Corporate Governance Conference 2006

Working Paper Competition

"Corporate Governance Reform: Adding Value?"
GOOD GOVERNANCE COMES WITH MEMBERSHIP

The Hong Kong Institute of Chartered Secretaries is an independent professional body with approximately 4,900 members and 2,600 students. It is dedicated to the promotion of its members’ role in the formulation and effective implementation of good corporate governance policies in Hong Kong and throughout China as well as the development of the profession of Chartered Secretary.

The Institute was first established in 1949 as an association of Hong Kong members of the Institute of Chartered Secretaries and Administrators (ICSA) of London. It became a branch of ICSA in 1990 before gaining local status in 1994.

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CONTENTS

Foreword 01
Paper of Winner 02
Paper of 1st runner-up 12
Paper of 2nd runner-up 24
List of Participants 34
Acknowledgements 35
FOREWORD

I am delighted to write this foreword to the three selected papers of the Institute’s first Working Paper Competition (WPC) contained in this booklet. The standard of entries has been impressive and I would like to offer my congratulations not only to the three winners but also to all those who entered the competition. It was not something to be undertaken lightly.

Corporate governance has been in the limelight for a number of years now and as President of the Institute it is heartening to see that it still commands the interest of not only the business world but also that of academia both on the teaching and student sides.

The WPC was initially conceived as a prelude to the Institute’s Corporate Governance Conference 2006. However it would seem that the number and high standard of entries means that it could easily merit being a standalone event and another vehicle for spreading the message that good governance is important not only to the corporate world but to the well being of Hong Kong.

Finally I would like to thank the panellists all of whom are academics who reviewed all of the papers and drew up a short list for the judges to consider, the judges who are a mixture of academics, practitioners and regulators for taking out of their very busy schedules to read the six short listed papers and of course the hard working Secretariat of the Institute for organising and promoting this competition.

I hope you find the papers interesting and once again congratulations to the three winners.

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INTRODUCTION

Effective corporate governance is at the core of an efficient market economy. In order to ensure that a company’s assets are being utilized in their interests, shareholders and other financial stakeholders must have access to information and have the ability to influence and control management, through both internal governance procedures and external legal and regulatory mechanisms.

Within the general corporate governance debate, there has been an increasing emphasis on the need for institutional investors to play an active role in the corporate governance.

In developed markets, large institutional investors pay considerable attention to corporate governance practices. Some of the world’s largest pension funds, such as the California Public Employees’ Retirement System (CalPERS) and Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA/CREFF) in the United States (US) and Hermes in the United Kingdom (UK), actively pursue corporate reform through their positions as major shareholders.

At global level, initiatives such as the International Corporate Governance Network (ICGN)’s code of practice in relation to investors’ governance responsibilities are beginning to change the climate for institutional investor activism.

The purpose of this paper is to examine the increasingly important role of institutional investors in corporate governance reform in Hong Kong. The first section provides a general overview of the development of institutional investor activism. The second section provides a general discussion on the role, incentives and growth of institutional investors in Hong Kong and the issues faced by the institutional investors which affect their willingness and ability to become actively involved in the governance of their investee companies. The last section evaluates the recent corporate governance reforms in Hong Kong and role of institutional investors in promoting the corporate governance with policy recommendations.

OVERVIEW OF DEVELOPMENT OF INSTITUTIONAL INVESTOR ACTIVISM

What is institutional investor

The term “institutional investor” commonly refers to an investor with funds under professional management in an organization that invests on behalf of a group of individuals, organization or a group of organizations. Institutional investors such as large pension funds, insurance companies and mutual funds have become the largest shareholders in many countries, having significant shareholdings in the companies in which they invest.

Growth of institutional investors

The late 1990s witnessed increasing interest and investment of institutional investors in corporations, particularly in the USA and UK.

The major growth in institutional investors in the UK up until 1993 was mainly due to the growth in pension funds and to a lesser extent, insurance funds. Both pension and insurance funds grew as the result of the increase in private retirement savings in the form of occupational or personal pension scheme and long term life insurance/assurance. In the UK, about 75% of British equities are held by institutional investors including about one-third held by pension funds. The latest figures published by Office of National Statistics in June 2004 showed that at the end of 2003, institutional investors in the UK own nearly 49% of UK equity.

Institutional ownership in the US, primarily made up of private and public pension funds, increased from 15.8% of corporate equity in 1965 to more than 50% by 1990 (Useem, 1993). By 1999, institutional investors held nearly 60% of the largest 1000 US corporations and they held collectively more than 50% of the shares in two thirds of these corporations (Financial Economists Roundtable, 1999).

The phenomenal growth in institutional ownership was not only confined to the USA and UK markets but also in international equities (Cadbury, 1999). The proportion in equities held by pension funds is expected to rise as a result of the ageing of worldwide population and the attendant rise in pension fund investment. Pension funds’ equity investment in emerging markets rose substantially, from US$24.2 billion and remained largely stable over 2000 at US$3.3 billion.
Institutional investors and corporate governance

The dominance of international institutional investors is hypothesized to be the single most important change and driver for corporate governance in the corporate sector in the future (Cadbury, 1999).

UK’s various corporate governance reports have all emphasized the important role that institutional investors have to play in corporate governance.

The Cadbury Report (1992) viewed institutional investors as having a special responsibility. “Because of their collective stake, we look to institutions ...... to use their influences as owners to ensure companies in which they have invested comply with the Code”. It suggested that institutional investors should encourage regular one-to-one meetings with directors of their investee companies; should make positive use of their voting rights and should pay attention to the composition of the board of directors of their investee companies.

The Greenbury Report (1995) emphasised investor institutions should use their power and influence to ensure implementation of best practice as set out in the Code.


Myners Review was critical of the role of the institutional investors in corporate governance issues and argued that pension fund managers were reluctant to take pre-emptive actions to tackle underperformance in investee companies (Myners, 2001).

In response to Myners’ criticisms, the UK government issued a consultative document (Encouraging Shareholder Activism, HM Treasury/DWP, 2002) which set out proposed legislation for making active monitoring and communicating with investee companies a legal duty for pension funds. The document also considered measures to make voting mandatory for pension fund managers in certain circumstances.

The Institutional Shareholders’ Committee (ISC, 2002), whose members comprise the Association of British Insurers (ABI), the National Association of Pensions Funds (NAPF), the Association of Investment Trust Companies (AFFC) and the Investment Management Association (IMA), published a statement of principles which made clear that institutional shareholders have a responsibility to monitor and communicate with investee companies and, moreover, intervene where necessary.

In recent years, increasing numbers of institutional investors have published their corporate governance guidelines. In 2002, Hermes, a large and influential institutional investor based in the UK, issued its Hermes Principles. ABI and NAPF have best practice corporate governance guidelines that encompass the recommendations of the UK’s Combined Code 2003. CalPERS has recognized the differences between U.S. and international investments by establishing different governance guidelines for different countries. Large public pension funds such as CalPERS and TRIAA-CREF have used their significant voting power to bring pressure on companies to improve their corporate governance (Gillan & Starks, 1998, 2000; Useem, 1996).

Institutional investors’ potential to exert significant influence on the companies has clear implication for corporate governance, especially in terms of standard on corporate governance and issues concerned with enforcement.

Empirical evidence

There is some empirical evidence that the rise in institutional shareholdings in recent decades has been associated with better corporate governance. Black1 has reviewed the US empirical studies and found that such studies produced mixed results. Recent surveys showed that the investors are willing to pay premium for well-governed companies.

In its Global Investor Opinion Survey of over 200 companies undertaken in 2000 and updated in 2002, McKinsey & Company found that 80% of the institutional investors would pay a premium for well-governed companies2. Around 60% of institutional investors will avoid investing in companies with poor corporate governance standards.

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A recent World Bank study³ stated that a high correlation exists between corporate governance and both a company’s operating performance and its market valuation. Specifically, a one standard deviation change in corporate governance practices resulted in an average increase of 23% in the company’s valuation. They concluded that investors are willing to pay a premium for companies with good corporate governance practices, because the risks are lower for those companies.

A 2001 survey by Credit Lyonnais Securities Asia (CLSA) on 495 companies in 25 emerging markets indicated that shares of companies with high corporate governance standards have enjoyed higher Price/Book (P/B) valuations⁴. Specifically, companies within the top quartile for corporate governance standards enjoyed an average P/B valuation that was 54% above the market average. In contrast, companies within the lowest quartile for corporate governance practices had average PB ratios that were 43% below the market average.

According to the 2006 Global Investor Study by Institutional Shareholders Services (ISS) which surveyed more than 300 institutional investors across 18 countries that manage $1.5 trillion, nearly one-third of the world’s estimated $33.1 trillion in equity assets, institutional investors across the globe are increasingly focused on better corporate governance. The report finds that institutional investors increasingly view governance as a business imperative that translates into a competitive advantage.

**INSTITUTIONAL INVESTOR ACTIVISM IN HONG KONG**

**Strong incentives for institutional investors to monitor**

In theory, there are strong incentives for institutional investors to take a proactive role in corporate governance in order to maximize their shareholders’ values for the following reasons:

1. Institutional investors have a bigger stake in the company compared with the most ordinary investors and many are required by their client’s portfolio to invest in some companies over a longer term. Accordingly, unlike small individual investors, large institutional investors have greater incentive and power to monitor the management and performance of their investee companies and try to influence its decisions rather than simply selling their stocks when they are dissatisfied.

2. As institutional ownership positions become larger, it may be very costly for the institutions to sell large blocks of their investments. The difficulties of disposing of shares of poorly performing corporations quickly and the limited alternative investment opportunities available in the market also contributed to the changing role of institutional investors.

3. Institutional investors who have large shareholdings can take the lead in coordinating the oversight of management activities with other shareholders. This could reduce the overall cost of monitoring for both individual and institutional investors.

**Characteristics of Hong Kong market**

In Hong Kong, the shareholding structure and agency problems differ markedly from that in the USA and UK.

**Family control and concentrated ownership**

Over seventy per cent of Hong Kong listed companies were majority controlled by a family or an individual (Hong Kong Society of Accountants, 1996). The ten wealthiest families in Hong Kong owned over forty-seven per cent of the total market capitalization of the Hong Kong Stock Exchange in 2000. Fifty-three percent of all listed companies had one shareholder or one family group of shareholders that owned fifty per cent or more of the entire issued capital (Hong Kong Society of Accountants, 1997). Accordingly, the relatively high family-based concentration of corporate ownership and control have led to a governance structure that enables the dominant shareholders to make key decisions on their own.


⁴ "CLSA Watch: Corporate Governance in the Emerging Markets" by Amar Gill, April 2001. This comprehensive survey was based on 495 companies in 25 emerging markets across Asia, Eastern Europe, South Africa and Latin America.
Lack of market for corporate control

In addition, market discipline mechanisms such as hostile takeovers cannot function properly in Hong Kong because of concentration or family ownership.

Lack of independent non-executive directors

The dominance of the family controlling shareholders effectively means only persons who are “acceptable” to the controlling shareholders will have a realistic chance of being elected to the board of companies in Hong Kong. Since the board is dominated by the controlling family, independent non-executive directors may have difficulties in functioning effectively even if they wanted to do so. Many investors were skeptical about existence of truly independent non-executive directors.

Therefore, the major governance problem in Hong Kong is not the agency conflict arising from the separation of ownership and control, but the expropriation of minority shareholders by the controlling shareholders. The institutional investors holding a comparatively low percentage of shares are unlikely to be able to exercise significant influence on corporate governance matters over the controlling family. As a result, their role in Hong Kong may be constrained by the shareholding structure due to the lack of voting power.

According to the Survey on International Institutional Investors’ Attitudes towards Corporate Governance Standards in Hong Kong conducted by Professor Judy Tsui and Ferdinand A Gul in 2003, the institutional investors in Hong Kong are most often minority shareholders and the majority of institutional investors in Hong Kong do not take an active role in monitoring their investee companies, for most of them the “Wall Street Walk” is their only option in cases where they object to management policies.

Growth of institutional investor activism in Hong Kong

As a result of the concentration of ownership and control of corporations by families, institutional investor activism is rare in Hong Kong and most of institutional investors in Hong Kong play a relatively passive and low-profile role.

However, it is interesting to note that there has been significant growth in the institutional shareholding in Hong Kong over the last ten years. The net asset value of Hong Kong authorized funds was over US$298 billion by the end of 1999 (HKIFA, 2000). The total assets managed by Hong Kong Investment Funds Association was about US$217 billion as at the end of June 2000.

The provident fund markets are developing in Hong Kong, which means that it will be a long time before the fund reaches a sufficient size to be able to behave like CalPERS. The Mandatory Provident Fund scheme will gradually increase the focus on the long-term returns. The growth in the institutional shareholding and the development of provident fund markets indicate the increasingly important role to be played by the institutional investors in promoting the corporate governance standards in Hong Kong.

Recent examples of activism are the attempts by Templeton Assets Management Limited, a subsidiary of Franklin Resources Inc. which is a global investment organization, to oppose the sale by Boto International Holdings Limited of its core artificial Christmas-tree business to an entity co-owned by Boto’s Chairman, and also vote down the proposed privatization offer of Henderson Investment Limited in 2002 and 2005, the terms of which being disadvantageous to the minority shareholders.

Ways of monitoring and intervention by institutional investors

The main objective of “institutional participation in corporate governance should be to maximize economic value for the institutional shareholders and their beneficiaries” (Financial Economists Roundtable, 1999). Institutional shareholders owed a fiduciary duty to ensure that investments are managed exclusively in the financial interests of their beneficiaries.

Globally, institutional investors have increasingly engaged in corporate governance activities, introducing proxy proposals and negotiating with management, with a goal of improving corporate performance. Increasingly, there is a trend of institutional investor activism internationally on two levels: agenda setting and voting; and shareholder litigation.
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Voting

The most visible form of institutional involvement in corporate governance is the exercise of voting rights. Voting is probably the only aspect of institution’s involvement in corporate governance that could realistically be the subject of specific request. The issue of whether institutional investors are legally obliged to be involved in corporate governance revolves largely around the duty of the fiduciary office holders to actively and genuinely consider whether and how to exercise their powers.

Failure to vote an equity investment will not normally involve a breach of duty so long as active and genuine consideration has been given to the issue whether to vote.

Shareholder litigation

Institutional investors can intervene by bringing legal actions against wrongdoers. However, legal action, either by way of derivative action or unfair prejudice petition, would in most cases be futile because of the potential costs of proceedings and the length of pleadings and trial involving extensive evidence.

Corporate governance guidelines

In recent years, increasing numbers of institutional investors, certainly in the US and to a lesser extent in the UK, have begun to publish their corporate governance principles. This is a practical way to convey their governance philosophy to the management of their investee companies.

Regular engagement

Other ways of intervention includes regular engagement through one-to-one meetings, roadshow presentation, etc.

Focus lists

CalPERS published an annual list of companies that it intends to target over their corporate governance practices and misdemeanors.

Through the tools of governance, such as one-to-one meetings, voting, focus lists, and rating systems, the institutional investors could demand a high standard of corporate governance from companies and only select shares with good corporate governance and thus become driving forces behind shareholder activism.

Factors influencing the willingness and ability of the institutional investors to pursue activism

Nevertheless, there are a number of issues or legal constraints faced by the institutional investors, which explains why institutional investors are not willing nor capable to pursue activism:

Lack of sufficient shareholding

The major problem with shareholding voting is that most small investors do not have a big enough share in the company to have any incentive to spend time and money on agenda setting and voting at annual general meetings of the investee companies.

Free rider problems

Institutional investors lack incentives to actively monitor because of the free-rider problems among themselves in monitoring managers of their investee companies. Institutional shareholders are likely to have to bear the cost of activism while the benefits of activism will be shared by all other shareholders. Accordingly, the benefit for the institutional shareholders will have to be large enough to justify the cost. This leads to disincentives for their active monitoring (Black, 1990; Admati et al., 1994; Pozen, 1994). Some institutional investor groups may adopt a strategy of “free-riding” on the activism of others and share in performance improvements on their portfolio (Daily et al., 1996).
Liquidity

Institutional investors might not want to sacrifice investment liquidity in order to achieve a greater voice in the activities of the investee companies. In order to obtain more inside confidential information about the investee companies, institutional investors have to maintain a certain level of ownership. This maintenance of the level of ownership could jeopardize their freedom to maintain liquidity in the investee companies (Bhide, 1993). Black and Coffee (1994) report that Prudential Portfolio Managers Ltd., the investment of subsidiary of the Prudential, own a stake of 5% or higher in about 200 companies, but become concerned about illiquidity at ownership stakes in the region of 10%. Until recently, institutional investors have shown preference to liquidity than control because the exercise of control over corporate management requires a sacrifice of liquidity. Though large institutional shareholders may receive benefits from monitoring, concentrated ownership can reduce market liquidity and in effect prohibit the investors to sell their shares.

Insider dealing

Institutional investors may be fearful of being an insider as they are likely in their activism to come across price sensitive information. If institutional investors become involved in the management of the investee companies, they become privy to inside information, which might in turn restrict them from dealing in the shares those companies.

Inability to trade the shares is cited commonly as a reason why institutions oppose the idea of non-executive directors being nominated by institutional investors to the investee companies. Accordingly, the insider trading provisions serve to restrict the amount of corporate governance activity performed by institutional shareholders.

While this is clearly an issue which fund managers need to consider, there are a number of ways in which they can deal with it. Not all intervention requires the acquisition of insider information. Fund managers can put in place the appropriate procedures to isolate information received in this way from their buy/sell decision making process. This is an issue already faced by banks who are both lender to and shareholder in a company, particularly as regards information received when a company gets into financial difficulties.

Conflict of interests

An economic barrier to the exercise of voting rights by the institutional investors is the conflict of interest that exists for fund managers owned by banks or insurance companies. Many fund managers are affiliated to commercial or investment banks or insurance companies, whose profits depend in part on their banking or insurance business with the same companies in which the funds invest. Unless an effective “Chinese wall” is in place, the ownership of fund managers by banks and insurance companies may place pressure on investment managers to vote with the management of a company when that company has a banking or insurance relationship with the parent company. Alternatively, such pressures may force fund managers to abstain from voting on contentious issues. Proposal to adopt confidential voting might be a solution but findings of empirical literature indicated that there is insignificant impact of confidential voting on voting outcomes.

Disclosure of proxy voting information is a possible practical solution to this problem, as managers are required to disclose to investors how they intend to deal with conflicts of interest in relation to fund voting.

There has long been debate in the US on the merits of mandating disclosure of voting policies and procedures by investment companies. The US Securities and Futures Commission requires registered management investment companies to disclose how they vote proxies relating to portfolio securities they hold. The primary purpose of the rule is to enable fund investors to monitor the role of institutional shareholders in the corporate governance practices of public companies. Since investment managers that act as responsible entities have a duty to consider whether to exercise their voting power and to exercise that power in the best financial interests of their investors, mandating proxy voting disclosure can be seen at best as a compliance tool to enable investors to confirm that duty has been met.

Stapledon (1998) on the other hand argued against mandatory disclosure proposal on two grounds. First, fund managers should be accountable to fund investors, not to the company concerned or some wider audience. Second, fund managers may fear the threat of losing business from taking an activist stand, which would chill investor activism instead of promoting it. Palminter (2002) disagrees with this point and states that there has been little evidence of corporate boycotts of activist funds. In the latest IFSA survey, most respondents were against requiring disclosure of voting practices.
Access to information

Institutional investors may not have sufficient information to actively monitor the company’s operations even though they have the information required to make their investment decisions (Kochhar and David, 1996). Also, institutional shareholders’ ability to monitor by legal action the management against expropriation or other wrongdoing depends on whether they have sufficient information about the transactions complained of.

ROLE OF INSTITUTIONAL INVESTORS IN CORPORATE GOVERNANCE REFORM IN HONG KONG

In the wake of Asian financial crisis and corporate collapses, such as Enron, Worldcom, there have been numerous corporate governance reform initiatives and international efforts. According to the Judy/Gul Survey on institutional investors in Hong Kong, all respondents supported corporate governance reform.

A great deal of work has been done over the last couple of years on corporate governance in Hong Kong. The main reform initiatives include:

• The Standing Committee on Company Law Reform (SCCLR) issued its Phase I and Phase II consultation paper in July 2001 and 2003 respectively, proposing actions to enhance the corporate governance regime in Hong Kong. The proposals relate to directorship, shareholders’ rights and conflicts of interests and corporate reporting.

• In January 2002, The Stock Exchange of Hong Kong Limited (“HKEx”) issued a consultation paper on proposed amendments to the Listing Rules relating to corporate governance issues. The paper concerns protection of shareholders’ rights in voting and share transactions, directors and board practices and corporate reporting and disclosure. The consultation conclusions were published in January 2003.

• In January 2004, HKEx published a consultation paper on exposure of draft Code on Corporate Governance Practices (the “CG Code”) and Corporate Governance Report and the consultation conclusions were published in November 2005. The CG Code, which becomes effective from 1 January 2005, is a significant enhancement of the previous Code of Best Practices. It provides useful support for listed companies in Hong Kong in advancing board practices and promoting good corporate governance practices.

• In July 2005, the shareholder remedies related provisions of the Companies (Amendment) Ordinance 2004 came into effect. The main purpose of the such amendments is to enhance the remedies available to shareholders receiving unfair treatment. The major amendments include the introduction of a new right to inspect company records, certain improvements to the unfair prejudice provisions under section 168A, a new right to commence a derivative action and a new right to apply to the court for injunctions.

The corporate governance reform in Hong Kong remained within voluntary framework. The CG Code, which adopts a “comply or explain” approach, sets out a minimum standard of corporate governance for Hong Kong listed companies, which is on par with the best current international practices. It largely modelled on the UK Combined Code but failed to incorporate provisions regarding institutional investors in three main areas, namely, dialogue with companies, evaluation of governance disclosures and considered use of votes by institutional shareholders. Further amendments to the CG Code will be required in light of future market developments.

To deal with the Hong Kong characteristics of family control and to address the problem of expropriation of minority shareholders, attempts should be made to strengthen and facilitate the monitoring role to be played by the institutional investors. With the increase in institutional ownership and development of provident fund markets in the long term, institutional investors in Hong Kong are growing in importance and will be a driving force for change. Initiatives concerning investor relations should be priority within the overall corporate governance agenda for reform.

Oversight by institutional investors will take place only where they concluded that the benefits of monitoring outweigh the costs. The focal point of policymakers’ efforts should be on measures that would sway the incentives of shareholders towards more active monitoring of corporate management, taking into consideration the issues and legal constraints faced by the institutional investors as mentioned in the above section. A policy prescription is to encourage the institutional investors to rely on “voice” instead of resorting to exit strategy, by the approaches of making “voice” less costly or making “exit” more expensive.

Another policy recommendation could be to pay more attention to encouraging the development and implementation of voting policies by institutional investors.
CONCLUSION

Good corporate governance is the key to improving economic efficiency, enhancing the attraction of our market and investors’ confidence and maintaining the stability of our financial system. The objective of corporate governance reform is to protect both the shareholders and investors. Large institutional investors increasingly pay attention to corporate governance practices and assume an increasingly important role in promoting corporate governance. This paper has examined the development of institutional investor activism, the role and incentives of institutional investors in corporate governance, and the issues and legal constraints the institutional investors face in being actively involved in monitoring and intervening in corporate governance issues of investee companies and highlighted the initiatives to involve and motivate institutional investors as a driving force to promote corporate governance and add value to the corporate governance reform in Hong Kong in future.

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1st Runner-up

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Ng Chor Sum Sam
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INTRODUCTION

As per the Organisation for Economic Co-operation and Development (OECD), corporate governance “involves a set of relationships between an organization’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the organization are set, and the means of attaining those objectives and monitoring performance are determined.”¹ In essence, it is accountability to all the stakeholders.

Developments in this area were simultaneously underway in the United States and the United Kingdom by the National Commission on Fraudulent Financial Reporting and the Cadbury Committee respectively back in early 1990’s. OECD later promulgated the Principles of Corporate Governance, pushing the matter up along the Global Issue List.

In the wake of the corporate scandals involving world-renowned companies, such as Enron, WorldCom and Viacom, it is thought expedient to maintain good corporate governance within a company. Yet, notwithstanding the statutory development which are rather kept abreast of the time, corporate governance development is still at quite a Greenfield level.

Therefore in this report, we would examine the issue in three main aspects, namely the transparency and disclosure requirements of a corporation; the transformed roles of shareholders and stakeholders; and the issues inside board governance and executive compensation. Relevant situation would be addressed to, followed by deficiencies noted in each aspect as well as our recommendation for further development.

We hope the analysis below would help stimulate some insights on how corporate governance in future should be positioned, and refined to avoid corporate transgressions and ultimately underpin the prosperity of our economy.

SECTION 1
TRANSPARENCY AND DISCLOSURE REQUIREMENT

The first of the meaty topic focuses on Transparency and Disclosure of information. With reference to the three fundamental principles of good governance identified in the Cadbury Report², namely Openness, Integrity and Accountability, this part of our discussion reviews how effective the organizations, especially those in Asia, are in achieving such a standard. The following examines Listed Companies and Public Bodies in two different aspects: the statutory regime and enforcement of the relevant legislation.

1. Listed Companies
   1.1 Present Situation

   As per Alastair Ross Goobey CBE, if super-power who tends to dictate the global agenda does not engage in an issue, it remains marginalized.³ Therefore the US response to the Enron and Worldcom scandals, in deploying strategies to prevent accounting fraudulent cases and undermine CEO-dominant paradigm has stimulated staggering concern on good corporate governance all across the world. The global village could now be mainly divided into two streams: first, the US approach, pursuant to the Sarbanes Oxley Act signed into law in 30th July 2002, which requires straight compliance with the prescribed rules and regulations with legal consequences and liabilities for any breaches. Second, the UK, Australia and most Asian Institution approach which is to “comply-or-explain”, which flexibility was implemented because companies would only be encouraged to comply with the relevant provisions. Shall non-compliance be desired, only explanation would be required and no legal liability would be attached thereafter. As for Hong Kong, the Hong Kong Stock Exchange (“HKSE”) has, on 30th January 2004, announced alterations to the Main Board and the GEM Listing Rules where amendments were addressed in the revised Code on Corporate Governance Practices and the new Corporate Governance Report.

¹ Adapted from the preamble of the Principles of Corporate Governance by the Organisation for Economic Co-operation and Development (OECD)
With reference to the limited concern on the Asian public in the value of good governance, Asian countries had in fact undergone a number of reforms in terms of legislation.  

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<th>Country</th>
<th>Title of code</th>
<th>Year Issued</th>
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<td>Republic of Korea</td>
<td>Code of Best Practice for Corporate Governance</td>
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<td>People’s Republic of China</td>
<td>Guidelines for Governance of Listed companies</td>
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1.2 Deficiencies and Recommendations

1.2.1 Statutory Requirement

Notwithstanding the great effort across the world in achieving a higher standard of transparency and greater accountability of the Chief Officers, there were still areas for improvement in terms of the statutory regimes.

First, a more convergent practice is required among Asian countries. The endorsement of the Principles listed by the Organisation for Economic Cooperation and Development ("OECD"), especially after the post-1997 crisis has nonetheless converged the countries to a set of common principles and even rules regarding corporate governance as per Hamid L Sharif and Said Zaidansyah of Asian Development Bank.  

Owing to the different customs and levels of development in the various Asian countries, it is understandably difficult to adopt a “one size fits all” approach across the region, yet a more general standard is nevertheless necessary to ensure that all Asian countries could effectively communicate under a level platform in view of the huge number of cross border transactions. If a commonly understandable and verifiable standard could still not be achieved in Asia, disadvantage is likely to be imposed on us when dealing with those of a well-developed governance environment.

Second, the adoption of the principle "comply or explain" is likely to be fraught with difficulties. Although such trait pays tribute to the Asian countries where it is impossible to have one pre-determined form of business model for all the companies, much effort should be paid in monitoring whether the explanation on non-compliance is fair enough.

Lastly, continuous effort is needed to boost development in Corporate Governance. As per Dominic Barton, Paul Coombes and Simon Chiu-Yin Wong, “Across Asia, too many companies remain unconvinced of the value of good governance, and change faces real-world impediments and disincentives”. It was only in the wake of the Asian Financial crisis and upon their counterparts' increasing concern on the issue when Asian countries increased their awareness on the topic. Much more impetus would be necessary for further development.

1.2.2 Law Enforcement

However, the divergence of standard in corporate governance across the region does not lie on our different legislations but the varying regulatory approaches adopted in the countries. Although clearly stated in the statues, lax policing in many of the Asian countries are vital in barring good governance.

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First, the weak investigative and regulatory power would undoubtedly undermine the enforcement of the law. For instance, Taiwan's Securities and Futures Commission has limited power in stopping corporate transgression. Stakeholders are not inclined to petition the court due to their distrust of the law enforcement agencies. To solve, it is recommended that stricter measures should be imposed when investigating corporate transgression cases. A nice example would be the Asian Development Bank helping Developing Member Countries like Pakistan to set up a completely independent Securities and Exchange Commission against improprieties committed by Companies.

Second, the lack of an unwavering will to enforce is also vital to the weak enforcement. Excuses for escaping from good governance are often apparently the predictable risen cost, and implicitly, political will. When encountering large and influential companies, the Commissions tend to succumb to the corporate titans and thereby relax their investigations. This is all down to the countries' determination to enforce which is more of a political concern than any legislation can alter.

Third, the concentrated share ownership in most Asian countries, except some in Japan and Hong Kong, raised problem in enforcement as well. The many family-owned enterprises, as against those institutional enterprises in other countries, imposes agency problem by which the controlling shareholder(s) would have disproportionate control over information within the company. Related transactions of the controlling shareholder at the expense of the other stakeholders would become much easier. These companies are often being stereotyped as being paternalistic and vested with nepotism. With regard to such a distinctive feature of Asian countries, strict internal control within the company is highly recommended to prove that family-owned enterprises do not necessarily mean such problem would be associated. Regulatory units in Asia should also be cautious of this feature.

Finally, education on ethic and conduct is another key to making good governance culture pervasive throughout the society. Afterall, quoting Mr. Andrew Sheung of his Keynote speech on corporate governance on 15th October 2004, “all the rules and regulations in the world will not prevent incompetence, deliberate fraud, deceptive conduct, or misleading and material non-disclosure by top management”. Nothing is more important than inculcating our future pillars of the society the gauge of ethics and morality.

2. Public Bodies

Public Bodies refer to all public sector organizations including “quasi-profit-orientated”, largely or fully self-funding and subverted bodies and other entities which serve a public purpose. As the practice in different countries vary, the scope of discussion will primarily focus on the public bodies in Hong Kong.

2.1 Present Situation

Public bodies are accountable to the general public for the use and stewardship of public funds and assets entrusted to them. They are expected to be a role model in exhibiting the standards set in the Cadbury Report to receive support from all of its stakeholders. Therefore a high standard of governance is likely to be expected.

In contrast to listed companies governed by the Companies Ordinance (Cap.32), the Listing Rules and relevant provisions, there is no predominant legislation other than guidelines in public sector organizations.
2.2 Deficiencies and Recommendations

First, the lack of a general regulatory framework generates difficulty in assessing the standard of corporate governance in the public sectors. On the regulatory front, a general guideline is insufficient in monitoring the public sectors although critics may argue such implies distrust in our public organizations. Nonetheless, regular independent external reviews and reporting to the public on performance is highly recommended to achieve the same goal.

Second, the measure of performance creates another difficulty. Key performance indicators, basing on performance of previous years and similar organizations, serve as management and accountability tool. The fact that public sectors are not profit-driven makes it incapable in using profit as a performance measurement. Identified goals and timeframes, instead, are used to assess how public sectors are doing. As a redress, benchmarking the performance of the organization against similar entities is likely to be a measure to improve performance.

SECTION 2

TRANSFORMED ROLES OF SHAREHOLDERS AND STAKEHOLDERS

The rights & functions of Shareholders and Stakeholders

With regards to a series of corporate scandals happened all over the world especially in the United States in recent years; the integrity of the Boards as well as the corporate compliance and disclosure requirements should definitely topped the priority list in carrying out suitable and convincing reform. After discussing about the leadership and compensation reform about the Boards in the previous section, it is now time to switch the focus over to the shareholders as well as stakeholders. In reality, the shareholders and the respective stakeholders of each corporation can, in fact, play a much active and effective role in terms of regulating and participating in the corporate decisions making process and general meetings. Shareholders’ roles and responsibilities should be strengthen as the internal surveillance agents in which they should bear the responsibility of checking and questioning the Board of directors, the financial statements as well as the strategies and development plan of the corporation itself. They should not merely focus on the return of their investment or the percentage growth of the corporation, but they should, from now on, be an intelligent and ethical investor, of the corporation starting from the sixth year of this millennium.

In terms of the stakeholders, similar to the strengthen roles of shareholders, should be able to judge and question the behaviour of the corporation, and a well established channel should be made to enhance the communication between the stakeholders and the corporation.

1. The Roles of shareholders

1.1 Current Situation

1.1.1 Conflicts of Interests

There have been quite a lot of situations revealing the conflicts of interests between shareholder and management. According to the article published by the Bank of China (Hong Kong)\(^1\) , “given insufficient oversight and disclosure is unfavourable to the shareholders, the increasing use of stock options in executive remuneration packages further widens the gap between management and shareholder interests.” Stock options are meant as an incentive to executives, enabling them to benefit from their efforts to increase shareholder value. However, the consequences were that executives tried to overstate the earnings so as to boost the stock prices to increase personal gain. Unfortunately, investors were then misled and became ultimate losers.

\(^1\) Bank of China (Hong Kong) (2002). Hong Kong’s Corporate Governance Reform in light of U.S. Corporate Scandals.
1.1.2 Insufficient knowledge in Accounting Standard and Corporate decisions

Based on the same article mentioned in the previous paragraph, there are a number of loopholes in the US Accounting standards after a series of corporate scandals. “For instance, special purpose entities with 3% or more ownership by external parties can be removed from the company’s balance sheet, enabling the company to conceal huge debt.” This reveals shareholders have no clue whether the Accounting Standards used by the corporation have played any sophisticated trick with the standards set by the Federal Accounting Standards Board under the authorization of the SEC.

As per Paul Coombes and Mark Watson, it shows that the premiums in Continental Europe suggest that, besides improved corporate governance at the board level, there is a need for more effective disclosure to shareholders of information on governance practices and financial issues. The high premiums in Asia and Latin America reflect the need for more fundamental disclosure of information and for stronger shareholder rights. In Latin America, local investors say that better disclosure is the main concern, while foreign investors see shareholder rights as the priority.12

1.2 Recommendation for reform

1.2.1 Active participation in Company’s decisions

First of all, for more than a century, only the directors rather than the shareholders concern about the corporation development strategies and their ethical behaviour. Time changes after a series of corporate scandals unveiled. The internal control mechanism of the Board needs to be improved undoubtedly; the disclosure and compliance reform is right behind it after the adoption of Sarbanes-Oxley Act in 2002. Shareholders, the most important, while the least proactive group, should be able to bring in a new synergy in supervising and questioning the corporation.

Secondly, as per Dominic Barton, Paul Coombes, and Simon Chiu-Yin Wong, investors could pressure corporations to comply with new governance requirements. In practice, most of them hope to remain silent as long as the growth prospects and risk premium outweigh all other factors, rather than to challenge the management when governance problems arise. Shareholders must become more proactive in supporting the reform and more willing to engage in management based on the Anglo-American standard. They should request the corporation to improve financial reporting and broader disclosure.

Thirdly, the Organization of Economic Cooperation and Development (OECD) have adopted the Principles of Corporate governance in 2004. From there, it clearly states out the basic while crucial rights of shareholders. “Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated.”14 Shareholders should be able to voice their views to board members and key executives regarding various corporate aspects such as the remuneration policy, annual external audit and other financial statements as well as sufficient and updated information over the issues, venues and dates of the general meeting. On top of that, the Hong Kong Code on Corporate Governance Practices points out that it is important for major shareholders to meet those non-executive committee members of the Board on appointment basis to address the issues concerned.15

1.2.2 The voting rights of Shareholders

As mentioned in the Asia’s Governance Challenge, “It would be better for corporation to allow minority shareholders to vote by proxy, to nominate and elect directors, and to raise questions at annual meetings.” On the other hand, in order to encourage the participation of shareholders in the general meeting, some corporations tend to simplify the procedures and documentation of filing amendments and resolutions as mentioned in the Principles of Corporate Governance by OECD.

14 OECD Principles of Corporate Governance (2004), pp40-48
This would be the key step in supervising and improving the corporate governance through active participation joining hands of shareholders after the corporate scandals. This would be a very good re-alignment of interests and refinement of the existing structure, so as to make the Board and managing directors realize the facts that their investors care about their corporate strategies and operations. After all, it is still the Board who has to manage the corporation and bear the consequences.

2. The Roles of Stakeholders

2.1 Current situation

Stakeholders include various financial institutions, partners, investors and employees. For decades, these parties mainly focus on the profits, investments and returns of the corporation. However, they do not take up an active role in checking or commenting on the corporate strategies or the operations over the years. Not until the whistle-blowing role played by an employee of Enron, did people finally realize that stakeholders can play a key role in the corporate governance process. A lot of people may not know that, as mentioned in the Principles of Corporate Governance, under all OECD jurisdictions, the rights of stakeholders are protected by laws and other contracts. Their under-performing attitude make the corporation thinks that they are always making the right decisions in various aspects. Similar to shareholders, stakeholders should play a much active role in communicating and questioning the issues and problems inside the corporation.

2.2 Recommendation for reform

2.2.1 Communication

As per Richard Dobbs, Keith Leslie, and Lenny T. Mendonca, corporation should be open minded and try to communicate more with the capital markets and employees. This will certainly help identifying and attracting the potential investors from the market. After explaining their corporate strategies and operations, the stakeholders should be willing to express their concerns over the issues addressed, so as to reach a mutual benefit over their long term partnership. According to the Principles of Corporate Governance, “Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.” This, in fact, is very important in closing up the relationship among stakeholders and the corporation.

2.2.2 Employees Participation

For the long term benefits of the corporation, it is important to include employee representation on boards as mentioned in the Principles of Corporate Governance; under the corporate governance structure, there should be works councils that consider employee viewpoints in certain key decisions. In terms of performance enhancing mechanisms, employee stock ownership plans or other profit sharing mechanisms are found in many countries. Pension commitment plans are often regarded as an element to maintain the healthy relationship between the company and its past and present employees.

This will not only enhance the sense of belonging among the employees, this also open up a channel for employees to share or express what they think is detrimental for the corporate development. This creates a win-win situation for both the corporation and their employees.

\[16\] OECD Principles of Corporate Governance (2004), pp46-48
SECTION 3

BOARD GOVERNANCE AND EXECUTIVE COMPENSATION

1. Board Governance

1.1 Current situation and deficiencies

Since Enron and WorldCom, the whole corporate world has been undergoing board reform. Although Board structures differ among countries and their procedures are influenced by the country's culture and traditions, the utmost responsibility of directors is still the same: acting with due diligence and care in the best interest of shareholders and the company.

General criticisms on Corporate Boards are directors’ minimal involvement in shaping and developing strategy and their lack of experience to effectively participate in doing so.\(^{18}\)

As for the emerging markets, the problem of inexperienced directors is more serious. Board of directors are usually associates of the selecting person, could be the CEO or the Chairman, not to mention that both could be the same person. Undoubtedly, the selection criteria of directors are questionable. For example, in certain important sectors, such as Banking, the Central Government has full control of the board. China Minsheng Banking\(^{19}\), for instance, the 87-year-old chairman just retired and the Company, despite owned by private businessmen, is waiting for the government to assign a new Chairman, which has the power to restructure the Board. It is unclear whether the assigned is professional and experienced. But without doubt, he will act in the best interest of the government but not the shareholders and the company.

1.2 Recommendation for reform

1.2.1 Reviewing and guiding corporate strategies

For the long term development of the company, reviewing and guiding corporate strategies: establishing company objectives, instigating business plan, approving budget and hedging various types of risks exposure are of essential importance.\(^{20}\) The responsibility of setting strategies is not only in the hands of management team, but the Board as well. Directors should be more involved in the monitoring process.

1.2.2 Selecting the right people on Board

1.2.2.1 The authority of CEO

In order to act in the best interest of the company and the shareholders, board members should be professional and experienced in the industry. It is recommended that selection process of the Board should be partially controlled by CEO. This higher authority of CEO to choose Board members increases the effectiveness of the board, despite a higher risk of biased decisions in executive compensation.

1.2.2.2 Full disclosure requirement

To discourage companies from appointing incompetent directors, the scholastic background, professional experience, qualifications and family connections should be fully disclosed. Such disclosure requirement imposes pressure on the nomination committee and the CEO from appointing incompetent directors.


1.2.3 Professionalizing the Board

In order to carry out board responsibilities professionally, directors should be encouraged to undertake continuous training. US had started these types of director training programmes long ago and Asian countries are strongly recommended to do the same. Topics such as fiduciary duties, the role of the audit committee, and other newest corporate governance issues shall be included. Continuous training will also develop a lifelong learning culture not only in the corporate board, but the whole company as well.

1.2.4 Maintaining high ethical standard

In the wake of scandals from Enron, WorldCom, numerous cases of insider trading to the most recent cases of Faurecia and Viacom, the Board should strictly enforce internal regulations, which are communicated through the whole company. It is strongly recommended that a senior executive in Internal Compliance Department to implement strict enforcement.

2. Executive Compensation

2.1 Current situation and deficiencies

Since 1990s, issuing employee stock options as the first step of incentives campaign has been prevailing. According to Sandy Weill, former Chairman of Citigroup, granting stock options is the most significant way to develop employee’s sense of ownership. Also, as compensation in form of cash imposes high level of pressure to profit and loss statement, non-cash form of compensations like the mentioned were widely employed. Board of directors also acknowledges the fact that one of the ultimate goals is to maintain and boost their stock value. Exercising stock options can boost the demand of the company’s stock, thus raising the short-term stock price. But these are only one side of the story.

Yet, shareholders criticizing on executive compensation are not breaking news anymore. The attached Wall Street Journal survey shows how miraculous CEO Compensation could be. A very recent lawsuit on Viacom Executives at 30th June was made by the company’s shareholders, who were outraged by the compensation of two executives Summer Redstone and Tom Freston. Both of them received a compensation of approximately $20 million, two times higher than that of the top executives of Walt Disney. Another recent lawsuit is that William McGuire, the Chief Executive Officer of UnitedHealth Group was accused of receiving backdated stock options. Apart from titanic level of basic salary in form of cash compensation, bonus in form of stock options etc have been widely criticized by shareholders, who have their earnings per share diluted through employee exercising the stock options.

Dr. McGuire has proposed to halt the Stock-Based pay amid scrutiny by Securities and Exchange Commission, ("SEC"). “We consider terminating, slowing down or stopping issuing executive options for the foreseeable future.” However, he fails to realize that the stock-based pay or stock option is simply providing employee an incentive to work for the company. Stopping issuing stock-based pay has more demerits than its merits.

Donald Johnston, Executive General of Organization for Economic Cooperation and Development pointed out that the most effective method to alleviate the outcry is to have effective shareholders participation in key corporate governance decision such as the stock-option compensation of employee. SEC also adopted new rules to force higher level of disclosure in executive pay, such as a figure summing up the total compensation paid to top executives, when and how stock options are granted, additional disclosure of perquisites and tables comprising director compensation and other retirement benefits. Higher level of disclosure is certainly important. But the solution to address the heart of the problem is not as simple as that.

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25 Please see the attached.
2.2 **Recommendation for reforms**

2.2.1 **Introduction of a deferment period**

The idea is originated from the call and refunding provisions of bond securities. Borrowers have the right to retire the debt, fully or partially, before the scheduled maturity date and should the market rate falls, replace the bond with a lower-cost. The deferment period acts as a call protection. Similarly, executive compensated with a stock option slotted with a deferment period ensures that CEOs focus on generating economic value in the long run and not on short-term booming of stock price.

2.2.2 **Aligning compensation with individual performance**

Critics argued that executive compensation is not related to performances. In “Time to Rethink CEO Compensation”, a Journal of AllBusiness, it pointed out the little correlation between executives’ compensation and their performances. Neil Harper, an Associate Principal of McKinsey also noted that 70 percent of the returns of companies are contributed to market and industrial factors.

2.2.2.1 **Removing seasonal effect on companies performance**

To evaluate executive performance, it is essential to remove seasonal macroeconomic conditions, such as the cyclical unemployment effect and impact of interest rate movements, and other event-driven factors from the net earnings of the company. This can be achieved using advanced econometrics techniques. But it is still controversial to decide which event-driven factors and macroeconomic indicators should be included in the equation.

2.2.2.2 **Benchmark executive against peers**

Sophisticated institutional investors found out a problem in aligning incentives with stock price. When S&P 500 rises by 50% and the company’s stock price only increases by 25%, clearly the company is underperforming, yet the wealth of CEO will still increase in a titanic manner through exercising the stock options. Indexed option can eliminate this problem — Benchmarking an executive against his peers from the same industry with similar asset base. The idea is that underperformed CEO should receive less non-cash compensation and outperformed CEO should receive more.

2.2.3 **Granting of other non-cash compensation**

Mentioned earlier, Dr. McGuire proposed a ban in stock-option compensation. It has already been discussed that it is impossible. The same sense of ownership effect can be imposed by granting other forms of non-cash compensation, such as stock appreciation rights and restricted stock. By granting the former, the recipient generally does not receive any shares of stock of the granting company. As a result, the earnings per share will not be diluted. Granting the latter introduces the merits of stock options: the sense of ownership. The CEOs will also care more about the long-term value of the firm. According to The Clark Report, 3Com had introduced these newly instigated rules.

“We anticipate greater use of performance based restricted stock to drive company performance.”

Susan Bowman, 3Com senior vice president of human resources

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CONCLUSION

The problem of corporate scandals happened around the world can possibly be well controlled, or hopefully, be eliminated. But before we reach this step, it requires a lot of effort and cooperation from the corporation itself, the board of directors, the shareholders, the stakeholders, the regulatory bodies and the government.

The Transparency and disclosure requirements of a corporation is what we first addressed in our paper; openness, integrity and accountability are our main focuses over this issue, we examined both the Listed Companies and Public Bodies regarding two different aspects, the statutory regime and enforcement of the relevant legislation, and see how effective the corporation can reach that standard.

Followed by the transformed roles of shareholders and stakeholders, in which, the shareholders should not merely focus on the returns and capital gains of the corporation, they should proactively voice out their concerns or opinions over the corporate strategies and operations, and the corporation should open different channels for them such as the annual general meeting and meeting by appointment; this resemble the transformed roles of the stakeholders as well.

Lastly, we addressed the issues inside board governance and executive compensation, choosing the right leaders for the board, upgrading the standard of the board and maintaining high ethical standards are the key concern we addressed; implementation of a deferment period, commensuration of compensation with performance, and adoption of non-cash compensation are the keys to handle this issue.

With the full implementation and utilization of the above areas, we are adding value to the reform of the corporate governance. We are confident that there is going to be a very bright and prosperous future for the development of corporate governance in the world including the emerging markets.

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2nd Runner-up

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1. RESEARCH OBJECTIVE

The main objective of this paper is to review and compare the corporate governance reforms in 4 East Asian Countries, namely Hong Kong SAR, China, Taiwan and South Korea after the Asian Financial Crisis (AFC), by using the current situation of corporate governance in that country. These countries' corporate governance set are said to be improved significantly in recent years. Through the process of comparison, we want to give an idea for the essence of corporate governance such that firms take their reform actions in the way that can build up reputation to stakeholders and protect their shareholders’ interests.

2. INTRODUCTION

The topic “Corporate Governance” was introduced by Berle and Means (1932, cited in Chen, 2005) more than half a century ago, but it only drawn people’s attention of its importance after the collapsed of corporations such as Enron and WorldCom’s financial scandal. The over-exaggerated stock prices and improper financial reporting as described by Niskanen (2005) has leaded to questions coming from the shareholders of the corporations — how the corporation is doing and how to protect their interests.

After the Asian Financial Crisis (AFC), corporations in East Asian countries and their governments had made various moves to enhance the corporate governance systems. While some of them had made a big move (e.g. the enforcement of the Securities and Futures Ordinance in 2002 (Gul and Tsui, 2004, p.16)), others still faces challenges (e.g. the state’s dominance of shareholdings in corporations in China (Zhang, 2004, cited in Gul and Tsui, 2004, pp.33-35).

This working paper gives out the basic meaning of corporate governance as well as the theories that supports the need of it. After that, we provide some insights on corporate governance of the four East Asian countries namely Hong Kong SAR, China, Taiwan and South Korea, with comparisons followed. Last but not least, the conclusion on the essence of corporate governance is located at the end of this paper.

3. DEFINITION OF CORPORATE GOVERNANCE (CG)

There is no exact definition of what corporate governance really is, as various literatures had put a different meaning on it. In its broadest sense, corporate governance is defined by the Cadbury Committee Report as “the system by which a company is being directed and controlled” (the Cadbury Committee Report, 1992, Cited in Davies, 2006, 3). It can also be viewed as “the set of relationships between the management, the Board of Directors (BOD), the shareholders as well as other stakeholders to the corporation” (HKICPA, 2006). Yet, the statement that best describes the term is the one stated by Parkinson (1994, cited in Solomon and Solomon, 2004):

“(corporate governance is) ... the process of supervision and control to ensure that the company’s management acts in accordance with the interests of shareholders.”

(p.13)

In practical run, it concerns the relationship between the Board of Directors (BOD), the senior management (who do normally referred by literatures as the agents) and its stakeholders. From the important matters such as the business direction of the corporation to other decisions like the remuneration, rotation and replacement of directors are within the border of corporate governance discussion (ICSA Guidance Note — Matters Reserved for the Board, 2003, cited in Knell, 2006).

There are a number of theories that have developed to explain the need of corporate governance. Two of which that build up its existence are the agency theory and the theory of incomplete contracts.

3.1 Agency Theory

This theory stresses on the separation of ownership and control as suggested by Berle and Means (1932, cited in Chen, 2005), and elaborated by Jensen and Meckling (1976, cited in Chen, 2005). They defined the agency relationship as a contract under one or more owners, the “principal”, engage another person, the “agent”, to provide services that are on behalf of the principal. In other words, in a corporation, the shareholders are actually the owners (the principal) of the corporation, who delegates decision-making authority to the senior management executives (the agents). Since the interests of the managers are not always in line with those of shareholders, they may act in a way that is at the expenses to the corporation...
as a whole. To ensure the agents are working properly for the principal, agency costs arises. It is the sum of the monitoring cost of principals, the bonding cost of agents and the residual loss that occurs when the owners dilute their ownership to the agents (e.g. over-consumption of perquisites such as holidays through the company (Solomon and Solomon, 2004)). There are two broad approaches to remedy the problem, with one of them being incentive scheme, in which more shareholdings is given to managers as to elicit higher efforts for the corporation, and the other being cutting down managers’ controlling powers towards the firm. (Chen, 2005, p.16)

3.2 The Theory of Incomplete Contracts

Although the agency theory indicates the separation of ownership and management, it assumes that it is possible to identify the complete set of contracts including all possible contingencies and up-to-date information (Hart, 1995, cited in Chen, 2005, p.17). However, it is not possible to create such a contract in reality due to complexity and enforcement costs. Therefore, the theory of incomplete contracts, proposed by Grossman and Hart suggests that a more general contract is more efficient than a detailed and comprehensive one, thus leaving a room for negotiation between the parties of the contracts. This theory helps explaining the origins of authority in firms, which is in the hands of capital contributors; and the fact that the burden of monitoring managers falls on managers. (1986, cited in Chen, 2005, pp.17-19)

4. CORPORATE GOVERNANCE REVIEW IN VARIOUS COUNTRIES IN EAST ASIA

In this section, brief reviews of the four East Asian countries are provided, with the focus on the structures of the board of directors and financial transparency.

4.1 Hong Kong SAR

Hong Kong is a city where family-owned enterprise composes the major part of the region’s businesses. Yet, these companies brought prosperity to the region. In recent years, Hong Kong has made various reforms and proposals to enhance the quality of corporate governance in Hong Kong.

Structure of the Board of Directors

The Companies Ordinance (Cap. 32) and the Securities and Futures Ordinance (Cap. 571) contains legal requirements concerning corporate governance, excluding fiduciary duties and duties of care and skill applicable to all directors, which are included in App. 14 of the Listing Rules. (Tsui and Stott, 2004, cited in Gul and Tsui, 2004, p.43; HKEx, 2006) One remarkable feature of the framework is that Hong Kong is the only East Asian country that has jurisdictions on the malfeasance by Board of Directors (Gul and Tsui, 2004, p.16).

Family-owned enterprises are the main type of companies in Hong Kong, and these families are taking an active role in corporations’ activities. OECD (2001) indicated that around 80% of listed companies are controlled by family members and more than a half has more than 50% of the total shareholdings. In those companies that family members holds less than 50% stake, the top management positions are filled by them.

Apart from this, there are some restrictions regarding to the composition of the Board. Under Listing Rule requirements (Ch. 3, Sec. 3.21), an audit committee is mandatory in a board of directors, chaired by an independent non-executive director (INED). Also, there must be at least three members, with the majority being INEDs. As for the whole board, there must be at least three INEDs. (HKEx, 2006) For the duties and responsibilities of the directors in the Board and the code of best practices on corporate governance, various organizations in Hong Kong had published non-statutory guidelines on these, including the Hong Kong Institute of Directors (HKIoD), the Hong Kong Institute of Certified Public Accountants (HKICPA) as well as the Hong Kong Exchange and Clearance Limited (HKEx).

Financial Transparency

In general, companies in Hong Kong have to comply with Hong Kong Accounting Standards (HKAS, formerly known as Statements of Standard Accounting Practices, SSAP) or International Accounting Standards (IAS), which are the most authoritative sources of Hong Kong GAAP. For listed companies they have to comply with additional requirements as set out by HKEx (OECD (2001), pp. 240 — 241; Tsui and...
Stott (2004), cited in Gul and Tsui, p.57). Although an external auditor is not required by Listing Rules on the Main Board, App.14 of Listing Rules and HKICPA’s publication “A Guide to Effective Audit Committee” mentioned the need for external auditors to ensure the financial statements prepared are reliable and accurate.

4.2 China

Developing the economy of China rapidly by foreign investment has been one of the goals of the Central Government. In this regard, the Shanghai Stock Exchange and Shenzhen Stock Exchange were founded in 1990 (Zhang, 2004, cited in Gul and Tsui, 2004, p.29). However, some negative factors, such as the poor quality of listed companies and the weak regulation, hinder the growth of the economy of China.

The Structure of the Board of Directors

There are two major Laws which place crucial influence to corporate governance in China, namely The Company Law and The Securities Law. The first major law, established in 1994, governs the establishment of limited liability companies and joint stock companies. The second major law is established in 2000, which regulates the trading of securities in both primary and secondary financial markets.

As various scholars had pointed out (Chen, 2005; Zhang, 2004), these laws are not fully developed. For instance, The Company Law has no prescription about the minority shareholders’ right for proposition, even though the Guidelines for Articles of Association of Listed Companies prescribes that shareholders with more than 5% of the total equity should have the right of proposition. In addition, the Company, Securities and Criminal Laws have defined all details of the responsibilities of the directors; nonetheless, the over-centralized ownership control of listed companies constitutes weak awareness of minority and other shareholders’ interests.

Since the early 1980s, many state owned enterprises started transforming to joint stock companies as to make it available for initial public offering. However, from Zhang’s findings (2004), the shares that are available to public only contributes around 30% of the total shareholdings and the rest are owned by the State and a “legal person” who represents the State. In addition, the largest shareholder in these corporations is often in a dominant position that they owned more than half of the total shareholdings (Li, 2001, cited in Gul and Tsui, 2004, pp.33-36) and they occupied half of the places inside the board (on average) (Shanghai Stock Exchange, 2000, cited in Chen, 2005, p.56).

As for the Board’s composition, corporations in China usually adopt the dual board structure that is similar to the Germany and Japan model. The Board of Directors, composed of shareholders of the company, decides the direction of the company while the Board of Supervisors (BOS), composed of representatives of shareholders and employees, monitors the performance of the Board of Directors. As the Board of Supervisor does not have the right to control and make strategic decisions, and the fact that over 70% of the chairman, vice chairmen and other members of this board are often internally promoted by the company itself (Zhang, 2003, cited in Gul and Tsui, 2004, pp.39-40).

Financial Transparency

All companies are required to comply with Chinese GAAP. Share-issuing companies, no matter listed or not, is required to comply with special accounting regulation known as Accounting System for Companies Limited by Shares (the Revised Chinese GAAP). Nevertheless, the financial statements were producing misleading results such that the profits reported under IAS are generally lower than that of Chinese GAAP by 20 to 30 percent. This is the result from required accounting practices, managerial opportunistic applications of Chinese GAAP, differences from regulations besides accounting standards and treatments in special events (Chen et. al, 1999, pp.8-12).

A listed company in China can issue A-shares and B-shares in the stock market, with the former available to the local citizens while the latter for overseas investors. Although both A-shares and B-shares for the same company have the same voting and dividend rights, the price of A-shares is higher than that of B-shares because of three reasons as observed by Chen et al. (1999, p.4):

(i) The reporting standards between A-shares and B-shares are different. The former is reported under Chinese GAAP while the latter under IAS.
(ii) Unreliable and inadequate information about the local economy and firms for foreign investors.

(iii) Arbitrage between A-shares and B-shares is not allowed.

Moreover, the financial statements can be easily manipulated by related parties and abnormal transactions. Zhang (2004) quoted a case of a company which sold the land use right with a net book value of RMB69.26 million to a related party for RMB219.26 million and a subsidiary with a net book value of 14.54 million to a related party for RMB94.14 million. These numbers actually have no meaning as these are arbitrarily assigned by both parties. (Cited in Gul and Tsui, 2004, p.43)

These factors would confuse investors, especially foreign investors when they compare the financial statements of the same industry between China and other countries.

4.3 Taiwan

From 1990 to 1997, Taiwan had experienced steady GDP growth. Although the growth rate was lower than that of other Asian countries like Korea, it was already higher than other Western industrialized countries like Canada and Germany. (OECD, 2001, p.423) Most of the listed companies were family-owned and family members possessed the largest shareholdings. The average shareholding of the largest family and its related parties is 29.03%. A lack of institutional ownership and high degree of ownership concentration led to a situation that the largest shareholder pursued their own interests at the expense of minority shareholders. (Bao et. al., 2004, cited in Gul and Tsui, 2004, pp.200-203)

It is found that the major problems of the current Taiwan corporate governance system are as followed:

i) Lack of independence of directors

ii) Insufficient separation of ownership and management

iii) Inefficient Enforcement of Law

The Structure of the Board of Directors

The Company Law and the Securities and Exchange Law regulate the quasi-public and listed companies and some specific corporations and should comply with other laws. For example, there is a Banking Law which governs the banking industry. (Bao et. al., 2004, cited in Gul and Tsui, 2004, p.200)

According to a survey of the Top 100 companies in Taiwan, it is not usual for the Board of Directors to have an audit committee, a remuneration committee or a nomination committee even after it is suggested by TSE/GTSM Best-Practice Principles, 2002. (Bao et. al., 2004, cited in Gul and Tsui, 2004, p.204) However, the government had recognized the need of protecting minority shareholders’ interests. In this regard, the Securities and Futures Development was established to help shareholders who wish to file a lawsuit against listed companies. The Securities investors and Futures Investors’ Protection Center was also built up to ensure the shareholders’ interests are not exploited by the listed companies by providing consulting, mediating and other services about the class action of the shareholders.

In 2002, the "Corporate Governance Best-Practice Principles for TSE/GTSM Listed companies" was published by TSE and GTSM. This document suggested that Taiwan listed companies should adopt measures to improve corporate governance within the country. These measures include increasing board independence, separation of the board chairperson and the general manager, establishment of sub-committees under the board such as audit committee, compensation committee and nomination committee for different purposes, recruitment of independent external auditor and legal counselor, and disclosure of suitable corporate governance practices.

Financial Transparency

The accounting standards in Taiwan are set by the Accounting Research and Development Foundation. It contains two committees, namely Financial Accounting Standards Committee (FASC) and Auditing Standards Committee (ASC). The accounting and auditing standards developed by these two committees together with the Commercial Accounting Law and the Accountants’ Law of Securities and Futures commission (SFC) regulate the accounting procedures and accountants’ conduct. (Bao et. al., 2004, cited in Gul and Tsui, 2004, p.201)
In 2000, SFC required listed companies to provide three separate annual documents, the consolidated operations report by business group, the consolidated financial statements of business group and the business relationship report. These reports aimed at increasing the transparency and reliability of the financial statements. This is because the transactions and operations of companies with a cross shareholding structure are complicated. (Bao et. al., 2004, cited in Gul and Tsui, 2004, p.209)

4.4 Korea

In the following paragraphs, Korea, an Asian miracle in the past, will be discussed. Some scholars attributed its remarkable economic development in the past four decades to chaebols, a term referring to large Korea business groups. Quoted from Chang (2003),

“....... a chaebol is a Korean business group. It encompasses many subsidiary firms under the same name. Chaebol originally meant money clique in Chinese and was used to refer to a group with a vast fortune”

(p.9)

The Structure of the Board of Directors

The Commercial Code, the Securities and Exchange Act, Act on External Audit of Stock Exchange and the Listing Rules form a basic regulatory framework. According to the Korean Commercial Law, Board of Directors is the top-level decision-making body of a company. The Government has enforced some polices and amended the law in order to improve the independence of non-executive directors and the power to protect the minority shareholders interests.

In Korea, Some large shareholders do not participate in the Board of Directors. However, they have the power to influence its decisions and appoint members of the Board. In practice, they play as shadow directors. This scenario induces problems of independence and exploiting minority shareholders’ interests.

The most influential amendments of the Law will be discussed below.

Measures to improve the independence of Board of Directors include the following:

(Jwa and Lee, 2004, pp.83-84)

i) 25 % of them should be outsiders.

ii) The shadow directors’ responsibility should be delineated

iii) The offices of the shadow chairman should be abolished

Some shadow directors became the Chief Executive Officer of the Chaebols after the implementation of the above measures, but the problems mentioned above have not yet been solved. Some independent directors are having close personal relationships with shadow directors’ families. (Chang, 2003, p.174) Therefore, the outsiders are not truly independent. According to a survey conducted by Korea Stock Exchange at 2000 (Cited in Chang 2003, p.211), these outside directors attended fewer than 66% of the business items presented during the board meetings.

Measures to address the problem of exploiting the minority shareholders’ interests are as follows:

i) The equity stake threshold required for shareholders to file class action lawsuit was reduced from 1 to 0.01% on condition that the shares had been hold for at least six months.

ii) The equity stake threshold required for shareholders to examine a firm’s accounting data was reduced from 3 to 1% on condition that the shares had been hold for at least six months.

(Commercial Code, Art 191/13, Citied in OECD, 2001, p.169)

After the financial crisis, Korean government imposed five principles for restructuring of Chaebols on January 13, 1998 (Chang, 2003, pp.190-191). One of the principles suggests that the responsibilities of family owners to minority shareholders should be enforced.
In December 1995, Kun-Hee Lee, Samsung Group chairman, donated 6 billion won to his son Jae-Young Lee. He exploited the insider information to invest in the unlisted affiliates of Samsung Group which were going to be listed. By the end of 1996, his wealth increased twelve times of his original investment. This case depicts how the major shareholders pursue their own interests to the detriment of minority shareholders. (Chang, 2003, pp.178-181)

**Financial Transparency**

There are many mutual debt guarantee practices between affiliates within the Chaebol. In 1997, the Asian Financial Crisis aroused the attention of Korean government to the importance of the financial transparency. At that time, International Monetary Fund suggested Korean government to implement the following measures. The following are the most significant policies.

i) Government should adopt international accounting principles to enhance the transparency of the Korean accounting system.

ii) Chaebols are requested to disclose information and make public their combined financial statements.


Besides, the government required Chaebols to establish an audit committee in which 2/3 of their members must be outside directors (Jwa and Lee, 2004, p.90), the independent auditors would be punished if they failed to produce reliable information about the companies they audited. (Chang, 2003, p.209)

The financial transparency reform part is more successful than the BOD part, but by not much. It is a good and big step for Korea to develop a well corporate governance system.

5. **ANALYSIS OF CORPORATE GOVERNANCE IN VARIOUS COUNTRIES**

In this section, the problems of these countries will be illustrated. Since corporate governances, especially in East Asian countries, are still under developed and there are exist rooms for improvement. They are classified under board structure and financial transparency.

5.1 **Board Structure**

We found that these regions did not have truly independent directors and effective protection of minority shareholders’ interests just after the Asian Financial Crisis. The independence of directors has been aroused the government concerns and improved. It, however, has many rooms for perfection.

In Hong Kong, Taiwan and Korea, most of the companies are family-owned. Family-owned does not mean family-controlled. The first one indicates that the founders and the largest shareholders of the companies are from the person and related family relatives. Family-controlled means the family having the largest holdings can fully control the company operations like making decisions, establishing strategies or deciding which industries to enter in. Family-controlled may give the family members chances to pursue their own interests while exploiting minority shareholders’ interests. As a Result, supervision is a must for listed companies to protect all of its’ shareholders’ interest.

While in China, state-owned enterprises are the most common forms of business. The State and the legal person which representing the state are the largest shareholders. Apart from this, the Board of Supervisors members are mainly promoted from the companies. As a result, the minority shareholders’ interests may not be protected properly.

In Hong Kong, most of the Medium sized enterprises are family-controlled. The family members are either Directors or the top-level management. While in Korea, even the family-controlled Chaebols Chairman (the Shadow Directors) became “visible’, they are still the owners and at the top management. There is a recent case of how the largest shareholder in a Korean Chaebol exploited the minority shareholders’ interests. In 2000, LG Chemical and LG Telecom sold shares of unlisted affiliates at lower prices to Chaebol family members. (Chang, 2003, pp.211-212)

In Taiwan, there are no audit committee, compensation committee and nomination committee to assist and supervise the functioning of the Board of Directors. The high concentration of ownership makes the things even worse.
In sum, the reform policies employed are inefficient and could not solve the problem, which appears to a majority of shareholders could still pursuing their own interest at the expense of the minority shareholders.

5.2 Financial Transparency

Lack of Accounting Harmonization

It is sensible that, to be competent in the global marketplace, comparable financial information is essential as it attracts potential investors worldwide. However, this can hardly achieved. This is because different accounting rules and principles are applied in different countries, even after the establishment of International Accounting Standards Board (IASB) and its International Accounting Standards (IAS). In Decker and Brunner’s view (2003, cited in Choi, 2003), there are many factors affecting the adoption of certain accounting rules, including economic, social, political and geographical factors; at the same time, users of financial statement also place influences on accounting standards.

The codifications of accounting standards are unique in different countries. Some economically developed countries have set up and provide explanations to accounting standards while other less economically developed countries have no such bodies to govern this. Thus, it can be seen that Hong Kong and Tai Wan has many institutions that set out guidelines to ensure that the financial statements are prepared in a true and fair view.

Financial Statements Disclosure

In some situations, the financial position can not be accurately presented due to the complexity of the corporations’ structure. This applies to all the countries discussed in this paper except Hong Kong, which has a more comprehensive regulatory framework to govern the listed companies. The cross-shareholding problem in Taiwan, the inseparable ownership of asset resulted from quick conversion from state-owned enterprises (SOEs) to joint stock companies and the Chaebols, characterized by large and complex ownership in Korea (Zhang, 2004, cited in Gul and Tsui, 2004, pp.179; (Korea part) ; Bao et. Al., 2004 cited in Gul and Tsui) had illustrated the problem. Also, the differences in accounting practices in China as discussed in part 4.2. have led to an opportunistic behaviour for owners to overestimate the assets and equities of the corporation. (Chen et. al., 1998, pp.10-13). One example is that the Chinese GAAP allows investments in other companies to be recorded either in cost method or equity method. Such choices make the financial statements easily be manipulated.

6. CONCLUSION

In this part, we conclude by giving out some suggestions to tackle the problems we mentioned above. Laws and regulations are of utmost importance in regulating business practices, as it is a must for quasi-listed companies to follow. Similar to the Code of Corporate Governance for Listed companies in China (2002) and the Taiwan Corporate Governance Best-Practice Principles 2002, they are not legally binding. In other words, the companies are not necessarily to act on what the codes suggested. So, regardless of how good the principles are, it cannot change anything. Sadly, what we have found in these cities is that they issued the Code, Best Practices or Principles of Corporate Governance, but did not focus on the corporate governance rules in listing rules. So, our main idea is to include corporate governance in the listing rules.

Besides focusing on a part of corporate governance in the listing rules, the rules should be precise and enforceable. If the rules are not precise enough, it leaves many loopholes for companies to exploit. For instance, the Code of Best Practice for Corporate Governance in Korea and Taiwan Corporate Governance Best-Practice Principles, the definition of independent directors is vague and hence, the Korean independent directors have close personal relationships with the largest shareholders’ families, it had led to the exploitation of minority shareholders’ interests like the case of LG, which discussed above. For enforceable rules, Hong Kong had requested the number of independent directors increased from two to three in 2004. However, some companies had not complied this requirement by the end of the deadline. The regulation means nothing if it cannot be enforced.

Apart from the definition of independent directors, some more restrictions should be added. i) A supervision committee like nominating committee must be established by independent directors. Evaluation is crucial to examine the performance of the Board and decide the reasonable compensation of the directors. With a supervision committee, the directors, as the highest level in the company, perceive that their performances
affect their re-election. According to a Hong Kong corporation, MTR Corporation 2005 Annual Report, one of the independent directors only attended 25% of the board meetings. Should the nomination committee negotiate with the director and inform him about the responsibilities of being a director? Most of the regions we discussed are family-owned. If the largest shareholders are the directors at the same time, the remunerations for them may lead to conflict of interests. For example, the largest shareholder may want to be paid more than the market price for his own interest, but it may harm the minority shareholders interest.

ii) For a company to attract more and more investors, a set of financial statement that is understandable throughout the world is essential. Therefore, a world standard should be promoted to let all financial users recognized, including those in foreign countries. We suggest that the International Accounting Standard (IAS) and the International Financial Reporting Standard (IFRS) should be adopted for all countries. Even though each country may have its own set of standards and reports to the public in line with their own country’s accounting standards, another set of financial statement using IAS should be prepared. As a general phenomenon, foreign investors do not know much about the accounting standards applied in the investing country.

The numbers that appears in the financial statements may have different meaning to them. The use of uniform standard is to ensure that all potential financial users will be understood the corporation and the deviations of financial statement will be reduced to the minimum as well. Also, notes to financial statements should be prepared to explain the deviations from IAS, if any.

Apart from adopting uniform standards, we also suggest that a full and clear disclosure is required for listed companies. Based on the findings in this paper, some countries such as China do not have clear disclosure about their financial position. Some joint stock companies still share the same bank account and other assets; the cross-shareholding among listed companies has made the corporate structure not clear enough to disclose the real situation. Therefore, we suggest that a detailed report concerning the corporate structure of the company is needed. In this way, financial users will be able to have more information about the structure of the firm and can make better capital investment decisions.

It should be noted that sound and reliable financial reporting attracts capital inflow and lower the cost or raising additional capital. Improving financial transparency is the best way to maximize the capital inflow in public offerings.

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