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Article information:

To cite this document:
Bryane Michael S.H. Goo , (2015),"Corporate governance and its reform in Hong Kong: a study in comparative corporate governance", Corporate Governance, Vol. 15 Iss 4 pp. 444 - 475
Permanent link to this document:
http://dx.doi.org/10.1108/CG-09-2013-0109

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Corporate governance and its reform in Hong Kong: a study in comparative corporate governance

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Abstract

Purpose – *The purpose of this paper was to determine to what extent Hong Kong's experience proves (or disproves) theories from corporate governance in the areas of family ownership, concentration, self-dealing in Hong, executive compensation and other issues. This paper – written in the comparative corporate governance tradition – uses data from Hong Kong to discuss wider trends and issues in the corporate governance literature.*

Design/methodology/approach – *The authors use the comparative corporate governance approach – exposing a range of corporate governance theories to the light of Hong Kong data. The authors purposely avoid over-theorising – leaving the data to speak for themselves for other researchers interested in such theorising.*

Findings – *The authors find that Hong Kong presents corporate challenges that are unique among upper-income jurisdictions – in terms of potentially harmful (shareholder value diminishing) family relationships, shareholder concentration and self-dealing by insiders. The authors also show that excessive executive compensation, accounting and audit weaknesses do not pose the same kinds of problems they do in other countries. The authors provide numerous comments on theoretical papers throughout the presentation in this paper.*

Research limitations/implications – *The authors chose a relatively unused research approach that eschews theory building – instead, the authors use data from a range of sectors to build an overall picture of corporate governance in Hong Kong. The authors subsequently affirm or critique the theories of others in this paper.*

Practical implications – *The original analysis conducted by the authors provided 22 recommendations for revising listing rules for Hong Kong's stock exchange. Others – particularly Asian officials – should consider Hong Kong's experience when revising their own corporate governance listing rules and regulations.*

Originality/value – *This paper offers new and original insights in four directions. First, the authors use the empiricist's method – presenting data from a wide range of corporate governance areas to comment on and critique existing studies. Second, the authors provide a system-wide view of corporate governance – showing how different parts of corporate governance rules work together using concrete data. Third, the authors provide a new study in the comparative corporate governance tradition – another brick in the wall that is "normal scientific progress". Fourth, the authors pose tentative resolutions to highly debated questions in corporate governance for the specific time and place of Hong Kong in the early 2010s.*

Keywords *Corporate governance, Company law*

Paper type *General review*

Introduction

What does corporate governance reform (and the lack of reform) teach us about our theorising about corporate governance over the years? Theory has filtered into concrete changes in financial law and listing requirements on many stock exchanges[1]. As the discipline narrows, more and more empirical studies look at very specific features of corporate governance (Harford *et al.*, 2008; Brown *et al.*, 2012). Legal- and policy-related studies look at normative issues of corporate governance reform[2]. Yet, the brunt of thinking about corporate governance as a topic in itself involves looking at reform at the

JEL classification – G34, P16, G28

Received 17 September 2013
Revised 14 March 2015
Accepted 30 May 2015

country level. Country studies make up the bread-and-butter of an area of study increasingly dominated by regression analysis or textual analysis of financial regulation[3]. This study of Hong Kong hopes to add another piece of the puzzle that comprises "comparative corporate governance"[4].

In this paper, we review recent developments in corporate governance in Hong Kong – in the comparative corporate governance tradition. We raise a particularly vexing question bedevilling theorists of decades – the extent to which government policy should reduce family control over listed companies. We also present data to show where corporate governance stands in Hong Kong, the extent of family control, the harms of self-dealing in Hong Kong, the possible effect of shareholder concentration on corporate governance performance and highlight two non-issues much talked about in the literature. Our paper takes an unabashedly empirical (un-theoretical) approach. We present the broad trends in the data – without imposing the strictures of regression analysis[5]. We hope to provide comparative corporate governance fodder – relatively free from theorising and excessive statistical manipulation, which our colleagues will use in their studies.

We organise our study as follows. The first section provides an overview of corporate governance in Hong Kong – boiling the complex phenomenon down to summary numbers compared with other jurisdictions. We also show how – at least in Hong Kong – better corporate governance correlates with higher share price premia[6]. The second section provides an overview of a key corporate governance problem outside the USA – how to deal with socially destructive family control of listing companies?[7] The third section deals with reducing self-dealing between connected parties. A recent wave of econometric studies have looked at the role of such self-dealing on shareholder value and corporate performance (Farrar and Watson, 2011). Yet, no one has really looked at how such self-dealing fits into the broader corporate governance picture (at either the natural *or* comparative level). The fourth section looks at concentrated shareholdings and its role in reducing the quality of corporate governance. Other studies provide econometric analysis of such concentration – though none really gives the flavour for the extent of such concentration, how it links to other issues of corporate governance and what steps are being taken to tackle the harms from such concentration[8] The fifth section provides an overview of two key issues in many jurisdictions – but not in Hong Kong. Executive pay and the integrity of accounting and auditing have posed serious questions in a number of places (Ho, 2005). As we promised not to corrupt the data with too much speculating, we present the data and leave our peers to debate the reasons why Hong Kong might be different. The final section concludes.

Where does Hong Kong stand in the ratings?

Corporate governance practices in Hong Kong worse than other international financial centres

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 the other at specific corporate governance practices[9]. 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[10].

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 (CLSA, 2012). Across all given criteria, Hong Kong companies (on average) rate higher than their Japanese

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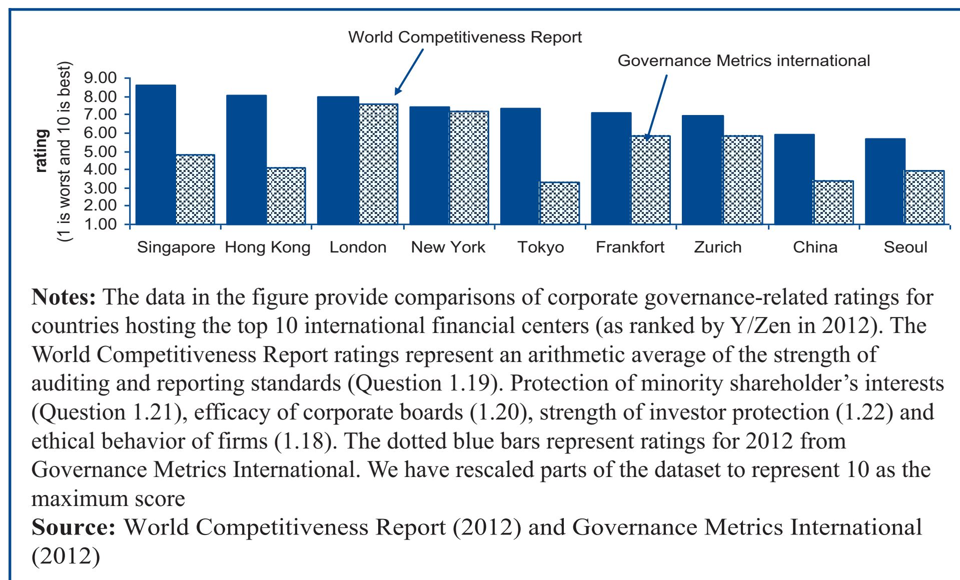
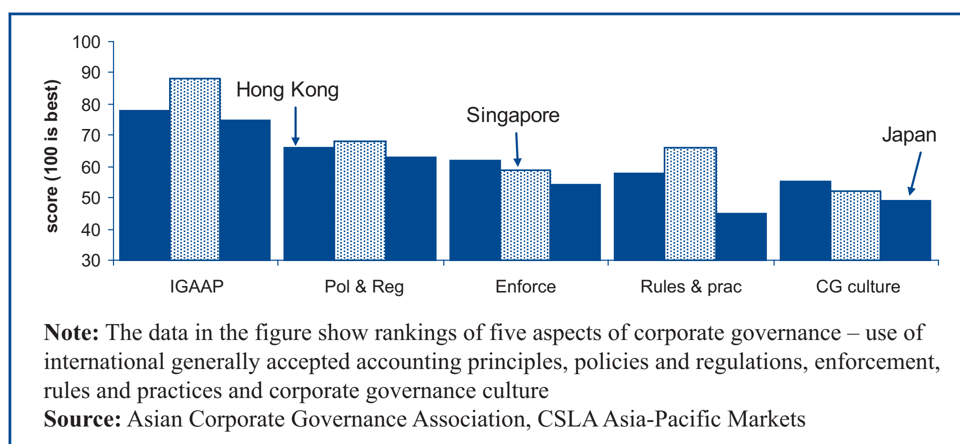
Figure 1 Hong Kong ranks excellently or poorly for corporate governance depending on who you believe



Notes: The data in the figure provide comparisons of corporate governance-related ratings for countries hosting the top 10 international financial centers (as ranked by Y/Zen in 2012). The World Competitiveness Report ratings represent an arithmetic average of the strength of auditing and reporting standards (Question 1.19). Protection of minority shareholder's interests (Question 1.21), efficacy of corporate boards (1.20), strength of investor protection (1.22) and ethical behavior of firms (1.18). The dotted blue bars represent ratings for 2012 from Governance Metrics International. We have rescaled parts of the dataset to represent 10 as the maximum score
Source: World Competitiveness Report (2012) and Governance Metrics International (2012)

Figure 2 Corporate governance in Hong Kong ranks ahead of Japan but behind Singapore



Note: The data in the figure show rankings of five aspects of corporate governance – use of international generally accepted accounting principles, policies and regulations, enforcement, rules and practices and corporate governance culture
Source: Asian Corporate Governance Association, CSLA Asia-Pacific Markets

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 per cent (up from about 70 per cent in 2005). Disclosure and transparency have deteriorated since 2005 from slightly over 90 per cent to about 83 per cent (on a scale from 0 to 100 per cent). Hong Kong companies still rate relatively low in

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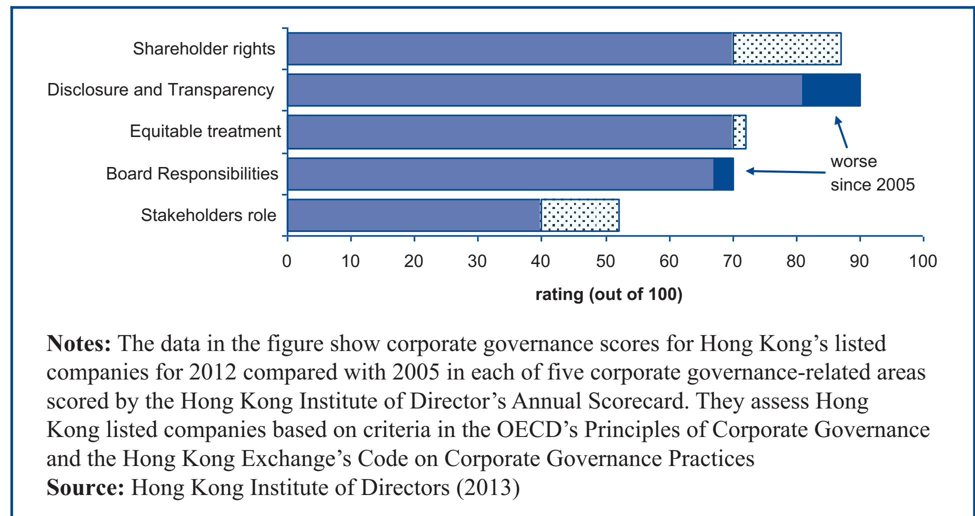
Figure 3 Corporate governance worse in transparency and board responsibilities since 2005?



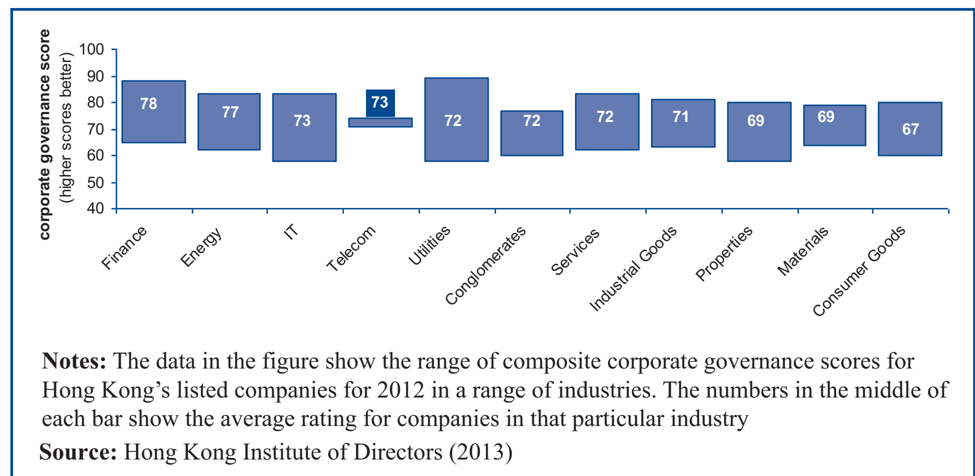
Notes: The data in the figure show corporate governance scores for Hong Kong's listed companies for 2012 compared with 2005 in each of five corporate governance-related areas scored by the Hong Kong Institute of Director's Annual Scorecard. They assess Hong Kong listed companies based on criteria in 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)

the area of equitable treatment of shareholders, board responsibilities for corporate governance and assigning roles to other stakeholders in corporate governance.

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[11].

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 –

Figure 4 Hong Kong corporate governance strongest in finance and energy and weakest in properties and consumer goods



Notes: 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)

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?

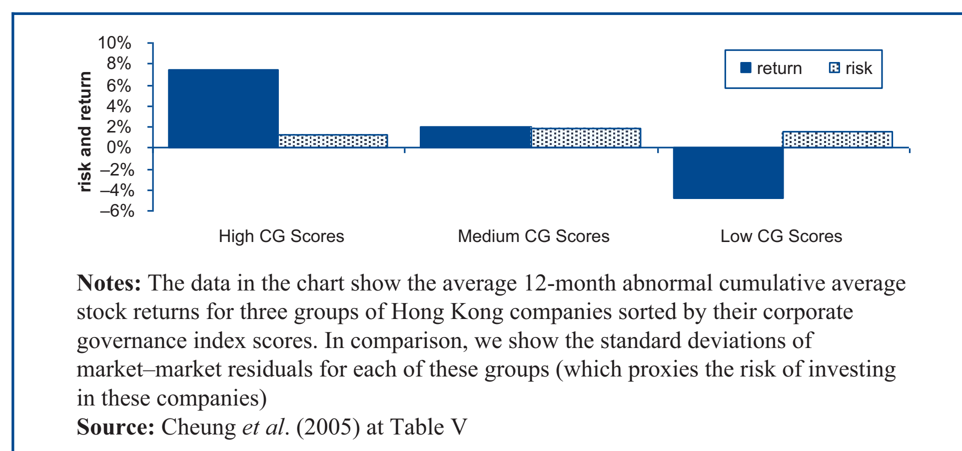
Bad corporate governance likely pulling down performance as an IFC

The data strongly suggest 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[12].

In 2005 (the only year we could obtain data for), high-corporate governance score companies earned an average abnormal stock return of about 8 per cent[13]. Their low-score colleague companies lost about 4 per cent over the course of 2005. Moreover, investors in the low corporate governance companies took on slightly more risk (about 1 per cent 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[14].

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 Organisation for Economic Co-operation and Development [OECD]) correlates with an almost 30 per cent reduction in company value for high-value companies[15]. For low-valued companies, worsening corporate governance made little difference to the already low company value. Similarly, improving corporate governance scores made little difference to corporate value for high-valued companies[16]. Improving corporate governance scores, however, did correlate with a 10

Figure 5 Hong Kong corporations with high corporate governance scores earned 11 per cent higher returns in 2005 with lower risk



Notes: The data in the chart show the average 12-month abnormal cumulative average stock returns for three groups of Hong Kong companies sorted by their corporate governance index scores. In comparison, we show the standard deviations of market–market residuals for each of these groups (which proxies the risk of investing in these companies)
Source: Cheung *et al*. (2005) at Table V

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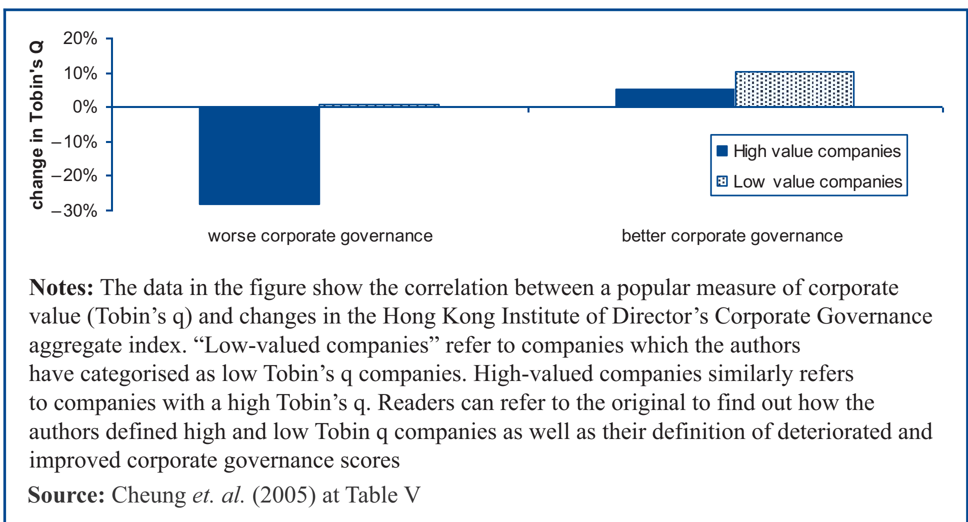
Figure 6 Bad corporate governance in Hong Kong has reduced firm value by almost 30 per cent and good corporate governance can increase value in low-value companies by 10 per cent



Notes: The data in the figure show the correlation between a popular measure of corporate value (Tobin's q) and changes in the Hong Kong Institute of Director's Corporate Governance aggregate index. "Low-valued companies" refer to companies which the authors have categorised as low Tobin's q companies. High-valued companies similarly refers to companies with a high Tobin's q. Readers can refer to the original to find out how the authors defined high and low Tobin q companies as well as their definition of deteriorated and improved corporate governance scores

Source: Cheung *et. al.* (2005) at Table V

per cent 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.*

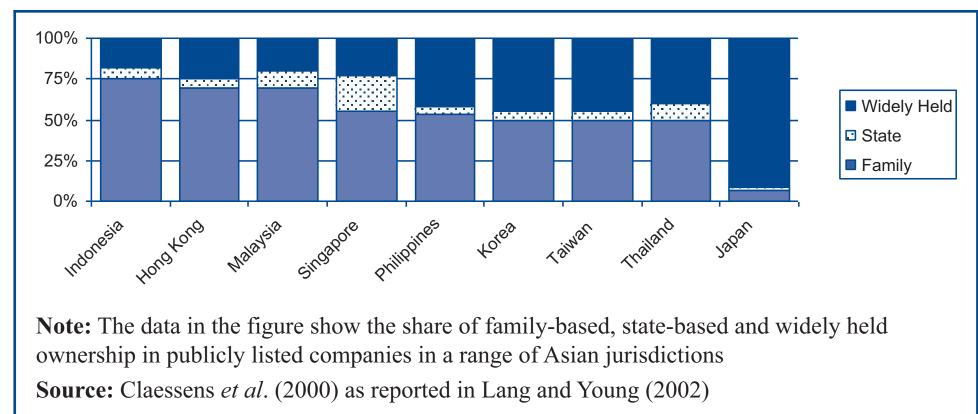
We know that poor corporate governance practices very likely reduce the size of investment into Hong Kong – particularly productive investment in Hong Kong's companies. We also know that other jurisdictions have better corporate governance practices than Hong Kong. These jurisdictions can provide a model as we think through ways of making Hong Kong a leading International Financial Centre (IFC). 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[17].

Families control much of Hong Kong's corporate life

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[18]. If data from the previous decade serve as any

Figure 7 Hong Hong's publicly traded companies under family control



Note: The data in the figure show the share of family-based, state-based and widely held ownership in publicly listed companies in a range of Asian jurisdictions

Source: Claessens *et al*. (2000) as reported in Lang and Young (2002)

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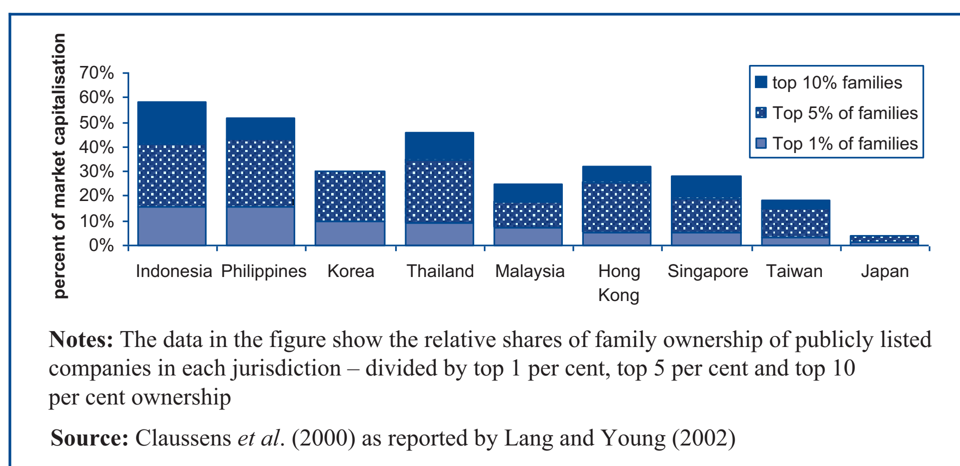
guide, as a share of publicly traded companies, Hong Kong families control the second highest share of these companies in the region – after Indonesia. Yet, the tai (top) of the tai-pan families control less of these companies than in other jurisdictions. Figure 8 shows the share of top 1, 5 and 10 per cent 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 USA 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 per cent of gross domestic product (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[19]. Without an operational law restricting anti-competitive behaviour, such large-scale family control as a per cent of GDP represents an area of concern[20].

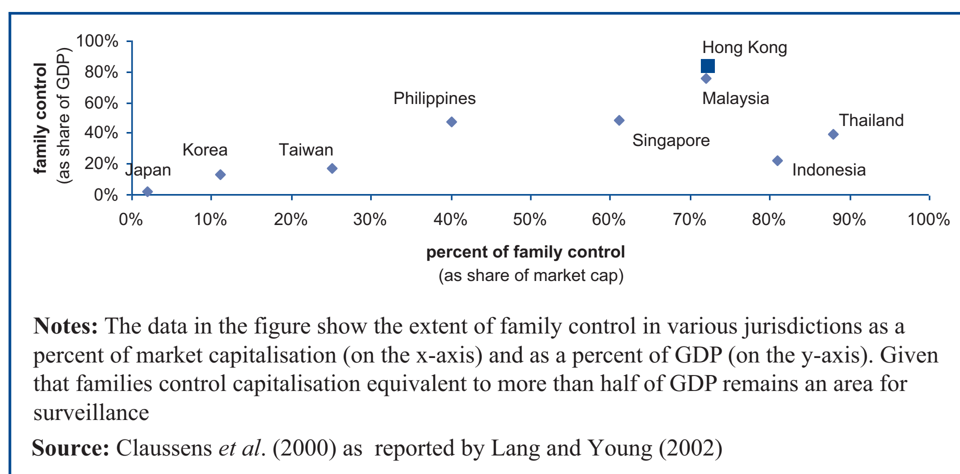
Figure 8 Top families own less of market cap than in other Asian countries



Notes: The data in the figure show the relative shares of family ownership of publicly listed companies in each jurisdiction – divided by top 1 per cent, top 5 per cent and top 10 per cent ownership

Source: Claussens *et al*. (2000) as reported by Lang and Young (2002)

Figure 9 Dominance of families in banking and overall economy mean few rights for outsiders



Notes: The data in the figure show the extent of family control in various jurisdictions as a percent of market capitalisation (on the x-axis) and as a percent of GDP (on the y-axis). Given that families control capitalisation equivalent to more than half of GDP remains an area for surveillance

Source: Claussens *et al*. (2000) as reported by Lang and Young (2002)

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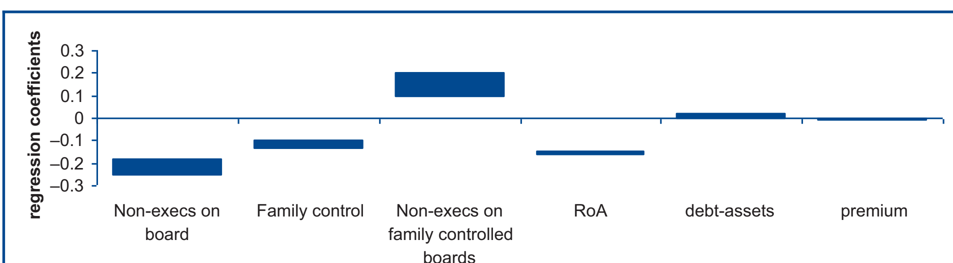
The data also point to a nefarious side of family control in the form of *corporate earnings management*. Jaggi *et al.* (2010) find that corporate boards in family-controlled firms fail to effectively function – leading to likely earnings misstatements. Figure 10 shows the results of their regression models attempting to find a correlation between family ownership and earnings misstatements. They claim to have found it. Boards with a higher proportion of independent directors have fewer estimated earnings misstatements. However, *higher levels of family control of a firm tend to weaken the effect that independent directors have on preventing earnings manipulation*[21].

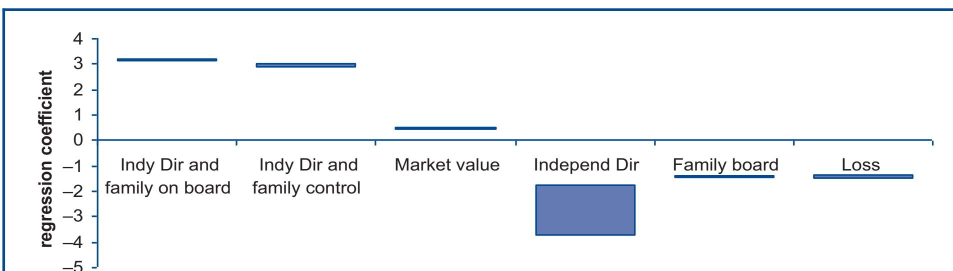
Independent directors clearly play a relatively small role in preventing earnings manipulation by family-controlled firms in Hong Kong. Figure 11 shows the results of regression analysis aimed at determining whether family-controlled boards and family-owned companies engage in earnings manipulation. 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

Figure 10 Family control of Hong Kong firms results in earnings manipulation whereas non-executive control decreases it



Notes: The data in the figure show the range of statistically significant regression coefficients (at the 5 per cent or "better") of measures of earnings management (either the absolute value of discretionary current accruals or the discretionary component of the quality of accruals. Having non-executives on the board promotes oversight – whereas family-controlled firms do not need to steal from themselves. Independent executives though fail to control self-serving earnings management among family controlled firms in Hong Kong
Source: Jaggi *et al*. (2009)

Figure 11 Effect of family control on probability of having positive earnings



Notes: The figure shows the magnitude of significantly significant coefficients in a range of regressions aimed at determining the effect of family ownership and control on earnings management for listed firms in Hong Kong. Variables like whether the firm operates in a litigious industry, ratio of market cap to book value, whether the firm uses a Big 5 auditor and performance-adjusted discretionary current accruals had not statistically significant correlation in this analysis
Source: Jaggi *et al*. (2009)

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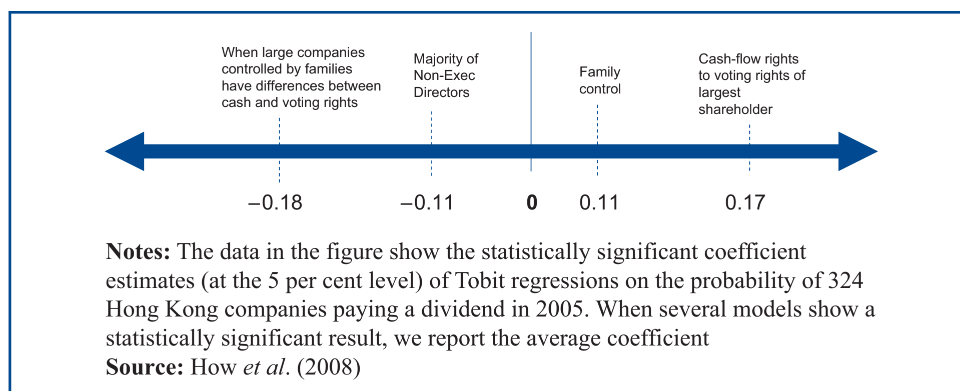
firms without such family control, the appointment of independent directors strongly correlates with fewer earnings misstatements. More worryingly (not shown in the Figure), other evidence suggests that family-controlled firms have significantly statistically more insider trading (Jaggi and Tsui, 2007). *These data provide strong evidence that family control serves to weaken the integrity of earnings reporting and other forms of internal control.*

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 (2007) find that board-level family control over companies reduces the effectiveness of audit committees. Chau and Leung (2006) also find such effects – mitigated by the presence of an independent board chairman. Chen and Jaggi (2000), for their part, find that family control leads to reduced financial disclosure. 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*[22].

Other evidence points to expropriation by families (or at least behaviour not conducive to maximising shareholder value). How *et al.* (2008) 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 *et al.* (2008) 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. 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)[23]. Clearly, expropriation would threaten Hong Kong's status as a premier IFC – requiring regulation to control[24].

A third harm comes from the *negative influence family disintegration has on equity valuations.* Fan *et al.* (2008) document the more than 50 per cent drop in cumulative asset returns three years after a family-controlled firm passed to successors. 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 that 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).

Figure 12 Importance of various factors in deciding Hong Kong companies' dividend paying practices



Notes: The data in the figure show the statistically significant coefficient estimates (at the 5 per cent 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)

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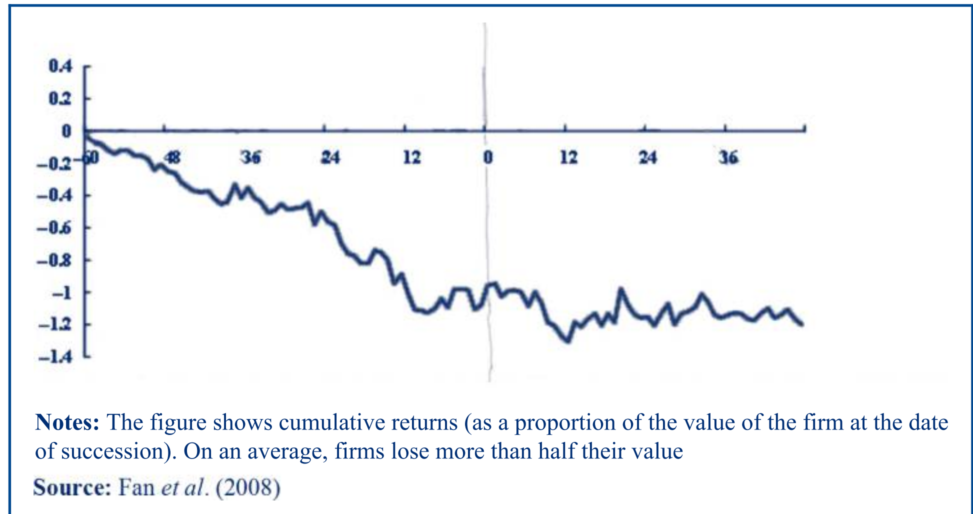
Figure 13 Cumulative average returns before and after a family – firm succession in Hong Kong



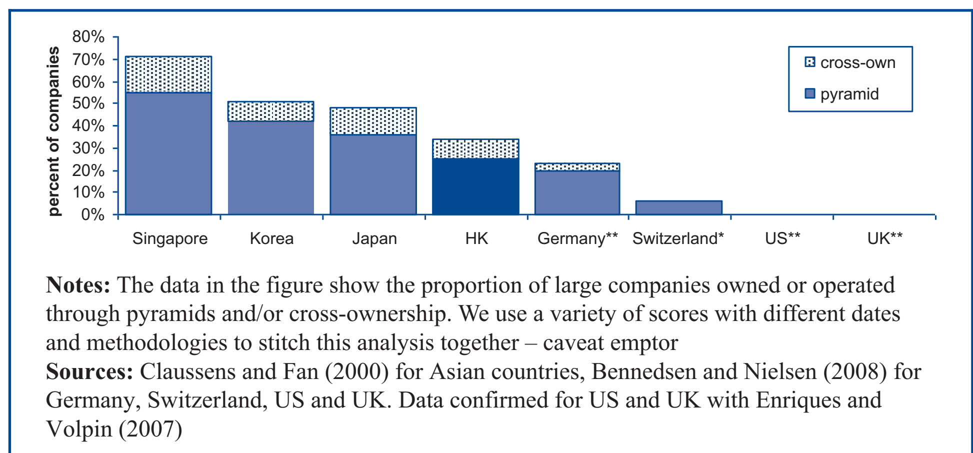
Notes: The figure shows cumulative returns (as a proportion of the value of the firm at the date of succession). On an average, firms lose more than half their value

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 *et al.* (2004) find that structures that allow families to control companies with small shareholdings (such as pyramid and cross-holding) causes *very negative economic impacts*. 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 utilisation 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[25].

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. The per cent 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 USA and UK). Such pyramid and cross-holding schemes potentially pose three harms to Hong Kong as

Figure 14 Hong Kong half way between its pyramiding Asian neighbours and its mature Western counterparts



Notes: The data in the figure show the proportion of large companies owned or operated through pyramids and/or cross-ownership. We use a variety of scores with different dates and methodologies to stitch this analysis together – caveat emptor

Sources: Claussens and Fan (2000) for Asian countries, Bennedsen and Nielsen (2008) for Germany, Switzerland, US and UK. Data confirmed for US and UK with Enriques and Volpin (2007)

an IFC. 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)[26]. Third, the circumstantial evidence suggests that pyramid structures in Hong Kong seek to redistribute benefits rather than make up for weaknesses in a law-given control[27]. 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 *et al.* (2005) find, we would not expect to see such structures in a jurisdiction like Hong Kong with very effective securities, company, property and contract law. Something else – besides self-protection – must be encouraging Hong Kong's families to exercise such control.

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 (2003), 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. Moreover, Mariassunta and Laeven (2007) 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). 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 (2007) find that these pension funds particularly affect board turnover and nomination committee decisions in smaller firms where their ownership buys a larger proportion of the shares.

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[28]. Figure 15 shows the estimated equity investment in Hong Kong shares by regulated pension schemes in the mandatory pension fund[29]. 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.

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[30]. 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 that would potentially lower returns and incur additional costs[31].

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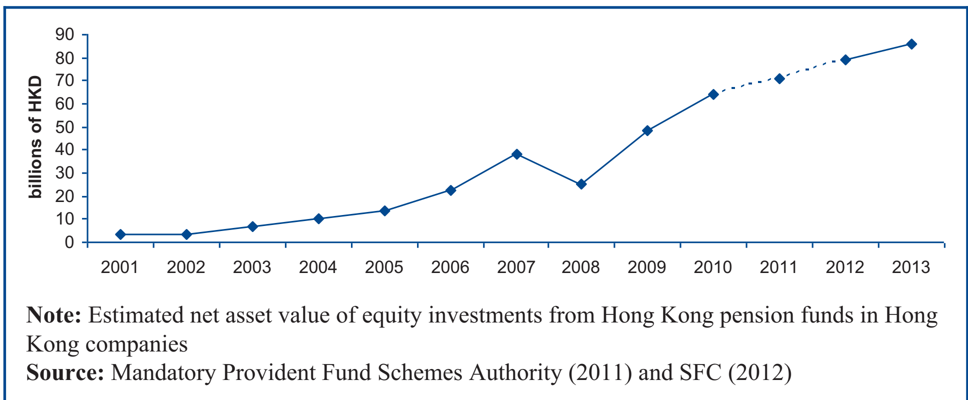
Figure 15 Hong Kong's pension schemes do not even generate enough funds to buy 1 per cent of Hang Seng's market capital



Note: Estimated net asset value of equity investments from Hong Kong pension funds in Hong Kong companies
Source: Mandatory Provident Fund Schemes Authority (2011) and SFC (2012)

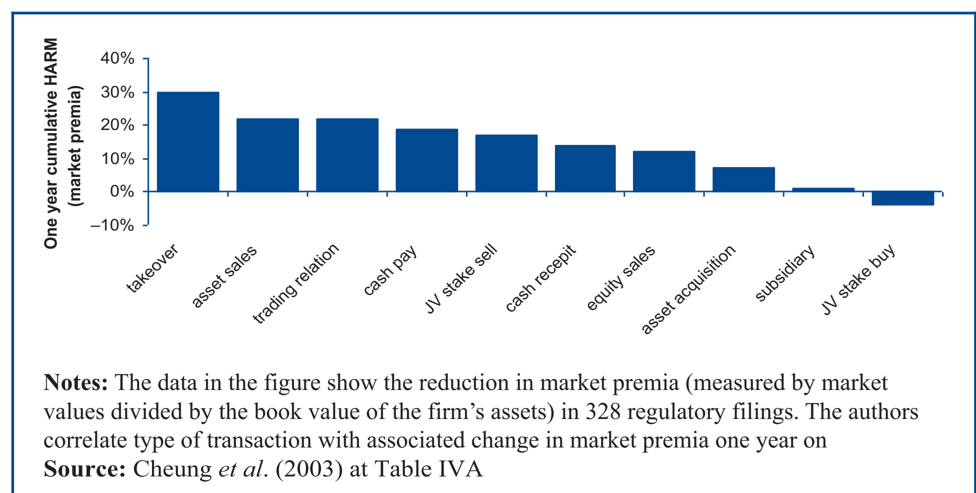
Reducing self-dealing by connected parties

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 *et al.* 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 per cent[32]. Asset sales between connected parties tend to reduce firm value (as measured by the market premium over book value) by about 20 per cent[33]. 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

Figure 16 Connected party takeovers and asset sales destroy about 25 per cent of the weighed-average value of Hong Kong companies at turn of the century



Notes: The data in the figure show the reduction in market premia (measured by market values divided by the book value of the firm's assets) in 328 regulatory filings. The authors correlate type of transaction with associated change in market premia one year on
Source: Cheung *et al*. (2003) at Table IVA

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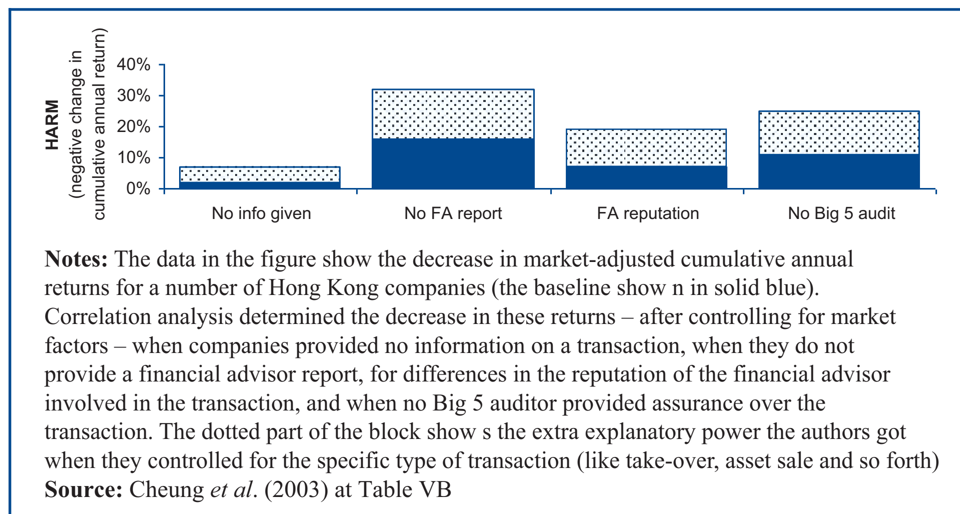
Figure 17 Lack of information on connected party transactions causes Hong Kong share prices to go down about 20 per cent within 10 days from the event



Notes: The data in the figure show the decrease in market-adjusted cumulative annual returns for a number of Hong Kong companies (the baseline show n in solid blue). Correlation analysis determined the decrease in these returns – after controlling for market factors – when companies provided no information on a transaction, when they do not provide a financial advisor report, for differences in the reputation of the financial advisor involved in the transaction, and when no Big 5 auditor provided assurance over the transaction. The dotted part of the block show s the extra explanatory power the authors got when they controlled for the specific type of transaction (like take-over, asset sale and so forth)
Source: Cheung *et al*. (2003) at Table VB

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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 per cent. When the financial advisor involved in the transaction provided no report, firm value fell in the authors' sample by about 30 per cent. These data clearly show a value to corporate governance relationships which promote the publicising of corporate transactions – particularly when connected parties are involved.

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[34]. 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.

The Hong Kong vetting regime

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 Box 1). 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)[35]. 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 (HKEx, 2008). Other mechanisms including pre-vetting and post-vetting by the board and shareholders themselves – in the form of announcements and authorisations[36].

The SFC has recently declared its desire to take over some of the self-regulatory vetting done by the Exchange[37]. Yet, whether the SFC or HKEx "vets" connected party

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Box 1. 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"[39].

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)[40]. The Listing Rules also classify connected transactions by whether they involve a one-off transaction or continuing (repeated) transactions[41].

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 approach 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 (OECD, 2012).

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)[42]. 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 the 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.

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 to minimise the harms from self-serving connected party transactions[38].

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. We can not assess the underlying economic interests holding these shares. But we can look at the custodians of these interests. Figure 18 shows the holdings of the top 5 custodians and shareholders in Hong Kong's corporations and the value (in market capitalisation) of the companies they hold. The data show only the names registered in the official database – meaning that custodians could hold shares in "street name". If custodians reflect the interests of the underlying shareholders, in 2013, the top 5 shareholders held between 95 and 100 per cent of the shares in 48 corporations with a market capitalisation of about HK$500 billion. These top 5 custodians held at least 75 per cent of the shares (a super majority) in 614 companies for a combined market value of HK$14.5 trillion. Figure 19, furthermore, shows the correlation between custodial 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. If these data reflect actual underlying economic control, without significant controls, these insiders could extract significant resources from these corporations.

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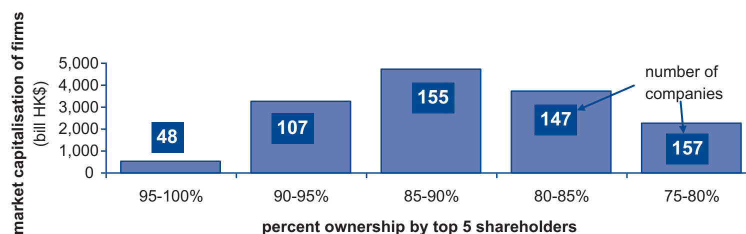
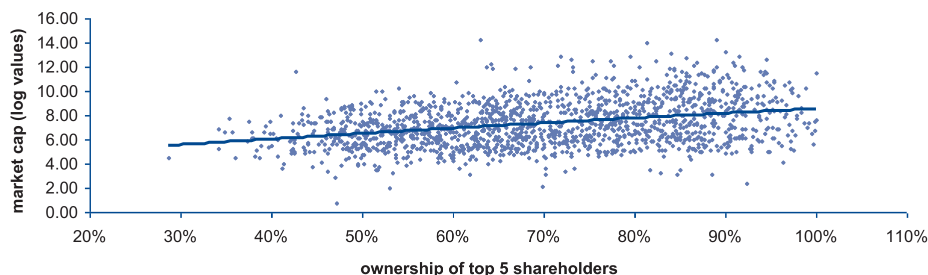
Figure 18 Top 5 custodians hold 70 per cent of Hong Kong's market capital, owning at least three-fourths of the shares or more



Notes: The data in the figure show s the extent to which the top 5 shareholders own companies in Hong Kong. On the x-axis, we show the proportion of shares these top 5 shareholders hold. On the y-axis, we show the market value of those companies. In black boxes, we show the number of companies in each category. Thus, the top 5 investors own between 95-100 per cent of the shares in 48 companies whose market capitalisation in 2013 consisted of roughly HK$500 billion
Source: webb-site.com

Figure 19 Economic concentration and economic power go hand-in-hand in Hong Kong



Notes: The data in the figure show the correlation between the percent of share ownership among the top 5 shareholders and the market capitalisation of these companies in 2013. Despite looking like a mass of dots, a correlation coefficient of 0.33 suggests some form of pattern broken up by lots of other factors
Source: Webb-site.com

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. The data about board overlap (also known as interlocking directorates) suggest the situation more complicated that the press intimates. Table I shows the number of overlapping director appointments for a range of publicly listed companies in Hong Kong[43]. Among the 20 companies with the largest numbers of directors, we sometimes see a 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 per cent 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.

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Table I Interlocking directorates in Hong Kong

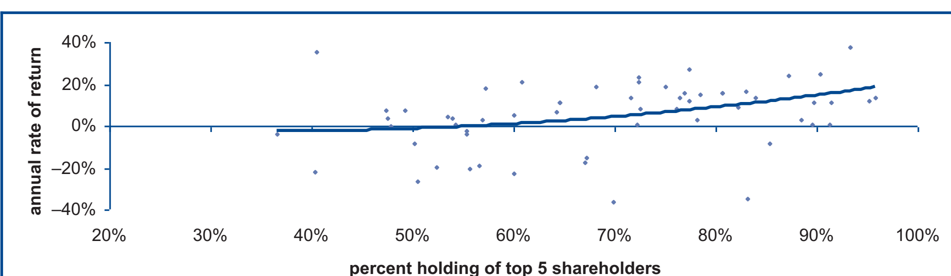
Company name	Average overlap[a]	Market capitalisation[b]	Directors	Overlaps
Bank of East Asia	9.3	$61.8	17	158
Sun Hung Kai Properties	6.1	$255.9	19	115
Cheung Kong (Holdings)	4.8	$232.8	21	101
Cheung Kong Infrastructure Holdings	4.6	$131.9	17	78
Henderson Land Development Company	3.9	$118.7	22	86
Cathay 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

Notes: [a]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; [b]market capitalisation expressed in billions Hong Kong dollars
Source: webb-site.com

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 20 shows the simple (and simplistic!) correlation between the concentration of equity custodianship 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)[44]. However, dispersed custodianship 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.

Figure 20 Too good to be true? Concentration seems to correlate with better returns in Hong Kong



Notes: The data show the compound annual average growth rates in equity valuations from 2003 to 2013 and the percent of equity ownership of the top 5 shareholders in Hong Kong listed companies. To make the plot less dense, we have randomly sampled from the roughly 700 observations we obtained
Source: Webb-site.com

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. Table II 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.

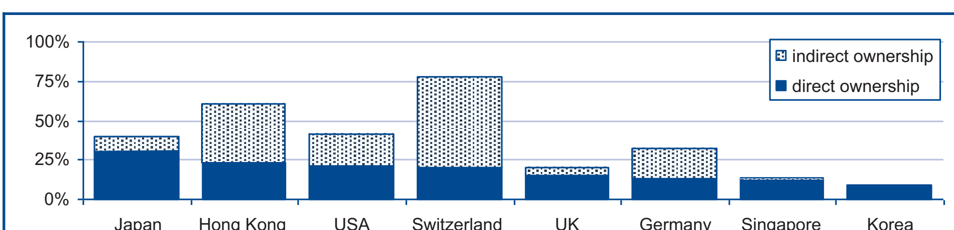
Does concentration actually crowd-out the small investor – depriving him or her of the profits such concentration seems to provide? Leaving issues of justice aside, owners can take more than their fair share – as long as minority shareholders have access to the lucre these owners' companies generate. Such concentration does not seem to deprive Hong Kong's equity holders of access to the lucre. Figure 21 shows the extent of equity ownership in Hong Kong as compared to the citizens of other IFCs. Hong Kong's citizen investors hold the second highest proportion of equity – about 25 per cent of households hold equity (Grout *et al.*, 2009). Concentrated owners do not seem to be holding all the shares amongst themselves. Wide-spread participation in Hong Kong equity does not

Table II Hong Kong's majority owners help themselves to their profits more than they should

Issue	*Description*
Self-serving salary payments	Cheung *et al.* (2003) find that even a 5% or more stake in a large Hong Kong company means executives get paid more
Self-serving dividend payments	Chen *et al.* (2005) find evidence for increased dividend payments as concentrated ownership increases. They view this as expropriation of other investors
Self-serving short-termism	Carney and Gedajlovic (2002) find evidence for lower capital expenditure and earnings manipulation among companies with high ownership concentrations
Earnings manipulation	Leung and Horowitz (2004) find that highly concentrated ownership correlates with less disclosure related to each of the firms' operating business segments
Other self-dealing	Zhang (2008) finds that dividend payments correlate with higher equity valuations–suggesting that investors pay a premium to be able to get their money back. Cheung *et al.* (2006) find concentrated ownership leads to reductions in firm value

Notes: 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

Figure 21 Concentration probably not restricting ownership possibilities for retail investors



Notes: The data in the figure show the proportion of equity ownership among each of the population's households shown. Direct ownership refers to portfolio holdings, whereas indirect holding refers to holdings in pension and other indirect forms
Source: Grout *et al*. (2009)

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seem to improve corporate governance practices. However, such participation does spread the gains of corporate profits among the population.

Derivative action – next steps towards 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 (the UK, the USA and Asian countries like Japan and Korea), the evidence shows that shareholder litigation – overall – improves governance (McTier and Wald, 2011; Punchniak *et al.*, 2012). Many have argued that Asian corporations tend to settle their corporate disputes using relationships and negotiation instead of litigation (or the threat of litigation). Punchniak (2013) shows convincingly that such a "theory of Asian non-litigiousness should be relegated to the dustbin of academic history". 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? Box 2 provides an overview of the relevant law in layperson terms. The basic principle to keep in mind – the company experiences the harms of corporate misgovernance, so only the company (or the board) can sue[45]. Harmed minority shareholders, directors or other parties may sue

Box 2. 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[47].

Who can not 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[48].

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[49].

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?[50] 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 do not 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 behalf.

Source: Kwan and Leung (2012).

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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[46].

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 Table III refers to). Let us step back and consider cases more generally related to "corporate governance". As shown in Table III, 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 eight cases in the past three 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.

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 (2012), governments are increasingly stepping away from international investment arbitration – as minority shareholders engage in forum shopping and other tactics to extract resources from companies. A number of scholars like Scarlett (2011) have found that derivate actions in Asia will only increase – creating an opportunity for Hong Kong's policymakers to use derivate action policy to improve corporate governance locally as well as attract cases to the burgeoning centre for international dispute resolution and arbitration.

Indeed, a recent case law suggests that arbitration proceedings should include derivative actions – at 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 (*Xiamen Xinjingdi* v. *Eton Group and Ors* [2012] HKCFI 915). The shareholder's failure to think about recouping the losses on behalf of the company through a derivative action later has

Table III 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	*In Re* Yung Kee Holdings Ltd.	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	*In Re* Asiafair International Ltd. & Others	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

Notes: 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 Table 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
Source: Lexis-Nexus Hong Kong cases – looking at cases involving "corporate governance"

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commentators claiming that "derivative action based on the New York Convention not recognised in Hong Kong" (Brock, 2012).

Yet, keeping derivative actions out of the courts and in halls of arbitration will require some pro-active policymaking. 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[51]. 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 (Finder, 2011). 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.

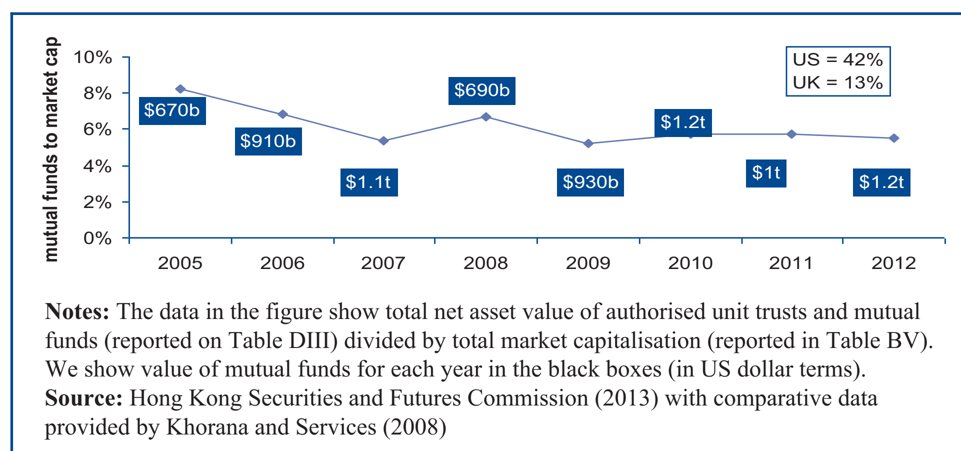
Open-ended vehicles to open closed-up corporations

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 that are basically "locked up"[52]. The Government has announced its intention to allow for such open-ended investments companies and trusts. However, so far, the investing community still waits for concrete initiatives or concrete action (Financial Secretary's Office, 2013)[53].

The data indicate that an open-ended investment structure would allow for the easy entrance *as well as exit* from highly concentrated companies. Figure 22 shows the size of Hong Kong's mutual fund industry – as a per cent of total market capitalisation and in absolute terms. In contrast to the US's 42 per cent or the UK's 13 per cent, such market shares have remained at around 6-7 per cent in Hong Kong. As we showed previously, a high proportion of households hold equity. However, the depth of such holdings (as shown in Figure 23) leaves much to be desired.

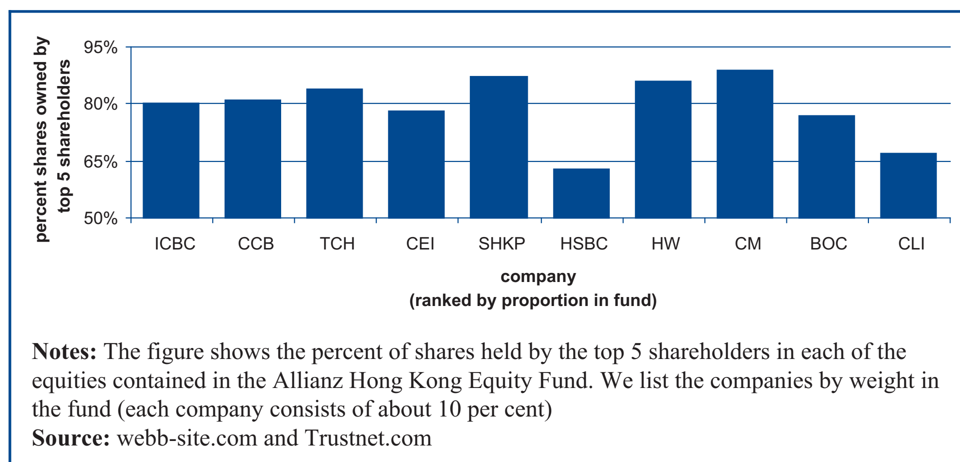
Allowing for open-ended investment companies would provide an effective way to deconcentrate and encourage retail investors to acquire stakes currently held by families. Experience from the USA, for example, shows that mutual fund capitalisation and investment has served as an important way that investors gain access to many of the US's leading corporations (Davis, 2008). 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 (Iliev and Lowry, 2014). Yet, even if mutual fund managers do not engage in any

Figure 22 Mutual funds represent tiny share of market capitalisation in Hong Kong



Notes: The data in the figure show total net asset value of authorised unit trusts and mutual funds (reported on Table DIII) divided by total market capitalisation (reported in Table BV). We show value of mutual funds for each year in the black boxes (in US dollar terms).
Source: Hong Kong Securities and Futures Commission (2013) with comparative data provided by Khorana and Services (2008)

Figure 23 Most of Allianz Hong Kong equity fund composed of highly concentrated companies



Notes: The figure shows the percent of shares held by the top 5 shareholders in each of the equities contained in the Allianz Hong Kong Equity Fund. We list the companies by weight in the fund (each company consists of about 10 per cent)
Source: webb-site.com and Trustnet.com

kind of activism, just the mere deconcentration of holdings may lead to reduced ability of insiders to abuse their discretionary authority over the corporations they own and govern[54].

Hong Kong's mutual funds should do much more than "disclosure" 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 (Trustnet, 2013). 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. Table IV shows the 10 securities held by the Allianz Hong Kong Equity Fund – and the per cent 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 per cent 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 Global Investors Fund (2012), we see no real analysis of the underlying risks or the practices of the constituent companies. 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 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*

Table IV Institutional owners moderate pay in Hong Kong much better than independent directors

Variable	*CEO pay*	*Directors' pay*	*Pay of five highest paid employees*	*Average executive director bonus*	*Bonus as part of total pay*
Group membership					
Directors' share ownership					
Institutional share ownership	–	–			
Per cent non-executive directors		+			

Notes: The data in the table 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)

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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.

Two non-issues in Hong Kong corporate governance

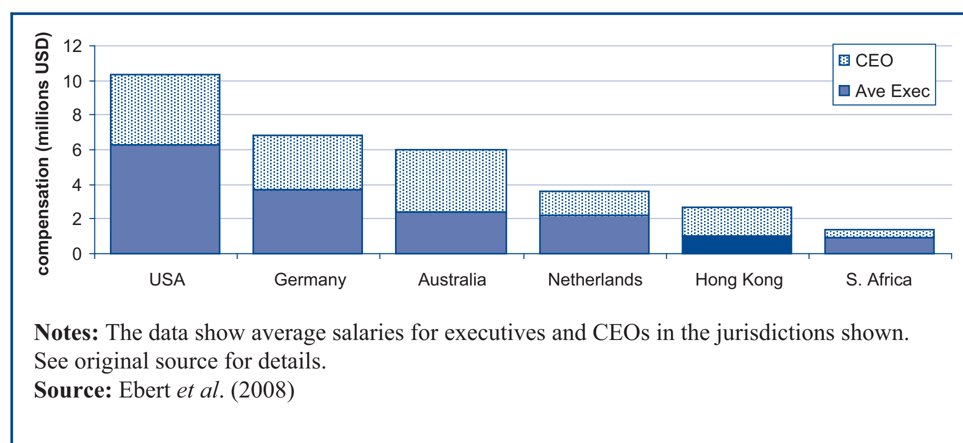
Trends in Hong Kong compensation show pay is not an issue

The recent incarnation of the Code of Corporate Governance has placed some stress on executive and director compensation[55]. 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. 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[56].

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 *et al.* (2003) – in a rather dated study by now – find no statistically significant effect of independent director presence on Hong Kong boards and executive pay. Cheng and Firth (2005), for their part, find that institutional ownership helps mitigate excessive executive pay increases. Table IV 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 per cent of non-executive directors pays a role in determining chief executive officer's, directors' and C-level executives' pay. Only institutional ownership seems to have a statistically significant mitigating relationship with senior businessperson pay. Wong (2009), for her part, finds that remuneration committees have succeeded in restraining executives' payments in Hong Kong.

Executive compensation in Hong Kong has remained extremely moderate – despite high real estate prices and cost of living. Figure 24 shows average executive compensation in Hong Kong and several comparator jurisdictions. The USA – 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 *et al.* 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*.

Figure 24 Executive compensation moderate in Hong Kong by international standards



Notes: The data show average salaries for executives and CEOs in the jurisdictions shown. See original source for details.
Source: Ebert *et al*. (2008)

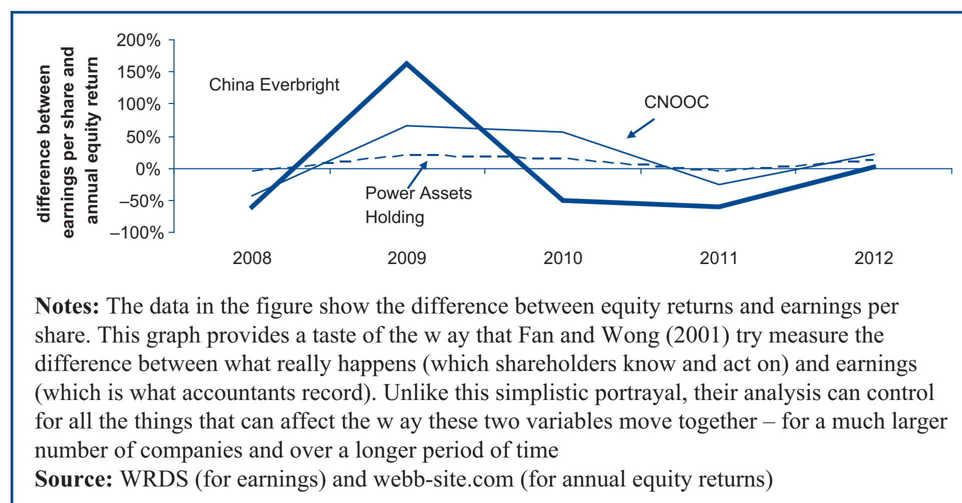
Accounting and auditing also seem okay-ish

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 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 25 illustrates the method used by Fan and Wong (2002) to try and detect accounting problems (as represented by misstated earnings). 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 25 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)[57].

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 (2002) 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 (2000) find that proportion of independent directors on a board positively affect voluntary accounting disclosures. Leung and Horwitz (2004) find similar results. Ferguson *et al.* (2002) find similar results for disclosures made by Chinese companies.

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. 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[58]. Table V shows the statistically significant factors in their analysis. The number of independent directors, directors on an audit committee and a Big Four auditor

Figure 25 The difference between earnings per share and annual stock returns "shows" accounting problems?



Notes: The data in the figure show the difference between equity returns and earnings per share. This graph provides a taste of the w ay that Fan and Wong (2001) try measure the difference between what really happens (which shareholders know and act on) and earnings (which is what accountants record). Unlike this simplistic portrayal, their analysis can control for all the things that can affect the w ay these two variables move together – for a much larger number of companies and over a longer period of time
Source: WRDS (for earnings) and webb-site.com (for annual equity returns)

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Table V Audit-related variables affecting "abnormal accruals"		
Place of listing	*Significant*	*Non-significant*
Hong Kong listed	Number of independent directors on audit committee, number of directors on audit committee, Big Four 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 Four auditor

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

statistically significantly correlate with "abnormal accruals". However, the mere existence of an audit commitment, 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 (2001) – for example – find that the presence of audit committees do increase voluntary disclosures in Hong Kong.

Conclusions

Corporate governance in Hong Kong has improved over the past decade. Hong Kong's corporate governance compares favourably with some of its IFC rivals. Yet, many parts of Hong Kong's corporate governance severely discourage the flow of funds to its companies (directly and through financial intermediaries). 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 of imagined) acts as a severe brake on domestic and foreign investment in Hong Kong's companies. But what does Hong Kong teach us about comparative corporate governance?

This paper presents data from Hong Kong in the comparative corporate governance tradition. Following that tradition, we present the facts (data) without the constraints imposed by econometric analysis or in-depth analysis of black letter law. We present data on five broad areas and the policy-specific issues and questions for Hong Kong. We present extensive footnotes to the literature during our presentation. Such an exposition allows us to provide three contributions to the broader literature. First, we show several features of Hong Kong's corporate governance that other systems do not have – like an obvious link between corporate governance quality and shareholder value, dominant and probably value-decreasing family control, value-diminishing shareholder concentration and good systems of executive compensation, accounting and auditing. Second, we provide data *as is* for comparative studies. By refraining from presenting a strong thesis, we allow our colleagues to use these results in their own theorizing. Third, we touch on numerous academic studies – pointing out how they reflect on (or fail to explain) Hong Kong's experience. We show how Hong Kong's specific experiences provide either reinforcement or a critique to the supposed universal truths presented in these studies.

Notes

1. Gillan (2006) provides a good overview of the theory. Karmel (2001) provides a review of the way theory has filtered in listing rules.

2. For a recent exposition in an international context, see David Skeel, *Inside-Out Corporate Governance*, 37 J. of Corp. L. 1, 2011.

3. These studies provide useful overviews of corporate governance in a jurisdiction. When read together, they form the pieces of the puzzle that comprises comparative corporate governance.

4. The use of country studies as a way of understanding broad patterns across time and countries has a venerable background. Fleckner and Hopt (2013) provide the philosophical underpinnings

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of the comparative corporate governance project, while Aguilera and Jackson (2010) provide a useful overview.

5. Scholars have increasingly turned to such an approach, calling it post-empirical, anti-empiricist, practitioner-focused and even post-modern! Journals have fought against the trend to present broad-brush pictures of corporate governance – letting the data speak for themselves. Effross (2009) provides a useful discussion about the schools of corporate governance theory (and a summary of our own approach).

6. Showing a link between better corporate governance and share premia has bedevilled theorists for decades. By showing this study, we hope to add to this unresolved debate using a simple and trenchant exposition. Daily *et al.* (2003) provide a discussion on the hopeless state of the complexity, multiple studies and unknowns in this debate.

7. Most academics – like Bartholomeusz and Tanewski (2006) – agree that the prevalence of family control outside the USA makes such control one of the most important issues, which US-focused academics understudy.

8. Gugler *et al.* (2008) provide a review of the econometrics of concentrated shareholding. Gilson (2006) discuss the law and policy of the issue.

9. The World Competitiveness Report (2012) 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 (2013) 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.

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

11. 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.

12. Cheung *et al.* (2011) 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.

13. 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.

14. A range of authors, like Zheng *et al.* (2010), periodically show how particular companies in Hong Kong use poor corporate governance practices to compete in the regions highly personalised and unstable markets.

15. 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 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 and board responsibilities.

16. Cheung *et al.* 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 and large companies listed in the MSCI index. Thus, the trend is not particular to Hong Kong-centred companies.

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17. Claessens and Fan's (2002) 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 (2010) in their recent summary of the literature on corporate governance.

18. A series of landmark papers – like Claessens *et al.* (2000) as well as Lang and Young (2002) – 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.

19. 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).

20. 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.

21. 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.

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

23. 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.

24. Goo and Weber (2003) 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.

25. We can not hope to summarise all these studies in a footnote. Bennedsen and Nielsen (2005) show the effects of pyramiding and provide a more than adequate review of the literature. As usual, Fan *et al.* (2008) show that China provides the exception that proves the rule.

26. Chen and Zhu (2010) provide a useful discussion of the effect such pyramiding and cross-holding relationships have had in China.

27. 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), or of an attempt by some shareholders to use control to redistribute the benefits of economic activity in their favour – or both.

28. 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 (1999) finding that pension fund activism helps improve returns in the companies they invest in. Woidtke (2002) finds that pension fund activism may not benefit other shareholders.

29. 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.

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

31 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.

32. 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.

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

34. 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.

35. The Hong Kong Institute of Chartered Secretaries (2008) provide a brief discussion of the vetting regime.

36. The OECD (2009) 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.

37. See Yiu (2012) for a discussion.

38. 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.

39. HKEx 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.

40. SEHK Listing Rules at 14A.13.

41. SEHK Listing Rules at 14A.14.

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

43. Webb-site.com, available online.

44. 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).

45. We do not want to turn this brief into a treatise on corporate law. See Goo (2010) for a fuller description.

46. Kwan and Leung (2012) provide another fine overview of derivative actions in the Hong Kong context.

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

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

49. *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.

50. Section 168BG.

51. Soteris Pittas, *Cyprus: Arbitration And Derivative Actions*, available online.

52. 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.

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53. 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".

54. 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 SFC (2003) 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). The SFC Handbook (2013) mutual fund managers also make no mention whatsoever of any implied duty to engage in any kind of oversight over the companies they invest in.

55. 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)).

56. Gregory-Smith (2012) 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.

57. 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.

58. 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 discretional) accruals as a measure of the extent to which management tries to influence reported earnings.

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