Asian Corporate Governance Association (ACGA)

"A Tempestuous Time for CG in Asia: Tracking the Peaks and Troughs"

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Introduction to ACGA

- An independent, non-profit membership association dedicated to facilitating improvements in corporate governance in Asia through research, advocacy and educational initiatives. Founded in Hong Kong in 1999 following—and as a response to—the Asian Financial Crisis of 1997-98.

- ACGA is unusual in having a membership that includes participants from across sectors and geographies. More than 100 organisations, including:
  - Global and regional pension funds and institutional investors
  - Listed companies based in Asia
  - Major multilateral banks
  - International leaders in accounting, insurance and financial services
  - University business schools

- Institutional investor members manage more than US$20 trillion globally.

Membership Network

- ACGA's membership network comprises a broad range of more than 100 Asian and global organisations with a strong interest in corporate governance. Members include:

Brief history of corporate governance

Over the past 30 years, financial markets in the US, Europe and Asia have undergone significant corporate governance reform:

- **1970s:** Financial misreporting and corporate collapses in the United States led to "independent" outside directors and audit committees.
- **1980s:** Corporate collapses in the United Kingdom led to the "Cadbury Report", which sets basic guidelines on board independence. It has been hugely influential and widely copied.
- **1997:** The Asian Financial Crisis led to sweeping regulatory change in the region and adoption of many international standards.
- **2002:** The Enron fraud in the US led to reform of the external auditor's role, greater accountability for financial reports, greater board oversight, and stronger internal controls.
- **2007:** The Global Financial Crisis led to much criticism of "Western" CG, but also spurred further reform in board oversight, board diversity, the role of shareholders, enforcement against insider trading, and so on.

Common global principles

	OECD Principles	USA	UK	Germany*	Hong Kong	China#	Thailand
Directors should be accountable to shareholders	Yes	Yes	Yes	Yes (and to employees)	Yes	Yes	Yes
Boards should be independent and supervise management	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Independent board committees (eg, audit, nomination)	Yes (OECD recommend)	Yes	Yes	Yes	Yes	Yes	Yes

*Answers refer to the Supervisory Board in Germany.

#In China, there is also a "board of supervisors" that formally supervises directors and senior managers.

Asian uniformity:
Boards before the Asian Financial Crisis of 1997-98

Market	CG Code on board governance?	Independent directors required?	Audit committees required?
China	No	No	No
Hong Kong	Minuscule	No	No
India	No	No	No
Indonesia	No	No	No
Japan	No	No	No
Korea	No	No	No
Malaysia	No	No	No
Philippines	No	No	No
Singapore	No	No	No
Taiwan	No	No	No
Thailand	No	No	No

The convergence towards international standards: Formal board structures after the Asian Financial Crisis

Market	CG Code on board governance?	Independent directors required?	Audit committees required?
China	2002	Yes	Yes
Hong Kong	1993/2004/2012	Yes	Yes
India	1999/2014	Yes	Yes
Indonesia	2001/2006	Yes	Yes
Japan	2015	Still optional	Still optional
Korea	1999/2003	Yes	Yes (large firms)
Malaysia	2000/2007/2012	Yes	Yes
Philippines	2002/2009	Yes	Yes
Singapore	2001/2005/2012	Yes	Yes
Taiwan	2002/2011	Yes	Being phased in
Thailand	1999/2006/2012	Yes	Yes

Asian complexity
Legal and regulatory variation

	Historic basis of company law	Board structure	Minimum # of INEDs
China	German	Dual (two boards) + Party C'tee	One-third
Hong Kong	English	Single	One-third
India	English	Single	33-50%
Indonesia	Dutch	Two-tier	30%
Japan	German	Quasi dual (two "boards")	One INED or ISA[α] (Two INEDs now recommended)
Korea	German/ Japanese	Single or quasi dual	25-50%
Malaysia	English	Single	Majority*
Philippines	American	Single	Two/20%
Singapore	English	Single	One third to majority*
Taiwan	German/ Japanese	Single or quasi dual	Two for certain companies
Thailand	French / mixed	Single	Three/one-third

*Majority suggested only if the chairman is non-independent. Not a mandatory rule.

α "ISA" refers to an independent statutory auditor (kansayaku).

Source: ACGA research

Asian complexity

Corporate ownership and cultural variation—a challenge for CG

	Dominant form of corporate ownership	State control of large caps?	Strength of family business culture
China	Concentrated	Extensive	Emerging
Hong Kong	Concentrated	Minimal	Strong
India	Concentrated	Some	Strong
Indonesia	Concentrated	Some	Strong
Japan	Dispersed, but control by management	Some	Weaker, but strong groups
Korea	Dispersed, but control by families	Some	Strong
Malaysia	Concentrated	Some	Strong
Philippines	Concentrated	Some	Strong
Singapore	Concentrated	Extensive	Strong among non-state firms
Taiwan	Dispersed, but control by families	Some	Strong
Thailand	Concentrated	Some	Strong

Source: ACGA research

Parallel tracks:
CG reform in Asia is moving on two tracks

1. International rules dominate in areas where common standards are politically acceptable and implementable. For example:
   - Accounting and financial reporting standards
   - Shareholder meetings / voting
   - Regulation of external auditors

2. Local practices continue to dominate where common standards are more controversial and/or regulatory and shareholder influence is more limited. For example:
   - Functioning of boards and board committees (as opposed to their formal structures, as seen earlier)
   - Dialogue with shareholders
   - Decisions on related-party transactions
   - Capital-raising exercises

ACGA Assessment of Macro CG in Asia

"CG Watch" survey. Market scores: 2010 to 2014					
(%)	**2010**	**2012**	**2014**	**Change 2012 vs 2014 (ppt)**	**Trend of CG reform**
1. = Hong Kong	65	66	**65**	(-1)	Weak leadership, tough enforcement
1. = Singapore	67	69	**64**	(-5)	International vs local contrast continues
3. Japan	57	55	**60**	(+5)	Landmark changes, can they be sustained?
4. = Thailand	55	58	**58**	-	Improving, but new legislation needed
4. = Malaysia	52	55	**58**	(+3)	Improving, but still too top-down
6. Taiwan	55	53	**56**	(+3)	Bold policy moves, can they be sustained?
7. India	48	51	**54**	(+3)	Bouncing back, Delhi more supportive
8. Korea	45	49	**49**	-	Indifferent leader, more active regulators
9. China	49	45	**45**	-	Focus on SOE reform, enforcement
10. = Philippines	37	41	**40**	(-1)	Slow reform, improved company reporting
10. = Indonesia	40	37	**39**	(+2)	Big ambitions, can they be achieved?

Source: ACGA, CLSA

China: Questions on the boom/bust

- Should the government / regulator / official media be actively encouraging people to invest in stocks (especially in such a retail-driven market like China)?
- Were the rules on margin trading too permissive?
- Were the rules on voluntary suspensions too permissive?
- How should investors and other market participants react? What can we do to help raise CG standards in China?

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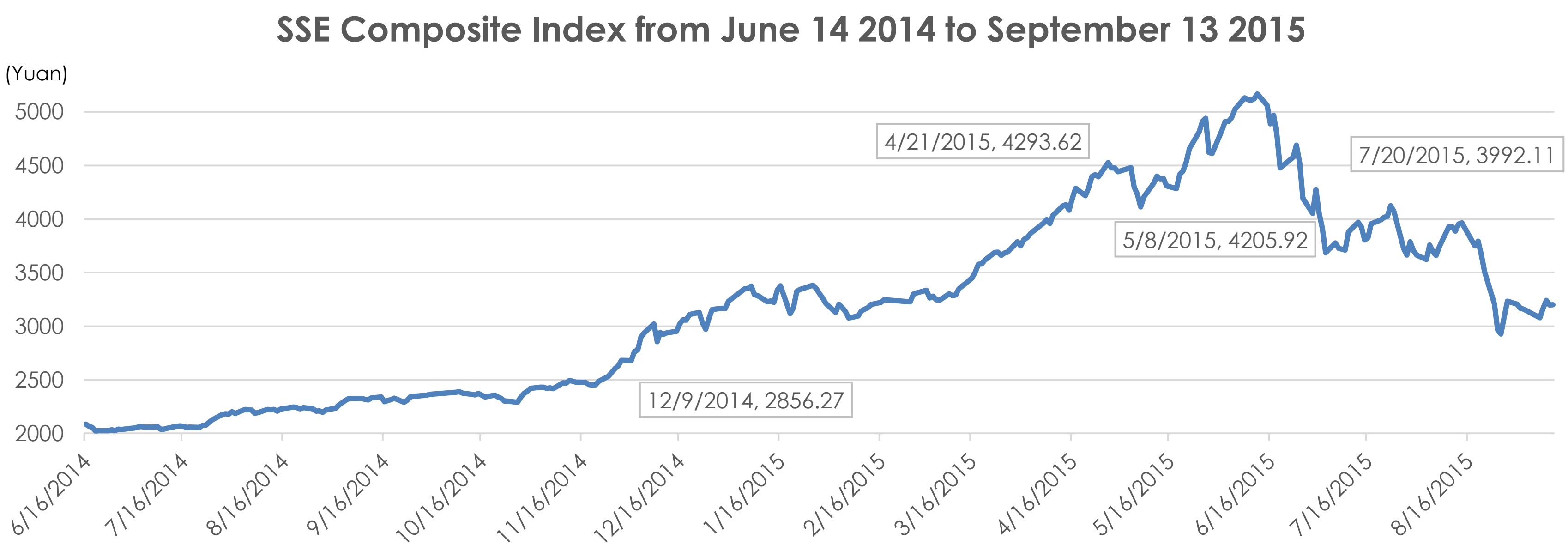
A short history of CG reform in China

The Asian Financial Crisis was the turning point for CG reform in Asia. China, though less directly affected, was influenced by these trends and got an early start with some quite bold reforms:

Year	CG Developments in China
2001	Guidelines on independent directors (CSRC)
2002	National Code of Corporate Governance (CSRC)
2003	Directive on quarterly reporting (CSRC)
2005	Bank governance guidelines (China Banking Regulatory Commission) and start of State-owned Assets Supervision and Administration Commission (SASAC) pilot programme on boards in central SOEs.
2007	Convergence of accounting and auditing standards with IFRS/ISA
	CSRC launched three-year campaign to strengthen listed company governance—use of funds, operation of board, internal controls.
2008	SSE launched its Corporate Governance Index
2013	CBRC new Corporate Governance Guidelines for commercial banks
2014	CAPCO guidelines on INEDs. CSRC rules on separate counting and disclosure for votes by the minority.

What the People's Daily said…



- ***2014.12.9*** *"As long as the stock market fluctuations have not threaten the domestic economy, the government should not interfere into it."*
- ***2015.4.21*** *"SSE 4000 is only the starting point of the Chinese bull market."*
- ***2015.5.8*** *"The momentum of a long-term bull market has not changed."*
- ***2015.7.20*** *"Government intervention in a stock market crisis is an international convention."*

Source: People's Daily

A short history of margin trading

- **2010.01.08** The State Council agreed to launch margin trading and short selling trial.
- **2010.03.31** China launched its margin trading and short selling trial programme in Shanghai and Shenzhen Stock Exchanges.
- **2013.04** Major securities firms in China lower the barrier of margin trading and short selling from account balance of 500K to 100K.
- **2014.08.07** Some major securities firm in China further lowered the barrier of margin trading and short selling from 100K to 50K and other firms followed afterwards.
- **2014.09.12** Shanghai and Shenzhen Stock Exchanges jointly announced an increase to 205 stocks in total (104 for Shanghai and 101 for Shenzhen) on the margin trading and short selling target list.
- ***2015.01** Securities firms set the barrier of margin trading and short selling back to account balance of 500K.

Policies to "save" the market

- **2015.7.1** Stock settlement fees lowered by about 33%.
- **2015.7.3** CSRC increased QFII quota from US$80 billion to US$150 billion.
- **2015.7.4** State Council decided to postpone IPOs, reopen date not known.
- **2015.7.4** CSRC asked 21 security firms together to buy at least 120 billion yuan in blue-chips ETF and asked 25 fund companies to buy their own equity funds and hold at least for one year.
- **2015.7.8** Ministry of Finance promised that it will not sell its shareholdings and asked management of major listed companies to hold their own shareholdings for next six months.
- **2015 7.8** China Security Finance Corporation provided 260 billion yuan (US$41.87 billion) in credit lines to 21 brokerages to help them buy stocks via proprietary trading.
- **2015.7.9** CSRC started cooperation with the Ministry of Public Security to investigate several alleged market manipulation cases.
- **2015.9.12** CSRC announced 240 million yuan fines for four major domestic brokers for not properly following margin trading rules.

How good is regulatory enforcement in China?

"CG Watch 2014": Category scores

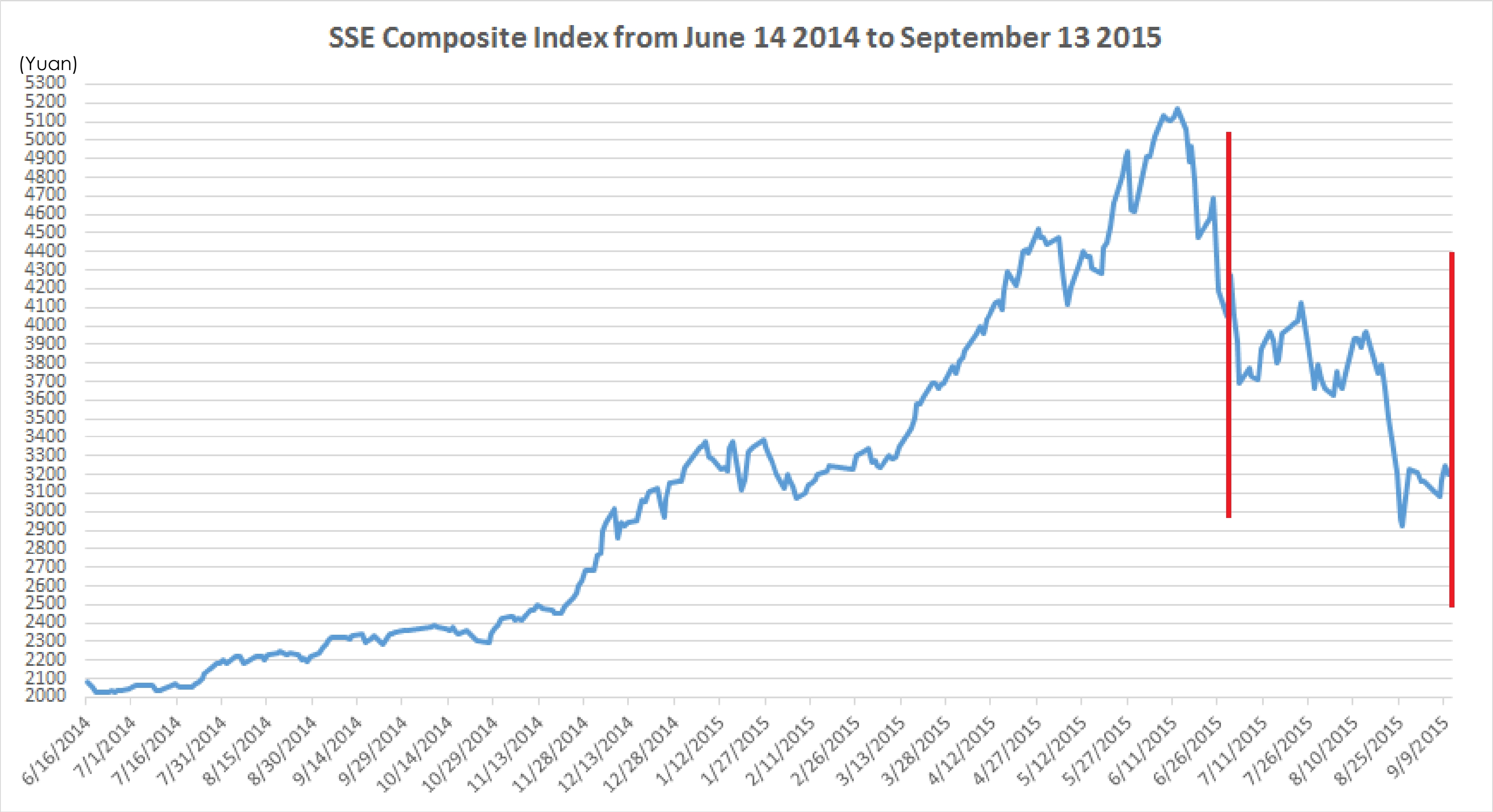
Market category scores						
(%)	Total	CG Rules & Practices	Enforcement	Political & Regulatory	IGAAP	CG Culture
1. = Hong Kong	**65**	61	71	69	72	51
1. = Singapore	**64**	63	56	64	85	54
3. Japan	**60**	48	62	61	72	55
4. = Thailand	**58**	62	51	48	80	50
4. = Malaysia	**58**	55	47	59	85	43
6. Taiwan	**56**	48	47	63	75	47
7. India	**54**	57	46	58	57	51
8. Korea	**49**	46	46	45	72	34
9. China	**45**	42	40	44	67	34
10. = Philippines	**40**	40	18	42	65	33
10. = Indonesia	**39**	34	24	44	62	32

Source: ACGA, CLSA

CSRC vs SFC enforcement 2015

Enforcement category	CSRC (to August 31, 2015)	SFC (to August 18, 2015)
Market manipulation	10	-
Insider trading	7	4
Utilising unpublished information	6	-
Non-standard trading procedures / disseminating fictitious information	19 (including 5 major securities firms in August)	-
Operational failure	-	10
Regulatory breaches (eg, unlicensed trading)	-	11
Banning/suspensions	-	10
Cold shoulders / disqualifications	-	6
Total	42	42

Market performance after "saving policies"



Source: Yahoo Finance

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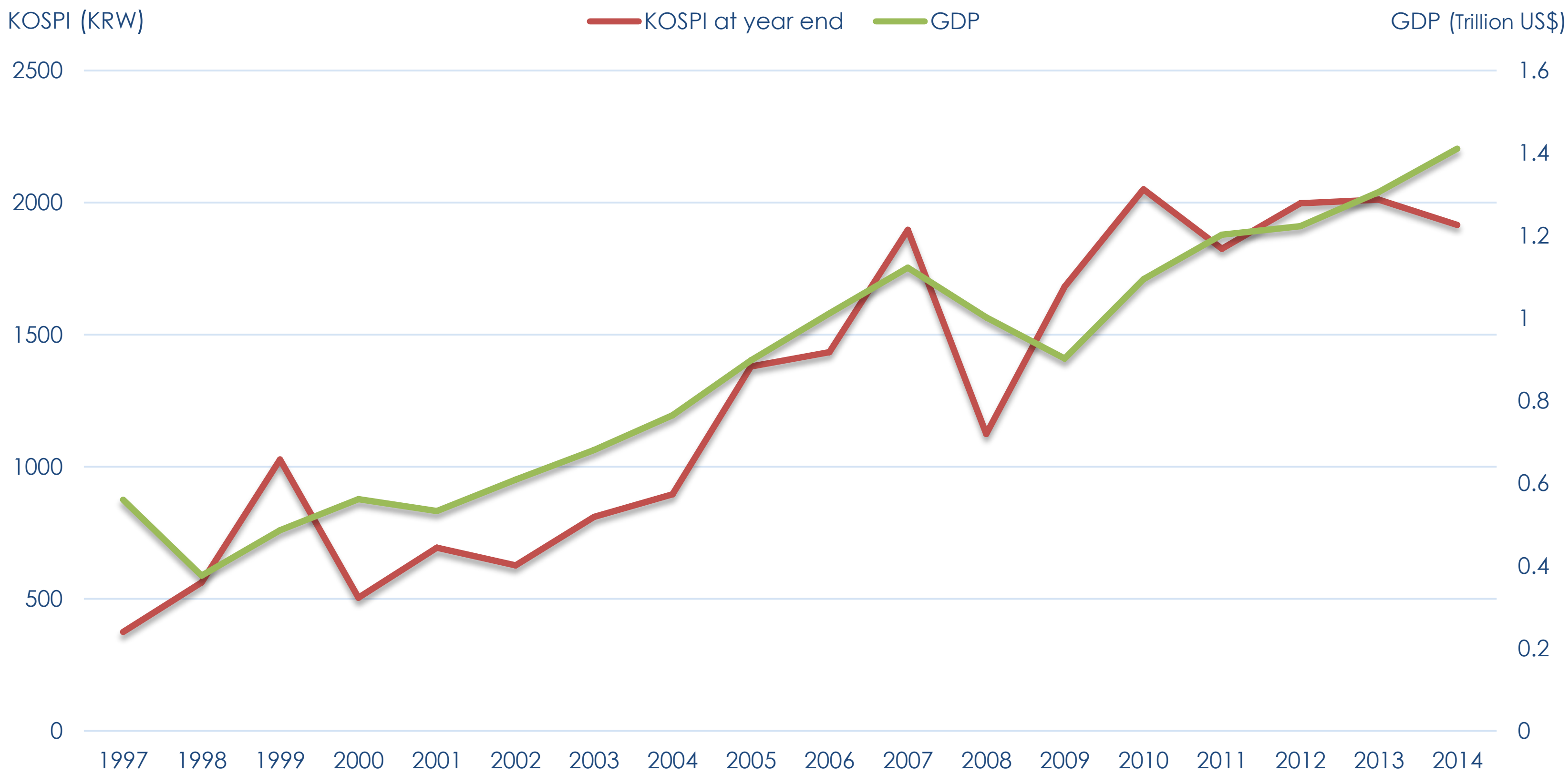
Economic development and market size:
Should stock markets grow in line with GDP?

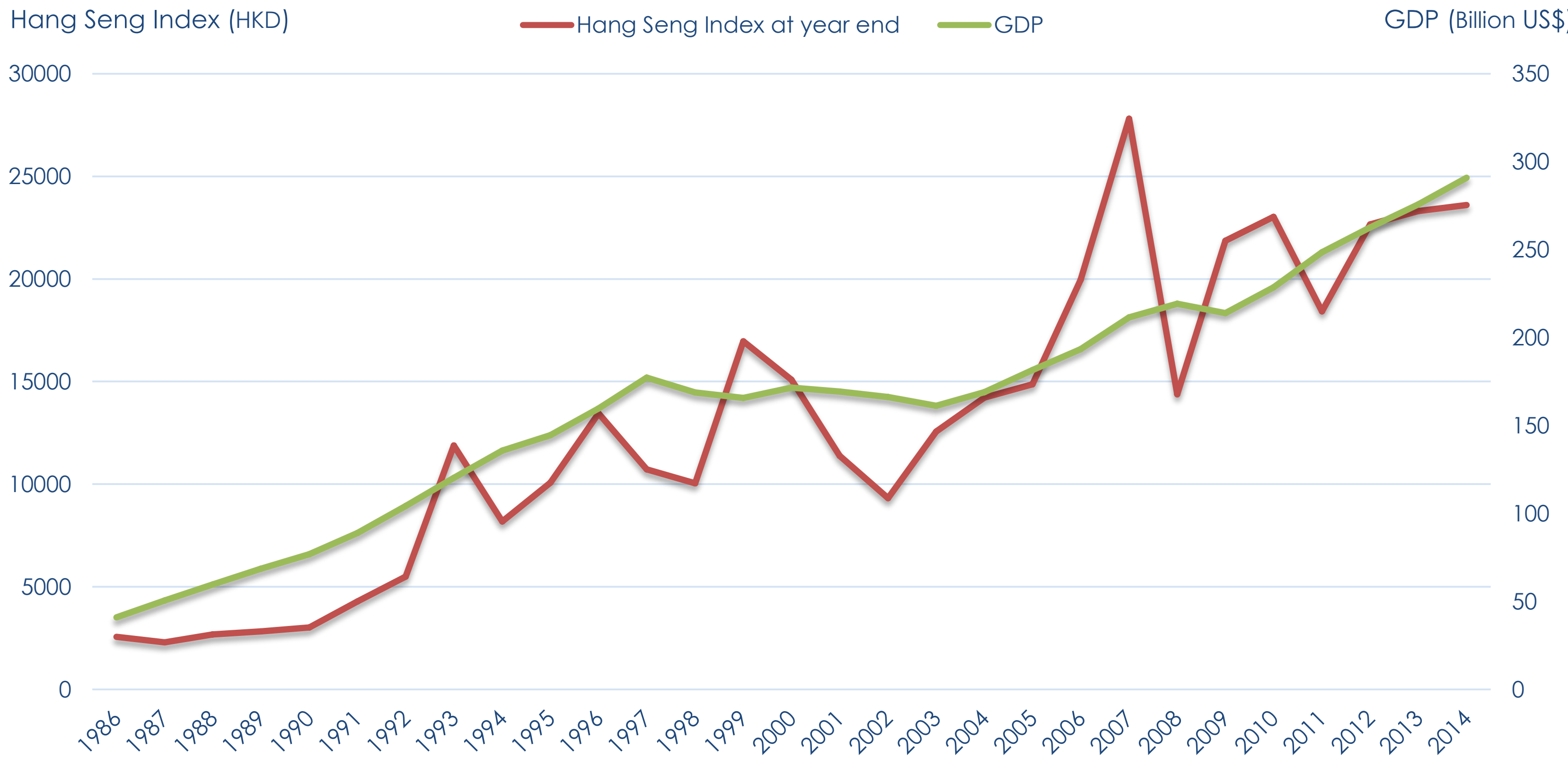
Korea GDP and KOSPI Index correlation from 1997-2014



Source: World Bank and Yahoo Finance

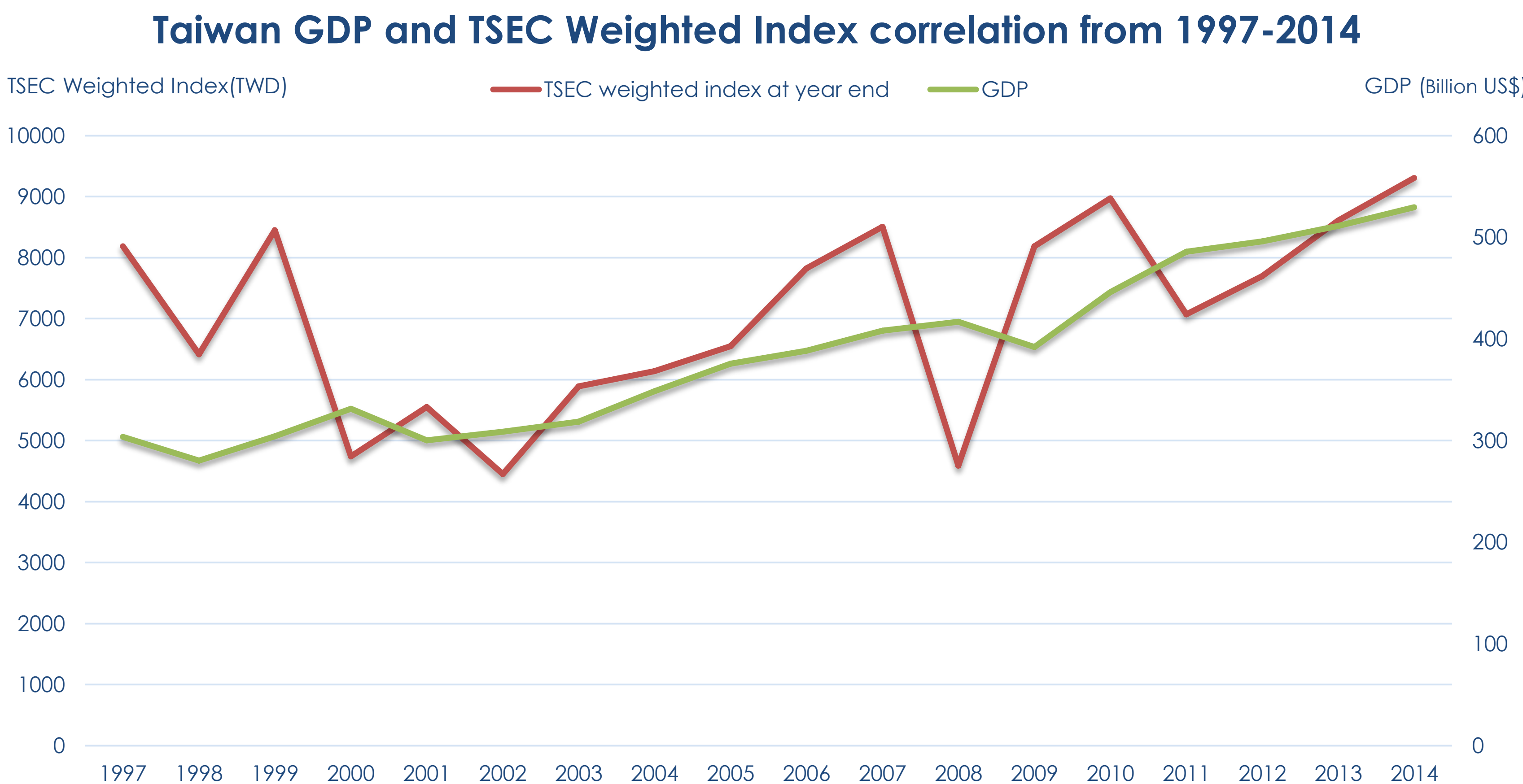
Economic development and market size

Hong Kong GDP and HSI correlation from 1986-2014



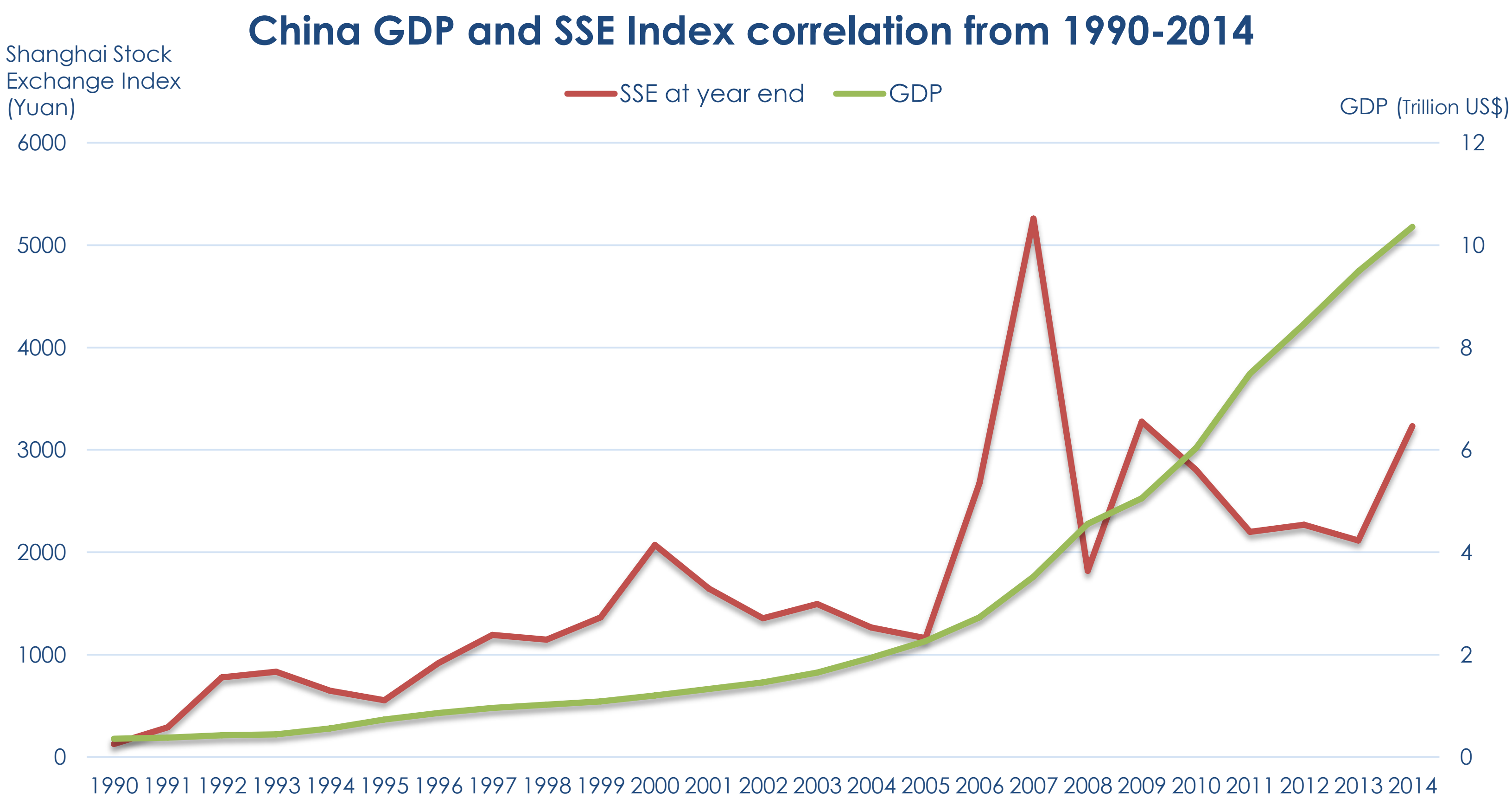
Source: World Bank and Yahoo Finance

Economic development and market size



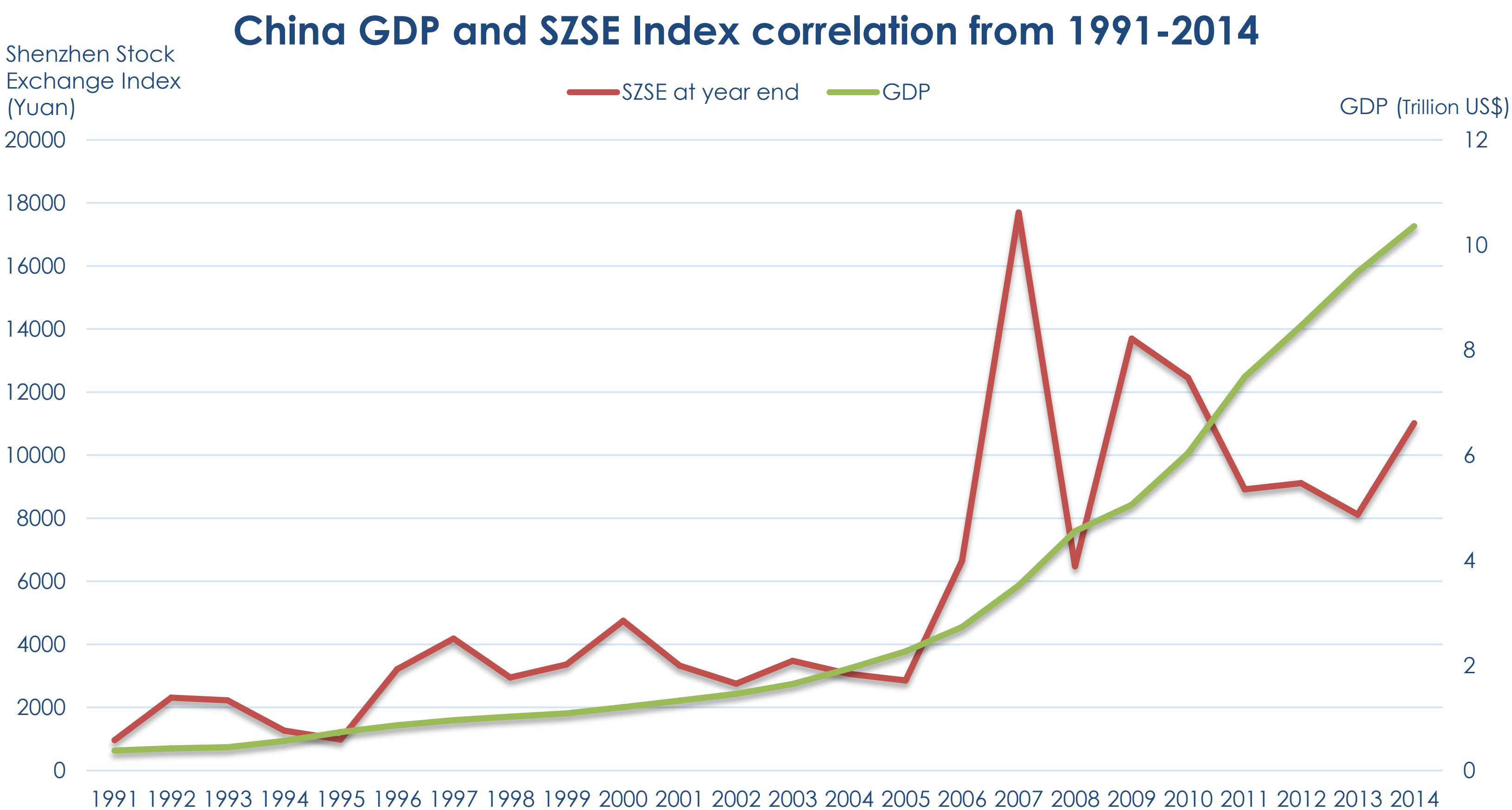
Source: World Bank and Yahoo Finance

Economic development and market size



Source: World Bank and Yahoo Finance

Economic development and market size



Source: World Bank and Yahoo Finance

Why is China out of sync?

- Majority of market cap historically dominated by big SOEs, yet majority of new jobs and economic value is being created by the private sector. (This does not apply to Shenzhen, however.)
- Large portion of issuers are listed overseas (HK, US, Singapore, etc).
- Historic reliance on bank loans rather than equity capital raising.
- Arbitrary moratoriums on IPOs. While these may have helped the index in the short term, they have also damaged trust in the market among sophisticated investors and its role as an efficient allocator of capital.

No	Date	No. trading days	Performance of SSE Index
1	July 21 – December 7, 1994	98	+65.75%
2	January 19 – June 9, 1995	96	+18.36%
3	July 5, 1995 – January 3, 1996	128	-12.6%
4	July 31 – November 2, 2001	69	-13.57%
5	August 26, 2004 – January 23, 2005	101	-7.86%
6	May 25, 2005 – January 2, 2006	264	+49.53%
7	September 16, 2008 – July 10, 2009	191	+43.09%
8	November 16, 2012 – Jan 17, 2014	**274**	**+1.89%**
9	July 4, 2015 – ?	?	?

What can we do?

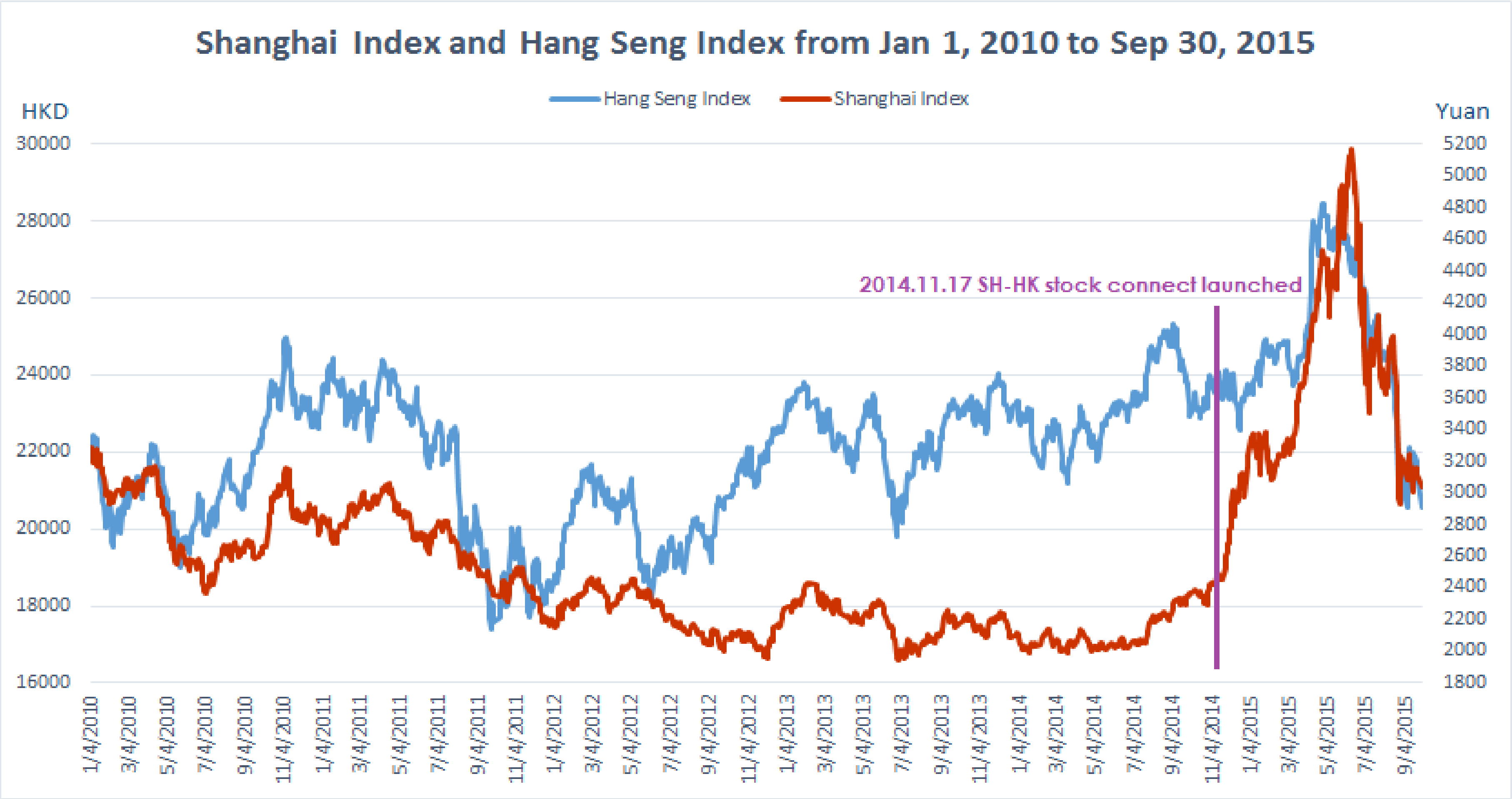
CG advocates in China cannot change the structure of the market or policy overnight. However individually and collectively the market could play a positive role over the next 5-10 years. For example, engaging with the government for:

1. More policy consistency, less arbitrary decision-making (eg, no more IPO moratoriums).
2. Opening the market more to the private sector.
3. Stricter rules on voluntary suspensions.
4. Stricter rules on margin trading for small accounts.
5. More consistent, transparent and expanded regulatory enforcement.
6. Upgraded CG standards for companies—China's CG Code is now quite out of date (2001).

Hong Kong

- Shanghai- Hong Kong Stock Connect:
  - Good for liquidity, but …. Closer correlation between the two markets, making Hong Kong more exposed to China issues (eg, voluntary suspensions, official policy) and investor sentiment.
  - What are the implications for Hong Kong's separate system of regulation, investor protection and rule of law?
- HKEx "Weighted Voting Rights" conclusions / SFC Rebuttal / HKEx throws in the towel
- SFC Consultation on Principles of Responsible Ownership
- HKEx Consultation on ESG Reporting Guide
- New Audit Regulatory Regime

Increasing correlation between SSE and HSI



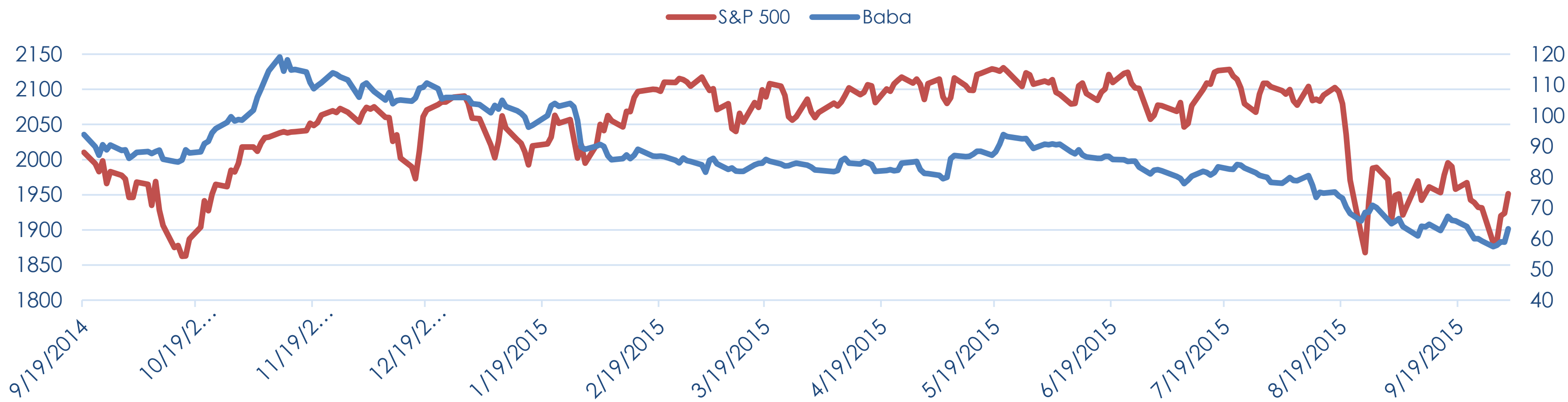
Source: Yahoo Finance

Weighted Voting Rights / Dual-class shares

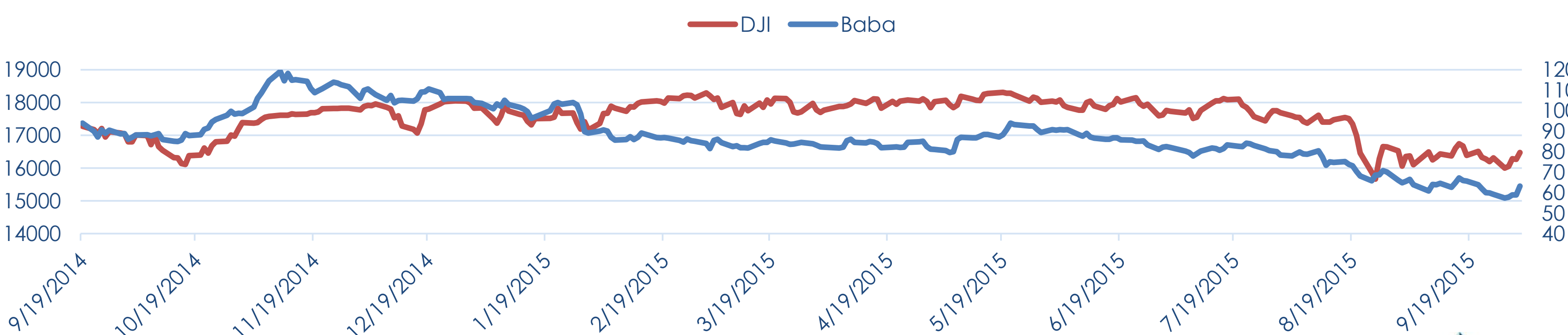
- Alibaba caused a major debate in Hong Kong in 2013 over the issue of "one share, one vote".
- **HKEx "Weighted Voting Rights" conclusions (June 19, 2015)**
  - "WVR (weighted voting rights) structures should not be available in all circumstances. We are considering proposing that, generally, 'one share, one vote' should prevail, but that **WVR structures should be allowed** for certain companies in certain circumstances and with certain safeguards. It is not our intention that such structures become commonplace in Hong Kong", said David Graham, HKEx's Chief Regulatory Officer and Head of Listing.
- **SFC rebuttal (June 25, 2015)**
  - "The Board of the SFC has unanimously concluded that **it does <u>not</u> support the draft proposal** for primary listings with WVR structures … A regime that relies on the subjective judgement of regulators to determine which listing applicants are eligible for WVR would give rise to regulatory uncertainty and could result in inconsistent and unfair decision-making."
- **HKEX Listing Committee announcement (October 5, 2015)**
  - Decided that in light of the SFC statement "it will not proceed with its draft proposal on Weighted Voting Rights (WVR) at this time".
  - "It will, however, keep this matter under review."

Alibaba’s performance vs benchmark since IPO

Baba's performance versus the S&P 500 Index from Sep 19, 2014 to Oct 2, 2015



Baba's performance versus the DJI Average Index from Sep 19, 2014 to Oct 2, 2015



Source: Yahoo Finance

HKEx Consultation on ESG Reporting Guide

- Key points from HKEx Consultation
  - A proposed combination of comply-or-explain general disclosure obligations and an initial set of required environmental KPIs.
  - Board has governance responsibilities related to a company's ESG risks.
  - Social factors will be deferred to a later stage.
  - Focus on disclosure of "material" (ie, price sensitive) factors and operational issues.
- What is the overarching goal here?
  - To persuade companies that E&S factors can be material to their business, hence investors need proper disclosure of such information.
  - Company boards need to take leadership of this reporting.

New Audit Regulatory Regime

- Hong Kong is one of the few markets in Asia or globally that is not a member of IFIAR – because our audit regulator is still HKICPA.
- June 2015: HK Government announced that the Financial Reporting Council (FRC) would become the “independent” audit regulator in future, with responsibility for:
  - Inspections of CPA firms
  - Investigations of audit irregularities (FRC currently does this)
  - Disciplinary action
- HKICPA will continue to look after:
  - Registration of auditors
  - Setting of professional standards
  - Continuing professional education

Japan – Stewardship Code

- In force since February 2014.
  - Modelled after the UK's and the first such code in Asia.
- Contains 7 "comply-or-explain" Principles (with 21 more detailed Guidances), including:
  - Institutional investors should have a clear policy on **how they fulfil their stewardship responsibilities**, and publicly disclose it.
  - Institutional investors should have **a clear policy on voting** and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist.
- As of August 2015, there were 197 domestic and foreign signatories:

Trust banks:	7
Investment managers:	139
Pension funds:	23
Insurance companies:	21
Others (Glass Lewis, ISS, etc):	7

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Japan – CG Code

- In force since June 2015.
  - Based on the *OECD Principles of Corporate Governance*.
- Also a "comply-or-explain" document focusing on:
  - Securing **the rights and equal treatment of shareholders** (eg, providing English translations for foreign shareholders)
  - Appropriate **cooperation with stakeholders** other than shareholders
  - Ensuring appropriate **information disclosure and transparency**
  - Responsibilities of **the board** (eg, at least 2 independent directors)
  - **Dialogue** with shareholders
- Initial reception quite positive:
  - "The rapid increase in the number of companies with outside directors will come as a surprise to many market observers."* – ***ISS***
  - "At last Japan has introduced corporate-governance reforms that will make a difference." – ***The Economist***
- But it is too early to tell the ultimate impact on Japanese corporate behaviour, as many companies opposed the Code!

*As of June 2015, 92% of companies listed on the TSE's 1st section had one or more outside directors – an increase of almost 18% from a year ago.

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Japan - Toshiba scandal

- What Toshiba did:
  - One of the country's biggest accounting scandals ever involving a giant of corporate Japan.
  - Since 2008, Toshiba had overstated profits by some ¥152 billion (US$1.27 billion) through intentional accounting fraud → eg, under-reporting costs, delaying expenses, not writing down unsellable inventories.
  - Independent investigators found that top managers orchestrated the deceitful practices → employees felt they could not act contrary.

TOSHIBA
Leading Innovation >>>

- What happened next:
  - The news triggered mass resignations of Toshiba's top brass.
  - The Tokyo Stock Exchange designated Toshiba a "security on alert".
  - Shareholders elected a new board with a majority of outsiders (7 outside directors and 4 inside directors) on September 30.
  - In addition, the Audit, Nomination and Compensation committees now have all outside directors.

Japan - Toshiba scandal

- CG implications for Toshiba:
  - ➢ Ironically, since the early 2000s, Toshiba had been seen as one of the first large Japanese companies to take CG reform seriously → voluntarily appointing outside directors and adopting the US/UK-style committee-system board structure.
  - ➢ But, clearly, such reforms were superficial → the board was dominated by insiders and outside directors were passive.
  - ➢ It is still unclear if Toshiba "gets" what needs to be done to fix its governance failings → eg, 3 incumbent/re-elected directors (2 insiders, 1 outsider) are leading its post-scandal overhaul.
- CG implications for Japan:
  - ➢ Along with the US$1.7 billion accounting scandal at Olympus in 2011, Toshiba's admission of deliberate accounting fraud means the possibility of additional as-yet unknown but similar cases coming to light cannot be ruled out.
  - ➢ Japanese regulators will need to beef up their oversight of corporate accounting and audit practices.
  - ➢ Investors should heighten scrutiny to make sure that Japan's CG reform is not merely form over substance.

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