CG WATCH 2016
Ecosystems matter
Asia's path to better home-grown governance

Special report

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Acknowledgements and disclaimer

This report was produced in collaboration with the Asian Corporate Governance Association (ACGA), an independent, non-profit organisation based in Hong Kong and working on behalf of all investors and other interested parties to improve corporate governance practices in Asia. CLSA is one of the Founding Corporate Sponsors of ACGA. For further information about the Association, including a list of its sponsors and members, see Appendix 1 of this report.

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

For important disclosures please refer to page 280.

Ecosystems matter

Improve engagement and governance slowly follows

Governance matters and the ecosystems that deliver it are the key. No single stakeholder can drive the process. It's the collective interaction of all parties that delivers better outcomes. Australia heads our bottom-up survey again and joins ACGA's top-down survey in 2016 at number one. Japan has moved up to number two on our scores. Reforms matter but how companies respond and deliver them is crucial. Investor engagement makes persistent improvement more likely. Asia is getting better and will continue to do so if stakeholders, including agitators, remain engaged. Even the friction adds value.

Australia shows why ecosystems are crucial

If there is a single message from ACGA's survey it's that the corporate-governance ecosystems in a market are *the* differentiating factor between long-term system success and failure. Hong Kong and Singapore do not consistently top their survey by accident, they have the best institutions. This survey's inclusion of regional leader Australia brought that into sharper focus.

Better governance leads to better fundamentals

Bottom up, Australia retains the clear leadership position in our updated 2016 CG Watch survey. Japan jumps to second as local reforms begin to tangibly improve behaviour. Elsewhere, ranks do not materially shift. We still can't confidently link CG and share prices but we can for proprietary metrics of governance and fundamental factors. The bottom line is better CG leads to better fundamental outcomes but is distinct from share-price action.

Investors are encouraged by improving engagement

To get a multi-stakeholder perspective we interviewed the Asian corporate-governance head from a major passive house (BlackRock) and a leading Asian active manager (Aberdeen Asset Management); we also spoke to a proxy advisor (Glass Lewis) and a corporate consultant (ISS Corporate Solutions). Asia's CG trend is improving, especially engagement levels. The interviewees suggest we should be optimistic about Asia's governance future but realistic in the context of clear structural differences.

Powerful forces are converging for a better ESG outlook

Finally, environmental, social and governance (ESG) has moved into the investing mainstream over the past two years. Drivers include tightening regulations, improving data, the Paris climate deal and mounting evidence ESG can help investment returns. In our sister report *Beyond the choir*, we include the latest environmental and social company scores. They are nearly flat with 2014 but this masks wide ranges within key sectors.

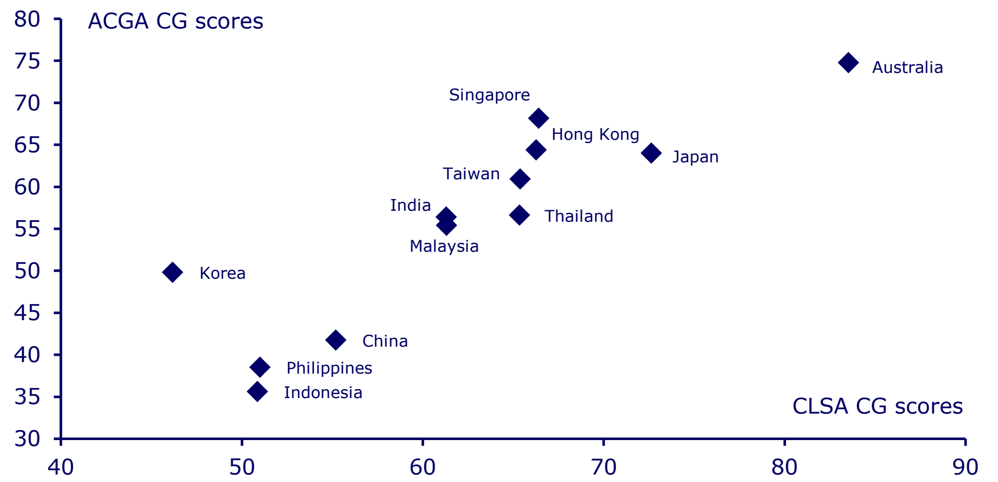
Difference between CLSA and ACGA scoring methodology

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

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

Please see Appendices 1-3 for CLSA and ACGA questionnaires

CLSA versus ACGA scores by market



Source: CLSA, ACGA

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Market CG scores - The ecosystem matters

If there is a single message from our survey this year, it is that the ecosystem of corporate governance (CG) in any market is not just important, it is *the* differentiating factor between long-term system success and failure. In various ways, our previous surveys have always shown this: Hong Kong and Singapore do not consistently top the survey by accident, they do it because they have the best institutions - legal, regulatory and economic - for CG in the region. But this year the inclusion of Australia brought many things into sharper focus, allowing us to look at old issues from a fresh perspective.

Australia included for the first time due to popular demand

We included Australia because for many years readers have been asking us to benchmark Asia against a developed market outside the region. We chose Australia for three basic reasons: it has been a regulatory model for many Asian markets over the past 15-20 years; its system contains elements of both US securities regulation and UK company law, yet it also has its own unique features and appears to us as balanced; and there was considerable interest in Australia for its inclusion in *CG Watch.* We very much hope that the comparisons we make in this report are an aid to understanding and also stimulate discussion. Our implication is not that Asian markets should copy every feature of Australia's CG regime - indeed, some aspects of it are not worth copying!

Australia's governance institutions are more diverse and robust than most in Asia

Having said that, the striking thing about Australia is just how robust its governance institutions are compared to many parts of Asia, and how its system has supported the development of richer, deeper and more balanced CG outcomes. It is not just a matter of more or better regulation (in some areas Asia has better rules), a more shareholder-friendly legal system, a more accountable government, a freer media, a diverse community of business associations and nonprofit organisations - although all these things certainly help. Nor is it because Australia has been at the CG game for longer (in some areas it has not). It is a combination of all these factors and something less easily defined - an apparent willingness on the part of diverse players in government, the business community, and the financial and NGO sectors to work together, an acceptance that they need to talk to each other, and a broader consensus about accountability.

Figure 1

CG Watch market scores: 2010 to 2016

(%)	2010	2012	2014	2016	Change 2014 vs 2016 (ppt)	Direction of CG reform
Australia	-	-	-	78	-	
1. Singapore	67	69	64	67	(+3)	Mostly sunny, but storms ahead?
2. Hong Kong	65	66	65	65	-	Action, reaction: the cycle of Hong Kong life
3. Japan	57	55	60	63	(+3)	Cultural change occurring, but rules still weak
4. Taiwan	55	53	56	60	(+4)	The form is in, now need the substance
5. Thailand	55	58	58	58	-	Could be on the verge of something great, if...
6. Malaysia	52	55	58	56	(-2)	Regulation improving, public governance failing
7. India	49	51	54	55	(+1)	Forward movement impeded by vested interests
8. Korea	45	49	49	52	(+3)	Forward movement impeded by vested interests
9. China	49	45	45	43	(-2)	Falling further behind, but enforcement better
10. Philippines	37	41	40	38	(-2)	New policy initiatives, but regulatory ennui
11. Indonesia	40	37	39	36	(-3)	Losing momentum after progress of recent years

Source: Asian Corporate Governance Association

"Accountability" a more opaque concept in Asia

Accountability is a more opaque concept in Asia. In our experience, many people in positions of authority - officials, company owners, directors and others - are often reluctant to talk to their inferiors or people they do not know. Trust is much harder to establish. Of course, there are many exceptions, as well as companies that are open to their shareholders. But as a general rule, this more constrained cultural and political dynamic broadly holds true.

Investors in Australia have access to company chairmen - not usually the case in Asia

Business culture has evolved very differently in Australia and this has profound implications for CG. While it was not always the case, major institutional shareholders today routinely have access to company chairmen, CEOs and independent directors. This is partly because of regulatory catalysts such as the "two-strike rule" on executive remuneration (only adopted in 2011), but also because there is a consensus that directors are, and *should* be, accountable to shareholders. This is itself a product of corporate-ownership structures that are more dispersed, leaving their professional managers little to hide behind when things go wrong. Boards actually remove underperforming CEOs. How often does that happen in Asia?

Elements of the Australian system are applicable to Asia

We do not expect corporate-ownership structures to change any time soon in Asia. Yet elements of the Australian system could be usefully applied in Asia. The benefit of an open door to shareholders is that you get to hear a wide range of useful opinions. Some of these may even be good for your business, as well as your governance.

Asian companies too often surprised by the reaction of shareholders

How many times in Asia have companies been taken by surprise at the negative reaction of their shareholders, stakeholders or society at large to a major value-destroying deal they just announced? Or to a securities law they just blatantly breached? There is an element of this reaction in almost every corporate scandal of the past few years. Yet company leaders and directors would not be surprised if they had more direct contact with key groups. Mediating through an investor relations team is just not sufficient. How do you know you are getting the full story?

Asia's hierarchical management-shareholder relationship is losing its utility value

Our view is that the more controlled and hierarchical management-shareholder communication system in Asia, while perhaps historically justifiable, is steadily losing its utility. Indeed, it may become a significant impediment to CG and capital-market development in this region, if it has not already. Japan and several other markets developing investor stewardship codes appear to agree.

Next 15 years must be about other parts of the ecosystem - firms and investors - doing their bit

As this and previous *CG Watch* surveys show, regulators have made a huge amount of progress in building stronger CG regimes in Asia over the past 15 years. The next 15 years needs to be about developing a more open corporate mindset around dialogue with shareholders and relevant stakeholder groups. Institutional investors need to utilise the moral authority given to them by stewardship codes and exercise their delegated ownership rights on behalf of beneficiaries. And Asian governments need to allow a deeper civil society to develop, one that is mutually reinforcing and caters to the needs of a more complex economy.

Reasons why markets went up or down

A note on the rankings

Key reasons why markets went up or down this year are:

1. **Singapore**: Revamped its enforcement strategy and regained ground lost in 2014. It also brought its overall CG regime more up to date.
2. **Hong Kong**: Despite some courageous regulatory decisions, it lost points (yet again) on the lack of an independent audit regulator.
3. **Japan**: Achieved a higher score due to new CG rules, but does not yet surpass Hong Kong.
4. **Taiwan**: Leapt into fourth on numerous CG and ESG initiatives, strong political support and better enforcement.
5. **Thailand**: Maintained score through regulatory changes, despite a difficult political environment, but fell in ranking due to Taiwan's rise.
6. **Malaysia**: Fell in score and ranking due to public-governance debacles.
7. **India**: Slightly higher score due to improved regulation and enforcement, but not enough to change the ranking.
8. **Korea**: Materially improved score thanks mainly to regulatory efforts, but not enough to change the ranking.
9. **China**: Score fell due to absence of major CG reform and regulatory mis-steps during stock-market crisis of mid-2015. But has much better enforcement than the Philippines or Indonesia.
10. **Philippines**: Score fell because of slow progress on reform and general CG standards well below other markets. Same ranking.
11. **Indonesia**: Despite some improvements in CG rules, and a new CG code, weaknesses in enforcement is holding it down. Same ranking.

Some different trends emerging from our category scores

Category scores

While the same patterns broadly hold in our category scores this year as in previous surveys, some interesting new points are emerging:

- In the early days of our survey, as one would expect, markets typically scored much higher for **CG rules & practices** than for **Enforcement**. This now holds true for just four markets: Thailand, India, the Philippines and Indonesia. There are two main reasons for this: a greater emphasis in our questions on company practices (eg, financial reporting) and much greater regulatory focus on enforcement. Interestingly, many regulators seem to find it easier to push through tougher enforcement than higher CG standards on the books (since the latter often requires a public consultation and more political capital; but no one can argue against better enforcement).
- **Enforcement** continues to be where markets show most consistent improvement over the years. This is due to heightened regulatory enforcement by securities commissions and stock exchanges, as well as enhanced private enforcement by institutional and retail investors through voting and engagement. Markets that did better this year due to regulatory enforcement include: Singapore, Malaysia, India and Korea. Markets that did better due to more active investor participation include Taiwan and India.
- Only a few markets stood out for notably improved scores in **Political & regulatory environment**: Singapore, Japan and Korea. More markets fell: Thailand, Malaysia, India, China and Indonesia. This sections takes a number of factors into account, such as degree of political support for CG

reform, proper funding of regulatory agencies, the quality of the judiciary, the presence or absence of an effective anticorruption agency, and whether the government is protecting or enhancing civil-service ethics. As this category shows, government commitment to all these factors can be uncertain and volatile.

Figure 2

Market category scores (CG Watch 2016)

(%)	Total	CG rules & practices	Enforcement	Political & regulatory	Accounting & auditing	CG culture
Australia	**78**	80	68	78	90	74
1. Singapore	**67**	63	63	67	87	55
2. Hong Kong	**65**	63	69	69	70	53
3. Japan	**63**	51	63	69	75	58
4. Taiwan	**60**	54	54	64	77	50
5. Thailand	**58**	64	51	45	77	50
6. Malaysia	**56**	54	54	48	82	42
7. India	**55**	59	51	56	58	49
8. Korea	**52**	48	50	53	70	41
9. China	**43**	38	40	36	67	34
10. Philippines	**38**	35	19	41	65	33
11. Indonesia	**36**	35	21	33	58	32

Source: Asian Corporate Governance Association

- **Accounting and auditing** continues to be the highest scoring category for most markets, due to the acceptance of international accounting and auditing standards by governments, as well as concepts of auditor independence and independent audit regulation. However, the scores for some markets are starting to fray as we look closer, in particular, at the quality of their auditing, audit regulation and auditor independence rules. Markets that have dropped in score here include Hong Kong, Thailand, Malaysia, Korea and Indonesia. A few markets have risen: Singapore, Japan, Taiwan and India.
- **CG culture**, always the most disappointing category, is starting to show some signs of life in some unexpected places, notably Korea, where it has bounced up from a low base (due to several small score increases for company dialogue, investor activism, director training disclosure and some other items). Incremental increases are evident in Japan and Taiwan.

North Asia finally stands out in this survey

One striking difference between this survey and the past two is how much North Asia's improvement stands out. In 2012, it was all Southeast Asia. In 2014, it was a mixed picture. In 2016, more North than Southeast. Three of the four major North Asian markets have improved in score (Japan, Taiwan and Korea) and one (Taiwan) has improved in ranking. Only China has underperformed. Meanwhile, Southeast Asia, which had been showing so much promise in recent years, is being let down by its governments and politicians.

Spare a thought for the regulator

Regulators are NOT solely responsible for their market rankings!

We fully appreciate the frustration that financial regulators and exchanges must feel when reviewing the results of this survey. We would say that the vast majority of the regulators we meet around the region are dedicated to their jobs and are doing their best to push reform ahead as far and as fast as they can. Indeed, a trend we have noticed is what one might describe as the "march of the technocrats". This is the increasing bifurcation we see in many markets between the open-minded, international and transparent style of capital-market regulators and the closed-minded, parochial and unaccountable behaviour of their political masters.

Financial regulators speak a different language to most government officials

True, the two groups are often serving different ends: financial regulators are trying to cater to a complex array of local and foreign stakeholders, and must be sensitive to international ideas, standards and language. Local politicians, on the other hand, have more self-interested, populist and domestic preoccupations. It is a hard circle to square.

The tone set by government makes a huge difference to good corporate and public governance

However, while capital-markets regulators and stock exchanges are a linchpin of CG standards in any market, they are not the only important part of the ecosystem that our survey measures. Public governance and government support are critical in the long term for greater accountability in corporate behaviour (private, as well as state-owned), and are as important as a free press, an effective justice system and engaged investors. We would argue that the tone set by the public sector matters greatly and can either restrict or foster what regulators are able to achieve in both policy and enforcement. As such, regulators should not be seen as solely responsible for movements in market scores - up or down - in *CG Watch*.

A note on methodology

Market survey improved this year: two questions dropped and three new questions added

ACGA market questionnaire

We have amended and updated the content of our questionnaire to remove questions we felt had become redundant or no longer of comparative value, and to add questions that highlight some newer issues. We also rewrote some questions to make the phrasing clearer. We have increased the total number of questions from 94 to 95, with two dropped and three added.

In **CG rules & practices**, we added one new question (A.20) on stewardship codes, since some markets in the region have issued such codes in the past two years to increase shareholder engagement.

We also rewrote slightly the three new questions we added in 2014 on sustainability reporting standards and practices (A.7, A.8 and A.9) to reflect the broader range of global standards in this area. We also added further explanation to our question about quarterly reporting (A.12) to differentiate between “template” reports with just numbers and more narrative-oriented reports, which seek to explain the numbers as well.

We made no changes to the **Enforcement** and **Political & regulatory environment** sections.

In **Accounting & auditing**, we changed the wording of one question (D.2) to recognise that the accounting rules of most markets in the region are “largely” in line with IFRS, since few markets are “fully” in line at any one point in time (given the onward march of IASB standards).

We added a further example to a question on the independence of external auditors (D.11), namely whether they had a duty to report fraud. We also clarified our question on independent oversight boards (D.12) to make it clear that their powers should cover both individual auditors and audit firms.

In **CG culture**, we dropped two somewhat general questions about CG standards of large caps and SMEs and added two more specific and timely ones on board evaluations (E.2) and director training (E.3). We also rewrote one question about the independence of chairmen and directors (E.6) to make the wording more concise.

Acknowledgements

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