance matters, risk management strategies, treasury policies and fare structures.

As outlined earlier, the Company has 7 INEDs on the 12-member Board, and the Chief Executive Officer ("CEO") is the only executive Director on the Board.

Dr. Raymond Ch'ien Kuo-fung, a Member of the Board and the non-executive Chairman of the Company since 1998 and 2003 respectively, was re-appointed by the Government in November 2009 as the non-executive Chairman with effect from December 2009 until December 2012.

As announced by the Company in December 2010, Mr. Chow Chung-kong retired from the position of CEO and ceased to be a Member of the Board and a Member of the Executive Directorate on 31 December 2011.

On 22 July 2011 and following a worldwide search for Mr. Chow's replacement, the Company announced the appointment of Mr. Jay Herbert Walder as CEO for an initial term of thirty months with effect from 1 January 2012. He became both a Member of the Executive Directorate and a Member of the Board of Directors with effect from the same date.

The appointment of Mr. Walder was unanimously recommended by the Search Panel (comprising Dr. Raymond Ch'ien Kuo-fung, non-executive Chairman of the Company, Mr. Edward Ho, Chairman of both Nominations Committee and Remuneration Committee, Mr. Alasdair Morrison, an independent non-executive Director, Ms Eva Cheng (the Secretary for Transport and Housing ("S for T&H")) and Professor Chan Ka-keung, Ceajer (the Secretary for Financial Services and the Treasury ("S for FS&T")) and the Nominations Committee, and approved by the Board. In addition, his remuneration and terms of employment were recommended and approved by the Remuneration Committee and further endorsed by the Board.

Before joining the Company, Mr. Walder was Chairman and Chief Executive Officer of the New York Metropolitan Transportation Authority, the largest passenger transportation authority in the United States.

Two of the non-executive Directors (being the office of the "S for T&H" and the office of the Commissioner for Transport ("C for T")) are appointed by the Chief Executive of the HKSAR under Section 8 of the MTR Ordinance. During the year, Ms Eva Cheng held the post of the S for T&H and Mr. Joseph Lai Yee-tak was the C for T. Another non-executive Director, Professor Chan Ka-keung, Ceajer, is the S for FS&T. The Government through The Financial Secretary Incorporated, holds approximately 76.6% of the issued share capital of the Company.

At the 2011 Annual General Meeting on 6 May 2011 (the "2011 AGM"), Mr. Alasdair George Morrison retired from office pursuant to Article 85 of the Articles of Association and was elected as a Member of the Board. In addition, Mr. Edward Ho Sing-tin, Mr. Ng Leung-sing and Mr. Abraham Shek Lai-him retired from office by rotation pursuant to Articles 87 and 88, and were re-elected as Members of the Board at the 2011 AGM. Please refer to page 120 of the Report of the Members of the Board for details of the Members of the Board who will retire from office at the 2012 Annual General Meeting pursuant to the relevant Article(s) of Association.

## CORPORATE GOVERNANCE REPORT

Coming from diverse business and professional backgrounds, the non-executive Directors actively bring their valuable experience to the Board for promoting the best interests of the Company and its shareholders. On the other hand, the INEDs contribute to ensuring that the interests of all shareholders of the Company are taken into account by the Board and that relevant issues are subjected to objective and dispassionate consideration by the Board.

At the January 2012 Board Meeting and as part of the directors' training programme put in place by the Company, the Company's external legal counsel provided a comprehensive update on the corporate governance regime under the Listing Rules to the Board including the requirements of the new CG Code. A discussion then followed during which the Legal Director & Secretary highlighted the implications of the revised Listing Rules and the new CG Code to both the Company and to individual Directors.

Regarding the Listing Rules requirement (effective on 1 January 2012) for directors to obtain a general understanding of an issuer's business and to follow up anything untoward that comes to their attention, it is considered that the current arrangements for keeping the Board informed of the Company's business performance through regular presentations and/or reports by Management at Board Meetings, and timely reports on urgent key events according to the Protocol at ad hoc Board Meetings are effective, and have satisfied the requirement. (Please also refer to page 94.) To improve on the existing practice, a CEO Executive Summary, covering key business issues and the financial performance of the Company will be made available to Members on a monthly basis from April 2012. An off site meeting for the Board to review the Company's corporate strategy is also under planning by the CEO and is scheduled to take place in mid 2012. In addition, a number of site visits to the Company's business operations will be arranged for Directors over the course of the year.

During the year, the Company has received confirmation from each INED about his/her independence under the Listing Rules, and continues to consider each of them to be independent. (Regarding the new CG Code requiring issuers to have formal letters of appointment for directors (this provision will become effective on 1 April 2012), please refer to "Appointment, Re-election and Removal of Members of the Board" section on page 97 reporting service contract of Members).

Each Director ensures that he/she can give sufficient time and attention to the affairs of the Company. In light of the new CG Code Principle on directors' time commitments (to take effect on 1 April 2012), the Chairman has agreed to hold a private Board Meeting (without the presence of the CEO and other Members of Executive Directorate) in April 2012 to review the contribution from each director in performing his/her responsibilities to the Company, and whether he/she is spending sufficient time in performing them.

As regards the new CG Code provision (effective 1 April 2012) requiring directors to disclose the number and nature of offices held in public companies or organisations and other significant commitments as well as their identity and the time involved (the "Commitments") to the issuer, all Directors have, at the Board Meeting in January 2012, agreed to disclose their Commitments to the Company in a timely manner. The Company's current practice of requesting Members of the Board to make a disclosure to the Company twice a year will also continue.

Biographies of the Members of the Board are set out on pages 112 to 115. Save as disclosed in this Annual Report, none of the Members of the Board and the Executive Directorate has any relationship (including financial, business, family or other material or relevant relationships) between each other, although the office of the S for T&H (Ms. Eva Cheng) and the office of the C for T (Mr. Joseph Lai Yee-tak) were both appointed by the Chief Executive of the HKSAR, and Professor Chan Ka-keung, Ceajer is the S for FS&T of the Government, and Ms. Christine Fang Meng-sang sits on various government advisory committees.

As permitted under its Articles of Association, it has been the practice of the Company to arrange Directors' and Officers' Liability Insurance for which Members of the Board and officers of the Company do not have to bear any excess.

In January 2012, a questionnaire was sent to all Members of the Board in order to enable the performance of the Board to be evaluated. The questionnaire sought their views on, for example, the overall performance of the Board, the composition of the Board, conduct of Board Meetings and provision of information to the Board, and the responses are currently being analyzed by the Company with a view to making further improvements in the manner in which the Board operates and in the Company's overall corporate governance regime.

## CHAIRMAN AND CHIEF EXECUTIVE OFFICER

The posts of Chairman and CEO are distinct and separate (please also refer to their appointments on page 91). The non-executive Chairman is responsible for chairing and managing the operations of the Board, as well as monitoring the performance of the CEO and other Members of the Executive Directorate. Apart from making sure that adequate information about the Company's business is provided to the Board on a timely basis, the Chairman provides leadership for the Board, and ensures views on all principal and appropriate issues are exchanged by all Directors (including the non-executive Directors) in a timely manner, by encouraging them to make a full and effective contribution to the discussion. Under the Chairman's guidance, all decisions have reflected the consensus of the Board. As head of the Executive Directorate and chairman of the Executive Committee (which comprises seven other Members of the Executive Directorate, and General Manager – Corporate Relations), the CEO is responsible to the Board for managing the business of the Company. Biographies of the Members of the Executive Directorate and the other Member of the Executive Committee are set out on pages 115 to 117.

## BOARD PROCEEDINGS

The Board meets in person regularly, and all Members of the Board have full and timely access to relevant information and may take independent professional advice at the Company's expense, if necessary, in accordance with the approved procedures.

The draft agenda for regular Board Meetings is prepared by the Legal Director & Secretary and approved by the Chairman of the Company. Members of the Board are advised to inform the Chairman or the Legal Director & Secretary not less than one week before the relevant Board Meeting if they wish to include a matter in the agenda of the Meeting.

The Board Meeting dates for the following year are usually fixed by the Legal Director & Secretary and agreed by the Chairman, before communicating with other Members of the Board in the third quarter of each year.

At regular Board Meetings, Members of the Executive Directorate together with senior managers report to the Board on their respective areas of business, including the railway operations, station commercial and retail related business, progress of projects, property and other businesses,

financial performance, legal issues, safety governance, risk management, corporate governance, human resources, sustainability, corporate responsibility and outlook. The CEO also submits his Executive Summary which focuses on the overall strategies and principal issues of the Company, to the Board. These reports, together with the discussions at Board Meetings, provide information to enable all Members of the Board to make informed decisions for the benefit of the Company. Please refer to page 92 for details of the Company's enhanced practice in this regard. The agenda together with Board papers are sent in full at least three days before the intended date of the Board Meeting.

All Members of the Board have access to the advice and services of the Legal Director & Secretary, who is responsible for ensuring that the correct Board procedures are followed and advises the Board on all corporate governance matters. The Members of the Board also have full access to all Members of the Executive Directorate as and when they consider necessary.

All Directors are required to comply with their common law duty to act in the best interests of the Company and have particular regard to the interest of the shareholders as a whole. Amongst others, all Directors are required to declare their interests, if any, in any transaction, arrangement or other proposal to be considered by the Board at Board Meetings.

Unless specifically permitted by the Articles of Association, a Director cannot cast a vote on any contract, transaction, arrangement or any other kind of proposal in which he has an interest and which he knows is material. For this purpose, interests of a person who is connected with a Director (including any of his associates) are treated as the interests of the Director himself. Interests purely as a result of an interest in the Company's shares, debentures or other securities are disregarded. A Director may not be included in the quorum for such part of a meeting that relates to a resolution he is not allowed to vote on but he shall be included in the quorum for all other parts of that Meeting. This reduces potential conflicts which might otherwise arise between the Company's business and an individual Director's other interests or appointments. The removal by the Stock Exchange (effective on 1 January 2012) of the 5% threshold exemption for voting on a resolution in which a director has an interest (as described in paragraph (3) of Note 1 in Appendix 3 to the Listing Rules) and its implications have been brought to the attention of Members of the Board at the January 2012 Board Meeting.

## CORPORATE GOVERNANCE REPORT

(Please also refer to the “Material Interests and Voting” section on page 96.)

Matters to be decided at Board Meetings are decided by a majority of votes from Directors allowed to vote, although the usual practice is that decisions reflect the consensus of the Board.

### Board Meetings

The Board held seven regular Meetings in 2011. In this regard, the Company again well exceeds the requirement of the Code which requires every listed issuer to hold Board Meetings at least four times a year.

During 2011 and in addition to the regular reports on the business and financial performance, examples of other key matters discussed at the Board Meetings included Hong Kong’s train service (including additional new trains for the Urban Line Network, the operation of the Fare Adjustment Mechanism and duty free shops), railway projects (such as South Island Line (East), Kwun Tong Line Extension and Shatin-Central Link), contract awards relating to railway projects (e.g. Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link, South Island Line (East), Kwun Tong Line Extension and Shatin-Central Link), Mainland of China’s railway projects (e.g. Shenzhen Metro Line 4 and Beijing Metro Line 4’s operations), overseas train operations (e.g. London Overground, Stockholm’s Metro and Melbourne’s Metropolitan train system), shareholders’ analysis and investors’ feedback, corporate governance, enterprise risk management, safety governance, internal control system, corporate responsibility, sustainability and pay review.

As there was no scheduled Board Meeting in February 2011, a written resolution of the Directors was passed in respect of the re-launch of Phase 2 of ‘Festival City’ (Tai Wai Maintenance Centre, Sha Tin Town Lot No. 529).

### Private/Other Board Meetings

In addition to the above regular Board Meetings which dealt with the business of the Company, the Chairman held four private/other Board Meetings during the year, principally on succession matters. As indicated below, only certain Members of Executive Directorate were invited to attend some of those Meetings for provision of relevant support.

The first Meeting was held on 3 March 2011 with a majority of non-executive Directors and Mr. Chow Chung Kong, the then CEO, without the presence of other Members of Executive

Directorate, to discuss Executive Directorate succession matters. At the Meeting, the Board resolved the appointment of Ms. Gillian Elizabeth Meller to become Legal Director & Secretary following the retirement of Mr. Leonard Bryan Turk, the appointment of Ms. Jeny Yeung Mei-chun to become Commercial Director, and the appointment of Mr. David Tang Chi-fai to become Property Director following the retirement of Mr. Thomas Ho Hang-kwong.

The second Meeting on 5 July 2011 was held by the Chairman with a majority of other non-executive Directors without the presence of all Members of Executive Directorate, in accordance with the Recommended Best Practice (A.2.7 of Appendix 14) of the Listing Rules. The Stock Exchange upgraded this Recommended Best Practice to become a Code Provision with effect from 1 April 2012.

A further Meeting was held on the same day with a majority of non-executive Directors, Mr. Chow Chung Kong, the then CEO, Mr. William Chan Fu-keung, Human Resources Director and Mr. Leonard Bryan Turk, the then Legal Director & Secretary, without the presence of other Members of Executive Directorate, to discuss the CEO’s succession. It was at that Meeting that the appointment of Mr. Walder and other related matters were approved and endorsed by the Board (please refer to page 91).

Another Meeting was held on 9 August 2011 with all non-executive Directors, Mr. Chow Chung Kong, the then CEO, and Mr. William Chan Fu-keung, Human Resources Director, without the presence of other Members of Executive Directorate, to discuss the executive succession plan for senior managers in the Projects Division. In addition, the Board resolved the appointment of Mr. Cheung Siu Wa (also known as Mr. Morris Cheung) to succeed Mr. William Chan Fu-keung and become Human Resources Director and a Member of Executive Directorate both with effect from 17 July 2012. To facilitate a smooth transition, it was further agreed to appoint Mr. Cheung as Human Resources Director – Designate in the fourth quarter of 2011. At that Meeting, the Board was further advised of the timing of the appointments of Ms. Meller (1 September 2011), Ms. Yeung (1 September 2011) and Mr. Tang (1 October 2011), and that they would become Members of the Executive Directorate on the same respective dates.

The attendance record of each Member of the Board (and relevant Members of Executive Directorate) is set out below:

## MEETINGS HELD IN 2011

|  | Board           | Private/<br>Other<br>Board | Audit<br>Committee | Remuneration<br>Committee | Nominations<br>Committee | Corporate<br>Responsibility<br>Committee | Annual<br>General<br>Meeting |
|--|-----------------|----------------------------|--------------------|---------------------------|--------------------------|--|------------------------------|
| Number of Meetings   | 7               | 4                          | 4                  | 5                         | 1                        | 2  | 1                            |
| <b>MEMBERS OF THE BOARD</b>  |                 |                            |                    |                           |                          |  |                              |
| <b>Non-executive Directors</b>   |                 |                            |                    |                           |                          |  |                              |
| Dr. Raymond Ch'ien Kuo-fung (Chairman)                                       | 7/7             | 4/4                        |                    |                           | 1/1                      | 2/2                                      | 1/1                          |
| Commissioner for Transport (Joseph Lai Yee-tak)                              | 5/7<br>(Note 1) | 4/4                        | 2/4<br>(Note 1)    |                           |                          |  | 0/1                          |
| Secretary for Transport and Housing (Eva Cheng)                              | 7/7             | 4/4                        |                    |                           | 1/1                      | 2/2                                      | 0/1                          |
| Professor Chan Ka-keung, Ceajer  | 3/7<br>(Note 2) | 0/4<br>(Note 2)            |                    | 5/5                       | 1/1                      |  | 0/1<br>(Note 2)              |
| <b>Independent Non-executive Directors</b>                                   |                 |                            |                    |                           |                          |  |                              |
| Vincent Cheng Hoi-chuen  | 5/7             | 1/4                        |                    | 3/5<br>(Note 3)           |                          | 1/2                                      | 1/1                          |
| Christine Fang Meng-sang   | 7/7             | 4/4                        |                    |                           | 1/1                      | 2/2                                      | 1/1                          |
| Edward Ho Sing-tin   | 7/7             | 4/4                        |                    | 5/5                       | 1/1                      |  | 1/1                          |
| T. Brian Stevenson   | 6/7             | 4/4                        | 4/4                | 4/5                       |                          |  | 1/1                          |
| Ng Leung-sing  | 6/7             | 3/4                        | 4/4                |                           | 1/1                      |  | 1/1                          |
| Abraham Shek Lai-him   | 7/7<br>(Note 4) | 4/4                        |                    |                           | 1/1                      | 1/2                                      | 1/1                          |
| Alasdair George Morrison   | 7/7             | 4/4                        | 3/4                | 4/5                       |                          |  | 1/1                          |
| <b>Executive Director</b>  |                 |                            |                    |                           |                          |  |                              |
| Chow Chung-kong (the then CEO and a member of Executive Directorate)         | 7/7             | 3/3                        |                    |                           |                          |  | 1/1                          |
| <b>MEMBERS OF THE EXECUTIVE DIRECTORATE</b>                                  |                 |                            |                    |                           |                          |  |                              |
| Leonard Bryan Turk (Legal Director & Secretary up to 31 August 2011)         |                 |                            |                    |                           |                          | 1/1<br>(Note 5)                          |                              |
| Gillian Elizabeth Meller (Legal Director & Secretary since 1 September 2011) |                 |                            |                    |                           |                          | 1/1<br>(Note 6)                          |                              |
| Thomas Ho Hang-kwong (Property Director up to 30 September 2011)             |                 |                            |                    |                           |                          | 1/1<br>(Note 7)                          |                              |

### Notes

- The alternate director of Mr. Joseph Lai Yee-tak attended the other 2 Board Meetings and the other 2 Audit Committee Meetings.
- An alternate director of Professor Chan Ka-keung, Ceajer attended the other Board Meetings (including private Board Meetings), and the Annual General Meeting.
- Mr. Vincent Cheng Hoi-chuen attended 1 Remuneration Committee Meeting by teleconference.
- Mr. Abraham Shek Lai-him attended 2 Board Meetings by teleconference.
- Mr. Leonard Bryan Turk ceased to be a member of the Corporate Responsibility Committee following his retirement as a Member of the Executive Committee of the Company on 1 September 2011.
- Ms. Gillian Elizabeth Meller was appointed as a member of the Corporate Responsibility Committee at the October 2011 Board Meeting.
- Mr. Thomas Ho Hang-kwong ceased to be a member of the Corporate Responsibility Committee following his retirement as a Member of the Executive Committee of the Company on 1 October 2011. The Board appointed Mr. Morris Cheung, Human Resources Director – Designate, as a member of the Corporate Responsibility Committee at the October 2011 Board Meeting.

## CORPORATE GOVERNANCE REPORT

The minutes of regular Board Meetings are prepared by Legal Manager – Company Secretarial, the Secretary of the Meetings with details of the matters considered by the Board and decisions reached, including any concerns raised by the Members of the Board or dissenting views expressed. The draft minutes are circulated to all Members of the Board for their comment within a reasonable time after the Meeting. The approval procedure is that the Board formally adopts the draft minutes at the subsequent Meeting. If Members of the Board have any comment on the draft minutes, they will discuss it at that Meeting, followed by a report on what has been agreed in the minutes of that Meeting. Minutes of Board Meetings are kept by the Legal Director & Secretary and open for inspection by all Members of the Board at the Company's registered office.

### MATERIAL INTERESTS AND VOTING

Please refer to the "Board Proceedings" section on page 93 regarding the common law duty of the Directors to act in the best interests of the Company and the prohibition on them to vote on any contract, transaction, arrangement or any other kind of proposal in which they have a material interest.

#### Government's Representatives on the Board

The Government is a substantial shareholder of the Company and the Chief Executive of the HKSAR may, pursuant to Section 8 of the MTR Ordinance, appoint up to three persons as "additional directors". Out of a total of 12 Board Members, three are Government-nominated representatives (being the office of the S for T&H, the office of the C for T (both pursuant to Section 8 of the MTR Ordinance) and Professor Chan Ka-keung, Ceajer) and seven of them (being the majority) are INEDs.

Each Director appointed by the Chief Executive of the HKSAR pursuant to Section 8 of the MTR Ordinance or by the Government through its shareholding must, like any other Director, act in the best interests of the Company.

On appointment to the Board and same as any other Director, each Government-nominated Director is given a comprehensive, formal and tailored induction programme highlighting, among other things, his/her duties under general law, statutes and the Listing Rules (including the fiduciary duty to act in good faith in the best interests of the Company as a whole, considering the interests of all its shareholders, majority or minority, present and future).

If a conflict arises between the interests of the Company and those of the Government, a Director appointed by the Chief Executive of the HKSAR pursuant to Section 8 of the MTR Ordinance or by the Government through its shareholding, would not be included in the quorum of part of a Meeting

that relates to the transaction, arrangement or other proposal being considered by the Board and would not be allowed to vote on the related resolution.

There are a number of contractual arrangements that have been entered into between the Company and the Government (and its related entities), some of which are continuing in nature. As the Government is a substantial shareholder of the Company, such contractual arrangements are connected transactions (and in some cases continuing connected transactions) for the purposes of the Listing Rules. The section headed "Continuing Connected Transactions" on pages 130 to 144 explains how, in accordance with the Listing Rules, these transactions are treated.

(Please also refer to the "Board Proceedings" section on page 93 regarding directors' declarations of interest and voting.)

### APPOINTMENT, RE-ELECTION AND REMOVAL OF MEMBERS OF THE BOARD

A person may be appointed as a Member of the Board at any time either by the shareholders in general meeting or by the Board upon recommendation by the Nominations Committee of the Company. Please refer to "The Board of Directors" section on page 91 regarding the appointment of Mr. Walder, the CEO. For appointment to be made by shareholders, please refer to the procedures available on the Company and the Stock Exchange websites. Directors who are appointed by the Board must retire at the first annual general meeting after their appointment. A Director who retires in this way is eligible for election at that annual general meeting, but is not taken into account when deciding which and how many Directors should retire by rotation. In either case, the Directors so elected and appointed are eligible for re-election and re-appointment.

At each annual general meeting of the Company, one third of the Directors (or, if the number of Directors is not divisible by three, such number as is nearest to and less than one third) must retire as Directors by rotation.

The Chief Executive of the HKSAR may, pursuant to Section 8 of the MTR Ordinance, appoint up to three persons as "additional directors". Directors appointed in this way may not be removed from office except by the Chief Executive of the HKSAR. These Directors are not subject to any requirement to retire by rotation nor will they be counted in the calculation of the number of Directors who must retire by rotation. In all other respects, the "additional directors" are treated for all purposes in the same way as other Directors and are, therefore, subject to the normal common law duties of directors, including to act in the best interests of the

Company. (Please refer to the “Material Interests and Voting” section on page 96.) The Chief Executive of the HKSAR has appointed the office of the S for T&H and the office of the C for T as “additional directors”.

Ahead of the new CG Code requiring an issuer to have formal letters of appointment for directors (to take effect from 1 April 2012) and during 2011, the Company had a service contract with each of the non-executive Directors (including Dr. Raymond Ch’ien Kuo-fung (non-executive Chairman) and Professor Chan Ka-keung, Ceajer (S for FS&T)) (save for the “additional directors”) specifying the terms of his/her continuous appointment as a non-executive Director and a Member of the relevant Board Committees, for a period not exceeding three years.

At the 2012 Annual General Meeting and in accordance with Articles 87 and 88 of the Articles of Association, Dr. Raymond Ch’ien Kuo-fung, Mr. T. Brian Stevenson and Professor Chan Ka-keung, Ceajer will retire by rotation and will offer themselves for re-election.

Mr. T. Brian Stevenson, an INED, the chairman of the Audit Committee and a Member of the Remuneration Committee has been a Member of the Board since October 2002.

As a chartered accountant, a non-executive director of The Hongkong and Shanghai Banking Corporation Limited, an Advisor to BT Asia Pacific and Chairman of the Hong Kong Jockey Club, Mr. Stevenson brings his valuable business and professional experience to the Board for promoting the best interests of the Company and its shareholders. Under his leadership as the chairman, the Audit Committee has, over the years, developed a comprehensive and well structured framework (e.g. regular interviews with Members of the Executive Directorate, and private sessions with Head of Internal Audit and the Company’s external auditors) ensuring all key business operations relating to the financial, efficiency and control aspects of the Company are reported according to the Terms of Reference, for discussion at the Committee’s meetings effectively and in a timely manner.

Mr. Stevenson is a Justice of the Peace, and a law degree holder from both Glasgow and Hong Kong Universities. He was awarded the Silver Bauhinia Star medal in 1998. From 1981 to 1999, he was the Senior Partner of Ernst & Young, Hong Kong.

At the 2009 Annual General Meeting, over 99.99% of the votes were in favour of Mr. Stevenson’s re-election as a Member of the Board.

The Company entered into a service contract with Mr. Stevenson for three years with effect from 2009, and has

continued to receive written confirmation from him annually on his independence in accordance with the Listing Rules.

Accordingly, the Board has resolved that Mr. Stevenson continues to be independent and should be re-elected as a Director at the 2012 Annual General Meeting.

The re-appointment of Mr. Stevenson at the 2012 Annual General Meeting will be in accordance with the relevant new CG Code requirements (to take effect on 1 April 2012).

Mr. Jay Herbert Walder, who was appointed by the Board after the 2011 Annual General Meeting, will retire under Article 85 of the Articles of Association and will offer himself for election at the 2012 Annual General Meeting.

## INDUCTION PROGRAMME AND OTHER TRAINING

On appointment to the Board, each of the Directors (including alternate directors) is given a comprehensive, formal and tailored induction programme on key areas of business operations and practices of the Company, as well as the general and specific duties of the directors under general law (common law and legislation) and the Listing Rules. All Directors (including alternate directors) are also given a Directors’ Manual on their appointment which sets out, amongst other things, the Directors’ duties and the Terms of Reference of the Board Committees. The Directors’ Manual is updated from time to time to reflect developments in those areas, following a report on the same at relevant Board Meeting(s). The latest update to the Directors’ Manual was in January 2012 following publication of the new CG Code and the associated Listing Rules by the Stock Exchange in October 2011.

To assist Directors’ continuing professional development, the Legal Director & Secretary recommends Directors to attend relevant seminars and courses. The costs for such training are borne by the Company.

In January 2012, a one to one training programme covering the roles of a director from the strategic, planning and management perspective, as well as the legal and practical aspects of corporate governance and the trends in these areas, was arranged for Mr. Jay Herbert Walder, the CEO. A similar training programme was provided to each of Ms. Gillian Elizabeth Meller, Ms. Jeny Yeung Mei-chun and Mr. David Tang Chi-fai shortly after their appointments to the position of Legal Director & Secretary (from 1 September 2011), Commercial Director (from 1 September 2011) and Property Director (from 1 October 2011) respectively and as Members of the Executive Directorate.

Please refer to the “The Board of Directors” section on page 92 highlighting further training arrangements for Members of the Board.

## ACCOUNTABILITY

The Members of the Board are responsible for preparing the accounts of the Company and of the Group. The accounts are prepared on a going concern basis and give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 2011, and of the Group's profit and cash flow for the year then ended. In preparing the accounts for the year ended 31 December 2011, the Members of the Board have selected appropriate accounting policies and, apart from those new and amended accounting policies as disclosed in the notes to the accounts for the year ended 31 December 2011, have applied them consistently with previous financial periods. Judgments and estimates have been made that are prudent and reasonable. The reporting responsibilities of the External Auditor are set out on page 105.

In support of the above, the accounts presented to the Board have been reviewed by the Members of the Executive Directorate. For both the annual and interim reports and accounts, the Finance Division is responsible for clearing them with the External Auditor and then the Audit Committee. In addition, all new and amended accounting standards and requirements, as well as changes in accounting policies adopted by the Company have been discussed and approved at the Audit Committee before adoption by the Company.

## BOARD COMMITTEES

As an integral part of good corporate governance, the Board has established a total of four Board Committees to oversee particular aspects of the Company's affairs. Each of these Committees is governed by its respective Terms of Reference which are available on the websites of both the Company and the Stock Exchange.

The Audit Committee, Remuneration Committee and Nominations Committee comprise only non-executive Directors. The chairman and the majority of Members in each Committee are INEDs.

The majority of Corporate Responsibility Committee Members are non-executive Directors. Ms. Gillian Elizabeth Meller, the Legal Director & Secretary, and Mr. Morris Cheung, the Human Resources Director – Designate are also on that Board Committee to facilitate discussion and implementation of policies. The appointments of Ms. Meller and Mr. Cheung were approved by the Board at the Board Meeting on 18 October 2011, following the retirement of Messrs. Leonard Bryan Turk and Thomas Ho.

All Committees are provided with sufficient resources to discharge their duties.

## Audit Committee

The Audit Committee consists of four non-executive Directors, three of whom are INEDs. The Members of the Committee are Mr. T. Brian Stevenson (chairman), Mr. Ng Leung-sing, the C for T (Mr. Joseph Lai Yee-tak), and Mr. Alasdair George Morrison. Mr. Stevenson, Mr. Ng and Mr. Morrison are also INEDs. None of the Committee Members is a partner or former partner of KPMG, the Company's External Auditor. The Finance & Business Development Director, the Head of Internal Audit and representatives of the External Auditor of the Company are expected to attend Meetings of the Committee. At the discretion of the Committee, others may also be invited to attend Meetings. The Committee meets regularly, and the External Auditor or the Finance & Business Development Director may request a Meeting if they consider it necessary. During 2011, the Committee met four times.

## Duties of Audit Committee

Under its Terms of Reference, the duties of the Audit Committee include financial and efficiency aspects as described below. Amongst other things, the Committee is required to oversee the relationship with the External Auditor, to review the financial information of the Company, and to oversee the Company's financial reporting system and internal control procedures. The Committee discusses with the External Auditor the nature and scope of audit and reporting obligations before the audit commences. Apart from giving pre-approval of all audit services, the Committee also pre-approves any non-audit services for complying with relevant legal requirements. The Committee is primarily responsible for making recommendations to the Board on the appointment and removal of the External Auditor, and approving the remuneration and terms of such engagement.

With respect to financial information of the Company, the Committee monitors the integrity of financial statements, annual and interim reports and accounts, together with the preliminary announcement of results and other announcements regarding the Company's financial information to be made public. In dealing with the financial information, the Committee liaises with the Board and the Executive Directorate (including the Finance & Business Development Director), and the chairman of the Committee further meets on an ad hoc basis with the Head of Internal Audit, representatives of the External Auditor, and Management. Apart from considering issues arising from the audit, the Committee discusses any matters that auditor(s) may wish to raise either privately or together with executive Director(s) and any other person.

The Committee is required to review, at least annually, the effectiveness of the Company's financial controls, internal control and risk management systems and to report to the Board that such a review has been carried out. These controls and systems allow the Board to monitor the Company's overall financial position and to protect its assets. The Committee's review for 2011 also covered its role in overseeing the Management's review of the adequacy of resources, qualifications and experience of staff of the Company's accounting and financial reporting function, and their training programmes and budget. (Please refer to the section headed "Internal Controls" below.) The Committee reviews and approves the annual Internal Audit Plan which includes audits on the efficiency of chosen activities or operations of the Company. In addition, the Committee reviews periodic reports from the Head of Internal Audit and the follow-up of major action plans recommended, and puts forward recommendations to the Board where appropriate.

As mentioned earlier (see page 90) and in line with the new CG Code (effective 1 April 2012), the Terms of Reference of the Audit Committee have been revised and were approved at the January 2012 Board Meeting.

The chairman of the Committee summarises the activities of the Committee and highlights issues arising therefrom by a report to the Board after each Audit Committee Meeting.

The minutes of the Audit Committee Meetings are prepared by the secretary of the meeting with details of the matters considered by the Committee Members and decisions reached, including any concerns raised by the Committee Members and dissenting views expressed. The draft minutes are circulated to the Committee Members for comments and the final version of the minutes is sent to the Committee Members for their records within a reasonable time after the Meeting and the minutes are open for inspection by the Committee Members at the Company's registered office. With reference to the Agenda Framework, the chairman of the Committee makes final determination on the agenda for the regular Committee Meetings.

#### **Work Performed by Audit Committee**

In 2011, the Audit Committee held four Meetings and, based on the Agenda Framework pre-agreed with the chairman of the Committee, a total of four Meetings had been scheduled for 2012. Among the four Meetings held in 2011, the Audit Committee had two separate Meetings for reviewing the annual results for the year ended 31 December 2010. The first Meeting concentrated on the business operations, internal control and internal audit related items, while the second Meeting focused on the accounting and financial reporting matters, as well as outstanding litigation, compliance and enterprise risk management issues.

The major work performed by the Committee in 2011 included:

- Review of and recommendation for the Board's approval the draft 2010 Annual Report and Accounts and 2011 Interim Report and Accounts;
- Review of Management Letter, tax issues, compliance and salient features of 2010 Annual Accounts and 2011 Interim Accounts presented by KPMG, the External Auditor;
- Review of the enhancements to the 2012 Audit Planning Process;
- Review of two Half-yearly Reports prepared by the Internal Audit Department;
- Approval of the 2012 Internal Audit Plan;
- Pre-approval of the audit and non-audit services provided by KPMG, the External Auditor;
- Review of KPMG's fees proposal for the 2011 audit;
- Preview of 2011 annual accounting and financial reporting issues;
- Review of the Report on Internal Control system for the year ended 31 December 2010;
- Review of the Report on Evaluation of Effectiveness of Internal Audit Department for 2010;
- Review of the Report on Staff Complaints for 2010;
- Review of the Enterprise Risk Management Report for 2010;
- Review of the outstanding litigation and compliance issues regarding Operating Agreement and Rail Merger Transaction Agreements, statutes and regulations relevant to the business of the Company;
- Confirmation of the financial figures for the 2010 payout under "2008 Variable Incentive Scheme";
- Review of the governance model adopted for the management by MTR of its subsidiaries and affiliates and the current status of implementation;
- Review key issues from the Audit/Governance Committees Minutes of wholly owned subsidiaries;
- Review management of information security at MTR; and
- Holding of private sessions with Head of Internal Audit and the External Auditor without the presence of Management.

## CORPORATE GOVERNANCE REPORT

Representatives of the External Auditor, the Finance & Business Development Director and the Head of Internal Audit attended all those Meetings for reporting and answering questions about their work. Further to that and by invitation, the Operations Director, the Projects Director, the Property Director and the Legal Director & Secretary (or their representatives) had respectively provided an overview of the Company's railway operations, new railway projects, property business as well as outstanding litigation, compliance and enterprise risk management matters to the Members at the Meetings. The Finance & Business Development Director also provided an overview of the business development and expansion outside of Hong Kong.

The attendance record of each Committee Member is shown on page 95 under the section "Board Proceedings".

### Remuneration Committee

The Remuneration Committee consists of five non-executive Directors, four of whom are INEDs. The Members of the Remuneration Committee are Mr. Edward Ho Sing-tin (chairman), Mr. T. Brian Stevenson, Mr. Vincent Cheng Hoi-chuen, Professor Chan Ka-keung, Ceajer and Mr. Alasdair George Morrison. Mr. Ho, Mr. Stevenson, Mr. Cheng and Mr. Morrison are INEDs.

### Duties of Remuneration Committee

The principal responsibilities of the Remuneration Committee include formulating a remuneration policy and practices that facilitate the employment of top quality personnel, recommending to the Board the remuneration of the Members of the Board who are non-executive Directors, determining with delegated responsibility the remuneration packages of the Members of the Board who are executive Directors and other Members of the Executive Directorate, and reviewing and approving performance-based remuneration by reference to the Board's corporate goals and objectives.

This model which the Committee has adopted is set out in its Terms of Reference and is consistent with the new CG Code (effective from 1 April 2012).

As mentioned earlier (see page 90), the Terms of Reference were approved at the January 2012 Board Meeting.

### Work Performed by Remuneration Committee

In 2011, the Remuneration Committee held five Meetings. In accordance with its Terms of Reference, the Committee performed the following work during the year:

- Approved the 2010 Remuneration Report as incorporated in the 2010 Annual Report;
- Reviewed and approved payouts under the Company's performance-based variable incentive scheme for the 2010 performance period;
- Determined and approved the remuneration package for Mr. Jay Herbert Walder who commenced employment as the Chief Executive Officer – Designate on 1 November 2011 and as the CEO on 1 January 2012;
- Conducted an annual review of the remuneration packages for Members of the Executive Directorate, which took effect in July 2011;
- Determined and approved the remuneration packages for the following new Members of the Executive Directorate:
  - Ms. Gillian Elizabeth Meller as Legal Director & Secretary (from 1 September 2011),
  - Ms. Jeny Yeung Mei-chun as Commercial Director (from 1 September 2011), and
  - Mr. David Tang Chi-fai as Property Director (from 1 October 2011); and
- Reviewed and approved the changes to the framework for determining share option awards.

The Remuneration Committee also met on 5 March 2012 to approve the 2011 Remuneration Report, which is set out on pages 108 to 111 and includes a description of the remuneration policy of the Company.

Attendance record of each Committee Member is shown on page 95 under the section "Board Proceedings".

### Nominations Committee

The Nominations Committee consists of seven non-executive Directors, four of whom are INEDs. The Members of the Nominations Committee are Mr. Edward Ho Sing-tin (chairman), Dr. Raymond Ch'ien Kuo-fung, Ms. Christine Fang Meng-sang, Mr. Abraham Shek Lai-him, Mr. Ng Leung-sing, Professor Chan Ka-keung, Ceajer and the S for T&H (Ms. Eva Cheng). Mr. Ho, Ms. Fang, Mr. Shek and Mr. Ng are also INEDs.

### Duties of Nominations Committee

The Nominations Committee nominates and recommends to the Board candidates for filling vacancies on the Board, and the positions of CEO, Finance Director (the "FD") and Chief Operating Officer (the "COO") (provided that the COO position exists). For the positions of FD and COO, the Committee may consider candidates recommended by the CEO, or any other candidates (provided that the CEO shall have the right to first agree to such other candidates).

As mentioned earlier (see page 90) and in line with the new CG Code (effective 1 April 2012), the Terms of Reference have been revised and were approved at the January 2012 Board Meeting.

Amongst other things and following the requirements of the new CG Code, arrangement has been made for the Nominations Committee to meet in April 2012 to review the structure, size and composition of the Board. The discussion will be supported by feedback from Members of the Board, in response to the January 2012 questionnaire on the evaluation of the Board's performance, in relation to which see page 92.

#### **Work Performed by Nominations Committee**

In 2011, the Nominations Committee held one Meeting. Attended by all Members of the Committee at the Meeting on 5 July 2011 and after discussion, the Committee agreed to recommend to the Board the appointment of Mr. Jay Herbert Walder (his biography is set out on pages 112 and 113) as the CEO and a Member of the Board both with effect from 1 January 2012.

The attendance record of each Committee Member is shown on page 95 under the section "Board Proceedings".

#### **Corporate Responsibility Committee**

The Corporate Responsibility Committee includes two non-executive Directors (i.e. Dr. Raymond Ch'ien Kuo-fung (Chairman) and the S for T&H (Ms. Eva Cheng)) and three independent non-executive Directors (i.e. Ms. Christine Fang Meng-sang, Mr. Abraham Shek Lai-him and Mr. Vincent Cheng Hoi-chuen). In addition and at the October 2011 Board Meeting, the Board appointed Ms. Gillian Elizabeth Meller (Legal Director & Secretary and a Member of Executive Directorate) and Mr. Morris Cheung\* (Human Resources Director – Designate) as Members of the Committee. Dr. Ch'ien is the Chairman of the Committee.

\* The Company has announced on 7 September 2011 that Mr. Cheung will become Human Resources Director and a Member of Executive Directorate both with effect from 17 July 2012.

#### **Duties of Corporate Responsibility Committee**

The duties of the Committee are to recommend a corporate responsibility policy to the Board for approval, monitor and oversee the implementation of the Company's corporate responsibility policy and initiatives, identify emerging corporate responsibility issues arising from external trends, review the Company's annual Sustainability Report and recommend endorsement by the Board, and provide updates to the Board as required. Please also refer to the "Corporate Responsibility" section on pages 86 to 89 of this Annual Report.

#### **Work Performed by Corporate Responsibility Committee**

In 2011, the Corporate Responsibility Committee held two Meetings. The major work performed by the Committee in 2011 included:

- Review of the implementation of the Company's community and staff engagement and communication programmes;
- Review of the sustainability development and environmental management of the Company;
- Review of corporate responsibility development of the Company; and
- Review of and recommendation for the Board's approval the draft 2010 Sustainability Report.

#### **INTERNAL CONTROLS**

The Board is responsible for the system of internal controls of the Company and its subsidiaries, setting appropriate policies and reviewing the effectiveness of such controls. Internal control is defined as a process effected by the Board, Management and other personnel, designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable, and not absolute assurance of the following:

- effectiveness and efficiency of operations
- reliability of financial reporting
- compliance with applicable laws and regulations
- effectiveness of risk management functions

Pursuant to the Protocol adopted by the Board, the Board has delegated the day-to-day management of the Company's business to the Executive Committee, and focuses its attention on matters affecting the Company's overall strategic policies, finances and shareholders.

Supported by the Members of the Executive Committee, the CEO who chairs the Executive Committee is responsible to the Board for the conduct of the business of the Company.

A number of committees have been established to assist the Executive Committee in the day-to-day management and control of the various core businesses and functions of the Company and its subsidiaries. Key committees include:

- Operations Executive Management Committee
- Operations Business Meeting
- Property Executive Management Committee
- Project Control Group

## CORPORATE GOVERNANCE REPORT

- Railway Development Steering Group
- Consultancy Services Management Committee
- European Business Executive Committee
- China Business Executive Committee
- Information Technology Executive Management Committee
- Financial Planning Committee
- Investment Committee
- Corporate Safety Management Committee
- Enterprise Risk Committee
- Code of Conduct Steering Committee
- Tender Board
- Executive Tender Panel
- Corporate Responsibility Steering Committee
- Crisis Management Committee

The Executive Committee is responsible for implementing the Board's policies on risk and control. In fulfilling its responsibilities, the Executive Committee identifies and evaluates the risks faced by the Company for consideration by the Board, and designs, operates and monitors a suitable system of internal controls which implements the policies adopted by the Board. The Executive Committee is accountable to the Board for monitoring the system of internal controls and providing assurance to the Board that it has done so. Additionally, all employees have responsibility for internal controls within their areas of accountability.

Various risk management strategies have been established by the Board as advised by the Executive Committee to identify, assess and reduce risks, including construction, business operations, finance, treasury, safety and enterprise risks as well as to ensure appropriate insurance coverage.

### Risk Assessment and Management

The Company's Enterprise Risk Management framework is an essential and integral part of corporate governance to help in sustaining business success and creating value for stakeholders. It is a corporate-wide systematic risk management process which aims to assist the Executive Committee and individual business areas to manage the key risks and support the Board in discharging its corporate governance responsibilities.

More details of the framework and process are given in the section headed Risk Management on page 84.

### Control Activities and Processes

To ensure the efficient and effective operation of business units and functions, and safety of operating railway and construction works in railway projects, Corporate General Instructions ("CGIs"), divisional/departmental procedures and manuals, committees, working groups and quality assurance units are established to achieve, monitor and enforce internal controls and evaluate their effectiveness.

CGIs and various departmental procedures and manuals are established for preventing or detecting unauthorised expenditures/payments, safeguarding the Company's assets, ensuring the accuracy and completeness of accounting records and timely preparation of reliable financial information.

All Department Heads, including Business and Project Managers for overseas projects, are responsible for ensuring the compliance with statutes and regulations applicable to their own functional units. They are required to identify any new or updated statutes, to assess their impact on the Company's operations, and to review at least once a year that relevant statutes/regulations are complied with. Potential and actual non-compliances are also reported and followed up by Department Heads and significant cases are reported to the respective Divisional Directors and the Executive Committee. Issues relating to compliance with statutes and regulations including potential and actual non-compliances, if any, and the status of rectification and actions taken to prevent recurrence are reported annually to the Executive Committee and Audit Committee.

The Internal Audit Department plays a major role, independent of the Company's management, in assessing and monitoring the internal controls of the Company. The Head of Internal Audit reports to the CEO and has direct access to the Audit Committee. The Department has unrestricted access to information that allows it to review all aspects of the Company's risk management, control and governance processes. On a regular basis, it conducts audits on financial, operational and compliance controls, and effectiveness of risk management functions of all business and functional units as well as the subsidiaries. Management is responsible for ensuring that control deficiencies highlighted in internal audits are rectified within a reasonable period. The Department produces an annual internal audit plan derived from risk assessment for the Audit Committee's approval. On a half-yearly basis, the Head of Internal Audit reports the audit findings and opinion on the system of internal controls to the Audit Committee.

On behalf of the Board, the Audit Committee evaluates the effectiveness of the Company's system of internal controls, including the reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws and regulations, effectiveness of risk management functions and the adequacy of resources, qualifications and experience of staff of the Company's accounting and financial reporting function. This is achieved primarily through approving the scope of the annual internal audit plan, reviewing the findings of internal audit work, the annual and interim financial statements, and the nature, scope of work, and report of the external auditors, and consideration of the following:

- the changes in the nature and extent of significant risks since the previous review and the Company's ability to respond to changes in its business and external environment;
- the scope and quality of management's ongoing monitoring of risks and the system of internal controls, the work of the Internal Audit Department, and the assurance provided by the Executive Committee;
- the extent and frequency with which the results of monitoring are communicated, enabling the Audit Committee to build up a cumulative assessment of the state of control in the Company and the effectiveness with which risk is being managed;
- the incidence of any significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the Company's financial performance or condition; and
- the effectiveness of the Company's processes in relation to financial reporting and statutory and regulatory compliance.

The processes for assessing internal controls by the Audit Committee have included: regular interviews with Members of the Executive Committee in relation to key business operations, internal control and compliance issues, both financial and non-financial; review of significant issues arising from internal audit reports and external audit report, private sessions with internal and external auditors, and review of annual assessment and certification of internal controls from Members of the Executive Committee, management of overseas subsidiaries and department heads in their areas of responsibility. The Audit Committee has also reviewed the papers prepared by the Executive Committee and

Internal Audit Department covering: 2010 Annual Report and Accounts, Preview of 2011 Annual Accounting issues, 2011 Interim Accounts, 2012 Internal Audit Plan, Internal Audit Department's Half-yearly Reports, Annual Report on Staff Complaints, Report on the Company's Internal Control System, Reporting of Outstanding Litigation and Compliance Issues, Enterprise Risk Management Report and Evaluation of Effectiveness of Internal Audit Department. The chairman of the Committee meets on an ad hoc basis with the Head of Internal Audit, representatives of the External Auditor and Management of the Company as appropriate. He summarizes activities of the Committee and highlights issues arising therefrom by a report to the Board after each Audit Committee Meeting.

The Company is committed to recruit, train and develop a team of qualified and competent accountants in order to oversee its financial reporting and other accounting-related matters. A process to capture and update relevant laws, rules and regulations applicable to the reporting and accounting function is in place. Designated officers will ensure relevant standards and ordinances including Hong Kong Financial Reporting Standards, the Listing Rules and the Companies Ordinance under their responsibility are complied with. Resources and provisions required to deliver accounting and financial reporting function are critically reviewed during the annual budgeting exercise. Company-wide recruitment process and staff development programmes are in place to address the competency, qualifications and experience required. Adherence to the process is confirmed on an annual basis by the designated officers to the Finance & Business Development Director who will conduct a formalized annual review and report to the Audit Committee for the review results. Confirmation of the process is also monitored by the Internal Audit Department. Based on the above, the Audit Committee considered the resources, qualifications and experience of staff of the Company's accounting and financial reporting function, and their training programmes and budget were adequate.

The Board has, through the Audit Committee, conducted the review of the effectiveness of the Company's system of internal controls for the year ended 31 December 2011, covering all material financial, operational and compliance controls, and risk management function, and concluded that adequate and effective internal controls are maintained to safeguard the shareholders' investment and the Company's assets. There were no significant control failings, weaknesses or significant areas of concern identified during the year which might affect shareholders.

### **Crisis Management Committee**

To uphold the reputation of being one of the best companies in Hong Kong and in order to help ensure that the Company will respond to and recover from crises in an organised and effective manner, including timely communications with principal stakeholders such as shareholders, the Company established a Crisis Management Committee in 1995. The Committee comprises relevant Members of the Executive Directorate and Executive Managers, and its operation is governed by a Crisis Management Manual which, among other things, sets out the duties of respective members. The Manual is kept up-to-date through regular reviews. The Crisis Management Committee conducts regular exercises to validate the crisis management organisation and arrangements and to provide practices for members. An exercise has been planned for the first quarter of 2012.

### **Continuous Disclosure Obligations regarding Price Sensitive Information**

The Company has developed a system with established policies, processes and procedures across all relevant Division(s) and Department(s) for complying with the disclosure obligations regarding price sensitive information. Further, a task force comprising all relevant heads of Department reviewed the system in detail and thoroughly went through the checklist sent by the Stock Exchange to all issuers in late 2008. The recommendation that the Company has an effective system in dealing with the disclosure obligations was reported to the Executive Committee, and then to the Board of Directors in December 2008. The system continues to be effective throughout 2011. Efforts to further enhance the system in the light of the business operations and development of the Company will continue.

### **Governance of Subsidiaries and Affiliate Companies**

The Company has a number of subsidiaries and affiliate companies which operate independent businesses in Hong Kong, the Mainland of China and overseas. Notwithstanding these subsidiaries and affiliate companies are separate legal entities, the Company has implemented a management governance structure ("Governance Structure") to ensure that it exercises an appropriate level of control and oversight as a shareholder of these subsidiaries and affiliate companies.

Pursuant to the Governance Structure, the Company exercises its control and oversight in a number of forms: imposition of internal controls, requirements for consent or consultation, reporting requirements and assurance. The management of each subsidiary or affiliate company is responsible for the

adoption of management practices and policies that are appropriate to the business nature and local situation, taking into account the management governance requirements of the Company, and developing a corporate governance manual for the entity which reflects both such management practices and policies as well as management governance requirements for approval by the relevant board of directors. Ongoing compliance with the manual is reported on a regular basis.

The Executive Committee reviews the Governance Structure and compliance by the subsidiaries and affiliate companies with it on an annual basis.

### **MODEL CODE FOR SECURITIES TRANSACTIONS BY DIRECTORS OF LISTED ISSUERS**

The Company has adopted the Model Code set out in Appendix 10 of the Listing Rules ("Model Code"). After having made specific enquiry, the Company confirms that Members of the Board and the Executive Directorate complied throughout the year with the Model Code. Senior managers, other nominated managers and staff who, because of their office in the Company, are likely to be in possession of unpublished price sensitive information, have been requested to comply with the provisions of the Model Code. In addition, every employee is bound by the Code of Conduct issued by the Company, amongst other things, to keep unpublished price sensitive information in strict confidence.

### **BUSINESS ETHICS**

The Company is committed to upholding a high standard of business ethics and integrity, which are critical to our continued success and for maintaining the trust of our stakeholders. The Company's Code of Conduct, Corporate Guidebook for All Staff and Corporate Guidebook for Managers (the "Guidebooks") are important tools to help employees understand and follow requirements on ethical practices. The Code of Conduct and the Guidebooks are reviewed and updated every two years to ensure appropriateness and compliance with legislation. The Company requires all employees to acknowledge their understanding of and agreement to abide by the Code of Conduct and the Guidebooks every two years. All employees are encouraged to report existing or perceived violations and malpractices. Staff who have genuine suspicions about wrongdoings are also provided with proper procedures to follow in a safe environment that encourages speaking up in complete confidence pursuant to the Speaking Up policy of the Company.

In addition, new recruits are briefed on the Code of Conduct and the Guidebooks, and such briefings form an integral part of staff induction and orientation programmes. Soft copy of the Code of Conduct is available on the Company's website.

A simplified Chinese-language version of the Code of Conduct is also issued to the Company's subsidiaries in the Mainland of China. Under the Code of Conduct, all subsidiaries are required to comply with the relevant local laws and regulations. To uphold a comparable ethical culture in other joint venture companies, guidelines on business ethics have also been published for staff's observance and compliance.

## EXTERNAL AUDITOR

The Company engages KPMG as its External Auditor. In order to maintain KPMG's independence and objectivity and the effectiveness of the audit process in accordance with applicable standards, the Audit Committee, under its Terms of Reference, pre-approves all audit services to be provided by KPMG and discusses with KPMG the nature and scope of their audit and reporting obligations before the audit commences.

The Audit Committee also reviews and pre-approves the engagement of KPMG to provide any non-audit services for complying with relevant legal requirements and seeks to balance the maintenance of objectivity with value for money.

The nature of audit and non-audit services provided by KPMG and fees paid to KPMG (including any entity that is under common control, ownership or management with the audit firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as part of the audit firm nationally or internationally) are set out in note 10D to the accounts on page 167.

On the part of KPMG, for maintaining integrity and objectivity, KPMG implements policies and procedures to comply with professional ethics and independence policies and requirements applicable to the work KPMG performs. During the year, the audit partner from KPMG serving the Group completed his seventh year and a rotation was effected to comply with the KPMG requirement to rotate off the audit engagement with the Company at least once every seven years.

## COMMUNICATION WITH SHAREHOLDERS

### Annual General Meeting ("AGM")

The Company's AGM is one of the principal channels of communication with its shareholders. It provides an

opportunity for shareholders to communicate face to face with the Directors about the Company's performance and operations. It has been the practice for the Chairman of the Company, the chairmen of the Board Committees, all Members of the Executive Committee and the External Auditor of the Company to attend AGMs to answer shareholders' questions.

The AGM for 2011 was held on 6 May at Rotunda 3 (6/F), Kowloonbay International Trade & Exhibition Centre, Kowloon Bay, Hong Kong. The 2012 AGM has been scheduled for 3 May. This is the third consecutive year of bringing forward the date of AGM in order to facilitate a direct dialogue between shareholders and Directors/Management on annual results and other performance of the Company of the preceding year.

### Chairman's Statement

The Chairman started the formal business of the AGM by reporting that riding on the recovery in Hong Kong's economy, the Company achieved in 2010 a strong set of results and all of the local businesses (including rail operation, station retail, shopping malls and property development) performed well. The financial performance of the rail franchises outside of Hong Kong was, as a whole, in line with the Company's expectations.

He then highlighted the key financial performance of the Company for 2010. In proposing the 2010 final dividend, he mentioned that, after a review of the Company's healthy financial condition, the Board had decided not to seek authority to renew the then Scrip Dividend Scheme at the meeting.

The Chairman gave an overview of the Company's business performance including the ridership, train service performance, station commercial and rail related businesses, property development, property rental and management, Ngong Ping Cable Car and associated theme village and Octopus Cards. EBITDA contributions from the rail subsidiaries in Stockholm, Melbourne and Shenzhen as well as the post-tax profit contribution from the rail associated companies in Beijing and London were reported.

Turning to future growth and within Hong Kong, the Chairman reported that the construction of the West Island Line and the Hong Kong section of the Express Rail Link were well underway; the South Island Line (East), the Kwun Tong Line Extension and the Shatin to Central Link had also made good progress in planning, design and approval processes.

The Chairman further gave a brief account of the businesses outside Hong Kong, including the commencement of full

## CORPORATE GOVERNANCE REPORT

passenger services on the refurbished and extended East London Line by London Overground, and the operations of the Daxing Line extension of Beijing Metro Line 4 through the Beijing associated company, as well as the take-over of operations of Phase 1 of Shenzhen Metro Line 4 with full line operation covering Phase 2 expected in the middle of 2011. Regulatory approval of the Public-Private Partnership project for the Hangzhou Metro Line 1 project was awaited.

The important roles of corporate governance, sustainability, corporate responsibility and community involvement, in the continued success of the Company, were recognised by the Chairman.

Looking ahead for the rest of 2011, the Chairman said it was expected that the global economic recovery would continue albeit overshadowed by a number of uncertainties. With continued economic growth, the Hong Kong rail business should see patronage increases. The other recurrent businesses including station commercial, advertising and property rental businesses which were market driven, should also be positive.

For property development, the Chairman expected to make profit booking of the shopping mall at Area 56 of Tseung Kwan O in the first half of 2011 and recognition of profit from Festival City in Tai Wai in 2011. Depending on market conditions, Tai Wai Station site and Tin Shui Wai Light Rail site might be tendered out. As development agent, West Rail Nam Cheong Station site and Tsuen Wan West site no. 5 might also be tendered out.

In light of some discussion in public forums about the Company's 2.2% fare increase under the Fare Adjustment Mechanism for 2011, the Chairman said the Company, as a key transport operator and a listed company in Hong Kong, had the dual obligations of providing quality passenger service as well as reasonable returns to shareholders.

From the train service perspective, the Chairman said the delivery, passenger journeys on time and punctuality all achieved 99.7% or above in 2010. In maintaining and upgrading the railway assets and station facilities, he said more than HK\$4 billion per annum had been spent.

On the fares side, the Chairman said there had been a general fare reduction of over HK\$600 million a year since 2007 (the time of the Rail Merger with Kowloon-Canton Railway Corporation). Moreover, the 2.2% fare increase would only be the second modest upward adjustment since 1997. Compared

with other modes of transport in Hong Kong, he said MTR fares were competitive and remained reasonable. This was also the case internationally.

As a very reasonable citizen, the Chairman said more than HK\$1.6 billion of concessions had been offered to the elderly, students and persons with disabilities in 2010. This benefited about 1.2 million passenger trips each day, and was equal to 14% of pre-tax profits.

To make a reasonable return for shareholders through dividends, the Chairman said efforts continued to enhance, amongst others, non-fare revenues and efficiency drives. This model was consistent with prudent and sound public finance. Leaders from around the world who visited the Company all commended the Company on its sustainable business model.

Before closing, the Chairman took the opportunity to thank Mr. C K Chow, the then CEO and a Member of the Board, who retired on 31 December 2011, for his outstanding job leading the Company from strength to strength and his very significant contribution to the Company. He said the Company was proceeding with a worldwide search including internal candidates to identify the right candidate for the post of CEO.

In addition, the Chairman welcomed Mr. Alasdair Morrison who joined the Board as an INED in July 2010. He also thanked Mr. Andrew McCusker who retired in December 2010 as Operations Director for his significant contributions to the Company, and welcomed Dr. Jacob Kam who succeeded Mr. McCusker.

### Resolutions passed at the 2011 AGM

After the Chairman's Statement and following the Company's previous practice, the Chairman proposed separate resolutions for each substantially separate issue at that AGM. Before the resolutions were considered, the Chairman exercised his right as the Chairman of the Meeting under Article 67 of the Articles of Association to call a poll on all resolutions. Being the first listed company in Hong Kong to conduct electronic poll voting since 2007, the Company conducted electronic poll voting at the AGM.

A total of ten resolutions were passed at the AGM (with resolution no. 3 comprising four separate resolutions), each by over 94% of the votes cast at the Meeting. The full text of the resolutions is set out in the AGM Circular (which comprised Notice of the AGM) to shareholders dated 31 March 2011. For the benefit of those shareholders who did not attend the AGM, below is a succinct summary of the resolutions passed:

- (1) Adoption of the audited Statement of Accounts and the Reports of the Directors and the Auditors of the Company for the year ended 31 December 2010;
- (2) Declaration of a final dividend of HK\$0.45 per share for the year ended 31 December 2010;
- (3) (a) Election of Mr. Alasdair George Morrison as a Member of the Board of Directors of the Company;
- (b) Re-election of Mr. Edward Ho Sing-tin as a Member of the Board of Directors of the Company;
- (c) Re-election of Mr. Ng Leung-sing as a Member of the Board of Directors of the Company; and
- (d) Re-election of Mr. Abraham Shek Lai-him as a Member of the Board of Directors of the Company.
- (4) Re-appointment of KPMG as Auditors of the Company and authorisation of the Board of Directors to determine their remuneration;
- (5) Grant of a general mandate to the Board of Directors to allot, issue, grant, distribute and otherwise deal with additional shares in the Company, not exceeding ten per cent. of the Company's issued share capital as at the date of this resolution\*;
- (6) Grant of a general mandate to the Board of Directors to purchase shares in the Company, not exceeding ten per cent. of the Company's issued share capital as at the date of this resolution\*; and
- (7) Conditional on the passing of resolutions 5 and 6, authorisation of the Board of Directors to exercise the powers to allot, issue, grant, distribute and otherwise deal with additional shares in the Company under resolution 5 in respect of the aggregate nominal amount of share capital in the Company purchased by the Company\*.

\* (The full text of the resolution is set out in the Notice of the AGM.)

The poll results were posted on the websites of both the Company and the Stock Exchange on the same day after the AGM. The Minutes of the AGM are also available on the Company's website replacing the webcast (which was posted on the website in the same evening after the AGM).

### Extraordinary General Meeting ("EGM")

The Company may also communicate with its shareholders through EGMs if and when appropriate.

If shareholders want to convene an EGM of the Company, those shareholders may requisition the Directors of the Company to do so, provided that at the date of requisition they hold, in aggregate, not less than one-twentieth of the paid-up capital of the Company. The shareholders' requisition must state the objects of the meeting requested and must be deposited at the registered office of the Company. The requisition may consist of several documents in like form, each signed by one or more of the shareholders concerned.

If, within 21 days from the date of the deposit of the requisition, the Directors of the Company do not proceed duly to convene an EGM for a day not more than 28 days after the date on which the notice convening the EGM is given, the relevant shareholders, or any of them representing more than one-half of the total voting rights of all of them, may themselves convene an EGM, provided that any EGM so convened is held within three months from the date of the original requisition.

### Procedures for Shareholders Putting Forward Proposals

Shareholders may put forward proposals for consideration at a general meeting according to the Companies Ordinance and the Company's Articles of Association.

As regards proposing a person for election as a director, please refer to the procedures available on the websites of the Company and the Stock Exchange (This Listing Rule requirement is effective from 1 April 2012).

### Enquiries from Shareholders

The Company has a Shareholders' Communication Policy to provide shareholders with information about the Company to enable them to engage actively with the Company and exercise their rights as shareholders in an informed manner (this new CG Code will be effective on 1 April 2012).

The Company's Shareholders Communication Policy available on both the websites of the Company and the Stock Exchange, has set out, amongst other things, a channel for shareholders' access to the Board and Management by writing to the Company Secretary of the Company.

Please also refer to the Investor Relations section on pages 82 and 83 on other means of communication with shareholders.