CORPORATE GOVERNANCE, OWNERSHIP AND STOCK PRICE DURING FINANCIAL CRISIS

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ABSTRACT
The financial crisis in the third quarter of 2008 devastated the global financial markets. This crisis has aroused great concern over the effectiveness of corporate governance mechanism to safeguard investor interests. This study examines the impact of the independence of the Board of Directors and share ownership structure on the market performance of 976 Hong Kong-listed companies during the period of 2008 to 2009. The results indicate that during this period of financial crisis, firms that do not have an independent outside director acting as the Chair of the Board and firms that have a smaller proportion of outside independent directors have better stock performance measured by market-adjusted cumulative stock return. Managerial ownership represented by proportion of shares held by CEO and directors as well as proportion of substantial shareholdings demonstrates a negative association with market-adjusted cumulative stock return. When focused on director ownership of shares in the audit committee, results in this study indicate a positive association between proportion of shares owned by independent directors and market-adjusted cumulative stock return.

INTRODUCTION
The financial crisis that started in the United States in 2008 quickly sent exchange markets into a freefall. A number of renowned investment banks, including Lehman Brothers and Merrill Lynch, collapsed. Share prices plummeted on the New York Stock Exchange. The Dow Jones Industrial Average instantly fell more than 500 points and many investors were caught in the turmoil. The financial collapse in the U.S. sent shockwaves across the globe and throughout Asia. Immediately after Lehman Brothers filed for bankruptcy protection on 15 September 2008, Japan's Nikkei Index fell by 4.95 percent, Taiwan's TWSE Index by 4.89 percent, Shanghai's SSE Index by 4.47 percent, and South Korea's KOSPI plummeted 6.1 percent (Chan 2008). The impact on the Asian markets was comparatively weaker than the initial crash in America. Nevertheless, Asian governments quickly adopted a range of measures, such as expansionary monetary and fiscal policies, to mitigate the effects of the crash and to stimulate the economy.

Hong Kong, one of the world's key financial centers, was inevitably hit by the global crisis. The Hang Seng Index also plunged by 5.4 percent on 15 September 2008. As in other countries, the

government and the monetary authorities implemented imperative measures to support Hong Kong's financial system. A 100 percent deposit protection scheme was promptly announced and HK$179 billion was injected into the banking system between September and December 2008 to enhance public confidence in the sector. Nevertheless, the stock market continued to tumble. On 28 October 2008 and 9 March 2009, the Hang Seng Index recorded its two lowest troughs at 11133.94 and 11344.58, respectively (-42.47% and -41.38%, respectively, from the end of August 2008).

While some shares dropped by less than 20 percent (e.g. Beijing Enterprises Holdings and Addchance Holdings), others plunged over 80 percent (e.g. Agtech Holdings and Acrossasia) in the months following the September crash. These huge discrepancies raise the question of why share prices of some companies are more stable than those of other companies when the market is falling. In other words, why did shareholders or potential investors still have confidence in certain companies during the slump? To address this issue, La Porta et al. (2000) investigate the relation between corporate governance and investor protection. They point out that firms are able to obtain outside finance on better terms if their shareholders' interests are better protected and that strong investor protection is associated with effective corporate governance. Gillan and Starks (2003) examine the relation between corporate governance and ownership structure and argue that good corporate governance structure attracts investors, especially institutional investors.

Good corporate governance is an important factor in maintaining investor confidence and, in particular, it entices outside capital during periods of economic depression. In addition, good corporate governance is expected to curb excessive levels of executive remuneration and safeguard against excessive risk-taking by management. With good corporate governance, shareholder interests can be protected. While it is difficult to measure management effort and performance, and minority interests are likely to be appropriated by insiders, outside and potential investors view corporate governance as a set of mechanisms for the self-protection of the company (La Porta et al., 2000). Investors are willing to pay premium prices for companies with good corporate governance. To a large extent, share price fluctuations during financial crisis reflect the degree of investor confidence in a company.

Most of the literature in this field measures the efficacy of corporate governance structures over non-crisis periods. Consequently, the results may not fully reflect the defense abilities and caliber of the mechanisms of corporate governance. A number of researchers conduct cross-country studies to assess the impact of the Asian financial crises of the late 1990s on corporate performance and governance structure (e.g. Johnson et al., 2000; Mitton, 2002; Klapper and Love, 2004; Davis-Friday, Eng, and Lin, 2006). But because of factors that differ across countries, Miller (2004) suggests studies should concentrate on one country or region of the world to control for the effect of these factors.

The 2008 financial crisis aroused great concern over the effectiveness of corporate governance mechanisms in safeguarding investor interests. Since there is an insufficient and inconclusive research on the impact financial crises have on existing corporate governance mechanisms, the global financial disaster of 2008 offers a good setting for assessing the effectiveness of governance system in protecting investor interest when capital markets are suddenly confronted with an unanticipated and rapid decline in stock prices. This research focuses on Hong Kong stock market. Hong Kong has been ranked first for 17 years by the Heritage Foundation in terms of economic freedom. It was also the most active market for initial public offering funds raised globally in both 2009 and 2010 (*Hong Kong: The Facts*, 2011). The objective of this study is to examine the relation between market-adjusted return and the quality of corporate governance

practices during the global financial crisis from September 2008 to August 2009. The results of this study will answer the question: Will the market reward Hong Kong companies for good corporate governance during financial crisis?

HYPOTHESES

In the wake of the Asian financial crisis in 1997, Asian governments acknowledged the importance of corporate governance. Before 1 January 2005, there was no legal provision concerning popular corporate governance issues such as the need for non-executive directors, audit committees, remuneration committees (especially for director remuneration), as well as separation of the chief executive officer and the chairman of the board. There were some guidelines published by external institutions, such as the Hong Kong Institute of Directors, on corporate governance issues. But they were only recommendations, non-compliance with which did not result in any sanction On 1 January 2005, the Hong Kong Stock Exchange implemented the Code on Corporate Governance Practice. The Code covers five areas of corporate governance issues: Board of Directors, Remuneration of Senior officers, Accountability and Audit, Delegation by the Board, and Communication with Shareholders. Hong Kong listed companies are required to comply with the Code unless they can provide a satisfactory explanation to the contrary. However, absence of the explanation will not lead to any penalty or sanctions.

This study assesses the link between corporate governance practice and shareholders' return in the market during the financial crisis in 2008-2009. Previous studies on Hong Kong firms did not have the benefit of evaluating the 2005 Code on Corporate Governance Practice. Several previous studies assert that corporate governance mechanisms provide better protection for market investors (La Porta et al., 2000 and Gillan and Starks, 2003). Investors are still confident in companies with sound governance structure (high-quality companies) when the market crashes. The market would expect that share prices of high-quality companies would rebound faster than those of low-quality companies; therefore, existing long-term shareholders would continue to hold the shares of high-quality companies even in turbulent times. In addition, potential investors would be more willing to invest in these companies when the share prices are deemed to be low-priced. As such, companies with good governance practices would outperform other companies. Therefore, the first hypothesis in this study is:

H1: There is a positive relation between corporate governance practice and stock performance during financial crisis.

Prior studies suggest that, in addition to corporate governance attributes, ownership structure is an important construct for assessing firm performance (Leung and Horwitz, 2010). Although Mitton (2002) as well as Leung and Horwitz (2010) find that higher ownership concentration is associated with better stock performance during the previous financial crisis, which supports the Alignment Theory, La Porta et al. (1999) find poor shareholder protection in firms with high degrees of ownership concentration. Claessens et al. (2000) suggest that large shareholders could be more likely to pursue objectives that are inconsistent with those of minority shareholders if they are involved with management of the firm.

One of the positive side effects of the financial crisis is that it created momentum for change. Governance challenges have been debated and implemented by different countries since the previous Asian financial crisis. Revisiting the issue of ownership structure and stock returns amid inconsistent results from previous studies is important. It allows an evaluation of changes and implementations of new corporate governance-related promulgations on the stock market. Therefore, this study tests the following hypothesis:

H2: There is a positive relation between management shareholdings and stock performance during financial crisis.

Many institutional investors do not play an active role in company's operation or governance. However, the trading of investors holding a major percentage of a company's shares in the market could have a significant effect on the company's stock price. The *Eversheds Board Report* (2011) analyzed the performance of 241 top companies from UK, USA, Continental Europe and Asia-Pacific between 2007 and December 2009 to investigate whether board composition had any direct relation with a company's ability to weather financial crisis. Defining substantial holdings as shareholders who hold 3% or more of issued share capital, the *Report* indicated that companies that performed better during October 2007 and December 2009 were significantly more likely to have a higher number of shareholders with a substantial shareholding. *Evershed Report* (2011) suggests that quicker decision making in companies with smaller boards and substantial holdings is a factor for success. In addition, the best performing companies were found in Hong Kong; however, only 25 Hong Kong companies from the Hang Seng Index were selected for the analysis in the *Report*, which represented only a very small percentage (less than 2%) of all companies in Hong Kong. Since the relation between substantial holdings and price performance during the financial crisis is an important issue that deserves more thorough examination, it is necessary to revisit the relation between substantial holdings and price performance during the financial crisis. Hence, the third hypothesis of this study is:

H3: There is a positive relation between proportion of substantial shareholdings and stock performance during financial crisis.

In passing the Sarbanes-Oxley Act of 2002 in the U.S., Congress took the unprecedented step of vesting the Audit Committee of listed companies with direct management responsibilities. In Section 301 of the Sarbanes-Oxley Act, Congress charged the Audit committee with direct responsibility for the appointment, compensation, and oversight of any work done by a registered public accounting firm engaged by a company reporting to the Securities and Exchange Commission. In Hong Kong, Chapter Three of the *Listing Rule* states that every listed issuer must establish an Audit Committee comprising only non-executive directors. The Audit Committee must be comprised of a minimum of three members, at least one of whom must be an independent non-executive director with appropriate professional qualifications or accounting or related financial management expertise (*Listing Rule* 3.10(2)). The majority of the Audit Committee members must be independent non-executive directors of the listed issuer and the Audit Committee must be chaired by an indepdent non-executive director. However, it is not until 1 July 2009 did the Audit Committee become a distinct legal requirement in the Companies Act in Hong Kong. During the period of financial crisis in this study, the establishment of an Audit Committee was not legally required. Instead, the "comply or explain" approach was adopted.

With public and political oversight comes the danger of over-regulation. Legal requirement of Audit Committee might have the short-term effect of increasing fixed costs for companies involved. Do investors care about Audit Committee independence? The answer to this question is important as it is the base of justification for the legal requirement of an independent Audit Committee. The fourth hypothesis of this study will address this question.

H4: There is a positive relation between proportion of independent directors on the Audit Committee and stock performance during financial crisis.

DATA

This study examines the corporate governance system in Hong Kong during the year after the financial crisis started. Since the American financial crisis started in September 2008, this study covers the full year from 1 September 2008 to 31 August 2009. Financial statement information and stock price data are extracted from *Datastream* database. Information on corporate governance and firm ownership is collected from the 2008 annual reports of companies included in this study.

Initially, all 1,269 companies listed on the Hong Kong Stock Exchange, Main Board as well as the Growth Enterprise Market, are included in this study. Firms are excluded from the sample if they were newly listed in 2008 (27), were suspended (39), or delisted in 2009 (2). Furthermore, firms that had missing financial data (224) or no annual report (1) are also excluded. A total of 976 firms remain in the final sample.

MODEL

Adapted from the work by Mitton (2002) and Leung and Horwitz (2010), the following regression model is used in this study.

$$AbnorRtn_{t+1} = \beta_0 + \beta_1 Duality_t + \beta_2 NonExeChair_t + \beta 3NumDirs_t + \beta_4 IndDir_t + \beta_5 CEOSh_t + \beta_6 DirSh_t + \beta_7 Chg\%BlkSh_{t+1} + \beta_8 BlkSh_t + \beta_9 AudIndDirs_t + \beta_{10} AudIndSh_t + \beta_{11} RemIndDirs_t + \beta_{12} RemIndSh_t + \beta_{13} Committees_t + \beta_{14} Lev_t + \beta_{15} LnSales_t + \beta_{16} Industry_t + \varepsilon_t$$

where

$AbnorRtn_{t+1}$: market-adjusted cumulative stock return

$Duality_t$: dummy variable--1 if CEO and chairman of the Board of Directors is the same person

$NonExeChair_t$: dummy variable--1 if chairman is non-executive director

$NumDirs_t$: number of directors

$IndDirs_t$: proportion of independent directors

$CEOSh_t$: shares held by CEO divided by total number of shares outstanding

$DirSh_t$: shares held by all directors (except CEO) divided by total number of shares outstanding

$BlkSh_t$: shares held by all substantial shareholders divided by total number of shares outstanding

$Chg\%BlkSh_{t+1}$: percentage change of shares held by block shareholders during the period

$AudIndDirs_t$: proportion of independent directors on the Audit Committee

$AudIndSh_t$: shares held by independent directors on the Audit Committee divided by total number of shares held by directors on the Audit Committee

$RemIndDirs_t$: proportion of independent directors on the Remuneration Committee

$RemIndSh_t$: shares held by independent directors on the Remuneration Committee divided by total number of shares held by directors on the Remuneration Committee

$Committees_t$: 1 if the firm has all three key committees (Audit, Remuneration, and Nomination), 2/3 if two, and 1/3 if one

Lev_t: ratio of total long-term debt to total assets

$LnSale_t$:	natural log of total sales in HK$ millions for the fiscal year ended during the period
$Industry_t$:	dummy variables for industry control

DEPENDENT VARIABLE

AbnorRtn, a market-adjusted cumulative stock return is used as a proxy for firm performance. Market return is defined as market-adjusted cumulative stock return. This market-adjusted return measures the cumulative abnormal return during the period of the crisis. Hang Seng Index is used to measure performance of the market when computing market-adjusted return.

INDEPENDENT VARIABLES

To measure the effectiveness of the established corporate system and structure, independent variables used include proxies for corporate governance and ownership structure.

This study examines different attributes of corporate governance. These attributes include independence of the board of directors and independence of the board's key committees (Audit Committee, Remuneration Committee, and Nomination Committee).

Independence of the Board of Directors is proxied by the duality of chairman and CEO (Duality—whether or not Chairman of the Board and CEO is the same person), Chairman's independence (NonExeChair—whether Chairman of the Board is an outside independent director) and the proportion of independent directors on the Board (IndDir). Also examined is the independence of the Remuneration Committee and the Audit Committee in terms of the proportion of independent directors on the committees (AudIndDirs and RemIndDirs) and the proportion of their shareholdings (AudIndSh and RemIndSh). In addition, the variable, Committees, is used to gauge whether the three major committees, Audit Committee, Remuneration Committee, and Nomination Committee, are all established. Finally, the size of the Board, i.e. number of directors (NumDirs), will also be examined.

Some researchers argue that ownership structure is part of corporate governance arrangement. However, many previous studies on the Asian financial crisis measure ownership structure, especially managerial ownership, separately (Davis-Friday et al., 2006; Lemmon and Lins, 2003; Leung and Horwitz, 2010). The present study follows the latter approach and measures different ownerships. CEOSh, DirSh, and BlkSh measure shareholdings of the chief executive director, all directors except the CEO, and all substantial investors, respectively. Because substantial investors hold large numbers of a company's shares, trading of their shares might affect the firm's share price movement. Hence, a variable, Chg%BlkSh, is adopted to measure the price movement due to block share trading.

External financing may constitute an endogenous constraint that affects the efficacy of corporate governance (Klapper and Love, 2004). It is argued that firms may improve their corporate governance practices to obtain loans or lower the cost of debt from financial institutions. Accordingly, gearing ratio (Lev) is used in this study as a control variable for the effect of external financing. Firm size, measured in terms of sales, is included as another control variable because size may affect firm performance and a company's ability to withstand the adverse effects of a financial crisis. In addition, an industry dummy variable is included to control for industry effect.

RESULTS

Table 1 shows the results of the regression analysis. The model is estimated using market-adjusted cumulative stock return, AbnorRtn, to measure the above-market return of the stock during the period.

As seen in Table 1, Duality and size of the Board of Directors do not seem to affect the return of the stock since Duality is not statistically significant. However, whether the Chairman is a non-executive director (NonExeChair) and the proportion of independent directors on the Board (IndDirs) are both negatively significant for the entire period in the study (p-values 0.0404 and 0.0912, respectively).

Having an independent Board of Directors is argued to be more effective than having a dependent one in carrying out the Board's responsibilities to create value for shareholders and to protect the interests of outside stockholders. The significant negative coefficients of NonExeChair and IndDirs imply that firms that do not have an independent outside director acting as the Chair of the Board and firms that have a smaller proportion of outside independent directors have better stock performance (AbnorRtn) during the crisis period. This unexpected result might seem contrary to the common belief that independence of the Board better protects investor interests. But Baliga et al. (1996) and Bhagat and Black (1999) find no evidence that having non-executive directors on the Board leads to better market performance. Klein (1998) and Yermack (1996) even find that having greater proportion of non-executive directors on the Board is negatively associated with firm performance. This negative association may be a result of non-executive directors not having adequate knowledge of the firm and having limited time to commit to their directorship because of their primary work responsibilities outside the firm. In the present study, when examining the relation between stock return and quality of corporate governance practices measured in terms of board independence, results lead to the rejection of Hypothesis 1, which states that there is a positive relation between corporate governance practice and stock performance during financial crisis.

Table 1
Regression Analysis--Factors Affecting Stock Return during Financial Crisis (2008-2009)

	Variable	$AbnorRtn_{t+1}$		
		Coeff	p-value	
	Intercept	147.5877	0.0015	***
1	$Duality_t$	-8.9319	0.1440	
2	$NonExeChair_t$	-12.8436	0.0404	**
3	$NumDirs_t$	-12.3226	0.3252	
4	$CEOSh_t$	-39.1887	0.0093	***
5	$DirSh_t$	-32.0280	0.0290	**
6	$Chg\%BlkSh_{t+1}$	0.0101	0.7458	
7	$BlkSh_t$	-31.5380	0.0187	**
8	$IndDirs_t$	-52.6887	0.0912	*
9	$AudIndDirs_t$	47.7152	0.0080	***
10	$AudIndSh_t$	-8.3627	0.1535	
11	$RemIndDirs_t$	4.8371	0.7592	
12	$RemIndSh_t$	-9.8926	0.2485	
13	$Committees_t$	-6.1309	0.6654	
14	Lev_t	29.9305	0.0113	**
15	$LnSales_t$	-3.3451	0.0294	**
	Industry dummies	Included		

Adjusted R-squared	0.0575
N	895

Notes:
Regressions are estimated using White's correction for heteroskedasticity.
*, ** and *** indicate significance at 10%, 5%, and 1% level, a two-tail test, respectively.

Table 1 shows how market-adjusted cumulative stock return is affected by firms' ownership structure during the global financial crisis. The proportion of shares held by CEOs and directors both have significant negative relation with AbnorRtn (p-values 0.0093 and 0.029, respectively). The negative coefficients associated with the above independent variables imply that higher concentration of stock ownership hurts stock performance during the crisis period. The greater the proportion of shares held by CEOs and directors, the lower the abnormal return. The results are consistent with the Expropriation Theory and lead to the rejection of Hypothesis 2, which states that there is a positive relation between management shareholdings and stock performance during financial crisis.

Similar to the results mentioned above, substantial shareholdings also has a significant negative relation with AbnorRtn, although at a lower significance level (p-value 0.0187). However, the changes in percentage of ownership and trading of substantial shareholders (Chg%BlkSh) do not have any effect on the return measure. This result contradicts the *Eversheds Board Report* (2011), which suggests companies with higher percentages of share capital held by shareholders who hold three percent or more of the issued share capital are better-performing companies. The differences in findings between this study and the *Eversheds Report* could be attributed to the different time coverage and different sample size. The current study focuses on the financial crisis and includes all Hong Kong companies, whereas the *Eversheds Report* is an international study (25 Hong Kong companies plus 216 companies from other countries) covering the period before, during, and after the financial crisis (October 2007 to December 2009). The results from this study lead to the rejection of Hypothesis 3,which states that there is a positive relation between substantial shareholdings and stock performance during financial crisis.

The audit committee is recognized as the cornerstone of successful and credible financial reporting, and both the demands and expectations placed on the Committee are increasing continuously. Audit Committee became a specific requirement of the Companies Act of Hong Kong since 1 July 2009. Hypothesis 4 is set to test investors' response to the component of the Audit Committee. Results of this study indicate that the proportion of independent directors on the Audit Committee has a positive relation with stock return (p-value 0.008). The larger the proportion of independent directors on the Audit Committee, the better the performance of the stock during period of financial crisis. Hence, Hypothesis 4 cannot be rejected. It appears that having an independent Audit Committee does boost investor confidence, although ownership concentration of independent director among all directors on the committee does not have any significance.

While the audit committee was the primary focus of the Sarbanes-Oxley Act of 2002, the Remuneration Committee plays an important role in the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law by President Obama on 21 July 2010. During the time of this study, according to Section B of the *Code on Corporate Governance Practices* (2005), all listed companies should establish a Remuneration Committee, with the majority of its members being independent nonexecutive directors (*Main Board Listing Rules*, Section B of Appendix 14). In Hong Kong, two key objectives of establishing a Remuneration Committee are to assist the Board of Directors to maintain a formal and transparent procedure for setting policy on director's

remuneration, and to determine and appropriate remuneration packages for all directors. The Remuneration Committee should ensure that remuneration arrangements support the strategic aims of the business and enable the recruitment, motivation, and retention of senior executives while complying with all rules and regulations. Unlike the Audit Committee, having a Remuneration Committee is not a legal requirement in Hong Kong. The absence of legal requirement for Remuneration Committee could be supported by the results of this study as no significant relation is found between market-adjusted cumulative return and proportion of independent directors as well as ownership concentration of independent directors among all directors of the Remuneration Committee.

Together with the Audit and Remuneration Committees, the Nominating Committee rounds out the three standing committees of a public company's Board of Directors. During the time of this study, according to Section A of the *Code on Corporate Governance Practices* (2005), all listed companies should establish a Nomination Committee chaired by the chairman of the Board or an independent non-executive director and comprises a majority of independent non-executive directors. In Hong Kong, the key objectives of establishing a Nomination Committee are to review the structure, size, as well as composition (including skills, knowledge and experience) of the Board at least annually, and make recommendations of any proposed changes to the Board to complement the issuer's corporate strategy (*Main Board Listing Rules*, Section A of Appendix 14). All three major committees (Audit Committee, Remuneration Committee, and Nomination Committee) are required as stated in the *Listing Rules* but only with a "comply or explain" approach. To assess investors' reaction to the establishment of these three committees, this study exams the relation between market-adjusted return and Committees, a variable that is coded 1 if the firm has all three key committees (Audit, Remuneration, and Nomination), 2/3 if two, and 1/3 if one. As shown in Table 1, whether or not a firm has all three major Committees (Audit Committee, Remuneration Committee, and Nomination Committee) has no significant relation with market-adjusted cumulative return.

Leverage, measured by the ratio of total long-term debt to total assets, is used as a proxy to control for the effect of external financing. Interestingly, the use of long-term debt has a significant positive relation with the return for the period (p-value 0.0113). Firms with high leverage are expected to be more adversely affected in a financial downturn, and their stocks are likely to experience bigger price declines. However, the results in this study imply that firms that employ higher leverage experience better returns during the global financial crisis period. The findings are consistent with those of Forbes' (2000) study, which does not find evidence of lower stocks returns on firms with higher debt levels during the 1997-1998 financial downturn.

When controlling for size effect, this study finds the size of the firm (LnSale) has a significant negative relation with the return (p-value 0.0294). Larger firms are expected to be better able to withstand the adverse effects of a financial crisis and recover quickly. But the results found in this study are contrary to expectations. One possible reason for the larger firms to experience worse stock performance during the financial crisis is that the downturn caused more investors to sell their holdings in large company stocks in order to get the cash that they need.

SUMMARY

The results of this study indicate that although whether or not the CEO and Chairman of the Board of Directors is the same person does not affect stock returns, having a non-executive Chair and large proportion of independent directors on the Board boosts investor confidence during the period. The results of this study are different from those of Leung and Horwitz (2010), who find CEO unity to be significant but independent directors to be insignificant in preserving firm value during the 1997-1998 financial crisis.

This study also finds that high concentration of ownership leads to lower stock returns, which supports the Expropriation Theory of ownership concentration that suggests high concentration of management ownership intensifies the conflict of interest between majority and minority shareholders. The finding is in contrary to the Alignment Theory (supported by Leung and Horwitz (2010) and Mitton (2002)), which suggests that high concentration of management ownership mitigates the conflict of interest between managers and shareholders.

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