Consultancy on a Survey on International Institutional Investors' Attitudes towards Corporate Governance Standards in Hong Kong in connection with the Corporate Governance Review

Final Report

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EXECUTIVE SUMMARY

The major objective of this consultancy brief is to outline institutional investors' attitudes towards corporate governance standards in Hong Kong. The theoretical framework for the analysis and understanding of modern corporations and the role of institutional investors are agency theory and incomplete contracting theory. Agency theory posits that there are problems associated with the conflict of interest between shareholders and managers and between controlling shareholders and minority shareholders. Incomplete contracting theory posits that problems arise because of the difficulties shareholders face in writing contracts to cover every contingency in the organization and the difficulties of enforcing and monitoring contacts. Both the law and corporate governance mechanisms including institutional investors' activism are important ways of controlling the agency problem and overcoming some of the problems of incomplete contracting.

The late 1990s witnessed increasing interest and investment of institutional investors in corporations, particularly in the USA and UK. Further, the increasing world integration arising from improvement in communication technology as well as growth in cross-border transactions including the rapid development of international capital markets has also contributed to an increase in institutional investments in international equities. As expected, the increase in institutional investment also saw an increase in institutional investors' interest in corporate governance and performance of the investee corporations. The dominance of international institutional investors in the modern day corporate landscape has been described as the single most important change and driver for corporate governance in the corporate sector in the future.

Institutional investors are likely to be actively involved in corporate governance and monitoring for three major reasons. First, institutional investors who have significant shareholding in their investee corporations have the incentive and the power to intervene in the operations of the firm through "institutional activism" such as public announcements, shareholder proposals and proxy contests. Second, as institutional ownership positions become larger, it may be very costly for the institutions to sell large blocks of their investments. Third, institutional investors who have large shareholdings can take the lead in coordinating the oversight of management activities with other shareholders. This could reduce the overall cost of monitoring for both individual and institutional investors. The above arguments provide strong incentives for institutional investors to take a proactive role in corporate governance in order to maximize their shareholders' values.

Prior empirical studies provide some evidence that institutional investors are able to foster good corporate governance practices. It was found that higher institutional investor ownership is associated with lower level of executive compensation, higher monitoring of incentive compensation, higher informativeness of accounting earnings, i.e., less earnings management and more emphasis on long-term shareholders' value, and more monitoring of the investee firms. However, there is some evidence in the literature that have found equivocal results on the link between institutional investors' ownership and firms' financial performance. These equivocal results could be due to two reasons. First, institutional investors can range from those who are mere traders to those who are investors. Second, the role of institutional investors in corporate governance of their investee companies should be considered in the context of the corporate governance culture as well as corporate governance mechanisms in place in the organizations and the severity of the agency problems. Failure to explicitly consider these factors could have confounded the results of studies that examine the link between institutional investors and firm performance. Clearly, an understanding and appreciation of the role of institutional investors must recognize the different types of institutional investors and the corporate governance culture in place.

Brancato's model of different types of institutional investors and the unique corporate governance and ownership environment provide a starting point and an analytical framework for our study in Hong Kong. We conduct a comprehensive review of the literature to identify the corporate information needs of institutional investors. The literature review provides the basis for designing our two methods of data collection namely, personal interviews and web-based questionnaire. The information needs of institutional investors are:

- Financial performance
- Future cash flows
- Dividend yield
- Stock liquidity
- Share price volatility
- Market risk
- Leverage
- Company size
- Company age
- Years listed in stock exchanges
- Cross-listing
- Book-to-market ratio
- Transaction costs
- Quality and disclosure of financial statements
- Availability of information
- Corporate strategy
- Quality of management
- Audit quality
- Conservatism
- Social or human resources information disclosure
- Level of corporate governance

Eleven institutional investors and two investment bankers were interviewed. They found that the quality of management in terms of management integrity is the most important factor in their investment decisions. They commented that if the quality of management is high, then the corporate governance mechanisms set up by the investee company will correspondingly be effective. If the quality of management cannot be relied upon, then any establishment of corporate governance mechanisms would only exist in form and not be effective in substance. Not many of the interviewees systematically factored in corporate governance as a significant factor in their investment decisions. They recognized that it is important but did not consider it explicitly in any evaluation criteria. Most of the interviewees believed that the single important mechanism for good corporate governance is the quality of independent non-executive directors (INDs). If they do not carry out their roles and functions properly, good corporate governance is non-existent. Many were very skeptical about the existence of "truly independent" INDs because of Hong Kong's "close knit" business community which is characterized by a large number of family owned firms. Past and future financial performance, future cash flows, quality of disclosure of financial statements and corporate strategy are very important factors that affect their investment decisions. Most respondents pointed out that family ownership in Hong Kong is an impediment to good corporate governance. Since the board is dominated by the controlling family, INDs may have difficulty in functioning effectively even if they wanted to do so. In many companies, they may not be related to the controlling family but they have been appointed by the Chairman or Chief Executive Officer (CEO) and so could be under the influence of the Chairman or CEO. All the interviewees believed that corporate governance would lead to better firm performance in the long run and they would pay a premium for firms with better corporate governance. They were still willing to invest in companies whose corporate governance is not perceived as of a comparable international standard on the condition that they were sufficiently compensated with higher returns.

Most respondents did not take an active role in monitoring their investee companies. Respondents felt that the Securities and Futures Commission should have wider investigative power for companies which do not comply with corporate governance guidelines, but believed that corporate governance cannot be legislated nor regulated. All respondents supported corporate governance reform in Hong Kong.

On the whole, findings obtained from the interviews and the web-based questionnaire respondents were in general consistent with each other. Both types of respondents ranked the quality of management, content of financial statements (including notes), corporate strategy and future financial performance as the most important factors affecting their investment decisions. Share price volatility was an important factor, and transaction costs as well as the book-to-market ratios were somewhat important. Corporate social responsibility disclosures and years listed on stock exchange were viewed as unimportant factors. However, there were results which were less consistent for the two groups of respondents. Trading liquidity was ranked as an important factor by the interview respondents, but the questionnaire respondents ranked it as one of the most important factors in their investment decisions; audit quality, though rated only as a somewhat important factor by the interview respondents, was viewed as an important factor by the questionnaire respondents. Past financial performance and future cash flow were two of the most important factors affecting the investment decisions of the interview respondents, but only considered as important by the questionnaire respondents. This was also true for leverage, market risk and dividend yield, in which the interview respondents ranked as important factors, while the questionnaire respondents viewed them as somewhat important. Though the opinions of the two groups of respondents on the importance of these factors were not closely aligned, distinctly diverging or contrasting views have not been found and the results are generally consistent and supportive of each other.

Interview respondents generally viewed corporate governance as a somewhat important factor in their investment decisions. It should be noted that the concept of corporate governance was divided into a number of questions which covered detailed corporate governance mechanisms and the respondents were asked to identify the importance of each of the mechanisms on their investment decisions. Results showed that questionnaire respondents generally regarded the independence of INDs and investor communication as the two most important factors they would consider in their investment decisions, and director share ownership, existence of audit committee, family ownership as well as the existence of directors' performance evaluation to be important factors. On the other hand, board composition and CEO domination were viewed as only somewhat important factors, while the existence of remuneration and nomination committees were not important in the respondents' investment decisions.

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CHAPTER 1 INTRODUCTION

An important feature of the modern corporate landscape is the existence of institutional investors such as insurance companies, pension funds and mutual funds. The term "institutional investor" commonly refers to an investor with funds under professional management in an organization that invests on behalf of a group of individuals, organization or a group of organizations. Though pension funds are the single largest category of institutional investor in the USA (48% of total institutional investors' assets by mid-1995), other key intermediaries such as investment companies, insurance companies and banks manage a substantial part of their assets as well. With the growth of the overall portfolio investment of institutional investors, there is a corresponding increase of interest in the monitoring role of institutional investors on behalf of less-informed clients. The monitoring role includes issues of whether institutional investors are active participants in the corporate governance of their investee corporations and whether this active monitoring results in improved corporate performance.

The central economic framework for the analysis and understanding of the role of institutional investors in the modern corporation is agency theory and the concept/theory of incomplete contracting. The agency problem arises as a result of the separation of ownership by shareholders (principals) and control by managers (agents). Shareholders provide economic resources to the corporations with the objective of maximizing returns from their investments in terms of increased firm values. As a result of information asymmetry, managers are likely to act opportunistically at the expense of shareholders' benefits in order to maximize their self-interests (Jensen and

Meckling, 1976; Fama and Jensen, 1983). In the absence of a mechanism to prevent this, shareholders face the risk that the managers may expropriate shareholders' capital.

Another feature of the modern corporation that exacerbates the agency problem is the problem of incomplete contracting. According to the "Theory of the Firm", the firm is viewed as a "nexus of contracts" or a set of contracts between a multitude of parties and individuals and the objective of the firm is to design the contracts in such a way as to minimize contracting costs including agency costs. The contracts are between the individuals and separate entities and there are myriad types of written and unwritten agreements among individuals in the firm. These contracts include formal contracts such as compensation and debt contracts and informal contracts such as informal working arrangements between managers such as organization charts and job descriptions. Accounting is viewed as an integral part of the contracts that define the firm. The contracts themselves and the enforcement and the monitoring of these contracts to ensure that managers act in the interest of shareholders are costly and can affect the firm's profitability and survival. Unfortunately, it is not possible to write contracts that cover every contingency in the business environment hence the existence of "incomplete contracts". The difficulties associated with writing contracts to cover every possible situation or contingency and the monitoring of these contracts becomes a very significant aspect of the agency problem.

Given that it is not possible to write contracts to cover every contingency and the difficulties of monitoring and enforcing them, the potential for managers to act opportunistically in modern day corporations with increasing separation of ownership and control becomes a problem. Manifestations of this opportunistic behavior may be seen in terms of the lack of corporate disclosures, expropriation of minority interests, and manipulation of accounting earnings to increase accounting based compensation schemes. How then do shareholders control managers to ensure that they act in ways to protect shareholders' funds and maximize their values? Both the existence and the enforcement of good corporate governance provide an answer to this question. Corporate governance can vary from one country to another because of legal and institutional differences. Our focus, however, is Hong Kong and good corporate governance mechanisms may be identified in terms of effective board structure and practices including independent non-executive directors (INDs), audit, remuneration and nomination committees, higher audit quality and better corporate disclosures. These corporate governance practices are expected to provide more effective monitoring and reduce the potential for opportunistic managerial behavior. Of particular interest in this brief is the growth of shareholding by institutional investors which has led them not only to become increasingly interested in corporate governance in their investee companies in order to protect their investments but also, in some cases, to participate in corporate governance. This interest and active involvement of institutional investors in the corporate governance of investee companies has given rise to the term "investor activism". Thus "investor activism" is also seen as a form of corporate governance (La Porta *et al.*, 1998; Shleifer and Vishny, 1997). The interest in institutional investors also stems from the fact that they are an important source of capital for the growth and development of the capital markets.

The major objective of this consultancy brief is to outline the institutional investors' attitudes towards corporate governance standards in Hong Kong. Before doing this, we first provide a comprehensive review of the extant institutional investment literature. We next discuss a theoretical analytical framework for understanding the role of institutional investors in Hong Kong. This is followed by a comprehensive literature review of the quantitative and qualitative information needs of institutional investors. These information needs then form the basis for the design of our interview questionnaire and web-based questionnaire. The final section contains our major findings and insights regarding the role of institutional investors in Hong Kong followed by conclusions of the study.

CHAPTER 2 LITERATURE REVIEW ON INSTITUTIONAL INVESTMENT

2.1 Introduction

Chapter 1 provides the theoretical background underlying the development of modern corporations. It outlines the agency problem and the concept of incomplete contracting which form the basis for understanding the need for good corporate governance. It also sets out the objective of this study and outlines the structure of our report. In this chapter, we trace the development of increased share ownership by institutional investors in developed markets. In order to understand the role of institutional investors on corporate governance of their investee companies, a comprehensive review of the literature on the link between institutional investors and corporate governance is conducted. The next section discusses the important relationship between institutional investors and firm performance. The last section identifies two possible reasons for the inconsistent results in prior studies on the relationship between institutional investors and corporate performance.

2.2 Development of Increased Ownership by Institutional Investors

Before the 1990s, the relationship between corporate management and institutional investors in developed markets was relatively straightforward. Individual shareholders were by and large silent holders of equity who would rarely exercise their rights to protect their interests in corporate governance matters (Black, 1992; Daily *et al.*, 1996). Institutional investors, on the other hand, could express their dissatisfaction with corporate management by doing "The Wall Street Walk" and selling their shares (Hirschmann, 1970; Edwards and Habbard, 2000; Daily *et al.,* 1996). Institutional investors were described as "passive monitors" because their shareholding in any particular corporation was relatively too small for them to be able to exercise any discernable influence on corporate governance matter. Thus, the small percentage of institutional ownership in developed capital markets such as the USA seems to be the main reason for “passive monitoring”. In general, shareholder or investor activism virtually did not exist in developed markets at that time.

The late 1990s saw dramatic changes in the corporate shareholding landscape in developed capital markets that brought to the fore issues related to shareholder rights and the protection of minority interests. One such change was the increasing interest and investment of institutional investors in corporations. The increase in investment, particularly in the USA, also saw an emergence of interest of the institutional investors in corporate governance and performance of the investee corporations (Brancato, 1997). The US witnessed a phenomenal growth in institutional investment particularly in the last ten years. Institutional ownership, primarily made up of private and public pension funds, increased from 15.8% of corporate equity in 1965 to more than 50% by 1990 (Useem, 1993). In terms of market capitalization, the percentage of institutional investment grew from US$1.9 trillion to a more than fivefold increase of US$10.2 trillion by the second quarter of 1995, representing almost 22% of all US financial assets at that time (Brancato, 1997). As compared to 1987, the percentage ownership in 1995 held by institutional investors in the top 1000 US companies grew from 46.6% to 57.2%. By 1999, institutional investors held nearly 60% of the largest 1000 US corporations and they held collectively more than 50% of the shares in two-thirds of these corporations (Financial Economists Roundtable, 1999).

The phenomenal growth in institutional ownership was not only confined to the USA and UK markets but also in international equities (Cadbury, 1999). In the UK, about 75% of British equities are held by institutional investors including about one-third held by pension funds. This proportion is expected to rise as a result of the aging of worldwide population and the attendant rise in pension fund investment. It is expected that there would be a corresponding increase in the proportion of their funds in equities in order to improve their returns. Increasing world integration arising from improvement in communication technology as well as growth in cross-border transactions including the rapid development of international capital markets are expected to cause an increase in investments in international equities. The dominance of international institutional investors is hypothesized to be the single most important change and driver for corporate governance in the corporate sector in the future (Cadbury, 1999). Such increases in the level of institutional ownership are expected to be accompanied by a higher level of shareholder activism that aims at changing the ways corporations are managed, monitored and governed. In short, the "exit strategy" for passive institutional shareholders would become inappropriate for institutional investors whose share ownership in investee corporations is comparatively larger. Moreover, the difficulties of disposing of shares of poorly performing corporations quickly and the limited alternative investment opportunities[1] available in the market have forced institutional investors to adopt a more proactive role in the corporate affairs of their investee corporations in order to protect their interests.

[1] This is true when institutional investors are given a mandate by their clients that requires them to implement indexed investment strategies which involve investing in a pre-specified set of firms such as S&P 500. This would limit their alternative investment opportunities but would assure a market return for their investment. (Daily *et al*., 1996)

The role of institutional investors in corporate governance has generated considerable debate (Beim and Calomiris, 2001; Financial Economists Roundtable, 1999). A backdrop to this debate is that there are some who advocated the American populist political tradition and argued vehemently that this accumulation of power in the hands of concentrated financial interests could be potentially dangerous. Others argued that this development of investor activism through the power generated by increased institutional ownership can be viewed as a solution to mitigate the agency problems associated with the separation of ownership from control in large corporations (Financial Economists Roundtable, 1999). The rationale for this argument is based on the fact that the voting rights through diffused share ownership is not an effective oversight mechanism over management and has created opportunities and latitude for management to entrench itself and pursue objectives that may not be consistent with shareholders' interests. However, increased institutional ownership is expected to reduce management opportunistic behavior. (Smith, 1996; Rajgopal and Venkatachalam, 1997; Bethel and Liebeskind, 1993).

The issue of whether the development of institutional investors in Hong Kong is beneficial will be discussed separately in the next chapter. It is worth emphasizing that agency problems and share ownership structures, including family ownership, in Hong Kong are different from developed markets such as the USA. The next section reviews the literature on the role of institutional investors.

2.3 Role of Institutional Investors in Corporate Governance

The main objective of "institutional participation in corporate governance should be to maximize economic value for the institutional shareholders and their beneficiaries"

(Financial Economists Roundtable, 1999, p.6). It should also be recognized that there may be some institutional investors who are constrained by non-economic objectives such as social and environmental concerns. This may lead them to pursue governance initiatives that may not maximize shareholders' value. In general, the increase in institutional investor ownership as a group has the potential to play a significant role in corporate governance and to enhance corporate effectiveness (Kochhar and David, 1996; Coffee, 1991; Pozen, 1994; Brancato, 1991; Schwab and Thomas, 1998; Silverstein, 1994). There are three major reasons why institutional investors are likely to be actively involved in corporate governance and monitoring.

First, institutional investors who have significant shareholding in their investee corporations have the incentive and the power to intervene in the operations of the firm through "institutional activism"[2] such as public announcements, shareholder proposals and proxy contests (Daily *et al*., 1996). Explicit powers refer to voting for or against board members in board meetings or annual general meetings and implicit powers include actions such as a strong showing of votes that are unfavorable to management which can increase the threat of takeover, or voting against management in takeover defenses proposals. In the USA, the primary tool of shareholder activism to seek corporate reform is through the proxy mechanism. Anecdotal evidence suggested that many institutional investor groups supported shareholder activism. Examples of shareholder activism included demands made by the International Brotherhood of Teamsters' pension fund and New York City Employees' Retirement System for a split in the roles of Chief Executive Officer (CEO) and Chairman in two of their investee corporations and the California Public Employees' Retirement

[2] "Institutional activism" refers to actions used to bolster their voting power and to pressure managers to comply with their demands.

System's (CalPERS) efforts to take away staggered board provisions in one of their investee corporations (Daily *et al.*, 1996). The larger the ownership position held by any institutions, the greater are its incentives to monitor management actively to benefit its shareholders and beneficiaries.

Second, as institutional ownership positions become larger, it may be very costly for the institutions to sell large blocks of their investments. Hirschmann (1970) posited through his "Exit versus Voice" model that institutional investors should have strong incentives to exercise their "voice" in governance decisions because their ownership is so large and their ability to "exit" is low[3]. Kochhar and David (1996), Gilson and Kraakman (1991) and Smith (1996) in their studies drew the same conclusions. The presence of strong incentives and their explicit power allows institutional investors to be actively involved in the monitoring of managerial decisions to achieve effective governance (Demsetz, 1983; Shleifer and Vishny, 1986; Monks and Minow, 1995). In fact, it was suggested that institutional investors are a form of corporate governance and the growth in institutional ownership should induce better governance (La Porta *et al.*, 1998).

Third, institutional investors who have large shareholdings can take the lead in coordinating the oversight of management activities with other shareholders. This could reduce the overall cost of monitoring for both individual and institutional investors (Financial Economists Roundtable, 1999). These three arguments provide strong incentives for institutional investors to take a proactive role in corporate governance in order to maximize their shareholders' values.

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[3] The ability to exit is low because it is difficult for them to find alternative investments or sell out current shares quickly without affecting share price or without incurring prohibitive costs.

A good example of active monitoring by institutional investors in the USA is CalPERS. They are widely regarded as the leader in shareholder activism in the US equities market as the largest public pension fund in the USA with over US$155 billion in assets at the end of 1999 (CalPERS Shareowner Forum, 2001). They admitted that they were "not simply a passive holder of stock… [but] a shareowner, and take seriously the responsibility that comes with company ownership" in their official corporate governance website, The *CalPERS Shareowner Forum*. Recently, CalPERS decided to increase its active corporate governance strategies. It established a new active corporate governance program in November 2001 that adds an additional US$1.7 billion to the pension fund investments and targets greater corporate governance strategies in Japanese and European markets. These are typical examples of a major institutional investor's initiative in monitoring and promoting corporate governance of their investee firms.

The next section reviews the extant literature on the effectiveness of the monitoring role of institutional investors. For this purpose, the studies are classified into three broad categories:

- Institutional investors as active participants in corporate governance.
- Institutional investors as passive participants in corporate governance.
- Linkages between institutional investors and firm performance.

2.3.1 Active Participants in Corporate Governance

The following studies provide support for the notion that institutional investors are actively involved in corporate governance (including monitoring) of their investee corporations.

- Wahal and McConnell (2000) studied corporate expenditures for property, plant and equipment and research and development (R&D) for over 2,500 US firms from 1988 to 1994. It was found that firm expenditure on property, plant and equipment and R&D was positively related to institutional ownership, suggesting that institutional investors play an active role in focusing firms on long-term shareholders' values.

- Bushee (1998) analyzed 13,994 firm-observations between 1983 and 1994 and found that managers were significantly less likely to cut R&D expenditure to reverse an earnings decline when institutional ownership was high. This suggests that the high proportion of institutional ownership allowed institutional investors to monitor and discipline managers so as to ensure the maximization of long-run values rather than short-term goals.

- Baysiner *et al*. (1991) studied 176 Fortune 500 companies and found that the concentration of equity among institutional investors positively affected corporate R&D spending.

- Hansen and Hill (1991) examined the relationship between R&D spending and institutional ownership over a 10-year period (1977-1987) for 129 US firms. It was found that higher levels of institutional ownership was associated with greater R&D expenditures.

The above studies showed that institutional activism would lead to the adoption of long-term innovation strategies, proxied by the increased investment in R&D.

- Gillan and Starks (2000) studied the effects of proposals sponsored by public pension funds, coordinated groups of investors, and individual investors in the USA, covering 2042 shareholder proposals[4] submitted in 452 companies from 1987-1994. They found that those proposals sponsored by institutions received significantly more favorable votes than those sponsored by independent individuals or religious organizations, and the voting outcome was strongly associated with sponsor identity and the percentage of institutional ownership. This suggests that institutional investors are in a better position to monitor the

[4] The shareholder proposals examined in the study included voting issues (such as confidential voting, cumulative voting), board and committee independence issues (such as director ownership increase board independence, director compensation) and issues related to repealing anti-takeover devices (such as repealing classified board, eliminating poison pills, fair price provisions, etc).

investee firms. This study also found that most proposals by institutional investors were related to the firm's corporate governance, such as the elimination of anti-takeover measures, changes in voting rights, increasing director independence in the board and some of its subcommittees.

- Smith (1996) examined the firm characteristics that would lead to activism by CalPERS, the leading institutional investor in the USA, and investigated whether shareholder activism is an effective means of monitoring. Using 51 firms involved in the 78 targeting events of CalPERS from 1987 to 1993, he examined whether events of activism resulted in changes in target firms' governance structure and shareholder wealth. He found that CalPERS tended to target larger firms with poor stock performance, lower market-to-book ratio and more industry diversification. Changes in governance structure were observed in 72% of the sample during the period, suggesting that there were positive effects of shareholder activism by CalPERS. In addition, activism was shown to lead to net benefits for the activist/shareholder wealth though no statistically significant change in operating performance was found.

- John and Klein (1995) argued that shareholder proposals could prod managers to improve the firm's operations because they were a form of "…shareholder participation which is not dominated by management". Dobrzynski (1990) also suggested that shareholder proposals would put management on the alert to act in their long-term interests. Hostile takeover bids (with the approval of the shareholders) could increase values when the new management, as a result of the successful takeover, could implement policy changes for the long-term benefits of shareholders. For example, shareholder proposals have been successfully introduced in several companies, including Avon Products, Inc., Gillette Co., Lockheed Corporation, and USX, Inc., to facilitate hostile takeover bids and could lead to an increase in shareholders' values.

- Nesbitt (1994) studied the long-term stock price performance of companies targeted by CalPERS, a leading institutional advocate for corporate governance in the USA, during the period 1987-1992, to assess whether shareholder value has been created as a result of such intervention by large institutional investors (e.g., the establishment of shareholder advisory committees, executive compensation committee reforms, pressure for more independent non-executive directors (INDs)). It was found that with CalPERS intervention, these targeted companies outperformed the S&P 500 by 41% over the subsequent five years.

The above studies showed that firms with higher institutional ownership would adopt more shareholder proposals which may lead to an increase in long-term shareholders' values.

- Brickley *et al.* (1988) examined 288 proposed anti-takeover amendments by 191 US firms, and they found that institutional investors and other blockholders were more involved in voting on anti-takeover amendments than non-blockholders and that institutional opposition was greater when the proposal seemed to harm stockholders. Evidence further suggested that institutions that were less subject to management influence were more likely to oppose management on anti-takeover amendments.

- Hartzell and Starks (2000) investigated the relationship between the concentration of institutional ownership and the level of director compensation, both of which were considered as corporate governance mechanisms. Using data from 1,500 US firms from 1991 to 1997, they found a significant negative association between the level of compensation and the concentration of institutional ownership, and a significant positive association between the pay-for-performance sensitivity of executive compensation and both the level and concentration of institutional ownership. These findings suggested that institutional ownership is an effective corporate governance mechanism to monitor incentive compensation.

- An interview study done by the Chartered Association of Certified Accountants in 1995 (now known as the Association of Chartered Certified Accountants), which surveyed senior UK fund directors and managers in 27 out of the top 35 UK equity investing financial institutions found that most of the UK financial institutions tried to monitor the management of investee companies "behind the scene". Respondents commented that this system generally worked well, thus reducing the need for changing any legislations. However, the report also revealed that on occasion, such an approach could prove unsuccessful. It was recommended that a combination of disciplinary approach, including the option of applying public pressure via the media, or passive monitoring (i.e., by selling their shares) should be considered (Holland, 1998).

- Rajgopal and Venkatachalam (1997) examined data from 1,541 US firms during the period 1989-1995 and found that the informativeness of data from accounting earnings increased with the level of institutional ownership. The level of institutional ownership was found to be inversely related to absolute discretionary accruals and income increasing discretionary accruals suggesting that earnings management is reduced with higher levels of institutional ownership. This supports the notion that institutional investors provide an effective monitoring function (whether it is perceived or actual).

- Pozen (1994) argued that although shareholder activism might be difficult to be directly linked to an improvement in financial returns, it can be beneficial to the institution's clients. Moreover the shareholder proposals could lead to decisions that are more favorable to a company's shareholders.

- Bethel and Liebeskind (1993) reported that institutional investor ownership was a significant determinant of downsizing, reductions in total diversification, and reductions in average annual investment to property, plant and equipment in 388 Fortune 500 sample firms in 1981. This evidence is consistent with the conjecture that institutional investors play a crucial role in monitoring and redirecting corporate strategy to prevent managers from over-expansion and over-diversification.

- Jensen (1993) argued that there was substantial support for the proposition that the internal control governance systems headed by the board of directors of publicly held corporations have generally failed to result in managers maximizing efficiency and value (Bhide, 1993; Roe, 1990; 1991). Jensen's study of 432 US firms found that the boards have largely failed in bringing about timely exit and downsizing for firms that have excess capacity or overcapacity. In order to remedy the situation, the author suggested that active investors, including the institutional investors, should be an important part of a well-functioning governance system because they have the financial interest and independence to view firm management and policies in an unbiased way. With more active investors' actions, better firm performance was expected.

- Black (1992) argued that when institutional investors take steps in shareholder activism (including demanding more INDs to sit on the board, discouraging corporate diversification, assessing the adequacy of CEO compensation, etc.), the value of the investee companies would increase.

- Agarwal and Mandelker (1990) analyzed the institutional ownership (including ownership by pension funds, bank and trust companies, endowments, mutual funds, and investment counsel firms) of 372 US firms and found that the existence of large shareholders leads to better monitoring of managers of the investee firms.

- Hill and Snell (1988) argued that shareholders prefer strategies which maximize their wealth, while managers prefer strategies which maximize their self interests. Therefore, when shareholders dominate in management decisions, innovation strategies would be favored over diversification since innovation is associated with higher firm profitability than diversification. This hypothesis was tested using 94 Fortune 500 firms and results showed that a higher shareholder ownership was positively associated related to R&D expenditure suggesting that shareholders prefer innovation over diversification. This would lead to higher profitability.

The studies reviewed above provide support for the notion that institutional investors are willing to act as monitors of corporate governance and that they are effective monitors of corporate governance in their investee companies as well. We now turn to studies that have found weak or no support for the notion that institutional ownership is positively associated with effective monitoring and improved corporate governance. In fact, some studies even go further to suggest that institutional investors could hamper effective corporate governance at the expense of pursuing long-term shareholders' interests.

2.4 Passive Participants in Corporate Governance

- Davis (1991) examined 440 US Fortune 500 firms during the period 1984-1989 inclusive and found that institutional investors ownership was associated with the adoption of more takeover defenses. This is consistent with the view that institutional investors supported management's takeover defenses, possibly at the expense of long-term shareholders' interests.

- Graves (1988) studied 112 US firms from 1976-1985 and found that the association between institutional investor ownership and corporate innovation was negative, and the firm's investment in R&D systematically decreased with institutional ownership. This suggests that institutional investors induced myopic investment behavior of the management.

- Palmer *et al*. (1987), using 147 US Fortune 500 firms in 1964, also found that there was a negative association between institutional ownership and corporate diversification suggesting that there is a focus on short-term profitability.

- Allan and Widman (2000), in a questionnaire study covering 68 public pension funds, found that the US public pension funds did not favor splitting CEO and Chairman any more than the CEOs themselves did. This could be due to the higher economic growth in the 1990s which was characterized by rising common stock prices for US corporations.

- Bushee (2001) studied 10,380 firm-observations between 1980 and 1992 and found that institutional investors preferred investee firms with higher near-term earnings. This suggests that institutional investors might induce myopic investment behavior. On the other hand, he did not find any evidence that institutional investors held back any expenditure on R&D which is an indicator of long-term earnings.

- Lipton and Rosenblum (1991) argued that even well-intentioned shareholder proposals could distract managers and harm their abilities to manage effectively. This suggests that monitoring by institutional investors would distract management from creating value for the firm.

- Romano (1993) and Saxton (1994) observed that institutional investors were subject to political control and could pursue objectives other than value maximization. It is possible that public institutions used corporate governance proposals to gain influence over the target firms' decisions, and to induce the firms to pursue politically motivated, value-decreasing investments. This suggests that corporate governance proposals sponsored specifically by public institutional investors would tend to decrease firm values and operating performance.

Other research studies have also found that public acts of institutional activism (such as proxy proposals) had little or no effect on shareholder value, raising questions about the existence and efficacy of institutional monitoring (Wahal, 1996; Karpoff *et al.*, 1996; Smith, 1996).

The main argument for the lack of association between institutional ownership and corporate governance is based on the view that institutional investors are essentially transient investors and are interested only in current-term earnings and short-term price fluctuations. They are "traders", instead of "owners" as perceived by the proponents of institutional activism (Graves and Waddock, 1990; Jacobs, 1991). Therefore, they have incentives to sell the firm's stock in the absence of expected current profits rather than trying to pressure management to adopt long-term value-increasing policies. This fear of "selling off" by institutional investors has, in fact, led some corporate managers to act myopically, at the expense of pursuing the long-run well-being of the firm (Coffee, 1991; Jacobs, 1991; Laverty, 1996).

2.5 Institutional Investor and Firm Performance

While institutional investors may be active participants in corporate governance, as suggested in some studies, it is not clear if this would lead to better firm performance. In this section, some of the empirical studies linking institutional investors with corporate performance are reviewed:

- Agarwal and Rao (1990) examined 1,200 US companies and found a negative relationship between the level of institutional holdings and the standard deviation of stock (proxying for specific risks of a particular stock) i.e., the higher the level of institutional shareholdings, the lower the risk for a particular stock.

- McConnell and Servases (1990) studied 1,173 US firms for 1976 and 1,093 US firms for 1986 and found a positive relationship between institutional ownership and corporate performance, i.e., the higher the level of institutional shareholding, the higher the corporate performance. These two studies by McConnell and Servases suggest that institutional investors are, to a great extent, effective monitors of management of corporations leading to lower risk and better performance.

- Daily *et al.*'s (1996) recent study, which used a random sample of 200 Fortune 500 corporations from 1990 to 1993, did not find significant results to support the two hypotheses namely: (i) the number of governance-related shareholder proposals (a proxy for shareholder activism) is positively associated with firm performance; and (ii) institutional investor holdings are positively associated with firm performance. This suggests that institutional holding and shareholder activism are not related to firm performance.

- Karpoff *et al.* (1996) examined 866 shareholder proposals on corporate governance for 317 US companies from 1986-1990. They found that firms attracting governance proposals have poor prior performance (as measured by the market-to-book ratio, operating return and sales growth). However, it was found that the proposals did not lead to any changes on operating returns, company share values or top management turnover. Even those proposals that received a majority of shareholder votes typically did not lead to any share price increases or discernible changes in firm policies. This suggests that the effects of shareholder activism generally did not result in any positive effects on firm values.

- Linn and McConnell (1983) studied 398 firms listed on the New York Stock Exchange during the period 1960-1980 and found that the average abnormal returns were insignificantly different from zero following announcements of charter amendments such as supermajority voting rules[5]. This was echoed by other studies such as DeAngelo and Rice (1983).

A number of reasons may be identified to explain the inconsistent findings on the effectiveness of institutional investor holdings on corporate performance.

2.6 Reasons for Inconsistent Results

Not all institutional investors are active shareholders because some of them lack incentives to monitor investees. For example, some institutional investor groups may adopt a strategy of "free riding" on the activism of others and share in performance improvements on their portfolios (Daily *et al.*, 1996). The following outlines some of the studies which suggest two major reasons that could account for the lack of incentives towards active monitoring.

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[5] Supermajority voting rules means that it requires about 80% of the holders of shares to cast in favor of any amendments.

2.6.1 Willingness and Ability of Institutional Investors to Pursue Activism

A number of reasons are outlined below to explain why institutional investors are not willing nor capable to pursue activism:

- Institutional investors lack the capability, and have little or no experience to directly monitor a corporation's managers (Prowse, 1991; Taylor, 1990).

- Institutional investors lack incentives to actively monitor because of the free-rider problems among themselves in monitoring managers of their investee companies. Since the benefits of activism would be shared by all shareholders, not just the clients of the active institutions, it is virtually impossible for the activist institutional investors to force all other benefiting shareholders to contribute to the effort of monitoring. This leads to disincentives for their active monitoring (Black, 1990; Admati *et al*., 1994; Pozen, 1994).

- In order to obtain more inside confidential information about the investee firms, institutional investors have to maintain a certain level of ownership. This maintenance of the level of ownership could jeopardize their freedom to maintain liquidity in the investee firms (Bhide, 1993).

- Though institutional investors would like to out-perform their peers and the market (through strategies such as institutional monitoring), out-performance is far less likely if they are seen by the market to be in opposition to the management or their strategies of the companies they invest in. This scenario may create disincentives for them to be involved in the corporate affairs of their investee companies (Jones and Morse, 1997).

- Institutional investors may also have a business relationship with investee companies in which they own shares. For example, insurance companies as institutional investors may provide their investee companies with underwriting services, and correspondingly, banks can provide them with loans. If they are actively involved in the corporate governance of their investee companies, they may risk losing their other businesses (Kochhar and David, 1996; Heard and Sherman, 1987; Herman, 1981; Black, 1992).

- Some rules are designed to intentionally keep institutional investment holdings small (Kochhar and David, 1996; Black, 1990; Roe, 1990; 1991). For example, section 13(d) of the Securities Exchange Act of 1934 and related SEC rules require any person or 'group' which beneficially owns more than 5% of a public company's stock to file a Schedule 13D containing disclosure about the person or group, its stock ownership, its plans with respect to the company, and various other matters. This imposes a disclosure obligation and creates legal risk for the institutional investors. The above prohibitive procedural and legal costs could deter institutional investors from acquiring a large percentage of shareholding in order to play an active role in the corporate governance of their investee firms.

- Institutional investors may not have sufficient information to actively monitor the company's operations even though they have the information required to make their investment decisions (Kochhar and David, 1996).

- Fabris and Greinke (1999) conducted interviews with nine Australian fund managers[6] and 27 individuals. They found that although informal communications with management as a form of monitoring was growing in both actual and perceived importance, six out of nine still followed an abstention policy, essentially voting only on contentious issues. Most of the interviewees pointed out a number of impediments to the exercise of proxy voting such as legal restrictions and conflicts of interest issues and they overwhelmingly considered activism appropriate only with the removal of perceived disincentives or practical difficulties.

2.6.2 Costs and Risks of Active Monitoring

There are numerous costs and risks for institutional investors who are willing to be actively involved in the corporate governance affairs of the investee firms. Macey (1998) identified the costs and risks associated with activism as follows:

- As the institutional investors operate in a competitive environment, they should accordingly concentrate on constructing portfolios of stocks that are designed effectively to eliminate firm-specific risk, and on keeping costs down. He argued that neither of these strategies is consistent with the monitoring and activism by the institutional investors as monitoring may involve substantial costs, including time, effort and skill.

- It is not clear that the human capital skills needed to be a successful fund manager are the same as the skills necessary to provide operational advice to the firms in which a fund is invested.

- The free-rider problem, in which any gains associated with activism must be shared with other investors, including rival investment funds is a disincentive, while the cost of these actions would be shouldered by the activists alone.

- Institutional investors might not want to sacrifice investment liquidity in order to achieve a greater voice in the activities of the firms in which they have invested. In particular, board membership in a company brings too many responsibilities.

[6] This survey included three respondents from investment management subsidiaries of insurance companies, three from superannuation fund managers and three from bank subsidiaries, unit trusts and trustees respectively.

Macey (1998) also argued that as the costs and risks for institutional investors to be activists are high, potential benefits associated with activism should be even higher in order to induce their interest and active participation.

Though all shareholders have exactly the same legal rights, institutional investors may have different objectives, namely short-term earnings focus versus long-term maximization of shareholder wealth and voting strategies. They can be categorized along a continuum from "investors / owners" on one extreme to "traders" on the other (Brancato, 1997). Dominance of different types of institutional investors may have different effects on their willingness to monitor and therefore have different effects on corporate governance. For example, Johnson and Greening (1999) distinguished two types of institutional investors: "pension fund equity" and "mutual and investment bank funds". Pension fund ownership was hypothesized to have a positive association with corporate social performance, while investment bank ownership should have a negative relationship. Pension fund managers are salaried and their compensation is not tied to investment performance and their holdings are relatively more long-term (Gilson and Kraakman, 1991). This provided pension fund managers with the incentives to be proactive in corporate governance while recognizing that their gains from social performance needed a longer time to realize (Hoskisson *et al.*, 1996). On the contrary, mutual and investment bank managers are rewarded based on their short-term, quarterly performance, and they tended to hold a stock for a shorter time (Gilson and Kraakman, 1991). On the other hand, Kochhar and David (1996) argued that both public pension funds and mutual funds would play an active role in corporate governance. Brickley *et al.* (1988) also found that mutual funds, endowments and foundations, and public pension funds were more likely to oppose anti-takeover charter amendments than banks, insurance companies, and trusts, while Van Nuys (1993) reported that banks and insurance companies (including those with business relationships with investee companies) were significantly more supportive of management-sponsored anti-takeover proposals than those institutional investors without business relationships. Bushee (2001) noted that although institutional investors *as a whole* have weak preferences for near-term earnings (no indication of myopic behavior at the expense of long-term benefits), *separating them into different groups* ("transient institutions" and "bank trusts") would result in different findings. Therefore, an in-depth understanding of the monitoring role of institutional investors must take into account the types of institutional investors with differing objectives and voting strategies.

In addition, it is worth pointing out that an assessment of the role and effectiveness of institutional investors in corporate governance has to also consider the corporate governance already in place in the organizations and the severity of agency problems. For example, the existence of family ownership could affect the incentives of institutional investors which, in turn, could have a significant bearing on the relationship between institutional ownership and corporate performance.

Though it is expected that the effects of institutional monitoring, if any, should eventually be reflected in operating and stock performance, researchers have been unable to document a strong association between institutional ownership and corporate performance (McConnell and Servaes, 1990; Chaganti and Damanpour, 1991). On the other hand, one may conclude from the above literature review that there could be a moderate relationship between institutional investors and corporate performance. To improve the corporate governance of a company, one cannot ignore the possible monitoring role played by the institutional investors. The perception of institutional investors on their own ability of monitoring may itself be a factor that may affect their investment decisions. If institutional investors have a short-term and myopic view of the company, corporate governance may have little place in their investment decision-making processes. However, if institutional investors were activists and they believe that they can exercise influence on the long-term growth of the company, then the standard of corporate governance in the firm may affect their investment decisions. However, the most important issue is whether there exists sufficient incentives for institutional investors to act as an active monitor of corporate governance.

The lack of incentives to monitor could be due to "free-riding" problems, lack of resources in terms of human talent and experience to monitor investee corporation directly, corporate governance in place in the organizations and the severity of the agency problems, etc. In addition, not all institutional investors are the same. Some institutional investors are looking for long-term value, for example, pension fund managers may have incentives to be proactive in corporate governance given that their gains from social performance needed a longer time horizon to realize. On the contrary, some such as investment bankers, are aiming at and being rewarded based on their short-run performance. Since they tend to hold a stock for a shorter time horizon, they have a weaker incentive to proactively interfere with the corporate affairs of their investee corporations.

2.7 Summary

The relationship between institutional investors and corporate management has changed in the last decade or so due to two main reasons. First, the increased shareholdings of institutional investors on their investee companies make the former "exit strategy" inappropriate. Second, the difficulties of disposing of shares of poorly performing corporations quickly and the limited alternative investment opportunities available in the market also contributed to the changing role of institutional investors. From the corporate governance perspective, the change in attitude of institutional investors towards their investees from "passive" to "proactive" is expected to provide a monitoring function to curb management's opportunistic behavior. In fact, empirical studies provide evidence that institutional investors are able to foster good corporate governance practices. For example, evidence of prior studies show that higher institutional investor ownership is associated with:

- Lower level of executive compensation.
- Higher monitoring of incentive compensation.
- Higher tendency to vote against value-decreasing takeover defenses.
- Comparatively more corporate innovations.
- Higher informativeness of accounting earnings, i.e., less earnings management.
- More emphasis on long-term shareholders' value.
- More monitoring of the investee firms.

In general, this stream of research studies provide evidence that active institutional investors could shape good corporate governance practices. However, in contrast, there are empirical research studies that do not support the notion that institutional investors are effective in monitoring management's opportunistic behavior. For example, empirical evidence shows that institutional investors supported management's takeover defenses possibly at the expense of long-term shareholders' interests. Likewise, another study found that corporate innovation including R&D systematically decreases with institutional ownership, which suggests that institutional investors may induce myopic investment behavior of the management. Similarly, the evidence in the literature on the link between institutional investors ownership and firm's financial performance has also been equivocal.

We offer some reasons for these equivocal results. First, as pointed out earlier, institutional investors can range from those who are mere traders to those who are investors (see Brancato's Framework in Chapter 3). Studies that fail to consider these differences could end up with weak results. Second, the role of institutional investors in corporate governance of their investee companies should be considered in the context of corporate governance in place in the organizations and the severity of the agency problems.

The next chapter develops the analytical framework for understanding the role of institutional investors and their impact on corporate governance. In developing the analytical framework, we will draw on the above literature review.

CHAPTER 3 ANALYTICAL FRAMEWORK

3.1 Introduction

The literature review in Chapter 2 provides an understanding of the different monitoring roles of institutional investors. It can range from active interventionist strategies such as shareholder proposals to directly intervene in the management decisions to passive strategies such as "quick sell off" as a result of a lack of interest and incentives to monitor. Therefore, different institutional investor objectives would lead to different participation levels in corporate governance initiatives of their investee corporations. Chapter 1 provides an overview of the agency problems and the role of corporate governance mechanisms. Failure to explicitly consider the different type of institutional investors and other corporate governance mechanisms in any one jurisdiction could have confounded the results of prior studies that examine the link between institutional investors and firm performance. Thus in this chapter, we juxtapose the different levels of institutional investor participation and the unique corporate governance environment in Hong Kong (including the agency issue) to provide an analytical framework for this study. To do this, we first draw on a model suggested by Brancato (1997).

3.2 Brancato Framework

Brancato (1997) classified institutional shareholders according to their investment objectives and corporate governance behavior along a spectrum, with institutional shareholders classified as investors at one end and as traders at the other. She defined investors as those whose interests are more aligned with the success of the corporation, and traders are those whose interests are more narrowly focused on achieving rates of return over a limited duration of time, regardless of the long-term outcome effect on the corporation. Table 3.1 depicts the different levels of shareholder participation with US examples. It shows the different objectives and roles that institutional investors play in relation to corporate management.

Table 3.1 Levels of Shareholder Participation

Shareholder Levels	Participation	Examples	Spectrum
1.	Active investor in financial and voting terms[1]	Warren Buffett, LENS, Inc. & other actively managed public pension funds	**Investors**
2.	Passive investor in financial terms but active in voting	CalPERS, New York State Common Retirement Fund & other funds which index stock but vote proxies	
3.	Active investor in financial terms but passive in voting	Trustee accounts at many banks & many corporate pension funds	
4.	Trader in financial terms and passive in voting	Most money managers, program traders	**Traders**

Source: adapted from Brancato (1997)

Active investors in "financial and voting terms" would participate actively in monitoring corporate governance practices. They are likely to monitor their investments for long-term future growth and maximization of shareholders' wealth

[1] Financial terms refer to financial performance of investee firms, proxied by sales and turnover growth, increased market share, return on equity, etc. Voting terms refer to institutional investors' influence in management decisions on corporate affairs.

(Brancato, 1997). On the other hand, traders, both in “financial terms and passive in voting” are less likely to participate in corporate governance practices even though their shareholdings may be proportionately large enough to allow them to exercise influence on management of the corporation. They also have a shorter investment horizon and are unlikely to stay in the corporation long enough to perform the monitoring function. The extent to which Level 1 institutional investors (depicted in Table 3.1) can make an impact on corporate governance and hence affect performance will of course depend on the corporate governance mechanisms already in place in the corporations and the severity of the agency problem. For example, the incentives for Level 1 institutional investors to play an active role in corporate governance would be less in corporations with strong corporate governance mechanisms already in place and where there is an alignment of interest between managers and shareholders. Therefore, it is important to emphasize that the pattern and extent of institutional investors’ monitoring role in corporate governance and management practices is likely to be different depending on their objectives (as in the Brancato Framework), the corporate governance levels already in place and the level of interest alignment between managers and shareholders. We consider the above proposition more fully below.

3.3 Ownership and Agency Problems

Issues relating to the quality of corporate governance and interest alignment between managers and shareholders and the role of institutional investors have to be evaluated and understood in the context of the institutional (including ownership) and regulatory processes that exist in different countries. Claessens *et al*. (2000) studied ownership and control of 2,980 stock exchange listed companies for the year 1996 in nine East

Asian economies namely: Hong Kong, Indonesia, Japan, South Korea, Singapore, Malaysia, the Philippines, Taiwan and Thailand. Ownership structure data for the year 1996 was obtained from the Worldscope database. They found that the majority of East Asian companies are affiliated to a group and thus are controlled by an entity that also controls a large number of other entities. In Hong Kong, more than 60% are group affiliated. The corporate groups are controlled by a complex web of ownership links. A corporation at the base of the pyramid is controlled by another, which in turn is controlled by another, and so on with an ultimate owner at the end of the chain. The ultimate owners in their study were classified as family, state, widely held financial institutions, and widely held corporations. A company was classified as widely held if no ultimate owners controlled at least 20% of the shares in each link in the chain of control. Their study showed that, except for Japan, all the other countries had a high proportion of family owned corporations. The situation in Hong Kong perhaps provides a case in point.

In Hong Kong, the shareholding structure and agency problems are quite different from the developed markets such as the USA. Family control is a significant feature of the corporate scene in Hong Kong listed companies with 66% being family owned (HKSA, 1997). Typically, a single extended family owns a significant proportion of the listed company's shares with the controlling family members or their nominees occupying senior management positions (Tsui and Lynn, 2001). One study found that the top fifteen families in Hong Kong held shares with market capitalization accounting for 84% of 1996 Gross Domestic Product (SCMP, 2000). It is not uncommon that the Chief Executive Officer (CEO) and Chairman are the same person representing the controlling family as well. A recent survey found that 15% and 2%

of the Hang Seng 100 Index companies in 1998 and 1999 respectively, had CEOs and Chairman being the same person representing the controlling family. With such a closely held shareholding structure, the typical agency problem arising from the separation of ownership from control may not be an issue. In fact, it is argued that family ownership can even be considered a corporate governance device as well (SCMP, 2000), since agency conflicts arising from the separation of ownership from control between shareholders and management are reduced. Family held shareholders who are actively involved in management are likely to pursue long-term value maximization objectives. Others have argued that the nature of the agency problem could be different since controlling shareholder in family owned firms can expropriate funds from the minority shareholders through a pyramidal organization structure whereby a private holding company sits at the top, with a second tier company holding the most valuable assets and the listed company at the third tier of the overall structure. Family domination and entrenchment in the shareholding ownership structure in Hong Kong has given rise to accusations of minority shareholder expropriations. These are, in fact, common agency problems that occur in countries with concentrated ownership (Shleifer and Vishny, 1997). Therefore, institutional investors holding a comparatively low percentage of shares are unlikely to be able to exercise significant influence on corporate governance matters over the controlling family. As a result, their role in Hong Kong may be constrained by the shareholding structure due to the lack of voting power. Perhaps the only alternative for institutional investors in this scenario is to resort to passive monitoring such as "selling off". On the other hand, there are a number of other more widely held companies in Hong Kong which are candidates for institutional investors who are interested in being active monitors.

Though the incentives for active participation in corporate governance matters by institutional investors may not currently exist in developing capital markets such as Hong Kong, US active institutional investors investing in Hong Kong equities expect a certain level and standard of corporate governance for their investee companies in Hong Kong. The largest 25 US public and private pension funds held a total of about US$85 billion in international stocks in 1994, representing 30% of all foreign equity investments held by all US investors. These figures represented a phenomenal fourfold increase from US$18 billion in 1989 to US$85 billion in 1994 (Brancato, 1997). Many of these US active institutional investors were willing to exercise their influence through the global proxies process[2]. Thus, institutional investors on the international equity market are likely to pursue activistic strategies on corporate governance matters in Hong Kong.

3.4 Growth of Institutional Investors in Hong Kong

Against the backdrop presented above, it is interesting to note that there has been significant growth in the institutional shareholding in Hong Kong over the last ten years. The net asset value of Hong Kong authorized funds was over US$298 billion by the end of 1999 (HKIFA, 2000). The total assets managed by Hong Kong Investment Funds Association was about US$217 billion as at the end of June 2000. A recent survey conducted by the Securities & Futures Commission documented an inexorable growth of the number of authorized unit trusts and mutual funds from 77 in 1981 to 1,701 in 2000 (HKIFA, 2000). This increasing trend of ownership by

[2] "Global proxies process" refers to the process where institutional investors in developed markets such as the USA can effectively vote for or against management decisions of their investeee companies globally in emerging markets. Such proxies voting is a powerful tool for international institutional investors to induce companies to pursue good management practices and promote better corporate governance.

institutions is likely to continue with the recent establishment of the Mandatory Provident Fund Scheme (MPF) in 2000. According to a government press release, as at February 28, 2001, the aggregate net asset values of all MPF schemes amounted to HK$11.6 billion (US$1.5 billion) (press release, April 12, 2001). Mr. Charles Lee Yeh-kwong, the Chairman of the Mandatory Provident Fund Schemes Authority (MPFA) estimated that the assets of the MPF schemes would total about HK$1 trillion (US$128 billion) (Lee, 2000), and the eventual size of MPF portfolios may reach 60-70% of Hong Kong's Gross Domestic Product (Tsang, 1999). More importantly, the HKSAR Government wishes to maintain the flexibility for the funds to make their own investment decisions. This is confirmed by the former Financial Secretary of the HKSAR Government, Mr. Donald Tsang "because of our already highly-developed financial services sector and a strong regulatory and legal regime, … we will have no asset allocation rules for the MPF schemes. In other words, it can invest anywhere on any instruments" (Tsang, 1999). It is expected that there would be many business opportunities for corporate trustees, banks, investment houses, insurers and other financial institutions. Therefore, this development in Hong Kong MPF has the potential to increase the proportion of institutional ownership in Hong Kong equities alongside the growing international trend of institutional interest ownership in Hong Kong.

Given that the goal of such institutional investor activism is to improve corporate performance and enhance shareholder value, it is necessary to overcome obstacles that focus on short-term corporate earnings (Daily *et al.*, 1996). In the last decade, two well-known propositions regarding the investment behavior of institutional investors were widely observed in the USA: institutional investors buy and sell for the short-term and investments by corporations are made to please short-term shareholders. This advocacy of short termism has diverted institutional investors away from focusing on corporate performance issues that would lead to maximization of long-term shareholders' wealth. Therefore, it is important that corporations market their stock to those who share their long-term investment objectives. This would then stabilize the shareholder base and ultimately minimize stock price volatility and help the market realize the fundamental value of the companies (Brancato, 1997).

3.5 Summary

Both Brancato's model and the unique corporate governance and ownership environment in Hong Kong provide an analytical framework for understanding the role of institutional investors in Hong Kong. This framework has a bearing on the methodology adopted in this study. The fact that there has been an increase in institutional investors in Hong Kong is a clear indication of the potential for more institutional investor activism in the region. In order to design and develop detailed questions for our interviews and web-based questionnaire, it is necessary to identify the corporate information needs of institutional investors. To identify and obtain this information, we conduct a comprehensive review of the literature which examines the corporate information needs of institutional investors. The next chapter reviews this literature with the aim of crystallizing the important corporate information needs of institutional investors.

CHAPTER 4 LITERATURE REVIEW ON CORPORATE INFORMATION NEEDS FOR INSTITUTIONAL INVESTORS

4.1 Introduction

Chapter 2 provided a literature review of linkages between institutional investor shareholding, corporate governance and firm performance. Chapter 3 drew on the Brancato model and agency theory to provide an analytical framework for our study objectives. In general, the two chapters suggest the following. First, far from being firmly conclusive, the weight of the evidence suggests there are linkages between institutional shareholding and participation in corporate governance as well as linkages between institutional shareholding and corporate performance. We attribute the weak evidence to the fact that the role of institutional shareholding should also be evaluated in the context of the institutional (including level and quality of corporate governance in place and agency problems) and the regulatory framework that exist in any one country. This chapter provides a more specific literature review with a view of identifying the different types of corporate information that institutional investors consider in their investment decisions. The next section reviews the empirical research studies and surveys that focus on both quantitative and qualitative factors that are likely to affect investment decisions of institutional investors. In addition, the literature on the "level" of corporate governance considered by institutional investors in their decisions is also reviewed. This literature review will form the basis for identifying the corporate information needs of institutional investors in the design of interview questionnaire and web-based questionnaire in the next chapter.

4.2 Factors Affecting Investment Decisions of Institutional Investors

The following sections review the company specific factors, both quantitative and qualitative, that affect institutional investors' investment decisions.

4.2.1 Quantitative Factors

4.2.1.1 Financial performance

Earnings per share was identified as the most common valuation method for Hong Kong equity analysts and fund managers in assessing a company's performance (PricewaterhouseCoopers, 2000).

Falkenstein (1996) who examined preferences of US (NYSE and AMEX listed stocks) open-end mutual funds for various stock characteristics for the years 1991 and 1992, found that mutual funds preferred stocks with higher prices and showed a strong aversion for stocks with low prices. This suggested that stock price should be one of the most important factors in affecting institutional investors' investment decisions.

Badrinath *et al*. (1989) conducted tests on a sample of 2,250 firms consisting of all NYSE and AMEX listed companies as at 31 December 1985 with a view to analying the investment behavior of institutional portfolio managers in the context of their fiduciary responsibilities arising from handling clients' capital. It was found that firms with a better history of past performance have higher levels of institutional ownership.

Gompers and Metrick (1997; 1998), however, did not find support for reliance on past performance. They ranked all stocks in the US market by their institutional ownership, and then examined bivariate and multivariate relationships among institutional ownership and firm characteristics. They also examined how large institutions differed from other investors. Their results showed that large institutional investors, when compared to other investors, preferred stocks that have lower returns for the previous year.

Hendry *et al*. (1999) conducted an interview with 68 UK institutional investors and corporate management (including fund managers, brokers' analysts, corporate management and human resources directors) on the issue of people management disclosure. When asked 'what types of information relating to company performance do companies and investors each value?', there was widespread agreement among the four groups on the following kinds of information valued in order of relative importance – financial data, corporate strategy, quality of management and people management.

A survey of 47 corporate investors in 1999 from a cross section of financial services industry including securities dealers and brokers, asset management firms, banks and insurance companies was conducted by PricewaterhouseCoopers (PwC) Singapore in co-operation with the Stock Exchange of Singapore. Results revealed that the most important factor influencing institutional investors' decisions to invest in a company was, not surprisingly, the financial results of the companies.

Financial performance of the company is an important factor in institutional investors' investment decisions.

4.2.1.2 Future cash flows

A Price Waterhouse survey released in 1998 showed that an increasing number (about 94%) of institutional investors in UK and 100% in Australia used cash flow modeling to arrive at their investment decisions. Cash flow is considered more useful than earnings since it is not affected by the different accounting policies that could be adopted by the management. Around 90% of Hong Kong equity analysts and fund managers used cash flow to evaluate a company's performance and 80% ranked cash flow as important as earnings per share in predicting share value.

Mills and Morling (1995) also argued that cash flow is also an important factor in institutional investors' investment decisions. It is clear from the above studies that cash flow is another important factor in institutional investors' investment decisions.

4.2.1.3 Dividend yield

Investments in a non-dividend paying stock may be considered by some portfolio managers as imprudent (Badrinath *et al.*, 1989). In order to discharge their fiduciary duty properly and avoid the possible charge of negligence, portfolio managers would tend to invest in stocks with a more promising dividend yield. Similar results which focused on the determinants of investment choices of insurance companies were found in a more recent study (Badrinath *et al.*, 1996). Gompers and Metrick (1998) also examined how large institutions differed from other investors. Their study ranked all stocks in the US market by their institutional ownership, and then examined bivariate and multivariate relationships among institutional ownership and a number of firm characteristics, including dividend yield. Dividend yield was found to be positively associated with institutional ownership, suggesting that institutional investors might prefer stocks with higher dividend yield. The above empirical evidence suggests that dividend yield is a significant factor in influencing institutional investors' investment decisions.

4.2.1.4 Stock liquidity

Badrinath *et al.* (1989; 1996) found that trading liquidity of a stock was positively associated with institutional ownership. This relationship was expected due to two reasons. First, high trading liquidity is generally associated with large firms.[1] Second, in order to minimize transaction costs (including administrative and research costs), *ceteris paribus,* institutions would tend to avoid over-diversification. Therefore, given that the dollar amount that institutions invested in any one stock may be substantial, block trades by institutions may exert significant price pressure if the stock's trading liquidity is low. In order to avoid such price risk, institutions would prefer stocks with higher trading liquidity (measured by the most recent year's annual trading volume in the firm's stock divided by the total number of shares outstanding).

Gompers and Metrick (1998) also found similar results. The large positions held by institutions might require them to invest in active trading stocks. If institutions turned over their portfolios and traded more often than individual investors, they might also be more sensitive to the transaction costs caused by large-percentage of bid-ask spreads for illiquid or low-priced stocks. This study used firm size, S&P 500 membership, share price, and share turnover as proxies for liquidity, and the results showed that all the above liquidity variables have consistent positive signs throughout

[1] This study also hypothesized that institutional investors would tend to invest in larger firms.

the sample, and many of these variables were statistically significant in most of the quarters examined.

Another recent study by Gompers and Metrick (2001) further confirmed the positive relationship between trading liquidity of a stock and institutional ownership. This study analyzed institutional investors' preferences for stock characteristics and the implications that these preferences have for stock prices and returns. Firm size, turnover and price (proxying for liquidity) had a strong and consistent positive relationship with institutional ownership.

Dahlquist and Robertsson (2001) also found stock liquidity to be one of the factors influencing foreign investors in their investment decisions. Using all 352 listed Swedish firms from 1991 to 1997, they studied the determinants of foreign ownership in Swedish firms and identified various firm attributes that are common to foreign ownership. They found that foreign investors typically were mutual funds and the firm characteristics demanded by foreign investors were common to those requested by institutional investors. Results showed that foreign investors and institutional investors had a similar preference for market liquidity.

Other empirical studies by Bhide (1993) and Roe (1994) put forth an opposing argument. They argued that increases in market liquidity reduced the desire of institutional investors to accumulate large blocks and hence reduced trading liquidity. Greater liquidity means that institutions have less ability to capitalize on better information because other investors can infer their private information from their trades (Bhide, 1993). Investors would therefore be more likely to passively invest (i.e., accumulate small percentage of shares) rather than accumulate large blocks of shares. Maug (1998) also developed a model to take into account the positive relationship between liquidity and concentrated ownership. This model is based on the argument that greater liquidity allowed investors with private information to accumulate large blocks of shares without revealing their information. It is thus an empirical question as to whether liquidity is positively or negatively associated with higher concentrated ownership. Regardless of which effect dominates, it seems reasonable to conclude that trading liquidity is one of the factors that would affect institutional investors' investment decisions.

4.2.1.5 Share price volatility

Modern portfolio theory suggests that only the market risk of a security is relevant for investment decisions (Badrinath *et al.*, 1989)[2]. Gompers and Metrick (1997; 1998) used stock volatility as a proxy for prudence in institutional investors' investment decisions. It was observed that regulatory restrictions and legal liability often imposed constraints on the perceived riskiness of individual stocks. If institutions were more concerned about making prudent investment decisions than are individuals, it is expected that institutional ownership would be negatively related to stock volatility (defined as the variance of monthly returns over the previous two years). Empirical results showed that the relationship was negative but not statistically significant.

Badrinath *et al.* (1989) expected that the relationship between the level of institutional ownership and total risk (as measured by the standard deviation of monthly equity returns) was negative because portfolio managers would avoid large losses on

[2] The institutional portfolio manager must also consider the total risk of each individual security (i.e. individual stock’ s volatility).

individual securities as this would adversely affect the overall portfolio performance. In some cases, legal action may be brought against portfolio managers for mismanagement. Falkenstein (1996) also found that mutual funds preferred stocks with higher volatility as this may lead to higher returns on their investments. On the basis of the above evidence, it is not entirely clear as to whether institutional investors prefer higher or lower stock volatility. However, the evidence at least suggested that stock volatility is also one of the factors affecting the investment choices of institutional investors.

4.2.1.6 Market risk

Badrinath *et al*. (1989) argued that though market risk (beta) should be included as one of the factors affecting institutional investors' investment decisions, the relationship between beta and institutional ownership is not clear. Holding a stock with a high beta could increase the expected return of the stock, thereby decreasing the possibility of sub-standard portfolio performance. This suggests a positive relationship between beta and institutional ownership. On the other hand, holding a stock with a higher beta also has a negative effect on expected return due to the presence of potential legal costs. If a manager is compensated under a symmetric performance incentive remuneration scheme with market return as the performance index, and the portfolio outperformed the market, the manager would earn a "bonus", and in the case of sub-market performance the manager bears a "loss". If there were no potential legal costs, the manager would be indifferent to the beta of the portfolio because the expected performance incentive payment would be zero. However, given legal costs which may have to be borne by the manager in addition to the losses from the symmetric incentive remuneration scheme, the total costs to the manager for under-performing the market is relatively higher than the benefit of outperforming it, and therefore, on balance, the manager may have an incentive to hold lower beta stocks. On the basis of the evidence, it is difficult to predict a positive relationship between beta and institutional ownership. In any case it does seem that market risk should be one of the factors that institutional investors should consider in their investment choices.

4.2.1.7 Leverage

Similarly, the empirical evidence regarding the relationship between institutional ownership and leverage is not straightforward (Badrinath *et al.*, 1989; 1996). Since leverage is positively related to both the total and market risk of a stock, it could either be positively or negatively related with institutional ownership. There is no conclusive evidence on the relationship between leverage (as measured by the ratio of debt to total asset) and institutional ownership.

4.2.1.8 Company size

Many studies found that firm size was one of the factors considered by institutional investors in their investment decisions. Badrinath *et al.* (1989; 1996) argued that institutional investors would restrict their investment activity primarily to the stocks of firms with higher market values, and individual investors would mainly restrict their investments to the stocks of firms with lower market values. They found a positive relationship between institutional ownership and firm size (measured by total assets). Other studies used market equity to proxy for firm size and found that size was monotonically related to institutional ownership (Gompers and Metrick, 1997; 1998; 2001). Dahlquist and Robertsson (2001) also found that foreign institutional investment increased with the size of the firm (measured by the market capitalization of the firm at the year-end). This further supports the hypothesis that institutional investors prefer to invest in large firms.

4.2.1.9 Company age

Firm age was used as a proxy for "prudence" by institutional investors in their investment decisions (Gompers and Metrick, 1998). If institutions were more affected by considerations of "prudence" than individual investors, it was expected that institutional ownership should be positively related to firm age. Results showed that institutional investors prefer to invest more of their capital in firms with a longer history.

4.2.1.10 Years listed in Stock Exchanges

Badrinath *et al*. (1989) study revealed that institutional investors preferred to invest in stocks with a longer history of stock exchange listing (either NYSE or AMEX in the study). This may be explained by the concept of "deemed prudence": i.e., the longer the stock is listed on the stock exchange, the more "prudent" it seems to be, and hence inducing more institutional investment. Falkenstein (1996), in an empirical study also found that mutual funds preferred stocks with a longer history of listing on the exchange. Mutual funds showed an aversion to firms that were newly listed as this might involve greater uncertainty in assessing their risks. On the basis of the above studies, the years of stock exchange listing is one of the factors that could affect institutional investors' investment decisions.

4.2.1.11 Cross-listing

Dahlquist and Robertsson (2001) argued that foreign investors (principally institutional investors) preferred investing in firms that were better known and this was proxied by whether the firms were listed on other stock exchanges. Firms with cross-listings are more likely to be better known and hence are more likely to be preferred by institutional investors. Thus, lower search costs for those better-known firms can be expected. Results showed that institutions indeed preferred such firms, which is consistent with the hypothesis that institutional investors preferred to invest in companies with less information asymmetry. Cross listing is one of the factors that could affect institutional investors' investment decisions.

4.2.1.12 Book-to-market ratio

Gompers and Metrick (1998) found that stocks with high book-to-market ratios have enjoyed higher historical returns than other stocks, and hence were able to attract more institutional investment. This study measured the book-to-market ratio by using book value for the fiscal year ended before the most recent June 30 divided by size (market equity) as of June 30. Empirical results supported their hypothesis that large institutions, when compared with other investors, preferred stocks that have higher book-to-market ratios.

However, other studies documented that the above relationship was not clear. Falkenstein (1996) pointed out that Lakonishok *et al.*'s (1994) study documented that institutions seemed to prefer "glamour stocks", which were analogous to growth stocks that have low book-to-market ratios. They hypothesized that previous success of the stocks helped institutions to justify their portfolios to investors, and also trend following may bias institutions towards these types of stocks. This holding preference is similar to Fama and French's (1992) finding that high book-to-market ratio stocks appeared to produce high risk adjusted returns (using a two factor model that includes size and the firm's market beta). On the other hand, the high demand for low book-to-market ratio stocks caused them to be overpriced which induced lower returns in the future. Falkenstein's (1996) study seemed to suggest that there appeared to be some evidence of a mutual fund preference towards value stocks (high book-to-market ratios). On the basis of the above mixed evidence, it is difficult to formulate any specific relationship between the book-to-market ratios and institutional investment. It does, however, seem that the book-to-market ratio should be one of the factors affecting the investment decisions of institutional investors, though there is no conclusive evidence on how important this factor is.

4.2.1.13 Transactions costs

Keim and Madhavan (1997) studied the magnitude and determinants of transaction costs for a sample of institutional investors which had complete information on the equity transactions of 21 institutions in NYSE from 1991 to 1993[3]. Trading costs included explicit and implicit costs. Explicit costs such as broker commission costs were comparatively easy to quantify, while implicit costs consisted of the price impact of a trade (others included taxes, clearance and settlement fees, but they were considered relatively insensitive to the choice of trading strategy). The price impact of the trade referred to the deviation of the transaction price from the "unperturbed" price that would prevail had the trade not occurred (the price impact of a trade can be negative if a trader bought at a price below the "unperturbed" price and liquidity

[3] The data was regarded as representative as the trading activity of the 21 institutions was substantial during the period (a total of 62,333 orders with a market value of approximately $83 billion).

providers would enjoy negative costs while liquidity demanders would face positive costs). It was found that total transactions costs were economically significant and were systematically related to trade difficulty and market liquidity. This result demonstrated the importance of understanding transaction costs in formulating and assessing an investment strategy (Chan and Lakonishok, 1993; 1995).

The importance of transactions costs in institutional investors' investment decisions was also noted by Gompers and Metrick (1998). They hypothesized that institutional investors would focus on liquidity and transaction costs in their investment choices. If institutions turned over their portfolios and traded more often than individuals, then they may also be more sensitive to the transactions costs caused by large-percentage bid-ask spreads for illiquid or low-priced stocks. It was also argued that some institutions, especially pension funds and endowments, often have longer investment horizons than most individuals, and many such institutional investors may only need to pay out their principal at a distant date or not at all, making them more willing to hold less liquid stocks if there was a premium return in equilibrium. Their study used firm size (market equity), S&P 500 membership, share price, and share turnover (volume divided by shares outstanding) as proxies for liquidity to see whether transactions costs would affect the institutions' choices on their investments (institutional ownership). It was found that institutions showed a strong preference for liquidity and investments in large companies suggesting that transaction costs, though an important factor, was not as important as liquidity and size.

In summary, it can be concluded that transaction costs would be a factor considered by institutional investors in their investment decisions alongside other factors as well.

4.2.2 Qualitative Factors

4.2.2.1 Quality and disclosure of financial statements

Our literature review covered many academic papers and surveys which discussed the possible relationship between institutional ownership and disclosure quality of the investee firms. According to the PwC survey in 1999, the importance of the quality of the company's financial statements and annual report (with a mean score of 4.0 out of 5) was ranked as the second most important factor (after financial results being ranked as number 1) in influencing institutional investors' investment decisions. Specifically, the disclosure of the company's strategies and initiatives, and the quality of management's discussion and analysis of its annual results and financial position in the annual report were considered important components of the quality and disclosures of financial statements. Almost half of the institutional investors surveyed (47%) indicated that they would not invest in a company with an unsatisfactory level disclosure in its financial statements.

Bushee and Noe (1999) documented empirical evidence on the importance of disclosure quality in influencing institutional investors' investment decisions. This study investigated the relationship between the quality of a firm's disclosure practices and the composition of a firm's institutional investor base. Disclosure quality was measured by the annual ranking of a firm's disclosure (published by the Association for Investment and Management Research (AIMR)) using 4,314 firm-observations that included all firms rated by AIMR between 1982 and 1996. They hypothesized that institutional investors could be sensitive to a firm's disclosure quality for a number of reasons:

- Better disclosure may reduce information asymmetry between the firm and investors. Institutional investors may prefer firms with better disclosure if it reduces the price impacts of trades (Healy *et al.*, 1999). Prior studies found that institutions tended to invest more heavily in firms with greater average trading volumes, consistent with institutions preferring firms for which trades are likely to have a lower price impact (Falkenstein, 1996; Gompers and Metrick, 1998). Diamond and Verrecchia (1991) also showed that a high level of disclosure reduces both bid-ask spreads and the amount of information potentially revealed by large trades, thus reducing the potential price impacts of trades.

- Disclosure quality may affect potential profit opportunities in a firm's stock. If a firm's disclosures provide a substitute for private information collection or if they reveal proprietary information to the market, the firm's long-run value may be impaired. Alternatively, Kim and Verrecchia (1994) argued that the ability of sophisticated investors to make profits is due to their superior ability to interpret the implications of public signals. Thus, the effect of disclosure quality on the profit opportunities of a corporation depends on its information gathering and processing capabilities.

- Public disclosures helped institutional investors to monitor the firm and determine when to engage in corporate governance activities. Bushman *et al.* (1999) argued that a "critical input to the effective operation of corporate governance mechanisms is information about how equity value is changing and why" (p.1). Smith (1996) also found that CalPERS chose which portfolio firms to target for shareholder activism based on public data. Thus, institutions may prefer firms with better disclosure especially if they choose to be active in corporate governance of their investee firms.

Bushee and Noe (1999) found different results for different types of institutional investors, but generally concluded that disclosure quality should be an important factor in determining their investment decisions. Their results suggested that transient institutions, which had high levels of portfolio turnover and diversification based on short-term news, invested more heavily in firms with higher disclosure quality and increased their holdings in response to an increase in disclosure quality. Quasi-indexer institutions who used indexing strategies held large, diversified portfolios and traded very infrequently, also invested more heavily in firms with higher disclosure quality. However, they tended to sell shares in firms that have lower disclosure quality but did not immediately increase holdings in firms with better quality disclosures, suggesting that they may rely on public disclosures as a low-cost mechanism for monitoring firm performance in their portfolios. Finally, dedicated institutions, which were characterized as firms with large holdings in a small number of firms and low portfolio turnover, showed no sensitivity to disclosure quality levels or changes, suggesting that these institutions relied on sources of information other than public disclosure. The results of this study also supported the notion that different types of institutional investors have different investment objectives and thus investment behavior.

Solomon *et al.* (2000a) also considered the importance of disclosure quality on institutions' investment choices. A survey on 522 UK fund managers, drawn randomly from four different categories (pension funds 44%, investment trusts 15%, unit trusts 11% and insurance companies 25%) was conducted in 1999. They found almost a third of total respondents (97 responses) displayed a strong preference (scores 6 or 7 on a seven-point scale as compared to a mean score of 5) for increased corporate risk disclosure because such disclosure would help to improve portfolio investment decisions.

Other research studies also reached similar conclusions on the importance of the quality and disclosures in financial statements. Mitton (2001), using a sample of 399 firms from Indonesia, Korea, Malaysia, the Philippines, and Thailand, examined the firm-level differences in different variables (including disclosure quality)[4] which had

[4] Other variables include ownership concentration and corporate diversification.

a significant impact on firm performance during the East Asian financial crisis (1997-1998). He used two proxies for disclosure quality:

- Firms with ADRs listed in the US at the beginning of the crisis would have higher disclosure quality because they would be subjected to additional reporting requirements beyond what were required in their home country and firms that tapped additional markets would automatically have a larger pool of investors including analysts who would demand more accounting disclosure.

- Firms that were audited by one of the Big Six CPA firms would be associated with higher disclosure quality because Big Six CPA firms might be less likely to ignore problems in a firm's financial statements because they have a greater reputation to protect.

The results of the study suggested that indicators of higher disclosure quality were associated with significantly better stock price performance during the crisis. Moreover, firms might create value by unilaterally opting for higher disclosure quality, even in countries where high disclosure quality might not be legally required.

La Porta *et al.* (1998) reviewed the legal systems and investor protection standards in more than 49 countries around the world (including common law jurisdictions and civil law jurisdictions). They commented that improved disclosure should reduce asymmetric information at the firm level and mitigate opportunities for expropriation. It was found that accounting standards play a critical role in corporate governance by enabling investors to understand the companies they invest in and increasing the likelihood that the contracts between managers and investors are more verifiable in court.

Based on the above literature, quality of disclosure is definitely one of the most important factors in the investment decisions of institutional investors.

4.2.2.2 Availability of information

According to Falkenstein (1996), the proxies for information (including firm age and news stories[5]) were significantly positively correlated with mutual fund ownership. He argued that firms with low profiles might require greater search costs in highlighting them as securities desirable for portfolio investment. They might also have a higher risk. The results showed that funds preferred investments in stocks that were covered in newspapers as well as those with a longer listing period, suggesting that availability of information may be a factor considered by institutional investors in their investment decisions.

4.2.2.3 Corporate strategy

Hendry *et al*. (1999), using an interview study with 86 UK fund managers, brokers' analysts, corporate management (including chief executive, finance directors, investor relations directors) and human resource directors in 1999, found that corporate strategy mattered for institutional investors in their investment decisions. It was found that fund managers preferred companies with simple business strategies and were wary of companies which formulated complex strategies that were difficult to understand. This was because experience has shown that companies with simple strategies were more likely to achieve their objectives. Both fund managers and analysts valued consistency, and were very concerned when companies showed signs of straying out of their core businesses. Some of them commented that they did not like diversification and valued the Chief Executive Officer's (CEO) commitment to their stated strategies. Institutional investors would also consider the corporate strategies of the firm before making their investment decisions.

[5] News stories included those posted in the *Atlanta Constitution, Boston Globe, Chicago Tribune, Christian Science Monitor, Los Angeles Times, New York Times, USA Today, Wall Street Journal, and the Washington Post*.

4.2.2.4 Quality of management

In their interview study, Hendry *et al*. (1999) commented that while the relative profit performance of an organization resulted from market and productivity factors, good people management could improve company performance. People management factors included management participation in decision-making and ideas-generation, open management style, high levels of management training, succession planning from the top, the balance between insiders and new recruits and top management incentives. This factor was found to have a significant effect on profitability. Not surprisingly, fund managers interviewed were more willing to invest in firms with better quality management.

4.2.2.5 Audit quality

The quality of the audit may affect the confidence institutional investors place on the firms in which they invest in a number of ways. Audit quality is defined as the likelihood that the auditor would discover material errors and irregularities and having discovered these, the likelihood that they would report them (Gul and Tsui, 1998; Gul, 1999). In the literature Big Five auditors are identified as higher quality auditors. A study of 468 Australian companies by Gul *et al.* (2001) showed that the earnings of firms audited by Big Five auditors were perceived by the market to be more informative than earnings of firms audited by the non-Big Five CPA firms. Similarly, Teoh and Wong (1993), in a US study, found that the market reacted more positively to earnings of firms audited by the Big Five auditors. Based on these results, we may conclude that institutional investors are more likely to favor firms with Big Five auditors.

Mitton (2001) stressed the importance of audit quality with reference to its effect on the disclosure quality of the firm. As discussed above in the section on disclosure quality, Mitton's study used Big Six auditors as a proxy for higher disclosure quality of the firm and found that the quality of auditor (Big Six auditors were generally regarded to be of higher quality and reliability) might affect the investment decisions of institutions.

Moreover, investors' perception of auditor's independence would also have effects on their assessment of various investments. Dykxhoorn and Sinning (1982), which was a report on the results of a mail survey with an aim to investigate the effect of the perceived independence of auditors on the financial decisions of financial statements users, revealed that perception of auditor's non-independence had significant negative effect on investors' investment prospect. However, it was shown that perception of more independence did not exhibit significant positive effect; perhaps it was because investors considered independence in the auditing profession to be the norm rather than the exception, so independence considerations were no longer a significant factor or variable in their decision-making processes.

Based on the above literature, we could conclude that audit quality should be one of the factors in which institutional investors would consider in their investment decisions.

4.2.2.6 Conservatism

Another major consideration institutional investors have to take into account in assessing their potential investment would be the need for prudence. Badrinath *et al.*'s

(1989) study analyzed the investment behavior of institutional portfolio managers within the context of their fiduciary responsibility arising from handling client's capital. They argued that during times of sluggish performance, prudence used in portfolio selection provided the "safety-net" for portfolio managers. The following quote from Curzio (1987) gives a good example of the use of prudence in an investment decision, " … if a fund manager invests $10 million in a B- stock and it collapses, he may very well risk his job. If the $10 million was invested in a B+ or higher rated stock, and it collapsed, his investment was justified." By definition, "a prudent investment is one which is deemed by others in the profession to be a reasonably sound investment." According to Badrinath *et al*. (1989), the investment choices of institutional investors tend to be limited to those "which are prudent at least in appearance" in order to avoid potential litigation (Edwards and Hubbard, 2000). Firm attributes including firm size, trading liquidity, total and market risk, leverage, historical performance, dividend yield, years exchange-listed were used to proxy for the measure of prudence in the study. This concept of a "safety-net" was extremely important to a portfolio manager. Another proxy for prudence is the concept of "external validation" which is measured by the ranking assigned to a firm's stock by an external agency such as the Standard and Poor's Corporation's (S&P) publication *Security Owner's Stock Guide*. Selecting to invest in only those securities which are ranked highly by an external agency such as S&P reduces the risk of the portfolio manager. If the manager's selected investment does poorly, the manager can hide behind this so long as he can demonstrate that the investment is considered reasonable by other institutional investors. It was found that firms ranked highly by S&P had a higher level of institutional investment.

Gompers and Metrick (1998; 2001) also analyzed the differences in investment behavior between institutional investors and other investors. They used firm size, S&P membership, firm age, dividend yield and volatility as proxies for prudence and hypothesized that if institutions were more affected by prudence considerations than individuals, institutional ownership should be positively related to size, S&P membership, firm age and dividend yield, and negatively related to volatility. Results using 1,300 US firms confirmed the above hypothesis.

As discussed above, prudence considerations should be an important factor affecting the investment decisions of institutional investors.

4.2.2.7 Social or human resources information disclosure

The disclosure of social responsibility or human resource information may also affect the investment decisions of institutional investors. Milne and Chan (1999) studied the usefulness of social disclosures from corporate annual reports for investment decision-making using a questionnaire study of 60 UK investment analysts. It was noted that social disclosure did not gain general importance until 1980s. Early surveys could only find moderate or no importance assigned to social responsibility information in institutional investors' investment decision-making processes (Benjamin and Stanga, 1977; Buzby and Falk, 1979). More recent surveys suggested that social, particularly environmental, information was important for investor decisions (Epstein, 1992; Deegan and Rankin, 1997). Human resource information either in the financial statements or as supplements was important for investor decisions as well (Acland, 1976; Schwan, 1976). Results from Milne and Chan's (1999) study found that social disclosures from annual reports did not elicit any more than a 15% switch in investment, holding all other factors such as financial performance, risk, size and industry constant.

Shelley Taylor and Associates' study in 1996 (Anonymous, 1997) found that institutional investors were looking more closely than ever at "human" or "intellectual" assets before making investment decisions (such as ethics, corporate values, development goals etc.). They compiled the data on 200 publicly traded multinational companies in the US and Europe, and reviewed more than 100 types of information that investors analyzed. They also presented the information needs of 62 of the world's largest and most influential institutional investors as they related to corporate disclosure practices. Other findings included:

- An increase in investors' interest in qualitative measures, such as ethics, corporate values, education and experience of a company's employees, and company's commitment to ongoing training and development.

- There was a striking similarity between the unmet informational needs of both US and European investors. They are as follows:

Disclosure Gaps

Issues most important to investors but least disclosed

For US Investors	**For European Investors**
R&D activities	R&D activities
Capital expenditures	Capital expenditures
Planned expenditures	Planned expenditures
Analysis of subsidiaries	Management structure
Values	Analysis of subsidiaries

From the above discussions, we can conclude that social or human resource information disclosures would also be considered by the institutional investors in making their investment decisions.

4.2.2.8 Level of corporate governance

The majority of research studies found that companies with better governance were more attractive to institutional investors. From the Investor Opinion Survey released by McKinsey & Company (2000), the importance of corporate governance in the investment decisions of institutions was highlighted. The report consisted of results from 3 surveys conducted by McKinsey & Company in co-operation with World Bank and *Institutional Investor*'s regional institutes in 1999 – 2000. They aimed to examine how shareholders perceived and valued corporate governance in developed and emerging markets. The surveys gathered responses from more than 200 institutional investors, (20% from USA, 40% from Latin America and 40% from Asia) which invested heavily internationally, and managed about US$3.25 trillion in assets.

It was found that:

- Seventy-five percent responded that board practices were at least as important as financial performance when they evaluated companies for investment.
- For Latin America, almost half of the respondents considered board practices to be more important than financial performance.
- Eighty percent of the respondents stated that they would pay more for the shares of a well-governed company than for those of a poorly governed one with comparable financial performance. They would pay 18% more for the shares of a well-governed UK or US company, 27% more for similar companies in Venezuela or Indonesia, 22% more in Italy, 24-26% more in Thailand, Malaysia and Korea, 20% more in Taiwan and Japan.
- In Asia and Latin America, where financial reporting is both limited and often of poor quality, institutional investors preferred not to put their trust in financial information alone, but also the performance of the board; in Europe and the US,

where the standard of reporting was higher, the relative importance of corporate governance was lower. Therefore corporate governance is important for institutional investors' investment decisions, but the degree of importance depends on the standard of corporate governance in different markets.

- Shareholder accountability was viewed to be an important issue for institutional investors and more shareholder communication was needed. Shareholder accountability should be improved by developing relationships with their shareholders through constant communications (Coombes and Watson, 2000; Investor Relations Business Editorial Staff, 2000).

- The fact that a majority of institutional investors have already taken corporate governance into account when making investment decisions was a powerful argument in favor of corporate governance reforms.

- The result indicated that companies could greatly improve their chances of attracting investment by introducing management incentives (such as share options) to bolster stock price.

PwC in co-operation with the Stock Exchange of Singapore (now known as the Singapore Exchange) conducted a similar survey in 1999 with an aim to assess the corporate governance regime in Singapore from the investor's point of view so as to provide businesses with greater insight into the expectations of their corporate investors. A total of 47 corporate investors were surveyed in October 1999, and they represented a cross-section of the financial services industry, including security dealers and brokers, asset management firms, banks and insurance companies. Questionnaires were sent to a target group of over 300 companies. Results showed that corporate governance was definitely one factor that investors would consider and that they would like to see improvements in corporate governance mechanisms and standards. The survey found that:

- Singapore's standard of corporate governance was rated slightly higher than Hong Kong's and Japan's, and significantly better than secondary capital markets such as Malaysia, Taiwan and Korea.

- While the standard of business ethics and corporate governance had improved as at the date of the survey (60% agreed that corporate governance standards had improved a little, while 19% considered it had improved considerably), annual report disclosures of listed companies were still lacking (74% of the respondents would like listed companies to disclose more information voluntarily).

- Ninety-three percent of the respondents would still consider investing in a company even when they were dissatisfied with the quality, qualification and experience of independent non-executive directors.

- Eighty-eight percent of the respondents were not too concerned if the number of non-executive directors was unsatisfactory.

- Areas requiring improvement included:

    - Increased disclosure of directors' dealings with related parties.
    - Separation of the roles of chairman and CEO.
    - Increased frequency of company reporting.
    - Clearer separation of company ownership and management; and
    - Clearer definition of directors' responsibilities.

- A preference for a voluntary self-regulatory regime was noted: fifty percent of the respondents pointed out that the investment community should oversee improvements in the standard of corporate governance in Singapore, while fifty-one percent expected the Singapore Exchange to drive the reform.

Two papers published by Solomon *et al*. (2000a, 2000b) reported the results of a survey conducted to assess the view of the institutional investors in UK on corporate governance reforms. A questionnaire survey was distributed to a sample of 522 fund managers in 1999 drawn randomly from 4 categories of institutional investors (pension funds 44%, investment trusts 15%, unit trusts 11% and insurance companies 25%). It was found that corporate governance reforms were generally welcomed by the respondents, and they agreed that there should be further corporate governance reforms in their investee companies (mean of 4.52 in a 7-point scale). Reforms on investor relation should receive priority amongst others as this could reduce agency costs.

Mitton's (2001) study examined the association between corporate governance (defined as disclosure quality, ownership concentration and corporate diversification) and firm performance during the East Asian financial crisis in 1997-1998. He found that corporate governance had an impact on firm performance during the crisis. The study included 399 firms from five countries namely Indonesia, Korea, Malaysia, the Philippines and Thailand that suffered disproportionately in terms of currency depreciation and stock market decline. The level of corporate governance of various firms was proxied by their disclosure quality (measured by whether the firm had an ADR listed in US and whether the firm's auditor was one of the Big Six CPA firms), ownership concentration and corporate diversification (measured by the number of industries in which each firm operates). It was found that:

- Higher disclosure quality was associated with significantly better stock price performance during the crisis, showing that firms might create value by unilaterally opting for higher disclosure quality, even in countries where high disclosure quality might not be legally required.
- Diversified firms, particularly those with significant variation in investment opportunities across divisions, performed worse than single-segment firms during the crisis, showing that cross-subsidization of divisions could account for some of the value loss of diversified firms during the crisis.

In conclusion, the results were consistent with the notion that improved corporate governance would have a positive effect on firm performance during the East Asian financial crisis, and in times of distress, corporate governance could have a larger effect on firm value.

Johnson *et al.*'s (2000) study supported the important role of corporate governance in the investment community and justified the need for improved corporate governance measures, especially in Asian countries/regions including Hong Kong. They studied 25 emerging markets from Latin America, Eastern Europe, Greece and Portugal in Europe, Middle East, South Africa and Asia (including Hong Kong). They presented evidence to show that weak legal institutions for corporate governance had a negative effect on the extent of exchange rate depreciations and stock market declines in the East Asian financial crisis. Corporate governance was measured in terms of enforceability of contracts (by assessing the efficiency of the judiciary, corruption, the rule of law and a general assessment of corporate governance) and shareholder's rights (including indices like anti-director rights, creditors rights and accounting standards, as suggested by La Porta *et al.*, 1998). Results concluded that investor protection was not important as long as the economy was still growing, but it matters once growth prospects declined, and "a mild shock can entail a large increase in stealing, which in turn causes a large depreciation." In this sense, the authors concluded that measures of corporate governance explained the extent of exchange rate depreciation and stock market decline better than standard macroeconomic measures during the Asian financial crisis 1997-98. If this was the case, it could be implied that corporate governance is an important factor for investors to consider in their investment choices, especially in times of economic distress.

Several papers published by La Porta *et al.* (1997; 1998; 1999; 2000) studied extensively the importance of corporate governance on external finance of the company. Using more than 49 countries around the world in their study, they argued that better investor protection (especially legal protection as stressed by the authors), led to more investor (including institutional investor) confidence. They also maintained that investor protection encourages the development of financial markets as a whole. Corporate governance was thus valued as an important factor in financial market development and firm value by the authors.

Some other studies examined the effect of specific corporate governance mechanisms on the institutional investors' investment choices. Vafeas (1999) investigated the possible association between board meeting frequency and firm value. By analyzing 307 US firms from 1990 to 1994, it was found that the annual number of board meetings was positively related to firm value for those firms with poor performance in prior years. He found that operating performance improved following years of abnormal board activity, and the improvements were most pronounced for firms with poor prior performance and firms not engaged in corporate control transactions. Overall, the results suggested that board activity, measured by board meeting frequency, is an important dimension of board operations and affected firm performance.

Pearl Meyer & Partners Inc., a New York-based executive compensation consulting firm, conducted a survey of 533 mutual fund managers in 1998 and found the following:

- Fifty-eight percent of the respondents stated that their investments were influenced by the level of CEO pay.
- Seventy-one percent stated that they were favorably influenced by stock-based pay plans.
- Eighty-three percent indicated that they were positively influenced, at least sometimes, when a company has a stated policy on stock ownership for top executives.
- Ninety percent reviewed the compensation and options tables in companies' annual proxy statements.
- Forty-nine percent reviewed the letter from the Board's Compensation Committee, which usually describes a company's compensation philosophy and explains its compensation programs (Maxey and ten Wolde, 1998).

In 1997 a survey was conducted for Russell Reynolds Associates by Wirthlin Worldwide on two types of US institutional investors, namely institutional shareholders (defined as those who worked in public and private pension funds, endowments, corporate investment management department, etc.) and portfolio managers (who often were retained to manage the equity investments of institutional shareholders, such as asset management firms, banks and mutual fund management companies). It was found that:

- The quality of a company's board of directors was an important factor when making investment decisions (with one-quarter of investors saying it was extremely or very important).
- Investors stated they did not have enough information to adequately evaluate boards, especially with respect to basic information on individual directors, such as their backgrounds, their business track records and their specific contributions to the boards on which they served, implying that investors were interested in examining these type of information in their investment decisions.
- Investors were paying closer attention to board composition issues. When evaluating boards, investors also examined the mix of inside and outside directors and the presence of board members with strategically critical skills.
- The racial and gender diversity of boards was not a key factor in investor decision making. Despite the attention this issue received, it had little impact on their investment decisions. While a sizable group of investors believed diversity was important, only a handful (4%) had ever decided not to invest in a company due to a lack of racial or gender diversity on its board.
- Investors felt that boards were best evaluated by outside parties, such as neutral, independent observers or shareholder activists.
- Investors felt strongly that boards need to be more aggressive in weeding out under-performing directors.
- Investors regarded succession planning to be a critical responsibility for both CEOs and boards of directors.
- Investors preferred the roles of the CEO to be separated from that of the chairman, so that the separate chairman could act as a check on a company's CEO and top management.
- Investors opposed placing limits on CEO compensation.

- There was widespread support for stock ownership by directors and for the elimination of outside director pensions as a way of aligning directors' interests.
- Institutional investors themselves have exercised moderate influence over the companies in which they invest, and they were not shy about voicing their opinions, showing that they were willing to play a monitoring role in the corporate governance of their investee firms.

Some papers have examined the effect of monitoring by the institutional investors themselves on the investment choices of institutional investors. Shleifer and Vishny (1997) suggested, after conducting a comprehensive survey of corporate governance systems all over the world, that some form of concentrated ownership was one of the "essential elements of a good corporate governance system" and institutional investors might prefer to invest more into markets (or firms) with higher levels of institutional ownership as this would be regarded as a sign of better governance.

It can be concluded from the above literature review that corporate governance should be one of the important factors affecting institutional investors' investment decisions.

4.3 Summary

The objective of this chapter is to identify the various types of quantitative and qualitative information that institutional investors would require for evaluating potential and current investees. A literature review was conducted to identify these factors. The following are the more important quantitative and qualitative factors that institutional investors would take into account in making their investment decisions:

- Financial performance
- Future cash flows
- Dividend yield
- Stock liquidity
- Share price volatility
- Market risk

- Leverage
- Company size
- Company age
- Years listed in stock exchanges
- Cross-listing
- Book-to-market ratio
- Transaction costs
- Quality and disclosure of financial statements
- Availability of information
- Corporate strategy
- Quality of management
- Audit quality
- Conservatism
- Social or human resources information disclosure
- Level of corporate governance

The above factors were either included in the interview questionnaire or web-based questionnaire. The next chapter outlines the approach and the methodology used for this study.

CHAPTER 5 METHODOLOGY

5.1 Introduction

The first four chapters provided the background to the study. In particular, we identified the objectives, reviewed the literature, provided an analytical framework for the role of institutional investors and identified the information needs of institutional investors. These chapters provided insights to the factors that are germane for the study of the role of institutional investors in Hong Kong. In this chapter, we outline the approach and methodology that we use to collect the information for this study.

5.2 Approach

Since the objective of this study is to survey international institutional investors' attitudes towards corporate governance standards in Hong Kong, in-depth interviews and web-based questionnaires were considered appropriate methods. Specifically, they were used to obtain information regarding the following:

- Identification of the corporate information needs that may affect their investment decisions.
- Ascertain their views on the appropriate level of corporate governance standards for Hong Kong.
- Ascertain their views on the common family shareholding structure in Hong Kong listed companies.
- Ascertain their expected level of standards and the type of corporate governance regimes of Mainland China companies seeking listings in Hong Kong.
- Seek their views on the need to introduce new corporate governance measures such as corporate governance rating and scoring in Hong Kong.

Before proceeding with the interviews and distribution of the web-based questionnaires, two essential steps were carried out. These are discussed in sections 5.2.1 and 5.2.2 below.

5.2.1 Identification of the Institutional Investors

Discussions with the chief executives of the Hong Kong Investment Funds Association (HKIFA) and the Hong Kong Securities Institute (HKSI) were held in order to identify the major players in institutional investment in Hong Kong. Consultations with the Securities and Futures Commission (SFC) were also undertaken to identify the potential institutional investors. Comments from members of the Steering Committee relating to the identification of institutional investors were also received at the progress meeting with the Steering Committee. On the basis of these consultations we identified target interviewees for our in-depth interviews and web-based questionnaires.

In-depth interview was the primary data collecting technique that we adopted for several reasons. First, the technique is versatile and allows us to collect information in great depth and detail. It allows the interviewer to probe with additional questions and gather supplemental information. Second, the interviewer has more control than with other kinds of interrogation. For example, the interviewer can assure that the correct respondent is replying and can set up and control the interviewing conditions. Finally, perhaps the greatest value of the interview method is that it facilitates the collection of more in-depth insights on the institutional investors' views in a more open and free format.

On the other hand, web-based questionnaires can provide us with a more representative view of their attitudes since it can be distributed to a larger sample of institutional investors. It is also time and cost efficient. The HKIFA and HKSI assisted us in identifying all the other institutional investors in Hong Kong for our web-based questionnaires and also in sending out the web based questionnaires to our selected respondents in order to ensure a higher response rate.

5.2.2 Comprehensive Literature Review

We conducted a comprehensive review of academic literature and institutional investors surveys on:

- the role of institutional investors and its effect on firm performance (refer to Chapter 2). On the basis of this literature review, an analytical framework for institutional investors was developed for understanding their role in the context of Hong Kong (refer to Chapter 3).

- the corporate information needs for institutional investors' investment decisions. This review formed the basis from which our interview questionnaire and our web-based questionnaires were developed (refer to Chapter 4).

The following lists the titles of the key academic journals and international institutional investors surveys conducted by international professional organizations (additional details are provided in the bibliography sections):

5.2.2.1 Academic journals

- Journal of Accounting & Economics
- Journal of Accounting Research
- The Accounting Review
- Journal of Finance
- Journal of Applied Corporate Finance
- Journal of Financial Economics
- Accounting, Organizations & Society
- Journal of Financial & Quantitative Analysis
- Contemporary Accounting Research

- Columbia Law Review
- Journal of Law & Economics
- Stanford Law Review
- Academy of Management Journal

5.2.2.2 Institutional investors' opinion surveys

- Corporate Governance 1999 Survey of Institutional Investors jointly conducted by PricewaterhouseCoopers and Singapore Exchange
- Investor Opinion Survey 2000 published by McKinsey & Company
- CG Watch – Corporate Governance in Emerging Markets published by Credit Lyonnais Securities Asia Limited, April 2001

5.3 In-depth Interviews

The preliminary interview list on the major international institutional investors was identified with the assistance of the SFC, the HKIFA and the HKSI. Based on the input from members of the Steering Committee, a final interview list consisting of 13 interviewees was selected for interview (see Appendix 1). They represented eleven key players in asset management and two investment banks with private wealth funds in Hong Kong.

Our interview questionnaire was developed based on the above literature review. The interview questionnaire was discussed in a progress meeting and comments were received from members of the Steering Committee. A pilot interview was conducted to assess initial reaction and clarity of the questions as well as the amount of time it would take. The interview questionnaire was then finalized based on the feedback received (see Appendix 2).

5.4 Web-based Questionnaires

The web-based questionnaire was developed for the following two reasons:

- since our respondents are international institutional investors, it is not uncommon for them to have internet access and it is feasible to utilize this technology to ensure a higher response rate.
- accurate and efficient data capturing can be ensured with a significant amount of time saved on data input and compilation because raw data can be entered into our database directly.

Based on the above literature review, a web-based questionnaire was developed. A significant amount of time was spent in "fine tuning" the questionnaire in order to ensure that only the most essential questions were included the time to complete the questionnaire did not exceed 30 minutes. The questionnaire was piloted tested by five academics in the Department of Accountancy, City University, in order to ascertain initial reactions on the content and presentation of the questions as well the time required for completion. Subsequent feedback was received and amendments were made to further improve the questionnaire. The web-based questionnaire is attached in Appendix 3a. Subsequently, based on the feedback received from the Steering Committee members, we have fine-tuned and shortened our web-based questionnaire. The revised version of the web-based questionnaire is attached in Appendix 3b.

In order to prevent any frivolous responses from "casual internet surfers", an individual login user identification number and password were assigned (web-based questionnaire was located at http://fbweb.cityu.edu.hk/tailormade/acjt). Both HKSI and HKIFA provided invaluable administrative support in distributing as well as following up with their members to ensure a high response rate.

Our sample respondents are defined as those institutional investors investing in Hong Kong. A total of 195 respondents were selected from the membership list of HKIFA and HKSI for distribution of the web-based questionnaires. They included 158 corporate members from the HKSI, 36 members of the HKIFA and the Chairman of the Hong Kong Institute of Investors. Corporate members of the HKSI whose sole and dominant business operations were in stock-broking businesses were thus excluded.

5.5 Data Analyses

Findings from the in-depth interviews are summarized in Chapter 6. Statistical tools were used to analyze the responses from the web-based questionnaires. The next chapter discusses the findings from both the interview questionnaires and web-based questionnaires.

5.6 Summary

The primary method of data collection was the personal interview method. The questions raised with the interviewees were based on the literature review which included an identification of the corporate information needs of institutional investors. We also used a web-based questionnaire to gather additional evidence. Both these research methods were expected to provide in-depth insights on attitudes and perceptions of respondents to a range of issues that straddle corporate governance and institutional investment issues in Hong Kong. The next chapter provides the findings of these personal interviews and web–based questionnaires.

CHAPTER 6 FINDINGS

6.1 Introduction

The two main vehicles we used to obtain information on the role of institutional investors were in-depth interview and the web-based questionnaire. This chapter outlines our findings from in-depth interview and web-based questionnaires. The first section provides descriptive information regarding the interviewees and this is followed by a summary and discussion of the general findings, supported, where appropriate, with literature review in Chapter 4 and detailed quotes from the interviewees. The second section similarly provides descriptive information regarding respondents from the web-based questionnaires, followed by a discussion of the findings.

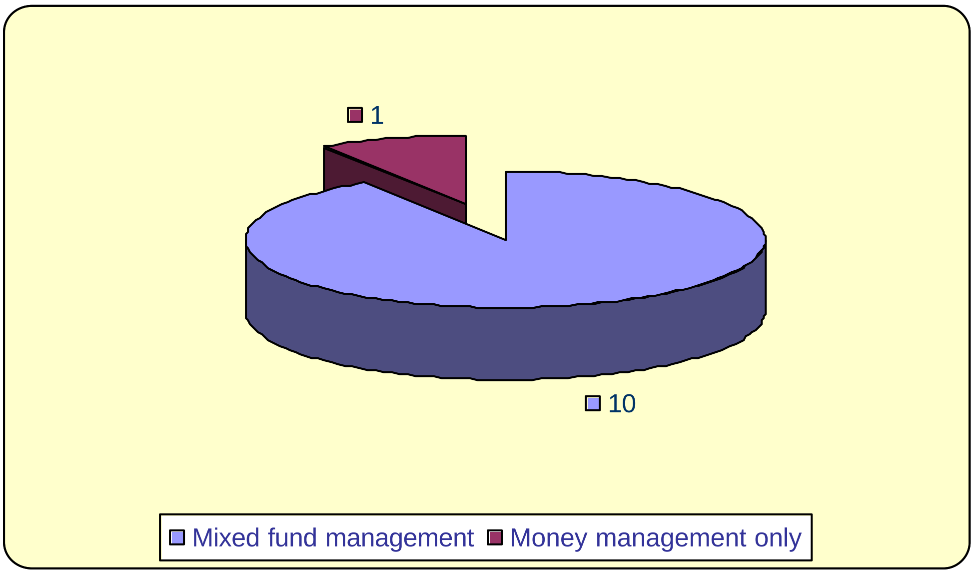
6.2 In-depth Interviews

An "interview questionnaire" was used to provide uniformity and guidance for conducting the eleven interviews with institutional investors from selected asset management companies. Of the thirteen institutional investors interviewed, eleven were asset management companies, and the remaining two were investment banks. Although their profiles were quite different, their attitudes towards corporate governance standards in Hong Kong were similar. Therefore, the information gathered form the interviewees representing the investment banks was excluded from the following profile descriptions, but their responses were included in the Findings section.

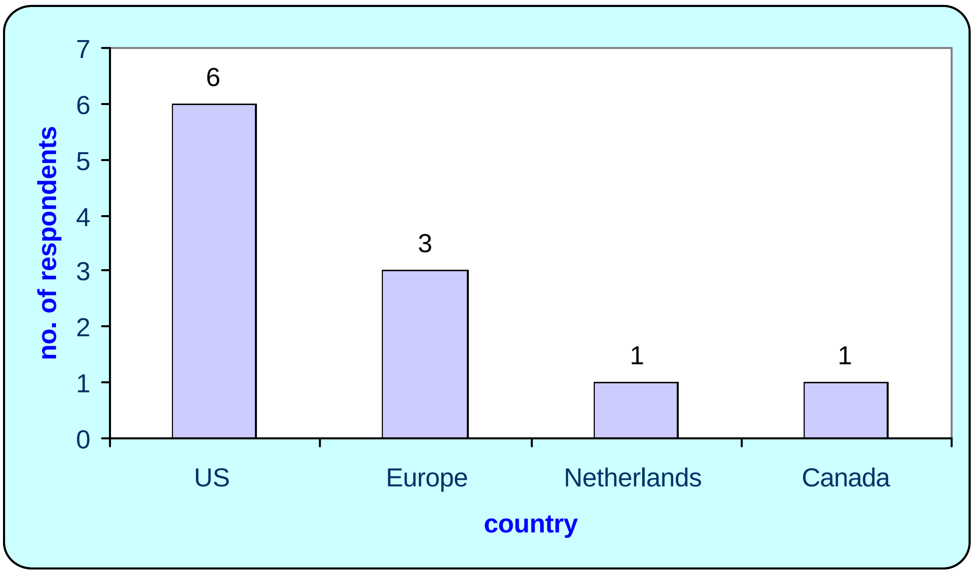
The following provides the profile descriptions for eleven institutional investors:

Profile Descriptions

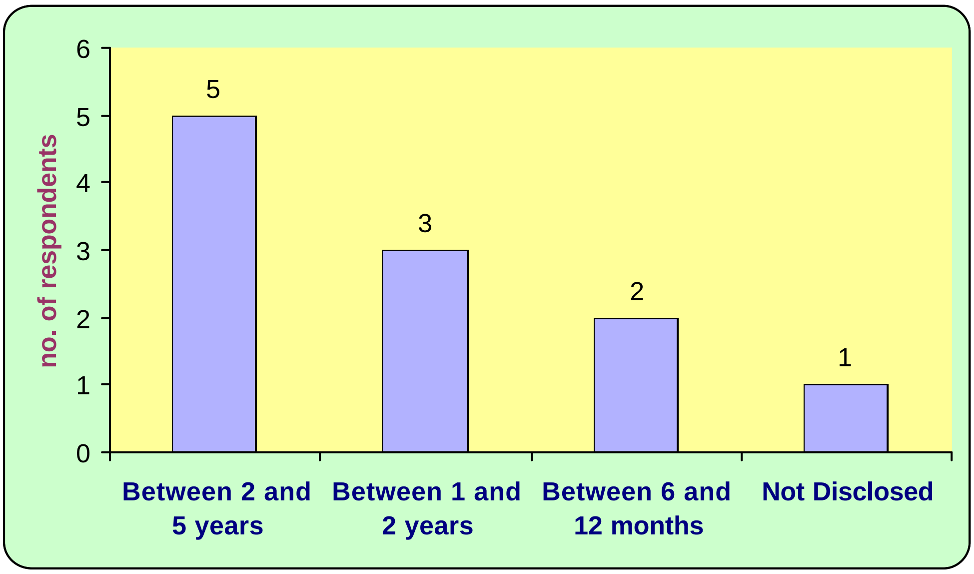
i) Categories of Businesses – the majority of interviewees represented a diverse range of asset management businesses, predominantly pension and mutual funds. Mixed fund management includes private investment funds, money management, investment banking, insurance, investment and unit trusts.



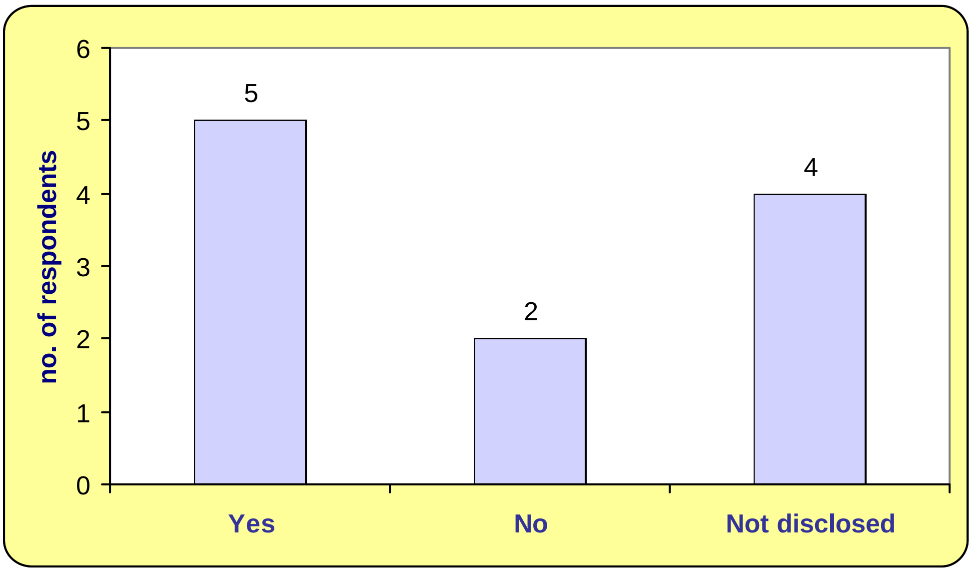
ii) Nationalities of Institutions – the majority of interviewees were US based companies.



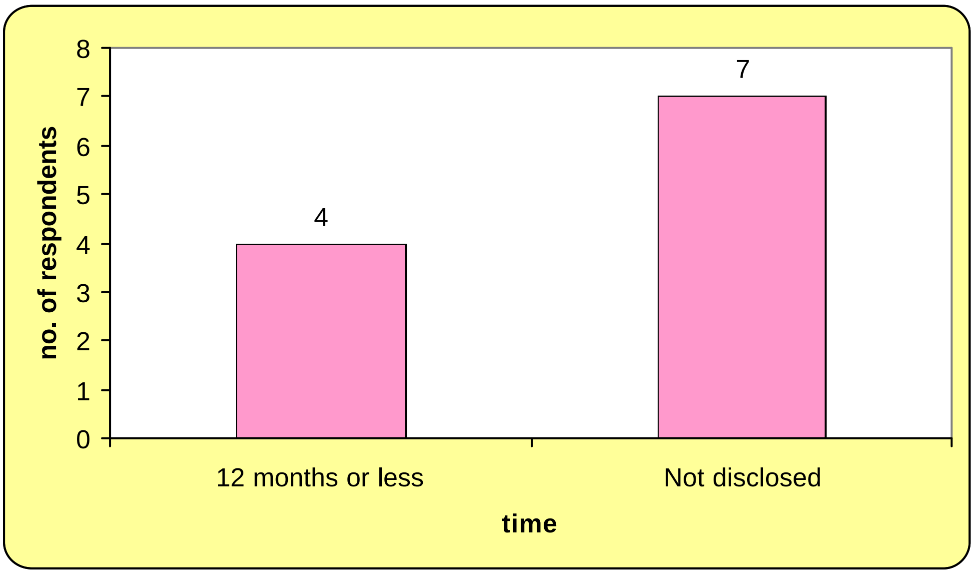
iii) Average Length of Portfolio Investment Horizon in Hong Kong – five respondents had portfolio investment horizons between two and five years.



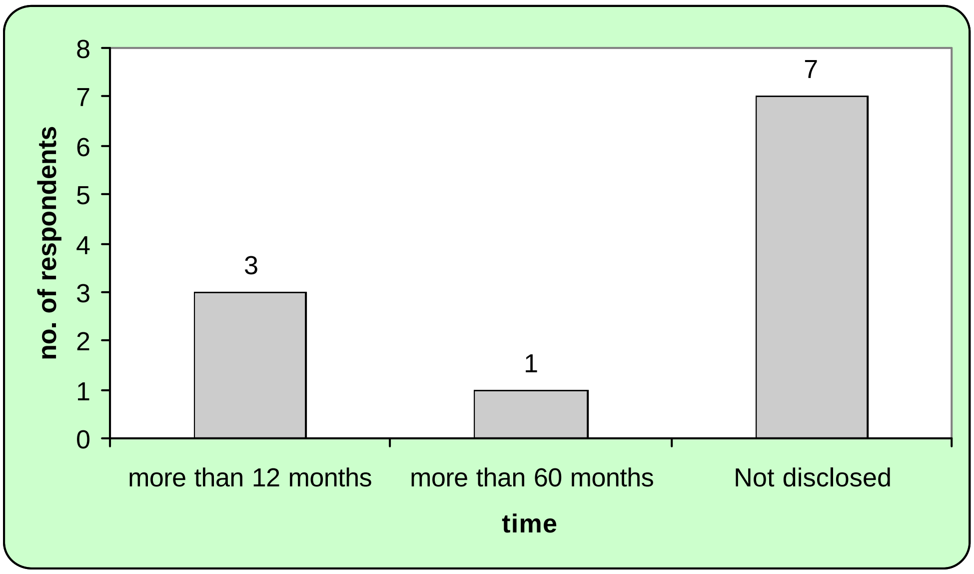
iv) Average Length of Portfolio Investment – five interviewees had the same average length of their portfolio investment for all capital markets, including Hong Kong.



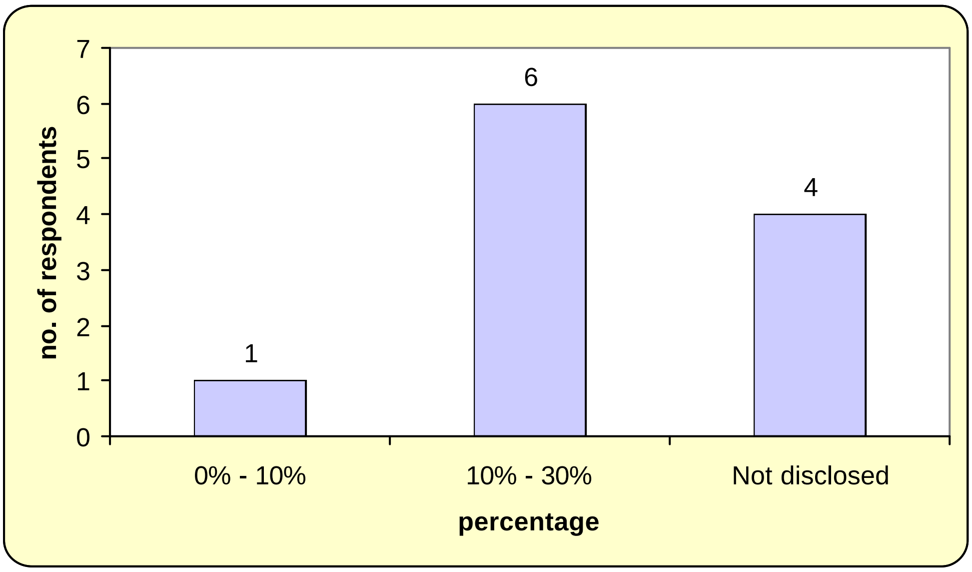
Meaning of Short-Term Investment – four interviewees regarded short-term investment as an investment as within 12 months.



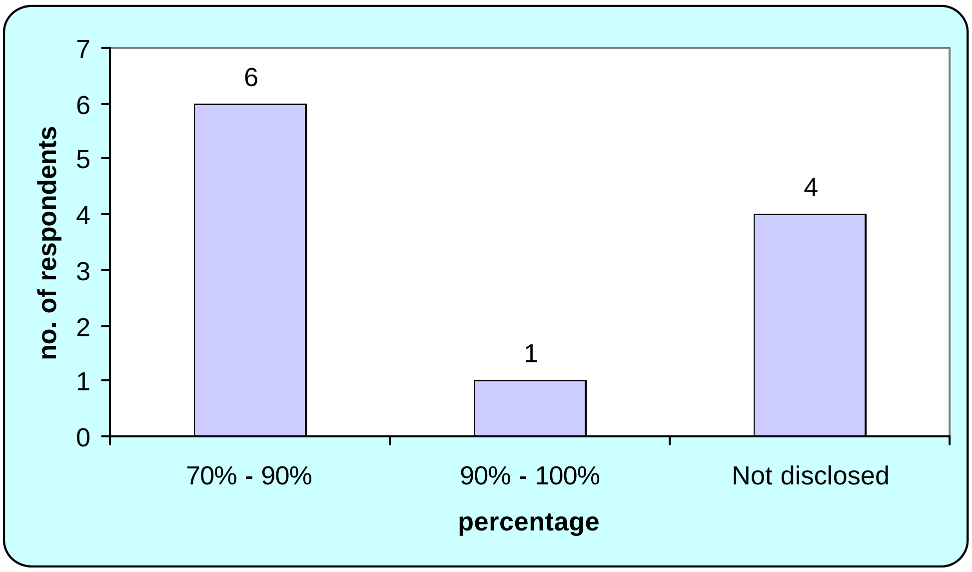
Meaning of Long-Term Investment – four interviewees considered long-term investment as beyond 12 months.



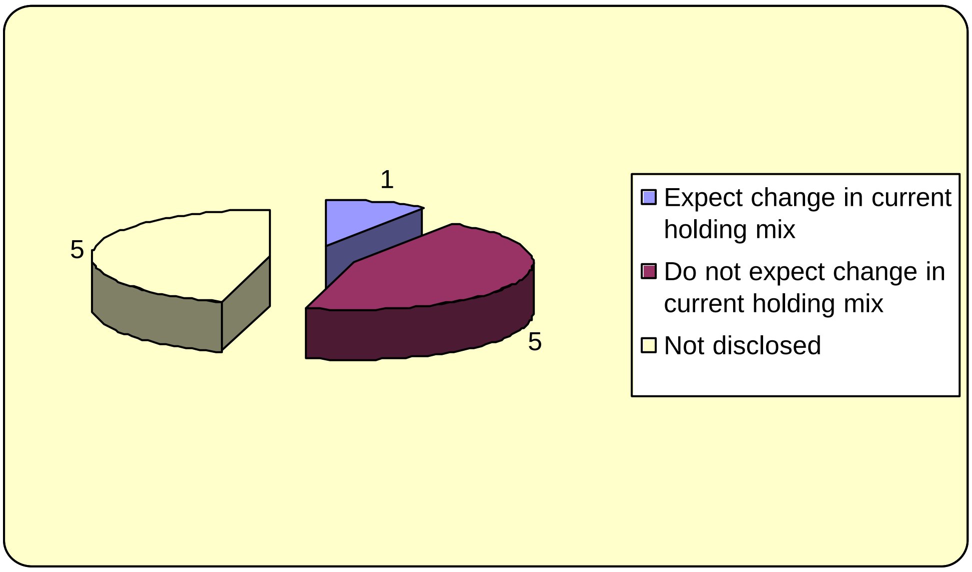
v) Percentage of Short-Term Investment to Total Portfolio – the majority of the interviewees indicated that their short-term investments ranged from 10% to 30% of their total investment portfolio.



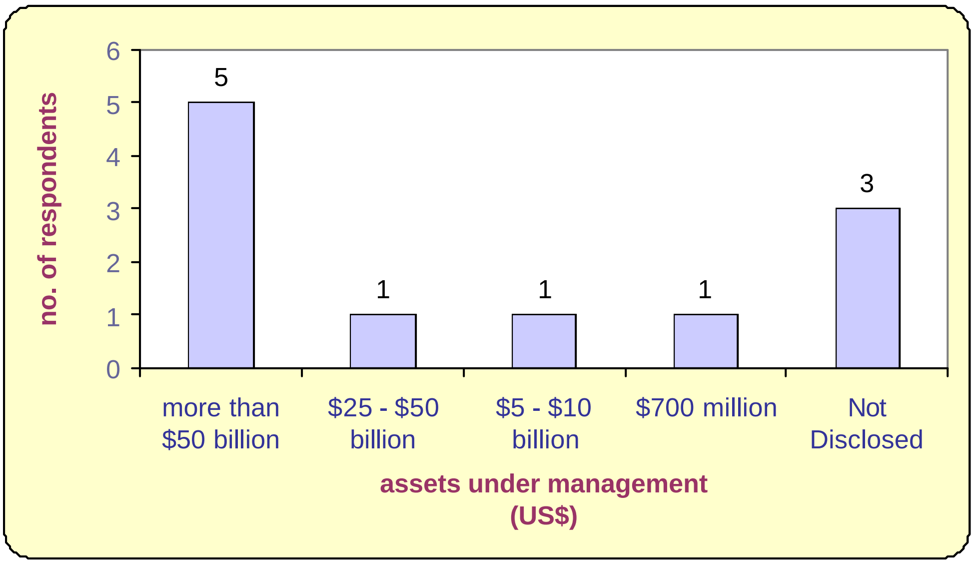
Percentage of Long-Term Investment to Total Portfolio – the majority of the interviewees indicated that their long-term investments ranged from 70% to 90% of their total investment portfolio.



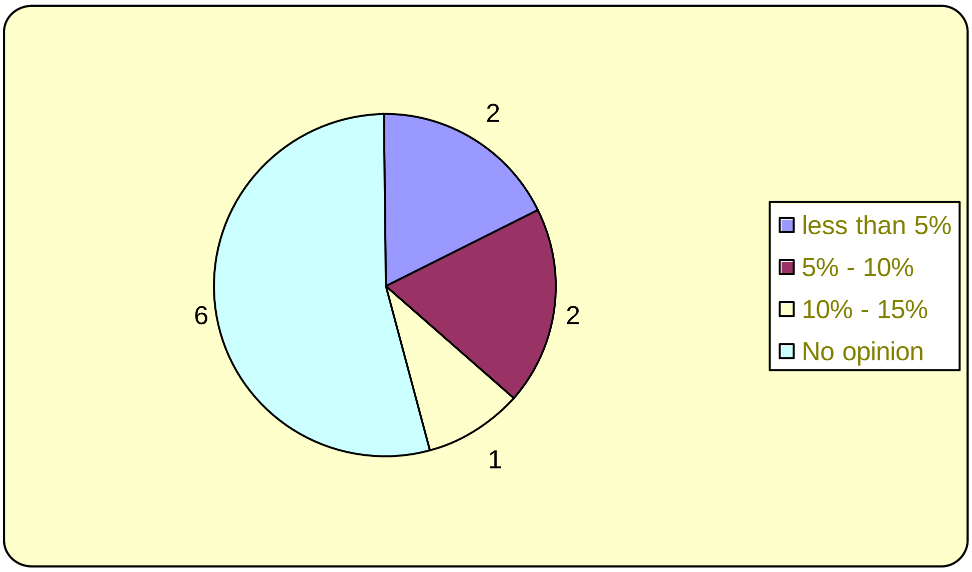
vi) Expected Changes in Current Holding Mix – about half of the interviewees did not expect any changes in their current holding mix in the near future. Their current holding mix is considered optimal.



vii) Size of Institutions (Value of assets under management) – almost half of the interviewees have assets under management of over US$50 billion.



viii) Market Shares of Institutions – about half of the interviewees considered their market share to be less than 15%.



ix) <u>Location</u>

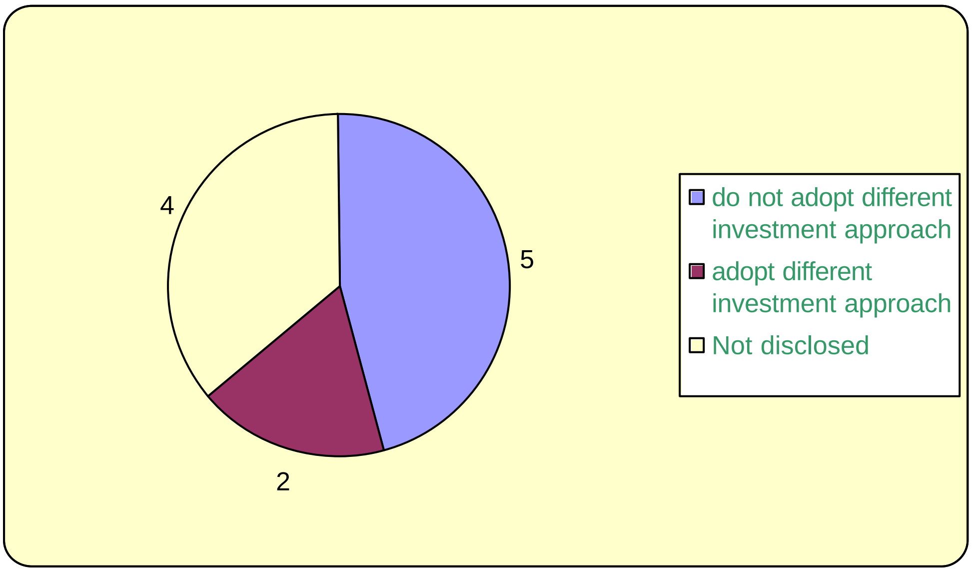
Place of Investment – the majority of respondents are currently investing in Hong Kong.

The following lists the countries, regions or exchanges they are currently investing in:

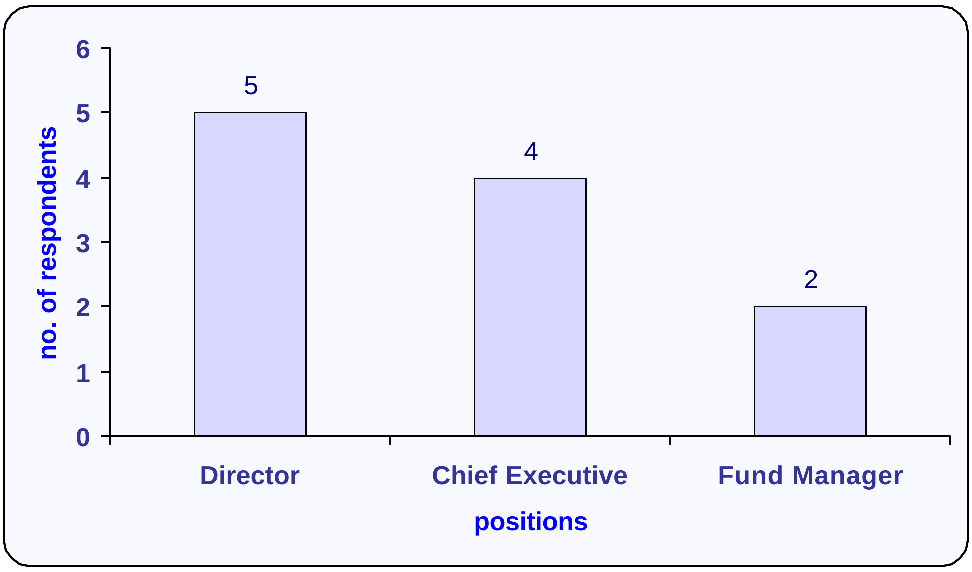
Never invested	Invested in the past but not now	Currently investing	Country, region or exchange
		8	Hong Kong
		8	Taiwan
1		7	Chinese Mainland
1		7	Malaysia
1		7	Indonesia
		8	Singapore
		8	Bangkok
1		7	Tokyo
1		7	Frankfurt
1		7	London
		8	Australia
1		7	USA
1		7	Canada
2	1	5	Latin America

Three interviewees did not provide any information.

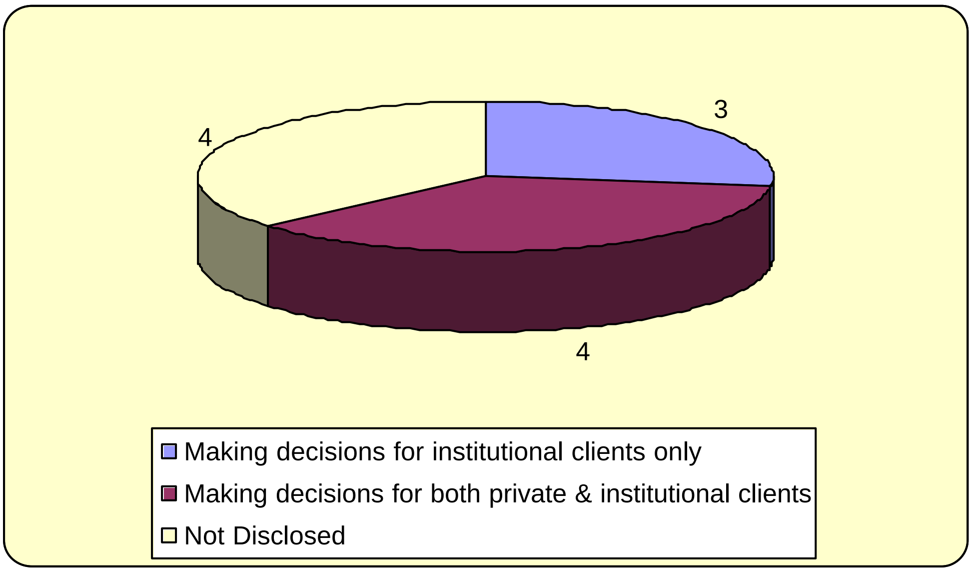
x) Investment Approach – about half of the interviewees indicated that they did not adopt the same investment approach or strategy in Hong Kong as in other markets.



xi) Position – the majority of the interviewees are directors or chief executives of asset management companies.



xii) Degree of Investment Responsibility – about half of the interviewees indicated that they make investment decisions on behalf of both their organizations' private and institutional clients.



6.3 Findings

6.3.1 Corporate Information Needs

Based on the literature review on the corporate information needs of institutional investors, our interviewees were asked to respond to the importance of several company specific factors ranking them from most important to unimportant. The respondents' ranking of the factors are as follows:

Most important:

- Quality of management
- Past financial performance
- Future financial performance
- Future cash flow
- Corporate strategy
- Content of financial statement (including notes)
- Information availability

Important:

- Dividend yield
- Trading liquidity
- Share price volatility
- Market risk, i.e. beta

- Leverage

Somewhat important:
- Company size
- Ratio of market price per share / book value per share
- Audit quality (whether audited by Big-Five CPA Firms)
- Transaction costs
- Corporate governance

Not important:
- Company age
- Years listed in stock exchanges
- Cross listing
- Conservatism
- Corporate social responsibilities disclosures, e.g., environmental issues

In general, almost all respondents indicated that they did not pay particular attention to macro factors even though they agreed that some of these factors may be considered when they made investment decisions. Specific findings on corporate information needs for institutional investors are discussed below.

6.3.1.1 Quality of management

Most respondents ranked quality of management as the most important factor in their investment decisions and integrity was regarded as an important ingredient for quality. They commented that if the quality of management is high, then the corporate governance mechanisms set up by the investee company will correspondingly be effective. On the other hand, if the quality of management cannot be relied upon, then any establishment of corporate governance mechanisms would only exist in form and not be effective in substance. Not many of the interviewees systematically factored in corporate governance as a significant factor in their investment decisions. They recognized that it is important but did not consider it explicitly in any evaluation criteria. However, one respondent from a UK based company mentioned that his company would adopt the UK Corporate Governance Guidelines in Hong Kong next year. This Guidelines explicitly considered corporate governance mechanisms in their evaluation guidelines such as CEO duality, board structure, board size, board independence, roles and functions of board committees such as nomination committee, remuneration committee, audit committee, executive director's remuneration, role of non-executive directors (NEDs), director independence etc.

The above findings are consistent with the conclusions in prior studies in the USA and UK, where quality of management was cited as one of the main factors affecting institutional investors' investment decisions. For example, in their UK interview study, Hendry *et al*. (1999) commented that while a majority of the relative profit performance of an organization resulted from market and productivity factors, good people management could improve company performance, which in turn would attract more capital from institutional investors to invest in these firms.

Examples of quotes from interviewees on the above finding are as follows:

- "The main factor in shaping a good governed environment is the quality of management, such as their track records."
- "Quality of management is very important when we assess the prospective investments, especially on the track record of the management, their integrity, and whether they are working in the best interest of the shareholders."

6.3.1.2 Financial results and other related factors

Seven out of eleven respondents believed that past and future financial performance, future cash flows and quality of disclosure of financial statements are very important factors that affected their investment decisions. Six out of eleven considered that corporate strategy also constitute a very important weighting in making investment decisions.

These two findings were generally consistent with the US study by Badrinath (1989), which found that firm size, past financial performance and trading liquidity were factors that were considered by institutional investors in their investment decisions. A more recent study conducted in US by Gompers and Metrick (1998) also found results which are consistent with our findings in Hong Kong that firm size, dividend yield, liquidity and historical performance of a stock could affect the investment choices of institutional investors.

Examples of quotes from interviewees on the above finding are as follows:

- "Ultimately it's the corporate performance that matters. But most likely companies with good corporate performance would have good corporate governance."

- "Past and future financial performance are what we are trying to determine. So, they are important (in our investment decisions)."

- "We would look at corporate governance issues after earnings and growth."

- "Corporate governance of the investee firms would affect our investment decisions, but itself not a decisive factor, as the determining factor affecting our investment choices is still the corporate performance."

- "We would look at corporate governance in our investment decisions, but only marginally (i.e. not a critical driver), as we will hold stocks that have "extremely bad governance". The "critical drivers" are profitability, earnings generation, free cash flow generation and management. In marginal case, we would hold a stock with better corporate governance."

- "Corporate governance will affect our investment decisions, only in that we would continue to hold the stocks when the corporate governance is good in that company."

- "Corporate governance is something that we are looking at…(but)… it is very clear, we do hold companies that have extremely bad corporate governance."

The above summarizes the findings on company specific factors which are important in institutional investors' investment decisions. The following summarizes the findings relating to corporate governance issues namely: quality of independent non-executive directors (INDs), family ownership, corporate governance and performance and corporate governance standard.

6.3.2 Corporate Governance Issues

Corporate governance is one of the factors that institutional investors considered in making their investment decisions. The following summarizes some of their perceptions regarding corporate governance:

6.3.2.1 Quality of independent non-executive directors (INDs)

Most of the interviewees believed that the most important mechanism for good corporate governance is the quality of INDs. If they do not carry out their roles and functions properly, good corporate governance is non-existent. Many were very skeptical about the existence of "truly independent" INDs because of Hong Kong's "close knit" business community which is characterized by a large number of family owned firms. Even if the INDs are well qualified to meet all the independent criteria i.e. no family relation, etc; the respondents were skeptical that the INDs were "truly independent" because of the high incidence of "interlocking" INDs who sit on each other's company's boards.

This view from respondents is consistent with a Hong Kong study by Chen and Jaggi (2000), who found that the ratio of INDs to the total number of directors on corporate boards was positively associated with the comprehensiveness of financial disclosures, though this association appeared to be weaker for family controlled firms compared to non-family controlled firms. This result suggests that INDs in family controlled firms are less effective. However, a PricewaterhouseCoopers (2000) survey found somewhat inconsistent results. Most of the respondents in the survey expressed openly that they would still consider investing in a company even when they were dissatisfied with the quality, qualification and experience of INDs, and most of them were not too concerned if the number of NEDs was unsatisfactory.

Examples of quotes from interviewees on the above finding are as follows:

- "We are skeptical about the independence of INDs."
- "The existing situation is that the INDs are not bold, nor prepared to voice out their concerns. They are not sure how independent they are."
- "The directors of Hong Kong listed companies only release good news but not for bad ones."
- "The role of INDs is to question the management, to question the direction of the company, to play a role on governance and all the corporate governance issues."
- "We doubt the independence of the INDs. Management still makes the operational decisions for the company and discloses selective information. Currently, corporate governance mechanism is only set up for the "rainy" days."
- "Qualification, business knowledge and independence of INDs are important."

6.3.2.2 Family ownership

Many respondents pointed out that family ownership in Hong Kong is an impediment to good corporate governance. Only one respondent commented that managerial concentration of ownership could align managers' interests with that of shareholders leading to maximization of shareholders' values. Since the board is dominated by the controlling family, INDs may have difficulty in functioning effectively even if they wanted to do so. In many companies, they may not be related to the controlling family but they have been appointed by the Chairman or Chief Executive Officer (CEO) and so could be under the influence of the Chairman or CEO. One respondent mentioned that minority shareholders should be given the right to appoint one member to the board to protect minority shareholders in family owned companies. Perhaps, this member representing the minority shareholder should be a member of the Nomination Committee. Others expressed the view that members of the Nomination Committee should all be INDs.

These views are consistent with the study by Claessens *et al.* (2000) who examined 2,980 firms in East Asian countries and found that the separation of ownership and control was most pronounced among family-controlled firms and small firms, and more than two-thirds of firms were controlled by a single shareholder. Moreover, managers of closely held firms tended to be relatives of the controlling shareholder's family, and older firms were generally family-controlled. These characteristics could lead to a higher risk of expropriation of minority shareholders. These findings regarding the role of family ownership in Hong Kong are also echoed in another paper by Claessens *et al*. (1999). Given these findings it is not surprising that respondents drew attention to the problem of family ownership in Hong Kong. Also, on the question of Nomination Committee it is interesting to note that Ramsay *et al*. (2000) surveyed 12 Australian institutional investors and found that most of those interviewed agreed that the members of the Nomination Committee should be INDs of the company.

Examples of quotes from interviewees on the above finding are as follows:

- "We would look at the ownership structure of the investee firms, investor communication in order to assess the level of corporate governance of that particular firm."

- "The ownership structure in Hong Kong is a key impediment to a better corporate governance environment in Hong Kong. Another issue is the related party transactions."

- "The different ownership structures of public companies in Hong Kong compared to western markets make the western corporate governance mechanisms solutions often inappropriate for our circumstances."

- "Family owners can ignore small investors' rights."

- "One of the main problems in Hong Kong listed companies is that there is no clear separation of ownership and control. In many cases the management themselves are the substantial shareholders of the company, so they would not have the threats of being fired. They need not be accountable to the shareholders."

- "Share ownership by the Chairman (especially when the Chairman's ownership is greater than that of the institutional investor) would be a good thing for our investments, as this is one of the assurances that the Chairman would manage the firm in the interest of the shareholders."

6.3.2.3 Corporate governance and performance

All the institutional investors interviewed believed that corporate governance would lead to better firm performance or lower the cost of capital in the long-term. They would be willing to pay a premium for firms with better corporate governance.

The fact that better corporate governance would lead to better firm performance is supported by a number of studies by Mitton (2001), Johnson *et al*. (2000) and La Porta *et al*. (1998). All of these studies concluded that good corporate governance would have a positive effect on firm performance, especially in times of financial crisis or distress. A survey conducted by McKinsey & Company (2000) suggested that institutional investors are willing to pay a premium for better governed companies.

Examples of quotes from interviewees on the above finding are as follows:

- "Corporate governance issues of the company should be reflected on the company performance and hence the stock price."

- "We believe that good corporate governance leads to better performance and more active participation by minority shareholders."

- "There is hard empirical evidence showing that good corporate governance leads to good performance."

- "The premium we are willing to pay would be higher in emerging markets."

- "We would specify a premium for the markets where the degree of corruption is high, and we would demand a much higher rate of return by investing in those companies."

- "We believe that good corporate governance leads to better performance in the long run."

- "We would demand a higher risk premium for H shares companies in Hong Kong, and these companies generally have higher earnings potential. Moreover, H shares companies have better disclosure than the Hong Kong based companies."

6.3.2.4 Corporate governance standard

The interviewees were asked to identify their investee companies and of these, identify those with good and poor corporate governance. The interviewees identified 16 listed companies and of these, eight companies were regarded as having good corporate governance and are comparable to international corporate governance standards and eight were considered to be poorly governed (the disclosure of the identities of the respective companies is potentially a sensitive issue and is therefore not disclosed). However, they would also consider investing in companies whose corporate governance is not perceived to be comparable to international standards provided their returns are sufficiently high enough to compensate for their perceived relatively low standard of corporate governance.

Our interviewees also mentioned that there are some firms they would never invest in, for example, the third and fourth liners whose management integrity cannot be relied on. They considered corporate governance to be non-existent in these companies.

The respondents generally were of the view that the overall corporate governance standard in Hong Kong falls far short of international standards. However, it is significantly higher than those in other South East Asian countries such as Malaysia, Indonesia, Thailand, Philippines. A word of caution from one of the interviewees was: "If Hong Kong does not move faster in this area, it will lose its competitive niche."

Some respondents expressed the view that they preferred to invest in Hong Kong over Singapore because there is less government interference in corporate strategies. Corporate decisions in Hong Kong companies are made based on efficiency rather than on government initiatives or prerogatives. Therefore, value maximization for shareholders can be achieved more efficiently by investing in Hong Kong companies than in Singaporean companies though the latter seemed to have a better standard of corporate governance. Most expressed the view that there should be similar requirements on corporate governance for Chinese Mainland companies which are listed in Hong Kong.

These sentiments are similar to the findings from the PricewaterhouseCoopers (2000) Survey of Institutional Investors. The results showed that Singapore's standard of corporate governance was rated slightly higher than Hong Kong's and Japan's, and significantly better than secondary capital markets such as Malaysia, Taiwan and Korea. The results of the Credit Lyonnais Securities Asia (CLSA) study of 495 companies in

25 emerging markets also found that Hong Kong and Singapore have higher corporate governance scores than other countries, namely Indonesia and Korea (CLSA, 2001).

Examples of quotes from interviewees on the above finding are as follows:

- "Less than 60 out of the around 600 Hong Kong listed companies (i.e., less than 10%) have a corporate governance level reaching the international standard (using UK and US standard as the proxy for 'international standard')."
- "There are well-governed companies in Hong Kong, but the number is small when compared with US… not more than ten."
- "The standard of corporate governance in Hong Kong is lower than that of the US, UK and Australia."
- "The standard of corporate governance is low in Hong Kong but the level of disclosure in alright."
- "Current corporate governance standard in Hong Kong is not too bad …"
- "Corporate governance in Hong Kong moves well towards a regulatory framework."
- "Hong Kong corporate governance standard is way behind contemporary thinking."
- "On the whole, corporate governance regime in Hong Kong is not bad, and the environment is improving; Securities and Futures Commission (SFC) and Hong Kong Exchanges and Clearing Limited (HKEx) are working hard at pushing forward corporate governance to a higher level. But the regulations in Hong Kong are not good enough, especially when compared with international standard."
- "In my perspective, the four well governed listed companies in Hong Kong are HSBC, Hutchison, Henderson, China Light and Power."
- "Five well governed companies in Hong Kong are HSBC, Li & Fung, Johnson Electric, Swires and HK & China Gas."
- "HSBC and Sun Hung Kai Property are companies that have good corporate governance."
- "The well-governed companies listed in Hong Kong include Swire Pacific, HSBC and Hang Seng.
- "Hong Kong is corruption free as compared with other countries in Asia. We have the largest Asian holdings outside Japan in Hong Kong, because Hong Kong

companies have good management and has relatively good corporate governance, attracting our capital to flow in."

- "I am happy with the level of disclosure in Hong Kong, and that's why when compared with other Asian markets, Hong Kong would come up to be the top. Hong Kong is even better than Singapore, though the latter is getting better. I am not convinced that the disclosure there is truly transparent in certain areas."

- "We would give a discount to the H shares companies listed in Hong Kong when compared to Hong Kong based listed companies."

- "The pace of Chinese Mainland on the issue of improving corporate governance is getting faster and the authority is very determined to get it right. The rules on INDs were even ahead of Hong Kong."

- "Though the strive for corporate governance in the Chinese Mainland is still primitive and in its early stage, its progress in corporate governance is in fact faster than that in Hong Kong, due to the fact that there is clear separation of ownership and management there, and the fact that they are much more willing to learn and adapt to new environment than the people in Hong Kong."

- "Most of the companies in Singapore are run by the government… it is true that they won't expropriate shareholders' interests, but I would make some reservations regarding whether these companies are really operating in the best interests of the shareholders. Disclosure is also insufficient in these companies."

The next section discusses the institutional investors' views on their role in corporate governance in Hong Kong.

6.3.3 Role of Institutional Investors

Based on Brancato's classification framework of shareholders, questions were designed to ascertain the role of institutional investors in Hong Kong.

6.3.3.1 Active participants in corporate governance

Most respondents expressed the view that they do not take an active role in monitoring their investee companies. One of the reasons was because they lacked the power to do so due to the small percentage of shareholding in their investee companies.

This is consistent with Edwards and Hubbard (2000) who argued that though total institutional ownership has increased significantly, this growth in ownership has not translated into institutional investors taking controlling positions in their investee firms. However, our results are not consistent with findings of prior studies which found that institutional investors should be willing to and are interested in monitoring their investee firms (Smith 1996; Holland 1998; Nesbitt 1994; Hartzell and Starks 2000). Such inconsistent results could be due to a lack of understanding of the different objectives of institutional investors who have different incentives (or disincentives) in taking an active role in the corporate governance of their investee companies.

Moreover, our interviewees found that it is more effective for them to do the "Wall Street Walk", i.e., to sell off their investment if they object to management policies. This is consistent with the views of the Australian institutional investors interviewed in Ramsay *et al.*'s (2000) study. They raised 'the option to sell' as one of the more economical choices instead of institutional investors stepping in and rectifying the problems. One respondent gave an example that she failed to out-vote management on an issue that affected the company's long-term performance. This shareholder action is considered rare in the Hong Kong corporate scene. By and large institutional investors interviewed believed that institutional shareholder activism is almost non-existent.

Examples of quotes from interviewees on the above finding are as follows:

- "We are generally passive in monitoring our investee firms, and we would decide whether to take any actions by considering whether the relevant investment is part of our "core holdings"."
- "I agreed that we have not been actively involved in the corporate governance or monitoring of the investee firms, e.g. we seldom vote; but we would keep on some inactive monitoring, such as attending the AGM, paying attention to the quality of

management, corporate strategy and the related party transactions of the company. We had never implemented our voting rights unless in "extreme cases"."

- "As an institutional fund, we should play a more active role in the corporate governance of our investee companies, but we fail to do so due to the different cultures between the Hong Kong market as compared with foreign markets such as the US. Hong Kong institutional investors tend to opt for the 'sell off' strategy instead of taking actions in monitoring the investee firms, unlike the overseas institutional investors' culture. But this strategy might be changed with improvement in corporate governance in Hong Kong."

- "HKEx should retain its supervisory role over the market and IT SHOULD NOT be the market participants to be involved in this kind of work, as this might lead to confusion."

- "Even after the government has taken some active steps, we do not want to take more active parts in the corporate governance of their investee companies, as there are too many difficulties."

- "With the launching of MPF in Hong Kong, we anticipate the growth in institutional investments. MPF will shift the balance towards institution away from retail, and we hope to strike the balance with 50% institutional investment and 50% retail businesses."

- "No doubt we [institutional investors] do have a role as an observer [to oversee companies management] … but I think as an observer, we should not play a significant role as we are not part of management [sitting on board and being part of the management] as well."

- "The institutional investors in Hong Kong are much more inactive as compared with those in the US."

- "We institutional investors should have been more active in monitoring our investee firms, but there are difficulties that hinder our actions. As the market, as well as our investor base grows, our investments in fact become more diversified than before, and therefore more difficult to consolidate different shareholders' voices; equally important is the lack of proper channels for us to address our concerns. Such culture has yet been developed in Hong Kong."

- "With the improvement of corporate governance in Hong Kong as compared with other markets, the rating in Hong Kong would be improved and this would lead to a higher percentage of investment from investors, including institutional ones".

- "Due diligence requirement is higher in China and institutional investors tend to pay more discount on H shares and Red Chips."

- "Institutional investors have no rights in Hong Kong. They cannot go to the court because it is expensive. They only make a lot of noise …"

6.3.3.2 Enforcement issues

Some interviewees observed that there are enforcement issues related to their roles as institutional investors. One of the difficulties for institutional investors to be active in monitoring their investee companies is the lack of power. Some respondents felt that the SFC should have wider investigative power for companies which do not comply with the Listing Rules and other related corporate governance guidelines. Other respondents felt that corporate governance cannot be legislated nor regulated. It should be encouraged as part of good corporate culture.

This view is consistent with La Porta *et al*'s (1998) findings which suggest that in jurisdictions where the legal protection for investors is weak, a strong system of legal enforcement may be able to act as a substitute. Institutional investors may prefer to invest more in markets with a stricter law enforcement, especially in markets where legal protection is weak.

Examples of quotes from interviewees on the above finding are as follows:

- "Though there should be corporate governance reforms in Hong Kong, the reforms should remain as part of the voluntary framework."
- "It is a chicken and egg situation. You want the government to do more, but you don't want corporate governance to be so constraining either."
- "We support the corporate governance reform in Hong Kong, but it is better to have the reforms accompanied by the change in attitude and behavior, instead of merely change of rules."
- "Corporate governance reform should be a matter of culture. We should get it right instead of just using stringent regulations."
- "To a certain extent, the existence of badly governed listed companies in Hong Kong is due to the lax listing rules and regulations in Hong Kong … particularly the lack of enforcement and insufficient penalties."

- "The process of raising the standard of corporate governance in Hong Kong should be gradual. At first we may not be able to achieve many things, but the culture would be gradually built up."

- "The corporate governance reforms should remain in a voluntary framework instead of being legislated."

- "Enforcement is an issue. There should be a penalty for directors (including audit committee members) for their non-compliance with the law and regulations e.g. dereliction of duties."

- "SFC and HKEx should be responsible for the governance of the companies listed in Hong Kong."

- "There should be a clearer separation and delineation of regulatory responsibilities between HKEx and SFC. Currently it is a bit confusing. For example, HKEx has a profit seeking motive and promotes quality companies to obtain listing in Hong Kong. At the same time, it has a regulatory role in monitoring the Hong Kong listed companies. Hence, the regulatory power should rest on SFC."

- "The SFC should be responsible for corporate governance."

- "The HKEx and SFC are only window dressing authorities. They do not address any real issues. The HKEx has too much vested interests and prefers to ask companies to self regulate."

- "There shouldn't be different sets of corporate governance standards for companies with different sizes. These should be made constant."

- "I feel that corporate governance is more important for the less well performing companies than other companies."

The above summarizes the respondents' views on corporate governance issues in Hong Kong. The following section discusses their opinions on corporate governance reform in Hong Kong.

6.3.4 Corporate Governance Reform

All respondents supported corporate governance reform, consistent with other surveys on the opinions of institutional investors on whether they would support similar reforms (Solomon *et al*., 2000a; McKinsey & Company, 2000; PricewaterhouseCoopers Singapore and Singapore Exchange, 2000). The most crucial element is management's willingness and integrity to improve corporate governance in their company. If they believe that corporate governance is beneficial to the company and would maximize shareholder values, then all the associated establishment of corporate governance mechanisms would be effective. It follows that the appointment of INDs who can exercise independent judgment and have the appropriate level of expertise to ask the right questions in the board and its committees would be the most important mechanism particularly in the context of family ownership in Hong Kong.

This is generally consistent with the findings in a similar interview survey on 12 Australian institutional investors (Ramsay *et al.*, 2000). Most of the respondents considered INDs, especially their qualifications, to be important in shaping a good corporate governance environment.

Examples of quotes from interviewees on the above finding are as follows:

- “The effect of corporate governance may not be reflected in the short term, but it would be increasingly important in the future, and in this aspect Hong Kong is losing out in the moment. We should catch up.”

- “It would be better for us with improvement in corporate governance in Hong Kong.”

- “We support the reforms on corporate governance in Hong Kong.”

- “After the corporate governance reforms, hopefully this would improve the valuations of Hong Kong companies and by default Hong Kong becomes a larger part of the market place because people see better quality of management, better quality disclosures and better earnings here.”

- “We would like Hong Kong to improve its corporate governance standard, but I think it is going to be hard to achieve due to the close relationships in Hong Kong.”

- “The ways of regulating the corporate governance reforms should follow the international practices.”

- "We feel that in Asia, even if there are rules or regulations on corporate governance, most companies will break them, and the regulations should be very strong in order to have proper impact."

- "Given that the way people do business is relationship based, it is difficult to "turn around the situation overnight". Definitely, we support the corporate governance reform in Hong Kong and agree that institutional investors have a monitoring role."

- "We think that regulation can raise the level of corporate governance in Hong Kong but this may not be an efficient way."

- "It would be good to have different sets of corporate governance standard for different categories of listed companies e.g. HS 100 companies vs. non-HS 100 companies."

- "The role of INDs and the board sub-committees (audit committee, remuneration committee and nomination committee) are important in the corporate governance of our investee firms."

- "The quality and the composition of the board members would be some issues that we would look at when assessing the corporate governance level of their investee firms."

- "The concept of independent non-executive is one of the important parts in shaping a good governance environment."

- "In order to have a higher standard of corporate governance, one requirement is that there should be a well-defined decision making process; and a well defined decision making process requires some forms of checks and controls, such as the existence of INDs."

- "Theoretically, the existence of INDs should be helpful in curing the problems in family ownership structure in Hong Kong; but I wonder if it could work in Hong Kong's corporate environment."

- "In order to raise the level of corporate governance in Hong Kong, we need to have better quality directors (both executive and non-executive) and improvements on financial reporting and disclosures i.e. transparency, particularly with respect to related parties transactions disclosure."

- "The minority shareholders should have the right to vote for the appointment of INDs."

- "Quarterly reporting would be very important for the investors."

- "Quarterly statement should be one of the possible changes."

- "More disclosure on related party transactions in Hong Kong companies would be desirable."

- "One of the current needs is to improve the quality of financial disclosure."

- "Disclosure of corporate strategy and financial details enhances the transparency of the company, which is very important in shaping a good governance environment.

- S&P rating is a good thing, and the investee companies should be as transparent as possible."

- "The frequency and quality of board meetings might not be so important in shaping a good corporate governance environment, but director remuneration matters a lot more, such as whether the management was paid up too much in terms of share options of the company."

- "The implementation of audit, remuneration and nomination committees would be difficult. It would function well if the corporate governance level in the market is high, but not if the market itself does not have a high level of corporate governance."

- "The launching of MPF is good for corporate governance in Hong Kong. As all people have to contribute their income to MPF, more discussions on the corporate governance of the Hong Kong companies are expected and gradually the issue would gain public attention and the culture would gradually develop."

- "To enhance investor communication is very important in raising the corporate governance level of a company."

The next section summarizes the above major findings.

6.4 Summary of Major Findings from Interviews

Eleven institutional investors and two investment bankers were interviewed, and a summary of the major findings are as follows:

- Quality of management is the most important factor in their investment decisions.

- Past and future financial performance, future cash flows, quality of disclosure of financial statements and corporate strategy are very important factors that affect their investment decisions.

- The most important mechanism for good corporate governance is the quality of INDs.

- Family ownership in Hong Kong is an impediment to good corporate governance.

- Corporate governance would lead to better firm performance in the long run and they would pay a premium for firms with better corporate governance.

- They were still willing to invest in companies whose corporate governance is not perceived as of a comparable international standard on the condition that their returns are sufficiently high.

- Most respondents did not take an active role in monitoring their investee companies.

- Respondents felt that the SFC should have wider investigative power for companies which do not comply with corporate governance guidelines, but believed that corporate governance cannot be legislated nor regulated.

- All respondents supported corporate governance reform in Hong Kong.

6.5 Web-based Questionnaire

Apart from the in-depth interviews, we have also employed two sets of web-based questionnaires to gauge the international institutional investors' attitudes towards the corporate governance standard in Hong Kong in a wider perspective. The response rate is about 12.3% (with 24 respondents' information received and analysed).

<u>Profile Descriptions</u>

i) Categories of Businesses – respondents came from a variety of businesses. In our sample, we have excluded institutions that their sole and dominant business is brokerage / dealing. However, some brokers cover fund management services.

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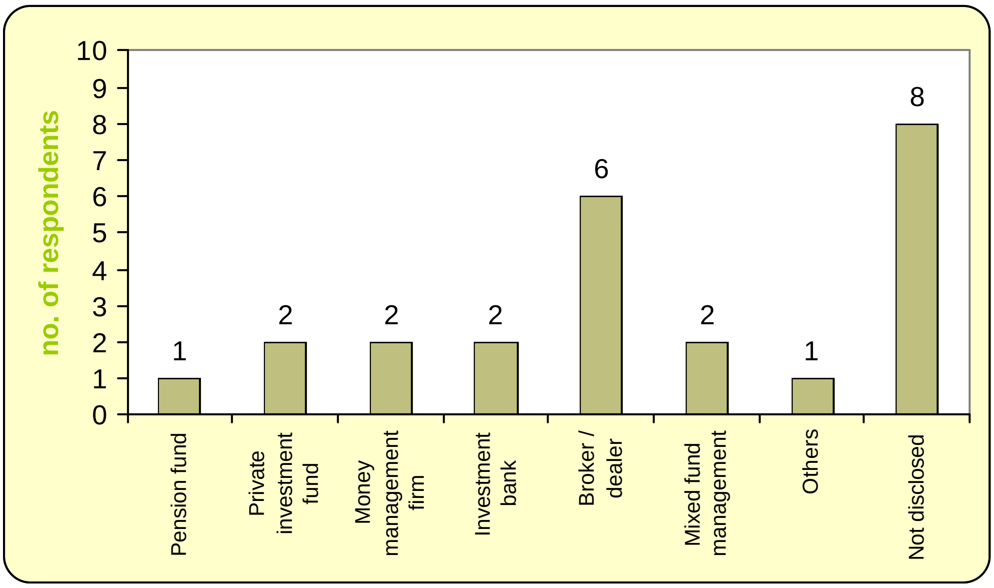
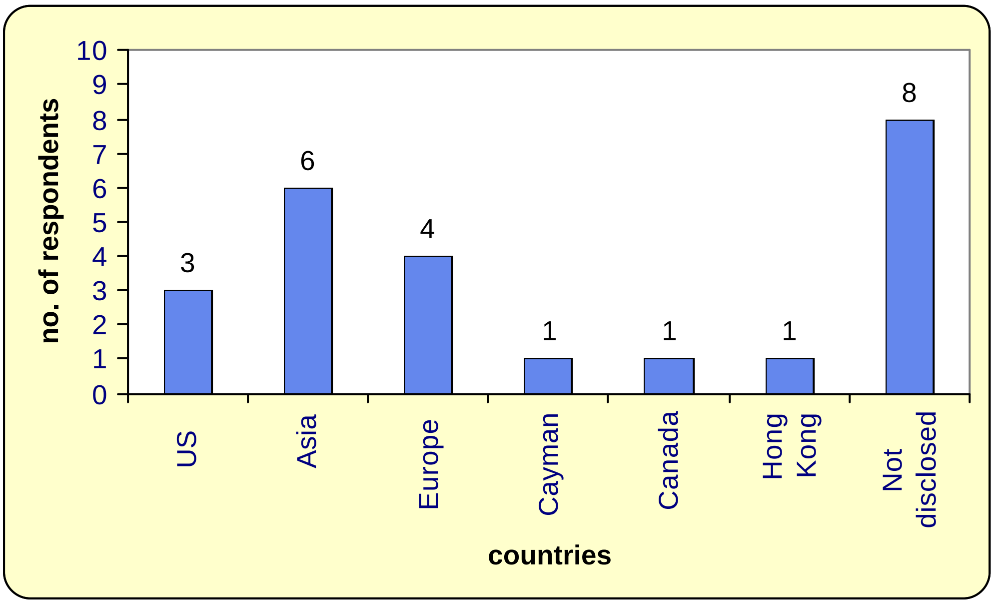
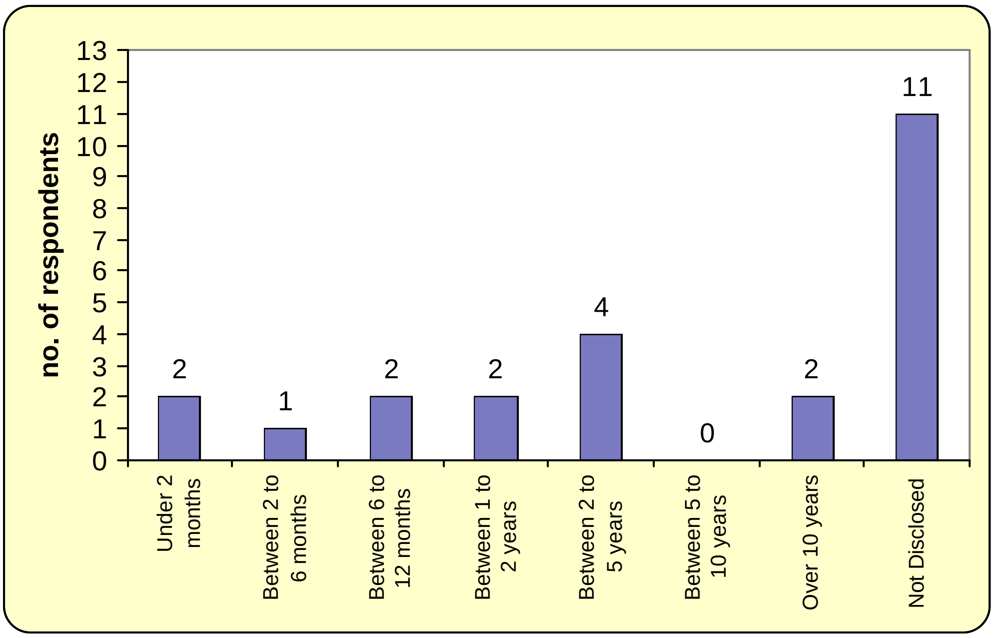


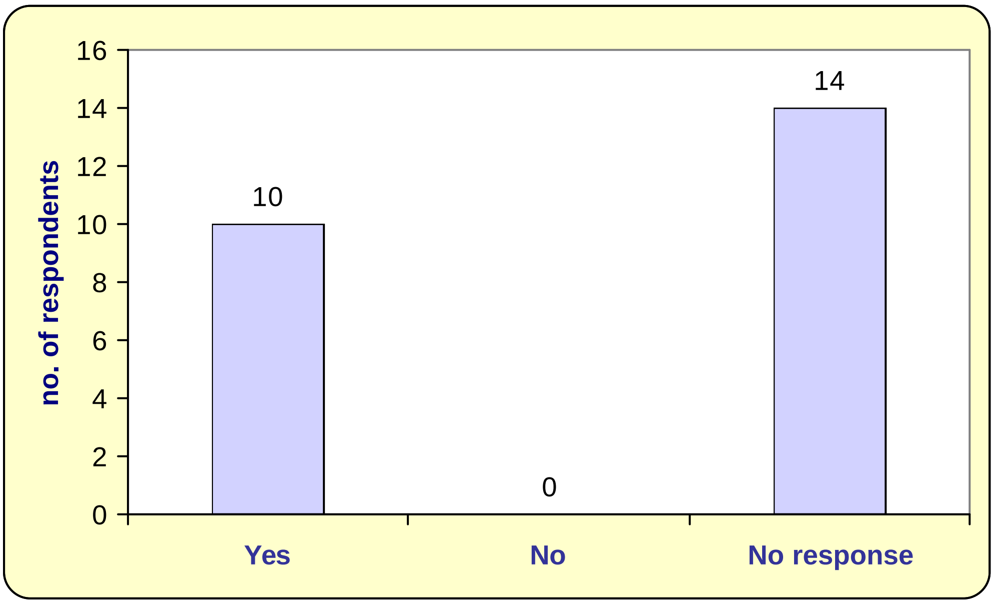
ii) Nationalities of Institutions – majority of respondents came from US, Asian and European countries



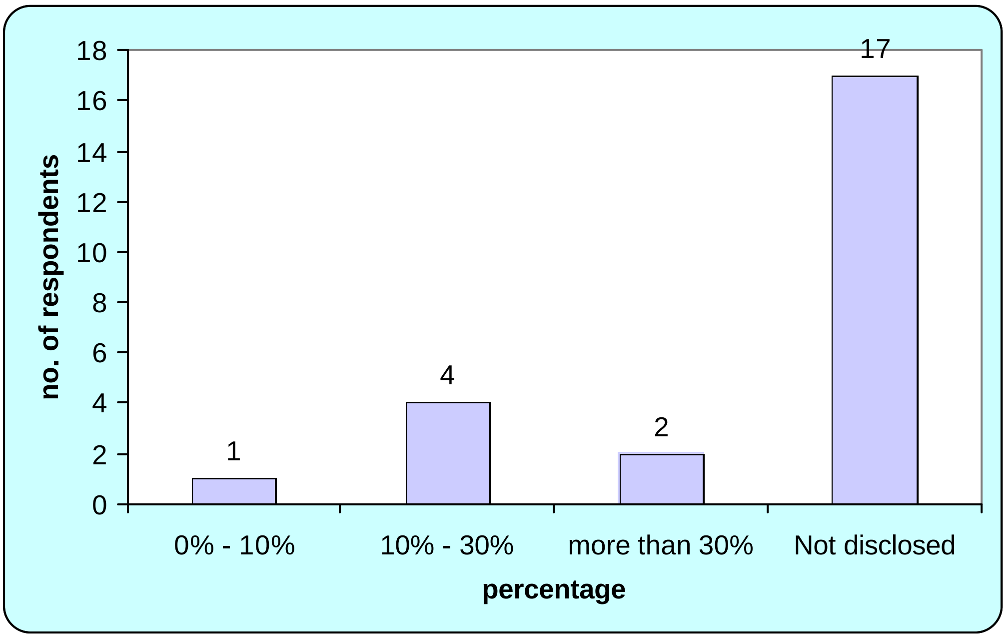
iii) Average Length of Portfolio Investment Horizon In Hong Kong – it varies across different respondents. The shortest average length is under two months and the longest over ten years.



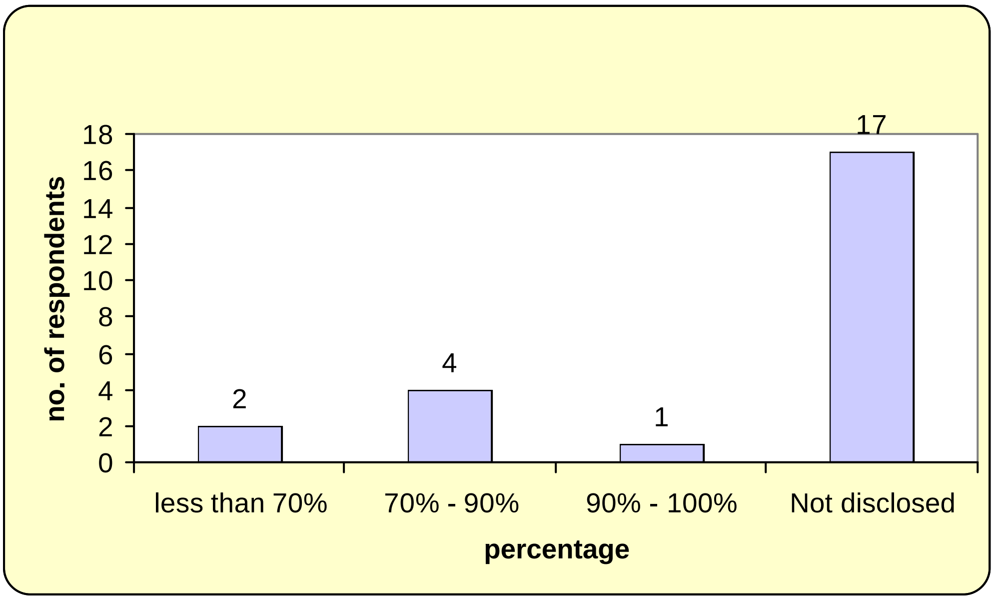
iv) Average Length of Portfolio Investment same for all Capital Markets – more than half of the interviewees stated that the average length of their portfolio investment is the same for all capital markets, including Hong Kong.



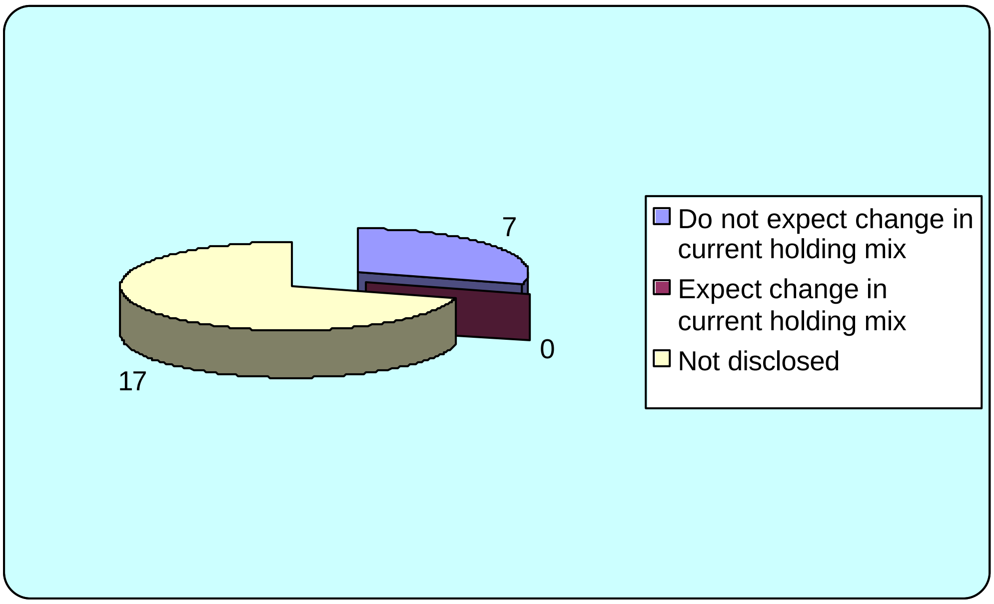
v) Percentage of Short-Term Investment to Total Portfolio – respondents generally have 10% to 30% of their total investment held as short-term investment.



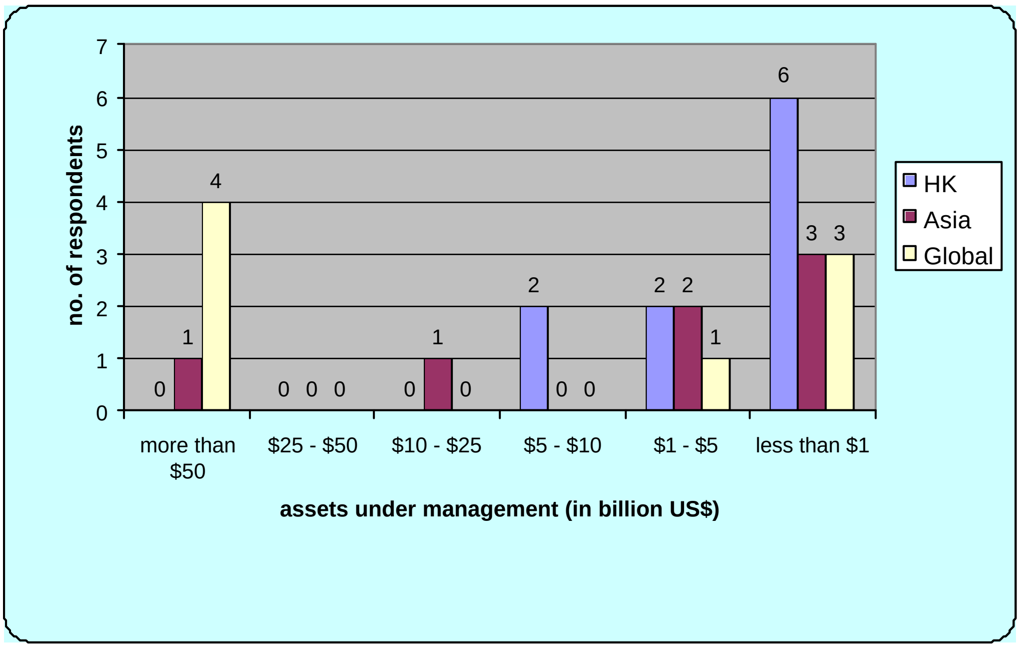
Percentage of Long-Term Investment to Total Portfolio – respondents generally have 70% to 90% of their total investment held as long-term investment.



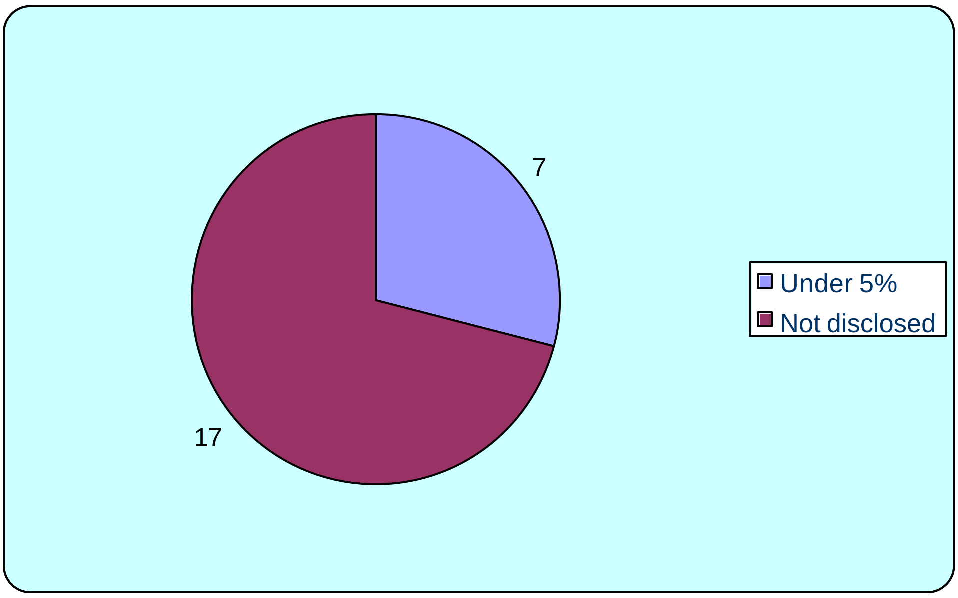
vi) Expected Changes in Current Holding Mix – most of the respondents indicated that they do not expect that they would change their current holding mix.



vii) Size of Institutions (Value of assets under management) – majority of the respondents have assets under management less than US$1 billion.



viii) Market Shares of Institutions – most of the respondents indicated that their perceived market share is under 5%.



ix) Location

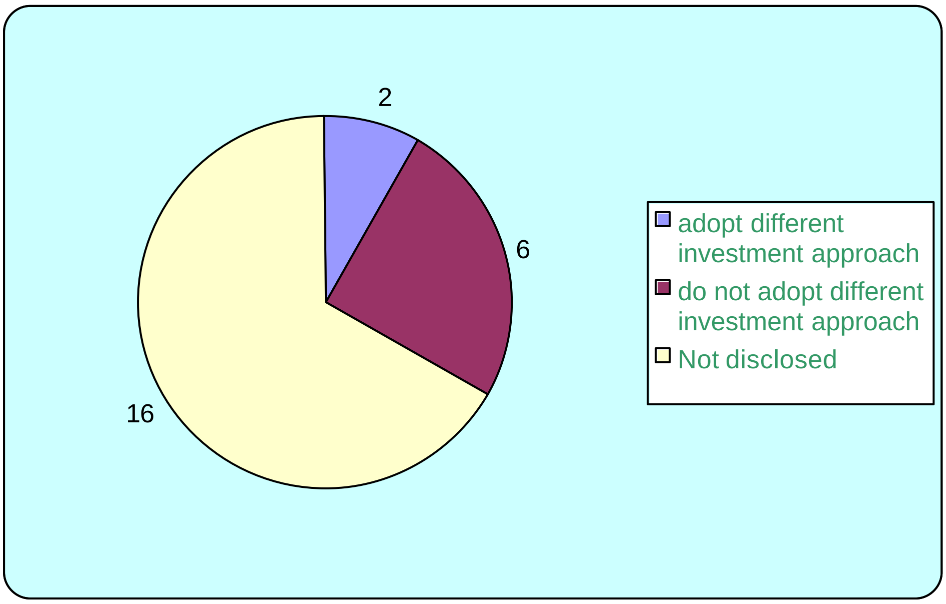
Place of Investment – the majority of respondents are currently investing in Hong Kong.

The following lists the countries, regions or exchanges they are currently investing in:

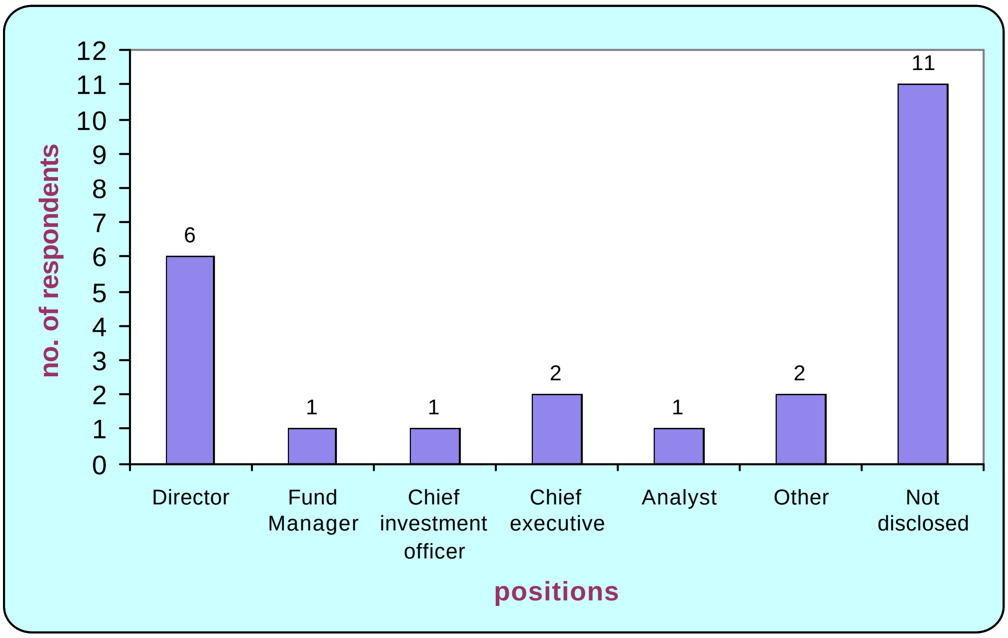
Never invested	Invested in the past but not now	Currently investing	Will be investing in future	Country, region or Exchange
0	1	9	0	Hong Kong
1	2	4	1	Taiwan
0	1	6	2	Chinese Mainland
1	2	5	0	Malaysia
1	3	4	0	Indonesia
0	2	6	0	Singapore
1	1	6	0	Bangkok
1	2	5	0	Tokyo
2	1	5	0	Frankfurt
1	1	5	1	London
0	1	6	1	Australia
1	0	7	0	USA
1	2	5	0	Canada
1	2	4	0	Latin America

Fourteen respondents did not provide any information.

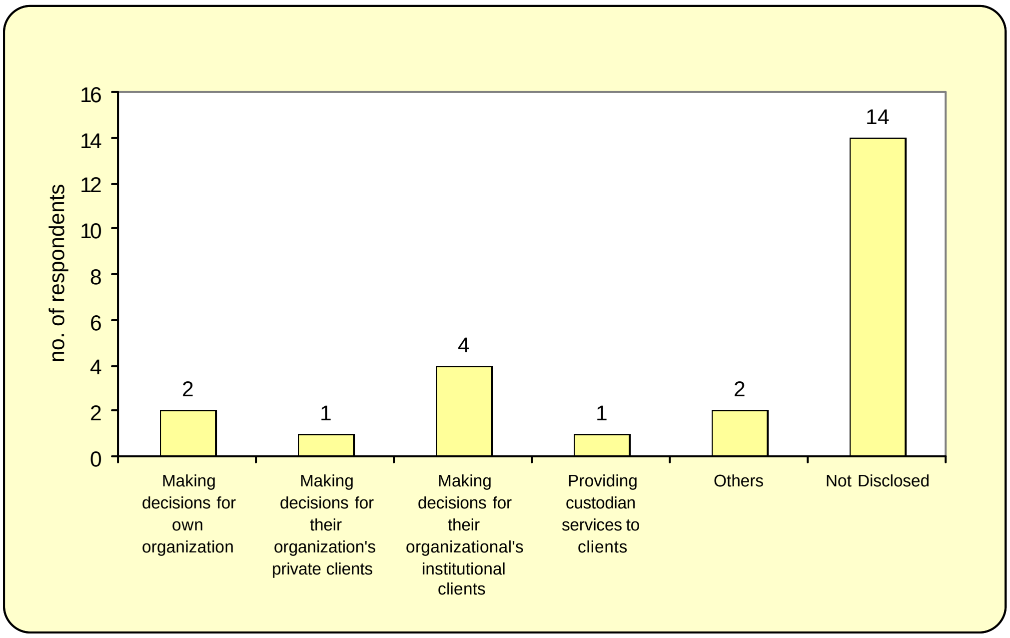
xi) Investment Approach – only two respondents indicated that they will adopt a different investment approach towards different markets.



xii) Position – majority of the respondents are directors or chief executives.



xiii) Degree of Investment Responsibility – most of the respondents are making investment decisions either for their own organizational, their organizational private clients or organizational institutional clients.



6.6 Findings from Questionnaire Survey

6.6.1 Corporate Information Needs

Similar to the ranking (in terms of value of importance) given by interviewees on company specific factors which are relevant for their investment decisions, respondents from web-based questionnaires were asked to indicate the importance of each of the following company-specific factors, from most important (score = 5) to not important (score = 1) in their investment decisions:

Most important:
Legal and regulatory environments
Content of financial statements (including notes)
Quality of management
Trading liquidity
Corporate strategy
Timeliness of annual reports
Audit quality (whether audited by Big 5 CPA firms)
Corruption

Important:
Future financial performance
Share price volatility
Past financial performance
Level of communication between institutional investors and investee companies
Future cash flow
Independence of INDs
Family ownership and influence
Auditor's report
A statement of responsibilities issued by directors in relation to the financial statements and the content of the annual report
Past cash flow

Somewhat important:
Directors' share ownership
Market risk i.e. beta
Existence of audit committees
Directors' performance evaluation
Ratio of market price per share / book value per share
Leverage
Transaction costs

Not important:
Dividend yield
Corporate social responsibility disclosures, e.g. environmental issues

CEO domination (Chairman and CEO being the same person)
Board composition i.e. percentage of INDs on the board
Existence of remuneration committees
Years listed on stock exchange
Existence of nomination committees
Equal dissemination of information among analysts and other investors

6.6.2 Corporate Governance Mechanisms

The following summarizes the key factors that contribute to good corporate governance (please refer to Appendix 4 for scores):

6.6.2.1 Quality of independent non-executive directors (INDs)

In general, the respondents considered the independence of the INDs to be an important factor contributing to good corporate governance. Moreover, they considered that INDs should have knowledge in finance and accounting. A transparent and effective system of nominating and terminating the tenure of INDs was also considered to be an important factor for effective good corporate governance.

6.6.2.2 Directors' remuneration

On average, respondents indicated that compulsory disclosure of compensation details of individual executive directors such as compensation for loss of office is an important factor leading to good corporate governance practices. They considered the pay and performance linkage to be important as well.

6.6.2.3 Board structure and practices

Respondents revealed that it is important to have formal performance evaluation of the CEOs and the Boards of Directors. They considered it important for the appointment of the Finance Directors or Chief Financial Officers and they should be qualified accountants.

It is interesting to note that respondents generally considered it only NOT important that the Chairman of the board not be the Managing Director or the CEO. Respondents were of the view that there should be some restrictions on the number of family members who can sit on the board and the majority of the board should be INDs.

Generally, respondents did not consider the following to be important: Majority of the board should consists of INDs, director training, existence of minority shareholder representative on the board, Chairman of the board should be an IND and INDs should not hold their positions on a board for more than three years.

6.6.2.4 Directors' contracts

Generally, respondents did not consider that detailed requirements on directors' contracts to be important for good corporate governance practices.

6.6.2.5 Annual report disclosures

On average, respondents commented that it was very important for annual financial statements with auditor's report to be sent to shareholders not more than four months after the financial year-end date, and they welcomed increased financial disclosure, specifically on directors' dealings with related parties, directors' benefits derived from exercising share options and/or warrants and other fees paid to the auditors. In addition, they also considered quarterly financial reporting, a statement of going concern in the annual report, a separate section or general statement on corporate governance in the annual report, a general statement of business risk in the annual report (i.e., foreign exchange exposure) to be important disclosures to improve corporate governance standards.

6.6.2.6 The role of auditors

Respondents considered that it was important that the auditors not be substantially engaged in non-audit services for auditee companies. Mandatory rotation of audit partners was also somewhat important. Instead, they believed that the following factors are quite important: the auditors should issue a statement of internal control weakness in the annual report; auditors should have responsibilities for fraud detection; and auditors should be given the right to review other financial reports or information (i.e., Management Discussion & Analysis).

6.6.2.7 Investor protection

The one-share-one-vote principle and the introduction of class actions against companies were factors that respondents considered moderately important for good corporate governance practices. However, they did not believe that institutional investors should have nominee directors on boards of investee companies.

6.6.2.8 Regulatory enforcement

Respondents generally considered that it was most important to have heavier penalties and sanctions imposed on insider trading. However, they did not believe that the SFC should be given more power to promote good corporate governance.

6.6.2.9 Others

On average, respondents did not believe that it was important to introduce corporate governance ratings of individual Hong Kong listed companies in order to boost the level of corporate governance in Hong Kong.

6.6.3 Corporate Governance in Hong Kong

On average, respondents were not quite satisfied (average value is 2.7) with the standard of corporate governance in Hong Kong (i.e., moderately satisfactory equals a score of 3). Moreover, respondents agreed to a certain extent that the current levels of risk disclosure and current annual report required disclosure were adequate. In addition, they also agreed that family shareholding structure in listed companies would adversely affect company financial performance and the proper management of board functions of the company. They generally agreed that good corporate governance is more important for poorly performing companies and that corporate governance requirements are as important for smaller listed companies as for larger companies. Nevertheless, they disagreed that ownership concentration by institutional investors could substitute for good corporate governance practices in protecting investors' rights.

Forty-six percent of the respondents indicated that their investment holding horizon and/or the proportion of Hong Kong investments would be lengthened and increased respectively if there are improvements in corporate governance practices in Hong Kong listed companies.

Fifty percent of the respondents were willing to pay a premium that ranges from 5% to 20% for a well-governed company in Hong Kong.

In terms of listed companies' corporate governance practices in general, respondents considered US to be the best amongst the eight nominated countries or regions, namely Australia, Canada, Hong Kong, Malaysia, Singapore, Taiwan, the UK and the USA, while Malaysia was considered to be the worst. In general, respondents considered the corporate governance practices in Hong Kong to be better than those in Taiwan and Malaysia.

Ranking of listed companies' corporate governance practices by country or region

Country or region	**Ranking (from best to worst)**
USA	1
UK	2
Canada	3
Australia	4
Singapore	5
HK	6
Taiwan	7
Malaysia	8

6.6.4 Corporate Governance Reform in Hong Kong

More than half of the respondents (54%) supported the introduction of corporate governance reforms in Hong Kong. On average, they strongly agreed that more guidance on corporate governance in the Code of Best Practice of the Listing Rules would further improve corporate governance in Hong Kong. They also agreed that corporate governance reforms should be legislated (in the Listing Rules and Companies Ordinance, etc.) and regulated (by the SFC but not the HKEx). Finally, they generally disagreed that corporate governance reforms should be voluntary.

6.6.5 Corporate Governance and Firm Performance

On average, respondents strongly agreed that good corporate governance would lead to better firm performance both in the short term and the long term. Generally, they defined short-term as being less than one or two years and long-term as being three to five years.

6.6.6 Mainland Chinese Companies Seeking Listings in Hong Kong

Respondents strongly agreed that higher corporate governance standards should be required for Mainland Chinese Companies seeking listings in Hong Kong. However, few of them gave details on the additional corporate governance mechanisms that they consider should be in place.

6.6.7 Institutional Investors' Activism

Out of the seven respondents that answered questions about shareholders' activism, five of them indicated that they would vote on all the board issues of their investee firms. Three of them responded that it was their firm's policy to abstain on board issues, and four of them said that they would vote for a management recommendation or proposal of their investee firms and settle disagreements with management before the annual general meeting. This seems to indicate that institutional investors exhibited the willingness to play an active role in resolving disagreements with management.

Four of the respondents indicated that they met their investee firms at least once a year. Only one respondent responded that the company would do nothing if he was dissatisfied with corporate governance of their investee firms. The other respondents indicated that they would either sell their shares (i.e., employ an exit strategy) or rectify the problem with management directly, depending on circumstances.

6.7 Summary of Findings from Interviews and Web-based Questionnaire Survey

Consistent results were obtained from both groups of respondents when the results from the web-based questionnaire results were compared with those collected from our in-depth interviews.

Both types of respondents ranked the quality of management, content of financial statements (including notes) and corporate strategy as the most important factors affecting their investment decisions. Share price volatility was an important factor, and transaction costs as well as the book-to-market ratios were somewhat important. Corporate social responsibilities disclosures and years listed on stock exchange were viewed by both groups of respondents as unimportant factors.

There were, however, results which were less consistent for the two groups of respondents. Trading liquidity was ranked as an important factor by the interview respondents, but the questionnaire respondents ranked it as one of the most important factors in their investment decisions; audit quality, though rated only as a somewhat important factor by the interview respondents, was viewed as one of the most important factors by the questionnaire respondents. On the other hand, past financial performance and future cash flow were two of the most important factors affecting the investment decisions of the interview respondents, but only considered as important by the questionnaire respondents. This was also true for leverage, market risk and dividend yield, in which the interview respondents ranked as important factors, while the questionnaire respondents viewed them as either "somewhat important" or even "not important". Though the opinions of the two groups of respondents on the importance of these factors were not closely aligned, distinctly diverging or contrasting views have not been found and the results are generally consistent and in support of each other.

Interview respondents generally viewed corporate governance as a somewhat important factor in their investment decisions. It should be noted that the concept of corporate governance was divided into a number of questions which covered detailed corporate governance mechanisms and the respondents were asked to identify the importance of each of the mechanisms on their investment decisions. Results showed that questionnaire respondents generally regarded the independence of INDs, investor communication as well as family ownership and influence as important factors they would consider in their investment decisions. On the other hand, the existence of director's performance evaluation, existence of audit committees and director share ownership were viewed as only somewhat important factors, while board composition (in terms of the proportion of INDs in the board), CEO domination, the existence of remuneration and nomination committees were not important in the respondents' investment decisions.

The next chapter contains the conclusion for this study based on the above detailed findings.

CHAPTER 7 SUMMARY AND LIMITATIONS

7.1 Summary

The objective of this study is to examine institutional investors' attitudes towards corporate governance standards in Hong Kong. Central to the analysis of modern corporations and the role of institutional investors are the agency and incomplete contracting problems. Agency problems can arise because of the conflict of interest between shareholders and managers and between controlling shareholders and minority shareholders. Incomplete contracting problems arise because of the difficulties of writing contracts to cover every contingency in the organization and the difficulties of enforcing/monitoring contacts. Both the law and corporate governance mechanisms are important ways of controlling the agency problem and overcoming the problem of incomplete contracting. These issues are outlined in Chapter 1. Chapter 2 introduces the idea that institutional investors could play an important role in corporate governance. In order to understand the role of institutional investors and its relationship with corporate governance, a comprehensive review of the extant literature on the active and passive role of institutional investors in corporate governance is conducted. We also provide a literature review on the link between institutional investors and firm performance with a discussion of the possible reasons for the inconsistent results obtained from prior empirical studies. Chapter 3 provides an analytical framework, drawn from the Brancato model, to understand the different roles and incentives of institutional investors. These can range from the active investor role (in which institutional investors have incentives to participate in corporate governance) to the passive trader role (in which institutional investors have little incentives to participate in corporate governance). These roles should not be seen in isolation but in the context of the institutional (including corporate governance) and regulatory framework existing in any one country. In Hong Kong, the role of family ownership and the agency problems arising from this type of ownership should be recognized in applying the Brancato Framework. Overall, the analytical framework allows us to better understand the results of prior studies outlined in Chapter 2. For example, the lack of evidence on the role of institutional investors in corporate governance could be due to the fact that the institutional investors are traders with short-term interest. Also, the inconsistent results between institutional shareholding and corporate performance could be due to the failure of these studies to explicitly recognize both the different types of institutional investors and the existence and strength of corporate governance, including the severity of the agency problems in place in the organization. This framework provides a basis for directing the substance and nature of the interview questions and web-based questionnaires. In order to design the interview questions and the web-based questionnaires, we also need to identify the corporate information that institutional investors would require for their investment decisions. To do this, we provide a review of the literature on corporate information needs for institutional investors. This is contained in Chapter 4.

Chapter 5 outlines the approach and discusses the methodology for achieving the objective of this study, namely to conduct interviews with a sample of institutional investors and distribute a web-based questionnaire. The findings from both the personal interviews and web-based questionnaires are discussed in Chapter 6.

The first part of Chapter 6 discusses the findings from the interviews. Quality of management in terms of management integrity was regarded as the most important factor for institutional investors' investment decisions. Other factors such as financial results, future cash flows, quality of disclosures of financial statements and corporate strategy were also considered as very important factors in their investment decisions.

While corporate governance was one of important factors that institutional investors considered in their investment decisions, it was not explicitly evaluated in any formal way. This finding suggests that perhaps corporate governance mechanisms are necessary only when the quality of management is poor. It is, however, difficult to disentangle good quality management and corporate governance since firms with high quality management are more likely to implement corporate governance policies that ensure transparency and good corporate governance.

The quality of independent non-executive directors (INDs) was found to be the most important mechanism for good corporate governance. However, whether truly "independent non-executive directors" can exist in Hong Kong's family owned listed companies emerged as a major empirical question. Some interviewees believed that family ownership was an impediment to good corporate governance. All institutional investors unanimously agreed that corporate governance would lead to better firm performance or lower the cost of capital in the long run. With regard to the corporate governance standard in Hong Kong, they believed that some of their investee companies had corporate governance standards comparable to international standards. However, they would still invest in companies whose corporate governance is not comparable to international standards as long as returns are sufficiently high. Overall, the consensus is that corporate governance standard in Hong Kong falls short of international standards.

It was also found that institutional investors did not play an active role in monitoring their investee companies because they lacked the power or influence to do so as a result of the relatively small percentage of shareholding. They had to resort to "sell off" if the returns were not high enough to compensate for the lack of corporate governance. Overall, corporate governance reform was very strongly supported by interviewees.

The second part of Chapter 6 discusses the findings from web-based questionnaires. The above findings from selected interviewees of institutional investors were generally consistent with those obtained from the web-based questionnaires. The less consistent results related to the detailed ranking of company specific factors by interviewees and web-based questionnaire respondents such as trading liquidity, audit quality, past financial performance, future cash flow, leverage, market risk and dividend yield.

Additional findings from the web-based questionnaires on corporate governance issues were obtained. These included the findings that investor communication was one of the most important corporate governance issues alongside other important issues such as director share ownership, existence of audit committee, family ownership and existence of directors' performance evaluation. In general, no distinctly divergent or contrasting views were reported.

7.2 Limitations

As in all research studies, there exists some limitations which may affect the generalizability of our results. One limitation is the poor response rate of 12.3% on our web-based questionnaires despite follow up efforts to improve it[1]. Based on the feedback we received from the HKSI, one of the main reasons contributing to the low response rate is that sample respondents are concerned about their identities being disclosed though we specified clearly in our survey that their identities would be kept strictly confidential.

Since the first part of our findings is obtained from selected interviews, the generalizability of our findings from the small number of interviewees needs to be interpreted with some caution. It should, however, be noted that these interviewees are representative of the key institutional investors in Hong Kong. Another limitation of the study is that some important information such as portfolio holding mix or optimal mix of the interviewees was not disclosed by our respondents as they regarded those information to be too sensitive and confidential. Finally, due to time constraints, the scope of our literature review had to be somewhat restricted. Only the major research studies published in top-tier accounting and finance journals (such as Journal of Accounting and Economics, Journal of Financial Economics, Journal of Finance, Corporate Governance) for the last ten years was reviewed.

[1] Based on the information given by the Hong Kong Securities Institute, the response rates of their two questionnaire surveys are as low as 10.2% and 6.1% respectively.

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Appendix 1

Completed Interview List

Asset Management Companies

1 ABN AMRO Asset Management (Asia) Limited

2 Citibank Global Asset Management (Asia) Ltd.

3 Fidelity Investments Management (Hong Kong) Ltd.

4 Friends Ivory & Sime Asia Ltd.

5 HSBC Asset Management (Hong Kong) Ltd.

6 INVESCO Asia Ltd.

7 JF Funds Ltd.

8 Manulife Funds Direct (Hong Kong) Ltd.

9 Schroder Investment Management (Hong Kong) Ltd.

10 State Street Global Advisors

11 Templeton Franklin Investment Services (Asia) Limited

Investment Banks

12 Goldman Sachs (Asia) L.L.C.

13 Merrill Lynch (Asia Pacific) Limited

Appendix 2

Interview on
The Attitudes of International Institutional Investors towards Corporate Governance Standards in Hong Kong

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Date: ____________ Time: ______________

Interviewer: Professor Judy Tsui / Professor Ferdinand A. Gul

Name of Interviewee and Institution: ____

Section A Particulars of Interviewee

1. Which of the following categories describes your institution?
   a. Pension fund
   b. Mutual fund
   c. Private investment fund
   d. Money management firm
   e. Investment bank
   f. Insurance company
   g. Investment trust company
   h. Unit trust company
   i. Broker / dealer
   j. Mixed fund management
   k. Others (please specify) __________________________

2. What is the nationality of your institution (or corporate parent)?
   a. US
   b. Asian
   c. European
   d. Latin American
   e. Other (please specify) ___________________________

3. What is the average length of your portfolio investment horizon for your investment in Hong Kong?
   a. Under 2 months
   b. Between 2 months and 6 months
   c. Between 6 months and 12 months
   d. Between 1 year and 2 years
   e. Between 2 years and 5 years
   f. Between 5 years and 10 years
   g. Over 10 years

4. Would your answer to question (3) above be different for your investment in markets other than Hong Kong?
   a. No, the average length of our portfolio investment horizon is the same for all markets
   b. Yes, the average length of our portfolio investment horizon is shorter for markets in ______________________
   c. Yes, the average length of our portfolio investment horizon is longer for markets in ______________________

5. If there is a difference, what is the reason for the difference in portfolio investment decision?

6. From your point of view, what constitutes short term and long term investments (see question 3 above):

   Short term ____________
   Long term ____________

7. Please indicate a rough estimate of your institution's current investment holding mix:
   Short-term investment: _______%
   Long-term investment: _______%

8. Do you expect any change in your institution's current investment holding mix in the near future?
   a. Yes, we expect it would change to:
      Short-term investment: _______%
      Long-term investment: _______%
   b. No

9. Is the current investment holding mix as indicated in question 6 the optimal mix for your institution?
   a. Yes
   b. No, our optimal mix should be:
      Short-term investment: _______%
      Long-term investment: _______%

10. Do you expect any change in your institution's optimal investment holding mix in the next 12 months?
    a. Yes, we expect it would change to:
       Short-term investment: _______%
       Long-term investment: _______%
    b. No

11. What is the size of your institution? (approximate value of assets under management, in US$)
    a. Less than $1 billion
    b. $1-5 billion
    c. $5-10 billion
    d. $10-25 billion
    e. $25-50 billion
    f. More than $50 billion

12. What is the market share of your institution in Hong Kong as perceived by you?
    a. Under 5%
    b. 5% - 10%
    c. 10% - 15%
    d. 15% - 20%
    e. 20% - 25%
    f. 25% - 50%
    g. Over 50%

13. For the countries, exchanges, and regions below, please state your organization's investment position.

Country	Never invested	Invested in the past but not now	Currently investing	Will be investing in future
Hong Kong				
Taiwan				
Chinese Mainland				
Malaysia				
Indonesia				
Singapore				
Bangkok				
Tokyo				
Frankfurt				
London				
Australia				
USA				
Canada				
Latin America				

14. Compared to Hong Kong, do you adopt a different investment approach or strategy towards other markets such as London or New York?
    a. Yes, I do Why? ______________________________
    b. No, I do not

15. What is your position in the company?
    a. Director
    b. Fund manager
    c. Chief investment officer
    d. Company secretary
    e. Head of corporate governance or corporate governance executive
    f. Chief executive
    g. Head of research
    h. Analyst
    i. Other (please specify) ____________________________

16. What is your degree of investment responsibility for your clients?
    a. Making decisions on behalf of own organization
    b. Making investment decisions on behalf of your organization's private clients
    c. Making investment decisions on behalf of your organization's institutional clients
    d. Making investment recommendations for research
    e. Providing custodian services to clients
    f. Others (please specify) ____________________

17. What are your assessment criteria in setting your investment strategies? How do you rank them in accordance with their relative importance in your investment decision? (Corporate information needs)

Assessment Criteria	Value (5 being very important)
a. Past Financial Performance	________
b. Future Financial Performance	________
c. Future Cash Flow	________
d. Dividend Yield	________
e. Trading Liquidity	________
f. Stock Volatility	________
g. Market Risk	________
h. Leverage	________
i. Company Size	________
j. Company Age	________
k. Years Listed in Exchanges	________
l. Cross Listing	________
m. Book to Market Ratio	________
n. Quality of Disclosure of Financial Statements	________
o. Information Availability	________
p. Conservatism	________
q. Audit Quality (audited by Big Five or not)	________
r. Social Disclosures, e.g. environmental protection	________
s. Transactions Costs, e.g. commissions and other transfer fees	________
t. Corporate Strategy	________
u. Quality of Management	________

v. corporate governance: ________

- Board Structure, Composition and Activity ________
- Frequency and Quality of Board Meetings ________
- CEO Domination (Chairperson and Chief Executive Officer (CEO) being the same person) ________
- Independence of Independent Non-executive Directors (INDs) ________
- Board / CEO / Director Evaluation ________
- Director Remuneration ________
- Ownership Structure and Influence ________
  1. Family ownership ________
  2. Political party ownership ________
- Effectiveness of: ________
  1. Audit Committee ________
  2. Nomination Committee ________
  3. Remuneration Committee ________
- Investor Communication ________
- Monitoring by Institutional Investors ________

Section B Interview Questions

The following is intended to guide and focus the interviews:

1. Are you aware of the meaning of corporate governance?

2. How do you characterize a company with good corporate governance?

3. Do you think that companies with good corporate governance strongly outperform companies with poor corporate governance in stock performance over short-, medium- or long-term?

4. From your investment experience, is that really the case? i.e. stocks with high corporate governance outperformed the stocks with low corporate governance?

5. Do you consider issues relating to corporate governance in assessing a company during your investment decision-making process?

   5.1. Could you give an example of a company with good corporate governance identifying clearly the corporate governance variables present?

   5.2. Would you be willing to pay more for a well-governed company's stock when compared to a poorly governed one when both have identical past performance and future potential? If so, what percentage premium do you estimate you would be willing to pay for good governance?

   5.3. Would there be differences in the premium you are willing to pay for better governance between different markets, especially between developed markets and emerging markets? If so, in what ways are they different?

6. If not, why not? Do you think that factors in the legal or regulatory environment will make you become more interested in corporate governance issues when making your investment decisions?

7. What are the bases upon which you evaluate the corporate governance of a company (if any)?

   - What are the sources of information from which you evaluate the corporate governance level of a company? Own in-house research, professional reports, public news or other?

   - Is it based on quantitative analysis (i.e. giving a score to each corporate governance attribute and ranking stocks in Hong Kong by corporate governance) or qualitative assessment?

   7.1 Current corporate governance standards in Hong Kong:

      - How do you view the standard of corporate governance in Hong Kong as compared to other countries / markets? Would it be a factor affecting your international investment strategies? If so, how important is it?

- Which business sector(s) in Hong Kong do you think have the highest / lowest level of corporate governance? Would that affect your decision in deciding whether to invest in those sectors?

- Please name five Hong Kong traded companies that you consider to have good corporate governance. What common attributes do they share?
  1. ______________________________
  2. ______________________________
  3. ______________________________
  4. ______________________________
  5. ______________________________

- Please name five Hong Kong traded companies that you consider to have bad corporate governance. What common attributes do they share?
  1. ______________________________
  2. ______________________________
  3. ______________________________
  4. ______________________________
  5. ______________________________

- Do you think that there are any mechanisms in Hong Kong to compensate for the deficiencies in corporate governance of Hong Kong companies? Could they replace the need for corporate governance reforms in increasing shareholder value (e.g. stricter law enforcement, higher and more concentrated ownership)?

- What do you think about the level of corporate governance of companies in the Chinese Mainland planning to be listed in Hong Kong?

- Since Hong Kong is not a sovereign state, do you think the SAR government can effectively oversee the governance structures of H share companies in Hong Kong?

- In the Hong Kong stock market, do you have different preferences of investment between Hong Kong based companies and those companies that are based in Mainland China? If so, what makes them different?

7.2 Which of the following specific corporate governance mechanisms do you think is more important in shaping a good corporate governance environment?

7.2.1 Board structure, director remuneration policy and directors' indemnity insurance

- Is the practice of Directors' Indemnity Insurance known to you? Is it important to you in your investment decisions? If so, how?
- Do you agree that the roles of Chairperson and CEO should be separated? If so, do you think that this is feasible and realistic in the Hong Kong corporate environment?

Others include:

- Frequency and quality of board meetings
  - Director remuneration policies
  - Board / director evaluation

- Director interest in shares of the company

7.2.2 Quality of directors
- Degree of independence of non-executive directors of the company
- Professional training of directors
- Directors' awareness and knowledge of corporate governance

7.2.3 The composition and effectiveness of various sub-committees within the board
- Do you support the setting up of the following committees with a view to increasing shareholder values of Hong Kong companies?

  Audit Committee : yes / no
  Nomination Committee : yes / no
  Remuneration Committee : yes / no

- What is your view on the effectiveness of these committees in improving the corporate governance level of a company, with respect to the specific business environment in Hong Kong? Do you think that the establishment of the above committees will improve the company's financial disclosure and corporate and market performance (e.g. ROE, ROA, market returns, market values)?

  Audit Committee:
  Nomination Committee:
  Remuneration Committee:

- What is the main concern for you in assessing the effectiveness of these committees? What is the most important aspect for each committee to be effective? (Composition? Number of meetings? Function? Role? Power? Control?)

  Audit Committee:
  Nomination Committee:
  Remuneration Committee:

7.2.4 Financial disclosure and reporting

7.2.5 Issues unique to Hong Kong / Asian corporate environment
- What is your view on the common family shareholding structure in Hong Kong listed companies? Would such a structure reduce your confidence of the level of corporate governance, and/or the investment desirability of Hong Kong companies?

- Do you think that the family shareholding structure in Hong Kong listed companies is detrimental to the interest of minority shareholders? Or are there any compensatory mechanisms in Hong Kong which can reduce or even eliminate the adverse effects resulting from such a structure?

- Do you think that the family shareholding structure in Hong Kong listed companies promotes the business performance of the firm?

- Would you be averse to investing in a company with nominees in which the *de facto* controllers or owners of the company are not known to you?

- Would you be averse to investing in a company with a pyramidal shareholding structure?

7.3 Who should be responsible for the governance? The government? The auditor? Institutional investors, as the substantial shareholders of the company?

7.3.1 Are you, as an institutional investor, interested in playing an active role in monitoring?

- If you hold a sufficiently large number of shares to influence the managerial actions of a company, would you do so?

  If so, in what ways (whether to improve corporate governance or just to press for more short-term profit)? Why or why not?

- When you are dissatisfied with the performance or corporate governance of an investee company, what kind of actions would you take? Would you sell the shares, intervene to rectify the problem, or do nothing? Why or why not?

7.3.2 What role do you think institutional investors can play in monitoring the investee companies?

- What is your view on the role of institutional investors in improving the corporate governance or company performance of the investee companies? Do you think that institutional investors should play an active role in corporate governance reforms in Hong Kong, just like what CalPERS is doing in the US?

- Do you think that your involvement in the company operations as an institutional shareholder would have any impact on the level of corporate governance, share value and degree of company innovation (like patent activity, timing of long-term investment spending) of the company?

- Do you believe that current developments such as the Tracker Fund or MPF would affect your role as institutional investors? Would there be any change in your view on corporate governance change because of this?

- Would you treat all institutional investors as one group in the role of monitoring managerial actions of the investee companies, or would different types of institutional investors have different methods and needs for monitoring the company?

- What do you think about the suggestion of compulsory voting for institutional investors in their investee companies? In your opinion, would that improve the corporate governance level of Hong Kong?

7.3.3 Have you *actually* intervened / participated in monitoring any companies in Hong Kong or elsewhere?

- Is it your policy to vote on board issues or is it your policy to abstain? Have you ever voted *against* a management recommendation? If so, what was the incentive motivating you to do so, instead of just selling the shares or discussing the issues with management informally? On what occasions would you employ such an action?

- A system for identifying potential problems within investee companies would facilitate your involvement in corporate governance. Do you have any formal or informal monitoring systems in place for this purpose?

- Do you maintain regular contacts with your investee companies? If so, how regular is that?

7.3.4 What are the costs of monitoring? What obstacles have you encountered?

- What is your view on the costs of monitoring? Do you think that this cost is so high that it acts as a disincentive to monitor, or that it is a cost that could not be avoided?

- Do you have any business relationships with your investee companies? Would that affect your decision on whether or not to intervene in the corporate governance of an investee company?

- What is your view on the general legal and regulatory environment of Hong Kong on shareholder activism? Do you think that it is generally favorable for institutional investors to intervene and monitor the board or it is a hindrance? Could you cite some legal rules and requirements that act as barriers to your activism? What reforms could you propose in order to eliminate them?

- Is the "free-rider problem" (the fact that benefits of intervention would be enjoyed by all shareholders while the costs of actions being shouldered only by those who had participated in the monitoring) a barrier to your activism?

- As the management of the board in your investee companies would generally have access to more material information than you have, do you think that you have insufficient information to monitor the companies in which you invest? Would this concern affect your decision whether to monitor the management of the investee companies?

7.3.5 What do you think could be done to overcome the obstacles that institutional investors's face in order to play an active role in monitoring their investee companies?

- Do you favor the proposal that institutional investors could have nominee directors on the boards of investee companies to represent their interests?

- How about confidential voting? Would the introduction of confidential voting give you more comfort in voting on major policies or management recommendations of the investee companies?

8. What changes are necessary in order to raise the level of corporate governance standards in Hong Kong?

8.1 Do you support reform of the following corporate governance factors with a view to increasing shareholder values of investee companies (with regard to the Hong Kong corporate environment)? To what degree will you change your investment policy in response to changes in these factors? Can you suggest what sort of changes would be required to increase shareholder values?

(i) Board structure
- Mandatory requirement of four board meetings per year, and six would be recommended as good practice
- Quality of board meetings should be enhanced e.g. an external professional who should attend the meeting

(ii) Director quality
- Mandatory appointment of Finance Director or Chief Financial Officer at board level and he or she should be a qualified accountant
- No CEO domination
- Directors' service contracts exceeding three years need shareholders' approval
- Declaration of independence by independent non-executive director (IND) annually
- At least 30% of the directors should be independent non-executive (instead of an absolute two) so that their power will not be "diluted" in a large board
- Requirement for INDs to have no past or present financial or other interest in the business of the company or its subsidiaries
- To improve director awareness of corporate governance through training and education
- Disclosure of details of offices held by each director under "non-group" and "within group" category

(iii) Reporting and disclosure
- Annual accounts together with auditor's report should be sent to shareholders not more than five months after the financial year end date
- Disclosure of the identity of the top five highest paid individuals in the company
- Disclosure in dollar amount of directors' benefits derived from exercise of share options and warrants
- Disclosure of non-audit fees paid to auditors
- Auditors to be given the right to comment on information other than the financial statements and notes in the annual report
- Mandatory audit partners rotation
- Auditor's report on the internal control weaknesses

- Increase the period in which directors are prohibited from trading the company's shares (currently one month before the earnings announcement date)

(iv) Issues specific to Hong Kong corporate environment
- Members of the same family should not constitute more than 50% of the voting members of the Board
- The practice of shareholder nominees on boards should be prohibited

8.2 In addition to specific reforms to improve the level of corporate governance in Hong Kong companies, we would also like your views on corporate governance reform of the following items:

- Should reforms remain in a voluntary framework or should it be under stronger government regulation?
- Do you think that the board of directors would be overburdened if stronger corporate governance requirements were imposed?
- Do you think that it would be detrimental to business performance of the company if management concentrates too much on issues of accountability?
- Do you think that corporate governance reforms are more important for companies with poor financial performance than those with good financial performance?
- Do you think that corporate governance reforms should be different for different business sectors or the same standard should be applied to all?
- Do you think that the same corporate governance requirements should be imposed on small sized companies as well as the large ones (such as those in HS 33 / HS 100)?
- Do you think that banks should be subject to a different set (perhaps more stringent) of corporate governance requirements as compared with other companies in Hong Kong?
- Do you agree that good corporate governance embraces fair treatment to minority shareholders?
- Do you agree that good corporate governance includes social responsibility, such as a commitment to the environment?

Appendix 3a
Web-based Questionnaire - Original

Part I - General Information

Please indicate the importance of the following factors in your investment decisions.

Financial Fundamentals

		Not Important 1	2	Moderately Important 3	4	Very Important 5
1.	Future Cash Flow	○	○	○	○	○
2.	Share Price Volatility	○	○	○	○	○
3.	Market Risk i.e. beta	○	○	○	○	○
4.	Trading Liquidity	○	○	○	○	○
5.	Future Financial Performance	○	○	○	○	○
6.	Leverage	○	○	○	○	○
7.	Dividend Yield	○	○	○	○	○
8.	Ratio of Market Price per share / Book Value per share	○	○	○	○	○
9.	Past Financial Performance	○	○	○	○	○

Board Structure, Ownership and Practices

		Not Important 1	2	Moderately Important 3	4	Very Important 5
10.	Existence of Nomination Committee	○	○	○	○	○
11.	Board Composition i.e. percentage of independent non-executive directors on the Board	○	○	○	○	○
12.	Quality of Management	○	○	○	○	○
13.	Directors' Share Ownership	○	○	○	○	○
14.	Independence of Independent Non-executive Directors	○	○	○	○	○
15.	Existence of Remuneration Committee	○	○	○	○	○
16.	CEO Domination (Chairman and CEO being the same person)	○	○	○	○	○
17.	Existence of Directors' Performance Evaluation	○	○	○	○	○
18.	Family Ownership and Influence	○	○	○	○	○
19.	Existence of Audit Committee	○	○	○	○	○

How important are the following factors in contributing to good corporate governance?

		Not Important 1	2	Moderately Important 3	4	Very Important 5
A.	**Quality of Independent Non-executive Directors**					
*	Independence of independent non-executive directors	○	○	○	○	○
*	The appointment of independent non-executive directors should be regulated by the Listing Rules of the Stock Exchange	○	○	○	○	○
*	A majority of the independent non-executive directors should have an understanding of finance or accounting	○	○	○	○	○
*	Independent non-executive directors should be appointed by the Nomination Committee	○	○	○	○	○
*	Reasons for the resignation/termination of independent non-executive directors should be disclosed	○	○	○	○	○

	Not Important		Moderately Important		Very Important
	1	2	3	4	5
B. Directors' Remuneration					
* Compulsory disclosure of individual executive director's remuneration	○	○	○	○	○
* Disclosure on directors' compensation for loss of office	○	○	○	○	○
* Performance and pay linkage	○	○	○	○	○
* Restrictions on contract severance compensation for directors	○	○	○	○	○
	1	2	3	4	5
C. Board Structure and Practices					
* Mandatory appointment of Finance Director / Chief Financial Officer at board level	○	○	○	○	○
* Finance Director / Chief Financial Officer should be a qualified accountant	○	○	○	○	○
* Chairman of the Board should not occupy the position as the CEO or Managing Director or President	○	○	○	○	○
* Restrictions on the number of family members who can sit on the Board	○	○	○	○	○
* Formal performance evaluation for:					
▸ Chief Executive Officers	○	○	○	○	○
▸ Board of Directors	○	○	○	○	○
* Chairman of the Board should be an independent non-executive director	○	○	○	○	○
* Majority of the board should be independent non-executive directors	○	○	○	○	○
* If the Chairman is the CEO, there should be a 'lead' independent non-executive director to co-ordinate the Board functions	○	○	○	○	○
* Independent non-executive directors should not hold their positions on a Board for more than 3 years	○	○	○	○	○
* A member on the Board should represent minority interests	○	○	○	○	○
* A mandatory requirement of at least four board meetings per year	○	○	○	○	○
* Initial training for executive and non-executive directors	○	○	○	○	○
* The board should draw up a code of ethics or statement of business practice so that all directors and employees know the standard of conduct expected	○	○	○	○	○
* Continuing education for directors is required	○	○	○	○	○
* Emphasis on the recruitment of quality directors, especially independent non-executive directors	○	○	○	○	○
	1	2	3	4	5
D. Directors' Service Contract					
* Directors' service contracts should not exceed 12 months	○	○	○	○	○
* Directors' service contracts exceeding three years need shareholders' approval	○	○	○	○	○

Please indicate the importance of the following factors in your investment decisions.

Annual Report Disclosures

	Not Important 1	2	Moderately Important 3	4	Very Important 5
20. Content of Financial Statements (including Notes)	◯	◯	◯	◯	◯
21. Corporate Social Responsibilities Disclosures, e.g. environmental issues	◯	◯	◯	◯	◯
22. Timeliness of Annual Reports	◯	◯	◯	◯	◯

How important are the following factors in contributing to good corporate governance?	Not Important 1	2	Moderately Important 3	4	Very Important 5
E. Annual Report Disclosures					
* Disclosure of directors' benefits derived from exercising share options and/or warrants	◯	◯	◯	◯	◯
* More disclosure on directors' dealings with related parties	◯	◯	◯	◯	◯
* Disclosure of other fees paid to the auditors in the financial statements	◯	◯	◯	◯	◯
* A separate section or general statement on corporate governance in the annual report	◯	◯	◯	◯	◯
* A general statement of business risk in the annual report e.g. foreign exchange exposure	◯	◯	◯	◯	◯
* Quarterly financial reporting	◯	◯	◯	◯	◯
* Annual financial statements together with the auditor's report should be sent to shareholders not more than four months after the financial year end date	◯	◯	◯	◯	◯
* A statement of going concern in the annual report	◯	◯	◯	◯	◯

Please indicate the importance of the following factors in your investment decisions.

Role of Auditors

	Not Important 1	2	Moderately Important 3	4	Very Important 5
23. Audit Quality (whether audited by Big 5 CPA Firms)	◯	◯	◯	◯	◯

How important are the following factors in contributing to good corporate governance?	Not Important 1	2	Moderately Important 3	4	Very Important 5
F. The Role of Auditors					
* A statement of internal control weaknesses in the annual report	◯	◯	◯	◯	◯
* Mandatory rotation of audit engagement partners	◯	◯	◯	◯	◯
* Auditors should be required to review other financial reports or information e.g. Management Discussion & Analysis	◯	◯	◯	◯	◯
* Auditors should not substantially engage in non-audit services for auditee companies	◯	◯	◯	◯	◯
* Auditors are responsible for fraud detection	◯	◯	◯	◯	◯

Please indicate the importance of the following factors in your investment decisions.

Investor Protection

	Not Important 1	2	Moderately Important 3	4	Very Important 5
24. Level of Communication between Institutional Investors and Investee Companies	◌	◌	◌	◌	◌

How important are the following factors in contributing to good corporate governance?

	Not Important 1	2	Moderately Important 3	4	Very Important 5
G. Investor Protection					
* Class actions against companies	◌	◌	◌	◌	◌
* One-share-one-vote principle	◌	◌	◌	◌	◌
* Institutional investors should have nominee directors on boards of investee companies	◌	◌	◌	◌	◌

* Please provide below your suggestions on how shareholders' rights could be better protected.

Please indicate the importance of the following factors in your investment decisions.

Regulatory Enforcement

	Not Important 1	2	Moderately Important 3	4	Very Important 5
25. Legal & Regulatory Environments	◌	◌	◌	◌	◌

How important are the following factors in contributing to good corporate governance?

	Not Important 1	2	Moderately Important 3	4	Very Important 5
H. Regulatory Enforcement					
* Heavier penalties and sanctions imposed on insider trading	◌	◌	◌	◌	◌
* Securities and Futures Commission should be given more power to promote good corporate governance	◌	◌	◌	◌	◌

	1	2	3	4	5
Others					
26. Transaction Costs	◌	◌	◌	◌	◌
27. Corporate Strategy	◌	◌	◌	◌	◌
28. Corruption	◌	◌	◌	◌	◌
29. Years Listed in Stock Exchange	◌	◌	◌	◌	◌

	Not Important 1	2	Moderately Important 3	4	Very Important 5
How important are the following factors in contributing to good corporate governance?					
I. Others					
* Introduction of corporate governance rating of individual HK listed company e.g. Standard & Poor's Rating	○	○	○	○	○

Part II - Corporate Governance in Hong Kong

Coporate Governance in Hong Kong

	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
30. State the level of your agreement with the following statements					
a. Ownership concentration by institutional investors could substitute for good corporate governance practices in protecting investors' rights	○	○	○	○	○
b. Corporate governance reforms have focused on accountability issues at the expense of business performance	○	○	○	○	○
c. Current levels of risk disclosures are adequate	○	○	○	○	○
d. Current requirements on annual report disclosure are adequate	○	○	○	○	○
e. Family shareholding structure in HK listed companies adversely affects:					
▸ company financial performance	○	○	○	○	○
▸ proper management of board functions of the company	○	○	○	○	○
f. Good corporate governance is more important for poor performing companies	○	○	○	○	○
g. High standard of corporate governance is as important for smaller listed companies as for larger companies	○	○	○	○	○

31. If you observe improvements in corporate governance practices in HK listed companies, will your investment strategies change?

○ a. No, it will not change

○ b. Yes, the investment horizon will be lengthened

○ c. Yes, the proportiion of investments will be increased

○ d. Yes, both b. & c.

32. Would you be willing to pay a premium for a well-governed company (as compared to a poorly governed company) in HK? If yes, please state the estimated premium that you would be prepared to pay.

○ a. Yes, please state the estimated premium: ______ %

○ b. No

33. Please rank the following countries in terms of their listed companies' corporate governance practices in general. (Rank 1 as the best and 8 as the worst)

i. Australia [1]
ii. Canada [1]
iii. Hong Kong [1]
iv. Malaysia [1]
v. Singapore [1]
vi. Taiwan [1]
vii. UK [1]
viii. US [1]

	Not Satisfactory 1	2	Moderately Satisfactory 3	4	Very Satisfactory 5
34. How do you rate the standard of corporate governance in HK?	○	○	○	○	○

35. Do you support the introduction of corporate governance reforms in HK?

○ a. Yes

○ b. No

	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
36. Corporate governance reform - should it be voluntary, regulated or legislated?					
▸ More guidance on corporate governance in the Code of Best Practice of the Listing Rules would further improve corporate governance in HK	○	○	○	○	○
▸ Corporate governance reforms should be regulated by the Listing Rules	○	○	○	○	○
- Listing Rules should be regulated by the Securities & Futures Commission and not the HK Exchanges & Clearing Limited	○	○	○	○	○
▸ Corporate governance should be legislated i.e. Companies Ordinance	○	○	○	○	○
▸ Corporate governance reforms should be voluntary	○	○	○	○	○

Part III - Corporate Governance Reform

	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
37. Do you agree that good corporate governance leads to better firm performance?					
a. In the short term please define: [ ] months	○	○	○	○	○
b. In the long term please define: [ ] months	○	○	○	○	○

Question 38 (section A & I) is subsumed under Part I - General Information

Part IV - Mainland Chinese Companies Seeking Listings in HK

	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
39. Do you agree that higher corporate governance standards should be required for Mainland Chinese Companies seeking listings in HK?	○	○	○	○	○

40.Please indicate additional corporate governance mechanisms that you consider should be in place.

Part V - Respondent's Information

41. Which of the following categories describes your institution? (Please click more than one where applicable)

- a. Pension fund
- b. Mutual fund
- c. Private investment fund
- d. Money management firm
- e. Investment bank
- f. Insurance company
- g. Investment trust company
- h. Unit trust company
- i. Broker / dealer
- j. Mixed fund management
- k. Others (please specify)

42. What is the nationality of your institution? (Please click more than one where applicable)

- a. US
- b. Asian
- c. European
- d. Latin American
- e. Others (please specify)

43. What is the average length of your portfolio investment horizon for your investment in HK?

- a. Under 2 months
- b. Between 2 months and 6 months
- c. Between 6 months and 12 months
- d. Between 1 year and 2 years
- e. Between 2 years and 5 years
- f. Between 5 years and 10 years
- g. Over 10 years

44. Would your answer to question (43) above be different for your investments in markets other than HK?

- a. No, the average length of our portfolio investment horizon is the same for all markets
- b. Yes, the average length of our portfolio investment horizon is shorter for markets in: (names of countries)
- c. Yes, the average length of our portfolio investment horizon is longer for markets in: (names of countries)

45. If there is a difference, what is the reason for the difference in portfolio investment decisions?

- a. Different corporate governance practices
- b. Reasons other than corporate governance issues
- c. Both a. & b.

46. Please provide an estimate of your institution's current investment holding mix:

a. Short-term investment: ____ %

b. Long-term investment: ____ %

47. Do you expect any changes in your institution's current investment holding mix in the near future?

- a. Yes, we expect it to change to:
  Short-term investment: ____ %
  Long-term investment: ____ %
- b. No

48. What is the size of your institution? (approximate value of assets under management, **in US$**)

	Less than US$1 billion	US$1 to US$5 billion	US$5 to US$10 billion	US$10 to US$25 billion	US$25 to US$50 billion	More than US$50 billion
a. Hong Kong	○	○	○	○	○	○
b. Asia	○	○	○	○	○	○
c. Global	○	○	○	○	○	○

49. What is your estimated market share in HK?

- a. Under 5 %
- b. 5% - 10%
- c. 10% - 15%
- d. 15% - 20%
- e. 20% - 25%
- f. 25% - 50%
- g. Over 50%

50. Please state your firm's investment position.

Country	Never invested	Invested in the past but not now	Currently investing	Will be investing in future
HK	☐	☐	☐	☐
Taiwan	☐	☐	☐	☐
Chinese Mainland	☐	☐	☐	☐
Malaysia	☐	☐	☐	☐
Indonesia	☐	☐	☐	☐
Singapore	☐	☐	☐	☐
Bangkok	☐	☐	☐	☐
Tokyo	☐	☐	☐	☐
Frankfurt	☐	☐	☐	☐
London	☐	☐	☐	☐
Australia	☐	☐	☐	☐
USA	☐	☐	☐	☐
Canada	☐	☐	☐	☐
Latin America	☐	☐	☐	☐

51. Compared to HK, do you adopt different investment strategies towards other developed markets such as London or New York?

- ○ a. Yes, I do
  Why? ____________________
- ○ b. No, I do not

52. What is your position in the company?

- ○ a. Director
- ○ b. Fund manager
- ○ c. Chief investment officer
- ○ d. Company secretary
- ○ e. Head of corporate governance or corporate governance executive
- ○ f. Chief executive
- ○ g. Head of research
- ○ h. Analyst
- ○ i. Other (please specify): ____________________

53. What is your degree of investment responsibility for your clients?

- a. Making decisions on behalf of own organization
- b. Making investment decisions on behalf of your organization's private clients
- c. Making investment decisions on behalf of your organization's institutional clients
- d. Providing custodian services to clients
- e. Others (please specify)

54. It is your firm's policy to:	Yes	No
a. vote on ALL the board issues of your investee firms		
b. to abstain on the board issues of your investee firms		
c. vote for a management recommendation or proposal		
d. settle disagreements with management before the annual general meeting		
55. You meet your investee firms at least once every year		
56. When you are dissatisfied with corporate governance of your investee firms, you would:		
a. do nothing		
b. sell our shares		
c. intervene to rectify the problem		
d. please specify		

57. Please provide any further information or make additional comments relating to corporate governance in HK below.

End of Questionnaire

Appendix 3b
Web-based Questionnaire - Revised

Part I - General Information

Please indicate the importance of the following factors in your investment decisions.

Financial Fundamentals

	Not Important 1	2	Moderately Important 3	4	Very Important 5
1. Future Cash Flow					
2. Share Price Volatility					
3. Market Risk i.e. beta					
4. Trading Liquidity					
5. Future Financial Performance					
6. Leverage					
7. Dividend Yield					
8. Ratio of Market Price per share / Book Value per share					
9. Past Financial Performance					
10. Past Cash Flow					

Board Structure, Ownership and Practices

	Not Important 1	2	Moderately Important 3	4	Very Important 5
11. Existence of Nomination Committee					
12. Board Composition i.e. percentage of independent non-executive directors on the Board					
13. Quality of Management					
14. Directors' Share Ownership					
15. Independence of Independent Non-executive Directors					
16. Existence of Remuneration Committee					
17. CEO Domination (Chairman and CEO being the same person)					
18. Existence of Directors' Performance Evaluation					
19. Family Ownership and Influence					
20. Existence of Audit Committee					

	Not Important 1	2	Moderately Important 3	4	Very Important 5

How important are the following factors in contributing to good corporate governance?

A. Quality of Independent Non-executive Directors

	1	2	3	4	5
♦ Independence of independent non-executive directors	◌	◌	◌	◌	◌
♦ The appointment of independent non-executive directors should be regulated by the Listing Rules of the Stock Exchange	◌	◌	◌	◌	◌
♦ A majority of the independent non-executive directors should have an understanding of finance or accounting	◌	◌	◌	◌	◌
♦ Independent non-executive directors should be appointed by the Nomination Committee	◌	◌	◌	◌	◌
♦ Reasons for the resignation/termination of independent non-executive directors should be disclosed	◌	◌	◌	◌	◌

♦ What is the optimal percentage of independent non-executive directors in a board of directors?

[ ] %

B. Board Structure and Practices

	1	2	3	4	5
♦ Chairman of the Board should not occupy the position as the CEO or Managing Director or President	◌	◌	◌	◌	◌
♦ Restrictions on the number of family members who can sit on the Board	◌	◌	◌	◌	◌
♦ Chairman of the Board should be an independent non-executive director	◌	◌	◌	◌	◌
♦ Majority of the board should be independent non-executive directors	◌	◌	◌	◌	◌
♦ A member on the Board should represent minority interests	◌	◌	◌	◌	◌
♦ The board should draw up a code of ethics or statement of business practice so that all directors and employees know the standard of conduct expected	◌	◌	◌	◌	◌
♦ Emphasis on the recruitment of quality directors, especially independent non-executive directors	◌	◌	◌	◌	◌

Please indicate the importance of the following factors in your investment decisions.

Annual Report Disclosures

	Not Important 1	2	Moderately Important 3	4	Very Important 5
21. Content of Financial Statements (including Notes)	◌	◌	◌	◌	◌
22. Timeliness of Annual Reports	◌	◌	◌	◌	◌
23. Auditor's Report	◌	◌	◌	◌	◌
24. A Statement of Responsibilities Issued by Directors in relation to the Financial Statements and the Content of the Annual Report.	◌	◌	◌	◌	◌

	Not Important 1	2	Moderately Important 3	4	Very Important 5
How important are the following factors in contributing to good corporate governance?					
C. Annual Report Disclosures					
♦ Disclosure of directors' benefits derived from exercising share options and/or warrants	◌	◌	◌	◌	◌
♦ More disclosure on directors' dealings with related parties	◌	◌	◌	◌	◌
♦ A separate section or general statement on corporate governance in the annual report	◌	◌	◌	◌	◌
♦ A general statement of business risk in the annual report e.g. foreign exchange exposure	◌	◌	◌	◌	◌
♦ Quarterly financial reporting	◌	◌	◌	◌	◌

Please indicate the importance of the following factors in your investment decisions.

Investor Protection

	Not Important 1	2	Moderately Important 3	4	Very Important 5
25. Level of Communication between Institutional Investors and Investee Companies	◌	◌	◌	◌	◌
26. Equal Dissemination of Information among Analysts and Other Investors	◌	◌	◌	◌	◌

	Not Important 1	2	Moderately Important 3	4	Very Important 5
How important are the following factors in contributing to good corporate governance?					
D. Investor Protection					
♦ Class actions against companies	◌	◌	◌	◌	◌
♦ One-share-one-vote principle	◌	◌	◌	◌	◌
♦ Institutional investors should have nominee directors on boards of investee companies	◌	◌	◌	◌	◌

Please indicate the importance of the following factors in your investment decisions.

Regulatory Enforcement

	Not Important 1	2	Moderately Important 3	4	Very Important 5
27. Legal & Regulatory Environments	◌	◌	◌	◌	◌

How important are the following factors in contributing to good corporate governance?	Not Important 1	2	Moderately Important 3	4	Very Important 5
E. Regulatory Enforcement					
♦ Heavier penalties and sanctions imposed on insider trading	○	○	○	○	○
♦ Securities and Futures Commission have more power of enforcement	○	○	○	○	○

Please indicate the importance of the following factors in your investment decisions.

How important are the following factors in contributing to good corporate governance?	Not Important 1	2	Moderately Important 3	4	Very Important 5
F. Others					
♦ Introduction of corporate governance rating of individual HK listed company e.g. Standard & Poor's Rating	○	○	○	○	○

Part II - Corporate Governance in Hong Kong

Coporate Governance in Hong Kong

28. State the level of your agreement with the following statements	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
a. Current requirements on annual report disclosure are adequate	○	○	○	○	○
b. Family shareholding structure in HK listed companies adversely affects:					
▸ company financial performance	○	○	○	○	○
▸ proper management of board functions of the company	○	○	○	○	○
c. Good corporate governance is more important for poor performing companies	○	○	○	○	○
d. High standard of corporate governance is as important for smaller listed companies as for larger companies	○	○	○	○	○
e. The present enforcement measures of Listing Rules are adequate	○	○	○	○	○

29. If you observe improvements in corporate governance practices in HK listed companies, will your investment strategies change?

- ○ a. No, it will not change
- ○ b. Yes, the investment horizon will be lengthened
- ○ c. Yes, the proportion of investments will be increased
- ○ d. Yes, both b. & c.

	Not Satisfactory 1	2	Moderately Satisfactory 3	4	Very Satisfactory 5
30. How do you rate the standard of corporate governance in HK?	◌	◌	◌	◌	◌

31. Do you support the introduction of corporate governance reforms in HK?

◌ a. Yes

◌ b. No

	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
32. Corporate governance reform - should it be voluntary, regulated or legislated?					
▸ More guidance on corporate governance in the Code of Best Practice of the Listing Rules would further improve corporate governance in HK	◌	◌	◌	◌	◌
▸ Corporate governance reforms should be regulated by the Listing Rules and	◌	◌	◌	◌	◌
a. The listing companies' regulation should lie with the Securities and Futures Commission	◌	◌	◌	◌	◌
b. The listing companies' regulation should lie with the HK Exchanges & Clearing Limited	◌	◌	◌	◌	◌
▸ Corporate governance should be legislated i.e. Companies Ordinance	◌	◌	◌	◌	◌
▸ Corporate governance reforms should be voluntary	◌	◌	◌	◌	◌

▸ What other types of enforcement measures would you wish to see in the future?

	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
33. Do you agree that good corporate governance leads to better firm performance?	◌	◌	◌	◌	◌

Part III - Mainland Chinese Companies Seeking Listings in HK

	Strongly Disagree 1	2	Neutral 3	4	Strongly Agree 5
34. Do you agree that higher corporate governance standards should be required for Mainland Chinese Companies seeking listings in HK?	○	○	○	○	○

Part IV - Respondent's Information

35. Which of the following categories describes your institution? (Please click more than one where applicable)

- ☐ a. Pension fund
- ☐ b. Mutual fund
- ☐ c. Private investment fund
- ☐ d. Money management firm
- ☐ e. Investment bank
- ☐ f. Insurance company
- ☐ g. Investment trust company
- ☐ h. Unit trust company
- ☐ i. Broker / dealer
- ☐ j. Mixed fund management
- ☐ k. Others (please specify) ____________

36. What is the nationality of your institution? (Please click more than one where applicable)

- ☐ a. US
- ☐ b. Asian
- ☐ c. European
- ☐ d. Latin American
- ☐ e. Others (please specify) ____________

37. What is the average length of your portfolio investment horizon for your investment in HK?

- ○ a. Under 2 months
- ○ b. Between 2 months and 6 months
- ○ c. Between 6 months and 12 months
- ○ d. Between 1 year and 2 years
- ○ e. Between 2 years and 5 years
- ○ f. Between 5 years and 10 years
- ○ g. Over 10 years

38. What is the size of your institution? (approximate value of assets under management, **in US$**)

	Less than US$1 billion	US$1 to US$5 billion	US$5 to US$10 billion	US$10 to US$25 billion	US$25 to US$50 billion	More than US$50 billion
a. Hong Kong	○	○	○	○	○	○
b. Asia	○	○	○	○	○	○
c. Global	○	○	○	○	○	○

39. What is your position in the company?

- ○ a. Director
- ○ b. Fund manager
- ○ c. Chief investment officer
- ○ d. Company secretary
- ○ e. Head of corporate governance or corporate governance executive
- ○ f. Chief executive
- ○ g. Head of research
- ○ h. Analyst
- ○ i. Other (please specify): ______

End of Questionnaire

Appendix 4

Average Score of Corporate Governance Factors by Respondents from Web-based Questionnaires

Factors	Average Score (5 = most important)
A. Quality of Independent Non-executive Directors (INDs)	
Independence of INDs	4.21
Reasons for the resignation/termination of INDs should be disclosed	4.07
Majority of the INDs should have an understanding of finance or accounting	4.00
The appointment of INDs should be regulated by the Listing Rules of the Stock Exchange	3.86
INDs should be appointed by the Nomination Committee	3.57
B. Directors' Remuneration	
Compulsory disclosure of individual executive director's remuneration	4.18
Performance and pay linkage	4.18
Disclosure on directors' compensation for loss of office	4.18
Restrictions on contract severance compensation for directors	4.00
C. Board Structure and Practices	
Formal performance evaluation of Chief Executive Officers (CEOs)	4.27
Finance Director / Chief Financial Officer should be a qualified accountant	4.09
Formal performance evaluation of Board of Directors	4.00
Mandatory appointment of Finance Director / Chief Financial Officer at board level	4.00
The board should draw up a code of ethics or statement of business practice so that all directors and employees know the standard of conduct expected from them	3.93
Emphasis on the recruitment of quality directors, especially INDs	3.92
Restrictions on the number of family members who can sit on the Board	3.71
A mandatory requirement of at least four board meetings per year	3.55
If the Chairman is the CEO, there should be a 'lead' IND to co-ordinate the Board functions	3.50
Initial training for executive and non-executive directors	3.45
Continuing education for directors	3.27
A member on the Board representing minority interests	3.21
Chairman of the Board <u>should not</u> occupy the positions of CEO, Managing Director or President	3.14
INDs should not hold their positions on a Board for more than three years	2.91
Majority of the board should be INDs	2.79
Chairman of the Board should be an IND	2.64

D. Directors' Contract

Directors' service contracts exceeding three years need shareholders' approval	3.00
Directors' service contracts should not exceed 12 months	2.73

E. Annual Report Disclosures

Annual financial statements together with auditors' report should be sent to shareholders not more than four months after the financial year end date	4.56
More disclosure on directors' dealings with related parties	4.54
Disclosure of directors' benefits derived from exercising share options and/or warrants	4.38
Quarterly financial reporting	4.23
A general statement of business risk in the annual reports e.g. foreign exchange exposure	4.15
A statement of going concern in the annual report	4.10
Disclosure of other fees paid to the auditors in the financial statements	4.10
A separate section or general statement on corporate governance in the annual report	4.08

F. The Role of Auditors

A statement of internal control weaknesses in the annual report	4.45
Auditors should be given the right to review other financial reports or information, e.g., Management Discussion & Analysis	4.18
Auditors are responsible for fraud detection	4.09
Auditors should not engage in substantial non-audit services for auditee companies	4.00
Mandatory rotation of audit partners	3.82

G. Investor Protection

One-share-one-vote principle	3.93
Class actions against companies	3.79
Institutional investors should have nominee directors on boards of investee companies	3.36

H. Regulatory Enforcement

Heavier penalty and sanctions imposed on insider trading	4.60
Securities and Futures Commission should be given more power to promote good corporate governance	3.47

I. Others

Introduction of corporate governance rating of individual Hong Kong listed company, e.g., Standard & Poor's Rating	3.50