

LEVEL 7 ASSESSMENT SPECIFICATION

Student name:	Janolfo T. Juntilla	Student ID number:	2134213
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Academic honesty / referencing:	Academic honesty is required. In the main body of your submission you must give credit to authors on whose research and ideas your work is based. Append to your submission a reference list that indicates the books, articles, etc. that you have used, cited or quoted in order to complete this assessment.		

Say on Pay : Does Hong Kong need it?

Introduction

“Man is a perpetually wanting animal” (Maslow, 1943).

An executive, just like any individual, needs meaningful reward and motivation to perform. This is a fundamental premise behind an organization’s remuneration system. For motivation to be effective, executives must believe that their performance is measured in accordance with standards that they could influence. A performance measure that is outside the influence of the executive would not just fail to motivate but may also induce improper behaviour (Mercer, 2009).

In the US, the financial crisis in 2008 trained a spotlight on executive compensation as executives of financial institutions that received financial assistance under the Troubled Asset Relief Program (TARP) continued to receive generous bonuses (Thomas, et al., 2012). Across the Atlantic, the controversy surrounding executive pay in the UK arose years earlier. Reports of excessive executive remuneration that dramatically increased in the mid-1990s received regular attention of the media (Cheffins & Thomas, 2001). A common criticism in the US and in the UK concerning executive compensation was that remuneration was not aligned with or hardly had any relation to business performance.

The response to this controversy both in the US and the UK was legislative reform. Other countries that experienced public discontent over excessive executive compensation have also introduced regulations affecting the manner of setting director and executive remuneration. The thrusts of legislative reform that came in the aftermath of this controversy were principally along the lines of (a) improved transparency that required disclosure of the amounts and elements of compensation of specified executives and (b) engagement with shareholders by giving them a voice in the pay practices of companies, i.e. a say on pay.

Literature review

The main piece of US legislation that enabled shareholders to signal their discontent over executive compensation practices is the 2010 Dodd-Frank Act. In the UK, it was section 241A of the Companies Act 1985 which gave shareholders an advisory vote on the directors’ remuneration report. Studies have been conducted on the effectiveness of these laws, right from the time when shareholders were allowed their first say on pay (Thomas, et al., 2012) (Cheffins & Thomas, 2001) up to most recent times (MacNeil, et al., 2020).

Other studies analysed voting patterns and explored factors that influenced say on pay voting (Ertimur, et al., 2013) (Ferri & Maber, 2013). One such study (Schwartz-Ziv & Wermers, 2022) provided some explanation and assuaged doubters of say on pay legislation who claimed that

shareholders do not have the ability and the attention to cast a meaningful vote (Cheffins & Thomas, 2001).

The main line of criticism of say on pay is its ability to influence executive pay practices and their relation to performance. Studies have been conducted to understand the relationship between CEO pay and performance (Collins, et al., 2019).

Other studies argued that say on pay votes should be made binding not merely advisory (Stathopoulos & Voulgaris, 2016).

Other countries have adopted say on pay regulations (Bourveau, et al., 2021) and are now actively assessing the effectiveness and value-enhancing capabilities together with its value -destroying potential, the unintended consequences.

Country	Year of SOP adoption	Advisory vs Binding
Australia	2005	Advisory
Belgium	2012	Advisory
Denmark	2007	Binding
Finland		Binding
France	2014	Advisory
Germany	2009	Advisory
Italy	2012	Advisory
Japan	2005	Binding
Netherlands	2004	Binding
Norway	2008	Binding
Portugal	2010	Advisory
South Africa	2011	Binding
Spain	2011	Advisory
Sweden	2006	Binding
Switzerland	2013	Binding
United Kingdom	2003	Advisory (Binding)
USA	2011	Advisory

Dodd-Frank requires shareholders to vote on the compensation of the “named executive officers” of a company. These named officers are the CEO, CFO and at least three other highest paid officers. Companies are required to explain in the Compensation and Discussion Analysis all material elements of the compensation of each named executive officers. The compensation elements comprise salary, employee benefits, perquisites, short-term incentives and long-term incentives.

Research Questions

This study proposes to answer whether Say on Pay regulation will benefit Hong Kong; and whether any reform in current regulations is needed in order to address problems related to executive compensation.

Design and methodology

This study examined the executive remuneration practices of select companies listed on the HKEX, focusing on the work and reports of their respective remuneration committees with reference to the Corporate Governance Code, Appendix 14 of the Exchange Listing Rules (CG Code). Some emphasis was given to listed entities that are also Authorised Institutions (AI) under the supervision of the Hong Kong Monetary Authority (HKMA). The reason for this is that these AIs are also expected to comply with the Guideline on a Sound Remuneration System issued by the HKMA (HKMA Guideline). These AIs are therefore required to comply with two non-statutory guidelines affecting their compensation policies.

The CG Code and the HKMA Guideline are both based on the principles of recommended good practice and compliance is mandated on a “comply or explain” basis. Both guidelines require the setting up of a remuneration committee and for that committee to make recommendations on the remuneration policy and structure of the remuneration of directors and senior management and to review and approve remuneration proposals from management (CG Code Provisions E.1.2 (a) and (b)) (HKMA Guideline paragraphs 2.1.8.3 and 2.1.8.5). Both guidelines emphasize the importance of independence of the members of the committee.

This study reviewed the 2021 annual report of the following companies listed on Table 1 below. These companies are all listed on the Main Board. Together, they account for a significant portion (22.74%) of the Exchange’s total market capitalization. CCB, HSBC and ICBC are also AIs.

Company	% HKEX Total Market Capitalization
Tencent	10.38
Alibaba	6.10
China Construction Bank – H Shares	3.07
HSBC Holdings plc	2.29
ICBC – H Shares	0.90

Table 1 (Source: HKEX Fact Book 2021)

Extensive reference was made to HKEX publications, namely HKEX Fact Book 2021 and to the Market Statistics 2021. These publications were the source of important curated information that were used to validate significant findings in this study.

Limitations

This study has inherent limitations as to its research approach. It did not investigate the reasons why companies adopted their current executive compensation practices and how they were able to justify these practices to their stakeholders. Perhaps, in future research, interviews with members or remuneration committees should be conducted. Valuable insights from those directly involved in

setting executive compensation will provide more evidence and improve the reliability of finding in this field of research.

A related issue that has not been investigated in this study is the independence of the members of the remuneration committee. This is significant because the independence of the individuals tasked with evaluating and recommending executive compensation policies will only be effective if they are not influenced by factors e.g. relationships and conflicts of interests, in discharging their responsibilities as gatekeepers. But yet again, this would be the focus of future research.

Findings

Of the entities chosen for this study, only HSBC provided a detailed discussion of its compensation policy and the composition and amounts paid to its directors and executives. This part of the annual report consisted of 30 pages. Tencent's remuneration report consisted of just 1 page, Alibaba's compensation report had 5 pages and ICBC's and CCB's annual reports did not even have any specific reference to a compensation report.

One could see an evident pattern of deficiency in providing the required disclosures that deviates from the CG Code and/or HKMA Guideline. This deviation could be partly explained by the fact that in Hong Kong, more than 75% of listed companies are incorporated offshore. This means that the corporate governance practices of these offshore entities are affected by rules that are in effect in both Hong Kong and in the place of incorporation (Johnstone & Goo, 2017).

For instance, Tricker and Li observed that Alibaba, a PRC incorporated company, prides itself on its leadership in corporate governance. It has complied with the requirements of the US SEC and the rules of NYSE. Yet an important question about its governance practice needs to be addressed because the shareholders of the company have minimal influence on governance. Alibaba's governance is in the hands of an entity – Alibaba Partnership. The members of this partnership are management insiders and major institutional investors.

Analysis and discussion

As of August 2022, Mainland enterprises account for 77.5% of market capitalization of the Hong Kong's Main Board and Growth Enterprise Market (GEM) (Source: Monthly Market Highlights HKEX). This share of market capitalization is represented by 904 entities, a significant portion of the total number of listed companies in Hong Kong. This brings to question whether Hong Kong regulators could impose Hong Kong corporate governance standards on companies incorporated in other jurisdictions. To illustrate this point, if an SOE listed its shares on HKEX, the state will maintain control of the SOE by ensuring that a state agency continue to hold the majority of the shares. Another

state agency, the China Securities Regulatory Commission (CSRC), the corporate regulatory arm of the state issues the corporate governance code and related regulations. While there is an obvious conflict of interest in this situation, Hong Kong regulators could take comfort from the fact that Mainland regulators have the necessary will and the appropriate mechanism to require SOEs to adopt sound corporate governance practices. Still, this situation may be exacerbated by the fact that Mainland SOEs come from background different from Hong Kong in terms of corporate governance culture, legal system, regulatory framework and market ideology. These present problems for Hong Kong regulators.

This does not mean that Hong Kong regulators should abandon reform efforts. There are still areas where meaningful corporate governance practices relating to executive remuneration could be improved. For instance, Johnstone and Goo, recommended increased transparency of disclosures concerning performance-linked remuneration. Specifically, they recommended that CG Code section B.1 be amended to include a requirement to disclose the bases considered by the remuneration committee in proposing remuneration that is linked to performance.

Another area of reform that could address concerns in executive remuneration is improved enforcement mechanism. Listing rules and the CG Code could be amended so that specific disclosures that do not comply with listing rules and CG Code could come within the scope of the Securities and Futures Ordinance. Presently, the sanctions under the SEHK do not have a deterrent effect (Johnstone & Goo, 2017).

Conclusion

The arguments advanced in this study considered Hong Kong's status as an international financial centre dominated by wealthy local families and state-owned enterprises. From a regulatory perspective Hong Kong benefited from its English common law pedigree that enhanced its status as a disciplined market. Hong Kong's corporate governance standards are in line with international best practice. Nevertheless, Hong Kong's distinct features call for prudence in indiscriminately adapting its corporate governance practices with those of the West, particularly the UK and the US.

Say on Pay regulations, based on evidence obtained so far in the US and in the UK, promote greater transparency and accountability. However, its ability to curb excess in executive compensation is still the subject of ongoing academic, regulatory and political debate. As pointed out earlier in this study, there are also concerns about the unintended consequences of Say on Pay regulations as they present opportunities for linking executive compensation with short-term performance and aligning pay with current share price without due regard to the long-term interest of the entities concerned.

This study considered the arguments that support the view that Western style Say on Pay regulations would not be the most suitable approach to address concerns about executive compensation in Hong

Kong's listed companies. The concentrated share ownership structure of nearly all of these companies negate any benefits that say on pay votes is intended to promote, that is, giving every shareholder a voice in setting executive compensation policy. Moreover, at least with respect to state owned enterprises listed in Hong Kong, executive compensation does not seem to be a controversial issue that needs priority attention. These entities are under close supervision by agencies of the Mainland government which control decision making and have the last "say" on pay.

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