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Many Hong Kong firms suffer from family-run cronyism, says economist

Aug 19 2014 Ajay Shamdasani, Compliance Complete

Many of Hong Kong's listed corporations suffer from family-run cronyism that has reduced company value, despite the territory having more robust corporate governance standards than some of its neighbours, an economist said. The net result, he said, was a diminution of shareholder value and fewer foreign funds being invested into local capital markets. However, he said the city's banking and financial sector had good corporate governance standards because of its status as an international financial centre.

"Finance in Hong Kong is one of the better areas of corporate governance and we see that mostly because of the importation of corporate governance standards from the U.S. and the UK," said Dr. Bryane Michael, a senior fellow at the University of Hong Kong's Faculty of Law. "It is clearly a result of regulatory arbitrage: because these good corporate governance practices are required by law in the U.S., they are imported into Hong Kong and Malaysia, and that is basically a freebie."

Speaking at a corporate governance conference hosted by the University of Malaya's Malaysia Centre of Regulatory Studies in Kuala Lumpur in early August, Michael said the import of such rules and standards into regional financial centres such as Hong Kong and Singapore was a boon for Asia's less developed markets.

"I think the lesson from this is that when Malaysia adopts these corporate governance practices and your companies then compete in places such as Brunei, Vietnam and Indonesia, you will export that 'corporate governance bonus' into these other jurisdictions. That regulatory arbitrage will benefit both Malaysia and the entire jurisdiction," Michael said.

Compliance implications

The data on Hong Kong's corporate governance standards is mixed, with surveys finding different results. For example, the latest edition (2013-2014) of The Global Competiveness Report ranks Hong Kong relatively high in terms of corporate governance. Michael also cited a research paper he co-authored with Professor Say Goo from HKU's law school, entitled "Last of the Tai-Pans: Improving the Sustainability of Long-Term Financial Flows by Improving Hong Kong's Corporate Governance", in which they concluded that Hong Kong ranks relatively low in terms of corporate governance.

Many large Asian conglomerates were family companies which led to inefficiency and reduced shareholder value. To that end, Michael said the city's broader corporate sector was highly concentrated and harmful to shareholder interests.

"In Hong Kong, we have a fairly controlled [corporate sphere]. Malaysia has the problem of state controlled [business], which we do not have in Hong Kong because of our neo-liberal background. But we [Hong Kong] have self-dealing by insiders, particularly family-run companies that are concentrated, coupled with ageism because our company directors tend to be much older than directors in other jurisdictions," Michael said.

He said compliance and legal staff at banks needed to be vigilant.

"Compliance professionals have to be aware anytime their firm is transacting business with family-owned or state-owned companies," Michael told Compliance Complete. "Transactions with these companies have higher levels of value-destroying connected-party transactions and lower alpha [stock market returns]. Companies that invest in their shares for cash management, pension fund purposes or to boost yields on the investment side are taking on additional 'family-owned company risk' that their shareholders and managers may not be aware of."

All in the family

Numerous studies cited in Michael and Goo's paper show that when families control Hong Kong corporations, it destroys company value.

"Family-owned and state-owned companies reduce corporate value because of their [relative] lack of corporate governance. Family control has negative impact on alpha, revenues and market size … How do we grab control from these families and spread it to the wider shareholding public?" Michael said.

He said minority shareholders were hurt because controlling families would often extract company resources for their own interests rather than a company's wider shareholder base.

"Many studies show that as families cede control of companies, returns start to fall. At first, that result is counterintuitive. It is because such families entrench themselves so completely within a company that as they remove themselves, it destroys the valuable relationships and a lot of the corporate governance techniques that they put in place to keep control of the company in the first place," Michael said.

Given the strong concentration of ownership at some publicly listed companies in Asia, it was therefore incumbent on regulators to continue to watch such companies to warn their investors about family controlled fiefdoms. "This is something we have only started to do in Hong Kong," Michael said.

He said it might be prudent to incentivise such families to sell their shares and reduce their control over companies to prevent long-term share price decreases.

"Investors in the U.S., UK and Europe see this problem: they see that certain families significantly control Hong Kong companies, so they do not put as many funds into local firms as they should; that reduces the value of assets at our

companies," Michael said.

Connected party transactions could also reduce shareholder value, as was often the case with self-dealing transactions in Hong Kong and mainland China, Michael said.

To an extent, such self-dealing could be reduced through confidential complaints, whistle-blowing policies or corporate governance activities which help raise awareness of family improprieties for shareholder constituencies, as well as tips to the outside investing world, Michael said.

"A lack of information on these transactions is also value-destroying; in order to reduce the negative impact of connected party transactions, we need more transparency," he said.

Michael also said top shareholders in listed companies in Hong Kong were likely to try to increase their stakes as the companies grew, to consolidate power — an issue that regulatory reform should address. Another problem was rejuvenating the "director class" at listed companies. Statistically, most Hong Kong directors were between 50 and 80 years old.

"These are elderly gentlemen that hold directorships in our corporations," Michael said. "Our directors tend to consolidate; a relatively large proportion of directors hold 14 to 17 directorships. That suggests there are not enough good directors to sit on the boards of our larger companies," he said.

Broader reform

Hong Kong and Malaysia could learn from the rules and policies employed in the U.S. following the 2001 Enron scandal and the 2008 global financial crisis, which resulted in the Sarbanes-Oxley Act, the Dodd-Frank Act, as well as guidance from the UK, he said.

"Solutions from the U.S. and UK can help Hong Kong and Malaysia increase minority shareholder rights through [revising] articles of association and other mechanisms to help direct corporate policies," Michael said.

For example, legal mechanisms such as unfair prejudice actions could allow minority shareholders to sue entrenched managers and owners that ran companies for themselves rather than all shareholders, Michael said. If compliance professionals took part in reforming the rights of minority shareholders it would raise the value of the compliance function and that of corporate governance in Hong Kong.

"As we improve corporate governance codes, listing rules and corporate law, we will see an improvement in overall governance and more assets attracted to Hong Kong: both from investors and those seeking to list on the local stock exchange," he said.

Additionally, if pension funds increased their holdings in the territory's large family-owned businesses, they would have

the requisite leverage as institutional investors, which small shareholders lack, to demand reform.

"Hong Kong pension schemes hold a relatively small proportion of Hong Kong listed companies. But if those pensions bought [more of] their stock, those shares would then be dispersed to pension holders, thereby increasing oversight of Hong Kong companies," Michael said.

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