

Asia Pacific Office of the CFA Institute Centre for
Financial Market Integrity

It Pays to Disclose

Bridging the Information Gap
in Executive-Compensation
Disclosures in Asia



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The mission of the CFA Institute Centre for Financial Market Integrity is to be a leading voice on issues of fairness, efficiency, and investor protection in global capital markets and to promote high standards of ethics, integrity, and professional excellence within the investment community.

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Bridging the Information Gap in Executive-Compensation Disclosures in Asia

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A Discussion Paper on Executive-Compensation Disclosure Practices

**Prepared by the Asia Pacific Office of the
CFA Institute Centre for Financial Market Integrity**

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Introduction

For companies in free-market economies, compensation programs form the foundation for not just attracting, retaining, and motivating employees but also aligning management's interests with those of shareowners. On the one hand, a well-designed compensation program can create incentives for executives to generate positive results for all shareowners. On the other hand, a poorly designed program can encourage company executives to make decisions that will generate additional compensation for themselves through short-term boosts in corporate performance rather than to implement strategies that focus on long-term growth.¹ How senior executives are compensated can affect shareowner value, so it is thus in the best interest of shareowners to be aware of and understand how companies link pay to performance.

The ability of shareowners to determine if an alignment of interests exists, however, hinges on the amount and quality of information available and communicated to them. The less investors understand how companies spend their funds, the more likely that abuses will occur and destroy shareowner value. This point continues to be proven with every headline exposing a company that has backdated its stock options, generously paid its chief executive whom it has just terminated, or bought a corporate jet for the personal use of its directors and their families. As such, recent regulatory reforms introduced by some of the world's leading financial markets to stem such damaging incidents have focused on improving the way companies disclose their executive-compensation practices.

As an advocate of fair and efficient capital markets, the CFA Institute Centre for Financial Market Integrity (hereafter the CFA Institute Centre) conducted between July and August 2007 one-on-one discussions with investors and investor-interest groups in Hong Kong, Singapore, and Japan (hereafter the participants) about their views on executive-compensation disclosure in their respective markets.² The three jurisdictions were chosen because they are the more developed and larger capital markets in the region. Many of the regulations and practices in these markets are also reflective of other Asian markets.

The aim of these discussions was to gather a consensus view on what the participants consider to be best practice in executive-compensation disclosure and to gauge their satisfaction on the quality of information provided by listed companies as well as the regulatory provisions governing remuneration disclosure in their relevant markets.

A note on the use of this report: In this report, *executive compensation* refers to the total amount of incentives paid to corporate officers in the form of salaries, bonuses, shares, perquisites, and pension benefits for their executive services. The term is used interchangeably with *remuneration*, *emoluments*, and *pay*. Executive-compensation *practices* refers to the process of setting compensation policy, the actual pay levels, and their disclosure in annual reports. *Senior executives* are the most senior executive officers and directors of listed companies, used interchangeably with *management* and *corporate managers*. *Regulators* are government authorities that set and enforce the rules and regulations, guidelines, and laws for domestic capital markets, including but not limited to stock exchanges and securities and exchange authorities.

¹CFA Institute Centre for Financial Market Integrity, *The Corporate Governance of Listed Companies: A Manual for Investors* (Charlottesville, VA: CFA Institute Centre Publications, March 2005).

²The CFA Institute Centre thanks the individuals and institutions that participated in this report and respects their request to remain anonymous.

Background

The past few years have been very good for senior executives in Asia. Total pay of CEOs of Hong Kong-listed companies rose by 9.7 percent in 2006,³ and three in four CEOs in Singapore's Straits Times Index received higher pay in 2006 than the year before.⁴ In Japan, directors of major corporations were paid 21 percent more in 2006, a further gain from the 15 percent hike they enjoyed in 2005.⁵ In all cases, the substantial increases in senior executives' compensation came alongside higher earnings or improved share-price performance of the companies they managed, which is not surprising because more companies in the region have adopted share-based compensation schemes. At least 90 percent of companies in Singapore and 80 percent in Hong Kong were offering share-based incentives as of 2005, from 70 percent and 50 percent, respectively, in 2001.⁶ In Japan, where the use of stock options only took root in 1997, at least 35 percent of companies offered the scheme in 2005, from 15 percent in 2001.⁷

Unlike in developed markets in the West, however, executive compensation has not been an issue of great concern in the investment community in Asia. Asian corporations—being typically majority owned and controlled by their founding chairmen and members of their families—are understood to have modest pay packages relative to Western standards, to make lesser stock-option grants, and to provide unexceptional perks and end-of-service benefits to key executives and directors. The majority of fund managers approached by the CFA Institute Centre did not view executive compensation as a factor that affects their investment decisions, and some expressed little interest in the subject at all. Almost unanimously, these investors believed that runaway executive compensation does not and is not likely to happen in their respective markets—despite evidence to the contrary.

In Singapore, for example, a real estate investment trust tied the compensation of its chief executive to the price performance of its shares upon initial public offering. With much publicity on the IPO, the CEO pocketed a sure S\$63 million without having to improve the underlying business of the trust. In Hong Kong, a medical equipment maker raised the compensation of its chief executive from HK\$836,000 to HK\$42 million in one year, with no explanation in its financial report for the extraordinary increase and in spite of only a marginal improvement in results. In Taiwan, a technology company introduced a share-based bonus plan that involved granting new shares valued at a deep discount to the current market price of existing shares, resulting in a 20 percent dilution of minority shareowners' ownership.

To be sure, these cases pale in comparison to those that have been reported in the United States and Europe, both in terms of the amounts of money involved and how often they have been exposed. But they also give investors reason to suspect that many more similar cases occur under the radar. A typical annual report—the only filing from which shareowners can glean the compensation practices of listed companies in Asia—will reveal little to no information on how much total pay executives and directors received in the current fiscal year, let alone on a historical basis. Not all senior executives—and in some cases none of them at all—are identified individually; salaries are declared in wide bands in some cases; noncash compensation lacks relevant details; and remuneration policy is almost never explained.

³Watson Wyatt Asia-Pacific, "CEO Pay Opportunity Increases along with Market Capitalization, Watson Wyatt Study Finds" (19 July 2007).

⁴"Leading Firms' Top Execs Get Higher Pay," *Business Times Singapore* (9 April 2007).

⁵"Director Pay Jumps 21% to Y60.3mn in FY06 on Improved Earnings," NikkeiNet Interactive (28 August 2007).

⁶Towers Perrin, "Equity Incentives around the World: The 2005 Study" (http://www.towersperrin.com/tp/getwebcachedoc?webc=HRS/USA/2005/200507/Equity_Report.pdf).

⁷Xu Peng, "Disclosure of Individual Executive Compensation and the Restructuring of Japan's Corporate Governance System," RIETI (Research Institute of Economy, Trade, and Industry; 16 June 2003): http://www.rieti.go.jp/cgj/en/columns/columns_010.htm.

Interestingly, this practice exists and thrives in an environment of light regulation. All executive-compensation guidelines in Singapore—and some in Hong Kong and Japan—are nothing more than recommended best practices set out in corporate governance codes endorsed by local regulators. Compliance is not mandatory, and noncompliance is absolved with the simplest of explanations. Even when the guidelines are incorporated in the listing rules of their stock exchanges, the rules themselves are nonstatutory, and violations carry light punishments, if at all noticed. And regardless of their legal status (in Japan, executive-compensation disclosure is required by law), the quality of information required leaves much to be desired.

A Global Perspective

The following global developments in executive compensation should be a reminder of the importance of disclosure and the role of regulators in preventing corporate pay abuses and promoting better governance of executive remuneration in listed companies.

Cases of Abuse

Following a number of high-profile scandals over the past few years, executive compensation has become a sensitive issue in the world's major financial markets. Early cases involving some of the largest business entities in their jurisdictions have been traced to flaws in the way senior executives were remunerated, and more recent cases put the spotlight directly on whether senior executives were paid far greater amounts than they deserved. In both circumstances, at the root of the problem lies the question of whether executive-compensation tools are being used fairly and are indeed aligned with the long-term interests of shareowners.

United States

In the United States, the collapse of Enron Corporation in 2001 brought to the fore the role of executive compensation in corporate governance. A series of investigations by government authorities revealed that the company committed widespread manipulation of financial accounts, with the goal of keeping its stock price at consistently high levels, potentially leading to multimillion dollar windfalls for its key executives, whose pay packages were substantially composed of share options and thus directly linked to the company's share-price performance.

But it was not until quite recently that executive compensation received more widespread scrutiny and criticism from investors and the media. Beginning early 2006, the *Wall Street Journal* started publishing a series of exclusive reports that found that a number of chief executives of large companies had committed backdating of stock options to increase their gains from this form of share-based compensation.⁸ As of March 2007, about 160 companies were being investigated by the U.S. Securities and Exchange Commission (SEC) and about 70 chief executives resigned or were fired after being implicated in such cases.⁹

Over the same period, generous salaries of chief executives were brought to light from SEC filings and then deemed excessive when cast against the performance of the companies they managed, thus arousing public criticism. In May 2007, the Corporate Library, a corporate governance consultancy, identified 12 companies that it said had overpaid their CEOs, who together received US\$1.2 billion for 2005–2006 despite having brought negative returns to shareowners and underperforming their peers in the 2000–05 period. These companies included retailer The Home Depot, which paid its former CEO Robert Nardelli US\$219.7 million while total shareholder returns declined 17.5 percent, and communications company Verizon Communications, which paid its CEO Ivan Seidenberg US\$192.5 million despite a 7.7 percent decline in returns.

Europe

While having lower remuneration levels compared with the United States,¹⁰ Europe has not been immune to corporate pay debates. In one of the most controversial cases in France this decade, former Vivendi CEO Jean-Marie Messier was taken to court in Paris and New York in 2002 for the €21 million severance pay he obtained from the conglomerate. The furor over

⁸Options backdating is the practice of granting stock options to employees in which the exercise price is set at a date prior to the date of grant, usually when the stock price of the company was significantly lower.

⁹AFL-CIO Executive PayWatch, "Stock Options Backdating and Spring Loading—CEO Pay Run Amok" (2007): <http://www.aflcio.org/corporatewatch/paywatch/stockoptions.cfm#ftnn7>.

¹⁰According to the report "Executive Excess 2007" released by the Institute for Policy Studies and United for a Fair Economy, the 20 highest paid executives in Europe received an average pay of US\$12.5 million in 2006, which is about one-third of the US\$36.4 million average pay received by the top 20 highest paid executives in the United States (see <http://www.ips-dc.org/reports/#84>).

generous exit packages re-emerged in 2007 when Noël Forgeard, co-CEO of Airbus maker EADS, received €8.5 million despite having been pushed out for aircraft delivery delays, prompting French President Nicolas Sarkozy to vow to ban “golden parachutes,”¹¹ or compensation arrangements that provide executives with substantial monetary benefits in the event of a change in control.¹²

Germany witnessed its own pay-related scandal when the country’s highest paid CEO, Josef Ackermann of Deutsche Bank, faced criminal charges for “breach of fiduciary trust” in 2004 for his role in approving what were claimed to be excessive bonuses—to the tune of €57 million—at Mannesmann, a telecommunications company where he was a board member.¹³ In 2007 in Switzerland, Thomas Minder, CEO of Swiss cosmetics company Trybol, collected signatures to push for a national vote to amend laws in favor of his proposals for keeping executive pay in check, such as a binding vote by shareowners on the total compensation of corporate management and supervisory and advisory boards as well as a ban on golden parachutes.¹⁴

Australia

Like at Enron, management-reward mechanisms were found to be at the core of the largest corporate collapse in Australian history. Following a series of acquisitions and massive financial losses, HIH Insurance was liquidated in 2001. Its former CEO, Rodney Adler, was found guilty of disseminating false or misleading information, dishonesty, and failure to discharge his duties as a director—all with the goal of propping up the stock price of the financially ailing company. A government investigation on the case concluded that a review of disclosure rules in Australia was in order so as to “achieve clear and comprehensive disclosure of all remuneration or other benefits paid to directors in whatever form.”¹⁵

Prior to the HIH Insurance collapse, the joint CEOs of telecommunications company One.Tel received public outcry after they paid themselves A\$6.9 million in bonuses that were tied to the market capitalization of the company. It was later discovered that the company hid more than A\$1.2 billion in debt from investors, and the company was deemed insolvent in May 2001.¹⁶

Regulatory Responses

Without doubt, many of the just-mentioned cases caused substantial financial losses to investors, who saw the value of their shares in the affected companies wiped out. In the case of Enron and HIH Insurance, they are also believed to have caused profound damage to investor confidence in financial markets in general. To help restore market integrity, regulators in their respective jurisdictions responded unanimously with strengthening corporate audit and disclosure rules, including provisions for executive compensation. In the process of introducing these reforms, regulators have acknowledged that poor alignment of management incentives with the long-term interests of shareowners was a major factor in lapses in corporate governance.

¹¹“Pay Slips,” *Economist* (21 June 2007): http://www.economist.com/opinion/displaystory.cfm?story_id=9366290.

¹²Lucian Bebchuk, Alma Cohen, and Allen Ferrell, “What Matters in Corporate Governance?” Harvard Law School John M. Olin Center Discussion Paper No. 491 (September 2004).

¹³Sarah Anderson, “CEO Pay Debate Spans the Atlantic,” *Asia Times Online* (31 August 2007): http://www.atimes.com/atimes/Global_Economy/IH31Dj02.html.

¹⁴“Minder’s Mission,” *Economist* (21 June 2007): http://www.economist.com/business/displaystory.cfm?story_id=9370567#top.

¹⁵“The Failure of HIH Insurance,” HIH Royal Commission (April 2003): <http://www.hihroyalcom.gov.au/finalreport/index.htm>.

¹⁶“Down and Dirty Down Under,” *Wall Street Journal—Asia* (19 June 2001).

The European Commission, for example, introduced guidelines in 2004 to promote convergence within the European Union toward best practices in director compensation.¹⁷ The commission stated that “remuneration is one of the key areas where executive directors may have a conflict of interest,” and as such, “remuneration systems should be subjected to appropriate governance controls based on adequate information rights.”¹⁸ To this end, the commission recommended that publicly listed companies communicate to shareowners a clear and comprehensive overview of their remuneration policy and disclose director remuneration on an individual basis.¹⁹ Countries that did not already have such provisions are taking notice. In 2006, Germany introduced a new law starting in 2007 requiring the disclosure of salaries of individual managers and supervisory board members.²⁰

In Australia, the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (CLERP 9) requires listed companies to disclose details of executive and director remuneration in annual reports—including a discussion of board policy for determining remuneration—as well as detailed information on the link between pay and corporate performance.²¹ CLERP 9 likewise requires a nonbinding, advisory vote by shareowners on director-remuneration reports of listed companies in annual general meetings and even requires chairmen of the board to give opportunities for shareowners to express their opinions on the report.²² The shareowner vote requirement takes after similar legislation in the United Kingdom (Section 241A of the Companies Act) that pioneered the provision in 2002 in spite of the absence of high-profile executive-compensation abuses in that market.

But the most sweeping reforms introduced by a regulator in any jurisdiction were no doubt those approved by the SEC in 2006—the first amendments to the laws relating to the disclosure of executive compensation by public companies since 1992—which effectively address one of the most conspicuously missing items in the Sarbanes–Oxley Act of 2002. The new rules are intended to make it easier for investors to find in corporate annual reports the total amount of compensation received by senior executives and directors, including a single figure that encompasses all elements of compensation.

Among the most important requirements of the new rules are (1) a compensation discussion and analysis section, which is a narrative description of a company’s most significant compensation policies and decisions; (2) a summary compensation table, which contains information, in dollar values, on individual executives’ total compensation (salary, bonus, stock awards, option awards, nonstock incentives, and all other compensation, including perquisites); and (3) a narrative disclosure of change-in-control and severance payments. The rules, the SEC argues, ensure that investors and compensation committees of corporate boards can access all the information they need to reach their own conclusions about executive compensation—whether, for example, they are aligned with corporate performance and whether pay levels are appropriate.²³

¹⁷Eugenia Unanyants-Jackson, *Directors’ Remuneration: A Pan-European Perspective*, (Witham, Essex, U.K.: Manifest Information Services, June 2006):11.

¹⁸Ibid.

¹⁹Ibid.

²⁰DSW (Deutsche Schutzvereinigung für Wertpapierbesitz e.V.), “DSW Newsletter” (November 2006): <http://www.dsw-info.de/uploads/media/Newsletter10.pdf>.

²¹Jennifer Hill, “Regulating Executive Remuneration: International Developments in the Post-Scandal Era,” Vanderbilt Law and Economics Research Paper No. 06-15 (2006):12–13.

²²Ibid.:16.

²³U.S. SEC Chairman Christopher Cox, “Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules” (17 January 2006): <http://www.sec.gov/news/speech/spch011706cc.htm>.

The Case for Better Disclosure in Asia

As the Asian business environment continues to progress and companies increasingly use performance-based pay schemes, investors—in particular minority shareowners—can benefit from a disclosure-based regime, one that recognizes their right to know if corporate managers are being paid fairly, justifiably, and according to performance. That Asian companies are different from Western counterparts in share-ownership structure should not instill complacency in monitoring their compensation practices. On the contrary, greater vigilance is imperative, given their traditionally weak governance systems. The rest of the developed world has moved toward a disclosure-based regime, having learned lessons from a series of headline-grabbing cases of excessive compensation. Asia should not wait for its own scandals to break out before remembering that discipline in disclosure pays.

What Investors Know

Participants in this report agree that the likelihood of executive compensation abuses in Asia reaching the same level of excess as seen in the United States or Europe is slim, citing three reasons.

First, Asian companies are generally smaller in size based on sales, earnings, and market capitalization. On the 2007 *Fortune 500* list of the world's biggest companies by revenues, only 120 are from Asia, including 67 from Japan, 2 from Hong Kong, and 1 from Singapore. Of the 50 most profitable on the list, only 5 are from the region.²⁴ Furthermore, the average market capitalization of companies in the Russell Asia Pacific Index, which tracks the 10 largest holdings in five markets in the region, was US\$31.44 billion as of 31 July 2007—half the average market size of companies in the Russell Global Index.²⁵ These figures mean that in terms of cash flow and capitalization, Asian companies have a much lower ceiling from which executive remuneration can be drawn and based upon.

Second, outside China and Japan, a large number of companies in Asia have the distinction of being majority owned and controlled by members of their founding families, who are believed to set moderate pay packages for themselves and instead derive their compensation from dividends. All investors that the CFA Institute Centre spoke with pointed to the same example to demonstrate this point: Li Ka-Shing, chairman of Hong Kong conglomerate Hutchison Whampoa Limited. In 2006, Li, Asia's wealthiest man, received HK\$50,000 in taxable income as director of the company and more than HK\$3.8 billion in tax-free dividends from his 51.8 percent ownership in the company.²⁶ Investors also argued that the use of stock options as an incentive to senior executives who are not family members and employees in general is very limited among so-called business dynasties in Asia. The reason: awarding them would only dilute the family's ownership.

Third, in Japan, investors agree that senior executives receive salaries that are only a few multiples higher than those of ordinary employees for cultural and structural reasons. A study that calculated the earnings of senior executives using their tax records—in the absence of individual remuneration data in annual reports—showed their average income to be one-third that of U.S. counterparts.²⁷ Unlike the rest of East Asia, Japanese companies are not typically controlled by a single powerful shareowner but by a group of business entities that they have cross-shareholding arrangements with. Organizations are also known to operate

²⁴The full list can be found at http://money.cnn.com/magazines/fortune/fortune500/2007/full_list/index.html.

²⁵Details of the indices are available at <http://www.russell.com/indexes>.

²⁶In its fiscal year ending December 2006, Hutchison Whampoa declared a dividend of HK\$1.73 per share on net profit of HK\$20 billion. Li Ka-Shing owns 2.2 billion shares in the company.

²⁷Minoru Nakazato, J. Mark Ramseyer, Eric B. Rasmusen, "Executive Compensation in Japan: Estimating Levels and Determinants from Tax Records," Harvard Law and Economics Discussion Paper No. 567 (December 2006).

based on seniority, and the promise of lifetime employment is a given. As such, a typical chief executive is more likely to have risen from the ranks than to be recruited from an outside organization. This practice spares companies the costs of poaching for talent, which, in turn, keeps executive pay levels in check.

Information Gap

Although these reasons remain valid, the CFA Institute Centre believes that the main reason executive compensation has received little attention in Asia has been overlooked—a chasm of uncertainty separates what investors perceive to be true and how listed companies actually remunerate their executives and directors. What investors know is largely based on general assumptions; what companies do in practice may not be reported comprehensively. Relative to international best practice, Asian listed companies disclose little about their remuneration arrangements, thanks to a confluence of three factors: weak disclosure requirements in their respective markets, investors' lack of initiative to demand better information, and as a result of both, a lack of incentives for companies to do better.

What results is a situation that ultimately puts investors at a disadvantage. Investors, after all, bear the responsibility of looking after their and their clients' interests. The CFA Institute Centre highlights the following weaknesses in the executive-compensation regime in Asia. These weaknesses may, on the one hand, render investors prone to a misalignment of management and shareowner interests and, on the other hand, expose the capital markets in general to potential risks of high-profile pay abuses in the future.

Lack of Regulatory Push

In Asia, the existing disclosure regimes do not foster an environment that allows investors, analysts, and the media to freely, easily, and comprehensively scrutinize the executive-compensation levels and practices of listed companies. The existing guidelines for disclosure were updated as recently as 2004 for Hong Kong and 2005 for Singapore and Japan. Executive-compensation disclosure is not a statutory requirement in either Hong Kong or Singapore.

In Hong Kong, provisions on executive-compensation arrangements are embodied in Appendix 16—Financial Disclosure of the Listing Rules of the Hong Kong Exchange (HKEx), supplemented in 2004 by Appendix 14—Code on Corporate Governance Practices.²⁸ The former lists the pay components that need to be reported both for directors and executives who are not already directors, and the latter sets the role of compensation committees in developing pay policies. Compliance to the code is not mandatory but on a “comply or explain” basis, and the Listing Rules are not statutory, which gives the HKEx limited powers to enforce market discipline. Although it has contractual powers to require listed companies to cooperate, the range of disciplinary measures available to it in relation to breaches is confined to public censure, statements of criticism, and disqualification of individuals as directors.²⁹

In Singapore, executive-compensation provisions fall outside the Listing Manual but in the nonmandatory Code of Corporate Governance, drafted by the Council on Corporate Disclosure and Governance, an agency under the Ministry of Finance. The Singapore Exchange (SGX) promulgated the code in 2001, adding an item in Chapter 7 of the Listing

²⁸Each section of the Code on Corporate Governance Practices of the Hong Kong Exchange Listing Rules sets out one general principle and two tiers of guidelines. The first-tier Code Provisions are expected standards of board practices, and the second-tier Recommended Best Practices are simply encouraged. In both cases, compliance is not mandatory. However, the HKEx has adopted a “comply or explain” approach for the Code Provisions, whereas it only encourages companies to explain deviations from the Recommended Best Practices.

²⁹“Submission of HKEx in Response to the Consultation Document on Proposals to Enhance the Regulation of Listing in Hong Kong,” Hong Kong Exchanges and Clearing Limited (14 January 2004): <http://www.hkex.com.hk/news/hkexnews/040114news.pdf>.

Manual that requires companies to describe their adherence to code provisions.³⁰ Compliance, however, is voluntary.³¹ And the listing rules are not statutory. A violation of listing rules does not lead to a fine; instead, the SGX uses milder forms of punishment, such as reprimands.

Both regulatory regimes stand in stark contrast to the United States, United Kingdom, and Japan, where executive-pay disclosure is mandatory under national laws, with corresponding sanctions in cases of noncompliance, such as fines. Companies listed in Britain have to abide by provisions in three chapters of the Companies Law; those in Japan have to comply with either the Companies Law or the newly implemented Financial Instruments and Exchanges Law. In the United States, disclosure is a requirement of several SEC rules and regulations. Those governing annual proxy statements and other SEC filings are largely found in Item 402 of Regulation S-K.

What investors are saying:

“As long as disclosure remains nonprescriptive, you can say confidently that it’s not going to have any favorable impact. People are going to be shy of disclosing. In Asia, many owner-managers forget that they took their companies public to solicit funds, and they’re using those funds to pay themselves. How detrimental is it to shareholders? It is detrimental when you don’t make profit and you pay yourself high salaries.”

Inadequate Information

Participants agree that regardless of the legal status of provisions on executive-compensation arrangements in Hong Kong, Singapore, and Japan, the quality and quantity of information sought by regulators and furnished by companies can be improved. Following are some of the most often cited inadequacies in the remuneration reports of companies listed in the three markets.

Poor presentation

In Hong Kong, companies lack uniformity in disclosing their executive-compensation arrangements. In some annual reports, the information may be found in the notes to the accounts, and in others, under the Corporate Governance Report section. In either case, details about share options as compensation are absent; instead, they are found in either the Directors’ Report section or in the accounts notes. In Japan, the corporate governance code of the Tokyo Stock Exchange gives companies the choice to report them under the Securities Report, Earnings Digest, or Sales (Business) Report section of annual reports. In Singapore, they are included in the Corporate Governance Report section. Hong Kong’s strength lies in its relatively clearer guidelines on how pay components are reported, whereas Singapore and Japan suffer from nonspecific provisions, giving companies the liberty to disclose selectively. In effect, the presentation of compensation arrangements in Asia is not investor friendly.

In the United States, executive-compensation disclosure is now accorded the same status as financial disclosure and business performance reviews. Following the new rules that took effect in 2007, companies are required to add a Compensation Disclosure and Analysis (CD&A) section in annual reports and proxy and registration statements that addresses the objectives and implementation of compensation programs. This discussion is followed by a tabular and narrative disclosure of current and historical compensation, equity-related interests, and other

³⁰Paragraph 710 in Chapter 7—Continuing Obligations of the Singapore Exchange Listing Manual states that, “An issuer must describe its corporate governance practices with specific reference to the principles of the Code in its annual report. It must disclose any deviation from any guideline of the Code together with an appropriate explanation for such deviation in the annual report.”

³¹Mak Yuen Teen, “Improving the Implementation of Corporate Governance Practices in Singapore,” Monetary Authority of Singapore and Singapore Exchange (26 June 2007): http://www.acga-asia.org/public/files/MAS_SGX_CG_Study_Executive_Summary_260607.pdf.

items, such as retirement and post-employment benefits. In the United Kingdom, companies are required to furnish their annual reports with a Directors' Remuneration Report in the notes to annual accounts that consists of four parts, including detailed information on remuneration committees and directors' remuneration as well as interpretative and supplementary provisions.

Identity of executives and directors

Although Asian markets have different guidelines on identifying executives and directors in remuneration reports, participants agree on one common ground: They all fall short of the best practice of reporting the compensation of executives on an individual basis, as practiced in the United States, United Kingdom, and Australia and as advocated by institutional investors worldwide. The current practice in Asia deprives shareowners of their right to know how much of the corporate funds they helped build are going to the individuals whom they have entrusted to run the business. It also turns a blind eye on individual accountability.

In Singapore, prior to adopting its corporate governance code, the SGX acknowledged that disclosure on an individual basis is in-line with global best practice and that shareowners have the right to know how directors are compensated. This awareness, however, failed to translate into policy because of considerations for directors' personal privacy and concerns that individual disclosure might lead to an inflation of directors' remuneration.³²

As such, companies are now required to identify directors and key executives based only on the range of their pay levels in bands of S\$250,000. This is a loose requirement; in some cases, companies have a ceiling to the bands, opting to disclose in such terms as "above S\$500,000." Individual disclosure of pay details is a recommended best practice for directors but not for executives who are not also directors. In Hong Kong, companies are required to disclose remuneration of directors on an individual basis, but for the five highest paid nondirector executives, they are required to disclose on an aggregated basis. In Japan, companies with the traditional statutory auditor board structure are not required to disclose the names of either directors or executives, although the few that have adopted the newly introduced committee system are.³³

What investors are saying:

"Companies say that for competitive reasons, they can't give information about certain employees' remuneration. That seems reasonable, but then again, any good human-resource consultant will be able to tell you what, for example, is the median, high-end, and low-end pay for a CFO position in any given industry. If a headhunter is determined enough, he will be able to poach anyone regardless of whether his salary is disclosed in an annual report or not."

"Disclosure in bands doesn't really help. What is 'above \$1 million'? It could be S\$10 million, in which case it's probably too much."

³²"Report of the Committee and Code of Corporate Governance," Corporate Governance Committee of the Singapore Exchange (21 March 2001): http://www.mas.gov.sg/resource/publications/consult_papers/corfinalrpt.pdf.

³³Unlike in most developed markets, large listed companies in Japan have two options with regards to the structure of their board of directors. Under the traditional statutory auditor system, the board is made up of representative directors and executive directors—all of whom serve as corporate executives. (Representative directors represent the company to stakeholders, and executive directors execute the strategies decided by the board.) Corporate auditors, chosen from outside the board, are then put in charge of auditing the performance of directors. This system was strengthened in 2003, when companies were required to have at least three corporate auditors, at least half of whom must be independent. Nonetheless, auditors have limited vetting powers; the system is traditionally dominated by insiders and is conducted by mutual monitoring. Also in 2003, Japan introduced the committee system used in the United States, where a board of directors oversees management and with audit, nomination, and compensation committees. As of 2007, fewer than 100 of more than 2,000 companies in the Tokyo Stock Exchange had adopted this structure.

Total compensation and breakdown of components

Executive compensation affects shareholder returns in many ways. The proportion of fixed and variable amounts in a pay package can influence an executive's business decisions and risk tolerance. Fixed salaries and cash bonuses are a direct cost to corporate funds, as are perquisites, or perks—from housing and car allowances to loan windows and private air travel for senior executives and their families. Where the value of any of these is perceived to be excessive or unjustified, it may present a reputation risk for the company through negative media coverage. Given executive compensation's obvious impact on returns, participants believe that investors should be able to know the totality and makeup of senior managers' total compensation. However, apart from the fact that executives are only selectively identified, Asian companies do not provide either a single figure of exact total compensation or a breakdown of its components.

In Singapore, the corporate governance code calls on companies to break down total compensation into fixed salaries, bonuses, benefits in kind, stock options, and other long-term incentives—but only as a percentage of an inexact amount (bands of S\$250,000). In Japan, a breakdown is not required at all. In Hong Kong, the Listing Rules come close to international best practice by requiring disclosure of six key pay components—namely, basic salaries, allowances, and benefits in kind; pension scheme contributions; performance bonuses; signing bonuses; end-of-service benefits; and directors' fees. One item missing is share-based compensation, although the absence of a minimum amount for allowances and benefits opens a loophole for companies to disclose perks selectively. This breakdown is also only required for directors, and not nondirector executives.

As such, anyone who wishes to determine corporate managers' pay components has to look beyond annual reports to come up with even ballpark amounts. In contrast, other major markets have clear-cut rules and guidelines on the presentation of executive compensation. In the United Kingdom, Part 3 of the Directors' Remuneration Report requires extensive amounts of information, including salaries, bonuses, allowances, and benefits in kind; share options; long-term incentive schemes; pensions; excess retirement benefits; and even compensation of past directors. One interesting provision of these requirements is that allowances are to be disclosed as long as they are chargeable to income taxes. The nature of any noncash benefits is also to be disclosed.³⁴

The United States has an equally extensive set of disclosure requirements. One of its most unique aspects is a summary compensation table, which serves as a one-stop source of information on executives' pay, including a single amount that sums up every type of compensation they received. As prescribed by the SEC, the summary compensation table—applicable to all named executive officers and relevant to the three most recently completed financial years—should contain the following columns: (1) name and principal position, (2) year, (3) total compensation, (4) salary, (5) bonus, (6) stock awards, (7) option awards, (8) nonstock incentive plan compensation, and (9) all other compensation, including perks valued at a minimum of US\$10,000.

What investors are saying:

"In Asia, what annual reports say about total remuneration is always a big question. That's where better disclosure comes in—to get a better sense of what managers are truly paid. One of the things we want to know is what is a director's total remuneration as a percentage of normalized profits. If it's close to 10 percent, we're going to have to question if he truly deserves it."

³⁴“Statutory Instrument 2002 No. 1986: The Directors' Remuneration Report Regulations 2002,” Office of Public Sector Information, U.K. (<http://www.opsi.gov.uk/si/si2002/20021986.htm>).

Share-based compensation

Share-based compensation is almost universally accepted as the most powerful tool for aligning managers' and shareowners' interests, whether in the form of stock options, restricted shares, or other long-term incentive plans. In principle, executives who also own shares in a company are more likely to manage the business with the view of enhancing the value of the shares, not only for their own obvious benefit but also for other shareowners'. Although stock options incrementally dilute ownership, investors approve of them in the hope that they will encourage senior executives to think and act like long-term shareowners. Problems arise, however, when share schemes induce some executives to "manage for the short term"—or to pursue strategies that will cause a short-term spike in the share price regardless of their long-term impact to the business. As such, it has become crucial for investors to be aware of the terms of share-based compensation, such as vesting schedules.

But even as share-based compensation is gaining popularity in Asia, guidelines on disclosure of its usage have not caught up, and they remain weaker compared with international best practice. In Hong Kong, remuneration arrangements as reported according to Appendix 16 of the Listing Rules make no mention of any form of share-based payments. In Singapore, they are reported under the Corporate Governance Report only as a percentage of total pay. In both markets, stock options of a certain minimum value awarded to executives are disclosed individually, with details on the number of options and their granting, vesting, and exercise schedules. Oddly, they are separated from the remuneration report and may instead be found under the Share Options section of the Directors' Report. In both cases, no disclosure provisions are made for share-based payments other than options.

In Japan—where share-based compensation remains a small portion of executive compensation and is almost exclusively in the form of stock options³⁵—disclosures are made in the Business Report section. Individual disclosure is not required—simply the number of directors, outside directors, and executives who received them. As such, most other details disclosed are clearly insufficient.

These requirements are less transparent compared with the United States and Britain, where extensive disclosure rules are applied and strictly enforced. In the United Kingdom, for example, the level of detail required in a Directors' Remuneration Report goes down to information on options that have been awarded and exercised, that have expired unexercised, and whose terms and conditions have been amended. In the United States, the new rules require two equity-based compensation tables: one on outstanding equity awards for each named executive officer, representing potential amounts the executive may receive in the future, and another on option exercises and stock vested, showing amounts actually realized on equity compensation during the past year.

In May 2007, the SGX sought public consultation on its proposed rule that would require companies to immediately announce any grant of share options to employees, with details on the following items: (1) the number of options granted; (2) the date of grant; (3) their exercise period; (4) the market price of the underlying securities on the date of grant; (5) the number of options granted to directors and controlling shareowners, if any; and (6) the validity period of the options. In its consultation paper, the SGX stated that the goal for the proposal is to prevent backdating of stock options.³⁶ The CFA Institute Centre viewed the proposal as a step in the right direction and recommended that the same information (and a few items the Centre suggested) be disclosed in annual reports.

³⁵Citing a 2005 Towers Perrin study in a 2007 presentation, Kathy Matsui, chief Japan strategist at Goldman Sachs in Tokyo, broke down the compensation of Japan's CEOs as follows: bonuses 8.1 percent, stock options 14.1 percent, benefits 21.4 percent, and base salary 56.4 percent. Towers Perrin's "Equity Incentives around the World: The 2005 Study" (see footnote 6) says 35 percent of companies in Japan have adopted stock options.

³⁶"Consultation on Proposed Amendments to the Listing Rules," Singapore Exchange (10 May 2007): http://info.sgx.com/SGXWeb_RMR.nsf/NEWDOCNAME/PC_100507.

Remuneration policy

To be sure, Asian regulators are aware of and advocate known best practices in setting executive and director remuneration. In Hong Kong and Singapore, corporate governance codes promote formal and transparent procedures for setting pay policy as well as the pay packages of individual directors. They also stipulate that remuneration levels should be competitive enough to attract and retain directors, but not more than necessary. More importantly, both encourage linking a substantial amount of executive directors' remuneration with long-term performance-related measures. Provisions on how to disclose remuneration policy, however, lack guidance on structure or content, leaving room for companies to provide only cursory information of little use to investors.

In Hong Kong, the Listing Rules require companies to provide a "general description" of their pay policy and long-term incentive schemes, as well as how directors' pay is determined. The Singapore code, in contrast, simply states the principle that companies "should provide clear disclosure of remuneration policy, level and mix of remuneration, and the procedure for setting remuneration in (their) annual report." In both markets, no specific provisions are made for disclosure of how share-based pay schemes were determined. Once again, Japan has a different approach. Companies with a committee-style board system are required to disclose executive-compensation policy in the Business Report, whereas those with the traditional statutory auditor system are not.

Not surprisingly, companies have taken advantage of these nonspecific provisions to provide vague descriptions of their pay arrangements. A study commissioned in 2007 by the SGX and MAS³⁷ found that 74 percent of companies listed in the main board did not disclose their procedure for setting remuneration, and 73 percent did not disclose the performance measures used. For companies listed in the secondary board, the figures are 93 percent and 70 percent, respectively. The study also found that the "comply or explain" spirit of the corporate governance code is often disregarded.

The importance of disclosure of remuneration policy cannot be understated. It is the section in annual reports from which investors can analyze how, or if, companies indeed link executive pay to performance. A thoughtful remuneration statement should explain the importance of variable and nonvariable components of directors' remuneration, explain the performance criteria that form the basis of entitlement to share options and other variable pay components, identify the parameters for bonus schemes and noncash benefits, and explain the rationale for these parameters.³⁸ To reassure that the policies were set independently, the remuneration statement should also discuss the mandate and composition of the remuneration committee, as well as include the names of external consultants whose services were used in determining remuneration policy.

How do Asian regulations compare with U.K. and U.S. requirements? In the United Kingdom, the Statement of Remuneration Policy comes under Part 2 of the Directors' Remuneration Reports for the current and subsequent financial years. Extensive details are required, including the performance conditions for entitlement to share options and long-term incentive schemes, the method for calculating how these conditions are met, and an explanation of why these conditions and calculation methods were chosen. In the United States, the policy statement falls under the CD&A section of regulatory filings, addressing the objectives of the company's compensation program, the elements of executive pay, the

³⁷ Mak Yuen Teen (see footnote 30).

³⁸ Eugenia Unanyants-Jackson, *Directors' Remuneration: A Pan-European Perspective*, (Witham, Essex, U.K.: Manifest Information Services, June 2006):18.

most important factors considered in determining compensation types and amounts, and how these factors achieve the stated objectives.³⁹

The following is an amalgam of three different remuneration-policy statements taken from randomly selected annual reports. It represents the extent of what is typically disclosed by listed companies in Hong Kong, Singapore, and Japan:

“The basis of determining the emoluments payable to directors and senior management is by reference to the level of emoluments normally granted by a listed company to directors and senior executives of comparable caliber and job responsibilities so as to ensure a fair and competitive remuneration package as is fit and appropriate. The remuneration policy for executive directors and senior management staff consists of both a fixed and variable component. The fixed component includes salary, pension fund contributions, and other allowances. The variable component comprises a performance-based bonus that is payable on achievement of individual and corporate performance targets. The remuneration of directors is thus generally fixed, but the performance-linked bonus for executive officers is decided based on the company’s and an individual’s personal performance.”

Given Asian companies’ cursory remuneration-policy statements—coupled with the lack of information on individual directors’ and executives’ remunerations, inadequate breakdown of remuneration components, and little disclosure on share-based compensation—shareowners are left blindsided as to how, or if, companies link executive compensation to relevant performance measures. They are thus unable to determine if corporate managers are paid fairly and justifiably.

No Pay for Performance

One of the factors that contributes to the lack of alignment of management’s and investors’ interests in Asia is that very few companies adopt pay-for-performance or long-term incentive (LTI) plans. Unlike stock options, LTI plans involve the granting of shares to senior executives, but only after a certain period of service (restricted stock) and/or after certain performance targets have been met (performance shares). Given that the share awards are deferred, LTI schemes are supposed to encourage directors to pursue strategies that would build corporate value over time. The adoption of these schemes is still in its nascent stage, at least compared with stock options.⁴⁰ Towers Perrin cites that the United Kingdom, the Netherlands, and Australia are global leaders in the use of performance shares as long-term incentives, with 60 percent, 55 percent, and 40 percent of listed companies, respectively, having implemented them. (Restricted stocks are much less widely used globally, peaking at 35 percent in the United States and 30 percent in Switzerland.) In Asia, the proportion is significantly lower. As of 2005, for example, only a quarter of companies listed in Singapore had implemented performance shares, versus a fifth in Hong Kong and none in Japan.

Asian regulators are aware of the benefits of pay for performance. In Singapore, the corporate governance code states that LTI schemes are “generally encouraged.” It suggests that both stock options and grants vest over a period of time, that only a portion of benefits be exercised each year, and that directors hold their shares beyond the vesting period. In some cases, however, structural factors hinder the widespread adoption of pay-for-performance plans. In Hong Kong, the Listing Rules have no provisions for equity incentives apart from options. Companies wishing to issue full-value shares to executive directors are unable to do so without a special waiver from the Hong Kong Exchange. This process can take several months and can be costly because of legal and other advisory fees.⁴¹ In Japan, where stock options were legalized only in 1997, none of the current securities or tax regulations address the use of share grants.

³⁹ Goodwin Procter, “Client Alert: SEC Votes to Propose Sweeping Changes to Compensation Disclosure Rules” (27 January 2006).

⁴⁰ According to Towers Perrin’s “Equity Incentives around the World: The 2005 Study” (see footnote 6), stock options are used by at least 80 percent of companies in the United States, United Kingdom, Australia, France, Canada, and Germany; 75 percent in Singapore; 55 percent in Hong Kong; and 35 percent in Japan.

⁴¹ Interview with Watson Wyatt Greater China (14 August 2007).

This lack of awareness has been demonstrated by cases of questionable execution of performance-linked schemes. In Singapore in 2007, a real estate investment trust was criticized by investors after it reported a net loss of S\$52.3 million for the period between its listing and the end of its fiscal year because it paid its managers S\$63 million in performance fees, which were partly tied to its share price out-performance of a certain index. The company's CEO justified that the fees resulted from substantial out-performance, adding "we could not have forecasted the performance fee and how the structure of this fee aligns our interests with those of our unitholders."⁴² Participants also cited a case in 2003 in which a technology company granted options—equivalent to 4.1 percent of outstanding shares—to its managers and employees at a 98 percent discount to market price. Apart from dilution, the scheme harmed minority shareowners because local accounting rules required the expensing of share bonuses at par value, which wiped out the company's profits.⁴³

What investors are saying:

"We are against any performance measure that has no connection to operations. It is totally unacceptable to pay your managers according to share performance. The market euphoria has got nothing to do with your performance."

"We want disclosure not only of the total remuneration package but also the benchmarks that executives and directors are evaluated against. An annual report can declare that the remuneration is performance based, but what qualifies as performance? Is selling off an asset that previous management bought at a profit performance? Is revaluation performance?"

Poor Oversight

Apart from light regulation and little investor vigilance, the most significant factor that renders Asian companies prone to pay abuses and misalignment of management's and shareowners' interests is poor oversight by the board of directors, owing to their perceived lack of independence.

In most organizations globally, boards exist to improve governance and make sure that management decisions are made without conflicts of interest. For listed companies, boards are expected to perform at least three crucial functions—monitor the business activities of the company, help select the chief executive and senior officers, and set the remuneration and incentives of the management team. In principle, directors are expected to oversee compensation practices to make sure that remuneration arrangements encourage the alignment of management's interests with those of other shareowners.

Asian regulators recognize the importance of the oversight role of the board of directors. With their adoption of corporate governance codes in the first half of the decade, Hong Kong and Singapore began to require listed companies to have audit, nomination, and remuneration committees within their boards. To ensure that their decisions are independent of management, both codes recommend that more than half of the members of each committee be independent. The Hong Kong code provides especially specific guidelines on the role of remuneration committees, including making recommendations on remuneration policy and structure, reviewing and approving performance-based remuneration, determining directors' and senior executives' pay packages, and ensuring that no director is involved in deciding his or her own remuneration.

Participants in this report agree, however, that these principles are detached from reality. Given the dominance of concentrated ownership in Asian companies—whether in the form of controlling families or cross-holding of shares among companies—dominant shareowners

⁴²"CitySpring Has Exceeded Projections in Prospectus," *Business Times* Letter to the Editor (17 May 2007).

⁴³Abe De Ramos, "Minority Revolt," *CFO Asia Magazine* (June 2003): <http://www.cfoasia.com/archives/200306-01.htm>.

have traditionally been able to install individuals whom they favor to sit on their boards and to determine the makeup of the relevant committees. This creates a situation in which the board's loyalty is divided between the minority shareowners whose interests they are supposed to represent and the majority that put them in their positions. The usual result is that the board of directors in a typical Asian company lacks independence and acts to rubberstamp decisions made by owner-managers.

Following are some cases of questionable executive-remuneration arrangements cited by participants in this report, who unanimously pointed to the lack of board independence for their occurrence.

- In Singapore, minority shareowners have criticized a printing company on two occasions for allegedly overpaying its chairman and CEO, the couple who founded and held controlling shares in the company. Since its IPO in 2000, the company has underperformed the market and not paid dividends, while directors' pay has exceeded profits. In 2003, investors filed a resolution to cap directors' total pay to a level that they argued was in-line with industry peers. The move was voted down by the majority shareowners. In 2006, the company was again criticized when investors found out directors were paid a total equivalent to 84 percent of profits, while shareowner returns, counting dividends, amounted to only 1.6 percent. The company responded that the pay was set and approved by members of the remuneration committee, a majority of whom were said to be independent.⁴⁴
- In Hong Kong, a medical equipment manufacturer paid its CEO, who is also the controlling shareholder, HK\$42 million in total compensation in the fiscal year ending March 2006, including HK\$35 million in discretionary bonus from HK\$836,000 in 2005. The 2006 amount represented 19 percent of profits attributable to shareholders, which, in turn, was a 64 percent improvement from the previous year. Nonetheless, the company's annual report provided no explanation for the increase.
- Also in Hong Kong, a listed venture capital company declared bonuses to several members of management, so much so that the company could not afford to pay them and thus incurred a liability. According to the company's annual report, bonuses paid and payable to management increased by US\$17.4 million to US\$34.2 million in the fiscal year ending 31 December 2006. Of that amount, US\$8.7 million was charged as an expense during the fiscal year; the balance, which included deferred bonuses from 2004 and 2005, "became an obligation and liability" in 2006.

Understandably, family controlled businesses often tend to attract more skepticism about their board's independence. In Hong Kong and Singapore, it is not uncommon for a listed company to be 50 percent owned by one individual or by members of the same family, who tend to hold senior positions even years after the company has gone public. Like managers of other listed companies, owner-managers are accountable to the investing public and are expected to pursue strategies that will enhance shareowner value over the long term. To prevent conflicts of interest, they are subject to scrutiny from the board of directors, who must ideally structure their compensation such that they are encouraged to deliver long-term returns to all shareowners. The reality, however, is that some owner-managers have free rein in running the business because of the fact that their substantial voting rights allow them to create a board that will unconditionally support their decisions—including how much they are paid.

As stated earlier, some investors contacted by the CFA Institute Centre believe that owner-managers tend to have modest pay levels because they are assumed to count dividends as their ultimate remuneration. Some studies, however, have pointed to the opposite. In a 2007 conference presentation based on a preliminary study comparing the compensation of CEOs of family and nonfamily businesses in Hong Kong in 2005, the Hong Kong Baptist University (HKBU) found that CEOs of family businesses received 95 percent more in average total

⁴⁴Lee Su Shyan, "Showdown Likely at Craft Print AGM," *Straits Times* (19 January 2006).

compensation than did their counterparts in nonfamily businesses,⁴⁵ in spite of their lower market capitalization.⁴⁶ Based on an earlier finding that company size is a more important determinant of executive-pay levels, the HKBU study concluded that CEOs of family businesses get excessive compensation because, in part, of a lack of independence of their companies' remuneration committees.

Although independence—or the lack of it—is difficult to prove, a survey by the Hong Kong Exchange has shed some light on the extent to which companies are struggling to comply with the recommended best practice. A survey it released in March 2007 found that 62 percent of listed companies chose not to comply with the code provision requiring nonexecutive directors to be appointed for a specific term subject to reelection—a measure that, in theory, was meant to distance the relationship of management from their overseers.⁴⁷ Furthermore, 23 percent of companies deviated from the provision on the establishment of a remuneration committee with a majority of independent, nonexecutive members. One common justification for the deviation, according to the survey, was that the small size of the company and/or its board did not warrant the use of resources (including additional costs) to establish a remuneration committee.

In Singapore, a loophole exists where a company can declare certain directors to be independent from management or the company, in spite of the existence of certain relationships between them. Guideline 2.1 of the code gives examples of relationships that may affect the director's independence; however, the code allows the nominating committee or the board to provide “waivers of independence” in cases where a director does not meet the criteria under the guideline.⁴⁸ In a survey of 167 companies in 2005, the Singapore Institute of Directors found that 16 percent of companies believed directors with relationships that fall under the guideline can still be independent if the nominating committee is satisfied that they are able to act independently. Although disclosures of “waivers of independence” in annual reports have been rare, the nonstatutory status of the “comply or explain” approach of the code leaves room to cast doubt on the survey's further finding that 74 percent of main board companies have a majority of independent directors on their compensation committees.

In Japan, independence of the board of directors is a concern, especially from the perspective of foreign shareowners. Japanese companies have the distinct characteristic of being owned by their stakeholders—such as creditors, suppliers, and corporate partners—through cross-holding of shares. At its height, more than half of the value of the equity market represented shares that companies held in one another.⁴⁹ It is not uncommon for a company's board to be composed of directors representing stakeholders—numbering up to 60 in some cases—with little or no outside directors.⁵⁰ Financial reforms at the start of the decade addressed the issue by introducing the committee system board structure, which requires “outside directors,” and encouraging companies using the traditional statutory auditor system to bring in outside directors as well.

⁴⁵ Centre for Corporate Governance and Financial Policy, Hong Kong Baptist University, “A Study on CEO Compensation of Family Businesses vs. Nonfamily Businesses in Hong Kong” (14 August 2007).

⁴⁶ The average market capitalization of the family businesses amounted to only HK\$2.76 billion, versus HK\$6.37 billion for nonfamily businesses.

⁴⁷ According to the HKEx analysis, “The vast majority of the large number of issuers that apparently do not intend to follow the code provision said that whilst their NEDs are not appointed for a specific term, they are subject to retirement by rotation each AGM.” “Analysis of Corporate Governance Practices Disclosure in 2005 Annual Report,” Hong Kong Exchanges and Clearing Limited (March 2007): <http://www.hkex.com.hk/listing/listrpt/analysis%20of%20cg%20practices%20disclosure.pdf>.

⁴⁸ Mak Yuen Teen (see footnote 30).

⁴⁹ Seiji Ogishima and Takao Kobayashi, “Cross-Shareholdings and Equity Valuation in Japan,” *Security Analysts Journal* (March 2002): <http://www.saa.or.jp/publication/ogishima&kobayashi.pdf>.

⁵⁰ Glen S. Fukushima, “Position Paper: The Corporate Governance Debate,” *Japan Today* (8 April 2002).

In 2006, the Tokyo Stock Exchange started to require listed companies to produce corporate governance reports that include descriptions of outside directors. One glowing peculiarity exists: Outside directors can be representatives from parent or affiliate companies, or even spouses of executive officers. In other words, outside directors can be anyone as long as he or she is not on the company's payroll. As such, the concept of "independent director" as it is known in the rest of Asia and the West remains alien to Japan.⁵¹ Given this scenario, executive-remuneration arrangements in Japan will maintain the status quo.

No Say on Pay

Asian markets have no regulations that require companies to put their total remuneration to a binding or advisory vote by shareowners, which is understandable given that executive-compensation disclosure in the region lacks many of the key features that make such a vote a worthwhile exercise. With weak regulatory guidelines on reporting on the one hand and the nonmandatory status of listing rules and corporate governance codes on the other, listed companies' remuneration reports in Asia lag behind global peers in terms of quality. At best, shareowners are allowed during annual meetings to vote on directors' fees, not their salaries let alone total remuneration. They may also vote on issuance of new shares that may be used for companies' stock-option plans, but not on the terms of the option plans themselves.

This situation puts Asian markets behind what participants agree to be the global best practice of giving shareowners "say on pay"—or advisory votes meant to solicit shareowners' views on the fairness of companies' executive compensation. These nonbinding votes are already required in the United Kingdom, which pioneered the exercise 2002, Australia, and Sweden. (The Netherlands took the idea one step further by making shareowner votes on executive compensation binding.) In 2007, the United States moved one step toward its adoption after the U.S. House of Representatives passed its nonbinding "say on pay" bill; a Senate vote remains pending as of January 2008. As the SEC noted, say on pay is not designed to cap executive pay levels or regulate executive compensation policies but to give stockholders a "meaningful say" on compensation practices.

What investors are saying:

"Say on pay wouldn't be too far-fetched in Asia. It's a form of checks and balances, and it would be a step forward—but you need to have major shareholders excluded from that vote for it to have any meaning. Otherwise, you get the challenge of agreeing that [the controlling shareowner is] setting his own pay fairly."

⁵¹Curtis Milhaupt, "Choice as Regulatory Reform: The Case of Japanese Corporate Governance," RIETI seminar presentation (12 May 2004): <http://www.rieti.go.jp/en/events/bbl/04051201.html>.

Summary of Findings and Recommendations

Executive-compensation disclosure is a key element of corporate governance. Most importantly, it allows shareowners to determine whether senior managers are being paid fairly and in-line with their interests. Bridging the information gap between them with better disclosure will allow shareowners not only to determine how companies align pay with performance but also to better prevent incidents of questionable executive compensation. Scrutinizing pay practices and spotting red flags are all dependent on the quality of information in financial reports. However, better disclosure can occur only with greater vigilance by shareowners, an initiative by companies to follow international best practice, and improved regulations.

First, investors should exercise vigilance in ensuring that management incentives are aligned with their long-term interests. The CFA Institute Centre encourages shareowners to diligently analyze the amount and composition of executive compensation and the policies companies use to set executive compensation in order to determine whether the compensation is reasonable in light of performance and whether the arrangement provides enough incentives for executives to pursue strategies that build long-term corporate value. When reviewing executive-compensation reports, investors should look for the total amount individual executives were paid, a detailed breakdown of their compensation packages, and the terms of share- and performance-based remuneration. Recognizing that annual reports may lack the relevant information, the CFA Institute Centre urges institutional investors—whose individual or cumulative ownership gives them better access to senior executives outside of general meetings—to perform their fiduciary duty and apply pressure on management, through dialogues or in writing, to disclose greater information than is currently given. Shareowners should also demand greater information on the background of independent directors and their relationships with the company.

Following are some questions that a participant suggests institutional investors should solicit from management with regards to executive compensation:

- What proportion of management remuneration is performance related?
- What are the performance criteria and their incentives?
- How are share-based compensation schemes designed?
- Did the remuneration committee review and approve the remuneration policy covering both fixed and variable pay components?
- What are the identities of the highest paid employees, and what is the amount of their compensation?
- What is the total executive compensation as a percentage of profits?

Second, investors should get their voices heard through proxy voting and in annual general meetings. The CFA Institute Centre urges minority shareowners to recognize the rights attached to the securities they own, particularly in relation to proceedings of annual general meetings and proxy voting. Although thresholds vary with regard to the number of votes required, shareowners in Asia are, in general, allowed to vote on the appointment and removal of directors, as well as the remuneration of board members.⁵² As such, to demonstrate their desire for companies to uphold board independence, shareowners are encouraged to exercise their rights and, where appropriate, (1) nominate independent nonexecutive directors for remuneration committees, (2) vote down nominees put forward by management whom they perceive to be lacking in independence, and (3) demand that independent board members be given a fixed term to maintain their distance from the influence of dominant shareowners.

⁵²In Singapore and Hong Kong, this vote applies only to directors' fees, which are separate from their salaries and total compensation package.

Likewise, with varying minimum numbers of shares required, shareowners can place items on annual general meeting agenda. The CFA Institute Centre encourages shareowners to use this channel, where appropriate or necessary, to influence companies to improve their disclosure practices, or even to demand shareholder approval of executive-remuneration arrangements. Although such a move may not lead to immediate changes—given the disproportionate voting rights of dominant shareowners—it may be seen as creating a transparent dialogue on executive compensation. In Japan, for example, the Kabunishi Ombudsman shareholder group has demanded that Sony Corporation, since its annual meeting in 2002, amend its articles of incorporation and disclose the compensation of its top-five executives, including the CEO, on an individual basis. The request has gradually gained support among other shareholders, with votes in favor of the move rising annually from 27 percent in 2002 to 44 percent in 2006.

Third, companies can contribute by voluntarily disclosing meaningful executive-compensation information. The CFA Institute Centre encourages companies to go beyond local guidelines and look toward global best practices in presenting executive-compensation information. Although companies may refer to the standards of disclosure as practiced in the United States or United Kingdom, the CFA Institute Centre, referring to its manual, *The Corporate Governance of Listed Companies: A Manual for Investors*, offers the following guidelines to address the key weaknesses of remuneration reports of Asian companies.

Individual disclosure: Executive-compensation disclosure on an individual basis is a common practice in major markets globally. Asian companies are strongly encouraged to follow suit because the practice stresses individual accountability of management and directors. The CFA Institute Centre believes companies in Asia have the wherewithal to exceed the highest disclosure standards currently in place in their respective jurisdictions and to be able to report not only the remuneration of individual directors but also the top-five executives who are not also directors.

Remuneration policy: Companies are encouraged to provide a discussion of the terms of their executive-compensation programs, including the parameters used in determining performance-based (such as bonuses) and share-based (such as stock options and long-term incentive plans) remuneration, the basis for the selection of these parameters, and how these metrics are calculated. The review should also include a statement of the role of the remuneration committee—or statutory auditors in the case of Japan—in setting compensation policy and whether the committee or auditors used consultants in setting the pay of executives or whether it relied on internal sources. The CFA Institute Centre believes that Items 2 and 3 of CLP Holdings Limited’s Remuneration Report in its 2006 annual report are a good example of comprehensive and relevant disclosure of remuneration policy for both senior management and nonexecutive directors.

Total compensation: For clarity, simplicity, and improved communication, the CFA Institute Centre encourages companies to disclose, in a tabular format similar to current practice in the United States, the actual total compensation paid to top executives during the current and previous year, including a detailed breakdown of pay components in currency values as opposed to percentages. The CFA Institute Centre endorses the nine-column tabular format required by the U.S. SEC as a good example of detailed reporting that allows shareowners to more accurately judge whether the company is receiving adequate returns for the investment it has made on executive management.

Share-based compensation terms: Because share-based compensation lies at the heart of the alignment of management and shareowner interests, companies are encouraged to provide the terms of this type of compensation in remuneration reports, along with the rest of the pay components. Participants agree that share-based compensation should take into consideration the long-term performance of the shares. The CFA Institute Centre believes that disclosure of details of stock-option plans—in the same tabular format currently in place in the United States—should include the amount of securities outstanding, the exercise prices and the expiration dates for each outstanding option, and the amounts individual executives realized by vesting their stock options in the last fiscal year.

Fourth, companies should recognize the role and independence of remuneration committees in setting executive-compensation policy. The CFA Institute Centre believes that a committee composed of only those board members who do not have ties to either management or any other group of insiders is more likely to decide on a compensation package that seeks to align the interests of senior executives with those of shareowners. As such, corporate boards are strongly encouraged to (1) appoint only, and truly, independent nonexecutive directors in remuneration committees; (2) provide their compensation committees with access to information and benchmarks from third-party experts that they need in setting compensation levels and policies (such as consultants that do not provide other services to and derive other fees from the company); (3) comply with corporate governance code provisions that independent directors should have fixed terms instead of making them retire and rejoin the board on a rotation basis; and (4) provide greater disclosure of relationships that candidates have with management and shareholders. As best practice, companies are also encouraged to have external auditors review their disclosure of code compliance.

Finally, regulators, together with investor groups and company executives, should work to enhance the current disclosure requirements and practices and bridge the information gap. The CFA Institute Centre lauds the reforms regulators have implemented to bring executive-remuneration disclosure practices of listed companies in the region closer to international practices, such as the adoption of corporate governance codes in Hong Kong and Singapore and the creation of the committee system corporate governance in Japan. Investors have welcomed these reforms, and listed companies that are subject to these reforms are largely compliant with their associated requirements. As the region's financial markets continue to mature, listed companies will now be in a position to take their disclosure practices to a higher level and give investors the amount and quality of information they deserve.

A greater push is needed, however, in the adoption of the “comply or explain” approach to the corporate governance codes through increased monitoring of companies’ observance of the substance, and not just the form, of the codes. The CFA Institute Centre lauds the initiative of the Hong Kong Exchange in conducting a survey of the compliance of listed companies to its code, and we hope that such surveys become regular undertakings by regulators across the region. Such surveys are a first step toward a more active involvement by regulators in pushing companies to thoroughly comply with their respective codes. Such surveys may aid in identifying companies that fail to comply, in strengthening enforcement of the comply or explain provision, and ultimately in publicly disclosing those in continued breach of compliance as an information service to investors.

Because the scope of powers of Asian regulators is limited due to the nonstatutory status of their listing rules, the CFA Institute Centre recommends that relevant bodies governing the securities markets provide more, and clearer, guidance in the way companies present their remuneration reports. Without such guidance, companies are left to interpret the provisions of the regulations, which, in turn, results in compliance with the code in letter rather than in spirit. As such, regulators in Asia are encouraged to continue to enhance their rules and regulations—including their corporate governance codes and listing rules—to include executive-compensation disclosure practices.

In conclusion, the CFA Institute Centre believes that there is currently an information gap that needs to be bridged. Although this report concentrated on Japan, Hong Kong, and Singapore, the findings have a wider application because most regulations and practices in other parts of Asia are similar to those in Hong Kong or Singapore. This report, including the summary, findings, and recommendations, is intended to create further discussions and debate by investors, companies, and regulators to work toward a higher standard of best practices in Asia and, ultimately, a better understanding of why it pays to disclose.

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