Hong Kong Institute of Chartered Secretaries

"Corporate Governance at the Crossroads"
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by

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Good afternoon ladies and gentlemen.

It is a pleasure to be invited to address you today on the subject of "Corporate Governance at the Crossroads".

I am going to address you briefly - in order for this to be easily digested whilst you finish your lunch - on where we currently are with corporate governance in the US, the UK and Asia; why we are now at the crossroads; and the direction in which we should be heading – which I am going to suggest includes the consideration of clean & green issues.

It is just over 15 years since the Cadbury Report was published on 1st December 1993. You could be excused for thinking that the Cadbury Committee was set up in response to the high profile corporate failures of the 80's, such as BCCI and Maxwell. However, it was not. The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to review those aspects of corporate governance specifically related to financial reporting and accountability. There was a concern at the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected. The underlying factors were seen as the looseness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business, and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards. The Committee's recommendations were focussed on the control and reporting functions of boards, and on the role of auditors. At the heart of the Committee's recommendations was a Code of Best Practice designed to achieve the necessary high standards of corporate behaviour.

The work of the Committee was not expected to attract attention, but the timing of the corporate scandals, which came hot on the tail of the formation of the Committee, raised its profile considerably.

The Greenbury Committee was convened in January 1995 to review directors' remuneration, in response to senior executives of newly-privatised utility companies paying themselves excessive and non-transparent remuneration packages. The Greenbury Committee reported in June of the same year and at the heart of the report was a recommendation that remuneration committees should be comprised of independent, non-executive directors as a check and balance leading to better control over directors' remuneration.

The Cadbury Committee defined corporate governance as 'the system by which companies are directed and controlled'. The Hampel Committee on corporate governance, which was set up to review the implementation of the Cadbury and Greenbury Committees, adopted that definition.

The current pre-occupation with corporate governance can be pinpointed to two events: the East Asian financial crisis of 1997, which saw the economies of Thailand, Indonesia, South Korea, Malaysia and the Philippines severely affected by the exit of foreign capital after property assets collapsed (the lack of corporate governance mechanisms in these countries highlighted the weaknesses of the institutions in their economies) and the US corporate crises which saw the corporate scandals and collapses such as Enron, WorldCom, Global Crossing and Tyco.

Following these crises, investors insisted on greater transparency on how companies are being run, and to a large degree, corporate governance is considered as one of the key factors in the recovery from that meltdown.

There are many different models of corporate governance around the world, but the current debate is largely focussed on the US versus UK models, that is the rules versus principles models of regulation. In this sense, it might be said that corporate governance is at a crossroads. From the Asian perspective, where are we now? Which road map do we follow? Which path should we be taking – the rules based direction or the principles based road?

The US Model

Each of the 50 states in the US has its own laws and rules in relation to corporate governance. These relate to matters such as the election of directors or the authorisation and designation of classes of securities.

In 2002 the Sarbanes-Oxley Act, or SOX, came in to effect in the US, establishing new or enhanced accounting and reporting standards for all US public companies. This legislation was prompted by the US corporate scandals which I have already mentioned.

The legislation is wide-ranging and establishes new or enhanced standards for all US company boards, management, and public accounting firms. The Act contains 11 sections ranging from additional corporate board responsibilities to criminal penalties. Supporters of the reforms believe the legislation was necessary and useful, whilst critics believe that it does more economic damage than it prevents.

Among its numerous provisions, SOX provides standards for issues ranging from the creation of a public company accounting oversight board, auditor independence, corporate responsibility, and enhanced financial disclosure.

The notorious section 404, requires that publicly traded companies establish, document and maintain internal controls and procedures for financial reporting. It also requires companies to check the effectiveness of internal controls and procedures for financial reporting. When this requirement was proposed it was thought to be reasonable. It was not at that time understood by the legislators that its implementation which requires the creation of extensive policies and controls within public companies to secure, document, process and verify material information dealing with financial results, would be very costly. It is this which has made the requirement controversial. Indeed, some have asserted that the onerous requirements of and the cost of implementing SOX has helped displace business from New York to London, where the FSA allegedly regulates the financial sector with a lighter touch.

Principles based regulation in the UK

In April 2007, the FSA released a report entitled "Principles Based Regulation – Focussing on the Outcomes that Matter". The report heralded the FSA's intention to move towards a more principles-based model of regulation, supplementing their risk-based and evidence-based approach. As explained in the paper, the initiative envisaged a move away from regulator dictated detailed prescriptive rules and supervisory actions on how firms should operate their business. Instead, the intention behind principles based regulation is to give firms the responsibility to decide how best to operate their businesses within the regulatory outcomes which are specified by the FSA. The proposal is to shift the balance of the FSA's activity towards setting out desirable regulatory outcomes in principles and outcome focussed rules. Notwithstanding, the FSA have acknowledged that they will never entirely get away from detailed rules and that they have an important continuing role in the regime to ensure adequate consumer protection and sufficient consistency between regulated entities. In addition, the FSA is bound to implement the constant flow of EU rules.

It has been argued that the principles versus rules dichotomy is overblown and that both jurisdictions employ both rules and principles, but that the SEC rely more on rules than principles whilst the FSA perhaps rely more on principles than rules. The reason for this is the differences between the markets. The US has the largest retail markets in the world, whilst the UK is more dominated by institutional and controlling shareholders. Large institutions are better able to cope with more general principles than less sophisticated individual investors.

It is certainly true that a regulatory system has to be designed and tailor made to fit the particular needs of the environment and the jurisdiction concerned.

Asia

The regulatory environment within Asia is somewhat different again to that in the US and the UK. The role of corporate governance in the US and European markets is to safeguard the interests of a diverse group of shareholders. Asia is different in that the business environment is populated to a far greater degree by family companies over which dominant shareholders have control and stakeholder relations are more informal. Similarly, there are the PRC state owned enterprises which are dominated by the state.

In Asia, a significant proportion of listed companies, and substantially all private companies, are family-run. The principal investors in even the largest enterprises are often family members or close friends.

Asian companies tend to have a smaller % of shares held by minority shareholders whose interests the regulators are seeking to protect. As a consequence, there is greater emphasis on transparency and disclosure in relation to connected party transactions, for example, and we have specific protection and remedies for minority shareholders.

Another issue is the separation of the roles of chairman and CEO. This was first proposed in the Cadbury report in 1992. Since the Enron incident in 2002, both the US and UK corporate governance rules prescribe that it is good corporate governance practice to separate the positions. In 2005, the HKEx introduced such a provision into its Code of Best Practice. However, in a recent report by the HKEx about the extent to which Hong Kong companies have complied with the Code, it was found that about 40% of companies did not separate the roles.

In family-owned and controlled companies it is natural that the founder of the business gets actively involved in the business at least in the initial years. Even if the role is split, the chairman of an Asian company will often be the majority shareholder and is therefore an executive chairman, even if he is not the CEO.

Similarly, Asia companies seem to face greater difficulties than companies in the west in finding INEDs. It can be hard to find truly independent or appropriately qualified people to take on these roles.

Notwithstanding these differences in business culture, it is the role of the SFC, and the Exchange, given the shared regulatory role in Hong Kong, to maintain a regulatory framework with international standards and integrity. Although as regulators in Asia we tend to look to Western jurisdictions (UK, US) and experience in applying corporate governance practices, it is not always the case that what is good for, or works in the West is appropriate here. We need to take into account the local market conditions and culture.

We believe that in order to achieve this and to protect investors whilst at the same time attracting market players and innovation in terms of new products, there must be a balanced regime. That is a balance between principle based regulation in which the firms have the freedom to work out their own way of complying with the requirements, and a set of rules to ensure uniformity and conformity. In that sense we are taking the middle road.

Corporate Governance is not just a matter of compliance with a set of rules, it is also a philosophy which we hope and anticipate that market participants will want to adhere to, recognising that good corporate governance means good returns for investors. We believe that investors want the reassurance that they are investing in a company which has integrity and is compliant.

Since the corporate scandals of the 1980's investors now are much more aware of the importance of corporate governance. In relation to the companies involved in the corporate scandals, the principles of responsibility to shareholders as a whole were clearly ignored.

There has been some academic writing about the correlation between good governance and good returns. Let me share a story from Korea. The Korean Corporate Governance Fund was launched recently. This is an investment vehicle established with an intention to make profits through ownership in poorly governed companies. The rationale behind this was that corporate governance problems can prevent a company from fully utilising its assets and potential for growth, and therefore that a change in ownership and the introduction of good corporate governance would put the companies' resources to better use and improve results. The result was that the value of share prices in a target company rose even before any changes when the fund announced a new target, and also the results of these companies increased and the share prices rose as good corporate governance was implemented by the fund. This therefore showed a correlation between good corporate governance and the market value of the company. Other investors saw this is a positive.

Similarly, a recent study in Thailand, in which the relationship between the adoption of a voluntary code of corporate governance and firm value was measured, a positive relationship was found. In other words, companies which had adopted the code also increased their share price.

Clean & green

So, looking further down the road – where are we ultimately going? What is ahead of us in the long term?

Corporate social responsibility is increasingly being made part of good corporate governance. An aspect of that, and perhaps a new direction for Asia to take, is in relation to clean & green issues - matters of growing concern globally.

Climate change is affecting the world generally and in Hong Kong we have the particular concern of pollution. Pollution has a huge impact on the workforce wanting to come and work in Hong Kong and the local population may be tempted to relocate in pursuit of clean air. Success in business is increasingly about the ability to attract and retain talent.

Global warming is going to have far reaching effects on the business community. It will have a huge impact on agriculture and water sources and supply, which in turn will have a knock on effect on industry. Unfortunately, whilst governments are beginning to wake up to global warming as a serious issue, in many cases growth remains their first priority. In its CG Watch 2007, CLSA has highlighted the importance of green issues in relation to corporate governance. As they put it, good governance goes beyond equitable treatment of minority shareholders. As is stated in the report: "Its seems implausible to say that a company has good governance, that is, it is generally well run, just because it displays satisfactory financial data and shares the returns equitably with all investors, irrespective of whether the corporation is reckless with regard to social and environmental issues…Good governance must include checks and balances to ensure profit maximisation is within constraints of being a responsible corporate citizen."

In 2001, the FTSE launched the FTSE4Good Index Series. This is a series of benchmark and tradable indices for socially responsible investors. The companies in the index take a wide view of socially responsible investment, but are useful for investors who want to find such companies. The indexes enable investors to see how well any investment is doing comparatively and provides a list of the companies that an ethical investor would wish to invest in. The FTSE4Good investment criteria are evolving but presently cover:

- working towards environmental sustainability
- developing positive relationships with stakeholders

- up-holding and supporting universal human rights
- ensuring good supply chain labour standards
- countering bribery

To reflect the growing importance of climate change eligibility for inclusion in the FTSE4Good Series is to be expanded to include climate change.

The FTSE4Good Series has rarely been out of the headlines in the UK. Many listed companies include the green globe logo in their annual reports and other corporate documents.

However, one commentator reported that a six-month study of Hong Kong companies had found only a basic level of awareness of corporate social responsibility, with most firms only interested in the concept if it would help their commercial interests. This was explained on the basis that the shareholders firstly want returns, secondly want the safety of their nest egg and that social responsibility comes a distant third. True up to a point – but CSR is central to commercial interests.

Talent

Another issue that Hong Kong corporates need to be alert to is that students today are more aware of clean & green issues and social responsibility. They are taught about it in their schools and moral and social issues are high on their agendas. When looking for an employer, these students are looking for companies with a good track record is corporate responsibility, and if the corporates are to attract and retain talent they need to have strong policies.

CLSA in collaboration with the Asian Corporate Governance Association, this year included a Clean & Green criteria in their corporate governance survey. They regard failure to heed the risk of climate change as irresponsible and poor corporate governance on a wider notion of it.

There is clearly a need to raise awareness of and responses to climate-change in Asia generally. We are at the crossroads and its time to take a decision and follow a chosen path.

The HKICS's website describes company secretaries as "high ranking professionals who are trained to uphold the highest standards of corporate governance, effective operations, compliance and administration. It goes on to say that the work of a company secretary is essential to the direction, governance, administration and management of a company and that the duties of a company secretary include advising the directors on good corporate governance practice and on development in good corporate governance practice. Company secretaries therefore have a very significant and responsible role in terms of how corporate governance is implemented in

Hong Kong but it is for all of us, in whatever role we play in relation to Hong Kong corporates, to help direct them into a socially responsible way of conducting their business, recognising that a clean & green approach means not only a healthy living environment for us all to enjoy but also better returns all round at the end of the day.

We feel that Hong Kong is going in the right direction, but we have to constantly keep that under review and ensure that we are on the right path.

Crossroads – would you start from here – seems reasonable but the road is still a long one.