



# Corporate Governance in Hong Kong, China

## Rising to the Challenge of Globalization

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## Introduction

Corporate governance refers to the rules and incentives by which the management of a company is directed and controlled to maximize the profitability and long-term value of the firm for shareholders while taking into account the interests of other legitimate stakeholders (Stone, Hurley, and Khemani 1998).

Corporate governance mechanisms may be broadly classified as external and internal mechanisms (Agrawal and Knoeber 1996). External mechanisms are determined by outsiders. These include institutional shareholdings, outside block holdings, and takeover activity. Internal mechanisms are decided by the firm's decision makers. These consist of insider shareholding, board membership and characteristics (such as size of the board, number of outside independent directors, and remuneration committees), debt financing, and the use of outside markets for managerial talent.

Good corporate governance, complemented by a sound business environment, can strengthen private investment, corporate performance, and economic growth. A comparison of corporate governance among Asian economies<sup>1</sup> indicated that Hong Kong, China (along with Malaysia and Singapore) maintains significantly higher standards of corporate governance and at the same time has developed more sophisticated and adequate legal systems to protect property rights than the rest of the countries in the region (Nam, Kang, and Kim 1999).

Although Hong Kong, China was also hard hit by the Asian financial turmoil, it has weathered the storm strongly and confidently. Between June 1997 and March 1998, the market capitalization of the Stock Exchange of Hong Kong (SEHK) shrank by 24 percent while that of other regional securities markets lost from 15 to 79 percent in US dollar terms.<sup>2</sup>

Hong Kong, China's trading, settlement, and risk management systems continued to work well throughout the period of volatility in the securities and futures markets. The institutional and regulatory frame-

work put in place in the last 10 years have proved to be effective in providing an open, fair, and orderly market. In the two cases where provisional liquidators had to be appointed in respect of Peregrine and CA Pacific, the failure of these companies did not cause any substantive systemic problem, nor did they lead to further volatility in the market (Financial Services Bureau 1998).

This study documents the corporate governance system in Hong Kong, China, to draw lessons from its strengths and weaknesses. It discusses the characteristics of the economy's firms, the regulatory framework, the problems encountered, and the measures undertaken, as well as additional recommendations to address them. Major cases of financial collapse arising from poor corporate governance are presented along with government actions to deal with them. The study provides specific policy recommendations and concludes with a discussion of prospects for the further enhancement of corporate governance in Hong Kong, China.

## State of Corporate Governance

### Characteristics of Firms

#### OWNERSHIP

In Hong Kong, China, most listed companies tend to be controlled by families. According to a survey of the ownership structure of 553 listed companies in the economy in 1995 and 1996 (Hong Kong Society of Accountants [HKSA] 1997b), 53 percent have one shareholder or one family group of shareholders owning more than half of the entire issued capital. Control by a single shareholder or family group extends to more than 35 percent of issued capital in 77 percent of the companies, and more than 25 percent of issued capital in 88 percent of the companies. The fact that a single shareholder or family group has majority ownership in most of the listed companies reflects the dominance of family-owned companies in the economy of Hong Kong, China.

## MANAGEMENT

Typical of the tight control of the owner groups over the listed companies is the majority shareholder also serving as the chief executive officer (CEO) of the company. The board of directors is also dominated by family members. The HKSA report shows that in 9 percent of the companies, at least half of the directors are family members. Among the companies in which more than 50 percent of issued capital is controlled by a single shareholder or family group, 73 percent have boards where 50 percent or more of the directors are family members. In 30 percent of the companies surveyed, family members hold 50 percent or more of the executive director positions.

## Regulatory Framework

The current framework of corporate governance in Hong Kong, China includes both statutory and nonstatutory requirements. Statutory requirements consist of the Companies Ordinance, Securities (Disclosure of Interests) Ordinance, Securities (Insider Dealing) Ordinance, and Takeover Codes. Nonstatutory requirements are those specified under the Listing Rules covering the number of independent non-executive directors, disclosures of connected transactions, and disclosures of the different components of directors' remuneration.

## REGULATORY BODIES

The Stock Exchange of Hong Kong is the primary front-line regulatory organization responsible for the day-to-day supervision and regulation of listed companies, their directors and controlling shareholders, and market users generally in respect of all listing-related matters. It performs a self-regulatory function, overseeing the conduct of its members, and operates a stock market providing a wide variety of products ranging from ordinary shares to options, warrants, unit trusts, and debt securities.

The Securities and Futures Commission (SFC) exercises prudential supervision over the securities,

futures, and financial investment industries. All rules made by the two exchanges (SEHK and Hong Kong futures Exchange [HKFE]) and the clearing houses are subject to SFC approval.

SFC administers statutory requirements to ensure full disclosure and fair treatment of the investing public. It regularly monitors trading in the securities and futures markets to detect possible malpractices. It also conducts periodic inspection visits of registered persons and makes inquiries in response to public complaints about misconduct by intermediaries and market malpractice.

SFC is empowered to inspect a listed company's books and records if its directors and officers are suspected of impropriety in the management of a company's affairs. Disciplinary actions and civil and criminal sanctions range from private or public censure to suspension or revocation of a license. Regarding criminal actions, SFC is responsible for the investigation of various criminal offenses and while it prosecutes minor offenses, serious matters are prosecuted at the independent discretion of the Director of Public Prosecutions.

SFC also has frontline regulatory responsibility for takeovers and mergers, offers of investment products, and financial intermediaries other than SEHK and HKFE members. Executive rulings at the request of any dissatisfied party and disciplinary matters are heard by the Takeovers and Mergers Panel, a committee established by SFC. The panel consists of representatives of SFC, SEHK, financial institutions, and other constituencies with an interest in takeovers and mergers.

Hong Kong, China's securities market regulations fully comply with the principles of the International Organization of Securities Commission (IOSCO).

## ORDINANCES

To ensure that listed companies are properly run and the rights of minority shareholders are protected, Hong Kong, China has various rules and codes for

specific areas of abuse. The following are the statutory requirements relating to corporate governance.

SEHK's Listing Rules are the main instrument for strengthening the principles and practice of corporate governance in listed companies. The rules state that directors are responsible for the management and operations of the listed companies, and are expected to fulfill their fiduciary duties (both collectively and individually) with as much skill, care, and diligence as commensurate at least with the standards set by the laws of Hong Kong, China. At least two nonexecutive directors must sit on the board of a company to ensure its independence and to minimize the influence of majority shareholders. Important amendments to the Listing Rules require the disclosure of directors' emoluments and other information, and a statement of directors' interests in the companies' five largest suppliers or customers. However, the Listing Rules have no legal effect, the most severe form of punishment being public censure and a period of cold shouldering.

SEHK's Code of Best Practice (see Box) serves as a guide for directors of listed companies. Although compliance with the code is voluntary, listed companies are required to state in their interim reports the extent of their compliance with the code during the accounting period covered.

The Companies Ordinance has important provisions regarding the establishment, organization, and management of companies, including such aspects as the issuance of shares and bonds, auditing, annual meetings, and the accountability of directors and other officers. These provisions apply to SEHK members and to corporations registered with SFC.

Under the Companies Ordinance, statutory reports are required annually for companies incorporated in Hong Kong, China and for overseas companies listed on SEHK. There are special accounting requirements for regulated entities, such as banks, securities dealers, and insurance companies. The Companies Ordinance stipulates the minimum disclosures that should be made in financial statements.

The Securities (Disclosure of Interests) Ordinance (SDIO) requires directors (including their spouses and children) and substantial shareholders (those holding at least 10 percent of the company's relevant share capital) to disclose their interest in the listed companies to SEHK. The aim is to provide a fair, orderly, transparent, and efficient market for listed securities. Substantial shareholders are required to notify SEHK of any additional acquisition or disposal of relevant shares.

SDIO also provides a regulatory framework and disclosure requirements for connected transactions. The Listing Rules define a connected transaction as a transaction between a listed issuer or its subsidiary and a connected person. If the transaction primarily involves financial assistance by a connected person to a listed issuer, the shareholders' interests must be protected. SEHK normally requires connected transactions to be approved by the shareholders in a general meeting, and restrains the connected person from voting on the issue. Once the terms of the connected transaction are agreed, the issuer must inform SEHK as soon as possible. Moreover, an independent expert acceptable to SEHK should affirm in a separate letter the fairness and reasonableness of the transaction where the shareholders are concerned. The reasons for the transaction and some key assumptions made must be stated in the letter.

The Securities (Inside Dealing) Ordinance supervises the use of price-sensitive information in securities trading. Common examples of price-sensitive information are the signing of an important contract, the establishment of a significant joint venture, a fundraising exercise, and statements regarding the company's prospective earnings and dividends. To ensure an objective and orderly market, the ordinance imposes heavy penalties for serious offenses.

The Code on Takeovers and Mergers is a good example of self-regulation. Among its provisions is the concept of perfect secrecy up to the time a takeover or merger is completed. The code also ensures a high standard of accuracy and fair presentation in

### Code of Best Practice for Listed Companies of the Stock Exchange of Hong Kong, China

The following guidelines are intended to form the skeleton of a code of best practice at which listed issuers should aim. They are not intended to be rules that are to be rigidly adhered to. All issuers are encouraged to devise their own codes of practice in the interest not only of their independent nonexecutive directors but of the board of directors as a whole.

- Full board meetings shall be held at least every six months. “Full” board meetings are meetings at which directors are physically present and not “paper” meetings or meetings by circulation.
- Except in emergencies, an agenda and accompanying board papers should be sent in full to all directors at least two days before the intended date of a board meeting (or such other period, as the board agrees).
- Except in emergencies, adequate notice of a board meeting should be provided to give all directors an opportunity to attend.
- All directors, executive and nonexecutive, are entitled to have access to board papers and materials. Where queries are raised by nonexecutive directors, steps must be taken to respond as promptly and fully as possible.
- Full minutes shall be kept by a duly appointed secretary of the meeting and such minutes shall be open for inspection at any time during office hours with reasonable notice by any director.
- The directors’ fees and any other reimbursement or emolument payable to an independent nonexecutive director shall be disclosed in full in the annual report and accounts of the issuer.
- Nonexecutive directors should be appointed for a specific term and that term should be disclosed in the annual report and accounts of the issuer.
- If, in respect of any matter discussed at a board meeting, the independent nonexecutive directors hold views contrary to those of the executive directors, the minutes should clearly reflect this fact.
- Arrangements shall be made in appropriate circumstances to enable the independent nonexecutive directors of the board, at their request, to seek separate professional advice at the expense of the issuer.
- Every nonexecutive director must ensure that he can give sufficient time and attention to the affairs of the issuer and should not accept the appointment if he cannot.
- If a matter to be considered by the board involves a conflict of interest for a substantial shareholder or a director, a full board meeting should be held and the matter should not be dealt with by circulation or by committee.
- If an independent nonexecutive director resigns or is removed from office, the exchange should be notified of the reasons for such action.
- Every director on the board is required to keep abreast of his responsibilities as a director of a listed issuer. Newly appointed board members should receive an appropriate briefing on the issuer’s affairs and be provided by the issuer’s company secretary with relevant corporate governance materials currently published by the exchange on an ongoing basis.
- The board should establish an audit committee with written terms of reference that deal clearly with its authority and duties. Among the committee’s principal duties should be the review and supervision of the issuer’s financial reporting process and internal controls. For further guidance on establishing an audit committee, listed issuers may refer to *A Guide for the Formation of an Audit Committee* published by the Hong Kong Society of Accountants in December 1997. Listed issuers may adopt the terms of reference set out in that guide, except that the committee may have a minimum of two members, or they may adopt any other comparable terms of reference for the implementation of audit committees. The committee should be appointed from among the nonexecutive directors and a majority of the nonexecutive directors should be independent.

Source: Stock Exchange of Hong Kong, China.

all communications to shareholders during the take-over or merger. Persons who acquire more than 35 percent of the shares of a company, for example, must extend an offer to all voting shareholders.

Other regulations that have a bearing on the listing of securities on SEHK are the Protection of Investors Ordinance, the Stock Exchanges Unification Ordinance, the Code on Unit Trusts and Mutual Funds, and the Code on Share Repurchases. These regulations set guidelines for Hong Kong, China’s

securities market to prevent improper trading and increase investors’ confidence.

### ACCOUNTING AND AUDITING STANDARDS<sup>3</sup>

Companies make mandatory disclosures as specified by HKSA’s Statements of Standard Accounting Practice (SSAPs). In addition, there are accounting standards and guidelines that, unlike the SSAPs, are not mandatory but that define best practices and should normally be followed.

Before 1993, Hong Kong, China's accounting and auditing standards and guidelines were primarily based on equivalent UK standards. Since 1993, HKSA has modeled its SSAPs on the International Accounting Standards (IAS) and its statements of auditing standards on the International Standards on Auditing (ISA), with the long-term objective of achieving full harmonization with IAS and ISA.

HKSA promulgates accounting and auditing standards after detailed evaluation of the relevant international standard and the preparation of an Exposure Draft incorporating any additional guidance or amendments arising from Hong Kong, China legislation or regulations. The Exposure Draft is released to all members, listed companies, regulators, chambers of commerce, and academics (and posted on HKSA's website on the Internet) for comment, and finalized after a review of the comments. Compliance with accounting standards is enforced by the Hong Kong Monetary Authority (HKMA) (for authorized banking institutions), SFC (for securities dealers), Insurance Authority (for insurance companies), and SEHK (for listed companies).

Accounting firms are selected for review at random and not in response to any complaint or referral. Reviewers are full-time employees of HKSA, and undertake on-site visits to the firms. They are given statutory powers of access to files and other information generated by the auditors. In appropriate cases, disciplinary action is taken to deal with cases of non-compliance with professional standards. Sanctions include fines and the suspension of licenses.

## Problems Encountered and Measures Undertaken

### Ensuring Independence of Management

Effective corporate governance depends on the separation of authority between a firm's managers, board of directors, and majority and minority shareholders. Managers are held accountable when there is inde-

pendent oversight by the board and an external auditor (Organisation for Economic Co-operation and Development [OECD] 1998).

Independent nonexecutive directors are seen to bring independent judgment to the overall strategy of the company, including key appointments and performance standards. To ensure their independence, they should be free of any business or financial connections with the company apart from their fees and shareholdings.

In Hong Kong, China, where most listed companies are dominated by one individual or family, the functions of chairman and chief executive officer are often difficult to separate in practice. Companies also have difficulty recruiting truly independent nonexecutive directors. In some cases, CEOs select the nonexecutive directors, compromising their independence.

Hong Kong, China has adopted the following recommendations of the UK Cadbury Report (1992) relating to boards of directors: mixing executive and nonexecutive directors on the board and guaranteeing the quality and quantity of nonexecutive directors; enabling independent nonexecutive directors to seek separate professional advice; and requiring regular board meetings, including two meetings to announce the interim and the annual results. Amendments made to the Listing Rules in 1993 require all listed companies to have at least two independent nonexecutive directors. SEHK guidelines clarify the qualifications, appointment, and role of these directors. Taking another step toward better corporate governance, SEHK published the *Guide for Directors of Listed Companies* in December 1996 to remind directors of their duties under the Listing Rules and the listing agreement. The guide even suggests what directors can say in front of reporters and analysts, and what they can do when remarks are inaccurately reported. Both issuers and directors are required to comply with the provisions of the guide.

The government should also consider adopting the other recommendations of the Cadbury Committee.

One such recommendation is the separation of the roles of CEO and chairman in large companies. There is no such listing requirement yet in Hong Kong, China. Another recommendation is the establishment of a nomination committee by the board of directors. The nomination committee can enhance the independence of the board structure. The boards of directors should also make efforts to improve their standards and procedures so as to strengthen the status and independence of nonexecutive directors.

## Disclosure and Transparency

Corporations must provide adequate, accurate, and timely information to shareholders and the public regarding financial performance, liabilities, ownership, and corporate governance issues. This is critical if investors are to be able to make informed judgments on the risks and rewards of any investment (OECD 1998).

### DIRECTORS' PAY

In Hong Kong, China, as in many Asian countries, the board generally determines its own remuneration. Without effective monitoring mechanisms, company directors may decide on excessive compensation that is totally unrelated to performance. The disclosure of executive remuneration is a key element in effective corporate governance. Minority shareholders can use this information to see whether senior management is deciding judiciously on executive compensation. This should also be an important portfolio selection criterion for institutional investors.

Disclosure of directors' compensation is an effective way of improving the corporate governance structure in Hong Kong, China. The rapid increase in directors' pay during the 1990s, associated particularly with stock options, has heightened the need for disclosure of directors' emoluments. To improve accountability and transparency in directors' remuneration, SEHK, since 1990, has urged listed companies to disclose their directors' remuneration on a voluntary basis. It has ruled that annual reports from

1995 onward must disclose information on the compensation of the top executives of listed companies. The information includes the total cash compensation for each of the five highest-paid directors and for the directors as a group. In addition to disclosure, it would be advisable for senior management to form an independent remuneration committee with nonexecutive board members to make remuneration decisions, as recommended in the Cadbury Report.

### CONNECTED TRANSACTIONS

In the early 1980s, banks in Hong Kong, China, which were then mostly owned by families, encountered difficulties. Reckless lending to connected parties was the major factor behind the banking problems. In order to deal with such abuses, the power to regulate bank ownership structure was strengthened and restrictions on connected lending were implemented under the Banking Ordinance in 1986. Since then, various legislative provisions and policy guidelines have been continuously updated by HKMA to achieve internationally accepted standards. Currently, most banks belong to financial groups, and the approval of HKMA is required in order to acquire 10 percent or more shares. Any person who exercises indirect control over the directors, even without voting rights, is also subject to approval by HKMA. With these efforts, the banking sector has played an important role in corporate governance. Banks are allowed to have equity shares in nonfinancial businesses of only up to 25 percent of their capital base. Despite this restriction on banks' equity ownership of nonfinancial businesses, banks have been able to effectively control corporate governance through efficient lending practices based on prudent risk assessment and reliable financial information (Nam, Kang, and Kim 1999).

Hong Kong, China requires shareholder approval and disclosure of connected transactions. SEHK tracks companies and directors who fail to notify shareholders about connected transactions. In early June 1995, Cheerful Holdings (which was listed in

April 1994) announced its failure to disclose a major connected transaction correctly. Its subsidiary, Cheerful Finance, had lent a total of HK\$197 million to International Cheerful (Holdings), a firm controlled by husband-and-wife directors Johnny Chee Jing-yin and Lisa Chee Siu-ling, although Cheerful Holdings made net profits of only HK\$24.98 million in 1994, and had net current assets of only HK\$128.3 million. The firm, in effect, had lent cash in excess of its net assets through its subsidiary company. This was revealed in its annual report, and the company was asked to make a statement by the SEHK Listings Division (*South China Morning Post [SCMP]*, 2 June 1995). The recommended practice is for a company to avoid any connected transactions.

#### **OTHER MEASURES TO IMPROVE TRANSPARENCY AND DISCLOSURE**

Improvements in the Listing Rules in April 1995 tightened the internal controls of companies. Listed companies must now disclose tax charges, changes in the provision for bad and doubtful debts, and capital adequacy and liquidity ratios.

To make corporate boards more effective, SEHK has likewise announced that annual and interim reports for accounting periods ending on or after 31 December 1995 should include a statement of compliance with the Code of Best Practice and give reasons for noncompliance.

The demand for greater corporate accountability has led some listed companies to adopt or to consider adopting audit committees. According to HKSA, only 2 percent of listed companies had audit committees in 1995. Although the concept is still evolving, the role of the independent auditor is considered vital to corporate governance and accountability.

On 30 June 1998, SFC issued a consultation paper on the revision of the Securities (Disclosure Interests) Ordinance. The main purpose of the consultation is to improve transparency. SFC suggests changing the substantial shareholding disclosure threshold from 10 to 5 percent, and shortening the

notification period from five calendar days to three business days.

#### **Financial Disclosure of People's Republic of China Companies Listed on the Stock Exchange of Hong Kong, China**

In step with the steady growth of H-shares and red chips, many investors have paid a great deal of attention to People's Republic of China (PRC)-listed companies in recent years. H-shares and red chips are shares in PRC enterprises or PRC-related enterprises listed in Hong Kong, China. The term "red chip" refers to PRC enterprises that have listed through acquisition and asset injection.

International investors often criticize PRC companies for their lack of transparency. Tougher guidelines introduced by the China Securities Regulatory Commission (CSRC) require companies to include accounting footnotes and a review of their business with the financial statements in their annual report to give a clearer picture of their financial status.

Most H-share companies were state-owned enterprises before their listing and still have the state as majority owner. They do not fully understand their obligations to their shareholders. Some of them seem uncertain about what constitutes price-sensitive information and how SEHK can be notified of this in a timely manner. These H-share companies, most of which are new to the market, have difficulty communicating effectively with the international investment community. Some tend to announce only good news, while others avoid communicating with the public altogether for fear of making inappropriate statements.

To protect investors, the Listing Rules for issuers from the PRC were amended in November 1994 and now require that PRC issuers comply with the same standards as those that apply to other companies listed in Hong Kong, China.

H-share companies need to improve in the following aspects:

- Understanding the obligations of a listed company toward its shareholders;
- Complying with disclosure requirements under the Listing Rules;
- Understanding the importance of effective communication with the international investment community; and
- Complying with other laws and regulations of Hong Kong, China.

The regulators of Hong Kong, China should monitor the performance of H-share companies and work effectively with the PRC regulatory authority to ensure the integrity of these companies.

## Major Cases of Poor Corporate Governance

### The Peregrine Case

#### BACKGROUND

Peregrine Investments Holdings Ltd. (Peregrine) was Asia's largest home-grown investment house outside Japan. The major activities of the Peregrine Group were investment holding, securities and equity brokerage, commodities and foreign-exchange brokerage, equity derivatives dealing, direct investments, and other financial services.

A major part of Peregrine's operations were in the equity market, but the company also issued and traded debt securities for Asian corporations. The Peregrine equity business earned a respectable US\$50 million a year, possibly the highest for any investment house in the region. The company's problems came mainly from concentrating its efforts in building up a fixed-income business, most of it in Asia. Peregrine generated most of its profit from Hong Kong, China with increasing contributions from other Asian countries. Hong Kong, China and other Asian economies accounted for 97 percent of the firm's total profit in 1996.

A major factor that contributed to the firm's collapse was its dealings with an Indonesian taxi company, Steady Safe. By mid-December 1996, Per-

egrine held US\$265 million worth of US dollar-denominated promissory notes from Steady Safe. The sum represented a third of Peregrine's total asset value. As the Indonesian rupiah began its precipitous fall in July 1997, trouble loomed. The rupiah hit 15,000 to the US dollar in January 1998, compared with a rate of about 2,200 a year earlier. This heralded a sharp drop in investor confidence. The dramatic plunge of the local currency rendered Steady Safe incapable of repaying the debt. In addition, there was no market for the debt issue because investors lacked confidence in Indonesia at that time. In the aftermath of the rupiah's plunge and investors' loss of faith in Indonesia, Peregrine's position in Steady Safe was worth only a small fraction of its original value. As it turned out, Steady Safe was not Peregrine's only problem. Even before Steady Safe's debt issue, the company had a huge position in Indonesian debt securities. Its debt equity-ratio had been very high—111 percent in 1996. At the time of the company's liquidation, Peregrine's debt portfolio amounted to US\$1 billion.

#### FAULTY RISK MANAGEMENT AND INTERNAL CONTROL SYSTEMS

One important question was who should be responsible for the large amounts advanced by the Peregrine fixed-income group. The amount involved was US\$265 million, and it is difficult to believe that anybody could make such a decision without the knowledge of the board or other senior management. Peregrine's risk management system must have been extremely lax. Under normal circumstances, a deal of this size would be considered a substantial transaction and should have been disclosed to the public under the listing regulations of SEHK. However, because this transaction involved an overseas party, it fell outside the regulatory framework.

According to an interview published in the *SCMP*, the chairman was not too familiar with the bond business. He had allowed his equity managers a great deal of freedom, and this freedom had simply been

extended to the fixed-income business. The managing director and another cofounder later stated that they had learned of the Steady Safe case at a very late stage, since they had been spending much of their time on the equities business and had not overseen the fixed-interest operations. However, if a business is moving into new areas or is developing new strategies, the board should be able to monitor and supervise the executive management in the new initiatives. If the senior management of Peregrine were not aware that this huge sum of money had been allocated to an Indonesian taxi company, then the internal controls were clearly faulty.

#### **DISCLOSURE FAILURE**

The information that Peregrine had built up fatally large exposures in the debt market became public just before the liquidation, showing that its officials had failed to disclose the true situation of the company to both SEHK and the company's shareholders. This is an inherent danger of the lack of transparency that is characteristic of many Asian businesses.

#### **ACTION TAKEN AND RECOMMENDATION**

The government of Hong Kong, China has hired an independent consultant to examine the Peregrine case and ascertain the lessons to be learned from it. The company's shareholders are the victims of the whole incident. It seems that the senior management did not fulfill their duty properly as directors, but it is not yet clear whether they will be prosecuted.

Financial institutions should be required to disclose more investment information, particularly on potential market risk. While it may not be realistic to expect these financial institutions to disclose the details of their investment strategies, it may be useful for investors if financial institutions were to include in their annual report a description of their risk management practices and the potential market risk of their portfolios.

## **The CA Pacific Securities Case**

### **BACKGROUND**

There are two types of investment accounts in Hong Kong, China: cash accounts and margin accounts. Cash accounts involve no leverage financing, and a brokerage house has no right to use a client's shares in a cash account as collateral for bank loans. The usual practice is for an affiliated finance company in the group to bridge the financial arrangement between banks and margin-account clients. These finance companies are not regulated by SFC. Since they are not involved in the banking business, they are also not regulated by HKMA.

CA Pacific Finance transferred shareholdings of cash accounts to margin accounts without the investors' knowledge. The investors' shares were used as collateral to secure bank loans. The company ran into liquidity problems because of the drop in the property and share markets. Shares used as collateral had been sold by the bank. Thus, investors in both cash and margin accounts lost their shares. CA Pacific Finance should have notified investors that their shareholdings were being used to secure bank loans. A detailed breakdown of the company's investment portfolio should also have been made known to investors, who could then have evaluated the risk of the brokerage house and decided whether or not to withdraw their shares.

As a result of the CA Pacific incident, public confidence in small- and medium-size brokerage houses dropped. Rumors of other houses in similar trouble spread. Investors rushed to liquidate their shares, causing chaos and showing a decline of public confidence in the financial market of Hong Kong, China. This problem was not new, as it had been mentioned in the Davison Report on the crash of the stock market in Hong Kong, China in October 1987.

In early May 1998, a small brokerage house, Forlux Securities, misused clients' shares to obtain margin financing without seeking approval, and conducted a money-lending business through a finance

arm. The owner disappeared, together with more than HK\$20 million worth of clients' shares. The crash of Forlux, coming as it did after the CA Pacific incident, further undermined public confidence in brokerages.

### **ACTIONS TAKEN AND RECOMMENDATIONS**

After the CA Pacific and Forlux incidents, SEHK and SFC started conducting regular visits to selected brokerage houses and their associated finance companies that were thought to have the same potential problems. The objective of these visits is to ensure the financial soundness of the houses. Sixty houses have been selected for inspection to determine the adequacy of their risk management procedures related to share-margin financing.

Eventually, the Financial Services Bureau, SEHK, and SFC set up a special task force to ensure a proper monitoring system for brokerage houses. There is undoubtedly a need to strengthen control of finance companies affiliated with brokerage houses as, under the present regulatory structure, they are regulated by neither SFC nor HKMA. The current suggestion is that SFC will be responsible for monitoring the financial activities of these companies.

The regulatory framework should be improved to distinguish clearly between cash and margin accounts. Brokerage houses should be strictly prohibited from transferring shares from cash accounts to margin accounts. Clear guidelines on share-margin financing should be issued to brokerage houses. Indicators such as capital adequacy and risk management practice should be used to determine the financial stability of these houses. These information should be reported regularly to the regulator and eventually disclosed to the public in a timely manner. Finally, the regulator should spend more effort on investor education.

## **Policy Recommendations**

In the long term, the globalization of financial markets will eventually shape corporate governance in

Hong Kong, China. Companies have to compete for capital. The international investment community will select companies with good corporate governance standards and good information disclosure. Then professional managers will play a more important role in running the company. To further improve corporate governance in Hong Kong, China, the following measures are recommended.

### **ENCOURAGE INCREASED PARTICIPATION FROM INSTITUTIONAL INVESTORS**

Increased participation from institutional investors will definitely help protect the rights of minority shareholders. As minority shareholders are more interested in short-term capital gains than in the company's affairs, most will not even attend the company's annual meeting and their views will never be heard. Institutional investors, on the other hand, tend to have a longer-term interest in the company, and will take a more active role in the annual meeting. The launch of the Mandatory Provident Fund in Hong Kong, China in 2000 will definitely help in shaping the economy's standards of corporate governance.

### **PROMOTE INVESTOR EDUCATION**

The general public should be continuously educated about shareholders' rights to enable them to participate effectively and vote in general meetings. Regulators should also ensure that shareholders are given enough information on the management and operations of the company and have enough time to digest this information before the meeting.

### **INCREASE FREQUENCY AND AVAILABILITY OF REPORTS**

Major world markets are moving toward semiannual or quarterly reporting. Currently, Hong Kong, China's listed companies are required to report interim semiannual and annual accounts. SEHK may require more frequent disclosure of company accounts by listed companies. Listed companies should also make their annual reports available on their websites.

Disclosure of more information will enhance the transparency of the company.

**PROMOTE GREATER TRANSPARENCY  
AND PROVIDE TRAINING  
FOR NONEXECUTIVE DIRECTORS**

Procedures should be instituted to ensure that nonexecutive directors act in the best interest of the shareholders. For example, their remuneration and attendance at board meetings should be disclosed. Some of these nonexecutive directors come from different backgrounds and the board should provide them with the necessary training and support. In addition, the board should give them enough information on the operations of the company.

## Prospects for the Enhancement of Corporate Governance<sup>4</sup>

In March 1999, the Financial Secretary announced a market reform package with three sets of objectives. The first objective is to modernize the regulatory framework by putting in place a new framework with clearer regulatory objectives and strengthened supervisory and investigative powers for SFC.

The second objective is to further enhance market infrastructure by setting up a single clearing arrangement for securities, stock options, and futures transactions; enhancing the financial technology architecture to facilitate direct processing of transactions across the financial markets; and moving toward a secure, scripless securities market through the use of robust networks. A Steering Committee on the Enhancement of the Financial Infrastructure was appointed to look at these issues and report to the Financial Secretary by September 1999.

The third objective of the market reform package is to modernize the market structure through the demutualization, merger, and public listing of the two exchanges and their clearing houses and the separation of ownership from trading rights. These changes

are aimed at enhancing responsiveness to market forces, bringing about economies of scale in terms of operational efficiency and infrastructure investment, facilitating risk management, and boosting Hong Kong, China's competitive position vis-à-vis other international markets. Public listing is also expected to enhance market discipline. The separation of ownership and trading rights is expected to bring about greater financial flexibility for members of the new entity, since the reforms would allow existing members to sell their shares in the company while retaining their trading rights.

The proposed new regulatory framework is embodied in the Securities and Futures Bill. The bill consolidates the existing laws governing the securities and futures markets, which are currently spread over some 10 ordinances and parts of the Companies Ordinance. In addition, it seeks to update certain terms and definitions to reflect developments in the financial markets, thereby simplifying the law and making it more user-friendly for market practitioners and users.

Major new regulatory measures include the following:

- *Introduction of a single license for market intermediaries to streamline regulatory arrangements and bring in new licensing requirements to enhance protection of clients' assets.*
- *Establishment of a civil Market Misconduct Tribunal (MMT) and expanding the existing criminal route to combat market misconduct.*
  - The bill will build on the strength of the Insider Dealing Tribunal and expand it into a Market Misconduct Tribunal. MMT will handle specified market misconduct activities, including insider dealing, and will apply the civil standard of proof, i.e., a balance of probabilities, in determining whether it is satisfied that cases referred to it have been proved.
  - MMT may order disgorgement of profits, order payment of legal costs and investigation

expenses, issue a “disqualification” order to disqualify a director from being a director of any listed company, issue a “cold shoulder” order (i.e., an order denying a person access to market facilities), issue a “cease and desist” order (i.e., an order not to breach the provisions of the bill again), and refer the possibility of disciplinary action to a body in which the person who has engaged in market misconduct is a member. Due care has been exercised in calibrating these civil sanctions to ensure that they are compatible with human rights requirements.

- As an alternative to the civil proceedings before MMT, the bill preserves and expands the existing criminal route for dealing with market misconduct activities, to be resorted to when there is sufficient evidence to meet the criminal standard and it is in the public interest to bring prosecution before the courts. The maximum penalty under the criminal route is 10 years’ imprisonment or a fine of up to US\$10 million. The rule against double jeopardy applies. A person cannot be tried in MMT and the courts for the same market misconduct.
- *Modernization of the disclosure regime for more timely dissemination of price-sensitive information to enable investors to make better informed decisions.* The bill reduces the disclosure threshold (from 10 to 5 percent) and time limit for disclosure (from five days to three business days). For greater transparency, certain disclosure requirements are also extended to securities interests held through derivative products. To reduce the compliance burden, the bill has also removed or simplified certain disclosure requirements.
- *Provision of assistance to investors in seeking compensation by creating specific private causes of action against market misconduct and false disclosure of information.* Under common law, a person who suffers loss as a

result of market misconduct may be able to seek redress through civil action against a person responsible for the misconduct. The path to civil redress under common law can be costly and riddled with obstacles. The bill will create a right of civil action in respect of market misconduct for which the plaintiff can claim compensation for loss and other remedies. The relevant provisions will stipulate that a person may sue another person to recover losses resulting from the latter’s market misconduct if the court is satisfied that it is fair, just, and reasonable for him to do so. It will also allow the findings of MMT and criminal convictions of market misconduct to be admitted as evidence if they are relevant and probative to these civil proceedings.

- *Institution of a flexible framework for the regulation of automated trading services to facilitate market innovation.*

The bill provides the following new powers to SFC:

- *Allowing SFC to require access to the working papers of an auditor of a listed corporation in a preliminary inquiry into alleged misconduct of the corporation.* Current law authorizes SFC to review the books and records of a listed company when there is alleged misconduct in its management. Under the bill, SFC will be entitled to seek explanations of an entry from the listed company. It may also request access to the working papers of the company’s auditors. In addition, SFC may make inquiries of counterparties to transactions that the company has entered into. These enhancements will enable SFC to inquire more effectively into allegations of fraud or other misconduct in respect of listed companies. Particular efforts have been made to raise the thresholds required for the exercise by SFC of these new inquiry powers to ensure that they are reasonable and in line with present-day legal conventions in respect of the rights of third parties. The bill also contains provisions to implement an earlier proposal to

provide auditors of listed companies who report to SFC any suspected fraud or misconduct in the management of a listed company with statutory immunity from liability under common law. The choice to report is entirely voluntary. The bill intends only to give immunity from the threat of civil liability to auditors who choose to sound such a warning to SFC in the course of their auditing work.

- *Enabling SFC to impose civil fines on intermediaries as a more proportionate disciplinary sanction.* Currently, when a licensed person engages in any misconduct, the disciplinary sanctions that SFC may administer are public or private reprimands, and suspension or revocation of the intermediary's registration. Reprimands could be too light in many cases, yet suspending or revoking an intermediary's registration might be excessive. The bill will give SFC two additional sanction options which may be calibrated in accordance with the gravity of the misconduct. They are civil fines of up to US\$10 million or three times the amount gained or loss avoided, whichever is higher; and suspension or revocation of an intermediary's licence in respect of part of its business only.
- *Granting SFC standing to intervene in civil proceedings between third parties to protect*

*the public interest.* As the financial market and its infrastructure become increasingly complex, what appear to be disputes between private parties are more and more likely to have an impact on the rest of the market system. The bill will give SFC standing to intervene in civil proceedings between third parties to provide its regulatory perspective and expert opinion. As safeguards, the bill will require that SFC must satisfy the court that such intervention is in the public interest; parties to the litigation will have the right to challenge SFC's intervention; and the intervention will be subject to such terms as the court considers just.

- *Allowing SFC to take custody of clients' assets from intermediaries to prevent dissipation of such assets.*

After a three-month consultation with the public and market participants and subsequent refinements, the government aims to introduce the composite Securities and Futures Bill to the Legislative Council in early 2000. With the legislation of the new regulatory framework, the government expects to achieve higher standards of transparency, accountability, and disclosure that are on a par with international standards and practices, thus making Hong Kong, China better equipped to face the challenges of the new millennium.

Appendix

## Executive Remuneration in Hong Kong, China

Many corporate executives in Hong Kong, China receive compensation packages on a par with those of the heads of large firms in the United States. In some extreme cases, the combined pay of executives may even exceed the net profits of the entire firm. Also, it is generally believed that top executives often decide their own pay at will. Such a contention raises doubts about the corporate governance of companies listed in Hong Kong, China. In a study of 1,518 companies for which executive compensation data were available for the period from 1990 to 1994, we looked at the level of executive pay and how it relates to a set of determining factors.

### THE OWNER-DIRECTOR-MANAGER

In the US, top corporate officials typically own a small portion of the stock of the company. Also, these managers are, at least in theory, monitored by the board of directors, which sees to it that the overall performance of the firm is in line with shareholders' interests. US companies are also subject to a more restrictive environment for setting compensation levels. Relevant factors include the presence of active groups of shareholders who are more aware of their rights.

In Hong Kong, China, listed companies tend to be dominated by major shareholders, either individual investors or family members. These shareholders usually hold executive positions and directorships in the companies. In other words, the monitor and the monitored are the same people. In the sample of companies, median ownership of the board of directors was 47.3 percent.

### COMPONENTS OF COMPENSATION

Because company directors in Hong Kong, China wear the hats of director and manager at the same time, they are also compensated in the same fashion.

The take-home element of compensation consists of two parts: the director's fee and emoluments. The former is a sum, usually a relatively fixed amount for all directors of the same firm, in compensation for their service on the board. Emoluments are similar to a salary plus bonus, and may differ significantly among directors of the same firm.

The pay for the role of director is lower than the reward for the role of manager. In the sample of companies, the median of the directors' fee was HK\$100,000 while the median of emoluments was HK\$4.5 million. These figures represented the combined amounts for a typical group of four or five directors. In terms of the relative significance of these figures, the median company paid out about 8 percent of its net profits to its directors.

### MEASURES OF CORPORATE PERFORMANCE

In attempting to relate directors' pay to company performance, we chose to use stock return and the "q-ratio." Stock return is taken as the sum of dividends and stock price appreciation in a one-year period. In other words, we tried to measure how well managers performed in terms of the return they generated for shareholders. The q-ratio is an indicator of management quality. The value of the  $q$  of a firm is defined as the ratio of the stock price to the book value of equity, or net assets free of debt. In general, the higher the stock market values a firm for its management rather than its assets, the higher the q-ratio.

We analyzed directors' compensation using compensation as a percentage of net profits, and compensation as a percentage of operating income. Our sample period was from 1990 to 1994. In order to put the figures on a common basis, we adjusted all variables to the price level of 1990. (See Table for a summary of these data.)

We divided our sample of 1,518 firms into three subgroups: small, medium, and large. In general, we found that firm size is a significant determinant of directors' compensation. The larger the firm, the

### Directors' Compensation by Company Group

Company Group	Median Market Equity Value (HK\$ million)	Directors' Compensation (HK\$ million)	Directors' Compensation/ Net Profit (%)	Directors' Compensation/ Operating Income (%)
Small	183	2.5	11	10
Medium	571	4.0	6	5
Large	2,902	6.4	2	2

Sources of basic data: Annual reports of listed companies; Datastream.

higher is the pay level. This finding is consistent with that for other markets. Furthermore, there is strong evidence that compensation as a percentage of net profits is inversely related to firm size. A similar result is obtained for compensation as a percentage of operating income. These results imply that smaller companies were paying out a larger portion of their income in the form of directors' compensation.

Another interesting issue is the relationship between director compensation and company performance. The question is simply whether the chief executive officer is rewarded according to firm performance. Our analysis showed that firm performance does not affect directors' compensation except in the large-firm subgroup in which pay was positively related to performance. Finally, we found

that directors' remuneration was sometimes larger than the profit of a company: directors continued to draw large compensation even when the company was losing money. In the sample group of companies, there were 132 such cases.

One indicator of good corporate governance practices is how directors are rewarded. The related question is how directors' performance should be measured. One possible solution is to set up a remuneration committee composed of independent nonexecutive directors. The evaluation criteria should include participation at board meetings, firm performance, and market situation. The criteria should be disclosed to shareholders. Besides cash remuneration, other noncash items, such as options scheme, should also be considered as part of the incentive package.

## Notes

<sup>1</sup>Hong Kong, China; Indonesia; Korea; Malaysia; Philippines; Singapore; and Thailand.

<sup>2</sup>Compared with end-June 1997 and expressed in US dollar terms, the Taipei, China market lost 15 percent; Singapore and Tokyo shrank by 27 and 31 percent, respectively; while the Philippines lost 45 percent and Indonesia 79 percent (Financial Services Bureau 1998).

<sup>3</sup>This section draws largely from the International Monetary Fund 1999.

<sup>4</sup>This portion is based on IMF (1999) and the Securities and Futures Bill.

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