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COVER STORY: Asia raises the bar

Author: | Published: 28 Aug 2018

Asia is improving corporate governance. But some companies aren't jumping at the opportunity

Market success hinges on many things, not least strong corporate governance standards. As Asian markets open up to foreign investment, the need for tougher governance is encouraging reform in financial centres across Asia. On the one hand, Asian businesses are facing pressure as domestic investors who have historically been passive when it comes to their investments become more engaged. On the other, foreign investors expanding their portfolios into Asia look for more transparency and accountability.

But cronyism is a common feature in family-owned businesses, and the separation of ownership and management is an aspect Asian businesses still need to work on. Figures show that 85% of Asian businesses are family-owned, and out of the world's largest 500 family- owned businesses, nearly 20% are located in the region.

Recent regulatory changes in a number of Asian countries have tried to target this issue though much more work is needed.

Against this backdrop, shareholder activism is spreading across Asia like never before. According to the Shareholder Activism in Asia report published by JPMorgan in May 2018, the number of activist campaigns in Asia accounted for 31% of total non-US activity, compared with 12% in 2011. Japan was responsible for 32% of activist campaigns with Hong Kong coming in second at 24%. China is fourth with 13%.

A number of shareholder disputes have made headlines in recent months. In Hong Kong, Bank of East Asia (BEA) directors and hedge fund Elliott Management are locked in a dispute over alleged mis-management on BEA's part. Central to the dispute are agreements BEA has with strategic partners Sumitomo Banking Corporation and Criteria Caixa which own 18.7% and 17.05% of BEA respectively. The agreements indicate that the investors cannot buy additional shares or sell shares as a block. Over in South Korea, Elliott called

on Hyundai to speed up governance by appointing more independent board members and making balance sheet reforms. Meanwhile in Japan, a record 42 Japanese public companies faced shareholder proposals in the June 2018 proxy season.

A strong push towards better corporate governance stems from both passive and actively managed funds that want to see change in how Asian companies are managed.

"Global institutional investors have increasingly bigger stakes in Asian corporates and are making sure that their voices are heard outside the US," says David Hunker, managing director, head of shareholder activism defense, J.P. Morgan. "These investors have been and will continue agitating for change in what they view as sub-par governance standards."

Asian markets that want to attract a more global group of investors don't want to be seen as tier two markets and are adjusting their standards to meet investor needs.

Hunker adds: "Many Asian corporations have family owners and managers, and have historically been controlled that way despite being publicly-traded. Investors want to level the disproportionate voting rights and gain a level playing field."

Shareholder activism has exposed regulatory shortfalls and regulators are under pressure to strengthen standards. Recent examples include South Korea's Financial Services Commission taking action by making public statements about minority shareholder rights, after the political fallout following recent high-profile activist campaigns. Former president Park Geun-hye was impeached and jailed over the corruption scandal linked to the merger of two Samsung companies, Samsung C&T Corp and Cheil Industries.

Regulatory changes are fuelling the confidence of activist shareholders and driving Asian countries to adopt international best practices in corporate governance and shareholder engagement. Key focus areas of regulatory reform are board and management, including transparency in chief executive successions and management remuneration; shareholder communications; and engaging institutional investors.

Stewardship and corporate governance codes also play an important role in influencing company behaviour. Australia, Japan, Hong Kong, the Philippines, South Korea, Malaysia, Taiwan, Thailand, and Singapore have all recently implemented stewardship codes.

"We felt it was a very positive step when earlier this year, the China Securities Regulatory Commission [CSRC] introduced new requirements that mandate all listed companies and bond issuers to disclose environmental, social and governance [ESG] risks associated with their operations," says Fiona Reynolds, chief executive of responsible investment organisation PRI.

The need for greater transparency is still an issue in Asia, but the region has made progress in this area. For instance, the stock exchanges in Malaysia and Hong Kong are demanding more disclosure on sustainability before public listings. Bursa Malaysia has been a regional leader in this regard and companies seeking a listing on the bourse have made significant inroads in ESG compliance.

Johnny Chan, head of legal at China Merchant Securities, observes that countries such as Singapore, Japan, Korea and Malaysia have made big steps in enhancing the independence and diversity of board representation by raising the proportion of independent directors.

"Increasing numbers of non-local investors are believed to be driving change and it's undeniable that Asian countries are moving closer to US and UK standards in corporate governance." he says.

Malaysia: Setting an example

Malaysia's Securities Commission's Code on corporate governance to increase the accountability and transparency of public companies took effect in April 2017. It forces companies to come up with concrete policies and action plans if they are not able to meet corporate governance requirements straightaway. Moving away from a comply-or-explain approach, the new method in the Code is inspired by the CARE acronym: comprehend, apply and report. The Code has 36 practices based on three principles:

- board leadership and effectiveness;
- audit, risk management and internal controls; and

- corporate reporting and stakeholder relationships.

Other practices, called step up practices, are recommended rather than mandatory, and are designed to encourage companies to further strengthen corporate governance.

In addition to reporting on a company's financial information, integrated reporting draws upon other value relevant information such as governance and environmental sustainability that lead to the company's creation of value.

While no sanctions are specified for a company that fails to adhere to the requirements under the Code, the Malaysia Securities Commission can withhold its approval for the initial public offering of any company preparing to list on the Bursa Malaysia if it does not comply with the Code and can't commit to doing so upon successful listing.

A number of changes in the new code target boards. A two-tier voting process involving controlling and non-controlling shareholders will be required to approve the appointment of independent directors in position for more than 12 years. Companies will also have to disclose how much they pay their top five executives. Boards will have to be composed of at least 30% of women by 2020.

"The business community is not thrilled with this but then this isn't unexpected," says Tay Beng Chai, managing partner at Tay & Partners. "The requirement of majority independent directors for larger companies and two-tier voting for long staying independent directors will help improve overall governance expectations. It is a mindset change that is needed and therefore it will move at an almost glacial pace."

"The investing public has started asking relevant and assertive questions," he added. "There will still be the usual door gifts that shareholders come for and which is a common motivation for attending annual general meetings. However, overall, we see a younger generation of shareholders asking and learning about the industries they have invested money in."

Hong Kong and Singapore are recognised as corporate governance leaders in Asia but a worrying tide is turning the other way

Kerrie Waring, ICGN

An undercurrent of risk

Although progress is being made, a wave of change has also swept through Asia, in particular, much-criticised amendments to the listings regimes in Hong Kong and Singapore.

"While both markets are traditionally recognised as corporate governance leaders in Asia, a worrying tide is turning the other way," says Kerrie Waring, chief executive, International Corporate Governance Network (ICGN). "They have embraced dual class share structures as a component of their listing rule frameworks."

She adds: "Dual class share structures are fundamentally flawed and carry significant governance risks by diluting minority shareholder protections, and create management entrenchment and limited accountability. In the extreme, such structures create opportunities for expropriation, with controlling shareholder gaining private benefits of control at the expense of minority shareholders."

With the internationalisation of China's capital markets and the inclusion of A-shares in the MSCI index, Shinzo Abe's ambitious goals to revive the Japanese economy and Hong Kong aiming to be a world class centre for company listings, all eyes are on how these jurisdictions are improving their standards for corporate governance.

Hong Kong: more needs to be done

The Report on Improving Corporate Governance in Hong Kong released in May 2018, commissioned by the Hong Kong Institute of Certified Public Accountants (HKICPA), found that the region's weaknesses primarily

revolved around the articulation of regulatory responsibilities especially between the Securities and Futures Commission (SFC) and the Hong Kong Exchange (HKEx), the quality of disclosure and transparency, as well as the ability of shareholders to seek redress when issuers and directors fail to meet expected standards.

"Hong Kong has largely kept up with international developments in the past two decades but we need to be more proactive in pursuing new initiatives to stay ahead as a global player," says Chris Joy, executive director, standards & regulation, HKICPA. "We should take into account the needs of business and market developments coupled with investor protection."

A number of recommendations focusing on board processes, and enforcement for regulatory agencies and shareholders were put forward to improve local corporate governance. For board processes, independent non-executive directors (INEDs) play a vital role in board effectiveness. Mechanisms that protect shareholders from potential abuses of the board need to be improved. Based on the findings of the report, the HKICPA is calling for listed companies to develop their own codes of conduct for INEDs on a comply-or-explain basis to help investors evaluate the role that companies expect their INEDs to fulfil and how effective they have been in performing the role. On the enforcement side, the report recommends that listed companies should be required to disclose any material breaches of listing rules and the steps taken to address these on an ongoing basis, as well as making an annual certification of the position.

But for shareholders, there is an enforcement vacuum between the powers of the SFC and the HKEx. In this regard, the HKICPA believes that regulatory efficiency could be improved by enabling earlier behaviour correction. For instance, the SFC should be given more graduated sanctioning powers, such as the power to fine a company as a first step to ordering the suspension of trading.

Syren Johnstone, executive director of the LLM in compliance & regulation at the University of Hong Kong, and the principal author of the HKICPA report along with Say Goo, professor of law at the University of Hong Kong, says progress in this market has focused less on truly innovative changes and more on creeping changes to existing codes. Other areas of progressive change have focused on the role of the industry regulator in relation to the listed market, and an increasing willingness to consider stronger means of enforcement such as through the courts.

"In the HKICPA report, we have queried the extent to which this succeeds in moving fundamental behaviours away from box-ticking compliance, and have made a series of recommendations we consider will be more effective and efficient," says Johnstone. "The most notable change affecting governance regulation is of course Hong Kong permitting weighted voting rights, subject to some safeguards, though it's too early to tell whether those safeguards will be adequate."

Other than the enforcement problem, which is a system design issue, the two biggest issues remain the role of INEDs and abuse by controlling shareholders. "How well the independent director concept really works in Asia, given the different context from its point of origin in the US, remains uncertain," explains Johnstone. "There is a growing recognition that an INED's understanding of their expected role and perception of liability, and their remuneration, need to be better aligned for the concept to have a chance of working properly."

There have been suggestions that the approach in the UK to empower INEDs should be followed, ie through dual voting and the requirement that the controlling shareholder enters into a relationship agreement that gives INEDs special powers. The HKICPA analysis considered the different mechanisms by which independence is determined or understood, the justification for altering the voting rights attached to shares, and concluded that there are more appropriate mechanisms for empowering the INED concept.

Too little, too weak

In July 2018, the HKEX published its conclusions to the consultation on proposed changes to Hong Kong's corporate governance code and related listing rules. The changes focus on improving board diversity and the independence of INEDs and will come into effect on January 1 2019.

Chan observes that the trend of amending the current rules related to directors, especially INEDs, to pursue greater transparency and accountability, are made based on corporate governance systems in the UK,

US, China and Singapore. It's believed that the reform would grant investors a better chance to assess a company before making investments.

Many Asian corporations have family owners and managers, and have historically been controlled that way despite being publicly-traded

David Hunker, JPMorgan

However, market participants believe the changes are not overly extreme and in line with the gradual shift Hong Kong is taking to improve corporate governance of listed companies.

"Overall, the changes in corporate governance are relatively mild and not a real landscape shift," says Craig Dally, partner at Linklaters. "For the past 20 years or so, Hong Kong has been slowly increasing its temperature on corporate governance."

Dally believes that the most significant changes are those related to the historical relationships of INEDs. One of these is the extended cooling period for a proposed INED who has been a director, partner, principal or an employee of a professional adviser providing services to the issuer and related from one to three years. Other independence criteria include the introduction of a one-year cooling off period for a proposed INED who has had material interests in the issuer's principal business activities in the past as well as the introduction of a new note to encourage inclusion of an INED's immediate family members' connection with the issuer in the assessment of their independence.

"The board diversity rule changes will apply some additional pressure on HK-listed boards to provide greater transparency but they are relatively light and are unlikely to change things too significantly," says Dally. "The key point will be whether nomination committees will feel like they can really just pay lip service to diversity and provide generic diversity explanations for board nominations, or whether the increased transparency of their reasoning will cause some to insist that a more diverse pool of directors is put forward. Time will tell."

The biggest impact is raising the corporate governance standards of Hong Kong listed company boards to international standards. "The recent areas of concern of international institutional investors include diversity, independence of INEDs and more engagement with shareholders," says Dominic Wai, partner at ONC Lawyers.

China: building momentum

The PRC is undoubtedly facing more pressure from the outside world to strengthen its corporate governance standards. There are more instances of shareholder activists making their views known in China.

"Exchanges and regulators in Hong Kong and China are raising the bar for listed companies by making things that were optional into regulations and recommended practices into code provisions," says an in-house counsel at a Chinese bank.

The in-house counsel adds: "The biggest problem for companies in China is the lack of transparency. For example, friends of controlling shareholders are often INEDs. Shareholder activists can help to improve corporate governance at companies if they don't resort to hostile actions."

From President Xi Jinping's anti-corruption drive to the focus on ESG in the 13th Five-Year Plan (2016-2020) and policies to deepen state-owned enterprises (SoE) reform, it's clear that China has taken governance right to the top of its political agenda.

However, the lack of transparency and access to information is a top concern for investors that want to engage with businesses. While some corporate governance transformations have followed international best practices, China is also experimenting with its own way of doing things to solve its own set of unique challenges. One of the interesting areas that China has made changes to recently is the reinforcement of Party committees inside Chinese companies.

Transparency calling

A Party committee is a body established by and reporting to the Chinese Communist Party that exists in both SoEs and private enterprises. It has wide ranging powers over businesses, including influence over the board of directors and provides guidance on how to comply with state laws. China created policy initiatives from 2010 to 2017 to strengthen corporate governance through Party committees and SoEs were required to incorporate them into their articles of association. Although the Party committee has a legal basis in both the Company Law and the Communist Party of China Constitution, it remains a murky concept, especially from the point of view of foreign investors.

The July 2018 Asian Corporate Governance Association's (ACGA) Awakening Governance report makes a number of recommendations to provide more clarity around Party committees. These include presenting reports of Party committees, such as details on membership and specific activities during the year; addressing the relationship and division of labour with the board of directors; and engaging more actively with minority shareholders, especially foreign institutional investors who are significant investors in the China market.

"As the Party organisation/committee is now a formal part of listed company governance structures, foreign institutional investors would welcome more transparency around its role and its decision-making relationship with the board of directors," says Jamie Allen, secretary general, ACGA. "We believe this would raise investor confidence as well as the understanding of China's system of corporate governance."

Further changes to corporate governance regulations in China can be expected. In June 2018, the CSRC issued a draft of the revised Code of Corporate Governance for Listed Companies for consultation. More guidance on the Code is expected from the China Association for Public Companies and the Asset Management Association of China. Proposed changes include putting more emphasis on ESG disclosure, reinforcing the accountability of the board of directors, including INEDs, and highlighting the role of institutional investors as stewards.

While the proposed amendments to the Code does include reference to the Party committees, Allen notes that there is no requirement for further disclosure. Furthermore, the Code doesn't operate on its own, and needs to work in conjunction with further improvements in corporate governance within the existing Company Law and Securities Law.

India: Beyond box-ticking

The Securities Exchange Board of India (Sebi) has amended its Listing Obligation and Disclosure Requirements Regulations 2015 (LODR), the law regulating corporate governance obligations of listed companies in the country. One of the key amendments relates to the separation of the roles of chairman and managing director, and further mandates that the people holding the two positions not be related to each other for the top 500 listed companies. This change will take effect from April 1 2020. Aimed at creating checks and balances to strengthen governance in line with global practices, this will lead to boardroom changes at large promoter driven companies in India.

Another change aims to improve the participation of women in boardrooms. The LODR now mandates the top 500 listed companies, with effect from April 1 2019, and the top 1000 listed companies, with effect from 2020, to appoint independent women directors. Earlier, the requirement was to appoint woman directors on the board but promoters treated this requirement as a box ticking exercise by appointing their female relatives to the relevant roles. This change will help foster gender diversity across corporate boards in India.

"The regulations are in place for a better corporate governance regime and to ensure improvement, but companies need to undertake compliance of these norms in spirit too," says Surbhi Kejriwal, partner at Khaitan & Co. "More emphasis should be put on stringent enforcement of existing regulations on errant companies, instead of introducing more regulations to curb the non-governance conduct."

The success of corporate governance measures depends on the degree of implementation and preparedness of the promoters to embrace the initiatives."

Japan: leading the pack

As part of Prime Minister Shinzo Abe's Three Arrows of Abenomics to revitalise Japan's economy and boost the corporate value of listed companies, a voluntary Stewardship Code was adopted in February 2014 and amended in May 2017. It encourages purposeful dialogue between investors and listed companies leading to the adoption in June 2015 of the Corporate Governance Code. In June 2018, the Tokyo Stock Exchange incorporated the principles set out in the Code into its listing rules.

Hunker observes that the relatively flat equity markets in Japan have pushed domestic investors to demand changes in governance regulations to create more value for shareholders.

"Japan has been thinking the most about corporate governance in Asia," he says. "It wants to be seen at the forefront of this issue."

Since the Corporate Governance Code was released, progress has been made. "But it seems decisive business judgments by management are insufficient at some companies and engagement between investors and companies is often merely a formality," says Tatsuya Nakayama, partner at Nishimura & Asahi.

In light of these issues, the Code was revised to make corporate governance reform more substantial. Basic ideas on the revision of the Code include the promotion of management decisions in response to changes in the business environment, the reduction of cross-shareholding, and the strengthening of asset owners' responsibilities mainly for corporate pension funds.

With this renewed focus on reform, Japanese companies have been urged to become more investor friendly.

What next?

Countries across Asia are adopting stricter rules on oversight of companies as both domestic and international investors increasingly question the lax governance standards and lack of transparency that are common in Asian businesses.

But jurisdictions are also realising that good governance means better businesses and stronger economies. Rather than a race to the bottom, Asian countries are gradually raising the bar and strengthening regulations to attract investors. However, much more still needs to be done. Creating stronger regulation is just the start. What is even more important is ensuring enforcement actually happens.

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