

# International Listing Induced Improvements in Corporate Governance Practices: The Case of China Mobile (Hong Kong)

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## ABSTRACT

International listing of China Mobile, the current number one player in China's mobile network business, has been regarded as a great success in terms of raising capital and financing expansion. However there has been a debate whether the international listing leads to a meaningful improvement in corporate governance. This paper employs the case-study approach and uses the OECD Principles of Corporate Governance as the analytical prism to examine the company's corporate governance strengths and weaknesses. It shows that the listing has induced significant improvements in major areas of corporate governance practices in the company but challenges remain in the area of defining and monitoring related-party transactions. This in-depth case study aims to provide inspirations and assistance for practitioners and policy-makers in transition economies to establish practical solutions to such challenges.

*Key words:* International listing, Corporate governance, Related-party transactions, Telecommunications sector, China, Hong Kong..

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## 1. Introduction

China Mobile (Hong Kong) Limited, the current number one player in China's mobile network businesses, was listed on the Hong Kong and New York stock exchanges on October 22nd, 1997.<sup>1</sup> The listing marked a significant step taken by Chinese government to invite international investors to take part in China's state-controlled telecommunication sector and to push forward corporate ownership and governance reforms in the sector. Different from the majority of telecommunications share offerings around the world which are secondary issues, meaning that the proceeds of the sale flow directly to the government, the initial public offerings (IPOs) of Chinese state-owned companies have been regarded as capital-raising primary offerings (Sun and Tong, 2003). Thanks to the nature of primary offering, China Mobile (Hong Kong) Limited (China Mobile, hereafter) then use the funds raised to purchase operating assets from fully state-owned holding companies and progressively gain the ability to provide mobile telephone and data services in all 31 China's provinces.

While it becomes widely acknowledged that the international listing of China Mobile is a great success in terms of raising capital and financing expansion, there has been a debate whether the international listing leads to a meaningful improvement in corporate governance (Ma, 2002; Tobin and Sun, 2005). China Mobile has been the recipient of numerous awards for its corporate governance standards and investor relations.<sup>2</sup> However, in other publications, China Mobile ranks poorly in the corporate governance league tables (CLSA, 2004). Given the sharp contrast in the existing assessments, in this paper we employ the case-study approach to examine the company's corporate governance strengths and weaknesses in depth. We use the OECD Principles of Corporate Governance as the analytical prism in general. We highlight the inherent difficulties in terms of how to define and monitor connected transactions when the controlling shareholder of the company is also the regulator and monopoly player of the market. We put an emphasis on the efforts taken by both the company and the stock exchanges to find a practical way to partially overcome these difficulties. Given the fact that partially privatized large corporations in transition economies have faced the similar difficulties, such an in-depth case study would be able to provide inspirations and assistance for practitioners and policy-makers in this field to establish practical solutions to these difficulties.<sup>3</sup>

The rest of the article is organised as follows. Section 2 provides background of China Mobile. Section 3 presents the analytical prism. Section 4 examines the

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<sup>1</sup> The company was called China Telecom (Hong Kong) Limited at the date of the initial public offering and changed its name to China Mobile (Hong Kong) Limited on June 28<sup>th</sup>, 2000 with the approval of shareholders.

<sup>2</sup> These awards include, for example, in 2003, the IR Magazine Asia Award for "Best IR from a Chinese Company" and IR Magazine China Award for "Best IR from a PRC Company"; in the same year China Mobile also was part of the Financial Times' "Global 500 Largest Companies" list, Business Week's "Global 1000 Most Valuable Companies" list and Forbes' "World's 400 A-List Companies" (China Mobile Annual Report 2004).

<sup>3</sup> A theoretical analysis on the role of bureaucratic entrepreneurs in promoting the rapid growth of China's telecommunications sector has been conducted by the same research group, see Tobin and Sun (2005).

international listing induced improvements in information disclosure and transparency. Section 5 discusses the inherent difficulties in defining and monitoring related-party transactions. It also analyses the achievements which have been made by both the company and the stock exchanges in this regard and the remaining challenges. Finally Section 6 summarises and makes concluding remarks.

## **2. Company Background**

Before its IPO, China Mobile's assets were entirely state-owned by the Ministry of Posts and Telecoms (MPT). In preparation for the IPO, major assets and ongoing businesses related to the provision of mobile telephony in China were restructured into a series of offshore, Hong Kong-based and domestic companies. All of these companies were ultimately owned by the MPT. The key assets of the MPT included in the China Mobile's IPO were the mobile phone businesses operating in the provinces of Guangdong and Zhejiang. Chinese mobile network operators like China Mobile are regulated by the government on a provincial basis. They are bound by substantial licensing and government permission to operate. At the time of its IPO, China Mobile only had licences to operate in Guangdong and Zhejiang and all of its ongoing business was transacted in these two provinces.

After the IPO, Chinese government held 75.7 per cent of the total outstanding shares through its holding vehicle China Mobile Hong Kong (BVI) Limited and public investors, including Vodafone, held the remaining 24.3 per cent. The IPO resulted in net proceeds of over US\$4 billions,<sup>4</sup> which were earmarked for expansion into other Chinese provinces by means of acquisitions. In accordance with this strategy, China Mobile conducted a series of transactions to acquire a total of 29 additional provincial and provincial city level mobile telephony companies. This gave China Mobile the ability to provide mobile telephony and data services in all 31 Chinese provinces as of July 1<sup>st</sup>, 2004.<sup>5</sup> The consideration for these transactions was a mixture of cash and newly issued China Mobile shares. In order to provide for the cash requirements of these transactions, China Mobile issued debt in the form of convertible and non-convertible loans, and sold additional tranches of equity to international institutional investors.

Following the decisions of the Ninth National People's Congress, which was conducted in March 1998, a reorganization of certain ministers took place in the year. One result of this reorganization was that all of the administrative functions of the MPT were assumed by the newly formed Ministry of Information Industry (MII). As a consequence, all of the counterparties to China Mobile's acquisitions were controlled by the MII.

China Mobile's successful fundraising efforts and its pursuit of acquisition-led expansion strategy have been marketed globally and in so doing have earned the company an international investor base. Its stock price reached an all time high in early 2000, and has since been in line with the global stock market downturn.

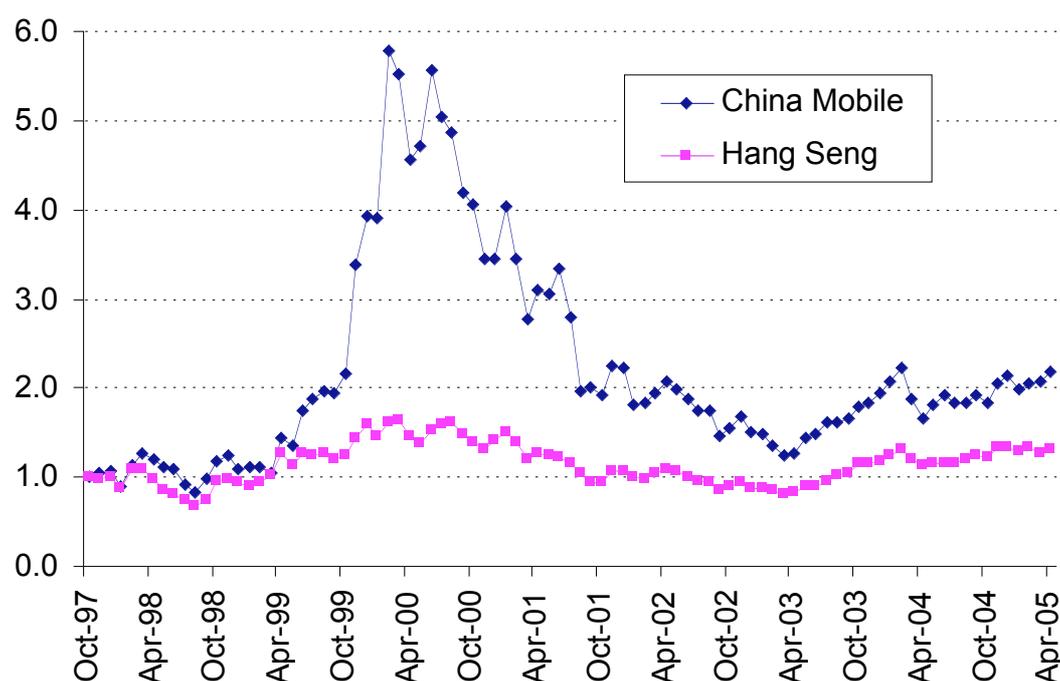
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<sup>4</sup> Actual net proceeds of the company's IPO and sale of Shares to the Corporate Investors were US\$4,039,738,989 as per China Mobile 20f Filings 1997.

<sup>5</sup> The acquisitions were conducted as follows: 1998: Jiangsu Mobile, 1999: Fujian Mobile, Henan Mobile, Hainan Mobile, 2000: Beijing Mobile, Tianjin Mobile, Shanghai Mobile, Shandong Mobile, Hebei Mobile, Liaoning Mobile, Guangxi Mobile, 2002: Anhui Mobile, Jiangxi Mobile, Sichuan Mobile, Hubei Mobile, Hunan Mobile, Shaanxi Mobile, Shanxi Mobile, Chongqing Mobile, 2004: Autonomous regions of Inner Mongolia, Jilin, Heilongjiang, Guizhou, Yunnan, Tibet, Gansui, Qinghai, Ningxia, XinJiang.

However, the stock price of China Mobile has often outperformed the Hang Seng overall index. Since April 2003, China Mobile's stock price has shown a much stronger upward trend than the Hang Seng Index (Figure 1) and its financial fundamentals are strong. China Mobile has been profitable since its listing in 1997 and has kept strong growth in both turnover and profits annually. In 2004, the company posted turnover of RMB 192 billion; as compared to RMB 159 billion in 2003, and RMB 15.5 billion 7 years earlier when it did its IPO. Profits show similar growth. In 2004, China Mobile posted profits of RMB 42 billion, a figure substantially in excess of profits announced in 2003 of RMB 36 billion (China Mobile Annual Report, various years).<sup>6</sup> Since the government tightly regulates tariffs and fees in the telecoms industry, this growth is directly tied to growth in the number of mobile users that subscribe to China Mobile services. China Mobile's subscriber base reached 204.292 million users at December 2004, from an initial base of 3.4 million in 1997, indicating a staggering increase of over 590 times in 7 years. In line with its financial success, in December 2002, the company announced its first ever dividend payout (at a 20 per cent payout ratio), and has grown its dividends steadily in 2003 and 2004 to payout ratios of 21 per cent and 32.7 per cent respectively (China Mobile Annual Report, various years; China Mobile 20f Filings 2002, 2003, 2004).

**Figure 1. Share price index of China Mobile versus index of Hang Seng (31/10/1997 = 1.0)**



Source: DataStream.

<sup>6</sup> The exchange rate during 1997-2005 is around US\$1 = RMB 8.28.

### **3. Analytical Prism**

In order to attract and retain international investors, China Mobile has recognized the importance to review and upgrade its corporate governance practices and to bring them up to international standards. The company's primary listing is on the Hong Kong Stock Exchange (HKSE) and the stock trades as American Depository Receipts (ADRs) on the New York Stock Exchange (NYSE).<sup>7</sup> Therefore, the company is subject to the Hong Kong Listing Rules, Hong Kong Companies Ordinance and US federal securities laws as they apply to non-US firms.<sup>8</sup> However, the more evolved corporate governance principles recommended by both the HKSE and NYSE are adhered to by companies on a purely voluntary basis. In corporate governance terms, the HKSE is ranked as one of Asia's best. In the 2004 CLSA CG Watch report on corporate governance in Asia, Hong Kong was ranked number two in the Asian countries, second only to Singapore. The CLSA report also acknowledges that the Asian region lags North America and Europe in corporate governance terms (CLSA, 2004). Therefore, in order to accommodate the international nature of its investor base and its ambition to be a strong player in leading international markets, it would be more appropriate to use an international standard to assess China Mobile's corporate governance, rather than rely entirely on comparison with its HKSE peers or other Chinese corporations. This paper will use the OECD Principals of Corporate Governance (OECD, 2004) for this assessment.

These Principles were unanimously endorsed by 29 OECD ministers in May 1999, and were later welcomed by the G7 leaders at the Summit in Cologne in June 1999. The International Corporate Governance Network (ICGN), an investor-led body representing more than US\$6 trillion in assets, welcomed the Principles as good common ground among diverse interests, practices and cultures. ICGN agrees that along with traditional financial criteria, the governance profile of a corporation is now an essential factor that investors take into consideration when deciding how to allocate their investment capital (Monks and Minow, 2004, Chapter 5). This view is echoed in the data compiled by the Asian Corporate Governance Association (ACGA) regarding market beta. Market beta is defined as a measure of an asset's risk in relation to the market; a higher beta indicates a higher risk and therefore more volatile price movement (Dreman, 2003). The findings in the ACGA report support the theory that market beta is a function of *both* corporate governance and its more traditional determinant, risk (CLSA, 2004, p. 14).

The OECD Principles were amended after a review conducted in 2002 and the 2004 version includes 6 major tenets of corporate governance. These are that a company should ensure: (1) the basis for an effective corporate governance framework exists, (2) the rights of shareholders, (3) the equitable treatment of shareholders, (4) the role of stakeholders in corporate governance, (5) disclosure and transparency are adequate, and (6) the responsibilities of the board are fulfilled (OECD, 2004). Although China is not a member of the OECD, these Principles are intended to assist governments in both the OECD and non-OECD states to evaluate and improve their corporate government practises. More relevantly, China Mobile is incorporated in Hong Kong and listed on HKSE and NYSE. These lead the OECD Principles to be

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<sup>7</sup> The ADR ratio began at 20:1 and on July 5, 2000 changed to 5:1.

<sup>8</sup> The HKSE listing rules refers to the "Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited". The relevant US laws includes US Securities Exchange Act of 1934, Sarbanes-Oxley Act of 2002, Listing Standards of NYSE as far as they apply to non-US issuers.

appropriate for reviewing China Mobile's corporate governance practice. The international listing itself has aimed at ensuring the Principles 1 to 3, which do not convey much requirement at individual company level for radical improvement after joining the market. Therefore in this case study, we will focus on the remaining three Principles. They are (a) Disclosure and Transparency, (b) Responsibility of the Board, and, (c) Role of Stakeholders. Our review will follow each of these three Principles closely and briefly on the others.

#### 4. Improvements in Disclosures and Transparency

The main goal of the Disclosure and Transparency Principle is to provide shareholders with sufficient information to make investment decisions. This goal affects a wide range of corporate areas including financial and operating results of the company, company objectives, major share ownership and voting rights, remuneration policy for directors and key employees, information about board directors and their independence, related party transactions, foreseeable risk factors, issues regarding employees and stakeholders, and the corporate governance code to which the company is required or voluntarily adheres to. In order to determine what information should be disclosed within the areas outlined, the concept of materiality appears. Material information is defined by the OECD as "information whose omission or misstatement could influence the economic decisions taken by users of information" (OECD, 2004). In the case of China mobile, the company provides good transparency to major areas of the business, while it leaves other facts about the company vague.

First, regarding the financial and operating results of the company, the information given is clear and the standards used for consolidating the financial reports after the multiple acquisitions are uniform. All reports use HK GAAP standards in which results of operations are accounted for from their date of acquisition as opposed to US GAAP which utilises the "pooling of interests" method (China Mobile 20f Filings, various years). Since listing in 1997, China Mobile has annually provided a clear outline of the impacts of using HK GAAP versus US GAAP on its financial statements. This is good practise, but the company could be able to do more to clarify its financial situation for international investors. A comparable example in this regard is Infosys, an Indian IT services company listed on the Mumbai Stock Exchange and regarded as the star in Asia's corporate governance stakes. Infosys reconciles its accounts in 8 different sets of GAAP (Barton *et al.*, 2004). China Mobile includes relevant exchange rates between currencies (RMB, US\$ and HK\$), to facilitate investor's review of the financials. The use of multiple currencies in the annual report of an internationally listed company is a necessary evil. However, stating accounts, payments, contracts and dividends in various currencies can be confusing to the reader and investors could benefit from further homogeneity within the documentation. In summary, the financial reporting of China Mobile has some flaws, but on the whole conforms to the disclosure requirements set out in the OECD Principles.

The Principle's recommendation to outline remuneration of directors on a personal basis has been clearly stated since the first draft of the OECD Principles in 1999. Nevertheless, until its 2004 annual report, China Mobile has only stated the aggregate payment made to directors and key employees. In terms of overall impact of the director's remuneration on the financial statements of the company, China Mobile has among one of the lowest ratios of remuneration to net profit in Asian listed companies, at a level of only 0.051 per cent (CLSA, 2004, p. 42), but the fact remains

that the company did not comply with the guideline to provide investors transparent information on the exact breakdown of the directors' remuneration until this year.

Second, general information about the members of the Board of Directors and the major share ownership and voting rights are clearly stated in the company's annual filings. The Board members have changed substantially year on year with only 4 of 13 directors serving on the board for more than 3 years. During any changes to directorships, information is provided to stakeholders on the new director's background and connection with the company and it is clearly stated if the director is executive, or non-executive and, if non-executive, if that director is considered by the company to be independent. Regarding directors, the company complies with the disclosure requirements, however, as we will discuss later in Section 5, its corporate governance practices regarding board composition and independence are questionable. The matter of share ownership has been made simple for China Mobile as at no time in the company's history has any shareholder except its holding company (China Mobile Hong Kong (BVI) Limited), owned more than 10 per cent of the company's shares, and therefore the share ownership for parties other than the holding company and key executives has not been material. However, since flotation, there has been a growing pool of granted share options to key executives. These options have varying strike prices and expiry dates; all of which are fully disclosed to investors in the company's annual reports. In 2002 a new share options scheme was adopted and the old scheme terminated. Information on this change was clear and timely. Therefore, the requirements of disclosure for these areas have been met by China Mobile.

Third, in the areas of company objectives, foreseeable risk factors and employee and stakeholder issues, China Mobile is also providing sufficient transparency. Growth through acquisition, organic growth in mobile user subscriber base, and migration of products and services to include data revenues as well as voice revenues have all been clearly stated as objectives for the company since the first investor communications in 1997 (China Mobile 20f Filings 1997), or as soon as they have become relevant. The company has excelled in providing a robust list of risk factors to its business and updating the list when new factors emerge, as evidenced by their outline of the affects of the SARS epidemic on their business in 2003 (China Mobile 20f Filings 2003). Furthermore, issues regarding employees and stakeholders in terms of legal proceedings and issues that will affect their involvement with the company have largely not been material. Therefore in the above-listed three areas of disclosure, China Mobile has shown close adherence to the OECD Principles.

China Mobile has adopted the Code of Corporate Governance Practises issued by the Hong Kong Stock Exchange in 2004 and therefore adheres to OECD's Principle regarding the framework of corporate governance. The company first publicly documented its corporate governance policies in the 2001 Annual report and has continued to outline specific changes and initiatives engaged by the company to foster improved corporate governance. These areas are clearly stated in its filing documents and much emphasis has been placed in recent years on the firm's commitment to fostering good corporate governance policies. This is a good start. China Mobile recognises that it does not comply with all of the NYSE listing rules, which in some regards are stricter than the rules for the HKSE. To date, there has been no indication in the publications to shareholders that the company intends to comply with the NYSE listing rules as a show of the firm's true dedication to outstanding corporate governance. While China Mobile has outlined the areas that fall short of the heightened recommendations of the NYSE market, and is therefore providing good

disclosure and transparency, it would be a stretch to commend the company on striving actively to overachieve on corporate governance. While the company does state its framework for corporate governance as required by the Principle of Disclosure, in order to improve, it would be advantageous to both disclose the NYSE standards and adhere to them.

## **5. Progresses and Challenges in the Area of Related-Party Transaction**

The primary area of concern with respect to China Mobile's disclosure requirements rests in its disclosure of related party transactions. China Mobile is ultimately controlled by the MII. The MII is responsible for the provision of regulations to the telecommunications industry in China. Therefore, nearly all of the material contracts that China Mobile enters into in the normal course of business are entered into with the MII or its related parties. These include roaming and interconnection arrangements, licensing of China Mobile trademark, spectrum fees, sharing of inter-provincial transmission line leasing fees, prepaid services, platform development, property leasing and management services, construction and related services, equipment maintenance and related services, transmission tower related agreements, and telecommunications services. All of these contracts, agreements and understandings and the risks associated with them are disclosed in the company's annual reports. Obviously, these agreements are all material and essential for China Mobile to continue to offer services to its customers.

The HKSE has granted the company waivers from compliance with the normal approval and disclosure requirements related to connected transactions under the Listing Rules,<sup>9</sup> with conditions. Primarily, these conditions are that the agreements are entered into in the normal course of business and, more significantly, the independent non-executive directors will annually review the transactions and the board of directors will approve them. These conditions put the onus to monitor related party transactions on the board of directors and, specifically, on the independent non-executives who sit on the relevant board subcommittees. Regarding the disclosure and transparency requirements, through the granting of the waiver from the HKSE, China Mobile is in line with corporate governance principles. However, this special arrangement clearly makes the Principle of Responsibilities of the Board of Directors become critically important.

As outlined earlier, China Mobile has been very acquisitive since 1997. These acquisitions have all been acquisitions of SOEs that are mobile network operators in various jurisdictions.<sup>10</sup> These transactions all had a related party as the counterparty to the acquisition. This has resulted in stock and cash being paid by China Mobile to its largest shareholder as consideration for these transactions. As a direct result, China Mobile Communications Corporation (CMCC), which controls China Mobile via its control vehicle China Mobile Hong Kong (BVI) Limited and which itself is fully (100 per cent) controlled by the MII and Chinese government, has retained in excess of 75 per cent of the fully diluted share capital of the listed company. Retaining this ownership level benefits the Chinese government because with a ownership of 75 per

<sup>9</sup> Except for specific areas including trademark licencing and prepaid services

<sup>10</sup> With the exception of the acquisition of a network business coordination company and a network planning and design company in July of 2004 as referenced in China Mobile 20f Filings 2003.

cent it can control the strategy and operating decisions of China Mobile and gives the MII the right to nominate the entire board of directors and, in turn, indirectly influence the selection of senior management. It also gives CMCC the right to determine timing and amount of dividends and provides veto power on proxy votes put forward to the shareholders at annual general meetings and extraordinary general meetings. The interests of CMCC as the company's ultimate controlling person could be easily in conflict with the interests of the company's minority shareholders.

This factor becomes very important when reviewing the acquisitions completed by China Mobile. During the acquisition process, a valuation for the asset being acquired must be agreed between the buyer and seller. In the case of China Mobile's acquisitions, this valuation negotiation took place between the company – the buyer, and its controlling shareholder – the seller. An obvious conflict of interest exists. This conflict of interest could lead to gross miscalculation of the value of the acquired asset to the benefit of CMCC and detriment of China Mobile's minority shareholders. In fact, the interdependence between listed companies and their parent companies creates strong incentives to distort information, particularly information about related-party transactions, which are frequently used in China to adjust operating results and financial positions, in particular with listed companies (Tenev *et al.* 2002; Green, 2003). The interests of the minority shareholder can only be protected by their representation via independent non-executive directors on the board, since it is the board of directors that must ultimately approve all major transactions of the company. Again, China Mobile is adhering to the appropriate disclosure and transparency requirements of the Principles, but the ultimate test of corporate governance rests with the composition and independence of the board and the decisions they take in the course of their duties.

The OECD Principles provide significant guidance regarding the board of directors under the Principle of Responsibilities of the Board. One of the sub-principles is that it is the duty of the company to have a sufficient number of independent, non-executive directors occupying seats on the board. In practice, the NYSE requires a *majority* of independent directors on the board. Having a majority of independent directors is seen as a benefit to the company since it forces the board of directors to act in the best interests of the shareholders as a group that oversees the management of the company, rather than functioning as an operational board filled with company executives. The HKSE only requires 3 non-executive directors on any given board. China Mobile complies with the HKSE guidelines and currently has 4 non-executive directors (Table 1). This number of non-executive directors account for 31 per cent of the current board members. Of these four non-executive directors, three are appointed by banks and the HKSE and thus being truly independent, and the remaining one is a deputy CEO of Vodafone. Vodafone has entered into an important strategic alliance with China Mobile for the global provision of data services. This operational and contractual link to the company would arguably challenge the Vodafone director's independence. In China Mobile's 2004 Annual Report, the director is listed as independent. If taking into account only unchallenged independence, the percentage of current directors that are really independent would become only 23 per cent. Historically, the maximum percentage of real independent directors on the China Mobile board occurred for 2 years in 2002 and 2003 and was 25 per cent. The low representation of independent directors on the board would be a critical flaw in China Mobile's corporate governance practices. It becomes critical for the company-specific reason that China Mobile has so many related party transactions, both operationally

and acquisition-related, for which the independent members of the board of directors must act as monitors.

**Table 1. China Mobile's Board of Directors 1997 through 2004**

	1997	1998	1999	2000	2001	2002	2003	2004
Total number of directors	11	11	12	12	12	12	12	13
No of non-executive directors	2	3	2	3	3	5	5	4
No of real independent directors	2	2	2	2	2	3	3	3
No of newly appointed directors	11	3	5	3	0	6	1	4

Source: Compiled from China Mobile 20f Filings (1997 to 2004).

At the time of IPO, the lack of independent directors can be explained in part by China mobile's business history. The company's origin of state-owned enterprise (SOE) did not require it to have any pre-existing outside investors prior to listing. Some other Chinese technology and telecoms firms listed on foreign exchanges such as Sina and LinkTone, both of which are listed on New York's NASDAQ stock market, started as private companies and raised finance from external sources as they grew. The result of private ownership origin was a board of directors that was comprised of interested, independent non-executives put in place by their venture capitalist firms prior to any public market listing. As an SOE, China Mobile was originally funded by the Chinese government and therefore had no need for directors who represented minority shareholder interests. Commencing at IPO and continuing thereafter, an outside investor should question the ability of an executive director of any previously state owned firm to understand director's responsibilities to minority shareholders with respect to rights protection, transparency, communications and the prudent use of capital (CLSA, 2004, p. 35). Prior to listing, these SOE executives had no experience in these matters. In these situations, the need for experienced non-executives to take a leading role in educating executive members on best practises is abundantly clear. However, acknowledging the need for independent directors and actually finding appropriate candidates are two separate matters. Recruiting appropriate non-executives to the board of Chinese companies is a recognized problem due to the small pool of qualified people in China (CLSA, 2004; Tenev *et al.*, 2002). This situation is continually improving as more Asian firms attain listings overseas. In the case of China Mobile, the company should make it a priority to find strong independent directors to address the current imbalance in its board.

Non-executive directors are also essential to fulfilling other corporate governance requirements as set out in the Principles. In particular, the formation of three board subcommittees is recommended, which are the audit committee, the remuneration committee, and the nominations committee. China Mobile has formed all three committees in 1998, 2000 and 2002 respectively. As recommended, the directors that sit on these committees are only the non-executive directors and they are there to monitor company activities on behalf of the shareholders. Again, the small number of non-executive board members at China Mobile hampers the effectiveness of these committees by requiring each director to sit on every committee and spread their limited time amongst more required projects. The 2004 Survey of corporate governance conducted by CLSA (2004, p. 127) found that China Mobile displayed a "negative corporate governance differentiator" as compared to other Hong Kong listed firms. This differentiator took the form of a lack of perceived safeguards in the audit committee – a particularly worrying fact when considering the importance of the independent audit committee on reviewing the plethora of China Mobile's related

party transactions. This fact had a serious negative impact on the company's ranking of corporate governance in the same report and was a contributing factor to it being highlighted on the list of companies that were failing some of the more important corporate governance test questions. This report put China Mobile in the third quartile of Hong Kong listed companies' corporate governance rankings. Considering the fact that McKinsey has estimated that investors are willing to pay an average premium of 25 per cent on a Chinese company's stock price for a well-governed company, a third quartile ranking should distress China Mobile's Board and current shareholders (Barton *et al.*).

Now let's consider the motivation of the Board of directors and key managers to represent shareholder interests. The principles of professionalism and ethics should be primary motivators for a director, however, often this is not enough to drive the director to make controversial statements in support of minority shareholders. The best way to ensure that the personal interests of the directors are aligned with the interests of the shareholders whom they represent is to make them minority shareholders themselves. This suggestion is made in this OECD Principle. At listing, China Mobile's directors and key executives held a total of 2,000 shares out of 11,780,788,000 shares outstanding (China Mobile 20f Filings 1997), a paltry proportion by any standards. The proportion of shares and options held by management has grown substantially since listing. Current China Mobile board directors hold 7.6 million options (at a variety of strike prices and exercise dates) accumulated over their years of service. The details of options held by non-executive directors are not disclosed and it is assumed that non-executive directors are compensated through the disclosed fees, salaries, allowances and benefits in kind, retirement scheme contributions, and performance related bonuses. On the matter of granting options to directors, China Mobile has augmented its options issuance so substantially in the past seven years that the abundance of options issued is deemed to be against shareholder's best interests as it significantly dilutes earnings per share (CLSA, 2004, p. 41). This development indicates that China Mobile has gone from having board members with little personal wealth at stake and therefore their interests being very poorly aligned with those of shareholders, to an over-issuance of options that are impacting shareholder returns. This situation exemplifies the need for balance and prudence when the board sanctions options granted to its members and other key employees. China Mobile has redressed its initial imbalance of director under-participation in the company's stock and in so doing has become more aligned with the OECD recommendations. However, options over-issuance has now become a corporate governance issue for China Mobile in its own right.

## **6. Concluding Remarks**

On the whole, China Mobile has strived to comply with good principles of corporate governance since its listing in 1997. It has succeeded on some fronts and failed on others. In the area of Disclosure and Transparency, the company has taken great pains in outlining operating and regulatory structures and risks to its investor community and has a good track record of communications. The company has also worked hard to grant options to tie directors closer to minority shareholders. The outlined OECD Principles of equitable treatment of shareholders, rights of shareholders and the provision of a framework for effective corporate governance have been well followed by China Mobile. China Mobile is in the business of providing

mobile telephony services to the Chinese market. While the MII continues to own a majority stake in China Mobile, there will be an inordinate number of related party transactions in the company's day to day business. Seemingly, China Mobile has explained these transactions and been granted a waiver by the HKSE on specific disclosure of certain transactions it is required to conduct with its controlling shareholder. This waiver does not dispel the risks these transactions pose for the minority investor. In fact, it simply puts an increasing level of duty to minority shareholders on the shoulders of the board of directors, and specifically, the independent members of that board.

Herein lie the potential failures of corporate governance in China Mobile. The heightened responsibility of the independent non-executive directors is not reflected in the board composition. It can be argued that China Mobile's related party transactions alone make it a perfect example of a company that requires a board of directors with an independent majority. In practise, the board is comprised of only 23 per cent independent directors. As recently as 2001, this level was only 17 per cent. This level of independent director participation is not sufficient to monitor the complex transactions in which the minority shareholder is at risk of unfair treatment to the hands of the controlling shareholder. In particular, acquisition valuation is a dangerous task to leave unmonitored. All of the 29 acquisitions China Mobile have entered into in the last seven years have resulted in billions of US dollars in payments to its controlling shareholder and have strengthened the ability for that shareholder to maintain control of over 75 per cent of the outstanding China Mobile stocks. The outstanding growth in subscriber base, revenues and profits have left China Mobile on the analyst's buy list and have seen the stock price recover after a market-wide fall in technology and telecom stock prices. As long as this success is achieved in lockstep with good corporate governance and long-term shareholder protection, it is something to celebrate.

This review of China Mobile has highlighted flaws in some fundamental aspects of its corporate governance. This seemingly conflicts with the honours and awards granted to China Mobile by various bodies for its corporate governance excellence. Industry awards may not take into account the more detailed aspects of disclosure including related party transactions. Furthermore, they may choose to commend the "least spoiled apple" in the barrel of Asian listed company corporate governance. If this is the case, the awards may be well won by China Mobile. The discrepancy between this review and the prima facie reflection of the awards on China Mobile's corporate governance should in any event be of interest to China Mobile shareholders. It should serve to remind minority shareholders that they are the ultimate winners and losers in China Mobile's corporate governance ranking when the public markets price corporate governance factors into its stock price.

Corporate governance is a reflection of quality of management and nothing can deter mismanagement better than high levels of transparency (CLSA, 2004, p. 23). This holds true for companies around the globe. In comparison to their counterparts in more developed capital markets, Chinese companies have added challenges: the need to educate executive and non-executive board members, the frequent agency problems associated with the controlling shareholder who is also the government, the lower standards of corporate governance required by the regional stock exchanges, to name a few. In response to this, many companies choose to list on multiple markets via the ADR system as China Mobile has done. Asian firms that trade shares in the US have higher governance rankings, especially in countries with weak legal systems (Klapper,

*et al.*, 2002; Sun and Tobin, 2005). However, a company's governance ranking is ultimately attributable to the decisions of its board of directors. In the case of China Mobile, the decisions of its directors seem wanting in certain areas and are to be commended in others. This is not surprising in a business with such rapid underlying growth. However, it is something that international investors should track diligently as their company plans its next phase of growth.

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