CG WATCH 2018

Hard decisions

Asia faces tough choices in CG reform

Special report

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Wilson House
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Central
HONG KONG SAR

www.acga-asia.org

CLSA Limited
18/F
One Pacific Place
88 Queensway
Admiralty
HONG KONG SAR

www.clsa.com

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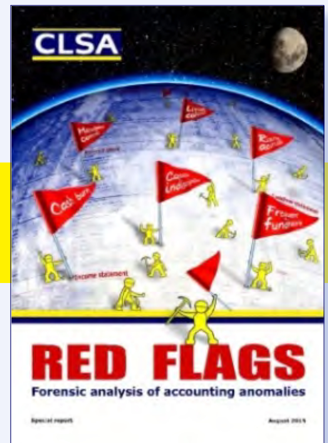
Jamie Allen, Secretary General

Jamie Allen is responsible for overall management of the Asian Corporate Governance Association (ACGA), as well as directing ACGA's research, advocacy and educational work in 12 Asia-Pacific markets. He is a published author and has more than 30 years' experience as a writer, editor and analyst covering the economies of Greater China and East Asia from Hong Kong.

Sleuthing for accounting fraud



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For important disclosures please refer to page 394.

Charles Yonts, CLSA
Head of Power & ESG Research
charles.yonts@clsa.com
+852 2600 8539

Jamie Allen, ACGA
Secretary General, ACGA
+852 2160 1788

Miriam Zhou, CLSA
+852 2600 7978

In collaboration with

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All prices quoted herein are as at close of business 4 December 2018, unless otherwise stated

Acknowledgements and disclaimer

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ACGA endorses the methodology used in the CLSA company survey and undertook the market rankings. ACGA did not participate in the assessments of companies, however, for which CLSA retains responsibility. ACGA bears final responsibility for the market rankings.

CG Watch through the years

Saints & sinners

April 2001

In our first edition we surveyed and ranked 495 stocks in 25 global emerging markets. High CG scorers generally outperform. South Africa, HK and Singapore score well, as do transport manufacturing, metals/ mining and consumer.

On a wing and a prayer

September 2007

We include "clean and green" criteria in our corporate-governance scoring. Climate change is now a matter of corporate responsibility, with attendant economic risks. Yet, Asian firms are largely ignoring the issue.

Make me holy . . .

February 2002

Almost invariably, companies with high CG scores remained market outperformers, this year. The top-CG quartile outperformed the country index in nine out of 10 of the Asian markets under CLSA coverage.

Stray not into perdition

September 2010

Corporate-governance standards have improved, but even the best Asian markets remain far from international best practice. Our CG Watch rankings may surprise investors this year even more than the 2007 reordering.

Fakin' it

April 2003

Companies are smartening up their act, as stocks with high CG scores outperform. But much of the improvement is in form - commitment is not yet clear. Market regulations are moving up and it is time for shareholders in the region to organise.

Tremors and cracks

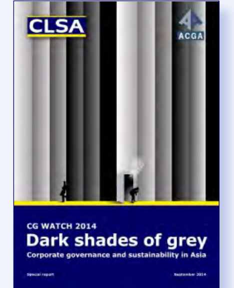
September 2012

Cracks in Asian corporate governance have become more apparent since our last CG Watch. We provide CG and ESG ratings on 865 stocks. We rank the markets and indicate issues investors should watch for in the tremors of Asian investing.

Spreading the word

September 2004

Our more rigorous CG survey of 10 markets in Asia ex-Japan finds improvements in many of the 450 stocks we cover, following new rules introduced in recent years. CG also emerges as an explanation for beta.



Dark shades of grey

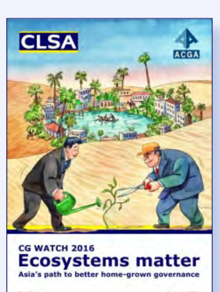
September 2014

This year we rate 944 companies in our Asia-Pacific coverage. Japan has moved higher while Hong Kong and Singapore have slipped. Corporate scores have fallen, particularly in Korea. We have revamped our environmental & social scoring.

The holy grail

October 2005

QARP (Quality at a reasonable price) is a guide for stock selection in the quest for high-CG stock performance. The QARP basket of the largest 100 stocks in Asia ex-Japan beat the large-cap sample in the three years to 2004.



Ecosystems matter

September 2016

Governance matters and ecosystems are key. No one stakeholder drives the process, it's the collective interaction that delivers outcomes. Australia heads our bottom-up survey and joins ACGA's top-down survey at No.1. Asia is improving.

Hard decisions

Asian market reform is under threat

Fostering more competitive markets through higher corporate-governance standards has driven Asian capital market reform over the past 20 years. While this edition of *CG Watch* provides plenty of evidence of the ongoing push towards better CG, the introduction of dual-class shares in Hong Kong and Singapore highlights the threat to that fundamental driver. For ACGA, this leaves little prospect of either market unseating leader Australia any time soon. In fact, both face tougher competition from top-movers like Malaysia.

Transparency and accountability continues, but fairness is under fire

To varying degrees, regulators across the region have sought to push, persuade or cajole market participants towards higher levels of transparency, accountability and fair treatment of consumers and shareholders. A belief in the value of transparency and accountability remains largely intact, but the third principle, fairness, has come under fire. In the face of competition from the USA for listings of Asian companies, certain governments have pushed aggressively for dual-class shares (DCS) as necessary to ‘maintain competitiveness and fund innovation’.

DCS hurts top-down scores for HK/Singapore

Asian leaders Hong Kong and Singapore have made opportunistic moves towards DCS, which has taken a toll on their scores in this year’s top-down survey. While both markets still rank in the top three, they do so by the barest of margins. Australia’s position at the top remains secure.

Malaysia was the top-mover in the surveys from both ACGA and CLSA

Malaysia was the biggest gainer in both ACGA’s top-down survey as well as CLSA’s bottom-up one this year, reflecting concrete moves to tackle endemic corruption issues fostered by the previous Najib regime. In contrast to ACGA, the introduction of DCS has not moved the needle for CLSA’s company-level scoring in Hong Kong or Singapore, simply because almost none of the companies we cover employ them. Our analysts continue to focus on capital management, independence and the risks around related parties. These areas are also in focus for short-sellers, who have recently stepped up attacks in the region.

Over-reliance on simple ESG scores is risky, but there is value in screens

The volume of environmental and social governance (ESG) data in Asia is skyrocketing to match surging demand. But the quality and comparability of that data remains hotly contested and we would caution against over-reliance on simple ESG scores. Nevertheless, there is still clearly value in screens. The Microstrategy team finds that companies with top quintile ESG scores outperformed the worst quintile by over 7% per annum over the past five years.

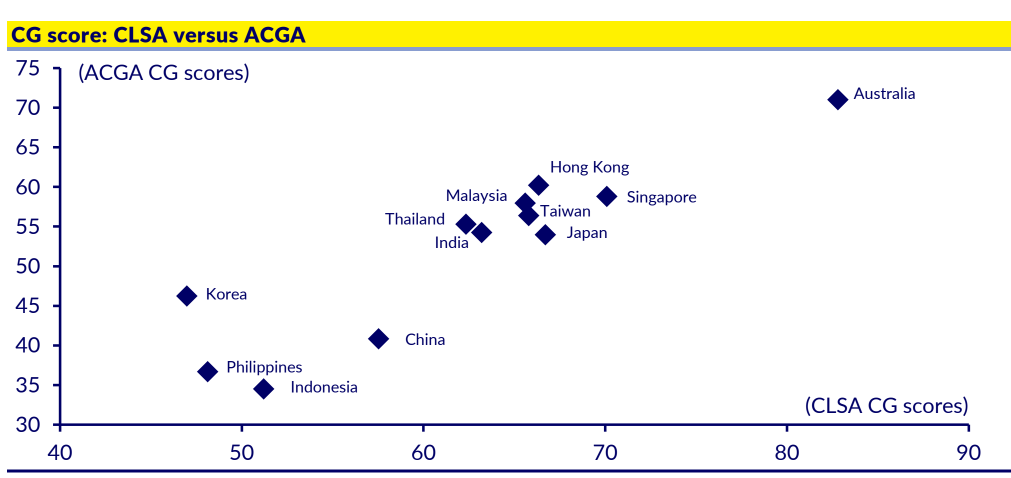
Difference between CLSA and ACGA scoring methodology

CLSA computes market scores based on aggregating bottom-up assessments of companies under CLSA coverage in Asia

ACGA computes market scores based on evaluating market performance using its survey

Please see Appendices 2-4 for CLSA and ACGA questionnaires

CG score: CLSA versus ACGA



Source: CLSA, ACGA

Transparency, accountability and fairness

For 20 years, the belief that better CG led to stronger capital markets held sway

A fundamental policy position has guided most capital market reform in Asia over the past two decades: that higher standards of corporate governance will lead to more competitive markets and companies. To varying degrees, regulators across the region have sought to push, persuade or cajole market participants of all kinds towards higher levels of transparency, accountability and fair treatment of consumers and shareholders. Governments have moved at different speeds, held back by local vested interests or entrenched laws and attitudes, and they have not always agreed on what the right mix of best practices should be. All of them, understandably, have sought to build upon existing institutions of law and governance. Yet amid all the obvious diversity in the region, convergence around these core principles has held sway.

Official mindsets now appear to be changing

Official mindsets now appear to be changing. The strong commitment to quality and better practices of the past 20 years is starting to become undermined by a more localist and divisive way of thinking. While a belief in the value of transparency and accountability remains largely intact, at least in official statements, some governments are showing a striking lack of interest in the third principle: fairness. In the face of stiff competition from the USA for listings of Asian companies, mostly so-called new-economy firms from China, certain governments have pushed aggressively for dual-class shares as necessary to 'maintain competitiveness and fund innovation'.

The change has been sudden: in the previous CG Watch in September 2016, the region was standing firm against dual-class shares (DCS) - or second-class shares as they should more accurately be called. Today advocates of DCS are trying to make it the new normal, accompanied by an obsessive focus on IPO numbers as the only yardstick that seems to matter when measuring capital market success.

Hong Kong pips Singapore to 2nd; Malaysia up to 4th; Japan down to 7th, tied with India

ACGA market CG scores

Market	Total (%)	Key CG reform themes and questions
1. Australia	71	Bank governance needs overhaul, time for a federal ICAC
2. Hong Kong	60	Going backwards on DCS, about to go forwards on audit regulation
3. Singapore	59	Going backwards on DCS, reform direction reflects contradictory ideas
4. Malaysia	58	Can new government rid the system of corruption and cronyism?
5. Taiwan	56	Moving forward, yet piecemeal reforms hinder progress
6. Thailand	55	Moving forward, yet corruption and decline in press freedom are concerns
=7. India	54	Bank governance needs overhaul, new audit regulator disappoints
=7. Japan	54	Heavy focus on soft law needs to be balanced with hard law reforms
9. Korea	46	Stewardship code gaining traction, but sadly so is DCS
10. China	41	Reinforcement of Party Committees raises numerous questions
11. Philippines	37	CG reform low on the government's priorities, direction unclear
12. Indonesia	34	CG reform low on the government's priorities, direction unclear

Source: ACGA

ACGA category scores: less is not more

The fairness principle has never been evenly applied

While the negative impact of DCS on the fairness principle is a new phenomenon in Asia, this is not the first time that regulators have shown ambivalence towards minority shareholder rights. Indeed, the fairness principle has always been unevenly applied in different markets. This is most directly reflected in our CG rules category (see following table) and in markets scoring less than 50%, namely Indonesia, Japan, Korea and the Philippines. Lukewarm respect for shareholder rights is evident in the weak or limited protections in the event of takeovers; dilutive capital raisings; limited disclosure on share pledging by controlling

shareholders; and annual general meetings organised at inconvenient times - the list could go on. However, it needs to be said that all markets, including the top-ranked ones, would score higher in CG rules if they closed loopholes in shareholder rights. Australia, Hong Kong and Singapore are not perfect.

Seven categories for CG Watch 2018

Market scores by category

(%)	AU	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH	Regional Average
1. Government & public governance	**65**	31	63	38	26	55	52	42	**23**	55	60	45	46
2. Regulators	57	56	**69**	60	**21**	52	56	61	25	54	60	50	52
- Funding, capacity, reform	54	48	60	60	**22**	48	56	**62**	24	48	60	52	50
- Enforcement	60	64	**78**	60	**19**	57	55	59	26	59	60	49	54
3. CG rules	**78**	58	74	68	**35**	47	45	70	43	68	63	68	60
4. Listed companies	73	36	55	62	43	48	38	57	44	63	56	63	53
5. Investors	**63**	**18**	26	36	19	53	33	38	21	32	33	30	34
6. Auditors & audit regulators	**84**	50	74	**39**	61	71	69	**84**	63	79	70	71	68
7. Civil society & media	**78**	**22**	60	71	44	62	31	47	38	62	51	51	51

Source: ACGA

The next 20 years

Has corporate governance in Asia improved?

The ACGA is often asked this tough question: Has corporate governance in Asia truly improved? Judging by the contents of this report and our sharp criticisms of certain issues and markets, as well as some of the low scores, you may conclude it has not. However, we look at corporate governance from where it has come as well as where we would like it to go. We would say there has been tremendous change in Asia over the past 20 years, not only in regulation but also the quality of the work being done by the best companies, the most committed investors, the most thoughtful auditors, the sharpest journalists and many other stakeholders. We see this plainly in all the meetings we have and research we do for *CG Watch* and other ACGA activities. The quality of the discussion and thinking is unlike anything we came across when we started.

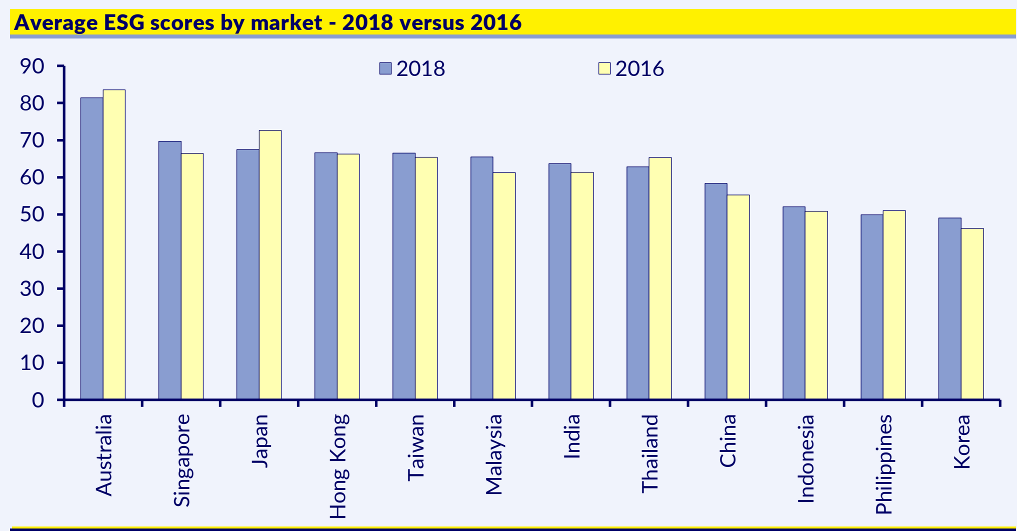
Australia and Korea remain the bookends in CLSA's survey

Australia breezed into first place; Malaysia was the biggest mover

Australia breezed into first place yet again this year in CLSA's bottom-up *company ESG* survey. The biggest mover in 2018 was Malaysia, where aggregate company scores jumped two spaces on optimism over the leadership change, as well as tangible improvements to enforcement and reporting. Frustration about the pace of reform pushed Korea into last place for the third time in a row. The volume of ESG data in Asia is skyrocketing to match surging demand, but the worth of that data is hotly contested. There are no shortcuts to integration, but we still see value in screens, particularly with activist short-sellers on the march.

ESG scores 2018 vs 2016 by market

Average ESG scores by market - 2018 versus 2016



Source: CLSA

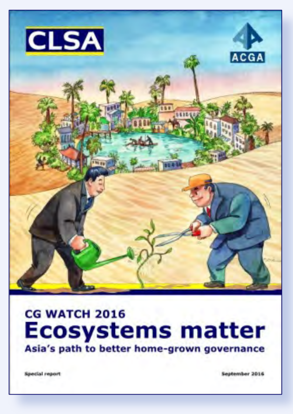
Average category scores have not changed dramatically from 2016, although stricter interpretation on diversity has brought down aggregate independence scores slightly.

Independence is again the lowest scoring category in CLSA's CG survey

Aggregate company scores by category

(%)	Discipline	Transparency	Independence	Responsibility	Fairness	CG	E/S	Blended ESG
Australia	74.9	92.2	77.5	84.2	85.2	82.8	68.6	81.4
China	51.4	61.7	46.2	52.7	75.7	57.5	65.3	58.3
Hong Kong	62.4	69.6	50.1	63.8	85.9	66.3	68.9	66.6
India	57.0	77.1	40.3	55.0	86.6	63.2	67.8	63.7
Indonesia	45.8	63.1	31.9	34.9	80.3	51.2	59.2	52.0
Japan	69.0	64.7	27.7	84.2	88.0	66.7	74.2	67.5
Korea	40.5	57.9	29.9	51.1	55.5	47.0	67.1	49.0
Malaysia	61.3	72.8	49.6	58.4	85.9	65.6	64.4	65.5
Philippines	59.6	59.0	27.5	31.0	63.7	48.1	65.3	49.9
Singapore	55.9	83.8	59.2	57.4	94.2	70.1	66.1	69.7
Taiwan	70.0	53.1	48.9	77.4	79.5	65.8	73.0	66.5
Thailand	53.1	81.8	58.1	37.5	81.3	62.3	66.7	62.8
Average	**58.4**	**69.7**	**45.6**	**57.3**	**80.2**	**62.2**	**67.2**	**62.7**
Average ex-Aus	56.9	67.7	42.7	54.9	79.7	60.4	67.1	61.0
Max-Min range (ex-Aus)	29.5	30.6	31.7	53.2	38.7	23.1	15.0	20.7

Note: Boxes highlight leader (green) and laggard (yellow) ex-Australia. Source: CLSA

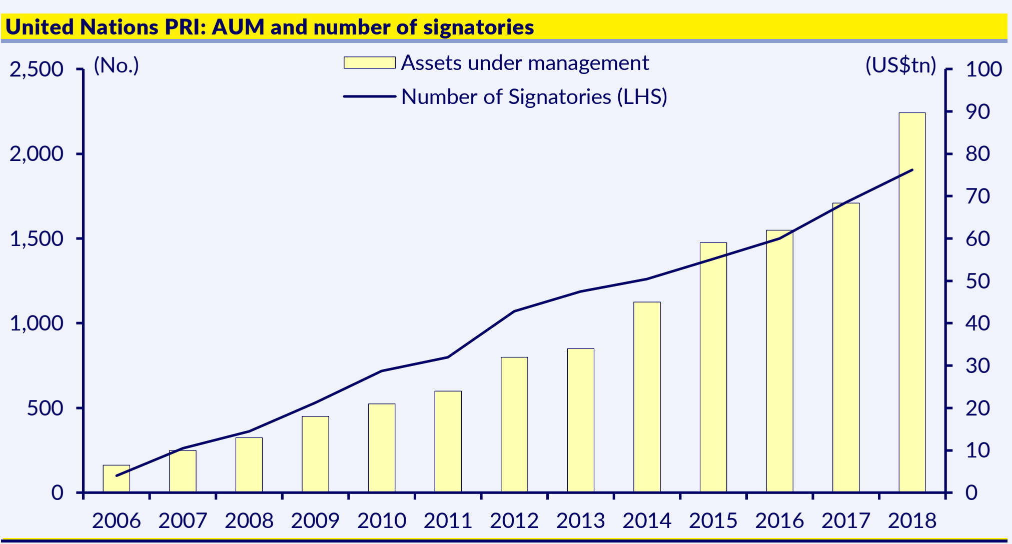


US$89.7tn invested sustainably

Growth in ESG investing continues apace, with sustainable assets under management expanding another 31% to US$89.7tn in 2018, according to principles for responsible investment (PRI). Investors and exchanges are pushing companies in Asia, in particular, to ratchet up ESG reporting. As of 2017, 42% of all GRI-standard sustainability reports came from Asia, versus 25% in 2011.

As of 2018, AUM reached US$89.7tn, up 31% YoY

United Nations PRI: AUM and number of signatories

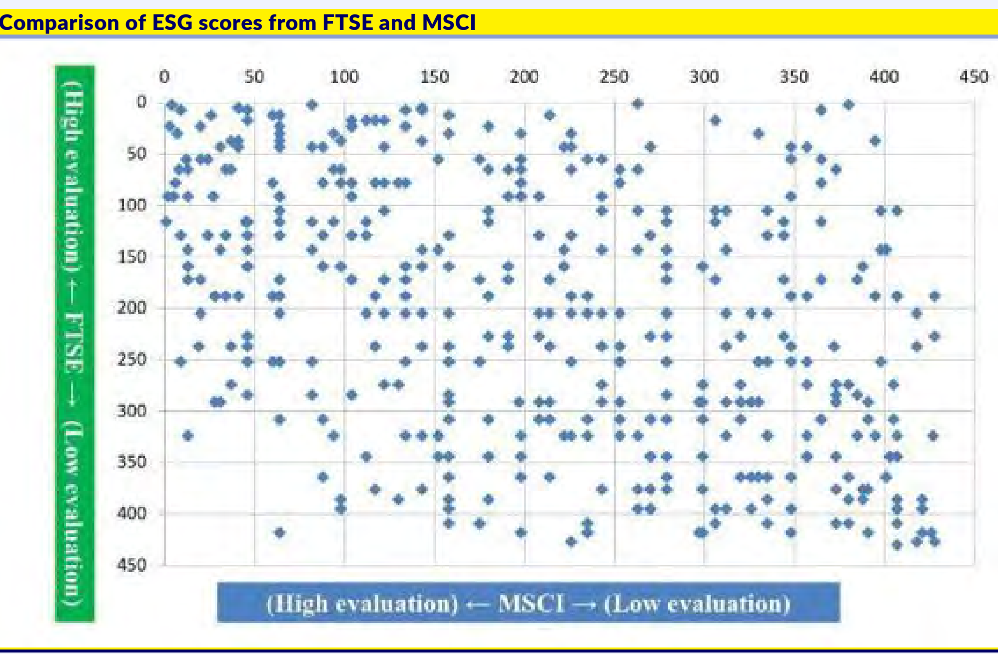


Source: CLSA, PRI

However, making sense of the data has not gotten any easier, despite a proliferation of third-party data providers. Over the past year, there have been a number of studies and media articles pointing out the lack of consistency between scoring methods. We believe that these studies do not discredit ESG data or the practice of scoring. However, it underscores the danger of relying on a simple final score for investment decisions.

Low correlation between service providers

Comparison of ESG scores from FTSE and MSCI

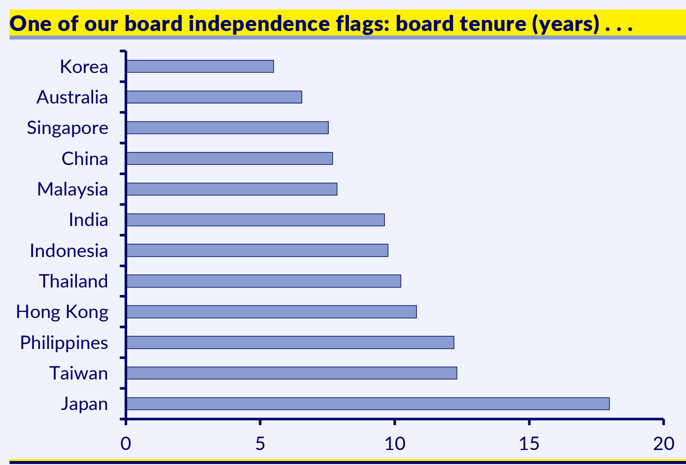


Source: CLSA, GPIF

Analysts retain discretion in scoring

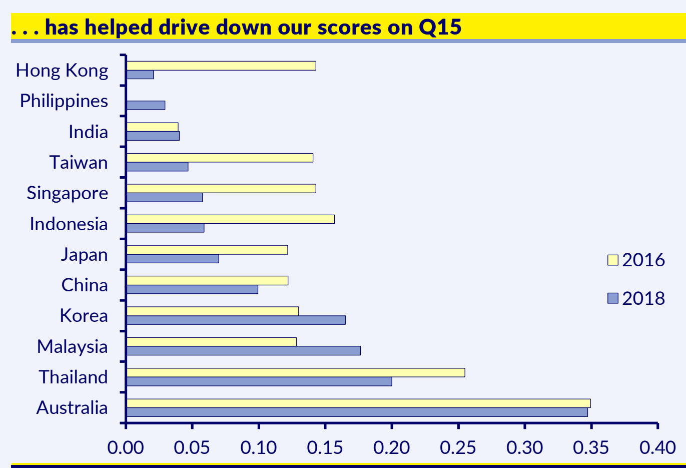
Against this backdrop, we incorporate more data screens into our scoring process, but analysts retain ultimate discretion. For example, if available data suggest that a company's board is not independent (long tenure, too big or too small, low share of independent directors) then we mark the company down on independence. However, the covering analyst can override that call with an explanation of what the data might be missing. This scoring process bolsters our efforts at broader ESG integration.

One of our board independence flags: board tenure (years) . . .



Source: CLSA, Factset

. . . has helped drive down our scores on Q15



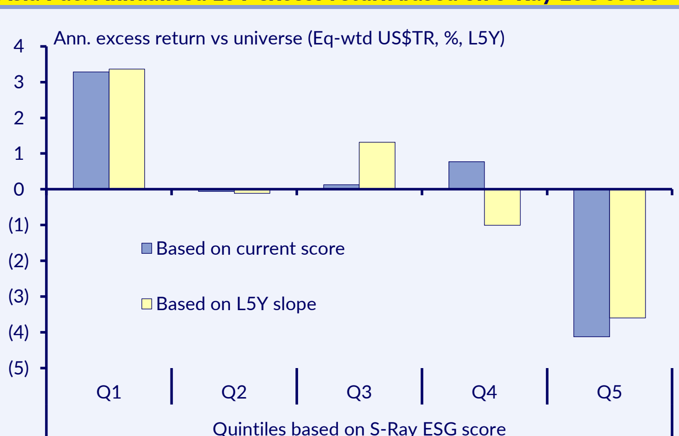
Note: whether INEDs act in a genuinely independent way, in some markets. Source: CLSA

Achieving outperformance with ESG . . .

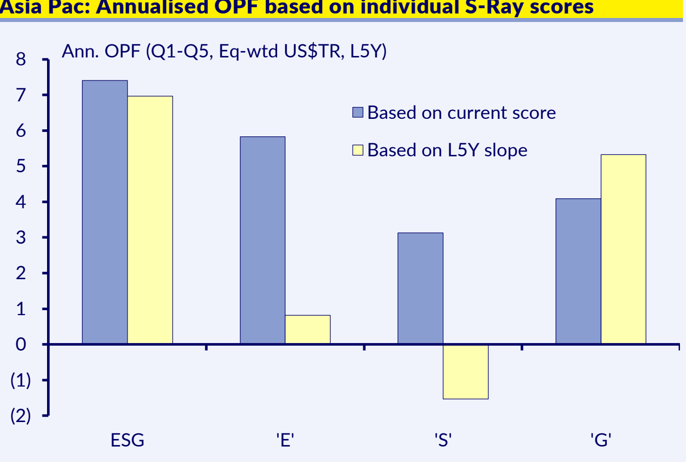
Does it 'work?'

While we are wary of fixating on the final ESG score, we still clearly see value from incorporating ESG scores into screens. Using scores from Arabesque S-Ray, CLSA's Microstrategy team found that companies with top quintile ESG scores, and those with the most improved scores, outperformed the worst quintile by over 7% per annum over the past five years. Outperformance was sustained even after adjusting for market and sector.

Asia Pac: Annualised L5Y excess return based on S-Ray ESG score



Asia Pac: Annualised OPF based on individual S-Ray scores



Note: Universe is broader Asia Pacific companies. Current S-Ray scores and at least last three years quarterly historical S-Ray scores and US-dollar total return have to be available. Q1 = highest; Q5 = lowest. Higher score the better. Source: Factset, Arabesque S-Ray, CLSA

. . . or mitigating disaster

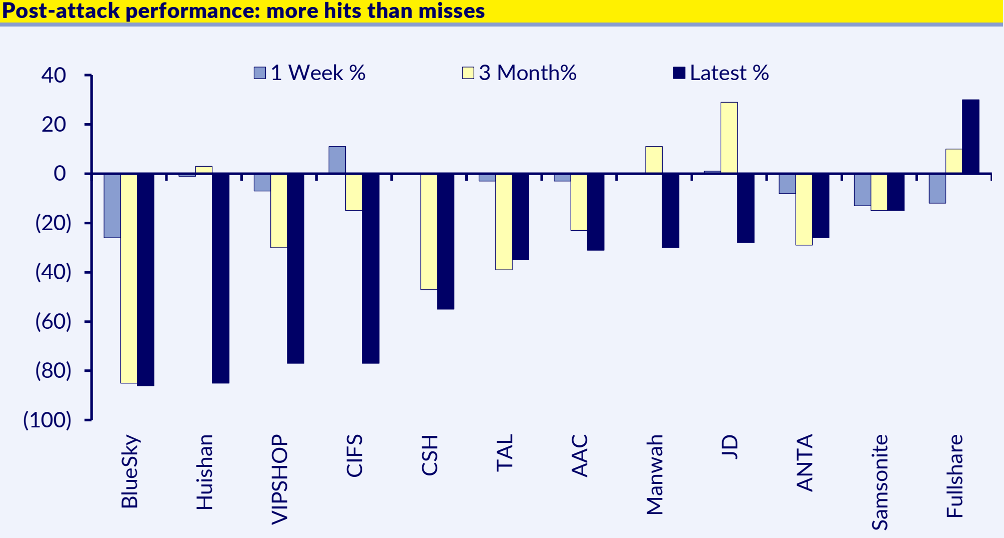
Our Microstrategy team has also incorporated ESG scores and metrics into screens to weed out potential corporate blow-ups. We have seen an uptick in such events over the past couple years, with a frenzy of (mostly successful) activist short-seller attacks. We reviewed 13 Asian short-seller attacks since January 2017 to pull out common red flags (related-party transactions and misreported financials), and spoke to two activist short-sellers about methodology and outlook for different sectors and markets around the region.

More hits than misses

While we do not endorse all of the short-sellers' allegations, we still see great value in breaking down the processes and indicators that they use. At the very least, it can help us to prep for future attacks. Activist short-sellers have seen more hits than misses, with the majority of stocks falling on a one- and three-month basis.

The majority of stocks falling on a one- and three-month basis

Post-attack performance: more hits than misses

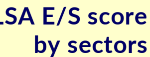


Note: Latest share price as of 26 September 2018. Source: Bloomberg, CLSA

Climate focus for environmental and social (E/S) issues

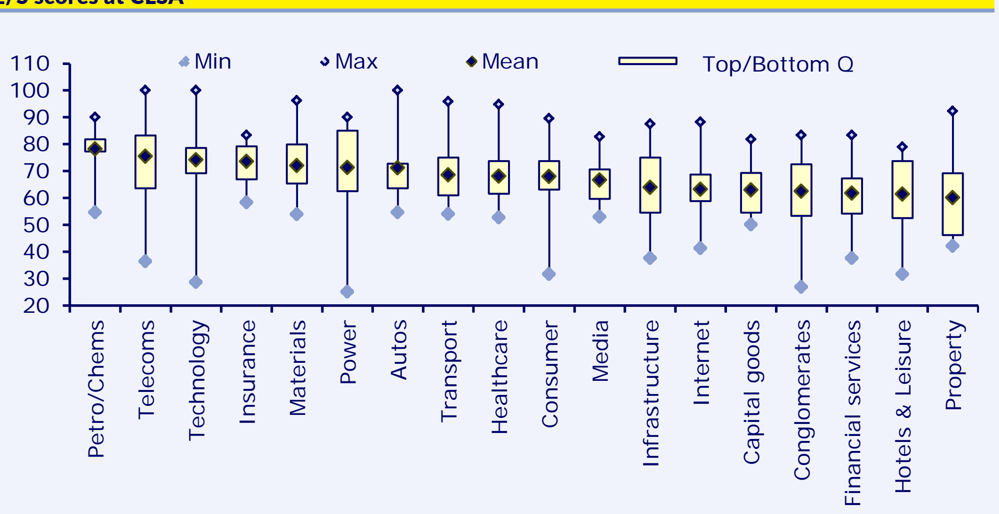
CLSA's E/S scoring is broken into 18 sectors

CLSA's analysts across the region score their companies on Environmental and Social (E/S) issues, with these scores feeding into blended ESG scores. Unlike Corporate Governance (CG) questions, which are the same across markets and across sectors, our E/S questions vary to reflect material issues for 18 specific sectors.



CLSA E/S score by sectors

E/S scores at CLSA



Source: CLSA

Climate change and Beautiful China are the overarching environmental themes

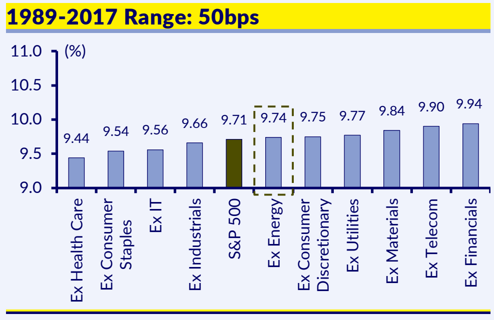
In addition to scoring, we have also written on a raft of environmental and social issues. A few recurring themes stand out: Xi Jinping's Beautiful China initiative and, of course, climate change. While it is not a new issue, the focus engendered by Paris has triggered a flurry of initiatives that are starting to bear fruit in Asia. The growing fossil-fuel divestment movement is a stand-out, with Standard Chartered becoming the latest major bank to halt funding to new coal-fired projects in the region.

More investors have committed to divest from fossil fuels

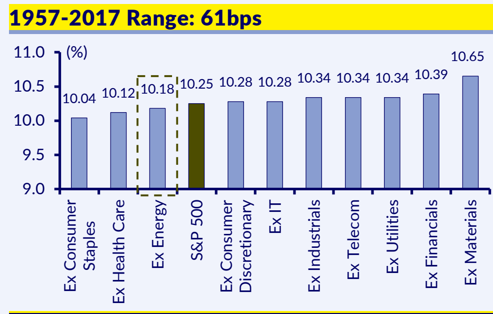
According to a September 2018 report by Arabella Advisors, investors managing US$6.2tn in AUM have committed to divest from fossil fuels, up from just US$52bn in 2014. Are they sacrificing performance? GMO's Jeremy Grantham takes a long term (multi-decadal) view, suggesting that, historically, fossil fuels have been nearly irrelevant to performance.

Grantham illustrates that removing energy from the S&P 500 for the past 28 years would have delivered an incremental 3bps pa performance (9.74% annualised vs 9.71%) versus the S&P 500. Going back 60 years, the same exercise would have cost you 7bps pa; going back 92 years, 5bps pa.

Divestment does not harm performance



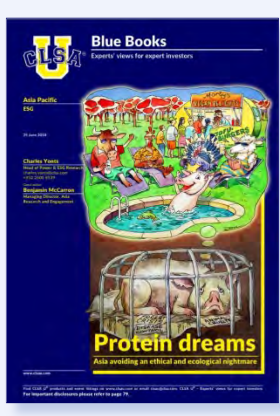
Source: CLSA; Jeremy Grantham: *The Race of Our Lives Revisited*



Source: CLSA; Jeremy Grantham: *The Race of Our Lives Revisited*

Growing appetite for protein and palm oil presents dangers

Climate change has also helped focus attention on Asia's unsustainably growing appetite for meat, which links to palm-oil deforestation. Thankfully, Electric Vehicles (EVs) have crowded biofuels out of the suite of solutions for transport emissions. But accelerating EV demand has also given rise to fears about growing mountains of toxic battery waste and unethical supply chains featuring children in the Congo. Supply-chain challenges remain, as well, across South and Southeast Asia five years after the tragedy of Rana Plaza. As workers' rights continue to improve in fits and starts across Asia, the region is also home to two-thirds of the world's estimated slaves. There is still a long way to go.



Exposure of protein companies to top-5 risk factors

Company	Food safety	Public health	Environmental footprint	Animal welfare	Labour standards
Charoen Pokphand Foods	1	3	2	2	2
China Mengniu	3	1	1	1	1
Guangdong Wens	1	1	2	3	3
Henan Shuanghui	2	1	3	3	3
Japfa Comfeed	1	1	3	3	2
Maruha Nichiro	2	2	1	2	2
New Hope Liuhe	2	1	3	3	3
NH Foods	2	2	1	3	1
Thai Union	3	3	1	na	2
WH Group	3	2	2	1	3

1 = low risk, 2 = medium risk, 3 = high risk; na = not applicable. Source: Asia Research & Engagement (ARE), taken from the CLSA-U bluebook Protein dreams

Markets overview

A long-held regulatory principle - that higher standards of corporate governance make markets more competitive - is under threat in Asia and so is the core principle of fairness.

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
+852 2160 1788

For 20 years the belief that better CG led to stronger capital markets held sway

For most of the past 20 years, a fundamental policy position has guided most capital market reform in Asia: that higher standards of corporate governance will lead to more competitive markets and companies. To varying degrees, regulators across the region have sought to push, persuade or cajole market participants of all kinds towards higher levels of transparency, accountability and fair treatment of consumers and shareholders. Governments have moved at different speeds, held back by local vested interests or entrenched laws and attitudes, and they have not always agreed on what the right mix of best practices should be. All of them, understandably, have sought to build upon existing institutions of law and governance. Yet amidst all the obvious diversity in the region, convergence around these core principles has held sway.

Official mindsets now appear to be changing

Official mindsets now appear to be changing. The strong commitment to quality and better practices of the past 20 years is starting to be undermined by a more localist and divisive way of thinking. While a belief in the value of transparency and accountability remains largely intact, at least in official statements, some governments are showing a striking lack of interest in the third principle: fairness. In the face of stiff competition from the Unites States for listings of Asian companies, mostly so-called new economy firms from China, certain governments have pushed aggressively for dual-class shares as necessary to 'maintain competitiveness and fund innovation'. The change has been sudden: when we published our last CG Watch in September 2016, the region was standing firm against dual-class shares (DCS) - or second-class shares as they should more accurately be called. Today advocates of DCS are trying to make it the new normal, accompanied by an obsessive focus on IPO numbers as the only yardstick that seems to matter when measuring capital market success.

Hong Kong pips Singapore to 2nd; Malaysia up to 4th; Japan down to 7th with India

ACGA market CG scores

Market	Total (%)	Key CG reform themes and questions
1. Australia	71	Bank governance needs overhaul, time for a federal ICAC
2. Hong Kong	60	Going backwards on DCS, about to go forwards on audit regulation
3. Singapore	59	Going backwards on DCS, reform direction reflects contradictory ideas
4. Malaysia	58	Can new government rid the system of corruption and cronyism?
5. Taiwan	56	Moving forward, yet piecemeal reforms hinder progress
6. Thailand	55	Moving forward, yet corruption and decline in press freedom are concerns
=7. India	54	Bank governance needs overhaul, new audit regulator disappoints
=7. Japan	54	Heavy focus on soft law needs to be balanced with hard law reforms
9. Korea	46	Stewardship code gaining traction, but sadly so is DCS
10. China	41	Reinforcement of Party Committees raises numerous questions
11. Philippines	37	CG reform low on the government's priorities, direction unclear
12. Indonesia	34	CG reform low on the government's priorities, direction unclear

Note: Total market scores are based on actual total scores, converted to a percentage and rounded. They are not an average of the seven category percentage scores. Total scores for each market was as follows: Australia (425); Hong Kong (364); Singapore (356); Malaysia (351); Taiwan (341); Thailand (334); India (328); Japan (325); Korea (280); China (247); Philippines (222); and Indonesia (209). Source: ACGA

Taking a toll

Hong Kong and Singapore are barely holding on to their top rankings due to DCS

The opportunistic moves towards DCS by its two leading proponents in Asia, namely Hong Kong and Singapore, have taken a toll on their scores in this year's CG Watch. While both markets still rank in the top three, as the table above shows, they do so by the barest of margins. Singapore would definitely have ranked above Hong Kong were it not for its DCS policy. And Hong Kong would have been several percentage points closer to Australia, bringing the gap down from 11 points closer to probably a seven or eight point difference—a much more respectable score for Hong Kong.

The score differential among the top five Asian markets is narrowing

Markets that did not move towards dual-class shares now have an opportunity to overtake Hong Kong and Singapore in future surveys, as the narrowing of the score differential among the top five Asian markets shows:

Figure 1

Top-5 Asian markets: Market score differentials, 2016 vs 2018 (percentage points)

	2016	2018
No.1 vs No.2, No.3, No.4, No.5	2, 4, 7, 9	1, 2, 4, 5
No.2 vs No.3, No.4, No.5	2, 5, 7	1, 3, 4

Note: The top Asian market in 2016 was Singapore. It is now Hong Kong. Source: ACGA

Where we took points off for DCS

Our approach to handling the dual-class issue was not to create new negative-scoring questions in our survey, as we felt this would be rather arbitrary: How many points should we deduct from category or total scores? Instead, we took a more organic approach and selected seven existing questions in the survey that were relevant in various ways to the DCS issue. We then reduced the score for each appropriately.

We addressed DCS through our existing survey, not with new negative questions

Most of the seven questions were in 1. Government & Public Governance; and 2. Regulators. They were: Q1.1, 1.2, 1.4, 1.5. And Q2.5, 2.6, 2.19. See Appendix 2 for our full survey of questions and scores.

Contagion

The "race to the bottom" that CG advocates feared is real . . . Korea joins the party . . .

One of ACGA's main concerns about dual-class shares being introduced in Hong Kong and Singapore was the potential for contagion around the region. Sure enough, in January 2018 a senior Korean government official, Kim Sang-Jo, chairman of the Fair Trade Commission, mused on the possibility of allowing DCS for firms listed on KOSDAQ, the country's second market for smaller companies. This led to a fierce debate as to whether the *chaebol*, the large family controlled conglomerates, should be allowed the same protection. While that had not been Kim's intention—his proposal was intended only to help capital-starved small firms raise cash—the incident showed how quickly this particular genie can escape from the bottle. Indeed, suggesting even a limited application of dual-class shares in a market such as Korea is highly short-sighted, since the Korean *chaebol* have been asking for special protection ever since poison pills became popular in Japan in the mid-2000s. The hotly contested merger between Samsung C&T and Cheil Industries in mid-2015, where the transaction was almost defeated by shareholder votes, only added to the *chaebols'* demands. While CG advocates in Korea started breathing more easily during 2018 as no new announcements were made on the issue, the incumbent Democratic Party of Korea then sprang a surprise in mid-October by announcing it would start discussions on DCS for privately held venture firms.

. . . and so does China

In China, the competitive response to Hong Kong's introduction of DCS was a proposal for China Depository Receipts (CDRs). One of Hong Kong's hopes was that it could attract mainland Chinese tech giants with a dual-share structure, such as Baidu and JD.com, or special partnership arrangements, namely Alibaba, to undertake secondary listings in Hong Kong. China wasted little time in coming up with a counter proposal—the CDR. While this plan has been postponed for the moment due to poor market conditions and weak investor response to the concept (in part because of the way it was originally structured), it has also opened the way to a broader discussion of DCS in China. Many academics and some officials for example are quite taken with the idea. Meanwhile, CDRs will almost certainly make a comeback when the time is right.

Other Asian markets have stood firm against DCS. But will it last?

Other Asian markets have so far stood firm against DCS and, accordingly, gained ground in our survey against Hong Kong and Singapore. The main winner in this regard is Malaysia. Yet officials there and elsewhere acknowledge that they will likely come under pressure to consider dual-class shares if their young firms choose to list in Hong Kong, Singapore or the US instead of at home.

Less is not more

The fairness principle has never been evenly applied

While the negative impact of DCS on the fairness principle is a new phenomenon in Asia, this is not the first time that regulators have shown ambivalence towards minority shareholder rights. Indeed, the fairness principle has always been unevenly applied in different markets. This is most directly reflected in our CG Rules category (see table below) and in markets scoring less than 50%, namely Indonesia, Japan, Korea, and the Philippines. Lukewarm respect for shareholder rights is evident in many areas: weak or limited protections in the event of takeovers; dilutive capital raisings; limited disclosure on share pledging by controlling shareholders; and annual general meetings organised at inconvenient times. The list could go on. However, it needs to be said that all markets, including the top-ranked ones, would score higher in CG Rules if they closed loopholes in shareholder rights. Australia, Hong Kong and Singapore are not perfect.

Scores for the seven categories in CG Watch 2018

Market scores by category

(%)	AU	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH	Regional Average
1. Government & public governance	**65**	31	63	38	26	55	52	42	**23**	55	60	45	46
2. Regulators	57	56	**69**	60	**21**	52	56	61	25	54	60	50	52
- Funding, capacity, reform	54	48	60	60	**22**	48	56	**62**	24	48	60	52	50
- Enforcement	60	64	**78**	60	**19**	57	55	59	26	59	60	49	54
3. CG rules	**78**	58	74	68	**35**	47	45	70	43	68	63	68	60
4. Listed companies	73	36	55	62	43	48	38	57	44	63	56	63	53
5. Investors	**63**	**18**	26	36	19	53	33	38	21	32	33	30	34
6. Auditors & audit regulators	**84**	50	74	**39**	61	71	69	**84**	63	79	70	71	68
7. Civil society & media	**78**	**22**	60	71	44	62	31	47	38	62	51	51	51

Source: ACGA

The issue of regulatory ambivalence is also reflected, though more indirectly, in the Government & Public Governance category. One reason why the scores for most markets are disappointing is because few jurisdictions make it easy or cost-effective for shareholders to access the legal system to resolve governance issues. Class-action lawsuits, even in the few places they are allowed, are hard to do and scarce. Whereas governments are comfortable giving stronger powers to regulators—something which has had a positive impact on enforcement outcomes—they are reluctant to strengthen shareholder rights too much.

Structural unfairness is baked into Asia's CG systems

Structural unfairness is therefore baked into corporate governance regulatory regimes around the region. While regulators have mandated many new structures of corporate governance, such as independent directors and board committees, most of these institutions are allowed to function in ways that suit the interests of controlling shareholders and management. For example, definitions of "independent director" usually contain loopholes that allow people with close business relationships to a company to become independent directors after short cooling-off periods of just one or two years. This has a certain practical logic to it, but is hard to justify if the goal is to create boards that can genuinely think independently and offer different points of view. As a result, many minority institutional investors are losing patience and would like to see different ways of voting for independent directors tried out, such as restricting or removing the ability of controlling shareholders to vote for independent directors they have nominated from the start. Needless to say, the political appetite among regulators to take on such a challenge is non-existent. (To give credit where it is due: Malaysia and Singapore have introduced two-tier voting systems for independent directors who have served on boards for extended periods. But this does not address the more difficult question of how to vote from Year 1.)

CG Watch 2018: Market rankings

There have been several changes in market rankings

There have been a number of changes in market rankings this year:

- The inclusion of Australia in the formal rankings pushes every other market down at least one place.
- Hong Kong beats Singapore to 2nd place, but only marginally.
- Malaysia is the biggest gainer, rising from 7th to 4th.
- Japan is the biggest decliner, falling from 4th to equal 7th.
- India rises one ranking, from 8th to equal 7th.

The other market rankings remain the same.

Hong Kong, Malaysia and India rise in rankings

Singapore and Japan fall

Other markets stay the same

Figure 2

Market rankings: CG Watch 2016 and 2018

Blue = Rising market   Green = Falling market

2016	2018
1. Australia	1. Australia
2. Singapore	2.Hong Kong
3. Hong Kong	3. Singapore
4. Japan	4. Malaysia
5. Taiwan	5. Taiwan
6. Thailand	6. Thailand
7. Malaysia	=7. Japan, India
8. India	
9. Korea	9. Korea
10. China	10. China
11. Philippines	11. Philippines
12. Indonesia	12. Indonesia

Source: ACGA

Market themes

Key themes in each market are as follows (in order of their ranking this year):

The 12 markets in our survey show wide diversity in the CG challenges they face

1. **Australia** has been tarnished by bank scandals that have gone from bad to worse and political infighting in the federal government. The lack of a national ICAC is emerging as a important issue, while the reputation of financial regulators continues to take a beating (not entirely justified). Institutional investors have developed two new stewardship codes (for pension funds and asset managers).

Negatives include weak regulation of corruption, DCS, poor bank governance, piecemeal approaches to reform, limited enforcement and so on

Positives include revised CG Codes, new Stewardship Codes, stronger delisting rules, better enforcement in some markets, focus on ESG and so on

2. **Hong Kong** has lost moral leadership through the introduction of DCS and the continued lack of any clear government strategy for corporate governance. In contrast, it continues to lead the region in enforcement. Although doing somewhat better on the supervision of auditors, the creation of an independent audit regulator has been delayed until 2019. Doing poorly on investor stewardship.
3. **Singapore** has also suffered reputational damage due to DCS, while policy contradictions abound in other areas, such as its new CG Code. Underperforming on enforcement despite the creation of a new regulatory entity under SGX. A series of corporate scandals have highlighted the weaknesses of its CG regime and limitations on minority shareholder rights.
4. **Malaysia** gets a new CG Code and a new government and starts to tackle endemic corruption issues fostered by the previous Najib administration. Stronger performance from financial regulators and institutional investors. A new Institutional Investor Committee is formed with the Minority Shareholder Watchdog Group—a regional first. Public governance concerns remain.
5. **Taiwan** launches a new CG Roadmap (2018 – 2020) and continues to make strides on enforcement. Electronic voting becomes mandatory and, by default, voting by poll. Progress continues on independent directors and audit committees. But a piecemeal approach to reform remains and certain weaknesses in minority shareholder rights linger.
6. **Thailand** brings in a substantially revised CG Code and a stewardship code, which most domestic institutional investors sign. Financial regulator finally gets civil powers and makes some (though limited) progress on enforcement. Media suffers from ongoing military rule, although anti-corruption commission gets expanded powers.
7. **Japan** revised its CG and Stewardship Codes and has placed much emphasis on enhancing company-investor dialogue. While important, the focus on soft law rather than hard regulatory change means that regulators have not been addressing shortcomings in minority shareholder rights. Institutional investor involvement in stewardship continues to grow.

7\. **India** introduces new CG rules/best practices and strengthens enforcement. The banking system comes in for heavy criticism. An independent auditor is finally established, but weakened almost immediately by politics. One bright spot is the investment management community, which is taking its ownership role increasingly seriously.

9. **Korea** continues to modernise its CG system, introducing both soft and hard law reforms, yet the policy direction of the new Moon administration remains unclear. Regulatory enforcement and supervision is steadily improving. Conglomerates make voluntary reforms. No improvement in fundamental weaknesses in minority shareholder rights.
10. **China** is emphasizing the importance of ESG for investors and moving ahead on some CG reform changes, including a revised CG Code (the first since 2002). The formalization of the role of Party Committees, and their incorporation in SOE articles of association, creates new challenges and questions. SOE reform gains some momentum, but it is not entirely clear whether "mixed ownership" will make a significant difference to corporate governance.
11. **The Philippines** has had a quiet two years, with minimal corporate governance reform, apart from a new CG Code, and governance low on the government's policy agenda. Recent evidence of politicization of the SEC's role a concern, with attacks on media. While enforcement remains weak, there is some evidence that CG disclosure is improving.

12. **Indonesia** has also made little progress in CG reform over the past two years, with governance low on the government's agenda. The securities regulator is isolated and the stock exchange puts little focus on corporate governance. Company disclosure is showing some signs of improvement and accounting/financial reporting standards are generally good. But insider trading and other market misconduct remains rife.

Category themes

The broad themes emerging from each category are as follows:

1. Government & public governance

Public governance has some way to go in Asia

Most markets underperformed in this category overall. Reasons included the lack of clear and credible strategies for CG reform, wavering political support for the policy and enforcement work of financial regulators, and securities commissions that are too closely tied to governments in political and budgetary terms. Points also lost in many markets due to the absence of a well-established and independent commission against corruption, a judiciary that is either not clean or not independent of government, and weak legal remedies available to minority shareholders.

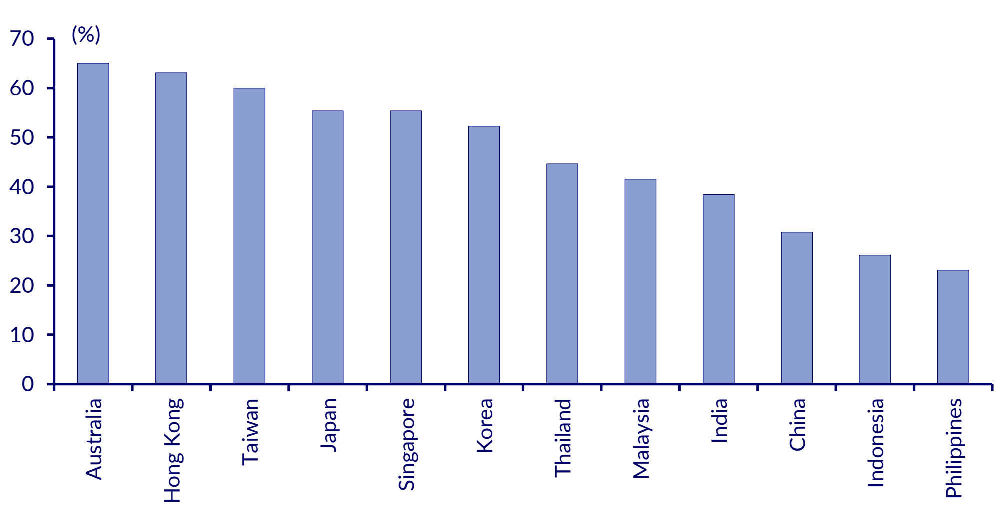
Even some better performing markets face challenges in their anti-corruption work . . .

Markets that score highest include Australia, Hong Kong, Japan, Singapore and Taiwan. All perform better on public governance and cleanliness, and the quality of their legal system and judiciary. All have anomalies, however, such as no federal ICAC in Australia or Japan, fragmented anti-corruption governance in Taiwan, and contradictory government policy on CG in Hong Kong and Singapore.

. . . such as the lack of a federal ICAC in Australia

Figure 3

Government & public governance: scores by market



Source: ACGA

2.1 Regulators: Funding, capacity-building and regulatory reform

Only five securities commissions appear well funded in Asia-Pacific

Some securities commissions in Asia-Pacific are well-funded relative to the job they have to do. They include: Hong Kong, India, Korea, Malaysia, and Thailand. Others are either less well-funded or poorly resourced. The source of funding is one factor that determines the adequacy of budgets: if funding comes from a levy on the market (the "user-pays system"), then it is more likely that funding will be sufficient. If a commission has to fight each year for a government budget allocation, as in Australia or Japan, then by definition it will not receive

as much as it would like. Levels of funding clearly affect the ability of commissions to undertake capacity building work, namely investment in staff, training, and new technology.

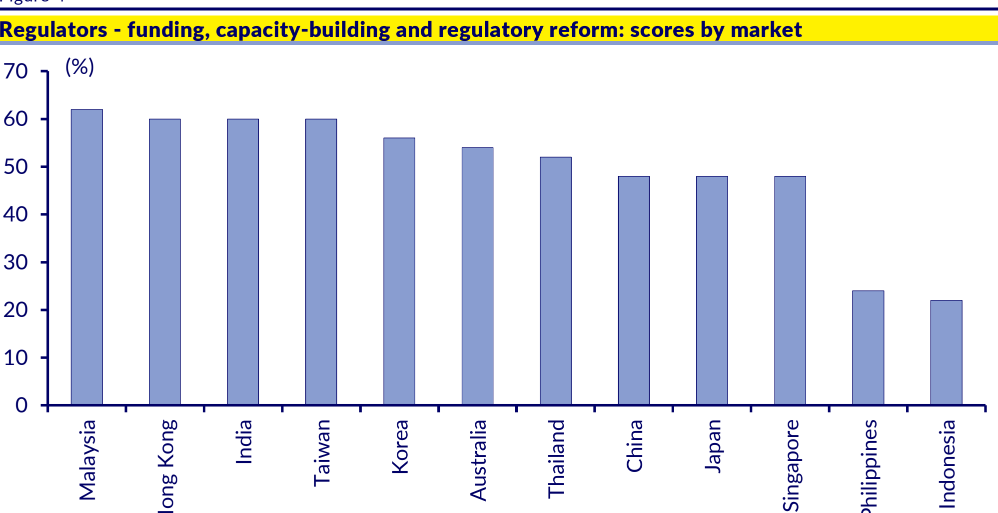
Scores given in this category for regulatory "effort"

We included regulatory reform in this category as an indication of the degree of effort being made by securities commissions and stock exchanges to improve rules and regulations. In general, better funded regulators tend to be able to do more on regulatory reform, something we found in Korea, Malaysia and Thailand. Other factors come into play as well, such as whether regulators have the political room and opportunity to make reforms. Hong Kong underperformed on the reform questions because we took points off for DCS, while Taiwan outperformed despite getting an average score for funding. In both cases, politics played a large part in the outcome.

Hong Kong got docked for the introduction of DCS

Figure 4

Regulators - funding, capacity-building and regulatory reform: scores by market



Source: ACGA

2.2 Regulators: Enforcement

Regulators tend to do better on enforcement than gaining new funding or in reform

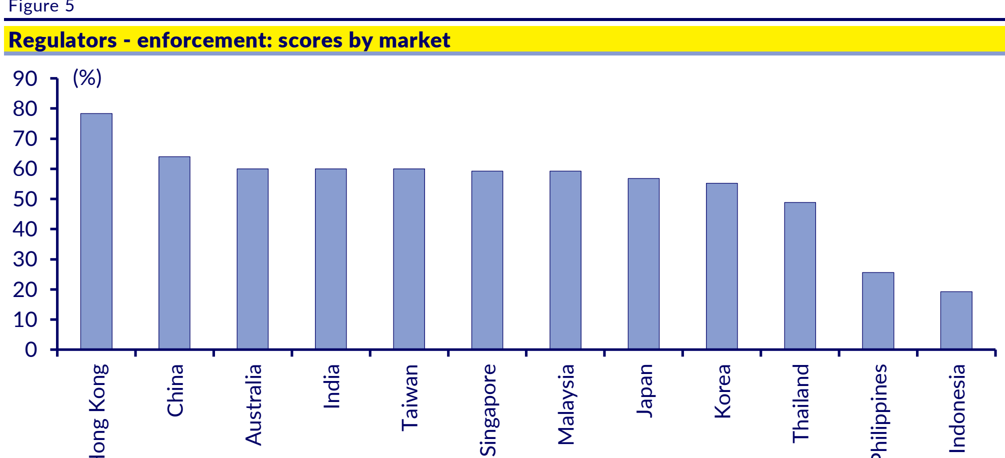
A better performing sub-category overall than the previous one. As shown in the category score table above, half of the markets (six out of 12) score higher for enforcement than for funding/capacity building, while another three score the same or almost the same. This is not too much of a surprise, since enforcement is one area in CG Watch that has consistently rated relatively well. There has been increasing pressure on regulators to enhance the effectiveness of enforcement and a good report card here goes a long way toward building credibility, not to mention popular and media support. For these reasons, governments have been happy to give regulators increasing powers - something we have seen in every market in Asia with the exception of Indonesia and the Philippines, and the possible exception of Japan (which occupies a more neutral position in this regard).

Note: We applied a weighting to the Enforcement scores: 60% for the first five questions on securities commissions and 40% to the second five mostly on stock exchanges. This recognises the heavier enforcement burden that commissions have in enforcing securities laws and their application of criminal, civil and administrative penalties. In contrast, stock exchanges enforce the listing rules with more limited powers. They play a critical role as frontline regulators, yet giving their work the same weight as that of securities commissions does not seem appropriate.

The Philippines and Indonesia stand out

Figure 5

Regulators - enforcement: scores by market



Source: ACGA

3. CG rules

Asia has been developing its CG rulebook since the late 1990s

In terms of absolute scores, this is one of the higher scoring categories in our survey. Then again it should be: Asia has been developing its CG rulebook since the late 1990s and after the Asian Financial Crisis. Markets generally rate well on paper for their standards of financial and CG reporting, while ESG and sustainability reporting standards are emerging. Places that perform best on the latter include Malaysia, Singapore, Taiwan and Thailand.

Markets do well on regulatory basics . . .

Most markets do well or reasonably well on the regulatory basics: disclosure of price-sensitive information, substantial ownership, and director trading; voting by poll; and rules on insider trading and market manipulation.

. . . but less well on rules that impinge upon controlling shareholders

Performance is much more mixed on: the need for controlling shareholders to disclose share pledges; "blackout" periods for director trading prior to results announcements; the disclosure and management of related-party transactions; and disclosure of executive and director remuneration. Perhaps it is because these issues all impinge more directly on the freedoms of company owners?

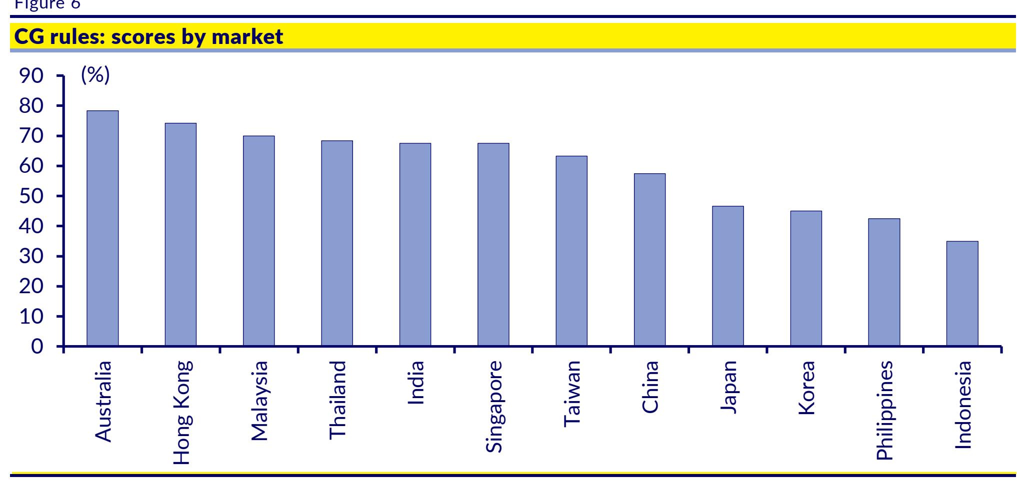
All do poorly on definitions of "independent director"

Meanwhile, there are some areas, as noted above in our comments on "structural unfairness", where almost all markets score lower: definitions of independent director; pre-emption rights to stop non-dilutive capital raisings; and director nominations.

Overall, this is one of the higher scoring categories

Figure 6

CG rules: scores by market



Source: ACGA

Variation in company CG both within and across markets

4. Listed companies

Apart from facile statements to the effect that large listed companies disclose more and better information than smaller issuers, or CG reporting is still full of boilerplate, or the investor relations sections of large-cap websites are pretty good, this is one section where it is extremely difficult to generalise across the region. The story here varies greatly by market and usually within markets. Indeed, one finding was that the quality of reporting on sustainability issues among the 15 large-cap firms reviewed was wider than we expected—from excellent to almost non-existent. And while it can be said that CG reporting in Australia is generally very good among the big companies, the paucity of some audit and nomination committee reports can be jarring.

Are large-caps always better than mid-caps?

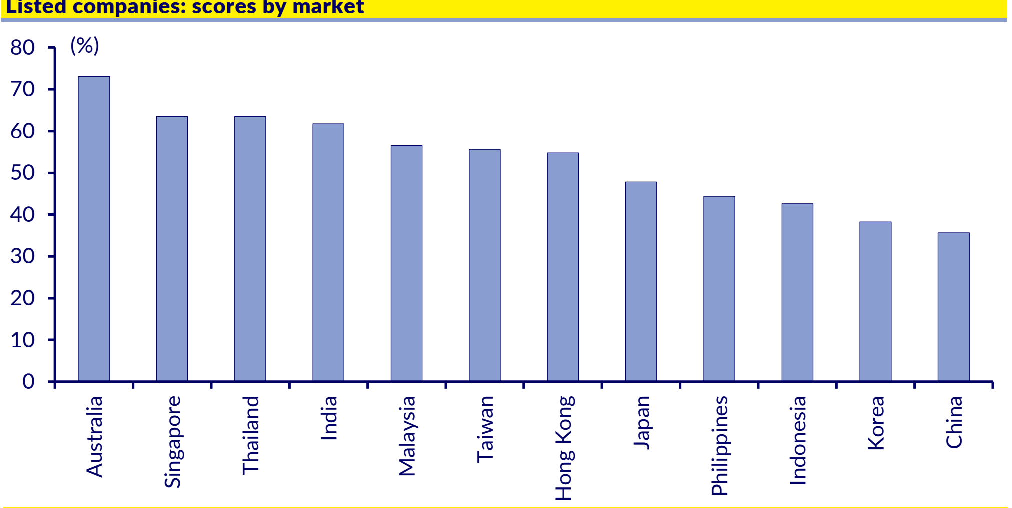
It may also be time to stop parroting the old slogan about large-caps being better than mid-caps. We have found various instances in different markets where mid-caps not only have more complete financial reporting (including fewer gaps in the notes to their accounts), but more interesting CG and sustainability reporting too.

One generalisation we will make: with the exception of Australia, scores in this category were more mediocre than we expected. We fear this reflects a recurring problem in Asian corporate governance: the compliance mentality with which so many listed companies approach CG regulation.

Scores in this category generally underwhelmed

Figure 7

Listed companies: scores by market



Source: ACGA

5. Investors

Companies do not appear to fear shareholder criticism

If listed companies think they can get away with boilerplate governance reporting and financial statements with obvious holes, one of the reasons must surely be because they do not fear any blowback from their shareholders? Indeed, the stand-out underperformer among all stakeholder groups in this survey is Investors. Visually, this is clearly apparent in the next section on "heat maps".

Committed investors remain few in number

The Investor category underperforms not because there are no asset owners or managers taking their ownership responsibilities seriously, or because those involved in voting and company engagement are doing a poor job. It is because such investors are still so few in number in Asia. The situation is somewhat different in Australia, which is why it comes first by a mile—though its score of 63% should be higher.

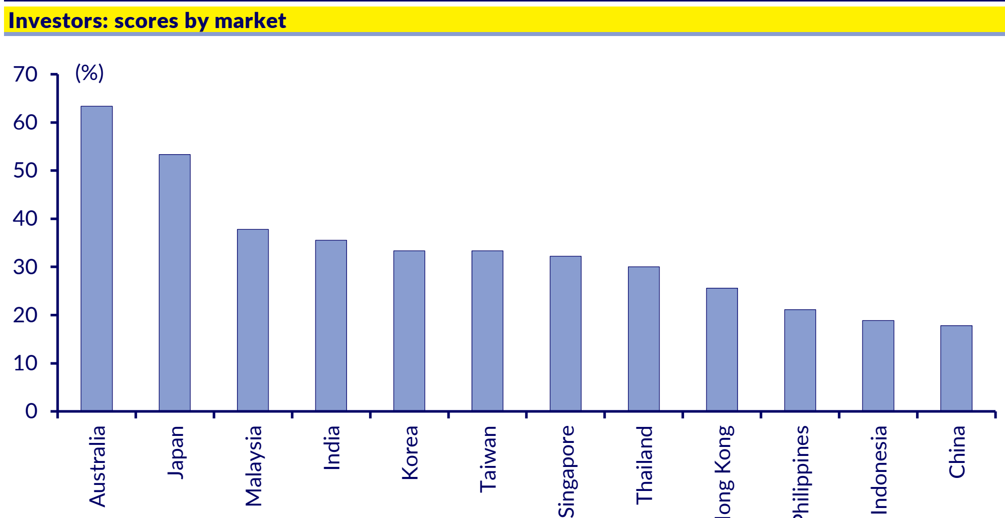
The gamechanger is likely to be stewardship codes

The gamechanger for investors should be the introduction of stewardship codes, which 8.5 out of 12 markets now have. The markets without them are China, Indonesia and the Philippines. The 0.5 is India, which has only a limited code for the insurance sector. Within the other eight, regulators or other national bodies are actively promoting their adoption by institutional investors in all places except two: Hong Kong and Singapore.

Investors were the standout underperformer among stakeholders

Figure 8

Investors: scores by market



Source: ACGA

6. Auditors & audit regulators

High scores here more to do with audit regulation than audit quality

This is the highest scoring category in our survey, although more for reasons relating to regulation (accounting and auditing standards, independence rules for auditors, and the effectiveness of audit regulators) than to audit quality itself. Only two questions address audit quality, while another two examine the extent to which large and mid-caps prepare for their annual audit.

Strong convergence with IFRS in most markets

Broad themes in accounting include the ongoing convergence with, or outright adoption of, international standards of financial reporting. Most markets are fully or almost fully converged with IFRS, with the exception of India and, to a lesser extent, Japan. Thailand was marked down slightly for unconvincing delays in the adoption of IFRS 9.

Introduction of KAMs is expanding

As for international auditing standards, the big story has been the adoption of the new long-form auditor reports with a focus on “key audit matters” (KAMs). Most markets have gotten there, even China, but not yet India, Indonesia and Japan. Korea is introducing KAMs in stages.

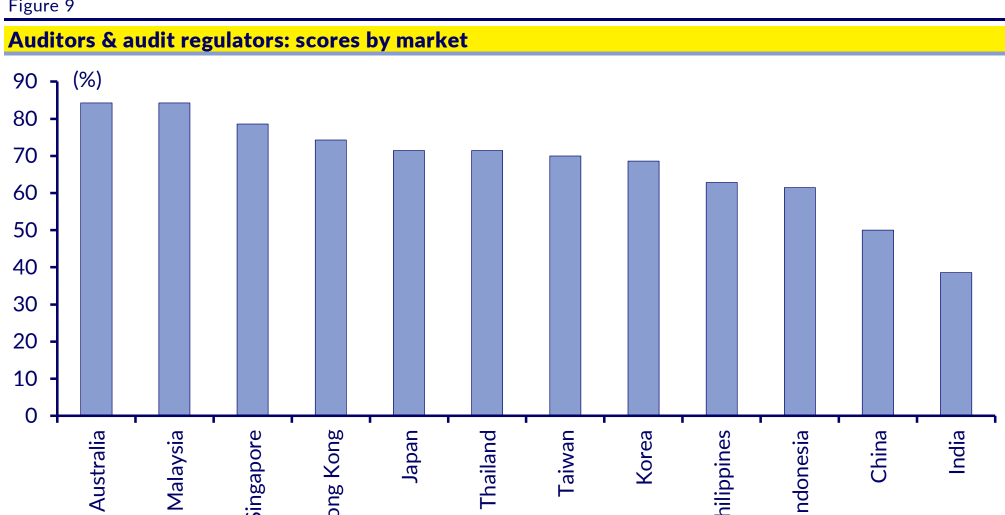
All markets now have an independent audit regulator, or soon will. But India is a question mark

Audit regulation is another big theme, with news that the region’s three traditional laggards - Hong Kong, India and the Philippines - are finally making progress. The Philippines is out front and has already joined IFIAR, the International Forum of Independent Audit Regulators. Hong Kong should finally see an independent audit regulator in 2019. While India moved to set one up in 2018, its status is unclear as the government permitted the local industry association to have influence on the new regulator’s governing body.

Perennial laggards - HK, India and the Philippines, are making moves

Figure 9

Auditors & audit regulators: scores by market



Source: ACGA

7. Civil society & media

Australia and India have the most vibrant civil societies in Asia. Hong Kong and Japan also diverse

As with Listed Companies, this is a difficult category about which to generalise. It is best seen through the lens of each market, rather than themes drawn from specific questions and issues. Certain places stand out for having vibrant and boisterous civil societies and media industries, in particular Australia and India, while Hong Kong and Japan both have a broad range of non-profit organisations and professional associations operating within more conservative business cultures. Civil society is diversifying in Malaysia, Singapore, Taiwan and Thailand, and would likely flourish much further if permitted. Some places seem to constrain themselves, such as Korea.

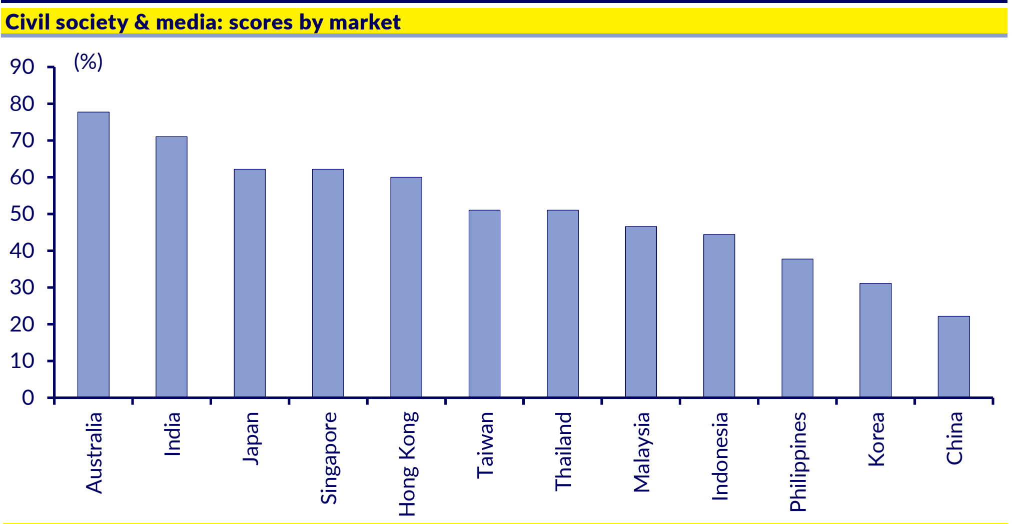
NGOs in Asia often rely on governments for funding and their existence . . .

One feature of civil society in parts of Asia that may not be apparent to outsiders is the need for non-profit organisations to garner government support, and often funding, in order to form and survive. Almost all the key shareholder/CG organisations in Southeast Asia, as well as Taiwan, are in this position. The positive is that without such support these organisations would not exist - and they all do good work. The flipside is that they are constrained in what they can say publicly about government policy.

. . . and are thus constrained in what they can say publicly

Figure 10

Civil society & media: scores by market



Source: ACGA

Contrasting the performance of key stakeholders and areas in Asian CG in 2018

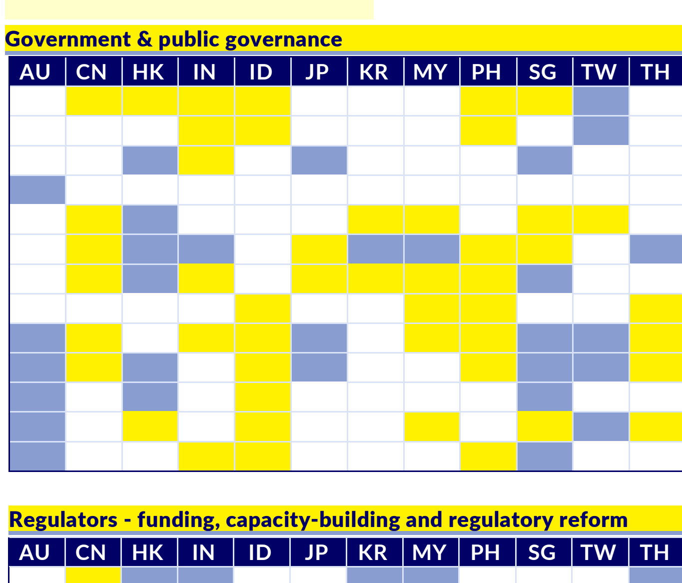
Legend:

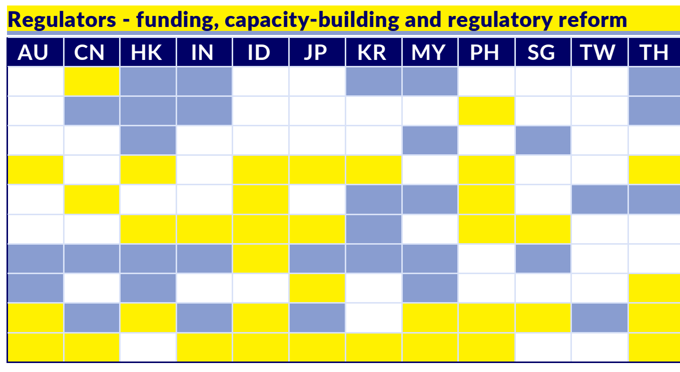
0-1 2-3 4-5

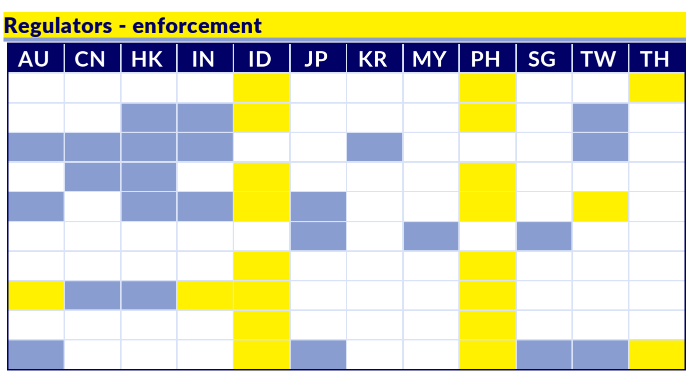
ACGA Asian CG ecosystem "heat maps"

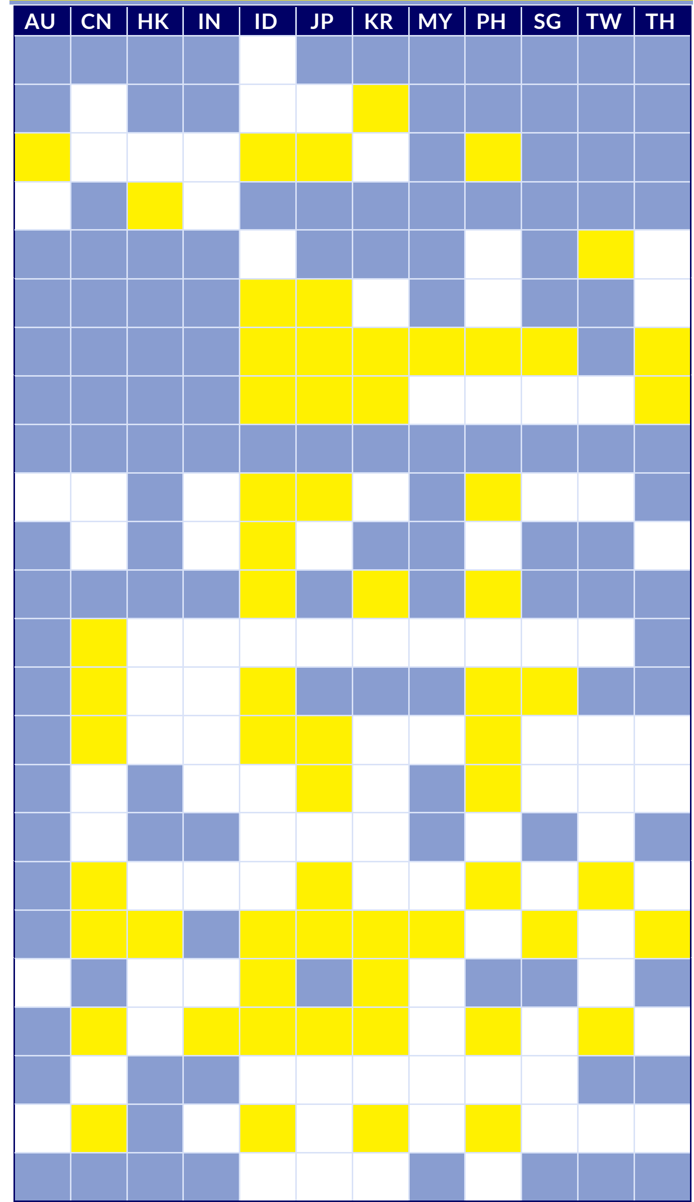
Converting the score for each question to a colour the following heat maps highlight the strengths and weaknesses of the different stakeholder groups and thematic areas that make up the Asian CG ecosystem. Blue represents high scores, yellow for low scores and white for moderate scores.

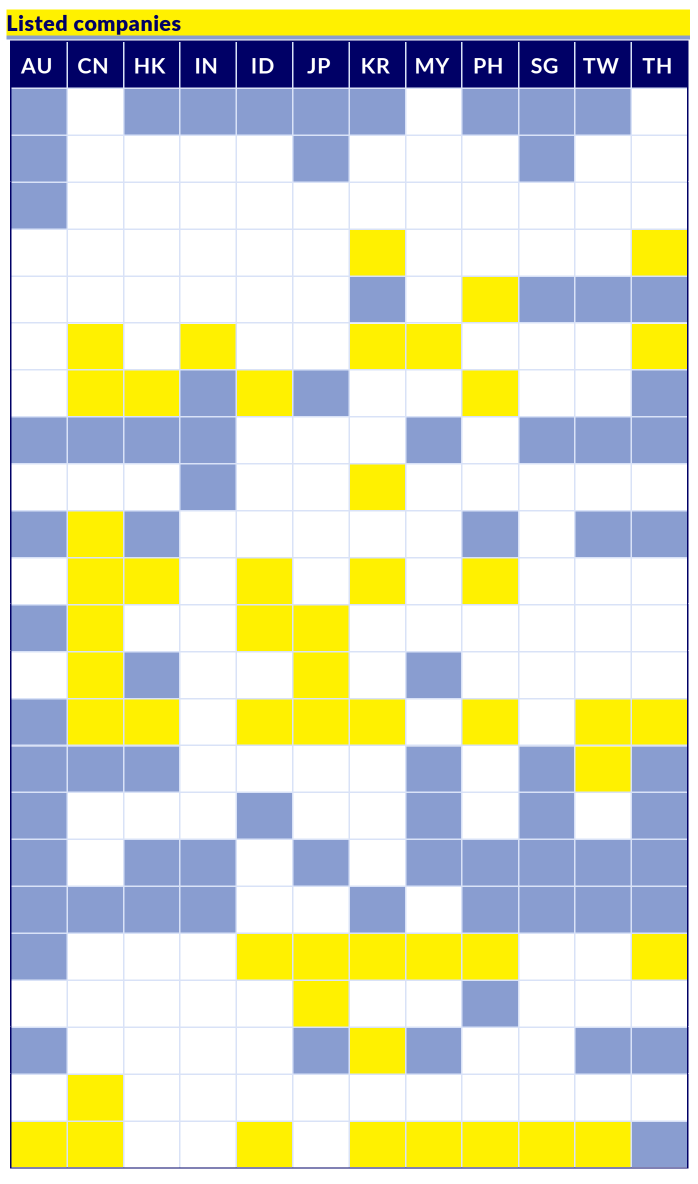
The highest scoring categories are auditors & audit regulators, CG rules and regulators - enforcement. The lowest scoring are Investors, government & public governance and regulators - funding. It is also possible to see that in some categories, such as enforcement or CG rules, the yellow cells are concentrated vertically (ie, under certain markets), whereas in investors all markets have a smattering of yellow.










Listed companies
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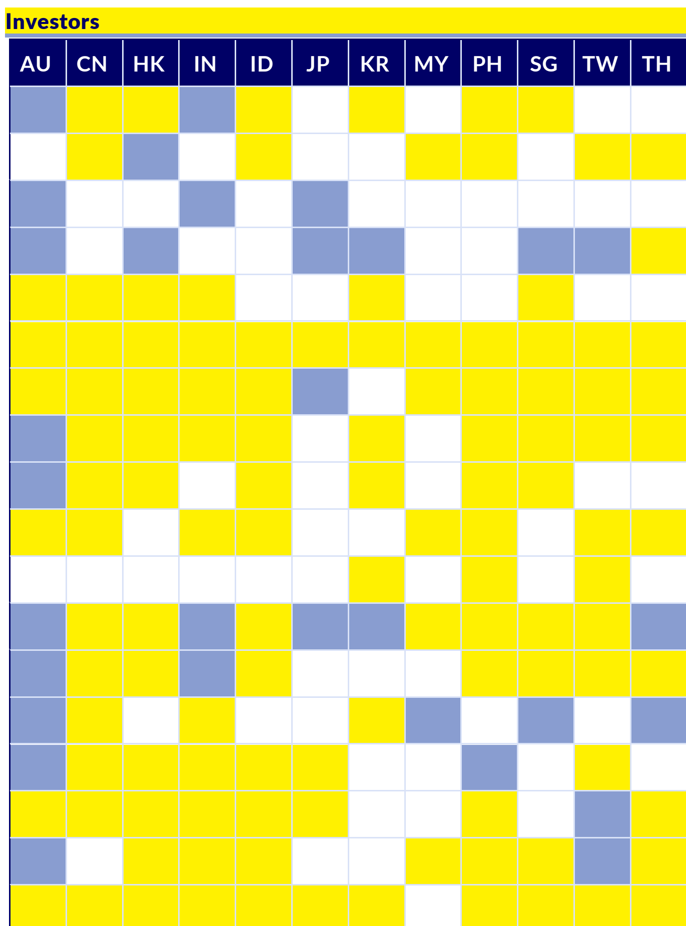
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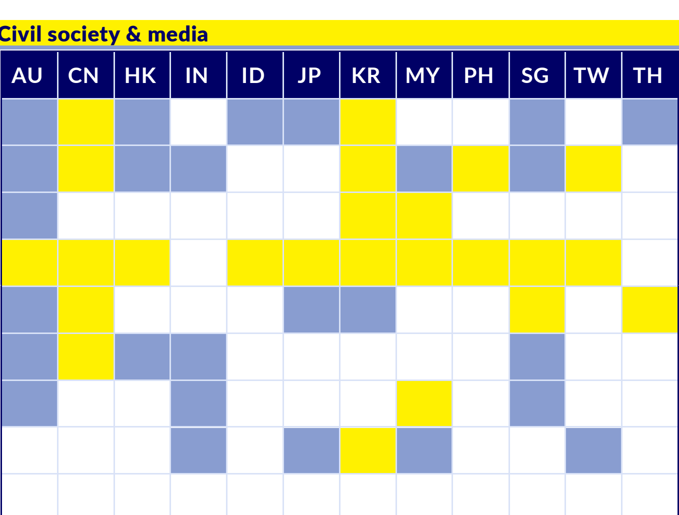
Civil society & media
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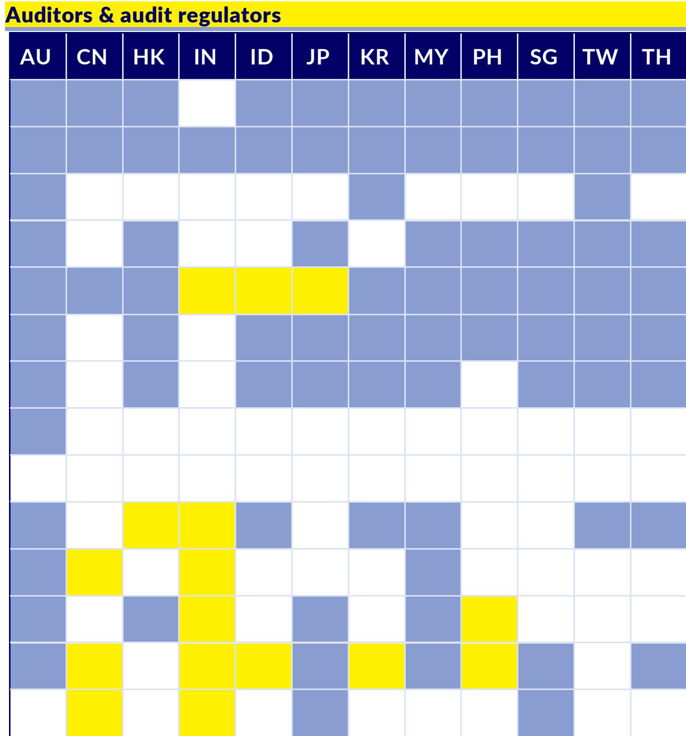
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The next 20 years -Tough questions

Can Asia create truly world-class and balanced CG systems?

As our survey shows, government and regulators have some tough decisions to make about the strategic direction of CG reform in the next 20 years. Will they continue to favour controlling shareholder interests or create more balanced, fairer systems? Can they foster truly world-class financial and CG reporting? Can they balance the introduction of dual-class shares with stronger legal tools for shareholders, so that investors can better protect themselves? Indeed, a striking feature of both the Hong Kong and Singapore approaches to DCS was the lack of any plan to address systemic regulatory weaknesses and give shareholders more options for dealing with downside risk. Safeguards were included in the listing rules changes, but relying on them would be like trying to stop a charging elephant with a broomstick.

Can investors create a more consistent approach to investment and CG policy?

Institutional investors also have soul searching to do. While opposed to dual-class shares in principle, they find it difficult in practice not to buy them. There are compelling and highly rational reasons for this - no fund is rewarded for underperforming their peers on matters of principle - yet such a dualistic approach undermines their standing in the eyes of policymakers, politicians and regulators. 'Why expend political capital protecting an industry that is not protecting itself?' has been the essence of the question we have received from regulators. Investing dedicated resources in stewardship and engagement - and doing so consistently and with tangible results over the next two decades - would appear to be the most sensible response from investors. There is a need to show regulators and companies that, DCS aside, the current focus on ESG and responsible investment is a strategic shift, not just a clever and short-term marketing ploy.

Can companies find ways to escape the compliance trap?

As for companies, one of their tough decisions is to work out whether the investment in good governance is worth it. Judging by the compliance mentality that most exhibit, their current answer would appear to be no. To an extent, this is a natural outcome of market structure: that is, the concentration of investment interest in a small number of large-caps. If you are not among such companies then market pressure will be limited, so why do more than the minimum? But this attitude is also an unfortunate byproduct of the way in which CG reform has been managed in Asia over the past 20 years. Despite promoting the "comply or explain" concept, regulators have given the impression in no uncertain terms that the key word is "comply". Companies duly comply and stock exchanges carry out surveys showing high levels of compliance - as if this is a good thing. If the system were truly working, we would be celebrating diversity of company governance systems and excellent explanations - and giving out awards for that! Instead, we have a governance monoculture where all listed companies look pretty much the same on the surface. No wonder the informational value of CG reporting is so limited for most investors.

Has corporate governance in Asia improved?

Finally, a tough question we are often asked: Has corporate governance in Asia truly improved? Judging by the contents of this report and our sharp criticisms of certain issues and markets, not to mention the low scores liberally scattered around, you may conclude it has not. However, we look at corporate governance from where it has come as well as where we would like it to go. We would say there has been tremendous change in Asia over the past 20 years, not only in regulation but also the quality of the work being done by the best companies, the most committed investors, the most thoughtful auditors, the sharpest journalists and many other stakeholders. We see this plainly in all the meetings we have and

research we do for CG Watch and other ACGA activities. The quality of the discussion and thinking is unlike anything we came across when we started. We hope this report provides some useful ideas for creating a stronger CG ecosystem in Asia over the next 20 years.

Methodology

The ACGA market survey has undergone significant changes this year

The ACGA market survey in *CG Watch 2018* is significantly different from the eight previous versions of the report. We have reorganised the structure from five thematic categories to seven categories based mainly around key stakeholder groups. We have increased the number of questions from 95 to 121, removing some questions, adding others, or making revisions. And we have developed a new and more rigorous six-point scoring system to replace our earlier five-point system. For these reasons, we have not sought to compare the total or category scores for each market with previous surveys.

Structure

We have moved from five thematic categories . . .

Since our first edition with CLSA in 2003, the structure of our market survey followed a thematic approach:

1. **CG rules & practices:** Examining key rules on corporate disclosure, governance, and shareholder rights, with an assessment of how certain rules were being implemented by companies.
2. **Enforcement:** Assessing the rigour and depth of both "public" (ie, regulatory) and "private" (ie, investor) enforcement.
3. **Political & regulatory environment:** An overview of the key regulatory and governmental institutions overseeing the capital markets, including central banks, securities commissions, stock exchanges, the judiciary, anti-corruption commissions, and the media.
4. **Accounting & auditing:** Rating the quality of accounting and auditing standards and practices, and the effectiveness of audit regulation.
5. **CG culture:** A broader category that took into account company practices on governance, the involvement of shareholder groups, professional bodies, business associations and others.

. . . to seven new categories built mainly around stakeholder groups

Our new survey is structured around seven categories, several of which overlap with those above:

1. **Government & public governance:** An overview of government CG policy, political support for regulators, bank governance, regulatory independence, progress on civil service ethics, and the independence/expertise of the judiciary and anti-corruption commissions. Specific questions on the powers and functions of financial regulators have been moved to the Regulators category. Media questions moved to Civil Society & Media.
2. **Regulators**: This category collates all the questions on financial regulators and is organised into two sub-categories: "2.1 Funding, Capacity Building, Regulatory Reform"; and "2.2 Enforcement". The first looks at regulatory resources, institutional development, and efforts made to improve CG regulation and standards. The second is now a pure regulatory enforcement score, with questions on "private enforcement" moved to the Investor category.

3. **CG rules:** Examining key rules on corporate disclosure, governance, and shareholder rights, but without an assessment of how certain rules are being implemented by companies. The latter questions have been moved to the Listed Companies category. CG Rules is now a clearer comparison of the current status of law, securities regulation, listing rules, and CG/ESG codes of best practice.
4. **Listed companies**: An in-depth examination of corporate disclosure and governance practices among 15 large-caps, selected to represent a diverse range of sectors, ownership types, and market cap size; and a more general examination of 10 mid-caps, selected along similar lines.
5. **Investors**: An assessment of the governance, engagement and advocacy initiatives of both domestic and foreign institutional investors (asset owners and managers) in each market, as well as retail investors and related associations.
6. **Auditors & audit regulators:** Rating the quality of accounting and auditing standards and practices, and the effectiveness of audit regulation;
7. **Civil society & media:** A review of the participation of non-profit groups, professional and business associations, and the media in CG activities, training and awareness-raising.

The new survey helps to delineate more clearly the role of different stakeholders

The purpose of this reorganisation is to delineate more clearly the role that different stakeholder groups play in the Asian corporate governance ecosystem, to draw more informative and timely comparisons, and to produce more targeted recommendations for regulators, companies, investors and others.

Questions

Most of the questions from our previous surveys have been retained

While there is not space to explain each and every change in the questions in detail, some broad points are worth emphasising. Firstly, most of the 95 questions in *CG Watch 2016* have been retained and allocated to their relevant category. Secondly, while we no longer have a category called "CG Culture", these questions primarily appear under Listed Companies, Investors, and Civil Society/Media. We continue to assess culture, but in a more contextualised way. Thirdly, some existing questions have been divided into two, in particular where we are assessing two distinct groups such as domestic and foreign investors. Fourthly, in response to feedback received, certain existing questions have been reworded to make their meaning clearer to readers.

Scoring system

Our new six-point scoring system has no neutral bias

Our new six-point system is based on the following numeric range: 0, 1, 2, 3, 4, 5. It replaces our older five-point system: 0, 0.25, 0.5, 0.75, 1. The key advantage of the new system is that it does not allow for a middle score and the potential for a neutral-bias.

ACGA undertakes the scoring internally based on our original and independent research. Individual-question scores are derived against a benchmark for each question, based either on the standard set by the leading market in a specific area or the regional/global best practice for a question, where the latter can be objectively ascertained. Scoring is done first for each market, then all market scores are compared to ensure, as far as possible, consistency in our analysis. While some questions are binary and objective, many require the application of judgement on the part of ACGA. We do not rely on outside respondents to complete any part of our survey and take full responsibility for any errors in the scoring.

A new survey was developed to assess listed companies

Listed companies survey

Another new feature of our report this year is a detailed survey underlying our listed company research. It comprises 19 main questions and 74 sub-questions on the 15 large-caps; and four main questions with 27 sub-questions on the mid-caps. In total, this produced more than 13,000 data points for the 180 large-caps reviewed and more than 3,000 data points for the 120 mid-caps. This information was aggregated to produce scores for each of the 23 high-level company questions for each market based on their listed company practices.

*This part of our survey was developed in collaboration with Asia Research & Engagement (ARE), Singapore.

Research on CG Watch draws from both primary and secondary sources

Acknowledgements

Dedicated research on *CG Watch 2018* was carried out throughout 2018 and draws upon ACGA's regular newsletter for members, the *Asia Regional Briefing*, published every two months, as well as new material. The research on each market was led by an individual team member with support from one or more others. Research sources included a wide range of printed and online materials from governments, regulators, companies, investors, accounting firms, law firms, civil society groups and the media. Numerous face-to-face and telephone interviews were also undertaken in each market, with follow up as necessary through written exchanges.

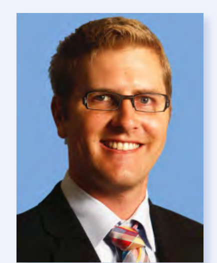
The research team on *CG Watch 2018* has more than doubled from 2016

In total, 20 people worked on *CG Watch 2018* compared to nine on *CG Watch 2016*. In addition to the author names already recognised in the market chapters, we would like to acknowledge the support of the following individuals:

- At ACGA: Bilal Khan, Edwin Chiu, Melissa Brown, Michelle Chaow and our operations team, Padma Venkat, Mikky Li, Ida Chan and Helen Wong for their forbearance!
- At Asia Research & Engagement (ARE), Singapore: Timothy Tan, Jeehee Moon, Xinying Tok, Serena Tan, Ed Yau and Andrea Giunti.

We would also like to thank ARE for collaborating on the development of our listed companies survey.

Lastly, we would like to acknowledge anonymously the many ACGA members who provided insights and information during the compiling of this report, as well as the many individuals and organisations whom we interviewed.



Charles Yonts
Head of Power & ESG Research
charles.yonts@clsa.com
+852 2600 8539

Driving into the data deluge

Australia breezed into first place yet again in our 2018 bottom-up *CG Watch* survey. The biggest mover this year was Malaysia, jumping two spaces on optimism over the leadership change, as well as tangible improvements to enforcement and reporting. Frustration about the pace of reform pushed Korea into last place for the third time in a row. The volume of ESG data in Asia is skyrocketing to match surging demand, but the worth of that data is hotly contested. There are no shortcuts to integration, but we still see value in screens.

US$89.7tn invested sustainably

Growth in ESG investing continues apace, with sustainable assets under management expanding another 31% to US$89.7tn in 2018, according to PRI. Investors and exchanges are pushing companies in Asia, in particular, to ratchet up ESG reporting. As of 2017, 42% of all GRI-standard sustainability reports came from Asia, versus 25% in 2011. However, making sense of the data has not gotten any easier, despite a proliferation of third-party data providers.

Analysts retain discretion in scoring

Against this backdrop, we are incorporating more data screens into our scoring process, but analysts retain ultimate discretion. For example, if available data suggest that a company's board is not independent (long tenure, too big or too small, low share of independent directors) then we mark the company down on independence. However, the covering analyst can override that call with an explanation of what the data might be missing.

Achieving outperformance with ESG . . .

While we are wary of fixating on the final ESG score, we still clearly see value from incorporating ESG scores into screens. Using scores from Arabesque S-Ray, CLSA's Microstrategy team found that companies with top quintile ESG scores, and those with the most improved scores, outperformed the worst quintile by over 7% per annum over the past five years. Outperformance was sustained even after adjusting for market and sector.

. . . or mitigating disaster

Our Microstrategy team has also incorporated ESG scores and metrics into screens to weed out potential corporate blow-ups. We have seen an uptick in such events over the past couple years, with a frenzy of (mostly successful) activist short-seller attacks. We reviewed 13 Asian short-seller attacks since January 2017 to pull out common red flags (related party transactions and misreported financials), and spoke to two activist short-sellers about methodology and outlook for different sectors and markets around the region.

Ranking changes are not material

Figure 11

Market rankings (based on company aggregate scores)

	2005	2007	2010	2012	2014	2016	2018
1	Thailand	Thailand	Thailand	Australia	Australia	Australia	Australia
2	Hong Kong	Hong Kong	Hong Kong	Singapore	Hong Kong	Japan	Singapore
3	Taiwan	Taiwan	Singapore	Hong Kong	Singapore	Singapore	Japan
4	Malaysia	Malaysia	India	Japan	Thailand	Hong Kong	Hong Kong
5	Singapore	India	Malaysia	Taiwan	Taiwan	Taiwan	Taiwan
6	India	Singapore	Taiwan	Malaysia	Japan	Thailand	Malaysia
7	Korea	Philippines	Philippines	Thailand	Malaysia	India	India
8	Philippines	Korea	Korea	India	India	Malaysia	Thailand
9	China	China	China	China	China	China	China
10	Indonesia	Indonesia	Indonesia	Korea	Indonesia	Philippines	Indonesia
11				Philippines	Philippines	Indonesia	Philippines
12				Indonesia	Korea	Korea	Korea

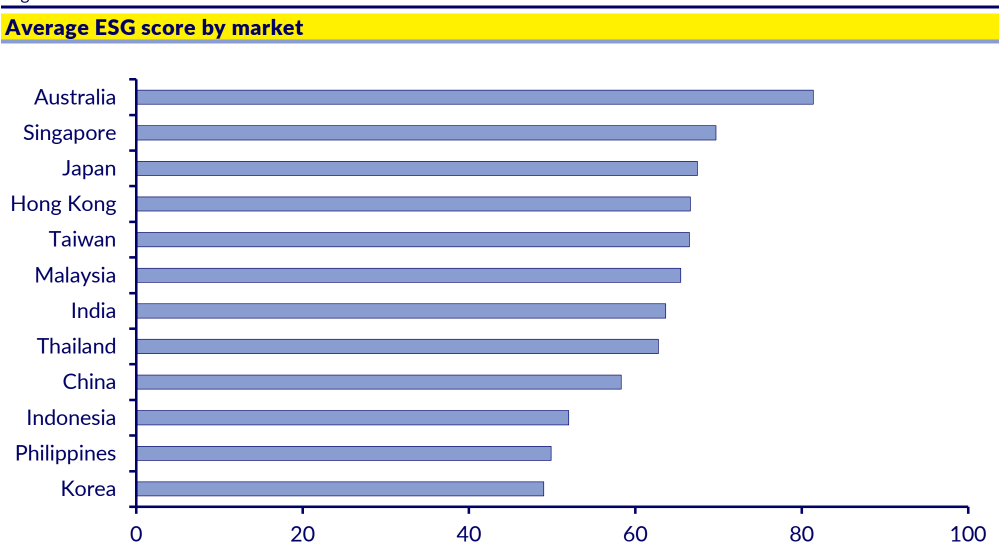
Source: CLSA

Australia retained its lead in our 2018 rankings

While Australia retained its lead in our 2018 bottom-up rankings, Singapore pushed ahead to second place ahead of Japan. The controversial dual-class share structure for the former hasn't yet had any impact on our ratings, while the latter got hit by our stricter interpretation of board independence and diversity.

Figure 12

Average ESG score by market



Source: CLSA

We can cross-check our aggregate company scores by market against ACGA's top-down scores. As with 2016, the big differences are in Japan and Korea. For Japan, our bottom-up view remains rosier than ACGA's top-down view, driven largely by our relatively greater focus on the improving capital management there. In Korea, our analysts' frustration with the slow pace of reform continues to show through in extremely low scores.

Difference between CLSA and ACGA scoring methodology

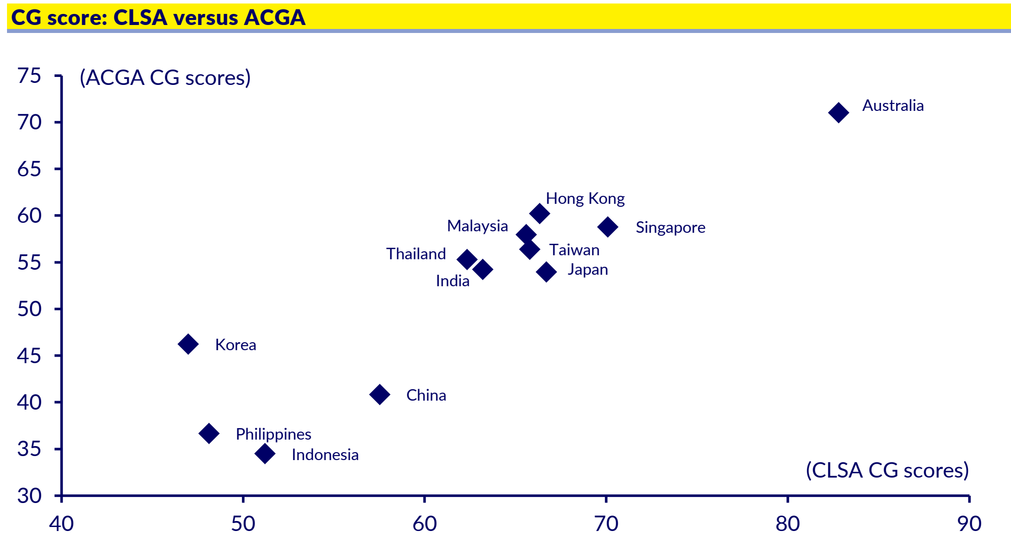
CLSA computes market scores based on aggregating bottom-up assessments of companies under CLSA coverage in Asia

ACGA computes market scores based on evaluating market performance using its survey

Please see Appendices 2-4 for CLSA and ACGA questionnaires

Figure 13

CG score: CLSA versus ACGA



Source: CLSA; ACGA

ESG data's shifting landscape

The ESG data landscape is shifting dramatically . . .

Before outlining the changes that we have made to our survey methodology and process for ESG integration, we take a detour through the rapidly shifting landscape of ESG data. The availability and quality of ESG data has continued to increase at a rapid clip over the past two years, particularly in Asia. But incorporating that data in a useful manner is only getting more complicated. While debate rages about which data to use and how to use it, we see some clear starting points and pitfalls to avoid.

Asian ESG reporting on the rise

. . . nowhere more than Asia

Based on a 2018 survey from KPMG, the share of Asian companies reporting on ESG jumped from 49% in 2011 to 78% in 2017. While we would not vouch for the average quality in the region matching Europe's, there has been a dramatic rise in Asian sustainability reports prepared to the exacting standards of the Global Reporting Initiative (GRI). In 2017, 42% of all GRI sustainability reports came from Asia, versus just 25% in 2011.

KPMG Survey of Corporate Responsibility Reporting 2017

Figure 14

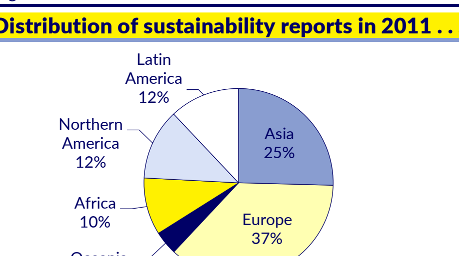
Asia achieves global parity in corporate responsibility reporting

Source: CLSA, KPMG

Dramatic rise in Asian sustainability reports

Figure 15

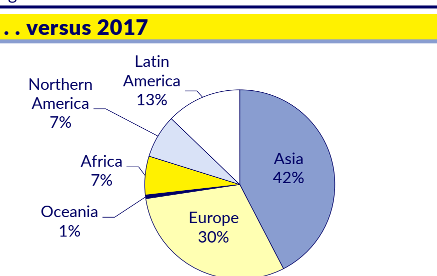
Distribution of sustainability reports in 2011 . . .



Note: Screened on 16 August 2018. Source: CLSA, GRI

Figure 16

. . . versus 2017



Note: Screened on 16 August 2018. Source: CLSA, GRI

Exchanges are a driving force . . .

Exchange requirements have been a big driver. All of the major markets have enhanced CG, ESG or sustainability reporting or CG/Stewardship codes in the past two years. Most markets also continue to ratchet up reporting standards from 'comply or explain' to 'mandatory.' In a fit of optimism, one could even argue that there is a 'race to the top' in reporting (though not necessarily standards). HK Exchange and the market regulator are clearly feeling pressure to move beyond 'comply or explain' for environmental/social reporting as China makes environmental disclosures mandatory in Shanghai and Shenzhen by 2020.

Figure 17

Sustainability and stock exchange

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Japan			Japan Stewardship Code (V)	Corporate Governance Code (M)			Enhancing Corporate Governance Code (CE)		
Malaysia					Listed companies with market cap > RM2bn to issue sustainability report by FY16 AR (M)		Listed companies with market cap RM1-2bn to issue sustainability report by FY17 AR (M)	Listed companies with market cap less than RM1bn to issue sustainability report by FY18 AR (M)	
China	SOEs to publish annual CSR report (M)		GHG Reporting (M)		Mandatory environmental disclosure for all listed companies (recommended)	Mandatory environmental disclosure for companies in the list of key emission enterprises of the Ministry of Environmental Protection (M)	Mandatory environmental disclosure for all listed companies (CE)		Mandatory environmental disclosure for all listed companies (M)
Taiwan				CSR Reporting for selected companies (M)		TSE : Listed companies with capital NT$10bn to issue CSR report by FY17 AR (M)			
South Korea					Corporate Governance Guideline by KSE and FSC (planned) Stewardship Code (planned)				
Singapore							Listed companies to report sustainability report (CE)		
Hong Kong	Implementation of ESG Guide (CE)	New code of Corporate Governance (CE)			Listed companies to follow general disclosure provision (CE)	Listed companies to report Environmental KPIs (CE)			

Note: mandatory = (M), voluntary = (V), comply or explain = (CE). Source: Bloomberg, exchanges, CLSA

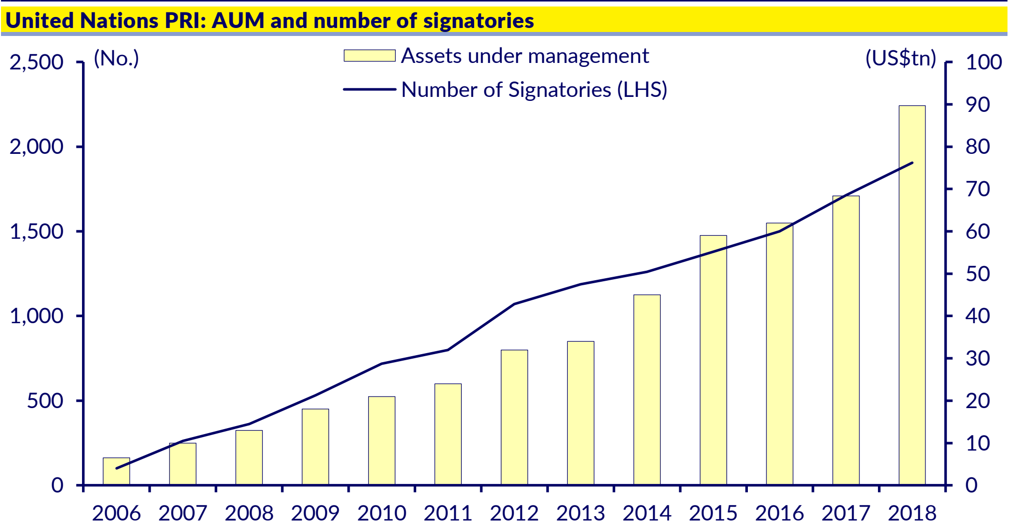
. . . so are investors

Beyond reporting requirements, corporates are also of course reacting to investor demand. According to the Principles for Responsible Investment (PRI), assets under management (AUM) that incorporates sustainability jumped 31% YoY to US$89.7tn in 2018. The number of ESG or SRI related ETFs has also nearly doubled over the past two years to 160. As investment managers ratchet up dedicated funds and integration into mainstream funds, they are demanding more data.

As of 2018, AUM reached US$89.7tn, up 31% YoY

Figure 18

United Nations PRI: AUM and number of signatories



Source: CLSA, PRI

ESG ETFs up 17% as of August 2018

Figure 19

A total of 161 ESG/SRI ETFs are traded globally

Note: screened on the 9 August 2018. Source: Bloomberg, CLSA

Third-party data providers are proliferating

Third-party ESG data providers continue to proliferate. The likes of CDP (previously called the Carbon Disclosure Project) have been rapidly expanding the breadth and depth of coverage globally. Then there is a host of new datasets available looking at a broad range of sustainability issues. A few of the many examples that we look at elsewhere in this report include: FAIRR for livestock production and IPE for Chinese environmental issues.

Standardisation lags, but efforts are underway

Finding standardised data sets across companies, markets and sectors is still a challenge. However, a great deal of work is being done. From an equity investor perspective, the US-based Sustainable Accounting Standards Board (SASB) is arguably at the forefront, focusing reports on key material KPIs. In 3Q18, SASB and GRI, which issues more comprehensive stakeholder-focused guidelines, have stepped up efforts to align reporting where possible. Both are running parallel to the disclosures recommended in 2017 by the task force on climate change (TCFD), which is gaining considerable momentum.

Data providers aim to fill the gap

To make sense of the growing mountain of ESG data, service providers and ratings agencies are expanding and proliferating. Below, we list a few of the better-known ones. The list is far from complete, with new providers seemingly popping up every day and established firms (like Moody's in September 2018) dramatically expanding their ESG ratings offerings.

Figure 20

Summary tables for data service providers

Data service provider	Background
MSCI	Launched in 2010. As part of the MSCI Group, MSCI provides ESG ratings for 6,500 global companies and more than 590,000 equity and fixed-income securities.
Sustainalytics	Sustainalytics is the 2008 consolidation of DSR (Netherlands), Scores (Germany) and AIS (Spain). Sustainalytics now covers 7,000+ companies across 42 sectors.
Bloomberg	Launched in 2009 when Bloomberg acquired New Energy Finance. Covers almost 9,500 companies across 83 countries. On track to provide ESG data for 13,000 companies by the end of 2018.
Thomson Reuters	Launched in 2009 when Thomson Reuters acquired Asset4. Covers over 7,000 global companies and includes over 400 metrics.
Arabesque	Launched S-Ray in 2017. Covers over 7,000 companies across 70 countries and includes over 200 ESG metrics.
RepRisk	Founded in 1998, RepRisk provides ESG reports for 110,000+ private and public companies in 34 sectors globally.
CSRHub	Founded in 2008. Provides ESG ratings and rankings performance for 18,052 companies across 135 industries in 33 countries.
Reputex	Founded in 1999. Offers research on carbon markets and electricity markets and provides in-depth modelling, pricing and policy analysis for renewable energy, power and emissions markets.
ECPI	ECPI was founded in 1997 providing investment and sustainability advisory services. ECPI research covers over 4,000 companies and maintains one of the world's largest sustainability databases.
FTSE	FTSE Russell has over 15 years of experience dealing with ESG data. FTSE Russell maintains two core data models: the ESG Ratings and Data model assesses operational ESG risks and performance; the Green Revenues data model classifies and measures revenue exposure to products that deliver environmental solutions. 4,100 and 13,500 companies are included in the ESG risk exposures and Green Revenues exposures.

Source: CLSA

Providers have come under fire

But is the data any good? Over the past year, there have been a number of studies and media articles pointing out the lack of consistency between scoring methods. We would argue that these studies do not discredit ESG data or the practice of scoring. However, it underscores the danger of relying on a simple final score for investment decisions.

Is Tesla good or bad?

As the WSJ reported in September (link), deviations can be extreme. FTSE ranked Tesla as the worst carmaker globally on ESG issues, while MSCI ranked it first. The article breaks down key differences in approach by the different agencies, as well as Sustainalytics, who ranks Tesla near the middle of the pack. In short, for Tesla, MSCI focuses on the carbon and clean tech opportunities engendered by Tesla's product mix, while FTSE hammers the company for poor disclosures.

Depends on who you ask

We also run Tesla through CLSA's scoring process, which does not treat it very nicely. On CG, the company would have landed in our bottom quintile, with a score of 34 out of 100. It got hit by lack of Discipline (Solarcity deal), lack of Independence (super majority & Solarcity deal). Scores in Responsibility, Fairness and Transparency were middling. Our focus on carbon and EVs for the auto-sector led to a strong 73 points for E/S. Given our 90% weighting toward CG in the blended ESG score, Tesla would land in the bottom quintile.

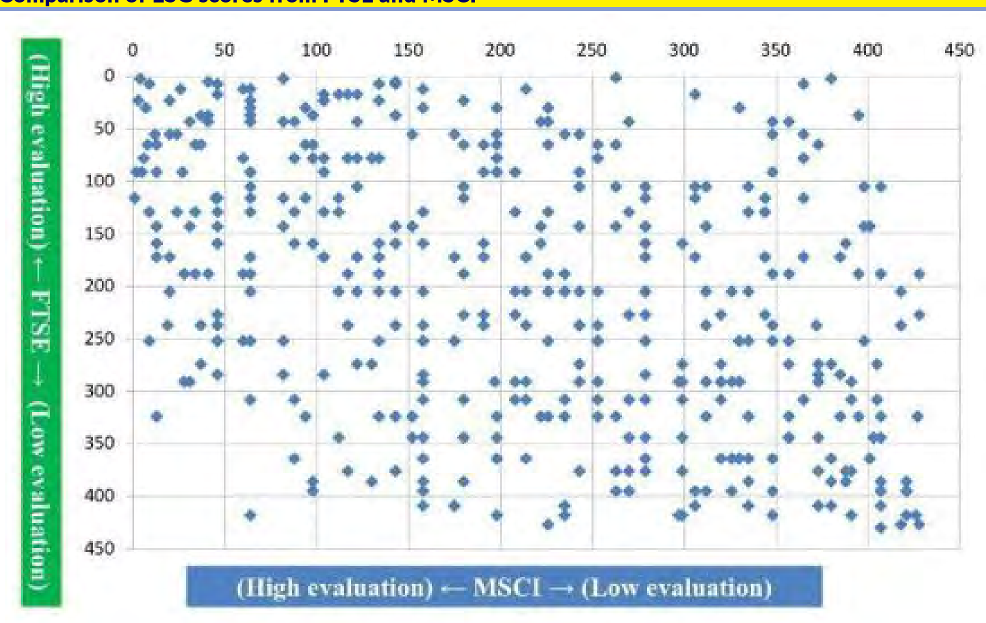
Nobody can seem to agree

Note this was before the September SEC settlement removing Elon Musk from the Chairman position for three years and requiring two more independent directors. Regardless, this lack of consistency between different ESG ratings is not limited to Tesla. Figure 21, from GPIF, illustrates the lack of correlation between scores from FTSE and MSCI. According to data provider CSRHub, the correlation between ESG ratings for MSCI and Sustainalytics is similarly low, at just 0.32.

Low correlation between service providers

Figure 21

Comparison of ESG scores from FTSE and MSCI



Source: CLSA, GPIF

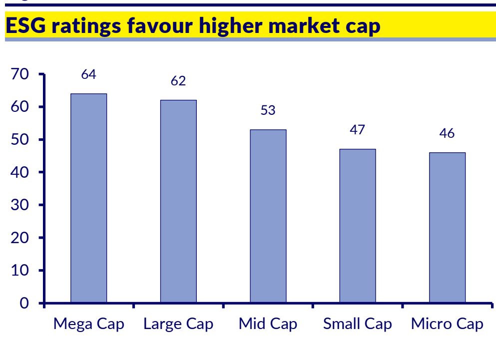
Pushing for standardisation

In July 2018, the conservative think tank The American Council for Capital Formation (ACCF) came out with a report breaking down the differences in ratings between MSCI, Sustainalytics, RepRisk and ISS. In the report, ACCF breaks out the different biases inherent in ESG scores. Figures 22 and 23 bear out that argument. ACCF goes further, though, arguing (in our reading) that ratings should be held back until they are fully standardised in regulatory filings, which, to us, feels like a stalling tactic. The push for standardisation remains valid.

Ratings tend to be biased towards those companies which report the most data

Figure 22

ESG ratings favour higher market cap



Source: CLSA, ACCF

Figure 23

ESG ratings bias across regions

Europe	Australia	Asia	North America
66	64	57	50

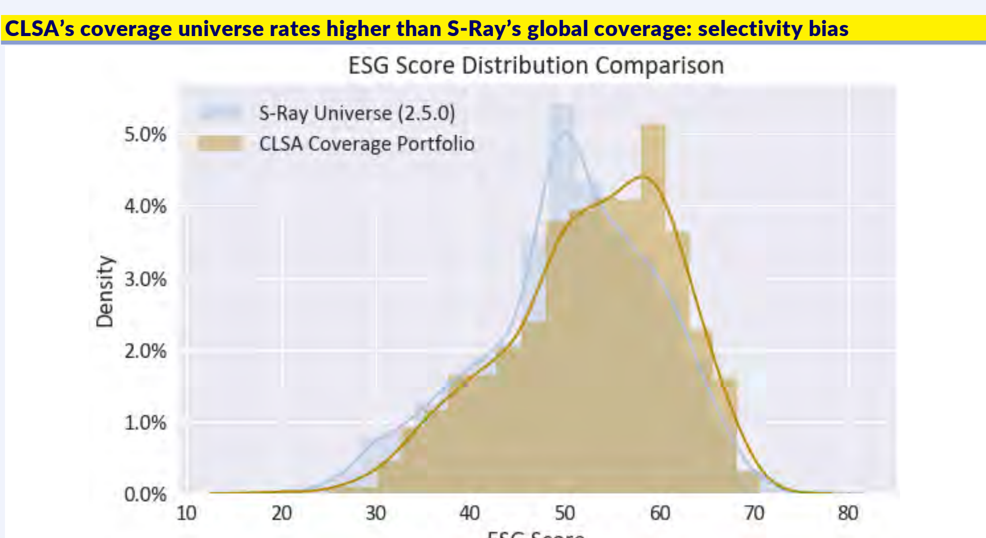
Source: CLSA, ACCF

Incorporating Arabesque S-Ray

For *CG Watch 2018*, we have incorporated ESG data from Arabesque S-ray both to identify fast-moving data and also as a proxy for consensus. By Arabesque's own description: 'Through machine learning and big data, Arabesque S-Ray® systematically combines over 250 environmental, social and governance (ESG) metrics with news signals from over 50,000 sources across 15 languages.' Environmental, Social, Governance and blended ESG scores are updated daily for over 7,000 corporations globally. S-Ray currently scores 74% of CLSA's stock coverage universe; however, for largecaps (>US$10bn) that figure grows to 95%.

Using S-Ray's ESG scores, CLSA's coverage universe rates 4.3% higher (mean) in aggregate than S-Ray's global coverage universe. This comes as no surprise, as we would naturally tend to select the better run companies to cover

CLSA's coverage universe rates higher than S-Ray's global coverage: selectivity bias



Source: Arabesque S-Ray, CLSA

Proxy for consensus

We want to be aware of instances where our scores deviate substantially from the street

The first way in which we use S-Ray is as a proxy for consensus. As with earnings forecasts, we do not change our numbers to match consensus, of course. However, we want to be aware of instances where our scores deviate substantially from the street. These gaps are provided to country research heads at CLSA, who are responsible for signing off on their respective teams' scores. As we illustrate elsewhere in this report, the correlation between ESG scores from different data providers is weak. Thus, at this stage we are only looking for the greatest deviations. Where scores deviate by three to four quintiles, the research heads work directly with analysts to see what we (or the market) might be missing.

Momentum

We are flagging top gainers and decliners

Our ESG scores at CLSA are live, in that they are meant to reflect the analysts' latest thinking. In reality, the scores do not change frequently or dramatically (mostly with annual reports or major events). Without getting too prescriptive, we also want to make sure that we are not missing any meaningful changes that occur outside the reporting period. As a first step, we are flagging top gainers and decliners in S-Ray scores to analysts on a monthly basis.

Next steps

Scoring is integral to our own ESG integration efforts

We have no intention of abandoning ESG scoring at CLSA. As painful and time-consuming as it can be, the process of scoring is integral to our own ESG integration efforts. Additionally, external data quality remains an issue. As Andreas Feiner, founding partner of Arabesque, says: the quality of ESG data today is only around 10% of where it will be in five years' time. We want to make sure we are not missing out on the myriad new alternative ESG datasets driven by big data, satellite imagery and machine learning. The field is evolving, alongside our process.

Changes to CLSA's survey

On the surface, our CG question has not changed in 2018 . . .

On the surface, our company-level CG survey has not changed from 2016. The survey is split up into five sections: discipline, transparency, independence, responsibility and fairness. Each is composed of three to seven questions, and contributes 18% to our blended ESG score (the remaining 10% comes from our E/S score). CG questions are the same across markets, but vary by sector for E/S (see Section 3).

. . . after moving toward more qualitative questions in 2016

In 2016, we made some of the questions more qualitative in hopes of better capturing substance over form. For example, the question asking whether independent directors made up at least half the board was replaced by a question asking whether there was evidence of directors behaving independently. As we acknowledged then, the greater scope for analyst interpretation increases the ever-present risk that the data is not comparable from country to country and sector to sector. Each analyst is likely to interpret it differently regardless of the definitional criteria. We see that as a worthwhile sacrifice both in order to evolve the thinking and to take advantage of our analysts' knowledge of their companies.

Introducing 'comply or explain'

While we continue to give analysts flexibility to answer most questions, we are also taking advantage of the improving availability and standardisation of third-party data to inform their scoring process. More specifically, we have introduced a 'comply or explain' element to a handful of questions where the analyst answer does not match with the answer implied by observable reported data. We also incorporate the fast-moving data from Arabesque S-ray to highlight stocks that could have experienced significant ESG changes between reporting periods.

Comply or explain

Analysts retain ultimate authority

While analysts retain ultimate authority over their companies' CG scores, we are increasingly challenging their scores with data points that do not align with their answers. As the availability of relevant data continues to improve, we will increase the number of data points for which analysts have to comply or explain. This is an important step both in making our scores more robust and in encouraging analysts to incorporate CG into their stock recommendations.

Weeding out excess optimism

The arguments range from black and white to the foggiest of grey areas. There is a consistent theme, however. Thus far, all of the external data serves to counteract an optimistic bias. For example, no simple data point could assure investors that a company's board is truly diverse, whereas a number of observations could suggest the opposite. Our process will continue to evolve with the quality and availability of data. Below, we highlight data that we are incorporating into our answers on: board diversity (Q17), conflicts of interest (Q21) and board independence (Q15).

Explicitly addressing gender diversity

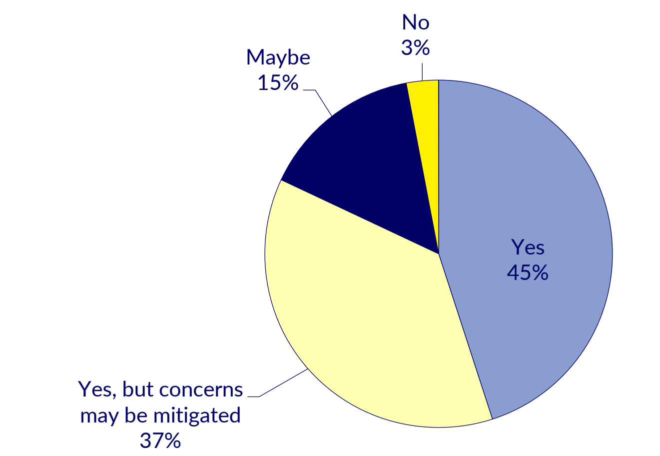
Does gender diversity on boards matter?

In October 2018, California mandated that publicly-traded companies appoint female directors to their boards, following in the footsteps of Norway, Iceland, Finland and Sweden. There is still active debate around whether quotas are the best way to improve gender diversity on boards. However, there is now little debate about whether gender diversity on boards has to increase. In a recent global investor survey from ISS, only 3% of respondents said that it would *not* be problematic if there were no females on the board.

Over 80% investors answered yes

Figure 24

Most investors consider it problematic if there is no female director on a public company board



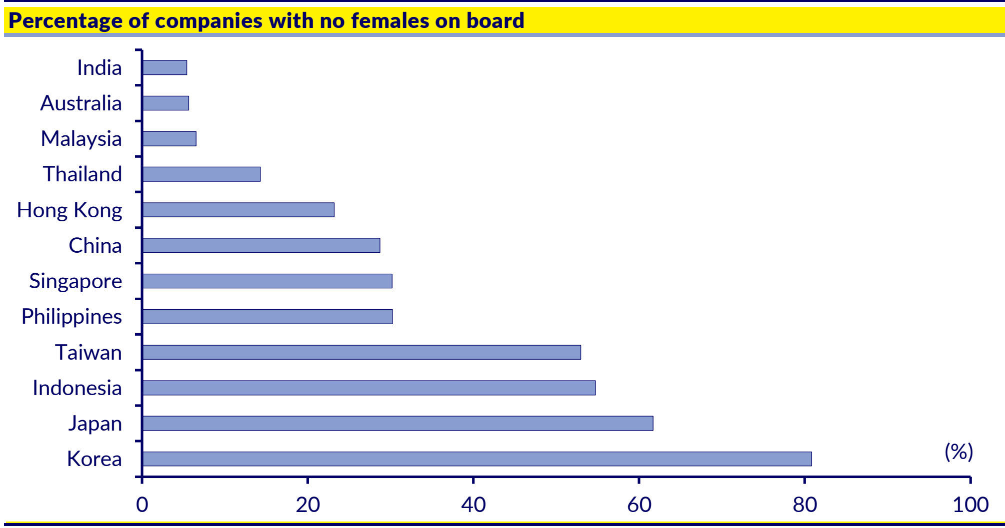
Source: ISS 2018 Governance Principles Survey

While female representation on boards is improving in Asia, the region still lags badly. Australia, India and Malaysia have specific targets, and - not surprisingly - stand out for lack of male-only boards. Singapore also has a specific target for 20% women's participation on boards by 2020, rising from there. Japan, Taiwan and the Philippines specifically mention gender in listing requirements. (See Appendix 6 for a summary of policies). Japan and Korea stand out for lack of female board representation.

Japan and Korea stand out for lack of female board representation

Figure 25

Percentage of companies with no females on board



Source: CLSA, Factset

Our survey does not feature any questions explicitly on gender diversity. However, gender diversity is one of the key indicators for one question:

Q17: Does the board composition reflect an attempt to bring diverse talent and backgrounds to the board?

The argument is that any company serious about getting diverse opinions from the board would at least have to have some female representation. Of course, simply having one (or more) woman on the board does not guarantee that it's a

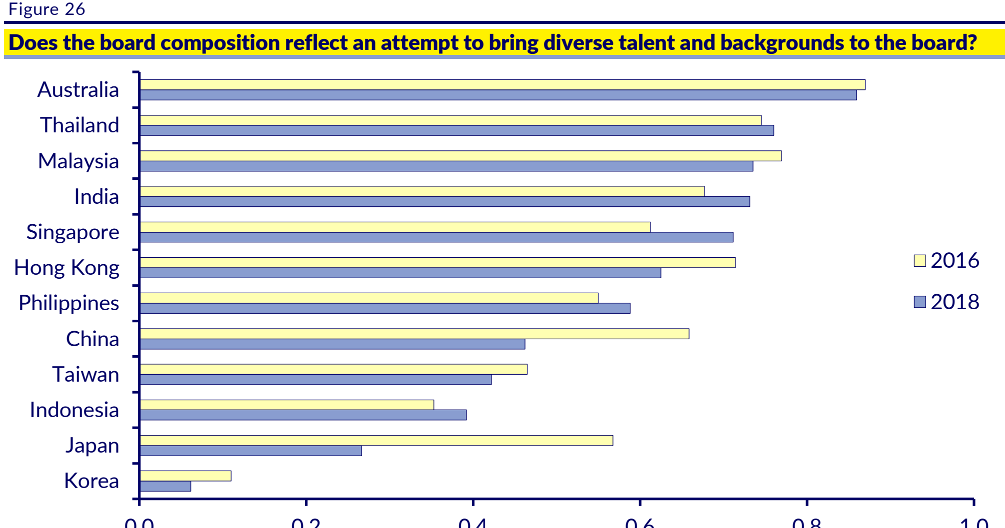
diverse board (CEO's wife, sister, etc), but the opposite should hold true: No women on the board would mean - in most cases - that the company is not making a serious attempt to have a diverse board.

In all, 9% of the companies with no female board representation had scored positively on Q17. No longer. Borrowing regulators' language, we have shifted gender diversity on boards from 'recommended' to 'comply or explain.' For some markets, there is no real excuse at this stage to not having any women on the board. For others, like Japan, that have only recently started the journey toward more diversity, we wanted to make some allowances. Even there, though, the company has to demonstrate that it is hitting all the marks on best practice for diversity (aside from gender). There are almost no exceptions.

Focus on gender diversity has pushed down board diversity scores substantially in Japan, China and Hong Kong

Figure 26

Does the board composition reflect an attempt to bring diverse talent and backgrounds to the board?



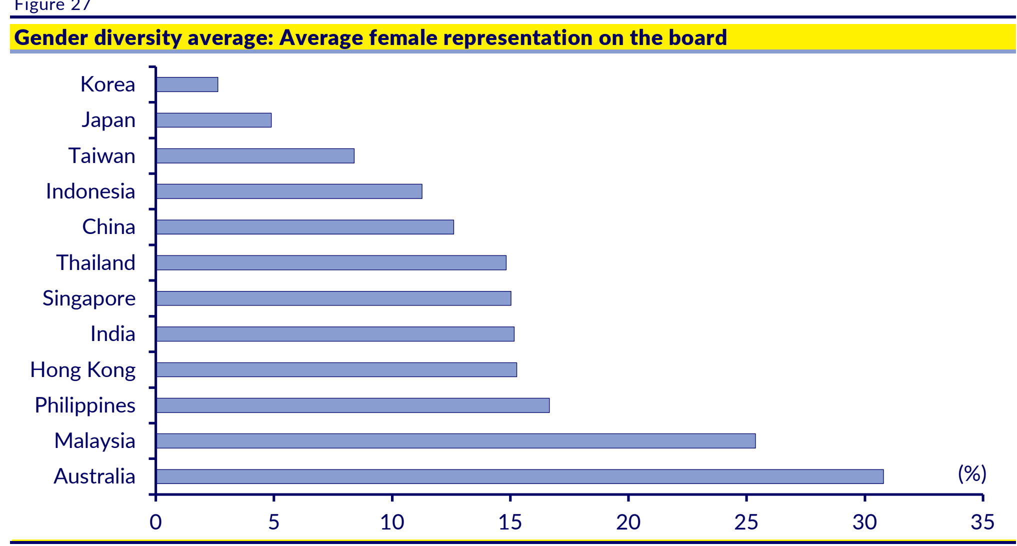
Source: CLSA

As standards on gender diversity improve across the region, we will raise the bar for 'comply or explain' on diversity beyond simply at least one female on the board. As Figure 27 makes abundantly clear, there is still a long way to go.

There is still a long way to go for gender diversity

Figure 27

Gender diversity average: Average female representation on the board



Source: CLSA, Factset

Finding conflicts of interest before they bite

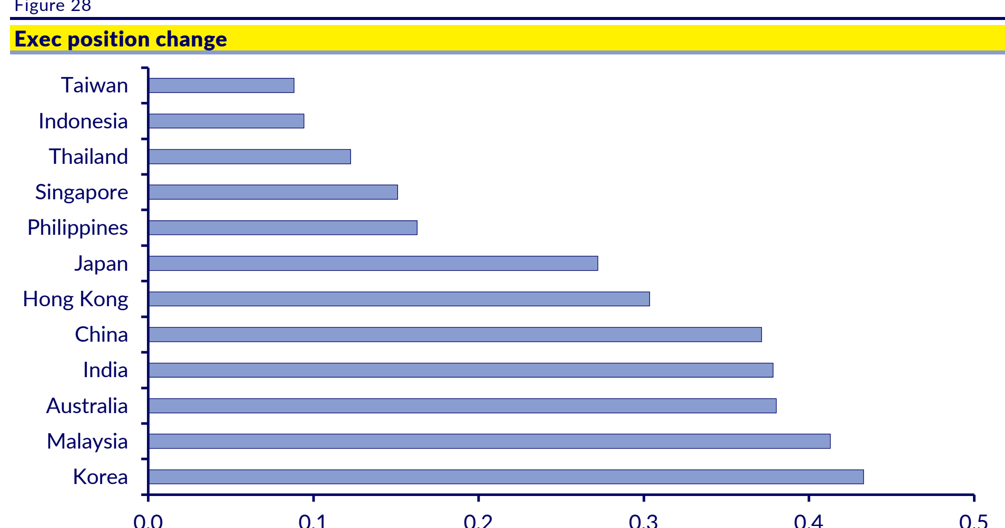
Conflicts of interest and management turnover

We watch related party transactions and cross-holdings for signs that conflicts of interest exist on the board or among senior management. Digging a bit deeper, we are also looking at top management turnover as an indication that something could be awry. Frequent changes of personnel in the crucial management roles (CEO, CFO, President) within a short period of time could be indicative of undisclosed problems or ineffective whistle-blower policy within the company.

Average exec position change within one year

Figure 28

Exec position change



Note: Executives (CEO, CFO or President) position changes occur when: 1) an interim replacement is appointed; 2) the holder of a position changes; or 3) a co-holder of a position is appointed. Multiple positions held by one person will be counted as one change for each position when the holder of those positions change. Source: CLSA, Factset

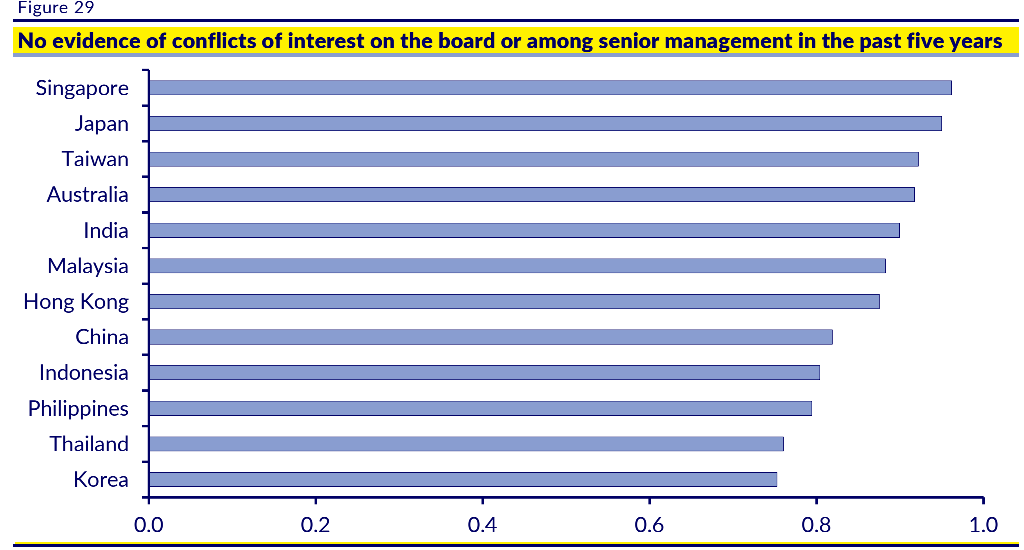
Among our coverage, nineteen companies around the region have experienced at least two management changes at the CEO/CFO/President level over the past year. We have focused analyst attention on these stocks to assure that the management changes do not mask a conflict of interest (as captured in our survey Q21) or other issues.

Q21: Has there been any evidence of conflicts of interest on the board or among senior management in the past five years?

Percentage of good corporate governance of Q21

Figure 29

No evidence of conflicts of interest on the board or among senior management in the past five years



Source: CLSA

Board independence and competence

Assessing board independence and competence

With our last update to the survey in 2016, we modified the question asking whether over half of the board was independent to:

Q15: Do the independent directors on the board act in a genuinely independent way?

Scores range from 0 (analyst concerns) to 0.5 (no negative evidence) and 1 (positive evidence showing a board has challenged management). We are now incorporating three flags to highlight potential lack of independence on the board: independent directors, average tenure and board size.

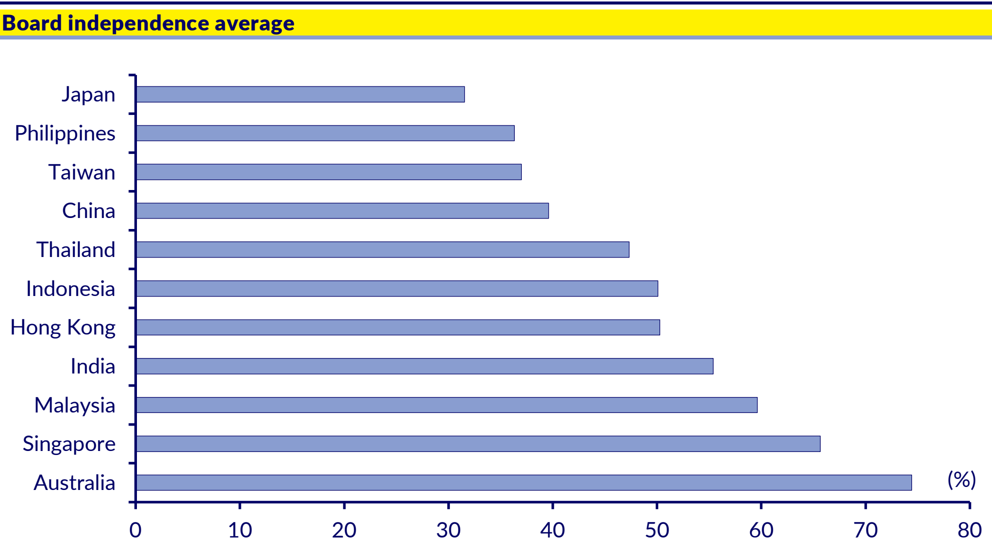
Flag one: Independent directors

In and of itself, a large share of independent directors on the board does not assure anything. However, too few independent directors is clearly a bad thing. For our calculations, companies that have a smaller share of independent directors than the market median trip the independence flag.

Average independent directors as percentage of total directors

Figure 30

Board independence average



Source: CLSA, Factset

Flag two: Tenure

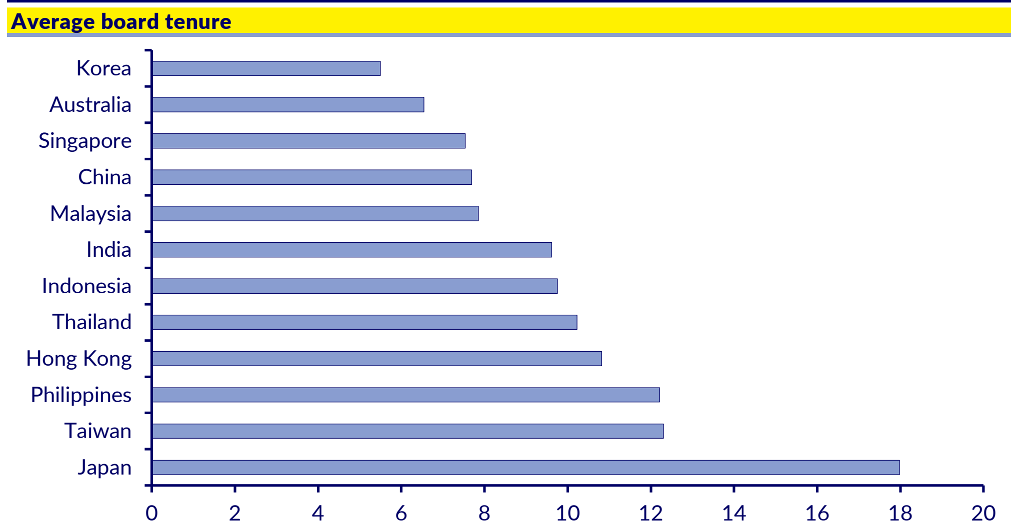
We can look at average board tenure as a red flag indicator. Typically, longer board tenure (>10 years) could lead to less independence. Abnormally short tenures are equally problematic, in that the board members are probably not as knowledgeable about the business as would be ideal.

For long tenures, Japan is the obvious stand-out with an average board tenure of 18 years. Of the 20 companies among CLSA coverage that boast an average board tenure of >30 years, all but two hail from Japan (Indonesia accounts for the other two). The data around short-tenures (<2 years) is skewed by IPOs and restructurings. Anything over 10 years trips this flag.

Too long or too short is not good; Japan stands out

Figure 31

Average board tenure



Source: CLSA, Factset

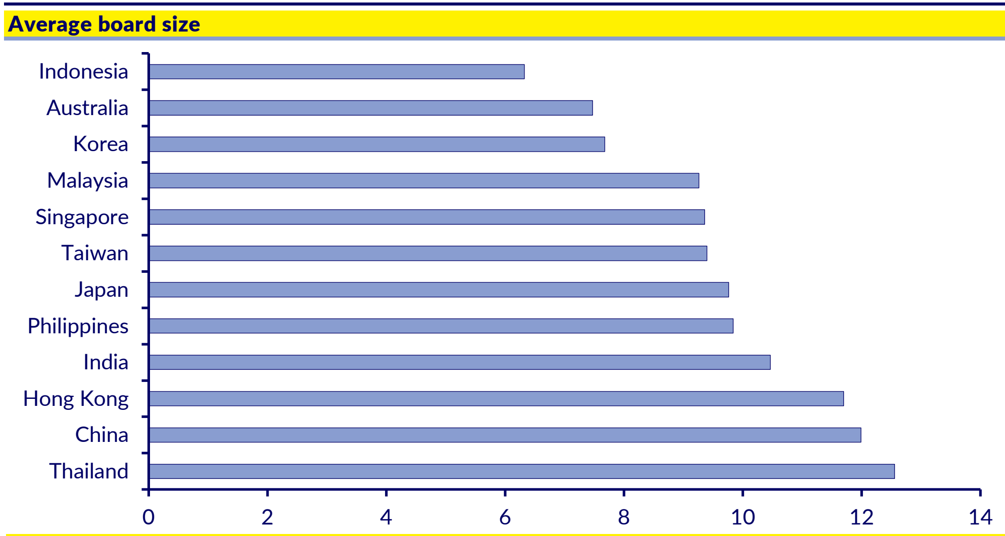
Flag three: Board size

Academic studies suggest the optimal board size is 10 members. Larger boards become unwieldly and ineffective, while much smaller boards tend to lack expertise and diversity of opinion and are usually dominated by company insiders. Around 60% of CLSA's coverage falls in the ideal 8-12 board members range. Those that do not, earn a flag.

Average number of directors by market

Figure 32

Average board size



Source: CLSA, Factset

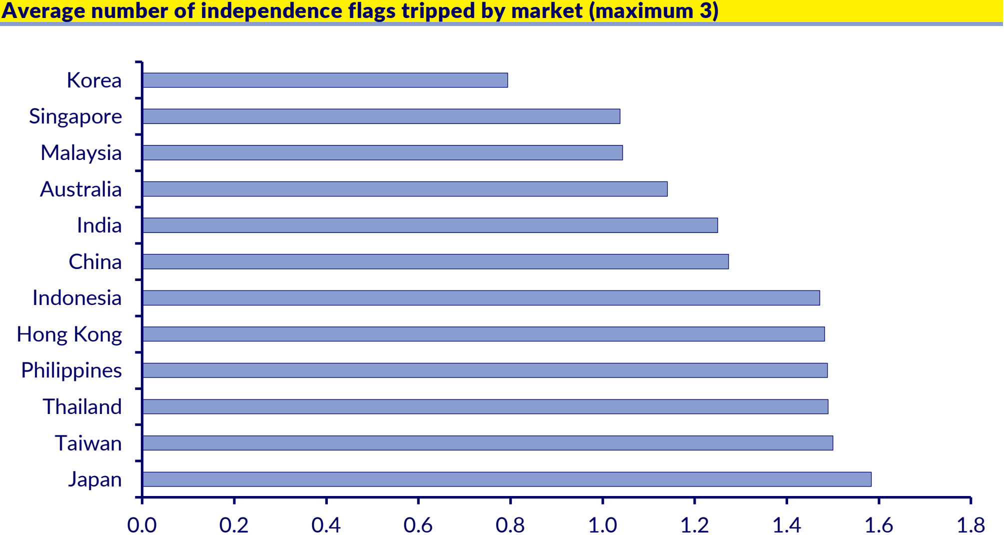
Three strikes

Sixty-nine of the companies under CLSA coverage trip all three flags and 402 trip two of them. For companies that tripped all three, we have asked analysts to either explain why they believe the board is truly independent or mark down the score to either 0 or 0.5.

Average number of red flags by market

Figure 33

Average number of independence flags tripped by market (maximum 3)

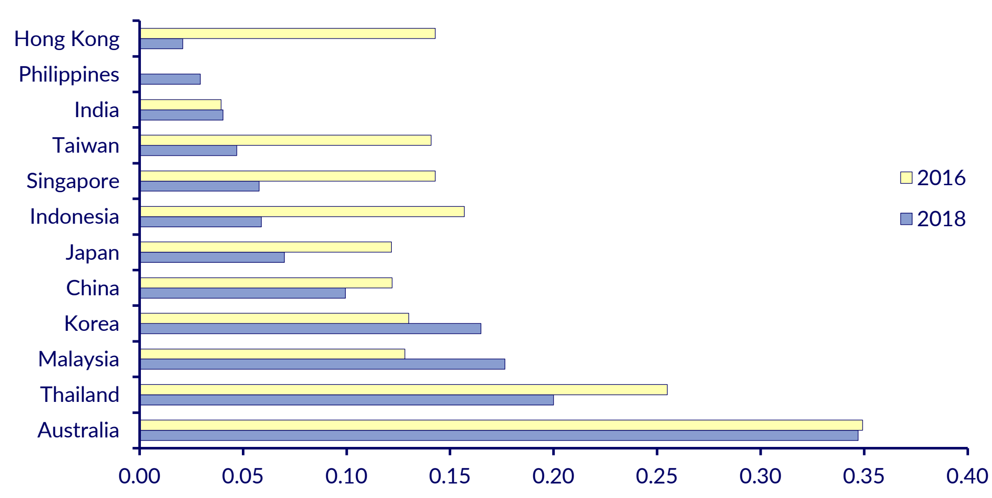


Source: CLSA, Factset

Board independences scores across markets wilt under the microscope

Figure 34

Do the independent non-executive directors on the board act in a genuinely independent way?



Source: CLSA

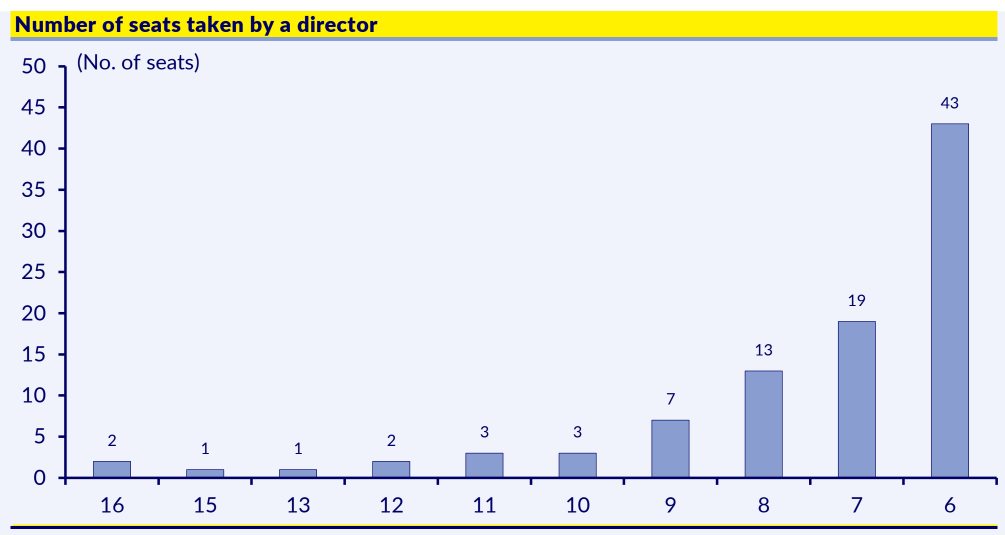
Overboarding is a classic red flag

Board busy-ness or 'overboarding' is one of the classic red flags to tease out non-independent boards. Hong Kong boards are among the world's busiest, with 65 people occupying 7% of the board seats for all HK-listed firms, based on data from WEBB-site. Two energetic gentlemen sit on a rather extraordinary sixteen boards while 94 people occupy six or more board seats.

This should start to change, albeit slowly, from January 2019, at which point companies looking to appoint a new independent director that is already sitting on six or more seats will have to explain why they are doing so.

Directors sitting on more than six seats in Hong Kong

Number of seats taken by a director



Source: CLSA, WEBB-site

Hong Kong's busiest board members and some of the companies they serve

List of board directors sitting on more than nine seats, with some notable examples

Director Name	Company	Number of Seats
Lam Lee George	C.P. Lotus Corp, DTXS Silk Road Ltd, Far East Ltd, Haitong Securities	16
Shek, Abraham Lai Him	SJM Hlds, Far East Ltd, Haitong Securities, Vongroup Ltd	16
Loke, Yu	Matrix Hlds, China Beidahuang Ltd, HK Life Sciences, Lamtex Ltd	15
Cheng, Erik Yuk Wo	C.P. Lotus Corp, CSI Properties Ltd, HKC(Holdings) Ltd, South China Asst Ltd	13
Poon, Chiu Kwok	Greentown Grp, Tsingtao Brewery, Avic Hlds, Yanzhou coal Ltd, Honghua grp Ltd	12
Wong, Chi Keung	Asia Orient Hlds, Regal Hotel, Yuexiu Property, Denway Motors Ltd	12
Fan, Anthony Ren Da	Uni president, CITIC Resources	11
	China Dev Bank	
Lee, Conway Kong Wai	Yashili International, CITIC Securities, West China Cement, China Taiping Insur	11
Wong, Edward Yun Kuen	Far East Ltd, Global Mastermind,	11
	Kingston Financial, Asia Coal, Detai New Energy	
Lee, Eddie Kwan Hung	Far East Ltd, FSE Services Grp, Vestate Grp, Newton Resources	10
Ngai, Maurice Wai Fung	China Coal Energy, China Medical Hlth Care, China Railway Ltd, BBMG Corp, HKBridge Financial	10
Wan, Peter Kam To	Haitong International, China Resources Land, Target Insurance Ltd, KFM Kingdom Ltd, Shanghai Pharma	10

Source: CLSA, WEBB-site

CLSA survey results for 2018

Aggregate scores by market are largely consistent with 2016

Figure 35 breaks down aggregate scores by market for the five categories contributing to our CG score, as well as our Environmental & Social (E/S) score, and the blended ESG score, including CG and E/S. For each category, the highest and lowest scores ex-Australia are highlighted.

Companies score best on Fairness . . .

Average category scores have not changed dramatically from 2016, although stricter interpretation on diversity has brought down aggregate **Independence** scores slightly. **Fairness** (remuneration, avoidance of controversy and conflicts of interest) is the segment in which companies score highest. This segment of the survey emphasises egregious violations that have been uncovered, as opposed to just conditions that would enable those violations. Korea comes in at the bottom, with Singapore garnering the highest score.

. . . followed by Transparency

Aggregate scores for **Transparency** (clear and timely reporting, access to management) are also quite high, albeit down slightly (2.7 pts) from 2016. Outside of Australia, the stand-out markets are Singapore, Thailand and India. Thailand could come as a surprise to some, but as explained in ACGA's country section, this aligns well with concrete top-down improvements.

Conflicts of interest mar Responsibility scores

On average, companies are delivering middling scores for **Discipline** (capital management, sticking to core businesses) and **Responsibility** (related party transactions, alignment of interests). For Discipline, Taiwan and Japan lead the pack. Japan is buoyed by our survey's focus on companies that are overspending on questionable investments, rather than lazy balance sheets. Korea brings up the rear, dragged down by the multifarious business lines and investments of the Chaebol. For Responsibility, the conflicts of interest endemic to Southeast Asian businesses show through in low scores for the Philippines, Indonesia and Thailand (by far the countries weakest category).

Independence remains the low point

Independence is, once again, comfortably the weakest category for our bottom-up survey. The Philippines scores lowest, but it has plenty of company from Korea, Indonesia and Japan at the bottom. Even after years of reform, most Asian countries have boards that are heavily influenced by a founding shareholder (promoter), controlling family or the government. In 2018, we have also gotten stricter on scoring for, in particular, the **Independence** category across markets, as explained in more detail above.

Australia continues to lead the pack

Figure 35

Aggregate company scores by category

(%)	Discipline	Transparency	Independence	Responsibility	Fairness	CG	E/S	Blended ESG
Australia	74.9	92.2	77.5	84.2	85.2	82.8	68.6	81.4
China	51.4	61.7	46.2	52.7	75.7	57.5	65.3	58.3
Hong Kong	62.4	69.6	50.1	63.8	85.9	66.3	68.9	66.6
India	57.0	77.1	40.3	55.0	86.6	63.2	67.8	63.7
Indonesia	45.8	63.1	31.9	34.9	80.3	51.2	59.2	52.0
Japan	69.0	64.7	27.7	84.2	88.0	66.7	74.2	67.5
Korea	40.5	57.9	29.9	51.1	55.5	47.0	67.1	49.0
Malaysia	61.3	72.8	49.6	58.4	85.9	65.6	64.4	65.5
Philippines	59.6	59.0	27.5	31.0	63.7	48.1	65.3	49.9
Singapore	55.9	83.8	59.2	57.4	94.2	70.1	66.1	69.7
Taiwan	70.0	53.1	48.9	77.4	79.5	65.8	73.0	66.5
Thailand	53.1	81.8	58.1	37.5	81.3	62.3	66.7	62.8
Average	**58.4**	**69.7**	**45.6**	**57.3**	**80.2**	**62.2**	**67.2**	**62.7**
Average ex-Aus	56.9	67.7	42.7	54.9	79.7	60.4	67.1	61.0
Max-Min range (ex-Aus)	29.5	30.6	31.7	53.2	38.7	23.1	15.0	20.7

Note: Boxes highlight leader (green) and laggard (gold) ex-Australia. Source: CLSA

Comparing the 2016 and 2018 results, the top, middle and bottom bands of scores are largely the same. Australia remains easily the highest scorer. Japan ceded second place to Singapore. The widely panned introduction of dual-class shares (DCS) there has not yet had any impact on bottom-up scoring.

The biggest mover was Malaysia, whose blended score rose from eighth to sixth place, nearly tied with Taiwan in fifth. Enforcement in Malaysia has already stepped up noticeably under the new leadership, and hopes are high that trend will continue. Thailand dropped two spots from sixth to eighth, dragged down by lower scores in the consumer and tourism sectors. Despite some improvements, China remains in the bottom band, ahead of Indonesia, the Philippines and Korea.

ESG scores 2018 vs 2016 by market

Figure 36

Average ESG scores by market (ranked by 2018 with 2016 side by side)

2018 | 2016

0 10 20 30 40 50 60 70 80 90

Australia, Singapore, Japan, Hong Kong, Taiwan, Malaysia, India, Thailand, China, Indonesia, Philippines, Korea

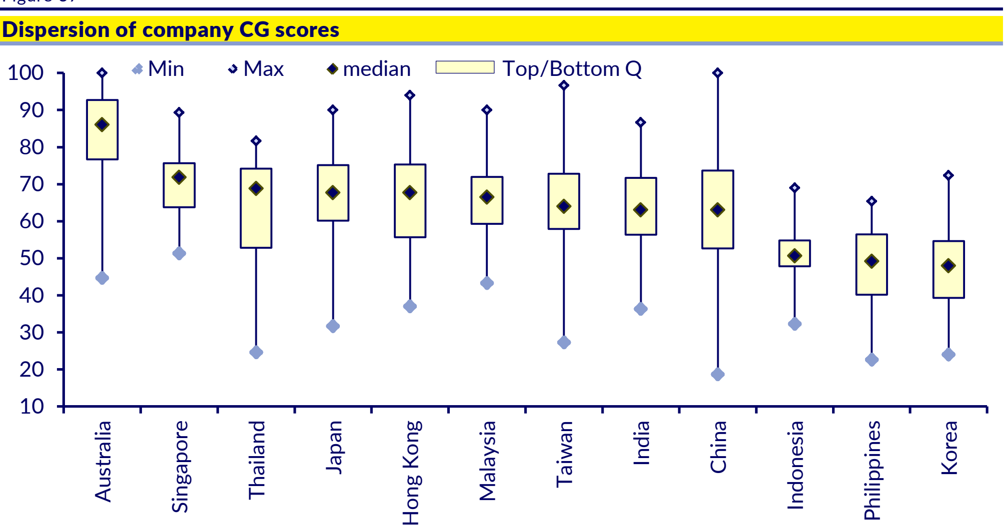
Source: CLSA

As one would expect, there is a wide dispersion of scores across each market.

CG scores high to low by median

Figure 37

Dispersion of company CG scores



Source: CLSA

Standout CG companies

Top-governance companies have been broken out by country

To give investors a better sense of the strongest governance players in each market we have presented three sets of tables at two size scales (market cap above and below US$10bn): the top-10 companies in Australia, which would otherwise dominate the results; the top-10 companies in Japan, given the scale of the market; and the top-five companies in each of the 10 Asia ex-Japan markets covered by this report.

Figure 38

Top-10 companies in Australia (market cap above US$10bn)

Ticker	Short name	Country	Sector
CSL AU	CSL	Australia	Healthcare
TCL AU	Transurban	Australia	Infrastructure
S32 AU	South32	Australia	Materials
WOW AU	Woolworths	Australia	Consumer
TLS AU	Telstra	Australia	Telecoms
GMG AU	Goodman	Australia	Property
WES AU	Wesfarmers	Australia	Consumer
SCG AU	Scentre	Australia	Property
SYD AU	Sydney Airport	Australia	Transport
AMC AU	Amcor	Australia	Materials

Source: CLSA

Figure 39

Top-10 companies in Australia (market cap below US$10bn)

Ticker	Short name	Country	Sector
NXT AU	NEXTDC	Australia	Technology
AZJ AU	Aurizon	Australia	Transport
XRO AU	Xero	Australia	Technology
SUL AU	Super Retail	Australia	Consumer
MTS AU	Metcash	Australia	Consumer
RHC AU	Ramsay Health Care	Australia	Healthcare
OSH AU	Oil Search	Australia	Petro/Chems
CMW AU	Cromwell	Australia	Property
GNC AU	GrainCorp	Australia	Consumer
CYB AU	CYBG	Australia	Financial services

Source: CLSA

Figure 40

Top-10 companies in Japan (market cap above US$10bn)

Ticker	Short name	Country	Sector
7203 JP	Toyota Motor	Japan	Autos
2587 JP	Suntory B&F	Japan	Consumer
4911 JP	Shiseido	Japan	Consumer
4502 JP	Takeda Pharma	Japan	Healthcare
7309 JP	Shimano	Japan	Consumer
2502 JP	Asahi Group	Japan	Consumer
6326 JP	Kubota	Japan	Autos
7270 JP	Subaru	Japan	Autos
7267 JP	Honda Motor	Japan	Autos
9433 JP	KDDI	Japan	Telecoms

Source: CLSA

Figure 41

Top-10 companies in Japan (market cap below US$10bn)

Ticker	Short name	Country	Sector
2337 JP	Ichigo	Japan	Property
3003 JP	Hulic Co Ltd	Japan	Property
2181 JP	Persol	Japan	Consumer
6506 JP	Yaskawa Electric	Japan	Technology
4927 JP	Pola Orbis	Japan	Consumer
7272 JP	Yamaha Motor	Japan	Autos
3088 JP	Matsumotokiyoshi	Japan	Consumer
2206 JP	Ezaki Glico	Japan	Consumer
7453 JP	Ryohin Keikaku	Japan	Consumer
4321 JP	Kenedix	Japan	Property

Source: CLSA

Figure 42

Top-5 companies in Asia ex-Japan by market (market cap above US$10bn)

Ticker	Short name	Country	Sector
2382 HK	Sunny Optical	China	Technology
002415 CH	Hikvision	China A-Share	Technology
1093 HK	CSPC Pharma	China	Healthcare
2318 HK	Ping An	China	Insurance
600276 CH	Hengrui Medicine	China A-Share	Healthcare
1299 HK	AIA	Hong Kong	Insurance
5 HK	HSBC	Hong Kong	Financial services
1997 HK	Wharf REIC	Hong Kong	Property
2 HK	CLP	Hong Kong	Power
388 HK	HK Exchanges	Hong Kong	Financial services
INFO IB	Infosys	India	Technology
TCS IB	Tata Consultancy	India	Technology
WPRO IB	Wipro	India	Technology
TTAN IB	Titan	India	Consumer
MM IB	Mahindra	India	Autos
ASII IJ	Astra	Indonesia	Conglomerates
BBCA IJ	Bank Central Asia	Indonesia	Financial services
BMRI IJ	Bank Mandiri	Indonesia	Financial services
BBRI IJ	Bank Rakyat	Indonesia	Financial services
BBNI IJ	Bank Negara	Indonesia	Financial services
003550 KS	LG	Korea	Conglomerates
055550 KS	Shinhan	Korea	Financial services
035420 KS	Naver	Korea	Internet
034730 KS	SK Holdings	Korea	Conglomerates
010950 KS	S-Oil	Korea	Petro/Chems
PBK MK	Public Bank	Malaysia	Financial services
MAY MK	Maybank	Malaysia	Financial services
MAXIS MK	Maxis	Malaysia	Telecoms
CIMB MK	CIMB	Malaysia	Financial services
TNB MK	Tenaga	Malaysia	Power
AC PM	Ayala Corp	Philippines	Conglomerates
BDO PM	BDO Unibank	Philippines	Financial services
ALI PM	Ayala Land	Philippines	Property
SM PM	SM Investments	Philippines	Conglomerates
SMPH PM	SM Prime	Philippines	Property
UOB SP	UOB	Singapore	Financial services
ST SP	Singtel	Singapore	Telecoms
DBS SP	DBS	Singapore	Financial services
OCBC SP	OCBC	Singapore	Financial services
CAPL SP	CapitaLand	Singapore	Property
2330 TT	TSMC	Taiwan	Technology
2912 TT	President Chain Store	Taiwan	Consumer
2454 TT	MediaTek	Taiwan	Technology
3045 TT	Taiwan Mobile	Taiwan	Telecoms
3008 TT	Largan	Taiwan	Technology
SCC TB	Siam Cement	Thailand	Materials
PTTGC TB	PTTGC	Thailand	Petro/Chems
BBL TB	Bangkok Bank	Thailand	Financial services
ADVANC TB	AIS	Thailand	Telecoms
PTTEP TB	PTT E&P	Thailand	Petro/Chems

Source: CLSA

Figure 43

Top-5 companies in Asia ex-Japan by market (market cap below US$10bn)

Ticker	Short name	Country	Sector
2018 HK	AAC	China	Technology
839 HK	China Education	China	Consumer
6169 HK	YuHua Edu	China	Consumer
600779 CH	Swellfun	China A-Share	Consumer
1478 HK	Q Technology	China	Technology
522 HK	ASM Pacific	Hong Kong	Technology
6160 HK	BeiGene	Hong Kong	Healthcare
973 HK	L'Occitane	Hong Kong	Consumer
178 HK	Sa Sa	Hong Kong	Consumer
14 HK	Hysan Dev	Hong Kong	Property
MRCO IB	Marico	India	Consumer
EIM IS	Eicher Motors	India	Autos
KNPL IN	Kansai Nerolac	India	Consumer
PSYS IN	Persistent Systems	India	Technology
DABUR IS	Dabur	India	Consumer
TOWR IJ	Sarana Menara	Indonesia	Telecoms
TBIG IJ	Tower Bersama	Indonesia	Telecoms
EXCL IJ	XL Axiata	Indonesia	Telecoms
KLBF IJ	Kalbe Farma	Indonesia	Consumer
JSMR IJ	Jasa Marga	Indonesia	Infrastructure
018880 KS	Hanon Systems	Korea	Autos
035720 KS	Kakao	Korea	Internet
098460 KQ	Koh Young Tech	Korea	Technology
120110 KS	Kolon Industries	Korea	Materials
028050 KS	Samsung Eng	Korea	Capital goods
WPRTS MK	Westports	Malaysia	Transport
INRI MK	Inari	Malaysia	Technology
ROTH MK	BAT Malaysia	Malaysia	Consumer
SCGB MK	SunCon	Malaysia	Infrastructure
IHH MK	IHH	Malaysia	Healthcare
GLO PM	Globe Telecom	Philippines	Telecoms
BPI PM	BPI	Philippines	Financial services
SECB PM	Security Bank	Philippines	Financial services
TEL PM	PLDT	Philippines	Telecoms
JFC PM	Jollibee	Philippines	Consumer
SGX SP	Singapore Exchange	Singapore	Financial services
MUST SP	Manulife Reit	Singapore	Property
CIT SP	City Developments	Singapore	Property
FCT SP	FCT	Singapore	Property
CD SP	ComfortDelGro	Singapore	Transport
2409 TT	AUO	Taiwan	Technology
4938 TT	Pegatron	Taiwan	Technology
2382 TT	Quanta	Taiwan	Technology
2357 TT	Asustek	Taiwan	Technology
2449 TT	King Yuan	Taiwan	Technology
TOP TB	Thai Oil	Thailand	Petro/Chems
EGCO TB	Egco	Thailand	Power
HMPRO TB	HomePro	Thailand	Consumer
AP TB	AP Thailand	Thailand	Property
IRPC TB	IRPC	Thailand	Petro/Chems

Source: CLSA

Charles Yonts
Head of Sustainable Research
charles.yonts@clsa.com
+852 2600 8539

Guest author
Melvin Glapion
Mithra Forensic

Beyond the spin: Nonfinancial CG cues and clues

There is a wise saying warning that past financial results are no guarantee of future returns. As true as that statement is, I would argue for a caveat regarding financial statement fraud. In every jurisdiction, across all time periods in both rising and declining markets, such activity is omnipresent and its discovery leads to significant value destruction. History provides a useful and reliable guide to the continued impact financial statement fraud will have on the future of financial markets.

As a direct result, a great deal of analytic energy is spent on trying to identify and avoid, or in some cases, profit from it. Typically, accounting metrics and ratios used to identify fraud have concentrated on financial statement metrics. The approach is a sound one: as companies engage in fraud, their numbers tend to show anomalies against prior periods as well as comparable firms. Spotting those anomalies early can serve as critical early warning signs to investors. The success of these metrics in rooting out fraud and manipulation has led to greater understanding of their benefits and a broader acceptance of their use.

But fraudsters study forensic accounting metrics too. They are aware, or should be aware, of critical red flags in their published accounts. As fraudsters become more skilled at spotting these red flags, they become savvier in concealing or confusing these metrics. Investors are left wanting for other methods to identify red flags.

They do not spend as much time on nonfinancial indicators

A promising area worth exploring is nonfinancial metrics. These are data points that are not presented in financial statements, but can be used as a sense check on financial numbers. Fraudsters tend to spend most of their time and energy on the accounts, which leaves open the possibility that nonfinancial metrics could serve as primary red flag or potentially confirmatory fraud indicators.

This is where we see signs of fraudsters trying to misdirect those most likely to find them out

Because nonfinancial metrics are not necessarily found all in one section, like financial accounts, it is difficult to assess which ones should be tracked and monitored, given the host of numbers to be found in disclosure notes, investor presentations, proxy materials, etc. I recommend you focus on metrics that relate to those entities and individuals that are tasked with combatting fraud. If a CEO and CFO have initiated a fraud, their major focus is twofold: (1) managing the financials to conceal the fraud; and (2) deterring and deceiving those who are most likely to identify the fraud. Financial statement ratio analysis is intended to weed out evidence of the first category. Nonfinancial metrics can identify evidence of the second.

Focus on these groups

Many nonfinancial metrics relate to the groups or entities that have a role in combatting fraud. Hence, I discuss red flag indicators in relation to each of these groups:

Senior executives

- Senior executives: studies have shown that senior executives in the form of chairman, CEO and CFO are the most likely perpetrators of financial statement fraud. Nonfinancial metrics to assess this group's likelihood of engaging in fraud include assessments of value of in-the-money stock options, insider holdings and history of working together. The typical profile of a fraudster is a male between the ages of 36 and 55, who colludes with others in an attempt to improve his personal wealth.

Board of directors

- Board of directors: while board members may be complicit in fraud, it is more often the case that the board's function has been subverted or compromised. Key nonfinancial metrics to assess are the level of interlocking directorates, the qualifications and tenure of board members and the overall busyness of board members.

External auditors

- External auditors: regulators have recently begun aggressively sanctioning auditors for lack of independence or failure to exercise a greater degree of professional scepticism. This is all for good reason; most large frauds, in both emerging and developed markets, happen on the watch of the big four audit firms. Some metrics to assess the audit firm's potential conflicts of interest or lack of independence include ratios of audit fees to company assets, the number of auditor firm employees who have assumed roles at a client and a divergence between audit opinions and internal control opinions.

Internal auditors

- Internal auditors: despite often having the necessary skills and traits to effectively monitor and contain financial statement fraud, internal auditors tend to be more reactive than proactive in their role. This is primarily because senior managers, who are often the perpetrators of fraud, limit and define the budgets, scopes and authority of these teams. Key metrics to monitor the internal audit team's effectiveness would be growth in resources in line with growth in assets or business complexity and the level of internal audit authority within the organisation.

Whistleblowers

- Whistleblowers: as frauds increase in complexity, the likelihood that more people will be forced to get involved or forced to engage in greater manipulation increases the chances that a whistleblower will come forward. It is difficult to know when a whistleblower has emerged, but companies retaliating against whistleblowers or fighting off regulators will begin to report higher contingent liabilities and higher legal fees, especially in comparison to peers. These companies will also experience a higher level of negative feedback in employee forums and may possibly get involved in more complex employment litigation.

Regulators

- Regulators: co-opting or conflicting a regulator takes time and concerted effort, but some companies engaged in fraud take advantage of existing relationships, develop closer ties with regulators by hiring former regulators or even lobbying regulators to support and defend them, citing the potential threat to local financial markets. Metrics that show evidence of this include the number of senior executives with former experience at a regulator, a historical overlap between executives and key decision makers at a regulatory agency or a history of aggressive lobbying for weaker regulatory oversight.

Short-sellers

- Short-sellers: typically, firms can only attempt to influence or deter shorts after a short-seller has called the company out as a fraud. Fraud and nonfraud firms engage in aggressive rebuttal campaigns, but fraud firms tend to lead with ad hominem attacks on the short-seller. They rarely provide robust and detailed point-by-point counterarguments raised by shorts. Ways to identify firms trying to deflect a valid short-seller report are to monitor the content and the tone of the response. Also, monitor whether subsequent to the short-seller report if the firm conducts an internal investigation, and if it does, what is the scope, budget and timeframe provided to assess whether it is sufficient to fully investigate the points raised by the short-seller.

Other metrics

- Other metrics: outside of the metrics used to assess the effectiveness of the key groups tasked with combatting fraud, it is helpful to monitor several other key metrics. These include charts and diagrams that seem too good to be true, statements from executives that align with the linguistic habits of fraudsters and statistics on readability of financial disclosure.

Seeking Alpha through ESG

Does ESG 'work?'

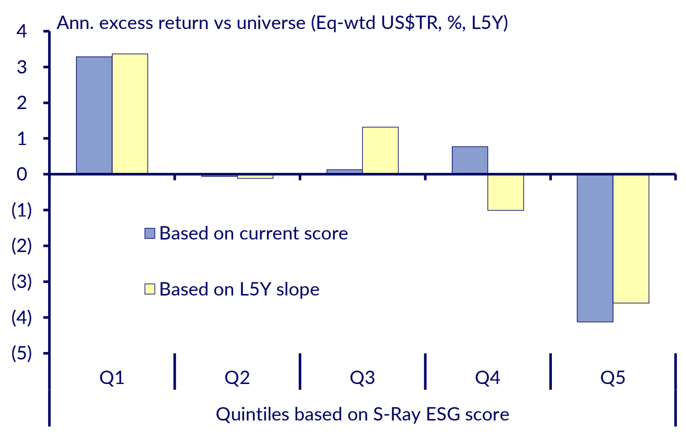
Does ESG 'work' from an investment perspective? We would argue that it 'works' insofar as ESG incorporation better enables our analysts to uncover long-term trends before they emerge in a company's financial statements. For reasons explained above - most notably data quality - we are wary of relying too heavily on a simple ESG score. However, with all of the caveats, there is now a formidable body of evidence indicating that ESG scores - used properly - can provide useful screens and add value to the investment process. CLSA's Microstrategy team has added to that body both with CLSA's scores as well as with data from Arabesque S-Ray.

Mahesh Kedia
Senior Analyst – Microstrategy
mahesh.kedia@clsa.com
+852 2600 8291

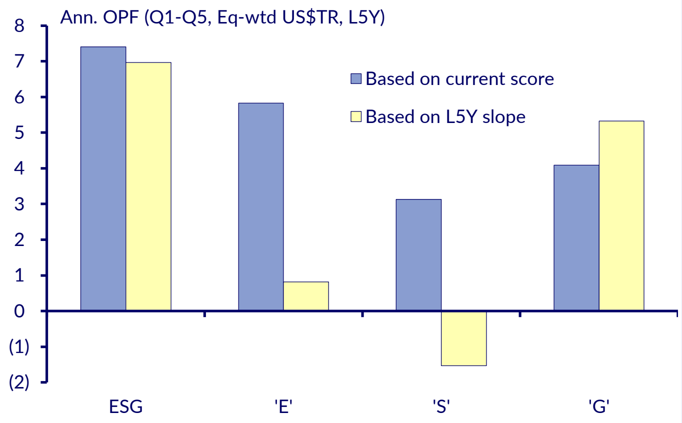
Scores matter

Zadeh et al (2018) highlight, in a recent article in Financials Analysts Journal (Q318), that over 80% of investors found ESG information useful, and over 60% found it pertinent to investment performance in their survey. To better understand the performance impact, we tracked the past five year performance of the Asia Pacific stock coverage of the Arabesque S-Ray database, segregated based on the ESG scores. We found that companies with the top quintile (Q1) S-Ray composite ESG scores and those with the most improved scores outperformed the worst quintile (Q5) by over 7% per annum over the past five years. The outperformance based on current scores was the highest for the Environment category while that for the improvement in scores was the highest for the governance category.

Asia Pac: Annualised L5Y excess return based on S-Ray ESG score



Asia Pac: Annualised OPF based on individual S-Ray scores

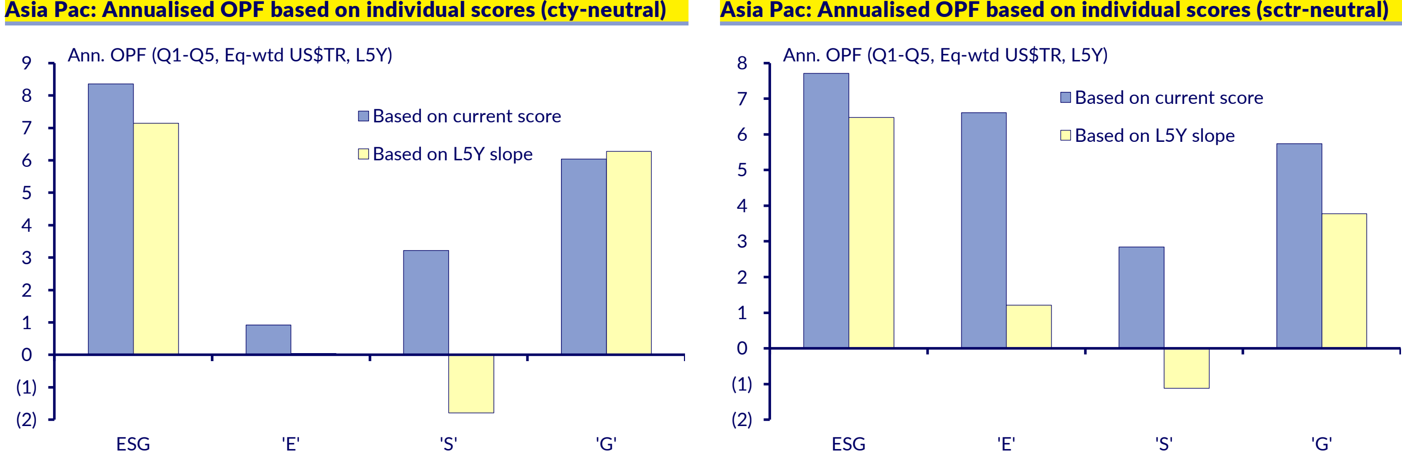


Note: Universe is broader Asia Pacific companies. Current S-Ray scores and at least last three years quarterly historical S-Ray scores and US-dollar total return have to be available. Q1 = highest; Q5 = lowest. Higher score the better. Source: Factset, Arabesque S-Ray, CLSA

Scores matters even after adjusting for market and sector differences

Even on a market and sector neutral basis, results were quite consistent.

Asia Pac: Annualised OPF based on individual scores (cty-neutral) | **Asia Pac: Annualised OPF based on individual scores (sctr-neutral)**



Note: Universe is broader Asia Pacific companies. Current S-Ray scores and at least last three years quarterly historical S-Ray scores and US-dollar total return have to be available. Q1 = highest; Q5 = lowest. Sector neutral is calculated based on GICS Level 1 classification. Source: Factset, Arabesque S-Ray, CLSA

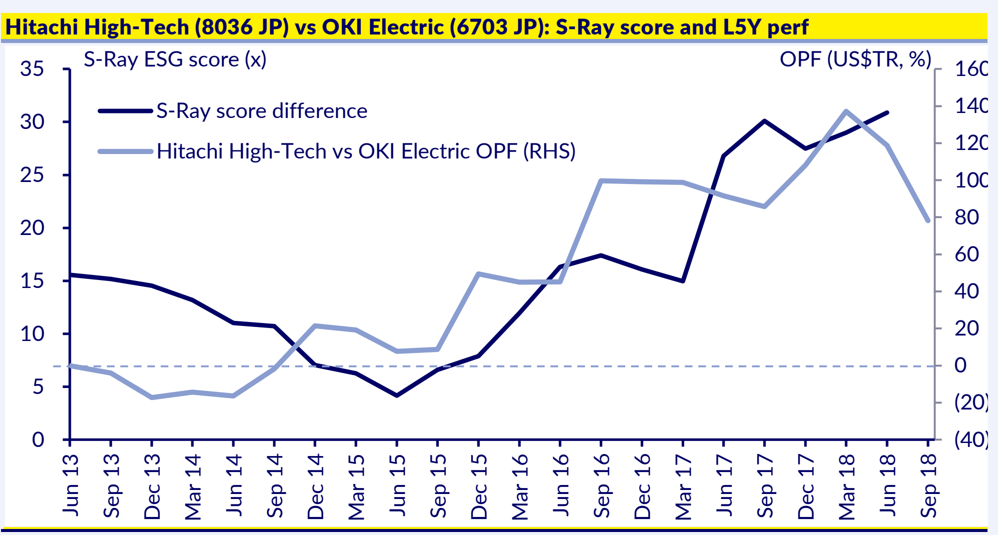
ESG effect visible even within same sub-industry pairs

Case study: Japanese tech companies

While the overall backtest already show the importance of ESG scores, sometimes the performance differential could be due to industry dynamics. Hence, to better understand the impact from ESG without the noise from country and industry differences, we picked stock pairs that belonged to the same country and sub-industry but with differing S-Ray ESG scores. Below we highlight one of the examples of how the growing differences in the ESG score between Hitachi High-Tech (HHT) and OKI Electric (OKIE) coincided with similar differential in returns over the past five years. Initially, the ESG score for HHT was falling relative to OKIE, and during that time, HHT was underperforming OKI. However, as the S-Ray ESG score difference started to rise from around five points to over 30 points, HHT was outperforming OKIE by over 100%. These findings further highlight that ESG data does correlate well with performance even after neutralising the market and sector differences.

ESG differences correlated well with relative price returns for Hitachi High-Tech and OKI Electric

Hitachi High-Tech (8036 JP) vs OKI Electric (6703 JP): S-Ray score and L5Y perf



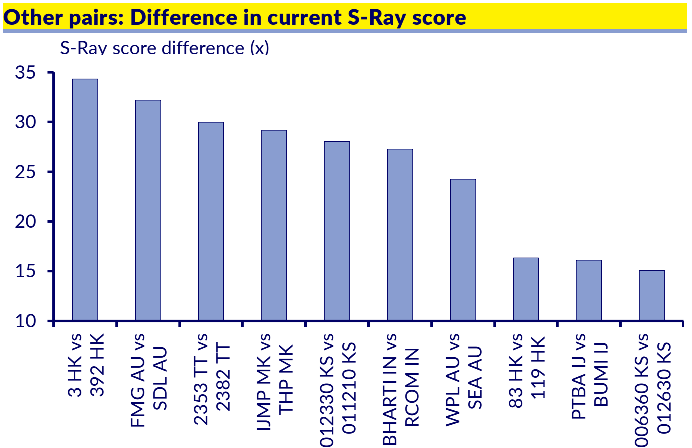
Source: Factset, Arabesque S-Ray, CLSA

Few other pairs show similar trends

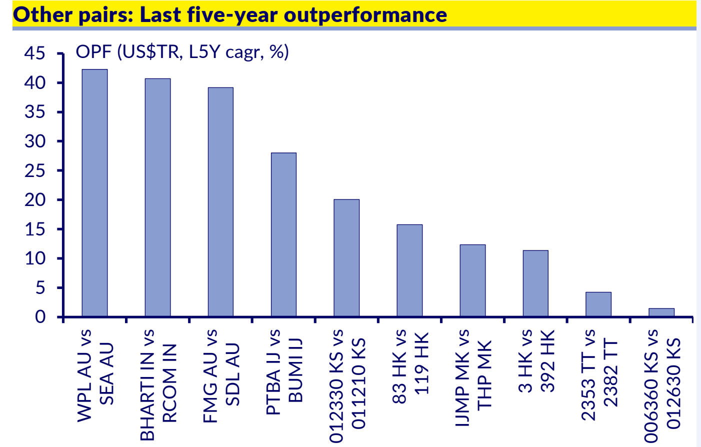
ESG importance noticed in a number of stock pairs

Below we highlight the result from an expanded study of same market and sub-industry pairs with ESG differences and their relative price returns.

Other pairs: Difference in current S-Ray score



Other pairs: Last five-year outperformance



Source: Factset, Arabesque S-Ray, CLSA

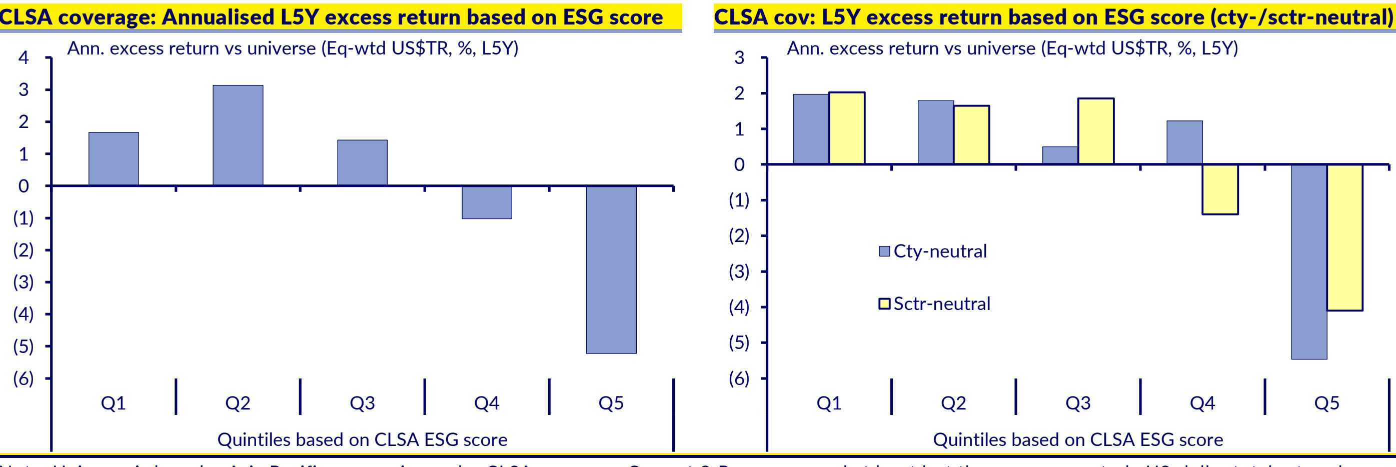
Bottom quintile of stocks based on CLSA ESG scores underperformed by 5% pa during the last five years

CLSA ESG scores highlight similarly strong performance differential

A further analysis of performance differential based on CLSA ESG scores yield similarly encouraging results. More specifically, the data shows that stocks currently in the bottom quintile of CLSA ESG scores have underperformed by 5% per annum over the past five years. The return profile doesn't change much even if we neutralise the results for market and sector differences. These results are even more encouraging given that CLSA covers close to 1,000 stocks in the Asia Pacific region and has a good mix of large and small/midcap stocks.

CLSA coverage: Annualised L5Y excess return based on ESG score

CLSA cov: L5Y excess return based on ESG score (cty-/sctr-neutral)



Note: Universe is broader Asia Pacific companies under CLSA coverage. Current S-Ray scores and at least last three years quarterly US-dollar total return have to be available. Q1 = highest; Q5 = lowest. Higher score the better. Sector neutral is calculated based on GICS Level 1 classification. Source: Factset, CLSA

There has been a recent uptick in short-seller attacks

Fraud: The pointy edge of governance

There is room to debate the exact definition of good governance, and what it means for corporate and share price performance. Debates about the merits of massive fraud are more one-sided. CLSA's Microstrategy team has developed a number of screens looking at both financial and CG cues to uncover fraud. The efforts seem particularly pertinent after a recent uptick in the number of high profile short-seller attacks. We've reviewed the major short-seller attacks of the past two years, and also interviewed two of the prominent short-sellers, to look for commonalities and assess the CG flags that they are using to find targets.

Microstrategy fraud detection tools

In the August 2018 *Future Hall of Fame* report, our Microstrategy team revised its strategy, first introduced in 2017, to identify potential smallcap multibaggers. In addition to the original framework, which blended traditional quant signals with fundamental sources of growth, the team introduced a 10-point management and board quality check. Desh Peramunetilleke wrote:

> 'In the past, we have applied our earnings and balance sheet quality risk scores (EQRS/BQRS) and Benford-B fraud detection tool to the screening process. However, based on the work done in the September 2017 CLSA U Blue book, Beyond the spin, and recent papers and cases, we introduce a 10-point non-financial metric check list to filter out stocks with corporate governance risk.
>
> These non-financial checks include, among others, whether the CEO/President has complete control over the company, how insiders view their own company, domestic investors' confidence in the stock, board structure, existence of significant related-party transactions and so on. Below we provide the full list of metrics, the classifying criteria and why we think they are a useful measure of CG risks.'

Incorporating a 10-point checklist

The 10 points, many of which were included in our company-wide CG scoring revisions, are spelled out in the report. The first round of screens for the Microstrategy team, as well as the short-sellers that we reviewed and interviewed, is almost always based on financial metrics. Those financial screens are then supplanted with CG screens and deep dives into the stocks.

Short-sellers beware

Citron's hit has not stopped short-sellers in Hong Kong

In 2016, Hong Kong's SFC accused well-known short-seller Andrew Left, founder of Citron Research, of spreading false and misleading information about Evergrande. He was found guilty and banned from trading in Hong Kong for five years. The ruling did not, as some had feared (or hoped), lead to an exodus of short-sellers from Hong Kong. Over the past two years, there has been a resurgence in high-profile short-seller attacks against Chinese companies. Some have not worked, as was the case with Evergrande, but more have triggered meaningful share price declines.

We don't endorse all of the activist short-seller arguments, but we see value in understanding their processes

We have studied short-seller reports issued against thirteen companies since Jan-17 to draw out commonalities, and assess where the approach could feed into our work on CG. We have also spoken to both Carson Block of Muddy Waters and Melvin Glapion of Mithra Research to better understand their thought process. **We in no way intend to endorse all of the short-sellers' accusations**, and have included comments from the covering analysts at CLSA where relevant. However, we still see great value in breaking down the processes and indicators that they are using. At the very least, it can help us to prep for future attacks.

Figure 44

Summary: The stocks and short sellers

Stock	Ticker	Short Seller	Stock	Ticker	Short Seller
Chong Sing Holdings	8207 HK	Anonymous Analytics	J.D.com	JD US	Mithra Forensic
Samsonite	1910 HK	Blue Orca	Vipshop	VIPS US	Mithra Forensic
TFS / Quintis Now Quintis Ltd	QIN AU	Glaucus	Huishan Dairy	6863 HK	Muddy Waters
Blue Sky Alternative Investments	BLA AU	Glaucus	China Internet Nationwide Fin Services (CINFS)	CIFS US	Muddy Waters
Fullshare	607 HK	Glaucus	TAL Education	TAL US	Muddy Waters
AAC	2018 HK	Gotham City Research	Man Wah Holdings	1999 HK	Muddy Waters
ANTA	2020 HK	GMT			

Source: CLSA

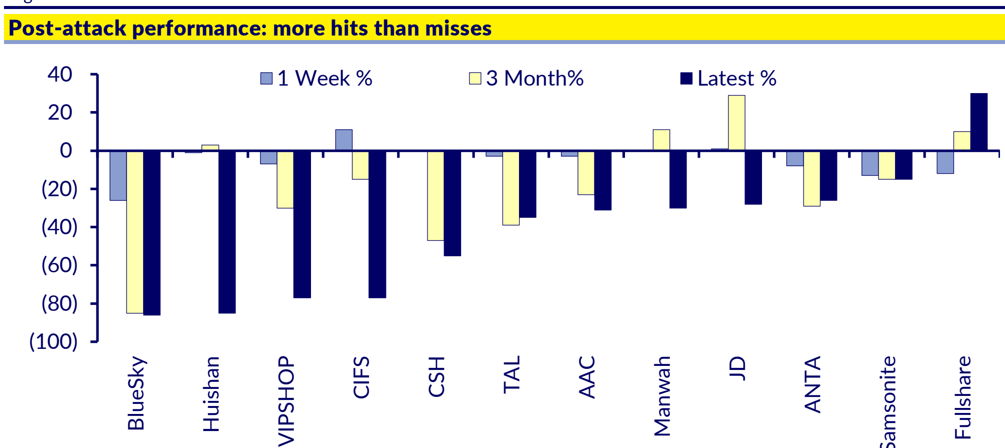
More hits than misses

There have been more hits than misses, with the majority of stocks falling on a one-month and three-month basis. Of those that hadn't yet dropped after three months: Huishan Dairy subsequently collapsed and was suspended (18 months and running); and JD.com has been hit by unrelated issues.

The majority of stocks falling on a 1-month and 3-month basis

Figure 45

Post-attack performance: more hits than misses



Note: Latest share price as of 26 September 2018. Source: Bloomberg, CLSA

Common themes and VIE structures

Nine instances of common accusations across reports

Common accusations across these reports include: inflated earnings/missing items in financial statements; dubious accounting policies and issues related to relate party transactions, either in the form of non-disclosure or questionable related party transactions, which in turn also points towards conflict of interest issues.

We found nine instances that point towards financial misreporting, seven instances with questionable related party transactions, five instances which give rise to conflict of interest and four instances related to dubious accounting policies. Other key issues included: a) management shifting away from core business; b) poor capital allocation and issuance; c) auditor independence; d) insider trading; e) tax evasion; and f) unfair remuneration.

Figure 46

Key allegations in short-seller reports

Allegations	Related CLSA CG question (No.)	China Internet Nationwide Financial Services	Man Wah	Samsonite	Blue Sky	Fullshare Holdings	TFS/ Quintis	JD	AAC	Chongsing Holdings Fintech	VIPS	ANTA	TAL	Huishan Dairy	Total
Misleading financials; financial mis-reporting	8	✓	✓	✓	✓		✓				✓	✓	✓	✓	9
Issues around related party transactions	19			✓		✓	✓		✓				✓	✓	6
Conflict of interest	21	✓		✓		✓	✓			✓				✓	6
Dubious accounting policies	9	✓		✓				✓					✓		4
Misallocation of capital	2										✓	✓			2
Issues with VIE structure	3	✓						✓						✓	3
Straying from core business	1									✓					1
Independence of auditor called into question	14									✓					1
Possibility of insider trading	23						✓								1

Source: Muddy Waters Research, CLSA, Glaucus Research, Mithra Forensic, Gotham City Research and Anonymous Analytics

Chinese government restricts or prohibits foreign investment in many domestic industries

A quick aside on Variable Interest Entity (VIE) structure: The Chinese government restricts or prohibits foreign investment in many domestic industries. In a VIE structure, a local Chinese entrepreneur has full operating ownership in a mainland company which also has contracts with a wholly-foreign owned enterprise, usually setup in Hong Kong for certain tax benefits, through which

foreign equity can flow into the mainland company without foreign investors having any operating ownership in the mainland company, however, the equity in concern is pledged into the contracts.

Two of the reports that we looked at feature a VIE structure: China Nationwide Financial Services and TAL Education Group. There is nothing wrong with using a VIE structure, per se. In fact, it is the only way for most of these companies to list. However, given that it makes it inherently more difficult for minority shareholders to seek redress when things go badly awry, VIE structures typically pop up on screens for short-sellers.

In the mind of a short-seller

Interview with Carson Block of Muddy Waters and Melvin Glapion of Mithra Forensic

To better understand activist short-sellers' process and outlooks for Asia, we conducted interviews with two of them: Carson Block, founder of Muddy Waters; and Melvin Glapion of Mithra Forensic. What follows is a summary of these discussions, which is edited into a single narrative to focus on the most important points.

Charles Yonts (CY): How do you select the stocks that you want to focus on? What sort of screens do you use and what next steps do you take?

One of the world's best known activist short-sellers, Carson Block is the founder of Muddy Waters Research

Carson Block (CB): Essentially we look for what's too good to be true. This is a very **qualitative process** for us, though. We don't rely much on screens. The problem we find with screens is that they don't include context of what's actually going on in the business. What appears to be an anomalous ratio or set of ratios really might not be that problematic. And the converse can be true.

We focus a lot, at the outset especially, on management and company statements. We read a lot of transcripts - often four to five years of every transcript read sequentially from oldest to newest, looking for patterns, promotional statements, things that have been announced with tremendous fanfare but then disappear and are never mentioned again. We also look to see where management evades questions. In contrast, a company where management is really low key and doesn't seem to be embellishing . . . that's generally not a company where we're going to find problems we focus on.

A veteran of KPMG and Kroll, Melvin Glapion is the founder Mithra Forensic, and a CLSA U author

Melvin Glapion (MG): First, I run a series of financial screens before dipping in to CG metrics. The things that are getting people on my radar screen are primarily around cashflow. It's companies that are reporting fantastic income results. They had these really great stories, but they're not generating cash. So it's the Tesla story writ large, but it's just all over the world.

[Melvin's preferred forensic accounting metrics are detailed in our September 2018 CLSA U *Beyond the spin* report where his CG metrics are detailed on page 19, 24 and 31.]

CY: Are you looking at any particular sectors or geographies right now?

Focusing on pharmaceutical, biotech, technology companies and consumer goods

MG: The industries that have been dominating my list for the past year are **pharmaceutical**, **biotech**, **technology** companies and **consumer goods**. We're in a cycle where everybody's looking for the next great thing because they know that perhaps the markets will take a turn for the worse. So they're buying the sort of story that the pharmaceutical or tech company is telling about a great product or something that's going to revolutionise this or disrupt that industry.

These are the companies getting all of the access to capital. They're making great promises, but their financials are already showing strain, meaning they're already tweaking their financial statements to get a little bit more net income and hide the fact that they should be writing off. For a lot of these companies, intangible assets are ballooning out of proportion.

And so these are companies that are basically not delivering bad news even though there's bad news in the companies already. The technologies that they're promising or have been promising are not working as predicted, but they're not taking the write offs. They're pushing the bad news further and further down the line. They cannot push forever. Additionally, I think it's global and the USA will become as interesting as Asia has been over the past couple of years.

CY: The USA has systems in place to protect investors, though.

The structures that have helped the USA combat fraud are falling by the wayside

MG: People always say 'the US is an advanced market, and you've got the DOJ and the SEC and investors are very savvy.' But I think what you'll find in the next couple of years is that a lot of the structures that have helped the US combat fraud and aggressive accounting are falling by the wayside or being dismantled.

On that point, the SEC has just proposed a rule that would effectively reduce the amount of money or the percentage of money that they paid to whistleblowers. This programme has actually allowed people to come forward and to report to the SEC and then get a percentage of whatever the FCC or the DOJ collects. The Trump Administration now wants to add some discretion into the rules so that the amount that's going to the whistleblower, the SEC commissioners can change it. No other programme like this in the USA has such a discretionary option. I think what that really is going to suggest is over the next several years, what you find is fewer and fewer whistleblowers will come forward, and the regulators will have a harder and harder time getting to the point where we say, "aha, it's an official fraud."

CB: One of the things that seems to be a global trend is that freedom of speech is under attack. At the same time, we've seen investigative journalism shrink by the day, both the pool of investigative journalists and budgets being devoted to this, especially in finance. So I think we're in an environment where it's easier to get away with poor corporate governance practices. There are just fewer people to call them out. This is also true in the US. And again where free speech is under threat in a way that I couldn't have imagined even two years ago.

Activist short selling is really the purest form of ESG investing

If you're looking to create an environment that promotes good corporate governance, activist short selling is really the purest form of ESG investing. I think a lot of ESG investing is really checklist driven, and often is just a fig leaf for bad behavior. Activist short selling, or real hard hitting investigative financial journalism, can rip the fig leaves off. If this type of criticism can thrive in a market, it disincentives would-be perpetrators of the problems. However, with free speech under attack, it makes it harder for us to do our work.

CY: The external auditors are also meant to protect investors, but the Big 4 have been coming under a lot of fire lately. One, do you think auditors are fulfilling their duty; and two, do you see the situation changing?

99.9% of investors don't understand what auditors actually do

CB: 99%, 99.9% of investors don't understand what auditors actually do and what they don't do. Auditors are not there to detect fraud carried out by top management. The professional standards of audit presume that management is telling the truth and the documents given the auditors are genuine. Generally speaking then, if a company turns out to be a fraud the auditor is exculpated from liability because management lied to them or they were presented with fraudulent documents. I've long said that in terms of managing fraud risks, investors would arguably be better off without companies being audited. The auditors are there to look at accounting methods, but the institution has been corroded over the years, like so many other institutions in our society.

MG doesn't hold out much hope for meaningful reform

MG: We go through this every five years where, the regulators think, we need to break up the firms or we need to build up that second tier. I don't hold out much hope that that's going to happen. Particularly in China, you have some other firms that compete with the Big 4 and give them a run for their money, but when it comes to the investing public, they know those four names and that's what they expect to see.

The other advantage the Big 4 have is that when Enron collapsed and when Arthur Andersen went down with it, the Big 4 became really smart and they restructured their businesses. So we all think of them as these monolithic institutions and that they're run like other corporations. They're really not. They are affiliations and associations. So, for example, when I worked for KPMG in London, we were part of the same company with KPMG in Germany. But actually KPMG in France, KPMG in Spain and Portugal had nothing to do with us because they were a completely different company. And they were set up that way because, if something happens in one jurisdiction and the whole KPMG entity in that jurisdiction goes down, it doesn't impact KPMG.

CY: What signs do you look for to indicate a strong or weak board?

Most boards are very deferential to the CEO even if the company is not dysfunctional

CB: We don't focus as much on the board. Most boards are very deferential to the CEO even if the company is not dysfunctional.

In terms of management, we're trying to find explanations for why they're saying or doing certain things. Sometimes it's pretty obvious. For example, the CEO sells US$50m worth of stock in the first six months of the year after getting the price to triple on the back of all these promises.

Other times we've gotten impressions that, when a CEO is built up as a business genius and wins all these awards, it can breed a decent amount of insecurity. If they start to hit rough patches, that can cause them to try to push the envelope in terms of accounting or even cross into fraud, digging a hole because they're afraid to shatter their image and have people thinking they are fallible.

Sometimes we get a picture. It doesn't look like the guy sold stock, but we really think that this is about ego insecurity or vanity. This is an iterative process and a lot of it's cumulative. It's not that we read one quote or we find the one data point and say, 'aha!' It's a mosaic of information.

When a board rolls over, simply saying that you don't like them is not enough

MG: When you have a board that just basically rolls over in line with the more powerful shareholder, that's usually a bigger problem. The challenge, in Asia and other markets, is that it's just so common. Simply saying that you don't like [the board] is not enough. I try to look for at least those hints of where the board should have shown some teeth and actually did.

Employee message boards are a valuable source of information

I often look at employee message boards or complaint boards. In the USA and Europe - and increasingly in Asia as well - you've got Glassdoor and similar things. What you find is that a lot of the even senior level employees will complain about the problems at the company that can get resolved on those message boards. So I can use them to see issues that the employees are raising. I can also see whether or not they're complaining that they can't get those issues addressed by either more senior level people in the company, or saying that the board is not knowledgeable about this, or senior management is not knowledgeable about this. So it's usually a secondary clue for me when I know a group of people are all-powerful on this board. But I try to look for other evidence where I can see people complaining and things not getting resolved. The sort of super structures are a problem that is not going away.

CY: Could you give any specific examples where you spotted problematic or weak boards?

MG: One would be **Theranos** (one-time unicorn blood-testing company declared a fraud in 2018), which I wrote about extensively in *Beyond the spin*. This was a group of very high-profile individuals (among them: Henry Kissinger and James Mattis), but they were: well past retirement age (average age of 80 in 2017, dragged down by the 25-year-old founder), had almost no expertise in medicine or blood-testing, lived nowhere near the company, and were extremely busy (average of five directorships). Aside from Holmes, they were all men as well.

Theranos an obvious recent example of a biased, disengaged and compliant board

Figure 47

Board composition of Theranos

Board members	12 with an advisory board of an additional 15+ individuals
Female board members	1 (Elizabeth Holmes)
Average age of board	80 (dragged down by 25-year-old Holmes)
Number of independent board members with expertise	1
Theranos location/predominant location of board members	Silicon Valley (West Coast)/Washington DC (East Coast)
Number of board members with formal accounting experience	0
Average number of directorships held	5
Dual role of chairman and CEO	Yes (Elizabeth Holmes)

Source: Author's analysis

Another would be **Vipshop**. The board was, of course, dominated by a couple of individuals that had worked together on other projects before. They all shared a common university. It's a very clubby board, and one that you would not rush to call 'independent.'

CY: There's been a proliferation of high-profile frauds over the past six years in HK/China in particular. Do you feel as if that's had any impact on cleaning up Asian corporate behaviour, or alternatively has fraud become more sophisticated and less easy to spot?

CB: I do expect that the prevalence of fraud is quite high still. The businesses are much more real, which I think makes it harder to detect the fraud. Also, they tend to be online businesses. It makes it harder to prove fraud and they are better at it.

'I was amazed that anybody could be this bad at fraud in China'

Asian fraudsters have learned a lot of lessons about how to better conceal their work, but every now and then we come across one that's just ridiculously sloppy. In December of last year, we came across one of these, a Regulation A+ offering called China nationwide internet financial services (CIFS). I was amazed that anybody could be this bad at fraud in China.

Another short-seller attack on Nasdaq-listed Chinese online finance company

Chinese company, **China Internet Nationwide Financial Services (CIFS US)**, was targeted by prominent short-seller Muddy Waters Capital in December last year. The Nasdaq-listed company is focused on providing one-stop financial services to enterprises based on big data and AI, and have enjoyed strong growth supported by its commercial earnings advisory service. However, Muddy Waters alleged that the borrowers that CIFS had made loans for (c.82.4% of loan balances) appeared to be sham counterparties and it had overstated its 2016 sales by fivefold. *Source: South China Morning Post*

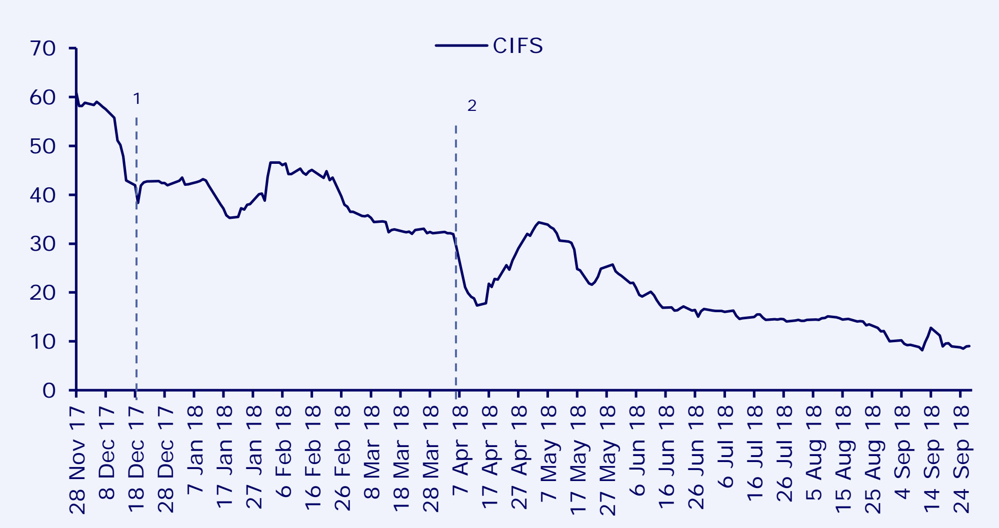
Date and event

	Date	Event
1	20 Dec 17	Short-Seller Report (MW)
2	06 Apr 18	MW hit again on Twitter

Source: CLSA, Bloomberg

CIFS share price reaction

CIFS share price chart



Source: CLSA, Bloomberg

CY: What is a Regulation A+ IPO?

Reverse takeovers (RTOs) have been replaced by the misleadingly named 'regulation A+' IPO

CB: Reverse takeovers (RTOs) have been replaced by the misleadingly named 'regulation A+' IPO. This basically replaced the reverse merger in practice. They're the bottom of the barrel, but some of them were held out to the public as being 'clean' because they were not a reverse merger. It's designed to allow companies that would otherwise have to avail themselves of reverse mergers to appear to be legitimate by pointing out that they went public via an IPO. In my view, the banks that do this are still boiler rooms, like the boiler rooms that did the RTOs.

Regulation A+ (Reg A+) is an alternative to a traditional IPO, which makes it easier for smaller, early stage companies to access capital. Through Reg A+, a company could raise up to US$50m in a 12-month period and have the offering be exempt from SEC and state securities law registrations. (link)

Reverse takeover (RTO) refers to 1) a smaller company taking over a large company, or 2) merger of the acquiring company into the target company (often to gain a public listing). (link) This vehicle was famously used by a number of Chinese frauds to gain access to US markets. More than 50 US-listed Chinese firms were either delisted or faced trading halts in 2011 and 2012, based on claims of fraud and other violations (link).

CY: How has the environment in China evolved since you started eight years ago?

Up until late 2011, our work wasn't an issue for the government

CB: Up until late 2011, our work wasn't an issue for the government. Sino-Forest was a game changer because it shifted conversation internationally about whether China was investible. We could see how sensitive the government had gotten already based on the reaction to our follow-up report on Focus Media. In late 2011 and early 2012, the PRC government, as I understand it, sent Public Security Bureau and Ministry of State Security personnel to meet with every registered investigation firm and due diligence firm in China. I understand that the questioning was pretty aggressive. As a result, things were pretty tight for a while, but then this really crescendo-ed in the middle of 2012, and by early-mid 2013, things had loosened up a little bit.

Today it's not ideal, but the government don't seem determined to prevent short selling

When we wrote our report on Huishan Dairy in December 2016, a couple of friends encouraged me to reach out to mainland media. I laughed it off when they first brought it up, thinking they wouldn't be allowed to write anything positive about short sellers or our research. But that turned out to be wrong; Chinese journalists were able to print things that were neutral or slanted favourably for us. Overall, today it's not an environment in which you can relax, but they don't seem to be determined to prevent short selling right now.

Huishan Dairy

In December 2016, Muddy Waters (MW) accused Huishan Dairy of fraud. After investigating the company's claim of being self-sufficient in producing Alfalfa (a feed for livestock) MW alleged that the Alfalfa was in fact being purchased through third parties, making CHDH's financials fraudulent. MW also claims that the chairman of the company was involved in questionable related party transactions, accusing him of stealing at least Rmb150m. MW also raised concern over the company's excessive leverage that even made the auditor of Huishan stop just shy of issuing a "going concern" warning. MW argued that, due to the excessive debt, the company could not make it through the year without defaulting. The company's trading was halted on 24 March 2017 after an 85% decline in the share price, and it remains halted as we write this.

MuddyWaters Short Seller report link:
http://www.muddywatersresearch.com/content/uploads/2016/12/MW_6863_HK_20161216.pdf

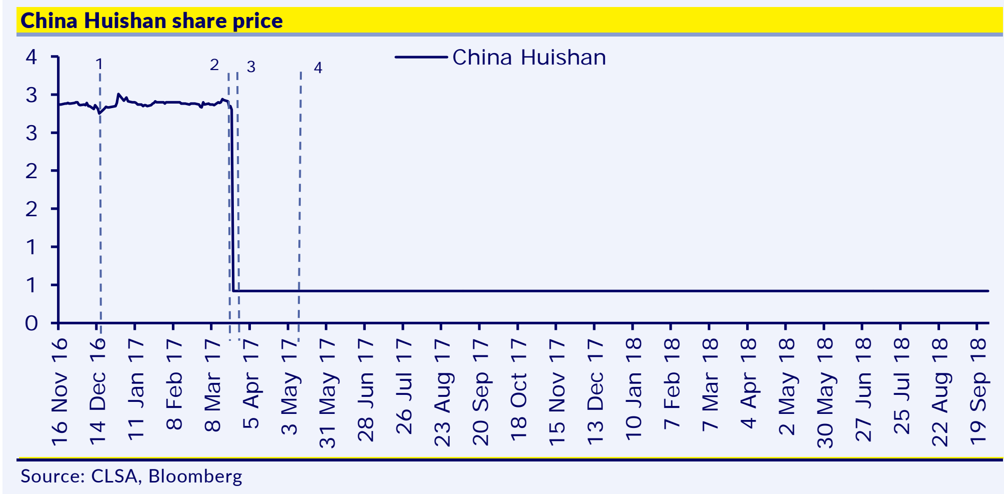
Dates and events

	Date	Event
1	16 Dec 16	Short-Seller Report (MW)
2	23 Mar 17	Representatives of Huishan were called into a meeting with 23 of its major local creditor banks
3	24 Mar 17	Trading halted
4	08 May 17	Hong Kong's SFC extended trading halt

Source: CLSA

China Huishan share-price reaction

China Huishan share price



Source: CLSA, Bloomberg

Disclosures have fallen off, but it is still more transparent than Delaware

Disclosures have also fallen off a bit. What happened is that the SAIC documents have been standardised. They used to provide a treasure trove of documents that would have capital verification reports and asset valuation reports, various permits where you could see the capacities of equipment, et cetera. Those are no longer accessible. But it's still pretty good; a lot more transparent than Cayman, BVI or Delaware.

CY: Can you give me any examples of companies that reacted in a particularly successful or positive fashion when they were targeted by short-sellers?

Companies typically provide a lot of granular information that's totally irrelevant

CB: Typically you see companies deny, or provide a lot of granular information about stuff that's totally irrelevant. But if you're looking for a case study of a company that was really facing a serious threat and was heavily shorted and dealt with it the right way, Glencore would be an example.

The stock was starting to fall below a little bit after Noble began wobbling and there was a real contrast there. Whereas Noble was denouncing the critics and saying 'we don't have any problems,' Glencore was pretty upfront that there were some issues. And then they had senior members of management pony up over US$500m of their own money in a larger equity raise. So rather than sticking their heads in the sand and pretending there wasn't a problem, management addressed its debt head on. Glencore wasn't he subject of a well-known activist campaign, but there had been a decent amount of public criticism.

Short reports with mixed results

Of the short-seller attacks that we looked at, only one - Huishan, led to a long-term suspension. Most stocks are down from attack levels, although in some cases arguably not for the reasons highlighted by the short-sellers. There has been one clear failure: Gotham City's attack on AAC. Blue Orca's attack on Samsonite has also had a negligible effect on the share price, but did lead to the CEO's ouster. Below, we look at the short-seller reports on CLSA-covered stocks, with relevant analyst commentary.

Cherry Ma
Senior Investment Analyst, Technology
cherry.ma@clsa.com
+852 2600 8704

Gotham City Research vs AAC Tech

In May 2017, Gotham City Research published a short seller report on AAC, accusing the company of using undisclosed related parties to evade Apple's labour standards, ultimately overstating and smoothing profits.

One of these third parties was Liantai, which was not a related party; nor did it produce components for Apple. Liantai is the main computer numerical control (CNC) outsourcing partner of AAC for preliminary CNC processing of metal casing; AAC has management teams stationed at Liantai to improve quality and efficiency. We believe the short-seller accusation might be based on erroneous information posted on online job search websites. Gotham City Research also demonstrated a lack of understanding of industry practises. Apple often has teams stationed at its key supplier's production site and conducts regular CSR surveys, therefore routinely monitoring suppliers' labour standards.

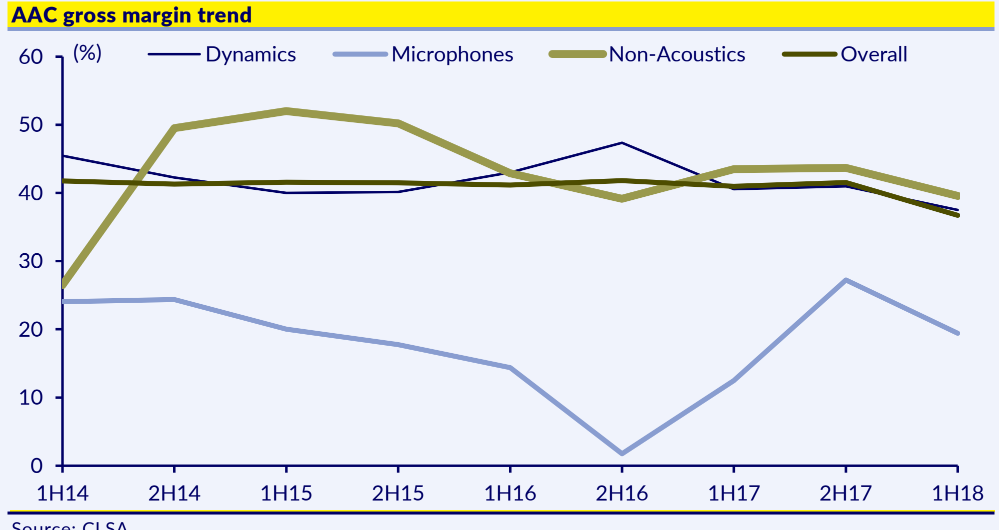
Gotham City also questioned AAC's stable gross margin trend, alleging it was driven by dubious accounting. However, a simple calculation of AAC's reported segment profitability reveals the stable corporate level gross margin was the result of product mix improvement with the introduction of the non-acoustic business. AAC's reported segment margins fluctuate between reporting periods due to factors such as product upgrade cycle, competitive pressure and technology leadership.

AAC suspended trading from 18 May 2017 to 7 June 2017. During the suspension, the company established a special committee of all independent non-executive directors of the company to investigate. The committee appointed Grant Thornton (an accounting firm) to conduct an independent review of Gotham's allegations. Grant Thornton independently selected and reviewed two suppliers and one sales distributor (the focused entities), and found no evidence of related party transactions that were made on non-arm's length terms. Subsequently, on 31 October 2017, AAC acquired Liantai for a consideration of Rmb50,554,000.

In an unusual twist, Anonymous Analytics (another short-seller) issued a 'Buy' rating

In an unusual twist, Anonymous Analytics (another short-seller) issued a 'Buy' rating report the day before AAC issued its clarification report and resumed trading. Incidentally, Anonymous Analytics also issued a 'Buy' rating report on another company after Gotham City attacked them.

AAC gross margin trend



Source: CLSA

Dates and events

	Date	Event
1	10 May 17	Gotham City Research published a short seller report on AAC
2	18 May 17	AAC suspended trading
3	31 Oct 17	AAC acquired Liantai for a consideration of RMB50,554,000

Source: CLSA

AAC share -price reaction

AAC share price

Source: CLSA, Bloomberg

Mariana Kou
Head of China Education & HK Consumer
mariana.kou@clsa.com
+852 2600 8190

Blue Orca versus Samsonite International (1910 HK)

On 24 May 2018, Blue Orca Capital accused Samsonite of inappropriate acquisitions, dubious related-party transactions and accounting policies. As we write this (8 August 2018), Samsonite's share price has seen seesaw movements since the report was published however price has largely remained between the high twenty and low thirty ranges. Samsonite is an American luggage manufacturer listed on the HKEX. At the time the Blue Orca report was published, Samsonite's market cap was approximately US$6.21bn and share price approximately HK$34.05.

CLSA's covering analyst, Mariana Kou, wrote a summary of the attack after it was issued **Samsonite - U-PF (Travel alert).** After the rebuttals, admissions and step-down of the CEO, she upgraded the stock, which had dropped 13% since the accusations. In her note **Samsonite - BUY (Board response),** Mariana walks through the issues, company reactions and argues that the board demonstrated a high level of integrity with its swift action.

Blue Orca report link:
http://offpisteinvesting.com/blue-orca-samsonite-short-report/

Samsonite response link:
http://www4.samsonite.com/_investordocs/20180524150715_E_Samsonite-%20Press%20Release%20-%20Response%20to%20Blue%20Orca%20(Final%202018-05-24).pdf

Climate: One E/S issue to rule them all

CLSA's E/S scoring is broken into 18 sectors

CLSA's analysts across the region score their companies on Environmental and Social (E/S) issues, with these scores feeding into blended ESG scores. Unlike Corporate Governance (CG) questions, which are the same across markets and across sectors, our E/S questions vary to reflect material issues for 18 specific sectors.

A shorter survey

In 2018, we shortened our E/S survey (introduced in 2014) from 20-25 questions per sector (on top of the 24 CG questions) to 9-10 questions, depending on the sector. The question cull, based on the Sustainable Accounting Standards Board (SASB) and conversations with research sector heads at CLSA, is meant to focus analysts on the most relevant questions. We also have a narrower set of three questions per sector that we would expect both analysts and informed IR representatives to be able to answer (Appendix 4).

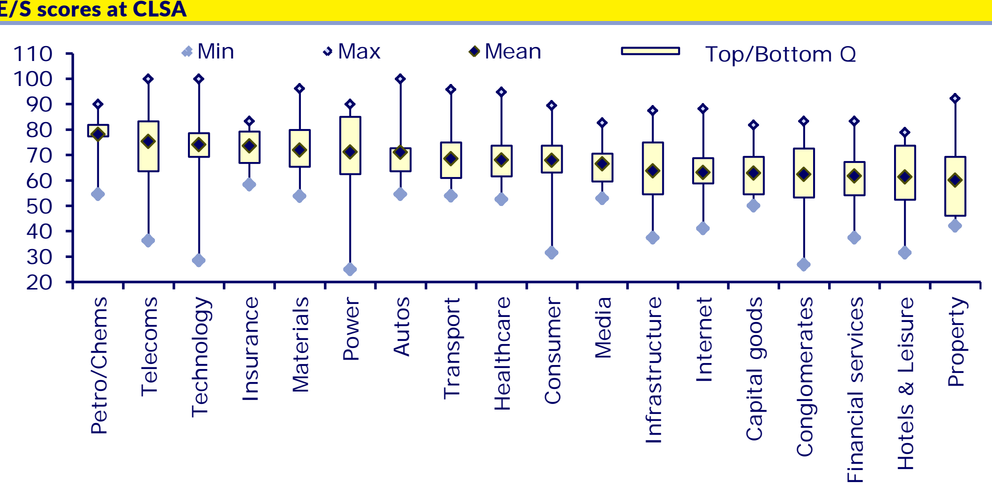
ESG reporting is improving across the region

As we discuss in Section 2, ESG reporting is improving markedly across the region, with most exchanges now requiring at least 'comply or explain' reporting on key metrics. However, standards are still far from consistent, and we continue to derive just 10% of our blended ESG score from the E/S component. This should in no way be taken to represent a lack of consideration for E/S issues, but we still feel as if they are better represented in deep-dive thematic reports rather than being embedded in a single score.

CLSA E/S score by sectors

Figure 48

E/S scores at CLSA



Source: CLSA

Climate change and Beautiful China are the overarching environmental themes

Over the past two years, we have written on scores of environmental and social issues. A few recurring themes stand out. First, of course, is climate change. While it is not a new issue, the focus engendered by Paris has triggered a flurry of initiatives that are starting to bear fruit in Asia. Most noticeably, and directly, have been reporting standards recommended by the Task Force for Climate Change Disclosure (TCFD) and the growing divestment movement. Climate solutions also feature heavily in Xi Jinping's Beautiful China initiative, as well as the country's ambitious Green Finance plans.

Growing appetite for protein and palm oil presents dangers

Climate change has also helped focus attention on Asia's unsustainably growing appetite for meat, which links to deforestation for palm oil. Thankfully, Electric Vehicles (EVs) have crowded biofuels out of the suite of solutions for transport

emissions. But accelerating EV demand has also given rise to fears about growing mountains of toxic battery waste and unethical supply chains featuring children in the Congo. Supply-chain challenges remain, as well, across South and Southeast Asia five years after the tragedy of Rana Plaza. As workers' rights continue to improve in fits and starts across Asia, the region is also home to two-thirds of the world's estimated slaves. There is still a long way to go.

TCFD and divestment come to Asia

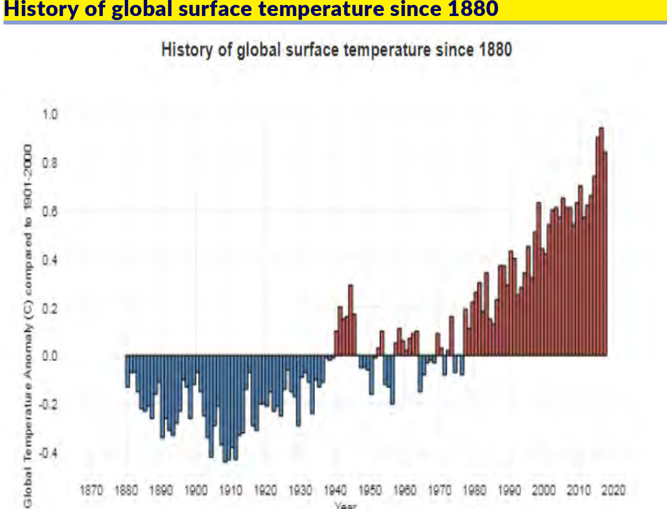
IPCC argues that we have only twelve years to limit climate change disaster

Donald Trump may remain unconvinced about man-made climate change, most recently indicating that he 'does not believe' the findings from his government's newly released National Climate Assessment (link). But he inhabits an increasingly lonely position. The Paris Accord in 2015 catalysed action globally, including in the USA. The extreme weather events of 2018, in particular, underscore the need to adapt to higher temperatures. A new report (October 2018) from the UN Intergovernmental Panel on Climate Change (IPCC) argues that we have only twelve years to limit climate change disaster. There are endless implications across sectors and geographies covered in both the sobering IPCC report (executive summary: http://report.ipcc.ch/sr15/pdf/sr15_spm_final.pdf) as well as a barrage of related, high-quality third-party studies.

At the Asian corporate level, we are seeing accelerated uptake of reporting standards recommended by the Task Force for Climate Change Disclosure (TCFD) and a surging fossil-fuels divestment movement.

Figure 49

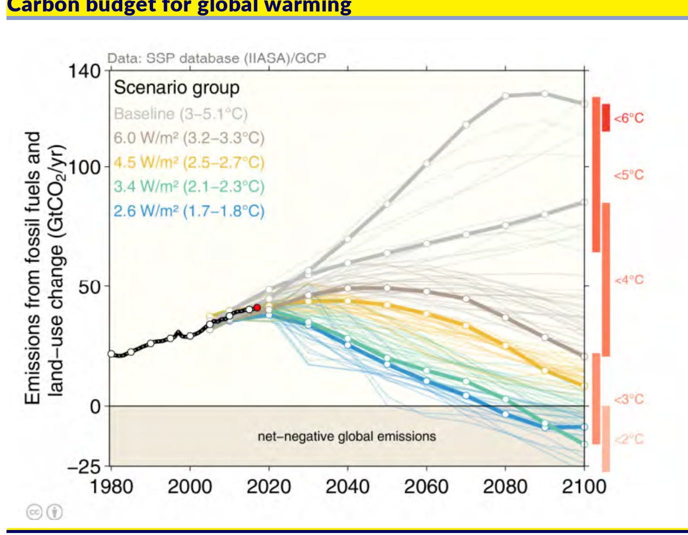
History of global surface temperature since 1880



Source: CLSA, NOAA

Figure 50

Carbon budget for global warming



Source: Riahi et al. 2016; IIASA SSP Database; Global Carbon Budget 2017

TCFD - yes, another acronym

Beginning to see meaningful reports based on TCFD standards in Asia in 2018

While there is increasing awareness about the prevalence, financial impact and macro-level of environmental/climate risks, the ability to quantify anything more meaningful than physical risk events due to severe and unpredictable weather events has been slow to evolve. Over the past two years, however, corporates and investors have coalesced around the reporting standards established by the Task Force on Climate-related Financial Disclosures (TCFD). We began to see meaningful reports based on these standards in Asia in 2018, with momentum clearly growing for more in 2019 and beyond.

TCFD issued disclosure recommendations of climate-related financial risks and opportunities

TCFD 101

In December 2015, The Financial Stability Board (FSB) formed the Task Force on Climate-related Financial Disclosures (TCFD) to address the impact climate change is having on companies and the global financial system. Under the leadership of Mark Carney, Governor of the Bank of England and Michael Bloomberg, former Mayor of New York, the Task Force issued recommendations aimed at helping companies disclose useful information so that financial markets could better understand climate-related financial risks and opportunities.

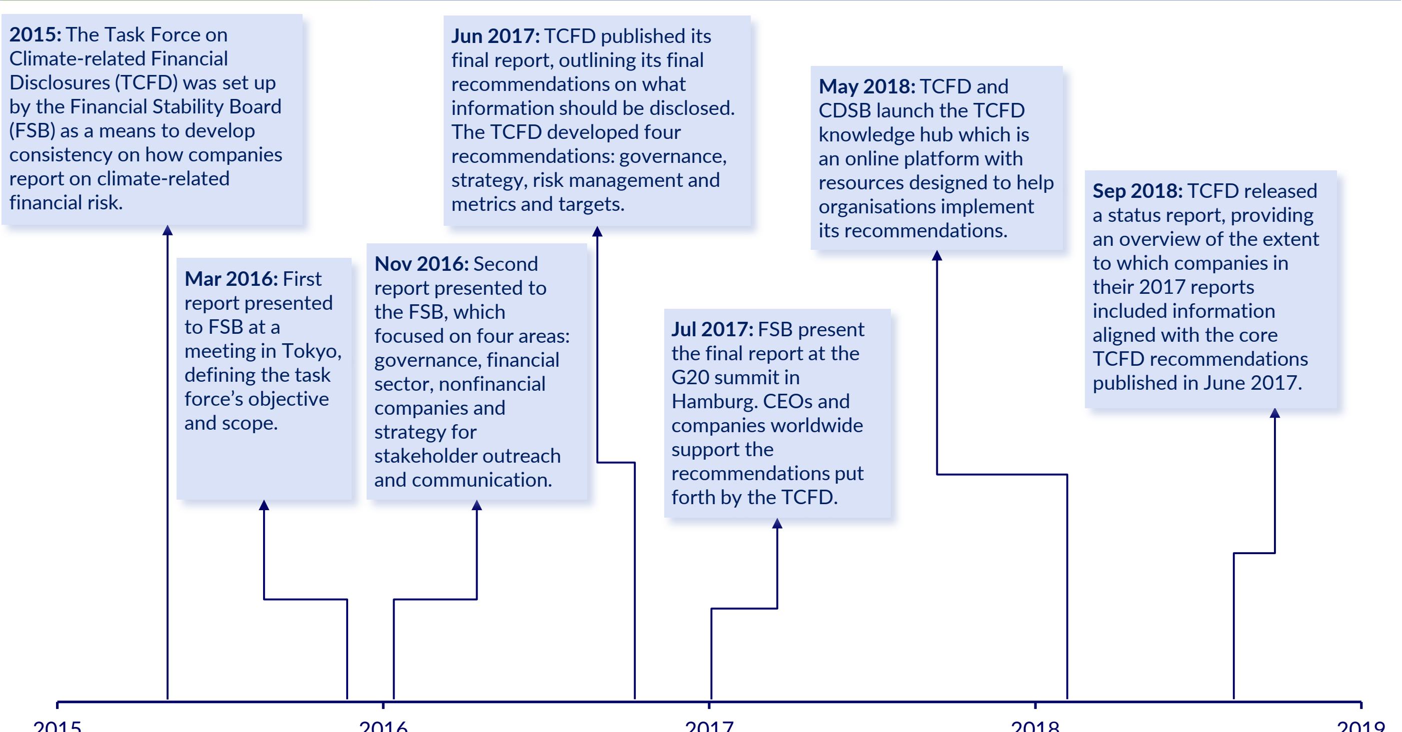
The voluntary recommendations are designed to help companies identify and disclose the potential financial impacts of climate-related risks and opportunities on their businesses, which in turn helps investors, lenders, insurers, and other stakeholders better assess and price risks and opportunities.

TCFD will promote adoption and monitoring implementation throughout 2019

The task force stated that it will continue its work on promoting adoption and monitoring implementation of its recommendations throughout 2019 and will deliver another status report to the FSB in June 2019. Additionally, numerous initiatives led by organizations such as the Principles for Responsible Investment (PRI), the World Business Council for Sustainable Development (WBCSD), the Institute of International Finance (IFF) and others are independently convening industry specific working groups to drive implementation of the TCFD recommendations.

Figure 51

TCFD timeline



Source: CLSA, TCFD

The TCFD provided recommends disclosures that companies in different sectors should follow to allow stakeholders to see how the organisation assesses climate-related risk in four key areas: Governance, strategy, risk management and metrics & targets.

Dylan Kelly
dylan.kelly@clsa.com
+61 2 8571 4263

South32 detailed its approach to climate change based on TCFD recommendations

South32 decided not to develop any new greenfield energy coal basins

South32 and TCFD

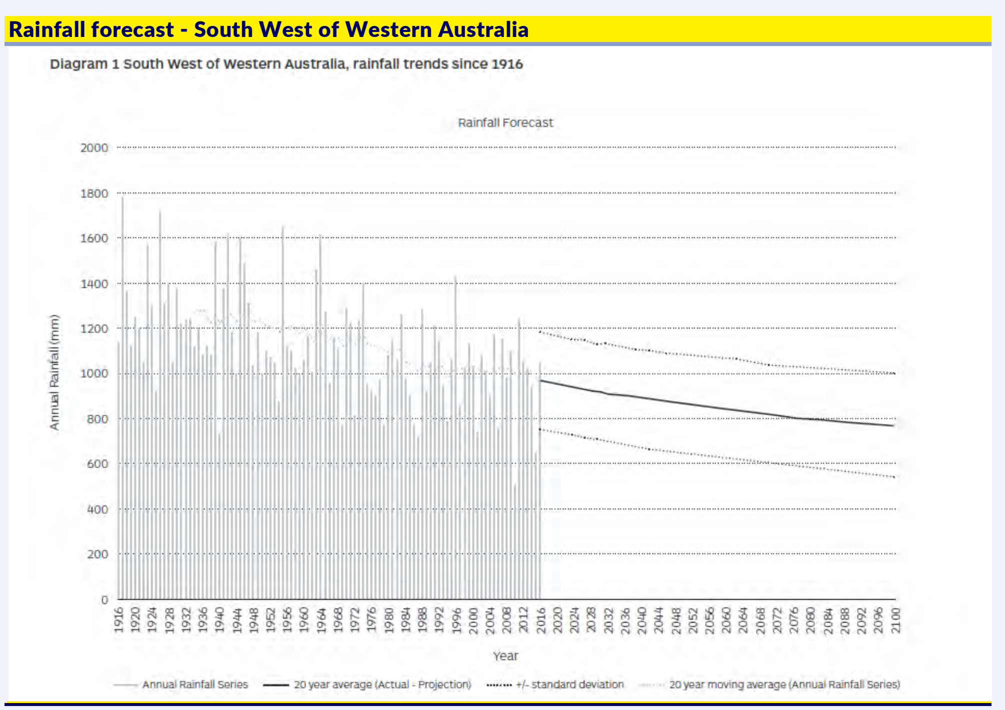
Not surprisingly, Australia leads other markets under CLSA's coverage when it comes to climate change disclosure. Miner South32 detailed its approach to climate change in a document based on TCFD recommendations and Dylan Kelly highlights the main points:

Since its spinoff from BHP in 2015, South32 has quickly charted a strategic path that vastly contrasts with the stance of its former owner. We were surprised to discover that not only does it have a climate-change strategy (not something you would typically associate with a miner) but a progressive framework that has influenced not only the current portfolio, but also future M&A decisions. This was partially evidenced in September 2018 when it announced the divestment of its c.30mtpa South African Thermal Coal portfolio. While we had initially thought this was a pure economic decision, it would appear it was at least partially influenced by this strategy. Management also cited the divestment decision as benefiting marketability to ESG-conscious investors such as Norges Bank as well as referencing the success of Rio Tinto's earlier coal exit.

We were also intrigued by its 2017 study into the types of commodities that are likely to be required in a world constrained by carbon. While it didn't mention any specific portfolio implicates, it specified this analysis resulted in its decision to not to develop any new greenfield energy coal basins.

In practical applications of managing climate change, we were struck by the case study in water usage at its Worsley Alumina refinery in Western Australia. It developed water supply forecasts for its region under various climate change scenarios (see below) which resulted in new water pipelines being developed to mitigate future supply risk.

Rainfall forecast - South West of Western Australia



Source: South32 internal climate modelling, 2017

Many companies disclose climate-related information; few disclose the financial impact of climate change

TCFD status and implementation

In 2018, the TCFD issued a Status Report providing an overview of the disclosure practices of nearly 1,800 companies. The majority of companies reviewed disclose climate-related information that aligns with at least one recommended disclosure. While many companies disclose climate-related information, few disclose the financial impact of climate change on the company. There are also few companies that describe the resilience of their strategies under different climate-related scenarios, such as a 2°C or lower scenario.

Asia clearly lags US and EU

Disclosures in Asia are clearly lagging the Americas, especially Europe. According to work from CDP and the Climate Disclosure Standards Board (CDSB) there is still a significant gap between the current climate-related disclosures and the recommendations made by the TCFD.

Few companies consider regulatory risk and physical risk

Only 28% of the 1,681 companies consider regulatory risk and 34% consider physical risk beyond six years demonstrating the focus is still very much on the short term. This is made worse as only 1 in 10 companies provide financial incentives for climate-related risks and opportunities. Even after the Paris agreement, only 68% of companies have reduced emissions due to reaching emission targets while 36% have increased their emissions. 46% of the companies reported on climate-related progress to the board more than once a year suggesting that there is still a majority who don't view climate change as a serious enough risk to warrant spending the extra time and resources monitoring it.

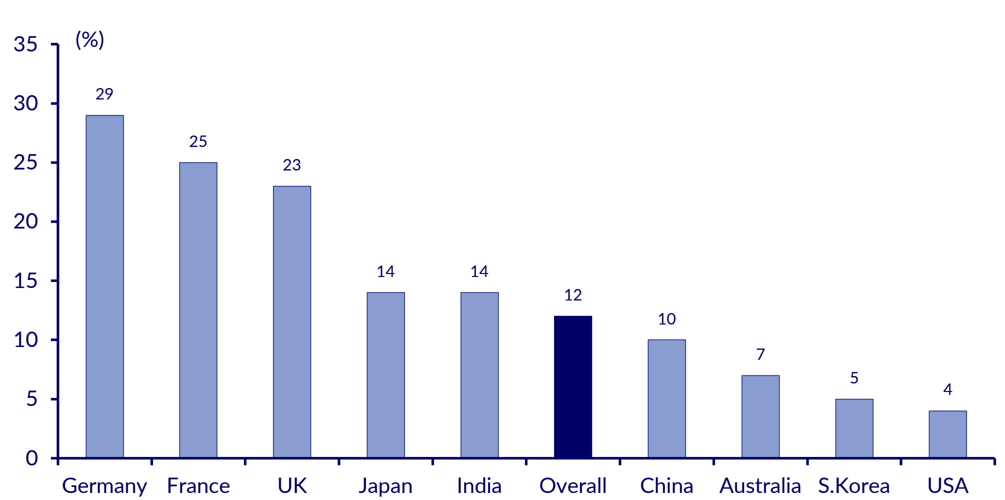
Europe appears ahead of the US and Asia in disclosure

Countries are beginning to react to the recommended disclosures. France passed article 173 which even if it wasn't based on the recommendations, is in line with them. The EU has begun to try to incorporate the recommendations into existing disclosure frameworks and has published an action plan to begin the process. Europe appears ahead of the US and Asia in disclosure as 9 out of 10 companies in Europe recognise the danger of regulatory risk but only 70% in the US and 53% in Canada do and only 53% recognise physical risk in China.

Europe, Japan and India outperforms other markets

Figure 52

Companies by country providing incentives to the board for climate change issues



Source: CDSB

Who is going to finance coal?

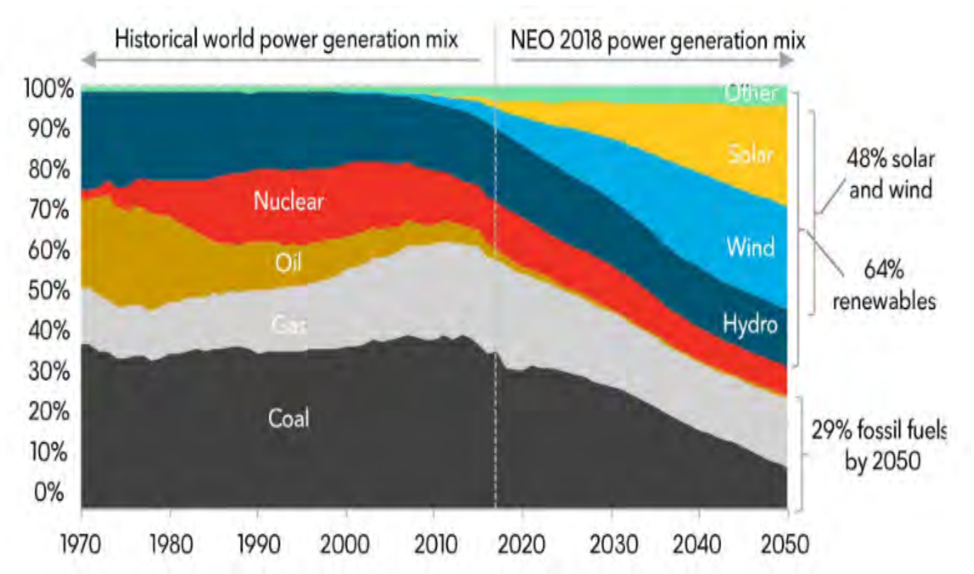
Carbon emissions will not decline quickly enough to meet temperature rise limit

The IPCC's October 2018 report argues that, for global temperature rise to be limited to 1.5°C, coal's share of electricity supply should be cut to 2% or less by 2050, from around 38% today. On Bloomberg New Energy Finance's (BNEF) forecasts, which factor in faster energy transition than most, coal generation peaks globally in around 2027, before falling sharply to 11% of world electricity by 2050. In other words, even under the most ambitious mainstream forecasts, carbon emissions will not decline quickly enough.

BNEF's energy mix forecast

Figure 53

Power generation mix



Source: CLSA, BNEF, IEA

Coal plant development has slowed sharply

There are some encouraging signs. Coal plant development has slowed sharply over the past couple years, with 634 GW of shelved projects, according to research from Coalswarm, the Sierra Club and Greenpeace (link). However, on their numbers, that still leaves 656 GW of projects under development, or an incremental one-third of total existing capacity today. Most of that development is happening in Asia. In addition to China (211 GW) and India (131 GW), the standouts include Vietnam (46 GW), Indonesia (38 GW), Bangladesh (22 GW) and Japan (19 GW).

Developments across these markets face growing headwinds from cheaper renewables, rising local resistance and local air quality concerns. Increasingly, they are also struggling to get funding. Over the past year, the global campaign to divest from fossil fuels has found firm footing in Asia, and specifically around funding of coal-fired power projects.

Divestment could actually help performance

Divestment impact on share-price performance

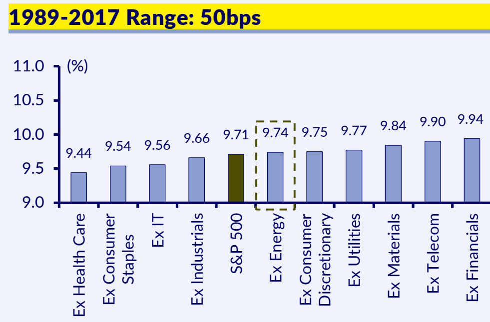
There are no shortage of studies indicating that divestment could actually help performance, rather than hinder it. For example, since its first full year of existence in 2011, the MSCI ACWI ex-fossil fuels index outperformed the MSCI ACWI Index five of seven years (link). Norges would have made an incremental US$38bn over the past decade if it had not been invested in oil and gas stocks (link).

Performance considerations can get bogged down in debates about timing. GMO's Jeremy Grantham takes a much longer (multi-decadal) view, suggesting that, historically, fossil fuels have been nearly irrelevant to performance (link).

What if removing Energy from the S&P 500?

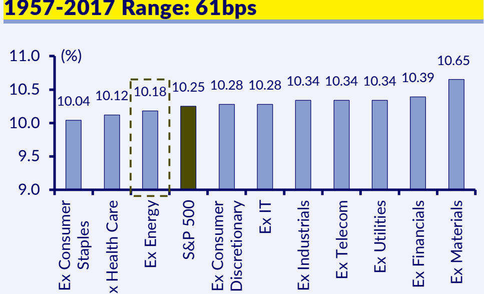
Grantham illustrates that removing Energy from the S&P 500 for the past 28 years would have delivered an incremental 3bps pa performance (9.74% annualised vs 9.71%) versus the S&P 500. Going back 60 years, the same exercise would have cost you 7bps pa; going back 92 years, 5bps pa.

1989-2017 Range: 50bps



Source: CLSA; Jeremy Grantham: *The Race of Our Lives Revisited*

1957-2017 Range: 61bps



Source: CLSA; Jeremy Grantham: *The Race of Our Lives Revisited*

This is not the sort of slam dunk that climate campaigners are likely to feature in slide decks. However, as Grantham also points out, the inevitable growth of climate policy going forward dramatically skews the risk for fossil fuels going forward. The Institute for Energy Economics and Financial Analysis (IEEFA) has compiled a detailed, investor-friendly breakdown of these risks (link).

More investors have committed to divest from fossil fuels

According to a September 2018 report by Arabella Advisors, investors managing US$6.2tn in AUM have committed to divest from fossil fuels, up from US$5.2tn in 2016 and just US$52bn in 2014. Even the September 2018 figure could be wildly out of date shortly. Norway's finance minister is currently mulling over whether to follow the advice of the central bank (divest) or the government-appointed commission (don't divest).

Divestment in Asia

Since late 2017, financial institutions across Asia have been racing to pull their funding for coal-fired power. The regional trend began in Australia, following similar moves in Europe (mostly) and the USA, and has since spread to Singapore, Japan and (less so) Hong Kong.

Banks declared to divest coal projects

Figure 54

Coal divestment around Asia

Bank	Date	Exceptions
Westpac	28 04 2017	Financing for any new thermal coal projects limited to existing coal producing basins and where the calorific value of coal meets the energy content of at least 6,300kCal/kg Gross as Received - ie, projects must rank in the top 15% globally
Commonwealth bank	16 11 2017	
ANZ	Dec 17	Will consider financing new coal fired power plants if they use advanced technologies and higher quality thermal coal to significantly reduce emissions to at least 0.8 tC02/MWh
NAB	14 12 2017	Support our existing customers across the mining and energy sectors
DBS	26 01 2018	Developing countries
HSBC	20 04 2018	Bangladesh, Indonesia and Vietnam, in order to appropriately balance local humanitarian needs with the need to transition to a low carbon economy
OCBC	Jul 18	
UOB	Jul 18	Super-critical coal-fired facility
Standard Chartered	25 09 2018	

Source: CLSA, banks websites

Interview with Tim Buckley, of Standard Chartered

After Standard Chartered delivered, arguably, the most ambitious divestment statement yet, we caught up with the Director of Energy Finance Studies, Australasia, Tim Buckley. Based in Sydney, Tim has 25 years of financial markets experience, specialising in equity valuation. The Institute for Energy Economics and Financial Analysis (IEEFA) conducts research and analyses on financial and economic issues related to energy and the environment. The institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy.

CY: On September 25, Standard Chartered's chairman announced that the bank would stop financing new coal-fired power plants (link). Why is this significant?

Standard Chartered announcement was a breakthrough on the divestment programme

Tim Buckley (TB): The Standard Chartered (SC) announcement was a breakthrough on the divestment programme. Normally, the first move is lip service, a bit of green-washing, and unclear. However, the SC chairman's statement is clear, aggressive and unequivocal: "We will not directly finance any new coal-fired power plants, including expansions, in any location." There's no 'except if it is ultra-super-critical' or 'except for these countries' or any other caveats. This is a globally important announcement. It is raising the bar. This isn't one step, it's 10 steps.

CY: There is still a significant pipeline of coal-fired projects across Asia and particularly Asean. How are they going to get financed?

Coal-fired projects across Asia are financed by public capital.

TB: Public capital subsidised finance for those power plants: JBIC, JACIA, Nippon Insurance, Sino-insurance, and the big-5 Chinese government owned banks (CDB, etc). Almost all of the coal-fired plants across Asia have a Chinese, Japanese or Korean public capital subsidy embedded.

The op-ed in the FT (Financial Times) from PM Abe is absolutely telling (link). Japan's heading the G20 next year. They have been a laggard, by underestimating technology change. But they are pivoting. It is no coincidence that PM Abe's op-ed came the day after Marubeni announced they were: doubling renewables, ceasing development of new coal power and halving exposure to existing coal power by 2030 - effective immediately. This comes on the tails of at least partial coal exits by Daiichi Life, Nippon Life, MUFG, Mizuho and SMBC, among others. Japan is the second largest provider of foreign capital for coal plants in the world. All of a sudden, it's not Marubeni moving in isolation, it's all the big Japanese financial institutions: four of the biggest banks, insurers, government pension investment fund (GPIF), etc.

Japan and Korea are moving out of coal

With Japan moving out of coal, that leaves Korea and China. But President Moon Jae-in is really shifting focus in South Korea: a 58GW renewables target, upping the coal tax by 30% to US$40/t, telling polluting coal plants to close for four months . . . they are now really focused on moving to the future: batteries, offshore wind and solar.

So, China: lending internationally is technology and fuel agnostic. To some degree, they are the last man standing. When the music starts to stop, though, will they continue to prop up the global coal industry? Unlikely, particularly given their push domestically for decarbonisation and clean power. We know that in the long term, capital flows to renewables suggest they are not agnostic. They are really just currently exporting stale, excess capacity into poor countries that cannot afford any alternatives at the moment. But the cost dynamics we are now seeing in India will make that end. This is true especially because most of those markets are using expensive imported coal that has doubled in price since 2016.

CY: Which of Australia's financial institutions has taken divestment risk and renewables opportunity most heartily on board?

Macquarie has taken divestment risk and renewables opportunity most heartily on board.

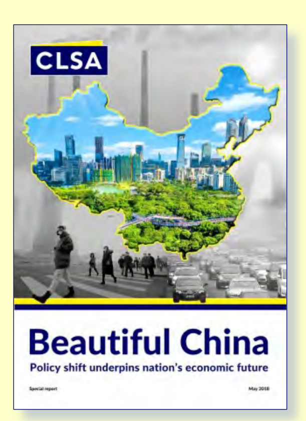
TB: The quiet one in Australia - Macquarie Group. It is one of the most advanced major financial groups when it comes to investment in renewable energy infrastructure: pension funds and also infrastructure. Renewables is one of its four pillars of global growth for the next decade, and it's been working toward this for the past five years.

It looked earlier this year at setting up an Asian green investment bank, replicating the Green Investment Bank in the UK (which Macq bought in 2017). It is also moving big-time into India. New MD Shemara Wikramanayake identified India is possibly one of the biggest opportunities for the firm.

Pension money market will become a major investor in renewables infrastructure over the next decade.

Pension money market globally will become a major investor in renewables infrastructure over the next decade. You can deploy billions into govt-backed PPAs with (generally) 6-8% pa returns for 20-25 year durations, doubling what you get in long-term bonds. For Macquarie, this is a perfect opportunity to make a capital profit on the projects, then recycle them into the pension markets.

Note: Our Australian Financials analyst, Brian Johnson, could not agree more. For his green investment case on Macquarie please see: **Macquarie - BUY (Kermit - Green and Greedy).**



Make China beautiful again

The past five years have shown 'Beautiful China' is much more than just another communist slogan. With central-government air cover, environmental-protection officials have been able to make full use of their dramatically upgraded arsenal of rules and regulations. At the outset of China's War on Pollution (2014), MEP officials were mostly firing blanks. China's leaders are determined to build upon the super-structure of new policies and regulations, and the nation's people will hold them to it. Support for clean energy and electric vehicles will not waiver even as development runs up against entrenched interests in China's sprawling old-energy economy. Also, fears of saturation in waste water and waste management should continue to prove unfounded. The two areas of policy focus are air pollution, and water and soil management.

Air pollution, a core focus

Top focus is air pollution

The initial focus in the clean-up has been around China's noxious air. Smog is much harder to hide than water or, especially, soil pollution. It is also the easiest of these issues to address. The basic levers the government can shift and drive policy from are: reduce coal consumption; replace coal with gas where possible; continue to grow solar capacity; simultaneously continue to scale wind. The government can also: provide financial incentives to accelerate the process; and complement the energy production mix shift with a parallel transport consumption mix shift in a massive, accelerated transition to EV.

(1) Reduce coal consumption

Coal is the obvious one

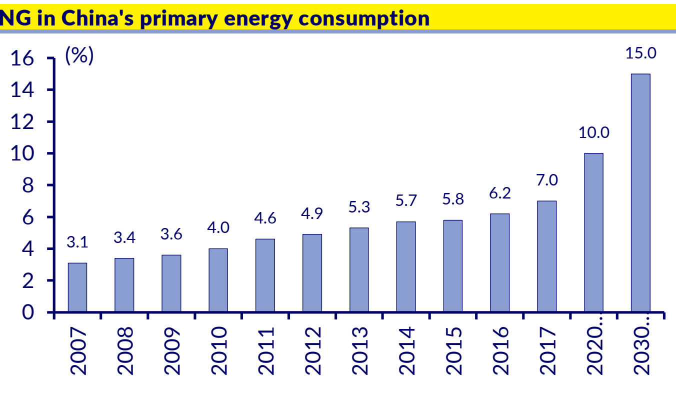
China's coal consumption may well have peaked, but the country will still rely on it for a declining, but large share of power generation for decades. By far the quickest way to reduce smog (if not carbon) from the power sector, is to shut down old inescapably polluting power plants, and then force all new or remaining plants to install and use the most advanced emissions-control equipment. The 13 FYP accelerated this endeavour that began with the 11th FYP.

(2) Replace with gas where possible

Gas is much cleaner than coal

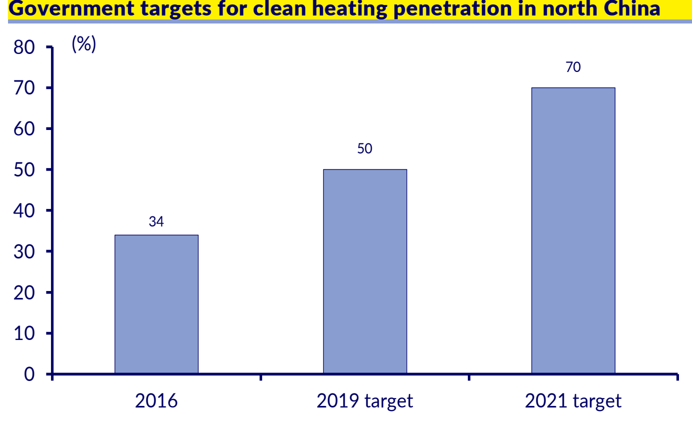
Gas burns cleaner than coal on all metrics. Gas-fired power also provides grid networks with valuable flexibility, as it can be ramped up or down almost immediately (coal-fired power takes hours). The drive to replace dirty coal with natural gas resulted in sharp acceleration in gas-consumption growth to 15% in 2017 versus mid- to high-single-digit growth rates in the previous three years. Increasing use of gas will remain an important leg of this energy transition, with the government targeting to increase share of gas in primary energy to 10% by 2020 and 15% by 2030 (from c.7% in 2017). To achieve the c.350bcm 2020 consumption target, 2017 growth will have to be sustained for next three years.

NG in China's primary energy consumption



Source: BP, NDRC

Government targets for clean heating penetration in north China



Source: NDRC

Solar to continue its trajectory and reach grid parity by 20CL

(3) Continue to grow solar capacity

In 2017, China added more solar than coal-fired power for the first time. Out to 2020, we anticipate a slight slowdown in annual installations as payments, business models and lending facilities struggle to catch up with the runaway growth. Underscoring the sector's challenges, policy-makers scaled back subsidies and targets to the sector on 31 May 2018. We believe the slowdown is temporary. Official 2020 targets have already been exceeded. We project cumulative solar installations to grow from 130GW in 2017 to 275GW in 20CL. China is targeting new solar installations to reach grid parity, making them subsidy free, by 2020. Long-term feed-in tariffs still dictate returns for the majority of installations. However, the transition to grid parity is well under way.

Wind will grow as well, but slower than solar

(4) Continue to scale wind

In 2017, more than three times as much solar capacity was added as wind. New wind-capacity additions have halved since 2015, ahead of a tariff cut and crackdown on new installations in oversupplied areas in 2016. We see some recovery in 2018, but generally expect wind additions in China to run at roughly half the rate of solar over the next decade (20-25GW pa). However, cumulative wind installations in China should still deliver 11/9% Cagrs for the next five to 10 years, on our forecasts. Wind developers are also benefitting from the slowdown in new additions, which has helped push consolidation and reduced curtailment (wasted generation). Leading wind operators are now generating positive free cashflow.

Successful launch of financial-incentive schemes will be a plus

(5) Provide financial incentives to accelerate the process

In 2017, both green-certificate and carbon-trading schemes went live in China. Both could be tremendously beneficial to renewable-energy operators. While both are of negligible consequence today, we expect that to change dramatically over the next couple years. As with green certificates, carbon certificates will become a real market in China, with meaningful costs for carbon emitters and potential revenue for clean-energy operators. There is simply too much political capital and international prestige already locked in for Beijing to abandon the plans. And if they can be made to work properly, they will be powerful drivers for supply-side reform and making a Beautiful China.

The clean energy financing mechanisms are part of a much broader suite of policy directives under China's Green Finance initiative. For more, see our interview below with the policy's primary architect, Ma Jun.

Dr Ma Jun is a chief architect of China's green finance plans

Dr Ma Jun is President of the Hong Kong Green Finance Association (HKGFA), Director of Green Finance Committee of China Society for Finance and Banking, and Co-chair of the G20 Green Finance Study Group. While serving as Chief Economist at the PBOC's research Bureau, he was instrumental in establishing China's Green Finance ambitions. We posed some questions about China's plans to Dr Ma and Hannah Routh, Partner, Sustainability and Climate Change Advisory, Deloitte China and Special Adviser to the Chair, HKGFA. Answers, below, have been edited for brevity and clarity.

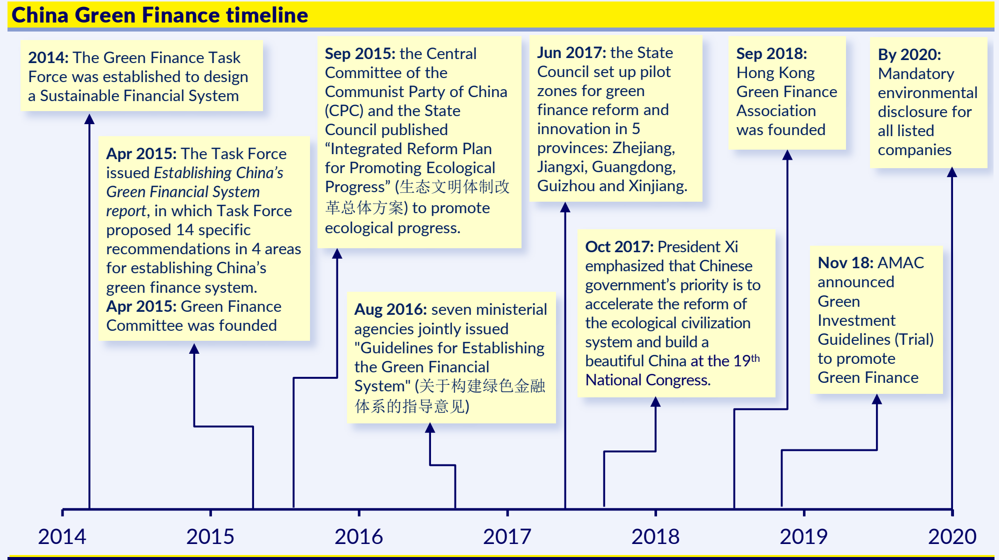
What do you see as the biggest achievements for China's green finance roll-out since the Guidelines for Establishing the Green Financial System were released and green finance made its debut at the G20 meeting two years ago?

Ma: There have been many important developments in China, but I would like to highlight four points:

Mandatory environmental disclosure is required by 2020

1. Mandatory environmental disclosure for listed companies is one of the requirements of the guidelines, and CSRC has announced their decision to achieve this by 2020. By end of 2018, listed companies in China will be required to report this information on a 'comply or explain' basis. This is a major achievement as high quality environmental data is a key enabler for most other aspects of the green finance market.

China Green Finance timeline



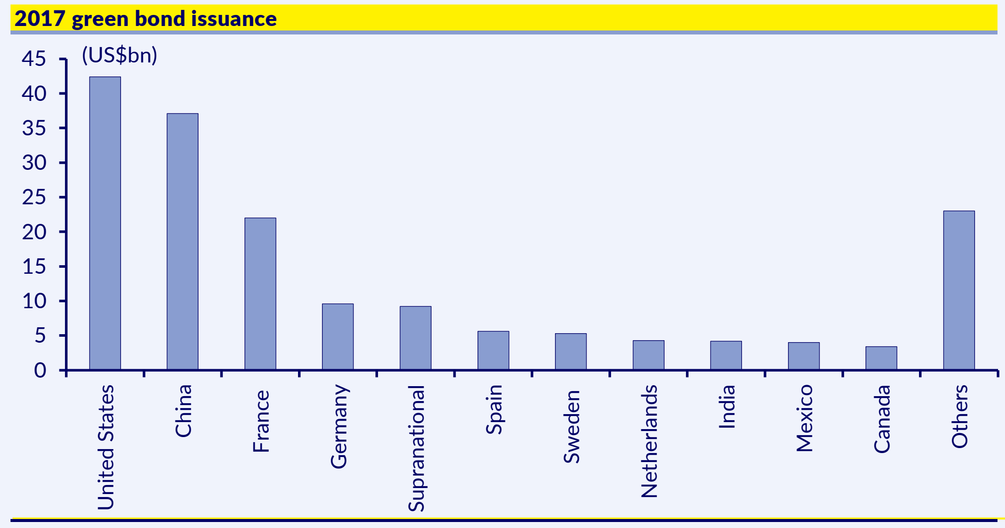
Source: CLSA

China issued a large number of green bonds

2. The launch of the green bond market in China, which has the largest demand for green financing in the world. Since the beginning of 2016, Chinese issuers have issued, in domestic and international markets, about 270 green bonds with a total value of about Rmb600bn.

China is a major player within a growing global green bond market

2017 green bond issuance



Source: CLSA, Climate Bonds Initiative

3. Introducing policy incentives for green finance. For example, the PBOC has introduced green re-lending facilities, which provides low-cost funding via commercial banks to green projects. The PBOC has also developed a green MPA method that gives banks with better green lending performance higher

MPA scores, which could translate into monetary incentives. Many local governments have used interest subsidies, guarantees, and green funds to support green investments. These incentives are not only reducing the funding costs of green projects, but also send an important signals to the market on the government's commitment to green development. Such signals can help crowd in private capital for green investment.

Financial institutions promote environmental risk analysis and research

4. Promoting environmental risk analysis by financial institutions. China Green Finance Committee (GFC) organised a series of research projects and has published a book on "Environmental Risk Analysis by Financial Institutions." It is the first book of its kind in the world. We are now promoting the methodologies developed in this book to banks and asset managers in China.

What are the key developments to watch over the next two to three years?

Ma: Green finance remains in its early stage, both in China and globally. There are many things to do for the coming years. Some areas that I am paying attention to are:

Bring One Belt One Road and green finance together

1. Green Belt and Road Investments. One Belt One Road is one of the defining initiatives of our generation, and green finance is surely another. Bringing the two together is vital to ensure that Belt and Road investments are sustainable in every sense of the word. This means focusing investments on green infrastructure such as renewable energy, as well as environmental and social safeguards for all investments.

2. A discussion on reducing risk weights for green assets for banks is now underway. I believe that by doing so, it can substantially reduce the funding cost of all green loans, and can more forcefully drive the green transformation of the financial sector and real economy. China is one of the very few countries that have a green loan definition and have data to show that green loans default less than non-green loans. Partly due to this reason, I think China should move first in introducing lower risk weights for green assets.

We will see TCFD and climate risk analysis and reporting become mainstream

3. Climate risk will be become more critical and material for investors across all asset classes. China's GFC is collaborating with London's GFI on a TCFD pilot, in which a group of Chinese and UK financial institutions will pilot TCFD reporting. After that, I believe we will see TCFD and climate risk analysis and reporting become mainstream.

What are your thoughts on the ongoing debate about green bond definitions, and especially funding "clean-coal projects" with green bonds?

Possible for large economies to develop a mutually accepted definition for green assets

Ma: During my co-chairing of the G20 green/sustainable finance study group, this issue has been debated for many years. I do not think it is feasible in the very near term to reach a global consensus on green taxonomy, as many countries have different natural resource endowments, environmental conditions, and policy preferences. But it is possible for some large economies - such as China and EU to develop a mutually accepted definition for some green assets, for the purpose of promoting cross-border green capital flows. The China GFC and EIB have worked on this project in the past years. Once EU has decided on its green taxonomy and an agency "owning" it - hopefully by next year, there will be a basis for a more meaningful discussion on China-EU convergence in green finance language.

You were quoted saying the NPL ratio for green loans in China was just 0.4% vs 1.8% for all loans. Along the same lines, NPLs for green credit in the five green finance pilot zones (as of March) stood at just 0.12% vs an average NPL ratio of 1.06% in those regions. Are these gaps being reflected anywhere in either

lending rates or calculation of risk weighted assets for the financial institutions? If so, where? And what will it take to spread more broadly? Are there any near-term catalysts to watch for?

Development of green loans in China

Ma: So far, some local governments, such as Huzhou City, have provided interest subsidies for green loans. Some banks, such as Industrial Bank, also provide a discount to interest rates for green loans. However, it is not yet a universal practice for green loans to be priced lower than non-green loans. That is one of the reasons why I am keen to promote the reduction of risk weights for green loans in the Chinese banking system.

You were just in Hong Kong to launch the HK Green Finance Association (of which you are Chairman and President). What role do you see Hong Kong playing in China's broader Green Finance ambitions?

Hong Kong can take the lead on developing a set of green banking principles

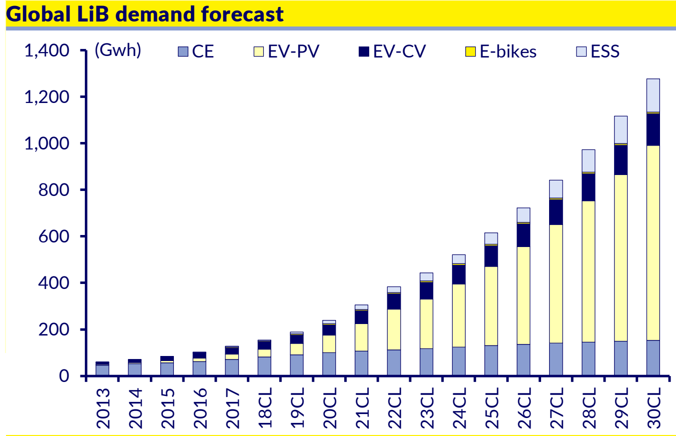
Ma: Hong Kong has long been the gateway to China for international investors. Specifically, Hong Kong can take the lead on developing a set of green banking principles, build on its strength as an asset management hub to incubate green asset managers, and continue to grow the local green bond market. On a regional level, I would like see more collaboration between Hong Kong and mainland China, and for Hong Kong to play a leading role in financing a green Belt and Road. The vast demand for green investment from China and the Belt & Road region can imply great opportunities for Hong Kong, which we hope will become a global green finance centre.

EVs and unintended consequences

Electrification of the transport fleet is also an important plank in China's efforts to fight air pollution. And China is, although the world's largest electric vehicle (EV) market, the country is far from alone. In 2017, passenger EV sales hit one million, and cumulative sales reached three million. With the launch of mass-market models, we expect new-EV sales to reach 20 million globally by 30CL, a robust 24.7% volume Cagr over 17-30CL. This equates to a 19.4% battery-volume Cagr over the same period, with demand from EVs alone reaching 1,000GWh - a tenfold increase in total lithium-ion consumption over 2016.

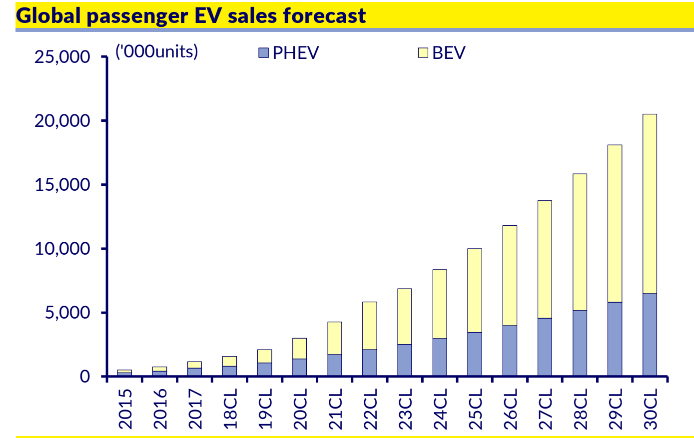
Unprecedented demand and investment suggest the battery supply chain - from raw-material producers and component providers to cell manufacturers and system integrators - is experiencing great strain. However, the sector, underpinned by structural growth dynamics, is likely to ensure continued demand growth and further consolidation, enabling winners to ease cost pressure.

Global LiB demand forecast



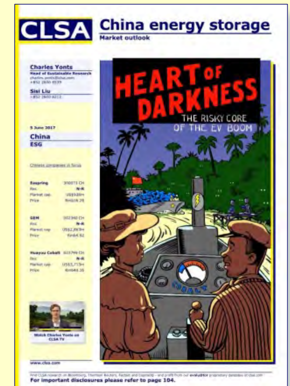
Note: CE (combustion engine), EV-PV/CV (Passenger/Commercial EV), ESS (Energy Storage System); Source: CLSA

Global passenger EV sales forecast



Note: PHEV (plug-in hybrid), BEV (battery electric vehicle); Source: CLSA

For an updated take for impact along the battery supply chain, see analyst Ken Shin's July 2018 *Battery Rush 3*. However, even before the market has really taken off, environmental and social concerns about batteries are mounting.



Heart of darkness

Investors have been focused on supply-chain issues around cobalt since a damning Amnesty International report in 2016. In short, nearly all of the batteries used in consumer electronics and electric vehicles require cobalt. Over half of the world's cobalt comes from the Democratic Republic of the Congo. Around 20% of that comes from 'artisanal' mines, where adults and children work side-by-side in appalling conditions. We have written extensively on the issue and corporate responses, most notably in our June 2017 *Heart of Darkness* report.

The issue is by no means resolved. However, major battery makers and their suppliers have spent the past two years bringing light to what was an incredibly opaque and fragmented supply chain. While we will continue to track plans and disclosure along the supply chain along with investors and NGOs, the ESG focus for batteries has shifted to disposal.

Mountains of molehills?

Hans Eric Melin of Circular Energy Storage suggests conventional wisdom is wrong

Rising demand for EVs, and thus li-ion batteries, has driven growing concerns about what is happening to these batteries after the cars are retired. Data is tricky to pin down, but it's widely reported that only 3-5% of li-ion batteries are recycled, suggesting mountains of toxic waste a few years out. We have engaged with Hans Eric Melin of Circular Energy Storage. His research and long years in the li-ion recycling field suggest conventional wisdom is wrong.

50% of the li-ion batteries that should be recycled are recycled

Rather than 3-5%, Hans Eric estimates that 50% of the li-ion batteries that should be recycled are recycled. That is still far from perfect, but a far cry from what's reported. Before being recycled, Hans argues that most li-ion batteries already today are finding their way to fruitful second lives in stationary storage, base stations and much more. Supply of used batteries cannot meet demand. Demand for base stations from China Tower alone far exceeds total second-life batteries on the market.

Asian firms are bulking up their end-of-life/recycling businesses

Hans Eric believes the wild underestimation of second-life and recycling markets stems from the fragmented supply chains and domination by China (and, less so, Korea). He estimates that recycled cobalt will more than double by 2024 from 2018's 14k tonnes. Lithium will grow more quickly from a lower base. Asian firms from materials suppliers to battery manufacturers and automakers are bulking up their end-of-life/recycling businesses.

Whether Hans Eric's relatively optimistic outlook for battery re-use and recycling plays out or not, EV makers are certain to continue coming under more scrutiny from both governments and investors for their end-of-life plans.

Rana Plaza five years on

Five years ago, in April 2013, Rana Plaza collapsed in Bangladesh killing 1134 and injuring another 2500 people making garments for well-known Western brands. The disaster triggered action to improve working conditions in Bangladesh and beyond, while also highlighting the challenges and risks inherent in moving manufacturing away from China.

Learning from the tragedy of Rana Plaza, with Rosey Hurst of Impactt

The tragedy of Rana Plaza: What's changed since 2013?

Source: Source: Photo by rijans, Flickr - Dhaka Savar Building Collapse, CC BY-SA 2.0, https://commons.wikimedia.org/w/index.php?curid=26051590

We caught up with Rosey Hurst, founder and director of ethical trade consultant Impactt, to discuss what has (and has not) improved for workers across Asia. Most of the below is taken from a call we hosted in May (link), along with some updates from Rosey in September.

About Impactt: With offices in China, Myanmar, India and Bangladesh, Impactt has been tracking 1,585 Asian factories employing 1.5m workers, and conducted 33k interviews, since 2006.

The good news: Bangladesh is safer for workers . . .

Two large organizations were formed after Rana Plaza: The Accord (mostly European) and The Alliance (mostly US / Aus). They've inspected/upgraded 2300 factories. The larger Accord focuses on fire and building safety. It is legally binding; signatories cannot use non-compliant suppliers. To date, 89% of problems have been remediated. The less confrontational Alliance has also completed 91% of remediation work. Unionization has spiked (132 in 2012 to >8k today), as have training and helplines.

. . . but it is still pretty miserable, with unethical practices proliferating

There is still a lot of work to be done. A recent study showed that 52% of women working in Bangladesh's textiles sector face physical harassment from supervisors. The long arm of labour inspectors does not reach many areas in Bangladesh or elsewhere, with major manufacturers relying more on unscrupulous sub-contractors. Worryingly, the Bangladeshi government is forcibly taking back the reins. The original Accord license ended in May, and the future remains uncertain.

The challenges with China and onshoring

Against the backdrop of Donald Trump's ongoing trade war with China, the ongoing challenges in Bangladesh highlight two important points.

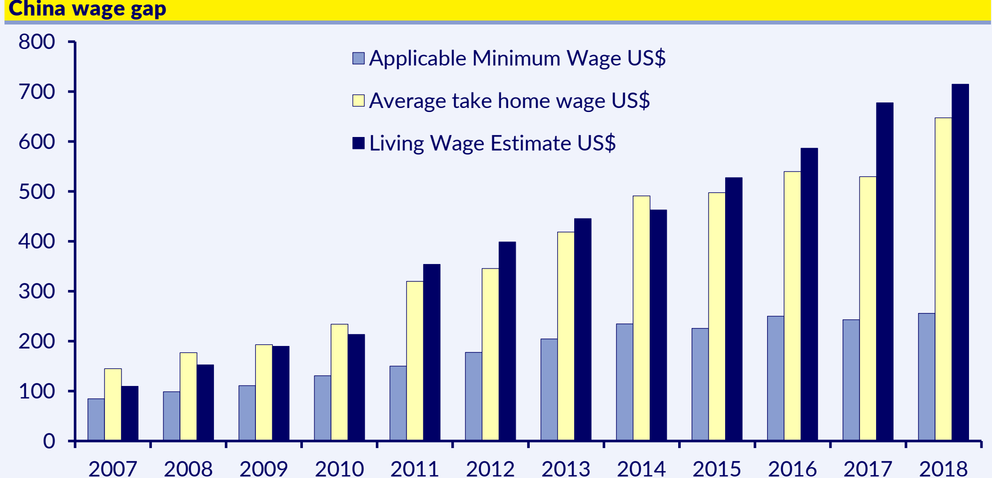
First is the shear difficulty of moving supply chains out of China. For at least the past decade, pundits have been speculating about the upcoming exodus from China's garments industry due to labour shortages, high labour costs, pollution concerns and more. However, there is no exodus.

Second, in many respects, that non-exodus could be a good thing. The magnitude of difference between China's living wage gap and those of India and Bangladesh is surprising. Further, moving shop to the better-regulated markets of the EU or North America is no panacea. In particular, Rosey cautions that conditions in Europe are worsening, with large scale migration and competition driving illegal operations – even slavery, from Turkey to Italy and the UK.

In China, the gap between take-home pay and Impactt's living wage estimate is 9%, not far from the figure for the UK

Economic development has trickled down to average workers in China much more efficiently than in . . .

China wage gap



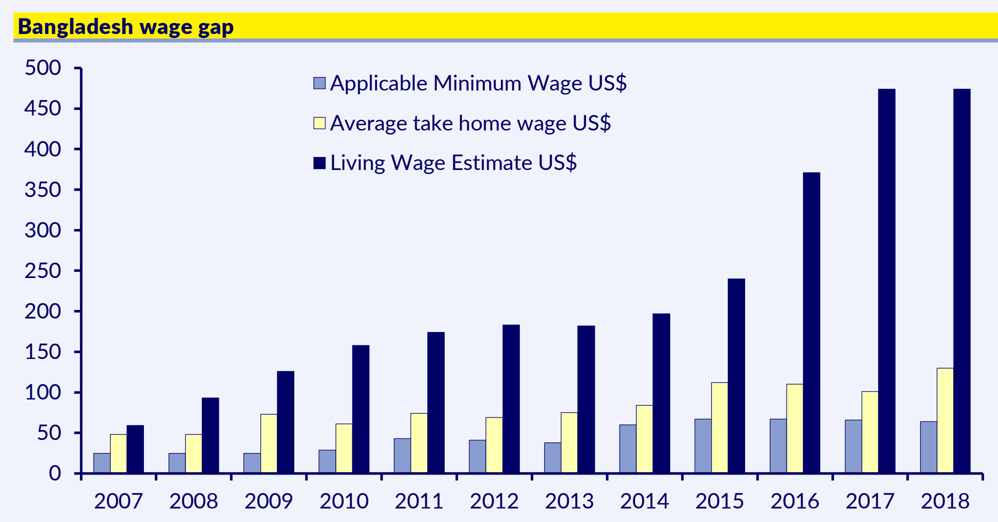
Source: Impactt

. . . Bangladesh, where the wage gap is 72%, even after accounting for the considerable amount of (often forced) overtime

Impactt is also seeing higher harassment rates of (largely) female workers by (largely) male management.

Rosey emphasises that the industry in Bangladesh really is improving in meaningful ways, though, thanks to improved health & safety as well as training

Bangladesh wage gap



Source: Impactt

Protein, trees and climate

If cattle were their own nation, they would be the world's third largest emitter of greenhouse gasses

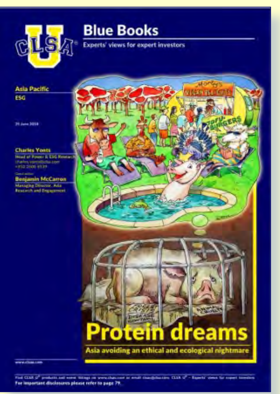
If cattle were their own nation, they would be the world's third largest emitter of greenhouse gasses (GHG). That stat comes courtesy of the Drawdown Project which ranks climate change solutions for their potential impact (link). Conversations about tools to fight climate change tend to dwell on energy: solar, wind power, nuclear and maybe carbon capture & sequestration (CCS). Hawken's work suggests that this is misguided. Solar (#8 farms; #10 rooftop) is nowhere near the top of the list for carbon reduction potential; wind is closer (#2 onshore; #22 offshore); nuclear is middling (#20) and CCS doesn't make the list at all.

This brings us back to cows. Adopting a plant rich diet ranks 4th for its potential to reduce carbon emissions. GHG emissions is one of the many risks that we look at for Asian meat, dairy and seafood companies in the CLSA-U bluebook Protein dreams, written with Asia Research and Engagement founder Ben McCarron.

Number five on the list for carbon reduction potential goes to 'protecting tropical rainforests.' That ties in closely to meat consumption (grazing), but – especially in Asia, also to Palm Oil. Our June 19 CLSA-U report *Keep palm*, written with Keith Lee and Jeanne Stampe of WWF, breaks down the rapidly evolving standards and best practice for engagement within the Palm Oil sector.

Excerpts from Protein dreams

This section is excerpted from the June 2018 report *Protein dreams*



Economic growth and rising incomes will continue to drive Asia's appetite for meat and seafood. Asia Research & Engagement (ARE) estimates that the region will consume 33% more meat and seafood by 2030, and 78% more in 2050 on the back of higher urbanisation rates and rising wealth.

Asia's integrated meat, dairy and seafood producers are major beneficiaries of these trends, which are central to their expansion and investment plans. Steady, well-supported gains suggest an attractive investment opportunity, but without proper management rising demand will have significant negative environmental and social consequences that could slow growth and potentially damage returns.

We review the most significant publicly-listed protein (meat, seafood and dairy) companies in Asia. Some are integrated producers, while others are mainly processors. These firms represent a small, but growing, percentage of Asia's overall protein production and are set to expand their share through consolidation and a shift towards more intensive farming practices. We estimate they account for 30% of the market capitalisation of Asian protein businesses.

Food safety, public health, environmental issues, animal welfare and labour standards are key risks

We first consider their exposure to the main risks that arise from Asia's protein-consumption growth which include food safety, nutrition, epidemic risk, environmental issues, animal-welfare demands and labour standards. For each firm, we assess whether the business model creates high, medium, or low exposure to each risk.

Relative importance of each risk depends on company-specific factors

We find that the relative importance of each issue depends on factors specific to each company. For example, we measure the impact of food-safety risk based on the exposure of each firm's sales to branded products. And with 99% of China Mengniu's sales attributed to items that carry its brand, the firm thus would face devastating consequences even if food-safety issues affected just a small portion of its offerings.

Henan Shuanghui and New Hope Liuhe rated as riskiest among our 10 companies

Exposure of protein companies to top-five risk factors

Company	Food safety	Public health	Environmental footprint	Animal welfare	Labour standards
Charoen Pokphand Foods	1	3	2	2	2
China Mengniu	3	1	1	1	1
Guangdong Wens	1	1	2	3	3
Henan Shuanghui	2	1	3	3	3
Japfa Comfeed	1	1	3	3	2
Maruha Nichiro	2	2	1	2	2
New Hope Liuhe	2	1	3	3	3
NH Foods	2	2	1	3	1
Thai Union	3	3	1	na	2
WH Group	3	2	2	1	3

1 = low risk, 2 = medium risk, 3 = high risk; na = not applicable. Source: Asia Research & Engagement (ARE)

Good policy and implementation standards can mitigate risks

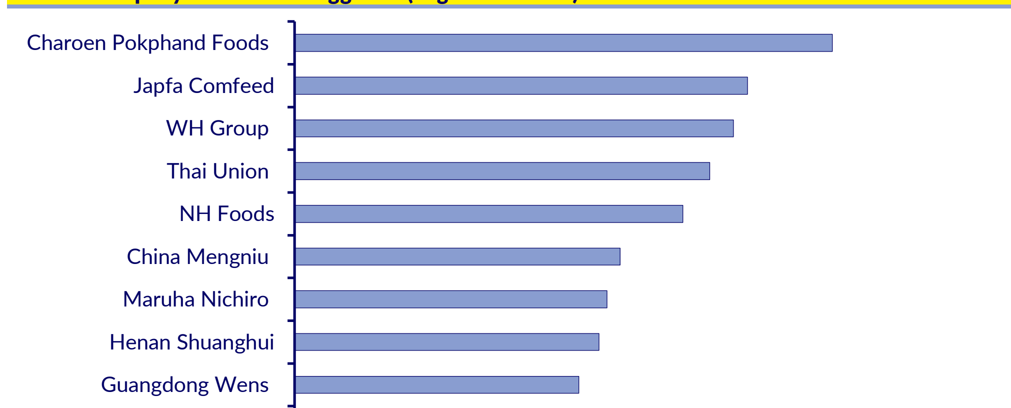
Firms can mitigate these risks through their policies and performance standards. Consequently, we base scores on their sustainability policies and disclosures. CP Foods led the group in data disclosure and was third to WH Group in policies. Consequently, CP Foods is likely mitigating some of the risks implied by its overall medium risk exposure rating through strong policies and quality controls.

New Hope Liuhe the most exposed company in terms of its business profile

New Hope Liuhe is the most exposed company in terms of its business profile. It also has the lowest combined score for policy and data disclosure. This will correspondingly increase the risks investors face. It is particularly relevant in the context of the firm's geographic expansion, particularly into Australia, a market with relatively higher expectations on sustainability.

Companies have a wide range of scores for policy and data disclosure

Protein company leaders and laggards[1] (Higher is better)



[1] Methodology: Each company received a point for a positive score on the questions listed in the Appendix. The percentage is based on the number of points per company divided by 48, which is the maximum number of points. Source: ARE

Excerpts from Keep palm . . .

The palm-oil industry produces a wide range of food products and consumables that the world relies upon. In the process, it provides livelihoods for millions of people and has lifted many out of poverty. However, the cultivation of this versatile and highly productive crop still threatens biodiversity and contributes to climate change.

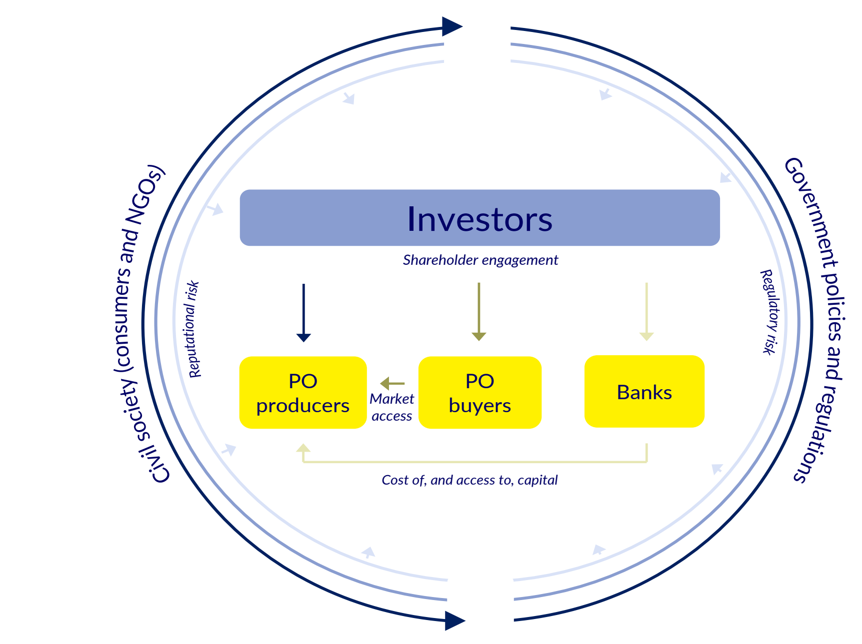
To address these issues, sector stakeholders - including civil society, industry and governments - have developed a range of schemes to certify the sustainability of palm-oil production. Given its scale and specificity, our guest authors focus on the Roundtable on Sustainable Palm Oil (RSPO), formed in 2004 by WWF, Unilever, the Malaysian Palm Oil Association and seven other founding members.[1] They argue that until the results of ongoing revisions to RSPO principles and criteria (P&Cs) - which aim to address its inadequate protection of forests and peatland - are released, current RSPO certification, combined with No Deforestation, No Peat, No Exploitation (NDPE) commitments, forms the gold standard for sustainable palm oil.

Increased risk of stranded-land assets

In response to RSPO shortcomings, in 2013 the industry developed a policy response that has come to be known as NDPE, but with no governing body, its adopters may define and implement it in different ways. The unified high-carbon stock (HCS) approach, introduced in November 2016, offers a rigorous and science-based definition of no-deforestation, while the no-peat criterion aims to curb the substantial climate-change impact of planting on peat. WWF believes these standards, combined with Indonesian peat regulations, increase the risk of stranded-land assets, which impact asset and company valuations.

The role of investors and other stakeholders

Investors' and other stakeholders' role in encouraging sustainable palm oil



Source: WWF

Certification the first step towards more sustainable planting practices

To address growing sustainability requirements and ensure smallholders are not left out of the journey, regulators in the key palm-oil-producing nations have launched the Malaysia Sustainable Palm Oil (MSPO) and Indonesia Sustainable Palm Oil (ISPO) national-standard certification schemes. WWF believes that while these initiatives fall short of RSPO standards, they are useful first steps.

[1] Founding organisations include Aarhus United UK Ltd., Karlshamns AB (Sweden), Malaysian Palm Oil Association (MPOA), Migros Genossenschafts Bund (Switzerland), Unilever NV (Netherlands), WWF, with Golden Hope Plantations Berhad (Malaysia), Loders Croklaan (Netherlands), Pacific Rim Palm Oil Ltd (Singapore) and The Body Shop (UK) on the executive board.

Indonesia's regulations outpace Malaysia's

Indonesian-government regulations bar the development of forests and peatland, while also requiring the restoration of the latter within existing concessions. Their effectiveness is of course subject to successful implementation and enforcement. Conversely, Malaysian peat regulations are less stringent, which could put its non-RSPO/NDPE-compliant producers at risk in terms of market access.

Price-sensitive consumers in Asia must not undermine sustainability drive

As Western palm-oil buyers increase their sustainability requirements and take radical steps with regard to supply-chain transparency, it is crucial that price-sensitive emerging markets also start to demand sustainable palm oil, or we risk seeing a two-tiered system.

Finance community playing a bigger role influencing the palm-oil value chain

But the pressure for more sustainable planting does not stop with buyer demand and government regulation - international banks now go beyond RSPO requirements, with requests for NDPE compliance and traceability when lending to producers. This has tightened less-compliant producers' access to capital. At the same time, some banks' new loan products enable agribusiness giants, such as Wilmar International and Olam International, to enjoy lower interest rates if they improve their sustainability ratings. Pressure from banks and investors for palm-oil-sector players to disclose against the Taskforce on Climate-related Financial Disclosures (TCFD) framework - which singles out "agriculture, food and forest products" as a high climate-risk sector - will only accelerate sustainability.

Investors have great influence along the entire supply chain. WWF recommends they encourage investees to adopt greater transparency, improve disclosures and take action to help producers towards greater sustainability. The following table shows the WWF's recommended priority points of engagement, which should be collaborative wherever possible.

Investor dialogue and engagement recommendations

<table>
<tr><th>Producers, traders and refiners</th><th>End-buyers</th><th>Banks</th></tr>
<tr><td colspan="2">❑ Improve transparency of operations and sourcing policies by disclosing against the TCFD, and UK-based environmental group CDP's forest-program disclosure framework</td><td>❑ Disclose how they are managing E&S risks, including deforestation, climate change and human-rights abuses in their lending activities, especially in agriculture and forestry sectors</td></tr>
<tr><td colspan="2">❑ Committing to setting science-based targets to minimise climate-risk exposure</td><td>❑ Develop and disclose a palm-oil sector policy that requires clients to make time-bound commitments to achieving 100% RSPO certification, NDPE compliance and supply-chain traceability to the plantation level, for own operations and third-party sources</td></tr>
<tr><td>❑ Disclose the location, size and composition of their planted and unplanted landbanks, such as land area consisting of peat, HCV and HCS areas. Where applicable, request companies disclose the number of hectares of land affected by Indonesia's forest and peat moratoria and expected peatland restoration requirements</td><td>❑ Commit to and disclose time-bound plans for sourcing only RSPO-certified (identity-preserved or segregated) and NDPE-compliant palm oil</td><td>❑ Disclose the percentage of palm-oil clients' production and processing operations verified as RSPO certified and NDPE compliant</td></tr>
<tr><td>❑ Join RSPO and develop/ disclose time-bound plans to achieving 100% RSPO certification; for more advanced companies, to make time-bound commitments to NDPE and 100% traceability to the plantation level</td><td>❑ Commit to and disclose time-bound plans for achieving 100% supply-chain transparency and traceability to the plantation level</td><td></td></tr>
<tr><td>❑ Participate in landscape and jurisdictional approach-based projects to address illegality and unsustainability in their smallholder supply bases</td><td>❑ Commit to purchasing a portion of their palm-oil supply from RSPO-certified smallholders or to supporting uncertified smallholders toward certification, preferably with a commitment to also purchase from them, through landscape or jurisdictional approach-based projects</td><td></td></tr>
</table>

Source: WWF

Notes

Market profiles

Australia 91

China 116

Hong Kong 141

India 163

Indonesia 192

Japan 207

Korea 240

Malaysia 260

Philippines 284

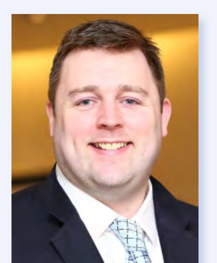
Singapore 303

Taiwan 330

Thailand 352

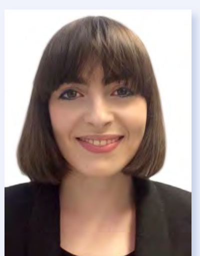
All prices quoted herein are as at close of business 4 December 2018, unless otherwise stated

Notes



Dr Heath Grow

Former Senior Research Manager, ACGA



Alexandra Einfeld

Research Associate, ACGA

alex@acga-asia.org

Jamie Allen

Secretary General, ACGA

jamie@acga-asia.org

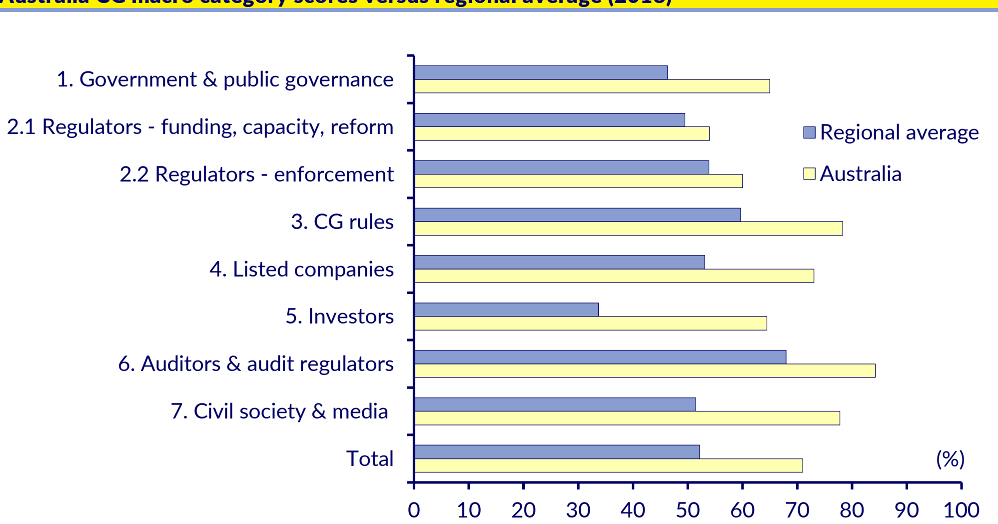
+852 2160 1788

Australia - A bank-burnt country

- Slim majority in the federal parliament is impeding reform
- Whistleblower legislation stalls in the senate; calls for a federal ICAC increase
- Regulator forces banks to compensate customers for "fees-for-no-service" scandal, while banking royal commission exposes unethical practices
- Corporate reporting strong on financials and CG, somewhat weaker than expected in ESG; company scores stand head and shoulders above the region
- Institutional investor bodies publish their own stewardship codes
- ASIC highlights ongoing problems with quality os audits

Figure 1

Australia CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

Australia ranked 1st with an overall score of 71%

Australia has once again performed well in most sections of *CG Watch* and ranks 1st overall. However, a litany of banking scandals and public-governance problems, as well as our reorganised survey and scoring system, has resulted in a score of 71% in 2018 - notably lower than the 78% it scored in 2016. The country scores highest on investors, and auditors & audit regulators, although there is still room for improvement in auditing, audit quality and regulation. Next-highest were CG rules, and civil society & media. Listed companies performed well, due to public disclosures and transparency, but somewhat below expectations. An unstable parliament, the financial-services royal commission and a range of public-governance weaknesses undermined both government & public governance, and regulators, which also suffered from funding and other limitations. In brief, despite a robust CG ecosystem, it does not lead the region in all areas and is letting itself down in both public and corporate governance.

1. Government & public governance

An unproductive parliament

Australia ranks 1st with score of 65%

Australia leads the region for government & public governance, yet has a relatively low score and only holds a slim lead over Hong Kong. Continued instability in the national parliament in Canberra has resulted in politicians turning their attention to party-based and personal issues, distracting them from their principal jobs as legislators. Since 2007, the country has had seven prime ministers, four general elections, two changes in ruling party and a difficult time keeping abreast of all the cabinet reshuffles. Consequently, successive governments have struggled to progress their legislative agendas - CG reforms are simply not a high priority. In contrast to almost all Asian markets, Australia still has no mandatory rule on voting by poll and a new law on whistleblowing has been delayed.

The Hayne royal commission

Financial-services royal commission launched in December 2017

The issue of alleged misconduct in the banking, superannuation and financial-services industry across Australia reached a peak during 2016-18. This led to the formation of a royal commission in December 2017, chaired by the Honourable Kenneth Hayne AC QC. Such misconduct is not new - over 2012-13, Australian banks and wealth-management companies were implicated in serious ethical breaches in their pension advisory businesses, leading to prosecutions by the Australian Securities and Investments Commission (ASIC), the peak securities regulator. ASIC later commenced court action against ANZ, NAB, Westpac (2016) and CBA (2018) for rigging the interbank interest rate, known as the bank bill swap rate (BBSW). In June 2016, former ASIC chairman Greg Medcraft began a campaign to force banks to address failings in their internal culture. After resisting pressure to establish a financial-services royal commission, the government relented in late 2017.

Banks and insurers have engaged in a range of misconduct

Although Australia came out of the global financial crisis in strong financial shape, its success appears to have bred complacency within the four big banks (Westpac, CBA, NAB and ANZ) and the four big insurance firms (IAG, AAI, QBE and Allianz). In addition to the problems outlined above, these highly profitable and apparently well-governed firms have between them engaged in a range of misconduct, including:

- Automating loan approvals using flawed algorithms and no human intervention;
- Bank officers telling consumers how to get around loan-approval processes and collecting sales commissions in the process;
- Lending money to people with little capacity to repay;
- Forging customer signatures on insurance documents;
- Not settling legitimate insurance claims;
- Facilitating money laundering; and
- Charging fees for no service (ie, services they knew they would not provide).

Interim report revealed endemic corporate greed

After receiving 9,388 submissions, the commission tabled its interim report in the federal parliament on 28 September 2018. Of the submissions, 62% related to banking, 9% to superannuation, 9% to financial advisory services and the remainder covered other areas. The clear message that permeates the report is that corporate greed has become endemic. There are significant questions to

answer as to how financial-services staff are remunerated, how banks lend, whether the response from the market and prudential regulators has been appropriate, and whether external dispute mechanisms are satisfactory. The full report is due to be released in February 2019.

Fragmented anticorruption framework

Corruption perceived to be rising gradually . . .

Although Australia is regarded as one of the least corrupt countries in the world, the problem may be slowly worsening. According to Transparency International (TI), Australia's score and rank in its annual *Corruption Perceptions Index* has fallen from 85% and seventh place in 2012 to 77% and 13th in 2017. Australia is now on equal footing with Hong Kong and Iceland.

. . . but limited evidence of an actual rise in corruption

There is little evidence on the ground that the overall rate of corruption has increased, although a number of high-profile incidents over the past two years have certainly sparked media and community interest. These include ministers and politicians inappropriately claiming expenses, corporate whistleblowing scandals that have highlighted weak protections for private-sector whistleblowers, and revelations during the Royal Commission into Trade Union Governance and Corruption in 2014-15 that there were instances of inappropriate revenue flows from employers to unions and their officials.

New initiatives on parliamentary expenses, whistleblower protection and corrupting benefits

The government has started to address these issues through various initiatives. It established the Independent Parliamentary Expenses Authority to oversee MPs' expenses. It drafted new laws, in particular the *Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2017* to strengthen whistleblower protection in the *Corporations Act*. And it passed the *Fair Work Amendment (Corrupting Benefits) Act 2017* in order to amend the *Fair Work Act 2009* in relation to the giving, receiving or soliciting of corrupting benefits.

Community views on what constitutes "corruption" are changing

Tackling corruption is a complex affair, due in part to the malleable nature of what constitutes "corrupt practice". Yet community values are changing, with people more critical today of undue influence. As one state anticorruption official put it, giving somone a bottle of wine as a gift may well be viewed as corruption today, especially if the recipient does not declare it, but 30 years ago it would have attracted much less attention.

Australia has a state-based anticorruption system

In an effort to keep their public sectors clean, each of the five state governments has established an independent anticorruption commission (ICAC) or similarly named body. Regarding the two territories, the Northern Territory will bring a commission into operation by the end of 2018, while the Australian Capital Territory is still debating the legislation to establish one.

State ICACs largely limited to investigating public-sector corruption

The primary function of the state-based bodies is to investigate allegations of wrongdoing and corruption within the public sector and public-private partnerships. In other words, their investigatory powers do not extend to corruption within the private sector, which is the remit of the police. Not surprisingly, state police do not prioritise this work because investigations are time consuming, labour intensive and do not align with community expectations of what the police should do.

Australia still lacks federal ICAC

A second weakness of the Australian system is the lack of a federal ICAC, a topic that has gained increasing prominence over the past two years. The gravity of corruption allegations at the Commonwealth level prompted the senate to look into public-sector corruption during 2016-17. It reconvened the Select

Committee on a National Integrity Commission in February 2017. This cross-party committee described the current multiagency framework as fragmented and identified at least 10 agencies that had 'specific legislative responsibilities to address and prevent corruption'. The Commonwealth Ombudsman, in contrast, said the separation of power was positive because it promoted 'accountability and transparency and can protect against abuse of power within the anti-corruption framework itself'.

Pressure builds for a federal ICAC

Strong support for federal ICAC

In December 2017, the Centre for Policy Development, an independent policy institute based in Sydney and Melbourne, released a discussion paper titled, 'What do Australian's Want? Active and Effective Government Fit for the Ages'. The paper suggests there is broad support in the community for establishing a federal ICAC (77% were in favour) and also a tougher code for parliamentarians (79%).

Federal opposition says it will establish national ICAC

In January 2018, the federal opposition Labor Party released a policy statement indicating its intention to establish a national ICAC within 12 months of being elected to government. The initial design contains provisions for investigating federal parliamentarians, their staff and other federal public servants. The policy does not appear to cover the private sector, even if an alleged corrupt practice involves the public sector. Meanwhile, while the government admits there are issues with the current system, it prefers to consolidate the powers of existing agencies with the aim of increasing their efficiency and effectiveness.

Federal politicians held to lower standard of conduct than public servants

One reason why many federal politicians may be lukewarm to the idea of a federal ICAC is because they are held to lower standards of conduct than public servants. The latter are subject to a mandatory code of conduct that covers a variety of conflicts of interest and requires the disclosure of material personal interests. Politicians are not bound by such a code. They only need declare their interests to parliament, while ministers must merely abide by a principles-based statement on ministerial standards that says they will 'be required to stand aside if charged with any criminal offence, or if the Prime Minister regards their conduct as constituting a prima facie breach.' Since the statement is not a code, the prime minister may change it at will.

New whistleblowing law delayed

Whistleblowing legislation is not uniform

Legislation that governs whistleblowing practices in Australia is not uniform. Private-sector disclosures are governed nationwide by the *Corporations Act*. Public-sector disclosures at the Commonwealth level are made in accordance with the *Public Interest Disclosure Act*, with equivalent legislation enacted in states and territories.

Private-sector provisions lag public sector

Current private-sector provisions contained in the *Corporations Act* (Part 9.4AAA) are relatively weak, eg, whistleblowers must be current employees, officers or a person or employee of a person with a contract to supply goods and services to a company. Anonymous disclosures are not permitted and disclosures must be in good faith.

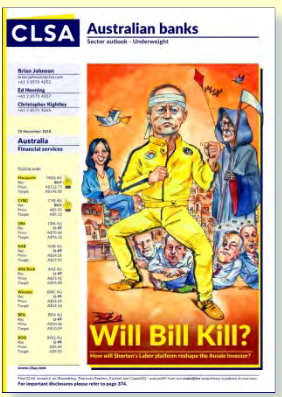
Bill to enhance whistleblower protections before the senate

In September 2016, the federal parliament convened a joint committee to rectify the situation in the corporate, public and not-for-profit sectors. The committee sought submissions and held public hearings on a range of issues. In December 2017, the first and second readings of the *Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2017* took place. The explanatory memo to the bill states that the *Corporations Act* will be amended to strengthen and consolidate whistleblower protection for the corporate and financial sectors, while whistlebelowers would be given protection when disclosing on breaches of tax laws. A greater number of people would be protected because disclosure could be made anonymously and there will be new sanctions against those who disclose the identity of whistleblowers without permission. The bill is still before the senate and has yet to progress to a second reading, despite a motion being moved to this effect on 7 December 2017.

ASX 200 companies have room to improve

Although the legislation may have stalled, the Australian Council of Superannuation Investors (ACSI), the peak body for industry pension funds in Australia, recently reviewed whistleblowing regimes in ASX 200 companies. In its March 2018 report, titled *Codes of Conduct, Whistleblowing and Corporate Culture*, it found that many companies were exhibiting good behaviour, while some needed a nudge in the right direction. The ability to make disclosures anonymously and without fear of reprisal is fundamental to whistleblowers feeling protected. While anonymous disclosures are not currently protected at law, it found that 55% of companies did allow some form of anonymity throughout the whistleblowing process. Retaliation against whistleblowers is prohibited for lawful disclosure, yet only 86% of companies explicitly state in their code of conduct, or standalone whistleblower policy, that the practice is not acceptable.

Brian Johnson
brian.johnson@clsa.com
+61 2 8571 4252



Financial services royal commission
Rumsfeld's "known knowns" - Lots of outrage, short on action

The financial-services royal commission (FSRC) interim report is long on outrage but short on action. The absence of specific recommended action was a lot better than was widely expected, and Australian banks initially rebounded. The body of the document details the banks' various digressions, but these were "known knowns". It was already expected that the FSRC would conclude that: (i) banks pursued 'short term profit at the expense of basic standards of honesty', (ii) product push became the focus regardless of client needs, and (iii) the punishments for deeds of misconduct were inconsequential.

So what did we learn from the FSRC interim report? Probably two things: (i) that as a result of inconsequential punishment, regulators were in part to blame for banks' bad behaviour, and (ii) there was not a problem with the regulation system per se, but rather the enforcement was weak. This is not to say that banks have escaped the FSRC unscathed, but rather that the day of reckoning isn't until the commission's final peport is released by 1 February 2019 (bank CEOs faced hostile FSRC hearings in November 2018 after the semi-annual Economics Committee Hearings in October 2018).

Amidst an admonishment from the federal treasurer and cries of regret from bank CEOs and the Australian Banking Association, it is noteworthy that the opposition Labor Party, currently well ahead in the polls, is again politicising the FSRC in contrast to the present prime minister's previous resistance towards a

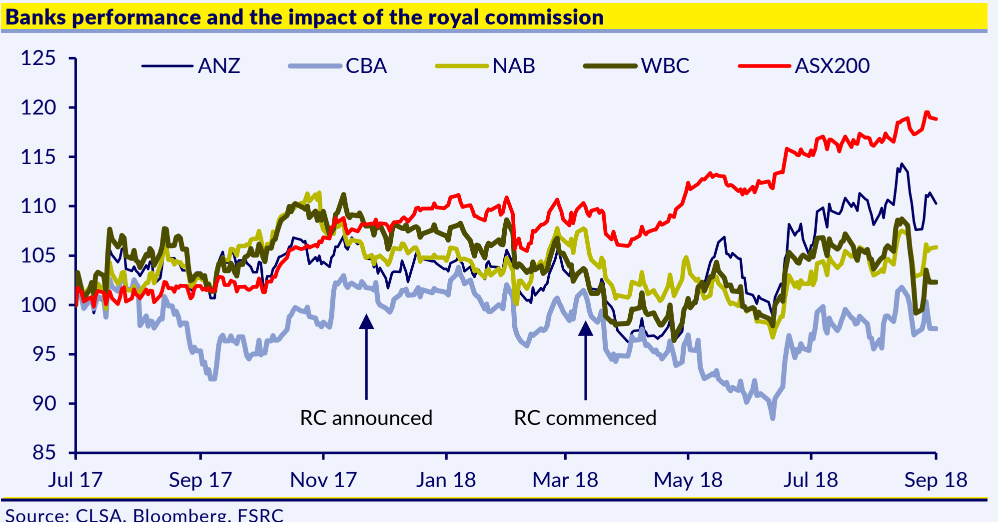
banking royal commission. Election campaign "bank bashing" by both the government and Labor has now commenced in the runup to the federal election, to be held before 19 May 2019. The Labor Party is ahead in the polls with bank unfriendly policies.

So what are the potential implications of the FSRC?

1. **Potential manageable financial penalties for legal breaches and remediation expenses**. Although the government has flagged its intention to lift potential ASIC penalties, it is unlikely this could be imposed retrospectively,
2. **The FSRC and looming federal election are likely to reduce banks previously unfettered pricing power to lift benchmark back-book housing-loan rates to preserve high ROEs.** The risk is that the federal 6bp bank levy is increased, which could easily obliterate the NIM uplift from September's housing repricing.
3. **Credit availability becomes more disciplined for housing, credit cards and auto loans.** Interest-only and high LVR loans will be harder to get, which will slow credit growth and temper Australian house prices. Banks are lobbying politicians to remove credit restrictions, due to the risk of a credit crunch.
4. **Conflicted commission structures for lending, wealth management and insurance will be removed.** There will be a shift towards much reduced "fees for service", which could be good for banks.
5. **Banks are losing the public-relations battle and increasingly moving to reduce fees**, eg, foreign ATM fees, and reduced FX transfer and retail banking fees - none of these moves are material.
6. **Under the new Bear regime, bank-executive remuneration will be directly impacted by penalties/remediation charges**. Further regulators will gain more interventionist powers (eg, in September 2018, ASIC released a report critical of the time banks took to report breaches and settle customer remediation).
7. **Royal commissions have broad investigative powers and a nasty habit of turning up new issues.**

Australian banks have underperformed ASX 200 since FSRC was announced and hearings commenced

Banks performance and the impact of the royal commission



Source: CLSA, Bloomberg, FSRC

2. Regulators

Australia ranks 5th with score of 57%

Australia underperforms in this part of our survey for a range of reasons. The Australian Securities and Investments Commission (ASIC), the peak securities regulator, suffers from funding issues, variable political support and reputational issues. It is not clear that ASIC or the ASX, the national stock exchange, have been investing substantially in improved surveillance and enforcement. There have been few major changes to company or securities laws and regulations in the past two years. Enforcement efforts have been mixed, while the lack of information provided by ASX making assessment of this work difficult. On a more positive note, Australia does well on access to regulatory and company information - and ASIC disclosure is impressive.

Treasury oversees financial regulation, with APRA and ASIC forming "twin peaks"

The treasury overseas the financial regulatory system in Australia and provides policy advice on fiscal stability, productivity and global integration. Two independent bodies, both of which have a high level of autonomy, have oversight of the market. The Australian Prudential Regulation Authority (APRA) undertakes prudential regulation of deposit-taking institutions, life and general insurance, and superannuation funds. ASIC is responsible for the regulation of conduct and consumer protection in the securities markets, and oversees the *Corporations Act 2001*, meaning it has a dual role as both the securities and corporate regulator. The two bodies thus make up what is often referred to as the "twin peaks" of the regulatory system.

ASX is the national exchange, while ACCC is the competititon regulator

Securities trading is carried out through the Australian Securities Exchange (ASX), a listed company that also has a frontline regulatory role over both listed companies and trading participants. Meanwhile, the Australian Competition & Consumer Commission (ACCC) monitors anticompetitive practices.

2.1 Funding, capacity-building and regulatory reform

Australia ranks six in this sub-category with a score of 54%

Australia performs below expectations in this sub-category. in part because of issues arising from the previous category - government & public governance - and also due to decisions made by individual regulatory agencies. It is important to note that this category examines progress and efforts made over the past two years in institutional capacity building and regulatory reform, as well as the current status of funding for regulators. Australia performs relatively better in the next sub-category: enforcement.

Levies from financial institutions make up bulk of APRA's funding

As independent bodies, APRA and ASIC have their own budget allocations. APRA is funded mainly from levies paid by the institutions it supervises. It collects financial institutions supervisory levies on behalf of the government - these typically amount to around A$250m per year - and pays this money into government consolidated revenue. The government then allocates a portion to APRA after deducting funds to cover other regulatory expenses. APRA's operating expenditure for the year ending 30 June 2018 was A$144m, compared to almost A$130m for the previous year, with the increase due not to a bigger employee benefit bill but rather payments to outside suppliers, such as professional services and consultants. While most of these expenses were covered by the government appropriation to APRA, a small portion was paid for by the authority's own sources of revenue, including recovery of expenses from prudential inquiries and "rendering of services".

New user-pays system for ASIC from 2018-19

The funding of ASIC has until recently been somewhat different: while it also receives budgetary allocations from the federal government, it has not been collecting levies from the institutions it supervises. This is changing in the current 2018/19 financial year with the introduction of new user-pays system.

ASIC expenses - and government funding - has been more volatile

Whereas APRA appears to be adequately funded for the work it has to do - its expenses have steadily increased from around A$116m in FY13 to A$144m in FY18, albeit with a dip to A$129m in FY17 - those for ASIC have experienced more of a U-shaped curve, as the following table shows:

Figure 2

ASIC expenses and budget allocations

(A$m)

FY	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Total expenses	411	405	354	371	392	401
Government allocations	350	346	312	311	341	348

Note: ASIC losses were fully attributable to the Australian government until FY18, when a substantial portion started to be covered by the new industry levies.

Source: ASIC annual reports, ACGA analysis

Does ASIC have sufficient funds to do its job?

Has ASIC had sufficient funds to do its job properly in recent years? It is a difficult question to answer, but the evidence suggests not. Certainly its drop in spending in recent years has been a negative - especially at a time when risks to the financial system were building up, as the recent banking royal commission has shown. It is also worth highlighting that ASIC's expenses in FY18 are actually lower than FY13, while the annual budgetary allocation from government is about the same. In contrast, APRA's budgetary allocation has risen from A$114m in FY13 to A$150m in FY18.

Compared to the SFC in Hong Kong, ASIC appears underfunded

Another point of comparision worth drawing is with the budget of Hong Kong's Securities and Futures Commission (SFC). It had expenses in 2017/18 of HK$1.7 bn (A$283m) - around 70% of ASICs' spending for the same year. Yet the SFC is only responsible for regulating the securities market in Hong Kong and governs one main law, the *Securities and Futures Ordinance (Cap 571)* and subsidiary regulation. ASIC is 'Australia's integrated corporate, markets, financial services and consumer credit regulator', as its annual report states, and administers 11 acts of parliament. It is also Australia's regulator for the external auditors of listed companies - a job the SFC does not have to do. The point is not to suggest the SFC has an easy life - far from it, as our Hong Kong chapter shows. Rather, that ASIC has a much bigger mountain to climb and fewer resources to do it with. (The SFC also does not have to argue with the government over annual budgetary allocations: since its founding it has been funded mostly by a levy on stock transactions, a far simpler system than the user-pays model ASIC is introducing.)

The government appears to accept ASIC needs more powers and funding

Although ASIC is regularly criticised by the government, politicians, business community, media and others for its performance, the commonwealth government appears to accept that the regulator needs more resources and powers. Canberra has, for example, agreed in-principle with all the recommendations contained in the *ASIC Enforcement Review Taskforce Report* of December 2017. It is making an additional A$550,000 available to the regulator to hire former audit-firm partners to inspect the big four auditing firms. And in response to the financial scandals that have plagued the nation, the government is also giving an additional A$70m to ASIC so that it may focus on enforcement, supervision and the creation of a taskforce that will 'conduct a proactive, targeted and thematic review into corporate governance to identify and pursue failings in large listed companies, including deploying staff to conduct new on-site surveillance and investigations.'

CG-related legislative reform has been light

Limited regulatory reform

Regulatory reform relevant to CG has been light in Australia over the past two years, thanks in large to the federal parliament's legislative bottleneck. As one official told ACGA, 'It is hard to get things through. There must be a burning platform to get things done.' He added that the civil service has trimmed down so much, 'they just do not have the people to do these things.' Some progress has been made, however, in the following areas (though not all initiatives have been turned into actual regulation):

Corporations Act amendments and phoenixing activity

- **Legislation:** The government has managed to amend the *Corporations Act 2001* on 17 occasions during 2016-18. The most significant change was the introduction of professional standards for financial advisers.
- **Phoenixing activity:** This refers to directors closing one company and starting a second, then transferring the assets from the first to the second to avoid debts from the first company. The government plans to address these scams by introducing a director identification number (DIN), which is designed to be a perverse tracking mechanism akin to a national identity number. The minister for revenue and financial services highlighted in September 2017 that the DIN database will 'interface with other government agencies and databases to allow regulators to map the relationships between individuals and entities and individuals and other [persons].' The peak body for directors, the Australian Institute of Company Directors, supports this initiative. Yet more than a year after announcing the plan, the government has made no further statements.

ASX listing rule amendments and reviews

Meanwhile, ASX has made certain amendments to its listing rules (or plans to):

- December 2017: A modified rule on reverse takeovers (an issue touched upon in CG Watch 2016). The ASX rule change was welcomed by lawyers, but it does not go as far as some investors and CG advocates would like.
- March 2018: An update to Guidance Note 8, which deals with the disclosure of market-sensitive contracts and disclosure by entities in financial difficulties. Guidance Note 12, which deals with significant changes to activities, was also updated to reflect a change in policy with regard to backdoor listings. Directors and proposed directors now have to supply evidence of their good name and character.
- May 2018: ASX began a six-month review of its rules and by the beginning of October 2018 had compiled more than 170 pages of proposed changes. The exchange plans to release a 35-page consultation on the proposed changes in the near future. During an interview with ACGA, the exchange indicated that the primary amendments would include: revisions to disclosure and integrity rules; efficiency measures to make rules simpler and easier to follow; some general housekeeping changes to terminology, format and presentation; removal of some outdated sections.

2.2 Enforcement

Australia ranks equal third in this sub-category with a weighted score of 60%

Australia performs reasonably well in this sub-category - and for reasons that may not resonate with many Australians: ASIC does better at enforcement than its public image suggests. Although still perceived in the media and public at large as a toothless tiger, and justifiably criticised for some of its handling of bank governance problems, it has arguably one of the toughest regulatory jobs in the country.

ASIC took on big banks over rigging of the interbank rate - and mostly won

Some of ASIC's enforcement initiatives and outcomes are well known. Under the former chairman, Greg Medcraft, it took on the big banks over their role in manipulating the bank bill swap rate (BBSW), and launched civil litigation against

ANZ in March 2016, Westpac in April 2016, National Australia Bank (NAB) in June 2016 and Commonwealth Bank (CBA) in January 2018. NAB and ANZ settled in November 2017 to the tune of A$50m each, while CBA parted with A$25m in June 2018. Westpac was the only bank to fight the case and win.

Some ASIC successes have barely registered with the public

Oddly, other ASIC successes seem to have barely registered with the business and financial community - judging by comments made to ACGA during our research for this survey. Well before the Hayne royal commission was formed in late 2017 and 'fees for no service' became the phrase *du jour*, ASIC had issued a detailed report, *Financial Advice: Fees for no service* (Report 499) in October 2016. It recovered A$222m for consumers affected by this scandal over 2016-18, with the number expected to rise to more than A$364m by the end of August 2018. Payments are ongoing, yet few people we spoke to seem to have read this report or even be aware of it.

Enforcement statistics tell a wider story

Detailed enforcement statistics in ASIC annual reports, enforcement outcomes reports and press releases on its website also tell a wider story - eg, from July 2016 to June 2018, ASIC achieved the following outcomes:

- Concluded 316 investigations and commenced a further 285;
- Banned 48 persons from being directors (July 2017-June 2018 only);
- Charged 40 persons in criminal proceedings and a further 805 persons in summary prosecutions for strict liability offences;
- Oversaw compensation and remediation payments of more than A$1.12bn to investors and consumers, including A$617m from four former officers and the fund manager of MFS Investment Management.
- Levied A$42m in civil penalties and more than A$6m in fines.
- Entered into 24 court-enforceable undertakings and received A$48m in community benefit fund payments. Levied an A$35m civil penalty on Westpac for breaching responsible lending obligations when providing home loans to consumers and not fully taking into account their ability to repay the loans.

A summary of ASIC's enforcement outcomes from July 2014 to June 2018 is presented in the table below and shows some interesting trends.

Figure 3

ASIC enforcement outcomes

	Criminal		Civil		Admin		Court enforceable undertaking & Negotiated Outcomes		Public Warning Notices		Sub-total	
	2014-16	2016-18	2014-16	2016-18	2014-16	2016-18	2014-16	2016-18	2014-16	2016-18	2014-16	2016-18
Corporate Governance												
Action against auditors					6	14	3	2			9	16
Action against liquidators	1	1	2	1	2	3	13	11			18	16
Action against directors	21	8	10	3	13	3		3	1		45	17
Insolvency	1	1		3	12						13	4
Other corporate governance misconduct			5	12	41	15	2	1			48	28
Total	**23**	**10**	**17**	**19**	**74**	**35**	**18**	**17**	**1**	**0**	**133**	**81**
Financial Services												
Credit	9	6	4	11	90	153	23	18			126	188
Dishonest conduct, misleading statements	6	8	29	34	46	50	6	6			87	98
Misappropriation, theft, fraud	3	1		2	10	10					13	13
Unlicensed conduct	1	1				1	2	21	2		5	23
Other financial services misconduct	4	2	8	23	69	78	52	39	2		135	142
Total	**23**	**18**	**41**	**70**	**215**	**292**	**83**	**84**	**4**	**0**	**366**	**464**
Market integrity												
Continuous disclosure	1	1		4	10	5	2				13	10
Insider trading	11	2	1	1		1	2				14	4
Market integrity rules					19	19		2			19	21
Market manipulation	6	1			1	2					7	3
Other market misconduct	7	4		7	2	9	3	8			12	28
Total	**25**	**8**	**1**	**12**	**32**	**36**	**7**	**10**	**0**	**0**	**65**	**66**
Combined Total	**71**	**36**	**59**	**101**	**321**	**363**	**108**	**111**	**5**	**0**	**564**	**611**

Note 1: This table excludes ASIC's enforcement outcomes for its Small Business category as it is beyond the scope of our analysis. Note 2: ASIC ceased reporting Public Warning Notices in 2014. Source: ASIC enforcement reports, ACGA analysis

Reduction in criminal prosecutions, rise in civil actions

One trend over the past two years has been a sharp reduction in the number of criminal prosecutions: from 71 in 2014-16 compared to 36 in 2016-18. Conversely, there has been a significant increase in the number of civil actions: from 59 to 101 over the same period. Meanwhile, administrative sanctions have risen and enforceable undertakings have stayed steady.

Decrease in actions against directors

Another trend is that actions against directors, whether criminal, civil or administrative, have decreased significantly from 45 cases in 2014-16 to just 17 in 2016-18. Other CG misconduct has broadly followed a similar path, with only 28 incidences in 2016-18 compared to 48 in the previous period.

Few insider trading and manipulation cases

The table also shows that the number of insider trading and market manipulation cases remain very low and fell over the two periods. While it is acknowledged that these crimes are difficult to police, the number of outcomes achieved by ASIC may not reflect the level of insider trading in the market.

The toothless part

Communication problems

While ASIC has made progress and deserves credit for its performance above, it often comes across as a poor communicator. While it is able to get the big story across - “bank culture needs to change” - it appears to have had less success in winning over the media, public and even politicians to its more technical achievements.

Royal commissioner takes aim at ASIC

It has also relied a great deal on the softer mechanisms of enforceable undertakings and negotiated outcomes, rather than taking offenders to court in criminal and civil cases. This point was echoed in the Hayne royal commission’s interim report:

> ‘When misconduct was revealed, it either went unpunished or the consequences did not meet the seriousness of what had been done. The conduct regulator, ASIC, rarely went to court to seek public denunciation of and punishment for misconduct. The misconduct was revealed, little happened beyond apology from the entity, a drawn out remediation program and protracted negotiation with ASIC of a media release, an infringement notice, or an enforceable undertaking that acknowledged no more than that ASIC had reasonable “concerns” about the entity’s conduct. Infringement notices imposed penalties that were immaterial for the large banks. Enforceable undertakings might require a “community benefit payment”, but the amount was far less than the penalty that ASIC could properly have asked a court to impose.’

ASX’s opaque disclosure

ASX enforces through a separate entity, ASX Compliance

The enforcement story at ASX is quite different. It carries out its frontline role through a subsidiary company, ASX Compliance, which surveils issuers and monitors their reports, announcements, market practices, approves new listings, and sanctions listed companies and other market participants for rule breaches.

Lots of statistics, but no narrative

While ASX publishes a useful monthly activity report that includes a year-on-year snapshot of key metrics such as listings, capital raisings, cash market volume and value, listings compliance activity, and enforcement work (including referals to ASIC), there is no narrative explanation of the statistics beyond simple labels, such as “continuous disclosure referrals” or “other referrals”.

No announcements of enforcement actions against individual companies

Nor is the exchange willing to change its policy on disclosure of enforcement actions against individual companies, an issue raised in *CG Watch 2016*. It delegates the responsibility of reporting reprimands and other sanctions to affected issuers. The probability, therefore, of identifying exactly whom the exchange is reprimanding is extremely low - unless one is able to monitor the daily announcements of 2,250 companies!

ASX enforcement disclosure well below best practices in Asia

We appreciate the ASX is a for-profit entity and, as such, faces conflicts of interest between its commercial and regulatory roles. But such a low level of disclosure would not be acceptable in Asia - and is far below the best-practice standard currently set by HKEX, another for-profit exchange, not to mention the increasing transparency from other exchanges, such as Bursa Malaysia and SGX.

Are regulators winning the battle?

Some evidence that the equity market is becoming cleaner

Some evidence suggests they are making an impact: ASIC's *2016 Review of Equity Market Cleanliness* found an overall improvement in the market over the past decade. The research examined the extent of information leakage ahead of material, price-sensitive announcements in Australia, finding a decline in anomalous trading over the examined period (the five years leading up to and after the transfer of market supervision to ASIC). While this result is positive, concerns remain about penalties for white collar crime being too low, as discussed further in the following section.

3. CG rules

Australia ranks 1st with a score of 78%

Australia continued its strong performance in this area from 2016, ranking 1st in the region with a score of 78%. Its financial reporting rules are on par with international benchmarks, while its corporate governance reporting standards range from good to excellent (with one exception - see below). Australia has a comprehensive and well-established continuous disclosure regime which imposes strict reporting obligations. Concepts like "independent director" are clearly defined under the rules and the national CG code is of high quality. Regulatory guidance documents are well written, practical and updated regularly. And companies are obliged to release their AGM notices with detailed agendas and explanatory circulars at least 28 days before the meeting.

Where Australia stands out

Highlights of Australia's CG-rule regime

Certain aspects of the Australian CG regime are significantly more robust than the rest of the region. For example:

- **Strict remuneration disclosure:** *The Corporations Act* obliges companies to present detailed remuneration reports to shareholders at AGMs. They must disclose the board's policies for determining the nature and amount of remuneration paid to key management personnel, the relationship between policies and company performance, performance hurdles and actual remuneration paid to senior executives and directors. Companies typically produce reports of 20-30 pages, a level of detail unseen in Asia. Indeed, some investors complain that the level of detail is too high!
- **Ease of nominating independent directors:** This is generally easier in Australia than other markets. There is no significant restriction at law and, while some companies impose a 5% shareholding or 100-signature requirement, others do not. One retail shareholder told ACGA he had nominated more than 40 individuals without difficulty.

- **Collective engagement:** Institutional shareholders are free to undertake collective engagement activities without undue burden from concert-party rules. While such rules exist in Australia, they are concerned with attempts by groups of investors to, as ASIC says, 'surreptiously obtain a substantial stake in or illegitimately obtain control over an entity' in a way that could harm the entity and the interests of other investors. Regulators are fully aware that routine engagement with companies on governance or ESG grounds does not constitute the type of concert-party action described above. ASIC published a regulatory guidance document (RG 128) on this subject in June 2015, titled *Collective Action by Investors*. It was based on previous guidance published in 1998 and 2007.

Revision of ASX corporate governance principles

Polarised response to CG-principles reform

In May 2018, the ASX Corporate Governance Council released a proposed fourth edition of its *Corporate Governance Principles and Recommendations*. With its consultation period coinciding with the Hayne royal commission and ongoing public scrutiny of corporate practices, the Council received a considerable response (100 submissions). While the exchange cannot change the *Corporations Act 2001*, it can bring about change by way of best practice - eg, in the revised principles, the exchange proposes listed entities should ensure that all resolutions at a meeting of security holders are decided by a poll, rather than by a show of hands. Other changes focus on accountability, governance, culture and social licence to operate, diversity, carbon and cyber risks, as well as whistleblowing policies.

What is a "social license to operate"?

The introduction of the concept of "social licence to operate" has, however, polarised respondents. This concept mandates that an entity's board has 'regard to the views and interests of a broader range of stakeholders than just the entity's security holders', such as employees, customers, suppliers, creditors, regulators, consumers, tax payers and local communities. Some respondents felt this was a positive step, especially amid a backdrop of multiple governance scandals revealing unethical behaviour towards such stakeholder groups by some of Australia's largest corporations. Others have raised concerns about inconsistency with Australian corporate law, which imposes on directors a statutory duty to act in the listed entity's best interest (section 181 of the *Corporations Act 2001*). The final version of the code will be released in early 2019.

Higher penalties for white collar crime

Civil penalties for white-collar crime criticised as too low

The recent Senate Committee on Penalties for White Collar Crime (2017) highlighted significant limitations in the effectiveness of civil penalties. In particular, penalties for insider trading have been repeatedly criticised as too low to be an effective deterrent. With a maximum of A$200,000 for an individual and A$1m for a body corporate, some commentators have argued that the penalties are viewed as just another cost of doing business, given the potential profits to be made.

Government agrees to increase penalties, but no date set

The government agreed to the Senate Committee's recommendation to increase the penalties for offences under the *Corporations Act 2001* to more closely reflect those in other countries. This has not yet come into force. The new penalties will be the greater of A$1.05m or 3x the value of benefits obtained, or losses avoided, for individuals and the greater of A$10.5m or three times the value of benefits obtained, or losses avoided or 10% of annual turnover for corporations.

Concerns that companies more easily escape prosecution than individuals

A further issue that concerned interviewees was the perception that companies more easily escape prosecution compared to individuals, given the higher cost and difficulty of pursuing litigation against them. The disparity between a high overall success rate (up to 97%) but few corporate prosecutions is seen as an overall trend across white-collar crime. Additionally, sentences have in some cases been well below the maximum penalty, in a context where the penalties prescribed by legislation have already been in need of increase.

Room for improvement: ESG reporting

Some large listed companies continue to have little or no sustainability reporting

Unlike several jurisdictions in Asia, formal ESG reporting is not a requirement under listing rules. The ASX CG principles includes a recommendation that companies disclose their material ESG risks and how they are managing them, but this is only subject to "comply or explain". To fill the guidance gap, the Australian Council of Superannuation Investors (ACSI) and the Financial Services Council (FSC), the peak industry body for asset managers, jointly published an ESG reporting guide in 2016. This followed research by ACSI showing that around a third of the top-200 companies did not have good quality ESG reporting (either very basic or none at all). ACSI has continued to track the quality of such reporting in Australia and outlines a number of improving trends in its latest report, published in June 2018. Yet the council also makes a pointed criticism: 'Yet again, ACSI has identified large listed companies who provide very little or no reporting on sustainability issues. This lack of transparency demonstrates lamentable complacency and a disregard for stakeholders' needs.'

Closed periods

Blackout rules allow companies significant flexibility

Closed periods that limit director trading ahead of the release of financial results are effectively mandated in Australia under ASX listing rules (Guidance Note 27). However, entities have significant flexibility as to how they put this into practice. They can choose between two options: either specify fixed blackout periods, during which trading by key management personnel is prohibited, while allowing trading during the rest of the year; or prohibit trading by key management personnel at all times, with the exception of specified short "trading windows".

Trading windows decrease risk of insider trading

The rules state that, 'Many people consider trading windows to be preferable to blackout periods, since they typically lead to shorter periods during which key management personnel are permitted to trade, making them more effective in reducing the risk of insider trading and easier to administer.'

Length and timing at the discretion of companies

The rules do not prescribe either the length or the timing for the required closed period - this is determined by the entity, based on what is appropriate for its circumstances and considering that the intent is to minimise the risk of insider trading and avoid the appearance of insider trading. However, the rules state that, 'ASX would generally expect entities to include within their closed period the period from, or just prior to, the close of books at half and full-year end until a reasonable period after the release of their financial results for the half and full-year respectively.'

Blackout rules are comprehensive, but complex

The rules contain a significant level of detail and the expectation conveyed as to the period of time is likely to be effective in preventing insider trading if followed. It is stronger than Hong Kong's requirement. However, the status of this period as an expectation rather than a strict requirement does not ensure compliance. Additionally, the guidance note setting out the rules is long and complex. A clearer set of rules might help to clarify this issue.

Voting by poll

Calls for reform to mandate voting by poll

Australia still does not have mandatory voting by poll, which would be a significant improvement in both symbolic and practical terms. ASX listing rules allow for the appointment of a scrutineer (Rule 14.8), disclosure of proxy votes is mandatory, and the vast majority of large-caps and many mid-caps already vote by poll. However, the Governance Institute of Australia and the Australian Shareholders' Association (ASA) have both called for reforms to introduce a poll on all resolutions rather than a show of hands as the default voting method. One of the key reasons is the effect on remuneration-related resolutions (the "two-strike rule"). ASIC has also expressed concerns about AGMs where a show-of-hands vote on remuneration reports resulted in resolutions being passed despite a significant number of proxy votes being against the report (ie, enough for the company to have received a 25% first strike if the vote had been taken on a poll).

Advances in technology facilitate change

It is worth noting that advances in technology are helping to make voting by poll more efficient, and this has supported the significant uptake among large companies. ACSI reports that around 75% of ASX 200 companies now use poll voting for all resolutions.

Brian Johnson
brian.johnson@clsa.com
+61 2 8571 4252

Subtle but significant change in Australian executive remuneration

Historically, Australian senior executives have been remunerated by way of a package, with three distinct components being: (i) fixed remuneration (FR) in cash (base pay), (ii) a target variable short-term incentive (STI), of which c.40% would be in cash and c.60% in scrip vesting in three- to four-years' time, and (iii) a target long-term incentive (LTI) in scrip vesting in three- to four-years' time, subject to prescribed hurdles being met (eg, peer relative TSR, ROE, ROE growth, etc). Depending on the assessed performance of the executive, the STI/LTI could be anywhere from 0% to c.150% of the FR. Superficially, this makes sense as the interests of executives and shareholders are aligned. However, with such a large component being scrip to be issued at a future date, the (i) valuation of, (ii) the determined issuance price, and (iii) the treatment of dividends during the vesting period of that scrip can have profound consequences on shareholder alignment.

Many Australian companies had used "fair value" to determine the present value of the probability-weighted value of shares to be issued in four years' time, with no dividend participation during the vesting period. While that sounds way too technical for most retail investors, we believe the mechanical outputs of fair-value scrip issuance can result in a significant misalignment with shareholders. Under the fair-value methodology, Australian companies would, (i) take the present share price and determine a NPV valuation for the dividends foregone during the vesting period, and (ii) determine a further issuance discount for the probability that these LTI shares may not vest if the hurdles are not met by way of using a Monte Carlo analysis. This can result in significant discounts between fair-value issuance prices and market prices. Regardless of whether fair value is used, there is a statutory requirement to disclose what it is.

CBA reward rights

Equity plan	Performance measure	Grant date	Fair value $	Performance period end	Expected life (years)	Expected volatility %	Risk free rate %	Dividend yield %
			Assumptions					
FY18 LTVR reward rights	Relative TSR	17 Nov 17	36.94	30 Jun 21	3.62	15	2.12	5.17
	Trust and reputation (positive TSR gateway)	17 Nov 17	57.11	30 Jun 21	3.62	15	2.12	5.17
	Employee engagement (positive TSR gateway)	17 Nov 17	57.11	30 Jun 21	3.62	15	2.12	5.17

Source: CLSA, CBA

4. Listed companies

Australia ranks 1st with a score of 73%

Australia is the clear leader in Asia Pacific for listed company governance and disclosure. It does particularly well in terms of its financial and CG reporting, produces the most detailed remuneration reporting, and provides thorough management discussion and analysis (MD&A) reports and good risk disclosure. Investor-relations websites are generally of high quality, with easily accessible company reports and announcements, analyst-briefing presentations and AGM materials. One somewhat unexpected result, however, was the variability we found in the quality of sustainability reporting: while most of the 15 large-caps surveyed produced detailed and informative reports, a few were exceedingly superficial or failed to address the key material issues facing their company or sector.

Financial reporting

Strong reporting standards in Australian companies

Australia issuers provide clear and detailed financial reporting. Companies that stood out in our survey included ASX, Wesfarmers, Mirvac, Telstra, BHP, Westpac and Commonwealth Bank. In addition to clearly laid out income statements, balance sheets (statements of financial position) and cashflow statements, Australian companies excel at providing detailed notes to the accounts. Two areas where reporting is considerably better than one generally finds in Asia are segment reporting and the breakdown of operating expenses ("expenses by nature"). Australian companies do not obfuscate by aggregating large items into an "other expenses" line that is not explained.

Audited results often released quickly

Australian large-caps also tend to be quick reporters: many release their audited annual results in less than 60 days - some take as little as 45 days - which reflects a disciplined and professional approach to account preparation.

CG reporting

Superior CG detail compared to Asian markets

Reading CG reports in Australia after reviewing those in Asia is like the transition from night to day. Larger companies and many smaller ones produce detailed CG statements that, at their best, provide real substance on board composition, the skills of directors, the work of board committees, engagement with shareholders, and remuneration paid to directors and senior executives. As noted in our CG-rules section, companies are required under the *Corporations Act* to produce detailed remuneration reports, upon which shareholders vote at the AGM. The level of detail provided, compared to most Asian markets, is quite staggering.

Audit and nomination committee reports often surprisingly bland

One curious aspect of Australian CG reporting, however, is the boilerplate descriptions in many annual reports on the work done by audit and nomination committees. While the remuneration-committee report is voluminous, for reasons stated above, other committee reports are sometimes no more than the terms of reference, a list of members and attendance statistics at meetings. More guidance here would be helpful.

ESG/sustainability reporting

Standard of sustainability reporting quite high

Australia is one of the few markets in Asia Pacific that sets generally high standards for sustainability reporting, in the absence of any formal rules or detailed stock exchange guidance. The argument has been, as noted in our CG-rules section, that market and investor pressure has been enough to force companies to do the right thing. Is this the case? Yes and no. Our survey found detailed reporting from some companies, such as Wesfarmers, Woolworths, BHP, Commonwealth Bank, Mirvac, and Telstra, but more minimal reporting from the likes of James Hardie Industries. Among the 10 mid-caps reviewed, most, not surprisingly, had shorter and less informative reports. One concerning trend we observed was the excessive use in some reports of generic “consultant speak”. Indeed, some reports have so much of it that the reader loses sight of which company or sector is being discussed.

ACSI’s new report

The latest report from ACSI on sustainability reporting among ASX 200 companies, published in June 2018, paints a picture of an improving reporting environment, but one that could be a lot better. Some highlights:

- The number of companies classified as “leading” or producing “detailed” reports has steadily risen from 39 in 2008 to 104 in 2017. Conversely, the number producing only “basic” or “moderate” reports has fallen from 130 to 76 over the same period.
- The number of companies not reporting at all has fallen from 31 in 2008 to 20 in 2017. Curiously, it rose to 40 in 2009 and dropped to only nine in 2015, suggesting some companies are not seeing value in this reporting.
- 95 companies (48%) disclosure a climate-related policy statement.
- 35 companies (17.5%) are considered “leading” (ie, they have outperformed in their reporting over the past four or more years).
- Nine companies are listed as “laggards” (ie, those that have not reported on sustainability for two or more years).

APRA’s report on CBA

Managerial and board incompetence behind CBA’s risk management problems

A useful corrective to the limitations of corporate reporting comes from a prudential inquiry APRA undertook to examine Commonwealth Bank’s governance, culture and accountability frameworks and practices. In early May 2018, the three-person panel released a scathing report on the bank, arguing that a culture of success had affected its ability to manage non-financial risk appropriately. The findings allude to little malintent within the bank - rather issues of managerial and board incompetence. CBA entered into an enforceable undertaking in response to the panel’s recommendations and accepted APRA’s penalty of applying an additional A$1bn to its capital requirement.

Richard Barwick
Head of Australian Consumer Research
richard.barwick@clsa.com
+61 2 8571 4277

Managing-directors selling shares

A managing director selling shares is rarely considered a good thing by investors, but some companies make a bad situation worse through a lack of effective communication around the issue. We consider Domino's as an example here and contrast this with Treasury Wine, which, we believe, has done a far better job in managing a delicate situation.

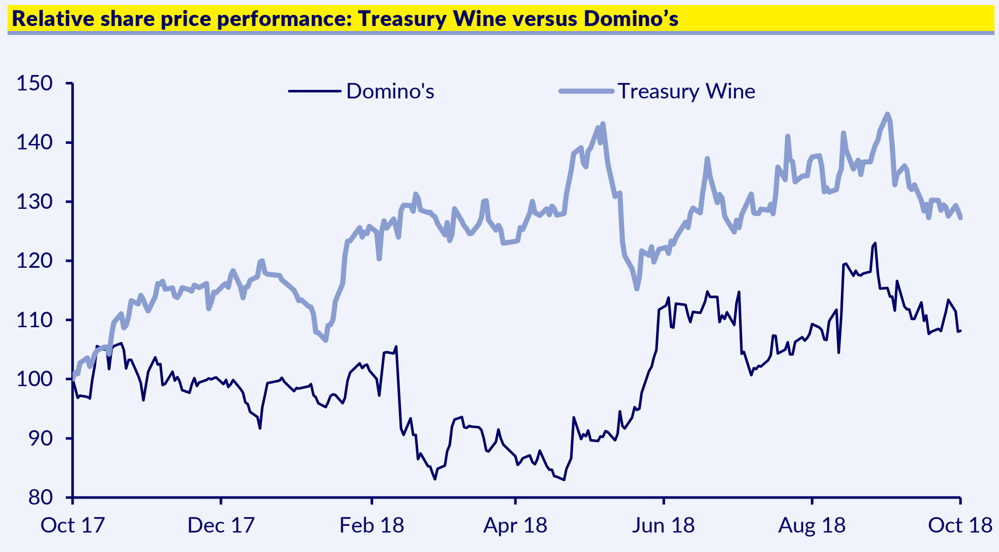
Last September, Treasury Wine forewarned the market its managing director would be selling shares, primarily to cover 'respective income tax liability on vested equity granted under the Company's Long Term Incentive Plan and Short Term Incentive Plan'. Further, given an on-market share buyback was in progress, the company also made clear 'such buy-back will be temporarily paused while such share sales are being executed in the market by the CEO.' This year, the company provided a cover letter to the Managing Director's Change of Director's Interest notice, explaining how many share and performance rights the managing director retained and again explained the issue of income-tax obligations associated with vested performance rights.

We see Domino's handling of a very similar issue as a stark and negative contrast to Treasury Wine, though recognise the Domino's situation was made worse by press reports of the managing director having a number of margin loans. Ultimately though, unlike Treasury Wine, Domino's didn't forewarn the market its managing director would be selling shares, nor pre-empt concerns regarding the managing director selling while an onmarket share buyback was taking place. As a result, the board of Domino's appeared very reactive to an ugly situation that could have been much better managed.

We recognise there are many factors driving share-price performance, but note Treasury Wine has materially outperformed Domino's over the past 12 months.

Treasury Wine's share price has outperformed that of Domino's

Relative share price performance: Treasury Wine versus Domino's



Source: CLSA

5. Investors

Australia ranks 1st with a score of 64%

Unlike the other markets in this survey, Australia performs well in both the institutional and retail investor sections of this category. It has well-established organisations representing both asset owners (pension funds) and asset managers - ACSI and the FSC respectively - and each produced a stewardship code for their members over the past year. There is also an active and experienced retail shareholder body, the Australian Shareholders Association. Board diversity and ESG/sustainability are among the top issues of concern for institutions, while one of the many issues of debate among retail shareholders is easier access to class actions.

Shareholder engagement: The 2017 AGM season

Increased engagement at AGMs shows shareholder dissatisfaction

A report by ASIC on the 2017 AGM season recorded a high overall level of shareholder engagement, with shareholders actively voicing discontent on matters, including company underperformance. The overall sentiment towards directors was more negative, compared to the previous year, with an increase in material against-votes to 18% on resolutions to elect directors. ASIC suggests this may indicate shareholders voicing dissatisfaction with company performance.

Low AGM attendance by institutional investors

Institutional investor interviewees reported that they rarely attended AGMs, with one commenting that AGMs were 'geared towards retail', but that AGMs in Australia were easier to attend than in other jurisdictions. Many would like to see the AGM become a more active and constructive forum for company dialogue.

Two stewardship codes

FSC publishes its first stewardship code in July 2017

The FSC published stewardship guidance for its members in July 2017. Called the *Principles of Internal Governance and Asset Stewardship* (FSC Standard 23), it replaced the previous Blue Book and became compulsory for full members of the FSC from 1 July 2018. Accordingly, they must disclose compliance with this standard for the year to 30 June 2019, with reporting by September 2019. It is the first compulsory asset-stewardship code for fund managers and comes after increased demand from investors that fund managers demonstrate how they account for ESG risk. Another driver behind its introduction was the concern that failure to do so would right Australia's international standing given that numerous other countries have such codes already, including the USA, UK, Japan, Hong Kong, Singapore, Malaysia, South Korea and Brazil. The new code is somewhat broader than most stewardship codes in Asia, and puts significant focus on the internal governance of funds.

ACSI releases first stewardship code for asset owners in March 2018

In May 2018, ACSI released its first stewardship code for asset owners. Called the *Australian Asset Owner Stewardship Code*, it sets out six principles related to the duties and obligations of superannuation funds in terms of disclosing their stewardship policies, activities and voting records, as well as the need to engage with companies and monitor the stewardship activities of external asset managers. Disclosure is based on the "if not, why not" standard (the terminology used in Australia for "comply or explain"). While the code is similar in structure and content to the UK stewardship code, it puts an original and welcome emphasis on the importance of asset owners engaging with policy makers and regulators on systemic issues of corporate governance, shareholder rights, climate change and ESG. Becoming a signatory is voluntary.

Investors seek better ESG reporting

ACSI makes a case for non-binding shareholder resolutions

Governance Institute finds opposition to giving shareholders more voice on ESG decisions

More CEOs in ASX 100 called "Andrew" than there are women!

Push for greater female board representation

ESG reporting and policy: Who decides?

As noted in our CG-rules section, ACSI and the FSC released a guide in 2016 for listed companies on ESG reporting. Their research found that 13% of ASX 200 companies failed to provide meaningful information on sustainability factors, and a further 17% provided only basic information. ACSI has been tracking sustainability reporting in Australia since 2008 and publishes an annual report (see the listed-companies section for highlights).

While there is broad agreement among stakeholders in Australia on the need for high quality ESG reporting, there is not surprisingly disagreement as to how much influence shareholders should have over boards in this area. ACSI kicked off a debate in October 2017 with the publication of a report called *Shareholder Resolutions in Australia: Is there a better way?* It highlighted the restrictions placed on shareholders in putting forward resolutions at company meetings, a system it described as 'flawed' and 'in need of reform". Unlike other developed markets that allow shareholders to put forward non-binding resolutions on a range of issues - something that can help to improve a company's governance or disclosure - in Australia shareholders are forced to put forward amendments to company articles (a much harder task) or vote against directors. ACSI would like to see a non-binding shareholder resolution framework put in place.

In response, the Governance Institute of Australia published a green paper in July 2018, titled *Shareholder resolutions: Is there a case for change?*, based on a roundtable discussion that it organised two months earlier, in May. While the roundtable itself did not produce a consensus answer, there was a feeling among several participants that the current system needed "streamlining" - though not agreement as to what form this should take. An accompanying survey of governance and risk professionals found that almost two thirds (63%) believed shareholders 'currently had a sufficient voice on environmental, social and governance (ESG) issues in relation to listed companies" and that "ESG decisions are a board matter.' This debate will no doubt continue.

Board diversity

Board diversity is another hot topic that also shows mixed progress. ACSI reports a decrease in all-male boards, from 32 in 2015 to seven in 2017. However, the organisation's recently released report, *CEO Pay in ASX 200 Companies*, states that it was unable to analyse gender pay diversity due to insufficient numbers of female chief executives. 'There were more CEOs called Andrew in the ASX 100 sample than women,' it noted wryly. The Australian Institute of Company Directors (AICD), meanwhile, reports that as of August 2018, the percentage of women on ASX 200 boards stood at 28.5%.

In line with the AICD, ACSI continues its drive to bring about board diversity through persuasion and voting pressure. Ahead of its annual conference in May 2017, ACSI CEO Louise Davidson warned listed companies with all-male boards via individual letters, and more broadly in the media, that unless ACSI could see evidence of corporate boards making appropriate movements to end homogeneity, and aiming for female representation of at least 30%, the organisation would urge its member funds to vote against incumbent directors' reappointment during investor meetings held in FY17/18. Davidson further warned that a 'meritocracy' defence would shield them from ACSI's agenda.

Shareholder claims make up 34% of class actions

Class-action reform on the horizon?
Shareholders seeking to take action against errant directors or companies in Australia benefit from a class-action regime that is considered one of the most plaintiff-friendly in the world. Shareholder claims are the most commonly filed class actions in the federal court (34% in the last five years), with breaches of Australia's demanding continuous disclosure laws a major source of claims. In the past five years, all shareholder class actions were funded by third-party litigation funders - the leading firm is IMF Bentham. There is also a small pool of plaintiff law firms that generally act in these cases, in particular Maurice Blackburn and Slater & Gordon.

Claims usually over breach of rules on continuous disclosure, misleading and deceptive conduct

The Australian Law Reform Commission (ALRC) will be reporting in December 2018 on the potential need to reform the class-action regime, including considering the impact of continuous disclosure obligations on listed entities. The commission published an initial discussion paper in June 2018, which proposed a review of the 'legal and economic impact' that the continuous disclosure regime and the misleading and deceptive conduct provisions have had on listed entities.

Have class actions limited the ability of directors to get insurance?

The ALRC suggests class actions based on these regimes may have had the unintended consequence of adversely affecting the availability of directors' and officers' insurance, with a 200% increase in premiums the last 12-18 months and at least one significant insurer leaving the market. Several commentators have drawn a link between the tendency for companies to be the target of funded shareholder class actions and significant increases in insurance premiums. However, the ALRC notes that the relationship between the two is not clear cut, in part because of a period of prior underpricing.

Reform to allow contingency fees may be coming

The ALRC is also considering proposals on allowing solicitors for class-action plaintiffs to charge contingency fees (currently prohibited in Australia) and increased licencing requirements for litigation funders.

6. Auditors & audit regulators

Australia ranks equal 1st with a score of 84%

Australia ranks equal 1st in this category because it has a sound system of accounting and auditing standards, high quality account preparation by listed companies (especially the larger ones), detailed disclosure of audit and non-audit fees, relatively good standards of auditing, and a reasonably robust audit regulator in ASIC. Yet there remains room for improvement in audit quality, as ASIC's regular inspection programme indicates.

ASIC inspection results

Last inspection report covered 23 firms auditing 97% of issuers, by market cap

Every 18 months, ASIC produces a report on its inspection activities, with the most recent being *Report 534*, released on 29 June 2017, which covers the 18-month period ending on 31 December 2016 and highlights the results of inspections of 23 audit firms. The review is intended to be representative, as four large national firms, 10 other national and network firms, and nine smaller firms were inspected and in aggregate the firms audit 97% of listed entities by market capitalisation. Audited entities were selected from 20 different industry groups, the majority coming from the materials, energy and capital goods industries.

One in four audit files showed the auditor failed to obtain reasonable assurance

Over the July 2015 to December 2016 period, ASIC measured 390 key audit areas across 93 audit files and found that in one in four (25%) the auditors did 'not obtain reasonable assurance that the financial report as a whole was free of material misstatement.' This compared to a figure of 19% of 463 key audit areas reviewed across 88 files over the previous inspection period from January 2014 to June 2015. ASIC commented that, 'Given the efforts by firms to improve audit quality and the consistency of execution of audits, this is a disappointing result. The findings suggest that further work and, in some cases, new or revised strategies are needed to improve quality.'

Key problem areas include revenue/ receivables, and impairment/valuation

The key findings highlighted that 30 files presented problems with revenue and receivables, while impairment and asset valuation ranked second with 29 files. In both areas the incidence of problems increased compared to the previous inspection period, leading ASIC to comment that 'these areas require further focus by auditors'.

Criticism of ASIC inspections

Not all quarters are happy with ASIC's audit inspections. A seasoned auditor working at a big-four firm told ACGA: 'ASIC inspectors come knocking on our door requesting to see our client's audit file, then they use a risk-based assessment method to do the job. Rather than critiquing the team on what they did and the associated outcome, they look at method. They critique the method! It's not the best system'.

Publically critical, privately collegial

For its part, ASIC emphasises caution over how its results are interpreted: 'Findings from our audit inspection programme do not necessarily mean that the financial reports audited were materially misstated. Rather, in our view the auditor did not have a sufficient basis to support their opinion on the financial report. Our inspections focus on higher risk audit areas and so caution is needed in generalising the results across the entire market.' It also notes that while firms may agree to take remedial action based on its findings, they often do not agree with ASIC's interpretations. Its approach to driving improvement could therefore be described as publically critical (of the industry) yet privately collegial (with regard to audit firms). This is not too different to the tactics used by other leading audit regulators in the region.

An argument over fees

Medcraft attacks audit business model

In October 2017, ASIC's outgoing chairman, Greg Medcraft, shot a broadside across the auditing industry, saying its business model was less than desirable and this was having an adverse affect on audit quality. He felt that audit fees in particular were too low. *The Australian Financial Review* published a comparison of audit-work revenue in October 2017 and found that, as of 30 June 2016, the highest percentage of such revenue was reported by EY (24%) and the lowest by Deloitte (16%).

Competition between audit firms is driving down fees

While Medcraft may be correct in stating fees are low for audit services, auditors say that competition is a significant factor in driving down fees. An auditor from a big-four firm told ACGA:

> 'There are four firms that are obviously concerned about where their market share is. These opportunities do not come very frequently. Each time they do there is quite intense competition to win the opportunity for these large assignments. It is that that is driving the price down. Plus, some users may not focus on the value that can be gained from a good audit and, therefore, they are more willing to accept lower prices as a significant part of their change decision.'

Enforcement

ASIC's enforcement outcomes

As highlighted in the Regulatory section of this chapter, ASIC released four enforcement-outcome reports between July 2016 to June 2018. Actions against auditors peaked in the first half of 2018, with 14 administrative sanctions out of 35 corporate governance-related penalties being targeted at auditors.

ASIC targets SMSF auditors

Over 2017-18, ASIC also targeted auditors of self-managed superannuation funds (SMSF). The regulator wrote to 404 auditors in November 2017 to indicate that they had not submitted annual statements and paid associated fees. As of February 2018, 29% of them had not complied with ASIC's request to furnish reports and fees, hence it cancelled their registration.

7. Civil society & media

Australia ranks 1st with a score of 78%

Australia scores highly in this category. It may be easy to justify the score, as one academic tried by stating, 'Australia has been playing the game longer, it's more developed.' But the reasons go deeper and include economic, social/cultural and political/legal factors that support the development of a range of civil-society organisations able to fund themselves, and a media that can operate unfettered from excessive state controls.

A range of professional associations support CG-awareness building

Australia has numerous professional associations supporting awareness of corporate governance to varying degrees, including the Australian Institute of Superannuation Trustees (AIST), CPA Australia, Chartered Accountants Australia and New Zealand (CAANZ), The Australasian Investor Relations Association (AIRA), as well as proxy advisors and remuneration consultants.

Not-for-profit investor organisations are active

As noted in previous sections of the chapter, not-for-profit investor organisations such as the Australian Council of Superannuation Investors (ACSI), the Financial Services Council (FSC), the Australian Shareholders Association (ASA) and the Responsible Investment Association of Australasia (RIAA) also play an active role in working to raise CG standards through advocacy work, engagement with investors and companies, and conferences or seminars.

Governance Institute of Australia supports governance professionals

Throughout the year, the Governance Institute of Australia, formerly the Company Secretaries Association, hosts a series of forums on various topics, such as governance, risk management, and the governance of non-profits and public-sector units. In addition to the forums, the institute's national conference brings together government ministers, governance experts and business leaders to discuss contemporary legal, governance and regulatory issues.

Australian Institute of Company Directors is the peak body for directors

The peak body for company directors is the Australian Institute of Company Directors (AICD). It organises training sessions for directors around the country on a weekly basis and engages in governance advocacy efforts, focusing on four key areas over 2016-18: not-for-profit governance, director remuneration, the role of directors in driving business productivity, and increasing female representation on the boards of ASX-listed companies.

Women on boards on the rise

The issue of women on boards has been a cornerstone policy of AICD since 2010, when women accounted for just 8.3% of all ASX 200 board members. Since that time, AICD has reported regularly on the issue. It current chair, Elizabeth Proust, indicated in her latest progress report (June-August 2018) that women now account for 28.5% of ASX 200 directors, an over 20ppt increase in eight years. AICD had set itself a target of achieving 30% female board representation by the end of 2018 - a goal now in sight.

Not practising what it preached

CPA Australia governance scandal

One less than inspiring aspect of the Australian civil society ecosystem over the past two years was a deep and bitter governance battle, now largely resolved, at CPA Australia. To cut a long story short, this centred on the accounting body's former CEO, the use of organisational funds to promote a book he had written, the development of a TV programme he hosted, and some other projects. Around the same time, the board began paying itself generous fees - their positions were previously honorary - and in response to a member revolt, decided to move its February 2017 AGM to Singapore! CPA Australia justified this by saying it was a 'demonstration of [its] ongoing commitment to growth in the Asia-Pacific region', where it has 37,000 members. Not surprisingly, many members left behind in Australia were deeply upset.

CPA Australia cleans house

In an effort to turn the situation, CPA Australia called for expressions of interest for non-executive directors in May 2017. It also terminated the CEO's contract on 23 June 2017, with immediate effect, then disclosed that he had been given an A$4.9m termination payment (equivalent to 3.5x his annual fixed salary). The entire board was replaced, effective 1 October 2017, and its size reduced from 12 directors to nine. The organisation later announced that it was reviewing its corporate strategy.

Academia

Growth in corporate and public governance research

Governance research and the promotion of standards has also grown over the past few years within the Australian academic context. The majority of the country's research-intensive universities have well-developed corporate and public governance research programmes attached to their business or law colleges. Many have created professorships specifically in governance in the past two years. Noticeably, there has been an increase in the delivery of CG units within undergraduage business degrees, as well as an uptick in the number of Master of Corporate Governance programmes around the nation.

Media

Active media commentary but heavy political focus

Australian media reports actively on CG policy developments and corporate abuses. A search of newspaper databases revealed that from 2016-18, more than 15,000 articles were published mentioning the key regulators, namely APRA (6,000 articles) and ASIC (9,000). The quality of reporting varies between publications. Australia boasts a core group of skilled financial and CG reporters, but less-experienced writers treat the subject in more superficial terms and, as in many countries, focus less on the substance of issues and more on the politics surrounding them. A good example of the latter is the prominence given to federal politicians each time they criticise ASIC for poor performance, without at the same time researching in any detail what ASIC has been doing on a specific issue.

ASIC continues to be frequently criticised

The recent royal commission provided an interesting case study on how the media report on ASIC. Notwithstanding the large amounts of evidence provided to the royal commission originating from ASIC investigations, the media continues to portray the regulator in a largely negative light. This is not entirely unjustified, as the quote from Justice Hayne earlier in this chapter indicates: ASIC no doubt should have taken a harder line against the banks. Yet something missing in much of the media coverage this year has been ASIC's enforcement work since late 2016 on the "fees for no service" issue. It published a substantive report in October 2016 (*Report 499*) and since then has won considerable compensation and remediation payments for bank customers. These achievements appear to have been forgotten in all the furore surrounding the royal commission. The lack of balance and background in some media coverage remains a concern.

Australia has made some progress on our 2016 recommendations

Recap and recommendations

Recap of CG Watch 2016

To what extent has Australia responded to the recommendations in our 2016 survey?

Figure 4

Australia: recap of 2016

	Recommendations	Outcomes
1.	Introduce mandatory voting by poll.	Included in proposed revisions to the ASX CG principles, but not a rule change yet.
2.	Improve boards' gender balance.	Achieved nearly 30% female representation.
3.	Encourage better SME non-financial reporting.	Some progress.
4.	ASX to improve its website and make suspension announcements when they relate to CG.	No progress.
5.	ASIC's dedicated engagement of the institutional investor community - both asset owners and managers.	Some progress.

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the market score to fall in 2020:

- Further evidence of governance and ethical failures in the banking industry.
- Whistleblower provisions not enacted in the *Corporations Act*.
- No federal independent anticorruption body established.
- No voting by poll provisions passed in the *Corporations Act*.
- No improvement in funding for ASIC.
- Higher penalties for white-collar crime not incorporated into legislation.

What to fix

Quick fix list

Issues to address as soon as possible:

- Introduce a listing rule or guidance on ESG/sustainability reporting.
- Introduce a clearer rule on closed periods for director trading.
- Voting by poll: repeatedly identified as an area in need of reform.
- Code of conduct for federal politicians that is enshrined in legislation.
- ASIC to provide a report on the auditing industry covering the capacity and structure of CPA firms, number and experience of CPAs, and how the industry has improved audit quality over the past 10 years.
- ASX to disclose enforcement action against listed companies.

Nana Li, CFA
Senior Research Analyst, ACGA
nana@acga-asia.org
+852 2160 1796

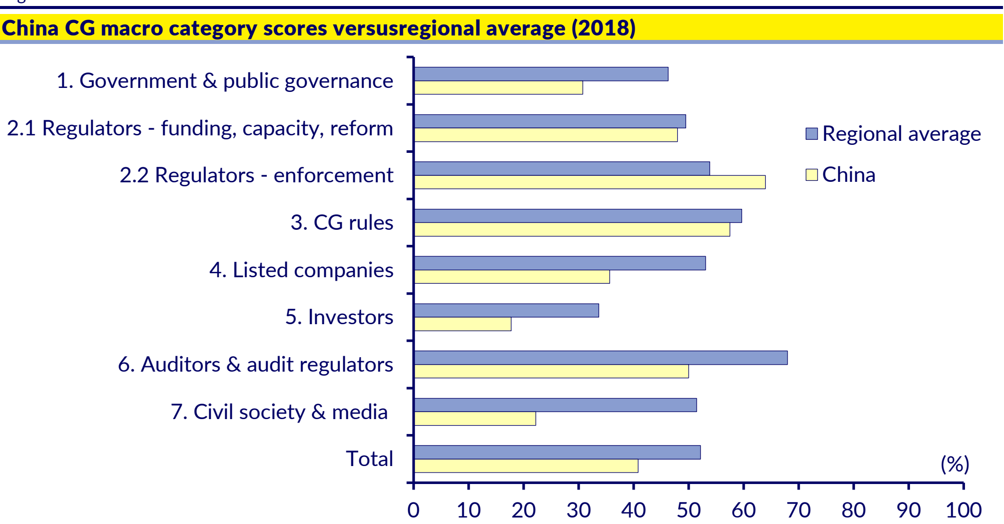
China - Slowly moving the mountain

- Party Committee leadership role is reinforced and anti-corruption campaign maintains momentum
- CBIRC formed to end the "one bank, three commissions" model, with CSRC continuing as a standalone entity
- CSRC finally releases revised CG code, but postpones China Depository Receipts following cool market reaction
- Regulatory enforcement continues to strengthen
- Companies disclose more about investor engagement activities, but mixed-ownership plan for SOEs receives mixed assessment
- Retail investors still dominate share trading, show no inclination towards activism; but some quasi-class actions have occurred since 2015
- The long-form audit report is fully adopted, while the MOF faces a dilemma between enhancing audit quality and encouraging consultancy services in CPA industry

China is ranked 10th with a score of 41%

Figure 1

China CG macro category scores versusregional average (2018)



Source: ACGA

Introduction

China's ranking has not changed from 2016 to 2018

China's ranking in this year's survey has not changed: it remains third last in 10th place. As noted in previous reports, a stable ranking does not mean that no progress has occurred over the previous two years. In fact, plenty of changes have occurred in China, some positive, some less so. The good news is that China has performed much better in enforcement, the result of lessons learned from the 2015 market collapse, while its performance in CG rules is respectable in both absolute and relative terms. The areas where it underperforms include, not surprisingly, government/public governance, investors, listed companies, auditors and civil society/media.

PCs officially out of the bag, but still lack transparency

In policy terms, the main development has been the Chinese government's drive to strengthen the leadership role of the Communist Party in every level of society. State-owned enterprises (SOEs) have been required to change their articles of association to incorporate Party Organisations, of which the Party Committee (PC) is a subset. The PC effectively stands above the board of

directors - though some dispute this on technical legal grounds - and must pre-approve all major decisions. Privately-owned enterprises (POEs) and foreign-owned enterprises are also under great pressure to form PCs if they do not already have them. Meanwhile, the level of disclosure around PCs is low. Foreign investors are mostly sceptical that these changes will improve the governance of companies, as the government contends. Others are willing to give the benefit of the doubt, but want to see more transparency on the role and activities of PCs.

CG code is finally revised - Some good points, but could have been more ambitious

A new Code on Corporate Governance (CG code) was published in 2018, the first amendment since the original code was issued in 2002. The new Code introduced the concept of the Party Committee for the first time, although it did not elaborate on how PCs should relate to the board of directors, nor required companies to disclose any information about their activities. The Code reaffirmed an April 2018 listing rule change making audit committees mandatory, although most listed companies already had them. It placed new emphasis on the role of institutional investors in corporate governance. And it highlighted the growing importance of environmental, social and governance (ESG) factors in both corporate management and investing. While the Code marks a step forward, it was somewhat disappointing in not introducing additional best practices around board governance, board composition/diversity and director independence.

"Responsible investment" and ESG are new hot topics

"Responsible investment" and ESG have become the new hot topics in the domestic investment management industry, yet many funds are still searching for the right direction and guidance on how to integrate ESG into their investments. A nudge from the government to support this transformation will be essential to maintain momentum.

Long-form audit report is formally adopted

In the area of accounting and auditing, China has fully adopted the new long-form audit report with "key audit matters". While the outcome is too early to tell, China at least deserves credit for doing this before some Asian markets, notably Japan.

Social media and censorship are both growing

Information dissemination has become easier given the popularity of social media, but the government has also been tightening its censorship of sensitive words. Director training is taking place, but without a nationwide organisation taking the lead to coordinate it.

1. Government & public governance

China ranks 10th with a score of 31%

China is ranked 10th in this section with a score of 31%. Several factors have contributed to this low ranking. The first is the lack of a comprehensive plan or "roadmap" from the government for improving corporate governance standards throughout the capital market and allowing all stakeholders to play their part. We recognise that the government has many other issues to worry about, especially at this time, yet an economic system as top-down as China's needs a clear direction from government if other stakeholders are to take corporate governance seriously.

The 13th Five-Year Plan sets broad outlines for financial market reform . . .

Broad outlines for improving a "modern market system" and "accelerate financial reform" are found in the 13th Five-Year Plan (2016-2020). The plan talks about creating a more open market system that allows for orderly and fair competition, breaking up industry monopolies and removing market barriers. It emphasises the need for the government to increase the delegation of powers to enterprises and reduce intervention in them, and to limit as far as possible the government pre-approval system. It also devotes a chapter to financial reform with a focus on

developing “open, transparent, and sound capital markets” and reforming the framework for financial regulation. Contained within a long list of ideas is a section on strengthening the rule of law and improving “systems that protect the rights and interests of financial consumers”.

. . . but only lightly touches upon corporate governance reform and development

While the 13th Five-Year Plan touches on a range issues relevant to corporate governance in China, there are only a few explicit references to the issue in the document. One relates to state enterprises and the need to “move faster to ensure that SOES introduce corporate and shareholding systems and improve their modern corporate structures and corporate governance”. A second reference highlights the need to “promote the switch to mixed ownership in financial institutions and improve corporate governance”.

The government’s stated aim is to ensure public ownership remains dominant

It is also important to note that although the Plan promises support to the “non-public sector” by making sure it “enjoys equal rights and opportunities and is subject to equal regulations”, the government’s primary objective is to maintain the dominance of public ownership. Enterprise reform is fundamentally intended to make SOEs “grow stronger, better, and bigger” and to help “a number of such enterprises develop their capacity for innovation and become internationally competitive”. There is no discussion in the plan on the need to foster better governance within private-sector firms, a sizeable part of the economy, job creation and listed-company sector.

The domestic market is opening gradually, but puzzles remain

A second reason for China’s low score is that despite a gradual opening of the domestic market to foreign direct and portfolio investment, many puzzles remain unsolved. One tricky issue is the variable-interest-entity (VIE) structure used by Chinese companies in restricted sectors to raise funding overseas, even though their businesses are strictly off limits to foreign investors. Following a consultation in 2015, investors and VIE companies have been waiting for an amendment to the Foreign Investment Law (FIL) from the Ministry of Commerce (MOFCOM). Current speculation is that the Ministry will adjust, not abolish, VIE structures. But uncertainties remain until the law is clarified.

China also lost points on questions relating to the independence of its regulatory institutions

Other questions on which China lost points in this category included the degree of independence of the securities commission (and its funding) from government, the independence of the judiciary, and the existence of an independence commission against corruption. As the following section shows, some areas of explicit governance reform in China have created new uncertainties and ambiguity.

The Party Committee revolution

Party leadership reinforced

Without doubt, the flagship governance policy of the past two years—it actually began somewhat earlier—has been the changing of company articles to reinforce the role of Party Committees (PC). This policy change was seeded as early as 2010, but picked up momentum following the election of Xi Jinping as General Secretary of the CPC in November 2012. It was given more shape by policy pronouncements over 2015 to 2017 that defined an enhanced role for such committees. Shortly after, even POEs and foreign-owned enterprises in China were told to “provide all necessary resources for their PCs to conduct Party activities”.

ICBC’s article amendments confirm the leadership role of its Party Committee

A flavour of the change can be seen in the June 2017 AGM circular of the Industrial and Commercial Bank of China (ICBC), the world’s largest bank by assets. Its announcement said that its new articles would stipulate that, “... the

Party Committee shall play the core leadership role, providing direction, managing the overall situation and ensuring implementation" (Article 13). Further, that, "... The opinions of the Party Committee shall be heard before the board of directors decides on material issues of the Bank" (Article 144). It is apparent from this wording that the PC is intended to be the highest decision-making body in the bank.

Many shareholders of ICBC were not happy. According to its AGM results, total votes Against were almost 17.5 billion and accounted for about 39% of the 45 billion H shares represented in the meeting (since the A shares are mostly owned by the Ministry of Finance, it is reasonable to assume that most of the Against votes came from disgruntled H shareholders). Similar outcomes were seen for China Construction Bank and Chongqing Iron & Steel, which saw votes Against of 12.8% and more than 70%, respectively. On the other hand, it is interesting to note that votes Against at some central SOEs, such as Sinopec, were miniscule. And there were certainly differences of opinion among foreign investors as to the impact—positive, neutral or negative—of these amendments on the actual governance of SOEs.

As of September 2018, more than 180 listed-companies in China had changed their articles to incorporate PCs. Although the number seems low, it is understood that companies were instructed to call for a vote on this amendment only after they have had sufficient communication with shareholders and could be confident of a successful outcome. This follows a case in Tianjin in early 2017 when shareholders rejected the PC amendment in a state real-estate firm. Not surprisingly, the number of firms changing their articles is higher among issuers on the Shanghai Stock Exchange (SSE), which has a greater proportion of SOEs, than on the Shenzhen Stock Exchange (SZSE). On 20 July 2018, the two bourses amended their own articles and emphasised the Party's leadership role.

The impact these article amendments will have on corporate governance in China is still hard to tell

At this stage it is hard to tell quite what impact these article amendments will have on the governance of listed companies in China, especially SOEs. It has certainly been a lively topic of discussion at numerous seminars and briefings hosted by law firms and others around the country. Views of participants tend to be mixed, with some arguing that the reform will help to strengthen the internal governance of enterprises and guard against corruption, not to mention providing clearer Party leadership and control of the state enterprise sector (all outcomes the government is hoping for). Conversely, others fear that the requirement for the PC to "pre-approve" all major decisions before they are sent to the board of directors will complicate decision-making and increase bureaucracy. It also remains unclear how the new-look PC will relate to the board of directors and supervisory board. Where will final accountability for decisions lie?

Some companies are starting to disclose the work of their Party Committees

Meanwhile, foreign investors who voted in favour of the article amendments in return for more transparency on the role of PCs are still waiting: little new information was provided in the 2017 annual reports of A and H share firms. Yet some Chinese companies have started to make a change. Sinopec Shanghai, for example, included a summary of its PC work for the first half of 2018 in an interim report issued on 22 August 2018. Although the content is quite vague, this initiative at least means the company has started to think about this issue. Hopefully, more companies will follow suit.

Anti-corruption campaign continues

Since 2013, 292 senior officials have been found guilty of serious violations of Party discipline

One area of public governance where China appears to have been making progress is in its anti-corruption work. On 19 October 2017, at a press conference on the sidelines of the 19th National Congress of the CPC, Yang Xiaodu, deputy secretary of the Central Commission for Discipline Inspection (CCDI), reported that the Party had conducted widespread investigations of senior officials in the five years since Xi Jinping became General Secretary. Among those investigated, 440 were at the provincial level or above, while 292 were found guilty of serious violations of Party discipline, mostly relating to corruption and political issues.

Thousands more had been punished at city, county and lower levels

Yang added that a further 278,000 Party members and officials had been punished over the past five years, including more than 8,900 officials at city level and over 63,000 at county level. The CCDI was also working with international organisations to crack down on a further 3,453 suspects who had fled the country, he said. As of October 2017, 48 fugitives among the top 100 listed on an Interpol red notice had been arrested.

One of the biggest scalps was Sun Zhengcai

One of the biggest scalps to date has been that of Sun Zhengcai. Once a candidate for a top leadership role, he was expelled from the Party by the Politburo of the CPC Central Committee in September 2017. This followed his abrupt removal in July the same year as secretary of Chongqing's Municipal CPC Committee. It was previously reported that Sun was being investigated for corruption. The decision to expel Sun and 11 other senior Party officials was endorsed at a full meeting of the Central Committee on 14 October 2017, shortly before the 19th National Congress. Sun was later replaced by Chen Miner, who is reportedly close to Xi Jinping.

Mr IPO goes to jail

On 28 September 2018, the Handan Intermediate People's Court sentenced Yao Gang, a former vice chairman of the CSRC (a.k.a. Mr IPO), to an 18-year prison term and fined him Rmb11m (US$1.6m approx) for taking bribes and insider trading. Yao was investigated by the CCDI for "severe disciplinary violations" in November 2015, after the stock market collapse earlier that year.

A new anti-corruption commission is established

Assessing the true impact of the anti-corruption campaign is a challenge

Enjoying a taste of success, the government decided to carry on its anti-corruption propaganda. On 14 March 2018, a new government body named the National Supervision Commission was created. The Commission will have the power to detain individuals who commit bribery or corruption offences, with a focus mostly on government officials and SOE managers. Individuals in the private sector may also be brought in to help with investigations. Generally speaking, a cleaner business environment should benefit corporate governance development. However, it is difficult to answer this question in China because of the limited transparency around the investigation and prosecution of officials. Whether this is a genuine attempt to clean up government or the by-product of a top-level power struggle remains a mystery to outsiders. A massive effort has certainly been put into detecting wrongdoers, especially within the Party, government agencies and state enterprises, and this appears to have had some deterrent effect, not to mention reduced spending by officials on luxuries and entertainment. Yet there is also evidence that this has frozen many normal business activities in China, such as legitimate business trips abroad for research and conferences.

Elinor Leung, CFA
Managing Director - Asia
Telecom & Internet Research
elinor.leung@clsa.com
+852 2600 8632

Mixed ownership reform at Unicom

China Unicom (CU) announced mixed ownership reform in October 2017. We have already seen a notable enhancement to growth momentum, quality and efficiency. The capital injection boosted financial strength, with financing cost reduced 64% YoY during 1H18. The reform also deepened synergetic cooperation with strategic investors, driving industrial internet revenue up 39% YoY. It has also helped establish a well-coordinated governance system and market-oriented incentive mechanisms.

Deal mechanics

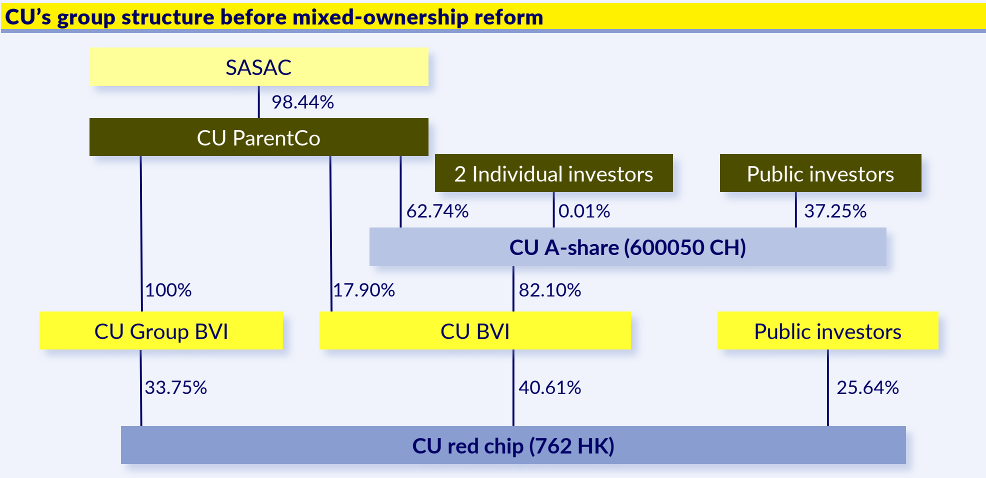
Strategic investors subscribed to 9bn new shares of CU A-shares (CU-A) and 1.9bn existing shares from the government and held an aggregated 35.2% stake in CU-A post deal. The transaction price was Rmb6.83 per share, implying a 9% discount to CU-A's share price before suspension.

In addition, CU-A would also grant 850m restrictive shares at Rmb3.79 per share in a employee incentive scheme, which represents 2.7% of CU-A enlarged capital.

Total consideration was Rmb78bn and CU-A received Rmb61.7bn in cash. Post deal, the government ownership in CU-A reduced from 62.7% to 36.7% and public shareholders' holding was diluted from 37.3% to 25.4%.

Pre-deal, parent holds 63% of CU-A

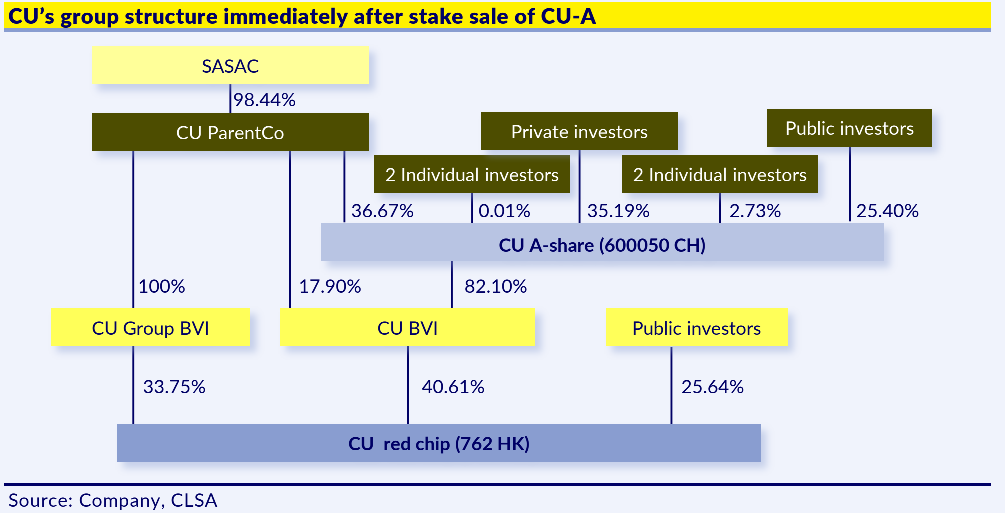
CU's group structure before mixed-ownership reform



Source: Company, CLSA

Post-deal, parent holds 37% of CU-A

CU's group structure immediately after stake sale of CU-A



Source: Company, CLSA

A total of 14 strategic investors participated in the transaction, including:

- China's top-four internet companies: Tencent, Baidu, JD.com and Alibaba (BATJ)
- Leading companies in industry verticals: Suning, Kuang-chi, Didi, Wangsu, Yonyou and Eastone
- Financial institutions and industry groups: China Life and CRRC
- Specialised funds: China Structural Reform Fund (CSRF) and Qianhai FoF

In total, it has 14 strategic investors

Among the investors, China Life acquired the largest holding at 10.2%, then CSRF at 6.1%. Tencent (under a 64:36 partnership with Cinda) has a 5.2% stake, largest among BATJ. Baidu, JD and Alibaba held 3.3%, 2.4% and 2.0% stake of CU-A.

On 28 November 2017, CU-red issued 6.7bn new shares for a cash consideration of HK$13.24 per share to China Unicom (BVI) Limited. The total Rmb61.7bn capital raised was injected into CU-red, which is using the capital to "enhance 4G capability, conduct 5G technical network trials and related business functions, build pre-commercial trial networks and invest in innovative businesses".

After the transaction, government-related entities effectively owned c.50% of CU-red, while strategic investors held 16.5%. Public investors (combination of CU-A and CU-red) was diluted from 38.1% to 32.5%.

Public shareholders will be diluted

CU red ship shareholding structure

Shareholder group (%)	Current	After CU-red placement
Government	61.9	50.0
Public investors	38.1	32.5
Strategic investors		16.5
Employees		1.3
Total	100.0	100.0

Source: Company, CLSA

Creating synergies from strategic partnerships

The mixed ownership reform was meant to: 1) create new revenue streams with strategic partners and 2) boost employee incentives and operating efficiency.

CU aims to develop opportunities in various areas

CU has signed strategic partnership agreements with each strategic investor. For different investor categories, CU set to cooperate in different targeted areas:

- BATJ: Potential co-operations will cover, but are not limited to, the areas of retail system, channel touch point, content aggregation, home internet, payment & internet finance, cloud computing, big data and IoT. For example, Alibaba and Tencent have set up ecommerce operation centers with CU separately. Although the current focus is limited to the operation of relative 2I2C phone plans, companies are actively seeking to expand the partnership.
- Industry vertical leaders: partnerships will focus on three main areas IoT, CDN and system integration.
- Financial institutions & industry groups: CU aims to explore potential in industrial internet, which will likely be a main application area in the 5G era. Payment & internet finance businesses is another highlight.

- Specialised funds: the partnership opens up opportunities for CU to work with numerous investee companies of the funds, including both SOEs and private enterprises.

Boost employee incentive and operating efficiency

Management highlighted the importance of improving corporate governance via mixed-ownership reform. CU-A plans to restructure its board of directors to a 15-member board, consisting of six representatives appointed by government, four representatives from strategic investors and another five independent non-executive directors. CU will maintain two different boards for CU-A and CU-red, with the former being more familiar with local regulation and market, while the latter excels on international know-how and governing standard.

Share incentive scheme could boost employee efficiency

The employee share ownership scheme was established to align interests of shareholders, employees and the company. The scheme could incentivise employees to improve cost control and profitability.

According to the August 2016 SASAC notice on the topic, employees can hold no more than a 30% stake in the company, and they should mainly acquire their stakes with cash, with exception for some shares in exchange for technology capabilities. Only "key R&D, management and operation personnel who have major impact on company business development" are eligible to participate, while state-appointed management and external directors are not allowed to join.

2. Regulators

China ranks equal 6th with a score of 56%

China performs better in this category in large part due to its strong performance on Enforcement, one of two sub-categories in this section. It also achieves a reasonable score, relative to other markets, in the first sub-category called Funding, capacity-building and regulatory reform, due to efforts made over the past two years.

China has been building a more coordinated regulatory infrastructure

The structure of the regulatory system governing the financial market has been undergoing significant change since our last survey. The 13th Five-Year Plan emphasised the need for more regulatory coordination and, accordingly, on 8 November 2017 the first meeting was held in Beijing of a new overarching policymaking body, the Financial Stability and Development Commission (FSDC). This is led by Vice Premier Liu He and comprises representatives of the State Council, Ministry of Finance (MOF), People's Bank of China (PBOC) and other financial regulatory bodies.

A range of agencies touch upon enterprise regulation

The banking and insurance commissions merged in March 2018

Another major development came on 13 March 2018, when the State Council announced the merger of the China Banking Regulatory Commission (CBRC) and the China Insurance Regulatory Commission (CIRC) to form the China Banking and Insurance Regulatory Commission (CBIRC). The China Securities Regulatory Commission (CSRC) continues as a standalone agency and supervises the two exchanges in Shanghai and Shenzhen. Thus the system has four tiers: 1) FSDC; 2) PBOC; 3) CBIRC and CSRC; and 4) the two exchanges, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE). Other agencies involved in enforcing securities and company law include, to varying degrees, MOF, MOFCOM, the State Administration of Foreign Exchange (for cases involving foreign capital flows), the National Audit Office (NAO) and the Ministry of Public Security.

2.1 Funding, capacity-building and regulatory reform

China ranks equal 8th in this sub-category with a score of 48%

Assessing the funding and capacity building of regulators in China is a challenge, since only limited information is provided and much of it is out of date. The CSRC's latest annual report is from 2016 when it reported having a total of 3,061 staff, of which 733 (24%) worked in headquarters and 2,328 (76%) in its regional offices, with an average age of 37 years old. This compares to figures cited in our last *CG Watch 2016* report, which drew upon the CSRC's 2014 annual report and showed that it had 3,176 staff, of which 794 (25%) worked in headquarters and 2,382 (75%) in regional offices, and with an average age of 36 years old. In other words, not much change.

CSRC appears well-staffed in absolute terms

In absolute terms, the CSRC seems reasonably well-staffed. For example, compared to the Hong Kong Securities and Futures Commission, which has around 870 staff and regulates 2,300 listed companies with a total market cap of the equivalent of Rmb26.8tn, the CSRC's 3,000 staff regulate 3,650 listed companies with a total market cap of Rmb46.8tn (as of 10 August 2018). Hence, more than three times the staff for a market about 50% bigger in issuer numbers and 75% larger in market cap. Such a comparison is not entirely fair, since China has a far more complex economy and financial market than Hong Kong, every organisation has bigger staff numbers in China and the numbers alone say nothing about skills and experience. Indeed, there is much evidence that the CSRC is under-resourced in terms of expertise.

The CSRC's budgetary growth has been modest

Meanwhile, CSRC budget reports for 2017 and 2018 indicate that its spending on surveillance, investigation, enforcement capacity and technology has remained steady at around 33% of total expenses, with only a 2% YoY increase in total budgeted expenses to match inflation. No detailed information on actual spending is provided.

The exchanges have been seconding staff to the CSRC on short-term projects and consultations

An interesting trend over the last two years has been the secondment of a number of staff from the two exchanges and other CSRC-affiliated organisations to the Commission to help with policy-making and regulatory consultations, especially those relating to corporate governance. Many were appointed on only a short-term and rotating basis, suggesting the CSRC may not have sufficient people to fill these positions internally. While secondments may be a pragmatic solution to a short-term problem, there is a risk they could impair the consistency and quality of policymaking over the medium to longer term. It also makes it difficult for outside parties to engage effectively with the Commission, since the responsible officers on particular topics keep changing.

Brave new world for IPOs still on hold

CSRC seeks extension of authorisation for an IPO-registration system

On 23 February 2018, five days before the expiry of an authorisation by the National People's Congress for the implementation of a long-discussed "registration-based IPO system", the chairman of the CSRC, Liu Shiyu, asked the Congress for a two-year extension to 29 February 2020. This reform would, in essence, change the current CSRC approval-based IPO system to a US-style registration system relying on enhanced disclosure and market forces to filter the good from the bad and value them accordingly. Liu acknowledged that various uncertainties in the Chinese market, such as the low level of sophistication of retail investors and the limited pricing discretion of intermediaries, mitigated against the early adoption of such a system.

Is the CSRC getting ready for an IPO-registration system?

Despite the delay to a registration-based system, it appears that the CSRC is getting ready for it in any case. It has made policy changes to improve information disclosure standards, such as on substantial ownership, and has conducted training and educational sessions for investors.

Regulatory officials often take up positions in the financial sector

Musical chairs

Another HR phenomenon worth highlighting is the tendency of senior CSRC officials to move into jobs in the financial sector. One of the latest was Huo Da, a former head of the CSRC's marketing department who joined China Merchants Securities as its new chairman in September 2017 after an almost 20-year career with the regulator. After leaving the CSRC, Huo was appointed as a part-time member of its 17th IPO approval committee.

A three-year cooling-off applies to officials joining private companies, but not SOEs

Such moves raise reasonable concerns about conflicts of interest. Indeed, according to the Civil Servant Law of China, former officials must comply with a cooling-off period of three years before they can join a company that used to be under their supervision or conduct any business related to their previous work. Although the CSRC has applied this rule since 2015, Huo could join China Merchants Securities because the rule does not apply to officials joining SOEs. In bureaucratic terms, such a move can be rationalised as simply a transfer within the political system.

Zhou Xiaochuan retires

A giant leaves the stage

Another landmark development has been the retirement of Zhou Xiaochuan, the longest-served governor of the PBOC, in March 2018, at age 70 after serving the bank for 15 years. Zhou's retirement should have occurred before the 19th Party Congress in mid-October 2017, but was delayed for unknown reasons. His former deputy, Yi Gang, took over the post and has become the first chief of a critical governance body with extensive overseas experience.

The merger of CBRC and CIRC marked an end to the "one bank, three commissions" model

One day after Zhou announced his retirement, the merger of CBRC and CIRC was made public. The merged commission, CBIRC, was officially launched on 8 April in Beijing, marking an end to the "one bank, three commissions" supervisory model that had lasted for 15 years. The merger also saw the two commissions give back their policymaking power to the PBOC, leaving the merged commission to focus on market supervision and rule implementation.

The "merger" looked more like a takeover

Although this merger has been long-expected by the market and is a key element in the effort to improve coordination among regulators, it did not include the CSRC as many previously anticipated. The official explanation was that the similarities in the work of the CBRC and CIRC made it more reasonable to merge these two entities. But the so-called "merger" looked more like a takeover of the CIRC by the CBRC, not least because the latter has a much larger regulatory remit. It may also in part be a punishment of the CIRC for the problems it caused in the market in recent years, in particular the aggressive buying of equities by insurance funds such as Anbang, Baoneng and others. Such purchases were possible partly because the former CIRC, under the leadership of Xiang Junbo, raised the threshold for investments in equities by insurance companies. Xiang was prosecuted for corruption in early 2017.

Regulators have also been pushing for more professionalism in compliance

Enhancing compliance

Capacity building has also taken place within financial firms. On 28 November 2016, the former CBRC issued guidance requiring all major banks and asset management companies to reform their legal departments by the end of 2017. This was aimed at improving the professionalism of inhouse legal staff in the banking industry and was the first policy of its kind. Shortly afterwards, on 30 December 2016, the former CIRC issued its "Insurance Company Compliance Managing Guideline", which required all insurance companies to set up compliance departments and have qualified compliance officers by 1 July 2017.

2.2 Enforcement

China ranks 2nd in this sub-category with a score of 64%

China is ranked second in this sub-category, its best position in the whole study, thanks to a strong enforcement campaign by the CSRC following the 2015 stock crisis and the CBRC's (now CBIRC) tough inspections on banks.

CSRC enforcement has been on the rise . . .

For 2017 as a whole, the total number of CSRC enforcement actions was 224 and total fines amounted to Rmb7.5bn - a 22% and 74% increase on 2016, respectively. Of these, 60 cases were related to information disclosure, 60 to insider trading, 21 to market manipulation, and 17 cases involved intermediary misconduct. Over the first half of 2018, the CSRC conducted 159 enforcement actions - a 41% increase on the same period in 2017. Of these, 63 cases were related to information disclosure, 36 to insider trading and 14 cases to market manipulation.

. . . and ever since the 2015 stock market crisis

Indeed, enforcement has been on the rise ever since the 2015 stock crisis. In 2016, the CSRC issued 218 sanctions in 183 general enforcement cases, an increase of 21% YoY, with total fines amounting to Rmb4.3bn - almost four times that of the previous year.

Fines in banking rose 10 times in 2017

In the banking sector, the former CBRC took 3,452 enforcement actions in 2017 against 1,877 financial institutions and issued fines totalling Rmb2.93bn, a ten-fold increase compared to 2016. There were 1,547 individuals punished as a result of these actions, of which 270 were banned from entering the banking industry or being a senior manager for a period ranging from a few years to life.

SSE disciplinary orders increased 30% in 2017

As for the two stock exchanges, they have also had an active couple of years. SSE made 90 disciplinary orders in 2017, a 30% increase on 2016, while SZSE made 103 disciplinary orders, on the par with that of 2016 (106 orders). The enforcement focus of both stock exchanges is market manipulation, fraudulent asset restructuring plans and abuse of the suspension mechanism. In particular, more than 40% of the enforcement actions undertaken by the SZSE related to false information disclosure. By October 2018, SSE had taken 183 enforcement actions against companies and individuals by way of public reprimand, public criticism, regulatory letters and regulatory concerns while SZSE had issued 395 regulatory letters to all listed companies on its three boards during the same period, according to an ACGA analysis of their announcements.

SSE and SZSE have been triggering mandatory delisting more frequently

An interesting development at the stock exchanges has been their more frequent use of mandatory delisting as a weapon to deter rule-breakers. For example, the SSE triggered the delisting of Jilin Jien Nickel Industry and Kunming Machine Tool Company in May 2018 and the SZSE did the same for Geeya Technology in June 2018.

Enforcement disclosure

Regulatory disclosure of enforcement actions has improved in China

Another area of improvement in regulatory performance since our last *CG Watch* survey has been the quality of information disclosure on enforcement by financial regulators. The CSRC now announces its enforcement actions at a weekly press conference with timely posts on its official WeChat account. Both the SSE and SZSE also disclose detailed explanations about each of their enforcement cases, while the SZSE makes weekly enforcement statistics available on both its website and official WeChat account.

Some high-profile individuals and firms have been prosecuted

Putting names to the numbers

Regulators have gone after some high-profile individuals and firms in the past two years - and won record fines and prison sentences. For example:

- On 23 January 2017, Xu Xiang, once called "the King of hedge funds", was sentenced to 5.5 years in prison and ordered to pay Rmb11bn by the Qingdao Intermediate People's Court for stock manipulation.
- On 24 February 2017, the former CIRC disqualified Yao Zhenhua, who initiated the hostile takeover bid against Vanke in 2015 from his position as chairman of Foresea Life and banned him from the insurance industry for 10 years. Two days later, another key protagonist in the Vanke case, Evergrande, was banned from buying stocks for one year, while two directors were banned from the insurance industry for five years and three years, respectively. Stocks linked to both groups plunged the next day.
- On 24 February 2017, the CSRC fined Xian Yan, a director of P2P Financial Information Service, the huge sum of Rmb3.47bn for manipulating company share prices. This record was later broken on 14 March 2018 in an enforcement decision against Bei Ba Dao Group, also for share price manipulation. The Rmb5.5bn fine was about six times the illegal gain made by the company.

CSRC punished the agitators of the stock crisis and claimed more was coming to them

Inconsistencies

While financial regulators have certainly been more vigorous in China over the past two years, they have not always been consistent. For example, on 25 November 2016, more than one year after the stock market chaos in July 2015, the CSRC finally released its enforcement decision against four major securities firms, two online trading platforms and one software company for their suspected irresponsible behaviours before the crisis. The four securities firms punished were GF Securities, Haitong Securities, Huatai Securities and Founder Securities. More than just slapping them with fines about three times the revenue they had made, the CSRC also told the media that the firms' annual ratings would be affected in 2017.

But . . .oops?

An annual rating from the CSRC affects a firm's business on many levels, especially its equity and bond issuer qualifications and the reserve it has to place with the China Securities Investor Protection Fund. However, tracking the development of the case above against the four brokers highlights that the ratings of three firms actually improved in 2017, while the fourth went up in 2018. No explanation has been given by the regulator as to this apparent change of heart.

Annual ratings of the four under-punished securities firms from 2016 to 2018

Figure 2

Four securities firms' ratings

Securities company	Confiscated (Rmbm)	Fine (Rmbm)	2016 rating	2017 rating	2018 rating
GF	6.8	20.41	BBB	AA	AA
Haitong	28.65	85.95	BBB	AA	AA
Huatai	18.23	54.7	BBB	AA	AA
Founder	7.86	15.72	C	C	A

Source: CSRC

CSRC lost a case in 2018 due to procedural error

It is also important to note that regulators do not always get it right in China - and the court system has been somewhat more active in saying so. On 17 July 2018, the Beijing High Court issued a decision in a case involving an individual fined Rmb1.3 billion by the CSRC for insider trading in 2016. In its ruling, the Court

stated that due to unclear facts and evidence provided by the CSRC, and the "illegal procedure" the regulator had followed, it found against the CSRC and ordered it to retract the fine. The High Court also criticised the CSRC for not conducting better due diligence in its investigation by using obvious clues to find a key suspect involved in this case.

Patricia Cheng
Head of China Financials Research
patricia.cheng@clsa.com
+852 2600 8683

Whipping boy

Chinese regulators have been setting new records every year in whipping the banks, brokers and insurance companies. For example, the CSRC issued 1,269 penalty orders in 2017, 30% higher YoY. And that's already after a 51% surge in 2016 and 47% in 2015. More than half of the cases were related to violation in information disclosure and insider trading. Total fines amounted to Rmb7.6bn last year, up by 80% YoY.

In banking, Bank of Nanjing apparently had received too many warnings from CBIRC so the CSRC had to reject its private placement plan (or so media reports suggested, the other theory being disaccord between the two regulators). In insurance, PICC's former president lost his job because of corruption and was given an 11-year sentencing. New auto business for Ping An, PICC and Taiping were suspended for three months in Sichuan in 1H18 because of rebate and other controversial practices.

To top it all off, the former chairman of China Huarong Asset Management was arrested earlier this year on corruption and other charges, most likely related to using international subsidiaries to make dubious investments at dubious valuations. The auditor had to give a qualified opinion for its interim report. The crackdown in misdemeanour is showing no signs of easing.

Financial institutions are having to tighten up governance, but we believe corruption is unlikely to go away.

3. CG rules

China ranks 8th with a score of 58%

China is ranked 8th in this section with a score of 58%. It did relatively better in this section because some key rules and guidelines have been amended or issued over the past two years, while many of its basic rules on financial reporting, disclosure of substantial ownership stakes, director trading and share pledges, among other things, are quite robust by regional standards.

A major event was the arrival of a new CG code

In terms of new rules and guidelines, a major event has been the arrival of the new Code of Corporate Governance for Listed Companies (CG code), recently revised for the first time after 16 years. The two stock exchanges have also been busy making more specific rules on information disclosure to provide investors more detailed information on various issues.

Changes to securities and company law are in the works

A number of legislative amendments are in process. The Securities Law finished its second review in April 2017 and is still undergoing a third review. The Company Law was under public consultation from 12 September to 5 October 2018 with an amendment focussing on broadening the application of share buybacks and formalising related procedures.

CDRs became a hot topic in early 2018

Other regulations have arrived more quickly. China Depository Receipts (CDRs) became a hot topic in early 2018, but were soon put on ice due to the market downturn and investor disinterest. Some rule changes surprised the market: intermediaries are now expected to shoulder more responsibility for any misbehaving issuers that they sponsor.

Revised CG code, finally

The revised CG code is finally here

On 15 June 2018, the CSRC issued its long-awaited draft of a revised CG code and allowed only a four-week consultation period. This is the first amendment of the Code since it was jointly issued by the CSRC and the former State Economic and Trade Commission (SETC) on 7 January 2002. The amendment began in August 2016 and was mainly carried out by the CSRC and the China Association for Public Companies (CAPCO). The final version was released just before the week-long holiday to celebrate National Day on 1 October 2018.

The new code emphasises Party construction in listed SOEs

The most significant change in the code is the addition of a clause (Article 5) stating that all listed SOEs must include "Party construction" work into their articles of association. In practical terms, this means forming a Party Committee, as described in our section on Government & Public Governance. At the same time, all listed companies are required to provide "necessary conditions for the activities of Party Organisations" in accordance with the Company Law (Article 19). Indeed, while this section is a new addition to the CG code, it is not entirely new in law - Article 19 of the Company Law has been in place since 1993. But the stipulation on amending articles of association is new. At this stage, companies are not required to disclose any information about the membership or activities of their Party Committees.

Audit committees are given more prominence, as are responsible investment and sustainable development

The new Code also places more emphasis on the importance of company articles, which are mentioned 37 times compared to 25 times in the original version. It says that all listed companies "shall" (ie, must) form audit committees (the original only said "may") and can form other specialist board committees, such as for strategy, nomination, remuneration and appraisal, as needed. The chairman of the audit committee must be an accounting professional (the original only said one of the independent directors on the committee had to be an accounting professional). The new code also stresses the accountability of the chairman and other board directors regarding shareholder protection, especially on the quality control of information disclosure (Article 93). Moreover, two new chapters are added to encourage responsible investment and engagement by asset owners (pension funds) and other institutional investors (Chapter 7), and to urge companies to make more voluntary contribution to the sustainable development of society and the environment (Chapter 8).

But most of the content in the new code closely follows the original version

Apart from the new policies mentioned above, the revision closely follows the content of the original code. For example, the ratio of independent directors remains at one-third, the description of board committees and their responsibilities has not changed, nor has the section on supervisory boards. One new point of emphasis, however, is that companies with a controlling shareholder owning 30% or more are now strongly recommended to adopt cumulative voting for their supervisors (Article 17). It was previously only required for directors.

The new CG code is not a self-contained document . . .

One major drawback of the code, in our view, is that it repeatedly refers to other guidelines to be produced in future by the two stock exchanges and self-regulatory associations, such as the China Association for Public Companies

(CAPCO) and the Asset Management Association of China (AMAC). Unlike many codes in Asia and elsewhere, China's CG code is not a self-contained document that serves as a unitary reference point on CG best practices.

. . . and does not follow "comply or explain"

Another important distinction to draw is that China, like most North Asian countries until recently, does not follow the "comply or explain" principle. Indeed, this concept does not exist in China. The code is rather a combination of principles and practices, some of which companies must follow and others they can choose to abide by. There are few penalties for non-compliance though.

CDRs: too good to be true?

CDRs become the hottest topic in early 2018

Seeing as Hong Kong was about to introduce dual-class shares (weighted voting rights) and allow secondary listings of overseas-listed Chinese tech companies, the CSRC told the press in February 2018 that it was considering launching China Depository Receipts (CDRs) to permit domestic investors to trade overseas-listed Chinese companies. On 30 March 2018, the State Council announced guidelines for promoting CDRs that focused on innovative companies in the internet, IT services, biotechnology and other high-tech or strategic emerging industries.

CDR guidelines were contradictory on the issue of investor protection

One contradiction became quickly apparent: although the guidelines said all issues relating to ownership structure, corporate governance and the operational rules of CDRs should comply with the regulations of the country in which the companies were listed, shareholder protection standards should not be lower than those prevailing in China. This posed an obvious conflict around dual-class shares, a capital structure not permitted in China yet adopted by most of the tech companies the CDR policy was trying to lure. Baidu, Sina and JD.com, among many others, have a DCS structure. Alibaba has a "special partnership" system that achieves the same result.

Investor passions cooled when they realised CDRs were not real "receipts"

On 7 June 2018, the CSRC issued nine documents to regulate and promote the issuance and trading of CDRs. But once investors realised that CDRs were not real "receipts", their interest cooled. Unlike the American Depository Receipts (ADRs) of foreign companies listed in the US, CDRs cannot be converted into actual shares of the underlying companies. The government also realised that the valuation model of overseas-listed China companies was fundamentally different from their peers in the A-share market, while current economic conditions were not ideal for the introduction of CDRs. The policy has therefore been put on hold, but will likely re-emerge when the time is right.

Raising the bar

CSRC put new curbs on senior management selling their shares in 2017

In other rule changes, in May 2017 the CSRC announced new curbs on the ability of the senior management, directors and controlling shareholders of listed companies to sell their shares. Such sales are a headache for the regulator, since they often accompany or presage a fall in share prices. Although designed as a market stabilisation measure, some criticised the new rule as only intensifying another long-standing problem in China - that of concentrated ownership. While it is not going to diminish significantly in China any time soon, not allowing major shareholders to reduce their stakes impedes the diversification of stock ownership and the strengthening of market discipline of companies.

Stock exchanges had hoped to raise the bar on disclosure of substantial ownership, but market reaction was negative

What also caught regulators by surprise was the negative reaction to a consultation, issued by the two exchanges on 12 April 2018, regarding disclosure of changes in substantial ownership. The exchanges sought to raise disclosure standards by proposing a reduction in the disclosure interval from every 5% to every 1% for stakes above 5%, thus bringing China's rules into line with international standards. But some market participants complained that greater transparency would allow other investors to free ride on the investment strategies of substantial shareholders and make it more costly for the latter to build bigger stakes. This and other new rule proposals were unfair, they claimed. As of end-October 2018, the exchanges had yet to issue any new formal rule changes.

Intermediaries will be expected to take more responsibility for the quality of IPOs they sponsor

It is also understood that intermediaries in China, including investment banks, law firms and audit firms, will be asked to take more responsibility for IPO applications they sponsor or work on. To some extent, the change has already happened. In a recent case involving a company called Dandong Xintai Electric, its law firm was fined by the CSRC for not fulfilling its fiduciary duty to review the auditor's work and detect fraud. For this reason, the 18th Listing Committee of the CSRC, which will be announced later in 2018, will consist of more representatives from intermediaries, a source told ACGA.

Other major rule changes in the past two years:

Other new regulations relating to corporate governance have included:

- In early May 2017, the SZSE amended its rules on independent directors to ask companies to increase disclosure of their track record and attendance.
- On 26 December 2017, the CSRC amended rules on the content and format of annual and interim reports of listed companies to encourage more disclosure on environmental, social, and governance (ESG) issues.
- On 18 May 2018, the State-owned Assets Supervision and Administration Commission (SASAC), MOF and the CSRC jointly issued the "Measures for the Supervision and Administration of State-owned Equities of Listed Companies" to streamline the management of state ownership in companies.
- On 12 July 2018, AMAC issued a consultation on its "Green Investment Guidelines (trial)". The consultation closed on 23 July after a 10-day consultation period. There are no conclusions yet.
- On 27 July 2018, the CSRC issued amended listing rules to toughen the mandatory delisting of issuers with serious misconduct.
- On 28 August 2018, the Insurance Association of China issued four voluntary guidelines to improve the governance standards of insurance companies.

4. Listed companies

China is ranked 12th with a score of 36%

China ranks last in this section with a score of 36% due to limited or boilerplate reporting on corporate governance matters, such as board and committee practices, board diversity, evaluation and director training. Sustainability or ESG reporting remains formulaic in China, despite rules on "CSR" reporting being in place since 2006. Boards mostly lack an independent chairman or lead independent director, while SOE boards do not have autonomy to make all major decisions. There is not a lot of transparency on executive remuneration policies, while reporting on related-party transactions could be better.

Companies do better on financial than CG or ESG reporting - not surprisingly

On the other hand, companies score somewhat better on financial reporting, the quality of their investor relations web pages, the presence of audit committees with financial and accounting expertise, whether fees paid to independent directors create conflicts of interest (eg, through the use of stock options), and their reporting on risks, internal controls and dividend policies.

Compliance reporting

Large caps are improving disclosure on shareholder engagement, but not on MD&As and RPTs

Among the 15 representative large-cap companies surveyed in detail, only a few provided a discussion on business segmentation and company strategy, such as Sinopec and Citic Securities. Some made an extra effort to put shareholder engagement on the record, including Baosteel, China Minsheng Bank, Shanghai Pudong Development Bank, China Yangtze Power, SAIC Motor, Yili Group, Gree Electric and Yunnan Baiyao. On related-party transactions, Sinopec was the only company that provided detailed approval thresholds, the reasoning behind transactions, and advice from an independent financial consultant during the transaction process.In terms of the 10 midcaps reviewed, most companies tended to give only boilerplate disclosure. But there were two exceptions: China Shipping Development, which disclosed specific actions during the current and past year in its CG report; and Shenzhen Expressway, which disclosed not only the attendance of all directors at board and shareholder meetings, but also for all board committee meetings, including two specific meetings for its independent directors.

Disclosure needs to be more useful for shareholders

Overall, the disclosure made by companies in our sample seems more compliance-driven than aimed at providing shareholders with useful information. This can be seen, for example, in the lack of any explanation of the rationale for major acquisitions or disposals. Or in the disclosure of specific risks without corresponding solutions and strategies provided. Or the existence of board committees with only a limited description of their work. Or in the discussion of sustainability policy without any specific targets for reducing emissions. And as for a board diversity policy, only two companies made any disclosure (Sinopec and China Minsheng Bank).

Barbarians inside the gates

POEs are aggressively changing their articles after the Vanke saga

Following the hostile takeover battle for Vanke over 2015 and 2016, a risk highlighted in *CG Watch 2016* was the possibility of entrepreneurs in China erecting new anti-takeover defences. One company that did so was Boya Bio-Pharmaceutical Group, listed in Shenzhen, which changed its articles (April 2018 version) to require an acquirer which owns 5% or more of the company to seek approval from the shareholder general meeting for any further acquisitions. If they do not, then the "acquisition will be regarded as a hostile takeover and the acquirer will be barred from nominating directors or supervisors and from calling an extraordinary general meeting". This is an appalling breach of shareholder rights.

Regulators have to step in to stop these practices

Regulators are trying to stop such unfair practices. The revised CG code includes a statement that, "listed company articles, shareholder meeting resolutions or board meeting resolutions should comply with rules to not disenfranchise shareholders or restrict any legal rights that belong to shareholders". However, the articles of Boya remain unchanged and more than 600 other POEs have amended their articles to include anti-takeover devices.

Nicole Wong
Head of Property Research
nicole.wong@clsa.com
+852 2600 8207

The Vanke saga in a nutshell

What happened?

Shareholder Baoneng began to accumulate Vanke shares from mid-2015. By mid-2016, Baoneng's stake reached almost 25% and it issued a letter proposing to dismiss all Vanke board members. The company was only able to avoid trouble after Shenzhen Metro, a subsidiary of the Shenzhen government, took an even bigger stake compared to Baoneng.

Vanke share register before and after the takeover battles

2015 Shareholders	Stake (%)	2017 Shareholders	Stake (%)
China Resources Group	14.9	Shenzhen Metro Group	29.4
HKSCC Nominees	12.0	Baoneng Group funds	25.4
Guoxin Securities-ICBC AM	4.1	HKSCC Nominees	11.9
China Life Insurance (2 funds)	1.4	Anbang Group (subsidiaries)	4.6
GIC Private	1.4	Guoxin Securities - ICBC AM	4.1
Liu Yuansheng	1.2	China Merchants fund	3.0
Merrill Lynch International	1.1	Western Leadbank - CCB fund	2.0
Vanke Labor Union Committee	0.6		
UBS AG	0.5		

Source: CLSA, Vanke 2017 Annual Report, ACGA

The lesson for listcos

Build an institutional shareholder base and look after the share price. For years, retail investors dominated Vanke's shareholder base, but the company had become complacent about its share price remainig undervalued, making Vanke vulnerable to a hostile takeover.

Timothy Lee
Head of China/HK Mid/Small Caps Research
timothy.lee@clsa.com
+852 2600 8461

Controversial IFRIC 12

Although Chinese enterprises' financial reporting has improved in general, Hong Kong's IFRIC 12 accounting standard has been a thorn in investors' (and analysts') sides. It dictates financial reporting for many HK-listed utilities, which provide long-term customer services contracts. For example, an incineration company operating in China but listed in Hong Kong must adopt IFRIC 12 in order to be compliant with the IFRS Foundation. Companies listed in Hong Kong that have adopted this rule include CEI, BE Water and Canvest; while exceptions include companies that are dual listed, such as Dynagreen, who are allowed to adopt alternative non-IFRS financial reporting, eg, Chinese Accounting Standards (CAS).

How it works

Using a waste-to-energy (WTE) plant as an example: Under IFRIC 12, the plant's construction revenue is recognised during the construction phase using the percentage of completion method, based on the expected mark-up of the project which is then applied to the actual construction costs incurred, despite no cash inflow generated until the project enters into the operational phase and begins to receive government compensation. Concurrently, this would also be considered revenue from the guaranteed portion of the overall revenue stream throughout the life of the contract (eg, the local government guarantees the WTE plant will receive waste equalling 80% of the designed capacity of the

plant throughout the 30-year concession right). The net present value of this guaranteed amount is recognised as a finance asset on balance sheet, with the balancing figure recognised as intangible assets during the construction phase.

Accounting entries	
During construction:	
Dr Construction cost (P&L, actual)	
	Cr Cash
Dr Financial assets (Net present value of guaranteed waste treatment fee)	
Dr Intangible assets (balancing figure)	
	Cr Construction revenue (P&L, construction cost + markup)
During Operation:	
Dr Cash (Actual tipping fee received)	
	Cr Tipping fee income (P&L, non-guaranteed amount)
	Cr Financial assets (B/S, guaranteed amount)
Dr Cost of sales - amortisation (P&L, over life of concession right)	
	Cr Accumulated amortisation - Intangible assets (B/S)

Note: Dr = debit, Cr = credit. Source: CLSA, IFRIC 12

Impact

IFRIC 12 therefore involves significant management judgement discretion, including the mark-up of the project, the estimated cost of the project, the estimated progress of construction, etc. It is also known to "overstate" revenue at the construction stage and "understate" revenue at the operational stage of the concession right.

2017 revenue and gross profit of the major utility companies adopting IFRIC 12

Company	CEI	BE Water	Canvest
Ticker	257.HK	371.HK	1381.HK
Unit	HK$m	HK$m	HK$m
Overall revenue	20,043	21,192	2,398
Revenue from IFRIC 12			
Construction revenue	13,242	6,647	1,266
Finance income	2,014	1,683	53
Revenue from IFRIC 12 as % of overall	76.1	39.3	55.0
Overall gross profit	7,133	6,465	819
Gross profit from IFRIC 12			
Construction revenue	3,005	1,662	211
Finance income	2,014	1,683	53
Gross profit from IFRIC 12 as % of overall	70.4	51.7	32.2

Source: Respective companies, CLSA

IFRIC 12 has been criticised by external parties . . .

This has led to uncertainty over the trustworthiness of the accounting treatments made by companies that have adopted IFRIC 12. For instance, GMT Research published a research report on 29 June 2017, which asked investors to avoid 12 Asian infrastructure names, citing IFRIC 12 as one of the most misguided accounting guidelines. The research firm also wrote a short-selling report on BEW on 16 December 2015 alleging that IFRIC 12 allowed the company to increase its earnings.

. . . but listcos have no choice but to use it

Adopting IFRIC 12 gives listcos flexibility, but it is not helpful in helping a company meet their investors' requirements. Unfortunately firms must adopt the new accounting standards if they are listed in Hong Knog. So, instead of critising the corporations for adopting IFRIC 12, look at the rule setter.

Focus on cashflow

Given the distortion on reported profit, an alternative is to look at a company's operating cashflow (OCF) to see its operating performance. Take Canvest as an example: From the reported OCF, we adjust for the construction cost of the BOT projects as well as non-current items to get the effective OCF from operations of the WTE plants. Canvest has generated positive effective OCF previously, and for each tonne of waste treated, the effective OCF falls in around Rmb150-200/t, with a lower level in 2017 due to some unsettled receivables from local governments as well as expansion into non-Guangdong areas (eg, Guangxi, Guizhou) where the treatment fee is lower.

Backing into Canvest's effective operating cashflow

(HK$m)	2011	2012	2013	2014	2015	2016	2017
Net operating cashflow	**76**	**204**	**221**	**202**	**(31)**	**(54)**	**(668)**
Add: Cost of BOT arrangement	-	-	-	206	486	703	1,055
Add: Change in non-current trade and other receivables, prepayments	-	-	-	(8)	11	15	132
Less: Change in non-current payables	-	-	-	-	(37)	(108)	39
Effective OCF	**76**	**204**	**221**	**400**	**429**	**557**	**557**

Source: Company, CLSA

Johnny Lau
johnny.lau@clsa.com
+852 2600 8175

IFRIC-12 and the trust deficit

Through exercises like the above, we believe we can construct a reasonable picture of the IFRIC-12 businesses that we cover. However, it is not perfect and investors are naturally treating these stocks with more caution. This caution was captured when the board of China Everbright (CEI), the largest WTE company in China, approved a HK%10bn rights issue in August 2018 and the subsequent share-price dip.

In this case, CEI did not do itself any favours. Most notably, there was insufficient disclosure of the use of funds with only a one-pager in the original announcement. Given that the company already seemed to have sufficient cash available to support its existing capex plans, this left minority shareholders confused as to the purpose of the rights issue. Many were also put off by the offer price of HK$6.00/share (discount of 31% vs 27% dilution) that was signed off by the board.

Ultimately, the round of funding was completed with 95% of the rights exercised, and the remaining 5% new shares taken up by excess rights application. However, it forces us to mark down our CG score on CEI, and apply a discount to our DCF-based valuation.

5. Investors

China ranks last with a score of 18%

China also ranks last in this section with a score of just 18%. This very low score is the result of a combination of systemic market characteristics: the lack of a defined stewardship code and large asset owner or owners taking the lead on responsible investment; the high proportion of retail investors with high trading turnover and little interest in CG; the many short-term focused institutional investors, which also have limited interest in CG and do minimal engagement with companies; the low attendance of investors at AGMs; and the low percentage of investors who vote against resolutions.

But seeds are being planted in several areas

The best thing that could be said about this area in China is that the score can only go up! Indeed, there have been some positives over the past year or two. The concept of "responsible investment" is slowly emerging as a topic of discussion in China, although most of the focus to date has been on environmental issues. A few domestic investment managers are starting to engage with companies on governance or ESG issues. The MSCI inclusion in June 2018 should lead to more focus by foreign investors on governance issues. Some local proxy advisors have been founded to provide voting advice on A-share companies. And shareholders are starting to use the legal system to seek compensation from companies. But these are all nascent developments that will take a long time to reach maturity.

Early days

AMAC has gotten the ball rolling on ESG, but a stewardship code would add momentum

Over the past two years, more institutional investors have started to talk about responsible investment or ESG following AMAC's promotion of these concepts. Some are even trying to incorporate ESG factors into their investment decision-making processes. But without a clear stewardship code to define these terms, and a leading asset owner to set the direction, it will be challenging for institutional investors to maintain momentum.

Market trading is still dominated by retail

One unique feature of China's capital market that affects the nature of regulation and company governance is the high proportion of retail investors. According to the latest statistical yearbook from the SSE, natural-person investor accounts made up 99.79% of all investor accounts and 85.62% of total trading value, including buying and selling, but only 23.7% of total share ownership in 2016. This helps to explain the high volatility and often irrational nature of the Chinese market, as well as why the CSRC's key focus is to protect the retail investor. It is also why companies feel little pressure from the market for improvements in corporate governance.

Retail participation in AGMs is declining, according to one law firm

Retail investors normally have no resources or motivation to participate in governance-related discussions, nor do many attend AGMs and vote on company resolutions. In fact, according to a partner of a major law firm in China, the participation rate of retail investors in shareholder meetings has declined over the past two years. In a recent general meeting of one of their clients, a large SOE, only one retail shareholder attended - and that was by internet!

Class action spring?

Quasi-class actions are starting to happen in China

An interesting development over the past few years has been the willingness of retail investors to use quasi-class actions to seek compensation from companies. The process is called "quasi" because a company must first receive an enforcement order from the CSRC before its shareholders can initiate a lawsuit. According to data provided by Valueonline, a Shenzhen-based compliance data

provider, there were 187 lawsuits against 28 companies with total compensation sought of Rmb1.75bn between March 2015 and August 2018. The largest claim has been Rmb444m filed by 73 investors against Shanghai DZH for false disclosure. All these cases are ongoing.

6. Auditors & audit regulators

China ranks 11th with a score of 50%

China is ranked 11th in this category with a score of 50%.

The audit regulatory system in China is complicated: the MOF has the final oversight power, while the National Audit Office (NAO) is responsible for auditing all the government bodies as well as SOEs and government agencies. The CSRC has some oversight of auditors of listed companies, but this is not its main task. And the Chinese Institute of Certified Public Accountants (CICPA) develops professional standards and rules for Chinese CPAs, formulates professional regulatory rules and takes disciplinary actions against offenders.

Going forward, CICPA will focus on being a professional body, while MOF will strengthen enforcement

Compared to 2016, it is understood that CICPA has become more of a professional than regulatory body, while the MOF is taking more of the burden of enforcement actions. Going forward, MOF will enhance its inspection, investigation and sanctioning of auditors and audit firms.

Audit quality is a black box

Audit quality in China is like an aeroplane black box: you only get to look inside after a crash

One reason for China's low score is that compared to other Asia-Pacific markets, information disclosure from audit regulators is limited. For example, no disciplinary proceeding decisions can be found on the MOF or CICPA's websites. The MOF does not disclose the results of its inspection of CPA firms auditing listed companies. CICPA does disclose its inspections of accounting firms and projects about twice a year (usually in the first half of the year due to the reporting season), but only gives general statistics with no further details. Sometimes the MOF discloses its enforcement work via the CSRC website, but this is not a regular practice and little information is provided.

Unclear timetable for CPA firm inspections

While the roles of the MOF, CSRC and CICPA are formally separate, they conduct overlapping inspections and investigations from time to time. It is also understood that while the three agencies are supposed to conduct cross-inspections of the big CPA firms every three years (one year by each), this process does not always happen.

CICPA's annual report on the top 100 firms and weekly report on the number of qualified reports are the only regular audit quality-related reports in China

More positively, CICPA does publish an annual list of the top 100 firms by performance and also publishes weekly/bi-weekly reports on the number of qualified vs clean opinions issued by audit firms. These two kinds of reports, although only available in Chinese, give a useful overview of the audit market and are about the only official public reports one can find on audit quality in China. Meanwhile, the top 100 ranking of firm performance in 2017 had still not been published as of end-October 2018. The only thing available is a top 100 ranking in terms of firm revenue, issued on 30 May 2018.

The dilemma for MOF

MOF is shifting its course from quantity to quality

The MOF has long been known for its focus on helping local accounting firms compete with international firms through restrictions on foreign audit firms conducting audits of Chinese companies, even for some listed on overseas markets. This is understandable, especially in the context of the current One Belt, One Road initiative that will encourage many Chinese firms to "go out" and the

national security concerns surrounding some sectors and state enterprises. However, it seems that over the past two years, the MOF is taking audit quality more seriously.

Two top-ranked local firms were punished for recording two disciplinary actions . . .

In early 2017, both Ruihua and BDO, two top local auditing firms in China that ranked second and fourth in the 2016 annual ranking, respectively, were banned by the MOF from auditing public companies for two months. This was because the firms had each registered two disciplinary actions within two years, enough to trigger a suspension. A source close to the matter told ACGA that although Ruihua resumed its business after the two-month suspension, reports from MOF showed that it had failed a performance review on various grounds. On 19 June 2017, the MOF and the CSRC made a joint announcement banning BDO from taking on new IPO-related business for two months. The ban is a consequence of the firm being punished twice by the CSRC, in July 2016 and May 2017, for a lack of due diligence in its auditing work.

. . . and more

Furthermore, on 12 June 2018, the CSRC announced it had stopped accepting IPO and refinancing materials from six accounting firms, namely BDO, Ruihua, Da Hua, Zhonghua, Xing Hua and Grant Thornton, because all had unresolved litigation claims against them or were under investigation by the Commission. This announcement caused a stir in the market as the six firms conduct auditing and accounting for more than 40% of the IPO applicants queuing for CSRC approval. However, it appears only new applications were affected, not ones already under review.

Could higher standards of auditing help to develop the CPA industry?

Not surprisingly, regulators have not sought to introduce "audit quality indicators" in China - an issue still under debate in many developed markets. The MOF seems to face a dilemma in choosing between promoting the business development of local CPA firms and penalising them for auditing failures. Perhaps the question needs to be turned around: how can the local CPA industry improve its standing and reputation over the longer term without higher standards of auditing? And a related issue: how can the executives running listed companies be persuaded to see greater value in audit? Stronger enforcement against failures in company financial reporting might help. Securities law and listing rule enforcement, therefore, needs to go hand in hand with audit regulation.

Signs of hope

Some new developments worth noting

There are a few signs that the groundwork is being laid for a more robust auditing industry in China. For example:

- **Key audit matters (KAMs)**: China fully adopted the new long-form audit report with KAMs since the beginning of 2018 - it became effective for dual-listed A+H firms one year earlier. For the first year, most auditors chose to state the obvious and not disclose much substantial information. But it will be interesting to do a further review on this for our next *CG Watch* in 2020.
- **New CG code:** The greater emphasis in the new code on the importance of audit committees as the key board committee, and the requirement for an accounting professional to chair these committees, should gradually raise the quality of this governance function within listed companies. On the other hand, the continued existence of supervisory boards complicates matters, since many of them fulfil functions similar to those of audit committees. Overlapping responsibilities and roles will remain a problem.

7. Civil society & media

China ranks last with a score of 22%

China also ranks last in this category with a score of 22%. One reason for this low ranking is the lack of any non-governmental, non-profit organisations focusing on improving corporate governance at the national or local levels in China. Local business associations are still revenue rather than ethically driven. Thanks to WeChat, news about corporate scandals and abuses by management are difficult to avoid, but news about corporate governance policy developments are, not surprisingly, much less popular.

Consultation periods for major regulation changes are usually too short to ask for genuine comments

A related factor impeding the development of public participation in CG reform in China is the short consultation periods typically allowed for major law and policy changes. These are usually only a couple weeks, or a month at most, which is too short for the general public who have little advance notice of these consultations to submit their comments, not to mention foreigners who first have to translate the consultation paper and then translate their submissions back into Chinese.

Training and education

China has no leading organisation doing systematic governance training for directors or . . . investors . . .

China has no leading organisation undertaking systematic training for listed company directors and asset managers on corporate governance or ESG. Some organisations are involved in this kind of work, such as CAPCO, SSE, SZSE and AMAC, but their programmes tend to be ad-hoc with corporate governance only one topic among many.

. . . for board secretaries

Similarly, no leading organisation exists to provide training for board secretaries, although the revised CG code certainly puts them in the spotlight as key players in promoting better governance quality. Board secretaries in China are comparable to company secretaries in other markets, except they tend to have wider responsibilities and a higher status within their enterprises (they are regarded as executives of the company). The Hong Kong Institute of Chartered Secretaries (HKICS), meanwhile, conducts regular training for their members who are working in the mainland.

Some academic research on CG is being carried out

On the academic side, both Nankai University and Beijing Normal University carry out annual CG market index reports based on their own research parameters. AMAC has done some research on CG and ESG topics in collaboration with the Development Research Centre of the State Council.

Investor services improved?

The Investor Services Center was founded by the CSRC in 2014

Given the importance of retail shareholders in China, the CSRC helped to found a new public organisation in December 2014 to provide support to them. Called the Investor Services Center (ISC) and based in Shanghai, ISC owns a small number of shares in more than 3,500 listed companies in China and sometimes votes on important AGM resolutions on behalf of retail investors. To this date, the transparency of its work is low and, having been founded by the CSRC, the Center's independence is limited, especially with regard to anything relating to SOEs. Nevertheless, by September 2018, ISC had initiated 12 legal actions against companies with a total remedies sought of more than Rmb60m.

ISC and CAPCO launched the "China Investor Website"

On 22 May 2018, ISC also initiated the "China Investor Website", an online service platform with CAPCO. The website is only available in Chinese and it is too early to tell how effective it will be.

China has fully achieved one out of five of our Quick Fix suggestions from 2016

Recap and recommendations

Recap of CG Watch 2016

To what extent has China responded to our recommendations from 2016?

Figure 3

China: recap of 2016

	Recommendations	Outcomes
1.	More meaningful statements about CG in annual reports	Not much change
2.	Quicker reporting of audited annual financials (less than 60 days)	No change
3.	More English disclosure on regulatory websites	No change
4.	Adopt the new long-form audit report	Done
5.	More efforts on investor education and director training	Some improvement recently, but too early to tell the effect

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the market score to fall in 2020:

- Low transparency around the work of Party Committees in listed companies
- Coordination among regulators does not improve after the restructuring
- No substantial change to regulations on independent directors
- China copies Hong Kong and introduces dual-class shares
- No defined stewardship code to boost engagement, or at least a work in progress
- SOE reform sees no substantial progress; no more genuine mixed-ownership projects
- Disclosure of audit regulation does not improve

What to fix

Quick fix list

Issues to address as soon as possible:

- A clear signal from the government to focus on corporate governance development
- Encourage companies to make more disclosure around Party Committees
- More English disclosure on regulatory websites (again!)
- Speed up the revision of the Securities Law and the promulgation of the Foreign Investment Law
- A defined stewardship code and/or a state asset owner taking the lead on engagement
- More meaningful disclosure on Key Audit Matters in the long-form audit report
- Do not introduce dual-class shares!

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
+852 2160 1788

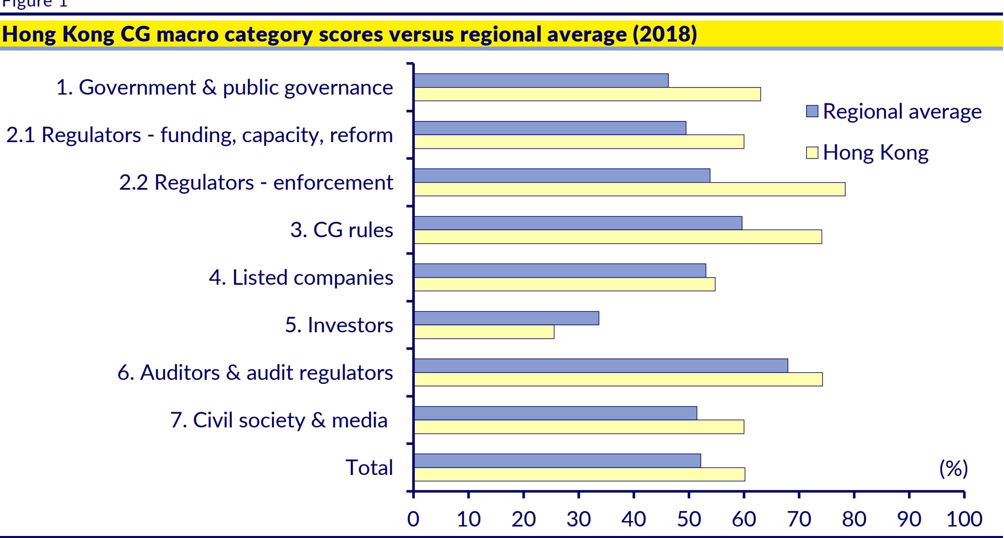
Nana Li
Senior Research Analyst, ACGA
nana@acga-asia.org
+852 2160 1796

Hong Kong – Wanting its cake

- Hong Kong loses points and credibility due to its introduction of dual-class shares in April 2018. Still no coherent government strategy on CG
- An independent audit regulator finally looks set to arrive in 2019
- Hong Kong shines on regulatory enforcement, with new "front-loaded" strategy from the SFC and high-quality disclosure from HKEX
- HKEX strengthens rules on capital raisings and delistings, but revised Corporate Governance Code disappoints
- Listed companies underperform in our new survey; board practices remain conservative
- Stewardship code has proved a disappointment, no local leadership.

Figure 1

Hong Kong CG macro category scores versus regional average (2018)



Source: ACGA

Hong Kong ranks 2nd with a score of 60%

Introduction

Hong Kong just pips Singapore to second place

Hong Kong's total score of 60% puts it in overall second place in this year's survey, some way below Australia and just marginally ahead of Singapore. Once again, this is not an impressive score for a market that prides itself on being an international financial centre. Although parts of the corporate governance ecosystem have improved over the past two years, the city lost points and credibility with its opportunistic introduction of dual-class shares (DCS) in April 2018. The flood of new DCS listings the exchange promised has, fortunately, not yet materialised. But this is a long-term game and we are only in the first quarter.

Dual-class shares have been introduced in Hong Kong with only weak safeguards

The whole DCS debate has been an unedifying spectacle. The final decision was as much politically as commercially driven, and reflected a lack of long-term thinking about systemic risks to the market or new legal powers and protections minority shareholders might need (all they got were some weak safeguards under the listing rules). Had the government said, 'we are introducing DCS but also bringing forward class-action reform', that at least would have been a balanced plan. Nor did Hong Kong use its latest revision to the Corporate Governance Code to significantly boost board governance practices, which are steadily falling behind other markets in the Asia Pacific region, as our survey shows.

Still no consistent government strategy on CG, but 2019 should herald a new independent audit regulator

Hong Kong also loses points in this year's survey for the perennial lack of any clear government strategy on CG reform - indeed, its policy decisions are often contradictory - and a continued delay in the introduction of an independent audit regulator. These are issues we have been writing about since 2010! On a brighter note, the Legislative Council's clause by clause dissection of the new FRC Amendment Bill 2018 is complete, and Hong Kong should have its independent regulator by 2019.

The SFC goes "frontloaded"

Some other things are moving forwards. Regulators have heightened powers, in particular the new "frontloaded enforcement" strategy of the Securities and Futures Commission (SFC), the "manager-in-charge" regime, and changes to the listing rules on delisting and abusive capital raising. Alongside the work of institutions such as the ICAC and the judiciary, enforcement by the SFC is one of the most robust features of Hong Kong's CG ecosystem. While enforcement by Hong Kong Exchanges and Clearing (HKEX) is not as impressive, its disclosure in this area has notably improved.

Performance across the CG ecosystem is mixed

Other aspects of Hong Kong's ecosystem have shown mixed performance. Investor stewardship is growing only slowly, in large part because of the lack of leadership from local asset owners. Hong Kong is a difficult city in which to be a shareholder activist, a function of weak legal remedies and entrenched boards unwilling to listen to outside advice. Listed companies rate quite well for financial reporting, but less well on CG and ESG reporting - although even in financial reporting there are notable gaps. And in the civil society arena, while Hong Kong does have established associations of directors, company secretaries, financial analysts, internal auditors and others, it still does not have a dedicated retail shareholder organisation. CG culture is a curious mix of modernity and antiquity.

1. Government and public governance

Hong Kong ranks 2nd with a score of 63%

Hong Kong has well-established government, legal and economic institutions among the most transparent and accountable in the region. The rule of law has persisted under "one country, two systems" and is arguably the jewel in the official crown. The executive branch of government is mostly efficient and clean, but suffers in legitimacy from a chief executive not elected by popular vote. The legislature allows for a constrained form of democracy and oversight of the executive, but is often inefficient and more interested in political gamesmanship than good law-making. The judiciary is professional and independent, however, there are concerns it is becoming subject to greater political pressure (both locally and from Beijing). The ICAC is still held in high regard, although it has lost some of its sheen in recent years.

Hong Kong should be scoring higher. Why doesn't it?

While Hong Kong does relatively well in this category compared to other jurisdictions in Asia, that is not saying much. It should be scoring much higher. In addition to the reasons outlined above, other contributing factors have been the introduction of dual-class shares in late April 2018, which in our view reflects a fundamental contradiction in CG policy; the government's at times wavering political support for the Securities and Futures Commission (SFC); and the continued dearth of proper legal remedies for minority shareholders who wish to litigate against companies. We agree with many commentators who say class action lawsuits should only be a measure of last resort. Yet the option should be available, and Hong Kong's inability to solve this problem robs the financial system of an important form of market discipline.

A change of administration in Hong Kong in July 2017 brought a new view on DCS

The DCS decision

The decision of the new Hong Kong government under Chief Executive Carrie Lam, who came into office in July 2017, was depressing for CG advocates on many counts. In contrast to the previous administration, which had a largely neutral stance, the new government's support for "weighted voted rights" (as DCS is called in Hong Kong) rested on the business case: that Hong Kong needed to get into the 21st century and create opportunities for exciting new companies to list on their own terms, lest they go to the US instead. The policy was sold on urgent competitive grounds and as offering investors more choice. Yet the decision was as much emotional as rational: the so-called "loss of Alibaba's IPO" in 2014 - the biggest in US IPO history until that point - continued to be a sore point in certain leadership circles. For these and other reasons, the long-term systemic risks of introducing DCS into Hong Kong were barely discussed.

There have been only two DCS listings since rules changed in April 2018

It is somewhat ironic, therefore, that so far the policy has not delivered on its promises. There have been only two DCS listings since the rules changed in April 2018 - smartphone maker Xiaomi, and online delivery services Meituan Dianping - whereas most other recent tech IPOs in Hong Kong from the mainland and elsewhere have been "one share, one vote" companies. DCS may yet take off in Hong Kong, but the evidence suggests many entrepreneurs are listing in Hong Kong for other reasons. The slogan the 'new economy needs a new form of corporate governance' has no credibility in our view. Witness the many emerging governance problems facing the US tech sector in recent months.

More positively, the SFC has boosted its enforcement work and budget

On a more positive note, the SFC has been allowed to carry on its enforcement work and, in particular, has introduced a new "direct intervention" strategy. It has also increased its budget, which requires government and legislative approval. (See Regulators below for a more detailed discussion.)

The HKMA has ramped up its focus on bank governance over the past two years

Bank governance

Over the past 20 years, the Hong Kong Monetary Authority (HKMA) has exerted tight supervision over the governance of banks. While we previously criticised what we perceived to be the HKMA's lukewarm approach to independent non-executive director (INED) standards in the past, in particular a soft guidance document on the "empowerment of INEDs" in 2016, it has since early 2017 ramped up its policy work on bank governance by writing to the CEOs of authorised institutions on a range of matters and updating governance guidelines. Key documents include:

- ❑ Letter on bank culture reform. (2 March 2017)
- ❑ Revision of HKMA supervisory manuals on corporate governance (CG-1) and risk management framework (IC-1). (11 October 2017)
- ❑ Letter regarding an "on-boarding programme for INEDs". (11 October 2017)
- ❑ Revision of supervisory manual on internal audit (IC-2). (31 October 2017).
- ❑ Revision of supervisory manual on competence and ethical behaviour (CG-6). (8 December 2017)
- ❑ Letter on knowledge kit for INEDs. (24 April 2018).

More emphasis on ethics, internal controls and INEDs

In sum, it has been putting more emphasis on bank ethics, internal controls and risk management, and the qualification of INEDs. It has also worked with the SFC on occasion, such as in November 2017 when the two issued a joint circular on managing conflicts of interest in financial groups. The HKMA's focus on these

issues is timely given the impact on the Hong Kong dollar peg of the trade war between China and the US, which is squeezing Hong Kong's foreign reserves. Banks are under the spotlight to tighten up risk management and internal control mechanisms to prepare for any potential change in the global market.

Corruption challenges

ICAC has comprehensive powers to tackle both public and private corruption

Most would agree a pillar of Hong Kong's economic success over the past 40 years has been the Independent Commission Against Corruption (ICAC), established in 1974 with comprehensive powers to tackle bribery and corruption across both the public and private sectors. The commission's independence is also "enshrined" in Article 57 of the Basic Law.

The arrest of Donald Tsang raised concerns about the integrity of the government

Historically, the ICAC has been seen as a highly effective enforcer. Like many of its counterparts in other jurisdictions, its work follows a "three-pronged strategy": law enforcement, systemic prevention, and community education. Yet the past few years have been less kind to Hong Kong's reputation for clean government, in the popular imagination at least. The arrest and prosecution of former Hong Kong Chief Executive, Donald Tsang, raised questions as to whether the government was as clean as everyone would like to believe. Others saw the arrest as a vindication the system works.

Tsang was sent to prison in early 2017 on bribery charges

Tsang was sentenced to 20 months in prison on 22 February 2017 (later cut to 12 months) after a career spanning 45 years in public office, including seven as Hong Kong's top official from 2005 to 2012. He had been found guilty of taking bribes from a Chinese property developer during his term in office and became the highest-ranking official to be sentenced in Hong Kong's history. Tsang's case came not long after his former No 2, Chief Secretary Rafael Hui, was charged and found guilty in 2014 of taking bribes from local property developer Sun Hung Kai Properties (SHKP). Hui was sentenced to seven and a half years in prison, while the former SHKP co-chairman, Thomas Kwok, was given a five-year sentence.

It would be fair to say these cases, and other operational issues at the ICAC, have taken some of the shine off the agency's reputation for effectiveness. In this context, an annual survey by the ICAC itself provides some interesting numbers:

Disparity between strong support for ICAC and assessment of its work

Figure 2

ICAC annual survey

Year	2014	2015	2016	2017
Sample size	1,498	1,433	1,528	1,516
ICAC deserves support	96.90%	97.00%	96.20%	96.80%
ICAC's anti-corruption work is very/quite effective	80.60%	80.30%	80.10%	78.80%

Source: ICAC Annual Survey 2017

A sizeable portion of Hong Kong people think corruption is very or quite common

Perhaps what is most interesting about the figures above - apart from that the assessment of the ICAC's effectiveness declined slightly in 2017 - is the large discrepancy between the almost unanimous agreement that the ICAC deserves support and the rating given for its effectiveness (an 18 percentage point difference). The survey also produces another finding many might find surprising: almost two thirds of respondents regularly answer the perceived prevalence of corruption in Hong Kong is either "not quite common" or "very uncommon", yet 28% believe it is either "very common" or "quite common". Clearly the ICAC's corruption prevention bureau has work to do.

Most people prosecuted for corruption are from the private sector

But it would be wrong to imply Hong Kong is going to the dogs. As other ICAC figures indicate, the peak year for people prosecuted or cautioned for corruption between 1974 and 2017 was 2002, when about 700 people were nabbed. Since then the annual figures have mostly been on the decline, reaching about 200 in 2017. And most of those prosecuted (193 persons) were either from the private sector (137) or private individuals interacting with government departments (36) or public bodies (3). Only a dozen civil servants were caught in the net.

Judicial challenges

Questions have been raised about the future of judicial independence . . .

Another pillar of Hong Kong's strength has been the judiciary and rule of law. Although the judiciary has maintained a reputation for independence and integrity post-1997, some recent political cases have caused disquiet: notably, harsh sentences imposed on democracy activists in August 2017 following a government appeal; and a ruckus in late 2016 over whether judges as well as other public officials must swear an oath of allegiance to China as well as Hong Kong. This followed an interpretation of Article 104 of the Basic Law by the Standing Committee of the National People's Congress in Beijing, stating that when officials swear allegiance to "the Hong Kong Special Administrative Region of the People's Republic of China" they are doing so to both China and Hong Kong. Some legislators thought the article meant only Hong Kong, while others worried about the implication for judicial independence.

. . . but a more immediate problem is a shortage of judges

Whatever political challenges the future may bring, a more immediate problem for the judiciary is a shortage of judges: seven out of 34 High Court positions and 36 out of 109 magistrate positions were unfilled as of March 2018, according to the *South China Morning Post*. Part of the reason is an enlarging pay gap between judges and lawyers (from 42% in 2010 to 60% in 2015), but the retirement age is another issue. The government has therefore backed a proposal to allow High Court judges and magistrates to serve until the ages of 75 and 70, respectively.

HKEX and DCS
No longer 'One Share, One Vote' (Asheefa Sarangi)

Asheefa Sarangi
Managing Director-HK and Singapore Banks
asheefa.sarangi@clsa.com
+852 2600 8300

Following a multi-year discourse, regulations were introduced in 2Q18 in Hong Kong to allow companies with weighted voting rights (WVR) structures to list on the Hong Kong Stock Exchange. The aim of this rule change is to enhance Hong Kong's appeal as a listings destination; particularly to up-and-coming new economy Chinese corporates.

Companies with WVR structures are now eligible to apply for HKSE listing provided a number of suitability and eligibility criteria are met

For WVR companies seeking a primary listing in Hong Kong, a number of suitability and eligibility criteria must be satisfied. The WVR applicant must be a new applicant; the WVR applicant must be "innovative"; the market capitalisation must be at least HK$40bn or at least HK$10bn with revenue of at least HK$1bn in the recent audited fiscal year; all WVR beneficiaries must collectively own a minimum 10% of the underlying economic interest in the company's total issued share capital at listing; non-WVR shareholders must hold at least 10% of voting power; the voting differential between WVR shares and non-WVR shares cannot exceed 10:1; and the public float requirement must be met (typically 25%).

And certain investor protection measures have been put in place

Certain investor protection measures also must be incorporated into constitutional documents. These include: greater disclosure, restriction to share class based WVR structure, voting rights requirements, restrictions on the increase of WVR shares, mandatory lapse of WVRs attached to a beneficiary's shares and enhanced corporate governance including the existence of a corporate governance committee comprised entirely of INEDs.

However this has not been enough to quell the corporate governance debate

However, the debate as to whether investors in companies with WVR structures have enough protection under the revised listing regime still rages on. Outside of questions over the adequacy of the safeguards themselves, in Hong Kong greater reliance is placed on the listing rules, the SFC and HKEX for enforcement, whereas legal action by minority shareholders is easier and more prevalent in other parts of the world. Reliance on the SFC and HKEX would be less controversial if there wasn't a concern about potential conflicts of interest. HKEX acts in a regulatory capacity and as a for-profit exchange. Further, both the SFC and HKEX are controlled by the HK government.

Striking a balance between investor protection and commerciality is challenging

In short, HKEX has tried to strike a balance between commerciality and corporate governance, but some may take the view the scales are tipped in favour of commerciality.

2. Regulators

Hong Kong ranks 1st overall with a score of 69%

Despite the introduction of dual-class shares, and consequent loss of points under the funding, capacity-building and regulatory reform" sub-category below, Hong Kong outperformed strongly on "Enforcement" to take first place in this section of our survey.

Hong Kong has a three-tier regulatory system

Hong Kong has a relatively robust and coherent securities market structure, with a strong securities commission taking the lead on enforcement. It has a three-tier system: the Financial Services and Treasury Bureau at the top representing the government and with overall responsibility for policy and oversight; the SFC in the middle as guardian of the Securities and Futures Ordinance and lead statutory enforcement agency; and HKEX at the bottom, running the cash and futures markets, as well as being the frontline regulator of the listing rules.

An inbuilt weakness is the potential for tension between the tiers

One inbuilt weakness in this system is the potential for tension between the different tiers, with blame for policy or regulatory failures usually landing at the door of the exchange or the SFC, but rarely the government (indeed that is precisely the purpose of the three tiers, as a former regulator once said). Another issue is the for-profit status of the exchange, which creates tension between its commercial and regulatory objectives - something that has been visible during the extended debate over DCS.

2.1 Funding, capacity-building and regulatory reform

Hong Kong ranks equal 2nd in this sub-category with a score of 60%

All the evidence suggests the SFC is one of the better funded securities regulators in Asia Pacific. Its budget and staff numbers have grown materially in recent years, reaching an income of HK$2bn (US$256m) in 2017/18 (to June 30) and expenditure of HK$1.7bn. It had total staff in the same fiscal year of 887 people, including 701 professional staff, while staff costs grew 29% over the three years to 2017/18. Average years of service is quite high (about eight years) and the commission provides quite an extensive training and e-learning programme for staff. It also seconds professionals to other government bodies in Hong Kong and signed an MOU with the China Securities Regulatory Commission (CSRC) in March 2018 to facilitate personnel exchanges.

The SFC benefits from a simple levy on stock transactions to fund its operations

The SFC benefits hugely from a simple yet effective levy on securities transactions for much of its income. The current levy is 0.0027% for each transaction, which is significantly less than the initial rate of 0.0125% when the levy mechanism was first set up in 1989. It also applies various other fees and charges, but notes in its last annual report: "We have not revised our fees and charges since 1994. Additionally, we have offered waivers for annual licensing fees five times since 2009. The current waiver is in effect for one year beginning 1 April 2018." Its generosity can be explained by the impact of the levy, which produced an income of HK$1.55bn in 2017/18 - a 52% increase as a result of high market turnover.

The SFC does not suffer from some of the limitations facing commissions elsewhere

Contrast these numbers with counterpart commissions in places like Australia and Japan. As their respective chapters in this report show, they typically have a much broader set of regulatory responsibilities (ie, banking, insurance, securities, auditor oversight, not just securities) yet have to make do with budgets either comparable or not commensurately higher given their greater workload. They have to engage in annual bargaining with government over scarce financial resources, something the SFC is freer from due to the levy. Indeed, at last count the SFC had an accumulated surplus of more than HK$7bn. And commission staff numbers in Australia and Japan are not growing as they are in Hong Kong. Our point is not that the SFC has an easy life, rather other commissions face a tougher operating environment. Yet this is a good thing for Hong Kong and one reason the SFC rates highly in this category of our survey.

HKEX's focus on profits raises doubts as to its commitment to regulation

As for HKEX, its situation is quite different. As a for-profit enterprise, it has always kept tight control and aims to grow income faster than expenses. In 2017, for example, its income grew 19% yet expenses rose only 3%. It did hire some new staff that year, but this was mainly for "strategic projects" (HKEX is not particularly forthcoming on investment in new staff or surveillance and enforcement technology). While the quality of its staff is high in our experience, its focus on profitability raises doubts as to whether it is investing sufficiently in regulation. In 2017, profit attributable to shareholders grew by 28%, earnings per share by 27%, and total dividends per share by 27%. It typically has a payout ratio of 90%. Meanwhile, reviewing the opening statements from the HKEX chairman and CEO in its 2017 annual report does not raise one's comfort level much: both of them devote minimal attention to regulatory matters.

HKEX has created the best listed-company report database in Asia

The best website in the east

One area where HKEX does inspire confidence is its database of company reports, announcements and circulars. This used to be part of its main website, but for several years has been contained in a dedicated site HKEXnews (www.hkexnews.hk). The site recently underwent a revamp.

The site is extremely easy to use and provides a single landing page for each listed company, with all of their annual and interim reports, meeting and other circulars, announcements, notices, prospectuses and so on in reverse chronological order (most recent first) from the time they were listed. The oldest information in the database goes back to 1999.

HKEXnews also provides a range of other market and regulatory documents, including:

- A list of all long-suspended companies

- Draft prospectuses of forthcoming IPOs
- A search function on substantial ownership of listed companies
- A range of other exchange enforcement actions.

It is by far the most intelligently designed exchange website in the region and its company database, although logical and simple, stands head and shoulders above anything else we have seen.

Another regulatory low point was the failure of proposals to reform Hong Kong's listing regime

Listing regime reform fails

A low point of the past two years was the failure of a joint proposal from the SFC and HKEX in 2016 to strengthen the IPO listing regime. The consultation proposed a new Listing Policy Committee (LPC) with real powers over policies and listing rules, and a new Listing Regulatory Committee (LRC) to deal with difficult listing applications. Both committees would have comprised officials from the SFC and HKEX, as well as some non-officials. While ACGA and others welcomed the proposals as improving the efficiency and transparency of Hong Kong's listing regime, a political backlash erupted with accusations the SFC was making a massive grab for power. We took a contrary view: that by putting itself on the frontline, the SFC would in fact be making itself more accountable.

Sadly, on 15 September 2016, the two regulators announced the reforms would not proceed in the form envisaged. The LPC would be replaced by an advisory entity (with no real power) the Listing Policy Panel (LPP). This was established on 9 March 2018 and consists of senior representatives from the SFC, the SEHK, the Listing Committee and the Takeovers Panel. The LRC was dropped entirely.

The SFC and HKEX did bring in a number of more positive rule changes in 2017 and 2018

New rules

Despite the decision to amend the listing rules to allow DCS in April 2018, other rule changes from the SFC and HKEX have mostly been more positive.

- **Senior manager responsibility regime:** In October 2017, the SFC initiated full implementation of a new "manager-in-charge" regime to impose greater accountability on senior managers of licensed financial intermediaries, such as brokers, fund companies and investment banks. Managers who work in risk management, compliance, finance, accounting and information technology are expected to be those most affected by the new regime.
- **Takeover rules**: In July 2018, the SFC amended the Takeovers Code to make it more shareholder friendly. The Takeovers Panel can now require compensation to be paid to investors who have incurred losses due to breaches of the code. And the voting threshold for approval of "whitewash waivers" by independent shareholders was raised from 50% to 75%.
- **Capital raisings:** In May 2018, HKEX tightened rules to reduce abusive capital-raising transactions, such as heavily discounted open offers and private placements that could deeply dilute the interests of existing shareholders. It also wants issuers to improve their disclosure on the use of capital raised.
- **Delisting rules**: In May 2018, HKEX also ditched its notoriously slow three-stage delisting process for a new regime that allows it to delist a Main Board-listed company suspended from trading for 18 continuous months and a GEM-listed company suspended for 12 continuous months.

- **CG Code**: In July 2018, HKEX published a revised version of its CG code. While some of the new measures proposed were positive, overall we were disappointed with the limited ambition and lack of original regulatory thinking in the new code. (See the next section on CG rules for more details).

Second-class shares

On 24 April 2018, HKEX announced its new listing rules on dual-class shares. We believe its approach for approving such listings, and the rules themselves, have a number of flaws.

- **Ring-fencing DCS to new IPOs only**: This approach is unlikely to last and/or existing issuers will find workarounds, such as spin-offs.
- **Only "innovative growth companies can apply":** Defining "innovative" is slippery. What is genuinely innovative about the business models of Xiaomi or Meituan? "High tech" does not always mean "innovative".
- **Selective approval process**: HKEX and its Listing Committee will over time find it difficult to make suitability judgments on a case-by-case basis.
- **Weak safeguards:** No time-based sunset clause was offered, yet this is what global investors most want to see. Other CG protections are of limited value.
- **Enforcement:** HKEX will find it difficult to enforce the new rules (eg, limiting DCS to key individuals/founders).

ACGA elaborated on these points in a letter sent to HKEX on 23 March 2018. It can be downloaded from the Advocacy (Statements and Submissions - Hong Kong) section of our website: www.acga-asia.org

2.2 Enforcement

Hong Kong ranks 1st in this sub-category with a weighted score of 78%

The SFC has developed a solid track record on enforcement over many years and continues to evolve its approach and strategy. As noted above, the main change over the past two years has been the move to what it calls a "frontloaded" or "direct intervention" approach, which in practice means taking pre-emptive action against companies if it has reason to believe the market is being misinformed or becoming disorderly or unfair.

The SFC is increasingly using pre-emptive measures against companies

One measure increasingly used by the SFC in this respect is to direct HKEX to suspend trading. As the table below shows, the commission issued a dozen "Rule 8" directions for such suspensions in 2017/18, compared to just four in 2016/17 and two in 2015/16. Companies targeted in 2017 included GME Group Holdings in February for suspicious market manipulation, Lerado Financial Group in June for misleading information disclosure and New Ray Medicine International Holdings in October for a suspicious acquisition.

Forced suspensions and "show cause" letters have multiplied in recent years

The SFC has also expanded its use of "show cause letters", which are sent to companies informing them they may be suspended if they do not provide a satisfactory explanation to the regulator. There were no such letters in 2015/16, then 11 in 2017/18. In other words, the SFC has gone from just two Rule 8/show cause actions to 23 in the space of three years.

Figure 3

SFC enforcement actions (selected)

	2017/18	2016/17	2015/16
Forced suspensions (Rule 8)	12	4	2
Show cause letters	11	3	0
Market misconduct investigations	274	407	507
Criminal, Civil and Market Misconduct Tribunal (MMT) proceedings			
Insider dealing: Individuals/corporations summonsed (summons laid)	4 (7)	0 (0)	1(3)
Insider dealing: Ongoing civil proceedings	13	16	13
Market manipulation: Individuals/corporations involved in ongoing MMT proceedings	3	3	16
Others: Individuals/corporations summonsed (summons laid)	10 (47)	10 (46)	20 (107)
Others: Individuals/corporations involved in ongoing civil proceedings	84	110	87
Others: Individuals/corporations involved in ongoing MMT proceedings	13	26	14

Note: The information above has been reorganised slightly by ACGA to flow with our narrative. Not all details from the relevant SFC table have been included. See p168 of its Annual Report 2017/18 for full details. Source: SFC Annual Report 2017/18.

Big fall in market misconduct investigations reflects a change of regulatory priorities

Some other notable points from the table above:

- The big fall in the number of market misconduct investigations was not, apparently, due to less effort on the part of the SFC. Rather, it was a reorganisation of investigation priorities toward higher impact cases, as commission staff told ACGA. (Note: This explanation was not contained in its annual report.)
- The number of new criminal insider trading cases each year is relatively low, although the commission does have more than a dozen ongoing civil proceedings against insider trading annually.
- The number of market manipulation cases before the Market Misconduct Tribunal has dropped to single digits in each of the past two financial years.
- The bulk of the criminal and civil action undertaken by the SFC each year is for other forms of market misconduct.

Intermediary misconduct is another major focus of the SFC's work

While intermediary misconduct is not a major focus of our survey, it is worth highlighting that in the year ending 31 March 2017, the SFC made 8,960 requests for trading and account records from intermediaries, completed 591 investigations, laid 46 criminal charges against eight individuals and two corporations, and secured convictions against four persons and two corporations. It also took disciplinary action against 54 licensed corporations and individuals with total fines of HK$93m, imposed bans on 25 individuals, and suspended and revoked the licences of eight persons for various wrongdoing.

SFC publishes new Compliance Bulletin

On 19 December 2017, the SFC published the first issue of its new Compliance Bulletin, which also focusses on intermediary regulation. This is consistent with its call over recent years for IPO sponsors to enhance their due diligence standards. The number of complaints against intermediaries and market activities rose almost 16% during the 2017 reporting year.

Case against CITIC Pacific ends in anti-climax

Ending with a whimper

The biggest surprise in regulatory enforcement over the past two years was undoubtedly the conclusion to the CITIC Pacific material non-disclosure case dating back a decade. Ending with a definite whimper, on 7 April 2017, the Market Misconduct Tribunal (MMT) finally announced its decision on CITIC's delayed disclosure of a US$2bn loss it made from hedging foreign exchange risks in an iron-ore joint-venture in Australia in October 2008. After an unprecedented 53-day hearing, the tribunal said in its 160-page report it had decided the firm and five of its former executive directors, including ex-chairman Larry Yung, the son of Rong Yiren, a former vice-president of China, had not engaged in any misconduct.

The ruling was unexpected, in part because a former assistant director of finance at the group, Simon Chui Wing-nin, had been convicted of insider dealing in 2014 for selling shares before the loss was announced. According to an earlier statement from the SFC, an estimated 4,500 investors suffered by buying CITIC shares between the time a boilerplate circular was issued by the company in September 2008 and the profit warning around one month later.

HKEX enforcement

HKEX investigates quite a few cases each year . . .

As a for-profit company, HKEX has never enjoyed a reputation as a tough enforcer of its listing rules. Indeed, a review of the enforcement statistics on its website suggests a 'steady as she goes' approach. For example, the latest data provided refers to the six months ending 30 June 2018, during which it undertook 57 investigations into Main Board issuers, a slight increase from the 54 for the same period a year earlier. Many of the cases in the first half of 2018 involved a breach of directors' duties, while the next largest individual category related to failure to comply with procedural requirements for notifiable and connected transactions. About 40% of the investigations involved multiple rule breaches.

. . . but enforcement outcomes rather modest

In terms of enforcement outcomes, this is where the story gets less exciting. There were just seven cases of public censure by the exchange against Main Board issuers in the first half of 2018, two cases where directors were required to undergo training, and five warning/caution letters. Still, this was somewhat more than the 10 actions across all categories in the first half of 2017.

(Note: The above statistics do not cover HKEX action against issuers and directors on the Growth Enterprise Market (GEM), the second board in Hong Kong. There were 15 investigations in 1H2017 and 20 in 1H2018. No sanctions were imposed for the former period, but 12 for the second.)

Much larger number of INEDs sanctioned in first half 2018 . . .

What is more interesting, however, is the higher number of independent directors being sanctioned, as the following table shows:

Figure 4

Number of directors subject to disciplinary sanctions

	Six months ended 30 June 2018			Six months ended 30 June 2017		
	MB	GEM	Total	MB	GEM	Total
Executive directors	13	23	36	9	0	9
Non-executive directors	1	4	5	2	0	2
INEDs	6	13	19	0	0	0
Total	20	40	60	11	0	11

Source: HKEX website

. . . but what does it mean?

Full-year figures for the previous two calendar years might appear to indicate more INEDs are being caught in the net: five were disciplined in 2016, just three in 2017, then 19 in the first half of 2018 alone. However, the numbers for 2016 and 2017 were all Main Board INEDs. The big increase in 2018 has come from GEM independent directors.

HKEX excels in disclosure of its enforcement work

One area where HKEX does excel, particularly in contrast to most of its peers around the region, is in the quality of its enforcement disclosure. In addition to clear statistical tables with narrative explanations, it produces uncluttered lists of all enforcement cases, with links to listing enforcement notices and relevant news releases. The notices summarise the companies and individuals involved, the specific rules breached, the nature of the breaches, a regulatory message, and the sanctions applied. The news releases then go into more detail. Enforcement statistics are archived back to 2015, a new half-yearly Enforcement Reporter newsletter started publication in July 2017, and HKEX produces guidance documents on its enforcement approach for issuers. If only all exchanges in Asia were able to disclose with such clarity!

3. CG rules

Hong Kong ranks 2nd with a score of 74%

While far from perfect, Hong Kong has long had one of the more robust CG rule books in the region. Financial reporting standards are generally high. Basic CG reporting standards are thorough, while new ESG reporting guidelines have increased the volume, if not yet the quality, of company disclosure in this area.

Where Hong Kong stands out

Certain shareholder rights are markedly stronger in Hong Kong, and always have been, than other parts of the region, including protections for shareholders in the event of a delisting that follows a takeover or a voluntary delisting, voting on major and connected transactions, and disclosure of related-party transactions. Yet as shareholders have been finding, the rules sometimes have loopholes that catch them unawares.

Where Hong Kong does well

As in many markets, rules in Hong Kong on disclosure of price-sensitive information, insider trading and market manipulation, director trading, disclosure of substantial ownership and creeping acquisitions, and voting by poll are robust. In some instances, Hong Kong got there well before others: it was the first market in the region to mandate voting by poll, as early as 2009. Singapore took another six years. Australia still does not mandate it - although China, India, Indonesia, Japan, Malaysia, Taiwan and Thailand all effectively do.

Where Hong Kong does badly

Hong Kong loses points, however, for certain persistent weaknesses. There is still no quarterly reporting for Main Board companies. Rules on private placements remain overly generous, with no sign of any appetite to change them. The definition of "independent director", although recently tightened, has gaps big enough to drive a chauffeur-driven Mercedes through them. And while Hong Kong has a well-written "stewardship code", it was not set up in a particularly effective way.

Note: See also the Singapore chapter for a summary of where Singapore is ahead or behind Hong Kong in terms of its CG rules.

Hong Kong also stands out for the ease of regulatory research

The user experience

A simple strength of Hong Kong, no doubt taken for granted by many, is the clear presentation of laws, regulations and listing rules. Finding them through regulatory and government websites is easy. Pinpointing the right section of a law or regulation is quick, because there is a detailed contents section (often with hyperlinks to the relevant section). And then understanding the rule is usually not difficult, because it has been written in fairly normal language. Believe it or not, this experience is the exception not the norm when researching CG regulation in Asia. The difference in Hong Kong is that thought and design have been applied to the user experience.

The revised CG code makes some welcome changes, but still sets the bar too low

Raising the bar, halfway

In November 2017, HKEX launched a consultation on its Corporate Governance Code, then published its conclusions in July 2018. The main changes covered such things as more transparency around the process and reasons for selecting independent directors, the definition of INEDs, greater board diversity, and requiring more transparency on dividend policy. The exchange also published a practical Guidance for Boards and Directors, although it stressed this did not form part of the listing rules. While these changes were a welcome development, on balance we believe the exchange is still setting the governance bar much lower than it needs to, or should, be. For example:

INED cooling-off periods are still very short in Hong Kong

- **Cooling-off periods for INEDs:** Increasing the cooling-off period from one to two years for former professional advisers before they can be considered independent is unconvincing. HKEX had proposed three years, which is itself not a long period in a tight business community such as Hong Kong, but dropped it to two years after opposition to this rule change. The same two-year standard applies for former audit partners before they can become a member of a listed company's audit committee (although in this case it is merely a "code provision" subject to comply or explain). This outcome reflects the limited effort that many listed companies in Hong Kong put into finding independent directors. Meanwhile, for people who have material interests in an issuer's principal business activities, the cooling-off period will rise from nothing to just one year!

The cap on directorships is too high and not nuanced

- **Cap on directorships**: The cap on the number of boards independent directors can sit on will remain at seven. ACGA has long called for no more than five (which is the maximum even in China) and fewer if a person holds the role of board chairman and/or is a full-time senior executive in another company.

Gender diversity is still too hot to handle

- **Board diversity:** HKEX followed through on a proposal to upgrade a "code provision" on board diversity to a listing rule. Issuers must now have such a policy and disclose it in their annual CG report. The exchange did not, however, agree to a suggestion from around a quarter of supportive respondents that diversity policies should also refer to gender.

Disclosure of cross directorships is only a recommended practice

- **Disclosure of cross-directorships:** HKEX also followed through on a proposal for the disclosure of any cross-directorships or significant links that an INED has with other directors. However, its proposal makes this a "recommended best practice" (RBP) only, meaning it will not be subject to comply or explain. Given the prevalence of close family and personal ties in Hong Kong, and the implications these have for related-party transactions, we believe this measure should have been a "code provision" if not a listing rule from the start.

No sign of lead independent directors any time soon

- **Lead independent directors:** In contrast to other major markets in Asia Pacific and around the world, HKEX has chosen not to require lead independent directors where the chairman is an executive director or connected person.

No change to one-third rule for independent directors

- **Three/one-third INED rule:** Nor will the exchange make any changes to its long-standing rule on minimum board independence (ie, a minimum of three INEDs making up at least one-third of the board).

Stewardship lite

Hong Kong's approach to investor stewardship is low key

There has been little change in the approach of the investment community to Hong Kong's stewardship code, the SFC's Principles of Responsible Investment, published in 2015. Unlike most Asian jurisdictions that have introduced such codes, the Hong Kong version is entirely voluntary and not subject to comply or explain. Nor is there an active programme on the part of the regulator to build up a signatory base, although a few asset managers have endorsed it, such as Vanguard Hong Kong, Robeco, BMO Global Asset Management (Asia), and JP Morgan Asset Management. Meanwhile, other asset managers, including many ACGA members, continue to carry out their voting and governance engagement work in accordance with their internal principles and guidelines. Many of the foreign funds are signatories to stewardship codes in their home or other markets, such as Australia, Japan, Malaysia, the Netherlands, and the UK. We believe the Hong Kong government should take a more active approach to promoting stewardship among local asset owners and managers.

4. Listed companies

Hong Kong ranks 7th with a score of 55%

Hong Kong companies scored lower here than we expected. The 15 large caps surveyed do well on financial reporting, while the 10 mid-caps perform slightly less well. Neither group shines on CG or ESG/sustainability reporting - something of a surprise, since large caps should be doing much better. Large caps are stronger on investor relations, director training, the fairness of INED fees, internal auditing, and disclosure of risk management. They do reasonably well on audit committees and board diversity. However, they do poorly on board evaluations, having an independent chairman or a lead independent director, and disclosing policies on executive remuneration, the management of related-party transactions, dividends, and corruption mitigation.

The inclusion of H shares lowered the Hong Kong score

An important point to highlight: The 15 large caps selected include several mainland state and private firms listed in Hong Kong. This had a dampening effect on the final category score.

Financial reporting

Areas where financial reporting could improve

Despite overall standards being quite high for financial reporting, certain areas require more clarification, including executive remuneration policies, the rationale for related-party transactions, the purpose of private placements, and dividend policies. For companies listed in the USA as well as Hong Kong, we still find differences between the depth and quality of the 20F reports they submit to the USA SEC and their Hong Kong annual reports. The former typically provide much more detail around risk factors and often present the information more impartially.

Unexplained "other expenses" continues to be a problem

Another lingering problem, and one we wrote about in CG Watch 2016, is the practice of some companies to aggregate a lot of operating expenses into a line called "other" and then not to explain them. The average score for the 15 large caps in our sample on this question was a measly 20%, which means most

companies had an "other expense" line amounting to more than 10% of total expenses, but did not provide detailed notes. In terms of the range of scores, four companies scored 80% and the remainder zero.

CG reporting

Still too much boilerplate CG reporting

This is another area we feel Hong Kong companies should be doing much better. Boilerplate reporting is still the norm in many company reports, especially in their board and committee reports. While they may give statistics on director attendance, they mostly do not provide meaningful insight into what directors or committees actually discussed during the year. The biographies of most directors are generic and brief, with no attempt to give a "skills matrix" on the mix of skills in the board. Only one company in our sample, CLP, provided such information in its annual report.

ESG reporting

ESG reporting received a boost in 2016-17 following new HKEX rules

ESG reporting took on a new life in Hong Kong starting from financial years beginning on 1 January 2016 and in response to an amended Environmental, Social and Governance Reporting Guide from HKEX. Originally published in 2012 as a voluntary guide only, the exchange upgraded it to comply or explain status in 2015. For the first year of reporting (2016), issuers would only have to provide general disclosure on a set of 11 environmental and social aspects (topics). From the second year (2017), they would also have to report against a set of environmental KPIs. Social KPIs remain voluntary.

HKEX has found a wide variation in the quality of ESG reports

On 18 May 2018, the exchange published its first review of ESG reporting by 400 randomly selected companies. It found overall compliance was satisfactory and all issuers selected had reported within the required timeframe (ie, three months after the publication of their annual reports). More than 80% reported on nine or more of the 11 aspects in the guide, while 94% complied with seven or more. Only 38% complied with all 11 aspects. Of the topics companies wrote about, "use of resources" recorded the highest compliance rate (98%), with "product responsibility" the lowest (73%). Not surprisingly, the exchange found a wide variation in the quality of reports, from excellent to box-ticking. It also found only 57% of issuers reported they had conducted a materiality assessment.

Only a few companies excel at sustainability reporting in Hong Kong

Our analysis of ESG/sustainability reports in Hong Kong found a wide variation in quality too. Only three of the 15 large-cap reports included a materiality matrix with a detailed explanation of how the issues selected linked to company strategy and operations, while another four companies had a matrix with a brief discussion. While only one large-cap did not provide any sustainability metrics, only eight of the remainder gave detailed figures. Four large-caps provided qualitative sustainability targets, but only two of them listed specific numerical targets within a defined timeframe.

Board diversity

Only a minority of large-caps provide detailed disclosure on board diversity policies

Some companies clearly do much better than others in terms of disclosing their board diversity policies, including (from our sample) Bank of China, CLP, Hang Seng Bank, HKEX and MTR. On the other hand, only five companies in our sample appear to conduct an annual board evaluation: Bank of China, Hang Seng Bank, CLP, Geely and HKEX. Among these, CLP has the most detailed disclosure about its assessment process and provides some summary findings.

SOEs in Hong Kong had to incorporate Party Committees into their articles in 2017

Party's penetration
The wave of article amendments made by listed companies in China to reinforce the leadership role of the Communist Party of China finally arrived in Hong Kong in 2017. HKEX data shows 123 issuers (5.43% of all listed companies) had changed their articles by September 2018 to reaffirm the Party Organisation (Committee) shall "play a leadership role, set the right direction, keep in mind the big picture, ensure the implementation of Party policies and principles, and discuss and decide on major issues of their enterprise in accordance with regulations".

123 H shares had done so by September 2018

All the 123 companies are Hong Kong-listed mainland companies and eight are blue chips (constituents of the Hang Seng Index): Sinopec, PetroChina, ICBC, Bank of China, China Construction Bank, Bank of Communications, China Shenhua Energy and CITIC. By and large, minority shareholders in Hong Kong have either not been too happy about this change - and voted against the amendments in 2017 - or have significant concerns as to the implications for listed company governance.

(See ACGA's 2018 China Report, Awakening Governance: The evolution of corporate governance in China, for a more detailed discussion of this issue.)

Jonathan Galligan
Head of Asia Gaming and Conglomerates
jonathan.galligan@clsa.com
+852 2600 8605

Jeffrey Kiang
jeffrey.kiang@clsa.com
+852 2600 8463

Stop the train
MTRC's Shatin-Central construction issues resulted in CEO Lincoln Leong falling on his sword and retiring, as the report MTRC submitted to the government on 15 June 2018 detailing the issues at Hung Hom Station contained "inaccuracies". While other issues have yet to be resolved, the existing entrustment agreement enables a maximum liability to the government only up to the project management fee of HK$7.9bn, equivalent to 2% of our NAV.

MTRC was informed by the Hong Kong government on 7 August 2018 that the report it submitted on 15 June 2018, which detailed the issues at the Hung Hom Station of the Shatin to Central Link (SCL,) contained "inaccuracies" with regards to the construction methodology. As a result, CEO Lincoln Leong will retire and Project Director Dr Philco Wong resigned. Chairman Frederick Ma issued his resignation to the government twice (7 July 2018 and 6 August 2018), but it was not accepted by the Hong Kong Chief Executive.

Shatin to Central issues will drag on

MTRC has had a number of construction issues arise with its embattled Shatin to Central Link, as construction defects in Hung Hom, To Kwa Wan and potentially Exhibition Centre stations have come to light. Where blame lies is still being assessed, both from a personnel perspective as well as between MTRC, the main contractor Leighton (Asia) and potentially yet to be identified parties.

Maximum liability of MTRC remains limited

While issues remain, the existing entrustment agreement between the government and MTRC enables a maximum liability only up to the amount of the total project fee of HK$7.9bn. If levied, the fine would lower our NAV by HK$1.3/sh (2% of the total). While the risk remains of how the government tries to increase the fine, how that would happen contractually is unclear, and the government's attempts to do this for the Express Rail Link project remain in arbitration.

Management changes at MTRC

Name	Position	Remarks
Lincoln Leong Kwok-kuen	Chief Executive Officer (CEO)	Announced his early retirement, but will only be effective once a replacement CEO has reported for duty
Philco Wong Nai-keung	Projects Director	Resigned as Projects Director and ceased to be an Executive Director with immediate effect
Three general managers	Shatin-Central Link's project management team	Names unidentified, but also resigned with immediate effect

Source: CLSA, MTRC

Projects summary - HKSAR government-owned project with MTRC as project manager

	Express Rail Link	Shatin-Central Link
Original capex (HK$bn)	**65**	**80**
Revised capex (HK$bn)	**84**	**97**
Project management fee paid/payable to MTRC (HK$m)	**6,340**	**7,893**
Revision of the entrustment agreement	Yes, in November 2015. Revision of the agreement was due to cost overrun	Na. The HKSAR government is studying the revised budget submitted by MTRC in December 2017. We do not see signs of agreement revision yet
Revision 1 – Capex	HKSAR government capped its capex at HK$84bn, and any excess of construction will be borne by MTRC	Na
Revision 2 - Liability cap	The liability cap of MTRC (as a result of cost overrun) increases from HK$4.94bn to HK$6.69bn, subject to arbitration	Na. MTRC's 2017's annual report stated: "The HKSAR Government has the right to claim against the Company if the Company breaches the SCL Agreements, and under each SCL Agreement, to be indemnified by the Company in relation to losses suffered by the HKSAR Government as a result of any negligence of the Company in performing its obligations under the relevant SCL Agreement. Under the SCL Entrustment Agreement, the Company's total aggregate liability to the HKSAR Government arising out of or in connection with the SCL Agreements is subject to a cap equal to the fees that the Company received under the SCL Agreements. (HK$7,893m in total)"
Revision 3 - Special dividend	MTRC declared special dividend, paying HK$19bn to the HKSAR in total. This indirectly financed HKSAR government on the cost overrun from HK$65bn to HK$84bn	Na

Source: CLSA, MTRC

5. Investors

Hong Kong ranks 9th with a score of 26%

A very poor result for Hong Kong and without question the weakest part of its CG ecosystem. Unlike several other Asia Pacific jurisdictions, in particular Australia, Japan and Malaysia, there is no public leadership on stewardship from domestic asset owners, including the Hong Kong Monetary Authority, or from domestic asset managers. Part of the problem is the size of both groups is small in absolute terms, with most of the energy on stewardship provided by foreign funds based in Hong Kong.

Institutional investors

Hong Kong has no institutional investor association dedicated to CG advocacy

Despite being an international finance centre with a fairly open market, Hong Kong has no local association of institutional investors dedicated to CG issues. A local mutual fund industry body, the Hong Kong Investment Funds Association (HKIFA), does participate in CG advocacy from time to time, such as the debate over dual-class shares. But this is not its primary function, which is to foster the development of the investment industry.

Local investors were interested in supporting DCS, but showed no interest in the revised CG

Some evidence of the level of interest in CG among investors in Hong Kong can be found in the submissions to stock exchange consultations. For the consultation on dual-class shares in 2017, for example, there were a total of 284 submissions including 35 from investment managers. Of these 35, 17 were from domestic institutional investors (excluding five who stayed anonymous) and most supported the introduction of DCS. In contrast, the level of local investor interest in the CG code consultation later the same year was much lower. There were a total of 91 submissions and only 10 from investment managers. None of the nine funds willing to have their names published were domestic investors.

Collective engagement

The Yingde Gases case in early 2017 brought several institutions together in a rare collective engagement

While most engagement with companies is carried out by institutions on an individual basis, they do come together when the situation demands. One such case over the past two years involved mainland company Yingde Gases Group, China's biggest industrial gas producer. Yingde first came under the media spotlight after shareholders discovered that despite a worsening financial situation, it had not responded to a US$1.34 billion bid made in December 2016 by US-based Air Products & Chemicals. If successful, the bid would have been the second-largest US takeover of a Chinese company in history. Yingde finally responded about a month later, saying it first needed to resolve certain "internal issues" before it could consider setting up an independent board committee to look into the bid. Yingde's shareholders were angry over the lack of action, while the internal issues turned out to be a fight within management for control. After lots of twists and turns, Air Products dropped its bid on 24 March 2017.

Retail

Retail shareholders are on their own in Hong Kong

Hong Kong is also somewhat unusual in not having an established retail shareholder association - unlike Australia, India, Malaysia, the Philippines, Singapore and Thailand. For many years, Hong Kong was unique in having an outspoken local CG advocate, David Webb, editor of Webb-site.com, but in recent years maverick commentators have also appeared in other markets. Retail investors in Hong Kong also face basic difficulties in attending AGMs; as there is no central depository system with their names (Hong Kong has yet to turn "scriptless"), meeting attendance requires a bureaucratic process. One of our analysts was rejected from attending an AGM not too long ago because the custodian bank forgot to pass the completed registration form to the company's IR department.

6. Auditors and audit regulators

Hong Kong ranks 4th with a score of 74%

At the time of publication of this report, Hong Kong was the only capital market in Asia Pacific without a functioning independent audit regulator of some sort. The other two laggards - India and the Philippines - have started to move ahead with their new bodies, albeit in a limited way. The good news is the detailed examination of the FRC Amendment Bill (2018) is complete and the Financial Reporting Council (FRC), whose powers to date have been limited to investigation, is expected to become a fully-fledged audit regulator in 2019. We have not been able to give higher scores for this, however, because the change has not yet happened.

A long and winding road

Audit regulation in Hong Kong is confusingly split between the HKICPA and the FRC

The FRC was established on 1 December 2006 as an independent statutory body, with the power to carry out investigations into auditing and reporting irregularities in relation to listed companies, and inquire into non-compliance with

accounting requirements. The Hong Kong Institute of Certified Public Accountants (HKICPA), the local accounting industry body, continued to carry out inspections of audit firms and auditors, took disciplinary action as necessary, and was responsible for registration, standard setting, and education. As time wore on, the view grew that Hong Kong needed an audit regulator fully independent of the profession - something that had already become the norm in most leading developed markets in Asia and around the world by the mid to late 2000s.

The government began consulting on an independent audit regulator only in 2014

The Hong Kong government finally issued a consultation on an independent audit regulator in June 2014. While many parts of the financial community supported the proposals, staunch opposition from segments of the accounting profession (mostly small and mid-sized firms) delayed progress. Eventually the FRC Amendment Bill 2018 was published in January 2018, after which it underwent close inspection and debate in the Legislative Council for the best part of a year. ACGA participated in a Council hearing on the Bill in March 2018.

Hong Kong should finally have an independent regulator in 2019

One positive change the government has proposed to the Bill is an amendment to ensure audit practitioners will not be appointed to the new FRC Council. While the regulator's governing body will comprise one-third accountants, they will be retired not practising auditors. This amendment was critical to ensure Hong Kong could achieve EU equivalence for its new independent audit regime. The Bill is expected to be enacted in early 2019. Under the new regime, HKICPA will still do registration, standard setting, and education.

FRC investigations

The FRC has increased its capacity to do investigations

How has the FRC been doing on investigations into auditing irregularities? According to announcements on its website, the number of completed investigations has steadily risen over the past eight years. As the table shows, the FRC is now completing more than double the number of investigations it did during most of the 2011-2014 period (with the exception of 2012):

Figure 5

Completed FRC investigations

Year	2011	2012	2013	2014	2015	2016	2017	2018[1]
Investigations completed	5	9	5	4	9	11	11	13

[1] By 13 November 2018. Source: FRC website, annual reports

HKICPA disciplinary cases

HKICPA is trying to improve its system of disciplinary committees . . .

While HKICPA is not independent of the accounting profession in Hong Kong, it has been taking measures to improve its disciplinary processes in recent years. The principal change is that disciplinary committees are now chaired and run by HKICPA members, not the institute itself, which provides some degree of independence and distance. In terms of the number of cases handled in any one year and the sanctions applied, the direction seems to be up.

. . . with some success

First, the number of disciplinary cases. As the following table shows, this rose considerably over the six-year period from 2012 to 2017 - from a caseload of 27 at the start to 60 at the end, with many more referrals coming from the institute's council. One concerning feature is that only one-third to one-half of the cases in any one year are being closed. This is partly a product of the disciplinary committee process itself - institute members give of their free time to do this work and, as ever in Hong Kong, people are busy and often travelling (a good reason for a fully funded and independent audit regulator). Another factor, and one beyond the institute's control, is a problem HKEX also faces: people finding

ways to delay the process and game the system. It is also worth noting that of the 32 cases before different disciplinary committees in mid-2018, most only started in 2017 or 2018, suggesting processing time is speeding up somewhat.

Figure 6

Number of HKICPA disciplinary cases

Year	2017	2016	2015	2014	2013	2012
At beginning of year	28	21	24	20	18	11
Council referral	32	21	20	25	24	16
Caseload	60	42	44	45	42	27
Closed	(18)	(14)	(23)	(21)	(22)	(9)
At end of year	42	28	21	24	20	18

Source: HKICPA website

Sanctions appear to be getting tougher

Second, sanctions appear to be getting tougher. To early July 2018, HKICPA had penalised auditors and CPA firms in 21 cases, with some of the sanctions being quite harsh (such as deregistration for five years). In the whole of 2017 there were only 12 cases, and 11 the previous year. In 2015, there were more cases at 22, but broadly speaking the penalties were lower.

Telling the story

HKICPA produces great reports - if you can find them!

While the HKICPA produces detailed annual reports on its enforcement and inspection (practice review) work, called Compliance and Quality Assurance, respectively - they are hard to find on its website. Indeed, it must be one of least intuitive and poorly designed professional association websites in Hong Kong!

What is missing?

HKICPA has yet to venture into new areas, like AQIs and audit firm governance

While the institute's inspection programme is designed to strengthen CPA firm management, quality control systems, and improve audit engagements, it has yet to venture into any of the new areas leading audit oversight boards in the rest of the region have been exploring. These include such things as audit quality indicators, audit firm governance, consolidation of small firms, and so on. Nor has it had cause to review the outdated seven-year rotation policy in Hong Kong for audit partners.

7. Civil society and media

Hong Kong ranks 5th with a score of 60%

Hong Kong has a vibrant and diverse civil society ecosystem supporting CG development. It has well-established institutes for directors and company secretaries helping to raise standards and awareness. The local branch of the CFA Institute is involved in policy research, while the Hong Kong Society of Financial Analysts runs topical seminars on corporate governance. The Hong Kong Venture Capital Association also runs seminars on governance and ESG. Indeed, if groups involved more directly in environmental, social and sustainability issues and advocacy were to be included, the total number would more than double.

Civil society groups participate actively in regulatory consultations

One strong characteristic of civil society culture in Hong Kong is the willingness of groups and individuals to participate actively in regulatory consultations. In one of the examples noted above under Investors, the 284 submissions on the dual-class share consultation included just about all the professional and industry bodies in the city. Among those not mentioned so far in this chapter are: ACCA Hong Kong, the Alternative Investment Management Association (AIMA), various local and foreign chambers of commerce, the Hong Kong Investor Relations Association, and numerous others. It should be noted that this consultation looked at issues other than DCS, such as the listing of pre-revenue biotech firms, so hence had wide appeal.

Regular director training

Institute of Directors

The Hong Kong Institute of Directors (HKIOD) runs regular director training programmes, as well as diploma and professional diploma courses, and organises senior level training with modules in Hong Kong and abroad. It highlights the significance of corporate governance on its website, and its courses include components relating to compliance, strategy, business environment, and board culture.

Regular company secretarial training

Institute of Chartered Secretaries

The Hong Kong Institute of Chartered Secretaries (HKICS) has an extensive continuing professional development programme for its members, with both online and physical training. It organises a corporate governance conference every two years, has a mentorship programme, and runs ad hoc events. It is worth noting it also has an office in Beijing and conducts training for its associate members there.

Most CFA members want stronger safeguards for DCS

CFA Institute

In August 2018, the CFA Institute published a report on dual-class shares in Asia that included a survey of 454 CFA members. This showed 53% opposed the introduction of DCS, while 97% believed additional safeguards were necessary.

Academics play a varied role in CG in Hong Kong

Academia and media

Academics play a varied role in CG in Hong Kong. They often sit on government or regulatory committees, such as the Financial Services Development Council, the HKEX Listing Committee, and other bodies. In addition to their own work, they sometimes undertake commissioned research; one of the most recent examples being a massive report for HKICPA on Improving Corporate Governance in Hong Kong, and undertaken by the Asian Institute of International Financial Law, University of Hong Kong.

Media coverage broadly improving

As in many markets, the quality of media coverage of corporate governance issues has improved over time, as journalists become more expert on the technicalities. Hong Kong benefits from having both a deep local and regional media. One loss in recent years was the sale of the *South China Morning Post* to Alibaba, which in our view has resulted in a noticeable decline in the balance of coverage on CG issues.

Recap and recommendations

Recap of CG Watch 2016

Hong Kong made some progress on our recommendation from 2016

How has Hong Kong responded to the recommendations in our 2016 survey?

Figure 7

Hong Kong: recap of 2016

Recommendations	Outcomes
1. Better disclosure on large unexplained expenses	Not much changed
2. Whistleblower protection for auditors	No change
3. An independent audit regulator	Coming soon!
4. More detailed and consistent enforcement data from HKEX	Much improved
5. Introduce board evaluations	Slight improvement
6. Improve non-financial (CG) reporting further, especially around board committees, remuneration policy	Slight improvement

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the markets score to fall in 2020:

- Introduction of "corporate DCS"
- No disclosure from H-shares on their Party Committee work
- Still no leadership from local asset owners on the stewardship code
- Still no independent auditor regulator
- Any impairment of the independence of the ICAC or the judiciary.

What to fix

Quick fix list

Issues to address as soon as possible:

- Do not introduce "corporate DCS"!
- Plug obvious holes in financial reporting
- Continue to develop best-practice guidance on board evaluations, diversity policy, and other new elements in revised CG code
- Make clear requirement for disclosure of Party Committees under the CG code
- Engage issuers to understand the purpose of ESG reporting.

Sharmila Gopinath
India Research Director, ACGA
sharmila@acga-asia.org
+91 98 465 13987

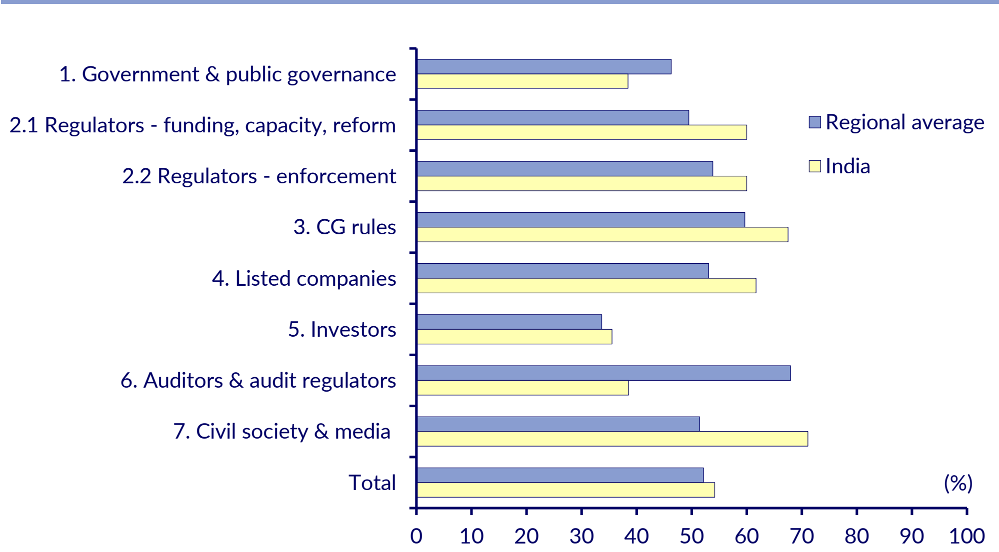
India - Every cloud has a silver lining

- Modi's "minimum government, maximum governance" slogan is questionable: "Digital India" (good); no Ombudsman (bad)
- Banking regulator suffers a fall from grace as non-performing assets (NPAs) continue to rise and bank scandals surface
- Independent audit regulator introduced, but in diluted form: ICAI, an industry body, still retains influence
- Corporate CG leaders stumble (Tata, Infosys)
- New Kotak Committee report made numerous recommendations for CG improvements: one woman independent non-executive director (INED); separation of chairman and CEO; more RPT disclosure

India ranks equal 7th with a score of 54%

Figure 1

India CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

Regulators caught unawares by bad corporate behaviour; boost CG norms in response

Two years ago, regulators in India told ACGA that it would take three to five years for perceptible changes to be seen from the new listing rules, new insider trading rules and the Companies Act 2013. Unfortunately, the last two years have instead seen regulators caught unawares as NPAs at public sector banks (PSBs) continued to rise, frauds were unearthed disguised as NPAs, and unlisted company actions undermined shareholder value at listed associates. Instead of burying its head in the sand, the securities regulator went back to the drawing board, formed a committee and accepted a slew of recommendations in early 2018 that will tighten governance norms in the coming few years. The banking regulator, however, found itself facing questions in parliament over its effectiveness as a regulator as frauds came to light and NPAs continued to plague bank balance sheets.

Investors up the ante: vote shares, agitate for change, no longer willing to vote with their feet

Shareholders continue to up the ante through the voting of shares and agitating for changes in the boardroom if they do not like what they are seeing. Successful? Partially. But it is far more interesting to see institutional and retail investors unwilling to just vote with their feet anymore. It is also telling how companies have reacted to this activism. While most have accepted the new paradigm, a doyen of corporate governance, Infosys, has now termed activist shareholders a "risk factor".

Sebi encourages top 500 companies to adopt integrated reporting - reports become more interesting

Annual reports have become more interesting to read, especially as a number of companies have adopted UK-style "integrated reporting", encouraged by the Securities and Exchange Board of India (Sebi) in February 2017. The regulator asked the top 500 companies that must produce business responsibility reports (BRR), which contain a range of non-financial information from talent retention to workplace diversity and environmental concerns, to also adopt integrated reporting. And for a number of companies that do not provide a sustainability report, BRRs were surprisingly informative.

Corporate governance stars, Tata and Infosys, become governance pariahs

Despite these improvements, the traditional stars of Indian corporate governance, Tata Group and Infosys, found themselves governance pariahs in 2017. Infosys had an unseemly public fight with one of its co-founders over governance issues, while Tata companies faced a governance storm when its parent company, Tata Sons, ousted its chairman, Cyrus Mistry, and proceeded to remove him and an independent director that sided with him from its listed companies. No reasons were given and shareholders felt the venerable company handled shareholder communications poorly during this period.

New independent audit regulator not so independent

In March 2018, the government announced a new and independent audit regulator. Sadly, its independence did not last long as the government relented to pressure from the Institute of Chartered Accountants of India (ICAI) and allowed its members to be a part of the new regulator.

Civil society becomes more corporate - collaborates to produce the India Responsible Business Index

Civil society is becoming better organised and more corporate - for example, a number of civil society organisations collaborated to produce the India Responsible Business Index. After three years, it has concluded that "community as a stakeholder is still not in the DNA of companies".

India continues to make progress, but it is hard fought and largely driven by regulators. While at least another five years is needed to embed progress, India is testament to the proverb that "every cloud has a silver lining".

Ankur Rudra
ankur.rudra@clsa.com
+91 22 6650 5059

Infosys - M&A and severance pay drives CEO and board changes
Infosys was embroiled in a public battle in 2016-17 that drew in its board and its iconic founder NR Narayana Murthy, involving several allegations of impropriety, board inaction and resulted in a change in CEO and several board members in 2017. The source of a lot of the controversy stemed from the 2015 acquisitions of Panaya (February 2015) and Skava (April 2015). This was followed by the departure of its then CFO Rajiv Bansal in December 2015. Subsequent disclosures indicated that Bansal received severance compensation amounting to about US$3m, which was c.30 months of salary and not Infosys' standard severance pay policy of three months.

The media reported impropriety in the acquisitions' valuations, the extent of the exit pay to the CFO, as well as inappropriate spending, compensation levels and lack of appropriate steps followed by the board. This was followed by media interviews and articles quoting Mr Murthy, where he suggested that Infosys' board had failed in ensuring appropriate governance, checks and balances. The board held a press conference to address several allegations and appointed law firms to probe the allegations. Infosys's board highlighted that these investigations did not find any wrong doing.

Infosys' CEO Vishal Sikka quit on 18 August 2017 citing media distractions. This was followed by Infosys board blaming Murthy in a strongly worded statement after the resignation. Over the following week, Infosys ex-CEO and co-founder Nandan Nilekani re-joined the firm as Non Executive Chairman and saw the departure of previous Chairman Seshasayee and three other board members. Nilekani committed to investigate all wrong doing by the previous board and close the matter raised by Murthy in public, start a CEO search and recompose the board over the following year. The departing CEO also signed a non-disparagement statement with Infosys.

Nilekani oversaw a review of Infosys' previous investigations and on 24 October 2017 issued a statement saying that the new board under his leadership found no wrongdoing and impropriety by the ex CEO and erstwhile board members in the Panaya case and the Rajiv Bansal severance issue. On December 6 2017, Infosys filed a consent plea with Sebi saying it will "neither admit nor deny finding of fact or conclusion of law" regarding allegations on "not seeking priot and separate approval of nomination and remuneration committee and the audit committee in relation to the severance agreement entered into with the former CFO". Infosys also entered an arbitration process with Rajiv Bansal on his outstanding dues. An arbitral tribunal ruled against Infosys in September 2018 and asked the company to pay Rajiv Bansal the outstanding severance pay with interest.

These incidents meant that Infosys changed its CEO, Chairman and saw the departure of four additional board members over the year - for a total departure of six board members. This was followed by four additions (CEO, Chairman and two new independent members). Each board committee has seen a change in Chairperson including the crucial audit committee and nomination and remuneration committee. It has dissolved two of its seven board committees - the committee of directors and finance, and the investment committee, thereby passing on the responsibility to the audit committee.

1. Government & public governance

India ranks 9th with a score of 38%

If a country's public governance is the bedrock upon which the corporate sector builds its governance structure, then India has a way to go yet. When Prime Minister Narendra Modi took office in 2014, he promised the country "minimum government, maximum governance" - a slogan that has only partially been fulfilled. Changes have occurred, digitalisation has largely helped remove the middlemen, but these are superficial changes at best.

Government does not appear to have a long-term CG strategy

In terms of a long-term corporate governance strategy, the government does not appear to have one. As in 2016, the slogan of the day is "Ease of Business", which has paid dividends in the World Bank rankings (see below). What does come through though is how regulators and the government are lurching from one crisis to the next: the Kotak Committee because of governance questions at Tata and Infosys; and amendments to the Banking Regulation Act because of increasing non-performing assets at public sector banks.

Lustre of good public governance takes a hit

Even the lustre of good governance that the Modi government enjoyed two years ago has taken a hit. Factors include the continued lack of an ombudsman and the government being accused of non-transparency and cronyism in an inter-governmental agreement with France to buy fighters, a case that has led to a public-interest litigation case in the Supreme Court. There has also been infighting in the Central Bureau of Investigation (CBI), with the government removing the CBI director from his post and once again landing in front of the Supreme Court. As one lawyer told ACGA when asked what was going on, "No idea. It's a circus".

Transparency International drops India two places; CVC tells a more nuanced story

According to Transparency International (TI), the whiff of corruption has seemingly gotten worse: India dropped two places in TI's Corruption Perceptions Index 2017. However, the 2017 annual report by the Central Vigilance Commission (CVC) tells a more nuanced story. CVC receives complaints regarding government corruption from the public and 2016 brought a sharp 67% increase in complaints over the previous year, followed by a sudden 52% decline in 2017. While some may view this as evidence that public-sector corruption is declining, it could also reflect other factors.

Ministries ignored advice from CVC in 2017 - can public trust their complaints are being taken seriously?

The CVC report also shows the challenges that the Commission faces in being heard. It noted in its report that "there were some significant deviations from the Commission's advice during 2017. For example, the Ministry of Railways, which had been advised to prosecute and impose a major penalty in one case, chose to instead issue an administrative warning. The Ministry of Aviation was advised to examine the role of the chief managing director of Air India in the appointment of a trainee pilot, but the Ministry did not examine his role and instead allowed him to retire with full benefits. How is the public to trust that their complaints are being taken seriously?

Digital India

"Digital India" to provide high-speed infrastructure to entire country and improve public governance

This administration's crowning achievement is probably "Digital India", a campaign launched by the prime minister to provide high-speed internet infrastructure for the entire country and improve public governance by ensuring government services are available digitally. Even though digitalisation began with the previous administration as a means of combating insidious government corruption, Modi repackaged it for more inclusiveness and wider coverage.

India vaults 30 places in World Bank's "Ease of Doing Business" as regulatory reforms are powered through

Making life easier for business

Modi has also powered through a number of regulatory reforms, including the Insolvency and Bankruptcy Code, 2016 (IBC), amendments to the Banking Regulation Act, 2017 as well as amendments to the Companies Act, 2013 to make it easier to do business in the country. All this saw India vault an impressive 30 places in 2017 to 100th in the World Bank's "Ease of Doing Business" index for the first time. Of the 10 Doing Business indicators, India showed significant improvement in the area of resolving insolvencies due to the IBC. It also saw gains in the areas of protecting minority investors, getting credit, and electricity connections. Despite these improvements, India continued to significantly lag in areas such as starting a business, enforcing contracts and dealing with construction permits.

Demonetisation shows disregard for checks and balances

In the dark on demonetisation

What gives us pause is the seeming disregard for checks and balances at the highest levels, which was exemplified by demonetisation. Modi announced the demonetisation of Rs500 and Rs1,000 notes on 8 November 2016, claiming that it would combat black money, corruption and fake currencies used to fund terrorism. Depending on which side of the political divide a person happens to stand on, s/he would either support or denounce his decision. It is still a highly contentious issue two years on.

Economic chaos ensued as 86% of currency in circulation was invalidated

The reality was that economic chaos ensued as 86% of the currency in circulation was invalidated: tourists were left stranded, ATMs had no money, banks shuttered its doors and daily workers paid in cash were left cashless! To date the BJP has never provided an accounting of how much black money was wiped out. But the Reserve Bank of India, in its 2017-18 annual report, stated that it had verified that Rs15.31tn of the banned notes had been returned to banks, which is 99% of the Rs15.42tn that was in circulation as of 8 November 2016. What happened to the trillions of black money that was supposed to have been destroyed by corrupt officials and not returned to banks for fear of scrutiny? This is a question the government will not answer.

BJP members refused to endorse committee report calling demonetisation "ill-conceived"

A draft report by the Standing Committee on Finance, finalised in early 2018, was highly critical of the demonetisation move, calling it "ill-conceived" and leading to the "lowering of the Gross Domestic Product (GDP) by at least 1 percentage point". The majority BJP members on the committee reportedly refused to adopt or discuss the report, which died in the water by the end of August when the committee's term came to an end.

Supreme Court provides solution that government ignores

Where is the new ombudsman?

Furthermore, if the Modi government is as intent on wiping out corruption in government circles as it claims, why has it not established a Lokpal or Ombudsman as provided in the Lokpal and Lokayuktas Act, 2013, an anti-corruption act? Rather, the government has used the excuse that there is no leader of the opposition to sit in the selection committee, even though the Supreme Court had provided a solution in April 2017, stating that under the law, a truncated committee without the leader of the opposition could appoint a Lokpal. Yet the government has chosen not to act, instead opting to dilute the act by passing an amendment bill in the lower House of Parliament, the Lok Sabha, in 2016, that did away with a provision in Section 44 requiring public servants to publicly disclose the assets and liabilities of their spouses and dependents.

Supreme Court loses patience with government, tells it to provide timeframe for appointment of Lokpal

What would happen to the CVC if and when a Lokpal came into existence? According to its website, the Commission is the "designated agency" that receives written complaints for the disclosure on any allegation of corruption or misuse of office and will then recommend appropriate action. Last year, the CVC Commissioner said in an interview that there were overlaps between the two bodies and that it had “communicated its suggestions” to parliament. Since there had been no move to appoint a Lokpal, the Supreme Court finally lost patience and ordered the government in July 2018 to give a timeframe for the appointment. The reply in late July, but it failed to satisfy the court.

RBI fall from grace

Banking issues escalate, Standing Committee questions how RBI has used its supervisory powers

RBI has had a spectacular fall from grace in recent years. Not only has it been unable to stem the rising tide of non-performing assets (NPAs) - gross NPA volume rose 13.7% from September 2017 to March 2018 - but insolvencies have unearthed frauds and the parliamentary Standing Committee on Finance questioned how well the central bank had used its supervisory powers in a September 2018 report. Interestingly, Urjut Patel, RBI governor, told the committee that RBI does not have enough regulatory powers over public-sector banks (PSBs), and that they were markedly weaker than the powers RBI has over private-sector banks - a point of view that the government vehemently disagreed with. However, this rift widened as the year came to an end.

NPAs continue to rise at public sector banks - RBI warns they will get worse before they get better

NPAs have been an issue in the banking sector for a long time, but it was brought front and centre in 2015 by former RBI governor, Dr Raghuram Rajan, who ended forbearance and forced an asset quality review of banks. He told the market that RBI intended to have “clean and fully provisioned bank balance sheets” by March 2017. Two years later that is no longer a possibility. As the regulator stated in its Financial Stability Report in June 2018, the gross NPA ratio of banks will likely rise further from 11.6% of total loans in March 2018 to 12.2% by March 2019. That figure, it predicted, would be far worse at 11 public sector banks (PSBs) under prompt corrective action (PCA), where the ratio will likely worsen from 21% in March 2018 to 22.3% by March 2019. The PCA framework was one of the tools RBI has been using to monitor the capital, asset quality and profitability of banks, specifying the trigger points when the regulator would take corrective action.

Recapitalisation for PSBs comes with clear-cut commitment to compatibility of governance issues

Further, the government announced in October 2017 a larger recapitalisation programme of Rs2tn to help PSBs. But RBI commented that the funds came with a clear-cut commitment from the government to the “compatibility of governance issues of PSBs”.

Rajan sent a list of high-profile frauds to the PM, but no action has been taken

However, NPAs was just one part of the problem at PSBs - frauds being the other. In its 2017-18 annual report, RBI reported that the number of cases of fraud had notably increased in that year to 5,835, from 4,500 in the past decade, with the sum of money involved increasing significantly to Rs410bn. It said this was due to the large fraud discovered at Punjab National Bank in January.

Frauds increased in 2017-18 to 5,835 from 4,500 in the past decade

According to Rajan, in a reply to the Parliament Estimates Committee on bank NPAs in September 2018, a fraud monitoring cell had been set up while he had been governor and he had sent a “a list of high profile cases to the PMO (Prime Minister’s Office) urging that we coordinate action to bring at least one or two to book.” But he added, “I am not aware of progress on this front.”

PSUs get CG pass

A lingering issue in India's CG regime is the exemption given to listed public-sector undertakings (PSUs) from compliance with various standards. From the requirement to appoint one woman director and an adequate number of independent directors, to new rules on electronic voting at shareholder meetings, PSUs get a pass. On the latter point, the State Bank of India, one of the country's largest banks, continues to hide behind the SBI Act and is the only listed company in the top 500 that fails to provide e-voting facilities at shareholder meetings.

Mahesh Nandurkar
Executive Director
mahesh.nandurkar@clsa.com
+91 22 6650 5079

Government-driven misuse of PSU money continues

The government has accelerated its utilisation of listed public-sector companies' resources for its own objectives in the last few quarters - particularly as government finances have become strained. In FY18, it directed the takeover of its stake in oil-marketing company HPCL by oil explorer ONGC. The latter paid the government Rs369bn to acquire this stake. Additionally, the government waived off open offers for other shareholders of HPCL after this merger. Given India's large dependence on crude-oil import, ONGC could have better deloyed the money for its own exploration and/or acquisition in foreign oil fields.

Unfortunately, the above incident is unlikely to be a one-off for PSUs. Another planned takeover of the government's stake is hydro power PSU SJVN by thermal power PSU NTPC, which is yet to be completed. Recently, in FY19, the government sold its stake in the badly debt-ridden IDBI Bank to the unlisted insurance major LIC. The government has a large disinvestment target for FY19 as well and already media reports indicate that large PSUs in power sector (such as PFC-REC, NTPC-NHPC) and in the oil sector (IOC-BPCL-GAIL) may again have such cross holdings come up.

2. Regulators

India ranks equal 3rd in this category with a score of 60%

India's better performance overall in this section, ranking equal third in the region with Taiwan, is the result of several factors: a series of regulatory reforms it has undertaken over the past two years; relatively well-funded regulators; and improvements made in enforcement, especially in surveillance technology. India's score and rank also benefits from it not undertaking any deeply regressive steps, such as the introduction of dual-class shares, something that has driven down scores in both Hong Kong and Singapore. And since India centralises more of its enforcement work in its securities commission, it receives a boost from the greater weighting we have applied to enforcement by securities commissions compared to stock exchanges.

Securities market is primarily regulated by Sebi and the two front-line regulators,

The securities market is regulated by the Securities and Exchange Board of India (Sebi), which comes under the Ministry of Finance (MoF), and the two front-line regulators, the National Stock Exchange of India (NSE) and the Bombay Stock Exchange (BSE). Other government entities with a role in the securities market include the Ministry of Corporate Affairs (MCA), which administers the Companies Act, 2013, and the Reserve Bank of India (RBI), the central bank, as well as the Insurance Regulatory Development Authority (IRDA). The Sebi board has a representative each from MCA, RBI and the Department of the Economic Affairs (DEA), a department under MoF.

Problems persist in enforcement, especially regarding insider trading

But celebration is not yet in order: India's moderate score of 60% is far from the highest ranked market - Hong Kong at 69% - and problems persist in enforcement, especially regarding insider trading, which has not seen much improvement. Meanwhile, its securities commission was given guidance twice in 2017, once from its own vigilance cell and then a guideline from the CVC, urging it to complete its investigations in a timely manner.

2.1 Funding, capacity-building and regulatory reform

India ranks equal 2nd in this sub-category with a score of 60%

The Exchanges, with a push from Sebi a few years back, have become far more active regulators, tethering technology as a means of enhancing their regulatory roles - a method Sebi has also been exploiting for a number of years. All three are self-funded, the exchanges mainly through transaction charges, listing fees, and book building fees. NSE had total revenue of around Rs25bn (US$345m) as at 31 March 2018, while BSE registered total revenue from operations of almost Rs48bn from its securities services, services to corporates and data provision fees.

Will becoming listed companies affect the regulatory effectiveness of the exchanges?

What is of concern to the market, though, is the impact that becoming listed will have on the regulatory effectiveness of the exchanges. BSE listed on the NSE in February 2017, while NSE is waiting in the wings for Sebi's approval. Interestingly, on 21 June 2018, the Sebi board accepted a recommendation mandating that exchanges must "disclose the resources committed towards regulatory functions and towards ensuring regulatory compliance, backed by activity based accounting" in order to enhance the transparency of how resources are being utilised. If implemented, this would provide a level of disclosure not seen in leading markets such as Australia, Hong Kong and Singapore.

Sebi, meanwhile, has been given financial autonomy by means of a separate fund under Section 14 of the Sebi Act, primarily comprising grants, fees on stock exchanges and brokers, processing IPOs, debt issues, mutual funds, as well as providing informal guidance to firms. In the year ended 31 March 2017, Sebi earned a total income of Rs7.5bn, but its general fund held a reserve of Rs31.7bn, a point of contention between Sebi and the government, and flagged by the Comptroller and Auditor General (CAG) in its 2017 report.

CAG stated the excess funds should be deposited with the government in a public account, an argument that goes back to 2011. In 2016, the then Sebi chairman, U K Sinha, argued that depositing Sebi funds in a government account would undermine the regulator's autonomy, an argument the government should take seriously. The funds, the regulator has argued, should be used by it for market expansion and investor programmes. The matter is currently under discussion between MoF and Sebi.

Sebi and the two exchanges continue to be under-staffed

Where the regulator and exchanges do not do so well is in capacity building, at least in terms of the number of employees they have. In a country that boasts more than 5,000 listed companies, the securities regulator only had 794 people as of March 2018. The NSE had 497 employees as of the same date, while BSE had 459. All three have invested heavily in technology for surveillance purposes over the past few years and have continued plans to bolster their technological infrastructure, but they are wanting in human capital. In contrast, the SEC in the USA has 4,200 employees to cover a market with 9,500 publicly-traded companies, while the Securities and Futures Commission in Hong Kong has around 880 staff for 2,100 listed companies. Sebi would appear to be seriously under-staffed, although it should be noted that most of India's 5,000 listed companies are extremely small and not a major focus for the regulator.

Sebi reacts to Tata and Infosys

Sebi chairman forms Kotak Committee to review CG norms in the wake of scandals

The past two years have been active ones for CG regulatory reform. On 1 March 2017, Ajay Tyagi, an Indian Administrative Services officer, took over as chairman of Sebi when India was still reeling from the Tata feud and the open war between Infosys co-founder, Narayana Murthy, and his company (*see Listed Companies below*). In the wake of this, Tyagi chose to constitute the Kotak Committee on Corporate Governance, headed by Uday Kotak, MD of Kotak Mahindra Bank, and comprising members from various sectors, including legal, accounting, industry and proxy advisors, to look into corporate governance norms. Formed in June 2017, the committee was given four months to finish its work and provide recommendations.

Sebi accepted more than half the committee's ideas, some with modifications

Sebi broadens enforcement framework for non-compliance with listing requirements

On 5 October 2017, the committee submitted its report. Then on 28 March 2018, Sebi accepted 40 of the 80 recommendations without any modifications, while 15 were accepted with modifications and 18 were rejected. *(See CG rules below for details on the Kotak Committee recommendations.)* Sebi also broadened the enforcement framework for non-compliance with its Listing Obligations and Disclosure Requirements (LODR). To "promote a better compliance culture", the securities regulator revised the framework to make it more comprehensive and include all "measurable provisions" of the listing requirements, including composition of the board, its committees, submission of CG compliance report and financial results. Non-compliance would initially lead to fines, then freezing the entire shareholding of the promoters and promoter group in the non-compliant company and their shares in any other securities; and if non-compliance persists, suspension and ultimate delisting of the company.

Banking gets an overhaul

Banking amendment allows RBI to initiate insolvency proceedings

One other important amendment that occurred in 2017 was the Banking Regulation (Amendment) Act, 2017. This allows the government to authorise RBI to initiate insolvency proceedings, to issue directions to banks on stressed assets and specify committees to advise banks, and includes a provision stating that the amendment is also applicable to the State Bank of India.

RBI establishes new enforcement department to speed up regulatory compliance

Additionally, RBI established a new enforcement department in April 2017 that it says will speed up regulatory compliance. It also revised its prompt corrective action framework to "incorporate more prudent risk-tolerance thresholds". The framework, initially issued in May 2014, includes guidelines as to when RBI will take action if the financial condition of a commercial bank falls below certain trigger points. Such action could include recapitalisation or restrictions on borrowing from inter-bank markets to the more drastic step of merging, amalgamating or liquidating a bank.

Pushing the fiduciary boundary?

Sebi plans a stricter framework for fiduciaries in the securities market, including auditors

Sebi is facing new challenges as it seeks ways to move forward in an increasingly fluid environment where financial information is leaked via social media and it is saddled with a burgeoning caseload. One new idea is a stricter framework for fiduciaries in the securities market, something which would include auditors. Not surprisingly, this is bitterly opposed by the Institute of Chartered Accountants of India (ICAI), which argues that external auditors are not fiduciaries. However, Sebi contends that it can, and should, regulate anyone associated with the securities market.

India ranks equal 3rd in this sub-category with a weighted score of 60%

2.2 Enforcement

Surveillance measures and actions have increased in the past two years at Sebi, which has overall responsibility for regulating market misconduct, and the two exchanges, which play a frontline regulatory role in terms of surveillance and initial investigations.

Some highlights of Sebi's progress in enforcement over 2017 and 2018:

- The biggest action taken in 2017 was against 331 purported listed shell companies that MCA had forwarded to Sebi. The regulator directed the stock exchanges to place trading restrictions on promoters/directors of the companies and place the scrips under graded surveillance measures until the stock exchanges had verified the credentials and fundamentals. To date, Sebi has passed interim orders in 39 cases, with forensic audits ordered in 31 of those cases. The exchanges, meanwhile, have issued interim directions in 112 cases and have ordered forensic audits in 95 cases.
- During 2017-18, Sebi launched nearly double the number of prosecutions than in 2016-17: 56 prosecutions against 407 persons/entities versus 33 prosecutions against 237 persons/entities. It also boasted a higher disposal rate of prosecution cases in 2017-18: 96 cases compared to 87 cases the previous year.
- Sebi revised (Settlement of Administrative and Civil Proceedings) (Second Amendment) regulations in December 2017 in order to expedite the settlement process before initiating proceedings under securities laws. And in 2017-18, Sebi received 241 applications for settlement compared to 171 applications in 2016-17. It disposed of 200 applications and collected almost Rs309m towards settlement, legal, administrative and disgorgement charges, compared to Rs135m in 2016-17.

The securities regulator has a constant backlog of cases

Meanwhile, Sebi has a constant backlog of cases to deal with. During 2017-18, it took up 117 new cases for investigation and completed 145, compared to 245 new and 155 completed cases the previous year. It typically takes many years to complete investigations and pass final orders, but issues interim orders in the meantime. As of 31 March 2018, it had 1,283 cases pending under adjudication proceedings where monetary penalties will be imposed if parties are found guilty. It disposed of 888 cases during 2017-18 and with penalties given (although these were not clearly specified), while adding a further 594 cases.

Weak on insider trading . . .

Enforcement against insider trading is a weak link in Sebi's armoury

In terms of insider trading, Sebi has been criticised for failing to investigate many cases and produce meaningful prosecutions. Limited human resources for investigations and under-utilisation of new powers given to the regulator are the usual two reasons given for this situation. However, we believe that there is also a mindset issue around the difficulty of proving and prosecuting insider trading. Despite the new powers it received in 2014 for surveillance and investigation, and stricter insider trading regulations that came into effect in 2015, the number of new insider trading cases taken up for investigation in 2017-18 was less than half the previous year: 15 compared to 34. Meanwhile, a mere six were completed during 2017-18 as against 15 the previous year.

. . . but sometimes innovative

Yet Sebi is getting more creative in pursuing insider trading cases

Sebi has, nevertheless, taken some interesting measures to pursue insider trading, as it did with Deep Industries in relation to three contracts in 2015 for hiring mobile drilling rigs from ONGC, a public-sector company. The Sebi investigation

showed that the managing director of Deep Industries had bought shares of the company during the period between finalising the contracts and announcing them to the exchanges - when information was price-sensitive and no trading should have taken place - while two other investors, Sujai Hamlai and his company VTIPL, were caught in the web after Sebi looked into Facebook relationships. All three sold their shares after announcing the contracts to the exchanges. An ex-party interim order was passed against all three in early 2018, impounding their gains from the sale of Rs24m (US$328,000 approx).

Price-sensitive information from some leading companies has leaked on social media prior to quarterly results

Leading banks and other companies were caught in the crosshairs in 2017 when a Reuters investigative report showed that price sensitive information had been leaked before the quarterly results of HDFC Bank, Axis Bank, Dr Reddy's and Wipro. After a preliminary investigation by Sebi, it directed both Axis Bank and HDFC Bank to strengthen their processes, systems and controls immediately. They were also told to submit an improvement report and explain who was responsible for monitoring their systems. Both banks were also ordered to conduct an internal inquiry into the leak and take appropriate action against those responsible.

The biggest case has been against Reliance Industries

But by far the most interesting, and oldest, case to come to fruition has been against Reliance Industries. After 10 years, Sebi found in March 2017 that Reliance Industries had fraudulently manipulated the market in 2007. It directed the company to repay Rs4.5bn with an interest of 12% per year since November 2007 until the date of payment. Reliance Industries and 12 other entities were also barred from the dealing in equity derivatives in the futures and options (F&O) segment of stock exchanges for a year.

In 2007, Reliance Petroleum (RPL) amalgamated with Reliance Industries, but prior to that Reliance Industries off-loaded 5% of it shares in RPL in the cash segment. Sebi argued that Reliance enlisted 12 other entities to take a position on Reliance Petroleum (RPL) for it in the futures market, cornering more than 93% of RPL November futures. Sebi contended this was fraudulent. Reliance then manipulated the F&O segment, by allowing the price to dip in November and then allowing all the open positions in the open market to expire, then selling the shares in the cash segment. Sebi concluded that, "This is a case of a unique strategy of not manipulating the price or volume in a single market, but manipulating the settlement price in one market to gain across the volumes accumulated in the other market."

On the frontline

While surveillance and investigation statistics are not available in NSE's annual reports, they are available in the BSE report. During 2017-18, BSE generated more than 66,200 surveillance alerts, of which it took up 1,101 for snap investigation. As of 31 March 2018, 207 cases were taken up for preliminary or detailed investigations, of which 126 reports had been forwarded to Sebi.

What is irritating, however, is the sheer difficulty of finding enforcement information on the two exchange websites. Lists of suspended companies are available, as are the fines they have paid. But to get to the right pages requires excessive effort or psychic knowledge. NSE is a little better than BSE, but not much. On a more positive note, and definitely a first, is that NSE has now provided a list of directors at 135 suspended companies.

Aashish Agarwal
Head of Research - India
aashish.agarwal@clsa.com
+91 22 6650 5075

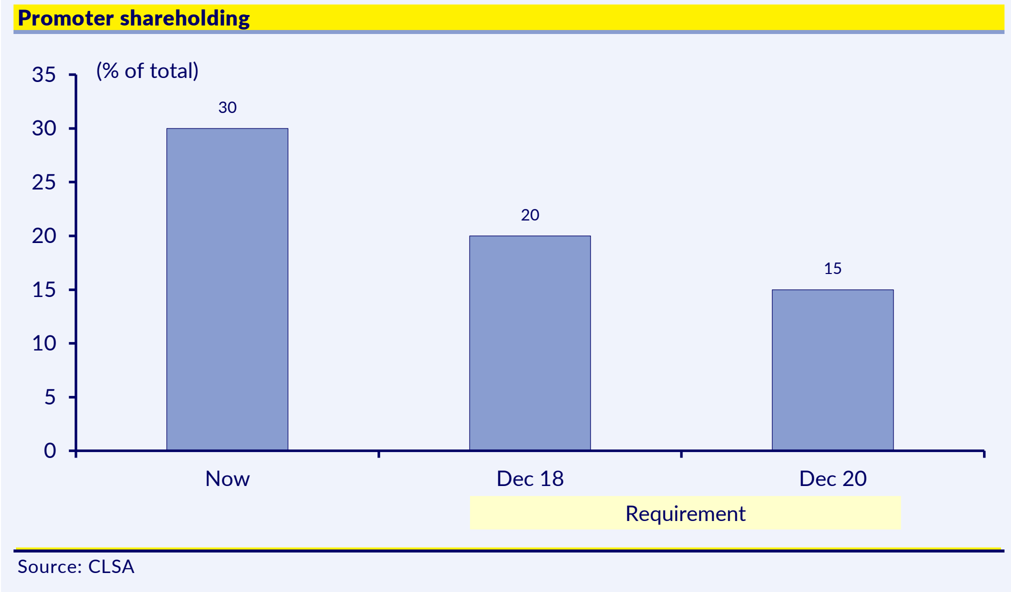
Prakhar Sharma
prakhar.sharma@clsa.com
+91 22 6650 5058

Promoter dilution debate

In Kotak Bank's case, promoters were supposed to bring down shareholding from 30% to 20% by December 2018 and to 15% by December 2020. While the understanding was that the dilution would come through either a selldown of equity stake by the promoter or the issue of new equity shares or any acquisition, the bank instead sought to issue preference shares to dilute the promoter's equity shareholding in the bank.

In August 2018, the bank's board approved the issuance of Rs5bn of Non-Convertible Perpetual Non-Cumulative Preference Shares. Since these are considered paid-up shares of bank, the board/bank interpreted that these would be eligible instruments to dilute promoter shareholding. In fact, by issuing shares worth just c.0.2% of Kotak's market cap, it could dilute promoter shareholding by 10ppt to c.20%. However, RBI rejected the bank's proposal as it said the issuance was not in line with the law. Kotak bank is in discussion with RBI on this issue. RBI's stance seems reasonable and it may also be indicating a conflict of interest. Recent media reports suggest Kotak Bank may seek an extension for the diliution timeline in promoter holding.

Promoter shareholding



Source: CLSA

3. CG rules

India ranks equal 4th with a score of 68%

Corporate governance rules in India changed for the better with the Companies Act, 2013, then 2015 ushered in the new Listing Obligations and Disclosure Requirements (LODR), amended continuous disclosure rules, and Sebi's Prohibition of Insider Trading Regulations. The changes were much-needed and included a modernised regime governing related-party transactions that allowed minority shareholders to approve material transactions and a more comprehensive list of material events that companies must disclose.

Regulators used e-voting to get voting by poll in through the backdoor

Regulators also got creative, finding a workaround to the voting by poll issue that companies had been resisting for years - both MCA and Sebi required listed companies to provide e-voting for their shareholders and this ushered in voting by poll. As a result, Indian companies today provide some of the most

comprehensive voting result announcements in the region. Sebi has also mandated board evaluation and became the first regulator to require the top 500 companies by market cap to publish a dividend policy. Diversity, at least gender diversity, was also a point MCA and Sebi pushed through, with Sebi mandating all listed company boards to have at least one woman director.

India's CG rulebook is quite strong, but contains many weaknesses

Despite these innovative moves, India's CG rulebook contains many weaknesses. Independent directors can sit on too many boards (the maximum is 10). People who have had a close working relationship with a company can be nominated as independent directors after a short cooling-off period of two to three years. The business responsibility report (BRR) is sometimes just a tick- box exercise, providing the absolute minimum or even meaningless information. Even the RPT regime was diluted by Sebi in 2015, replacing the requirement for obtaining a special resolution with that of an ordinary resolution, cutting minority shareholder approval from 75% to 50%.

Last two years have shown that rules are not enough

What has become apparent in the last two years is that rules are not enough. Following the first glow of the new rules in 2013 and 2015, there was a belief that corporate governance regulation had been mastered for the time being and it would take a few years to ensure that corporate culture caught up to the spirit of the rules. The past couple of years, unfortunately, has shown this view to be overly optimistic.

Kotak committee

Kotak committee reviewed CG norms and came up with 80 recommendations in double quick time

The Kotak committee reviewed corporate governance norms in India over four months in mid-2017 and, in quick time, produced 80 recommendations by early October 2017. While the committee did not address everything, a number of the proposals Sebi accepted were long overdue, while other amendments were a natural progression of existing rules.

Some of the accepted recommendations include:

- Enhanced disclosure of RPTs and related parties to be allowed to vote against RPTs
- Making it compulsory to have one woman independent director on the boards of the top 500 listed companies by 1 April 2019 and the top 1,000 listed companies by 1 April 2020
- Lowering the maximum number of directorships, from 10 to eight by 1 April 2019 and to seven by 1 April 2020. In addition, managing directors or whole-time (ie, executive) directors in listed companies may not serve as independent directors in more than three listed companies
- Mandating the disclosure of a director "skills matrix" listing the competencies of each director
- Separating chairman and CEO for top 500 companies from 1 April 2020

The mindsets of promoters needs to change for new CG norms to work

While these regulations have only just been announced, there is an expectation that disclosure will get better. But as one lawyer told ACGA, it is more important that promoters (controlling shareholders) be made aware of the benefits of governance. If their mindset does not change, nothing will work.

New stewardship codes

IRDA and PFRDA have take the lead on a common stewardship code

In April 2016, a common stewardship code for investors was first mooted in India by the Financial Stability and Development Council (FSDC), an apex body of financial regulators constituted in 2013 with the aim of strengthening and institutionalising the mechanism for maintaining financial stability and enhancing inter-regulatory coordination. Interestingly, the next step was not taken by Sebi, as one might have expected, but by the Insurance Regulatory and Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA), which both issued codes for institutional investors in their sectors. IRDA set the ball rolling in March 2017 when it published stewardship principles that insurers were meant to adopt as policies by 21 September 2017. There were seven principles:

1. Insurers should formulate a policy on the discharge of their stewardship responsibilities and publicly disclose it
2. Insurers should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it
3. Investors should monitor their invested companies
4. Insurers should have a clear policy on intervention in invested companies
5. Insurers should have a clear policy for collaboration with other institutional investors, where required, to preserve the interests of the policyholders (ultimate investors), which should be disclosed
6. Insurers should have a clear policy on voting and disclosure of voting activity;
7. Insurers should report periodically on their stewardship activities

PFRDA followed suit in May 2018

Sebi has already ensured mutual funds have been voting for a number of years

Meanwhile, mutual funds are already required by Sebi to publish voting policies on their websites, as well as how they vote at investee companies and their reasoning behind votes. They have not been required to adopt a stewardship code as yet, but according to Sebi it is close to finalising a common stewardship code with the IRDA and PFRDA along the lines of the UK Stewardship Code.

Vivek Maheshwari
vivek.maheshwari@clsa.com
+91 22 6650 5053

Uneven shave: Minority stake in Indian company through an unlisted entity

Colgate acquired a 14% stake in Bombay Shaving Company (BSC), which retails 32 products in shaving, bath & body, skin and beard care. On the face of it, the acquisition is small, but raises concerns on governance due to category overlap. Given Colgate India's local understanding and strong distribution muscle, acquisition by the listco would have made more sense.

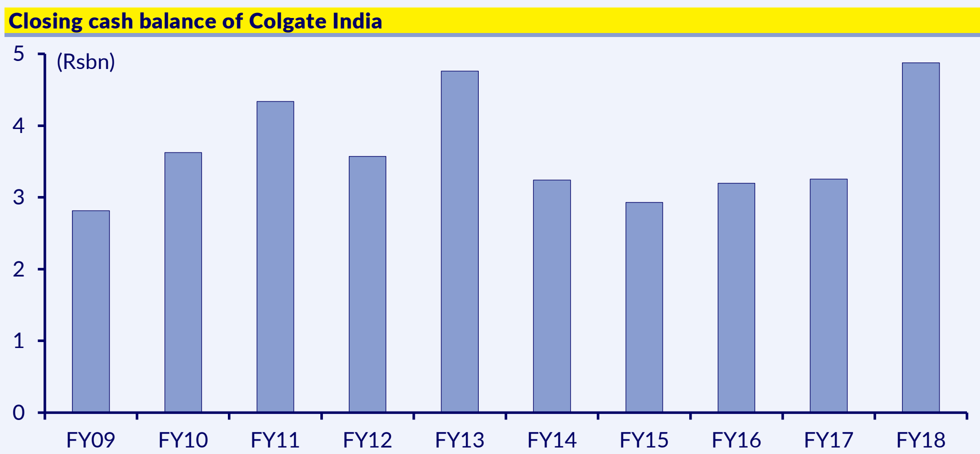
We were surprised that, rather than Colgate India, the acquisition was done by a regional (unlisted) subsidiary of Colgate US. While the business is small today and only a minority stake was acquired, we still see this as a conflict of interest for Colgate India's minority shareholders given BSC also operates in the personal care and grooming segments.

Additionally, BSC's CEO noted that Colgate would be assisting them with product development, expansion of distribution reach and brand building, as per Economic Times. If the business format ramps-up over time, Colgate India

shareholders' would not participate in any upside from this. At this point, we are unsure whether BSC will have an alliance with the listed Indian entity and if it does, what the potential commercial terms are.

Colgate India has a strong balance sheet yet the acquisition was done by the unlisted entity

Closing cash balance of Colgate India



Source: CLSA, Company data

Vivek Maheshwari
vivek.maheshwari@clsa.com
+91 22 6650 5053

Kotak committee impact on consumer names

In April 2018, the Sebi accepted several recommendations from the Kotak committee, which aims to improve the corporate governance and reporting standards for Indian corporates.

Royalty payments over 2% will now require approval from at least half of minority shareholders. However, there is ambiguity with respect to existing contracts, which may impact HUL, Colgate, Nestle and GSK Consumer.

Enhanced disclosure has also been proposed for related-party transactions. Several companies (ITC, USL and Jubilant Foods) do not report consol results, which is to be mandated. Additional CG regulations include one independent woman director, a separate CEO/Chairman position, etc. The timelines for corporates to comply have been set. While implementation of some regulations must be ensured by April 2019, others (including the separation of CEO and Chairman positions) the deadline is April 2020.

Sebi has accepted several proposals of Kotak Committee to enhance governance standards

Royalty payments to parent . . .

Among the most important results from the Kotak committee for consumer names, Indian MNCs like Hindustan Unilever, Nestle, GSK Cons pay 3-5% to parent as royalty (or technical know-how fees in some cases like HUL). Over the past five years, HUL and Nestle have seen an increase in royalties. However, Sebi has now stated that royalty to related party requires approval from a majority of minority shareholders, where payment exceeds 2%.

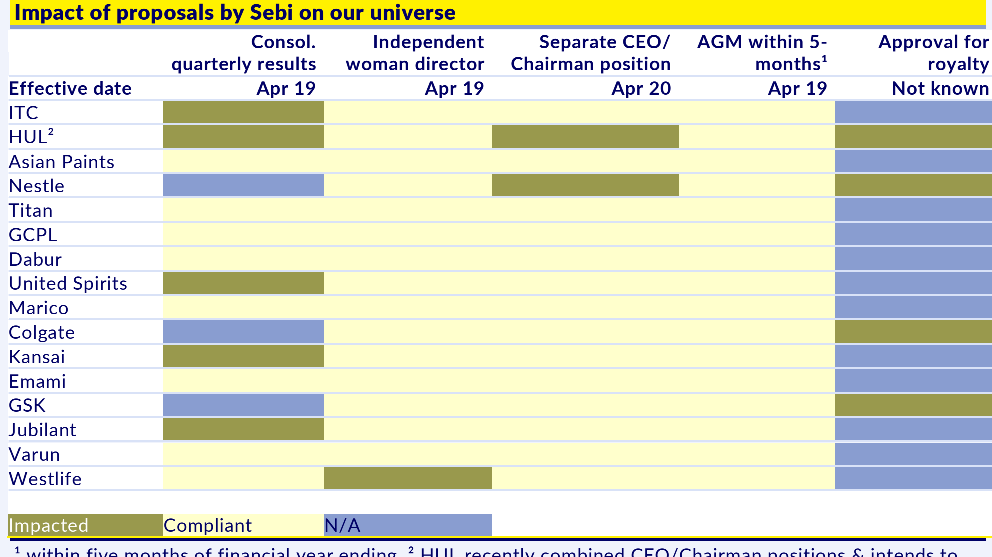
. . . future secured, but clarity on present

While the proposed regulation is not yet very clear, talks with industry experts suggest that the cap is on all fees including royalty and technical know-how. There is lack of clarity whether existing royalty agreements in excess of 2% will need reapproval or the status quo would continue. In case there is any change with the existing royalty structure, we note that every 1% change in royalty has 4-5% impact on earnings for HUL, Nestle, Colgate and GSK.

Approval from more than half of minority shareholders for royalty payments of >2% is the key regulation

A few more proposals to have an impact

Companies are required to report consolidated quarterly results from April 2019 and we note that currently, ITC, HUL, USL and Jubilant Foods report only standalone numbers. The CEO and Chairman positions should also be separated by April 2020 and HUL and Nestle will need to comply. There should also be an independent woman director on the board and interestingly except for Westlife Dev, all others already comply with the proposal.



Impact of proposals by Sebi on our universe

	Consol. quarterly results	Independent woman director	Separate CEO/ Chairman position	AGM within 5-months[1]	Approval for royalty
Effective date	Apr 19	Apr 19	Apr 20	Apr 19	Not known
ITC	Impacted	Compliant	Compliant	Compliant	N/A
HUL[2]	Impacted	Compliant	Impacted	Compliant	Impacted
Asian Paints	Compliant	Compliant	Compliant	Compliant	N/A
Nestle	N/A	Compliant	Impacted	Compliant	Impacted
Titan	Compliant	Compliant	Compliant	Compliant	N/A
GCPL	Compliant	Compliant	Compliant	Compliant	N/A
Dabur	Compliant	Compliant	Compliant	Compliant	N/A
United Spirits	Impacted	Compliant	Compliant	Compliant	N/A
Marico	Compliant	Compliant	Compliant	Compliant	N/A
Colgate	N/A	Compliant	Compliant	Compliant	Impacted
Kansai	Impacted	Compliant	Compliant	Compliant	N/A
Emami	Compliant	Compliant	Compliant	Compliant	N/A
GSK	N/A	Compliant	Compliant	Compliant	Impacted
Jubilant	Impacted	Compliant	Compliant	Compliant	N/A
Varun	Compliant	Compliant	Compliant	Compliant	N/A
Westlife	Compliant	Impacted	Compliant	Compliant	N/A

Impacted | Compliant | N/A

[1] within five months of financial year ending. [2] HUL recently combined CEO/Chairman positions & intends to comply by due date; Source: Companies; CLSA

4. Listed companies

India ranks 4th with a score of 62%

India ranks relatively well in this section, in large part because of well-written reports and easily traversable websites, but loses points for, once again, a sheer disregard for the spirit of governance. But this is a tale of two cultures: one filled with light, informative reports, easy-to-use websites, and boards that believe in transparency and treating their stakeholders well; the other is dark and filled with governance issues. Sometimes, the two collide. One hears the usual: 'such-and-such is an anomaly, you should concentrate on the top 100 companies'. The issue is that the problem often resides in the top 100 companies.

MD&As and remuneration policy disclosure is good, but committee reports are boilerplate

To be fair, reports from the larger companies are extensive and usually informative: MD&As, for the most part, are not formulaic, and remuneration policies are better spelt out than they have been in the past. But issues remain with, among other things, board committee reports. Interestingly, midcaps hold their own in many areas of corporate reporting.

"Other other expenses" in the notes, with no further explanation

Financial reporting

Big companies generally did well in financial reporting, but in certain cases segment information and geographical footprint - the easy stuff - was difficult to pinpoint. Is it a chore to let your shareholders know what your businesses are and where you operate? A number of companies, both large and medium-sized, were unable to provide detailed notes on "other expenses". Some companies even provided a line called "miscellaneous expenses", with no further explanation, at the end of their "other expenses" table. An "other other" expense! However, companies listed in the USA had accounts that were easier to navigate.

High-level discourse in many MD&As

A welcome finding was the high-level discourse that many companies, both large and mid-sized, published in their MD&As, touching on current operations, business opportunities and mid- to long-term strategies.

CG reporting

Large CG reports, devoid of meaningful information, remain a common sight. They fulfil the criteria enumerated in the listing rules, but fail to engage the reader, especially with regard to committee reports. Some companies stretched the terms of reference of board committees over two pages, but failed to speak about the committee agenda for the year, or whether recommendations from the previous year had been acted upon.

Where a number of large companies disappointed was in their board diversity policies. In one or two cases, there was no policy. Instead, readers were treated to a one-liner in the nomination and remuneration committee report that stated the committee was supposed to come up with a board diversity policy, but when that might be and where it might be found was a mystery. Generally, diversity policies are boilerplate, giving lip service to gender diversity, but rarely more than that. Companies with more foreign shareholders tend to do better.

Remuneration policies have definitely improved in the past two years, with some of the larger companies being quite specific about how they compensate key management personnel. And while many did not have the type of detail that ICICI Bank had, companies, including mid-sized ones, are beginning to give a better explanation of how compensation is tied to KPIs and company performance.

ESG reporting

Even without sustainability reports, a large number of companies provide fairly decent ESG infomation

Here again, if a company was listed abroad or had a large foreign shareholder presence, its ESG report was usually good. But even without a sustainability report as such, a number of companies still provided fairly decent information about their energy saving measures, training for employees and whether their policies on corruption and ethics encompassed their supply chain. Some of the larger companies also provided a materiality map or matrix that was developed after engaging with stakeholders. Where a number of companies fell short, however, was the lack of detail on their stakeholder engagement and on whistle-blowing policies.

Midcaps

The midcaps we reviewed tend to hold their own where annual reports are concerned, and are consistent in speaking about their sustainability efforts. While their reports may not be as substantial as the big boys, they are not to be scoffed at: policies and codes; diversity in the workplace and training of employees; fighting corruption; and environmental risks can usually all be found in their business responsibility reports. But where SMEs trump their bigger brothers is on websites, which are easier to traverse and the information far more likely to be found. Larger companies have decent websites and the information is there, but not always in plain sight. HDFC, for example, did not even have its latest sustainability report on its website - it could only be found through a link in its BRR.

Websites

Many larger companies had less than stellar websites, with out-of-date information or wrong

HDFC was not the only company that had a less than stellar website. Indeed, it was invariably the larger companies that had out-of-date information or wrong notices up on their websites. Hats off to public-sector companies for overhauling their websites, but Bharat Petroleum needs to ensure that the correct notices are uploaded, while Tata Consultancy Services needs to update its letter of appointment to independent directors - the current letter on its website is signed by Cyrus Mistry, its erstwhile chairman who was shown the door by Tata Sons in October 2016.

Torrid time for top companies

Tata and Infosys have had a tough two years for CG

Despite progress being made in corporate disclosure and governance in the wider large- and mid-cap market, the past two years has been a torrid time for some of India's leading companies, starting with the stalwarts of corporate governance: Tata and Infosys. Tata Sons, the unlisted holding company of the Tata Group that controls more than 20 publicly listed companies, unceremoniously ousted its chairman, Cyrus Mistry, in October 2016, with no explanations given. Key Tata Group firms promptly lost more than Rs200bn in market value. Then on 10 November 2016, Tata Sons called EGMs at six listed companies in order to remove Mistry as their chairman. But it was a second resolution in the EGM notices that more seriously called into question the governance practices at Tata companies. This sought to remove a long-serving independent director, Nusli Wadia, from the boards of Tata Chemicals, Tata Motors and Tata Steel. His crime? He had allegedly been "acting in concert" with Mistry and seeking to "cause harm" to the group.

Mistry and Wadia take legal action against Tata Sons

Tata Sons succeeded in removing both men and changed course by installing a long-serving Tata man, Natarajan Chandrasekaran, as chairman of Tata Sons. Mistry and Wadia have both taken legal action. Mistry is currently waiting on the National Company Law Appellate Tribunal to hear his case, while Wadia has hit the group with a US$439.6m defamation suit, which will likely take years to proceed through the Indian court system. What became apparent from this episode was just how convoluted the Tata Group ownership structure actually is—something not fully understood before. It also highlighted the limited recourse that minority shareholders have when a corporate feud of this nature blows up.

Infosys co-founder, Narayana Murthy, lambasted the company for CG lapses in 2017

With the market still reeling from the Tata debacle, Infosys entered the news in February 2017 when its co-founder, Narayana Murthy, publicly lambasted the company for lapses in corporate governance. By August 2017, Infosys CEO, Vishal Sikka, had resigned, and the board released a six-page letter blaming Murthy for the resignation. At the time, the company lost more than Rs300 billion in market value. Oddly, Infosys saw fit to pronounce a little while later that activist shareholders were a risk factor (*see Investors section below*).

PNB has been victim to the largest bank fraud in Indian history

The worst was yet to come, however. Punjab National Bank (PNB), the second largest state-run lender, helped bring in 2018 by announcing in late January that it had been the victim of the largest bank fraud in Indian history, worth more than US$2 billion. The embezzlement had been going on since 2008, yet the perpetrators, jewellers Nirav Modi and his uncle Mehul Choksi and their families, managed to flee India just days before the authorities were informed of the scam. Former CEO of PNB, Usha Ananthasubramanian, and two other executives

directors of the bank have been charged by the Central Bureau of Investigation (CBI), while the Indian government has formally asked the UK to extradite Modi, who is seeking political asylum in Britain.

ICICI Bank was forced to defend its CEO against allegations of conflict of interest

Before the market could catch its collective breath, ICICI Bank, the second largest private-sector bank in India, was forced to defend its CEO and MD, Chanda Kochhar, against a whistle-blower accusation citing conflict of interest on a Rs32 billion loan to the Videocon Group, a deal that allegedly benefitted her husband, Deepak Kochhar, as well. The board at first stood by Kochhar, refusing to initiate an independent inquiry into the allegations, but eventually succumbed after a second round of charges came to light. Kochhar went on leave in June at the beginning of the investigation, while the bank appointed Sandeep Bakhshi as an executive director and COO of the bank. But on 4 October 2018, and before the investigation concluded, Kochhar resigned. One depressing aspect of this fiasco was that transparency did not appear to be high on ICICI's list, since the media reported everything before the bank did, which then forced the two exchanges to chase the bank to verify the "rumours".

Latest debacle involves unlisted IL&FS that amassed US$12 billion in debts it cannot repay

Meanwhile, the latest debacle involves Infrastructure Leasing & Financial Services (IL&FS), an unlisted company that has amassed debts worth more than US$12 billion that it cannot repay. IL&FS is a quasi-government body and a non-bank financial company (NBFC) regulated by the RBI. Things started going sideways when two subsidiaries defaulted on payments to lenders from July to September 2018, which had a domino effect on other IL&FS subsidiaries. The listed ones told the stock exchanges that they were defaulting on payments. By September, the nightmare was in full swing as rating agencies downgraded the rating status of IL&FS and its subsidiaries, and mutual funds with high exposure to the IL&FS group and its subsidiaries suddenly saw their net asset value plunging.

The government was eventually forced to step in on 1 October 2018 and take control of the company, firing most of the old board and installing a new one with six of their nominees. The new board reported that the situation could be far worse, as the company had far more subsidiaries than initially known, and therefore the debt on the books could be higher than US$12 billion. The Serious Fraud Investigation Office has also begun investigating amidst reports that management spent lavishly on themselves. The case raises numerous questions, not least what was RBI doing? Why did the major shareholders, including the Life Insurance Corporation of India with 25%, Orix Corporation of Japan with 23% and the Abu Dhabi Investment Authority with 12%, which all had shareholder directors on the board, not get an inkling of the problem? And to what extent were the auditors aware of the underlying problems? In 2017 the auditor was Deloitte, while this year it has been SRBC & Co.

The IL&FS scam was also the start of open warfare between RBI and the government: deputy RBI governor, Viral Acharya, gave a speech on 26 October 2018 titled, "On the Importance of Independent Regulatory Institutions – The Case of the Central Bank". This was reportedly in response to the government trying to strongarm RBI into following its directions.

The centre, worried about the liquidity crunch facing NBFCs, asked the banking regulator to open a special liquidity window for them. The regulator refused, but tension has been continually rising between the two parties as the government

tries to strongarm the central bank. Indeed, it is threatening to invoke Section 7 of the RBI Act, which would allow the government to issue orders to the central bank that the latter would have to follow. No government has ever invoked this section in 83 years of RBI's existence. But this is not the first time RBI and this government have tussled: Rajan resigned in 2016 following attacks on him by a BJP member of parliament.

The government is reported to have sent three letters under Section 7(1) to the RBI governor, looking for consultation on three specific issues:

- A 12 February 2018 circular that tightened norms for bad loan resolution: RBI told banks to set timelines for resolving large NPAs, failing which banks would have to mandatorily refer them to insolvency court. The government wants RBI to exempt power companies.
- The government would like the governor's views on using RBI's capital reserves to help fund its fiscal deficit; and
- Withdrawal of the PCA framework on 11 banks constraining them from lending to SMEs.

It has also been reported that Patel has threatened to resign. However, a compromise was reached on 2 November 2018, when RBI opened a special liquidity window for NBFCs.

Aashish Agarwal
Head of Research - India
aashish.agarwal@clsa.com
+91 22 6650 5075

Prakhar Sharma
prakhar.sharma@clsa.com
+91 22 6650 5058

Divergence between boards and regulator widening
This year's most important development was the divergence in opinions between companies' board of directors and the central bank/other regulators, especially regarding CEO reappointments. Last year, the boards of Axis Bank and Yes Bank approved the reappointment of CEOs for three years, but the RBI disagreed and requested new appointments within four months to a year. The disagreement is understood to be on the lines of either weaker asset quality & disclosures or the need to split the position between bank promoter and CEO.

Even in case of ICICI Bank, the board initially stated that there were no lapses on the part of the erstwhile CEO, but due to pressure from regulators/whistle-blowers, it pushed them to initiate an independent inquiry. In Kotak Bank's case, the board of directors had approved the offering of preference shares to dilute equity stake of promoters in the company from 30% to under 20%, but the RBI rejected these plans (currently the banm and RBI are still in discussion).

Recently the RBI took a hard stance against Bandhan Bank's delay in diluting promoters' shareholding from above 80% to 40% within the set time limit of three years and restricted it from opening branches unless approved by RBI. It also capped the salary hike for the MD-CEO.

In our view, the increasing engagement of regulators, as well as divergence in opinions, will push boards to look at matters more deeply and make independent decisions - all of which should benefit investors and shareholders.

Regulators became more assertive and were seen to differ with banks on several key decisions during the year

Bank	Issue	Board decision	Regulator decision	Current status
AXIS BANK	Re-appointment of Ms. Shikha Sharma as MD & CEO	3 year extension recommended from Jun 18	RBI asked Board to reconsider its decision	Mrs. Sharma asked term to be shortened till Dec18
ICICI Bank	Allegations of conflict of interest against Ms. Chanda Kochhar (MD & CEO)	Board stated that there were no lapses in disclosures/ governance	Sebi served show-cause notice to ICICI on probe into alleged lapses	Ms. Kochhar on indefinite leave pending finalization of probe; RBI, Sebi are yet to conclude probe.
YES BANK	Re-appointment of Mr. Rana Kapoor as MD & CEO	3 year extension recommended from Sep 18	RBI limited extension to Jan 19	Board to search for successor and seek 3-6m further extension for Mr. Kapoor
kotak Kotak Mahindra Bank	Issue of preference share to dilute promoter stake from 30% to sub-20%	Permitted the bank to offer preference shares	RBI declined permission for issue of preference shares to dilute equity stake	Board is in discussion with RBI. It believes this is in line relevant laws that focus on 'paid-up' capital
Bandhan Bank	Delay in diluting promoter shareholding from 82% to 40% within 3 years of grant of license	Delay in compyng with regulation	Branch opening restricted (only based on approval from RBI) and no hike in CEO salary	Bank in discussion with RBI and may dilute holding through M&A/ capital raise- but can take time

Source: News, BSE, CLSA

Mahesh Nandurkar
Executive Director
mahesh.nandurkar@clsa.com
+91 22 6650 5079

On-the-run promoters

In February 2018, Punjab National Bank (PNB) disclosed that it had discovered US$1.8bn worth of fraudulent transactions at a branch in Mumbai. This was being done in favour of a leading diamond merchant Nirav Modi and another firm called Gitanjali Gems with complicity of some bank officials. There were operational lapses at the bank's end as unauthorised letters of undertakings were being used by these firms to borrow money from foreign branches of Indian banks which were guaranteed by PNB.

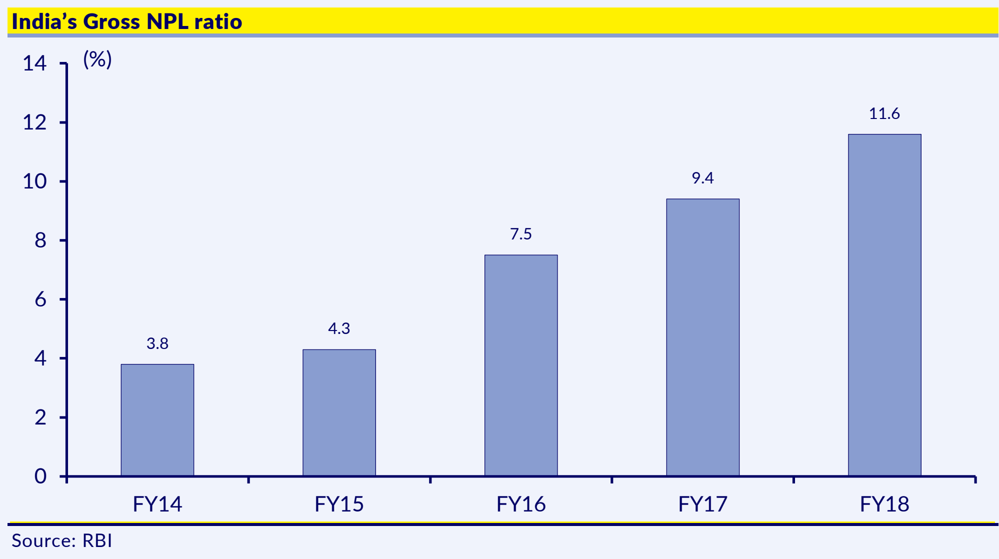
The fraudulent transactions had been going on for seven years but were never caught. By the time the fraud was uncovered by the bank, the promoters of the two companies (who are related to each other) and their family members had already fled India. Mehul Choksi (the promoter of Gitanjai Gems) has since taken Antigua citizenship and India is now working with the Antiguan government to extradite him to India. Media reports suggest that Nirav Modi is trying to get political asylum in Britain. He has been declared wanted by Interpol and his properties in India and abroad have been seized.

This has created lot of political noise in India as another promoter Vijay Mallya, who defaulted on more than US$1.5bn of loans taken by now defunct Kingfisher Airlines, fled from India to London in March 2016. He has been accused of several frauds and siphoning off money from the entity to which the banks lent. There were also personal guarantees on some parts of the loans. Extradition of Mallya is still ongoing and the UK Westminster Magistrates' Court has reserved its decision on his extradition to India for December 10.

After these developments, the Indian government passed the Fugitive Economic Offenders Bill in July 2018, which will help the government confiscate properties of economic fugitives with offences exceeding Rs1bn among other provisions. This comes after the parliament legislated the Insolvency and Bankruptcy Code in 2016 which has created an orderly mechanism for corporate NPA resolution.

RBI mandated recognition norms has led to higher NPL recognition in India

India's Gross NPL ratio



Source: RBI

5. Investors

India ranks 4th with a score of 36%

While India ranks well in this category, its score of 36% highlights the poor performance of most markets in this category. We acknowledged in 2016 that institutional investors in India had become more involved in CG issues, while even retail investors were starting to question companies. In 2017, InGovern, a proxy advisor, published its *India Proxy Season 2017* and called that year "the tipping point of shareholder activism in India", with an "unprecedented" number of cases where shareholders opposed boards and management.

Institutional voting and litigation

Mutual/pension funds and insurers have to disclose their votes at investee companies

Mutual and pension funds in India have been the easiest institutional investors to track in terms of their involvement in CG, because the former have been required to disclose their votes by Sebi since 2011 and the latter by PFRDA since 2015. As of September 2017, insurers joined that pool following IRDA's requirement that they have a stewardship policy and disclose their votes. All this has led to a more active institutional investor base in the market. According to Institutional Investor Advisory Services (IiAS), a proxy advisory firm, abstention votes among mutual funds and pension funds have dropped significantly from 24% in fiscal 2014 to 11% in fiscal 2017, while foreign institutional investors (FII) continue to make a difference with "top FIIs exercising their full franchisee in all their investee companies".

Proxy advisors have pushed institutional investors to be more active

According to InGovern, 45 companies out of the top 100 saw “at least one AGM proposal that got more than 20% dissenting votes either by institutional or non-institutional shareholders and, in one case, by the promoters of the company”. But it would also be fair to say that most domestic investors would not be as engaged as they are were it not for these local proxy advisors.

Foreign institutional investors succeeded in removing board members at Fortis Healthcare

Another watershed moment came in 2018 as two foreign institutional investors, Jupiter Management and Eastbridge Group, asked for an EGM at Fortis Healthcare, a publicly listed group facing funding and legal issues, to remove the current four board members - Dr Brian Tempest, Harpal Singh, Savina Vaisoha and Lt Gen Tejinder Singh Shergill - and put forward three names for appointment as independent directors - Suvalaxmi Chakraborty, Ravi Rajagopal and Indrajit Banerjee. In late May, they succeeded in their bid.

Two funds approach NCLT to stop Religare Enterprises investing in a subsidiary

The other reason for seeing 2017 as a tipping point was the arrival of shareholder litigation. Two funds, India Horizon Fund and IDBI Trusteeship, approached the National Company Law Tribunal (NCLT) to obtain a stay order on a proposed investment by Religare Enterprises in its subsidiary, Religare Capital Markets. The tribunal did not approve the stay order. India Horizon Fund also petitioned NCLT to remove the entire board of Religare Enterprises for irrational and fraudulent management of funds, and while the tribunal refused interim relief, it is still pending adjudication before NCLT.

Companies Act makes it easy for minority shareholders to approach NCLT

The Companies Act 2013 allows minority shareholders to approach the tribunal because of “oppression or mismanagement” by the promoters or the directors or board of a company. To do so, minority shareholders need only:

- Be 100 shareholders or one-tenth the total number of shareholders, whichever is lesser: or
- Have a stake of at least 10% in a company.

It might, however, get harder to launch litigation because the tribunals are having to deal with a rising number of cases under the new insolvency law.

Retail gets into the fight

Growing retail participation in the stock market through mutual funds

It is harder to track retail investors and their activities, but according to data from the NSE, there is growing retail participation in the stock market through mutual funds, while individual investors are also learning to flex their voices in the marketplace. Last year, for example, retail shareholders joined their institutional cousins in chalking up a win at Raymond, a diversified group with majority business interests in textile and apparel sectors. Raymond had proposed to sell one of its prime properties to its chairman and some of his relatives at a price lower than 10% of its market value. The resolution failed when 99.61% of institutional investors and 92.35% of non-institutional investors voted against the proposal.

Small shareholders look for a seat at the table

Small shareholders also looked for a seat on the board at Alembic, where a group of 1,000+ retail investors under a portfolio manager, Unifi Capital, wanted to appoint Murali Rajagopalachari as a small shareholder director. The proposal was the first of its kind in India. Alembic rejected the proposal, claiming conflict of interest because Rajagopalachari was a director in various Unifi group entities and 914 of the shareholders who made the proposal were clients of Unifi. But the company’s final excuse for rejecting the proposal was that 320 people had only

become shareholders in the five days prior to making the request, which it claimed showed that Unifi Capital had used these people to ensure its nominee got on the board by "clearly misusing the provisions of Section 151".

A small investor with just 10 shares takes on Reliance Communications

It was, however, the petition by Shailesh Mehta to prevent the merger between Systema Shyam and Reliance Communications that marked the high point in retail activism in recent years. Mehta only held 10 shares in Reliance Communications, but because the merger was opaque and Mehta thought it would impact shareholder interests so he filed a petition in 2016. The reaction of Reliance's Chairman, Anil Ambani, at the 2017 AGM was telling: Mehta told newspapers that he had to barge into the meeting and struggled to get to the podium to speak. Once there, Ambani told Mehta he was not welcome and tried to shut him down. Ambani also told all the shareholders that Mehta had cost banks and other shareholders by challenging the merger. For his part, Mehta no longer invests in the stock market, stating his belief that companies do not care about their investors and whatever protections there are for minority investors, there is no effective mechanism for implementing them.

While Ambani's behaviour may have been expected, the 2017 20-F filing by Infosys with the US Securities and Exchange Commission was not: it claimed that activist shareholders were a risk factor. This was shocking because Infosys has always positioned itself as a vanguard of corporate governance. It stated that "actions of activist shareholders may adversely affect our ability to execute our strategic priorities, and could impact the trading value of our securities". It was not clear who Infosys was referring to, but in early 2017, the company had been publicly criticised by its co-founder Narayana Murthy for its corporate governance standards.

6. Auditors & audit regulators

India ranks last with a score of 39%

There are numerous reasons why India performs poorly in this section, ranking last with a score of just 39%. Some are the same as in previous years and relate to accounting standards and the slow adoption of an independent audit regulator. Some issues are new. On balance, accounting and auditing reform is a case of two steps forward, three back.

On accounting standards, the government continues to drag its feet on the implementation of IndAS, the Indian accounting standards that are intended to converge with IFRS. While non-financial listed companies began adopting the standards between April 2016 and April 2017, a process that is complete, exemptions were given to insurance companies, banks and non-bank financial companies. Although IRDA and RBI announced they would begin adopting the standards as of 1 April 2018, both regulators have said that their sectors are not yet ready to adopt them. Non-bank financial companies were told to start adopting the standards from 1 April 2018, while banks can defer adoption for a year and insurance companies until 2020. A concern is that new issues will crop up between now and then, leading to further delay. It is worth remembering that it has been seven years since the government announced convergence. So far 41 Ind-AS have been notified as of 1 April 2017.

ICAI finds itself on the back foot

As for audit regulation, the Institute of Chartered Accountants of India (ICAI) has found itself on the back foot over the past two years as more companies have had their audits questioned, financial regulators are imposing tougher rules on auditors, and even the prime minister admonished the Institute for being a poor regulator. Enforcement has never been ICAI's forte.

RBI introduces framework to take action against statutory auditors in cases of lapse

All of this has led to a number of interesting developments in 2018. Sebi is looking to regulate fiduciaries, including auditors and valuers (*see CG Rules above*). The RBI issued a framework earlier this year that aims to take action against statutory auditors of commercial banks in cases of lapse. And the government finally announced the establishment of the National Financial Reporting Authority (NFRA).

An independent audit regulator?

Modi chastises ICAI publicly for lacking teeth; a year later MCA announces the NFRA, an independent audit regulator

For a brief moment in time, it seemed as if the government realised that India needed a a truly independent audit regulator. On 1 July 2017, Modi chastised ICAI in public and said that it lacked regulatory teeth. He expressed the view that some chartered accountants (CAs) helped companies and individuals launder money and evade taxes. He also questioned why only 25 CAs had been prosecuted in the past 11 years, noting that more than 1,400 cases were still pending. Then the PNB scam broke at the tail-end of January 2018 and MCA announced the establishment of the NFRA in March 2018.

NFRA's independence has been compromised from the start

But it was a brief fling with independence as the government announced that besides the chairman and three full-time members, there would be nine part-time members, three of whom would be the president of ICAI, the chairperson of the Accounting Standards Board, ICAI, and the chairperson of the Auditing and Assurance Standard Board, ICAI. While the full-time members need to declare that they have "no conflict of interest or lack of independence" in their appointment, the part-time members don't need to do so.

RBI takes up the cudgels

Financial regulators need to supervise auditors working in their sectors

So it is left to other regulators to supervise auditors working in their space, and RBI took up the challenge in June 2018 by announcing new procedures to address poor auditing at commercial banks. Things finally came to a head in the banking sector when the regulator found massive discrepancies between assessments of non-performing loans by RBI inspectors and those carried out by the auditors of both private- and public-sector banks.

RBI can refuse approval for auditors working for banks

Under the new rules, if RBI is dissatisfied with an auditor's quality of work or conduct, it can decide not to approve their appointments for commercial bank audits for a specified period of time. The regulator can also withhold approval from auditors who have been debarred by other regulators and law-enforcement agencies, and can debar firms that have cases pending against them with other agencies involving public interest.

Satyam saga finally ends

Sebi took 9 years to pass judgement on Satyam

It has taken nine years, but Sebi finally passed judgement on PwC and its two audit partners in connection to the Satyam embezzlement in 2009. Ramalinga Raju, founder of Satyam Computer, admitted on 7 January 2009 to embezzling almost Rs142 billion from the company. The government took over the company and appointed nominee directors to the board, as well as a new CEO and special advisors. Eventually the company was acquired by Tech Mahindra in an auction in 2009 and the two firms merged in 2013.

PWC cannot audit listed firms for two years

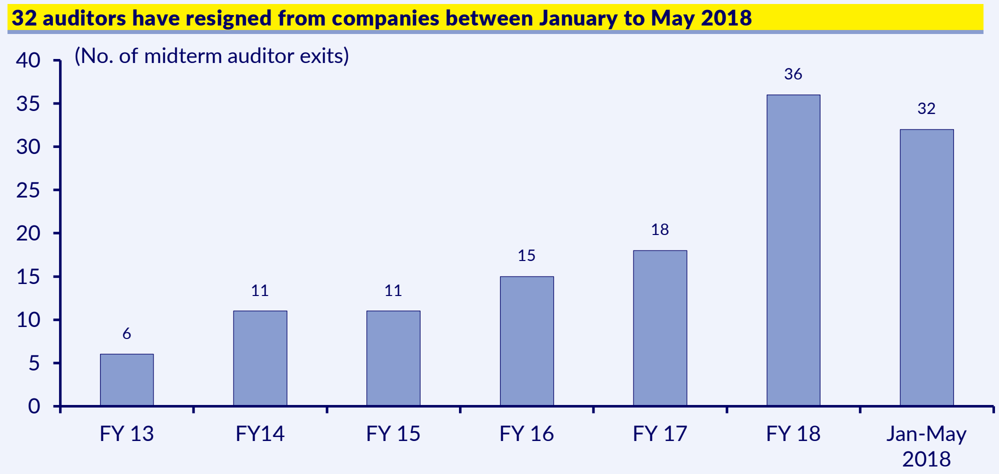
Price Waterhouse, the Indian arm of PWC, was the auditor on record for Satyam. It was fined US$6m in 2011 for "repeatedly conducting deficient audits of the company's financial statements and enabling a massive accounting fraud to go undetected for several years". In January 2018, Sebi took the unprecedented step of banning PwC from audits of listed firms for two years. The regulator also ordered the company and the two audit partners who worked on the Satyam account to pay Rs130.9m with 12% interest from 7 January 2009.

Chirag Shah
chirag.shah@clsa.com
+91 22 6650 5055

Auditor exits under the microscope

Since the beginning of the year, auditors of more than 30 firms have resigned citing reasons such as inadequate information shared. The resignations have been led by the fear of being blamed for any resulting poor corporate governance standards. The Ministry of Corporate Affairs has begun investigation into these resignations and wants audit firms to disclose the reasons for resignations.

32 auditors have resigned from companies between January to May 2018



Source: Media articles, CLSA

PwC was banned from auditing Indian listed companies for two years by Sebi

Earlier this year, the Sebi announced that it banned PwC from auditing listed companies for two years after finding systemic problems in its auditing process in regards to Satyam Computer Services, which was involved in a US$1bn accounting fraud in 2009. Auditors are now more cautious, announcing exits wherever they are not satisfied with the disclosures by their client companies. They are also resigning due to fears around the new regulatory body, National Financial Reporting Authority (NFRA), which will have investigative and punitive powers with wide powers to enforce compliance of accounting standards. NFRA will have the ability to investigate, either suo motu or on a reference made to it by the central government, the matters of professional or other misconduct committed by any accounting firm.

Auditor resignations from some of the notable companies

Auditor	Company
Price Waterhouse & Co	Vakrangee
Price Waterhouse & Co	Atlanta Ltd
Price Waterhouse & Co	Edelweiss Financial Services
Deloitte Haskins & Sells	Manpasand Beverages
Sai Kanwar and Associates	Fourth Dimension Solutions
MR Ravindra Sharma & Associates	Hanung Toys
Patankar & Associates	Inox Wind
Mehrotra and Mehrotra	Bhushan Steel
M/s Ramanand and Associates Chartered Accounts	Pratibha Industries
M/S K.M. Garg &Co, Chartered Accountants	Raj Rayon Industries
K.R. & Co, Chartered Accountants	Winsome Yarns
M/s. Pravin Chandak & Associates	Sri Adhikari Brothers TV Network
VDSR & Co, Chartered Accountants.	Surana Industries

Source: Media articles, CLSA

Government is monitoring the issue

The central government plans to revise auditing standards, given that current regulations permit auditors to resign 'in the event of non-cooperation' which allows for vague and sweeping reasons.

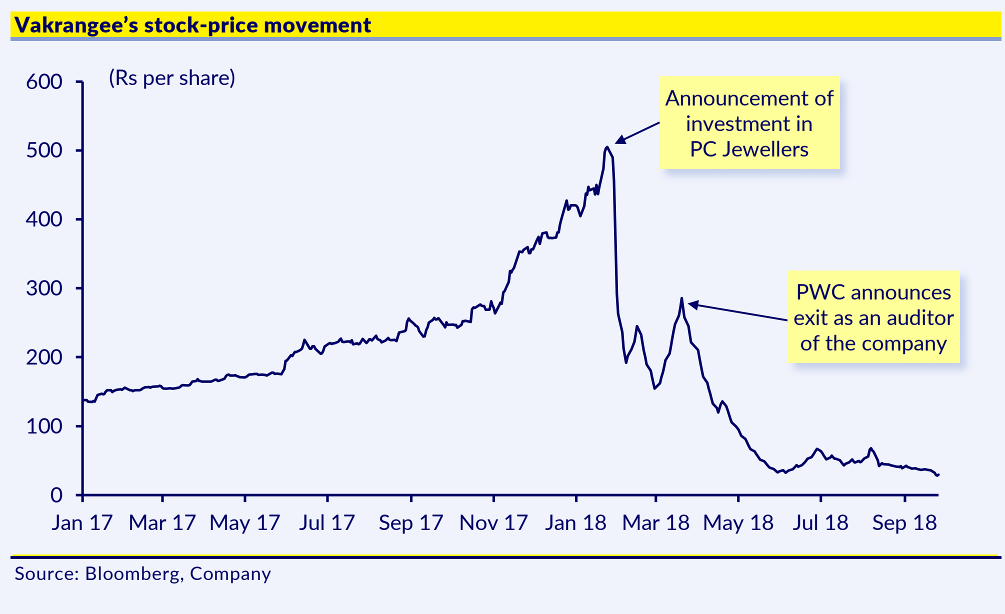
Mahesh Nandurkar
Executive Director
mahesh.nandurkar@clsa.com
+91 22 6650 5079

Vakrangee muddled in corporate-governance issues

Vakrangee, a financial-inclusion company with a market cap of over US$8bn at the start of 2018, declared on 25 January that it had bought 2m shares of PC Jewellers as an investment. Following the announcement Vakrangee saw its stock price fall, while it stated that the transaction was done in line with its internal treasury policy. It also maintained that no further such investments would be made in the future, but there was no clarity on whether it would sell its PC Jewellers shareholding. At the same time, the jewellery company's stock price declined sharply, which we believe was prompted by market fears of a possible business relationship between the two firms. There were also news reports that Vakrangee was being investigated by Sebi for possible stock-price manipulation.

By April 2018, there were reports that not all of Vakrangee's 40,000 centres were operational and investors raised concerns over the company's revenue-recognition practices, which were based on GMV. Soon thereafter, PwC announced its exit from Vakrangee as an auditor, stating that its responses to information requests were either inadequate or had contradicted earlier statements. Vakrangee subsequently announced a share-buyback plan, but later rescinded its statement. The Ministry of Corporate Affairs recently ordered an investigation into Vakrangee's accounting books.

Vakrangee's stock-price movement



Source: Bloomberg, Company

7. Civil society & media

India ranks 2nd with a score of 71%

India did well in this section: media, professional associations, business chambers, academics and civil society organisations are all invested and interested in ensuring corporates become better responsible citizens. Both the Federation of Indian Chambers of Commerce and Industry (FICCI) and the Confederation of Indian Industry (CII) have centres of corporate governance and hold seminars for their members throughout the country. Professional associations, such as the Institute of Company Secretaries of India (ICSI) and the Chartered Financial Analysts (CFA) Institute, are also active participants in the corporate governance space, being involved in policy debates and consultations.

Media has proved to be a great leveller

Media proved to be the great leveller: Reuters did the investigation that made Sebi look into potential insider trading through WhatsApp. The media also told the market, and sometimes ICICI Bank itself, what was happening in the bank, leading to investigations by the exchanges.

Making business better

Responsible Business Index analyses the responsibility reports of top 100 BSE companies

What has emerged is the interest civil society is showing in keeping corporates accountable, especially when it comes to sustainability. A collaboration between a number of civil society organisations began the India Responsible Business Index, which analyses the business responsibility reports of the top 100 companies listed on the BSE on inclusive policies.

Businesses have higher disclosure in areas that are legally mandated, defeating spirit of voluntary disclosure

Started in 2015, it analyses disclosure on five parameters of social inclusion: non-discrimination in the workplace, respecting employee dignity and human rights, community development, inclusiveness supply chain and community as business stakeholders. According to the latest report, there has been "very little perceptible change" in how and what businesses are disclosing: banks continued to fail to report on supply chain and "higher disclosure are only in areas that are legally mandated, defeating the spirit of voluntary disclosure". It further damned businesses and regulators alike by stating "there is seemingly little effort from Businesses, the Ministry, Sebi or the government to make a difference".

A different perspective

Chambers and professional associations active proponents of good governance

The chambers and professional associations have long been active proponents of good governance, and both FICCI and CII, along with ICSI and ICAI, were members of the Kotak Committee on Corporate Governance. While ICAI is seen as an impediment to the setting up of an independent audit regulator, ICSI and the chambers have worked with their members on governance issues for a number of years. Both chambers provide training programmes for women interested in being board directors.

Initiative to support organisations fight corruption and fraud

CII is also a founding member of the CII-ITC Centre of Excellence for Sustainable Development, which has a number of initiatives and programmes on issues of climate change, sustainability reporting and better business practices. One of its initiatives, started in 2015 and lasting for 48 months, is the Siemens Integrity Initiative – India. The initiative supports organisations fighting corruption and fraud and aims to help "large companies in major Indian cities to adopt responsible business practices" while influencing their supply chain and raising awareness amongst local stakeholders and government agencies, which would eventually lead to reduced corruption in businesses.

Recap and recommendations

Recap of CG Watch 2016

Market report card

To what extent has India responded to our recommendations from 2016?

Figure 2

India: recap of 2016

Recommendations	Outcomes
1. Publish cashflow statements and balance sheet with quarterly reports.	Sebi has mandated cashflow statements for half-yearly reports.
2. Improve enforcement disclosure on regulatory websites.	No change.
3. Ensure PSUs comply with Listing Regulations.	No change.
4. Release AGM notices 28 days before date of meeting.	No change.
5. Address loopholes in RPT regime.	Enhanced disclosure of RPTs; related parties allowed to vote against RPTs (Kotak Committee recommendation).
6. Establish the National Financial Reporting Authority (NFRA).	NFRA established, but its independence is in doubt.

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the markets score to fall in 2020:

- No progress in fixing the non-performing assets of banks!
- Government erodes independence of the NFRA even more
- Board committee reports do not evolve, continue to be mostly boilerplate
- No improvement in large-cap websites

What to fix

Quick fix list

Issues to address as soon as possible:

- Appoint an Ombudsman or Lokpal - it has been five years since the enabling law was passed by parliament
- Improve enforcement disclosure on regulatory websites and annual reports
- Ensure public-sector units (state enterprises) comply with all CG rules
- Release AGM notices 28 days before date of meeting

Christopher Leahy
Specialist Consultant, ACGA
chris@acga-asia.org

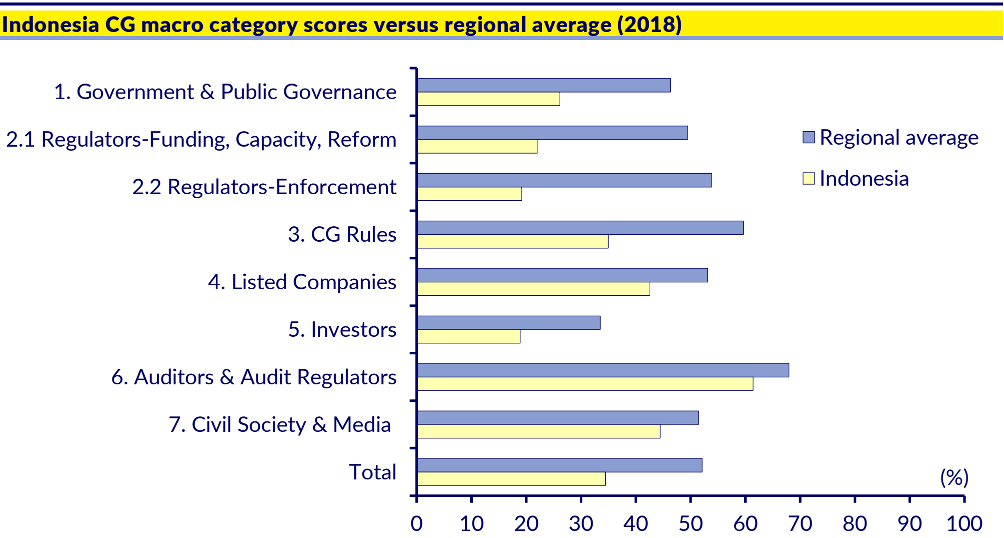
Indonesia - Time for systemic reform

- CG reform remains a low political priority - new impetus is needed
- The securities regulator is fighting a lonely CG battle promoting reforms . . .
- . . . with the stock exchange seemingly disinterested in CG
- Some good parts: company disclosure has (reluctantly) improved . . .
- . . . and financial disclosure is also good . . .
- . . . but some areas are awful: insider trading remains rife with no enforcement . . .
- . . . and weak related-party transaction rules are too easily abused by insiders

Indonesia ranks 12th with a score of 34%

Figure 1

Indonesia CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

Understandably, CG just isn't on the political agenda

It is hard to escape the feeling that, as far as Indonesian corporate governance goes, the government of President Joko Widodo has bigger problems on its plate. And frankly, it is difficult to disagree. A sprawling archipelago of some 17,000 islands with multiple points of cultural and ethnic tension, and a natural resource curse to boot, it is a wonder that the country remains a functioning democracy. Rampant corruption, racism and religious intolerance remain probably the biggest challenges the country faces. More recently a series of natural disasters and a currency that has halved in value are providing additional challenges for the government. Little wonder therefore that, despite valiant efforts from a few constituencies, Indonesia remains a CG laggard.

Reform largely the work of the OJK and few others . . . IDX still isn't one of them

Much of the credit for the CG reform that has occurred over the last six years or so must go to the Otoritas Jasa Keuangan (OJK), Indonesia's capital markets regulator, which has led the CG agenda and been supported by various constituencies, notably the Indonesian Institute for Corporate Directorship (IICD) and the International Finance Corporation (IFC). Curiously, the Indonesia Stock Exchange (IDX) has been absent from these reforms: we failed to identify a single initiative, guideline or regulation introduced by IDX in the last two years and inquiries to that effect in Indonesia were met by embarrassed nods.

Indonesia's CG contradictions

Indonesia is a real contradiction in CG. There is a genuine desire on the part of certain interested constituencies to improve standards - the OJK's 2014 CG Roadmap was a serious attempt to set out a CG reform agenda. In January 2014 the OJK and IFC also jointly-issued Indonesia's first CG manual, then in 2015 the OJK followed up with the Corporate Governance Guidelines for Public Companies, moving to a 'comply or explain' regime to improve company disclosure. Some of the new OJK rule changes, such as forcing reluctant shareholders to disclose ultimate beneficial ownership, represent the serious side of Indonesia's attempt to develop its stock market.

But insider trading is rampant and goes unpunished

However, Indonesia's capital market still lags best practice by a considerable margin. Insider trading remains a huge problem - not surprising perhaps when you have no "blackout" rules (ie, closed periods for director trading) and enforcement against insiders is largely non-existent. Minority shareholders still face a rough ride in Indonesia, with protections on pre-emption, related-party transactions and takeovers all in need of strengthening. To improve materially from here, Indonesia needs to get serious about enforcement: by prosecuting insiders, naming and shaming errant companies, and cracking down on market manipulation.

Enforcement is the key . . . and the KPK is the model

The signs are that the latter action is starting: both OJK and IDX have taken some enforcement measures against securities firms. But sanctions are limited, with fines and licence suspension/revocations their most potent weapons. Prosecution of insider traders currently requires OJK to go through the courts, a process so fraught with complications as to be impractical. Yet prosecutorial success against criminals is possible: just look at the success of Indonesia's anti-corruption commission, the KPK, which has the right to prosecute its own cases. Vest such powers in the OJK for exceptional cases and insider trading will immediately become a far more precarious activity.

1. Government & public governance

Indonesia ranks 11th with a score of 26%

Indonesian corporate governance seems to exist in spite of the government rather than because of it. The key proponent for governance reform in the last five years and more has been the Otoritas Jasa Keuangan (OJK), Indonesia's super regulator that oversees banks, investment banks, insurance companies, securities firms and just about anything else connected with the capital markets. It was the OJK that produced the 2014 CG Roadmap that promised much and delivered some. OJK also co-authored Indonesia's first CG manual (with the IFC) in 2014 and issued its Corporate Governance Guidelines for Public Companies in November 2015. It is fair to say that had government support been stronger for the OJK, CG reform would have been accelerated.

Useful new guidelines for listed companies

The Indonesian Corporate Governance Manual aimed to set out and encourage best practices in CG, although it was basic and focused on OECD principles. Far more significant was the November 2015 OJK publication of Corporate Governance Guidelines for Public Companies, which forced listed companies to make significant improvements in disclosure or to explain why they would not. An extensive and well-drafted document, it supersedes an earlier CG Code from 2006.

A 2017 master plan contained no direct mention of CG

In October 2017, OJK issued its 10 Master Policies for 2017-2022, strategic goals aimed at transforming the agency into a more independent and credible supervisory agency that can help grow the country's capital markets. Notably, the policies make no direct mention of CG, but instead focus on improving supervision of financial services and undertaking reform of the financial sector, principally to increase capacity and liquidity. The policies do not mention any plans to overhaul the corporate or the securities codes and the only mention of enforcement is in relation to cracking down on scams and Ponzi schemes. This seems like an opportunity wasted.

OJK became fully self-funded in 2016

A more positive development is that the OJK is now fully self-funded, allowing it to operate independently of government budget constraints. That said, OJK non-executive commissioners, who are appointed by parliament, remain close to political circles, with senior civil servants and academics comprising the majority of members. Other commissioners include the OJK's key executives, such as the chief executives of banking supervision, capital market supervision, and insurance and pensions, as well as the head of audit and risk management. The OJK Board of Commissioners also includes an ex-officio member from Bank Indonesia and the Ministry of Finance.

OJK wears many regulatory hats

In addition to regulating the capital markets, the OJK also regulates the country's domestic banks, insurance companies and other financial institutions. As a bank regulator, it is regarded as effective, particularly with respect to the country's largest banking groups. It has also been active in pushing governance reform in the banking sector, tightening rules on audit, risk management and certain aspects of disclosure and transparency, in addition to the more traditional functions of bank regulation, such as capital adequacy and liquidity.

OJK has started to crack down on errant securities and insurance companies

The agency has been actively overseeing the securities and insurance markets, particularly on the enforcement side, issuing a large number of fines, suspensions and in some cases, withdrawal of licences for erring firms. Of course, more could always be done, but the OJK's supervision of securities and insurance companies provides some deterrent and offers optimism for more effective enforcement against errant listed companies in due course.

Minority shareholder rights are still weak

Shareholder legal rights in Indonesia are, in practice and compared to other markets, limited in some key respects. Under Indonesian law, minority shareholders representing at least 10% of total voting shares can launch a derivative suit on behalf of the company against the directors or commissioners for acts that are either unlawful and/or are prejudicial to the shareholders and third parties. In practice, corralling enough minority shareholders to speak for 10% or more of a company's votes is a monumental task and effectively puts paid to any meaningful legal action taken by aggrieved minority shareholders.

State-owned enterprises need significant reform

Reform of Indonesia's creaky, inefficient and corrupt state-owned sector is a major part of President Joko Widodo's government. Progress has been slow since much-needed reforms are slow to make their way through a sceptical and in some cases, complicit parliament. Part of Jokowi's plan is to create state-owned champions in certain sectors, known as state-owned holding companies, although many are sceptical that the SOE sector should be playing such a role in a country with endemic corruption, given historical precedents. Further reform of the SOE sector is likely to be slow and difficult to achieve.

Anti-corruption successes

KPK's anti-corruption crusade continues . . .

Indonesia's anti-corruption commission, the KPK, continues its surprisingly successful fight against corruption in the public sector. In the past two years, it has successfully prosecuted several politicians, including the former speaker of the House, Setyo Novanto, Ariesman Widjaja, CEO of Podomoro Land, and most notably (and recently), Syafruddin Arsyad Temenggung, the former head of the Indonesia Bank Restructuring Agency over alleged irregularities relating to Indonesia's bank restructuring activities post the Asian Financial Crisis.

. . . and there is much to do

The KPK's success in prosecuting cases of corruption continues to increase. In 2016, the latest available data, it conducted 96 preliminary investigations, 140 investigations and 77 prosecutions and enforced 81 final and binding court decisions, all record statistics since the body was formed in 2002. Bribery was overwhelmingly the most common issue faced by the KPK, accounting for approximately 85% of all cases investigated.

Indonesia's national corruption ranking is slipping

While the KPK continues its valuable work and there is some evidence that its actions are making public officers more accountable, the endemic nature of Indonesia's corruption means that it will be many years before we see any material reduction. In Transparency International's *2017 Corruption Perceptions Index*, Indonesia ranked 101st, sandwiched between Colombia and Panama, a drop of five places from 2016.

Corruption runs deep in the legal system

Corruption within law enforcement and the courts system remain deeply ingrained and while class action is theoretically possible in Indonesia, no such action has ever been launched and there is, in practical terms, no legal recourse for shareholders against corrupt management or controlling shareholders.

Indonesia has signed up to the OECD's open governance partnership

Meanwhile, Indonesia is a signatory to the OECD's Open Governance Partnership initiative, which aims to increase accountability, integrity, transparency as well as citizen engagement in government. The OECD's October 2016 *Open Government in Indonesia* review noted the many challenges faced by the vast archipelago and the specific difficulties in implementing national goals and objectives at local and even regional levels.

Devolution of authority risks increasing local corruption

A key part of the government's strategy to achieve this is to decentralise decision making and push authority to local governments. That of course comes at the risk of higher bribery and corruption among local officials, which makes the KPK's continued progress in tackling bribery and corruption even more important. To improve public engagement with anti-corruption activities, the KPK operates an extensive whistle-blowing system to permit the public to report official wrongdoing.

Yusuf Winoto
yusuf.winoto@clsa.com
+62 21 2554 8821

Local community group in Rembang vs Semen Indonesia

State-owned cement company, Semen Indonesia, faced opposition from the local community groups of Kendeng mountains of Rembang Regency related to the construction of a cement plant in the area. They alleged that the process of submitting the mining licenses for the cement plant was not open and transparent to the community and it was feared that there would be environmental damages.

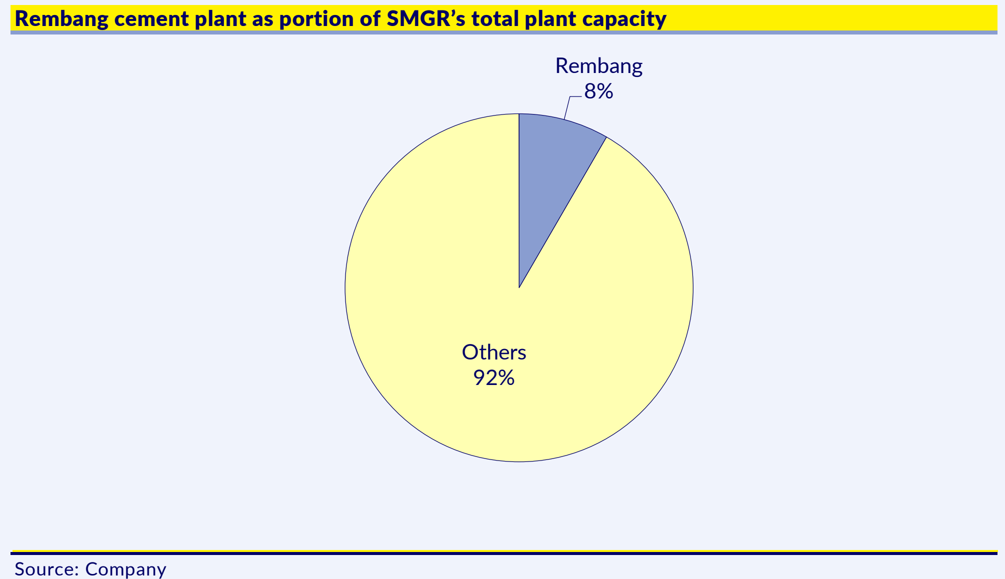
Semen Indonesia faced opposition from local community groups of the Kendeng Mountains

The main point of contention was around mining in the area in order to supply raw material to the plant, a point to which the government ultimately agreed. Rather than source locally, Semen Indonesia has opted to source materials externally and began operating in July 2017, six months behind schedule. Reliance on third parties for raw material has raised costs at the plant (the detail on cost is not available), but the company had not yet invested meaningfully in the mine and thus did not incur material write-down expenses.

Rembang plant has a total cement capacity of 3mn tonnes, or 8% of SMGR's total plant capacity, and is currently running at c.70% utilisation. The impact on our earnings forecasts from moving to external sourcing for material is minimal.

Rembang plant accounts for 8% of total SMGR's plant capacity

Rembang cement plant as portion of SMGR's total plant capacity



Source: Company

2. Regulators

Indonesia ranks 12th with an overall score of 21%

Indonesia's capital markets regulatory system looks like many others in the region, with a securities regulatory commission, the OJK, taking the lead on capital market regulation and a stock exchange, IDX, ostensibly as the frontline regulator of the listing rules. Formed from the ineffective and under-resourced Bapepam, Indonesia's original securities regulator, the OJK was merged with parts of the central bank, Bank Indonesia, that were responsible for regulatory oversight of banks and insurance companies. While the strategy to form one integrated regulator may be sound in principle, the practice in a country as difficult to govern in Indonesia is challenging.

2.1 Funding, capacity-building and regulatory reform

Indonesia ranks 12th in this sub-category with a score of 22%

Initially funded directly by government, the OJK has been fully funded via levies on banks, insurance companies and securities firms since 2016. OJK receives funding from annual fees, sanctions and fines as well as funds from management of its own levy fund. These sources all come from the banking sector, capital markets and non-banking financial industry, with the largest contributor being from capital markets practitioners and companies. This funding has enabled the OJK to hire more permanent staff - 3,656 out of a total of almost 4,000 in 2017 - whereas in prior years it relied heavily on secondees from Bank Indonesia and contract staff.

Draft regulations for financial holding companies

A major reform for the financial sector was announced in June 2017, when the OJK said it would issue new regulations requiring "financial conglomerates" to have financial holding companies. According to the OJK, the reform "marks an effort to complement and strengthen policies of integrated supervision on financial conglomerates, based on feedback from the financial services industry and results of the researches conducted on prevailing practices in several countries". It added that, "The presence of special holding companies for the financial services sector makes it possible for a financial holding company to consolidate and control all of the financial conglomerate's activities." This issue has in fact been discussed in Indonesia for several years and stems from the need to ensure that all financial service businesses run by a conglomerate are adequately capitalised and governed - otherwise a part could bring down the whole.

New accounting and auditing ROSC

In 2017, the OJK also completed an update and review of Indonesia's accounting and auditing standards under the IMF/World Bank's Reports on the Observance of Standards and Codes (ROSC) in Accounting and Auditing. The review is expected to improve evaluation of Indonesian companies by domestic and international investors.

Where has IDX been?

While the OJK has been reasonably active in its CG reform efforts over the past few years, the same cannot be said of IDX. A for-profit exchange, IDX seems to have overlooked the fact that it is the frontline regulator for listed companies. We failed to find a single CG initiative launched by IDX in the last two years and those we met during our travels in Indonesia couldn't identify any either. Requests to meet IDX staff to discuss our research went unanswered.

2.2 Enforcement

Indonesia ranks 12th in this sub-category with a weighted score of 19%

With a securities regulator that is still a little too close to government influence for our liking, and an exchange that is disinterested in CG reform, it is perhaps unsurprising that the weakest link in Indonesia's regulatory structure is enforcement. IDX has delisted just two companies since 2015 and most of its sanctions against listed companies are merely by way of written notice - little more than slap on the wrist - and limited suspensions. In almost all areas, enforcement activity by IDX appears to have reduced rather than increased in the last two years.

Enforcement started against securities firms . . . but it's a light touch

The OJK and to a lesser extent, IDX, have gone after malfeasance and skulduggery at securities firms to some extent - mainly issuing fines and suspending licences for market manipulation. But criminal action against insider trading requires referral to the Attorney General's Office and prosecution through Indonesia's creaky, corrupt and incompetent courts system.

Indonesia is yet to successfully prosecute an insider trading case

Meanwhile, despite reasonably strong financial resources, both OJK and IDX appear to lack the skilled human resources sufficient to undertake robust enforcement. Since introducing electronic market surveillance more than 20 years ago, Bapepam and now OJK have failed to successfully prosecute a single insider trading case (although they have investigated a number of cases). To make matters worse, the lack of any "blackout" rules (ie, closed periods) for director trading seems like an open invitation to insiders to trade their shares with impunity.

Merlissa Trisno
merlissa.trisno@clsa.com
+62 21 2554 8834

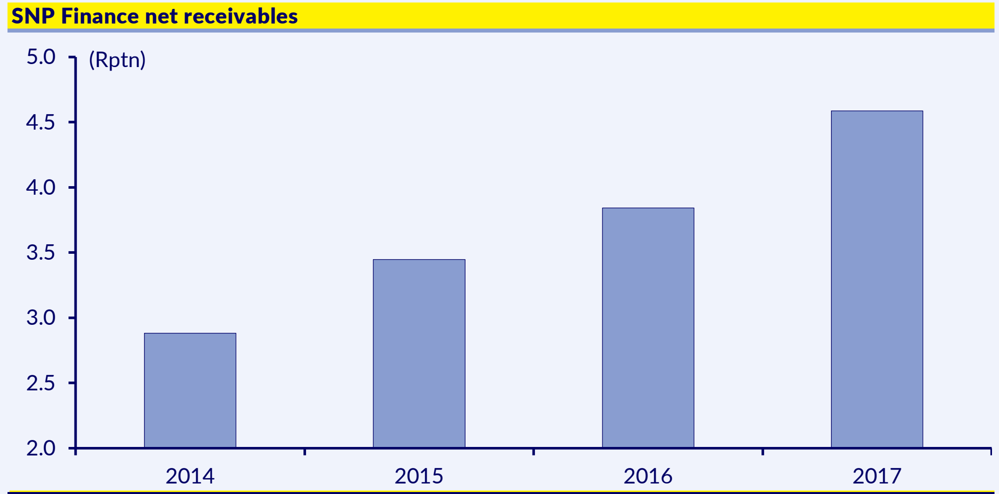
Consumer finance company suspected of Rp14tn credit fraud

Sunprima Nusantara Pembiayaan (SNP Finance) is a financial services subsidiary of the Columbia group with over 30 years' experience in trading and financing electronic goods and furniture. Previously, SNP Finance asked for debt payment suspension after the default of its interest rate payment on two series of medium-term notes (MTN) totalling Rp6.75bn. The company owed Rp1.85tn from MTNs to 336 holders.

Fourteen banks are also listed as creditors for SNP Finance (totaling Rp2.2tn), including the three big banks, including Bank Mandiri, Bank Central Asia and Bank Panin. Currently the company is being suspended from operations by the Financial Services Authority (OJK).

Manipulating of its receivables

SNP Finance net receivables



Source: Pefindo

Five executives have been named as suspects

Recently, the National Police (POLRI) stated that the company defrauded 14 banks by manipulating its receivables list which was used as security for credit applications to banks. Further, POLRI stated that SNP was added to, duplicated, and reused the receivables list so that creditors would dispense as much as they asked for according to the list. The police have arrested and named five SNP executives as suspects, including the president director, operational director, finance director, accounting manager and assistant finance manager. It is likely that they will be charged with fraud, embezzlement and money laundering.

Regulators should closely monitor this case

This ordeal is quite surprising because SNP Finance received a good rating from Indonesia's credit rating agency, Pefindo, earlier this year, indicating capacity to meet long-term financial commitments is strong. Regulators should further investigate to find the root of the problem so that similar cases do not happen again in the future.

3. CG rules

Indonesia ranks 12th with a score of 35%

Indonesia has improved its rules for corporate governance over the last four years, largely as a result of the OJK's initiatives highlighted above, namely the 2014 CG Roadmap and the 2015 Corporate Governance Guidelines for Public Companies, as well as the new company disclosure initiatives from 2017. While the disclosure-based requirements have improved company transparency somewhat, the old shibboleths of board remuneration disclosure, related-party transactions, and minority shareholder protections have not been adequately addressed.

Indonesian rules are a curious mixture of good and bad

Rules-wise, Indonesia remains a curious mix of good and bad. While ultimate beneficial owners of shareholders of 5% or more must now be disclosed, Indonesia still has no rules requiring "blackout" periods that restrict directors from trading shares ahead of results announcements or other corporate events. To police this issue, OJK relies solely on the insider trading law, which to date has proved inadequate. This area requires a major overhaul by regulators, but any attempt to do so would of course meet stiff resistance from boards and controlling shareholders.

RPT rules need a drastic overhaul . . .

Rules on related-party transactions (RPTs) remain lax and the current rule (2009) needs an overhaul. Indonesia recognises two kinds of RPT: "affiliated transactions", which just require disclosure and "conflict of interest" transactions (where a director, commissioner and/or major shareholder is a party to a transaction), which require prior independent shareholder approval. The problem is that with the latter the definition of such transactions is so narrow and the ability to obfuscate direct insider involvement is such as to provide ample opportunity for interested parties to dodge the requirements, a problem acknowledged by local CG experts during interviews. While both types of RPTs require review by a company's audit committee, the OJK is planning to revise existing rules to unify both types of RPTs under one definition and one set of rules. We look forward to this reform.

. . . while board remuneration disclosure needs improving . . .

Disclosure of board remuneration is still a sensitive issue in Indonesia, with most companies still disclosing remuneration on a grouped basis rather than individually and on a comply or explain basis. The OJK limits bank commissioners to one bank seat and one other (non-bank) seat. Other (non-bank) commissioners can sit on up to five separate boards. OJK rules now mandate two terms for non-executive directors (NEDs) of listed companies, each term of five years each. Thereafter, NEDs must resign or undergo a shareholder vote prior to re-appointment. OJK and IDX rules provide some requirements for an INED or independent commissioner to demonstrate independence from a controlling shareholder, any other director, commissioner or sponsoring bank or broker, but the cooling-off period to achieve "independence" is just six months, which significantly dilutes the efficacy of the rule.

. . . and minority shareholder protections are too weak . . .

Minority shareholder protections remain generally weak in Indonesia: pre-emption rules exist and the maximum issuance of 10% of issued share capital is reasonable and in line with regional standards; yet there are no limits on issue price discounts. Thanks to OJK intervention, annual meeting notices must be sent to shareholders 22 days before the meeting - still outside our own guideline of 28 days, but probably sufficient to enable shareholders (especially foreign) to vote in an informed way - but information requirements are weak: the rule stipulates that, "shareholders have the right to receive information on the meeting agenda and corresponding material related to the agenda as long as it is not against the interest of the Public Limited Company".

. . . as are rules on takeovers and major transactions

Minority protections on takeovers and tender offers are also poor and easy to manipulate. OJK tightened up rules on takeovers somewhat in 2018 via a new rule that requires a mandatory takeover in certain circumstances below the previous 50% threshold. But rules on major transactions are also weak, with notification, disclosure and approval thresholds and requirements materially behind regional best practice in markets such as Hong Kong.

4. Listed companies

Indonesia ranks 10th with a score of 43%

Like many markets in Asia, Indonesia's listed companies adopt a compliance-focused approach to CG. If the OJK has a rule, generally they will follow it, albeit reluctantly at times, and always on a 'comply or explain' basis. This approach is not surprising given the prescriptive way Indonesia's regulators have often taken to revising CG standards, motivated at least in part by regional scorecards and annual awards and surveys.

Financial reporting

Financial reporting and IR websites are good . . . but timeliness isn't

Our in-depth review of 15 large-caps and 10 mid-caps confirmed what we have seen in previous years, that financial reporting is of a high standard in Indonesia and in part because accounting standards are closely aligned with international norms. Investor relations websites are another bright spot, with both large and mid-caps generally providing decent disclosure of financial, regulatory and other information in English and Bahasa. Indonesia does less well, however, in terms of companies releasing their audited financial reports quickly (that is, within 60 days of the period end).

CG reporting

CG reporting is still compliance-driven

CG reporting is much patchier, with few companies showing evidence of meaningful and thoughtful discussion and presentation of governance policies and programmes. Indeed, most reporting is driven by compliance factors. There are some notable exceptions: a few of Indonesia's larger banks have significant disclosure around governance and risk management systems, largely because it is mandated by the OJK, and a few natural resources companies appear to have taken CG more seriously.

Disclosure on boards and committees is mostly weak

Companies generally provide information with respect to individual board attendance, but remuneration disclosure is grouped rather than disclosed individually, and remuneration policies are extremely basic, if they are discussed at all. Board committee reports are generally weak and uninformative, with the only exception being audit committees, where standards of disclosure are generally higher than for other board committees.

Novel approach to audit committees

Indonesia's approach to audit committees (AC) is interesting. The Chair is required to be an independent commissioner while the other members must be unconnected audit industry practitioners: no other board members sit on the AC. While this makes for a more independent AC than many other markets, there are mixed views in Indonesia as to whether the AC thus becomes too disconnected from the company it is serving.

ESG reporting

ESG is reporting is more like CSR . . .

ESG reporting, admittedly more in its infancy in Indonesia, is much weaker, with many corporate reports providing brief coverage of little more than recycling programmes, charity foundations and employee offsites. Reports generally read more like corporate social responsibility reports of activities than a focussed, coherent discussion of ESG issues and how they affect the company and its stakeholders.

. . . and very limited

Every company in its annual report provides a policy statement on ESG, but most are basic and clearly compliance-focused. Almost no companies provide materiality indices, sustainability metrics or targets, and there are very limited communications with stakeholders relating to ESG plans or programmes. If Indonesian companies are going to properly implement ESG strategies and report on them, it is likely going to require further intervention from regulators.

Board evaluation and training

Director training is a bright spot

Indonesian boards do seem to undertake reasonable evaluation processes on an annual basis (although standards of course vary) and training is something that seems to be genuinely valued in Indonesian culture, and enthusiastically embraced. Indonesia has a number of bodies that provide valuable board training and evaluation services, most notably, the Indonesian Institute for Corporate Directorship. Board diversity is something that Indonesia enjoys more due to cultural issues than proactive measures, since women are more readily accepted in senior executive positions and in the board room than in most other Asian markets.

Policies and committees are there but not always followed

OJK requirements mean that Indonesian company boards have policies with respect to internal risk control, anti-corruption and RPTS, although the efficacy of these policies is less clear.

Board remuneration, especially for commissioners, needs reform

Board remuneration is unusual in Indonesia, where the local equivalent of non-executive directors (commissioners) earn salaries, and sometimes bonuses, rather than fixed board fees. BOC members are paid salaries based on a fixed percentage of the salary of the company's CEO, with the President Commissioner (Chair) typically receiving 40% of the salary of the President Director (CEO) and the other commissioners receiving 90% of the salary of the President Commissioner. Securing a seat on the board of commissioners of a bank or a major conglomerate, for example, can be highly remunerative.

5. Investors

Indonesia ranks 11th with a score of 19%

Investor engagement in Indonesia remains limited, with most foreign investors tending to sell in the face of company recalcitrance rather than engage, especially given the high level of concentrated family ownership. The development of Indonesia's institutional investors is in its infancy and comprises principally local insurance companies and investment arms of several large domestic banks. Asset ownership in Indonesia is dominated by the employee social security system, a mandatory pensions system known locally as Jamsostek, a growing number of employer-sponsored pension funds known as Dana Pensiun Pencari Kerja (DPPK), and financial institution pension funds called Dana Pensiun Lembaga Keuangan (DPLK).

Domestic pension asset ownership a drag on equity investment

As a result of concentrated asset ownership in local pension schemes, domestic institutional investment is focused heavily on short-term investments, principally because many still manage defined-benefit schemes. Pension fund investment is therefore heavily skewed towards investment in short-term money market instruments with equity investment forming a small part of overall investment portfolios. And it will likely take many years before we will see the domestic institutional market develop to the extent where it will be able to actively engage companies and advocate for CG reform.

Institutional investors

Attendance and voting at meetings is good . . . but no one likes to ask difficult questions

Local institutional investors typically will attend annual company meetings and do actively vote, but few engage with company boards ahead of votes. There is virtually no activism against prejudicial resolutions and few will actively vote against resolutions proposed at the annual meeting. While they are required by law to disclose any conflicts of interest, domestic institutional investors are not required to disclose their voting decisions. The same can be said of foreign institutional investors who will attend and vote, but tend to sell their holdings in companies where they disagree with management policies or proposals rather than engage and seek to influence the agenda or actively vote against resolutions. While some foreign investors are engaging with local companies, they are the exception not the norm.

Foreign investors experience prejudicial transactions

Foreign institutional investors that we have spoken with about engagement issues in Indonesia grumble about abusive related-party transactions announced post facto, especially material changes in royalty payments to overseas subsidiaries that have a material effect on financial returns, takeovers that effectively disadvantage minority shareholders since mandatory triggers are too high, and insider self-dealing in private placements.

Collective engagement rare and no CG focus funds

There are no CG "focus funds" in Indonesia that are actively pushing a CG agenda or engaging with companies to improve CG standards, no institutional investor association and no stewardship code at present. We have witnessed some attempts on behalf of foreign institutional investors to engage with companies collectively on issues of importance, but such attempts are rare and have never proved successful.

Retail investors

Retail investors like to vote, but don't challenge companies

Retail investment is lively but still small relative to the size of the Indonesian market. As with institutional investors, so with retail. While they tend to be enthusiastic attendees of and voters at annual meetings, few retail investors, if any, actively vote against management-proposed resolutions, there is no evidence of collective engagement of companies by retail investors, nor do they launch law suits. While it is possible for regulators, such as OJK, to launch such suits on behalf of retail investors against companies and management, this has never happened in Indonesia. Indonesian companies and the families that control them are generally regarded as far too powerful for retail investors to take on, especially in Indonesia's creaky and corrupt legal system.

There is no retail investor association in Indonesia

Likewise, retail investors have not formed any shareholder associations to work on their behalf to advocate and promote better CG. According to sources we spoke with in Jakarta, an attempt to form such an association was made, but the idea was killed by none other than the stock exchange.

6. Auditors & audit regulators

Indonesia ranks 10th with a score of 61%

Accounting and auditing standards compare well with international standards: Indonesia's approach to IFRS adoption is to maintain its national GAAP (Indonesian Financial Accounting Standards) and converge them gradually with IFRSs to the maximum extent possible. Indonesia is 95% compliant with IFRS and is approximately one to two years behind in adoption. According to sources within the local accounting profession, the OJK is proposing to give listed companies an option to comply 100% with IFRS or to remain 95% compliant. There is currently no plan for a mandatory full adoption of IFRS.

Auditing standards are fully compliant

In contrast, Indonesian auditing standards have been fully compliant with International Standards of Auditing (ISAs) since 2012, when the Institut Akuntan Publik Indonesia/Indonesian Institute of Certified Public Accountants (IAPI), which has direct responsibility for setting auditing standards in Indonesia, adopted IAS for the audit financial statements of all listed companies.

Code of Ethics mandates audit partner rotation and limits non-audit work

Like other markets in the region and globally, the Indonesian Institute of Accountants has adopted a Code of Ethics for its members that governs the way in which public accounting firms interact with their audit clients. The code is based on the 2014 International Code of Ethics for Professional Accountants and includes limits for partners on audit accounts before mandatory rotation, limits on non-audit work that external auditors can provide as well as the requirement on auditors to report fraud witnessed at audit accounts.

Audit statements

Company accounts compare well with international standards, but disclosure could be better

Listed companies are disclosing audit and non-audit fees paid to their external auditors, but detailed narratives are effectively voluntary and few companies provide much detail. In general, the audited accounts of listed companies in Indonesia compare well with international standards given the converged nature of the standards as well as the fact that most listed companies are engaging external auditors that are local affiliates of the major accounting firms, including the Big Four audit firms.

Mid-caps generally compare well with their large-cap counterparts

There are some discernible differences between standards and disclosure in audit reports of smaller listed companies compared with larger listed companies, although this is not universally the case. Generally, the differences arise when smaller listed companies engage very small external audit firms to undertake their audits.

Audit regulation

Indonesia has an alphabet soup of audit regulators . . . but it does seem to work

Indonesia's audit oversight regime is a little confusing, with several bodies regulating external accounting firms depending on their remit. Audit and accountancy practitioners must be members of Ikatan Akuntan Indonesia/Institute of Indonesia Chartered Accountants (IAI) (for accountants) or Institut Akuntan Publik Indonesia/Indonesian Institute of Certified Public Accountants (IAPI) (for public accountants). Auditors are regulated by IAPI under the Public Accountants Act 2011, while the Ministry of Finance has appointed the PPPK (Pusat Pembinaan Profesi Keuangan/Center for Supervision of the Financial Service Profession) as the body to regulate and supervise statutory auditors. OJK meanwhile also registers and oversees auditors for entities under its supervision, which includes banks, securities firms and insurance companies.

The auditor shortage continues; there are attempts to address constraints

Despite the multiple regulators and oversight bodies, disclosure of enforcement work by these bodies is hard to find. In addition, while every interested party in Indonesia will admit that, like many markets in Asia, Indonesia is suffering from a chronic shortage of audit professionals, there is scant evidence of meaningful research into capacity issues and available resources. That said, there is some indication that cooperation between regulators is beginning to tackle capacity constraints.

Merlissa Trisno
merlissa.trisno@clsa.com
+62 21 2554 8834

Baby's death leads to lawsuit at private hospital Mitra Keluarga

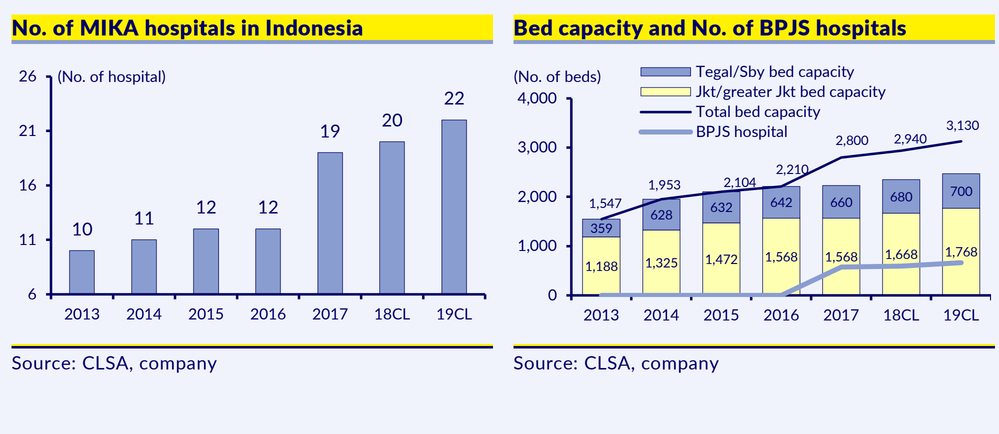
The incident happened in Kalideres hospital

On 3 September 2017, an incident at Mitra Keluarga Hospitals ended with the death of a baby, later known as the 'Baby Debora' case. The baby was brought to Mitra Keluarga Kalideres and diagnosed with cyanosis by the emergency department. The problem emerged when the hospital asked for a payment deposit to move the baby to a paediatric intensive care unit (PICU), which the parents could not afford. Delayed care led to the death.

The Jakarta Public Health Office formed an investigation team to audit the medical and management services given to Debora, as well as the hospital as a whole. The results showed that the emergency doctor who handled the case followed proper procedures. However the commission concluded that the hospital's management did not fully understand the laws and regulations related to the hospital. The commission was most concerned with the hospital's demand for a down payment before treatment, which in its view, should not be required of the guardian nor be considered until the patient is in a stable condition.

MIKA has to pass the accreditation within six months

On the recommendations of the auditors, Ragam Sehat Multifita, the owner of MIKA Kalideres Hospital, had to overhaul the management ranks up to the leaders at the hospital. In addition, MIKA Kalideres Hospital must also pass the hospital accreditation no later than six months after the decision letter is issued, and must be reaccredited every two years. As per April 2018, Kalideres hospital has turned into BPJS hospital, together with two other hospitals - Bekasi Timur and Waru.



Source: CLSA, company

Source: CLSA, company

7. Civil society & media

Indonesia ranks 9th with a score of 44%

Indonesia's civil society is surprisingly active given the existing weak CG regime and the absence of regulatory impetus from IDX. The Indonesian Institute for Corporate Directorship (IICD) is one of the region's more active director bodies and undertakes important advocacy and lobbying work with regulators to improve CG regulations and standards, as well as conducting extensive CG training for boards of Indonesian listed companies. IICD acted as the approved domestic body for the Asean CG Scorecard and has played an active role in liaising with the IFC and OJK in connection with the "Corporate Governance Guidelines for Public Companies".

Encouraging number of other organisations that undertake CG training

Other than IICD, Indonesia has several other organisations that undertake CG training and awareness in various forms and produce research on CG issues. These include the local affiliates of several international accounting firms, as well as the Indonesian Association of Corporate Secretaries, the National Committee on Governance (KNKG), the Indonesian Audit Committee Institute (IKAI) the Institute of Internal Auditors Indonesia and the National Center for Sustainability Reporting Indonesia, which undertakes training and certification programmes based on the Global Reporting Initiative.

Corporate groups focus on commercial issues over CG

In contrast with the advocacy and training activities of these associations and organisations, Indonesia's business chambers and associations, such as the Indonesian Publicly Listed Companies Association, or AEI, are much less active in CG advocacy and training, focusing instead on lobbying government departments and regulators relating to commercial issues.

CG research largely academic

Indonesia has its fair share of CG-focused research, but this tends to be driven mainly academia and is more theoretical and top down than practical. The country lacks vocal CG advocates that publish articles on specific CG issues and problems and that lobby government and regulators for change.

Media is free . . . but reporting is basic . . . and can be bought

The media are generally open and lively in Indonesia and able to report freely on CG issues. That said, detailed reporting on CG issues or misdemeanours on a company basis is less common, perhaps because the level of expertise is lacking among local media. In addition, it is not unheard of for negative articles to be spiked or bought off by controlling shareholders. Journalists have been intimidated or even threatened in the past, including foreign journalists, so there is a degree of self-censorship in Indonesia's press coverage. Most media report basic business information with little or no focus on CG issues. The exceptions are when international investors or creditors are involved, when reporting becomes more detailed and focused, likely because international media are also reporting on the issue. However, even in some circumstances, reporting can be toned down or stories pulled due to concerns about intimidation from certain promoters.

Recap and recommendations

Recap of CG Watch 2016

Indonesia has made progress on some of our recommendations

How has Indonesia responded to the recommendations in our 2016 survey?

Figure 2

Indonesia: recap of 2016

	Recommendations	Outcomes
1.	Tighten existing rules on RPTs and pre-emption	Still to be done, although RPT rules revision said to be in the pipeline
2.	Improve the definition of "independent director"	Some progress, but could be tighter
3.	IDX to enforce its rules more actively	No signs of life
4.	Appoint one audit regulator and stick with them	Still an alphabet soup of audit oversight, but it seems to work
5.	Better disclosure of remuneration, audit and non-audit fees	Much to do: more narrative, more detail
6.	Fix regulatory websites	OJK website slightly better, but still incomplete (especially in English)

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the markets score to fall in 2020:

- No material improvement in enforcement regulation and activity
- Continued apathy and disinterest on the part of the stock exchange
- No progress on revising rules on RPTs or other major areas of shareholder rights
- A failure to implement blackout rules for insiders
- Did we mention the OJK website?! Candidate for double penalties!

What to fix

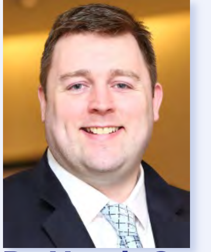
Quick fix list

Issues to address as soon as possible:

- OJK - please, please, fix your website!
- IDX - establish a CG division and vest it with real power
- Introduce mandatory blackout periods
- Finally fix those rules on RPTs and pre-emption
- Longer term: Undertake a root and branch review of CG laws, regulations and rules, with a view to developing a longer plan for reform

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
+852 2160 1788

Sumika Hashimoto
Research Associate, ACGA
sumika@acga-asia.org



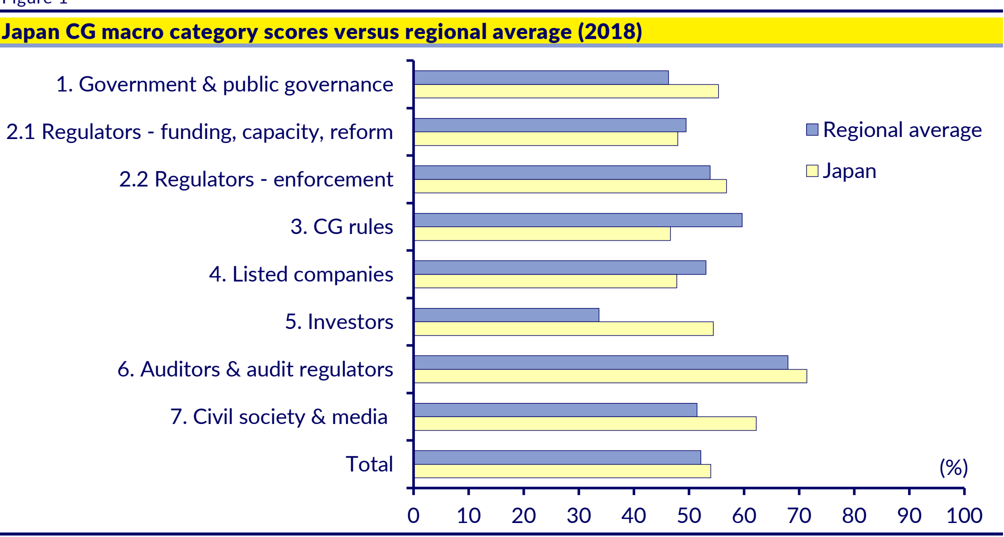
Dr Heath Grow
Former Senior Research Manager, ACGA

Japan - Keeping it complicated

- Unbalanced focus on soft law compared to hard law; CG rules and shareholder rights remain weak in many areas
- Regulatory enforcement outcomes limited and statistical trends not well explained
- Growth of independent directors and audit committees strong on paper, but board culture and practices remain largely the same in many firms
- Depth and quality of corporate reporting has significant gaps
- Stewardship Code and GPIF are forcing asset managers to be more active
- Civil society and media becoming more engaged on CG and ESG

Figure 1

Japan CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

Japan ranks equal 7th with a score of 54%

Japan's total score of 54% puts it in equal 7th place in this year's survey with India, which rises one place. This is a marked fall in ranking for Japan from our last survey in 2016, when it came fourth (after adjusting for the inclusion of Australia). While parts of its governance ecosystem have strengthened - see in particular our investors and civil society and media categories - the evidence suggests overall progress is plateauing. Much of the regulatory effort over the past two years has been focussed on "soft law", such as codes of best practice and governance guidelines, as opposed to "hard law" and regulation. As the chart above shows, Japan yet again scores poorly in CG rules. It is also underperforms on listed companies. In our view, changes to company and securities law, as well as the listing rules, are needed to create a more balanced and fair capital market. Reform cannot only be about aspirational best practices.

CG reform seems to have reached a plateau, after many years of progress

Japan offers listed companies three choices of board system

Underlying the slow progress in CG reform in Japan is the fact that it has one of the most complicated systems of corporate law in Asia-Pacific, offering listed companies no less than three options for board governance and audit committees. Almost all other markets we cover in Asia allow for just one. Those that provide for two - Korea and Taiwan - insist larger firms and increasingly smaller issuers follow just one. The argument in Japan, from the conservative Nippon Keidanren (Japan Business Federation) and others, is that this system

offers companies choice. We beg to differ and believe it creates opacity and confusion, especially among foreign investors, who are then criticised for not understanding the Japanese system. Yet even locals find the system confusing at times.

Complexity is also seen in the fragmented system of corporate reporting

Complexity also arises in the functioning of traditional *Kansayaku* (statutory auditor) board companies that are encouraged to form "advisory" committees on nomination and compensation that have no legal basis (hence responsibility cannot be apportioned). It can be seen in the four choices of accounting standards open to listed companies, as well as a highly fragmented financial and non-financial reporting system that forces companies to produce different (though overlapping) reports according to company law, securities law, and the listing rules. Navigating this maze is a challenge and more difficult than it should be in a modern capital market.

Japan revised both its stewardship and CG codes in the past two years

Despite this challenging context, progress has been made over the past two years. Japan revised its Stewardship Code in 2017 and made some much-needed changes. It amended its CG code in 2018, although to less effect. It also adopted an Audit Firm Governance Code in 2017, a first for the region and a response to the numerous accounting scandals of recent years. The past two years have also seen continued growth in the involvement of domestic institutional investors in corporate governance and ESG policy and advocacy. It remains one of the few markets in the region big enough and liberal enough to allow, or at least tolerate, shareholder activism and law suits. It also has an increasingly vibrant civil society and media.

While Japan deserves credit for major policy reforms, there is a risk that reform is losing momentum

Japan deserves considerable credit for the major reforms it has undertaken in corporate governance over the past decade. The policy landscape today is vastly different, and accepted practices such as independent directors, transparent shareholder meetings and active investor ownership, were once unthinkable - or barely practised. The risk is that reform is losing momentum and a worsening macro-economic environment will justify going slow.

1. Government and public governance

Japan ranks equal 4th with a score of 55%

While Japan's fourth place for government and public governance is a relatively good result, its moderate score of 55% reflects a system that in parts is both robust and weak. The government of Prime Minister Shinzo Abe has taken a fairly consistent approach to corporate governance reform in recent years, pushing forward amendments to both the stewardship and CG codes, emphasising the importance of improved company-investor dialogue, as well as raising the bar for auditors. Yet it has not always given the Financial Services Agency (FSA) the consistent political support it needs to push forward new policies and stronger enforcement. The FSA is not particularly independent of government and is funded through government budget allocations, rather than independent levies. And the country lacks some institutions standard in most markets, such as a national anti-corruption agency.

Japan scores best in areas such as bank supervision, judicial independence, and access to law

Where Japan scored better in this category was in areas such as the existence of a national CG policy, the effective supervision of banks, generally high standards of civil service ethics and accountability, a clean and independent judiciary, and the ability of minority shareholders to access the legal system.

Policy leadership

The New Economic Policy Package of December 2017 highlighted CG

The Abe government has shown leadership on corporate governance in a number of ways over the past two years. At the highest level of government, for example, the Cabinet Office announced a New Economic Policy Package in early December 2017. The suite of policies focus on three key areas for the following three years: human resource development, supply system innovation, and how Japan will respond to additional fiscal demands. Under the supply system heading is a section called corporate governance revolution, that outlines the government's intention to develop guidance aimed at encouraging decisive management decision-making, effective use of retained earnings, the development of better processes for CEO appointment and dismissal, reduction of cross shareholdings, and the participation of corporate pension funds in stewardship activities. These five points were reflected in the amendment of the CG code, released at the beginning of June 2018.

The Japanese government regularly forms expert committees on CG

As in previous years, the Japanese government has also continued its practice of forming expert committees to discuss new policy directions and initiatives. In January 2017, the FSA formed a new Council of Experts to review the progress of the country's Stewardship Code, first published in February 2014. The council later went on to review the CG code of June 2015. Other FSA committees and task forces looked at issues such as fair disclosure and how to improve financial and non-financial disclosure.

METI plays a somewhat unusual role in the CG policy ecosystem in Japan

The Ministry of Economy, Trade and Industry (METI) is also a central player in corporate governance policy in Japan. Its role is somewhat unusual in that it has no jurisdiction over company or securities law, which are the purview of the Ministry of Justice and the FSA, respectively. But with its close contacts to industry and its traditional role in setting industrial policy, METI believes it has a part to play in shaping improved dialogue between companies and investors, the evolution of corporate reporting towards the integrated reporting style of the UK, and greater investment focus on long-term investment in sustainable development and growth. Since mid-2016 it has formed study groups in all these areas and produced guidance documents.

While METI's participation fits neatly into Japan's focus on seeing CG reform as a way to enhance corporate, and therefore economic, value and competitiveness, its instincts are sometimes at odds with those of financial regulators. Simply put, METI likes to promote greater flexibility for companies and the simplification of reporting, whereas the FSA, like most of its counterparts in the region, is looking to raise minimum governance standards and foster more corporate transparency, which in practice means more detailed reporting. The end result has been, from time to time, mixed messages being sent to companies and investors. This could also help to explain why, despite having robust CG rules in some areas, Japan has strikingly lax rules in others (a topic we discuss in our CG rules chapter). The fact is that vested business interests put up strong resistance almost every time a new CG regulation is proposed.

The third key entity is the Ministry of Justice

The third key government entity involved in CG policy is the Ministry of Justice (MOJ). It is considerably less active than either the FSA or METI, but gears up every few years to review the company law with the assistance of a group of experts on its Legislative Council. In early 2018 it released a consultation on amending the Companies Act (see Regulators - funding, capacity-building and regulatory reform for more details).

Regulatory consultations in Japan could be longer

One feature of the Japanese system worth highlighting in this context, but not often discussed, is its approach to regulatory consultations. While regulators are well-organised in forming expert councils and working groups, which are then given several months to discuss an issue, its public consultations are always run to tight deadlines (rarely exceeding a month) and timed either at the end of the year (holiday season for most foreign investors) or during the busy Q2 proxy season. Longer consultation periods of two to three months would be welcome and in line with other leading markets.

Bank governance

Major banks are held to higher standards of governance

The FSA takes a strict approach to regulating banks in Japan. While it does not have a separate bank governance code, its oversight policy regarding major banks raises the bar by setting higher expectations in a number of areas: the quality, ability and gender of board candidates; the level of independence on the board; and more specific and detailed disclosure about risks. It does this by posing a series of questions to banks. For example, when considering a candidate for the role of outside director, in addition to reviewing personal, financial and business relationships, it asks "do you carefully consider" gender? It has also been applying pressure on major banks, and insurers, to reduce risk by cutting their holdings of listed company equities.

Governance reform could help banks strengthen their business and profitability

While the FSA believes the Japanese financial system "as a whole remains robust and stable", it is concerned about the decreasing profitability of the seven major banking groups, as it explains in its Assessments and Strategic Priorities 2018 report. It is even more concerned about the 106 regional banks, more than half of which are losing money in their core businesses - a number that has been increasing in recent years. The FSA sees governance reform as part of the answer to the problems of both the major and regional banks.

A fragmented anti-corruption system

Japan does not have a national anti-corruption agency

Unlike many other markets in the region, Japan does not have a single, coordinated body that addresses bribery and corruption issues in the public and/or private sectors. Instead, there are different government agencies doing this work, including the police, the Fair Trade Commission (FTC), the National Tax Administration Agency and others. The FTC was set up to enforce the Anti-Monopoly Act and has some operational independence from government. This fragmentation may explain why Japan's ranking in international surveys of bribery and corruption is less impressive than one might expect: it came 18th out of 177 countries in Transparency International's Corruption Perceptions Index 2013 and slipped to 20th out of 180 countries in 2017. Among the jurisdictions in Asia-Pacific that we cover, it ranks below Singapore, Australia and Hong Kong.

Christopher Richter
Senior Research Analyst
christopher.richter@clsa.com
+81 3 4578 8035

Subaru - The letter and the spirit

Subaru was caught out by compliance issues during 2017. Like Nissan, it was found to have inspection procedures that did not conform to the letter of Ministry of Land, Infrastructure, Transport and Tourism (MLIT) requirements for vehicle inspections. Interestingly, "a factory culture of excessive focus on technical skills" leading to "scepticism regarding the reasonableness of results" was cited as reasons. In other words, Subaru's overconfident engineers believed their processes were better than the procedures spelled out in the rules, and did not take the rules too seriously.

Overconfident engineers at the root of the final inspection lapse

The first scandal also uncovered problems with fuel economy testing

Like any good blockbuster, the end of the final vehicle inspection in late 2017 led to a sequel, as problems with fuel economy testing added to the controversy. Subaru reported to MLIT it found instances where testing for fuel economy deviated from rules for vehicle running speed, and the test room's humidity levels deviated from the inspection rules for a small percentage of vehicles. In this case, excessive work volume, weak internal controls, and lack of awareness of standards were factors behind the problems.

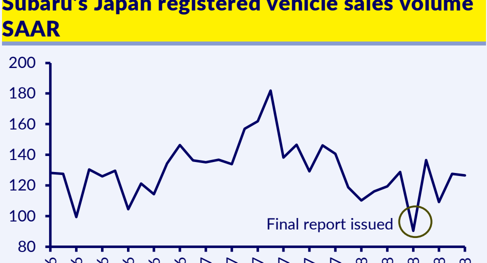
The consequences for Subaru were grave

While Subaru staff and management may have thought the tests unimportant, the consequences were not. Subaru said it would see ¥20bn in losses connected to vehicle inspections. Much of the management team was forced to step down. It has also seen its share of the Japanese registered vehicle market decline in 2018-to-date to 3.6% from 4.3% a year earlier. Its share price also suffered. Recent history has been horrible for Subaru, given a lack of new models, trade war worries, airbag recall expenses, and misjudging USA demand.

However, is over-regulation that does not protect public safety part of the problem?

However, digging deeper we wonder if a bureaucratic culture prone to over-regulation is partially responsible. While a lot of vehicles have been inspected and re-tested, as far as we know, none have needed repairs, so no public safety quality assurance issue is present. The inspection requirements that also tripped up Nissan Motor have also been identified as non-tariff trade barriers by the US Trade Representative's Office. We suspect these inspections will be quickly bargained away by PM Abe in negotiations with the USA. Indeed, the risk bureaucrats would lose authority is perhaps an important reason they came down so hard on scofflaws. Who is the villain?

Subaru's Japan registered vehicle sales volume SAAR



Source: CLSA based on JAMA data

Subaru's share price performance vs TOPIX

Source: CLSA based on Datastream

2. Regulators

Japan ranks 9th overall in this category with a score of 53%

Japan underperforms in this category for a range of reasons. We have introduced some new questions on the sufficiency and transparency of regulatory budgets, as well as investment in surveillance, investigation and enforcement, but found limited information on this in Japan. While the FSA gains points for amending its stewardship and CG codes, and for introducing the governance code for auditors, it lost points for not addressing more hard-law issues. There has been little in the way of original amendments to the JPX listing rules over the past two years, while the most interesting change - on the disclosure of "*sodanyaku/komon*" (counsellor/advisor) relationships - is still only a voluntary standard. Regulatory databases for the disclosure of mandated corporate reports and announcements are fragmented, poorly organised, and limited in terms of historical data. And enforcement outcomes in the area of market misconduct have, with some exceptions, been fairly underwhelming over the past two years.

Where Japan scores well

In contrast, Japan scores well in our survey in the following areas: the availability of English translations of key legislation; the existence of an established electronic voting platform; and the quality of disclosure on regulatory enforcement.

Japan has three key entities regulating the securities market

The main features of Japan's financial regulatory system are:

- **Financial Services Agency** (FSA), the peak body responsible for oversight of banking, insurance, other financial services, and the securities market. The FSA is headed by a commissioner, currently Toshihide Endo, and overseen by the Minister of State for Financial Services, currently the veteran politician Taro Aso. Its governance structure contains no separate board of directors or commissioners, unlike some leading markets around the world such as Hong Kong and the UK, where the securities regulator is overseen by a board comprising both official and independent members.
- **Securities and Exchange Surveillance Commission** (SESC), an entity under the FSA that carries out enforcement of the Financial Instruments and Exchange Act (FIEA) as well as related laws.
- **Japan Stock Exchange** (JPX), a holding company formed after the merger of the Tokyo Stock Exchange (TSE) and Osaka Securities Exchange in 2013. TSE manages the cash equities market, while the Osaka Exchange trades derivatives. JPX created a separate entity called Japan Exchange Regulation to handle enforcement of the listing and trading rules. It also owns a clearing company and a securities depository.

2.1 Funding, capacity-building and regulatory reform

Japan ranks 8th with a score of 48%

Limited information is available in English regarding the FSA's staffing levels, budget or its investment in new enforcement technology. It used to publish an annual report, but this was only a narrative report (it lacked financials) and ceased in 2014. The agency today publishes two documents, a summary of its strategic directions and policies for the coming year, and a review of progress made over the previous year. These are useful documents, but again contain only a qualitative assessment of its work and the main strategic priorities facing the banking, insurance and financial services sectors.

Limited data on the FSA budget is available in English, but there is some in Japanese

Some FSA financial information is available in its Japanese-language budget requests to the National Cabinet Office. The FY2018 version contains some interesting statistics:

- Personnel costs for the current fiscal year are expected to reach ¥18.2 billion (about US$161m), an increase of ¥200m (US$1.8m) from the previous year - a growth rate of just over 1%
- Information technology costs will be ¥3 billion (US$26m), a ¥200m increase from the previous year
- Investments in enforcement and technology over the past few years include ¥120m for enhancing the monitoring of financial institutions and cyber security in FY2017, and a similar amount for promoting fintech and cyber security this fiscal year.

While the FSA does not provide total staff numbers, it is limited by law to a headcount of 1,582. This year it planned to increase staff by a net seven people (20 new positions less 13 rationalised positions).

The FSA's budget does not seem large, given its broad scope of work

These numbers do not suggest an agency brimming with extra funds. Its staff expenditure of US$161m, for example, is the equivalent of about HK$1,255m. For FY2018 (ending 30 June 2018). The Securities and Futures Commission in Hong Kong spent HK$1,282m on staff - an almost identical figure for a commission that only covers securities, whereas the FSA regulates banking, insurance and securities - and provides the independent audit regulator.

The FSA has big plans for transformation over the coming years

Nevertheless, the FSA has some big plans for capacity building. In a paper called For Providing Better Financial Services in the Era of Transition, an English translation of which appeared in late September 2018, it starts with the following warning: "Accelerating digitalization, declining population and aging, and prolonged low-interest rates have been drastically changing finance." It goes on to say financial institutions must not only comply with laws and regulations, they must be more "customer-oriented" and "more efficiently provide financial services that suit the needs of customers". Boards of directors have an important role to play in this transition, giving direction to management teams and holding them to account. So too does the FSA, which intends to improve the quality of financial administration and transform itself into the Financial Nurturing Agency.

The FSA will change its supervisory model: "from checklists to engagement"

Of the several components to the FSA's transformation plan, two are worth highlighting here: an emphasis on ongoing corporate governance reform to help "vitalize the capital market and secure market integrity and transparency", and reforming the FSA itself. The latter comprises HR objectives (making the agency a "satisfying and fulfilling workplace" and hiring more young officials) and a new supervisory approach called "replacing checklists with engagement" (that is, reducing reliance on compliance checklists when regulating financial institutions, and engaging more with them on issues that matter to the real economy and their customers, such as bank culture, governance, risk management and business models). While the plans come with few specifics at this stage, one concrete measure will be the abolition of the checklist for FSA inspectors, called the Inspection Manual, in April 2019 or later. The agency also plans more discussion papers on specific topics in 2019.

SESC resources

The SESC plans to invest more in technology

The SESC produces a detailed and informative annual report that covers its market oversight, investigation, inspection and enforcement work. The report touches on capacity building in general terms, such as the training of staff to analyse and investigate cross-border market misconduct, and studying how to use information technology better in market surveillance (RegTech). However, no budgetary information is provided on the above areas.

SESC staff grew strongly from 2002 to 2014

One set of statistics the SESC does provide, however, is staff numbers: a presentation prepared to mark its 25th anniversary in 2017 indicates its total staffing grew rapidly between 2002 and 2014, after which it flattened out. Total headcount was 748 people in FY2017 (ending 31 March 2018), of which slightly more than half were in Tokyo, and the remainder in 11 local finance bureaus around Japan.

JPX resources

JPX staffing levels are around the same as five years ago

Total staff at JPX reached 1,093 in FY2017 - slightly higher than FY2013 when it employed 1,023 people, and moderately above 975 in FY2015. About 200 people work in JPX Regulation, half of which are employed in listed company compliance and market surveillance. The remainder are in listing examination and other areas. JPX says its staff has sufficient experience in the stock market and that it also hires outside professionals, such as lawyers, auditors and accountants.

JPX is applying AI to market surveillance, but few details are available

Assessing capacity building at JPX is a challenge, since it does not provide detailed numbers on budget or investment in technology. However, it says that each department of JPX regulation has a sufficient budget to utilise external professionals when needed, and that it has been investing in technology. In March 2018, it developed a system with NEC and Hitachi that applies artificial intelligence to market surveillance.

JPX maintains tight control over costs and is focussed on growing its profits

It is clear, however, that JPX maintains tight control over costs: operating expenses declined from about ¥59 billion in FY 2013 to ¥53 billion in FY 2014 and ¥51 billion in FY 2015, after which they have stayed largely flat. Over the same period net income has risen from ¥33 billion to ¥50 billion in FY2017. Dividends per share have more than tripled, while ROE has increased from 17% to 19%. As a listed company in its own right, as well as a regulator, JPX is clearly focussed on profitability.

Fair disclosure

A new rule on fair disclosure is one of the few examples of hard law reform

One area where hard law reform has taken place over the past two years is in “fair disclosure”. In December 2016, the Task Force on Fair Disclosure Rule, chaired by Professor Etsuro Kuronuma of Waseda Law School, released a report on its suggestions for a fair disclosure rule in Japan. As the report states, while Japan has rules on the disclosure of material information in a timely manner, it does not require listed companies which provide "inside information to a third party before its public disclosure" to also release such information to other investors at the same time. This led to cases where brokers passed on material non-public information to clients, such as the case against Credit Suisse in 2016.

A task force gave advice on the scope of the fair disclosure rule

The task force recommended the coverage of the rule should broadly correspond to current insider trading regulation, but its scope may need to be widened to include other non-public information of a price sensitive nature. Its report also noted the types of information that would not need to be disclosed, such as general information given on plant tours or business briefings that are not price sensitive.

The fair disclosure rule came into force on 1 April 2018

An amendment to the FIEA was enacted on 17 May 2017, and came into force on 1 April 2018. The FSA also released a set of fair disclosure guidelines, in Japanese only, to illustrate some common interpretations of the rules. It stated its belief, however, that good practices will be built through constructive dialogue between listed companies and investors.

Japan's fragmented system of corporate reporting is matched by an equally fragmented system for online distribution of company reports

Website and reporting woes

An ongoing frustration when analysing listed companies in Japan is the fragmented system of corporate disclosure and report dissemination, something that leads to massive time-wasting. The system is structured as follows:

1. **Business reports:** Required by company law to be published before AGMs, which are mostly held in the third month after the financial year-end. These reports are available on company websites and contain an initial audit of the financial statements (with a basic set of notes), some governance information, and the agenda for the annual meeting. Large companies typically release them six to eight weeks after the financial year-end.

2. **Annual and quarterly securities reports:** Mandated by the FIEA, these must be filed with the company's local finance bureau through EDINET, the government's Electronic Disclosure for Investors' NETwork created in June 2001. Annual securities reports must be filed within three months of the financial year-end, meaning they usually arrive just after the AGM. This is problematic for several reasons: they have to undergo a second audit to ensure there were no material developments occurring between the financial year-end and the release of the business reports; they contain a more detailed set of notes to the accounts; and the vast majority are in Japanese only. Companies also file extraordinary reports required under the FIEA through EDINET.

3. **Timely disclosure notices and other TSE-mandated disclosure:** Under the listing rules, companies must file announcements to the TSE on important decisions and events, such as the issuance of new shares, dividend payments, changes in auditors or major shareholders, quarterly financial results, and so on. While announcements for the past year or two are available for free on the JPX website, as well as financial results for the past five years, the full suite of information is only available to subscribers of TDNet (the Timely Disclosure Network). Issuers must also file annual CG reports to the exchange. These are free, but only a small minority of companies translate them into English - 172 at last count on 16 November 2018.

Companies also voluntarily release other key documents through their websites, such as ESG/sustainability reports (including integrated reports), which are not mandatory, and annual reports, which contain only summary financial and non-financial information (ie, they are basically marketing documents).

We recommend creating a single database for all company reports and announcements

Our recommendations are as follows: firstly, create a single, user-friendly government or exchange-managed database for all company reports (statutory and non-statutory). A good model here would be the HKEXnews website managed by Hong Kong Exchanges and Clearing. As an example of simplicity and accessibility, we are also impressed with the Japanese Law Translation website run by the Ministry of Justice.

Secondly, all issuer information released to the TSE should not be sold to subscribers, but made available freely to all users from the date of IPO onwards (or at least for the past 15 years if the listing took place earlier). HKEXnews provides company reports, announcements and other documents dating back to 1999. Other company reports, where available, should also be provided for at least 15 years.

The government has taken initial steps to streamline corporate reporting . . .

Streamlining corporate disclosure

To its credit, the Japanese government has also started to address the issue of fragmented corporate reporting. In December 2017, an interdepartmental effort including the FSA and MOJ produced a report that made suggestions on how the content of business reports and annual securities reports could be more unified and standardised through a common reporting language. In January 2018, the FSA amended the Cabinet Office Ordinance on descriptions of large shareholders and stock options in the annual securities report, so as to bring them in line with the business report; while in March 2018 the MOJ made certain complementary legislative amendments. The government also encouraged later AGMs (ie, beyond the usual three months after the financial year-end), so companies have more time to unify their report contents and, ideally, publish the annual securities report before the AGM. It is still early days, however, and there is no indication laws will be amended to allow companies to produce just one report before the AGM, as is common in most other major markets around the region and globally.

. . . and to encourage more useful corporate reporting

Enhancing corporate disclosure

A related set of issues the FSA has been examining is the content, usefulness and timing of corporate disclosure in Japan. In December 2017, it tasked a Working Group on Corporate Disclosure under its Financial System Council to look into these matters and launched a one-month public consultation on 20 April 2018. The consultation posed 18 questions and highlighted four key issues:

1. Enhancing financial and narrative (non-financial) information
2. Providing corporate governance information for constructive dialogue
3. Assuring reliability and timeliness of information, and
4. Other issues, such as the accessibility of the Electronic Disclosure for Investors Network (EDINET) and English translation.

The Working Group on Corporate Disclosure suggested a number of ways forward

The working group's report was published on 28 June 2018 and contains an interesting description of the strengths and weaknesses of corporate disclosure in Japan. It points to a number of ways forward, such as the need for more expansive and meaningful MD&A reports (not just the conversion of numerical information to narrative information, as many companies do); improved disclosure around risk factors; and more comprehensive corporate governance reporting, including on management remuneration, cross-shareholdings, and in the governance information provided in the annual securities report and CG report.

Perhaps the most revealing fact in the report is only 22 out of 3,600 listed companies with year-ends between December 2016 and November 2017 produced their annual securities reports before their AGMs. They were:

Only 22 of 3,600 listed companies publish their annual securities reports before their AGM

Figure 2

The 22 listed companies that released an annual securities report before their AGM

ASKUL	TOWA
e-Seikatsu	Japan Exchange Group
KAGOME	Hulic
Kyowa Hakko Kirin	Hokushin
Kubota Pharmaceutical Holdings	Hodogaya Chemical
KOKEN	HOYA
Komatsu	Matsui Securities
SAKURA Internet	Yahoo Japan
Sanyo Chemical Industries	YAMATO HOLDINGS
The SHIGA BANK	Yamane Medical
TAIYO BUSSAN KAISHA	LIFENET INSURANCE

Note: Companies listed in same order and form as in the Working Group's report. Source: Report of the Working Group on Corporate Disclosure, p23, footnote 47.

Still waiting for the MOJ's amendments to the Companies Act

Amending the Companies Act: still waiting

As noted earlier, in February 2018 the MOJ released a consultation on amending the Companies Act to improve corporate governance. The measures suggested were limited in scope and included mandating the electronic provision of AGM materials, the earlier release of AGM notices/agendas, and restricting the number and content of proposals from individual shareholders (a response to cases in the past where this right has been abused). The consultation also focussed on the remuneration of board members and asked whether independent directors should be mandated in company law. The MOJ has yet to conclude its deliberations on these amendments.

Few changes to the TSE listing rules other than the *Sodanyaku/Komon* recommendation

TSE listing rules: still the same (mostly)

The TSE has had a fairly quite couple of years in terms of amendments to its listing rules. Apart from some minor changes to take account of the revised CG code, the most noteworthy development was the introduction in January 2018 of a voluntary disclosure measure on *Sodanyaku* and *Komon*. These are the senior counsellors and advisors, often former company presidents and senior executives, who are employed after retirement to play a continuing role with the company. At best, they provide useful advice and act as ambassadors for the firm. At worst, they interfere in management and board decision-making and hold back progress in the company. The TSE measure followed research carried out by METI in 2017 on the issue and increasing complaints from investors. Companies are encouraged to disclose the names, purpose and appointment periods of these advisors in their CG reports. They are also asked to report on whether they are paid (but not the amount). It is hoped investors will use this information in their engagement with companies. As of late November 2018, 1,187 companies provided such disclosure, with 634 informing the market they have *Sodanyaku/Komon*.

Japan ranks 8th in this sub-category with a weighted score of 57%

2.2 Enforcement

As the score and ranking indicates, Japan's enforcement efforts and outcomes are not among the most robust in the region. Our research found financial regulators in Japan do not have a strong reputation for vigorously enforcing their own rules. Their efforts over the past two years do not appear to have changed markedly

from previous periods. There are a limited number of cases against serious market misconduct, such as insider trading. And the conflict of interest within the JPX between its regulatory and commercial objectives appears strong.

SESC produces a detailed report on its enforcement approach and outcomes

It is not all bad news, however. Japan does rate well in this sub-category on a number of questions. Disclosure by regulators of their enforcement action, especially the SESC, is good and well-organised. The exchange has a relatively strong set of powers to sanction breaches of its listing rules, if it chooses to use them. And, unlike some markets in Asia, we do not see much evidence regulators and government agencies do not cooperate with each other.

SESC

Figures provided in the SESC's annual reports highlight some salient trends over the five years from 2013 to 2017 (numbers below rounded):

- The SESC and its local finance bureaus undertake 1,000-1,100 market oversight examinations each year to "identify signs of suspicious market misconduct"

Only a small number of insider trading cases

- Only a small proportion of these examinations, 12-14 in most years, relate to insider trading; while another 85-95 involve market manipulation
- Each year the SESC makes 50-65 recommendations for sanctions: most of these are administrative penalties, in particular monetary penalties, for market misconduct; a few are for disclosure violations, and only a small proportion involved the filing of criminal charges
- The number of criminal charges filed annually over the five-year period ranged from just three to eight cases
- There were fewer market oversight examinations, insider trading cases, recommendations for administrative monetary penalties, and criminal charges filed in 2017 than the previous year. This does not necessarily indicate a reduction in effort by the SESC, however, it could be the result of a time lag in enforcement action
- The time-lag effect can be seen also in the big increase in recommendations for monetary penalties against insider trading between 2015 (22 cases) and 2016 (43 cases), then a sharp drop again in 2017 (21 cases).

A few inferences can be drawn from these statistics: Japanese regulators do not file many criminal charges, but prefer to apply fines. The number of insider trading cases is low - especially given the size of the Japanese market and the number of listed companies. And, clearly, very few people go to jail for insider trading.

JPX regulation

JPX statistics on enforcement indicate a low number of cases

Figures provided by JPX for the same five-year period (FY2013 to FY2017) indicate the following:

- The number of "inappropriate disclosures" increased from 217 in FY2013 to 281 in FY2014 following the merger between the TSE and Osaka Exchange, then relatively flat since at 260 to 280 cases a year

Few companies are put as "securities on alert" for possible delisting

- The number of new "security on alert" companies, like Toshiba for its accounting fraud, has ranged from zero to four each year. It has been zero for most of the past two years. On 1 September 2018, SDS Holdings became the first to be put on alert this year - also for accounting fraud

Some six to 10 companies each year are required to give an improvement report

- The number of companies requiring an "improvement report" in each of the past five years would form an almost perfect smile if plotted on a chart: 10, six, one, six, and nine. The number of "public announcements" are similar
- There has been a declining number of issuers subject to penalty for violating the listing agreement, from seven in FY2014 to one in FY2017.

It should be noted that when companies become a "security on alert", the label can often remain for more than a year or two before they complete their remedial improvements and the designation is cancelled. Hence, Toshiba carried such a designation from September 2015 to October 2017.

More narrative explanation from JPX would help make sense of its enforcement data

As with SEC statistics, the JPX enforcement outcomes do not appear high in absolute terms - certainly not for a market with about 3,600 listed companies. Some narrative explanation of the results - and why the exchange thinks they are acceptable - would be welcome. It would also be helpful if the exchange clarified why companies committing accounting fraud are quickly put on alert, whereas those merely falsifying data (Kobe Steel and others) are not.

3. CG rules

Japan ranks 9th with a score of 47%

This is Japan's worst-performing category and an area it has never scored highly in our survey. The good news first: financial reporting standards are quite high. CG reporting standards have broadly improved with the advent of the CG code in 2015 and enhanced CG reports required under the listing rules. ESG/sustainability reporting is detailed and extensive, especially among the larger companies, despite no formal disclosure rules or guidelines from the regulators. Japan also has robust rules on quarterly reporting, disclosure of substantial ownership and price-sensitive information, and deserves credit for being the first market in Asia to adopt a stewardship code. Why is its score so low then?

Where Japan's CG rules fall below best practice . . .

The score is low because there are a larger number of areas where Japan's CG rules are either weaker than leading markets in Asia-Pacific and/or fall below regional and international best practices. These include:

- Disclosure of director trading, share pledging and related-party transactions
- Takeover rules and protection of minority shareholders
- Blackout periods (ie, closed periods for director trading)
- Executive and director remuneration disclosure
- AGM clustering/tight timeframes for AGMs
- Rules on collective engagement and concert-party action

. . . where they share flaws found in other markets

There are also areas where Japan's rules share flaws are found in other markets:

- Definition of "independent director"

- Late deadlines for release of AGM notices/circulars
- Scope and independence of audit committees
- Director nomination process
- Private placement rules (called "third-party allotments" in Japan).

Many of these issues have been unresolved for years

These are not new issues. ACGA has been writing about third-party allotments and AGM deadlines since our 2008 White Paper on Corporate Governance in Japan. The interplay between collective engagement, concert-party rules and company dialogue has been a point of discussion with regulators for at least the past four years. Foreign investor requests for a detailed regulatory guidance document, such as is found in Australia and the UK, have not received much of a response. To be fair, the FSA did produce a legal clarification in 2014, but it raises as many questions as it answers. Meanwhile, each year institutional investors come up against the limitations of shareholder rights in Japan in relation to such things as takeovers, related-party transactions, and capital raisings - and ACGA receives a steady stream of alerts from members.

But first, highlights of some positive changes . . .

Revised Stewardship Code

A revised Stewardship Code was released in May 2017

One of the best things regulators have done in the past two years was the May 2017 revision of the Principles for Responsible Institutional Investors (Japan's Stewardship Code). A number of important changes were made:

- Asset owners ought to be actively engaged in stewardship
- Institutional investors should disclose voting records for each investee company at the individual agenda item level
- Institutional investors are encouraged to collectively engage with other institutional investors when appropriate
- Asset managers should implement measures and governance structures to reduce and disclose conflicts of interest (in relation to voting and company dialogue).

The inclusion of language on collective engagement was a significant improvement

The inclusion of wording on collective engagement was a significant improvement on the original 2014 code, which omitted any such reference. Another notable, yet rather vague, amendment stated that, "the management of institutional investors should have appropriate capability and experience to effectively fulfil their stewardship responsibilities".

Revised CG code

A revised CG code was released in June 2018

Following the revision of the Stewardship Code, the Council of Experts under the FSA (see above) got to work discussing an update to the CG code and an accompanying set of Guidelines for Investor and Company Engagement. Changes were proposed and made under five headings:

1. **Management decisions:** Companies need to improve their corporate governance in order to enhance corporate value and make more decisive decisions in response to changes in the business environment. Part of this process is identifying the cost of capital before making major decisions

The revise code focussed on five main topics, but could have gone a lot further

2. **Investment strategy:** Strategic investments in fixed assets, HR and R&D are important for increasing corporate value over the longer term. Appropriate financial management is a core part of this process
3. **Appointment/dismissal of CEOs:** Boards need to play an active role in succession planning for the CEO and other top executives. They should also establish "objective, timely, and transparent" policies and procedures for appointing and dismissing senior executives
4. **Cross-shareholdings:** Companies should disclose and publicise their policies on the rationale for any cross-shareholdings as well as an annual assessment of the costs and benefits of such holdings, a specific voting policy for them, and any policies for reducing cross-shareholdings
5. **Asset owners:** Company pension funds are "asset owners" and should take measures to enhance their investment expertise through improvement of their human resources and operational practices.

While these are all important issues, they are probably among the least contentious amendments that could have been proposed (with the possible exception of cross-shareholdings). More contentious changes did not see the light of day, such as increasing the expected minimum number of independent directors from two to three (or one third), timing the AGM for later (ie, the fourth month), elaborating on the role of women on boards and in management, clarifying the definition of independent directors (especially with regard to business partners), elaborating on the role of audit committees within boards, and encouraging genuine cultural change within boards so more start to play a strategic and oversight role (not an operational decision-making function, as many clearly still do). Given the code is a "comply or explain" document, the amendments could have been more ambitious.

Our recommendations for ways to level the playing field

Moving shareholder rights forward

As there is not space here to cover in detail all the CG rule issues we perceive in Japan, we will focus on four key recommendations.

1. **Collective engagement and making important suggestions:** The FSA's February 2014 memo Clarification of Legal Issues Related to the Development of Japan's Stewardship Code was a useful starting point for understanding, among other things, how the joint holder (ie, concert party) concept under the large shareholding reporting rules worked. A core principle here is that investors need to carefully consider the disclosure obligations of entering into any agreement, such as for voting on company resolutions. These provisions are not unreasonable if the block of shareholders voting together is significant.

   What is unusual in Japan, however, is a prohibition against "making important suggestions" to companies on corporate governance, business strategy, financial management, and so on. The regulator advises investors to turn their suggestions into questions and merely engage in an exchange of information. This rule is excessively restrictive, in our view, and considerably dampens the scope and nature of investor-company dialogue. It is a problem affecting not just foreign investors, but also domestic investors who are seeking to collaborate. We recommend the FIEA be amended.

2. **Takeovers:** Japan's takeover rules require certain processes to be followed by listed companies upon receipt of a takeover bid. These include: the acquirer to disclose details of the takeover proposal; company management to disclose whether it is for or against the offer; and the takeover to be conducted between one and three months after the bid, so as to give shareholders sufficient time to consider it. The rules also require a mandatory general offer for all shares if an ownership stake reaches 33%.

   One important protection that Japan does not offer minority shareholders -but Hong Kong does - is a requirement for independent shareholder approval if the takeover results in a compulsory acquisition and therefore delisting. The Hong Kong Takeovers Code is strict on this point and sets high thresholds for shareholder approval. In contrast in Japan, as JPX announcements on securities under supervision indicate, boards of directors have the right to decide on takeover bids and delistings. We recommend this right be given to shareholders instead and Japan adopt similar rules as Hong Kong.

3. **Executive remuneration disclosure:** Instead of limiting disclosure to executive earnings more than ¥100m, we recommend the exact remuneration of all directors (both inside and outside) and at least the top five executives be disclosed on an annual basis. This has become the norm in leading markets such as Australia, while transparency around executive pay is growing across the region. The recent scandal at Nissan over the pay of Carlos Ghosn indicates the need for strong internal checks and balances over corporate governance generally and executive pay in particular. It also supports the value of a well-functioning remuneration committee with proper powers to supervise management pay.

4. **Definition of independent director:** While TSE listing rules set the basic definition for an independent outside director in Japan, companies are left to work out certain things for themselves, namely how to define the threshold at which a director from a business partner would cease to be considered independent. Companies have come up with different thresholds, which creates a degree of confusion in the market and among investors. The TSE is waiting to see what the de facto market standard is before firming up a rule. We recommend it firms it up as soon as possible.

Both hard and soft law are needed for a balanced CG regime

An important point to emphasise is we are not suggesting hard law is in some way superior to soft law. Both are critical for a healthy CG regime. The aim should be to get the balance right and ensure shareholders are not disenfranchised. If shareholders are to play their proper role as stewards of companies, they need to be able to trust that directors and the legal regime will treat them fairly. We believe this is an important component of creating long-term and sustainable value creation in Japan.

Note: ACGA is planning to update our White Paper on Corporate Governance in Japan in 2019. In that document we will delve into the full scope of CG rule issues in Japan and provide broader analyses and recommendations.

Christopher Richter
Senior Research Analyst
christopher.richter@clsa.com
+81 3 4578 8035

News reports indicate prior to his arrest, Ghosn was planning a full Renault-Nissan merger

Renault is not being allowed to appoint a replacement director . . .

. . . and will potentially be locked out until Jun-19

Renault's current influence on the board is far below its ownership ratio

The situation lays bare the problems stemming from Japan's lack of external directors

Management coup at Nissan

In November 2018, Nissan's board voted to oust Chairman Carlos Ghosn. We believe this was a management coup using alleged malfeasance by Ghosn to create leverage against top shareholder Renault to change the structure of the shareholding relationship between the two companies. We see the key question not as 'what did Ghosn do?', as the alleged actions go back many years, but rather: why now?

News reports indicate prior to his arrest, Ghosn was planning a full Renault-Nissan merger. In prior media comments, CEO Hiroto Saikawa, who took over from Ghosn, was clearly opposed to the idea of a merger. Initially, the optics about the timing of the arrest and merger looked terrible, and we hoped Nissan would combat that and share facts to maintain its credibility. As the week wore on, it increasing looked to us like the speculation was correct.

For example, Nissan has declined to send Renault details of the evidence collected about Ghosn, citing the ongoing investigation. However, without evidence, Renault has indicated it cannot evaluate its position on him. However, it nominated Thierry Bollare interim CEO, as Ghosn is incarcerated for the time being and cannot fulfil his official duties.

After dismissing Ghosn as chairman, and both Ghosn and Kelly as representative directors, but not fully dismissing them from the board, Nissan sent Renault a letter which said it would not allow Renault to name a replacement because Ghosn remains a Nissan director and, in Nissan's view, Renault isn't entitled to any further representation on the Nissan board. A Nissan spokesman said removing Ghosn as a director would require a shareholder vote (there is a Japanese legal distinction between director and representative director).

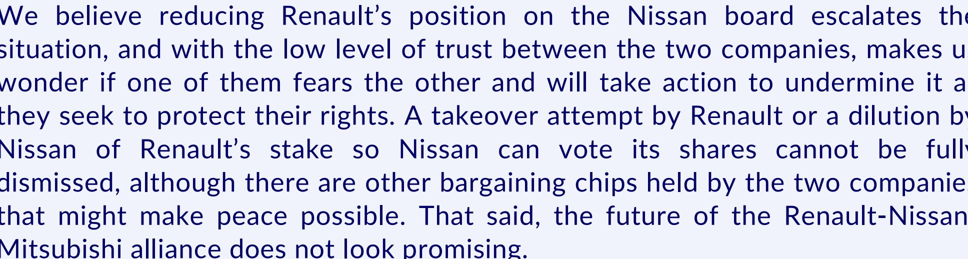
The latter is perhaps the strongest evidence yet that this was a coup rather than merely the reining in of a wayward executive. This effectively locks out Renault, Nissan's largest shareholder with a 43.7% stake, perhaps until the June 2019 shareholders' meeting.

Nissan Motor – Board of Directors

Name	Affiliation	Comment
Carlos Ghosn	Renault	Removed as chairman on 23 November
Greg Kelly	Renault	Removed as representative director on 23 November
Hiroto Saikawa	Nissan	CEO
Hideyuki Sakamoto	Nissan	EVP – manufacturing and supply chain management
Toshiyuki Shiga	Nissan	Vice-chairman, former COO
Jean-Baptiste Duzan	Renault	Former Renault director of financial operations
Bernard Rey	Renault	Former Renault Formula One team president
Keiko Ihara	Independent	Professional race car driver
Masakazu Toyoda	Independent	Former METI official

Source: *Automotive News* and CLSA

We do not see this situation as having positive implications for Nissan's corporate governance or corporate governance in Japan. It has laid bare the risk associated with the main defect in many Japanese companies' corporate governance: the lack of outside directors. We would expect pressure to change this practice to become overwhelming.



We believe reducing Renault's position on the Nissan board escalates the situation, and with the low level of trust between the two companies, makes us wonder if one of them fears the other and will take action to undermine it as they seek to protect their rights. A takeover attempt by Renault or a dilution by Nissan of Renault's stake so Nissan can vote its shares cannot be fully dismissed, although there are other bargaining chips held by the two companies that might make peace possible. That said, the future of the Renault-Nissan-Mitsubishi alliance does not look promising.

The future of the Renault-Nissan-Mitsubishi alliance does not look promising

While Ghosn has not been indicted yet for alleged wrongdoing, and he reportedly denies the charges, we see him as no longer relevant. He will not return to Nissan or Mitsubishi, and we see it as unlikely he will return to Renault. The two Renault-affiliated directors who viewed the evidence against him (but are not allowed to discuss it with Renault) also voted for his removal from Renault. Although the odds are low, an attempt by Renault to assert its shareholder rights could be a positive influence on Nissan's share price.

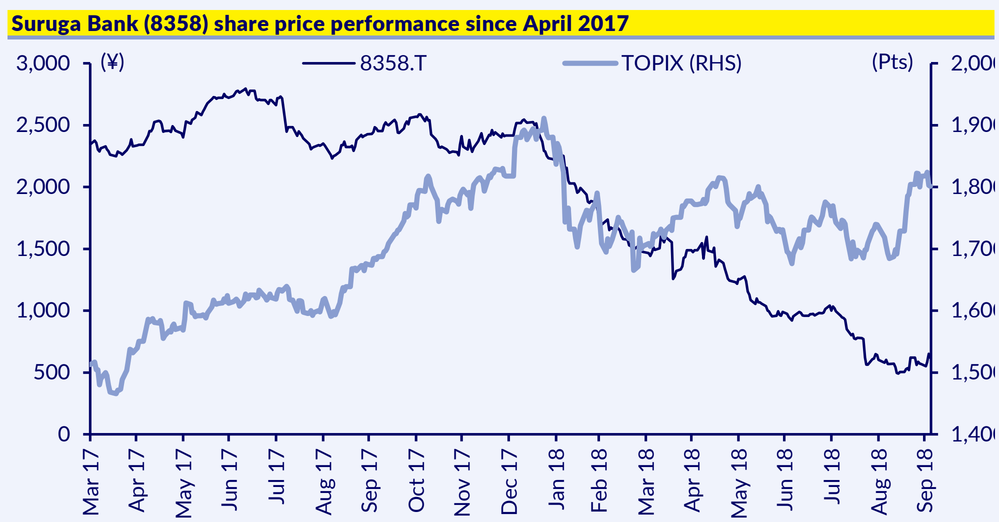
Hideyasu Ban
Senior Research Analyst
hideyasu.ban@clsa.com
+81 3 4578 8074

Fall from position as best in class bank

Suruga Bank (8358), a mid-sized regional bank, traded at a premium over its peers up to the end of last year, when improper lending practices were uncovered. In the past, its differentiated model focusing on retail loans in its niche segment resulted in double digit ROE and over 1x book valuation, while other regional banks struggled to maintain mid-single digit ROE and below 1x book valuation. Now its stated PBR is down to a lower end of the sector range.

Suruga Bank share price performance

Suruga Bank (8358) share price performance since April 2017



Source: CLSA, Factset

Bank went too far, because of the pressure for growth?

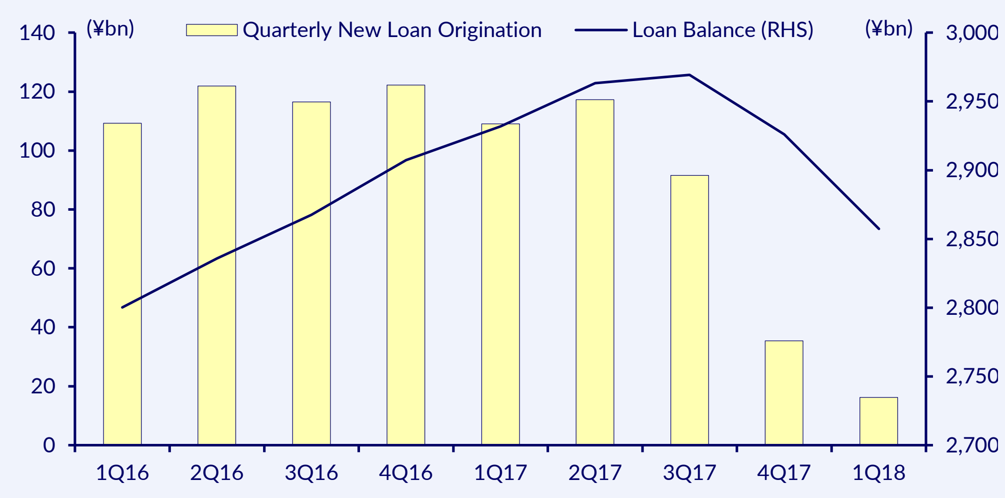
The bank specializes in retail mortgage lending. As of June, over 80% of its loan book was retail secured lending (regional bank average is 25-30%). It also focused on investment type mortgage loan products (customers invest in rental apartments and houses). Banks in general rely on the referral program of rental house developers for their customer acquisitions. The developers and brokers often prepare loan application documentation with and for their clients. Upon default of rental fee payment at a "shared house" operator, the bank said it found some documents were altered (cash flow projection, bank statement which back up the asset value of the properties and customer's credit worthiness).

The bank did not act until the issues were revealed

Back in June, the bank revised down its already disclosed F17 (ending March 18) earnings. That was followed by its June quarter earnings announcement in which its NPL ratio almost doubled from the Mar 18 level. Such a big change in the NPL numbers was as a result of reassessment of loan quality made under "inappropriate" procedures. It indicated further reassessment could lead to a bigger NPL and provisioning requirement in the following quarter.

New loan origination has plummeted

Suruga Bank (8358) retail loan trend: quick turnaround of new loan origination (resurrection of franchise) under new governance system seems to be critical



Source: CLSA, Company data

No monitoring over executive officers by the board and insufficient internal control and decision making system

In response to the earnings revision, the bank set up an independent committee to investigate the issues. The committee issued a report in September that indicated: the credit screening division reported the risks and issues to the vice president (who had deceased), but the information was not shared with the other management and board members; the front office had greater power so the checks and balances system did not work. The report also pointed out there was always pressure in terms of achieving very aggressive sales goals and the internal audit did not function.

Lessons learned

The founding family own about 15% of the bank and members were leading executive officers for a long time. According to its annual filing at Mar 2017, before the issues surfaced, the bank's board consisted of 11 members, and three were outsiders with diverse backgrounds. It also had three independent auditors. At least, for the formality, it had a comparable governance structure to the other financial institutions. But it did not have a proper communication system by which potential issues were shared with those outside members of the board and the auditing committee. The report pointed out the corporate culture was distorted under the influence of the founding family.

It has been reported the founding family is selling its shares in the bank, and the new management team expressed an intention to change the corporate culture. This again hammers home the truism that substance (communication system and corporate culture) is more important than formality (ie, governance structure).

John Seagrim
hideyasu.ban@clsa.com
+44 20 7614 7245

The view from our sales desk, John Seagrim, 16 October 2018

Squeeze-out provisions

There's a problem with NTT's takeover of NTT Urban - in fact there has been a problem with most, if not all, of the recent cash takeovers in Japan. The problem is that they have all included not one but two "squeeze-out" provisions; the first of which is understandable, but the second of which is not just reprehensible, it's thoroughly contemptible. I first came across the second provision with Panasonic's takeover of Panahome 18 months ago, but the adoption of this threatened second contemptible squeeze-out has become almost universal in subsequent cash tender offers.

The first, understandable, squeeze-out is the provision in Japan's corporate code that allows for the squeezing out of the remaining minority shareholders if the acquiring company has secured 90% or more of the target's shares - ie, if at least 90% of shareholders in the acquiree company tender their shares, then those that haven't are obliged to sell their shares to the acquirer at the same price.

But the second thoroughly contemptible squeeze-out (which is a blatant misuse of article 235 of the Japanese corporate code) is a resolution made by the board of the acquiree that, if less than 90% but more than 66.666% of shareholders tender their shares, then the board will undertake a massive reverse stock split which leaves all the holders of the remaining minorities with fractional shares (or odd lots) - and fractional shares or odd lots, by law, can only ever be sold back to the issuing company.

This is exactly what the board of NTT Urban has undertaken to do if less than 90% of NTT Urban's shareholders tender their shares to NTT. What is doubly egregious about the situation is NTT already owns more than 66.666% of NTT Urban - so even if not a single minority shareholder tenders their shares, it's a done deal.

The problem is this may be contemptible, unethical, immoral, not to mention an appalling abuse of minority shareholders, but, as it stands, it's not illegal.

What though is questionable - and should be challenged - is the fiduciary duty of a board to protect its minority shareholders - how can NTT Urban's board be acting in the interests of its minority shareholders when it has already undertaken to impose a reverse stock split to force this deal through, even if none of the minority shareholders want to tender their shares? Seth Fischer took issue with the board of Panahome over the same, and I believe is still pursuing the Panahome directors in court for a failure of their fiduciary duty to minority shareholders. Maybe if one's a shareholder of NTT Urban one should threaten do the same.

4. Listed companies

Japan ranks 8th with a score of 48%

Japanese companies scored well below what we expected in this category. While financial reporting standards are generally high among both large and mid-caps, we found some notable weaknesses. As expected, CG reporting was disappointing and ESG/sustainability reporting (which for us includes integrated reporting) was mixed. With the exception of clearer policies on dividends and buybacks, the quick release of audited annual accounts (through business reports) and the existence (though not necessarily performance) of internal audit

departments, company scores for board governance and leadership were generally average or mediocre. Simple things taken for granted in other markets, such as disclosure of director remuneration policy or director training, are quite limited in Japan. One positive development, however, is the recent emergence of a collaborative effort by leading companies to fight corruption in overseas markets.

Financial reporting

While financial reports are broadly sound, they contain some notable gaps

The accounts of the 15 large-cap and 10 mid-cap companies we surveyed in detail were robust in terms of the basic financial information provided on their P&L, balance sheet and cashflow statements. However, key gaps for some or all companies included:

- **Notes to the accounts:** For most companies, the business reports published prior to AGMs contain a reduced set of notes. While more detail is provided in the annual securities report, this is usually only in Japanese and comes after the AGM. More detailed notes are also contained in the 20F annual reports Japanese companies listed in the USA have to provide to the USA SEC. Normally the 20F reports are much more informative than annual securities reports. This applies whether firms are using USA GAAP or IFRS.
- **Operating expenses:** While nine of the 15 large caps reviewed provided a detailed breakdown of operating expenses in their notes, the remainder either did not or gave only limited information.

Companies report less on payables and receivables than they used to

- **Account receivables and payables:** A glaring finding was that none of the companies surveyed provided a breakdown of their receivables and payables - they gave only a simple line item in their balance sheets. Japanese companies used to provide figures on this in relation to their top five to 10 customers and suppliers, but they no longer have to do so.
- **Related-party transactions (RPTs):** There is inconsistency in the presentation of information on RPTs between the annual securities report, which provides aggregated data on total sales, purchases and other transactions with affiliated companies, and the business reports, which include the names of related companies, percentage ownership stakes, nature of their relationship with the parent company, nature of transaction, value of transactions, and so on.

CG reporting

CG reports are full of boilerplate

Once again, the quality and depth of reporting on corporate governance structures and practices by companies remains formulaic and only partially informative. While the new disclosure on the *Sodanyaku/Komon* issue is welcome, most companies provide only the barest of descriptions of what their advisors do - leaving the reader wanting much more. Ditto for the tables on independent directors and their relationship to the company - it is often not possible to understand whether a director is genuinely independent or not.

CG reports contain minimal information on board committees, training, evaluation, and remuneration

In terms of board practices, we found most of the companies surveyed did not provide enough information on the following activities:

- Board committee reports, including voluntary committees, and director attendance
- Director training - what, who, how often?
- Board evaluations - these tend to be simple statements saying the board as a whole is operating effectively

- Remuneration reporting - individual remuneration is only provided for board members paid more than ¥100m (ie, this would only apply to inside/executive directors). Disclosure is not required for executives paid more than this, but not on the board. Nor is information provided on fees paid to other individual board members or the company's policy for remuneration of independent directors (although the good news is that few are paid with stock options).

ESG/sustainability reporting

ESG, sustainability and integrated reporting of higher quality than CG reporting

It is often said Japan has the largest number of integrated reports of any market. It would be more accurate to say that it has the highest number of ESG reports that are called "integrated reports", since many of these reports do not actually follow the specific integrated reporting standard of the International Integrated Reporting Council (IIRC) in the UK. Nomenclature aside, our survey found a high standard of ESG reporting among six of the 15 companies reviewed, moderate reporting by another three firms, and dismal to poor among the remainder. This was a worse result than we expected.

Our survey found lots of holes in large-cap ESG reporting

While the better reporters provide long, detailed and generally interesting ESG reports, the general reporting landscape is as follows:

- Only about half of companies explain how they engage with their stakeholders
- Less than half provide a useful "materiality matrix" and/or list of the most critical ESG and sustainability issues they face
- Companies perform better in terms of explaining how they address the material issues they face, with 10 of the 15 giving some policy detail
- Companies also perform better at providing sustainability metrics, such as statistics on CO_2, waste emissions, electricity usage and so on (nine of 15)
- Only two of the 15 companies produce detailed sustainability targets, while another two gave some information.

In conclusion, most ESG reporting is backward looking, and few companies are genuinely linking this reporting to their long-term business strategies or challenges.

Board independence and diversity

Little information provided on board diversity or the value of independent directors

Although JPX statistics regularly show the percentage of independent directors at Japanese companies is rapidly increasing, with an increasing number of firms going beyond the expected minimum of two, little information is provided by companies on the value these directors add to the board, or even why they have been chosen. Nor is there much focus on diversity in gender terms: while the number of women directors is growing rapidly in absolute terms - from only about 100 in 2011 to 900 in 2017 - they still only account for 3.5% of all directors.

Only 9% of companies intend to increase the ratio of women on their boards

A METI survey of 874 listed companies in 2017 found only 9% intended to increase female participation, only 22% wanted to increase the number of external directors, and just 10% planned to diversify the experience of external directors. A mere 2% said they would increase the ratio of foreign directors.

Not surprisingly, our survey found minimal to no disclosure on board diversity policies. And only two of the 15 large caps had an independent chairman.

ACGA has ongoing concerns about audit committees in Japan

Audit committees and internal auditing

For a long time, ACGA has been concerned *Kansayaku* boards and audit committees under the three committee system do not, for the most part, provide the level of oversight of financial reporting and internal controls companies require. And even if some do, the level of disclosure of their work in most company reports is woeful.

The adoption of a new third system of board governance in 2015 has not allayed our concerns

Our confidence was not greatly enhanced with the adoption of a third board governance system in 2015, that of the Audit and Supervisory Committee Company. While more than 800 listed companies have moved from the *Kansayaku* system to this new system, many appear to have done so to meet the new independent director requirements (ie converting their outside *Kansayaku* into outside directors and calling them independent). Structural weaknesses in the first two systems are being replicated in the third, such as executive/inside directors being allowed to chair the new audit and supervisory committees.

Our survey found numerous weaknesses in internal audits and controls

Our survey found numerous problems with the system of internal audit and controls in Japan.

- Internal audit departments in traditional *Kansayaku* companies have no direct reporting line to the board of directors. In the recent Suruga Bank case, unlawful lending was reported to the *Kansayaku* board by internal audit, but was not escalated to the board of directors
- Risk mitigation strategies for identified risks are often not clearly explained
- Whistleblowing is mostly for internal use only and not open to the public
- Codes of conduct in most companies are not extended to suppliers.

About 80% of internal audit departments in Japan report to the chairman or president, not the audit committee

Recent FSA data supports a sceptical view of internal audit reporting lines and governance. It was found 80% of internal audit departments report to the president or chairman, not the audit committee, while only 10% report to the board meeting or the audit committee in the case of companies using either the three committee system or the new audit and supervisory committee.

On a more positive note:

A private-sector initiative organised by the UN Global Compact Network Japan released seven principles for fighting corruption

UN Global Compact Japan steps up anti-corruption campaign

In 1 March 2018, a group of volunteer lawyers and investors from the United Nations Global Compact Network in Japan (UNGCN) released the Tokyo Principles for Strengthening Anti-Corruption Initiatives. The UNGCN advocates a commitment by the upper echelons of management and enhanced disclosure of anti-corruption measures by companies that will foster better corporate behaviour and governance, and ultimately enhance corporate value.

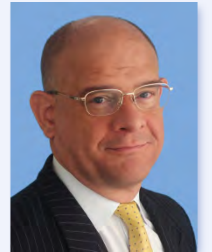
The Tokyo Principles cover seven areas:

1. Commitment and actions by top management
2. Adopting a risk-based approach
3. Establishment of fundamental policy and internal rules
4. Establishment of organisational structure
5. Managing third parties

6. Training

7. Monitoring and continuous improvement.

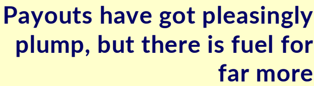
The working group also released a free anti-bribery assessment tool in conjunction with the Anti-Bribery Committee Japan. This 35-item tool allows companies to measure their adherence with the principles and assess areas of risk. The working group believes the tool will provide useful information that could be highlighted during investor-company dialogues, and be an aid to promote transparency and greater disclosure of non-financial information. It argues Japanese companies have fallen behind foreign firms in terms of disclosing their efforts to fight corruption. Since a growing number of Japanese companies have operations in emerging markets, the UNGCN hopes the tool will help raise corporate awareness of poor practices in such markets.



Nicholas Smith
nicholas.smith@clsa.com
+81 3 4578 8033

Dividends and buybacks

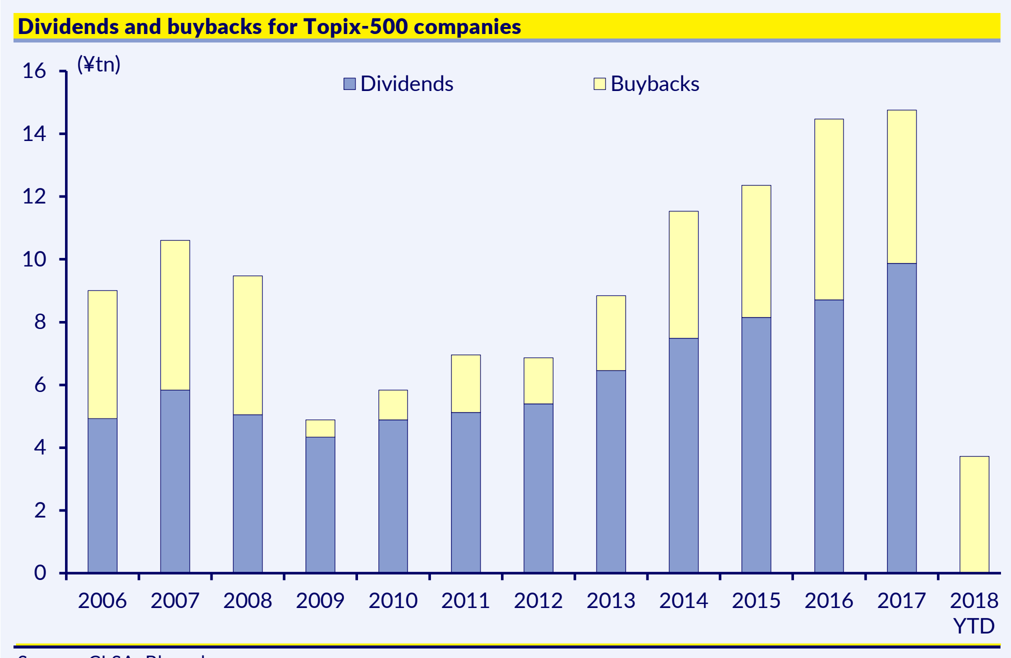
Since 2000, dividends per share have grown appreciably faster for Topix than for the S&P. Over the past decade, the cyclically adjusted dividend payout rate for Topix-500 companies is 39% (42% for non-financials). Buybacks, first permitted in 2001, are now comparable in size to dividends. The potential for further growth is large, given that 56% of Topix non-financials are net-cash, against less than 20% in the USA and European markets. We also look at companies where their holdings of other companies are worth more than their whole market cap - another case of excess capital being valued at essentially zero and so begging to be returned to shareholders. Companies announcing buybacks appear to perform far better in the USA, but it pays to look for companies likely to buy back for the first time because the response is far larger then.



Payouts have got pleasingly plump, but there is fuel for far more

Buybacks and dividends together came to 47% of profits in 2017

Dividends and buybacks for Topix-500 companies



Source: CLSA, Bloomberg

Robert Purcell
robert.purcell@clsa.com
+81 3 4578 8037

Kitz and Nifco

Kitz (6498, BUY) is Japan's top domestic producer of industrial valves and fluid-control products, essential fittings used in LNG plants, petroleum refineries and the construction industry. Atypical for a Japanese company, it has conducted a series of stock buybacks and cancellations since 2008. Specifically, over the past two years, it has bought-back and cancelled 17% of shares outstanding. At the same time, it has gradually raised its DPS from ¥9 per share in FY3/09 to ¥13 in FY3/17. Its official policy is for a 25% consolidated base dividend payout. Including buybacks, this equals an aggregate of one-third of total payout. It has also dispensed of more than half of its cross-shareholdings since 2016, in an effort to make its balance sheet more capital efficiency.

Nifco (7988, BUY) is a producer of plastic fasteners and connectors that speed time-to-assembly for auto OEMs. It has steadily become more shareholder friendly following the passing two years ago of its founder, Toshiaki Ogasawara at age 85.

Specific examples of improving corporate governance include disposal of noncore assets (sale of *Japan Times* newspaper), period share buybacks and cancellations, and a strategic review of all of its overseas subsidiaries to measure and assess capex at plant level in order to improve ROIC. Surplus capital has also been directed at acquiring two businesses in Germany with ties to Volkswagen and BMW. By overlaying higher value-added Nifco products onto these networks, management intends to raise incremental ROIC.

5. Investors

Japan ranks 2nd with a score of 53%

This is Japan's best-performing category in terms of rankings, and is well-deserved. Much of the credit goes to the FSA for introducing the Stewardship Code in 2014 and its work since to encourage investors to sign up to the code. The Government Pension Investment Fund (GPIF) has been aggressive in compelling its external asset managers to take the code seriously, while METI deserves credit for setting up various working groups to explore how to improve investor-company dialogue. At the same time, the Pension Fund Association has become active again, focussing in particular on the complex issue of cross-shareholdings, and helping to establish the first investor association dedicated to collective engagement (see below).

Stewardship Code

Japan's Stewardship Code has almost 240 signatories

As of mid-November 2018, 237 institutional investors had signed up to the code, comprising six trust banks, 170 investment managers, 32 pension funds, 22 insurance companies and seven signatories classified as others. An interesting feature of this list is that it contains both bondholders and equity holders. There is a sizeable proportion of foreign names among the investment managers, with some signing up more than once through different fund companies. And, more recently, a number of corporate pension funds have signed, such as those from the big banks (Mizuho, MUTB/MUFG, SMBC) and industrials like Eisai, Mitsubishi Corporation, NTT, Panasonic, and SECOM (the first to do so).

Group discussion and collective engagement

Regular investor discussion groups have been formed in recent years

While much of the stewardship work of signatories is carried out on an individual basis, the past few years have seen the emergence of discussion groups among investors and others. The first two were the Japan Stewardship Forum, an

informal discussion group, and the Forum of Investors Japan, which holds meetings about once a quarter on different topics of governance and stewardship, then summarises the views of members in written minutes available on its website: www.investorforum.jp

Until 2017, however, Japan lacked a formal association of institutional investors dedicated to the promotion of corporate governance. Then, in October 2017, a group of five organisations formed the Institutional Investors Collective Engagement Forum (IICEF) to carry out collective shareholder engagement with listed companies. The five founding members were the Pension Fund Association, Sumitomo Mitsui Asset Management, Sumitomo Mitsui Trust Bank, Mitsubishi UFJ Trust Bank, and Resona Bank. This development was significant, not only because it was the first attempt to create a formal organisation for institutional investors, but the focus would squarely be on collective engagement. (Note: The Pension Fund Association occupies a somewhat unusual position in Japan - it has long been an advocate for better corporate governance and greater shareholder involvement, but is actually an association of corporate pension funds. It also manages its own fund, whose assets are derived from corporate pension funds that have disbanded.)

IICEF published its first advocacy letter on 15 January 2018, focusing on the issue of ESG materiality and disclosure. It sent letters to a number of listed companies and held follow-up meetings. On 19 July, it wrote to companies that had suffered major scandals in recent years and requested meetings with their outside directors/corporate auditors to share investor perspectives on how to manage and effectively disclose such scandals. In October, it wrote additional letters on how companies should respond when they face large numbers of against votes at shareholder meetings and on takeover defence measures.

The Life Insurance Association has also formed a collective engagement group

The next noteworthy development came in March 2018, when the Life Insurance Association of Japan announced it would also set up a collective engagement consortium. The group comprised 10 major life insurance companies that are members of the association's Corporate Value Improvement Working Group. Its first initiative was a collective letter writing campaign to request improvements and dialogue with 100 companies on issues relating to shareholder returns, the election of independent directors, and disclosure of business plans.

Voting disclosure

Investors are now encouraged to disclose votes down to the individual company level

A major change in Japan encouraged, although not mandated, by the revised Stewardship Code was disclosure by institutional investors on how they have voted their shares at the individual company and resolution level. This was introduced to address potential conflicts of interest in the asset management industry, namely the perceived pressure on funds owned by banks and insurance companies not to vote against major corporate clients of the parent company.

While the reform has attracted criticism, a large number of funds have agreed to disclose

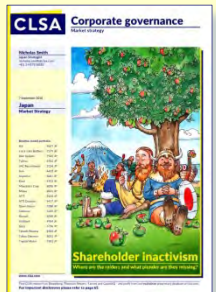
The reform has attracted criticism. Some fear funds will either not vote against management or merely vote against the easy issues, like low ROE figures or director retirement bonuses. Or that voting against will become the de facto way in which active stewardship is measured, thus minimising the importance of engagement with companies. On the other hand, the reform has clearly taken hold: as early as December 2017, more than 70 investment managers, trust banks and life insurance companies had started to do it, according to data from the FSA. (It should be noted that prior to this reform, institutions in Japan were disclosing aggregate voting data.)

The GPIF has been busy over the past two years

GPIF

The huge GPIF has had an active two years. Since 1 September 2016, when it held the first meeting of its Business and Asset Owners' Forum to discuss common issues of governance and stewardship, it has launched several initiatives. In mid-November 2016, it held the first meeting of another new discussion group, the Global Asset Owner's Forum, to share best practices on stewardship for pension funds. It carried out a survey of its external fund managers on the best corporate governance and best integrated reports in Japan. In June 2017, it published a set of stewardship and proxy voting principles for its external fund managers. In November 2017, the third meeting of the Global Asset Owners' Forum was arranged. In April 2018, it released the results of a third survey assessing how listed companies rate the stewardship activities of institutional investors. And in the same month, it held the fourth meeting of the Business and Asset Owners' Forum. It shows no signs of letting up just yet.

Nicholas Smith
nicholas.smith@clsa.com
+81 3 4578 8033



Shareholder inactivism

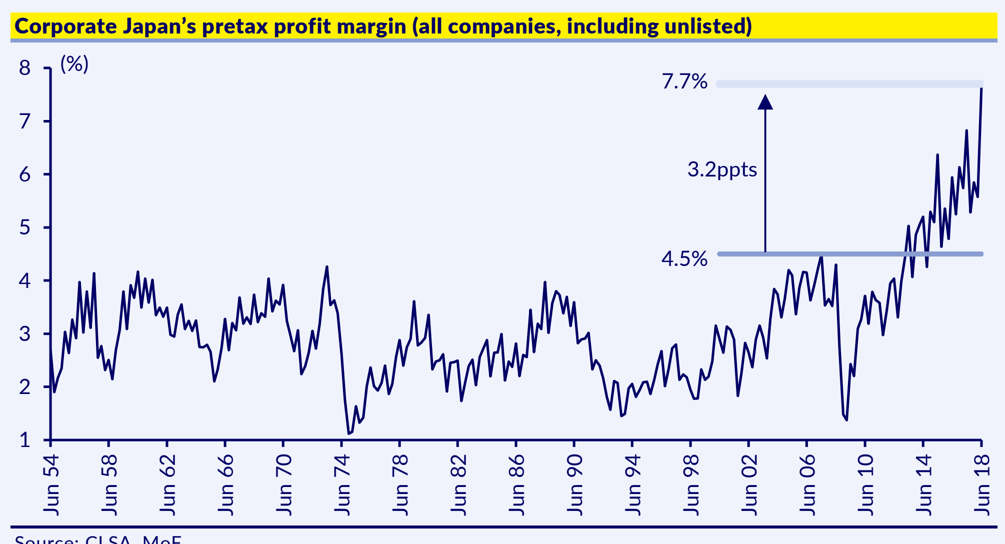
With dirt-cheap valuations and balance sheets bloated with excess capital, the Japanese market appears plump and ripe for the picking. But the feared foreign raiding parties, thus far, have been few and remarkably timid. Despite considerable powers given to shareholders, investors have mostly voted in line with company management. Profitability is at all-time highs, but the potential to raise returns far further by sweating lazy capital seems huge. What is needed is engagement.

Japan a huge outperformer, yet its shares have not kept pace with profits

Japanese profitability has soared under Abe to a peak half as high again as any in 64 years of data. Since he took office, Japan's stock market has outperformed all major markets except the USA - and by a wide margin. The driver has not been BoJ buying because earnings multiples went down, not up. Corporate governance reform has had a big impact, in turn driven by the pressing need to hike pension-fund returns by making a bond/equity switch, escaping dangerous overexposure to a bond market where almost 60% is in negative yield. Defined benefit makes up 96% of Japanese pension assets, so plans need to pay out whether they make money or not. For this switch to work, equities have to boost returns and build tattered trust. Japan is a country with little equity culture - 79% of people say they have never owned an equity, and 87% have never owned a mutual fund.

Profitability has improved beyond recognition

Corporate Japan's pretax profit margin (all companies, including unlisted)



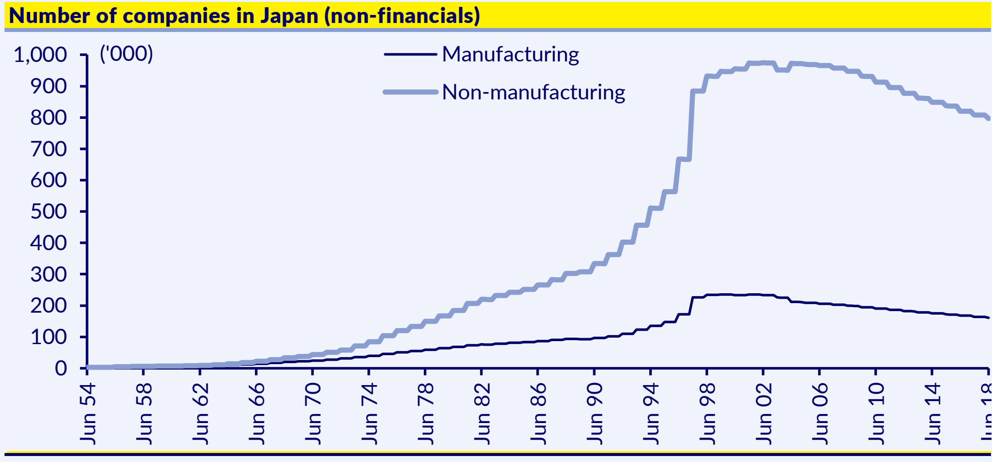
Source: CLSA, MoF

Japan has gone from bubble to anti-bubble; profitability surged unnoticed

The Japanese market has gone from bubble to anti-bubble: almost 40% of Topix stocks trade below tangible book; 22% trade below 5x EV/Ebitda; and negative enterprise values are not rare. Dividend yields are comfortably above those in the USA and 220bps above the 10-year JGB alternative. No longer an ROE basket case, returns have caught up with continental Europe but trade at almost 30% lower PBs. But while profit margins have expanded, balance sheets have got even stodgier - making further ROE improvement potentially relatively simple - through investor engagement. The shrinking population is forcing firms to exit noncore businesses, while tax changes are driving a cull of zombie businesses, allowing real companies to start to make real money. The secular surge in profitability still has plenty of upside potential.

The zombie cull has begun

Number of companies in Japan (non-financials)



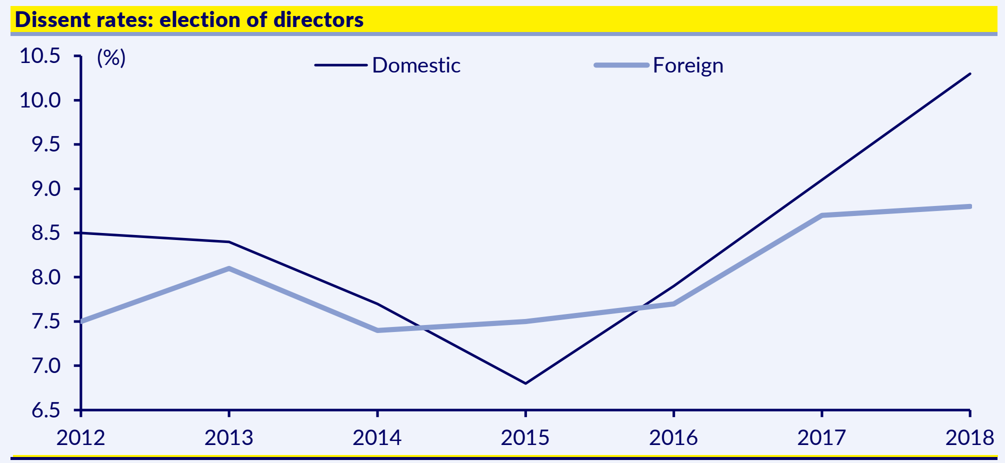
Source: CLSA, MoF

Shareholders have considerable powers, but fail to use them

Japanese law gives shareholders considerable powers often lacking in other stock markets, but it cannot force them to use those powers. Although this was the first year institutional investors had to disclose how they voted at AGMs on both a company by company and line item by line item basis, with the aim of naming and shaming those who vote contrary to their fiduciary responsibilities, the vast majority of shareholders still voted in line with company management. An analysis of the Benthos proprietary database of AGM results reveals the percentage of CEOs with re-election support rates of over 95% fell from 63% in 2016 to 46% in 2018, yet shareholders did not vote out a single CEO, despite a large population of ROE dwarves failing to cover their cost of capital over extended periods. Sadly, most of the shareholder proposals were rejected. Foreigners, while blaming cross-shareholdings for problems, surprisingly dissent less than domestic investors.

Dissent rates from foreigners are even lower than for domestics

Dissent rates: election of directors



Source: CLSA, ICJ

6. Auditors and audit regulators

Japan ranks 5th with a score of 71%

Japan exhibits both marked strengths and weaknesses in this category. In line with the complexity theme, it allows listed companies to follow one of four accounting standard frameworks: J-GAAP, as issued by the Accounting Standards Board of Japan (ASBJ); IFRS; Japan's Modified International Standards (JMIS); and USA GAAP. As the Japan Institute of Certified Public Accountants (JICPA) explains: “JMIS are a new set of accounting standards inaugurated by ASBJ in 2015 and developed based on the endorsement process of accounting standards and interpretations issued by the International Accounting Standards Board (IASB).” JICPA also notes the “voluntary application of IFRS Standards is continuously expanding”. While the direction of travel is broadly positive, we hope that accounting standard setters review financial reporting in Japan and find ways to fill the gaps highlighted in our Listed Companies section.

Auditor self-governance

Japan adopted an audit firm governance code in 2017

Given the numerous accounting and data frauds in Japan in recent years - which to an extent reflect a failure also of auditing - one of the more pertinent audit-related reforms has been the adoption of an audit firm governance code. First promulgated by the FSA on 31 March 2017, the Principles for Effective Management of Audit Firms comprises five principles and related guidance for enhancing audit quality and CPA firm governance. It was primarily intended for large-sized audit firms conducting audits of major listed companies, but other firms can voluntarily apply it. Based on "comply or explain ", they are:

The five principles in the code

1. Audit firms have a public interest role to ensure the credibility of financial information through audits, and should seek to protect stakeholders
2. Audit firms should have effective management and continuously enhance audit quality
3. Audit firms should have a function for supervising and evaluating their management from an independent viewpoint (ie, appoint independent persons to their boards)
4. Audit firms should develop an operational structure to effectively manage their organisations, including HR policies and staff retention
5. Audit firms should explain their implementation of the code so as to allow capital market participants to assess the quality of their audits.

As of 1 October 2018, 15 CPA firms had adopted the code according to FSA data.

KAMs can wait

Japan has been slow to adopt the new long-form audit report

Less impressive has been Japan’s approach to adopting the new long-form audit report with key audit matters (KAMs). Although launched by international audit standards setters in December 2016, and adopted by most major markets in Asia and globally, JICPA and local audit firms have argued they need more time to develop practical guidelines for KAMS in Japan. The first such reports will not appear until the financial year 2020 (ending on 31 March 2021). Other revisions will come into effect 12 months earlier.

Audit inspections and enforcement

Japan’s lead audit regulator, the CPAAOB, is part of the FSA

The lead inspection agency and audit regulator in Japan is the Certified Public Accountants and Auditing Oversight Board (CPAAOB), an entity that is part of the FSA. CPAAOB carries out regular inspections of the Big Four firms once every two years, then follows up with a somewhat lighter inspection in the intervening

years. Second-tier audit firms are inspected every two to three years, while smaller firms are inspected only on an as-needed basis. In 2012-2016 it carried out 54 inspections, of which 10 were targeted at the Big Four, seven at second-tier firms, and 36 at small and medium-sized audit firms. The average number of individual audit engagements reviewed during each Big Four inspection is slightly less than eight.

In terms of sanctions emanating from CPAAOB inspections, the numbers are small. In each of the past five years, they have ranged from one "recommendation to the FSA" to four or five. CPAAOB instead shares its findings on operational management, quality control systems and audit engagements with the firm and engages in dialogue with it. It grades its overall assessment on a five-point scale from "generally satisfactory" (quite rare) to "extremely unsatisfactory" (which normally results in a recommendation to the FSA, because deficiencies are significant and it is unlikely the firm will undertake voluntary remediation).

Complementing CPAAOB's inspection process is a regular review undertaken by JIPCA of quality control practices at audit firms. Although JICPA's quality control review was originally conducted as part of the self-regulatory mechanism within the auditing profession, it was incorporated into the CPA Law in May 2003. Since then it has had to report the results of its reviews to CPAAOB, with the latter seeking further information and conducting on-site inspections as necessary of audit firms, audited companies, and JICPA itself.

Telling the story

Read the Monitoring Report for insights into the auditing industry

Although CPAAOB publishes limited information on itself in terms of budgets and capacity building, it does publish some helpful reports on its own work and the auditing industry in Japan. Each year, for example, it releases a Monitoring Report which provides an introduction to the inspection and quality control reviews programme for audit firms (as outlined above), as well as useful statistics on the audit sector (number of CPAs, audit firms, changes in auditors, IPOs, number of firms adopting IFRS and who audits them). The report also goes into detail on the operation of audit firms (structure of firms, fees, audit teams, partners, education and training of auditors, and so on). If you want a detailed understanding of the auditing industry in Japan, and how it interacts with listed companies, it is an excellent resource and unusual in the region for its level of detail.

Each year the CPAAOB outlines it priorities for the coming year

CPAAOB also publishes an annual set of priorities, its Basic Plan for Monitoring Audit Firms. The most recent was published in July 2018 and covers the year until the end of June 2019. Not surprisingly, it touches upon issues relating to the audit firm governance code, recent accounting scandals, and the implications of the greater use of IT in audits for cyber security risk, among other things.

Read the Case Report for insights into audit quality

The third informative document is the Case Report from Audit Firms Inspection Results. As its name suggests, it summarises the findings of CPAAOB's inspections and highlights deficiencies/areas for improvement in audit firm quality control systems and audit engagements. It provides an excellent insight into the strengths and weaknesses of auditing in Japan. It is not a page-turner, but well worth the read.

7. Civil society and media

Japan ranks 3rd with a score of 62%

Japan's diverse civil society and self-funded non-profit sector, as well as an increasingly experienced media, have resulted in a strong score and ranking in this category.

Director training

Director training in Japan is going from strength to strength

There are a range of organisations undertaking director training in Japan. One of the first was the Japan Association of Corporate Directors (JACD), founded by a group of senior executives in 2002. In 2009, the Board Director Training Institute (BDTI) of Japan was created as a "public interest" non-profit (not an easy designation to get in Japan). Other entities run seminars and conferences for directors and company managers on corporate governance from time to time, including JPX, the large accounting firms, and universities.

Professional and CG associations

Many professional associations take an active interest in CG

In contrast to many markets in the region, professional associations in Japan tend to take a strong interest in corporate governance and ESG. This group includes, the Japan Investor Relations Association, the Japan Investment Advisors Association, and the local branch of the CFA Institute.

The Japan CG Network undertakes education, training, research and some advocacy

The most sustained focus, however, comes from the Japan Corporate Governance Network (JCGN), a non-profit organisation formed in January 2012 through a merger of the Japan Independent Directors Network, the Japan Corporate Governance Forum and the Japan Corporate Governance Research Institute. It holds regular seminars and study groups that are well-attended by members and provides training to directors and board secretariat members. Its research arm, now called the Japan Corporate Governance Institute, carries out a regular survey of company governance, the JCG Index Survey. And it contributes letters on regulatory policy.

Private-sector involvement

The private sector also participates in CG advocacy and research

A range of financial institutions, accounting firms and IR companies are actively involved in CG/ESG research or awareness-raising. Nomura Research Institute (NRI) runs a regular IFRS Digital Reporting Workshop bringing together institutional investors and companies. KPMG Japan carries out surveys on how investors and companies view the new world of stewardship. The IR divisions of MUTB (Japan Shareholder Services) and Mizuho Bank (J-IRIS) produce detailed research on AGMs and proxy voting. Private IR firms are also active: J-EURUS and IR Japan. (Note: ACGA has collaborated with KPMG, MUTB, and NRI in recent years.)

Academia and media

Academics play an influential role in CG reform

Academics from disciplines such as law, management and finance have long played an influential role in CG reform. They helped found the Japan Corporate Governance Forum in the mid-1990s and developed its first Corporate Governance Principles in 1998. They are called upon to chair the specialist FSA expert councils and METI study groups set up to discuss issues of CG and ESG, while legal academics sit on MOJ committees formed to review the company law.

Media coverage of CG has become more open and balanced

As for the media, it would be fair to say the past 10 to 15 years has brought a steady improvement in the quality of reporting on corporate governance - from the often sensationalist and xenophobic articles on "foreign raiders" in the 2000s to a more open and balanced assessment today of Japan's CG strengths and weaknesses and the positive role that different stakeholders, including foreign investors, can play. It is also evident there are more senior reporters today with an interest in CG.

Stephen Barker
stephen.barker@clsa.com
+81 3 4578 8038

Takeda: Response to concerns over acquisition of Shire

A small but vocal group of shareholders is actively opposing Takeda's plan to acquire Shire

A small but vocal group of shareholders is actively opposing Takeda's plan to acquire Shire. This group, centred upon former staff, has generated significant publicity for its cause, well out of proportion to its ownership or influence on other shareholders.

Takeda has very good corporate governance and the proposed acquisition is both highly accretive to EPS and an excellent strategic fit. Takeda's board of directors and management have been highly transparent about their motivation for proposing this deal. And management's explanations seem to have been accepted since the vast majority of Takeda's shareholders seem likely to vote in favour of the proposed deal.

EGM is coming up, and likely to favour management

To proceed with this deal, Takeda's board will need to call an extraordinary general meeting of shareholders and secure 67% of votes in favour. Voting results at the AGM in June indicate management will have no problem securing the votes it needs. It seems likely Takeda will hold this EGM in December, potentially clearing the way for the deal to close before the end of this calendar year.

Shareholders opposed to Takeda's plan to buy Shire have rallied together to form a group, which they have dubbed Thinking about Takeda's Bright Future (TTBF). The group of about 130 shareholders is estimated to control less than 2% of Takeda's shares, but does have some limited star power in the form of Kazu Takeda, a descendant of the founder of the 237-year-old company.

Japanese media has lavished attention on TTBF

Partisan Japanese media – which routinely ignores the legitimate concerns of professional activist investors – has lavished a lot of attention on TTBF. But the influence of TTBF on Takeda's shareholders has been minimal. It sponsored a proposal that would have forced the board to seek explicit shareholder approval for any acquisition valued at more than $10bn. This was widely viewed as a sort of referendum on the plan to buy Shire. It received less than 10% support.

TTBF has published its concerns in an open letter to Takeda's CEO, questioning the substantial debt Takeda will assume and the premium it has agreed to pay for Shire's shares. But management has repeatedly addressed these concerns, and any response it makes will reiterate the same points. It is CLSA's view, and the view of the vast majority of Takeda's shareholders, that the planned acquisition will make it a stronger company.

More about the opposition to change rather than corporate governance

The biggest lesson from this ongoing episode has less to do with Takeda's corporate governance and more to do with the enduring opposition to change among Japanese management, both active and retired. If it were to change its strategy in response to the backward looking nostalgia of a group of Takeda OBs and their mouthpiece - who just happens to share his name with the company - then that would be a scandal indeed.

Takeda President Christophe Weber

Takeda President Christophe Weber

Source: CLSA, company

Recap and recommendations

Recap of CG Watch 2016

Japan has made limited progress on our 2016 recommendations

How has Japan responded to the recommendations in our 2016 survey?

Figure 3

Japan: recap of 2016

	Recommendations	Outcomes
1.	Refine definition of independent director on business relationships	No progress
2.	Combine all non-financial and CG information in a single report	No progress
3.	Listed companies to set later record dates and hold later AGM	No progress
4.	More CG reports in English	Some progress - but still less than 12% of TSE First Section companies
5.	More director training for both inside and outside directors	Some progress - but hard to ascertain since disclosure is poor on this point

Source: ACGA

Downgrade watchlist

What to avoid

Factors that could force the Japan market score to fall in 2020:

- No progress on the five areas listed above
- No effort to balance soft law reform with critical hard law changes
- No improvement in enforcement, or disclosure of budgets and capacity building
- No further progress on streamlining fragmented financial reporting
- No improvement in disclosure areas highlighted in Listed Companies
- Investors face ongoing legal challenges to collective engagement.

Quick fix list

What to fix

Issues to address as soon as possible:

- Definition of independent director
- Provide detailed guidance on collective engagement and, ideally, remove the prohibition against making "important suggestions"
- Set quotas for AGMs to encourage companies to spread out their meetings
- Mandate disclosure of *Sodanyaku/Komon*
- Undertake systematic review of weaknesses in shareholder rights.

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
+852 2160 1788

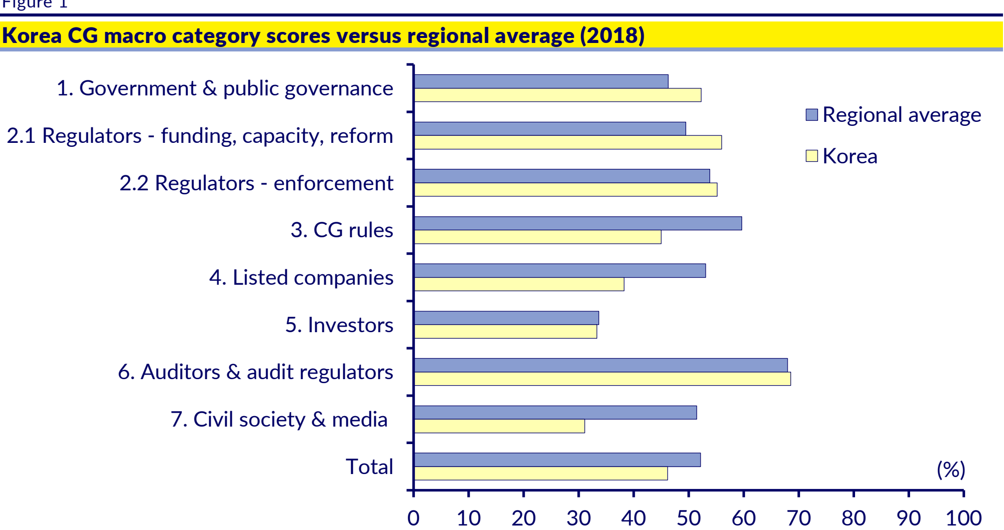
Korea - New Moon rising?

- The new Moon administration brings hopes of deeper CG reform, delivers some changes, but then spectre of dual-class shares spoils the party
- Fair Trade Commission takes on unfair trading practices at *chaebol*, other regulatory enforcement gets better
- New external audit act brings strong government intervention in audit firms
- "Comply or explain" introduced for revised CG Code - but its scope is limited
- Stewardship Code introduced for investors; NPS signs up in July 2018
- No improvement in policy of rotating government officials quickly
- CG disclosure among top companies improving, but standards generally low

Korea ranks 9th with a score of 46%

Figure 1

Korea CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

Korea's ranking this year, but *not* her score, can be compared with our 2016 survey

Korea ranks ninth again in this year's CG Watch, with a score of 46%, based on our more comprehensive survey and revised scoring system. It is important to emphasise that while the market rankings in this survey can be compared with our last survey in 2016, the overall scores cannot. The fact that Korea's score of 46% is lower than the 52% she gained in 2016 does not mean that CG standards are falling. Rather, the outcome is simply different as a result of our tougher scoring system, new questions and revised survey structure. Indeed, the same pattern can be seen in most markets in this survey, including the highest ranking ones. *(For more details, please see our "Methodology" in Section 1.)*

Despite making progress, systemic weaknesses hold down Korea's ranking

Korea does however perform well in two categories - Regulators and Auditors & audit regulators - and is showing improvement in others. The government has focussed on regulatory improvements in certain areas, especially auditing, financial sector governance and enforcement of fair trade laws, and it has quite actively promoted policies on "comply or explain" and 'investor stewardship'. Yet in objective terms, the Korean CG system remains significantly weaker than most of its competitors in Asia-Pacific and successive Korean governments have failed to make headway on core issues of corporate accountability, shareholder rights and the official appointment system.

Optimism greeted the arrival of the Moon administration . . .

When the new Moon Jae-In administration came to power through national elections in early May 2017, there was optimism that this reformist government would make real progress on both public and corporate governance reform. At first it did not disappoint. The government took tough action against breaches of unfair trading and related-party transaction rules, instituted new rules on auditor independence and sought higher standards of governance for financial companies, among other things.

. . . but recent months have followed the usual playbook

Yet the past year has also shown how difficult CG reform is in Korea and how easily government policy can be overwhelmed by macro-economic and political considerations. In early 2018, the government floated the idea of allowing small and medium enterprises (SMEs) a wider range of financing options through the issuance of dual-class shares (DCS). In October, this plan became a stated policy of the ruling Democratic Party. Meanwhile, a slowing export sector and nervousness about the China-US trade war prompted the government to find ways to boost growth and jobs. Such macro concerns are understandable and need to be addressed by government, but where does this leave systemic capital market and corporate-governance reform?

Societal tolerance of corruption and official/corporate misbehaviour is on the decline

Some things, however, do appear to have genuinely changed over the past two years. Perhaps the biggest development has been in societal attitudes towards both public and private-sector corruption as a result of the impeachment of Park Guen-Hye in late 2016/early 2017. Expectations of officials and business leaders are now significantly higher. There also appears to be a greater awareness among global Korean companies that they must benchmark themselves against global standards of governance and sustainability, not local standards. There has also been some rapprochement with institutional investors on issues of board diversity and dividend payments—but not enough yet to have a marked impact on the “Korea discount”. Is a new moon rising on public and corporate governance in Korea? On balance that seems to be the case, but if so it is for reasons that go well beyond the current administration.

1. Government & public governance

Korea ranks 6th with a score of 52%

When the Moon Jae-In administration came to power following the impeachment of President Park Geun-Hye for corruption, there were many grounds for optimism. A leading CG advocate, Professor Kim Sang-Jo, became the new chairman of the Fair Trade Commission (FTC), while Professor Jang Ha-Sung, one of the earliest and internationally famous CG proponents from Korea, became a senior economic adviser. Moon’s assumption of power was preceded by some important policy developments: the country’s outdated CG Code of 2003 was revised and reissued in August 2016 and its first Stewardship Code was published in December 2016. Regulatory agencies used the hiatus of the impeachment and the weakened state of traditional opponents to reform, in particular the powerful business lobby, the Federation of Korean Industries, to drive through these changes. The stage was set.

The government hit the ground running on enforcement and made some reforms

At first all seemed to go according to plan. Within a few months, the FTC took tough action against breaches of unfair trading and related-party transaction rules. The Financial Services Commisssion (FSC) pushed through a major amendment of the Act of External Auditors to radically revamp auditor independence in Korea. And the Moon administration approached reform of the Commercial Act, the company law, in a tactically sensible way. It said that it would not seek dramatic changes quickly—something it could not achieve in any

case since it lacked the numbers in the National Assembly to force change through—but would appeal to the leading conglomerates, the *chaebol*, to make voluntary reforms.

Yet reform momentum is slowing as attention turns towards the economy

Yet contradictions and distractions started to appear quite quickly. Kim Sang-Jo mused in January 2018 on the idea of allowing DCS for smaller firms seeking a listing on KOSDAQ, the second board for high growth companies—this is now an official policy of the ruling party. There has been no clear direction on reform of the Commercial Act around basic issues of corporate governance, while opposition in the National Assembly to even the most modest of company law amendments has stymied progress. Meanwhile, in response to a worsening economic environment, much of the policy focus during mid- to late-2018 has been around innovation, deregulation, job creation and supporting SMEs. Under the banner of creating a "fairer economy", the government has also been trying to push "income-led" growth through hikes in the minimum wage—something that SMEs predictably say is hurting them. Once again, it feels like short-term economic imperatives are overwhelming longer term corporate reform possibilities—a recurring theme in Korea.

Bank governance

Financial institution governance is a major focus of the FSC

The governance of banks and financial institutions in Korea has been an important feature of regulatory policy since oversight failures of mutual savings banks in 2011-12. This led to the creation of a new Financial Consumer Protection Agency, followed by a model code of corporate governance for banks in 2014, and then a new financial institutions governance law in 2015 (which came into effect from 1 August 2016). Some banks, such as Shinhan Financial, took these reforms seriously, and others, such as KB Financial, allowed shareholders to start nominating independent directors.

A new code of best practice for conglomerates with financial subsidiaries

Reform of bank and financial institution governance is ongoing. In late January 2018, the FSC announced a plan for enhancing the supervision of "financial conglomerates" (ie, non-financial groups that have significant financial subsidiaries but are not covered by conventional supervision). It said it would start with a draft code of best practice, which was produced in April and finalised in July. Although a legislative amendment has been sent to the National Assembly, its status is unclear and media commentary suggests that the debates will be heated.

New CG rules for financial firms unveiled in March 2018

Shortly afterwards, in March 2018, the FSC announced a series of new governance rules for financial firms, saying that further changes were necessary because the governance of such companies "still falls short of expectations of shareholders and financial consumers in ensuring transparency and accountability". The new rules would cover four main areas: extending the "fit and proper test" from just the largest shareholder to all major shareholders; the CEO nomination process; compliance and internal controls; and remuneration disclosure. The Commission announced on 11 September 2018 that the amendment bill had passed the Cabinet and that it would be submitted to the National Assembly in September.

Arguments in the National Assembly over the "fit and proper test"

The National Assembly is currently debating this bill, with disagreement in particular over the "fit and proper test". The plan to expand this clause to all major shareholders was withdrawn as recommended by the Regulatory Reform Committee, which felt the regulatory coverage was too broad and the impact analysis of such regulation insufficient. However, on 20 November 2018, one

ruling party politician, Dongsu Yoo, proposed an amendment to revive the clause to cover all major shareholders. He argued that shareholder decisions were often carried out collectively, rather than individually, hence it was necessary to include all major shareholders in a "fit and proper test".

Some investors fear banks are over-regulated

While the measures outlined above appear sensible, some institutional investors fear that banks are over-regulated in Korea. As one told ACGA: "My biggest issue with the financial groups is too much regulation, even into operational issues. There is no differentiation among the financial group companies and they cannot make shareholder friendly policies by themselves." Still, one problem from the past - the tendency of governments to interfere in the running of large banks, with CEOs and even board members changing whenever a new president takes charge of the country - has diminished under the new administration.

Anti-corruption blues

Korea ranks in the middle of international surveys on perceptions of corruption

In terms of levels of corruption, Korea occupies a middle position in international rankings. Having ranked 46th in the Transparency International (TI) *2013 Corruption Perceptions Index* survey, it came 51st in 2017. Among the 31 markets covered in Asia-Pacific, it ranks 9th, below the usual suspects as well as Brunei and Bhutan, but above Malaysia, China, India, Thailand, Indonesia and the Philippines and a swathe of smaller countries. TI's comment on Korea is that its score has remained "fairly stable" over the past six years (at around 54-55). Korea also receives a modest rating in the PERC Asia Pacific Risk Guide: a score of 45, compared to Taiwan at 55, Hong Kong at 71 and Singapore at 92.

ACRC in Korea only has jurisdiction over public-sector corruption

The agency tasked with mitigating corruption in Korea is the Anti-Corruption & Civil Rights Commission (ACRC), launched in February 2008. Its powers are limited to investigating public-sector corruption and, in this context, it also acts as the ombudsman for public complaints about government administration. Under the new government, the ACRC has a new goal - to turn Korea into a "nation free from corruption" - and a new eight-point plan to strengthen its role as the "anti-corruption control tower".

ACRC is quite well-resourced, but it has much to do

While it seems well-resourced in terms of staff - 518 in 2017 - and budget - ₩74bn (US$66m) - it is difficult to assess how effective the agency has been. Its annual report describes an agency that is working hard on several fronts and dealing with thousands of cases and complaints. Yet the perception among people we speak to in the financial markets is that it is rather weak. Indeed, the ACRC's own website quotes a survey, albeit from 2014, indicating that 63% of people "believe Korean society is corrupt" - hardly a ringing endorsement of its work to that point. Such findings led directly to the passage of the "Improper Solicitation and Graft Act" in September 2016.

The new anti-graft act appears to have had an impact in its first year

The Act appears to have had some impact. During its first 10 months, a total of 4,052 violations of the Act were reported, according to ACRC's 2017 annual report, although the majority of these (almost 3,200) were for not properly reporting honorariums paid for giving outside lectures. More substantively, there were 242 cases regarding "improper solicitation" and 620 cases involving the "acceptance of money or valuables". In terms of follow-up enforcement action, 121 cases were referred to investigative agencies or requests made for administrative penalties. Of these, administrative fines or disciplinary action were imposed in 29 cases, while 11 cases resulted in prosecution.

A public survey indicates that most officials think corruption has declined . . .

In September 2017, the Korea Institute of Public Administration released the results of a survey of the attitudes of more than 3,000 people regarding the impact of the Act. The results were quite revealing:

- 90% of public servants and 85% of officers of organisations related to public service said they had experienced a decrease in the occurrence of being offered entertainment or gifts.
- An "overwhelming majority" of respondents, including almost 86% of public officials and 80% of employees of organisations related to public service, believed that "fairness in performing public duties had been enhanced".

. . . but ordinary citizens and journalists are more sceptical

- Yet ordinary citizens and journalists took a somewhat more sceptical view: only 57% of the former and 43% of the latter agreed that there had been an improvement in the "impartiality of public officials" following the Act.

Paul Choi
Head of Research - Korea
paul.choi@clsa.com
+82 2 397 8520

Light at the end of the tunnel

Corporate governance in Korea is still lags regional and global peers. Management transparency is less than stellar, abuse of minority investors is still quite frequent and capital return to shareholders is low. Therefore, it is no surprise that Korea has scored low in CLSA's CG survey, historically.

However, there is evidence that things are changing. There has been a notable decline in the incidents of corporate governance abuse by owners or management in the past year or so. Minority voices have also become noticeably louder, albeit from a very low base.

Sentiment has improved for mergers and acquisitions

An example is the change in sentiment towards mergers. Korea's minority investors have historically suffered significant disadvantages during past mergers and acquisitions due to a lack of mandatory-bid rules and the mandating of all mergers based on market price. While the rules and law have not changed, two recent cases indicate shifts in sentiment:

Hyundai Motor cancelled a split and merger contract amid opposition from minority investors

- **Hyundai Motor group withdraws from Mobis-Glovis merger (2018):** In March 2018, Hyundai Motor group (HMG) officially announced a spin-off of Mobis, a merger with Glovis and a share swap by the Chung family - simultaneously. Amid opposition from minority investors, most notably US hedge fund Elliott Management, on the controversy around the merger-split ratio, HMG held a board meeting in May and decided to cancel its split and merger contract. It acknowledged there had been insufficient communication with shareholders and the market during the preparation of the restructuring plan. International proxy advisory services also had advised against the merger, but the cancelation was mainly due to minority investors' opposition. As HMG still needs to solve its circular holdings, per FTC policy direction and the movement of the other chaebols, the company will need an alternative restructuring plan.

KB Financial's chairman actively supported the premium of tender offer price to prevent shareholder objections

- **KB Financial merger of KB Insurance (2017):** Last April, KB Financial announced a tender offer for the remaining 60% stake in KB Insurance (KBI) at an 18% premium to the 52-week high of ₩33,000. KB Financial's chairman actively supported the premium for the tender offer price to prevent shareholder objections, as had happened with the acquisition of Hyundai Securities in May 2016. Shareholders against the tender offer may swap their KBI shares with c.0.57 KB Financial treasury shares. Appraisal rights were given to dissenting minority shareholders at a ₩27,495 share

price, a 17% discount to the tender offer price to restrict exercise of appraisal rights. Out of the remaining 60% stake in KBI, 54.5% of shareholders agreed to the tender offer price, while 5.7% of shareholders preferred the share-swap deal.

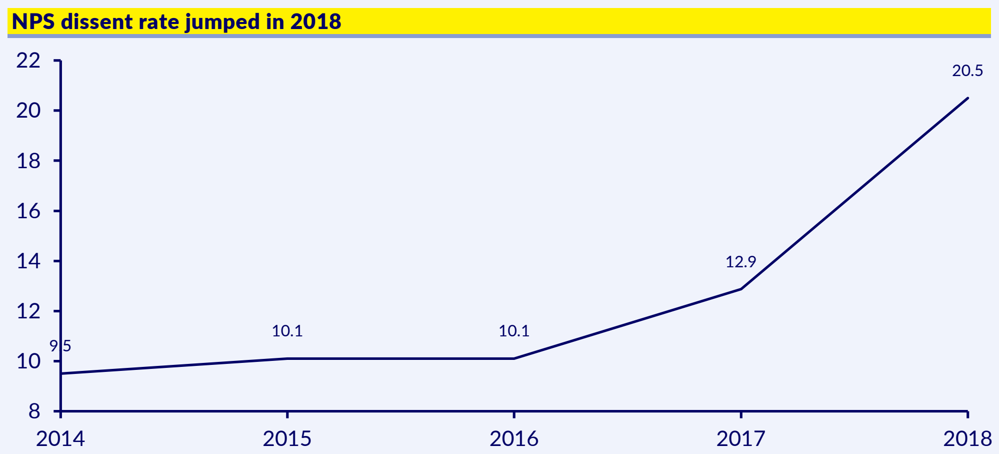
Stewardship code adoption

Attitudes changed

The driving force behind these events is the attitude change of institutional investors, especially domestically. The nationwide corruption scandal that resulted in the then-president's impeachment as well as the arrest of former head of the National Pension and the head of major chaebol group in 2017, has driven the adoption of Korea's stewardship code. The general public's interest and perceived value of the proxy vote has gone up considerably, and the proxy vote dissent rate (voting against the investee company's management) of NPS and other local institutions has increased significantly.

Dissent rate of NPS saw dramatic jump in 2018, up 7.1pt YoY to 20.5%

NPS dissent rate jumped in 2018



Source: CLSA, NPS

Local asset managers' dissent rate increased after stewardship code adoption

Before stewardship code adoption (April 2016 - March 2017)

No.	Local asset manager	No. of companies	No. of item	Approving votes	Dissenting votes	Dissent rate (%)	Neutral	Not exercised
1	Tongyang Asset Management	54	347	338	8	2.30	1	-
2	Mirae Asset Management	134	727	664	29	4.00	23	11
3	Shinhan BNP Paribas Asset Management	28	155	133	1	0.60	14	7
4	Meritz Asset Management	90	548	493	55	10.00	-	-
5	Truston Asset Management	55	387	344	43	11.10	-	-
6	Hi Asset Management	20	136	130	-	0.00	6	-
7	Korea Investment Value Asset Management	91	607	599	8	1.30	-	-
8	Korea Investment Trust Asset Management	98	481	479	2	0.40	-	-
9	KB Asset Management	133	809	724	39	4.80	46	-
	Total	**703**	**4,197**	**3,904**	**185**	**4.40**	**90**	**18**

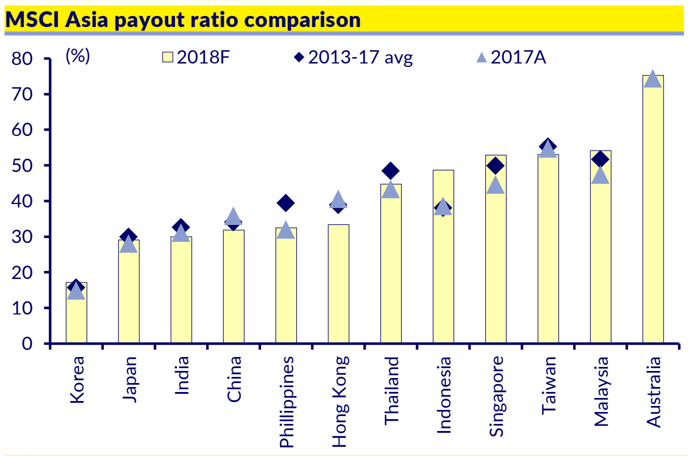
After stewardship code adoption (April 2017 - March 2018)

No.	Local asset manager	No. of companies	No. of item	Approving votes	Dissenting votes	Dissent rate (%)	Neutral	Not exercised
1	Tongyang Asset Management	100	693	617	76	11.00	-	-
2	Mirae Asset Management	169	970	840	117	12.10	12	1
3	Shinhan BNP Paribas Asset Management	33	227	189	24	10.60	14	-
4	Meritz Asset Management	83	452	404	48	10.60	-	-
5	Truston Asset Management	133	885	819	65	7.30	1	-
6	Hi Asset Management	28	160	120	25	15.60	15	-
7	Korea Investment Value Asset Management	61	390	357	31	7.90	-	2
8	Korea Investment Trust Asset Management	113	756	727	29	3.80	-	-
9	KB Asset Management	162	847	723	112	13.20	12	-
	Total	**882**	**5,380**	**4,796**	**527**	**9.80**	**54**	**3**

Source: CLSA, The Bell

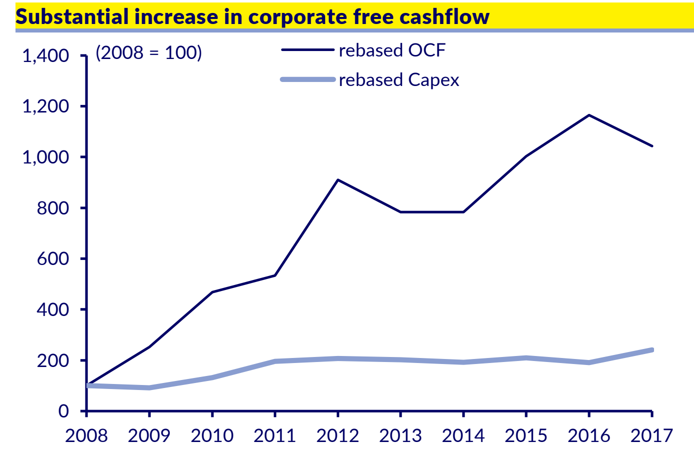
Returning excess capital to shareholders in the form of increased dividend and/or share cancellation is a possible improvement. The National Pension now publishes a list of companies that have 'excessively low' payouts despite capacity.

MSCI Asia payout ratio comparison



Source: CLSA, Bloomberg

Substantial increase in corporate free cashflow



Source: CLSA, Quantiwise

NPS focus is on companies with low payout but have capacity to increase

List of companies NPS opposed on low payout

Ticker	Company	Mkt cap (₩bn)	Cash/ mkt cap (%)	Payout (17) (%)	Div yld (17) (%)
003920.KS	Nam Yang Dairy Products*	467	23	17	0.20
005440.KS	Hyundai Greenfood*	1,309	38	6	0.60
079430.KS	Hyundai Livart	491	5	5	0.50
005430.KS	Korea Airport Service	126	28	7	1.20
029460.KS	KC	246	16	3	1.00
037710.KS	Gwangju Shinsegae	335	0	4	0.60
100840.KS	S&T Corporation	108	54	2	0.00
108380.KQ	Daeyang Electric	112	45	0	0.00
240810.KQ	Wonik IPS	1,044	4	9	0.70
243070.KQ	Huons	704	2	12	0.50

Note: cash includes long-term available-for-sale financial assets. *Watch-list companies for low payout.
Source: CLSA, QuantiWise.

The ownership structure of Korea's large conglomerates also improved

Better ownership structure of Korea's large conglomerates has been a meaningful government improvement. With pressure from the Fair Trade Commission, the new government has pushed conglomerates to break their circular ownerships. These Chaebol-favoured ownership structures have long been criticised as a way for a major shareholders to enhance control with little direct ownership. Substantial parts of related company assets that had previously been locked up as non-core stakes in affiliate companies are now getting unwound as circular structures become untangled, thereby allowing greater efficiency of capital.

All major conglomerates have reduced their shareholdings in 2018

Most circular shareholdings are gone

	Samsung	Hyundai Motor	Lotte	Hyundai Heavy	Daelim	Hyundai dep store	Young poong	Hyundai Dev	Total
2013	2,555	7	95,033	1	1	3	11	4	97,615
2014	14	6	417	1	1	3	7	4	453
2015	10	6	416	1	1	3	7	4	448
2016	7	4	67	1	1	3	7	4	94
2017	7	4	67	2	1	3	7	4	95
2018	0*	4	0	1	0	0	1	4	10

Note: Samsung F&M and SEMCO disclosed in 20 September they will sell entire stakes in Samsung C&T.
Source: CLSA

2. Regulators

Korea ranks 7th overall with a score of 56%

This is Korea's second-best category in terms of its score and its overall rank is a respectable seventh. There are two parts to this category and in one of them, Funding, capacity-building and regulatory reform, Korea ranks fifth in the region. In the second, Enforcement, where scores are weighted, it comes ninth. Despite the low ranking, we believe that enforcement is improving in Korea - it is just that other markets are still doing much better.

Korea splits its financial regulator into two distinct entities

Korea has a somewhat different regulatory structure to other markets, in that it splits its main financial regulator into two connected but distinct bodies. The key agencies responsible for different aspects of corporate governance in Korea include:

- The Financial Services Commission (FSC) has overall policy responsibility for regulating banks and other financial services firms, including insurance and oversees the securities markets as well as audit regulation. A sub-committee called the Securities and Futures Commission (SFC) has delegated responsibility for oversight of the securities and futures markets.
- The Financial Supervisory Service (FSS) is the supervisory and enforcement arm of the FSC and is located in the financial district on Yeoeuido island, whereas the FSC is in central Seoul.
- The Korea Exchange (KRX) is a for-profit entity, owned mostly by brokers and under the supervision of government. It is the frontline regulator for the stock market.
- The Ministry of Justice (MOJ) has oversight of company law, the Commercial Act, and general corporate governance rules (ie, for companies other than banks and financial institutions).
- The Fair Trade Commission (FTC) regulates competition and the fairness of transactions among companies, especially the large conglomerates *(chaebol)*.

There are entrenched structural challenges in the Korean system

There are a number of key challenges in this system. The FSC has limited autonomy from government. Its board contains nine commissioners, including ex-officio positions held by representatives of the Ministry of Strategy and Finance, the Bank of Korea, and the Korea Deposit Insurance Corporation. There is ongoing fragmentation in the approach taken to CG policy by the FSC/FSS and the MOJ, with the latter far less active than the former in developing reforms. And there is a two-year rotation rule for officials (sometimes less), which means that continuity of policymaking and institutional memory is being constantly undermined and diluted. ACGA has lost count of the number of officials we have met over the past 15 to 20 years! Other markets have much more continuity and allow officials to develop expertise in corporate governance - something we think is essential for good decision-making.

2.1 Funding, capacity-building and regulatory reform

Korea ranks 5th in this sub-category with a score of 56%

One of the strengths of the Korean financial regulatory system is that the funding of the FSS is independent of the government budget. More than 95% of its annual income comes from fees charged to supervisees, while a small amount is provided by the Bank of Korea. In calendar year 2016, FSS income rose 6% to ₩314bn (US$282m) from ₩296bn the previous year. In 2017, it increased almost 9% to ₩342bn. Although the FSS has a broad range of supervisory tasks covering banking and non-banking financial-sector supervision, insurance, capital markets, consumer protection and audit regulation, in absolute terms its expenditure (which closely matches its income) appears reasonable though not excessive. Its salary

expenditure in 2017 was almost ₩203bn (US$182m), making it somewhat better funded than Japan's Financial Services Agency (FSA), which has a similar range of tasks. The FSA expects to spend US$161m on personnel costs in FY2018. Meanwhile, the FSS in Korea had a staff of 1,880 people at the end of 2016 and 1,940 people at end-2017. The FSA in Japan today has slightly less than 1,600.

KRX keeps tight control on costs and is focussed on profit. How much does it spend on regulation?

As for KRX, its operating expenses have not changed much over the past three years, increasing only 1.8% from 2015 to 2017. Operating revenue for 2017 increased by 6.2% to slightly less than ₩347bn, while operating expenses rose less than 1% to just under ₩283bn. It achieved a net income of ₩71.5bn, an increase of almost 25% from the previous year, due to increases in both operating income and non-operating income, including income from fund management. Like most for-profit stock exchanges in the region, the KRX clearly maintains tight control over costs, including salary expenses. It pays around 40% of its profit as dividends and puts another 15-20% into a "dividend equalisation reserve". Most of the remainder goes into a "business expansion reserve". What is not clear from its annual report is how much KRX is investing in enhancing its regulatory function and whether this is growing over time.

Electronic voting

Korea has made good progress in adopting e-voting

One area of capacity building that Korea has undertaken successfully in recent years is in electronic voting (e-voting). The Korea Securities Depository (KSD) developed an e-voting platform in 2010 and initially targeted it at domestic retail shareholders, prompted in large part by the problem of "shadow voting" (essentially, unvoted shares being cast in favour of management in order to meet quorum requirements). The idea was to making voting easier.

Small- and medium-sized companies are using e-voting more than large-caps

Although participation was low in the early years, it has picked up since. By March 2015, 116 KOSPI and 220 KOSDAQ companies were using the system, increasing to 155 and 328, respectively, by March 2016. They have grown further: by February 2018, KSD reported that 57% of all 2,240 listed companies had contracted it for e-voting. Interestingly, larger caps tend to participate less - only 16% of the top 100 firms by market cap have e-voting systems compared to an average of 45% for all 789 KOSPI companies.

One database for all company reports and announcements would be a big improvement

KIND can be cruel

KIND is a database run by KRX for the "timely disclosure" notices and announcements that listed companies must disclose under the Listing Rules. The range of company documents provided is extensive, many go back to 1999 (or depending on when the company was listed), and the titles of items are all translated into English on the English version of the site. Unfortunately, the content of the underlying documents is almost entirely in Korean, while some items are title-only, no content.

DART, a company database run by the FSS for disclosure required under securities laws (eg, periodic reports, material disclosure), is also extensive - in Korean. Its English site often has problems, such as search functions that do not always work and promises of reports dating back five years or more that do not seem to exist.

A single database for all company disclosure, with more documents translated into English, would be a very welcome improvement. For example, the new CG reports being produced by companies under the "comply or explain" regime could be translated.

The FSC and FTC have brought in several regulatory amendments

A busy programme

Key regulatory reforms and proposals over the past two years have included:

- **September 2017:** Amended Act on External Audit of Stock Companies passed in the National Assembly. (See Auditors & audit regulators for more details.)
- **January 2018:** FSC announces plan for comprehensive supervision of "financial conglomerates". (See Bank governance above for details.)
- **March 2018:** The FTC formed a special committee to modernise the 1980 fair trade law. The committee held its first meeting in mid-March and selected 17 issues for reform, including price fixing, abuse of market position and corporate groups/holding company structures. Although Korea's antitrust law has been revised 27 times since 1980, it is still criticised for being outdated. This would be the first comprehensive amendment in 38 years. The bill passed Cabinet on 27 November 2018 and was submitted to the National Assembly. Not surprisingly, it has been criticised by the opposition party as a "business killer".
- **March 2018:** In mid-March, FSC announced a series of new governance rules for financial firms. (See Bank governance above for details.)
- **May 2018**: FSC introduced new measures to stop any more "fat finger" episodes, such as the one at Samsung Securities on 6 April 2018 when an employee input incorrect information on dividends to be paid to employee shareholders. Instead of ₩1,000 being paid out per share, 1,000 new shares were issued for each share, creating a massive and illegal issuance of new shares.

KRX is focussing on improving listed-company CG disclosure

Meanwhile, over at the stock exchange:

- **KRX 10 Principles - 1**: In March 2017, KRX kicked off the new CG Code with a simplified list of 10 disclosure items for companies to follow under the new "comply or explain" rules. Adoption however has been disappointing: 70 companies in 2017, rising to 95 in 2018 - a less than 13% participation rate among KOSPI issuers. The exchange has also been critical of the quality of some of the new CG reports.

- **KRX 10 Principles - 2:** As a result of the low take-up rate, the FSC announced in March 2018 that mandatory disclosure under the 10 Principles would be required for around 185 large caps (ie, those with assets of ₩2tn or more) from 2019. This would be extended to all KOSPI companies within two years (ie, from 2021). KRX has also formed a new "Comply or Explain Working Committee" comprising representatives from government, the KRX, National Pension Service, academics and others to discuss developing the principles in future.

The other major reform of the past two years was the introduction of Korea's Stewardship Code in late 2016. This is an issue we cover in more detail under Investors below.

Korea ranks 9th with a score of 55%

2.2 Enforcement

Korea's score for enforcement is reasonable, but this was a tightly contested category. Enforcement by the FTC and FSS has become more vigorous and focussed over the past two years. Where Korea loses points is in the presentation of information on regulatory enforcement - although it is markedly better in Korean than English - and because of the somewhat opaque regulatory activities of KRX. A few more percentage points and Korea would have ranked notably higher.

Some key statistics from FSS annual reports on "unfair trading" (ie, market misconduct):

- **Cases initiated/received:** Over a six-year period from 2012, the number of unfair trading cases that the FSS initiated or received per year declined from a high of 271 in 2012 to 157 in 2015, rose to 208 in 2016, then declined again to 136 in 2017. A lot of these cases are referred to the FSS by KRX and this explain much of the volatility in the annual figures. For example, in 2016, when KRX referrals doubled to 127 cases, the FSS stated in its annual report that this was, "most likely because of the presidential election (in 2017) that fueled speculative stock investment".

Number of FSS investigations has declined

- **Cases investigated:** In terms of FSS investigations, the number has declined from 229 in 2013 to 172 in both 2015 and 2016, then fell further to 139 in 2017. The reason the FSS gives in its 2016 annual report is honest: "The number of investigations has been falling since 2012 as unfair trading has become ever more sophisticated and more difficult to detect." The types of market misconduct investigated include: fraudulent trading, market manipulation, insider trading, failure to report large shareholdings and acquisitions, and violaton of short-swing profit or lock-up rules. Insider trading provided the largest number of investigations in 2016, followed by failure to report large shareholdings and acquisitions. In 2017, it was again insider trading, but this time followed by market manipulation.
- **Enforcement actions:** The total number of actions fell from 199 in 2013 to 125 cases in 2015, bounced back to 149 in 2016, then fell again to 108 in 2017. Most of these involve criminal referrals to prosecution authorities, followed by warnings and other disciplinary actions. The fewest number of actions cover disgorgement of profits.

FSS could provide more narrative explanation in its annual report

While the statistics provided by the FSS on unfair trading are interesting, there is limited narrative explanation accompanying the data in either the English or Korean versions of its annual report. To be fair, the FSS does provide more analysis of enforcement on its Korean website. It also produces press releases in both languages on other things such as supervisory actions taken against disclosure violations.

KRX: between persuasion and enforcement

KRX provides less disclosure on its enforcement outcomes

Although KRX has a range of powers to enforce its listing rules, including enhanced ability to fine issuers for violating disclosure rules, much of its focus is on helping listed companies and members improve their internal control systems to prevent unfair trading and other malpractices, and persuading companies to improve their disclosure and governance practices. It touches only briefly in its annual report on enforcement outcomes, but does focus attention on the supporting role it is playing to the FSS on surveillance of unfair trading. One interesting area of development for KRX is its growing use of big data and artificial intelligence in "next generation market surveillance" - though no investment numbers or details are provided. There is also limited information provided on enforcement on the KRX website - especially in English. Its news release section contains quite a few regulatory announcements over the past two years, but little on enforcement.

3. CG rules

Korea ranks 10th with a score of 45%

This is the first of three categories that drag down Korea's overall score and ranking - the other two being Listed companies and Civil society & media. Korea generally scores well for its basic financial reporting standards and rules on

disclosure of material price-sensitive information, insider trading, the existence of a stewardship code, and the limits on the number of directorships that independent directors can hold. However, it scores poorly in the following areas:

- CG reporting rules
- ESG/sustainability reporting rules
- Disclosure of share pledges
- Disclosure of executive and director remuneration
- Lack of mandatory voting by poll
- No “blackout” or closed period for director trading
- Lack of a mandatory tender offer bid
- Private placements

Comply or explain

It will take time to inculcate comply or explain

While the FSC and KRX are making efforts to improve disclosure of corporate governance practices (as noted above in relation to the KRX 10 Principles), this will likely take some time. It is worth highlighting that while Korea was one of the first markets in Asia to develop a code of corporate governance in 1999, and revised it in 2003, compliance was entirely voluntary. Even when the latest version of the *Code of Best Practices for Corporate Governance* was published on 26 July 2016, it was still not subject to “comply or explain”. That did not come until March 2017. It is perhaps not surprising that regulators have had to take a firmer line on cajoling companies to start explaining. On the other hand, regulators must share some of the blame by setting the bar so low on CG disclosure in the past. A fascinating study by FSS and released in August 2018 highlights just how limited much of the CG disclosure in Korea has been. (See Listed companies for more details).

KRX has been trying to get issuers to think more for themselves

This shift towards getting companies to think more for themselves was also apparent in a 2016 amendment to the KOSPI Market Disclosure Regulation. Clause 7(1) sets out rules on "timely disclosure”, stating that material matters must be disclosed on the day the event occurred or the following day for some matters. Although the regulations were detailed and extensive, KRX had to amend them to introduce the concept of "all-inclusive" disclosure. In the past, companies said they had not disclosed events because they were not told to do so - the list of material events provided in the rule did not cover all possible cases. The new rule put the onus on companies to disclose under more of a "principles-based" policy.

Stewardship code

The Stewardship Code has been one of the most positive developments since 2016

Another positive development over the past two years was the publication in December 2016 of the Korea Stewardship Code, more formally called the *Principles on the Stewardship Responsibilities of Institutional Investors.* Led by the Korea Corporate Governance Services (KCGS), a research think tank linked to KRX and funded by eight organisations (including the exchange, KSD and others), the code closely follows the UK stewardship code in terms of structure. Its seven principles cover the importance of institutional investors disclosing a clear stewardship policy, managing conflicts of interest, monitoring investee companies, formulating internal guidelines on stewardship, having a proxy voting policy and disclosing votes cast, reporting back to clients and beneficiaries, and developing the capabilities and expertise to implement stewardship in an “active and effective manner”.

The Code recommends collective discussion

While the code does not explicitly encourage "collective engagement" by shareholders, the commentary to Principle 7 does encourage discussion and sharing of information: "Institutional investors can establish forums, etc, with the aim of stimulating debates and discussions and to pursue mutual interests, as well as to share and learn relevant experiences and opinions about successful shareholder engagement cases, to improve their expertise and the quality of their shareholder activities." (See Investors for more discussion of the Stewardship Code.)

Moving shareholder rights forward

Suggestions for priority CG rule changes

While there is not space here to provide a detailed analysis of all the questions on which we marked Korea down for CG rules, we would like to highlight the following suggestions:

Reintroduce mandatory TOBs

- **Mandatory takeover bids:** We recommend that Korea return to the rules it had prior to the Asian Financial Crisis in 1997 and require bidders to undertake mandatory and fair general offers to all shareholders in the event of a takeover. This is an issue raised repeatedly by minority institutional investors who are tired of seeing premiums paid for controlling stakes, then a lower average price offered to minority shareholders. "They (the bidders) drive the price down to buy out the minority shareholders. They admit this publicly and do not see anything wrong with it," as one institutional investor said to ACGA.

Upgrade remuneration disclosure

- **Executive remuneration:** Article 159 of the Financial Investment Services and Capital Markets Act (FSCMA) provides for disclosure of the aggregate remuneration of executive officers (including stock options), as well as remuneration of individual officers if they earn more than ₩500m (US$450,000 approx), and the top 5 highest paid individuals if they earn more than ₩500m. Since many Korean companies have become global organisations and, accordingly, are being judged against international standards of board governance, it would make sense to align rules on the disclosure of director and executive remuneration with global norms, at least for large firms.

Review the use of private placements

- **Pre-emption rights (private placements):** Although such rights are envisaged under FSCMA, the law allows companies to issue shares to specified persons "where necessary to achieve the managerial purposes of the corporation, such as investment in new technology or improvement in new technology". (Article 165-6) We recommend that FSS undertakes an analysis of private placements in Korea to see how they are being used and their dilutive impact on shareholders. Leading markets in Asia provide stronger investor protections around such placements.

Tighten rules on share pledging

- **Share pledging**: While rules on the disclosure of shares pledged by controlling shareholders exist, the quality of such disclosure is often poor and the rules do not seem to be strongly enforced. Disclosure tends to come at the end of the year, rather than immediately as a separate announcement.

4. Listed companies

Korea ranks 11th with a score of 38%

Despite basic financial reporting rules being sound in Korea and thorough financial reporting from large-caps, the market score and ranking was dragged down in this category by low scores for CG reporting, much lower quality reporting generally by mid-caps and underperformance on a range of board governance practices, such as evaluations, disclosure of director training, board diversity and so on. One brighter spot among the large-caps, but not mid-caps, was ESG/sustainability reporting.

Financial reporting is quite robust . . .

Financial reporting

The good news: Timeliness rules in Korea are on par with the rest of the region (ie, annual "business reports" due within 90 days and interim/quarterly reports within 45 days). Continuous or "timely" disclosure of material matters must be disclosed on the day the event occurred or the following day for certain matters under KRX disclosure rules. And KRX upped the ante on timely disclosure in April 2017 by expanding the scope of such disclosure and increasing the fines for violations fivefold. The best reporters in our survey in this category were: KB Financial, KEPCO, LG Display, Samsung Electronics, Shinhan Financial and SK Hynix.

. . . but template disclosure leads to superficial reports

One systemic weakness is the prevalence of "template disclosure", whereby companies follow set templates for reports and announcements, with limited narrative (especially in quarterly reports and some material disclosure announcements). We found MD&A disclosure often limited. Reports and timely disclosure notices are usually not translated into English. And investor relations websites varied hugely in quality, even among the 15 large-caps we assessed in detail.

Most CG reporting in Korea is limited and shallow

CG reporting

A small number of large firms have relatively high-quality CG disclosure, similar to the list above for financial reporting. Most firms rated averagely, while some scored low: Kakao, Shinsegae. As in other markets the usual problems were: boilerplate reporting; limited information board and committee discussions; scant biographical details on directors and why they were selected; and scarce reporting on independent director fee policies. We have high hopes that the new requirements for "comply or explain" reporting under the revised CG Code will produce much more detailed CG reports. Indeed, most of the larger companies we reviewed do now have such reports - but they are only in Korean.

Average board structures and practices well behind global and regional best practices

The FSS speaks

On 9 August 2018, the FSS released the results of a survey it had undertaken into the CG disclosure found in the 2017 annual reports of 1,087 listed companies with assets of more than KRW100 billion. The results were eye-opening:

- Average boards have just 5.4 directors, and the CEO is chairman in most.
- Companies have an average of just 1.8 board committees.
- The participation rate of CEOs in board committees was highest in nomination committees (called "outside director nomination committees") at 61%, followed by remuneration committees at 37%, then RPT committees at 30%.
- Boards meet on average almost 14 times per year.
- Disclosure on the extent of objections from independent/outside directors to board decisions is miniscule: only 19 companies disclosed such opposition, and only three specified the reasons. (And these points come from just the first two pages of the FSS's 11-page summary!)

Few formal rules for ESG reporting

ESG reporting

While the FSC established a Green Posting System in 2012 that required around 500 firms to disclose their greenhouse gas emissions and energy usage, and firms listed on KRX were required to include the information in their annual reports, there are no actual listing rules or guidance on ESG or sustainability reporting from the exchange. While there had been plans to develop a model ESG code" in 2016, this was postponed. However, KRX is a member of the Sustainable Stock Exchanges initiative and has produced three sustainability indices. Meanwhile, KCGS developed some broad environmental and social guidelines in 2010 and measures the ESG performance of companies.

Yet most Korean large-caps do well in this area

It is probably not surprising then that most Korean large-caps in our survey scored quite well for ESG/sustainability reporting. Areas of strength included discussion with stakeholder groups prior to developing a list or matrix of material issues to focus on and provision of sustainability metrics and targets. Indeed, around 12 of the firms reviewed scored highly in these areas. One area where almost all companies lost points, however, was in the extent to which they were able to put their sustainability reporting and policies into the context of their broader busisness strategy and operational challenges.

5. Investors

Korea ranks equal 5th with a score of 33%

Despite the low score, Korea does reasonably well in this category and is on a par with Taiwan. One reason is the introduction of the Stewardship Code and the impact this is having on investor voting behaviour, especially by the National Pension Service (NPS). The market score also benefits from the work that certain foreign investors have been doing in Korea to engage with *chaebol* firms.

Stewardship signatories

The Stewardship Code now has 70 signatories

The Stewardship Code currently has 70 signatories, most of which are public-equity asset managers (mostly domestic but some local) or private equity managers. There are also two insurance companies, two brokers, and one bank. And one pension fund, the NPS, which joined on 30 July 2018 after much internal discussion and preparation.

Some signatories are starting to vote more against company resolutions

What difference has being a signatory to the Code made to the behaviour of signatories? Apart from publicly stating support for the Code on their websites, and publishing an explanation of how they comply with the Code, one of the early tangible outcome has been higher levels of voting against AGM resolutions. According to data from KCGS in late September 2018, the average votes against of domestic institutional investor signatories rose from 1.72% in 2015 to 5.72% in 2018. The range figures are much more interesting: from four funds with zero votes against in 2018 (and most previous years) to five funds on between 8-12% in 2018 compared to almost nothing four years ago, and one fund with more than 26% votes against in 2018 (a doubling of its rate of voting against).

National Pension Service

There are high hopes for the NPS playing a leadership role in stewardship

There are high expectations of the impact that the NPS will have on CG in Korea now that it is a signatory to the Code. Indeed, over the past few years its proportion of votes Against have risen from around 10% per year in 2014 to 2016, then to almost 13% in 2017 and just over 20% in 2018. Many hope that the NPS will be able to play a transformational role similar to that of the GPIF in Japan in recent years.

But the NPS faces political constraints . . .

Optimism may need to be tempered, however, since there is controversy around the participation of NPS in the Code and its exercise of shareholder rights generally. Some critics believe that the NPS will start intervening too much in company governance and management, or that Korean asset managers will blindly apply its voting policy to all of their holdings in Korea, not just assets managed for the NPS. Others have questioned the independence of the NPS from government. As it reports to the Ministry of Health and Welfare (MHW), some fear it will use its voting rights to further government policy. In mid-March 2018 the MHW said that the NPS would delegate much of its voting rights to a committee of private experts to prevent abuse by government or politicians.

. . . and is voluntarily taking a cautious approach

Then in early August 2018, the NPS released a statement on how it intended to apply the Code. It said that initially it would only vote on issues that were not related to "involvement in corporate management", and that it would only do the latter once "special conditions are established and implementation plans are formulated". Yet it would also retain the right to do so beforehand if necessary. Meanwhile, NPS would also entrust its voting rights to external fund managers to "address concerns about excessive meddling" and would form a "Committee of Stewardship Responsibilities".

Some CG advocates think NPS is being too accommodating

Within the CG community, concerns have been expressed that the NPS may be going too far in mollifying its critics. In late July 2018, Solidarity for Economic Reform (SER), the country's leading independent CG advocacy organisation, wrote a commentary criticising the fund for being "overly cautious" in its approach to the Stewardship Code. SER said that "the idea of reconsidering the adoption of right to engage in management only after enabling conditions have been laid out is nothing other than the NPS de facto announcing it won't exercise its shareholder rights, particularly as there are already double or triple mechanisms in the Proposal to prevent excessive exertion of influence into management". Watch this space.

Collective engagement?

Korean rules on concert-party action could affect the growth of stewardship

Given that institutional investor participation in stewardship is still a new phenomenon in Korea, and the fact that many asset managers are owned by the chaebol, it is not surprising that there has been little individual or collective domestic investor engagement with companies. Indeed, like Japan, Korea has some quite tricky concert party ('joint holder") rules that could limit investor behaviour. Following the adoption of the Code, the FSC released a guideline (only in Korean) that said in effect, 'participating in a forum and exchanging opinions is not considered to be creating a 'legal joint holder' relationship, but when collective engagement has an impact on a business or company, such as firing a board member, it would be considered joint holding'.

Korea's strict 5% rule also throws a curve ball at stewardship

A related challenge, especially for institutions with substantial holdings, is the particular nature of the 5% rule in Korea. Once you reach this level, you must not only disclose that fact, but announce if you plan to remain a financial investor only or participate in (ie, try to influence) management. A fund that is typically investing for financial purposes, but occasionally engages with companies and makes suggestions on governance or business strategy improvements, could be inadvertently breaching this regulation.

6. Auditors & audit regulators

Korea ranks 8th with a score of 69%

This is Korea's highest scoring category and has much to do with its strong adoption of international accounting and auditing standards over the past decade and more. Unlike some jurisdictions in Asia that seek to "converge" with IFRS

over time, Korea made the bold move to undertake full adoption with no modifications starting in 2011. All listed companies and financial organisations were subject to these new standards. But these efforts did not come out of nowhere: the Korean Accounting Standards Board (KASB) participated in discussions with the International Accounting Standards Board in the development of IFRS and reflected the views of domestic stakeholders. It then actively endorsed the standards and translated them into Korean. This posed challenges, since IFRS leans towards being principles-based and allowing for interpretation, whereas previous Korean accounting standards were highly prescriptive.

New Act on external audit

A major new act on external auditors was passed in September 2017

Without doubt the biggest seismic shift in the auditing world in Korea over the past two years has been the passage, in late September 2017, of an amendment to the Act on External Audit of Stock Companies. Very much a reaction to accounting frauds of recent years, such as Daewoo Shipbuilding and Marine Engineering in 2016, the FSC describes the new Act as the "most far-reaching reform of Korea's accounting and audit practices" and likens it to a "Korean version of the Sarbanes-Oxley Act". The reforms will affect auditors, companies, and regulators, with key measures as follows:

The FSS will designate auditors for all listed companies

- **Auditors:** The right of the regulator to designate (ie, choose) an auditor for a listed company is being expanded from companies under special supervision to all listed companies over time. In essence, the regulator will appoint an auditor for three years out of every nine, after which time the auditor will need to be changed.
- **Companies:** Stronger rules on internal audit and controls relating to accounting management with a view to making companies more accountable.
- **Regulators:** An enhanced supervisory role and stricter disciplinary action, including higher financial and criminal penalties (including longer prison terms) for accounting fraud.

While this reform appears draconian on paper and received a mixed reception from auditors, it may well bring benefits to the auditing industry. Firstly, it may force listed companies to respect their auditors more and allow the latter to operate more independently, especially during the three-year designation period. Auditor independence is not seen as high in Korea. Secondly, it might give auditors the chance to put up their fees, universally regarded as low in Korea.

Enforcement

Although the FSS is quite active, its disclosure of audit regulatory activities is minimal

One area of where Korea does not perform as well as some other markets in Asia is in the disclosure of its audit regulatory work. While Australia, Malaysia, Singapore and Thailand produce detailed reports on their inspection programmes covering CPA firms and audit engagments, the FSS merely devotes three pages in its annual report to the subject. Around 130 audit engagement reviews are done annually by the FSS and the Korean Institute of Certified Public Accountants (KICPA), with deficiencies found in more than half of them. This leads to a variety of sanctions on audited companies, audit firms and individual auditors. The FSS is also responsible for inspecting 41 audit firms and carries out around 10 each year. Other firms are inspected by KICPA.

7. Civil society & media

Korea ranks 11th with a score of 31%

Korean civil society as it relates to the corporate governance ecosystem has a somewhat different shape to other markets. There is no formal institute of directors undertaking regular training, although an informal groups of retired executives and professors hold seminars from time to time. There is no institute of company secretaries or the equivalent. And there is no national retail shareholder association per se. On the other hand, there is a famous non-profit advocacy group, SER, comprising professionals and academics dedicated to improving CG in Korea. And KCGS, the research think tank funded in part by KRX, is taking on a wider set of roles. The involvement of other professional and industry bodies is patchy, although Korea does have an active ESG association.

Solidarity for Economic Reform (SER)

SER has a distinguished pedigree in Korean corporate governance shareholder activism

The origins of SER date back to the mid-1990s when a civil rights organisation, the People's Solidarity for Participatory Democracy (PSPD), formed the Participatory Economic Committee (PSPD-PEC) to work on corporate governance advocacy. Led by Professor Jang Ha-Sung of Korea University and now a senior economic advisor to President Moon, PSPD-PEC launched a series of high-profile shareholder activist campaigns against the top five leading *chaebol*. The committee evolved into SER in 2006 and its founding chairman was Professor Kim Sang-Jo, now chairman of the Fair Trade Commission in Korea. The current chairman is Professor Kim Woo-Chan.

Today SER has evolved into more of an advocacy organisation

SER is involved in raising awareness and writing public commentaries on corporate governance and major economic issues on its website (www.ser.or.kr). It is more involved these days in trying to influence policy and regulation, rather than direct action against companies. In late November 2018, for example, it objected to the ruling party's decision to promote dual-class shares for venture-capital funded companies, even though the idea originated from its former chairman, Kim Sang-Jo. It has close ties to the Economic Reform Research Institute (www.erri.or.kr).

Korea Corporate Governance Service (KCGS)

KCGS has evolved into a multi-dimensional service provider and advocacy body

KCGS began life in the early 2000s under the Korea Exchange and was tasked with assessing the corporate govenance of listed companies and producing surveys on the top-ranked companies. Its work has evolved over the years to include analysis of company ESG as well as corporate governance. It has developed its own proxy voting guidelines (the most recent from February 2018) and provides a proxy voting advisory service for domestic institutional investors. It was tasked in 2014-2015 with the unenviable job of revising the 2003 CG Code and, after much difficult negotiation with business groups and government agencies, published a revision in July 2016. It was next given the then-poisoned chalice of the stewardship code, which in the 2015-2016 period no one else wanted to take on. This should have been a job for the FSC. Suffice to say, following the rapid completion of the stewardship code in late 2016 during the turmoil of the impeachment against President Park, the role of KCGS has grown.

Other business associations play a more limited role

Others

Support for corporate governance from industry associations is mixed. The Korean Financial Investment Association (KOFIA) organises professional and investor education, but does not involve itself greatly in CG matters. The Korea Listed Companies Association (KLCA) provides consulting and training to listed companies and publishes specialist reports on issues such as internal accounting management, improving the issuance of stocks, K-IFRS, and articles of association. Some observers hope that KLCA will assume a greater role in promoting better CG within the business sector now that the influence of the conservative Federation of Korean Industries has diminished given it role in the bribery scandal surrounding former President Park.

But KoSIF is doing good work in the ESG space

In the ESG space, there is the Korea Sustainable Investment Forum (KoSIF), a sister body to similar "SIFs" around the world. Since its inception in 2007, it has promoted socially responsible investment in the finance market in Korea. The organisation is active on legislative advocacy by providing support to the members of the National Assembly on sustainability-related legislation. In 2014, KoSIF worked with a National Assembly member to propose an amendment to the National Pension Service Act to mandate that NPS disclose ESG considerations in its investments. The amendment bill was enacted in January 2015. KoSIF is now awaiting the approval of an amendment to the National Finance Law that is expected to expand the ESG disclosure duty to all public pension funds (67 as of 2017). KoSIF is also the ground team for the Carbon Disclosure Project in Korea.

Recap and recommendations

Recap of CG Watch 2016

Korea has made progress on some recommendations from 2016

How has Korea responded to the recommendations in our 2016 survey?

Figure 2

Korea: recap of 2016

	Recommendations	Outcomes
1.	Follow through on "comply or explain" for new CG Code (as planned)	Partially completed in 2017; further progress in 2018-2019
2.	Finish Stewardship Code	Completed in December 2016
3.	FSS to produce separate report on its audit regulatory work	No progress
4.	Mandate voting by poll	No progress
5.	Companies to review board composition and director skills	Partial progress among some leading firms
6.	Companies to arrange meetings between shareholders and directors	Good progress among leading firms

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the markets score to fall in 2020:

- ❑ Formal introduction of dual-class shares
- ❑ No improvement in appointment of officials for short terms
- ❑ No attempt to address areas of weak shareholder rights
- ❑ Corporate CG disclosure fails to improve under new "comply or explain" rules
- ❑ Implementation of stewardship code, especially by NPS, stalls
- ❑ Listed companies show decreased willing to meet with investors

What to fix

Quick fix list

Issues to address as soon as possible:

- FSS to produce separate report on regulation of auditors
- More companies invite shareholders to nominate one or two independent directors
- Companies to enhance disclosure: board composition, remuneration, committees
- Regulators to allow time for proper consultation on new rules
- Introduce a rule on mandatory takeover bids

Benjamin McCarron
Specialist Consultant, ACGA
benjamin@acga-asia.org
+65 8299 6852

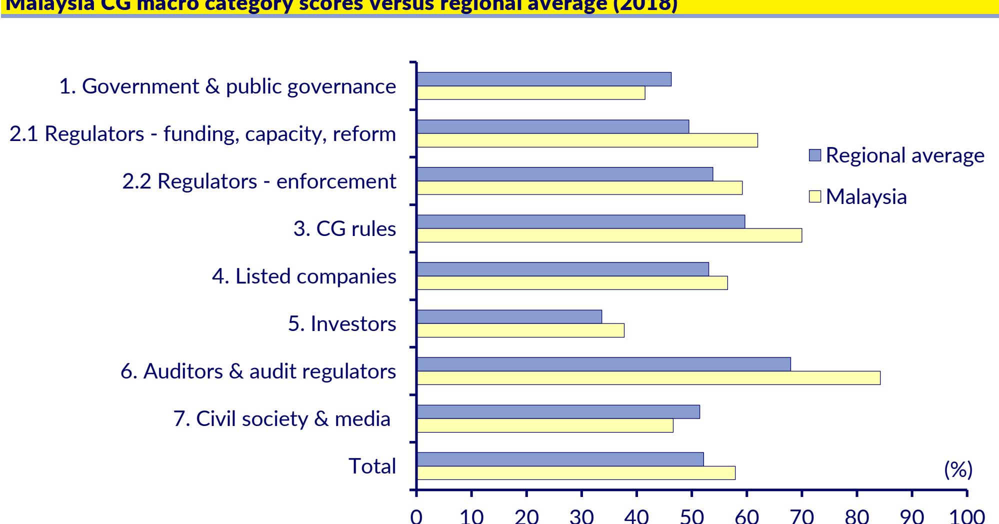
Malaysia - Back to the future

- New government creates strong focus on anticorruption, arrests the former prime minister, his wife and other politicians
- Regulators continue with CG reforms, including a new Companies Act and significant revisions to the CG code
- Regulation of listed-company audits is independent and robust, but development of the accountancy profession and regulation of unlisted audits need to be addressed
- Steady progress on investor stewardship, including among domestic funds, with many more signing up to the Malaysian Code for Institutional Investors
- Civil society strong overall, as shown in the election, but there is a limited focus on corporate governance

Malaysia ranks 4th with a score of 58%

Figure 1

Malaysia CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

General election marks start of a new era for Malaysia

The general election on 9 May 2018 was a watershed moment in Malaysian history and the only time since the first post-independence election in 1959 that a government has formed without the ruling Barisan Nasional (National Front) coalition (or its predecessor the Alliance). On visits to Malaysia after this event we found the nation in celebratory mood, with much talk about "Malaysia 2.0".

Corruption at 1MDB undermined the integrity of the Malaysian state

The mood was entirely different two years ago, when the Malaysian chapter of *CG Watch* was titled, "Trouble at the Top". While *CG Watch* examines corporate governance and maintains a politically neutral stance, it necessarily assesses the extent to which public governance influences and shapes the corporate governance ecosystem. Corruption in Malaysia, particularly involving the disappearance of funds from state-controlled 1MDB, intensified under the previous government and undermined the integrity of the country's institutions, as did arbitrary leadership changes at multiple state economic and regulatory agencies (an attempt to quash corruption investigations).

Critical change as finance minister role separated from prime minister

The recent change in government and a wholesale rejuvenation of key official positions offer a clear opportunity to address these issues. The arrest and charges against the former prime minister, Najib Razak, represent a clean break with the past. Of equal importance, the role of finance minister is no longer combined with the prime ministership.

Mahathir has opportunity to remedy other past mistakes

Malaysia's story is also fascinating because in charting a new course, it has gone back to the future in selecting Dr Mahathir Mohamed as prime minister. It was Mahathir who originally took over the portfolio of finance minister when he was prime minister during the Asian Financial Crisis of the late 1990s; and concerns today over the independence of the judiciary stem from his previous time in office, when he clashed with senior judges. Early indications suggest, however, that Dr Mahathir has had a change of heart as to how best to run a country. We hope that institutional reforms continue and that the eventual succession of power from Mahathir, the world's oldest living leader, will be smooth. None of this can be guaranteed, of course, and our low score for Government & Public Governance reflects these challenges and uncertainties.

New Companies Act and CG Code

Multiple other factors have supported CG reform in Malaysia over the past two years. There is a new Companies Act, the first since 1965, a major revision to the Malaysian Code on Corporate Governance (MCCG), and some significant changes to listing rules including stronger remuneration disclosure and increased audit-committee responsibilities.

Good momentum on investor stewardship

Investors are starting to make their collective voices heard, albeit from a low base. The Malaysian Code for Institutional investors, which got off to a slow start in 2014, has many more signatories, including several of Malaysia's largest domestic asset owners and foreign investment managers. A new Institutional Investors Council (IIC) has been formed to drive collaborative engagement, while the Minority Shareholders Watch Group (MSWG) has continued to raise governance issues directly with companies and acts as the secretariat for the IIC.

Stronger accounting regulation needed

One area where Malaysia has consistently performed well is in audit regulation. Despite a change of leadership, the Audit Oversight Board continues to be one of the region's more effective regulators in this area. Nevertheless, broader challenges remain in the development of the accountancy profession and regulation of audits for non-public-interest entities.

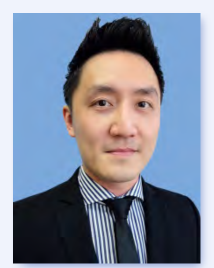
Sue Lin Lim
Head of Research - Malaysia
suelin.lim@clsa.com
+60 3 2056 7875

Major movers

CLSA's aggregate ESG company scores jumped 7% from 2016 to 2018. In short, we have seen many of the points highlighted in ACGA's market overview filter down to the corporate level. The biggest movers in our survey, with +/- score changes of more than 20% from 2016 to 2018 are CIMB, Genting Malaysia and 7-Eleven.

The good . . .

CIMB, whose score was previously weighed down by a range of factors, standout for improving independence. Chief among them were earlier acquisitions that, in hindsight, did not create shareholder value. Money distributed by CIMB's former-chairman, Nazir Razak, for the 13th general elections in 2013 who was then CEO also raised more than a few eyebrows on independence. For the former, CIMB has since avoided any large deployment of capital with outsized risk, and for the



Peter Kong
Deputy Head of Research - Malaysia
peter.kong@clsa.com
+60 3 2056 7877

latter. CIMB had put in place plans for immediate improvements as well as strengthened internal rules; brother to ex-Prime Minister Najib Razak, Nazir had also subsequently been cleared by the current attorney general in 2016.

We have also noticed improvements in the quality of CIMB's disclosure, especially with addition of its corporate governance report since 2017, and citizenship report since 2016. In 2018, CIMB also joined the UN's responsible banking group, being the only member in Malaysia and Asean to be a founding member of the sustainable initiative.

. . . the bad . . .

7-Eleven posted the biggest decline in ESG score, driven by slippage in our responsibility metrics. There were a few bad apples in the listed-company space, such as Sapura Energy (unjustified high remuneration for CEO), Felda Global ventures (land deals) and Lotte Chemical Titan (which lacked transparency in its IPO).

. . . and the lovely

Ultimately, though, this does not detract from an overall improvement. Malaysian listed companies that qualify for the FTSE4Good Bursa Malaysia Index (which screens for environmental, social and governance) now total 56 firms, compared to 24 back in 2014. To this end, sustainable practice had also been emphasised, as Bursa Malaysia under its sustainable framework requires all listed companies to report sustainability from 2018.

FTSE4Good index constituents - Top 10

	CG score per CLSA
Public Bank	90
Tenaga Nasional	na
Maybank	70
CIMB	67
Petronas Chemicals	na
Axiata	66
Sime Darby Plantation	na
Digi	72
Maxis	68
Petronas Gas	na

Source: FTSE4Good

1. Government and public governance

Malaysia ranks 8th with a score of 42%

The government and public-governance score for Malaysia was 42%, for a rank of 8th on this measure. The emphasis for *CG Watch* is the extent to which the government and public governance provide a supportive and conducive environment in which higher standards of corporate governance can flourish.

Former prime minister arrested and charged

The new leadership has a strong focus on addressing corruption and restoring confidence in key public institutions damaged during alleged cover-ups, particularly in relation to 1MDB. The most symbolic steps have been the arrest on 32 charges of former prime minister, Najib Razak, and of his wife, Rosmah Mansor, on 17 counts.

New government in place for only five months

The administration has only been in place for five months at the publication date of *CG Watch 2018*. As in previous years, the score reflects only actions already taken and does not score intentions for future reform. Nevertheless, the

government has already implemented a range of measures and these are reflected in the score, with plenty of potential for increases in future years as institutional reforms continue.

Changing key personnel

Government institutions have undergone major leadership changes

At this early stage the actions taken primarily relate to major changes at the head of key institutions and government-linked companies, and steps to address corruption. Perhaps the most important change has been the appointment of a separate finance minister, a position given to Lim Guan Eng, the leader of the Democratic Action Party and former chief minister of Penang. One possible reason Najib continued the practice of being both PM and minister of finance is that it enabled him to quash investigations into 1MDB.

Media freedom has increased with repeal of the Anti-Fake News Act

The new government also set up a Council of Eminent Persons to advise on economic reforms and a Committee on Institutional Reform to address perceived weaknesses in Malaysian institutions. One of the important early legal reforms was the repeal of what was known as the Anti-Fake News Act. The act came into force shortly before the election and was widely viewed as a way to restrict criticism of the government.

Leaders of 15 key state organisations have been replaced so far

The table below shows some of the senior leadership changes at 18 critical organisations. In most cases the chairman, governor or CEO has been replaced, but in one organisation, the sovereign wealth fund Khazanah, it is the entire board. At the same time, the new government has decreed that sitting politicians can no longer serve on the boards of listed companies. These developments are likely to be significant for corporate governance and active ownership in Malaysia, since there are many large listed government-linked companies (GLCs) with stakes held by the various government-linked investment companies (GLICs). While many senior individuals at these organisations have resigned or been asked to resign, some have progressed in their careers. Shahril Ridza Ridzuan, who was CEO of the Employees Provident Fund (EPF), has been appointed managing director of Khazanah, while Nik Amlizan Mohamed has been appointed CEO of the Armed Forces Fund Board (LTAT) from her role as CIO at Kumpulan Wang Persaraan (KWAP).

Figure 2

Senior leadership changes

Organisation	Type	Position changed
Federal Court of Malaysia	Judicial	Chief Justice
Court of Appeal	Judicial	President
Malaysian Anti-Corruption Commission (MACC)	Agency	Chief Commissioner
Bank Negara Malaysia	Agency	Governor
Securities Commission	Agency	Chair
National Higher Education Fund (PTPTN)	Agency	Chair
Federal Land Development Authority (FELDA)	Agency	Chair
Khazanah	GLIC	Entire board
Employees Provident Fund (EPF)	GLIC	CEO
Permodalan Nasional Berhad (PNB)	GLIC	Chair
Social Security Organisation	GLIC	Chair
Armed Forces Fund Board	GLIC	Chair
Tabung Haji	GLIC	Chair
Petronas	GLC	Chair
CIMB Group	Listed GLC	Chair
Felda Global Ventures	Listed GLC	CEO
Telecom Malaysia	Listed GLC	CEO
Malaysia Airports	Listed GLC	Managing Director

Source: ACGA

Figure 3

Addressing corruption

Source: Ben McCarron, ACGA

'My government recognises that we live in a new era, one where the excesses of crony capitalism of a former era must remain in the past.' Then Prime Minister Najib Razak shares views at the World Capital Markets Symposium, 6 February 2018.

Former anti-corruption heads restored at the anti-corruption commission . . .

Corruption has been a critical area for the new administration, which moved quickly to appoint key people as many incumbents resigned in the aftermath of the election. The new chief commissioner of the Malaysian Anti-Corruption Commission (MACC) is Mohd Shukri Abdull, who had an emotional return to the organisation where he had spent his career. He had been deputy chief commissioner of the MACC and was responsible for the initial investigations into 1MDB before they were closed down.

. . . and at the new policy centre, GIACC

Meanwhile, former MACC chief commissioner, Abu Kassim Mohamed, was appointed to set up and head a new National Centre for Governance, Integrity and Anti-Corruption (GIACC), which will coordinate and oversee policy and implementation in combating graft. These policies will include asset registers for politicians and, at a later date, civil servants as well. GIACC is also working with public-sector organisations to address areas of high corruption risk and develop action plans. The election has provided a window of opportunity to implement much-needed reforms.

Next steps

Bring individuals involved in 1MDB scandal to justice

Immediate next steps involve continuing what has already started, with perhaps further changes in key personnel and taking corruption cases, particularly those linked to 1MDB, to trial. If these proceedings follow due legal process, with outcomes rooted in evidence, an important signal will have been sent. Otherwise concerns will grow of a politically motivated witch-hunt, particularly when combined with the extent of personnel changes across the civil service and GLCs.

Develop a longer-term strategy on public governance

Over the medium to longer term, a range of public governance reforms are needed. Possible measures include:

- Strengthening the independence of the judiciary, including limiting the role of the prime minister in appointing senior judges;
- Improving democratic participation and transparency, including the passage of a Freedom of Information Act;
- Repealing the Sedition Act (a manifesto promise of the ruling coalition);
- Strengthening asset-declaration requirements for politicians and civil servants;
- Limiting the role of the PM in appointing the Attorney General (AG) or separating some of the prosecutorial powers from the AG's advisory role (it was the former AG who blocked domestic investigations into 1MDB).

Some of these reforms would require constitutional amendments and a two-thirds parliamentary majority, which the current coalition government does not have.

Government should reduce interference at GLCs and GLICs

Many commentators have also expressed concern at the high level of government control and involvement in the economy through government-linked companies (GLCs) and government-linked investment companies (GLICs). While GLCs are typically run by professional boards as a result of earlier transformation programmes, the significant management changes following the election highlight both the levels of political involvement under the previous administration and the continuing extent of government control. A critical longer-term test for the government is whether it can relinquish or reduce state control over the economy. Or will it revert to the autocratic style usually favoured by the country's leaders, especially in reaction to political or economic crises?

2. Regulators

Malaysia ranks 2nd overall in Regulators, with a score of 61%

This is Malaysia's best-performing category and reflects the consistent efforts of regulators, even before the change of government, in promoting company and CG reforms and engaging in capacity-building. Reasonably good results were also seen in enforcement.

The Securities Commission is the peak regulator. Bursa Malaysia is the frontline regulator of the listing rules

The Securities Commission (SC) is the peak regulator for the capital markets in Malaysia. Established through the Securities Commission Act 1993, it reports to the Minister of Finance and its annual accounts are tabled in Parliament. Bursa Malaysia (Bursa) is a for-profit company listed on its own exchange. It has a significant role through setting listing rules and then exercising surveillance over the market and enforcing breaches of the rules. Where it detects potential breaches of laws it will refer these to relevant authorities, such as the SC or the Companies Commission of Malaysia.

Bank Negara Malaysia supervises banks

Bank Negara Malaysia (BNM), the central bank, also has responsibilities for financial-sector development and maintaining financial stability. These duties entail regulation and supervision of financial institutions, particularly banks.

2.1 Funding, capacity-building and regulatory reform

Malaysia ranks top in this subcategory, with a score of 62%

Malaysia's high relative score of 62% in this subcategory, with its first place reflecting a number of factors: strong funding of regulators; ongoing capacity-building; concerted efforts on regulatory reform; and some creative thinking around how to support governance improvements at listed companies. It edges out other markets here, in particular Hong Kong and its arch-rival Singapore, because of the consistency of its efforts and the fact it has not succumbed to the allure of dual-class shares.

The Securities Commission is well funded

The bulk of the funding for the SC comes from levies on the purchase or sale of listed securities and derivatives. This provides a degree of stability to its funding, a sufficient budget to hire experienced staff, and frees it from the need to engage in constant bargaining over allocations from government. The SC had income of RM204m in 2017 compared to RM173m in 2016 and RM179m in 2015. Its balance sheet includes total assets of RM995m, with holdings in government bonds and cash deposits totalling RM725m. And it had 742 employees at the end of 2017, slightly less than the 753 at the end of 2016. By comparison, the Securities and Futures Commission in Hong Kong, which has a similar scope of duties but a much larger and more complex market to supervise, had 887 staff (of which 701 were classified as "professional") in mid-2018. On balance, the SC appears to be well-resourced - a conclusion reinforced by our interaction with the Commission.

New Companies Act

New Companies Act 2016 the first since 1965

Malaysia has also undertaken some significant legislative reform in the last two years. In particular, the new Companies Act 2016, which largely came into force in January 2017. This was the first new company law since 1965 and introduced several pro-governance measures:

- A codification of directors' duties and responsibilities, with increased penalties;
- Updated shareholder rights, such as making it easier to call general meetings, the ability to require companies to circulate written resolutions, making directors service contracts available for shareholders to review, pre-emption rights are assumed subject to a company's constitution, and fewer restrictions on the use of proxies.
- Strengthened provisions around communication between auditors and shareholders.

The new Act is also pro-small business and seeks to cut red-tape by allowing single member/director companies, abolishes the AGM requirement for private companies, and decouples the lodgement of financial statements from that of the annual report.

Major revision to CG Code: do you CARE?

Another strategic priority for the country has been the adoption of a substantially revised Malaysian Code on Corporate Governance (MCCG), published in April 2017. It remains a code based on a set of principles. New features include a clever acronym, CARE, which exhorts listed companies to "Comprehend, Apply, and Report" on their governance practices. Specifically, companies should explain how their practices achieve the "intended outcomes" for each principle in the MCCG or provide an alternative if they choose not to follow one or more of its best-practice recommendations. The aim is to get companies to think harder about corporate governance and not simply comply for the sake of compliance. Hence, the use of the word "apply" rather than "comply". Like their counterparts in Thailand, Malaysian regulators believe the "comply or explain" mantra has been misunderstood in the local market - a point on which we would agree.

Big CG data

Fixed CG reporting template enables automated monitoring

The SC has also made it a priority to leverage technology to enhance monitoring of corporate-governance practices, which has combined well with the new Code. A Bursa listing rule update following the introduction of MCCG required companies to disclose the application of the new code in a prescribed format. This template approach has allowed the SC to automatically review conformance to the code.

While initial findings have shown good adherence to many MCCG principles, the more interesting analysis is what companies are not doing. There have been low adoption rates, perhaps not surprisingly, in the proportion of independent directors, limiting independent-director tenures to nine years or holding a two-tier vote on their re-election, and having a target for women on the boards of large companies of 30%. It is worth highlighting that on these latter two policies Malaysia is more progressive than most Asian jurisdictions.

Other practices that companies are reticent to follow include: remuneration disclosure, particularly on a named basis; integrated reporting; and the use of technology to enable shareholder participation in meetings, such as recording of proceedings and electronic voting.

Busy bees at Bursa

Bursa has also introduced reforms . . .

Bursa has also had a productive two years. Revisions to its listing rules include:

- Changes to harmonise the rules with the new Companies Act and MCCG;
- Amendments to the listing framework for mineral, oil and gas companies;
- Improved remuneration disclosure for directors, with annual shareholder approval; and
- Additional responsibilities for audit committees.

For more details, see the next section on CG rules.

. . . and is offering more support to companies on reporting and sustainability

To complement its rule-making, Bursa provides listed companies with a range of resources and guidelines to improve their disclosure and governance practices. It updated its guide on how to produce management discussion and analysis (MD&A) statements, something that became a requirement following a 2016 listing rule change. It supported the Malaysian Institute of Chartered Secretaries and Administrators (MAICSA) to produce a best-practice guide for AGMs. And it launched BursaSUSTAIN, a portal with multiple resources on sustainability, in April 2018.

2.2 Enforcement

Malaysia ranks equal-3rd with a weighted score in this sub-category of 60%

Malaysia's reputation suffered in previous years from the quashing of domestic investigations into the scandals at 1MDB. As noted, the May 2018 national election brought in significant changes and the former prime minister has been charged with a total of 32 offences and denied permission to travel abroad.

But custodial sentences highlight progress for market enforcement

Progress has continued on enforcement of capital-market offences. In *CG Watch 2016*, we noted cases in which the courts had provided custodial sentences for providing false information to regulators. For this *CG Watch*, we more closely reviewed enforcement of insider-trading cases, which can be a litmus test for enforcement as legal professionals, including judges, may not understand the damage insider trading does to the market, viewing such crimes as victimless.

Insider-trading cases take a long time to resolve in Malaysia

One challenge for insider-trading cases in Malaysia is that they typically have a long gestation period. We reviewed 26 enforcement cases reported by the SC involving charges against 68 individuals between 2016 and 2018. For 20 individuals charged with insider trading, and where a charge date was provided, the time between the alleged incident and the date of charging ranged from five years to 11 years, with a mean of 7.7 years. This compared to a range of 0.6 years to 10.8 years, with a mean of 4.4 years, for 41 individuals charged with other

crimes and for which a charge date was provided. The length of time tended to be much shorter for a crime such as submitting misleading or false information to the SC or Bursa.

And challenges with insider-trading convictions remain

It has also been challenging for the SC to achieve convictions for insider trading compared to other offences. For nine individuals subject to criminal proceedings for insider trading, four defendants were convicted with custodial sentences of five years, two of which are under appeal. The Attorney General withdrew charges for three of the nine individuals without providing reasons - the SC successfully pursued civil penalties - and the court gave a discharge not amounting to acquittal for two individuals upon the request of the prosecution. In contrast, of 23 individuals who faced criminal charges for other offences, eight of them were convicted and received custodial sentences ranging from six to 18 months. One defendant was found not guilty in the Sessions Court and the prosecution has appealed, while one defendant is on the run. Trials are ongoing for the other 13 defendants.

A Lotte poor disclosure

Fines and reprimands followed post-IPO profit warning at Lotte Chemical

Lotte Chemical Titan Holding (LCT) was at the centre of a notable enforcement case relating to the company's IPO in 2017. LCT, its board, lead advisor Maybank, and auditor Ernst & Young were all disciplined. The LCT prospectus mentioned that water disruption had caused a plant shutdown for between two and 11 days, but the full impact on profitability was not disclosed.

LCT proceeded to list on 3 July 2017 at a price of RM6.50. When it released financial results on 1 August 2017, it revealed a 72% decline in net profit for the second financial quarter. This was below market expectations and sparked a fall in the share price to a low of RM4.34. In addition to reprimands, the SC issued fines to the company of RM560,000 and to two directors of RM441,000 each. Maybank received a fine of RM450,000 and EY of RM297,500. The parties have all applied for a review of the SC decisions.

Bursa bravely plays its part

Electronic documentation easier to disseminate and easier to monitor

Bursa is the frontline regulator. It has significant roles in surveillance and enforcement of its listing rules, and where necessary reports irregularities to relevant authorities. We were saddened to hear of an acid attack on a senior Bursa staff member on 10 July 2018 that may have been linked to enforcement.

Bursa has continued to invest in automated surveillance. The BursaLINK system that enables electronic submission and dissemination of announcements also makes it easier to conduct monitoring operations.

Financial reporting issues increased due to problems at Chinese companies

Financial reporting is one area subject to monitoring. In the past two years there has been an increase in delays in financial reporting, with the proportion of reports delayed rising from around half a percent to nearly one percent. This increase was mainly due to Malaysia-listed Chinese companies where there were multiple serious problems.

Annual audited accounts required after four months, not three as in most markets

One area where Malaysia has different rules to other markets is in deadlines for annual audited accounts. While most other markets in the region require audited statements within three months, Malaysia allows four. All quarterly reports, including the fourth quarterly report, are due within two months, but these do not need to be audited.

Material deviations are addressed through fines and reprimands

Bursa also monitors the difference between the reported fourth-quarter numbers and subsequent annual audited numbers and will discipline companies or directors for significant deviations. Bursa noted that less than 1.5% of companies had material deviations between their 2017 fourth quarter results and the annual audited accounts.

Disclosure of enforcement

One area where Bursa has improved is in the disclosure of its enforcement activities. The table below shows the number of enforcement actions and the amount of fines by different parties. While Bursa notes a decline in the number of actions, it does not provide an explanation.

Decline in actions

Figure 4

Number of recipients of enforcement actions

Type	2016 number	2016 fines (RM)	2017 number	2017 fines (RM)
Listing rule breach - Companies	14	-	9	
Listing rule breach - Directors	38	2,117,00	21	5,040,800
Business rule breach - Intermediaries	8	233,500	3	9,000
Business rule breach - Persons	17	2,047,200	7	158,000

Source: Bursa annual reports

Next steps

Introduce electronic voting

Voting at general meetings must now be by poll and is typically handled electronically within meetings. A further step would be the creation of an electronic voting system that allows shareholders to cast votes externally (ie, they would not have to attend), such as is found in China, Japan, Korea and Taiwan. The SC has already identified this as a priority.

Strengthen pre-IPO governance preparation

There is also potential to strengthen governance preparation during the IPO process. We noted the enforcement around Lotte Chemical IPO, discussion on the SC website of intermediary governance, and guidelines on prospectus disclosures that includes requiring discussion of the board committees. However, we could not find safeguards on governance ahead of IPOs, such as appointing independent non-executive directors well in advance and establishing and ensuring the proper function of board committees, particularly the audit committee.

Maintain enforcement momentum

Maintain momentum on enforcement, working with judges to ensure they continue to provide custodial sentences that act as a deterrent to capital market offences.

Enhance efforts on climate change

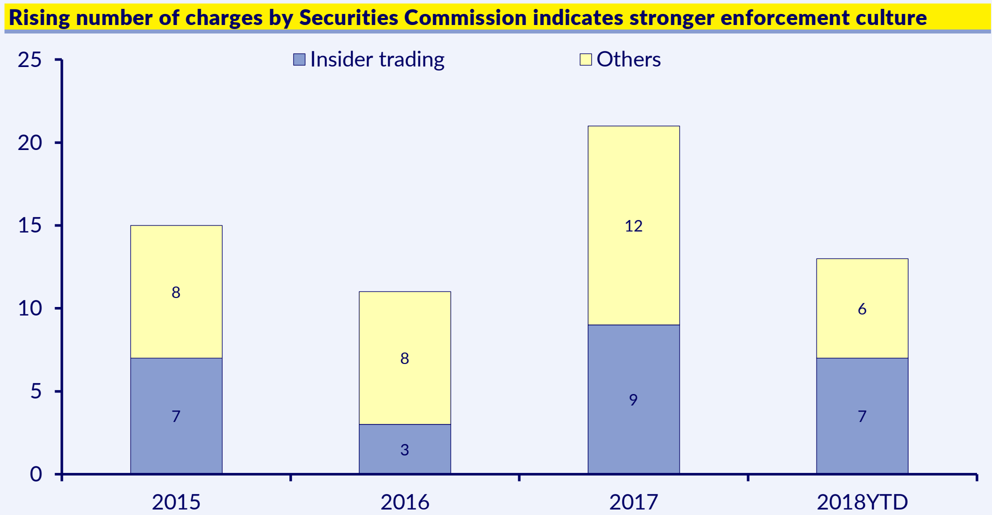
One area where regulators could go much further is on efforts to address climate change. Multiple industries from agriculture to power to healthcare will face issues due to flooding, heatwaves and droughts. At the same time Malaysia is still heavily reliant on fossil fuels. Financial regulators should ensure that these factors are properly considered by financial institutions when allocating capital and that companies are providing sufficient information to show they have plans to address both adaptation as temperatures rise and mitigation at least in line with Malaysia's commitments under the Paris Agreement on climate change.

Sue Lin Lim
Head of Research - Malaysia
suelin.lim@clsa.com
+60 3 2056 7875

Emphasising enforcement

Malaysia's strengthening enforcement culture shows through in multiple ways. First, it can be observed simply in the rising number of charges/cases acted upon by the Securities Commission, especially those relating to insider trading.

Rising number of charges by Securities Commission indicates stronger enforcement culture



Note: As of 3 October 2018. Source: Securities Commission

Errant financial firms also face naming and shaming by the Central Bank beginning January 2018, with enforcement actions published, to act as greater deterrent to malpractices in addition to the monetary fines on infringements that are already in place (RM116m in fines and penalties between 2015 and 2017).

Further, there are clear-cut efforts to make directors liable. The Companies Bill, enforced since 2017, lengthens the arm of the law to hold company director's to greater account - a more serious five-year imprisonment and RM3m fine, or both, if there is a criminal conviction. Specific to dividend declarations, directors now have personal liability if the company fails a solvency requirement where it fails to meet its debts for 12 months after paying dividends.

3. CG rules

Malaysia ranks 3rd, with a score of 70%

Malaysia scores highly in this category because financial regulators have been making steady progress tightening rules over a prolonged period of time. This has resulted in an overall score for rules of 70%, to rank 3rd on this measure. Malaysia's financial reporting rules are mostly on par with international benchmarks, though companies have four, rather than three, months for their audited annual results. Corporate governance reporting standards have improved with the advent of the new CG Code, but a new reporting template that is monitored automatically by the SC (good) may encourage more boilerplate reporting (bad). Bursa is pushing for better MD&As and sustainability disclosure. The concept of independent director is defined under the rules, but a short cooling-off period reduces its effectiveness. Companies are encouraged to provide AGM notices with detailed agendas and explanatory circulars 28 days before the meeting, although the legal requirement is still 21 days' notice.

More changes to both hard and soft rules

The last two years have seen multiple changes to hard and soft rules through the adoption of the new Companies Act, the upgrade to the CG Code, updates to regulations on takeovers and mergers, and various other listing rule changes.

Two-tier independence vote an innovation

One innovative change is the introduction of a two-tier vote on independent directors who have served for 12 years or more. MCCG Practice 4.2 states that where directors are re-elected as an independent director after the ninth year of service, there should be annual approval from shareholders; and where a director is proposed for re-election as an independent director after 12 years of service, there should be a two-tier vote to gain shareholder approval. Under this system, large shareholders (defined as the largest shareholder, or a shareholder with more than 33%, or with the power to appoint the majority of directors, or with de factor operational control) vote in Tier 1 and the other shareholders vote in Tier 2. The vote is successful if a majority in both tiers vote in support of the resolution. Early indications have shown that investors are using this feature where offered, with material dissenting Tier 2 votes of between 35% and 48% at AGMs held between January 2018 and June 2018. In the case of one issuer, CN Asia Berhad, the dissenting Tier 2 vote was 73%.

Better remuneration disclosure - but what about the link to performance and strategy?

Rules also tightened around remuneration disclosure - an issue highlighted in *CG Watch 2016*. Director fees and benefits are now subject to annual approval from shareholders and must be disclosed in detail on a named basis, with a breakdown into different components, such as fees, benefits, salary, bonus, benefits in kind, and other emoluments. MCCG Practice 7.2 stipulates that under the CARE approach there should be disclosure on a named and component basis for the top five senior-management personnel, but only in bands of RM50,000. The "step up" in Practice 7.3 encourages companies to 'fully disclose the detailed remuneration of each member of senior management on a named basis'. While these changes represent an increase in transparency regarding the quantum and nature of remuneration, they still do not help investors understand the links, if any, between management pay and corporate performance, or how pay links to a company's evolving strategy - a point we also raised in our earlier report.

Audit committee oversight of internal audit strengthened

Bursa also upgraded audit-committee responsibilities to include reviewing and reporting to the board on the internal audit plan. The previous rule referred to the 'internal audit programme', an ambiguous term according to market feedback. The audit committee must also undertake a review and report to the board on the internal audit reports and recommendations raised. This is to ensure that the audit committee is better informed about findings and recommendations arising from internal audit.

Good to see Malaysia standing firm on dual-class shares

Finally, we commend Malaysia for standing firm so far on dual-class shares. These disenfranchise minority investors and can result in entrenched management teams. We believe it is not appropriate for listed companies attracting public money to have structures that create such an entrenched imbalance between cashflow rights and control rights. Management teams that wish to ensure the market will be patient as they execute a long-term strategy can present their case to shareholders, who typically take a longer-term view where it is in their interests to do so.

Next steps

While Malaysia scores well overall for rules, there remain multiple areas to address.

Increase cooling-off period for independent directors

One is the need to ensure a longer cooling-off period for independent directors. Directors that are independent from management and controlling shareholders are a critical protection for minority investors. The current definition only provides a cooling-off period of two years where directors have previously acted as an officer or advisor to a listed company, or as a partner, director, or major shareholder of a firm that has provided advisory services to a listed company. This is simply not long enough, as prior relationships may stretch back years or decades.

Link remuneration disclosure to strategy

While there have been significant improvements in remuneration disclosure, these are not yet linked to strategy.

Introduce a mandatory 28-day AGM notice period

The mandatory deadline for publishing final AGM agendas and supporting circulars is 21 calendar days before the meeting under the listing rules. MCCG Practice 12.1 specifies 28 calendar days under the CARE approach. We believe it would be better to make the 28-day notice period mandatory.

Introduce rules on disclosure of share pledging

There have been examples in several Asian markets of sharp falls in share prices where controlling shareholders have pledged shares as collateral for loans and the lenders have taken possession and sold down these shares. Consequently, transparency of share pledges is an important protection to introduce.

Encourage ESG management that actually addresses material issues

Regarding sustainability disclosure, as in other markets, companies generally need to undertake a more specific assessment of their material issues over the long term. Further, even where management provides policy, indicators and targets, there is generally little discussion of whether these actions will be sufficient to actually solve the overall challenge being addressed. This is particularly important for climate change, which requires a major restructuring of multiple industries, including energy, transport and agriculture.

4. Listed companies

Malaysia ranks equal 5th scoring 57%

Malaysian companies have been improving their disclosure in recent years, with the support of investors, regulators and civil society to a more limited extent. This has resulted in an overall score of 57%, to rank equal-fifth with Taiwan on this measure. As with other markets we reviewed 15 large companies and, for some questions, 10 medium-sized companies to support our views on company practices.

Websites are generally informative

The large companies generally had helpful websites, which hosted their annual reports and company announcements. Sustainability reports were embedded in the annual report or available separately on the websites, which often included further supporting ESG information. Only three of the companies provided links to recordings of presentations to investors/analysts, which often surface more information than the formal financial reports.

Financial reporting

Financial reporting is timely and detailed . . .

Overall, both the large and medium-sized companies provided detailed and timely financial reporting. In Malaysia, financial statements are required within 60 days of the period end, but they do not have to be audited at this stage. All of the companies released their results in time. Some exceeded requirements, such as Public Bank, which released audited results for 2017 on 22 February 2018.

. . . except for costs

Malaysian financial reporting provides relatively less detail on operating costs and other comprehensive income. A mere two banks, AMMB and Maybank, provided somewhat detailed breakdowns of their costs. The other 13 companies only provided a functional breakdown into broad administrative, selling and other expenses categories. In some cases, companies had a note setting out 'expenses by nature' (ie, by type or category), but these were often not comprehensive in that the expenses listed did not sum to the cost lines provided in the P&L statements.

A lack of detail on contractor expenses at Dialog Group

In some cases, there were significant unanalysed movements in cost of sales. For example, Dialog Group's contract expenditure rose from RM1.4bn in 2016 to RM2.4bn in 2017, making up a large proportion of cost of sales of RM2.2bn in 2016 and RM3.1bn in 2017. There was no discussion in the annual report about these significant movements, nor in the movement in gross margins, which declined from 12.6% to 9.7%.

CG reporting

CG reporting is typically boilerplate

An update to the listing rules requires companies to produce a CG report in a fixed template describing compliance with the MCCG for reporting periods on or after 31 December 2017. This provides a further source of information in addition to the annual report. As is the case for most markets, corporate-governance reporting is primarily compliance focused. For example, the typical reports from board committees include the terms of reference, which could be hosted separately on the website, while reviews of activities during the year provide lists of standing items with little information related to specific company's activities during the reporting period.

Companies perform board evaluations, but usually do not share findings

The discussion of board evaluations often provides limited information, though Malaysian companies still do better than other markets, with less than half of the large companies providing specific areas to address from the evaluation - beyond commending the directors and overall board for having done a good job. Maybank provides an interesting writeup of its board evaluation, including points that it has incorporated into its improvement plan, notably on director training for disruption and cyber security, and on improving ESG practices and processes.

Director training disclosure is more detailed

One area where Malaysia stands out compared to other markets is in disclosure of training. All provided details on training, with 12 out of the 15 larger companies setting out training undertaken in the year by each director.

Remuneration disclosure improving for amount, but not for structure

Disclosure relating to directors' fees is improving, following changes in the listing rules. These rules should also drive better disclosure of senior-management remuneration. However, none of the companies provided detailed links between company strategy and the structure of remuneration. Without this information it is not possible to analyse a critical driver of senior-management behaviour. AMMB provided information that, while generic, at least included some of the

factors to which KPIs related. IJM provides some of the actual ratios used. Hap Seng Consolidated discusses senior-management pay in a remuneration policy. This does not provide much detail, yet is still better than many companies, which only refer to management's experience and market rates. Hap Seng states: 'The framework of measurement is based on pre-determined Key Performance Indicators (KPIs) under three main areas of the Group's Balanced Scorecard namely Financials, Customers & Market, Internal Business Processes and Learning & Growth.'

Risk assessment good, but less information on mitigation

Aside from Hap Seng, all of the 15 large companies reviewed had risk sections in their annual reports and 12 provided detailed discussion on company-specific risks. However, there was little discussion of the specific measures taken to manage the identified risks. While five companies provided details, 10 provided either no information or only a general statement on how the risks were managed, which makes it difficult to tell whether they have taken sound measures.

ESG reporting

Sustainability reports making progress, but are issues actually managed?

Sustainability reporting in Malaysia is above average compared to other markets. Many of the companies discuss communications with stakeholders and 12 of the 15 larger candidates provided a materiality matrix. Aside from AMMB, all the large names we provided policy relevant to the identified material issues. While sustainability efforts are now underway at Malaysian companies, they are not yet convincing in terms of managing the issues effectively. Most did not provide targets relating to management of the material issues that they had identified and very few addressed the majority of issues material to their sector as defined by the Sustainability Accounting Standards Board (SASB) in the United States.

Banks discuss their own carbon footprint, but not their loan-portfolio footprint

These failings are relevant both for companies and for the market as a whole. For instance, Malaysia is susceptible to significant impacts from climate change and will need to invest both to adapt to the effects and to reduce greenhouse gases in line with its commitments under the Paris Agreement. Indeed, all three of the banks we reviewed - AMMB, Public Bank and Maybank - discussed reducing their energy and carbon footprint, providing relevant data. However, AMMB and Public Bank provided no discussion or policy on how climate change or environmental factors were relevant to their lending decisions to high-carbon businesses or infrastructure. Maybank refers to 'Supporting the transition to an economy that limits global warming' as a low priority in its materiality matrix. Although it follows through with a mention that it has relevant policies regarding client ESG standards, there are no details.

Sapura Energy highlights gaps in strategic thinking on climate

Sapura Energy provided an interesting example of the lack of joined-up thinking. It mentioned how a solar plant at its Perth subsidiary had saved 60% of its electricity costs and was reducing the subsidiary's carbon footprint. However, there was no other mention of the strategic implications of climate change for the business, which is an integrated upstream oil and gas services supplier that faces risks of decreased client spending if carbon regulation tightens and renewable costs continue to fall.

Mid-sized companies not necessarily less detailed

Financial reporting for the 10 mid-sized companies we reviewed was comparably detailed to that of the large companies, but the smaller businesses were simpler. Corporate governance reporting was also at a similar standard. There was a

significant difference in the standards of sustainability reporting, however, where the smaller businesses were far behind. This is to be expected, as businesses with market capitalisations below RM2bn only had to include sustainability statements for year-ends on or after 31 December 2017.

Next steps

Make recordings of presentations available

Companies should host presentations and recordings of analyst presentations or briefings on their websites.

Better detail on costs

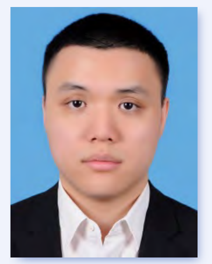
Emphasise the importance of providing detailed breakdowns of cost, so there are not significant areas that are unanalysable from the financial statements.

Identify and manage strategic implications of climate change

Greater focus on implications of climate change for business strategy. Bank Negara Malaysia could assist banks in supporting a national transition to a low-carbon, climate-change resilient economy.

Focus more on specific risk identification and mitigation

Increase emphasis on steps to fully address and mitigate specific risks companies have identified, including those relating to material sustainability issues.



Paul Yap
paul.yap@clsa.com
+60 3 2056 7872

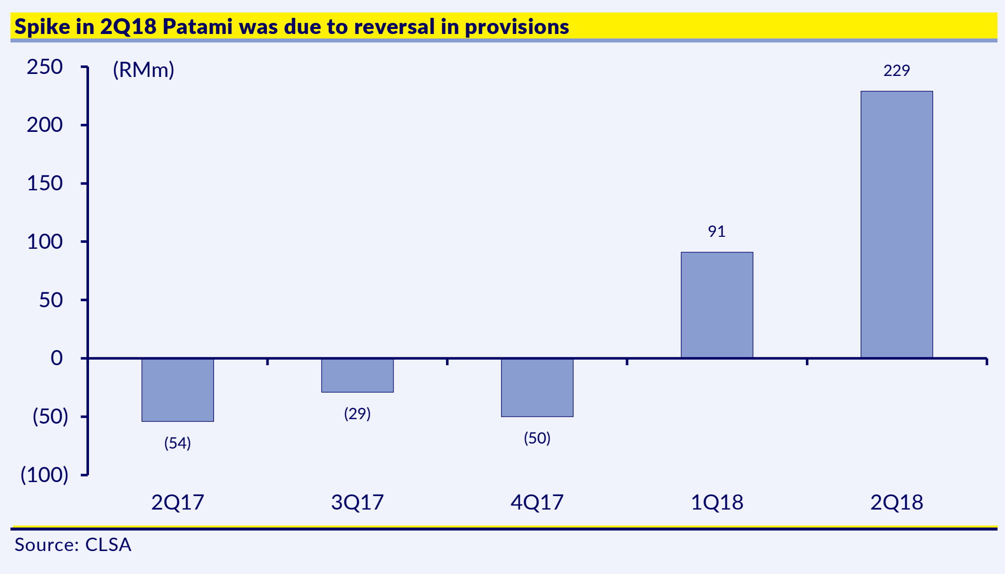
UMW: More disclosure needed

Despite overall improvements, there are still clearly gaps in disclosure. UMW's 2Q18 earnings appeared spectacular, until you realised this was distorted by a reversal in provisions. Management declined to reveal the figure, only mentioning that it relates to the provision of financial guarantees to its unlisted oil and gas segment. Not adjusted to core earnings, this would have inflated results, with the company appearing to generate more profits than it actually did. It also distorts earning trends, both on a quarterly and yearly basis.

Given the complexity of its accounts, due to its various business segments and minority stakes, more has to be done in assisting analysts to derive a true reflection of UMW's sustainable profits. Another situation occurred with the company's 17A results. Sizeable writedowns were only disclosed during its post-results analyst briefing. Even then, it did not give the minority interests portion of the writedowns, making it impossible to adjust for.

Sustainable earnings growth?

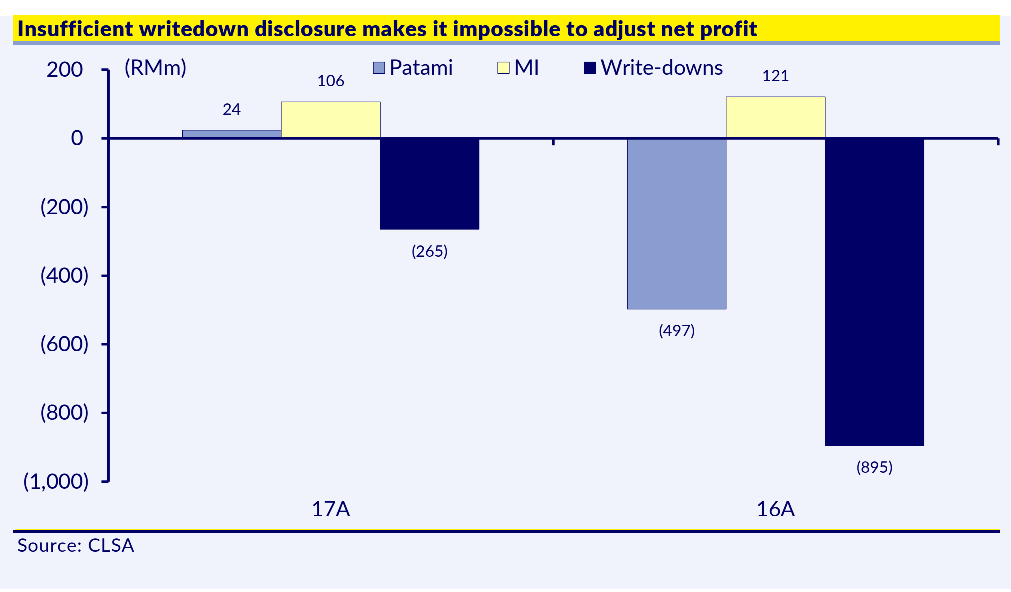
Spike in 2Q18 Patami was due to reversal in provisions



Source: CLSA

It is impossible to tell from public disclosures

Insufficient writedown disclosure makes it impossible to adjust net profit



Source: CLSA

5. Investors

Malaysia ranks 3rd with a score of 38%

Malaysia ranks 3rd in this section, albeit on a low score of 38% - a significant 16ppt difference between it and second-placed Japan. This is not to diminish Malaysia's tangible achievements in this area in recent years. Rather it reflects the fact that the investor ecosystem across Asia remains undeveloped from a CG point of view, investor stewardship is still a new concept, and companies mostly feel little pressure from shareholders.

Malaysia has GLICs - large domestic asset owners

A factor in Malaysia's favour is the presence in its equity markets of a group of large asset owners, the seven government-linked investment companies or GLICs. These hold controlling stakes in more than 40% of Bursa-listed companies on a market-cap-weighted basis. Aside from the GLICs, there are large domestic subsidiaries of global asset managers as well as multiple domestic asset managers.

A leader in Islamic finance, but this does not include stewardship

Malaysia is the largest country for Islamic finance outside of the Gulf states. Consequently, the asset-management industry is familiar with the concept of using ESG considerations to change the universe of stocks. However, the emphasis has been on product involvement, such as no tobacco, rather than on the behaviour of companies, such as poor labour relations. Islamic finance concepts have not yet extended to stewardship in the sense of encouraging better behaviour from investee companies. Meanwhile, the SC's *Guidelines on Sustainable and Responsible Investment Funds* do not mention engagement or stewardship at all.

Increasing signatories to the local stewardship code

Nevertheless, conventional investment management has shown progress on active ownership. The Malaysian Code for Institutional Investors was launched in June 2014 and serves as Malaysia's stewardship code. There were six initial signatories, all of them international investors. Two domestic investors joined in 2015. Since then the list of signatories has expanded to 20. The list includes three GLICs: Kumpulan Wang Persaraan (KWAP), the civil service pension fund; Khazanah Nasional, the country's sovereign wealth fund and supervisor of GLCs; and the Employees Provident Fund (EPF), the nation's largest pension system. The code also has eight supporters ranging from governance bodies to local companies.

The IIC is a novel collective engagement platform

Another special feature of the Malaysian stewardship environment is the Institutional Investor Council (IIC), which formed in July 2015 but was not formally established until December 2017. It is a forum for the largest asset owners as well as insurance and pension industry bodies to discuss governance and ESG. It also provides a focal point for collaboration between investors seeking to advance stewardship in Malaysia and has undertaken three collective engagements to date:

- Lotte Chemical's IPO, where the first quarterly results indicated sharp falls in profit (see the Enforcement section above);
- Multiple governance concerns at Felda Global Ventures; and
- High CEO pay at Sapura Energy.

The IIC collaborative model is unusual in that it brings together a large pool of domestic investment and the engagement is undertaken by leading members of the investment organisations, such as CEOs and CIOs.

International investor engagement is rare beyond palm oil

In line with domestic stewardship efforts, some domestic funds have published their voting and engagement policies, provide some voting information, and attend AGMs. Foreign investors with representation in the local market are also discharging ownership responsibilities, including reporting, aligning either with global practices or the local code. Conversely, there remains a low level of engagement activity by funds without a local presence, reflecting the allocation of stewardship resources to markets with a higher weighting than Malaysia. However, the palm-oil industry continues to receive attention. In August 2018, 90 investors managing US$6.7tn sent a letter to the Roundtable on Sustainable Palm Oil (RSPO), urging it to tighten its standards.

Retail investor questions getting tougher

Retail shareholders often attend AGMs in Malaysia, sometimes in large numbers. While many come for the food and there are anecdotes of time-wasting, including singing, a growing number ask detailed questions, grounded in financial and corporate-governance analysis.

MSWG is a leading local governance advocate

Watching CG, a distinctive part of the investor community in Malaysia is the Minority Shareholders Watch Group (MSWG). MSWG is primarily funded by the Capital Market Development Fund, a government agency. It produces research and analysis on Malaysian companies, including the local assessment for the Asean CG Scorecard. It sends questions to companies ahead of their AGMs and often presents these to the meeting. And the group acts as the secretariat for the IIC.

From a regional perspective, MSWG's role is unusual in its breadth and depth: company analysis, advocacy on behalf of retail shareholders, and collaboration with institutional investors. Its newsletters provide a helpful summary of events in the market and it has the tough role of facilitating the adoption of the Malaysian Code for Institutional Investors. There is no other organisation quite like it, although the Korea Corporate Governance Service performs some similar functions. It is a shame that MSWG cannot be fully funded by domestic investors.

Next steps

GLIC leadership changes present an opportunity

A broader takeup of active ownership among GLICs following the election and recent leadership changes would be a positive.

Public policies and voting records needed from domestic funds

Domestic and international funds could deepen disclosure around their CG policies and voting records and strengthen their teams, particularly on environmental and social issues, to deepen and broaden the basis of engagement.

Stewardship convergence with Islamic finance a major opportunity

There is also much to be gained from a cross-fertilisation of ideas between Islamic finance and responsible investment. The next iteration of guidelines on SRI and Islamic finance compliant funds should highlight the importance of considering the behaviour of investee companies, not just products, and the wider stewardship role that institutional investors could play.

6. Auditors and audit regulators

Malaysia ranks equal-1st, with a score of 84%

Malaysia scores 84% to come equal-1st with Australia in this category, a result in large part due to solid progress made by the Audit Oversight Board (AOB), one of the region's most effective audit regulators and probably the best communicator. The AOB acts as an independent regulator to promote 'confidence in the quality and reliability of audited financial statements of public-interest entities and scheduled funds in Malaysia', the responsibility for scheduled funds being added to its remit in 2017. Unlike its counterpart in Singapore, ACRA, it has powers over both CPA firms and individual auditors.

Accounting and auditing standards are in line with international standards

Local accounting and auditing standards have both kept pace with international standards. Local implementation of IFRS 9 proceeded according to the international timeline and extended audit reports with key audit matters are required. As with other markets, the industry faces challenges retaining staff and there are audit quality issues related to all firms, particularly outside the major firms. One potential issue we have noted regarding audit independence is where audit committees include former partners from the external auditor.

The AOB provides useful and informative reporting

We mentioned our positive opinion of the AOB as a regulator in previous editions of *CG Watch*. Its annual report and a separate annual inspections report, first issued in 2018, set a good example for the region, providing details of its inspection programmes as well as giving useful insight into the structure and practices of the CPA industry, and where the AOB is focusing on improvements. Prior to 2018, it covered its inspection activity in detail in its annual report.

AOB reviewed 19 audit engagements

The AOB continued its inspection programme, reviewing 19 audit engagements for the six major firms and eight audit engagements at four other firms. All the engagement inspections for the other audit firms revealed that significant improvements were required. Common findings from the inspections included: acceptance of clients prior to completing client evaluations; failure to assemble audit engagement files within 60 days of the audit report; some re-inspected firms failing to address previously identified issues; and some firms having failures in identifying audit-quality issues.

It has taken a proactive stance on the industry

The AOB has been taking action to ensure that auditors for public-interest entities have the capacity to handle audit engagements. This has resulted in a decline over the last five years in the numbers of small audit firms with less than 10 partners. In line with this consolidation, AOB has strengthened its registration criteria and continued with its enforcement, including issuing fines, reprimands, and in some cases temporary bans on taking on work.

With four enforcement actions in the year

There were enforcement actions for failure to comply with International Standards on Auditing at one firm in 2017 and three firms in 2018. The actions all involved smaller firms, with sanctions against firms or individual audit partners including reprimands, fines, and in the case of Siew Boon Yeong and Associates, prohibitions from auditing public-interest entities (PIE) firms for nine months. There were two appeals to the SC, both of which were rejected.

Shape of the industry

The audit industry is highly concentrated

The market for PIE audits remains concentrated, with the six major audit firms undertaking 764 PIE audits of firms that account for 93% of market capitalisation, while the other 43 locally registered audit firms undertake 384 PIE audits representing 7% of market capitalisation. The statistics for scheduled funds are even more concentrated in the six major audit firms. There are also five foreign-registered firms that undertake seven PIE audits.

Audit partners taking fewer clients a potential positive for audit quality

The ability of audit partners to provide oversight of audits is a critical factor for quality. Considering the top 10 audit firms, between 2015 and 2017 the number of PIEs declined from 938 to 921, while the number of audit partners increased from 196 to 206. The number of PIE's per partner stayed at 5. However, the number of PIE-related clients per audit partner fell from 58 to 52 and the number of non-PIE clients per partner fell from 154 to 143 over the same period. As the AOB itself notes, 'a lower number of audit clients per partner would allow for greater partner involvement'.

Aging amongst senior partners requires succession planning

One longer-term issue is the age profile of audit partners, 42% of whom are 50 years or older. Of these, 36% are aged 60 or above and concentrated in firms with fewer than 10 partners. This makes succession planning particularly important and could result in further consolidation in future.

Declining staff turnover, but fee growth less than staff-cost growth

On a more positive note, annual staff turnover rates fell from 28% to 22% between 2015 and 2017. There was a slightly lower proportion of staff at firms that have only been there for one year: 22% in 2017 vs 24% in 2016. Meanwhile, audit fees actually rose 5.3% in 2017, slightly less than staff cost growth of 6.1%.

Auditor rotation and cooling-off periods both extended

Like Singapore, Malaysia is following international norms and amending its rules on the rotation of PIE audit partners. Issued by the Malaysian Institute of Accountants (MIA) and relevant for periods from 15 December 2018, the rule on rotation is changing from five years with a two-year cooling-off period to seven years with a cooling-off period of five years for the engagement partner, three years for the engagement quality review partner, and two years for other key audit partners. The full rules take effect for reports after 15 December 2023. For audits prior to this, the transition rules are the same as the full new rules, except that the engagement partner only has a three-year cooling-off period.

Malaysia is not obliged to lengthen its rotation period

It is important to highlight that the seven-year rotation standard has long been a feature of international auditor independence standards issued by IESBA in New York. IESBA is extending the cooling-off periods to enhance auditor independence and professional scepticism. Malaysia and Singapore are not obliged to increase their current five-year rotation rules to seven years.

There have been major issues at Bursa-listed Chinese companies

There have been major challenges with accounting and auditing at Malaysian-listed PRC companies, such as Multi Sports Holdings, where the auditor was unable to obtain information regarding the status of multiple mainland-Chinese subsidiaries. In August 2018, the SC signed an MoU with China's Ministry of Finance that former SC chair, Tan Sri Ranjit Ajit Singh, stated would 'enable both countries to benefit in areas of mutual interest relating to accounting and auditing'.

A different story outside PIEs

There are accounting and auditing issues for non-public-interest entities

The challenges for the Malaysian accounting and auditing professions appear greater outside public-interest entities. Malaysia has to ensure that the industry is well-governed and that there are enough qualified accountants to serve the nation's needs for accounting and audit as the economy grows. MIA is currently responsible for both regulation and professional education for accountants and non-public-interest entity audits.

Need to build a more robust accountancy profession in Malaysia

A 2012 World Bank *Report on the Observance of Standards and Codes in Accounting and Auditing* provided a set of recommendations in relation to these needs. In light of this report, the Committee to Strengthen the Accountancy Profession in Malaysia (CSAP) was established with representation from relevant Malaysian institutions. Its report, submitted to the Minister of Finance in August 2015, contained 15 recommendations and included a target of 60,000 accountants by 2020. The Minister of Finance accepted the report and mandated the SC to set up a committee to implement the recommendations.

Confusion caused by dual MIA roles: it is regulator and professional body. CSAP recommended separation

The recommendations from these reports include strengthening accounting certifications to ensure high standards and requisite professional experience, and addressing how to grow the profession to meet the needs of the economy. The World Bank report also includes a recommendation that 'an independent review of the governance structure of MIA should be conducted'. CSAP carried out this review, but noted the confusion caused by the dual roles of MIA as both a regulator and professional body. It recommended that a 'new regulatory body to be set up to lead the accountancy profession in Malaysia'.

International accounting body also notes move away from self-regulation

The International Federation of Accountants (IFAC), a global membership organisation for accounting bodies such as MIA, responded to the recommendations during drafting. IFAC commended the approach of making recommendations specific to the Malaysian environment and also noted that 'in recent years many jurisdictions have moved away from a model whereby the profession is almost totally self-regulated to arrangements whereby the regulatory community has greater involvement'.

MIA 2017 report discusses CSAP recommendations, but 2018 report does not

MIA is the secretariat of the implementing committee. Its 2017 annual report provides significant discussion of the recommendations, including steps taken on surveillance and enforcement. However, there was an unexpected change in leadership at the MIA in August 2017 and the 2018 annual report provides limited reference to the recommendations.

There are several major challenges to developing the accounting profession

Observers mentioned several challenges to developing the accounting profession in Malaysia. These include ensuring it develops in line with the nation's interests, having a consistent quality standard for certified accountants, and strengthening enforcement.

There is no competency exam for MIA membership

MIA members are entitled to the designation of Chartered Accountant Malaysia. Membership is open to local university accounting graduates with three years' work experience. However, there is no competency examination to determine membership. This creates varied levels of competency across the profession.

MIA enforcement figures highlight the issue of varying levels of competency

The MIA's surveillance and enforcement figures highlight the problem. They show that in the financial year 2017/18, out of 56 final reports issued into reviews of selected high-risk firms, only two had a straightforward pass. There were 24 reports with unsatisfactory findings requiring follow up, 14 that were

unsatisfactory and required disciplinary action, and two cases of firms assigned at Type 4 rating that indicates practitioners had behaved unethically. These failings highlight significant challenges.

MIA has a diverse constituency that makes reform difficult

Observers note that MIA has not been able to align with national interests and strengthen its enforcement when it is a member organisation with many constituents that may be disadvantaged by the necessary actions. This was in fact the reason for the proposal to introduce a new regulatory body. It will be important to restart this process and the SC should ensure there is no further slippage in implementing the reforms.

Next steps

Accounting regulation needs stronger governance standards

Ensure continued reform of the broader accounting profession with a new regulatory body for accountancy. Address the governance framework at MIA, maintain progress on enforcement, improve professional qualification standards with appropriate curriculum and experience requirements.

Audit independence relies on stronger definition of independent directors

Strengthen the independence of audit committees, ensuring longer cooling-off periods before former audit partners can chair audit committees at companies where their previous firm conducts the audit.

7. Civil society and media

Malaysia ranks 8th, scoring 47%

Malaysia's score of only 47% and 8th rank in this category reflects the many challenges that civil-society organisations and the media have faced under successive and often autocratic governments. Indeed, the high levels of concern across society over the direction of the country, and a more engaged electorate over the past two years, directly led to the first significant change in government since the formation of an independent Malaysia. However, the focus for this section is on whether civil society and the media are addressing questions of corporate governance, rather than broader social or political concerns. Consequently, our emphasis is on the various professional associations and non-profits that play a role in developing corporate governance.

Training and education

Director institute relaunched

The newest organisation to emerge is the Institute of Corporate Directors Malaysia (ICDM), which launched on 1 October 2018. Chaired by former SC chair, Tan Sri Zarinah Anwar, it took over the functions of the Malaysian Directors Academy, which ceased operation at the end of 2017. ICDM has the potential to fulfil a constructive role in the Malaysian CG ecosystem.

MAICSA issued AGM practice guide

Of older vintage is the Malaysian Institute of Chartered Secretaries and Administrators (MAICSA), whose history dates back to its founding in 1959 as an affiliate member of the UK's Institute of Chartered Secretaries and Administrators. It serves as the gazetted professional body for chartered secretaries in Malaysia. MAICSA runs multiple training events. In November 2016 it published a *Best Practice Guide on AGMs for Listed Issuers* with Bursa's support.

MICG, Iclif, MACD provide training to support the director ecosystem

Other organisations include:

- The Iclif Leadership and Governance Centre, which runs training programmes for directors. These include the Financial Institutions Directors' Education Programme (FIDE) for directors in financial institutions, the Mandatory Accreditation Programme (MAP) for new listed company directors, and the Shariah Leaders Education Programme (SLE) to develop members of Shariah committees.

- The Malaysian Institute of Corporate Governance (MICG), a membership organisation founded by the Federation of Public Listed Companies, the Malaysian Institute of Accountants, the Malaysian Institute of Certified Public Accountants, MAICSA, and the Malaysian Institute of Directors. It provides various training programmes and resources and in July 2018 launched the Pathway to a Governance Practitioner Programme, which will support the development of governance practitioners.

- The Malaysian Alliance of Corporate Directors (MACD), which is part of the global network of director institutes and provides training.

Research

Study highlights role of government in economy through GLCs/GLICs

A review of university publications revealed a significant decline in Malaysian studies of corporate governance in recent years. However, we have seen some civil-society studies that address corporate governance (aside from the work of MSWG covered in the Investors section). A notable example is a book titled, *Minister of Finance Incorporated: Ownership and Control of Corporate Malaysia*, by Terence Gomez with support from the Institute for Democracy and Economic Affairs (IDEAS). This sets out the extent and manner of government involvement in the economy through GLICs and GLCs, which is particularly high for Malaysia.

Other CG-related publications and research includes:

- An inaugural study on *Transparency in Corporate Reporting*, published by The Malaysian Institute for Corporate Governance (MICG) in 2017.
- G25, a group of influential Malays including former civil servants, also produces work on institutional reform that is relevant to corporate-governance standards.

Governance and sustainability

RSPO an interesting model of supply-chain governance

In the area of environment and sustainability, the Roundtable on Sustainable Palm Oil (RSPO), which has its primary base in Malaysia, is an interesting example of an organisation that supports governance of sustainability across a supply chain. RSPO-certified palm oil has made progress and represents 19% of global palm-oil sales. The RSPO has also received requests, including from investors, for it to tighten standards. While standards have strengthened, this has taken time due to the consensus decision-making process, the limited premium for certified palm oil, and the costs for certifying smallholders unless there is local government support.

The media is much freer under the new administration

One challenge noted in *CG Watch* 2016 was suppression of the media, with suspensions for organisations that published on 1MDB, such as the Edge and The Malaysian Insider. We are pleased to note what appears to be a much less restrictive atmosphere for the media post the May 2018 election. Indeed, in August 2018 the new government repealed an anti-fake news law passed by the previous government in April 2018 and which had received broad condemnation as a tool to prevent publication of dissenting views.

Next steps

Regulators can make civil-society participation in consultations easier

Encourage stronger inputs from professional associations and civil-society organisations into regulatory consultations. One useful step to make it easier is for the SC and other relevant bodies is to provide longer public consultation periods.

Malaysia's response to our suggestions from 2016 has been mixed

Recap and recommendations

Recap of CG Watch 2016

To what extent has Malaysia responded to our recommendations from 2016?

Figure 5

Malaysia: recap of 2016

	Recommendations	Outcomes
1.	Provide more detail on enforcement cases, including a statistical analysis of enforcement trends	Limited progress. Further detail and analysis possible
2.	Improve disclosure of remuneration levels and structure of management pay	Significant progress. But link between incentives and strategy still not communicated
3.	Tighten definition of "independent director" (eg, longer cooling-off periods)	No action
4.	Investors should express their views on CG, strategy, sustainability and capital allocation more assertively; and sign the Malaysian Code for Institutional Investors	More signatories. IIC undertakes first collective engagements with companies
5.	Maintain momentum on enforcement and surveillance	Progress continued

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the market's score to fall in 2020:

- The government or regulators seek to introduce dual-class shares
- Regulatory reform fails in the accounting profession
- Corruption investigations at 1MDB and other infrastructure projects fail to deliver results with due process or become a politicised witch-hunt
- Limited tangible outcomes from institutional reform and the GIACC
- Slowing momentum on stewardship and active ownership

What to fix

Quick-fix list

Issues to address as soon as possible:

- Encourage stronger participation from professional associations and civil society in regulatory consultations, including longer consultation periods
- Strengthen the definition of independent director with longer cooling-off periods
- Enhance remuneration disclosure so that the links to strategy are evident
- Introduce electronic voting ahead of the AGM and extend the mandatory notice period to 28 days
- Continue to press companies to address material sustainability issues

Christopher Leahy
Specialist Consultant, ACGA
chris@acga-asia.org
+65 8201 0855

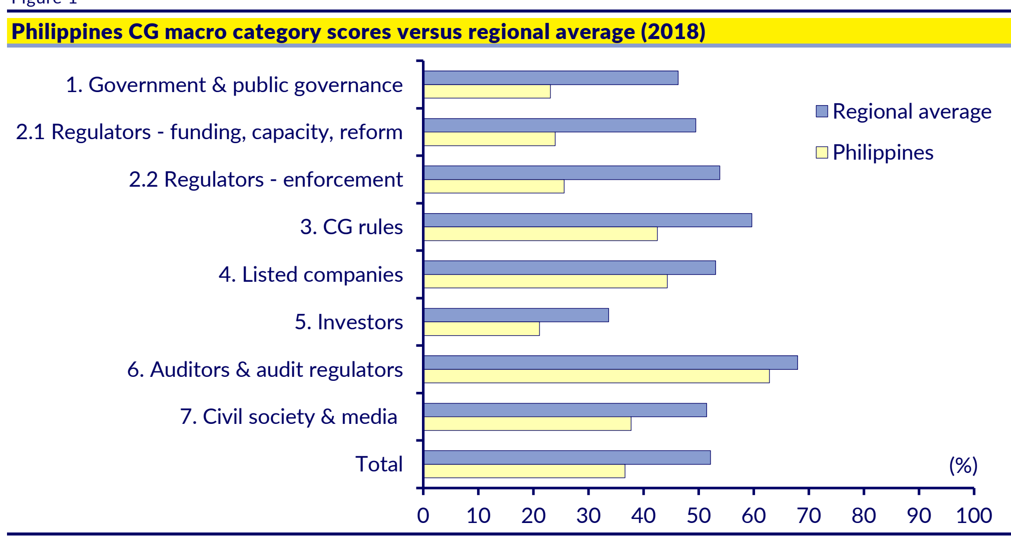
Philippines - Fits and starts

- Corporate governance very low on the government's agenda
- Reform tends to be regulator-driven and reactive to external events
- Recent evidence of politicisation of the SEC is a real concern
- There have been few major CG reforms for two years
- CG disclosure has improved and accounting and auditing standards are high
- Enforcement remains weak and patchy at best.

Philippines ranks 11th with a score of 37%

Figure 1

Philippines CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

CG is not the country's biggest concern

Corporate governance sits far down on the agenda of the government of President Rodrigo Duterte, if indeed it appears at all. To be fair, the country has more significant issues: rampant corruption, a crushing need for new and replacement infrastructure, high under-employment, anti-competitive industries and now, a ballooning budget deficit and high inflation. Need we go on?

Corporates a drag on governance

There is little to no impetus from within the country's cosy corporate sector to push CG reforms: life is far too good as it is. Indeed, regulators have met stiff resistance in the past to CG reform proposals from vested corporate interests. The Philippines lacks the mature domestic institutional investor base needed to drive a CG agenda, in the main because equity investment remains limited to a relatively small and affluent section of society, and government savings and social security systems are not nearly large enough to grow the country's equity ownership at a rate sufficient to generate a culture of equity ownership among retail investors.

Regulators react to outside pressure

With companies mostly not interested, and institutional investment limited, CG reform in the Philippines stutters along in fits and starts at the hands of the regulators, principally driven by the Securities and Exchange Commission (SEC). The extent and pace of any reform is very much driven by the SEC Chair, a Presidential appointment. Over the last three or four years, the SEC has tended to be reactive in its reform efforts, most notably to outside stimuli: the Asean CG Scorecard for instance. There is little evidence of a strong proactive reform agenda from either the SEC or the Philippine Stock Exchange (PSE).

CG will remain behind other markets for some time

Until genuine regulatory reform emerges, supported by institutional and retail engagement and embraced by a more reform-minded corporate sector, CG in the Philippines will progress inconsistently, remaining materially behind best practice in other markets in Asia-Pacific.

Alfred Dy
Head of Research
alfred.dy@clsa.com
+63 2 860 4008

Some good news and some bad news

A mixed bag

Since our last CG Watch in 2016, the Philippines has produced a mixed bag of results in terms of corporate governance.

On the positive side, we note the six-month closure of Boracay Island; and Megawide's decision to revoke a bank guarantee it had issued in favour of a prospective corporate client.

On the negative side, we note: the continued inability of toll road and water concessionaires to effect previously agreed upon rate hikes; the controversial approval of Landing International Development Ltd's US$1.5bn casino project in Entertainment City; the Energy Regulatory Commission's (ERC's) decision to move the implementation of the Competitive Selection Process (CSP); Metrobank's rogue employee incident; San Miguel Corporation's tender offer for Liberty Telecoms; DNL's leases with owner's private companies; Melco Resort Philippines planned delisting on the cusp of profitability; Wilcon's store leases from owner's private companies; the ongoing corporate mess in Alliance Select Foods; Double Dragon's booking of revenue; and a lone gunman wreaking havoc at Resort World Manila (RWM).

1. Government and public governance

Philippines ranks 12th with a score of 23%

The reactionary and machismo administration of President Rodrigo Duterte means government and public governance sit uneasily in the same sentence in the Philippines. A self-styled war on drugs that has seen thousands murdered, a successful political purge of all meaningful opposition, and an administration that looks increasingly reactionary; it is little surprise corporate governance appears so low on the government's agenda.

CG not on the agenda, but some bright spots in economic reform

That said, Duterte has shown some reformist economic zeal. He has railed (rightly) against the duopolistic inefficiencies of the country's inadequate and extortionate telecoms sector, threatened (rightly) the oligopolistic business empires of the country's crony corporate families, and promised (rightly) to jail corrupt civil servants and politicians. Yet the whiff of corruption is never too far from his own administration: Duterte is regarded as far too close to mainland Chinese interests and is heavily backed and influenced by families close to the Marcos family, including former President Gloria Macapagal Arroyo, now firmly back in a position of power and influence.

Key guardians of the economy largely untouched

More positive for the country is the fact Duterte has largely left the more competent institutions of government alone. The Department of Finance (DoF) under Carlos Dominguez continues to operate with sufficient independence of the country's infamous political squabbling; while the central bank, Bangko Sentral Ng Pilipinas (BSP), long a proudly independent institution, continues to govern the country's exuberant banking sector with skill and credibility. Given the economic headwinds facing the Philippines, after years of plain sailing, the country will need all of this experience to manage the tougher years ahead.

SEC used as a political pawn

While government has largely stayed away from politicising the DoF and the BSP, the same cannot be said of the Securities and Exchange Commission (SEC), the country's chief regulator. In January 2018, the SEC revoked the certificate of incorporation of local media outlet Rappler Inc, ostensibly for breaching stringent foreign ownership restrictions in the media sector. But it was widely acknowledged the SEC investigation was mandated by Duterte, enraged by the website's criticism of his regime: the SEC even acknowledged it had been instructed by the Office of the Solicitor General (a Duterte appointee) to launch an inquiry. And in April 2018, the SEC abruptly tightened rules on external auditor appointments as a result of an Administrative Order from the Office of the President, not so much because the president thought it a good thing to do, but more so the country would score better in the World Bank's Ease of Doing Business Report.

Judicial independence attacked by the Executive

The judiciary has also been subject to attack by the president: Chief Justice Maria Lourdes Sereno, a fierce critic, was removed earlier this year from her position on spurious grounds and via unconstitutional means. There are no special courts used to try securities cases, although the Philippines judiciary does have a reasonable familiarity with issues relating to company law and securities case law. Class action is possible in the Philippines, but the requirement to prove a case qualifies for such treatment and the general prohibition on contingent funding both tend to stymie cases.

SOE reforms have stalled

The previous administration made some inroads on improving the governance of state-owned companies, known locally as Government-Owned and Controlled Corporations (GOCCs), but those reforms seem to have stalled of late. GOCC board members are appointed by the GOCC Commission on Governance and, ultimately, by the president on one-year terms. Most GOCCs are not statutorily independent but report to an administrative department, so remain heavily susceptible to political interference.

2. Regulators

Philippines ranks 11th overall with a score of 25%

The Philippines' securities regulatory system follows a similar structure to most Asian markets, with the Securities and Exchange Commission (SEC) being the primary regulator and the Philippine Stock Exchange (PSE), a for-profit bourse listed on its own exchange, acting as frontline regulator. In addition to its securities market responsibilities, the SEC registers and deregisters companies, licences and regulates finance and securities companies, issues new implementing rules and regulations under the various corporate and market ordinances and regulates external auditors. While the SEC is functionally independent of government, it relies on a budget allocation from the Department of Finance, and proudly talks about its leading revenue-generation status on behalf of the central government via fees and levies. The chair of the SEC is a presidential appointment for a fixed term and its commissioners are generally civil servants. Government influence over the SEC is therefore material.

2.1 Funding, capacity-building and regulatory reform

The Philippines ranks 11th in this sub-category with a score of 24%

The SEC continues to lack sufficient funding to undertake its securities market regulatory functions. In part, this is because of its material revenue generating role for the central government. In 2016 - the latest available data - it collected PHP2.8 billion (US$58m) for the national government, while receiving a budget allocation of just PHP635m (US$13m) - one of the smallest in the region by a long way. Case in point: a new purpose-built building has been planned for almost

three years with no sign of imminent completion, now slated for 2020. Meanwhile, the SEC operates from two separate and temporary locations, neither of which is fit for purpose. The lack of funding also explains the SEC's poor website, which is difficult to navigate, out of date in parts, and not even secure. The latest available annual report on the SEC website is from 2016. This from the regulator that aims to protect the public from Ponzi schemes and phishing attacks while demanding prompt filing of annual reports from companies it regulates.

The PSE is in rude financial health

The PSE is better-funded as a self-regulatory organization: in 2017 it reported profits of PHP828m on revenue of PHP1.6 billion. It receives no government budget allocation and recently moved in to a brand new purpose-built office on Fort Bonifacio. The contrast with the SEC could not be starker. The PSE website is also a much better product than the SEC. Its Edge system for company disclosure is especially good: it is well-constructed, loads quickly and is easy to navigate. A shame it only provides two years of historic company data.

Regulator reacts to outside pressure to reform . . .

Regulatory reform in the Philippines has progressed intermittently over the last few years, and normally requires some form of external catalyst to generate sufficient collective momentum. An example of this is the SEC's laudable CG code for PLCs, issued in 2016, which was a swift and strong reaction to poor scores in the Asean CG Scorecard, a regional CG survey of listed companies. However, 2016 was the last year for major CG rules and regulations: we have failed to identify any significant initiatives by the SEC or PSE since. Meanwhile, the SEC relies on the Corporation Code from 1980 and the Securities and Regulation Code of 2000. Neither has had a material revision, which is long overdue.

. . . and bows to pressure from within

In another sign of outside influence on the SEC, in April 2018 it announced a material dilution of its definition of independent director, introducing for the first time a cooling-off period of two years for people who have business relationships with listed companies (previously no cooling-off period had been allowed). Sources at the time suggested the SEC had bowed to pressure from companies that found the current restrictions too stringent.

2.2 Enforcement

The Philippines ranks 11th in this sub-category with a score of 26%

Enforcement remains weak in the Philippines, but has slightly improved under the new SEC Chair, Emilio Aquino. Much of the SEC's enforcement activity is aimed at shutting down Ponzi schemes and other scams that affect the *hoi polloi*: understandable given investment in the stock market remains the purview of the privileged few. Arguably, there is better political mileage to be made in shutting down scams than in protecting wealthy investors from losing money to unscrupulous companies and management. The SEC did move to increase the minimum public ownership (MPO) of listed companies in May 2017, requiring all new listing candidates to ensure a MPO of 20% from July 2017, while mandating existing listed companies to increase their MPO to 15% by end 2018 and to 20% before the end of 2020.

A more sinister move by the SEC was the politically-motivated action in March 2018 against Rappler Inc, a media company highly critical of the Duterte regime. At least the Rappler incident proved the SEC can enforce — when it wants to (or is told to). It investigated one case of insider trading in 2016, the latest date for which data is available.

PSE enforcement livelier and less political

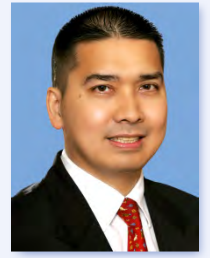
PSE enforcement seems to be a bit more enthusiastic than the SEC, and less politicised. It clamped down on Calata Corporation's mind-boggling list of listing rule breaches and delisted the company in December 2017.

PSE monitors insider trading . . . but want happens to these cases?

The PSE still operates its Capital Market Integrity Corporation (CMIC), which monitors and investigates insider trading market manipulation and securities violations. According to the PSE's 2017 annual report, CMIC referred 26 cases of securities violations in 2017 to the SEC and 12 violations of PSE listing rules. What happened to those cases is unclear: most likely they remain with the SEC, which is slow to investigate and, in the case of further action, is required to refer cases to the Office of the Attorney General.

Alliance Select case proves the Philippines can enforce . . . when it wants to

Other than the limited regulatory enforcement cited above, there have been few examples of any other major enforcement cases against errant companies. One example worthy of note is the December 2017 criminal indictment by the Department of Justice of the management and shareholders of a tuna canning company, Alliance Select Foods International, for violations of the corporate code. The case is especially notable since it arose from an ill-fated investment made by two Singapore investors who launched a derivative suit against controlling shareholder Jonathan Dee and family, accusing them of "deliberately mismanaging and siphoning company finances for their personal gain" and citing alleged significant undisclosed related-party transactions. The case proves the Philippines has both the laws and means to prosecute fraud and corruption, but too often lacks the political will to do so.



Alfred Dy
Head of Research
alfred.dy@clsa.com
+63 2 860 4008

Metrobank's rogue employee incident

In 3Q17, Metrobank was hit by a rogue employee incident when its Corporate Services Management Division Head, Ma Victoria S Lopez siphoned off P1.7bn from the bank through falsification of commercial documents. Metrobank, on July 26, 2017, filed criminal charges with the Regional Trial Court - National Capital Region Makati City versus Ma Victoria "Marivic" S Lopez, et al for the *ex parte* application for a writ of attachment and collection of sum of money amounting to P900m and all accrued and accruing interests and penalties, plus damages and cost of suit. Ms Lopez was arrested by operatives of the National Bureau of Investigation's (NBI) anti-Fraud Division on July 17, 2017 at MBT's main office in Makati City and has been detained at the NBI office since then.

A senior bank executive siphons off P1.7bn

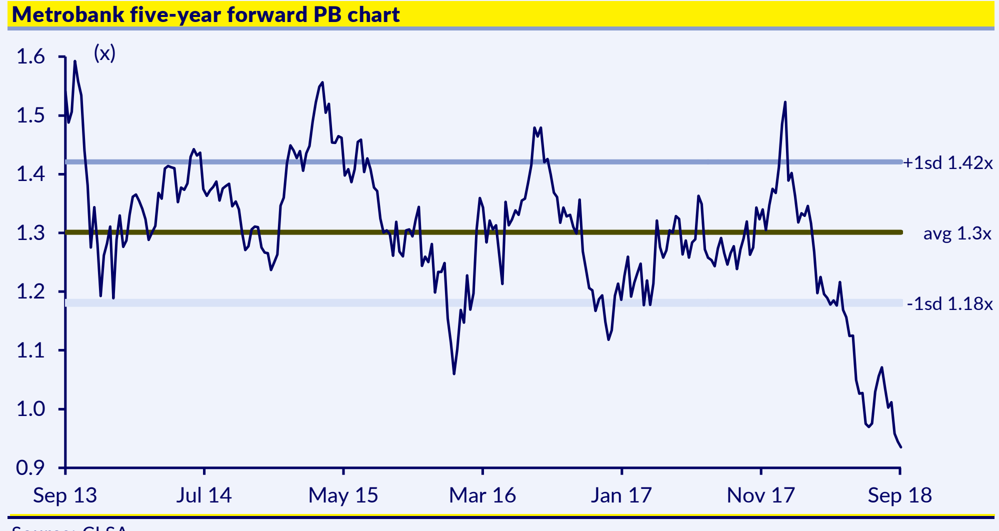
In November 2017, Metrobank Chairman Arthur Ty disclosed a rigorous audit process resulted in the bank determining conclusively the amount stolen by Ms Lopez stood at P1.7bn. Bangko Sentral ng Pilipinas (BSP) unveiled a slew of sanctions against Metrobank in relation to the fraud. They included: reprimands and suspension of directors and officials; allocating P4.45bn of its capital on a consolidated basis to cover for higher risk. This requirement is subject to periodic review and will be lifted when the bank is determined to have put in place adequate risk control measures to address the weaknesses noted; and Metrobank was ordered to execute and submit a letter of commitment to be implemented and completed within one year, to enhance corporate governance, credit administration, internal controls and audit, risk management, and customer on-boarding and monitoring process. The BSP did not levy any outright financial penalty on Metrobank. The P4.45bn in extra capital to be

Bangko Sentral ng Pilipinas imposes penalties

allocated to cover for higher risk only translates to 0.3% of common equity tier one (CET-1) ratio and thus does not really move the needle, given Metrobank had a CET-1 ratio of 13.3% as of 9M17.

Concerns about controls have hit Metrobank's share price

Metrobank five-year forward PB chart



Source: CLSA

Jose-Paolo Fontanilla
jose.paolo.fontanilla@clsa.com
+63 2 860 4006

Toll-road and water rate hike blues

Difficult regulatory environment for toll road companies

The regulatory environment for toll road businesses had been tough for Metro Pacific since the previous administration. It has been unable to secure inflation-based increases - as agreed upon under its concession agreements - for its North Luzon Expressway (NLEX), Manila-Cavite Expressway (CAVITEX) and Subic-Clark Tarlac Expressway (SCTEX) operations since 2012.

As of end-June 2018, the revenue claims from the delayed tariff increases for NLEX, CAVITEX and SCTEX totalled P9.8bn.

Revenue loss/claims from delayed toll rate hikes

Pbn	2012	2013	2014	2015	2016	2017	1H18	Total
NLEX	-	0.8	0.8	1.2	1.3	1.9	1.0	7.0
CAVITEX	0.1	0.1	0.2	0.3	0.3	0.3	0.3	1.6
SCTEX	-	-	-	0.1	0.4	0.5	0.2	1.2

Source: Metro Pacific

Revenue claims from MPI's delayed toll rate hikes reached a combined P9.8bn as of end-June 2018

In April 2016, Metro Pacific kicked off an arbitration process against the government. However, both parties decided to negotiate on a compromise agreement and settle the issue out of court. Possible courses of action involve a staggered catch-up on rates until 2023, as well as an extension of the concessions to address the revenue claims.

Legal battles have been a norm for the Philippine water regulation scene

Arbitration proceedings have been the norm for Manila-based water distribution utility companies when it comes to dealing with their regulators. Metro Pacific's subsidiary Maynilad Water has found itself using this legal avenue since 2013.

Maynilad has been back and forth as to arbitration in dealing with local regulations

Timeline of Maynilad Water's arbitration proceedings

Date	Event
Jan 13	Maynilad submitted to the MWSS Regulatory Office a five-year business plan covering 2013-2017 that required an increase in the company's basic charges by P8.58 per cubic meter
Sep 13	The MWSS-RO issued a resolution that instead ordered Maynilad to cut rates by P1.46 per cubic meter over a five-year period with a key point of the argument revolving around its exemption in the payment of corporate income taxes. This prompted the company to seek arbitration
Jan-15	An appeals panel presided over by the International Chamber of Commerce (ICC) awarded Maynilad an average increase of P3.06 per cubic meter on top of the current basic rate of P31.28 for the five-year rate rebasing period
Mar 15	Maynilad sent a letter to the Department of Finance seeking P3.44bn in compensation for 26 months' worth of tariff increases that it could not collect from its customers due to inaction on the part of regulators
Jul 17	The three-member arbitral tribunal of the ICC issued a decision unanimously upholding the validity of Maynilad's claim for the delayed implementation of its relevant tariffs for the rebasing period 2013 to 2017
Feb 18	The Philippine Republic filed an application with the High Court of Singapore to set aside the 24 Jul 2017 ruling issued by the arbitration tribunal in favour of Maynilad
Oct 18	The Singapore High Court officially dismissed the Philippine Republic's petition to set aside the July ruling of the arbitral tribunal that unanimously ruled in favour of Maynilad

Source: CLSA, Metro Pacific

In spite of securing two favourable rulings from international courts during that time span, the regulating body Metropolitan Waterworks and Sewerage System (MWSS) has to this date yet to enforce any of the rate increases that should have been awarded to Maynilad.

While the current administration - upon assumption of power in mid-2016 - had earlier indicated it would abide by international arbitration rulings that may be favourable to Metro Pacific, it has acted in a manner opposite to a point the government asked the tribunal to set aside its 24 July 2017 ruling.

Jose-Paolo Fontanilla
jose.paolo.fontanilla@clsa.com
+63 2 860 4006

Flip-flopping on Landing's casino license

A moratorium on new casinos in Manila

Philippine Amusement and Gaming Corp (PAGCOR) Chairperson Andrea Domingo said on March 2017 her office had approved a five-year moratorium on new casinos in Metro Manila, to give existing players breathing space to mature the market. This was reinforced by a nationwide moratorium imposed on January 2018, after President Rodrigo Duterte raised concerns about the "proliferation" of casinos in the country.

But a new casino license was recently issued

Despite the regulator's moratorium and the president's pronouncements against new gaming licenses nationwide, Hong Kong-listed casino investor Landing International Development says a wholly-owned unit has been granted a provisional gaming licence by the Philippine Amusement and Gaming Corp (PAGCOR) to operate a casino in Entertainment City.

Landing intends to build an integrated resort dubbed NayonLanding

Landing intends to build an integrated resort dubbed NayonLanding. It will comprise a casino, indoor cultural theme park and waterpark, an indoor movie-based theme park, convention centre, luxury hotels, international retail, and dining. Management indicated NayonLanding will be a family-oriented resort, offering different cultural, leisure, and entertainment experiences. The resort will be built on a 9.6ha parcel of land within Entertainment City, with a planned construction floor area of about 610,000sqm.

The company has a lease agreement with Nayong Pilipino Foundation (a government entity) for the use of the land, once relevant licences were obtained from PAGCOR and NEDA. The provisions in a draft version of the lease contract between the Nayong Pilipino Foundation and Landing International included a term of lease of 50 years, subject to approval from the country's Tourism Infrastructure and Enterprise Zone Authority. The lease provisions were eventually amended in July, with an increase of 140% in the monthly rental fee to be paid by Landing International, and a decrease in the initial lease period from 50 years to 25 years.

President Duterte steps in

On the day of the casino's ground breaking the president removed all the Board of Directors of Nayong Pilipino Foundation for allowing the government entity to enter into a "disadvantageous" lease agreement with Landing. He ordered the country's Department of Justice to review the land lease contract between Nayong Pilipino Foundation (NPF) and Landing International as he believed the lease agreement was entered into without public bidding and was disadvantageous to the government. The Department of Justice concluded the lease contract void *ab initio* as it is a build-to-operate (BOT) contract disguised as a lease contract, which would have required a public bidding process.

NayonLanding location

Source: CLSA, GoogleMaps

3. CG rules

The Philippines ranks 11th with a score of 43%

The Philippines's CG rules received a shot in the arm in December 2016 when the SEC issued its revised CG Code for Listed Companies, which took effect on 1 January 2017. The code has improved disclosure standards somewhat, but companies are given an effective opt out via the "comply or explain" principle. The higher minimum public-float standard aside, there have been no material updates to CG rules since then - but at least one dilution, as noted above.

Financial reporting is good; CG/ESG standards are low

Financial reporting standards in the Philippines are of a high standard, because it has a policy to adopt International Financial Reporting Standards and International Standards on Auditing. The dominance of local affiliates of the Big Four accounting firms, which apply international standards across their audits, also helps. But the timeliness of reporting could be better: current rules stipulate quarterly reports must be issued within 45 days (quite normal for the region, although 30 days is best practice), and annual results within 105 days (behind the regional normal of 90 days and well behind best practice of 60 days or less).

"Comply or explain" regime appears to be undermining CG adoption . . .

CG rules are really focused around the Annual Corporate Governance Report and the CG Code for Listed Companies. While both of these initiatives helped raise disclosure standards among listed companies, the rules require simple disclosure of CG issues rather than encourage a discussion of such issues. There is also a convenient opt-out on a "comply or explain" basis. The result is a series of disclosures that, in most cases, provide shareholders with a compliance-driven disclosure list that is of little practical benefit.

. . . while ESG is very much in its infancy

ESG/sustainability disclosure standards are even more rudimentary than their CG counterparts. For example, ESG is mentioned just twice in passing in the SEC CG Guide for PLCs, while reporting rules are "big picture" rather than detailed. The code states companies should have a "clear and focused policy" relating to ESG and should follow a globally-recognised standard or framework in reporting sustainability and non-financial issues. As with CG rules, ESG reporting requirements are on a "comply or explain" basis, with predictable results.

Disclosure rules for substantial shareholders are weak . . .

Rules relating to disclosure of shareholdings are behind regional best practice: holders of 5% or more must disclose their ownership position within five business days (far too slow); and any material change (deemed 5% again, which is far too high) must be disclosed within three business days. The central bank sets its minimum threshold disclosure limits for banks at 2%, so why can't the SEC and PSE follow suit?

. . . yet insider blackout and insider trading restrictions are robust

Curiously, while substantial shareholder disclosure rules are poor, the Philippines has quite robust "blackout" rules for insiders: they cannot trade for one month before any results announcement and during the two days immediately following the disclosure of material non-public information. Its rules on price-sensitive information (PSI) disclosure are also best-in-class: under PSE rules, PSI must be disclosed to the PSE within 10 minutes with an immediate suspension during trading hours. A full announcement is required within 24 hours. And rules against insider trading are also robust on paper; the problem is they are not adequately enforced. On a more positive note, there is a permanent ban on any person convicted of fraud from serving as a director.

Related-party rules are among the weakest in Asia

The Philippines' rules on related-party transactions (RPTs) are among the weakest in the region: RPTs, regardless of nature or size, do not require independent shareholder approval. Rather, all RPTs must be disclosed in the company's annual report and are effectively "ratified" by all shareholders at the annual stockholders' meeting (ASM) by approving the accounts.

AGM notice periods are good, but voting practices at AGMs are not

Speaking of voting, poll voting at the ASM is still not required in the Philippines - it is only a recommended best practice in the 2016 CG code. Few companies practice it. Some still run their voting procedures according to the antiquated *viva voce* (or oral) approval practice. Notice periods for the ASM are, however, quite good: most companies issue detailed notices well in advance of the required regulatory deadlines of 15 days.

The worst of the rest

Other issues with CG rules in the Philippines include:

- A short two-year cooling-off period for independent directors
- Audit committees are not required to comprise only independent directors (whose independence in the Philippines is often highly suspect anyhow)
- Filipino companies are not expected to disclose individual board member remuneration

- The treatment of pre-emption rights for minority shareholders is bizarre: the rights are enshrined in the Corporation Code, but the articles of association of practically all Filipino companies disapply them
- Protection for minority investors in takeovers and tender offers remains weak; and the Philippines still has no takeovers code.

4. Listed companies

The Philippines ranks 9th with a score of 44%

Filipino companies are generally reluctant CG reformers. Much of the CG disclosure has been forced on them by the SEC - in some cases at the behest of government - and after external stimuli, such as a poor score in regional governance surveys. There are some stand-out companies where boards have embraced the spirit rather than the letter of the rule, but they are the usual suspects: companies led by Aboitiz, Ayala, Pangilinan and, thanks to the country's central bank BSP, many Filipino-listed banks. The remaining companies paint a more dismal picture, with a clear difference in financial, CG and ESG disclosure standards between large firms and mid-caps.

Financial reporting

Financial reporting is basically sound in the Philippines

Timeliness of financial reporting is mixed, with large caps generally releasing their audited financial results within 60 days of the year-end, while mid-caps tend to be quite a bit slower. In general, both large and small companies in the Philippines have sound financial reporting and provide detailed breakdowns of revenue and expenses, balance sheet items and so on. Interim results always include a cashflow statement. The investor relations sections of websites are generally good, with plenty of financial and shareholder information, although some can be difficult to navigate.

Disclosure on M&A, debt and MD&A is less impressive

Less consistent are disclosures relating to acquisitions, divestments and indebtedness. MD&A disclosure is generally adequate but often not up to international standards. Aboitiz Ventures is a stand-out in terms of MD&A disclosure, with a comprehensive description of its businesses as well as discussion of strategy and impact of its business on the environment.

CG reporting

CG reporting is basically compliance-driven

CG reporting among Filipino companies is quite weak, except as it relates to compliance disclosure mandated by the Annual Corporate Governance Report. Board attendance by directors is provided, but generally not down to the committee level. Companies provide details of share issuance during the year, as this is required by the accounting standards, while shareholder engagement activities are usually disclosed only in brief.

Very weak disclosure on board committees

Probably the weakest area of CG reporting is disclosure of board committee work. Few companies provide any detail on the operation of their audit committee - some provide no discussion at all. Nomination and remuneration committees are not required by the CG code and consequently they are not usually formed. Instead, the code "encourages" companies to establish, among other things, a corporate governance committee to establish remuneration standards and policies. While these committees are formed, their role is quite general in practice and result in relatively limited disclosure of board remuneration levels and policies, even among the large companies.

ESG reporting

Most companies do not get ESG, but there are a few stand-outs

Standards on ESG reporting among Filipino companies vary significantly, with most providing virtually no information at all, yet certain companies, notably Aboitiz Equity Ventures, Bank of the Philippine Islands and Globe Telecom,

disclose to a good standard. ESG is very much a new subject in the Philippines and again, in the vast majority of cases, is only on the agenda due to the insistence of the SEC. It is clear from our research the vast majority of local companies have little or no grasp of ESG issues or their relevance to their companies. Among the few companies that have embraced ESG, disclosure on stakeholder engagement, sustainability policy, and sustainability metrics and targets is detailed.

Board composition and culture

Board composition and (genuine) independence cause key CG issues . . .

Perhaps the biggest drag on CG reform in the Philippines is company boards. While private sector boards are generally free of outside (ie, state) influence and are able to make independent decisions, they are seldom sufficiently independent from the controlling shareholder and/or family. Too many companies are stuffed with family members: sons, daughters, wives, and cousins. There is little justification for their presence other than familial connection, and usually not even a statement on their connection to the controlling shareholder. INEDs tend to sit on boards for far too long to continue to qualify as independent by any rational measure. Many are octogenarians; some even die in office. When the SEC forced board and term limits on INED appointments, it was met with furious resistance from listed companies. A compromise was found via the "comply or explain" route: go past nine years and an INED can stay on as a non-independent director with an annual shareholder vote. INEDs who “collect” board seats past the SEC recommended limit of five can continue to do so if this is disclosed.

. . . and are deliberately designed to maintain the status quo

The weakness in board composition perpetuates the status quo: most boards of listed companies are comfortable as they are and resistant to major change. While companies undertake annual board evaluations, they mostly do so because it is mandated. Similarly, few companies do more about promoting board diversity than the minimum required. More positively, Filipino companies do benefit from the significant contribution of women in senior management roles and on boards.

Chair/CEO roles often kept in the family

Other problems that weaken governance of boards of Filipino companies include the lack of an independent chairman: with so many local companies controlled by powerful families, it is common to see the chair and CEO roles shared between brothers, cousins or between father and son. This happens even at some of the better governed companies. Other non-family chairpersons have been in position so long their independence is highly questionable.

Filipino boards like training, but dislike disclosing remuneration

Board remuneration and its disclosure remains another blind spot for companies, with group disclosure for the top five highest paid executives only. Perennial claims of personal security and poaching risks around individual disclosure are long in the tooth and appear an excuse for a lack of transparency. On a more positive note, induction and ongoing training for directors is disclosed in annual reports – because it has to be – but there does seem to be a genuine interest among some companies to undertake board training and evaluation.

Audit committees are weak, while internal auditing standards are good

The Philippines is one of the few countries in the region that still cannot form genuinely independent audit committees: a few select companies take this issue seriously, but all too many either appoint non-independent directors to their audit committee or, in some cases, executive directors. Curiously, this weakness contrasts with internal audit departments that are generally of a decent standard, and disclosure of internal controls and risk management procedures that are also sound. While there is plenty of boilerplate disclosure around risk mitigation by some companies, others take a thoughtful approach to the issue, and the listed banks, understandably, take it most seriously of all.

Bennette Fajardo
bennette.fajardo@clsa.com
+63 2 860 4014

ERC moved the implementation of CSP

Meralco was dragged into the controversy surrounding the unfortunate suicide of Energy Regulatory Commission (ERC) Director Francisco Villa in his home on 9 November, 2016. Atty Villa's family indicated he had been under tremendous stress and pressure as he was being forced by his superiors to rig bids and approve contracts that were sure to be scrutinised by the Commission on Audit.

Meralco was linked to the suicide of an ERC official involving the company's alleged midnight deals

Meralco's name surfaced when Congressman Carlos Zarate on 21 November, 2016 urged the House of Representatives to investigate alleged "midnight deals" made by the ERC and generation companies affiliated with the distribution utility, insinuating these had a hand in causing the suicide of Atty Villa.

The firm has since denied any links to the corruption allegations

Meralco has since denied any links to the corruption allegations involving the ERC. It said the power supply agreements (PSA) were filed in accordance with existing ERC rules and regulations, adding that these go through a transparent and rigorous public hearing process.

Nevertheless, the signing of the PSAs was brought to attention and the company could very well be pulled into congressional hearings on the matter. Rep Zarate pointed out Meralco ended up securing the 20-year agreements just four days before the 30 April 2016 deadline, which was already an extension of the originally set date of 6 November 2015.

All deals after the deadline have to go through a competitive selection process (CSP), whereas before they were only done bilaterally. Distribution utilities are now required to undertake competitive bidding to secure power supply agreements with generation companies.

The supply agreements were made before a key ERC deadline

The deals Meralco entered into and were filed with the ERC on that date involve 3,551MW of electricity, and are broken down as follows:

- 225MW out of the 300MW RP Energy coal power plant in Subic. RP Energy is a consortium of Meralco, Aboitiz Power (AP) and Taiwan Cogeneration, in which the former owns 47%
- 400MW out of the 2x350MW St Raphael Power Generation Corp (SRPGC), which is a joint venture of Meralco and Semirara (SCC)
- Full output coming from the 2x600MW Atimonan One coal plant, which is being developed by Meralco
- 528MW each from two San Miguel (SMC) power plants, Cental Luzon Premiere Power Corp (CLPPC) and Mariveles Power Generation Corp (MPGC). Meralco acquired a 49% interest in MPGC. MPGC and CLPPC will each build a 4x150MW circulating fluidized bed (CFB) coal power plant
- PSA's were also signed between Meralco and units of Global Business Power Corp (GBPC); Panay Energy Development Corp (PEDC); and Global Luzon Energy Development Corp (GLEDC). The distribution utility firm will purchase up to 70MW from PEDC and 600MW to GLEDC, respectively. Meralco owns 14% of GBPC.

Joyce Anne Ramos
joyce.anne.ramos@clsa.com
+63 2 860 4012

An issue of trust in Alliance Select Foods

Investors demand inspection of company's books

In March 2018, the Department of Justice ordered prosecutors to file a case against businessman George Sycip and Alliance Select Foods' (Alliance) board of directors Jonathan Dee, Alvin Dee, Joanna Dee-Laurel, Teresita Ladanga, Grace Dogillo, and Arak Ratborihan over an alleged multimillion investment scam. It all started back in January 2014 when investors Dr Albert Hong Hin Kay and Hedy Yap-Chua, who purchased an about 34% stake in Alliance in 2009, demanded an inspection of company records after it started to register losses despite posting good revenues. The two investors believed they had the right as shareholders and directors to see the details of what they believed to be "murky financial transactions and dealings".

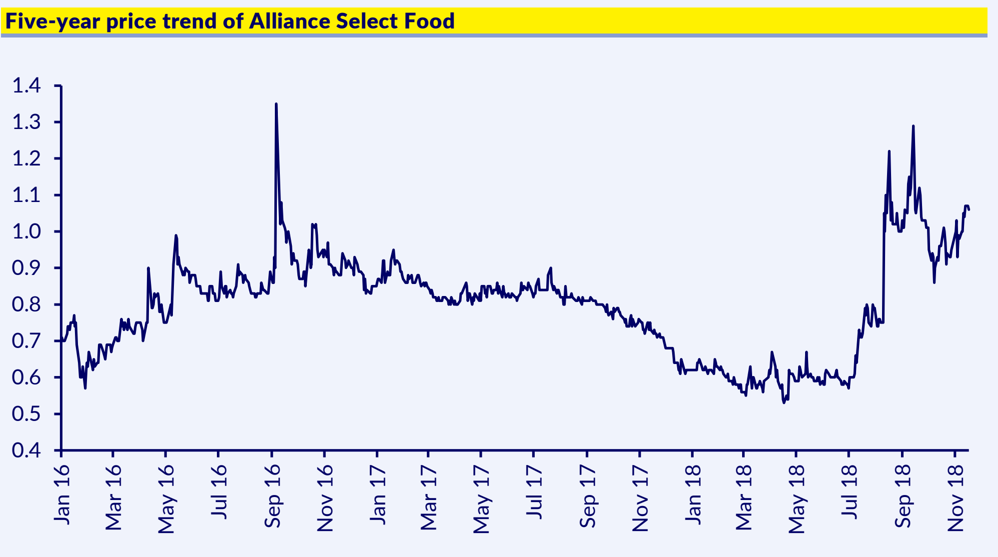
A bail-out for the Dee family?

However, despite their repeated attempts to gain access, the company records remained closed and inaccessible. Hence, citing violations of the Philippine Corporate Code, Hong and Chua filed a criminal complaint against Sycip and other fellow directors for blocking their rights to inspect the books of a publicly listed company. The complainants alleged the respondents improperly used their investments in the company to engage in supposedly illegal activities and transactions. Hong and Chua believed Alliance was being used as a vehicle to bail out the Dee family from its debt in First Dominion Prime Holdings. First Dominion, which the Dee family has a 56% stake in, had unsecured debt of P2.39bn. Allegedly, Alliance was founded on a rehabilitation plan to refinance the insolvent First Dominion.

In the latest resolution of the Justice Department, it stated "we agree that the false pretences employed by respondents that Alliance is a yielding business and a wise investment with attractive profits. Stated otherwise, had they known that Alliance was a vehicle to bail out the Dee companies and indulge in a sophisticated scheme to recover the lost business empire of the Dee family, complainants would not have parted with their money."

Not trading like an investment scam

Five-year price trend of Alliance Select Food



Source: CLSA

5. Investors

The Philippines ranks 10th with a score of 21%

Both institutional and retail investment in the Philippines remain fairly limited, although they are growing quickly, fuelled in part by the strong stock market run over the last few years. The country has several home-grown investment institutions, including insurance companies such as Sun Life of Canada (Philippines), BPI-Philam Life and Philippine AXA Life, as well as bank offshoots, including Banco De Oro Trust & Investments, First Metro Asset Management and BPI Asset Management. There is also some equity investment by the government social security and pension systems, notably the Government Service Insurance System and the Social Security System. Foreign portfolio investment has grown during the strong market run, but is understandably skittish toward signs of macroeconomic vulnerabilities and currency weakness. Sell downs by international investors can be both fast and brutal.

Retail investment is growing, but from a low base

Retail investment has grown as interest in the stock market's rise has gained traction, but low levels of personal savings relative to many other Asian markets means the stock market remains the purview of the wealthier minority. Past attempts by the government to generate additional retail investment into the market have helped somewhat, but the reality is the country has more pressing problems to deal with.

Institutional Investors

Asset managers mostly do not promote higher CG standards

With a limited number of domestic institutional investors, perhaps it is not surprising there is little evidence of asset owners or managers promoting higher CG standards. While some may be keen to do so if given the opportunity, the power of local companies makes that a challenging proposition. The same goes for foreign institutional investors, which tend to simply sell CG-challenged companies rather than try to engage with them. This difficult relationship perhaps explains why we see most domestic and foreign institutional investors voting their shares, but nearly always with management. AGM attendance tends to be limited too.

Investor engagement is limited

There is very limited active engagement with management among domestic or foreign investors. There are no local CG focus funds that we are aware of, although we have come across some CG focussed funds with a global mandate that invest successfully in the Philippines. These funds tend to invest and engage with management alone rather than engage on a collective basis.

Foreign investors are often taken by surprise by the low standards of protection

Foreign investors have faced a number of difficulties with Filipino companies over the last two years that demonstrate weak regulations and the imbalance of power between controlling and minority shareholders. These include a tender offer launched that provided effective control to an incoming investor group over a listed company, but without the need to launch a full takeover offer for minority shareholders, despite plans to delist and restrict dividends. Foreign investors were also subjected to a controlling shareholder in a major listed company who inserted proposed changes in company articles that granted him significantly greater control over a company's share capital, but without providing compensation to minority investors.

Retail investors

Retail investors are a small but boisterous crowd . . .

While limited in number relative to the country's overall population, retail investors tend to be a more boisterous lot than their institutional counterparts. Attendance at AGMs is quite high and, based on post-AGM disclosure of

searching questions posed to management, the meetings can be quite lively. We have even seen evidence in the last two years of retail investors voting against incumbent management, especially in the case of controversial issues, the most notable perhaps being the successful campaign by foreign investors against management and controlling shareholders in Alliance Select, which was also a rare case of minority investors litigating against controlling shareholders. And several local retail investors volubly lobbied Calata Corp for a take-private offer after the PSE delisted it.

. . . with an independent and active shareholder association

Finally, unlike Indonesia, which has tried and failed, the Philippines has a thriving independent retail investors' association in SharePHIL, which remains active in CG advocacy.

Jose-Paolo Fontanilla
jose.paolo.fontanilla@clsa.com
+63 2 860 4006

Megawide's board of directors had earlier given approval to the granting of a corporate guarantee on the loan of a prospective client

Megawide's share price took a beating during the peak of the corporate guarantee issue, but recovered after management pulled out of this following negative investor feedback

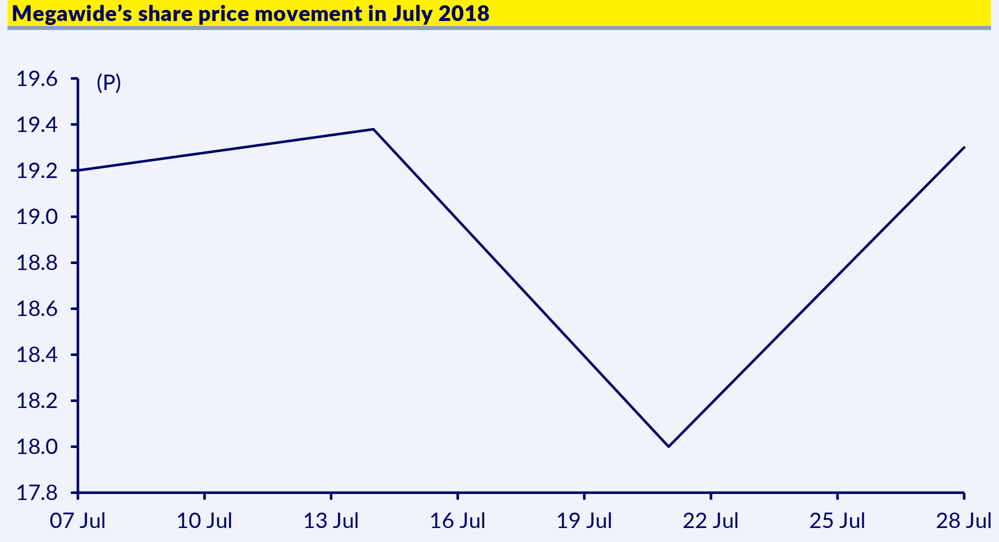
Megawide heeds the call of investors

After holding up against the general Philippine market downturn for the first half of the year, Megawide's share price in mid-July took a beating. The company's board approved a corporate guarantee on a client's loan that would fund the completion of a mixed-use high rise condominium.

In exchange for taking on the associated risk, Megawide would have earned gross profit margins of around 20-22% for this project, higher than the 15% it would normally fetch, but this sort of risk was clearly outside of the company's core competency. Adding to the complication is the relationship by affinity of the company's chief marketing and corporate information officer Louie Ferrer to the principles of the prospective client, Major Homes.

Management responded to the negative investor reaction, pulling out of this venture. The company's share price reacted accordingly.

Megawide's share price movement in July 2018



Source: CLSA evalu@tor

Bennette Fajardo
bennette.fajardo@clsa.com
+63 2 860 4014

Melco Phils conducted private placement and subscription transactions at P14.00 and P11.30/sh

Tender offer price of majority shareholder is at P7.25/sh

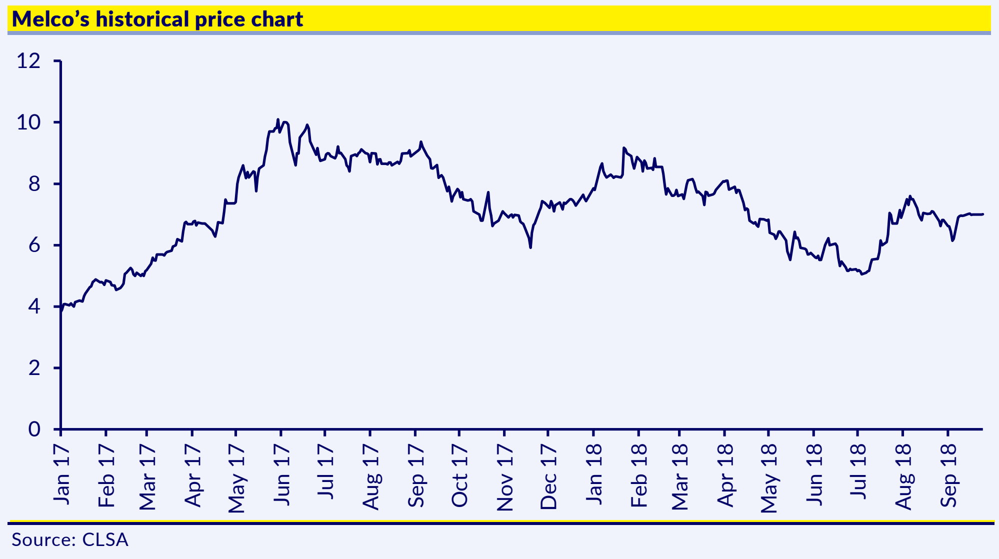
Investor concern on delisting, given improving profitability

Melco delisting on the cusp of profitability

Melco Philippines entered the Philippine Stock Exchange via a backdoor listing through Manchester International Holdings Unlimited Corp in December 2012. Melco Philippines conducted a placement and subscription transaction with MCE (Philippines) Investments Limited and qualified investors at P14.00/sh and P11.30/sh on 24 April 2013 and 24 June 2014, respectively. It also conducted a private placement with MCE (Philippines) Investments Limited at P3.90/sh on 23 November, 2015. The transactions were made before the start of commercial operations of City of Dreams Manila.

On 10 September, 2018, Melco Philippines disclosed its board of directors had approved a plan to delist from the Philippine Stock Exchange. In relation to the planned delisting, majority shareholder MCO (Philippines) Investments Limited intends to conduct a tender offer to buy out the 1,569,786,768 public common shares outstanding. The tender offer price is at P7.25/sh, which is at the higher end of the third party financial adviser's valuation range of P6.11/sh and P7.49/sh. However, investors and analysts alike have expressed concerns regarding the planned delisting, implying valuations could have been higher, given improving profitability.

Melco's historical price chart



Source: CLSA

6. Auditors and audit regulators

The Philippines ranks 9th with a score of 63%

Standards of accounting and auditing are one of the brighter CG spots in the Philippines, hence the higher absolute score and better ranking than for most categories in our survey. The Big 4 accounting firms dominate the local auditing scene via local affiliates among listed companies, and standards are generally high. While there remain differences between IFRS and Philippine Financial Reporting Standards (PFRS), they are limited. The SEC requires all listed companies to follow PFRS and the PFRS Council has a stated policy of adopting IFRS as PFRS. Local auditing standards, by contrast, are fully aligned with international auditing standards: the Auditing and Assurance Standards Council has adopted the Philippine Standards on Auditing, which incorporate the International Standards on Auditing.

Companies comply with audit rotation, but disclosure on non-audit work could improve

Listed companies are required to rotate their external audit partner every five years under the Securities Regulation Code, and evidence from annual reports suggests companies comply. While disclosure of audit and non-audit fees should also be disclosed via the SEC's Annual Corporate Governance Report, we found few companies providing more than the minimum disclosure. Meanwhile, the new long-form auditor reports focussing on "key audit matters" (KAMs) are required and are being produced.

Audit reports compiled by Big Four firms are of a high standard, even for smaller companies

Generally, we found audited annual reports among large listed companies are well drafted and provide detailed notes, suggesting they are well prepared for their annual audit. Unsurprisingly, smaller companies tended to have more auditing issues, although standards are still fairly high. The exception to this would be small listed companies that have engaged small independent audit firms, where there was a noticeable drop in quality of disclosure and a corresponding increase in issues with the audit.

No full-service independent audit regulator yet

The oversight of external auditors is undertaken by the SEC via its Office of General Audit (OGA). The SEC conducts periodic inspections under its SOAR program (SEC Audit Oversight Review), but as this was launched only in 2017 it is too early to tell how effective the programme has been. We found limited information and disclosure on OGA activities, which are largely restricted to accreditation of audit firms as well as ongoing monitoring of audit firms' compliance with rules. Aside from the ultimate sanction of the withdrawal of a firm's accreditation, the OGA does not possess many powers of enforcement. There is a fairly up to date list of all accredited external auditors and audit firms on the SEC website. But we found no evidence of any research or surveys by the OGA of audit industry capacity in the Philippines.

But the OGA works with the BSP and the Philippines is now a member of IFIAR

The OGA undertakes limited work with the CPA profession to promote training and licensing requirements under its SOAR programme, although it is less clear it is actively promoting quality and governance improvements. There is no suggestion the OGA is focused on introducing audit quality indicators, although it has worked proactively with the BSP to enhance auditing standards among local banks. Another positive note is the Philippines is now a member of the International Forum of Independent Audit Regulators (IFIAR), the international club of audit regulators that are independent of the accounting profession. This is something most Asian jurisdictions have achieved, with the embarrassing exception of Hong Kong and India.

7. Civil society and media

The Philippines ranks 10th with a score of 38%

CG issues play a minimal role in civil society in the Philippines. Among the business and political elite, there is a strong and inherent reluctance to reform: why would they want to change things when so much about the system works to perpetuate the grip on power of political dynasties and business empires? Real reform in the Philippines arises either from a small number of open-minded institutions or from external stimuli.

Director institute an advocate for stronger CG . . .

One agent for change in the past has been the Institute for Corporate Directors, which, despite being funded by many of the most powerful business families, has played an important role over many years in raising awareness and understanding, and promoting higher standards of CG. The ICD is also an important stakeholder in the Asean CG Scorecard process. Despite a number of setbacks, ICD continues its active CG training activities and is well-regarded.

. . . SharePHIL is another welcome advocate . . .

Another change agent is SharePHIL, an independently funded retail shareholder association that has made some progress in advancing CG issues among its members. It is an active group of reform-minded individuals, although being independent it is budget-constrained.

. . . and that's about it

And sadly, that is where much of the internal CG debate seems to end. There is no institute of chartered secretaries, and other professional associations - of accountants, bankers, and financial analysts - do little to raise awareness of CG other than hold some training courses. When the SEC compiled a working group for the CG code for PLCs, in addition to the BSP, PSE, ICD and SharePHIL, other participants included the Institute of Internal Auditors Philippines, Good Governance Advocates and Practitioners of the Philippines, Management Association of the Philippines and Financial Executives of the Philippines. But that was in 2016, and there is scant evidence since that professional associations are actively involved in CG awareness-raising.

No impetus for CG reform from business interests

As with professional associations, so with business associations: there is no evidence chambers of commerce or business federations are promoting higher CG standards. The most powerful business association in the country, the Makati Business Club, is more involved with other international business associations and promoting multinational initiatives against corruption, and free speech. The National Competitiveness Council has done good work improving the country's competitiveness in the World Bank's Ease of Doing Business rankings in the last few years, but good CG and competitiveness are not perfectly correlated.

Serious media are limited but capable . . .

The media in the Philippines is active and lively, but not always accurate and is seldom detailed in its analysis. Hence reporting of major CG issues or scandals relating to companies can be limited. That said, there was reasonable coverage of some of the more egregious scandals (Calata Corp, Alliance Select, Alphaland) from the more serious media outlets, including The Inquirer, the Manila Bulletin and Rappler.

. . . but increasingly circumscribed by a vindictive Executive

Journalism in the Philippines has always been a precarious profession, with physical threats and intimidation common from unscrupulous businessmen or outraged politicians. This threat has increased under the current administration, which objects to criticism of any kind and responds with vitriol and vindictive threats. Alarmingly, the last two years have seen threats against non-compliant media ramped up, with the Inquirer pushed into a sale to a Duterte sympathiser after negative coverage of the administration, and media website Rappler caught in a politically-inspired dispute with the SEC after heavy criticism of the president. Other media organisations have responded with increased self-censorship.

Recap and recommendations

Recap of CG Watch 2016

How has the Philippines responded to our 2016 recommendations?

The Philippines has made some progress on our recommendations

Figure 2

Philippines: recap of 2016

	Recommendations	Outcomes
1.	More detail on enforcement activities on regulatory websites	Still very limited data
2.	PSE should provide more than two years of historic company data	No change
3.	Poll voting to be mandated	Recommended via 2016 CG Code, but only subject to "comply or explain"
4.	Mandate fully-independent audit committees	No change. Again, contained in the 2016 CG Code as best practice, but many companies do not comply
5.	Enforce director term limits strictly	Term limits were forced on reluctant companies, but an escape clause allows many to circumvent

Source: ACGA

Downgrade watchlist

What to avoid

Factors that could force the Philippines' market score to fall in 2020:

- Continued manipulation by government of the SEC
- Lack or reform of CG code and further CG initiatives from regulators
- Absence of reform of related-party transactions
- Absence of reform of audit committee composition
- Further erosion of media independence
- Continued lack of enforcement, especially insider trading.

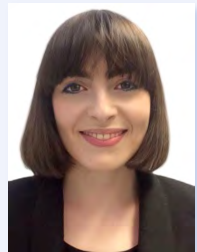
Quick fix list

What to fix

Issues to address as soon as possible:

- PSE to include more than two years of company data on its Edge website – easy!
- SEC and PSE to include detailed enforcement data on websites – easier!
- Mandate key CG issues: term limits, poll voting, AC independence, director remuneration
- Tighten definition of independence for INEDs, lengthen cooling-off periods and mandate split of Chair and CEO - and then police it!
- Introduce a Takeovers Code – even a basic one!

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
+852 2160 1788


Alexandra Einfeld
Research Associate, ACGA
alex@acga-asia.org

Singapore - Contradictory city

- Introduction of dual-class shares (DCS) damages regulatory credibility and contradicts emphasis on investor stewardship
- CG policy contradictions apparent in revised CG Code, enforcement strategy and some listing-rule changes
- Lack of transparency in MAS funding for securities regulation, while information sparse on certain proposed new laws
- Mixed results from regulatory enforcement: penalties for insider trading mostly low; new SGX RegCo has brought more vigour; but litany of corporate scandals raises doubts about deterrence effect of enforcement
- Listed company financial reporting mostly sound, CG reports quite good, some mid-cap sustainability reports better than large-caps
- Ambition of independent audit regulator appears diminished

Figure 1

Singapore CG macro category scores versus regional average (2018)

Source: ACGA

Singapore ranks 3rd, with a score of 59%

Introduction

Singapore just pips Malaysia to 3rd place in our survey

Singapore's total score of 59% puts it in 3rd place in this year's survey, just ahead of a resurgent Malaysia. While Singapore's CG ecosystem has strengthened in various areas over the past two years, it has lost points for the hasty and opportunistic adoption of dual-class shares in late-June 2018 as well as other contradictory CG policies, a lack of transparency in some areas of government and legal reform, and an inconsistent approach to regulatory enforcement. As in previous surveys, Singapore performs best in accounting and auditing (although even here its lead agency appears to have lost some vigour). It also has a fairly robust CG rulebook, an active and quite diverse civil society, and a more critical formal and informal media.

The regulatory low point was the introduction of dual-class shares in June 2018

Without question, the regulatory low point of the past two years has been the introduction of dual-class shares (DCS). Having consulted the market in February 2017, a few months before Hong Kong launched its own consultation in June 2017, the Singapore Exchange (SGX) then waited until Hong Kong announced

rules on DCS in late April 2018 before finalising an almost identical set of rules two months later in late-June. While Singapore may not have been the first mover in terms of rule changes, its earlier start arguably prompted Hong Kong to speed up. It thus deserves a large part of the blame for catalysing the current "race to the bottom" over DCS in Asia. Whether the policy has been worth the reputational damage is debatable: not one DCS firm had listed in Singapore by the time of publication of this report.

The new SGC RegCo is a more positive development, though doubts remain as to its longer-term effectiveness

A more positive regulatory story has been the formation of SGX Regulation (SGX RegCo), a separate entity owned by SGX and responsible for enforcing the listing and trading rules of the exchange. Much like ASX Compliance in Australia and JPX Regulation in Japan, this entity is intended to operate more independently than its predecessor, the internal SGX regulatory division. Another welcome development was the renewal of the cooperative enforcement arrangement between the Monetary Authority of Singapore (MAS) and the Civil Affairs Department (CAD) of the Police that allows MAS to work with CAD on criminal cases. Despite these positive institutional developments, enforcement outcomes in Singapore are often milder than one would expect and sometimes inconsistent. SGX RegCo has become more interventionist over the course of 2018, but there are doubts about the longer-term effectiveness of its work and the deterrent effect of its enforcement actions against directors and listed companies.

Singapore has seen a litany of corporate scandals, which in turn have galvanised media and social-media commentary

At the company level, Singapore has seen a litany of corporate scandals engulfing not just smaller private firms such as YuuZoo and Datapulse, or listed firms from mainland China whose accounts are inexplicably lost or catch fire, but also large-caps or former large-caps. Noble Group has seen its shares fall 99% since mid-2014 as a result of uncertainties over its accounts and business model, while Keppel Corp, a government-linked company, was forced to pay a massive fine to regulators in Brazil, the USA and Singapore for its part in the bribery scandal surrounding Petrobras, the big Brazilian oil major. Interestingly, these cases have galvanised a degree of media and social-media criticism not seen before in Singapore, from both local and foreign commentators.

1. Government and public governance

Singapore ranks equal-4th, with a score of 55%

Singapore has a solid system of government with strong political and economic institutions managed by capable officials, robust supervision over the governance of banks and state-controlled enterprises ("government-linked companies"), and an effective anti-corruption agency. Yet it scores below expectations in this category for a range of reasons. One is the lack of a clear government strategy for CG reform - instead there is a patchwork of conflicting policies and intentions, with positive ideas neutralised by negative ones, such as the way in which the concept of the "independent director" has been treated in the new CG Code or the decision to introduce DCS.

Singapore's regulatory structure, with MAS acting as both central bank and financial regulator, has drawbacks

A second reason for the low score is the unique nature of its financial regulatory system, with MAS being the central bank as well as the single regulator for banking, insurance and the securities market. As we have argued in previous issues of CG Watch, we believe this model has significant drawbacks. Other contributing factors include the legal system, which works well if you want to resolve general commercial disputes but offers limited legal remedies to minority shareholders of listed companies, and a high degree of opacity around the progress of promised new legislation.

Politicians buy into the DCS concept

The political push for DCS

The SGX annual report for 2017 describes dual-class shares as that year's most important regulatory development. The introduction of DCS followed a report by the Committee on the Future Economy, which was convened in January 2016 to 'review Singapore's economic strategies'. It recommended that the government permit DCS structures, but with appropriate safeguards to promote market transparency and mitigate governance risks. The intention was that this would give an advantage to Singapore as a market that could attract and retain "innovative" issuers. Like Hong Kong, Singapore wants to compete with New York for the listing of new China and Asian tech firms. Officials have also been at pains to point out that the policy is designed to attract homegrown internet and tech firms - one of the most likely targets being Grab, the dominant ride-hailing app in Southeast Asia and headquartered in Singapore.

Singapore's tiny IPO market a driving force behind DCS

The DCS decision was clearly a response also to the weak performance of Singapore's IPO market in recent years, as the following table for the mainboard shows:

Figure 2

SGX Mainboard listings, 2014-18

	2014	2015	2016	2017	20181
Number of IPOs	15	6	9	11	6
Number of IPOs with market cap >S$200m	11	1	5	7	4

1As of mid-November 2018. Source: SGX website, ACGA analysis

Many of the mainboard listings are Reits, ETFs, investment funds and GDRs

Not only is the number of mainboard new listings very low, but the number of medium to large-sized IPOs of S$200m and above is even lower. What the table does not show is that many of the listings are Reits, ETFs, investment funds and GDRs. In most years, the number of IPOs on Catalist, the second board for small companies, exceeds the mainboard. And it is worth highlighting that as of mid-November 2018, SGX had yet to welcome its first dual-class share IPO.

MAS is closely linked to the Singapore government: its chairman is the deputy PM and other board members include ministers

The unique role of MAS

As Singapore's central bank, the Monetary Authority of Singapore has responsibility for monetary policy formulation and macroeconomic surveillance. It is also an 'integrated supervisor overseeing all financial institutions in Singapore - banks, insurers, capital market intermediaries, financial advisors, and the stock exchange', as it states on its website. It is accountable to the Ministry of Finance and its board members and executive directors are appointed by the President. The chairman of MAS is the deputy prime minister, while other board members include the minister for finance, minister for education and the Attorney-General as well as some other officials and private individuals.

The independence that MAS enjoys as a financial regulator is unclear

One of the challenges of this model is that the degree of autonomy MAS enjoys as a securities regulator is unclear. Its leadership is either part of or closely tied to government, while funding for its financial-supervisory divisions is subsumed within the broader MAS budget. It not possible to ascertain the precise level of resources or priority MAS accords its work as a securities regulator, although it would appear that this function ranks below central banking and the supervision of systematically important banks and insurers. One practical outcome is that enforcement of capital-market misconduct, although strengthened in recent years, still lacks the focus and vigour of a market like Hong Kong.

Litigation cul-de-sac

Minority shareholders of listed companies have few legal options in Singapore

Aggrieved minority shareholders of listed companies have few legal options to seek redress in Singapore. On paper, remedies such as "oppression against minority" suits and statutory derivative actions do exist. But these come with a range of technical requirements and, given the loser-pays system and associated financial risks, there have been few cases. Moreover, derivative actions do not produce compensation for investors.

"Representation actions" are permissible, but there have been few cases

Unlike the US or Australia, Singapore does not permit litigation-funding for class actions. However, it is possible to undertake self-funded "representative actions" under the Rules of Court. This type of proceeding requires all claimants to demonstrate the "same interest" in proceedings, meaning that there are significant issues of fact or law common to all claimants. All members of the class need to be identified and allow a representative to represent them, with costs funded by the plaintiffs. An extensive search of the legal literature in Singapore produced only two examples of such actions in the past 20 years: the Raffles Town Club case over 2001-5 that involved almost 4,900 people; and a more recent case involving around 200 people against a company called Treasure Resort, the new manager of the Sijori Resort Club on Sentosa Island, in 2013. There have been no cases against listed companies.

Some listed companies are suing their own shareholders

Conversely, some companies have taken legal action against their own shareholders. In September 2018, the directors of Stamford Land Corporation sued outspoken retail shareholder, Mano Sabnani, for defamation. Stamford Land alleged that he had made defamatory statements in a Facebook post and a letter published by *The Business Times* in late-July 2018 that reflected allegedly defamatory comments he made at its AGMs in 2016 and 2018. At the meetings, Sabnani questioned Stamford's management, its low dividend payout, and high remuneration for senior office-bearers. While his lawyers argued his remarks were fair comment, both parties reached an "amicable settlement" in early-October 2018, according to *The Business Times*, with Sabnani retracting his comments and apologising. Both parties thanked SGX for facilitating the settlement, with SGX RegCo releasing a statement that it 'firmly believes in and encourages constructive and robust discussions between shareholders and directors during annual shareholder meetings'. But it added a warning: 'While these meetings are subject to qualified privilege . . . [this] may not extend to comments that are published or quoted on social or mainstream media.' This case could have a chilling effect on the willingness of investors to criticise companies openly in future.

Bank governance

Bank governance is generally robust in Singapore

One of the more robust features of the financial regulatory system in Singapore is its supervision of banks. The conduct of banks is primarily regulated under the Banking Act, related subsidiary legislation, and various notices, circulars, guidelines, practice notes and codes issued by MAS from time to time. Under the Banking Act, a licensed bank must appoint an MAS-approved auditor annually, while the auditor must report to the Authority on various prescribed matters. MAS further applies "fit and proper guidelines" to banks and their directors and senior managers and has developed a separate set of *Guidelines on Corporate Governance* for financial-holding companies, banks and insurers. The latter were first developed in the mid-2000s, then revised in 2010 and 2013. They set somewhat higher standards of governance than those applying to normal listed companies.

The Banking Act was amended in 2016 to strengthen prudential standards, depositor protection and CG . . . but is still not in force

Another step forward came in February 2016 when the Singapore parliament amended the Banking Act to strengthen prudential safeguards and depositor protection, as well as enhance the risk-management and governance of banks. The Banking (Amendment) Act 2016 allows MAS to require a foreign bank branch to incorporate 'all or part of its banking business' in Singapore, 'where this is in the interest of the public', according to an MAS statement before parliament. It also empowers MAS to direct banks to remove key executives 'if they are found not to be fit and proper', protect external auditors from liability if they disclose information in good faith, remove external auditors who do not discharge their duties satisfactorily, and direct a bank to terminate any transaction with related parties that is detrimental to depositor interests. Having been passed in 2016, the Banking (Amendment) Act 2016 was gazetted in May 2017. It is still not in force, but is scheduled to take effect by the end of 2018.

In early-2017, MAS issued a consultation paper on proposed amendments to the Banking Regulations and Banking (Corporate Governance) Regulations. These are 'necessary to support the amendments in the Banking (Amendment) Act' and cover, among other things, new standards and penalties on risk management, a requirement that banks seek MAS approval for major stakes in cooperative societies and trusts, and a new rule giving the Authority powers to approve the head of treasury operations in Singapore of any bank incorporated outside Singapore. Although the consultation closed in March 2017, conclusions have yet to be released.

Fighting corruption

Singapore scores well in surveys assessing levels of public and private corruption

Singapore ranks well in surveys of corruption and civil-service ethics. The Political & Economic Risk Consultancy, a Hong Kong-based research consultancy, has consistently ranked Singapore as the least-corrupt out of the 16 countries it tracks in Asia. And Transparency International listed Singapore as 6th globally in its 2017 Corruption Perceptions Index.

Much of the credit goes to the CPIB, which has wide powers

Much of the credit for this performance must go to the Corrupt Practices Investigation Bureau (CPIB), a government agency with wide powers under the Prevention of Corruption Act to tackle corruption in both the public and private sectors. Over the five years from 2013 to 2017, CPIB received between 736 and 877 complaints annually from the public - the high point being in 2015 - and investigates around 100 to 150 of these each year. Most cases relate to private-sector corruption (around 85-92% per year over 2015 to 2017), with the vast majority of these involving corrupt behaviour between private individuals only. Around 10% of cases involve private individuals trying, and failing, to bribe government officials. And 8-15% of cases involve government officials soliciting bribes. Most private corruption occurs in sectors such as construction, various wholesale and retail businesses, and warehousing, transport and logistics.

While the incidence of corruption seems to be declining, the Keppel case raises obvious questions

On some metrics, it appears that the incidence of corruption is declining in Singapore. The number of complaints fell in both 2016 and 2017, while the number of investigations in 2017 fell to 103, an all-time low. There was also a fall in the percentage of investigations involving public-sector employees seeking bribes from 15% in 2016 to 8% in 2017. On the other hand, the number of total prosecutions increased in 2017 - to 141 cases - from 104 in 2016 and 120 in 2015. This could, of course, relate to the usual time lag in bringing prosecutions. A more serious issue has been the involvement of a subsidiary of Keppel Corporation, a major government-linked company (GLC), in alleged corruption outside of Singapore (see box below). While the case refers to activities between 2001 and 2014, it raises broader questions as to the robustness of ethical standards and internal controls within leading listed companies.

2. Regulators

Singapore ranks 8th with a score of 54%

Singapore's low rank of eighth in this category and score of only 54% is a result primarily of its relatively poor performance in the first subcategory (funding, capacity-building and regulatory reform), especially on a number of questions relating to budgetary transparency, regulatory websites and CG reform (including a loss of points for the introduction of dual-class shares and some other regressive policy steps). It does much better in enforcement, where it ranks equal 3rd with several markets.

MAS has only civil powers of sanction against firms and individuals

As noted in the previous section, Singapore has a unique capital market regulatory system: the Monetary Authority of Singapore is both a central bank and regulator of the banking, insurance, and securities sectors. MAS has only civil powers of enforcement, thus limiting the sanctions it can apply in cases of market misconduct. Criminal powers are vested in other parts of government, notably the Commercial Affairs Department (CAD) of the Singapore Police. Since March 2015 the two have worked together in a cooperative partnership to investigate criminal cases and this has strengthened enforcement outcomes somewhat - yet the number of cases remains low.

The Attorney General has oversight of the MAS's exercise of powers

Where MAS wishes to institute civil penalty proceedings for breaches under the acts it administers, it must obtain consent of the public prosecutor. The Attorney-General, as public prosecutor, has discretionary power to institute criminal proceedings for any offence, including those under MAS-administered laws and regulations, and also maintains oversight of the Authority's exercise of powers.

SGX has frontline responsibility for enforcing the listing and trading rules

The Singapore Exchange (SGX) is a private firm listed on its own market. It has "frontline" responsibility for enforcing its listing and trading rules, and is supervised by MAS. In April 2017 the exchange formed Singapore Exchange Regulation (SGX RegCo) in order to strengthen its enforcement work and address the conflicts of interest that arise from being both a commercial and regulatory entity. SGX describes RegCo as an 'independently-governed subsidiary of SGX that undertakes all regulatory functions on behalf of SGX and its regulated subsidiaries'. It has a separate board of directors with a majority of members independent of SGX, its management, and companies listed on the Singapore exchange. RegCo began operations in September 2017.

2.1 Funding, capacity-building and regulatory reform

Singapore ranks equal 8th in this subcategory with a score of 48%

A new feature of our survey this year is a more focused set of questions relating to the funding and capacity building work of financial regulators. Unlike other leading markets in the region, this information is not easily available in Singapore. MAS does not produce a segregated budget for its financial regulatory function, let alone its supervision of the securities market, but only aggregate figures for its entire budget. Its latest annual report indicates that salary costs increased modestly from S$195m for the 2017 financial year (ending 31 March) to S$203m for FY18. Staff benefits and training remained steady at S$11m, while IT expenditure increased from S$16m in 2017 to S$21m in 2018. Little further information is provided on these numbers. It is understood, however, that MAS has increased its enforcement staff headcount over the past two to three years, and is investing in new enforcement technology.

SGX is somewhat more transparent than MAS in terms of its revenue and expenses

As a listed company, SGX is more transparent. Its latest annual report for 2017 shows that operating profit and expenses have been fairly consistent in recent years, and that the two most significant expenses have been staff and technology.

Interestingly, salaries have risen over the past two years for the SGX Group, which includes the local exchange and two wholly-owned subsidiaries, the Baltic Exchange and the Energy Market Company. But they have fallen for the "Company", which operates the Singapore stock exchange, from S$73m for the 2017 financial year (ending 30 June) to slightly below S$64m for FY18. No details are provided as to why this was or how these salary costs were allocated.

SGX staff turnover appears quite high, but it continues to invest in training

In terms of staffing, the 2018 financial year saw 136 new hires and 117 resignations from a pool of 806 people, a fairly high turnover. SGX has invested in training in recent years, increasing the average training per employee from 29 hours in FY16 to 35 in FY17 and to 44 hours in FY18. While this is positive, the annual report talks about staff development only in general terms. It is not clear, for example, how much of the training is related to regulatory enforcement work.

SGX is investing in technology to reduce its manual processes

Meanwhile, SGX "the company" increased investment in technology from S$60m in FY17 to just over S$62m in FY18, mostly due to an increase in system maintenance and rental, followed by depreciation and, lastly, communication charges. SGX reported that after an internal review it enhanced its SMARTS alert service, which automatically detects and alerts the exchange of irregular market behaviour such as unusual price movements or trading volumes, but it did not disclose much further information in its annual report about these enhancements. It is understood, however, that SGX is moving towards reducing its manual processes, using technology more to monitor the market and news media, and expanding its knowledge-management systems.

No details are provided on the staffing and budgeting of SGX RegCo

Overall, there are a lot of high-level numbers in the SGX report on funding and capacity, but little narrative as to what they mean. While there is some discussion of the educational, enforcement and IPO/listings compliance work of SGX RegCo, the new and independent regulatory subsidiary, there are no details on its budget or staffing.

The exchange maintains strict control over costs and profit targets

In contrast, there is substantial emphasis on the exchange's financial performance, return on equity (ROE), and dividend-payout ratio. SGX's net profit has remained remarkably constant at around S$350m-360m in recent years, as has its ROE of around 35% and dividend-payout ratio of 86-88%. It keeps strict control of its operating profit and cost-to-income ratio, among other things. The broad picture from its annual report is of an exchange that prioritises business results above regulation.

The SGX website provides an inefficient database of company documents

Website woes - 1

SGX has long had a website that is neither easy nor intuitive to navigate, especially when looking for company reports, listing rules and enforcement actions. While the exchange is launching a new website, a continuing weakness is the availability of company reports, announcements, circulars and other notices. For example:

- On the old SGX website, annual reports are available for only the past five years - compared to up to 20 years on the HKEX site. Interim, quarterly, and sustainability reports are often available for only the most recent year or two.
- On the old SGX site, company documents are not organised under easily accessible individual company pages, as on the HKEX site, but by type of report. This is far more time-consuming.

- The new SGX website appears to retain most of the above flaws and inefficient database organisation. It also has a challenging calendar function for selecting reports or announcements from specific periods. Meanwhile, searches for annual reports and announcements from leading companies produced entries only for the past two to three years. We presume this is due to the new site still being in beta form as of mid-November 2018.

Reforms: Good, bad and grey

Positive CG reforms have been undermined by regressive moves

Singapore has undertaken a number of regulatory reforms over the past two years that affect corporate governance. While some represent a step forward, others do not - principally the introduction of DCS and the potential dismantling of parts of its quarterly reporting regime. As a result, Singapore loses some points for regulatory reform - as does Hong Kong. Key developments, in chronological order, include:

- **A revised code of corporate governance:** In February 2017, MAS formed a new Corporate Governance Council to review the existing CG Code of 2012. The Council published a consultation paper on proposed changes in January 2018 and SGX simultaneously consulted on requisite amendments to the listing rules. The Council released its final recommendations, which MAS has accepted, in August 2018.

Dual-class shares

- **Dual-class shares (DCS):** In February 2017, SGX consulted the market on the introduction of DCS. Although the consultation ended in mid-April 2017, the new rules did not appear until June 2018.
- **Rights issues:** In March 2017, SGX allowed issuers to seek a general mandate at their AGMs to double the size of renounceable rights issues from 50% of issued capital to 100%. This rule was introduced to provide companies with easier financing opportunities and would be in effect until 31 December 2018.

Continuous disclosure rules

- **Continuous disclosure rules:** SGX released a consultation paper on 'enhancements to continuous disclosure' in December 2017. These covered secondary fund raising, interested-person transactions (ie, related-party transactions) and significant transactions and loans. Amendments were made to the listing rules in 2/3Q 2018.
- **Quarterly reporting:** In January 2018, SGX consulted on whether to retain quarterly reporting (QR) in response to concerns about compliance costs being 'repeatedly raised among market professionals and listed companies'. Conversely, the exchange recognised that investors 'prefer adjustments to QR to be tempered'. SGX proposed a series of rule changes that would allow smaller issuers to cease QR entirely, while also giving minority shareholders of other companies the right to vote on whether to opt out of QR every three years. If retained, SGX proposed that quarterly reports for the first and third quarters be simplified to basically the key financial statements, while new issuers could be exempt from QR until the third AGM after their listing date. As of mid-November 2018, the exchange had yet to finalise its decision.

"Fast Track" programme

- **"Fast Track" programme:** In early-April 2018, SGX launched a "Fast Track" programme to allow companies with good governance and a record of compliance with the rules to receive priority clearance for selected corporate actions, such as circulars, requests for waivers and share placements. At the time of launch, 60 companies were included in the list. Many were the usual

large-cap/GLC names from the mainboard, but eight smaller Catalist firms also made it and one bad boy from the past - China Aviation Oil. The list has not been updated since then.

Addressing weaknesses in the system

The above moves are part of a carrot-and-stick strategy to address weaknesses in the system, while providing some incentives and flexibility to issuers. While admirable in spirit, two risks remain: it will always be hard to achieve consensus on where flexibility should be allowed, with some stakeholders (usually investors) feeling short-changed. And there is the danger of mixed messages: Is Singapore genuinely trying to improve CG, or weaken it to make the local securities market more competitive? These contradictory policy moves have undermined confidence in Singapore's strategic intentions.

2.2 Enforcement

Singapore ranks equal-6th in this subcategory with a weighted score of 59%

While Singapore does better in this regulatory subcategory, it is well behind the leader (Hong Kong). While some tough punishments have been meted out against certain individuals and companies, enforcement action in Singapore often appears to be inconsistent and somewhat weak. SGX enforcement is becoming more interventionist and transparent under the new RegCo, yet companies forced to do special audits are left to manage this process themselves. Follow-up can be lacking: SGX refers numerous cases to MAS, yet little more is heard of them. And disclosure of regulatory action, while better than a few years ago, is far from the benchmark set by Hong Kong.

MAS wields its stick, unevenly

There have been few insider-trading and manipulation cases in Singapore . . .

The table below summarises MAS enforcement cases and sanctions since 2016, with all the data drawn from news releases on its website:

. . . but more on false trading and fraud, while 1MDB was a focus in 2016 and 2017

MAS likes to use prohibition orders and fines, and is starting to send some people to jail

Figure 3

MAS enforcement: Cases & sanctions, 2016 - 2018

No. of cases by type	2016	2017	2018 (to October)
Insider trading	2	1	2
Market manipulation	1	-	-
False trading	-	4	1
Fraud/breach of trust	-	3	3
1MDB	5	3	-
Others1	1	4	4
TOTAL	9	15	10
No. of sanctions by type			
Financial penalty	4	6	2
Imprisonment	1	2	1
Prohibition orders	1	11	10
Voluntary undertaking	1	1	-
Others2	3	4	2

[1] 'Other breaches' include failure to comply with licensing and business-conduct rules, providing false information to MAS, and mis-selling investment products. [2] 'Other sanctions' include withdrawal of fund-manager or merchant-bank status, licence revocation, reprimands. Note: The number of cases and sanctions does not equal, because some cases produce multiple sanctions against one or more individuals. Tracking sanctions is also difficult because single press releases may refer to different sanctions applied in different years. Source: MAS news releases, ACGA analysis

There have been fewer enforcement actions by MAS in 2018 vs 2017

As the table above shows, the number of cases per year for each type of breach is only in single digits. While 2017 was noticeably more active than 2016, the numbers so far for 2018 (to end-October) imply fewer cases for the full year than in 2017. What is also apparent is the small number of insider trading and market manipulation cases, but a larger number of false trading and breach of trust/fraud cases, and the obvious focus on 1MDB in 2016 and 2017. 1MDB is the Malaysian development bank caught up in embezzlement and corruption charges that directly led to the toppling of the country's former prime minister, Najib Razak, in May 2018.

A remisier was sent to jail for defrauding two intermediaries

In terms of sanctions, most are civil in nature and include monetary penalties and prohibition orders. Since it only has civil powers, MAS cannot on its own initiate a criminal investigation that leads to the jailing of suspects. Its joint-enforcement arrangement with the CAD, however, can lead to criminal sanctions. Indeed, one such case came in March 2017 when Dennis Tey, a remisier (a broker working on commission not for a monthly salary) with DBS Vickers Securities, was sentenced to 16 weeks in prison for defrauding two financial intermediaries in transactions involving "contracts for difference". He made the princely sum of S$30,329 for his troubles.

An investor was sent to jail for false trading

A second case came in January 2018 when Mok Piak Liang was sentenced to four months in prison for false trading. Mok manipulated the shares of Wilton Resources by purchasing them at the end of the trading day on 13 separate occasions, artificially pushing up their price. He did this to avoid top-up payments on margin loans with two financial institutions.

Some prohibition orders have been quite severe

The use of prohibition orders by MAS has also been interesting. Although limited in number, some of the penalties have been quite severe. For example:

- A prohibition order of 12 years to a UOB employee for fraud. The individual cannot undertake securities and futures activities, financial-advisory services or be involved in a financial-advisory firm during this time. He set up a company to trade in shares and forex without a licence and misappropriated S$520,000 from clients.
- A prohibition order of eight years to an AIA employee for fraud. The individual cannot carry on insurance business or provide advisory services. He deceived a client who could not read English into signing insurance policy documents and making him a joint holder of her bank account.

Ups and downs of insider trading

Penalties for insider trading tend to be lighter than for fraud

The story on insider trading is, as in previous years, less compelling. MAS reports only five successful cases in the past three years and these have resulted in either civil monetary penalties (typically three times the profit made or loss avoided), prohibition orders or voluntary undertakings. In contrast to the tougher line taken for fraud against clients by financial-services personnel, it would appear that enforcement agencies do not view insider trading as an equally serious crime.

Civil penalties are common for insider trading

In one case in May 2018, a vice president of finance at Genting sold company shares while in possession of nonpublic, price-sensitive information concerning its financial results and avoided a small loss of just over S$13,000. MAS imposed only a civil penalty of S$50,000. In a similar case in November 2017, a managing director of CSE-Transtel sold shares in its parent company prior to the announcement of poor financial results and avoided a loss of almost S$169,000. MAS imposed a civil penalty of S$423,000, ordered him to pay its legal costs and extracted a voluntary undertaking from him not to be a company director or be involved in the management of a company for two years. While these crimes may appear "victimless", and therefore not as worthy as fraud for serious punishment, they are nonetheless blatant acts of cheating by company managers who should know better. The message to the market seems to be that insider trading will be treated more leniently.

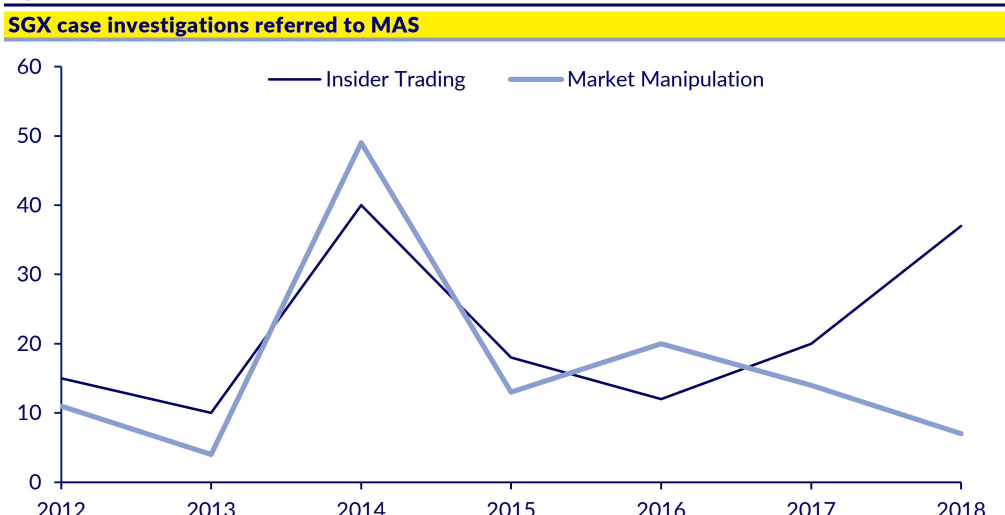
SGX referrals to MAS on insider trading are rising

The other disconnect in this area in Singapore is the big difference between the small number of cases investigated by MAS and the large and rising number of referrals on insider trading from SGX. As the chart below indicates, the exchange has been sending 10 to 40 referrals to MAS each year since 2012. The numbers spiked in 2014, then started rising again in 2017. Although 2018 is not yet at an end, the number of referrals has almost doubled. And while a majority of these cases over the past two years involve insider trading around companies with market caps of less than S$1bn, around 20% to 33% relate to companies worth more than S$1bn. It would appear that these are not insignificant cases.

The number of SGX referrals to MAS on insider trading has been on the rise

Figure 4

SGX case investigations referred to MAS



Source: SGX website, ACGA analysis

To be fair to MAS, however, it should be noted that the Authority does not make the final decision on how to prosecute insider-trading cases. Following investigation, it makes a recommendation to the Attorney-General's chambers on whether criminal or civil action be brought. The prosecution then decides whether or not to proceed.

Simple improvements could be made to the MAS website on disclosure of enforcement data

Website woes - 2

While enforcement information is quite detailed on the MAS website, two simple improvements would greatly enhance the user experience:

- Create an "Enforcement" link on the homepage to a dedicated enforcement section: one currently needs to look under "News & Publications" and then find the "Enforcement Actions" tab among 12 other items in a drop-down list. It is not the most intuitive navigational route for enforcement data.
- Provide clear year-on-year enforcement statistics with explanations as to what the changes in numbers mean. Trying to calculate the exact number of sanctions from press releases is time consuming, because sanctions may be amended over time and single press releases can contain information relating to more than one year. Although the MAS annual report contains a new "infographic" on enforcement statistics, this is somewhat confusing and does not give sufficient detail to identify to which cases the information refers. A simple table with year-on-year numbers would be clearer.

SGX is seeking to raise the bar on enforcement, but with mixed results to date

SGX RegCo rides into town, fast and slow

As we noted in our previous CG Watch report, SGX started getting more serious on enforcement of the listing rules since mid-2015, when it appointed Tan Boon Gin as its new chief regulatory officer. Tan came to SGX with years of experience as a public prosecutor and CAD investigator. Within a short space of time, the exchange's enforcement actions took on a higher profile and its new releases on individual cases became more informative. These trends have continued, along with an increased willingness to intervene in problem companies or transactions. However, the exchange has also come in for sharp criticism of its handling of the Noble Group and other corporate cases, while questions are being raised about the effectiveness of some of its favoured regulatory tools. And as the number of disciplinary actions below show, SGX does not reprimand many companies or directors each year.

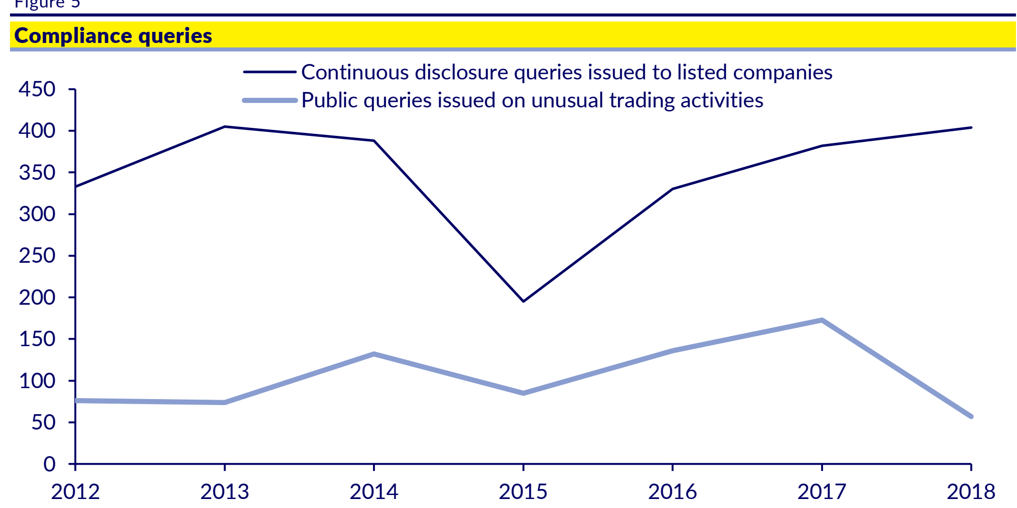
Compliance queries on continuous disclosure have bounced back

From a macro perspective, the following chart indicates one area where SGX has been focusing more of its surveillance and monitoring work - on continuous disclosure. From a low point in 2015, the number of queries issued to listed companies on continuous disclosure has steadily increased and, despite 2018 not being over, the number has already equalled the high point in 2013. Interestingly, there appear to be fewer cases of unusual trading activities.

The number of SGX referrals to MAS on insider trading has been on the rise

Figure 5

Compliance queries



Source: SGX website, ACGA analysis

Disciplinary action is relatively limited in absolute terms . . .

SGX collates all of its actions against companies, directors and trading participants in a section of its new website called Public Disciplinary Actions. The picture for the past three years is as follows and shows that disciplinary action is limited in absolute terms:

- **2018** (year to date): 16 disciplinary actions, including four reprimands for the mainboard (all involving one company), 11 for Catalist (two companies) and one against a trading representative that involved a fine and education programme.
- **2017:** seven disciplinary actions, including one reprimand for the mainboard and six fines and expulsion/suspension orders against securities or derivatives traders.
- **2016:** 13 disciplinary actions, including nine reprimands for the mainboard (four companies), three reprimands for Catalist (one company) and one fine/suspension order against a securities broker.

Selective intervention

. . . but RegCo is taking action on certain issuers

The more interesting and potentially far-reaching aspect of RegCo's work is its willingness to intervene from time to time in controversial company cases. For example:

March 2018: YuuZoo

- In March 2018, RegCo suspended the shares of YuuZoo, an e-commerce and social-networking services provider, after certain items in the company's financial statements could not be verified by auditors. SGX had earlier issued YuuZoo a 'notice of compliance' requiring it to disclose the opinion of its statutory auditor, RT, on the trust and reasonableness of two items in its consolidated financial statements. However, RT notified YuuZoo that it was 'unable to obtain sufficient appropriate audit evidence' to provide an opinion on the matter. YuuZoo was also investigated by CAD for possible breaches of the Securities and Futures Act.

April 2018: Noble Group

- In April 2018, RegCo issued a statement on the restructuring support agreement (RSA) of troubled commodities trader, Noble Group, which has been in trouble since 2015 following an anonymous report from Iceberg Research questioning the company's accounting treatments. Noble stated that its RSA would transfer almost all its assets into a new company in which existing shareholders would be diluted to a 10% interest. Shareholders would be invited to vote on the RSA. In the event that it is not approved, Noble would apply to do an alternative restructuring in which shareholders who voted against the restructuring would get nothing in the new company. SGX opined that this was unfair and urged Noble and senior creditors to treat all shareholders equally.

May 2018: Vard Holdings

- In May 2018, RegCo weighed in on a voluntary delisting proposal from a shipbuilder called Vard Holdings. Vard planned to privatise the company, which required the consent of both shareholders and the SGX. At the EGM on 30 April 2018, the controlling shareholder (who held 96% of voting shares) not surprisingly supported the deal, but other shareholders complained to SGX about the contents of the circular issued to convene the EGM and the conduct of the meeting. After reviewing the circular, RegCo 'noted certain inaccuracies in the financial evaluation of the terms of the exit offer'. Accordingly, it told Vard to reissue the circular and convene another meeting.

A new blacklist on errant directors goes live in May 2018

Another recent initiative from RegCo was the launch of the 'Directors' and Executive Officers' Watchlist' in May 2018. This lists former directors and officers of listed companies that have faced disciplinary action from SGX or been uncooperative in response to SGX inquiries. At launch the list contained the names of 64 individuals associated with 23 listed companies - as of November 2018 it had not changed. If issuers wish to nominate directors whose names appear on the Watchlist, they must first seek the approval of SGX.

SGX has more powers and is working in partnership with members firms to reduce trading breaches

In response to queries from ACGA, SGX highlighted two other important developments in its enforcement work. Firstly, since October 2015, when the Listings Disciplinary Committee was established, the exchange has had a wider range of enforcement powers under the listing rules. Prior to that time it could only publicly reprimand directors and issuers. Since then it can also fine, impose cold-shoulder orders, delist, and force directors to resign. Secondly, it has been taking a stronger pre-emptive approach to breaches of its trading rules (ie, the rules that broker members must follow). In September 2016 the exchange launched two initiatives in partnership with its member firms: a Trade Surveillance Handbook and a Members' Surveillance Dashboard. In the year to October 2017, these two initiatives led to an average 50% decline in trading misconduct, according to SGX.

Doubts remain over the effectiveness of SGX enforcement

Questions and concerns

Despite its more active efforts over the past two years, a number of questions and concerns emerge from a review of RegCo's enforcement actions and announcements. They include:

- **Delays in enforcement action:** There often appears to be an extended period of time between the occurrence of a breach and SGX public action. For example, in May 2015, YuuZoo blatantly misused information from an independent research report to talk up its valuation. Although quite straightforward, and even taking into account the principles of natural justice, the 14 months that SGX took to issue its reprimand seemed long.

  An even longer delay occurred in the case of SingPost, which misinformed the market about an acquisition in July 2014, but was not reprimanded until May 2017. During this period the company was required to undertake various special audits, summaries of which were disclosed in May and July 2016. In October 2016 the company announced that it had 'substantially implemented' all of the recommendations of the special auditors and this was confirmed by the company lawyers, Lee & Lee, in December 2016. It seemed as if the company and the firms serving it were determining the speed of completion in this case.

Deeper concern about regulatory enforcement in Singapore

- **Outsourcing investigations:** The SingPost and subsequent cases, such as Datapulse in early 2018, raise a deeper concern about regulatory enforcement in Singapore - the tendency to instruct offending companies to hire special auditors to review their internal controls and governance problems, and then suggest remedial measures. Since the listed company manages these auditors and consultants, and since the latter are often examining the very directors and executives who caused the breach in the first place, there is a perception in the market that this process lacks independence and credibility. As Professor Mak Yuen Teen, a veteran observer of the CG regime in Singapore, said in a September 2018 blog on the Datapulse compliance review, which was undertaken by the law firm Lee and Lee:

  > The report makes clear who is calling the shots in the review and who it is for. It says it is intended for, and only for, the benefit of the Board, the AC (audit committee) and no other person. Not for SGX which ordered the review, or for shareholders who are paying for it.

  Professor Mak adds: 'The trouble is that the AC consists of the same directors whose actions are the subject of the review.'

Surprisingly, no remedial action is given, even after quite serious breaches the listing rules

- **Referrals and remedial measures:** While the RegCo news releases are extremely detailed, they often end with the words, 'SGX has referred the case to the relevant authorities' (ie, MAS). No follow-up information is provided as to what happens next. Indeed, few, if any, of the directors and companies sanctioned by SGX appear on the MAS enforcement actions list. As for remedial measures, while companies that undertake special audits are required to take follow-up remedial action of some sort, quite a few of the RegCo reprimands come with no apparent remedial action required. This is surprising, since most of the reprimands relate to serious breaches of the listing rules.

Yew Kiang Wong
Head of Research - Singapore
yew.kiang.wong@clsa.com
+65 6416 7885

Wen Han Lim
wen.han.lim@clsa.com
+65 6416 7804

There have been a number of relatively high-profile issues with listed companies in Singapore over the past couple years. In addition to Vard, YuuZoo, Keppel and the ongoing issues at Noble Group, the events at Midas and Trek 2000 offer valuable insights.

Midas hit by ongoing irregularities and litigation matters
Trading in shares of the railway parts maker Midas Holdings has been suspended since 8 February 2018 in both Singapore and Hong Kong. The initial issue surrounding the company started in November 2017, when its share price plummeted 50% for no immediately evident reason, and on 3 January 2018, Midas's Hong Kong-listed shares surged more than 400% amid contract wins.

However, on 8 February 2018, Midas Holdings called for trading to halt before a series of lawsuits filed by creditors surfaced later in the day. While litigation matters continue to surround the group, the then-CEO Patrick Chew resigned with immediate effect on 22 March citing health issues and to disassociate himself from the company. As investigations became more serious, with the audit committee lodging a police report over a possible breach of securities law and irregularities in the group's operations in China, the chairman Chen Wei Ping was ousted from the company by SGX on 2 April.

As investigations carried on, more creditors - ranging from Chinese state-owned finance companies to individual money-lenders - have emerged and claimed against the company for unpaid loans. This came about as the board discovered unauthorised loans and guarantees involving its Chinese subsidiaries. SGX RegCo continues to engage with the Chinese Embassy in Singapore to communicate with the relevant authorities in China regarding the developments.

In May 2018, the board declared that the company is unable to operate as a going concern, while Midas's external auditor Mazars separately said the audited financial statements between 2012 and 2016 could no longer be relied upon. In light of the company's circumstances, trading remains halted and the company faces the prospects of its shares being delisted from the Hong Kong exchange. In August 2018 the Midas board unveiled a timeline of eight months to produce an annual report in order to avoid the delisting.

Trek 2000 indicted over fake sales
On 23 April 2018, forensic accountants from RSM Corporate Advisory published a report claiming possible transgressions - round-tripping, fabrication of documents and fraudulent claims under the Productivity and Innovation Credit (PIC) scheme at Trek 2000 International between 2007 and 2016. The responsible parties include Henry Tan (chairman, CEO and executive director), Foo Kok Wah (president of operations, sales and customised solutions division), Poo Teng Pin (former group director of R&D) and Gurcharan Singh (former CFO). Nonetheless, the issues identified drew a denial from Tan, who instead described them as 'shortcomings' at an AGM held the following day.

In any case, the few key issues identified by RSM were:

- **Round-tripping transactions involving T-Data and S-Com HK**: S-Com HK profited a total of US$266,647.45 from the transactions (between 2008 and 2014) where its involvement was not properly or reasonably justified.

- **Transactions with Colite Technology:** Critical facts pertaining to the US$3.2m sale of UM1G chips could not be established, due to the lack of personnel with knowledge or details.
- **Transactions relating To eSD Inventories:** Poor record-keeping of inventories, which did not reflect the underlying situation.
- **Transactions with Key Asic:** Four purported invoices totalling S$523,600 and US$18,387 paid to Tan and T-Data respectively, which Key Asic confirmed it did not issue and had no record of.

In light of the wrongdoings, the SGX banned Tan, Foo, Poo and Gurcharan from holding any company directorship for a period of three years on 26 April 2018.

3. CG rules

Singapore ranks equal-4th, with a score of 68%

Singapore has a reasonably strong CG rule book, hence scores relatively well in this section. As in Hong Kong, financial-reporting standards are generally high, basic CG reporting rules are substantive, and formal ESG reporting guidelines now exist. While Hong Kong ranks higher than Singapore in this section, there are some areas where Singapore has stricter rules, as the following table shows:

Singapore has stricter rules in some areas compared to Hong Kong . . .

Figure 6

Singapore above Hong Kong	
Private placements	Both places allow issuance of up to 20% of issued capital, but Singapore restricts discounts to 10%. HK allows up to 20%.
New director training	From 1 January 2019, directors in an IPO who have no prior experience as directors will have to undergo training. Previously, companies only had to state whether or not the director had undergone any training.
Board independence ratio	If the chairman of a board is non-independent, then a majority of the board must be independent directors.
Two-tier voting	From January 2022, Singapore will institute a two-tier voting system for independent directors who have served for nine years.

Source: ACGA research

There are also several areas where Hong Kong's rules are stricter than Singapore's:

. . . and vice versa

Figure 7

Hong Kong above Singapore	
Share pledging	Controlling shareholders in HK must disclose any pledges of their own shares in a listed company. Singapore does not require this.
Related-party transactions	Definition of connected persons broader in HK than Singapore; includes 'deemed connected person'.
Voluntary delistings	Controlling shareholders and their associates must abstain from voting in favour in Hong Kong. All shareholders can vote in Singapore. Hong Kong has stricter voting thresholds for companies incorporated in jurisdictions with no compulsory acquisition rule. And Singapore is considering diluting its approval threshold from 75% to 50%.
Minimum number of independent directors (INEDs)	HK requires a minimum of three/one-third INEDs. Singapore still only requires two and will move to the one-third rule only from January 2022. The minimum of two will remain.
Blackout periods	Hong Kong imposes a two-month "blackout" or closed period for director trading before the release of annual financial results and one month before quarterly reports (if any) and interims. Singapore sets one month for annuals and two weeks for quarterly reports.

Source: ACGA research

New code highs and lows

New CG Code a mix of good, bad and odd

Singapore adopted a new and greatly simplified Code of Corporate Governance in August 2018, along with an accompanying and more detailed document called the Practice Guidance. The revised code will apply from the start of 2019, and further changes will take effect in January 2022. Some of the more progressive changes include items that have been moved from the previous Code to the Listing Rules. For example:

Some of the more progressive changes

- **Definition of independent director**: Certain tests of 'non-independence', such as those relating to former/current employees and directors with immediate family members who are former/current employees, will be elevated from the Code to the Listing Rules, thus giving them a firmer regulatory basis (ie, they will be mandatory for all listed companies, not merely subject to 'comply or explain').
- **Two-tier voting:** Where an independent director has served nine consecutive years, his/her continuation on the board will no longer be subject just to a 'particularly rigorous review', as in the old Code. The rules will, from January 2022, require a two-tier vote from (i) all shareholders; and (ii) all shareholders, excluding directors, the chief executive officer, and their associates. This system is similar to one already adopted in Malaysia, where the two-tier vote kicks in at 12 years.
- **Induction training:** All incoming directors 'should receive comprehensive and tailored induction on joining the board'.
- **Internal controls/audit**: Boards must comment on the 'adequacy and effectiveness' of internal controls and establish an 'effective' internal audit function.

Some of the less progressive items include:

Some of the less progressive changes

- **Cooling-off periods**: No change to the three-year rule for former employees and immediate family members who have worked for the company. Also no change to the one-year cooling-off for people who have had a business relationship with the company (ie, who have accepted 'significant compensation' from the company).
- **Definition of independent director:** Previously all the tests for 'independence' were contained in the CG Code. They are now split between three documents with different regulatory implications: 1) Mandatory tests in the Listing Rules, as highlighted above; 2) A general definition in the revised CG Code, subject to comply or explain; and 3) The remaining tests in the new Practice Guidance document, which is not subject to comply or explain but is entirely voluntary. Not only is this a confusing arrangement, it demotes some important tests of independence, such as those relating to significant business relationships, to the Practice Guidance.
- **The Practice Guidance:** With the new CG Code more of a principles-based document, much of the specificity of the earlier Code has been moved to this document. This includes, for example, much of the substance relating to director duties, board composition, board performance/evaluation, remuneration policy and disclosure, and other items. There is a risk that issuers will take the Guidance less seriously than the previous Code.

- **ESG/sustainability:** The new Code and Guidance take an exceedingly minimalist approach to this area. This is odd, given that SGX launched its own Sustainability Reporting Guideline a couple of years ago.

DCS - Disappointing controls for shareholders

SGX promised strong safeguards to protect against abuse of minorities

When SGX introduced DCS in mid-2018, the new rules comprised a number of safeguards designed to protect small shareholders from potential abuse. For example, major decisions subject to a shareholder vote at a general meeting, such as changes to the articles of association, the election of independent directors, the variation of shareholder rights, the selection of auditors, a reverse takeover, and a winding up or delisting, would still be subject to a majority vote, based on one share, one vote. Multiple voting rights are capped at 10 votes per share and their holders must be stipulated at the time of the IPO. And multiple voting rights automatically convert to one-share, one-vote if they are sold or transferred to persons outside the 'permitted holder group' or in the event of the death, incapacity, retirement or resignation of the responsible director representing the permitted holder group and no new responsible director is appointed.

The safeguards will not level the playing field much

In reality, it is likely that these safeguards will do little to level the playing field. Independent directors and auditors will still be nominated, in almost all cases, by the DCS holders. The automatic conversion process looks quite watertight, but it is easy to imagine responsible directors taking a lesser role in a company without the exchange being aware of it. In any case, it would be relatively simple to appoint a new responsible director. And the rules do not contain the one element that institutional investors would most like to see - a time-based sunset clause that brings DCS to hard stop after 7-10 years. Given that even innovative, new-economy companies start to mature and become less profitable at some point, the logic for DCS in perpetuity is threadbare.

Taking the pulse

Related-party-transaction rules have loopholes

Another area where the SGX rules need strengthening relates to related-party transactions, called interested person transactions (IPT) in Singapore. In January 2018, Professor Mak Yuen Teen questioned the efficacy of SGX's Listing Rules in protecting the interests of minority investors, following the case of Datapulse Technology. Datapulse's acquisition of haircare products company, Wayco, raised concerns due to the apparently close connections between Wayco and the new major shareholder and new CEO of Datapulse. The acquisition took place just days after the new controlling shareholder acquired control of Datapulse.

The definition of 'associate' is narrow in Singapore

Despite clear relationships between the parties, this matter did not fall within the SGX IPT rules (Chapter 9). The rules state that an interested person refers to a 'director, chief executive officer or controlling shareholder of the listed company, or any of their associates'. Part of the problem is that the definition of 'associates' is too narrow to capture the nature of the relevant business connections. Professor Mak pointed out that Hong Kong has stronger protections, including a catch-all provision that allows the exchange to deem a person or company to be a related party in connection with a transaction, forcing RPT rules to apply. However, Singapore does not have any such safety valve.

Yew Kiang Wong
Head of Research - Singapore
yew.kiang.wong@clsa.com
+65 6416 7885

Datapulse Technology gripped over company's direction
The saga started in 23 November2017 when it was revealed that a single buyer, Ng Siew Hong, acquired a 29% majority stake in the former disk-drive maker Datapulse Technology from former CEO Ng Cheow Chye while paying a premium of 52.8% over the last transacted price.

With the new controlling shareholder, the board was immediately reshuffled with four new directors coming on by 11 December 2017. A day later, the company announced a deal to buy a Malaysia-based haircare products company, Wayco Manufacturing for S$3.43m, an unrelated company from its core business.

By 15 December 2017, the transaction had been completed. Apart from how quickly the deal was done, the vendor was reportedly a close business associate of Ng Siew Hong, per 23 February notice of compliance from the SGX RegCo. Other major shareholders, Ng Bie Tjin (daughter of Datapulse's former chairman) and Ng Khim Guan (co-founder), took notice of the transactions and decided to call for an extraordinary general meeting (EGM) to oust the board. SGX RegCo later took action as well in 23 February 2018 and required Datapulse to appoint an independent reviewer. Lee & Lee was appointed on 11 April 2018.

On 20 April 2018, the EGM took place with more than 200 shareholders present. But to Ng Bie Tjin's dismay, the reigning board gets to keep their roles as shareholders backed the company's proposed diversification plans away from the disk-making business.

On September 2018, an independent review firm, Lee & Lee conducted a review of Datapulse Technology's internal controls and corporate governance practices which revealed that the Wayco transaction was conducted hastily without any proper due diligence conducted by Datapulse. In return, the vendor of Wayco provided an undertaking to buy back Wayco for the same consideration amount paid by Datapulse in the event that Datapulse discovers any material adverse irregularity or defect in Wayco. However, the terms 'material adverse effect' and 'material extent' were not clearly defined in the supplemental agreement. Though Lee & Lee found no systemic failure by Datapulse, it will continue to conduct additional reviews on the company. Meanwhile, Datapulse has since agreed to adopt recommendations to improve internal controls and corporate governance.

4. Listed companies

Singapore ranks equal-2nd, scoring 63%

Singapore ranks equal 2nd in this category with Thailand, with large-cap companies performing reasonably well overall as expected. They scored highest for their investor relations websites, financial reporting, audit committees, internal audit, disclosure of internal controls and risk management, and ESG/sustainability reporting. They were somewhat less impressive in terms of CG reporting, the speed with which they produce audited annual accounts, board evaluation, disclosure of director and executive remuneration, and management of related-party transactions, dividend policies and corruption-mitigation work. As for the mid-cap firms, although the quality of their reporting was generally below that of their larger brethren, one or two stood out for their sustainability reporting.

Financial reporting is mostly robust in Singapore

Financial reporting

As a group, the 15 large-caps almost all did well on basic aspects of financial reporting, including the level of detail provided in their P&Ls, balance sheets, cashflow statements and notes to their accounts. They also provided useful MD&A summaries, segment information about the range of their businesses, and details on their investments in joint ventures and subsidiaries/associates. The best reporters in this area were the likes of DBS Bank, SGX, Olam and ComfortDelGro, while a weaker performer was electronics manufacturer, Venture Corporation, which gave limited information on its revenue breakdown and operating expenses, and little discussion of its business segments in its MD&A.

Operating expense disclosure is an area of weakness

Disclosure on operating expenses was one area where a number of the large-caps - five of 15 - either underperformed or could have been clearer. Venture Corporation has a large line called 'other operating expenses' in its P&L, but no detailed breakdown of these expenses in the notes. Dairy Farm is another that does not account clearly for all of its selling, general and administrative expenses (SG&A): by our calculation, its accounts do not fully explain around 36% of such expenses. Meanwhile, Genting Singapore shows a large 'other operating expense' line in its P&L that amounts to 38% of its total SG&A for 2017, but reconciling this aggregate figure with the detailed numbers in a table on 'expenses and income by nature' is quite laborious. A simpler 'expenses by nature' table would help.

CG reporting is strongest on board composition and director attendance

CG reporting

Listed companies in Singapore are required to report on the extent to which their corporate-governance practices align with the Code of Corporate Governance. Accordingly, both large- and mid-caps include quite detailed CG statements in their annual reports. This disclosure is useful in gaining an understanding of board composition, probable level of independence (ie, is there an independent chairman or lead independent director?), director-attendance records, and fees paid to independent directors. They are much less useful when trying to understand the actual level of individual director skills, what each board committee actually does during the year, and how the company engages with shareholders.

Reporting on board committees is formulaic

Sadly, formulaic board-committee reporting remains alive and well in Singapore. We assessed reports for audit, nomination and remuneration committees across 15 large-caps, and only three - DBS, SGX and Wilmar - stood out for having genuinely informative reports that explained what these committees actually discussed during the year. The typical board committee report gives its composition, terms of reference and a generic description of items covered during the year. It is entirely possible to read these reports and, half way through, completely lose sight of which company they are describing!

Sustainability reporting is better than CG reporting

ESG/sustainability reporting

With the advent of the SGX Sustainability Reporting Guide on a comply or explain basis in July 2016, the quality of corporate disclosure in this area has been on an improving trend. While some companies stood out for the quality of their sustainability reports prior to this date, such as the property developer CDL, the rule change has been the catalyst for a wider range of large- and mid-caps to think about the impact of sustainability issues on their businesses. Under the SGX Guide, companies are encouraged to report on five key issues:

- Material ESG factors
- Policies, practices and performance - in relation to the material factors
- Targets - for the forthcoming year
- The sustainability reporting framework they have selected (eg, GRI)
- A board statement on how it has considered sustainability issues

Accordingly, our review of large-caps found a fairly high degree of compliance with these five factors. Companies provided useful disclosure regarding their engagement with stakeholders in the development of sustainability reports, most give a "materiality matrix" or equivalent list of material factors, have policies to address the material issues selected, and almost all include detailed numbers on their usage of resources, waste emissions and targets. Although mid-cap reporting was, as expected, of generally lower quality, one firm that stood out for the relevance and focus of its sustainability report was Roxy-Pacific Holdings, a property company.

Few firms ask themselves the big questions on sustainability

Perhaps the least convincing aspect of sustainability reporting in Singapore, as in other markets, is the extent to which companies explicitly link the data and analysis provided to their long-term business outlook and strategy. It quite often feels as if companies are gathering and publishing all this information but without a clear sense of what it means for their future. Will their business model hold for the long term? Could climate change force a radical change on them? Most reports do not seek to answer such big questions.

Yew Kiang Wong
Head of Research - Singapore
yew.kiang.wong@clsa.com
+65 6416 7885

Yamada's unique risk: Fire destroy financial records

At 2:30pm on 30 August 2017, Yamada Green Resources reported that a transport vehicle carrying its financial documents and IT/computer hardware was engulfed in flames. The Fujian-based agricultural food product producer reported that the fire led to the destruction of a large part of the company's FY17 and FY18 finance documents, including certain payment and receiving vouchers, invoices and banking-related advice, as well as backup information stored in the IT/computer hardware. The stock was suspended from trading following the announcement.

The company initially announced a profit loss warning earlier on 11 August 2017 and sought an extension until 29 October 2017 to report its financial results. The company further reasoned that the delay was due to high staff turnover in its finance function. Later, the group sought additional approval from the Singapore Exchange to delay its financial results for the year ended June 2017 to May 2018 as it expects its external auditor BDO to face some difficulty in finalising the audit.

Following the events, Zhou Chen took over the role of chief financial officer with effect fom 12 January 2018. On 1 April 2018, an independent auditor Deloitte has reconciled Yamada's cash balance of its China subsidiaries' bank accounts for FY17. The match was done across physical and online statements, as well as historical statements provided by the company. However, the bank balances excluded cheques that were not posted until after 30 June 2017.

5. Investors

Singapore ranks seventh, with a score of 32%

Like Hong Kong, Singapore does not perform as well in this category as one might expect of an international financial centre. While both cities have some active institutional investors which take their ownership and governance responsibilities seriously, they are few in number - partly a function of their limited pension systems and small populations. Both cities have a set of investor-stewardship principles, but these documents are merely voluntary guidelines: they are not subject to comply or explain. Yet Singapore does have one advantage over Hong Kong - an active retail shareholder association.

Institutional investors

Mainstream domestic investors have a low profile on CG and ESG issues

As a group, mainstream institutional investors in Singapore have a fairly low profile on corporate-governance issues. They vote their shares, engage with companies (though rarely attend AGMs) and respond to consultations; but it tends to be the same names that are willing to take any sort of public stance, and most of the latter are foreign investors. For example, of the 43 named responses to the MAS consultation on the revised CG Code in 2Q18, only one represented domestic institutional investors in Singapore - and it was an industry body, the Investment Management Association of Singapore (IMAS). Contrast this to the 12 responses received from foreign asset owners, managers and associations.

Investors are underrepresented on official bodies and committees

Apart from the historic involvement of Temasek Holdings in the governance of government-linked companies, and more recently its grandfathering of the *Singapore Stewardship Principles for Responsible Investors* in November 2016, there are few catalysts for a more active investor base. Institutions were barely represented in the Corporate Governance Council formed by MAS to review the CG Code in 2017 and they are almost nonexistent in the SGX Listings Advisory Committee. This may in part be due to the fact that finding people with the right level of seniority and expertise is not always easy, but one gets the impression that regulators are not actively seeking investor participation in these bodies.

Retail investors

Singapore has an active retail association - SIAS

It is a different story at the retail level. Singapore has the Securities Investors Association of Singapore (SIAS), now almost 20 years old, which carries out a range of CG-related activities and services for and on behalf of retail shareholders. SIAS is the primary reason why Singapore scores higher than Hong Kong in this category.

SIAS weighs in on company disputes and problems

SIAS likes to weigh in on company scandals and points of dispute, seeing itself as an arbitrator between the firm and small shareholders. It has opined several times in recent years on the Noble Group accounting scandal and restructuring, and more recently commented on the near collapse of Hyflux, a former market darling whose company name ominously predicted the state of its share price.

SIAS also opines on transactions deemed unfair to minority shareholders

SIAS also comments on transactions where the terms offered to minority shareholders are perceived to be unfair. For example, it criticised a connected takeover and acquisition of listed commodities firm, GMG Global (GMG), by Halcyon Agri Corporation (HAC) in 2016. HAC's offer was deemed 'not fair but reasonable', by an independent financial advisor, RHB Securities. HAC is controlled by Sinochem International Corporation (SIC), part of the China state-owned giant, Sinochem Group. While such split opinions are not unheard of in Singapore, what irked SIAS was that as part of a related and simultaneous transaction, HAC agreed to acquire certain assets from an SIC subsidiary on terms

more favourable than those offered to GMG minority shareholders. Opining on this asset deal, the same independent financial advisor employed different share price assumptions than those used in the GMG takeover, with no explanation as to its rationale. Understandably, SIAS felt that HAC's parent, SIC, was receiving more favourable terms for the assets it agreed to sell to HAC than the terms HAC had offered to GMG minorities, and called for HAC to improve the terms for GMG minorities. The calls went unheeded and both transactions went ahead.

Shareholder activism

Shareholder activism has arrived, sporadically

An interesting development in Singapore in recent years has been the sporadic rise of shareholder activism against individual companies by investment funds and individuals. In February 2017, a group of 66 unit holders requisitioned an EGM at a real-estate investment trust, Sabana Shari'ah Compliant Reit, and sought the removal of the Reit manager. They were dissatisfied with a drop in dividends, significant losses on revaluations of properties previously acquired, and a questionable valuation of a proposed acquisition. Following the EGM in late-April 2017, a controversial sale-and-leaseback agreement with the promoter of the Reit manager was terminated.

Meanwhile, the biggest case of the past two years has been Goldilocks versus Noble:

Too hard, too soft, just right?

Goldilocks creeps into Noble's house, but does not fall asleep

One of Singapore's few shareholder claims is the recent case of Goldilocks Investment, a fund owned by the Abu Dhabi Investment Agency, versus Noble Group, an SGX-listed commodities trader struggling through a controversial financial restructuring because of substantial debt. On 29 January 2018, Noble proposed restructuring terms that outraged minority shareholders, who discovered that their interests would be diluted to just 10% in a massive debt-for-equity swap, while 20% would be allocated to senior management.

The relationship between Noble and Goldilocks Investment, a major shareholder with an 8.1% share, deteriorated quickly. Noble refused to accept nominations for non-executive directors that Goldilocks was to propose at the upcoming AGM, claiming that the fund's notice and request were defective under Bermuda law, where Noble is domiciled. Goldilocks filed a lawsuit in March, alleging Noble inflated profits to raise money and seeking relief on behalf of shareholders, including about US$169m paid to executives and interest and damages, plus a declaration from the court that the defendants breached their fiduciary duties. Goldilocks also sought an injunction, seeking to restrain Noble from holding its AGM and executing the restructuring. Goldilocks successfully obtained an interim injunction from the Singapore High Court in April 2018 preventing Noble from holding its AGM pending determination of substantive issues.

Noble and Goldilocks resolved their dispute in June 2018 after Noble improved its offer and the parties agreed to terminate all legal claims and proceedings against each other. Goldilocks will be entitled to nominate a director to the board. In August, shareholders backed a deal that left them with 20% ownership of the business, with 70% handed to a group of creditors comprising mainly hedge funds and 10% to management.

6. Auditors and audit regulators

Singapore ranks 3rd, with a score of 79%

Singapore has always performed strongly in this section because it has one of the region's more developed systems for audit regulation, while its audit regulator, the Accounting and Corporate Regulatory Authority (ACRA) has been proactive in raising audit-quality standards and working with the local CPA industry to strengthen their internal controls and staffing capacity. But events of the past two years have seen some backsliding in ACRA's work and this has affected its overall score and ranking.

Where is the Act?

ACRA lacks disciplinary powers over CPA firms

A longstanding weakness in Singapore's audit regulatory system is the limited powers enjoyed by ACRA over audit firms. While it has authority over individual CPAs, and does sanction them if problems are found in its audit-engagement inspections or for other reasons, it does not have similar powers over firms. ACRA is able to carry out regular inspections of firms and can make recommendations to them, but this is only done on an "advisory basis".

The Accountants Act could finally be amended in 2019

For many years the government has talked about amending the Accountants Act to give ACRA greater powers. In October 2017, for example, the Senior Minister of State for Law and Finance, Indranee Rajah, told the Singapore Accountancy and Audit Convention that ACRA would be empowered to conduct firm-level inspections in line with regulatory regimes in the USA, UK and Australia, and impose sanctions for noncompliance. Since then, there has been radio silence in terms of official announcements. It is understood, however, that a promised public consultation should take place in early-2019, with a draft Accountants Amendment Bill going to parliament in the second half of that year.

Where is the FRSP?

FRSP took a one-year break; next report coming soon

Another area where ACRA appears to have slipped is its annual review of the financial statements of listed companies, the Financial Reporting Surveillance Program (FRSP). Initially launched in 2015, this is intended to raise compliance with accounting standards and give directors guidance on how to do so. The second report for 2016 was published in September 2016. Since then there have been no further updates. However, ACRA told ACGA that the programme took a one-year break in 2017 to 'review policies and processes' and that it would publish the third FRSP report in January 2019.

PMP on track

ACRA's annual inspection of CPA firms and CPAs is continuing as normal

There has been no delay in the publication of ACRA's Practice Monitoring Programme (PMP) report, which summarises its annual inspection of CPA firms and public accountants. The PMP appears to be paying dividends, as ACRA outlines in its *12th Public Report 2018*, published in October 2018:

- 'For the current year, we remain on track to achieve the audit quality target to reduce by 25% the proportion of inspected audits of listed entity engagements with at least one finding. ACRA had set this target in 2016 for the six audit firms that are part of the Global Public Policy Committee (GPPC) networks that perform listed company audits. The target is to be achieved over the four-year period from 2015 to 2019.'
- 'Encouragingly, the usage of the AQI framework is increasing. For the period 1 April 2017 to 31 March 2018, Big Four audit firms have taken the initiative to share AQI data with even more audit committees as compared to the prior year.'

CPA firms in Singapore face a range of HR challenges

HR not on track

Somewhat less encouragingly, ACRA highlighted the following industry HR trends in its latest PMP report:

- **Staff turnover rate:** Several CPA firms have experienced 'significantly higher overall staff turnover during the current period of inspection compared to prior period'. Further analysis showed this was mainly due to 'increased attrition of audit seniors'. ACRA says that firms explain this spike in turnover to 'sector reorganisation of the audit practice, changes to audit technology and better prospects in the outside market.'
- **Staff leverage ratios:** The ratio of staff to partners among some firms continues to be high. 'This is an indication that inadequate time might be spent by partners on the audit engagements,' ACRA said.
- **Time spent by engagement partners/EQCR partners:** ACRA has seen a 'declining trend' in the involvement of engagement partners in audit engagements, but engagement quality control review (EQCR) partners have been 'increasingly involved in the engagements'.

While ACRA did not provide any statistics on the patterns above in its 2018 report, it has done so in previous PMP reports.

Singapore is extending the cooling-off period for auditors of listed companies . . .

Rotation slows

In line with developments at the international auditing standards level, ACRA is planning changes to its Code of Professional Conduct and Ethics for Public Accountants and Accounting Entities (the ACRA Code) from 15 December 2018. In order to enhance auditor independence and professional scepticism, the cooling-off period after a rotation will be extended from two years to five years for the engagement partner, from two years to three years for the EQCR, while other key audit partners will remain at two years. Meanwhile, the 'time-on periods' for all key audit partners - the number of years they can consecutively audit a public-interest entity - will remain at seven years.

. . . and is extending the rotation period from five to seven years

Less positively, Singapore is lengthening the time-on period for auditors of listed companies. Despite the seven-year standard in the ACRA Code, SGX listing rules stipulate that rotation of audit partners must take place after five years. SGX has now 'agreed to harmonise the time-on and cooling-off requirements in Singapore and to have one single point of reference for the requirements', said ACRA. In other words, key audit partners can in future audit listed companies for seven years before rotating. Notably, the five-year rule will remain for audits of large charities and 'institutions of a public character', which will therefore face higher standards than listed companies. While any adverse impacts from this rule change may be limited, such a change of policy direction does not seem necessary, nor consistent with ACRA's drive to enhance audit quality.

Singapore ranks equal-3rd, with a score of 62%

7. Civil society and media

Singapore has a fairly broad and deep civil society, including well-established associations of directors and company secretaries, other professional bodies involved in promoting corporate governance and participating in regulatory consultations, and original research carried out by local academic institutions and professional bodies. The media has also developed in recent years, with writers on corporate governance becoming more experienced, and a wider debate taking place over issues such as dual-class shares, the rights of minority shareholders in voluntary delistings, and the benefits of new voting systems for independent directors.

Training and education

The Singapore Institute of Directors offers a range of training programmes . . .

The Singapore Institute of Directors (SID) is the leading training organisation for directors in Singapore. It runs a range of courses, from short talks for people thinking about becoming a director, to entry-level training for first-time appointees to the boards of listed companies, and to advanced courses and master classes for more experienced directors. One of these is the International Directors Programme organised in conjunction with INSEAD. SID also does an annual update for members and non-members on corporate-governance developments in Singapore and will arrange bespoke sessions for listed companies on request.

. . . and publishes guides for boards and board committees

SID also publishes a series of *CG Guides for Boards in Singapore*, covering the running of the board and key board committees, and with explanations and references to the relevant sections of the CG Code. These guides are detailed - the audit committee guide alone runs to more than 500 pages. There is also a guide to the CG Code itself and a *Sustainability Guide for Boards*, published in partnership with KPMG.

Company secretaries are also well served by an active membership body

For company secretaries, the lead industry body is the Singapore Association of the Institute of Chartered Secretaries and Administrators (SAICSA). It runs a month-long course, repeated throughout the year, called the Fundamentals of Corporate Secretarial Practice. It also puts on specialist courses on such topics as preparing and filing XBRL financial statements and complying with anti-money-laundering/terrorist-financing rules, and ad hoc courses on risk management, HR and complying with the Charities Act.

Research

A range of academic and professional associations carry out original research on CG

A number of professional and academic bodies undertake original research on corporate governance in Singapore. Key regular reports include:

- The Singapore Governance and Transparency Index (SGTI), led by the Centre for Governance, Institutions and Organisations (CGIO) at NUS Business School, undertaken in collaboration with the Singapore Institute of Directors and CPA Australia, and supported by *The Business Times*. SGTI annually assesses listed companies on CG disclosure and practices, as well as the 'timeliness, accessibility and transparency of their financial results announcements'. The latest results were released on 6 August 2018.
- The Asean Corporate Governance Scorecard, a joint regional initiative of several organisations led by the Asian Development Bank and the Asean Capital Markets Forum. The domestic ranking bodies in Singapore are SID and CGIO. Carried out annually, the latest scorecard was published in early-April 2018.
- Singapore Directorship Report, published by SID and supported by ACRA, SGX and three industry partners: Deloitte, Handshakes and NTU. It provides an in-depth analysis of 3,603 directors on the boards of 737 companies, business trusts and Reits listed on the SGX as at 31 December 2017. While the latest version is not freely available, the 2016 version is published on the SID website. It covers a range of topics such as director remuneration, gender diversity, multiple directorships, size of boards by company type and market cap, committee sizes and numerous other datapoints.

Recap and recommendations

Recap of CG Watch 2016

Singapore's response to our 2016 suggestions has been mixed

To what extent has Singapore responded to our recommendations from 2016?

Figure 8

Singapore: recap of 2016

	Recommendations	Outcomes
1.	Do not introduce dual-class shares	DCS introduced in June 2018
2.	Companies to improve nonfinancial reporting (remuneration, board evaluation, committees)	Some improvement, but mixed. Some SMEs showing good performance
3.	Strengthen regulatory enforcement	New SGX RegCo formed in 2017 and somewhat more interventionist
4.	SGX to improve database of company announcements and reports	No significant change, although SGX has a new website
5.	Introduce amendments to Accountants Act to give ACGA legal powers over CPA firms	Still delayed
6.	Domestic institutional investors to play a more public role in CG policy and stewardship	Still waiting

Source: ACGA

Downgrade watchlist

What to avoid

Factors that could force the market score to fall in 2020:

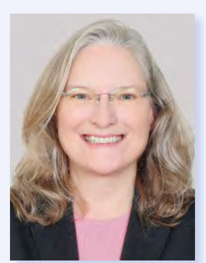
- No systematic analysis by MAS of its enforcement outcomes or disclosure of its budget for securities regulation.
- Enforcement efforts by MAS and SGX RegCo wane.
- No improvement in SGX company-reports database.
- Any significant dilution in quarterly-reporting rules.
- Amendments to Accountants Act still delayed.
- Low profile of domestic institutional investors on CG and stewardship continues.
- No improvement in company disclosure of operating expenses.

Quick-fix list

What to fix

Issues to address as soon as possible:

- MAS to improve enforcement disclosure in its annual report and website, including the fate of referrals from SGX.
- MAS to enhance transparency around its budget for securities regulation.
- SGX to create a company reports database as extensive as the HKEX version.
- SGX to disclose and analyse enforcement statistics more systematically.
- SGX to review definition of interested person and minority protections in voluntary delistings and major transactions.
- Listed companies to provide meaningful board-committee reports.
- Listed companies to link sustainability reporting and data gathering more closely to their business models/strategies.


Neesha Wolf
Taiwan Research Editor, ACGA
neesha@acga-asia.org
+886 9 2814 1070

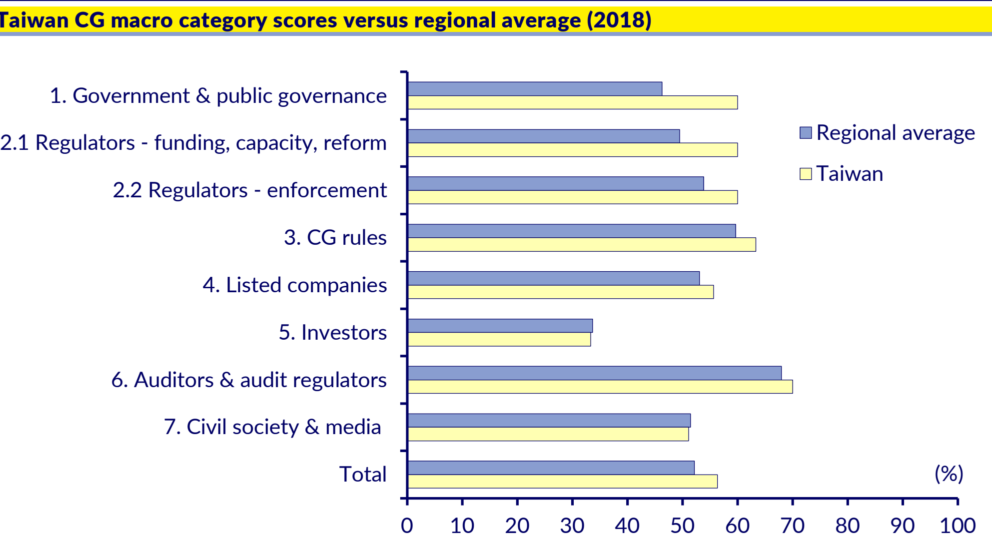
Taiwan - Less than sum of its parts

- Momentum continues on CG reform, agency integration, and enforcement, but anti-corruption regime remains fragmented
- FSC ups the ante on bank governance, a persistent problem area
- Constant changes in FSC leadership continue, limiting the perceived power and independence of the regulator
- Despite new Roadmap, CG reform is often piecemeal - a deeper systemic approach is needed that addresses remaining bottlenecks and issues
- New confiscation law adds teeth to enforcement measures
- CG rules improving, but old problems persist: still no proper 5% rule for disclosing substantial ownership, causing harm to some listed companies
- New civil groups starting to sprout up

Taiwan ranks 5th with a score of 56%

Figure 1

Taiwan CG macro category scores versus regional average (2018)



Source: ACGA

Introduction

Taiwan ranks 5th with a score of 56%

Taiwan ranks fifth in CG Watch this year with a score of 57%, behind Australia, Hong Kong, Singapore and Malaysia. Given the presence of Australia in our market ranking, Taiwan's position is effectively the same as in 2016 when it ranked fourth without the inclusion of Australia. As noted in our Regional Overview, the closeness of the total scores between the middle-ranking markets indicates the pace of CG reform among them has been picking up. Yet it is striking how different the category scores are between Malaysia, Singapore, Taiwan and Thailand.

Proactive reform efforts offset by outdated rules

Taiwan has been proactive in policymaking, strengthening public governance, the adoption of new CG rules, and more vigorous enforcement. As a result, it performs strongly and above average in the government and regulator categories, where it ranks third and fourth, respectively. It performs less well in the overall comprehensiveness of its CG rules, with some outdated provisions and standards that are more useful to its ubiquitous blockholders (shareholders who typically have stakes of 5%-10%) than to smaller minority shareholders. Although it leads

the region in some areas, notably ESG reporting requirements and pre-disclosure of share trades by controlling shareholders and directors, its rulebook remains a patchwork of modern and outdated elements. This is a key reason why Taiwan's ranking falls to seventh in this area.

Taiwan's performance across categories is remarkably consistent

In the other categories, namely listed companies, investors, auditors and audit regulators, and civil society and media, Taiwan generally ranks fifth or slightly underperforms at sixth. Unlike many other markets, its overall performance is remarkably consistent.

Ranking stays the same despite solid efforts - largely due to rulebook and coherence of disclosure

The net result is that while Taiwan has been putting a great deal of effort into its CG reforms in recent years, and deserves credit for its initiatives, its ranking has not changed. This will no doubt be a frustrating result for the many officials working hard to improve corporate governance and capital market quality in Taiwan. They can take comfort from the fact that they are holding their own in a more difficult and complex survey - and are only marginally behind Singapore and Malaysia. What do those markets have that Taiwan does not? In Singapore, it includes such things as a clearer CG rulebook, better governance and disclosure among listed companies, and a stronger audit regulator. In Malaysia, it is a notably stronger CG rulebook, more transparent disclosure around regulatory enforcement, a more active investor community, and a stronger audit regulator.

Lack of comprehensive, system-wide view hampers effectiveness at front lines

For Taiwan to progress further, we believe issues at both the micro and macro level need to be addressed. While it's the micro level where these problems are most likely to appear, it is our view that the source of the problem lies in the macro level. A whirlwind of leadership changes at the securities commission and the absence of a comprehensive, big-picture view of the CG landscape have limited the perspective of regulators and, hence, their effectiveness.

1. Government and public governance

Taiwan ranks 3rd with a score of 60%

Taiwan's score of 60% in this category places its third in the region, behind only Australia and Hong Kong. Solid institutions and government support for CG, as well as numerous reform efforts contributed to the strong showing.

New CG roadmap adopts shorter three-year horizon

After achieving many of the objectives set out in its 2013 Corporate Governance Roadmap, Taiwan adopted the New Corporate Governance Roadmap (2018-2020) in April 2018. The new roadmap aims for faster results within a shorter horizon of three years compared to the previous five years. It features five action plans: deepening CG culture, enhancing board function, promoting shareholder activism, strengthening information transparency, and augmenting regulatory enforcement. Some specifics include promoting English information disclosure and enhancing investor relationships, promoting reasonable remuneration for directors and strengthening the supervisory function of boards.

Control Yuan

Extensive system in place for investigating public corruption allegations

In terms of public governance, Taiwan scores well in no small part due to its unique Control Yuan. This long-standing institution is a branch of the government, equal in stature to the executive, the legislative or judicial branches, and it accepts and investigates complaints from anybody about government affairs (ie, public governance). Last year it received 15,000 complaints, investigated 313 cases, issued 99 corrective measures and impeached 32 officials. It also handles mandatory declarations on the property and assets of more than 60,000 government and elected officials under an extensive and detailed system.

Agencies that are independent in other markets are not in Taiwan

Other agencies also address corruption issues. The Ministry of Justice Investigation Bureau (MJIB) covers private corruption cases and the Agency Against Corruption (AAC) focuses more on clean politics, legislation and civil servants. But none of these are able to operate independently of the government of the day, unlike the ICAC bodies found in certain other Asian markets. This points to an aversion to independent agencies in Taiwan. In 2010 the AAC and Financial Supervisory Commission (FSC) were both specifically prevented from becoming autonomous entities. In 2016, Taiwan also dissolved its Supreme Prosecutors Office's Special Investigation Division, which had been devoted to investigating corruption cases against senior officials, following questions raised about its impartiality.

Does Taiwan have the will to allow independent institutions to emerge?

All of these developments create doubt as to whether Taiwan has the will to nurture strong institutions that are not directly and completely under government control. This reluctance to establish independent entities could be due to concerns related to its authoritarian past or to finding skilled administrators who can remain independent. Whatever the case, as Taiwan advances on its path to becoming a more developed and open society, it may be time for more such independent entities to arise.

Bank governance

FSC stymied by courts in case against former Mega chairman

Governance of financial industry still Taiwan's Achilles' heel

Supervision of bank governance is handled by the FSC in Taiwan, not the central bank as in other markets. Bank governance has long been a weak spot for Taiwan and has become a target of overdue regulatory efforts after a string of scandals. Over 2016 and 2017, the FSC imposed penalties for internal control and auditing system breaches in 186 cases. There is now increased emphasis on tougher penalties for poor governance, and in 2018 new plans were afoot to ease merger and acquisition rules to alleviate the highly fragmented banking industry. Enhanced "fit and proper" requirements for board members of financial institutions need immediate attention. A case illustrating this point involved Mega International Commercial Bank (owned by Mega FHC), which was fined US$180m in the US in 2016 for breaches of money laundering rules (a case highlighted also in CG Watch 2016). The then-Mega chairman, Mckinney Tsai, has since been charged with insider trading and breach of trust. The FSC ordered Tsai dismissed from his position and barred him from working in the financial sector for five years, but not before Tsai resigned (aggressively so, as he tendered his resignation 10 times in six months). Taiwan's courts have ruled twice this year saying the FSC was out of line for taking disciplinary action against Tsai, because he had already resigned and was thus an individual and not a bank official at the time the FSC issued its sanction. Such rulings create obvious problems for the FSC's ability to supervise the industry.

Judiciary

Specialized judges handle economic cases

That said, Taiwan is starting to perform better in our survey for the quality and independence of its judiciary. In recent years, the judiciary has focussed on developing the expertise of judges handling economic cases, with extra courses and research papers as part of the requirements to being appointed as a judge. The High Court now has 12 specialised panels of three to four judges each handling economic crimes, while the Supreme Court has judges handling civil securities cases. A massive judicial reform effort to collect citizen and expert input on improving transparency, enhancing the rights of victims, and strengthening institutions was also undertaken, but few changes have been implemented yet.

A new commercial court is in the works

A specialised commercial court of nine judges is in the works and is likely to be housed within the new Intellectual Property Court. This commercial court at the High Court level will only appeal to the Supreme Court with the intention of reducing the time it takes to wrap up cases. The average number of days to final judgment reached a high of 184 in 2014, before falling to a low of 111 in 2016. However, a number of cases have dragged on for more than a decade. That said, it is possible that some accused of wrong-doing could experience a perverse incentive to prolong court proceedings, because the law stipulates they would only be removed from executive or board positions after a final ruling.

The revolving door

Ever-changing leadership at the securities commission still a concern

While Taiwan possesses a relatively coherent regulatory system governing the securities market, one longstanding issue of concern is the frequent changes in leadership at the FSC. The commission has had 11 chairpersons since its founding in 2004 and while the current incumbent is well-regarded and a much-needed proactive reformer, no one knows how long he will stay.

On a more positive note, Taiwan has a unique system (covered in more depth under Investors) that allows minority shareholders access to the legal system through the Securities and Futures Investors Protection Center - something that China has now copied.

Sebastian Hou, CLST
sebastian.hou@cl-sec.com
+886 2 2326 8165

Amid the generally improving outlook for corporate governance in Taiwan, there have been a series of scandals in the construction and financial sectors.

Farglory corruption cases; public anger at construction companies

Farglory Group founder Chao Teng-hsiung has faced charges including bribery and breach of trust in cases involving several public construction projects. It was awarded the contract to construct the ill-fated Taipei Dome in 2004. Building began in 2011 after delays but was halted in 2015 by the Taipei city government as it was found to have deviated from the approved blueprint, with inadequate fire safety and evacuation measures, and to pose a threat to the surrounding commercial area and metro line in the event of collapse. Senior figures from both political parties have been questioned in a three-pronged corruption probe into the property developer, including former president Ma Ying-jeou who at the time was mayor of Taipei, and Taiwan Stock Exchange Chairman Lee Sush-der, who was accused of approving changes to the project parameters which benefited Farglory.

Faglory chairman

Faglory Chairman Chao Teng-hsiung (趙藤雄) being arrested

Source: CLSA, Taiwan news

The group has also been embroiled in several other scandals, including the rezoning of land in two districts to facilitate the construction of housing projects instead of industrial development, and on the alleged pocketing of excessive fees by Chao Teng-hsiung from a Farglory insurance subsidiary. Farglory is also said to have paid off a New Taipei City councillor to obtain a positive report on a piece of land it bought to construct apartment buildings in an area known for frequent landslides. Farglory Life, a unit of the Farglory Group, was also hit with a NT$14.4m (US$494,030) fine, the highest ever imposed on a life insurer, for alleged corporate governance violations in a series of real-estate development projects.

It is not uncommon for developers to bribe local politicians to secure lucrative construction bids. Against a backdrop of endemic cronyism and political corruption, cost-cutting by construction companies is a very real concern. In the 2016 Southern Taiwan earthquake, scores of individuals died in the collapse of the Weiguan Jinlong Building in Tainan. Weiguan Construction was found to have skirted building codes to cut costs, packing large rectangular cooking oil cans inside walls and polystyrene in supporting beams mixed with concrete. The human cost of shoddy construction is real, and there are increasing calls for the government to do more to rein in the developers.

2016 Southern Taiwan earthquake

2016 Southern Taiwan earthquake

Source: CLSA, Wikicommons

Taiwan's banking industry problems

Banking scandals and the separation of corporate and state power

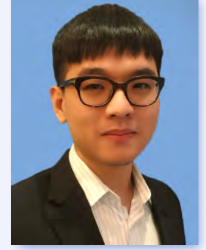
A spate of recent scandals involving SinoPac, Mega and the Ching Fu shipbuilding fiasco underscore the problems in Taiwan's banking industry. SinoPac Holdings chairman Ho Shou-chuan and two others are accused of granting illegal loans to an "offshore company with no real operations". This comes on the back of the ex-chairman of Mega International Commercial Bank's indictment on charges including insider trading, and several massive fines slapped on Mega by the USA for money laundering. The Financial Supervisory Commission (FSC) also recently punished seven state-run banks involved in the Ching-Fu Shipbuilding loan scandal which erupted in August 2017, and resulted in indictments and fraud charges after a whistleblower alerted the navy that the company was falsifying its progress reports for a US$1.19bn dollar project, contracted from the Ministry of National Defense, to build six mine countermeasure vessels for Taiwan's military.

Taishin Financial plans to cut the number of seats on its board of directors

In what the company says is a bid to improve the board's diversity and supervisory function, Taishin Financial plans to cut the number of seats on its board of directors from nine to seven, but this is widely viewed as a check against New Taipei City-based residential property developer Pau Jar Group, which reportedly acquired a more than 5% stake in Taishin Financial with the aim of gaining board representation. Financial Supervisory Commission Chairman Wellington Koo said the government does not like to see overconcentration of financial institution shares in the hands of a few industrial conglomerates, and that he is sceptical about business groups owning shares in more than two financial institutions at the same time.

Taiwan law only requires disclosure/approval for interests of 10% or more, unlike the rest of the region

This raises an important issue. While Taiwan has attempted to separate commercial banks and industrial companies by, for example, imposing ceilings on individuals or companies' share ownership, and restricting their right to sit on boards or hold voting stocks, the law only requires disclosure/approval for interests of 10% or more, unlike the rest of the region where it is 5%. This has allowed Pau Jar to amass stakes of 9.99% in Taishin and other banks and then demand board seats despite its lack of banking experience and having only held the shares for a short time. The challenge for the government will be how to assure a complete separation of the financial and industrial sectors without impeding the sustainable development of the financial industry. This is exacerbated by the murkiness of many of Taiwan's large financial institutions which, while ostensibly private, still retain close ties to the state.



Ken Shih, CLST
ken.shih@cl-sec.com
+886 2 2326 8152

Acquisition or infiltration?

Recent events at denim-maker Roo Hsing highlight the additional governance risks introduced by Taiwan's complicated relationship with China. Established in 1977, Roo Hsing (4414 TT) started out as a small garment manufacturer in Taiwan. Chen Shih-Hsiu invested in the company in 2009 and now serves as its chairman. Leveraging his background in investment banking, he started to reorganise and conduct M&A to grow Roo Hsing's business. Its merger in 2017 with China-based jeans maker JD United Holdings was a milestone, creating one of the world's leading denim manufacturers. An NT$1.5bn injection from Taiwan's National Development Fund helped seal the NT$13bn deal, and Roo Hsing became the largest jeans maker, accounting for 7% of global supply.

In 2018, a Taiwanese legislator disclosed that the National Development Fund had made a net loss of NT$3bn from its stake and that one of the investors was the owner of JD United Holdings and a Chinese national. The legislator charged that most of Roo Hsing's Taiwanese management had been replaced by JD United's Chinese executives, and that this cross-shareholding structure was aimed at helping JD United reversely acquire Roo Hsing as a shell company. The company countered that the investor was born and raised in the US and had renounced his Chinese nationality. The legislator cast doubt on the investor's background, given he was in charge of a state-run Chinese import/export company despite his US citizenship. Some murky transactions and accounting between Roo Hsing and JD United have also since emerged. The Financial Supervisory Commission has filed a case with the Taipei District Prosecutors office, which is launching an investigation.

The issue of Chinese investment in Taiwan is back in focus. The cabinet has passed draft amendments to the Act Governing Relations Between the People of the Taiwan Area and the Mainland Area, which will raise fines for individual or institutional Chinese investors that invest in Taiwan via illegal means. The draft has been listed as a priority for the current legislative session. According to the proposed amendments, individual or institutional Chinese investors must obtain permission from the authorities or will be subject to a fine ranging from NT$50,000 to NT$25m (currently NT$120,000 to NT$600,000).

2. Regulators

Taiwan ranks equal 3rd with an overall score of 60%

Taiwan scored 60% in this section, ranking only behind Hong Kong and Malaysia, and on par with India. Its consistent approach to reform, stronger regulatory agencies, and higher penalties for wrongdoing all helped boost its score. It ranks slightly better in the first sub-category on funding, capacity building and regulatory reform than in the second on enforcement. Although it has made progress in enforcement, regulators in other markets tend to be more coordinated in their work and more effective in communicating their achievements. Taiwan's absolute score of 60% indicates there are still many institutional weaknesses to address.

Regulatory system is housed in a variety of agencies

Taiwan's regulatory and enforcement system is an interesting and, in places innovative, patchwork of closely connected entities:

- The Financial Supervisory Commission (FSC) is a government administrative organ overseeing the financial markets and regulating banking, insurance, and the securities market. It is also the regulator of listed-company auditors.
- Under the FSC, the Securities and Futures Bureau (SFB) supervises securities issuance and trading, and sanctions listed companies for breaching disclosure and other securities regulations. Its powers are limited to administrative penalties, including fines. It liaises with other arms of government for further enforcement action.
- The Ministry of Justice Investigation Bureau (MJIB) undertakes domestic security and criminal investigations. Its Economic Crimes Unit, established in 2014, handles criminal cases and investigations involving listed companies. The MJIB passes cases to prosecutors for indictment.
- The Taiwan Stock Exchange (TWSE) is a private corporation but not a listed company, unlike its counterparts in Australia, Hong Kong, Japan, Singapore and certain other markets in the region. One-third of its board are FSC appointees representing the public interest. It monitors and enforces breaches of listing rules, although serious cases of misconduct are passed on to the SFB. It is home to the Corporate Governance Center, established in 2013. It consolidates information and resources, handles global outreach and serves as the primary contact window and "face" of CG in Taiwan.
- The Taiwan Depository and Clearing Corporation (TDCC) serves as the settlement, clearing and central depository platform, as well as managing StockVote, the second major electronic voting (e-voting) platform for investors in Asia after ICJ in Japan. It will also soon provide a range of investor communication services for issuing companies.

- A special feature of the capital market system in Taiwan is the Securities and Futures Investors Protection Center (SFIPC), which takes up civil cases, including litigation and arbitration, on behalf of retail shareholders.

2.1 Funding, capacity-building and regulatory reform

Taiwan ranks equal 2nd in this sub-category with a score of 60%

Taiwan does well in this category, in part because its primary securities regulators are relatively well resourced given the size of its securities market, and have been building capacity across the board: both the FSC and SFB have added staff, while MJIB has added technological capability. The TWSE has also added staff, but does not disclose specific figures. More significantly, Taiwan has undertaken some major regulatory reforms over the past two years and it has one of the few fully functioning electronic voting systems in the region, which is particularly beneficial to cross-border institutional investors voting at shareholder meetings.

FSC budget mostly comes from regulatory fees

The FSC is largely self-funded, with about three-quarters of its budget coming from regulatory fees. It has been adding staff, with a total of 1,058 employees across its four sub-agencies and in its central offices, with 225 in the SFB. The FSC has a budget of NT$1.4 billion (about US$46m), which has largely stayed steady for the past two years. The MJIB has about 200 agents in its Economic Crimes Unit.

Regulatory system is more integrated and established

The regulatory system as a whole has shown improvements over time. Following the establishment of the CG centre and CG roadmap in 2013, and the MJIB Economic Crimes Unit in 2014, the regulatory system has become more integrated, stronger and firmly established, a sign of increased internal coordination.

New roadmap sets direction

New CG roadmap has a more ambitious timeframe

The new Corporate Governance Roadmap (2018-2020) sets a three-year horizon, shorter than the previous version at five years, aiming for faster reform. Objectives are arranged across 13 areas, including: more English disclosure, promoting reasonable director remuneration and requiring its disclosure, and strengthening the independence of internal auditors. One of the more important objectives is to strengthen boards so they can get the information they need from board chairs who also serve as CEOs.

Legal amendments have aimed to strengthen CG, but not all have passed

Revisions to the Securities Exchange Act and the Company Act in 2018 help in this regard. Provisions have passed that give directors the power to demand the information they need to do their jobs, as well as to hire professionals such as accountants or attorneys at the company's expense to assist them if needed. Regulators tried to pass legislation that would require disclosure of the final beneficiary of all listed companies, but this was shot down by the legislature - as was a provision that would have required CG professionals (company secretaries).

Changes to company law allow for more diverse board nominees

The necessary legislation has also cleared to require board nomination systems, and this has already removed the right of boards to screen candidates. This right was used in the past to eliminate candidates on spurious grounds, such as not providing an elementary school graduation certificate. Shareholders holding 50% of shares for three months or more now also have the right to call a shareholder meeting without the board's approval. However, this is an extremely high threshold.

E-voting now mandatory for all listed companies

Electronic voting is now mandatory for all listed companies in Taiwan. The TDCC is also expanding the platform to become an investor relations platform. It will consolidate IR contact information for all Taiwanese companies and ease direct engagement, as well as provide ESG ratings. The system is slated to go live in January 2019, and there are plans to extend services for issuers to include information on voting policies and records. Votes must be submitted two days ahead of time, just beyond Japan's one day, although issues remain for various international investor voting systems connecting with Taiwan's platform.

Voting by poll is the de facto norm, but still not mandated

E-voting has largely led to de facto voting by poll for most firms in Taiwan. Listed companies are also required to upload the number of votes (for/against/abstain) for distributions, charter amendments, acceptance of reports and elections, and thus voting by poll has become the norm for companies to simplify processes. Nevertheless, a loophole still exists as voting by poll is not explicitly required for all resolutions. This seems a small housekeeping task that could be easily rectified, and we wonder why it has not been resolved.

IPO preparation calls for comply or explain CG practices

Taiwan has taken a proactive approach to instilling good CG practices in firms preparing for IPOs. It requires an eight-page self-assessment that forces would-be listed firms to consider their CG performance and develop plans to improve. The MJIB also conducts training on what constitutes corruption and embezzlement and the like, and how to prevent them. Being a law enforcement arm, the fact that the MJIB conducts this training signals the gravity and importance of the material to potential issuers.

Taiwan's CG regime is not always clear to outsiders

However, while most of the pieces in the regulatory puzzle are there and broadly moving together, the nature and direction of the system is not immediately clear to outsiders. Several factors contribute to this problem.

'The craziness of politics'

FSC is largely self-funded, but subject to legislative oversight

While the FSC is largely self-funded, it clearly remains a government unit. Its chairperson and all of its commissioners are government appointees, and the law dictates that vice chairs must also be civil servants. The FSC is also subject to legislative oversight, with its chairperson regularly hauled in for a grilling by boisterous legislators.

FSC changes leadership often; now on its third chair since 2016!

That the FSC operates in an uncertain political context is no better illustrated than in the constant changes in its leadership, which rotates like a merry-go-round. The term for the chairperson was originally set at four years, but legislative changes in 2010 made the FSC an administrative organ, rather than an independent body, and eliminated those terms. Since the FSC was established in 2004, no chairperson has come close to completing four years. Whenever there is a change of government, the chair changes. The current administration of President Tsai Ing-wen took office in 2016 and is on its third chair already.

Changeable leadership creates uncertainty in the system

Lack of continuity in leadership is likely to produce at least two undesirable outcomes. The first is uncertainty within the FSC about what tomorrow might bring. The second is an entrenched layer of top staff who hold the place together, but without the authority to take charge. There could also be resistance to the agenda of any new leader, since staff know it will likely not be long before the chair is gone and they can revert to what they did before.

Lack of leadership continuity arouses doubts

Regardless of the facts on the ground, this creates an impression of weakness in the system. The perception is that as soon as a new chair takes action against entrenched business interests, which the latter resist, the government will have the chair removed. Or worse, if the head of the FSC does not do what the government wants, he or she will be removed. Another possible impression is that there is no one in Taiwan who is independent and skilled enough to be trusted to run the organisation properly.

Gains in coherence come at cost of autonomy and power

Put together, these factors rob the FSC of its power and independence, and have cost Taiwan dearly in the scoring. While it gains points for the level of coherence of action and current government support for policy changes and enforcement, it loses more points on autonomy and because of the commission's ever-changing leadership. A quote we heard on the issue sums up the situation: "I think one of the things that has been Taiwan's saving grace is the, (while) not quite Singapore-level of sophistication and education among their senior civil servants, but (they are) a close second. The senior guys are really good. They get whipsawed by the craziness of politics, but they really do know what they're doing. Although the policy itself may not be transparent, the motivation is usually pretty easy to figure out. But the sophistication and competence drops off dramatically. You get the senior guys who have PhDs from major institutions, then you've got the mid-levels who just want to keep their heads down and don't want to take responsibility for anything."

Restrictive recruitment

Staff of civil servants offer stability, but limited innovation

This leads to a related issue: recruitment policy. As a government administrative organ, the FSC is almost exclusively staffed by civil servants. While this offers a great deal of stability to the organisation and a high degree of institutional knowledge, it limits innovation and the availability and influence of outside perspectives.

Lack of outside perspective increases risk

This is particularly important in Taiwanese society, which is traditionally hierarchical and where personal relationships have been known to trump the rules. Without practitioners or those with international expertise, there is a risk that regulators could be blindsided by market practices that cannot be clearly seen through a civil servant lens. To address these same concerns, Hong Kong has long hired experienced regulators from Australia and Canada for senior positions in the Securities and Futures Commission (SFC), in particular in roles relating to enforcement and market supervision (where an outsider can be inherently more independent). The SFC also recruits professional staff from the private sector in Hong Kong. While language is more of a barrier in Taiwan, we recommend it do the same.

Who sees the big picture?

Coherence has strengthened among regulatory agencies . . .

Although the regulatory apparatus in Taiwan is scattered across several agencies, there is a high level of integration, which we noted in CG Watch 2016 and which has clearly improved. Staff are well-informed about what other groups are doing; they collaborate often, and frequently serve on each other's committees. The FSC has even embedded MJIB and prosecutor staff onsite.

. . . but structure remains decentralised

However, the structure remains decentralised. When asked who is in charge of CG in Taiwan, one regulator said in all sincerity, "We all are!" While such enthusiasm is laudable, the lack of clear and consistent leadership or a big-picture view of the system has caused Taiwan to lose points in this evaluation.

CG roadmap serves leadership role, but human unit still needed

While members of the different units come together to produce the CG roadmap, which serves as a guiding document for the process, there is no obvious oversight unit at a high level tracking and managing it. In communicating with regulators, each unit can talk very professionally about their part, but not how it fits into a bigger whole. There does not appear to be one agency responsible for holding and communicating a system-wide view of what's going on.

MOEA holds clear, comprehensive systemic view - for legal amendments

The closest we have found to a systemic view was among staff at the Ministry of Economic Affairs (MOEA), who seemed quite clear on the direction of needed changes and appeared to be making solid efforts to update laws to address local problems, within the limitations inherent in a democratic structure. Their approach is quite pragmatic and comprehensive, implementing change step by step, proposing what they think they can get passed while planning what requirements to strengthen later. However, this group only handles legal amendments, not the whole system.

Leadership change and civil servant culture at FSC inhibits system-wide view

While the responsibility could fall to the FSC, its constant changes in leadership undermine continuity. The civil servant culture of the commission has not produced a system-wide view of Taiwan's CG regime. Or if it has, it has not communicated it.

Piecemeal reform

Reform often focusses on specific problems, not broader systemic issues

Without a complete and coherent picture of the CG system, it is hard to assess how well CG reform is proceeding. The result is that reform efforts, while focussed and diligent, often come across as piecemeal and fragmented. They are responses to specific needs and past criticisms, such as the lack of voting by poll, independent directors and audit committees, rather than being derived from a system-wide understanding and analysis of an issue, such as the right level of corporate disclosure, the pros and cons of cumulative voting, or whether minority shareholders have sufficient rights to ensure that investor stewardship makes a genuine difference to the CG ecosystem over time.

Information is also fragmented

Fragmentation is also painfully apparent in the depth and quality of information provided on corporate governance. There is plenty of raw data, but precious little has been processed into a usable format. The reader is usually left to figure out for themselves what it all means. For example, there is now a new CG roadmap, but how did Taiwan do on the old roadmap? To what extent did its proposed solutions solve the problems they were trying to address? A CG expert might know, but a general investor or market participant would not. How were the targets in the new CG roadmap chosen? What are the gaps in the system they were devised to solve?

Enforcement data is available, but not consolidated or interpreted

Another area where communication is less than coherent is enforcement figures are strewn across websites for the FSC, SFB, MJIB, TWSE, SFIPC, and the Judicial Yuan, although links to several of these appear on the TWSE's CG Center webpages. Sometimes the material is in English, but usually just in Chinese, often referring to specific article numbers in different pieces of legislation, without naming the infraction. This assumes the reader will know what substantive breaches the article numbers refer to. Compare this with leading markets in the region that consolidate all enforcement information in one or two clearly accessible parts of the securities commission annual report or website under a simple "Enforcement" heading. As one person in the system said, "Well, it all makes sense to us, but I don't think we communicate it very well." **That** is exactly the point.

Websites show improvement, but user experience still painful

Laborious legal research

While there have been improvements in regulatory websites in Taiwan - they are smoother, faster and more complete today - there is a continued lack of attention to the user experience when it comes to accessing information. Tabs are often cluttered and not intuitive, and there is an assumption the reader knows where and how to find anything. A few examples:

1. Legislation online has no html contents page or index in English that aids quick access to a specific section. Laws provide only a simple contents page with sections listed by article number, and often just a general content heading or no heading. It is still necessary to scan each section to find what you are looking for. Or you need to search for certain words and phrases, which can be very hit and miss.

2. While there is a centralised official website with laws translated into English, there is no way to know if one can trust that the information shown is the most recent. For example, a search of the Company Act in English in October 2018 failed to show changes that were made to the law in July 2018, and there was no notice the law had changed. A scan of the site around the date the amendments passed (6 July) or the date of promulgation (1 August) also gave no indication the law had changed. So, despite being the official centralised website, it could not answer the simple question, “What are the latest changes to the Company Act in Taiwan?” As to the legislative history, while there is a list of dates when the law was changed, there is no way to check what actually changed within the law.

3. For one regulatory agency, an English version of its annual report was attached to the end of its long Chinese version, but with no indication provided up front that a translation was available. We found it by accident.

4. On one website, there is no way to search by code or company name for information. You can only scroll through all 300+ items to find things. These are organised by stock codes, not alphabetically, and require an intimate understanding of such codes.

Taiwan’s CG effort is wasted if no one can find evidence of results

The impact of Taiwan’s rigorous CG efforts will be diluted if observers cannot find evidence of the results or make sense of them. Regulators are advised to review the websites and/or annual reports of regulators in Hong Kong and Malaysia for inspiration.

2.2 Enforcement

Taiwan ranks equal 3rd in this sub-category with a weighted score of 60%

While Taiwan has made a solid effort in enforcement since our last report, and its score in this sub-category is in line with “funding, capacity building, regulatory reform”, its ranking is one level lower. Taiwan loses points against other markets because of a fragmented and rather confusing approach to communicating its otherwise good work in enforcement. This is not a new observation in CG Watch.

Confiscation law and anti-money laundering rules help MJIB crack down

The MJIB Economic Crimes Unit serves as the criminal enforcement arm of Taiwan’s regulatory system. This well-resourced division employs 200 agents covering crimes such as corruption, embezzlement, fraud, market manipulation and insider trading. As mentioned in CG Watch *2016*, legal changes that took

effect in 2016 provided for confiscation of ill-gotten assets. This and other recent changes, such as the strengthening of anti-money laundering practices that made it easier to track the movement of money and illegal activity, have led to a huge jump in confiscation judgments, from about US$16m in 2015 to US$291m last year, adding a long-absent deterrent effect to Taiwan's regulatory system.

MJIB also takes a soft enforcement approach

Beyond these achievements, the MJIB has been creative and proactive in its efforts to curb economic crime. It provides training to various associations and companies on what constitutes corruption, embezzlement, manipulation and insider trading. It has conducted more than 600 training sessions since 2014 and held 158 meetings reaching more than 7,900 companies and 25,000 representatives. This is a surprising level of outreach for what is essentially a law enforcement and national security organisation.

The SFIPC

SFIPC files class-action lawsuits and arbitration claims for shareholders

One organisation that is truly unique to Taiwan is the Securities and Futures Investors Protection Center (SFIPC). The SFIPC is a quasi-governmental unit established in 2004 that owns a small number of shares in all listed firms in Taiwan, giving it certain shareholder rights that it can wield at scale. To do so, it is authorised to file class-action lawsuits or arbitration claims in its own name once it has been asked to do so by at least 20 securities investors. It also provides consultation and mediation between shareholders and issuers, as well as handling investor complaints and managing an investor compensation fund.

SFIPC takes clear, effective action on civil cases

The SFIPC has emerged as a de facto civil law enforcement arm of the regulatory system and has been quite active. In 2017 alone it represented more than 26,000 investors in 19 class action suits, comprising total claims of more than NT$7.95 billion (US$257m). By the end of 2017, it had been involved in 39 class action suits awarding final judgments in favour of small investors of about NT$4.65 billion in settlements. As of the end of 2017, it had 117 class action suits still pending in court or in enforcement, while 118 cases had been closed.

CG Evaluation System produces social pressure for firms to improve CG practices

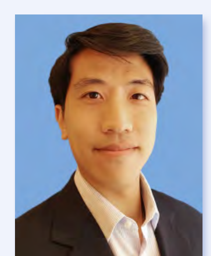
The main tools available to the SFB and TWSE are fines and other administrative penalties. However, they have also developed an interesting soft enforcement approach by instituting an annual CG Evaluation System. The structure of the evaluation is based mainly on the OECD's six CG principles. In 2015, regulators started announcing the evaluation rankings for companies that scored in the top 20%. This was extended to the top 50% in 2016. From 2017, they have announced the rankings for every firm, leaving poor performers with nowhere to hide. This approach creates social pressure to improve performance without resorting to the penalty system.

Major prosecutions cropping up at regular intervals

In terms of actual cases, some of the highest profile ones are:

- SinoPac: Former SinoPac FHC chairman, Ho Shou-chuan, was indicted in August 2017 over irregular loans. The case was exposed because of whistleblowing.
- Ching Fu: At least five people were indicted and 54 bank officials punished in 2018 over a syndicated loan involving several state-owned financial institutions to Ching Fu Shipbuilding. The sour loan deal was for a navy project the company was unable to fulfil and came to light through whistleblowing.
- XPEC: XPEC Entertainment chairman, Aaron Hsu, was sentenced in February 2018 to 18 years in prison for fraud in an initial ruling. XPEC was ostensibly going to be bought by a Japanese firm, but it turned out to be a plot devised by Hsu.

- PEWC: Former Pacific Electric Wire and Cable (PEWC) chairman, Jack Sun, began a three-year prison term in September 2017 for embezzlement and illegal transfer crimes that took place in the 1990s.
- Ting Hsin: Former Ting Hsin Oil and Fat Industrial Co chairman Wei Ying-chung, began a two-year prison term in July 2017 for fraud for the 2013 tainted oil scandal.



Andrew Wong, CLST
andrew.wong@cl-sec.com
+886 2 2326 8151

Protecting the whistleblowers

Taiwan continues to make strides in internationalising its business environment by making efforts to better protect whistleblowers. Given the regularity that corruption or unethical behaviour seems to surface in the news, a strengthening of support for whistleblowers is a welcome sight, in our view. Taiwan's Agency Against Corruption held a workshop on protecting whistleblowers in mid-2017, with the aim of drafting legislation that would emulate the international anti-corruption standards set out in the UN Convention Against Corruption. Officials from Asia Pacific nations such as the USA, Japan, South Korea, Singapore, Thailand, and others were in attendance.

Taiwan's then Minister of Justice, Chiu Tai-San, stressed the need to offer personal protection for whistleblowers, given Taiwan's lack of a comprehensive framework for such situations. With an effective system that can offer protection and monetary compensation in place, we believe more individuals will be willing to risk their livelihoods to better protect Taiwan's business environment and society at large. While this workshop is only an incremental sign of an improving stance on corporate governance, we nonetheless believe it is a step in the right direction for Taiwan, as the island strives to attract international talent and stymie the outflow of home grown talent searching for an out from Taiwan's opaque business culture.

3. CG rules

Taiwan ranks 7th with a score of 63%

Taiwan's score of 63% for CG rules is higher than most of its other category scores in this survey, yet its ranking (seventh) is well below - an indication that this remains one of the weaker aspects of its CG ecosystem. Australia is the clear leader in this category, followed by Hong Kong, Malaysia, and then India, Singapore and Thailand (all on the same score). Despite its active reform efforts, Taiwan continues to lose points in several key areas. It is also important to note that some of its major reforms in recent years, notably on independent directors, audit committees and director nomination systems, merely bring it level with reforms made much earlier in other markets.

Gaps in the rulebook

Substantial ownership starts at 10%, not 5% as in most markets

Unlike other markets in the region, virtually all of which require disclosure when an ownership stake in a listed companies reaches 5%, Taiwan has clung to its outdated 10% threshold. While this point may have seemed academic to regulators in the past, the recent Pau Jar case brought it to the fore.

The Pau jar case in 2017-18 showed why the 10% rule was unfair to the market

From the fall of 2017, Pau Jar Asset Management, an arm of a local construction firm, quietly acquired stakes in several Taiwan banks at just below the 10% disclosure threshold. Regulators were aware of this, since they must be notified when a shareholding in a financial company reaches 5%, but the 10% rule for public disclosure allowed Pau Jar to fly under the market radar. This is important because, in Taiwan, such a stake is high enough to become a "blockholder" and

possibly win at least one board seat. Minority shareholders suddenly woke up to find that Pau Jar, which had no prior experience in the banking industry, had a large enough stake to seek board representation on not one, but several banks, giving it immediate influence in the industry.

Pau Jar sought seats on three financial boards — and succeeded in one of them

In late 2017, Pau Jar targeted two seats at COTA Commercial Bank at an extraordinary meeting in December, but after the FSC stepped in, the group ended up supporting candidates from Far Eastern Air Transport, which took five seats on the board but did not gain a majority. Pau Jar then turned its attention in June 2018 to the annual meetings of Taishin Financial Holdings and China Bills Finance. While it failed to win any seats at Taishin, it reached consensus with China Bills on nominees and two representatives of Pau Jar subsidiary Ho Chu Investment were elected; one of them was the director and vice president of Pau Jar. The next target for the company is likely to be SinoPac Financial, which will hold elections in two years.

Among other things, Taiwan should tighten its "fit and proper" standards for directors of financial firms

There are several issues here, the first being disclosure. The gold standard in the region is disclosure of 5% stakes and then at each additional percentage point (the "creeper rule"). We suggest Taiwan adopt the same. Second, the separation of financial and non-financial industries, a key objective of the FSC, should be maintained. Third, the qualifications of board members. While diversity of opinion on the board is to be commended, "fit and proper" requirements for board membership of financial institutions must take precedence. Taiwan has an extensive list of requirements, but would do well to tighten these standards, particularly in terms of experience. Finally, there is the issue of cumulative voting, which makes it possible for those with shareholdings of only 10% to obtain a board seat. Although intended to benefit minority shareholders, cumulative voting is often of most benefit to blockholders.

Private placements have no cap on the amount of shares that can be issued, and 20% discounts are permitted

Beyond these, Taiwan also lost points on private placements - the issuance of new shares to a select group of shareholders - because it allows for a 20% discount to the current share price (vs Malaysia's 10%). And there are no caps on the amount of shares that can be issued for cash, as opposed to Malaysia where the limit is no more than 10% of issued capital.

Where Taiwan compares well

Pre-disclosure of share transactions for directors leads regional best practice

Conversely, Taiwan gets full marks for timely disclosure of share transactions for directors and controlling shareholders, defined as those exceeding the 10% threshold. The intention to transfer anything more than 10,000 shares must be reported to the stock exchange at least three days in advance by 17:30, and is then announced on the disclosure system at 18:00. The SFB is quite strict on this and regularly issues fines for transgressions.

Laws banning directors involved in corporate crime have fallen behind

In past surveys, Taiwan was one of the few jurisdictions with laws requiring directors and managers convicted of serious corporate crimes to resign their positions. However, the rules are not perfect. In the case of fraud, breach of trust or misappropriation, resignation is not required unless there is a sentence of one year or more in prison.

Audit committees well on the way to full implementation

There are other bright spots too. Audit committees are being phased in and 60% of firms on the main bourse now have them. Taiwan missed full points here because they are not yet mandatory, nor implemented across the board, but it did get extra credit because audit committees are fully independent. All listed companies have independent directors and remuneration committees, which are mandatory.

ESG reporting is strong in Taiwan . . .

Taiwan boasts one of the most extensive ESG reporting regimes in the world, with more than 300 listed companies issuing sustainability reports last year to the Global Reporting Initiative (GRI) standard. It is the No. 1 producer of GRI reports worldwide in both absolute and relative terms. At an ACGA event in May 2018, one investor member commented: "Some [markets] are coming from nowhere to lead international practice, especially Taiwanese companies. There have been massive improvements in ESG disclosure in Taiwan ... When I have to give a good example [of an ESG report], now I go to Taiwan ... I'd be happy to have that level of report that [a Taiwanese company does] for every company in Asia. I have 75 questions I need answers to - from the reports in Taiwan, I can get 95% of what I need."

. . . but still misses a key investor need and faces upcoming competition

While Taiwan is doing extremely well in this arena, it did not earn full marks. Many companies still fail to convey a solid understanding of material sustainability issues and their strategy for addressing them - a key piece of information investors need. There is no requirement to assess ESG risks, which other leading markets have. Many reports do not yet link sustainability to KPIs for management. Finally, only larger companies and those from certain sectors, such as food, chemicals and finance, are required to report; and many reports are not in English. Although ESG reporting is one of the few areas where Taiwan really shines, it could soon lose its lead. To help Taiwan keep its grip, the sustainability reporting requirement should be phased in for more listed firms, and ESG factors added or tightened on risk assessment requirements.

Nomination systems now common, and legislative changes help the process

Plans are also in place to require board nomination systems, although not nomination committees. Required legislation has already cleared and 72.5% of TWSE-listed companies have already implemented nomination systems. Shareholders individually or collectively holding 1% of shares already have the right to nominate candidates - one of the region's more liberal rules in this area. In the past, however, companies were not under an obligation to disclose minority shareholder nominees and boards had the right to screen out candidates on spurious grounds. Legislative changes to the company law on 6 July 2018 removed such arbitrary rights, and instituted sharp penalties for those who interfere with nominee names on the list of candidates presented for election at a company's annual general meeting.

AOB motions on key issues no longer allowed

New company law amendments also no longer allow motions for capital cuts or going private to be proposed as extraordinary or "any other business" motions during the shareholder meeting. They must now be on the agenda.

4. Listed companies

Taiwan ranks 6th with a score of 56%

Taiwan's score of 56% placed it sixth behind Australia, Singapore, Thailand, India and Malaysia. The strongest showing for Taiwan in this section was in terms of internal control and risk management, as well as ESG reporting. Where Taiwan companies lagged was in terms of independence of the chairman, lack of lead independent directors, quality of information provided in board reports, lack of disclosure around executive remuneration policy, and clear and credible policies for mitigating corruption.

Risk disclosure is strong among listed firms

Companies in Taiwan scored well on internal control and risk management items because nearly all the firms in our survey disclosed key material risks specific to the company and steps to manage them. Taiwan has extensive requirements for such disclosure in its reporting rules.

Audit committees seem independent, but disclosure still a problem

CG reporting

Taiwan has a special rule that all members of an audit committee must be independent directors, and all of a firm's independent directors must be on the audit committee. If the audit committee is fully independent, why did Taiwan companies not get full marks on this question? The reason is insufficient disclosure. First, often there was not enough detailed information on the members of the committee to assess whether they were truly independent. It was also not always clear who was the chair of the committee or what level of skill that person possessed.

Independence of directors still hard to assess

A similar problem exists in terms of independent directors. Very few Taiwanese firms have a lead independent director. While many firms offer a 10-point matrix explaining their view on the independence of individual directors, there is usually no biography or CV provided to allow readers to reach their own conclusions. This issue extends to the chairman position. Taiwan scored a zero on chair independence, because chairs frequently serve as CEOs or are not independent for other reasons.

Remuneration disclosure is still not specific enough

Another area of weakness was director and senior executive remuneration disclosure, which is usually presented in overly broad bands that provide little useful information. The TWSE CG Center says that 33% of firms disclose the exact amount of remuneration, but many of the large cap firms in our survey did not. Only two of 15 disclosed such information. Firms also seldom disclosed any information about their remuneration policy.

Nomination committees remain rare

Finally, few Taiwanese companies have a nomination committee, and thus no nomination committee report. In the past, the board screened candidates, but these laws were recently changed and nomination systems are being implemented. However, nomination committees are still needed as they perform board evaluations and identify skills gaps to be filled.

Taiwan has a lot of GRI reporting, but focus on ESG risks is limited

ESG reporting

Taiwan firms performed well on general ESG disclosure, due in no small part to the mandatory GRI reporting requirements for certain sectors. However, disclosure was spotty in terms of assessing material ESG risks, communicating concrete strategies to address those risks, and linking ESG performance to executive KPIs and remuneration. While other markets do not have such extensive reporting regimes, many have ESG risk disclosure requirements that need to take into account company strategy.

5. Investors

Taiwan ranked equal 5th with a score of 33%

Like most markets, other than Australia and Japan, Taiwan's investor ecosystem is still in an early stage of development from a corporate governance point of view, hence the low score but reasonable ranking. Scrappy and active retail investors boosted the score, while reticent domestic institutional investors lurking in the background weighed it down.

Domestic institutional investors vote, but not much against

Institutional investors

In terms of voting, domestic institutional investors are voting their shares, but there is an almost complete absence of voting against, according to our analysis of the first seven funds to sign up to the Stewardship Code. Ditto for disclosure of voting down to the firm level. With stronger scores on those two measures, foreign institutional investors do vote, with more than 80% of FINI-held shares exercising their voting rights. Those we spoke to said they definitely do vote

against -also indicated by the AGM voting results companies publish. Some foreign investors told ACGA there were still problems with international proxy voting platforms linking to the TDCC StockVote platform, particularly relating to onshore fund voting, cumulative voting, and long lead times.

Stewardship Code attracted 100 signatories

While domestic institutional investors may not seem particularly engaged, the Stewardship Code is going great guns and now has 100 signatories. It provides for collective engagement, although there is not much evidence of anyone exercising that yet. Compliance statements are limited and tend to follow a template, but they exist and serve as a foundation for further work. Many statements for domestic institutional investors say they have a quiet word with firms rather than vote against, but there is little evidence this actually happens and the process is not transparent.

Retail

No major central retail investor association exists

There is no central retail investor association in Taiwan, although ad hoc groups of investors are quick to form and speak out against errant directors or companies. Because the Securities and Futures Investors Protection Center acts to organise legal action and protect investor rights, this may have removed the incentive for investors to create their own permanent association.

Retail investors at Powerchip rally to win board seat

On the shareholder activism front, one interesting case in 2018 involved Powerchip, a memory chip company. Retail investors of the company organised themselves into an association, and in just four months amassed a 20% stake and got the group's founder elected to the board. The group's methodology and success offer a template for others to follow.

Sebastian Hou, CLST
sebastian.hou@cl-sec.com
+886 2 2326 8165

Retail shareholders take on Powerchip

Previously a leading DRAM chip supplier in Taiwan, Powerchip ran into trouble in 2012 after accumulating more than NT$100bn in debt due to a severe industry supply glut. It then delisted from the Taiwan Stock Exchange as its book value plunged into negative territory. It has since transformed itself into a foundry for driver and power-management ICs and niche memory chips for other companies on a contract basis. It plans to invest NT$300bn to build a wafer foundry in northern Taiwan, and is eyeing the local capital market to raise funds and relist in 2020.

Powerchip will have to convince investors its business outlook is more sustainable this time round. Last time it got burned and saw its investments go to zero when it delisted. Many believe the chairman Frank Huang (indicted by Taiwan prosecutors on charges of insider trading and breach of trust in 2008) painted an overly positive picture of the company at the time to lure investors to buy shares despite its troubles, so understandably people will have doubts upon hearing of the comeback plan.

'Surprise attack' was an unknown variable into the company's operations and Taiwan's capital markets

A group of retail investors who suffered from the collapse took matters into their own hands, forming a so-called "self-saving group" to fight for compensation from the company and supervise it from a shareholder point of view. In May, the group secured itself a seat on the board by amassing some 16-20% of the company's stock. The founder Frank Huang was elected with the highest number of votes, followed by the group's convener. Local media are calling this a 'surprise attack' and a 'battle for the board' and say it casts an unknown variable into the company's operations and Taiwan's capital markets, in what is an interesting development in smaller shareholder activism on the island.

Powerchip's shareholders

Shareholder	Holding (%)	Position
Huang, Chung Ren	4.54	CEO/Director
Lin Wei Ch'eng	0.88	
Ch'en Chia Yih	0.84	
Huang Ch'ung Heng	0.29	Younger brother of Huang Chung Ren
T'ung Kui Ts'ung	0.19	Senior VP/Representative of Novax Tech
Ch'en Jui Lung	0.05	Chairman
Wang Ch'i Kuo	0.04	President/Director
Hsieh Tsai Chu	0.02	Vice CEO
Wu Ming Ch'ang	0.02	Associate Director
Wu Yuan Hsiung	0.02	VP
Ch'en Chang Chien	0.02	VP
Liu Chih Neng	0.02	VP
Chang Shou Jen	0.01	Associate Director
Ch'en Tsun Liang	0.01	Associate Director
Ch'en Chin Lung	0.01	
Hsieh Ming Lin	0.01	VP
P'ang Chung Yih	0.01	Associate Director

Source: CLSA

6. Auditors and audit regulators

Taiwan ranks 7th with a score of 70%

Taiwan has a robust audit industry with some depth and an independent audit regulator. A creative approach to regulating audit fee disclosure helped to boost its score in this category, but could not make up for the unconscionably low fees overall or the limited disclosure from the audit regulator on its annual inspection programme and general audit quality in Taiwan - two areas where other markets, such as Malaysia, Australia and Singapore, do particularly well. Even Hong Kong, which still lacks an independent audit regulator, produces more informative regulatory disclosure than Taiwan.

Market shows "twin peaks" phenomenon of good audit preparation

In terms of account preparation prior to an audit, auditors we spoke to noted an improvement in recent years among both their large- and mid-cap listed clients. One auditor attributed this to the long "cooking time" these firms have invested in learning, saying that many "baby" firms have grown up under the guidance of the Big 4, and the value of that investment was now becoming apparent.

Low fees

Notoriously low fees plague auditors

As in other markets, the audit and accounting sector is plagued by fee competition. What is different in Taiwan is lower absolute incomes compared to other markets arguably make the problem even more serious. One senior auditor told ACGA his standard billing rate could be as low as US$13-16 an hour, a symptom of Taiwan's low salary quagmire and well below hourly charge rates we heard about in Korea. Some firms are "firing" customers who demand ever lower fees, a rational move if there is to be any hope of maintaining audit quality.

Taiwan adopts unique audit fee disclosure rules

Taiwan has taken an interesting approach to addressing this problem by requiring disclosure if audit fees have been reduced. First, if a company changes its accounting firm and audit fees are lower by any amount than the previous year, the before and after amounts and the reasons for the lower fees must be disclosed. Second, if a company keeps its accounting firm and fees are reduced by 15% or more, the amount and the reasons must be disclosed. Taiwan gets points for this creative approach and we advise other markets to adopt it. However, a 15% reduction is quite high and well above commonly accepted levels of materiality of 5-10%. We recommend reducing the percentage.

ARDF bridges regulators, CPA association and industry

Research and regulation

The Accounting Research and Development Foundation is an entity unique to Taiwan. Established in the 1980s, the foundation serves as a bridge between regulators and the accounting profession. It handles accounting and auditing standards, building a healthy accounting system for commerce and industry, conducting research on accounting and auditing issues, and developing accounting professionals through an extensive array of education programs. It is also involved in policy matters and liaises with the local CPA association, although it is not involved in disciplinary actions.

CPA discipline is disclosed, but hard to find and not extensive

The FSC handles disciplinary action against auditors with the help of the CPA association. Disclosure is timely, appearing in the Executive Yuan Gazette within a few days. However, this disclosure is hard to find, not detailed, not consolidated and not in English. There also does not appear to be a report linking cases of specific financial crimes to auditors or audit firms. A quick fix item would be to prepare a report on major financial crimes each year (perhaps included in the audit inspection report) and answer the question “where was the auditor?”

Audit inspection report could be beefed up

In terms of disclosure on audit regulation, Taiwan is fairly minimalist: while the FSC prepares an annual audit inspection report, it is brief (13 pages for the most recent one) and does not seem to come out at regular times each year. It has also remained largely unchanged over the last five years. It covers audit capacity and CPA firm staffing and revenue. It also reviews inspection methodology and then spends a few pages on findings, but does not give the reader a real sense of an answer to the question “what is the quality of audits in Taiwan?” It is not necessary to create a big, glossy report, but a more satisfying answer to this question with data to back it up would be welcome. A peek at Malaysia’s report could offer regulators some ideas.

7. Civil society and media

Taiwan ranked equal 6th with a score of 51%

Taiwan’s score of 51% and equal 6th ranking for civil society and media indicates that, along with CG rules and investors, this is one of the weaker parts of its CG ecosystem. While it gained points in this section for the training programmes offered by various institutions and its free press, it lost points because of limited development of non-governmental civil society organisations promoting CG. But things are starting to change.

Taiwan’s free press shines; CG reporting skill advances

In terms of the media, Taiwan’s press is ranked the freest in all of Asia by Reporters Without Borders and reporters are able to actively report on CG issues. Indeed, they are quite gleeful in their coverage of corporate abuses and shareholder responses. Skill in CG reporting has developed and local coverage on recent CG stories, for example changes to the Company Act and the Pau Jar case in mid-2018, conveyed the key issues well, clearly explaining different perspectives.

Civil groups still largely government affiliated

Civil groups

Where Taiwan flounders in this section is because of its limited development of civil society groups. There are groups that do good work, including the Taiwan Corporate Governance Association (TCGA) and the CPA Association, but they are heavily government affiliated or funded. There is limited evidence of truly independent organisations emerging.

TIoD gathers around topics of interest to family businesses

One notable exception is the Taiwan Institute of Directors (TIoD). This organisation is unlike institutes of directors in other markets in that it focuses almost exclusively on family businesses - a huge segment in Taiwan. TIoD has

Brand new CG professionals association is off and running

Lots of training available, but not organized into a coherent development programme

Taiwan has made progress on enforcement, e-voting and stewardship, less so on company disclosure

sponsored thought provoking and well attended forums on CG issues, and has the necessary gravitas to get key players in the room. This kind of organisation is crucial to offering the space for spirited conversation without the heaviness of government sponsorship. We heartily encourage this group to continue its efforts and focus on family business. We also suggest there be an independent organisation (perhaps TIoD or a new group) that focuses on issues and support for all directors for all companies, not just family businesses.

New association

Another exciting development is a new and independently funded CG professionals' association, provisionally called the Governance Professionals Institute of Taiwan. This brand new group had attracted 112 members by June 2018, including 36 from companies, with the rest accountants. It is partnering with a local university to develop a master's degree in CG. While there were government plans to require CG professionals (ie, company secretaries) in all listed companies, this amendment was shot down by the legislature in the summer of 2018.

One area where Taiwan could improve is the coherence of its training programmes. There are a huge number of courses and a wide variety of topics offered by the TWSE, TCGA, ARDF and other organisations, with many firms offering their own induction training. Directors are required to attend a certain number of hours of courses each year. However, there does not seem to be any set progression in these courses from elementary to advanced. It would be helpful if there was a basic training certificate programme or "boot camp" for new directors to let them know their rights, responsibilities and to develop some fundamental skills. A director development roadmap could be offered to guide them on how to improve and how to protect themselves in this position. Such a programme could serve to expand Taiwan's limited pool of independent director candidates.

Recap and recommendations

Recap of CG Watch 2016

To what extent has Taiwan responded to our recommendations from 2016?

Figure 2

Taiwan: recap of 2016

	Recommendations	Outcomes
1.	Ensure CG/ESG reporting is not formulaic	Improving, but boilerplate in CG reports remains. ESG reports do not adequately cover ESG risk and strategy
2.	Maintain interest in Stewardship Code	Burgeoning interest: 100 signatories, mostly domestic
3.	Maintain enforcement momentum	Strong enforcement effort apparent and strengthened confiscation rules
4.	Enhance reporting on board committees and remuneration	Detailed remuneration disclosure still scarce; board committee reports still mediocre or non-existent
5.	Promote more English-language reporting	Gradually improving. A new requirement coming from TWSE. Meanwhile, 267 issuers (29%) provide an English AGM Handbook. But some large companies still do not have English annual reports
6.	Expand voting by poll	Expanded e-voting means more voting by poll, but still no explicit rule
7.	Allow cumulative e-voting	Issues still exist when voting from international platforms

Source: ACGA

What to avoid

Downgrade watchlist

Factors that could force the market's score to fall in 2020:

- ❑ Current FSC chairman leaves job early, like his predecessors
- ❑ No progress in developing a less piecemeal, more systemic approach to reform
- ❑ Regulatory websites remain difficult to navigate and regulations hard to read efficiently; enforcement data remains unconsolidated
- ❑ No change in current substantial ownership threshold of 10%
- ❑ No inclusion in ESG reporting rules of a materiality and risk assessment
- ❑ No improvement in FSC annual audit inspection report
- ❑ No further tangible progress in investor stewardship

What to fix

Quick fix list

Issues to address as soon as possible:

- ❑ Enhance the independence of the FSC with practitioners
- ❑ Produce more coherent enforcement statistics/reports
- ❑ Make online legislation easier to scan and search
- ❑ Adopt an explicit rule on voting by poll for all resolutions
- ❑ Extend sustainability reporting to more of the market
- ❑ Audit fee disclosure: reduce trigger for disclosure to 5-10% fall in audit fees instead of current 15%
- ❑ Prepare report linking major financial crimes to auditors and beef up audit inspection report

Benjamin McCarron
Specialist Consultant, ACGA
benjamin@acga-asia.org
+65 8299 6852

Thailand - Laws change, government remains the same

- SEC obtains civil sanctioning powers and better misconduct rules, leading to broader and deeper enforcement - yet the strike rate on criminal cases remains low.
- An active period for reform in other areas, including rules on insider trading, anti-corruption and qualifications of CFOs - but new regulations hard to decipher.
- A delay in the implementation of IFRS 9 on financial instruments raises questions about banking supervision and accounting regulation.
- Thai companies continue to receive recognition for good sustainability disclosure, but do they fully address the key strategic issues?
- The decline in press freedom and draconian defamation laws hinder corporate accountability efforts.
- An Investment Governance Code ushers in a new era of investor stewardship, while a revamped CG Code challenges companies to "apply" rather than "comply".

Thailand ranks 6th overall with a score of 55%

Figure 1

Thailand CG macro category scores versus regional average (2018)

Source: ACGA

Introduction

Elections delayed while laws are changed

Thailand's score of 55%, ranking 6th overall, is a similar result to CG Watch 2016, despite our new survey, additional questions and stricter scoring methodology. The military junta that launched a coup in 2014 remains in power, having pushed back the target date for elections multiple times - according to Prime Minister Prayut Chan-o-cha, elections are now set for February 2019. The official reason for the postponements is that time is required to pass organic laws.

SEC receives civil sanction powers, misconduct rules upgraded

On the legislative front, there have been many changes that affect corporate governance, from new powers for the Securities and Exchange Commission (SEC) to a new anti-corruption act and changes to auditing laws. The SEC has had a busy two years. New civil sanctioning powers and upgraded rules on market misconduct allow it to pursue cases with a wider range of enforcement tools, whereas previously it was struggling to secure criminal convictions. Although it remains to be seen whether insider trading and market manipulation will really be deterred without criminal convictions and custodial sentences, the fact that the SEC has increased the size of its enforcement teams is an indication of its intent to be more effective.

CG Code revamped and stewardship code published

The SEC published two codes in 2017. The Corporate Governance Code 2017 is a major revamp from the previous version. It restructures its principles to address the primary question of how boards should conduct their affairs, changing from the previous structure, which was based on the OECD's five principles. The Investment Governance Code is a new document that sets out stewardship responsibilities for institutional investors in the Thai market. There has been a high level of sign up from the industry.

Thai companies continue with strong disclosure

Thai companies continue to perform well both in our new company survey and in international rankings, particularly for sustainability. This includes a high representation in the DJSI indices; the highest average score for the Asean CG Scorecard; and in the Corporate Knights' study, Measuring Sustainability Disclosure: Ranking the World's Stock Exchanges, Thailand came 10th overall, the highest performing exchange in Asia.

Delay to accounting standard implementation raises questions

One cause for concern was a delay in the implementation of IFRS 9, the revised accounting standard for financial instruments that includes tighter standards for impairment of assets. Thai accounting standards follow automatically one year after international implementation timelines. However, the Oversight Committee on Accounting Professions (OCAP) announced a delay in this case of one year. Doubts were expressed, even by the committee chair, over the official reason that SMEs were concerned bank profitability would suffer, resulting in higher priced loans in future. The delay is only for one year, but the weak reason, the failure to follow the usual procedures, and the fact that no other Asian market has taken this action all raise questions. These include whether the banks need more time to smooth numbers and, if so, why? Or whether there are other weaknesses in oversight of the banking sector.

Defamation laws have had a chilling effect

Another feature has been the ongoing challenge to press freedom, with Thailand's position in the World Press Freedom Index declining from 130 to 140 out of 180 countries between 2014 and 2018. One reason for the low score that is particularly relevant for holding companies to account is defamation rules that are criminal as well as civil in nature. Journalists and human rights advocates can face considerable uncertainty and long and costly court proceedings, even when they have acted with the highest professional standards.

Suchart Techaposai
Head of Research – Thailand
suchart.techaposai@clsa.com
+66 2 257 4632

Thailand: Aiming high, progress achieved

Laws and practices have improved; still room for small cap firms to catch up

The military government has made significant achievements on CG/ESG issues by passing and revising laws, as well as improving enforcement to gain recognition from the USA and the EU on human trafficking and sustainable fishing, respectively. Together with the private sector, it also implemented measures and campaigned publicly against corruption. On the capital market side, Thailand's Securities and Exchange Commission (SEC) has been active in enforcement and promoting best practice. The Federation of Accounting Professions has also provided auditors an active role in expressing their findings and opinions to investors in their audit reports. Large companies have also been more active in ensuring high CG/ESG practices. Unfortunately, small cap companies were found substandard, with executives abusing their powers for their own benefit. This was partly caused by the low interest rate environment of the past couple years pushing savers to risky credit investments, providing easy money for small cap companies.

Progress achieved

Improving international recognition in laws and enforcement

First and foremost, Thailand has been upgraded on the latest 2017 Trafficking In Persons report issued by the USA government, from Tier-3 in 2014 to Tier-2 "Watch List" in 2016 and Tier-2 this year. This followed two years of serious regulation revamps and enforcement against human trafficking crimes.

Past mistakes by listed companies were fixed

At the company level, CPALL has taken steps to improve its CG standards by hiring an external consulting firm, EY, to review and revise its CG and ethical practices to be in line with international standards, and also to educate directors, senior executives and staff on the new standards. PTTGC has been timely in SET filing on all corporate events.

But slightly lower corporate ESG scores from CLSA analysts

Lower 2018 CG scores

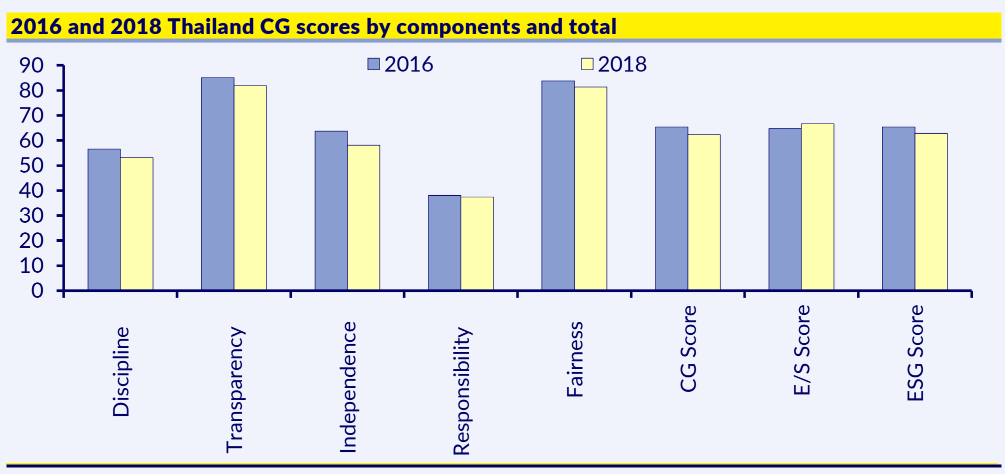
In 2018, the aggregate corporate ESG scores for Thailand in CLSA's survey fell to 62.8 vs 65.4 in 2016. This was driven by a decline in the consumer and tourism related sectors, where listed companies have grown via acquisitions amid weak domestic growth in Thailand. This drag was partly offset by companies in the oil and gas and materials sectors, which were conservative in their business conducts in the low oil price environment.

Petrochemical and refineries scored well in 2018 CG

Siam Cement has kept its top ranking in Thailand's big cap space. Joining it this year are Thai Oil, AP, HomePro, and EGCO, thanks to their conservative management style amid weak domestic growth.

Thailand CG scores 2016 vs 2018

2016 and 2018 Thailand CG scores by components and total



Source: CLSA 2018 CG Watch Survey

1. Government and public governance

Thailand ranks 7th with a score of 45%

While the Thai government has not produced an overarching CG roadmap or strategy that sets the direction for the medium term, it has introduced multiple legislative reforms that are directly relevant to corporate governance and in support of regulators. These include new civil sanctioning powers for the SEC, amended anti-corruption legislation, the introduction of class-action suits, and changes to SOE audits. The reforms have addressed weaknesses in obtaining justice through the legal system. Where Thailand loses points in this section is primarily on its anti-corruption work, the effectiveness and efficiency of law enforcement on white-collar crime, some issues relating to bank governance, and the extent to which minority shareholders are utilising the legal system to resolve disputes.

New laws

SEC obtains civil sanction powers

In the past there was a very low conviction rate for the criminal complaints the SEC referred to the public prosecutor. It therefore asked for, and received, civil sanctioning powers during the last round of securities law reforms. It can now pursue civil penalties against offenders ahead of criminal actions. The regulator has to present such cases to the Civil Sanctions Committee, which is also responsible for determining the appropriate penalties for each case. The SEC can pursue sanctions through the civil procedure when parties refuse to pay the penalty. The reforms also strengthened the definitions of market misconduct offences.

Anti-corruption act extends corporate liability to foreign companies

A new 2018 anti-corruption law, formally named the Act Supplementing the Constitution Relating to the Prevention and Suppression of Corruption, similarly addresses challenges to bringing offenders to justice. Amendments in 2015 to the previous anti-corruption law introduced corporate liability. The new law extends to foreign companies operating in Thailand. There is a liability where a bribe is given by an associated person such as an employee, agent, or joint venture partner. There is a defence for companies that can prove they had adequate procedures in place to prevent corruption. The National Anti-Corruption Commission (NACC) issued guidelines in 2017 on appropriate internal control measures that apply under the new law. There are provisions to streamline the way in which NACC seeks international assistance to collect evidence.

Rolls-Royce investigations have not made progress

The new law will presumably help in cases like that of Rolls-Royce, which admitted it had paid bribes in Thailand as part of a deferred prosecution agreement with UK regulators in January 2017. Rolls-Royce said that it had agreed to pay US$18.8m to regional intermediaries in Thailand, some of which was for “agents of the state in Thailand and employees of Thai Airways”. This was in order to obtain engine contracts and allegedly took place in the 1990s. In another case, Rolls-Royce was alleged to have paid US$11m to top executives at PTT and PTTEP between 2000 and 2013. The NACC investigated these allegations, but in January 2018 said it was facing an uphill task and had to wait for evidence from foreign authorities. In June 2018, Thai Airways announced a deal to undertake repair and maintenance of Rolls-Royce engines that the airline expects to generate Baht5 billion (US$150m) revenue. Rolls-Royce will invest Baht1 billion in facilities at Don Mueang airport.

Harder to run from new anti-corruption law

The new anti-corruption law also specifies that for criminal proceedings, the time period for the statute of limitations will be suspended for defendants that have escaped. This is in response to multiple cases for a range of crimes in recent years

where the accused elected to flee the country, as opposed to standing trial. Two of the highest profile examples include former Prime Minister Yingluck Shinawatra's dereliction of duty charges and Red Bull heir Vorayuth Yoovidhya's drink driving charges.

OAG to transition away from listed SOE audits

The government has also implemented changes to the State Audit Act and the Fiscal Discipline Act. These support the transition of listed SOE audits away from the Office of the Auditor General (OAG) and toward the competitive audit market that has better capacity to handle complex audits.

First class action case finds against Ford

The government introduced class actions to the Civil Procedure Code, effective from December 2015. There have been multiple suits initiated under the new procedures relating to environmental and consumer cases. The first successful class action was concluded in September 2018, when the courts found in favour of 291 plaintiffs against Ford for selling defective products. Ford was ordered to pay Baht23m in compensation to the affected plaintiffs. Prior to this, the courts issued an injunction to stop work at Wax Garbage Recycle Centre Co (Waxga) after a group of 20 villagers received certification to sue the company as a class for dumping chemical waste from its factories. There has not yet been an investor led class action case.

Public governance challenges

Press freedom deteriorates

Thailand has suffered a deterioration in press freedom in recent years, with its ranking in the World Press Freedom Index declining from 130 to 140 out of 180 countries between 2014 and 2018. This frustrates civil society efforts to raise standards, including in corporate governance. There are strict laws on defamation and libel laws; very strict lese majeste laws; and actions taken against critics of the regime, particularly during the referendum on the constitution in August 2016. The restrictions on criticism of the government may relax when the country returns to democratic rule following the next election - now projected for February 2019, a date that has already been pushed back multiple times. However, it may take an act of parliament to limit the defamation laws, such as by removing criminal proceedings or creating strong defences for true statements.

Where Thailand also loses points

Thailand also loses points in this section for gaps in supervision over the governance of banks, limited tangible progress in reducing public sector corruption (although one hopes the new law leads to improvements in the future), and the independence of the judiciary.

Bank of Thailand aims for stability through financial institution supervision

The Bank of Thailand (BoT) has a role in regulating the finance sector. Specifically, it is responsible for supervising, examining and analysing "the financial status and performance, and risk management system of the financial institutions in order to promote financial institutions' stability".

TFRS9 implementation delay raises bank loan quality concerns

We noted comments from various sources questioning whether BoT is taking a strong stance supervising banks, particularly on non-performing loans. In this regard, it was concerning to see the delay in implementation of TFRS9, which includes a more conservative approach to impairment of assets than the prior standard. BoT has taken positive steps in other areas. In October 2016, it set up the Financial Consumer Protection and Market Conduct Department to address consumer protection issues, and prevent them arising in the first place through stronger approaches to managing market conduct.

BoT should act to prevent climate change effects on financial stability

BoT has not yet taken strong steps on green financing and assessing prudential risks presented by climate change. The Financial Stability Board (FSB) noted climate change related factors such as new regulations, technological changes, or physical effects could undermine business models or result in impairments to assets. Should these issues become widespread there is a risk to financial stability. The FSB created the Taskforce on Climate-related Financial Disclosure (TCFD) to produce recommendations on how companies should disclose to demonstrate to investors how they are embedding such considerations into their strategies. There are supplemental disclosure guidelines for financial institutions.

Next steps

NACC needs to successfully use its new powers

The 2018 anti-corruption act has only recently come into force. It remains to be seen whether it provides the NACC with the tools to tackle corruption.

Reform defamation laws

The government should act to address the chilling effect of defamation laws on free speech by removing the criminal offence from defamation laws.

Maintain positive start for class actions

The first successful class action case bodes well for future cases already taken to court. These will determine whether the procedure provides an effective remedy in Thailand. No investor led cases have been filed.

Stick to TFRS9 timetable

Ensure there is no further delay in implementing TFRS9.

Reinvigorate SOE reform

A bill to reform the governance of SOEs was deliberated by the national legislative assembly in 2017. This is intended to separate SOEs from ministries, reducing the potential for political interference or corruption, and address inefficient operations. However, there has been no further progress.

2. Regulators

Thailand ranks 10th with an overall score of 50%

The SEC was established on 16 May 1992 under the Securities and Exchange Act 2535 (1992) (SEA). The purpose was to address unfair market practices and insufficient investor protection through establishing a single capital market regulator to coordinate functions previously handled by multiple different agencies.

SET has maintained its non-profit roots

Trading started at The Stock Exchange of Thailand (SET) on 30 April 1975, although it was then called the Securities Exchange of Thailand, changing to its current name on 1 January 1991. SET is unusual in that it remains one of the few major Asian stock exchanges to be a non-profit company. Also, it has a far lower role in enforcement than other exchanges in the region, with most of the responsibilities falling on the SEC.

2.1 Funding, capacity-building and regulatory reform

Thailand ranks 7th in this sub-category with a score of 52%

Thailand scored 52% and ranked seventh in this sub-category. It could have been higher were it not for persistent weaknesses in the dissemination and organisation of regulatory information, and the exchange's limited database of freely available company reports and announcements.

The SEC has a strong financial position, with total assets of Baht7.9 billion at the end of 2017 and fee income and a contribution from SET of Baht1.3 billion, which more than covered expenses for the year. Staff has increased over the last few years from 539 in 2015 to 601 at the end of 2017. This included additional employees in enforcement, which has been restructured into two divisions, one to focus on cases of corporate fraud and the other on market misconduct. In

contrast, there were relatively static staff levels at SET, with employees rising from 714 in 2015 to 752 in 2016 and then falling slightly to 738 in 2017.

This has been a period of significant reform

The government and SEC introduced major reforms between 2016 and 2018, including:

- The introduction of civil sanctioning powers for the SEC
- Changes to the State Audit Act and Fiscal Discipline Act, which together mean that listed SOEs will in time cease relying on the Office of the Auditor General
- Introduction of the anti-corruption law which came into effect on 22 July 2018 and includes an emphasis on companies
- A major restructuring and upgrade of the Thai Corporate Governance Code
- The introduction of the Investment Governance Code: I Code for Institutional Investors, Thailand's version of a stewardship code
- New qualification and experience requirements for CFOs and chief accountants of companies undertaking an IPO.

But it is hard to find all the regulations

Disappointingly, it can be a challenge in Thailand to identify up-to-date regulations. The SEC website includes a helpful table showing how letters are used to designate the issuing body for various regulations. However, it is often not clear which body should issue certain rules, which limits the utility of the relevant rule search functions. Furthermore, at least for translated versions, the documents do not always have contents pages or provide a date stamp at the front identifying when the document came into force or what amendments have been incorporated. This can be true for laws as well as notifications. Where a rule amendment is issued in a notification from a different body than the original notification it replaced, it becomes even more challenging to locate the current rule. We do not face such challenges in finding regulations in Malaysia, Singapore or Hong Kong, nor even in markets ranking lower in our survey, such as Japan and Korea. We would welcome a more streamlined approach to the promulgation of regulations, with greater functionality in the database for retrieving them, documents that start with clear html contents pages, and complete information regarding the relevant dates, ideally highlighting throughout the document when specific paragraphs have been updated.

News, public hearings, and civil sanction cases are not in English

There are further information bottlenecks. The SEC typically has short windows for public hearings and does not provide the documents in English. This makes it hard to obtain input from international parties. There are also parts of the SEC website that are not translated, and there are periods when the news release channel is not translated for several months. Nor are the civil penalty enforcement cases translated, although the criminal and administrative cases are.

SET has stayed a non-profit

Most stock exchanges in the region are for-profit companies, and in many cases the stock exchanges list their own shares. SET is a government founded non-profit, although there have been calls for it to be changed to for-profit status every few years over the last decade. This theoretically creates a different incentive structure around the corporate governance of listed companies from other markets, with less emphasis on short term profits and less pressure to relax corporate governance standards to promote listings and growth in the market. In practice, developments have worked differently. SET has had a strong historic role in promoting its services and the Thai capital market and is subject to commercial drivers. It has used its approach to ESG as a point of differentiation,

especially in seeking foreign investors. It has thus promoted sustainability to its companies over a prolonged period, resulting in Thai companies receiving frequent international recognition for their ESG disclosure standards.

Market promotion to move to Capital Market Development Fund in time

SET's activities through the years have resulted in a significant surplus. In 2017 and 2018, the government looked to this surplus to support the introduction of a Capital Market Development Fund (CMDF). There has been wrangling over the level of financial support from SET to the CMDF. The fund will require changes to the SEA that are currently under discussion.

SET should make historic announcements and reports available

One area where the commercial focus has adverse consequences is in the hosting of historical information on companies. SET only provides two years' announcements and financial reports, selling access to information for previous years. We believe it is inappropriate to sell access to these reports and announcements, which should be for the public good. The exchange did not originate the information, which belongs to companies, and the repository is important for investors of any size, as well as for civil society organisations seeking to understand corporate behaviour. Hong Kong, Malaysia and some other markets provide information stretching back more than 15 years. Thailand therefore continues to lose points in this area.

2.2 Enforcement

Thailand ranks 10th in this sub-category with a weighted score of 48%

Despite finally giving the SEC a suite of much-needed civil powers, Thailand scores poorly for regulatory enforcement for a range of reasons: modest enforcement outcomes, especially in criminal cases; weak support for the SEC from other law enforcement agencies; and regulatory disclosure that could be a lot better yet has not changed significantly in recent years.

Conviction rates low for criminal cases

The SEC faced significant challenges in obtaining satisfactory conclusions to criminal complaints in the past. Between 2012 and 2016, it filed a complaint in 27 cases. However, the public prosecutor took only five of these cases to the criminal court, which in turn only returned convictions in two. The result was the SEC had successful outcomes for only 7% of the cases for which it filed criminal complaints, which is clearly far too low to provide a deterrent effect. The lack of powers and failings of the system became clear following the CP ALL case, which came to light in December 2015. There was clear insider trading by directors, who paid a fine and stayed on the company's board.

SEC finally obtained civil sanctioning powers in December 2016

Following the CP ALL case and subsequent outcry from the public and investment community, the SEC's long-running quest for civil sanctioning powers was successful and they came into effect on 12 December 2016. These allow it to submit sanctions for approval from the Civil Sanctions Committee, which comprises the Attorney General as Chairman, the Permanent Secretary of the Ministry of Finance, the Director-General of the Department of Special Investigation (under the Police), the Governor of the Bank of Thailand, and the SEC Secretary General as members. Where the committee issues sanctions that are not accepted by the alleged offender, the SEC may bring the case to court under the Civil Procedure Code.

These provide for a wider range of penalties and lower burden of proof

Civil sanctions may be applied in cases of unfair securities trading, making false statements/concealing information, failing to perform duties as a director, and using a trading account in another's name to conceal an identity. The civil

sanctions are specified in SEA section 317/4, with penalties in 317/5, and include:

1. A civil penalty, depending on the offence
2. Disgorgement of profit from an offence
3. A trading ban for up to five years
4. A ban from senior positions in a securities company of up to 10 years
5. Reimbursement of investigation expenses incurred by the SEC Office.

The SEC has wasted no time in using its new powers

There were 36 cases considered under the civil sanction regime between 2017 and Q2 2018. Of these, 19 resulted in a monetary penalty and seven were filed at court. There were 10 cases dismissed, 28% of the total. However, this was lower than the 41% dismissal rate observed for the previous four years under the criminal sanction regime.

Market misconduct rules also clarified

The law on unfair securities trading practices, SEA sections 238 to 244, also underwent significant changes, clarifying and broadening the meaning of market manipulation and insider trading, and introducing the offence of front running. The law now makes it an offence for anyone to use or disseminate inside information where this could lead to trading, which brings "tippees" (recipients of inside information) into the regime. There are also categories of primary insiders, such as directors, that are presumed to have inside information, and a further category that are presumed to have inside information if they engage in unusual trading, such as family members of directors. Derivatives trading is now covered by the regulations.

But the need for a custodial deterrent will remain

We view these changes as strongly positive, as they allow the SEC to progress with its enforcement work. However, we also believe that custodial sentences remain an important deterrent for market misconduct offences. While the SEC now has better laws that it can enforce through the civil sanctions system, we are concerned it may still not be possible to change behaviour in the market without addressing the deeper failings in the legal system.

SET's role in enforcement is limited

The division of enforcement responsibilities between SET and SEC is unusual. SET has a much reduced role compared to stock exchanges in other markets, which have a broader duty to ensure companies behave in accordance with listing rules. SET's primary responsibility is to ensure fair trading, which is interpreted as ensuring adequate information through financial reporting, and warning investors where there are suspicious transactions or a poor financial position. It does this through providing various signs that urge investors to exercise caution, halting or suspending trading, or limiting trading through prohibiting trading on margin.

SET should provide analysis of reasons for applying its trading signs

SET could provide more helpful disclosure, such as an analysis of the patterns of use of the different trading signs, perhaps setting out in a table the reasons for introducing the signs, to understand how company behaviours are changing through time. While it provides simple enforcement statistics for the past three years, there is no narrative explanation of what the numbers mean.

Next steps

Provide free access to historic company records

SET should provide free access to current and historical company records, including announcements, the initial prospectus, and all financial and other reports for at least the past 10 years.

Streamline searching for regulations

SEC should continue translation of its news releases and translate its civil sanction cases. It should also review the search functions for disseminating regulations.

Strengthen understanding of strategic climate change risks

BoT and SET should consider adoption of a stronger approach to climate related financial disclosure to reduce systemic risks from climate change (see Listed Companies section).

Suchart Techaposai
Head of Research – Thailand
suchart.techaposai@clsa.com
+66 2 257 4632

Default-led findings

Low interest rates pushed savers to risky debt investment and abuse of proceeds in small cap names

Global liquidity tightening led by the US Federal Reserve has triggered rising bond yields and reversed lax credit appetite among domestic investors. Small cap companies raising non-rated debt to fund their operations went into sequential default series from 4Q16 through 2017, revealing corporate governance issues hidden underneath. Three defaulted companies revealed fraudulent behaviour and embezzlement: Energy Earth, IFEC, and KC Property. All cases have been criminally charged by the SEC and are under investigation.

Energy Earth

Forged documents by senior executives for bank loan

The coal trading company sourced coal for manufacturers in Thailand. Over time it expanded its operations funded by debt securities issued to domestic investors. The failure to roll its short-term papers in 2017 triggered a payment default, paving the way for debt restructuring. Through the process, Krung Thai Bank, its main bank, found it had forged bills of lading for coal shipments to borrow from the bank. Eleven executives were charged in a criminal case by the SEC on 12 Jun 2018, and are currently under investigation by the Department of Special Investigation (DSI).

IFEC

Former chairman abused his power to benefit himself

The company expanded quickly via asset acquisition funded with debt securities issued to domestic investors during 2014-16. The series of payment defaults in late 2016 revealed potential fraudulent acquisition cases leading to disputes among major shareholders, corporate board room and shareholder meeting wars, and shareholder voting fraud. On 26 Feb 2018, the SEC filed a criminal case against the former chairman Wichai Thavornwattanayong to the Economic Crime Suppression Division on his intention to not file with the SET on the debt default case, leading to trading suspension since 12 January, the illegal intervention on shareholder voting and fraud on asset acquisition and borrowing.

KC Property

Abuse of corporate money by senior executives

The residential property developer company went into a debt payment default in late 2016. Through the debt restructuring and investigation, seven senior executives were found to be involved in fraudulent behaviour misusing proceeds raised from debt securities issuance for personal benefit and criminally charged by the SEC on 5 Jan 2018. The case is under investigation by the DSI.

3. CG rules

Thailand ranks equal 4th with a score of 68%

Thailand's regulators made steady progress on tightening rules between 2016 and 2018. This resulted in a score for CG rules of 68%, to rank equal fourth with India. Changes include a major revision to the CG Code; the introduction of the Investment Governance Code (see Investors section); and upgraded rules on market misconduct, particularly insider trading (see the Regulators section). However, it is important to clarify that this section of our survey assesses the quality and depth of CG rules on the books, not changes made over the previous two years - scores for achievements in regulatory reform are given under Regulators.

With a new, detailed CG Code emphasising sustainable development

The SEC launched the new CG Code in March 2017, a significant upgrade from the previous version with major structural changes. Thailand aligned the previous version to the five OECD principles of corporate governance, whereas the new code is structured around the responsibilities and accountability of the board. It aims to push companies to think through their strategy, rather than adopting a compliance mindset. There have been comments that various company scoring systems, such as the Thai Institute of Directors' Corporate Governance Rating and the Asean CG Scorecard, have focussed on form rather than substance. The new CG Code and outreach efforts from the SEC have tried to address both the compliance mindset and emphasise substance. This is one reason the code has shifted from "comply or explain" to "apply or explain". The code is also intended to support an economy wide drive to sustainable development. The preamble states, "value created should not only be good for the company but also for its shareholders, stakeholders, the capital market and the society at large". As a result, it contains guidance on responsibilities to stakeholders in multiple areas, not only shareholders.

Financial reports are produced promptly

Rules on financial reporting are strong in Thailand, particularly for the timely provision of financial statements. Audited statements must be presented within 60 days, while quarterly results must be presented within 45 days. There are significant CG reporting requirements through the annual registration statement, Form 56-1, and on an "apply or explain" basis throughout the new CG Code. This specifies disclosure relating to each committee, including information where consultants are used, and details on board evaluation and training.

Form 56-1 has ESG disclosure rules, including anti-corruption

Form 56-1 includes sustainability reporting requirements. These set out minimum standards of disclosure, the need to address material issues, and the broad issues to report on. Reporting can be in the annual report, a sustainability report, or through other means. There should be policies, procedures and performance information. A notable positive is the requirement to provide information relating to legal or reputational allegations. Form 56-1 refers companies to the GRI standard and to SET's ESG disclosure guidelines, although these were not available in English through the website. It also emphasises managing corruption.

There are gaps in ESG reporting rules, despite strong practices

Although SET introduced sustainability reporting guidelines in 2010 - much earlier than most other Asian stock exchanges - Thailand's sustainability reporting rules do not provide the same logic as those of Malaysia and Singapore, which have a stronger emphasis on communication with stakeholders, identification of material issues, and disclosure of performance data. Nor do they push companies to disclose certain quantified KPIs as in Hong Kong. While the rules are strong and innovative in respect of disclosure of controversies and the emphasis on steps to address corruption, there is evidence of gaps in the strategic thinking on sustainability among some companies (see Listed Companies section).

Gaps in the rulebook

Rules on disclosure of substantial ownership have gaps

The rules on disclosure of "substantial ownership" require reporting within three business days to the market via the SET portal, and to the SEC office every time a holding moves through a multiple of 5% (ie 5%, 10%, 15%, and so on). Similarly, directors and closely connected parties have three business days to report any changes in holdings. These requirements are not as strict as in most Asian and foreign markets, which require disclosure of changes in holdings at each percentage point threshold, rather than five percentage points, and that disclosure should be within one business day (including for directors). Despite more flexible rules, this has been an area of frequent enforcement for the SEC.

Between July 2016 and September 2018 there were 17 cases in which owners breached disclosure rules and received criminal fines totalling Baht9.3m. There were also 12 cases in which directors breached the rules, resulting in fines totalling Baht2.7m.

Stronger insider trading rules, but no mandatory "blackout" period

Thai companies are not required to have a "blackout" period ahead of financial reporting (a closed period when directors and insiders cannot trade). Form 56-1 includes a requirement that companies report their policies and procedures for handling inside information and for monitoring their securities trading, "especially during the month before public disclosure of financial statements". There is a corresponding duty in Principle 6.3 of the new CG Code to protect the company's assets and information and monitor adherence to confidentiality requirements by insiders. Yet there is no explicit blackout rule, unlike in Hong Kong, Singapore and some other markets.

Increase cooling-off period for independent directors

A major issue is the need to ensure a longer cooling-off period for independent directors. Directors that are independent from management and controlling shareholders are a critical protection for minority investors. The current definition only provides a cooling-off period of two years where directors have previously acted as an officer or advisor to a listed company. This is simply not long enough, as prior relationships may stretch back years or decades.

AGM attendance for foreign shareholders can be a headache

One challenge for international investors - and something we know from personal experience - is the paperwork that can be involved if a foreign shareholder wishes to attend an AGM. In our case, we held shares in a leading Thai listed company. We first had to have our identity documents and those of two directors in the broker notarised, then this package of documents needed to be verified by the local Thai embassy before they were sent to the company. This took the time of multiple senior personnel and a high fee. However, these rules and obstacles are not universal, because we were able to attend another Thai AGM with straightforward documentation requirements.

Introduce rules on disclosure of share pledging

There have been examples in several Asian markets of sharp falls in share prices where controlling shareholders have pledged shares as collateral for loans and the lenders have taken possession and sold down these shares. Consequently, transparency of share pledges is an important protection to introduce.

Next steps

Stand firm on DCS

Do not introduce dual-class shares.

Lengthen director cooling-off periods

Increase board independence through longer cooling-off periods.

Reduce paperwork on foreigner AGM attendance

Ensure that firms do not place administrative barriers in the way of international shareholders seeking to attend AGMs.

Improve disclosure of substantial share ownership

Improve rules on director dealing and disclosable shareholdings by shortening the time to disclose to one business day, and reducing the incremental disclosure requirement for owners to each one percentage point increase or decrease above 5%.

Encourage ESG management that actually addresses material issues

Strengthen ESG disclosure further. While this is strong in Thailand and management often provides policy, indicators and targets, there is generally little discussion of whether these actions will be sufficient to actually solve the overall challenge being addressed. This is particularly important for climate change, which requires a major restructuring of multiple industries, including energy, transport, and agriculture.

4. Listed companies

Thailand ranks equal 2nd with a score of 63%

Thai companies have some of the strongest disclosure of all the markets we review for our survey. This has resulted in an overall score for this section of 63%, to rank an impressive equal second with Singapore. This assessment broadly aligns with the strong performance of Thai companies in other reviews, such as the Asean CG Scorecard, the Dow Jones Sustainability Indices, and a global study of stock exchanges from Corporate Knights on disclosure of quantified KPIs in sustainability reporting (in which the Thai stock exchange was the highest scoring Asian market). As with other markets, we reviewed 15 large companies and, for some questions, 10 medium-sized companies to support our views on company practices.

Websites were typically helpful

The large companies all had helpful websites and the group was among the best in the region on this measure. Beyond hosting annual reports, sustainability reports, and AGM materials, the companies also provided further information, with 11 out of 15 making webcasts of presentations available. All the large companies provided sustainability reports, either as standalone documents or embedded in the annual report.

Fast provision of audited statements, with detail

The large and medium-sized companies provided timely financial reporting. In Thailand, audited financial statements are required within 60 days of the year end, and the companies we reviewed provided them in this timeframe.

Financial reporting

But operating cost disclosure is less detailed

One area where Thai companies are less detailed is in providing breakdowns of operating costs. Often there is little detail in the P&L statement, no accompanying note with a detailed list of expenses by nature (in addition to function), and little discussion in the MD&A. For example, Bank of Ayudhya had operating costs of about Baht48 billion (about US$1.4 billion) in 2017. It provided a very limited breakdown of costs in the P&L statement, with no footnote. The breakdown included a row of “Others” with an amount of just under Baht13 billion (about US$400m) representing about 27% of operating costs, but with no further explanation. The proportion was slightly higher in the prior year. There is no formal discussion of the movement of costs in the annual report, MD&A for 2017, or in analyst presentations aside from the statement that the cost to income ratio moved from 47.1% in 2017 to 48% in 2017. The investor presentation flags that it remains below the 50% target. This information gap makes it harder for investors and analysis to understand or project the prospects for the company.

CG reporting

Form 56-1 often only available in Thai

As in many other markets, corporate governance reporting is formulaic and provides little detail on events that have been discussed during the year. One challenge is that companies provide information both in the annual report, which is translated into English, and Form 56-1, which is often only in Thai. There appears to be a duplication of effort in producing both documents, while there is a risk that international investors are not able to readily access key information.

Thai companies generally have good risk reporting . . .

Thai companies generally have good risk reporting, with discussion of specific risks and, for seven of the 15 large companies reviewed, specific actions taken to address them. Reporting also includes board evaluations, with scores provided for the factors assessed. However, no companies provided specific findings or recommendations and there was no discussion of follow ups on these. The large companies all provided some information on training, typically stating the topics covered for each director. However, many of the companies showed low participation, with three or fewer directors attending training for eight out of the 15 companies.

ESG reporting

. . . and strong ESG disclosure for large companies

Many companies provide detailed sustainability reporting based on the GRI standard, with clear presentation of the range of communications with stakeholders, clear prioritisation of issues, presentation of detailed policies, and relevant metrics. This has led Thailand to a strong performance on international sustainability rankings, such as having a good representation in DJSI and a high representation among leaders in the Asean CG Scorecard. However, challenges remain on strategic issues and not all companies have embraced sustainability reporting.

Airports of Thailand provides detailed greenhouse gas data . . .

For example, Airports of Thailand mentions its Green Airport Master Plan 2016-2017. The reporting includes very detailed quantitative performance data for many indicators for its airports and across the business. For greenhouse gas emissions there are detailed breakdowns by airport, including the passenger intensities for each airport. There are also targets to reduce total emissions at each airport. However, there is no discussion of the implication of emissions from the value chain, which includes the flights. This is material from a strategic perspective.

. . . without stating the risk climate change poses for long-term capacity growth

The company's sustainability report sets out its expansion plans, which project capacity growth to handle almost 219 million passengers annually by 2030/31, up from 97 million in 2016 - although the actual number of passengers in 2016 was 129 million. There is no comment on whether the emissions implied by this growth in passengers is consistent with national or global climate change targets. Using an emissions estimate of 0.25 tCO_2e on average per passenger flight (a little less than the emissions for a flight from Seoul to Bangkok) provides a carbon estimate for total flight emissions by 2030 of 54.7 $MtCO_2e$. To give a sense of the scale, Thailand has an objective under the Paris Agreement to reduce its emissions by 20% from a business as usual (BAU) projection for 2030 (or 25% following the deal and subject to international support). The BAU projection for 2030 is 555$MtCO_2e$, indicating a national target of 444$MtCO_2e$. International aviation emissions are outside the scope of national commitments. Nevertheless, the high and growing absolute level of emissions implied by airport capacity expansion poses long-term strategic questions for the growth of Airports of Thailand that are not addressed in its reporting. The international aviation industry has already announced its intention to cap net aviation emissions from 2020.

Coal company Banpu recognises strategic risk from climate change

In contrast, coal mining and power firm Banpu in its reporting acknowledges risks from emissions regulation and physical impacts due to climate change. It has started to address mitigation issues with greenhouse gas intensity reduction targets in both mining and power and, most importantly, an investment plan to achieve a 20% share of total energy production from renewable energy by 2025.

However, it is not clear from the reporting what changes there will be in the overall share of investments in different fuel sources. In other words, whether or not the company is significantly slowing the rate of coal asset investment at this time, and seeking to align its strategy and overall spending plans to those required to meet national targets or the Paris Agreement.

There are major gaps in remuneration disclosure

One area where Thai companies lag the region is in remuneration disclosure, which is particularly poor for executives. For directors, large companies typically provide the fees for each individual and the basis for the payment in terms of meetings and committee positions. However, Thai companies also pay a bonus for directors, including independent directors, which can be more than the base pay. Often the bonus is based on the dividend. For many companies the payout is higher than the rest of the fee. For Thai Oil it was more than two times the fee for many directors. Executive remuneration disclosure is worse. There is often a figure for the total of the senior management team, but no detail and no information for the top five executives, let alone individual senior executives. We did not find any information linking director pay to business strategy or KPIs when reviewing the annual reports of the 15 large companies. However, we noted the Banpu sustainability report says that business goals and environmental and social KPIs are included in CEO and senior executive compensation.

Mid- and small-sized companies have much further to go

Financial reporting for the 10 mid-sized companies we reviewed was comparably detailed to that of the large companies, with a similar lack of detail on costs. Corporate governance reporting was at a far lower standard overall. Similarly, smaller companies were far behind on sustainability reporting, with several providing no information or just a statement on philanthropic donations.

Company anti-corruption efforts a notable positive

One area where Thai companies have innovated is in their efforts to address corruption. The Collective Action Coalition Against Corruption (CAC) has spearheaded these initiatives following its formation in 2010. So far 911 companies have joined CAC, 332 of which have undergone certification. Many of these are large listed companies. The Thai Institute of Directors provides the secretariat for CAC. Joining companies must declare zero tolerance for any form of corruption and establish anti-bribery and corruption systems. The chairman or CEO must sign the application form to become a CAC member. Certification must be renewed every three years.

Next steps

Enhance cost disclosure

Work with companies to address limited disclosure on costs.

Identify strategic challenges from sustainability

Work with companies, particularly those in highly resource intensive value chains, to ensure they are properly addressing issues that are strategic to their company.

Improve remuneration disclosure

Improve remuneration disclosure, providing the structure of incentive packages for senior management so investors can understand the link between performance and pay.

Address gaps in mid- and small-company reporting

Work with medium- and small-size companies to improve their disclosure across a range of issues, as this is much weaker than for the larger companies. Also ensure REITs and infrastructure funds provide broader levels of disclosure.

Enhance English-language disclosure

Ensure a level playing field by having all relevant information translated into English, rather than having some information only in Thai in Form 56-1.

Weerapat Wonk-urai
weerapat.wonk.urai@clsa.com
+66 2 257 4642

Aggressive lending practices checked by BoT

Past lending practices have been questionable

The Siam Commercial Bank's (SCB TH; UPF) lending standards were called into question after it was revealed it was the sole lender to several risky large corporate and individual borrowers with a relationship with the bank. These included loans to: Sahaviriya Steel Industry (SSI TB: N-R); Pete Bodharamik (CEO of Jasmine International (JAS TB: N-R) for a tender offer of JAS shares; Pace Development (PACE TB: N-R); and Wind Energy Holding Plc (not listed).

That such loans could be granted suggests a weak risk management committee. Previously, the bank's chairperson of the committee was Arthit Nantavidya, President and CEO of SCB. The questionable loans prompted the Bank of Thailand (BoT) to exert its supervision power to encourage the board to replace him with an independent director, who was a BoT retiree.

5. Investors

Thailand ranks 8th with a score of 30%

The SEC launched Thailand's version of a stewardship code, the Investment Governance Code for Institutional Investors (I Code), in February 2017 after consultations in 2016. It has the support of the major public asset owners and investment and insurance industry associations. This has led to wide adoption, including 26 asset managers, 14 insurance companies, six provident funds, two other private securities/investment organisations, the Government Pension Fund and the Social Securities Fund. The Thai Investors Association (TIA) and SEC are also signatories. While progress is being made on stewardship, Thailand's score of 30% and eighth rank indicates there is much further to go, as in most of the region.

The code is highly detailed

Thailand's I Code follows the UK stewardship code, with detailed sub-principles and a strong emphasis on sustainability. It encourages collaborative engagement as the most effective strategy in some circumstances. Principle 6.2 flags that investors should not breach concert-party rules. However, these have not posed a problem for coordinated investor engagement activities, such as in the case of director insider trading at CP ALL, where investors came together to agree to vote against directors standing for re-election at the 2016 AGM.

AIMC helps to coordinate investor CG efforts . . .

The Association of Investment Management Companies (AIMC) is a focal point for collective industry efforts on corporate governance. Its efforts have included coordinating views on public hearings, facilitating the discussions regarding CP ALL, supporting the development of the CG Fund, and publishing proxy voting policy guidelines for its members to follow.

. . . while TIA keeps an eye on AGMs

The TIA has an important role in monitoring and improving standards at AGMs. It sends volunteers to meetings with a checklist to complete on detailed aspects of the proceedings.

Domestic investors have good voting disclosure . . .

Thai asset managers have reasonably good voting disclosure, with records typically published in Thai. These show the number of meetings attended, company names, the number of resolutions voted and the number for which the direction was against or abstain. Brief reasons for any votes against are typically provided, but, interestingly, investors tend not to disclose their shareholdings in individual companies (unlike similar disclosure in Australia, India, Japan and Korea). There were typically against or abstain votes for the "Any Other Business" (AOB) resolution, which is a feature of Thai AGMs. Since investors do not have

information in advance of the meeting to be able to vote on AOB agenda items, they are no longer acceptable in most other markets.

. . . but few against votes

Aside from AOB resolutions, disclosure typically reveals investors rarely vote against companies. In general, it is not straightforward for them to determine the right level of assertiveness in their relations with companies. However, where investors are only disagreeing on a few resolutions, this could indicate they are not taking strong enough steps to hold management accountable across their portfolio.

The CG Fund is a way to reward companies for good standards

In February 2017, the Federation of Thai Capital Market Organisations, 11 asset management firms, the Anti-Corruption Organization of Thailand, KhonThai Foundation, Thailand Development Research Institute, and Change Venture launched the Thai Governance Fund. This initiative aims to encourage companies to strengthen their CG standards. It determines a universe of shares and the 11 asset management firms can launch funds that only hold companies from this universe. The screening criteria state companies must have four stars or better in the Thai Institute of Directors (IoD) Corporate Governance Rating (CGR), and must have been certified by the Collective Action Coalition Against Corruption (CAC). The list is then subject to a further review by the fund before AIMC announces it. The fund management companies have also agreed to contribute 40% of the management fee to support the efforts of organisations that promote corporate governance and anti-corruption work.

But analytical gaps remain

Thailand has not yet developed a deeper, more fundamental analysis of its companies. TIA uses its checklist; the IoD primarily assesses disclosure for both its CGR scoring and for the Asean CG Scorecard; the AIMC provides guidelines for voting, but only rarely coordinates action on specific circumstances. None of these activities address company level strategic issues arising from governance or sustainability, nor do they provide consistent and deep analysis of proxy voting issues. This would be one way to address the challenge of form over substance. In Malaysia, the Minority Shareholder Watch Group (MSWG) plays such a role. In Thailand, this analysis gap is only partly filled by fund managers that have launched ESG funds and use a robust process, including speaking with companies.

Next steps

Remove AOB item from voting forms

Engage regulators to have them clarify there cannot be resolutions or votes carried under the Any Other Business standing item.

Investors should be more assertive

Given the relatively low levels of against votes, investors could be more assertive in their voting at company meetings.

Consider funding more analytical company research on ESG

Consider whether and how to deepen and broaden the research base on listed companies to continue to improve corporate performance, such as through developing local proxy services, or a think tank, or representative services.

6. Auditors and audit regulators

Thailand ranks equal 5th with a score of 71%

Thailand performs reasonably well in this category - equal fifth on a respectable score of 71% - because it has a robust system of accounting and auditing, a diligent audit regulator (housed within the SEC) and a professional body, the Federation of Accounting Professionals (FAP), that takes its educational, standard-setting and disciplinary roles seriously. However, while local accounting standards typically follow International Financial Reporting Standards (IFRS) with

a one-year delay in implementation, a poorly explained delay in the introduction of IFRS 9 on financial instruments has not reflected well on banking regulation and the system of accounting regulation. Thailand's ranking dipped as a result.

Audit inspections follow a three-year cycle

The SEC regulates audits for listed companies through its Accounting and Auditing Supervision Department. It undertakes audit inspections and publishes the results annually. The inspections proceeded in three cycles, the first from 2010 to 2012, the second from 2013 to 2015 and the third from 1 January 2016 to 31 December 2018. Its Independent Audit Inspection Activities Report 2017 includes results for the partially completed third cycle. The report contains findings from eight audit inspections undertaken during the year with recommendations for improvement.

Steady improvement, but engagement performance scores the lowest

The audit inspections review auditors across six factors. The average scores for each factor have shown improvement since the first inspection cycle, and all the factors have shown an improvement since the second cycle, apart from a marginal worsening in the average score for human resources. For the eight inspected firms, all the findings for client acceptance and continuance and human resources were acceptable or better. Engagement performance had the worst score, a result of incomplete audit manuals and audit programmes, non-compliance with audit manuals and programmes, engagement quality control reviewers not being used appropriately, and not completed final engagement files.

Audit partner rotation systems need strengthening

Like most markets in Asia and elsewhere, Thailand requires audit partners to rotate every five years. Yet one of the findings of the audit inspection programme was that firms may not have clear policies on rotation. The SEC has therefore recommended the strengthening of audit partner rotation polices and systems as a remedial measure. It also noted some firms did not have a policy to limit dependency on large clients. It considers problems may occur if a single corporate client accounts for 15% or more of an accounting firm's total audit revenue.

AQI's reveal high staff turnover rates

The SEC started collecting Audit Quality Indicator (AQI) data in 2016 and 2017, and holds this in relation to the 19 firms inspected during that period. The regulator emphasises training where there are deficiencies, rather than enforcement. Not surprisingly, the AQI data reveals challenges with attracting staff and high turnover rates (27% overall), particularly for local firms (30%) - similar problems are seen in every market. The SEC says that in 2018 it will continue to collaborate with FAP and the Thailand Securities Institute to conduct relevant training, including on IFRS9 and the implications of KAMs.

Limited enforcement against auditors

The 2017 inspection report does not mention any enforcement action taken against auditors during the year, although there were two warning letters sent to an auditor and the head of the audit firm for "Failure to comply with the requirement of professional standards". In 2016 there was an "Enjoining" for the same reason. The SEC mandated two listed companies to restate financial statements and three companies were ordered to undertake special audits.

Revamping state enterprise audits

Rules to phase OAG out of listed company audits

Historically, the Office of the Auditor General (OAG) has audited state-owned enterprises (SOEs). In its 2013 ROSC report on corporate governance in Thailand, the World Bank noted that the "OAG does not always have the needed expertise to audit complex financial statements produced by listed companies" and recommended extending listed SOE audits to highly qualified firms. In 2017 and

2018 a revision to the State Audit Act prohibited OAG from charging SOEs an audit fee and a revision to the Fiscal Discipline Act permitted SOEs to use other auditors. The effect has been to disincentivise the OAG from undertaking listed SOE audits and it is seeking to discontinue them after the 2019 financial year.

CFO/chief accountant requirements upgraded

The SEC upgraded qualifications for CFOs and chief accountants effective from 1 January 2018. This introduced annual training requirements for CFOs and chief accountants that hold positions in listed companies, or where they have been out of the role for less than a year. When a firm appoints a new CFO or chief accountant, the latter must have a minimum of a bachelor's degree or equivalent and experience of either three years in accounting or finance in the last five years or, in the case of a new CFO, five years in a field beneficial to the company's business within the last seven years. New IPOs must have had their CFO in place for a year prior to listing.

IFRS 9, which mainly affects banks, has been delayed ...

IFRS 9 was due to come into force in Thailand on 1 January 2019. However, in May 2018 the Bank of Thailand said this was a decision for the Oversight Committee on Accounting Professions (OCAP), which subsequently announced a delay in July 2018. The new standard will now come into force a year later than originally intended on 1 January 2020. IFRS 9 includes stricter standards for recognising impairments of financial instruments, primarily affecting banks. The Joint Standing Committee on Commerce, Banking, and Industry (JSCCBI), an OCAP member, said some SMEs were worried they would face higher loan costs under the new rules. Apparently, and in an unusual move, SMEs expressed concern for bank profitability, based on the idea that if there was faster impairment and falls in profitability, the banks would have to charge loans at a higher rate. JSCCBI lobbied for a delay until 2022 on this basis.

... raising questions about banking regulation

However, there were disagreements. Nuntawan Sakuntanaga, the commerce permanent secretary and OCAP chair said loan extensions by financial institutions were based on the country's economic conditions and the repayment ability of the borrower. The Federation of Thai Capital Market Organisations (FETCO) also disagreed with the delay. FETCO comprises seven bodies, including associations representing the investment industry, insurance, listed companies, and the Stock Exchange. The negative effects of the delay are limited as it is only for one year. However, Thailand is the only market that has deferred implementation at this late stage and for a weak reason, raising questions over the processes for banking and accounting regulation.

Next steps

Stronger enforcement

Strengthen disciplinary action over auditors.

Audit committees to focus on audit quality

Continue to encourage audit committees to focus on audit quality, not just price, and allow them to make use of audit quality indicators.

Provide further details on structure of audit industry

Publish a broader analysis of the structure of the auditing industry so investors have a better sense of the depth of expertise in the CPA profession in Thailand.

Implement TFRS 9 without delay

Implement TFRS 9 without further delay and revise the structure of accountancy oversight so that special interests are not able to prevent changes in future.

Suchart Techaposai
Head of Research – Thailand
suchart.techaposai@clsa.com
+66 2 257 4632

Role of the active auditor

TSA 706 (Revised) launched in 2016 made auditors provide significant matters on their audit findings to investors

Auditors have become more proactive in their regular audits, and have expressed more findings valuable to investors on both risks and potential CG issues. This followed the Thai Standards on Auditing on the Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report, TSA 706 (Revised), launched by the Federation of Accounting Professions in April 2016, and effective from the 2016 financial statement and auditor report onwards.

Group Lease

Unscrupulous transactions to overestimate its earnings

The odyssey of Group Lease illustrates auditors' increasingly proactive stance in Thailand. In the 2016 results, its auditor EY highlighted the company's lending practices in two sizeable loans partly collateralized with lender shares appraised at the current market value. Excluding the lender's shares, both loans were under collateralized, at 53% and 60%. The release of its 2016 financial statement on 28 Feb 2017 triggered a 70% share price decline over the following two weeks. The incident triggered an investigation by the SEC and led to a criminal charge against its CEO and Chairman Mitsuji Konoshita on 16 Oct 2017, which released him from his executive roles in the company. The company was also ordered by the SEC to amend its financial statement to fairly reflect the nature of such loans.

7. Civil society and media

Thailand ranks equal 6th with a score of 51%

Thailand has long had a closely connected web of civil society organisations advocating for improved corporate governance standards and representing listed companies, institutional and retail investors, directors, company secretaries, accountants, financial analysts and others. One only needs to attend a CG conference in Bangkok to see the large number of logos of non-profit organisations supporting the event. It also has a unique private sector coalition seeking to reduce the incidence of corruption. All of this is positive, but we have two broad concerns: an obvious decline in media freedom in recent years and the criminalisation of defamation.

Training and education

Institute of Directors plays key role in training . . .

The Thai Institute of Directors (IoD) has been a strong and positive feature of the corporate governance landscape. In recent years, this was under the leadership of President and CEO Dr Bandid Nijathaworn, who completed his term on 30 June 2018. The acting President and CEO is Chalwat Utaiwan until a successor is found. The IoD has an active director training programme, which served 3,381 participants in 2017 - up from 3,084 in 2016 and 2,494 in 2015. Interestingly, the average age profile of directors being trained has fallen from 63 years old in 2000-2007 to 49 years since 2014. Over this time the share of directors from non-listed companies has risen from 27% to more than 53%. These trends suggest the professionalization of directors in Thailand is real and extensive.

. . . and through rating companies, supporting anti-corruption efforts

The IoD also runs important initiatives, such as the Corporate Governance Rating (CGR), which is a disclosure assessment of Thai listed companies. This is used by investors in various ways to screen out low-scoring companies and is a primary tool for the new CG Fund. The IoD refers to 16 policy initiatives since 2014. It also acts as the secretariat of the Private Sector Collective Action Coalition Against Corruption.

TLCA supports with companies

The Thai Listed Companies Association (TLCA) also plays an important role in the corporate governance ecosystem. Its mission includes promoting corporate governance, sustainable development, and anti-corruption practices and supporting the sharing of information, including SEC and SET regulations. It has 509 listed company members, conducts training for company secretaries and hosts the Thai Company Secretaries Club.

But JSCCIB held back accounting standards

Not all business associations have been as supportive as IoD or TLCA. The Joint Standing Committee on Commerce, Industry, and Banking (JSCCIB), which is formed from bodies on trade, industry, and banking, called for delays on the implementation of IFRS 9 in 2018 (see Auditors and Audit Regulators).

Research and green advocacy

Recent increase in university studies on CG and ESG

A review of studies published on SSRN found seven papers on Thai corporate governance published in 2018 from a range of sources, including Sripatum University, Kasetsart University, Rajamangala University of Technology Suvarnabhumi, and Rangsit University. This is a significant increase. There were no new studies posted in 2017 (only three old postings more than a decade old), one in 2016, none in 2015, and two in 2014. This is a positive sign, particularly as the Thai Development Research Institute is no longer publishing on corporate governance.

Other development and NGO activity, but less focussed on corporate governance

The United Nations main centre of activity in Asia and the Pacific is based in Bangkok. This provides an extra emphasis on development matters. However, the related activities rarely address corporate governance directly. Similarly, there is a broad range of non-profit organisations working to address charitable causes in Thailand. Some of the environmental NGOs campaign on issues that also relate to corporate activity, particularly in supply chains, such as human rights in seafood. But usually NGO activity is based around issues, rather than to address corporate governance directly. They have varying levels of sophistication when it comes to engaging with corporates.

Press freedom

There are multiple challenges to media freedom

An increasing challenge in recent years has been the decline in press freedom, which undermines the ability of journalists to hold companies to account. Multiple factors combine to create this chilling effect. Thailand has very strict lèse majesté laws. Additional restrictions have been imposed on criticism of the government since the military regime came to power in 2014; and these were particularly strict in the run up to the August 2016 referendum on the new constitution, when there were multiple arrests for possession of information critical of the proposed changes. A further factor is contempt of court rules that make it hard to express opinions on legal cases. New laws from early 2018 make it an imprisonable offense to undertake 'a violation of the court powers' by making a criticism of the Constitutional Court, unless this is done in good faith and in a polite manner. From a corporate governance perspective, however, a more immediate challenge is the country's defamation laws, which makes defamation a criminal not just a civil offence.

Criminal defamation cases by companies having a chilling effect

One example was the case of Andy Hall, a journalist who conducted interviews with workers for NGO Finnwatch about labour conditions at the Thai Natural Fruit Company, part of the supply chain of major Finnish retailers. Hall faced criminal defamation charges with custodial sentences as well as civil litigation. The proceedings began in 2013 and lasted into 2018 due to multiple appeals. Hall was found guilty by the Bangkok South Criminal Court in September 2016. Subsequently, in May 2018, the Appeals Court quashed his conviction and ruled

Court judgements leave reporters in an uncertain position

that Hall had interviewed the workers and there was a real possibility of labour rights abuses. The decision is seen as a victory for credible reporting and free speech in general. But cases have not always ended so happily.

In March 2018, the Appeals Court ruled in the other direction when it overturned a decision by the Criminal Court to dismiss criminal defamation charges brought by Tungkum, a Thai mining company, against the Thai Public Broadcast Services (PBS) and four of its journalists. Thai PBS had reported on the environmental effects of Tungkum's mining on six villages. The Criminal Court previously dismissed the charges in November 2016, finding that the reporters acted professionally and relied on credible sources.

Truth must be proven and is not always a defence

The criminalisation of defamation leads to a perverse situation. A common defence to defamation allegations is that the information is true. However, to use this defence, the alleged defamer has to prove the statement is true. In effect, a defendant has to prove their innocence, reversing the usual presumption. Further, in Thailand, the truth of a statement is not a relevant defence where a defamatory statement concerns personal matters and if it is not of benefit to the public to know the statement.

Next steps

Raise civil society participation in CG reform

Encourage greater participation of civil society organisations in consultations around corporate governance reform.

Address defamation laws so reporters can fulfil their function

Remove the criminal offense from defamation laws so journalists and civil society actors are able to perform their function of holding companies to account without undue fear of personal criminal sanctions.

Recap and recommendations

Recap of CG Watch 2016

Thailand has made more progress on some of the harder reforms

To what extent has Thailand responded to our recommendations from 2016?

Figure 2

Thailand: recap of 2016

	Recommendations	Outcome
1.	Quicker translation of key documents for public hearings; better accessibility of documents on SEC/SET websites	No change
2.	SET to archive company reports and announcements for at least five years	No change
3.	More informative summaries of regulatory information from SET	Limited improvement
4.	Encourage better ongoing disclosure of price sensitive information	No change
5.	Publish investigation and sanction statistics for audit investigations	Investigation reporting good, but few sanctions
6.	Complete long list of legal reforms	Many reforms introduced
7.	Maintain momentum on enforcement	Limited improvement

Source: ACGA

Downgrade watch list

What to avoid

Factors that could force the markets' score to fall in 2020:

- ❑ Investors do not step up their engagement efforts in line with the I Code and continue to have low levels of against votes
- ❑ Further deterioration in press freedom
- ❑ Further delay in adoption of TFRS 9 or other international accounting standards

- Further delays in the implementation of SOE reform
- Failure to properly address strategic sustainability issues, particularly climate change

Quick fix list

What to fix

Issues to address as soon as possible:

- SET to make the full history of company information available
- SEC to translate news, civil sanction reports, and relevant public hearing documents with longer hearing periods
- Introduce longer cooling-off periods into the definition of independent director
- Improve remuneration disclosure, particularly for senior executives, so that investors can understand the structure of the relationship between business strategy, individual performance, and incentivisation
- Address disclosure weaknesses for smaller companies
- Regulators should work on material issue management, particularly for climate change
- Remove criminal charges from defamation laws

Appendix 1: About ACGA

Jamie Allen
Secretary General, ACGA
jamie@acga-asia.org
Room 1801, 18F, Wilson House
19-27 Wyndham Street,
Central, HK
Tel: (852) 2160 1788
Fax: (852) 2147 3818

The Asian Corporate Governance Association (ACGA) is a non-profit membership association dedicated to promoting substantive improvements in CG and ESG in Asia through independent research, advocacy and education. ACGA engages in a constructive dialogue with regulators, institutional investors and listed companies on key CG/ESG issues and works towards making improvements.

China report

One of ACGA's most recent initiatives was a major report on China, titled "Awakening Governance: The evolution of corporate governance in China", and published in July 2018. It provides an independent and objective review of the history, nature and trajectory of CG in China. At more than 200 pages, it seeks to explain China's unique system of corporate governance to foreign investors and the relevance of emerging global CG/ESG best practices to China-listed companies and domestic institutional investors. It contains a series of practical recommendations to regulators, companies and investors for improvement.

- The report is available in both English and (simplified) Chinese versions. A pdf version can be downloaded on https://www.acga-asia.org/thematic-research.php

For more details on ACGA's activities and a database of information on CG in Asia, see our website: www.acga-asia.org

Membership network

ACGA is funded by a membership base of more than 110 highly regarded organisations based in Asia and other parts of the world, including:

- Many of the world's largest asset owners and managers. ACGA investor members manage more than US$30 trillion globally and hold significant stakes in Asian companies.
- Highly regarded listed companies, professional firms, and financial and insurance intermediaries based in Asia.
- Two major multilateral banks.
- Leading educational bodies.

For a full list of our members, see the "Members" page on www.acga-asia.org

Founding Sponsor

CLSA is one of the original Founding Corporate Sponsors of ACGA and continues to support the Association's work. We have been honoured to work with CLSA since 2001.

Foundation Sponsor

NBIM
Norges Bank Investment Management

ACGA was also honoured to welcome Norges Bank Investment Management (NBIM) of Norway as our first "Foundation Sponsor" in 2012. NBIM had been a valued member of ACGA for many years and this commitment marked a considerable enhancement of its support for CG and ESG improvement in the Asia region.

Appendix 2: ACGA Market-ranking survey

1. Government & public governance

		AU	CN	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	To what extent does the current government administration (executive branch) have a clear and credible long-term strategy for promoting corporate governance reform to support capital-market and business-sector development?	2	1	0	1	0	3	3	2	0	1	4	2
2	To what extent does the government provide consistent political support for the policy and enforcement work of financial regulators (ie, securities commissions and stock exchanges)?	2	2	2	1	0	2	3	3	0	2	4	3
3	To what extent has the central bank or equivalent financial authority exerted effective supervision over the governance of banks?	3	3	4	1	2	4	3	3	3	4	2	3
4	Is there a coherent structure to the regulatory system governing the securities market, including the IPO regime (ie, one without clear conflicts of interest involving either the securities commission or the stock exchange; without fragmentation and disagreement between different regulatory authorities; and where there is a clearly definable securities commission or bureau taking the lead on enforcement)?	4	2	3	3	2	3	3	3	3	3	3	3
5	Is the securities commission formally and practically autonomous of government (ie, not part of the ministry of finance; nor has the minister of finance or another senior official as chairman; nor unduly influenced by government)?	3	0	4	3	2	2	1	1	2	1	1	3
6	Is the securities commission funded independently (eg, a levy on securities transactions), not dependent on an annual budgetary allocation from government, and has control over its own budget?	2	0	5	4	3	1	4	4	1	1	2	4
7	Is there an independent commission against corruption with powers of sufficient depth and breadth to tackle public- and private-sector corruption?	2	1	4	1	3	1	1	1	0	4	2	2
8	How far advanced is the government in tackling public- and private-sector corruption?	3	2	3	2	1	2	2	1	1	3	3	1
9	To what extent has the government achieved and maintained high standards of public governance and accountability (eg, independent audits by a strong ombudsman, encouragement of whistleblowing, mandating disclosure of assets owned by senior officials and politicians, cooling-off periods before retired officials can join private firms)?	4	1	3	1	1	4	3	1	0	4	4	1
10	To what extent is the judiciary seen to be independent and clean in relation to company and securities cases?	5	1	5	2	1	5	3	2	0	4	4	1
11	To what extent is the judiciary skilled in handling company law and securities cases?	5	2	5	3	0	3	3	3	2	5	3	2
12	Does the legal system allow minority shareholders fair and efficient access to courts to settle disputes? (ie, in terms of the cost of going to court and the range of legal remedies available).	4	2	0	2	1	3	3	0	2	0	4	1
13	Does the government follow best practice standards as regards listed SOE governance (ie, it requires them to follow the same governance standards as private-sector issuers, refrains from interfering in their governance, and so on)?	na	3	3	1	1	3	2	3	1	4	3	3
	Score	39	20	41	25	17	36	34	27	15	36	39	29
	%	65	31	63	38	26	55	52	42	23	55	60	45
	Rank	1	10	2	9	11	4	6	8	12	4	3	7

Source: ACGA

Note: Please see our Methodology on page 27 - 29 for full details.

2. Regulators													
2.1	**Funding, capacity-building and regulatory reform**	**AU**	**CN**	**HK**	**IN**	**ID**	**JP**	**KR**	**MY**	**PH**	**SG**	**TW**	**TH**
1	Is the securities commission sufficiently resourced in terms of funding and skilled staff to carry out its regulatory objectives?	3	1	5	4	2	3	4	4	2	3	3	5
2	To what extent has the securities commission been investing in surveillance, investigation and enforcement capacity and technology over the past two years?	3	4	5	4	2	2	3	3	1	3	3	4
3	Is the stock exchange (or exchanges) sufficiently resourced in terms of funding and skilled staff to carry out enforcement of the listing rules?	3	2	4	3	2	3	2	4	2	4	2	3
4	To what extent has the stock exchange been investing in surveillance, investigation and enforcement capacity and technology over the past two years?	1	2	1	3	1	1	1	3	1	3	2	1
5	Has the government and/or securities commission been modernising company and securities laws, regulations and codes over the past two years to improve corporate governance and address relevant local CG problems?	3	1	2	3	1	3	4	4	1	2	5	5
6	Has the stock exchange been modernising its listing rules, and related best-practice codes and guidelines, over the past two years to improve corporate governance?	3	2	1	1	0	1	4	3	0	1	3	3
7	Do the securities commission and stock exchange have informative websites with English translations of all key laws, rules and regulations easily accessible?	5	4	5	5	1	4	4	5	2	4	3	3
8	Does the stock exchange (or related agencies) provide an efficient, extensive and historical online database of issuer announcements, notices, circulars and reports archived for at least 15 years and in English?	5	3	5	2	2	1	3	5	2	2	2	1
9	Has the stock exchange or another organisation developed an open electronic voting platform (“straight through processing”) for investors?	0	4	0	5	0	5	3	0	0	0	5	0
10	Do financial regulators demand that intermediaries, especially investment bank sponsors, promote meaningful governance preparation in companies about to undergo an IPO?	1	1	2	0	0	1	0	0	1	2	2	1
	Score	27	24	30	30	11	24	28	31	12	24	30	26
	%	54	48	60	60	22	48	56	62	24	48	60	52
	Rank	6	8	2	2	12	8	5	1	11	8	2	7
2.2	**Enforcement**												
11	Do financial regulators in your country have a reputation for vigorously and consistently enforcing securities laws and regulations?	2	2	3	2	1	2	2	2	1	2	3	1
12	Have their efforts improved and evolved over the past two years?	3	3	4	4	1	2	3	3	1	3	4	3
13	Does the securities commission have effective powers of surveillance, investigation, sanction, and compensation?	4	4	5	4	2	3	4	3	2	3	4	3
14	Has the securities commission had a successful track record enforcing against all forms of market misconduct over the past two years, including insider trading, market manipulation, fraud, embezzlement, and false disclosure?	3	4	5	3	0	2	3	3	1	3	3	3
15	Does the securities commission disclose multi-year data on its enforcement activities, with explanations as to what the data means and detailed announcements on individual cases?	5	3	5	4	0	4	3	3	1	3	1	3
16	Does the stock exchange (or related agencies) have an effective range of powers to sanction breaches of the listing rules?	3	3	3	3	3	4	3	5	3	4	3	3
17	Has the stock exchange had a successful track record enforcing breaches of its listing rules over the past two years?	2	3	3	3	1	3	2	3	1	3	3	2
18	Does the stock exchange disclose detailed data and explanations of its enforcement activities?	1	4	5	1	1	3	2	3	1	3	2	2
19	Does the stock exchange take steps to minimise and control conflicts of interests, such as between its commercial and regulatory objectives?	2	3	2	2	0	2	2	3	1	2	3	3
20	Do financial regulators receive efficient and committed support from other national enforcement agencies and institutions (ie, the police, attorney general, courts)?	4	3	3	3	1	4	3	2	1	4	4	1
	Enforcement weighted (60/40) score	30	32	39.2	30	9.6	28.4	27.6	29.6	12.8	29.6	30	24.4
	%	60	64	78	60	19	57	55	59	26	59	60	49
	Rank	3	2	1	3	12	8	9	6	11	6	3	10

Note: We have applied a 60% weighting to the first five questions under Enforcement and 40% to the second five questions. Source: ACGA

3. CG rules

		AU	CN	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Do financial reporting standards (ie, rules) compare favourably against international standards? (ie, timeliness of reporting; robust continuous disclosure; detailed MD&A; sufficient narrative and notes to the P&L, balance sheet, cashflow; and so on)	5	4	5	4	3	4	4	4	4	5	4	5
2	Do CG reporting standards compare favourably against international standards? (ie, requirements for a Report of the Directors; CG statements or reports; board and committee disclosure; director biographies; internal controls and audit; discussion of risk factors)	5	2	4	4	3	3	1	4	4	4	4	4
3	Do ESG/sustainability reporting standards compare favourably against international standards? (ie, company law rule on ESG risk statement; stock exchange ESG reporting rules; a sustainability section in the annual report; a separate GRI or Integrated Report)	1	2	3	2	1	1	2	4	1	4	4	4
4	Is quarterly reporting mandatory, is it consolidated and does it provide adequate and credible P&L, cash flow and balance sheet data (with adequate explanation of the numbers)?	2	4	1	3	4	5	4	5	4	5	5	5
5	Must investors disclose ownership stakes of 5% and above (ie, when they become a substantial shareholder) as well as "creeping" increases of one percentage point?	5	5	5	4	3	5	5	5	2	5	0	2
6	Must directors and controlling shareholders disclose share transactions within 1 working day?	4	5	4	4	1	0	3	4	2	4	5	3
7	Must controlling shareholders disclose share pledges in a timely manner?	4	5	5	4	1	0	0	0	1	1	4	0
8	Is there a closed period (a "black out") of at least 2 months before annual results and 1 month before interim/quarterly results during which directors cannot trade their shares?	4	5	5	5	1	1	0	2	3	3	2	0
9	Are there clear and robust rules on the immediate disclosure of price-sensitive information?	5	4	5	4	4	5	5	5	5	5	5	4
10	Are there clear and robust rules on the timely disclosure of related-party transactions (continuing, small, and large transactions), including the right of minority shareholders to approve major RPTs?	3	3	5	3	1	1	2	5	1	3	2	5
11	Are there clear and robust rules prohibiting insider trading and market manipulation?	4	3	5	3	1	3	4	4	3	4	4	3
12	Is voting by poll mandatory for all resolutions at general meetings, followed by disclosure of results within 1 day?	4	5	5	4	1	4	0	5	1	5	4	5
13	Is there an up-to-date national code of best practice--and accompanying guidance documents--that takes note of evolving international CG standards and is fit for purpose locally (ie, addresses fundamental CG problems in the domestic market)?	4	1	3	3	2	3	3	3	2	3	3	4
14	Is there a stewardship code for institutional investors based on the "comply or explain" standard and that seeks investor signatories?	4	0	2	2	1	5	5	5	0	1	5	5
15	Is there a clear and robust definition of “independent director” in the code or listing rules? (ie, one stating independent directors should be independent of both management and the controlling shareholder; that does not allow former executives or former professional advisors/auditors to become independent directors after short "cooling-off" periods, nor people with business relationships).	4	1	2	2	1	1	2	2	1	2	2	3
16	Must companies disclose the exact remuneration of individual directors and senior executives (top 5) by name?	5	3	4	3	2	1	2	4	1	2	3	3
17	Are fully independent audit committees mandatory and given broad powers to review financial reporting and internal controls, and communicate independently with both the external and internal auditor?	4	3	4	4	2	2	3	4	2	4	2	5
18	Are fully independent nomination committees mandatory and given broad powers to nominate independent directors?	4	1	3	3	2	1	2	2	1	3	1	3
19	Can minority shareholders easily nominate independent directors?	4	0	1	4	1	0	0	1	2	1	3	0
20	Is there a statutory or regulatory requirement that directors convicted of fraud or other serious corporate crimes must resign their positions on boards and in management?	3	4	3	3	0	4	0	2	5	5	2	5
21	Are pre-emption rights for minority shareholders—their right to buy any new shares issued by the company on a pro-rata basis—firmly protected? (ie, new shares issued for cash must keep to strict caps of no more than 5-10% of issued capital and a 5-10% discount to the current share price; shareholders can approve the extension of such placement mandates at each AGM; and/or measures have been introduced to allow for much faster rights issues)	4	1	2	1	1	1	0	3	1	2	1	2
22	Do companies have to release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?	4	3	4	4	3	2	3	3	2	2	4	4
23	Are there clear and robust rules for the protection of minority shareholders during takeovers, voluntary delistings (taking companies private) and any other major transactions where a conflict of interest is inherent between majority and minority shareholders, including RPTs?	3	0	4	3	1	2	1	3	1	3	2	3
24	Are institutional shareholders free to undertake collective engagement activities without an undue burden from concert-party rules?	5	5	5	5	2	2	3	5	2	5	5	5
	Score	94	69	89	81	42	56	54	84	51	81	76	82
	%	78	58	74	68	35	47	45	70	43	68	63	68
	Rank	1	8	2	4	12	9	10	3	11	4	7	4

Source: ACGA

4. Listed companies

		AU	CN	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Do the financial reports of large-cap companies compare favourably against international best practice? Both in terms of periodic reports and ad hoc announcements.	4	3	4	4	4	4	4	3	5	4	4	3
2	Do the financial reports of small- and medium-sized companies compare favourably against large caps in their own market?	4	3	3	3	3	4	2	3	2	4	3	3
3	Do the CG reports of large-cap companies compare favourably against international best practice?	4	2	3	3	2	2	2	2	2	3	3	3
4	Do the CG reports of small- and medium-sized companies compare favourably against large caps in their own market?	3	2	3	2	3	2	0	2	2	3	2	1
5	Do the ESG/sustainability reports of large-cap companies compare favourably against international best practice?	3	2	2	3	2	3	4	3	1	4	4	4
6	Do the ESG/sustainability reports of small- and medium-sized companies compare favourably against large caps in their own market?	2	1	2	1	3	2	0	1	2	3	2	1
7	Do large-cap companies report their audited annual financial results within two months (60 days)?	3	0	0	5	1	4	2	2	0	2	3	5
8	Do the investor relations sections of the websites of large-cap companies provide comprehensive, timely and quick access to all relevant financial, CG and sustainability reports, as well as ad hoc company announcements?	4	4	4	4	3	3	2	4	3	4	4	4
9	Do the investor relations sections of the websites of small- and medium-sized companies provide comprehensive, timely and quick access to all relevant financial, CG and sustainability reports, as well as ad hoc company announcements?	3	3	3	4	3	3	1	2	2	3	2	3
10	Do company boards have the autonomy to make key decisions, free of outside influence?	5	0	4	3	3	3	3	3	4	3	4	4
11	Do companies undertake annual board evaluations, either internally or using external consultants, and disclose how they act on the results?	3	0	1	3	1	2	1	3	1	3	2	3
12	Do companies disclose and implement credible board diversity policies?	5	0	3	2	1	0	2	3	2	3	3	2
13	Do companies provide induction and ongoing training to their directors--executive and non-executive--and disclose these programmes in their annual reports?	3	1	4	3	2	0	2	4	2	3	3	3
14	Do companies generally have an independent chairman and/or lead independent director?	5	0	1	3	1	1	1	3	0	3	0	0
15	Are independent directors fairly and appropriately compensated (ie, in a way that does not compromise their independence)?	5	4	4	2	2	2	3	4	2	4	1	4
16	Are audit committees (or an equivalent) fully independent, clearly competent in financial reporting/accounting matters, and detailed in their reporting to shareholders?	4	3	3	3	4	2	3	4	2	4	3	4
17	Do companies have internal audit departments that report to the audit committee?	5	2	4	5	2	4	2	5	4	5	4	5
18	Do listed companies provide adequate and credible disclosure of their internal-control and risk-management processes?	4	4	4	4	3	3	4	3	4	4	5	5
19	Do listed companies provide detailed explanation of their executive remuneration policies?	5	2	2	3	0	1	1	1	1	3	3	0
20	Do companies have clear and credible policies for managing related-party transactions?	3	2	2	3	2	1	2	3	5	3	2	3
21	Do companies have clear, fair and sensible policies on dividends and buybacks?	4	3	2	3	2	4	1	4	3	3	5	5
22	Do companies have clear and credible policies for mitigating corruption?	3	0	2	2	2	2	2	3	2	2	2	3
23	Does the local private sector cooperate to fight corruption?	0	0	3	3	0	3	0	0	0	0	0	5
	Score	84	41	63	71	49	55	44	65	51	73	64	73
	%	73	36	55	62	43	48	38	57	44	63	56	63
	Rank	1	12	7	4	10	8	11	5	9	2	6	2

Source: ACGA

5. Investors

		AU	CN	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Are domestic institutional investors (asset owners and managers) working to promote better corporate governance through public policy?	5	1	1	4	1	3	1	3	1	1	2	3
2	Are foreign institutional investors (asset owners and managers) working to promote better corporate governance through public policy?	2	1	4	2	1	3	2	1	1	2	1	0
3	Do domestic institutional investors actively exercise their voting rights, including voting against resolutions with which they disagree?	5	2	2	4	3	4	2	3	2	2	3	3
4	Do foreign institutional investors actively exercise their voting rights, including voting against resolutions with which they disagree?	4	3	4	3	3	4	4	2	2	4	4	1
5	Do domestic institutional investors often attend annual general meetings?	1	1	0	0	2	2	1	3	2	1	3	3
6	Do foreign institutional investors often attend annual general meetings?	1	0	1	0	1	1	1	1	1	1	0	0
7	Do activist or focus funds exist that seek to address specific company issues or transactions?	1	0	1	0	0	5	2	0	0	1	0	1
8	Do domestic asset owners (in particular state pension and investment funds) play a leadership role in prompting responsible investment and investor stewardship?	5	1	0	0	0	3	1	3	0	1	0	1
9	Do domestic institutional investors engage in regular individual or collective engagement?	4	0	0	3	0	3	0	2	0	0	2	2
10	Do foreign institutional investors engage in regular individual or collective engagement?	1	1	3	1	1	2	2	1	1	2	1	0
11	Are domestic institutional investors effectively managing commercial conflicts of interest?	3	2	3	2	2	2	1	2	0	2	1	2
12	Do institutional investors disclose voting down to the company level and provide reasons for any votes against?	5	0	0	5	0	5	4	0	0	0	0	4
13	Have local proxy advisory services emerged?	5	1	0	5	0	3	2	2	0	0	0	0
14	Do retail shareholders see the annual general meeting as an opportunity to engage with companies and ask substantive questions?	4	1	2	1	3	3	0	4	2	5	3	4
15	Have retail shareholders formed their own (ie, self-funded) associations to promote improved corporate governance?	5	0	0	0	0	1	2	3	4	3	1	3
16	Do retail shareholders launch public activist campaigns against errant directors or companies?	1	0	1	1	0	1	2	2	1	3	4	0
17	Do retail shareholders (or government agencies acting on their behalf) undertake lawsuits against errant directors or companies?	4	2	1	1	0	3	2	0	1	1	5	0
18	Do retail shareholder groups collaborate with institutional investors?	1	0	0	0	0	0	1	2	1	0	0	0
	Score	57	16	23	32	17	48	30	34	19	29	30	27
	%	63	18	26	36	19	53	33	38	21	32	33	30
	Rank	1	12	9	4	11	2	5	3	10	7	5	8

Source: ACGA

6. Auditors & audit regulators		AU	CN	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Are local accounting standards in line with evolving international financial reporting standards (IFRS)?	5	5	5	3	5	5	5	5	5	5	5	4
2	Are local auditing standards in line with evolving international standards of auditing (ISAs)?	5	4	5	4	5	5	5	5	5	5	4	5
3	Has the government or accounting regulator enacted effective rules on the independence of external auditors? (eg, by introducing limits on the non-audit work that external auditors can do; requirements for audit-partner rotation; whistleblower protection for auditors; a positive duty for auditors to report fraud; and so on)	4	3	3	3	3	3	4	3	3	3	4	3
4	Is disclosure of audit and non-audit fees paid to the external auditor required, with accompanying commentary sufficient to make clear what the non-audit work is?	5	2	5	3	3	4	3	4	5	5	4	4
5	Are extended auditor reports focussing on "key audit matters" (KAMs) required?	5	5	5	1	0	0	4	5	5	5	5	5
6	Are large listed companies well prepared for their annual audit? (ie, the auditor does not need to assist with final account preparation; management assumptions underlying complex accounting treatments, such as in valuation of assets or transactions, are clear; the CFO has up-to-date knowledge of new accounting standards)	5	3	5	3	4	5	4	4	4	5	4	4
7	Are the audits of large companies of high quality and in line with international best practice? (ie, the audit firms follow proper quality control standards; audit partners spend sufficient time supervising audits; there is evidence of auditors pushing back on overly flexible interpretation by management of accounting standards; audits are done by a single firm)	4	3	4	3	4	4	4	4	3	4	4	4
8	Are small- and medium-sized listed companies well prepared for their annual audit? (ie, the auditor does not need to assist with final account preparation; management assumptions underlying complex accounting treatments, such as in valuation of assets or transactions, are clear; the CFO has up-to-date knowledge of new accounting standards)	4	2	3	3	3	3	3	3	3	3	3	3
9	Are the audits of small- and medium-sized companies of high quality and in line with international best practice? (ie, the audit firms follow proper quality control standards; audit partners spend sufficient time supervising audits; there is evidence of auditors pushing back on overly flexible interpretation by management of accounting standards; audits are done by a single firm)	3	2	3	2	3	3	3	3	3	3	3	3
10	Has the government established an independent regulator to oversee listed-company audit and with clear powers of registration, inspection, investigation, and sanction (over both auditors and audit firms)?	4	2	1	1	4	3	4	5	2	3	4	4
11	Does the audit regulator exercise effective and independent disciplinary control over the audit profession?	4	1	2	0	3	2	3	5	2	2	2	2
12	Does the audit regulator disclose its enforcement work and other activities on a timely and detailed basis?	4	2	5	0	2	4	3	5	1	3	2	3
13	Does the audit regulator publish a detailed report on its inspection programme, audit quality, and audit industry capacity (ie, the level of skills and experience in the CPA profession) every one to two years?	4	1	3	0	1	5	0	5	1	4	2	4
14	Does the audit regulator work proactively with the CPA profession to promote capacity, quality and governance improvements within audit firms? (This could include, among other things, requiring firms to meet a set of "audit quality indicators". Or creating an "audit firm govenance code". Or pushing small firms to consolidate.)	3	0	3	1	3	4	3	3	2	5	3	2
	Score	59	35	52	27	43	50	48	59	44	55	49	50
	%	84	50	74	39	61	71	69	84	63	79	70	71
	Rank	1	11	4	12	10	5	8	1	9	3	7	5

Source: ACGA

7. Civil society & media		AU	CN	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Is there an institute of directors (or equivalent) actively engaged in director training?	5	1	4	2	4	4	0	2	3	4	3	5
2	Is there an institute of company secretaries (or equivalent) actively engaged in company secretarial training?	5	1	4	5	3	2	0	5	0	4	1	2
3	Are other professional or industry associations—of accountants, financial analysts and so on—helping to raise awareness of corporate governance?	4	2	3	2	2	3	1	1	2	3	3	3
4	Are business associations—chambers of commerce, business federations and so on—working with their members to improve corporate governance?	0	0	0	3	1	1	0	0	1	1	1	2
5	Are other non-profit organisations working to raise standards of corporate governance and sustainability?	5	0	2	3	2	5	5	3	2	1	2	1
6	Are these groups also involved in public policy discussions and consultations on corporate governance?	5	0	5	5	2	3	2	2	2	5	3	3
7	Are professional associations and academic organisations carrying out original and credible research on local CG practices?	5	2	3	5	2	3	3	1	2	4	3	2
8	Does the print media actively and impartially report on corporate governance policy developments and corporate abuses?	3	2	3	4	2	4	1	4	2	3	4	2
9	Is the print media sufficiently skilled at reporting on corporate governance?	3	2	3	3	2	3	2	3	3	3	3	3
	Score	35	10	27	32	20	28	14	21	17	28	23	23
	%	78	22	60	71	44	62	31	47	38	62	51	51
	Rank	1	12	5	2	9	3	11	8	10	3	6	6

Source: ACGA

Appendix 3: CLSA CG questionnaire

Questions in bold carry negative scoring . . .

Discipline (18% weight)

Question number	Range of scores	Question	Guidelines
1	0,1	Does management stick to a clearly defined core businesses?	Core business represent the industries and skill sets a company has shown a clear competence and ideally has competitive advantage in. It is subjective. Tangential acquisitions or new ventures that build on the skills that the company is recognised by the market and customers as holding could be deemed by the analyst to broaden the core business over time (eg, Hyundai Motor acquiring a construction business is not within its core business. Apple moving into the auto industry could be argued as still within its core competence of software and design, based on innovation).
2	0,1	Are you confident management clearly understands its company's cost of capital and uses it as a key input in capital allocation?	Answer 'No' if you have any reason to believe any of the below are true: You cannot find reference to the costs of capital in company's communication material or during interactions with investors The company has a history of continuing to fund businesses which do not earn their costs of capital
3	**0,1**	**Has the company issued any capital (debt or equity) in the past five years which was clearly not in the best interests of shareholders?**	**Answer 'Yes' if you have any reason to believe the below are true:** ❑ **There was an expensive acquisition with unconvincing arguments for synergies** ❑ **It provided inadequate disclosure for the reasons of capital issuance and capital usage** ❑ **You are concerned about solvency implications of current balance-sheet structure or any recent debt issuance**
4	**0,1**	**In the past five years has the company engaged in any type of restructuring which conflicts with shareholder interests?**	**Transactions which conflict with shareholder interests include the following:** ❑ **Spinoff of strategically important or imminently profitable businesses to related parties (eg, the Baidu deal with iQiyi)** ❑ **Mergers or demergers done at material deviations to analysts' estimates of a fair price** ❑ **Transactions which increase voting control of one group at the expense of another without a control premium**
5	0,1	Is the company free from government interference?	Answer 'No' if you have any reason to believe any of the below are true: ❑ The company faces indirect pressure to alter pricing, hiring investment or any material entity level decisions in any way which would hurt shareholder interests to support government goals ❑ This does not include normal regulations which are within the confines of a company's official mandate that allows it to earn an previously agreed upon regulatory return
06a	0,1	Has management disclosed reasonable return on capital (eg, ROA or ROE or ROIC) targets? If so, please state such in (6b).	The time horizon and specific type of metric is not important. A target which is unnecessarily high and encourages the company to take undue risk should be answered 'No'.
06b			Please state the metric used by the company and the number in metric-number format (eg, ROE-15 or ROA-13 or ROIC-7).

Source: CLSA

Transparency (18% weight)

Question number	Range of scores	Question	Guidelines
7	0,1	Does the company publish its full-year results within two months of the end of the financial year?	The formal regulation is three months for audited annual accounts in most markets, but two months is seen as good practice. Best practice is now one month or less
8	0, 0.25, 0.5, 0.75, 1	Are the financial reports clear and informative?	For every question below answered true take off 0.25 per question (which means four or more questions answered true will result in a score of 0): ❑ If over the past five years there has been occasion when the results announced lacked disclosure subsequently revealed as relevant; ie, restated accounts ❑ If key footnotes to the accounts are unintelligible ❑ If negative factors were downplayed when presenting company results which were important in assessing the business value ❑ If there is inadequate information on the below items: ■ revenue/profit split for different businesses ■ regions/countries ■ product lines ❑ If there is inadequate disclosure and/or inadequate provisions for contingent liabilities, NPLs or likely future losses ❑ If there is inadequate detail of group/related company transactions and the rationale ❑ If there is inadequate disclosure regarding 'other expenses' ❑ If there is an auditor qualification
9	0,1	Are the accounts free of controversial interpretations of IFRS or of dubious accounting policies?	Answer 'No' if you have any reason to believe any of the below are true: ❑ If the company has changed accounting policies, or adopted a controversial accounting practice which boosted its stated earnings ❑ If proforma or unaudited results statements are notably different from actual audited accounts ❑ If expenses have not been sufficiently 'disaggregated' as per IAS 1 ❑ If profits are consistently rising in the face of falling cashflow to the extent analysts are concerned about the number ❑ If the valuation of any assets (eg, biological assets such as forests) does not appear to have a sound basis
10	0,1	Does the company consistently disclose major and price-sensitive information punctually?	Answer 'No' if there have been cases in the past five years when the share price moved noticeably just before a material announcement or results release and in a direction which anticipated the announcement
11	0,1	Do analysts and investors have good access to senior management?	Good access implies accessibility soon after results are announced and timely meetings where analysts are given all relevant information and are not misled

Source: CLSA

Independence (18% weight)

Question number	Range of scores	Question	Guidelines
12		**Is there any reason to doubt the independence of the chairman?**	**Answer 'Yes' for following the circumstances:** ❑ **The chairman is a relative of the CEO and or senior executive and there is no established history of prioritising shareholders over family goals** ❑ **The chairman was formerly a long-term employee of the company and has no history of challenging management decisions (ie, he is only technically 'independent' due to the cooling-off prescriptions in the listing rules)** ❑ **The chairman is a government appointee and was clearly appointed for political reasons** ❑ **The chairman has a reputation for being a weak leader**
13	0,1	Does the company have an effective and independent audit committee?	Answer 'No' if you have any reason to believe any of the below are uncertain or false: ❑ The audit committee is chaired by a genuinely independent director and more than half its members are independent directors ❑ All members of the committee, including the independent directors, have financial expertise - and one member is a financial or accounting expert ❑ The committee membership also has a range of expertise in relevant industries or service sectors ❑ The committee meets regularly, well before board meetings, and communicates directly with internal auditors (this information, if it exists, should be in the audit committee report in the annual report) ❑ The audit committee report contains substantive information about the financial, accounting and risk issues it discussed during the year (ie, the report is not just a boilerplate description of its terms of reference, membership, director attendance statistics and so on)
14	**0,1**	**Has the company been involved in a scandal in the past five years which raises questions about the independence of external auditors?**	**For example, DSME's losses were delayed from being reporting for several years with auditor endorsement. It was later revealed by regulators, which forced auditors to admit their fault on the matter. Also, Toshiba overstated its operating profit over seven years due to overly aggressive management pressure.**
15	0, 0.5, 1	Do the independent nonexecutive directors on the board act in a genuinely independent way?	Here we are looking for analysts to provide their best assessment of the competence and substantive independence of the board. In the past five years has the company provided: 1 = positive evidence of specific action which shows a board has challenged management 0.5 = no negative evidence 0 = if the analyst has any concerns or is aware of negative behaviour Some examples of negative behaviours are: ❑ Approved transactions that analyst believe were unattractive ❑ Approved unreasonable remuneration packages ❑ Failed to take action when the competence of senior executives was questioned by outsiders
16	0, 0.25, 0.5, 0.75, 1	Does the company vote by poll at AGMs and EGMs for all resolutions and release detailed results the next day (where all votes including those through proxies are given their appropriate weight based on the percentages of shareholding, as opposed to a show of hands)?	Score the company based on how many of gold standard questions are answered 'Yes' Give a score of 1 for all 3 questions: 0.75 for having 2 out of 3 questions 0.5 for having 1 out of 3 questions 0.25 if you believe company is doing something on this topic 0 if you believe company is doing nothing Gold standard: 1. All votes are counted on each resolution, including both proxy votes (ie, sent in beforehand, usually from institutional investors) and any votes cast during the meeting (mostly by retail shareholders, but sometimes institutions as well) **2. The company engages an independent third party (eg, a law or accounting firm or share registrar) to scrutinise the vote count** 3. The company publishes the detailed results no later than one day after the meeting (detailed results = full disclosure of all votes - For, Against and Abstain - on each resolution, as well as a report on the number of shares eligible to vote at the meeting)
17	0,1	Does the board composition reflect an attempt to bring diverse talent and backgrounds to the board?	Answer 'No' if the independent directors are mainly retired executives or retired government officials, or if the board is all male

Source: CLSA

Responsibility (18% weight)			
Question number	Range of scores	Question	Guidelines
18	0,1	Can you confirm no one with a criminal conviction is sitting on the board or in a senior executive position in the company?	This excludes traffic offences and overtly political convictions
19	**0,1**	**Over the past five years, has the company engaged in any related-party transactions which harm the interests of noncontrolling shareholders?**	**Answer 'Yes' if the company engages in any of the following:** ❑ **Sourcing key materials from a related party, or using a related party which is not part of the listed group as a distribution channel (this does not include related-party transactions (RPT) which are not harmful to shareholder interests; RPTs are not necessarily bad if genuinely done at arm's length and free from conflicts of interest)** ❑ **Placing funds in deposit or for investments in a related parties which meet the following criteria:** ■ **Which are not part of the listed group** ■ **The annual report discussion of related-party transactions runs over two short paragraphs** ■ **The listed company has invested in businesses where the controlling shareholders have interests in the past three years** ❑ **However, the analyst should not consider the economic impact of such transactions as we are focusing on culture and behaviour, not materiality (any RPT which raises red flags should indicate a 'Yes' regardless of size)**
20	0,1	Is the controlling shareholder's primary financial interest the listed company?	Answer 'No' if the company is any of the following: ❑ A government-controlled entity ❑ A listed company where the ultimate shareholder(s) have various other business interests Note: if no controlling shareholder put Yes

Fairness (18% weight)			
Question number	Range of scores	Question	Guidelines
21	**0,1**	**Has there been any evidence of conflicts of interest on the board or among senior management in the past five years?**	**Answer 'Yes' if you have any reason to believe there were any of the following:** ❑ **Questionable inter-company transactions** ❑ **Management fees paid from the listed group to a parent company, or to a private company controlled by the major shareholders on the basis of revenues or profits** ❑ **Mergers or demergers took place which disadvantaged minorities**
22	**0,1**	**Has the company issued any securities which decouple voting rights from economic rights?**	**Answer 'Yes' if:** ❑ **Any classes of ordinary shares which disenfranchised their holders** ❑ **They issued any dual-class shares** ❑ **There has been any preferential access to or pricing of any securities which were not offered to all shareholders**
23	**0,1**	**Have there been any controversies/questions over whether share trading by board members, or placements by the company have been fair, fully transparent and well-intentioned?**	**Answer 'Yes' if any of the below are true:** ❑ **Announcements were made to the exchange after three working days** ❑ **Major shareholders did not reveal all transactions including those under nominee names** ❑ **It is believed that the parties related to the major shareholders involved in transactions were not disclosed to the exchange, or were accused of insider trading**
24	0,1	Is remuneration of the board and executive compensation fair?	Answer 'Yes' if any of the below is true: ❑ Is there a clear link between the company's fundamentals and remuneration? ❑ The company does not use asymmetric payoff structures such as long-dated options ❑ Is all remuneration immediately expensed and reported in detail within the primary accounts rather than as footnotes

Source: CLSA

Appendix 4: CLSA E/S questions by sector

Key E/S questions by sector

Sector	Key questions
Autos	What is the company's strategy regarding fuel efficiency and alternative transport? Has it established a good relationship with the workforce? What is its track record on product safety?
Capital goods	Does the company serve end markets that face risks or opportunities due to resource constraints? Does it provide solutions for environmental problems, or does it serve end markets at risk from regulation? How is it managing its safety record?
Conglomerates	How proactive is management's approach to sustainability/ESG? To what extent are the company's underlying operating assets at risk from sustainability/ESG issues? To what extent does sustainability/ESG provide opportunities for the company's underlying operating assets?
Consumer	How does the company ensure that its suppliers are using raw materials that are recycled or sustainably sourced as far as possible? How is it handling water issues across its value chain, from factory discharges to water access in raw-material supply? How does it ensure that its suppliers are not cutting corners in a way that could affect its reputation?
Financials	To what extent is the institution systemically important and how does it prudently manage its risks? How is the company positioned to meet the evolving needs of consumers in its target geographies, specifically for ageing consumers or where there is an emerging middle class? How does the institution manage sustainability/ESG-related risk in its credit processes?
Tech Hardware (Previously 'ICT)	To what extent is it investing in reducing its in-house energy use and managing water quality? What is its track record on worker safety and how does it ensure supply-chain standards? Does the company rely on critical raw materials that are at particular risk of supply disruption or ethical issues? (ie – Conflict minerals (Tin, Tantalum, Tungsten, Gold) or Cobalt or Rare Earth materials) If so, does the company adequately manage these risks?
Internet (Previously 'ICT')	How is the company managing the protection of customer data? Is the company taking steps to mitigate any social issues created by consumption of its services? If the company operates data centres: What is it doing to reduce its carbon footprint and ensure sufficient water supply? If the company does not operate data centres: Has it been involved in any major incidents?
Telcos (Previously 'ICT')	How is it managing the protection of customer data? What is the company doing to reduce its carbon footprint (most importantly, reducing cost at data centres) and ensure sufficient water supply (again, data centres)? How is the company's track record with interruptions, other performance issues?
Materials	How is the company ensuring it has sufficient access to raw materials, particularly access to water? How is it handling its relations with communities in its operating areas? What regulation is expected for pollution in the normal course of business and relating to violations? What steps is the company taking to manage pollution and how effective have these moves been?
Petrochems	Is the company maintaining its reserve-replacement ratio at more than one without dramatic increases in expenditure? Does it have uncontested access to its production areas? What is its track record on Occupational Health and Safety (OHS)/pollution?
Power	What is the company doing to mitigate environmental emissions and what are the implications for returns? How is it positioning itself in light of declining renewables cost curves? To what extent is the company at risk of regulation on price increases that reduce returns in order to provide an affordable supply?
Property	How do the company's buildings compare in terms of energy use per square metre to other facilities with a similar use? What sort of natural disaster risk does the company face? Does it take adequate measures to prevent losses from potential disasters? How does it ensure that contractors are minimising site-level environmental, health and safety violations?
Transport	How is the company managing energy- and carbon-related risks? What is its safety track record and what steps is the company taking to address passenger safety? How have the company's labour relations been relative to peers?

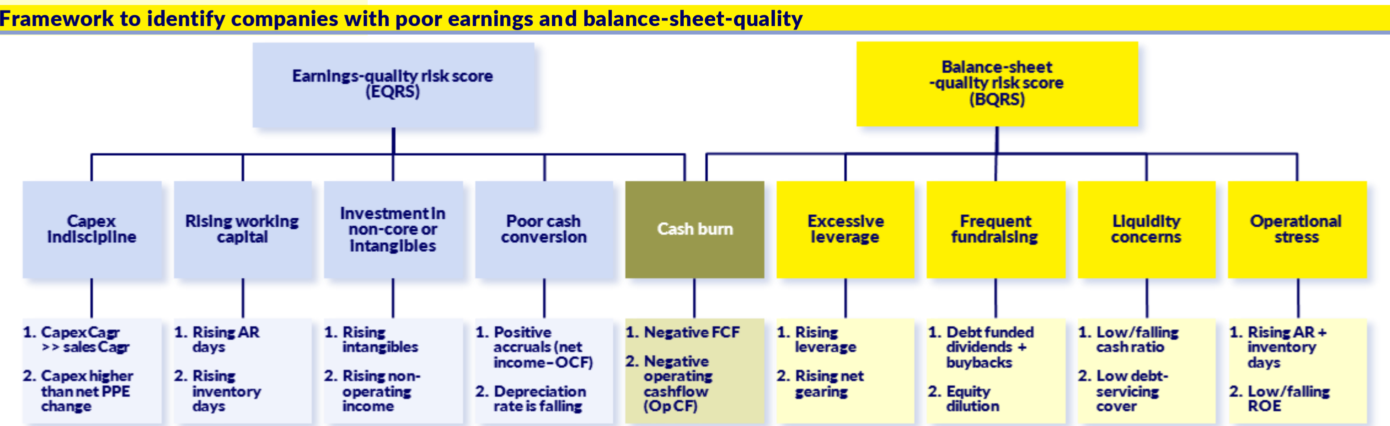
Source: CLSA, ARE

Scoring criteria explained

Appendix 5: Microstrategy EQRS and BQRS

Below we highlight the modified framework presented in our *Off to the races* report. This framework can be used globally and we have also developed a risk framework for the banks sector. The detailed criteria for the earnings and balance-sheet quality framework are as follows.

Framework to identify companies with poor earnings and balance-sheet-quality



Source: CLSA

Definition of factors we tested for (factors in bold used to calculate final risk scores)

Factor	Definition	Criteria[1]
Earnings-quality risk (EQRS) factors		
1. Capex >> sales Cagr	Last 3-year capex versus sales Cagr	3-year capex Cagr exceed sales Cagr by more than 5ppt
2. Capex > net PPE change	(Capex - change in net PPE - depreciation expense) as a % of assets	Positive number for the past two years
3. Negative FCF	Operating cashflow - capex	Negative FCF for the past two years
4. Negative operating cashflow	Operating cashflow	Negative operating cashflow (last year)
5. Intangibles (rising)	Intangible assets as a % of total assets	At a four-year peak
6. Depreciation rate (falling)	Depreciation as a % of net PPE	At a four-year trough
7. Accruals (% of sales)	(Net Income - operating cashflow) / Sales	Positive ratio for the past two years
8. AR days (rising)	Accounts receivable[2] * 365 / Sales	At a four-year peak
9. Inventory days (rising)	Inventory[2] * 365 / Cost of goods sold	At a four-year peak
10. Non-op income (rising)	Non-operating income as a % of sales	At a four-year peak
Balance-sheet-quality risk (BQRS) factors		
1. Negative FCF	Operating cashflow - capex	Negative FCF for the past two years
2. Negative operating cashflow	Operating cashflow	Negative operating cashflow (last year)
3. Leverage (High and rising)	Total assets to equity	Current leverage >2x and at a four-year peak
4. NDE (High and rising)	Net debt-to-equity	Current NDE >40% and at a four-year peak
5. Debt-funded dividends and buybacks	Debt issuance *100 / (Dividends + buybacks)	Current (dividend + buyback) payout more than 25% and funded entirely by debt for the past three years
6. Equity dilution	New equity issued as a % of total equity	New equity issuance for each of past three years >5%
7. Cash ratio (Low & falling)	Cash and equivalents / Current liabilities	Current cash ratio < 0.5x and at a four-year trough
8. Debt-servicing cover (low and falling)	Ebitda / (Short term debt + Interest expense)	Current debt-servicing cover < 1x and at a four-year trough, or is negative
9. AR + inventory days (rising)	(Account receivable * 365 / Sales) + (Inventory * 365 / Cost of goods sold)	At a four-year peak
10. ROE (low and falling)	Net income as a % of average shareholder equity	Current ROE less than 15% and at a four-year trough, or is negative

[1] We have introduced some buffers (see Appendix 2) to ensure that the conditions are not being met marginally and that the ratios can give a relevant signal.
[2] Average of the opening and closing balances. Source: Factset, CLSA

Appendix 6: Gender diversity listing requirements

Gender diversity policy

Country	Policy	Targets
Australia	A listed entity should establish a diversity policy, and the diversity policy or a summary of it should be disclosed. The policy should include requirements for the board or a relevant committee of the board to set measurable objectives for achieving gender diversity and to assess annually both the objectives and progress in achieving them.	The Australian Institute of Company Directors (AICD) set a target of 30% for female serving on all boards, and indicated that ASX 200 companies should reach the target by 2018.
India	At least one woman director on the board of directors of every listed entity.	Committee on Corporate Governance recommends that every listed entity have at least one independent woman director on its board of directors.
Malaysia	The board discloses in its annual report the company's policies on gender diversity, its targets and measures to meet those targets.	For Large Companies, the board must have at least 30% women directors (Large Companies are: Companies on the FTSE Bursa Malaysia Top 100 Index; or Companies with market capitalisation of RM2 billion and above). *
Singapore	The board diversity policy and progress made towards implementing the board diversity policy, including objectives, are disclosed in the company's annual report.	Singapore's Diversity Action Committee ("DAC") announced a triple-tier target of increasing women's participation on boards of all companies listed on SGX to 20% by 2020, 25% by 2025 and 30% by 2030.
Japan	The board should be well balanced in knowledge, experience and skills in order to fulfill its roles and responsibilities, and it should be constituted in a manner to achieve both diversity, including gender and international experience, and appropriate size.	na
Taiwan	The composition of the board of directors shall be determined by taking diversity into consideration. Basic requirements and values are Gender, age, nationality and culture.	na
Philippines	The Board should have a policy on board diversity. A board diversity policy is not limited to gender diversity. It also includes diversity in age, ethnicity, culture, skills, competence and knowledge. On gender diversity policy, a good example is to increase the number of female directors, including female independent directors.	na
Hong Kong	The diversity policy and the progress made towards meeting the measureable objective in the policy must be disclosed in the corporate governance report.	na
China	na	na
Indonesia	na	na
Thailand	na	na
Korea	na	na

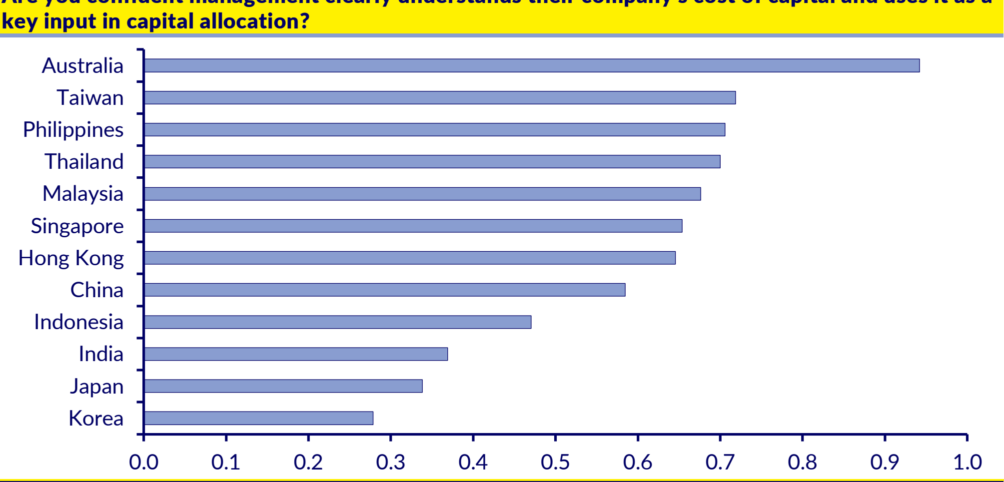
Note: * required, not recommended. Source: CLSA, exchange websites

Appendix 7: CLSA scores on key questions

Below, see aggregate answers to some key questions by market.

Q2: Australia (good) and Korea (bad) remain the standouts for capital management

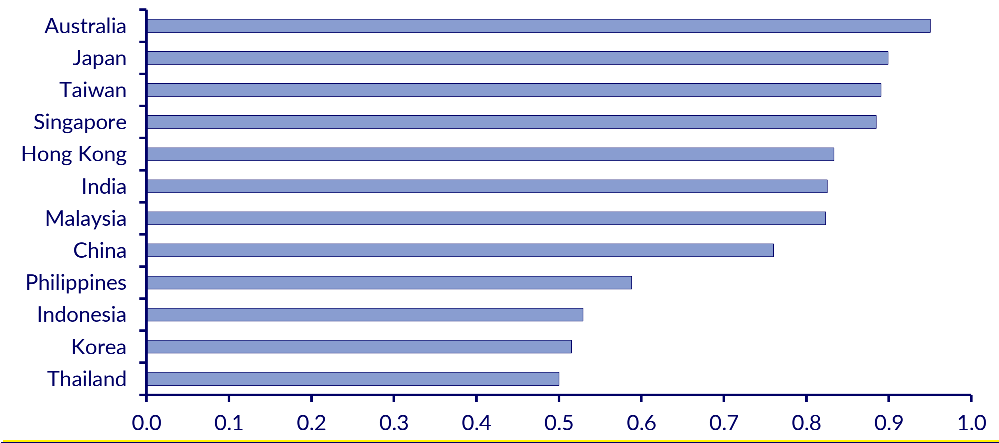
Are you confident management clearly understands their company's cost of capital and uses it as a key input in capital allocation?



Source: CLSA

Q19: Thailand, Korea and Indonesia are most problematic for related party transactions

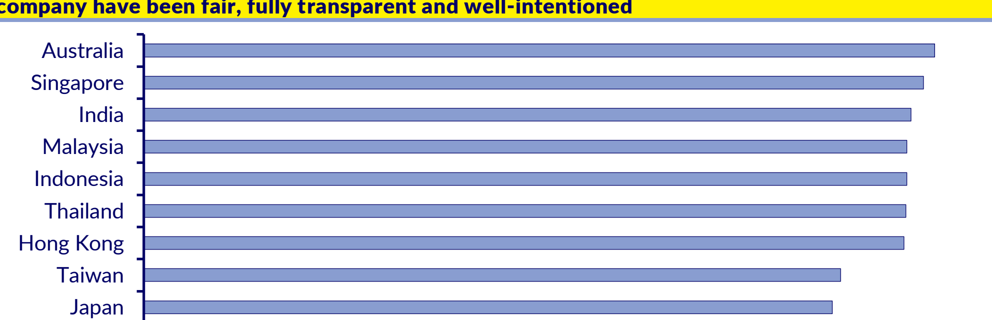
Over the past five years, the company engaged in no related-party transactions which harm the interests of non-controlling shareholders



Source: CLSA

Q23: Controversies over share placements and trading abound in Korea and the Philippines

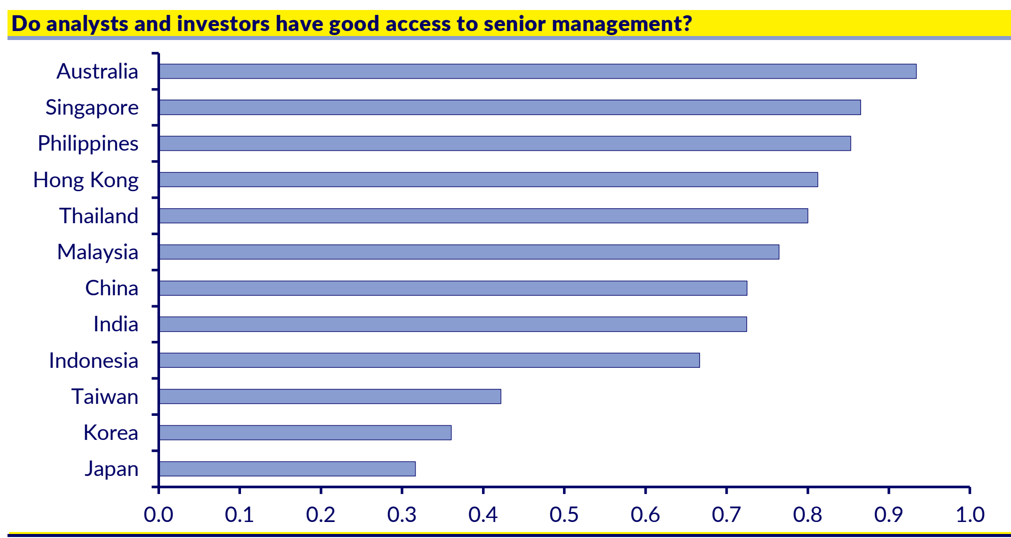
No controversies/questions over whether share trading by board members, or placements by the company have been fair, fully transparent and well-intentioned



Source: CLSA

Q11: Access to senior management lags in North Asia

Do analysts and investors have good access to senior management?



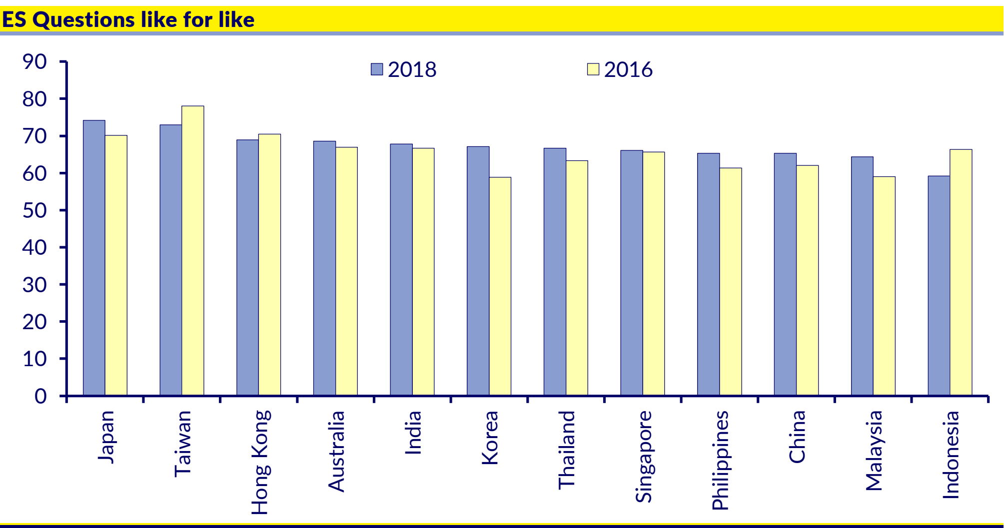
Source: CLSA

Like for like

This year we cut our number of E/S questions form 20-25 questions, depending on sector, to 8-10 questions per sector. Most countries were within +/-5% of previous score, but there was clearly some impact from the change. If we had not changed the number of questions, the scores would have moved as follows:

We decreased no. of ES questions this year, with minimal impact on scores

ES Questions like for like

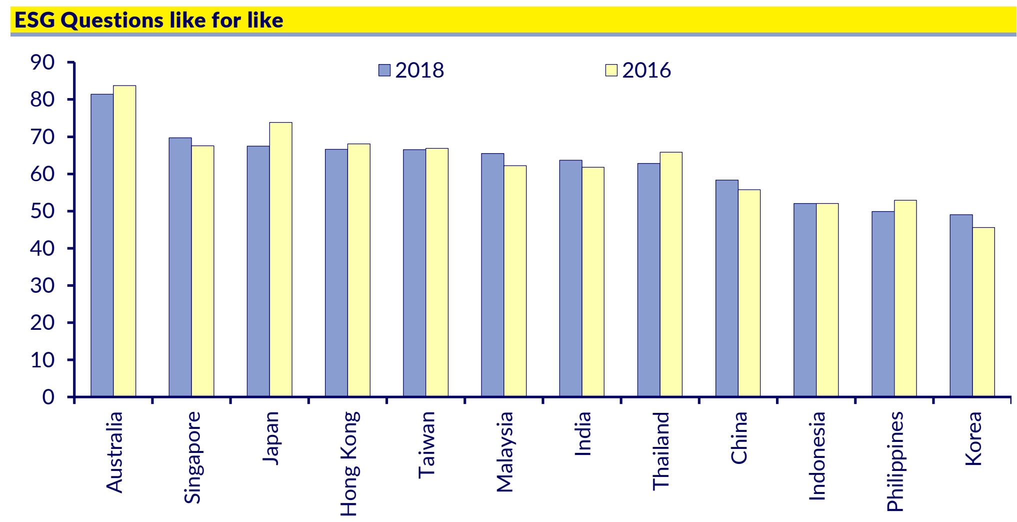


Source: CLSA

Likewise, the 2016 ESG scores used in like for like analysis are based on old CG scores which we did not make changes and new E/S scores which we recalculate based on constant questions. There would be no impact to rankings.

Most countries are within +5% /-5% changes

ESG Questions like for like



Source: CLSA

Appendix 8: Data screens for CLSA CG scores

In the main body of the report, we illustrate how we use some data points to engage with analysts on specific questions. This process will continue to evolve with the quality and availability of data. Below, we highlight some more examples we are using currently.

Q14: Audit fees

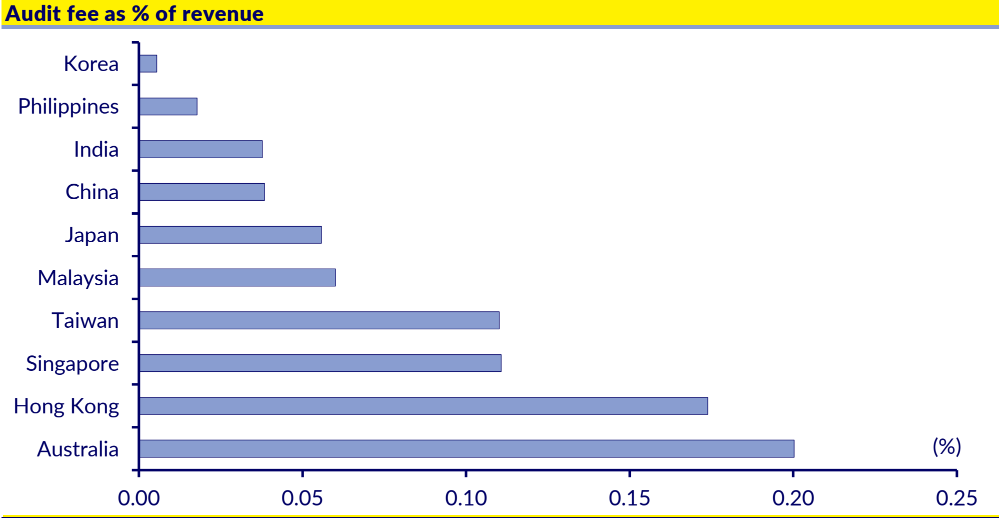
As Melvin Glapion wrote in our 2017 CLSA-U report *Beyond the spin*: 'External auditors play a central role in maintaining the integrity of financial statements. They are, in many instances, specifically tasked with looking out for fraud and manipulation, and in certain jurisdictions legally required to report suspicions of fraudulent accounting.'

Melvin went on to describe risks related to external auditors as well as a number of key metrics relating to auditors for fraud detection. We focus on one of them: audit fees as % of revenue. Unusually low fees could indicate that a company is trying to starve the auditor, providing insufficient resources for a thorough search of the books. Unusually high fees could also be a problem. Audit remuneration items reported in the annual financial statements is comprised of the statutory audit fees paid to auditors and other consulting fees. The 'other fees' item is where companies could potentially utilise to influence external auditors' opinions.

Amongst our coverage, audit fees range from an average of 0.2% for Australia all the way down to 0.01% in Korea.

Lack of data of Thailand and Indonesia market

Audit fee as % of revenue



Note: FY17 revenue and audit fees; market size: Australia: 135; Japan: 176; China: 173; India: 83; Hong Kong: 56; Singapore: 47; Malaysia: 46; Philippines: 10; Taiwan:1, Korea:1, Thailand: 0, Indonesia:0. Source: CLSA

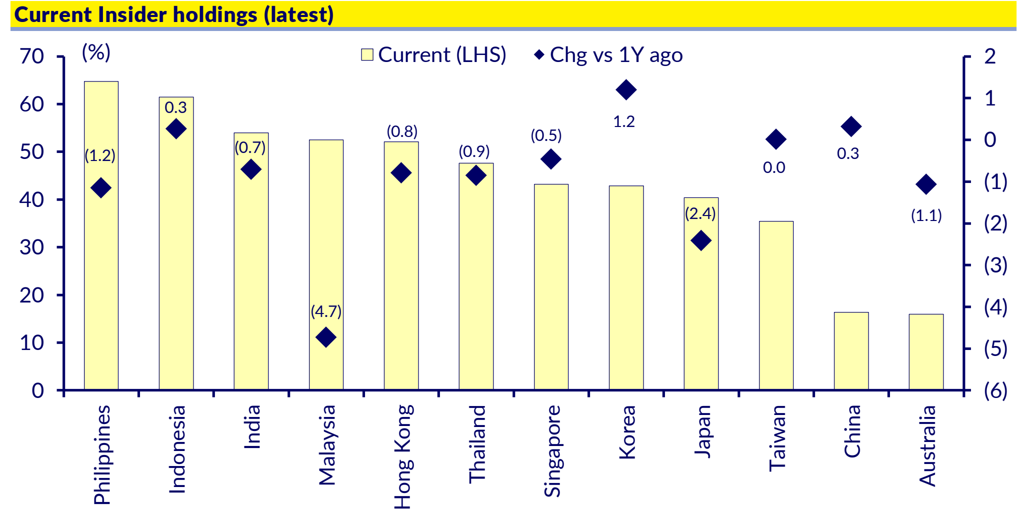
We highlighted companies for which audit fees as a % of revenue is 50% more or less than the country average to analysts for consideration in answering Q14, which questions the independence of external auditors.

Insider holdings and its change: no direct survey link, but important

Insiders still hold a large share of the listed equities across Asia, with 35-65% across most markets. The outliers are Australia, which better matches developed markets globally, and China, for which a number of SOE's pass under Factset's radar undetected.

Percentage of insider holdings and change vs 1Y ago

Current Insider holdings (latest)



Source: CLSA, Factset

Changes in insider holdings have a relatively weak direct link to our CG Survey, and data coverage is spotty (444 companies out of our coverage). We highlight the metric to relevant analysts and include it here, though, because sell-downs by insiders can serve as a powerful warning signal.

From CLSA's Microstrategy team

Appendix 9: Overlap between CLSA and S-Ray

A comparison of the CLSA and S-Ray ESG data showed that there could be some differences between the two set of scores. Indeed, given the different coverage universe (in terms of size), only 237 stocks were common between CLSA and S-Ray ESG database (Note: Current overlap is much higher). However, stocks that were in the bottom quintile of CLSA scores, broadly underperformed even if they were in the top quintile based on S-Ray data. In contrast, stocks in the bottom quintile of S-Ray but within the top quintile based on CLSA scores outperformed.

Asia Pac: Count of stocks with overlapping scores

Count of stocks		CLSA ESG score					
		Q1	Q2	Q3	Q4	Q5	Total
S-Ray ESG score	Q1	18	17	11	15	10	**71**
	Q2	16	8	12	17	6	**59**
	Q3	4	13	3	8	14	**42**
	Q4	7	5	7	8	7	**34**
	Q5	5	1	7	6	12	**31**
	Total	**50**	**44**	**40**	**54**	**49**	**237**

Asia Pac: OPF of stocks with overlapping scores (vs universe)

OPF vs overlapped universe		CLSA ESG score				
		Q1	Q2	Q3	Q4	Q5
S-Ray ESG score	Q1	1.8	1.7	0.5	(0.5)	(4.8)
	Q2	1.4	6.0	2.1	(1.6)	(4.2)
	Q3	(0.1)	5.1	2.4	3.7	0.9
	Q4	3.0	(1.9)	6.8	(6.9)	(2.4)
	Q5	2.4	1.9	(12.2)	(1.2)	(6.5)

Note: Universe is broader Asia Pacific companies. Current S-Ray and CLSA ESG scores as well as at least last three years quarterly historical S-Ray scores and US-dollar total return have to be available. Q1 = highest; Q5 = lowest. Higher score the better. OPF is based on L5Y equal-weighted US-dollar total return.
Source: Factset, Arabesque S-Ray, CLSA

Appendix 10: Acronyms

CG acronyms

ACGA	The Asian Corporate Governance Association
BNEF	Bloomberg New Energy Finance
CDP	Carbon Disclosure Project
CG	Corporate governance
DCS	Dual-class shares
ESG	Environmental, social, governance
ETF	Exchange traded fund
FAIRR	The Farm Animal Investment Risk and Return
GFC	Green Finance Committee
GHG	Greenhouse gas
GRI	Global Reporting Initiative
HKGFA	Hong Kong Green Finance Association
IEEFA	The Institute for Energy Economics and Financial Analysis
IPCC	UN Intergovernmental Panel on Climate Change
IPE	The Institute of Public & Environmental Affairs
OECD	The Organisation for Economic Co-operation and Development
PRI	Principles for Responsible Investment
RTO	Reverse takeovers
SASB	Sustainable Accounting Standards Board
SOE	State-owned enterprise
SRI	Socially Responsible Investment
TCFD	The task force on climate change

Source: CLSA

Companies mentioned

7-Eleven (SEM MK - RM1.29 - SELL)
AAC (2018 HK - HK$54.95 - SELL)[1]
Aboitiz (N-R)
AIA (1299 HK - HK$64.35 - O-PF)[1]
Air Products (N-R)
Airports of Thailand (AOT TB - BT64.8 - SELL)
AIS (ADVANC TB - BT178.0 - BUY)[1]
Alibaba (BABA US - US$156.28 - BUY)
Alliance Select Food (N-R)
Allianz (N-R)
Amcor (AMC AU - A$13.34 - U-PF)[1]
AMMB (N-R)
Anbang (N-R)
Anta Sports (2020 HK - HK$36.15 - BUY)[1]
ANZ Bank (ANZ AU - A$26.96 - U-PF)[1]
AP Thailand (AP TB - BT7.0 - BUY)[1]
Asahi Group (2502 JP - ¥4,846 - BUY)[1]
Asia Coal (N-R)
Asia Orient (N-R)
Asian Paints (APNT IS - RS1,350.3 - BUY)
Askul (N-R)
ASM Pacific (522 HK - HK$78.40 - SELL)[1]
Astra (ASII IJ - RP8,400 - BUY)[1]
Asustek (2357 TT - NT$217.0 - U-PF)[1]
ASX (ASX AU - A$61.08 - U-PF)
Atlanta Ltd (N-R)
AUO (2409 TT - NT$12.7 - SELL)[1]
Aurizon (AZJ AU - A$4.21 - BUY)[1]
Avic Holding (N-R)
Axiata (AXIATA MK - RM3.63 - BUY)
Axis Bank (AXSB IB - RS630.4 - BUY)
Ayala Corp (AC PM - P945.00 - BUY)[1]
Ayala Land (ALI PM - P40.90 - BUY)[1]
Baidu (BIDU US - US$188.44 - BUY)
Baiyao - A (N-R)
Bandhan Bank (N-R)
Bangkok Bank (BBL TB - BT210.0 - BUY)[1]
Bank Central Asia (BBCA IJ - RP25,500 - BUY)[1]
Bank Mandiri (BMRI IJ - RP7,450 - BUY)[1]
Bank Negara (BBNI IJ - RP8,650 - O-PF)[1]
Bank Negara (N-R)
Bank of Ayudhya (N-R)
Bank of Nanjing (N-R)
Bank Rakyat (BBRI IJ - RP3,600 - U-PF)[1]
Banpu (BANPU TB - BT16.8 - BUY)
Baosteel (N-R)
BAT Malaysia (ROTH MK - RM36.60 - SELL)[1]
BBMG (N-R)
BDO Unibank (BDO PM - P130.20 - O-PF)[1]
BE Water (371 HK - HK$4.53 - BUY)
BeiGene (6160 HK - HK$84.55 - BUY)[1]
Bharat Petro (BPCL IB - RS329.6 - SELL)
BHP (BHP AU - A$30.61 - O-PF)[1]
Bhushan Steel (N-R)
BLA (N-R)
BLA (N-R)
Boya Bio-Pharmaceutical Group (N-R)
BP (N-R)
BPI (BPI PM - P93.95 - BUY)[1]
BPI-Philam Life (N-R)
Bursa Malaysia (N-R)
C.P. Lotus Corp (N-R)
Calata Corp (N-R)
Canvest (1381 HK - HK$4.02 - BUY)
CapitaLand (CAPL SP - S$3.15 - BUY)[1]
CBA (CBA AU - A$72.09 - O-PF)[1]
CCB (939 HK - HK$6.67 - BUY)
CDB (N-R)
Cheil Industries (N-R)
China Baoneng Grp (N-R)
China Beidahuang Ltd (N-R)
China Coal (N-R)
China Dev Bank (N-R)
China Education (839 HK - HK$11.00 - BUY)[1]
China Internet Nationwide Fin Services (N-R)
China Life - A (601628 CH - RMB21.48 - SELL)
China Life (2628 HK - HK$16.80 - U-PF)
China Med & Health (N-R)
China Merchants fund (N-R)
China Railway Ltd (N-R)
China Resources Group (N-R)
China Shipping Development (N-R)
China Unicom (762 HK - HK$9.07 - BUY)
China Unicom BVI (N-R)
China Unicom Group BVI (N-R)
Ching-Fu Shipbuilding (N-R)
Chongqing Iron (N-R)
CIMB (CIMB MK - RM5.70 - BUY)[1]
CITIC (N-R)
CITIC Pacific (N-R)
Citic Resources (N-R)
CITIC Securities (N-R)
City Developments (CIT SP - S$8.55 - BUY)[1]
CLP (2 HK - HK$88.90 - SELL)[1]
CLPPC (N-R)
Colgate India (CLGT IB - RS1,231.8 - BUY)
ComfortDelGro (CD SP - S$2.09 - O-PF)
COTA Commercial Bank (N-R)
CP All (CPALL TB - BT68.5 - BUY)
CP Foods (CPF TB - BT25.5 - BUY)[1]
CR Land (1109 HK - HK$29.00 - O-PF)[1]
Credit China (N-R)
Cromwell (CMW AU - A$1.03 - U-PF)[1]
CRRC (1766 HK - HK$7.30 - BUY)

CSI Properties (N-R)
CSL (CSL AU - A$179.50 - BUY)[1]
CSPC Pharma (1093 HK - HK$16.16 - U-PF)[1]
CYBG (CYB AU - A$3.64 - BUY)[1]
Dabur (DABUR IS - RS420.9 - BUY)[1]
Daelim (000210 KS - ₩94,800 - O-PF)
Daewoo E&C (047040 KS - ₩4,970 - U-PF)
Daeyang Electric (N-R)
Dairy Farm (DFI SP - US$8.85 - O-PF)
Datapulse Technology (N-R)
DBS (DBS SP - S$23.70 - BUY)[1]
Denway Motors Ltd (N-R)
Detai New Energy (N-R)
Didi (N-R)
Digi (DIGI MK - RM4.24 - U-PF)
Dr Reddy's (N-R)
DSME (N-R)
DTXS Silk Road Ltd (N-R)
Edelweiss Financial Services (N-R)
Egco (EGCO TB - BT235.0 - BUY)[1]
Eicher Motors (EIM IS - RS23,807.5 - BUY)[1]
Eisai (N-R)
Emami (HMN IS - RS435.6 - BUY)
e-Seikatsu (N-R)
Everbright (257 HK - HK$6.84 - BUY)
Evergrande (N-R)
Ezaki Glico (2206 JP - ¥5,490 - BUY)[1]
Facebook (N-R)
Far East Ltd (N-R)
Far Eastern Air Transport (N-R)
Far EasTone (4904 TT - NT$72.5 - U-PF)
Farglory Group (N-R)
FCT (FCT SP - S$2.16 - U-PF)[1]
FGV (N-R)
Founder Securities (N-R)
Fourth Dimension Solutions (N-R)
FSE Services Grp (N-R)
Fullshare (N-R)
Gail (GAIL IB - RS339.6 - BUY)
GBPC (N-R)
Geely (N-R)
Genting Singapore (GENS SP - S$0.97 - BUY)
GF Securities (N-R)
GIC Private Limited (N-R)
GLEDC (N-R)
Global Mastermind (N-R)
Globe Telecom (GLO PM - P2,000.00 - U-PF)[1]
GMG Global (N-R)
Godrej Consumer (GCPL IB - RS746.0 - O-PF)
Goodman (GMG AU - A$10.70 - O-PF)[1]
GrainCorp (GNC AU - A$7.63 - SELL)[1]
Gree (000651 CH - RMB37.07 - SELL)
Greentown China (N-R)
Group Lease (N-R)
GSK Consumer (SKB IS - RS7,209.1 - BUY)
Guoxin Securities (N-R)
Gwangju Shinsegae (N-R)
Haitong Securities (N-R)
Hang Seng Bank (11 HK - HK$180.60 - U-PF)
Hanon Systems (018880 KS - ₩10,450 - BUY)[1]
Hanung Toys (N-R)
Hap Seng Cons (N-R)
HDC Hyundai Dev (294870 KS - ₩42,000 - BUY)
HDFC Bank (HDFCB IB - RS2,130.0 - BUY)
Hengrui Medicine (600276 CH - RMB62.51 - U-PF)[1]
Hikvision (002415 CH - RMB25.72 - BUY)[1]
Hindustan Petro (HPCL IB - RS242.9 - SELL)
Hitachi Hi-Tech (N-R)
HK Exchanges (388 HK - HK$228.20 - BUY)[1]
HK Life Sciences (N-R)
HKBridge Financial (N-R)
HKC(Holdings) Ltd (N-R)
HKSCC Nominees (N-R)
Hodogaya Chemical (N-R)
HomePro (HMPRO TB - BT15.2 - SELL)[1]
Honda Motor (7267 JP - ¥3,205 - BUY)[1]
Honghua (N-R)
Hoya (7741 JP - ¥6,900 - O-PF)
HSBC (5 HK - HK$67.10 - BUY)[1]
Huarong Asset Mgmt (N-R)
Huatai (N-R)
Huishan Dairy (N-R)
HUL (N-R)
Hulic (N-R)
Huons (N-R)
Hyflux (N-R)
Hysan Dev (14 HK - HK$38.85 - U-PF)[1]
Hyundai dep store (N-R)
Hyundai Green Food (N-R)
Hyundai Heavy (009540 KS - ₩132,000 - BUY)
Hyundai Livart (N-R)
Hyundai Motor (005380 KS - ₩101,000 - O-PF)
IAG (N-R)
ICBC (1398 HK - HK$5.56 - BUY)
Ichigo (2337 JP - ¥384 - BUY)[1]
ICICI Bank (ICICIBC IB - RS362.2 - BUY)
IDBI Bank (N-R)
IHH (IHH MK - RM4.92 - U-PF)[1]
IL&FS (N-R)
IMF Bentham (N-R)
Inari (INRI MK - RM1.60 - BUY)[1]
Indian Oil (IOCL IB - RS134.8 - SELL)
Infosys (INFO IB - RS637.0 - BUY)[1]
Inox Wind (N-R)
iQIYI (IQ US - US$19.92 - BUY)
IRPC (IRPC TB - BT6.0 - U-PF)[1]

ITC (ITC IB - RS287.4 - BUY)
Japan Exchange (N-R)
Japfa Comfeed (N-R)
Jasa Marga (JSMR IJ - RP4,000 - U-PF)[1]
JD United Holdings (N-R)
JD.com (JD US - US$20.84 - U-PF)[1]
Jollibee (JFC PM - P283.00 - BUY)[1]
Jubilant Food (JUBI IN - RS1,226.1 - BUY)
Kagome (N-R)
Kakao (035720 KS - ₩110,500 - SELL)[1]
Kalbe Farma (KLBF IJ - RP1,570 - U-PF)[1]
Kansai Nerolac (KNPL IN - RS460.9 - U-PF)[1]
Kansai Nerolac (KNPL IN - RS463.4 - U-PF)
KB Financial (105560 KS - ₩47,200 - U-PF)
KB Insurance (N-R)
KC (N-R)
KC Tech (N-R)
KDDI (9433 JP - ¥2,647 - BUY)[1]
Kenedix (4321 JP - ¥535 - BUY)[1]
Kepco (N-R)
Keppel Corp (KEP SP - S$6.15 - BUY)
KFM Kingdom Ltd (N-R)
King Yuan (2449 TT - NT$20.8 - SELL)[2]
Kingston Financial (N-R)
Kitz (6498 JP - ¥972 - BUY)
Koh Young Tech (098460 KQ - ₩83,800 - BUY)[1]
Koken (N-R)
Kolon Industries (120110 KS - ₩53,600 - O-PF)[1]
Komatsu (6301 JP - ¥3,033 - BUY)
Korea Airport Service (N-R)
Kotak Bank (KMB IB - RS1,210.2 - BUY)
Krung Thai Bank (KTB TB - BT20.2 - U-PF)
Kuang-chi (N-R)
Kubota (6326 JP - ¥1,848 - BUY)[1]
Kubota Pharmaceutical Holdings (N-R)
Kyowa Kirin (N-R)
Lamtex (N-R)
Largan (3008 TT - NT$3,485.0 - BUY)[1]
Leighton Asia (N-R)
Lerado (N-R)
LG (003550 KS - ₩72,400 - BUY)[1]
LG Display (034220 KS - ₩17,550 - U-PF)
LIC of India (N-R)
Lifenet Insurance (N-R)
L'Occitane (973 HK - HK$14.64 - O-PF)[1]
Lotte Chemical (011170 KS - ₩272,500 - BUY)
Lotte Chemical Titan (N-R)
Lotte Corporation (N-R)
Macquarie (MQG AU - A$115.04 - BUY)[1]
Mahindra (MM IB - RS752.4 - BUY)[1]
Malaysia Airports (MAHB MK - RM7.67 - O-PF)
Man Wah (1999 HK - HK$3.38 - BUY)[1]
Manpasand Beverages (N-R)
Manulife Reit (MUST SP - US$0.77 - O-PF)[1]
Marico (MRCO IB - RS364.6 - BUY)[1]
Mariveles Power Generation Corp (N-R)
Maruha Nichiro (N-R)
Matrix Hlds (N-R)
Matsui Securities (N-R)
Matsumotokiyoshi (3088 JP - ¥4,240 - BUY)[1]
Maxis (MAXIS MK - RM5.40 - SELL)[1]
Maybank (MAY MK - RM9.40 - O-PF)[1]
Maynilad Water (N-R)
MediaTek (2454 TT - NT$232.0 - U-PF)[1]
Mega FHC (N-R)
Mega International Commercial Bank (N-R)
Megawide (MWIDE PM - P18.20 - BUY)
Meituan (N-R)
Mengniu Dairy (2319 HK - HK$23.95 - BUY)[1]
Meralco (N-R)
Merrill Lynch International (N-R)
Metcash (MTS AU - A$2.82 - SELL)[1]
Metro Pacific (MPI PM - P4.70 - U-PF)
Metrobank (MBT PM - P74.60 - BUY)
Minsheng (1988 HK - HK$5.78 - SELL)
Mirvac (MGR AU - A$2.19 - O-PF)
Mitra Keluarga (MIKA IJ - RP1,590 - SELL)
Mitsubishi UFJ Trust and Banking Corporation (N-R)
Mizuho Bank (N-R)
MMC (7211 JP - ¥696 - O-PF)
Mobis-Glovis (N-R)
MTR (66 HK - HK$40.60 - O-PF)
MUFG (N-R)
NAB (NAB AU - A$24.91 - O-PF)[1]
Namyang Dairy (N-R)
Naver (035420 KS - ₩125,000 - BUY)[1]
Nestle India (NEST IB - RS10,603.5 - BUY)
New Higher Edu (2001 HK - HK$4.21 - BUY)[1]
New Hope Liuhe (N-R)
Newcrest Mining (NCM AU - A$20.75 - O-PF)
Newton Resources (N-R)
NEXTDC (NXT AU - A$5.97 - BUY)[1]
NH Foods (N-R)
NHPC (N-R)
Nifco (7988 JP - ¥2,895 - BUY)
Nissan Motor (7201 JP - ¥994 - O-PF)
Noble Group (N-R)
NTPC (NTPC IS - RS142.2 - BUY)
NTT (9432 JP - ¥4,680 - BUY)
NTT Urban (N-R)
OCBC (OCBC SP - S$11.13 - BUY)[1]
Oil & Natural Gas (ONGC IB - RS140.8 - BUY)
Oil Search (OSH AU - A$7.21 - BUY)[1]
Oki Electric Industry (N-R)
Olam (N-R)
Pace Development (N-R)

Panasonic (6752 JP - ¥1,164 - O-PF)
Pangilinan (N-R)
Panin Bank (N-R)
PBS (N-R)
PC Jewellers (N-R)
PEDC (N-R)
Pegatron (4938 TT - NT$51.3 - U-PF)[1]
Persistent Systems (PSYS IN - RS564.9 - BUY)[1]
Persol (2181 JP - ¥1,947 - BUY)[1]
Petrobras (N-R)
PetroChina (857 HK - HK$5.49 - BUY)
Petronas Chemicals (PCHEM MK - RM9.20 - O-PF)
Petronas Gas (PTG MK - RM18.94 - U-PF)
PEWC (N-R)
Philippie AXA Life (N-R)
PICC Group (1339 HK - HK$3.37 - U-PF)
Ping An (2318 HK - HK$75.25 - O-PF)[1]
PLDT (TEL PM - P1,176.00 - O-PF)[1]
PNB (PNB IB - RS69.7 - SELL)
Pola Orbis (4927 JP - ¥3,230 - BUY)[1]
Powerchip (N-R)
Prakit (N-R)
Pratibha (N-R)
President Chain Store (2912 TT - NT$322.5 - U-PF)[2]
PTT (PTT TB - BT49.2 - BUY)
PTT E&P (PTTEP TB - BT128.5 - BUY)[1]
PTTGC (PTTGC TB - BT77.2 - BUY)[1]
Public Bank (PBK MK - RM24.80 - O-PF)[1]
Q Technology (1478 HK - HK$4.57 - SELL)
QBE (N-R)
Quanta (2382 TT - NT$49.5 - U-PF)[1]
Raj Rayon Industries (N-R)
Ramsay Health Care (RHC AU - A$54.32 - BUY)[1]
REC (N-R)
Regal Hotels (N-R)
Reliance Petroleum (N-R)
Renault (N-R)
Resona Bank (N-R)
Rio Tinto (RIO AU - A$72.00 - O-PF)[1]
Rolls-Royce (N-R)
Roo Hsing (N-R)
Ryohin Keikaku (7453 JP - ¥30,400 - BUY)[1]
S&T Corporation (N-R)
Sa Sa (178 HK - HK$3.19 - BUY)[1]
Sahaviriya Steel (N-R)
SAIC (N-R)
Sakura Internet (N-R)
Samsonite (1910 HK - HK$22.95 - BUY)[1]
Samsung C&T (028260 KS - ₩102,500 - BUY)
Samsung Electronics (005930 KS - ₩41,850 - BUY)
Samsung Eng (028050 KS - ₩17,850 - O-PF)[1]
Samsung Group (N-R)
Samsung Securities (N-R)
Sanyou Chem (N-R)
Sapura Energy (N-R)
Sarana Menara (TOWR IJ - RP510 - BUY)[1]
Scentre (SCG AU - A$4.06 - O-PF)[1]
Secom (N-R)
Security Bank (SECB PM - P159.00 - BUY)[1]
Semen Indonesia (SMGR IJ - RP12,025 - O-PF)
Semirara (SCC PM - P26.20 - BUY)
Shanghai Pharma (2607 HK - HK$19.08 - BUY)[1]
Shenhua (1088 HK - HK$17.38 - BUY)
Shenzhen Expway (N-R)
Shenzhen Metro (N-R)
Shiga Bank (N-R)
Shimano (7309 JP - ¥15,910 - BUY)[1]
Shinhan (055550 KS - ₩42,400 - BUY)[1]
Shinsegae (004170 KS - ₩291,000 - U-PF)
Shiseido (4911 JP - ¥7,406 - BUY)[1]
Shuanghui (N-R)
Siam Cement (SCC TB - BT440.0 - BUY)[1]
Siam Commercial Bank (SCB TB - BT136.5 - O-PF)
Sime Darby Plantation (SDPL MK - RM4.70 - U-PF)
Singapore Exchange (SGX SP - S$7.23 - U-PF)[1]
SingPost (SPOST SP - S$0.98 - SELL)
Singtel (ST SP - S$3.11 - BUY)[1]
SinoPac Holdings (N-R)
Sinopec (386 HK - HK$6.65 - BUY)
SJM (880 HK - HK$7.23 - U-PF)[1]
SJM Hlds (N-R)
SJVN (N-R)
SK Holdings (034730 KS - ₩273,000 - BUY)[1]
SK Hynix (000660 KS - ₩69,600 - BUY)
SM Investments (SM PM - P915.00 - SELL)[1]
SM Prime (SMPH PM - P34.40 - SELL)[1]
S-Oil (010950 KS - ₩106,500 - U-PF)[1]
South China Asst Ltd (N-R)
South32 (S32 AU - A$3.11 - O-PF)[1]
SPD Bank (N-R)
Sri Adhikari Brothers TV Network (N-R)
SSI Group Inc (N-R)
St Raphael Power Generation Corp (N-R)
Stamford Land (N-R)
Standard Chartered (2888 HK - HK$62.30 - BUY)[1]
Subaru (7270 JP - ¥2,604 - BUY)[1]
Sumitomo Mitsui (N-R)
Sun Life of Canada (Philippines) (N-R)
SunCon (SCGB MK - RM1.53 - SELL)[1]
Suning (N-R)
Sunny Optical (2382 HK - HK$75.40 - BUY)[1]
Suntory B&F (2587 JP - ¥4,710 - U-PF)[1]
Super Retail (SUL AU - A$7.59 - BUY)[1]
Surana Industries (N-R)
Suruga Bank (N-R)
Swellfun (600779 CH - RMB28.31 - BUY)[1]

Sydney Airport (SYD AU - A$6.82 - U-PF)[1]
Taiping Insurance (966 HK - HK$25.65 - O-PF)[1]
Taishin Financial Holdings (N-R)
Taiwan Mobile (3045 TT - NT$109.5 - O-PF)[2]
Taiyo Bussan Kaisha (N-R)
Takeda Pharma (4502 JP - ¥4,180 - BUY)[1]
TAL Edu (TAL US - US$28.10 - BUY)[1]
Target Insurance Ltd (N-R)
Tata Chemicals (N-R)
Tata Consultancy (TCS IB - RS1,888.3 - BUY)[1]
Tata Group (N-R)
Tata Motors (TTMT IB - RS177.3 - SELL)
Tata Sons (N-R)
Tata Steel (TATA IB - RS533.5 - BUY)
Telecom Malaysia (N-R)
Telstra (TLS AU - A$2.95 - U-PF)[1]
Temasek (N-R)
Tenaga (TNB MK - RM14.72 - BUY)[1]
Tencent (700 HK - HK$312.00 - BUY)
Thai Airways (THAI TB - BT14.6 - SELL)
Thai Oil (TOP TB - BT73.8 - BUY)[1]
Thai Union (TU TB - BT18.3 - BUY)[1]
Ting Hsin Oil and Fat Industrial Co (N-R)
Titan (TTAN IB - RS914.0 - SELL)[1]
Toshiba (6502 JP - ¥3,665 - O-PF)
Towa (N-R)
Tower Bersama (TBIG IJ - RP4,000 - BUY)[1]
Toyota Motor (7203 JP - ¥6,927 - BUY)[1]
Transurban (TCL AU - A$11.52 - BUY)[1]
Treasury Wine (TWE AU - A$14.15 - BUY)
Trek 2000 (N-R)
Tsingtao (168 HK - HK$30.75 - U-PF)[1]
TSMC (2330 TT - NT$226.5 - BUY)[2]
UBS (N-R)
Umw (UMWH MK - RM5.05 - BUY)
Uni president (N-R)
United Spirits (UNSP IB - RS634.5 - O-PF)
UOB (UOB SP - S$24.80 - BUY)[1]
Vakrangee (N-R)
Vanke (2202 HK - HK$26.90 - BUY)
Vard (N-R)
Varun Beverages (VBL IN - RS763.2 - BUY)
Vestate Group (N-R)
Vipshop (VIPS US - US$5.56 - U-PF)[1]
Vongroup (N-R)
VTIPL (N-R)
Wangsu (300017 CH - RMB7.76 - SELL)
WCC (N-R)
Wens Foodstuffs (N-R)
Wesfarmers (WES AU - A$31.46 - U-PF)
Western Leadbank (N-R)
Westlife (WLDL IN - RS344.1 - BUY)
Westpac (WBC AU - A$26.28 - U-PF)[1]
Westports (WPRTS MK - RM3.69 - U-PF)[1]
WH (N-R)
Wharf REIC (1997 HK - HK$49.35 - O-PF)[1]
Wilmar (WIL SP - S$3.16 - U-PF)[1]
Winsome Yarns (N-R)
Wipro (WPRO IB - RS311.9 - SELL)[1]
Wonik IPS (240810 KS - ₩21,850 - O-PF)
Woolworths (WOW AU - A$29.79 - SELL)[1]
Xero (XRO AU - A$39.36 - BUY)[1]
Xiaomi (1810 HK - HK$14.28 - BUY)
XL Axiata (EXCL IJ - RP2,200 - SELL)[1]
XPEC (N-R)
Yahoo Japan (4689 JP - ¥325 - O-PF)
Yamada Green Resources (N-R)
Yamaha Motor (7272 JP - ¥2,270 - O-PF)[1]
Yamane Medical (N-R)
Yamato (9064 JP - ¥2,998 - BUY)
Yangtze Power (N-R)
Yanzhou Coal (N-R)
Yanzhou coal Ltd (N-R)
Yashili (1230 HK - HK$1.41 - BUY)[1]
Yaskawa Electric (6506 JP - ¥3,575 - U-PF)[1]
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Yili (600887 CH - RMB23.83 - U-PF)
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YuHua Edu (6169 HK - HK$3.11 - BUY)[1]
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Research & sales offices

www.clsa.com

Australia - Melbourne
CLSA Australia Pty Ltd
Level 30
35 Collins Street
Melbourne VIC 3000
Tel: +61 2 8571 4200
Fax: +61 2 9221 1188

Australia - Sydney
CLSA Australia Pty Ltd
Level 35
Grosvenor Place
225 George Street
Sydney NSW 2000
Tel: +61 2 8571 4200
Fax: +61 2 9221 1188

China - Beijing
CLSA Limited - Beijing Rep Office
Unit 10-12, Level 25
China World Trade Center Tower 2
1 Jian Guo Men Wai Ave
Beijing 100004
Tel: +86 10 5965 2188
Fax: +86 10 6505 2209

China - Shanghai
CLSA Limited - Shanghai Rep Office
Room 910, 9/F
100 Century Avenue
Pudong New Area
Shanghai 200120
Tel: +86 21 2020 5888
Fax: +86 21 2020 5777

China - Shenzhen
CLSA Limited - Shenzhen Rep Office
Room 3111, Shun Hing Square
Di Wang Commercial Centre
5002 Shennan Road East
Shenzhen 518008
Tel: +86 755 8246 1755
Fax: +86 755 8246 1754

Hong Kong
CLSA Limited
18/F, One Pacific Place
88 Queensway
Hong Kong
Tel: +852 2600 8888
Fax: +852 2868 0189

India
CLSA India Private Limited
8/F, Dalamal House
Nariman Point
Mumbai 400021
Tel: +91 22 6650 5050
Fax: +91 22 2284 0271

Indonesia
PT CLSA Sekuritas Indonesia
WISMA GKBI Suite 901
Jl Jenderal Sudirman No.28
Jakarta 10210
Tel: +62 21 2554 8888
Fax: +62 21 574 6920

Japan
CLSA Securities Japan Co. Ltd
16/F, Shiodome Sumitomo Building
1-9-2, Higashi-Shimbashi
Minato-ku, Tokyo 105-0021
Tel: +81 3 4578 8000
Fax: +81 3 4578 8080

Korea
CLSA Securities Korea Ltd
30/F, One IFC
10 Gukjegeumyung-ro
Yeongdeungpo-gu
Seoul, 07326
Tel: +82 2 397 8400
Fax: +82 2 771 8583

Malaysia
CLSA Securities Malaysia Sdn Bhd
Suite 20-01, Level 20
Menara Dion
27 Jalan Sultan Ismail
50250 Kuala Lumpur
Tel: +60 3 2056 7888
Fax: +60 3 2056 7988

Philippines
CLSA Philippines, Inc
19/F, Tower 2
The Enterprise Center
6766 Ayala corner Paseo de Roxas
Makati City
Tel: +63 2 860 4000
Fax: +63 2 860 4051

Singapore
CLSA Singapore Pte Ltd
80 Raffles Place, No.18-01
UOB Plaza 1
Singapore 048624
Tel: +65 6416 7888
Fax: +65 6533 8922

Sri Lanka
CT CLSA Securities (PVT) Ltd
4-14 Majestic City,
10 Station Road,
Colombo 4, Sri Lanka
Tel: +94 11 255 2290 to 2294
Fax: +94 11 255 2289

Taiwan
CL Securities Taiwan
Company Limited*
27/F, 95, Section 2
Dun Hua South Road
Taipei 10682
Tel: +886 2 2326 8188
Fax: +886 2 2326 8166

Thailand
CLSA Securities (Thailand) Ltd
16/F, M. Thai Tower
All Seasons Place
87 Wireless Road,
Pathumwan, Bangkok 10330
Tel: +66 2 257 4600
Fax: +66 2 253 0532

United Kingdom
CLSA (UK)
12/F, Moor House
120 London Wall
London EC2Y 5ET
Tel: +44 20 7614 7000
Fax: +44 20 7614 7070

USA - New York
CLSA Americas, LLC
1301 Avenue of The Americas
15th Floor,
New York 10019
Tel: +1 212 408 5888
Fax: +1 212 261 2502

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Australia	+61 2 8571 4201
China (Shanghai)	+86 21 2020 5810
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