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Asian Corporate Governance Association (ACGA)

"Building Confidence in the Integrity of Capital Markets"

Presentation by

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"Capital Market Regulation:
Emerging Trends and Regulatory Structures".
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Agenda

1. Market Integrity and Investor Confidence
2. Rating Market Integrity in Asia
3. Increasing Importance of Corporate Governance to Institutional Investors
4. Conclusion: The Role of Regulators, Investors and Judges in Enhancing Market Integrity

Introducing ACGA

- The Asian Corporate Governance Association (ACGA) was formed in 1999 to help facilitate the implementation of effective corporate governance in Asia. Our scope of work covers research, advocacy and educational events in 11 Asian countries.

- ACGA is incorporated in Hong Kong as a non-profit association and is independently funded by a corporate membership base.

1. Market integrity and investor confidence

Hong Kong Listing Rules:

- "The principal function of the Exchange is to provide a fair, orderly and efficient market for the trading of securities." (Rule 2.01, Listing Rules of the Stock Exchange of Hong Kong.)

- The Listing Rules "reflect currently acceptable standards in the market place and are designed to ensure that investors have and can maintain confidence in the market..." (Rule 2.03)

Bursa Malaysia Listing Rules

- "Investors and the public shall be kept fully informed by the listed issuers of all facts or information that might affect their interests and, in particular, full, accurate and timely disclosure shall be made of any information which may reasonably be expected to have a material effect on the price, value or market activity in the securities of listed issuers" (Rule 2.03 (2))

- "All holders of securities shall be treated fairly and equitably" (Rule 2.03 (3))

Basic principles

- Fairness:
  - All shareholders of a listed company—whether they are large or small, retail or institutional—should be treated equally in certain fundamental ways (eg, voting rights, dividends, right to attend shareholder meetings).
  - All shareholders should be able, without too much difficulty or expense, to nominate directors to the board.
- But this does not mean that all shareholders are in fact equal:
  - Controlling shareholders appoint / dominate the board.
  - Significant stakes of 1% to 5% are often required before shareholders can nominate directors or make proposals.

More basic principles

- Transparency:
  - Because of massive asymmetry of information between companies and their public shareholders, issuers are obliged to keep the market sufficiently informed of their operational and financial performance, major investment decisions and risks.
  - Investors should be able, on an ongoing basis, to assess the investment risk of individual companies.
- Translating transparency into practice raises immediate questions:
  - Company accounts are inherently backward looking and, in a volatile market, quickly out of date.
  - Financial reports vary greatly in detail and quality.

"Market integrity" – Easier said than done

- The stated principles of all regulatory bodies, whether in Asia, the US or elsewhere, are right and appropriate, yet will always remain aspirational. Why?
  - Government support for a genuinely level playing field is unstable and often undermined by powerful interests.
  - Regulators are perennially under-resourced and behind the market curve. (Is this intentional? Do governments actually want regulatory systems to succeed? Do they know what is required?)
  - Financial innovation is relentless, and the opportunities for fraud and mis-selling of products is immense.
  - Many institutional investors do not take their fiduciary responsibilities seriously.

2. Rating market integrity in Asia: "CG Watch"

Market	2004[1]	2005[2]	2007[3]
1. Hong Kong	67	69	67 ↓
2. Singapore	75	70 ↓	65 ↓
3. India	62	61 ↓	56 ↓
4. Taiwan	55	52 ↓	54
5. Japan	-	-	51
=6. Korea	58	50 ↓	49 ↓
=6. Malaysia	60	56 ↓	49 ↓
8. Thailand	53	50 ↓	47 ↓
9. China	48	44 ↓	45
10. Philippines	50	48 ↓	41 ↓
11. Indonesia	40	37 ↓	37

1. Introduced a detailed survey and scoring methodology in 2004.
2. Made the methodology more regorous in 2005.
3. Enhanced the methodology further in 2007. (No survey in 2006.)

Source: "CG Watch", a joint report by ACGA and CLSA Asia-Pacific Markets

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Why scores in "CG Watch 2007" were lower

- Methodology became more rigorous
- "The more we looked, the less we found"
- Varying degrees of regulator, issuer and investor complacency in booming markets
  - "The job is done, we now just need to refine the rules" (No one says this anymore!)
- Political paralysis (eg, Korea) or upheaval (eg, Thailand)
- Accounting + auditing standards & practices lagged international norms more than expected in many markets

Disclosure strengths and weaknesses

To what extent are Asian markets achieving their stated objectives of fair markets and timely, material disclosure?

- The quality of financial and non-financial reporting among large caps has generally improved, but quality is uneven. It is often much worse in smaller issuers.
- Reporting deadlines have shortened in most countries, but continue to vary and are long in some.
- Continuous disclosure of price-sensitive information remains poor across the board.
- IPO prospectuses must contain more information, but drafts often provided only to certain investors & analysts.
- AGM agendas lack detail and no disclosure of voting results.

3. Increasing importance of CG to institutional investors

- Hard data on the extent to which institutional investors incorporate corporate governance analysis into their investing in Asia is extremely limited. But anecdotal evidence points to a growing, if highly fragmented and uneven, level of interest (mostly among global funds). This can be seen in their desire for:
  - Strengthened shareholder rights
  - More effective regulatory enforcement
  - Better board practices
  - Better data on ESG

Strengthened shareholder rights

- What investors are looking for:
  - **Proxy voting:** earlier release of final agendas/circulars; full voting by poll (or, as a first step, the publication of proxy votes received before meetings); and publication of full voting results.
  - **Shareholder meetings:** easier access for fund managers to meetings (eg, the "two-proxy problem" in Singapore).
  - **Fairer "general mandates":** tighter rules on dilutive private placements sought (eg, Hong Kong, Japan, Singapore and Taiwan). Maintain the line in Malaysia!
  - **Privatisations/delistings:** protections for minority shareholders (eg, approval processes) are weak in much of Asia.

More effective enforcement

- What the market expects:
  - **Regulatory spine and focus:** a clear and consistent signal to the market on policy and enforcement.
  - **Securities law:** a faster, fairer approach to dealing with insider trading and fraud.
  - **Listing rules:** most exchanges have weak powers to enforce their own rules; investors want to see more rigour and efficiency.
  - **CG Codes:** these are rarely "enforced" or promoted; exchanges could be more proactive (eg, in IPOs)
  - **Transparency:** regulators could be much more active in disclosing their enforcement actions and processes.

Better board practices

- What investors are looking for:
  - **Independent directors:** more openness among controlling shareholders and management to their business value; less cynicism please.
  - **Board composition:** should reflect the business needs of the company.
  - **Board structure/committees:** less box-ticking and more thought as to how board committees are structured and operated, and the types of committees formed.
  - **Director training:** a conundrum—if mandatory, can become a box-ticking exercise; if voluntary, there will be a limited take-up. Focus on pre-IPO? Tests?

Data on ESG

- "CSR" (corporate social responsibility) has changed and morphed into "ESG" (environmental, social, governance).
- ESG brings a greater focus on the need for investors to incorporate environmental, social and governance **risks** into the investment process. For example:
  - United Nations Principles of Responsible Investment (UNPRI).
  - Greater attention paid on whether newly listed companies meet requisite environmental and labour standards.
  - Global pension funds are look for fund managers who can invest along ESG lines.
- Question: Should it be E + S + G, or G as the basis for E & S?

4. Conclusion: The Role of Regulators, Investors and Judges in Enhancing Market Integrity

- **Regulators and governments:** The primary actors in ensuring market integrity. Financial regulators are the front line of defence and bear the brunt of market anger and criticism. This is somewhat unfair, since they operate within a set of financial, legal, ethical and political constraints imposed by government.
- Through better negotiation, regulators need to impress upon the executive branch of government what is required to create and maintain stock market integrity.
- Financial regulators within countries need to work together and avoid infighting, suspicion or competition.
- Regulators also need to spend more time genuinely and actively talking to the market, not simply engaging in formalistic and rushed consultations.

Conclusion continued

- **Investors:** A secondary actor, but extremely important in ensuring that "market discipline" is more than a hollow phrase. Both retail and institutional investors have a role to play in alerting companies that they care about governance and intend to take their ownership responsibilities seriously. Market discipline complements, rather than substitutes, regulatory discipline.

- **Judges:** Shareholders of listed companies rarely go to court in most Asian countries, but when they do they often find that the judiciary is unprepared and inexpert in company and securities law. Building capacity and expertise among judges is critical for the long-term enhancement of market integrity.

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