



Fiduciary Duties and Work Ethics of Management

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Management of State-Owned Enterprises key to Economic Reform

- **State-owned enterprises remain the pillars of the Chinese economy;**
- **SOE reform is of critical importance to China's transition to a market economy;**
- **Speeding up and promoting SOE reform is a key component part of China's economic reform and economic development strategy**



Sun Tsu & Art of War

“Therefore we should analyse and compare the conditions of ourselves and an enemy from five factors in order to forecast if we will win before the beginning of war. The five factors are as follows:

- ◆ the first is *Tao or morality*;
- ◆ the second, *heaven*;
- ◆ the third, *earth*;
- ◆ the fourth, *generalship*, and
- ◆ the fifth, *law & discipline*.



Quotations from Sun Tsu (2)

- ◆ **What is *Tao*? The Tao is the moral right that make the people follow their ruler and share their ups and downs fearlessly during the war.**
- ◆ **What is *heaven*? Heaven means time, weather, and the cycle of seasons.**
- ◆ **What is *earth*? Earth signifies the geographical conditions, distance, strategically layout, and whether conditions are favourable or unfavourable to survival.**
- ◆ **What is generalship? The commander is one with five virtues: intelligence, trustworthiness, benevolence, courage, and discipline.**
- ◆ **What is law & discipline? The law refers to the command structure, the assignment of ranks, and the deployment and use of military supplies.**



Assessing who will win

- | | |
|------------------------|-----------------------------|
| • People talent | <i>Generalship</i> |
| • Risks | <i>Heaven</i> |
| • Ethics | <i>Tao</i> |
| • Incentive Structure | <i>Law & Discipline</i> |
| • Resources/technology | <i>Earth</i> |



Global Competition is Corporate Competition

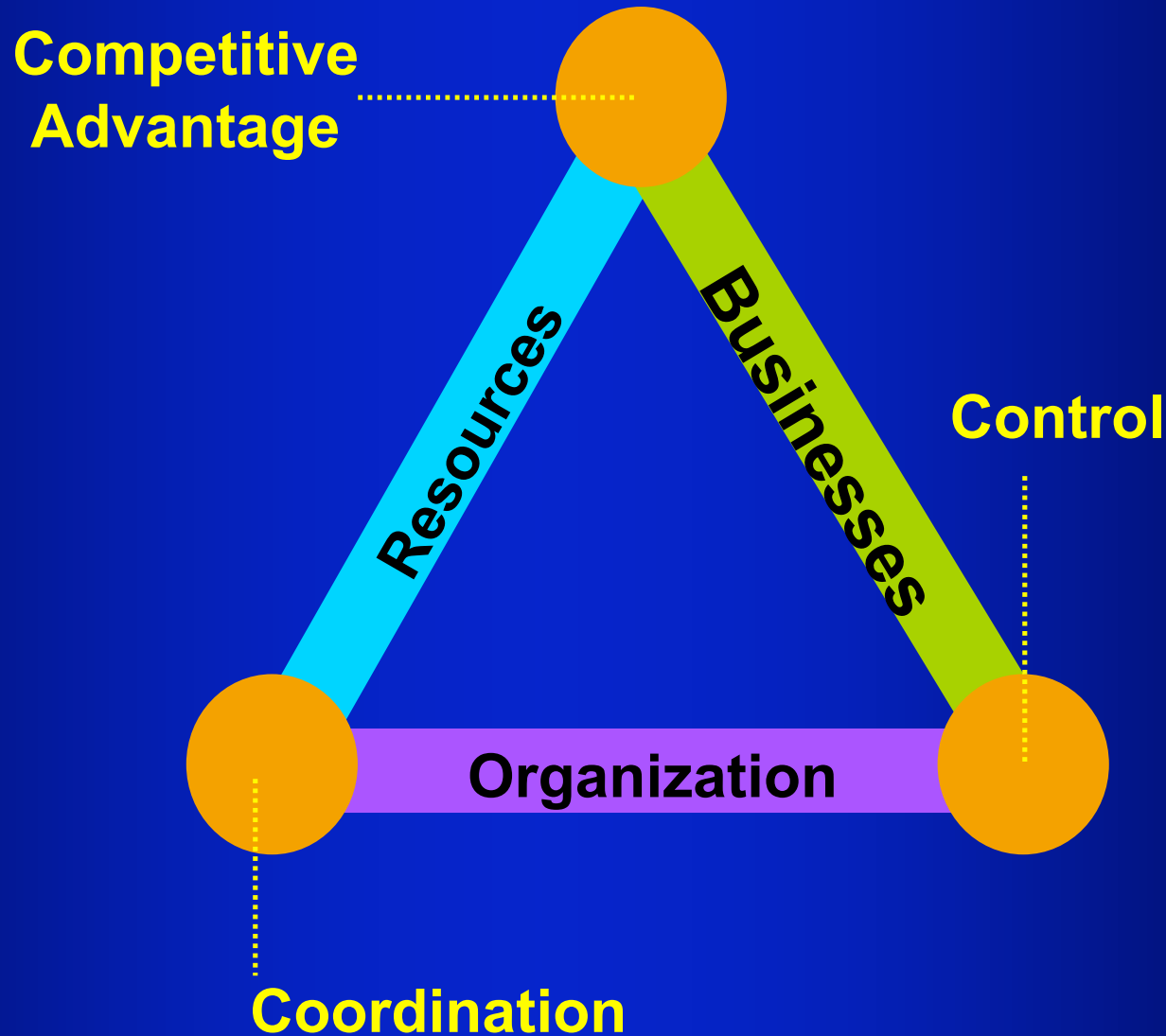
- In a competitive world, the efficiency of economies depends critically on the efficiency of their enterprises;
- Corporate efficiency depends on objectives, resources, knowledge, technology and management processes
- Efficiency cannot be measured just by short-run profits, but by long-run productivity and competitiveness
- Competition key to enterprise success



Global Competition is Knowledge Competition

- Management needs information to analyze, decide and act;
- But information needs management to become knowledge;
- Knowledge and Technology is useless without risk assessment & management
- Knowledge management and incentives key to:
 - good risk management
 - good corporate governance

The Triangle of Corporate Strategy





Four key functions of financial markets

- Resource allocation
- Price discovery
- Risk Management
- Corporate Governance



Information & Markets

- Markets need real time, reliable information to make correct decisions, especially for risk management in highly volatile environment;
- High quality information need:
 - **Good accounting standards**
 - **Reliable, timely statistical & reporting systems**
 - **Capacity to process, analyze and decide on information critical to competitive success**



Lessons of Asian crisis

- **Bad accounting =**
- **Bad statistics =**
- **Bad decision-making =**
- **Bad risk management =**
- **Flawed policies =**
- **Financial crisis**



Lack of CPAs

◆ Number of CPAs:

- Mainland China: 125,000
- Hong Kong: 14,819
- U.S.A.: 425,000

◆ Number of people each CPA serves:

- Mainland China: 9,650
- Hong Kong: 436
- U.S.A.: 650



Failure of Risk Management

- ◆ Maturity mismatch
- ◆ Currency mismatch
- ◆ Credit risks grossly under-estimated
- ◆ Leverage under-reported
- ◆ Volatility of asset prices and capital flows grossly under-estimated
- ◆ Need for better VAR models
- ◆ Need for National Risk Management



Risk Management

- ◆ **Identify the risk** - does left hand know what right hand is doing?
- ◆ **Measure the risk**
- ◆ **Pricing the risk** - do interest rates reflect true risks?
- ◆ **Hedging the risk** - dynamic hedging
- ◆ **Stress test the risk** - how much can the system take?



Risk Management is therefore Knowledge Management

- ◆ Complexity of Global economy means we must shift risk management to lowest level of self responsibility:
 - ✦ Consumer must know risks - buyer beware
 - ✦ Investor must have relevant price-sensitive information to assess risks
 - ✦ Management and workers must have clear roles and responsibilities
- ◆ Must have clear principles, codes, standards, rules and regulations
- ◆ **Need to educate:** consumer, investor, management and regulator of **rights, responsibilities and risks**



What is Corporate Governance?

- The system by which companies are directed and controlled;
- The processes or software which ensure that the directors, managers and controllers of companies are accountable to the shareholders and other stakeholders
- Corporate governance involves ethics, codes of conduct, rules and laws

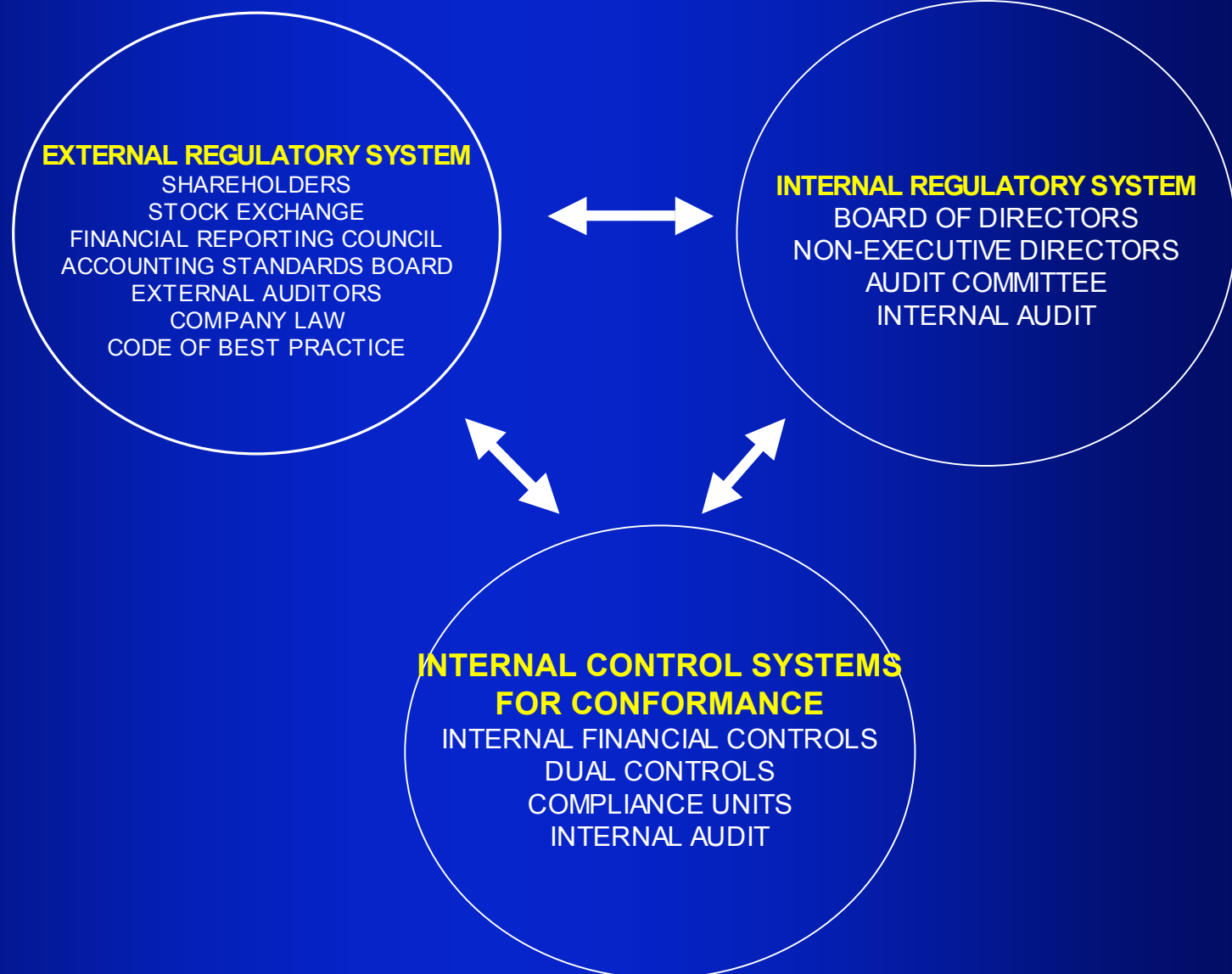


Delegation & Trust - Principal vs Agents

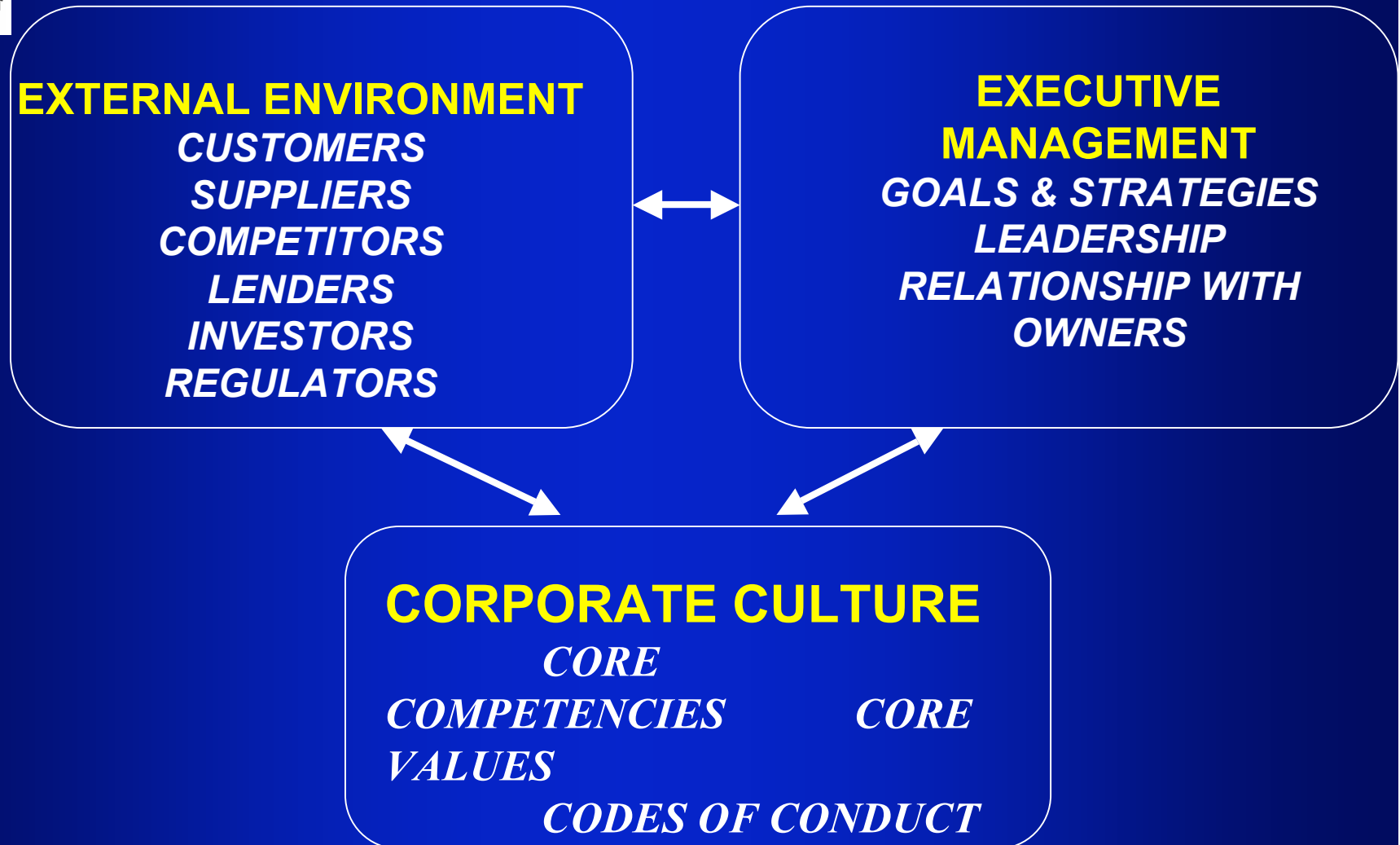
- Corporate governance is all about delegation and trust:
 - Owners (Principal) delegate power to the management (Agent), but **managers must perform their fiduciary duties with integrity**;
 - The managers should be subject to the checks and balances which prevent the abuse of power;
- It covers the fiduciary duties of the directors, the management, auditors, legal advisers and also regulators.

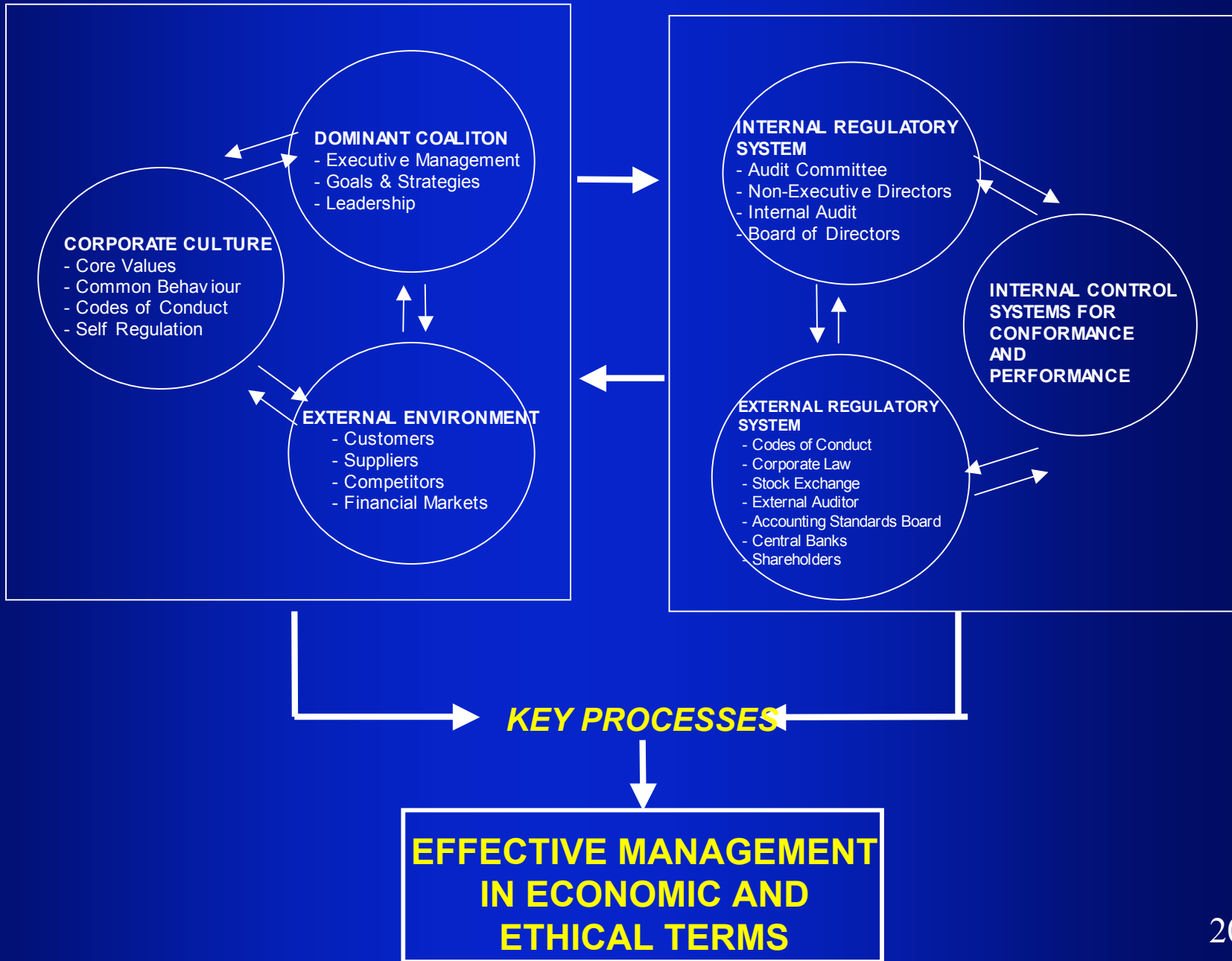


Corporate governance: conformance



Executive management: performance







Functions of a Governing Board (1) *(defined by American Law Institute):*

- Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives;
- Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed;
- Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions;



Functions of Governing Board (2)

- Review and, where appropriate, approve major changes in appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements; and
- Perform such other functions as prescribed by law, or assigned by the charter of the corporation.



OECD Principles of Corporate Governance:

- the rights of shareholders;
- the equitable treatment of shareholders;
- the role of stakeholders in corporate governance;
- disclosure and transparency; and
- the responsibilities of the board.



Fiduciary Duties

- **Directors should act with honesty, integrity and candour towards their company, in particular towards the interests of shareholders;**
- **The fiduciary duty is to company as a whole, and to both minority and majority shareholders;**
- **Act honestly in good faith, giving all shareholders equal, sufficient and accurate information on all issues affecting their interests;**
- **Directors should not treat a company as though it exists for their personal benefit;**



Duty to Majority Owner or Others?

- **Interests of Majority Owner may conflict with other stakeholders, such as minority shareholders, employees, creditors or public interest.**
- **Director should take only those actions a “prudent person” would take to further the best interests of the beneficiary;**
- **Actions deemed imprudent can result in personal liability to Director;**
- **Separation of ownership and management;**
 - **Conflict between interests of management and owners**



Self-serving Behaviour Among Directors

- Ownership of many public listed companies scattered amongst many shareholders;
- Widespread ownership prevents effective control over corporate performance;
- Managers/insiders may nominate allies to directorships and give shareholders little or no chance but to ratify their choices;
- Managers may exhibit self-serving behavior and maximize their own welfare at the expense of shareholders



Agents becoming Principals

- **Insiders may push personal security, power, prestige, advancement and individual income highly valued than corporate profits;**
- **Insiders may behave as if public listed company belongs to them rather than shareholders;**
- **These companies lose focus, competitiveness and are exposed to fraud, insider dealing and losses.**
- **Must align right incentive and management's interests with that of the company, such as share option scheme**
- **Accountability of managers and Board critical to success**



Insiders vs Outsiders

- If not rewarded or controlled properly, insiders/management may control company for their own benefit;
- In Eastern Europe, privatization has in many cases become privitization
- Corporate Governance seeks solution to this through ethical, legal, regulatory, and procedural arrangements
- Ethics alone is not enough
- **Trust but verify!**



Examples of Insider Abuses

- **Insider trading in shares - based on insider information;**
- **Corruption - taking bribes or illegal commissions in corporate transactions**
- **Nepotism - giving jobs to friends and relatives**
- **Conflict of interests - preference given on unfair basis**
- **Fraud - stealing corporate assets**
- **Incompetence - negligence of duties**
- **Waste - excessive expenditure**



Corporate Abuses: Global Examples

- ◆ **US:** Milken, Drexel & Lambert - Insider trading in junk bonds - fined US\$650 mn (1988)
- ◆ **UK:** Leeson, Barings Bros, Fraud in futures trading, Singapore- loss £850 mn (1995)
- ◆ **Japan:** Hamanaka, Sumitomo, Unauthorized trading in copper futures, loss US\$2.6 bn (1996)
- ◆ **France:** Credit Lyonnais, Bad loan losses FFr 96.5 bn (US\$15.3 bn) 1999



Incentives & Checks & Balances

Two hands - four eyes

- **Good Governance is responsibility of both owners and agents/managers**
- Owners/shareholders must define clear objectives for management to fulfill, with good incentives for performance;
- Board must set strategic direction, benchmark performance and select key managers and put in place checks & balances (**four eyes principle**)
- Managers must implement objectives, maximize long-term shareholder wealth, and demonstrate that they operate with integrity, efficiency and transparency.



What is Business Ethics?

- **Business ethics covers whole spectrum of interaction between individuals, companies, industries and society;**
- **Business ethics is not merely operating within the law;**
- **It is about how we conduct our business affairs fairly and legally, irrespective of an individual's or a company's standing and size of operation in the market;**
- **Ethical standards help define the way a corporation becomes a good “corporate citizen” that acts not only to maximize profits, but also in the public interest.**



Corporate Social Responsibility

- **Directors may feel that their only job is to ensure corporate profitability and legal compliance;**
- **Business ethics requires directors to exercise their powers with responsibility and in the interests of all stake-holders;**
- **Non-executive directors increasingly seen as outsiders who represent independent public interests**
- **Directors must not be afraid to voice broader societal interests that can be affected by board decisions, and distinguishing the company's interests from personal interests.**



Senior Management Competencies

- Judgement
- Self-confidence
- Strategic perspective
- Achievement focus
- Communication
- Information search
- Building teams
- Influencing others



Directors' Personal Qualities

- Strategic perception and decision-making
- Analytical understanding
- Communication
- Interacting with Others
- Board management
- Achieving results



Strategic perception and decision-making:

- Perspective
- Organizational awareness
- Strategic awareness
- Vision
- Imagination
- Judgement
- Decisiveness
- Change-oriented



Analytical understanding

- **Information collection**
- **Detail consciousness**
- **Numerical interpretation**
- **Problem analysis**
- **Critical faculty**



Communication

- Oral communication
- Listening
- Openness
- Written communication



Interacting with Others

- **Co-ordinating**
- **Assertiveness**
- **Impact**
- **Persuasiveness**
- **Motivating others**
- **Sensitivity**
- **Flexibility**



Board management:

- **Planning**
- **Delegating**
- **Appraising**
- **Developing directors**



Achieving results

- Energy
- Achievement-motivation
- Determination
- Independence
- Risk taking
- Business sense
- Resilience
- Integrity



Knowledge specific to Board of Directors

- **OECD Corporate governance standards**
- **Board roles, relationships and processes**
- **Basic standards of good practice, corporate finance, accounting principles and audit practices**
- **Company law & law covering company operations**



Directors & Company specific knowledge

- **Evaluating strategic options and risks**
- **Strengths and weaknesses of the company;**
- **Selection, appraisal, remuneration and development of directors;**
- **Company memorandum and articles of association**



Directors & business environment

- **Contemporary thinking and developments in business leadership, management practices and organizational behavior**
- **Public affairs and corporate communications**
- **Political, economic, social/cultural and technological influences**
- **Key trends in company's environment**



Regulating Standards of Behaviour

- ◆ The financial industry regulates corporate behaviour through legal registration
- ◆ with the SFC, a person must satisfy the SFC that he is a “fit and proper person”.
- ◆ The onus is on the applicant to prove that he meets the necessary requirements for registration, whether he is an individual or a company;
- ◆ If person misbehaves, his registration can be revoked or be subject to sanction under the law



IOSCO Standards of Behaviour

- International Organization of Securities Commissions laid down 7 principles as the cornerstone of conduct requirements for financial practitioners in Hong Kong. These principles embrace the spirit of legislation and the basic ethical values of the entire financial industry in Hong Kong:
 - ❖ Honesty and fairness
 - Diligence
 - Capabilities
 - Information about clients
 - Information for clients
 - Conflicts of interest
 - Compliance



Prevention of Bribery Ordinance

- Offering and accepting an advantage both constituting an offence;
- Unauthorized commission in custody of another person;
- Excessive entertainment and gifts;
- Customs not to be a defense;
- Verbal agreement counts;



Sanctions under Ordinance

- An offence committed notwithstanding incomplete corrupt transaction;
- Maximum penalty is seven years' imprisonment and a fine of HK\$500,000; prohibition from taking up a management post of any corporation/public body or practicing any profession for a period not exceeding seven years.



Internal Incentives & Legal Sanctions are not enough!

- Corporate self-discipline is ineffective and breeds suspicion in the market place;
- Regulatory oversight cannot catch all the abuses;
- **Internal and External oversight is enhanced by Market oversight!**
- This requires:-
 - Enhancing flow of corporate information to shareholders and stakeholders;
 - Ensuring legislative infrastructure and legal process which enable shareholders and stakeholders to enforce their rights.



What Is Transparency?

- The process by which information about existing conditions, decisions and actions is made accessible, visible and understandable;
- Greater transparency will:-
 - allow decisions to be better informed;
 - contribute to higher quality decisions;
 - lead to improvements in resource allocation;
 - contribute to financial stability and ultimately in economic growth and prosperity.



Transparency & Accountability

❖ Greater transparency will

- contribute to identification and pricing of risk;
 - help to inform market expectations;
 - help to stabilize markets during periods of uncertainty;
 - contribute to the effectiveness of announced policies;
- **In the absence of full, timely and accurate disclosure, market participants will:**
 - have difficulty comparing the financial performance of different firms;
 - may make investment decisions on the basis of inference about the information that is not provided
 - may sell or withdrawal additional credit or investments



Five Elements of Disclosure

- Timeliness
- Completeness
- Consistency
- Risk management
- Audit and control processes



What is Accountability?

- The need to justify and accept responsibility for decisions taken;
- The relationship between policy-makers and the constituencies to which they are responsible;
- Impose discipline on decision-makers;
- Help to improve the quality of decisions taken



Transparency strengthens public accountability

- Transparency promotes accountability by obliging decision-makers to make their decisions and the reasoning behind them known;
- Accountability enhances market efficiency;
- Accountability can be enhanced by:
 - properly constituted boards of directors and audit committees;
 - vigilant observation by responsible shareholders;
 - full and timely disclosure of information provided by effective reporting and auditing systems.



Benefits of Greater Transparency and Accountability

- Greater transparency and accountability are not just about the availability of timely information;
- They are the ethics of corporate policy and decision-making;
- Greater transparency and better accountability encourage:
 - Policy adjustments to begin earlier to prevent mistakes;
 - Managers and shareholders to communicate better to reduce uncertainty;
 - Corporations and managers to take account of the implications of their actions both for themselves and for their counterparts.



Key Challenges Facing SOEs in Corporate Governance Area

- How to improve quality of accounting and auditing?
- How to improve information disclosure and transparency?
- How to improve corporate governance, internal controls & checks and balances?
- How to create and improve management incentive system?
- How to readjust the ownership structure and diversify funding sources?



How Capital Markets Can Help SOE Reforms

(Listing in Hong Kong as example)

Improve quality of accounting and auditing:

- mandatory auditing by outside auditors;
- independence of auditors;
- international-standard accounting and auditing;

Improve information disclosure and transparency:

- publication of annual and interim results in a timely manner;
- timely disclosure of price-sensitive information;
- GEM listings require quarterly publication of financial information;



Public Listing helps Corporate Governance

Improve internal controls, transparency & accountability through greater checks and balances:

- Listing Rules;
- Code on Takeovers and Mergers;
- Code on Share Repurchases;
- Independent non-executive directors;
- Independent auditing system;
- Approval by minority shareholders for certain major transactions;
- Majority shareholders need to abstain from voting in certain situations;
- Prohibition against persons with criminal convictions from becoming directors;
- Regulatory surveillance and investigation of financial market misconduct and crime



Listing Improves Management Incentives & New Funding & Risk Management

Create and improve management incentive system:

- Share options widely used in listed companies to align management's interest with shareholders;
- Listing allows comparison with market benchmarks as effective way to evaluate the performance of management;
- Working for Listed companies improve management prestige & market value/salaries

Provide better funding and risk management for better-performing companies

- higher credit rating;
- lower borrowing cost;
- stronger demand for their stock;
- easier access to different funding & risk management tools



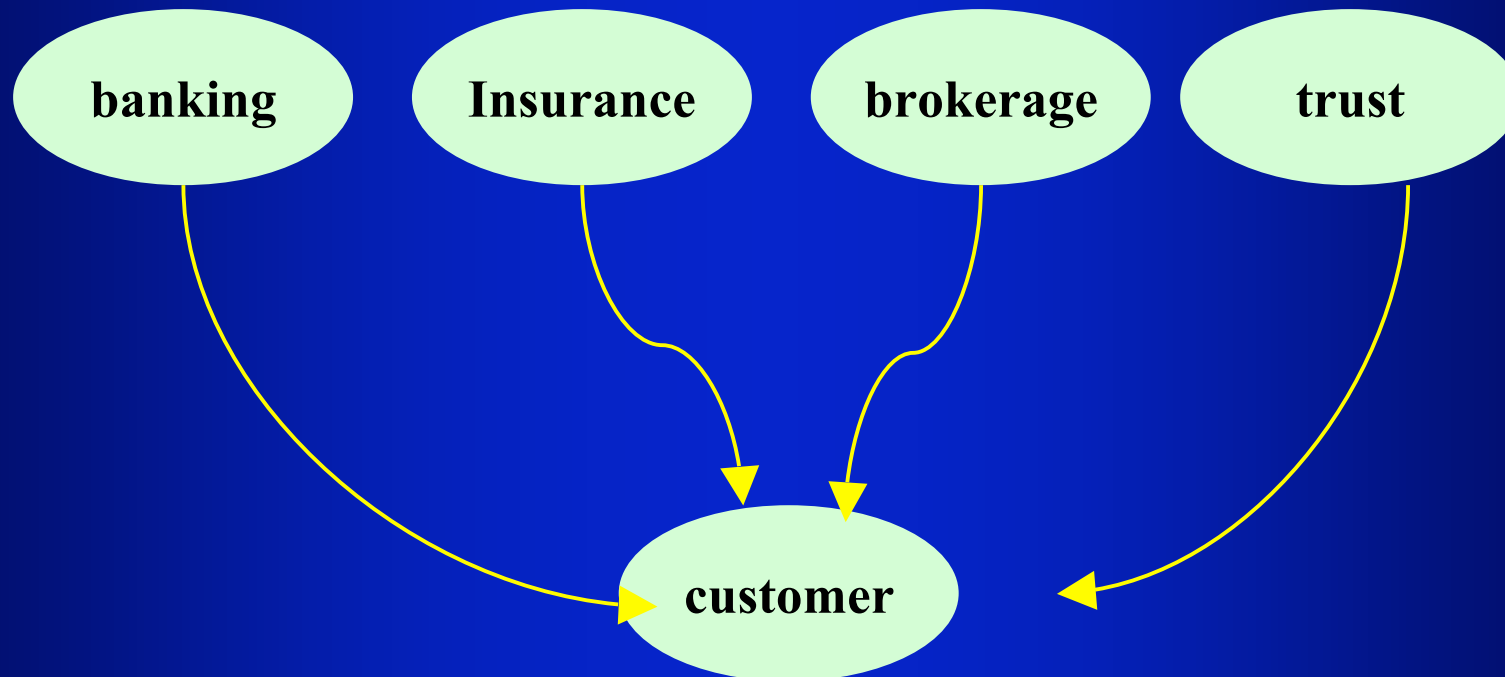
Different Models of Modern Organizations

- There are different styles of Corporate Governance and Structures
 - Arrival of Internet Technology has changed style of communication and information exchange;
 - Web technology strengthens potential for greater transparency and better accountability
 - Web can remove traditional layers of intermediation and wasteful bureaucracy;
 - Information sharing can enhance innovation, creativity and competitiveness
 - But managing new organization requires new skills, knowledge and styles!



Changing structure of banking & finance

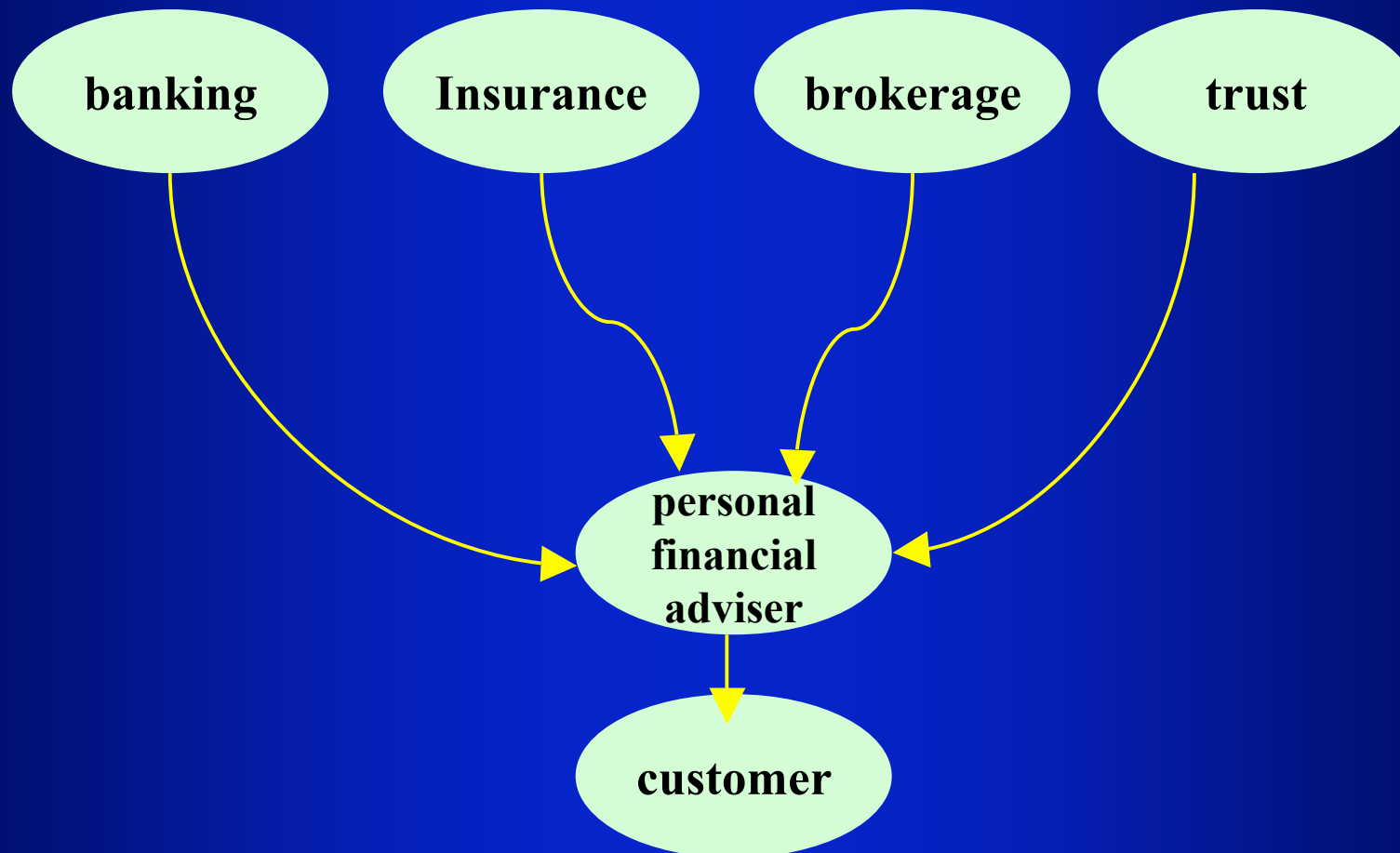
Traditionally, each intermediary operates as a silo they approach the customer independently.





Delivering service through one agent

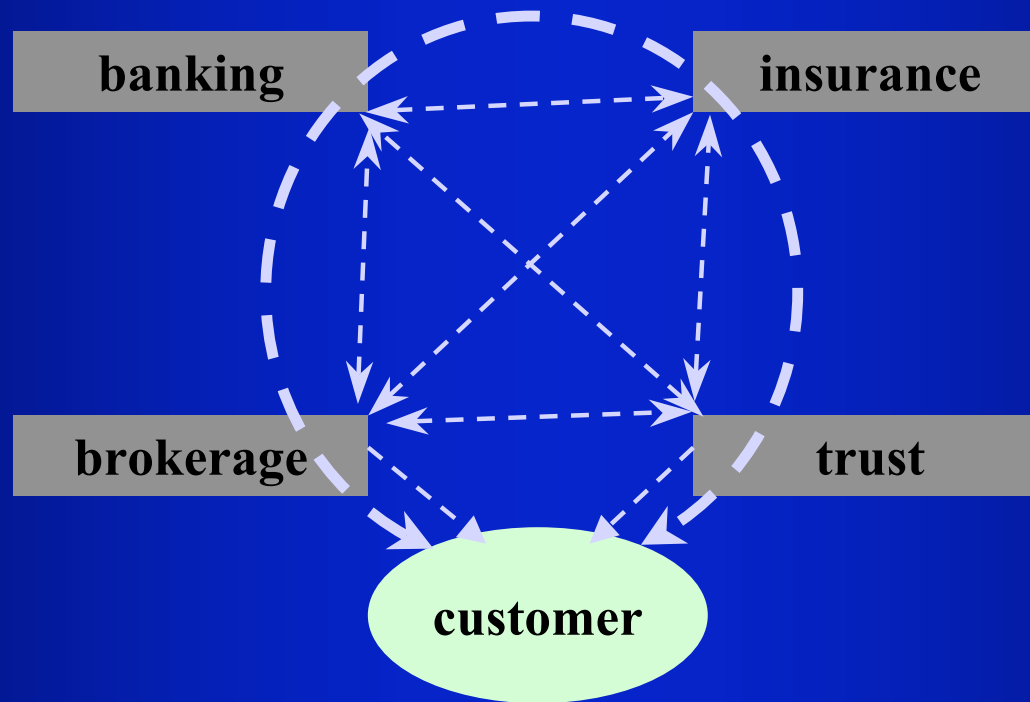
Another strategic option is to approach customer through a single financial adviser - acting as a hub:



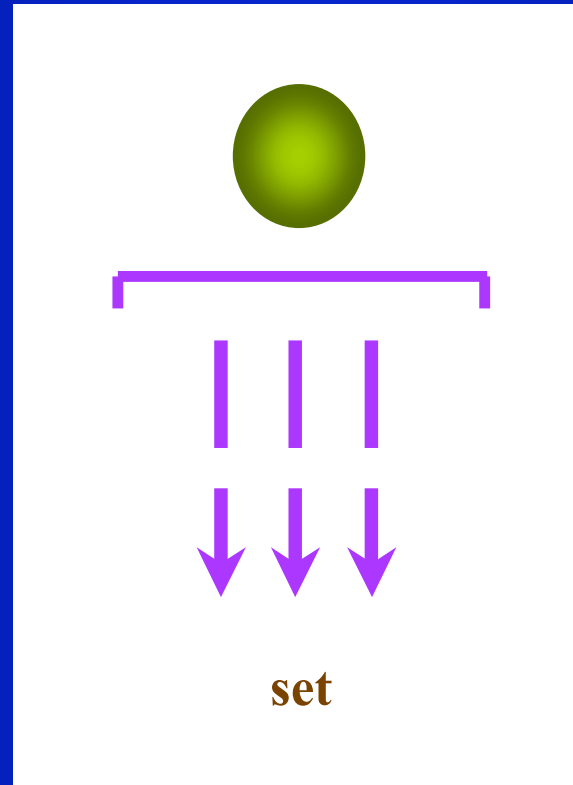


Web-based service delivery

Web technology allows each business division to work cooperatively as a web to provide total service to customers

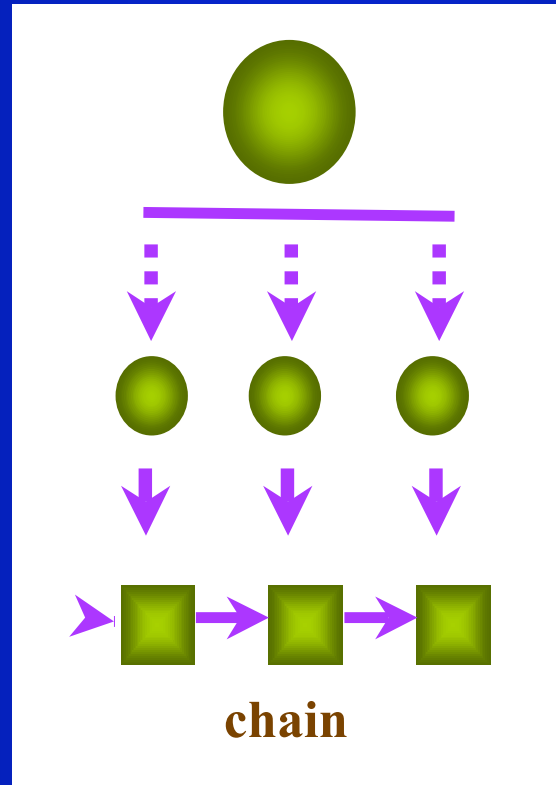


The Four Philosophies of Managing: Allocation



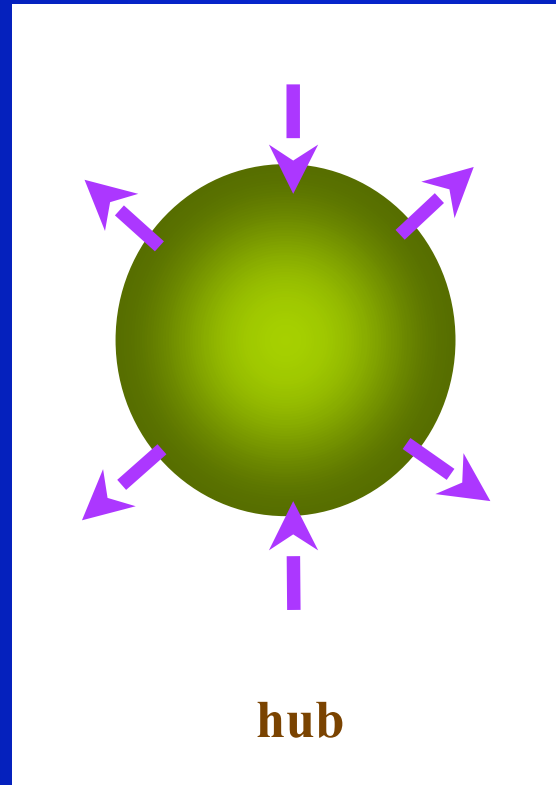
**In the set, managers look
it over - they allocate.**

Managing by Control



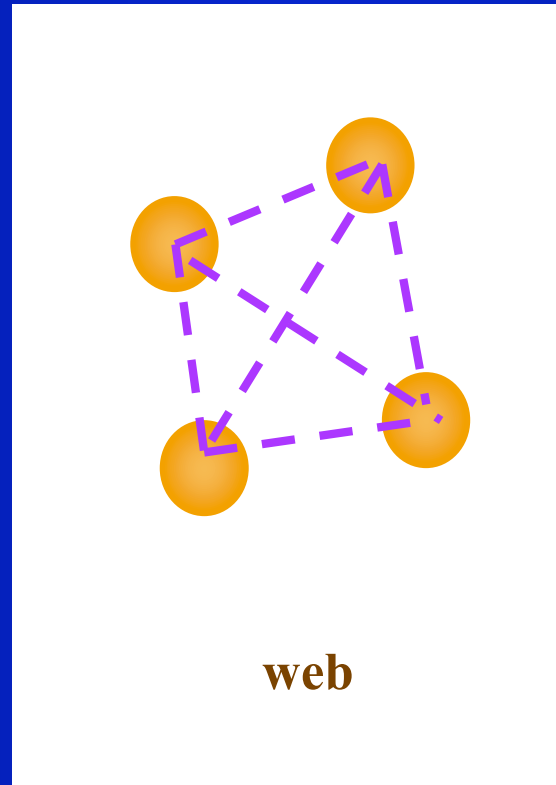
**In the chain, managers lay
it on - they control.**

Managing through coordination



In the hub, managers draw it in, they coordinate.

Managing through Web Energizing structure



**In the web, managers link
it all, they energize.**

THE FIVE PHASES OF GROWTH

