

Hong Kong

Corporate governance workshop

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Creating a CG community

Corporate governance issues remain in the headlines: a large listed bank is reported to have lent HK\$2bn to a group with various listed vehicles, from which the controlling shareholder allegedly filched cash. Hong Kong's reputation as a world-class financial centre is at stake. A recent workshop brought together various interested parties and raised key issues with the aim of forming a networking group to capture ideas for the ongoing process to advance CG in Hong Kong.

Creating a CG community

- CG issues keep reappearing for Hong Kong-listed mainland companies, as well as family-controlled and other closely-knit groups.
- Hong Kong's reputation is the key to maintaining a premier position in raising international capital.
- Reforming corporate culture must be an ongoing process.

Background, agenda and objectives of the workshop

- The 10 Sept workshop hosted 50 participants: senior civil servants, regulators, corporate directors, market participants and academics.
- Objective was to create an informal environment for key stakeholders to enable collective learning and collaborate in networking for change.

Dialogue sessions summary

- Commitment from the top is essential for both companies and society.
- Government has to 'walk the walk'.
- A business case can be made, but has yet to be demonstrated.
- Enforcement needs to be strong – investors need to be enabled.
- Pressure could come from trustees on how funds are managed.

Civic Exchange's observations

- The complexity of issues requires stakeholders to collaborate.
- Planning groups and other workshops for actionable ideas to follow.
- Public sector / regulators should explore areas of consensus.

Workshop issues

What is CG?	Regulations and litigation
Fundamental values	Boards and directors
Culture	Shareholders and family control
Who should drive CG?	Observations and suggestions for progress
What is the business case?	

Source: CLSA Asia-Pacific Markets

www.clsa.com

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Christine Loh is CEO of Civic Exchange, an independent, non-profit, public-policy think tank established in Hong Kong with a mission to:

1. Promote civic education, public awareness and participation in governance by strengthening civic participation in public life;
2. Undertake research and development in economic, social and political policies and practices to help shape the breadth and depth of public-policy debate and so to advance policies that are sustainable, resilient, non-violent, economically efficient, just, participatory, locally appropriate and spiritually rewarding; and
3. Integrate skills and experience across various disciplines including academia, business, politics, finance, technology and the non-profit-making sectors.

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Creating a CG community

CG issues remain in the headlines. Within days of a workshop on corporate governance (CG) organised by Civic Exchange, sponsored by CLSA and the Companies Registry, front page newspaper headlines were of a Shanghai-listed property company that had HK\$198m filched by the controlling shareholder. Its sister company listed in Hong Kong had board representatives from a large listed Hong Kong bank, who appear to have been blissfully unaware of unsavoury related-party transactions of this group which had borrowed HK\$2bn from the bank.

Are checks and balances in place?

Ten years ago, Hong Kong was the pillar for capitalism in Asia. Its record on creating shareholder value and corporate governance was ahead of other markets in the region. Now more than half of the companies listed in the market are from a different jurisdiction, subject to different laws and enforcement. Meanwhile, controlling family interest in major listed companies raise risks made obvious by the Asian financial crisis. Major listed entities in Hong Kong have taken huge bets on new technology; their partners have written off these investments, which raise questions on whether appropriate checks and balances are in place with the largest listed groups in the market.

Hong Kong's reputation as a world-class financial centre is at stake

At stake is the reputation of Hong Kong as a world class financial centre – its ability to remain ahead in the business of raising international capital for companies in the region and creating value for shareholders.

Key issues raised

The CG workshop raised key issues. Does progress in this area require a top-down push from the regulators, or should it be bottom-up via market forces? Has the business case for good corporate governance been clearly articulated? Should the Exchange be rushing for a greater number of listed companies if quantity might compromise quality for the market? Does Hong Kong need more rules or more enforcement? Do shareholders have the tools to make a difference? Is the political system, where accountability seems thin and the influence of tycoons appears thick, a hindrance in pushing for better overall governance?

Innovative suggestions from different perspectives

This workshop brought together very senior civil servants, regulators, corporate directors, market participants and academics to gel ideas from different perspectives. Innovative suggestions were thrown up, eg, having special courts to hear CG cases, introducing class action suits, making audit committee proceedings public, creating a community of interest, undertaking studies to identify the benefits of CG on cost of capital, etc.

How to make a practical difference

The challenge is making a practical difference. CG standards constitute the prevailing corporate norms. Best practices – in essence, integrity – cannot be legally proscribed. Changing the corporate culture will have to be an ongoing process involving continued discussion; evolving a confidence-building regulatory structure; and disseminating the core idea that best CG practices are integral to creating world-class companies where checks and balances, proper risk management and equitable treatment of all stakeholders is part of the corporate culture. This is to be the first of a series of discussions. Views on potential changes that could make a difference are clearly welcome. Watch this space for germination of ideas and an attempt to build positive momentum for Hong Kong's claim to being Asia's leading financial city.

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**Workshop held on 10
September 2003 to
explore how CG can be
improved in Hong Kong**

Encouraging results

Background to the CG workshop

Civic Exchange, together with the Companies Registry and CLSA Asia-Pacific Markets, co-hosted what is hoped to be the first of a series of workshops on corporate governance on 10 September 2003. The objective of the series is to create an informal environment on an ongoing basis for key stakeholders to get to know each other and to explore how corporate governance standards may be improved in Hong Kong. While good corporate governance practice is relevant to both private and listed companies, there is greater concern over the latter as shares are sold to the general public. A recent study showed that there are approximately one million equity investors in Hong Kong's public companies – that is one in five persons invests in the local stock market.¹

The result from the first workshop was encouraging. There are many individuals, companies and institutions interested in corporate governance: firstly, in order to learn about the subject; secondly, to explore how the various complex strands are related to their responsibilities and business; and thirdly, to understand how the issues impact on the future of Hong Kong as a business centre in the region.

**Ingredients present
for a change**

There is clearly a sufficient base of knowledge and interest to build upon in the coming one to two years. Indeed, the ingredients appear to be present for a noticeable take-off although many of the individuals, companies and institutions that are at the forefront of promoting and practicing good corporate governance appear to feel discouraged by what they perceive to be an overall lukewarm environment for change.

**Workshop to provide
collaborative networking**

The purpose of the series of workshop should therefore be to enable collective learning and collaborative networking for change. The individuals who are already playing a leadership role within the various organizations need to have opportunities to get to know each other better so as to know that there are fellow travellers working towards the same end, and that there is a growing community of concern in Hong Kong to achieve better corporate governance. In other words, it will be through the efforts of these same leaders to turn what is perceived to be an overall lukewarm environment into a more engaging one. The goal should be to enable and empower this community to explore ideas, and collaborate with each other.

We provide a number of observations at the end of this report for the workshop participants to consider and for the planning of future workshops and other activities.

¹ www.hkex.com.hk/news/hkexnews/030422news.htm.

Key objectives

Maximum opportunity to tap collective wisdom of the group

Workshop objectives

The key objectives of the workshop on 10 September were:

- ❑ To begin the process of creating a community of interest around Corporate Governance (CG) in Hong Kong;
- ❑ To understand the current issues affecting the CG community; and
- ❑ To explore future needs of the CG community;
- ❑ To capture ideas on “next steps” for a CG programme

Workshop methodology

The workshop, designed and facilitated by Insight Dynamics, provided for maximum opportunity to “tap” the collective wisdom of the group through information dissemination (presentations) and information sharing (insight development). During the first 30-minute facilitated session, participants were briefed on the “insighting” process and encouraged to explore diversity and engage in open dialogue around the theme. They were then free to discuss the preceding presentation sessions or any other content deemed relevant to the theme of the day. Each of the eight tables selected a table host who acted as coordinator and recorder for their table of five to six people.

During subsequent “facilitated sessions” the table hosts remained at the tables while others moved to any other table they wished.

At the end of each rotation the hosts collated the data which was recorded in two forms; each idea/insight/comment was written on a ‘post-it’ note; and a table summary form was completed (these notes and summaries have been retained at the Civic Exchange office).

The ‘post-it’ notes were used for developing an affinity diagram to “cluster” the data. This clustered data is presented below. The table summaries were used to brief the incoming table guests on the previous group’s content as well as becoming a record of raw data for the planning.

Agenda and participants

Workshop presentations

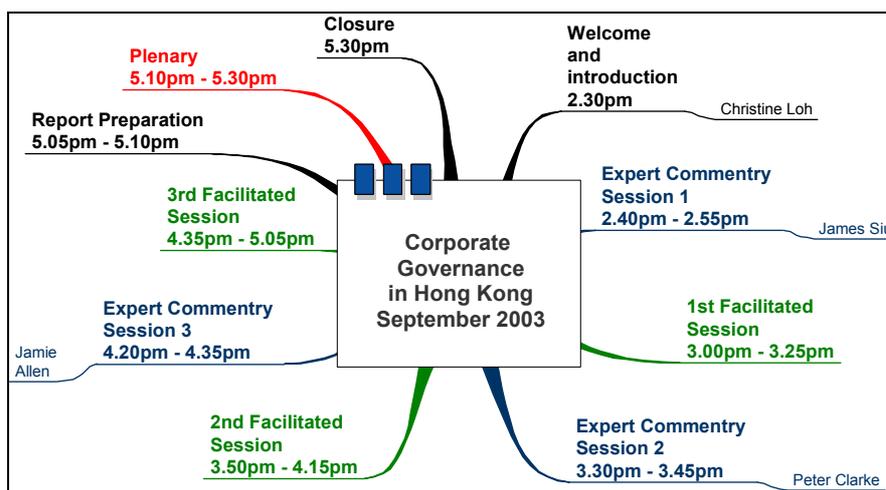
The workshop was opened by Christine Loh, CEO of Civic Exchange. The venue provider, James Ogilvy-Stuart, of Bloomberg welcomed the participants. The Companies Registrar, Gordon Jones, set the context of the importance of CG for Hong Kong. Amar Gill of CLSA Asia-Pacific Markets spoke about CLSA's past efforts in producing a CG ranking of companies.

Three individuals were invited to make short presentations of approximately 15 minutes each in the various expert commentary sessions. The presenters were encouraged to stimulate and be provocative in order to generate more lively discussions. James Siu (Director and Chief Compliance Officer) of Li & Fung spoke about why his company had embarked on improving CG and shared insights of how it evolved internally; Peter Clarke (Member of the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure - 2003) spoke about CG in a broader international context and what Hong Kong needed to do to move forward; and Jamie Allen (General-Secretary, Asian Corporate Governance Association) spoke about why Hong Kong companies could not afford to be complacent even though Hong Kong's standards are high when compared to other places in the region. Clarke and Allen noted that Hong Kong was in danger of being 'stuck' in making further CG advances.

The focus of the workshop took place at the three dialogue sessions where participants discussed the issues at greater depth. The fruit of their discussions have been captured below.

Figure 1

Workshop plan



Source: Insight Dynamics, Civic Exchange

Workshop participants

There were 50 participants at the workshop comprising of senior representatives from the public sector (government, stock exchange, and regulator), as well as the private sector, including senior corporate representatives of listed companies (management and independent directors), fund managers, financial analysts, academics, professionals, and NGOs. The contact list is available for the workshop participants.

Presenters encouraged to stimulate discussion included James Siu of Li & Fung, Peter Clarke of the Expert Group and Jamie Allen of ACGA

50 participants from public and private sectors

Three rounds of dialogue sessions

The term "CG" is not always clear

Dialogue sessions summary

The following are the main clusters of responses from the three rounds of dialogue sessions among the participants. There are overlaps in the issues raised, which is not surprising as the issues are inter-related (see also mind map for Table Reports at the end of this section):

What is Corporate Governance?

Participants asked what exactly was 'CG', noting that it was not always clear what the term entailed. The following 'post-it' notes were illuminating in terms of how participants saw the problems of definition:

- What really is CG and what are the benefits?
 - To stop unfair transfers of value between corporate stakeholders
 - Good CG is about getting things down efficiently and effectively within the legal-ethical-moral framework of society within which one operates
 - CG can only start to change if controlling shareholders are persuaded – discussions on best standards do percolate back and can make a difference but there won't be sudden changes
- Bad governance – where there is strong financial incentive versus weak deterrent
 - Low chance of discovery
 - Low penalty if discovered
 - Low risk of litigation
 - No class-action rights
- How can CG work well enough to get people interested?
 - What is the model for good CG?
 - Is the Anglo-Saxon model effective?
 - Do process rules? For example, board commitment really works
- Separation of roles of chairman and CEO is not essential
- Problem of global enforcement
- Listed companies can be fair weather friends
 - When they are good, investors are happy
 - When they are bad, nothing can be done as they erode value

CG is related to integrity

Support from the top is essential

Fundamental values

It was generally recognised and accepted that CG had fundamental characteristics that were related to ethical values – such as transparency, honesty, accountability and integrity. The following ‘post-it’ notes were collected:

- ❑ ‘True and fair’ – old audit report principles
- ❑ CG comes from the heart, not the head
- ❑ CG is about doing the right thing
- ❑ Accountability is the true basis of CG
- ❑ Values of the person determines the corporate culture
- ❑ Character of corporate leaders is important
- ❑ Need to be honest and responsible to build a business
- ❑ Punish wrongdoers

Culture

Participants also raised questions about the role of culture in CG. There was a strong sense that support and commitment from the top was essential to ensure good CG so that good CG practices flowed throughout – whether within a company or within society as a whole:

- ❑ Change of corporate culture needs self-interested pressure
 - To change, or else!
 - Leadership from government or civil society
- ❑ Good CG is part of good business culture – companies with good CG would be excellent in many aspects
- ❑ Look at building value in a positive way – not just in terms of monitoring
- ❑ Good CG helps management make better judgments
- ❑ Good CG helps better risk management
- ❑ Culture of family-controlled companies inhibits non-executive directors’ performance
- ❑ Effect of current weak overall governance in Hong Kong is that business ethics are being eroded
- ❑ 80% of the companies listed in Hong Kong are not incorporated here (mainly PRC, Bermuda and Cayman Islands) – although they are not beyond the reach of local law/regulators – and many of the 20% are family controlled

Government has to play a top-down role

CG is important for risk management – its link with profitability is difficult to demonstrate

Who should drive CG?

There was a general sense that the HKSAR Government had to play a leadership and top-down driven role to promote better CG in Hong Kong although participants also explored how CG could be driven by a bottom-up process:

- ❑ Government to 'walk the walk' and not 'talk the talk' in order to set an example
- ❑ Government example is crucial – sets poor example to Hong Kong community, eg, the accountability system is not accountable, cronyism, handing of the Expert Group Report, share-holding in MTR, etc
- ❑ Hong Kong companies tend to have poor CG but a number are fraudulent, eg, splitting; reissuing shares, etc
- ❑ Punitive laws and rigorous enforcement are needed as effective deterrent (only government and regulators can do this)
- ❑ If the business case for CG cannot be clearly established then it has to be driven from the top via regulation
- ❑ There should be simple and clear rules with specialist enforcement
- ❑ Government's job to create a level playing field

What is the business case for CG?

Participants noted that since companies had to pay a premium for good CG, they explored why companies would go through the trouble and expense of achieving high CG standards. They asked whether an adequate business case could be made:

- ❑ Hard to make demonstrable link between CG and profitability
- ❑ CG is not about relationship between the company and others – it is an important internal control and risk management
- ❑ Business case can be made:
 - Whether cost of capital is lowered – although evidence unclear
 - Could affect insurance premium
 - Reduce risk for companies, directors and auditors
 - Best companies have strong ethics, leadership, risk containment
 - CG helps to promote and enhance 'branding'
 - Best companies do more than comply with regulations – they develop sound management processes that make them successful
 - For stable, long-term growth, a company has to have all the stakeholders on side
 - Example of bad CG – Barings versus Example of good CG – First Pacific – how good CG overcame reputation problems, which affected the locations of its underlying assets (Philippines and Indonesia)
- ❑ Need more evidence that CG affects performance and improved CG benefits the company in the marketplace

Directors will embrace CG if there is a threat personally

Board has the most control over governance

Regulations

There was consensus among the participants that issues of regulations, enforcement and deterrence needed to be better aligned although there were also questions raised about balancing proper regulation and litigation:

- ❑ Tighten regulations and quality of listed companies – or could impact on investor perception about the Hong Kong market
- ❑ Directors will embrace CG if there is clear threat of personal risk of penalties for breaching rules
- ❑ Need strong enforcement, there are plenty of rules already
- ❑ In the Asian context, are there effective enforcement tools in a ‘non-litigious’ environment?

Boards and directors

The focus of CG debates had often been centred round the role of boards of directors to ensure good CG because the part of a company that had the most control over governance was at the board where the critical decisions were made. Participants noted that:

- ❑ Non-executive directors should be truly independent of management
- ❑ Where management is the controlling shareholder and gets to vote on election/removal of non-executive directors, they are dependent on management and therefore not independent – solution – only independent shareholders should vote on election of non-executive directors
- ❑ Dominating shareholder structures are not always ‘bad’
- ❑ Non-executive directors should know accounting
- ❑ Value of non-executive directors can play wider role eg networking, than just compliance
- ❑ Boards should have a compulsory audit committee
- ❑ Independent non-executive directors should have new protection if they have new liabilities, eg, pay, time spent, etc
- ❑ Don’t overstate role of non-executive directors – they are there to assist and nurture a company’s development acting as objective monitors, make constructive criticisms and proposals; catalyse remedial actions; add value, etc – they are not there to do the work of the executive directors
- ❑ Should there be an Asian model of CG?

Issues arising from family-controlled companies

Shareholders and family control

There was general recognition that in Hong Kong, there were many listed companies where the founders and their families were the controlling shareholders, which could lead to insider or connected party dealings that would not be in the interest of minority shareholders. Issues noted included:

- ❑ Voting – can be a farce
 - Show of hands disenfranchised public shareholders; proxies not counted, etc
 - Brokers and banks have no obligations to seek voting instructions from beneficiaries
 - Investors don't know when meetings are held
- ❑ Greater pressure on fund managers re proxy voting and CG monitoring must come from trustees of big funds farming out money to fund managers
- ❑ More information and education for stakeholders to enable more effective expression of rights
- ❑ Might need class action suits

Participants' observations

The participants provided the workshop with a range of observations that reflected how key stakeholders saw the issue of CG in Hong Kong. The observations provide useful guidance to consider when planning future workshops and activities to promote CG:

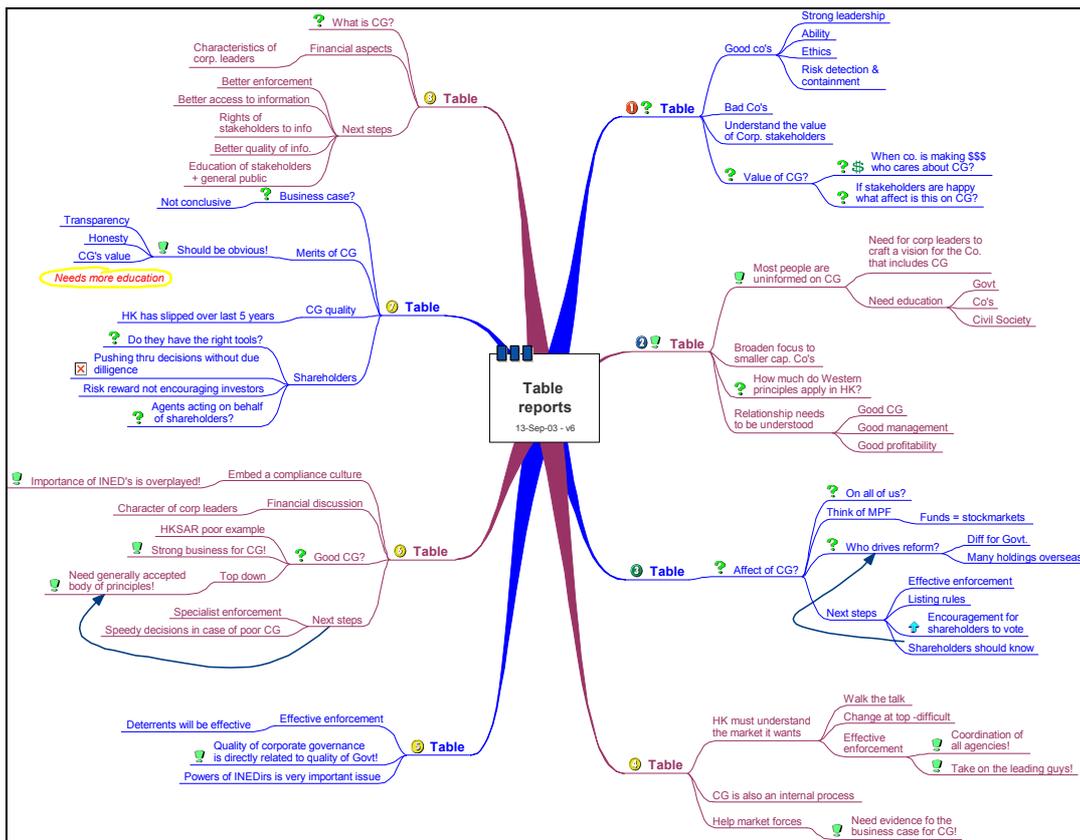
- ❑ What Hong Kong needs right now:
 - Better understanding of CG
 - Better research and information on the business case for CG – eg, articulate risk management benefits
 - Consider how family controlled companies can become more professional organisations
 - Encourage corporate leaders to commit to better CG – how?
 - Instil definition of 'independence' for non-executive directors
 - Take carrot and stick approach – encourage behavioural change but also improve deterrent mechanisms
 - Create specialist courts?
 - Educate judges?
 - Financial analysts can do more in highlighting corporate behaviour and provide useful data to increase transparency
 - Require audit committees within boards – should audit committee's deliberation (meeting records) be made public to improve transparency?
 - Consider whether there is a Western versus Asian model of CG
 - Consider how HK can deal with mainland companies listed here

Suggestions to advance CG in Hong Kong

- Hong Kong needs to show it has credible markets to remain a regional business centre leader – even though ranked second, no time to be complacent
- Is there a bottom-up approach to promoting CG? – eg, promote understanding in Hong Kong that CG affects everyone as we are all investors through MPF

Figure 2

Summary of table reports



Source: Insight Dynamics, Civic Exchange

Civic Exchange’s observations

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CG is a complex subject because it involves multi-disciplinary issues, which makes it hard to define for some participants – hence the constant question of what is CG.²

There are at least five areas of focus, each one of them being a major area of concern as articulated by the participants:

1. Individual ethics, corporate cultures, and social mores;
2. Internal control and incentives mechanism for companies;
3. External monitoring mechanisms;
4. Law and regulations; and
5. Political environment.

Different scopes of view

Each of these areas of concern affects how capital market stakeholders behave. For those who take a narrow view of CG, they tend to focus on the relationship between the key primary market participants in setting the direction and performance of companies (eg, management, directors, controlling shareholders). For those who take a broader view, they focus on the rights and responsibilities of market participants as well as the monitoring and regulatory institutions. For those who take an even broader view, they also take into account the general local political environment and its appetite for change, and Hong Kong’s international position.

Complexity as many issues need to be taken into account

It appears daunting for any individual that in order to understand the state of CG in Hong Kong and consider how it could be improved, one has to take so many issues into account. The complexity of the subject creates a sense of inability for any individual, company, or institution to move things forward on its own. The complexity also makes it hard for a central authority to ‘coordinate’. The success of promoting CG reform requires many stakeholders to work together.

Participants bring a range of expertise

While individual participants may lack knowledge in some of the five areas identified above as relevant to the subject of CG, collectively the participants were knowledgeable about many aspects of the subject. Indeed, individual participants were more often than not quite expert in at least one to two areas.

Knowledge gaps can be filled

A good way to enhance and speed-up learning about the subject is to create informal opportunities for them to learn from each other and learn collectively rather than expect people to do the hard slog on their own. In other words, we can fill our knowledge gaps by learning from others who are knowledgeable in those areas where we are ignorant. This can be best done through informal gatherings, such as the CG workshop, that are designed for free-flowing dialogue to take place. People weigh what they hear from others against what they know and their own experience. They compare notes with one another, assess the views of others, and they consult their own values.

² The OECD defines CG as “the system by which business corporations are directed and controlled”.

Judiciary – an area that could increase its knowledge of CG issues

First workshop for concerned parties proved there already is a community of interest

Participants offered to create opportunities within their organisations

Research in cognitive studies confirms that people learn and form their views via interactions with other people through dialogue and discussion.³

Furthermore, experts can be invited to take up difficult issues where more research is needed to fill the collective knowledge gaps. The workshop participants who are academics offered to carry out specific topics of research if they know which areas are of the greatest interest to the CG stakeholders. Indeed, there may be existing research that they could already share with other participants.

The participants also identified the judiciary as a possible area that could increase its knowledge about CG issues as there are many areas of corporate conduct that come before the courts. For example, the Magistrates Courts hear a range of cases involving failure to comply with various provisions of the Companies Ordinance, the Company Court hears cases involving shareholder disputes; and the Insider Dealing Tribunal deals with insider dealing cases etc. The Judicial Studies Board, which provides continuing legal education for judges, is the right body to explore how to assist judges to have more information about CG issues. Briefings and courses will need to be well focused.

Creating and sustaining a community of interest

It does take time for people to digest complex issues and arrive at considered judgments and decisions, which is why Civic Exchange envisage a series of workshops on CG over the course of the next 12 months. The first workshop appears to have achieved the purpose of enabling the participants to meet each other and to know that there is already a community of interest in CG. The participants can interact directly with each other and via Civic Exchange and other stakeholder organizations, which may play a neutral role and can create more frequent contacts among the participants in between workshops.

A number of participants have already offered to assist in creating a more encouraging climate for promoting CG. Ideas included:

- (a) Helping to form and participate in a planning group for actionable future activities and workshop; and
- (b) Helping to craft a working vision for the next few years to improving CG in Hong Kong, solicit feedback, design a process to help build consensus among market participants, and build commitment from the stakeholders.

Encourage groups to work internally and externally

Some participants have also offered to create opportunities within their organisations so that collaboration among stakeholders can be explored and promoted. Ideas included:

- (a) We put out this special report on the observations generated by the workshop in order to bring this back to the attention of investors and encourage discussion among institutions on what the investing community can do to encourage companies to progress in this area;

³ Daniel Yankelovich, *The Magic of Dialogue: Transforming Conflict into Cooperation*, Touchstone Book, 1999, pages 25-26.

An informal workshop solely for public-sector representatives?

- (b) Investment houses may work on developing “informal reminders” to their financial analysts of general recurring issues relating to CG and give suggestions on how to deal with them; and
- (c) Institute of Directors and Hong Kong Institute of Company Secretaries to explore how they can work internally to find new or more effective ways to promote CG.

Public-sector coordination

An additional idea is for an informal workshop to be designed solely for public sector representatives (government, Companies Registry, Stock Exchange, and SFC) to come together to explore areas of consensus so that a unified position may be adopted to promote CG. It is vitally important that the public sector stakeholders have a planned, coordinated programme to handle legislative and regulatory reforms (as with the Corporate Governance Action Plan).