

Current issues in HK-listed Corporate Governance

David M. Webb
Editor, Webb-site.com
Hong Kong, 27-May-2011

Why governance matters

- Investors will discount prices for the net present value of expected governance losses
- They will also discount for uncertainty caused by slow, shallow or infrequent disclosure
- Lower share prices = higher cost of capital
- Higher cost of capital means fewer viable projects
- This hinders economic development and international competitiveness of an economy
- High transparency, fair treatment of investors and a statutory framework which protects this will result in lower cost of capital and a stronger economy
- Without the framework, a good company can always go bad. Markets discount prices for that risk. There is a “sovereign ceiling” on governance ratings

INEDs

- Most markets require independent non-executive directors, but only in name
- If the controlling shareholder can vote on INED elections, then the INEDs are dependent on the controller, not independent of it
- Consequently INEDs are often just rubber stamps
- No regulator I know of has yet addressed this problem
- Independent directors should be elected by independent shareholders. Controlling shareholders and other directors should be required to abstain
- Boards could still nominate candidates, but candidates would have to be acceptable to independent shareholders
- INEDs would have a mandate, and be held accountable at the next election
- Failing that, we should scrap the requirement for INEDs rather than provide false comfort, and let listed companies decide whether they want their boards to be credible or not

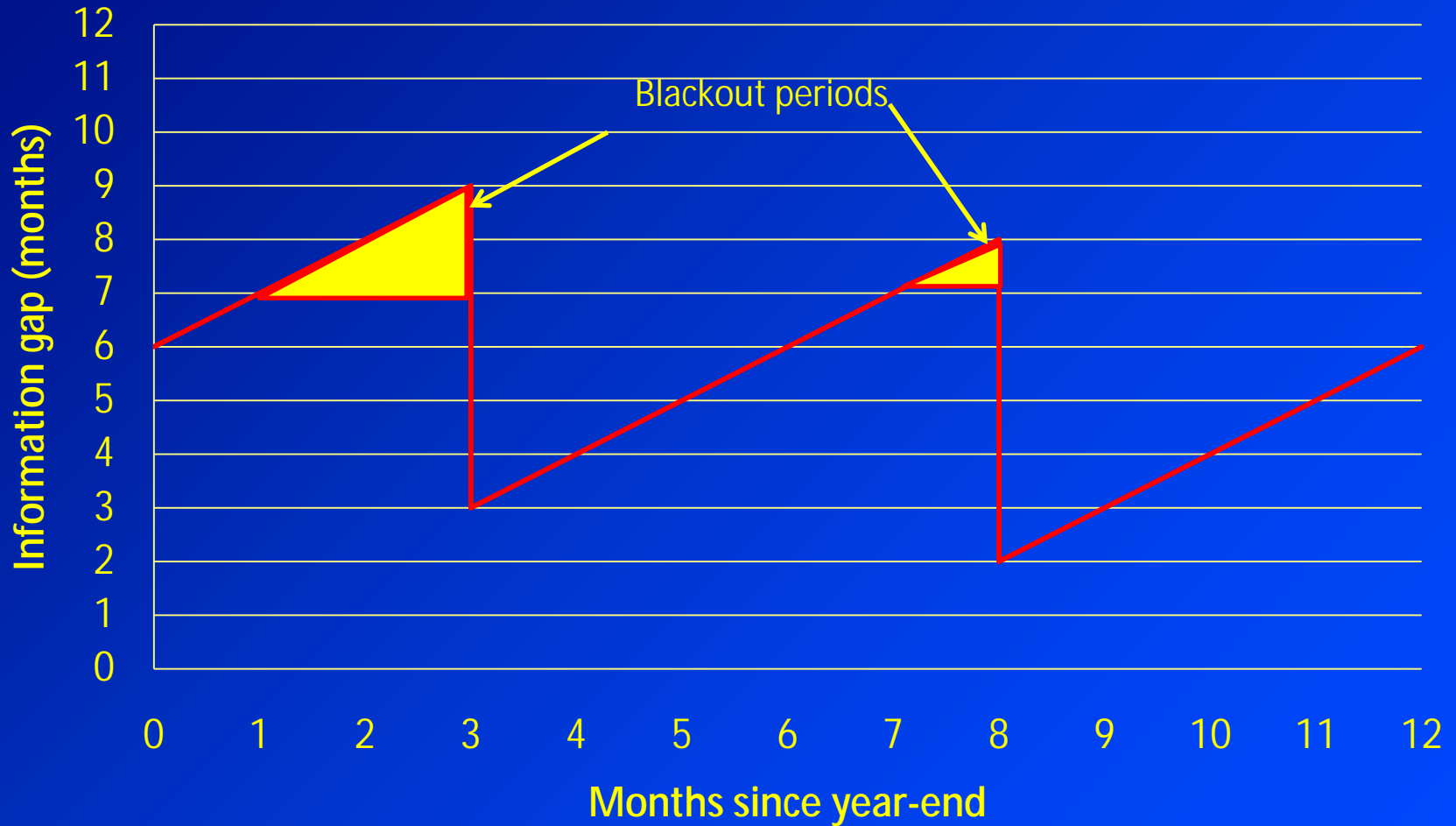
Shareholder communications

- In many markets, including HK, retail investors are *de facto* disenfranchised
- It is important that voting materials should reach retail investors, but if banks and brokers hold the stock as nominees, then they won't pass on the material unless they have to
- In small companies, with low institutional ownership, value-destroying proposals such as connected transactions can get passed due to low voter turnout
- All the checks and balances fail if shareowners don't vote
- Regulators can and should require intermediaries to pass materials to clients and to seek voting instructions
- Communication costs would be absorbed in the fee structures of intermediaries
- Institutions should treat voting rights as part of the asset and exercise them. Beware stock-lending – if you lend, don't be surprised if your stock is voted against your interests.

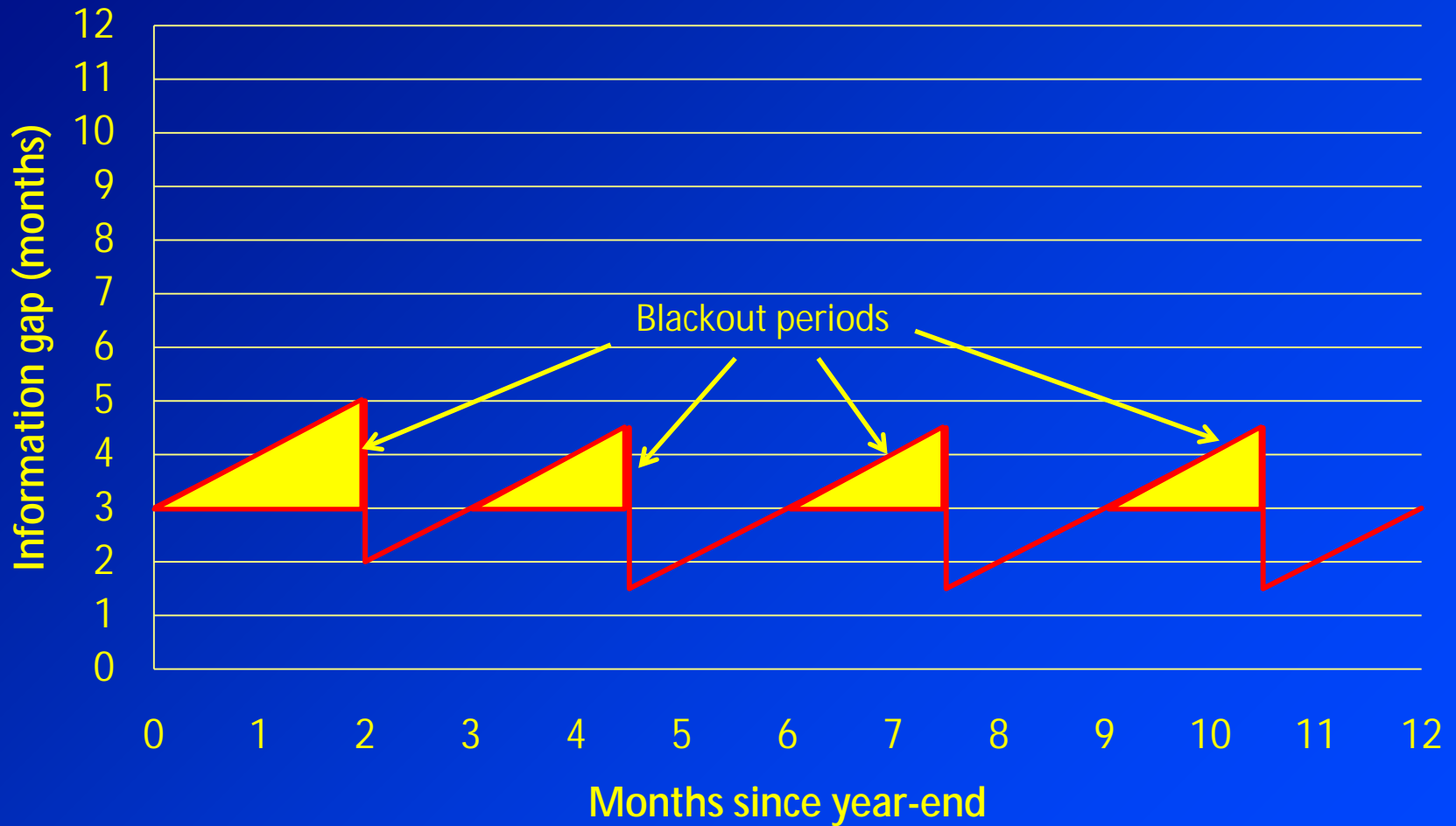
The incentive to delay results

- The Blackout rule (as amended 1-Apr-2009):
 - No insider dealing for 2 months before annual results or 1 month before interim results
 - Insiders decide when to announce results, up to 3 months after the year end or 2 months after the half-year end
 - The later the results, the more time insiders have to deal on the information advantage
- Reform abandoned (was due 1-Jan-2009):
 - No dealing from the year-end or half-year end until you announce your results
 - The faster results are published, the more time insiders have to deal each year

The information gap and the blackout rule



What is achievable: frequent, fast disclosure



Regulatory reach

- HK has no extradition treaty with mainland
- Reason: one country, two systems. If a treaty were bilateral, then HK residents could be extradited to face mainland charges like “leaking state secrets”, “subversion of state power” etc.
- A unilateral treaty is politically unlikely
- So HK law-enforcement and regulators have no more reach than the US DoJ/SEC, and depend on goodwill of mainland counterparts
- Investors should price underlying risk based on location of management *and* business
- If management of a mainland business is based in HK, that’s better than having them both in the mainland PRC

Political realities

- China to banks: go forth and lend (2009). Policy-driven and corruption-driven lending, not based on credit analysis
- Before bank IPOs, bad loans were taken out, but not bad lenders
- China still only 1/3 of the way from central planning to market economy
- Govt has majority stakes in all major SOEs
- Top-level management are political appointees, often shuffled between listed entities (banks, airlines, telecoms, petroleum etc.) or in and out of govt
- So it is hard to believe that the competing companies are evolving stand-alone strategies
- China still a control-state – of media, politics and big business. No medium-term prospect of selling down SOEs to minority or zero
- Entrepreneurs are promising, but many had to cut legal corners to succeed, and might not treat their minority shareholders any better. A substantial discount should be applied relative to developed markets.

Group Finance Companies

- Many large groups have GFCs, controlled by parent. Listed children are expected to support parent and siblings with inter-company loans via GFCs or even directly.
- Recent example: China Resources. 6 listcos. 2 got voted down by independent shareholders.
- If listed companies are so interdependent, then they should be merged. Otherwise, surplus capital should be returned to shareholders, not abused in this way.
- Remember the lessons of Japan's main-bank system
- Protect your investment – just say no.

Bad governance: missing deterrent

- Regulatory “name and shame” (Listing Rules) – minimal deterrent effect
- Civil tribunal - disgorgement of profits & legal expenses. Probability of being caught is less than 100%, so not a big deterrent
- Criminal prosecution – fines and jail, but need proof beyond reasonable doubt rather than balance of probabilities
- Tribunal/criminal route depends on government bringing the action. With limited resources, few cases are brought
- Derivative actions: benefit goes to company, which might still be abused by the same defendants. Costs are still an issue until court awards expenses from company. So this route has not yet been used
- Shareholders could sue, but cost is prohibitive to each shareholder, and joint action is hard to coordinate. Those who don't participate get a free ride.
- So there is a missing element to the deterrent system
- How to facilitate shareholder litigation?

SCALP

- Shareholder Class Action, Loser Pays
- Judge decides whether to allow case as a class action
- Class members can opt out of the action, otherwise they are bound by it
- Loser pays costs (as at present), so frivolous actions are deterred
- Only viable if the representative plaintiff does not have to give the class a free ride on the downside (costs)
- So we need Litigation Funding Companies (LFCs) and contingent legal fees, so the plaintiff is protected
- This would add a private-sector deterrent to bad governance, thereby reducing it
- Australia has had class actions for 20 years. LFCs are now listed
- HK Law Reform Commission has consulted public (Nov-2009) on the way forward. No conclusion yet. Tycoons likely to oppose it
- System could apply to any case, including consumer actions

Other reform issues in HK

- Quarterly financial reporting – proposed in 2002 and 2007, abandoned twice, leaving HK lagging most Asian markets
- Statutory backing for Listing Rules – proposed twice, watered down and now pending legislation on a single rule – the continuous disclosure of Price-Sensitive Information, but with civil penalties only. Whereas false statements carry jail time.
- Location of Listing Regulator – we have a for-profit regulator, which is a conflict of interest. The SFC should take this over
- Scrip-less registration of shares – on the drawing board since 1998. We still have immobilized bundles of paper and “board lots” of shares. Consequently most shareowners have no legal rights
- Lack of duty of care from auditors to shareholders (House of Lords, 1990)
- Lack of right to rely on prospectus for on-market purchases. And you have to prove that you have read it even if you bought in the IPO.
- Abolishing the head-count in schemes of arrangement (PCCW!)

Webb-site.com

- Founded in 1998. Not-for-profit, the site and related activity takes about half my time
- The other half, I research and invest in HK small-caps
- Corporate horror stories end up on Webb-site
- under-valued well-governed companies go into my portfolio
- ...and occasionally, the other way around
- Over 20,000 subscribers to a free newsletter
- Opinion polling
- Site covers economic governance too, advocating free and fair markets, transparency, accountability, civil liberties, tax reform, land revenue reform, minimal intervention and economically-rational policy-making
- A “who’s who” database covers all listed company directors, advisors, legislators, district councilors, government statutory/advisory bodies and the relationships between them

Thank you!

