March 2024

HKCGI Guidance Note – Startup Governance – Board and Structuring Issues

The focus of this guidance note is on startup governance. Any organisation needs to adopt governance best practices because they provide a structure for accountability and transparency in decision-making and other matters for strategy implementation. This guidance note will show that governance is particularly important for a startup and cannot be ignored as it builds its business. Further, if governance issues are not properly addressed, a startup may not be able to survive, let alone pursue a successful listing, sale or other exit strategy for its founder and investors.

Case Study: FTX Governance issues

FTX was a startup founded in 2019 and grew rapidly over the ensuing three years, valuing itself at $32 billion in January 2022. However, around the middle of 2022, questions arose regarding its affiliation with its sister company, Alameda Research, when it was discovered that 40% of FTX's crypto market trading volume was from Alameda Research. It then became apparent that Alameda Research had utilised FTX's client deposits, and customers demanded a return of their deposits in November 2022, which caused a crypto token sell-off. Following this, three prominent members of FTX were arrested and entered guilty pleas to criminal charges. Sam Bankman-Fried, the company's founder, could be sentenced to up to 120 years in jail for conspiracy and fraud.

The Board

FTX did not have a board, as Sam and his colleagues as the executive controlled it. For a startup, it should have a carefully structured board. The OECD's Principles of Corporate Governance 2023[1] clarifies a common misnomer that the board is advisory in nature. The

1 https://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2023_ed750b30-en

- *This guidance note is a collation of the thoughts of* ***Ms Edith Shih FCG(CS, CGP) HKFCG(CS, CGP)(PE)****, Honorary Adviser to Council, Past International President, The Chartered Governance Institute and Past President, HKCGI; Executive Director and Company Secretary, CK Hutchison Holdings Limited*
- *Prepared by* ***Mohan Datwani FCG HKFCG(PE)****, Institute Deputy Chief Executive*
- *Comments and suggestions: mohan.datwani@hkcgi.org.hk.*

board's main duties include not only providing advice but also strategy formulation, management supervision, risk assessment, and other control mechanism implementation. These were all lacking at FTX. To structure an effective board, a startup should address the following important issues.

- **Independence**: For a startup, having independent and non-executive directors with the right authority cannot be overstated. This is necessary to provide constructive challenges and views conducive to strategy implementation. As part of good governance practice, at least one-third of the directors should be independent.

  There are other views that the majority of a board should comprise independent directors. There is a need for the startup to seek to balance the desire for some control by its founder and the expectations of investors and the regulations for the industry concerned as to the proportion of independent directors.

  It may be necessary for certain startup boards to have shareholders appointed as board members from a commercial perspective. From a governance standpoint, they must not be categorised as independent directors.

  Moving on to the management side of things, although management reports to the board, board members should not try to fill managerial roles to preserve the board's independence.

- **Diversity**: This must be recognised and considered when structuring startup boards. Gender diversity is a perspective, and generally, there is an expectation that there should be at least 30% women on boards. Overall, the focus is on the essential competencies required for efficient governance. The board should have the appropriate board matrix regarding skills, and the startup should develop its board matrix for its industry. Please find an example below.

Structure and Size						Committees				Qualification		Skills and Expertise					
Name	Age	Years on Board	Gender	Ethnicity (Chinese)	ED/NED/INED	Audit	Nomination	Remuneration	Sustainability	Professional	Educational	Business Management	Strategic Planning & Risk Management	Financial Reporting/Banking	Legal/Regulatory	Sustainability	Related Industry Knowledge/Experience

- **Law, Business Knowledge, and Finance**: In particular, the board needs representation from individuals with legal, business, and financial backgrounds. These skill sets are important to ensure legal compliance, prudent financial management, and well-informed decision-making based on industry experience.

- **Risk Management:** Increasingly, the startup should be conversant in risk management. For example, a tech startup should be concerned with cyber risk. It is for startups to identify potential risks and develop strategies to mitigate them through governance control. The presence of board and management members with risk expertise is an important consideration by startups.

- **Experts in HR and Sustainability**: The startup could consider having people with experience in sustainability and human resources (HR) on its board, as appropriate.

The above are some structuring issues for an effective board from the applied governance perspective. It might well be that the main agenda of the day for the startup is such that these cannot be fully addressed, but they should be considered over time. The independence issue should be given priority.

Other structuring issues

As the startup develops, it will need to address other governance issues. The following highlights some of these.

Transparency, Compliance, and Ethical Culture

Developing an ethical culture in a startup, as with any organisation is crucial. Regular reporting and transparency are essential, particularly for businesses looking to raise capital. Programmes for raising awareness, consultation with seasoned organisations, and adopting policies that meet the demands of the particular industry should all be implemented.

Protection of Intellectual Property

Intellectual property protection (IP) is crucial for technological and other startups. A customised approach to IP management is required, emphasising determining the extent of IP protections in different marketplaces and ensuring applications and practices to protect them.

Equity for Workers

A governance issue is the conflict between offering stock options to staff members as a reward for their loyalty and the difficulties involved with vested options. Non-compete agreements and aligning equity with employee contributions should be considered.

Weighing Voting Rights

Weighted voting rights are rights attached to the founder shares that aim to give the founder control of the startup. From a practical governance standpoint, these might be acceptable for certain startups, notwithstanding possible governance concerns that not all shareholders are treated equally. However, there should be protections, such as the sunset clause, the necessity of a corporate governance committee, a continuing compliance advisor, and improved disclosure. Invariably, professional advice will be sought when developing a weighted voting right structure for a startup.

Suggestions for Startup Boards

The following practical suggestions are provided for the initial structuring a successful board startup:

- The CEO and Chairman have different functions. In many controlled companies, initially, they may be the same person, but at some stage, investors would want to avoid the over-concentration of power in one individual.

- Make sure boards have an adequate number of independent directors. This was discussed, and one-third of independent directors is an initial yardstick to work towards as the startup develops.

- An independent nomination committee for nominating director candidates is a good idea. If the persons proposing director candidates are not independent, the possibility of having the elements of independence would be reduced.

- Give diverse perspectives on the board top priority. The development of a skills matrix suitable for the startup is important.

- Include a director on the audit committee with a background in finance. This is important to provide financial oversight.

- Strengthen the board's oversight of sustainability-related matters. Investors are increasingly concerned with ESG and other sustainability issues, which should be addressed appropriately.

- At some stage, as the startup's business successfully develops, there should be implementation of board assessment to provide constructive feedback on the board's effectiveness and to identify any gaps in developing the startup business.

In conclusion, risk management, strategy formulation, and supervision require an efficient board from the outset of a startup's business. Early on, startups should create a foundational structure for corporate governance, stressing the long-term advantages. The governance structure should be reviewed as startups move through different phases. The development and success of a startup depend heavily on having sound governance from the outset, and to draw an analogy between a startup and building a skyscraper, both cannot be built without a solid foundation.