Corporate Governance In Asian Markets

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Introduction

Progress in corporate governance is often measured in terms of 'years from crisis'. It has now been a full 15 years since Asia's financial crisis, and five since the global financial crisis. In a mirror of its industrial and economic progress, Asia has progressed rapidly both in terms of regulatory frameworks and corporate governance culture during that time. Encouragingly, this evolution continues. Indeed, during the last year or so several markets finalized enhancements to corporate governance regulation that had their origin in the global financial crisis.

Malaysia, for example, released its new Code on Corporate Governance in March, part of a well-planned process that began with a broad-ranging five year Corporate Governance Blueprint in July 2011 – see: bit.ly/R5P8LW. The code identifies areas for improvement including not only corporate governance but listing rules and relevant laws. Other jurisdictions have been similarly active. Both Singapore and Hong Kong have revised their codes of corporate governance in the past year, while also strengthening listing rules. They address issues of tenure and 'over-boarding' in the new codes, but both stop short of prescribing mandatory limits for a serving periods or directorships held.

Following this surge in regulatory activity, a handful of jurisdictions in the region now have corporate governance frameworks that are arguably world class. Many of the changes have reflected the global mood in corporate governance, and have, for example, aimed to include risk management and diversity. However, events around the region during the year – including several corporate governance 'scandals' – have reinforced the need not only for robust rules and regulations, but also for investors to have an appreciation of the corporate governance culture at the companies (and countries) in which they invest. Rules and regulations alone do not ensure the quality of corporate governance.

Independence

Much of what has been put in place in the region over the past few years has focused on the structure of boards, the proportion of independent directors required on boards, and boards' role in risk management. Singapore's new code of corporate governance includes some well-crafted rules on independent directors that aim to limit the concentration of boardroom power.

For example, where the role of chairman/chief executive is combined, or where families dominate these roles, half of the board must be independent (typically, in Singapore, one-third independence is the requirement). Hong Kong amended listing rules to require issuers to appoint independent directors representing at least one-third of the board (previously, listing rules required three independent directors, while the code included as a recommended best practice that one-third of the board be independent – see: bit.ly/SUaMEV.

Yet the concept of the independent director is an import from Western models of corporate governance. Although it has proved (moderately) successful there in overseeing management in the context of an atomised shareholder base, in Asia it is typically either a family or state that owns the controlling stakes in companies. These controlling promoters get to recruit, nominate, and elect independent directors. As such, it would seem unrealistic to expect much independence from any director.

To be sure, there are some hardworking and experienced individuals serving as independent directors in the region, whose boards are tremendously lucky to have them. Yet they remain the exception. All too often it is difficult for shareholders to assess what the individual brings to the board, other than compliance with the respective codes.

This is changing, albeit slowly, as more boards undertake formal assessment of their own performance, forcing them to consider the skills required for board renewal.

State In Play

While rules and regulations are important, regulators are often constrained in their power to act, particularly when listed companies are based offshore. In Singapore, one company's independent directors, as well as its CEO, resigned en masse after failing to appoint a special auditor, as the exchange had instructed. As the company was Singapore-listed, yet based in China, this led to a standoff with the exchange. The episode was just the latest involving so-called S-Chips; mainland Chinese companies, run by entrepreneurs rather than the state, and listed in Singapore.

Indeed, geographic and political influences on corporate governance thinking were apparent elsewhere during the year. For example, in the audit field, investor concerns have historically focused on auditor rotation, non-audit fees and auditor tenure. This year we have come across situations where state secrecy rules (real or perceived) have affected both firms' ability to make material available to auditors, as well as auditors' ability to provide material to regulators. This has been the case with

a handful of Chinese companies. While it would be misleading to suggest such problems are common, the risks are real. It is not just China (where many firms are listed overseas), either. In other markets management teams of questionable quality may cite 'state secrecy' in order to hide information.

In the Philippines, changes to the way that courts view preference shares led some companies to issue new shares to meet foreign ownership limit. In Korea, meanwhile, this was the first year investors were affected by revisions to the Commercial Act, which allows company boards to approve financial statements (including income allocation) – something that had previously been the purview of shareholders.

Short Shrift

Away from regulations, this past year has seen a relatively new form of research proliferating, namely the shortseller report. Investors have long been used to short views, and to analysts discussing possible weaknesses in companies. This new breed of research firm is typically unknown, with uncertain motives and business models. What they do have in common is, a) an ability to focus on complex ownership structures, b) an appetite for on-the-ground research and fact corroboration and, c) an ability to effect a sometimes immediate and dramatic response to the company's stock price. Although the success of these reports has been mixed, they have highlighted the risks in certain company models and the need for investors to read thoroughly company reports and prospectuses (which usually contain a decent overview of the structures employed by these companies).

2012 Scorecard

Towards the end of 2012, the latest edition of 'CG Watch' (produced by the Asian Corporate Governance Association in collaboration with CLSA) was released. Widely seen as the most trusted reference point for measuring corporate governance in the region, the report once again put Singapore on top, marginally extending its lead over Hong Kong, whereas Indonesia and the Philippines were bottom and second bottom.

These market rankings would likely find consensus among many investing in the region. Less intuitively, Japan placed equal fourth in the market rankings (slipping one place from 2010), yet its companies were the second highest in terms of improvement (after Singapore). Similarly, Hong Kong placed second on the market rankings, yet its companies saw scores fall by between 1.5 and 2 percentage points, performing worse than, for example, their Malaysian peers in terms of year-on-year change.

There are obviously caveats when drawing conclusions from the change in annual scores. Still, the company rankings are useful for investors to assess what is happening 'on the ground'. Singapore scored highest for 'CG Culture', while Japan came in a surprising equal second with Hong Kong. There is an explanation for this.

Japanese companies have improved significantly over the past few years despite attracting criticism for their governance methods. An increasing number of them are appointing outside directors, and some are even appointing foreign directors. (Hitachi has been commended for reducing the number of inside directors on its board and for its appointment of two non-Japanese as outside directors in 2012).

Final Words

Despite the advances in regulatory frameworks, 2012 has proved to be a year where events have thrown up new corporate governance issues for investors. At the same time, there were variations on the old themes of fraud, corruption and malfeasance.

Developments on the regulatory front have served to move the corporate governance framework forward in many markets, and this is reassuring.

However, as investors, we do not place too much emphasis on regulators or faith in independent directors. The best protection is a good pair of shoes, a passport and a willingness to meet management and their companies face to face. Despite the various corporate governance 'scandals' of 2012, there remain many very well run companies in the region that possess a conservatism and respect for balance sheet metrics that is sometimes lacking in Western markets. These companies have a strong focus on corporate governance and minority shareholders. They should be held in high regard. ■

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