Asian Corporate Governance Association (ACGA)

"Corporate Governance Failures in Asia: How can Directors and Corporate Counsel Help to Manage Risk?"

Presentation by
Jamie Allen, Secretary General, ACGA
Hong Kong Corporate Counsel Association
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Agenda

1. Rating Corporate Governance Quality in Asia
2. Case Studies of Governance Failures
3. How Directors and Corporate Counsel can Help to Manage Risk
4. Conclusion

Introducing ACGA

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

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

1. Rating Corporate Governance Quality in Asia: ACGA – CLSA "CG Watch" Survey

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

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

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

Why scores in "CG Watch 2007" were lower

- Methodology became more rigorous
- "The more we looked, the less we found"
- Varying degrees of regulator, issuer and investor complacency in booming markets
  - "The job is done, we now just need to refine the rules"
- Political paralysis (eg, Korea) or upheaval (eg, Thailand)
- Accounting + auditing standards & practices lagged international norms more than expected (in many markets)

“CG Watch 2007” category scores (%)

Market	CG Rules & Practices	Enforcement	Political/ Regulatory	IGAAP	CG Culture	TOTAL
1. Hong Kong	60	56	73	83	61	67
2. Singapore	70	50	65	88	53	65
3. India	59	38	58	75	50	56
4. Taiwan	49	47	60	70	46	54
5. Japan	43	46	52	72	49	52
=6. Korea	45	39	48	68	43	49
=6. Malaysia	44	35	56	78	33	49
8. Thailand	58	36	31	70	39	47
9. China	43	33	52	73	25	45
10. Philippines	39	19	38	75	36	41
11. Indonesia	39	22	35	65	25	37

Source: “CG Watch 2007”, ACGA & CLSA Asia-Pacific Markets

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"CG Watch 2009"

Topical issues in our next survey include:

- Are governments taking a more strategic view of corporate governance as a result of this crisis, or are they seeking expedient solutions to immediate problems?
- Are regulators removing or waiving any core shareholder rights to allow easier capital raising in response to the financial crisis?
- How sound are systems of corporate financial reporting and external auditing?
- Are listed companies seeking a more open dialogue with their shareholders and key stakeholders?
- Are shareholders exercising their ownership rights more vigorously following the crisis?
- Are directors becoming more knowledgeable and committed?

2. Case studies of Governance Failures

- China Aviation Oil, Singapore
- Satyam Computer, India
- Citic Pacific, Hong Kong

China Aviation Oil, Singapore

- China Aviation Oil (CAO) faced near collapse in late 2004 due to losses of more than US$500m from risky trading in oil derivatives. Shares suspended in November 2004.
- In June 2005, creditors approved a debt restructuring. The company formed a special committee to advise on corporate governance issues.
- In late February 2006, former finance chief, Peter Lim, was jailed for two years and fined S$150,000 for making false and misleading statements about the trading losses.
- In early March 2006, three mainland directors, Jia Changbin, Gu Yanfei and Li Yongji, were fined S$150,000 each for intentionally failing to notify SGX about the the trading losses. Jia fined an additional S$250,000 for insider trading.
- Chen Juilin, former CEO, was sentenced to 4.25 years in jail and fined S$335,000, for conspiring to cheat, failing to notify SGX of CAO's losses, making false and misleading statements, breaching his director duties and insider trading.
- CAO shares resumed trading in late March 2006 with a new (independent) chairman and a new board, including new independent directors.

Two years later

- In April 2008, Mrs Lee Suet-fern, an independent director, resigned from CAO's board. She also chaired its audit and disclosure committees. Her letter of resignation stated:
  - "… it has become, as a result of the company's approach to information flow and the management of decision making, review and oversight, increasingly difficult for me to properly discharge my duties as an independent director of the company".
- In November 2008, CAO's independent chairman, Lim Jit Poh, also resigned. However, it appeared that his departure was more amicable. He said:
  - "Now that CAO has successfully rebuilt its business with proper governance structure and management team in place, my work at CAO is completed and it is timely for me to step down as CAO enters a new phase of development. It has been gratifying to see CAO emerge from the restructuring successfully and is now well positioned to execute its corporate strategy."

Satyam Computer, India

- On December 16, 2008, the Satyam board “unanimously” approves a US$1.6 billion acquisition of 51% of Maytas Infrastructure and 100% of Maytas Properties—two companies whose senior executives were the sons of Satyam chairman and founder, Ramalinga Raju.
- That evening during a conference call, institutional investors told Raju that they were implacably opposed to the deal. Satyam’s share price fell more than 50% overnight on Nasdaq.
- On December 17, 2008, Raju reverses his decision.
- By December 28, three independent directors resign from the board as further discrepancies come to the surface.
- On January 7, 2009, Raju resigns as chairman. He confesses in a letter of resignation to defrauding the company of more than US$1billion over several years by doctoring the company’s books. He claimed to have been acting on his own.

Satyam 2

- On January 9, 2009, the Andhra Pradesh police took Raju and two others into custody: his brother, Rama Raju, CEO and managing director at Satyam, and Srinivas Vadlamani, CFO.
- On the same day, the Central Government disbands the board and on January 11 appoints three high-profile members to the board. Three more are appointed on January 15.
- On January 24, two partners from Price Waterhouse, the company's auditors, are detained.
- Andhra Pradesh police refuse to allow SEBI, the market regulator, and other regulators to question the defendants without court permission!
- Lower court denies SEBI petition on technical grounds. It appeals to the Andhra Pradesh High Court, but faces delays, so moves its appeal to the Supreme Court (SC) on February 2. The SC granted the regulator permission on February 3 to interview the defendants.

Satyam 3

- Through February and March 2009, SEBI and the Ministry of Corporate Affairs amend rules to help the company survive. On March 6, SEBI gave the company approval to start a global competitive bidding process.

- On April 7, Vadlamani told the Institute of Chartered Accountants of India (ICAI) that other people in the finance department helped to cover up the fraud. Three more Satyam employees from its finance department are arrested.

- The same day, the Central Bureau of Investigation (CBI) filed a 300-page charge sheet against the six Satyam executives, two Price Waterhouse partners and a director at SRSR Advisory Services. The charges include criminal conspiracy, cheating, cheating by impersonation, forgery, falsification of accounts, etc. CBI has cited 433 witnesses and 1532 documents.

- On April 13, Tech Mahindra wins auction bid for a controlling stake in Satyam.

Citic Pacific, Hong Kong

- On October 20, 2008, Citic Pacific issued a profit warning on unauthorised leveraged forex contracts (on the Australian dollar and linked to an iron ore mine) that could result in losses of up to US$2 billion. Its parent, CITIC Group, had to cover its exposure.
- CITIC Pacific senior management had become aware of the problem on September 7.
- Hong Kong's Listing Rules (13.09(1)) expressly require disclosure of "material" information "as soon as practicable".
- On October 22, the SFC announced that it had begun a formal investigation into the company. This is still ongoing.
- On January 2, 2009, Citic disclosed that its entire board of directors was under investigation by the SFC.
- The ICAC began an investigation on April 3, 2009, prompting Larry Yung and Henry Fan to resign five days later. They were replaced by Chang Zhenming, vice chairman of CITIC Group.

3. Managing Risk

- Types of corporate governance risk:
  1. Regulatory risk
  2. Board risk
  3. Organisational risk
  4. Shareholder (investment) risk
  5. Stakeholder risk

- Directors are responsible for understanding these risks and ensuring that management takes mitigating action.
- Corporate counsel, along with other internal units, have a constructive advisory role to play.

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Regulatory risk

- Regulatory regimes undergo constant evolution:
  - **Securities laws:** In recent years, a much stronger focus on insider trading, fraud, market manipulation.
  - **Company law:** New focus on director duties, organisation of annual shareholder meetings, statutory derivative actions.
  - **Listing rules:** Stricter requirements on financial reporting, independent directors, audit committees, connected transactions, voting by poll, stock options.
  - **CG Codes:** Broader and deeper “soft law” guidelines on board governance, the role of directors, and auditing.
- How many directors of listed companies understand the full extent of these changes? The basic content of the law? And the regulatory and reputational risks that they face?
- Many complain that there is “too much regulation”. But …

Hong Kong's rising regulatory bar has not impeded capital market growth

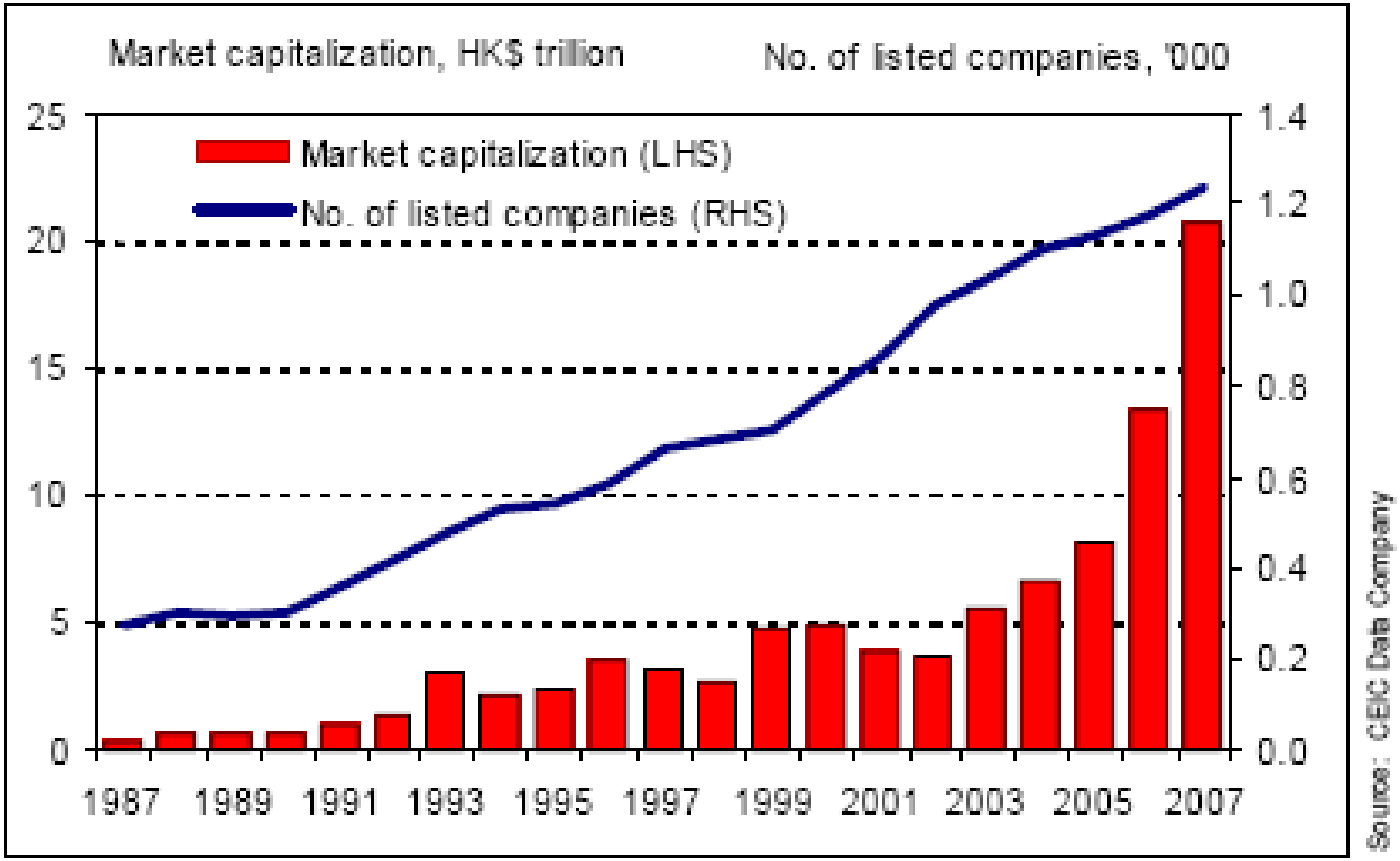

*Chart taken from Bauhinia Foundation report, 2008.

Board risk

- Are companies, especially smaller ones, getting good value from their boards?
  - **Board composition:** Is it appropriate, given the strategic direction and needs of the company?
  - **Board committees:** More thought could be given, in many companies, to the choice of committees, how they operate and what they should achieve.
  - **Independent directors:** If implemented well, they can bring considerable value to a board. But controlling shareholders need to allow them "voice".
  - **Director expertise:** The word "training" is despised by most directors. Yet a good director is an informed director. Knowledge needs to be updated.

Organisational risk

- Are companies investing sufficiently in robust internal controls and creating a culture of accountability?
  - **Reporting lines:** Is the board properly supervising major areas of risk (eg, forex hedging contracts, large M&A transactions)? Does it prioritise risk?
  - **Accounting systems:** Preparation of accounts. Use of information technology. Decisions by senior management on accounting policy.
  - **Internal audit:** Who does it report to—the CFO or chair of the Audit Committee?
  - **External auditor:** Does the company allow its auditor to talk directly to the Audit Committee?

Shareholder (investment) risk

- Companies like to diversify their shareholder base. But is the board aware of how rapidly the expectations and behaviour of institutional and retail shareholders is changing?
  - **Proxy voting:** Investors need the earlier release of final AGM agendas if they are to vote in an informed way (28 days). They want their votes properly counted ("voting by poll") and the results published.
  - **"Pre-emption rights":** Large and dilutive private placements to a select group of investors increases risk to other shareholders.
  - **Privatisations/delistings:** Protection for minority shareholders (eg, approval processes) are weak in much of Asia. Better in Hong Kong, but the PCCW case highlights a legal problem.
  - **Related-party transactions:** Large transactions that benefit the controlling shareholder also increase investment risk and will devalue the company over time. For this reason, one notorious Hong Kong company has a PE of 0.53 and a PBR of 0.05.
- An open dialogue with shareholders is good preventative medicine.

Stakeholder risk

- Stakeholder communities and issues are often fluid and also evolve in response to external factors:
  - Among investors, the understanding of "CSR" (corporate social responsibility) is changing and morphing into "ESG" (environmental, social, governance). ESG puts an explicit governance foundation under CSR.
  - Greater focus on the need for investors to incorporate environmental, social and governance **risks** into the investment process. For example:
    - United Nations Principles of Responsible Investment (UNPRI).
    - Greater attention on whether newly listed companies meet requisite environmental and labour standards.
    - Global pension funds looking for fund managers who can invest along ESG lines.
- Integrating ESG into a company's strategy and operations is the name of the game, but easier said than done.

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4. Conclusion

- Corporate governance has improved in Asia, but quality varies considerably between markets and companies.
- Governance failures may start within companies, but ultimately reflect weaknesses at the top.
- CG risk is a moving target. Directors and managers cannot afford hubris.
- Directors are responsible for understanding risk and ensuring that managers mitigate it.
- Corporate counsel have an important and constructive advisory role to play.

Contact details

Jamie Allen
Secretary General
Asian Corporate Governance Association Ltd

Room 203, 2F, Baskerville House
13 Duddell Street, Central, Hong Kong

Tel: (852) 2160 1788 (general)
Tel: (852) 2872 4048 (direct)
Fax: (852) 2147 3818
Email: jamie@acga-asia.org
Website: www.acga-asia.org