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Asian Corporate Governance Association (ACGA)

**“Comply or Explain:
The Art of Persuasion in Corporate Governance”**

Presentation by:

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KRX & CGS Public Hearing
on the Amendment of the Korea CG Code
KRX, April 18, 2016

Agenda

1. Introduction to ACGA
2. The emergence of “comply or explain” in the UK
3. Corporate Governance codes in Asia and Europe
4. Stewardship codes

1. Introduction to ACGA

- Founded in Hong Kong in 1999 following—and as a response to—the Asian Financial Crisis of 1997-98.
- An independent, non-profit membership association dedicated to facilitating systemic and long-term improvements in corporate governance in Asia through research, advocacy and educational initiatives.
- ACGA has a global and regional membership base of 111 organisations covering a range of sectors:
 - Pension funds and investment managers
 - Asian listed companies
 - Multilateral banks
 - Accounting, insurance and financial service firms
 - Business associations
- ACGA investor members manage more than US\$24 trillion globally.

Selected investor members



ACGA Involvement in Korea

1. First ACGA Public Seminar: Held in Seoul in May 2000
2. Seven “CG Watch” reports since 2003—Korea one of 11 markets ranked. (Report #8 to be published in September 2016)
3. ACGA Investor Delegation to Korea, September 2011
4. ACGA 13th Annual Conference, Seoul, November 2013
5. Letter campaign to 27 chaebol on unaudited accounts, February 2014. Follow up in 2015 and 2016.
6. Supported investor member engagement in Korea over 2015-16

2. The emergence of “Comply or Explain”

- **United Kingdom, early 1990s:** Corporate collapses, concerns over auditing and executive pay led to the “Cadbury Report”, a seminal document on the “financial aspects of corporate governance”, published in December 1992. Hugely influential and widely copied.
- The Cadbury Report produced a short Code of Best Practice, which companies were expected to follow or “give reasons for any areas of non-compliance”. The London Stock Exchange created a continuing listing obligation to this effect (ie, a disclosure obligation).
- Cadbury argued that “compliance with a voluntary code coupled with disclosure, will prove more effective than a statutory code. It is directed at establishing best practice, at encouraging pressure from shareholders to hasten its widespread adoption, and at allowing some flexibility in implementation”.

(Underlining added)

Implementation of “Comply or Explain”

Cadbury envisages four essential actors in any “comply or explain” regime:

1. **Listed company boards:** They can choose to comply with the best practices in the Code or explain why they do not. But they should do so in spirit and substance, not form.
 2. **Regulators:** They must ensure that the Code’s disclosure obligation is taken seriously by companies and take enforcement action under the Listing Rules if it is not (eg, a reprimand).
 3. **Shareholders:** Since they elect directors, shareholders have a responsibility as owners to hold boards accountable in their implementation of the Code.
 4. **Auditors:** They are formally appointed by shareholders and must ensure the financial reports of companies are true and fair, and that their audit is done with professional objectivity. Cadbury also envisaged auditors would review board compliance with the Code.
- These four parts are interconnected. Drop any one or more and the system loses integrity and cohesion.

Early challenges

- **Hampel Committee, January 1998:** Formed in late 1995 to review the implementation of the Cadbury Committee's recommendations and those of a subsequent committee addressing remuneration—the Greenbury Committee.
- Hampel reported that companies often felt shareholders or their advisers treated the Codes as “sets of prescriptive rules”, which led to box-ticking.
- Hampel also criticised some companies for taking the “easier option” of box-ticking, rather than “the diligent pursuit of corporate governance objectives”.
- And, presciently, he argued against lower standards for smaller companies—a controversial issue still today.

“Any distinction by size would be arbitrary; more importantly, we consider that high standards of governance are as important for smaller listed companies as for larger ones.”

3. CG Codes in Asia-Pacific

Market	CG Code adoption	Amendment	“Comply or explain”?
Australia	2003	2007, 2010, 2014	Yes
China	2002	-	No (mandatory)
Hong Kong	2004	2012	Yes
India	1999	2014	Yes
Indonesia	2001	2006, 2016?	No / Yes?
Japan	2015	-	Yes
Korea	1999	2003, 2016	No (voluntary) / Yes?
Malaysia	2000	2007, 2012	Yes
Philippines	2002	2009	No (mandatory)
Singapore	2001	2005, 2012	Yes
Taiwan	2002	2011, 2015	Yes
Thailand	1999	2002, 2006, 2012	Yes

CG Codes in selected European countries

Market	CG Code adoption	Amendment	Code compliance: Mandatory or Comply/ explain?
Germany	2002	2003 to 2015 (11 revisions)	Both
Belgium	2004	2009	Both
Spain	2006	2013, 2015	Voluntary/Comply or explain
Finland	2004	2008, 2010	Mandatory
France	2003	2007 to 2015 (5 revisions)	Voluntary/Comply or explain
Italy	2006	2010 to 2015 (4 revisions)	Voluntary/Comply or explain
Netherlands	2003	2008	Both
UK	1998	2003 to 2016 (6 revisions)	Both
Sweden	2005	2008, 2010, 2015	Mandatory

Source: AMF, France

How does Asia measure up?

- Although the Cadbury Report (and later the “UK Combined Code”) has had a profound impact on Asian CG Codes—some largely copying it and/or the OECD Principles—the performance of the four actors has much room for improvement:
 - **Company** explanations often verge on the formulaic (“boilerplate”).
 - **Regulators** rarely take enforcement action for poor disclosure.
 - **Shareholder** ability to hold boards accountable is limited.
 - **Audit** quality hard to assess, lack of professional scepticism.
- This has implications for Korea: Governance reform needs to ensure that the right cultural incentives and institutional structures are in place if the amended CG Code is to achieve its objectives.
- It is worth noting that even in the UK, these processes are far from perfect. A 2013 review found that many companies struggled to articulate why they deviated from some aspects of the Code.

What “comply or explain” is not

- There seems to be a view that “comply or explain” means either ‘comply and simply state that you have complied’ or ‘do not comply and provide an explanation as to why you have not’.
- However, companies need to provide some explanation to shareholders even when they do comply. How are they implementing the principles and guidelines in a Code, and what have been the results of this action?
- Hence, “comply or explain” should really be written: “comply and explain, or do not comply and explain”.

4. Stewardship Codes

- UK “Stewardship Code” (2010, 2012)
- Netherlands “Best Practices for Engaged Share Ownership” (2011)
- Japan “Stewardship Code” (2014)
- Malaysia “Code for Institutional Investors” (2014)
- Hong Kong “Principles of Responsible Ownership” (2016)
- Taiwan “Stewardship Principles for Institutional Investors” (2016)

Coming up in Asia:

- Singapore
- Thailand
- Korea

“Stewardship” before stewardship codes

- **1980s/1990s:** State pension funds in the US began to develop policies and strategies on corporate governance. Voting shares, highlighting poor performers (CalPERS).
- **1990s/2000s:** Pension funds and asset managers in the UK started to follow suit, with voting/CG policies and active voting.
- **2000s:** Superannuation (pension) funds in Australia became actively involved in corporate governance issues and voting.
- **2005:** National Pension Service in Korea revised its voting policies.
- **Mid-2000s:** ACGA members actively voting in this region.
- **2010:** Employees Provident Fund, Malaysia, published its internal CG Principles and Voting Guidelines.

Global investor approaches to Asian companies: past 10+ years

	Comment
“Passive”	Only invest in companies, passive as shareholder
“Automatic voters”	Some shareholder responsibilities, institutions starting to vote, but somewhat automatically
“Informed voters”	Investors who take a focussed and risk-based approach as shareholder (e.g. voting on all or selected parts of their shareholdings)
“Light touch engagement”	Investors starting to exercise their rights and responsibilities as shareholders (e.g. undertake or participate in letter campaigns or conference calls with companies)
“Active owners” (Stewards)	Act as owners of the company (e.g. building long term relationship, engagement strategy, advising etc.)

Evolution over time



Modern “stewardship” – Post 2010 / GFC

- Institutional investors (pension funds and investment managers) are under increasing pressure to act as “stewards” of the capital they invest and of the assets they invest in (through holding the board to account).
- What does this mean in practice?
 - Investors need to take “environmental, social, and governance” (ESG) factors into account when investing.
 - They need explicitly to engage in “purposeful dialogue” with company management/directors.
- The Global Financial Crisis (GFC) has led to enormous pressure on institutional investors to be better stewards. Great criticism that many of them ignored CG and ESG factors before the GFC, leading to large investment losses.

Key Questions & Issues

1. Directors are the primary stewards of a company. How should shareholders exercise their “stewardship” function most effectively? What is the right relationship between the two groups?
2. Investor stewardship comprises two parts: stewardship of the capital with which they have been entrusted (the “fiduciary duty” concept); and stewardship over the companies in which they invest (the “ownership concept”). Both are critical. Yet most of the discussion and focus is on the latter.
3. How do institutions manage and disclose the conflicts of interest they face?
4. How do state pension/investment institutions manage the political interference they face?
5. Should pension funds (“asset owners”) drive stewardship, with investment funds (“asset managers”) playing a secondary role?

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