CLSA
ASIA-PACIFIC MARKETS

CG Watch 2010

Corporate governance in Asia

ACGA
In collaboration with the Asian Corporate Governance Association

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6 September 2010

Asia
Special report

Highest-ranked markets

Singapore
Hong Kong
Japan
Taiwan
Thailand

Top-scoring CG stocks

HK Exchanges (388 HK)
Nintendo (7974 JP)
Li & Fung (494 HK)
TSMC (2330 TT)
HSBC (5 HK)
Infosys (INFO IB)
Sony (6758 JP)
Sumitomo Metal (5405 JP)
Tokyo Electron (8035 JP)
Tokyo Gas (9531 JP)
Canon (7751 JP)
Wipro (WPRO IB)
Ricoh (7752 JP)
Mitsui (8031 JP)
OCBC (OCBC SP)

Stray not into perdition

Asia's CG momentum slows

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Stray not into perdition

Asia's CG momentum slows

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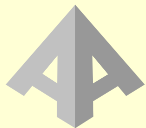

In collaboration with the Asian Corporate Governance Association

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ACGA endorses the methodology used in this survey and contributed to the country analysis. It did not participate in the assessments of companies, for which CLSA retains responsibility.

Stray not into perdition

Market CG scores - Sinners repent

Corporate-governance standards have improved over the past decade, but even the best Asian markets remain far from international best practice. Regulators make it too easy for companies to stray and get away with box-ticking. Markets still lack effective rules on fundamentals such as independent directors and audit committees. Not enough has been invested to make best practices work. Meanwhile, most institutional investors are yet to invest sufficiently in voting, engagement or stewardship. Rather than use the global financial crisis as a platform to push reform forward, governments have taken a complacent view, happy that the crisis this time did not start in Asia.

Changes in market rankings

On the ACGA-CLSA market rankings, Singapore and Hong Kong switch places at the top this year while Thailand and Japan have seen the biggest improvements. Indonesia moves higher against the Philippines which scored the lowest. Korea has regressed and is now third from the bottom.

Measuring governance

We have streamlined the CG questionnaire, revamped our Clean & Green (C&G) scoring and combined this with corporate social responsibility (CSR) for a 10% weight in the overall score. In all, we scored 580 companies in the region, including Japan. In recent crisis years, the risk to CG was on the downside. Our corporate scores slipped in Indonesia and Taiwan but moved up in Singapore, India and Thailand. Like other regions, Asia has had some debacles but not a systemic breakdown in governance, unlike the experience of the Asian crisis in the 1990s. Reduced gearing of both companies and controlling shareholders has lowered the risk of conflicts of interest and of blowouts in the region. Average scores have remained steady; however a wider gap between companies in the better and worse markets is apparent.

Social responsibility is on the rise

Corporate social responsibility in terms of CSR publications is on the rise. Asia now accounts for more than 20% of global CSR reports versus 12% just five years ago. CSR reporting, however, is still mostly voluntary. Japan is clearly ahead, with companies emitting large amounts of greenhouse gases (GHGs) required to calculate and report these emissions. But even Chinese firms are encouraged to publish CSR reports to improve the country's branding, reputation and competitiveness. Environmental laws have tightened, with higher associated fines/sanctions. Many companies however mistake contributing to local charities as CSR, when it is just a small part.

Large caps dominate the high-CG rankings in the region but see inside for mid-caps with comparable CG scores

Top-20 CG large caps in Asia

	Code	Country	Sector
HK Exchanges	388 HK	Hong Kong	Financial services
Nintendo	7974 JP	Japan	Technology
Li & Fung	494 HK	Hong Kong	Consumer
TSMC	2330 TT	Taiwan	Technology
HSBC	5 HK	Hong Kong	Financial services
Infosys	INFO IB	India	Technology
Sony	6758 JP	Japan	Technology
Sumitomo Metal Ind	5405 JP	Japan	Materials
Tokyo Electron	8035 JP	Japan	Technology
Tokyo Gas	9531 JP	Japan	Power
Canon	7751 JP	Japan	Technology
Wipro	WPRO IB	India	Technology
Ricoh	7752 JP	Japan	Technology
Mitsui	8031 JP	Japan	Conglomerates
OCBC	OCBC SP	Singapore	Financial services
LG Electronics	066570 KS	Korea	Technology
Nippon Steel	5401 JP	Japan	Materials
Toshiba	6502 JP	Japan	Technology
Hoya	7741 JP	Japan	Technology
Mitsubishi Corp	8058 JP	Japan	Conglomerates

Source: CLSA Asia-Pacific Markets

Corporate standards

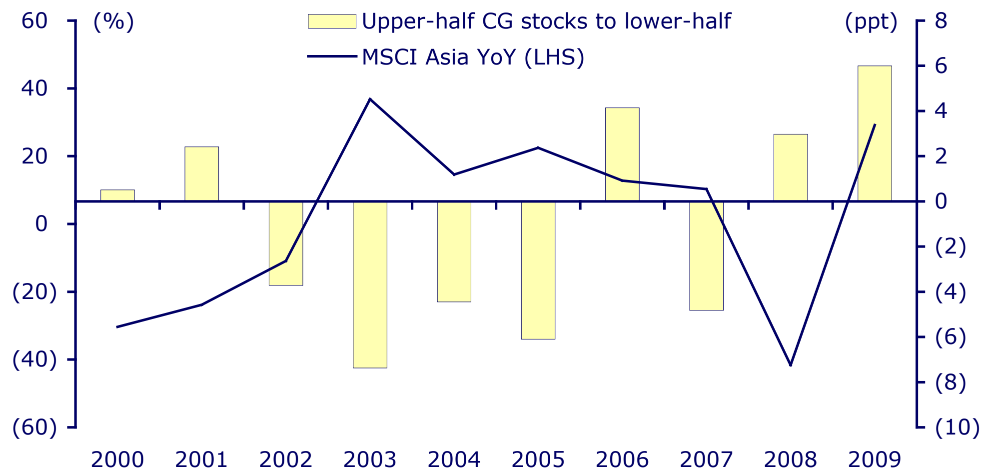
A snapshot across the region reveals areas where CG can be improved against the overall average corporate score that is just 52.7%. Large caps tend to have better CG. Particularly in Japan, blue chips have a median CG score almost seven points higher than that for the overall market. Among the highest-scoring companies in the region are **HK Exchanges**, **Li & Fung**, **TSMC**, **HSBC**, **Infosys** as well as **Nintendo**, **Sony**, **Sumitomo Metal** and **Tokyo Electron**. Some medium-sized companies also have high standards including **CapitaMalls Asia**, **Kasikornbank**, **Bank of Ayudhya**, **Konica Minolta**, **Nikon**, **Hynix** and **Manila Water**.

Does CG matter?

The structures and processes of good CG may not obviously boost the performance of a business, but without them investors face the risk that the economic value created may be hijacked. In the worst instances, lack of CG demolishes a stock. Our Quant team published a report, *Nice guys finish ahead* (11 June 2010), where they stripped out CG from other market-related factors to find that a 10-point difference in the CLSA CG score has been associated with 7.3% additional performance for a stock over nine months after CG scores were updated.

High-CG stocks tend to perform better when markets are weak

Performance of upper-half CG stocks to lower-half vs MSCI Asia Pacific



Source: CLSA Asia-Pacific Markets

Poor-CG stocks are a drag

Our updated tests suggest poor-CG stocks suffer a drag in performance. These are companies where investors are more likely to be disadvantaged. Improving CG is correlated with stock outperformance, while falling CG is associated with poor stock returns. We find that removing the lowest-CG stocks from a low-PE basket enhances the already strong performance of this value screen. Investors are thus provided with the opportunity, by avoiding the worst-CG companies, to reduce risk while achieving higher returns.

Higher returns with lower risk?

This seems to fly against the axiom of finance that returns cannot be boosted without higher risk, except that the market may not yet have fixed on the means to measure and thus price in CG risk. For investors, the continued relevance of our CG rating of companies and markets is that beyond the ivory tower, this remains an under-researched area. Yet it has important implications for portfolio returns. Identifying red flags and avoiding CG scum should help investors avoid being caught in a bog of value traps.

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Market CG scores - Sinners repent

Market scores have changed with improved scores for Thailand, Japan, Indonesia . . .

Once again, our *CG Watch* market scores and rankings have changed, with results that may surprise investors even more than the reordering that took place in our last survey in 2007. Thailand, Japan and Indonesia - having underperformed in the past, often for extended periods - stand out this year. Thailand enjoyed an eight percentage-point jump in its absolute score and wins the award for "most improved". Japan rose five percentage points and Indonesia three points. Given that reforms in Japan appeared to be stuck only two years ago, its performance in this survey shows what can be done when regulators show determination and market consensus starts to shift. As for Indonesia, the odds for a long time have been on it retaining last place in this survey. This is no longer the case, as it has moved ahead of the Philippines.

. . . as well as Malaysia and China

Two other markets which deserve special merit are Malaysia and China, whose scores rose by three and four percentage points. Although a better result than in 2007, Malaysia's progress is somewhat more incremental than Indonesia's and less surprising. Moreover, its ranking (sixth) has not changed. China's performance, relative to its 2007 score and position, is better across the board and builds on its improvements in our last survey.

Worst performers are India, Korea and Philippines

The worst performers this year are less of a surprise, although their final scores may be: India, Korea and the Philippines. India's score collapsed by seven percentage points, in large part because we overrated it last time (although we still believe it is improving slowly). Korea's slide accelerated, thanks largely to the anti-reform administration of Lee Myung-bak. And the Philippines fell because of disappointing results in most categories of the survey, expecially "CG culture".

Scores in percentages. Markets listed according to 2010 position

Figure 1

CG Watch market scores: 2007 vs 2010

(%)	2007	2010	Change (ppt)	Trend of CG reform
1. Singapore	65	67	(+2)	Improving slowly, negatives cancel positives
2. Hong Kong	67	65	(-2)	Some regression, static overall
3. Japan	52	57	(+5)	Improving, but will reform be sustained?
= 4. Taiwan	54	55	(+1)	Static overall, loss of focus
= 4. Thailand	47	55	(+8)	Improving, but political uncertainties remain
6. Malaysia	49	52	(+3)	Improving, but held back by "CG culture"
= 7. India	56	49	(-7)	Over-rated last time, but slow improvements
= 7. China	45	49	(+4)	Improving, but held back by "CG culture"
9. Korea	49	45	(-4)	Regressing, turning inward
10. Indonesia	37	40	(+3)	Improving, but weak political system
11. Philippines	41	37	(-4)	Regressing, but new government may help

Source: Asian Corporate Governance Association

Singapore and HK should be performing at a higher level of CG

What of Hong Kong, Singapore and Taiwan? Singapore regains the top spot this year with a two-point increase in its score, while Hong Kong falls by the same amount and moves back to second. Taiwan remains at fourth, with a marginally higher score than in 2007, but this time shares the honours with Thailand. These results, however, are nothing to celebrate, especially in regard to Singapore and Hong Kong. Both should be performing at a much higher level for financial centres that aspire to follow international standards and which have not yet, despite a decade of reform, cracked the 70% mark.

Scores more important than the ranking

While the ranking of markets is interesting and relevant, we believe readers (and especially regulators) should focus more on their scores, how these have changed, and what this says about their market and state of CG reform. This is why we have chosen this year to emphasise in this introducton not the simple ranking of markets, but the extent to which they have improved, stayed the same, or regressed.

Some have improved, others slipped

As the table above indicates, seven markets have improved in score this year (although two of those by tiny amounts) and four have fallen. The 11 markets could be divided into the following groups:

- **Improvers:** Japan, Thailand, Malaysia, China, Indonesia
- **Marginal improvers:** Singapore, Taiwan
- **Marginal decliners:** Hong Kong
- **Decliners:** Korea, Philippines
- **Outlier:** India (The country's decline in score was due more to a change in view on our part - we overrated India the last time - rather than a genuine regression in the quality of its governance regime. In fact, it is slowly improving).

Can Japan sustain reforms?

The above table also highlights whether these trends are likely to continue. Despite Japan's tangible progress over the past three years, it is not at all certain whether regulators can sustain reforms. Thailand has done well, but still faces serious political uncertainties that could cause its reforms to stall. And whether Indonesia can truly rise above its endemic corruption for a sustained period is anyone's guess.

Upside potential as well for both Singapore and HK

On the upside, Singapore could see its score increase if it took certain clearly defined actions, some of which are relatively easy (such as mandating or encouraging companies to vote by poll at their AGMs) and some of which are not (such as completing its company law amendment process). Hong Kong could also increase its score, but to do so would require finding the political courage to reignite the reform process and for the government to think more strategically about the role of corporate governance in its capital markets - a little more highbrow than the mechanics of voting at shareholder meetings (something which Hong Kong, incidentally, has already resolved). The situation and rankings are therefore fluid.

Scores comparable for the first time

Scores are comparable with 2007

It is worth emphasising that the market scores in this edition of "CG Watch" can be compared with our last survey in 2007 because the questionnaire applied to the markets is largely the same and our five-point scoring system has not changed. This contrasts with previous editions of "CG Watch", namely in 2004, 2005 and 2007, when we made significant changes to both the questionnaire and the scoring system in each of those years. This led to most market scores falling as questions (and our answers) became sharper and the scoring system became tougher. This did not mean that the quality of corporate governance in Asia was falling, rather that our assessment was becoming more critical.

This year, however, a fall in score generally indicates that a market has gone backwards. The one exception is India, for reasons noted above. (For more details on survey methodology, see the box at the end of Section 1. Appendix 2 provides the detailed survey questions and answers).

We make comparison of Asian market CG scores with what might be expected as a world class benchmark

How advanced is CG in Asia?

While regulators undeniably like to focus on relative rankings, and we prefer to see whether a market has improved over the short to medium term, it is also worth asking what the absolute scores for Asia say about the state of development of the region's corporate governance. After more than ten years of reform, how advanced are Asian markets compared to global standards?

No template exists that points precisely to the level a country would have to achieve to earn the right to say it had a world-class corporate governance system. However, common sense and our own questionnaire suggest that a score of 80%+ would be a reasonable cut-off point. On this basis, one could construct the following table to show how much farther our 11 markets would have to go before they could claim to be world class.

Even Singapore and HK have long way to go to claim to be truly world standard

Figure 2

Gap analysis: Asia vs nominal world-class CG benchmark

(%)	2010 Score	World-Class Benchmark 80%
1. Singapore	67	(-13)
2. Hong Kong	65	(-15)
3. Japan	57	(-23)
= 4. Taiwan	55	(-25)
= 4. Thailand	55	(-25)
6. Malaysia	52	(-28)
= 7. India	49	(-31)
= 7. China	49	(-31)
9. Korea	45	(-35)
10. Indonesia	40	(-40)
11. Philippines	37	(-43)

Source: Asian Corporate Governance Association

We readily admit that this analysis, and our choice of 80%, is subjective. However, it does indicate that even the best Asian markets - Singapore and Hong Kong - have a long way to go before they can claim to be truly international.

Market scores are a simple average of 5 categories

Category scores: What's in the mix?

The table below shows the percentage scores that each market gained in the five categories in the survey: "CG Rules and Practices", "Enforcement", "Political and Regulatory Environment", "IGAAP" (ie, accounting and auditing), and "CG culture". The total score for each market is a simple average of these five scores. Each category is weighted the same.

Highest score for Asian markets is 67% with lowest score at 37%

Figure 3

Market category scores

(%)	Total	CG rules & practices	Enforce-ment	Political & regulatory	IGAAP	CG Culture
1. Singapore	67	65	60	69	88	53
2. Hong Kong	65	59	63	67	80	54
3. Japan	57	45	53	62	75	53
= 4. Taiwan	55	50	47	56	78	46
= 4. Thailand	55	56	42	54	73	49
6. Malaysia	52	49	38	60	80	32
= 7. India	49	46	36	54	63	43
= 7. China	49	47	36	56	75	30
9. Korea	45	43	28	44	78	33
10. Indonesia	40	39	28	33	67	32
11. Philippines	37	35	15	37	75	25

Source: Asian Corporate Governance Association

Scores for accounting and auditing relatively high across the markets

As the table shows, scores for **IGAAP** (accounting and auditing) are considerably higher than other categories. This is largely because all markets have a policy of following International Financial Reporting Standards (IFRS) for accounting and International Standards on Auditing (ISA) for auditing. Since the Enron crisis in 2001, all markets in Asia have followed the lead of the US and other developed markets and focussed attention on the independence of external auditors (CPAs), which in practical terms means such things as introducing limits on the non-audit work that auditors can do, requiring rotation of audit partners and/or firms, and providing whistleblower protection for auditors. More recently, there has been a growing emphasis on the need to create an independent regulatory system for the audit industry, as confidence in the ability of CPA institutes to regulate their own members has vanished.

HK and India do not have an independent audit regulator unlike Singapore

As the differences in the scores suggest, however, markets in Asia vary in the extent to which they have moved up this reform curve. Singapore is a clear leader because its accounting and auditing standards and practices are close to international norms, and it has an independent audit regulator. Hong Kong's score is noticeably lower, in large part because it still lacks an independent regulator. India does poorly in this category for a similar reason, but also because of serious questions about its audit industry.

CG reform over past decade largely state-driven

Political and regulatory environment is the category that generally earns the next highest scores, a reflection of the fact that corporate governance reform in Asia over the past decade and more has been largely a state-driven, top-down process. The scores also reflect the institutional capacity building that almost all markets are engaging in (ie, strengthening their financial regulatory bodies and judiciaries) and their investment in creating online databases of laws, regulations and listed company announcements. The higher the score, the more sophisticated the political/regulatory system.

Some markets score well on political and regulatory environment but get dragged down elsewhere

While scores for this category often tally quite closely with a market's total score, and indicate therefore where it will come in our rankings, this is not always the case. Both Malaysia and China do a lot better on political and regulatory than their overall ranking would suggest - an indication that their main CG problems lie elsewhere (see below).

For markets with better CG, narrow gap between rules and practices vs enforcement

When we first started working with CLSA on "CG Watch" in 2003 there used to be a sharp distinction between scores for **CG rules and practices** and **enforcement**. This is what most people would expect, since writing rules is supposed to be easier than enforcing them. As Table 3 shows, this is indeed the case for seven of the lower ranked markets - their scores for rules are at least 10 percentage points higher than their scores for enforcement (for some the gap is even greater). But for the top four markets in our survey, the score for rules is either only a few points higher (Singapore, Taiwan) or actually lower (Hong Kong and Japan). While this may seem odd, the reasons are as follows:

Enforcement becoming a better indicator of a market's overall CG ranking

- The pace of new reform (ie, rule making) has slowed, while greater emphasis has been put on enforcement. Indeed, the top four markets in our survey also earn significantly higher scores for enforcement than the other markets. Equally interesting is the fact that the ordering of enforcement scores, from highest to lowest, produces a very similar result to our overall market rankings this year. There are some discrepancies, including Hong Kong having a slightly higher score than Singapore, Taiwan being a few points above Thailand, and Korea being on par with Indonesia. But otherwise it seems clear that the enforcement category is a much better indicator of a market's overall ranking than any other category.

- A second factor is that we amended our CG rules category a few years ago to assess not only whether certain rules existed on paper, but whether companies were implementing them properly. It seemed pointless (and inaccurate) to give full points for rules that companies were ignoring or only partially putting into practice. This led to falls in the overall score for this category in all markets.

Enforcement includes private actions

- Another part of the story is that our enforcement category looks not only at "public enforcement" by regulators, but "private enforcement" by shareholders and market intermediaries (eg, such things as voting of shares, attending AGMs and nominating independent directors). Such activity tends to be more prevalent in the more advanced markets.

The fifth and final category is **CG culture**, a category that broadly looks at what companies, investors, intermediaries, non-profit organisations and the media are doing to raise CG standards voluntarily. There is no clear correlation here between the scores and market rankings, and the higher ranked markets do not stand out as being particularly good. India, which ranks equal seventh overall, has a CG-culture score that is almost as good as Taiwan, which comes equal fourth. And the scores for Malaysia, Korea and Indonesia are almost identical.

Reform still top down

Reform has been state-driven and top-down

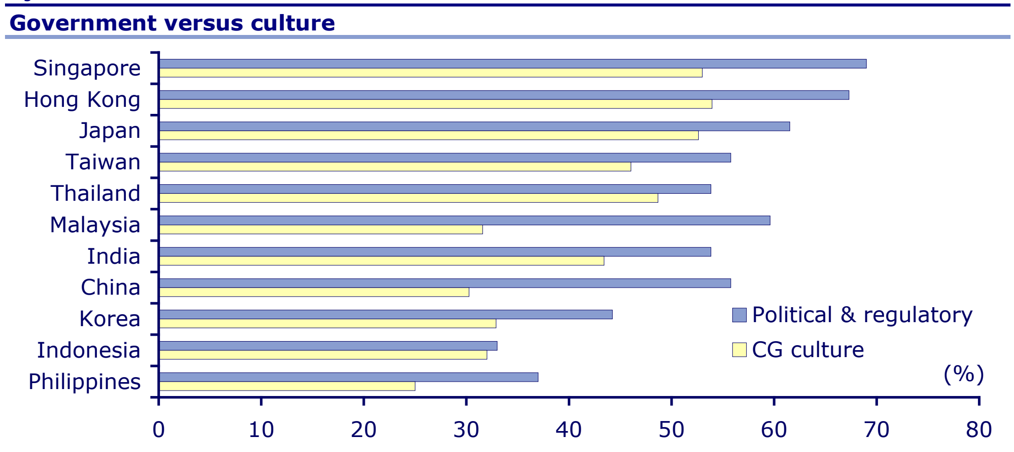
The last point above highlights a salient feature of corporate governance reform in Asia since the late 1990s. The parts of the system that governments and regulators are responsible for - rules, public enforcement, political and regulatory institutions, and IGAAP - are far more impressive and advanced than developments in the private sector and wider community. Reform is still fundamentally state-driven and top-down, and it is not entirely clear if governments in some places are winning their populations over to the necessity and value of corporate governance.

The chart below contrasts the score that each of our 11 markets gained for **political and regulatory environment** with their mark for **CG culture**. The gap in all markets is noticeable, with the exception of Indonesia - something that is due to both fundamental weaknesses in its public institutions and improvements in the work being done by NGOs, director training institutes and the media. But the gap is greatest in Malaysia and China - an issue that we believe poses risks for their CG regimes in future.

Significant gaps between scores driven by government and regulators vs overall CG culture in most markets, particularly Malaysia and China

Figure 4

Government versus culture



Source: Asian Corporate Governance Association

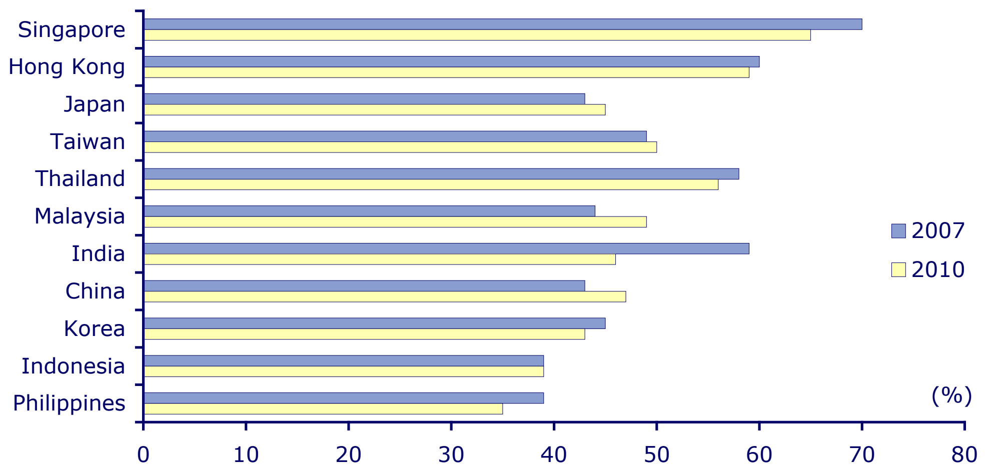
How category scores have changed

How have category scores changed from 2007 to 2010? As the chart below shows, the answer is not much for **CG rules and practices**. Only four markets have higher scores - Japan, Taiwan, Malaysia and China - and even some of these have improved only marginally. The remaining markets either declined in score or stayed the same, including regional leaders Singapore and Hong Kong.

Only Japan, Taiwan, Malaysia and China have scores that moved up for rules and practices

Figure 5

CG rules and practices: 2007 vs 2010



Source: Asian Corporate Governance Association

Reform fatigue appears to be setting in

This outcome partly reflects the trend noted above regarding the pace of reform slowing in many markets. A certain amount of 'reform fatigue' has set in - something that is especially apparent in Hong Kong, Taiwan, India and Korea - and/or regulators are finding it is taking longer to get reforms through than expected - Singapore, Taiwan again and possibly the Philippines.

We have taken a tougher line in the scoring here as international best practices . . .

Another reason is that we have had to take a tougher line in this section on certain questions because international best practices and investor expectations have moved forward, both in response to the global financial crisis and as part of the evolution in recent years of "responsible investment" (ie, investment that takes ESG or environmental, social and governance issues into account). Even investors who do not see themselves as ESG advocates are taking a stronger interest in corporate governance issues today.

. . . and investor expectations have moved forward

This all plays out in demands from investors for more detailed financial and non-financial reporting, as well as higher expectations for the continuous disclosure of material information, protection of pre-emption rights, and voting by poll at AGMs. It has also resulted in new best-practice ideas for boards and directors (such as setting limits on the number of directorships that each director can have) and for investors (such as requiring them to follow a new "stewardship code", as in the UK).

Asian markets starting to fall behind global standards - a negative consequence of coming through the global financial crisis relatively well

The reality is that most Asian markets are starting to fall further behind global standards in many of the areas listed above, and we have marked scores down on individual questions accordingly. This is one tangible and negative consequence of Asia coming through the global financial crisis largely unscathed. Hopes that the crisis would prove a catalyst for a new round of serious reform proved unfounded, thanks primarily to the global fiscal

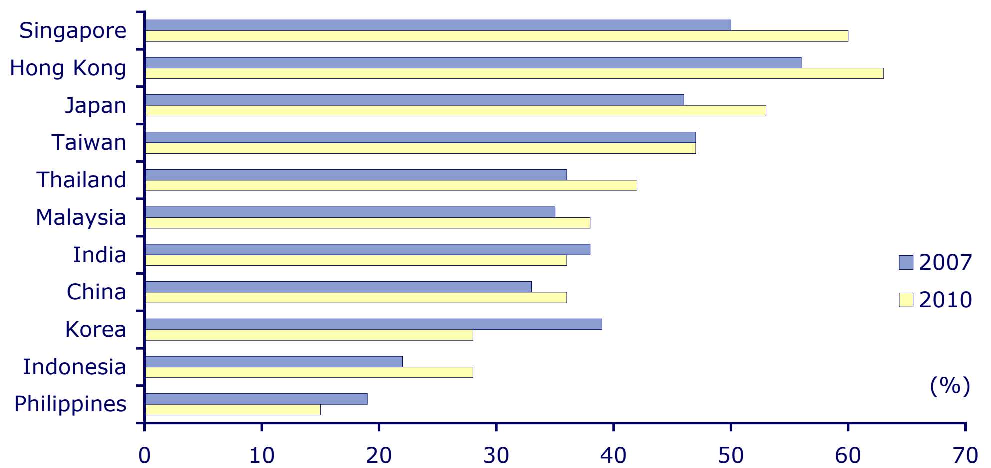
stimulus in 2009 that saw stock markets bounce back (especially in Asia) and governments, investors and just about everybody breathing a collective sigh of relief. Asia may well pay for this complacency in future.

The picture is entirely different for **enforcement** . . .

Markets with lower CG rating generally dragged down by enforcement score

Figure 6

Enforcement: 2007 vs 2010



Source: Asian Corporate Governance Association

Seven markets sae enforcement score rise, but fell for three of the markets

Seven markets saw rises in enforcement scores and some by reasonably large amounts, including Singapore, Hong Kong, Japan, Thailand and Indonesia. One did not change (Taiwan), while three fell (India, Korea and the Philippines). (See market sections for more details on each country's performance in this and other categories.)

To some extent higher score because of better information

To some extent the increased scores were a result of the way we answered two questions focusing on whether statutory regulators (securities commissions) and stock exchanges were investing more financial and human resources in investigation and enforcement. In 2007, we gave zero points for both questions in all markets, because insufficient official data was available on which to make a judgement. This year we decided the data was better and we could form a view.

Regulators are taking enforcement more seriously

The higher enforcement scores also confirm a trend we saw in previous surveys - that regulators are taking this aspect of their job more seriously. This is good news and means that corporate governance in Asia is being put on a firmer footing. But as ever, some qualification is needed. Much enforcement action falls into the "administrative sanctions" basket and results in such things as fines, bans, orders and warnings against companies and individuals. These can sometimes be quite severe, such as a hefty fine or period for disqualification for a director or broker, though often they are not.

Few markets made progress prosecuting insider trading and market manipulation

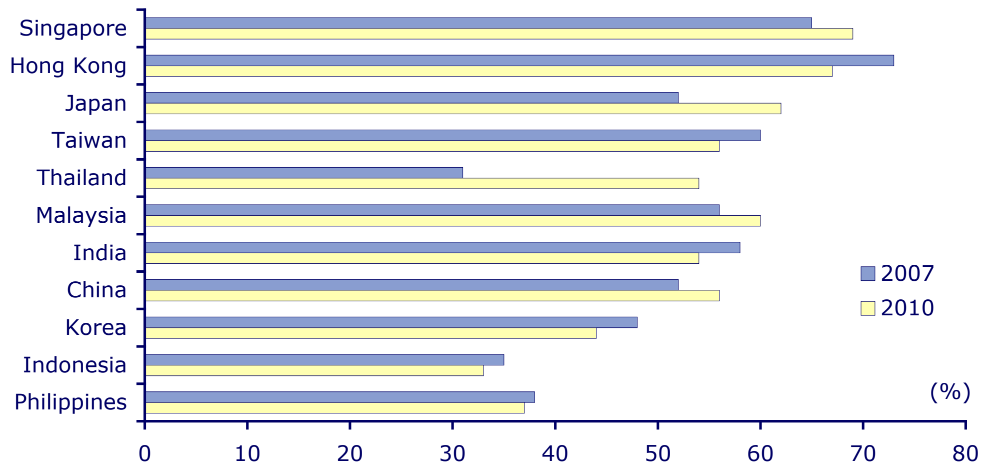
Of more concern is that few markets have made much progress in the prosecution of insider trading and market manipulation. Hong Kong is leading the way in this area (although it is far from perfect), with Singapore a little way behind. But in many Asian markets such cases are either rare or non-existent. Old habits and attitudes die hard.

Whether Hong Kong can sustain its effort in enforcement is an open question. Much of its progress is the result of the hard work of a few individuals in the Securities and Futures Commission (some of whom are on short contracts), rather than an official, government-led response to a problem. Indeed, the results of the **political and regulatory environment** category do not augur well for Hong Kong . . .

Political and regulatory score up most significantly for Japan, Thailand

Figure 7

Political and regulatory environment: 2007 vs 2010



Source: Asian Corporate Governance Association

Six of the markets had lower score for this category with HK having biggest decline

As the chart shows, six of 11 markets fell in score, with Hong Kong leading the way down (-6 points) and neatly reversing almost all the numerical gains it made in enforcement. Other markets that fell included Taiwan, India, Korea, Indonesia and the Philippines.

The India score came down because of our negative rerating for the country, while the lower score in the Philippines is not significant. The two-point drop in Indonesia reflected core weaknesses in public-sector institutions, but that is nothing new.

Some seem to have lost the strategic focus

More worrying were the results for the other three markets, all of which fell because we believe that their governments and regulators have either lost strategic focus and the courage of former convictions (Hong Kong, Taiwan), have lost momentum (Hong Kong and Taiwan again) or are actively working against good corporate governance (Korea).

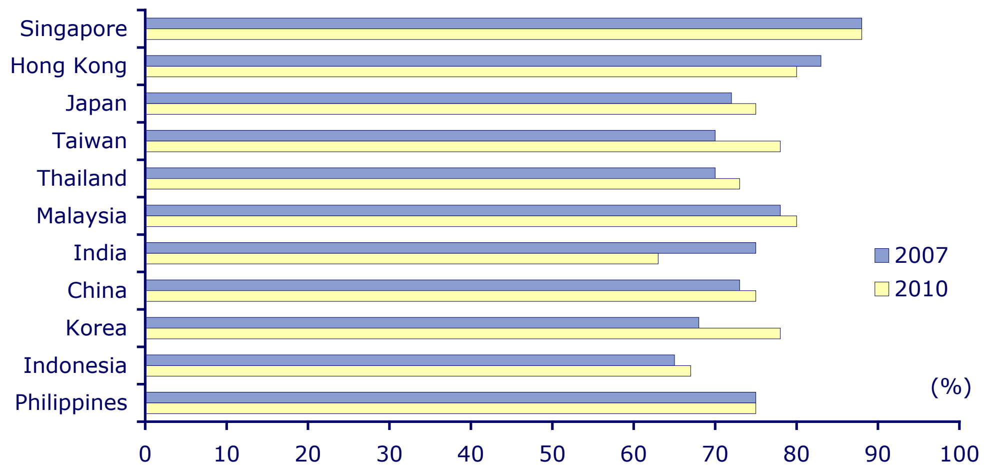
Of the markets whose scores increased, the stand-out performer was Thailand (+23 points), with a good improvement from Japan (+6 points). Regulators in Thailand have managed to keep the reform process going despite all the political uncertainties of the past four years, and are more than back to where they were in 2005. Meanwhile, the Japanese government has surprised on the upside and enacted reforms in the face of stiff opposition. (See respective market sections for details.)

Patterns become a little more predictable again in **IGAAP** . . .

Score for accounting and auditing standards has risen for Taiwan but slipped for India

Figure 8

IGAAP: 2007 vs 2010



Source: Asian Corporate Governance Association

HK and India saw a lower score on IGAAP . . .

Most markets saw an incremental increase in scores for accounting and auditing from 2007 to 2010. Two markets stayed level (Singapore and the Philippines), while two markets fell (Hong Kong and India). Hong Kong's incremental fall was due to it not having an independent audit regulator, while India's was due both to our re-rating and to the many problems that have come to light in its audit industry post-Satyam.

. . . but Taiwan and Korea's score moved up

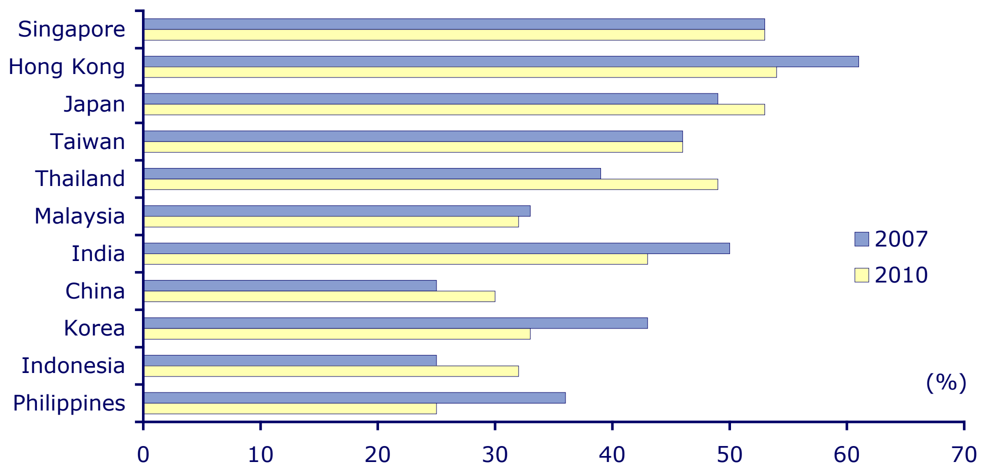
On the positive side, Taiwan's eight-point rise followed improvements in the quality of auditing, especially among small- and medium-sized companies, and its efforts to strengthen the regulation of auditors. The most interesting result, however, was Korea. IGAAP is the one area where Korea has improved markedly since 2007, with its accounting standards and practices moving closer to international norms and higher scores for audit regulation.

Unfortunately, Korea undid all of this good work in **CG culture** . . .

Score for CG culture has improved notably in Thailand and Indonesia

Figure 9

CG Culture: 2007 vs 2010



Source: Asian Corporate Governance Association

Thailand's rise owing to voluntary action by listed companies

A mixed result, with five markets falling, two staying level and four improving compared to 2007. Thailand produced the best performance (+10 points), followed by Indonesia (+7 points). Thailand's rise in score had a lot to do with voluntary action being taken by listed companies to improve shareholder meetings, including voting by poll, and to efforts being made by shareholder groups and other NGOs to promote better corporate governance. Indonesia rose for reasons given above - more NGO activity, director training, and a more diligent media. It is worth noting, however, that both increases came on top of previously low scores. Whether improvements can be sustained will be interesting to watch.

Korea and HK worst performers for a drop in scores on CG culture

After Korea, the worst performer in this category was Hong Kong (-7 points). Part of the damage in Hong Kong was done by the fight over the "blackout period" in late 2008 and early 2009, not one of the city's more honourable episodes. We also marked Hong Kong down for the quality of the communication between companies and shareholders. And the city lost points because of two new questions relating to the quality of disclosure on executive compensation policies and whether the local exchange (or other entity) has a plan to develop an electronic voting platform for investors (linking voting shareholders directly to companies and/or their share registrars, as in Japan).

Conclusion

Markets lost by the wayside a few years ago have managed to turn their fortunes around for now

Perhaps the most uplifting news in *CG Watch 2010* is that markets that seemed to be lost by the wayside only a few years ago have managed to turn their fortunes around (at least for now). Regulators really do seem to have gotten religion as far as enforcement is concerned, even if they are not making huge progress in fighting serious criminal malfeasance such as insider trading and market manipulation. And the solid groundwork being laid in accounting and auditing standards, practices and regulation should bode well for the long term.

But disappointing progress in Singapore and Hong Kong

There is no question that the most disappointing aspect of our survey is the inability of Singapore and Hong Kong to rise above their persistent second-rate scores and truly show some leadership. Korea's sharp turn backwards is also sad to see for a country once lauded for taking risks on CG reform. Hopefully, the medium term will bring a more forward-looking and strategic approach to corporate governance from all three markets.

Challenge is to inspire the private sector

The one challenge that all governments and regulators face is inspiring their private sectors to undertake governance reforms voluntarily and seeing this as in their own self-interest. The gap between political/regulatory environment and CG culture needs to be narrowed. Markets that do this well will likely sustain their regulatory reforms more effectively and efficiently (and at lower cost to government), and produce real substance in their corporate governance systems. This can only be good for capital market development.

Minor changes in scoring methodology for markets

Methodology

The survey on which the market scores are based on in *CG Watch 2010* has undergone some small changes since 2007.

Two questions were dropped because we felt they added little analytical value - one on whether the pay of independent directors was increasing, and the other on whether CFOs needed to sign a company's accounts.

One question on the disclosure of material information and related-party transactions was split into two. (A.12 and A.13)

Four new questions were added:

1. Does the central bank (or the banking regulator) exercise effective regulatory powers over the governance of banks? (C.2)
2. Does the audit regulator exercise effect disciplinary control over the audit profession? (D.14)
3. Do listed companies provide a detailed explanation of their executive and employee remuneration policies? (E.8)
4. Has the stock exchange or another organisation developed an open electronic voting platform ("straight through processing") for investors? (E.10)

Detailed scoring of markets is shown in Appendix 2

And the wording of a few questions was altered slightly to clarify meaning.

In all, the survey increased from 87 questions in 2007 to 90 in 2010.

Our five-point scoring system for each question did not change. It remained as follows: Yes (1 point); Largely (0.75); Somewhat (0.5); Marginally (0.25); and No (0 points).

Measuring governance

On average, CG scores in Asia remain steady but a wider gap now between better and worse

The risk on the CG scores was to the downside through the turmoil of recent years. Our corporate scores have slipped in Indonesia and Taiwan but moved up in Singapore, India and Thailand. Overall there has not been a systemic failure in governance over the recent global financial crisis unlike the Asian crisis of the nineties. Reduced gearing of companies, and we believe also of controlling shareholders, has lowered the risk of conflicts of interest and of corporate blowouts in the region. The average CG score of companies has maintained although a wider gap in the scores of the better and worse markets is apparent.

CG scoring streamlined; C&G scores revamped and combined with CSR

The most prominent Asian corporate implosion in recent years, Satyam, carries various lessons. For us, it leads to a greater weight in the scoring on whether the chairman is an independent director which we move to negative scoring in our questionnaire. We have streamlined the overall questionnaire, revamped our Clean & Green (C&G) scoring and combined it with corporate social responsibility (CSR) in the CG scoring this year.

Satyam lessons

Satyam was the biggest CG fiasco in Asia in recent years

The biggest CG scandal for corporate Asia since we did our last report was found in Satyam. Its undoing appears to stem from a desire by management to set high growth projections but then fraudulently putting out numbers to suggest that the company was meeting these targets. Initially, the shortfall was easily closed by the controlling shareholder injecting his own cash around balance sheet dates. Meanwhile the payroll may have been padded to suggest the company was continuing to grow their key human resource. But as the problems persisted for a number of years, they snowballed to an humongous scale. Ultimately over US$1bn was apparently being fraudulently stated as part of the cash balance of the company that did not exist and the payroll that reportedly included some 13,000 persons who were phantom which would have inflated the actual headcount by over 30%.

Outright fraud can deceive those within a company as well as outsiders

There were a few other similar cases in the region of corporate implosion where the main issue was simply fraud. These involve a complete breakdown of governance. There may have been the general representation of good or acceptable CG. Blatant fraud can often go on for a while and deceive those who seek to uphold good governance within a company as well as outsiders' perceptions of it. More often, the signals of fraud are in the accounts rather than in corporate-governance standards.

Missing interest income

For Satyam, the mismatch between interest income which was below what the purported cash balance should have earned was an issue for a number of years and the single biggest red flag. However the company had persuaded the investing community for a while that there were legitimate reasons why it was not earning the full interest on the purported cash balance. Because this had continued for a few years, the concern over this issue abated.

Lacking in various aspects of CG

Satyam certainly did not provide all the usual checks of good governance either. For instance, the Chairman was not an independent director, but was the same person as the CEO. Ultimately it was the Chairman/CEO who was the key perpetrator of the fraud that unravelled the company. Related to the financials, was the role played by the audit committee. The composition of the committee appeared to be kosher. It was chaired by an independent director who indeed had financial expertise - he was a finance professor at Harvard. However, while a respected academic, the audit committee chair did not have

experience in accounts or audit practice. In addition, he was resident in the United States and mostly his presence at meetings of the committee was through dialing onto a conference call.

Satyam had won some prizes for CG!

Satyam has since been taken over by Tech Mahindra. We no longer cover the stock hence there is no current score for the company. In 2007, we had given it a CG score of 54.6%, and it rated in the second quartile for our India universe. Its score was just above India's average CG score then of 51.6%. However, by some other corporate-governance rankings, Satyam had been placed right at the top for the market.

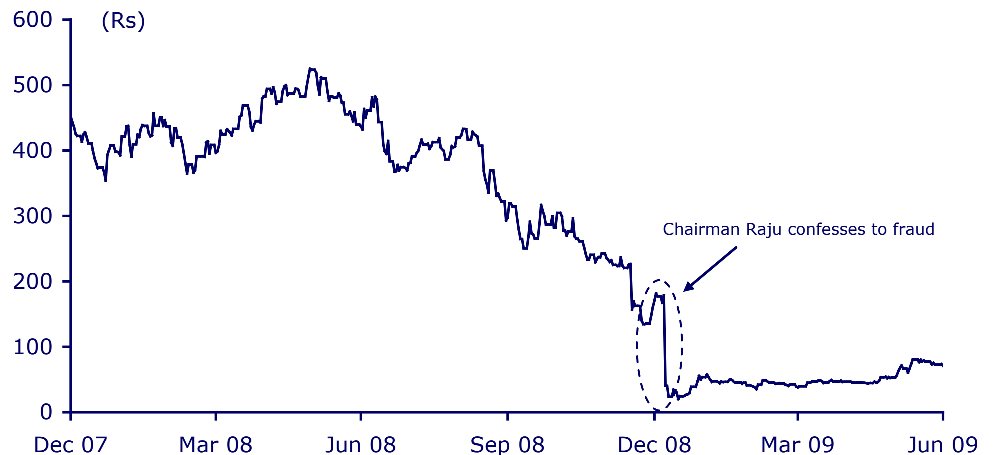
Form vs substance

This underscores the weakness of just checking the box, or focusing on the form rather than the substance, in determining commitment to corporate governance. While Satyam had the trappings of a proper audit committee, this committee overlooked the red flag in the accounts, the missing interest income. This raises the question whether expertise in finance and accounting for one to play the required role in an audit committee can come from academic experience alone, or if it should involve actual practice in the accounting or auditing profession. It also raises the question of whether a member of the committee who is usually not physically present at meetings can contribute effectively.

From its high in 2008, Satyam share price fell over 90% by early 2009

Figure 10

The cost of no governance: Satyam's share price 2008-09



Source: CLSA Asia-Pacific Markets, Bloomberg

Acquisition of assets from a related party a desperate act to close the gaps

The final act of desperation before the sad unravelling of the company was when it proposed to acquire unrelated businesses in a related-party transaction. The vendor of these businesses was none other than the Chairman. This way, the cash that had been injected into the company by the Chairman in falsifying the accounts over a number of years could be reversed through a transaction where the company purchases an asset from the Chairman. Thus the Chairman would have been able to remove from the stated balance sheet cash that was never really there.

Be mindful of related party transactions

Diversifying into unrelated businesses is poor corporate governance and is a question we already test for in our survey. For investors, the Satyam debacle also highlights some of the more sinister possibilities that can arise from such transactions, as well as from on-going related party transactions in the running of a business.

Proper audit committees and need for independent chairman

The Satyam unravelling also underscores the importance of having a proper audit committee. This is already one of the questions with negative scoring, i.e. has much greater weight in our scoring. It also highlights the need to have an independent chairman. Where the chairman is not independent, he can be expected to be supportive of views presented to the board by management. Worse, when there is fraud being perpetrated by management, he may be colluding. Without an independent chairman, there is little assurance that the board can play its key role of supervising management, and where necessary to be a check on management. We have thus added the question whether the chairman is an independent non-executive to those that carry negative scoring in our current CG scoring of companies.

Gearing of the controlling shareholder and his other business interests are also key

The Satyam scandal ultimately blew up because the Chairman was geared to the hilt and started receiving margin calls when the stock price began to tumble. This underscores the risk to a company if the controlling shareholder is highly geared, which sometimes arises when he has various other businesses that he is running. The Indian authorities now require promoters to disclose whether they are using shares of their companies for their personal debt. Still greater transparency over other businesses of a controlling shareholder and their personal/private-company gearing levels are information that remains largely opaque to investors. In our questionnaire, we do seek to establish if a given company is the primary financial interest of the controlling shareholder, and whether the shareholder is known or believed to be highly geared. Such information, however, is not always readily available.

Truth in Satyam?

"Satyam" in Hindi means truth. Ironically, the name will be associated with fraud for a long time yet. Still various truths about governance emerge from this corporate blowout.

Key issues in corporate scoring

CG questionnaire streamlined, 10 questions removed

This year we have streamlined the questions of the main part of the CG questionnaire. Ten questions were eliminated from the earlier fifty-six questions in the main part of our CG score. These were questions where 90% or more of the companies we surveyed had a positive answer, and thus were not discriminating or having much impact in the overall score. The questions that remain in our CG scoring are in Appendix 3 while that have been eliminated are shown in Appendix 4.

46 questions remain in the core part of the CG scoring making up 6 sections

The main part of the CG survey, comprising 90% of the overall score, is now answered through 46 questions from 56 previously. These 46 questions make up six sections. As before, having an equal 15% weight in the CG scoring are the following six sections:

- Discipline
- Accountability
- Transparency
- Responsibility
- Independence
- Fairness

16 of the questions have extra weight through negative scoring

Each section has between seven to nine questions. Within each section a positive score has an equal weight. However, as before, we also include questions with negative scoring. For these, a negative answer results in one

quarter of the score for that section being deducted. We see these questions as requiring greater weight, where not meeting the criterion is a clear mark against the company. In the previous CG scoring exercise we had 15 questions with negative scoring. For this year whether a company has an independent non-executive chairman has also been made a question with negative scoring. The list of questions now carrying a penalty for a negative answer is shown in the table on the next page.

Questions have a Yes/No answer

The questions in the main part of the survey are answered by the analysts covering the company. All questions relating to the company's score have a Yes or No answer to reduce subjectivity. Of the 46 questions in the main part of the survey, 30 or 65% are objective questions of fact. These include whether the Chairman is independent, whether the company has a properly constituted audit committee, as well as nomination and remuneration committees etc.

16 questions involve interpretation by the analyst but could swing the score by as much as 55%

However 16 questions are open to some interpretation by the analyst, for instance whether the company in the last five years has made decisions that benefit the controlling shareholder or management at the expense of minority shareholders, or whether the company is able to maximise shareholder value within legal limits without interference of the government etc. Just 35% of the questions are thus subjective, however a number of these questions carry negative scoring. The effect is that scoring all of these interpretative questions negatively would reduce the overall score by 55%.

Interpretative questions required to assess actual commitment through track record of the company

A purely objective assessment inevitably tests only for the formal structures of governance and is thus a box-ticking exercise. To include questions about the track record of the company necessarily involves interpretation on whether the company has actually transgressed. Again, to reduce the subjectivity, the questions are phrased such that any controversy on these issues should result in a negative mark; that is, the benefit of the doubt is against the company in the CG scoring. This is because so much that goes on in a company is not known to outsiders that where there is some public controversy, investors' concern should be raised. We believe these interpretative questions need to be part of the score to round off the scoring with the company's track record. The balance in our scoring is that the objective questions and those with interpretation ultimately have around equal weight in the final score.

About 95% of the changes in the score are within 10ppt

The cost in this trade-off is that there can be fairly major changes in headline CG scores when there is an analyst change and a new analyst fundamentally disagrees with the scoring of the predecessor. These problems do occur, although are very much the exception rather than the rule. Thus in the current scoring, we had 22 changes in CG scores of over 10-points for the companies in our coverage owing to the analyst disagreeing with the earlier scoring. This is 6.4% of the total sample of 326 companies which were scored both this year and in our previous exercise in 2007. Some 96% of the changes due to disagreement with the earlier score was within 15ppts of the earlier score. However in seven instances, or 2% of the companies scored in both years, the change was over 20-points, with the maximum such change being 28.6 points.

Sixteen questions have negative scoring

Figure 11

Questions with negative scoring in the company CG assessment

Q2:	Has the company diversified into non-core businesses in the past five years?
Q4:	Has the company issued equity, or warrants/options, for acquisitions or financing projects where there has been controversy over whether the project/acquisition is financially sound, or whether the issue of equity was the best way to finance the project, or where it was not clear what the purpose was for raising equity capital? Has the company issued options/equity to management/directors at a rate equivalent to more than 5% increase in share capital over three years?
Q7:	Is the company able to make business decisions within regulatory/legal constraints but without government/political pressure that restricts its ability to maximise shareholder value?
Q12:	Are the financial reports in any way unclear or uninformative?
Q13:	Are accounts presented according to internationally accepted accounting standards? Have there been any controversial accounting policies?
Q17:	Has the company applied for a waiver on disclosure rules?
Q18:	Have there been controversies over whether the board/senior management have made decisions in the past five years that benefited them at the expense of shareholders?
Q19:	Is the Chairman an independent non-executive director?
Q21:	Is there an audit committee chaired by an independent director, an independent director with financial expertise and more than half of the committee made up of independent directors?
Q27:	Has the number of independent directors on the board reduced over the past three years?
Q34:	Have there been any controversies over whether the board and/or senior management have taken measures to safeguard the interests of all, not just the dominant, shareholders?
Q37:	Does the company engage in material related-party transactions?
Q39:	Is the controlling shareholder's primary financial interest other than the listed company?
Q40:	Have there been controversies over decisions where controlling shareholders are believed to have gained at the expense of minorities?
Q44:	Have there been any controversy over the company issuing depositary receipts that were seen to have benefited mainly the major shareholders; has the company or major shareholders issued/sold shares at near peak prices without prior guidance on why the shares might be fully valued?
Q46:	Has the remuneration of the Board increased faster than net profit?

Source: CLSA Asia-Pacific Markets

Lowest quartile score indicates the highest score in that quartile while highest quartile score indicate that scores are at and above that level

Figure 12

Lowest/highest, bottom/top quartile levels and average CG scores

(%)	Lowest	Lowest quartile[1]	Mean	Highest quartile[2]	Highest
China	21.9	38.2	47.2	56.6	70.3
Hong Kong	22.0	48.7	56.0	65.3	81.9
India	34.2	46.9	53.0	61.0	77.3
Indonesia	16.2	29.2	41.3	58.6	69.1
Japan	10.4	43.9	53.0	65.6	80.3
Korea	21.1	43.5	52.4	60.9	77.6
Malaysia	26.5	51.4	54.5	60.8	71.3
Philippines	33.0	44.2	53.9	64.6	76.6
Singapore	41.9	51.0	57.8	64.3	88.5
Taiwan	6.4	43.4	49.0	58.8	78.9
Thailand	45.8	56.3	61.7	64.0	84.9

[1] Highest score for lowest quartile; [2] Lowest score for top quartile. Source: CLSA Asia-Pacific Markets

45-point gap in score between the average score of the top and lowest decile companies - the scoring differentiates between companies that are clearly better from those that are poor on CG

The scoring system is not ideal; certainly none are. Satyam, for instance, was winning CG awards (although not anywhere the top of our scores), just before it collapsed. However, we believe our scoring system gives a reasonable ranking with near 95% accuracy within a 10-point range. That is, only around 5% of the score changes from a new analyst are beyond this range. Differences in CG score of a few points hardly establish which company is truly ahead on CG. However, differences in score of 10-points or more likely do reflect actual differences in CG commitment of the companies. The top CG quartile for the region has an average CG score of 68% versus the bottom quartile at 36%, a 32-point difference. The top decile, meanwhile, has an average score of 73% versus the bottom decile averaging 28%, a 45-point gap in their respective CG scores. These differences in scores we believe do reflect the top ranked companies having much better CG compared to the bottom ranked ones.

C&G and SRI

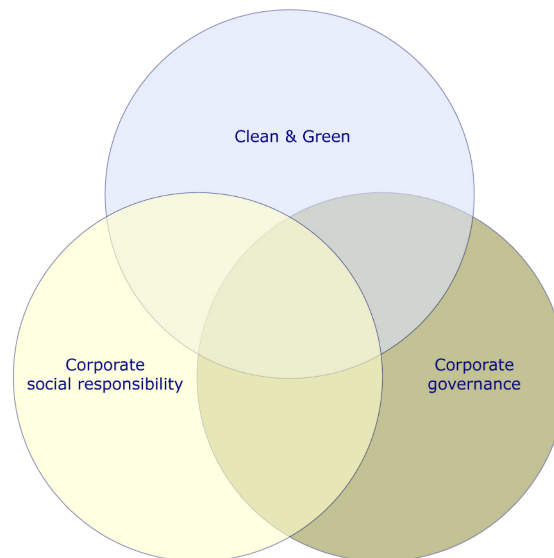
C&G combined with SRI have a 10% weight in the overall CG score

The remaining 10% of the score was previously a carbon-impact survey that we titled "Clean & Green" (C&G). This part of the survey has been enhanced in the current scoring to include Corporate Social Responsibility (CSR). The C&G and CSR sections have been given a combined weight that remains at 10% of the overall CG score. The weight has not been increased for these segments from what we previously gave for C&G alone, as the core notion of corporate governance, we believe, should remain the six concepts, or core sections, that we mentioned above. Appendices 5 and 6 provide the questions that we have used for the C&G and CSR sections of the survey.

Corporate governance, Clean & Green and CSR are concepts that impinge, are related but nevertheless distinct

Figure 13

Interaction of notions of corporate governance



Source: CLSA Asia-Pacific Markets

Certainly, a broader notion of corporate governance would include how the company acts on environmental and social responsibility issues. However, these are issues that interact with the other elements, rather than displace them as core elements of corporate governance. Thus we give these elements a fairly limited 10% weight in the overall score so that the weight of the "core" elements is not reduced. This also allows for the overall score reached in this exercise to be broadly comparable with our previous scores.

Changes in the corporate-governance scoring

For main part of CG questionnaire, changes in scoring had less than 5-pt impact on the score for 95% of the companies

The changes in our scoring for the main part of the CG score, excluding C&G/CSR, were not major. On our original sample of companies with CG scores in our database, we found the average change in the score to be minus 0.5% as a result of eliminating the ten questions. (See Appendix 4 for the questions that have been removed from the questionnaire.) For 95% of the companies, the change in score from removing these questions had less than a 5ppt impact on the CG score. However, the maximum impact was an 8-point differential in the scoring from excluding the ten questions.

Bigger impact from negative scoring where chairman not independent

A more significant change in the scoring has come through introducing negative scoring on an additional question, that is where a company does not have an independent non-executive chairman. (See the sub-section above on Satyam for a key reason we now introduce negative scoring on this issue.) On average across markets, this has reduced the score for "Independence" by 16-points. The heavy toll on the score for the section is because for questions with negative scoring, a "No" answer leads to 25% of the score for that section being deducted.

For some markets, this reduces the overall CG score by 3.5%

Each of the core CG sections having a 15% weight. The 16-point decline in the average score for this section from the additional question with negative scoring, results in a modest 2.3% average decline in the overall CG score across markets. The biggest impact is on the scores for Indonesia, China, Hong Kong and India. As less than 10% of the sample of companies have an independent chairman in these markets, their average score for "Independence" drops by around 20ppts. Still, the impact on their overall CG score is approximately minus 3.5%.

Overall score also impacted by C&G and CSR

The overall score also has an impact owing to the new C&G and CSR combined scoring. These are given a combined weight of 10% together. The score for these sections are based on the responses of the companies and this year saw a much higher response rate on these surveys. 91% of the companies we covered responded to the survey this year, a significant improvement from the 58% response rate to the survey in 2007. The average C&G score in our 2007 scoring was 21% across all the companies then, but this has moved up to 51% for the companies in this survey. A more detailed analysis of the C&G and CSR scores is in Section 3 of this report.

CG progress has stalled

For comparisons with previous scores, we use questions that are the same as in 2007

To get a proper perspective of the actual change in CG at the company level, we focus on questions that are the same this year as in 2007. Thus in these comparisons we exclude the C&G and CSR scores. We find the the CG score by the corporate survey is flat averaging across markets, based on companies scored in 2007 as well as this year, applying the same questions and the same scoring for the two surveys (that is before making the change for the additional negative scoring question).

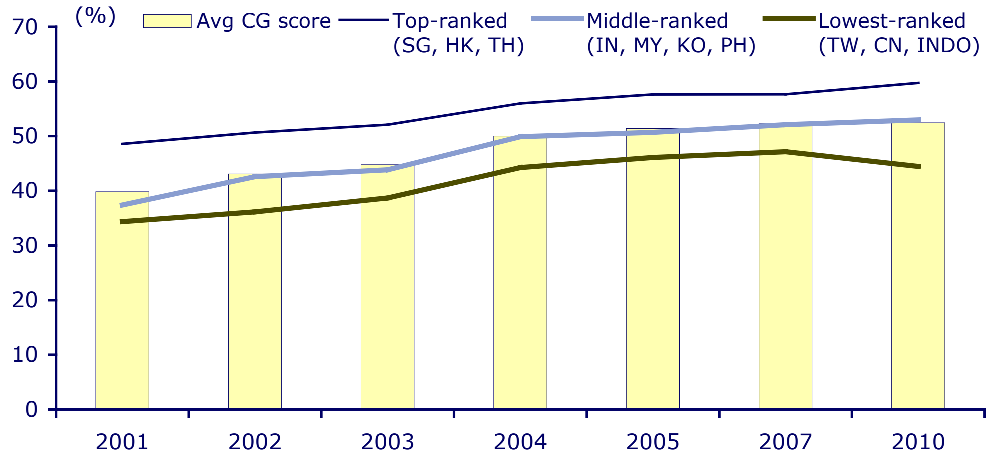
Singapore, India and Thailand have seen score improvements for their companies

The biggest improvement in the comparable scoring was for Singapore. The average score for its companies rose by 4.8ppts compared to our earlier score. This is mainly owing to new analysts covering banks and the offshore drilling sector who have upgraded the CG scores for their companies. India and Thailand saw improvements in their core CG scoring of between 2 to 2.9ppts while the average comparable score for China rose 0.8ppt as most of its companies that we cover are listed in Hong Kong which has in 2010 made voting by poll mandatory.

Overall scores across the markets for companies are flat compared to 2007 - better markets with rising scores offset by poorer markets where scores declined

Figure 14

Change in CG scores of companies since 2001



Source: CLSA Asia-Pacific Markets

Decline in scores for companies in Indonesia, Taiwan and marginally for HK

The largest drop however was for Indonesia where the average corporate score fell by 4.9 points, reflecting stricter scoring. Taiwan's score declined 3.5ppts with a more rigid interpretation for questions regarding audit committees. Malaysia's score on comparable questions in the 2007 and 2010 surveys declined marginally, by 0.6ppt. But the average score for comparable questions changed by 0.5ppt or less for Hong Kong, Korea and the Philippines.

Fairly steady improvement in scores between 2001 to 2005 that slowed by 2007

Figure 14 shows the change in CG scores since 2001. We have used the percentage change in the CG scores of the companies in the earlier years, and applied those to the current 2010 scores excluding C&G and SRI (as these sections significantly increase the overall average but do not reflect any real improvement in core CG). The chart shows there was fairly steady improvement in overall CG of companies for the region between 2001 and 2005. The rate of improvement slowed over 2005 to 2007. We now find that since 2007 to 2010, CG improvement for the region has stalled but with a wider gap apparent between the companies that score better in Singapore, Hong Kong and Thailand against the companies that score more poorly in Indonesia, China and Taiwan.

Resources for better CG would not have been a priority for many companies in recent years

That CG improvement at the corporate level has taken a pause over the last three years should not be a major surprise. Over 2008-09, as the world grappled with the global financial crisis, the priority of companies would have been to look after their cashflows to ensure survival. Non-essential expenditures would have been put off. Hiring more independent directors or other resources for better CG generally would not have been given priority.

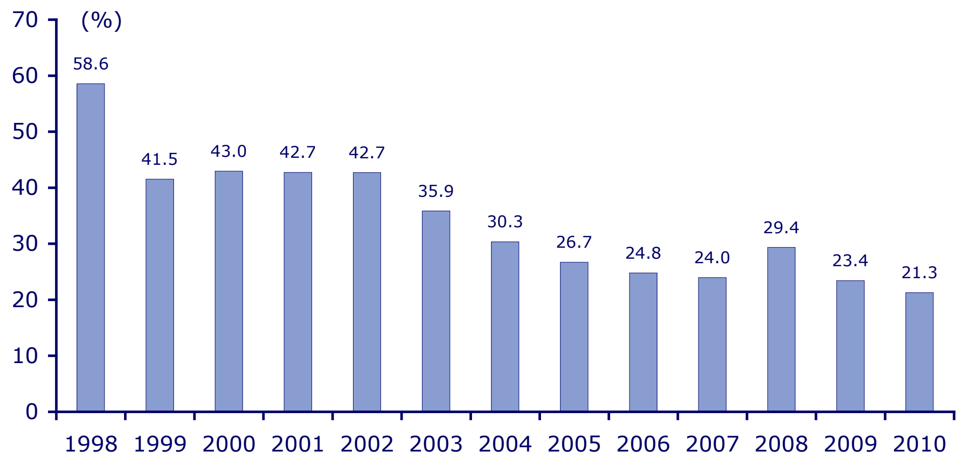
Risk for the scores were on the downside

Indeed, the greater risk was to the downside for the CG scores. Corporate groups in Asia under pressure have in the past used public-listed companies, where the controlling shareholders interest is diluted, to bail out privately held concerns. Various cases of fraud across the region notwithstanding (not unlike other parts of the world), the recent global financial crisis was markedly different from the Asian financial crisis of the nineties. Corporate transgressions were common to practically all the markets in the region then. In the recent crisis, they have been very much the exception. In the late nineties, corporate governance became a major issue for Asian markets because it was seen then as a scarce commodity. This time around there has not been any systematic breakdown in governance for the markets we cover.

Net gearing has fallen to one-third the level ten years back hence Asian companies rode the recent crisis more comfortably than the Asian one ten years back

Figure 15

Asia ex-Japan net gearing



Source: CLSA Asia-Pacific Markets

CG standards have been maintained partly owing to much lower gearing

Overall CG scores have held overall, rather than fallen, in the Asian markets through this recent crisis. A key reason is reduced leverage. Gearing for Asian companies has fallen since the Asian crisis as shown in Figure 15. With lower gearing levels, companies faced less stress in the recent Great Recession. More relevant, although impossible to get hard data on, gearing at the level of the controlling shareholders and their private interests almost certainly is also lower from ten years back. Thus there was less urgency to bail out private concerns. Companies by and large found they could ride through the recent years' financial turmoil without exploiting their listed concerns and sullying their name with investors.

Companies are still cautious and not likely yet to be spending much for areas like CG

The global scenario has improved over the last eighteen months but uncertainties remain about the sustainability of the recovery. Hence companies are likely to remain cautious on what might be deemed non-essential expenditures. Certainly, it appears too soon into the recovery for major initiatives to improve corporate governance to be seen. There has been some improvement in certain markets and companies, but also some disappointments which we discuss in the following sections.

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Social responsibility on the rise

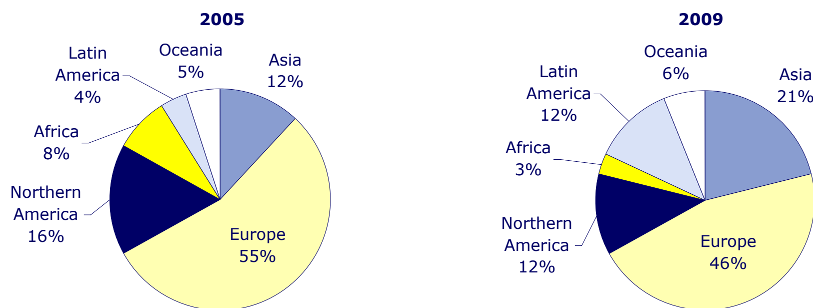
This year we include for the first time a review of corporate social responsibility across our coverage as well as continuing to review environmental performance with the ongoing Clean & Green audit.

In 2009, 21% of CSR reports made available were from companies in Asia

Corporate social responsibility if defined by the publication of CSR reports apears to be on the rise in Asia . The region now accounts for more than 20% of global CSR reports versus 12% just five years ago.

Figure 16

Geographic breakdown of CSR reports



Source: CLSA Asia-Pacific Markets; Global Reporting Initiative; Companies

Forced or voluntary?

Across the world the reporting CSR activities falls into two key camps, mandated or voluntary. For example, the UK Companies Act (2006) explicitly mandates social and environmental reporting. Article 417 states that the director's report of a quoted company must 'to the extent necessary for an understanding of the development, performance or position of the company's business, include…social and community issues, including information about any policies of the company in relation to these matters.'

The UK Pensions Act in 2000, prompted a higher level of disclosure in pension funds:

But even before the UK Companies Act mandated reporting an amendment to the UK Pensions Act in 2000, prompted a higher level of disclosure in pension funds: It requires fund managers to tell members whether they consider the ethical, social or environmental impact of the companies they invest in. Managers still have the option to state that they do not take these impacts into account, but the fact that they are required to disclose their policies put greater pressure on them to justify their stances.

Other countries in Europe, including **Austria**, **Belgium**, **France**, **Germany**, **Italy** and **Sweden**, have all enacted similar legislation. In Asia the whole thing is still mostly voluntary.

China increasingly pushing CSR

China - In the case of China, the government has been promoting CSR, through influencing the behaviour of its state-owned enterprises. For many years now Article 5 of Chinese Company Law requires companies to 'undertake social responsibility' in the course of business. Then in 2006, the government published *Guidelines for Publishing Corporate Responsibility Reporting in China*. The government is promoting CSR as a means to improve the brand, reputation and competitiveness of Chinese companies and is encouraging them to publish reports. We are not at the stage where governments are responding with sanctions or implementing mechanisms to enforce such regulations. However, with Beijing taking a stance on promotion

and spreading awareness, it indicates that CSR is on its agenda. The two Chinese stock exchanges, the Shenzhen and Shanghai Stock Exchanges, recently took action in promoting CSR disclosure. In August 2009, the Shanghai Stock Exchange also launched the *Responsibility Index*, selecting the top-100 socially responsible companies on the stock exchange.

Japan a long way ahead

Japan - The Japanese government has demonstrated itself as an advocate for CSR promotion in particular through environment-related and climate-change specific legislation. With the Environmental Reporting Guidelines and the Law Concerning Promotion of Environmental Consideration in Business Activities, enacted in 2004, it has been promoting environmental reporting far earlier than other governments in the region. With the introduction of a mandatory greenhouse gas (GHG) accounting and reporting system, entities emitting large amounts of GHGs are now obliged to calculate and report these emissions.

Malaysia mandates disclosure

Malaysia - Bursa Malaysia, the Malaysian stock exchange, has long promoted strong corporate responsibility and governance. In 2004, the Malaysian government came out in support of voluntary CSR reporting, but during the 2007/08 intersession period, the Malaysian prime minister announced support for mandatory disclosure of CSR activities in annual financial reports of publicly listed companies. The listing rules have since been amended to require reporting of CSR activities or to state if there are none.

Philippines - In August 2007, the Philippines Board of Investment (BoI) required CSR programmes and reporting. Under the 2007 investment priorities plan, companies granted six-year income tax holidays need to issue annual reports on implementation of their CSR programmes during the last two years of the period.

Mandatory in Indonesia

Indonesia - In July 2007 the government of Indonesia enacted a corporate law that required most companies outside of the financial sector to report their CSR activities. In addition, Article 74 requires all companies that impact the environment to implement CSR programmes.

HK still voluntary

Hong Kong - Back in 2006, the Financial Services and Treasury Bureau launched a comprehensive rewrite of the local companies' ordinance with the aim of improving the SAR's attractiveness as a financial centre. Expectations are that the new ordinance could be passed into law by the end of 2010. One proposed requirement is that companies will have to include in their annual reports 'information relating to environmental and employee matters is in line with international trends to promote corporate social responsibility'.

Korea - Business in Korea and Japan share many similarities when it comes to CSR reporting. Korean and Japanese businesses show increased interest in global CSR dialogue. There are ongoing improvements in governance; transparency and stakeholder-engagement. There have also been a number of initiatives to align Korean business practices with those of the UN Global Compact.

Australia - its been mandatory for more than 20 years

Australia - Since 1988, public companies in Australia have been under an obligation to report on environmental and social performance stated in the Corporations Act, 2001. Companies are required to provide details of: their performance in relation to environmental regulation; and any breaches of environmental laws and licences such as those relating to GHG management in their annual reports. These obligations have been further enhanced.

Singapore - CSR reporting is entirely voluntary. Section 201(c) of the companies act requires the directors set out, the profit and loss account, a balance-sheet that complies with the requirements of the accounting standards, and to give a true and fair view of the state of affairs of the company. One reason often cited by observers as to why Singapore remains a voluntary CSR market is the government takes a light regulation approach in order to appear more business friendly.

Thailand - To stimulate CSR awareness among Thai companies, the stock exchange has begun to give awards to listed companies for outstanding CSR projects and established a CSR Promotion Fund at the end of 2008 to increase CSR awareness and implementation. In a related initiative, a CSR committee comprising both the public and private sectors has proposed a CSR roadmap for Thai-listed companies and has developed a CSR handbook.

Figure 17

CSR issues companies face

Workplace	Marketplace	Environment	Community
❑ Disciplinary practices	❑ Access to products and services	❑ Materials consumption (energy use, water, office consumables)	❑ Involvement with the community
❑ Work/life balance	❑ Advertising and pricing	❑ Waste management	❑ Investment in the local community
❑ Health and safety	❑ Business ethics	❑ Transport	❑ Exposure to human rights risks for investment activities arising from third-party activities
❑ Learning and development	❑ Customer service	❑ Property design and management	❑ Indigenous rights
❑ Diversity and equal opportunities	❑ Privacy	❑ Indirect impacts	
❑ Freedom of association/collective bargaining	❑ Terms of trade		
❑ Forced and child labour	❑ Supplier relationships		
❑ Bullying and harassment	❑ Value of products and		

Figure 18

Our corporate sustainably questionnaire

Does the company have a social policy/vision that it articulates?
Does the company set out its expected behaviours in a code of conduct/business ethics?
Is there one person within the firm who is responsible for setting goals & objectives related to the social impact of the company and its activities?
Does the company engage in social initiatives such as corporate giving/community programmes grants scholarships etc
Does the company have anti corruption policies and practices in place?
Does the company have health and safety policies which it implements at all its sites and places of work
Have there been any major H&S incidents in the past 3 years?
Does the company pay the appropriate level of taxes in the countries in which it operates?
Does the company engage in appropriate sourcing practices to ensure social responsibility in terms of its suppliers?
Does the most recent annual report or chairman's statement carry details of corporate social responsibility
If a CSR report or statement exists does it disclose performance and gaps?

Figure 19

Our Clean & Green questionnaire

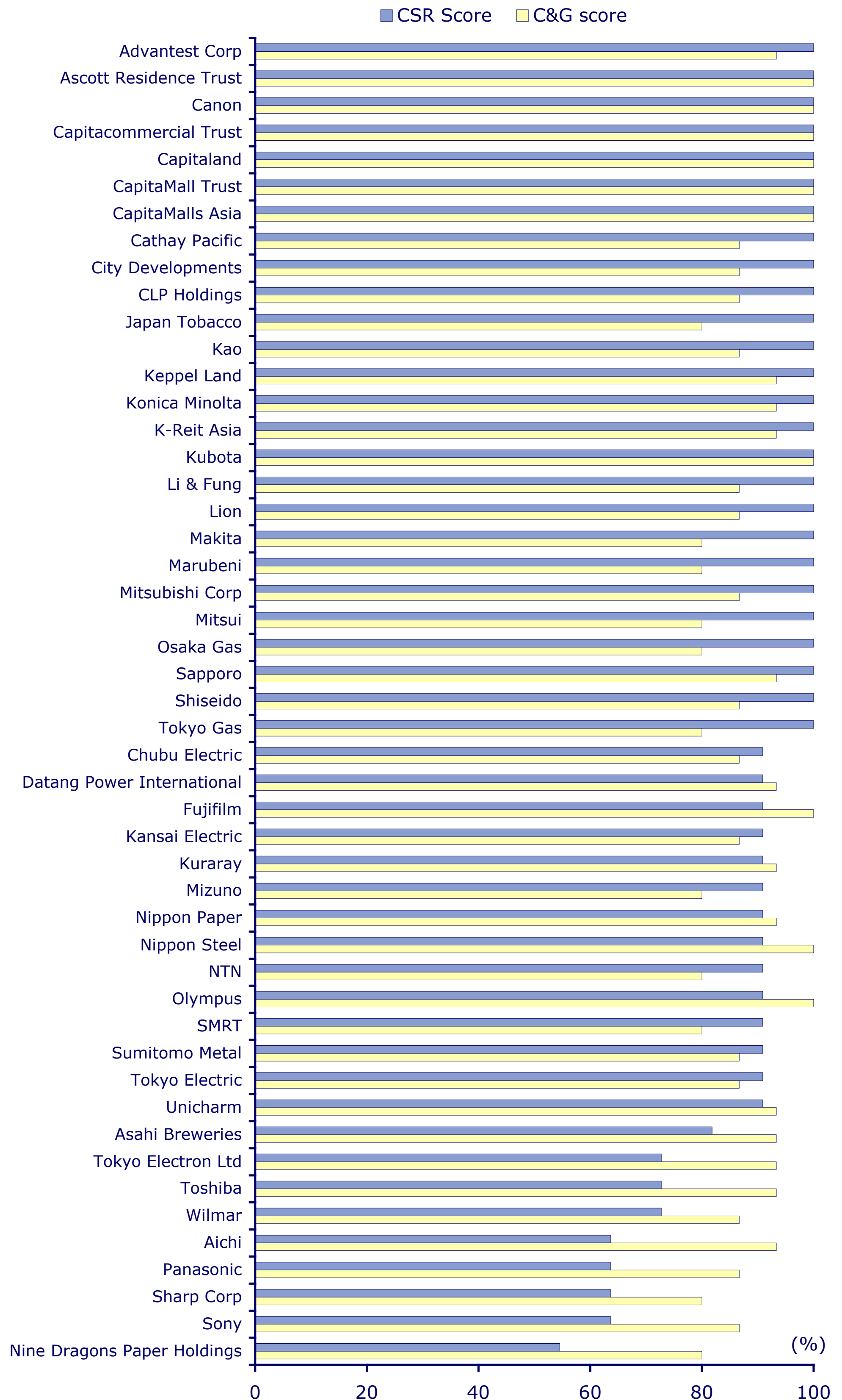
Is any individual or committee responsible for the company's environmental controls? (If yes, please provide their name or head of committee?)
Does this person/committee report directly to the Board?
Is the company aware of any current government regulation that requires it to monitor or reduce emissions? (If yes, please specify)
Does the company have any mechanisms in place to monitor and report GHG emissions? (If yes, please specify)
Has the company quantified annual emissions of CO_2/GHG or pollutants such as NO_2, SO_2 etc in either of the past two financial years? (If yes, please include the data in the comments field)
Has the company set voluntary or regulatory-mandated targets for CO_2/GHG emission reductions? (If yes, are targets absolute or a % of emissions)
Has the company set targets for reduction of water use? (If yes, are targets absolute or a % reduction)
Has the company set targets for reduction of other waste/pollutants? (If yes, are targets absolute or % reduction)
Has the company ever received a fine for environmental infraction?
Does the company recycle waste (inc waste water, paper etc)? If so, please describe the extent and approach
Is the company ISO 14000 or similarly accredited?

Source: CLSA Asia-Pacific Markets

Highest C&G and CSR scores for Japanese companies followed by some Singaporean ones

Figure 20

Our coverage - Highest scores

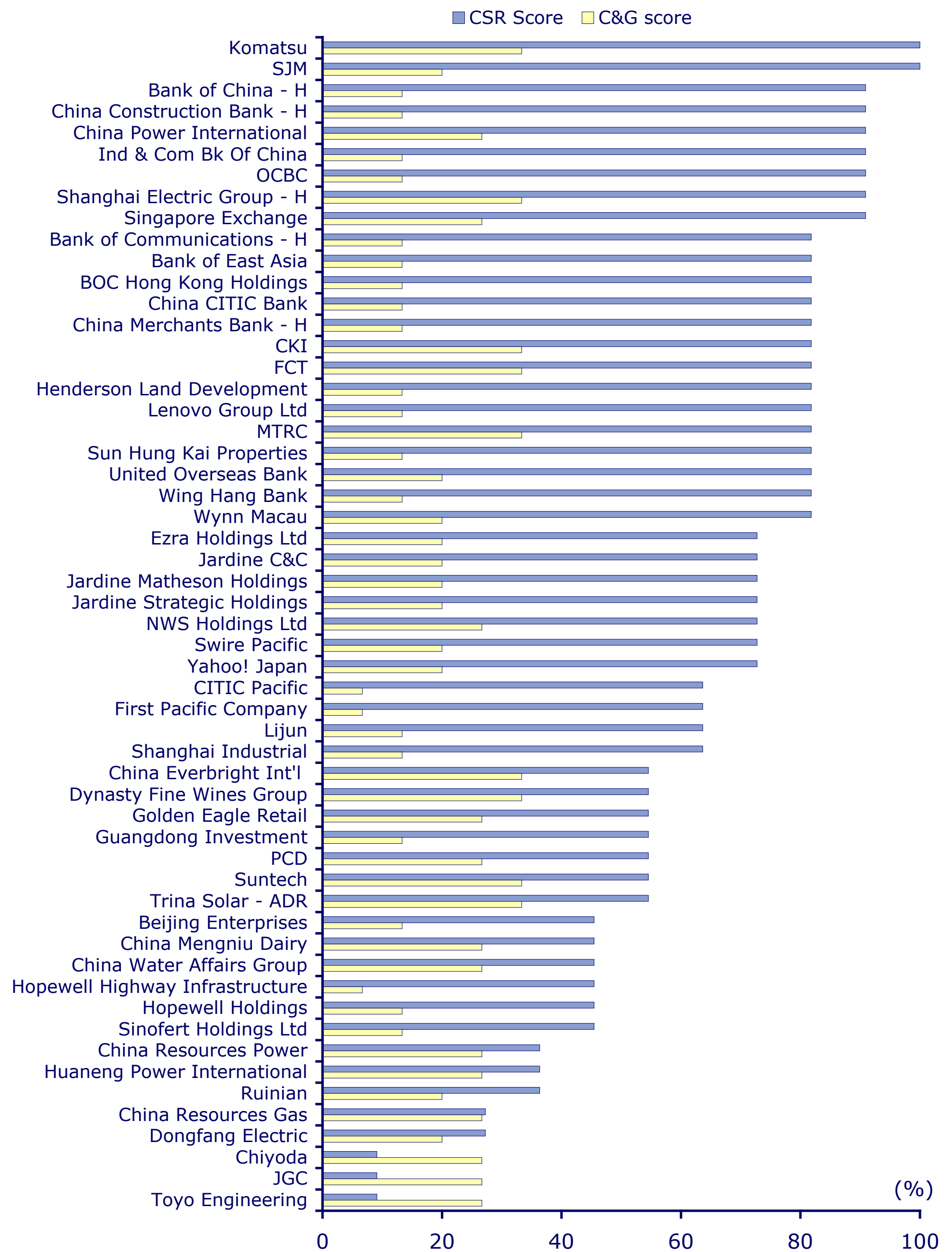


Source: CLSA Asia-Pacific Markets

Of the companies that responded to our survey, some of weakest scores for C&G and CSR out of HK and China

Figure 21

The worst performers - Our coverage



Note: excludes companies with zero score not scores, Source: CLSA Asia-Pacific Markets

Clean & Green - A shift from climate change to pollution

C&G survey adjusted to reflect increasing concern over pollution and emissions

This year we adjusted our Clean & Green questionnaire to reflect an increasing concern over pollution and emissions in general. Previous surveys' had a high focus on emissions of climate change related CO_2. Recent high profile pollution events such as the Zijin mine toxic chemical release have focused investor attention on other forms of pollution.

Environmental laws tightening

We believe that environmental laws are tightening across the region and fines and sanctions equally increasing for companies that breach these laws. The large BP oil spill in the USA demonstrates the kind of fines and economic costs that companies face when things go wrong.

Imposing more stringent environmental requirements

In December 2009, China's National People's Congress approved a new torts law that will increase liabilities for environmental pollution. We see this as another step forward in China's environmental protection movement.

In November 2005, a toxic spill into the Songhua River put an international spotlight on China's environmental problems. The same year, a trial court in Baotou, Inner Mongolia, awarded a local state-owned water supply company USD 421,000 for its losses due to pollution in the Yellow River caused by the operations of a few local paper-making companies. In 2007 and 2008, Chinese courts heard as many as 1,400 torts claims, respectively, against businesses causing environmental pollution. In 2009, a manganese processing plant in Hunan province was closed and two factory officials were detained after 1,300 children in the area were found to have excessive levels of lead in their blood.

In response to these accidents and to demonstrate its determination in fighting pollution, China's environmental protection authority has begun imposing more stringent environmental requirements. After four reviews since 2002, the Standing Committee of the **National People's Congress in late 2009 approved the Torts Law**, which sets out the general principle for environmental liability that a **polluter will be held liable for pollution it causes**.

The Torts Law, which took effect last month, came about as a result of years of drafting and revisions following a string of controversial torts cases, including the collapse of a 13-floor building at the Lotus Riverside residential complex in Shanghai on June 27, 2009, and the tainted infant formula powder scandals in 2008.

The 92-article law covers liabilities for a range of events, including damage caused by defective products, traffic accidents, medical accidents, work-related injuries and pollution, and even damage caused by pets. One Torts Law chapter is devoted to establishing general guidelines for environmental torts liabilities:

Article 65 of the Torts Law provides that a polluter will be held liable for damages it causes. If a company's discharges or emissions are proven to cause environmental pollution, and if other companies or individuals consequently incur losses and damages, **regardless of whether the polluter is at fault** or whether the pollution discharges are within allowed volumes, the company will be liable for the damages.

Burden of proof: the polluter must prove that its emissions or discharges did not cause damage or show conditions under which it bears no liability or lessened liability.

Environmental liabilities. There are three types of environmental liabilities under Chinese environmental laws: administrative, civil and criminal.

- **Administrative liability -** Administrative environmental liability is most commonly imposed by the Ministry of Environmental Protection (MEP) or the local Environmental Protection Bureau (EPB) against corporate violators of environmental laws and regulations. By severity from low to high, administrative environmental liability results in warnings, fines, confiscation of illegal gains, orders to stop operation or use, revocations of licence or permit, and orders to shut down and terminate operations. For example, if a company violates the Water Pollution Law, EPB may order the company to take treatment measures to eliminate pollutants within a specified period or designate a qualified company to carry out treatment or remediation work at the polluter's cost. **EPB may also impose fines on the polluter of 20% of the direct losses caused by the pollution event**. In the case of a serious water pollution event, subject to the approval by a competent people's governmental, EPB may order the polluter to shut down, impose fines on the polluter of 30% of the direct losses caused by the pollution event, and impose fines on individuals directly responsible for the pollution of up to 50% of the income the person received from the polluter for the preceding year.

- **Civil liability -** As discussed above, the Torts Law provides that a polluter will be held liable for the pollution it causes. Major civil liabilities the polluter may incur include elimination of the hazard and compensation for damages. For instance, the water pollution law provides that **an entity or individual damaged by water pollution is entitled to claim the elimination of the hazard and compensation for the damages against the polluter.**

- **Criminal liability -** Criminal liability is set out in China's Criminal Code as amended in 1997. Nine articles in the code criminalise pollution acts, such as dumping hazardous waste, that severely damage the environment. Based on the consequence of the crime, **a violator could be jailed for up to 15 years and fined**. If a company is found guilty of causing serious pollution accidents or damages, the company will be fined, and persons directly responsible for the offense, eg, a general manager, safety manager, board director, etc., will be punished in accordance with relevant provisions.

Corporate social responsibility - It's different in Asia

Unique issues faced by Asian companies

Looking at corporate social responsibility in Asia requires a different set of lenses. It's a region undergoing significant change. The wealth gap is significant and as a region it contains some of the world's fastest growing economies alongside slowly developing legal and corporate-governance systems. We believe that there are a number of unique issues faced by Asian companies.

- Predominantly homogeneous populations means that ethnic diversity at work isn't as relevant
- Many Asian corporations are significantly family/chairman owned and run essentially as family businesses
- Operations across multiple geographies and tax regimes in what are essentially rapidly developing countries. This results in wide gaps in labour standards and legislation
- Significant societal wealth gap - across Asia the gap between rich and poor is significant

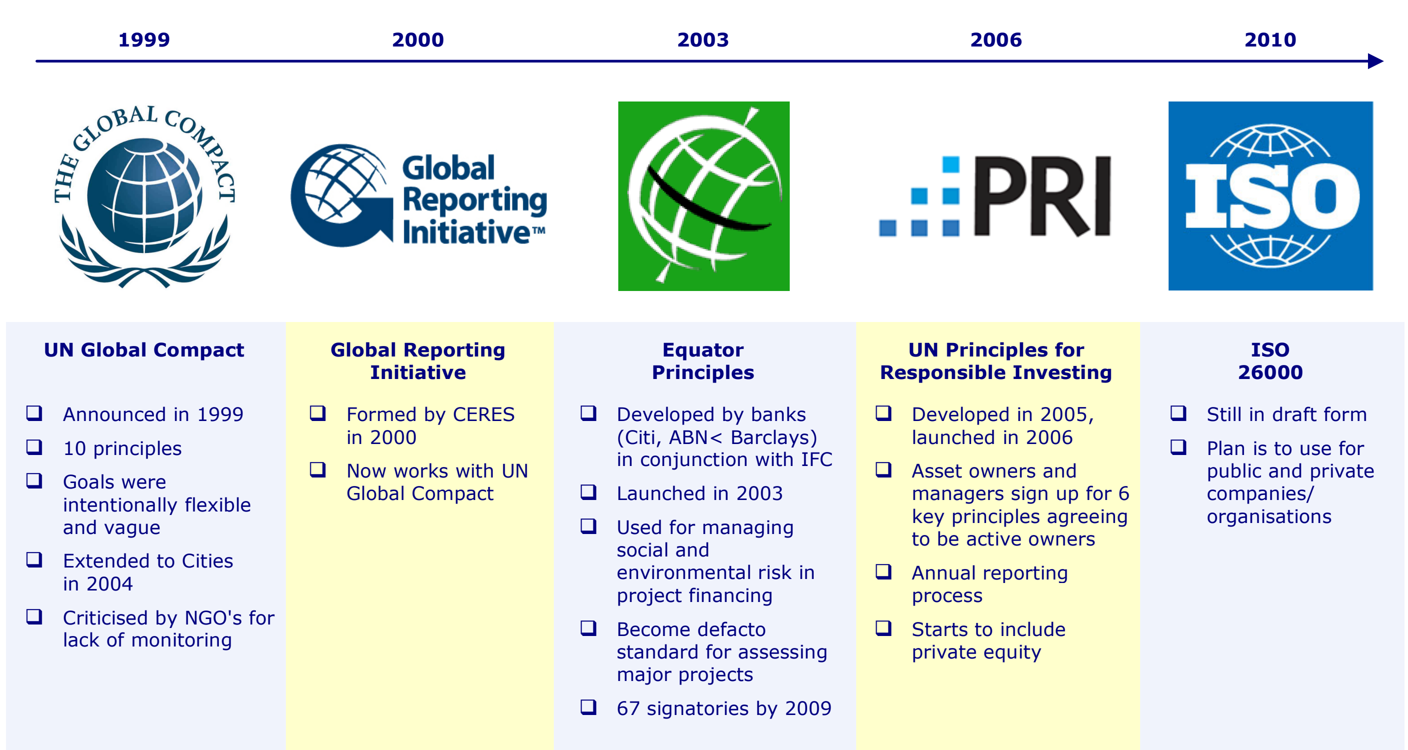
CSR isn't philanthropy

Companies need to engage with society

Many Asian organisations seem to mistake contributing to local charities as CSR, when in fact its just a small part. The wealth gap between wealthy individuals and the large corporations they typically manage and the poorer members of society is significant in Asia so giving is prominent in the Philippines, and Thailand. Simply giving a percentage of profits away is no substitute to actually engaging with society to deliver outcomes.

Figure 22

Increasing focus on responsible investing



Source: CLSA Asia-Pacific Markets

Corporate standards

Large caps dominate the high CG scores but some medium-sized companies also have high scores

A snapshot across the region shows various areas where CG can be improved given that the overall average CG score is just 52.7%. Large caps tend to have better CG. Particularly in Japan, the large caps have a median CG score almost 7-points higher than that for the overall market. Among the highest scoring companies in the region are HK Exchanges, Li & Fung, TSMC, HSBC, Infosys as well as Nintendo, Sony, Sumitomo Metal and Tokyo Electron. Some medium-sized companies also have high CG standards including CapitaMalls Asia, Kasikornbank, Bank of Ayudhya, Konica Minolta, Nikon, Hynix and Manila Water.

Governance of companies

Top-down scoring done through ACGA preferred for ranking markets on CG

Our ranking of markets for CG is done in Section 1 by the Asian Corporate Governance Association (ACGA) in collaboration with our research heads in each of the markets. This ranking analyses the markets and scores for five categories, viz rules and practices, enforcement, political and regulatory environment, accounting and auditing as well as overall CG culture. This is our preferred approach to rank markets for corporate governance via a thorough top-down analysis that incorporates some bottom-up elements with regard to the general practices of companies in the markets.

The top-down ACGA score also takes into account practices of financial intermediaries (auditors and securities companies) as well as regulation and enforcement. It thus gives a better representation of overall governance in the markets compared to a focus just on the listed companies.

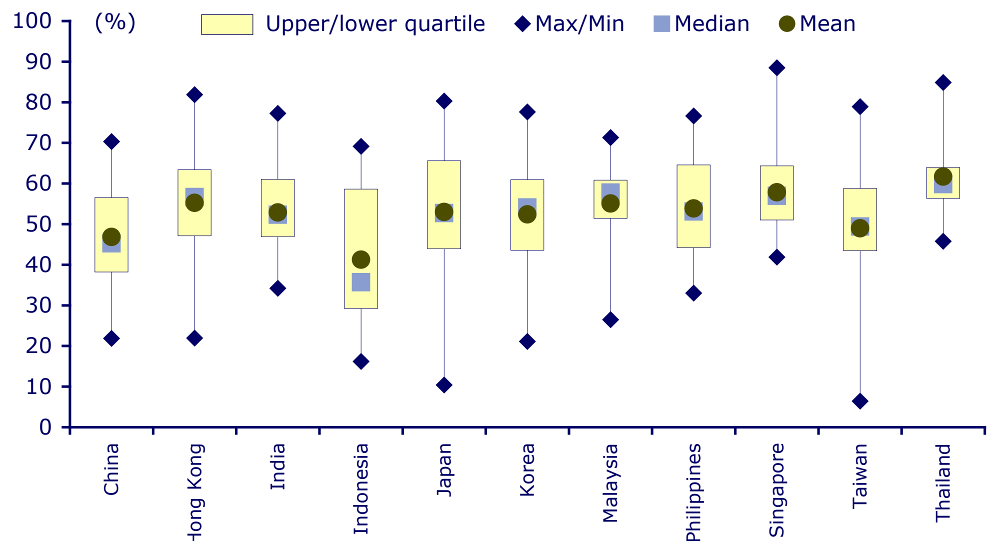
Averaging bottom-up scores distorted by varying sample size for individual markets

The main drawback of making inter-market conclusions from the bottom-up scores of the companies are that the sample size of individual markets in some cases are not very large, for instance just 11 companies from Indonesia and 18 from Thailand. The companies scored, companies that are part of our core coverage in these markets, are likely to be the better for CG in these markets. Having a following of institutional investors, these companies face greater pressure from their investor base to meet international standards of governance.

Wide range in the CG scores for the corporates hence focusing just on the average score can be misleading

Figure 23

CG scores of companies by markets



Source: CLSA Asia-Pacific Markets

In most markets, scores are highly dispersed

Nevertheless a comparison of the bottom-up scores is relevant to determine the level of governance typically seen of companies that international investors might encounter. Figure 23 shows the average CG scores of the companies we assess by markets. As important as the average score, is the dispersion in the scores. In most markets the scores are highly dispersed, but particularly so for Hong Kong, Indonesia, Japan, Korea and Taiwan.

Thai companies come ahead on average CG scores

Thailand comes out with the highest average CG score of its companies in our sample although for the very highest scores Singapore and Hong Kong are ahead. However, Thailand was also the leader in the average corporate scores for Asia ex-Japan in our 2007 ranking. This is partly explained by a smaller sample size (18 companies), but also the result of regulators making a bigger push to require higher standards of the companies. For instance, voting by poll has been driven by the regulator and most Thai companies now adopt this for their AGM/EGMs. Other than Hong Kong where it has also been made mandatory, voting by poll is practically non-existent in the other markets.

Thai companies in our sample also all score positively on publishing full year results within three months and interims within 45 day. They have properly constituted audit committees with the authority to nominate external auditors. By the ACGA-CLSA top-down ranking of markets, Thailand comes just after Singapore, Hong Kong and Japan.

HK companies have a lower average CG score than Singapore which can be explained by their relative C&G/CSR scores

Of the markets with a larger sample size, Singapore has a slightly higher average score for corporate governance of the companies we surveyed at 57.8% versus Hong Kong where the average is at 56%. The difference is fully accounted for by the difference in the C&G/CSR scores. We had a poor response from the Hong Kong companies on these surveys, as a result of which the Hong Kong companies had an average 40% score for this section, whilst the response from the Singaporean companies was better and they scored 66% for C&G/CSR. With a 10% weight for this section, this difference amounts to 2.6ppts for the average CG score, and tipped Singapore to a higher corporate score than for Hong Kong.

HK scores also pulled down because it does not yet have quarterly reporting

Note another factor for a lower score for Hong Kong is that it does not yet require quarterly reporting while Singapore does. In terms of the median score, however, Hong Kong is at 57.5%, slightly ahead of Singapore at 57.0%. The median score represents the level for a more typical company (where half the score are below that level and another half above). The average, represented by the mean, gets pulled in the direction where there are more outliers.

Average CG score in HK pulled down by some companies with very low scores

With Hong Kong, the mean CG score is lower than the median indicating there are more companies that drag down the average score and more than offset some companies with the highest scores regionally, eg, HK Exchanges, Li & Fung and HSBC. For Singapore the mean CG is higher than the median, reflecting that it has more outliers that pull up the average score. Among the companies in Singapore that score near the highest on our corporate-governance rankings include CapitaMalls Asia, OCBC and CapitaLand.

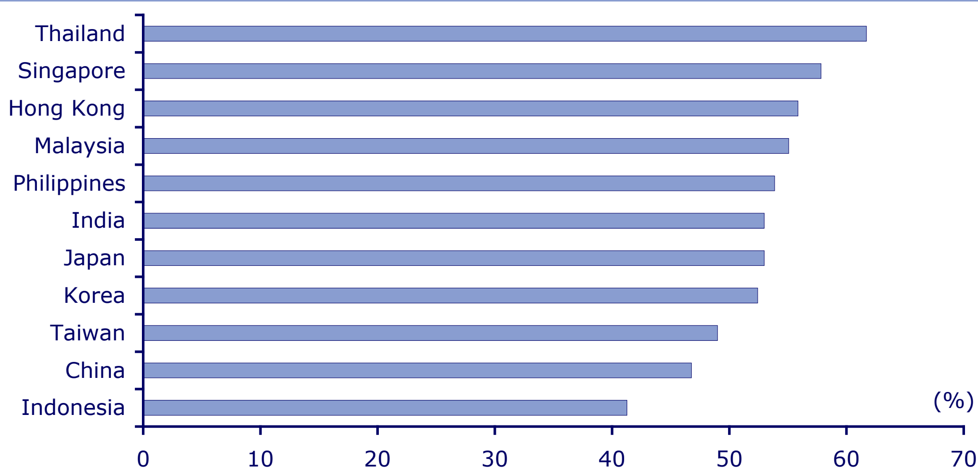
Malaysia, Philippines, India, Korea have average scores of 52% to 55%

Malaysia, Philippines, India Japan and Korea have average CG scores at around 52-55%. The median and the mean scores are pretty much identical for most of these markets. However, the mean score for Malaysian companies is 2.5ppts lower than the median, reflecting that some of the companies have a much lower level of governance than what is typical of the market. Korea, similarly has a mean CG score for its companies that is 1.7-points below the median.

On average CG scores of companies, Thailand, Singapore, Hong Kong come out at the top, while Indonesia, China and Taiwan are at the bottom

Figure 24

Average CG scores of companies



Source: CLSA Asia-Pacific Markets

Indonesian companies have the lowest average CG score

Indonesian companies have the lowest scores which is not a surprise. The sample size for the market is relatively small at just eleven companies with scores updated for this survey. If other companies were included, most of which may not have much of an institutional investor base, the CG average for Indonesian companies would like be marked even lower.

Next lowest are the average scores of Chinese companies

Next lowest, on our ranking for CG at the level of the companies is China. This is again not a surprise. Chinese corporate scores are pulled down in particular in the areas of responsibility, discipline and awareness, as shown in Figure 25.

Taiwanese corporate scores average third from the bottom

Third from the bottom on average corporate scores is Taiwan. The score for its companies is poor partly because a number of companies we cover do not even have an audit committee. (Taiwan and Japan are the two markets in the region where audit committees are not mandatory.) Thus only 51% of our sample for Taiwan has a properly constituted audit committee versus 87% on average across the markets. Taiwan would then score poorly on the question whether audit committees nominate external auditors. It also gets a low score for dilution risk and for not announcing full year results within three months. The regulations for the market allow full-year results to be released up to four months from the end of the year.

Figure 25

Overall CG scores and by categories for companies

(%)	Discipline	Transparency	Independence	Accountability	Responsibility	Fairness	C&G/CSR	Overall CG
China	45.1	70.8	29.0	59.5	32.1	49.0	43.3	47.2
HK	58.2	75.3	23.1	62.2	62.7	64.8	40.4	56.0
India	56.0	78.3	24.1	48.7	47.8	58.8	59.3	53.0
Indonesia	48.9	50.8	34.7	26.1	40.6	28.6	68.2	41.3
Japan	47.7	76.4	21.2	50.7	72.4	60.9	36.0	53.0
Korea	51.9	79.4	30.9	30.9	44.0	67.7	47.9	52.4
Malaysia	63.6	92.2	43.6	27.9	55.7	50.2	45.5	54.5
Philippines	51.6	83.7	47.6	35.4	38.4	59.4	64.6	53.9
Singapore	59.5	87.0	52.8	32.2	52.8	57.2	66.1	57.8
Taiwan	57.2	64.1	12.9	32.4	63.3	57.5	58.5	49.0
Thailand	54.2	94.1	51.4	69.4	46.4	72.4	35.0	61.7
Average	54.0	77.4	33.8	43.2	50.6	56.9	51.3	52.7

Source: CLSA Asia-Pacific Markets

With a larger number of companies scored for Japan, the average score has declined

Japan, a market that we first surveyed for corporate governance in our previous 2007 report with just 44 companies, now has a larger representation of 133 companies that have been scored. With a larger sampling, as expected the average score moves lower. This has pushed down the Japan corporate score into the lower half of our country averages, which might be a surprise. Japan however has various peculiarities and, as noted above, it is one of the two markets where audit committees are not mandatory.

Japan has only partial voting by poll

Japan also does not have full voting by poll (thus scoring negatively on this question) even though it has what could be considered partial voting by poll. That is, companies take a tally of proxy votes ahead of their meetings and where proxies are sufficient to carry items on the agenda, the meetings will generally do away with a vote. That may be an efficient way of managing the meetings: the items on the agenda would be passed with or without full voting by poll. However, without generally giving a chance for dissenting votes to be captured and recorded, the level of disagreement on particular items being passed does not become transparent to other shareholders, management or the public.

Japanese norms often different

This reflects how the Japanese way of doing things might be different from international norms. Other areas in our score where Japanese companies do poorly include management not providing any assessment of their cost of capital, companies building up cash balances and thus dragging their ROE, companies not making public the next day the result of votes in AGM/EGMs and a number of companies where controlling shareholders are believed to be highly geared.

Snapshots across markets

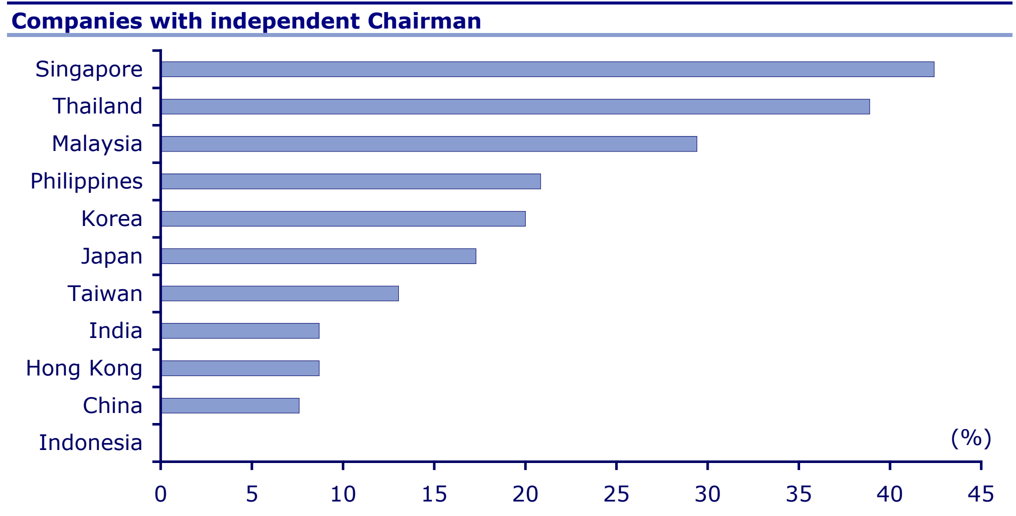
Snapshots to illustrate country strengths and weaknesses

Below we present a snapshot on how the companies we assess perform on some of the more objective criteria of corporate governance. The snapshots illustrate some of the strengths and weaknesses in governance typically found in the companies. We find, for instance, that averaging by markets just 19% of the companies have an independent chairman, a key CG risk as the Satyam episode revealed. None of the companies we scored in Indonesia have an independent chairman, and less than 10% of the companies in China, Hong Kong and India have chairmen who are independent.

Less than 10% of chairmen are independent in India, HK and China; none for Indonesian companies we cover

Figure 26

Companies with independent Chairman

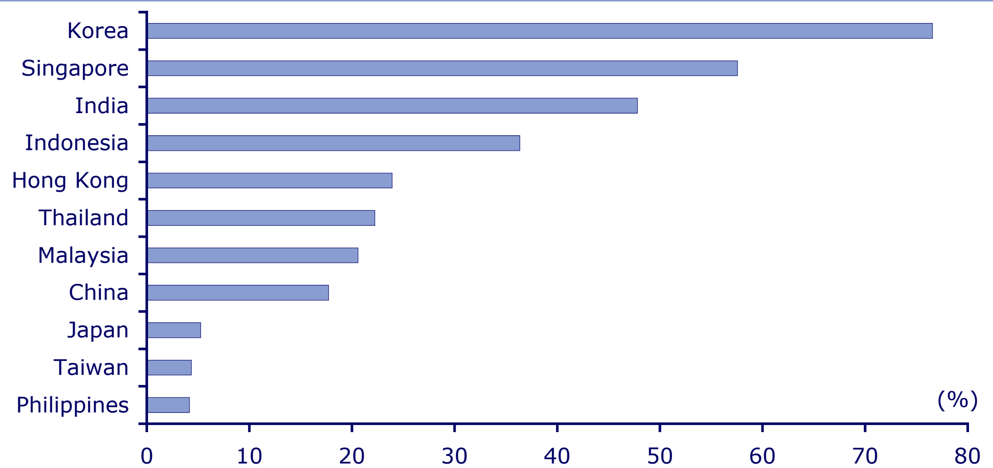


Source: CLSA Asia-Pacific Markets

Very few companies with independent directors are making up a majority of the board in the Philippines, Taiwan and Japan

Figure 27

Companies with independent directors who are over half the board



Source: CLSA Asia-Pacific Markets

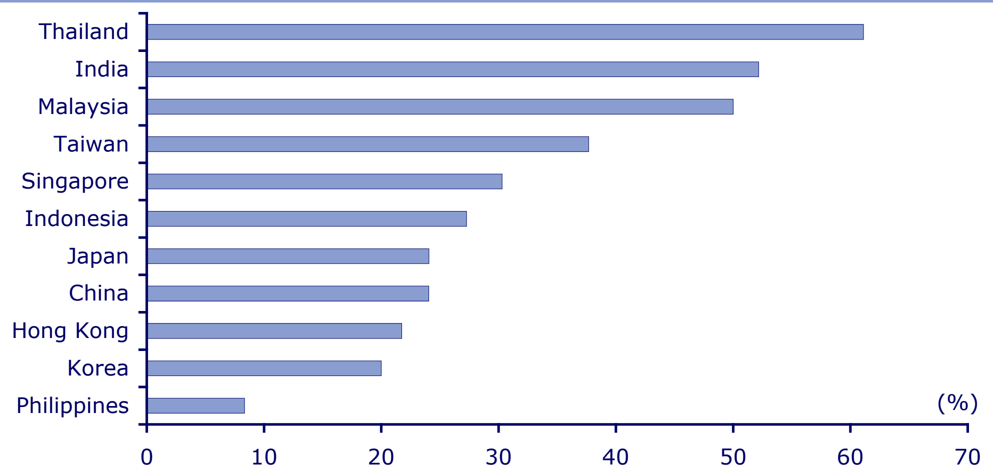
Independent directors on board key for oversight over management

Having a majority of the board represented by independent directors is also a key measure to indicate that the board is able to exercise oversight on management. Where the majority on the board are management or related parties, this function is not likely to be carried out as diligently. Barely 5% of the companies we surveyed have independent directors making up the majority of their boards in the Philippines, Taiwan and Japan. Only in Korea and Singapore do we have over half the companies with a majority of independent directors. For India, just under half of our companies surveyed have independent directors making up a majority of their board.

Over half in our study have increased independent directors in the past three years in Thailand, India, Malaysia but practically none in the Philippines

Figure 28

Companies with an increase in independent directors over last 3 years



Source: CLSA Asia-Pacific Markets

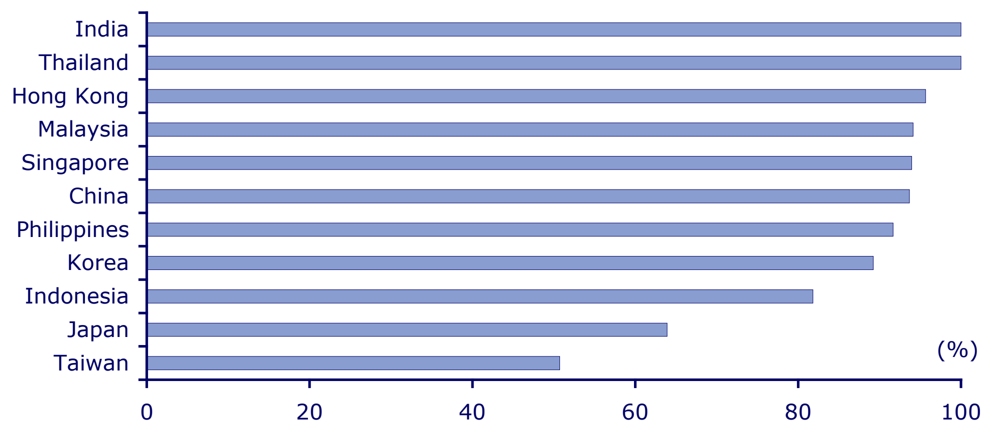
Few companies increased independent directors over last 3 years

There is plenty of scope for Asian companies to increase the number of independent directors. In the last three years, however, they have not generally been in a rush to do so except in Thailand where 61% of the companies we survey have increased the number of independent directors. In India and Malaysia around half of the companies have increased the number of independent directors but less than a quarter of our sample in Japan, China, Hong Kong and Korea and in the Philippines only 8% of the companies have increased independent directors on their boards.

Audit committees are not compulsory in Taiwan and Japan; for other markets there may be issues on composition of the committee

Figure 29

Companies with properly constituted audit committees



Source: CLSA Asia-Pacific Markets

Audit committee needs to be propertly constituted

Our criteria of a proper audit committee includes having a chairman who is an independent director, that more than half the members of the committee should be independent directors and that at least one of the independent directors on the committee should have expertise in accounts or audit. As audit committees are not compulsory in Taiwan and Japan, only half of our Taiwan sample and less than two-third of our sample in Japan have a proper audit committee. In Indonesia, by our sample around one-fifth of the companies do not meet the full criteria of a proper audit committee. Similar issues on the composition of the audit committee affect approximately one-tenth of the companies we cover in Korea and the Philippines, as well as approximately 5% of our sample in China, Singapore, Malaysia and Hong Kong.

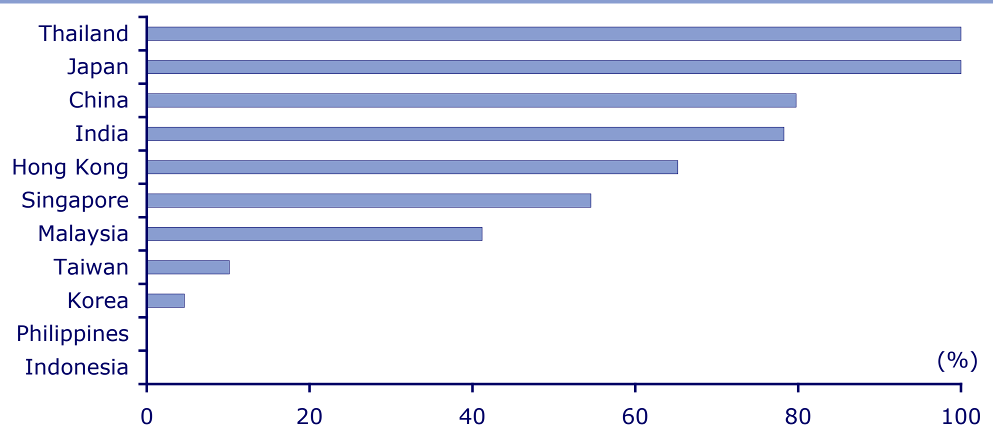
Audit committee should nominate external auditors

A mark of greater accountability is that the audit committee should nominate the external auditors, not just review their work. With full power to determine the external auditors, management can keep auditors who are friendly to them. Audit committees or audit-related supervisors on the board having the power to nominate external auditors is the norm in Thailand and Japan (where the audit supervisor on the Board determines the external auditors). However the choice of auditors is solely the prerogative of management for companies in Indonesia the Philippines, and also mostly for Korea, Taiwan and Malaysia.

Audit committees or audit supervisor on the Board in Japan nominate the external auditors; management keep discretion on external auditors in Indonesia and the Philippines

Figure 30

Companies where audit committee nominates the external auditors



Source: CLSA Asia-Pacific Markets

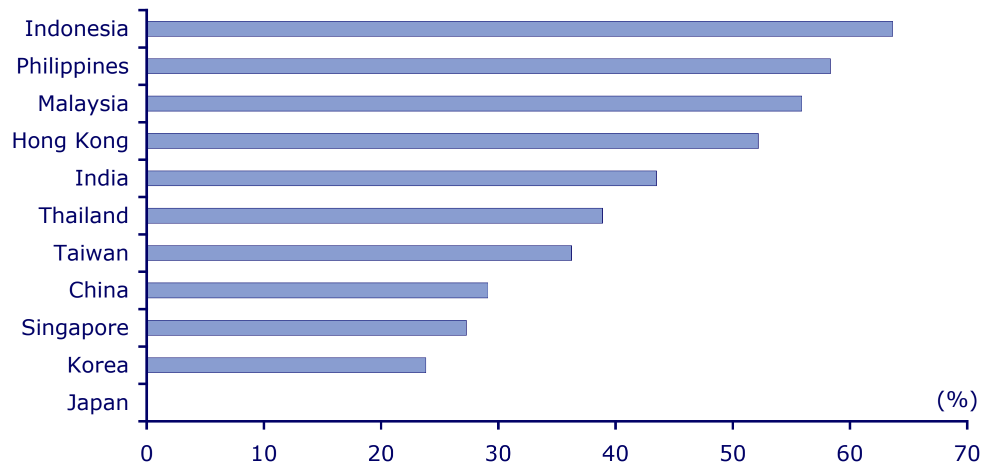
Financial discipline involves having appropriate WACC estimate and ROA/ ROE targets

Financial discipline includes having an appropriate cost of capital estimate that sets the hurdle for new investment / acquisition decisions, and having ROA or ROE targets against which future results can be benchmarked. Japanese companies however do not provide any cost of capital estimates. In Korea, Singapore and China as well, less than one-third of the companies give cost of capital estimates that are within 10% of our estimates. Across our sample in all countries, less than 30% of the companies bother with publicly disclosed ROA or ROE targets.

Indonesian, Philippines and Malaysian companies give reasonable estimates for their cost of capital; Japanese companies do not provide any estimate

Figure 31

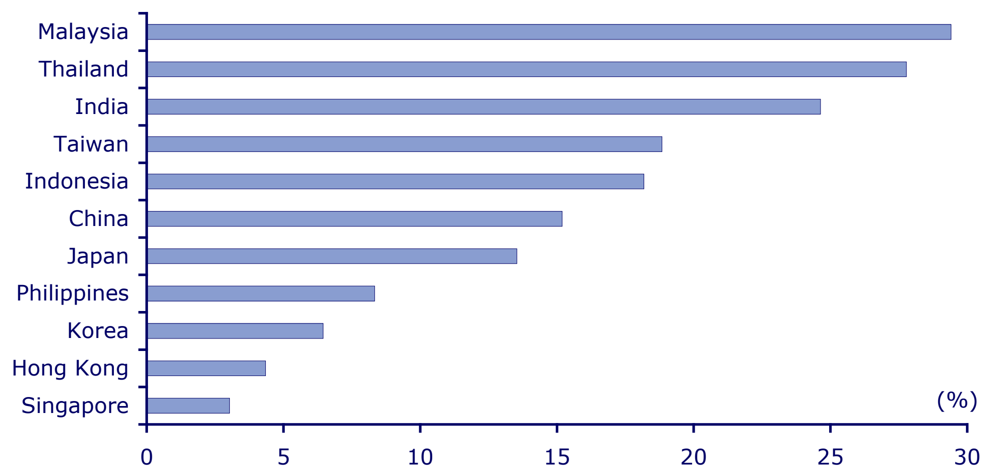
Companies that provide appropriate cost of capital estimates



Few Singaporean, HK, Korean of Philippine companies disclose ROA or ROE targets; across the other countries in the region as well, most companies do not provide these targets

Figure 32

Companies that disclose 3- or 5-year ROA or ROE targets



Source: CLSA Asia-Pacific Markets

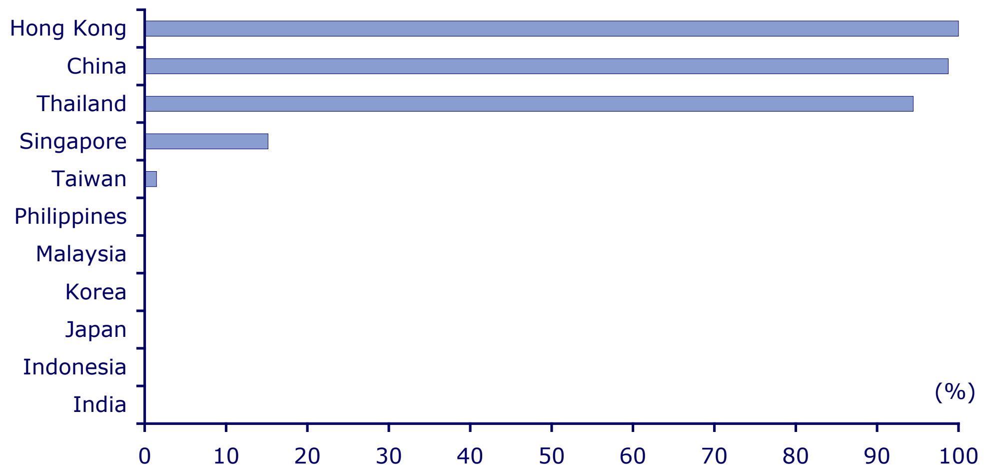
Voting by poll is a litmus test for enfranchising shareholders

Voting by poll, a litmus test for shareholders being enfranchised, requires all votes cast in an AGM/EGM by those present as well as by proxy to be tallied against the percentage shareholding. This has been made mandatory in Hong Kong (thus extends to the Chinese companies listed in Hong Kong) and is also now the norm for Thailand. A few Singaporean companies are moving in this direction. In Taiwan so far only TSMC has adopted voting by poll. For the rest of Asia, as the chart below shows, this is still non-existent.

Not a mistake in the chart - in Thailand, China/HK voting by poll is the norm, but non-existent for most of the region

Figure 33

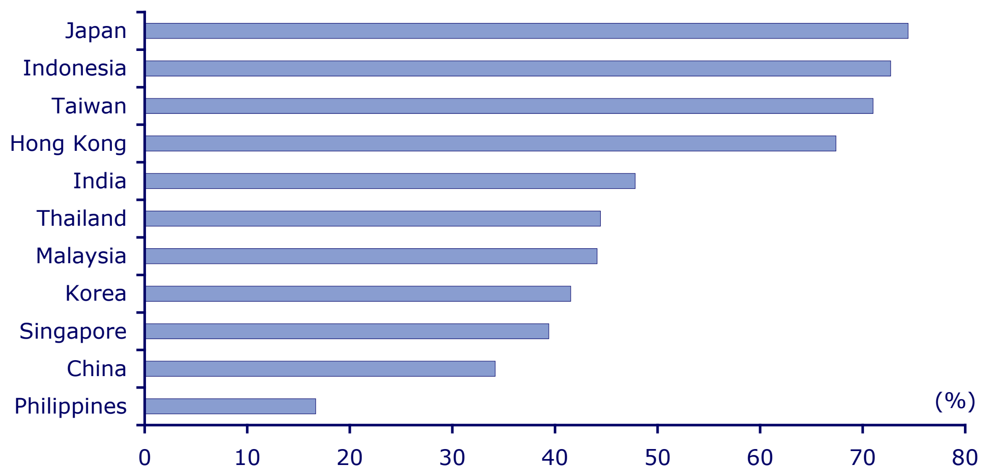
Companies that vote by poll



Higher CG risk arising from conflict of interest where companies not the primary financial interest of the controlling shareholder in markets like Philippines, China, Korea, Malaysia with Singapore score on this pulled down because of GLCs

Figure 34

Controlling shareholders primary financial interest is the listed company



Source: CLSA Asia-Pacific Markets

Conflict of interest has been the main risk of major CG lapses in Asia

The main CG risk in Asia has been from conflict of interest in the controlling shareholders. They might have a diluted stake in a company, or other businesses of the controlling shareholder might dominate over his financial interest in a given listed company. At crunch time, the controlling shareholders priorities favouring private interests that are fully-owned might translate into transgressions impacting negatively on their listed companies. Even at other times, the temptation could be inviting to use the listed company to benefit other concerns - the risk that arises from ongoing related party transactions. Thus, whether the controlling shareholders' primary financial interest is the given listed company should be a key issue to watch for corporate-governance risk.

In most markets, controlling shareholders interest for over half of the companies do not appear aligned with investors

We score negatively on the question whether the primary financial concern of the controlling shareholder is the listed company if it is held via any convoluted shareholding structure, or is a subsidiary of another listed company, or where the controlling shareholder is the government. The government's primary interest is almost never the maximisation of value of any company that it might have listed. Government-controlled companies are usually professionally managed, but often other priorities over-ride, eg, when inflationary concerns for the economy result in a government deferring tariff increases for a utility, or when government-controlled airlines are required to fly to uneconomical destinations.

As the chart above shows, for half or more of the companies we cover in the Philippines, China, Singapore, Korea, Malaysia, Thailand and India, the controlling shareholders primary financial interest is not the listed company. Even for Hong Kong, Taiwan, Indonesia and Japan, there is a potential risk from the controlling shareholder's interest not being aligned with investors for 25% or more of the companies in our sample.

CG of larger caps

Larger caps have higher CG, particularly so for Japan

It is not surprising that larger firms tend to have better CG. Larger companies are in a better position to pay for capable independent directors, to have the various board committees and to implement the other checks and balances central to good governance. While our overall CG score for markets we cover is 52.7%, the largest 100 by market cap for Asia ex-Japan, with market caps in excess of US$10bn, have an average CG score of 54.7% (with a higher median CG score of 55.8%). Larger caps in Japan have better scores. The largest 50 in our Japanese coverage, with market caps of US$9bn and above, have a mean CG score of 56.7%, with a higher median of 59.9%. Thirteen of the 23 larger caps with CG scores of 70% and higher, are from Japan.

Of the 25 top CG large caps, 6 are from HK and 5 from India

Figure 35 shows the top quartile stocks for CG by our ranking of the large caps for Asia ex-Japan. These companies have a score of 65% and above. Of the 25, six are from Hong Kong. Indeed the top three from Hong Kong - HK Exchanges, Li & Fung and HSBC - have about the highest absolute scores at around 80%. The other three from the territory in the top quartile CG ranking for large caps are CLP, Swire and Sun Hung Kai Properties. Five of the companies from this list are from India. Infosys remains one of the top ranked for the scoring regionally, followed in India by Wipro, Bharti, HDFC and HDFC Bank also with good CG scores.

From China only ICBC makes it to the top quartile CG of large caps

Korea has four names among the top quartile CG ranking of large caps: LG Electronics, Shinhan Financial, Posco and Samsung Electronics. Singapore has just three large caps in the top quartile CG ranking of large caps: OCBC, CapitaLand and Singtel. From Taiwan, TSMC is one of the top five regionally while China Steel is also in the top quartile. Malaysia has two banks in the top quartile CG ranking of large caps regionally, viz CIMB and Public Bank. Telkom and Astra from Indonesia also make the list. From China, only ICBC is in the top quartile CG of large caps.

Top CG ranked among the large caps are HK Ex, Li & Fung, TSMC, HSBC, Infosys with CG scores at around 80%

Figure 35

Top quartile CG ranking of large caps Asia ex-Japan

	Code	Market	Sector
HK Exchanges	388 HK	Hong Kong	Financial services
Li & Fung	494 HK	Hong Kong	Consumer
TSMC	2330 TT	Taiwan	Technology
HSBC	5 HK	Hong Kong	Financial services
Infosys	INFO IB	India	Technology
Wipro	WPRO IB	India	Technology
OCBC	OCBC SP	Singapore	Financial services
LG Electronics	066570 KS	Korea	Technology
CLP	2 HK	Hong Kong	Power
CIMB	CIMB MK	Malaysia	Financial services
Swire Pacific	19 HK	Hong Kong	Property
Bharti Airtel	BHARTI IS	India	Telecoms
CapitaLand	CAPL SP	Singapore	Property
Shinhan Financial	055550 KS	Korea	Financial services
Posco	005490 KS	Korea	Materials
Sun Hung Kai Prop	16 HK	Hong Kong	Property
Public Bank	PBKF MK	Malaysia	Financial services
Telkom Indonesia	TLKM IJ	Indonesia	Telecoms
Samsung Electronics	005930 KS	Korea	Technology
SingTel	ST SP	Singapore	Telecoms
China Steel	2002 TT	Taiwan	Materials
Astra International	ASII IJ	Indonesia	Conglomerates
ICBC	1398 HK	China	Financial services
HDFC	HDFC IB	India	Financial services
HDFC Bank	HDFCB IB	India	Financial services

Source: CLSA Asia-Pacific Markets

Consumer electronic companies at the top for CG in Japan

Figure 36 shows the top quintile CG stocks of the larger caps in Japan. Noticeable is that the highest scores are dominated by consumer electronics names, eg, Nintendo, Sony, Canon, Ricoh, Panasonic and Fujifilm. With international suppliers and customers that they deal with, these firms need to be run at a correspondingly higher level of transparency and governance.

Top ranked for CG among large caps in Japan is Nintendo; slightly below are Sony, Sumitomo Metal, Tokyo Electron

Figure 36

Top-20 CG ranking of Japan large caps

	Code	Sector
Nintendo	7974 JP	Technology
Sony	6758 JP	Technology
Sumitomo Metal Ind	5405 JP	Materials
Tokyo Electron	8035 JP	Technology
Tokyo Gas	9531 JP	Power
Canon	7751 JP	Technology
Ricoh	7752 JP	Technology
Mitsui	8031 JP	Conglomerates
Nippon Steel	5401 JP	Materials
Toshiba	6502 JP	Technology
Hoya	7741 JP	Technology
Mitsubishi Corp	8058 JP	Conglomerates
Marubeni	8002 JP	Materials
Panasonic	6752 JP	Technology
Fujifilm	4901 JP	Materials
Sharp	6753.T	Technology
Inpex	1605.T	Petroleum & Chemicals
JFE	5411 JP	Materials
Kansai Electric	9503 JP	Power
Tokyo Electric	9501 JP	Power

Source: CLSA Asia-Pacific Markets

Some of the mid and smaller caps also have high CG

High CG of medium and smaller caps

A fair number of medium and smaller caps (ie, with market caps below US$10bn) also have high standards of governance. Of these, we show those with CG scores of 70% and higher in Figure 37, comprising 20 names. We find that the Reits in Singapore generally have high standards imposed and Thai companies also have high regulatory standards imposed. CapitaMalls Asia, Kasikornbank, Bank of Ayudhya, Konica Minolta, Hynix, Nikon, Manila Water among those that lead for CG among the mid to smaller caps in the region.

Among the top in our CG rankings with market cap below US$10bn are CapitaMalls Asia, Kasikornbank, Bank of Ayudhya, Konica Minolta, Hynix, Nikon, Manila Water

Figure 37

High CG below US$10bn market cap

	Code	Country	Sector
CapitaMalls Asia	CMA SP	Singapore	Property
Kasikornbank	KBANK TB	Thailand	Financial services
Bank of Ayudhya	BAY TB	Thailand	Financial services
Konica Minolta	4902 JP	Japan	Technology
Hynix Semiconductor	000660 KS	Korea	Technology
Nikon	7731 JP	Japan	Technology
Manila Water	MWC PM	Philippines	Miscellaneous
Siam Commercial Bank	SCB TB	Thailand	Financial services
Yes Bank	YES IB	India	Financial services
OCI	010060 KS	Korea	Materials
Orion	001800 KS	Korea	Consumer
Osaka Gas	9532 JP	Japan	Power
Young Fast	3622 TT	Taiwan	Technology
Nippon Paper	3893 JP	Japan	Materials
Bangkok Bank	BBL TB	Thailand	Financial services
Ayala	AC PM	Philippines	Conglomerates
Olympus	7733 JP	Japan	Technology
Advantest	6857 JP	Japan	Technology
Kuraray	3405 JP	Japan	Materials
Nine Dragons	2689 HK	China	Materials

Source: CLSA Asia-Pacific Markets

Does CG matter?

Our Quant team finding supports positive impact of CG on performance

Conceptually, there is little reason why having the structures and processes of good CG should lead to added stock performance. Except that not having them is often quite detrimental for a stock. Searching for the impact of CG on stock performance is however devilishly tricky. We are helped by the recent paper from our Quant team which strips out CG from other market-related factors. The finding, using the last five years' CG scoring of companies by CLSA, is that a 10-point difference in the CG score has been associated with a 7.3% additional performance for a stock over the following nine months after a CG score update.

Poor CG stocks in particular appear to be the drag

Our own updated tests of stocks sorted by CG going back one-, three-, five- and ten years indicate that on average higher CG stocks perform better than lower ones. Breaking this down by CG quartiles, the evidence suggests that in particular it is poor CG stocks that drag down performance. This is hardly surprising given that poor CG companies are more likely to see economic value being hijacked rather than shared equitably with investors. We also find evidence over the last three years of improving CG correlated with stock outperformance, whilst falling CG is associated with poor stock returns.

Value screen performance can be enhanced by taking out poor CG stocks

We examined whether performance of a basket selected by attractive PE, a standard valuation measure, can be enhanced by applying CG criteria. Removing the lowest CG stocks from the low PE basket enhances the already strong performance of this value screen over the last ten years. A conclusion similar to that from our Quant team is that CG is not yet efficiently incorporated into stock prices. This provides investors with the opportunity of avoiding the worst CG companies, thus presumably reducing the risk in the portfolio, but nevertheless getting higher returns.

Higher returns with lower risk?

This finding seems to fly against the axiom of finance that returns cannot be boosted without higher risk. However, the market may not yet have fixed on the means to measure and thus price in risk associated with poor CG. For investors, the continued relevance of our CG rating of companies and markets is that beyond academic pieces, this remains systematically an under-researched area with important implications for returns of portfolios. The key conclusion is to identify red flags and avoid CG scum to minimise the risk of being caught in a bog of value-traps.

Quant test: Nice guys finish ahead

Quant study to isolate impact of CG on stock performance isolated from other factors

In June 2010, our Quant team headed by Chris Lobello produced a report titled *Nice guys finish ahead* seeking to isolate the impact of CG on stock performance. (See Appendix 7 for the full paper.) The team isolated CG from other factors that would likely impact on performance, in particular the country/market and sector performance as well as market cap of stocks. Some 1,554 observations on 875 different companies were tested where our analysts had entered a CG score between 2004 and 2009, to determine the performance of the stock over the following nine months. The test was over nine months to avoid overlap of periods of observation, as in some cases CG scores were updated in periods just under a year.

The returns from good corporate governance

Figure 38

CG and stock performance regression test

Rn = constant + bnCGn + cnSize + dnC1 +….+ gnCm + hnS1+…. pnS2 + error

where:	R	is the ninth-month forward return
	CG	is the corporate governance factor score
	Ci's	country dummy variable
	Si's	Sector dummy variable
	N	refers to stock n

	Coefficient (%)	t-stat
Corporate governance	**0.7**	**7.19**
Size	(13.6)	(5.80)
Country - average (absolute value)	21.7	2.13
Sector - average (absolute value)	33.5	2.85

Source: CLSA Asia-Pacific Markets

10-points on CLSA CG score equates to 7.3% performance over following 9 months

The Quant test is an econometrically more sophisticated way of establishing if CG has an impact on stock performance, isolating it from some other key factors that often distort the result. The finding was extremely encouraging. Every 10-point difference in the CG score was found to have been positively correlated with a 7.3% performance for the stock over the following nine months when these other factors are stripped out. The finding had a highly significant t-stat of 7.1. Importantly, it was not just a change in CG that was associated with this strong performance, but the level of CG itself. This indicates that better CG has an impact of stocks that is persistent. As Chris writes in the paper, the implication is that the market does not quickly digest the publicly available information on CG which has an effect even over a few quarters.

Other forces could be driving the performance

Chris does not discount that the impact of CG on stock performance could be related to other factors and thus explained by these other factors that might be associated with both. One possibility discussed in the paper is the growth of SRI-related funds. Over 2005-07, SRI assets have increased by more than 18% while the broader universe of all funds under professional management only increased by less than 3%. For these funds, CG is likely to be one of the factors driving the investment decision. It is likely that factors such as these might at least partly explain the correlation between CG and stock performance, however there is little reason to expect these factors to suddenly disappear. Hence in all probability, the correlation between CG and stock performance is likely to stay. Still, the result reminds us that CG in itself is hardly over-riding in determining stock performance; other factors like size of the stock as well as market and sector direction are also as important, if not often more so.

Performance of higher versus lower CG stocks

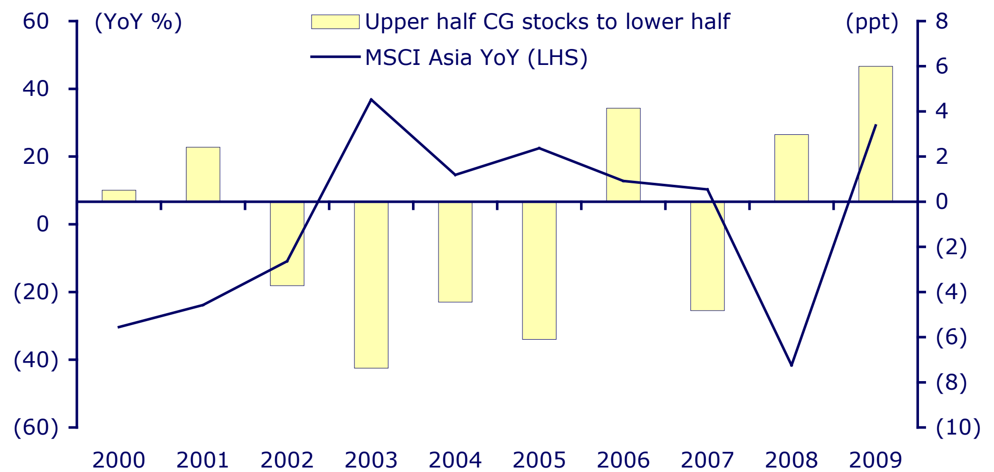
When markets are strong, higher CG stocks found to generally UPF lower CG

Figure 39 shows the performance of the upper half of stocks sorted for CG by our current rankings against the lower half for the last ten years, plotted against the performance of the MSCI Asia Pacific index. The upper half stocks for CG have outperformed the lower half in the last two years, but we find they outperformed in just five of the last ten years. Strikingly, four of the five years where the higher CG stocks underperformed (2003-2005 and 2007) were periods when Asian equity markets were fairly strong. Indeed, in 2003 the regional index had the strongest performance over the last ten years, up 37%, while the higher CG stocks did relatively the worst compared to the lower CG stocks.

When MSCI Asia Pacific fell by 10% or more, higher CG stocks generally outperformed . . .

Figure 39

Performance of upper half CG stocks to lower half vs MSCI Asia Pacific



Source: CLSA Asia-Pacific Markets, Bloomberg

. . . although 2002 was an exception

Meanwhile, in three of the four years where the index fell by 10% or more, higher CG stocks outperformed, i.e. in 2000, 2001 and 2008. The exception was 2002, when the index declined but higher CG stocks underperformed; however this was after two consecutive years when higher CG stocks had outperformed. Thus probably by 2002, the selling for investors were in the remnants which were likely to be higher CG stocks that had done better in the earlier two years and were still in their holdings.

Risk appetite explains the inverse relationship between CG stock performance and markets

Although annual performance from a ten year period is hardly conclusive statistically, it indicates that higher CG stocks tend to perform better when markets are declining, whilst poorer CG stocks perform better when markets are strong. The performance of high CG stocks being inversely related with the direction of markets is a point made in our earlier CG reports. Risk appetite appears to be the underlying reason. Rising markets increase the risk appetite of investors and leads to poorer CG stocks performing better, whilst declining risk appetite in falling markets generally works in favour of the performance of higher CG stocks.

Higher CG stocks have outperformed lower CG over last ten years

Despite the counter-cyclical performance of high CG stocks, over the long-term the evidence is that these stocks tend to outperform. In the region, over the last ten years, the higher CG stocks have provided a median return of 112.5% versus 96.3% for the lower half of CG stocks that we cover. However, as Figures 40 and 41 on the next page show, this performance need not come from the very top CG companies but may well be from those that are slightly better than average on CG.

We use median rather than mean

Note that for our analysis of relative performance, we use median returns of stocks sorted by CG quartiles or halves, rather than the mean performance. One or two stocks that might have gone up multi-fold over the five to ten year period we are looking at can significantly distort the mean. The median gives the typical performance of a stock in that CG group.

The returns of our baskets, not market cap weighted, are compared to the overall basket of stocks in our study

We compare the returns of these stocks against the overall basket of stocks in our study rather than against an index for the region, as the index is skewed towards performance of larger caps. This often gives the paradoxical result that the simple average performance of each quartile comes out higher than the index. Each basket, not weighted by market cap, is likely to have

performance pushed up by mid- and smaller caps. Each of the CG quartiles or halves could thus outperform a market-cap weighted index where the large caps are likely to have dampened the returns.

Market cap weighting skews the findings towards the larger caps

Our tests are to determine if on average higher CG stocks outperform, and lower CG stocks underperform. To represent the typical performance of these stocks, we use a simple median performance of the stocks in CG quartiles or halves, rather than market cap weighting the returns which would skew the findings towards the larger caps.

Poor CG appears to be a drag rather than high CG a boost for performance

Bottom quartile CG stocks a drag

Sorting stocks by CG and examining their relative performance, we find the bottom ranked stocks for CG have underperformed, over the last year (2009), as well as the last three and 10 years. The median 10-year return of stocks where we have a CG rating was 104% with the median performance of the bottom-quartile CG stocks at 91% over the period. For the last year (2009), the median of the bottom CG quartile across the region underperformed that of the overall sample by 11ppts.

Figure 40

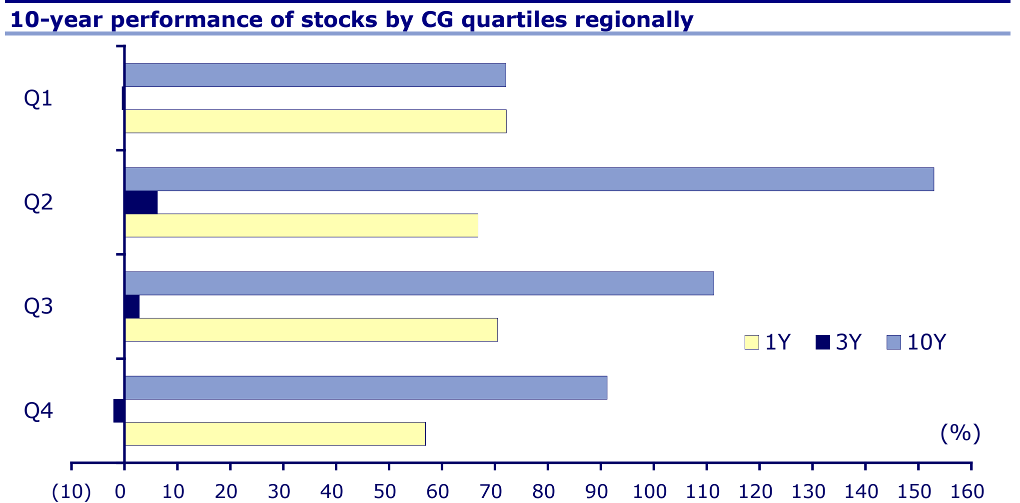
1-, 3-, 5- 10-year median performance of stocks by regional CG quartiles

	1yr	3yr	5yr	10 yr
Top quartile	72.1	(0.4)	59.6	72.1
2nd quartile	66.8	6.2	66.2	152.9
3rd quartile	70.5	2.8	78.8	111.3
Bottom quartile	56.9	(2.0)	66.0	91.2
Median of overall basket	**68.4**	**2.3**	**66.5**	**103.7**

Bottom quartile CG stocks have underperformed over the last 1-, 3- and 10-years, although top quartile CG stocks performed worst over last ten years

Figure 41

10-year performance of stocks by CG quartiles regionally



Source: CLSA Asia-Pacific Markets

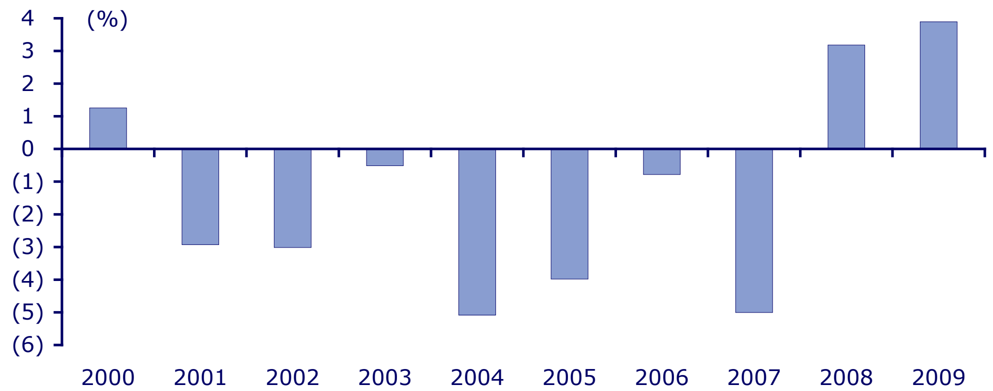
Top CG quartile has underperformed over the last ten years

However, the top ranked stocks on CG are not consistent outperformers. More often than not, the top CG quartile underperforms the overall basket as we see in Figures 41 and 42. These stocks outperformed regionally over the last two years, however they have outperformed in only three of the last ten years. In this 10-year period, the median performance of our overall basket was up 104% while the top CG quartile stocks rose only by a median of 72%. High CG in itself does not seem to be generally associated with stock outperformance.

Top CG quartile regionally has outperformed only in 3 of last 10 years

Figure 42

Rel perf of highest quartile CG stocks regionally against the median: 2000-09



Source: CLSA Asia-Pacific Markets

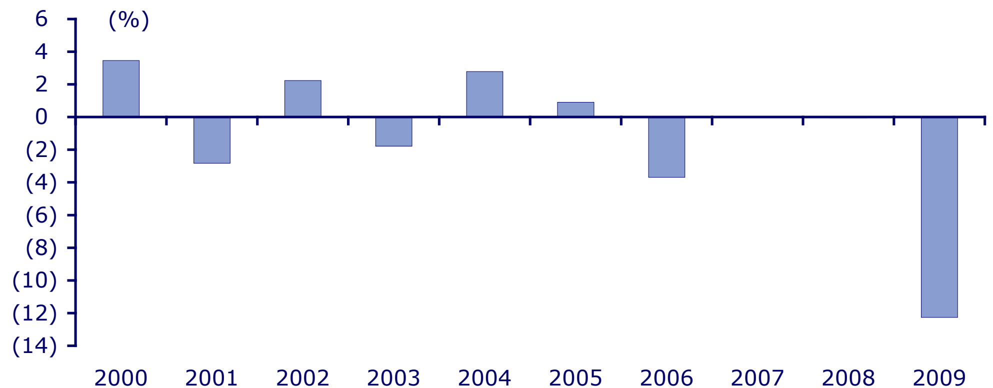
Market direction a factor determining performance of low CG stocks

The bottom quartile of CG stocks regionally underperformed in five of the last 10 years, which as we indicated above is likely to be a function of market conditions and risk appetite. However, their relatively greater underperformance in these years (in particular 2009), and more marginal outperformance in the other years, meant that overall the returns of these bottom CG quartile was poor over the period.

Low CG stocks underperformed in 5 of the last 10 years although quite significantly in 2009

Figure 43

Rel performance of lowest quartile CG stocks regionally against median: 2000-09



Source: CLSA Asia-Pacific Markets

Poor CG stocks will UPF if economic value created not shared equally with investors

These findings support the view that high CG in itself may not be sufficient to generate stock outperformance. However, poor CG is often a key factor that drags the performance of a stock. Over time, poor CG stocks can be expected to underperform if the economic value generated by the business is often hijacked by the controlling shareholder or management. Returns to minorities thus can be expected to be poor.

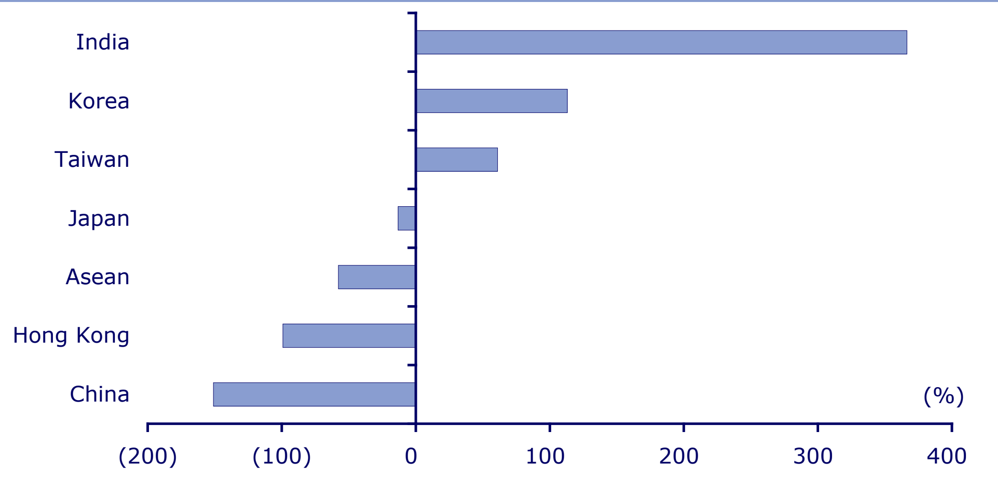
Greater discrimination on CG in certain markets

By markets, we find a good correlation between the lowest quartile CG stocks under-performing against the overall country basket for China, Hong Kong, the ASEAN markets and Japan over the last 10 years. This suggests that either investors are more discriminating about corporate governance and/or that there is greater hijacking of economic value for the poor CG stocks in these markets.

Lowest CG stocks underperform especially in China, HK, ASEAN markets and Japan but have outperformed strongly in India

Figure 44

Performance of lowest CG quartile to the median of respective markets over 10 years to 2009



Source: CLSA Asia-Pacific Markets

Our sample, biased towards better CG companies, not ideal to determine overall relative performance of stocks sorted by CG

However for our Indian, Korean and Taiwanese sample, the poorest CG quartile did not underperform the respective country's basket of stocks over the last 10 years. The findings also highlight the importance of choice of sample. For India, our current sample excludes Satyam which we no longer cover. Presuming that our sample in most markets is biased towards better CG companies, and often the worst CG stocks have been dropped from coverage, it is likely to be more difficult to get clear results of the relative performance of stocks sorted by CG. The reality is likely to be that the poorest CG stocks, not given a CG rating at all, will have much greater under-performance.

More recent underperformance of poor CG stocks

For Korea, the bottom CG quartile in our sample has underperformed the country basket over the last one and three years, whilst for Taiwan and India they underperformed in the last year.

Periods of uncertainty could favour higher CG stocks

Interestingly over 2009 when investors came back strongly into equity markets after the earlier two years of turmoil, there was a clear preference for better CG stocks. The upper half of stocks by our CG ranking outperformed the lower half in most markets in 2009. This reflects a general preference for better CG stocks when investors are returning to markets but are somewhat uncertain about the overall economic outlook.

Lower CG large caps found generally to OPF over the longer term

For large caps, we find the lower half of stocks sorted by CG generally outperformed the upper half CG stocks. Over the last 10 years, the lower half outperformed the upper half by 177ppts. For Japan, of the top 50 large caps, the lower half for CG outperformed the upper half by a negligible 0.3ppt margin. This indicates that for the larger caps, investors may be taking the overall CG levels as likely to be reasonably good, and there is no clear underperformance for the poorer CG group.

But in 2009 even for large caps stronger returns from higher CG names

It could, however, also be a result of mid-cap stocks with large re-rating getting into the larger cap category that may not have as high CG as those already in the large cap group. The impact of re-rating could distort the result of CG ranking and stock performance. Interestingly, for the last year, the higher CG stocks of the large caps have outperformed for both Asia ex-Japan (by 15.7ppts) and for Japan (by 13.3ppts).

Stocks that saw improving CG had quite strong performance typically

Change in CG a driver of performance

There is reasonable evidence that stocks with rising CG have strong outperformance whilst those with declining CG underperform. In our universe, 24 stocks had changes in scores of more than 10ppts since our last CG rating across the region in 2007, where the analyst's view is that this reflected real CG change in the companies. Twelve of the companies had a significant positive change in CG score. These are shown in Figure 45. The median performance of these stocks over the three year period to end-2009 was 49.6% (with a mean of +111.7%), compared to the median return for the stocks in our overall universe which over the period produced a return of 2.3% (mean of 23.5%).

Figure 45

Rising CG and three-year stock performance to end-2009

Co.	Code	Change in CG score (ppt)	Price perf in US$, 2006-09 (%)	Comments
Man Electric - A	MER.PS	48.8	342.9	Change in CG with control passed to First Pac
Philex Mining	PX.PS	28.5	580.9	Change in CG with control passed to First Pac
PNOC-EDC	EDC.PS	21.6	28.5	Change in CG with privatisation; sold by the govt to private hands
Bank of Baroda	BOB.BO	22.3	102.6	Access to management has improved
E Sun Financial	2884.TW	19.8	(35.5)	Improved on independent directors etc
S-Oil Corporation	010950.KS	18.4	(37.1)	Management are more transparent, prior transgressions more than 5 years back
China Res Enterprises	0291.HK	16.7	27.2	Divestment of non-core assets and clearer financial targets
CIMB	CIMB.KL	14.9	70.8	A more independent board that oversees management
Chroma	2360.TW	14.2	162.5	Improved significantly on transparency
L&T	LART.BO	12.9	121.3	Increase in independent directors, more timely release of announcements, better access to and guidance from management
HCL Technologies	HCLT.BO	11.8	8.9	Disclosure has improved, quarterly accounts are audited, improved communication with investors
Taishin Financial	2887.TW	10.6	(32.7)	Increased independent directors but still have a low score
Median		**17.6**	**49.6**	

Source: CLSA Asia-Pacific Markets

Nine of 12 stocks identified with CG improvement had a return significantly higher than the median

Certainly not all of the stocks with CG improvement outperformed. Three of these had an absolute decline. But 9 of the 12 stocks with improved CG rose above the median return for stocks in our universe. Among the top performing in the list are Philex Mining and Manila Electric, where the improvement in CG of 33 to 53 points respectively came with a change in control moving to First Pacific which resulted in massive returns. In the region, Chroma of Taiwan with a 14 point CG improvement, L&T and Bank of Baroda from India also more than doubled with an improvement in CG scores of 13 – 22 points.

8 of 13 identified with CG decline had a return below the sample median

Meanwhile the median return of the 12 stocks with notable deterioration in CG over the last three years was -20.8% (mean of -11.3%). While we no longer cover Satyam, we have included the stock among those with a major CG decline since our last report. In dollar terms, the stock is down 80% over the last three years even after a corporate rescue by Tech Mahindra. That reflects the much greater downside for companies with CG debacles, if they do not de-list altogether.

Figure 46

Declining CG and three-year stock performance to end-2009

Company	Code	Change in CG score (ppt)	Price perf in US$, 2006-09 (%)	Comments
Satyam	SCS.BO	na	(80.7)	Fraud, ineffective audit committee, proposed related party transaction to benefit controlling shareholder
MUFG	8306 JP	(43.7)	(60.3)	New analyst but we score negatively for maximising value independently of govt pressure and dilution suffered by shareholders etc
Mizuho	8411.T	(37.2)	(74.8)	New analyst but we score negatively for maximising value independently of govt pressure and dilution suffered by shareholders etc
SMFG	8316 JP	(33.3)	(72.0)	New analyst but we score negatively for maximising value independently of govt pressure and dilution suffered by shareholders etc
Sime Darby	SIME.KL	(31.1)	28.4	CEO forced to resign on cost overruns for Bakun and international projects which were discovered by an independent director and a working group four years after the losses were originally incurred; losses had not been taken to the P&L when incurred; failure of internal controls
Yuanta Financial	2885.TW	(21.1)	47.0	Founders have fallen foul of the law
Li Ning	2331.HK	(16.8)	137.4	Less disclosure on operating data
Everlight	2393.TW	(15.8)	39.4	Access to management has reduced with departure of former CFO; Company has also had dilute raising of capital
Genting Malaysia	GENM.KL	(15.5)	(0.8)	Issues arising from acquisitions by the Co from related parties
Shin Kong FHC	2888.TW	(15.0)	(57.4)	Management issues and capital raising
CITIC Pacific	0267.HK	(10.5)	(21.9)	Forex losses reflecting poor internal controls and poor disclosure to the market
D-Link	2332.TW	(10.4)	(19.6)	Ran into issues with regulator on public disclosure
Median		**(16.8)**	**(20.8)**	

Source: CLSA Asia-Pacific Markets

Some stocks with declining CG helped by improving fundamentals for their sector

Within this universe, four of the 12 stocks that had a decline in CG nevertheless did well, for instance Sime Darby, Yuanta, Li Ning and Everlight. In most of these cases, business conditions and sector performance would have contributed here. Others with large declines in CG scores have suffered significant stock underperformance, in particular the Japanese banks where increased dilution and reduced ability to maximise value for shareholders resulted in a sharp drop in their CG scores.

Other factors may offset CG change

Just 24 stocks have seen significant CG change (which we believe reflects a real change); these are equally distributed among those with score improvements versus declines. The evidence from the last three years is that companies with CG improvements saw major outperformance, which is likely to have been helped by fundamental factors working in their favour. Those with CG disappointments have seen stock underperformance, although other fundamental factors may have worked to support the stocks.

CG as a boost on value

Screening out low CG stocks from a cheap PE basket adds to its performance

We back tested the entire universe of stocks under our coverage for those with the cheapest trailing PE at the end of each year for the last 10 years. On these we then applied CG overlays. Our finding is that adding a high CG overlay on the lowest PE stocks does not give added performance. However a CG overlay that takes out the lowest CG stocks is found to give stronger performance.

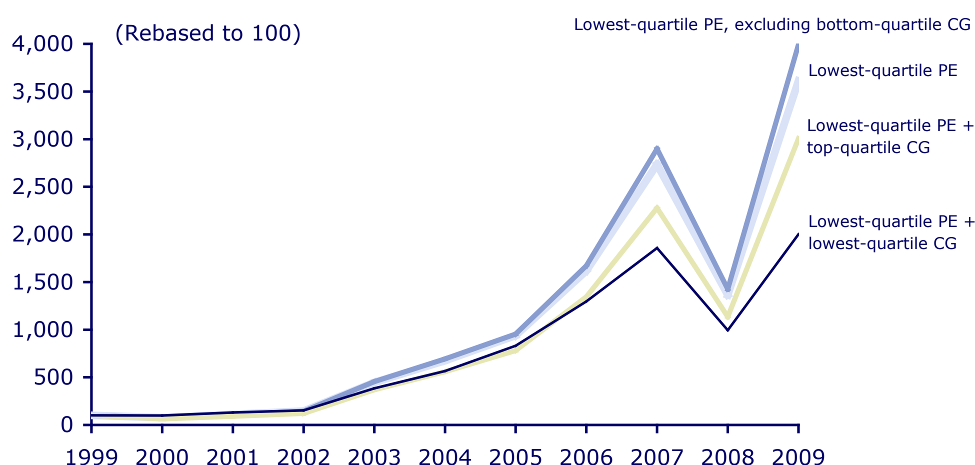
Massive performance from cheap PE stocks

Stocks with the lowest quartile (ie, cheapest) PE, rebalanced at the end of each year, gave a huge 43.1% compounded annual return over the last 10 years. This is massive outperformance when compared for instance with the 12.3% compounded return for stocks in the most expensive PE quartile. For this period, the MSCI Asia Pacific index rose at a compounded rate of minus 1.6%. As mentioned above, the performance of different baskets not weighted by market cap can each outperform a market-cap weighted index because of the distortions of the large caps; hence we compare the performance of one basket against another relevant basket or the total basket of stocks.

Eliminating lowest CG stocks boosts the performance of the cheap PE basket, but choosing just high CG stocks of the low PE basket detracts from performance

Figure 47

Top quartile PE stocks (cheapest PE) with CG screens



Source: CLSA Asia-Pacific Markets

High CG filter on the lowest PE stocks not found to give added performance

On the cheapest PE basket, we applied various CG screens. From this basket, taking only those in the highest CG quartile of our ranking does not lead to better performance. The basket of stocks with the lowest (cheapest) quartile PE and top quartile CG scores gave an annualised return of 40.5% over the last 10 years, underperforming the lowest PE basket without any CG filter which produced a 43.1% annual return.

But cheap PE excluding lowest CG does seem to give added performance

However, the market seems to hold back somewhat on cheap PE stocks with low CG. Of the lowest quartile PE stocks, if one perversely chose stocks with the lowest quartile CG, one would have managed a return of 34.9%, underperforming the straight lowest PE basket by almost 10ppts annually. But excluding the lowest CG stocks improves the performance of the cheapest PE basket by 1.5ppts annually, giving an average annual return of 44.6%.

Figure 48

Yearly performance of low PE basket with CG screens

(%)	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Lowest quartile PE stocks	(22.4)	42.2	32.3	205.6	51.2	39.1	72.4	69.0	(50.1)	164.8
Highest quartile PE	(26.4)	(15.9)	(2.7)	59.1	23.6	43.4	55.8	64.9	(58.0)	73.4
Lowest quartile PE +Top quartile CG	(35.8)	42.2	32.3	205.6	51.5	39.6	72.4	69.3	(50.1)	164.8
Lowest quartile PE + Bottom quartile CG	(1.6)	33.1	16.6	151.5	47.3	47.0	56.0	43.2	(46.5)	101.3
Lowest quartile PE excluding bottom quartile CG	(26.6)	44.2	35.9	216.1	52.5	37.4	75.3	73.5	(50.8)	180.2

Source: CLSA Asia-Pacific Markets

Filtering out lowest CG would reduce risk but seems to add to return

Figure 48 above summarises the results of these tests. We find that in seven of the last 10 years, taking out the worst CG stocks from the lowest PE basket outperforms against the simple low-PE strategy. (The exceptions were 2000, 2005 and 2008.) Although we do not find any simple relationship between CG and beta, high CG is associated with lower operational risk. If we take a broader notion of risk rather than defining it solely based on the historical correlation of a stock with the market (i.e. its beta), then adding a CG filter to take out poor CG names seems to reduce risk while producing slightly higher returns. This would be a travesty of financial theory. As long as CG is under-utilised for portfolios, this appears an opportunity for investors to exploit which corroborates the finding of our Quant team in the front of this section.

Death of Qarp

Qarp definition

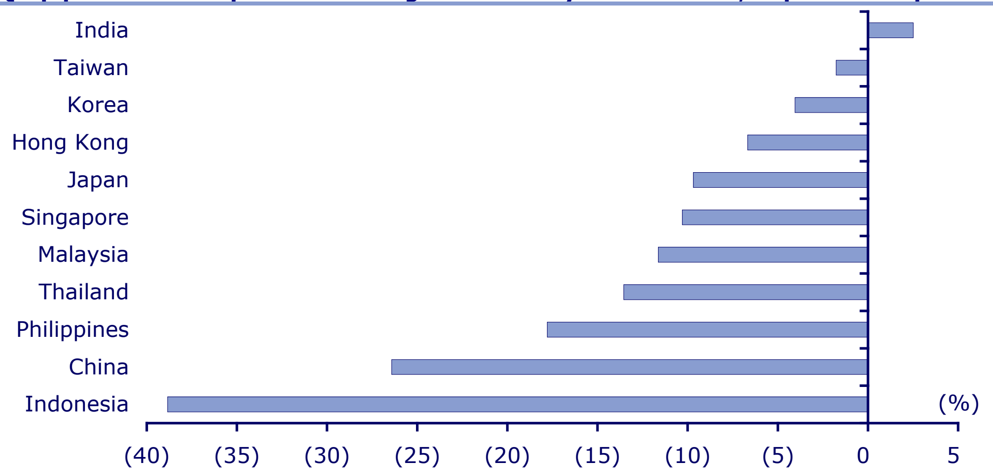
We introduced the concept of Quality at a reasonable price (Qarp) as a stock picking approach in our 2005 regional CG report. These were defined as companies with higher than average CG scores in their respective markets, ROE higher than the cost of equity (COE), with at least 10% upside to theoretical value derived using the Gordon growth model.

Qarp picks underperformed in 10 of the 11 markets while outperforming in India

Underperformance is particularly strong across ASEAN and China

Figure 49

Qarp picks relative performance against country MSCI indices, Sept 07 to Sept 08



Source: CLSA Asia-Pacific Markets

Qarp picks have underperformed across most markets

The initial performance of the Qarp picks from 2005 to 2007 was encouraging. However, those from our 2007 report underperformed significantly against the local MSCI index in 10 of the 11 markets over the following year into 2008, with only slight outperformance in India.

Qarp picks have underperformed in eight of the 11 markets from Sep-07 until Aug-10

These 2007 Qarp stocks if held unchanged through to August 2010 would have underperformed in eight of the eleven markets. While they outperformed in Hong Kong, Taiwan and Singapore by 11-25ppts the Qarp stocks underperformed in the other markets we track by 16-63ppts.

While conceptually the idea of a basket of stocks with high CG, good ROE and attractive PB valuations is an attractive one, our updated findings of the impact of CG on stock performance, particularly with the benefit of the experience of the markets through the global financial crisis, are that the CG screens applied to remove poor CG stocks provides higher returns than using it to select for high CG stocks. We have thus discontinued the Qarp list for this report.

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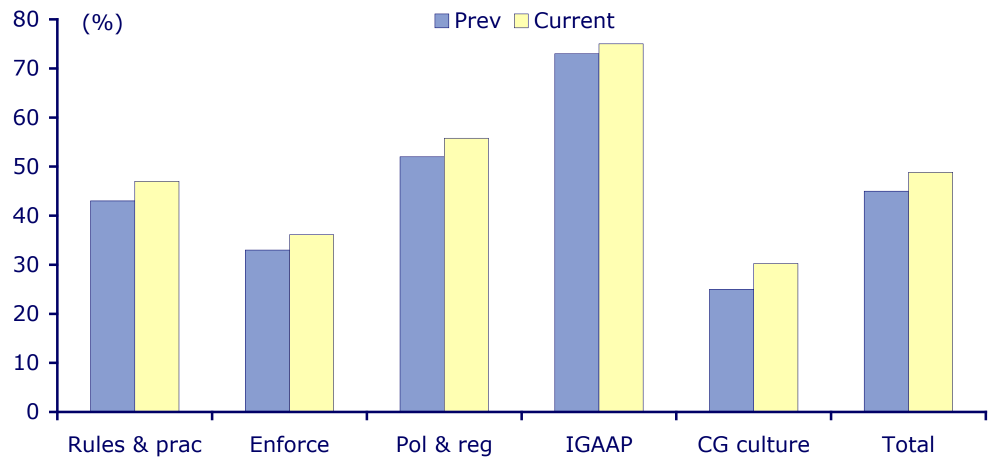
China - Steady improvement

China climbed two notches to equal seventh place with India in *CG Watch 2010*, with its total score rising from 45% in 2007 to 49% this year. Gradual progress can be seen in four of five categories of the survey, with a slightly smaller increase in accounting and auditing. It would seem that regulators and market participants have taken to heart, intentionally or unintentionally, Deng Xiaoping's exhortation to 'cross the river by feeling the stones'.

Modest improvement in scores for each category but weaker on CG culture

Figure 50

China CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Score of 49% is not bad for an emerging market

While China remains in the bottom half of our study this year, and has been there since the beginning of the survey in early 2000s, it would be fair to say that its score of 49% is not bad for an emerging market that hardly knew the phrase "corporate governance" 10 years ago. In contrast, Singapore (67%), Hong Kong (65%) and Japan (57%) should all be doing much better - their capital markets have been developing for much longer and the first two markets at least claim to be following international standards.

China closing in on HK CG score

Thinking radically, if China continues to improve at its current rate of four percentage points every three years, it should equal or even surpass Hong Kong in this survey by 2022! This would be a fitting start to "Shanghai 2020" (the government's ambitious plan to turn the city into an international financial centre around that date). Of course, this scenario assumes China will keep improving steadily and Hong Kong will remain static. Neither scenario seems entirely plausible, since progress in China is unlikely to be linear (nor is it in any country) and Hong Kong will no doubt improve in some areas, although probably not until after the current government (good at slow pedalling on corporate-governance reform) ends its term.

China's score for political & regulatory environment is much higher than the score for CG culture

One area of risk in China lies in the dichotomy between its scores for rules, political and regulatory environment, and IGAAP, and its score for CG culture. In other words, the aspects of the country's corporate-governance regime for which the government is responsible are far more impressive than developments within the market and private sector. While almost all jurisdictions in Asia exhibit a similar state-driven, top-down style of reform, the gap in China is particularly marked. Its score for political and regulatory environment, for example, is 26 percentage points higher than its score for CG culture (only Malaysia has a higher discrepancy).

If China is to create a truly international financial centre in Shanghai, a change of attitude and behaviour among market participants will be needed. Part of the problem, in fact, may be the translation of "corporate governance" into Chinese: the local term *"gongsi zhili"* implies (government) control and regulation of companies, not enlightened self-interest and self-discipline on the part of companies and their stakeholders.

CG rules and practices

Score for rules and practices has moved up 4ppts

Whereas scores for CG rules and practices in several markets have fallen this year (largely because their CG regimes are not keeping pace with international standards), China's score has risen four percentage points to 47%. Improvements have been seen in non-financial reporting standards and practices, but from a low base. Quarterly reporting is more detailed than three years ago. And the regulatory regime for the prompt disclosure of price-sensitive material events and transactions has progressed (as a review of the company announcements section of the Shanghai Stock Exchange website indicates).

CSRC busy promulgating and amending rules

In terms of new regulations, the China Securities Regulatory Commission (CSRC), the national securities regulator, has had a busy few years promulgating and amending rules and decrees on listed companies and market intermediaries. For example:

- Administrative Measures on Sponsorship for Securities Issuance and Listing (August 2008; amended May 2009)
- Amendment in Regulations for Listed Companies' Cash Dividend (October 2008)
- Article 63 of the Administration Measures on Takeover of Listed Companies (May 2006; amended August 2008)
- Administration Measures for Significant Asset Restructuring of Listed Companies (May 2008)

CSRC's rules focused on securities firms and investment managers

While none of these are as grand as the new Securities Law of 2005 (which came into effect in 2006), they are important regulations that should help to improve the securities market over time. It is also worth pointing out that a large part of the CSRC's rule making is focused on securities firms and investment managers, not just listed companies.

The exchanges have been busy too. The Shanghai Stock Exchange, for example, launched a CG assessment system in December 2007, has created new stock indices for corporate governance and corporate social responsibility, and has published advisory papers for companies, including a recent guideline from August 2009 on the election, appointment and conduct of directors of listed companies. The Exchange also revised its listing rules again in September 2008.

China's CG code becoming outdated

But as China's score suggests, areas of weakness remain. Its Code of Corporate Governance for Listed Companies is becoming outdated, having been published in January 2002, and would benefit from a review. The section on shareholder meetings contains many good principles, but lacks details and should be updated (as this is one area where investor expectations and behaviour have changed greatly around the world over the past five years). The section on board rules and procedures does not make explicit that listed companies should plan board meetings at least one year ahead. Many companies in China do not, including leading state enterprises, and this causes considerable difficulty for directors, especially those living outside the mainland (including in Hong Kong).

Deadline for audited results is four months

Other aspects of China's CG regime that are behind international best practice include: the deadline for audited annual results is still four months; securities laws do not provide a credible deterrent against insider trading; the legal system offers limited remedies for investors wanting to resolve disputes and there is no system of precedence in the court system; and pre-emption rights do not exist for shareholders.

Enforcement

China's enforcement score improved slightly

China's score for enforcement has improved slightly, from 33% in 2007 to 36% this year. Enforcement data from the CSRC suggest that the regulator is genuinely working harder to penalise companies and individuals who are breaking the rules, and is hiring new staff to help it do so. The Commission has also been trying to improve the effectiveness of enforcement in recent years by separating the investigation of cases from their review and recently held, in October 2009, the first joint meeting between its Administrative Sanction Committee and the disciplinary committees of the two stock exchanges to improve coordination and communication on enforcement.

Regulator's power of sanction is limited

While the regulator's powers of investigation appear quite robust (and it has regional offices to help carry out this work), its powers of sanction are sometimes limited: many of the penalties it hands down are only administrative in nature (such as orders, bans, warnings, revoking of licences, fines and confiscations). According to a CSRC press release, a massive case of fraudulent accounting and false disclosure in 2009 involving a company called Beiya Industrial resulted only in two executives responsible being banned from the securities market for life. There was no mention of criminal prosecution.

Nor does the regulator refer many cases to the public security bureau for criminal prosecution. From 2008 to March 2009, the Commission handed over only 19 suspected criminal cases to the public security organs. Of these, only eight related to insider trading and two to market manipulation.

A company rejected a vote against a proposal because insufficient reasons were given

As would be expected, "private enforcement" of shareholder rights is relatively limited in China. While some domestic and cross-border institutional investors vote, anecdotal evidence suggests that many do not. And even when institutions try to abstain or vote against resolutions, listed companies have been known to reject these votes out of hand. One ACGA member in 2009 had its votes against a resolution rejected because the board secretary decided it had not given sufficient reasons for voting against!

Political and regulatory environment

Political & regulatory score for China moved higher

Given that much of the credit for China's improved score this year has to go to the government and regulatory agencies, for reasons outlined above, it is not surprising that its score in this category has also improved, from 52% in 2007 to 56% this year.

China's system of CG will not mimic the Western model

There was a time shortly after the start of the global financial crisis when criticism from officials in Beijing regarding Western banking practices suggested the country might turn its back on international norms of corporate governance. Now that the dust has settled somewhat, this no longer seems to be case - although scepticism of foreign advice will no doubt remain, for understandable reasons. What is perhaps more interesting is that despite all the debate in the media about whose system of capitalism is best, the story on the ground is still one of pragmatism. The CSRC and the exchanges are getting on with the job of improving regulation and enforcement, and emphasising efficiency, good management, shareholder protection and corporate profitability

and accountability among listed companies. There is not much evidence that the government is deviating markedly from its previous path. (This does not mean, however, that China intends to create a system of corporate governance that mimics any Western model. Its system will continue to be a hybrid, with strongly entrenched local institutions and practices).

Management of IPO system could improve

Some areas where China's political and regulatory score could improve include: the management of its IPO system, particularly the turning on and off of the new-listings tap (which we believe adds to market volatility); and the translation and dissemination of new regulations and announcements on the websites of the CSRC and the two exchanges. While the websites of all three organisations have become much more useful and well organised in recent years, there remains a large gap in quality between the Chinese and English versions.

Accounting and auditing (IGAAP)

Accounting and auditing score was up slightly

China's score rose slightly in this category from 73% in 2007 to 75% this year. One reason for its relatively high score is the country's policy, since 2007, of following international standards of accounting (IFRS). A second factor is that the CSRC actively reviews the quality of annual reports and provides guidance to listed companies. In 2009, for example, it summarised its reviews of the 2007 and 2008 reports of China's 1,600+ listed firms and found a range of problems, such as the measurement and disclosure of fair-value accounts, the scope of consolidation and the way companies dealt with direct and indirect donations by their controlling shareholders.

The CSRC also has responsibility for supervising the audit of listed-company annual reports. In 2008-09, it enhanced its supervision in this area by carrying out a 'comprehensive supervision and guidance on the accounting firms' practicing activities', ranging from accepting new business to formulating an audit plan, and conducting and completing the audit. The CSRC further said that it encourages its agencies to make their 'listed company supervision records' available to audit firms, so as to improve the quality of audit.

Seeking to grow and make mainland audit firms more competitive

Beijing's longer-term plan is to encourage the growth and competitiveness of mainland audit firms by allowing them to audit the books of PRC companies listed in the Hong Kong stockmarket - a scheme that is facing some resistance in Hong Kong, but is likely to be approved. Li Xiaoxue, Secretary of the Discipline Inspection Committee of the CSRC, told a conference in Zhuhai, Guangdong in December 2009 that the participation of domestic accounting firms in the scheme would be 'boosted steadily and orderly to encourage them to grow better, larger and stronger and march into the international market'.

Meanwhile, the Ministry of Finance (MOF) and the Chinese Institute of Certified Public Accountants (CICPA) also have responsibility for the regulation of the wider audit industry.

CG culture

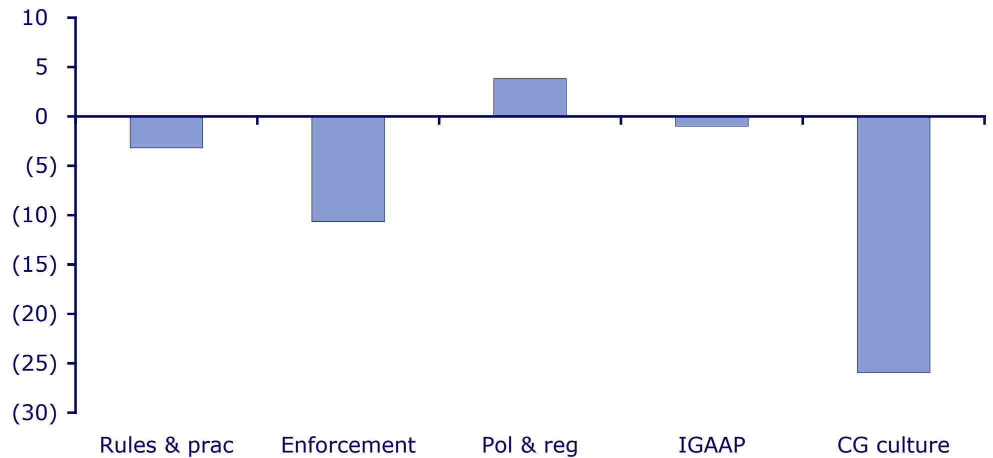
CG culture is where China's score is weakest

Although governance culture is where China's score is weakest, this category did improve from 25% in 2007 to 30% this year. Ironically, one of the reasons was government-inspired - a new regulation on extending the responsibilities of "sponsors" (ie, investment banks) who manage the IPO process for new listing candidates. Sponsors now have obligations to advise companies after their IPOs as well as before (something that their counterparts in other markets have successfully resisted, since it extends their liability for problems in newly listed firms).

Above Asian average for political and regulatory environment but below in other categories, in particular culture

Figure 51

China: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Other reasons for the rise in score include a slightly higher mark for the value that listed companies generally place on corporate governance, and a gradual increase in the willingness of large listed companies to follow the spirit, not merely the letter, of corporate-governance rules. This latter trend is apparent in the more professional way in which some major state-owned enterprises are running their boards of directors. It can also be seen in the disclosure of information that previously was under wraps, such as the members of the board who make up the company's Party committee.

CLSA corporate scores

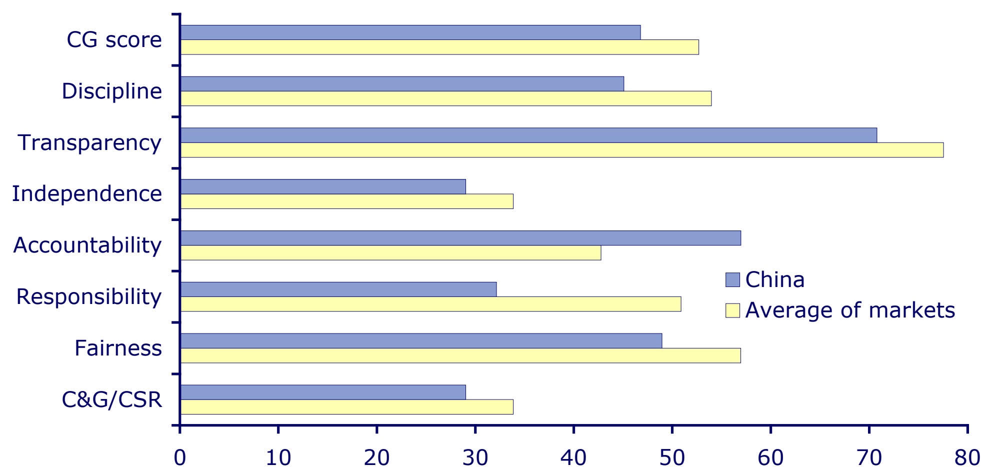
China corporations mostly have lower scores than regional average . . .

China's average corporate score is some 6ppts lower than the regional average. It is weaker in the areas of accountability, discipline and fairness against the regional average, but scores higher than companies in the rest of Asia for accountability (ie, composition of the board).

. . . but they do better on accountability - ie, board composition

Figure 52

China corporate scores against regional average



Source: CLSA Asia-Pacific Markets

Mid-cap Nine Dragons has the highest score in China

ICBC, however, has the highest CG score among the large caps in China

Figure 53 presents the top-scoring companies on CG in China. While banks are generally among the highest, Nine Dragons Paper has the top score and is 5ppts ahead of the others.

Figure 53

China: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
Nine Dragons Paper	2689 HK	China Gas	384 HK
Dongxiang	3818 HK	Dongfang Electric	1072 HK
Anta	2020 HK	Golden Eagle Retail	3308 HK
ICBC	1398 HK	Suntech	STP US
China Resources Enterprises	291 HK	Bank of Communications	3328 HK
Sina	SINA US	Shanghai Electric	2727 HK
Bank of China	3988 HK	Hidili	1393 HK
China Coal	1898 HK	Datang Power International	991 HK
Belle	1880 HK	Yanzhou Coal	1171 HK
China Merchants Bank	3968 HK	Ctrip.com International	CTRP US
Zhaojin Mining	1818 HK	China Resources Gas	1133 HK
China Shenhua Energy	1088 HK	China Life Insurance	2628 HK
Aluminium Corporation of China	2600 HK	CNOOC	883 HK
China Construction Bank	939 HK	Tsingtao Brewery	168 HK
Parkson Retail	3368 HK	New World Dept Store China	825 HK
Li Ning	2331 HK	Jiangxi Copper	358 HK
PCD	331 HK	Huadian Power International	1071 HK
Want Want China	151 HK	China Resources Power	836 HK
Ping An Insurance	2318 HK	PICC Property & Casualty	2328 HK
Sinofert	297 HK	China Cosco	1919 HK

Source: CLSA Asia-Pacific Markets

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Hong Kong - Reform stalls

Hong Kong dropped back to second place in this year's *CG Watch*, after having dethroned Singapore for the first time in 2007. While its total score fell only two percentage points - from 67% to 65% - both the direction of reform in Hong Kong and its final score are of concern. After a good performance in 2008, when a series of positive listing-rule changes were agreed upon, the city suffered something of a regulatory breakdown in early 2009 following an attack by local tycoons on plans to extend the blackout period for director share trading. Since then, little meaningful corporate-governance policy or regulatory reform has taken place.

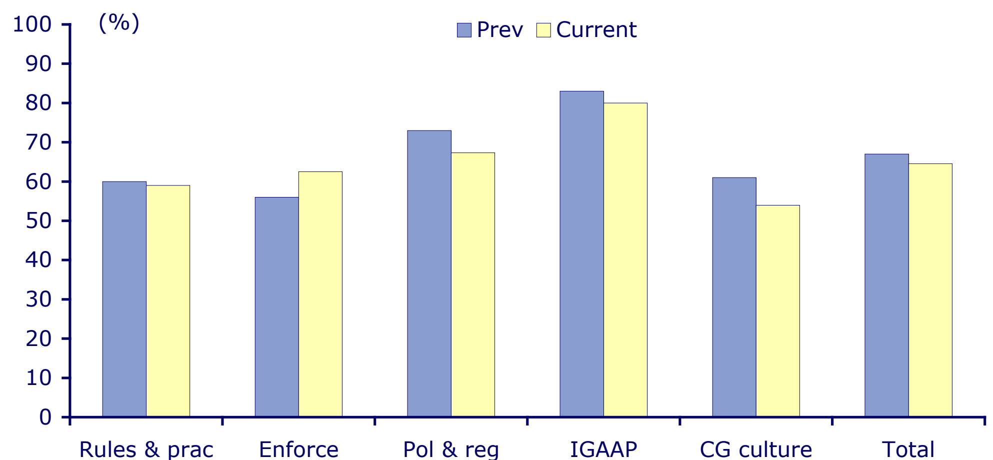
Enforcement by the SFC has improved

The one bright spot in Hong Kong's CG regime over the past 18 months has been regulatory enforcement, where the Securities and Futures Commission (SFC), the main regulator of the securities markets, has taken a tougher and more effective line against insider trading, market manipulation and other misconduct. This enthusiasm is not shared, however, by the Hong Kong government, which displays an ambivalent attitude towards corporate governance and is more concerned about short-term expansion of the stockmarket (in which it is a substantial shareholder). Much of the drive to boost listings is a reaction to competitive (or perceived) pressures from Shanghai.

HK's CG culture and political/regulatory environment scores dragged its overall score lower

Figure 54

Hong Kong CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

CG rules and practices

Minor decline in score for rules and practices

Hong Kong's score dropped slightly in this category from 60% in 2007 to 59% this year - a case of the positives being cancelled out by the negatives.

Shortening of period to report results

During 2008, Hong Kong Exchanges and Clearing (HKEx), the parent company for the stock and futures exchanges, announced a number of improvements to the listing rules. These included shortening reporting deadlines for audited annual results (from four to three months) and for interim results (from three to two months). Although a step forward, it should be noted that both rules fall short of regional best practice in Asia of two months for audited annuals and 45 days for interims. And the amendments for interim results only became effective on 30 June 2010 and those for annual results will not take effect until 31 December 2010.

But reporting deadlines are longer than regional best practice and quarterly reporting not mandatory

Despite these changes, we rated financial-reporting standards and practices in Hong Kong lower than in 2007, mostly because the city has fallen further behind regional and international standards. Not only are its reporting deadlines longer than even regional best practices, but it still lacks any form of mandatory quarterly reporting (not even the rather general "interim management statements" now required in the UK) and the quality of continuous disclosure of material events has been found wanting (partly thanks to the global financial crisis, which exposed poor disclosure practices among many listed companies).

Weak continuous disclosure for various companies

The problem of weak continuous disclosure is not confined to one size or type of company, as the following examples illustrate:

Citic Pacific, an established "red chip" (Chinese companies incorporated and listed in Hong Kong), waited weeks in the latter part of 2008 before informing the market that it had discovered it had leveraged foreign-exchange contracts that could result in losses of up to HK$15.5bn (US$2bn). According to the listing rules in Hong Kong, the firm should have disclosed such price-sensitive information as soon as practicable (which means within days not weeks).

Fu Ji Food and Catering, a private mainland company based in Shanghai, suddenly announced a voluntary winding-up of its operations in mid-2009, claiming that its independent financial adviser had uncovered 'significant financial challenges' for the company, and that its financial position and outlook 'had been deteriorating quite rapidly'. Yet in the months prior to this announcement, Fu Ji experienced a number of material events that were each price-sensitive and should have been disclosed.

HK is first market in Asia to mandate voting by poll

The year 2008 also brought a significant consultation exercise carried out by HKEx on a series of amendments to the listing rules, covering issues such as disclosure of changes in issued share capital, voting at general meetings, disclosure of information about and by directors, and disclosure of information in takeovers. Many of the final rule changes, which were announced in November 2008, were positive from the corporate-governance perspective. For example, Hong Kong became the first and only market in Asia to mandate voting by poll for all resolutions at all shareholder meetings.

Rule on blackout period backfired due to the long deadline to report results

Unfortunately, one of the new rules - on the blackout period - backfired. This proposal would have extended the close period when directors were not allowed to trade securities from 30 days before the announcement of a company's annual and interim results (ie, two months in total) to the entire period between the end of each listed firm's financial year (and half-year) and the date on which it published its results. With Hong Kong's long reporting deadlines, this would have meant a blackout of seven months for companies that used all the allotted time (although faster reporters would have had shorter blackouts). Moreover, with reporting deadlines being cut, the maximum blackout would have fallen to six months in 2010 and five months in 2011.

HKEx's Listing Committee had to back down against pressure from tycoons

The extension was designed to limit the ability of company insiders to trade on information that had not been made public between their financial period ends and the start of their respective close periods. When Hong Kong's local tycoons appreciated the full impact of the proposed rule change, many of them launched a vociferous media campaign attacking the Exchange and its Listing Committee (which decides on rule changes). They also privately

lobbied the government, regulators and members of the Listing Committee. With no support from government, or indeed the SFC, the Exchange and its Listing Committee were eventually forced to back down and agree on a watered-down version of the rule in February 2009.

Regulators shied away from any bold reform in 2009

One consequence of the blackout fight has been that regulators have shied away from bold reforms since early 2009. In the latter part of that year the Exchange produced its decision on the final item in the 2008 consultation paper - whether to introduce new rules limiting the general mandate governing private placements. Many institutional investors and governance advocates have long argued that Hong Kong's permitted limit for private placements of 20% of issued share capital per year and up to a 20% discount is too potentially dilutive. Investors have been voting against these mandates, which come up at AGMs, in large numbers since at least 2003-04. Yet the Exchange decided to do nothing, saying there were 'no compelling grounds for deviation from the status quo' and rather predictably blamed a (predictable) lack of consensus among market stakeholders and the global financial crisis for its decision.

Enforcement

Higher score for enforcement

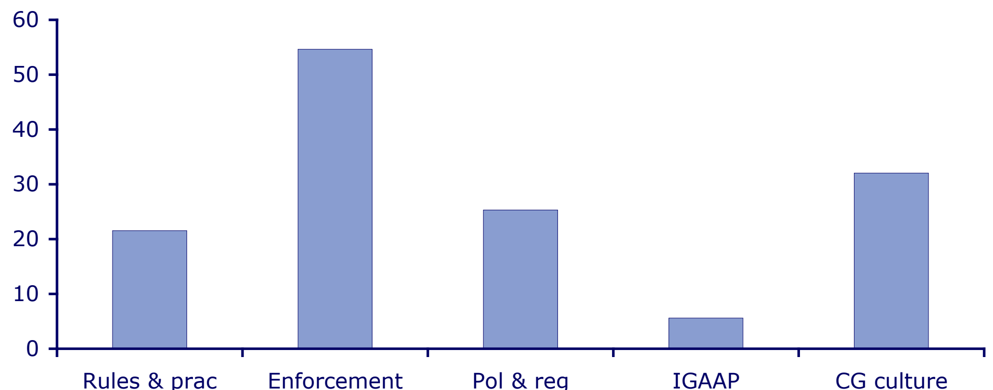
Enforcement is where Hong Kong has seen genuine progress in the past three years and its score reflects this - rising from 56% in 2007 to 63% this year. The SFC has upped the ante against insider trading and successfully prosecuted several cases through the courts. It has also won some other firsts:

- In March 2010, the High Court upheld a petition by the securities regulator directing Rontex International, a company involved in garments and premium products trading, to bring legal proceedings against three former executive directors for compensation. It was the first time that the Commission had obtained an order in the High Court 'directing a listed company to commence civil proceedings to seek recovery of compensation for the loss and damage suffered by the company as a result of directors' misconduct'.
- In the same month, the securities regulator obtained orders from the High Court to disqualify two former executive directors of Warderly International for failing to ensure timely disclosure of material information to the company's shareholders. It was the first time that directors had been disqualified on this charge in Hong Kong.

Above regional average for most categories, in particular on enforcement

Figure 55

Hong Kong: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Other limbs of enforcement have not seen similar progress

Two other limbs of enforcement in Hong Kong, namely enforcement of the listing rules by the Exchange and "private enforcement" by minority shareholders of their rights, have not witnessed similar progress. While it would be fair to say that the Exchange has become more focused in its enforcement efforts, its limited powers and cumbersome processes ensure that breaches of the listing rules still take a long time to resolve (often two to three years). Meanwhile, retail shareholders tend to defend themselves on a case-by-case basis, while the participation of institutional investors is largely limited to voting in AGMs.

Political and regulatory environment

Competitive pressure from China is affecting standards for the market

We dropped Hong Kong's score in this category from 73% in 2007 to 67% this year for a number of reasons. First, we believe the government has an even less clear, consistent and credible policy in support of corporate-governance reform than previously. While paying lip service to the need to maintain international standards of corporate governance, it is far more interested in Hong Kong winning new listings from around the world (some from jurisdictions with much weaker investor protections than Hong Kong) than it is in maintaining regulatory quality. This is in large part a response to the fear of losing listings from China and the competitive threat posed by Shanghai. Yet new listings from the mainland continue to come (when regulators there have not artificially turned off the tap). And surely a better response to Shanghai would be to move up, not down, the market quality curve and continue to give investors strong reasons for investing in the Hong Kong stockmarket.

Split in chairman role at the SFC seems to have affected its independence

Another factor for marking Hong Kong down concerns the independence of the statutory regulator, the SFC. While the Commission has a certain degree of independence from government, bolstered by its funding through a levy on the stockmarket rather than an annual budgetary allocation (as some other commissions suffer), the move a few years ago to split the role of chairman and CEO, and make the chairmanship a non-executive position, has affected its ability to act and think independently, in our view. This is reflected in the lack of progress on quarterly reporting, for example, and the blackout period episode (when the SFC showed little support for the Exchange).

A third reason for the lower score is that we took a harder view on whether the legal system in Hong Kong allowed minority shareholders effective access to courts to settle disputes? We believe the answer is a firm 'No'.

Accounting and auditing (IGAAP)

HK not able to join IFIAR

Hong Kong's score deteriorated slightly here, falling from 83% to 80%. The main reason is that we put more emphasis in this survey on the independence and effectiveness of the audit regulator (ie, regulator of CPA firms). In contrast to many developed markets, both in Asia and around the world, Hong Kong has not established an audit regulator that is genuinely independent of the audit industry. The new Financial Reporting Council has a limited investigatory role, while disciplinary and sanctioning powers remain with the Hong Kong Institute of Certified Public Accountants, a self-regulatory body. For this reason, Hong Kong is not able to join the International Forum of Independent Audit Regulators (IFIAR), a network of audit regulators from around the world. Other markets in Asia are already members of IFIAR, including Japan, Korea and Singapore, while Malaysia is likely to join having recently established an Audit Oversight Board under its Securities Commission earlier this year.

HK's score for CG culture has declined

CG culture

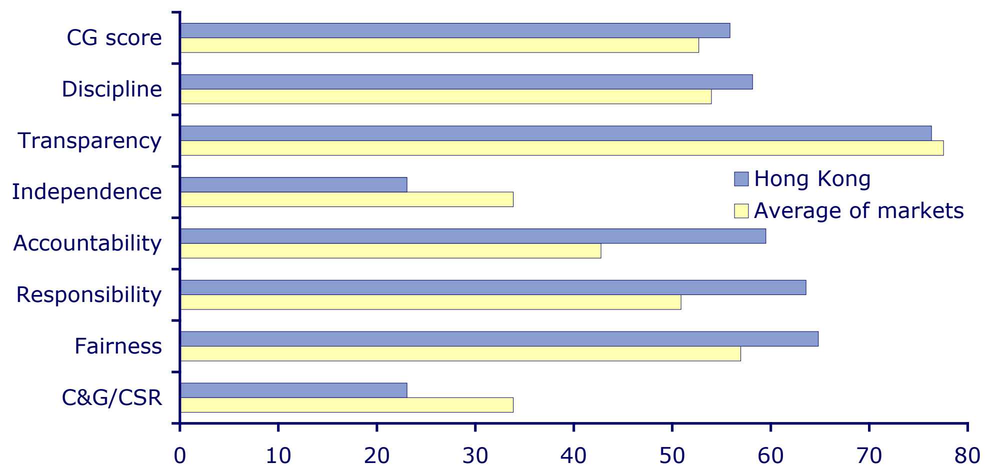
This category witnessed a sharp decrease in score, from 61% in 2007 to 54% this year. The reasons ranged from the behaviour of tycoons in the blackout fight to scepticism as to whether most listed companies are genuinely interested in engaging in a dialogue with their shareholders. The score also fell because the city fared poorly on two new questions relating to disclosure of executive and employee remuneration policies, and whether an open electronic voting platform (straight-through from investor to company) had been developed for shareholder meetings.

Slightly higher than regional average for most categories except C&G/CSR and independence

CLSA corporate scores

Figure 56

Hong Kong corporate scores against regional average



Source: CLSA Asia-Pacific Markets

The scores for Hong Kong corporations are generally higher than the regional average but notably on our C&G/CSR score, they scored on average 10 points lower than the Asian average. They also score 10 points lower for independence, ie, whether the companies have an independent chairman, board committees, etc.

The top-ranking companies in Hong Kong are also among those with the highest CG scores regionally, including HKEx, Li & Fung and HSBC. Swire, CLP and Lee & Man Paper also score well.

HKEx, Li & Fung, HSBC are among top scorers regionally, also high CG scores for Swire and CLP

Figure 57

Hong Kong: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
HK Exchanges & Clearing	388 HK	Wharf	4 HK
Li & Fung	494 HK	Cheung Kong	1 HK
HSBC	5 HK	Cathay Pacific	293 HK
Swire Pacific	19 HK	Hang Seng Bank	11 HK
CLP	2 HK	MTRC	66 HK
Lee & Man Paper	2314 HK	Wing Hang Bank	302 HK
OOIL	316 HK	Ports Design	589 HK
Sun Hung Kai Properties	16 HK	Kerry Properties	683 HK
Esprit	330 HK	Hopewell Highway	737 HK
Bank of East Asia	23 HK	BOC Hong Kong	2388 HK
SouthGobi Energy Resources	1878 HK	Wynn Macau	1128 HK
Standard Chartered	2888 HK		

Source: CLSA Asia-Pacific Markets

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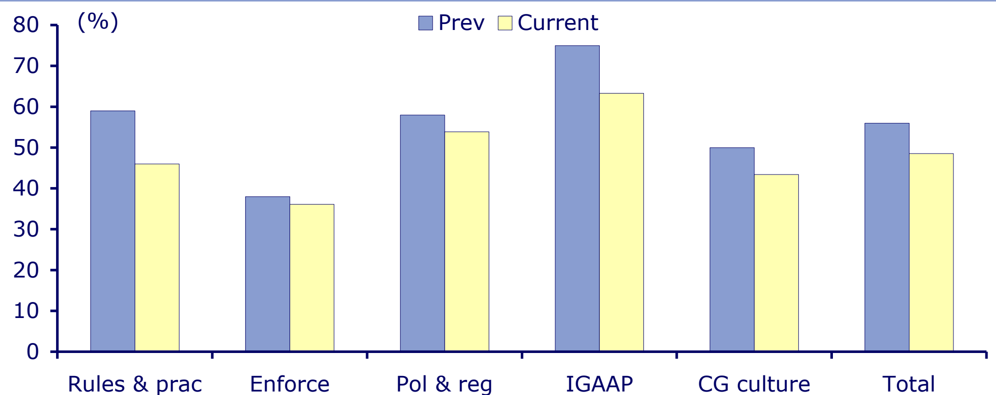
India - Market downgrade

India's total score and ranking in *CG Watch 2010* fell significantly, from 56% in our 2007 survey to 49% this year and from third to equal seventh place with China. This was not purely, or even largely, because of the Satyam scandal in 2008-09, although that crisis did throw light on serious problems in some auditing practices in India and, less surprisingly, on the ineffectiveness of many boards. The more stringent assessment this time is due more to entrenched problems in the country's wider corporate-governance regime, which is reflected in scores falling in all five categories in this year's survey.

Scores for most CG categories lower for India compared to our previous scoring

Figure 58

India CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Reform fatigue set in

Turn the clock back to 1998, when the Confederation of Indian Industry (CII) published its landmark corporate-governance code, and the country was a regional leader in this field in Asia. In the early to mid-2000s, it built a reputation for corporate-governance leadership on the back of its IT industry, some financial companies and a group of enlightened business leaders, and proceeded to recommend best practices on numerous issues such as board independence, board committees, corporate disclosure, risk management and auditing. Then, sometime in the latter half of the decade, reform fatigue set in. Industry argued that more new rules were not necessary, as India had plenty already, while a booming economy and stockmarket distracted attention from new challenges.

Has not addressed local governance challenges

Sadly, India is no longer seen as a corporate-governance leader in the region. As we argued in ACGA's *White Paper on Corporate Governance in India*, published in January 2010, while the country has imported numerous global standards of corporate governance over the past decade, it has failed to adequately address key local governance challenges such as the accountability of promoters (controlling shareholders), the regulation of related-party transactions and the governance of the audit profession.

Our rerating of India downwards this year does not imply the country's corporate-governance regime has regressed. In fact, we think it is slowly improving. However, following further research in the past three years, we have concluded that India's corporate-governance regime is not as robust as previously thought.

CG rules and practices

Various factors dragged down score for rules and practices

India's score in this category dropped from 59% in 2007 to 46% this year. The reasons were many and varied, including lower scores for the quality and speed of periodic financial reporting, the disclosure of related-party transactions, whether securities laws provided an adequate deterrent to

insider trading, whether the country's best practice Code on Corporate Governance was keeping pace with international standards, the extent of disclosure on executive remuneration, the quality and independence of audit committees and whether minority shareholders could easily nominate independent directors. (Note: Our scores for many of the same questions in other markets fell as well, partly because standards and expectations have moved on and what looked good three years ago no longer shines as brightly; and because we are taking a tougher view on some issues.)

Elaborating on one of the items listed above - the quality and speed of financial reporting - some of the problems in India are as follows:

Flexibility in publishing audited final results

- Companies are potentially allowed generous deadlines for the publication of audited annual results. Whereas best practice in Asia is 60 days from a company's financial year-end, the Companies Act allows six months. The listing rules also govern periodic reports, but are rather confusingly constructed. A company that publishes an unaudited fourth-quarter report does not need to publish its audited full-year results until 'they are approved by the board' (no time is specified). Otherwise, it must publish its audited full-year results in 60 days (until recently the rule was 90 days).
- Companies are not required to issue balance sheets and cashflow statements with their quarterly reports.

Companies are not consistent in timing of results announcement

- Many Indian blue chips do publish audited annual results within 60 days and those listed abroad often provide more than just a P&L statement in their quarterly reports. However, some companies have been known to change their accounting and/or reporting practices from year to year. Reliance Industries, for example, has been inconsistent in the timing of publication of its full-year results. In 2007 and 2008, it released its audited annual financial statement within 30 days of its year-end (31 March), whereas in 2006 and 2009 it took five months or more. Meanwhile, reporting practices among small and medium enterprises (SMEs) are typically of lower quality than large caps.

To partially rectify the disclosure problems highlighted above, the Securities Exchange Board of India (SEBI) issued a circular in April 2010 requiring companies to disclose balance sheets as well as P&L statements on an interim basis (ie, half-yearly). It also stated that the timeline to submit audited annual results would be reduced from 90 days to 60 days for companies that do not publish unaudited fourth-quarter reports. But this rule failed to address the issue of when a company should publish its audited annual results if it chose to publish an unaudited fourth-quarter report.

Weak with regard to related-party transactions

We also marked India down for its weak regime governing related-party transactions. As the Satyam scandal highlighted, Indian companies need only obtain board approval for related-party transactions, even large ones, not broader shareholder approval (as in Hong Kong and Singapore). Stock-exchange listing rules merely mandate audit committees to review related-party transactions and disclose them in the quarterly compliance reports and corporate-governance sections of annual reports of listed companies. Accounting Standard 18 also governs disclosure of such transactions - but not related transactions between state enterprises.

Listing rules are the preferred way to check on related-party deals

A logical place to incorporate stronger checks on related transactions would be in the listing rules or SEBI regulations. However, such an outcome is unlikely, since the regulator appears to believe that this area is the purview of the Ministry of Corporate Affairs (MCA), which oversees the Companies Act. Yet, as we argued in

ACGA's White Paper, regulating the related transactions of listed companies through a general company-law amendment is an inefficient way to address the problem, since company law covers all types of incorporated firms (listed and unlisted) and passing amendments to legislation is usually much slower than changing listing rules or securities regulations. Most other markets in Asia, if they have rules on related transactions, choose this latter route.

Companies now need to provide details of shares pledged by promoters

Has other progress been made in the past three years? Yes, but it has been piecemeal. In November 2008, SEBI tightened rules on the disclosure of share transactions by directors and controlling shareholders (from four to two working days). Then in 2009, the securities regulator issued a new rule directing companies to provide details of any shares pledged by promoters and a quarterly statement of the share-ownership patterns of promoter groups (previously this was only required once a year).

Free-float requirement increased but state-owned entities exempted

More recently, the Takeover Regulation Advisory Committee of SEBI reviewed the Takeover Code and issued new draft regulations in July 2010 aimed at simplifying India's complex takeover rules. The consultation period for these regulations ends in August, after which they will go before SEBI for approval. And in June 2010, the Ministry of Finance controversially announced that listed companies must have at least a 25% public float, up from 10%, and gave companies three years to comply (through an annual addition of at least 5%). State-owned enterprises, however, are exempt.

Companies Bill 2009 is winding its way through Parliament

Meanwhile, in August 2009, MCA reintroduced the Companies Bill into Parliament after the re-election of the government. The Bill, which was first introduced into Parliament in 2008 and seeks a comprehensive revision of the Companies Act 1956, was under examination by the Parliamentary Standing Committee on Finance in the early part of 2010, after which it was to have submitted its draft report to MCA and the Cabinet in July 2010. However, the Standing Committee only met on 20 August 2010 for the 'consideration and adoption of draft report on the Companies Bill, 2009' after which MCA was given a few hours to look over the report before it was submitted to Parliament. It is hoped that a new Act will be enacted by year-end.

Enforcement

Enforcement is a challenge in India

Enforcement of regulations has long been acknowledged as challenging in India, which is why it scored only 38% in 2007. This year it slipped to 36%.

One area of concern is the public-sector bureaucracy, parts of which are still afflicted by corruption. There is also a lack of coordination and cooperation between different levels of government. In January 2009, SEBI and the Serious Fraud Investigation Office were hamstrung when trying to interview the chairman of Satyam, Ramalinga Raju, after he had surrendered to the Andhra Pradesh (AP) police. The police and the state government, who were loyal to Raju, denied SEBI and the Serious Fraud Investigation Office access and said they needed to get permission from the courts. SEBI applied to the AP lower court, but was denied. It next approached the High Court, but the latter continually postponed the hearing. Finally, SEBI was forced to go to the Supreme Court, which eventually approved its application to question Raju.

Companies can issue preferential warrants to promoters

The other main area of concern is private enforcement or, more specifically, the limited rights that shareholders enjoy in India to protect their interests. The India White Paper, for example, highlighted a unique rule that allows companies to issue preferential warrants to their promoters (controlling shareholders), a type of transaction that looks suspiciously like insider trading. Yet the only check and balance on such issuance is shareholder

SEBI not acting on this issue

Lack of coordination and cooperation between different parts of government

Accounting score saw biggest decline for India

Above regional average for CG culture but below on accounting standards, enforcement as well as rules and practices

approval at a general meeting. Although a 75% vote in favour is required, since all shareholders can vote, and since promoters typically own large or majority stakes, approval is a foregone conclusion in most cases.

Regulators have been made aware of the issue, and how it damages both minority shareholder interests and the reputation of India's capital markets, but they have failed to act. In 2009, a Mumbai-based shareholder association, Rajkot Saher Jilla Grahak Suraksha Mandal, brought a case against the government, stating in its petition that it was trying to 'expose a massive and orchestrated scam by the promoters and people enjoying controlling interest in a large number of companies' who used SEBI's rules to profit themselves 'at the cost of the company and its investors'. The Bombay High Court referred the case back to SEBI. The petition cited a number of companies that had cancelled the promoters' warrants, forfeiting the upfront money paid by the promoters, and reissuing the warrants again to the same promoters at a lower price. The association wanted SEBI to alter its rules to protect the interest of all investors. SEBI, however, concluded that current regulations provided sufficient safeguards.

Political and regulatory environment

India's score in this category also slid - from 58% in 2007 to 54% this year - mostly for reasons already given: a lack of coordination and cooperation between different parts of government on policy and enforcement; the absence of a coherent and credible long-term strategy on corporate governance; a piecemeal approach to reform; and regulators who are subject to lobbying from vested business interests (for example, the gradualist nature of the Corporate Governance Voluntary Guidelines 2009). To be fair, India's difficulties in this area are no different from most other countries in Asia and its score is similar to more highly ranked markets.

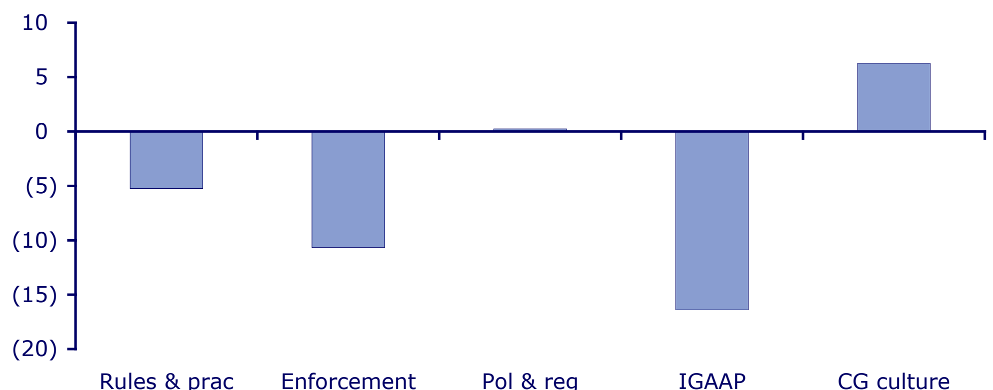
A few years ago, the picture looked quite different - regulators in India did seem to have a vision and strategy in place. When we researched *CG Watch 2007*, MCA had recently enacted MCA-21, an e-filing programme to streamline corporate filings and deter corrupt practices by its officers. MCA was also in the middle of a major review of the Companies Act 1956. Since then, the progress of reform has slowed and the Ministry has had difficulty pushing the new Companies Bill through Parliament.

Accounting and auditing (IGAAP)

Alongside CG rules and practices, this was the category where India's score suffered the biggest fall, from 75% in 2007 to 63% this year.

Figure 59

India: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

We marked India down on accounting and auditing standards and practices, in part because despite a policy to adopt IFRS fully by 2011, market participants believe it will be a daunting task: laws will have to be amended for full convergence to take place and auditors will have to be trained in IFRS. Many practitioners say that the small CPA firms, which account for more than 90% of audit firms in India, have not received adequate training in IFRS and it is already the second half of 2010.

Small firms are auditing large companies, which raises issues

What is also apparent is that a number of small firms audit some of the large companies, including state enterprises - a number of which are listed on exchanges outside India and are Fortune 500 companies. It is doubtful that smaller firms have the geographical reach and depth of knowledge to handle the accounts of companies that are becoming increasingly global. It is also unlikely that they would be able to scrutinise the internal controls and risk-management processes of their clients as thoroughly as they should.

Lack of results from QRB

However, it is in the area of audit regulation that India's score has suffered the most: we believe the government has failed to strengthen this to any significant degree. One action by the government in 2007 - to set up an independent body, the ICAI Quality Review Board (QRB) - largely failed. The QRB was designed to set standards for services provided by the member firms of the Institute of Chartered Accountants of India (ICAI), review the quality of services provided by them and ensure they adhere to various statutory and other regulatory requirements. But few results were achieved and the QRB claimed that the Institute failed to provide any support to it.

ICAI not seen as an effective regulator

Meanwhile, ICAI, as a self-regulatory body, has a reputation for being a weak regulator for two primary reasons. First, it has a plethora of committees that oversee disciplinary actions, but evidence suggests that they are not adequately coordinated. Second, it fears litigation from audit firms. Since any penalty levied by ICAI can be challenged in court, the Institute can and does take a long time to decide on penalties. It does not want to face lengthy court cases and pay exorbitant legal fees.

CG culture

Few listed firms are willing to engage in dialogue on governance with shareholders

We downgraded our score here from 50% in 2007 to 43% this year. Basic issues that have become increasingly important to cross-border investors, such as the transparency of shareholder meetings and voting by poll, are either not well understood in India or are still treated with a degree of scorn by companies. And few listed firms, except leading blue chips and some state enterprises, seem willing to engage in a dialogue with their shareholders on governance issues (although they may have sophisticated investor relations teams that efficiently convey financial data).

To a certain extent, companies cannot be blamed. They feel little pressure from the market, because few fund managers are willing to speak publicly about corporate governance (or vote their shares and attend meetings), and retail shareholder associations are a weak force. On the other hand, fund managers clearly fear angering powerful companies and the commercial consequences of taking a public stand. Given that India is a democracy with a relatively free media and a vibrant culture of discussion and debate, one would hope that there is more scope for institutional investors and financial intermediaries to raise concerns about corporate governance.

Indian corporate scores are in line with average generally and higher on accountability

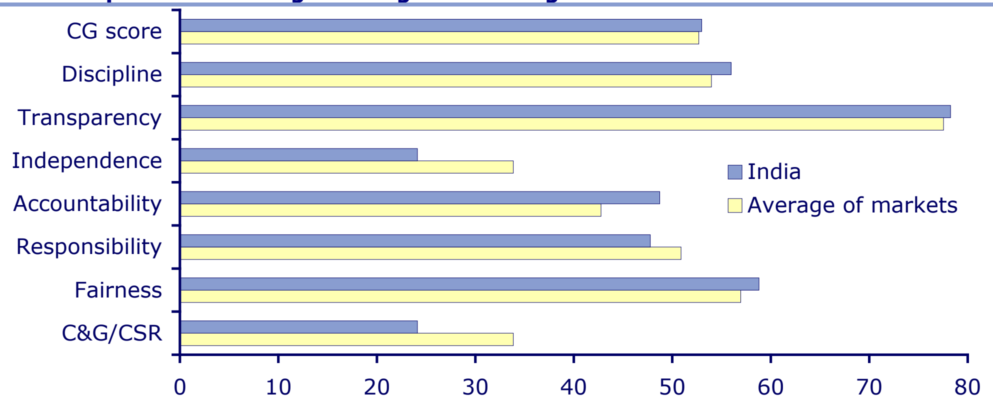
Infosys has one of highest scores regionally; good scores also for Wipro, Yes Bank, Bharti

While many in the investment community and corporate sector seem to have taken a backseat these past three years, business organisations such as the Federation of Indian Chambers of Commerce & Industry (FICCI), professional organisations like the Institute of Company Secretaries of India (ICSI) and some shareholder organisations continue to promote and raise awareness of corporate governance practices. In 2009, FICCI and Grant Thornton published the inaugural FICCI Grant Thornton Corporate Governance Review 2009, while ICSI updated its Corporate Governance – Modules of Best Practice. ICSI also initiated a secretarial audit programme that has been voluntarily taken up by some companies and which it hopes will be mandated in the new Companies Act.

CLSA corporate scores

Figure 60

India corporate scores against regional average



Source: CLSA Asia-Pacific Markets

India's average CG score for its companies is in line with the region. It scores higher than average for accountability in the corporate scores but lower than the average on our C&G/CSR scoring as well as on independence (having an independent chairman, composition of board committees, etc.)

Infosys of India has one of the highest scores in our ranking regionally. Other companies with good CG scores in India are Wipro, Yes Bank and Bharti Airtel.

Figure 61

India: Companies in top two CG quartiles

Top quartile	Code	Second quartile	Code
Infosys	INFO IB	ICICI Bank	ICICIBC IB
Wipro	WPRO IB	Grasim	GRASIM IB
Yes Bank	YES IB	Colgate-Palmolive India	CLGT IB
Bharti Airtel	BHARTI IS	NTPC	NATP IS
Axis Bank	AXSB IB	Suzlon Energy	SUEL IB
Glaxosmithkline	GLXO IB	Crompton Greaves	CRG IB
Housing Development Finance	HDFC IB	Hexaware Technologies	HEXW IS
HDFC Bank	HDFCB IB	Ultratech	UTCEM IB
BHEL	BHEL IB	Patni Computer Systems	PATNI IS
Tata Consultancy Services	TCS IB	Nestle India	NEST IB
Mindtree	MTCL IB	Godrej Consumer	GCPL IB
Hindustan Unilever	HUVR IB	Cadila	CDH IB
L&T	LT IB	Ambuja Cements	ACEM IB
ITC	ITC IB	Zee Telefilms	Z IB
Dr Reddy	DRRD IB	Tata Motors	TTMT IB
HCL Technologies	HCLT IB	CESC	CESC IB
Shree Cement	SRCM IB	Sun Pharmaceuticals	SUNP IB
ABB	ABB IB		

Source: CLSA Asia-Pacific Markets

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Indonesia - Off the bottom

Indonesia finally moved up a notch from its consistent last-place finish in *CG Watch*, with a score of 40% and a modest three-percentage-point increase over its final tally in 2007. While coming second last may be nothing to rejoice about, it represents a definite improvement on the Indonesia of yesterday.

Many of the country's key issues remain unchanged: endemic corruption and limited political will to tackle the problem. The battle royal between its anti-corruption commission, Komisi Pemberantasan Korupsi (KPK), on the one hand and the Attorney General's Office and police on the other is an indication of just how serious Indonesia's corruption issues are. Meanwhile, the vacillation of President Susilo Bambang Yudhoyono over his support for the KPK illustrates how politicised any meaningful attempt to tackle these issues will inevitably become.

The two categories in which Indonesia showed most progress in this survey were enforcement and CG culture, which increased by six and seven percentage points. IGAAP recorded a modest two-percentage-point increase, while political and regulatory environment actually suffered a two-percentage-point decline.

CG rules and practices

Score for rules and practices unchanged

This is the only category score from 2007 that has remained unchanged, at 39%. There have been some improvements in rules and practices in Indonesia over the past three years, including:

- Strengthened disclosure of related-party and conflicted transactions;
- Improved non-financial reporting standards, with an emphasis on corporate social responsibility (CSR) reporting;
- More active audit committees.

Lack of will to tackle certain issues

These have, however, been offset by a lack of political and regulatory will to tackle certain issues, including:

- Securities laws that fail to require disclosure of share transactions within three working days;
- Securities laws that fail to prevent insider trading and market manipulation; and
- A judiciary that fails to convict people when they are brought to trial.

Code for CG is neither mandatory nor "comply or explain"

While Indonesia has a national Code of Corporate Governance, it is neither mandatory nor following the principle of "comply or explain". It is merely a set of principles and general guidelines for a wide range of companies, including unlisted ones. The country has also developed a plethora of codes of best practice for different sectors, companies and professions, including public governance (ie, government), banks, state-owned enterprises and actuaries. More codes are on the way for Aceh, oil and gas, local government and political party governance, among others. Although the relevant authorities talk about how actively they "socialise" these codes (ie, inculcate them in the general public and target audience through training and seminars), one cannot help feeling that the net is being cast too wide and the authorities are trying to do too much. Given Indonesia's limited resources, surely it would be better to focus on getting listed-company governance right and expanding to perhaps a couple of additional areas.

Greater seriousness on enforcement but a lot of ground to make up

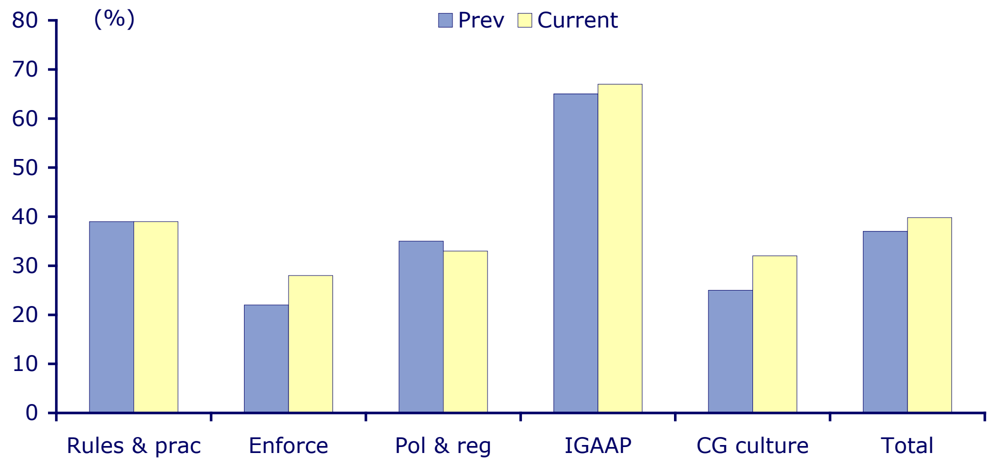
Enforcement

Indonesia's score in this category improved from 22% in 2007 to 28% this year, no small feat for a country that ranked 111 out of 180 countries in the 2009 Corruption Perceptions Index by Transparency International. Our sense is that market participants and regulators are genuinely becoming more serious about enforcement, although they clearly have a lot of ground to make up.

Score improved more for enforcement and CG culture

Figure 62

Indonesia CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Much of the credit goes to the anti-corruption agency, KPK, which has scored some notable successes against vested business and political interests. It has, however, been much quieter during the second term of President Yudhoyono, who was re-elected in 2009. The role of the KPK came under threat after two of its deputies were suspended (since reinstated) during a fight with the Attorney General's Office and the police; and Antasari Azhar, the head of the KPK at the time, was convicted of organising the murder of a rival.

Enforcement statistics indicate greater activity at Bapepam

The securities regulator, Bapepam, also appears to be better organised and supported than the last time we ran this survey, as reflected in more impressive enforcement statistics. While Bapepam admitted that its powers of sanction were limited, with most of its penalties being administrative in nature (such as fines, freezing of accounts and ordering companies to take certain actions), it has become more active. In 2008 it undertook 76 administrative investigations, rising to 133 in 2009 and 119 in the first four months of 2010.

Bapepam has to go through AG chambers for prosecution

If Bapepam wants to pursue criminal charges against market miscreants, however, it must refer cases to the Attorney General. Not surprisingly, according to one official, these are 'very difficult to prove', a euphemism for dealing with one of the country's most intractable and compromised institutions. In fact, only 11 criminal cases were on the books as of May 2010. It should be noted that if and when the single financial regulator, Otoritas Jasa Keuangan (OJK), is created later this year, Bapepam's powers will increase. It will also become the single, independent regulator for certified public accountant (CPA) firms.

Voting not taken seriously

Another area of marginal activity is shareholder activism. A few global institutional investors vote their holdings, as do some of the larger domestic pension funds, such as Jamsostek. But there is very limited engagement, if any, with listed firms. Some ACGA members vote against resolutions they do not like or where insufficient information is available. But it appears that most companies do not yet take voting seriously.

Well regarded banking regulator

Political and regulatory environment

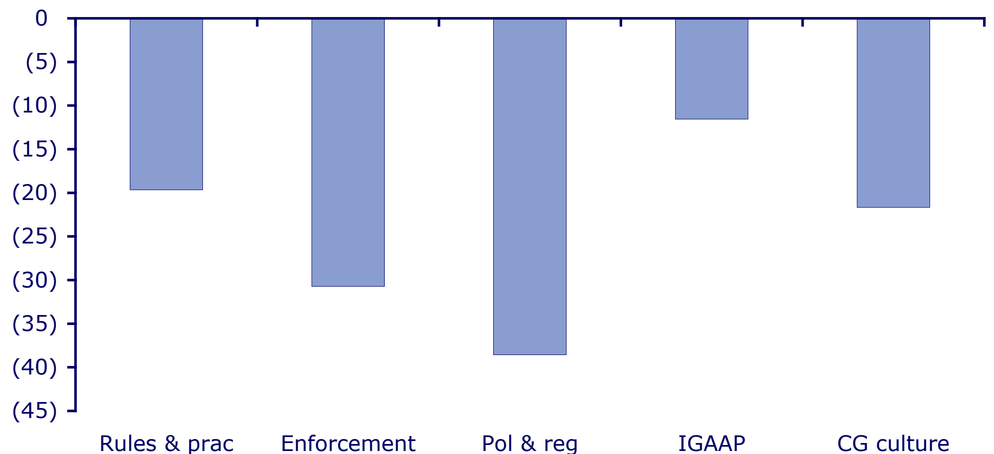
The overall score for this category fell slightly from 35% in 2007 to 33% this year. As in CG rules and practices, there are positive features, including:

- A well regarded banking regulator in Bank Indonesia and a banking system that is generally viewed as open and reasonably regulated; and
- A regulatory system for the securities market that is slowly getting better, as Bapepam takes a stronger enforcement role.

Indonesia's scores for macro categories are, however, lower than regional averages

Figure 63

Indonesia: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Indonesia is the only market where score for political and regulatory environment not higher than for CG culture

Yet when you look at our table comparing the scores for political/regulatory environment with CG culture for all 11 markets (see Section 1), you will find an anomaly. In every market, except Indonesia, government action to improve corporate governance clearly exceeds efforts made by the private sector (as reflected in CG culture). This suggests that CG reform across the region has largely been a state-driven, top-down process. Indonesia, however, is the only market where the two scores are almost identical, highlighting both systemic weaknesses in its political and regulatory system and, more positively, greater efforts being made in recent years by the wider community to improve corporate governance.

An example of regulatory weakness is the Indonesia Stock Exchange, which has been fairly quiet over the past three years on corporate-governance reform. The contrast with the old Jakarta Stock Exchange, which enacted some seminal reforms to its listing rules in 2004, is notable.

Bapepam dropped its English website

Bizarrely, it is actually harder today to find English translations of new and amended securities laws and regulations since Bapepam merged with the Directorate General of Financial Institutions to become Bapepam-LK and then, for some strange reason, dropped its English website. The old Bapepam website was far more useful.

But it is the judiciary that is of most concern - the Attorney General's Office is considered to be one of the most corrupt institutions in Indonesia, while judges can almost always be had for a price.

Accounting and auditing (IGAAP)

Basic accounting rules are mostly in line with international standards

Indonesia's IGAAP score improved slightly from 65% in 2007 to 67% this year. Basic accounting rules are now mostly in line with international standards and the accounting policies and practices of a number of large companies compare well with global standards and best practices.

But audit quality is suspect

On the other hand, audit quality at small- and medium-sized companies is suspect. Indonesia only has around 900-1,000 CPAs, more than 40% of whom are over 70 years of age. One foreign auditor told ACGA that his firm would rather not hire people from local second-tier CPA firms, preferring instead to hire fresh graduates whom they could then train intensively. In his view, the quality of auditors at the second-tier firms and below was 'very poor', but he added it was more a problem of incompetence than corruption.

External auditors restricted on pursuing non-audit work

What is heartening is that the government appears to be taking a tougher line on limiting the non-audit work that external auditors can do. But one auditor complained that the rules were too strict, saying 'You cannot provide any other services. It is stricter than the SEC. It is crazy!'

CG culture

NGOs and media are instrumentally improving the CG culture

The strongest-performing category, Indonesia's score here rose from 25% in 2007 to 32% this year. While we note above that more large Indonesian companies are making meaningful efforts to improve corporate governance, disclosure and transparency, they are not so much the reason for the increase. It is due to efforts by non-government organisations (NGOs) to become more involved in the securities market, undertake research into corporate-governance practices and organise training of directors. It is also the result of a more open, critical and effective media.

The Indonesian Institute of Corporate Governance (IICG) and the Indonesian Institute for Corporate Directorship (IICD) both invest a lot of time and effort in surveying the quality of governance of listed companies. Meanwhile, IICD and Lembaga Komisaris dan Direktur Indonesia (LKDI) both undertake the training of directors. The media has also proven to be lively and unrestricted when it comes to reporting on scandals and corporate-governance issues.

CLSA corporate scores

Transparency, fairness and accountability pulled down overall score

However, CLSA analysts gave Indonesian companies an average score of 41 points, against the regional average of 52.7. These firms score significantly lower on transparency, accountability and fairness, although they are close to regional averages on independence and C&G/CSR. Indonesia's highest-scoring corporations are United Tractors, Telkom and Astra but they score slightly below the good scores of the rest of the region.

United Tractors, Telkom and Astra had top scores

Figure 64

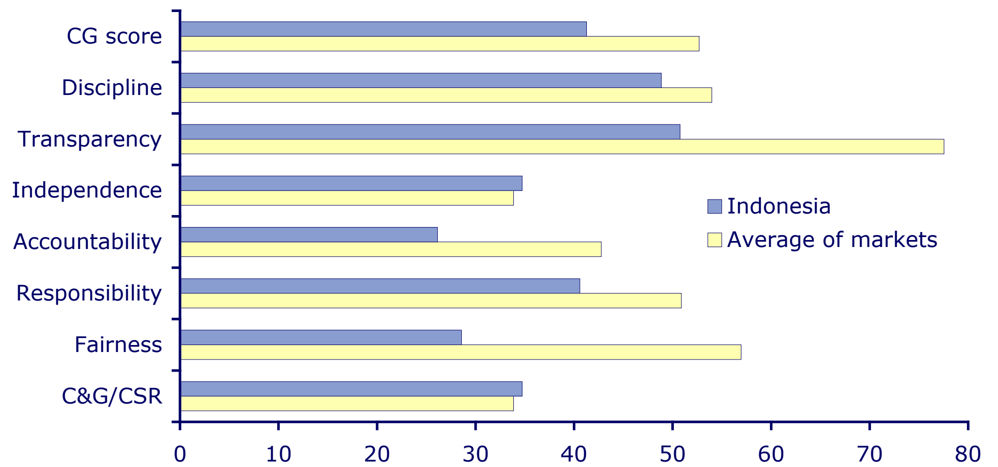
Indonesia: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
United Tractors	UNTR IJ	Bakrie Sumatra	UNSP IJ
Telkom	TLKM IJ	Bank Negara Indonesia	BBNI IJ
Astra International	ASII IJ	Bank Central Asia	BBCA IJ

Indonesian corporations score lower than the region

Figure 65

Indonesia corporate scores against regional average



Source: CLSA Asia-Pacific Markets

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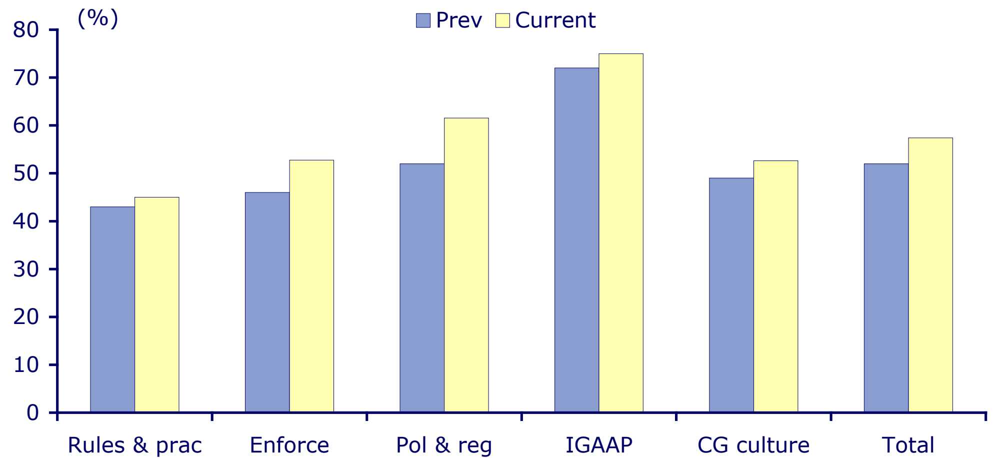
Japan - Improving but lacks urgency

With major improvements in a number of categories, Japan climbs two notches to third place in this year's survey. The country's overall score rose five percentage points from 52% in 2007 to 57% this year, lifted by a large jump in its score for political and regulatory environment. Japanese regulators have been quite active over the past two years (especially in 2009) setting new rules and driving higher disclosure standards in certain areas. Even if many of these standards are only a first step towards international best practices, we believe the country's corporate-governance regime is in a much more positive position today than three years ago. Regulators are more open-minded, several companies are making voluntary changes (mostly for sound business reasons) and some productive developments are taking place in shareholder engagement.

Political and regulatory category saw the biggest improvement

Figure 66

Japan CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

No sense of urgency about need for further reform

Alas, many Japanese companies, if not the majority, remain unaware or unconvinced of the value of good corporate governance and often express hostility to reforms. Regulatory reforms have been productive, but it is not clear what will come next. Will regulators keep driving change, or will they sit back? And despite the weakened state of Japan's capital market, there does not seem to be a strong sense of urgency within the government and the regulatory system about the need for further reform.

Score is low for a developed economy

Benchmarked against global norms, therefore, Japan's score in *CG Watch 2010* is hardly impressive. As one of the world's most advanced economies, the country should be well ahead of where it is, if not leading the region. While 57% would be an excellent score for an emerging or newly industrialised economy, it is low for a developed one.

CG rules and practices

Modest improvements in rules

Japan's score in this category increased just two percentage points from 43% to 45%, partly reflecting the fact that the changes afoot, while productive, are not taking place in leaps and bounds. The modest increase and relatively low score are also a result of the stricter line we are taking in assessing some questions, such as those relating to whether a market has a single national code of best practice on corporate governance, a robust definition of independent director and functioning audit committees - all things still absent in Japan.

FSA's new rules raise standards for non-financial disclosure

On the positive side, the Financial Services Agency (FSA), the main securities regulator, recently issued new rules to bring non-financial disclosure closer to global norms. Required disclosure as of March 2010 includes executive compensation of more than ¥100m (about US$1.2m), a company's top 30 or any cross-shareholdings exceeding 1% of its capital, and the voting results from shareholder meetings. Companies also have to disclose their reasons for choosing a certain type of governance system.

In December 2009, the Tokyo Stock Exchange (TSE) published a definition of "independent director" for the first time and required listed companies to appoint at least one independent director or one independent statutory auditor. It also made a series of other changes to its listing rules in 2009.

No consensus set of standards on board practices

On the negative side, Japan still has no consensus set of standards on board best practices, largely thanks to opposition from certain conservative business groups. These groups argue that companies should have the right to choose their own system of corporate governance, a stance that seems reasonable enough until one realises that companies usually look to the regulator for guidance on such issues as board structure. Moreover, the lack of an agreed set of norms creates uncertainty about what is going on inside Japanese company boards, which in turn undermines investor confidence in the capital market. Put simply, global investors and even many domestic investors do not believe that their interests are sufficiently represented within company boards.

Other problem areas include the lack of mandatory voting by poll, which means that when companies publish detailed voting results, they only do so for votes cast "by proxy" (mostly votes sent in before a shareholder meeting by institutional and some retail investors).

***Kansayaku* usually in place instead of audit committee, but cannot be a real substitute**

Audit committees are found in only a tiny percentage of listed companies (less than 3%), as many Japanese firms, commentators and investors believe the *kansayaku* (statutory auditor) system to be a substitute for audit committees and independent directors. We disagree. Statutory auditors play a useful but very different role to audit committees. Their core task is to supervise a company's compliance with laws and regulations and, while they can make suggestions in board meetings, they have no formal vote and are not board members. An audit committee, in contrast, reviews a company's financial reports, performance and internal control processes, and helps the board to assess and manage risk. It is a much broader role and is undertaken by people who are directors, mostly independent, and have equal legal standing with other directors. Many audit committees in Asia and elsewhere do not function properly, it is true, but the potential is there for them to act as a critical check on management.

Lastly, new rules introduced by the TSE in August 2009 on third-party allotments (ie, private placements) remain somewhat vague. Although a step in the right direction, these rules need to be reviewed for their effectiveness.

Enforcement

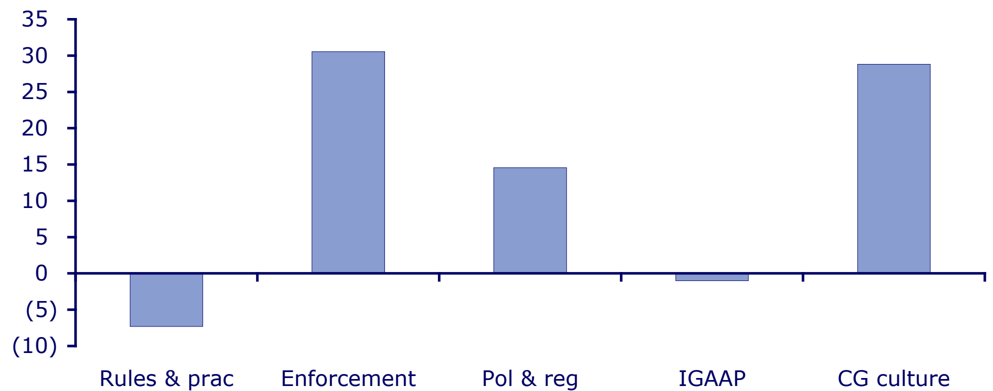
Points given for securities regulator and stock exchange investing in resources

The large increase in score from 46% in 2007 to 53% for enforcement is partly a result of additional points gained in two questions for which we gave zero marks in all markets in our previous survey (because we felt there was insufficient data on which to make a judgement). These related to whether the main securities regulator and stock exchange had been investing significantly more financial and human resources in investigation and enforcement in recent years. We have taken a view this year based on better data and have accorded Japan some extra points.

Above regional average for enforcement, CG culture and political and regulatory environment

Figure 67

Japan: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Large amount of automatic voting

One other positive development is the fact that market disciplinary pressure is increasing from investors. Most domestic and foreign institutional investors vote and, it would be fair to say, are doing so in an increasingly informed manner (ie, making their own decisions as opposed to just automatically following the advice of proxy voting advisers). But there remains a large amount of automatic voting, something that seems of questionable value (and can produce anomalous results if an adviser gets something wrong).

Authorities do not seem to take tough line on insider trading or market manipulation

Otherwise, the record of Japanese regulators on enforcing their own corporate-governance regulations over the past three years has been mixed -as the middling score of 53% suggests. The FSA delegates enforcement to the Securities and Exchange Surveillance Commission (SESC), which is supposed to be independent. The SESC is doing more surveillance and enforcement, but much of its focus is on intermediaries (brokers), asset managers and credit-rating agencies, not listed companies. Most investors we speak to consider its efforts inconsistent and that it is not enforcing laws in key areas, such as insider trading (which investors believe is fairly common in Japan, especially among local brokers). We have found little data to suggest that the authorities are taking a tough line on insider trading or market manipulation.

Political and regulatory environment

FSE becoming more effective; TSE pushing ahead with reforms

It is improvements in the political and regulatory environment where Japan shines brightest in this year's survey. The score in this category is up 10 percentage points to 62%, from 52% in 2007, mainly due to more active regulators. Although still subject to political and business pressure, the FSA is becoming more effective. The TSE is also pushing ahead with reforms, although the heavy pressure it is under from issuers is reflected in the compromise rules it produces.

Independent directors are not yet mandatory - only an incremental change over next couple of years

The new rules on disclosure that the FSA announced in March 2010 (as highlighted above) were far from perfect, but represented quite a symbolic and refreshing departure for Japan, as did the TSE's new rule in 2009 on independent directors. After years of denying that independent directors were necessary or even useful, Japanese regulators and some companies now accept that they have a role to play. (Although it should be noted that independent directors are still not mandatory and the TSE's rule change will lead to only incremental change over the next couple of years.)

Four policy papers published in Japan after ACGA's white paper on CG

Some of the impetus for this flurry of action came from sustained dialogue ACGA and its investor members have maintained with various Japanese regulators, ministries and listed companies since the publication of ACGA's *White Paper on Corporate Governance in Japan* in 2008. In the following year, four policy papers were published by Japanese business and government agencies - including the FSA and TSE - which contained initial suggestions for many of the reforms since adopted.

On an ancillary note, both FSA and TSE websites are much improved from 2007, with translations of most key laws and regulations into English. And Japan has also signed the International Organisation of Securities Commissions' Multilateral Memorandum of Understanding. Both of these changes have bumped up scores in the relevant questions.

Legal system not developed as a tool for investors

Meanwhile, the country lost points in questions relating to its legal system and media. The Japanese legal system has not developed as a tool for minority shareholders as much as we thought it would. And in our view the media is not entirely free of business or political pressures when it comes to reporting CG-related matters.

Accounting and auditing (IGAAP)

Differences remain between Japanese accounting and IFRS

The accounting and auditing category score for Japan has improved marginally by three percentage points to 75%. Differences between Japanese GAAP and IFRS remain (eg, many companies still do not report "comprehensive income" or fair-value accounts). According to an MOU between the International Accounting Standards Board (IASB) and the Accounting Standards Board of Japan (ASBJ), there should be convergence between Japanese GAAP and IFRS by June 2011. Despite the convergence plans, Japan will only decide in 2012 whether to require domestically listed companies to use IFRS for their consolidated financial statements. But in December 2009, the FSA said it would allow certain listed companies in Japan to start using IFRS voluntarily from fiscal years ended 31 March 2010. According to a statement in December 2008, the European Union considers Japanese GAAP to be largely equivalent to IFRS.

Auditing practices largely in line with international standards

Japanese auditing practices are largely in line with international standards of auditing and convergence is ongoing. The CPA and Auditing Oversight Board (CPAAOB) were established in 2004 as an independent audit regulator and falls under the FSA. The CPAAOB seems to be doing a reasonable, if not incredibly active, job. It relies heavily on the Japanese Institute of Certified Public Accountants, the audit industry body, to carry out initial quality control reviews of CPA firms in Japan (which the CPAAOB then reviews). This structure could create the potential for conflict of interest.

Japan is a member of IFIAR, an association of independent audit regulators from around the world (including countries such as the UK, the USA, Canada, Singapore, France, the Netherlands and Australia).

CG culture

Diverse views on governance in the corporate sector

Japan's CG culture is somewhat less rigid today than in 2007, as reflected in the increase in score for this category from 49% to 53%. Among large listed companies it is still mostly the usual suspects that are doing more than the rules require (eg, Asahi, Shiseido, Eisai), but a group of smaller firms is also taking voluntary action (eg, Autobacs, Daiwa House). The Japanese corporate sector is more diverse and open to new governance ideas than the country's conservative reputation would suggest.

Clustering of meetings remains a problem but is improving

Shareholder meetings are getting better, partly because of regulatory prodding and rule changes, but also because some companies are releasing their final agendas and business reports earlier, and scheduling their meetings before the rush of AGMs in the last two weeks of June. Clustering of meetings is still a problem, but is gradually improving.

Dialogue remains difficult between investors and large Japanese firms

Dialogue between investors and Japanese blue chips, however, is generally much harder than it should be. This is something that is only likely to change gradually and as a result of growing personal relationships between managers and shareholders, rather than any top-down rule change.

Japan Engagement Consortium was formed in 2009

In terms of promoting better corporate-governance practices, a few foreign investors are becoming active, as are one or two domestic institutions. Tokio Marine Asset Management, for example, joined with a UK provider of stewardship services, Governance for Owners, to form the Japan Engagement Consortium in 2009. The aim of this consortium, which is backed by Railpen and Universities Superannuation Scheme of the UK, is to engage with Japanese companies 'in a Japanese way'.

NGOs are promoting CG reform

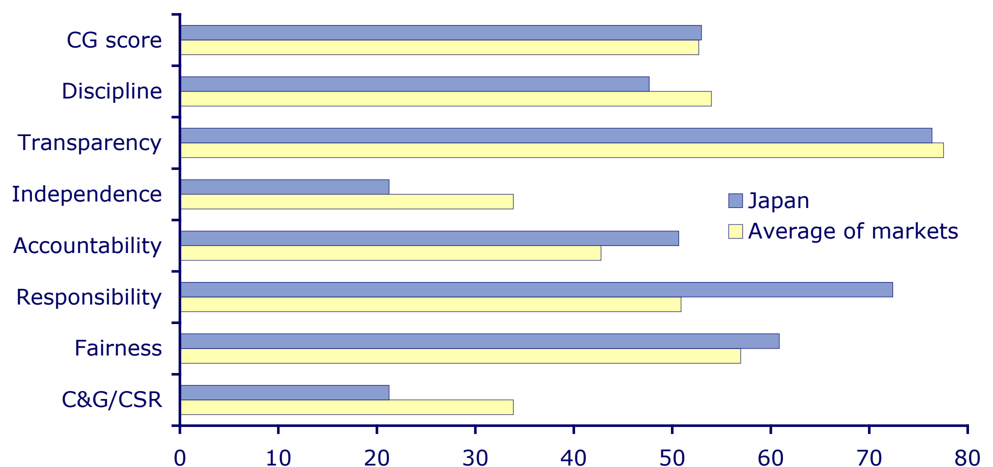
It should be noted that the Pension Fund Association is no longer playing the leadership role it once did, while there is no evidence that the huge Government Pension Investment Fund has a policy on corporate governance. But there are a number of NGOs involved in promoting corporate-governance reform and training, including Shagai-Net (Japan Independent Directors Network), the Japan Association of Corporate Directors and the Japan Corporate Governance Forum. There is also a new initiative called the Board Directors Training Institute.

CLSA corporate scores

Japanese firms score higher than the region on responsibility and accountability

Figure 68

Japan corporate scores against regional average



Source: CLSA Asia-Pacific Markets

By the ratings of CLSA analysts, Japanese corporations have an average CG score of 53, only marginally higher than the regional average of 52.7. The companies score higher than the regional average on responsibility and accountability but lower on independence (having an independent chairman, composition of board committees) and by the responses we received, lower than average also on the newly introduced combined scoring for C&G/CSR.

Nintendo, Konica, Nikon and Sony are among top scorers regionally

Figure 69

Japan: Companies in top-two CG quartiles

Top quartile	**Code**	**Second quartile**	**Code**
Nintendo	7974 JP	Ryobi	5851 JP
Konica Minolta	4902 JP	Fujitsu	6702 JP
Nikon	7731 JP	Taiyo Yuden	6976 JP
Sony	6758 JP	Japex	1662 JP
Sumitomo Metal	5405 JP	Asahi Glass	5201 JP
Tokyo Electron	8035 JP	Kyocera	6971 JP
Tokyo Gas	9531 JP	Nippon Paint	4612 JP
Canon	7751 JP	Oji Paper	3861 JP
Ricoh	7752 JP	Unicharm	8113 JP
Osaka Gas	9532 JP	CMP	4617 JP
Mitsui	8031 JP	Square Enix	9684 JP
Nippon Steel	5401 JP	Teijin	3401 JP
Toshiba	6502 JP	Honda Motor	7267 JP
Nippon Paper	3893 JP	Toyota Motor	7203 JP
Hoya	7741 JP	Kubota	6326 JP
Mitsubishi Corp	8058 JP	Dentsu	4324 JP
Marubeni	8002 JP	Kansai Paint	4613 JP
Olympus	7733 JP	Shima Seiki	6222 JP
Advantest	6857 JP	Mandom	4917 JP
Kuraray	3405 JP	Toshiba Machine	6104 JP
Panasonic	6752 JP	Nissan Motor	7201 JP
Fujifilm	4901 JP	NGK Spark Plug	5334 JP
Rengo	3941 JP	Minebea	6479 JP
Sharp	6753 JP	Nidec	6594 JP
Inpex	1605 JP	Shiseido	4911 JP
TDK	6762 JP	Shimano	7309 JP
THK	6481 JP	Daikin Industries	6367 JP
JFE	5411 JP	Yahoo! Japan	4689 JP
Capcom	9697 JP	Aichi	6345 JP
Kansai Electric	9503 JP	Fujitec	6406 JP
Elpida Memory	6665 JP	Max	6454 JP
Chubu Electric	9502 JP	NTN	6472 JP
Tokyo Electric	9501 JP	Yamaha Motor	7272 JP

Source: CLSA Asia-Pacific Markets

Consumer-electronics companies have generally higher CG scores in Japan

The highest-scoring corporations in our ranking are Nintendo, Konica Minolta, Nikon, Sony and Sumitomo Metal. In general, we find the international consumer-electronics companies having higher CG scores, as their transparency standards need to be at international levels to meet the requirements of their customers and suppliers.

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Korea - CG not a priority

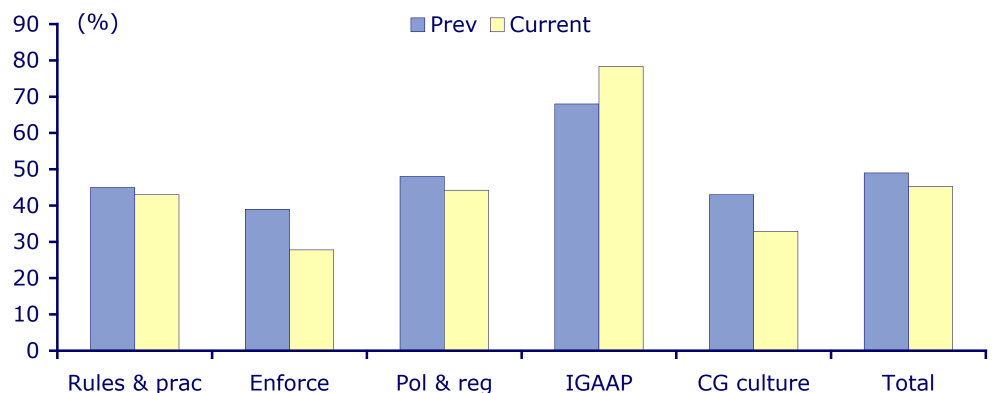
Korea's CG development has stalled; its market CG ranking has dropped

Once seen as ahead of the curve regionally, Korea's corporate-governance development over the past three years has clearly stalled and, in some areas, backtracked. The country's failure to keep its forward momentum is reflected in both its notably lower score and ranking this year - 45% and ninth, compared to 49% and equal sixth (with Malaysia) in *CG Watch 2007*. Korea's score has suffered in three of the five categories in the survey -enforcement, political and regulatory environment, and CG culture. Its score for rules and practices has fallen slightly, while its IGAAP (accounting and auditing) score has risen considerably - the one bright spot in its performance.

Improvement in accounting standards but slipped in other areas

Figure 70

Korea CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

This result is not surprising because President Lee Myung-bak, a conservative who came to power in early 2008, is unabashedly pro-big business (*chaebol*) and has relegated corporate governance to near the bottom of the government's policy priorities. His own career prior to politics was at the Hyundai Group, one of Korea's largest *chaebol*, and his elevation to presidency means that the country's family-controlled conglomerates once again feel accepted as they are, warts and all.

The upshot for Korea's CG regime has been less an attempt to roll back the myriad reforms that President Lee's two anti-*chaebol* predecessors put in place after the Asian financial crisis than a return to a certain "business as usual" mindset among both listed companies and top government officials. That is to say, they again regard adherence to global standards of corporate governance as largely a distraction from the pursuit of profits and economic growth. And Korea's relatively painless escape from the global financial crisis has only served to buttress this view.

***Chaebols* allowed to increase their ownership of banks**

The Lee administration has, on occasion, moved the regulatory goalposts firmly in the *chaebols*' favour. A change in the law in 2009, for example, more than doubled - from 4% to 9% - the permitted limit on their ownership of commercial banks, something long on the top of the *chaebols*' wishlist. The likely effect is a worsening in the concentration of economic power in the country, as most banks do not have controlling shareholders.

Proposal to allow poison pills

However the most troubling development in recent months has been the government's proposal to allow listed companies to adopt poison pills. The Ministry of Justice (MOJ) claims that Korean companies need these anti-takeover devices because rule changes in recent years have made hostile

takeover bids much easier, yet domestic companies have few means to defend themselves (eg, Korea has no takeovers code). The MOJ's proposed bill, which is likely to be tabled in the National Assembly shortly, elicited a strongly negative reaction from many global investors.

Inconsistency in commitment

The main issue in Korea is not blatantly pro-*chaebol* legislative exercises, which have been limited, but fragility and inconsistency in the country's commitment to improved corporate governance - as reflected in the wavering actions and views of the government, the shareholder-unfriendly practices of listed companies, and weaknesses in certain regulations and market institutions.

Rules and enforcement

Score for rules and practices remains relatively unchanged

Korea's score for CG rules and practices (43%) remains largely the same as in 2007 (45%), although there were variations in its performance within this category. We rated financial-reporting standards higher than three years ago, mainly due to the fact that the country has made progress in convergence towards International Financial Reporting Standards (IFRS). We maintained the same score for non-financial reporting standards, despite the government's new requirement on carbon disclosure, because little progress has been made on other important aspects of non-financial disclosure (such as those relating to shareholder meetings and publication of detailed voting results). And we downgraded the score for non-financial reporting practices among listed companies, because the latter have not kept pace with evolving global standards.

Non-financial reporting is poor

Particular areas of non-financial-reporting weakness in Korea include management discussion and analysis (MD&A), director reports, CG statements and the disclosure of annual-meeting materials and voting results. Even among major companies these sections of annual and business reports are not as detailed or informative as those found in other Asian and global companies, with a considerable volume of boilerplate information provided. Information in English, meanwhile, is usually much sparser than the Korean version.

Independent directors do not seem effective

We have also become more sceptical about how seriously Korean listed companies take the duties of board directors. Most local governance experts believe the system of independent directors is not working as intended, with many "outside directors" (the term used in Korea) being university professors or former government officials who owe their seats on a board to their relationship with the chairman or CEO. Generous levels of director compensation, which can top six figures in US-dollar terms at some large listed companies, are believed to undermine the independence of outside directors. And it remains unclear if these non-businessmen (there are few women) are sufficiently qualified to oversee company management. In corporate Korea, where employee loyalty to companies is often presumed for life, it is extremely rare to see cross-fertilisation of senior executives from rival companies at the board level.

Being convicted of serious corporate crimes no bar to being at the helm

Then there are the cases of *chaebol* tycoons who, despite having committed serious corporate crimes, almost always return to the helm of their business empires after a short period out of the limelight. This is what happened with Lee Kun-hee, a convicted tax evader who was reinstated as chairman of Samsung Electronics in March 2010, three months after he was granted a pardon by Lee Myung-bak. A conspicuous case of selective and politically driven enforcement, this case contributed to Korea's significantly lower score for enforcement this year (28%, compared to 39% in 2007).

The official reason for the presidential reprieve was that Korea needed the full lobbying efforts of the former Samsung chief to secure the 2018 Winter Olympic Games. (Lee Kun-hee is a member of the IOC - International Olympic Committee

- while Samsung Electronics is an official sponsor of the London 2012 Summer Games.) Yet this effort may fail, since the IOC ethics commission ruled shortly after the pardon that Lee had 'tarnished the reputation of the Olympic movement' and banned him from sitting on any IOC commission for five years.

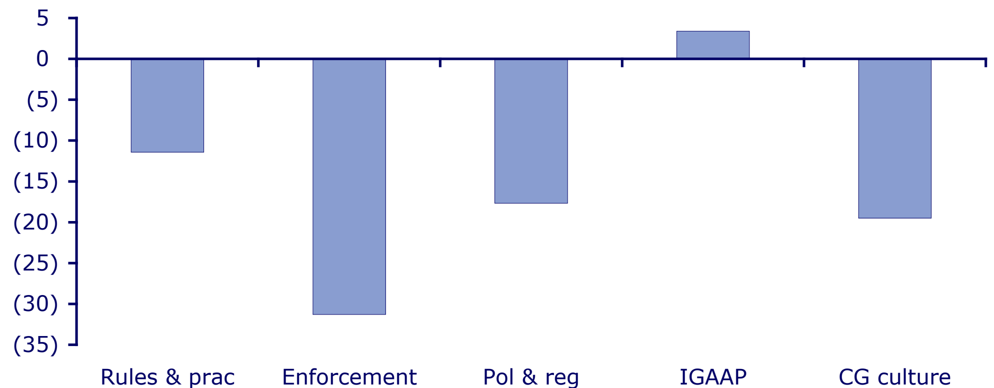
Confusion in official titles but little doubt who calls the shots

A second, more egregious, aspect of Lee's comeback was the fact that the Samsung Electronics board apparently followed no proper nominating procedure to reappoint him as "chairman". The formal chairman of its board remains Lee Yoon-woo (no relation), who confusingly carries the title of "vice chairman" in terms of his company rank. Yet legally, the only legitimate chairman of Samsung Electronics is Lee Yoon-woo - even though there is no doubt both inside and outside the company who calls the shots.

For most categories, Korea's macro scores are below regional average

Figure 71

Korea: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Political and regulatory institutions/CG culture

Score on political and regulatory environment slipped

Not surprisingly, for reasons given above, Korea's score in our political and regulatory environment category (44%) is four percentage points lower this year than in 2007 (48%). We believe there has been a big pendulum swing in the Korean government away from improving corporate governance. Gone is the reformist zeal of the two administrations under the liberal presidencies of Roh Moo-hyun and Kim Dae-jung. The current administration has no corporate-governance strategy to speak of and there have been no major improvements to CG laws. Neither the new Financial Investment Services and Capital Markets Act of 2009, nor the repackaged Commercial Act remedies Korea's numerous shortcomings in basic CG regulations, such as a lack of voting by poll at shareholder meetings, separating the roles of the chairman and the CEO, and stricter approval procedures for transactions that can impinge on the rights of minority shareholders (eg, private placements), to name just a few.

As for Korea's market authorities, they too display some outmoded behaviour. The Financial Services Commission (FSC), the powerful organisation that once spearheaded financial- and corporate-sector reforms, is one of the least accessible regulators in Asia (in ACGA's experience) and its rule book one of the least user-friendly (eg, major laws and regulations rarely contain any tables of content, cross-references or indexes - suggesting that regulators do not think they will be read by anyone other than specialist lawyers).

FSS sometimes acts like an arm of the Blue House

Meanwhile, the Financial Supervisory Service (FSS), the sole market regulator that executes the FSC's policies on banks, securities firms and insurers, acts at times less like an independent regulator than an arm of the Blue House, the

presidential office. In December 2009 it launched a high-profile investigation of Kookmin Bank, soon after Kang Chung-won, the bank's long-term CEO, was named as the chairman of its parent, KB Financial, one of the country's largest - and entirely private - financial institutions. Although he denied the government had put pressure on him, Kang gave up his nomination within weeks. The suspicion that the FSS investigation was politically motivated only deepened when, six months later, KB Financial's board chose a close presidential adviser with no banking experience to be its new chief. On 20 August, the FSS banned Kang from working in a financial company for three years, holding him responsible for some 400bn won in losses stemming from his decision to acquire a bank in Kazakhstan in 2008 without properly informing the board about the risks involved. Many local CG observers, however, believe Kang's bigger sin was that he dared to rely only on KB Financial's board procedure without also seeking the government's blessing for his promotion.

CG culture has been eroded

The trends described above have also eroded Korea's corporate-governance culture, the score for which has fallen to 33% in this survey from 43% in 2007. Although a number of leading Korean companies take governance seriously (especially privatised former state firms such as Posco, which have no controlling-family owners), the typical listed company evidently sees little tangible value in practicing it well, judging by their actions. There is virtually no company, for example, that voluntarily votes by poll at shareholder meetings or discloses detailed voting results. On this issue, Korea is increasingly out of sync with developments in major Asian markets, including Japan, and seems unaware that this has become a significant issue for many global, and some large domestic, investors.

Media is meek on CG issues

One particularly troubling aspect of Korea's CG culture since 2007 has been the meeker role played by the normally feisty media in exposing corporate scandals and governance failures. In the memoir, *Thinking of Samsung*, by a former group chief legal counsel, the author claims to have helped the company conduct an alleged bribery operation targeting politicians, civil servants and judges during his time at the company over 1997-2004. When it was published in February 2010 the book became an instant bestseller, yet hardly any domestic newspaper wrote about it. (The domestic media also gave scant coverage to the IOC ethics commission's ruling on Lee Kun-hee.)

Accounting and auditing

Accounting standards converging with IFRS

One positive development in Korea has been in the area of accounting and auditing rules and practices. The country's score in the IGAAP category this year is 10 percentage points higher than in 2007 - 78% compared to 68%. This is partly because its accounting standards are converging with IFRS and Korean companies have been making preparations to adopt them. IFRS will become mandatory for all listed companies from 1 January 2011, but more than 50 large corporations have already started to do so. The Korea Accounting Standards Board has accepted and translated much of the IFRS rules into Korean, and will incorporate them into Korea's Generally Accepted Accounting Principles by 2011.

Consolidated quarterly accounts will become mandatory

Korea's migration to IFRS also means consolidated quarterly accounts will become mandatory for companies with assets of more than 2tn won from next year, and for all companies from 2013. Under IFRS, the consolidation threshold will be triggered when a company holds 50% or more equity in another company - or exercises "effective control" over it. The latter provision should make it harder for companies to skirt the numerical ceiling with a series of 49% stakes in subsidiaries.

However, Korea has a genuinely independent audit regulator

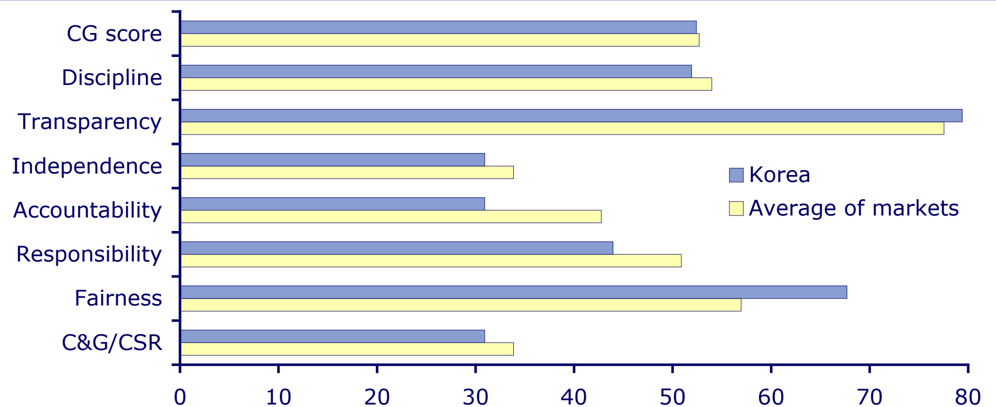
Meanwhile, the FSS continues to keep the accounting and auditing industry on a fairly short leash by routinely checking and reviewing the quality of companies' financial statements and auditors' reports. Sanctions for non-compliance or shoddy work include fines and a ban on the accounting firm from offering further services to the client involved. Korea is one country in Asia with a genuinely independent audit regulator - along with the likes of Japan and Singapore. That is to say, the regulator is not controlled by the audit profession. As such, it is a member of IFIAR, a quasi-official body that meets twice a year to share information and discuss audit regulatory issues around the world. Other members include Australia, Canada, Denmark, France, Germany, Netherlands, Norway and several others.

CLSA corporate scores

Korean companies' overall CG score slightly lower than Asian average

Figure 72

Korea corporate scores against regional average



Source: CLSA Asia-Pacific Markets

Weaker than average on accountability but stronger on fairness

The Korean corporations have an overall average CG score of 52.4, which is similar to the average for the region. The companies score lower than average on accountability (having independent directors, audit committees that nominate external auditors, voting by poll, etc) although higher on fairness (compensation of the board, equal class shares, etc). Hynix's score is in the top decile regionally, and is a few points ahead of the others for the market. OCI, Orion and LG Electronics also have good CG scores.

Hynix scores a few points more than others

OCI, Orion and LG Elec also have good scores

Figure 73

Korea: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
Hynix Semiconductor	000660 KS	LG Display	034220 KS
OCI	010060 KS	Sung Kwang Bend	014620 KS
Orion	001800 KS	S-Oil	010950 KS
LG Electronics	066570 KS	Hankook Tire	000240 KS
Shinhan Financial	055550 KS	Industrial Bank Of Korea	024110 KS
Hana Financial	086790 KS	KB Financial	105560 KS
Posco	005490 KS	Korea Exchange Bank	004940 KS
Samsung Electronics	005930 KS	LG Household and Healthcare	051900 KS
LG Corp	003550 KS	Doosan Corp	000150 KS
Hyundai Steel	004020 KS	Samsung SDI	006400 KS
Samsung Card	029780 KS	SK Telecom	017670 KS
Samsung F&M	000810 KS	Hana Tour Service	039130 KQ
Busan Bank	005280 KS	Hyundai Development	012630 KS
Daegu Bank	005270 KS	GS Engineering & Construction	006360 KS
GS Holdings Corp	078930 KS	KT	030200 KS
NHN Corp	035420 KS	KT&G	033780 KS
LIG	000810 KS		

Source: CLSA Asia-Pacific Markets

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Malaysia - Top-down progress

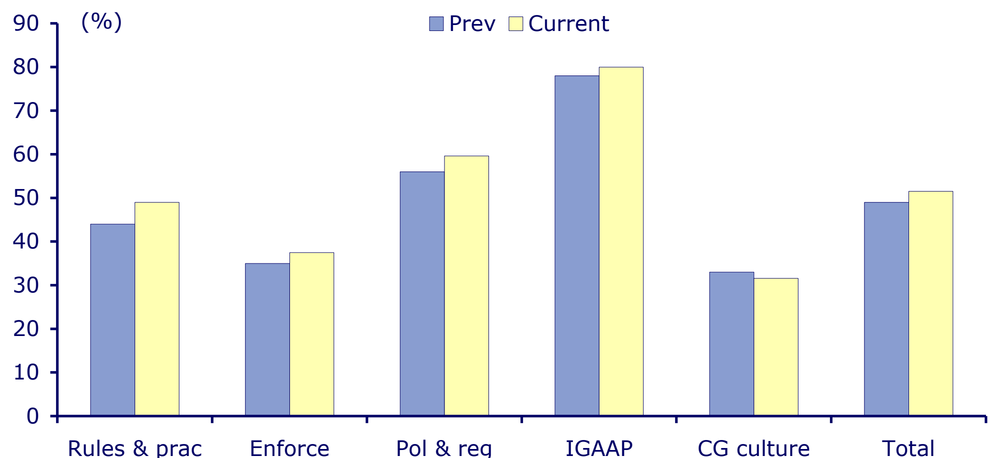
Decline in score for CG culture

Malaysia retained its sixth spot in our rankings this year, but with a higher overall score of 52% compared to 49% in 2007. Regulators have been making steady progress in the past three years and appear more open to listening to the market. Yet doubts remain. A major issue we have is how much of this is window dressing and how much is genuine change? Will this take corporate-governance practices beyond box-ticking? These uncertainties are why Malaysia's CG culture score recorded a one-percentage drop this year, whereas all other categories saw improvement.

Other categories of CG score seen slight improvement

Figure 74

Malaysia CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Higher score for enforcement

An area that has improved is enforcement. The Securities Commission (SC), in particular, has been active. The score for the section increased from 35% in 2007 to 38% this year. Yet, we find that securities laws have not proved to be a meaningful deterrent against insider trading and market manipulation, as enforcement statistics show (see Enforcement section below).

Marked progress in rules & practices, political & regulatory environment

The two categories that showed a marked improvement this year were CG rules and practices, and political and regulatory environment, which increased by five percentage points and four percentage points respectively. IGAAP, meanwhile, recorded a modest two-percentage-point increase.

Gap between official push and overall CG culture

In most markets, it is government efforts that lead corporate-governance reforms, but nowhere is this more obvious than in Malaysia. Looking at our table comparing the scores for political and regulatory environment with CG culture for all 11 markets (Section 1), the 28% gap for Malaysia is easily the widest. It is this weakness in local CG culture that is holding the market back.

CG rules and practices

This is the most improved category, with the score increasing from 44% in 2007 to 49% this year. A few individual scores in this section decreased (due in large part to us taking a stricter view on some issues):

Audited full-year results need not be published within 60 days

- Malaysia is not adopting the best practice of having listed firms publish their audited annual results within 60 days after financial year ends;
- Continuous disclosure practices, while better than they were three years ago, still fall short of global standards; and

- A Code of Corporate Governance that was last revised in 2007 and which has not kept up with international best practices. For example, it does not provide a section on shareholder meetings - how they should be conducted, how votes should be counted and results published.

A major shareholder can nominate an independent director in certain circumstances

The improvements, however, act as a counterbalance. Of particular interest is the definition of independent directors, which was amended last year when Bursa Malaysia (BM) revised its listing rules. Malaysia trumps other regional markets because it is the only jurisdiction where a major shareholder can nominate an independent director, if:

- The major shareholder's aggregate shareholding in the said corporation, directly or indirectly, is not more than 15% of the issued and paid-up capital (excluding treasury shares) of the said corporation;
- The major shareholder is not deemed to be a promoter of the said corporation; and
- The major shareholder is either a statutory institution that is managing funds belonging to the general public; or an entity established as a collective investment scheme, such as closed-end funds, unit trusts or investment funds (but excluding investment holding companies).

Institutional investors could play a role nominating independent directors

While this may seem counterintuitive, large institutional investors often own 5% or more of a company, but not be "connected" to it in any other way. Hence, they could play a useful role in nominating independent directors on the board of family-controlled and state-owned companies in Asia (something that would not necessarily work as well in the West, where listed companies tend to lack dominant controlling shareholders). Rules in other markets, however, fail to recognise this and constrain investors from engaging with their investee companies.

Regulators open to listening to feedback

We also stated that the regulators are more open to listening to market practitioners. In February 2009, when BM and the SC published a consultation paper on proposed new guidelines and amendments to the listing rules, one of the proposals was to increase the "general mandate" for non-pro-rata private placements from 10% to 20%, which would have put it on par with Singapore and Hong Kong. ACGA and several of our members wrote to the regulators expressing our opposition to the amendment. To their credit, the authorities decided against the change.

Enforcement

Private enforcement on the rise

Malaysia is slowly improving in enforcement as the score in this category improved by three percentage points. The primary reasons, however, are due more to private enforcement than regulatory action, including:

- Institutional investors, such as the Employees Provident Fund (EPF), Aberdeen Asset Management and Corston Smith, are attending some annual general meetings, voicing their concerns and voting against resolutions they do not agree with;
- The Minority Shareholder Watchdog Group (MSWG), which was initially set up by the government to help protect minority shareholder interests, provides a voice for retail shareholders and has taken on a more active role in shareholder meetings over the past three years; and
- The 2009 amended Listing Requirements (Part C, 16.06 (b)) strengthened the delisting rules to protect minority shareholders.

Poor record in prosecuting insider trading and market-manipulation cases

Evidence suggests that both the SC and Bursa have been investing more in their investigation and enforcement units in the past few years. The market acknowledges the efforts of the securities regulator in bringing cases against offenders, but it has a poor record prosecuting insider trading and other market-manipulation cases.

The SC brought three market-manipulation cases to court in the past three years - one in 2008; one in 2009; and one in 2010. The case in 2010 dated back to 2005 and the sentence imposed is being appealed by the SC, as is the acquittal of the defendants in another case in 2009. We find it hard to believe that insider trading and market manipulation happens so rarely in Malaysia, unlike the rest of Asia.

Political and regulatory environment

Regulators are trying to better the system

This category increased its score from 56% in 2007 to 60% this year. There are a couple of blemishes, the main one being that the government lacks a clear long-term strategy to deal with corporate-governance reform. And we find that, while the government is interested in having a thriving capital market, it is often distracted by the latest global trend - in this case, corporate social responsibility (CSR), with both the SC and Bursa wanting to make Malaysia a hub for CSR in the next few years. We would argue that a company that lacks good corporate governance is hardly likely to have meaningful CSR practices and strategies, even though they might publish regular sustainability reports. Despite this, we believe the government and regulators have been trying to better the system.

Bank Negara has high credibility

Positive features in the political and regulatory environment include:

- The country's banking regulator, Bank Negara Malaysia, which is seen by the market as head and shoulders above other Malaysian regulators, as one investor put it;
- The completion of the Companies Act review and the promise of a new Companies Bill to be tabled in Parliament by the Companies Commission of Malaysia (SSM) next year;
- Amendments to the Securities Commission Act to establish an Audit Oversight Board; and
- Listing-rules amendments undertaken by Bursa and the SC.

Consultation papers being tabled

Meanwhile, Bursa and the SC tabled two more consultation papers in July 2010. One consultation is looking at proposals aimed at:

- Enhancing the continuing disclosure and financial-reporting obligations of listed companies;
- Enhancing corporate-governance requirements; and
- Reviewing the framework of share schemes for employees.

Will clarify on disclosure requirements

The second consultation looks at Bursa's proposal to issue a Corporate Disclosure Guide that would clarify and illustrate how the requirements should be applied in practice. According to Bursa, it also sets out the best practices for establishing internal policies and procedures to enable listed companies to fulfil their disclosure obligations. The consultation period ended on 19 August. While this consultation is interesting, we cannot take it into consideration for this survey since the process is not yet complete. The timing of the consultation, however, is also odd since it is the middle of summer and most people in much of Asia, Europe and North America are on holiday.

On track for full convergence with IFRS in 2012

Accounting and auditing (IGAAP)

Malaysia's score for this category saw a slight improvement, moving up to 80% from 78% in 2007. The country is on track for full convergence with IFRS in 2012, except for possibly IAS 41 Agriculture. According to an auditor in Malaysia, the Malaysian Accounting Standards Board has submitted a proposal to the International Accounting Standards Board (IASB) to improve IAS 41, which IASB has included on its agenda for consideration.

We also note that accounting policies and practices among large companies are now more in line with IFRS. Small- and medium-sized companies, on the other hand, have a way to go yet since their financial statement disclosure is usually limited to the bare minimum Bursa stipulates, according to investors.

Audit Oversight Board has been set up

Where Malaysia has made significant progress is in the establishment of an Audit Oversight Board, a special independent body to regulate auditors in the country, under the Securities Commission. While we applaud the step, which moves it ahead of Hong Kong, only time will tell how active and effective it is.

Slight decline in score on CG culture

CG culture

This is the one category that dipped slightly this year to 32% from 33% in 2007. Not enough has improved, especially at the company level. Investors cite Public Bank, and multinationals such as British American Tobacco, Digi and Nestle, as "good" companies, but these are the usual suspects with most of them adopting best practices because of their parent companies abroad.

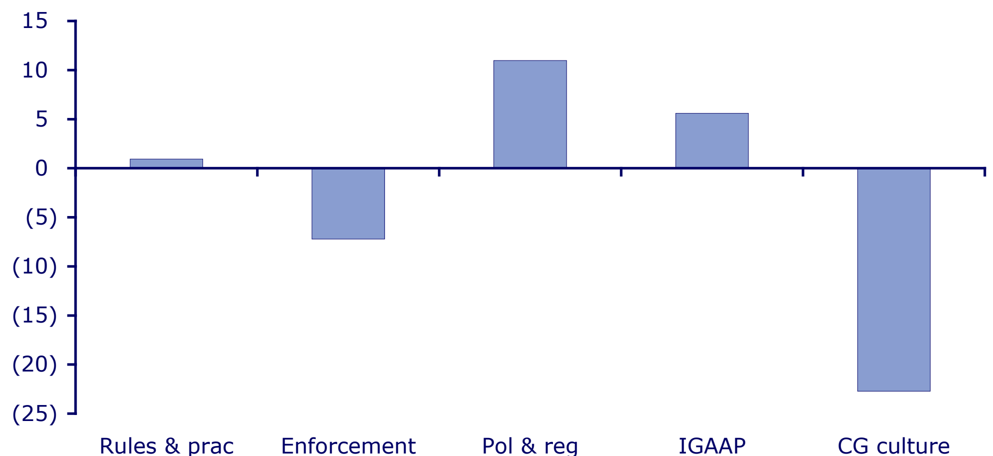
Lags Thailand and Singapore on voting by poll

Most firms continue to fail to have meaningful dialogue with their shareholders, and while they are open to answering questions posed to them at AGMs, they will not consider voting by poll or even publish proxy results. Not one company has voluntarily started voting by poll, unlike Thailand and even Singapore to a smaller extent.

CG culture is the area where Malaysia's score is significantly lower than the regional average

Figure 75

Malaysia: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Investment community is doing more to promote CG

What has improved, though, is the involvement of the investment community, both institutional and retail, in promoting better corporate-governance practices:

- EPF and Aberdeen Asset Management have been actively promoting better corporate-governance practices in the companies they invest in, with EPF producing a corporate-governance handbook this year for their investee companies;

- In 2008, Corston Smith and Hermes Equity Ownership Services set up two corporate-governance funds to invest in the Asean region; and
- MSWG has been active in the past few years educating retail investors on "etiquette" at AGMs - how to behave and the types of questions to ask.

Directors of banks have to attend education programme annually

Other market participants have also been more engaged in trying to raise the awareness of best practices through various programmes. Bank Negara Malaysia developed the Financial Institutions Directors' Education (FIDE) programme, which all directors sitting on bank boards must attend every year. The Securities Industry Development Corporation and PricewaterhouseCoopers Malaysia jointly provide training programmes for directors sitting on listed companies, although these are not mandatory.

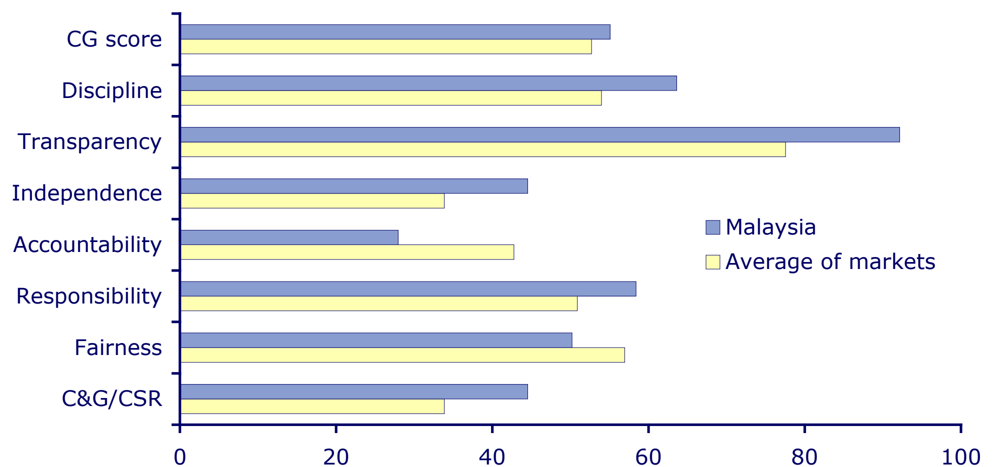
Now if only the companies would join in.

CLSA corporate scores

Malaysian corporate score is slightly higher than average on overall CG

Figure 76

Malaysia corporate scores against regional average



Source: CLSA Asia-Pacific Markets

Malaysian corporations weaker on accountability

The average CG score for Malaysian corporations at 55% is slightly higher than the regional average at 53. Malaysian companies do well particularly on transparency and independence as well as on the new C&G/CSR scores. Their main area of weakness in our scoring is on accountability, viz the number of independent directors, whether the audit committee appoints external auditors, voting by poll, etc. CIMB, Tanjong and Public Bank score the highest in Malaysia. Their scores are also good regionally.

CIMB, Tanjong and Public Bank ahead on CG in Malaysia

Figure 77

Malaysia: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
CIMB	CIMB MK	Genting Plantations	GENP MK
Tanjong	TJN MK	Media Prima	MPR MK
Public Bank	PBKF MK	Maxis	MAXIS MK
Lafarge Malayan Cement	LMC MK	Digi	DIGI MK
IJM Land	IJMLD MK	Parkson Holdings	PKS MK
BAT Malaysia	ROTH MK	Bursa Malaysia	BURSA MK
Top Glove	TOPG MK	Tenaga Nasional	TNB MK
IJM	IJM MK	Gamuda	GAMU MK
SP Setia	SPSB MK		

Source: CLSA Asia-Pacific Markets

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Philippines - Fallen back

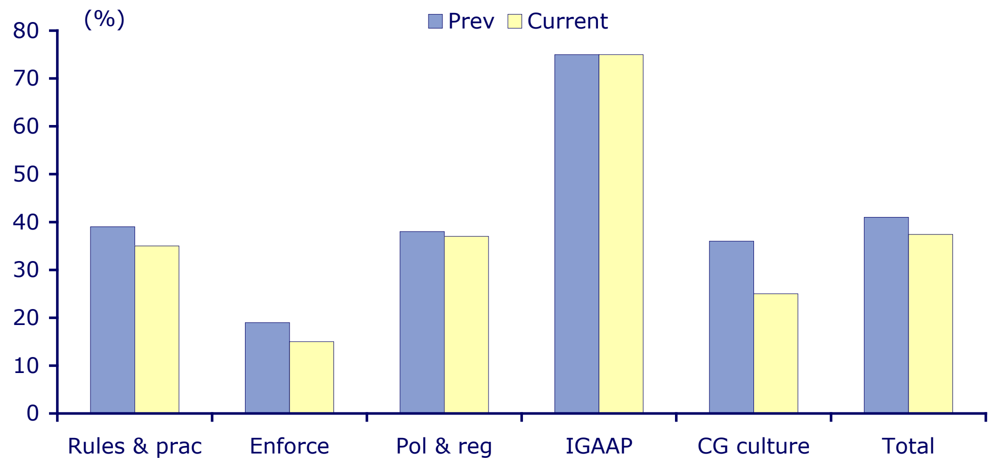
The most disappointing market in *CG Watch 2010* is the Philippines, which achieved what it has long threatened since we began this survey - last place, with its score dropping from 41% in 2007 to 37%.

Two of the country's largest and most respected corporations, International Container Terminal Services and San Miguel, recently disenfranchised minority shareholders of their rights of pre-emption by changing their bye-laws. There is little evidence that the Securities and Exchange Commission (SEC) or the Philippine Stock Exchange (PSE) have made much progress in improving regulatory oversight of the markets. And as one local businessman told ACGA in an interview, 'the only people who trade in our stockmarket are those with inside information'.

Modest decline in overall score but other markets' scoring has risen thus pulling down ranking for the Philippines

Figure 78

Philippines CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Scores for most categories slipped

In this year's survey, the Philippines' scores in every category fell except for IGAAP, a category in which practically every market in our survey scores well. Of special note is the poor showing in CG culture, which recorded an 11-percentage-point drop this year. In contrast, the CG rules and practices and enforcement categories only fell by four percentage points each, while the political and regulatory environment section dropped by one percentage point.

CG rules and practices

While the Philippines' score in this category only declined by four percentage points - from 39% in 2007 to 35% this year - it is the source of the fall that gives most cause for concern.

Some of the larger companies appear to be regressing

In other markets in our survey, it is the larger-market-cap companies that are the leaders in corporate-governance reform. But in the Philippines, some seem to be regressing rather than improving. While the reporting practices of a number of the better blue chips (such as PLDT, Ayala and SM group) compare well against international best practices, others, such as San Miguel, are less impressive. This is especially true in the disclosure of price-sensitive information and related-party transactions. In July 2010 alone, the PSE wrote to San Miguel three times to clarify material information that had leaked to the press before the firm had informed the market, a sign that the regime for disclosure of price-sensitive information is woefully inadequate.

Regulations set a bar below even regional best practices

Many codes and securities laws in the Philippines lag international, and even regional, best practices. Yet regulators and companies seem unaware of the problem. A case in point is the Code of Corporate Governance, published by the SEC in 2002 and revised in 2009. Although the revision was an improvement in some ways, it continues to set the bar low in many areas, including:

- Companies need only appoint two independent directors or at least 20% of its board size, but not less than two (most other codes in Asia stipulate three or one-third of the board);
- The Code permits companies to set guidelines on the number of directorships its board members can hold; and
- The Code fails to provide detailed guidance on disclosure of executive compensation.

Further guidelines may come

The 2002 and 2009 Codes reiterate several standards found in laws and regulations, but fail to set aspirational targets for companies to achieve over the longer term (at least compared to codes in other Asian markets). This is why the PSE felt the need to introduce a few additional guidelines on corporate governance for listed companies in November 2007 and floated ideas in the latter part of 2009 for a more substantive set of Corporate Governance Guidelines for Listed Companies (due to be published soon). (Note: The SEC Code applies to a wider range of companies than just listed ones.)

Loose conditions for independent directors

This was not the only wasted opportunity on the part of the SEC, which issued a circular in 2009 with very weak restrictions on outgoing executive directors and officers qualifying later as independent directors:

- A regular director who resigns or whose term ends on the day of the election can qualify for nomination and election as an independent director after a two-year cooling-off period; and
- Persons appointed as chairman "emeritus", "ex-officio" directors/officers or members of any executive advisory board, or otherwise appointed in a capacity to assist the board in the performance of its duties and responsibilities can qualify as an independent director after just a one-year cooling-off period.

That said, the Code did allow for the permanent disqualification of any director convicted of a crime. It remains to be seen whether this requirement will be any more than theoretical, given the regulators' poor record in enforcement.

Key personnel at the Exchange associated with reform have left

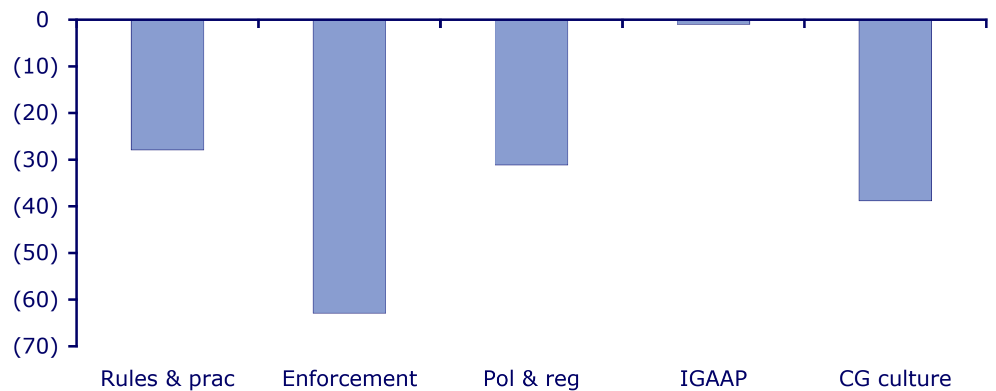
Enforcement

This category also fell by four percentage points - from 19% in 2007 to 15% - due to the inability of regulators to enforce their own rules and extremely weak "private enforcement" by investors and intermediaries. In the past three years, under the Arroyo administration, the efforts by regulators to enforce rules have regressed markedly. The PSE did make some interesting moves in 2009 when it publicly criticised brokers who had breached its rules, and its compliance department was diligent in following up on disclosure of material events (as mentioned in the case of San Miguel). While diligence in following up breaches of rules is commendable, many listed firms in the Philippines ignore the SEC and PSE and continue to flaunt the rules as they regard the regulators as toothless. The Exchange seemed to be improving in 2009, but in early 2010 lost Francis Lim (CEO) and Jonathan Moreno (head of corporate governance), two of its strongest corporate-governance-reform advocates.

Philippines scores lower than the region on most categories in particular enforcement

Figure 79

Philippines: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

SEC not sufficiently resourced

The securities regulator, the SEC, is clearly not sufficiently resourced. Many of its enforcement actions focus on issuing petty fines for technical breaches of filing rules, rather than substantive issues. These fines are a source of funds for the government and form part of the considerable revenue that the SEC passes back to the treasury each year. Yet the SEC still has to go cap-in-hand to the government each year to find sufficient funds to operate. How can the chief securities regulator possibly function effectively in such an environment? In 2009, when it tried to force local brokers to sell down to just 20% ownership of the PSE, a legal requirement dating back many years, the brokers simply slapped a temporary restraining order on the SEC. And the SEC told a forum in Manila early this year that some companies had even ignored its requests to hold general meetings.

PCGG has been compromised

Meanwhile, the Presidential Commission for Good Governance (PCGG), an institution designed to undertake investigations into major corruption scandals, became seriously compromised under the previous administration. The PCGG was regarded in a more positive light several years ago after some high-profile investigations, but has become mired in politics after several of its senior commissioners tried to survive the end of the Arroyo administration. Commentators are doubtful that PCGG could launch an effective and independent investigation into allegations surrounding the former first family in the current environment.

Political and regulatory environment

Too early to tell if new government will give CG a renewed push

This category only slipped by one percentage point to 37% from three years ago but remains markedly worse than all other markets in Asia, with the exception of Indonesia. Corporate governance enjoyed a low priority under the Arroyo administrations, especially during her second term, and it is much too early to tell whether the new Aquino government (elected in May 2010) will offer more substance. Even if it does, meaningful improvement from these low levels will take time.

SEC is more of a cash cow for the government

The standing of the SEC in government is clearly low, while temporary restraining orders and other legal posturing by market participants limit its scope of action. The Commission sometimes seems to be more of a cash cow for the government than a regulator, as it raises revenue through company registration fees, fines for breaches of rules and other things. In its 2009 annual report, it even boasted, 'the SEC managed to meet, and in fact exceeded, its financial commitments to the national government'. It must be the only securities regulator in Asia that would make such a statement.

SEC wholly dependent on annual budget allocation by the government

Unfortunately, the SEC can keep only a small portion of the revenue it raises and is almost wholly dependent on an annual budget allocation, which it has to fight over with the government every year. We understand that it spends a significant amount of its time securing this much-needed, yet ultimately inadequate budget. This is a great shame, since the SEC could become a force to be reckoned with in the Philippine capital markets if it was afforded a proper budget and allowed to use the money it generates to invest in good people, systems and enforcement.

The banking regulator is much more professional

In complete contrast to the SEC, and an indication of what effective local regulation can look like, is the banking regulator and central bank, Bangko Sentral ng Pilipinas (BSP). A highly regarded and independent institution, BSP has focused on improving the governance of banks since the early 2000s and has also managed the nation's finances adeptly despite domestic political uncertainty and international financial crises. Its approach is far more professional and serious than the efforts by the SEC regarding listed companies.

Accounting & auditing (IGAAP)

Score on accounting was held steady

This is the one category where the score held steady at 75% this year. We did find some positives, however, such as:

- Better accounting policies and practices at large companies;
- Introduction of new regulations to strengthen the independence of external auditors; and
- The government is gradually strengthening the regulation of the auditing profession.

Some enforcement seen against CPA firms

Enforcement data show that the SEC's Office of the General Accountant is taking some action against CPA firms. The Commission's 2009 annual report states that it imposed monetary fines on 20 accredited external auditors for violations of the Guidelines on Accreditation and Reportorial Requirements of External Auditors arising from material deficiencies noted in reviews of the financial statements of their clients. And the accreditation of seven external auditors was downgraded for failure to comply with the required level of audit quality as accredited auditors. However, these sanctions appear relatively light.

CG culture

Large decline in score for CG culture

This section suffered the most, plunging from 36% in 2007 to 25% this year, comfortably the lowest score in this category of any of the markets in our survey. The Philippines clearly went backwards over the past few years under the previous administration. Corruption levels appear to have risen, political interference has increased and, with toothless regulators expected to operate on shoestring budgets, it is perhaps not surprising that some large companies have felt little compunction in dismantling the pre-emption rights of their shareholders.

There has also been a lack of enthusiasm so far for a proposal by the PSE to launch a board for better-governed companies - the Maharlika Board - since most companies seem to enjoy the status quo. However, some companies said they had not been properly briefed on the proposal, nor understood the rationale behind some of the new standards proposed. The PSE has since tried to address these concerns.

Investors seem to have thrown in the towel

Investment institutions have also reported unwillingness among companies to engage in real dialogue with their shareholders. For their part, investors seem to have thrown in the towel: foreign ownership of the local market has been in steady decline in the past few years and foreign direct investment is the lowest of any of the markets in our survey.

Some hope from change in government

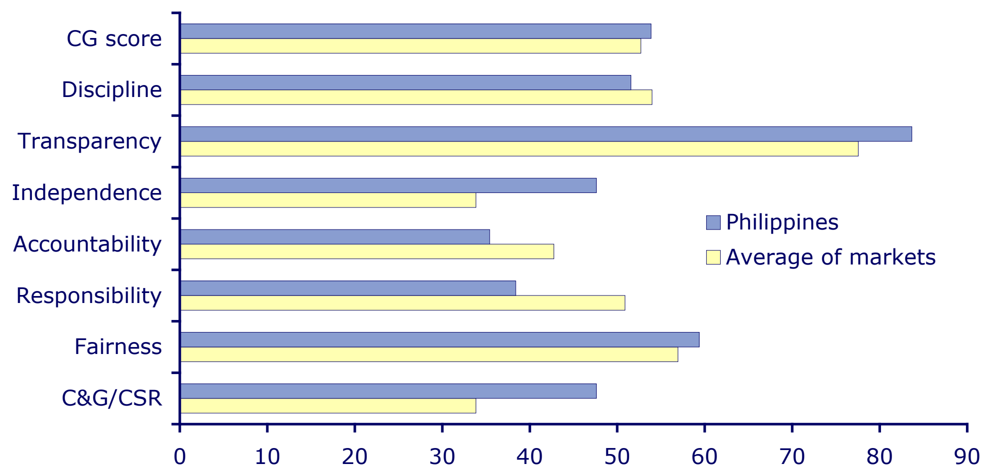
It is difficult to be optimistic about the state of corporate governance in a country that has stagnated politically for so long and whose outgoing administration has been mired in corruption scandals and allegations. Perhaps the best that can be said about the Philippines is that it has a new political administration that wants to eradicate corruption and raise governance standards generally. None of that, however, counts for much in our survey this year. It is to be hoped that the new government can speedily enact the kinds of changes needed to improve in time for our next survey.

CLSA corporate scores

Philippine corporate score in line with regional average but helped by good C&G/CSR score

Figure 80

Philippines corporate scores against regional average



Source: CLSA Asia-Pacific Markets

Philippine firms score better for independence and transparency but weaker on responsibility and accountability

The average CG score of Philippine corporations is just one percentage point higher than our regional average, but this is entirely due to their relatively high scoring on C&G/CSR. Here they scored some 14 percentage points higher than the average, and with the category's 10% weight in the overall score, this gave the average Philippine corporate CG score a boost of just over one percentage point. In the main part of our CG scoring for corporations, we find Philippine companies higher on independence and transparency but weaker on responsibility and accountability. Of the companies, Manila Water, Aboitiz Power and PNOC-EDC have CG scores that are very respectable regionally.

Manila Water, Aboitiz Power and PNOC-EDC have very respectable CG scores regionally

Figure 81

Philippines: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
Manila Water Company	MWC PM	Ayala Land	ALI PM
Ayala Corp	AC PM	ICTSI	ICT PM
Aboitiz Power	AP PM	Manila Electric	MER PM
PNOC-EDC	EDC PM	Philex Mining	PX PM
Globe	GLO PM	SM Prime	SMPH PM
Bank of the Philippine Islands	BPI PM	SM Investments	SM PM

Source: CLSA Asia-Pacific Markets

Singapore - Moved up to pole

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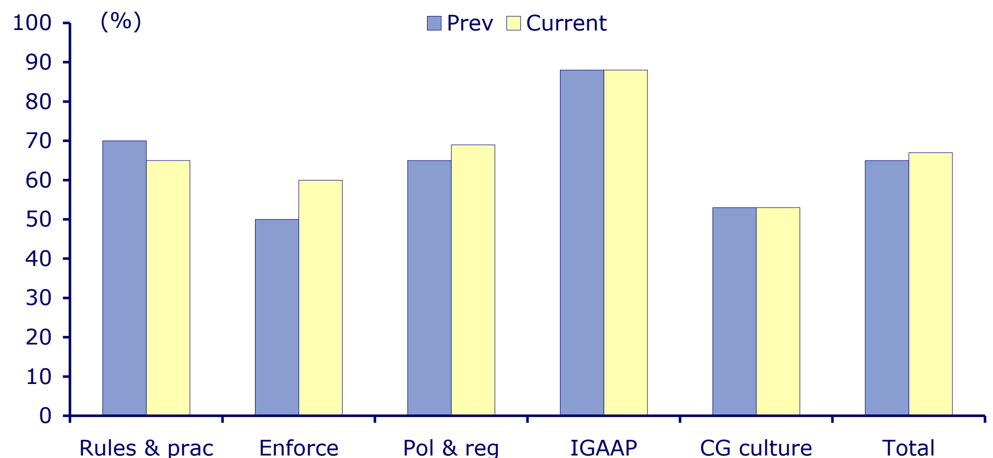
Singapore regained the top spot in *CG Watch* this year, narrowly edging out Hong Kong (which took first place for the first time in 2007). However, Singapore did not achieve this distinction by making huge strides in corporate-governance reform, as reflected in its score improving only two percentage points. Rather, it made incremental progress to its regulatory regime, put renewed emphasis on corporate-governance policy in 2009 and improved enforcement. More significantly, in terms of relative rankings, Singapore gained from Hong Kong's loss of momentum and focus during 2009. Whereas Hong Kong had made progress during 2008, it lost its nerve the following year after local tycoons vociferously berated regulators for trying to extend the blackout period restricting share trading by directors (see the Hong Kong section).

Incremental improvements across most categories

Figure 82

Singapore CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

But absolute score still below 70%, indicating potential improvement

Yet, as we argue in Section 1, the focus of attention should not be confined to a market's relative ranking in *CG Watch* - its total average score is at least as important. From this perspective, neither Singapore nor Hong Kong has a great deal to celebrate. After more than a decade of corporate-governance reform, and despite claiming to follow international standards, neither market exceeds a score of 70%. As financial centres, both markets should be building much stronger corporate-governance regimes. The following analysis highlights areas where Singapore is moving ahead and slipping behind.

CG rules and practices

SGC amended listing rules to enhance disclosure

Over the past two years, Singapore has made a number of improvements to its CG regime and published various consultation papers. In March 2009, the Singapore Exchange (SGX) amended its listing rules to enhance disclosure of changes in capital and the use of proceeds from fund-raising exercises, and tighten rules on the disqualification of directors, among other things. In December 2009, SGX launched the consultation paper "Proposed New Measures and Rule Amendments to Strengthen Corporate Governance Practice". This included suggestions such as requiring an audit committee's assessment of a company's internal controls to be disclosed, the appointment of a governance adviser for newly listed companies, and strengthening regulation governing the role of boards, key executive officers and auditors.

In March 2010, the Monetary Authority of Singapore issued a consultation paper on various enhancements to its corporate-governance framework for locally incorporated banks, financial holding companies and direct insurers.

Various consultation papers have been issued

And since 2007-08, the Singapore government has been engaged in an extensive review of the Companies Act, with a view to strengthening areas such as director duties, shareholder rights and meetings, and accounts and audit. A consultation paper should be published before the end of 2010 (it was originally due in 2009).

But several areas where Singapore is slipping behind global standards

Despite these reforms and proposed reforms, Singapore's score for rules and practices has fallen from 70% in 2007 to 65% this year. This is partly because this section of our survey does not award scores for proposed regulatory change, only reforms that have been enacted. It is also because there are several areas where Singapore regulation and corporate practice is falling behind global standards, including:

Non-financial reporting standards and practices. While basic rules for non-financial reporting are in place, including requirements for management discussion & analysis, report of directors and a CG statement, much of the disclosure that results is formulaic and of limited value to investors (eg, director attendance statistics that may or may not be meaningful; CG statements that dwell on corporate policy more than practice). Moreover, reporting by Singapore-listed companies on new issues such as carbon disclosure is minimal.

Does not require independent director to be independent of controlling shareholders or management

Code of Corporate Governance. The Code was last revised in 2005 and has fallen behind the curve in certain respects, such as the definition of "independent director". Unlike most developed markets in Asia and elsewhere, Singapore does not require independent directors of listed companies to be independent of controlling shareholders as well as management. Its Code only states that an independent director should have 'no relationship with the company, its related companies or its officers'. (In contrast, the Banking Act in Singapore explicitly requires independent directors of banks to be independent of substantial shareholders.)

Number of independent directors. While the Code of Corporate Governance encourages listed companies to have at least one-third of their board made up of independent directors, the listing rule still only requires two. In strict rule terms, this puts Singapore behind Hong Kong, China, India, Korea and Thailand, slightly behind Malaysia and on a par with the Philippines.

AGM meeting notices. The basic rule in Singapore for the release of notices of general meetings is still only 14 days, compared to 20-21 days in several other Asian markets (such as China, Hong Kong and Malaysia), and global practice of 28 days.

Voting by poll is voluntary

Voting by poll. A small number of leading companies in Singapore should be commended for voluntarily voting by poll at their annual general meetings over the past year: Noble Group, Singapore Airlines, Singapore Exchange, Fraser and Neave, Asia-Pacific Breweries, Frasers Commercial Trust, Frasers Centrepoint Trust and SingTel.

This begs the question as to why the more than 600 other listed companies, in particular blue-chip banks and industrial firms, are not yet doing so? Or why the Singapore Exchange, in its capacity as a regulator, is not urging firms to do

so? Voting by poll is becoming standard best practice for the counting of votes at shareholder meetings globally and is the only system fair to all shareholders. It is now mandatory in Hong Kong and a *de facto* practice in Thailand.

Certain shareholder rights suspended following the global financial crisis

A further troubling aspect of Singapore's CG regulatory regime was a decision by the Exchange to roll back certain shareholder rights following the global financial crisis in 2008. These affected protections for minority shareholders in the underwriting of rights issues by substantial shareholders and the level of discount allowed for dilutive private placements. These changes were described as temporary, were justified by the financial crisis and will be reviewed at the end of 2010. While the Exchange said it had consulted the market on these decisions, it appeared that few if any global investors were asked for their views.

Enforcement

A 10ppt increase in score for enforcement, thanks to SGX

One area of definite progress in Singapore since 2007 has been enforcement - reflected in the rise in its score from 50% to 60%. Much of the credit should go to SGX, which has been far more active in enforcing its rules since the global financial crisis than before, and in disclosing the results, as a glance down its list of press releases will show.

In response to a false-accounting disclosure crisis in late 2008 and early 2009 among some Singapore-listed China stocks (S chips), the Exchange initiated an exercise to strengthen oversight of these firms and instructed auditors to conduct a detailed examination of bank balances. Auditors found no adverse findings at 80% of these companies.

SGX stopped a delisting proposal it deemed unfair

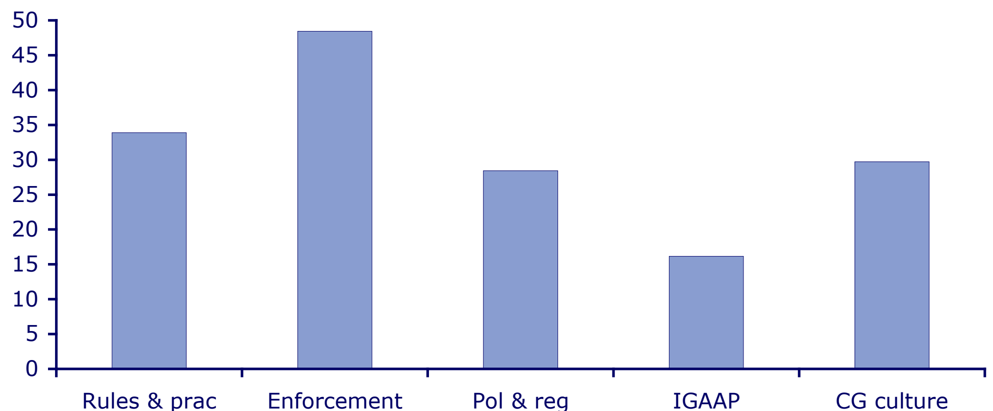
SGX has also taken a tougher line on voluntary privatisations. In August 2009 it forced Kingboard Chemical of Hong Kong to cancel plans to delist and privatise its Singapore-listed subsidiary, Elec & Eltek, because it considered that the terms offered to minority shareholders were 'neither fair nor reasonable under current market conditions', according to a Kingboard announcement at the time.

And in early 2010, the Exchange took the unusual step of announcing the names of 10 former directors of six listed companies in Singapore who had breached listing regulations and were not eligible to act as directors of listed companies without its prior permission.

Singapore's score on enforcement significantly higher than the regional average

Figure 83

Singapore: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Greater efforts in private enforcement

The higher score for enforcement in *CG Watch 2010* also reflects greater efforts being made by investors to "privately enforce" their rights. On two occasions since early 2009 minority shareholders have defeated company proposals to delist from the Exchange. In late February 2009, minority shareholders stopped Full-Apex, a Singapore-listed Chinese manufacturer of plastic bottles, from delisting. The following September more than 10% of the shareholders of Tsit Wing International prevented its privatisation.

Institutional investors are also gradually becoming more engaged in Singapore, both in terms of voting their shares and engaging with companies. Meanwhile, minority shareholders have sought to nominate independent directors to boards on several occasions over the past three years. Despite failing in their efforts, minorities in Singapore are more active in this regard than their counterparts in most other Asian markets.

Political and regulatory environment

Reforms initiated by SGX and MAS allow for higher score on political and regulatory environment

Singapore's score in this category increased from 65% in 2007 to 69% this year, in part due to the efforts made by the government, MAS and SGX over the past two years to either initiate or enact reforms (as described above). A further factor was the improvement in the SGX website, which now offers better organisation of and easier access to rules, regulations, company announcements, SGX press releases (and enforcement work) and other documents. While it still lacks the archival value of exchange websites in Hong Kong, Malaysia and several other markets, it is a much more useful site than three years ago.

CG Council being set up

One other new initiative worth highlighting is the new Corporate Governance Council, which was announced in November 2009 and is tasked with revising the Code of Corporate Governance. The Council comprises members from both listed companies and stakeholder groups (although it is heavily issuer-centric and has only one institutional and one retail shareholder representative).

Accounting and auditing

Accounting and auditing score unchanged, highest in the region owing to quality of audit regulation

The score here remains unchanged from 2007 and at 88% is the highest in the region. This is less due to the fact that Singapore's accounting and auditing standards are close to international level, as other markets score highly on these questions as well. Rather, it is due to the quality of audit regulation in Singapore and the active work of the Accounting and Corporate Regulatory Authority (ACRA), which is independent of the CPA industry it is regulating. ACRA issued an enhanced Code of Professional Conduct and Ethics that took effect on 1 August 2009 and regularly publishes reviews of audit quality in Singapore through its practice-monitoring programme. It is one of the strongest and most independent audit regulators in the region and is a member of the International Forum of Independent Audit Regulators (IFIAR) - a body that Hong Kong, for one, is not able to join because it lacks an independent audit regulator.

CG culture

Most companies resist voluntary change

Our score in this category also remains unchanged at 53%. While a few listed companies are showing willingness to engage with their shareholders and run more transparent meetings, the vast majority resist voluntary change and will act only when the regulator tells them to. This mindset means that relatively easy reforms, such as voting by poll, are much harder to bring about than they should be.

Scores pulled up by C&G/CSR as well as independence and transparency

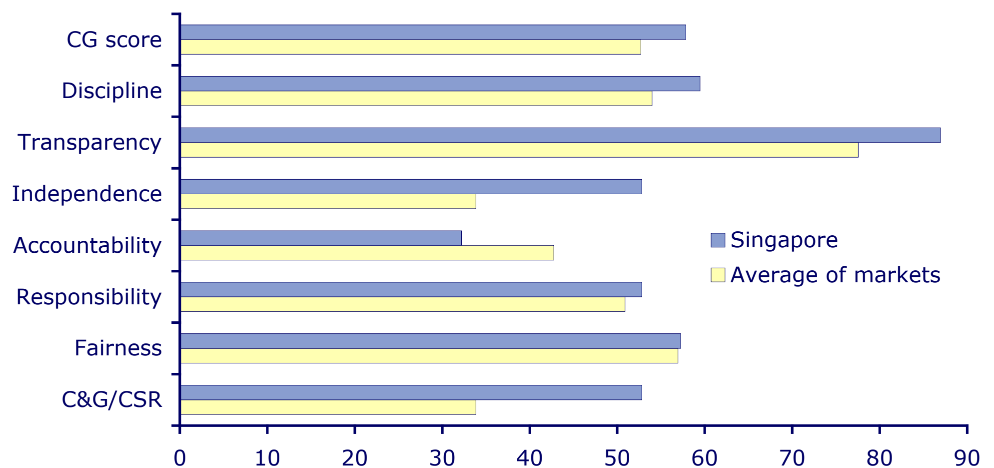
CLSA corporate scores

The average CG score of 57.8 for Singapore is one of the highest regionally. This is partly helped by Singaporean corporations getting an average of 52.8 for C&G/CSR, the highest in the region. The Singaporean score for this category is 19 percentage points. With a 10% weight in the overall score, this helps lift the overall Singaporean corporate score on CG by almost two percentage points. Other areas where Singaporean companies score generally higher than the regional average are independence and transparency but they are lower than the regional average on accountability (the number of independent directors, whether the audit committee nominates external auditors, voting by poll, etc.)

Singaporean corporate score on CG is five percentage points higher than regional average

Figure 84

Singapore corporate scores against regional average



Reits in Singapore have high CG standards regulated on them

Figure 85

Singapore: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
CapitaMalls Asia	CMA SP	CapitaCommercial Trust	CCT SP
OCBC	OCBC SP	ComfortDelGro	CD SP
CapitaMall Trust	CT SP	United Overseas Bank	UOB SP
Capitaland	CAPL SP	SMRT	MRT SP
FCT	FCT SP	K-Reit Asia	KREIT SP
SembCorp Industries	SCI SP	Singapore Exchange	SGX SP
Singapore Telecom	ST SP	ST Engineering	STE SP
MobileOne	M1 SP	Golden Agri	GGR SP
City Developments	CIT SP		

Source: CLSA Asia-Pacific Markets

Singapore's CapitaLand and other Reits score well. OCBC, Fraser Centrepoint Trust (FCT) and SembCorp Industries also got good scores compared with the region. Regulations on the Reits impose high governance standards.

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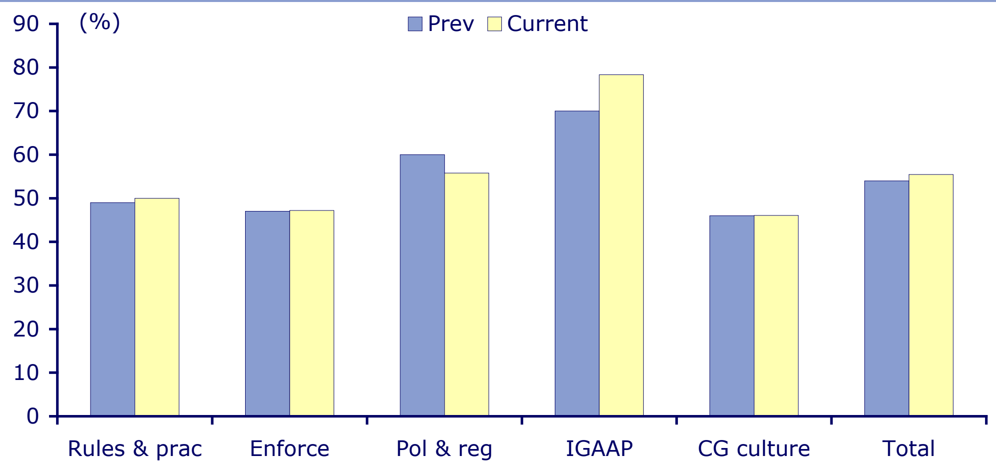
Taiwan - In a holding pattern

Taiwan's corporate-governance regime over the past two to three years has largely been caught in a holding pattern, as reflected in it maintaining its fourth position in our survey and with a similar score as in 2007 - 55% this year compared to 54% previously. This does not mean that nothing has changed in Taiwan: some new regulations have been introduced; leading companies are slowly warming to the concept of more transparent shareholder meetings; and improvements are evident in accounting and auditing. But, on balance, its reform drive has lost some momentum and regulators are having difficulty pushing legislative amendments through the island's tricky parliamentary system.

Score for accounting standards saw the biggest improvement

Figure 86

Taiwan CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

CG rules and practices

CG rules falling behind international best practices

Taiwan's score remained basically the same in this category - 50% compared to 49% in 2007. While several regulatory amendments have been made over the past three years, these have tended to be piecemeal and only partially address the issues at hand. A second factor is that some of Taiwan's corporate-governance rules are falling behind international best practices and we are marking scores down in all markets where this is the case.

Piecemeal reform

The best example of piecemeal reform is in the area of shareholder meetings and proxy voting. Regulators have tightened rules on the deadline for releasing final AGM agendas and "handbooks" (the detailed background material for the meeting) - it now stands at 21 days - and are quite permissive in allowing shareholders to nominate directors. Yet the overall mechanics for meetings are often confusing and complicated, with the result that voting is considerably more difficult than it should be. We believe this undermines the integrity of Taiwan's capital market. For example:

- Candidates for election as directors can be nominated at the last moment in a contested election (and shareholders can even nominate themselves). This means that the final list of nominees may not be complete prior to a meeting.
- Foreign institutional investors can solicit proxy votes from other shareholders (eg, in a contested election), but cannot give them. This effectively means that foreign shareholders cannot solicit from other foreign shareholders, only from domestic ones (which greatly limits the scope for any proxy contest).

- Taiwan still does not allow "split voting", hence votes of cross-border investors are often invalidated. (Note: An amendment to the company law to allow split voting has been languishing in Parliament for some time.)

Ballots held for election of directors/supervisors but not for other resolutions

While ballots are held for the election of directors and supervisors (ie, votes are counted), the same is not true for other resolutions. Hence, there is no full voting by poll or full publication of detailed voting results on each resolution.

Examples of the second issue - rules that are falling behind global and regional best practice - include such things as:

- Disclosure of substantial ownership stakes only kicks in at 10% for the average listed company (versus 5% for most other markets in Asia). While the Financial Supervisory Commission (FSC), the peak regulator, now asks for disclosure in annual reports of all shareholders with stakes of 5% or more, this fails to inform the market promptly. The FSC also now requires all stakes of 5% and above in a financial holding company to be disclosed.

Independent directors are mandatory for newly listed companies but not for those already listed

- Independent directors are mandatory for newly listed companies, but not all listed firms. Consequently, only 288 listed companies out of a total of 741 had independent directors, as of March 2010.
- Audit committees are not mandatory. Companies can continue to choose between them and supervisors. While the role of supervisors is somewhat similar on paper to an audit committee, this does not often seem to be the case in practice.

Rules have improved in certain areas including consolidated quarterly reporting

Areas where rules and guidelines have improved include the introduction in 2008 of consolidated quarterly reporting, new rules from December 2009 on the disclosure of remuneration for directors and supervisors in annual reports, and a new set of Corporate Social Responsibility Best Practice Principles from the Taiwan Stock Exchange (TWSE) and the GreTai Securities Market (GTSM) in February 2010.

Meanwhile, in October 2009 the FSC amended the Corporate Governance Best-Practice Principles for Securities Investment Trust (SITE) and Securities Investment Consulting Enterprises (SICEs), which required these intermediaries to disclose information regarding the remuneration of directors, supervisors and general managers.

Enforcement

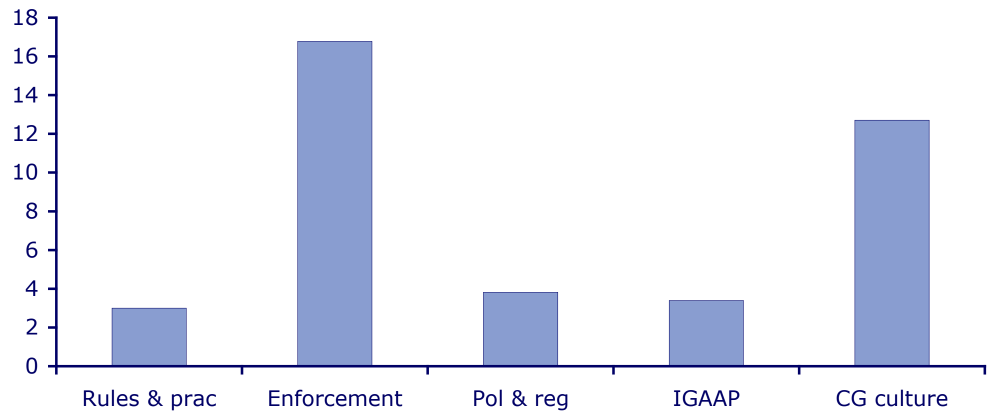
Enforcement score is unchanged . . .

The score for enforcement - 47% - remains unchanged from 2007. Following a clear improvement over 2005-07, regulatory enforcement efforts have stayed largely steady since then (although securities regulators seem somewhat less enthusiastic than previously). Disclosure of enforcement activity is mixed, with the FSC providing more information than the TWSE. FSC data show that much of the recent effort has been on the banking sector (including financial fraud), as opposed to the securities and insurance markets. Its banking bureau, for example, has recorded many more penalty cases since early 2009 than its securities and insurance bureaus (although the situation was reversed in 2008). Meanwhile, little information is available on enforcement against insider trading or market manipulation, although there have been a number of cases of short-swing profit disgorgement (ie, forcing insiders to give back profits made on share trading over a six-month period).

. . . but above the regional average

Figure 87

Taiwan: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

SFIPC undertakes law suits against directors on behalf of small investors

One area where data show an upward trend is in the number of cases that the FSC and its Securities and Futures Bureau pass on each year to the Securities and Futures Investor Protection Centre (SFIPC), an agency that undertakes law suits against directors and others on behalf of small investors, among other activities. In 2008, the FSC asked the SFIPC to represent 70,201 investors in 34 class-action suits against accountants, underwriters, board directors and public companies that engaged in illegal activities. In 2009, this figure rose to 80,054 investors in 108 class-action suits.

Private enforcement is becoming more interesting

"Private enforcement" is also gradually becoming more interesting in Taiwan, with foreign institutional investors voting their shares quite actively and starting to engage with companies. One asset manager, PGGM Investments of the Netherlands (and an ACGA member), has been attending AGMs in Taiwan over the past two years and speaking on behalf of itself and a number of other global institutions. Other investors that have regularly been voting their shares include several overseas pension and sovereign wealth funds, as well as a domestic public pension fund. Domestic mutual funds, on the other hand, generally do not vote actively.

Loss of momentum in reform process

Political and regulatory environment

Taiwan's score dipped by four percentage points in this category - from 60% in 2007 to 56% this year - because we believe there has been a loss of momentum and focus in the reform process. While financial regulators have continued to make rule changes, much of this work is somewhat fragmented and lacks an overall organising strategy. Why have the regulators not been able to develop a more systematic approach to the issue of shareholder meetings and voting? Changes made to date have been positive, but fail to address core issues (as noted above). And why enhance disclosure in one area, but not another? For example, why require the threshold for substantial share ownership to be 5% for financial holding companies, but 10% for listed companies in general? Often the logic of corporate-governance reform in Taiwan is not entirely clear.

Head of FSC has changed three times since 2008

Financial regulators also operate in a challenging political environment. The head of the FSC changed three times since 2008. Regulators must negotiate with the government for their budgetary allocation. They do not enjoy a dedicated income from a levy on the stockmarket like their counterparts in

some other Asian markets. And the passage of legislative amendments through the Legislative Yuan, the parliament, can be tortuous, as the long wait for split voting testifies.

Time-consuming to find documents

Another challenge in Taiwan is the presentation of securities laws and regulations. While all major rules are translated and available on a legal website, the chronological organisation of the files on the site often makes it time-consuming to find particular documents. Laws and regulations rarely have contents pages, clear divisions between sections, or indexes. Hence, it is often necessary to read entire documents to find a specific rule. The contrast with the organisation and online dissemination of regulations in markets such as Hong Kong, Japan and Malaysia, to name just a few places, is stark.

Accounting and auditing (IGAAP)

Accounting standards are converging with IFRS, and Taiwan has an audit regulator who is independent of the profession

This is the category where Taiwan improved the most over the past three years, with its score moving up eight percentage points to 78%. Although Taiwan will not become fully compliant with IFRS until 2013 for listed companies, its accounting standards have been steadily converging. A second area of progress, according to local auditors, has been in the quality of account preparation and auditing among small- and medium-sized companies. A third can be seen in various regulatory changes, including new rules on the disclosure of consolidated accounts and of audit and non-audit fees paid to the external auditor. And lastly, Taiwan is strengthening regulation of the audit industry. It is one of about half a dozen jurisdictions in Asia where its ultimate audit regulator, the FSC, is independent of the profession. As such, it has been able to join IFIAR.

CG culture

Little change in CG culture overall

No change occurred in Taiwan's score of 46% for corporate-governance culture. While some companies are making tangible efforts to improve their dialogue with shareholders, we see little change overall from 2007. One leading firm, TSMC, should be commended for voluntarily voting by poll at its AGM in June 2010 - the first Taiwanese company to do so. And a second, Acer, should be recognised for voluntarily publishing detailed results of all shareholder votes received by proxy for its AGMs in 2009 and 2010. Some other firms are also showing interest in enhancing the transparency of their shareholder meetings.

Two more organisations doing valuable work are the Taiwan Depository and Clearing Company (TDCC) and the Taiwan Corporate Governance Association (TCGA). TDCC is a government agency that is developing an electronic voting platform for investors, called StockVote. And TCGA is a non-profit organisation that engages in corporate-governance training, assessments and awareness-raising. While it is still early days, the level of interest in corporate governance in Taiwan is growing.

CLSA corporate scores

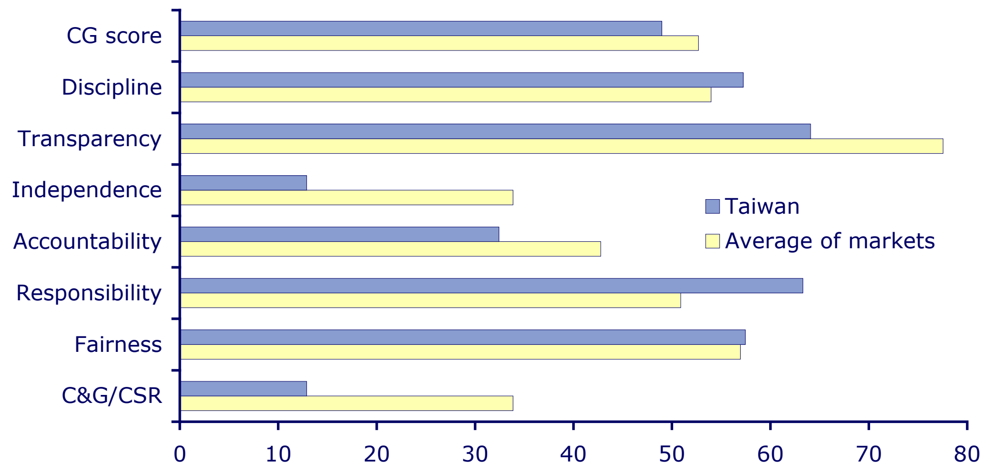
Overall score pulled up by C&G/CSR as well as independence and transparency scores

Taiwanese corporations score poorly on independence (whether the chairman is independent, composition of board committees, etc) as well as on transparency and C&G/CSR. Their scores, are however, above regional average for responsibility (related-party transactions, whether controlling shareholders main financial interest in the listed company, etc). TSMC is among the best performers by our corporate ranking regionally and is seven percentage points clear of the next in Taiwan. The other companies in the first quartile in the market score only slightly better than the regional average.

Taiwanese corporate CG score almost four points below regional average

Figure 88

Taiwan corporate scores against regional average



TSMC is clearly ahead of other companies in Taiwan in terms of CG

Figure 89

Taiwan: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
Taiwan Semiconductor (TSMC)	2330 TT	Asustek Computer	2357 TT
Young Fast Optoelectronics	3622 TT	Giant Manufacturing	9921 TT
Richtek	6286 TT	Cathay Financial	2882 TT
Vanguard	5347 TT	Novatek Microelectronics	3034 TT
China Steel	2002 TT	FATC	8131 TT
Lite-On Technology	2301 TT	Alpha Networks	3380 TT
Chroma	2360 TT	HTC	2498 TT
Greatek	2441 TT	Advantech	2395 TT
AUO	2409 TT	Catcher Tech	2474 TT
Quanta	2382 TT	Mirle Automation	2464 TT
WPG	3702 TT	Chunghwa Telecom	2412 TT
Acer	2353 TT	Advanced Semiconductor	2311 TT
Siliconware Precision	2325 TT	Formosa Chemicals and Fibre	1326 TT
Compal Electronics	2324 TT	Unimicron	3037 TT
Realtek	2379 TT	E.Sun Financial	2884 TT
E Ink	8069 TT	Taiwan Mobile	3045 TT
United Microelectronics	2303 TT	Epistar	2448 TT

Source: CLSA Asia-Pacific Markets

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Thailand - Leap in ranking

Thailand surprises in *CG Watch 2010*, leapfrogging from eighth position three years ago to equal fourth with Taiwan this year, with the overall score rising eight percentage points to 55%. Despite the political uncertainty during the past four years since the coup that ousted former Prime Minister Thaksin Shinawatra in September 2006, financial regulators have managed to keep up the pressure for better corporate-governance practices and listed companies have been willing to adopt certain of them voluntarily (albeit with some encouragement from regulators).

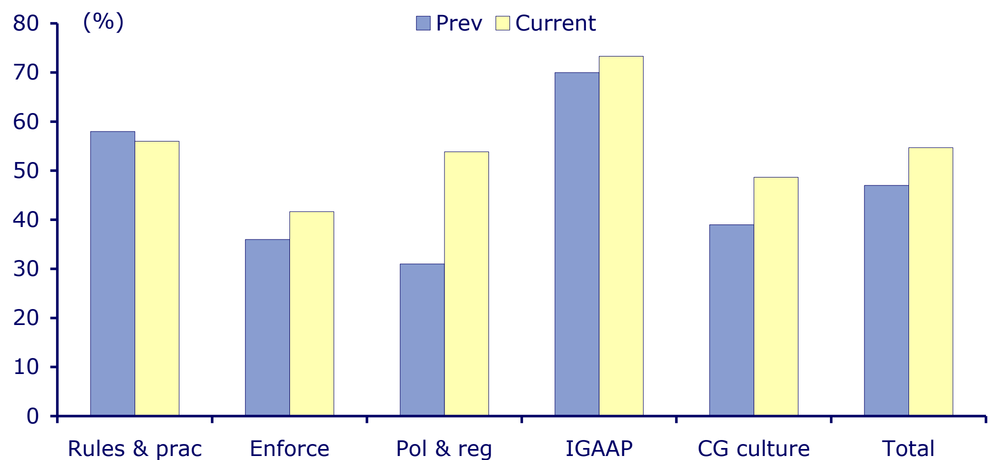
Score for political and regulatory environment saw biggest improvement

Scores in four of the five macro categories in this survey have been upgraded for Thailand, with the rating for political and regulatory environment increasing the most - an impressive 23 percentage points. This might appear counter-intuitive given the ongoing stalemate between Thailand's opposing political factions, but was in large part due to the significant efforts made by the Securities and Exchange Commission (SEC) and the Stock Exchange of Thailand (SET) to improve governance standards in the stockmarket. Both the SEC and the SET told us that they analysed in detail the findings from *CG Watch 2007* and tried to address key areas where they had been marked down. Although the absolute score for Thailand indicates that it still has some way to go in developing its corporate-governance system, the progress made since 2007 represents a meaningful and refreshing step forward.

Huge progress in score for political and regulatory environment

Figure 90

Thailand CG macro category scores - Current compared to 2007



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

CG rules and practices

Minor decline in score for rules and practices owing to stricter scoring

Thailand's score in this category slipped slightly from 58% in 2007 to 56%, largely because the tougher line we are taking on various questions, including the quality of financial and non-financial reporting, cancelled out any higher scores from positive improvements. (But the enhanced regulatory efforts are recognised in other categories, particularly political and regulatory environment.)

Several new SEC regulations since 2007

Positive developments in CG rules and practices include several new SEC regulations since *CG Watch 2007*. These regulations emanate from the Capital Market Development Committee, which was effectively reappointed by Prime Minister Abhisit Vejjajiva and whose role is to devise and execute a master plan for the Thai capital markets. Several notable amendments to the Securities and Exchange Act have emerged from this initiative, including:

- Stronger protections for investor interests (especially minority interests);
- A clearer scope of duties and liabilities for directors of listed companies (including an improved definition of "independent non-executive director");
- Regulations that describe "unworthy characteristics" in directors and executives that would prevent them from sitting on a board;
- Tighter definitions of associates and concert parties of controlling shareholders; and
- New rules relating to the protection of whistleblowers.

Thailand is excelling on voting by poll, which debunks myth that it is too difficult to implement

One area where Thailand is excelling, and earned higher scores this year, is in voting by poll. Even though poll voting is not strictly mandatory, virtually every listed company votes by poll at general meetings. Thai listed companies have been encouraged by the regulators and NGOs such as Thai Investors Association (TIA) and the Thai Institute of Directors (TIOD) to vote by poll. Retail investors who attend AGMs on behalf of TIA have been instructed on how to ask questions and ask for a vote by poll. All votes - for, against, abstentions - are counted and often announced immediately at the general meeting (if electronic voting is employed, which is increasingly the case). Full results are published the next business day on the SET website, a requirement that is strictly monitored by the SEC. This is a remarkable achievement, particularly in light of the slow pace of voting by poll in most other Asian markets and the fact that few would have expected Thailand to take a lead in this area. Thailand's initiative, a laudable collaboration between regulators and market participants, also comprehensively debunks the myth prevalent in many other Asian markets that voting by poll is somehow too difficult and/or expensive to implement.

But gap in quality of reporting practices between larger and smaller companies

Areas of ongoing weakness, meanwhile, include a gap in the quality of financial and non-financial reporting practices between Thailand's large listed companies - SET 50 or SET 100 - and small- and medium-sized firms. Standards of financial and non-financial reporting (as opposed to practices) are also an issue. While some disclosure rules have become more stringent since 2007, Thai accounting standards are still not fully compliant with IFRS (see Accounting and Auditing section below) although there is a clear plan to become fully compliant within three years.

Lack of credible deterrent against insider trading and market manipulation

Another challenge is the lack of a credible regulatory deterrent against insider trading and market manipulation, and lax rules on the release of detailed AGM agendas. Regulations stipulate notice periods of only seven days for general meetings and 14 days for meetings with special business (whereas global best practice is 28 days). Market practice, however, is better than the rules would imply: more than 50% of Thailand-listed companies post detailed agenda on their websites 30 days prior to meetings, according to the AGM Assessment Project undertaken by the TIA and the SEC. For this reason, we have not marked Thailand down on this question as much as we otherwise would have.

Enforcement

Enhanced shareholder activity boosts enforcement score

Enforcement is improving slowly in Thailand, as reflected in the increase in its score in this category from 36% in 2007 to 42% this year. However, it is important to note that this was mostly due to enhanced shareholder, rather than regulatory activity. And in our opinion, regulatory enforcement remains something of an Achilles' heel for Thailand, especially in the area of insider trading and market manipulation. This is a weakness that needs to be addressed if the country is to improve its score meaningfully in future surveys.

Regulators lack powers to pursue criminal cases

We rated regulators more highly on whether they are trying to enforce rules, but downgraded them on whether they have been investing more resources in investigation and enforcement, disclosing detailed information on their enforcement track records, and enjoying success in prosecuting serious criminal cases. It is generally admitted that regulators in Thailand are hamstrung by a complex legal system and lack the statutory powers to pursue offenders. Indeed, many investors believe that there has been no real action against insider dealing; and even official statistics on enforcement show a decline in insider-trading cases.

Investors who are members of AIMC obliged to vote at AGMs

Shareholder voting and engagement, in contrast, is becoming more interesting in Thailand, albeit with the help of new rules and official support. For example, both domestic and foreign institutional investors who are members of the Association of Investment Management Companies (AIMC) are now obliged by the SEC to vote at AGMs. And under SEC/AIMC rules, they are also required to attend annual meetings and vote against resolutions that breach AIMC voting policy.

TIA, funded by SEC, participated in AGMs as well

At the retail level, TIA, which is also funded by the SEC, participates actively in AGMs - they attend every general meeting held by SET-listed companies - and, as noted above, carries out an assessment of the conduct of annual meetings. TIA also encourages retail shareholders to attend, ask pertinent questions and vote.

While there may be limits to how effective officially sanctioned shareholder activism can be in any country, so far the efforts in Thailand seem to be beneficial to the market

Political and regulatory environment

Score on political and regulatory environment slid during Thaksin's regime, now back up

Thailand's score in this category rose from 31% in 2007 to 54% this year, a very large increase but one that basically brings our rating back to where it was in 2005 (when we marked the country's political and regulatory environment at 50%). The score fell drastically in 2007, mostly because of the negative impact that the Thaksin regime had on corporate-governance policy in Thailand. It has risen again this year in recognition of the efforts being made by financial regulators under a new and more accountable administration. This is not to say, of course, that the overarching political situation in Thailand shows any signs of resolution: no one we spoke to in Thailand believes that is going to happen anytime soon. Rather, Thailand's regulatory environment is improving in spite of the political problems.

SEC improved governance oversight and has amended listing rules

The SEC has improved governance oversight through the Capital Market Development Plan (CMDP), while the SET has amended its listing rules. The CMDP encompasses eight key reform measures including:

- Ending the SET monopoly. A proposal to demutualise the SET is already in parliament.
- Proposals to liberalise the securities industry and improve standards of governance and conduct.
- Plans to reform the legal framework to introduce civil penalties and class action, to improve the tax system for the capital markets and introduce new financial products.
- The establishment of a national savings fund to include Thais not already covered by existing saving systems.

- Encouraging and promoting a savings and investments culture and the development of a domestic bond market.

Thailand has also joined IOSCO

Since *CG Watch 2007*, Thailand has become a signatory to the Multilateral Memorandum of Understanding of the International Organisation of Securities Commissions (IOSCO), an initiative that aims to improve cross-border enforcement and the exchange of information among international securities regulators.

Enjoys an effective banking regulator

Thailand's score also improved by virtue of a new question in our survey with respect to the effectiveness of the central bank in regulating local banks. Thailand has a widely acknowledged and effective banking regulator that operates largely free of political interference and that has made significant progress in improving transparency and accountability among local lenders. Scores for judicial independence as well as media also rose.

Accounting and auditing (IGAAP)

Scores in this section have mostly not moved since 2007 and the only reason for the three-percentage-point increase - from 70% to 73% - is a new question on whether the audit regulator exercises effective disciplinary control over the audit profession.

Continuing differences between Thai GAAP and IFRS

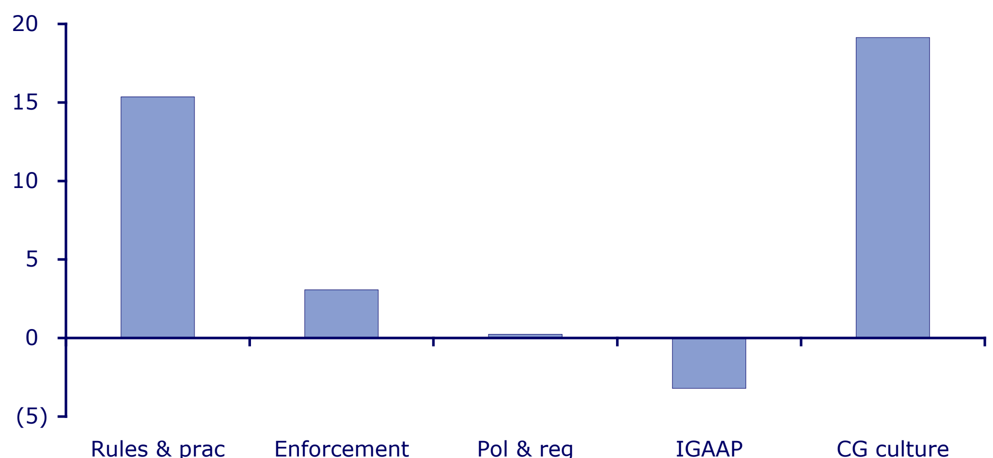
The reason why other scores have not changed is due to the continuing differences between Thai GAAP and IFRS, mainly concerning treatment for asset impairment. Furthermore, regulators have stated that they are only aiming for full compliance by 2013, although the majority of Thai Accounting Standards will be in line with IFRS by 2011. That said, it should be noted that many Thai listed companies are already reporting using IFRS standards, especially those with listings in key Western markets.

CG culture

Above regional average on CG culture as well as on rules and practices

Figure 91

Thailand: Deviation of CG macro category scores from regional average



Source: Asian Corporate Governance Association, CLSA Asia-Pacific Markets

Thailand scored 49% in this category, a marked increase from the 39% it received in 2007, because we felt that a real effort had been made by both companies and the investment community to improve corporate-governance practices. Most of the questions here scored higher, except for two: whether SMEs were actively trying to improve their dialogue and communication with

Genuine effort by companies and investment community to improve CG practices

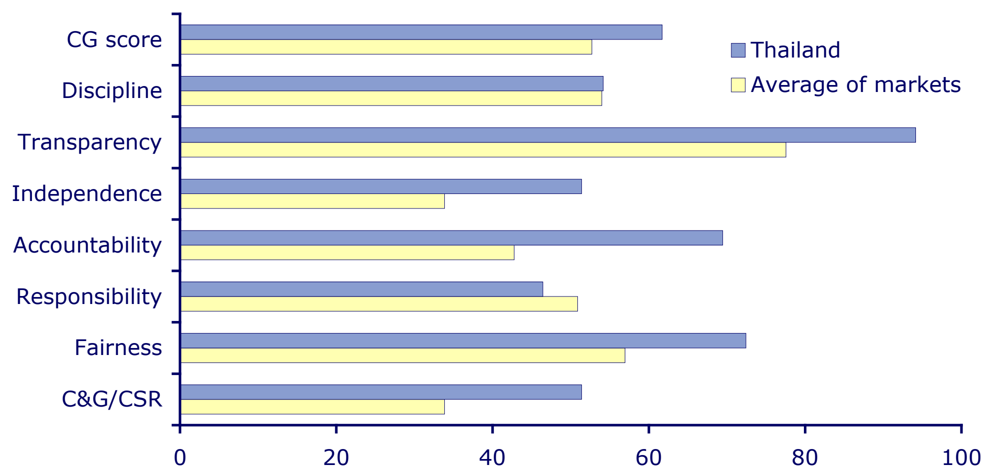
their shareholders; and whether professional associations and academic organisations were carrying out original research on local CG practices. There is clearly a widening gap between the governance standards of larger Thai companies and those of smaller listed firms (where regulators and practitioners freely admit there remains much room for improvement); perhaps something for Thailand to work on in time for the next *CG Watch*?

CLSA corporate scores

Thai companies in our sample score nine points higher than the region

Figure 92

Thailand corporate scores against regional average



Source: CLSA Asia-Pacific Markets

Our sample of corporations for Thailand is not large at 18, but on average they score the highest of the other countries and nine percentage points above the regional average, given the top-down push from the regulator on CG standards. In particular, we find the Thai corporations scoring very well on accountability but also transparency, independence, fairness and the new C&G/CSR category. The banks are particularly impressive. Kasikornbank and Bank of Ayudhya have scores that are among the highest in the region. Also with good scores are Siam Commercial and Bangkok Bank.

Banks have the highest CG with Kasikornbank and Bank of Ayudhya getting very high scores even compared regionally

Figure 93

Thailand: Companies in top-two CG quartiles

Top quartile	Code	Second quartile	Code
Kasikornbank	KBANK TB	The Siam Cement	SCC TB
Bank of Ayudhya	BAY TB	Banpu	BANPU TB
Siam Commercial Bank	SCB TB	Electricity Generating	EGCO TB
Bangkok Bank	BBL TB	Land and Houses	LH TB
BEC World	BEC TB		

Source: CLSA Asia-Pacific Markets

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Appendix 1: About ACGA

The Asian Corporate Governance Association (ACGA) is a non-profit, membership association dedicated to promoting substantive improvements in corporate governance in Asia through independent research, advocacy and education. ACGA engages in a constructive dialogue with regulators, institutional investors and listed companies on key corporate governance issues and works towards making improvements.

- For more details on ACGA's activities and a database of information on corporate governance in Asia, see our website: www.acga-asia.org

Membership network

ACGA is funded by a membership base of more than 80 highly regarded organisations based in Asia and other parts of the world, including:

- Several of the world's largest asset owners and managers. ACGA investor members manage more than US$10 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.

Note: CLSA Asia-Pacific Markets is a founding corporate sponsor of ACGA.

- For a full list of ACGA's members, see the "Members" page on our website: www.acga-asia.org

Governing council

ACGA is governed by a Council elected from among its membership:

1. Ambassador Linda Tsao Yang: Former Independent Director, Bank of China (HK)
2. Douglas Henck: Former President, Sun Life Financial Asia
3. Peter Bowie: Former Senior Partner, Deloitte China
4. Linda Csellak: Head, Asia Pacific Equities, MFC Global Investment Management
5. Shasi Gangadharan: Vice President, Chubb Insurance, Asia Pacific
6. Veronica John: CEO, IDFC Capital, Singapore
7. Robert Morrison: Former Chairman and CEO, CLSA Asia Pacific Markets
8. Anthony Muh: Founder and CEO, Clearpool Capital, Hong Kong
9. Stan Shih: Co-founder, Acer Group; & Group Chairman, iD SoftCapital, Taiwan
10. Pote Videt: Managing Director, Lombard Investments, Thailand
11. Steven Watson: Senior Vice President, Capital Research, Hong Kong

Appendix 2: ACGA/CLSA market-ranking survey

Evaluation of Asian markets on corporate governance norms

I.	**CG rules and practices**	**CH**	**HK**	**IN**	**ID**	**JP**	**KR**	**MY**	**PH**	**SP**	**TW**	**TH**
1.	Do financial reporting standards compare favourably against international standards? (eg, frequency and timeliness of reporting; international accounting standards; continuous disclosure rules; and so on)	L	L	L	L	L	L	L	L	Y	L	L
2.	Do financial reporting practices among large listed companies* compare favourably against international best practices? (*main index)	L	L	L	S	L	L	L	S	Y	L	L
3.	Do financial reporting practices among small- and medium-sized listed companies compare favourably against international best practices?	S	S	M	M	S	L	S	M	S	L	M
4.	Do non-financial reporting standards compare favourably to international standards? (ie, the MD&A, Report of Directors, corporate governance statements, CSR/ESG or sustainability reports, carbon disclosure)	S	L	L	S	L	S	S	L	L	L	S
5.	Do non-financial reporting practices among large listed companies* compare favourably to international best practices? (*main index)	S	L	L	S	L	M	M	S	S	S	L
6.	Do non-financial reporting practices among small- and medium-sized listed companies compare favourably to international best practices?	M	S	M	M	S	M	N	M	M	S	M
7.	Do large listed companies report their audited annual financial results within two months or 60 days?	N	M	L	S	S	S	N	N	Y	M	Y
8.	Do small- and medium-sized listed companies report their audited annual results within two months or 60 days?	M	N	M	S	S	S	N	N	Y	N	Y
9.	Is quarterly reporting mandatory, is it consolidated and does it provide adequate and credible P&L, cash flow and balance sheet data?	Y	N	S	Y	Y	L	Y	Y	Y	Y	Y
10.	Do securities laws require disclosure of ownership stakes of 5% and above (ie, when an investor becomes a substantial shareholder)?	Y	Y	Y	S	Y	Y	Y	Y	Y	N	Y
11.	Do securities laws require disclosure of share transactions by directors and controlling shareholders within 3 working days?	S	Y	L	M	N	L	Y	N	Y	S	Y
12.	Does the regulatory regime ensure adequate and prompt disclosure of price-sensitive material events and transactions? (ie, sufficient information to allow informed minority investors to assess the risk to themselves of these transactions)	L	S	S	M	S	S	S	N	L	S	S
13.	Does the regulatory regime ensure adequate and timely disclosure of related-party transactions (continuing, small, and large transactions)?	S	L	N	M	L	S	L	N	L	S	M
14.	Do securities laws provide a credible deterrent against insider trading and market manipulation?	N	S	N	N	M	M	N	N	L	M	N
15.	Are class-action lawsuits permitted and undertaken?	M	N	M	M	N	M	N	N	N	L	N
16.	Is voting by poll mandatory for resolutions at AGMs?	N	Y	N	N	S	N	N	N	N	M	L
17.	Is there a national code (or codes) of best practice based on international CG standards?	S	L	L	S	N	L	L	M	L	S	L
18.	Is there a clear and robust definition of "independent director" in the code or listing rules? (ie, one that says independent directors should be independent of both management and the controlling shareholder; which does not make it easy for former employees and former/current professional advisors to become independent directors; and which produces genuinely independent directors)	S	S	S	S	N	S	L	M	M	S	S
19.	Must companies disclose the exact remuneration of individual directors and senior executives (top 5) by name (or do they)?	S	Y	L	N	M	N	S	M	S	S	S
20.	Are audit committees (or an equivalent) mandatory and implemented?	Y	Y	Y	Y	M	Y	Y	Y	Y	S	Y
21.	Are audit committees (or an equivalent) chaired by a genuinely independent director and given sufficient powers in practice (by the company) to examine financial reports and announcements, internal controls and the independence of external auditors? Are they operating independently?	M	S	M	S	M	N	M	N	S	M	M
22.	Can minority shareholders easily nominate independent directors and are these candidates likely to be elected?	N	M	N	N	N	N	N	N	M	M	M
23.	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?	L	L	N	N	Y	N	L	Y	Y	Y	L
24.	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, enshrined in the company law and requiring a supermajority - 75% - to disapply them; and with any new shares only issued under fairly strict caps on percentage of issued capital and price discounts)	N	M	N	Y	N	N	S	N	S	M	N
25.	Do companies release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?	L	L	L	N	S	M	L	Y	M	L	M

Continued on the next page

Evaluation of Asian markets (Cont'd)

II	Enforcement	CH	HK	IN	ID	JP	KR	MY	PH	SP	TW	TH
1.	Do financial regulators in your country have a reputation for vigorously and consistently enforcing their own CG rules and regulations?	S	S	M	M	S	M	S	N	L	S	S
2.	Have their efforts improved tangibly in recent years?	Y	Y	L	S	L	N	L	M	Y	S	Y
3.	Are securities regulators seen to treat all companies and individuals equally?	S	S	S	N	S	N	M	N	L	S	M
4.	Are the regulatory authorities sufficiently resourced - in terms of funding and skilled staff - to do their job properly?	S	S	S	M	L	S	S	N	L	S	S
5.	Does the main statutory regulator (ie, the securities commission) have effective powers of investigation and sanction?	S	L	S	S	Y	L	S	M	L	Y	S
6.	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years? (eg, against cases of market misconduct such as insider trading, share-price manipulation, self-dealing)	S	Y	M	M	S	N	S	N	L	S	L
7.	Has it had a successful track record prosecuting cases of insider trading and other market manipulation in recent years?	N	Y	M	N	M	S	N	N	L	S	N
8.	Does the stock exchange have effective powers to sanction breaches of its listing rules?	M	M	M	M	S	M	S	M	M	M	M
9.	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years?	S	M	M	N	M	N	S	S	S	N	S
10.	Do the regulators (ie, the securities commission and the stock exchange) disclose detailed and credible data on their enforcement track records?	L	Y	S	M	S	M	L	S	S	S	M
11.	Do institutional investors (domestic and foreign) exercise their voting rights?	M	L	M	S	Y	M	S	M	L	L	L
12.	Are institutional investors actively voting against resolutions with which they disagree?	M	Y	S	S	L	M	M	M	L	Y	S
13.	Do institutional investors (domestic and foreign) often attend annual general meetings?	N	N	M	M	M	M	M	M	M	S	S
14.	Do minority shareholders (institutional or retail) often nominate independent directors?	N	N	N	N	N	M	N	N	M	N	N
15.	Do retail shareholders see the annual general meeting as an opportunity to engage with companies and ask substantive questions?	N	L	M	S	S	S	S	M	S	M	Y
16.	Are minority shareholder activists willing to launch lawsuits against companies and/or their directors?	M	N	M	N	M	Y	N	N	N	S	N
17.	Are minority shareholders adequately protected during takeovers, privatisations, and voluntary delistings?	S	Y	S	M	S	N	S	N	S	M	M
18.	Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	M	Y	M	L	L	N	N	N	Y	S	N
III	**Political and regulatory environment**	**CH**	**HK**	**IN**	**ID**	**JP**	**KR**	**MY**	**PH**	**SP**	**TW**	**TH**
1.	Does the government have a clear, consistent and credible policy in support of corporate governance reform?	S	M	M	S	S	N	M	N	S	S	S
2.	Does the central bank exercise effective regulatory powers over the governance of banks?	L	L	Y	L	M	S	Y	Y	Y	S	Y
3.	Is there a coherent and effective structure to the regulatory system governing the securities market? (ie, one without clear conflicts of interest involving either the securities commission or the stock exchange; and without fragmentation and disagreement between different financial and economic regulatory authorities)	S	S	M	S	S	S	S	N	L	S	S
4.	Is the statutory regulator (ie, 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; not unduly influenced by government; and not dependent on the government for its annual budget)?	N	M	S	M	M	N	M	M	M	N	M
5.	Has the government and/or the statutory regulator been actively reviewing and modernising company and securities laws in recent years (ie, to improve corporate governance and bring local rules and regulations up to international standards)?	Y	S	S	M	Y	M	S	M	L	L	S
6.	Has the stock exchange been actively reviewing and modernising its listing rules in recent years (ie, with a view to improving corporate governance)?	L	S	M	N	L	M	L	S	S	M	S
7.	Has the securities commission signed the IOSCO Multilateral Memorandum of Understanding?	Y	Y	Y	M	Y	Y	Y	M	Y	M	Y
8.	Do the regulators (ie, securities commission and stock exchange) have informative websites, with English translations of all key laws, rules and regulations easily accessible?	L	Y	L	M	L	L	Y	L	Y	L	S
9.	Does the stock exchange provide an efficient, extensive and historical online database of issuer announcements, notices, circulars and reports (ie, archived for at least 4-5 years)?	Y	Y	L	S	Y	L	Y	S	L	Y	M
10.	Does the legal system allow minority shareholders effective access to courts to settle disputes? (ie, in terms of the cost of going to court and the range of legal remedies available)	M	N	N	N	M	S	M	N	M	L	N
11.	Is the judiciary independent and clean (in relation to company and securities cases)?	M	Y	S	N	L	S	S	N	S	L	S
12.	Is the judiciary sufficiently skilled in handling securities cases?	N	Y	M	N	M	S	M	M	Y	M	S
13.	Is the media free to report on corporate governance abuses among listed companies?	S	Y	Y	Y	L	M	S	Y	L	Y	Y

Continued on the next page

Evaluation of Asian markets (Cont'd)

IV	Accounting and auditing (IGAAP)	CH	HK	IN	ID	JP	KR	MY	PH	SP	TW	TH
1.	Does the government or the accounting regulator have a policy of following international (IFRS) accounting standards?	Y	Y	L	Y	Y	L	Y	Y	Y	Y	Y
2.	Are local accounting rules in line with international standards?	L	Y	L	L	L	L	Y	Y	Y	L	L
3.	Are accounting policies and practices among large companies in line with international standards and best practices?	L	Y	L	L	L	L	Y	L	Y	L	L
4.	Are accounting policies and practices among small- and medium-sized companies in line with international standards and best practices?	S	L	M	M	S	L	M	M	S	L	S
5.	Do the rules require disclosure of consolidated accounts?	Y	Y	Y	Y	Y	L	Y	Y	Y	Y	Y
6.	Do the rules require detailed segment reporting?	Y	Y	Y	L	S	L	Y	Y	Y	L	Y
7.	Is disclosure of audit and non-audit fees paid to the external auditor required, with accompanying commentary?	L	L	L	N	L	L	S	S	M	L	Y
8.	Does the government or the accounting regulator have a policy of following international standards on auditing (ie, the standards promulgated by the International Federation of Accountants in New York)?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
9.	Are local auditing rules in line with international standards?	L	Y	L	L	L	L	Y	Y	Y	L	L
10.	Are auditing practices among large companies in line with int'l best practices?	L	Y	L	L	L	L	Y	L	Y	Y	L
11.	Are auditing practices among small- and medium-sized companies in line with international best practices?	M	L	M	M	S	S	M	S	S	L	S
12.	Is the government or the accounting regulator actively implementing new international best practices 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, etc)	L	S	S	L	S	Y	Y	L	Y	L	S
13.	Is the government strengthening the regulation of the auditing profession? (eg, by setting up an independent oversight board)	S	M	N	S	L	L	L	M	Y	L	L
14.	Does the audit regulator exercise effect disciplinary control over the audit profession?	S	N	N	S	L	L	M	S	Y	M	L
15.	Is the expensing of share-based payments mandatory?	Y	Y	Y	Y	Y	Y	Y	Y	Y	L	N
V	**CG culture**	**CH**	**HK**	**IN**	**ID**	**JP**	**KR**	**MY**	**PH**	**SP**	**TW**	**TH**
1.	Does the average listed company believe that corporate governance will provide tangible benefits? (eg, lower cost of capital, improved share price, better risk management, etc)	M	S	M	N	M	M	N	N	S	M	M
2.	Are large listed companies* genuinely trying to follow the spirit, not merely the letter, of corporate governance rules? (ie, in practical terms this would mean doing more than the rules require)	S	S	S	S	S	M	S	M	S	S	S
3.	Is there an up and coming group of small- and/or mid-cap stocks that is gaining a reputation for being well-governed and also going 'beyond compliance'?	M	S	M	M	S	N	M	N	M	M	L
4.	Are large listed companies actively seeking to improve their communication and dialogue with shareholders? (eg, through open discussion, more regular briefings and detailed disclosure, and transparent shareholder meetings)	L	L	L	S	S	N	S	S	L	L	Y
5.	Are small- and medium-sized listed companies actively seeking to improve their communication and dialogue with shareholders?	M	M	M	M	S	N	N	M	S	M	M
6.	Do company boards generally have separate chairmen and CEOs, with the Chairman being independent of the CEO?	N	M	M	M	M	M	N	N	M	S	M
7.	Do listed companies provide adequate disclosure of their internal-control and risk-management functions in their annual reports?	M	S	S	M	S	M	M	M	S	M	S
8.	Do listed companies provide a detailed explanation of their executive and employee remuneration policies?	M	M	M	N	M	N	N	N	M	M	S
9.	Is there a trend towards listed companies voluntarily voting by poll at their AGMs and making the results public afterwards?	M	Y	N	N	N	N	N	N	M	N	Y
10.	Has the stock exchange or another organisation developed an open electronic voting platform ("straight through processing") for investors?	S	N	N	N	Y	N	N	N	N	M	N
11.	Do "reputation intermediaries" (ie, investment banks, accountants, lawyers) or stock exchanges promote high standards of corporate governance in clients about to undergo an IPO?	M	N	N	N	N	N	N	N	M	N	N
12.	Are institutional investors (domestic and foreign) actively engaged in promoting better corporate governance practices?	N	M	M	N	M	M	M	N	S	S	S
13.	Have institutional investors set up any corporate governance "focus funds"?	N	N	N	N	L	Y	M	N	M	N	M
14.	Are retail investors or non-profit organisations engaged in promoting better corporate governance practices?	N	Y	L	L	Y	Y	L	N	Y	Y	S
15.	Have retail investors or members of the public formed their own independent (ie, self-funded) shareholder or corporate governance organisations?	N	S	Y	S	Y	Y	M	N	L	L	M
16.	Is there an institute of directors (or equivalent) actively engaged in director training?	M	Y	S	Y	L	M	Y	Y	Y	L	Y
17.	Are other professional associations of accountants, company secretaries, financial analysts and so on promoting corporate governance training and awareness raising?	S	Y	Y	S	S	M	Y	Y	Y	S	M
18.	Are professional associations and academic organisations carrying out original research on local CG practices?	Y	Y	Y	S	Y	Y	S	S	Y	Y	S
19.	Does the media actively and impartially report on corporate governance reforms and developments?	S	Y	L	L	S	S	S	Y	S	Y	Y

IN = India; ID = Indonesia; Y = Yes (+ 1 point); L = Largely (+ 0.75 point); S = Somewhat (+ 0.5 point); M = Marginally (+ 0.25 point); N = No (0 point), Source: Asian Corporate Governance Association

Appendix 3: CLSA CG questionnaire

Note: Questions in bold carry negative scoring.

Three of eight questions on Discipline carry negative scoring

Discipline (15% weight)

1. Do senior management or the controlling shareholders have a meaningful direct stake in the equity of the company? (Ie not via other listed entities and not via options; a meaningful equity stake would be one of significant absolute value against the estimated net worth of the respective individuals).

2. **Does management stick to clearly defined core businesses?**

3. A) What is management's estimate of its cost of equity?

   B) What is management's estimate of its weighted average cost of capital?

   C) Is management's estimate of its cost of capital and of cost of equity within 10% of our estimate based on its capital structure? (Answer "No" if either estimate is beyond 10% of our estimate).

4. **Over the past five years, is it true that the company has not issued equity, or warrants/options for new equity, for acquisitions and/or financing new projects where there was controversy over whether the acquisition/project was financially sound, or whether the issue of equity was necessary if gearing was not high by industry standards, or whether equity financing was the best way of financing a project, or where the purpose for raising equity capital was not clear? Is it also true that the company has not issued options/equity to management/directors as compensation at a rate equivalent to more than a 5% increase in share capital over three years, and that there is no reason to be concerned on these grounds about the issue of equity/warrants for new equity in the foreseeable future?**

5. Over the past five years, is it true that the company has not built up cash levels, through retained earnings or cash calls, that have brought down ROE?

6. Is it true that the company does not have a history over the past five years of restructurings, mergers, demergers or spin-offs that reflect either mismanagement, abandonment of earlier strategies, booking exceptional gains when operating profits are weak, or an intention to hide losses?

7. **Is the company able to make business decisions (eg pricing/investments) within regulatory/legal constraints but without government/political pressure that restricts its ability to maximise shareholder value?**

8. Has management disclosed three- or five-year ROA or ROE targets? If so, please state in (10b).

Three of nine questions in Transparency section have negative scoring

Transparency (15% weight)

9. Does the company publish its full year results within three months of the end of the financial year?

10. Does the company publish/announce semi-annual and quarterly results within 45 days of the end of the half-year?

11. A) In the past 12 months, what is the longest time period between the Board meeting to accept results for a period (quarterly/half-year/finals), and the announcement of the results?

    B) Has the public announcement of results been no longer than two working days after the Board meeting? Is it true that there has not been any case in the past five years when the share price moved noticeably just before the release of results and in a direction that anticipated the results?

12. **Are the reports clear and informative?** ("No" if consolidated accounts are not presented; or if over the past five years there has been occasion when the results announced lacked disclosure subsequently revealed as relevant; if key footnotes to the accounts are unintelligible; if negative factors were downplayed when presenting the company's results that were important in assessing the business value; or if there is inadequate information on the revenue/profit split for different businesses, or regions/countries and product lines; or inadequate disclosure and/or provisions for contingent liabilities, NPLs and/or likely future losses; or inadequate details of group/related company transactions and their rationale).

13. **Are accounts presented according to internationally accepted accounting standards (IGAAP)? Are the accounts free of substantial non-IGAAP compliant qualifications and of any controversial accounting policies?** (If the company provides two or more sets of accounts and at least one that is readily accessible is according to IGAAP, answer "Yes". If the company has changed accounting policies, or adopted a controversial accounting practice which has boosted stated earnings, answer "No").

14. Does the company consistently disclose major and market-sensitive information punctually? Is it true that the company has not in the past five years failed to disclose information that investors deemed relevant in a timely fashion? ("No", eg, if there is any instance over the past five years of share price movement ahead of and anticipating an announcement which was believed to be insider buying).

15. Do analysts 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.

16. Does the company have an English-language website where results and other announcements are updated promptly (no later than one business day)?

17. **Is it true that the company has not applied for a waiver on disclosure rules for the market?**

Three of seven questions in Independence section carries negative scoring

Q19 turned into one with negative scoring in the questionnaire for this year

Only one of the eight questions under Accountability have negative scoring

Independence (15% weight)

18. **Is it true that there has been no controversy or questions raised over whether the Board and senior management have made decisions in the past five years that benefit them, at the expense of shareholders?** (Any questionable inter-company transactions would mean "No").

19. **Is the Chairman an independent, non-executive director?**

20. Does the company have an executive or management committee that makes most of the executive decisions, which is substantially different from members of the Board and not believed to be dominated by major shareholders? (Ie no more than half are also Board members, and major shareholder not perceived as dominating executive decision making).

21. **Does the company have an audit committee? Is it chaired by a perceived genuine independent director and are more than half the members of the audit committee independent directors? Is there an independent director with financial expertise named on the committee?**

22. Does the company have a remuneration committee? Is it chaired by a perceived genuine independent director?

23. Does the company have a nominating committee? Is it chaired by a perceived genuine independent director?

24. Are the external auditors of the company in other respects seen to be completely unrelated to the company? Does the company provide a breakdown of audit and non-audit fees paid to auditors, and if so are the non-audit fees not more than one-third of the audit fees? Does the company disclose that the audit partner, or auditing firm, is rotated every five years? [No if any of the above is scored negatively].

Accountability (15% weight)

25. Does the company have independent, non-executive directors who are nominated by minority shareholders? (Directors nominated by investors or who represent other shareholders apart from the largest controlling shareholder would qualify; otherwise answer "No").

26. Do independent, non-executive directors account for more than 50% of the Board?

27. A) What was the number of independent directors at the end of three years ago (2006)?

    B) And at the end of the last year (2009)?

    C) Has the company increased the number of independent directors over the past three years? (Plans to increase independent directors will count as a negative answer.) **If the company has reduced the number of directors, answer "No";** if number of independent directors are the same insert "0".

28. Are Board members well briefed before Board meetings? Are they provided, as far as the analyst can tell, with the necessary information for effective scrutiny of the company, prior to the meeting, in a clear and informative manner? (Answers 35-37 must be based on direct

communication with an independent Board member. If no access is provided, and no verification of an independent director is provided, answer "No" to each question).

29. Does the audit committee nominate external auditors as disclosed in the annual report (or other publicly available statement)?

30. Does the audit committee supervise internal audit and accounting procedures as far as the analyst can tell?

31. Do companies vote by poll (as opposed to by show of hands) at AGMs and EGMs for all resolutions?

32. Do companies make publicly available by the next working day the result of the votes taken during the AGM/EGM?

Responsibility (15% weight)

Three of seven questions under Responsibility also with negative scoring

33. If the Board/senior management have made decisions in recent years seen to benefit them at the expense of shareholders (cf Q18 above), has the company been seen as acting effectively against individuals responsible and corrected such behaviour promptly, ie within six months? (If no such case, answer this question as "Yes").

34. **Is it true that there is no controversy or questions over whether the Board and/or senior management take measures to safeguard the interests of all and not just the dominant shareholders?** (Eg if EGMs with genuine independent advice for related-party transactions were not held, or independent verification of appropriate pricing for recurrent related-party transactions was not obtained, answer "No").

35. Is it true that there have been no controversies/questions over whether share trading by Board members has been fair, fully transparent and well intentioned? (Are announcements made to the exchange within three working days, and do the major shareholders reveal all transactions including those under nominee names? Any case where it is believed by some that parties related to major shareholder were involved in transactions not disclosed to the exchange, or allegations of insider trading, would mean "No").

36. A) How many members are on the Board?

    B) Is the Board small enough to be efficient and effective? (If more than 12, answer "No").

37. **Is it true that the company does not engage in material related-party transactions?** (Eg sourcing key materials from a related party, or using a related party that is not part of the listed group as a distribution channel, or placing funds in deposit or for investments in a related party that is not part of the listed group, or where the annual report discussion of related party transactions runs over two short paragraphs, or where the listed company has invested in businesses where the controlling shareholder has interests in the past three years, would count as a negative answer. Note that a related party that is not part of the listed group would include a unit under the parent which may be separately listed).

38. Is it true that the controlling shareholder (whether an individual or company) is not known or widely believed to be highly geared?

39. **Is the controlling shareholder's primary financial interest the listed company?** (Ie not a government-controlled entity, or a listed company where the ultimate shareholder has various other business interests. Answer "No" if the company is a subsidiary of a separately listed parent).

Fairness (15% weight)

Three of seven questions in Fairness section have negative scoring

40. **Is it true that there has not been any controversy or questions raised over any decisions by senior management in the past five years where majority shareholders are believed to have gained at the expense of minority shareholders?** (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 would be deemed a negative).

41. Do all equity holders have the right to call General Meetings? (Any classes of shares that disenfranchise their holders would mean a "No" answer).

42. Does the company have cumulative voting for Board representation? (Ie where minority shareholders with say a 20% interest will be able to appoint directors representing one-fifth of the Board).

43. Is senior management unquestionably seen as trying to ensure fair value is reflected in the market price of the stock, by guiding market expectations about fundamentals in the right direction through frank discussion on risk/returns, actions like share buybacks and investor meetings, etc?

44. **Is it true there have been no questions or perceived controversy over whether the company has issued depositary receipts that benefited primarily major shareholders, nor has the company issued new shares to investors near peak prices, nor have the major shareholders sold shares near peak prices without prior guidance to the market on why shares are seen as fully valued? Also, the company has not issued shares to friendly parties just prior to AGM/EGMs where there are controversial matters being voted on at the shareholder meeting?**

45. Does the head of Investor Relations report to either the CEO or a Board member?

46. A) What is total remuneration of the Board as a percentage of net profit after exceptionals?

    B) **Over the past five years, is it true that total directors' remuneration has not increased faster than net profit after exceptionals as far as an analyst can tell?** (Answer "No" if directors' remuneration has increased faster than profits or if company does not make any declaration to clarify).

Appendix 4: CG questions removed

9 questions removed from the questionnaire and one merged with another question; thus 10 less questions in main CG section

Numbering here indicates the question number in the 2007 survey

Discipline

1. Has the company issued a "mission statement" that explicitly places a priority on good corporate governance or has the company or management publicly articulated principles of good corporate governance that it is committed to maintaining? Does the company's Annual Report include a section devoted to the company's performance in implementing corporate governance principles?

2. Does senior management use debt for investments/capex only where ROA (or average ROI) is clearly higher than cost of debt and where interest cover is no less than 2.5x? In using debt, has management always shown sensitivity to potential asset-liability duration and currency mismatches?

Q13 merged with Q12 on release of half-year results

3. Does the company publish/announce quarterly results within 45 days of the end of the quarter?

Transparency

4. Does the company provide sufficient disclosure on dilutive instruments?

Independence

5. Is it true that the Board has no direct representatives of banks or other large creditors of the company who are likely to direct corporate policy in favour of creditors rather than shareholders?

Accountability

6. Are the Board members and members of the executive/management committee substantially different such that the Board is clearly seen to be playing a primarily supervisory as opposed to an executive role? (Ie no more than half of one committee sits on the other?

7. Are full Board meetings held at least once a quarter?

Responsibility

8. Does the company have a known record of taking effective measures in the event of mismanagement? Over the past five years, if there were flagrant business failures or misdemeanours, were the persons responsible appropriately and voluntarily punished? (If no cases, the company does not have such a record, then answer this question as "No").

Fairness

9. Are all necessary (ie not just obligatory, but also relevant in the view of the analyst regarding accounting etc) information for General Meetings made available prior to the General Meeting?

10. Does the controlling shareholder group own less than 40% of the company?

Appendix 5: CLSA C&G survey

15 questions in revamped C&G survey

Leadership

1. Is any individual or committee responsible for the company's environmental controls? (If yes, please provide name of person or head of committee?)

2. Does this person/committee report directly to the Board?

Recognition and reaction

3. Is the company aware of any current Government regulation that requires it to monitor or reduce emissions? (If yes, please specify)

4. Does the company have any mechanisms in place to monitor and report GHG emissions? (If yes, please specify)

5. Has the company quantified annual emissions of CO_2/GHG or pollutants such as NO_2, SO_2 etc in either of the past two financial years? (If yes, please include the data in the comments field)

6. Has the company set voluntary or regulatory-mandated targets for CO_2/GHG emission reductions? (If yes, are targets absolute or a % of emissions)

7. Has the company set targets for reduction of water use? (If yes, are targets absolute or a % reduction)

8. Has the company set targets for reduction of other waste/pollutants? (If yes, are targets absolute or % reduction)

9. Has the company ever received a fine for environmental infraction?

10. Does the company recycle waste (inc waste water, paper etc)? – if so please describe the extent and approach

11. Is the company ISO 14000 or similarly accredited?

Disclosure

12. Does the most recent Annual Report or Chairman's Statement carry details of environmental impact

Looking to the future

13. Do any existing R&D projects involve innovative technology to reduce emissions or utilise renewable energy sources?

14. Will any business unit benefit from climate change or increased regulation and general acceptance of the need to reduce emissions? (If yes, please specify)

15. Have any suppliers/vendors/contractors been selected in order to lower the company's indirect emissions footprint? (If yes, please specify)

Appendix 6: CLSA CSR survey

Policies and objectives

11 questions in newly introduced CSR survey

1. Does the company have a social policy/vision that it articulates?
2. Does the company set out its expected behaviours in a Code of Conduct/Business Ethics?
3. Is there one person within the company who is responsible for setting goals and objectives related to the social impact of the company and its activities?

Implementation

4. Does the company engage in social initiatives such as corporate giving/community programmes grants scholarships etc
5. Does the company have anti corruption policies and practices in place?
6. Does the company have health and safety policies which it implements at all its sites and places of work
7. Have there been any major H&S incidents in the past 3 years?
8. Does the company pay the appropriate level of taxes in the countries in which it operates?
9. Does the company engage in appropriate sourcing practices to ensure social responsibility in terms of its suppliers?

Results and disclosure

10. Does the most recent Annual Report or Chairman's Statement carry details of Corporate Social Responsibility
11. If a CSR report or statement exists does it disclose performance and gaps?

Appendix 7: Nice guys finish ahead

Share-price boost from good corporate governance

With investors making increased efforts to focus on corporate governance, we ask the seemingly simple, yet devilishly complex question of exactly how much that focus is worth in terms of future stock returns. Exactly how much return benefit is added from Asian stocks that are mindful of best practices and focus on shareholder interests? Do the best intentions of the good guys get kicked to the side as markets advance, or can good corporate governance reward shareholders throughout market cycles? And exactly how much are investors paid for searching out good corporate governance anyway? To answer these questions we look back over five years of CLSA's Corporate Governance Scores and strip out other correlated factors such as market, industry, size, etc, and measure the added price return that comes solely from their standing on the Corporate Governance Score with all else being held equal.

Quant team's analysis of CG scores and stock performance

- The results show that good corporate governance does pay for shareholders, with a 10-point difference in CLSA's Corporate Governance Score being worth an extra 7.3% in performance over the next three quarters, all else equal.
- This linkage of CLSA's Corporate Governance Score to future returns is particularly interesting as the scores are generated by a logical, a priori expectation of what good corporate governance should be, using input from the Asian Corporate Governance Association, APEC, the OECD and, of course, our own view. These scores are not generated to intentionally link up to back-tested return profiles, yet they strongly fit with future returns.

Markets appear to be missing something hence allowing continued gains

- This also demonstrates that despite expectations that knowledge of each stock's corporate-governance capabilities would already be well known and hence probably in the price, markets appear to be somehow missing something in this view that systematically leads to continued future gains.
- With our next regular update on corporate governance due out soon, investors would be well served to keep an eye out for this look at management's commitment to the shareholders and act accordingly in the months ahead.

Regression statistics

	Coefficient (%)	t-stat
Corporate governance	**0.7[1]**	**7.19**
Size	(13.6)	(5.80)
Country - average (absolute value)	21.7	2.13
Sector - average (absolute value)	33.5	2.85

[1] The price-return benefit from good corporate governance. Source: CLSA Asia-Pacific Markets

Rewards for saints and sinners in CG are not always obvious

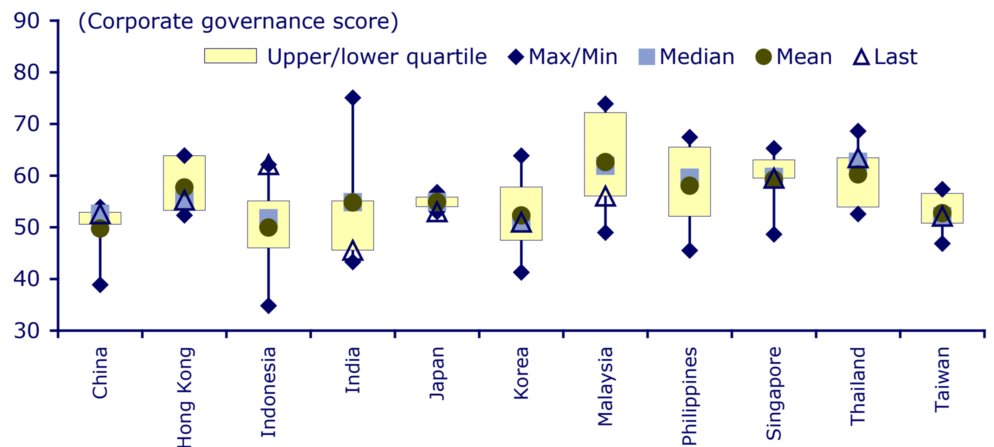
Conventional wisdom would tell us that nice guys finish last. Certainly in stock markets there is little expectation that the saints are necessarily well rewarded for their good actions, while the sinners seem to gain at least short-term advantage from a willingness to cut corners and ignore some shareholders' interests. Considering this, it would appear that any hope that shareholders gain from investing in companies with better corporate governance is something that should be investigated and not simply taken on faith. Are listed companies that practice good corporate governance rewarded through better stock-price performance, and if so, by how much?

Interaction of CG with other factors needs to be disentangled

This question is particularly difficult to answer given the strong interaction between corporate governance and other key sources of market return, including market/country, industry and size. As one would expect, given diverse regulatory demands across markets, different countries tend to see structurally different levels of corporate-governance scores, all leading to strong correlations between corporate governance and the listing market. As such when markets shifts significantly, because of other, much stronger macroeconomic factors, this can outweigh and swamp any signals due to the benefits of better corporate governance.

Where stock is listed has a bearing on its CG score

Corporate governance scores are clearly linked to a stock's nationality



Source: CLSA Asia-Pacific Markets

Simple measures of performance against CG likely to give nebulous picture

This is not the only potential linkage that can cloud the picture, as there are strong links between industry and corporate governance, size and so on. Given that these common factors are among the most important in driving common sources of risk or return, their high correspondence to degrees of corporate governance means that any simple attempt to measure the performance benefit would likely provide a nebulous picture of these interlinked sources of price performance.

To clear the haze surrounding this issue and determine the exact benefit of good corporate governance to future returns, we have taken the CLSA Corporate Governance scores, now one of the longest-serving measures of this important topic, entering their second decade, and applied quantitative tools of multivariate regression to isolate and identify the common stock-return sources and thereby determine the typical return benefit due solely to improved corporate governance, all else equal. These results show a strong positive tendency for stocks with higher corporate governance to outperform in following months, suggesting that a focus on corporate governance and the CLSA scores can provide alpha in addition to peace of mind and the peaceful sleep of the good.

CLSA's Corporate Governance Score

CLSA's first CG report issued in 2000

We first began to focus on corporate governance in 2000, at a time where a recent run in markets after the Asian financial crisis had been fuelled by a steady inflow of investment funds to emerging markets that were just starting to reverse. Hence, as we put it in a report title, it was only as the tide began to go out that investors discovered *Who's swimming naked?* regarding corporate governance. As we noted in this capstone report, it was the Asian crisis of 1997 that really drew attention to the issue in the region as investors were forced to look past claims that cultural and market practices meant that corporate-governance issues in Asia should not be measured by the same expectations.

Some amendments through the years in the CG scoring

The first study was based on a survey of 115 key companies, a number that has increased over the years until the last formal report covered just under 600 Asian-listed companies. The survey method is based on a series of questions under key categories of corporate practice, including topics such as discipline, transparency, independence, accountability, and accounting and auditing. Many of these questions look to focus in on areas that are of particular interest to the question of minority-shareholder treatment in Asia, such as concentrated ownership in the hands of controlling individuals or even families for many listed companies or developments in regulation and oversight.

The questions have not remained the same over the years but have adapted along with evolving expectations. This is perhaps most notable with the addition of a Clean & Green portion to the survey in 2007 to heighten the focus on social responsibility as it looks at environmental issues. Each year though the survey provides a direct measure of Asian companies' approach to their professional practices in a systematic and public fashion. As such in addition to helping prod these same companies towards greater efforts and praising those who are at the forefront of working in the best interests of shareholders, this score provides a unique historical record of how investors and market participants viewed various companies at that time, from the perspective of what issues were then most pressing. Therefore unlike any attempt to build backwards for an assumption of what the market should be looking at, the CLSA Corporate Governance Score provides a timeline history of how companies performed against the corporate-governance expectations of that time. This provides a unique tool for asking the question of whether a focus on corporate governance does lead through to shareholder returns, and if so by how much.

Why corporate governance matters

Amar Gill

Intuitively, corporate governance matters to investors although usually it is in the breach of accepted governance standards that has an obvious impact on stock prices. Over the years that CLSA has done corporate-governance scoring, we have found it fiendishly difficult to isolate the effect of corporate governance on stock-price performance. Most investors, too, appear to be of the view that a certain level of corporate governance associated with a company is "in the price" hence not a share-price driver - unless the company does something to materially affect the perception of its corporate governance. Thus, in day-to-day portfolio construction, corporate governance is not often given much consideration.

Hence it is pleasing to see the Quant analysis which strips out the effect of market direction, as well as country and sector effects, to find a statistically significant correlation between corporate governance and stock-price performance. Could the correlation be spurious? Not if there is a good explanation for it. From our earlier corporate-governance reports we have shown a natural tie-in between good governance and good management generally. Companies that are well-managed will pay greater heed to corporate governance. Those companies are likely also to pay greater attention to their balance sheet and financial ratios. If well-run companies have good corporate governance as well as generally better financials and higher EVA®, it should not be surprising that these stocks tend to outperform, stripping out other macro factors impacting on stocks.

Our Quant team's finding is that it is the absolute level of corporate governance, not just the change, which is correlated with stock returns. For investors, the implication is that after selecting for markets and sectors, the level of corporate governance coming in through stock selection will also likely impact portfolio performance. Is there a good measure of corporate governance? While we do not cover every stock in the market, the finding implicitly endorses the corporate-governance scores that we provide as historically having provided a fairly reliable guide on the governance standards of companies we follow. Thus, watch for our overall update on these scores in our next regional corporate governance report to be issued in the next few weeks.

Key questions have remained in the questionnaire through the last decade

Change with consistency
Corporate-governance questions in 2000 that are still in the current questionnaire

Discipline

2. Does senior management have a significant portion of their net worth in the company?

3. Does management stick to its clearly defined core businesses?

4. Does senior management have the attitude that new equity should never be issued, unless the money raised will result in an above average return?

Transparency

10. Is management willing to disclose targets publicly, even though it risks failure?

13. Does the company publish/announce quarterly reports? Does the company publish its quarterly reports within six weeks of the end of the quarter?

14. Are the reports clear and informative?

15. Are all the accounts done according to IGAAP? Are the accounts free of substantial non-IGAAP compliant qualifications?

16. Does the company consistently disclose major and market-sensitive information? Does it do so punctually?

20. Do analysts have good access to senior management? Good access implies timely meetings, where analysts are given all relevant information and are not misled.

Independence

25. Is the chairman an independent, non-executive director?

27. Do the independent, non-executive directors account for more than 50% of the board?

30. Are the board members and members of the executive/management committee substantially different?

31. Does the company have an audit committee? Is it chaired by a genuine independent director?

32. Does the company have a remuneration committee? Is it chaired by a genuine independent director?

33. Does the company have a nominating committee? Is it chaired by a genuine independent director?

34. Other than as auditors, are the external auditors of the company completely unrelated to the company?

Accountability

39. Are board members well briefed before the board meetings? Are they provided with the necessary information, prior to the meeting, in a clear and informative manner?

40. Does the audit committee nominate and review the work of external auditors?

41. Does the audit committee supervise internal audit and accounting procedures?

Responsibility

43. Do the board and senior management take measures to safeguard the interests of all and not just the dominant shareholders? Has the board and senior management ever made decisions that benefit them, at the expense of shareholders? (Any loans to group companies/JVs, non-core/non-control group-investments, etc, should mean a "No").

45. Is the share trading by board members fair, fully transparent and well intentioned?

46. Is the board small enough to be efficient and effective?

Fairness

48. Do small shareholders have the ability to call general meetings?

52. Does senior management try to ensure that there is fair value reflected in the current market price, by guiding market expectations about fundamentals in the right direction (through frank discussion on risk/returns, actions like share buy-backs and investor meetings, etc)?

Social awareness (replaced as Clean & Green)

57. Is the company explicitly environmentally conscious? Does it promote use of environmentally efficient products, or takes steps to reduce pollution, or to participate in environment-related campaigns?

Source: CLSA Asia-Pacific Markets

At various points different classes of CG stocks appeared to perform better

Measuring the return

The question of how good corporate governance is linked in to outperformance was of course asked from the very outset in the inaugural 2000 report. At that time they relied on looking at portfolios such as the Top 30, and looking at the correlation of scores and backtested returns. Even at this point they noted that 'drawing inferences from this data is tricky.'[1] This became clear in later years when the annual survey reported shifts in how it perceived the return benefit of high marks, with recognition that market direction and trend mattered, and that the strong linkages between the scores and market, industry and size, to name just three factors, clouded the picture of what exactly was driving the share price at any given time. As a result, at some points it looked as though the corporate-governance score worked well consistently, at some points it appeared that it fared best in advancing markets, and at some points it seemed to work best when markets were falling.

Therefore to properly determine and measure the forward-looking value of the CLSA Corporate Governance Scores over time, we need to break the problem down and identify how much the score itself contributes to return, isolating this from other key common factors such as market, industry and size.

We assessed performance starting with CG scores from 2004

Methodology

To do this we looked back over the history of all of CLSA's Corporate Governance Scores since 2004. We selected this year as a starting point as the earliest surveys looked across the full range of emerging markets, as we did at the time. While this provided me with my now antique CLSA Emerging Markets backpack, this disturbed the time series for many stocks in the early study as they are from markets we no longer cover. As such, starting with 2004 gives us a largely uninterrupted history by stock. Also, the data from 2004 is kept in evalu@tor and hence is readily available to us and clients.

From there, we used these raw historical scores to look at how they predicted future return, adjusting for several key market drivers. We looked at returns over the following nine months to help minimise issues of data overlap, as scores were entered throughout the year, however the vast majority were updated near the publication of our annual report on corporate governance. As the annual release dates varied over the years and submission dates were spread out before the each report was published, looking at only the next three quarters helps us to remove issues of overlapping time frames.

[1] Amar Gill, "The Tide's Gone Out: Who's Swimming Naked?", *Corporate Governance,* October 2000, p4.

Our previous CG reports

Corporate governance report release dates

Date	Report title
3 Oct 2000	Corporate governance (*Who's swimming naked?*) - October 2000
6 Apr 2001	CG Watch - Corporate governance in emerging markets (*Saints & sinners*) - April 2001
8 Feb 2002	CG Watch - Corporate governance in emerging markets (*Make me holy…*) - February 2002
9 Apr 2003	CG Watch - Corporate governance in Asia (*Fakin' it*) - April 2003
2 Sep 2004	CG Watch - Corporate governance in Asia (*Spreading the word*) - September 2004
18 Oct 2005	CG Watch - Corporate governance in Asia (*The holy grail*) - October 2005
18 May 2006	*The holy grail*: Qarp screen - May 2006
13 Sep 2006	C&G Audit 2006: Carbon management in corporate Asia - September 2006
17 Sep 2007	CG Watch - Corporate governance in Asia (*On a wing and a prayer*) - September 2007
11 Jan 2008	Greening of governance in Asia: *On a wing and a prayer* - January 2008

Source: CLSA Asia-Pacific Markets

Dummy variables for country/market and size of the company

In addition to the corporate-governance score, we wanted to isolate other key sources of return. We included dummy variables for country/market, and sector, and a normalised score for market cap. These are not only three of the most significant sources of risk and return, but they are also areas that seemed to flummox earlier, more straightforward attempts to measure the corporate-governance-score contribution to performance. After a bit of discussion as to whether we should in some way normalise or otherwise try to adapt the corporate-governance scores themselves, we decided for various reasons that the simplest approach was best and left them in their raw form. The nine-month forward returns were then regressed onto these variables for all the stocks over the six-year history. For more details on the specifics of the methodology, please see Appendix.

The results

Examinded 1,554 observations from 875 companies

In controlling these other key factors and looking at 1,554 separate observances from 875 companies, we found a strong and consistent measure of future returns linked into the corporate-governance score. In essence, with everything else held constant, an increase in the CLSA Corporate Governance Score by one point, leads to an additional outperformance of 0.73% in the following nine months. This is nearly 0.75% of additional performance over just the three quarters, equating to 0.97% on an annualised basis (although we are of course not measuring over that time and do not expect the return to necessarily be continuous). This means that for a ten-point increase, for example moving from a score of 60 up to 70, we would expect that the stock would see an average addition of 7.3% to its performance in the nine months ahead, all else equal.

Significant t-stat

Regression statistics

	Coefficient (%)	t-stat
Corporate governance	**0.7**	**7.19**
Size	(13.6)	(5.80)
Country – average (absolute value)	21.7	2.13
Sector – average (absolute value)	33.5	2.85

Source: CLSA Asia-Pacific Markets

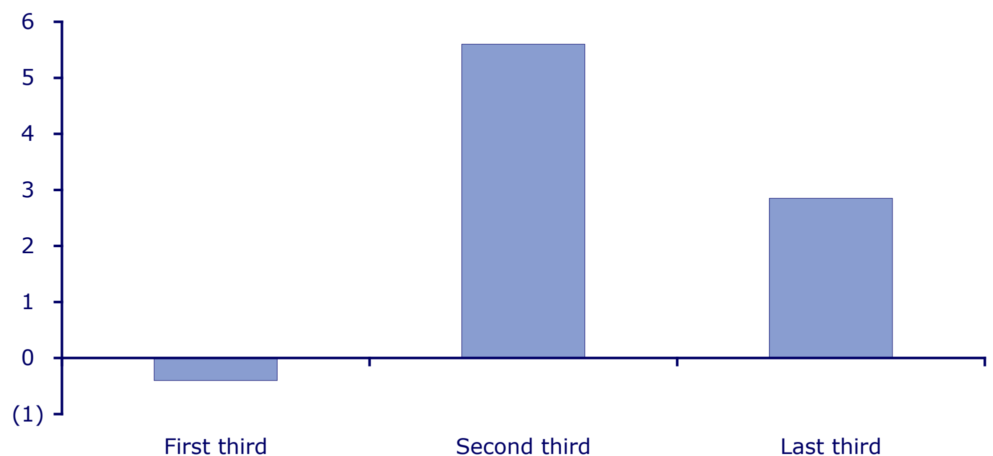
This is a very strong result, both in terms of the measured impact on performance as well as for the weight of the statistics, with a 5.9 t-stat, showing a statistically strong link between score and future return. This tells us that all else equal, corporate governance drives future outperformance.

Reaction to CG scores slipped into negative territory for a short period

However, this is the average score over the period. The specific strength varies by company and also somewhat over time. In particular, the reaction during the recent global financial crisis managed to slip into negative territory for a short period. This is perhaps surprising as one would hope that investing in better managed, shareholder-friendly companies would provide additional insulation from loss during times of crisis, yet that was the one period when companies with better corporate governance seemed to structurally underperform.

Higher t-stat for the middle third period examined

t-statistic on Corporate Governance Score through time



Source: CLSA Asia-Pacific Markets

Area worth focusing on for portfolio managers

Still, given the strong linkage over the majority of the test period, coupled with the more important point that there is a logical reason to expect some sort of return relationship from these scores, it is apparent that this is an area that fund managers need to look at. Even in that short period where the corporate-governance scores were not driving positive returns, they were still systematically pushing prices. As such it is clear from these results that corporate governance matters to price performance. Far from simply serving as a generalised set of ideals for a small group of Don Quixote-esque idealists, the CLSA Corporate Governance Score helps fund managers with their most fundamental responsibility - to make money for their investors.

What does all this mean?

Reliable scoring system for CG scores

There are several observations we can take away from these strong positive results. First, we should note the work done by our thematic team, as well as collaborators such as the Asian Corporate Governance Association over the years to build such a superb scoring system from first principles that it does indeed provide insight into future return. It should not be overlooked that this system is not a statistical optimisation of what combination of signals is best linked to returns. Instead it has been developed with a view of what should work and drive returns. The results demonstrate that these fundamentally driven expectations of best-management practices on the shareholder’s behalf do indeed offer value.

Moreover, this provides a notable long-term price benefit to the engaged companies. The increased performance is based on the absolute level of the corporate-governance score and not in a measure of improvement. It appears that companies that have already attained a higher best-practice level continue to benefit over the long term. Far from paying a price for good corporate governance through higher overheads and lost opportunities, these listed companies manage to provide shareholders with extra return to match their better-than-average practices. Forget the idealism - this is a way to make more money.

The market does not immediately digest publicly-available info

Also, these findings importantly point out that the market does not immediately digest this publicly-available information, but instead seems to come to terms with it over the next few quarters, hence helping to drive the excess return. Investors are not overly efficient at pricing in the benefit despite its public availability. This suggests that a focus on corporate-governance changes is a useful tool for beating markets and should not be left solely to specialist funds, although arguably as more investors start to focus on this topic the drawn-out pricing inefficiencies will collapse into more immediate movements.

CG should incorporated into full-investment process

Specifically on that point, this analysis has identified a strong link between corporate governance and future returns as a single factor. Of course this on its own is not a complete strategy. Instead this should be examined and potentially included as part of the full-investment process. Fundamental investment styles will want to reexamine their own inspection of corporate governance issues to decide if they can benefit from a stronger focus in this area, while quantitative funds will want to test this unique time-series data to determine if it can add value and complement the other factors in investment modelling. There are also likely to be other ways to better interpret the linkage such as looking at changes in the scores and peak levels that offer a sweetspot for change, assuming that the relationship is not purely linear across the full range of possible scores, and so on. Such specific inspections would be best explored in conjunction with the optimal-fit relative to other preselected factors.

Caveats

Scoring system has not been static

There are several key caveats to note. First, as mentioned earlier this survey has changed over time. While we consider this ongoing flexibility one of the score's strengths, as it has been able to dynamically adapt to the most recent expectations of best-management practices and responsibility to stakeholders, it also leaves open the possibility that the score could quickly go off track if a poor decision is made. Any look at the CLSA Corporate Governance Score has to come with a corresponding effort to understand the methodology and intent, and a look at what has changed since the previous measure. Investors will want to make sure that any changes reflect market demands. Our cooperation with the Asian Corporate Governance Association, of which we are a founding member, should help ensure this and is likely to be a key reason for the corporate-governance score's benefit to date.

CG score a proxy for analyst sentiment?

Of course, it is also possible that the score is in a sense proxying analyst sentiment. They are most often updated around the time of our large annual report, otherwise they are updated when major companies issue reports. While the score is survey-based, there is always room for additional interpretation and unconscious bias, and as such it could be argued that they

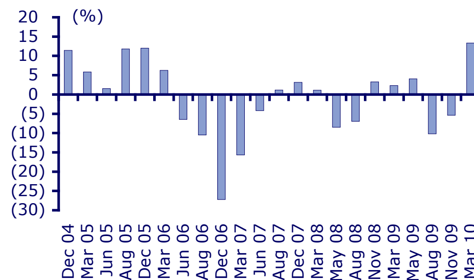
partially reflect an analyst's underlying view on a stock, and perhaps an unconscious reflection of their enthusiasm for a story. While there is almost certainly some small degree of this influence, the nature of the survey-scoring system suggests that this would at most serve to shift scores at the margins. Furthermore, sell-side analysts' direct recommendations do not typically offer high-information content nor do a great job of highlighting future return potential, which would seem to indicate that whatever bias there is in the final-score compilation, is it is unlikely to add any predictive power, let alone serve as the key driver.

Could be due to a hidden valuation factor

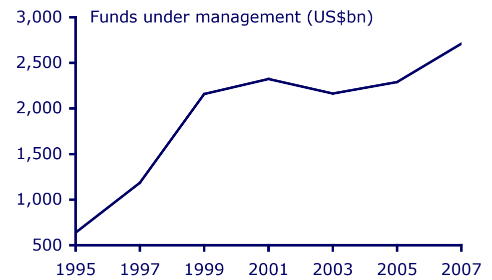
Might the linkage of the corporate-governance score to a fundamental valuation factor be the real driver? In which case we should focus instead on that fundamental and not worry about the score. We suggested that there can sometimes be a link between corporate governance and ROE, and we have also considered that good corporate-governance scores might be clumped around companies with stable earnings and hence the metric is mimicking EPS stability. Looking briefly at these though, we see that there does not seem to be a long-term pattern tying them together, and hence the score itself is certainly more than a simple reflection of these valuation issues, assuming that it is influenced at all.

Funds linked to SRI have grown

Correlation between CG and ROE



SRI in the USA



Source: CLSA Asia-Pacific Markets

SRI assets increased more than 18% from 2005-07

As a further concern, we should be aware that there could be other related forces at work, and that it might not be entirely a return from the business benefit of good work and management practice. Since the original report, corporate governance has grown in importance for the fund-management industry. By 2007, roughly 11% of assets under professional management in the USA were involved in the broader, but related category of socially responsible investment (SRI). What is more, the growth for such funds is well in advance of overall industry trends. From 2005-07 alone, SRI assets increased by more than 18%, while the broader universe of all funds under professional management only increased by less than 3%.

Need to understand why the statistical relationship holds

This growth in SRI, or more specifically the resulting flows of investment funds, could be at least a factor in the relative outperformance of good corporate-governance companies or could even be the entire driver. While the results demonstrate that the corporate-governance score is what is driving the return and that these are not simply coincidental, we have no way of knowing why it is having that influence. Is it because of the broader, underlying company benefit of being run in fair and responsible fashion, or is it simply due to money chasing this key theme of recent years.

Still, the results do suggest that anyone interested in returns needs to keep an eye on the corporate-governance score regardless of the underlying reason for it pushing prices. Investors should be aware though of the possibility that some or perhaps even all of the benefit comes from this thematic flow, in which case any major change in SRI growth could have a serious impact on this relationship.

Where next?

High CG scores support fundamental calls

Our regular update on corporate governance in Asia will be out soon, and investors of all ilks will want to see this to learn which companies seem best positioned to gain from the corporate-governance benefit. Still, for now we can look at which have the best history of high scores and as such could be best poised in the months to come. A look at the stocks that have most regularly posted the highest scores in our survey shows the names that have consistently strong performers and are also highlighted as also being preferred calls from our fundamental analysis are **Kasikornbank**, **HDC** (and **Wipro**.

Relevant metric for performance

Beyond that, investors might wish to pay more attention to this topic now that we have demonstrated a direct link to returns. Far from being solely an issue of altruism, there are solid fundamental reasons to believe that companies managed with the best, long-term interests of their shareholders and other key parties should outperform over time. With that outperformance now demonstrated and quantified, all investors should start to look at these metrics as they search for performance.

Top CG scores (prior to update of 2010 report)

Top-25 current corporate-governance score

Country	Code	Company name	CG score
TH	BANPU TB	Banpu	85.0
TH	PSL TB	Precious Shipping	83.5
TH	KBANK TB	Kasikornbank	82.6
IN	INFO IS	Infosys Technologies	78.5
MY	CIMB MK	CIMB Group	76.5
TH	BBL TB	Bangkok Bank	75.8
CN	322 HK	Tingyi	75.8
TH	TISCO TB	Tisco Financial	75.1
TH	LPN TB	LPN Development	73.9
TH	HANA TB	Hana Microelectronics	72.8
TH	BAY TB	Bank of Ayudhya	72.2
TH	EGCO TB	Electricity Generating	72.0
TH	PS TB	Preuksa Real Estate	71.8
TH	GLOW TB	Glow Energy	71.7
CN	1813 HK	KWG Property	71.6
SG	UOB SP	United Overseas Bank	71.5
MY	AIRA MK	Airasia	70.7
TH	TTA TB	Thoresen Thai Agencies	70.1
TH	CPN TB	Central Pattana	69.6
HK	341 HK	Cafe de Coral	69.5
TH	TOP TB	Thai Oil	69.3
TH	SCB TB	Siam Commercial Bank	68.9
TH	KK TB	Kiatnakin Bank	68.7
KR	003550 KS	LG Corp	68.7
TH	AP TB	Asian Property Development	68.3

Source: CLSA Asia-Pacific Markets

Methodology

Regression analysis

Used standard regression analysis

In this study, we use standard regression analysis to examine the significance of corporate governance as a quantitative factor. We control for size, country and sector by including them as additional regressors. Country and sector enter as dummy variables. We have typically updated the corporate-governance scores at a minimum of nine months. Taking this into light we have chosen to analyse the relationship between nine-month returns and the relevant factors to avoid any overlaps in the data and to minimise factor decay. Even though we have controlled for the main drivers of returns in the region we cannot rule out that corporate governance is not interacting with another unobserved factor here.

$$R_n = \text{constant} + b_n CG_n + c_n Size + d_n C1 + \ldots + g_n Cm + h_n S1 + \ldots p_n S2 + \text{error}$$

where:		
	R	is the ninth-month forward return
	CG	is the corporate governance factor score
	Ci's	country dummy variable
	Si's	Sector dummy variable
	N	refers to stock n

Portfolio approach

Alternative is to isolate CG effect

An alternative approach, isolating the corporate-governance effect, more akin to what a fund would do in practice is to use some form of optimisation. Given a factor model, portfolios are constructed that have maximum exposure to a target factor, zero exposure to all other factors, and minimum portfolio risk. The idea here is to maximise exposure to the corporate-governance score while neutralising the effect of size, country and sector. Formally:

$$\text{Max}(w)\ w'CG - \tfrac{1}{2} * \lambda w' \Sigma w \quad \text{s.t}\ w'F = 0$$

Where w are the active portfolio weights, CG the Corporate Governance Scores, Σ the covariance matrix, F a matrix of the factors we are to neutralise, and λ the risk aversion factor. Included in F is a unity vector that ensures the active weights sum to zero. The analytical solution to this problem is:

$$w = 1/\lambda \Sigma^{-1}[CG - F(F'\Sigma^{-1}F)^{-1}(F'\Sigma^{-1}CG)]$$

The risk aversion factor in this setting will scale up expected returns at the expense of variability but will have no effect on the ex-post information ratio. This optimisation is carried out every time period, typically augmented with shorting, liquidity and turnover constraints. In practice the performance of this strategy will also be influenced by the market impact costs of trading into and out of the relevant positions.

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