
Last of the Tai-Pans: Improving the Sustainability of Long-Term Financial Flows by Improving Hong Kong's Corporate Governance

AIIFL Working Paper No. 16

November 2013

Asian Institute of International Financial Law
Faculty of Law
The University of Hong Kong
www.AIIFL.com



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Last of the Tai-Pans: Improving the Sustainability of Long-Term Financial Flows by Improving Hong Kong’s Corporate Governance

Bryane Michael, University of Hong Kong
and
Say Goo, University of Hong Kong

Executive Summary

Hong Kong leads the rank tables as an international financial centre. However, the data indicate that some parts of her corporate governance arrangements probably detract from – rather than contribute to – that leading position. In this brief, we show how excessive shareholding concentration, probably self-dealing, insufficient minority shareholder recourse to mechanisms aimed at protecting their investments, and Hong Kong’s close links with several “tax havens” probably weaken Hong Kong’s role as an international financial centre. We present 18 recommendations aimed at increasing the volume of international financial capital coming to the city by improving Hong Kong’s corporate governance.

Disclaimer: This Working Paper represents an input into a chapter about corporate governance for a research project looking at Hong Kong’s competitiveness as an international financial centre. The Working Paper aims to provide new and innovative analysis and recommendations in the liberal, academic tradition. The analysis and material in this Working Paper have not been screened or commented upon by any of the research group members. Nothing in this paper reflects the official views of the research group, the University of Hong Kong or the institutions to which the authors affiliate.

Disclaimer

The material in this Working Paper reflects analysis (and our interpretation of that analysis) from over a decade of other authors' work. In some cases, the data we present are over a decade old (though the only data available). We write this paper as a spur to discussion rather than as a definitive consulting report. The reader may not rely on any of the data or analysis in this paper and should do their own analysis (and reach their own conclusions). Some results may even contradict our own or others' previously published findings. This working paper serves as an input into a more definitive analysis which should appear in 2014. We hope you find this paper useful, informative.

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Overview of Recommendations

Recommendation 1: Create a SFC watch-list, based on results of IFRS 8 reporting on *Operating Segments*, of holding companies (non investment companies) which: a) exercise an active role on the board of another company, b) consist of 75% or more of assets in securities (or property) of another corporation (particularly through foreign jurisdictions). The SFC would discuss with company in the first instance and publicise results of its discussion if company did not engage in remedial action.

Recommendation 2: Produce a brochure for dissemination in organisations like the Hong Kong Retirement Schemes Association to educate schemes' investment committee members and trustees about risks of family-controlled firms and rights of shareholders under the HKEx Code of Corporate Governance

Recommendation 3: Prepare a HK\$3 million tender for a research project which quantifies the de facto separation between control and cash rights in Hong Kong's listed companies – and require the methodology and results to be published in a peer-reviewed economics journal.

Recommendation 4: Introduce provisions into the Hong Kong Code of Corporate Governance (new provision section G) requiring listed companies to: a) waive their right to sue for libel against good faith whistleblowers, b) adopt internal policies which prevent retaliation and c) reward good-faith whistleblowers.

Recommendation 5: Scrap the SFC and HKEx concentration announcements and move to a former Webb-Site Concentration database

Recommendation 6: Increase information to shareholders and others about the use of the new Arbitration Ordinance in seeking redress by arbitration instead of derivative actions and encourage documents of incorporation to contain arbitration clauses.

Recommendation 7: Pass regulation allowing for open-ended investment trusts and corporations

Recommendation 8: Encourage shareholder knowledge about the companies a mutual fund holds in the fund's prospectus and incorporate a feedback mechanism into the Code of Corporate Governance specifically focused on facilitating communication between investors and fund managers

Recommendation 9: Disseminate the Model Articles of Association for the Hong Kong Association of Minority Shareholders and encourage interested parties to participate in such an Association.

Recommendation 10: Encourage Directors in the Code of Corporate Governance (particularly non-executive directors) to learn the skills contained in programmes like the UK Institute of Director's Board Evaluation Toolkit

Recommendation 11: Create a HKEx committee with the terms of reference to create an apprentice system for junior directors and a market for directors so they can acquire experience

Recommendation 12: Require Directors – in their appointment contracts -- to disclose their board appointments, the amount of time they spend, and the amounts of time required

Recommendation 13: Introduce a voting scheme for independent directors into the Code of Corporate Governance such that shareholders not among the top 10% shareholders can nominate one or more independent directors.

Recommendation 14: Increase funding to the Companies Registry by HK\$100 million to conduct checks of directors of companies and maintain a disqualified directors' database.

Recommendation 15: Move the new round of concrete Code Provisions onto the Listing Rules

Recommendation 16: Remove requirement for annual CG reports. Keep information online, use internal audit to monitor and propose improvements. Use annual reports for results/outcomes based (rather than inputs-based) reporting.

Recommendation 17: Use Professional Associations to Develop Specific Guidance for Directors in their Industry related to Training Needs, Risk Assessment and other aspects of governance

Recommendation 18: Put to tender a \$2 million scheme to develop a Code of Corporate Governance for non-listed companies and develop a viable business model for providing advice to companies on adopting such a model and propagating it to Company Secretaries.

Last of the Tai-Pans: Improving the Sustainability of Long-Term Financial Flows by Improving Hong Kong's Corporate Governance

Introduction

The quality of corporate governance in Hong Kong will determine the archipelago's ranking among international financial centres in the years ahead. Hong Kong's corporate governance has undergone significant changes in the 2000s -- thanks to revisions to the Companies Ordinance, a new Code on Corporate Governance Practices for Hong Kong's listed companies, and other legal changes. Yet, scandals involving Hong Kong's business elite show that corporate governance has room for improvement. The most recent, involving Barry Cheung Chun-Yuen, who has taken a leave of absence following an investigation into fraud at the Hong Kong Mercantile Exchange, highlights some of the problems.¹ A new form of tai-pans (meaning literally "top class" in Cantonese) control many of Hong Kong's listed and unlisted corporations. Such control -- and the occasional public and private scandals such control has engendered -- stifles foreign investment and ultimately the depth and stability of Hong Kong as a leading international financial centre.

A new wave of corporate governance-related legislative and regulatory reforms will need decrease concentration and family-control of Hong Kong's corporations -- as well as increase transparency and accountability in corporate affairs. In this brief, we describe the current "state of play" related a number of corporate governance-related topics -- compared with countries harbouring other world class financial centres).² Each section covers one aspect of corporate governance -- including family control, self-dealing, shareholder concentration, skills and independence of directors on corporate boards, effect of incorporation abroad on governance, tackling fraud, and revisions to the Hong Kong Exchange's Code of Corporate Governance. We also discuss ways that regulation can help to promote good corporate governance. We provide 18 recommendations throughout our exposition aimed at increasing the volume of finance to Hong Kong corporations and handled by Hong Kong's financial institutions.

Before describing our results, we should point out several caveats related to our study. First, for the purposes of our working paper, we judge corporate governance arrangements based only on their impact on finance to Hong Kong's corporations and financial institutions. We ignore other criteria -- like legal, ethical, and organisational measures of corporate governance.³ Second, we have chosen topics where data suggest positive (rather than normative) changes would affect Hong Kong's rank as an international financial centre. We do not tackle the wide range of other issues -- like

¹ Austin Chiu & Enoch Yiu, *HKMEx founder Barry Cheung sued for HK\$40m debt*, SCMP 3 AUG, 2013, available [online](#).

² These comparator jurisdictions include Germany, Switzerland, the US, UK, Japan, Korea, and Singapore. We have chosen these comparators as they sport cities also rank among the top 10 international financial centres as ranked by the authoritative Y/Zen survey. For these survey results, see Mark Yeandle and Chiara von Gunten, *Global Financial Centres Index 13, 2013*, available [online](#).

³ A wide range of commentators provide metrics for assessing corporate governance. See Angus Young, *Regulating Corporate Governance in China and Hong Kong: Do Chinese Values and Ethics Have a Place in the Age of Globalization?*, *Proceedings of the The Fifth Annual Conference : The Asian Studies Association of Hong Kong*, 2010.

improving the ease of merger and acquisitions -- in order to focus on these issue where research provides relatively clear recommendations. We also do not discuss the corporate governance of financial institutions – as Hong Kong will get plenty of advice about this (and many of her financial institutions will receive dictates from foreign jurisdictions). Third, we write this paper as scholars seeking to make liberal and pro-active recommendations for reform. We do not censor ourselves based on political sensitivities or practicality of implementing the recommendations we propose. Policymakers in Hong Kong will take what they find useful – and leave the rest. Our analysis may also motivate them and regulators in other jurisdictions to generate new ideas in corporate governance.

Where Does Hong Kong Stand in the Ratings (and Why Should We Care)?

Corporate Governance Practices in Hong Kong Worse than Other IFCs

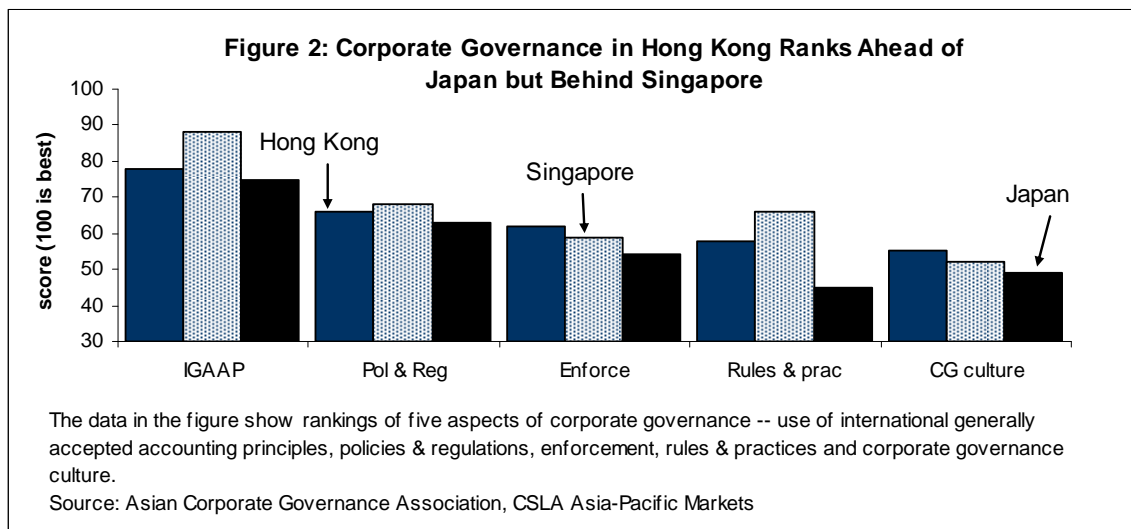
Depending on which corporate governance measure you look at, Hong Kong ranks excellently or poorly. Figure 1 contrasts two different measures of corporate governance – one looking at the business system in general and one at specific corporate governance practices.⁴ According to the World Competitiveness Forum data, Hong Kong ranks second (only behind Singapore). Yet, judging by expert assessment, Hong Kong companies have many reforms to undertake – both in comparison to other countries and in terms of achieving maximum scores on these kinds of evaluations.⁵



⁴ The World Competitiveness Report provides data showing Hong Kong's corporate governance practices in relation to its comparator jurisdictions – using a survey of business executives. The Governance Metrics International data attempt to use expert evaluation of corporate governance practices. Together we hope these provide some insight into Hong Kong's corporate governance practices in the aggregate. Yet, the wide disparities between these data show that social scientists have a long way to go before they will generate reliable and internationally accepted data about corporate governance. See World Competitive Report, 2012, available [online](#). See also Governance Metrics International, available [online](#).

⁵ Throughout this section, we wish to present the data without providing too much interpretation. Thus, we do not speculate about the data presented from Figure 1 to Figure 6.

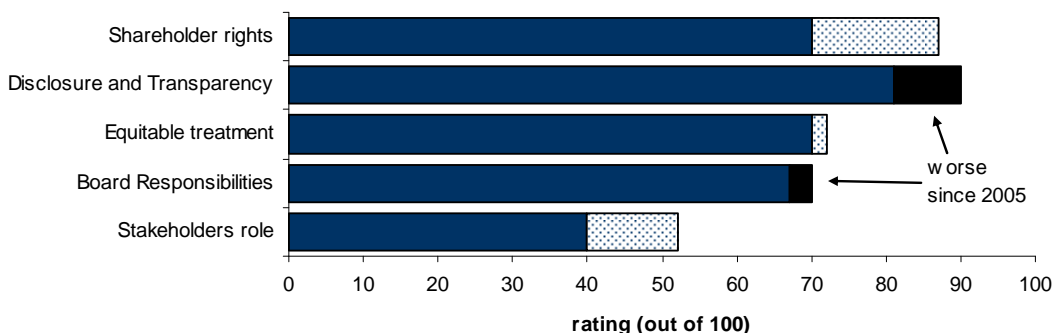
Hong Kong companies' corporate governance practices seem best in the area of accounting and worst in terms of the overall corporate governance culture (whatever that is). Figure 2 shows scores assigned to various aspects of corporate governance in Hong Kong by CLSA analysts – including compliance with internationally generally accepted accounting principles, policies and regulations, internal enforcement, rules and practices, and a corporate governance culture.⁶ Across all given criteria, Hong Kong companies (on average) rate higher than their Japanese counterparts. However, Singaporean companies rate higher on average in compliance with internationally generally accepted accounting principles, adopting “good” corporate governance policies and regulations as well as rules and practices. Particularly noteworthy – Hong Kong does not rate near perfect (with scores of 90 or above) in any of these areas of corporate governance. In areas like rules and practices, a score of 60 leaves much to be desired.



Rankings of more specific aspects of Hong Kong's corporate governance indicate that local companies have improved in some areas and declined in others. Figure 3 shows scores assigned by the Hong Kong Institute of Directors in five areas of Hong Kong companies' corporate governance-related policies and practices. Shareholder rights score a respectable 88% (up from about 70% in 2005). Disclosure and transparency have deteriorated since 2005 from slightly over 90% to about 83% (on a scale from 0% to 100%). Hong Kong companies still rate relatively low in the area of equitable treatment of shareholders, board responsibilities for corporate governance and assigning roles to other stakeholders in corporate governance.

⁶ See CLSA Corporate Governance Watch, 2012.

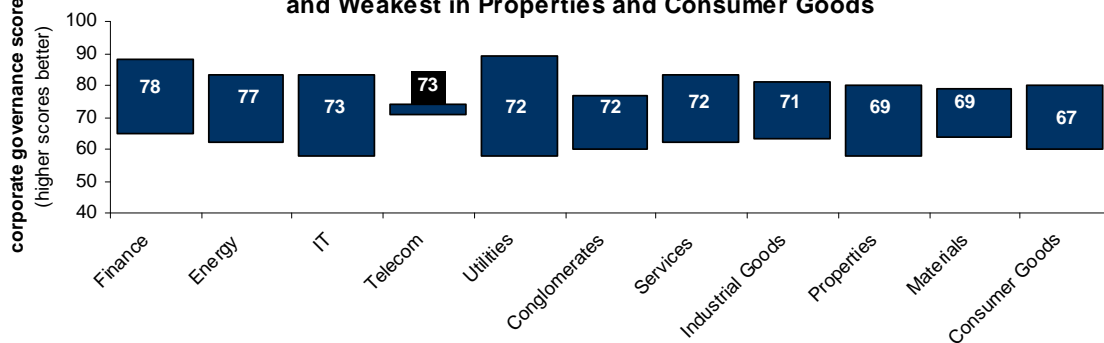
Figure 3: Corporate Governance Worse in Transparency and Board Responsibilities since 2005?



The data in the figure show corporate governance scores for Hong Kong's listed companies for 2012 compared with 2005 in each of 5 corporate governance related areas scored by the Hong Kong Institute of Director's Annual Scorecard. They assess Hong Kong listed companies based on criteria in the OECD's Principles of Corporate Governance and the Hong Kong Exchange's Code on Corporate Governance Practices. Source: Hong Kong Institute of Directors (2013).

Corporate governance policies and practices clearly differ between companies and industries. Figure 4 shows the range of scores for companies in each industry – and the average corporate governance score across industries. Hong Kong utility companies exhibit the widest variation in corporate governance scores – from roughly 60 to close to 90. Telecom companies exhibit the least variation – centring around 73. These scores indicate that corporate governance regulations in Hong Kong (or the lack of those regulations) have led to very different corporate governance practices and policies within and between industries.⁷

Figure 4: Hong Kong Corporate Governance Strongest in Finance and Energy and Weakest in Properties and Consumer Goods



The data in the figure show the range of composite corporate governance scores for Hong Kong's listed companies for 2012 in a range of industries. The numbers in the middle of each bar show the average rating for companies in that particular industry. Source: Hong Kong Institute of Directors (2013).

⁷ The reader interested in more analysis of this figure (like the other figures in this section) should see the source publications. We use this section to present the “stylised facts” and set the stage for our own subsequent analysis.

We care about these scores for three reasons. First, quantitative estimates related to corporate governance provide a quick and easy way to understand a complex issue in complex markets. Second, they allow for international comparisons across time – allowing academics and policymakers to monitor progress and test regulatory hypotheses. Third – and most importantly for our purposes - quantitative estimates related to quality and quantity of corporate governance policies within companies allow us to find correlations with economic performance – like corporate profitability and shareholder investment. What do the data tell us about the link between the quality/quantity of corporate governance policies in Hong Kong and firm performance?

Bad corporate governance likely pulling down performance as an IFC

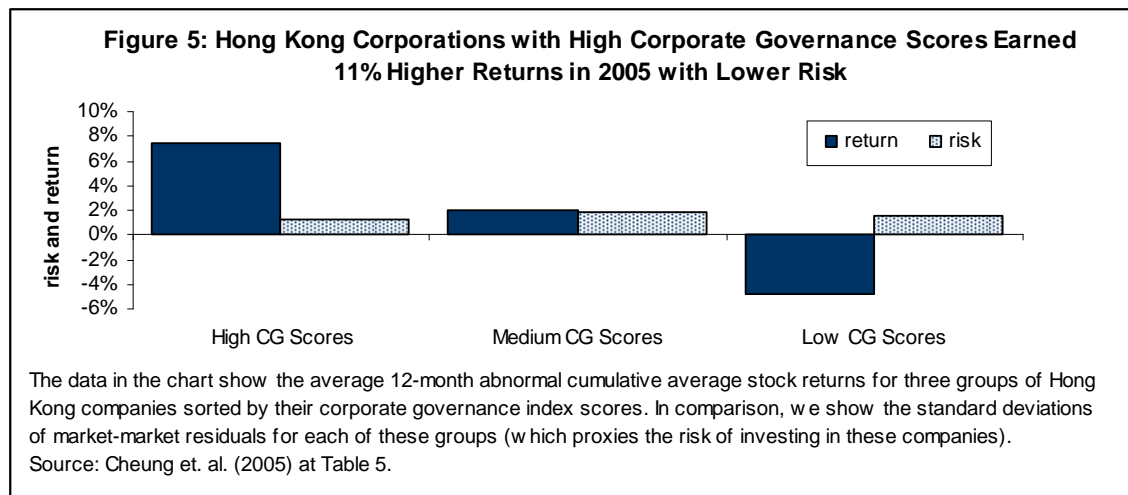
The data strongly suggests that improvements in corporate governance lead to higher market valuations and investment in Hong Kong companies. We do not have direct data on corporate governance indicator scores and equity investment. But we do have data showing the relationship between equity returns, risk (as measured by the standard deviation of those returns) and corporate governance scores. In theory, higher return companies should attract more investment. Figure 5 shows the relationship between equity returns, risks and corporate governance scores for Hong Kong companies in 2005.⁸

In 2005 (the only year we could obtain data for), high corporate governance score companies earned an average abnormal stock return of about 8%.⁹ Their low score colleague companies lost about 4% over the course of 2005. Moreover, investors in the low corporate governance companies took on slightly more risk (about 1% standard deviation in returns) for their poor returns. Some academics and practitioners have argued that Hong Kong's sometimes poor corporate governance practices have helped these companies earn money. The data no longer bear this out.¹⁰

⁸ Cheung and his co-authors conduct regression analysis comparing corporate governance scores they assign to Hong Kong companies and returns – but only for 2005. Obtaining more recent corporate governance scores from the Hong Kong Institute of Directors proves exceedingly difficult. Thus, we could neither repeat these statistical tests, nor report more recent data. See Yan-Leung Cheung, Thomas Connelly, Ping Jiang, and Piman Limpaphayom, *Does Corporate Governance Predict Future Performance? Evidence from Hong Kong*, FIN. MAN., 2011.

⁹ These returns reflects gains (or losses) made by shareholders overall. As we discuss later, insiders may earn higher returns from their investments in the company through expropriating other shareholders.

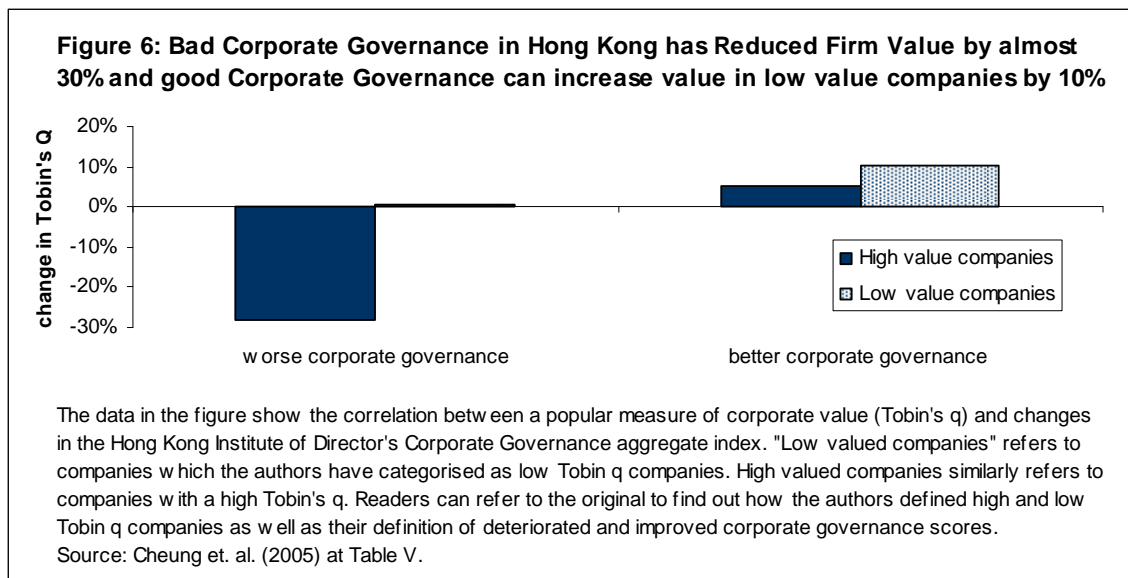
¹⁰ A range of authors periodically show how particular companies in Hong Kong use poor corporate governance practices in order to compete in the regions highly personalised and unstable markets. For example, see Victor Zheng, Siu-Lun Wong & Wen-Bin Sun, *Taking-off through the stock market: the evolution of Chinese family business and Hong Kong's regional financial position*, In Ho, TC and Cheng, L (Eds.), *ECONOMIC DYNAMISM IN THE SINOSPHERES AND ANGLOSPHERES: IDENTITIES, INTEGRATION AND COMPETITION*, Hong Kong: The University of Hong Kong, 2010.



More sophisticated analysis bears out these findings. The simplistic analysis shown above does not control for (account for) a range of market and other factors that can interfere with the relationship between corporate governance and market performance. Yet, more sophisticated analysis supports the same conclusion. Companies with better corporate governance earn higher returns on their investments than those with low corporate governance scores. Figure 6 shows the results of statistical analysis looking at the extent to which changes in corporate governance lead to (or at least correlate with) higher company valuations. As shown, worsening corporate governance scores (as measured by an assessment methodology proposed by the OECD) correlates with an almost 30% reduction in company value for high-value companies.¹¹ For low valued companies, worsening corporate governance made little difference to already low company value. Similarly, improving corporate governance scores made little difference to corporate value for high-valued companies.¹² Improving corporate governance scores, however, did correlate with a 10% improvement in valuations for low-valued companies. **These data imply that high valued companies have the most to lose from deteriorating corporate governance practices, whereas low valued firms have the most to gain from improving practices.**

¹¹ Company value refers to Tobin's q – an indicator which compares (divides) the market value of a company's stock with its equity book value. The reader can think of Tobin's q as the extra value priced into a stock above the simple cost of its assets. Such value can reflect growth opportunities, management skills and other parts of the company which make the company more valuable than the sum of its parts. The OECD methodology refers to mostly binary (yes/no) answers to 86 questions covering the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency as well as board responsibilities.

¹² Prof. Cheung's and colleagues also point to several other conclusions. First, the measure of corporate value does not affect the results. Corporate governance affects corporate value – whether measured as market-to-book value or as Tobin's q. Second, corporate governance changes affect China-based companies as well as large companies listed in the MSCI index. Thus, the trend is not particular to Hong Kong centred companies.



We know that poor corporate governance practices very likely reduce the size of investment into Hong Kong – particularly productive investment in Hong Kong’s companies. We also know that other jurisdictions have better corporate governance practices than Hong Kong. These jurisdictions can provide a model as we think through ways of making Hong Kong a leading international financial centre. The literature identifies a number of topics which we treat in this brief – including the role of family-control, concentrated ownership, the role of independent directors and other issues.¹³

Tackling Abusive Indirect Family Control

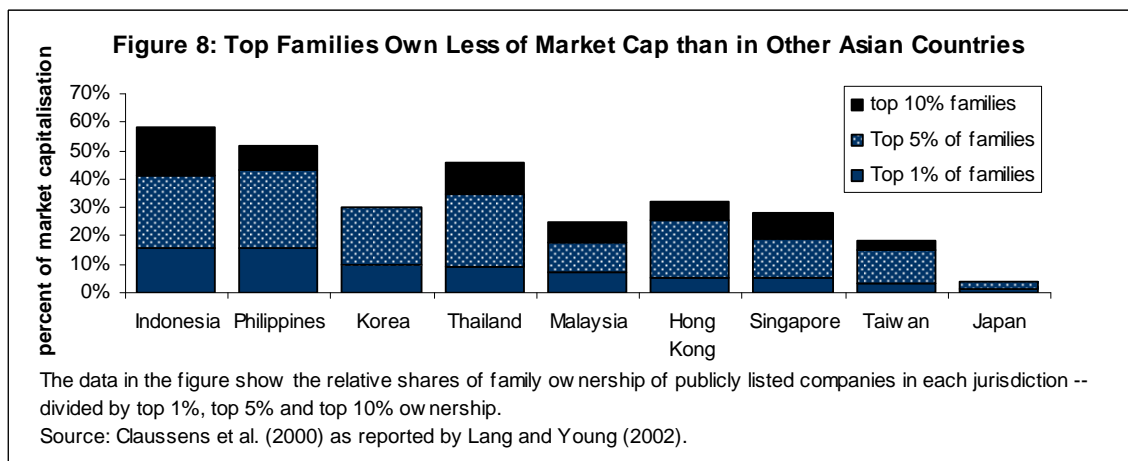
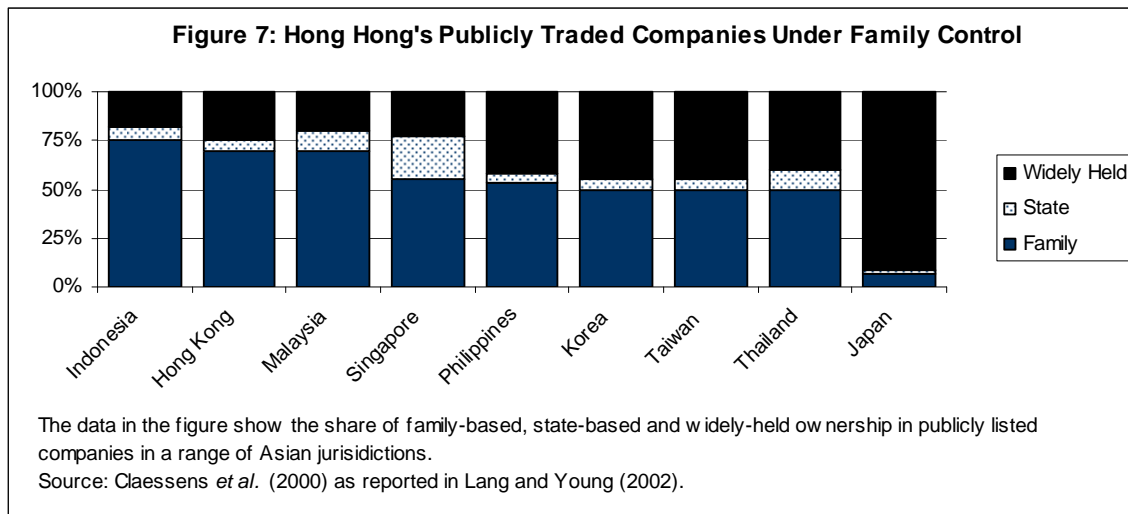
Hong Kong has grown out of family-controlled capitalism

Families have controlled – and continue to control – Hong Kong’s corporations. Figure 7 shows the extent of such ownership.¹⁴ If data from the previous decade serve as any guide, as a share of publicly-traded companies, Hong Kong families control the second highest share of these companies in the region – after Indonesia. Yet, the tai (top) of the tai-pan families control less of these companies than in other jurisdictions. Figure 8

¹³ Claessens and Fan’s overview of corporate governance in Asia remains a landmark piece for understanding the main corporate governance issues confronting Asian countries (including Hong Kong). Much of our thinking for this article also comes from the issues identified by Bebchuk and Weisbach in their recent summary of the literature on corporate governance. See Stijn Claessens and Joseph Fan, *Corporate Governance in Asia: A Survey*, 3 INT’L REV. OF FIN. 2, 2002, available [online](#). See also Lucian Bebchuk and Michael Weisbach, *The State of Corporate Governance Research*, 23 REV. OF FIN. STUD. 3, 2010, available [online](#).

¹⁴ A series of landmark papers from around 2000 provide academics with most of our knowledge about the state of family capitalism in Asia. Academics should repeat the methodology used in these papers to track changes over time. See Stijn Claessens, Simeon Djankov, and Larry Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. OF FIN. ECON. 1–2, 2000. See also Larry Lang and Leslie Young, *Minority Shareholders’ Rights under Family Controlled Regime*, conference paper for the Fourth Asian Roundtable on Corporate Governance: Shareholder Rights and the Equitable Treatment of Shareholders in Mumbai, India on 11-12 November 2002, available [online](#).

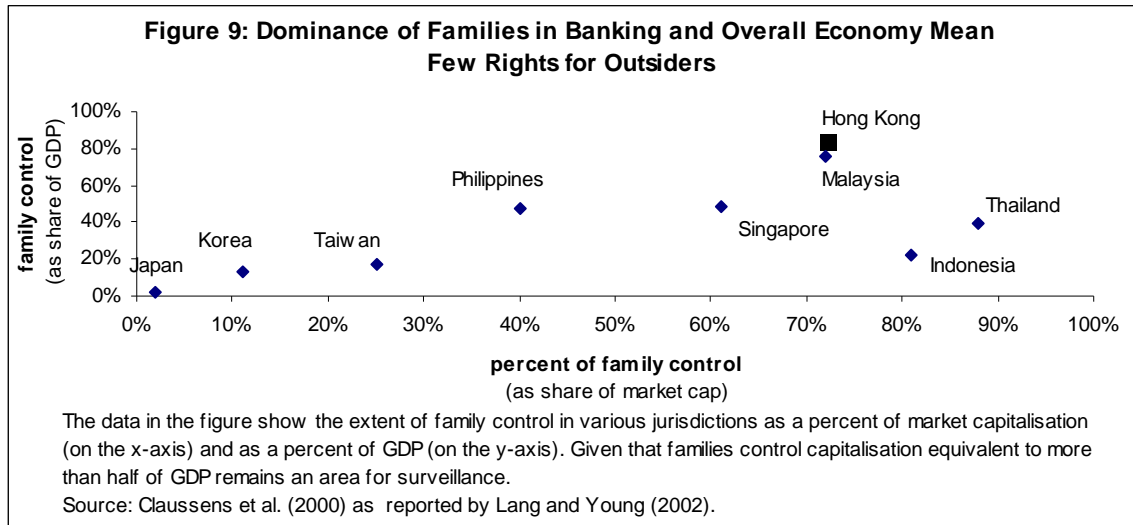
shows the share of top 1%, 5% and 10% richest families in such equity ownership. Hong Kong rates relatively low among Asian countries in terms of the proportion of extremely rich family ownership of equities. Yet, compared with other upper-income jurisdictions like the UK, the US or even Continental Europe, such shareholding still represents a higher proportion of equity valuations than in other countries.



Such family-based corporate governance **risks to crowd out non-family based interests**. Figure 9 shows the correlation between family ownership of listed shares and their share as a percent of GDP. Hong Kong's policymakers should not worry about family dominance of gross metropolitan product if such dominance results from their intrinsic intelligence or risk-taking and encourages other investment. However, if family entrenchment discriminates against or crowds-out productive investment, policy should seek to change the status quo.¹⁵ Without an operational law restricting anti-competitive

¹⁵ By change the "status quo," we mean that regulations should provide dominating families with incentives to crowd-in productive investment and reduce their stake in the overall economy over time as the result of incentives (and not expropriation).

behaviour, such large scale family control as a percent of GDP represents an area of concern.¹⁶

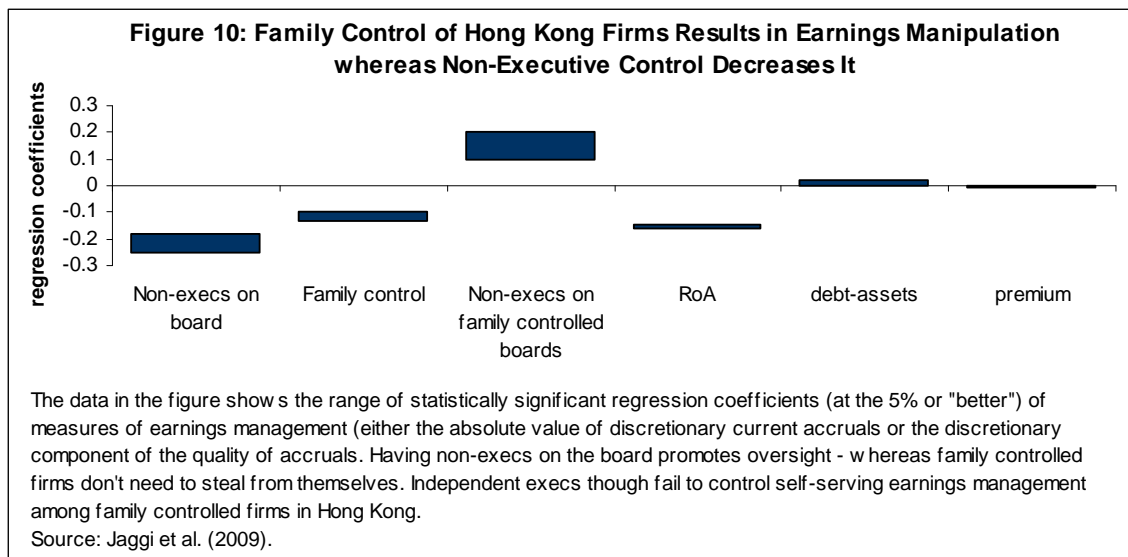


The data also point to a nefarious side of family control in the form of **corporate earnings management**. Jaggi and co-authors find that corporate boards in family-controlled firms fail to effectively function -- leading to likely earnings mis-statements.¹⁷ Figure 10 shows the results of their regression models attempting to find a correlation between family ownership and earnings mis-statements. They claim to have found it. Boards with a higher proportion of independent directors have fewer estimated earnings mis-statements. However, **higher levels of family control of a firm tend to weaken the effect that independent directors have on preventing earnings manipulation.**¹⁸

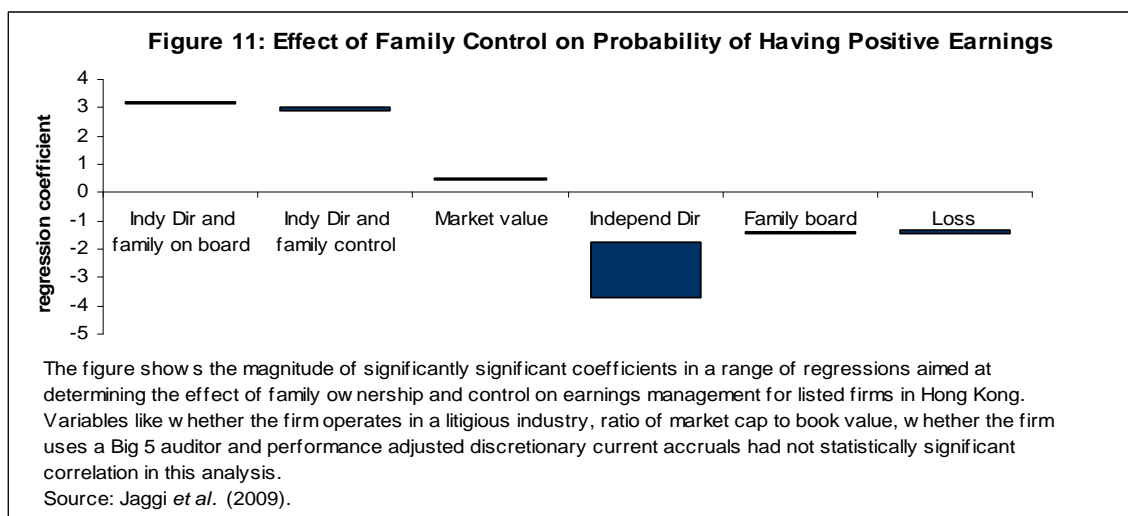
¹⁶ At the time of this writing, the Government has established a new Competition Commission under the 2012 Competition Ordinance. Yet, its powers of enforcement in areas of collusion between family members across companies remain to be seen.

¹⁷ See Bikki Jaggi, Sidney Leung, Ferdinand Gul, *Family control, board independence and earnings management: Evidence based on Hong Kong firms*, 28 J. ACCOUNT. PUB. POL.4, 2010.

¹⁸ The third bar from the left titled “non-execs on family controlled boards” refers to the way that a higher proportion of non-executives on the board interacts (in the statistical sense of the word) with higher levels of family control. The number of independent non-executive directors required by the Hong Kong *Listing Rules* has undergone some change during the time of these authors’ study. A discussion of the way that regulatory change might influence these data would take us outside the scope of this already large working paper. Thus, we just let the data speak for themselves –for now.



Independent directors clearly play a relatively small role in preventing earnings manipulation by family controlled firms in Hong Kong. Figure 11 shows the results of regression analysis aimed at determining whether family controlled boards and family owned companies engage in earnings manipulation. Even when independent directors serve on a company board, companies with strong family control and/or ownership show statistically significantly more earnings manipulation than firms without such ownership and control (as shown by the two left-hand side bars in Figure 11). In firms without such family control, the appointment of independent directors strongly correlates with fewer earnings mis-statements. More worryingly (not shown in the Figure), other evidence suggests that family controlled firms have significantly statistically more insider trading.¹⁹ **These data provide strong evidence that family control serves to weaken the integrity of earnings reporting and other forms of internal control.**



¹⁹ Bikki Jaggi and Judy Tsui, *Insider Trading, Earnings Management and Corporate Governance: Empirical Evidence Based on Hong Kong Firms*, 18 J. OF INT'L FIN. MAN. & ACC. 3, 2007.

Little doubt remains that family-based board-level control leads to serious lapses in Hong Kong companies' internal controls. To summarise the studies we have looked at, Jaggi and Leung find that board-level family control over companies reduces the effectiveness of audit committees.²⁰ Chau and Leung also find such effects – mitigated by the presence of an independent board chairman.²¹ Chen and Jaggi, for their part, find that family control leads to reduced financial disclosure.²² These data – coming mostly from two authors (Jaggi and Leung) over the span of a decade – do not definitely prove that Hong Kong's family controlled corporations engage in criminal activities. However, when combined with other data from jurisdictions showing a similar relation, these studies show that **family-control represents a possible risk indicator for activities like earning management, insider trading, and financial under-reporting.**²³

Other evidence points to expropriation by families (or at least behaviour not conducive to maximising shareholder value). How and co-authors find evidence of expropriation of minority shareholders by family controlled firms. Figure 12 shows the magnitude of various parameter estimates in explaining Hong Kong companies' dividend payment practices. How and co-authors argue that the divergence between cash and control rights in Hong Kong companies has led to the under-payment of dividends by family controlled firms.²⁴ Such under-payment, in their view, reflects the expropriation of minority shareholders. Such expropriation – if true – would lead to less investment (as minority outside investors would fear losing money to such expropriation).²⁵ Clearly, expropriation would threaten Hong Kong's status as a premier international financial centre – requiring regulation to control.²⁶

²⁰ Bikki Jaggi and Sidney Leung, Impact of family dominance on monitoring of earnings management by audit committees: Evidence from Hong Kong, 16 J. OF INT'L ACC., AUDIT & TAX. 1, 2007.

²¹ Gerald Chau and Patrick Leung, The impact of board composition and family ownership on audit committee formation: Evidence from Hong Kong, 15 J. OF INT'L ACC., AUDIT & TAX. 1, 2006.

²² Charles Chen and Bikki Jaggi, *Association between independent non-executive directors, family control and financial disclosures in Hong Kong*, 19 J. OF ACC. & PUB. POL. 4-5, 2000.

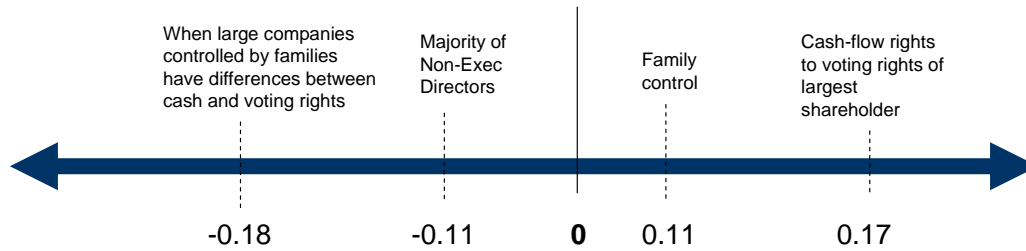
²³ As we discuss later, these data suggest that policy seek to provide incentive-compatible ways of encouraging families to relinquish some control.

²⁴ Janice How, Peter Verhoeven and Cici Wu, *Dividends and Expropriation in Hong Kong*, 4 J. OF ACCOUNT. & FIN. 1, 2008.

²⁵ How et al., as typical of an econometric study, do not show that such expropriation actually occurs – only that the company retains profits susceptible to future expropriation. The authors provide no proof that insiders subsequently expropriate these retained earnings.

²⁶ Goo and Weber argue that – in light of such expropriation – the Hong Kong authorities should put in place laws (at both the legislative and regulatory levels) to protect minority shareholder rights. We present of these remedies later in the paper when we discuss concentration and other topics related to the reform of corporate governance law in Hong Kong. See Say Goo and R. Weber, *The Expropriation Game: Minority Shareholders' Protection*, 33 H. K. L. J. 1, 2003.

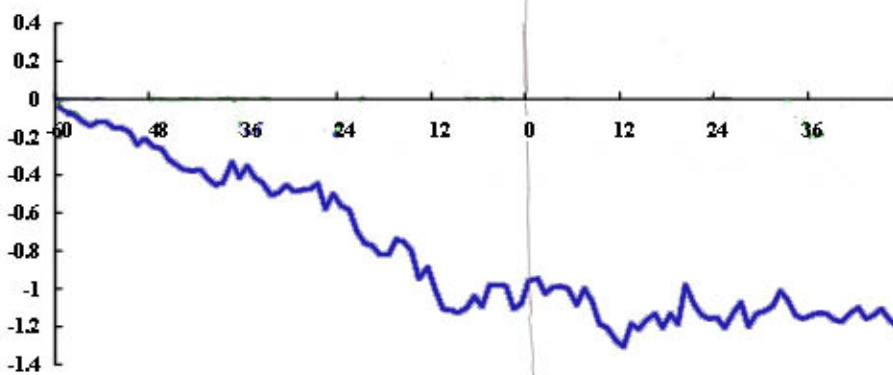
Figure 12: Importance of Various Factors in Deciding Hong Kong Companies' Dividend Paying Practices



The data in the figure show the statistically significant coefficient estimates (at the 5% level) of Tobit regressions on the probability of 324 Hong Kong companies paying a dividend in 2005. When several models show a statistically significant result, we report the average coefficient.
Source: How et al. (2008).

A third harm comes from the **negative influence family disintegration has on equity valuations**. Fan and colleagues document the more than 50% drop in cumulative asset returns 3 years after a family-controlled firm passed to successors.²⁷ They attribute the drop to specific assets which the founders have – which they can not easily pass to others in the family. Regardless of the reasons, the fact remains – family controlled firms pose a risk to equity values. Lack of succession planning represents just one more reason why family control of firms in Hong Kong represents a corporate governance issue which deters potential investment.

Figure 13: Cumulative Average Returns Before and After a Family-Firm Succession in Hong Kong



The figure shows the cumulative average returns (as a proportion of the value of the firm at the date of succession). On average, firms lose more than half their value.
Source: Fan et al. (2008).

A final problem relates to the **pyramid and cross-holding arrangements** which keep these families in power. In a recent review of pyramid structures, Morck and coauthors

²⁷ See Joseph Fan, Ming Jian and Yin-Hua Yeh, *Family Firm Succession: The Roles of Specialized Assets and Transfer Costs*, CU WORKING PAPER 8, available [online](#).

find that structures which allow families to control companies with small shareholdings (such as pyramid and cross-holding) causes very negative economic impacts.²⁸ Some of these effects include agency and entrenchment problems (because they exercise control without putting up much of their own capital), diversion of corporate resources for private use/enjoyment, poor utilization of resources, distorted allocation of capital allocation, reduced rate of innovation, and the political capture of state regulation and lawmaking. Most studies of pyramids and cross-holding structures show they reduce shareholder value.²⁹

Hong Kong – according to old data – appeared to exhibit pyramid and cross-holding control over companies. Figure 14 shows estimates of pyramid and cross-holding ownership in Hong Kong as opposed to other Asian countries.³⁰ The percent of companies engaged in pyramidal or cross-holding structures in Hong Kong used to (and possibly still does) exceed those in most of the more advanced financial markets (like the US and UK). Such pyramid and cross-holding schemes potentially pose three harms to Hong Kong as an international financial centre. First, in theory, they reduce transparency and accountability – as investors do not know who the ultimate owners (and thus controllers) of their investments are. Second, these structures lengthen the relationship between owners, controllers and controlled agents. These longer-linked agency chains increasingly misalign incentives between the workers at the end of the chain (with the incentive to do the least amount of work for the highest amount of pay) and their ultimate principals (who have incentives to produce as much as possible with the least amount of resources).³¹ Third, the circumstantial evidence suggests that pyramid structures in Hong Kong seek to redistribute benefits rather than make up for weaknesses in law-given control.³² The prevailing theory of pyramid structures, cross-holding and concentration suggests that such structures seek to remedy faults in the legal framework which prevent investors from getting their money back. We expect these structures in weak rule-of-law jurisdictions. Yet, as Krishnamurti and colleagues find, we would not expect to see such structures in a jurisdiction like Hong Kong with very effective securities, company,

²⁸ Randall Morck, Daniel Wolfenzon, & Bernard Yeung, Corporate Governance, Economic Entrenchment and Growth, NBER Working Paper 10692, 2004, available [online](#).

²⁹ We can not hope to summarise all these studies in a footnote. Bennedsen and Kasper Nielsen show the effects of pyramiding and provide a more than adequate review of the literature. See Morten Bennedsen and Kasper Nielsen, The Principle of Proportionality: Separating the Impact of Dual Class Shares, Pyramids and Cross-ownership on Firm Value Across Legal Regimes in Western Europe, CIE Discussion Papers with number 2005-14, available [online](#).

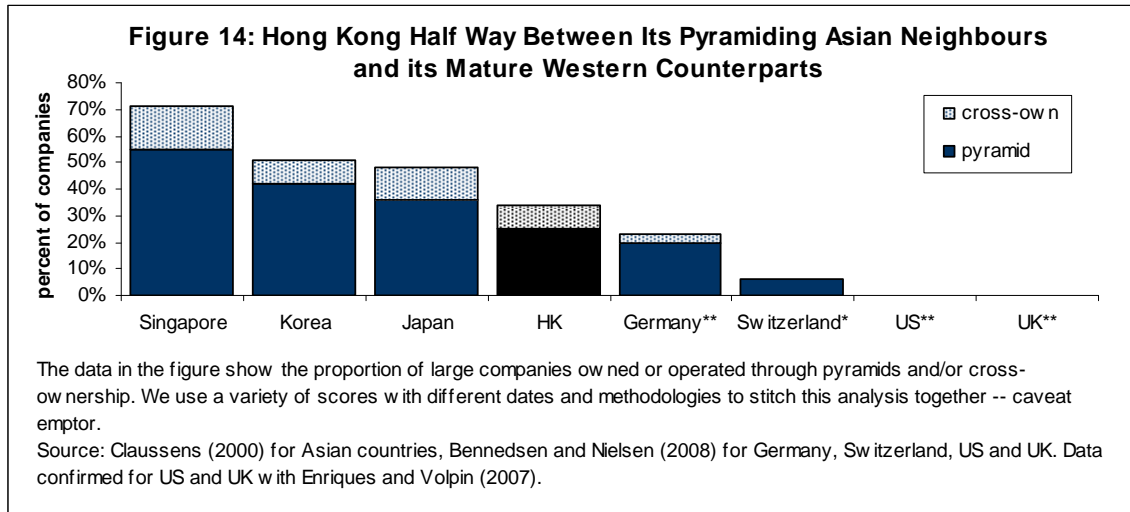
As usual, Fan and colleagues show that China provides the exception that proves the rule. See also

³⁰ See Morten Bennedsen and Kasper Nielsen, Incentives and Entrenchment Effects in European Ownership, 34 J. of Bank. & Fin. 9, 2010. See also Luca Enriques and Paolo Volpin, Corporate Governance Reforms in Continental Europe, 21 J. of Econ. Perspect. 1, 2007.

³¹ For a discussion of the effect such pyramiding and cross-holding relationships have had in China, see Chao Chen and Song Zhu, Corporate Pyramid, Ownership Structure, and Firm Performance: Evidence from China, available [online](#).

³² Academics have theorised that pyramids and business groups help businesspersons co-ordinate and control their resources when laws fail to protect these interests. Pyramid structures (as we have discussed) also may serve to channel resources toward particular shareholders. As such, the existence of pyramidal and highly linked business structures may serve as an indicator of a legal environment (where arm's length contracts fail to provide for sufficient control over business transactions), of an attempt by some shareholders to use control to redistribute the benefits of economic activity in their favour – or both.

property and contract law.³³ Something else – besides self-protection – must be encouraging Hong Kong’s families to exercise such control.



Regulating families per se and doing nothing are not options

Family control clearly restrains Hong Kong’s role as an international financial centre. The econometric evidence shows that family firms attract far less portfolio investment -- particularly from abroad – than non-family dominated firms. Such evidence strongly suggests that family control (at least at this point in time) hinders rather than fosters Hong Kong’s role as an international financial centre.³⁴ Policymaking will need to find a way to reduce family control by encouraging broader participation in these companies rather than trying to wrestle control away from families.

One option consists of engaging in risk-based enforcement of accounting and securities regulations, giving family-ownership a higher risk-weighting. The econometric evidence suggests that families tend to engage in practices generally harmful for broader market development. Instead of targeting the underlying cause (because of the political and/or other difficulties), policymakers could decide to target the effects of family ownership. Such effects include earnings management, insider trading, possible appropriation of minority shareholder interests and other effects.

The Securities and Futures Commission (SFC), in its normal market surveillance operations, could place heavier weight on family-controlled firms. That means increased inspection as well as closer analysis of securities transactions and other transactions conducted by these firms. Such profiling has the disadvantage of shifting family

³³ See Chandrasekhar Krishnamurti, Aleksandar Sevic and Zeljo Sevic, Legal Environment, Firm-level Corporate Governance and Expropriation of Minority Shareholders in Asia, 38 Econ. Change and Restruct. 1, 2005.

³⁴ Evidence from other jurisdictions supports this view. For example, Morck and Yeung find evidence in their econometric survey that large scale control of a country’s corporations by a few leading families tends to reduce economic growth. See Randall Morck and Bernard Yeung, *Family Control and the Rent-Seeking Society*, 28 ENTREPREN. THEO. & PRACT. 4, 2004.

ownership underground.³⁵ Moreover, profiling against firms based on aggregate statistical profiles may discriminate against specific firms who have committed no offences. We thus do not recommend this activity.

Another option consists of doing nothing and letting centrifugal forces of families pull these holdings apart. The international evidence suggests that the problem of family-controlled firms (operated for the benefit primarily of those families) will disappear by itself. Most upper-income jurisdictions have evolved from family capitalism to widely dispersed ownership and arms-length control.³⁶ Family business groups – like those supposedly characterised by Hong Kong’s controlling interests – should lose interest in family-based control as investor protection improves.³⁷

Media analysis of Hong Kong family holdings suggest that inheritance and family disputes will cause family-stakes in their companies to decrease over time. *The Economist* takes a strong (as usual) view on Hong Kong companies. The by-line of their 2011 article states their position clearly “As ageing tycoons die, their heirs are feuding and their empires are at risk.”³⁸ They present many of the major (now elder) business family heads and show possible heirs. These family heads include Ka-Shing Li, Siu-Hing Kwong, Robert Kwok, Yu-Tung Cheng, Stanley Ho, Che-Woo Lui, David Li and Gordon Wu.³⁹ Even if succession does not break apart these companies, then simple old age will prevent family heads from governing the large business holdings to their own advantage.⁴⁰ In another media view of family-centred control over Hong Kong’s economy, the new competition law promises to remove the market power which these family heads exploited through poor corporate governance arrangements in order to earn rents.⁴¹ Yet, these views fail to show how the corporate governance regime which would evolve to fill the gap left by these family heads would perform better than those left behind by the aging family group heads.

³⁵ As we show in this working paper, actual ownership of Hong Kong’s companies remains opaque by international standards. Real owners and controllers can use nominee directors and front-companies to control their business interests.

³⁶ Julian Franks, Colin Mayer, Paolo Volpin and Hannes Wagner, Evolution of Family Capitalism: A Comparative Study of France, Germany, Italy and the UK, available [online](#).

³⁷ For a theory of family business groups and the rationale for these groups in Hong Kong and other Asian countries, see Heitor Almeida and Daniel Wolfenzon, A Theory of Pyramidal Ownership and Family Business Groups, 61 J. of Fin. 6, 2006.

³⁸ Economist, *Dusk for the patriarchs*, 3 February 2011, available [online](#).

³⁹ Following the English convention, we show first names first and last names last – leading to references sometimes hard on the ear (like the person ubiquitously known as Li Ka-Shing).

⁴⁰ Te-Ping Chen, *Hong Kong's Tycoons Under Attack*, available [online](#).

⁴¹ Eddie Leung and Pepe Escobar, The Rulers of the Hong Kong Game, Asia Times, Aug 3, 2012, available [online](#).

Exposing family pyramids to disinfecting sunlight

Hong Kong's upper-income peers take two routes toward mitigating extreme and unfair family-based control of large economic interests.⁴² The first approach, generally used on the Continent, various regulatory measures seek to reduce or control the separation of cash and control rights which allows families undue and lasting multi-generational influence over their corporate legacies. The second approach, generally used in the UK and US, consists of extensive reporting requirements.⁴³ As long as pyramidal and cross-holdings are reported to the stock exchanges, then investors can engage in socially optimal oversight.

Hong Kong should adopt a version of the US-UK model, tailored for Hong Kong's own specific circumstances. In the US and UK, firms can make such disclosures – mostly because such holding structures do not already exist.⁴⁴ In Hong Kong, such structures underpin concentrated and family control (if you believe the most recent data). We thus recommend that the SFC creates a watch-list of these holding (and cross-holding) structures as a way to add transparency into Hong Kong corporate relations. Based on these companies' own IFRS 8 reporting, these lists would: a) report which corporate structures have the capacity to act for others and b) report when corporate entities act on behalf of others.⁴⁵ They would only report on cases the SFC found disturbing after first consulting with the corporate organisation involved. Many EU Member States with significant pyramid structures in their own financial markets use such an approach.

Recommendation 1: Create a SFC watch-list, based on results of IFRS 8 reporting on *Operating Segments*, of holding companies (non investment companies) which: a) exercise an active role on the board of another company, b) consist of 75% or more of assets in securities (or property) of another corporation (particularly through foreign jurisdictions). The SFC would discuss with company in the first instance and publicise results of its discussion if company did not engage in remedial action.

⁴² Shearman & Sterling, *Proportionality Between Ownership and Control in EU Listed Companies: Comparative Legal Study*, available [online](#).

⁴³ A recent consultation about pyramids in the EU noted that “since the main problems with pyramid groups seemed to come from a lack of transparency, the investors' risk concerning pyramidal groups could be effectively met by the corresponding transparency requirements in the documents to be published for stock exchange listing.” By 2011 when the EU Green Paper outlining the EU Corporate Governance Framework came out, it made no mention of pyramids or family groups. See Synthesis of the responses to the Communication of the Commission to the Council and the European Parliament "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" – COM (2003) 284 final of 21 May 2003, available [online](#). See also Green Paper: The EU corporate governance framework, COM(2011) 164 final, 2011, available [online](#).

⁴⁴ Bank and Cheffins show that pyramid structures have never been popular in the US. The lack of these kinds of structures comes from cultural factors more than cost and benefit ones. See Steven Bank and Brian Cheffins, *The Corporate Pyramid Fable*, 84 *Bus. Hist. Rev.* 3, 2010.

⁴⁵ IFRS 8 refers to the most recent incarnation of the International Accounting Standards Board rules replacing IAS 14 and requiring companies to provide reports broken down by entity, major products/services, geographical areas and so forth.

Encourage Hong Kong pensions to engage in governance-related activism

The historical evidence shows that pension investments in the domestic stock markets lead to wider-spread holdings of companies and improved oversight over these companies. Sweden provides a recent and useful example for Hong Kong – both because of its size (economically and in population terms) and the rapid government-led development of a domestic pension industry. Henrekson and Jakobsson, in their study of Sweden, document two factors that contributed to the large-scale reduction of family ownership and control in Sweden’s traditionally family dominated corporations. Foreign acquisitions of Swedish firms and large investments made by the national and company pension funds helped to disperse share ownership and reduce the concentration of family ownership.⁴⁶ Moreover, Mariassunta and Laeven provide strong (statistically significant) evidence that pension fund ownership of Swedish shares led to increased value and better corporate governance (as measured by representation on nomination committees).⁴⁷ They also find a decrease in the premiums commanded by the largest shareholder(s). In a concurrent study looking at the actual effect of Swedish pension fund participation on corporate boards, Engvall and Holmberg find that these pension funds particularly affect board turn-over and nomination committee decisions in smaller firms where their ownership buys a larger proportion of the shares.⁴⁸

Increased investment by Hong Kong’s pension schemes into local companies could help reduce harmful family control over family-owned and controlled firms. However, their small share of investment in local equity restricts their ability to promote the good corporate governance practices which will ultimately increase their rates of return.⁴⁹ Figure 12 shows the estimated equity investment in Hong Kong shares by regulated pension schemes in the mandatory pension fund.⁵⁰ While investment by the mandatory pension schemes has increased over the years in local equities, such investment still represents a microscopic part of total equity investment. On their own, these schemes will have little bargaining power to militate for better corporate governance.

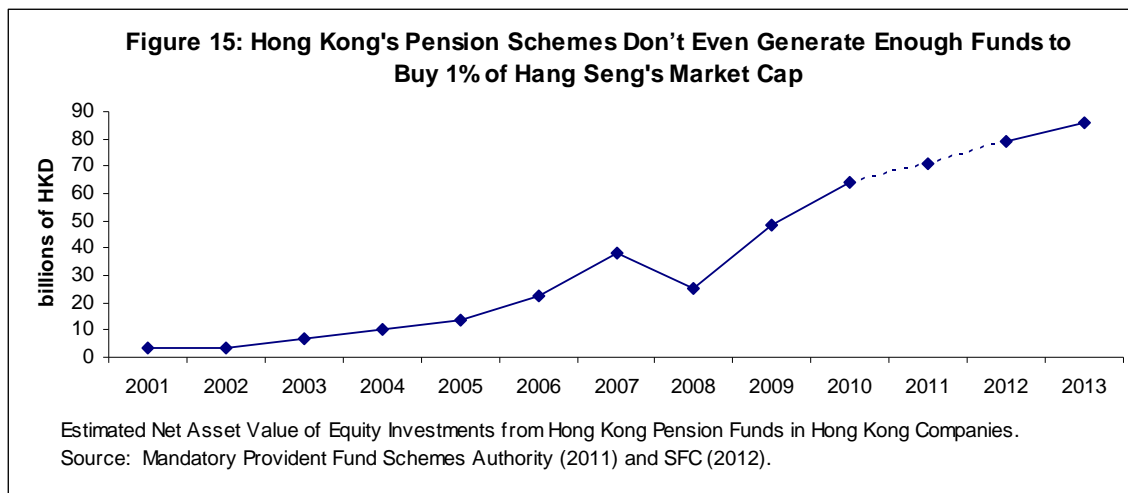
⁴⁶ See Magnus Henrekson and Ulf Jakobsson, *The Swedish Model of Corporate Ownership and Control in Transition*, SSE/EFI WP SERIES NO 521, 2003, available [online](#).

⁴⁷ See Giannetti Mariassunta and Luc Laeven, *Pension Reform, Ownership Structure, and Corporate Governance: Evidence from Sweden*, CEPR WP DP6489, 2007, available [online](#).

⁴⁸ See Magnus Engvall and Christian Holmberg, *Nomination Committees, Pension Funds and Board Turnover: Evidence from the Swedish Code of Corporate Governance*, 2007, available [online](#).

⁴⁹ While we know that pension investment often corresponds with higher rates of return in particular public companies, we do not know if such returns come from their shareholder activism. The evidence is decidedly mixed – with authors like Del Guercio and Hawkins finding that pension fund activism helps improve returns in the companies they invest in. Woidtke finds that pension fund activism may not benefit other shareholders. See Diane Del Guercio and Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, J. OF FIN. ECON. 52, 1999. See also Tracie Woidtke, *Agents Watching Agents?: Evidence from Pension Fund Ownership and Firm Value*, 63 J. OF FIN. ECON., 2002.

⁵⁰ The main pension schemes in Hong Kong consist of the Mandatory Provident Fund (a mandatory scheme) and the Occupational Retirement Schemes Ordinance funds (a voluntary scheme). We show the value of investment by the mandatory fund only. The estimated investment in the much larger voluntary scheme would only about double the estimated equity stake these funds have in local companies. See *Mandatory Provident Fund Schemes Authority, A 10-Year Investment Performance Review of the MPF System (2000-2010)*, available [online](#). For 2013 data, available [online](#).



Hong Kong pensions could not play a crucial role in improving corporate governance among Hong Kong's listed (and unlisted) companies. With only HK\$2 billion on average per Mandatory Pension Fund scheme, the amount of money each fund has at its disposal remains small.⁵¹ The legal ability of pension trustees and investment board members to militate for better corporate governance in the firms they invest in remains dubious at best. Their duty under Hong Kong's trust law towards their beneficiaries may not extend to using investment criteria which would potentially lower returns and incur additional costs.⁵²

Within the confines of Hong Kong law and practice at present, we recommend giving pension scheme trustees a brochure describing the risks of investing in companies with high shareholder concentrations. The SFC already issues regular warnings about the risks of high equity ownership concentration.⁵³ Hong Kong pension investment committee members and trustee do not need to engage on a campaign of activism. However, a clear understanding of their rights as shareholders and ways to exercise them serves their beneficiaries' interests.⁵⁴

Recommendation 2: Produce a brochure for dissemination in organisations like the Hong Kong Retirement Schemes Association to educate schemes' investment committee members and trustees about risks of family-controlled firms and rights of shareholders under the HKEx Code of Corporate Governance

⁵¹ *Id.* We have divided funds under management by the number of funds to arrive at your highly biased average.

⁵² Trustees have a duty to ensure their beneficiaries receive the most return for their investment. By requiring the companies they invest in to follow policies which may lower these returns, such requirements may actually breach the investment trustee's duty to his or her investor.

⁵³ SFC, High shareholding concentration announcements, available [online](#).

⁵⁴ Eventually, some of these funds may accumulate enough shares to ask for Board seats. When such a time comes, the next generation of corporate governance advisors can advise these pension fund institutional investors on ways of encouraging the good corporate governance practices which will help their funds as well as the Hong Kong family-owned businesses they invest in.

Any further rulemaking in this area may impair trustees' obligation to maximise returns for their shareholders. However, if a Hong Kong Association of Minority Shareholders starts to function (see separate recommendation about this), the Association could work to find ways that these schemes could co-ordinate on particular types of activism. For example, if several trustees feel strongly about an issue, the Association could serve as a forum for them to co-ordinate voting as a block. A database on shareholder concentration (see separate recommendation) would also help these pension investment managers in understanding the risks of investing in concentrated family enterprises.

One other measure might be to fund research by Hong Kong's universities about the effect the separation of cash and control rights actually has on Hong Kong's companies. In fact, we know little about the effect that family ownership – and the corporate governance of family firms – has on corporate valuations. We do not know for sure whether the various mechanisms families use to separate profit-sharing from control actually represent a policy issue.⁵⁵ We also do not know how informal relationship-based contracts between shareholders in Hong Kong replace the official one share-many votes schemes in other upper-income jurisdictions. With a method of measurement such as governance and assurance by the academic community about the validity of such an approach, Hong Kong's policymakers can make more reliable policy about family-controlled firms.

Recommendation 3: Prepare a HK\$3 million tender for a research project which quantifies the *de facto* separation between control and cash rights in Hong Kong's listed companies – and require the methodology and results to be published in a peer-reviewed economics journal.

Reducing Self-Dealing By Connected Parties

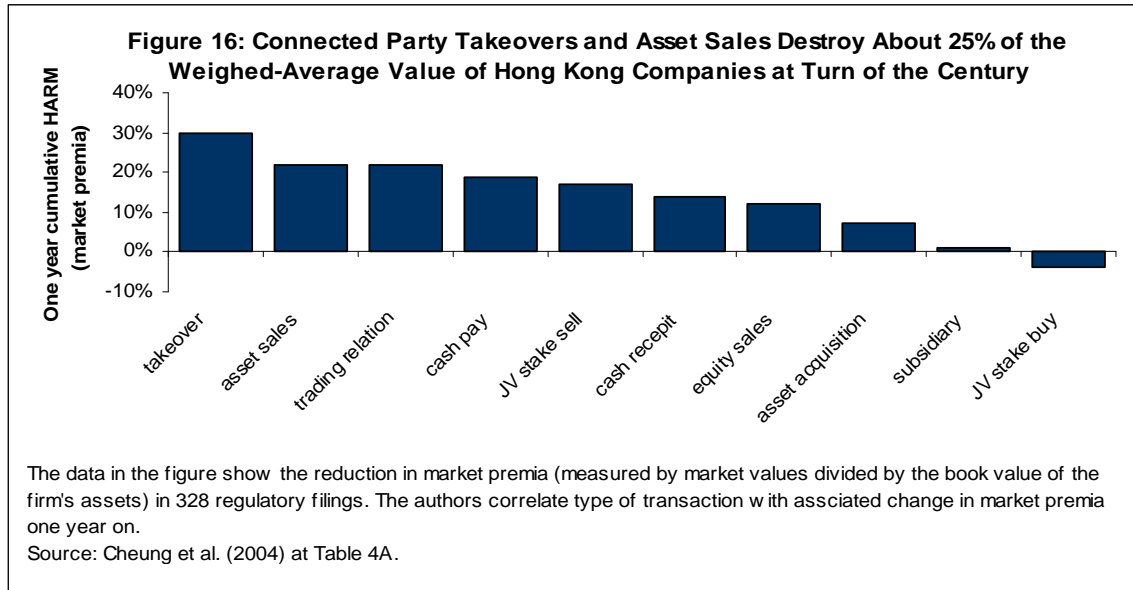
Connected parties do more harm than good

Connected party transactions clearly reduce shareholder value in Hong Kong. Figure 16 shows the reduction in market premia (the excess market value of the firms' shares over and above their book value). Cheung and colleagues want to know the extent to which Hong Kong directors engage in tunnelling, propping and expropriation. To measure the extent of expropriation by "insiders," they measure the extent to which a range of connected party transactions affect firm value in Hong Kong. The figure shows the summary results of their findings. When connected parties engage in takeover (M&A) activity, firm value decreases by about 30%.⁵⁶ Asset sales between connected parties tend to reduce firm value (as measured by the market premium over book value) by about

⁵⁵ These mechanisms include multiple voting right shares (of shareholders with instructions to vote one-share one-vote shares a certain way), non-voting shares, pyramid structures, priority shares, ownership ceilings, golden shares, cross-share holdings and so forth. In the Hong Kong context, these structures likely involve informal tacit agreements rather than formal legal shareholder structures. As such, research will need to "translate" the formal structures identified in other jurisdictions into their Hong Kong informal relationship-based context.

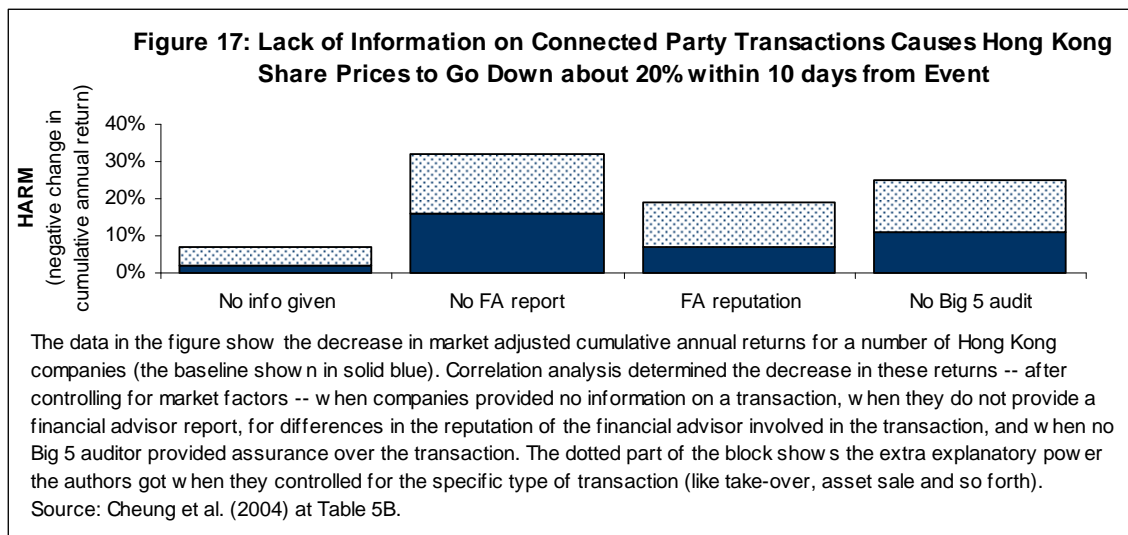
⁵⁶ We show decreases in firm value in the figure as positive numbers to provide the reader with intuitions about the harms to the company involved in these activities.

20%.⁵⁷ Such transactions suggest tunnelling – as most transactions should aim to increase (rather than decrease) firm value. Such data suggest that corporate governance arrangements do not protect those who contribute the capital that insiders spirit away through connected party transactions.



Lack of information about connected party transactions has also resulted in the destruction of firm value in Hong Kong. Figure 17 shows the reduction in firm value (expressed in positive numbers as a harm) due to several informational constraints related to connected party transactions. When the company provided no public information about a connected party transaction, cumulative annual returns on average fell by about 10%. When the financial advisor involved in the transaction provided no report, firm value fell in the authors' sample by about 30%. These data clearly show a value to corporate governance relationships which promote the publicising of corporate transactions – particularly when connected parties are involved.

⁵⁷ Book value represents the value of all assets at their cost.



We think that the best way of controlling related party transactions in Hong Kong consists of strengthening minority shareholder oversight (through a HAMS-like structure) and derivative actions.⁵⁸ The present system relies on the goodwill of corporate directors and executives to voluntarily disclose their related party transactions. We think that increased soft law requirements aimed at requiring such disclosures will simply encourage these individuals to better conceal these transactions. As such, only harmed parties – acting in the company’s interest *as well as their own interest* – have the incentives needed to police such harmful related party transactions. Individuals close to these transactions (dock loader, consignment recipients, and so forth) also have incentives to protect the corporations for which they work. We thus see whistleblowing – leading to directors’ actions and potentially derivative action -- as the best remedy in Hong Kong for harmful related-party transactions.

Vetting is for animals, not connected parties

Hong Kong has one of the most extensive and restrictive connected persons regimes in the world. The regime covers a wide range of transactions (see Figure 18). However, the regime relies mostly on the goodwill of executives in companies to self-declare connected party transactions. Such goodwill consists of announcements made by Hong Kong’s listed companies which the HKEx “pre-vets” (no longer in use) or “post-vets” (still in use).⁵⁹ Under such a post-vetting regime, the HKEx receives announcements of connected party transactions and determines their appropriateness (in themselves and for formal announcement to the companies stakeholders).⁶⁰ Other mechanisms including pre-

⁵⁸ HAMS refers to proposals floated in the early 2000s for a Hong Kong Association of Minority Shareholders. We discuss later in this brief how to establish such an Association.

⁵⁹ For a brief discussion of the vetting regime, see Hong Kong Institute of Chartered Secretaries, *A Comparative Study of Continuing Disclosure in Hong Kong and the PRC: Implications for Cross Border Listings on H-share and A-share Markets*, 2008, available [online](#).

⁶⁰ HKEx, *Guide on Practices and Procedures for Post-Vetting Announcements of Listed Issuers and Handling Matters Involving Trading Arrangements Prior to Publication of Announcements*, available [online](#).

vetting and post-vetting by the Board and by shareholders themselves – in the form of announcements and authorisations.⁶¹

The SFC has recently declared its desire to take over some of the self-regulatory vetting done by the Exchange.⁶² Yet, whether the SFC or HKEx “vets” connected party announcements misses the point. Any regime which requires connected parties to “out” themselves does not represent an incentive-compatible rule. In other words, connected parties engaged in self enrichment at the expense of other shareholders have little incentive to declare these transactions under current Hong Kong law. We squarely believe in what the OECD calls ex-post enforcement in order to minimise the harms from self-serving connected party transactions.⁶³

Figure 18: Hong Kong Exchange Rules on Dealing with Connected Party Transactions

Who is a connected person? A director, chief executive or substantial shareholder of a listed company, a previous director or most importantly “any associate of a connected person.”⁶⁴

What transactions are covered? In some cases connected transactions can cover transactions between the company and a person who is not a “connected person” (in the sense defined by the Listing Rules).⁶⁵ The Listing Rules also classify connected transactions by whether they involve a one-off transaction or continuing (repeated) transactions.⁶⁶

What about borrowing or giving money? Financial assistance can be given to a listed company by a connected party if given on normal commercial terms and the company does not pledge its own assets as security. Otherwise, the company must disclose it and seek independent shareholder approval. If the listed company gives (rather than takes) money, the company will need to disclose and seek shareholder approval if the financial assistance does not come on normal commercial terms and exceeds certain minimum limits.

How do the Listing Requirements differ from OECD practice? Many jurisdictions require an independent financial advisor to give advice on connected party transactions or have independent director(s) permission to engage in such transactions. In other words, self-enforcement still appears to be the norm in the OECD as well as Hong Kong.⁶⁷

⁶¹ The OECD refers to such announcements and authorisations as ex-ante enforcement mechanisms (for preventing self-serving connected party transactions). Many jurisdictions in Asia use these mechanisms – usually with little effect on preventing abuses. See OECD, Guide on Fighting Abusive Related Party Transactions in Asia, available [online](#).

⁶² Enoch Yiu, *SFC craves exchange's vetting role on listings*, SCMP, 05 August, 2012, available [online](#).

⁶³ The eponym ex-post misleads – as the threat of actual enforcement will likely dissuade self-serving far more than ex-ante announcements which would scarcely lead to actual investigation by shareholders or securities regulators.

⁶⁴ SEHK Listing Rule 1.01,19A.04. The associate rules get complex. For a diagrammatic exposition of connected parties in connected transactions, see HKEx, *Guide on Connected Transaction Rules*, available [online](#).

⁶⁵ SEHK Listing Rules at 14A.13.

⁶⁶ *Id* at 14A.14.

⁶⁷ OECD, Related Party Transactions and Minority Shareholder Rights, available [online](#).

How Can Regulators and Others Find Out about Transactions that Do Not Comply With the *Listing Rules*? Few mechanisms exist to “out” these transactions – other than the goodwill of management. Internal and external audit seems to serve as the key method of detection (though this depends on risk assigned by the internal audit department).⁶⁸ Minority shareholders who find out about these activities can sue on behalf of the company if they can prove damages. In theory, whistleblowers who saw the transaction can also blow the whistle. However, this is unlikely as they get no protection and have little motive under existing Hong Kong law.

Source: Hong Kong Institute of Chartered Secretaries (2008). We have translated legalistic language into a simplified version for non-lawyers. See original for exact language.

Creating a Whistleblowers regime for connected party transactions

Whistleblowing works – in preventing harmful connected party transactions and other finds of corporate fraud. Echoing a rich literature about the detection of corporate fraud, Dyck and co-authors use statistical analysis in the US to show that whistleblowing detects far more fraud than regulatory agencies like the SEC.⁶⁹ Whistleblowing programmes increase firm value by reducing self-dealing, providing companies with strong incentives to detect and prevent self-dealing among corporate executives, owners and directors.⁷⁰ Experience from the US shows that providing employees and others with internal recourse (complaint mechanisms) before they use external channels (like regulatory agencies and the media) clearly allows companies to tackle self-dealing.⁷¹

Hong Kong does not have whistleblowing legislation – and probably will not anytime soon. The lack of black letter law encouraging companies in Hong Kong to protect whistleblowers has resulted in a lack of such programmes.⁷² Figure 19 shows data from Hong Kong’s companies about their whistleblower protection practices.

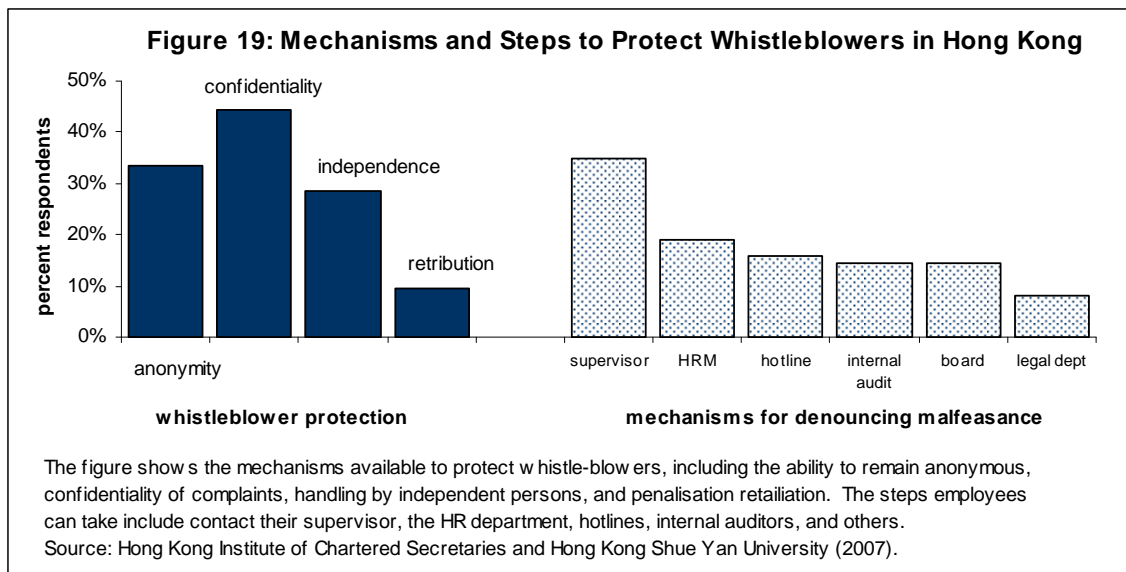
⁶⁸ Under internal audit rules, the company management can require internal auditors not to disclose this information.

⁶⁹ See Alexander Dyck, Adair Morse, and Luigi Zingales, Who Blows the Whistle on Corporate Fraud?, 65 J. of Fin. 6, 2010.

⁷⁰ See Robert Bowen, Andrew Call, and Shiva Rajgopal, *Whistle-Blowing: Target Firm Characteristics and Economic Consequences*, 85 ACCOUNT. REV. 4, 2010.

⁷¹ See Gladys Lee and Neil Fargher, *Companies’ Use of Whistle-Blowing to Detect Fraud: An Examination of Corporate Whistle-Blowing Policies*, 114 J. OF BUS. ETHICS 2, 2013.

⁷² Chris Fordham, *Hong Kong must protect corporate whistle-blowers to check fraud*, SCMP 7 May 2013, available [online](#).



In order to promote wider-spread adoption of these practices, we recommend in the first instance to require listed companies to adopt whistleblower protection provisions. Such an approach – incorporating these protections in the Code of Corporate Governance – serves three purposes. First, adoption as a regulatory (a self-regulatory measure) increases speed of adoption – allowing Hong Kong’s companies to reap the increased investment concomitant with such protections. Second, adoption under Code of Corporate Governance allows companies who already have such programmes to “comply or explain.” Such comply or explain (and particularly the explanations) will help prepare the empirical basis for eventual lawmaking. Third, introducing these provisions as a listing requirement (either directly or first in the “voluntary” Code of Corporate Governance) will prepare companies for the inevitable whistleblower legislation that will come. Indeed, many of the companies operating in Hong Kong already must comply with whistleblower protections laws at home in the form of Sarbanes-Oxley and/or the Public Interest Disclosure Act.⁷³

Recommendation 4: Introduce provisions into the Hong Kong Code of Corporate Governance (new provision section G) requiring listed companies to: a) waive their right to sue for libel against good faith whistleblowers, b) adopt internal policies which prevent retaliation and c) reward good-faith whistleblowers.

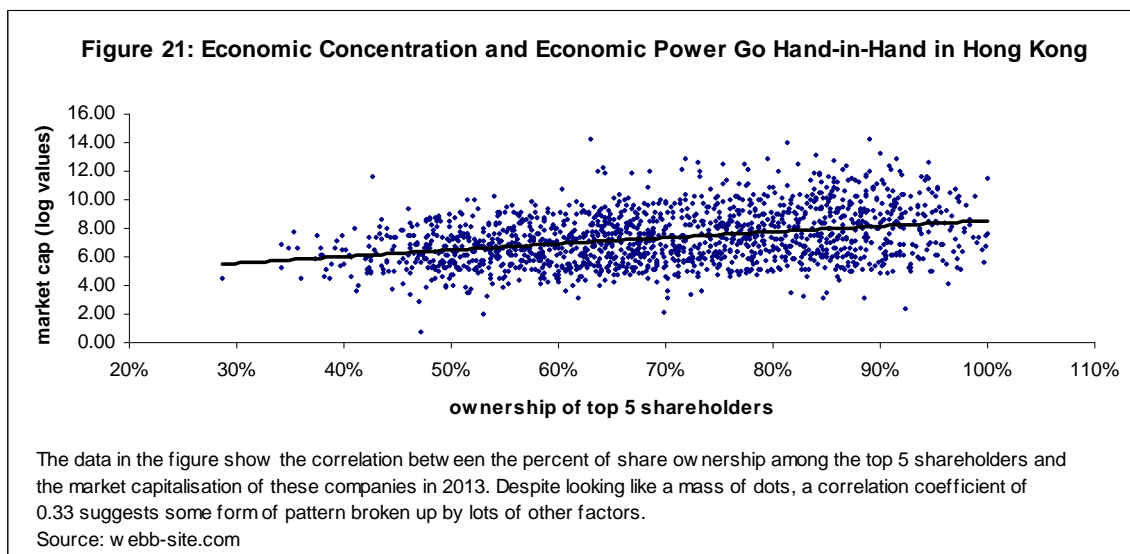
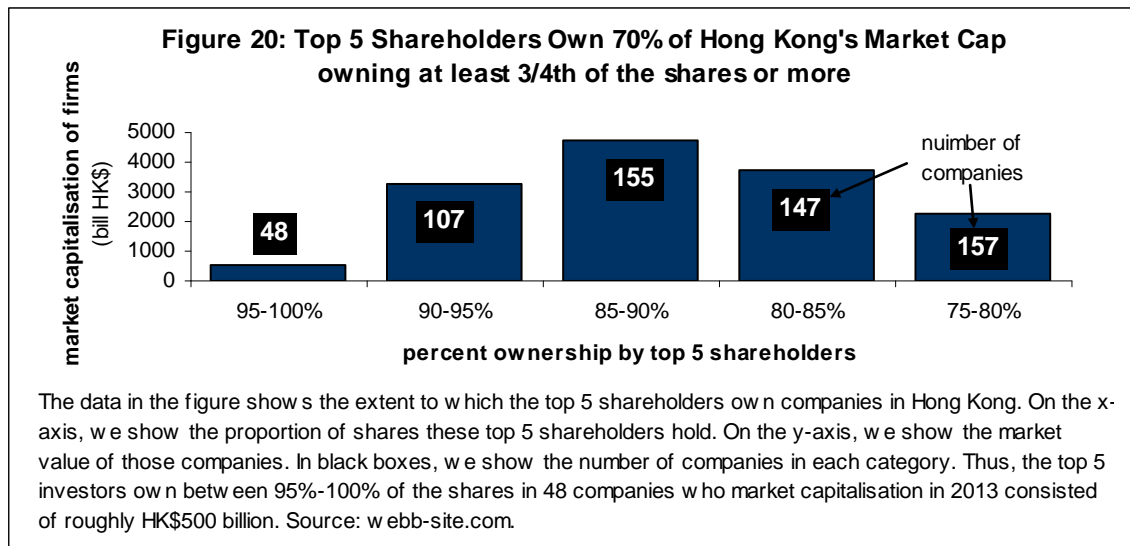
Reducing Concentration in Hong Kong Shareholding

No doubt that shareholding concentrated in Hong Kong

A few shareholders hold a large proportion of the shares in Hong Kong’s corporations. Figure 20 shows the holdings of the top 5 shareholders in Hong Kong’s corporations and the value (in market capitalisation) of the companies they hold. In 2013, the top 5

⁷³ For an overview of the issues, see Rachel Beller, Whistleblower Protection Legislation of the East and West: Can It Really Reduce Corporate Fraud and Improve Corporate Governance, 7 N.Y.U. J. L. & Bus. 873, 2011.

shareholders held between 95% and 100% of the shares in 48 corporations with a market capitalisation of about HK\$500 billion. These top 5 shareholders held at least 75% of the shares (a super-majority) in 614 companies for a combined market value of \$HK14.5 trillion. Figure 21 furthermore shows the correlation between concentration and market value (size). Larger companies (by market cap) tend to have more (rather than less) concentrated ownership. This implies that a small group of shareholders control large amounts of resources. Without significant controls, these insiders could extract significant resources from these corporations.



The data suggests that a relatively small group of individuals do control a large amount of Hong Kong's market capitalisation – creating a group of system-wide insiders.⁷⁴ If you

⁷⁴ We wanted – based on our work in other countries – to show that the media exaggerates the extent of insider control. After looking at the data, we found they do – six families may not control the breadth of

believe the press, six families run Hong Kong – Li family, Kwok family, Lee family, Cheng family, Pao and Kadoorie.⁷⁵ The data about board overlap (also known as interlocking directorates) suggest the situation more complicated than the press intimates. Figure 22 shows the number of overlapping director appointments for a range of publicly listed companies in Hong Kong.⁷⁶ Among the 20 companies with the largest numbers of directors, we see sometimes significant overlap. The 17 directors at the Bank of East Asia, for example, overlap with 158 other organisations (including public interest and non-profit organisations). The 22 directors of Henderson Land Development serve on 86 other listed companies – making for an average overlap of 3.9 organisations per director. In total, these organisations represent 10% of reported market capitalisation. As such, these overlapping directorates do not control vast swaths of the corporate economy. Moreover, many of these represent independent non-executive directorates. However, the existence of a group of insiders in Hong Kong – like in most economies – represents an issue for policymaker supervision.

Figure 22: Interlocking Directorates in Hong Kong

Company Name	Average Overlap*	Market Cap**	Directors	Overlaps
Bank of East Asia	9.3	\$61.8	17	158
Sun Hung Kai Properties	6.1	\$255.9	19	115
Cheung Kong (Holdings)	4.8	\$232.8	21	101
Cheung Kong Infrastructure Holdings	4.6	\$131.9	17	78
Henderson Land Development Company	3.9	\$118.7	22	86
Cathay Pacific Airways	3.8	\$52.3	17	65
Power Assets Holdings	3.2	\$143	18	58
Haitong Securities Co.	3.2	\$4.5	17	54
China Minsheng Banking Corp.	2.8	\$45.4	18	50
China Mengniu Dairy Company	2.8	\$49.9	17	47
Ping An Insurance (Group) Company Of China	2.7	\$165.9	19	52
Country Garden Holdings Company	2.2	\$69.2	21	46
United Company Rusal Plc	1.7	\$45.4	18	31
CSPC Pharmaceutical Group	1.6	\$14.5	17	28
Prudential Public Limited Company	1.6	\$322.2	18	28
Beijing Enterprises Holdings	1.5	\$66	17	25
Beijing Enterprises Water Group	1.4	\$21.7	17	23
Standard Chartered Plc	0.9	\$415.6	20	17
Weichai Power Co.	0.7	\$12	18	12
Hybrid Kinetic Group	0.3	\$0.9	18	5

Source: webb-site.com

* Average overlap shows the number of overlapping companies divided by the number of directors. Such average overlaps may exaggerate the extent of commercial overlap, as many of the organisations listed represent charitable and/or non-profit organisations.

** Market capitalisation expressed in billions Hong Kong dollars

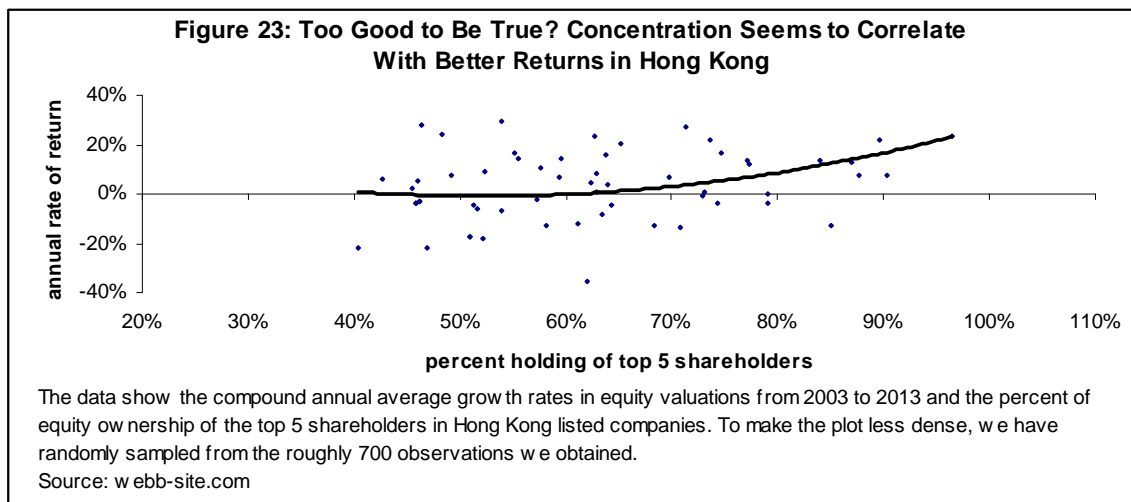
Hong Kong's corporate equity. However, a relative small group of 20 people do have a large number of simultaneous board appointments.

⁷⁵ Disparities in wealth have made the “tycoons” easy targets. They own a lot of wealth (depth of wealth expressed in market capitalisation terms) but control a far less range of corporate resources than the media portrays. See Chen *supra* note at 32. See also Time Out, *The Men Who Rule Hong Kong*, available [online](#).

⁷⁶ Webb-site.com, available [online](#).

Concentrated holdings by non-board members do more harm than good

At first glance, concentration and higher equity returns seem to go hand-in-hand. Figure 23 shows the simple (and simplistic!) correlation between the concentration of equity ownership and average rates of return. The figure shows a positive relationship – suggesting that concentrated equity ownership among Hong Kong’s companies enhances value (or at least unadjusted equity price increases).⁷⁷ However, dispersed ownership also seems to correlate with higher average rates of return (though with much more variance in individual company rates of return). The almost uniformly positive returns for highly concentrated companies though looks suspicious – and bears further investigation.



After controlling for the range of factors that influence the effect of concentration on firm value, the (very) limited evidence available suggests that concentrated holdings decrease firm value in Hong Kong. Figure 24 shows a number of studies which look at the extent to which these concentrated owners enrich themselves through self-serving dividend and salary payment practices.

⁷⁷ We say “unadjusted” because we would want to adjust these data for changes in the overall market, the riskiness of each stock, macroeconomic factors, and so forth. We wanted to let the data speak for themselves without too much interpretation – as the econometric studies we cite throughout this report get heavily “controlled” (in the statistical sense of the word).

Figure 24: Hong Kong's Majority Owners Help Themselves to their Profits More than the Should?

Issue	Description
Self-serving salary payments	Cheung and colleagues that even 5% stake or more in a large Hong Kong company means executives get paid more. ⁷⁸
Self-serving dividend payments	Chen et al. find evidence for increased dividend payments as concentrated ownership increases. They view this as expropriation of other investors. ⁷⁹
Self-serving short-termism	Carney and Eric Gedajlovic find evidence for lower capital expenditure and earnings manipulation among companies with high ownership concentrations. ⁸⁰
Earnings manipulation	Leung and Horowitz find that highly concentrated ownership correlates with less disclosure related to each of the firms' operating business segments. ⁸¹
Other self-dealing	Zhang finds that dividend payments correlate with higher equity valuations – suggesting that investors pay a premium to be able to get their money back. ⁸² Cheung and co-authors find concentrated ownership leads to reductions in firm value. ⁸³

Insiders may also take the company public when a public valuation will likely bring large premiums over the book value of assets and then go private again when the market under-values shares. We do not discuss such self-serving profit-taking as no rigorous academic research exists on this trend.

Source: cited authors.

Does concentration actually crowd-out the small investor – depriving him or her of the profits such concentration seems to provide? Leaving issues of justice aside, owners can take more than their fair share – as long as minority shareholders have access to the lucre these owners' companies generate. Such concentration does not seem to deprive Hong Kong's equity holders of access to the lucre. Figure 25 shows the extent of equity ownership in Hong Kong as compared to the citizens of other international financial centres. Hong Kong's citizen investors hold the second highest proportion of equity --- about 25% of households hold equity.⁸⁴ Concentrated owners do not seem to be holding all the shares amongst themselves. Wide-spread participation in Hong Kong equity does not seem to improve corporate governance practices. However, such participation does spread the gains of corporate profits among the population.

⁷⁸ Yan-Leung Cheung, Aris Stouraitis and Anita Wong, Ownership Concentration and Executive Compensation in Closely Held Firms: Evidence from Hong Kong, KIMR WP No.14/2003, available [online](#).

⁷⁹ Zhilan Chen, Yan-Leung Cheung, Aris Stouraitis, and Anita Wong, *Ownership concentration, firm performance, and dividend policy in Hong Kong*, 13 PACIFIC-BASIN FIN. J. 4, 2005.

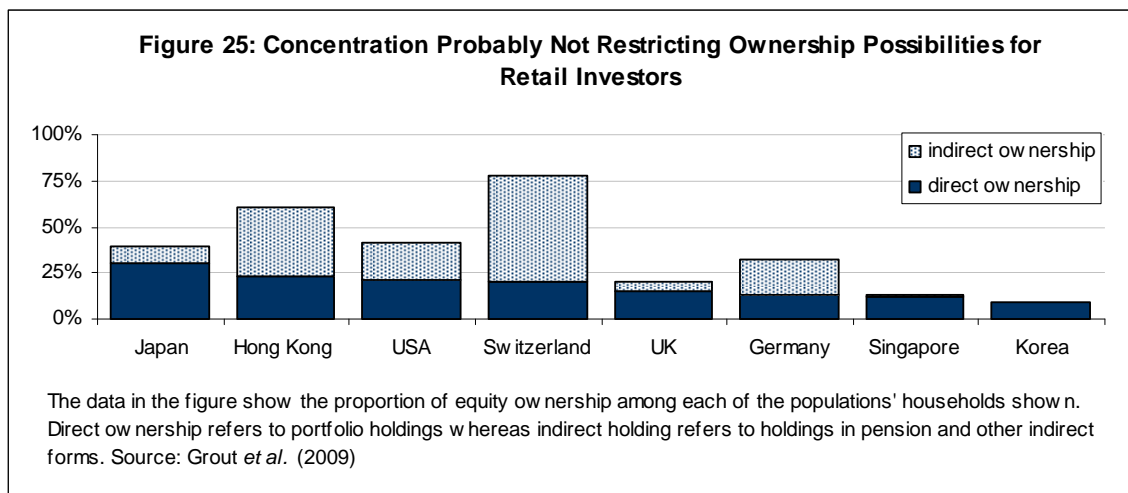
⁸⁰ Michael Carney and Eric Gedajlovic, The Coupling of Ownership and Control and the Allocation of Financial Resources: Evidence from Hong Kong, 39 J. of Manage. Stud. 1, 2002.

⁸¹ Sidney Leung and Bertrand Horwitz, Director Ownership and Voluntary Segment Disclosure: Hong Kong Evidence, 15 J. OF INT'L FIN. MANAGE. & ACCOUNT. 3, 2004.

⁸² Hai-Yan Zhang, *Corporate governance and dividend policy: A comparison of Chinese firms listed in Hong Kong and in the Mainland*, 19 CHINA ECON. REV. 3, 2008.

⁸³ Yan-Leung Cheung, Raghavendra Rau, and Aris Stouraitis, *Tunneling, Propping and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, 82 J. OF FIN. ECON. 2, 2006.

⁸⁴ See Paul Grout, William Megginson and Anna Zalewska, One Half-Billion Shareholders and Counting: Determinants of Individual Share Ownership around the World, available [online](#).



Creating a concentration index

Concentrated ownership in Hong Kong probably has a positive as well as negative effect on Hong Kong companies' profitability and the ability to attract investment. The literature has been divided on to solve the "collective action problem" Hong Kong's companies epitomize. On the one hand, large and concentrated shareholders have strong incentives to maximise profits (though their own personal profits first). On the other hand, they need to provide enough protections to other shareholders so they will invest in the first place.

Should Hong Kong's regulators trust that contracts (corporate articles of association, shareholder agreements and so forth) will provide this confidence? Or should they pass further regulations which keep concentrated owners from using wage, dividend, and other policies from extracting value from their corporations?⁸⁵ Hong Kong's investors clearly do not need protections that the American or British investors needed when legislation sought to defend them from the "oligarchs." We therefore recommend to keep the current notification scheme – with a slight modification.

We recommend that the SFC (not the HKEx) "make provision for" no-cost publicly available data on companies' shareholding concentrations.⁸⁶ At present, the SFC provides High Shareholder Concentration announcements.⁸⁷ However, at a frequency of 1-2 per month and at only 1-2 pages each, these announcements do not contain nearly enough information in order for investors to analyse the risks that concentration might pose

⁸⁵ For a fascinating discussion of the merits of contracts versus legislation, and the ways that each responds to market incentives, see Eric Hilt, *When Did Ownership Separate from Control? Corporate Governance in the Early Nineteenth Century*, NBER WP 13093, 2007.

⁸⁶ Make provision for means either doing it themselves, asking the HKEx to do it as part of a self-regulation programme or leaving it to the Webb-site, an eventual Association of Minority Stakeholders or other NGO body.

⁸⁷ SFC, High Shareholder Concentration Announcements, available [online](#).

(particularly as part of a portfolio of these concentrated holdings).⁸⁸ By providing more detailed data about shareholdings and concentrations, investors can decide for themselves (using statistical analysis) how concentration in any one company (or group of companies) affects their overall financial interest.

Recommendation 5: Scrap the SFC and HKEx concentration announcements and move to a former Webb-Site Concentration database

Derivative action – next steps toward empowering minority shareholders

Much econometric evidence supports the common sense intuition that shareholder litigation increases firm value by “cleaning up” corporate governance. In contexts from most of the OECD (UK, US, as well as Asian countries like Japan and Korea), the evidence shows that shareholder litigation – overall – improves governance.⁸⁹ Many have argued that Asian corporations tend to settle their corporate disputes using relationships and negotiation instead of litigation (or the threat of litigation). Puchniak shows convincingly that such a “theory of Asian non-litigiousness should be relegated to the dustbin of academic history.”⁹⁰ Shareholder litigation will likely improve corporate governance – and thus cause more investment to come to Hong Kong’s companies.

What can Hong Kong’s shareholders do if they find governance practices which reduce profitability and threaten their own investing interests? Figure 26 provides an overview of the relevant law in layperson terms. The basic principle to keep in mind – the company experiences the harms of corporate mis-governance, so only the company (or the board) can sue.⁹¹ Harmed minority shareholders, directors, or other parties may sue mal-governing directors – but only on behalf of the company. We call these “derivative actions” because such lawsuits (or actions) “derive from” the company’s interests. The use of such civil litigation can thus prevent, detect and/or punish self-serving behaviour by directors and senior management.⁹²

⁸⁸ Without going into too much high theory of corporate finance, when investors combine securities with concentrated holdings into a same portfolio, the risks inherent in each of them may interact (in terms of overall risk and return) completely separately from the risks each one poses individually.

⁸⁹ See Brian McTier and John Wald, The causes and consequences of securities class action litigation, 17 J. of Corp. Fin. 3, 2011. For an overall description in Asia, see Dan Puchniak, Harald Baum, and Michael Ewing-Chow, The derivative action in asia: a comparative and functional approaches, Paris: Lavoisier, 2012. .

⁹⁰ Dan Puchniak, The Derivative Action in Asia: A Complex Reality, available [online](#), at 1.

⁹¹ We don’t want to turn this brief into a treatise on corporate law. For more, see Say Goo, *Multiple Derivative Action and Common Law Derivative Action Revisited: A Tale of Two Jurisdictions*, 10 J. OF CORP. L. STUD. 1, 2010.

Multiple Derivative Action and Common Law Derivative Action Revisited: A Tale of Two Jurisdictions

⁹² Kwan and Leung provide another fine overview of derivative actions in the Hong Kong context. See Paul Kwan and Vivien Leung, *Statutory Derivative Actions - New hope for minority shareholders?*, available [online](#).

Figure 26: Q&A about Remedies Available to Minority Shareholders

When can shareholders sue? When the suit benefits the company (not necessarily the shareholder), the suit represents a serious issue and the company's management have not brought any related suit on behalf of the company.

Who can sue? Any shareholder of the company or a "related company" (like a holding company or subsidiary) registered in Hong Kong,⁹³

Who can't sue? People who obtain the benefits of shares held by others and people (like suppliers, partners and others) who seek to prevent the company's management from doing something.⁹⁴

What represents a serious issue adversely affecting the company? The monetary value can be low, but the court must be convinced that the case would benefit the company.⁹⁵

Can shareholders second guess management? Not really. Directors may choose not to pursue certain rights (like debt recovery) due to broader corporate interests like preserving valuable business relationships. In these cases, the court would weigh heavily the directors' (and board's) judgment.

Can shareholders pursue self-dealing directors and execs? Yes. If shareholders sue the on the grounds of self-dealing, the court will necessarily discount rose coloured arguments that self-dealing was done in the corporate interest.

What can the court do?⁹⁶ The court can order management to do (or not to do) something. The court can require certain proceedings, or order the appointment of an "independent person" to investigate the allegation.

Can shareholders probe into the company's finances? Kind of. If the shareholder has solid evidence pointing to the alleged harm against the company, the court can require disclosure (or require that the "independent person" investigating the allegation look at the financials). Without reasonably solid proof, the shareholder would need to ask a friendly director to look into the matter (as directors generally have the right to look at financials under most circumstances and incorporation structures).

How much help could suing shareholders expect from the courts? We don't know yet. Few cases have created doctrines guiding courts about the extent to which they should help shareholders dig for information. Remember that the court and shareholder act on the company's behalf, not on the shareholder's.

Source: Kwan and Leung (2012).

⁹³ Section 168B(C) of the Hong Kong Companies Act of 2005.

⁹⁴ *Re Luen Fat Paint Co Ltd* (unreported, HCMP 1791/2009, 11 February 2010),

⁹⁵ *See In Re F & S Express Ltd*, 4 HKLRD 743, 2005, *In Re Grand Field Group Holdings Ltd* 3 HKC 81, 2009; *In Re Li Chung Shing Tong (Holdings) Ltd*, 5 HKC 531, 2011. *See also* *Carpenter Pioneer Park Pty Ltd* NSWSC 1007, 20004, *In Re Li Chung Shing Tong Ltd*, 5 HKC 531, 2011 and *Fiduciary Ltd v Morningstar Research Pty Ltd*, NSWSC 442, 2005.

⁹⁶ Section 168BG

While derivative actions (lawsuits by harmed parties who seek redress in the company’s interests) can provide an important way to improve corporate governance, Hong Kong’s shareholders have scarcely made use of such actions. Scarcely four cases have surfaced which merit attention (as Figure 26 refers to). Let us step back and consider cases more generally related to “corporate governance.” As shown in Figure 27, a number of other cases appearing in Hong Kong’s courts make reference to corporate governance issues concomitant with other crimes and offences. We have not decided if the 8 cases in the last 3 years to mention issues of corporate governance represent a little or a lot. In any cases, companies – and their shareholders – clearly have an interest in stopping poor corporate governance practices before they escalate into crimes.

Figure 27: A Parade of Cases in Which the Judge or Parties Make Reference to the Company’s Corporate Governance since 2010

Year	Case	Crimes/Issues
2013	HKSAR v. Tsang Wai Lun Wayland & Others	Conspiracy to defraud — Sham transactions — Conspiracy to publish false statement — Conspiracy to deal in property known or believed to represent proceeds of indictable offence
2012	<i>In Re Yung Kee Holdings Ltd</i>	Conduct of management unfairly prejudicial to member
2012	Billion Express Industrial Ltd. v. Tsang Hung Kong	Lawfulness of resolutions and Whether failure to give notice a mere informality and irregularity
2011	Wong Kar Gee Mimi v. Hung Kin Sang Raymond & Another	Whether member entitled to inspect documents of company’s subsidiaries
2011	SFC v. Cheung Keng Ching & Others	Disqualification of Directors — Direction that Company sue its former directors
2011	<i>In Re Asiafair International Ltd & Others</i>	Laying profit and loss accounts before shareholders
2011	Akai Holdings Ltd. (In Liq) v. Kasikorn Bank PCL	Whether executive chairman and CEO was clothed with apparent authority to commit company to transaction
2010	HKSAR v. Habibullah Abdul Rahman & Others	Conspiracy to defraud

Source: Lexis-Nexus Hong Kong cases – looking at cases involving “corporate governance.” We do not specifically provide analysis of cases involving directors’ duties, unfair prejudice cases (where majority shareholders have unfairly helped themselves at the expense of minority shareholders), or insider trading cases. We want to use this figure to illustrate the limited extent to which cases, categorised by Lexis-Nexus as corporate governance related cases, have come onto Hong Kong court of appeals’ dockets.

Returning to our discussion of derivative action, arbitration of derivative actions can well support Hong Kong’s ambitions as a world-centre for investment arbitration. According to D’Agostino, governments are increasingly stepping away from international investment arbitration – as minority shareholders engage in forum shopping and other tactics to extract resources from companies.⁹⁷ A number of scholars have found that derivate actions in Asia will only increase – creating an opportunity for Hong Kong’s

⁹⁷ Joseph D’Agostino, *Rescuing International Investment Arbitration: Introducing Derivative Actions, Class Actions, and Compulsory Joinder*, 98 *Vir. L.Rev.*, 2012.

policymakers to use derivative action policy to improve corporate governance locally as well as attract cases to the burgeoning centre for international dispute resolution and arbitration.⁹⁸

Indeed, recent case law suggests that arbitration proceedings should include derivative actions – least investor recourse be lost if parties later sue in court to enforce the arbitration judgment. In a recent case, Xiamen Xinjingdi sought to bring a derivative action against a company to recover an award granted in arbitration. The company had reorganised in the meantime, and so the original judgment was no longer valid.⁹⁹ The shareholder’s failure to think about recouping the losses on behalf of the company through a derivative action later has commentators claiming that “derivative action based on the New York Convention not recognised in Hong Kong.”¹⁰⁰

Yet, keeping derivative actions out of the courts and in halls of arbitration will require some pro-active policy-making. A recent Cypriot Supreme Court ruling found that shareholders could not require arbitration in a derivative action because the companies’ incorporating documents did not include such a provision.¹⁰¹ Often, investors have seen arbitration clauses in agreements as a way of forestalling derivative actions. However, a recent in a Chinese court provides a useful case for Hong Kong’s policymakers to examine. In that case, Chinese courts found that arbitration clauses could not exclude derivative action.¹⁰² Rather than substitutes, arbitration and derivative action can serve as complements as a way to promote the reliable recovery of investments by minority investors and a way to promote good governance.

Recommendation 6: Increase information to shareholders and others about the use of the new Arbitration Ordinance in seeking redress by arbitration instead of derivative actions and encourage documents of incorporation to contain arbitration clauses.

Open-ended vehicles to open closed-up corporations

Open-ended mutual funds would give investors (both at home and abroad) a safe vehicle for investing in Hong Kong’s highly concentrated corporations. At present, retail investors and investors abroad interested in diversifying their portfolios can buy funds basically “locked up.”¹⁰³ The Government has announced its intention to allow for such

⁹⁸ For a discussion of the rising trend in two of the region’s largest economies to use derivative action, see Ann M. Scarlett, *Investors Beware: Assessing Shareholder Derivative Litigation in India and China*, 33 U. PA. J. INT’L L. 1.

⁹⁹ See Xiamen Xinjingdi v Eton Group & Ors, 2012, HKCFI 915. For third-party description of the case, see Adam Silverman, Hong Kong court refuses to allow derivative action based on enforcement of arbitral award, available [online](#).

¹⁰⁰ Denis Brock, Derivative action based on the New York Convention not recognised in Hong Kong, available [online](#).

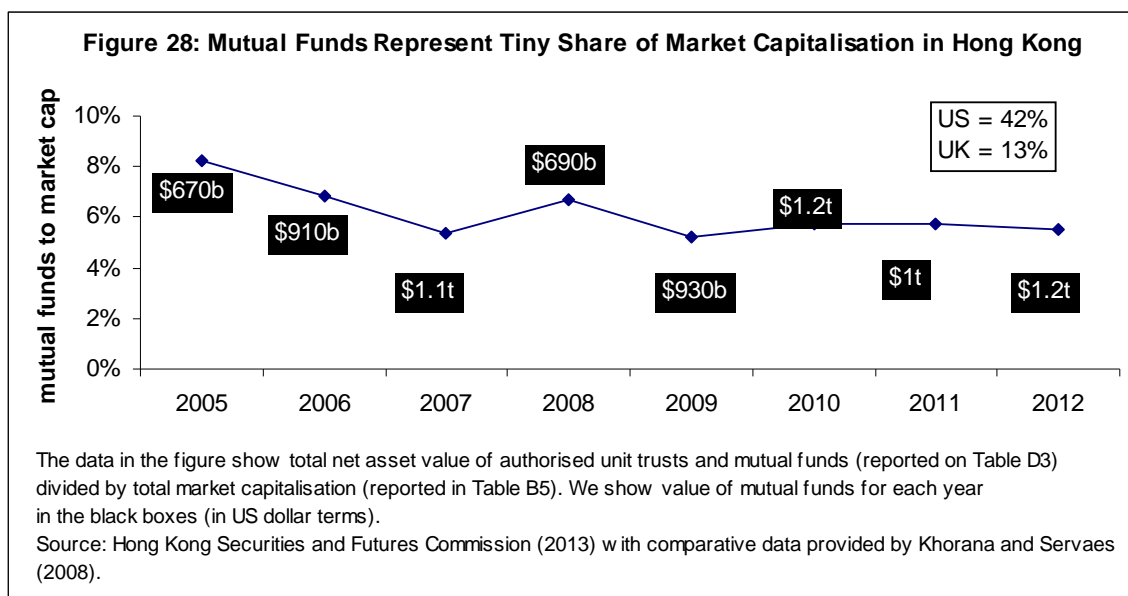
¹⁰¹ Soteris Pittas, *Cyprus: Arbitration And Derivative Actions*, available [online](#).

¹⁰² Susan Finder, Shareholder Derivative Actions in China: Lessons to Be Learned From Shin Kong, Bloomberg Law, 2011, available [online](#).

¹⁰³ These “locked” funds – known as closed-ended and/or unit trust funds – do not allow investors to tell their stakes back to investment companies for the value of their shares.

open-ended investments companies and trusts. However, so far, the investing community still waits for concrete initiatives or concrete action.¹⁰⁴

The data indicate that an open-ended investment structure would allow for the easy entrance as well as exit from highly concentrated companies. Figure 28 shows the size of Hong Kong’s mutual fund industry – as a percent of total market capitalisation and in absolute terms. In contrast to the US’s 42% or the UK’s 13%, such market shares have remained at around 6%-7% in Hong Kong. As we showed previously, a high proportion of households hold equity. However, the depth of such holdings (as shown in Figure 28) leaves much to be desired.



Allowing for open-ended investment companies would provide an effective way to deconcentrate and encourage retail investors to acquire stakes currently held by families. Experience from the US for example shows that mutual fund capitalisation and investment has served as an important way that investors gain access to many of the US’s leading corporations.¹⁰⁵ Such access in turn, has resulted in better governance and deconcentration. However, mutual fund managers’ voting behaviour in shareholder meetings depends far more on the cost of obtaining and acting on information – suggesting a strong policy-role for government to encourage more wide disclosure of information to investors.¹⁰⁶ Yet, even if mutual fund managers do not engage in any kind of activism, just the mere deconcentration of holdings may lead to reduced ability of

¹⁰⁴ In the recent budget speech, the Financial Secretary has noted that, “[The] open-ended Investment Company, [is] an increasingly popular form used in the fund industry. We are discussing the relevant legal and regulatory frameworks with regulators. The public will be consulted once a proposal is drawn up.” See Budget Speech by the Financial Secretary, 2013, at 46, available [online](#).

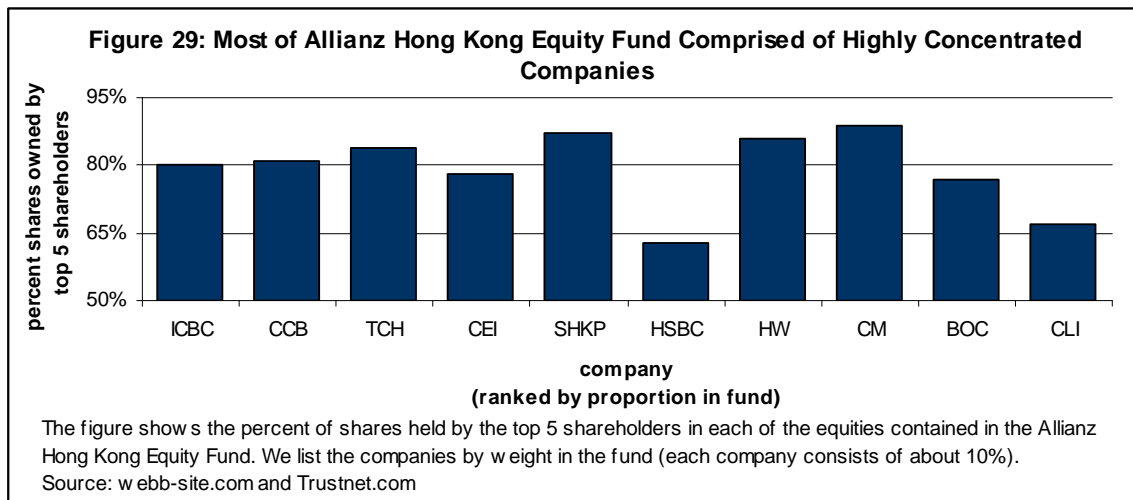
¹⁰⁵ Gerald Davis, *A new finance capitalism? Mutual funds and ownership re-concentration in the United States*, EURO. MANAGE. REV. 5, 2008.

¹⁰⁶ Peter Iliev and Michelle Lowry, *Are Mutual Funds Active Voters?*, available [online](#).

insiders to abuse their discretionary authority over the corporations they own and govern.¹⁰⁷

Recommendation 7: Pass regulation allowing for open-ended investment trusts and corporations

Hong Kong’s mutual funds should do much more than “disclosure” in order to attract funding and improve the governance of the companies these funds invest in. A simple internet search shows 27 funds that invest in Hong Kong equities.¹⁰⁸ Yet, potential and actual shareholders in these mutual funds can know relatively little about the governance practices of the companies they invest in. Finding constituent securities in mutual funds – much less their corporate governance practices – requires some digging. Figure 29 shows the 10 securities held by the Allianz Hong Kong Equity Fund – and the percent of the shares in each company held by the top 5 shareholders. As shown, the Allianz Fund clearly tags along for the ride – with the top 5 investors holding about 80% of the shares the Fund invests in (on average).



The average investor can not know easily about the corporate governance practices of the securities in his/her portfolio – much less express preferences to fund managers. Looking at the prospectus for the Allianz Hong Kong fund, we see no real analysis of the underlying risks or the practices of the constituent companies.¹⁰⁹ Management could at least inform investors about the reasons why they have chosen the companies for their fund (so investors can decide for themselves if these reasons comprise reasons to hold the

¹⁰⁷ At present, nothing in Hong Kong law even hints at the use of investment management as a way of militating for better governance among Hong Kong’s companies. The Fund Manager Code of Conduct makes no mention of considerations to take into account vis-à-vis the companies these fund managers invest in (other than the usual like avoiding insider trading and conflicts of interest). See SFC, Fund Manager Code of Conduct, 2003, available [online](#). The SFC Handbook mutual fund managers also makes no mention whatsoever of any implied duty to engage in any kind of oversight over the companies they invest in. See SFC, Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, 2013, available [online](#).

¹⁰⁸ Trustnet, Hong Kong Mutual Funds / Prices & Performance, 2013, available [online](#).

¹⁰⁹ Allianz Global Investors Fund, available [online](#).

fund). **Hong Kong’s closed-end fund market is particularly harmful in that it cuts off incentives to establish communication between fund managers, their investors and the companies they invest in.** Large companies must provide corporate governance reports – yet the even (sometimes) larger funds that invest in them have no such requirement.

We recommend that management provide at least a basic discussion about the corporate governance factors involved in the companies they invest in. Corporate governance clearly affects these funds’ risks and returns. Such explanations do not need to be long and detailed (thus increasing underwriting and management fees). Instead, management can provide the analysis they must surely have already done.¹¹⁰ We also recommend introducing into the Code of Corporate Governance requirements for funds to hear and respond to investors’ concerns (including concerns about the governance of the companies they invest in).¹¹¹

Recommendation 8: Encourage shareholder knowledge about the companies a mutual fund holds in the fund’s prospectus and incorporate a feedback mechanism into the Code of Corporate Governance specifically focused on facilitating communication between investors and fund managers

Finally getting a Minority Shareholders Association

David Webb (a minority shareholder activist in Hong Kong) has militated for more than a decade for the Hong Kong Association of Minority Shareholders.¹¹² His proposals have languished, in part because of the lack of incentives government, investors and companies have in particular parts of his proposal (and the general impracticality of his design). Figure 30 shows the main elements of his 2001 proposal. We also show the way that his could proposal could be restructured so as to create an incentive-compatible association based in existing law.

¹¹⁰ Interestingly, nothing in the SFC Handbook nor the Code of Conduct even hints at any obligation for fund managers to provide information necessary for investors to make informed decisions or any duty toward them. Acting fairly, disclosure, diligence and the other “general principles” aim at letting the investor obtain and evaluate information. Such an arrangement will discourage investors – who seek greater protections – from investing in Hong Kong.

¹¹¹ As we point out later, the Code of Corporate Governance seems to come from common use and tradition inherited from the British more than any principles contained in Hong Kong’s securities and other legislation. Hong Kong has no particular jurisdictional principles related to the public interest or the collective good. As such, we can only base these proposals in the Code of Corporate Governance – as the various Codes and Guidelines issued by the SFC provide no basis at all for these proposals.

¹¹² The HAMS Initiative: Representing & Activating Minority Shareholders, available [online](#).

Figure 30: A Good Proposal for an Association of Minority Shareholders

	Webb’s proposal	Incentive compatible approach
Legal form	Public body	Non-for-profit association
Management	Board of Governors	Board of Trustees
Mandate	Policy, Ratings and Enforcement	Civil society activism and possible legal aid
Revenue	LegCo funding, a transaction tax plus membership fees	Membership and trading-based income
Lobbying	Would lobby SFC and HKEx for pro-minority shareholder friendly policies	No change. Would probably crowd-in foreign minority investment.
Ratings	Quasi-regulatory professional assessment	Assessment by hired experts in order to generate trading revenue
Enforcement	Legal advice clinics and a regulatory agency	Regulatory advice clinic only
Creation method	Political (public) action	Private action

Source: webb-site.com and authors.

The Association’s legal form should be a not-for-profit association rather than a public body.¹¹³ The Association – created by a group of activists – would run like any other civil society association such as the Hong Kong Institute of Directors. Such a structure would likely take the usual board of trustees plus executive management structure.¹¹⁴ Association would represent minority stakeholders and organisations interested in promoting the interests of these stakeholders.¹¹⁵ Unlike the original plan to hire lawyers and accountants, members would provide advice – based on their own incentives. Webb proposed a ratings division. Instead, these ratings could represent a revenue source and sold to potential investors, institutions, libraries and so forth – much like other corporate governance ratings on the market.¹¹⁶ Legal action aimed at protecting minority stakeholders’ rights would consist of providing free legal advice (as part of the Association’s charitable objects) and advising on cases *pro bono* in order to encourage charitable donations.¹¹⁷

¹¹³ Webb notes the Association would take a “semi-statutory body” form. He advocates a Good Governance Levy and Statutory immunity for executives of the Association – clearly implying the organisation would exist as a public body (or executive agency).

¹¹⁴ In Webb’s original proposal, the Board would consist half of individuals and half corporate members. As associations can have only natural persons as Board members, the Articles of Association might provide for half the Board seats to go to individuals as agents of their corporations. As economists, we would want to study the profile of shareholding in Hong Kong in order to propose the optimal Board composition.

¹¹⁵ Economic theory points to a number of reasons why even institutional investors and majority shareholders would support the rights of minority shareholders *in the system as a whole*.

¹¹⁶ A wide range of organisations provide commercially available corporate governance related ratings (some of which we referred to earlier in this report). The market would determine the price for these ratings (and thus provide a measure of their social value). Previous econometric evidence suggests these scores generate actual and predictable value in Hong Kong. *See Corporate Governance and Firm Valuations: Evidence from Hong Kong*, Adrian Lei and Frank Song, 2004, available [online](#).

¹¹⁷ Hong Kong law strongly dissuades third parties bringing suits and sharing profits. In this model, successful derivative actions brought about as a result of the Association’s advice would encourage charitable contributions – much as Greenpeace’s visible work protecting whales encourages individuals to contribute to their results-oriented NGO.

What can government – and particularly the Financial Services Development Council – do in order to encourage the creation of a HAMS? The Council – and its members – should not actively work on creating such an Association. However, the Council can encourage interested parties in Hong Kong’s civil society to take up the more viable version of Webb’s 2001 proposal. We include a Model Articles of Association for the not-for-profit association in Appendix I.

Recommendation 9: Disseminate the Model Articles of Association for the Hong Kong Association of Minority Shareholders and encourage interested parties to participate in such an Association.

Qualification and Independence of Board Directors

Training and education doesn’t make a difference for boards – kind of

Education makes a difference for investors, not managers. If these trends hold at the board-level, then the Code of Corporate Governance’s training requirements will “work” for non-executive (but not executive) directors.¹¹⁸ On the one hand, education clearly has no apparent influence on executives’ managerial and governance performance (and thus executive directors’ performance).¹¹⁹ These studies tend to find three things. First, CEOs and executives from higher ranked undergraduate and MBA programmes perform no better than those from lower ranked programmes. Second, firms whose executives and chief executives have MBAs and law degrees perform no better than firms with those which have senior managers without such specialist training. Indeed, CEOs without graduate degrees in their sample did slightly better. Third, experience matters far more for executives’ and directors’ performance than training or education.¹²⁰

On the other hand, Gottesman and Morey represent the relatively wide body of research showing a link between education (specifically in business administration) and investment performance.¹²¹ They find three trends in their study of investment managers and investment performance which might bear out for their investor-director counterparts on boards.¹²² First, holding an MBA and having high GMAT scores statistically significantly positively correlates with investment fund performance. Second, “quality”

¹¹⁸ Provision A.6.5 of the Code of Corporate Governance stipulates that “all directors should participate in continuous professional development to develop and refresh their knowledge and skills.”

¹¹⁹ We chose Gottesman and Morey as a reference because they encapsulate succinctly the findings from this branch of the literature. In general, the studies fail to find any link between education, training and executive (and thus executive director) performance. See Aron Gottesman and Matthew Morey, *Does a Better Education Make For Better Managers? An Empirical Examination of CEO Educational Quality and Firm Performance*, available [online](#).

¹²⁰ For a recent incarnation of these studies, see Thomas Ng and Daniel Feldman, *Organizational Tenure and Job Performance*, 36 J. OF MANAGE. 5., 2010.

¹²¹ Aron Gottesman and Matthew Morey, *Manager education and mutual fund performance*, 13 J. OF EMPIRIC. FIN. 2, 2006.

¹²² Non-independent board directors are by definition major investors in the firm. They hold a large enough interest in the corporation to make them non-independent. For its part, the firm invests in portfolios of activities, people and assets. Economists have long been comfortable with the equivalence between investing directly in equities or investing in a company that invests in equities. We hope the reader will see this as clearly and easily as we see it.

the MBA program positively and significantly correlates with fund performance. Managers who hold MBAs from schools ranked a top 30 ranked MBA programme (on *Business Week* rankings) earn higher returns than investment strategists and managers without MBA degrees and those holding MBAs from unranked programs. Third, other qualifications – like a CFA, a masters degree (except for MBA) or doctorate – did not seem to help these investment managers.

What do studies of investment managers have to do with board-level directors? Most of the strategy done at the Board-level basically consists of investment activity. Which senior manager to hire? Which business lines should the company pursue next year? How much funding should accounting and compliance get in order to minimise regulatory risk? All these represent investment decisions. Non-managerial directors clearly represent investors (whether as major shareholders in the company themselves or as key decision makers). We thus recommend that the “investor” directors train in the MBA-related topics (like strategy, finance and marketing). We do not want to endorse any particular skills or product. We choose the topics assessed by the UK Institute of Directors Evaluation Toolkit because their description is relatively comprehensive and the topics broad enough to cover specific topics of relevance to individual companies.¹²³

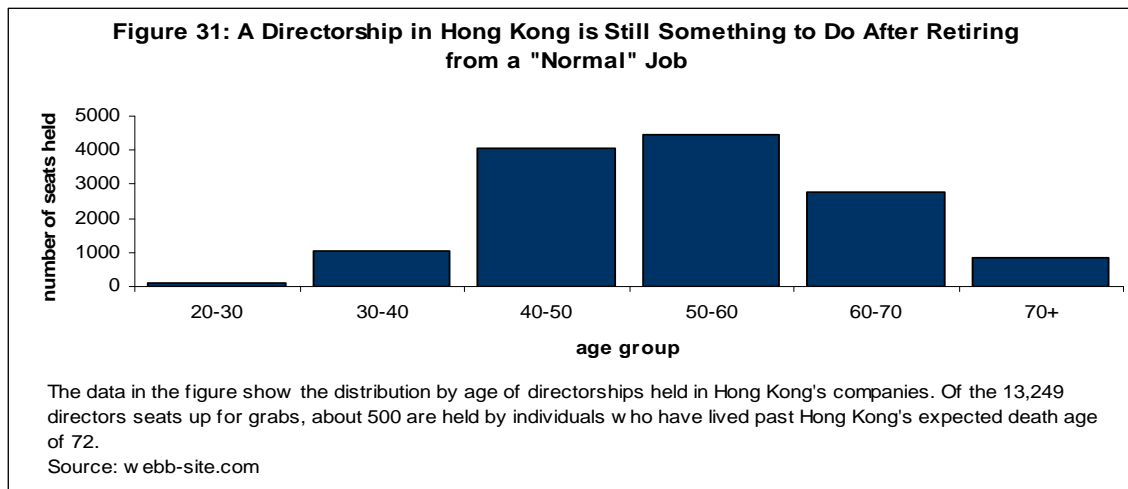
Recommendation 10: Encourage Directors in the Code of Corporate Governance (particularly non-executive directors) to learn the skills contained in programmes like the UK Institute of Director’s Board Evaluation Toolkit

Experience – not training or education -- serves as a key predictor of a director’s performance.¹²⁴ As such, instead of mandating training, the HKEx should work with civil society organisations like the HKIoD to strengthen apprentice schemes and a flexible job market for corporate directors.¹²⁵ The data suggest that a directorship in Hong Kong still relies on experience and contacts built up over a long career – rather than skill. Figure 31 shows the age in 2013 of directors in Hong Kong’s listed companies. The average age sits at around 55 years old (the age when many used to contemplate retirement). While the average age for other elite professions (like professors, CEOs and top-ranked lawyers and economists) has fallen significantly, the market for directors appears to defy this trend. Hong Kong – and specifically the Chartered Institute of Corporate Secretaries -- has made significant strides in professionalizing the occupation of (and thus lowering the age of) the corporate secretary. A similar revolution needs to take place among directors.

¹²³ IoD, Board Evaluation, available [online](#). Hong Kong corporate governance professionals have already begun working in this direction. See Hong Kong Institute of Directors, *SME Corporate Governance Toolkit: From Guidelines to Implementation*, available [online](#).

¹²⁴ A number of studies show that experience serves as a rich predictor of directors’ performance – both in general and on specific sub-committees. To cite one example, Dezoort and colleagues show that an audit committee member’s experience determined their ability to interact with external auditors. See F. DeZoort and Steven Salterio, *The Effects of Corporate Governance Experience and Financial - Reporting and Audit Knowledge on Audit Committee Members' Judgments*, 20 *AUDITING* 2, 2001.

¹²⁵ At present, the HKIoD does provide a directors’ matching service. However, the extremely long list of people looking – combined with old average ages of directors suggests the market is not clearly adequately at the younger age segments.



The best way to encourage the professionalisation of corporate directors (which the Code of Corporate Governance clearly seeks to do) consists of making corporate directorship into a self-regulating profession. As the HKEx has already sought to regulate the experience and performance standards of directors through the Code of Corporate Governance, the HKEx should create an ad hoc committee with the terms of reference for creating such a profession. A first step could be creating an apprentice system for young investor-managers keen on serving as a director on a larger company. The standing committee would decide on methods of training, evaluation, job “matching” and so forth.

Recommendation 11: Create a HKEx committee with the terms of reference to create an apprentice system for junior directors and a market for directors so they can acquire experience

How many directors and independent directors should Hong Kong's boards have?

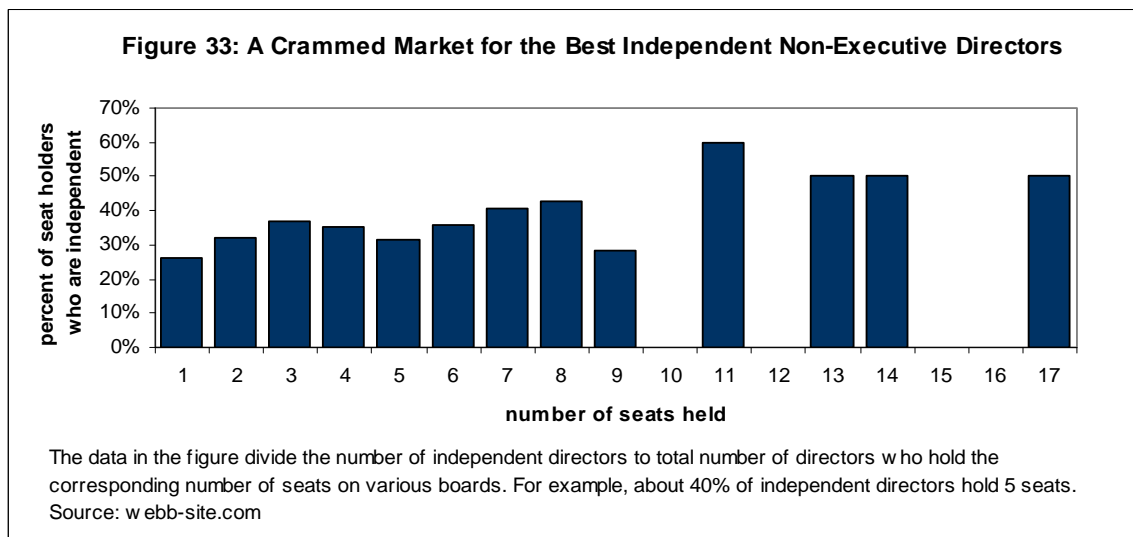
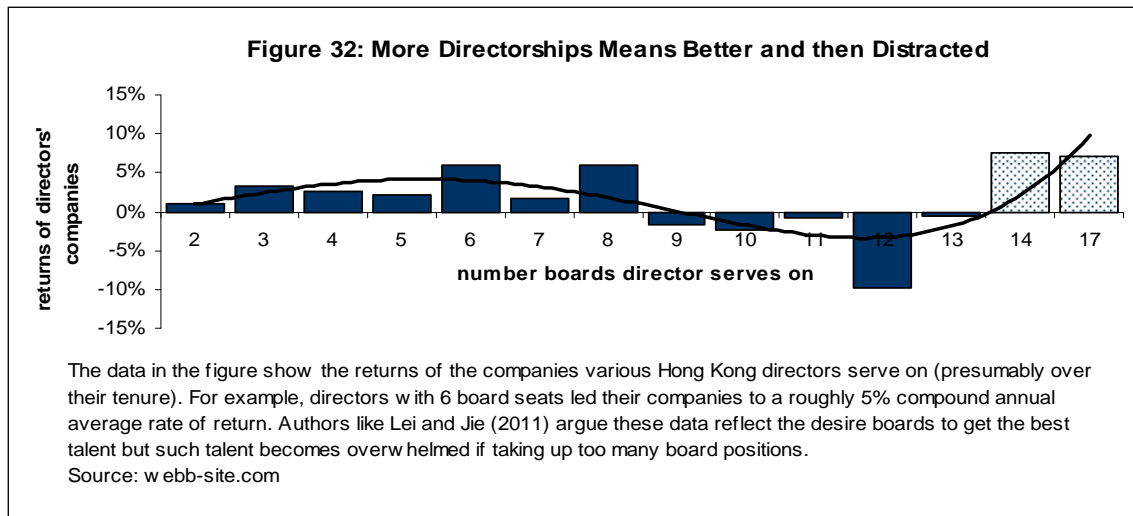
The best directors balance multiple board appointments with the strains of becoming too busy. For Hong Kong, the data suggest that 6 directorships serves as the maximum for Hong Kong's very effective directors. Figure 32 shows the rates of return on the companies that various Hong Kong directors governed in 2013. Companies want to attract the most (or most influential) directors – who in turn take on several directorships. However, past 6 directorships, the data suggest these directors become too busy and their returns start to fall.¹²⁶ Numerous proposals to limit the number of boards directors sit on focus on the “busyness” part of a director's ability to handle such appointments – without looking at the “skill” part.¹²⁷ Figure 33 shows – specifically for independent directors – the number of directorships each one has. For example, 60% of independent directors made up the group of 5 directors who held 11 seats. Roughly 3,000 independent directors

¹²⁶ Lei and Jie, looking at data from 2001 to 2009, argue that independent director quality pushes up the number of board they sit on – whereas their busyness decreases it. The optimal number of directorships for any director then depends on his governing skills and time management. See Adrian Lei and Deng Jie, Multiple Directorships of Independent Directors and Firm Performance: Evidence from Hong Kong, 2011, available [online](#).

¹²⁷ For an overview of the last attempt to limit directorships in Hong Kong, see Enoch Yiu, Plan to limit number of directorships scrapped, SCMP 14 August, 2012, available [online](#).

held one board seat – compared with the 9,000 directors that held such seats. Independent directors – when they hold directorships – seem to hold many. Assuming independent directors quality distributed the same way as other directors, then they should hold 33% of the seats across the board. For example, the independent directors who were just as good as the other directors who hold 11 seats should hold only 33% of these seats. They do not. They hold 60% of these seats. This suggests either independent directors who hold more seats are very much superior to their non-independent colleagues – or more likely serious under-supply and over-demand for excellent independent directors.

Proposals aimed at limiting directorships would cause serious under-supply in the market for directors.¹²⁸



¹²⁸ Our proposal to introduce a mentoring system would address the supply constraint faced by firms for directors. The market environment sets the demand for directors – so policy can not directly influence this (except for types of directors like those sitting on audit, nomination, and remuneration committees).

We thus recommend changing disclosure requirements about directors' other commitments in the Code of Corporate Governance from a code provision into a contractual requirement.¹²⁹ We recommend adding this to their appointment contract because the Code provision does not help boards understand the reasons and background to an board appointee's other commitments. Disclosure does not equal understanding. By making disclosure a part of the contract process – directors can understand what parts of the nominees skills militate for more rather than fewer appointments. Companies can continue to report this information in their corporate governance reports.

Recommendation 12: Require Directors – in their appointment contracts -- to disclose their board appointments, the amount of time they spend, and the amounts of time required

The other – extremely valid question – concerns whether independent directors actually work. The Hong Kong media points to independent directors like Hans-Joachim Korber and Lim Meng An who resigned rather than face the difficult problems faced by their companies. On the one hand, a host of academic evidence (which we have previously reviewed) supports the fact that independent directors “work” better than the alternative.¹³⁰ On the other hand, we David Webb makes an excellent point when he notes that independent directors who require the votes of concentrated majority shareholders can not act independently or objectively.¹³¹ **Current board room incentives perversely suppress the expression of dissenting opinions which can promote board performance.**¹³²

What system of independent directorship would attract the most investment into Hong Kong's financial institutions and companies? Would a “party-list” like approach advocated by David Webb (whereby minority shareholders vote in one or two independent directors) encourage or repel foreign and local investors? The data show that independent directors increase firm value – but we do not know if such statistical findings would translate into portfolio managers' dollars. Figure 34 – if representative at all of true local preferences – suggest that reserving some independent director spots for

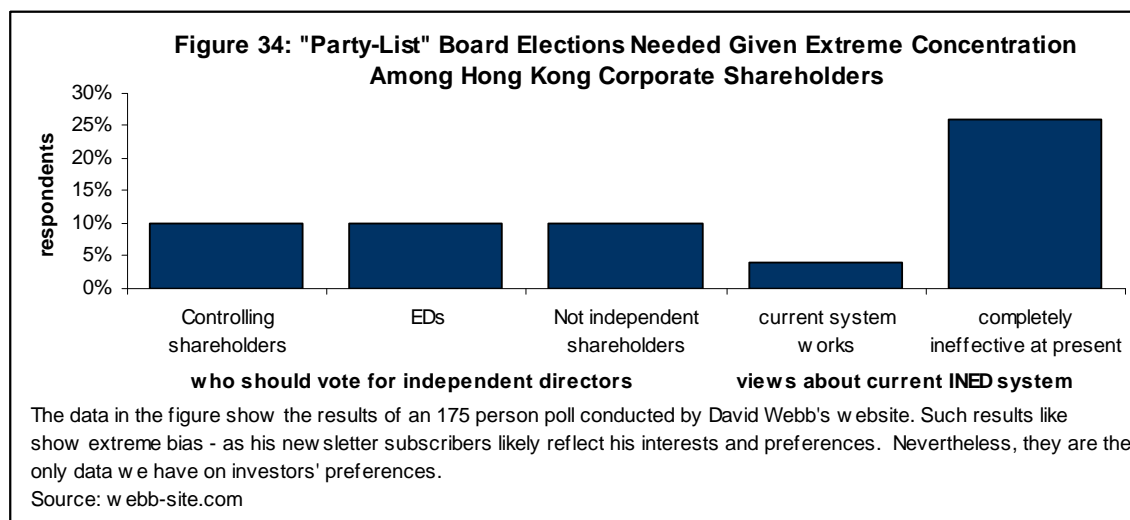
¹²⁹ Code provision A6.6 stipulates that “each director should disclose to the issuer at the time of his appointment, and in a timely manner for any change, the number and nature of offices held in public companies or organisations and other significant commitments. The identity of the public companies or organisations and an indication of the time involved should also be disclosed. The board should determine for itself how frequently this disclosure should be made.”

¹³⁰ We have cited numerous studies in the earlier part of this working paper “proving” that independent directors in Hong Kong has restrained self-dealing in a family-controlled company context. For a snapshot of the extent of independent director appointments on Hong Kong boards and various sub-committees, see *CFA Institute, Board Governance - How Independent Are Boards in Hong Kong Main Board Companies?*, available [online](#).

¹³¹ David Webb, The three wise monkeys of HK boards, available [online](#).

¹³² Our analysis of the personal costs and benefits independent directors' voting indicate that such directors will almost always have strong pecuniary incentives to agree with the majority shareholders. Hong Kong does not represent the only jurisdiction providing these perverse incentives. For more, see Lauren Cohen, Andrea Frazzini and Christopher Malloy, *Hiring Cheerleaders: Board Appointments of “Independent” Directors*, 58 *MANAGE. SCI.* 6, 2012.

minority shareholder election might be popular among investors. Popularity in the UK suggests these proposals may also find favour on the South China Sea.¹³³



Such an approach would improve corporate governance – and thus investment prospects of Hong Kong as an international financial centre for three reasons. First, the extent data shows that truly independent independent-directors do improve a company’s investment prospects.¹³⁴ When companies really need outside capital, they tend to desire truly independent directors.¹³⁵ Second, “dissenting opinions” by independent directors during board meetings and AGMs help serve as the empirical fodder for changing long-term codes of corporate governance. Webb wants independent directors to have their own section in annual reports and to have the right to submit reports to the SFC. Even if they do none of these things (and they certainly won’t) their deliberations will publicly identify weak parts of Hong Kong companies’ corporate governance. With such information, policymakers will have evidence for future corporate governance reform proposals. Third, such a proposal would improve the system without affecting the economic interests of majority shareholders. Even 33% directors would have relatively little say during board meetings – and no voting power at AGMs. As such, their deliberations would likely generate a fair amount of public discussion, without actually impairing the interests of Hong Kong’s concentrated shareholders in the short-term.

Recommendation 13: Introduce a voting scheme for independent directors into the Code of Corporate Governance such that shareholders not among the top 10% shareholders can nominate one or more independent directors.

¹³³ Nadia Boro, FSA Weighs in on Minority Shareholder Protections, available [online](#).

¹³⁴ As a clever proxy for independence, Miletkov and colleagues look at independent directorships of high-flying foreigners. These foreigners – with different cultures than their company boards – represent a natural experiment giving us a glimpse at how directors appointed with very different corporate cultures would perform. See Mihail Miletkov, Annette Poulsen and Babajide Wintoki, *Importing Governance: A Multinational Study of the Determinants and Effects of Having Foreign Independent Directors*, Paper for the European Finance Association, available [online](#).

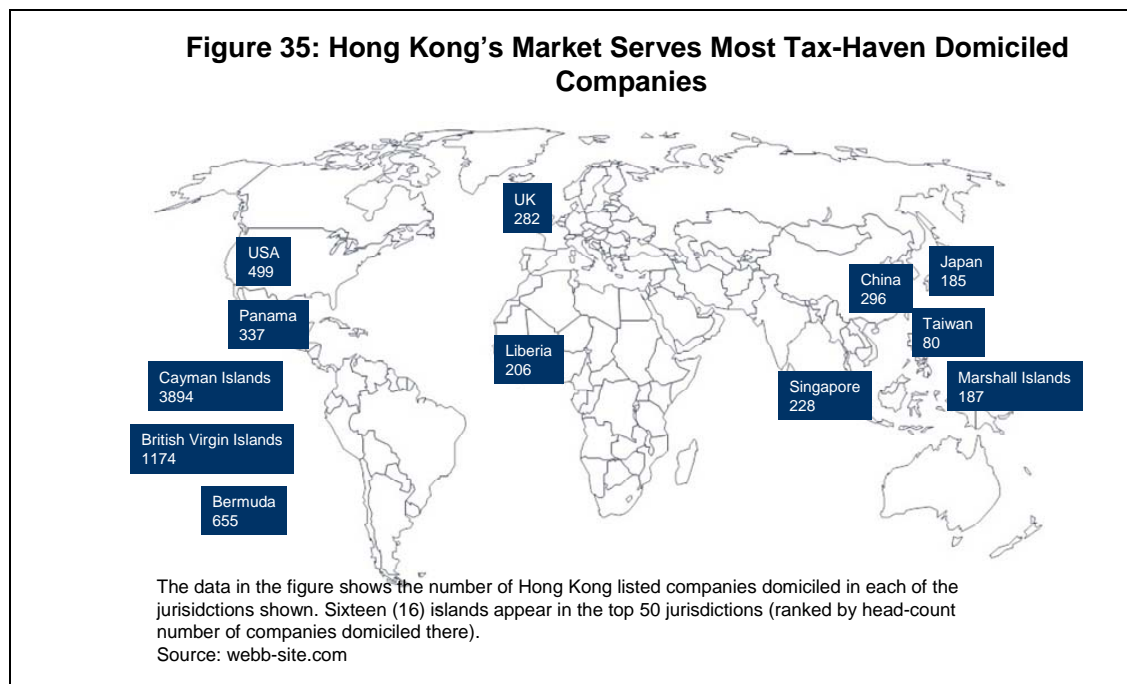
¹³⁵ Jay Dahya, Orlin Dimitrov, and John McConnell, *Does Board Independence Matter in Companies with a Controlling Shareholder?*, 21 J. OF APPLIED CORP. FIN. 1, 2009.

Reducing Secrecy in the Board Room and at the AGM

Corporate Governance in Hong Kong's Role as a "Tax Haven"

Effort by the world's largest economies to tackle secrecy jurisdictions has intensified in 2013. Both at the G8 and G20, the US, the UK and international organisations like the OECD have militated for increased information sharing and reduced secrecy among the world's "tax havens."¹³⁶ At first glance, these deliberations have nothing to do with Hong Kong – a respected participant in the Financial Stability Board reviews.¹³⁷ Such first glances are wrong. **Increased action to reduce the twin advantages of secrecy and tax efficiency available in many jurisdictions will affect fundamental approaches to corporate governance in Hong Kong.**

The Hong Kong Exchange hosts roughly 50% of its listed companies domiciled in jurisdictions widely deemed as tax havens. Figure 35 shows the number of companies listed on the Hong Kong exchange with registered offices abroad. As shown, the Cayman Islands and British Virgin Islands account for about 40% of all listed companies. These companies may place nominee directors and shareholders on the boards of these companies. As such, many of the directors serving on Hong Kong's companies – particularly its unlisted companies – may represent concealed interests.



¹³⁶ The Guardian summarises the summer G8 summit's deliberations on tax havens as mostly ineffective – so far. See Larry Elliott, G8 summit and tax evasion: what's really been achieved?, Guardian 18 June 2013, available [online](#).

¹³⁷ FSB, MONITORING PROGRESS – Hong Kong September 2011, available [online](#).

Hong Kong fits into an ecosystem of tax optimisation (avoidance) strategies which relies – in part -- on financial transfers from and to “secrecy jurisdictions.”¹³⁸ Figure 36 shows the flows of portfolio investments in 2012 between Hong Kong and its largest outward and inward investment partner jurisdictions. As shown, Hong Kong sits at the nexus of investment between China and much as the OECD. However, the British Virgin Islands and Cayman islands intermediate much of this flow. Neither the Cayman Islands or BVI produce goods and services which Hong Kong financial and industrial companies would want to invest in. They also do not have the productive base to generate financial capital to invest in Hong Kong. Yet, the British Virgin Islands represents Hong Kong’s second largest investment partner (both in terms of outward and inward investment). The Bermuda Islands represented Hong Kong’s third largest outward investment partner. Clearly, international policies aimed at affecting the governance of companies in the BVIs, Bermuda, Netherlands and the UK will impact enormously on Hong Kong’s role as a leading financial centre.

Figure 36: What Happens to Hong Kong as an IFC When the Top 5 Tax Havens No Longer Have Secrecy?

Outward Direct Investment Positions	billions HK dollars	Inward Direct Investment Positions	billions HK dollars
China	\$8,072	China	\$2,907
British Virgin Islands	\$2,844	British Virgin Islands	\$2,529
Bermuda	\$249	Netherlands	\$1,007
United Kingdom	\$120	Bermuda	\$525
Hungary	\$85	United States	\$644
Luxembourg	\$82	United Kingdom	\$460
Other Countries Confidential	\$74	Japan	\$291
Singapore	\$70	Cayman Islands	\$150
		Singapore	\$111

Source: IMF’s Coordinated Foreign Direct Investment Survey for 2010. Numbers have been rounded down (fractions have been truncated).

Recent declarations to tackle the opacity of tax havens threatens Hong Kong’s role as a premier international financial centre.¹³⁹ If jurisdictions like the BVI released information about their banking clients’ funds and the beneficial owners and directors of these companies, such policy changes would reduce demand for financial placements and corporate registrations in Hong Kong. **Foreign incorporation (particularly in BVI and the Bermuda Islands) represents an important part of Hong Kong’s overall system of corporate governance.**¹⁴⁰

¹³⁸ For a study of the way that company incorporators use Hong Kong companies as part of an inter-jurisdictional approach to reducing their tax obligations, see J. Sharman, Shopping for Anonymous Shell Companies: An Audit Study of Anonymity and Crime in the International Financial System, 24 J. ECON PERSPECT 4, available [online](#).

¹³⁹ Much of the literature gives a normative and ethical tint to the discussion of Hong Kong and other financial centre’s information sharing policies with tax authorities abroad. We take no moral or ethical position in this brief – providing advice aimed at maximising the value of funds managed by Hong Kong financial firms and corporations.

¹⁴⁰ For a press description of the link between China, Hong Kong and the BVIs, see Toh Han Shih, British Virgin Islands picks Hong Kong to be its Asia hub, SCMP 13 April, 2013, available [online](#).

Changes which affect the incentives to incorporate and operate from these foreign jurisdictions will impact on corporate governance in Hong Kong (and its attractiveness as an international financial centre).¹⁴¹ Figure 37 shows Hong Kong’s secrecy rankings – clearly indicating that Hong Kong attracts funds in large part of the secrecy the jurisdictions offers to local and foreign investors. Secrecy in Hong Kong and the BVI combine to layer transactions in difficult-to-trace investments. No taxes in the BVI and low taxes in Hong Kong combine to significantly lower the effective tax rate of investments incorporated, managed and sold in these jurisdictions.

Figure 37: Hong Kong in a Global System of Highly Competitive Jurisdictions

Jurisdiction	Financial Secrecy Index (100% worst)	Company ownership records	Bilateral tax treaty score (100% best)	Max Tax rate	Source
IFC peers					
Switzerland	100%	No	0%	30%	
Hong Kong	73%	No	0%	16.5%	
USA	62%	No	100%	0%*	
Singapore	59%	No	7%	17%	
Japan	37%	No	72%	30%	
Germany	36%	No	65%	33%	
UK	27%	No	100%	21%-28%	*
Korea	17%	No	100%	--	--
Investment Partners					
Netherlands	11%	No	100%	25,5%	*
BVI	33%	No	12%	0%	*
Bermuda	29%	No	15%	0%	*
Cayman Islands	88%	No	12%	0%	*
Luxembourg	86%	No	8%	29%	*

Source: Tax Justice Network (we have rescaled their scores onto a more understandable 0% to 100% range). No information available for China.

* for Delaware (jurisdiction of choice)

Ironically, the evidence suggests that these foreign incorporated companies list in Hong Kong because of its stringent corporate governance practices.¹⁴² MacNeil and Lau find in their comparison of overseas companies’ listings on the Hong Kong and London stock exchanges that many foreign companies choose to list in Hong Kong because of its relatively reliable and stringent corporate governance requirements.¹⁴³ Hong Kong’s

¹⁴¹ The *Hong Kong Company Secretaries Handbook* represents a small piece of anecdotal evidence attesting to the importance of foreign jurisdictions in Hong Kong’s system of corporate governance. The recent Handbook contains 8 out of 40 chapters on incorporating in foreign jurisdictions – with explanations about incorporation in Panama, China, Singapore, BVI, Bermuda, Cayman Islands, and Liberia.

¹⁴² If the BVI and Bermuda Islands lose (through diplomatic pressure) their secrecy and tax advantages, Hong Kong’s best move would consist of filling the void they leave by lowering its tax rate. Such fiscal policy would significant increase financial placements in Hong Kong. As we must focus our discussion specifically on corporate governance, we do not discuss this fiscal policy “game” further.

¹⁴³ The close link between Hong Kong and the British Virgin Islands and Bermuda occurs because Hong Kong regulators have found company law in these jurisdiction compatible with listing on the HKSE. See

corporate governance arrangements help provide protections to external financiers putting money into highly secretive companies – in terms of ensuring they can recover their money as well as in ensuring tax authorities can not.¹⁴⁴ **Hong Kong attracts money in part because its corporate governance regulations help protect investors seek to avail themselves of the secrecy that Hong Kong and jurisdictions in which their companies incorporate (like the BVI and Bermuda) provide.**

As recent evidence suggests, Hong Kong’s highly concentrated shareholding may actually result from the foreign incorporations that reduce Hong Kong listed companies’ global tax burden.¹⁴⁵

Dealing with secret investors

Who could forget “The Bungle in the Jungle” – Min-Xuan’s Huang’s casino scam in Laos immortalised in Forbes?¹⁴⁶ Who could remember it? Using a number of IDs, vacant premises in Hong Kong, and privacy protections which made looking into his background extremely difficult, he – and many others like him – could perpetrate frauds which under the credibility of all Hong Kong corporations. The lack of an accurate directors registry and background checks in Hong Kong make its companies ripe vehicles for fraud at home and abroad.

Even among Hong Kong’s blue chips, non-identified investors make interests identify to identify. Figure 38 shows the companies with the highest proportion of unidentified investors. Even stalwarts like HSBC and the HKEx itself have large numbers of unidentified investors. **The combination of unidentified (or under-identified) directors and shareholders results in corporate governance in Hong Kong which gives excess weight to concealed interests.** Such a combination allows directors – particularly for unlisted corporations – to engage in fraud via their companies.

Iain MacNeil and Alex Lau, International Corporate Regulation: Listing Rules and Overseas Companies, 50 INT’L & COMP. L. QUART. 4, 2001.

¹⁴⁴ See Valentina Bruno and Stijn Claessens, *Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?*, WBPRCWPAPER 4140, 2007.

¹⁴⁵ Desai and Dharmapala find that taxation can encourage good corporate governance (because tax authority monitoring prevents the most egregious expropriation of minority shareholders). Without such regulatory oversight, concentrated shareholding represents a method of “self-protection” which removes opportunities to expropriate minority shareholders. See Mihir Desai and Dhammika Dharmapala, *Taxation and Corporate Governance: An Economic Approach*, MPI Studies on Intellectual Property, Competition and Tax Law 3, 2008.

¹⁴⁶ Ron Gluckman, *Bungle In The Jungle*, Forbes, 11 July 2011, available [online](#).

Figure 38: Investor Secrecy Means Hong Kong’s Minority Shareholders Don’t Know Who Votes for What

Company	# non-ID investors	Number ID investors	share of non-ID in total
Larger Companies			
HSBC Holdings Plc	3,003	31	99.7%
Bank of China	2,450	31	91.4%
Industrial And Commercial Bank of China	2,312	23	88.7%
China Life Insurance Company	2,011	21	99.5%
China Construction Bank Corporation	1,977	19	99.9%
PCCW	1,580	2	99.2%
HKT	1,472	2	99.8%
Petrochina Company	1,182	7	99.7%
Hong Kong Exchanges and Clearing	1,171	20	99.0%
Smaller Companies			
Midland IC&I	23	0	72%
TCC International Holdings	39	1	56%
China Eastern Airlines Corporation	98	2	55%
Sing Tao News Corporation	23	0	51%
CCT Tech International	80	0	51%
K. Wah International Holdings	120	2	50%
CCLand Holdings	85	0	49%
Qualipak International Holdings	76	0	47%
CIMC Enric Holdings	6	0	44%

Source: webb-site.com

New proposals to provide for directors’ identities and directors’ reports represent steps in the right direction – as long as the Companies Registry can enforce the new regulations. Changes to the Companies Ordinance promise to keep the identities of Hong Kong’s companies public. They also provide for directors’ reports – which should make directors’ actions more transparent.¹⁴⁷ Gordon Jones, the former Registrar of Companies from 1993 to 2007, has argued for heightened enforcement powers to ensure that directors give their real addresses and remain available for Registry questioning.¹⁴⁸

We propose to almost double the Company Registry’s current budget (of about HK\$125 million) in order to provide resources for effective enforcement of its corporate governance related obligations.¹⁴⁹ For the roughly 6,600 summons the Registry issued in 2012, such a budget represented a meagre HK\$19,000 per summons (not including expenses for other activities). First, the money would go toward checking directors’ declared addresses and other information. Second, the money would go toward enforcing

¹⁴⁷ Companies Registry, New Companies Ordinance Subsidiary Legislation for Implementation of the new Companies Ordinance: Phase One Consultation Document, at chap. 2, 2012, available [online](#).

¹⁴⁸ Gordon Jones, No good can come of new company director rule, SCMP 13 February, 2013, available [online](#).

¹⁴⁹ HKG, Head 46 — GENERAL EXPENSES OF THE CIVIL SERVICE, available [online](#).

the directors' report regulation and Directors' identification schemes. Third, find a way to encourage the wide-spread adoption of its Directors' Duties guidance.¹⁵⁰

Recommendation 14: Increase funding to the Companies Registry by HK\$100 million to conduct checks of directors of companies and maintain a disqualified directors' database.

Two Non-Issues in Hong Kong Corporate Governance

Trends in Hong Kong Compensation show pay isn't an issue

The recent incarnation of the Code of Corporate Governance has placed some stress on executive and director compensation.¹⁵¹ In many other jurisdictions – executive remuneration represents an important corporate governance issue. Powerful executives with board-appointments (or not) influence board members into voting for excessive pay packages.¹⁵² Despite the perceived or real influence these high-paid executives have over boards, some evidence supports Code provisions militating for strong and independent remuneration committees.¹⁵³

Three studies in particular tell us something about the likely effectiveness of Code pertaining to board-level oversight over executive remuneration in Hong Kong. Chen and co-authors – in a rather dated study by now -- find no statistically significant effect of independent director presence on Hong Kong boards and executive pay.¹⁵⁴ Cheng and Firth, for their part, find that institutional ownership helps mitigate excessive executive pay increases. Figure 39 shows the results of their regression analysis – looking at the extent to which the company's membership in a corporate holding group, extensive directors' shareholding, institutional share ownership and the percent of non-executive directors pays a role in determining CEO, directors and C-level executives' pay.¹⁵⁵ Only institutional ownership seems to have a statistically significant mitigating relationship with senior businessperson pay. Wong, for her part, finds that remuneration committees have succeeded in restraining executives' payments in Hong Kong.¹⁵⁶

¹⁵⁰ Companies Registry, Non-statutory Guidelines on Directors' Duties, available [online](#).

¹⁵¹ Section B in particular requests that remuneration committees evaluate proposals for compensation “in reference to the board's corporate goals and objectives” (at art. B1.2(b)).

¹⁵²

¹⁵³ Gregory-Smith represents one of the latest in a long line of empirical studies looking at the extent to which remuneration committees help rein in executive salaries. He finds no evidence (at least in the UK) that independent directors sitting on remuneration committees help rein in such salaries. See Ian Gregory-Smith Chief Executive Pay and Remuneration Committee Independence, 74 Ox. Bull. of Econ and Stat. 4, 2012.

¹⁵⁴ See Zhi-Lan Chen, Yan-Leung Cheung and Aris Stouraitis, *Ownership Concentration and Executive Compensation in Closely-Held Firms: Evidence from Hong Kong*, HKIMR WORKING PAPER NO. 14, 2003

¹⁵⁵ See Suwina Cheng and Michael Firth, *Ownership, Corporate Governance and Top Management Pay in Hong Kong*, 13CORP. GOV. 2, 2005.

¹⁵⁶ Shuk-Fong Wong, *The Effect of Remuneration Committee on Directors' Remuneration in Hong Kong*, available [online](#).

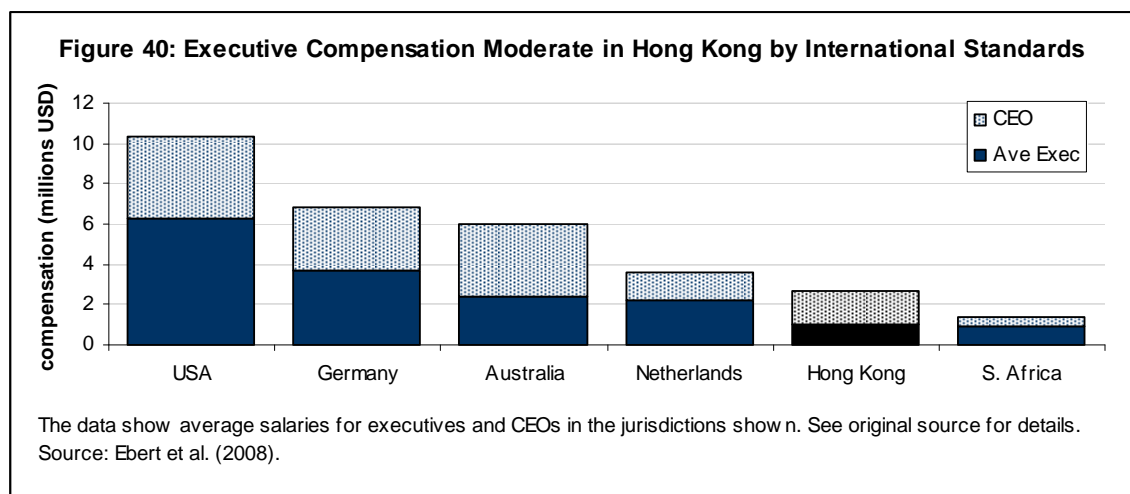
Figure 39: Institutional Owners Moderate Pay in Hong Kong Much Better than Independent Directors

	CEO pay	Directors' pay	Pay of five highest paid employees	Ave. exec director bonus	Bonus as part of total pay
Group membership					
Directors' share ownership					
Institutional share ownership	-	-			
Percent non-exec directors		+			

The data in the figure show the variables significant at the 5% confidence level and the direction of the correlation between the corporate governance related factor (listed as rows) and the performance related variable (listed in the columns). Empty cells mean the authors found no statistically significant correlation related to those factors.

Source: Cheng and Firth (2005).

Executive compensation in Hong Kong has remained extremely moderate – despite high real estate prices and cost of living. Figure 40 shows average executive compensation in Hong Kong and several comparator jurisdictions.¹⁵⁷ The US – unsurprisingly – has the highest levels (in absolute terms) of executive compensation. Hong Kong comes in second-to-last among the countries the author’s studied – showing that pay-levels have a long way to go in a global market for executive services where prices should equalise across countries. Yet, the roughly \$2.3 million estimated by Ebert and colleagues comes on high – compared to the \$1.5 million Cheng and Firth estimate or the \$1.2 million Wong estimates. Compared with the size and span of the corporations they run, Hong Kong’s executives seem positively underpaid.

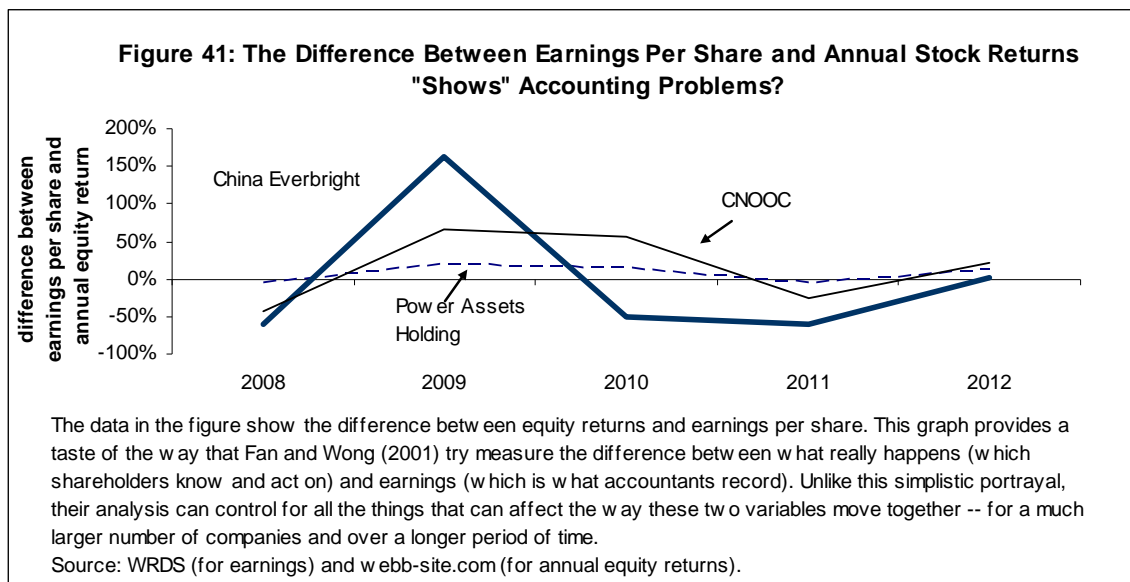


Accounting and auditing also seem okay-ish

The Code of Corporate Governance appears to make many broad admonitions which do not seem will impact on Hong Kong corporations’ governance greatly. Hong Kong listed companies’ accounting and auditing practices already comprise its strongest corporate

¹⁵⁷ Franz Ebert, Raymond Torres and Konstantinos Papadakis, Executive compensation: Trends and policy issues, available [online](#).

governance area (as measured by CSLA and other data). Yet, the data suggest that corporate governance affects (causes) accounting weaknesses far more than any particular accounting rules. Figure 41 illustrates the method used by Fan and Wong to try and detect accounting problems (as represented by mis-stated earnings).¹⁵⁸ In theory, changes in a company's share price should reflect the changed (expected and/or actual) of changes in earnings. Investors will pay for shares the money they expect to get back through the company's earnings. Figure 41 shows that equity prices for Hong Kong listed shares can change far differently than changes in earnings. For example, in just a few short years, the China Everbright's share price changed far more than changes in underlying earnings (in 2009) and then went down when earnings went up (in 2010 and 2011).¹⁵⁹



The data suggest a gap between share price valuations and accounting valuations of Hong Kong companies which suggest manipulation by these corporation's concentrated and family-controlled interests. Fan and Wong find – if you believe their innovative research methodology – that share prices changes do not reflect underlying earnings movements. They interpret such a divergence as proof of earnings manipulation (which several other authors have found using other methods). They find that insider control (highly concentrated voting rights) “interacts” with earnings statements such that share prices react negatively to higher declared earnings. In other words, investors do not believe the higher (or lower) earnings insider-controlled companies say they have. Chen and Jaggi find that proportion of independent directors on a board positively affect voluntary

¹⁵⁸ See Fan, Joseph Fan and TJ Wong, Corporate Ownership Structure and the Informativeness of Accounting Earnings in East Asia, 33 J. of Account. & Econ. 3, 2002.

¹⁵⁹ A million factors (quite literally) could explain these gaps for any particular stock in any particular year. Some include the role of investor expectations, fluctuations in the demand for shares caused by investors' incomes, over and undershooting, one-off accounting events, and so forth. Over large numbers of observations, these random factors should cancel out.

accounting disclosures.¹⁶⁰ Leung and Horwitz find similar results.¹⁶¹ Ferguson and colleagues find similar results for disclosures made by Chinese companies.¹⁶²

Some claim that lax accounting and audit standards will draw companies to financial centres like Hong Kong. The data seem to show that tight audit controls provide investors with assurance. This promotes – rather than deters – investment. Lin et al. (2009) find that Chinese companies that list in Hong Kong have lower abnormal returns.¹⁶³ Such lower abnormal returns though stem from more accurate financial statements – due to audit committee oversight. In contrast, companies that list in China do not have lower abnormal accruals.¹⁶⁴ Figure 42 shows the statistically significant factors in their analysis. The number independent directors, directors on an audit committee and having a big four auditor statistically significantly correlate with “abnormal accruals.” However, the mere existence of an audit committee, the experience of audit committee members and the number of audit committee meetings did not statistically significantly correlate with such abnormal accruals. Such data suggest that many of the provisions in the Hong Kong Code of Corporate Governance aimed at increasing the number of audit committee meetings, will have little effect. Instead, they might do things like increase public disclosure of information. Ho and Wong – for example -- find that the presence of audit committees do increase voluntary disclosures in Hong Kong.¹⁶⁵

Figure 42: Audit Related Variables Affecting “Abnormal Accruals”

	significant	non-significant
Hong Kong listed	number of independent directors on audit committee, number of directors on audit committee, Big 4 auditor.	existence of audit committee, experience of audit committee members, number of audit committee meetings.
China listed	independent ownership and state ownership.	existence of audit committee, Big 4 auditor

Source: Lin *et al.* (2009) at Tables 3 and 4.

¹⁶⁰ Charles Chen and Bikki Jaggi, Association between independent non-executive directors, family control and financial disclosures in Hong Kong, 19 J. of Account. & Pub. Pol. 4-5, 2000.

¹⁶¹ Sidney Leung and Bertrand Horwitz, Director Ownership and Voluntary Segment Disclosure: Hong Kong Evidence, 15 J. OF INT’L FIN. MANAGE. & ACCOUNT. 3, 2004.

¹⁶² Michael Ferguson, Kevin Lam and Grace Lee, *Voluntary Disclosure by State-owned Enterprises Listed on the Stock Exchange of Hong Kong*, 13 J. OF INT’L FIN. MAN. & ACC. 2, 2002.

¹⁶³ Philip Lin, Marion Hutchinson and Majella Percy, The Role of the Audit Committee and Institutional Investors in Constraining Earnings Management: Evidence from Chinese Firms, 2009, available [online](#).

¹⁶⁴ Abnormal accruals refers to the extent that management try to manage earnings – by accounting for certain discretionary accounting items now rather than later. Many items on a company’s balance sheet will affect earnings, but no cash flow – like depreciation. Many accruals (the difference between earnings and cash received) will come about because of standard accounting treatment (non-discretionary). Some will come about because of deliberate management decisions about how to account for certain events like a loss (discretionary accruals). Scholars use abnormal (or discretionary) accruals as a measure of the extent to which management tries to influence reported earnings.

¹⁶⁵ Simon Ho and Kar-Shun Wong, *A study of the relationship between corporate governance structures and the extent of voluntary disclosure*, 10 J. OF INT’L ACCOUNT, AUDIT. & TAX. 2, 2001.

Revising and the Code of Corporate Governance

Hong Kong has joined almost every other jurisdiction in the world in adopting a code of corporate governance covering at least part of its private sector (listed companies). Hong Kong operates a comply-or-explain code – with few official sanctions in case of non-compliance. Internal audit serves as the *de facto* means of monitoring and enforcing the Hong Kong Code of Corporate Governance (with an extremely marginal role for investor oversight).¹⁶⁶ However, companies will only comply to the extent that the gains from compliance exceed the costs. As such, **Hong Kong listed companies' best strategy consists of pretending to comply – without engaging in serious reform.** Such action results in added regulatory costs without obtaining the benefits that actual improvements in corporate governance confer on companies and business clusters.¹⁶⁷

The research from other jurisdictions supports this conclusion. Research suggests that the current comply-or-explain approach does not work terribly well.¹⁶⁸ Arcot and co-authors, in their review of compliance with the UK's Combined Code (of corporate governance) find both insufficient explanation and cases where explanations corresponded poorly with the intent of the provision.¹⁶⁹ The literature dedicated to assessing the performance of self-regulatory comply-or-explain codes shows these codes perform poorly.¹⁷⁰ Hong Kong's code of corporate governance shows the same weaknesses as those from other jurisdictions.

The Code mostly abstract and unenforceable

The revised 2012 Code of Corporate Governance contains over 100 provisions. The Code requires companies to issue corporate governance reports and engage in a fair amount of work on relatively arbitrary principles. Figure 43 shows our own assessment of the specificity and likely effectiveness of each of the Code's articles. We recognise the many downfalls to rating each code provision individually – which doesn't look at the way

¹⁶⁶ The Corporate Governance Code enters into an internal audit framework in two ways. First, internal auditors would evaluate the risks various aspects of governance pose – and audit the controls covering those risks. Second, internal auditors may audit compliance with the Code itself. Yet, in both cases, the audit would propose changes.

¹⁶⁷ Some companies will seek to do more than the bare minimum for political reasons or out of personal beliefs in the benefits such activities may confer. Such actions – while very real – represent a departure from standard economic logic (and are thus unpredictable).

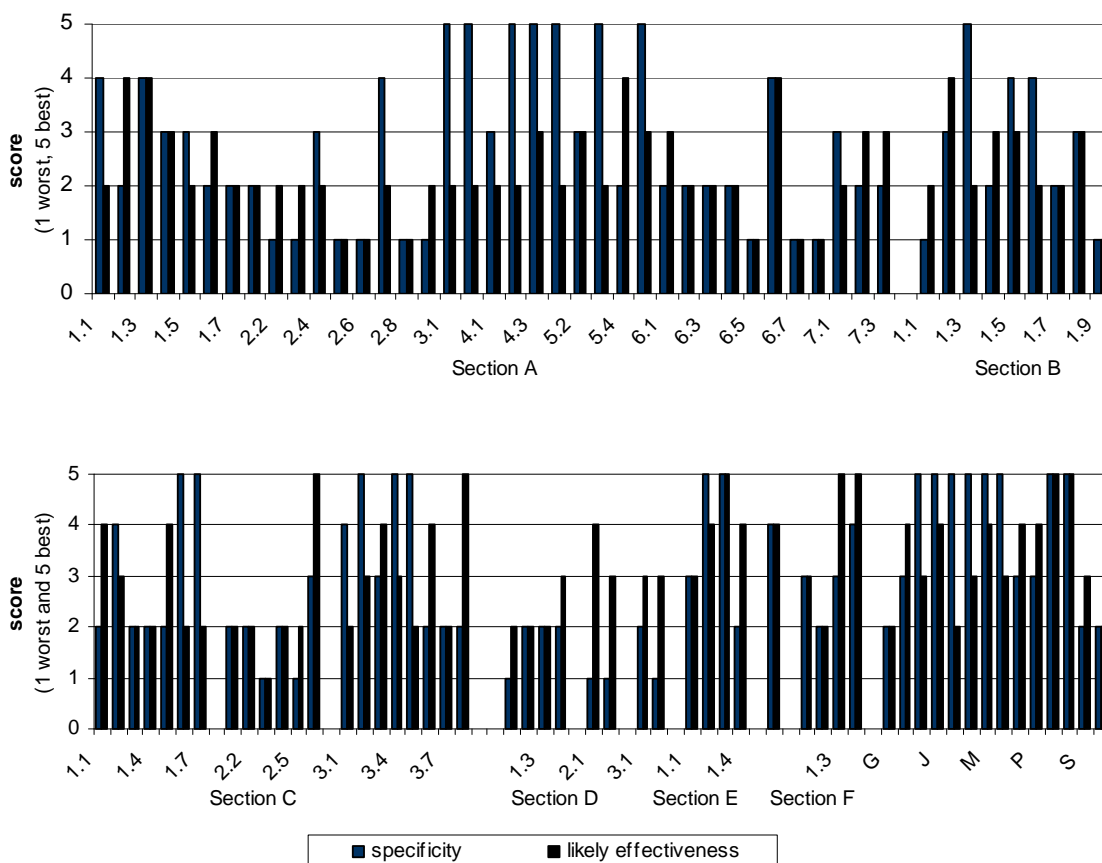
¹⁶⁸ As usual, China represents the exception that proves the rule. Chen and Zhang show statistically significant decreases in earnings mis-statements after the adoption of the 2002 Code of Corporate Governance for Listed Companies in China. See Jean Chen and Hai-Tao. Zhang, *The Impact of the Corporate Governance Code on Earnings Management: Evidence from Chinese Listed Companies*, EURO. FIN. MANAGE. forthcoming, 2013.

¹⁶⁹ Sridhar Arcot, Valentina Bruno, Antoine Faure Grimaud, *Corporate Governance in the UK: Is the Comply-or-Explain Approach Working?* CORP. GOV. AT LSE DP 1, 2005, available [online](#).

¹⁷⁰ As of 2013, academics have assessed the performance of these codes in Italy, Germany, the Slovak Republic, the UK and Romania (among other countries). We do not review these studies in order not to draw too much attention from our project of analysing Hong Kong's corporate governance-related regulations. For an overview, see Jan Andersson, *Evolution of Company Law, Corporate Governance Codes and the Principle of Comply or Explain - A Critical Review*, NORDIC & EURO. COMP. L. WORKING PAPER NO. 10-19, 2011.

provisions interact, their cumulative effect and so forth. However, these data provide a “dashboard” which allows the reader to see these provisions at a glance.

Figure 43: Many of the Provisions in the Hong Kong Code of Corporate Governance Non-Specific and Probably Non-Effective

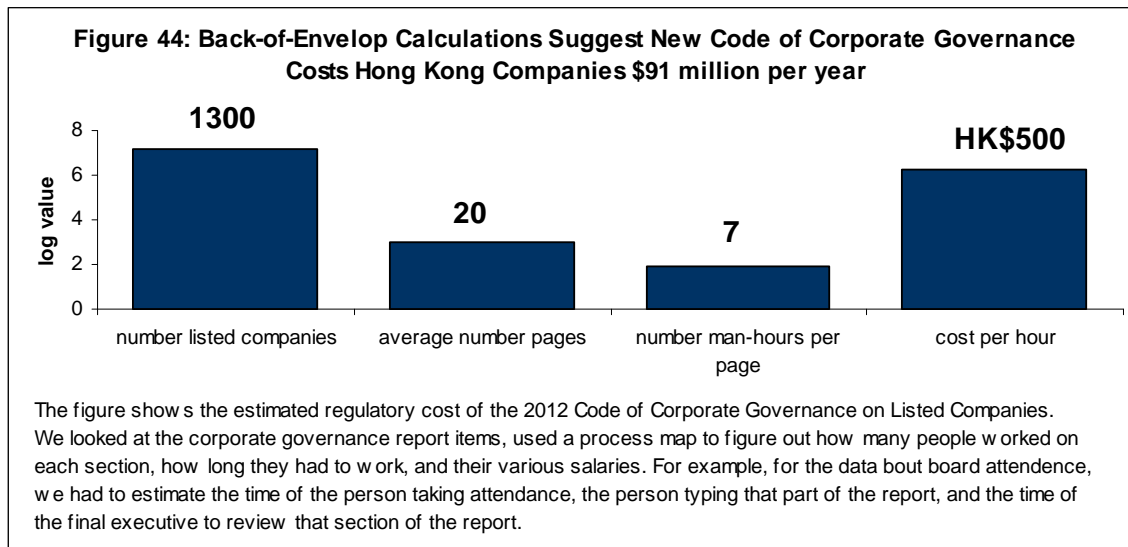


The data in the figure show our scores of each of Hong Kong’s Code of Corporate Governance provisions based on their specificity and likely effectiveness. We base our estimates on our own (albeit) subjective experiences and previous conducting in other upper-income jurisdictions. Source: authors.

The Code presently represents a mixture of very specific and very general (principles based) provisions. In our own assessment, 22 of the provisions score a 5 (leaving little if any room for interpretation) in terms of specificity. Roughly 17 of the provisions score a 1 (being completely abstract and providing no guidance whatsoever). The later sections (from G onward) contain the most specific provisions. Such an assessment may underestimate the specificity of Hong Kong’s listed companies’ corporate governance, as many of the highly specific provisions have already moved into company law and the Listing Requirements in previous reforms.

The 2005 and 2012 Codes of Corporate Governance represented fine first steps toward improving corporate governance in Hong Kong. However, the cost of maintaining the new system will likely exceed the gains (in terms of time spend, ambiguity and so forth).

Figure 44 shows our estimates of the 2012 Code on Hong Kong’s listed companies. We can not quantify benefits, as they accrue to all companies rather than individual companies. However, we can estimate the costs to each company and aggregate upward. As shown, the costs exceed the benefits – putting into peril Hong Kong’s role as an international financial centre (at least a little bit). **Our back-of-the-envelope calculations suggest that the 2012 Code of Corporate Governance costs companies at least \$91 million per year.**



We recommend dividing the 2012 Code into legally-binding provisions (SFC regulations) and a separate code which industry groups would oversee. Placing parts – particularly the specific parts of the Code -- into SFC regulations should pose little problem in practice – if even if such rulemaking poses fascinating constitutional questions (see Figure 45).¹⁷¹ Clearly, the SFC has numerous reasons for adopting a more predictable and less arbitrary corporate governance regime.¹⁷² “Compliance” (and we use the word lightly) with provisions like giving board sub-committees “sufficiently clear terms of reference to enable them to perform their functions properly” is difficult to assess or even explain.¹⁷³ Understanding what qualifies as a sufficient explanation (in the comply-or-explain regime) also poses serious practical enforcement problems.

¹⁷¹ In our other work, we generally look to the country’s constitution and its jurisprudential traditions in order to figure out where to place certain competencies, rights, obligations and so forth. Hong Kong represents a fascinating case, as pragmatism seems to guide legislation and subsidiary regulation far more than usual principles like equality, freedom, social interest and so forth. For a study showing the diversity (and the way each jurisdiction “grounded” various governance principles into its domestic legislation, see http://ec.europa.eu/internal_market/company/docs/board/2013-study-analysis_en.pdf)

¹⁷² During the 2011-2012 consultation on the revised Codes, numerous companies mentioned the abstract nature of the Code and the cost of compliance with what seemed to many like “ticking the boxes.” See HKEx, *Responses to Consultation Paper*, available [online](#).

¹⁷³ Hong Kong Code of Corporate Governance at D2.1.

Figure 45: The Constitutional Law of Minority Shareholder Rights

Constitutional principles underpin all legislation and subsidiary regulation in any jurisdiction – including laws protecting the rights of minority shareholders. In many European jurisdictions, the public interest forms a firm constitutional principle which underpins the rationale for increasing access to information by shareholders and interested third-parties. Equitable treatment of directors on a board forms another principle (defined over time through many cases). In Hong Kong’s Basic Law, mention of a society or a public interest remains conspicuously absent. The Basic Law guarantees the right to property (in Article 6). But the Basic Law mentions nothing about the public interest – except perhaps existing in the *moeurs* of public interest inherited from “common law, rules of equity, ordinances, subordinate legislation and customary law” (as enshrined in Article 8). As such, eventual legal provisions in a Code of Corporate Governance dealing with information disclosure and certain rights of minority shareholders would need to be based in the principle of the “protection of the right of private property” and/or jurisprudential traditions imported from common and customary law. Such academic considerations may seem trivial. However, for a legal system in the throes of (re)establishing its jurisprudence, the constitutional foundations for Hong Kong’s corporate law will determine what legislators and regulators can (and can not) do in the years ahead – like vesting the SFC with certain authorities.

At present, the Code represents an unenforceable first step toward establishing certainly accepted corporate governance practices. Almost all listed companies have “complied” (again using the term loosely) with the Code. Yet, Hong Kong’s lawmakers should put in place a more objective, cheaper, and (frankly) useful system.

Putting in place a new Code of Corporate Governance (again already!)

Hong Kong should follow the path that many of its upper-income jurisdiction peers have adopted – by passing some of the more tangible elements of the Code of Corporate Governance into hard law. Across the EU, hard law provisions have increased passed some of the less controversial elements of these codes into corporate law – like the duty to notify shareholders about meetings in advance of the annual general meeting and so forth. In the EU, the Directive on Shareholder Rights represents an obvious example of Commission attempts to standardise “best practices” in corporate governance and introduce them into the legislation of EU member states.¹⁷⁴ Hong Kong corporate governance-related rulemaking should go down a similar path.¹⁷⁵

The HKEx should require the specific and concrete reporting and informational requirements contained in the current code for listing. We recommend those provisions we have identified in our own review of the Code with a score of 5 for specificity. As most companies already comply with these requirements, the passage into the Exchange’s

¹⁷⁴ Directive on Shareholder Rights, available [online](#).

¹⁷⁵ The Code of Corporate Governance represents only one area of soft law corporate governance related rulemaking. Other codes and guidelines include Company Registry’s Guide on Directors’ Duties and the SFC’s Hong Kong Codes on Takeovers and Mergers and Share Repurchases. For more, see Hilda Chiu and Victor Lee, Stephenson Harwood, Corporate governance and directors’ duties in Hong Kong, available [online](#).

“hard regulation” should not encounter too much criticism. Passing them into formal requirements achieves three things. First, companies no longer need to report on them during their corporate governance report. This would free up time and resources for management to discuss more substantive issues. Second, this would give the Exchange formal powers of sanction – such as the use of fines and/or delisting in the worst case. Third, a formal requirement would level the playing field- ensuring universal adoption.

Recommendation 15: Move the new round of concrete Code Provisions onto the Listing Rules

The strategy underpinning the Code of Corporate Governance consists of encouraging as dissemination of information as possible to the public. Such dissemination – in theory – encourages investors to exercise oversight over these companies’ corporate governance practices. Efforts to encourage the production of information as a “public good” include awards by the Hong Kong Institute of Certified Public Accountants (HKICPA).¹⁷⁶ However, a closer analysis of the information disclosed reveals that investors really can not act on much of it. Figure 46 shows examples of the information provided by CLP’s corporate governance report.¹⁷⁷ Very little of the information can invest the decision to invest – or the decision to bring a shareholders’ resolution. Making these reports more informative will require CLP’s (and other companies’) compliance professionals “thinking like an investor.” What information would they want to see if they were investors? What information would actually matter? The fault – in our view – lies with the HKEx – which has not provided incentives for annual report writers to provide truly useful information.

¹⁷⁶ For the more recent awards, see [online](#).

¹⁷⁷ We quite unrigorously chose CLP because its corporate governance appeared first on the Google search of Hong Kong companies’ corporate governance reports. Our choice represents coincidence – rather than any desire to hold up CLP as a case of bad practice.

Figure 46: Thinking Like An Investor for CLP's Corporate Governance Report

Information about companies' corporate governance practices can help investors make better decisions. Such information can also help investors vote with their feet when companies run poorly. However, the information given must actually help these investors. Compliance officers and senior managers should step back and ask "would I as an investor find this useful?" The following represents examples of inputs-based information contained in the *2012 CLP Corporate Governance Report*. We also show how this 18 page report could move to a results-based format – focusing on what those corporate governance activities actually achieved.

Input-based reporting: The most recent shareholders' meeting was the AGM held on 8 May 2012 at the Hong Kong Polytechnic University, Kowloon, Hong Kong. Major items discussed included the amendment to Article 139 of the Company's Articles of Association, which allows the Board to a) declare a dividend by way of a distribution in specie of securities in any other company which is listed on any stock exchange."¹⁷⁸

Example of hypothetical outcomes-based report: We changed the Articles of Association to allow investors to receive dividends as shares of any listed stock world-wide. Such disbursements will allow our investors to diversify out of CLP and keep us from diluting our equity base. This will increase your overall returns (because you can diversify in the way you want). This will also keep your ownership in the company undiluted.

Input-based reporting: "Re-election of Mr. William Mocatta...as Director[] of the Company (99.7%)."¹⁷⁹

Example of hypothetical outcomes-based report: The shareholders re-elected Mr. William Mocatta as Director by 99.7% of the vote. As a UK chartered accountant and director of several other Hong Kong firms, he uniquely can evaluate the international power company's complex financial arrangements. At 60, he is young enough to serve for quite some time on our Board.

On page 99, we see a table showing the number of Board and committee meetings each director attended. Such statistics recall grade call roll-call. Instead of reporting that Michael Kadoorie attended 1 out of 1 nomination committee meetings, why not report what he did? The temptation to manipulate the number of meetings to ensure full attendance could not be more obvious – even to a passive observer.

Source: CLP Group Annual Report, available [online](#).

We think that internal audit departments (groups) can do a much better job at enforcing the Code of Corporate Governance than investors – at least in Hong Kong and at least now. Four arguments militate for using internal audit rather than investor activism in Hong Kong. First, investor activism has always been weak in Hong Kong. Materials published in companies' corporate governance reports are unlikely to lead to improved governance practices. Second, listed companies have already produced most of the information for these reports. Little benefit would come from continuing to provide the relatively input-based material. Third, internal audit departments can obtain information

¹⁷⁸ CLP Holdings 2012 Annual Report, at 96, available [online](#).

¹⁷⁹ *Id.*

that investors can not usually obtain. Most audit charters provide internal auditors with Board-level support for their work – which remains confidential.¹⁸⁰ As investors, we do not care so much that companies have failed to follow a particular provision. We care more that they have identified and quantified the risks involved and take action where such action improves profitability. Fourth, internal audit departments have far more training than investors in identifying risks associated with corporate governance, quantifying the potential losses associated with those risks and providing value-adding recommendations aimed at mitigating those risks.

Current corporate governance reports can provide investors with real and valuable information. We think that reports on the outcomes of corporate governance activities would inform investors, improve governance practices and provide useful material for internal audits far more than the current grocery-list-of-things-done approach.

Recommendation 16: Modify requirement for annual CG reports. Keep information online, use internal audit to monitor and propose improvements. Use annual reports for results/outcomes based (rather than inputs-based) reporting.

What to do about the many principles-based provisions contained in the current Code? How to assess the extent to which corporations comply with provisions like A2.3 (stating that “the chairman should be responsible for ensuring that directors receive, in a timely manner, adequate information which must be accurate, clear, complete and reliable.”) Who can assess phrases like “timely manner,” “adequate information” and “accurate, clear, complete and reliable”? We would argue that industry and professional groups in that corporations’ sector can judge (and advise) on issues like this far more effectively than securities regulators.

Industry groups alone can decide what kinds of knowledge and engagement directors and independent non-executive directors need to comply with many of the rules-based regulations. Consider provision A.6.8, requiring that “independent non-executive directors and other non-executive directors should make a positive contribution to the development of the issuer’s strategy and policies through independent, constructive and informed comment.” If the corporation is a large construction company, why not let an association like the Construction Industry Council help decide what an independent non-executive independent director needs know (in collaboration with the relevant academics and other experts?) They can provide very specific details which the overall securities regulator (SFC or even HKEx) can not. They would also know about risks facing that particular industry – and can help develop the standards used to assess whether directors adequately faced those risks.

Recommendation 17: Use Professional Associations to Develop Specific Guidance for Directors in their Industry related to Training Needs, Risk Assessment and other aspects of governance

¹⁸⁰ The quantitative evidence for Hong Kong suggests that audit departments and boards produce more information for public scrutiny – making audits complements rather than substitutes for investors oversight. See Simon Ho and Kar-Shun Wong, *A study of the relationship between corporate governance structures and the extent of voluntary disclosure*, 10 J. OF INT’L ACCOUNT., AUDIT. & TAX. 2, 2001.

Public companies account for only 1% of the roughly 1 million companies registered in Hong Kong.¹⁸¹ How to improve corporate governance in these other companies – thereby making them more attractive for investment? Hong Kong’s various academic, professional and other associations have done very little work on corporate governance among non-listed companies. While the Hong Kong’s Institute of Director’s guide represents a start, the guide is still far too legalistic for the average company boss to understand.¹⁸²

Hong Kong should follow the approach several other countries have taken to encourage a code of corporate governance among non-listed companies. Many small and medium enterprises favour improving corporate governance collectively.¹⁸³ Such codes for all companies decrease the first-mover disadvantage companies who unilaterally adopt such codes face. However, we have little idea what kinds of corporate governance practices would help the smaller non-listed companies. Academic research has been almost completely silent on the topic – because of the lack of data. Yet, we know that good corporate governance would like significantly increase their profitability and investment prospects.

We thus propose to use Government funding of a research grant or tender to develop such a code with the companies that would use it. The IoD Toolkit represents an excellent start. However, its length and complexity mean further work needs to be done. The tender/grant could also develop data which would draw attention to Hong Kong’s work. As such, the grant can both improve corporate governance practices as well as draw investors’ attention to this sector.

Recommendation 18: Put to tender a \$2 million scheme to develop a Code of Corporate Governance for non-listed companies and develop a viable business model for providing advice to companies on adopting such a model and propagating it to Company Secretaries.

Conclusions

Corporate governance in Hong Kong has improved over the last decade. Hong Kong’s corporate governance compares favourably with some of its international financial centre rivals. Yet, many parts of Hong Kong’s corporate governance severely discourage the flow of funds to its companies (directly and through financial intermediaries). A tai-pan group does really control much of corporate Hong Kong. Moreover, foreign investors know that – decreasing potential investment.

¹⁸¹ In 2012, the Hong Kong companies registry contained only about 11,560 public companies – compared with 1,033,100 companies (rounding up).

¹⁸² See HKIoD, *Guidelines on Corporate Governance for SMEs in Hong Kong*, available [online](#). The Government has already been very proactive in this area, funding the SME Corporate Governance Toolkit. The 240 page document seems rather a lot for a SME owner to absorb.

¹⁸³ See Quoted Companies Alliance, *SMEs want their own corporate governance code*, available [online](#).

In this brief, we illustrate – using data – how family control and high levels of investor concentration lead to self-dealing. Such self-dealing (either real or imagined) acts as a severe brake on domestic and foreign investment in Hong Kong’s companies. Provisions in Hong Kong’s company law which promote secrecy and “tax efficiency” may not be able to keep funds flowing indefinitely in and through Hong Kong. We provide a set of 18 recommendations which should promote corporate governance in Hong Kong and increase investments (and thus Hong Kong’s ranking among international financial centres).

Appendix I: Model Articles of Association for a Hong Kong Association for Minority Shareholders

INTRODUCTORY PROVISIONS

1. Name. The Hong Kong Association of Minority Shareholders (hereinafter Association).
2. Charitable objects. The Association shall seek to:
 - a) engage in policy advocacy through printed and internet materials as well as lectures and public consultations,
 - b) receive complaints from minority shareholders and other interested parties and provide informal advice,
 - c) publish materials relevant to corporate governance and issues affecting minority shareholders on its website,
 - d) co-ordinate the ranking of corporate governance policies and practices of Hong Kong's companies,
 - e) promote research and new ideas in governing corporations and issues affecting minority shareholders at home and abroad,
 - f) provide travel and accommodation funding for speakers and experts, and
 - g) co-operate with Hong Kong, Asian and international government, business and civil society organisations in promoting corporate governance.
3. Intent of Membership in the Association. The Association aims to create a social contract between members, whereby they receive rights as well as obligations in active participation for furthering corporate governance in Hong Kong.
4. Intent of work on Corporate Governance. To encourage corporate activities (as well as government policies) which encourage collective action on improving corporate governance as well as to discourage practices which benefit one or a sub-set of companies and/or stakeholders in those companies to the detriment of all companies and/or stakeholders.

MEMBERSHIP

5. Types of membership. Any natural person of any residency or nationality may become a member.

6. Members' Agency and Representations. Unless they represent Agents of Corporations (see below), members shall act only with the broader social and corporate interest in mind – “leaving their organisation at the door.”

7. Agents of Corporations. Individuals may join the Association explicitly as agents or representatives of particular corporations and/or organisations, including companies, corporations, partnerships, government bodies, and international organisations.

8. Conditions of membership for Agents of Corporations. Members joining as Agents of Corporations shall be subject to the following terms:

- a) members representing an organisation must mark the “agent” box on the application form,
- b) only one person may represent a company or other organisation,
- c) individuals may not join as an Agent of a Corporation and as an individual member (no dual memberships),
- d) members who join as agents or representatives of their corporation may transfer their membership to another member of that company or organisation,
- e) such Agents of Corporations shall have a special mark or colour on membership lists, name tags and so forth indicating they association as representatives or agents of a corporate body.

9. Benefits of membership. Members shall have the right to the following:

- a) receiving the Association's regular newsletters, communications, and
- b) opt-in access to blogs, viewpoints and other materials prepared by Members for other Members and the public,
- c) vote for Governing Committee members in the Annual General Meeting,
- d) share viewpoints and materials as part of consultations and as part of regular Association discourse,
- e) participation -- on an individual invitation basis -- in events, studies and other “public goods and services” provided by Association members,

f) providing funding to the Association for specific corporate governance-related projects of interest to the members individually, as a sub-group and/or collectively,

g) openly object to campaigns conducted on particular topics, and

h) right of reply when Members critique corporate governance practices,

10. Obligations of membership. Members shall:

a) contribute an annual membership fee,

b) provide feedback (as much as practicable) on consultations and other requests by individuals working with or for the Association,

c) help arrange meeting space, webspace or other in-kind contributions to the Association's activities (with the understanding that giving such contributions does not imply agreement with viewpoints expressed),

d) engage in constructive criticism of individual and/or collective practices (including campaigns and other Association work with the Member does not agree with).

11. Membership fees. The Executive Director shall set membership fees each year, in consultation with the membership at the Annual General Meeting.

12. Money as Speech Rule. Spending on sponsorships, advertising and projects shall not detriment the ability of other Member to engage in debate, share viewpoints and engage in Association activities.

13. Revocation of Membership. After returning the member's membership fee, the Executive Director may revoke any individual membership if that member:

a) engages in repeated disruptive communication (spamming, obscene language), or

b) uses Association access or resources for personal gain.

14. Critiques of corporate governance practices. Members may critique the corporate governance practices of organisations and/or specific government or corporate policies on the proviso that such critiques:

a) must be constructive, offer value-adding alternatives and use a respectful tone of voice,

b) may be libel (and the Association bears no liability for the free speech of its Members), and

c) may attract a reply by the organisation involved.

STRUCTURE AND FUNCTION OF THE GOVERNING COMMITTEE

15. Purposes of the Governing Committee. The Governing Committee shall:

- a) decide on major topics and issues to address for each year,
- b) review management's proposed advocacy campaigns for the year,
- c) review advice given to interested parties approaching the Association, assessing risks and rewards to the Association of providing such advice,
- d) provide specialist advice on particular activities conducted or co-ordinated by the Association (such as how to engage in corporate governance ratings or giving public policy advice on accounting issues associated with better corporate governance),
- e) review and approve the budget proposed by the Executive Director, and
- f) help raise funds and the Association's public visibility.

16. Number of Governing Committee. The Governing Committee shall consist of up to 7 members, including a Chairperson.

17. Functions of the Chairperson. The Chairperson of the Governing Committee shall:

- a) work with the Executive Director on defining topics for discussion and vote during each annual Governing Committee meeting,
- b) canvass opinions among members of the Governing Committee, bringing in members and outside perspectives as necessary,
- c) review periodically the work of the Association and its Executive Director to see how such work executes the Governing Committee's strategy and serves the Association's charitable objects,
- d) engage with corporate boards and government bodies to fulfil the Association's objects,
- e) encourage third-parties like academics and pro-bono lawyers to contribute advice on projects undertaken in Hong Kong aimed at promoting good corporate governance, and
- f) hold accountability for the Association's effects on corporate governance in Hong Kong.

18. Election to the Governing Committee. Members shall elect 7 members to serve on the Governing Committee by rank vote (with their most preferred person ranked as 1, second most as 2 and so forth). The seven individuals receiving the seven lowest aggregate scores shall serve for that year on the Governing Committee.

19. Diversity Statement during Elections. To discourage group-think, encourage broad participation and diversity among the Board, the election materials must contain the following statement “Members should think of the Board as a whole when voting. We thus encourage you to elect individuals represent a broad spectrum of professions and viewpoints in order to prevent the usual grouping of lawyers and accountants on the Board.”

20. Canvassing for Elections. Members may submit a one-page maximum briefing for members to consider during elections. They may include their background (reasons why they should be elected), their strategic priorities (campaign “promises”) and other relevant information.

21. Governing Committee Meetings. The Chairperson may convene Governing Committee meetings as needed in between annual meetings. These meetings may be held in person, electronically (through Skype or other internet conferencing software) or through Committee resolutions discussed and voted upon by email.

22. Agenda Items, Resolutions and Minutes. The Chairperson shall circulate issues for discussion and resolutions to vote on. Minutes shall include only outcomes and other considerations needed for Association policy making.

23. Publication on Internet site. The Chairperson shall ensure minutes appear on the Association’s website as soon as possible after the meeting.

NOMINATION AND FUNCTIONS OF THE EXECUTIVE DIRECTOR

24. Nomination of the Executive Director. The Governing Committee shall appoint an Executive Director to oversee the day-to-day operation of the Association.

25. Duties of the Executive Director. The Executive Director shall:

a) develop an work plan consisting of campaigns, publications, events and specialist advising (such as giving feedback on public consultations) in order to implement the strategic directors set by the Governing Committee,

b) oversee work done on rating corporate governance in Hong Kong, disseminating those results and responding to complaints,

c) oversee the intermediation of advice from minority shareholders seeking advice and those providing such advice,

d) ensure the website provides information and materials useful for achieving the Association’s charitable objects,

- e) ensure that campaigns work on a collaborative rather than conflictual basis (particularly when the Association militates for improving corporate governance in specific companies or groups of companies),
- f) budget Association funds and ensure efficient/effective spending of those funds,
- g) negotiate partnerships and collaborations with local and international organisations,
- h) review any analytical materials (studies, datasets and so forth) produced officially by the Association staff or by hired consultants, and
- i) respond in the first instance to complaints and ideas raised by members,

26. Delegation. The Executive Director may delegate any tasks to other staff and individuals working with or for the Association under the terms of contracts reviewed by the Chairperson of the Governing Committee.

27. Executive Director's Employment. The Executive Director serves as an employee of the Association and does not sit on the Governing Committee.

28. Removal of the Executive Director. The Governing Committee may vote, by majority, for the removal of an Executive Director. The Governing Committee alone decides whether to put the removal of the Executive Director to a vote.

ACTIVITIES

29. Website. The Association shall keep a website which shall post:

- a) relevant research on issues affecting the governance of Hong Kong's corporations and the interests of minority shareholders,
- b) materials related to present and past advocacy campaigns,
- c) materials representatives or agents of institutions wish to disseminate (subject to the Executive Director's approval),
- d) a blog where individuals may post their ideas, and
- e) databases or quantitative data for use by companies, researchers and other interested parties.

30. Corporate Governance Ratings. The Executive Director may work with any individual or organisation in order to produce corporate governance ratings. The market shall decide on the appropriate of the methodology and usefulness of the final ratings.

31. Offer of advice. Association members may arrange for the giving of advice to minority shareholders and other interested parties (as allowed by law) by:

- a) offering such advice directly (on the proviso that they do not offer such advice in exchange for consideration of any kind and clearly state such advice is given as public speech),
- b) arranging or referring these persons to professional lawyers, accountants, and other professionals, and/or
- c) providing blogs, pamphlets and other materials in general nature and addressing broad issues,

32. Matching. The Association may engage in matching corporate governance needs with related skills or resources held by Members and/or third-parties. Such matching may include finding independent directors, corporate governance advisors, venue for meetings about specific topics affecting minority shareholders and so forth.

33. Campaigns. The Association may organise campaigns to deal with specific topics, regulations and other issues of importance to minority shareholders. Association-related staff and members may collect and use public information in such campaigns.

34. Media work. The Association's staff may work with the Hong Kong medias, explaining particular corporate governance issues in plain language and/or arranging for Members to over views on a topic.

OTHER PROVISIONS

34. Shareholding. The Association may hold a monetarily insignificantly amount of shares in various Hong Kong corporations for the purpose of obtaining information and participating in shareholder meetings. All share ownership must be indicated on the Association's website and recording in the annual accounts.

25. Insurance. In light of its role in advocating change and making comments about particular organisations, the Executive Director must arrange for insurance for all Directors and executive staff.

26. Limits on Liability. The Governing Committee and Executive Director shall ensure that the Association does not incur any kind of liability which passes on to Members. To that end, they shall conduct activities through association limited liability companies, partnerships, third-party service providers and other structures in a way which prevents liability from passing onto Members.

27. Annual report. The Executive Director shall prepare an annual report in the format he or she deems most fitting, covering:

- a) activities conducted by the Association and outcomes of those activities (in terms of laws changed, votes in specific companies affected, and so forth),

- b) how monies were raised and spent,
- c) how the Association worked together each of its charitable objects, and
- d) significant problems or risks facing the Association.

28. Charitable use of funds. The Association may not, under any circumstances:

- a) use its funds for aims other than those listed in these Articles,
- b) distribute incomes or properties to any member or person working with or for the Association,
- c) pay any form of remuneration to members of the Governing Committee,
- d) use the proceeds (dividends or capital gains from shares held by the Association) for anything other than its charitable objects.

29. Dissolution clause. If the Association winds up, its assets and properties shall go to another Hong Kong charity with similar aims (including charitable educational establishments).

30. Accounting. The Executive Director must arrange for the keeping of accounts and the production of annual financial statements.

31. Hong Kong spending clause. The Executive shall ensure that revenues earned and donations received by the Association substantially stay and are spent in Hong Kong.

32. Language. Members may communicate in any language, but the Association shall not have the obligation to communicate to Members or other parties in any particular language.