The Hong Kong Institute of Chartered Secretaries
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Keynote address

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Introduction

The recent global financial crisis happened due to a confluence of factors. It has been criticised as a failure of governance on the part of governments, on the part of regulators, on the part of market participants, and on the part of investors. As a result, the world is undergoing the most comprehensive financial reform agenda since the Great Depression and on a global scale.

Last week, the release of the 2,200-page report of the bankruptcy examiner for Lehman Brothers has "added more fuel to the existing fire", with some drawing parallels to Enron. The report is a stark reminder of how much more work needs to be done in order to rebuild confidence in financial institutions. Auditors, which have so far escaped blame for the financial crisis, would now come under the spotlight. We can expect a debate on whether there is a need for further reforms in respect of corporate governance.

Today's conference theme is on "Shareholder Rights", which is at the core of corporate governance, as well as an important foundation stone for sustainable capital markets. However, my remarks this morning would be on the broader topic of corporate governance, as there is ample opportunity for particular areas of shareholder rights to be deliberated by the expert panels. After a brief discussion on the importance of corporate governance in rebuilding confidence and economic prosperity, I will touch on some of the international initiatives to strengthen corporate governance, before wrapping up with some ongoing initiatives in Hong Kong for better corporate governance and the protection of investors.

Corporate governance for confidence and economic prosperity

Financial markets serve an essential function in intermediating between economic entities that need financing and capital and those who wish to earn a return on their savings for a given level of risk. What underpins the continued functioning of financial markets is confidence of savers and investors that they will not lose their money due to negligence or mismanagement on the part of fund raisers or intermediaries, and that they will not be cheated and will be treated fairly.

In practice, corporations have to put in place a system of governance that protects the interests of the shareholders, investors and savers, and which limits opportunistic behaviour by those in control of the company's operations. Traditionally, business performance is an important factor in attracting capital, but trust in effective corporate governance is of growing importance, particularly in the aftermath of corporate scandals and the recent financial crisis that has created a trust deficit in big corporations.

In the aftermath of the high-profile and corporate and auditing scandals involving major US corporates such as Enron and WorldCom, the Sarbanes-Oxley Act, or SOX, was introduced in 2002 to protect investors and the general public. Views on SOX were divided. Some welcomed the reform as much needed, while others viewed it as an overkill which made US companies lose competitiveness.

The examiner's report on Lehman might well trigger investigations on whether other institutions adopted similar creative financial reporting practice. It remains to be seen where the findings of the Lehman report might lead ongoing reforms. Might this give rise to SOX II?

The crisis has caused investors to suffer huge losses and vast sums of public money to be spent on bailing out corporations and financial institutions. There is agreement on the need for better corporate governance in order to bolster overall public confidence in financial markets and the corporate world. Governance reform is important for sustaining the recovery of financial markets, business enterprises and economic growth.

Corporate governance reforms on the international front

The global financial crisis pointed to the need to strengthen overall risk management and governance and the creation of appropriate incentive structures that discourage excessive risk taking. The G20 has been driving reforms for global implementation to avoid regulatory arbitrage and ensure a level playing field.

Proposals to strengthen corporate governance include establishing appropriate risk management systems and providing managers responsible for risk control with the appropriate authority and independence.

The issue of bonuses and compensation has received much public attention and demand for reform, given the huge bonuses enjoyed by banks on the back of financial innovations that have created risks that are not well understood, and which are opaque and interconnected across financial markets. In this regard, the G20 has endorsed the Principles on Sound Compensation Practices and Implementation Standards developed by the Financial Stability Board (FSB).

The Walker Review on corporate governance for UK financial institutions

I would now like to turn to the UK government's initiative on corporate governance reform for the financial industry. Sir David Walker was commissioned to review the corporate governance in UK banks in the light of massive losses and the failure of the banking system.

In his report, which was published in November 2009, Sir David said that there was a need to get corporate governance back to centre stage, as improved governance can play an important complementary role to regulatory reform by instilling greater confidence in the way banks are being run by their boards and overseen by their owners. This would help regulators to strike the right balance and not allow the regulatory pendulum to swing too far to cause harm on banking services.

The recommendations of the Walker Review recommended overhauling the boards of banks and other big financial institutions by strengthening the role of non-executives and giving them new responsibilities to monitor risk and remuneration. The recommendations include the following:

- Chairman of the board to face annual re-election
- Chairman of the remuneration committee to face re-election if report gets less than 75 per cent approval
- Non-executives to face tougher scrutiny under Financial Services Authority (FSA) authorisation process
- Banks should have board level risk committees chaired by non-executive
- Risk committees to scrutinise and if necessary block big transactions
- Chief Risk Officer can only be sacked with agreement of board
- Remuneration Committees should disclose right of high-paid employees to receive enhanced benefits

In addition, the Review recommended that institutional investors play a more active role as owners of businesses. Towards this end, it recommended that the Code on Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should operate as a Stewardship Code on a comply or explain basis.

The UK FSA has confirmed that it will implement the recommendation of the Walker Review that the FSA should require institutions that are authorised asset managers to disclose on their website whether and, if so, how they commit to the Stewardship Code. In addition, they should indicate whether their mandates from major clients include provisions in support of engagement activity.

The Walker Review also encouraged that foreign investors should commit to the Code on a voluntary basis in the belief that this was likely to be in their own interests and in that of their clients as ultimate beneficiaries.

US corporate governance reforms

Turning to the US, corporate governance proposals include measures to enhance shareholder influence so that they can exert some discipline on boards and management to be more accountable and act in a manner that is not detrimental to shareholders. For example, there have been calls to give shareholders the right to elect new boards, submit resolutions for stockholder votes, and have more say in compensation, as well as legislation to prevent managers from making it difficult for shareholders to exercise their ownership rights.

Last week, Senator Dodd's Financial Reform Bill included important corporate governance reforms for shareholders. They include granting shareholders the right to have advisory or non-binding votes on executive pay and the right to nominate directors through company-issued proxy ballots.

Basel Committee on Banking Supervision

Before I turn to developments in Hong Kong, I would like to briefly mention that last Tuesday the Basel Committee on Banking Supervision had issued a set of principles for enhancing sound corporate governance practices at banking organisations. The principles touch on:

- the role of the board;
- the board's qualifications;
- the importance of an independent risk management function;
- the need to identify, monitor and manage risks; and
- the board's active oversight of compensation.

Reform initiatives in Hong Kong

I would now like to turn to ongoing initiatives in Hong Kong to improve corporate governance and the rights of shareholders, as well as providing investors with better protection and choice.

First, the Listing Committee is considering whether issuers should set up a corporate governance committee and how the role of the company secretary may be further enhanced. In addition, some items in the Code on Corporate Governance Practices (CG Code) are being reviewed for possible enhancements that are benchmarked against international standards. Topics covered include disclosure of information on directors, shareholders meetings and matters relating to directors, in particular, independent non-executive directors.

Second, the consultation on the rewrite of Hong Kong's Companies Ordinance has come to a close last week. We can look forward to the conclusions and, hopefully enhancements to the system of corporate governance in Hong Kong. However, one should be mindful that as in any reform process the world over, stakeholders have different interests and positions on the various reform proposals, and intense lobbying can shape the final outcome. It was interesting that, according to press reports, there was a last minute rush of submissions of comments by listed companies that supported the scrapping of the "head count" test.

Third, last Friday, the Hong Kong Monetary Authority issued a guideline on sound compensation system, which reflects the Principles for Sound Compensation Practices and the Implementation Standards issued by the FSB to ensure that compensation practices in the financial industry are consistent with, and promote, effective risk management. The SFC issued a press release supporting the FSB Principles, and called on major investment banks that are part of an internationally active financial conglomerate to review their remuneration practices by reference to the FSB recommendations.

Fourth, the SFC had issued the consultation paper on Proposals to Enhance Protection for the Investing Public last September. The proposals are aimed at strengthening our regulatory regime regarding the sale of investment products to retail investors and to better protect the interests of investors. The proposals would enhance the disclosure of product risks and features, strengthen the code of conduct governing intermediaries and selling practices, and introduce the concept of a cooling-off period.

In addition, it has been proposed for all structured products to be brought under the Securities and Futures Ordinance (SFO) by transferring the regulation of public offers of structured products in the form of debentures from the Companies Ordinance prospectus regime to the regulatory regime under the SFO.

Fifth, the joint-proposal by the SFC, Hong Kong Exchanges and Clearing Ltd and the Federation of Share Registrars to implement a scripless market in Hong Kong would offer better choice and better protection to the investors in Hong Kong. A scripless securities market offers investors the choice of direct ownership. This would enhance shareholder transparency, and enable direct and more efficient corporate communications and corporate action services to be provided to shareholders. This would be good for corporate governance and investor protection.

Last, but by no means the least, the government has announced its intention to launch a new round of consultation on the legislative proposals to codify certain disclosure requirements on price-sensitive information. The statutory obligation to disclose price-sensitive information when implemented will undoubtedly enhance transparency and prevent the misuse of privileged information. Last week, the SFC obtained orders in the High Court to disqualify two former executive directors of a company for failing to ensure timely disclosure of material information to the company's shareholders. This is the first time directors have been disqualified for this type of misconduct.

Concluding remarks

Corporate governance is one aspect of the reforms in play to strengthen the global financial system. Effective corporate governance involves the board, management and owners diligently and responsibly playing the roles that are expected of them. It is a system that maintains the balance between control and ownership, and helps companies to grow and support employment, economic growth and prosperity.

Shareholders have rights and they also have responsibilities. They have the responsibility to exercise self-discipline in choosing wisely the companies in which to invest. They have rights that they can exercise to bring pressure on companies to act responsibly in their best interests.

Market discipline and self-discipline are important complements to the discipline of regulation. The three elements have to work together to achieve the right balance that enables market intermediaries to offer their services to economic entities to better manage their risk and meet their funding needs, and to enable savers to earn an appropriate return that suits their risk appetite.

Reforms will not guarantee that there will not be another crisis, but they are needed to address the weaknesses that could again create conditions that undermine stability. We all have a stake in making the reforms work. We need better governance on the part of all stakeholders in order to ensure that economic prosperity would be sustainable.

Thank you.