

Keynote speech at Companies Registry Corporate Governance Roundtable

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Corporate Governance is a fiendishly difficult topic to pin down. It's incredibly broad, and perhaps that's why it seems to be the subject of so much discussion and generates a very large volume of academic research. From a regulator's point of view, we have everything from the types of voluntary codes pioneered by Sir Adrian Cadbury in the UK 25 years ago to the hard law of the type exemplified by the Sarbanes Oxley Act in the US 15 years ago. And lots of different rules and practices in between.

Sarbanes Oxley was a legislative response to the severe corporate governance crisis exemplified by the US energy company Enron's extremely creative accounting practices. Those of you who were around at the time will recall that top executives went to jail, and the legal liability for governance failures was cranked up.

You may even remember that after the Arthur Andersen collapse, everyone thought that the big four auditors would no longer offer consultancy services to their audit clients. As is usually the case, memories fade and reforms are diluted as political attention moves on and lobbyists work their magic.

The same seems to be happening now to the reforms put in place in response to the global financial crisis 10 years ago. You will have seen that there is now a lot of talk about rolling back Dodd Frank in the US.

Sir Paul Tucker, the former Deputy Governor of the Bank of England, was the driving force behind the Hay Davison report, which responded to Hong Kong's own financial crisis in the 1980s with the creation of the Securities and Futures Commission (SFC).

He is now Chair of the Systemic Risk Council in the US, which recently issued a very clear warning about the rollback of regulation. It said that if we dilute the measures taken to make the global financial system more able to withstand shocks, and bearing in mind dangerously high levels of global debt, the next financial crisis could be even more severe than the last. That's because after years of low rates and quantitative easing (QE), the central banks, the only other line of defence, have run out of firepower.

The problem is that as the crisis recedes, politicians and the public are increasingly influenced by those who say that post-crisis regulation went too far and is anti-growth. This is part of a familiar cycle, which means that reformers who once had widespread support often become isolated and defensive as the political atmosphere changes.



And it's an old story. The campaign against child labour in the early period of industrialisation provoked a response from mining companies and textile mills that has echoed for centuries whenever the prospect of interference looms. That is that regulation, whether motivated by concerns over social justice, environmental pollution or safety, threatens the ability of companies to compete. As competitiveness declines, the argument goes, negative effects ripple through the broader economy.

So my first message today is that the corporate governance agenda, just like the post-crisis financial reforms, goes in cycles depending on whether there is a near-term crisis that truly captures political and public attention. Right now I think we are mid-cycle, as concerns such as executive pay and bank culture aren't really up there with the collapse of Enron and Arthur Andersen.

But that isn't to say there aren't any important governance issues that deserve urgent attention. So today I'll touch on three. First, some of the more serious conduct and governance issues we are dealing with in Hong Kong's listed sector. Second, an important debate about how company managers may be pursuing short-term goals over long-term investment. And finally climate change, a topic which at first sight may seem to have little to do with corporate governance.

At the first panel this morning, the SFC's Executive Director of Corporate Finance Brian Ho talked about some of the things we are doing in relation to listed companies. I don't want to repeat what he said. But I should emphasise that the SFC will continue to focus on key areas of concern.

One is about conduct and structural problems affecting GEM¹ IPOs² where extreme share price volatility harms innocent investors and erodes market quality. We will also follow up on our examination of highly dilutive, repeated share issues by companies which often end up transferring substantial value from public shareholders to corporate insiders. And we will continue to work on policies to deal with backdoor listings and shell activity designed to circumvent normal entry requirements for our stock market.

On top of this, our enforcement division has prioritised corporate fraud and misfeasance, as well as IPO sponsor standards, as a key area of attention.

I should say that many of the problems we see involve repeat patterns of behaviour by a minority of locally listed companies and financial intermediaries which either directly harms public investors or paints a misleading picture in a company's financial statements.

Our listed market is the bedrock of financial services activity in Hong Kong, so we at the SFC will do everything we can to ensure that all investors can participate in this market with very high levels of confidence in Hong Kong's standards.

We will also make sure that we are transparent about our own work, and to this end we will shortly make an announcement to update the public on developments in GEM IPOs following our recent interventions.

¹ Growth Enterprise Market

² Initial Public Offerings



Now I'll move away from the sharp end of the SFC's work to look at corporate governance from two very different angles – short-termism and climate change.

The corporate short-termism debate

Concerns about corporate short-termism have been discussed for years in one form or another, but have recently resurfaced as a big area of contention. In fact this issue is at the heart of the whole governance discussion. It even underlies different views about the best governance structures for tech companies – most recently in relation to the Snap IPO in the US where the only shares with voting rights are held by the company's founders.

On one side of the argument is the view that corporate managers aren't investing properly in the long term because they are heavily incentivised to pursue short-term goals.

The allegation is that corporate activities are mainly directed to meet quarterly financial targets and to boost short-term share performance. Techniques used to achieve this range from share buy-backs financed by cheap borrowing, to the various ways in which companies present financial statements in a more favourable light such as exotic versions of EBITDA.³

When asked about this, some managers say they are simply responding to shareholder demands and that shareholder value is all that counts. And it's true that under most legal systems, directors owe their duties primarily to shareholders, which is one of the reasons why some ESG⁴ reporting programmes can be difficult to pursue.

But of course the way that executive compensation packages and bonuses are designed means that there is often a large amount of self-interest involved for these directors and managers.

And I should say here that the situation in Hong Kong and Asia is far more nuanced. What I have described is usually seen as more of a US or European problem.

Family and state control of Asian companies may well operate to moderate temptations to pursue short-term approaches. But in my experience, decisions driven by near-term share price performance can still have a significant influence, even in Asia. For example, defensive reactions to short-seller research reports can definitely add to an overall incentive to prioritise very short-term performance.

So I would say that the general perception that there is an epidemic of short-termism which undermines good governance is fairly well accepted.

When asked why they are so keen to maintain control, the founders of companies like Snap usually say that it's because they want to focus on their core vision. Debating with shareholders about share prices and quarterly results will only distract them from achieving their long-term goals, be it changing the world or disrupting it. And that's especially the case if a company has yet to turn a profit, so that its impressive IPO valuation can only be about its long-term earnings potential.

This debate resurfaced last month when McKinsey released a [report](#) claiming to show that it pays to manage for the long term. According to McKinsey's research, companies which

³ Earnings before interest, tax, depreciation and amortisation

⁴ Environmental, Social and Governance



operate with a long-term mindset consistently outperform industry peers on nearly every important financial measure.

Now it may seem blindingly obvious that a company which takes a long-term view will perform better over a longer period than one that is wholly focused on the short term.

But the reality is probably more complicated.

After the McKinsey study appeared, there was quite a bit of scepticism, and I think for good reason.

Writing for the Financial Times, the former head of the US Treasury Larry Summers said that McKinsey had failed to demonstrate a causal relationship between a long-term mindset and being successful. That's because the criteria McKinsey used to define long-termism were the same as those which separate intrinsically great companies from those that aren't so great.

The point is that the best run companies can afford to take a long view because they have the advantage of having excellent managers and a product or service with deep market penetration which delivers consistently solid financial performance. And these are precisely the things that mediocre companies don't have. It's hard to plan for the future when your margins are rapidly deteriorating and you're struggling just to stay in business.

Another criticism is that the study doesn't accurately reflect what's really happening in the economy. It turns out that the bad effects of short-termism are not so easy to find.

The Economist has pointed out that if companies were to ramp up investment in response to criticism about the use of cash for buy-backs and the like, this would only create surplus economic capacity. This implies that the problem is really about large amounts of retained profits that have been hard to deploy in a very uncertain business environment.

And this gets to the core issue, which is that perhaps the whole short-term-long-term thing is a distraction from the issues that really matter.

The reality is that companies which are able to plan effectively for long-term projects while still meeting their targets from quarter-to-quarter will continue to succeed and ride out short-term volatility. And because they have developed strong reputations for performance and, crucially, good governance, they can count on the support of investors to tide them over when they do report subpar quarterly results.

From this standpoint a focus on governance structures designed to avoid pressure from the market to deliver short-term performance may be a distraction from the real drivers of corporate success.

Passive Investing

Before leaving the subject of short-termism I'd like to comment on some changes in investor behaviour that could also have a big impact on corporate governance.



This is to do with the rise of index investing and the very large money flows from active funds to passive mutual funds and ETFs.⁵

A recent survey found that Hong Kong advisors had almost 30 percent of their portfolios allocated to passive strategies and expected this to increase.

This has the potential to be a real problem. If a large slice of institutional investor money is passive, this could mean that few of them have any interest in holding boards to account. The concern is that if boards do not feel accountable to shareholders, incentives for good governance could wither away.

Recently we have been engaging more with companies and asset managers about the implications of this. Basically, we want to encourage all asset managers to focus on how companies are governed and how they manage risks, and to get involved where necessary.

Just over a year ago, we introduced a new stewardship code, which we call the [Principles of Responsible Ownership](#). The principles aim to encourage investors to constructively engage with companies and to establish clear voting policies.

And in line with this we have in fact seen that some of the largest managers of index tracking funds are pursuing stewardship initiatives. These programmes are interesting because they tend to have a long-term focus. And that's for the simple reason that these managers – Blackrock, Vanguard and the like – are by definition permanently invested across the market. Nevertheless, I should say that as shareholders of thousands of companies, they have a big challenge to properly resource their engagement efforts.

But, overall, we expect that as long-term institutional investors more closely monitor and engage with companies, this will be a major contributor to good corporate governance.

Moving the needle on sustainability

I'll now turn to the rather left-field subject of climate change, and explain why this is also relevant to governance.

Global warming was the focus of the recent Paris Agreement, which aims to hold any increase in global temperatures to “well below” 2°C. The agreement also recognises that finance will play a big part in any transition to a low-carbon economy.

Some companies recognised very early on that climate change was likely to have a big impact on their business models, either as a threat or as a potential opportunity. So energy companies have been struggling with the problem of stranded assets. These are those oil and gas reserves that simply can't be exploited if you assume a transition to a low-carbon world. Clearly this has major financial and strategic implications for these companies.

Quite a few stock exchanges and regulators require corporate reporting about sustainability, but the details vary enormously. This makes this type of disclosure hard to use, because investors don't have the ability to compare different companies properly.

⁵ Exchange-traded funds



There are also a vast number of voluntary sustainability standards which overlap and sometimes even contradict one another. This makes it difficult for companies which operate across many jurisdictions to know what to disclose.

As a result, there have been calls for better global coordination to make corporate sustainability reporting more consistent and easily understood.

To this end a really interesting international project is now being led by Michael Bloomberg, involving leading companies such as Unilever, Aviva and Google. The idea is to come up with a framework for companies to produce consistent climate-related financial disclosures.

Now if you think that this is all a bit idealistic and isn't relevant to Hong Kong, let me say why it is.

If you are an investor, this information is essential to properly price the shares of companies which are exposed to climate-related risks. In reality, this is a very large number of companies given the potential effects of global warming over the long term. For this reason, major institutional investors are deeply interested in the Bloomberg initiative because they welcome the promise of being able to make better informed investment decisions.

Information about climate change is especially important for insurance companies and pension funds because their liabilities to pensioners and policy holders are extremely long term.

So there is a real demand here and I expect that we will eventually move from a voluntary framework to a type of mandatory sustainability reporting which is far more comprehensive and harmonised.

Now, the Bloomberg group just closed a public consultation on its detailed recommendations.

One of these was for companies to use a new technique – so-called “scenario analysis” – to better disclose the actual and potential effects of climate-related risks on their businesses, strategies and financial planning.

This type of analysis uses consistent and explicit assumptions to determine plausible future development paths. It uses hard data and models, but can also include narratives to explore relationships and trends for which little or no numerical data is available. One scenario is about the transition to a 2°C world.

So there is a lot going in this area, although obviously there are many challenges, not least a difficult political debate about global warming.

I'm firmly of the view that this project has special significance for Hong Kong. China is now heavily invested in the environmental agenda. So Mainland and other companies listed in Hong Kong are ideally placed to lead the charge globally as part of their governance programmes.

Conclusion

Corporate governance is often seen as a fuzzy or soft topic. But I hope that I have managed to show why it matters in 2017 as much as it did in the aftermath of Enron.



The issues straddle the sharp end of corporate conduct in Hong Kong listed companies to the global dimension of climate risks. In both cases, responsible corporate governance is essential to enable the market to allocate savings to productive long-term opportunities, which is really the whole point of the exercise.

Thank you.