Towards better corporate governance

Chamber of Hong Kong Listed Companies 11th anniversary gala dinner

Carlson Tong
SFC's Chairman

12 December 2013

Chairman Sun, distinguished guests, ladies and gentlemen, Good evening. It is my pleasure to join you here at the 2013 Hong Kong Corporate Governance Excellence Awards and 11th Anniversary Gala Dinner of the Chamber of Hong Kong Listed Companies. First of all, let me congratulate Patrick for being elected as the chairman but I would also like to recognise your former Chairman KS Lo for his leadership in making the voice of the Chamber heard. Patrick, I am afraid you have big shoes to fill!

I would like to extend my heartiest congratulations to all our award recipients. This is a remarkable achievement for you and the companies that you represent, having met the stringent criteria and selection process of these Awards set by the judging panel chaired by Eddy Fong, my predecessor as SFC Chairman. I know Eddy always sets high standards for himself and anything that he is involved in, so I can't begin to imagine what the winners have to go through to stand the test and be selected.

Characteristics of Hong Kong market

Having been a practicing accountant for more than 30 years and for the last year as a regulator, I believe I am in a good position to observe the standard of corporate governance among listed companies in the Hong Kong market. My observation is that whilst there has no doubt been significant improvement over the years as Hong Kong kept in pace with the global development of governance rules and regulations, we should not be complacent and there is always room for improvement.

Having said that, we have fared well on the global scoreboard. According to the World Economic Forum's Global Competitiveness Report issued this year, Hong Kong rose to the 9th position out of 144 markets and took second place among Asian economies. Notably, Hong Kong made it to No. 1 globally in terms of financial market development, scoring high on metrics such as financing through local equity market, affordability of financial services, ease of access to loans, regulation of securities exchange, etc.

While our market is active and well-regulated, the background of Hong Kong-listed companies is quite varied. As at 31 October, Mainland enterprises took up 57% of Hong Kong's total market capitalisation and 68% of the market turnover. Many of these companies are mid-cap, privately owned and family-run enterprises, to whom corporate governance is something of a work in progress, and the culture of responsible corporate practices has yet to truly set in. But let's not get discouraged: many of the world's largest multinational corporations started out as family business and are still growing: Wal-Mart, Samsung, Toyota, LVMH, IKEA, to name but a few. And by choosing to list in Hong Kong, most Mainland enterprises comply fully with Hong Kong's rules and have maintained high corporate governance standards, including some of tonight's well-deserved winners.

Sound and effective corporate governance

Following the global financial crisis, there have been calls for ethical business behavior and greater accountability and transparency to create a more sustainable market environment. This is where corporate governance comes in as it establishes the mechanisms necessary to ensure that a corporation is properly run and professionally managed.

Whilst corporate governance is an evolving discipline, there are universally accepted elements of good corporate governance, which form the backbone of the Awards' selection criteria. For instance, well-defined shareholder rights, sound control function and processes, high transparency and accountability, an empowered board of directors, as well as corporate social responsibility.

In essence, corporate governance is a commitment to stakeholders and the wider community. While regulators can provide guidelines or set out relevant directives, moral commitment to good corporate governance is something that largely comes from the heart. Thus, companies should refrain from taking a boilerplate or check-box approach to complying with corporate governance standards. Rather than asking, "is this legal?", you should rephrase the question and ask yourself, "is this the right thing to do?"

At this point, you may very well think corporate governance is all well-meaning and high sounding, but what good does it do to you and your company?

In fact, there is increasing empirical evidence around the world showing that bad governance raises a red flag for increased risk and often undermines shareholder value. The opposite also holds true. As far back as 2003, a study by two Harvard economists and a Wharton School professor already revealed the strong correlation between corporate governance and stock returns. Encouragingly, the findings show that companies with stronger shareholder rights had higher company value, stronger profits and higher sales growth than their peers.

Separately, a McKinsey survey conducted in the same year concluded that the quality of corporate governance was one of the main factors influencing institutional investors' investment decision in a company. It was found that global institutional investors would be willing to pay a premium of 22% for investments in well-governed Asian companies, as opposed to other companies with comparable market potential but poor corporate governance.

Hence good corporate governance doesn't just keep your company out of trouble. In the long term, it pays off by attracting investors, lowering borrowing costs and leading to potential credit rating upgrades. Ultimately, it helps improve share-price performance of your company.

Board of directors' role

So what can companies do to improve corporate governance?

I believe companies can begin to attach higher importance to the role of their board of directors as an internal gatekeeper. This is a challenge which can be made easier by having effective independent non-executive directors (NEDs) on the board. Whilst the commitment to take one's responsibility seriously certainly makes a difference, the NED's degree of involvement and exposure to the company's business matter even more.

It is widely accepted that NEDs are involved in the "non-executive" side of the business, taking a backseat from the company's day-to-day operations, participating in the strategic decision-making process and overseeing senior management. Many NEDs are able to meet the minimum requirement of attending board meetings and discussing board papers in boardrooms. Regrettably, some of them have been reduced to taking an "armchair strategist" approach and rubber-stamping management decisions.

This has to change. Too often there is excessive delegation in the company's internal control and risk management functions to staff, specifically to legal, compliance, and internal audit personnel, all the while paying little attention to directorial responsibility.

To set it right, directors, executive or otherwise, should watch over business operations while taking up the responsibility of corporate governance. Within the organisation, they have a unique role to play in taking the lead to nurture a strong corporate governance culture at all levels. It is imperative that they have a clear understanding of their responsibilities and the severity of the consequences they will face for failing to meet their obligations.

Just to demonstrate the importance of the role of the INED, you may be interested to learn that the UK Financial Conduct Authority has just published a consultation conclusion titled "Enhancing the effectiveness of the Listing Regime and further consultation" requiring the separate voting of independent directors both by the shareholders as a whole and the independent shareholders as a separate class. It says that independent directors have a critical role to play in promoting effective corporate governance.

What more can be done? Board diversity may be one of the answers. As I mentioned before, effective independent NEDs is one factor; another is more women to serve on boards. You may be surprised to learn that only 10% of directors of Hong Kong-listed companies are women, and some 40% of listed companies do not even have a female director in the boardroom. And we are living in a city where women account for about half of the total population! I hope this will change with the implementation of Hong Kong Exchanges and Clearing Limited's new requirement on listed companies' policy concerning board diversity, subject to "comply or explain" requirements, in September this year.

Corporate governance in Hong Kong

So where does Hong Kong stand in terms of corporate governance?

According to CLSA and the Asian Corporate Governance Association's Corporate Governance Watch 2012 report, which surveyed 864 firms across 11 Asian markets, Hong Kong received the second-highest corporate governance score in Asia. It is worth noting that

Hong Kong came first in terms of regulatory enforcement, posting a double-digit increase in its enforcement score from 56 in 2007 to 68 in 2012.

Clearly, Hong Kong has come a long way in setting corporate governance standards and promoting good practices. For listed companies, their corporate conduct is primarily governed by the Stock Exchange of Hong Kong Limited and up to now, to a lesser extent, the SFC, but this is going to change as I will explain later.

Over the years, the SFC has expanded its regulatory oversight of listed companies to cover three key areas, two of which are new:

first, the dual filing regime, under which we are able to veto listings on the ground of public interests, and to exercise enforcement powers against persons issuing false or misleading corporate information;

next, the inside information disclosure regime, which came into effect on 1 January 2013, provides statutory backing to continuous disclosure obligation of inside information. As at 31 October, there were increases of 47% in corporate announcements and 16% in profit warnings and alerts; and

more recently, the new IPO sponsor regime, effective 1 October this year, aims to enhance the IPO gatekeeping process and the quality of listings.

We have had a higher public profile in our enforcement work in recent years, due in part to our dealings with misconduct in the management of listed companies, many of which led to outcomes that were favourable to the investing public

Despite the current regulatory regime and the steps we've taken, there are still market concerns over listed companies' serious corporate misconduct and how it can be detected. The number of listing-related complaints we receive has continued to account for 25-30% of total complaints filed with the SFC in the past five years. In the same period, we have commenced investigations into more than 130 cases of corporate mis-governance. Suffice to say that early detection of misconduct can greatly reduce damage to the market.

New corporate regulator approach

I must emphasise that in its development as an international financial centre, Hong Kong cannot afford to fall behind global corporate governance standards and best practices. This is not a time for complacency, and we have to continue to push ahead so as to enhance investor confidence in our markets.

The SFC will continue with its proactive approach in gatekeeping and encouraging timely information disclosures to ensure that listed companies comply with statutory disclosure requirements and wrongdoers are punished. But is there a middle ground in between prevention and sanction in the current disclosure-based regime? Is there a way to increase chances of detecting serious corporate misconduct without introducing new rules or leading to the undesirable result of over-regulating?

As thought-provoking as these questions may be, it is not in the SFC's culture to leave questions unanswered, and this is certainly not the way we operate.

We are going to be more proactive in overseeing corporate conduct of listed companies. This will mean more surveillance, analysis and enforcement work on our part and expanding a role we have already been performing under the inside information regime and as a result of referrals from HKEx and complaints received.

A major priority for the SFC is to take on broader, more proactive oversight of listed companies as a corporate regulator. As a first step, we have set up the Corporate Regulation team under our Corporate Finance division to review company announcements, circulars and reports; monitor press reports and analyst research; conduct periodic in-depth review of each company and adopt risk-based criteria to focus on particular companies, for example companies with history of losses, frequent corporate restructuring, changes of auditors, etc.

Our new approach does not require a radical departure from what we have been doing but a significant step in the development of our role as a statutory regulator.

By actively detecting misconduct and following up on suspicious activity, we hope to identify red flags and enhance the SFC's role in maintaining quality markets and high corporate governance standards, as well as protecting investors. This should also instil confidence in listed companies that misconduct will be detected, public corporate information is reliable and a level-playing field can be maintained. We are working closely with the Exchange to reduce any unnecessary duplication of work that may arise as a result of this new role.

Closing remarks

We count on your continued support and partnership in enhancing Hong Kong's corporate governance standards. The key thing here is that you and your companies stand to benefit from better corporate governance, which will in turn allow Hong Kong to sustain its position as a leading international financial centre.

Sound and effective corporate governance cannot rely solely on the legislative framework, but rather requires self-discipline and the proper execution of duties by directors, checks and balances and the promotion of a clean corporate culture. I believe that "tone at the top" is the key because it drives the behavior of the whole organisation all the way through from the chairman, the board and down to the front line. Good market conduct is driven by good behaviour, not by rules and regulations. As aptly put by Louis Gerstner, former IBM Chairman and CEO, "the real mechanism for corporate governance is the active involvement of the owners".

Let me conclude by congratulating the Chamber of Hong Kong Listed Companies on its 11th anniversary and all of tonight's winners. It is to the benefit of the markets that good corporate governance and business ethics are recognised and awarded. I look forward to close collaboration between you and the SFC to uphold the quality of the markets, and wish you all a very pleasant evening.

Thank you.