CG WATCH 2016

Ecosystems matter

Asia's path to better home-grown governance

Special report **September 2016**

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In collaboration with

ACGA
Asian Corporate Governance Association

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All prices quoted herein are as at close of business 14 September 2016, unless otherwise stated

Acknowledgements and disclaimer

This report was produced in collaboration with the Asian Corporate Governance Association (ACGA), an independent, non-profit organisation based in Hong Kong and working on behalf of all investors and other interested parties to improve corporate governance practices in Asia. CLSA is one of the Founding Corporate Sponsors of ACGA. For further information about the Association, including a list of its sponsors and members, see Appendix 1 of this report.

ACGA endorses the methodology used in the CLSA company survey and undertook the market rankings, with input from CLSA. ACGA did not participate in the assessments of companies, however, for which CLSA retains responsibility. ACGA bears final responsibility for the market rankings.

For important disclosures please refer to page 280.

Ecosystems matter

Improve engagement and governance slowly follows

Governance matters and the ecosystems that deliver it are the key. No single stakeholder can drive the process. It's the collective interaction of all parties that delivers better outcomes. Australia heads our bottom-up survey again and joins ACGA's top-down survey in 2016 at number one. Japan has moved up to number two on our scores. Reforms matter but how companies respond and deliver them is crucial. Investor engagement makes persistent improvement more likely. Asia is getting better and will continue to do so if stakeholders, including agitators, remain engaged. Even the friction adds value.

Australia shows why ecosystems are crucial

If there is a single message from ACGA's survey it's that the corporate-governance ecosystems in a market are *the* differentiating factor between long-term system success and failure. Hong Kong and Singapore do not consistently top their survey by accident, they have the best institutions. This survey's inclusion of regional leader Australia brought that into sharper focus.

Better governance leads to better fundamentals

Bottom up, Australia retains the clear leadership position in our updated 2016 CG Watch survey. Japan jumps to second as local reforms begin to tangibly improve behaviour. Elsewhere, ranks do not materially shift. We still can't confidently link CG and share prices but we can for proprietary metrics of governance and fundamental factors. The bottom line is better CG leads to better fundamental outcomes but is distinct from share-price action.

Investors are encouraged by improving engagement

To get a multi-stakeholder perspective we interviewed the Asian corporate-governance head from a major passive house (BlackRock) and a leading Asian active manager (Aberdeen Asset Management); we also spoke to a proxy advisor (Glass Lewis) and a corporate consultant (ISS Corporate Solutions). Asia's CG trend is improving, especially engagement levels. The interviewees suggest we should be optimistic about Asia's governance future but realistic in the context of clear structural differences.

Powerful forces are converging for a better ESG outlook

Finally, environmental, social and governance (ESG) has moved into the investing mainstream over the past two years. Drivers include tightening regulations, improving data, the Paris climate deal and mounting evidence ESG can help investment returns. In our sister report *Beyond the choir*, we include the latest environmental and social company scores. They are nearly flat with 2014 but this masks wide ranges within key sectors.

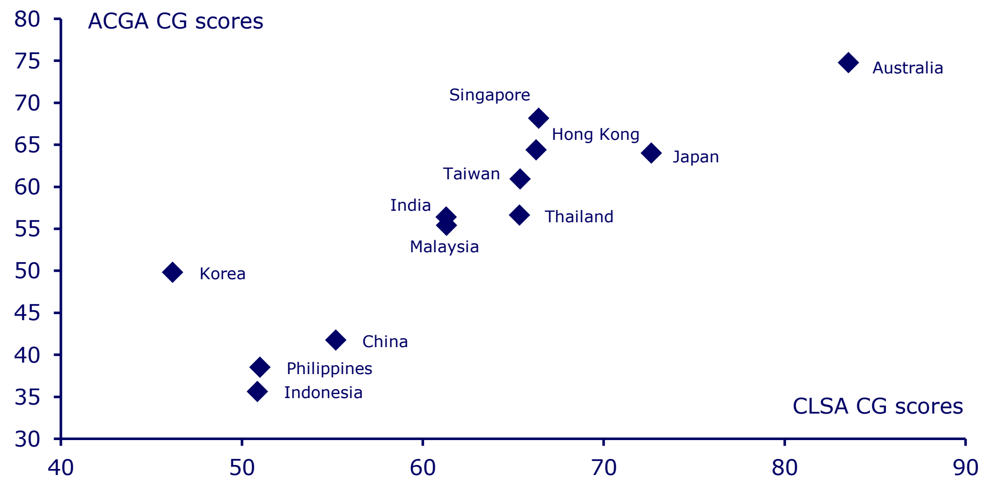
Difference between CLSA and ACGA scoring methodology

CLSA computes country scores based on aggregating bottom-up assessments of companies under CLSA coverage in Asia

ACGA computes country scores based on evaluating country performance using its survey

Please see Appendices 1-3 for CLSA and ACGA questionnaires

CLSA versus ACGA scores by market



Source: CLSA, ACGA

Engage to improve

Improve engagement and governance slowly follows

Governance matters and the ecosystems that deliver it are the key. No single stakeholder group can drive the process. It's the collective interaction of all parties that delivers better outcomes. Australia heads our bottom-up survey again and joins ACGA's top-down survey in 2016 at number one. Japan has moved up to second on our scores. Reforms matter but how companies respond and deliver them is crucial. Investor engagement makes persistent improvement more likely. Asia is improving and will continue to do so if stakeholders, including agitators, remain engaged. Even the friction adds value.

Major CG scores - The ecosystem matters

Ecosystem is everything

If there is a single message from ACGA's survey this year, it is that the ecosystem of corporate governance (CG) in any market is not just important, it is *the* differentiating factor between long-term system success and failure. In various ways, its previous surveys have always shown this: Hong Kong and Singapore do not consistently top the survey by accident, they do it because they have the best institutions - legal, regulatory and economic - for CG in the region. But this year the inclusion of Australia brought many things into sharper focus, allowing the team to look at old issues from a fresh perspective.

Australia included for the first time due to popular demand

ACGA included Australia because for many years readers have been asking it to benchmark Asia against a developed market outside the region. It chose Australia for three basic reasons: it has been a regulatory model for many Asian markets over the past 15-20 years; its system contains elements of both US securities regulation and UK company law, yet it also has its own unique features and appears to us as balanced; and there was considerable interest in Australia for its inclusion in *CG Watch.* We very much hope that the comparisons it makes in this report are an aid to understanding and also stimulate discussion. ACGA's implication is not that Asian markets should copy every feature of Australia's CG regime - indeed, some aspects of it are not worth copying!

Elements of the Australian system are applicable to Asia

ACGA does not expect corporate-ownership structures to change any time soon in Asia. Yet elements of the Australian system could be usefully applied in Asia. The benefit of an open door to shareholders is that you get to hear a wide range of useful opinions. Some of these may even be good for your business, as well as your governance.

CG Watch market scores: 2010 to 2016

(%)	2010	2012	2014	2016	Change 2014 vs 2016 (ppt)	Direction of CG reform
Australia	-	-	-	78	-	
1. Singapore	67	69	64	67	(+3)	Mostly sunny, but storms ahead?
2. Hong Kong	65	66	65	65	-	Action, reaction: the cycle of Hong Kong life
3. Japan	57	55	60	63	(+3)	Cultural change occurring, but rules still weak
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9. China	49	45	45	43	(-2)	Falling further behind, but enforcement better
10. Philippines	37	41	40	38	(-2)	New policy initiatives, but regulatory ennui
11. Indonesia	40	37	39	36	(-3)	Losing momentum after progress of recent years

Source: Asian Corporate Governance Association

CLSA survey indicates Australia leads all categories

Overall CG scores and by market by category for companies

(%)	Discipline	Transparency	Independence	Responsibility	Fairness	E&S	Overall CG
Australia	76.1	93.3	77.2	86.2	93.9	67.2	83.5
China	46.2	58.7	47.1	49.2	70.4	63.3	55.2
Hong Kong	66.4	71.6	49.2	61.0	84.3	64.4	66.3
India	55.7	73.0	35.7	55.2	84.7	65.4	61.3
Indonesia	53.6	68.8	19.3	30.9	77.9	57.8	50.9
Japan	71.2	86.9	35.5	84.8	87.3	68.0	72.6
Korea	39.5	59.8	19.4	45.8	57.3	62.5	46.2
Malaysia	57.7	67.1	38.3	57.1	85.4	63.1	61.3
Philippines	59.1	58.1	27.9	35.5	66.1	65.9	51.0
Singapore	58.6	86.1	51.3	52.8	85.7	62.0	66.4
Taiwan	66.0	60.5	49.8	73.1	76.4	67.3	65.4
Thailand	56.6	85.0	63.7	38.0	83.7	64.7	65.4
Average	58.9	72.4	42.9	55.8	79.4	64.3	62.1
Average ex-Aus	57.3	70.5	39.7	53.0	78.1	64.0	60.2
Max-Min range (ex-Aus)	31.6	28.8	44.4	53.9	30.0	10.2	26.5

Note: Boxes highlight leader (green) and laggard (gold) ex-Australia. Source: CLSA 2016 CG Watch survey.

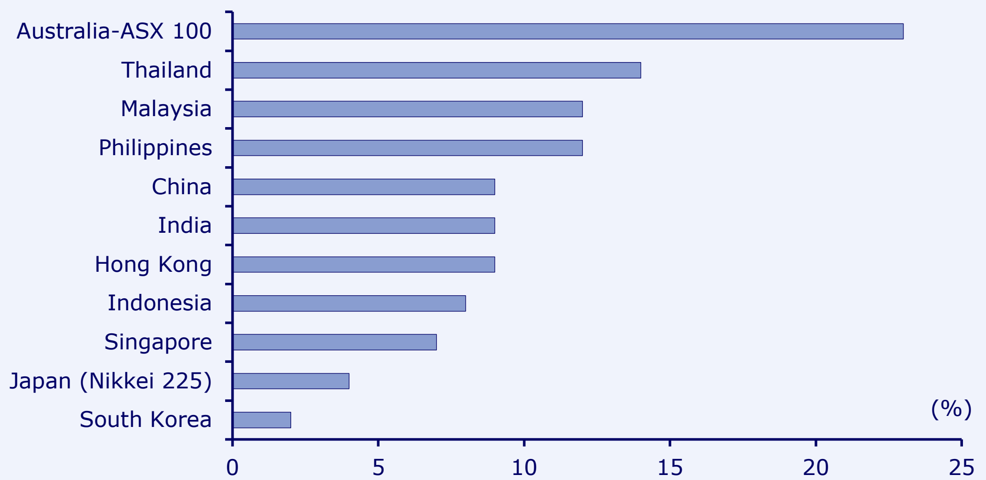
Governance institutions are more diverse and robust than most in Asia

Australia is ahead of Asia

The striking thing about Australia is how robust its governance is compared to Asia. The system supports development of richer, deeper and more balanced CG outcomes. It is not just more or better regulation (in some areas Asia has better rules), a more shareholder-friendly legal system, a more accountable government, a freer media, a diverse community of business associations and non-profit organisations - although all these help. It is a combination of all these factors and something less easily defined - an apparent willingness on the part of diverse players in government, the business community, and the financial and NGO sectors to work together, an acceptance that they need to talk to each other, and a broader consensus about accountability.

Australia leads board gender diversity in APAC

Board gender diversity in Asia Pacific region



Source: CLSA, ISS

Asia's hierarchical management-shareholder system is losing its utility value

ACGA's view is that the controlled and hierarchical management-shareholder communication system in Asia, while perhaps historically justifiable, is steadily losing its utility. Indeed, it may become a significant impediment to CG and capital-market development in this region, if it has not already. Japan, and several other markets that are developing investor stewardship codes, appear to agree.

Corporate swings and roundabouts

Australia remains ascendant, while Japanese reforms boosted it to second

Updating our bottom-up CG scores sees Australia retain the clear leadership position. The big jump this year is with Japan on a combination of a clear drive to reform local governance and the elimination of some technical questions from the survey that disproportionately hurt its prior rankings. Hong Kong and Singapore continue to score well bottom up. The tail of the scores is unchanged; the Philippines, Indonesia and Korea still show the most scope for improvement.

Ranking changes are not material outside of Japan's improvement

Historical market rankings vs 2016

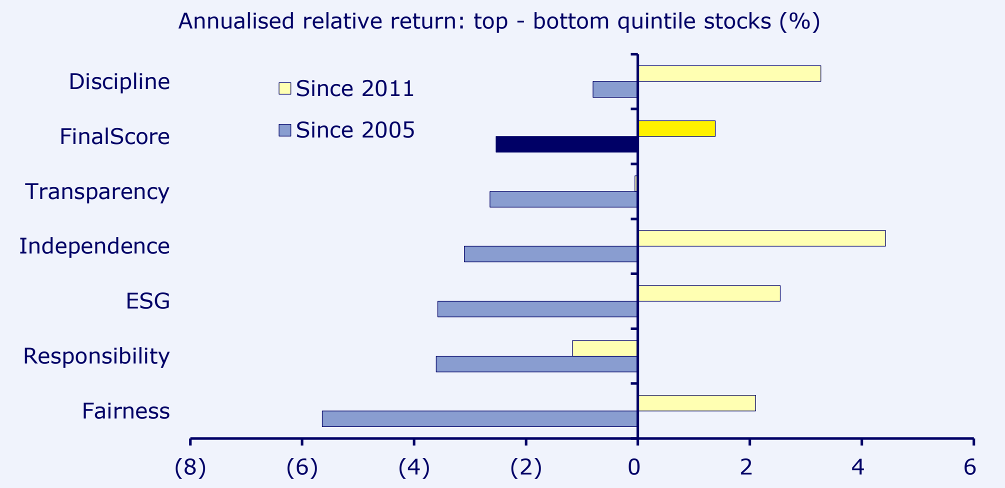
Country ranking	2005	2007	2010	2012	2014	2016
1	Thailand	Thailand	Thailand	Australia	Australia	Australia
2	Hong Kong	Hong Kong	Hong Kong	Singapore	Hong Kong	Japan
3	Taiwan	Taiwan	Singapore	Hong Kong	Singapore	Singapore
4	Malaysia	Malaysia	India	Japan	Thailand	Hong Kong
5	Singapore	India	Malaysia	Taiwan	Taiwan	Taiwan
6	India	Singapore	Taiwan	Malaysia	Japan	Thailand
7	Korea	Philippines	Philippines	Thailand	Malaysia	India
8	Philippines	Korea	Korea	India	India	Malaysia
9	China	China	China	China	China	China
10	Indonesia	Indonesia	Indonesia	Korea	Indonesia	Philippines
11				Philippines	Philippines	Indonesia
12				Indonesia	Korea	Korea

Source: CLSA 2005-16 CG Watch survey

One of the common questions we receive is the extent to which we can tie good CG to good share-price performance. The frustration is that the conclusions of the academic literature are often inconclusive and at times contradictory. From our perspective, the lack of consistency is likely to continue. The fundamental challenge is that share-price performance is a function of an extraordinarily wide range of factors; most of which are completely outside governance's *direct* sphere of influence. Updating the analysis with 2016 data, this view remains valid.

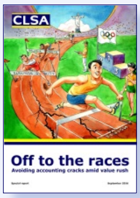
Governance is difficult to link to share-price performance

Asia ex-Japan performance by CG quintiles



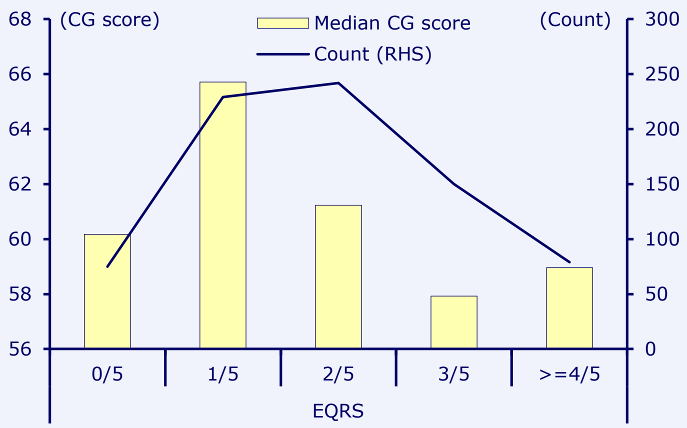
Source: CLSA

Strong governance companies deliver superior fundamental outcomes

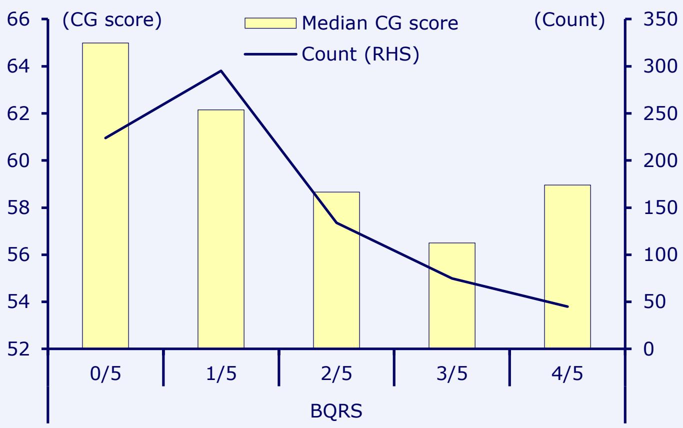


We expected to find more direct relationships between CG scores and the fundamental factors over which management has greater control. Reviewing the excellent Microstrategy data, that is exactly what we found. The majority of the team's fundamental factors exhibit better performance for the top-quintile CG companies versus bottom-quintile names. What increases our confidence is the clear relationships between CG quintiles and Microstrategy's proprietary earnings-quality-risk scores (EQRS) and balance-sheet-quality-risk scores (BQRS). Importantly, the balance-sheet conclusions (where management has greatest control) are stronger and the correlations more direct.

Median CG score by EQRS basket



Median CG score by BQRS basket



Source: CLSA, evalu@tor, CG Watch data, Microstrategy

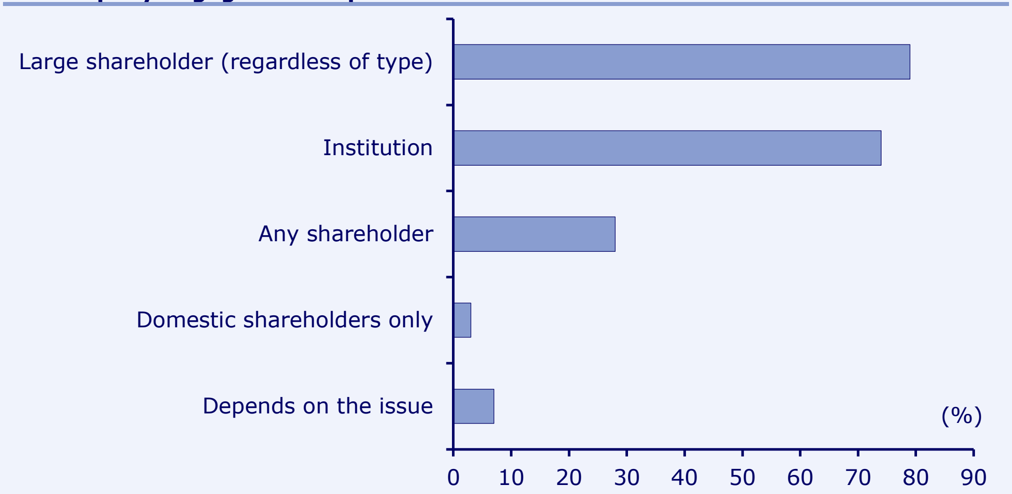
Some practitioners perspectives

To enhance the analysis of the 2016 survey we introduced investor interviews

One flaw of our current survey approach is that it implicitly puts much of the onus for good governance on the companies and how they interact with their environments. To get a better multi-stakeholder perspective we interviewed the Asian CG head from a major passive house (BlackRock) and a leading Asian active manager (Aberdeen Asset Management), a proxy advisor (Glass Lewis), and a corporate consultant (ISS Corporate Solutions). They are all active across the region.

US companies usually engage with large shareholders or institutions

US company engagement experience as a benchmark

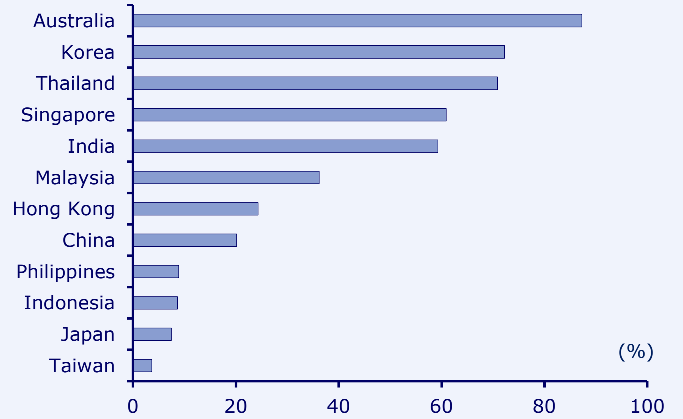


Source: CLSA, ISS

Challenges measuring governance lead to a preference for greater engagement

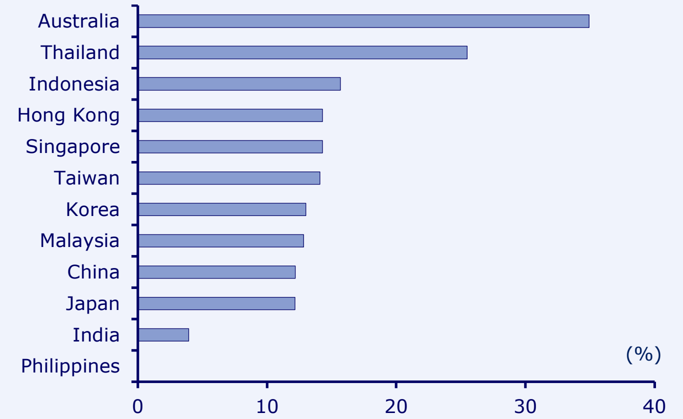
We found that investors tend to have a difficult time accurately measuring and, especially, quantifying governance. Industry disclosure tends to be generic and attempts to force-fit numbers can be counterproductive. Our interviews point to increased industry calls for a deprioritisation of simplistic assumptions like measuring the number of independent directors that can be easily gamed. Competence and confidence in the desire for mutually beneficial outcomes are far more important and harder to assign a number to.

2014 CG: Where half board are independent directors



Source: CLSA 2014 CG Watch survey

2016 CG: Evidence directors behaving independently



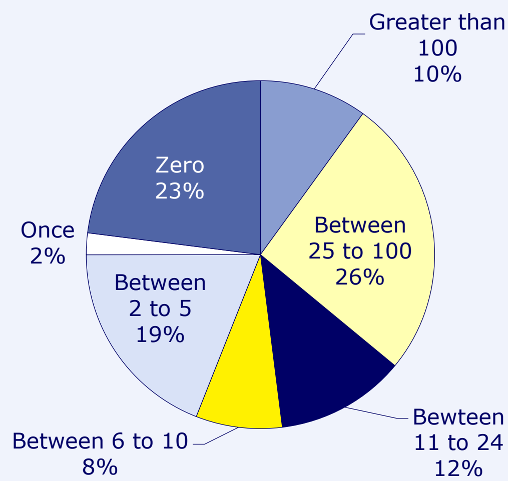
Source: CLSA 2016 CG Watch survey

Strong governance companies deliver superior fundamental outcomes

Our interviewees were most focused on qualitative assessments of corporate performance. It was not surprising to hear about a growing importance of investor-to-company engagement (and increasingly visa-versa). To that end, all interviewees we spoke to believe access in the region is getting better, albeit there is a substantial gap to the benchmark, which is clearly Australia. Structural differences primarily around concentration of ownership into government or family hands suggest that Asia is unlikely to replicate all of the changes of the Australian precedent. Nonetheless, a combination of ageing families, more active governments, more engaged institutional investors and company efforts to develop better relationships with their investors are all contributing to a sustainable trend of improvement.

Majority of the companies initiated more than six engagements a year

US issuer engagement frequency



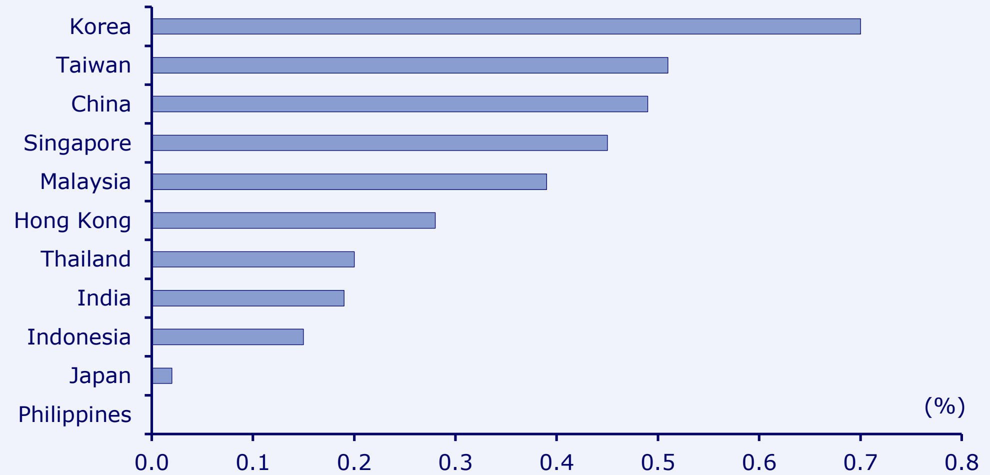
Source: CLSA, ISS

Essentially all resolutions get passed in Asia, highest failure ratio is 0.7% in Korea

The experience of the last decade seems to suggest that regulatory shocks, investor-company vote clashes and even activist events on balance more often tend to be catalysts for improvement rather than for reversion to the worst behaviours. That said, all interviewees acknowledged true conflict is exceptionally rare, and while the engagement process is essentially designed to preclude its requirement, the reality is that egregious behaviours continue in Asia and are not being rejected as much as they would be in the absence of structural constraints. Asia still has a long way to go versus global best practice.

Regulatory shocks and investors-corporate conflicts, on balance, have helped process

Failure ratio of resolutions by market



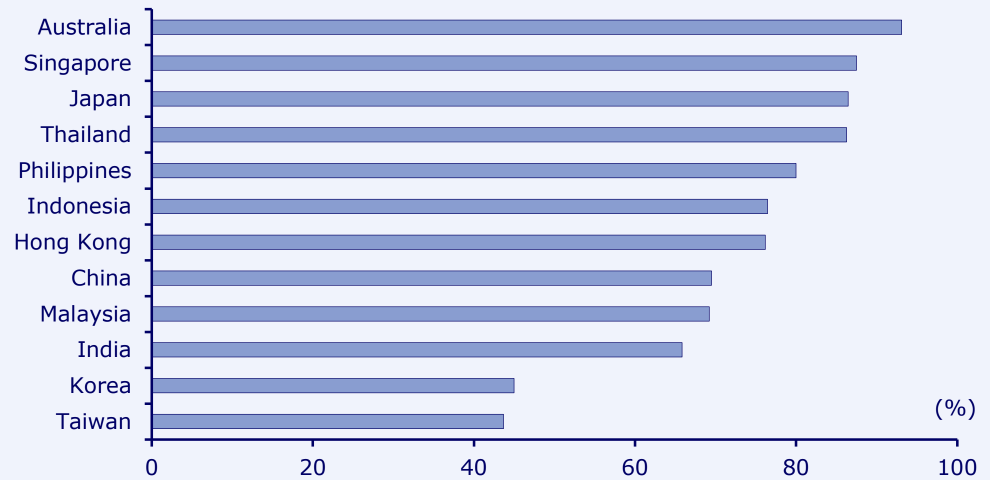
Source: CLSA 2016 CG Watch survey

Clear investor appetite to deepen and broaden the engagement process

The key area of opportunity in Asia is not just to deepen the access and so the quality and impact of the discourse but to broaden it. There is a clear appetite to see more of the director community, encourage the deepening of the skill pool there and work collaboratively to better understand one another. Overall, the interviewees suggest we should be optimistic about the future of Asian governance but realistic in the context of clear structural differences. Warren Buffett was right; companies ultimately get the shareholders they deserve. This analysis tells us that they must work collaboratively with the companies so that Asia ultimately gets the companies it deserves as well.

Korea and Taiwan stands out with low company access

Percentage of companies assessed as providing access by country



Source: CLSA 2016 CG Watch survey

Beyond the choir

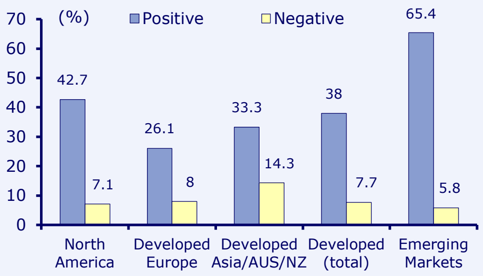
Four powerful forces at work

Environmental, social and governance (ESG) has quietly moved into the investing mainstream over the past two years. Drivers include tightening regulations, improving data, the Paris climate deal and, above all, mounting evidence that ESG can help deliver investment returns. At CLSA, our latest environmental and social company scores are nearly flat with 2014 but this masks wide ranges within key sectors.

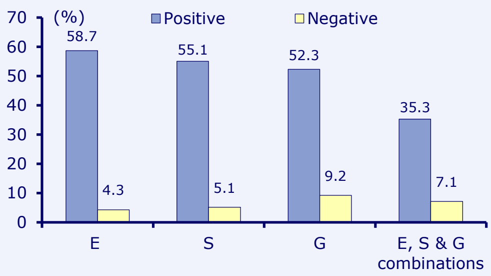
On paper, ESG has been growing fast for a long time. The assets under management signed up to the UN Principles of Responsible Investment expanded sixfold from 2007 to US$62tn in 2016, and Asia's share is growing. However, much of the flurry of ESG-related reports seemed to be just more preaching to the proverbial choir, with a growing lexicon of acronyms and metrics unintelligible to non-specialists. Over the past couple years, this has all changed.

Emerging markets show strongest link

ESG and CFP links across regions



E, S and G categories in relation to CPF



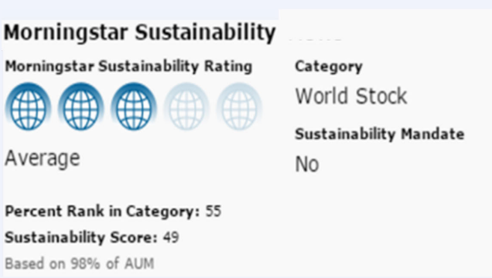
Source: Friede, Busch, Bassen via (ESG & Corporate Financial Performance: Mapping the global landscape)

Creating a multitrillion dollar opportunity

ESG has got its mojo back. Drivers include ESG fund ratings, surprisingly successful climate-change negotiations in Paris, China's ongoing war on pollution, the haze in Singapore and the step-change in reputational risk for Western brands stemming from more visible supply chains. In Appendix 1 of our sister E&S report, we also speak to long-term Asian practitioners across the ESG value chain to get a more nuanced view of what is changing and why.

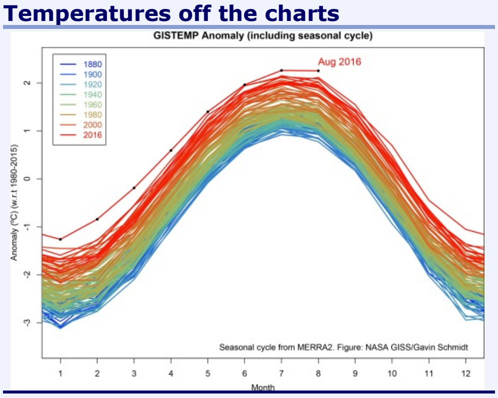
As temperatures soar, asset owners are scrutinising ESG performance

You really don't want one globe



Source: Morningstar

Temperatures off the charts



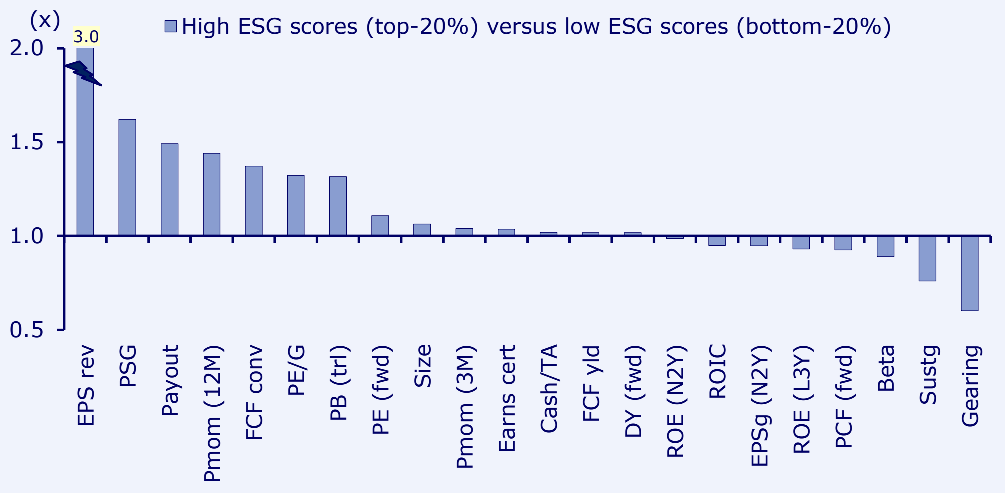
Source: Bloomberg

Need to be aware of significant downside risks

Companies that better manage environmental and social risks should theoretically deliver better returns over time. That theoretical link is grounded in a growing body of academic research and investor studies. Among these, our Microstrategy team shows that companies which achieve higher ESG scores also perform better on earnings revisions and payout; they also exhibit better free cashflow quality and lower balance-sheet risk.

High ESG has lower downgrade and balance-sheet risk

Characteristics analysis: Asian stocks with high ESG scores versus low ESG scores

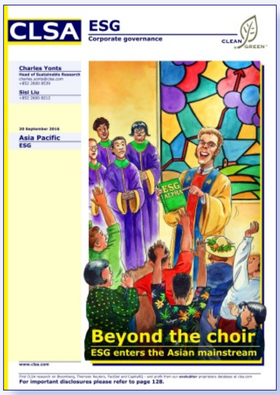


Note: Universe is broader Asia Pacific ex-Japan universe with market cap greater than US$500m and more than three analysts coverage. Current CLSA ESG score is used. Source: CLSA, FactSet

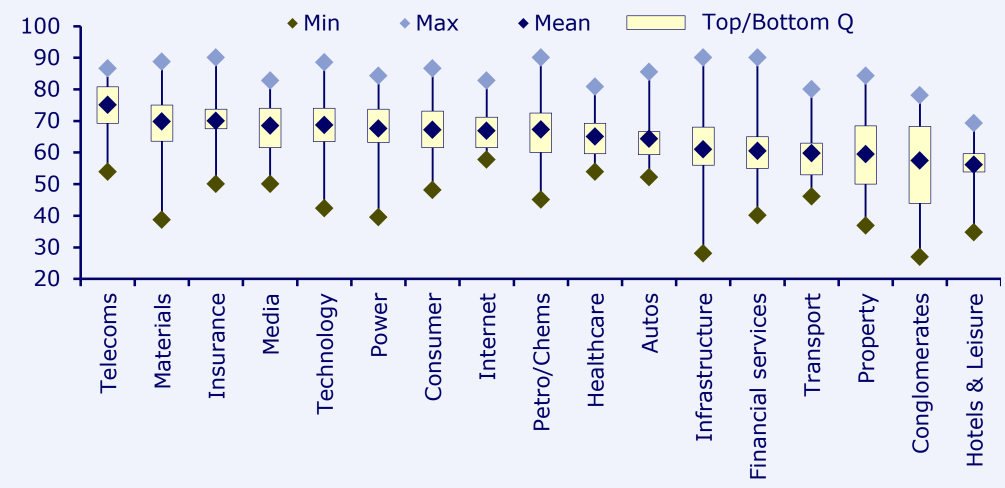
Take another look at the climate business

Poor data quality has been the biggest challenge for ESG research. Our research analysts score the c.1,000 companies that we cover across the region on key material issues, broken into 11 different sectors. We view it as a valuable starting point for better analysis, but it is more qualitative than quantitative. As Asian exchanges ramp up reporting requirements over the next three years, driving up the quality of data available, ESG will surely continue to win converts among mainstream investors.

Breaking down to CLSA sectors



E/S scores at CLSA



Source: CLSA

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Market CG scores - The ecosystem matters

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Australia's governance institutions are more diverse and robust than most in Asia

Having said that, the striking thing about Australia is just how robust its governance institutions are compared to many parts of Asia, and how its system has supported the development of richer, deeper and more balanced CG outcomes. It is not just a matter of more or better regulation (in some areas Asia has better rules), a more shareholder-friendly legal system, a more accountable government, a freer media, a diverse community of business associations and nonprofit organisations - although all these things certainly help. Nor is it because Australia has been at the CG game for longer (in some areas it has not). It is a combination of all these factors and something less easily defined - an apparent willingness on the part of diverse players in government, the business community, and the financial and NGO sectors to work together, an acceptance that they need to talk to each other, and a broader consensus about accountability.

Figure 1

CG Watch market scores: 2010 to 2016

(%)	2010	2012	2014	2016	Change 2014 vs 2016 (ppt)	Direction of CG reform
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3. Japan	57	55	60	63	(+3)	Cultural change occurring, but rules still weak
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11. Indonesia	40	37	39	36	(-3)	Losing momentum after progress of recent years

Source: Asian Corporate Governance Association

"Accountability" a more opaque concept in Asia

Accountability is a more opaque concept in Asia. In our experience, many people in positions of authority - officials, company owners, directors and others - are often reluctant to talk to their inferiors or people they do not know. Trust is much harder to establish. Of course, there are many exceptions, as well as companies that are open to their shareholders. But as a general rule, this more constrained cultural and political dynamic broadly holds true.

Investors in Australia have access to company chairmen - not usually the case in Asia

Business culture has evolved very differently in Australia and this has profound implications for CG. While it was not always the case, major institutional shareholders today routinely have access to company chairmen, CEOs and independent directors. This is partly because of regulatory catalysts such as the "two-strike rule" on executive remuneration (only adopted in 2011), but also because there is a consensus that directors are, and *should* be, accountable to shareholders. This is itself a product of corporate-ownership structures that are more dispersed, leaving their professional managers little to hide behind when things go wrong. Boards actually remove underperforming CEOs. How often does that happen in Asia?

Elements of the Australian system are applicable to Asia

We do not expect corporate-ownership structures to change any time soon in Asia. Yet elements of the Australian system could be usefully applied in Asia. The benefit of an open door to shareholders is that you get to hear a wide range of useful opinions. Some of these may even be good for your business, as well as your governance.

Asian companies too often surprised by the reaction of shareholders

How many times in Asia have companies been taken by surprise at the negative reaction of their shareholders, stakeholders or society at large to a major value-destroying deal they just announced? Or to a securities law they just blatantly breached? There is an element of this reaction in almost every corporate scandal of the past few years. Yet company leaders and directors would not be surprised if they had more direct contact with key groups. Mediating through an investor relations team is just not sufficient. How do you know you are getting the full story?

Asia's hierarchical management-shareholder relationship is losing its utility value

Our view is that the more controlled and hierarchical management-shareholder communication system in Asia, while perhaps historically justifiable, is steadily losing its utility. Indeed, it may become a significant impediment to CG and capital-market development in this region, if it has not already. Japan and several other markets developing investor stewardship codes appear to agree.

Next 15 years must be about other parts of the ecosystem - firms and investors - doing their bit

As this and previous *CG Watch* surveys show, regulators have made a huge amount of progress in building stronger CG regimes in Asia over the past 15 years. The next 15 years needs to be about developing a more open corporate mindset around dialogue with shareholders and relevant stakeholder groups. Institutional investors need to utilise the moral authority given to them by stewardship codes and exercise their delegated ownership rights on behalf of beneficiaries. And Asian governments need to allow a deeper civil society to develop, one that is mutually reinforcing and caters to the needs of a more complex economy.

Reasons why markets went up or down

A note on the rankings

Key reasons why markets went up or down this year are:

1. **Singapore**: Revamped its enforcement strategy and regained ground lost in 2014. It also brought its overall CG regime more up to date.
2. **Hong Kong**: Despite some courageous regulatory decisions, it lost points (yet again) on the lack of an independent audit regulator.
3. **Japan**: Achieved a higher score due to new CG rules, but does not yet surpass Hong Kong.
4. **Taiwan**: Leapt into fourth on numerous CG and ESG initiatives, strong political support and better enforcement.
5. **Thailand**: Maintained score through regulatory changes, despite a difficult political environment, but fell in ranking due to Taiwan's rise.
6. **Malaysia**: Fell in score and ranking due to public-governance debacles.
7. **India**: Slightly higher score due to improved regulation and enforcement, but not enough to change the ranking.
8. **Korea**: Materially improved score thanks mainly to regulatory efforts, but not enough to change the ranking.
9. **China**: Score fell due to absence of major CG reform and regulatory mis-steps during stock-market crisis of mid-2015. But has much better enforcement than the Philippines or Indonesia.
10. **Philippines**: Score fell because of slow progress on reform and general CG standards well below other markets. Same ranking.
11. **Indonesia**: Despite some improvements in CG rules, and a new CG code, weaknesses in enforcement is holding it down. Same ranking.

Some different trends emerging from our category scores

Category scores

While the same patterns broadly hold in our category scores this year as in previous surveys, some interesting new points are emerging:

- In the early days of our survey, as one would expect, markets typically scored much higher for **CG rules & practices** than for **Enforcement**. This now holds true for just four markets: Thailand, India, the Philippines and Indonesia. There are two main reasons for this: a greater emphasis in our questions on company practices (eg, financial reporting) and much greater regulatory focus on enforcement. Interestingly, many regulators seem to find it easier to push through tougher enforcement than higher CG standards on the books (since the latter often requires a public consultation and more political capital; but no one can argue against better enforcement).
- **Enforcement** continues to be where markets show most consistent improvement over the years. This is due to heightened regulatory enforcement by securities commissions and stock exchanges, as well as enhanced private enforcement by institutional and retail investors through voting and engagement. Markets that did better this year due to regulatory enforcement include: Singapore, Malaysia, India and Korea. Markets that did better due to more active investor participation include Taiwan and India.
- Only a few markets stood out for notably improved scores in **Political & regulatory environment**: Singapore, Japan and Korea. More markets fell: Thailand, Malaysia, India, China and Indonesia. This sections takes a number of factors into account, such as degree of political support for CG

reform, proper funding of regulatory agencies, the quality of the judiciary, the presence or absence of an effective anticorruption agency, and whether the government is protecting or enhancing civil-service ethics. As this category shows, government commitment to all these factors can be uncertain and volatile.

Figure 2

Market category scores (CG Watch 2016)

(%)	Total	CG rules & practices	Enforcement	Political & regulatory	Accounting & auditing	CG culture
Australia	**78**	80	68	78	90	74
1. Singapore	**67**	63	63	67	87	55
2. Hong Kong	**65**	63	69	69	70	53
3. Japan	**63**	51	63	69	75	58
4. Taiwan	**60**	54	54	64	77	50
5. Thailand	**58**	64	51	45	77	50
6. Malaysia	**56**	54	54	48	82	42
7. India	**55**	59	51	56	58	49
8. Korea	**52**	48	50	53	70	41
9. China	**43**	38	40	36	67	34
10. Philippines	**38**	35	19	41	65	33
11. Indonesia	**36**	35	21	33	58	32

Source: Asian Corporate Governance Association

- **Accounting and auditing** continues to be the highest scoring category for most markets, due to the acceptance of international accounting and auditing standards by governments, as well as concepts of auditor independence and independent audit regulation. However, the scores for some markets are starting to fray as we look closer, in particular, at the quality of their auditing, audit regulation and auditor independence rules. Markets that have dropped in score here include Hong Kong, Thailand, Malaysia, Korea and Indonesia. A few markets have risen: Singapore, Japan, Taiwan and India.
- **CG culture**, always the most disappointing category, is starting to show some signs of life in some unexpected places, notably Korea, where it has bounced up from a low base (due to several small score increases for company dialogue, investor activism, director training disclosure and some other items). Incremental increases are evident in Japan and Taiwan.

North Asia finally stands out in this survey

One striking difference between this survey and the past two is how much North Asia's improvement stands out. In 2012, it was all Southeast Asia. In 2014, it was a mixed picture. In 2016, more North than Southeast. Three of the four major North Asian markets have improved in score (Japan, Taiwan and Korea) and one (Taiwan) has improved in ranking. Only China has underperformed. Meanwhile, Southeast Asia, which had been showing so much promise in recent years, is being let down by its governments and politicians.

Spare a thought for the regulator

Regulators are NOT solely responsible for their market rankings!

We fully appreciate the frustration that financial regulators and exchanges must feel when reviewing the results of this survey. We would say that the vast majority of the regulators we meet around the region are dedicated to their jobs and are doing their best to push reform ahead as far and as fast as they can. Indeed, a trend we have noticed is what one might describe as the "march of the technocrats". This is the increasing bifurcation we see in many markets between the open-minded, international and transparent style of capital-market regulators and the closed-minded, parochial and unaccountable behaviour of their political masters.

Financial regulators speak a different language to most government officials

True, the two groups are often serving different ends: financial regulators are trying to cater to a complex array of local and foreign stakeholders, and must be sensitive to international ideas, standards and language. Local politicians, on the other hand, have more self-interested, populist and domestic preoccupations. It is a hard circle to square.

The tone set by government makes a huge difference to good corporate and public governance

However, while capital-markets regulators and stock exchanges are a linchpin of CG standards in any market, they are not the only important part of the ecosystem that our survey measures. Public governance and government support are critical in the long term for greater accountability in corporate behaviour (private, as well as state-owned), and are as important as a free press, an effective justice system and engaged investors. We would argue that the tone set by the public sector matters greatly and can either restrict or foster what regulators are able to achieve in both policy and enforcement. As such, regulators should not be seen as solely responsible for movements in market scores - up or down - in *CG Watch*.

A note on methodology

ACGA market questionnaire

Market survey improved this year: two questions dropped and three new questions added

We have amended and updated the content of our questionnaire to remove questions we felt had become redundant or no longer of comparative value, and to add questions that highlight some newer issues. We also rewrote some questions to make the phrasing clearer. We have increased the total number of questions from 94 to 95, with two dropped and three added.

In **CG rules & practices**, we added one new question (A.20) on stewardship codes, since some markets in the region have issued such codes in the past two years to increase shareholder engagement.

We also rewrote slightly the three new questions we added in 2014 on sustainability reporting standards and practices (A.7, A.8 and A.9) to reflect the broader range of global standards in this area. We also added further explanation to our question about quarterly reporting (A.12) to differentiate between "template" reports with just numbers and more narrative-oriented reports, which seek to explain the numbers as well.

We made no changes to the **Enforcement** and **Political & regulatory environment** sections.

In **Accounting & auditing**, we changed the wording of one question (D.2) to recognise that the accounting rules of most markets in the region are "largely" in line with IFRS, since few markets are "fully" in line at any one point in time (given the onward march of IASB standards).

We added a further example to a question on the independence of external auditors (D.11), namely whether they had a duty to report fraud. We also clarified our question on independent oversight boards (D.12) to make it clear that their powers should cover both individual auditors and audit firms.

In **CG culture**, we dropped two somewhat general questions about CG standards of large caps and SMEs and added two more specific and timely ones on board evaluations (E.2) and director training (E.3). We also rewrote one question about the independence of chairmen and directors (E.6) to make the wording more concise.

Acknowledgements

Research on *CG Watch 2016* was carried out over February to August 2016 by a team that included four senior research directors, one analyst, two consultants and two research assistants. We would like to acknowledge the fine support of the following people: Neesha Wolf, Shivani Hemnani and Loong Siu Chung.

Corporate swings and roundabouts

Better governance leads to better fundamentals

Australia retains the clear leadership position after updating the data for our 2016 CG watch survey. Japan jumps to second as local reforms begin to tangibly improve behaviour there. While the new data does little to resolve the question of a clear link between CG score and share-price performance, we wouldn't expect it to. We were, however, able to demonstrate a clear link between CG rankings and the fundamental performance of our coverage by coupling proprietary metrics in both fields. The bottom line is better CG leads to better fundamental outcomes but is distinct from share-price action.

Australia remains ascendant, while Japanese reforms boosted it to second

Updating our bottom-up CG scores sees Australia retain the clear leadership position. The big jump this year is with Japan on a combination of a clear drive to reform local governance and the elimination of some technical questions from the survey that disproportionately hurt its prior rankings. Hong Kong and Singapore continue to score well bottom up. The tail of the scores is unchanged; the Philippines, Indonesia and Korea still show the most scope for improvement.

Governance is difficult to link to share-price performance

One of the common questions we receive is the extent to which we can tie good CG to good share-price performance. The frustration is that the conclusions of the academic literature are often inconclusive and at times contradictory. From our perspective, the lack of consistency is likely to continue. The fundamental challenge is that share-price performance is a function of an extraordinarily wide range of factors; most of which are completely outside governance's *direct* sphere of influence. Updating the analysis with 2016 data, this view remains valid.

Strong governance companies deliver superior fundamental outcomes

We expected to find more direct relationships between CG scores and the fundamental factors over which management has greater control. Reviewing the excellent Microstrategy data, that is exactly what we found. The majority of the team's fundamental factors exhibit better performance for the top-quintile CG companies versus bottom-quintile names. What increases our confidence is the clear relationships between CG quintiles and Microstrategy's proprietary earnings-quality-risk scores (EQRS) and balance-sheet-quality-risk scores (BQRS). Importantly, the balance-sheet conclusions (where management has greatest control) are stronger and the correlations more direct.

Ranking changes are not material outside of Japan's improvement

Figure 3

Historical market rankings vs 2016

Country ranking	2005	2007	2010	2012	2014	2016
1	Thailand	Thailand	Thailand	Australia	Australia	Australia
2	Hong Kong	Hong Kong	Hong Kong	Singapore	Hong Kong	Japan
3	Taiwan	Taiwan	Singapore	Hong Kong	Singapore	Singapore
4	Malaysia	Malaysia	India	Japan	Thailand	Hong Kong
5	Singapore	India	Malaysia	Taiwan	Taiwan	Taiwan
6	India	Singapore	Taiwan	Malaysia	Japan	Thailand
7	Korea	Philippines	Philippines	Thailand	Malaysia	India
8	Philippines	Korea	Korea	India	India	Malaysia
9	China	China	China	China	China	China
10	Indonesia	Indonesia	Indonesia	Korea	Indonesia	Philippines
11				Philippines	Philippines	Indonesia
12				Indonesia	Korea	Korea

Source: CLSA 2001-16 CG Watch survey

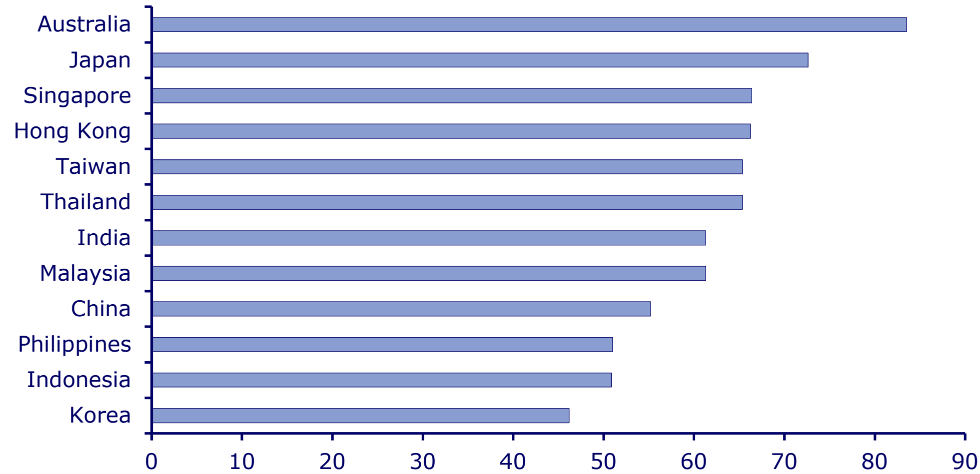
Australia remains ascendant while Japanese reform boosted it to the second ranking

When we aggregate our CG scores we encourage investors to focus less on the specific number and more on the rankings and relative trends. The language we like to use disregards the specific address and focuses more on the neighbourhood. Applying this lens the core conclusion of the bottom up is that the general trend of gradual improvement for Asia continues, with one exception, Japan has moved back into the best Asian neighbourhood.

Ranking changes are not material outside of Japan's improvement

Figure 4

Average CG scores by market



Source: CLSA

Conclusions are broadly consistent with ACGA findings

We can cross-check bottom-up conclusions by comparing them with ACGA's top-down findings. The key differences are Japan and Korea. Japanese analysts are more favourable on improving focus on returns to capital and accessibility. For Korea, the analysts see bottom-up reform lagging top-down efforts (which is a consistent conclusion but drives the score differential).

Difference between CLSA and ACGA scoring methodology

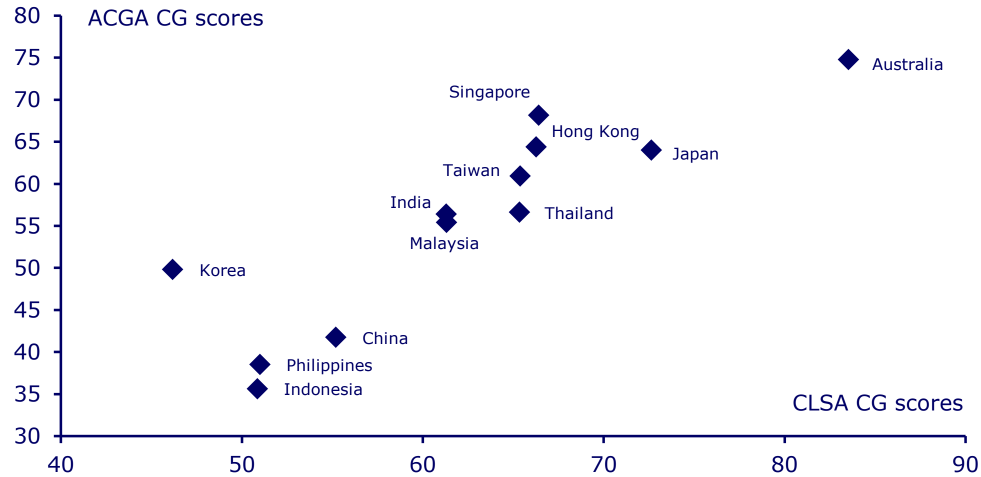
CLSA computes country scores based on aggregating bottom-up assessments of companies under CLSA coverage in Asia

ACGA computes country scores based on evaluating country performance using its survey

Please see Appendices 1-3 for CLSA and ACGA questionnaires

Figure 5

CLSA versus ACGA scores by market



Source: CLSA, ACGA

Criteria used in CG scoring

Other than E&S, five core sections in CG scoring

Before delving further into the results it is important to revisit the methodology and to understand where and how it has changed. The five sections of the core CG scoring methodology remain the same: discipline, transparency, independence, responsibility and fairness. Each has three to seven questions, which together are assigned an 18% weight for each of the five categories in our overall CG score (the residual 10% continues to be assigned to the E&S score). The full questionnaire is provided in Appendix 3.

We have adjusted the questions in some cases to improve survey's utility

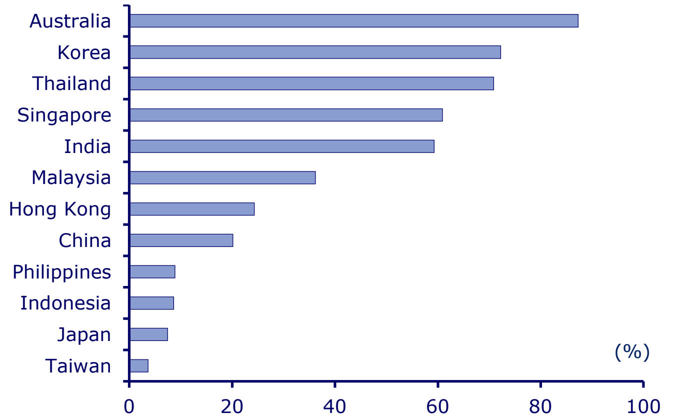
What has changed this year is that we simplified the wording of questions to try to increase consistency of understanding and scoring from analysts (we retained detailed guidelines on how to score each). We also removed or replaced questions that we feared had lost relevance or could be gamed.

Simplest example is looking at changes to independent director questions

The simplest way to demonstrate this point is to look at the issue of director independence. There is much debate around both the substantive value of the concept (does independence matter or is it about the core intention and competence of the director), and our ability to measure it regardless (many companies have 'independent' directors from a compliance code standpoint that are essentially friendly parties of the major shareholder). So for the 2016 survey some of the prior questions that asked about the number of independent directors were removed and replaced with a qualitative assessment by the covering analyst as to whether the independent nonexecutive directors are acting in a genuinely independent way.

Figure 6

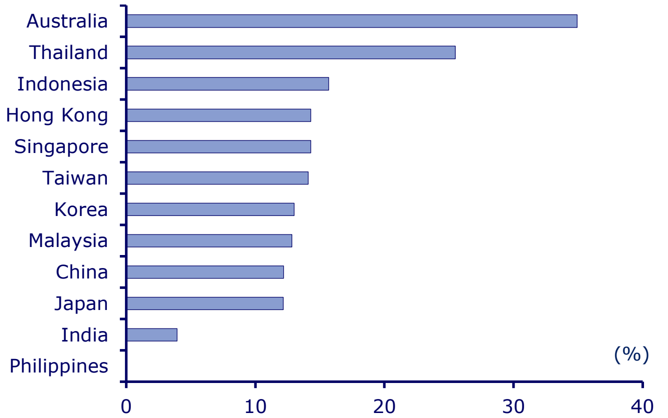
2014 CG: Where half board are independent directors



Source: CLSA 2014 CG Watch survey

Figure 7

2016 CG: Evidence directors behaving independently



Source: CLSA 2016 CG Watch survey

Changing question limits the value of comparing score year to year but evolves the thinking

These changes are intended to improve the quality of the insights we can draw from the process, however, we must acknowledge they introduce new complications. First, the data from year to year becomes less comparable as we cannot directly compare the questions or total scores. Second, the greater scope for analyst interpretation increases the ever-present risk that the data is not comparable from country to country and sector to sector. Each analyst is likely to interpret it differently regardless of the definitional criteria. While we acknowledge these issues (and they are indeed apparent in the results) we would argue that the flexibility adds value and, like financial accounting, being aware of the framework can help one interpret the richer output. Furthermore, our goal is to evolve the thinking and the best way we can do this is to be willing to sacrifice comparability.

Ultimately it is up to the reader to decide how to apply these results. The main issues under each category and any changes applied are outlined below.

Discipline
Unchanged:

Does the firm stick to core businesses, understand its cost of equity, etc?

- Management sticks to clearly defined core businesses.
- The company has not issued capital against owners interests.
- The company does not have a history of restructurings that reflect mismanagement, misappropriation or abandoning earlier strategies.
- The company is free from government interference.
- Management discloses ROA or ROE targets.

Modified:

- Requests on specific estimates of its cost of equity were replaced with analysts assessment of whether the company can demonstrate its ability to understand and apply the concept through its actions.

Removed:

- Specific estimates of WACC and COE (eliminate faux precision)
- Has the company increased cash and thus brought down its ROE (redundant to other questions, in some circumstances cash buildup may be prudent).

Transparency
Unchanged:

Are results announced promptly?

Are other announcements also timely?

- Full-year financials available within two months.
- Financial reports are clear and informative.
- Accounts are free of controversial interpretations of IFRS and do not adopt dubious accounting policies.
- The company discloses major market-sensitive information punctually.
- Analysts and investors have good access to senior management.

Removed: (overlapping prescriptive data has been rationalised)

- Specific minimum days to disclose board meeting notes and interim items.

Independence
Unchanged:

Does the company have a proper audit committee, etc?

- The company has an audit committee chaired by an independent director. More than half of the audit committee members are independent directors and all members have financial expertise.
- External auditors are in other respects unrelated to the company. The auditors provide a breakdown of audit and non-audit fees. And the audit partner or auditing firm is rotated every five years.
- The company has voting by poll at AGMs and EGMs, with detailed results released by the next day.
- The board composition reflects an attempt to bring diverse talents onto the board.

Modified:

- From chairman classified as independent, nonexecutive director to whether there is any reason to doubt the independence
- From independent directors more than 50% of board to evidence of genuinely independent behaviour.

Removed: (evidence the below have been gamed in some markets)

- Number of independent directors on the board
- Whether there has been any increase or decrease in the number independent of directors over the past three years.
- Number of family members on the board.

Responsibility
Unchanged:

Does any senior figure have a criminal conviction, etc?

- There is nobody with a criminal conviction reflecting negatively on integrity either on the board or holding a senior executive position.
- The company does not engage in material related-party transactions.
- The company represents the controlling shareholder's primary financial interest.

Removed:

- The company discloses whether independent directors have attended at least three-quarters of all board meetings (potential to game).
- Controlling shareholder is not known to be highly geared (speculative).

Fairness
Unchanged:

Have there been any controversial decisions disadvantaging minorities, on share placement etc?

- There has been no controversy over whether the board or senior management have made decisions in the past five years that benefitted them at the expense of investors.
- The company has not issued nonvoting common shares.
- There has been no controversy about share trading by board members. Placements by the company have been fair, fully transparent and well-intentioned.

Modified:

- From directors' remuneration has not increased faster than net profit after exceptional over the past five years to analyst assessment as to whether director and executive compensation is fair.

Removed:

- Board remuneration as a percentage of net profit (too prescriptive, board fees are likely to be stable while profit is unlikely to be, why many skew rankings unfairly)

Fairness is Asia's strongest category as it measures the most egregious violations

CLSA survey results for 2016

Figure 8 shows CLSA country coverage with the six components of the total CG score broken out. Given Australia's very strong results (top score for all six categories) the following category discussion excludes the country. Asia scores best in fairness (remuneration, the coupling of economic and voting rights, the avoidance of controversy and conflicts of interests). In large part this reflects that violations here represent the more egregious governance transgressions. For that reason a low-70s or high-60s score will materially impact a country's ranking. We would note the Philippines and Korea are weakest here; Japan is the strongest (ex-Australia).

Transparency is good as countries can adopt accounting codes

The other section where scores are generally higher overall is transparency (the publication of timely and accurate financial and nonfinancial information including providing access to management). Countries' ability to benchmark against global accounting standards probably contributes to the higher scores. Again the higher average scores here create a material ranking impact for poor performance. Japan is strong (ex-Australia), while Taiwan, the Philippines, Korea and China are weak.

Japan is strongest in all categories but independence

Figure 8

Overall CG scores and by market by category for companies

(%)	Discipline	Transparency	Independence	Responsibility	Fairness	E&S	Overall CG
Australia	76.1	93.3	77.2	86.2	93.9	67.2	83.5
China	46.2	58.7	47.1	49.2	70.4	63.3	55.2
Hong Kong	66.4	71.6	49.2	61.0	84.3	64.4	66.3
India	55.7	73.0	35.7	55.2	84.7	65.4	61.3
Indonesia	53.6	68.8	19.3	30.9	77.9	57.8	50.9
Japan	71.2	86.9	35.5	84.8	87.3	68.0	72.6
Korea	39.5	59.8	19.4	45.8	57.3	62.5	46.2
Malaysia	57.7	67.1	38.3	57.1	85.4	63.1	61.3
Philippines	59.1	58.1	27.9	35.5	66.1	65.9	51.0
Singapore	58.6	86.1	51.3	52.8	85.7	62.0	66.4
Taiwan	66.0	60.5	49.8	73.1	76.4	67.3	65.4
Thailand	56.6	85.0	63.7	38.0	83.7	64.7	65.4
Average	58.9	72.4	42.9	55.8	79.4	64.3	62.1
Average ex-Aus	57.3	70.5	39.7	53.0	78.1	64.0	60.2
Max-Min range (ex-Aus)	31.6	28.8	44.4	53.9	30.0	10.2	26.5

Note: Boxes highlight leader (green) and laggard (gold) ex-Australia. Source: CLSA 2016 CG Watch survey.

Discipline produces middling scores even for the stronger markets

Discipline produces more middling scores (free from government interference sticking to a core business, focusing on returns to capital and avoiding unnecessary capital issuance). It is interesting that this is also the weakest category for Australia where disclosure of return targets, government interference and capital issuance all played a role in lowering the score). The ex-Australia range is also relatively tight with most countries scoring in the 50-60% range. Korea is by far the standout weak link here at 39%.

Asia is structurally challenged in discipline by its ownership structures

Responsibility (alignment of interests, criminal convictions and related-party transactions), yields scores (ex-Australia) of close to 50%. The gap between the leader (Japan) and the laggard (Indonesia) is also widest at 54 points. This is one of Asia's key challenges, high family or government ownership creating conflicts of interests between majority and minority shareholders.

This is even more damaging to the independence scores

Finally, independence produces the lowest overall scores. Nine of the 12 countries fail to hit even the 50% mark here. This category also produces the lowest absolute scores with Indonesia and Korea sub-20% and Indian, and Malaysia and the Philippines below 40%. The reality is that most Asian countries have boards that are heavily influenced by a founding shareholder, controlling family or the government that can undermine minority alignment.

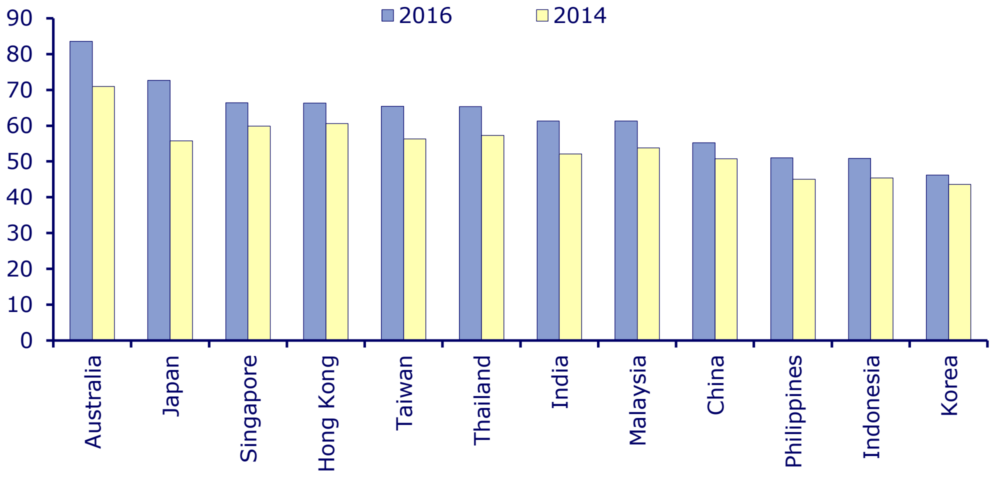
Changing questions suggest we should focus on ranks more than scores for time series

Comparing the 2014 and 2016 results, country by country, highlights both the challenges and opportunities of this work. The data show us universal increases across the scores, however, we know some of these changes are probably a function of eliminating the more prescriptive questions. Where we can be comfortable is that each country is answering exactly the same set of questions and as a result the ranks will provide more consistent information from year to year. On that front, it is only Japan that has moved materially, rising from sixth to second. While this is a significant jump we would note that Japan was fourth in the 2014 survey behind Hong Kong and Singapore, which have traditionally been neck and neck in the final rankings.

Japan is the key change

Figure 9

Average CG scores by market (ranked by 2016 with 2014 side by side)



Source: CLSA 2014 and 2016 CG Watch survey

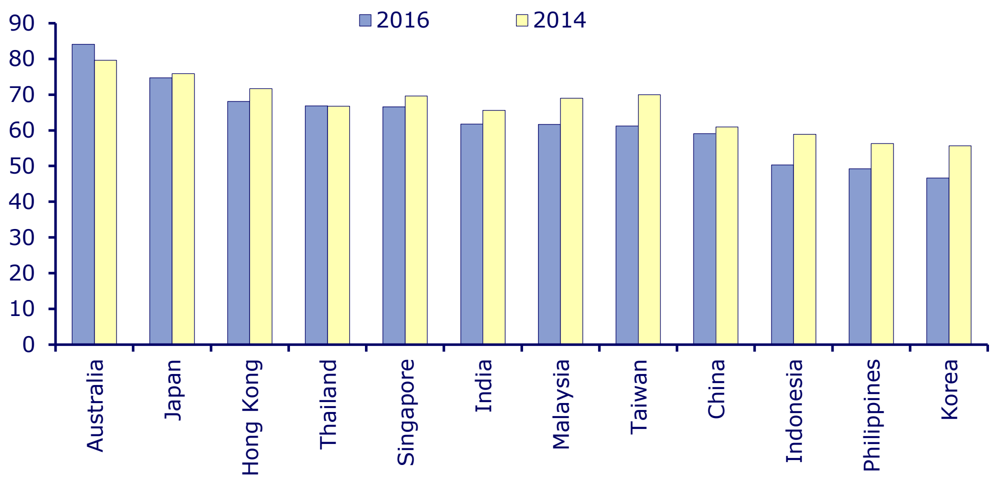
Part of this is Abenomics and partly it is greater freedom to assess Japan accurately

Ultimately, Japan's 2016 result probably captures genuine improvement as a result of the Abenomics-inspired reform programmes already mentioned, combined with an ability to better capture its true position via some more flexible questions. For the remaining countries, much of the lift is from the changes in the scoring both because of the largely unchanged rankings if we use like-for-like scores (and downward bias for the weaker countries).

On this basis most countries were within +/-5% of previous score

Figure 10

Like for like comparison of 2014 and 2016 by market (on constant questions)



Source: CLSA 2014 and 2016 CG Watch survey

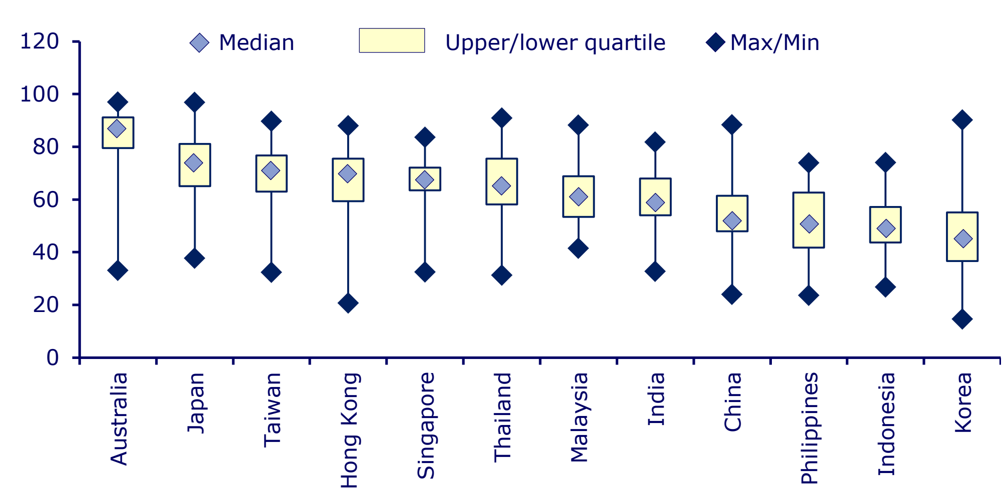
There is significant dispersion of answers even within countries

Averages can be misleading. As such we analysed the range within country scores. Broadly speaking the conclusions are consistent. While it is tempting as a financial analyst to try to scale for volatility (a governance Sharpe ratio if you will) we are reluctant to do so. Larger more developed countries tend to have wider ranges. We suspect this involves having some world-class mega-caps and deeper small-cap universes by virtue of their scale. So some of the difference may be purely a function of the datasets; Asean countries show tighter ranges but also tend to have fewer companies covered.

However, median results are broadly consistent with averages

Figure 11

Dispersion of company CG scores (F72 CGW 14)



Source: CLSA 2016 CG Watch survey

Consistency between median and average data suggests conclusions are broadly robust

Nevertheless the consistency between the average and median ranks suggests the conclusions are robust (eight out of the 12 countries' ranks are unchanged). That said, there are still differences. Taiwan jumps from fifth to third (+2), Singapore (-2) and India (-1) both fall. Rather than challenging the conclusions, this reminds us that the specific ranks of similarly scored countries are not particularly informative (despite the significant attention they can sometimes draw). What is more conclusive is the clusters of countries. Australia is the clear benchmark. Hong Kong, Singapore, Taiwan

We are less interested in specific country ranks and more interested in country clusters

and Thailand have relatively robust governance. Malaysia, India and China represent the stronger of the laggards. The Philippines, Indonesia and Korea have the greatest scope for improvement.

Figure 12

Comparison of country

Rank	Country	Median	Rank	Country	Average	Rank change
1	Australia	86.8	1	Australia	83.5	0
2	Japan	74.3	2	Japan	72.6	0
3	Taiwan	71.5	3	Singapore	66.4	2
4	Hong Kong	70.4	4	Hong Kong	66.3	0
5	Singapore	68.1	5	Taiwan	65.4	(2)
6	Thailand	65.9	6	Thailand	65.4	0
7	Malaysia	61.9	7	India	61.3	1
8	India	59.8	8	Malaysia	61.3	(1)
9	China	53.2	9	China	55.2	0
10	Philippines	52.1	10	Philippines	51.0	0
11	Indonesia	50.4	11	Indonesia	50.9	0
12	Korea	46.7	12	Korea	46.2	0

Source: CLSA 2016 CG Watch survey

We provided charting snapshots on the most objective or assessable datapoints we collect

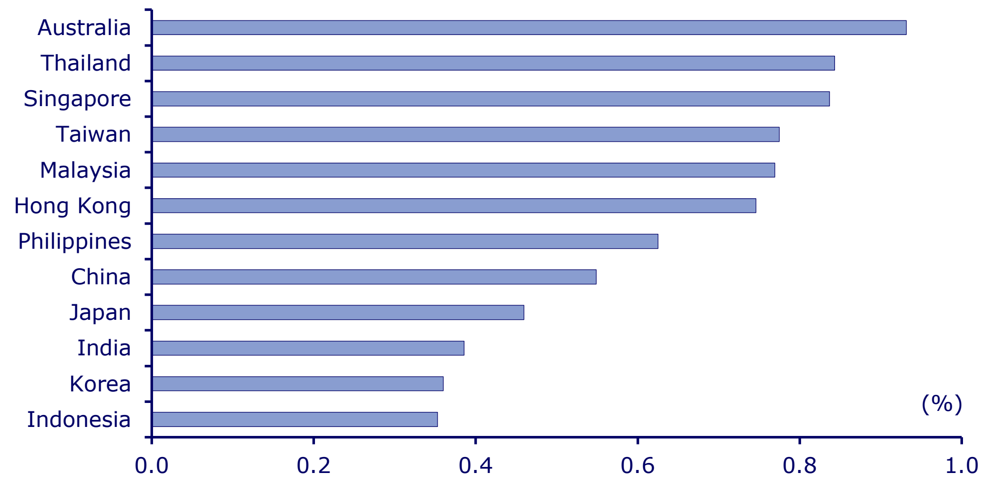
Snapshots by market

In the subsequent chapter, we provided interviews with some governance experts from the investment community. To provide context to their answers we include data snapshots charting country performance across the various criteria the interviewees reference. The following commentary charts data snapshots on the remaining questions, focusing where we believe the analysts are most likely to be able to make informed decisions because the questions present the least debate about data subjectivity or measurement difficulties. Figure 13 gets to the core of how good governance can help shareholders achieve their goals: the percentage of companies: where analysts are confident cost of capital is a core driver of capital allocation.

A company's ability to manage its cost of capital is a core issue all analysts focus on

Figure 13

Are you confident cost of capital is a key input to management thinking?



Source: CLSA 2016 CG Watch survey

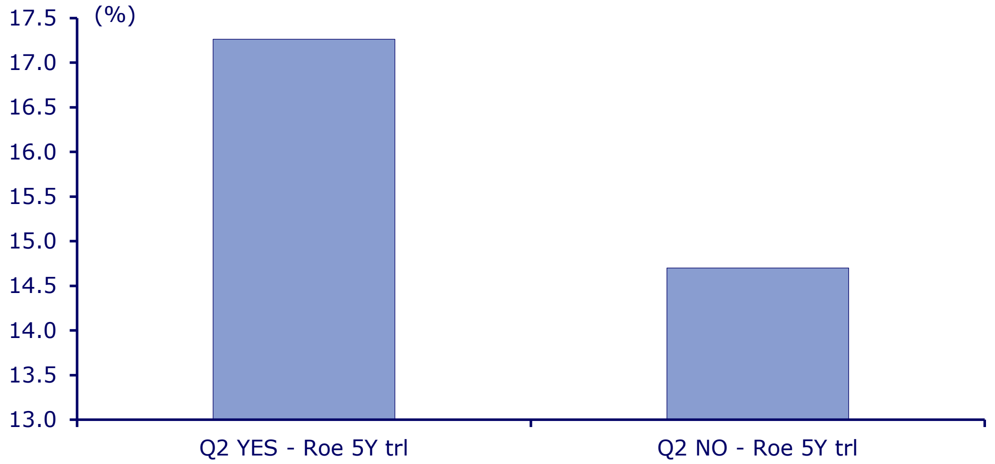
Japan is likely to lift its return orientation with time

Analysts' assessments of a company's return orientation make broad sense. They also provide an interesting study on policy lags versus actual behaviour. While Japan saw universal jumps in simpler factors like access, a returns culture will come with time, we expect its scores to rise in 2018. To test analysts' conclusions, we screened average ROEs for the good and poor capital-allocator groups, the results speak for themselves, governance matters.

And the data strongly supports their conclusions

Figure 14

ROE comparison of companies who do and don't understand cost of capital



Source: CLSA 2016 CG Watch survey, evalu@tor

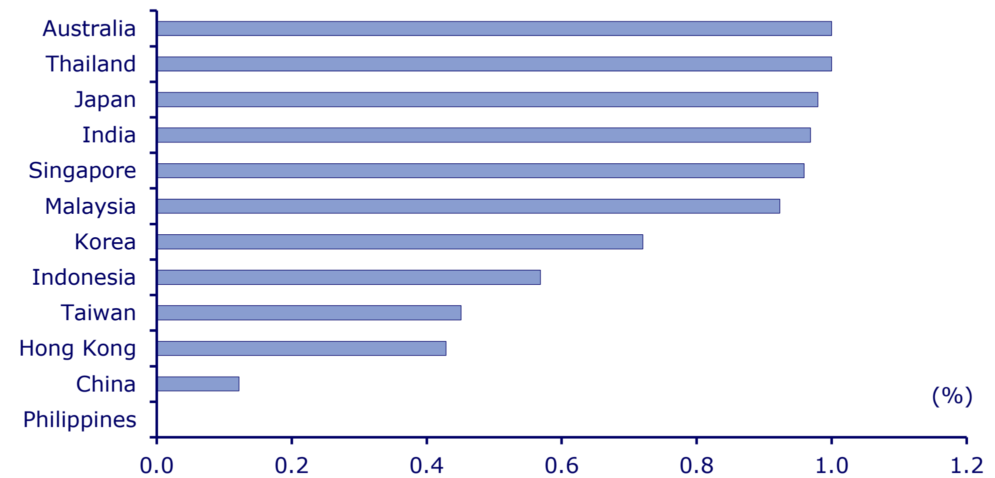
Hong Kong's interim report format may lessen the urgency with which reports are disclosed

Looking at transparency, we believe the speed with which countries release financial reports is a good indication of the reporting culture. While there is an element of regulatory pressure here, the point is that these pressures add value over time. The one result that surprised was Hong Kong; however Danie Schutte (Head of Research) reminds us that Hong Kong is an interim reporting market and so the sense of urgency around periodic reporting tends to be lower. The market requirement is also three months for full-year results versus two months for interim results.

Half of markets in Asia have a high percentage of companies that report within 60 days

Figure 15

Does the company publish its full-year results within two months?



Source: CLSA 2016 CG Watch survey

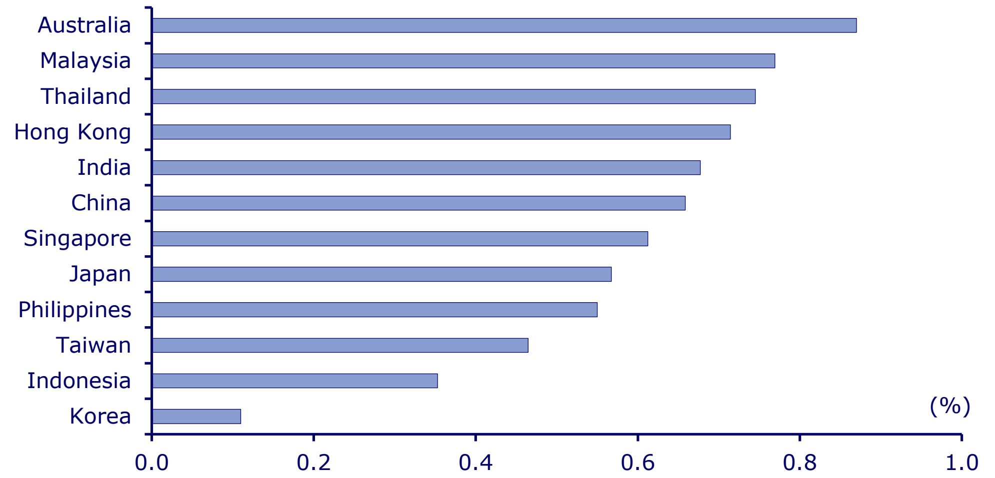
Board diversity is one area where the traditional governance leaders' edge disappears

Board diversity is another area where some of the traditionally stronger governance markets also struggle. Singapore and Japan rank seventh and eighth respectively. The Japanese team tells us its market is made up of a preponderance of organically grown, inwardly-looking companies dominated by chronically loyal managers brought up in lifetime employment systems that has bred a suspicion of outside interference. Turning back to Singapore, Jonathan Galligan reminds us that for many of its companies the boards are comprised of mainly domestic management as opposed to more international teams. Moreover, there is a lot of overlap across boards in Singapore.

It is not surprising to see Australia top this category or Korea to rank last

Figure 16

Does the board composition reflect attempt to bring diversity



Source: CLSA 2016 CG Watch survey

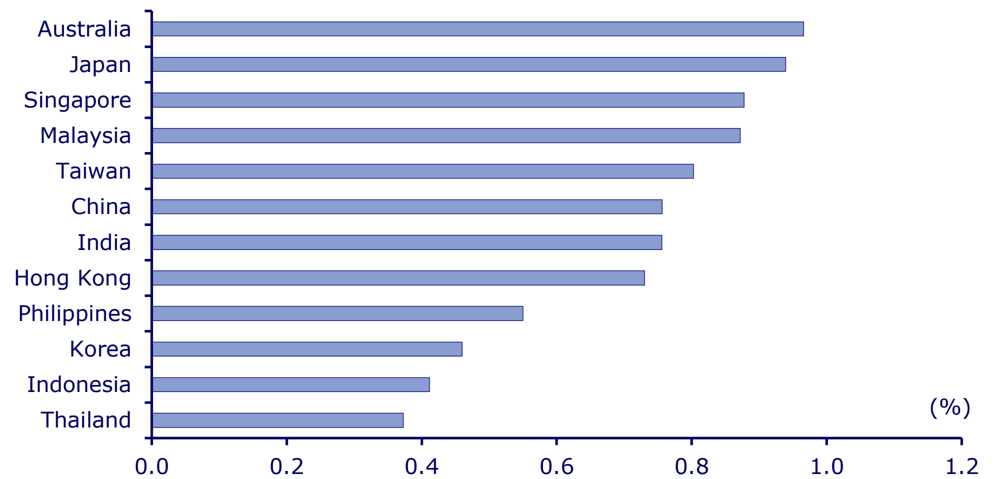
Related-party transactions remain a structural problem in Asia

Sadly the evidence on related-party transaction (RPTs) offers us few surprises and remains a structural issue for Asia to overcome. Korea, Indonesia and Thailand retain their regular billing as markets where harmful related transactions remain a structural problem. Without changes to the regulations (exclusion from RPT votes) or ownership structures, there is little reason to expect this to change. That said, Hong Kong's experience shows us restrictive rules alone are not enough. There is a cultural element to what is deemed to be acceptable actions. To that end, we would point out Japan, where cross holdings and conglomerates are prevalent, but harmful RPTs are not.

Concentration of ownership plays the key role here

Figure 17

Has the company avoided related-party transactions that harm minorities?



Source: CLSA 2016 CG Watch survey

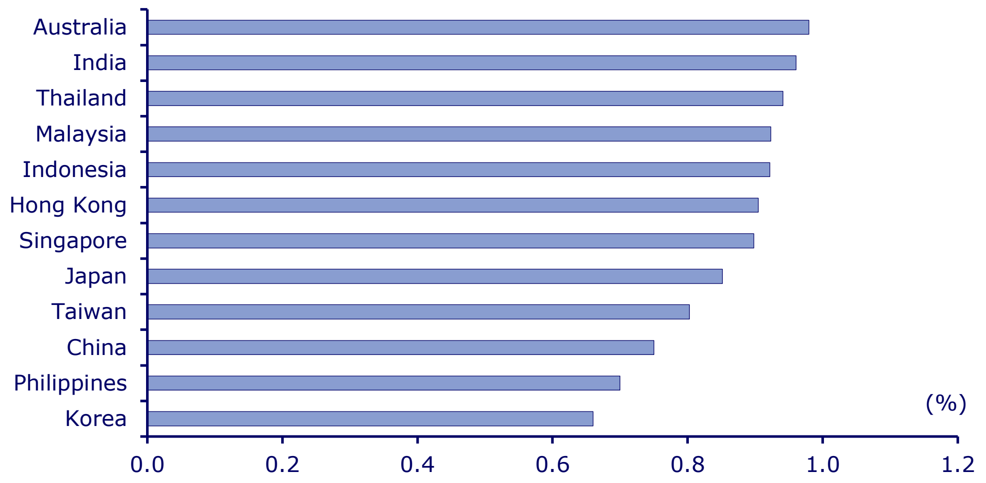
Indian points to strong regulation as driving good results on placements and board-member trading

India managed to secure second place on the issue of board-related share transactions and placements. In another reminder of the importance of regulators the team points out that Sebi (Securities & Exchange Board of India) has strict regulations on insider trading and disclosure norms putting significant pressure on the board members and top management to trade in only certain timeframe windows where appropriate disclosures are made. Korea was particularly weak during the 2014-16 period; even the better-governed institutionally-owned banks made some questionable placements.

Korea has seen a cluster of harmful issues across multiple sectors in past two years

Figure 18

Are board member share trading and company placements fair and transparent?



Source: CLSA 2016 CG Watch survey

CG and share-price performance

Governance is difficult to link to share-price performance

One of the common questions we receive is the extent to which we can tie good corporate governance to good share-price performance. The frustration is that the conclusions of the academic literature are often inconclusive and at times contradictory. From our perspective, the lack of consistency is likely to continue. The fundamental challenge is that share-price performance is a function of an extraordinarily wide range of factors; most of which are completely outside governance's *direct* sphere of influence.

However, we see no clear reason why it should be

If we simplify a company's share-price performance to changes in its earnings and multiple (ignoring dividends for the sake of the thought experiment), then the question becomes the degree to which governance should be the *causal* driver. The reality is that growth is heavily influenced by industry and broader economic conditions. Likewise, the *change* in a multiple is not just influenced by those factors, but also starting multiples (valuations are highly mean reverting). Thus, even where one has conviction that governance has a strong role to play in a company's fundamentals, there will be significant noise in the share-price data. We should not expect a strong empirical link.

Relative performance appears to be inversely correlated to market strength

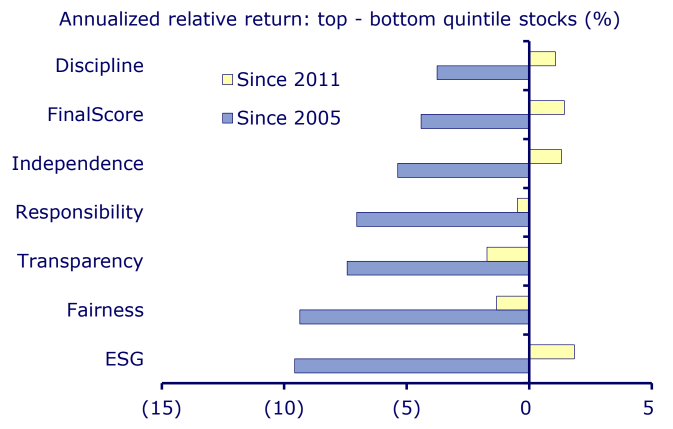
This conundrum becomes clearest as one tries to extract meaningful conclusions from our own data. Granted if we torture the numbers sufficiently we can ultimate get them to talk; and perhaps even tell us what we want to hear. But on balance, it is difficult to tie governance scores to consistent absolute or relative performance conclusions. Over the years, we have produced some weak correlations that are usually strongest where markets are weak. Indeed, more often than not, we have found strong governance scores are correlated with material underperformance during strong market advances that is recaptured during periods of market distress. This, perhaps, logically makes sense, in that companies with superior governance are likely to be taking less risk, possibly exhibiting lower betas a result (see Figure 27).

However, this could just be capturing beta which will naturally be correlated to governance

This view remains valid after updating the research with 2016 data. The Microstrategy team's insightful analysis shows us that since 2005, the median performance of top-quintile CG companies has materially underperformed the bottom-quintile companies. That said, since 2011 (a period when the index has been essentially flat) the companies with top-quintile CG score actually marginally outperformed. Even trying to control for the dizzying array of factors that could be driving the data, the results are inconclusive.

Figure 19

Asia ex-Japan performance by CG quintiles



Source: CLSA, evalu@tor, CG Watch data, Microstrategy

Figure 20

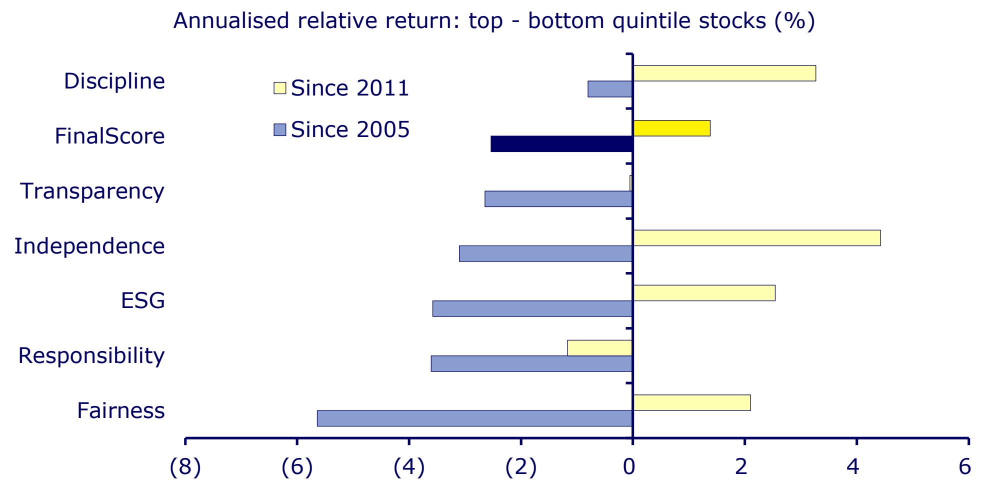
Asia ex-Japan index performance

Source: CLSA, Bloomberg

CG score performance once country effect is removed

Figure 21

Asia ex-Japan country neutral

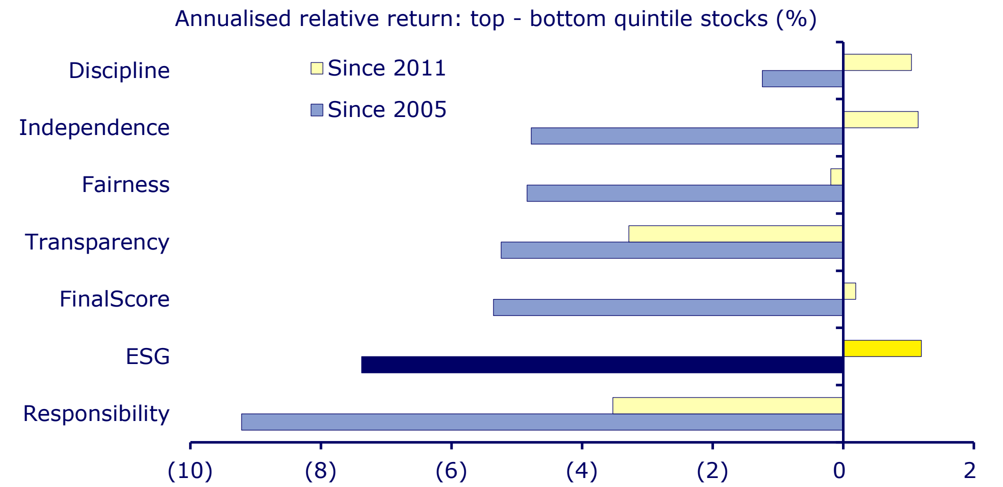


Source: CLSA, evalu@tor, CG Watch data, Microstrategy

Furthermore, sector neutralisation fails to confirm governance's performance contribution

Figure 22

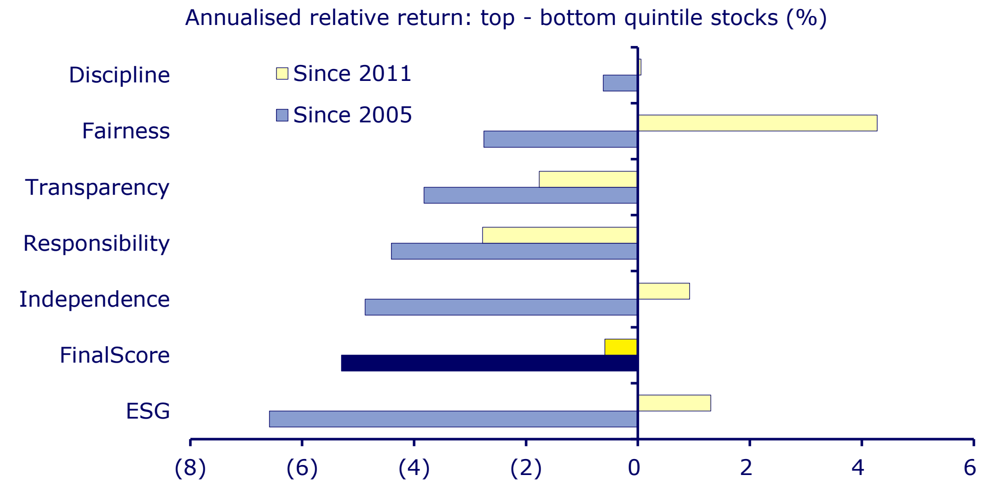
Asia ex-Japan sector neutral



Worse, putting it all together shows consistent underperformance

Figure 23

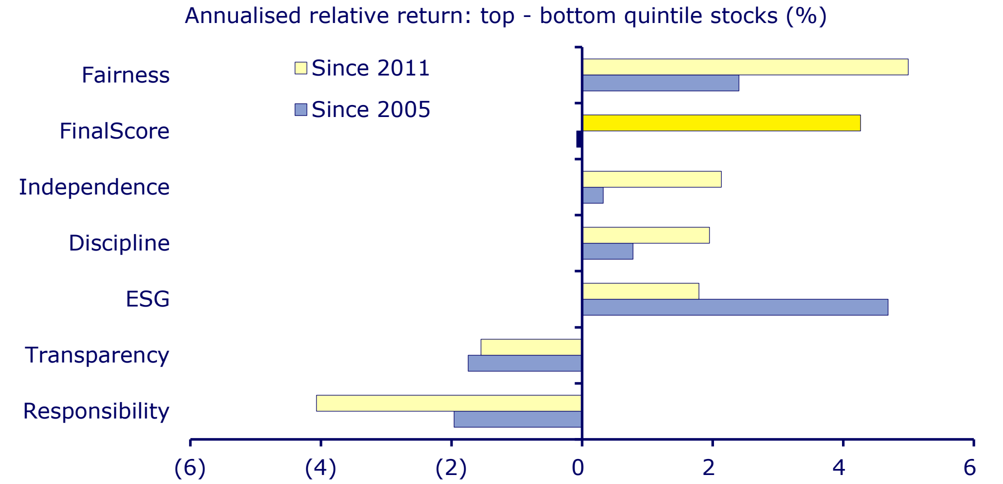
Asia ex-Japan sector and country neutral



Neutralising for size does appear to help especially since 2011

Figure 24

Asia ex-Japan size neutral

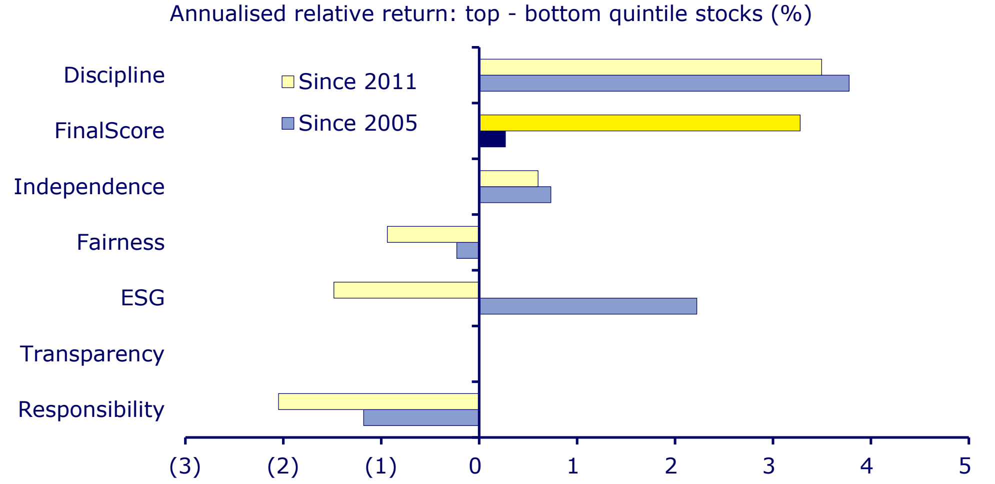


Source: CLSA, evalu@tor, CG Watch data, Microstrategy

Similarly neutralising for value (PE) has some positive result since 2011 (equal-weighted basis)

Figure 25

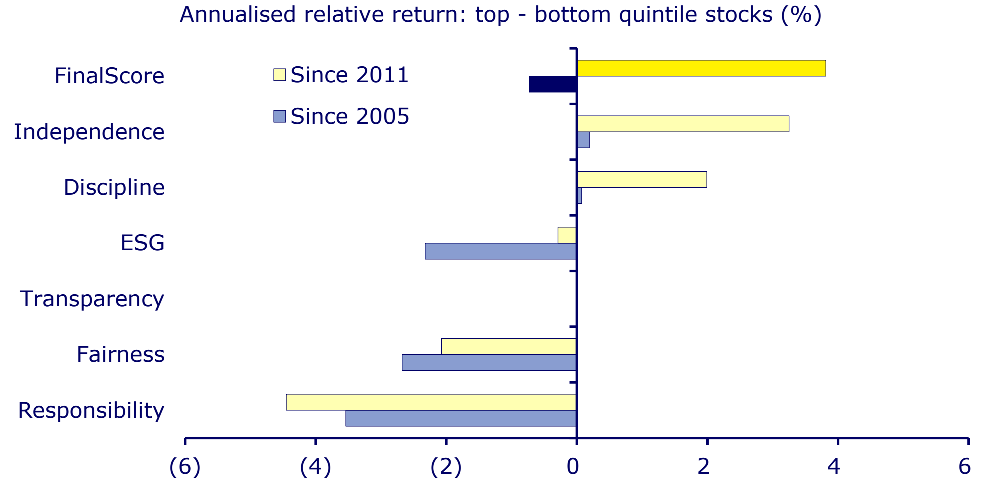
Asia ex-Japan value neutral



As does neutralising for quality (ROE) but ultimately it is far from conclusive

Figure 26

Asia ex-Japan quality neutral



Source: CLSA, evalu@tor, CG Watch data, Microstrategy

We would expect to find a better relationship between fundamental factors and CG scores

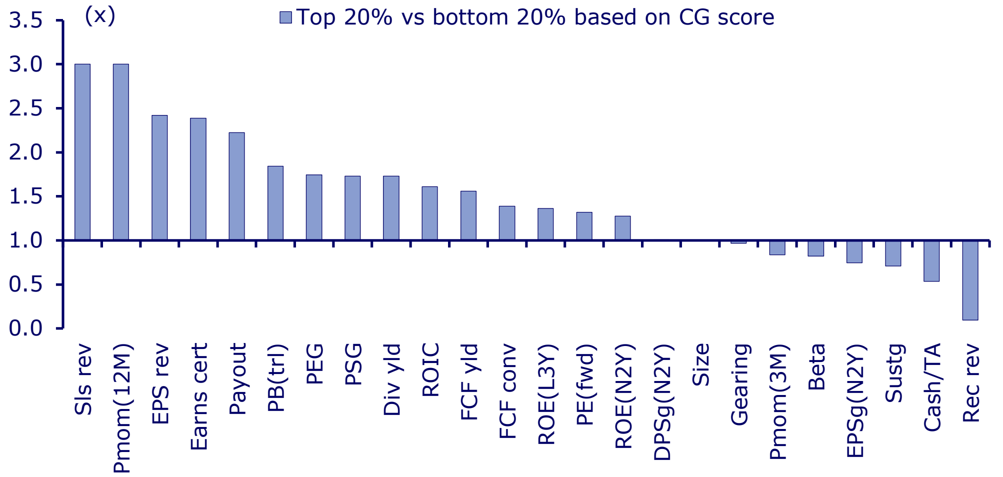
CG and fundamental performance

Where we would expect to find more direct relationships with CG scores is by focusing on the areas where management has greater control. We contend that higher CG-scored companies should show better fundamentals; especially in the factors management can directly influence or control. Reviewing that Microstrategy data that is exactly what we find. The vast majority of fundamental factors exhibit better performance for the top-quintile CG companies when compared to the bottom-quintile companies.

That is exactly what the data suggest

Figure 27

Difference on fundamental factor performance by governance quintiles



Source: CLSA, evalu@tor, CG Watch data, Microstrategy

EQRS and BQRS data are most compelling and show a clear link with CG performance

What gives us increasing confidence in this conclusion is the clear relationship between CG quintiles and EQRS and BQRS scores. As a reminder EQRS and BQRS scores are proprietary metrics developed by the CLSA Microstrategy team to measure earnings and balance-sheet quality. Here we find companies with high earnings-quality risk tend to have a lower CG score. We draw the same conclusions on a balance-sheet basis. What is important is that the balance-sheet conclusions are slightly stronger and the correlations more direct. This is important because management has greater direct influence on its balance sheet. We would argue this is clear evidence that better governance is associated with better fundamentals.

Figure 28

Median CG score by EQRS basket

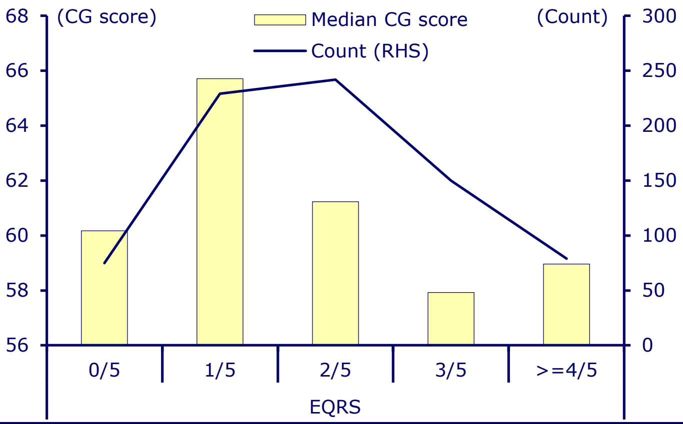
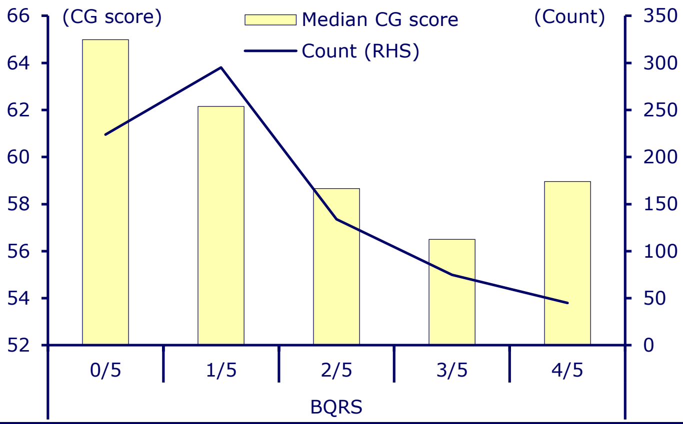


Figure 29

Median CG score by BQRS basket



Source: CLSA, evalu@tor, CG Watch data, Microstrategy

Standout CG companies

Top-governance companies have been broken out by country

To give investors a better sense of the strongest governance players in each market we have presented three sets of tables at two size scales (market cap above and below US$10bn): the top-10 companies in Australia, which would otherwise dominate the results; the top-10 companies in Japan, given the scale of the market; and the top-five companies in each of the 10 Asia ex-Japan markets covered by this report.

Figure 30

Top-10 companies in Australia (mkt cap above US$10bn)

	Short name	Country	Sector
CSL AU	CSL	Australia	Healthcare
WOW AU	Woolworths	Australia	Consumer
BXB AU	Brambles	Australia	Transport
TCL AU	Transurban	Australia	Infrastructure
RHC AU	Ramsay Health Care	Australia	Healthcare
AMC AU	Amcor	Australia	Materials
SUN AU	Suncorp	Australia	Insurance
TLS AU	Telstra	Australia	Telecoms
WES AU	Wesfarmers	Australia	Consumer
AMP AU	AMP	Australia	Insurance

Figure 31

Top-10 companies in Australia (mkt cap below US$10bn)

	Short name	Country	Sector
NXT AU	NEXTDC	Australia	Technology
SUL AU	Super Retail	Australia	Consumer
XRO AU	Xero	Australia	Technology
SDA AU	SpeedCast	Australia	Telecoms
BWX AU	BWX	Australia	Consumer
MTS AU	Metcash	Australia	Consumer
MYR AU	Myer	Australia	Consumer
CCL AU	Coca-Cola Amatil	Australia	Consumer
DMP AU	Domino's	Australia	Consumer
BAL AU	Bellamy's	Australia	Consumer

Figure 32

Top-10 companies in Japan (mkt cap above US$10bn)

	Short name	Country	Sector
6326 JP	Kubota	Japan	Autos
6301 JP	Komatsu	Japan	Capital goods
9433 JP	KDDI	Japan	Telecoms
7203 JP	Toyota Motor	Japan	Autos
7011 JP	MHI	Japan	Conglomerates
7267 JP	Honda Motor	Japan	Autos
2587 JP	Suntory B&F	Japan	Consumer
4452 JP	Kao	Japan	Consumer
7309 JP	Shimano	Japan	Consumer
3382 JP	Seven & I	Japan	Consumer

Figure 33

Top-10 companies in Japan (mkt cap below US$10bn)

	Short name	Country	Sector
7013 JP	IHI	Japan	Conglomerates
4927 JP	Pola Orbis	Japan	Consumer
3668 JP	Colopl	Japan	Internet
7261 JP	Mazda Motor	Japan	Autos
7012 JP	KHI	Japan	Conglomerates
7272 JP	Yamaha Motor	Japan	Autos
3086 JP	J Front Retailing	Japan	Consumer
4272 JP	Nippon Kayaku	Japan	Petro/Chems
6361 JP	Ebara	Japan	Capital goods
6506 JP	Yaskawa Electric	Japan	Technology

Source: CLSA 2016 CG Watch survey

Figure 34

Top-five companies in Asia ex-Japan by market (mkt cap above US$10bn)

	Short name	Country	Sector
2018 HK	AAC	China	Technology
JD US	JD.com	China	Internet
700 HK	Tencent	China	Internet
NTES US	NetEase	China	Internet
883 HK	CNOOC	China	Petro/Chems
1299 HK	AIA	Hong Kong	Insurance
19 HK	Swire Pacific	Hong Kong	Property
4 HK	Wharf	Hong Kong	Property
1928 HK	Sands China	Hong Kong	Hotels & Leisure
2 HK	CLP	Hong Kong	Power
INFO IB	Infosys	India	Technology
TCS IB	Tata Consultancy	India	Technology
WPRO IB	Wipro	India	Technology
BJAUT IS	Bajaj Auto	India	Autos
KMB IB	Kotak Bank	India	Financial services
UNVR IJ	Unilever Indo	Indonesia	Consumer
ASII IJ	Astra Intl	Indonesia	Conglomerates
HMSP IJ	HM Sampoerna	Indonesia	Consumer
TLKM IJ	Telkom	Indonesia	Telecoms
BBCA IJ	BCA	Indonesia	Financial services
035420 KS	Naver	Korea	Technology
055550 KS	Shinhan	Korea	Financial services
051900 KS	LG H&H	Korea	Consumer
051910 KS	LG Chem	Korea	Petro/Chems
105560 KS	KB Financial	Korea	Financial services
IHH MK	IHH	Malaysia	Healthcare
MAXIS MK	Maxis	Malaysia	Telecoms
AXIATA MK	Axiata	Malaysia	Telecoms
PCHEM MK	Petronas Chemicals	Malaysia	Petro/Chems
SIME MK	Sime Darby	Malaysia	Materials
AC PM	Ayala Corp	Philippines	Conglomerates
ALI PM	Ayala Land	Philippines	Property
SM PM	SM Investments	Philippines	Conglomerates
JGS PM	JG Summit	Philippines	Conglomerates
SMPH PM	SM Prime	Philippines	Property
ST SP	Singtel	Singapore	Telecoms
CAPL SP	CapitaLand	Singapore	Property
OCBC SP	OCBC	Singapore	Financial services
UOB SP	UOB	Singapore	Financial services
WIL SP	Wilmar	Singapore	Consumer
2330 TT	TSMC	Taiwan	Technology
3045 TT	Taiwan Mobile	Taiwan	Telecoms
2454 TT	MediaTek	Taiwan	Technology
1216 TT	Uni-President	Taiwan	Consumer
3008 TT	Largan	Taiwan	Technology
SCC TB	Siam Cement	Thailand	Materials
ADVANC TB	AIS	Thailand	Telecoms
BDMS TB	Bangkok Dusit	Thailand	Healthcare
KBANK TB	Kasikornbank	Thailand	Financial services
PTT TB	PTT	Thailand	Petro/Chems

Source: CLSA 2016 CG Watch survey

Figure 35

Top-five companies in Asia ex-Japan by market (mkt cap below US$10bn)

	Short name	Country	Sector
2382 HK	Sunny Optical	China	Technology
XRS US	TAL Edu	China	Consumer
1478 HK	Q Technology	China	Technology
867 HK	CMS	China	Healthcare
1317 HK	Maple Leaf Edu	China	Consumer
3315 HK	Goldpac	Hong Kong	Technology
327 HK	Pax Global	Hong Kong	Technology
178 HK	Sa Sa	Hong Kong	Consumer
973 HK	L'Occitane	Hong Kong	Consumer
1910 HK	Samsonite	Hong Kong	Consumer
MRCO IB	Marico	India	Consumer
EIM IS	Eicher Motors	India	Autos
PSYS IN	Persistent Systems	India	Technology
DABUR IS	Dabur	India	Consumer
ECLX IB	eClerx	India	Technology
BIRD IJ	Blue Bird	Indonesia	Transport
SMRA IJ	Summarecon	Indonesia	Property
MIKA IJ	Mitra Keluarga	Indonesia	Healthcare
TOWR IJ	Sarana Menara	Indonesia	Telecoms
INCO IJ	Vale Indonesia	Indonesia	Materials
035720 KQ	Kakao	Korea	Internet
139130 KS	DGB Financial	Korea	Financial services
138930 KS	BNK Financial	Korea	Financial services
086790 KS	Hana Financial	Korea	Financial services
024950 KQ	Samchuly Bicycle	Korea	Hotels & Leisure
WPRTS MK	Westports	Malaysia	Transport
KRI MK	Kossan Rubber	Malaysia	Healthcare
ROTH MK	BAT Malaysia	Malaysia	Consumer
IJM MK	IJM Corp	Malaysia	Capital goods
HART MK	Hartalega	Malaysia	Healthcare
DMPL PM	Del Monte Pacific	Philippines	Consumer
CNPF PM	Century Pacific	Philippines	Consumer
JFC PM	Jollibee	Philippines	Consumer
GLO PM	Globe Telecom	Philippines	Telecoms
BPI PM	BPI	Philippines	Financial services
CD SP	ComfortDelGro	Singapore	Transport
FCT SP	FCT	Singapore	Property
SGX SP	SGX	Singapore	Financial services
RFMD SP	Raffles Medical	Singapore	Healthcare
STH SP	StarHub	Singapore	Telecoms
4938 TT	Pegatron	Taiwan	Technology
2382 TT	Quanta	Taiwan	Technology
2357 TT	Asustek	Taiwan	Technology
1476 TT	Eclat Textile	Taiwan	Consumer
6166 TT	Adlink	Taiwan	Technology
SPALI TB	Supalai	Thailand	Property
BANPU TB	Banpu	Thailand	Materials
STEC TB	Stecon	Thailand	Capital goods
UNIQ TB	Unique E&C	Thailand	Capital goods
MAJOR TB	Major Cineplex	Thailand	Media

Source: CLSA 2016 CG Watch survey

Some practitioners perspectives

CLSA has assessed CG performance of its universe since 2001

CLSA has evaluated the corporate-governance performance of its coverage since 2001. Our process is to work with our entire regional analyst team on survey-based assessments of each company's relative performance. We aggregate this data up to derive market and regional views. To cross-check these conclusions we work with the ACGA team, which conducts regulatory, macro and other top-down market surveys of each country.

To enhance the analysis of the 2016 survey we introduced investor interviews

One flaw of this process is that it implicitly puts much of the onus for good governance on the companies and how they interact with their environments. To get a better multi-stakeholder perspective we interviewed the CG head from a major passive house (BlackRock) and a leading Asian active manager (Aberdeen Asset Management) a proxy advisor (Glass Lewis) and a corporate consultant (ISS Corporate Solutions). They are all active across the region.

Challenges around measuring governance lead to a preference for greater engagement

We found that investors tend to have a difficult time accurately measuring and, especially, quantifying governance. Industry disclosure tends to be generic and attempts to force fit numbers can be counterproductive. Our interviews point to increased industry calls for a deprioritisation of simplistic assumptions like measuring the number of independent directors that can be easily gamed. Competence and confidence in the desire for mutually beneficial outcomes are far more important and harder to assign a number to.

Asian governance is continually improving but is unlikely to match Australian experience

Our interviewees were most focused on qualitative assessments of corporate performance. It was not surprising to hear about a growing importance of investor-to-company engagement (and increasingly visa-versa). To that end, all interviewees we spoke to believe access in the region is getting better, albeit there is a substantial gap to the benchmark, which is clearly Australia. Structural differences primarily around concentration of ownership into government or family hands suggest that Asia is unlikely to replicate all of the changes of the Australian precedent. Nonetheless, a combination of ageing families, more active governments, more engaged institutional investors and company efforts to develop better relationships with their investors are all contributing to a sustainable trend of improvement.

Regulatory shocks and investors-corporate conflicts, on balance, have helped the process

The experience of the last decade seems to suggest that regulatory shocks, investor-company vote clashes and even activist events on balance more often tend to be catalysts for improvement rather than for reversion to the worst behaviours. That said, all interviewees acknowledged true conflict is exceptionally rare, and while the engagement process is essentially designed to preclude its requirement, the reality is that egregious behaviours continue in Asia and are not being rejected as much as they would be in the absence of structural constraints. Asia still has a long way to go versus global best practice.

There is a clear investor appetite to deepen and broaden the engagement process

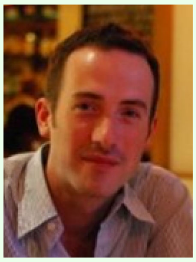
The key area of opportunity in Asia is not just to deepen the access and so the quality and impact of the discourse but to broaden it. There is a clear appetite to see more of the director community, encourage the deepening of the skill pool there and work collaboratively to better understand one another. Overall the interviewees suggest we should be optimistic about the future of Asian governance but realistic in the context of clear structural differences. Warren Buffett was right; companies ultimately get the shareholders they deserve. This analysis tells us that they must work collaboratively with the companies so that Asia ultimately gets the companies it deserves as well.

Interviewee profiles

Interview process: To better understand investor and advisor perspectives of corporate governance in Asia, CLSA sat down with four governance experts in the region. The interviews were conducted separately via phone. To allow contrasting views, many of the questions were the same. What follows is a summary of these discussions, which is edited into a single narrative to focus on the most important points and ease the reading process for investors. It does not represent an accurate flow of each individual discussion. Disparate answers have been stitched together in a manner we estimated to be most useful to the reader. Summaries of the full interviews (though not word for word) are outlined in Appendices 4-7, we highly recommend interested readers go through those as well.

Pru Benett - BlackRock

Pru Bennett is head of BlackRock's Investment Stewardship team for Asia Pacific, leading efforts in Asia, Japan, Australia and New Zealand. She is active in public corporate governance, stewardship and responsible investment debate, and regularly speaks and represents BlackRock on a number of industry and regulatory bodies. In 2013, Bennett was named as one of Australia's top-10 'Women of Influence in CG'. She joined BlackRock in August 2010 from Regnan Governance Research and Engagement, where she served as Head of Corporate Governance. From 1998, she was a director of Australian proxy-advisor Corporate Governance International, which Glass Lewis & Co acquired in 2006. Prior to working in CG, she was Investor Relations Manager for Qantas Airways. Bennett is a member of the Australian Institute of Chartered Accountants and has a BCom from the University of New South Wales.



David Smith - Aberdeen Asset Management

Dr Smith joined Aberdeen Asset Management in 2011 from Institutional Shareholder Services, where he spent four years, most recently as head of Asia ex-Japan research. There he led a team of 20 regional analysts. The majority of his career has been in the research and investigation of aspects of governance, and he is the author of several published papers. Smith has been based in Singapore since 2006, first working at HIM Governance, a governance advocacy group. He has also held posts at Hermes, the activist investor.

Daniel Smith - Glass Lewis

Daniel J Smith is general manager of CGI Glass Lewis. Smith has nearly a decade of experience in corporate governance across several major markets. He joined CGI Glass Lewis in 2014, after holding a number of research, client services and operations positions at Institutional Shareholder Services in Australia, the USA and UK. He has published numerous studies and is a regular speaker on governance issues. Smith is a graduate of the University of California, Santa Cruz, and has a master's degree from the Edmund A Walsh School of Foreign Service at Georgetown University, where he studied international business diplomacy.

Jun Frank - ISS Corporate Solution

Jun Frank is Executive Director at ISS Corporate Solutions (ICS). Jun joined ICS in August 2015, and is responsible for its North Asian markets, focusing on helping Japanese and Korean companies improve their corporate-governance practices, while supporting issuers in broader Asia. Prior to ICS, Frank headed ISS's Asia ex-Japan research, overseeing proxy advisory service and policy developments for the region. He has also served as Director of Asian Proxy Research at Glass Lewis, where he managed corporate-governance research on Asian companies from 2005. In 2008, he was named a 'Rising Star of Corporate Governance' by Millstein Center for Corporate Governance and Performance at the Yale School of Management. Frank holds a BA from the University of California at Berkeley and an MBA with concentrations in corporate finance and investments from the University of Notre Dame.

CLSA has rated companies on the quality of their governance for 15 years now, however, no one really rates the research community or investor contributions. Are we being a little hypocritical, should we be?

Low voting ratio's in Asia make engagement more important

Dan (Glass Lewis): There is definitely some room for improvement. If you look at the share registers of listed Asian companies many of them are closely held. It can be difficult to affect change solely through voting. That is why we think engagement with portfolio companies on governance issues can be really valuable. Anecdotally many of our clients that have exposure to Asian equities have ramped up their engagement in Asia over the past few years.

Foreign institutional investors are the most engaged on governance in Asia

Jun (ICS): Investors actions vary by market. In Asia, foreign investors who are based in Europe or the USA and invest into Asia are most active. They tend to be pretty engaged in terms of voting. Foreign investors are also more likely to be engaged with the company to push for change and exchange viewpoints. Asian domestic investors in general are less engaged.

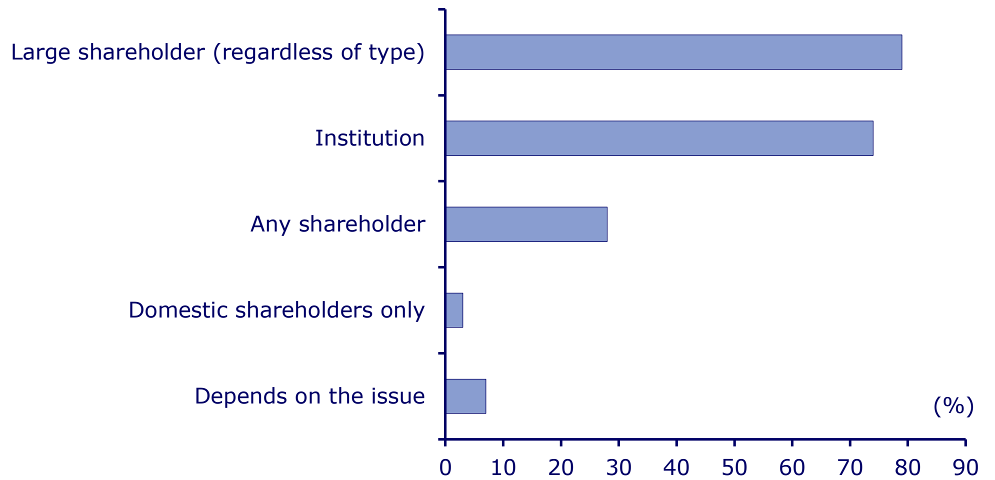
Activist hedge funds have actually added a lot of value in Asia in recent years

Pru (Blackrock): Activist investors are probably having the most high-profile impact. But there is also a role for other investors such as BlackRock where our interactions with G Resources (an active long-term holding) demonstrate that we are willing to take public action that goes beyond simply executing within the less visible voting process when we believe the circumstances demand it.

US companies usually engage with large shareholder or institution

Figure 36

US company engagement experience as a benchmark



Source: CLSA, ISS

What do you think is driving these differences in voting behaviours by size of institution and market domicile?

Differing regulatory backgrounds can contribute to voting differences

Dan (Glass Lewis): If you are talking about US or Australian firms, these are two groups of investors that I have the most familiarity with; there are years and sometimes decades of compliance obligations really baked into voting behaviours. So differences in regulatory environment probably contribute. You can combine that with general differences in ownership composition. If you are a local investment firm based in Singapore or Hong Kong you would probably expect a large portion of your investment universe to be comprised of companies with a controlling or at least a dominating shareholder. Here you kind of know that you are essentially going along for the ride.

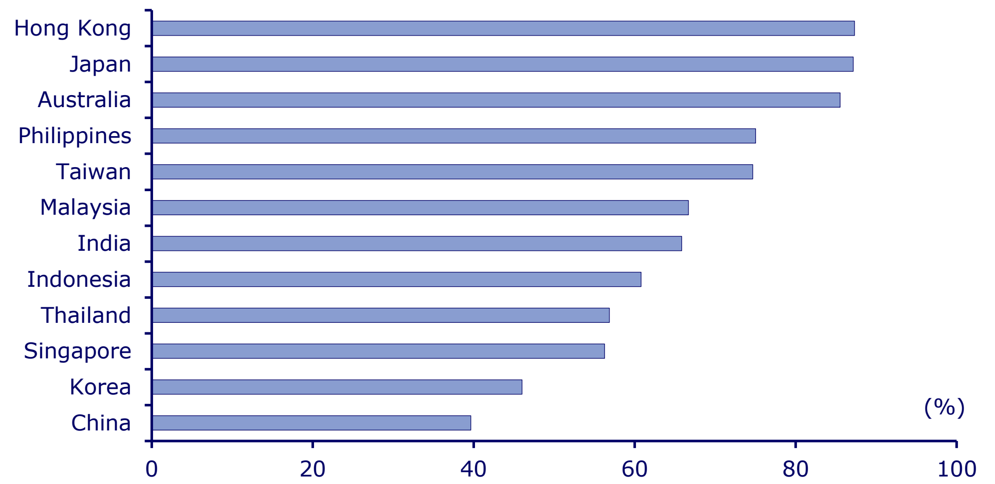
Market maturity and ownership structures heavily influence governance

Jun (ICS): Culture is a strong factor in Asia. When you look at overseas markets with clear active ownership it tends to be more mature markets with longer histories and more established institutional investors. Also in Asia, confrontation is sometimes taboo, which is further complicated by the fact that ownership in Asia can be highly concentrated with the founding family or the state as the controlling or major shareholder. Another significant impediment to more investor-issuer engagement is conflicts of interest. Often times in Asia, asset managers themselves have significant business with, or are even owned by, the corporations. The institution may become much less willing to challenge management and may not want to exercise voting rights. One consideration is the cost-benefit of engagement. If investors conclude a vote cannot influence the outcome they may opt not to do it. Finally investment horizon plays a role. For markets like China there is a higher propensity to trade. For those investors that are trading based on price movements and quarterly earnings, governance is less likely to be important.

Government interference is still prevalent in some markets

Figure 37

Percentage of companies free from government interference by country



Source: CLSA

We look at the quality of the company before we look at the valuation

David Smith (Aberdeen): Asia is a dynamic region in terms of the people you will be co-investing with. We are ultimately co-investors in most companies here and so we want to make sure we are investing with companies that will look out for minority shareholders; with owner-managers that will look out for minority shareholders. We put a lot of emphasis on the quality of governance before we invest. We find that it is best to frontload our governance work. If you take shortcuts at the front end, something might go wrong and then you are going to have to roll your sleeves up to try to extricate yourself.

Interestingly academic governance research often finds that family-based companies (and or founder-run companies) often outperform as long as the right conditions exist. Would you agree? What are the right conditions?

The right family ownership can lead to better long-term orientation and outcomes

David Smith (Aberdeen): That is absolutely right. If you are the type of investor who holds a truly long-term perspective, a long-term view on value creation and on strategy and execution; then finding a major family shareholder can be ideal. This is by virtue of sometimes their similarly large investment at stake but it can also be their outlook. They can be more willing to look at an investment opportunity that may not pay back in the next three or four quarters but they can assess that in two to three years and so they (and therefore we as a large minority position) will be very well placed. It is tough to make that case in some markets but we are reasonably comfortable with the families that we invest in.

What percentages of investors that are eligible to vote actually do and is this a rising or a falling trend? Are there significantly different trends by country?

Global investment houses are almost universally voting, small investment houses are less likely to

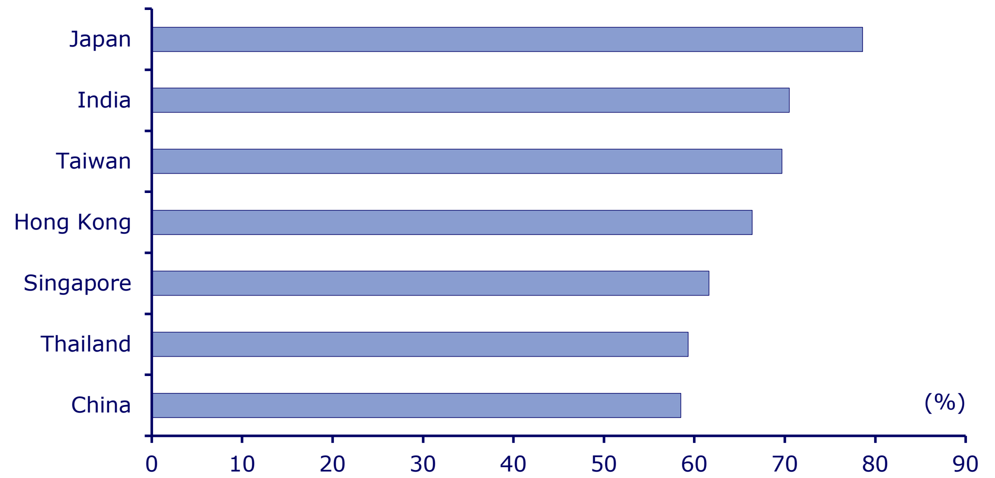
Dan (Glass Lewis): It really depends on the type of shareholder. Often they are large investment houses with headquarters in the USA and other developed markets where there are legal requirements for US investment companies to vote their shares. If they are already voting in their US jurisdiction it would be inconsistent at a firm level not to vote in other jurisdictions subject to cost restraints on things like power of attorney or share blocking.

Data is spotty and the range by market is wide but vote participation is rising

Jun (ICS): The data is spotty. A lot of markets do not disclose voting results and or the breakdown of the vote. For those markets, we have no data on voter turnout or approval rates. They are Korea, Malaysia and Thailand. Aggregating markets with robust data we would say the regional trend is improving. In Hong Kong the voter turnout was roughly 68-69% last year for the companies covered by proxy adviser Institutional Shareholder Services, the parent company of ICS, and this year it went up by 1ppt to around 70%. So it is slowly improving. For some markets like China, where the voter turnout is about 55%, the data is less encouraging. However, this data includes the controlling shareholder vote. Therefore, the actual turnout for minority shareholders is an extremely small percentage. I believe Japan has the highest turnout in Asia with around 80% among large companies.

Figure 38

AGM voter turnout by market



Source: CLSA, ISS

Is it the vote action that matters, or engagement over time?

While votes matter engagement is essential

Pru (Blackrock): You must have both. For BlackRock, given the breadth of companies we own positions in, we cannot engage with every company. However, for egregious matters, engagement is more effective than voting. Sometimes just by looking at the agenda it's a no-brainer for us to vote against. However, after engaging with the company there are times where you gain an understanding about why you might support it.

Deep consistent engagement is far more valuable than voting alone

Dan (Glass Lewis): If you look at the mechanism, voting is largely a binary decision. You are either supportive of management or against it. Similarly, the voting outcome is binary too; either the resolution passes or it doesn't. As a result, voting as a mechanism doesn't tell too much of a story about why the result was cast. That is why sustained engagement, a consistent regime between management, boards and shareholders over long periods of time can be really valuable. I think that probably matters more in the long term.

Both have a role depending on the cost and potential benefit at stake

Jun (ICS): I see this as a continuum. Voting, engagement, activism and even shareholder litigation are all ways of exercising your ownership rights. Voting is the method with the lowest cost and risk. For voting you can outsource the process and it is also the least confrontational option. You can be anonymous, you do not have to explain why you voted a certain way and you are only one of many voters. Engagement can be more costly and potentially cause tension with the company. To engage you need to research your portfolio to identify the specific issues to address. You need to talk to the companies consuming time and resources. These costs can increase as you escalate an issue with decisions such as proxy battles and litigation. That said, with that escalation comes the potential for greater rewards.

A vote is a culmination of private engagements; it is rare we would use it to first raise a concern

David Smith (Aberdeen): For issues that are more strategic I think the vote is typically a culmination of private engagements. It is rare that we would first voice our concerns through an AGM vote. We have had engagements that go on for years. If you think engagement in Asia means initiating a process in January and seeing some results in March or April you are going to be quite disappointed! Of course one of the elevations of engagement is a vote at an AGM. That is where you want to be more vocal in your dissatisfaction.

We (CLSA) tend to see Australia as a benchmark for good governance, how does Asian access compare to Australia today?

Australian engagement model is more mature and a benchmark for Asia

Pru (Blackrock): We agree Australia is a benchmark; the engagement model is quite mature there. One of the driving forces was the two-strikes rule and the nonbinding vote on remuneration reports. In contrast, the engagement model is still developing in Asia. Getting access to management where we have a large holding or active holding is usually not a problem. However, access to chairmen is more difficult in Asia.

Australia's access sophistication makes it almost unfair to compare it with Asian markets

Dan (Glass Lewis): Australia has a really sophisticated engagement regime. In that sense it is almost unfair to compare Asian markets against Australia. It is at a slightly higher level in Singapore, Hong Kong and Japan but again not nearly to the level we see in Australia.

Significantly better access than Asia

Jun (ICS): Whether Australia is an appropriate model for Asia I am less sure. Structural and cultural difference may make it an unrealistic target for Asia.

If the regulators and companies across the Asia jurisdictions were trying to think about what a sophisticated model looks like, what are the hallmarks of the Australian model that you think are most valuable?

Australia's process runs separate NDRs (management) and governance roadshows (board)

Dan (Glass Lewis): It's important to look at it in two separate streams. One is the traditional access that investors have to management to ask fundamental questions. Separate from that stream is the corporate governance stream. So to what extent do governance specialists, who may or may not be equity analysts or portfolio managers themselves, have access to the board and to governance experts at the company. In Australia, those channels are clearly understood by the largest companies. Boards have built into their quarterly or annual calendars the expectations that they will block out chunks of their time for so-called governance roadshows, which is different to the typical nondeal roadshows, where the CEO and CFO typically meet with portfolio managers.

What about the trend in access? Has the gap to Australia narrowed or widened over time and what are your expectations for the future?

Asia's gap to Australia will narrow slowly with time

Pru (Blackrock): We expect the gap to narrow. I have worked in corporate governance for 20 years and I can tell you in the late nineties in Australia, companies did not engage with shareholders in the manner they do today.

There is a clear trend for more engagement, especially in Japan

Jun (ICS): At least in Japan it is getting much better and that is the feedback from my corporate clients. After the introduction of the stewardship code the dynamic of investor and issuer relationships has improved. More investors are asking for engagement with senior management. Furthermore, not only are the companies responding to more requests for engagement but they are making requests themselves and making senior executives more available.

Two-strikes rule

The "two-strikes" test was legislated by the government in June 2011. The "first strike" occurs when a company's remuneration report receives an "against" vote of 25% or more of eligible votes cast at an AGM. Subsequently, the company's remuneration report is required to explain whether shareholders' concerns have been taken into account, and either how or why they have not been taken into account.

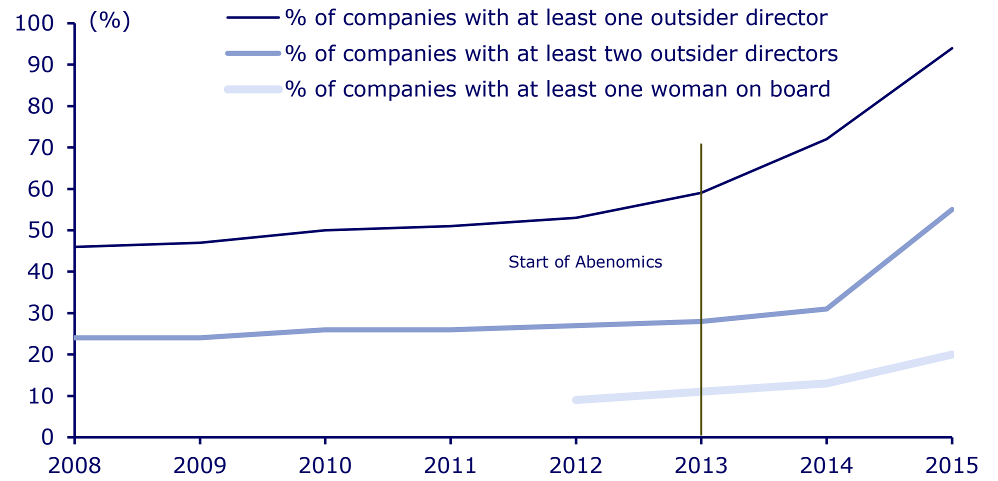
The "second strike" occurs if the company receives a second "against" vote of 25% or more at the following year's AGM. Where this occurs, a separate conditional resolution will be put to shareholders at the same AGM to determine whether the directors will need to stand for re-election at an EGM within 90 days (the "spill resolution"). If the spill resolution is passed by 50% or more of eligible votes cast, another meeting of the company's shareholders must take place within 90 days (the "spill meeting"). Individuals that were directors when the directors' report was passed at the most recent AGM cease to hold office immediately before the spill meeting, and are then required to stand for re-election at the spill meeting. If, by the time of the spill meeting, none of these individuals remain as directors of the company and have been replaced by other individuals, then the company does not need to hold a spill meeting.

Source: CGI Glass Lewis

Abenomics helped drive change in board diversity

Figure 39

Abenomics driving change in board diversity



Source: CLSA, ISS

Does this suggest the eventual selling down of these stakes leads to better engagement or do we face structurally lower access for Asia?

Reduce SOE and family ownership can contribute to this

Pru (Blackrock): It will depend on the succession planning that takes place. I see that the trajectory is in the right direction but it is the slope of the curve that may not match Australia. It is unlikely to be as rapid as Australia's transformation from say 1997 to 2007, when they had the nonbinding vote on remuneration that came in during 2006, which really raised engagement. That was also followed by the two strikes rule in 2011, which then took engagement to another level.

What is the more productive conversation, both from the perspective of investors and companies; board level discussion or management? Or must investors do both and if so what is the right balance?

There is increase demand from investors to meet board members

Jun (ICS): Institutional investors tend to prefer meeting senior executives like the CEO or CFO. A growing trend in the rest of the world, not so much in Asia, is gaining access to independent directors such as independent chairmen or the lead independent director. Shareholders of course want to meet with the CEO, but increasingly, they also want to speak to independent directors, who are actually charged with representing their interests on the board.

Blackrock focuses governance conversation at the board level

Pru (Blackrock): It depends on the topic. For executive remuneration and pay of the CEO, you don't have that discussion with the management, you simply can't; likewise for succession planning of the chairman. There is a clear line between what is an issue for the board and what is an issue for management.

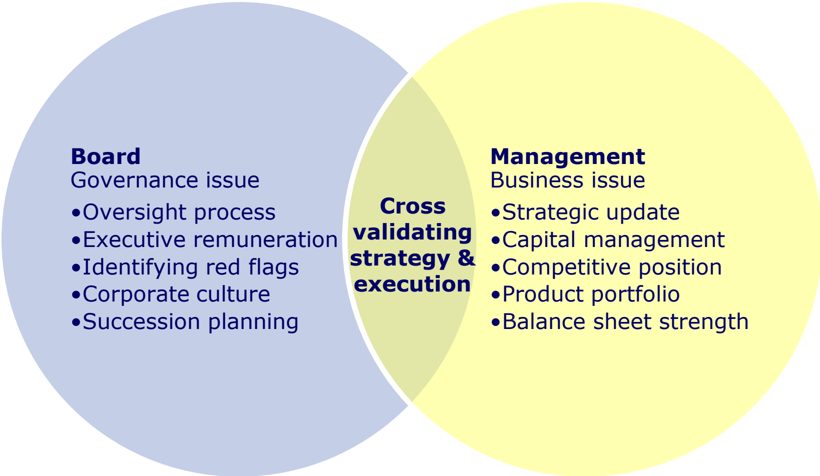
Speaking to both management and boards is the richest most useful interaction model

David Smith (Aberdeen): We find them both productive but for different reasons and of course at different points in cycle. The core to our process is interaction with management and we will typically try to meet management two, three or even four times a year. Not just for financial updates but for strategic updates as well. But we find meetings with the board members useful. Sometimes management will tell you everything is hunky dory but the board will flag certain issues that it is less comfortable with. It is also useful when the company is going through a strategic change or the industry is challenged, to get a different perspective on that. As investors, what we want to do is to understand our companies and their people as well as possible.

Need to engage both with board and management to cross validate strategy and execution

Figure 40

Typical engagement models in Asia



Source: CLSA

So you are saying active managers are likely to focus on talking but governance specialists should focus their energy more on the board?

Board is key point of management oversight

Pru (Blackrock): Yes that's correct, but investors still need to speak to both. The board is the body that is providing oversight of management, approving the strategy and measuring the implementation of that strategy. As such, they should be able to identify issues before they devolve into material problems. Their job is to question management, sometimes coach them and to generally increase the probability of success. If portfolio managers exclusively meet with company management they are less likely to get an indication of board quality, which may impact long-term performance, or at a minimum they will naturally get a less objective assessment. This is why you need independent and competent boards to carry out that role.

Would you agree with the argument that business issues are for management discussions and governance issues for board discussions?

Company secretary can be an excellent way to begin a relationship with the board of directors

Dan (Glass Lewis): Generally, I think that is pretty much on point. It depends on the context, the previous level of engagement with management and the company broadly and how involved or receptive the directors are. Some chairmen are very hands on and are comfortable getting into the weeds. Other chairman, perhaps their skills are in other areas and so don't feel comfortable going into that level of detail. And that's okay, we are not saying we have preference either way. We should also consider what governance issues are going on with the company more broadly. In our experience, from interacting with companies which are at varying stages of maturity in terms of governance engagement, the company secretary is often times a really good starting point due to the unique nature of that role. Because they are supporting and effectively reporting to the board but they are still a member of management. They have the ability to translate what is going on from a process and governance point of view without spruiking the business.

It makes sense to focus governance question to board level interactions

Jun (ICS): I think it makes a lot of sense. However, from the perspective of some companies (especially in Asia) it may be a difficult to allow access to nonexecutive directors. There are sensitivities around what information is disclosed for fear that the company may not be able to control the message

Isn't that the exactly the point? The board is supposed to be the guardian of governance whereas management's incentive is to control the message and in many respects their continued tenure is based on sustaining the market's approval where messaging plays a key part. Isn't a reduced ability of management to control the message regardless of substance a good thing?

No all directors are comfortable with or trained to communicate with investors

Jun (ICS): Not every director is sufficiently prepared to speak with institutional investors and represent the company. These directors may need training on what is allowed to be disclosed or not. What some companies have done is to assign lead directors or the chairman as the main person who communicates with investors where the company must make sure to provide sufficient support to these directors. So what I mean by controlling the message is that when engaging investors in a private setting there is always the risk of inadvertently leaking insider information. This could prove a significant problem for all parties. Directors must be trained in how to be able to effectively handle these communications and what can be disclosed.

Doesn't this come to the issue of competence? The danger for tightly held companies is that the board can effectively become a façade to create the appearance of appropriate governance structures. Isn't the best way to demonstrate the substance of the board to make them available to those whose job it is to assess the substance of a company's governance?

But investors need to develop this competence and should be available

Jun (ICS): I absolutely agree with that. I think it is reasonable for investors to demand access to these board members to really assess if these board members are truly representing their interests.

Do investors have an obligation to demonstrate commitment to and knowledge of a company in order to request management face time?

It is incumbent on us to be responsible and engaged owners

David Smith (Aberdeen): I can't speak for all investors but we see our investments as more of a partnership for a long-term position. When we ask for management's time, we hope that management also get something out of the meetings. We are not sitting down asking them what their GP margin forecast for the next quarter is. We're hopefully pushing on its strategic challenges. Our general feedback is that management find our meetings somewhat useful. We also think if we have capital invested in a company then management should speak to us and pleasingly they do.

Management can't meet everyone but ultimately it must engage with the providers of capital

Dan (Glass Lewis): It can be a slippery slope there. By whose definition do you meet a certain amount of knowledge, commitment or minimum threshold of shareholding. It is not realistic for management to meet every shareholder or potential shareholder. There are practical realities that mean we need to put restraints on it. However, severe restraints can be used as an excuse to deny access to discuss legitimate issues. I don't think there is a clear rule of thumb and certainly shareholders ought to leave it to management's discretion. But to be clear, putting the onus on shareholders to prove they are worth management's time seems to get the issue backward from my point of view. At the end of the day they are the ones providing capital.

Is that really true? If you own five basis points of the company and trade on short holding periods how are you adding any value to management or any real value-add in the true capital-allocation function. For some investors surely management has an obligation to say no on the argument that Warren Buffett is right, ultimately you get the shareholder that you deserve?

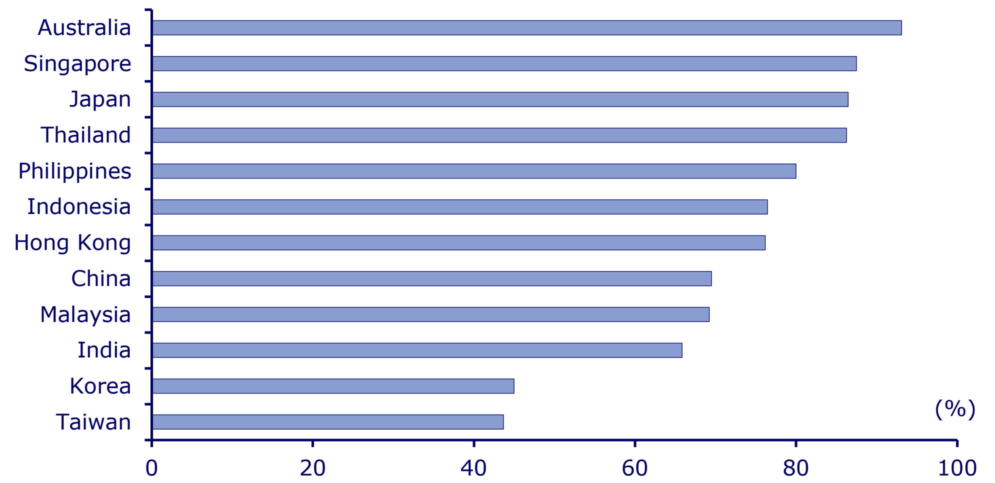
Companies should consider meetings based the expected quality of the interaction

Dan (Glass Lewis): That is a fair enough point. I think it becomes a question of what are the issues that shareholders wish to discuss, instead of talking about how long an investor is going to be on the register or how large of a stake they have, that is irrelevant. What's more important is whether they are pointing out materiality gaps in my disclosures, that through addressing, I might be able to potentially rerate my company value in the market.

Korea and Taiwan stands out with low company access

Figure 41

Percentage of companies assessed as providing access by country



Source: CLSA CG Watch 2016 Survey

Would you see board access as a missed opportunity not just to improve the quality of the discourse but reduce the direct drain on management time?

Active managers benefit from speaking to both management and the board

Pru (Blackrock): I thoroughly support the idea of talking to boards for understanding corporate culture because it comes from the top. However we should remember if your discussions with the board are focused on issues specific to the board, there is less scope to save management time because you should not be having those discussions with management anyway. I certainly support that speaking to the board can help investors better understand not just how the company is doing but how management is doing.

There is some efficiency to providing access to the board but its more about quality of discourse

Jun (ICS): Another opportunity is simply proximity. With Hong Kong, for example, a lot of investors are based overseas and some of the board members are based overseas. So it is logistically easier for these board members to meet with investors.

Board members can augment management meetings and improve engagement productivity

Dan (Glass Lewis): Yes, I think there is some legitimacy in that. There is no doubt the board stepping in and taking some of the load on the governance-related discussion with shareholders could effectively help management deploy the scarce resource of their time more effectively.

Talking to boards is a fantastic way to build conviction in the governance process

David Smith (Aberdeen): Yes. Whether it reduces the burden on management I don't know. I am not sure if investors would reduce their request for management interaction having met the board because the discussions are by nature different. I think this is a missed opportunity for companies, they can highlight the background of the directors and the skills that they bring to the board to give investors some comfort that the corporate-governance mechanisms, and checks and balances are in place. As investors, we get a lot of detail on financials in an annual report but when it comes to corporate governance disclosures they tend to be somewhat bland so it is difficult to see if governance is actually working. You can have quite good discussions with board members that help us to see how governance actually works.

Isn't meeting investors that sometimes own only basis points of a company (sometimes for quarters rather than years) a waste of management time? Could companies argue that several hours a quarter open to any and all that wish to psychically or virtually attend is enough?

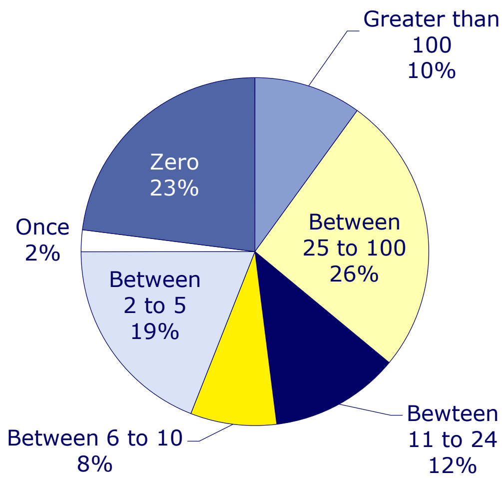
Quarterly briefing is not enough, private engagement is also required and many actively do it

Jun (ICS): Quarterly analyst briefings do not negate the need for private engagement. The frequency will really depend on the company. Our parent company ISS did some research on engagement trends globally. The majority of the companies we surveyed initiated more than six engagements a year, and 26% actually said 25-100 engagements a year. The key takeaway from all of this is that there is a significant portion of the market that understands the value of engagement and does it frequently.

Majority of the companies initiated more than six engagements a year

Figure 42

US issuer engagement frequency



Source: CLSA, ISS

Meeting activists, even if they hold short-term positions, can still be of great value

David Smith (Aberdeen): I have a strong view; management's job is to run the company. It's not meeting investors every Thursday. What management needs to do is prioritise what types of investors it wants to meet through its outreach. It might want to deprioritise investors that it thinks are traders. However, even that is a tough decision to make. Activism is rare in Asia but sometimes activists can come onto the register who make very useful suggestions or maybe make the same suggestions that we have been making but are more vocal about it from the get go.

Access is critical but efficiency of access is a relevant consideration

Pru (Blackrock): I think providing access is critical and having quarterly calls to answer questions from investors and analysts during that time is a good example of an efficient way for a company to communicate with shareholders. If shareholders decide not to utilise those channels, I can agree it becomes more reasonable for management to express reluctance for additional time.

We have heard that for some companies where governance was not particularly strong but they were starting to engage, they were finding the processes uncomfortable but quite valuable. Has this been your experience?

Management new to engagement are sometimes surprised how useful they find it

Jun (ICS): I remember one Japanese company CEO who went on a roadshow for the first time and met with a big pension fund in what proved to be a very intense meeting. The IR manager was very nervous and CEO was initially very upset. However, in the end he found the trip in its entirety to be very meaningful to him in that he had no idea about many of the viewpoints and concerns the investors had expressed. Because he learned so much he will continue doing this on a regular basis. So absolutely, engagement can have a significant impact on executive level thinking

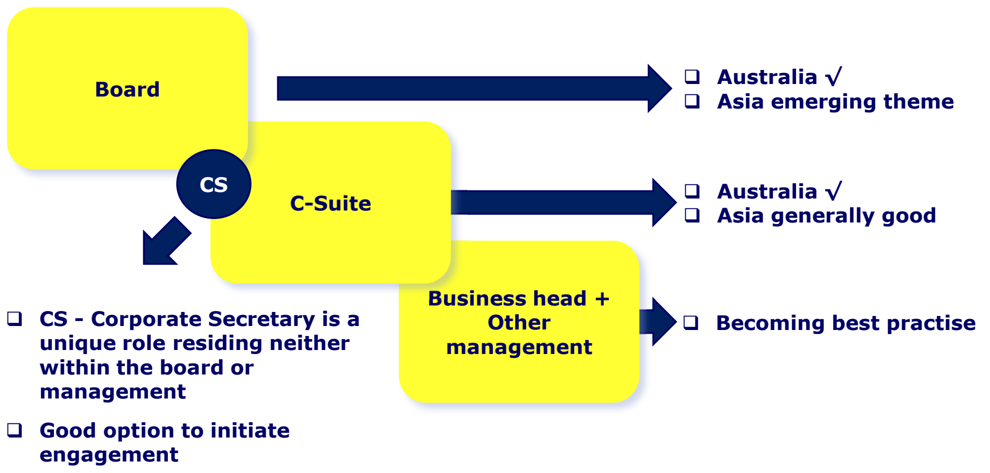
Valuable engagement becomes most clear after long period of persistence

Dan (Glass Lewis): Yes very much so. Over the years, we develop relationships with directors to get a mutual understanding. When you are sitting across the table from someone for the 10th or 12th or 15th time you develop a mutual appreciation of each other's perspective. We have certainly seen anecdotally, and taking a step back at a market-wide level, a translation of that into enhanced disclosure and I think more meaningful disclosure on the key areas of governance matters that we have been focusing on.

Corporate secretary may be a good option to initiate engagement

Figure 43

Range and role of access choices available to corporate



Source: CLSA

David, we suspect Aberdeen's ability to get access to the management is better due to your scale and style of investment. Within that context, if you reach a certain scale and commitment level is Asian access comparable to the rest of the world, or do gaps exist even for very large, long-term holders?

Changing trends is more access to above C-suite (the board) and below (business heads)

David Smith (Aberdeen): Of course there are pockets of difference, but on the whole we get good access. Where things are changing, and this is more for the market as a whole, not just for Aberdeen; is investors are getting better access to more sub C-suite management. You've seen a lot of reverse roadshows, you are seeing things like business heads being brought out to see investors; so that is changing across the market.

We are getting more access to board level nonexecutive directors

One other pleasing change, I am not sure if this is the case for other investors, is that we are getting far more access to board-level nonexecutive directors like the chairman around the region. This has certainly been the case in Australia, Singapore and Hong Kong, for example, where maybe you didn't get that access 10 years ago when I first moved here.

Are the best companies for access the ones that try to think holistically about the most efficient ways to reach the maximum number of investors, rather than doing ad-hoc engagements that, by their nature, will tend to favour the larger or more aggressive investors?

We use ad-hoc engagement to address specific issues

Pru (Blackrock): Our ad-hoc engagement is used when we have specific issues to raise. More often than not, we are a substantial shareholder and it is important for us to meet, share our views and develop the relationship. This is important because, if an issue arises and we have some specific concerns, we know who to talk to and they know us. This immediately leads to more effective and efficient discussions. While there are natural efficiencies to proxy-advisor research that we all value, it is nonetheless still important for boards to remember that votes are made by shareholders not by proxy advisors.

This raises an important question; has the investment community essentially outsourced the voting process to proxy advisors and does that dilute the value of the process? Also isn't there the potential for conflicts of interest?

Proxy voters are a valuable productive tool but ultimately do not vote, shareholder do

Pru (Blackrock): Blackrock uses two proxy advisors in each market so we are not overly influenced by one or the other. We have one of the proxy advisors implement our custom policies because around 70% of proposals are not controversial. We don't seek to review every proposal as our goal is to focus on the remaining 30% that requires our attention. We have systems in place to escalate these kinds of proposals. This is a practical reality around how we can execute the process when we are invested in 5,000 companies in the Asian region. Our policy is on the website and publicly available to the companies.

What is the fundamental role of proxy advisors in your mind? What do you think are the frustrations that investors might have?

Proxy advisors sometimes play the role of foil to help investors say 'no'

Dan (Glass Lewis): I think the proxy advisors play an important role in the governance of companies and as a part of the investment decision-making process and investment maintenance process. Our research helps investors identify risks in their portfolio companies. Of course, it's their right to determine how best to integrate our research into their decision-making process. For some investors that may mean using our research as a foil, almost like a 'good-cop, bad-cop' strategy. And that way, it potentially allows investors to avoid losing access to management. We have received specific feedback from some of our clients that they sometimes feel reticent to vote against management lest they be cut out of the corporate-access market.

Couldn't you argue that is a value-added function? While it can be frustrating as proxy advisors yourself in that partly, you want investors to own the decision. Especially if the choice to own the decision is more likely to precipitate behavioural changes from management. But if we are on a spectrum in a journey when we are waiting for the behaviours and accepted norms to evolve over time; isn't it better to blame the proxy advisors but vote and send a signal. In an Asian context often an indirect message is heard more than a direct one? That way the change process at least begins.

The foil role can help in the journey to better behaviours - engagement is key to make that work

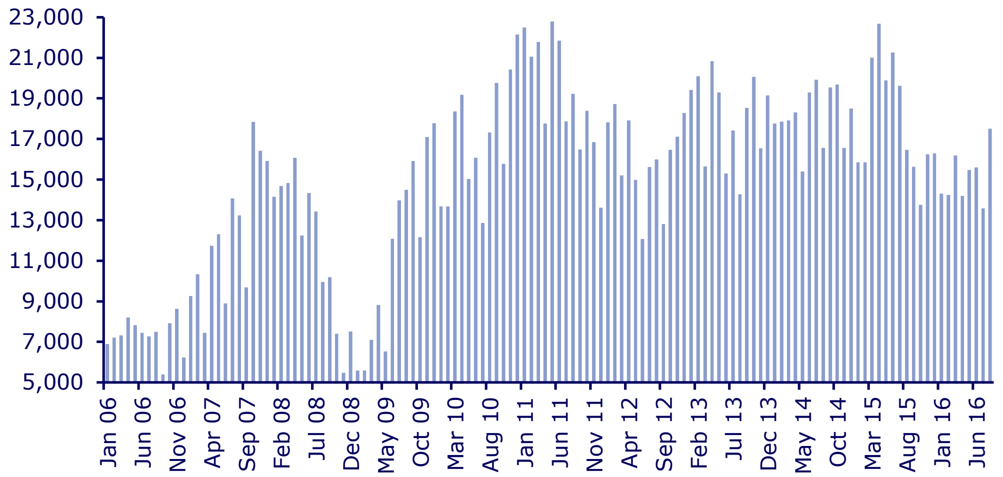
Dan (Glass Lewis): Well you don't stay in the proxy advisor industry for long if you don't have a thick skin. As a service provider to our clients, within constraints, we are happy for them to rely on our recommendations and research as they see fit. If that means we need to jump on some grenades for them then so be it. To be clear, the key thing is that we don't want to raise issues for the sake of raising them. We want to identify the core fundamental risk for the long-term investment process for that particular company. If this facilitates a dialogue that contributes to better outcomes for shareholders even though it causes grief for the company, then so be it. It doesn't have to mean that it ultimately translates to a vote against management.

Some would argue that passive investment is a threat to improving corporate governance. Interestingly, the Harvard Business Review recently quoted academic research arguing the opposite? What would be your take on the active versus passive debate for ensuring good governance?

Assets in the top-10 Asia Pacific ETF grew by 2.5x in the last 10 years

Figure 44

Top-10 Asia Pacific ETF total assets (2006-16)



Source: CLSA, Bloomberg

Passive investment can augment active governance effort

Pru (Blackrock): I think they are different and complementary. Passive investors like BlackRock have dedicated teams to address the issue of governance and so do influence and raise the bar in certain markets. However, active managers have an advantage of having the power of selling their shares. McKinsey did some research that well-governed companies attract a higher valuation. We believe good governance can lower your cost of capital. In that respect we see a missed opportunity. This is because a lot of companies in Asia look at governance as a compliance issue and so it is managed from within their legal or compliance departments

However, we look at it as a strategic issue. Especially for family-controlled companies. We are not arbitrarily saying please make one third of your board independent. We want to see people on the board that we are confident are competent and provide value added oversight of management. The reality is that families in Asia have often built extraordinary companies from nothing over decades. The company will have a particular culture that could be adding a lot of value that we don't want to interfere with. However, as companies keep maturing we believe that there is value in fresh blood and better board processes to keep that growth going. Furthermore, we see this governance evolution as an advantage to the families themselves because they are long-term investors just as we are

You raise a good point, the debate about independence. In CG Watch 2016 we actually decided to remove arbitrary questions about the number of independent directors. Should we be looking more at board competence rather than setting arbitrary targets for the number of "independent" directors, a concept that can be easily gamed in our view?

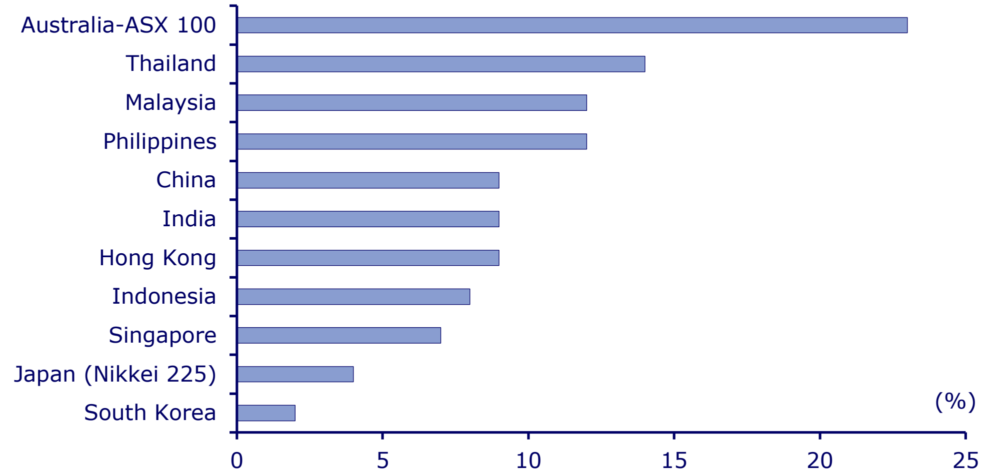
A focus on board competence is more value added than independence

Pru (Blackrock): Our standard approach is to assume that directors are not independent unless proven otherwise. Discussions around independence are often not constructive. Some of the most competent directors that I have seen were not independent and vice versa. However, in seeking to transition the focus to the issues of competence, skill depth and diversity on boards, we also face significant information challenges. This is because it is only mandatory to release their name, age, and current and former directorships

Australia leading board gender diversity in Asia Pacific region

Figure 45

Board gender diversity in Asia Pacific region



Source: CLSA, ISS

David, Pru Bennett of Blackrock was saying her bug bear is that she is far more interested in competence than independence insofar as someone might not be independent but if it is clear through their behaviours that they have the long-term interest to the company at heart, then she values their role. However, she's more concerned that they care about long-term outcome and they are competent not if they fit some specific definition of independence.

One of the bigger trends in Asia is that the independence of directors is being gamed somewhat

David Smith (Aberdeen): Yes, you are right. We tend to look to competence and to what an individual brings to the board. One of the bigger trends in Asia is that the independence of directors is being gamed somewhat and you've seen a growth in dependent directors that are structurally independent (for example academics) but dependent on the company for their pension, so they bring few other skills to the board other that structural independence.

... and their willingness to say 'yes' to the Chairman...

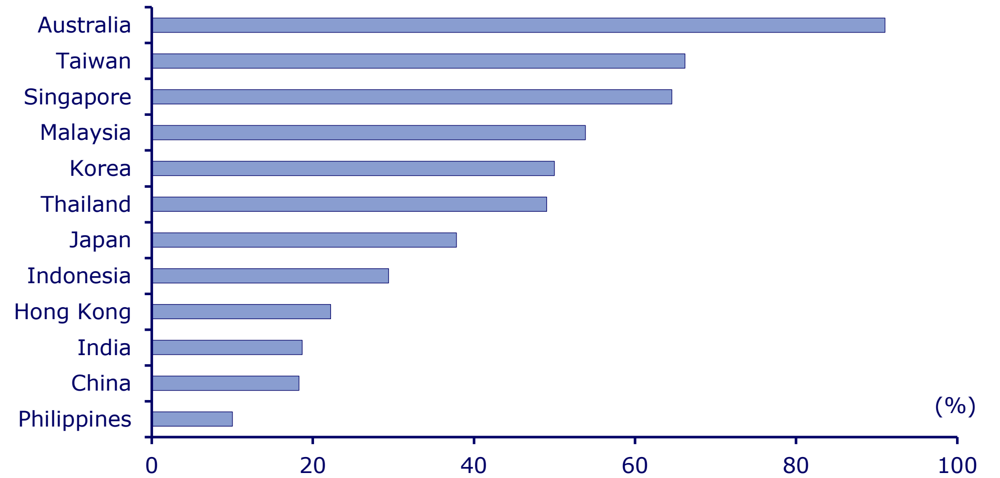
If a director challenges management and brings industry experience to the board then that is great

David Smith (Aberdeen): Yes quite. To Pru's point; if someone is able to demonstrate that they challenge management, they provide a counterpoint to management thinking and bring industry experience to the board then that is great. Then the challenge is; do investors get to meet these individuals. Great access to the board or certainly chairmen would give investors some comfort, even though a company may be one independent director short of compliance with a code, that the board is robust.

Chairman's independence is often doubted in Asia Pacific except Australia

Figure 46

Companies where chairman independence is beyond doubt, by country



Source: CLSA CG Watch 2016 Survey

So that brings us to another key issue. While collaboration is often the best means of mutual advancement, there will be times when investors must call boards and or management to task? Do you think that is happening enough?

We see some clear examples of investors challenging companies in Asia

Pru (Blackrock): Well the Elliott's of this world certainly do, and I would argue that Blackrock do so as well. We have had a very public disagreement (which is ongoing for that matter) with G Resources.

It's important to vote your convictions even when the result is already known

David Smith (Aberdeen): It's not enough I would say. Certainly investors could do more. I think there can be a preference for the Wall Street walk (selling your position); particularly given the presence of controlling shareholders who will dominate the AGM vote. The piping around Asia can mean that you are investing with a controlling shareholder with 60% or 70%. If you are upset with management's actions it can be challenging to defeat a resolution that's on the agenda. We think there is value in voting against a resolution if we feel strongly, even if it is going to pass, because then we can show it to management. We can say if you remove the family vote you can see that no one else favours this resolution and that has been particularly useful in the markets like Hong Kong for things like general mandates.

What percentage of resolutions is actually rejected? Is there any evidence that investors are actually saying no to companies and what is the trend?

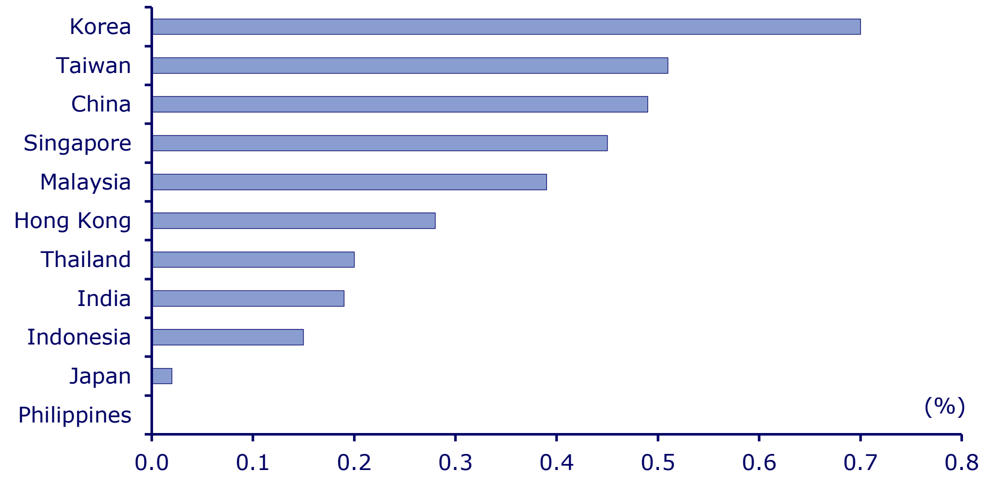
Percentage of resolutions that get voted down is extremely low

Jun (ICS): The short answer is resolutions that get voted down are extremely rare. It is something like 0.5% or less in certain markets. There are certain types of resolutions that tend to get voted down more often. In Hong Kong, related-party transactions tend to get voted down more. The big reason for that is because controlling shareholders or interested shareholders are not allowed to vote. So minority shareholders have a much larger say. Also, these transactions can potentially have negative consequences for investors; there is economic value at stake, increasing the incentives to say no. Other resolutions have a higher likelihood of review like amending articles of incorporation or M&A, but overall the vast majority, more than 99%, pass resolution without issue.

Essentially all resolutions gets passed in Asia, highest failure ratio is 0.7% in Korea

Figure 47

Failure ratio of resolutions by market



Source: CLSA, ISS

That's extraordinary! Does that say that, in practically terms, there is basically no true check and balance actually taking place?

Resolution fail rates are too crude a tool to measure governance performance

Jun (ICS): Vote results are not the best standard of measurement to assess checks and balances. The vote outcome is heavily dependent on the shareholder structure. It is especially important to consider, if a majority of minorities voted against a resolution. This is, at a minimum, a powerful indicator to management that something is wrong. Management should then speak to the dissenting investors to address their concerns.

Investors can vote yes but privately express concerns to constructively affect change over time

Dan (Glass Lewis): I think what happens behind closed doors in the privacy of boardrooms and phone discussions is a lot more meaningful than reading the vote results. Even though you do not see as much change as one might expect we do not have any problem at all with that change happening slowly as the result of discussions happening outside of the public domain.

What can we do to improve the situation?

'Independent' directors of tightly held companies often misunderstand the fiduciary duties

Pru (Blackrock): We would like to see directors better understand their role in regards to minority shareholders. Often times, they have been voted in by the major block shareholders. These types of directors are more likely to see their responsibilities as primarily aligned to the block shareholder. If we vote against a company, it is critical to communicate with the board about why.

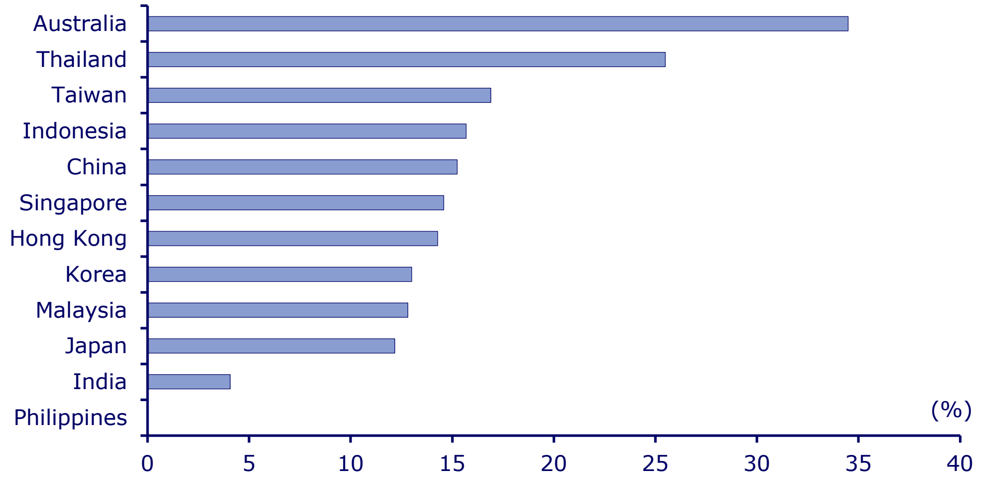
In part, the director nomination and elections process is the challenge

David Smith (Aberdeen): We place a lot of emphasis on independent directors and say they are the ones that should hold management to account. But the reality is that they are recruited by, nominated by, and appointed by the controlling shareholder, who determines their presence on the board. If you look at the UK experience, the UK has actually amended AGM voting for controlled companies, having had that experience recently. Now there are two votes, one by all shareholders and one by just minority shareholders. So the second vote is an advisory vote, I will not go into details here, but it's an interesting situation. Maybe to help minority shareholders hold management or the board to account more, the voting mechanism needs to change? Because even if you are incredibly unhappy with a director and you vote against, if the controlling shareholder re-elects him and shows a lack of interest in what minorities say, then as a shareholder you are challenged.

Independence of directors need improvement

Figure 48

Percentage of companies believe to have genuinely independent directors



Source: CLSA CG Watch 2016 Survey

It would be interesting if we went to a world where selecting independent directors was equivalent to a related-party transaction; that would change the game in Asia.

We end up voting for independent directors based on independence rather than competence

David Smith (Aberdeen): Yes, you are absolutely right and we do say that one share one vote is holy to investors. And I am sure you will have seen the discussion in Singapore at the moment on dual-class shares. But for certain transactions, we do disenfranchise controlling shareholders like RPTs that you mentioned. So maybe we should do that for independent directors. As you say it is boiler plate at the moment. I think most of the region is somewhat reduced to voting for independent directors based on their independence rather than competence. So are they independent, tick, should we vote for them, well we have no reason not to, I suppose is what the market says.

What are the top one-to-three things that you think we should be focusing on to improve governance in Asia

Keep trying to engage and prepare to ensure high-quality engagements

Dan (Glass Lewis): Keep on trying to engage, in other words don't give up. When you get a meeting come prepared, know the company's specific context not just your own policy approach. Finally, make sure you clearly articulate the relevance of governance issues to the core investment thesis of your firm.

Invest in companies who's behaviours suggests they deserve the capital

David Smith (Aberdeen): Firstly it starts with capital allocation; that is investing in companies that display good corporate governance. I think once you have invested, it is incumbent on investors to have a good dialogue with management and make it clear what you expect from it in terms of execution over the next three, four, five years. Investor should also make clear their expectations of what good behaviour or corporate governance look like. We need to see it as a partnership that can grow and reel discussions away from things like Ebitda or GP margins for the next quarter, more towards longer-term issues. This will help improve governance in the region. Finally, no one invests hoping that the regulator will save your bacon; by the time you need to ask the regulator for something then typically value has already been destroyed. But making sure the regulatory playing field is conducive to long-term investing and reduces avenues to expropriation for example, and removes some of those temptations that might be there, is also something that investors should be focusing on.

What are the key developments that have taken the bulk of your attention in the last several years?

Constant communication is the dominant feature of the Blackrock approach

Pru (Blackrock): The dominant feature of our engagement has been focused on communication. This is why we have a guideline for Hong Kong and it will be rolled out to other jurisdictions. It outlines our expectation of disclosure and communication particularly around our definition of the board and how it operates. Overall, we want the relationship to be cordial, as we are in it for the long term; the nature of our mandate means typically we can't sell.

'One could almost make an argument that votes on remuneration should not exist'

David Smith (Aberdeen): One issue that has taken up too much of our time is remuneration; particularly in markets like Australia. Remuneration reports are too complex, structures are too complex. Companies sometimes struggle to understand what kind of behaviour these schemes are driving. We'd much prefer to have far simpler remuneration schemes that are longer dated in terms of the performance conditions. One could almost make an argument that votes on remuneration should not exist. We should just hold the chairman of a remuneration committee (rem-com) to account, not hold specific votes. We don't have a vote on strategy for example and that is far more important

Dan (Glass Lewis): Be aware of unintended consequences of regulatory or legislative change when it comes to governance issues.

That is interesting, is there something specific that you have in mind? What might that mean for investors reading this?

Look for unintended consequences of regulations (good and bad)

Dan (Glass Lewis): To use Australia as an example, in 2011 the two-strike regime was introduced. The fear at the time was that it would prove a massive destabilising force. In practice, in the five years since its introduction, that has not happened. But what has happened is it really helped ramp-up the level of engagement, especially between boards and shareholders. That is an example of unintended (positive) consequence.

Thank you so much for your time, any closing comments for us?

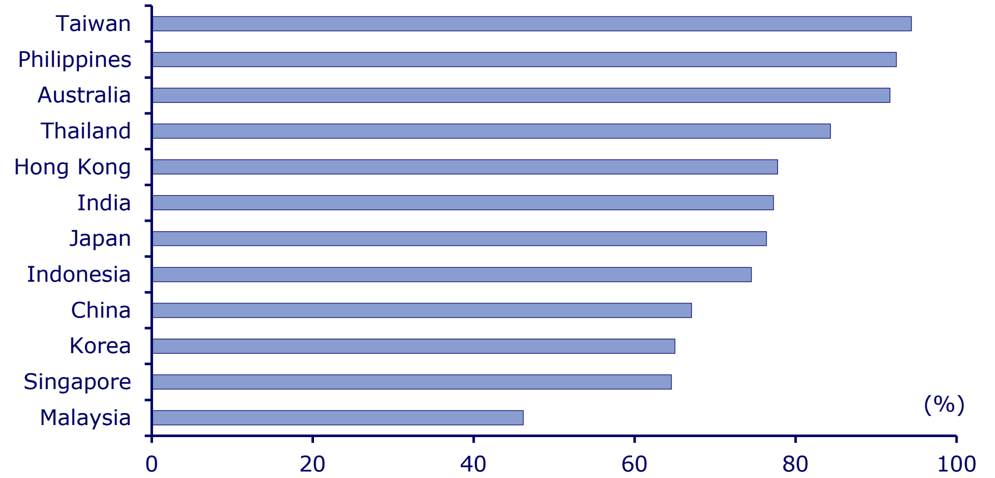
Blackrock is most interesting in continually enhance board competence

Pru (Blackrock): Engagement matters. For governance, boards are where it should be focused. Boards matter and the competence of the board is the key. We want strong oversight and active engagement. To that end, board fees are too low in Asia. We would support paying higher fees if it resulted in more qualified, competent and accessible boards. Thank you

Majority of analysts believe remuneration of the board and management is fair

Figure 49

Percentage of companies with fair remuneration of the board and management



Source: CLSA CG Watch 2016 Survey

Let's collaborate, make as much or your team (management) and board available as possible

David Smith (Aberdeen): For management teams they should continue to make themselves available to investors. In fact, make as much of the team as is practical available to investors. I encourage boards to have more discussions with investors. Boards should be less hesitant is perhaps the best way to put it. We are not here to hold their feet to the fire when we first meet the board, we just want to understand how the board looks at certain issues. We are looking for a constructive and collaborative relationships with boards and management. It is certainly not going to be a hostile experience, one would hope, unless it needs to be.

Recommend investors vote, engage and, where appropriate, collaborate more

Jun (ICS): Voting and giving feedback to companies could foster better understanding among companies of the value of good governance and help narrow the gap in understanding. Constructive engagements could create a positive feedback loop that helps enhance corporate governance over the long term. From the company side, transparency is the most important thing in Asia to have good communication and governance. It's an area that many Asian markets and companies fall behind, compared to their Western counterparts. It is the foundation of having accountability. Information access is integral to raising mutual understanding.

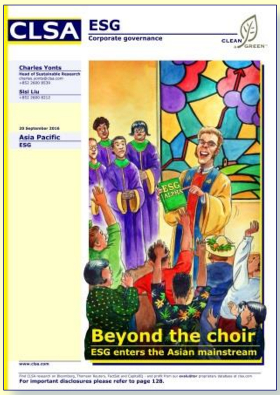
Be as open and transparent as you can with your proxy advisors

Dan (Glass Lewis): To investors, be open and transparent with proxy advisors on what your priorities are. It is not that we have the ability to guarantee making those our priorities but at least we know where you are coming from.

Is there a message that is relevant to boards or management?

Dan (Glass Lewis): Governance-related exposures often get shoehorned into compliance, lowest common-denominator box-ticking exercises. But if you don't look at it as a compliance exercise, but more as a communication exercise - really kind of telling your story - I think that's where companies are finally working out governance has a tremendous ability to really add value to all of their shareholders.

Beyond the choir



Environmental, social and governance (ESG) has quietly moved into the investing mainstream

Environmental, social and governance (ESG) has quietly moved into the investing mainstream in the two years since our last *CG Watch* report, *Dark shades of grey: Corporate governance and sustainability in Asia*. There has been a proliferation of focused funds, assets under management and indexes, both globally and in Asia. Drivers include tightening regulations with resulting improvements in data quality, successful climate negotiations in Paris and, above all, mounting evidence that ESG can help deliver investment returns.

Our sector-specific scoring and questions can help investors mitigate risk without sacrificing returns

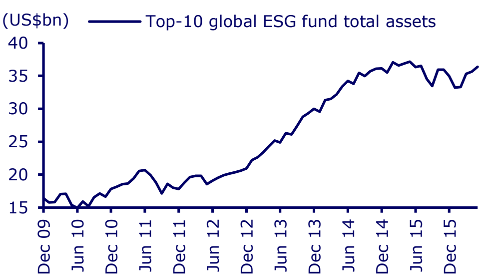
Thematically, the big issues in Asia have continued to ratchet up, with the ongoing war on pollution in China, deforestation in Indonesia and migrant worker abuse around the region. While the level of reporting has been improving rapidly, there are still gaping holes in coverage. Our firm-wide research fills many of those gaps. Bloomberg has full ESG scores for just 38% of our market-cap weighted coverage in Asia. As we work to integrate ESG into our fundamental stock research, our sector-specific scoring and questions can help investors mitigate risk without sacrificing returns.

ESG-focused funds grew from US$21bn AUM in 2013 to US$36bn in 2016

ESG issues are becoming integral to investment strategies worldwide. Narrowly defined, global ESG-focused funds expanded from US$21bn in 2013 to US$36bn AUM in 2016. It is still a drop in the ocean compared to the US$62tn that has agreed to incorporate sustainability issues into investment decisions under the UN Principles of Responsible Investment. The number of signatories, including asset owners and managers, has increased from 200 in 2006 to over 1,500 by April 2016.

Figure 50

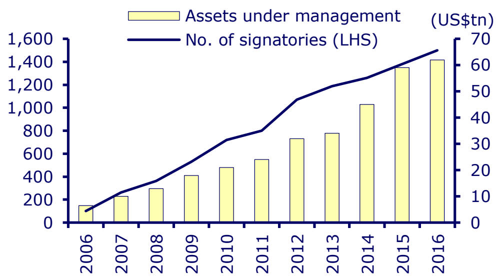
Top ESG fund assets up 70% since 2013



Source: CLSA, Bloomberg

Figure 51

UN-PRI has over 1,500 signatories



Source: UN-PRI, CLSA

From aspiration to actualisation

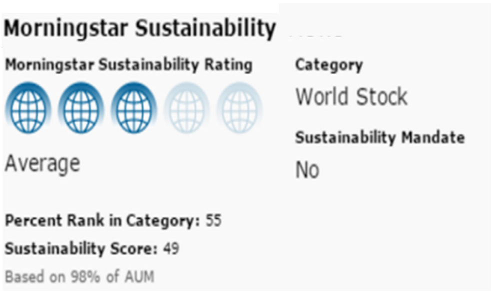
ESG fund ratings from Morningstar and MSCI are driving more enforcement

These are, of course, huge numbers, albeit only 13% of the US$450tn value of global total AUM, according to UN Environment Programme (UNEP) data. But what does it mean? Not much, argue sceptics, who rightly point out that the principles are entirely voluntary and aspirational. However, enforcement is picking up. The most visible proximate driver was the introduction of MSCI and Morningstar ESG fund ratings. More fundamentally, a host of underlying changes are making ESG metrics more immediately relevant. Standouts include the Paris climate-change agreements in December, China's war on pollution and tighter exchange reporting requirements.

As temperatures soar, asset owners are scrutinising managers' ESG performance

Figure 52

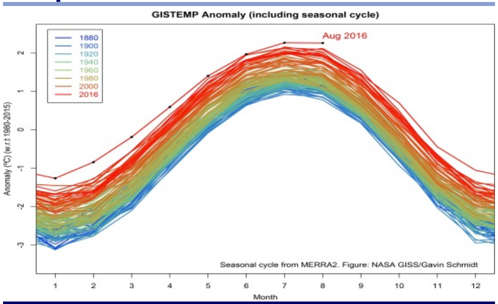
You really don't want one globe



Source: Morningstar

Figure 53

Temperatures off the charts



Source: NASA

Biggest driver of integration is that it works

Because it works

The biggest driver of integration is that it works. There is a growing body of academic research indicating that integrating ESG can deliver both alpha and smarter beta. Over the past year alone, we have seen at least three giant meta-studies on ESG links to performance.

Positively correlated in 63% of 2,000 studies; negatively in just 10%

In the biggest of these, Deutsche Asset & Wealth Management released a report with the University of Hamburg reviewing more than 2,000 studies on ESG and corporate financial performance (CFP). Of the studies they examined, 63% show a positive correlation between ESG factors and financial performance, versus 10% of those that display a negative relationship.

Independently, environmental (E), social (S), and governance (G) factors show similar results

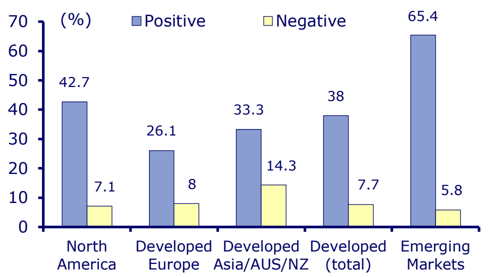
They found no significant performance deviation from using environmental or social factors, as opposed to governance standards. Likewise, relationships have been stable over time, particularly since the 1990s.

By region, emerging markets showed the strongest link between ESG and performance (65% positive, 6% negative), while developed Asia showed the weakest link (33% positive, 14% negative).

Emerging markets show the strongest link

Figure 54

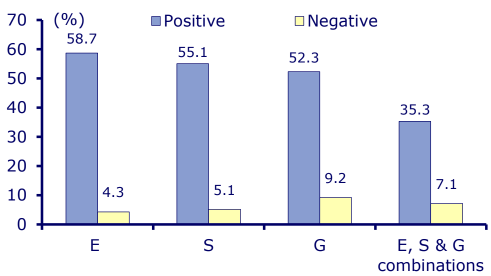
ESG and CFP links across regions



Source: Friede, Busch, Bassen via (ESG & Corporate Financial Performance: Mapping the global landscape)

Figure 55

E,S and G categories in relation to CPF



Source: Friede, Busch, Bassen via (ESG & Corporate Financial Performance: Mapping the global landscape)

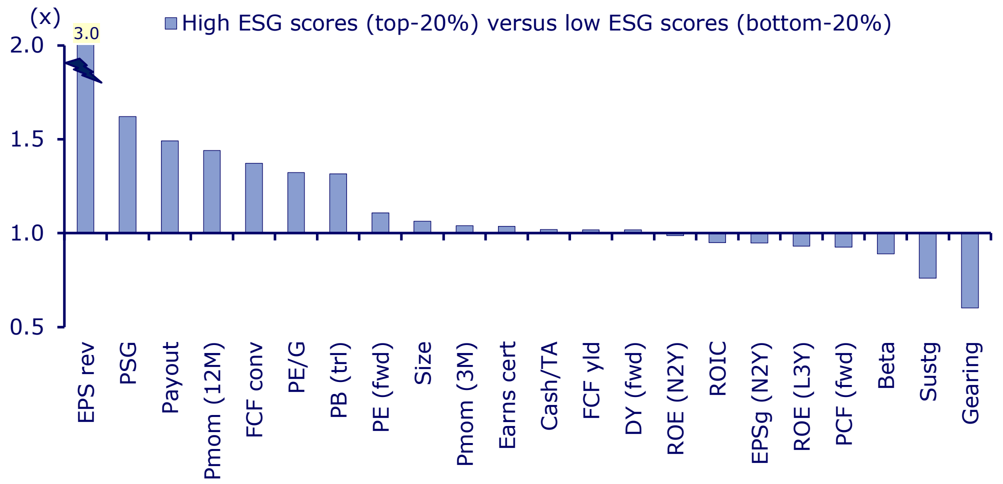
Our Microstrategy team also shows outperformance for high ESG stocks

Our Microstrategy team has also demonstrated superior returns for higher ESG-rated stocks. They also analyse the characteristics of high-ESG stocks, using our in-house ESG scores. In the following chart, we present the factor exposure analysis highlighting the characteristics of the high ESG basket relative to the low basket within Asia Pacific ex-Japan. The result highlights that the high ESG basket scores well on earnings revisions and payout, while also exhibiting better free-cashflow quality and lower balance-sheet risk.

High ESG basket has lower downgrade and balance-sheet risks

Figure 56

Characteristics analysis: Asian stocks with high ESG scores vs low ESG scores



Note: Universe is broader Asia Pacific ex-Japan universe with market cap greater than US$500m and more than three analysts coverage. Current CLSA ESG score is used. Source: CLSA, FactSet

Inside the sausage factory

By far the greatest challenge with ESG analysis remains the data

By far the greatest challenge with ESG analysis remains the data. There is not yet consensus on which ESG metrics need to be reported, let alone consistent and audited reporting across markets. The head of an ESG quant fund was quoted saying that ESG data is about 10% of where it needs to be[1]. Both the quantity and quality of reports is improving, though, and Asia is catching up.

Number of firms filing sustainability reports grew 13x over 2005-15

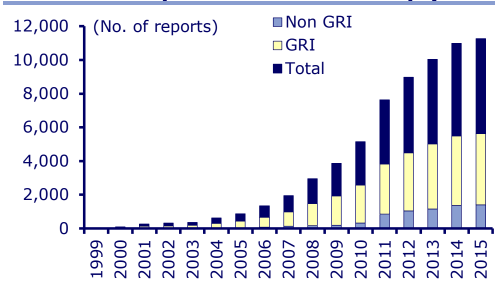
Over 2005-15, the number of companies issuing sustainability reports grew from 436 to 5,634, according to the Global Reporting Initiative (GRI). Of these, 28% came from Asia in 2015, up from 17% in 2011. However ESG coverage in Asia is still light. Around 72% of the 1,000+ companies that our analysts rank across Asia have ESG disclosure scores from Bloomberg.

However, this only guarantees a very basic level of information. Headline scores from ESG data provider Sustainalytics are also available on Bloomberg. On a market-cap weighted basis, only 38% of the companies that CLSA scores have Sustainalytics ESG scores on Bloomberg. Just over half of the companies we score have ISS governance scores available on Bloomberg.

Just 38% of firms that CLSA scores have Sustainalytics ESG scores on Bloomberg

Figure 57

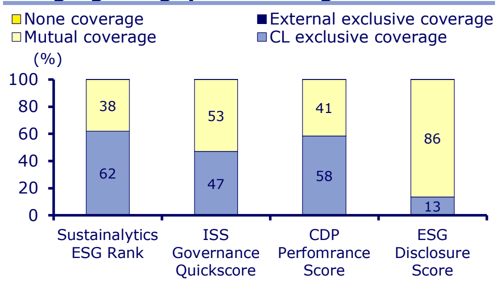
No. of ESG reports increased sharply



Source: GRI, CLSA

Figure 58

Bridging the gap in coverage



Note: Market-cap weighted and as of 19 Aug 2016. Source: CLSA, Bloomberg

[1] 'Data quality is a challenge. I believe that the data quality of ESG is only at 10 percent of where it will be in the future. It's just good enough in order to make money and pick better stocks, and support the security analysis.' Andreas Feiner, head of ESG Research at Arabesque, quoted in Bloomberg Brief

Over the next three years, five major Asian exchanges will launch ESG reporting requirements

The exchanges

Over the next three years, five major Asian exchanges will introduce ESG reporting requirements. Japan is a step ahead with its Stewardship Code and Korea is widely expected to soon follow suit. Unlike previous endeavours, the new ESG reporting standards are either mandatory (as in Taiwan and Malaysia) or comply/explains (as in Hong Kong and Singapore).

There will of course be growing pains through the early reports. However, investors have been heavily involved with the consultation process and there is a heavy emphasis on materiality.

Figure 59

Sustainability and stock exchange

	2012	2013	2014	2015	2016	2017	2018
Japan			Japan Stewardship Code (V)	Corporate Governance Code (M)			
Malaysia							Listed companies with market cap >RM2bn to issue sustainability report by FY16 AR (M)
China						2016: Mandatory environmental disclosure for all listed companies (recommended)	
Taiwan				CSR Reporting for select companies (M)			TSE: Listed companies with capital >NT$10bn to issue CSR report by FY17 AR (M)
South Korea						2016: Corporate Governance Guideline by KSE and FSC (planned) Stewardship Code (planned)	
Singapore							By 2018, primary-listed companies to report (M) four core requirements, including board responsibility and relevant reporting framework (CE)
Hong Kong	Implementation of ESG Guide (CE)						From 2017, listed companies to report Environmental KPIs (CE)

Note: Mandatory=(M), voluntary=(V), comply or explain=(CE). Source: Bloomberg, exchanges, CLSA

Exchanges and data providers are not developing their ESG reporting plans in isolation

Real reporting

The exchanges and data providers are not developing their ESG reporting plans in isolation. GRI has established gold-standard sustainability reports for different sectors and industries. It is a solid framework and the Taiwan Stock Exchange is directly incorporating GRI into its ESG reporting requirements. If anything, the complaint about GRI reporting is that it includes too much information that is important to stakeholders, but not necessarily shareholders.

Focus is shifting to materiality and relevance to investors

We see at least two major initiatives that aim to whittle down ESG reporting to key issues material to shareholders, which can then either be integrated into financial reporting or set alongside it.

Integrated Reporting is part of a framework being tested worldwide

The more ambitious of these is Integrated Reporting (IR), in which relevant ESG metrics are, as suggested by the name, integrated into the regular financial reporting process. The International Integrated Reporting Council (IIRC), a global coalition of regulators, investors, accountants and companies, has developed an IR Framework that is being tested around the world.

SASB to boil down ESG metrics to those of interest to investors

The sustainable accounting standards board (SASB), currently headed by Michael Bloomberg, aims to boil down ESG metrics to those that are both of interest to investors and have (potential) financial impact. As the SASB says, its 'Materiality Map is based on tests designed to prioritise issues on behalf of the "reasonable investor".'

CLSA environmental/social (E/S) scoring

Our analysts assign ESG scores to nearly all of the firms under our coverage in Asia

Our analysts assign ESG scores to nearly all of the companies that we cover across Asia (including Australia). Our scores are heavily skewed toward the G, or governance, component, which accounts for 90% of overall company scores. This reflects the higher quality of reporting for governance issues (ie, independent board members, audit committees and minority shareholder protections) versus environmental and social matters. We also have essentially consistent scoring dating back to 2001 for core governance, whereas serious environmental/social (E/S) scoring only dates back to 2014.

Eleven sector surveys focus on potential P&L/ BS impact

Despite accounting for just 10% of our overall ESG score, the E/S component of our scoring is, if anything, more involved than the governance component. The questions are broken down into 11 different sectors, with an emphasis on items that would most easily translate to a P&L/balance sheet impact for that particular industry. We also have eight general ESG questions that we consider universally applicable across sectors.

Breakdown by sector

Focus on intra-sector comparisons

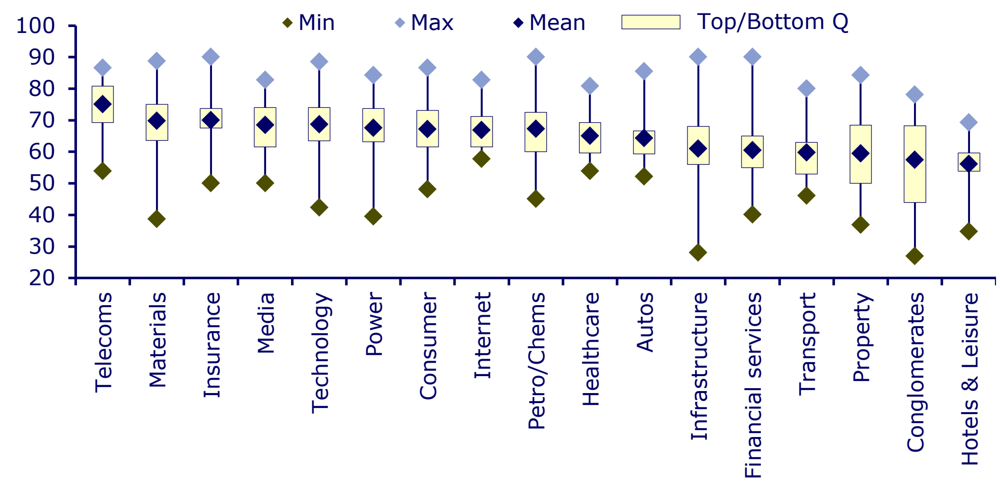
While we audit scores across sectors, they are most useful for intra-sector comparisons. For example, a coal miner with good disclosure and a comprehensive plan to deal with the risk of shrinking demand in the face of carbon and renewable energy policy is still, at the end of the day, a coal miner. Thus, the E/S score could be relatively high versus competitors, but overall risk is still substantial. Meanwhile, a software company might pay a lot less attention to E/S issues, and thus score low, but still face a much smaller risk to earnings or assets than the coal miner.

With this in mind, it is not a huge surprise that the No.2 and No.6 highest-average E/S scores belong to the materials and power sectors. They also have among the widest range of scores, indicating materially different risk profiles between the best and worst practitioners within those sectors.

Materials firms tend to report more on E/S issues due to the link to earnings risk

Figure 60

CLSA E/S scores across sectors



Source: CLSA

Key themes and deeper dives

We use the E/S questionnaire as a starting point

Above all, we use the E/S questionnaire as a starting point for unique questions that would not emerge from standard financial statements or industry analyses. Scores on key questions flag potential issues that the analysts can weave into a quality assessment of the business. We are taking deeper dives on key matters that include internet-search liabilities, tailing dams, plantations, migrant labour rights and water risk to power and mines.

Baidu and medical ads

Internet stocks tend to garner less attention on ESG issues compared to extractive industries or power. But arguably the biggest ESG story of the past year in Asia, from a stock standpoint, involves Baidu.

Chinese search giant Baidu was found partly responsible for the death of a student

In April, the Chinese search giant was found partly responsible for the death of a student who had received ineffective cancer treatment advertised on Baidu. This forced the company to implement a series of reforms around all of its ads, particularly medical marketing. The stock was down 17% in three months; our China internet analyst Elinor Leung cut net profit for 16-18CL by 16-24% on the back of this event.

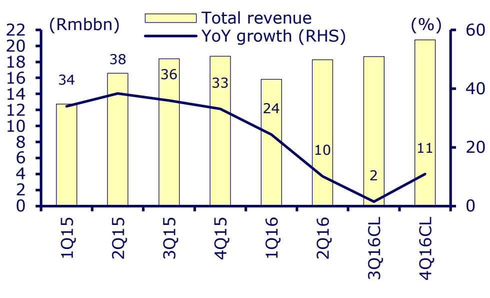
Even with the benefit of hindsight, there still was no easy way to predict the issues at Baidu. However, it did get tripped up by one of the questions in our questionnaire.

Relevant question: For internet/media, to what extent is the company able to set its own independent editorial policies? (Q15)

Catastrophic E/S tail risk for Baidu revenue

Figure 61

Baidu - Revenue implications



Source: CLSA

Figure 62

Village destroyed by failing tailing dam

Source: Senado Federal (Bento Rodrigues, Mariana, Minas Gerais), CC BY 2.0, via Wikimedia Commons

Tailing dams - Samarco was extreme, but not alone

There have been 214 recorded tailings dam failures since 1960

The materials sector faces a veritable cornucopia of highly-visible material risks from E/S issues. Our Australian resources analyst, Dylan Kelly, focuses on a potentially catastrophic tail risk for miners that is not widely understood: tailing dams. In November 2015, a tailings dam at the Samarco iron ore mine in Brazil failed, killing 17 people, destroying two communities and contaminating 86% of the Rio Doce River. The worst environmental disaster in Brazil's history will have profound implications for not only joint owners BHP Billiton and Vale, but the sector as a whole.

Regrettably, what occurred at Samarco is not an isolated incident, with industry studies citing that since 1960 there have been 214 recorded tailings failures globally. We cover this at a very high level in our E/S questions.

Question: Has the company been subject to incidents or enforcement actions relating to manufacturing or mining? (Q8)

Question: Has the company been involved in any major incidents, where the company had some responsibility, not covered in answers to previous questions? (Q19)

The palm oil sector is an easy target . . .

Plantations - rating the burn

With a history of land clearing and burning that has harmed biodiversity, flora and fauna across Indonesia and Malaysia, the palm-oil industry is an easy target. The sector has also raised the ire of neighbouring countries, such as Singapore, by contributing to the haze that has plagued Southeast Asia with a direct impact on human health.

. . . but it is also essential

In addition to the well-documented problems, palm oil has redeeming qualities. It is an efficient crop that produces the most edible oil per hectare of land. And in just under 50 years, it has risen from an unknown product outside of Africa to become the world leader in edible oils, holding a 30% market share. Without it, we would have had to clear five to 10 times more land to feed the explosion in demand over the past half-century. Palm-oil cultivation also employs more than four million people across Malaysia and Indonesia and has helped communities break out of the poverty trap by providing a sustainable source of income.

We review the major issues and explain how fires are linked to drought and peat, and also why solutions require better collaboration between communities, industry and local governments. In addition, we highlight instances of deforestation and peat clearance that are controversial and are preconditions for fires. Borneo, for example, lost 30% of its forest cover between 1973 and 2010. Forest clearance occurred over 5.1m ha of peatland across Malaysia, Kalimantan and Sumatra during 1990-2008.

Palm fires and a ranking of which companies are least likely to cause them

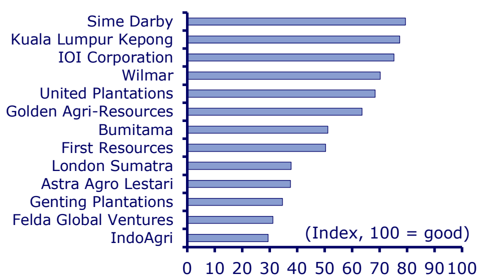
Figure 63

Fire in central Kalimantan

Source: Ground Fire by Bjorn Vaughan, reproduced with permission

Figure 64

Leaders/laggards in the palm-oil sector



Source: CLSA, Asia Research and Engagement

Tracking the supply chain for the consumer sector is essential

Consumer - Reputational risk writ large

Generally, resource constraints and environmental issues are less directly relevant for the consumer sector, with food-related industries the notable exception, where supply factors are critical. The main issues are consequently the relationship with the consumer - responsible marketing and product safety - and a growing awareness of the importance of managing both environmental and labour standards in the supply chain.

CP Foods was accused of buying fishmeal from boats manned by slaves

CP Foods

Charoen Pokphand (CP) Foods, the world's largest prawn farmer, was accused in 2014 by *The Guardian* of buying fishmeal, which it feeds to its farmed prawns, from suppliers that owned, or were operating or buying from fishing boats manned with slaves.

Whether true or not, Carrefour suspended purchases

Carrefour - a dominant distributor of CP Food products - subsequently released a statement that it would suspend purchases from the company. Walmart, the world's largest retailer, opened up to *The Guardian*, stating that it is "actively engaged in the issue and are bringing together stakeholders to help eradicate human trafficking from Thailand's seafood export sector".

We reflect the risk in our scoring . . .

To reflect on these issues, our head of Thailand research and analyst covering CP Foods, Suchart Techaposai, has knocked down the company's scores on three E/S questions:

- -1 on "Has the company been involved in any supply-chain incidents?"
- -1 on "Have there been any significant labour-relation issues?"
- -1 on "Has the company been involved in any major incidents, where the company had some responsibility, not covered in answers to previous questions?"

. . . but the company has taken big steps to improve

Overall, the company has a satisfactory score, however, as Suchart believes it did well on product safety, product innovation and attempts to address those threats. It has had a supply-chain check in cooperation with various nongovernment organisations (NGOs) and international buyers of its products if requested and sourced fishmeal only from reliable sources. As a further example, in May 2016, CP Foods - along with four other government and private agencies - established Thailand's first facility focused on countering human trafficking.

CP Foods' share price sank temporarily on slave fishing allegations

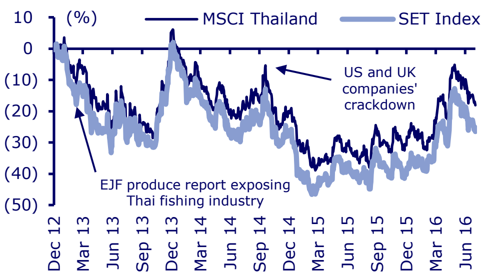
Figure 65

Thai fishing boat

Source: Flickr

Figure 66

CP's share price relative to Thai indices



Source: CLSA, Bloomberg

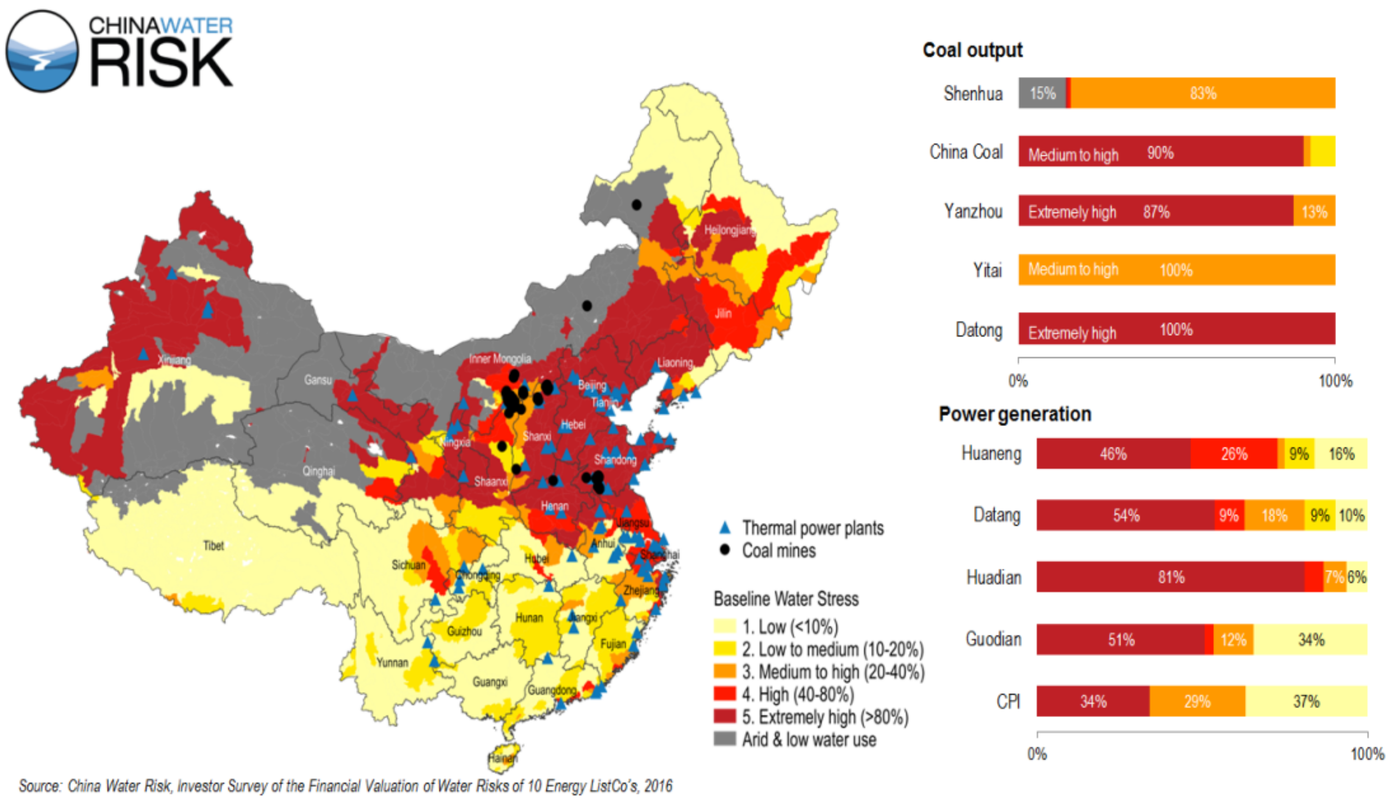
Water is critical to everything and theoretically easy to quantify

The next step: Quantifying water risk

Water is critical to nearly everything that we do and is accordingly a key focus for ESG disclosure across most sectors. In China, coal and power stand out. A big part of the reason water is a focal point for disclosures is that it is easy to translate into earnings or asset impact. In theory. In practice, there is still a great deal of primary research and guesswork necessary to assess water risk to corporate P&L and balance sheets.

Figure 67

Coal, power and water mismatch



Source: China Water Risk

As part of this report, we talked to China Water Risk (CWR) about its recent attempt to quantify water risk for the five big coal miners and five big independent power producers (IPPs) in the country. They looked at water risks through three perspectives: shadow pricing and impact on P&L; exposure to water stress of assets; and regulatory risks and compliance costs.

Working through disclosures - government, corporate and NGO - and using all of the various tools available to investors, CWR showed significant asset and regulatory risk. Using shadow pricing, they also show potential downside impact on Ebitda margin, ranging from -1% to -13% for the coal-5 and from -3% to -24% for the power-5. (Refer to Section 4 to see our China Water Risk interview, as well as the firm's methodology and findings).

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Australia - Evolving faster

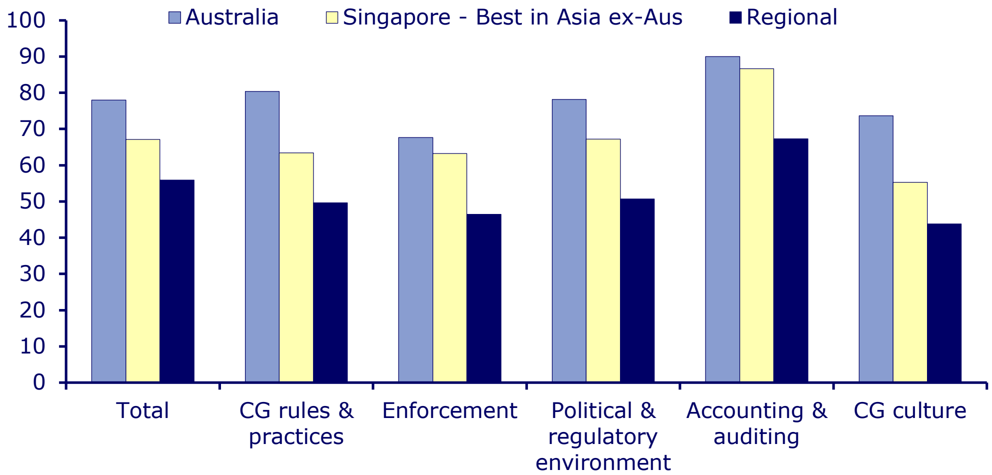
Key issues and trends

- Australia's CG regime is broader, deeper and more developed than its counterparts in Asia, but it has some clear weaknesses
- High scores for corporate reporting, political/regulatory environment (overall), accounting/auditing and CG culture
- Lower scores for enforcement, regulatory funding and anticorruption efforts
- Shareholder rights are robust, but urgent fixes are needed in minority protection in reverse takeovers and voting by poll
- Australia's faster CG evolution reflects its deeper regulatory foundations, stronger public-sector accountability and more open CG culture

Australia's CG regime is broader, deeper and more developed

Figure 68

Australia CG macro category scores vs best (ex-Aus) and regional average (2016)



Source: ACGA

This report marks the first time we have included Australia in *CG Watch*

This report marks the first time that ACGA has incorporated Australia into our regional *CG Watch* survey. Since our goal is to provide a qualitative and quantitative benchmark against which to assess CG reform and development in Asia, not to create an artificial competition, we decided not to include Australia in the ranking of 11 markets at this time.

Australia's CG regime is more established than Asia and consequently scores higher

As the chart shows, Australia outpaces Asia on most CG metrics. Readers might think that this is only to be expected, since the country's CG system began evolving earlier than those in Asia. To a degree this is true, particularly in the area of hard law, regulation, the creation of new capital-market regulatory institutions, director training and the formation of retail and institutional shareholder associations.

But in some areas, CG practices in Australia are not much older - they have just evolved faster

In other areas, however, Australia's adoption of new CG standards is a more recent phenomenon and not much older than Asia. The first CG Codes of best practice in Asia were adopted in the late 1990s - in Australia, only a few years before with the publication in 1995 of the IFSA "Blue Book", a CG guide for fund managers and corporations. The extensive involvement of business associations and non-profit groups in education, training, policy and advocacy essentially started from about the mid-1990s and picked up speed in the 2000s. And board diversity is almost as new to Australia as it is to Asia.

Regulatory history accounts for only part of Australia's strong performance

This suggests that regulatory history accounts for only part of Australia's outperformance in this survey. Just as important has been the more open cultural and political environment in which these developments are emerging. It was not so long ago that institutional investors found getting meetings with company directors a challenge. Now regular communication is commonplace, even with the chairmen and independent directors of listed companies. This is in stark contrast to Asia, where most dialogue still takes place at the middle management/investor relations level.

Government agencies are more accountable, companies do less boilerplate reporting

A similar openness is evident across many sectors in Australia. Financial regulators subject themselves to public scrutiny. Companies provide substantive information in their reports and rely less on formulaic writing. And there is a vibrant civil society comprising business associations, investor bodies, academics and other non-profit organisations involved in the governance debate.

Not all is perfect: Australia lags Asia in some areas

But not all is perfect: Australia lags best practice in Asia in some areas of minority shareholder protection; corruption continues to rear its head in the public and private sectors; media reporting on CG is sometimes biased; and the regulatory funding model leaves a lot to be desired.

CG rules and practices

A score of 80% puts Australia 16ppts above the best in Asia

Australia's score of 80% puts it well above the highest mark in Asia for this category of 64% and significantly above the regional average of 51%. Areas where Australia is a clear leader include:

Areas where Australia is well ahead of Asia:

- Financial reporting
- Continuous disclosure
- CG reporting
- Rem disclosure
- Board composition

Financial reporting: More thorough and readable, especially among large-caps (most of which report audited annuals in less than 60 days).

Continuous disclosure: Rules are historically based on company law (the Corporations Act), with regulators progressively refining regulation and disclosure guidance since the early 2000s. In contrast, this did not become an issue in Asia until after the Global Financial Crisis. Hong Kong's statutory requirement for price-sensitive information disclosure only took effect in January 2013.

Nonfinancial/corporate governance reporting: There is a huge gap between Australia and Asia in the quality of large-cap CG reporting in terms of volume of information, substance and originality. One company's report does not necessarily read like another's. It appears that many companies have taken to heart the admonition from the ASX Corporate Governance Council convened by the Australian Securities Exchange (ASX) not to engage in 'pedantic or legalistic' disclosure.

Executive remuneration disclosure and 'say on pay': Although disclosure is good in Hong Kong, the Asian leader in this area, practice in Australia is noticeably better, with clearer links between pay and performance. Disclosure of executive remuneration (top-five managers) dates back to 1998, while the more recent "two-strikes rule" of July 2011 has been another major catalyst.

Board composition - independence, diversity: It is well ahead both in terms of the percentage of independent directors on boards - the ASX CGC Principles says they should be a majority - and thinking around the right 'skills matrix' for a board, including diversity (gender, experience and expertise).

Individual directors in Australia should be able to read and understand company accounts

Financial literacy: In addition to other skills that directors have, there is a regulatory expectation in Australia that all directors have a duty of skill, competence and diligence regarding the financial report. Individual directors should be able to understand company accounts and question accounting treatments; they cannot rely on the audit committee or auditor. This is entirely different to Asia, where a lower standard is applied to director financial literacy, and board skills are discussed in collective terms. To be fair to Asia, however, this was not a big issue in Australia until the Centro Properties fiasco of 2010, when directors overlooked the misallocation of debt from short-term to long-term and were not aware the company was effectively insolvent.

Australia has developed a unique and fair system of capital raising

Rights issues: While there has been debate over the fairness of rules governing private placements, Australia is unique in developing a more efficient system of capital-raising called the 'accelerated entitlement offer'. This combines speed of execution with fairness to all shareholders.

Where Australia is on par

Areas where standards are broadly similar to Asia, include:

Definition of "independent director" in Australia has some weak points

INED 'cooling off': Like most markets in Asia, and indeed around the world, Australia adopts a prescriptive recommendation in its CG Principles for 'cooling-off periods' for former executives, partners/directors/senior employees of professional advisors, and people with material business relationships. While the Australian standard of three years is slightly better than Hong Kong's two- and one-year rules - and arguably more suited to the local business environment, where concentrated ownership is less of an issue - a somewhat longer period would remove doubt and the need for companies to defend appointments.

SME reporting suffers from a quality gap - just like Asia

SME corporate reporting: All the evidence shows that SME disclosure in Australia suffers, in general, from the same quality gap one finds in Asia - especially in nonfinancial reporting.

Rules on pre-emption rights are similar to Asia

Pre-emption rights: Permissible percentage ratios for private placements - 15% of issued capital and up to a 20% discount - are similar to Asia. In 2012, the ASX allowed mid-to-small-cap companies a further 10% mandate if they received 75% approval at an AGM. The discount could not be more than 25%.

Where Australia lags Asia

Australia's RTO rules are weaker than HK and Singapore

Reverse takeovers: As noted in a recent ASX consultation paper from November 2015, protections accorded shareholders of 'bidder' companies in a reverse takeover are weaker than jurisdictions in Asia (Hong Kong, Singapore) as well as London, New York and Toronto.

Surprisingly, voting by poll is not mandatory

Voting by poll: Still not mandatory in Australia, although large companies generally do vote by poll and the Corporations Act was amended in 1998 to require listed companies to disclose proxy votes on each resolution. One reason for mandating polls is to properly recognise the will of shareholders on the two-strikes rule, which kicks in when votes against remuneration reports are 25% or more over two consecutive years. There have been cases where proxy votes against are more than 30%, yet the resolution is passed on a show of hands. While such cases appear to be rare, requiring a poll would seem a sensible and relatively painless reform.

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Remuneration the highest-profile CG issue in Australia

CG and CSR are perceived as established practices, executive compensation a key issue

Given that Australia is a developed market, corporate governance and corporate social responsibility are perceived to be established practices. Since the GFC, executive compensation levels have come under fire in Australia. This is a similar issue seen across a number of developed markets, particularly in the face of dwindling profits. The key concerns boils down to an inadequate link between executive compensation, particularly short-/long-term incentives, and company performance. Increasingly we observe investors focused on the relative ease of management roles in a market famous for duopolies.

Introduced "two-strikes rule" to Corporations Act in 2011

In June 2011, the current Australian government passed the Corporations Amendment Act 2011 (improving accountability on director and executive remuneration). This introduced a two-strikes rule to the Corporations Act, which was put into effect prior to the 2011 AGM season. Under this rule, if a remuneration report receives 25% or more 'no' votes (of shares present and voting) at two successive AGMs, shareholders will have to vote on a board spill motion at the AGM. The entire board (aside from CEO) can be voted out if more than 50% of shareholders present and voting, vote against the board. Three companies received a second strike in 2015 (Mortgage Choice, Reckon and UGL), but in each case the board spill resolution did not pass.

Significant increase in corporations engaging with shareholders and proxy advisors

Over the past five years, we have observed a significant increase in Australian corporations engaging with shareholders and proxy advisors to resolve any remuneration issues. And it is clear that such engagement is broader than around just remuneration, given the vote on the remuneration report could be used to protest other measures. We view this as a positive and there is a particular improvement in engagement, where companies have received a first strike vote. A variety of measures have been taken to avoid triggering a strike, ranging from overhauling pay packages to simply improving disclosure.

Investors more willing to vote against election of directors

Associated with this, we have also seen an increase in investor willingness to vote against election of directors. In 2015, four directors resigned immediately before AGMs, presumably with the knowledge of negative vote outcomes (at Origin, Bradken and Villa World). We have also seen a step-up in direct chairman engagement to directly address shareholder concerns.

High-profile companies receiving a strike in 2015: UGL, AusNet, Pac Brands, Ansell, Premier Inv ALS and Downes

The 2015 AGM season (Oct/Nov-15) saw a slight increase in the number of major companies receiving a first strike. However, some are still learning the hard way - the clearest message from shareholders is still being delivered to boards through a first strike to their company. There is no question that companies need to recognise that shareholder engagement standards have irreversibly changed. High profile companies that received a first strike in 2015 included UGL, AusNet, Pacific Brands, Ansell, Premier Investments, ALS and Downer EDI (in descending order of negative vote). It is worth noting that a similar proportion of the ASX100 index received strike votes in 2015 as those in the ASX200, so size of company does not always lead to better investor perceptions around governance.

Other areas where CG rules in Australia are less stringent . . .

Finally, there are several other areas where rules in Australia are somewhat less strict than in Asia, including:

- **Audit committees**: Only mandatory for the top-500 listed companies and only the top-300 need comply with the recommendations of the ASX CG Principles on composition and operation of audit committees;
- **Quarterly reporting**: Only mandatory for certain issuers, such as startups and mining exploration entities, and limited to a quarterly cashflow statement;
- **Related-party transactions (RPTs)**: Rules are similar in principle, but generally less comprehensive and specific than best practice in Asia; for a crude comparison, the HKEx rules on RPTs run to 43 pages compared to 10 pages for the comparable ASX chapter.

. . . and for a reason

There are reasons for these differences, of course. As is often pointed out, many of Australia's 2,200-plus listed companies are tiny miners or other small firms with boards of only three to four people, so how could you expect them to form a separate audit committee? Indeed, the top-500 companies account for 95% of market cap in any case - and an interesting KPMG study on compliance with the ASX CG Principles in 2015 found that 75% of companies outside the top 500 do have audit committees. Hence, the rules, though limited, are acting as a catalyst for better CG among smaller issuers.

Different corporate-ownership structures explain some of the differences . . .

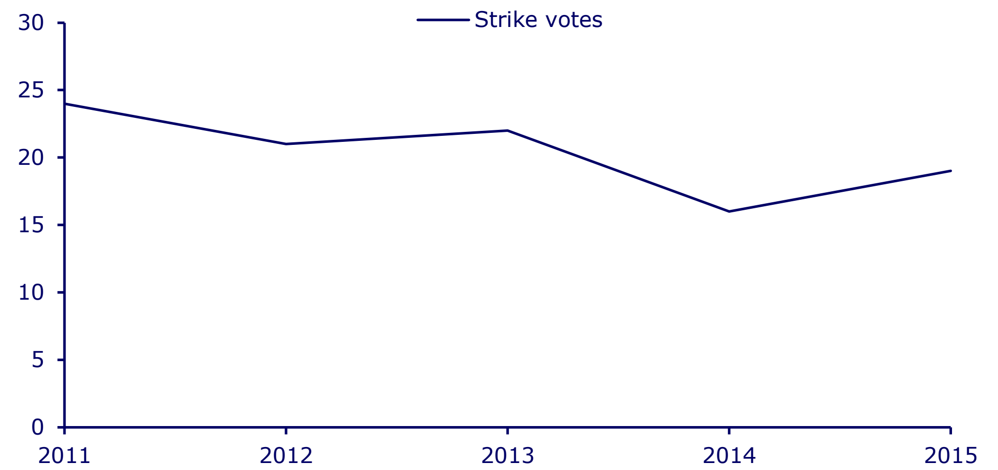
. . . but will Australia's rules always be fit for purpose?

On RPTs, the obvious reply is that Australian listed companies have different corporate-ownership structures (dispersed rather than concentrated), with fewer massive conglomerates and therefore a lower risk of RPTs. One could also argue that its listed companies are managed primarily by professional managers who feel primarily accountable to shareholders, rather than by family members or state officials whose loyalty is to others (while broadly true, such a statement is almost certainly too kind to many Australian companies and too harsh on the best managed firms in Asia). Yet what happens when an Asian or other firm with a controlling shareholder and numerous listed and unlisted affiliated firms lists on the ASX - are the rules sufficient to protect minority shareholders from any RPTs that result?

Slight rise in major companies receiving a first strike during 2015 AGM season

Figure 69

Strike votes against remuneration reports since 2011



Source: Ownership Matters

Enforcement

Score of 68% on par with best in Asia

This is the weakest part of the survey for Australia, which scores 68%, in line with Hong Kong. More so than any other market in the region, there is a mismatch between enforcement and the public perception of enforcement in Australia. Reading the business press one might think the Australian Securities & Investments Commission (Asic), the peak corporate and securities regulator, is a fairly timid organisation that dislikes going to court or catching the big fish. To quote from a Senate inquiry in 2014 into Asic's performance, many believe it is a 'watchdog with no teeth'.

Expectations of Asic are extremely high

An underlying problem, it would be fair to say, is that the public has extremely high expectations of Asic. As the Senate inquiry also said, 'consumers have unrealistic expectations of what Asic can do and the extent to which the regulator is able to protect their interests or investigate their complaints'. Ironically, when Asic does get tough, such as its recent actions taken against Australia's major banks for manipulating interest rates, it is duly attacked for being politically opportunistic!

Asic has had its fair share of enforcement failures

Asic has had its share of high-profile enforcement failures over the years. Two often cited are the case against miner Andrew Forrest for alleged misleading and deceptive conduct over 2006-12 and the disappointing outcome in a more recent criminal prosecution of ABC Learning Centres, a company that collapsed after the global financial crisis.

But also some notable recent successes

But it has also had a number of high-profile successes. One of the most interesting is an eight-year sentence handed down for insider trading in March 2016 to Steven Xiao, former boss of Hanlong, a mainland Chinese mining firm. Then in June 2016, Asic won another insider trading case against Sydney businessman, Oliver Curtis, following the successful conviction of his friend and tipper, John Hartman, in 2010.

Look at the data for a more nuanced view of Asic's performance

A broader view of the regulator's performance can be found in the data. Virtually every day or other day an enforcement announcement will appear on the Asic website; while not all of them relate to issues examined in this report - insider trading, market manipulation, director malfeasance, false disclosure - a large proportion do. Then every six months Asic publishes detailed reports on its 'enforcement outcomes' and 'regulation of corporate finance'. And its annual report contains useful aggregate statistics on investigations completed and started, civil, criminal and administrative cases, and compensation secured for investors. It is not a picture of an inactive or negligent organisation.

Asic challenges

Asic's funding model is problematic

Yet Asic does face some difficult challenges. First, and perhaps most significant, is underfunding. Its core budget is provided by federal-government allocation and has been dropping in recent years, from A$350m in 2012/13 and A$347m in 2013/14 and to A$312m in 2014/15. A recent government 'capability review' of the regulator will result in higher funding in future, but the additional money is targeted at specific tasks and is spread over four years. While a new 'industry funding model' is also being introduced - meaning cost recovery from the most heavily regulated sectors - this will not solve all of Asic's funding problems.

Asic has to oversee dizzying area of sectors, companies and individuals

With a limited budget, Asic has to enforce 14 acts of parliament and oversee a dizzying array of sectors, companies and individuals. Its annual report provides revealing detail on the contrast between staff numbers and regulatory universe. For example, in 2014/15 it had:

- **59 staff** to supervise 164 authorised deposit-takers; 5,779 credit licensees; 33,736 credit representatives; 97 licensed general insurance companies; 27 life insurers; and more.
- **46 staff** to supervise 2.25m registered companies, of which 23,792 are public companies, and 2,140 are listed entities.
- **32 staff** to supervise 4,596 registered company auditors; 28,000 companies required to produce financial reports; 6,669 auditors of self-managed super funds.

(Note: This is not a complete list of Asic staff.)

Asic has a somewhat confusing corporate structure

A second issue is Asic's corporate structure. Unlike most Asian securities commissions, which are organised along functional lines (eg, intermediary licensing, market infrastructure, listings/corporate disclosure, investment products and enforcement), Asic is structured around industry/sector lines and the 'stakeholder groups' it supervises. This followed a review by McKinsey in 2008, the idea being it should bring the regulator closer to the industries it regulates. There are three organisational areas, with five sections under them:

1. **Markets**: One department for market infrastructure, market supervision, investment banks; a second for corporations, insolvency, corporate reporting.
2. **Investors and financial consumers**: One department for financial advisers, financial literacy, deposit takers; a second for investment and pension funds, and small business compliance.
3. **Registry:** One department for company registry.

Each of the five departments is led by a commissioner (though one commissioner does two) and has its own enforcement capability. In place of an overall director of enforcement, which Asic had in the past, it has an Enforcement Committee that meets every fortnight and comprises all the commissioners and relevant senior executives. While Asic believes this model works, not everyone in the market is convinced. As one veteran capital market participant exclaimed, 'Asic is an enforcement organisation. They still do not have a national director of enforcement!' In his view, the current structure can lead to inefficiency and delayed justice, such as the recent insider trading case against Oliver Curtis. Although successful, the case dates back to crimes committed over 2007-08. (To be fair, other insider trading cases have been completed more quickly.)

Judgments seem contradictory

A third issue is an apparent contradiction in court judgements. In many cases of insider trading the individuals concerned do not serve their (relatively short) prison terms, but are allowed out early on payment of a small sum and a promise of good behaviour for 18 months. Given how blatant some of these actions were, does this send the wrong signal to the market?

Why is Asic only seeking a fine in the Hochtief insider trading case?

Indeed, some of Asic's decisions seem somewhat contradictory. In the ongoing case of Hochtief, the German construction company that earlier this year admitted to insider trading in Leighton shares in 2014, Asic is seeking 'a declaration of contravention and a financial penalty order against the company'. Why is the regulator not seeking more than a financial penalty? This seems unfair to individuals who have gone to prison for the same crime.

ASX enforcement

ASX continues to have a frontline regulatory role . . .

While the main enforcement story in Australia is Asic, the ASX continues to play a role here. Although Asic took over market supervision from the exchange in 2010, as part of effort to reduce conflicts of interest in the regulatory system, the ASX still has a frontline role with regard to enforcing its listing rules. Through its subsidiary, ASX Compliance, it approves new listings, carries out monitoring and surveillance of company reports and announcements, media stories, trading patterns, and so on.

. . . with a limited range of enforcement powers

ASX has a fairly normal, though limited, range of enforcement powers for an exchange that is both a for-profit entity and a regulator. It can force issuers to make announcements whenever there is market uncertainty regarding their shares, tell them to unwind transactions that do not comply with the listing rules, take issuers to court, and suspend or delist. But ASX cannot impose fines or civil penalties against listed companies. And if believes that an issuer has committed a 'significant contravention', such as a failure to follow continuous disclosure rules, it will report this to Asic. Since the listing contract has statutory backing from the Corporations Act, this allows Asic to take a wide range of civil and criminal enforcement action against listed companies and directors.

ASX reports on enforcement monthly

ASX reports on its enforcement activity each month through a newsletter called the *Compliance Monthly,* which provides granular figures on the number of new listings, delistings, suspensions, continuous disclosure queries by the exchange, referrals to Asic, data on enforcement cases commenced and finished, and waivers given to listed companies, among other things. While such systematic statistical reporting is well in advance of anything found in Asia, three other things stand out: ASX provides little or no narrative explanation of its enforcement actions against listed companies, it gives out a lot of waivers, and it does not publicly reprimand companies or directors.

ASX does not provide detailed explanation of enforcement actions against companies, but it does for waivers

An ASX officer explained the reasoning behind its enforcement approach. First, it is prohibited from providing substantive explanation of an individual enforcement action lest this prejudices a subsequent Asic investigation. Second, while it does give a lot of waivers, most of them are uncontroversial. Indeed, the exchange publishes a fortnightly register with details about the issuer, the rule in question, its decision, and the basis for its decision. ASX also knows that what securities lawyers and others really want to know is what waivers were not given and why, hence it has just started publishing a report on this (although on an anonymous basis). The report covers the first six months of 2016 and also deals with rejected listing applications.

Exchange does not publicly reprimand firms, but suspends those who breach listing rules

Third, on the issue of public reprimands, which are a common feature of stock-exchange enforcement activity in Asia, the ASX says it seeks to use its powers more indirectly. Its aim is always to get an issuer to disclose what it should to the market - and if that fails, the exchange will refer the case to Asic. Moreover, the exchange does not have a formal tool allowing it to reprimand, nor does it generally believe in naming and shaming. However, it does have broad powers of suspension and delisting, and will use these if a company's behaviour is serious enough to warrant it. Indeed, its monthly compliance report indicates a fairly active programme of suspensions for listing rule breaches this year: four in April, five in May and three in June. In addition, the ASX brought in a new rule on long-term suspensions in January 2016: any firm suspended for three years or more will automatically be delisted.

Criticisms of ASX enforcement

Despite all the above, there is a perception in the market that ASX is not as diligent an enforcer as it could be, that it gives out waivers too easily, and that it continues to suffer from conflicts of interest. Some of the criticisms relate more to listing-rule policy than enforcement, with the recent consultation on reverse takeovers a good example. People are upset that ASX has not yet published a report on submissions received, as it does for most other consultations. The exchange, however, says that it will pick up work again on this consultation in the second half of this year. It is fully absorbed at present by another consultation on its listings regime.

Two areas where ASX could enhance transparency

There do seem to be two things that Asic could do quite quickly to aid transparency: make its website more user-friendly (finding suspension notices, for example, can be quite arduous for the uninitiated); and publish announcements, like other exchanges, of positive enforcement action against companies. If a company is suspended for breaching a listing rule, shouldn't it be the responsibility of the exchange to make this decision public? It seems odd that companies must self-report on such regulatory matters.

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Newcrest selective disclosure from 2013

In addition to Newcrest being a major underperformer for 2012 and 2013, it also had a much-publicised disclosure issue in June 2013. This resulted in a settlement with Asic in June 2014, admitting contraventions of the continuous disclosure provisions of the Corporations Act. Newcrest's reputation was most impacted, given the size of the fine (A$1.2m) was small compared to its A$10bn-plus market capitalisation.

Breached continuous disclosure obligations

The larger issue/concern was the class action. Newcrest had to pay A$36m to shareholders who brought a class action against the company for breaching its continuous disclosure obligations. This was paid this year.

Due to the selective disclosure incident, NCM started 'pre-releasing' results. This involved releasing (to the market) operational and financial data as soon as head-office received it, instead of waiting for all data to be collated and released all-at-once in the quarterly report.

Aussie companies more nervous about market communications, which could increase volatility

More broadly across the Australian market, other companies now appear to be more nervous about communications with the market as a result of this. Blackout restrictions prior to result disclosure are being more stringently adhered to, which is a positive for confidence around selective disclosure. However, there is a risk around less regular and informative communication from companies, which could ultimately result in increased stock price volatility.

Political and regulatory environment

Score of 78% well above the best in Asia

Unsurprisingly, Australia is well ahead of Asia in this category, scoring 78%. This is the product of a more established and transparent regulatory system, an active programme of regulatory reform and/or updating, an excellent archive of regulatory and corporate documents easily accessible, strong legal remedies for shareholders and an expert judiciary, a free media and a relatively clean government. Where Australia loses points is Asic's reliance on the federal government for its annual budget (which restricts autonomy), limited progress on updating of the ASX listing rules, and the lack of a federal ICAC.

Australia has a unique "twin peaks" model of financial regulation

Australia is unique in being the first developed market to deploy a 'twin peaks' model of financial regulation. One peak is the Australian Prudential Regulatory Authority (Apra), which regulates the soundness of financial institutions and seeks to ensure that their risk management and internal controls are strong. The second is Asic, which describes itself as an 'Australia's integrated corporate, markets, financial services and consumer credit regulator'.

Consumers first

"Consumers" come first in the Australian regulatory environment

A distinct feature of Asic's role is a much stronger narrative around consumer protection than one finds among its counterparts in Asia. Go to the Asic website and you will see the word 'consumers' front and centre. Go to the SFC website in Hong Kong and you will not. The focus in Hong Kong is more on protecting 'investors' generally, not just retail. Indeed, regulatory policy across Asia is targeted at protecting all minority shareholders, whether retail or institutional, a product no doubt of different corporate-ownership structures and the need to contain controlling shareholders.

Federal government has boosted Asic's funding - ostensibly for consumer protection

The consumer focus in Australia is also evident in the government's response to the Asic Capability Review, initiated by the Treasury in July 2015 and carried out by an expert panel in the latter half of that year. The government's press release was titled: 'Improving consumer outcomes in financial services', and went on to declare that it would commit A$127m over the next four years to 'better protect consumers'. This is not wholly true. The new funds will be spent on a range of activities that should benefit a range of market participants, not just consumers (unless, in the end, we are all consumers).

This consumer ideology dates back to the early days of Asic

Asic's consumer/retail mission is not new: it dates from 1998, when a forerunner entity, the Australian Securities Commission (ASC), took over the consumer protection functions of the Insurance and Superannuation Commission and was given responsibility for consumer protection in insurance, superannuation and banking, as outlined in a 2008 paper by Melbourne academics, Bernard Mees and Ian Ramsay. ASC then became Asic.

Institutional investors are expected to look after themselves

The reason we dwell on this point is that it is accompanied by a belief that institutional investors can largely look after themselves and resolve governance problems through private arrangements with financial intermediaries and listed companies. This is a reasonable position to take given the huge relative size of the institutional investment industry in Australia - except when a regulatory response is needed. Institutional investors cannot, for example, fix weaknesses in Australia's regulation of reverse takeovers, nor can they change the rules and mandate voting by poll at all shareholder meetings.

In 2015, Asic published a guide on collective action by institutional investors

This is not to say that Asic never focuses on institutional investors. In June 2015, it published Regulatory Guide 128 on 'Collective action by investors', which 'provides guidance to promote investor engagement on corporate governance' and outlines when collective action could subject investors to the takeover and substantial holding rules in the company law.

A stronger interest in the concerns of institutional investors seems warranted

However, our observation is that Asic could take more interest in the regulatory concerns of institutional investors. To be fair, it does show some concern: its 'Regulation of corporate finance' report for July-December 2015 touches on the practice of some companies voting by a show of hands on remuneration reports when proxy votes indicate that a vote against of more than 25% may be achieved. In this instance, however, Asic merely shared it concerns with the Governance Institute, a professional body that seeks to raise standards of AGMs.

Regulatory reform

Asic has an active programme of regulatory reform and renewal

Meanwhile, Asic has been quite active on the regulatory front over the past two years. A few highlights:

- Working with the ASX on listings quality
- May 2016: consultation on improving historical information in **prospectuses**, with an emphasis on 'effective disclosure for retail investors'
- December 2015: the Takeovers Panel published a guidance note (No.23) on **Shareholder intention statements**, with the aim of ensuring that these statements are not misleading
- November 2015: Asic updated its regulatory guide (No.49) on **Employee incentive schemes**

Improving culture is a major Asic theme today . . .

In terms of policy thinking, a major focus of Asic at present is on improving the culture of the Australian financial system. As its states in its *Corporate Plan 2015-16 to 2018-19:*

> *Gatekeeper culture is a driver of conduct in the financial system. Poor culture, resulting in lack of transparency and chronic under-pricing of risk, has been noted as one of the causes of the 2008 global financial crisis and remains a risk.*

. . . with the focus very much on banks

It has identified poor gatekeeper culture and conduct in lenders, directors, auditors and insolvency practitioners, and intends to pay more attention to these in the coming years. In public statements, Asic chairman, Greg Medcraft, has taken aim, in particular, at the culture of banks in Australia, following a major scandal in the financial-planning industry that saw many pensioners lose their life savings to unethical or illegal financial advisory practices.

The ASX dimension

ASX convenes a stakeholder council that oversees the CGC Principles

The central policy focus of the ASX in CG is its convening of the multi-stakeholder council, which issues the *Corporate governance principles and recommendations*, a best practice guide first published in 2003, substantially revised in 2007, amended slightly in 2010, and then republished in March 2014, following a comprehensive review. All ASX-listed entities must disclose the extent of their compliance with the guide as part of their listing obligations. In place of the UK 'comply-or-explain' terminology, Australia has 'if not, why not', which means the same thing.

ASX consulting at present to improve IPO quality

ASX also shapes CG in Australia through its listing rules. Its main initiative at present is a consultation on listing entry requirements that aims to improve IPO quality. This was led by a dramatic 140% increase in the number of backdoor listings in 2015, especially from China, driven by the financial difficulties faced by junior (ie, small) mining firms as a result of the oil-price collapse and commodity slump. Many of these firms faced the prospect of going into administration if they could not get into a new business.

Exchange has an absolute discretion to approve or reject listings

As part of this review, the exchange is also planning to tighten its listing process and remove the right of appeal to the ASX Appeals Tribunal, a body made up of vested market interests that in the past has waved through some dubious IPOs. Indeed, the ASX listing rules already give the exchange an absolute discretion to reject a listing and not have to give a reason - something it had not invoked until June this year when it rejected the IPO of Guvera, a music-sharing company that had tiny revenue, large losses and a mysteriously large valuation.

Other consultations in recent months on continuous disclosure, reverse takeovers, and private placements

The exchange also undertook a number of consultations on listing rule amendments in 2015, including on continuous disclosure in June, private placements in October, and reverse takeovers in November (to which it will return later in 2016). On private placements, it consulted on whether a new 2012 rule on more flexible placements for smaller issuers was working fairly and effectively. Ownership Matters, an independent proxy voting advisory firm, argued that the fact shareholders voted down requests for additional placement powers in 6% of cases was significant (given how rarely resolutions are voted down in Australia). ASX disagrees, however, and is planning only minor changes to the rule.

Anti-corruption under attack

Why does Australia have a fragmented, state-based ICAC system?

One aspect of Australia's political and regulatory environment that appears oddly out of sync is its continuing state-based system of anticorruption commissions. In contrast, the law and regulation governing companies, securities markets, the financial system (banking, insurance and consumer credit), as well as competition and consumer law, are all federal. This was not achieved without a fight, but is arguably one of the foundations of the country's successful and generally well-regulated economy. It is not clear why anticorruption efforts should be any different.

South Australia seen as having one of the best anticorruption regimes

It is generally considered that not all state ICACs are cut from the same cloth, with South Australia said by some to have the best system and New South Wales (NSW) without doubt the most controversial. The NSW ICAC has been in the news a great deal over 2015-16, largely in relation to a perversion-of-justice case it brought against a senior public prosecutor called Margaret Cunneen SC. She was eventually exonerated, but threw oil on the flames by saying the NSW ICAC was 'out of control', a 'rogue agency' and should be 'completely destroyed'. It seems bizarre that a public servant would attack a government agency tasked with controlling corruption in this way.

Missing prospectus forecasts

Over the past few years there has been few large IPOs, most of the primary issuance action has been smaller companies. Given limited track records of a number of these companies, earnings guidance for one to two years in a prospectus takes on increased importance. It is difficult to track such data but anecdotally there has been a pickup in companies missing earnings guidance (or meeting earnings guidance with low-quality earnings results). Some examples include:

- McGrath (MEA AU). Announced in April 2016 that it would miss prospectus guidance due to an unforeseen low volume of listings and sales, particularly in the North and North Western suburbs of Sydney.
- MYOB (MYO AU). Would have missed its FY15 prospectus forecast (December year-end) if acquisitions made post-IPO were excluded and adjusting for increased capitalisation of R&D expenses. In the latest result (1H16), it would have missed prospectus forecast for SME Solutions, its most important division, excluding acquisitions.
- Spotless (SPO AU). Previously owned by Private Equity, Spotless listed in May 2014. While SPO met FY14 and FY15 prospectus forecasts, the company issued a market update prior to its 1H16 results announcing that FY16 results would be impacted by a series of one-off and other charges, arising from the methodology used in depreciating assets.
- Integral Diagnostics (IDX AU). Previously owned by Private Equity, and listed in October 2015. In February 2016, given industry headwinds, IDX management stated that the company did not achieve its prospectus forecasts revenue and earnings targets due to weak 1H16 diagnostic imaging (DI) markets.
- Estia Health (EHE AU). Estia was previously owned by Private Equity, and listed in December 2014. In February 2016, EHE missed prospectus Ebitda forecasts by A$2.2m due to: increased corporate costs (A$4.9m) designed to fund future growth; and the impact of lower-margin acquisitions.
- Monash IVF (MVF AU). Monash was also previously owned by Private Equity, and listed in June 2014. In February 2015, MVF downgraded FY15 guidance by 5% at Ebitda and 8% at NPAT line. MVF expects an improvement in financial performance in 2H15. Further to the update provided at the Monash IVF Group AGM in October 2014, the effect of a contracting ARS market in the first half has revised Monash IVF's Prospectus forecasts for FY15.
- Japara Health (JHC AU). Listed in April 2014. In August 2014, JHC proforma FY14 Ebitda was A$40m, a 3.6% miss from the prospectus forecast of A$41.5m. This was the only figure presented that was comparable with FY14 proforma prospectus forecasts. Management attributed the earnings shortfall to lower occupancy in 1HFY14 due to influenza, a phenomenon that impacted the industry.
- Dick Smith (DHS AU). Management delivered FY14 Ebitda of A$74.4m, ahead of the prospectus forecast of A$71.8m. Then Dick Smith's reported FY15 earnings met consensus expectations with NPAT of A$43m. FY16 NPAT guidance provided at the time of the FY15 result (A$45m-A$48m) also covered consensus expectations. However, FY15 sales (particularly 4Q15) and cashflow were weak, which created concerns as to the quality of earnings. Exactly what went wrong is still subject to conjecture but we believe the initial (upon acquisition by private equity) value of inventory was written-down and this deflated inventory values was used to underpin future reported earnings. It also seems to be the case that management made buying decisions based on supplier rebates rather than consumer demand and this created a situation whereby sales floundered and working-capital commitments rose.

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Accounting and auditing

Score of 90% slightly better than the best in Asia

In line with several markets in Asia, Australia scores well for accounting and auditing standards, practices, auditor independence rules, audit regulation and CPA education. Compared to its nearest rivals, its higher score of 90% is a result of one or more of the following factors: better disclosure around audit and non-audit fees; somewhat better application of accounting standards by listed companies (reflected in more thorough accounts); and a greater expectation that auditors will report fraud.

Asic also oversees the regulation of auditors

Australia's independent audit regulator is Asic and it carries out reviews of large and small CPA firms every 18 months. Its most recent report covered the period to 30 June 2015 and was published in December of that year. The report is a review of 21 firms and selected audits they undertook of financial statements with year-ends from 30 June 2013 to 31 December 2014. Asic found that in 19% of 463 key audit areas across 111 audit files auditors had not obtained reasonable assurance that the reports were free from material misstatement (compared to 20% in its previous inspection report). A major area of concern was around asset impairment.

Audit quality problems, unsurprisingly, are similar to all other markets

The underlying causes of these problems are similar to most other markets, namely insufficient audit evidence, inadequate professional scepticism, and over-reliance on the use of experts. The regulator's response has been to work with the industry, in particular the six largest firms, to get them to develop action plans and other initiatives for ongoing improvement. It seems a little frustrated by progress:

> While firms have made good efforts to maintain and improve audit quality, these are yet to be fully reflected in our risk-based inspection findings. Some action plan initiatives have been more effective than others. Plans should be regularly reviewed to ensure that they are effective and new initiatives are adopted to improve audit quality.

Debate over what are the right metrics against which to measure auditor quality?

For their part, the firms recognise that Asic's regulatory capability is getting better with each inspection cycle. Their core concerns these days focus on whether the regulator always chooses the right metrics of audit quality, and whether it has staff of sufficient expertise and experience to carry out these inspections.

No one seems to like the idea of mandatory Audit-quality indicators

One thing on which many agree is that a mandatory set of audit-quality indicators (AQIs) is a bad idea. This is the concept, adopted in Singapore, that audit firms measure themselves against AQIs defined by the regulator and make this information available to audit committees should they ask. The idea is that this will help audit committees select the best auditor.

Generic AQIs are useless to an audit committee

But one veteran accountant we spoke to described this approach as 'nonsense'. What an audit committee wanted to know, in his view, was not generic information about the CPA firm as a whole, but the capabilities and expertise of the audit team being sent to its company. 'What have the team brought to me? What expertise do they have in my audit?' Average AQI data was irrelevant, in this person's view.

Are audit committees any better in Australia? Not really

Another point of wholehearted agreement is that audit committees in Australia are a mixed bag. Those in the biggest listed companies, the ASX200, are pretty good. But after that, the quality starts declining and many committees rely on the auditor for guidance. This is the wrong way around, according to another veteran auditor. 'Audit quality depends on the quality of the audit committee. The latter has a phenomenal amount of information to help the auditor - what is happening in the organisation, friction points. I think the regulator has missed that. They see them as two separate roles.' He also expressed the view that auditors, for their part, were often 'not very good at articulating their warnings' and audit committee chairs may not be good at handling constructive criticism. 'Audit committees succeed or fail based on the quality of the chair,' he said. On all these points, Australia and Asia are more similar than different.

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Australian retailers - Dark aisles

Earlier this year, we teamed up with forensic accountant Melvin Glapion to bring an impartial and fresh perspective to analysing Australian retailer company financials in our *Dark aisles* report. There is a clear and discernible gap in the transparency and quality of disclosures provided by Australian retailers versus those of global retailers.

The following figure provides an overview of all of the companies with respect to transparency. As can be seen, all three Australian companies fared less well with, Wesfarmers rated best, Metcash second and Woolworths in last position. One of the key reasons for the low transparency scores at the Australian companies is that, in several instances, they did not address some of the 14 key disclosure items. Moreover, when they did, they failed to provide sufficient detail or context which, in comparison, would have been clearly highlighted in financial statements of the US and European retailers.

Global retailers score better on quality and transparency than Australian retailers

The following below shows that two clusters are evident when quality metrics are overlaid with the transparency scores. Tesco, Walmart and Sainsbury's occupy the far-right cluster, exhibiting both high levels of transparency and earnings quality. The Australian firms form the second cluster. Wesfarmers is the closest Australian firm to the international peers in terms of its quality and transparency. Metcash and Woolworths are lower, although the former has been improving in terms of quality.

Woolworth's remains the largest risk

Our analysis shows that whether in terms of its allowances, impairments, or a host of other issues, Woolworths has not properly accounted for the risks to its financial assets. Overall we estimate that based on FY15 disclosure, Woolworths had over A$6.7bn at risk of being written down.

Woolworths took a chunk of that medicine in its Home Improvement business with a A$3.25bn writedown in its 1H16 results. The writedown was dominated by PP&E and leases, accounting for A$2.7bn and inventory impairment of around A$550m. Then just ahead at its FY16 result Woolworths took a further A$959m writedown with approximately half of this amount focused on PP&E and leases and one-third reflecting the writeoff of EziBuy intangibles. Woolworths is clearly a business under pressure with sales and profit challenges across nearly all of its businesses. We believe it remains at risk of a further A$2.5bn write-down.A$2.5bn writedown.

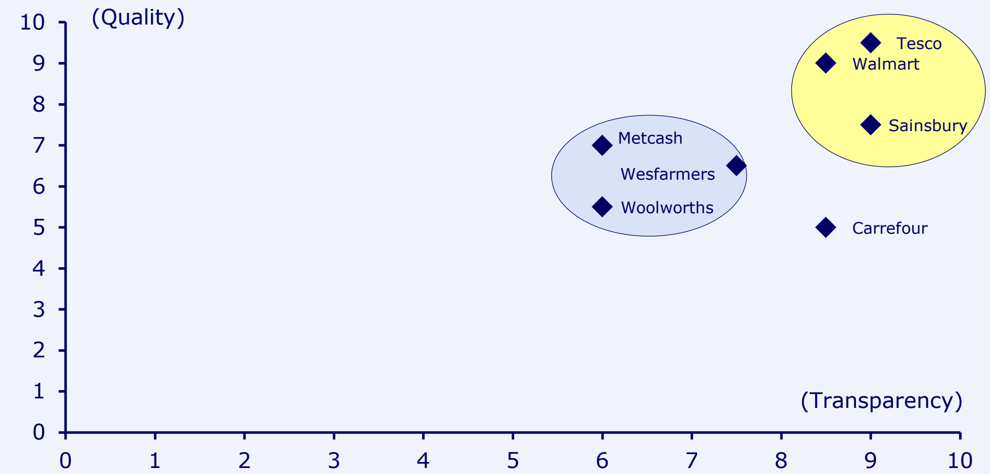
Overview of transparency

	Revenue Recognition	Supplier Income	Allowances	Capex Spend	Impairments	Restructuring	Contingencies & Provisions	Like-for-Like	Segment Reporting
Tesco	3	3	3	3	3	1	3	3	3
Sainsbury	3	1	3	1	3	3		3	3
Walmart	3	1	3	3	3	3	1	3	1
Carrefour	3	1	1		1	1	3	3	3
Metcash	3		1		3	1	1	1	
Woolworths	3			1	1	3	1		
Wesfarmers	3		3	1		1	1	3	3

= Transparent = Limited disclosure = Opaque

Global retailers better than Aussie retailers

Quality versus transparency



Source: CLSA

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Slater and Gordon Asic investigation

In March 2015, SGH acquired Quindell's distressed Professional Services Division (PSD) for £637m (A$1.2bn). The UK regulator subsequently launched an investigation into Quindell's accounting practices.

Following this, in April 2015, Asic launched an investigation into SGH's audit relationship with Pitcher Partners after it admitted to an accounting error of its own in its existing UK business, whereby cashflows had been overstated since June 2012.

Accounting issues uncovered, largely overstatement of WIP assets

A full investigation was then launched into SGH whereby companywide accounting issues were uncovered, largely in relation to the overstatement of WIP assets. The investigation is ongoing. The stock has fallen 90% since this was uncovered.

CG culture

Score of 74% well above the best in Asia

The biggest difference in score between Australia and Asia is in CG culture, with around 16ppts between it and the next highest-scoring market. The most significant factors at the company level include:

- A much more open relationship between company boards and shareholders, with a consensus that directors should be accountable to shareholders.
- A greater understanding among directors as to their roles, responsibilities, legal duties and market expectations.
- More diverse boards with a higher percentage of women directors, and an obvious attempt among the bigger companies to think through board composition from a strategic perspective. (The most obvious thing lacking in this area, however, is the presence of directors with deep Asia experience - even in companies that have close business ties to the region.)
- A higher proportion of independent directors, a stronger role for them.
- A higher proportion of genuinely independent chairmen.

Australia also has a vastly broader and deeper community of private-sector and civil-society groups involved in CG than you would find in any Asian market. Some have been around for decades.

Director training has been established in Australia since the 1960s

Director institutes have been operating around Australia in one form or another since the 1960s and this led to the formation of a single national body, the **Australian Institute of Company Directors (AICD)**, in 1990. AICD has a membership of more than 38,000 and offices and training courses around the country. AICD also participates actively in advocacy on behalf of its members. Another point of note is that it has had an involvement in Asia since at least the late 1990s, when it provided assistance to the development of the Thai Institute of Directors. It now runs conferences and training courses in the region.

While on the subject of business associations with Asian ties, two other entities worth a mention are **Chartered Accountants Australia and New Zealand (CAANZ)** and **CPA Australia**. The former represents around 100,000 members and the latter more than 150,000. Both have offices and operations around the region to serve their members, and take an interest in CG issues both locally and regionally.

Country has had a retail shareholders body for just as long

On the investor side, the **Australian Shareholders Association (ASA)**, based in Sydney, was formed in 1960 and is an active representative of retail shareholder interests, attending AGMs and voting on their behalf (if appointed as a proxy). ASA monitors selected companies, mostly the larger ones, announces its voting intentions for their AGMs and then writes a brief report afterwards. It carries out research on CG issues in Australia, responds to numerous regulatory consultations, and has a programme of events around the country.

Investment managers have the FSC . . .

The peak body for the private-sector investment industry is the **Financial Services Council (FSC)**, formerly called IFSA and also in Sydney. It made an early running with the publication in 1995 of its "Blue Book", a guidance note on CG for fund managers and corporations. The book is now in its 6th edition and was last revised in 2009. FSC has also put out policies for its members on the disclosure of proxy votes at AGMs. Asset managers in Australia provide a high level of disclosure on voting, with details provided on individual resolutions at each company meeting.

Pension funds have AIST and ACSI . . .

Asset owners (pension funds) are well served by two Melbourne-based bodies, the **Australian Institute of Superannuation Trustees (AIST)**, which represents the directors (trustees) on pension boards, and the **Australian Council of Superannuation Investors (ACSI)**, which represents the large industry pension funds, predominantly headquartered in Melbourne. Both AIST and ACSI provide a range of educational and research services for their members, while ACSI also gives proxy voting advice and engages with selected companies on behalf of its members.

ACSI has a broad-based programme of research, advocacy and engagement

ACSI is a good example of a younger organisation, formed in 2001, that quickly established itself as the voice of the nation's industry super funds on CG and ESG/sustainability issues. Its independent research examines issues such as CEO and director pay, board composition, and sustainability reporting in the top-200 listed companies. It engages with the same companies on governance risks relating to such things as board independence and diversity, remuneration and supply chains. It also makes submissions to the government and regulators, with recent letters covering collective action by investors, bribery, reverse takeovers and carbon-risk disclosure.

Pension fund beneficiaries have ASFA . . .

One additional pension non-profit that should be mentioned is the **Association of Superannuation Funds of Australia**, which describes itself as the 'peak policy, research and advocacy body' for the country's pension system and emphasises that it is 'non-sector aligned' (it focuses on 'whole-of-system issues' and takes 'positions that are in the best interest of fund members, rather than advocating any one sector's interests over another'.

CG officers in companies have the Governance Institute . . .

Back at the company level, there is also the **Governance Institute**, based in Sydney. Its membership comprises professionals working in companies on governance issues, such as company secretaries, risk managers, directors and others. The Institute, which was formerly called Chartered Secretaries Australia, also participates in regulatory consultations, provides practical advice to its members and others, and carries out research on governance practices among listed companies (such as a report in 2012 on disclosures about board reviews).

Depth and breadth of Australia's CG/ESG services are like a lush forest compared to Asia's semi-arid plains

And Australia also has some specialist proxy advisors, such as **Ownership Matters**, and CG/ESG engagement specialists, such as **Regnan**, working on behalf of institutional clients. In short, it would be fair to say that every sector and group working on CG in Australia appears well catered for, with considerable educational and other resources on tap for those who want it.

A strong CG culture leads to a better ecosystem and better long-term policymaking

As one would expect, there is often considerable disagreement between the groups on the proper direction of CG reform. Issues that have raised debate include the liabilities of directors, the value and usefulness of the annual general meeting, and whether industry super funds should have a mandatory independent component on their boards (some do, but most do not). Yet the diversity of the debate remains refreshing, especially from the perspective of Asia's more constrained CG cultures, and no doubt contributes to better policy outcomes over the long term.

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CBA financial planning scandal; Regulator inaction

Bank financial planning scandal

For years, financial planners/advisers representing the Commonwealth Bank (CBA, Australia's largest retail bank) financial planning have been providing advice to clients, that did not meet the requirements of appropriateness and reasonableness.

Several serious allegations of forgery, fraud and misleading clients with inappropriate advice, came to light in 2013, three and half years after whistleblowers at CBA first approached the regulator Asic. For CBA whistle-blower Jeff Morris, a former financial planner, moves to reform the financial planning industry and rid it of long-term inadequacies and conflicts should begin with a new regulator. 'As a whistle-blower, I came face to face with Asic's complacent disinterest and inertia,' he said.

While, initially a slow process, Asic finally jumped on the case and banned eight CBA planners from the industry. During this time the bank paid out millions of dollars to compensate the victims for its mistakes.

More than a thousand risk-adverse clients of CBA suffered losses when they were put into risky products by financial advisers. These risky investments subsequently fell during the financial crisis. In another instance, one financial adviser was convicted of forging client signatures on applications for financial products, creating false file notes, engaging in misleading and deceptive conduct, giving inappropriate advice and charging excessive fees. Another adviser was given a three-year ban for providing inappropriate advice to retail clients, including gearing them up with margin loans and high-risk managed investment scheme (MIS) Timbercorp, which culminated in their financial ruin.

A crisis of confidence

Sadly, the scandals are not just restricted to CBA. The string of financial scandals at Australia's major banks stretch from alleged interest-rate rigging, to financial planning and life insurance. The crisis in confidence in the financial planning industry has been intensifying for years. Asic revealed that there have been 900 breach reports against planners filed in the last couple of years. This is quite intense, given that there are around 38,000 financial planners in the industry.

Across these multiple advice allegations, Asic charges have been very inconsistent. While one was banned for life for forgery (but with no criminal action), other convicted advisers were banned for seven years with ability to re-enter the market after the ban time is served, and yet some others were given a three-year ban. There is little transparency of how Asic decides on penalties - hearings are conducted in secret, decisions are confidential, only the outcome is published.

The scandals discussed above show that when companies get too focused on the bottom line, without any regard for the wellbeing of people who are relying on their services, this could lead to serious corporate-governance issues. Especially, when the regulator responsible for providing oversight is perceived to be inadequate or insufficiently resourced, governance problems are even more deep-rooted.

Bank alerted customers after it was too late

Letter sent by bank alerting Mr and Mrs Crowe to possible forgery

Commonwealth Financial Planning

Commonwealth Financial Planning Limited ABN 65 003 900 169 AFSL 231139

15 May 2014

Dear Mr and Mrs Crowe

Former adviser Rick Gillespie – reviewing your documentation

I refer to our telephone conversation on 15 May 2014 regarding concerns about former Commonwealth Financial Planning adviser Rick Gillespie, and our investigation into the possible forgery of customer signatures.

Mr Gillespie has since been permanently banned by ASIC from providing financial services. We have engaged with ASIC, our industry regulator, and are keeping them abreast of our investigations.

As discussed, we have prepared a documentation pack which is enclosed. This includes an attachment index, listing each of the documents to be reviewed by you. We ask that you take the time to review these documents, paying particular attention to the signatures, to ensure they are yours, prior to our next discussion. We also ask that you please review and bring to our meeting any documents you have received from

Source: Sydney Morning Herald

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- No mandatory voting by poll
- No change to minority protection rights in reverse takeovers
- No improvement in core funding for Asic
- Continuing problems found in audits of listed companies
- Continuing problems in the nation's anticorruption efforts

Quick fixes

What to fix

- Introduce voting by poll on the "two-strikes rule"
- Improve the gender balance on boards
- Encourage better SME nonfinancial reporting
- ASX to improve its website and make suspension announcements when they relate to CG
- Dedicated engagement by Asic of the institutional investor community, both asset owners and managers

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China - Slipping further

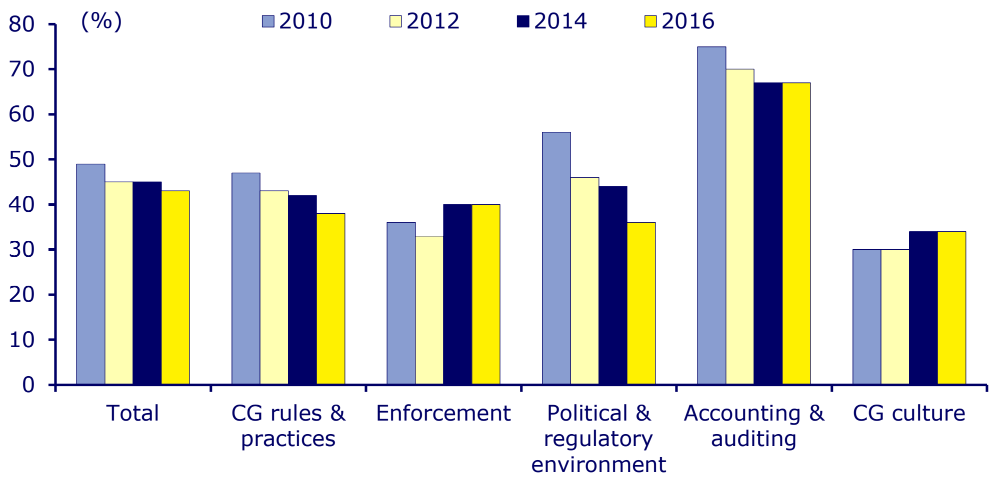
Key issues and trends

- Chaos during the 2015 stock crisis highlights regulatory weaknesses
- Regulator needs more resources to strengthen enforcement and coordination among state agencies needs to be improved
- New Corporate Governance Code finally in the works
- SOE reform changes shape, mega mergers likely bad for CG
- Takeovers in China may not produce better governance outcomes
- Political risk paramount when investing in China

Overall score falls from 45% in 2014 to 43% in 2016

Figure 70

China CG macro category scores



Source: ACGA

There was a time, around 2010, when CG reform in China was progressing at such a steady rate that we half-jokingly suggested it might catch up with Hong Kong in 2022. Those days are long gone. China's score has instead been on a downward trend in recent years, as the chart above shows, and it is hard to see what will change in the near future. On the other hand, if China brings in a new Corporate Governance Code as planned, focusing more closely on SOE governance, and creates a more consistent regulatory regime for the capital market, there is no reason why its score could not rise again.

CG rules and practices

Score falls from 42% in 2014 to 38% in 2016

The score for this section has returned to an historical low point in our survey, the product once again of two things: limited CG reform in China, and the rest of the region moving further ahead.

CG regime is falling further behind other markets in Asia

A good example of stalled reform is the country's outdated Corporate Governance Code, a best-practice guideline first released in 2002 but never updated (in contrast, most Asian markets have revised their codes once, if not twice, since then). There are plans to produce a revised code by the end of this year, with a stronger focus on information disclosure and specific key performance indicators (KPI) by industry. It is understood the International Finance Corporation is assisting this effort. Encouragingly, in late August 2016, Liu Shiyu, the new chairman of the China Securities Regulatory Commission (CSRC), the peak financial regulator, told a CG seminar in Beijing that he hoped the revision of the CG Code would be speeded up.

A new CG Code is badly needed

A new code would certainly help with many CG aspects, including improved disclosure, board governance and relations with shareholders. An area in urgent need of reform is corporate reporting. One of the problems in China - as in other parts of North Asia - is the regulators' tendency to produce sample reporting templates for companies to follow. While the intention may be to assist companies, the end result is that they inevitably report in the same way and produce a great deal of boilerplate. Many quarterly reports, for example, contain only figures with little accompanying explanation. Annual reports have CG chapters that are highly formulaic and legalistic. It often seems that the main purpose of such reporting is to provide regulators with standardised information for comparison purposes, which makes supervision easier, rather than to give investors useful information on which to make decisions. One of the few areas of nonfinancial reporting with meaningful disclosure is the risk-assessment section of annual reports.

Improved CSR reporting largely focusing on environmental issues

In terms of sustainability reporting, the number of listed companies issuing such reports has steadily increased over the past two years as awareness of corporate social responsibility (CSR) grows. A major regulatory driver has been a new Environmental Protection Law, which took effect on 1 January 2015, and imposes more specific requirements on environmental disclosure for certain companies. As a result, the majority of CSR reports focus mostly on environmental topics, while disclosure about governance and social issues remains weak. Only a few reports are audited by independent third parties.

Large-cap sustainability reports more likely to follow global standard

In our sample analysis of 25 listed companies, 20% of 15 large-caps did not issue a sustainability report for 2015, although half of the remainder referenced an international standard, such as GRI G4, as the basis for their report. Practices among SMEs were worse - six out of 10 companies in our sample did not produce a sustainability report for 2015 and only one company disclosed any KPIs.

General consensus that independent directors provide little value

Turning to board composition and independence, the general consensus is that most independent directors are still just "vases" in boards - there to add colour, not to object to decisions or provide useful suggestions. This is mainly because most of them are still appointed or nominated by executive directors or the chairman, not the general shareholders, hence cannot be genuinely independent and represent minority shareholders' interests.

We have slightly increased the score for voting by poll

One question where we increased China's score was the issue of voting by poll. While there are no stock-exchange rules mandating voting by poll, the company law makes it clear that 'one share, one vote' is the norm. In practice, therefore, companies do count the vote and published detailed voting results quickly after their AGMs. The reason we do not give the question a full point is because there have been cases in the past where companies have rejected 'votes against' for no good reason.

Enforcement

Score stays flat at 40%

Securities enforcement in China over the past two years has been a game of two halves. The first is the period before the stock-market crisis of June 2015, when policymakers, regulators and the media were boosting the market and enforcement was less of a priority. The second is the 12 months since, when tough enforcement has been the name of the game. China's score has remained flat in this section, however, not because of inconsistent enforcement. Rather, it is the result of two other factors - insufficient resources for enforcement and a downgrade for the participation of investors in voting and engagement.

An increase in enforcement post-crisis is clear from the data

The change in enforcement post-crisis is evident in the data. The CSRC investigated 71 cases of market manipulation in 2015 - almost four times as many cases as in 2014. It also issued 109 sanctions in 88 general enforcement cases in the first six months of 2016, an increase of 85% year-on-year, with total fines amounting to Rmb2.55bn (US$383m) - almost 20 times the level meted out in the first half of 2015 (note: none of this money was paid back to investors). Of the 88 cases this year, 30 were for insider trading and 18 for market manipulation (no comparable data were provided for last year). The CSRC also handed 22 cases of market misconduct among brokers, listed companies and investment funds (as well as individuals working for these groups) to the public security bureau for investigation in August 2015 - more than it had ever passed on before.

Broker misconduct in the news

While the CSRC has taken a stronger supervisory approach towards market participants generally over the past year, much of the news has been about brokers. For example, it banned Guotai Junan Securities from acting as a market maker for three months for manipulating shares in February 2016. It probed Southwest Securities and Industrial Securities for market manipulation in June 2016. And it probed four subsidiaries of Founder Group in August 2016 for breaching securities laws and not disclosing related-party transactions.

Shanghai and Shenzhen exchanges get in on act

Not to be left out, the two stock exchanges have also carried out more enforcement over the past year. For the first half of 2016, the Shanghai Stock Exchange (SSE) issued 22 public reprimands and criticisms, a 150% increase year-on-year, and the comparable figure for the Shenzhen Stock Exchange (SZSE) was 40 sanctions, a more than 40% increase. The SZSE's higher number is because it supervises the smaller GEM board as well as its mainboard. It is worth noting, that the exchanges are only self-regulatory bodies with limited powers.

Zhuhai Boyuan delisting in 2016 an enforcement turning point

In terms of company cases, an interesting development occurred in March 2016 when the SSE announced its first-ever compulsory company delisting, namely Zhuhai Boyuan Investment, for breaching information disclosure rules. Later, the CSRC announced plans to delist Dandong Xintai Electric on Shenzhen's ChiNext board for falsifying IPO documents.

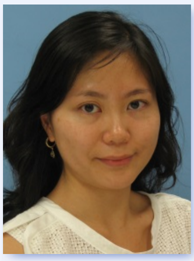
CCDI has been active against corrupt officials

As for actions against individuals, the removal of Deng Ruixiang as a member of the CSRC's IPO review committee was one of the first high-profile cases. The Central Commission for Discipline Inspection (CCDI), mainland China's anti-graft agency, discovered he had engaged in insider dealing in September 2014. CCDI also prosecuted Zhang Yujun, an assistant CSRC chairman overseeing brokerages and fund houses, for corruption in September 2015. Then, in November 2015, the public security bureau arrested Xu Xiang, the so-called "hedge fund king" of China, for manipulating share prices.

Are the regulators fully armed?

Regulators must be fully armed with financial and human resources to enforce effectively

As noted, one factor for maintaining China's score this time is insufficient human resources capacity in regulatory agencies. It is understood that the CSRC has experienced a high staff turnover in recent years, thus putting its ability to deal with a massive market such as China in question. While the regulator does not publish detailed information on staffing levels, its annual report for 2014 (the most recent available) stated it had 3,167 staff, of which almost 25% were in Beijing and the remainder spread around regional offices. Revealingly, it reported its average staff age as just 36 years old. While, the CSRC has urged the two exchanges to speed up the establishment of their own independent enforcement departments (each will comprise about 80 officials), the Commission will do most enforcement for the foreseeable future.



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CSRC review, suspends nine IPO applications by Southwest Securities

Southwest Securities (600369 CH) announced in June that CSRC was investigating its role as an IPO sponsor. All advisory activities have been suspended during the probe. It must withdraw from acting as IPO sponsor and financial advisor. According to news reports, 10 restructuring projects, 13 refinancing, one bond underwriting plus nine IPOs have been shelved.

It is part of CSRC's wider investigation into misconduct of intermediaries. Based in Chongqing, Southwest Securities is not the only broker being reprimanded. Xinye Securities (6001377 CH) was another target. The case is now closed with Xinye found guilty of negligent IPO due diligence. It failed to verify the accuracy of the financial accounts of Xintai Electric (300372 CH) and the company continued to falsify the accounts after listing on the GEM board. The investigation started in July 2015 and in July this year Xinye agreed to set up an Rmb550m fund to compensate investors. Although Xintai's briefly resumed trading, Shenzhen Stock Exchange insisted on its delisting. The stock was last traded on 22 August 2016.

Risky growth in investment banking

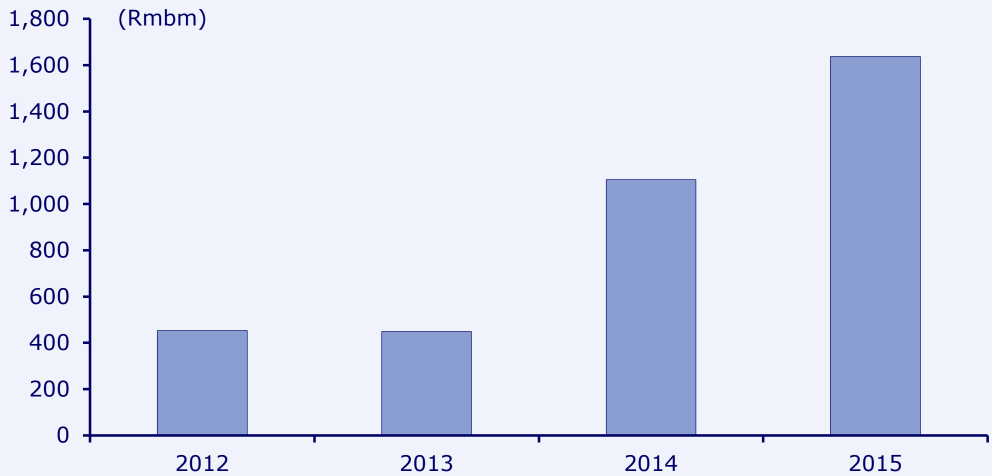
The securities watchdog discloses its rating of stockbrokers every year in July. Last year, a total of 27 brokers received an AA rating (nobody got the highest AAA). This year, only seven managed to stay in the same class. The unprecedented scale of downgrades highlights the industry's insufficient risk management.

CSCR investigation of South West Securities lead to suspension of all advisory activities

For Southwest, investigations are ongoing. Reportedly, it is related to its role of underwriter in a private placement where the parent of the listed company was suspected of deceit. Strong growth of the investment banking business in recent years could have led to gaps in oversight. The segment brought in Rmb1.6bn of revenue in 2015, or 19% of the total. If claims of fraud are found, Southwest will face financial damage with serious implications for its reputation and future business. The stockbroker has been hit with more regulatory run-ins. In the same week as CSRC's announcement, the company put out a separate statement on another breach, that its proprietary trading desk in Chongqing held an undisclosed stake of more than 5% in a listed company.

Risky growth in investment banking

Strong growth in investment banking business



Source: Company, CLSA

Domestic institutional investors play little role in China CG

The second factor keeping the score from rising is weak participation by investors, especially domestic institutional investors, in share voting and company engagement. While domestic funds, most of which are state enterprises, do vote, few have any formal CG policies or engage with companies around governance issues. This is a disappointing outcome and we have reassessed scores accordingly.

Political and regulatory environment

Score has fallen from 44% in 2014 to 36% in 2016

It has been a volatile two years for the stock market in China and the country's reputation for capital-market regulation. While some policies and rule changes have followed a consistent regulatory philosophy, such as the China Banking Regulatory Commission's (CBRC) efforts to improve bank governance, the same cannot be said across the board. Indeed, numerous rules have been changed to fix previous rules that were poorly designed or as a reaction to the market collapse and the government's desire to exercise greater control.

Stock crisis led to a regulatory about-turn

One example of a regulatory about-turn was the CSRC's backtracking on M&A rules. In October 2014, it promulgated amended rules on takeovers and asset restructurings of listed companies that were intended to eliminate the requirement for CSRC's approval and signal a move towards a more market-oriented capital market. After the stock crisis, it reversed this decision and is reviewing all deals going back to 2011.

Efforts to control and calm the market proved unsuccessful

Before the crisis started in mid-June 2015 there were numerous signs of looming trouble, such as soaring trading volumes and unrealistic valuations. The government thought it could control investor exuberance by tightening up rules on broker margin lending, only later to realise that the bigger issue was shadow lending via private-to-private channels. Once the CSRC became aware of the seriousness of the situation, it began using an old regulatory tool, the IPO moratorium, to try to stabilise the market. It also formed a 'country team' to buy shares, and doubled the collateral required for margin trading. Needless to say, once panic set in, these tools were ineffective.

CSRC leadership change

CSRC is likely to take a more measured approach under its new chairman

The crisis led to a leadership change at the CSRC and, we hope, a more measured approach to regulatory policy. The new CSRC chairman, Liu Shiyu, a former head of the Agricultural Bank of China, took over from Xiao Gang, previously head of the Bank of China, in February 2016. Indeed, it is striking that almost all CSRC chairmen have come from the banking sector, rather than investment or securities. This is largely because, following China's strict official appointment system, there are not yet people of sufficient seniority from the securities industry to fill the post of CSRC chairman.

CSRC needs to find its right position in the market

Over the past decade or more, the CSRC has found it difficult to educate China's millions of fickle retail investors that it cannot control all market movements. Moving forward, it has to find its right position in the market. This should involve not interfering in the name of stabilisation, but to design consistent policies and allow the market to function on its own as far as possible. It seems clear that the multiple IPO moratoriums over the past 20 years have done more harm than good, undermining both market stability and the value of the two stock exchanges as capital-raising venues. And a policy hastily consulted on in mid-2015 to introduce a circuit breaker from January 2016 was a well-documented disaster, causing investor panic in China and around the world.

A merger of three financial commissions and PBOC is on the drawing board

One solution to the regulatory problem in China could be the merging of the People's Bank of China with the three commissions in charge of banking, insurance and securities. Indeed, it is understood that such a merger has been confirmed, though no formal document has been released. If it happens, it will most likely be after the retirement of Zhou Xiaochuan, current governor of the PBOC, in 2017.

Improving coordination and making sound monetary policies

There are two factors behind this proposed merger. One is to improve coordination among regulators. The other is for the PBOC to have more accurate and complete information on capital flows to help it make monetary policy. It has become much harder for the PBOC to track capital flows, given the size and complexity of the stock market. However, as the insurance and securities sectors are still relatively immature, one wonders if a merger would significantly improve all regulatory practices.

Whatever happened to . . . SOE reform?

SOE reform has not proceeded as expected

In *CG Watch 2014*, we had high expectations for the reform of stated-owned enterprises (SOEs). At the time, reform was intended to restructure the assets and management of these behemoths and reduce bureaucracy. One concept much talked about was 'mixed ownership', which was aimed at introducing new shareholders (including domestic and foreign investment funds and local private firms), lessen intervention from government, create more diversified boards and therefore better governed companies. Although not off the table, there has been little public discussion of this idea recently and the few restructurings undertaken were somewhat disappointing.

Massive mergers are on the cards

Instead, a key focus of SOE reform today is the mega merger: joining two central state-owned enterprises (CSOEs) and creating not a more nimble firm, but one that can compete better globally. While such mergers would certainly reduce the often intense competition between PRC state enterprises vying for business in foreign markets (eg, construction or railway contracts), they could also lead to inefficiencies over time and lower the bargaining power of suppliers and counterparties. Two industries targeted for mergers in the near term are equipment manufacturing and coal. We have doubts that this policy will improve the governance of CSOEs.

Debt-to-equity swaps and aid packages to help some SOEs

Another frequently-mentioned topic in SOE reform is the debt-to-equity swap, aimed at deleveraging enterprises in certain sectors (coal and steel). This is not a new idea, as similar schemes were first used in the early 2000s, when national asset-management companies such as Cinda were set up. A further idea being considered is the provision of aid packages to a small number of SOEs in particular difficulty.

Sasac issues new guidelines on SOE reform

Meanwhile, it is worth mentioning that one year after the State-owned Assets Supervision and Administration Commission (Sasac) issued a guideline to deepen SOE reform, the commission issued another 17 supplementary documents in early September 2016. Documents made public to this date include: *Advice on SOEs' function and classification*, *Advice on introduction of employees incentive scheme in mixed-owned SOEs*; and *Advice on promoting the restructuring of CSOEs*.

New regulation

A range of reforms underway, but fragmented and piecemeal

Despite the many macro regulatory problems China faces, some positive changes are underway in specific areas of regulation. For example:

- The CBRC amended its *Guidelines on Internal Control of Commercial Banks* in September 2014, then issued Notice No. 82 to shed light on shadow banking in April 2016;
- The National People's Congress passed amendments to the Criminal Law, introducing stricter measures against bribe-givers and ruling out commutation for the most corrupt figures, effective November 2015;

Judicial interpretations, new guidelines from regulators, draft consultations and changes to laws resulted from this investigation

- The Supreme People's Court issued its fourth draft judicial interpretation on the Company Law in April 2016
- The two stock exchanges issued new guidelines on voluntary stock suspensions in May 2016 to deal with the situation that a number of companies used the voluntary suspension mechanism as a shelter to avoid further collapse of their share prices during the stock crisis
- The CSRC issued a draft consultation paper to discuss ways to cool the overheated purchase of shell companies in June 2016
- The government is drafting a market-friendlier Securities Law which may come into effect in early 2017

While we have taken some of these into account in our scoring this time, work on the company and securities laws is not included as it is ongoing.

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Baidu medical incident

Baidu's medical incident broke out in April after a 23-year-old student Wei Zexi died from receiving ineffective cancer treatments advertised on Baidu. The student was diagnosed with synovial sarcoma two years ago, and went to the Second Hospital of Beijing Armed Police for treatment found, which he found on Baidu's search engine. The hospital in question is a public class 3A institution (3A is the best-rated hospital), but it was subsequently revealed that the treatment was outsourced to a private contractor, potentially related to the Fujian Putian Chinese Health Industry Chamber of Commerce, and was not carried out by the Armed Police Corps. The incidence drew significant public attention.

Ineffective cancer treatment leads to a death and an investigation of Baidu

Regulators, including the Central Leading Group for Cyberspace Affairs, the Department of Advertising Regulation of the SAIC, and the National Health and Family Planning Commission, sent a special investigation team to Baidu. The investigation conclusion stated that Baidu should share the responsibility of the death of university graduate Wei Zexi as the mix of ad and natural search results had confused users. The regulator required Baidu to limit its ads to 30% of webpages and to rank search ads based on credibility instead of pricing before 31 May. Baidu was also asked to refrain from providing online marketing services to medical organisations which do not have requisite qualifications from competent regulatory authorities.

Baidu removes 126m army-hospital related adds

In response, Baidu immediately removed 126m ads from 2,518 army-related hospitals, and said the company was going to: inspect all of its medical related ads to assess whether they have received government approval; change advertisement rankings from pricing to credibility; control ad numbers, limit to not more than 30% of a webpage; show risk alert; strengthen medical content provision; and set up a Rmb1bn health foundation. Baidu said the company has complied with all government requirements by 26 May.

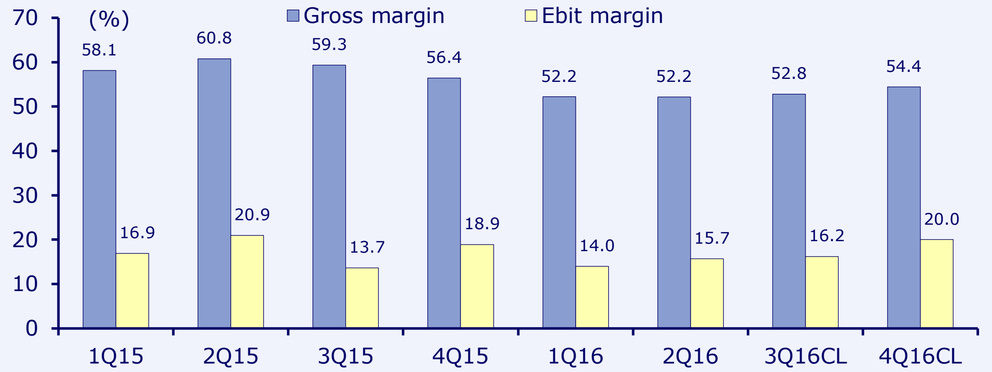
Government tightened regulation in healthcare and online ad sectors

Baidu's 2Q16 revenue was negatively impacted by around Rmb2.4bn. As the government has tightened regulation in healthcare and online ad sectors, all medical institutions require government approval for advertising. Medical/healthcare could represent about 20% of the total revenue, and now over half of its medical customers have reduced or delayed marketing activities on Baidu. 3Q16 guidance was also weak at 5.4-8.6% YoY growth and also weak because of the full-quarter impact from the medical incident and the fact that Baidu has expanded advertiser verification to all industries and sectors. All advertisers are now required to provide a proof of ICP (internet content provider) licence and enterprise account to advertise on Baidu. Companies who can't provide the verification documents will be suspended immediately. Advertiser growth could therefore be slower and CPC may also fall. Baidu expects the impact to last two to three quarters as the clean-up process may take time.

We believe medical advertisers will mostly come back to Baidu once approved, and neutral demand for search remains solid in China. This incident lowered 2Q revenue by around Rmb2.4bn for two months, which should imply a Rmb3.6bn impact due to medical incidents alone for three months in 3Q. However, with the expanded advertiser verification, the total impact reflected in the guidance was around Rmb3.8bn. The negative outcome from the medical advertising investigation could be smaller than the company guidance and combined with strong growth from other segments, overall market expectations for Baidu may now be too low. We believe businesses are likely to be back on track in 2017. We have lowered our revenue estimates for 2016-18 by 9-11% and non-GAAP net profit estimates by 16-24% post Baidu 2Q results due to the incident; and the stock was down 17% during the three months after the incident, which has likely factored in all the negative news.

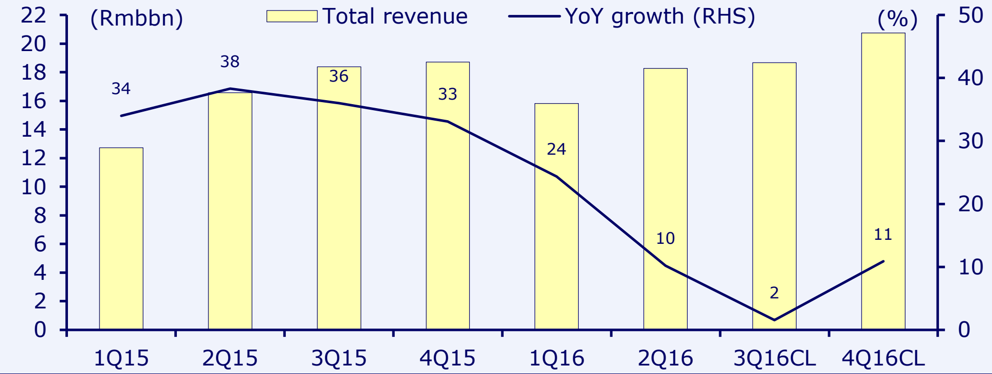
Baidu margins bottoming

Baidu - gross margin (%) and Ebit margin (%)



Revenue growth is now returning following a period diminishing growth

Baidu total revenue and YoY growth



Source: CLSA

Accounting and auditing

Score stays the same at 67%

In line with the overall category score, the scores for individual questions are mostly unchanged. We slightly increased the score for accounting standards, but this was the result of a rewording one question and needing to ensure we scored China consistently with other markets. We slightly reduced the score on whether the audit regulator publishes an annual report on audit industry capacity, as China's practice here is behind other markets.

China will not be adopting the new audit report from December 2016

Unlike other markets in Asia, China's accounting industry is less dominated by the Big Four and, therefore, the quality of accounting and auditing practices varies considerably among companies. This is a large part of the reason why the country is not ready to adopt the new long-form audit report from the end of 2016, as proposed by the International Auditing and Assurance Standards Board (IAASB). The Chinese Institute of Certified Public Accountants (CICPA) has not started any training related to the adoption of the new audit report, although some Big-Four firms said they had started training staff and communicating with clients about the change following the IAASB's release of the new standard in January 2015.

Audit cooperation between the USA and China behind schedule

In terms of audit regulation, the big story over the past two years has been the ongoing and tense negotiations between the USA and China over allowing the US Public Company Accounting Oversight Board access to the audit working papers of CPA firms in China auditing mainland companies listed in the USA). Lack of access has also led to the US Securities and Exchange Commission suing the Chinese affiliates of the Big Four (for more on both stories, see next page).

Regulator has taken further steps to protect local accounting firms

In an effort to gain greater control over who carries out auditing work in China, the Ministry of Finance (MOF) issued provisional regulations in May 2015 on foreign auditors working in the mainland on a temporary basis. The new regulations require foreign audit firms that audit overseas-listed China companies to join forces with a China-based audit firm with at least 25 certified public accountants. It is believed the new rules posed few challenges to the Big Four, given that they have developed sufficient local capability in China. However, small US-based CPA firms, which have taken the brunt of the blame for accounting irregularities of Chinese companies listed in the USA, may well find it tough to comply. Meanwhile, accounting practices in Hong Kong, Macau and Taiwan have been exempted from the new rule if the mainland companies they audit have at least half of their shares owned by investors in those markets.

MOF worries about accounting fraud, while small CPAs worry about staying in business

Other areas of challenge or concern in China include:

- The MOF's major concern over the next few years is accounting fraud as a result of the economic downturn.
- The fee schedule of the audit industry was suppressed following a new policy in 2015 that removed the lower-band of audit fees. While this move was aimed at trying to kill off some low-quality accounting firms, a number of CPA firms now say they have to rely on non-audit products, such as consulting services, to make a living. Without any regulation on non-audit fees disclosure, the independence of some auditors is likely to be undermined.

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Big-Four auditors dispute with SEC

US-listed Chinese companies, like Alibaba and Baidu, have been subject to a long-running dispute between Chinese and US regulators. However, there are hopes that the issue will soon to be resolved, as Alibaba and Baidu are preparing for an audit inspection by US officials 'in the coming months' to review audit work done on these two firms, according to a *Wall Street Journal* article published in August 2016.

Long running audit related disputes between Chinese and US regulators may be coming to an end

The dispute surfaced in late 2012, when the US Securities and Exchange Commission (SEC) formally charged five audit firms on failures to turn over audit working papers of nine US-listed Chinese companies for review by the Public Company Accounting Oversight Board (PCAOB). The PCAOB was created by the Sarbanes Oxley Act as a reaction to several major accounting scandals such as Enron. It is the auditor of the auditors, which inspects and regulates accounting firms. Under US rules, accounting firms who issue audit reports for US-listed companies are required to register with the PCAOB, and are subject to periodic inspection.

Releasing audit documents to the PCAOB could be a criminal violation of China's State Secret Laws

However, Chinese public accounting firms, including local affiliates of the Big Four, are prevented from inspections by the PCAOB; as releasing audit documents to the PCAOB could be a criminal violation of China's State Secret Laws. This means all US-listed multinationals with substantial Chinese operations, regardless of country of domicile, were impacted. In 2013, the PCAOB signed a memorandum of understanding that provides a mechanism for audit document sharing with the China Securities Regulatory Commission and China's Ministry of Finance, but progress remains slow and the PCAOB was still prevented from doing inspections.

In January 2014, a SEC administrative law judge issued a ruling against the Chinese affiliates of the Big-Four accounting firms, and called for a six-month suspension of these firms. The case was settled in February 2015, when the firms eventually agreed to pay US$500,000 each to be free from the six-month ban. It was agreed that audit documents would be turned over to the SEC after being examined by Chinese authorities. Discussion for a joint pilot inspection between US and Chinese regulators have been ongoing. However, in December 2015, PCAOB chairman James Doty commented publicly that they were close to an agreement to proceed with inspections, only to have negotiations break down. If inspections on Alibaba and Baidu materialise in the coming months, it would be seen as a major breakthrough.

CG culture

Score stays the same at 34%

Despite the collapse of the stockmarket, recent concerns about China's economic future, and doubts about the governance of SOEs and private firms, it appears little substantive attention is being paid within the market to improving CG. We see no new CG success stories in either the private or state sectors - and an awful lot of bad practice, especially among tech companies listed abroad. It was disappointing to hear recently from an important state agency that attention to CG was diminishing in their organisation and they had just dismissed their CG department.

Battles for corporate control emerge

Yet, it has not been a dull two years. Battles for the control of corporations have blasted into public view, giving China a taste of US-style hostile takeovers. On 1 December 2015, shareholders of Shanshui Cement, a leading

Chinese cement producer, voted to replace the entire board, and its chairman, Zhang Bin. They also voted to appoint a new board, led by the head of its largest shareholder and arch-rival, China Tianrui Group Cement. This has not gone smoothly.

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Shanshui Cement shows shortcomings of CG practice

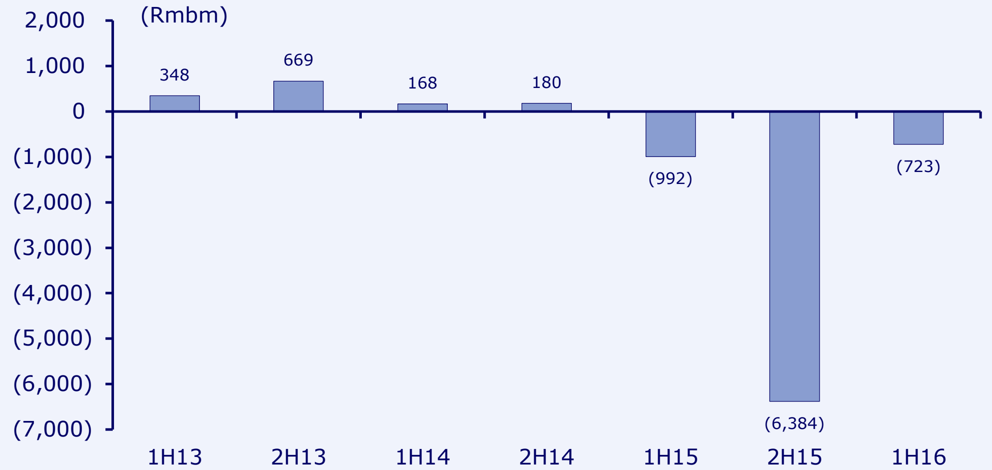
There have been many issues related to a long battle between the largest shareholder, Tianrui Group and the ex-chairman. Since April 2015, there has been a default in corporate bonds due to a change in control, lawsuits from the new chairman against the former chairman and the father of ex-chairman, and even the mayor of Jinan Cit. In the meantime, the company has been reporting significant losses.

Largest shareholder, takes on ex-chairman

The battle began in April 2015, when Mr Li Liufa and his Tianrui Group became the largest shareholder of Shanshui Cement. Following several attempts, Li Liufa received shareholders' approval to become the new chairman of Shanshui Cement in December 2015, replacing Mr Zhang Bin, whose father was essentially the founder of the company, but has less than 5% ultimate ownership. Shares have been suspended since April 2015.

Shanshui Cement has been reporting significant losses

Shanshui Cement's net profit



Source: Company

Vanke under attack

Another company under attack has been Vanke, a leading Shenzhen firm and the largest property developer in China. Since July 2015, it has been subject to a hostile takeover by Baoneng, another Shenzhen group. After many twists and turns, the battle has become even more interesting, with Evergrande, a Guangzhou-based property developer, joining the fight in August 2016.

Evergrande's disclosure whopper

At this stage, nobody knows who is going to be the winner. But one thing seems certain - the afternoon of 4 August 2016 will be remembered by A-share investors as the day Evergrande denied a media report that it had purchased a stake in Vanke, retracted it one hour later, then two hours later announced (after the market had closed) that it had indeed bought an aggregated 4.68% stake in Vanke on the secondary market. Curiously, this misleading disclosure did not appear to draw the ire of regulators. But the next day, the Shenzhen Stock Exchange sent a regulatory letter to Vanke asking if it had leaked the Evergrande purchase to the market. Vanke denied it had done any such thing.

Company owners will likely seek greater control post-Vanke

It is hard to draw firm conclusions regarding the state of CG in China from these events. It would be wrong to assume that takeovers inherently improve the governance of target companies - as the academic literature typically suggests - because the target management may have better governance than the bidder. This seems to be the case with Vanke. Wang Shi, chairman and founder, has long emphasised the importance of professional management and was happy to keep the combined ownership of his management team in single digits. Indeed, Wang himself owns less than 0.1% of the company's shares. Until Baoneng came along, Vanke's largest shareholder was China Resources, an SOE that did not interfere much in management decisions. The danger now is that the Vanke case will lead entrepreneurs in China to conclude that they must ensure outright control at all times.

Beware political risk and disappearing chairmen

Increasingly, investors in China also need to be aware of political risk. In late November 2015, Guotai Junan International, a Hong Kong subsidiary of one of China's largest brokerages, said it had been unable to reach its chairman, Yim Fung, for a week, prompting its share price to plunge 12% on the day. Similarly, the chairman of Fosun International, Guo Guangchang, was reportedly detained by police at Shanghai airport on 10 December 2015. This led to the suspension of its Hong Kong-listed shares the following day. Guo reappeared after four days, but refused to disclose any details of the incident. When Fosun's shares resumed trading, they fell more than 13%.

Shareholders get a hotline

One positive on which to end: while institutional-investor engagement with companies is limited, China's two exchanges have opened online boards for shareholders to communicate with companies directly. It is hoped that this will stop rumours spreading in the market. One interesting case came in mid-2015, when shareholders of Xinhua Department Store were not satisfied with the management and asked it to restructure its board.

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JPMorgan Chase probed for hiring official's son

A probe of JPMorgan Chase's hiring practices over whether it had hired princelings (children of senior Chinese government officials) to win business in Hong Kong has uncovered red flags across Asia. It is alleged the JPMorgan Chase hired Gao Jue, despite a poor performance at job interviews, because his father Gao Hucheng, China's Minister of Commerce, assured that he would 'go the extra mile' for the investment bank.

Hiring princelings has come under scrutiny

For two decades since Deng Xiaoping's 1992 *Southern Tour*, Chinese enterprises have been connecting with the international capital market at an accelerated pace. The move is not only for financing purpose, but also hoping capital-market supervision could help improve Chinese enterprises' operating efficiency and CG. Higher awareness gained through international capital-market participation could also gain foreign business and boost exports. Under this background, international investment banks have led the way in IPOs of Chinese enterprises overseas, thanks to their superior distribution platforms, global connections and ability the to ensure billions of dollars of stocks get sold at premium prices.

Was the foreign Corrupt Practices Act (FCPA) violated?

The Chinese Commerce Ministry can rule on inbound or outbound mergers and acquisitions, which is an important business to all global investment banks. While neither JPMorgan Chase or the banking regulator directly make rulings, the issue is whether JPMorgan Chase hired relatives of influential Chinese officials or executives of SOEs to help obtain business or even as a reward for past support, and whether that is a potential violation of the Foreign Corrupt Practices Act (FCPA), which makes it illegal to provide or pay benefits to a foreign government officials. Also the FCPA clearly states what records must be kept to ensure compliance.

On 22 July 2016, Bloomberg reported JPMorgan Chase is expected to settle later this year with the US Justice Department and Securities and Exchange Commission to end the three-year probe over hiring in Asia. The media has speculated that the bank could be expected to pay around US$200m in settlements. The princelings hiring issue has obviously posed significant compliance problems for other foreign investment banks as well. According to the South China Morning Post, it is alleged that other banks under scrutiny over its Asia hiring practices include Citigroup, Credit Suisse, Goldman Sachs and Deutsche Bank.

Three-year probe over hiring in Asia

Figure 71

JPMorgan Chase probed for hiring princeling

Date	Update
24 Mar 14	Bloomberg reported that Fang Fang, JPMorgan Chase CEO of investment banking for China, left the firm. It was alleged that Fang was involved in hiring of princelings to help gain business.
06 Feb 15	The Wall Street Journal reported that JPMorgan Chase was under scrutiny by US authorities for hiring Gao Jue in December 2016. He is the son of China's Minister of Commerce, Gao Hucheng.
22 Jul 16	Bloomberg reported JPMorgan Chase is near settlement with US Justice Department and Securities and Exchange Commission to end the three-year probe over hiring in Asia. The bank is expected to pay around US$200m.

Source: CLSA, Bloomberg, The Wall Street Journal

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- No improvement in nonfinancial and CG reporting standards, and continuation of boilerplate reporting among companies
- No revised CG Code
- No progress on SOE governance
- Continuing lack of consistency and direction in capital-market regulation
- No adoption of the new long-form audit report

Quick fixes

What to fix

- More meaningful statements about CG in annual reports
- Quicken the reporting of audited financial statements
- More English disclosure on regulatory websites
- Adopt the new long-form audit report
- More efforts on investors education and directors training

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Hong Kong - One city, two mindsets

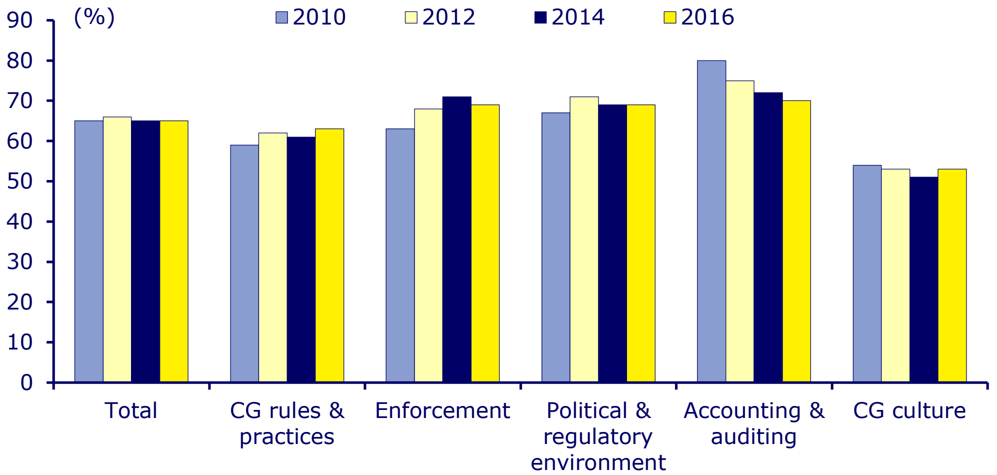
Key issues and trends

- Regulator nudges institutional investors towards active ownership; says a firm no to dual-class shares
- Controversy around consultation on new listing regime to reduce HKEx conflicts and improve regulatory coordination
- Regulators put more weight on nonfinancial reporting, practices improve but boilerplate remains
- Frequency and timing of financial reporting remains a concern; disclosure around large expenses items problematic
- Still no independent audit regulator
- Some positive improvements in company CG culture, but shareholder engagement limited

Overall score stays the same at 65%

Figure 72

Hong Kong CG macro category scores



Source: ACGA

Raging debate on dual-class shares

Like its mother country, Hong Kong has had an eventful couple of years for CG. The period started with a raging debate on dual-class shares and, despite the Securities and Futures Commission (SFC) firmly rejecting the concept in mid-2015, ended with the CEO of Hong Kong Exchanges and Clearing (HKEx) once again flying the dual-class flag. The catalyst appears to have been a media story from Singapore saying that the listings advisory committee of the Singapore Exchange (SGX) would soon give the green light to SGX to hold a consultation on the subject. Episodes such as this encapsulate the tension in Hong Kong between those who believe higher CG standards lay the basis for long-term capital-market development and those who would like to lower standards to foster more IPO transactions in the short term. This tension can be productive, as the open debate on dual-class shares showed. But it can just as easily poison the well, as a campaign against current proposals to improve the listing regime highlights.

Negatives cancel out the positives

Our score stays flat in this survey not because there have been no improvements in Hong Kong's CG regime, but once again the negatives cancel out the positives. As we have noted in previous surveys, Hong Kong still lacks any sort of overarching government strategy on CG, it remains one of the few markets in Asia without an independent audit regulator, and the culture of governance in companies, while improving, is moving forward glacially. Part of Hong Kong's problem is that it lacks an established community of domestic asset owners, such as pension funds, who can drive improved governance from below, as happens in many developed and even emerging markets around the world. Market pressure therefore relies on a handful of committed investment managers, mostly branches of overseas organisations with limited resources, and a fragmented assortment of other groups and individuals (including some local business leaders). Against them are ranged a much more powerful cohort of local tycoons, business associations, investment banks and other intermediaries. Without clear government leadership, forward progress will always be tortuous.

CG rules and practices

Score rises from 61% in 2014 to 63% in 2016

Our score rises two points to acknowledge efforts made by both HKEx and the SFC to improve CG standards. However, the score for this section was held down somewhat by a lower mark for the frequency of corporate reporting and less than a full point for a new question on investor stewardship codes.

Risk management has been incorporated into the CG Code

An important policy change took place in December 2014, when HKEx published its conclusions to a consultation on risk management and internal control, effective from the beginning of 2016. The most significant change was to incorporate the concept of risk management into the CG Code. The revised code has upgraded the information disclosure requirement on internal controls and a recommended best practice (RBP) on internal audit was upgraded to a code provision (that is, subject to comply or explain).

Exchange also raised ESG reporting standards to comply or explain

One year later, in December 2015, the HKEx published another conclusions paper on a consultation it carried out on upgrading its ESG Reporting Guide from an RBP to a code provision, also effective from the beginning of 2016. However, the seven-month timeframe for reporting is still the same (we think it too long) and third-party assurance is not required for ESG reports.

Stewardship lite

A stewardship code has arrived, but impact will be diminished without input from local institutions

In March 2016, the SFC released its much-awaited conclusions to a consultation on its proposed stewardship code for Hong Kong, called the *Principles of responsible ownership.* The good news was that the SFC largely dismissed complaints about higher costs and the inconvenience of more investor engagement. However, the code remains voluntary and the regulator has decided not to invite signatories at this stage. While both decisions seem sensible, given the peculiarities of Hong Kong's investment industry, the fact that new codes in other markets are more ambitious means we have scored those markets (Japan, Malaysia, Taiwan) slightly higher.

Bonus issues of shares more than doubled size are disallowed

The first half of 2016 also saw HKEX issue a guidance letter in April to inform companies that 'large-scale' bonus issues of shares amounting to double or more their issued capital would most likely not receive listing approval, since such issues can lead to speculative activity. In its announcement, the Exchange said listed companies were obliged to make the time interval as short as possible and ensure that a fair and orderly process was in place.

Financial reporting: where less is not more

Hong Kong is Asia's only market not to require quarterly reporting for mainboard issuers

A long-standing issue in Hong Kong is the frequency of financial reporting. The current rule still only requires two periodic reports per year for companies listed on the mainboard, meaning that investors remain stuck with outdated financial information (often more than six months old) on which to make decisions. While this may not be a problem for investors in well-established large caps with predictable operations, we continue to believe it is unacceptable for investors in smaller and/or more volatile companies, especially ones with controlling shareholders who monopolise information and do not meet their continuous disclosure obligations.

There are numerous cases where the performance of companies has changed drastically over a half-year period, such as Gome or Cosmo-lady in the first half of 2016. Moreover, the argument that quarterly reporting intensifies short-term thinking on the part of management has always been hard to stomach in Hong Kong, given its famously short-term business culture. It also bothers us that the positives of quarterly reporting - enhanced internal accounting systems and more precise reporting - are never discussed.

The practice of SMEs needs to be improved

A second area of weakness in Hong Kong financial reporting is the speed with which large caps release their audited annual accounts. Like most markets in the region, Hong Kong sets a three-month regulatory deadline for these reports. But in some markets, notably Australia and Thailand, blue chips make an effort to get their audited annuals out well within 60 days, which remains regional best practice. A sample analysis of 15 large caps and 10 SMEs in Hong Kong found only a few of the former published in less than 60 days - the average was 64 days, with a range from 28 to 78 days - and none of the latter did so. Again, unlike some other markets, such as Korea and Taiwan, these numbers do not seem to be improving over time. The inference we draw is that listed companies in Hong Kong are probably not investing in upgrading their internal accounting and management information systems.

The unexplained other expenses in blue chips

A third problem that has appeared on our radar screen over the past year is the issue of large unexplained expense lines in income statements. In early 2016, we researched all companies in the Heng Sang Index (except for those incorporated outside Hong Kong or China) and found a low level of transparency among quite a few companies that commonly aggregate a portion of operating expenses under the 'other' category. We also found the volume of such expenses to be quite high in many companies and clearly material in relation to both total operating expenses and net profit (more than 100% of net profit in some cases). This strikes us a fairly blatant disregard of accounting standards and we think is worthy of further study. (To be fair, we have found similar problems in other markets around the region.)

Nonfinancial reporting: ESG tops CG?

Large-cap nonfinancial reporting on CG is much better than that of SMEs

Our sample company analysis also looked at nonfinancial reporting in 2015 annual reports. Our main findings showed a marked difference, as one would expect, between large-cap and SME reporting quality:

- Almost all large caps have clear statements about strategy and half link remuneration policies to performance
- One third have detailed CG reports and meaningful directors' reports
- Almost all large caps have detailed discussion about risk assessment and internal control
- Most SME disclosure around strategy, remuneration policy is less clear
- No detailed corporate governance report or meaningful directors' report found in the sample SMEs
- Most SMEs only discussed the financial risks they were facing, with no statements about internal control

Both large caps and SMEs do well on ESG reporting

While our sample size was small, it was interesting to note that the same disparity was less apparent in the area of ESG reporting. All the large caps in our sample issued ESG reports for 2015 (90% for 2014) and 60% of the reports referred to an internationally recognised index such as GRI G4 indexes (50% in 2014). About two-thirds of the companies disclosed KPI data. Yet the improvement was more apparent among SMEs: 70% of companies in our sample issued ESG reports for 2015 (50% for 2014) and 50% of the reports were of a decent quality (20% in 2014). Also, it is worth noting that almost all the sample companies integrated their ESG reports into annual reports in 2015.

Enforcement

Score falls from 71% in 2014 to 69% in 2016

Despite Singapore's significant increase in its enforcement score, Hong Kong continues to set the benchmark in the region, as its score of 69% indicates. This was primarily due, as in previous years, to the efforts of the SFC. The overall score fell slightly, however, as we marked down one question on institutional investor voting: the inclusion of Australia in the survey, and greater progress being made in some other Asian markets (India and Japan), led us to reassess the degree of effort being made in Hong Kong.

SFC has been putting more resources into enforcement

The SFC has had a busy two years. It took enforcement action against 33 companies in 2015, a 57% rise year-on-year, and collected fines amounting to almost HK$71m (US$9.1m), a 13% increase on 2014 and 75% more than in 2013. It has added to its staffing capacity, hiring 15 enforcement personnel in 2015, while its 2016 budget submitted to the Legislative Council (LegCo) included six new executive posts in the enforcement division to ensure the Commission could handle an increasing number of enforcement and litigation cases, and maintain adequate supervision of a growing number of intermediaries within the market.

Box-ticking practices will no longer pass SFC's supervision

The Commission has also placed more emphasis on directors' responsibilities. On more than one occasion it has said that box-ticking exercises, such as having control systems in place without actual adoption, will no longer pass its enhanced supervisory approach. In January 2015, the SFC sought court orders against current and former directors of First China Financial Network Holdings, a Hong Kong-listed issuer, to pay Rmb18.7m to compensate First China's shareholders for a breach of directors' duties. Later in February, it banned the former CEO of Ping An Securities for a year for acting as a nominee in a number of suspicious transactions and failing to ensure that sufficient anti-money-laundering procedures and training were in place. The regulator fined the company HK$6m in July 2014 over the same issue.

Insider trading is of course an important focus of SFC enforcement. According to the commission's annual report for 2015, it investigated 110 and 111 cases on insider trading in 2015 and 2014, compared to 74 and 67 cases in 2013 and 2012. Besides, in January 2016, the Court of First Instance in the landmark ruling of the SFC against Young & Lee decided that Section 300 of the SFO (which prohibits the use of fraudulent or deceptive schemes in transactions involving securities) is not restricted to transactions involving local listed securities, but also applies to local transactions involving overseas listed securities.

Breaking new ground

Actions ensured that Hong Kong still sets the benchmark for the region

Other notable securities enforcement cases over the past two years include:

- October 2014: the Market Misconduct Tribunal (MMT) ruled that Tiger Asia Management engaged in market misconduct and ordered that the company and an executive be banned from trading securities for four years (see blue box on the next page).

- February 2015: the SFC won a landmark winding-up case in the Hong Kong courts against China Metal Recycling, a Cayman Islands-incorporated company that fraudulently listed in Hong Kong.
- July 2015: the SFC announced its first case for breaching price-sensitive information (PSI) disclosure rules against AcrossAsia. It commenced proceedings in the MMT against Mayer Holdings and Yorkey Optical International for the same reason in March and April 2016, respectively.
- 12 July 2016: the last hearing in the long-running case against CITIC Pacific for nondisclosure of a material event in October 2008. A judgement is expected to be handed down towards the end of 2016.

Long search for new enforcement chief

SFC found it hard to replace Mark Steward

One systemic weakness in Hong Kong, however, is the difficulty the SFC has had in localising its head of enforcement, a role traditionally given to a foreigner. When Mark Steward, former head of enforcement, retired in September 2015 after nine years in the role, it was interesting that it took the Commission the best part of six months to announce a replacement (which suggests succession planning challenges); and the person selected was not a local hire or promoted from within, but the former director of enforcement at the Ontario Securities Commission, Thomas Atkinson, who was recruited through an international headhunter. This is not to suggest that the SFC should not bring outside regulators to Hong Kong. On the contrary, they have contributed a lot to the city, have great depth of experience, and clearly have more freedom of action than a local regulatory official would have. Still, it says a lot about the tight-knit business and political culture in Hong Kong that no local lawyer or official has so far been promoted to this position.

HKEx is not seen as a tough enforcer, but it is becoming slightly more transparent

As in previous surveys, we rate HKEx less well for its enforcement capabilities and actions. As a for-profit-listed company, the Exchange has a restricted range of enforcement powers, a more limited appetite for taking disciplinary action against its clients (listed companies), and puts fewer resources into the task. One thing the exchange does do well, however, is write clear and detailed announcements about reprimands it issues against directors or companies. The only problem is that you have to know where to look for them - on the News Releases page on its website (and even then you need to trawl through every item to find one - surely this could be better organised). More positively, from 2015 onwards, HKEx has started publishing detailed statistics on enforcement investigations by target (company or director) and issue (director duties, late or qualified reporting, prolonged suspension of trading, and so on).

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Tiger Asia's settlement with the regulator amounted to US$44m

Tiger Asia banned from trading securities

In 2012, the US SEC found New York-based hedge fund Tiger Asia and its portfolio manager Sung Kook "Bill" Hwang guilty of insider trading. The original offences were committed in 2008/09, when Tiger Asia short-sold two Chinese bank stocks based on material nonpublic information it received relating to impending private-placement offerings. The short positions were subsequently covered with the placement shares purchased at a significant discount to the stocks' prevailing market prices. The settlement with the SEC was US$44m, vis-à-vis the US$16.7m in illicit profits that were made by the hedge fund in the trades.

SFC has the ability to bring a case against parties with no physical presence in Hong Kong

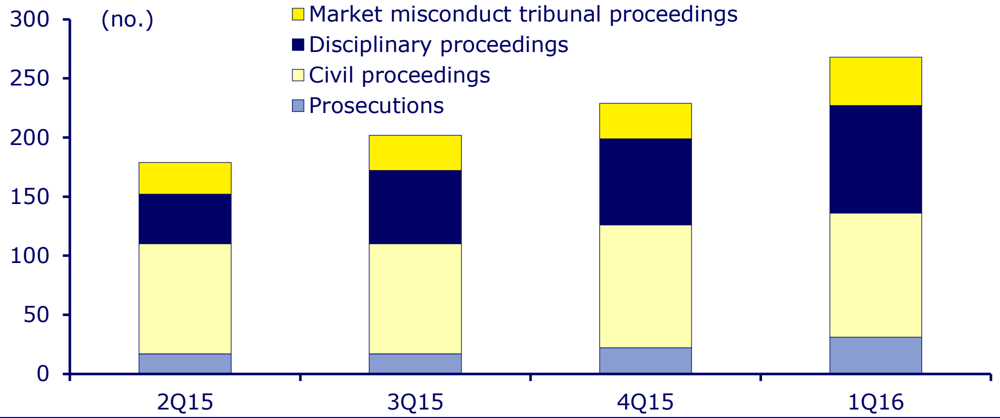
Despite Tiger Asia having no physical presence in HK, the SFC similarly brought a case against the hedge fund and its managers. In 2014, the Market Misconduct Tribunal (MMT), an independent body in Hong Kong with jurisdiction over Hong Kong market misconduct and breach of disclosure offences determined that Tiger Asia has indeed engaged in market misconduct, and gave it a four-year cold shoulder order (banned from trading securities in Hong Kong, the maximum sentence was five years). In addition, the SFC recovered HK$45m (US$5.8m) for the benefit of victims.

The case was significant because it was the first case directly presented to the MMT by the SFC, signalling the start of a period of more aggressive enforcement by the regulator; prior to 2012, proceedings could only be initiated by the Financial Secretary of HK.

Enforcement proceedings are on the rise

Figure 73

Persons subject to ongoing or concluded enforcement proceedings



Source: CLSA, SFC

Political and regulatory environment

Score stays at 69%

Over the past two years, Hong Kong has witnessed some landmark policy decisions that reflect the core strength of its regulatory system - the SFC's principled stand against dual-class shares being the prime example. However, the fact that there is still no clear government policy or strategy on CG drags down the score. Why is such a strategy important? We would argue that Hong Kong needs to think more clearly, in particular about how its capital market differs from, and competes with, China in the coming years. Nurturing Hong Kong's higher standards in regulatory quality and investor protection would seem a no-brainer, which is one of many reasons why self-interested proposals for allowing dual-class shares make no sense to us.

HKEx pushed hard to introduce WVR

First of all, kudos to the SFC for holding its ground on the weighted voting rights (WVR) issue (dual-class shares). The debate began in mid-2013 when bourses in Hong Kong and the USA began competing to host Alibaba Group's IPO. The climax came in June 2015, after the HKEx issued its long-awaited conclusions to the Concept Paper on WVR released in August 2014, saying that there was support for a second-stage consultation for rule changes.

SFC rejected the idea

Less than a week later, the SFC, which supervises HKEx on listing and other matters, issued a public statement that its board had unanimously decided that it does not support the draft proposals for a second-stage consultation. Finally, in October 2015, the Listing Committee (LC) of the exchange said that it would not proceed with its draft proposal to allow WVR 'at this time' after considering the negative view of the SFC.

A new listing regime is proposed

New listing regime

With WVR put to bed (or perhaps not?), the battleground has moved on to a debate about the right sort of listing regime for Hong Kong. In order to enhance regulatory cooperation and communication in Hong Kong's three-tier system (the government, SFC and HKEC), and reduce the conflicts that HKEx faces as a dual regulator and for-profit listed company, the SFC and HKEx in mid-June 2016 jointly launched a five-month consultation on proposals to enhance the decision-making and governance structure for listing regulation.

Proposed changes will give the SFC and the HKEx more opportunity to communicate

One significant reform proposed is that the CEO of HKEx will no longer have an automatic seat on the LC. A second proposal involves the creation of two new committees above the LC. One is the Listing Policy Committee, which would 'steer' work on listing rule amendments and listing policy, as well as have formal oversight of the work of the Listing Department in the Exchange (including appraising the performance of senior executives of the department). The other committee is called the Listing Regulatory Committee, which would take over the task of deliberating on complicated or sensitive listing cases from the LC (those that have 'suitability concerns or broader policy implications').

Opposition to the reforms has been intense, but we are supportive

Opposition to the proposals have been quite intense. For example, Christopher Cheung Wah-fung, a member of LegCo, issued an open letter to Ashley Alder, chief executive of the SFC, demanding the suspension of the reform consultation as the change is against the principle that government bodies should not be involved in market operations. However, we are supportive of the proposed change. While the new structure will not fully resolve the conflicts surrounding HKEx, it will bring the SFC into the listing policy and regulatory discussion much earlier than at present and should encourage the two regulators to resolve matters more efficiently (as well as take joint responsibility).

Stock Connect has caused market assimilation

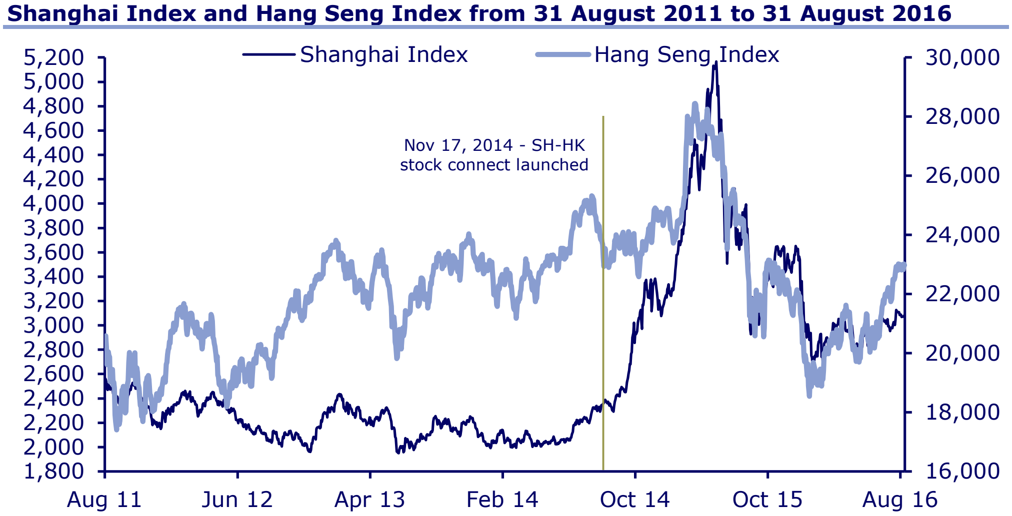
Stock Connect = Price connect!

Shanghai-Hong Kong stock connect was launched on 17 November 2014. Also, from 1 July 2015, eligible mainland Chinese and Hong Kong funds are allowed to distribute in each other's market through a streamlined vetting process. While these changes have brought some trading benefits to both Hong Kong and mainland markets, they also caused the unavoidable increasing integration between the two markets.

Recent HSI rally puts it ahead of Shanghai Index over a five-year period

Figure 74

Shanghai Index and Hang Seng Index from 31 August 2011 to 31 August 2016



Source: CLSA, Yahoo Finance

SFC still has no power to investigate companies or individuals in mainland

One month before launching Shanghai-Hong Kong Stock Connect, the SFC and the China Securities Regulatory Commission (CSRC) signed a memorandum of understanding (MOU) on strengthening cross-boundary regulatory and enforcement cooperation. However, significant systemic bottlenecks remain in reality. Despite the increasing number of issuers from mainland listings in Hong Kong, the SFC still faces limitations on conducting investigations in the mainland or accessing audit working papers there.

One country, one system?

Questions over ICAC's independence and effectiveness

Another threat to public governance in Hong Kong - and an area where we have marked this section down - is corruption and public-service ethics. This has involved both senior officials and leading businessmen in Hong Kong and raises questions about the independence and effectiveness of the Independent Commission Against Corruption (ICAC).

First the individuals. In December 2014, property tycoon Thomas Kwok of Sun Hung Kai Properties and Rafael Hui, a former chief secretary of Hong Kong, were convicted of bribery and given prison sentences of five years and seven and a half years, respectively. Then, in January 2015, allegations of impropriety were raised against the territory's former chief executive, Donald Tsang, making him the highest-ranking Hong Kong official to face a corruption trial. During a hearing on 18 December that year, he pleaded not guilty to wrongdoing in public office. The High Court trial has not yet been set, and it is not expected to take place before 2017.

Public believes Beijing pressured ICAC to dismiss senior official

As for the ICAC, it cannot seem to stay out of the news. The latest controversy regards the recent and sudden departure, without a proper explanation, of Rebecca Li Bo-lan, former head of operations and deputy commissioner. The general public believes that the ICAC was under pressure from Beijing to fire Li, allegedly to stop her investigating a HK$50m deal between CY Leung, the chief executive of Hong Kong, and Australian engineering firm UGL. Whatever the truth of the matter, that people are now prepared to believe the worst of the ICAC does not augur well for its future.

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CKI and Power Assets - CG fiasco

One of Li Ka Shing's famous quotes is '*It is the man who goes to the table to ask and squeeze for the last nickel who is never happy*'. However, the managers and directors of Cheung Kong Infrastructure (CKI) seemed to have completely forgotten this lesson from the founder when it came to the proposing the merger between CKI and Power Assets.

In September 2015 CKI (75.7% owned by CK Hutch) offered 1.04 shares for each share of PAH in a proposed merger deal. The exchange ratio was based on the average of closing prices of the previous five trading days before the announcement. The catch was that this ratio was close to an all-time low ratio between the two stocks - the five-year average ratio at the time of the merger announcement was 1.3x. For more details please see our note ***Marrying for money***.

Never ignore the lessons of the Chairman

CLSA's fair value estimate of the ratio at that time was 1.16. Our meetings with the investors suggested that almost all were unhappy with the merger ratio of 1.04 and most of them believed a fair ratio would be 1.15-1.20x. (***Will the Superman blink?).***

At the time the CLSA meetings with clients suggested unhappiness

In October 2015 CKI decided to raise the ratio to 1.066 (***Superman blinks but not enough***), which was based on one-month average trading prices of the two companies. This was still some way from fair value, as well as the historical trading range and investors who were not going to vote in favour of the merger at 1.04 wouldn't have changed their minds at 1.066.

Governance issues are lingering in the form of potential special dividends

However, the group, probably overconfident after CKH-Hutch merger, ignored the minority shareholders' concerns. The CKH-Hutch merger, despite being relatively unfavourable for Hutch's minority shareholders, was approved as it led to value unlocking, which benefited Hutch shareholders as well. However, there was no such value unlocking in the CKI-PAH merger. The group proposed to pay out a special dividend in the event of the merger. However, the dividend was to be paid from cash that belonged to Power Assets and would have been paid to shareholders of Power Assets as well as those of CKI post-merger. It was CKI shareholders who were the beneficiaries of this deal with Power Assets getting nothing in return.

In the merger circular independent financial advisor (IFA) tried to justify the deal through analyses of 'contribution' and 'comparable companies', which ended up with an even lower ratio than the proposed exchange ratio. We believe these valuation methods were flawed because either these do not give any value to PAH's cash stash or used 15x PE for PAH's UK business while using 20.4x for CKI's or ended up effectively valuing cash on PAH's BS at 1x but debt at as high as 3x. ***(Don't argue with Mr Market)***

Independent financial advisors could not convince the market

Shareholders saw through these and the proxy advisors - ISS and Glass Lewis - recommended shareholders vote the deal down. Both the proxy advisors had scathing comments about the deal. ISS wrote '*There are material conflicts of interest inherent in this merger and the governance structures of CKI and PAH are not sufficiently robust to ensure that the transactions were reviewed as independently and objectively as minority shareholders might hope.'* (***Status quo a no-go***)

Proxy advisors recommended shareholders to vote the deal down

We were hopeful until the end that the group would follow its founder's maxim and leave something on the table for minority shareholders. However, it decided to go for voting at the merger ratio at 1.066x and shareholders turned down the proposal (***Shareholders strike back***) by a huge margin. Small mom-and-pop shareholders reportedly heavily criticised the management and directors of the two companies at the meeting held to approve the merger.

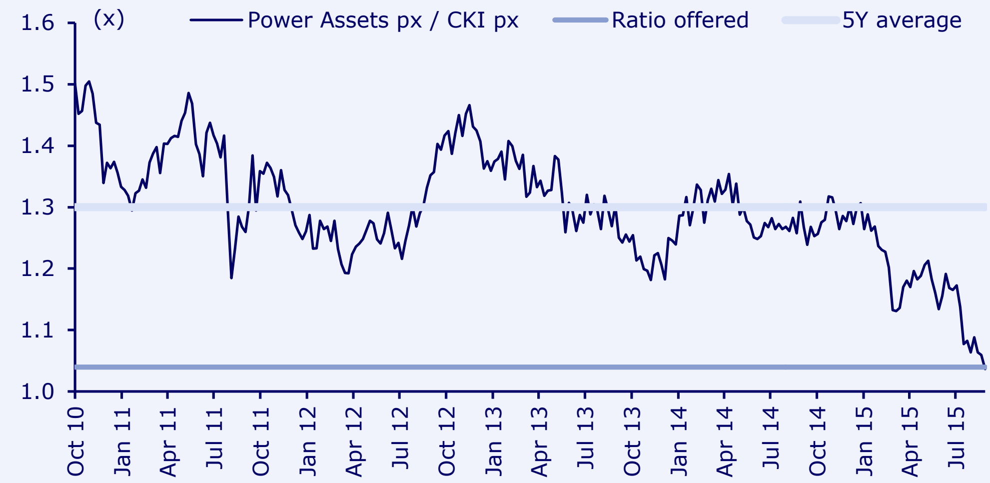
The CG issues that were exposed by this proposed merger have not ended yet. The group was willing to pay a special dividend of HK$8/share if the merger went through. It is now nearly a year since the deal was first proposed and even today Power Assets, which would have less need of cash compared to the combined CKI-PAH, has not paid any special dividend. It has been sitting on close to HK$60bn of cash for nearly 2.5 years now, earning negligible returns but not paying it to minority shareholders.

CKI shareholders was about to get a free ride

So, how did the shareholders who turned down the deal fare? Despite Power Assets not paying out the cash on its hand as dividends, the ratio of Power Assets to CKI's share price as of last close was 1.14 - a 7% premium to the merger ratio. Over this period, PAH has also offered a higher dividend yield than CKI. The effective ratio would have been much higher if Power Assets had paid a special dividend. We would urge the management of Power Assets to heed another piece of advice from Mr Li: '*In Chinese we have a saying: If you want to be successful, whatever your business or position, you need to accept different opinions and different people',* and pay a special dividend.

Ratio of share prices of Power Assets to CKI for five years before proposed merger

Ratio of share prices of CKI to Power Assets for five years before proposed merger



Power Asset shareholders have the final say

Results of the votes at the PAH Court meeting for approving the merger scheme

Resolution	Number of votes	
	For	Against
To approve the scheme (m)	347.5	336.9
Total votes (%)	**50.77**	**49.23**
For votes required to pass the resolution (%)	75.0	
Disinterested shareholders voting for and against (%)	**26.64**	**25.83**
Disinterested s'holders needed to vote against to reject proposal (%)		10.0

Source: CLSA

Accounting and auditing

Score falls from 72% in 2014 to 70% in 2016

The score for this section has been falling since 2010, driven down by the ongoing lack of an independent audit regulatory regime. Some progress was made in the past two years to solve this long-standing issue, while the Hong Kong Institute of Certified Public Accountants (HKICPA) still acts as the sole regulator of the audit profession, despite also providing training and membership services to about 40,000 accountants in the city.

Hong Kong will adopt the new audit report from December 2016

The good news is that Hong Kong is going to adopt the new audit report proposed by the International Auditing and Assurance Standards Board from December 2016. The most significant change of the new form is the disclosure of key audit matters, which will help shareholders understand the principal areas of concern that auditors have regarding materiality or uncertainty. Some pioneers are seen in the market, such as the Swire Group, which adopted the new audit report for its 2015 annual reports.

Let the FRC lead

FRC has limited powers. HKCIPA still main audit regulator in Hong Kong

Under the current regime, the Financial Reporting Council (FRC) investigates cases of auditing irregularity and passes them to the HKICPA if it believes disciplinary action is warranted. It then typically takes the HKICPA several months or more to decide what to do, while the sanctions imposed, if any, are sometimes unsatisfactory.

Government plans to make FRC the independent audit regulator, eventually

In a widely anticipated move, the Financial Services and the Treasury Bureau (FSTB) of the Hong Kong Government published conclusions in June 2015 to a consultation paper on proposals to improve the regulatory regime for auditors of listed companies in Hong Kong. The FSTB, at last, said it would prepare amendments to the Professional Accountants Ordinance and the FRC Ordinance for the 2016-17 legislative year, with a view to making the FRC the independent audit regulator for Hong Kong. That said, nothing happened before the end of August 2016, when the term of the current Legco ended. The proposal could now go forward in late 2016, although it is highly unlikely that LegCo would pass the new law until 2017 at the earliest, meaning Hong Kong will not have an independent audit regulator until 2018 at the earliest, or possibly later. At this rate, it is not impossible for Hong Kong to be the last or second-last regime in Asia to establish an independent auditor regulator! The other two markets without one are India and the Philippines.

No rotation rule or whistleblower protection for auditors in Hong Kong

Hong Kong also loses points here for not having a standard on auditor rotation, nor providing a whistleblower protection rule for auditors in Hong Kong, thus it is hard to expect auditors to help much on detecting wrongdoers.

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Superb Summit's credibility questioned by Muddy Waters

Superb Summit (1228.HK) used to engage in exploitation and management of timber resources in China and market and sell a wide range of timber products. Meanwhile, it started to change its focus on resources products in China, including trading and subsequently on coal-to-chemical projects.

Muddy Water accused Superb Summit of being a fraud in November 2014

On 19 November 2014, Muddy Waters published a report claiming Superb Summit was a fraud. The accusations were summarised as follows: Superb Summit's reported 2013 revenue represented revenue of Tianjin Libao, a coal-trading company that Superb Summit claimed to have acquired in 2012. Muddy Waters argued the acquisition was a fake by referencing the Tianjin SAIC filing and hence argued that the reported revenue should have been zero in 2013; the acquisition of Beijing Jinfeite, at a cost of Rmb1.5bn could be a fraud, given it is a one-man chemical engineering consulting business with no real assets or worthy patent; and it had not announced a material contribution from any of its new business lines in the past seven years.

SFC asked for suspension of trading of Superb Summit's shares

Superb Summit's shares have been suspended since November 2014

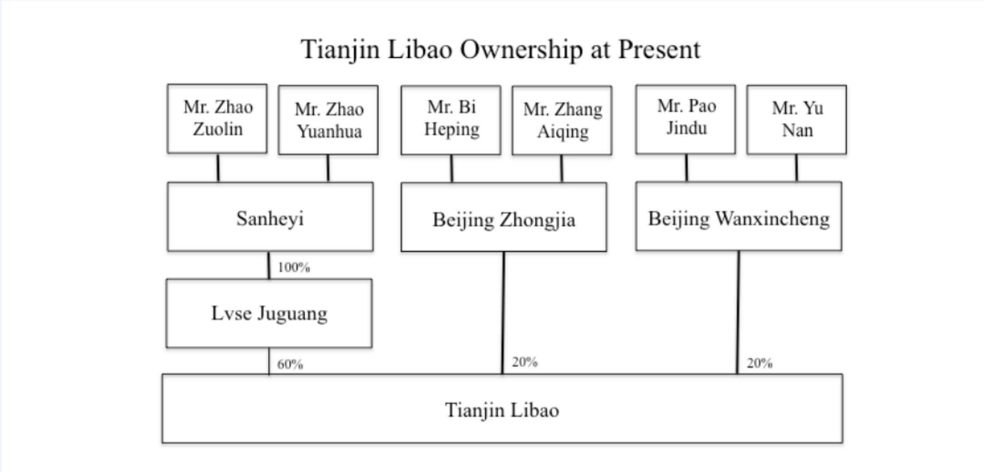
Superb Summit asked for trading suspension on 20 November 2014, and it issued a statement nearly two months later saying the Muddy Waters report contained 'misleading statements and fabricated contents', but this is still pending detailed clarification. On 15 December 2015, the SFC directed HKEx to suspend trading of Superb Summit's shares with a rarely used provision (Rule 8(1)), which says the regulator can halt trading in a stock if it believes a company has given 'any materially false, incomplete or misleading information', has failed to comply with SFC rules, or if the SFC deems it is in the public interest to do so. The company's share trading never resumed afterwards. No specific reason was given, and an SFC spokesman declined to comment on the order. Trading of the company's shares remain suspended as of this report's publication.

Likely inflation of asset values, which involve high element of judgement and estimates

This case suggests that there is a higher risk of accounting fraud when management judgement or estimates are involved. The acquisition of Beijing Jinfeite, for instance, resulted in HK$1.5bn intangible asset determined by valuation method, which included estimates of future profitability/cashflows of projects, which are highly uncertain especially for a private company and with relatively short operating history, and probably relates to a *hot* theme (coal-to-chemical, although complex, it was a relatively hot theme in market during 2012-13). The significant impairment of HK$196m in 2014 (or 12.8% of intangible assets) booked from the acquisition incurred in the same year was actually a hint that value was overestimated, and the impairment was likely magnified in 2015 (but the company has yet to publish its 2015 annual results). More measurements may need to be taken to detect accounting fraud that the existing auditing principles fail to detect.

Muddy Waters claimed that Superb did not own major coal-trading subsidiary Tianjin Libao

Tianjin Libao's shareholding as disclosed by Tianjin SAIC at the time



Source: Muddy Water Research, CLSA

Impairment of intangible asset in same year of recognition

Intangible asset movement related to acquisition of Beijing Jinfeite

22. INTANGIBLE ASSETS 22. 無形資產

		Total 總額 HK$'000 千港元
Cost	**成本**	
Balance at 1 January 2013 and 31 December 2013	於二零一三年一月一日及 二零一三年十二月三十一日之結餘	—
Acquisition through business combinations	透過業務合併而收購	1,537,810
At 31 December 2014	於二零一四年十二月三十一日	1,537,810
Accumulated amortisation and impairment	**累計攤銷及減值**	
Balance at 1 January 2013 and 31 December 2013	於二零一三年一月一日及 二零一三年十二月三十一日之結餘	—
Amortisation expense	攤銷開支	102,520
Impairment losses recognised in profit or loss	於損益確認之減值虧損	196,290
At 31 December 2014	於二零一四年十二月三十一日	298,810
Carrying amounts	**賬面值**	
At 31 December 2014	於二零一四年十二月三十一日	1,239,000
At 31 December 2013	於二零一三年十二月三十一日	—

Source: Superb Summit's 2014 annual report, CLSA

CG culture

Score rises slightly from 51% in 2014 to 53% in 2016

Hong Kong's CG Code last underwent a general revision in 2012 to improve the governance standards of companies. Now that four years have passed, it can be seen that the revision did bring some positive effects to the practices of listed companies. Meanwhile, certain shortcomings are more apparent and led to a slight raise in the score for this section.

High compliance rate of the revised CG Code among companies

In May 2016, HKEx published its second report tracking compliance among listed issuers with the CG Code. The first covered the 2014 annual reports for 1,237 issuers with December year-ends, while the second looked at 318 issuers with March year-ends. Overall, 98% of companies were found to have complied with at least 70 of the 75 Code provisions, but the ratio of companies following all 75 provisions dropped noticeably to just 35% for December firms and 25% for March.

Our company analysis found a wide gap of CG standard between large caps and SMEs

In our sample company analysis of 15 large caps and 10 SMEs, the practices of most companies are promising. Although there is still much form over substance, some key findings included:

- All companies provided a continuous professional development programme to directors, and a record of training received
- Most large caps provided induction or orientation briefing materials to new directors (and six SMEs did so too)
- Two-thirds of large caps have a well-diversified board and six SMEs had an above-average diversified board
- 60% of large caps did a board diversity study, while only one SME did
- 8% of companies have independent nonexecutive directors as chairmen and another 24% have nonexecutive directors as chairmen
- Only a few companies have adopted board evaluation procedures, with the most common approach being to send out questionnaires to directors individually

Shareholder engagement and activism

Strong shareholder rights, no e-voting

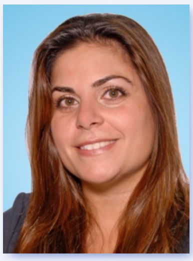
Hong Kong has a strong tradition of voting by poll and strong minority shareholder protections in some aspects. For example, in November 2015, shareholders voted down a proposed merger of Cheung Kong Infrastructure and Power Assets (PAH) on the basis that PAH was undervalued. Despite the prevalence of polls, Hong Kong has never shown interest in electronic voting.

Shareholder engagement in Hong Kong is still at an early stage

It is difficult for retail shareholders to attend AGMs since there is no central depository system with retail names (ie, no scripless shareholdings, as in Singapore, where retail names are on the share register). Only a small number of companies, such as CLP, release detailed AGM minutes with Q&A. Institutional investor participation in public CG advocacy is limited, with only a few frequently mentioned names appearing, such as APG, Blackrock and Aberdeen. Hong Kong's three domestic asset owners, the Hong Kong Monetary Authority, the Hospital Authority and the Jockey Club, are non-existent from an active ownership point of view.

Two high-profile cases of shareholder activism over the past two years

There have been two high-profile cases of shareholder activism over the past two years. One is the ongoing battle between the Bank of East Asia and Elliott Advisors, which most recently filed legal proceedings in July 2016 against the bank for diluting minority shareholders when issuing shares and its entrenched management team. The other was a campaign led by Blackrock Asia-Pacific, which in early 2016 sought to block G-Resources Group from selling its major asset, a gold mine, and entering an entirely different industry. The deal, however, was approved by 58.8% of votes in March.



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Elliot challenge BEA on corporate governance

Minority shareholder activism against publicly listed companies in HK is relatively rare

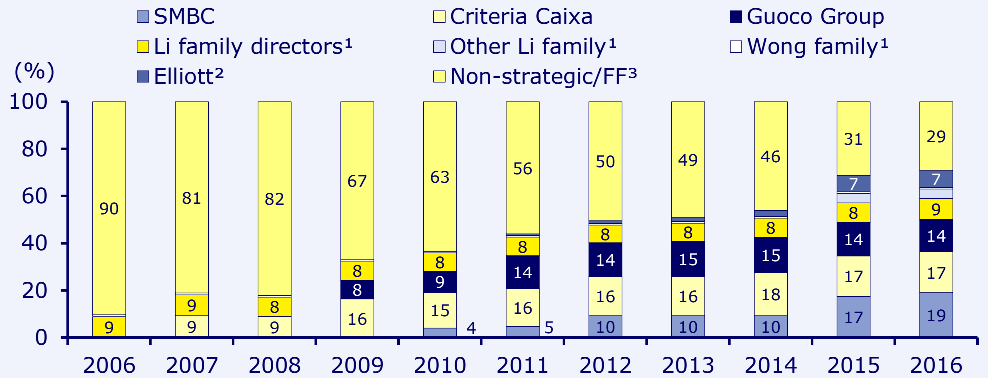
Minority shareholder activism against publicly-listed companies in HK is relatively rare. Section 740 of the Companies Ordinance provides that either shareholders holding 2.5% of the voting rights or at least five shareholders of the company may apply to the court for an order requiring the company to disclose its records or documents. Elliott Advisors (plaintiff), used Section 740 to serve a summons on BEA and all 18 board directors, alleging that the bank had abused its mandate when it agreed to sell a 9.53% stake to Sumitomo Mitsui Banking in September 2014.

The placement and subscription of shares took place in March 2015. In June 2015, The Court of First Instance (CFI) found that the plaintiff's application had been made in good faith and that the inspection was for a proper purpose. According to the CFI's judgement: the BEA board failed to consider properly the proposed placement; BEA did not appear to be in need of additional capital immediately proper to the proposed placement; the proposed placement was not an appropriate means of raising capital for BEA; and the potential for enhanced collaboration between BEA and SMBC did not justify the proposed placement. The CFI also rejected BEA's argument on confidentiality.

Following this judgement, Elliott commenced legal proceedings against BEA and a number of former or current directors personally in the form of an unfair prejudice petition; Elliott stepped up the publicity of its requests for change and/or the sale of the bank; Elliott, the Li family and SMBC increased their shareholdings; BEA set out more aggressive strategic targets, made some changes to its board of directors and decided to withdraw one of its proposed resolutions for its 97th AGM; minority shareholders signalled discontent both verbally and via poll results for specific other resolutions at the same AGM. These developments have provided support for the bank's share price.

Bank's founding families and strategic investors now account for >70% of BEA's shareholder base

Evolution of BEA's shareholder base



¹ Two of the bank's founding families. Other Li family interests were provided in Elliott's unfair prejudice petition dated July 2016. ² Largely based on Elliott's exchange filings and legal documents from 2015 onwards. ³ Two investment managers held a collective 12.11% stake in 2006. FF refers to free float. Source: CLSA, Company, Bloomberg, Elliott, Newswires, Hong Kong Exchange, St. James Press

Political risk must be considered when making investment in Hong Kong

Political risk for investors

Just as in China, and for the same reason, investors in Hong Kong face political risks when buying H shares. Examples include the missing directors of Guotai Junan International and Fosun International in December 2015 and the nosedive of Macau's gaming revenue after China launched its anti-graft campaign in 2013.

PICC P&C bought shares of PICC Health at a bad price to perform "national service"

Another recent example is the purchase of new shares of PICC Health by PICC P&C in June 2016. Although this transaction accounts for only 2.3% of PICC P&C's total net asset base, the valuation seemed excessive. The price offered implied a price to book value of 3.5x, compared to the average among Chinese H-share issuers of just 1.2x. Even worse, PICC Health has made consistent losses over the past few years - its after-tax loss in 2015 was Rmb135m - while the average industry return on equity was 12% at the time.

Some local associations are not helping on promoting a better CG standard

Mixed signals

Last but by no means the least, CG culture cannot be discussed in Hong Kong without highlighting the contradictory role that some local associations have played in the policymaking process. Despite professing to be a CG believer, the Hong Kong Chamber of Listed Companies, which represents smaller issuers, was a big supporter of WVR and strongly opposed the SFC's plans for a stewardship code. Unsurprisingly, it has taken a high profile in the fight against the new listing regime consultation. Sadly, the policy position of the Hong Kong Institute of Directors also became less clear on WVR following a leadership change in 2015.

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Property tycoon Thomas Kwok guilty of bribery

Thomas Kwok, then joint-chairman of SHKP, was convicted

On 19 December 2014 Thomas Kwok, then joint-chairman of SHKP, was convicted of conspiracy to commit misconduct in public office. Raymond Kwok, the other joint-chairman then, and younger brother of Thomas, was cleared of all charges.

The conviction on Thomas was made after an arrest almost two years back. On 29 March 2012 SHKP announced that 'joint chairmen Thomas Kwok and Raymond Kwok were arrested by the ICAC in connection with an investigation into an offence under the Prevention of Bribery Ordinance'. This was after a 18 March 2012 arrest made by the ICAC of Executive Director Thomas Chan. Then on 13 July 2013 the ICAC (Independent Commission Against Corruption) pressed charges.

SHKP reacted quickly after the conviction, announcing on the same day that Thomas Kwok had resigned as chairman, managing director and executive director of the company with immediate effect; and Adam Kwok, son of Thomas Kwok, ceased to be the alternative director to Thomas Kwok but is appointed executive director.

Thomas Kwok resigned and his son, Adam ceased to be an alternative

The case was unexpected, and not quite a textbook example of bad CG, as the developer had enjoyed a good reputation in Hong Kong in terms of delivering quality apartments, treating employees fairly and contributing to the society in various ways. Also, the 'bribe' amount was small, and no solid benefit for SHKP was established. Rafael Hui, the former Chief Secretary of Hong Kong, was found guilty of the following charges: not disclosing the rent-free use of two luxury flats owned by SHKP and concealing from the government an unsecured HK$3m loan from a subsidiary of SHKP while in office. SHKP responded to the findings quickly and professionally after the conviction of Rafael Hui, but must have known that providing the rent-free flats and an unsecured loan, posed risks.

SHKP has been playing catch up

SHKP's share-price performance versus HSI property

Source: CLSA

Downgrade watchlist

What to avoid

Factors that could force the country's score to fall in 2018:

- No tangible improvements in financial reporting
- No impact of the stewardship code
- HKEx has another go on WVR introduction
- No independent audit regulator
- No improvement in board diversity, especially in gender

Quick fixes

What to fix

- Better disclosure on large unexplained expenses
- More communication among regulators
- Whistleblower protection for auditors
- An independent audit regulator
- More detailed and consistent enforcement data from HKEx
- Introduce board evaluations
- Improve nonfinancial (CG) reporting further, especially around board committees, remuneration policy

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India - A masala of good and bad

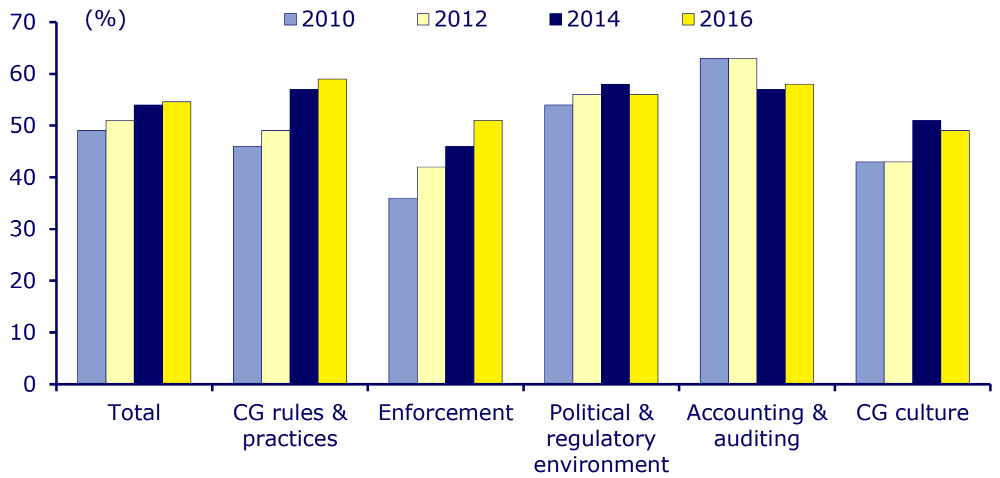
Key issues and trends

- New listing and disclosure regulations issued, backed by law
- RPT rules diluted in both the listing regulations and the Companies Act
- Balance sheets at PSBs will be cleaned up by March 2017
- Institutional and retail investors are both stepping up to the plate
- Industry looks to self-regulate by signing a model code of conduct for ethical business practices

Overall score: Rises from 54% in 2014 to 55% in 2016

Figure 75

India CG macro category scores



Source: ACGA

A slew of good things sprinkled with bad

The title says it all. For every good thing that has occurred in India's CG, there was something bad to add to the mix. India has a new set of listing regulations from the Securities and Exchange Board of India (SEBI) that include a slew of good things: the listing rules are now enforceable by law; continuous disclosure rules have been strengthened; and exchanges are empowered to fine, suspend and delist. But unfortunately SEBI then bowed to pressure and diluted its related-party transaction rules to align them with the fairly recently amended Companies Act 2013.

Substantive reports but loses with boilerplate, or worse, meaningless disclosure

Annual reports are more substantive, yet there is still boilerplate, or even worse, meaningless disclosure. In one business-responsibility report, when asked of the number of permanent employees with disabilities, the company stated that because it is an equal opportunity employer, it does not 'have a system of compiling such data'. This is not a believable statement.

Independence of RBI threatened

India had a much-lauded economist as its central-bank governor, Dr Raghuram Rajan, and to his credit forced public-sector banks to recognise their nonperforming assets, with the promise that bank balance sheets would be fully provisioned and clean by March 2017. Even as this work was ongoing, Dr Rajan chose to leave at the end of his tenure amid personal attacks from a minister of parliament, bringing into question the independence of the Reserve Bank of India (RBI).

Act is a moveable feast

The newish Companies Act continues to be a moveable feast, with a second round of amendments tabled in parliament before the first round has been fully implemented. As a senior official at the Ministry of Corporate Affairs (MCA) told ACGA, 'we are just trying to bring some harmony and balance to the Act'. But it is moving forward in some areas: the National Company Law Tribunal and the National Company Law Appellate Tribunal were both constituted in June 2016.

Give the market three to five years, regulators say, for reforms to make an impact

As we study India, it is telling that both MCA and the securities regulator told ACGA to give the market three to five years to fully assimilate the regulations in spirit. While we appreciate that reform takes time, it seems a pity that it is taking much of corporate India such a long time to wake up to governance best practices.

CG rule and practices

Rises from 57% in 2014 to 59% in 2016

India registered a rise in this section as regulators have been quite busy over the past two years, bringing in a slew of regulatory changes that affect institutions across the board. SEBI and the Insurance Regulatory and Development Authority (IRDA) upped the governance ante.

LODR consolidates listing agreements – fully enforceable by law

SEBI was the busiest, ushering in the new Listing Obligations and Disclosure Regulations (LODR), a mandatory dividend policy for companies, and new insider-trading regulations. Announced in September 2015, LODR was not merely a series of amendments to the listing agreement, it was a replacement - consolidating and streamlining existing agreements for different segments of the capital market - and fully enforceable by law. This is a crucial point, since market participants had tried to argue the listing agreement was only a contract between issuers and stock exchanges, and SEBI could not enforce it, since it was not a participant in the agreement. However, many markets have given 'statutory backing' to the listing rules, allowing securities commissions to take enforcement action when necessary.

Exchanges empowered as front-line regulators

One of its main features, though, is the 'obligations of stock exchanges and provisions in case of default', which provides exchanges with the powers to sanction noncompliant entities (see also Enforcement section), including:

- Imposition of fines
- Suspension of trading
- Freezing of promoter/promoter group holding of designated securities, in coordination with depositories

Continuous disclosure rules overhauled

Furthermore, the regulator overhauled continuous disclosure rules, dividing them into two categories: what must be disclosed, 'without applying any test of materiality', and those that need to be 'if considered material'. A more comprehensive list of material events has been provided, leaving less room for companies to complain that guidance has not been given. But the question remains: how effective will they be? There are only so many material events that a regulator can list, and these change from sector to sector. Already, one company has been less than compliant (see Ricoh India under CG culture subsection) and it took a few months to suspend its shares.

SEBI mandates dividend policy, but will it be another box-ticking exercise?

In July 2016, SEBI amended LODR again and mandated dividend policies: the top-500 companies by market cap must formulate and disclose a dividend policy on their websites and in annual reports. Since dividend distribution by Indian companies is sketchy at best, and investor groups have been complaining about this for years, SEBI decided to act. While many investors welcome the rule, some believe it will only result in a box-ticking response. We shall see.

Market up in arms on new onerous insider trading rules

On insider trading, SEBI's amended Prohibition of Insider Trading Regulations came into effect in May 2015. While many market participants are up in arms about this rule on the basis that it is too onerous, with the definition of insider being too encompassing, once again it is probably best to wait and see.

IRDA one of the last regulators to align CG guidelines with the Act

Meanwhile, the insurance regulator published draft CG guidelines on 1 February 2016 to bring its existing guidelines, issued in August 2009, in line with the Companies Act. Following a consultation, the guidelines were issued on 18 May 2016 and cover CG practices, appointment of senior management and statutory auditors. Additions to the guidelines included fit-and-proper criteria for directors and the mandatory establishment of certain committees, including those for audit, investment, and risk management.

Reversing the clock

New BJP government watered down the new Companies Act 2013

Even as regulators rolled out new rules, there were a few rewrites to the regulatory script that reversed gains minority shareholders made in 2014. In *CG Watch 2014*, we noted that even before the ink had dried on the Companies Act 2013, the new BJP-led government had started bowing to pressure on related-party transactions. But worse was to come as the government amended the Act to aid 'ease of business'. In May 2015, the new Companies (Amendment) Act 2015 came into force and, among other things, diluted rules on RPTs by replacing a requirement for a special resolution of minority shareholders (a 75% vote) to approve major transactions with just an ordinary resolution (50%).

SEBI partially caves on RPT rules, maintains that related parties not allowed to vote

SEBI initially held its ground, but in September 2015 it too succumbed to pressure from the market and government, and loosened RPT rules in the new Listing Regulations to align them with the Act. But unlike the amended Act, SEBI at least maintained that related parties must 'abstain from voting on such resolutions whether the entity is a related party to the particular transaction or not'.

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Tata deal with NTT had a buyback clause which laws do not agree on

Tata Sons and NTT Docomo: Pre-guessing regulator proved risky

In November 2008, NTT Docomo entered into an agreement with Tata Sons to acquire 26.5% stake in Tata Teleservices (TTSL) for Rs127bn. The agreement had a put option built in, which allowed Docomo to sell back its stake in TTSL to Tata Sons for higher of fair value or 50% of cost of acquisition after five years if certain performance metrics were not met.

In November 2013, RBI notified amendments to Foreign Exchange Management Act (FEMA) regulations, which prohibited FDI into India with built in assured returns. With Tata Teleservices in losses, in July 2014, Docomo exercised the put option in July 2014 and called upon Tata Sons to acquire its entire shareholding at Rs58/share (50% of the acquisition cost) or find a buyer instead.

Tata wanted to uphold agreement . . .

. . . but court processes and delays led to Docomo approaching international court of arbitration

Tata Sons-Docomo issue of exit has been hanging for three years now

With Tata being unsuccessful in finding a buyer, it was obliged to buyback the stake itself. However, after taking an opinion from the Finance Ministry, the RBI did not permit this transaction as TTSL's fair value had fallen to Rs23/share and under the revised FEMA regulations, acquisition of shares on a predetermined rate (assured return) was not allowed.

Docomo subsequently moved the London Court of International Arbitration in 2015. In June 2016, The International Arbitration Court ordered Tata Sons to pay US$1.2bn to Docomo for breach of contract. Following this, Docomo approached the Delhi High Court in July 2016 to enforce the arbitral award. Subsequently, Tata Sons has placed the entire amount with the High Court.

This is an example of how a well-meaning corporate group aiming to abide by the shareholders agreement is forbidden from abiding by it due to regulatory/policy level changes from the Government of India.

Timelines

Nov 08	**NTT Docomo acquires 26.5% stake in TTSL with a put option**	**Jan 15**	**NTT Docomo moved the London Court of International Arbitration**
Nov 13	**FEMA regulations modified to prohibit assured returns in FDI**	**Jun 16**	**International Arbitration Court ordered Tata Sons to pay US$1.2bn to NTT Docomo**
Jul 14	**NTT Docomo exercises put option to sell entire stake at 50% of acquisition price**	**Jul 16**	**NTT Docomo approached Delhi High Court to enforce the arbitral award**
Nov-Dec 14	**RBI/govt prohibited Tata Sons from buying back TTSL stake from NTT Docomo as it was**	**Aug 16**	**Tata Sons have placed the entire US$1.2bn with the High Court**

Source: CLSA

Enforcement

Rises from 46% in 2014 to 51% in 2016

Enforcement showed the most progress in our survey this year. Old cases continue, while the RBI, SEBI and the two national exchanges, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSEL), have all extended their enforcement efforts.

RBI intent on cleaning banking sector

The data reflects the extent to which RBI has been intent on cleaning up the banking sector. Whereas it penalised only one bank in 2014, the following year it issued fines against 23 banks for various infractions, including failure to follow loan and know-your-customer guidelines and anti-money laundering norms. Then in July 2016, it imposed monetary penalties totalling Rs270m (US$4m) on 13 banks, while eight more were advised to place 'appropriate measures and review them from time to time to ensure strict compliance of KYC (know-your-customer) requirements and FEMA (foreign exchange management act) provisions'. The investigation into these 21 banks, which commenced in late 2015, found 'weaknesses in the internal control systems, management oversight and violation of certain regulatory guidelines issued by the Reserve Bank'.

Enforcement disclosure still lags on SEBI website

While such data is fairly easy to find on RBI's website, SEBI continues to disappoint when it comes to effective disclosure of specific regulatory activities. The information is there, however, if you have the time to troll through all its orders.

Regulator not always successful in testing its new powers

The regulator has been testing its new powers, not always successfully, as was with Vinod Hingorani case. Hingorani was the first person to be jailed by SEBI (in December 2014) using its new powers under the Securities Law (Amendment) Act 2014, which allows the regulator to jail a person when trying to recover funds. But in March, the Bombay High Court ruled that 'ordering the arrest and detention for not giving a proposal of repayment is a sheer abuse of power' and set aside the detention saying it was 'patently illegal and arbitrary'. But is this SEBI misusing its powers or the judiciary being unable to accept the regulator's new powers?

SEBI sends strong message to market on investment schemes

SEBI has had more success pursuing collective investment schemes. In September 2015, it levied its highest fine, Rs73bn, against PACL, a Delhi-based property developer, which it has been pursuing since 1998, and four of its directors, for raising money from the public without registering with SEBI. Then in December, to send a strong message to the market, the regulator initiated proceedings against the company, attaching the assets of the company and its promoters and directors, because it failed to refund Rs491bn to its investors as SEBI had directed. SEBI is auctioning off the properties to recover money owed.

Mixed results in insider trading cases

Insider trading cases, unsurprisingly, continue to bring in mixed results. In March 2016, the regulator ordered that illegal gains worth more than Rs14m be impounded. Abhijit Rajan, former CMD of Gammon Infrastructure, and three other entities had made the money in an insider-trading case. SEBI had brought the case against Rajan in 2014. In the same month, it dropped a case against Reliance Petroinvestments, a unit of Reliance Industries, that it had been pursuing for nearly nine years. It did so on the grounds of an 'absence of any evidence'. Ironically, Reliance Industries had offered more than once to a consent order, similar to an out-of-court settlement, but SEBI had refused.

Cases completed on the rise at SEBI

Statistics from SEBI on its work between 2010-11 and 2014-15 show several interesting trends:

- Market manipulation and price rigging accounts for the largest number of new investigations taken up
- The number of new investigations increased over 2011-12 and 2012-13, then declined in the following two years
- Cases completed, however, have been on the rise: from 82 at the beginning of this period to 119 in the middle, and 122 at the end
- After market manipulation, insider trading accounts for the second-largest number of cases completed.

Exchanges now flex their enforcement muscles

Beyond these investigations, SEBI has begun to deploy exchanges to compulsorily delist suspended companies, thereby addressing another longstanding issue clogging the market. On 17 August 2016, BSE delisted 194 companies, while the NSE is delisting 140 in a phased manner, due to conclude by the end of October. In another first, exchanges also began fining companies for noncompliance in appointing a woman director on their boards.

Investor action

Investors refuse to sit idly by in the face of egregious actions by companies

But this story is not just about regulatory enforcement: private enforcement from investors, both institutional and retail, has also been in evidence. An October 2015 report, *India Proxy Season 2015*, by InGovern, a proxy advisory firm, showed increased activism by institutional investors, with resolutions proposed by Siemens, United Spirits and JSW being voted against by more than 20% of institutional investors, and failing to get the requisite majority to pass.

Retail investors waking up to new regulations

Meanwhile, retail investors took matters into their own hands and requisitioned a shareholder meeting at Ricoh India in August 2016 to vote out the entire audit committee for failing to 'perform their fiduciary responsibility towards the minority shareholders of the company'. The shareholders also put forward a resolution to appoint an independent director. They failed on all counts, but retail investors are waking up to the new regulations.

Investors to SBI: provide e-voting, you are not exempt!

Not even public-sector undertakings (PSUs) have escaped the ire of retail investors. In January 2016, the State Bank of India (SBI) was schooled in how listed companies should provide an e-voting platform at all meetings, or show the exemption in the listing regulations that allows them not to! According to Institutional Investors Advisory Services, another proxy advisory firm, a look at the voting data on 'others', which includes retail investors and body corporates, shows the average median voting percentage has been steadily increasing from 6% in 2014 to 14% in 2016 to date.

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Cairn India and Vedanta: A case of related-party transaction

Cairn, the cash rich parent of Sesa Goa, made a US$1.25bn loan to it without calling the transaction material

In July 2014, Cairn India's subsidiary, Cairn India Holdings Limited (CIHL), entered into an agreement to extend an US$1.25bn loan to a subsidiary of Sesa Goa - part of the Vedanta group. At that time, the company stated that this is not a 'material' transaction (as per legal definition) and hence no approval of shareholders/disclosure was required.

This event led to significant concerns around leakage of cash and was possibly the key reason for the stock being forced to trade below cash per-share levels (Rs148 at end-March 2016) for most of the eight months during November 2015-June 2016. This was one of the few instances when shareholders of a high quality oil-producing asset suffered significant wealth erosion because of questionable CG. CIHL again extended the maturity of this US$1.25bn loan in May 2016 by two years, which could be argued to be based on a narrow interpretation of SEBI's laws.

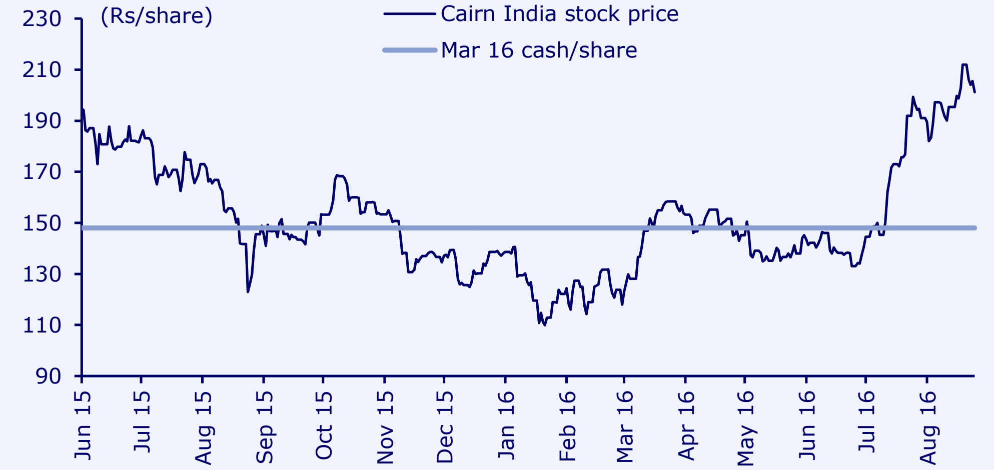
Cairn announced a merger plan with group company Vedanta but again minority shareholders resisted initial offer forcing a deal sweetening in July 2016

In June 2015, Vedanta announced a merger plan with Cairn India wherein for every equity share held, a minority shareholder of Cairn India would get one equity share and one redeemable preference share in Vedanta, with a face value of Rs10. However, possibly due to lack of shareholder interest in the initial offer, Vedanta sweetened the deal in July 2016 by adding three more redeemable preference shares of Rs10 each (equating to a total of additional Rs30) to the original offer. Vedanta stated that the rational for this merger was based on the core logic that a commodity conglomerate is a preferred set-up to a pure oil & gas company. However, as majority of minority shareholders of Cairn India need to vote in favour of this proposal, the final outcome remains to be seen.

While the jury is still out on this transaction, this is a good example of how SEBI's rule change in 2014 benefits minority shareholders and have helped the minority shareholders. Lack of support from minority shareholders to the initial merger ratio drove a sweeter offer by the majority.

Cairn traded substantially below its cash value before Vedanta revised offer in July 2016

Cairn India stock price vs cash value



Source: CLSA, Bloomberg

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Grasim-Aditya Birla-Nuvo merger: Two large holdcos; no synergies

Attempt to merge two large companies with diversified interests has no apparent synergistic benefits

In August 2016, in a bid to simplify corporate structure, the Grasim and Aditya Birla Nuvo boards approved the merger of the two companies. Grasim has a 60% stake in UltraTech, along with minor stakes in group firms like Idea Cellular, Hindalco and ABNL, and also VSF and chemical businesses at a standalone level. ABNL, has stakes in Idea Cellular and financial services with the standalone business encompassing agri, rayon solar, and so on. The promoter holding in the new entity would go up to 39% (versus 31.3% in Grasim and 58.4% in ABNL).

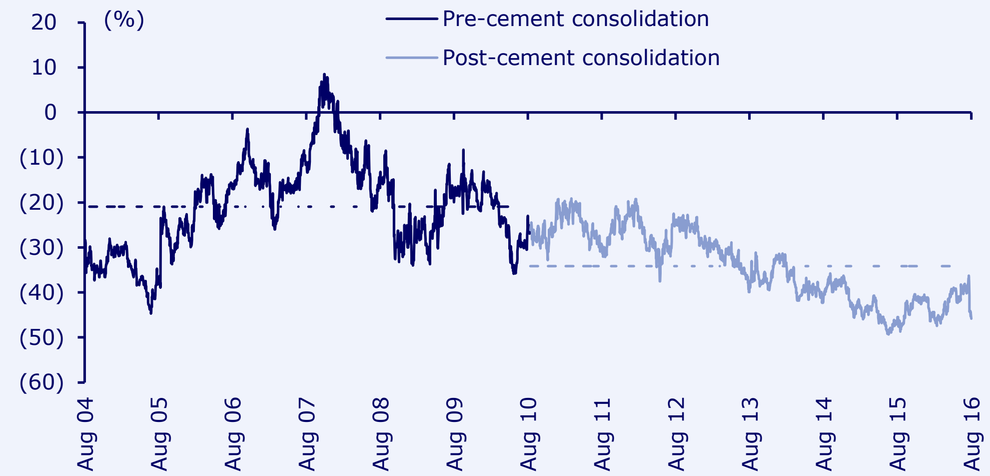
If the merger proposal is accepted by minority shareholders, Grasim will become a highly-diversified conglomerate with interests across cement, telecom, financial services, VSF and investments. While on a reported basis, cement is the biggest contributor to Ebitda at 41%, adjusted for economic interest, telecom actually contributes 36%, followed by cement at 30%. The standalone company would have smaller businesses, while the bulk of the value is likely to come from subsidiaries for which investors have an option to play directly in the market.

Yet to go through the minority approval process but fear is Grasim will be seen as an un-investible stock

We believe the deal would be value destructive for minority shareholders as it raises concerns on: capital allocations, especially for telecom sector where competitive intensity is rising; and uncertainty on eventual conglomerate discount, which the market would assign post listing of the financial-services arm. The current market price is factoring 47% of the conglomerate discount, which we believe should expand further, given increased in complexities and uncertainties arising out of merger proposal. While there are not many comparables for Grasim, our analysis for holdcos indicate that the discount range could be around 50-80%.

Holdco discount expanded after cement business was merged into step down subsidiary and post the AB Nuvo merger, it may increase more

Grasim holdco discount



Source: CLSA, Bloomberg

Political and regulatory environment

Falls from 58% in 2014 to 56% in 2016

India failed to make headway in this section as business and political interests eroded governance objectives and poor political leadership undermined confidence in the independence of the central bank.

Governance in government improves

'Ease of business' is the slogan that the Bharatiya Janata Party (BJP)-led New Democratic Alliance (NDA) government has adopted, even as it continues to speak governance. To be fair, it has only been guilty of allowing various ministers to put their feet in their mouths, so far avoiding the stain of corruption scandals that overshadowed the Congress-led UPA government. In fact, governance in government has perceptually improved, with market observers noting that banks no longer get calls from ministers to approve 'x, y, or z' loan to some company or the other.

Many PSUs found lacking as they fail to comply with listing regulations

Less positively, the lack of compliance with governance norms at PSUs brought scores down here. How can the government expect companies to embrace CG when its own companies are not fully compliant? A wide array fail to fulfil various clauses in the listing regulations, from failing to appoint woman directors to their boards, to having no independent directors. SBI is the only listed company in the top-500 that fails to provide e-voting facilities for its shareholders at meetings, citing the SBI Act.

Banking crisis at PSBs

However, it has been a banking crisis at public-sector banks (PSBs), and a recent threat to the independence of the central bank, that put the nail in the coffin of India's score in this section. For much of the past two years, the RBI has been a proactive and effective regulator, and it took on board a number of suggestions that appeared in the damning 2014 Nayak report on the parlous state of bank governance in India. But these initiatives came in the midst of rising nonperforming assets (NPAs) at PSBs, a matter of concern for years.

RBI intent on having clean, fully provisioned bank balance sheets by March 2017

The Nayak report highlighted the highly 'fragile' financial position of PSBs, which it said had been 'partly masked by regulatory forbearance'. Rajan ended this forbearance in April 2015 and began the asset-quality review 'to ensure banks were taking proactive steps to clean up their balance sheets'. In 2016, he reiterated that the RBI intended to have 'clean and fully provisioned bank balance sheets by March 2017', but this is proving to be painful for the market. What has emerged is the abysmal state of risk management at PSBs, which had fallen over themselves to provide loans, especially for infrastructure, to stimulate growth - often under pressure from government.

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Coal India, Power major NTPC and oil refiner IOCL tasked with reviving three fertiliser plants

Government forces unrelated diversification for PSUs

In July 2016, the central government approved the revival of three closed fertiliser plants, which were previously also run by central government entities. This time around, three listed and cash-rich PSUs were tasked with the Rs200bn capex required for the project. An SPV of NTPC, Coal India and IOCL has been formed for the purpose.

May not be the most efficient way of SBI's capital deployment though

Though the overall objective of the government is to boost the capex in the country, a better way could have been to let the public PSUs return cash to shareholders, including the government, which could then have been utilised for the purpose.

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As part of PSU bank reform plans, government has started merger of smaller banks with larger ones

Government drives PSU bank consolidation

In the largest consolidation of public-sector banks (PSB) in India, the State Bank of India announced the merger of its five subsidiary banks and Bharatiya Mahila Bank (BMB) with itself. SBI is the largest bank in India with an 18% share of banking-sector loans and the merger will increase its share further to 23%. While the merger leads to some upfront costs (NPL provisions and pension costs), management has indicated benefits in the medium term that will compensate these.

The decision to merge businesses was accorded by the board of directors of the banks and as SBI Act exempts them from taking approvals from minority shareholders, banks have formed a grievance-mechanism for shareholders to raise any concerns, which will be addressed by the boards. From a long-term perspective, we believe that the merger of subsidiary-banks is positive as SBI (parent) enjoys a much stronger franchise and with the merger they can prune duplication in staff/employee and benefit from best practices. Alignment of staff (especially unionised force) will be key.

Closure of duplicate bank branches and a reduction in staff costs could have driven the near-term synergistic savings, this appears unlikely as the majority shareholder (Government of India) will find it politically unsuitable. On the other hand, however, it is a step towards improved governance as the operating structure is becoming more efficient as the needless competition between subsidiaries and parent company is avoided.

SBI will be merging 5 subsidiary banks and BMB with itself

SBI's subsidiary banks and BMB

Bank	SBI's shareholding (%)	Status
State Bank of Bikaner Jaipur (SBBJ)	75	Listed
State Bank of Mysore (SBM)	90	Listed
State Bank of Travancore (SBT)	79	Listed
State Bank of Hyderabad (SBH)	100	Unlisted
State Bank of Patiala (SBP)	100	Unlisted
Bharatiya Mahila Bank (BMB)		100% owned by Govt.

Source: Banks, CLSA

Merger would increase standalone loans by 28%

Key features of the proposed merged entity on a pro forma basis

	SBI	Associate banks	Merged entity
Branches (Mar-16) ('000 Nos.)	17	7	24
Employees (Mar-16) ('000 Nos.)	208	73	280
Deposits, Jun-16 (Rsbn)	17,824	5,171	22,994
Advances, Jun-16 (Rsbn)	14,165	3,952	18,117
Net profit, FY16 (Rsbn)	100	16	116
CAR, Mar 16 (%)	13.1	11.6	12.7
Gross NPA, Jun-16 (Rsbn)	1,015	361	1,377
Gross NPA, Jun-16 (%)	6.9	9.1	7.6
Net NPA, Jun-16 (Rsbn)	574	217	792
Net NPA, Jun-16 (%)	4.0	5.5	4.4
Std restructured advances, Jun-16 (Rsbn)	366	225	591
Std restructured advances, Jun-16 (%)	2.5	4.5	3.3

Note: BMB and effect of revaluation reserves are not included. Branches and employs for State Bank of Hyderabad and State Bank of Patiala are based on Mar-15. Source: Bank, CLSA

Rajan exits RBI amidst personal attacks: independence of RBI called into question

As the market reeled from the rising NPAs at state banks, Rajan wrote to RBI staff in June 2016, informing them that he would be returning to academia once his tenure ended on 4 September 2016. As Rajan became governor in 2013, this is the first time in more than 20 years that an RBI governor has not served five years. But what was also disconcerting was that in the lead up to his announcement a BJP member of parliament, Subramanian Swamy, a Harvard-educated economist, accused Rajan of not being 'mentally fully Indian' and of 'wilfully' wrecking the economy. He told Modi that it was in India's 'national interest' to remove Rajan. To cut a long story short, the incident has not reflected well on the prime minister or his party and many fear that the independence of the Reserve Bank has been compromised.

As Rajan exits, he argues for RBI's continued independence and ability to say no

Following his decision, Rajan has continued his outspokenness, stating that the RBI's independence and the central bank's ability to say no should be guarded. The government regained some credibility by opting for continuity and appointing the current deputy RBI governor, Dr Urjit Patel, as Rajan's replacement in August 2016. Caught flatfooted by Rajan's announcement, the government quickly announced a radical liberalisation of India's foreign direct investment regime to allay foreign-investor fears. Modi declared India the most 'open economy in the world for FDI', following the announcement. The policy change marks the opening up of multiple sectors to 100% foreign ownership, including strategic and sensitive sectors such as defence and pharmaceuticals. The BJP's nationalist wing, however, views the reforms as a betrayal and expects to have them rolled them back. Watch this space.

Accounting and auditing

Rises from 57% in 2014 to 58% in 2016

This section had a moderate increase because the government finally announced a roadmap for the phased implementation of 39 Ind-AS, the Indian version of International Financial Reporting Standards (IFRS) with significant 'carve-outs' to reflect the Indian environment. The standards had originally been announced in 2011, but implementation had been put on the backburner because the industry 'did not allow it to go forward' at that time, according to Amarjit Chopra, chairman of the National Advisory Committee on Accounting Standards.

Roadmap for IFRS convergence, but companies still not ready

In April 2015, MCA's Companies (Indian Accounting Standards) Rules, 2015 came into force. The rules became mandatory for various categories of companies in stages between April 2016 and April 2017. To give weight to Chopra's assertion that industry was the logjam, SEBI announced that it would allow for 'relaxations' in the first year of Ind-AS implementation. After five years, they are still not ready!

New IFRS roadmap for banks from 2018 onwards

The 2015 roadmap did not include insurance firms, banks and nonbanking financial companies (NBFCs), but MCA announced a roadmap for them on 18 January 2016, and RBI has announced which institutions would comply from 1 April 2018 onwards.

Independent audit regulator, NFRA, is the requirement of the day

An independent audit regulator has still not been formed, but there is light at the end of the tunnel. A recommendation in the February 2016 report on the second set of amendments to the Companies Act was the need for the early establishment of an independent audit regulator, the National Financial Reporting Authority (NFRA). Despite the Institute of Chartered Accountants of India (ICAI) voicing its 'concerns' and arguing that it was already 'discharging its regulatory functions with regard to discipline', the recognition that 'the need for an independent body to oversee the profession is a requirement of the day' carried through.

ICAI continues to lobby government against NFRA, but the ship has already sailed

A matter of concern, though, was the suggestion that consultation may be carried out with ICAI in regard to 'the jurisdiction of NFRA and the ICAI representation on NFRA' - a move to placate ICAI, which told ACGA in mid-2016 that it continued to lobby the government to shelve the idea of a separate audit regulator. But according to MCA, that ship has already sailed!

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Shift to Ind AS brings India closer to IFRS; impacts earnings

New Indian accounting standards (Ind AS) move the country a step closer to international financial reporting standards (IFRS). The new standards primarily focus on improving disclosures for financial instruments and introduce concepts of other comprehensive income (OCI). Implemented from June 2016 (banks and financials in June 2018), these new standards have led to a chaotic and stretched June 2016 earnings season .

Large companies seeing major impacts so far include ITC, Maruti and Bharti Infratel

Several large companies have already seen a major impact of the Ind AS implementation. Bharti Infratel, for example, had its reported revenue cut by c.55% as line-by-line consolidation of a large subsidiary was disallowed. ITC was one of the major companies which had to report significantly higher employee costs due to ESOP related accounting, driving about 5% earnings cuts. Some companies were positively impacted too with Maruti Suzuki seeing higher financial income and lower depreciation driving net profit higher.

Indian accounting standards are moving much closer to IFRS from June-16 quarter reporting

The major impact of the new accounting standards is expected to be on banks, so much so, that implementation will be done two years post that of other companies. Meanwhile, the central bank has already asked the banks to report earnings as per new accounting standards to allow the RBI separately to gauge the impact of Ind AS.

Accounting for financial instruments is where the biggest change has come for Indian companies

Figure 76

Major highlights of transition to Ind AS

Key concept	Impact
Shift to IFRS	• Continuing to converge on IFRS with carve-outs (differences). • Eventual move to IFRS is on horizon.
Neutrality vs conservatism	• Concept of 'lower of cost or market value' changes to 'market value' for acquisitions, impairments and financial instruments accounting.
Underlying business vs rules-based calculations	• Greater flexibility to companies in estimation of items like useful life of assets; fair valuation of investments - come at cost of sacrificing comparability.
Principle-based accounting	• Looking at 'substance of agreement', eg, while determining consolidation criteria; some 'take-or-pay' agreements become leases; convertible bonds split into equity & debt component.
Higher disclosure standards	• New statements on 'other comprehensive income' and 'changes in equity'. • Details on underlying assumptions in estimating fair valuations.

Source: CLSA

CG culture

Falls from 51% in 2014 to 49% in 2016

CG culture has seen a slight fall this year, due to the inability of many corporations to plan ahead for change, boilerplate remuneration policies and board evaluations, and disregard for the spirit of governance rules.

Investors and proxy advisory firms continue to raise the bar

First the positives: as mentioned earlier, investors, both institutional and retail, are stepping up to the plate. Institutional investors now have to provide a rationale for their votes and, while most of it is still boilerplate, it is a step in the right direction. Proxy advisory firms continue to produce interesting reports on the state of the market and company actions, including IiAS's analysis of the Grasim - Aditya Birla Nuovo merger and InGovern's report on board evaluations.

FICCI's new survey highlights issues and positives of CG reform three years later

Meanwhile, the Federation of Indian Chamber of Commerce and Industry (FICCI) recently published a report *Corporate Governance in India@2016: Where Do We Stand?* A number of issues raised are ones that ACGA also finds to be true: redundancy in reporting; too many regulators in the mix; and a marked improvement in financial and nonfinancial disclosures.

Annual reports are getting better

Annual reports, in general, are much more substantive than in the past, providing useful information in the MD&A and risk assessment and management sections, as well as business-responsibility reports. This is truer of the large and mid-sized companies that have a larger institutional investor base, but overall there is a trend towards better, informative annual reports. Yet remuneration policies and board evaluations continue to be boilerplate: all policies are designed to 'retain quality talent', and directors are usually happy with how their board evaluation went. As board evaluations are new to the market, companies can be excused for the poor quality of disclosure on that score. But not on the inability to provide a clear-cut remuneration policy for directors and key managerial staff in its own industry.

Companies continue to be ambivalent about corporate governance reforms

Actions by companies also show that the spirit of the governance reform is still not imbedded into their psyche. CG is an evolving process and requires an ability to think ahead, which any good company should be able to accomplish. With that mind, it was interesting to be told by an industry association of how companies had failed to respond to initial consultations by the MCA, only to have them rush back and ask the association to intervene and ask for amendments to the rules. Even more galling, a governance expert told ACGA that some fairly large companies had established whistleblower policies, as regulations required, but then failed to tell their stakeholders and staff about them! Actions really do speak louder than words.

Ricoh India fails to disclose the extent of problems; independent review sought

Moreover, there is the example of Ricoh India, which failed to publish its quarterlies in September and December 2015. To be fair, the company informed the exchange that it was because they had appointed a new audit firm, BSR & Co, but it failed to disclose at the outset that this new auditor had issues with certain transactions and an outside CA firm, SS Kothari Mehta & Co, had been hired for the review. Instead, it told the exchange the board had 'considered and taken note of the recommendations of the Statutory Auditors of the Company'. In March 2016, BSE placed them in the Z category for noncompliance of listing regulations for two consecutive quarters, which meant trades on shares could only be settled on a trade-by-trade basis. On 20 April, the company finally came clean - or as clean as it could at that stage - by stating that its auditors had not agreed with the findings of the outside firm, forcing Ricoh India to appoint a law firm and PwC for a forensic review. It added that the preliminary findings from that review showed that audited accounts did not provide a 'true and fair view of the state of affairs of the company'. Following further investigations by various parties, including PwC, the company stated that it estimated a loss of Rs11.23bn for the year ended 31 March 2016. Ricoh Japan agreed to infuse the amount into Ricoh India to cover the loss without diluting existing shareholders' shares.

Self-regulate or be prepared for more rules from regulators

In light of all this, it is noteworthy that the Confederation of Indian Industry is pushing industry members to sign a Model Code of Conduct for Ethical Business Practices, where companies will regulate themselves or else get regulated by regulators. It will be interesting to watch where that journey takes Indian companies.

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Kingfisher fiasco: Triggers Bankruptcy law reform

The recent event of Kingfisher promoter Mr Vijay Mallya fleeing the country over rising noise on his defaulting loans is one of the first such instances of PSU banks in India going after promoters of large corporations. In February 2016, Diageo, who bought the United Spirits company from Vijay Mallya, decided to pay Mallya US$75m over a five-year period. In exchange, Mallya was to step down as executive chairman and director at United Spirits. This deal came at a time when the government had forced major bad loan recognitions at banks, which was grabbing media headlines.

Since Mallya owed c.Rs90bn to banks, partly secured by 'personal guarantee', the move by Diageo triggered a consortium of banks that lent money to Mallya to pursue him for its return. Subsequently, in March 2016, Mallya fled India for London, from where he has, to date, not returned.

Settlement between Diageo and previous owner Mallya triggered a media frenzy as same coincided with the bad loan issue

In his defence, later in interviews, Mallya has said that being chased for NPA recovery was witchhunt, given that several other large corporations had also defaulted on far larger loans. However, the benefit for India has been that the move helped push forth the new bankruptcy law in parliament which sets time-bound and well-defined procedures for bankruptcy proceedings. Earlier, the promoters would hide behind complicated and long-draw bankruptcy procedures, to essentially hold on to their corporate empires.

Mallya claimed that a media witch-hunt was on against him

Headlines in India when Mallya left the country

House divided over Mallya, Congress accuses BJP of helping 'thieves'

Updated: Mar 10, 2016 19:50 IST

http://www.hindustantimes.com/india/live-cong-rakes-up-mallya-issue-in-rs-accuses-govt-of-helping-him-flea-india/story-sJdt0yxUaoiWn01FT9yCrI.html

Vijay Mallya: The tycoon who gave big business a bad name

http://www.livemint.com/Sundayapp/FKunjfhS6JAAnV3OEfnm6H/Vijay-Mallya-The-tycoon-who-gave-big-business-a-bad-name.html

Court declares Mallya a proclaimed offender

http://www.thehindu.com/news/national/vijay-mallya-declared-proclaimed-offender/article8728455.ece

Source: CLSA

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- Failure to clean the balance sheets of PSBs by March 2017
- No progress in addressing loopholes in the RPT regime
- No progress in establishing the National Financial Reporting Authority
- MCA amendments that dilute corporate governance initiatives

Quick fixes

What to fix

- Release cashflow and balance-sheet data with quarterly reports
- Improve enforcement sections on websites of regulators
- Ensure PSUs comply with Listing Regulations
- Release AGM notices at least 28 days before date of meeting

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Indonesia - Forwards, and sideways

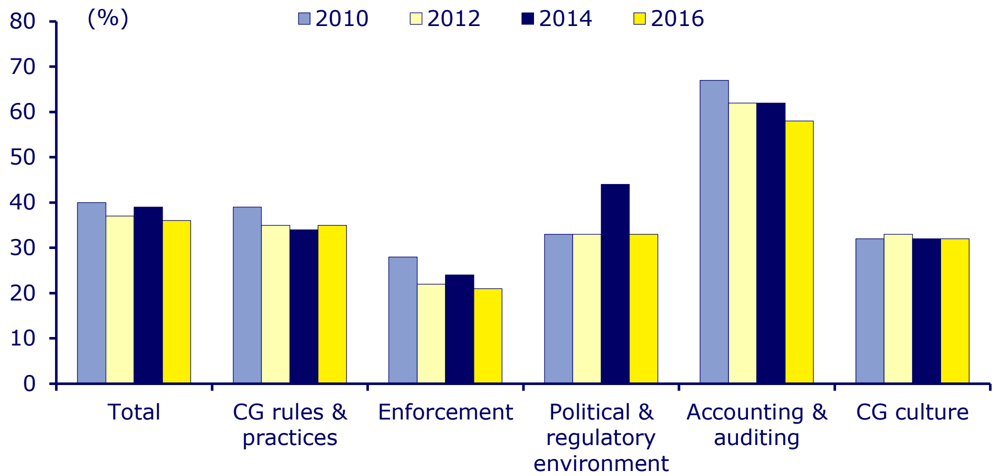
Key issues and trends

- OJK has been busy with new CG rules, but bowed to market pressure by relaxing rules on share buybacks. Where is the IDX in regulation?
- Enforcement remains a serious problem. The proposed link up between OJK with the KPK and AGO (if it works) is welcome.
- Insider trading continues unabated and market enforcement remains a worry.
- KPK has continued its charmed life by winning some high-profile corruption cases.
- Indonesia flip-flopped on foreign investment with tightened and then relaxed rules, cancelled foreign licences only to cut red tape for new business licences.
- RPTs remain a major market flaw: rules are weak, disclosure poor, compliance spotty and enforcement non-existent.
- Self-dealing in debt restructuring at the expense of foreign investors seems to be back in vogue given tighter lending conditions.
- Domestic institutional investor engagement remains non-existent.

Overall score falls from 39% in 2014 to 36% in 2016

Figure 77

Indonesia CG macro category scores



Source: ACGA

The much-vaunted *CG Roadmap* of the Indonesia Financial Services Authority (OJK) has started to pay dividends and CG rules have been tightened in some key areas. But enforcement, as ever, remains a key problem and more resources are needed to make any serious attempt to tackle the problem. The IDX has delivered little from a regulatory standpoint and it seems that the exchange has all but handed over market regulation to OJK to concentrate on business.

Government progress has been mixed, with an initial regression in openness towards foreign investment in key sectors, later reversed. The anticorruption drive continues largely in the right direction, however, and the KPK has defied many predictions of its imminent demise. Attempts to kill it off by politicians and corrupt civil servants have resulted in higher-profile convictions. CG culture overall remains weak and superficial in Indonesia.

CG rules and policies

Score rises slightly from 34% in 2014 to 35% in 2016

Indonesian financial reporting remains behind international best practices and there is a clear difference in the reporting by some of Indonesia's biggest, and better-governed, companies (PGN, Telkom, Antam and BRI) and those of most other players, with smaller and medium-sized companies noticeably weaker in financial reporting and disclosure.

CG and ESG disclosure improving somewhat

Nonfinancial reporting standards for CG disclosure in Indonesia have improved somewhat since our last report, as the OJK issued new guidelines in November 2015, mandating public companies to meet new CG reporting guidelines, which will come in to effect from December this year on a comply-or-explain basis. Most companies are not reporting in accordance with best international practices, however, and as with financial reporting, only a few standout companies (BRI, PGN, Telkom and Unilever) provide comprehensive CG and ESG disclosure.

Release of results lags 60-day best practice

Financial reporting timeliness has not improved much since our last survey: large companies in Indonesia typically report audited annual reports within 90 days of their financial year-end, in line with the OJK rule, while smaller companies are typically slower. Few companies report more quickly on a voluntary basis. Exceptions are the large banks and Astra, all of which report closer to our best-practice benchmark of 60 days. Quarterly reporting among most Indonesian companies remains of a good standard.

Still big problems with PSI and related disclosures

The prompt disclosure of price-sensitive information remains a problem. Indonesian regulations in respect of disclosure of directors' dealings, changes in shareholdings of ownership stakes of 5% or more, as well as disclosure requirements for related-party transactions all fall far short of best practice. There is little indication that these rules will be tightened any time soon. Of course, even if they are, Indonesia's creaky enforcement regime will be incapable of monitoring and enforcing such rule changes.

Likewise, securities laws against insider trading and market manipulation are as good as non-existent and with no credible deterrent, insider trading remains a serious problem in Indonesia. OJK needs to give serious thought to tackling this problem if scores in our survey for rules and practices as well as enforcement are going to rise meaningfully.

But progress on voting by poll (or ballot)

On a more positive note, with some prompting from OJK, poll voting seems to have taken hold in Indonesia with most companies recognising and counting votes for, against and abstentions. In many cases, voting results are disclosed in detail, including by resolution, which is a marked improvement on previous years. Generally, shareholder meetings for Indonesian companies are becoming more interactive with minority shareholders willing and prepared to make their voices heard.

Pre-emption rights in Indonesia weaker than they may appear

Pre-emption rules are more robust, at least on paper, than one might expect. Under the Indonesian CG Code, any share issue for cash must be offered to existing shareholders on a pre-emptive basis. However, a new rule in December 2014 permits a non-pre-emptive issue of shares for cash up to 10% of the issued share capital, as long as a general meeting of shareholders approves it. While the 10% threshold is broadly in line with regional best practice, the rule contains a loophole that stipulates that the 10% threshold does not apply 'if the issue is to improve a company's financial position'. Clearly, this provides plenty of wriggle room for boards and management.

A new definition of independence needed . . .

Board practices remain behind international standards. The definition of independent director provided by legislation remains weak and has not been substantively updated, raising doubts about the genuine independence of nominally independent directors on the boards of Indonesian companies. A revision of the rules to provide a more robust definition is overdue.

. . . and remuneration disclosure standards need to improve

The disclosure of individual director remuneration remains a problem. While the local CG Code defies best practice as full, individual disclosure, the code is operated on a comply-or-explain basis and in practice few companies bother to meet this requirement (Antam and Telkom are notable exceptions). The OJK is concerned about the apparent low remuneration paid to boards of commissioners relative to the importance of the body and has called for better and more transparent systems of remuneration to be introduced.

Audit committees work OK, but they aren't independent

One of the board of commissioner's key roles is the operation of audit committees, which are mandated under OJK rules. Generally, these operate well and disclosure standards among local companies are good, especially among large-cap private and state-owned companies. However, in practice, commissioners are seldom genuinely independent from the company and especially the major shareholder(s). While the rules require a third of audit-committee members to be genuinely independent, in practice many are not.

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BW Plantation expose weaker RPT rules

BW Plantation (BW) transaction was done under somewhat mysterious circumstances as the Rajawali group built up a sudden position of 21.55% in BW (from 0%) by fully acquiring two BVI companies in September 2015. These were basically holding vehicles for stakes in BW, which were issued in a prior placement/share-crossing transaction during November-December 2014. The two BVI companies did not seem to hold any other businesses beyond their stake in BW, and no information was disclosed about the funding/eventual owners of the BVI companies.

Prior to Rajawali's the stake purchase, BW appointed Stephen K Sulistyo, the Managing Director of business development and investment at Rajawali group, as the president commissioner of BW in July 2015.

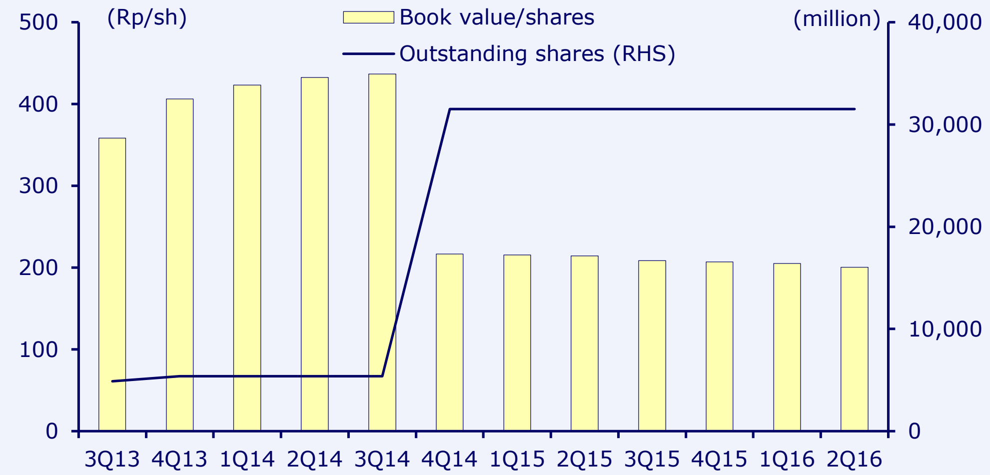
Difficult choice of massive dilution or accepting the high valuation of the target assets

The eventual acquisition of BW in November 2015 via an effective reverse takeover through an asset injection into BW was also shrouded in controversy. The six for one rights were issued at a significant discount of 60% to the last close price, with the original promoters (BW Investindo) forgoing it rights to Rajawali to give it an effective stake of more than 50% of BW after the rights issue. This led to an effective change in ownership, while the assets being injected from Rajawali was not subject to a shareholder vote via a loophole in Indonesia's listing requirements.

The eventual deal left investors stuck between being massively diluted by 85%, or subscribing to the rights and acquiescing to the valuation of Rajawali's assets being injected. The lack of a proper choice in this issue raises the lax regulations for Indonesia around related-party transactions, and an area that clearly needs to be tightened up by the regulators.

Value declined despite asset injection

BWPT's book value per share decline to half its previous level post dilution



Source: CLSA

Enforcement

Score falls from 24% in 2014 to 21% in 2016

Enforcement continues to be a major problem. Even with improving rules and regulations as part of the new Indonesian CG Code, which come into effect next year, without significant investment in enforcement staff and resources, there is little likelihood that regulators will be able to police compliance effectively. It is true that the OJK has invested in enforcement in recent years and its initiatives to work more closely with the AGO and the KPK, Indonesia's anticorruption commission, are a step in the right direction. However, after several years of investment, it is difficult to demonstrate the practical effects of the additional recruitment and as a result, our scores for enforcement have dropped.

Weak powers, weak regulators

The OJK's powers against market misconduct remain largely sanctions and penalty-based. It has taken little action against listed companies: most recent enforcement has focused on punishing securities firms for market manipulation schemes. The same can be said for the stock exchange: IDX continues to operate as if it is a for-profit first and market regulator second: there is little evidence of any meaningful investment in its enforcement resources. It did suspend the licences of three major securities firms for rigging the shares of a state-owned mining company, however, including state-owned securities giant, Danareksa (see blue box on next page). The intervention was welcome, since similar activities have gone unpunished in previous years.

No convictions for insider trading

Indonesia has rarely, if ever, convicted anyone of insider trading, even though market practitioners will all tell you that it remains a key problem. Enforcement data are difficult to find on the OJK website and almost impossible on the IDX site.

KPK leads the way, but mostly against the public sector

On a positive note, the KPK continues to investigate and prosecute corruption and has recently claimed some high-profile scalps, including the former CEO of major local real-estate developer, Agung Podomoro Land, Ariesman Widjaja. He was caught in a corruption scandal involving bribes paid to local government officials in Jakarta relating to a massive and controversial land reclamation project. While the KPK is clearly doing a great job and has survived many political attempts on its life, it is important to remember that its remit is to tackle corruption in the public sector. Private-sector corruption continues largely untouched and, as with the Podomoro Land case, usually comes to light when it entails bribery of public officials.

Retail investors active; institutional investors somnolent

Market enforcement in Indonesia is also weak. While the retail market is actually increasingly active, with good attendance and participation at company meetings, few shareholders actively vote against board resolutions and minority investors do not get to nominate nonexecutive directors. Takeover rules remain materially behind international standards and shareholders have no practical access to the courts to seek redress. Perhaps most importantly, Indonesia's domestic institutional investors play only a limited role in engaging with companies and voting their shares. This remains a serious gap in market enforcement. The asset management arms of foreign funds are a little more engaged.

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IDX suspends three brokerages after signs of fictitious transactions

On 11 November 2015, the Indonesian Stock Exchange (IDX) suspended three stock-brokerage firms colluding in alleged fictitious transactions in the shares of state-owned mining company Sekawan Intipratama. The shares fell 65% over three weeks due to the alleged scheme, which has since been referred to peak financial regulator, the OJK, for further investigation.

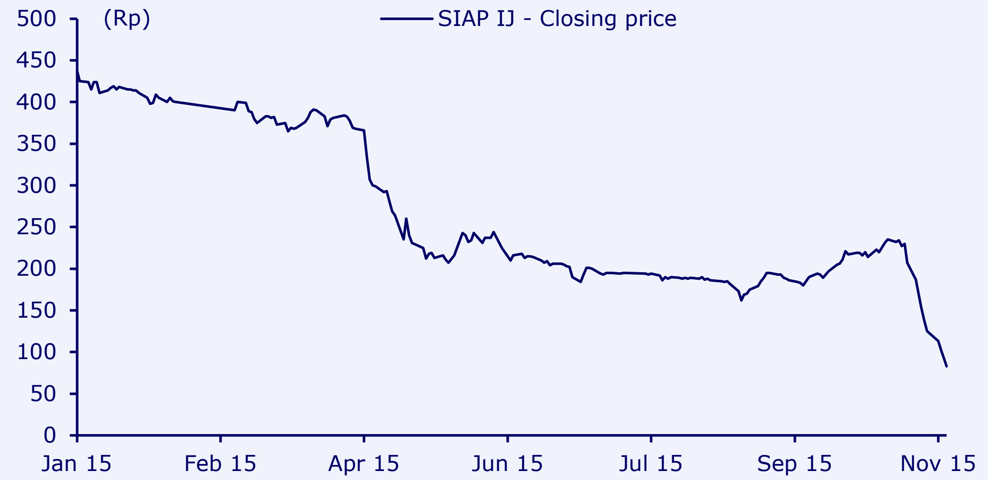
The IDX said it had found signs of fictitious transactions whereby seemingly separate accounts colluded to trade the shares in a manner that would prevent the share price from falling. According to the IDX, the three firms failed to carry out adequate internal control and know-your-client procedures. Despite this and the ongoing investigation, the three securities companies' suspension was lifted the next day without explanation.

An SOE firm was one of the parties penalised

State-Owned Enterprises Minister Rini Soemarno has demanded the suspension of senior executives of Danareksa Sekuritas for internal oversight failures, pending a full independent investigation into the scandal. While the infraction itself is clearly negative, the fact is, enforcement is taking place and even a SEO, such as Danareksa, is liable.

Fall that lead to suspension

Sekawan Inti Prima' share price



Source: CLSA

Political and regulatory environment

Score falls from 44% in 2014 to 33% in 2016

Indonesia's political environment has changed markedly under new President Joko Widodo. Policy initially appeared to be driven by a strong anti-foreign sentiment, with further restrictions on foreign investment and the revocation of a significant number of business licences granted to foreign business ventures. Foreign investors and companies complained bitterly of bias and left in droves. The anti-foreign sentiment has reduced somewhat, perhaps in response to the deteriorating economic outlook, and the government has made progress in cutting red tape for the grant of new business licences.

Roadmap momentum seems to have slipped

In terms of governance, Indonesia continues to lack a coherent policy for reform. While the OJK is to be applauded for its *CG Roadmap* initiative, it is now more than two years old and it is difficult to escape the feeling that some of the valuable momentum created by the Roadmap has slipped. The OJK continues to perform well in its role as bank regulator - Indonesia's banks are some of the best-governed companies in the country - but its CG policy more generally appears muddled at times. As mentioned previously, the absence of a credible enforcement deterrent means that compliance with the CG rules is often at the whim of companies.

Corporate and securities laws in need of an overhaul

OJK has started to operate more independently from the government, especially since it has moved to a self-funded business model. However, its commissioners are still appointed by government so its independence is effectively limited. Company and securities laws are overdue a revamp, notwithstanding the Roadmap, since they remain materially behind international standards. Meanwhile, from a regulatory perspective, OJK is clearly doing all the heavy lifting and IDX seems to have delivered little, with no material new regulation in the past two years.

Regulatory websites in need of an upgrade

Both OJK and IDX need to overhaul their websites and management of databases. OJK's site is better than it was, but English language data are available much later than Bahasa and it can be devilishly difficult to find information on it. IDX does not appear to have any enforcement data on its website and its database of corporate announcements and information, while generally easy to navigate, only provides two years' rolling data, which is far too little.

Foreign investors still at the mercy of local courts

Indonesia's court system remains effectively closed to investors seeking recourse against companies, especially for foreign investors (see blue box on next page). The legal system is slow, cumbersome and corrupt and is easily manipulated. An attempt last year to recruit specialist judges for securities legislation is welcome, but even so, case progress will likely remain slow and vulnerable to influence. Media are more used to reporting on corruption scandals and investigations than CG issues.

Government overhaul of SOEs welcome

The KPK remains the clear shining light in public governance and it continues its campaign against corrupt officials with considerable gusto. Governance among government-linked companies remains a challenge, although President Widodo's cabinet unveiled plans to overhaul governance at SOEs and demonstrated its determination with a high profile investigation of the distribution activities of state oil giant Pertamina.

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Government favouring local note holders on Trikomsel

Financially distressed cell-phone retailer, Jakarta-listed Trikomsel, incurred the ire of its Singapore note-holders when, on 10 February 2016, its administrators rejected the claim of trustees acting for the note holders, while simultaneously recognising a secured intercompany claim from an Indonesian subsidiary.

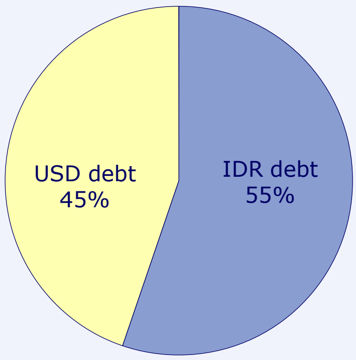
Local creditors opt to restructure than foreclose

Trikomsel defaulted last year on S$220m (US$156m), of Singapore dollar-denominated notes. Arbitrary and unequal treatment of creditors, usually at the expense of foreign creditors in favour of local ones, is common in Indonesia's chaotic bankruptcy system. Trikomsel is 44.9% owned by Singapore-listed Polaris, a regional reseller of cell phones and IT equipment. The group is controlled by Indonesian businessman, Sugiono Wiyono Sugialam. Standard Chartered Private Equity owns 25% of Polaris.

Trikomsel's default also affected three Indonesian banks (BCA, BNI and Mandiri) two of which were state-owned. Instead of pursuing foreclosure of collateral, the three banks restructured the loans with Trikomsel.

IDR debt was bigger

Trikomsel's debt - Bulk was in Rp, which was loaned by local and foreign banks



Source: CLSA

Accounting and auditing

Score falls from 62% in 2014 to 58% in 2016

Indonesia's financial reporting standards follow closely those of IFRS and convergence with IFRS is a stated government policy. Despite close alignment, however, local accounting standards are not fully aligned with IFRS and are not expected to be for some time, largely due to fundamental differences in accounting policies towards plantation assets, a key driver of Indonesia's economy. Convergence timing has improved over the past few years with a gap of just one year between new IFRS policies and the adoption by local accounting standards, an improvement from three years previously.

Company accounting practices are mixed

Accounting practices among large-cap companies are generally very good in Indonesia, because the majority are audited by Big-Four firms and affiliates, which bring in global standards. The situation is markedly different among smaller companies however, where the dearth of qualified auditors in Indonesia and a material resource issue mean that small local audit firms tend to be more prevalent. Transparency and disclosure drops markedly and there are suggestions from our research that many smaller companies rely to varying degrees on their audit firms to prepare accounting information.

Audit regulation becoming chaotic

Indonesia's regulation of the audit profession is becoming chaotic, with too many regulators having oversight of a fragmented market. In our *CG Watch 2014* research report we wrote about audit firms changing corporate names and promoting new partners just to meet tough audit firm rotation requirements issued by government regulators. While the regulators have realised the error of their policies and relaxed firm rotation in favour of partner-rotation, OJK recently floated the idea of introducing audit firm rotation for the companies it oversees (which of course includes listed companies). The local audit profession is understandably up in arms over the proposal and the situation is in danger of becoming farcical. Leadership and direction is clearly needed, ideally from a single audit regulator.

Shortage of accountants being addressed

More positive are the claims from the various accounting associations that they are gradually getting to grips with the chronic shortage of auditors in Indonesia. Through a combination of training and changes to recruitment policies, the industry tells us that accounting graduate numbers are up as is recruitment into audit firms themselves. Of course, the key will be whether these new graduates remain in the profession long enough: drop-out rates in audit firms are high in Indonesia. But it seems to be heading in the right direction finally.

Audit and non-audit fee disclosure among companies still weak

Disclosure of audit and non-audit fees by companies in Indonesia is generally made, largely because it is now mandated under the CG Code (albeit on a comply-or-explain basis) and compliance has improved since our last report. More commonly, however, companies disclose audit fees rather than non-audit fees and when they do disclose the latter, descriptions of what the non-audit fees are for are not detailed enough.

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Aligning accounting policies for tower firms' investment properties

For telecom tower companies such as Sarana Menara Nusantara, and Tower Bersama, there used to be two different options to account for their tower assets. Sarana Menara used the more conventional policy to depreciate its tower assets over 20 years.

Meanwhile, Tower Bersama and the rest of the publicly-listed tower companies, account their tower assets as investment properties. As investment properties, they are initially accounted at cost and in subsequent recognitions they are accounted at fair value. Gains or losses may arise depending on the change to fair value.

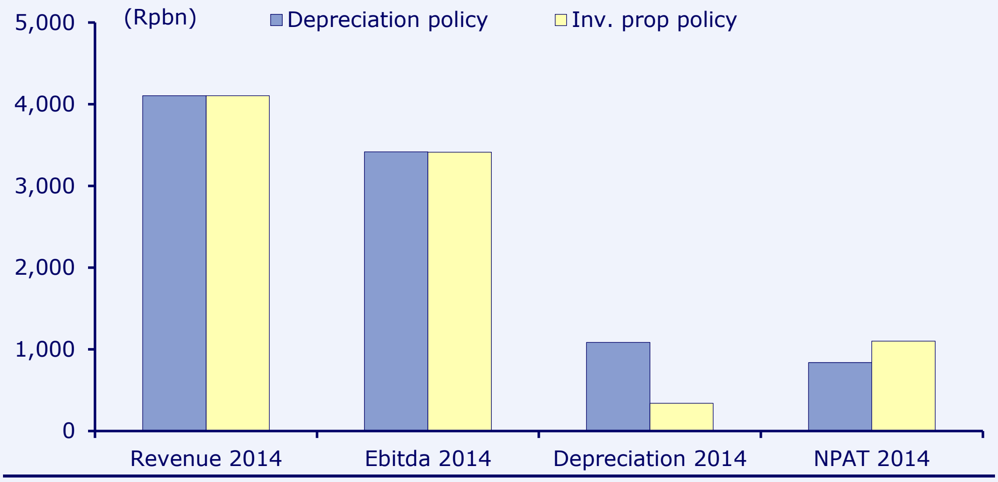
Regulator pushed for uniformity of policy across the same sector

At the request of IDX, Sarana Menara had to change its accounting policy to align with the rest of the industry. Because this was a request from regulators, the bigger accounting firms that resisted the latter accounting policy had to yield. This method is now accepted as standard for tower companies in Indonesia.

The market typically values tower companies using Ebitda rather than NPAT, so such changes have little impact on valuations. However, NPAT could shift dramatically as a result of the change. As a result, forecasting dividend becomes more challenging since the revaluation procedures are unclear.

Differences post policy change

Sarana Menara's financial performance - Pre- and post-revaluation policy change



Source: CLSA

CG culture

Score stays at 32%

The CG culture has yet to penetrate the boardroom of the average Indonesian company. Partly as a result of the history of governance reform, it is all too easy for boards to regard CG as a compliance process. This has only increased with the introduction of the OJK's revised CG Code and its philosophy of disclosure under a comply-or-explain regime. As with every market in Asia, however, there are some exceptions: in Indonesia, most of these seem to be SOEs: Telkom, Antam, BRI and PGN, although Kalbe Farma and Saratoga Investama are worth a mention too.

Board evaluations are mostly not serious and director training is formulaic

Of the companies that we researched, few boards undertook detailed and comprehensive board evaluations (a clear sign of a company's serious focus on board performance and composition). Of those that did, even fewer hired external consultants to undertake the evaluation. Similarly, director training, although disclosed as required by the CG Code, is in most cases, formulaic and provides limited disclosure.

Indonesian companies "get" investor relations

As with previous surveys, we found Indonesian companies to be relatively sophisticated in terms of investor relations and most listed companies have decent IR sections of their websites with in most cases, comprehensive information and disclosures. Of the companies that we reviewed, the best websites were Kalbe Farma, Bank Permata and PGN.

Independence is a major problem on most boards

The independence of board structures among Indonesian companies remains a poor relative to most other markets. While they might seem more independent than companies in other markets, with their split-board structures, the reality is that in most cases the controlling shareholder or family controls both the board of commissioners, as well as the board of directors. In many of the companies we reviewed, the controlling shareholding family shared the President Commissioner (Chairman) and President Director (CEO) roles, making it difficult to accept that the two boards can operate as intended.

Internal controls and risk management disclosure much improved . . .

Internal control and risk-management disclosure has improved since our last research, largely as a result of detailed requirements in the revised Indonesian CG Code. Some companies we reviewed - Telkom, Antam, Kalbe

Farma and Saratoga - provide significant disclosure and discussion of the business risks faced by the group and how the group manages each risk. Other companies we looked at are much less forthcoming - notably Ciputra, Matahari and Ramayana - but generally we detected improved disclosure of internal risks and risk management among Indonesian companies.

. . . but the same can't be said of board and senior management remuneration disclosure

By contrast, disclosure of board and senior management remuneration details and policies are weak, with most companies choosing only to disclose remuneration on the most basic of levels. The key exception here was Telkom, which discloses in full all remuneration, but then Telkom is US-listed. Bank Mandiri disclosed the remuneration of the boards of commissioners and directors, while PGN provided aggregate remuneration details for each board on a combined basis, but declined to identify individual remuneration save for the President Director. Those companies were very much the exception: most others merely provided simple remuneration totals.

Voting by poll seems to have caught on in Indonesia

As discussed earlier, voting by poll has caught on in Indonesia in the last two years, mostly as a result of efforts by OJK to introduce the concept to companies, but also partly because companies have been encouraged to do so, perhaps by peer pressure and/or shareholders. Most listed companies in Indonesia are now conducting some form of poll voting and capturing all votes, for against and abstentions. Disclosure of voting results is less consistent, but is certainly improving. There are no e-voting platforms available in Indonesia.

Institutional investor engagement in Indonesia is non-existent

Less encouraging is the absence of any visible signs of domestic institutional investor engagement with companies. We have found no evidence of any domestic funds with a CG focus and unlike most other Asean markets there are no retail-investor associations or NGOs actively promoting CG or engaging with Indonesian companies. That said, the local Institute of Directors as well as various professional associations, notably accounting and auditing bodies, are providing some CG training and promotional activities.

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RCT report corrupt panel of judges ruling in favour of Langgam

Local anticorruption watchdog, Riau Corruption Trial (RCT), which exposes corruption within local government in the smog-afflicted Indonesian province of Riau, reported an entire panel of judges from a local district court in June. The case involved a controversial ruling in favour of a company cited for violations of environmental protection laws over illegal land clearing.

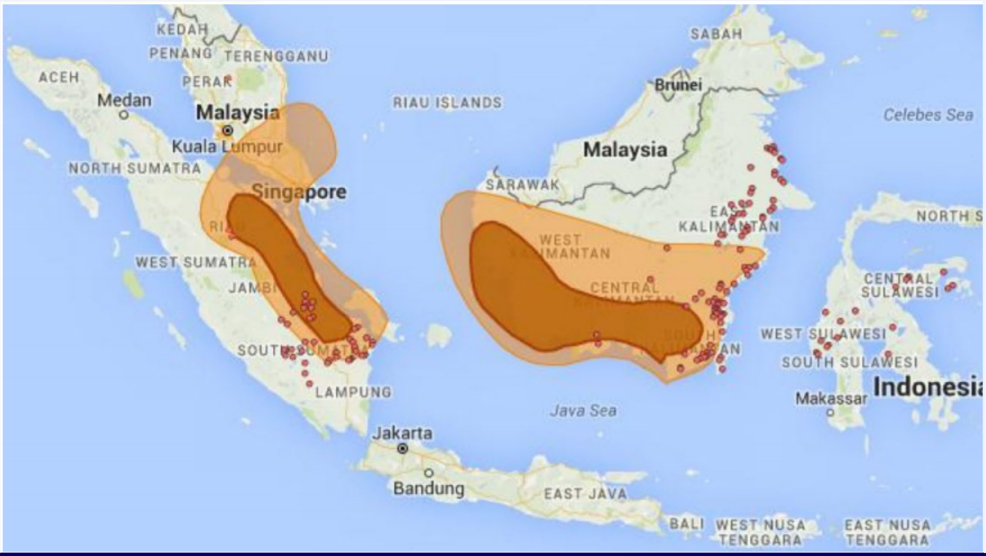
According to RCT, the field trial undertaken in April by the judges to examine evidence in the 533 hectare land-burning case was carried out using cars and speedboats provided by Langgam Inti Hibrindo, a palm-oil plantation services provider and the defendant in the case. RCT claimed that the company even provided lunch for the judges, all in violation of government regulations. RCT has filed a complaint with the Judicial Commission in Jakarta seeking action against the judges.

Corruption report was received and acted upon by the President's team

The government takes such cases seriously. It recognises that it needs to undertake Judicial Reform. Prior to when the verdict was read, the Anti-Corruption Commission (KPK) was investigating the Secretary of the Supreme Court for corruption. Since December 2015, KPK has made five arrests within the judicial bureaucracy. While there are still room for improvement, the tone has become more positive.

Forest fire areas in 2015

Forest fires in Sumatera and Borneo led to haze in Singapore and Malaysia



Source: Government of Singapore

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- A lack of progress from government and regulators on tackling insider trading
- A failure of regulators to beef up regulations and enforcement. IDX needs to enforce its rules effectively
- No progress in overhauling outdated securities and company laws
- Continued weakness in regulatory definitions of 'independent' for BOD/BOC purposes

Quick fixes

What to fix

- Tighten existing rules on related-party transactions and pre-emption to close gaping holes
- Improve the definition of 'independent director' in the OJK and IDX rules.
- IDX can start enforcing its rules
- Appoint one audit regulator and stick with them
- Force better disclosure of board and senior management remuneration and audit and non-audit fees
- Fix the regulator websites
  - Improve the English language content
  - Clear and up-to-date enforcement data
  - Deepen the IDX database of listed company data

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Japan - The hard work begins

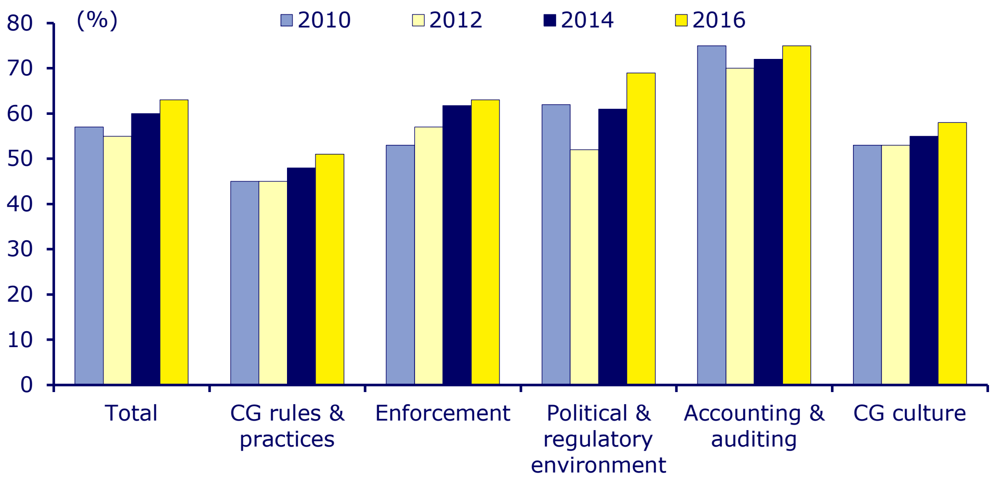
Key issues and trends

- Implementation of 2014 Stewardship Code and 2015 CG Code begins in earnest, many find it harder than expected
- Corporate reporting is highly fragmented and variable in quality: Japan a leader in sustainability reporting, but a laggard in CG reporting
- Some basic CG rules and shareholder rights still need to be reviewed
- Accounting frauds and other scandals highlight the need for stronger internal controls and audit committees, and better auditing
- Retail shareholders not afraid to sue companies
- Significant increase in the appointment of outside directors, but do they understand their role? Director training essential.
- Rise of the 'advisory nomination committee' a cause for concern

Overall score rises from 60% in 2014 to 63% in 2016

Figure 78

Japan CG macro category scores



Source: ACGA

Despite the inevitable box-ticking, some genuine change seems to be occurring in Japan

Following a surge in CG reform over 2014 and 2015, when Japan became the first country to adopt a stewardship code in Asia and the last to produce a consensus national CG Code, the country is knuckling down to the hard and less glamorous task of implementing these new rules and best practices. Despite inevitable charges of box-ticking, boilerplate disclosure and expected resistance from some sections of business, some genuine behavioural change seems to be emerging. Japan certainly has a different CG environment to four years ago, prior to the Abe government's election win, and this is reflected in its score rising in our last three surveys: from 55% in 2012 to 60% in 2014 and to 63% this year. In the face of competition from other markets, it has maintained its third place in our survey.

If Japan continues to adapt, there is no reason why its score could not surpass 70% in future

Yet, as we often say, a score in the low 60s for a country as sophisticated and developed as Japan is a rather underwhelming outcome. Compare this to Australia, which scores 78%, and the contrast is clear. Yet the Australian business environment did not use to be particularly shareholder friendly: seats on boards were for the boys, and the adoption of modern disclosure practices is a relatively recent phenomenon. Its higher score is the result of a business culture that has, for a range of reasons, been able to adapt more quickly and keep improving. We hope that Japan will show a similar evolutionary spirit and that its score will steadily rise past 70% in coming surveys. Not an impossible target.

CG rules and practices

Score rises from 48% in 2014 to 51% in 2016

If there is one part of *CG Watch* where Japan underperforms relative to itself and other markets, it is this category. While the score has risen through the introduction of the landmark CG Code in June 2015, and because we have added a new question on stewardship codes, the final result remains disappointing compared to Japan's more creditable performance in other categories of the survey. It is also noticeably below other high-ranked markets. If Japan scored in line with Hong Kong and Singapore in this category, it would likely come second overall.

Japan scores quite well on financial reporting, sustainability reporting, voting by poll

There are some areas of CG rules and practices where Japan scores quite well, or no worse than other leading markets. These include the quality of financial reporting, the adoption of sustainability reporting (where Japan is one of the leaders in the region), the move towards voting by poll (or at least disclosing all the proxy votes cast), and a stronger understanding of the need for controls on insider trading and other forms of market misconduct.

Japan is a leader in sustainability reporting

It is worth highlighting the issue of sustainability reporting, as this is an area where Japanese companies outperform. Even though formal rules on ESG disclosure are relatively limited, other than an environmental disclosure law last updated in 2012, a large number of big firms undertake extensive reporting based on the GRI format or following the guidance from the International Integrated Reporting Council (IIRC) in London. Indeed, according to a KPMG survey, more than 200 major firms now undertake 'integrated reporting' in some form (though many of the reports look more like standard sustainability reports than strict integrated reports following the IIRC model). There is clearly room for improvement in reporting quality, and greater linkage between corporate strategy/operations and sustainability challenges, but this shows that firms in Japan will adapt when they see a benefit in doing so.

But a laggard in nonfinancial reporting

Sadly, the same is not yet true in most other areas of nonfinancial reporting, which we define as including the MD&A, report of directors, CG statements, and any other governance-related information. While MD&As are often thorough and informative, we find CG-related reporting in Japan to be particularly disappointing. It is not just that it is early days for compliance with the new CG Code, which requires listed companies to follow the comply-or-explain model and explain their governance systems and practices in a CG Report disclosed to the Tokyo Stock Exchange (TSE). Since the first reports were required from late 2015, there has been an expected deluge of new reporting. One issue is that little of it is in English: as the TSE website indicates, only 124 listed companies translated their CG reports into English as of 5 September 2016.

Finding nonfinancial information in most markets is easy

The bigger issue is how and where to find CG information from companies, and what you get once you are there. Perhaps the best way to describe the challenge is to contrast the way one searches for such information in most markets compared to Japan. In the average market, the steps are simple:

1. Go to company or stock exchange website, download annual report
2. Read annual report sections on MD&A, report of the directors, CG statements, and so on
3. Review company website to review any additional CG-related information (eg, Articles of Association, background details on board committees, updated director bios)

Finding nonfinancial information in Japan is hard

It is not a complex exercise.

The same is not true in Japan. Here is what you need to do to ensure you have covered all the bases:

1. Go to company website, download the annual report.
2. Read annual report - you will quickly realise it is not a 'statutory' document required by law, but more of an optional marketing document. Typically contains only superficial CG sections.
3. Go to the company's sustainability or CSR report - quite often these contain more CG information than the annual report.
4. Go to the company's summary annual financial statement - these unaudited accounts are typically released six weeks after the end of the financial year and contain good MD&A-type information. (The actual audited accounts are not produced until three months after year-end.)
5. Go to the company's 'business report', a statutory document that must be produced for the AGM and contains a wealth of detail on both financial and nonfinancial topics, as well as the AGM agenda and meeting materials. This is often the best source for biographical material on directors and, to a lesser extent, the operation of the board and its committees.
6. Go to the TSE website and download the company's new CG Report, which contains a detailed summary of its compliance with the new CG Code. (As noted, only a few of these are in English at this stage.)
7. Go back to the company's website to look for any additional CG-related information. For example, some companies have produced informative 'CG Guidelines' that outline their approach to corporate governance and how their boards work.

Because it is fragmented across many different reports

This can be an excruciating exercise. For one or two companies, it is not a major problem. But when you multiply the extra effort required across numerous companies, it becomes a significant time-waster.

Reforms still needed in several areas

Finally, another reason for Japan's low score in this category is that there remain many areas where reforms are still outstanding (or have been undertaken, but not to a satisfactory level from a minority shareholder point of view). These include:

New share issuances: Although rules were changed a few years ago by the Japan Securities Dealers Association (JSDA) to make the system more transparent for companies and fairer for shareholders, the net result has been disappointing, according to issuers, intermediaries and investors. The nub of the problem is that brokers do not share feedback and bookbuilding information on an attributable (named) basis with companies, hence the latter do not know which of their shareholders are contributing constructively to the process. Allocations still typically go to favoured clients of brokers who are not necessarily the best long-term shareholders. This also hampers CG because, in the case of IPOs, the company starts life with no knowledge of what its prospective shareholders said.

Definition of independent director: While the rules have been tightened in recent years, in particular by the TSE, investors would like to see firmer restrictions on business partners or associates, or people linked to them, becoming independent outside directors.

Shareholders in Japan suffer from lack of access to annual meetings

AGM access: As in some other markets, institutional investors in Japan do not have their names on the share registers of listed companies, hence often find it difficult to attend AGMs in person. While a business association called Zenkabukon has developed a helpful guideline for companies on how they can facilitate investor participation in meetings, the most efficient solution would be a law change to allow custodian banks and other legal owners of shares to appoint multiple proxies to meetings. This is the case in Hong Kong and recently became law in Singapore.

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Toyota issue Model AA Class shares, new hybrid securities
When BUY-rated Toyota named the shares Model AA after one of its early models, many investors initially re-coiled at this bit of bad corporate governance. We even wrote an indignant note on this issue last year as we took a lot of abuse about it during a European roadshow (*Japan autos (Mad as hell)*).

Nonetheless, as the dust settled, and institutional investors saw the tiny size of the issue, the questions frequently turned to 'why are we talking about this?' Indeed, the initial issue of Model AA shares represent 1.4% of outstanding and up to a maximum of 5% is authorised. We detected virtually no move in the share price on the back of this event. Interestingly, despite a recommendation of a NO vote by proxy advisor Institutional Shareholder Services, the measure authorising the share's issue passed with little opposition at the June 2015 general shareholders meeting.

Model AA shares backfired

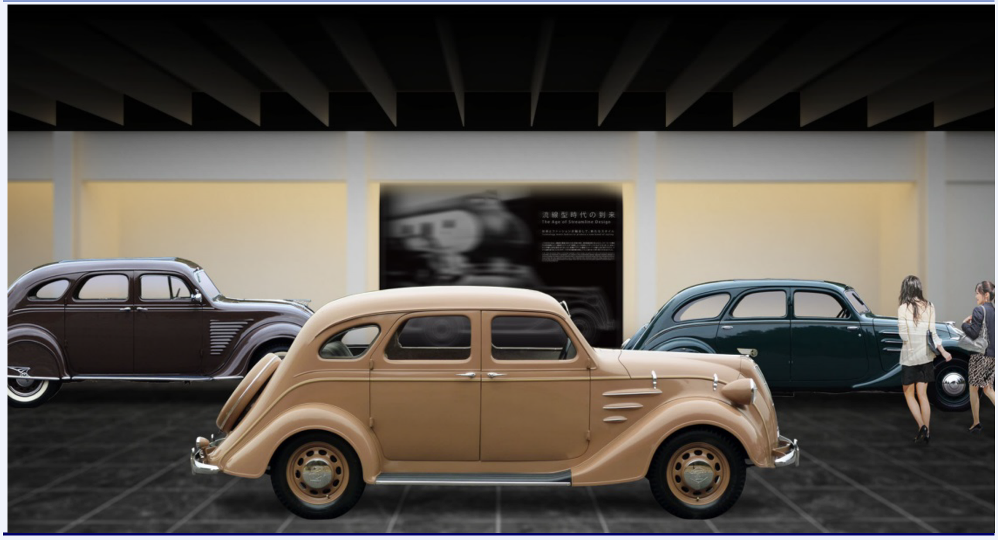
These shares do not seem a particularly enticing investment. They were issued at 120% of the common stock share price, come with voting rights, but not listed, and are redeemable after five years at face value. A 0.5% dividend would be paid in the first year of issuance, increasing in 0.5% increments to a maximum of 2.5% in the fifth year. This is well below the 3.4% common shareholders currently get. To avoid dilution, Toyota will repurchase an equivalent amount of common shares.

The shares seem aimed at increasing the number of stable, long-term retail investors who like a stable, guaranteed dividend and want to avoid share price volatility. Toyota also may have intended to pay lip service to Prime Minister Abe's attempts to promote investment in Japanese companies without disgorging much of Toyota's idle and growing US$130bn balance sheet pile of cash and securities. The idle cash issue is probably a much more material CG issue for Toyota than Model AA.

However, it seems that this old model has backfired, as we haven't heard nary a word from Toyota on this share class since the initial shares were issued. It seems that Toyota has got the message and is leaving this jalopy in the garage.

Classic original Model AA

The original Model AA - a classic, but the new version backfired



Source: Toyota Newsroom

Enforcement

Score rises from 62% in 2014 to 63% in 2016

While the past two years have brought some landmark cases of company malfeasance, notably the accounting fraud at Toshiba, scores here broadly stayed the same, with a couple rising and a couple falling. Regulators continue to enforce rules quite actively, while investors continue to vote all their shares and make their displeasure known on resolutions they typically do not like, such as the re-election of certain directors, poison pills, and retirement bonuses. But we do not see a material change in how either group is operating, though this might change in the coming years. Japan's score here of 63% is respectable by regional standards - in line with Singapore, though still somewhat behind Australia at 68% and Hong Kong at 69%.

Toshiba accounting scandal drew a reasonably robust response from regulators

The regulatory response on Toshiba has been largely as expected. The company was marked as a 'security on alert' by the TSE in September 2015 and fined a modest amount of ¥91m (US$750,000 approximately at the time). Then in early December of last year, the Securities and Exchange Surveillance Commission (SESC), the enforcement arm of the Financial Services Agency (FSA), took tougher action and recommended that the company be fined a record ¥7.37bn (US$60m approximately). However, there is no sign yet of the regulator taking prosecutorial action against Toshiba executives.

Retail shareholders have launched numerous lawsuits

Minority shareholders in Japan have been more forthright. As the table shows, there have to date been 12 suits filed against Toshiba by individuals, groups of individuals, and one corporate shareholder, Japan Trustee Services Bank, which has filed two cases. The total amount of compensation being sought is ¥14.78bn, with most of this (¥11.9bn) coming from the second action filed by Japan Trustee in late August 2016. These shareholders join the company itself, which has also sued five former executives, including three former presidents - Hisao Tanaka, Norio Sasaki and Atsutoshi Nishida - for their role in causing the massive accounting scandal.

Japan Trustee Services Bank has filed two cases

Figure 79

Toshiba law suits by individuals and corporates

Court	Plaintiff(s)	Number of plaintiff(s)	Approx amount (¥m)
Osaka District Court	Individual	1	56
Osaka District Court	Individuals	45	173
Osaka District Court	Individuals	104	420
Fukuoka District Court	Individuals	6	34
Fukuoka District Court	Individuals	10	37
Tokyo District Court	Corporate shareholder		
	(Japan Trustee Services Bank)	1	¥1.26bn
Tokyo District Court	Individuals	50	300
Tokyo District Court	Individuals	147	350
Takamatsu District Court	Individuals	25	85
Takamatsu District Court	Individuals	5	9
Hiroshima District Court, Fukuyama Branch	Individual	1	57
Tokyo District Court	Corporate shareholder		
	(Japan Trustee Services Bank)	1	¥12bn

Source: Toshiba

Institutions have preferred to engage behind the scenes

Although Toshiba inflicted considerable pain on its foreign and domestic institutional investors as well, as its falling share price attests, their public response has been quite muted. Many have engaged with the company behind the scenes and some clearly used their votes to express their displeasure at the company's most recent AGM on 26 June 2016, when one director, Satoshi Tsunakawa, the most senior executive director up for re-election, drew a large vote against of more than 12%. Votes against the other directors, most of whom were independent outside directors, were no more than 1-2%.

Toyota AA shares caused tension with foreign institutional investors

Domestic institutions, meanwhile, were fairly quiet in response to another high-profile corporate case in mid-2015, a decision by Toyota to issue a new and special class of hybrid securities called the 'Model AA Class' shares. The shares are unlisted, cannot be traded, function more like a debt instrument, yet carry voting rights. In this case, a group of foreign shareholders went public with a letter to the company and then voted against the proposal at the firm's June 2015 AGM - despite a vote against of almost 25%, the resolution achieved the required two-thirds majority. Although the company promoted these new shares as in keeping with the spirit of the new CG Code, on the grounds that were targeted at 'long-term domestic shareholders', many disagreed and viewed the development with concern, lest other companies followed suit. Disappointment was also expressed at the silence from the local investment community, especially since the new Stewardship Code was supposed to galvanise active ownership.

SESC has a new head and promises a more proactive strategy

While dramatic changes in the public behaviour of institutional investors seems unlikely in the near term, one feature of the enforcement environment that may well change in the coming years is the role of the SESC. It is developing a new and ostensibly more praoactive enforcement strategy under its new secretary general, Kiyotaka Sasaki, a banking regulator who formerly headed the CPA Audit Oversight Board, which is also under the FSA.

SESC takes action against brokers for mishandling inside information

One focus of the SESC's work over the past year has been on the improper use of inside information by brokers (ie, passing on to clients material nonpublic information gained in analyst meetings with companies). In December 2015, it recommended punishment against Deutsche Securities, followed by a similar charge against Credit Suisse in April 2016.

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Line investigated for virtual cash, and Pokemon Go next

Line found unwelcome scrutiny associated with virtual currencies . . .

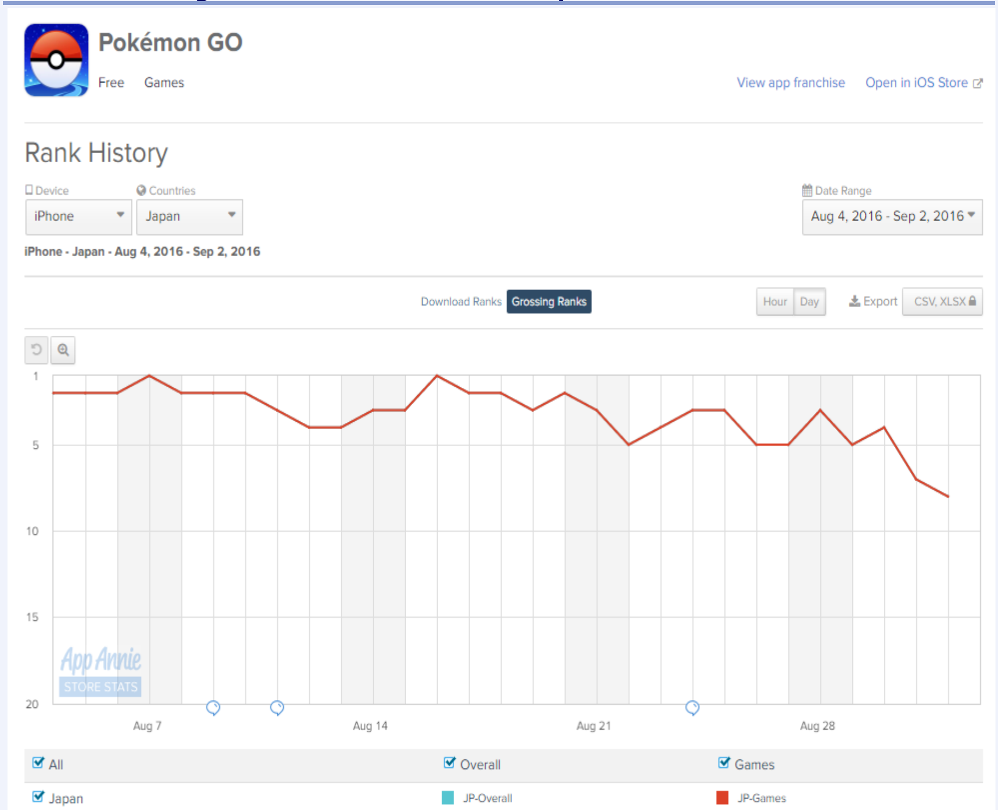
In April 2016, it was reported that Line, the operator of the popular messaging app in Japan, had drawn the scrutiny of the Kanto Local Finance Bureau for not making deposits with the Justice Ministry as a form of bankruptcy insurance for consumers making advance payments, such as for prepaid cards or virtual currencies. While Line had made deposits equivalent to half of the value of the virtual currencies used in other games in Japan, as required by law, it was unclear whether the item in question found in popular game Line Pop fits the definition of a virtual currency.

. . . as did Pokemon Go publisher Niantic

More recently, it was reported that Japan's Financial Services Agency planned to conduct an inquiry into whether the publisher of Pokemon Go, US company Niantic, is setting aside the necessary deposits against a proportion of prepaid Pokecoins, the virtual currency used in Pokemon Go. The scale of such deposits is likely to be very meaningful for Niantic, given the company's limited footprint in Japan, but it is highly unlikely that the issue will go so far as to impede Niantic from doing business as usual in Japan. Both cases illustrate the challenge of regulating new technologies, particularly across borders.

Pokemon Go beginning to slide down the charts in Japan

Revenue ranking on iOS for Pokemon Go in Japan



Source: CLSA App Annie

Political and regulatory environment

Score rises from 61% in 2014 to 69% in 2016

Japan is one of the few countries in Asia to have had a consistent and generally credible government CG policy over the past two years. Indeed, the refreshing thing about the Abe government is that it has continued to make CG part of its overall 'economic revitalisation' plans - so different to many other markets, where CG is seen as a hindrance and a cost to business.

Scores have risen on bank regulation, regulatory coherence, the judiciary, and the media

Scores in this section, accordingly, have risen on several questions, including the effective regulation of banks, the overall coherence of the regulatory system, and the quality of the judiciary. We also gave higher marks this time on media reporting about CG - we believe it is becoming more professional and balanced.

Japan's use of public - private policy committees is significant

Japan is also different from other markets in its extensive use of public-private committees to discuss policy. The same happens in other places, but not nearly to the same degree. Indeed, the Ministry of Economy Trade and Industry (METI) and the FSA have between them formed so many study groups and committees over the past two years that it is hard to keep up - sometimes one group seems to blur into another!

METI has formed study groups on AGMs, company dialogue, CG systems

METI alone has formed study groups on promoting dialogue between companies and investors, the 'electronification' of AGMs, sustainable value creation, and CG systems. The FSA created a Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Corporate Governance Code in late 2015 and consulted on what it should discuss. It has also formed councils and working groups on corporate disclosure, accounting and auditing, and the financial system.

These groups reflect a serious attempt to discuss challenging issues

What is admirable about these groups, councils and committees is that they reflect a serious attempt on the part of officialdom to understand and garner input from companies, market practitioners, academics and other experts on difficult areas of policymaking and CG practice; and that public-spirited individuals are willing to devote many hours to sitting on them. The METI group on AGMs, for example, discussed the seemingly intractable problem of meeting-date clustering and explored whether companies had the option of delaying their AGMs beyond the usual three months. Contrary to what many firmly believed before, the group's discussions showed that companies in Japan do have flexibility to set a record date after their year-end (31 March for most firms) and so hold their AGM after June (annual meetings must be held within three months of your record date - not your year-end). In this sense, the METI group served an extremely useful purpose. Unfortunately, the group was not able to resolve the issue - in large part because of numerous practical objections raised by company representatives (read: administrative inertia). Yet the cat is now out of the bag.

FSA formed a committee on the new CG and Stewardship Codes

Likewise, the FSA's Council on the Stewardship and CG Codes has discussed a number of challenging and timely governance topics, such as:

- Appointment/dismissal of CEOs
- Composition and evaluation of corporate boards
- Investor conflicts of interest in the voting chain
- Cross-shareholdings

Indeed, if you want to get a feel for what people in Japan consider to be the most important CG or ESG issues, the agendas of these committees is a good place to start.

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World's largest pension fund promoting CG

The Government Pension Investment Fund, or GPIF, is known as the world's largest public pension fund with ¥130tn (US$1,275bn) under management as of June 2016. The fund was established by the Government of Japan, and is organised as an independent administrative institution within the Ministry of Health, Labour and Welfare. It manages both the Japan National Pension and the Government Employees' Pension.

Move of GPIF into equity investments represents a tectonic shift in CG

The GPIF made a historical shift in October 2014 by cutting its reliance on low-yielding domestic bonds and increasing weightings of stocks and other riskier assets. The weighting in stocks was lifted to 50% from the previous 25%. GPIF currently has about 20% of its assets allocated in domestic equity while foreign equity accounted for 22%, and foreign debt 13% of the total portfolio. The fund can adjust the weighting in equities by 9% in either direction.

GPIF publically committed itself in 2015 to strengthening ESG principles

In May 2015, the GPIF established a set of new investment principles. Performance targets were set focusing on its long-term investment horizon. The fund also introduced principle centres around stewardship. On 16 September the same year, the GPIF publicly committed itself to strengthening its environmental, social and governance (ESG) activities by signing the United Nations' Principles for Responsible Investment (UNPRI). Japan's prime minister, Shinzo Abe, made the announcement at the UN General Assembly on 27 September 2016.

The UNPRI principles are intended to 'better align investors with broader objectives of society'. The GPIF later released a statement saying that 'It is our belief that considering ESG issues properly will lead to increase in corporate value, foster sustainable growth of the investee companies, and enhance the medium-to-long-term investment return for the pension recipients'.

GPIF is seeking an exchange of opinions with global pension funds renowned for pursuing ESG strategies

GPIF's efforts have continued to develop its governance this year. Exactly a year on from when the fund signed the UNPRI, the company started engaging with a cohort of 10 companies this September. GPIF has also announced plans to set up a Global Asset Owners Forum, whereby it will meet with global pension funds renowned for pursuing ESG strategies to share ideas. It is the first time in the history of the GPIF that it is officially seeking an exchange of opinions with non-Japanese asset managers. The Forum comprises around 20 asset owners including CalSTRS, CalPERS, Florida State Board of Administration, State of Wisconsin Investment Board, Canada's Ontario Teachers' Pension Plan, the UK's Universities Superannuation Scheme and Dutch asset manager PGGM.

GPIF's internal rules prohibit the company from managing equity investments directly. However, the fund will mandate all of its external managers to sign the PRI and to execute its ESG commitments. The GPIF will analyse their ESG activities and disclose the findings annually.

It is hard to assess the practical value of all these committees - measuring outcomes more clearly would be good

It is hard to assess the value or contribution of all of these committees and study groups. Some are formed with a specific purpose in mind, such as the creation of a stewardship or CG Code, then appear to deliver. Others seem to be more talk-shops to allow officials to gain market intelligence or understanding - in itself a good idea - or as a way for the government to nudge companies and investors towards certain outcomes (such as, 'please start talking to each other more') or as a way to build consensus around a new idea (such as the need for more diverse boards). What would be quite helpful is a simplified list kept at both METI and the FSA of the main agendas items of these committees, what conclusions were reached, and which decisions or ideas led to tangible regulatory or market outcomes. This might help to avoid the inevitable perception that such committees are all talk and no action.

Collective engagement by investors potentially faces some legal obstacles

One issue on which we would like to see some regulatory focus over the coming two years is collective engagement by institutional investors. Unlike stewardship codes in the UK, Netherlands and the parts of Asia that have adopted them (ie, Hong Kong, Malaysia and Taiwan), the Japanese code does not explicitly encourage collective engagement. Yet nor does it discourage it. However, Japan has rules on concert-party action (called joint holders) that could inhibit the ability of institutions to work together and collaborate on company engagement. This is an area deserving of further examination and discussion, so that the spirit of the Stewardship Code is not inadvertently undermined by other regulation.

Accounting and auditing

Score rises from 72% in 2014 to 75% in 2016

Discussion in the accounting and auditing sector in Japan over the past year has been dominated by the Toshiba fraud and the fallout from it. Two major outcomes have been the strong disciplinary action taken against the Toshiba auditor and proposals for a new auditor governance code.

Toshiba auditor punished severely in late 2015

In late December 2015, the FSA issued an administrative order to Ernst & Young ShinNihon, Toshiba's auditor, which stopped the firm accepting new clients for the three months from January to March 2016 and required it to improve its operations. According to the FSA's brief announcement, partners of the firm had 'in negligence of due care' attested to the financial statements of the company for three years - 2010, 2012 and 2013 - despite the material misstatements contained in them. While the first punishment against the firm may seem quite light, the FSA also suspended seven partners of the firm for between one and six months, and it fined EY ShinNihon ¥2.1bn (US$17.4m). As a result, the CPA firm's chief executive, Koichi Hanabusa, resigned and several staff took steep pay cuts. It is understood that the firm had been auditing Toshiba for decades.

FSA committee proposes an audit firm governance code

Then on 8 March 2016, a council formed by the FSA to advise on improving accounting and auditing published a paper recommending the development of an 'audit firm governance code'. The council is opting for a principles-based code and states that CPA firms should be requested to produce a 'self-motivated and effective response'. It made recommendations in four areas:

- ❑ Enhancing provision of information about audit to shareholders
- ❑ Strengthening the ability to detect corporate fraud
- ❑ Assessing audit quality and auditor independence from third parties, such as regulators and the Japan ICPA
- ❑ Improving the environment for high-quality audit

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Percentage-of-completion accounting was just the tip of the iceberg

The massive charges Toshiba encountered in its accounting scandals became a major source of concern regarding the company's sustainability

Toshiba accounting scandal

Toshiba was involved in one of Japan's most sounded accounting scandals in recent history. On 3 April 2015 Toshiba announced that it had established a special investigation committee (formed by internal personnel and external experts) to conduct an investigation over irregularities on the percentage-of-completion method of accounting related to some of the company's infrastructure projects. On 8 May, Toshiba withdrew its guidance for FY3/16 and announced that further time would be required to conduct a detailed investigation into the facts and causes leading to the irregular accounting practices. At the same time, Toshiba announced that the framework of the investigation would shift from one conducted by the special investigation committee to an independent investigation committee formed by external members only.

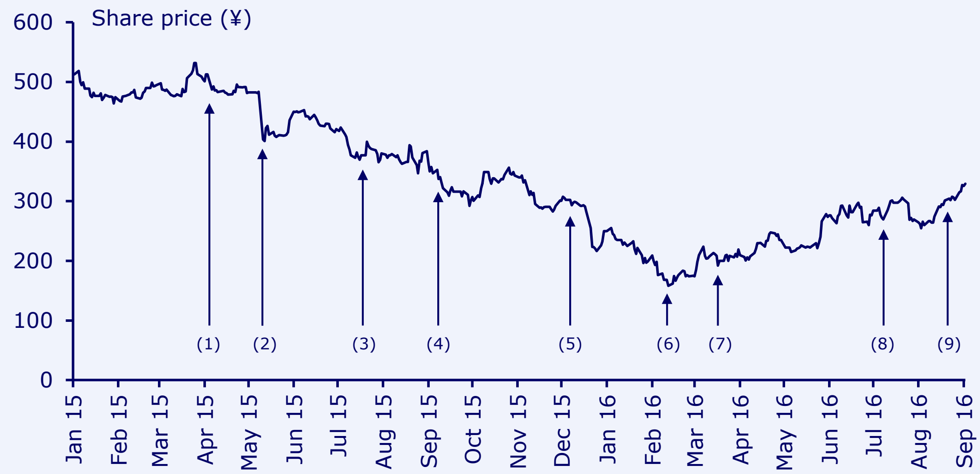
The independent investigation committee found past accounting irregularities beyond the percentage-of-completion accounting method for infrastructure projects. Accounting irregularities were also found for parts transactions in the PC business, the recording of operating expenses in the Visual Products business and the valuation of inventory in the semiconductor business. As result of the findings, Toshiba restated its past financial results for fiscal years FY3/10 through FY3/15 with a cumulative restated amount of ¥224.8bn to profits before income taxes. Subsequently, Toshiba wrote off assets totalling ¥126.9bn (including all equity and debt to the South Texas nuclear power project and home appliances and partial impairments to discrete semiconductors and the automotive/batteries businesses). Toshiba took further charges related to restructuring of the home-appliances business (¥22bn) and the HDD business (¥4bn) and wrote-off further assets related to the power transmission and distribution business (¥8.2bn) and nuclear business subsidiary Westinghouse (¥247.6bn). Largely influenced by the restructuring charges, Toshiba had net losses of ¥460bn in FY3/16.

The massive charges had caused a severe deterioration of Toshiba's balance sheet and this, in turn, was a major source of concern for the company's sustainability. To stabilise its financial situation Toshiba sold its medical business operations through a bid process that was won by Canon (¥665.5bn). The operating performance has started stabilising and the company turned into profit in its 1QFY3/17. The balance sheet remains weak, but the risk of further writeoffs is now small.

Toshiba has paid a high price throughout this accounting scandal, but the company has finally started to show that it has learnt its lesson. Top management has been changed and new compliance rules have been made effective. Toshiba has also improved its disclosure policies and transparency. The company held its first ever IR Day on 6 July 2016 and more information is being made available to analysts regarding the performance at the subsegment level.

Toshiba has been busy since the scandal erupted

Toshiba's share price and timeline of major events



Source: Company data, DataStream, CLSA

(1) **April 2015:** Toshiba announces the establishment of a special investigation committee to conduct an investigation over irregularities on the percentage-of-completion method of accounting related to some infrastructure projects.

(2) **May 2015:** Toshiba withdraws guidance for FY3/16. Framework of investigation is shifted to an independent investigation committee formed by external members only.

(3) **July 2015:** Report from independent investigation committee is received. Irregularities were also found in PC business, Visual Product business and Semiconductor business. President Tanaka resigns. Mr Muromachi is appointed as new president.

(4) **September 2015:** Toshiba restated its past financial results for fiscal years FY3/10 through FY3/15 with a cumulative restated amount of ¥224.8bn to profits before income taxes. Tokyo Stock Exchange and Nagoya Stock Exchange designate Toshiba shares as 'Securities on Alert'.

(5) **December 2015:** The Securities and Exchange Surveillance Commission make a recommendation to the Prime Minister and the Commissioner of the Financial Services Agency for administrative monetary penalty payment of ¥7.4bn, the highest in Japan's history.

(6) **February 2016:** Toshiba introduces revised methodologies for budget development and evaluation of in-house company performance.

(7) **March 2016:** Toshiba releases 'Improvement Plan and Situation Report', a summary of the analysis of the causes of the company's accounting issues and preventive measures taken to enhance compliance. Final agreement for the sale of Toshiba Medical to Canon is signed. Toshiba and Midea sign MOU on sale of Toshiba's Home Appliances business.

(8) **July 2016:** Toshiba hosts its first ever IR Day.

(9) **August 2017:** Toshiba releases a 'Status of Improvement Situation Report'. Toshiba is scheduled to present written confirmation of internal management systems to the Tokyo Stock Exchange and the Nagoya Stock Exchange on 15 September. This is a step towards the cancellation of its designation as a Security on Alert.

IFIAR plans to set up its secretariat in Tokyo

On lighter news, on 21 April 2016, the International Forum of Independent Audit Regulators (IFIAR), the international body comprising more than 50 national independent audit regulators, announced at its annual meeting in London that its permanent secretariat would be set up in Tokyo from around April 2017. IFIAR was established in 2006 in the wake of major accounting scandals, such as Enron, as 'a platform for dialogue and information-sharing regarding audit quality matters and regulatory practices around the world'. The choice of Japan is seen as reflecting the rising profile of Asian corporations and investor interest in them, necessitating more reliable audit quality in the region.

CG culture

Score rises from 55% in 2014 to 58% in 2016

An aggregation of many small changes in CG practice in Japan over the past two years led to the rise in score here. While much of this may be form over substance, it is a truism that substance in governance rarely emerges from nothing. It needs a framework around which to develop.

There is certainly no shortage of form:

Plenty of evidence of CG structural change in Japan

- TSE statistics show a steady adoption of independent directors (INEDs) among its listed companies. In mid-July 2016, almost all companies (97%) in the first section of the TSE had appointed INEDs, while almost 80% had appointed two or more. Both figures indicated substantial jumps from the year before.
- While clustering is still a significant problem in Japan - 32% of firms with a March year-end (640 companies) held AGMs on the peak day this year of June 29 - this is actually a lower proportion than the 41% of last year. And if you think this is bad, spare a thought for anyone voting 20 years ago, when 95% of companies held their annual meetings on the same day! Yet clustering in the final seven days of June remains: this year 70% of firms held AGMs on 24, 28, 29 June. *(TSE data analysed by Sumitomo Trust)*
- The proportion of English meeting notices increased to 30% of companies this year from 20% last year.

High level of compliance claimed with new CG Code . . . but

The fact this is early days in board reform in Japan is evident in yet more analysis from the TSE, this time on disclosure within the new CG Reports. On 20 January 2016, the exchange released statistical analysis of 2,487 companies that had filed a report by the end of December 2015. Of 1,858 companies listed on the TSE's first and second sections, almost 12% claimed compliance with all 73 principles in the CG Code, while more than 66% complied with 90% or more. We would suggest these numbers be taken with a grain of salt. However, it was the areas with the highest 'noncompliance rates' that were more interesting:

- Board evaluation and disclosure (64%)
- Electronic voting/English AGM notices (56%)
- Two or more independent directors (43%)

Companies mixed in their reasons for non-compliance

Of the reasons for noncompliance, 29% of the 1,642 companies that provided explanations said they intended to comply with most of the principles in the future, while 44% said they had yet to make up their minds. About a quarter, however, admitted that they had no plans to comply, with reasons given including 'due to specific circumstances' and 'alternative measures to be taken'.

Nomination committees are still rare in Japan

While the statistics on new independent directors may look impressive, two areas where boards typically remain weak in Japan are the lack of proper committees for nomination and audit. Very few companies follow the three-company system, which provides the most robust foundation for board governance in Japan in our view. While the traditional *Kansayaku* (statutory auditor) board system has undergone reforms over the years, we continue to believe it has certain structural, legal and philosophical flaws that limit its effectiveness as a true substitute for an audit committee.

We continue to remain skeptical about the new third system of board governance

At the same time, the new third board system, the Audit and Supervisory Committee Company, designed to bridge the gap between the two previous systems and now adopted by around 300 listed companies, also falls short. One reason is that companies with such committees do not need to form statutory nomination committees - a crucial missing link in the governance of most listed firms (along with the lack of audit committees). Indeed, it has been expressed to us on several occasions that this is precisely the attraction of the new system to so many companies. While some of them do have nomination committees, on closer inspection you will find they are described as 'discretionary advisory bodies to the board'. In other words, they have no legal basis or formal authority, and their advice does not need to be followed. Even more strangely, some companies with such committees have refused to disclose who the members are!

Institutional investors are also finding it hard to adapt to new practices

Just as listed companies are finding that adapting to new CG practices is not easy, so too are institutional investors. In January 2016, the Government Pension Investment Fund (GPIF), the country's largest institutional investor, published a summary report of its stewardship activities in 2015. Part of this was a survey of its own external asset managers. As GPIF cannot invest directly in companies, it needs to carry out its ownership policies through its external asset managers. It duly interviewed all 20 managers of its domestic equities on their stewardship activities and, perhaps unsurprisingly, found a few flaws. For example, some had internal governance problems, while other ignored potential conflicts of interest with parent companies when voting their shares.

GPIF surveyed companies and many criticised the early stewardship efforts of investors

Then in April 2016, GPIF released the results of a survey it undertook in of JPX Nikkei Index 400 companies on their interaction with the Fund's external asset managers. Based on responses from 260 companies, the key findings included both positives and negatives:

- Respondents 'recognised and appreciated . . . investors' questions about business strategy and ESG issues'
- Many companies felt it 'undesirable' that some investors were asking formal questions and seeking meetings just to meet internal performance targets
- Investors did not always understand the 'circumstances surrounding companies' before making 'one-way propositions'
- Companies want direct dialogue with asset owners, and expect them to motivate their asset managers to carry out constructive dialogues.

GPIF pushes passive managers to think harder about stewardship

Commenting on the results, the GPIF added that 'it is especially important for passive managers to uphold their stewardship responsibilities because most of GPIF's domestic equity portfolio is managed passively'. The Fund also expressed its concerns about investors' often short-term focus and a lack of willingness to engage long term with companies.

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Mitsubishi Motors admits doctoring fuel efficiency data

Uncovered Mitsubishi Motors is no stranger to scandal, and it was embroiled in several during the late 1990s and early 2000s, which drover the company to the brink of bankruptcy, and it was only saved from extinction by the largess of other Mitsubishi group companies, which represented the troubled automakers largest shareholders. However, over the past decade, Mitsubishi Motors kept its nose clean; but once you've got a record, a stigma remains, and its share price was massacred, halving very quickly.

Enter top Japan autos BUY Nissan Motor, the aggrieved party. Nissan outsources production of its 660cc displacement mini-vehicles (a special tax-favoured vehicle segment indigenous to Japan) with the bulk of them coming from Mitsubishi Motors. Moreover, about two-thirds of Mitsubishi's mini-vehicle production was for Nissan. Nissan discovered Mitsubishi's fuel-economy issue when developing a next generation model and compelled Mitsubishi to report it.

Mitsubishi Motors is no stranger to scandal

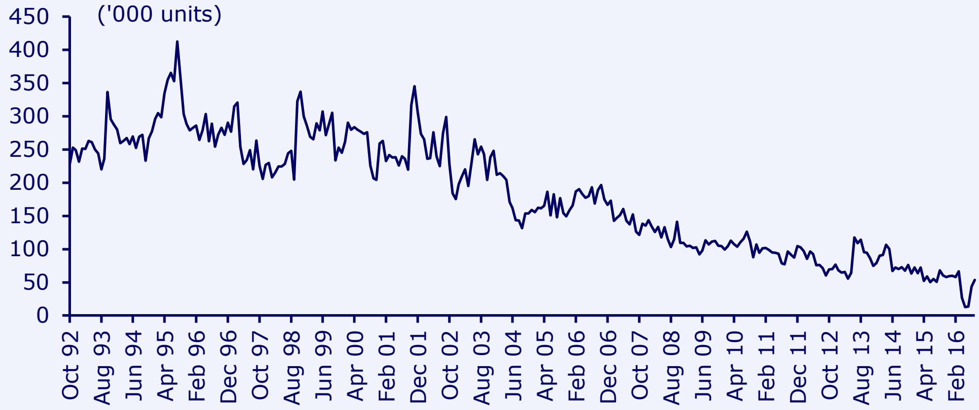
Within days of the news breaking, Nissan announced that it would be making an investment for one-third of Mitsubishi Motors. Many were amazed at the speed that Nissan had made this decision, but we recall when Nissan and Mitsubishi had their first mini-vehicle tie, idly contemplating the complementary nature of the two companies, and how it could be a nice acquisition for Nissan, but could never imagine Mitsubishi selling. For example, Mitsubishi has a fantastic Asean business, while Nissan's is weak. Moreover, Mitsubishi does not own an auto-finance unit. Nissan's is world class. The mini-vehicle business is small fry compared to these opportunities. Perhaps Nissan had similar thoughts and simply dusted off an old playbook. It was an inspired move.

Who says corporate governance lapses can't have a silver lining?

In any case, Mitsubishi Motor's lapse pales to some of the other shenanigans we have seen in the global auto industry. For example, consider Toyota's 2010 unintentional braking problem, GM's ignition switch defect and Takata's exploding airbags. All of these issues got people killed. VW's diesel emissions cheating probably had an impact on people's health. In comparison, Mitsubishi overstating vehicle fuel economy by 8% seems small potatoes in comparison.

Consumers already leaving it behind

Mitsubishi's mini-vehicle SAAR in Japan



Source: CLSA

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- Poor implementation of stewardship principles by investors, including their disclosure in response to the Code
- Limited impact of the new CG Code on fostering genuinely improved dialogue between companies and investors
- No tangible improvement in the extent of English-language reporting
- Any negative impact of concert-party rules on collective engagement
- Shareholder access to AGMs continues to be restricted
- No effort made to reduce fragmented corporate reporting
- Continuation of the hybrid and opaque voluntary nomination committee

Quick fixes

What to fix

- Amend public offering rules so that brokers must share material information with companies, and investors get fairer allocation
- Refine definition of independent director on business relationships
- Companies to combine all non-financial/CG reporting in a single source
- Encourage listed companies to set later record dates, allowing them to hold AGMs in July
- Encourage companies to publish CG reports in English
- Companies to organise director training not just for outside directors, but for current and future inside directors as well

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Korea - Pockets of progress

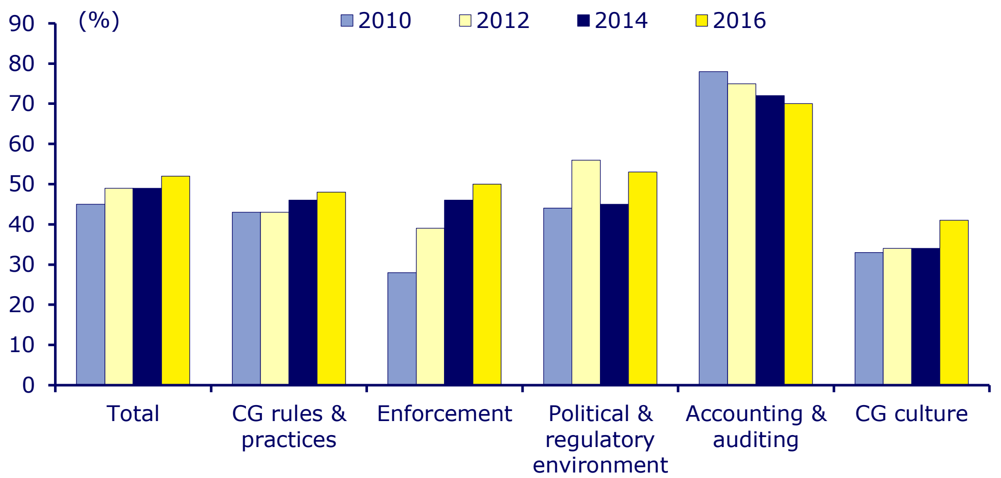
Key issues and trends

- Concerns over the economy and jobs - and *chaebol* resistance - have made it a tough two years for CG policy
- Financial regulators have moved ahead with reforms on bank governance, but show reluctance on investor stewardship code
- KRX improves listing rules and finalises the long-awaited CG Code update
- Regulatory enforcement is getting better
- New anticorruption law raises hopes of a cleaner public service
- Concerns rise over accounting and auditing irregularities
- Investors see red over *chaebol* transactions

Overall score rises from 49% in 2014 to 52% in 2016

Figure 80

Korea CG macro category scores



Source: ACGA

Park government leadership on CG less than lukewarm

The Park government's leadership on CG reform, already weak when we did our last *CG Watch*, declined further over 2015-16, due to concerns over a declining economy and a lack of job creation. In contrast to Japan, where the term 'economic revitalisation' positively links reform to enhancing corporate value, in Korea it is the opposite. Indeed, one loses count of the number of times people say that CG reform will cause a 'big burden' for companies and should be approached cautiously. There is only a limited discussion of the benefits that reform might bring.

Yet financial regulators have made headway

Despite this difficult environment, financial regulators have made some important improvements in regulation and enforcement - and this accounts for Korea's score rising in related sections of our survey and the overall score rising from 49% in 2014 to 52% this year. In one section, 'CG rules and practices', the score has risen somewhat less than expected. This is because we marked certain questions down relative to other markets, including a new one on investor stewardship codes, and because the inclusion of Australia in this year's survey has resulted in a tougher benchmark being applied across the board.

CG rules and practices

Score rises from 46% in 2014 to 48% in 2016

Despite a number of improvements in CG rules appearing over the past two years, Korea's score in this category increases only incrementally for two reasons: ongoing weaknesses in certain areas of corporate disclosure and shareholder rights; and a widening gap between Korea and other markets, even in areas where the country has shown progress.

New law on CG of financial firms

The primary legislative change of the past two years has been a new law on the governance of financial institutions, called the Act on the Corporate Governance of Financial Companies, which was promulgated in July 2015 and took effect from August 2016. It was preceded in December 2014 by a best practice guideline from the Financial Services Commission (FSC), the peak financial regulator, that followed the comply-or-explain model. These initiatives began in April 2013 following a number of CG scandals involving financial institutions.

Board governance of financial firms set to improve

Key features of the new law include, for example:

- Qualifications of external directors strengthened: there is now a three-year cooling-off period for former executives, employees and nonexecutive directors;
- External independent directors should make up the majority of the board, regardless of the type of financial service company
- Companies should develop and disclose an internal code on CG, including principles and procedures for board and committee meetings
- Appointees to audit committees should satisfy the requirements for appointment as an external director; and the voting rights of major shareholders are restricted when voting on audit committee members

It is hoped that these new rules will also limit government interference in banks and allow the latter to create more market-oriented governance systems.

Korea finally updates its 2003 CG Code in line with global best practices

The other big news was the arrival in August 2016 of a long-awaited revision to Korea's CG Code of 2003. This has been led by the Korea Corporate Governance Service (KCGS), an affiliate of KRX, and brings CG standards closer to international best practice in several areas:

- Companies should make an effort to provide voting by ballots or e-voting, and disclosure of detailed voting results is recommended
- Outside directors should not take on too many roles
- Institutional investors should actively exercise their shareholder rights by adopting an engagement policy and disclosing it. If they belong to a bigger corporate entity, they should also disclose their special relationships and how this influences voting
- Large companies are recommended to split the role of chairman and CEO, or appoint a lead outside director
- Firms should publicly announce their CEO succession plan or policy
- Companies should not elect any person who has been responsible for violating shareholder rights or damaging corporate value as a director

The Code also recommends that outside directors be periodically trained for better performance and newly-elected directors should participate in a CG training programme. It further suggests that firms evaluate inside and outside directors and reflect the results in their remuneration decisions, as well as director re-election. And the code mentions that a 28-day advance notice for the AGM agenda is best practice.

Code is also not yet comply or explain

All these changes are positive. However, it needs to be emphasised that Korea remains one of the few markets in Asia where the CG Code is not a comply-or-explain requirement under stock-exchange listing rules. It is a voluntary document that relatively few companies explicitly follow. This should change next year, following a promise by KRX to amend its listing rules on this point in the second half of this year. We also look forward to the English translation of the new code.

Plans for an investor stewardship code have stalled

Two years ago, there was cautious optimism that Korea would have an investor stewardship code by now. Since Japan introduced its code in 2014, several more markets have followed suit, including Malaysia (2014), Hong Kong and Taiwan (both 2016). Singapore's code is due out shortly. Although the FSC and KRX consulted locally on a stewardship code in 2015, the drafting process has been delayed and the FSC is delegating responsibility to KCGS. While the goal is to produce a code by the end of 2016, resistance from the business sector could prolong its finalisation.

NPS could play a critical leadership role on a stewardship code

As an aside, one advantage Korea has over the likes of Hong Kong and Singapore in this area is the existence of a national pension fund, the National Pension Service (NPS), that invests directly in listed companies. Although NPS faces well-known challenges to voting its shares against powerful local interests, it could in theory play an important leadership role in the implementation of a stewardship code. The value of these codes in driving more frequent and constructive communication between companies and investors should not be underestimated.

KRX promoting more English disclosure

Other areas of progress in Korea include improved rules on the promotion of English-language disclosure and price-sensitive information (PSI). KRX amended its listing rules in May 2016 to encourage greater levels of English disclosure, especially among large caps and, in the same month, upgraded its rules on timely disclosure: it is shifting from a prescriptive system where companies disclose only what they must to a principles-based system where they have more responsibility to decide what is material.

These moves are positive, yet there remain many areas where basic CG standards in Korea are falling further behind regional best practice:

- Nonfinancial and CG disclosure is limited, formulaic and often of poor quality (eg, remuneration policy; the actual work of board committees; directors' bios and training; board evaluation)
- While PSI disclosure looks set to improve, much reporting follows a template format with financial numbers but no narrative explanation
- Lack of mandatory voting by poll and disclosure of detailed results
- Weak pre-emption rights for minority shareholders (though it should also be noted that Korean firms do little equity capital raising on the secondary market; they prefer debt or use retained cash)

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KB Financial's top leaders started a power struggle which led to both resigning

Feud went on to change the regulatory stance to be more market-friendly

New CEO held key positions in KBFG, and bank put in new internal CG regulations

Kookmin Bank and Kookmin Financial board crisis

The power struggle between the heads of the holding company KB Financial (Lim, Youngrok) and KB Kookmin Bank (Lee, Kunho) wreaked havoc on Korea's largest financial institution in 3Q14. Starting as a disagreement around changing KB Kookmin Bank's online banking-system operator from IBM to Unix, the standoff ultimately turned into a power struggle.

Conflict between the two leaders started in early 2014 when Lim pushed forward with changing KB Kookmin Bank's system operator to Unix. Opposed to the change, Lee asked the financial regulators to investigate whether Lim was trying to conceal operational errors during Unix system tests. The two leaders of KBFG were penalised by the regulators, and Lee immediately announced his resignation. Lim refused to step down, threatening to sue the regulators on the grounds of unfair punishment. When Lim finally agreed to resign, the group was left with an institutional warning from the regulators, a senior management vacuum, and an urgent need to select a new leadership team.

Timeline of KBFG power struggle

Date	Event
9/4/2014	FSS decides severity of punishment as 'formal reprimand'
9/12/2014	FSC escalates severity of punishment to 'suspension'
9/15/2014	Board of Directors recommend Lim to step down, but Lim refuses
9/17/2014	Board of Directors agree to dismiss Lim
9/28/2014	Lim resigns from the board of directors
10/5/2014	Search Committee announces nine candidates for new CEO

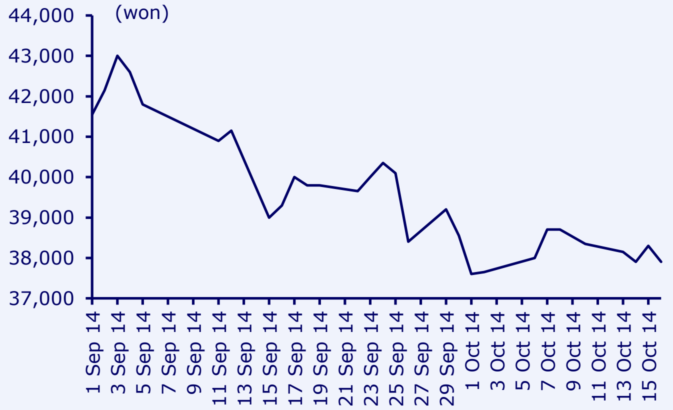
Source: CLSA, Press analysis

The markets responded by initially pushing down its share price. KBFG's shares fell 8% from the day the FSS announced its punishment against KBFG to the day the board of directors recommended Lim to step down (6% from the punishment announcement to the day Lim was dismissed). To be fair, the stock has actually outperformed the sector index as it was a chronic underperformer up to this event.

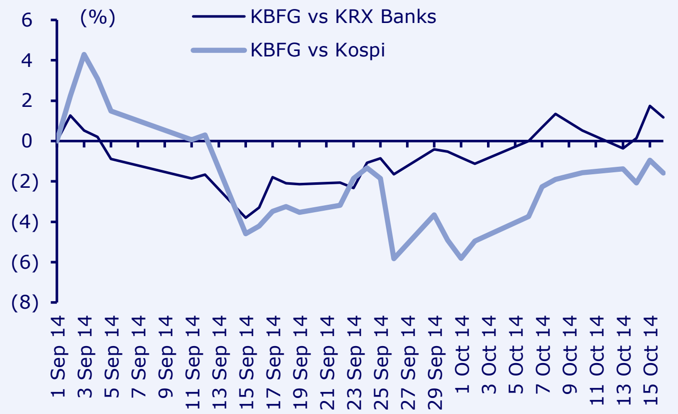
The appointment of the new CEO of KBFG, Yoon Jongkyu (also acting CEO of KB Kookmin bank), who had previously held key positions such as CFO and CRO at KBFG, signified the move away from government-directed CG to a more market-led governance structure. KBFG has put in place new internal CG regulations that severely limit the authority of external directors and has moved away from a college-professor-heavy board to a market-expert-based board (only two external directors out of seven have no working experience in a financial company). These events have led to structural changes in how the bank views risk management, and new leadership has defined a shareholder-friendly strategy for the bank, which has led to increased profitability.

KBFG's feud led to the replacement of the Financial Supervisory Services governor at a time when the Financial Services Commission chairman was changed, leading to a more market-oriented regulatory environment (the FSC chairman previously headed NH Financial). Regulators have since been talking about giving more freedom to the banks in terms of dividend payout and pricing - key factors for the Korean bank discount versus global peers.

KBFG share-price movement



KBFG relative share-price movement



Source: CLSA, Quantiwise

Enforcement

Score rises from 46% in 2014 to 50% in 2016

There is much in the Korean enforcement environment that one can be critical of, primarily the ongoing practice of pardoning corporate leaders convicted of crimes. President Park Geun-hye pardoned SK Group chairman, Chey Tae-won, in August 2015, despite vowing during her election campaign not to continue this discredited practice. Pardons have not been given to all *chaebol* executives serving prison sentences, although there is regular speculation in the media about who will be let out next.

Fines in Korea are often less than the illegal profit made

A second issue is the level of punishment meted out to companies for illegal practices, with fines often less than the profit made. For example, in June 2016, the Fair Trade Commission (FTC), which regulates intragroup transactions within *chaebols*, fined two affiliates of the Hyundai Group (not to be confused with the Hyundai Motor group) a total of 1.29bn won (US$1.14m) for conducting illegal intragroup transactions. Yet the FTC also said that it estimated the controlling Hyun family had gained 2bn won from these transactions. As a veteran lawyer noted, the concept of 'punitive fines' was still not well understood or accepted in Korea and efforts to reform this system would be difficult, in part because legal professors (who play an influential role in setting legal policy) would probably object. Some of the more conservative professors view the law as tantamount to a sacred text and are staunch defenders of the status quo.

Korea provides little information in English on regulatory enforcement

A third perennial is the limited information available in English about regulatory enforcement. Most disclosure about ongoing cases is found only in the English media - not on regulatory websites - and is extremely difficult to corroborate. While regulators do provide aggregate statistics on enforcement in their annual reports, or when asked, it is often difficult to interpret what the numbers mean. The degree of explanation could be significantly enhanced to cater both to existing foreign investors and the government's long-term goal of internationalising Korean capital markets.

Despite negatives, score rises due to efforts of regulators

Despite these negatives, the score for enforcement has risen steadily over the past four surveys since 2010 because the efforts of key regulatory agencies - the FTC, the Financial Supervisory Service (FSS), and KRX - have all shown signs of improvement.

FTC gets higher fining power against *chaebol* for RPTs

Following a 2015 revision to the level of punishments allowed under the antitrust law, the FTC undertook the investigations described above into illegal intra-group transactions. With the announcement of the Hyundai Group fine, an FTC official said that this was the first time it had imposed sanctions against a company for transactions leading to personal gains to the controlling family.

FSS takes tough line against Lotte

The FSS, which is the enforcement arm of the FSC, has been active on several fronts. The most high-profile have included actions in mid-2016 against Lotte Group companies for alleged embezzlement and malpractice and Daewoo Shipbuilding for accounting fraud (see blue box on next page). Moreover, the FSS uncovered twice as many cases of corporate disclosure violations in 2015 as it did in the previous year: 126 vs 63. The regulator attributed the leap to its efforts to streamline the detection process and ramp up investigative manpower.

KRX gets tougher on "unfaithful disclosures"

KRX, meanwhile, has focused much of its enforcement efforts on controlling 'unfaithful disclosures' by listed companies. Its fining power has doubled from 100m won to 200m won, listed companies that break the rules must submit an improvement plan and then a performance report six months later (previously they were only supervised for one month), and the exchange can now demand the replacement of people who 'habitually make unfaithful disclosures'. Statistics on the number of unfaithful disclosure cases and the fines imposed suggest the regime is becoming more stringent: from 29 cases and fines of 50m won in 2014, to 25 cases and fines of 286m won in 2015, and to three cases and fines of 108m won for the first three-and-a-half months of this year.

Investor voting on the rise

In terms of institutional shareholder voting, domestic investors vote in large numbers more because they are required to do so than out of any belief that voting has a positive governance or investment value. They must also disclose how they have voted, with most unsurprisingly in favour of management (many Korean asset managers are owned by *chaebol* groups, hence face a clear conflict of interest).

NPS will vote against companies when it can

In contrast, the National Pension Service is a more informed voter that will go against companies from time to time. But its actions can appear contradictory. For example, it voted against the merger of SK Corporation and SK C&C in 2015, but in favour the Samsung-controlled Cheil Industries takeover of Samsung C&T in the same year. Had the NPS voted against the latter transaction, as many foreign investors had hoped, it would not have gone through. The decision was the result of a power struggle within the NPS.

Foreign investors are active voters, but the lack of polls means no transparency on patterns

Foreign investors, who in many cases comprise the majority on the share registers of many companies, are also active voters (going on both anecdotal information and available data on the total number of votes cast at certain AGMs, such as Samsung Electronics). While not shy about voting against resolutions with which they disagree, it is unclear what impact foreign voting has on the governance of Korean corporations - and the lack of any detailed voting results means that the market can never see. This is one reason why AGM voting transparency is so important, even if it is somewhat embarrassing for the companies concerned. Listed companies in other markets have come to terms with this issue. We hope Korean firms will too.

Little use of class-action law since it was enacted in 2005

A unique feature of the Korean legal system about which there had once been considerable excitement, namely the class-action law of 2005, has proved of limited value. While seven suits have been filed, it was not until March 2016 that the courts allowed the first to go to trial - a case against a foreign bank, the Royal Bank of Canada.

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Differentiated treatment on *chaebol* cases

Investors should expect the unexpected in legal issues involving *chaebol* families

The incumbent government has demonstrated a degree of inconsistent treatment regarding the imprisonment and pardoning of Korean *chaebol* chairmen. Investors should expect the unexpected outcome when it comes to legal issue around Korean *chaebol* family considering recent government stances. While there has been little evidence that Korean conglomerates' business performance was materially impacted by their respective chairmen's imprisonments, we did see clear short-term volatility as a result of local speculation on the incumbent government's preference regarding selective *chaebol*s, it obviously does have impact on share price.

Complications for Korean *chaebol* families rising after drastic proposals by Democratic Party

Still, complications for Korean *chaebol* families are rising from a rapidly changing regulatory environment, mostly owing to the drastic proposals by the Democratic Party (Minjoo Party). There are proposals to limit the use of treasury shares in the holdco formation processes to bolster minority shareholders' rights in such a major transaction (these transactions have become common practice in Korea). This can have implications for future *chaebol* family control. Of course, there will be a tedious process of negotiation for final revisions to *chaebol*-related regulations, but the direction is clearly against *chaebols* without 'clean' structures. Our base case is that Samsung and the Hyundai Motor groups will have to react fast before major changes in the transaction rules for restructuring.

Proposal against *chaebol* regulation in 2016

Proposed revision	The proposer	Details in Proposal	Implication to Korean conglomerates
Insurance Law	Lee, Jong Gul	Insurance Asset management ratio from acquisition cost to market price	Samsung Life to sell Samsung Electronics stakes
Commercial Law	Park, Yong Jin	Treasury shares not to be allocated to OP Co in split process	Advantage of treasury shares in split process will mitigate
Corporate Tax Law	Park, Young Sun	Corporate tax on treasury shares allocated to OP Co in split process	Advantage of treasury shares in split process will mitigate
Commercial Law	Park, Young Sun	Equal treatment on disposal of treasury shares	Selective disposal of treasury shares is not allowed: Samsung C&T case (just sold to KCC Corp) is not possible
Fair Trade Act	Park, Yong Jin	Restricting voting right by public foundation	Impossible to bolster control through public foundation

Source: CLSA, Parliament Library

Investors should note that blocking a small-scale merger under this law is easier than before

The One Shot law is now in effect. But this is applicable just to the oversupplied industries, so major Samsung group companies are not expected to use this regulation, except for Samsung Engineering and Samsung Heavy. But investors should note that blocking a small-scale merger under the law is actually easier than before.

One Shot law is now in effect but is just for the oversupplied industries

Overview of One Shot law

Definition	**Restructuring including merger and business renovation**
Standard for oversupply	Revenue and OPM deterioration
Review committee	Four from parliament, four from government, 12 from private sector
Review period	30 days from government, 30 days from review committee
Cancellation	Inheritance of management control, unfair support on subsidiaries
Oversupply criteria	**Meeting all three criteria**
(1) OPM	3-year OPM decrease 15% more than 10-year average
(2) Operation	Utilisation rate: Deterioration of 3-year average of the industry is more severe than overall industries.
	Inventory ratio: Deterioration of 3-year average of the industry is more severe than overall industries.
	Service production index to hiring: Deterioration of 3-year average of the industry is more severe than overall industries.
	Price/Cost: 3-year increase (decrease) in ASP is smaller (bigger) than increase (decrease) in Cost
	Industry indicators: Notable deterioration of representative industry indicators (ie, No. of construction companies bankrupt)
(3) Demand	Demand recovery is not expected and mismatch with supply is not going away anytime soon

One Shot law benefits

Support from One shot Law	One Shot Law	Commercial Law and others
Small-scale split	Less than 10% of total asset: just board approval	No explicit regulation on small scale split
Small-scale merger/swap	New shares/treasury shares are less than 20%: just board approval 10% of shares objection->normal merger	New shares/treasury shares are less than 10%: just board approval 20% of shares objection->normal merger
Short-form merger	80% of total shares: Just board approval	90% of total shares: just board approval
Shareholders' meeting	7 days' notice	14 days' notice
Creditors' objection	10 business days or can skip the process	At least one-month grace period
Put back option	10 days after shareholders meeting	20 days after shareholders meeting
	Settlement three months after put back (for listed)	Settlement one month after put back (for listed)

Source: CLSA, Ministry of Law

Political and regulatory environment

Score rises from 45% in 2014 to 53% in 2016

Regulatory efforts help to push score back up

Korea has regained much of the ground it lost in this category in our last survey in 2014, when the score fell from 56% in 2012 to 45% in 2014 as a result of the Park government's failure to follow up on her 'economic democratisation' mandate, a shift towards deregulation, and a freezing of planned amendments to the Commercial Act (the company law). While her government's view of CG reform has not fundamentally changed, things have become more complicated following the ruling party's loss of its majority in the National Assembly in national elections in April 2016. This gives the opposition Minjoo Party a chance to block Park's legislative agenda in the period until her term ends in February 2018 and to put forward some of its own ideas, as is happening (see above).

Greater regulatory efforts pushing the score up

Our score for this section has bounced back to 53%, which reflects that some positive underlying forces are at work in Korea, despite all the political noise. Factors pushing up the score this time include:

- The successful conclusion to the FSC's efforts to bring in the new best practice guidelines and law on the governance of banks and other financial institutions (we noted the former in our last survey, but did not award points as it had yet to be passed)
- Renewed efforts made by the KRX to tighten its listing rules and shepherd in the revised CG Code
- A more energised anti-corruption agency, the Anti-Corruption and Civil Rights Commission (ACRC)
- The introduction of a new anticorruption law, the Improper Solicitation and Graft Act, that will take effect on 28 September 2016

KRX is also planning a series of listing rule changes in the second half of 2016, but these will be too late to affect this year's score.

Structural and systemic HR factors holding the score down

Apart from the Park government's lack of a clear and compelling strategy on CG reform, factors holding the score down this time include:

- A fragmented regulatory regime for CG policy and regulation, with the Ministry of Justice having responsibility for nonfinancial companies (and no resources to enforce breaches of governance structures stipulated by the Commercial Act) and the FSC having responsibility for financial institutions
- The ongoing - and highly counterproductive - two-year rotation policy for government officials (an issue we have written about in every issue of *CG Watch* this decade)
- The lack of a user-friendly public database of company reports, announcements and notices going back 10 years and in English (while the DART system provides some of this material, it is not consistent, comprehensive or reliable)

Public-sector whistleblowing system seems to be working

Somewhat disturbingly, or perhaps encouragingly, the number of whistleblowing reports to ACRC about corrupt behaviour in public-sector agencies increased over 2013-15 compared to previous years (with 2014 having the largest incidence). Only a small percentage of the reports made to ACRC are referred to an investigative agency. However, of the 1,567 reports referred since 2002, ACRC has received the inspection results on 1,245 cases and corruption has been confirmed in 71% of them.

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HMC overpays for Kepco head office land site

Kepco booked 7.7trn won gain on sale from this transaction

HMC shareholders were furious with this announcement

HMC group has had various corporate governance issues in the past

Hyundai Motor share dropped 9.2% on the day when the bid amount was disclosed

Hyundai Motor purchases KEPCO property for 3x assessed value

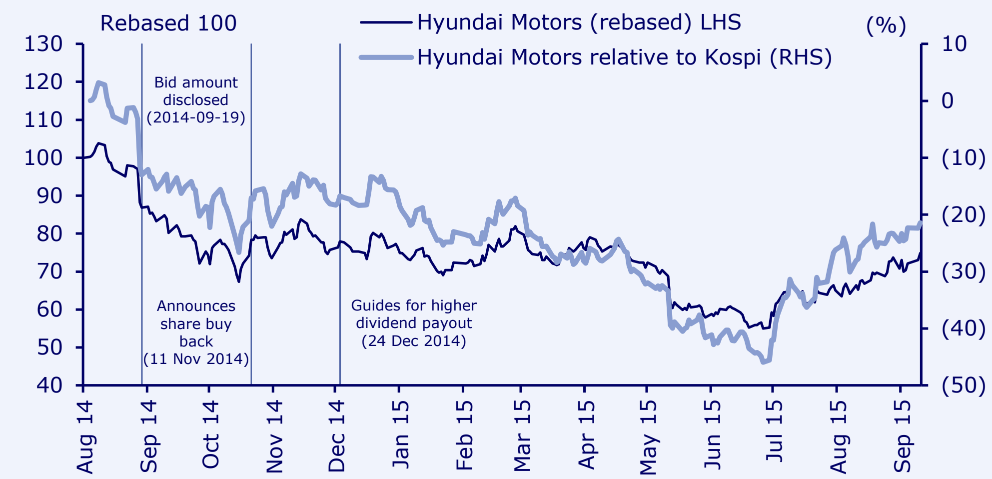
In September 2014 it emerged that the HMC group had bid and won the Kepco head office landsite up for auction, at a price of 10.5tn won. At first many observers assumed this number included the cost of the building, since the market value had been closer to 3-4tn won, with some expectations of 5-6tn won. But, in fact, this was only for the landsite, and the expected building cost of 3-4tn won, not to mention the 1tn won tax cost, would be additional. To put the 11.5tn won in perspective (10.5tn plus 1tn for tax), every 300,000 car capacity is generally about 1tn won, so this was roughly 3.3m car capacity, more than Kia's 3m cars a year output.

The purchase was split 55%/25%/20% for HMC/Mobis/Kia. Meanwhile, Kepco has the land on its books at 2.8tn won and so took a massive 7.7tn won gain on sale. This helped motivate the government to push for higher dividends in 2015 from Kepco as the money was paid out over the following year from September 2014 bid date.

In comments immediately following the bid, MK Chung, chairman of HMC, was quoted in the Korean press as saying he did not mind overpaying for the land since Kepco was a government company and the money was going back to the people, effectively. This was likely more a PR suggested comment, but with shareholders reeling from the share price fall following the announcement, it also triggered further anger. Indeed, HMC was so over-run with upset investors that management came out with a 1% share buyback announcement by November 2014 to help appease the market.

The HMC group has had issues in the past on CG, such as creating logistics firm Glovis, a family-controlled company that had an edge and high returns originally from logistics of HMC's own cars. On top of this, its chairman had spent some time in prison on bribery charges, and the circular ownership of the group and intercompany transactions also led to question marks; as did the 3tn won investment in Hyundai Engineering. But the amount of money involved here was substantial, and we believe it has hurt the multiples that the market might otherwise reward HMC, although only slightly, since the fundamentals have also deteriorated in recent years with declining operating margin on a stronger won, and more intense pricing in China, Russia and Brazil.

Hyundai Motor share price rebased to 100 during the acquisition of Kepco HQ



Source: CLSA, Quantiwise

Accounting and auditing

Score dips from 72% in 2014 to 70% in 2016

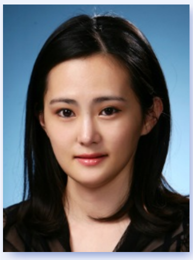
While the scores in most areas of this section have stayed the same, an overall dip in score is warranted given the accounting and auditing irregularities of the past year. Following the admission of accounting fraud at Daewoo Shipbuilding and Marine Engineering (DSME), which hid massive losses over several years while being audited by Deloitte Anjin (see blue box on next page), questions have been raised about the integrity of the accounting and auditing at other shipbuilding companies that present a going-concern problem. As analysts have highlighted, why did none of the auditors of these firms express any concern in early 2016 about their high debt levels and declining revenues?

While some large caps meet high standards of accounting, recent frauds hold score down

Unlike other developed markets in Asia, where we give large caps a full point on whether their internal accounting policies and practices are up to international standard, for Korea we have maintained our score at 0.75. We have also maintained our score on the auditing of large caps at the same 0.75 level. While this may seem unfair to the many companies who do have high standards - especially those companies that now produce their audited annual results within 60 days of their year-end, which requires considerable effort on the part of both companies and auditors - the issue of questionable accounting continues to rear its head in Korea in many forms and not just in companies in difficult sectors such as shipbuilding.

FSS discloses much less about its audit regulatory work than counterparts in the region

The overall score has also declined slightly here for certain other reasons. While Korea has an independent audit regulator, the FSS, that appears to be actively inspecting CPA firms and audit engagements, its level of disclosure on these activities and the remedial measures it demands of auditors is limited compared to best practice in the region. We also have doubts, based on recent events, whether rules on auditor independence are working as effectively as they should. Indeed, Korea's rule on audit partner rotation - three years, then a three-year cooling off - is possibly too tight? Three years is a short period in which to master the accounts of any company.



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Deloitte Anjin admits DSME accounting fraud

Massive accounting scandal on one of shipbuilders

Transparent and reliable financial reporting and auditing are the lifeblood of the capital markets. Investors had lost trust in DSME after allegations emerged that it had committed massive accounting fraud to the tune of 5.4tn won over past several years. Critically these claims suggest this fraud was systematically ordered by top management. In response to these allegations and the subsequent confession of complicity on the part of the Auditor (Deloitte Anjin), trading of DSME stocks has been suspended from 14 July 2016 subject to a full investigation by the end of August. CLSA dropped coverage of DSME with a SELL rating on 17 August 2016.

It caused a disruption on economic order of the entire sector

What was particularly damaging was that DSME's accounting malfeasance disrupted the fair-market competition and economic order of the entire sector as the other two major shipbuilders in Korea, Hyundai Heavy and Samsung Heavy, suffered losses in large part as a direct result of DSME's aggressive pricing strategies. DSME was able to survive this low pricing window for a period by underreporting production costs and thereby exaggerating profit.

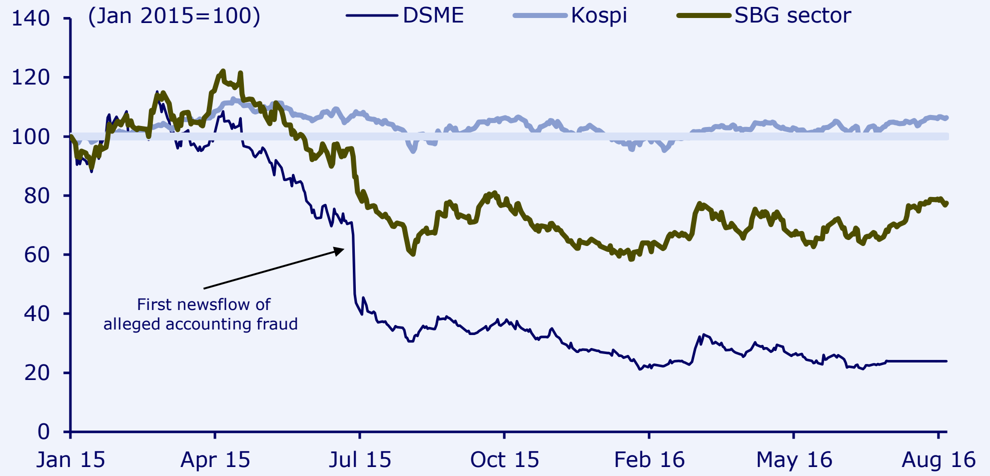
Deloitte was at the centre of criticism over the lax supervision (along with creditors' continued provision of loans to DSME). This is further complicated by the leadership of two government banks, KDB and KEXIM, in the credit process as the primary lenders. It is clear the responsibility for these events is not confined to the auditors, or management alone. A confluence of conflicts of interest came together to significantly increase the risks of misappropriation.

The challenge for Korea in moving forward is to avoid throwing good capital after bad and allowing the insolvency process to work. The appropriate strategy to demonstrate consequences is not just to pursue the individuals and institutions involved but to wind up the company. However, given the heavy exposure of government banks to this company and the thousands of direct and indirect jobs at stake, we cannot rule out a government directive to merge this failed entity with one of its two remaining major competitors.

Share price dipped on alleged accounting fraud

A possible government-led merger to resolve the insolvency of DSME

DSME share price



Source: CLSA, Quantiwise

CG culture

Score rises from 34% in 2014 to 41% in 2016

Like many markets in Asia, Korea's CG culture score significantly lags the other areas of CG. While some leading companies have shown a more positive approach to engaging with their shareholders in the past year, Korea remains a tough market for CG advocacy and progress is rarely linear. Indeed, the analogy of a merry-go-round often comes to mind: just as you think you are moving away from your starting point and getting somewhere, you find yourself curving around and heading back to where you started!

Traditional obstacles to CG are numerous and deeply entrenched

Traditional obstacles to CG improvement remain: family control of conglomerates without commensurate ownership (in many ways the root of the country's unbalanced CG system); cash hoarding and persistent low dividends; the propensity for related transactions within conglomerate groups; insider boards that struggle to appoint outside directors with business experience; a lack of director training; low levels of respect accorded to minority shareholders; and so on.

Issues interlinked: hoarding cash, low dividends, no need or desire to issue new shares, low respect for minority shareholders

Many of these issues are interlinked. If you hoard cash and do not need to raise equity capital from the secondary market, what is the incentive to pay your minority shareholders reasonable dividends? If you need funds, raise debt instead (particularly if raising equity might dilute your already small stake). Indeed, statistics from the FSS show that secondary offerings of new equity in Korea over 2013 and 2014 ran at about 4tn won (US$3.6bn) per year, compared to around 116tn won for debt issues. If you focus only on debt raised by nonfinancial firms, it still runs at 41-42tn won per year. (Ironically, these firms may well find themselves facing bondholders with a stronger interest in CG in the coming years!)

Korean firms are a victim of their own success and local culture

From a CG perspective, Korean firms are a victim of their own success and the idiosyncrasies of local culture. Many companies appreciate that it would be a good idea to have outside directors with some business experience, in addition to candidates from academia and the public sector. Yet the pool of appropriate local candidates is thin, as business people with sufficient seniority and relevant industry expertise are likely to come from your direct competitor. Meanwhile, director training, although seen as a worthy thing for outside directors to undergo, seems rarely to be offered to the chairman or his family. Yet inside directors arguably need development and guidance too - perhaps more so, since they wield so much decision-making power.

Egregious corporate transactions have fired up the ire of shareholders

Over the past two years this tense *status quo* has been disturbed by a series of high-profile corporate transactions that have angered minority shareholders and galvanised them into action or, at the very least, renewed concern. The first was the Hyundai Motor land deal in September 2014, followed by the crisis in KB Financial in late 2014, Samsung's intra-group deal between Cheil and C&T in mid-2015, and more recently the alleged embezzlement within the Lotte Group.

Corporate transactions highlight weak board governance and the investment risks of conglomerates

These cases raise a number of governance issues of direct interest to investors, namely: lack of checks and balances in board decision-making and the limited influence of outside directors (Hyundai, KB Financial); fair valuation for minority shareholders in takeover situations (Cheil-C&T); the financial risks of conglomerate structures and circular ownership (all of them); and government interference in listed companies (KB Financial).

KB and HMC are trying to address their governance deficits

Despite all the negatives listed above, our score for CG culture in Korea has risen for a combination of interlocking reasons. Some companies are trying to address their governance deficits. KB Financial changed its management and board structure, and became possibly the first Korean listed company to actively encourage minority shareholders to nominate an independent director (which an ACGA member, APG Asset Management Asia, duly did in support from other investors). At the request of shareholders - and one in particular, YK Park of APG - Hyundai Motor created a CG committee of the board in 2015, published its first CG Charter in February 2016, and has taken the chairman of its CG Committee, Professor You Jae Yi, on nondeal roadshows around the world to meet shareholders and discuss CG. We developments are positive, and we hope they will continue.

Some companies are adopting new CG practices

The score in this section has also risen because we introduced three new questions and Korea did slightly better on them than the previous ones. The new questions relate to board evaluation, director training and the presence of an independent chairman or lead independent director. While these areas are all new to Korea, some of the larger companies and banks are starting to adopt one or more of these practices, hence we increased the overall score accordingly.

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Korean corporate culture tends to be authoritarian

Various *chaebol* scandals indicate extrapolation of such a culture

Korean culture applies to CG culture between major and minor shareholders to a certain extent

Korean Air - Nut rage

Korea's working culture tends to be authoritarian. For modern Korea, war is never out of sight. After the country was born out of World War Two, it immediately experienced the Korea War, and has lived under the North Korean threat since. It does not help that all men, the majority of the work force, have mandatory military duty and that the leaders during the country's growth era, when the corporate culture was being formed, were ex-military generals who gained power through coup. So it is no surprise that Korean corporate culture developed in authoritarian military style of order and execution.

A recent series of incidents involving *chaebol* owner family members' mistreatment of their employees and disregard for law that brought public rage is an extrapolation of such a culture. Cho Hyun Ah, vice chairman of the Korean Airline who is the daughter of Cho Yang-ho, the Korean Airline chairman and CEO, infuriated the public, infuriated the Korean public by ejecting flight attendants from a plane that was about to take off because they allegedly served macadamia nuts in an inappropriate manner. Another incident involved Jeong Il-Sun, the grandson of Hyundai founder, who is known to have routinely mistreated many of his personal drivers. His 140-page manual of odd rules for drivers was infamous. He was not alone in mistreating the drivers as the public discovered in an incident involving the son of Daelim's chairman.

This kind of authoritarian mindset towards the owner-employee relationship also applies to CG culture towards the relationship between majority and minority shareholders, to a certain extent.

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- The new CG Code does not become subject to a comply-or-explain requirement under the listing rules
- No progress made on the proposed investor stewardship code
- No improvement in disclosure of regulatory enforcement
- No action against auditors for irregularities in companies facing prosecution for accounting fraud
- Limited progress in board governance and director education

Quick fixes

What to fix

- All of the above!
- FSS produces an annual report detailing its audit regulatory work and HR capacity in the accounting industry (as other markets do)
- Fix DART - ensure it works properly and has a full complement of English-language documents on listed companies going back 10 years
- Mandate voting by poll
- Companies to review board composition and the expertise/contribution of each of their directors
- Companies proactively arrange meetings between shareholders and directors

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Malaysia - Trouble at the top

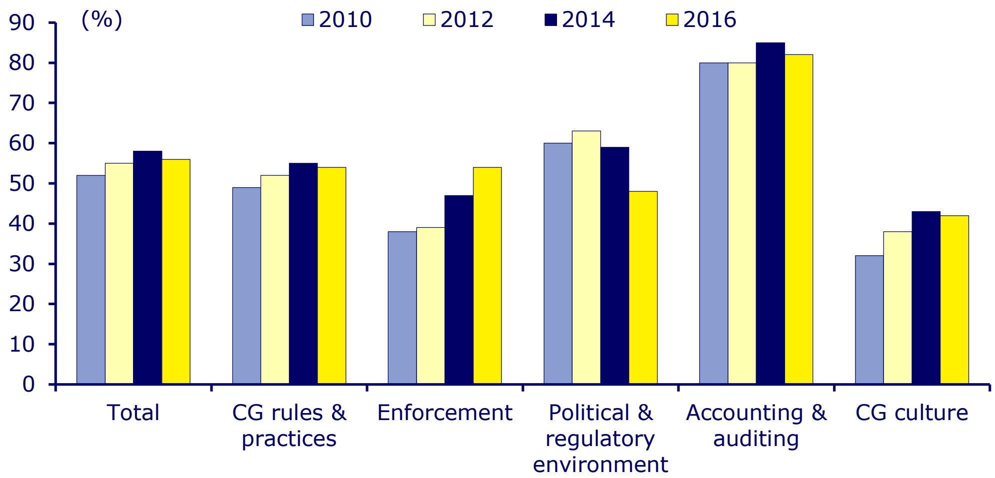
Key issues and trends

- Malaysia being pulled in opposite directions, lower score overall
- Regulators take strong steps on enforcement and regulation
- New mandatory voting by poll, MD&A and sustainability disclosure
- Securities Commission wins important court victories
- 1MDB saga casts a pall over country and key government institutions
- Suspension and closure of media outlets suggests lower press freedom
- After a slow start, domestic stewardship efforts are building

Overall score falls from 58% in 2014 to 56% in 2016

Figure 81

Malaysia CG macro category scores



Source: ACGA

Fallout from 1MDB undermined overall scores

In 2014, we noted that Malaysia was unique in consistently improving in score across each of our four *CG Watch* surveys since 2007. Unfortunately, this trend has now come to an end. While we upgrade Malaysia this year for enforcement of capital-market offences and several favourable regulatory and policy changes, the fallout from the 1MDB crisis has had an adverse effect on the political and regulatory environment for public and corporate governance. This has resulted, on balance, in a modest decline in the overall score.

Though improved regulation and enforcement are notable positives

Notwithstanding the trouble at the top, regulators in Malaysia managed a strong showing on new reforms and a number of wins on enforcement. New regulations over the past two years have included mandatory voting by poll and disclosure requirements for MD&A and sustainability reporting. In addition, the legislature has extended some powers to the Securities Commission and the Audit Oversight Board (AOB). In enforcement, the Securities Commissions is continuing to win in court, with one market manipulation case achieving a five-year custodial sentence. The AOB has for the first time withdrawn approval for an auditor.

Stewardship adoption off to a slow start

One area to watch is the evolution of stewardship practices at the large state investment funds. Malaysia has a strong contingent of asset owners and there was excitement over the launch of the Malaysian Code for Institutional Investors in June 2014. However, only one major domestic asset owner has become a signatory. Nevertheless, the funds have formed the Institutional Investor Council and two have published and revised their CG policies. We look forward to the further development of active ownership in the country.

CG rules and practices

Score slips slightly from 55% in 2014 to 54% in 2016%

Overall scores went sideways in this section. There was a tension between regulatory progress in some key areas - including mandatory voting by poll, which took effect from 1 July 2016 - and other areas where we tightened our assessment as a result of firming international standards and practices.

Malaysia is slightly behind on providing audited annual statements

One area we scored more strictly this year was financial reporting standards and practices. Malaysian listed companies have four months to produce their audited annual financials (published in an annual report), rather than the standard three months in other markets. This is balanced to some extent by the practice of companies typically releasing their fourth-quarter results - and effectively the full-year numbers - within two months. As Bursa Malaysia points out, these are typically the same as the numbers in the final annual report. However, we dropped the score here slightly for two reasons: as the fourth-quarter numbers are not audited, shareholders do not get final audited accounts as quickly as in other markets; and a sample of companies found they do not consistently provide much narrative explanation in their 4Q report.

But has caught up on nonfinancial disclosure, with new sustainability and MD&A requirements

More positively, there has been progress on standards of nonfinancial reporting. Companies must now provide an MD&A for annual reports issued for financial years ending on or after 31 December 2016 - a reform that ACGA has long advocated. And following a listing rule update in October 2015, companies must also produce a sustainability statement. This is being implemented in phases for companies of different sizes, with reports mandatory for all companies from 31 December 2018.

Still a long way to go on strategic sustainability disclosure . . .

We tightened our assessment for sustainability reporting at small and mid-sized companies, as few in our sample provided disclosure addressing key long-term risks. Fraser and Neave was an honourable exception, with the company going as far as to provide an index to show how it is reducing the sugar content of its beverages. We maintained our assessment of the larger companies, partly as there is good disclosure from the palm-oil sector. Less favourably, we note that Tenaga Nasional did not provide information on its carbon footprint from burning fossil fuels in the environmental disclosure and commitment sections of its 2015 annual report. This is hardly a credible position for a power company that will have to implement Malaysia's contribution to greenhouse-gas emissions reduction post the global climate agreement in Paris in December 2015.

. . . and basic remuneration disclosure

We also downgraded the score for disclosure on remuneration, which is worse in Malaysia than many other markets. The requirement is to disclose director fees in bands of RM50,000 and many companies simply follow this, meaning that it is not possible to determine individual director fees, let alone the remuneration and incentivisation packages of senior management. Bursa Malaysia clarified in May 2016 that companies must have shareholder approval for any increase in director fees. However, this misses the key point that shareholders do not understand how incentive structures relate to individual and company performance - if indeed they do relate. The lack of disclosure on remuneration contrasts with detailed disclosure on director training in many Malaysian annual reports.

A new CG Code is coming soon

Looking ahead, an ongoing reform is a proposed update to the Malaysian Code of CG, first introduced in 2000 and revised in 2007 and 2012. The Securities Commission announced a consultation on a proposed draft on 18 April 2016. Key elements include a move to an 'apply or explain an alternative' approach from 'comply or explain', and the use of new categories called 'Core' and 'Core+' to distinguish expected from superior voluntary practices. We maintained our score on the code and await the publication of the new version. We hope that, in line with our consultation response, the eventual revised code includes a strong set of 'Core+' practices.

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1MDB crisis

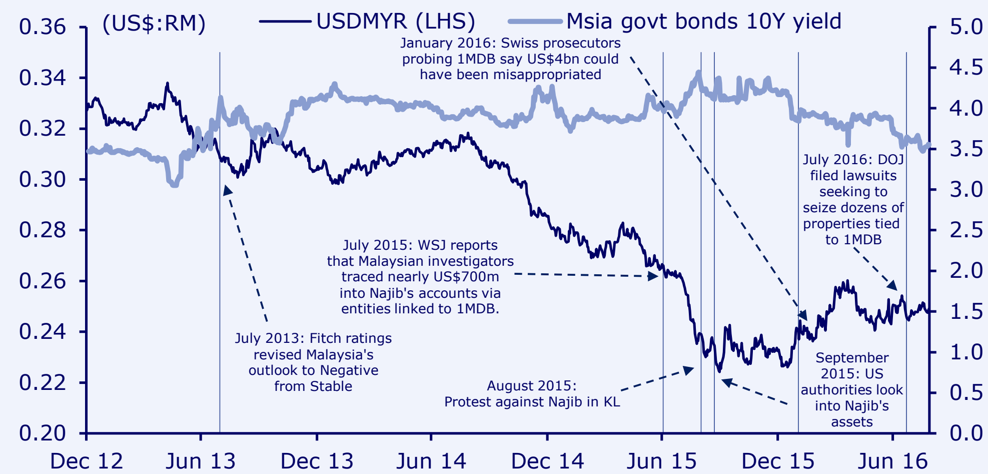
Established in 2009, government-owned 1MDB accumulated key property and power assets, racking up RM42bn gross debt in the process at end-FY14 (March yearend) through debt explicitly/implicitly guaranteed by the government. Concerns regarding 1MDB, which media and politicians have criticised for its perceived opaqueness, may pose a threat to Malaysia's banking system and fiscal position. These fears have intensified following its apparent struggle to repay an RM2bn loan (and others) to local banks despite extensions. With unknown debt obligations and suspicious assets further exacerbated by its inability to produce a March-2015 annual report, severe doubts have been cast to the legality of the fund's operations.

Mounting 1MDB concerns casts doubts over governance

The US Department of Justice's recent civil case naming the Prime Minister's stepson and business partner in seizing dozens of properties (up to US$1bn) with connections to the 1MDB fund has somewhat identified the 'elephant in the room'. However, the Malaysian authorities seem to have done little to bring the culprits to court. This, in turn, has cast severe doubts on the basic form of governance in Malaysia.

Recent 1MDB related events have not been positive

1MDB and its impact to yields and RM



Source: CLSA

Enforcement

Score rises from 47% in 2014 to 54% in 2016

The enforcement score for Malaysia increased significantly as we took a more positive view of efforts by the Securities Commission and Bursa Malaysia in a number of areas, including insider trading, market manipulation and audit oversight, and to a lesser extent market enforcement from institutional investors. A broader interpretation of enforcement would include accountability at nonlisted companies, such as 1MDB, and the role of banks in facilitating payments. However, we have covered this in the political and regulatory section.

Criminal justice is slow, but custodial sentences are appearing

It is hard for regulators to maintain standards in the market without a court system that is willing to hand out penalties for serious breaches of capital-market rules. We have previously noted the painfully slow process in obtaining prosecutions in Malaysia. This remains the case. Even so, regulators appear to be winning court battles quite consistently and the Securities Commission was proud to cite a number of successes, including longer prison sentences for submitting false or misleading statements. For example, a sentence announced on 29 February 2016 for Low Thiam Hock in relation to manipulation of Repco shares in December 1997 was the highest imposed to date - a five-year prison term and a fine of RM5m. The sentence, however, was suspended pending an appeal.

Five years is the highest prison sentence yet for market manipulation

More SC victories . . .

The Securities Commission also noted a landmark decision that imposed custodial sentences on a former CEO, two ex-directors and a former company executive of Inix Technologies for offences relating to the issuance of Inix's prospectus, which contained false information and the submission of false statements to Bursa Malaysia. The former CEO was jailed for 18 months and the other three for 12 months each. Another victory came in March 2016, when the Court of Appeal unanimously upheld convictions against two directors for manipulating shares over a period of four months in late 2004 to early 2005. One of the directors, Dato' Philip Wong Chee Keong, was sentenced to two years in jail and fined RM3m (US$750,000). The other, Francis Bun Lit Chun, was jailed for three months and fined RM2m.

. . . but slow cases undermine deterrent effect

It is a strong positive that capital-market offenses are finally attracting prison sentences in Malaysia, although the long duration of cases, with some taking more than 10 years to conclude, arguably reduces the deterrent effect.

First case against an auditor for helping a client mislead investors

There was also a notable success in relation to audit supervision. On 21 October 2015, the KL Sessions Court sentenced Yue Chi Kin, an audit partner at the time of Messrs Roger Yue, Tan & Associates, to a one-year jail term and a fine of RM400,000 for his part in helping United U-Li Corporation inflate its profit numbers in the year to 31 December 2004. This was the first case in which the Securities Commission had charged an auditor for assisting a public company to make a misleading statement to Bursa Malaysia.

In another case relating to audit supervision, in January 2016 the Court of Appeals upheld an appeal from the Securities Commission over a move by audit firm Crowe Howarth and two audit partners to dismiss an enforcement action taken by the Audit Oversight Board.

Witness statements continued to receive protection from disclosure

The Securities Commission was also able to defend its processes. In January 2016, the Federal Court found in favour of the Securities Commission relating to protection for witness statements. A defendant in a securities law case attempted to force disclosure of statements made by witnesses during a Securities Commission investigation. The court allowed these to remain confidential due to public interest. Allowing disclosure of such statements would discourage future witness statements, said the court, and 'greatly prejudice the SC's ability to carry out future investigations'.

Regulators received greater examination powers

Beyond success in court, regulators have received new powers through legislative amendments to the Capital Markets and Services Act and the Securities Commission Malaysia Act. These further protect investors through reducing the protection for preparers of disclosure documents that result in false or misleading statements and clarifies a broader ability to claim damages from responsible parties. Examination powers have increased to allow the Securities Commission to appoint an independent advisor in relation to takeover offers and to broaden the scope of examination powers to include persons performing outsourced functions for regulated entities. The Audit Oversight Board also has an extended remit including for scheduled funds and reporting accountants.

And have invested further in technology

The regulators have also invested in technology to improve corporate surveillance. This included a range of techniques and enhanced technology to assess unusual patterns in financial reporting or insider trading. Beyond surveillance, regulators have undertaken training for directors to ensure they understand the importance of capital market offences. In our conversations, regulators noted that there were reduced numbers of referrals for insider trading and reduced cases of insider trading coming to light. It was not possible to know if this is due to the deterrent effect of prosecutions. However, the pattern of offences showed that insiders were typically trying to hide their trades using the accounts of friends, acquaintances, or remisiers - and in quite a few of cases, the accounts of mistresses. This indicates a better understanding of insider trading rules in Malaysia than in some other countries. For example, during the high-profile insider trading case that engulfed CP All in Thailand in late 2015, the deputy chairman initially claimed he did not know he had done wrong and cited his use of a trading account in his own name as evidence.

High standards of disclosure on regulatory enforcement continue . . .

One notable positive for Malaysia is the clear way in which regulators present enforcement information. There are a variety of sources, including for the Securities Commission its website, annual reports and newsletter, *The Reporter*. The enforcement section in the Commission's annual report proceeds in a logical manner, setting out events over the year with clear statistical summaries. Bursa Malaysia also presents information through its website and annual reports.

. . . but regulators could go further

As mentioned in our 2014 survey, however, it would be helpful if regulators provided comprehensive statistics showing trends through time (five or more years), with a breakdown into complaints, referrals, investigations, prosecutions, settlements, convictions and acquittals and an explanation of what all the numbers mean. This would help independent observers assess the level of progress that regulators have made. Currently it is hard to understand trends in enforcement by type of activity, such as insider trading, as the Securities Commission does not provide this overview. Bursa provides a high-level summary on its website of two years of enforcement data, broken down by enforcement action taken, rather than by erroneous activity. Bursa's presentation of enforcement cases is limited, with a focus on disclosing anonymised case studies, rather than actual reports. Oddly, the website provides ongoing enforcement considerations, such as unusual market activity, on a general media release page, rather than in its own section.

Stewardship code has mixed reception

Beyond the regulators, we have also taken a more favourable view of the level of engagement undertaken by institutional investors in the market. Although the Malaysian Code for Institutional Investors has to date only attracted KWAP, the civil service pension fund, as a signatory from among the country's leading asset owners, there seems to be a greater level of interest and activity overall in voting and acting on CG from the major institutional investors. Both KWAP and EPF, the national pension system, have published (and revised) internal codes of CG. We reviewed the voting patterns at a few companies and found that between 50% and 75% of the noncontrolling investor shares were voted (there will be more data on voting in future following the implementation of mandatory voting by poll). In addition, there are a number of companies that have representatives from EPF and PNB, another state fund, on their boards, even though there is a different controlling shareholder.

Malaysia also saw a different type of market enforcement in the case of poor standards in relation to palm-oil developments. At IOI Corporation, the company's shares fell following suspension from the Roundtable on Sustainable Palm Oil, a multi-stakeholder initiative that sets a benchmark for certified sustainable production in the sector.

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IOI Corp - Suspension from RSPO

When they say once bitten twice shy, it clearly doesn't apply to IOI. Despite having been suspended once due to infringements of Roundtable on Sustainable Palm Oil (RSPO) regulations in 2011, its RSPO certification for both its plantations and refineries was suspended in April 2016 due to allegations of yet another infringement of RSPO regulations.

This has led to a slew of IOI's end clients (ie, Nestle, Unilever and Kao) announcing that they will be terminating their supply contract with IOI Corp. They have all pledged to source fully sustainable palm oil by the end of this decade at the latest, while IOI's suspension from RSPO means that they have to find an alternative source.

IOI made good progress on sustainability but is still under scrutiny

The full effect was felt in IOI's 2016 April-June quarter (fiscal 4Q16), which saw refining margins drop from a historical average of 4% to just 2.4% as the impact of the RSPO suspension filtered through its operations.

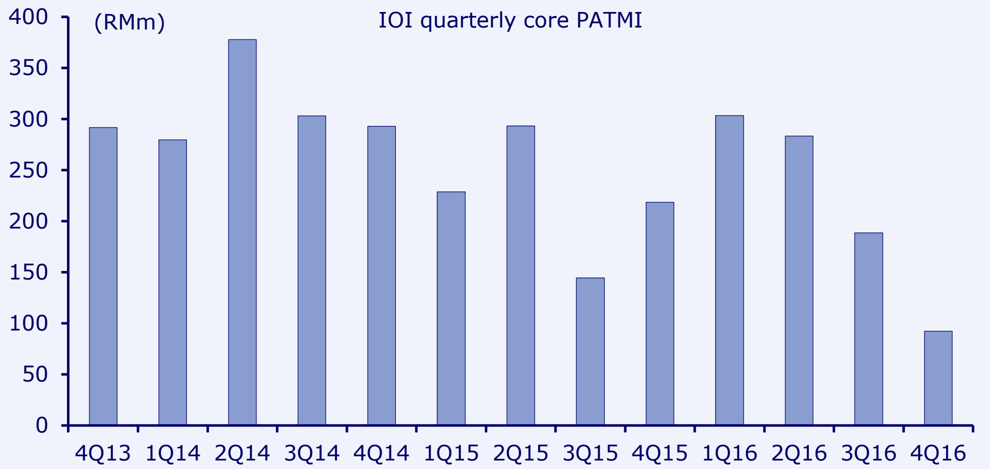
While the RSPO suspension has been lifted after positive action from IOI, it is still subject to RSPO inspection and could be reinstated with immediate effect if the RSPO finds any further infringements or IOI fails to comply fully with the restoration programme.

As such, the customers that have cut ties off with IOI will likely be hesitant in moving back to using IOI as a supplier, and hence keep margins under pressure for the company in the near term.

In this instance, being a good corporate citizen shows itself very clearly in the dollars and cents, as it becomes clear that the best way to enforce good corporate citizenship, is always through the P&L.

IOI's quarterly core earnings fell in 4Q16 as poor refining margins impacted earnings

IOI's quarterly core earnings



Source: CLSA

Political and regulatory environment

Score collapses from 59% in 2014 to 48% in 2016

Frankly, it has been a shame to see the fallout from the 1MDB crisis in Malaysia. There has been a stark difference in findings and approach between international and domestic investigations into the organisation, with many leadership changes at the organisations responsible for domestic investigations. It is worth noting that the direct financial impact of these incidents appears to have been contained. And that they have not tarnished the entire Malaysian capital market: there remain many listed companies both under family and state control that are well removed from the issues. However, the 1MDB saga carries implications for the integrity of some key government institutions.

International investigations gather pace

International investigations into 1MDB are continuing in several countries, including the USA, Switzerland, Singapore and Luxembourg. The US Department of Justice (DOJ) announced on 20 July 2016, that it was pursuing civil forfeiture to recover US$1bn in relation to the case. DOJ alleges that 1MDB money supposedly invested for the benefit of the people of Malaysia has been diverted into a variety of assets, including artwork, a private jet, luxury real estate and - in an ironic twist - funding the Hollywood blockbuster, *Wolf of Wall Street*. US authorities have also started an investigation into Goldman Sachs for its role in promoting an international bond for the fund. Meanwhile, the Monetary Authority of Singapore (MAS) announced in March 2016 that due to its role in the case, BSI Bank would lose its status as a merchant bank, the first time since 1984 that MAS has withdrawn a merchant banking licence approval. MAS also found breaches of anti-money laundering controls at DBS, Standard Chartered and UBS, and will take action against the firms in due course.

While domestic investigations find no fault

In Malaysia, the Attorney General's Chambers investigated 1MDB until the Attorney General was changed. The Malaysian Anti-Corruption Commission (MACC), which does not have the power to prosecute, continued its own investigations into 1MDB after the new Attorney General closed the case. Subsequently, the Chief Commissioner of MACC resigned, with effect from 1 August 2016, more than two years before his contract was due to expire. Bank Negara Malaysia continued investigations into 1MDB under its long standing governor, Dr Zeti Akhtar Aziz. However, her term came to an end after 16 years on 30 April 2016. The new governor, BNM insider Muhammad bin Ibrahim, was only announced three days before starting in the role. The BNM investigation has now also closed. According to a *Financial Times* story of 31 July 2016, the former attorney general, former BNM governor, and former MACC chief were the subject of a police report accusing them of providing confidential information to foreign agencies.

Concerns grow over press freedom

The 1MDB case has also led to concerns of a reduction in press freedom in Malaysia. *The Edge* newspaper has faced suspensions of *The Edge Weekly*, while it chose to close its subsidiary, *The Malaysian Insider*, after it was suspended for reporting on the case.

Malaysia fares worse than other markets

As a result of these events, Malaysia's score for Political/regulatory has dropped considerably. Scores fell in the following areas: the lack of a clear, consistent and credible government policy on CG; a perception of reduced effectiveness on the part of the central bank in exercising its powers; the depth of media skill and freedom in reporting on CG; the independence of the anticorruption commission; and whether government was making progress on improving standards of public governance.

A more modern company law on the way

On a more positive note, Malaysian legislators passed the Companies Bill 2015 on 28 April 2016. This is expected to come into force over 12 to 18 months after related rules and regulations are drafted. The changes include: codifications of duties and responsibilities of directors and the board; whistleblowing provisions; an upgrade in meeting notice periods; updated shareholders rights; and strengthened provisions around communication between the auditor and shareholders.

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FELDA steps in FGVH purchase of Eagle High Plantation

When Felda Global Ventures Holdings (FGVH) announced the planned acquisition of a 37% stake in Eagle High Plantations for US$680m, it was met with significant pushback from investors, who deemed the deal as too expensive versus fair market valuation. The purchase price implied a premium of 75% to Eagle High's last close share price, and this was despite not getting control for the company.

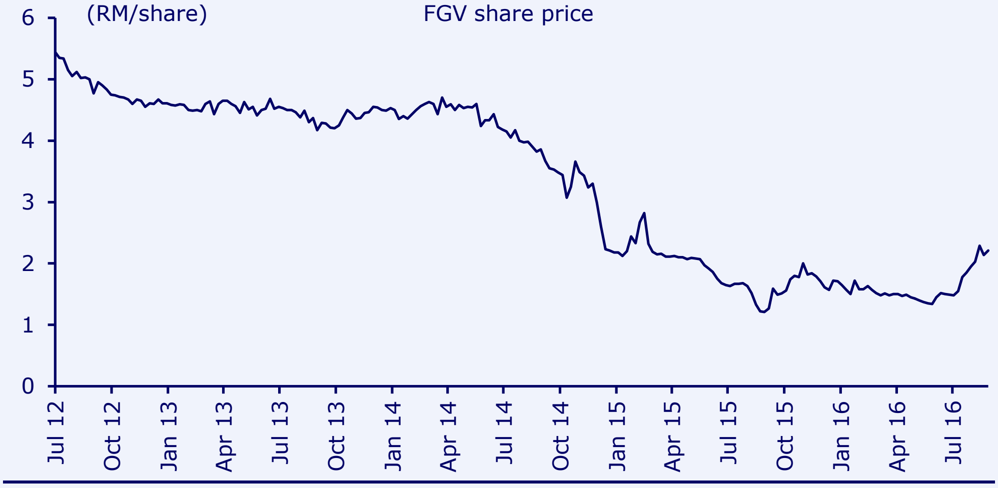
The pushback from minority shareholders was strong enough for FGVH to announce that it was not able to close the transaction in time, and was subsequently followed up with news that FGV's parent, FELDA, would step in instead to acquire the stake while FGVH would be a minority in the stake purchase. However, we have yet to hear any news about the deal closing since FGV stated that they would not proceed with the deal in November 2015.

Felda and its perennial problems

While this is a good case example of how minority shareholders were able to influence the decision of the company where it felt like the acquisition did not make economic sense, it also bring to the fore the risks of Malaysian political influence spilling over into the corporate world as there had been local papers suggesting that the connection between the Malaysian Prime Minister and the owner of Eagle High was one of the driving factors for the deal. This also highlighted the need for better board of director representation as we note that eight of the nine directors have all previously served in either the government or civil service.

FGV's share price has been under pressure ever since the announcement of the Eagle High deal

FGV's share price



Source: CLSA, Bloomberg

Accounting and auditing

Scores slips from 85% in 2014 to 82% in 2016

Accounting and auditing standards continued to score well in Malaysia, though we tightened our assessment slightly for a few reasons. One factor is that we received various comments that companies often have to rework their accounts after review from auditors - or rely on auditors to help with final account preparation - and that there is insufficient challenge from audit committees.

We note uncertain audit chair independence

We also noted that in some of the companies we reviewed, the chair of the audit committee was a former partner at the auditor. We believe that this could reduce the level of independence on both sides. Currently, the Bursa Malaysia definition of independence allows a two-year cooling-off period for former professional advisers. This seems too short for such an important role.

AOB continues to perform

The Audit Oversight Board (AOB) continued with its work to enhance standards of auditing at public-interest entities (PIEs). Following amendments to legislation, it now has purview over scheduled funds and reporting accountants.

With detailed market assessments . . .

The AOB publishes a detailed annual report including the results of its assessment of audit firms and their coverage of PIEs. There is continued concentration of PIE auditing by large audit firms: firms with 10 partners or more collectively audit more than 922 PIEs, covering 96% of listed company market capitalisation. The AOB noted audit fees grew in 2015 in line with previous years, while salary pressure moderated. This is good news as tight margins in the industry have been a concern.

. . . a solid inspections programme . . .

The AOB undertakes a wide range of activities including inspections. It said that findings from the latter revealed audit firms needed to strengthen quality controls in a holistic manner in the areas of partner accountability, human resources, training and monitoring. It also said firms should focus on remediation of organisational and quality control issues, rather than just talk about 'inputs' (ie, throwing more people and resources at the problem).

. . . and strong steps on enforcement

There was, moreover, progress in two significant enforcement cases. For the first time the AOB revoked an auditing license. Also, the Court of Appeal upheld an appeal by the Securities Commission over a move by audit firm Crowe Horwath and two audit partners to dismiss an AOB enforcement action. The case involved the CPA firm's alleged failure to comply with international auditing standards in a 2010 audit of Silverbird Group, a manufacturer of bakery and confectionary products. Crowe Horwath and the two partners sought protection from the AOB action under the Whistleblower Protection Act 2010, however the Securities Commission argued successfully that their action was an abuse of court process and that they were not entitled to such protection. This reversed an earlier loss in the High Court.

We hope the AOB will manage a successful board transition

Meanwhile, there have been significant changes in the composition of the AOB board this year. Members are appointed for a maximum of two terms of three years each. Out of seven members, four have finished their terms and the executive chairman has stepped down. We have formed a positive opinion of the AOB and hope that it will continue to exercise effective oversight with the significant change in board membership.

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Unprecedented move to remove audit licence

SC's continued enforcement of the capital markets is commendable

Auditing licence revoked for first time in Malaysian history

A rather important milestone was reached in Malaysia when in 2 December 2015, the Audit Oversight Board of the Securities Commission of Malaysia revoked the registration of an audit firm Wong Weng Foo & Co, along with the Managing Partner, Wong Weng Foo and its Partner, Abdul Halim Husin under section 31Q(1)(a)(B) of the Securities Commission Malaysia Act 1993 (SCMA), as they were found to have failed in complying with auditing standards in the engagement performance of two public listed entities. The firm was found guilty of not carrying out its practice honestly, competently and with due care when it failed to implement the remedial action as reported to AOB in respect of past inspection findings.

This is was a big deal as it was the first time the SC used its powers to revoke the registration of auditors, which in turn affirmed its commitment in promoting confidence in the reliability of audited financial statements in public listed entities.

Chairman of the Securities Commission - Datuk Ranjit Singh

Source: Securities Commission

CG culture

Score edges down from 43% in 2014 to 42% in 2016

This category of our survey considers whether companies and directors see value in CG and take the steps necessary to capture this value. We found few changes overall on this measure, with minor movements in our assessment leading to a small decrease in the score.

Board assessments provide no information to investors

There were changes in three questions this year relating to board evaluation, director training and the existence of an independent chairman and/or lead independent director. On the first, we identified that while companies undertake board assessments each year, they pass on few insights from these processes to shareholders through corporate disclosure.

But training details are strong

In contrast, there is detailed disclosure on training. We have noted in the past that Malaysia has a strong set of institutions involved in training, including ICLIF, which conducts training for financial institutions and business leaders, and Minda, which historically trained directors at state firms and relaunched in March 2016 as the Malaysian institute of directors (but couldn't change its name due to the legal meaning of 'institute' in Malaysia). We heard that directors are increasingly seeking out relevant skills on a voluntary basis.

Malaysia unusual in having senior independent directors

On the issue of independent chairman/lead independent director, Malaysia is one of the better-performing markets in the region. While board chairs are generally not independent, the Malaysian CG Code refers to the need for a senior independent director, who should be the chair of the nominating committee. Consequently, a number of companies satisfied the requirements of the question, even on our view of independence, which is rather stricter than Bursa Malaysia's definition.

Remuneration disclosure still very weak

Conversely, we downgraded the score for remuneration disclosure. Many companies do not even provide disclosure of individual director fees, let alone more detailed information on senior management remuneration that allows investors to understand the link, if any, between pay and individual or corporate performance.

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Questionable revenue recognition scheme over its associate companies

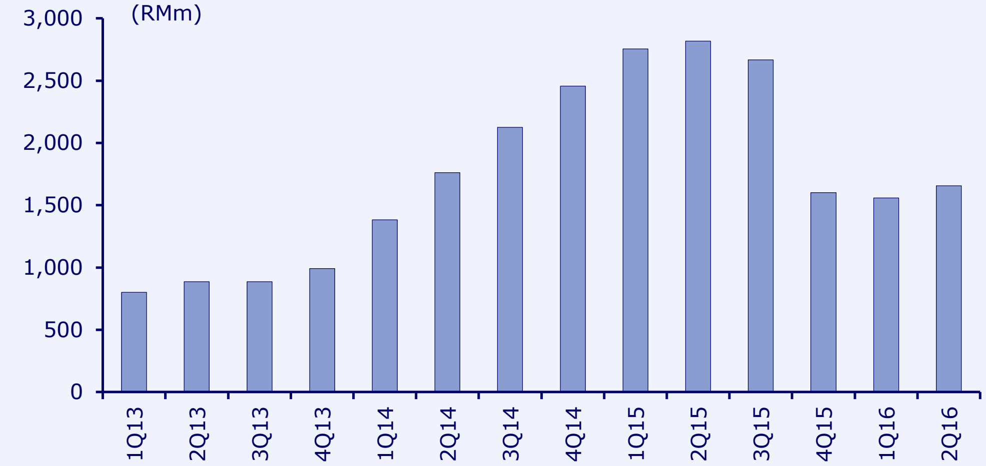
Air Asia's revenue recognition on lease questionable

AirAsia has been leasing aircraft to its own affiliate airlines in Asean for a profit, resulting in material leasing income generation from its own associates. Many of these affiliate airlines have, however, been struggling to generate positive operating cashflow during times of high oil prices, and were thus unable to pay the lease charges to AirAsia. However, AirAsia has continued to recognise the revenue generated from these leasing agreements, resulting in a drastic increase in receivables that have no certainty of being collected.

For now though, low oil prices have been kind to these affiliate airlines and receivables owed from these entities have been declining, but these carriers may struggle again when oil prices tick up. The company is nonetheless trying to provide more transparency by spinning off this leasing business.

Receivables have increased substantially since 2013 but recently reduced on low oil prices

Air Asia - Receivables owned by associates



Source: Company, CLSA

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Lack of transparency in 'Others' a concern

UMW lacks transparency on 'Others' items

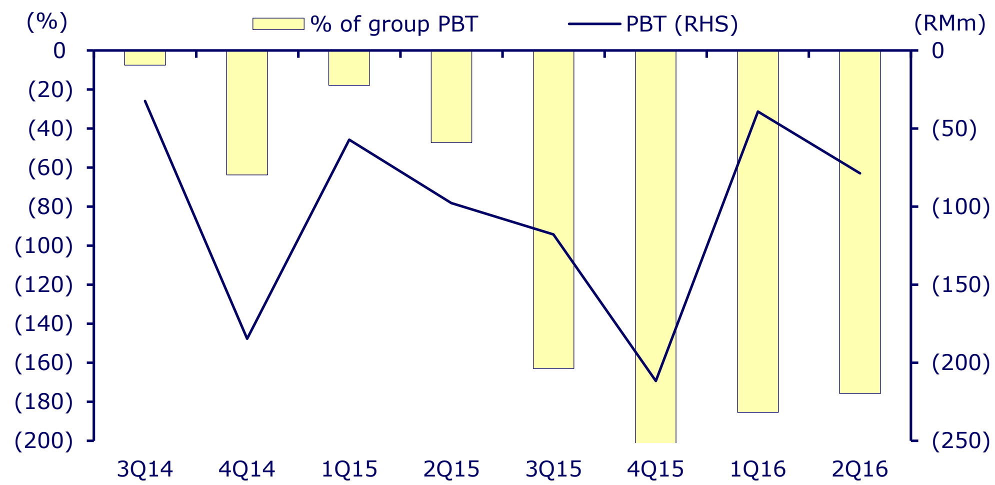
Car-manufacturing conglomerate UMW has material revenue and earnings contribution from a segment termed 'Others'. Nonetheless, fluctuations in this segment has been drastic over the years, but the company has not been forthcoming in providing explanations/key drivers behind the variations in segment performance, nor has it provided a comprehensive list of the assets classified under this segment.

While this has been largely ignored by analysts during the good times, things have turned for the worse as the 'Others' segment has been a huge value destroyer for the company, posting sharp losses every quarter. The large unexplained losses from this blackbox of a segment have been frustrating to analysts and investors. As well as poor CG, the possibility that it is an avenue for the company to include nonbusiness-related costs cannot be ruled out.

UMW saw major losses for 'others' segment

Figure 82

UMW's PBT losses from 'Others' segment



Source: Company, CLSA

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- Failure to maintain the momentum on enforcement and surveillance
- A slowdown in the pace of regulatory reforms
- Continued slow adoption of stewardship practices at the leading funds
- A further deterioration of press freedom and ability to report on CG stories
- A lack of improvement in public governance

Quick fixes

What to fix

- Provide more detail on regulatory enforcement cases, including a statistical analysis of enforcement trends
- Improve the disclosure on remuneration so that investors know the fees and can understand at least the structure of management pay, if not the individual detail
- Tighten the definition of 'independent director', including lengthening cooling-off periods
- Investors should more assertively express their views on CG, strategy, sustainability and capital allocation - and sign the Malaysian Code for Institutional Investors

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Philippines - Reluctant reformer

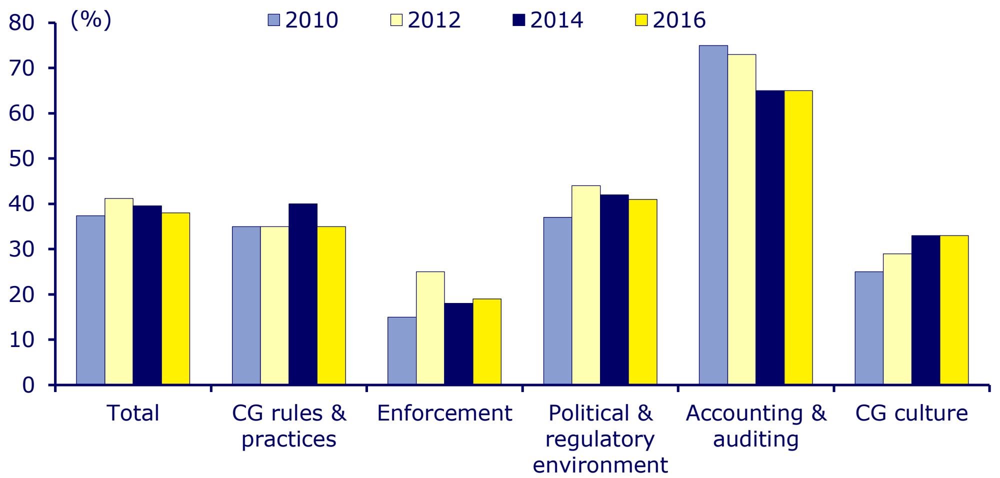
Key issues and trends

- Much-needed CG reform appears to be finally underway after the publication of the SEC's CG Blueprint in November 2015
- However, the SEC has faced an uphill battle with recalcitrant companies and the ultimate reforms risk being circumscribed
- CG reform remains very much a work in progress in the Philippines
- Enforcement remains one of the country's weakest areas
- Politics is becoming more colourful with unpredictable populist President Duterte. Will he really get to grips with corruption?
- Accounting and auditing is in good shape, although audit regulation needs to be stepped up. There are signs that the SEC is turning the screw
- There remains a fundamental lack of belief in the benefits and value of better CG standards among most Filipino companies

Overall score falls from 40% in 2014 to 38% in 2016

Figure 83

Philippines CG macro category scores



Source: ACGA

At the eleventh hour, the Philippines looks like it is finally getting serious about CG reform. Led by the SEC at the behest of the Department of Finance, the centrepiece of the SEC's proposed CG reform is its CG Blueprint, published late 2015. While some bold measures were originally proposed, some (but by no means all) have been ditched in the face of fierce opposition from companies and business groups.

It remains to be seen how the SEC's laudable initiative will eventually materialise. Several key areas of weakness where reforms are proposed - board procedures, related-party transactions, shareholder voting - will nonetheless end up far short of best practice. Against a background of rising international standards, the Philippines risks reforming too little, too late.

The new government of President Duterte is proving to be alarmingly efficient as it cracks down on the country's drug plague. Duterte also talks tough on tackling corruption, fast tracking infrastructure investment and improving the business environment for foreign investors, all equally important for the country's long-term economic future, but talk is cheap. Action is needed.

CG rules and practices

Score falls from 40% in 2014 to 35% in 2016

A late starter in Asean CG, the government seems finally to be getting serious about CG and a lot has started to happen after a weak showing in our *CG Watch 2014* report and alarmingly low debut scores for its leading companies in the CG Asean scorecard. Indeed, the SEC CG Blueprint, a laudable effort to provide fresh impetus into CG reform in the country, is at the same time a sobering testimony on the state of CG in the country and demonstrates how far behind leading regional standards it has fallen.

Reviews of the Corporate Governance Code are underway (last revised in 2009), as well as for the Securities Regulation Code (SRC) and the Corporation Code (Corp Code). CG reform remains a work in progress and we await the practical manifestations of the SEC's CG Blueprint with interest.

A compromise, but welcome nonetheless

Amid stiff corporate resistance to certain CG reforms (see CG culture subsection) the SEC has compromised and clearly will do so in other matters yet to be nailed down. The revised CG Code, once issued, will operate on a comply-or-explain basis. Much is and will be prescriptive. Some of the more contentious issues have been ducked but overall the SEC initiative is welcome progress.

SEC leading the CG charge

As in Indonesia, the regulatory commission seems to lead the charge, with the local bourse behind. Unlike IDX in Indonesia, however, the PSE has made some changes to regulation, introducing short-selling regulations and working with the SEC on CG reform. Its initiative to widen its laudable Minimum Public Ownership initiative from 10% to 20% was however, still born.

CG disclosure generally weak, with some notable exceptions

While local financial reporting standards and practices are generally good, with solid quarterly reporting, local CG reporting standards remain far behind accepted international best practice and even lag regional best practices. Until the effects of the CG Blueprint are felt via the revised SRC and Corp Code, CG disclosure standards remain based on the SEC's Annual Corporate Governance Report initiative of 2013. That said, principally among large caps, (eg, Ayala Group, PLDT, Meralco and SMIC) some groups have gone far past local standards of disclosure. Small-cap CG disclosure is far weaker.

ESG reporting a long way off

Local CSR and ESG disclosure requirements are still weak, as the SEC admits in its Blueprint. What requirements exist are basic and enshrined in the CSR Act. The SEC says it plans to conduct a study on appropriate ESG reporting requirements and integrate these into the PSE listing regulations, but it is unclear what they will entail or how they will compare with emerging regional ESG reporting standards. Unsurprisingly, ESG reporting among most listed companies in the Philippines falls far short of international standards. Ayala is a stand out exception to this statement. There are few others.

Disclosure regulations weak . . .

Regulations for disclosure by major shareholders and directors also fall short of best practice, again acknowledged in the SEC Blueprint. While PSE listing rules mandate immediate disclosure of any information deemed to be price sensitive, it is doubtful that the rule is readily enforced.

. . . RPT rules even weaker

Related-party transactions (RPTs) remain a major hole in both securities laws and listing rules. Current rules require detailed annual disclosure of RPTs post facto, but there is no requirement to obtain prior approval from minority shareholders of the larger ones (as with most markets) and the new Blueprint admits the problem and helpfully proposes to tighten the definition of RPTs by adopting the BSP version. However, less helpfully, there is still no plan to require shareholder approval even in the newly revised regulations. This remains a major flaw in the regulatory framework and leaves the scope for self-dealing by unscrupulous insiders uncomfortably wide. The risk is exacerbated by a weak definition of independence for the purposes of acting as a director of a company, which affects board and committee structures, most notably audit committees.

Equally troublesome is the lack of dilution protection for minority shareholders. While pre-emption protections exist in law, in practice, such laws are purposefully disapplied by companies via amendments to their Articles. There is no plan to change this practice.

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Government efforts to enhance governance among SOEs

A goodbye gift from former President Benigno Aquino, III.

Before stepping down as President of the Philippines, Benigno 'Noynoy' Aquino, approved a new compensation system for government owned and controlled corporations (GOCCs). The new compensation system is intended to improve CG in GOCCs via providing a standardised compensation and benefits system for GOCCs; regulation of procurement; and audit examination.

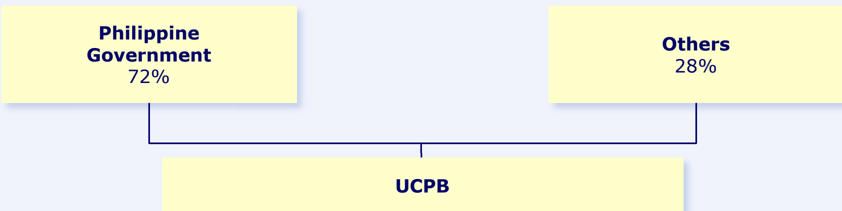
Better governance ahead for UCPB

One company that will be covered by the new compensation system is the United Coconut Planters Bank (UCPB), which is majority owned by the Philippine government. UCPB has had some ownership and financial issues in the past and had to receive billions of pesos in cash infusion from the government. The then Aquino administration's plan to privatise UCPB suffered a blow in 2015, when the Supreme Court issued a temporary restraining order against the sale. As of this time, we are unclear whether the administration of Rodrigo Duterte will privatise the bank. At present, it is in good financial health and is among the top-15 banks in the country in terms of assets and capital.

The new compensation system should improve overall CG in UCPB and should also improve overall employee morale and productivity as employees are now assured that their compensation package is aligned with their counterparts in other GOCCs. Moreover, we believe that the regulation of procurement should result in lower purchasing price and also better quality of purchase. We also believe that the audit examination should ensure that bank processes and business practices remain compliant with best-practice standards. At the end of it, whether UCPB is privatised or not, the bank should benefit from the aforesaid system and as such, a return to the times it had some financial issues is unlikely.

UCPB is among top-15 banks in the country

UCPB profile



Assets (Pbn)	272
Loans (Pbn)	114
Deposits (Pbn)	230
Leverage (x)	15.46
Branches	188
CET-1 (%)	9.28

Source: CLSA

Enforcement

Score rises slightly from 18% in 2014 to 19% in 2016

Enforcement is easily the Philippines' weakest area in CG, especially with respect to regulatory enforcement, and there is precious little to report by way of material progress since our *CG Watch 2014* report. True, the PSE delisted Alphaland (see blue box on next page) for one of the most egregious examples of suppression of minority rights we have ever seen, but the Calata market rigging scandal goes unpunished years on, and aggrieved minority shareholders got nowhere with Alliance Select Foods.

SEC seeks a bigger stick . . .

In its defence, the SEC admits that its fines and penalties are way too low and it is seeking to amend the Securities Regulation Code (SRC) to allow it to impose stiffer penalties on market miscreants, but the fact is that there is little by way of market enforcement ongoing. The SEC has no right to bring criminal cases against insider traders and market manipulators, but is proposing civil enforcement via an amendment to the SRC. We will see if that gets past vested interest in Congress.

. . . and more resources

Resources for enforcement at the SEC, by admission, remain scarce and what resource it does have at its disposal is directed more at stamping out off-market investment scams and Ponzi schemes than it is at insider trading.

Insider trading goes unpunished

The PSE has invested in the past in surveillance software and does have a market monitoring and surveillance team, but insider trading still goes unpunished. There are no meaningful up-to-date market enforcement statistics on the SEC Capital Markets Integrity Corporation website.

Market enforcement isn't happening

Market enforcement is equally weak: there are few if any examples of minority shareholders, institutional or otherwise, holding boards to account for corporate misdemeanours. The SEC is mulling introducing some form of stewardship code to encourage more investor participation and says it may even mandate certain domestic investors to disclose voting policies and actions.

Takeover protections need an overhaul

Takeover protections in the Philippines remain weak and below international standards. The SEC acknowledges the need to improve takeover protection in its Blueprint but then, confusingly, suggests investors rely on protection from the Philippine Competition Act, which somewhat misses the point.

Arbitration plans are interesting

A more interesting initiative in the Blueprint is the SEC's idea to engage arbitration bodies to provide some redress for minority shareholders, perhaps acting as arbiter itself. Details need to be worked out, but it could provide an interesting from of redress if implemented properly.

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Alphaland delisted from PSE after violating disclosure rules

On September 2014, the Philippine Stock Exchange (PSE) ordered the delisting of property developer Alphaland for noncompliance with disclosure standards, citing the company's 'failure to submit full, fair, accurate and timely material information' on several occasions within a 12-month period.

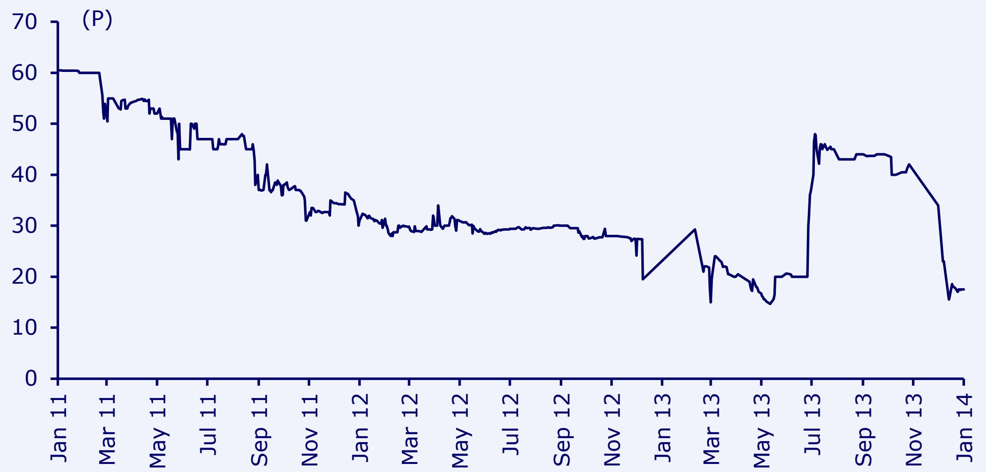
Alphaland was noncompliant with disclosure standards

One cited instance involves the controversial sale of Alphaland shares between Ashmore Investment Management Limited or Alphaland Holdings (Singapore) and Credit Suisse (Singapore). In January 2014, Alphaland filed a criminal complaint against two executives of its long-time investor, London-based private equity fund Ashmore, for the 'simulated' sale of 49.608m Alphaland shares (2.5% ownership) made in December 2012 to Credit Suisse. This increased the company's public ownership from 8% to 10.53%, allowing it to comply with the Philippine Stock Exchange's (PSE) listing requirement. Alphaland, however, claimed that Ashmore continues to be the beneficial owner of these shares. Eventually, the former partners agreed to settle their dispute with Ashmore receiving Alphaland assets in exchange for cash.

Although this was resolved, with poor disclosures on the issue, as well as on 'cases involving the company, its state of financial distress and its representation of its conduct of a stock rights offering which it later admitted as a minority offering,' the company is now delisted from the PSE.

Alphaland's share price fell steadily following a series of controversies with Ashmore

Alphaland's historical share price prior to delisting



Source: Bloomberg

Political and regulatory environment

Score falls slightly from 42% in 2014 to 41% in 2016

The outgoing Aquino administration had too many other major problems to deal with to treat CG with real seriousness and it is not clear that CG under President Duterte will fare much better (to put it mildly).

Some good work with GOCCs

That said, Aquino's administration did overhaul the foreign investment restrictions, now probably the most restrictive of any in Asean, but the changes were piecemeal and came far too late in the administration's term. More creditable was the administration's focus on improving the GOCCs (the Filipino term for SOEs), with a GOCC charter introduced that presented tangible benefits in governance. In tandem with this initiative, a solid overhaul of administrative and regulatory requirements for setting up and operating businesses produced a tangible improvement in the country's ease-of-doing-business scores.

Will Duterte take on corruption?

The forthcoming political and regulatory landscape is far from clear with the new Duterte administration, although he clearly intends to tackle corruption head on (still one of the country's fundamental problems). Will he form an independent commission against corruption at last? Will he take on the oligopolies and duopolies that so badly restrict the country's closed economy? The answers to these questions will be crucial to driving any regulatory reform agenda.

Comply or explain . . . or don't comply and complain?

While the SEC's CG Blueprint initiative is laudable, there remains a lack of coherence among the regulators with respect to its position on CG. The SEC is clearly leading the charge in terms of regulation, but it is also clear that the entire regime will be based on a comply-or-explain basis. The SEC's approach seems to be to present the requirements and leave it up to the companies themselves to decide whether or not they comply. Unless investors push them to comply, it is not clear that the regulators intend to intervene. Meanwhile, the PSE has not updated any CG-related regulation since our last *CG Watch* and appears to be taking a back seat in CG reform.

SEC wants more power & autonomy

On a more positive note, the SEC is clearly seeking more autonomy and power from the government. Perhaps ambitiously, it talks about restructuring itself into 'an autonomous body in terms of financing/funding' and says it intends to introduce its own roadmap in 2017, with a view to modelling itself on the BSP as a regulator. Now that really would change things!

Judiciary slow and too easily influenced

The country's judiciary, while generally regarded as competent to hear complex securities cases, is all too easily influenced and the legal system is slow and cumbersome. Except that is for the issue of Temporary Restraining Orders, dubbed TROs, which are all too easy to obtain from local judges and in the wrong hands, and can severely slow up due process.

Bank secrecy leads to abuse

Bank secrecy laws remain some of the toughest in the world and are open to rampant abuse (see blue box on next page). If the BSP and SEC' current attempt to prise these open can get past Congress and is successful, it will be a major coup for the financial regulators and finally permit the SEC to join IOSCO.

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RCBC caught in a money laundering scandal

An unfortunate incident but the bank is moving on

RCBC recently involved in a money-laundering scam

Rizal Commercial Banking Corporation (RCBC), a top-10 bank in the country in terms of assets and capital became embroiled in a high-profile money-laundering scandal in March 2016. What happened essentially, was that four individuals using fake identities opened four bank accounts at the Jupiter Street, Makati City. The four accounts subsequently received a total of US$81m, which was stolen by cyber thieves from the Bangladesh Central Bank's account with the Federal Reserve Bank of New York. The cash was quickly remitted out to casinos and junket operators in Manila, apparently without the knowledge RCBC's senior management.

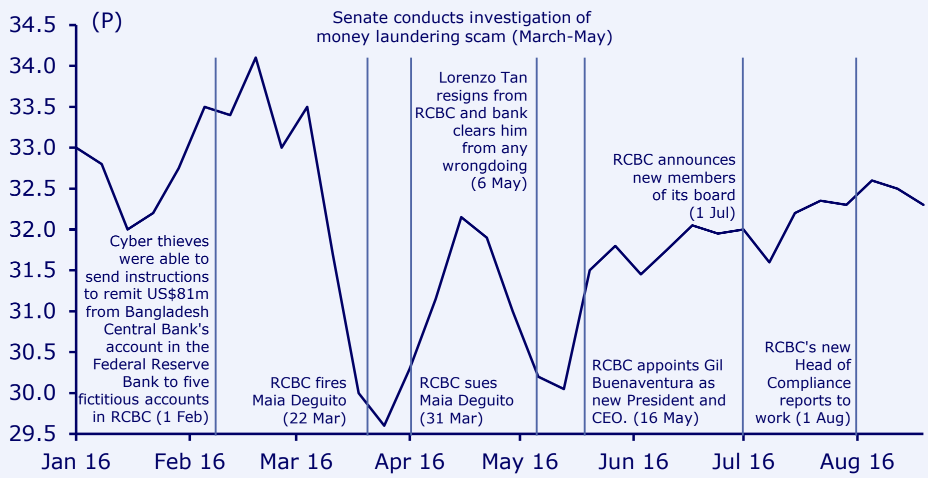
The Jupiter Street branch manager, Ms Maia Deguito, later testified to Congress that RCBC President and CEO Lorenzo V Tan knew about the accounts and the transfers. Tan, in turn, denied these accusations. The incident exposed weak financial and procedural controls at RCBC. Tan offered his resignation to give the bank a fresh start. The board of directors accepted Tan's offer and has also cleared him of any wrongdoing. On the other hand. Deguito was dismissed. RCBC has also filed criminal charges against Deguito for falsification of commercial documents.

Though the recent incident has caused some reputational damage to RCBC, the bank is now moving on. It has appointed a new President and CEO, Mr Gil Buenaventura, who is a seasoned banker with 30 years of experience at major financial institutions like the Bank of the Philippine Islands and the Development Bank of the Philippines. RCBC has also hired a new compliance officer and replaced some independent directors with new ones.

The Central Bank has also levied a P1bn (US$21.3m) penalty to be paid within a year in two equal tranches. RCBC has agreed pay up, which it can easily do, given its 13.48% common-equity tier-one (CET-1) ratio as of 30 June 2016 against the Central Bank minimum requirement of 8.5%. RCBC mentioned that the impact to CET-1 ratio is only around 25bps. The P1bn penalty is equivalent to around 20% of RCBC's 16CL net-income estimate of P4.9bn. Book value as of YE15 stood at P41.50/share. We estimate that the negative impact to book value was just P0.715/share.

RCBC's share price has not yet recovered since money-laundering incident

RCBC's price performance



Source: CLSA

Accounting and auditing

Score stays at 65%

The Philippines' auditing and accounting standards are closely aligned with those of IFRS, save for marginal differences relating to the treatment of certain real-estate assets and the country has an established policy of convergence with IFRS.

Big Four keep standards high . . .

Accounting practices among large-cap companies are good in the Philippines since most are audited by Big-Four firms and affiliates, which tend to bring in global standards. At smaller-cap companies, standards are not as high, but the predominance of the Big Four among PSE-listed corporations means that standards among listed companies are generally good.

. . . but leads to lots of non-audit work

The heavy influence of Big-Four audit firms on Filipino companies inevitably leads to the issue of non-audit work undertaken by these firms and the disclosure of fees associated with it. Generally, company accounts of PSE listed companies include details of audit fees and non-audit fees, along with a sum, but detailed disclosure of the work undertaken could be better.

Still no independent audit regulator . . .

Despite the strong accounting and auditing standards and the relatively high auditing standards among independent audit firms, the Philippines still lacks an independent audit regulator, something the SEC now seems determined to address and it has talked at some length in the CG Blueprint of increasing audit oversight, whether the industry likes it or not.

. . . but the SEC has a plan

The SEC introduced a new requirement for auditors to submit an oath to adhere to the profession's Code of Ethics and also issued new audit guidelines for external audit firms. Now, as part of its CG Blueprint, the SEC wants to develop what it calls its SEC Oversight Assurance Review, which would send SEC officers from the Office of the General Accountant to examine the working papers and files of public audit firms, focusing principally on listed companies. If the SEC can pull this off, it will be a major coup. Pro tem, some disciplinary oversight and quality control is exerted over the profession via several industry bodies, including the Philippine Institute of Certified Public Accountants, the Institute of Internal Auditors Philippines and the Management Association of the Philippines.

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Puregold's various acquisitions

As part of its continuing expansion efforts, Puregold has acquired six, family-run supermarket chains: Kareila Management for S&R stores, Gant Group of Companies for Parco Supermarkets, Company E for Eunilane Foodmart and Grocer E, San Roque Supermarket for San Roque Supermarkets, First Lane Super Traders for NE Bodega and Goldtempo for Budgetlane supermarket - since it went public in 2012.

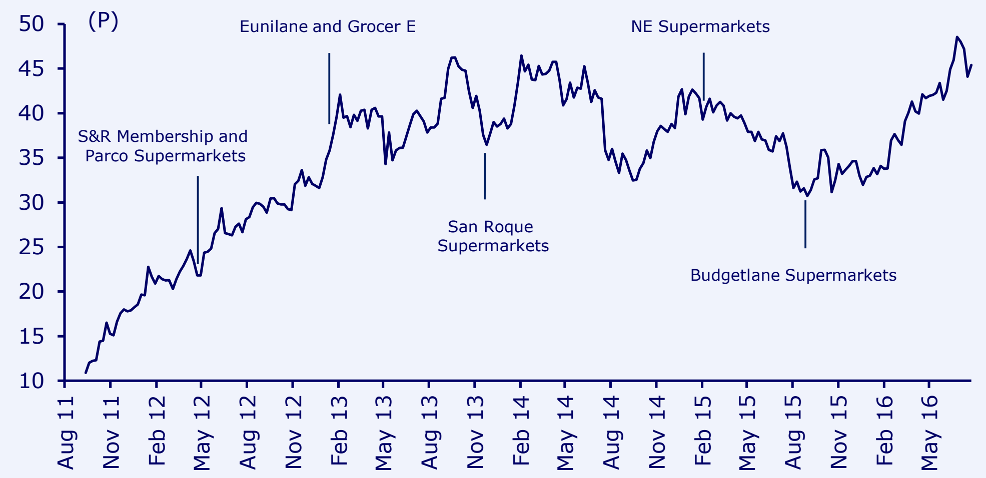
Even audited financial statements of smaller, privately-held firms can be understated for tax purposes

The majority of these acquisitions were presented as positive and immediately earnings accretive but that was difficult to validate. Although data is easily accessible via the SEC website, it was widely believed that the financial statements of these smaller, less formal, family-run entities were often understated for tax purposes. Even the audited versions of their financial statements were hard to rely on since most were audited by individuals or smaller auditing firms which had no affiliations with international auditing firms and are not obliged to follow best practices.

Not all acquisitions were viewed positively by the market

In the case of Puregold, of the six companies it acquired, only Gant Group of Companies was audited by SGV, a local member of the Ernst & Young group, while the rest were audited by smaller accounting firms and/or individuals, some of which aren't even accredited by the local SEC.

Stock-price performance



Source: CLSA, company disclosures

CG culture

Score stays at 33%

Perhaps the real Achilles' heel of the country, few companies seem to believe in the benefits of CG reform and some have fiercely resisted changes to existing regulations, as evidenced by the SEC's pullback from certain proposals in its CG Blueprint. For the majority of Filipino corporations, CG remains a compliance/disclosure exercise forced upon them by regulators.

Some standout companies but most are dragging their feet

That said, a few companies stand out for their approach to CG: Ayala Land, Meralco, Aboitiz Equity Ventures and Del Monte Pacific, for example, have all clearly thought about their CG and ESG responsibilities and embraced them, so there is some hope. Less encouraging is the unseemly spat between regulators and pressure groups and vested business interests over the proposal to limit board terms, which ended in a suboptimal compromise.

Independence is a real problem . . .

Genuinely independent directors remain a rare sight on the boards of most Filipino companies. With weak regulatory definitions and a small and clubby business elite, few listed companies recruit genuinely independent directors. Coupled with term limits that will only bite in a few years' time (and then on a comply-or-explain basis) this is likely to be an area in which the Philippines lags its regional peers for some time to come. Similarly, few companies conduct genuine board evaluation and performance procedures, although training seems to be more popular with boards.

. . . and boards hate to disclose their pay

Filipino companies also seem to hate to disclose board remuneration, other than to group it into totalled bands, or disclose totals for senior management and board members. A notable exception is Ayala Land, which provides a full breakdown of its remuneration policies, and awards for its board and senior management. Unfortunately the SEC's comply-or-explain regime is unlikely to encourage many other listed companies to follow this example.

Investor relations good, and getting better

Investor relations is something most Filipino companies are good at and there has been a gradual improvement in the willingness of local companies to engage with outside shareholders, including foreign investors over the last few years.

Philippines lagging on GMS voting practices

That said, voting by poll is very much the exception, with the 'viva voce' system of a show of hands still the boards' preferred method of voting. Institutional investors in the Philippines do not tend to vote at meetings enough and engagement is minimal. Much of the company engagement that does go on in the Philippines is left to the work of retail-focused organisations such as SharePHIL, which continues to promote active voting by its members and other shareholders at the GMS of major listed companies.

Media worried about undue influence and threats

Notable CG scandals during the period include the bitter spat between the board and controlling shareholder of Alliance Select Foods with its Singaporean institutional shareholders and of course, the embarrassing money-laundering scandal at Rizal Commercial Banking Corporation. While reporting of these and other scandals was extensive, our research has detected an increasing nervousness among media outlets about negative press amid instances of undue influence and even threats on media from interested parties.

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SMC's sale of telecom business to PLDT and Globe raises questions

PLDT and Globe have acquired San Miguel's telecom business

PLDT and Globe announced on 30 May 2016 that they would acquire San Miguel's telecom business in a 50-50 split deal. San Miguel already has a monopoly in the valuable 700MHz spectrum (which provides huge coverage and good quality). It also holds bandwidth in 800MHz, 1.8GHz and 2.3GHz. The total acquisition price was P70bn with P69.1bn for Vega, which included P52.08bn for a 100% equity interest in Vega Telecom and the assumption of around P17.02bn of liabilities. The consideration for the acquisition of New Century was P691m, which included P576m for 100% equity interest and the assumption of around P115m of liabilities. The total consideration for the acquisition of eTelco was P206m, which included P191m for a 100% equity interest and the assumption of around P15m of liabilities.

PLDT and Globe will cause acquired companies to relinquish certain radio frequencies

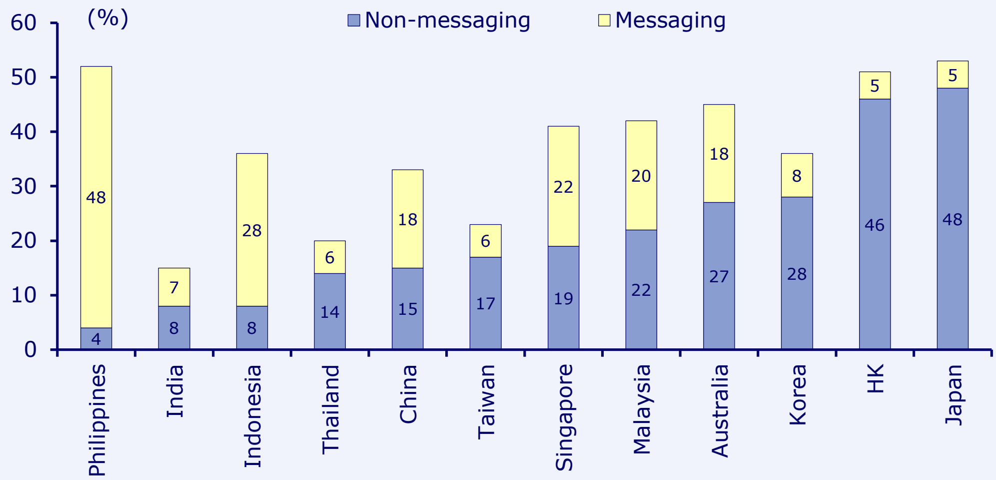
PLDT and Globe will cause the acquired companies to relinquish certain radio frequencies in the 700MHz, 850MHz, 2,500MHz and 3,500MHz bands and to return these radio frequencies to the government through the National Telecommunications Commission (NTC). These radio frequencies to be returned by subsidiaries of Vega Telecom to the NTC, together with radio frequencies already held by the NTC, will be sufficient to allow a third-party operator to enter the market.

PCC is investigating 700MHz issue

The Philippine Competition Commission (PCC), however, is investigating the 700MHz issue and how San Miguel has been able to obtain and maintain control of the scarce frequency, despite calls for a public bidding.

Philippines is still in early days for data

Data as a % of mobile Arpu



Source: CLSA

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- Further dilution of the CG Blueprint proposals
- No demonstrable improvement in enforcement
- No attempt to address independence on boards
- Regression in company disclosure despite the comply-or-explain regime
- No attempt to address RPTs, pre-emption or takeover protections

Quick fixes

What to fix

- More and clearer enforcement data on regulatory websites
- PSE to deepen its company announcements database from two years
- Mandate voting by poll
- Mandate fully independent audit committees
- Enforce term limits strictly

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Singapore - Sunlight and shadow

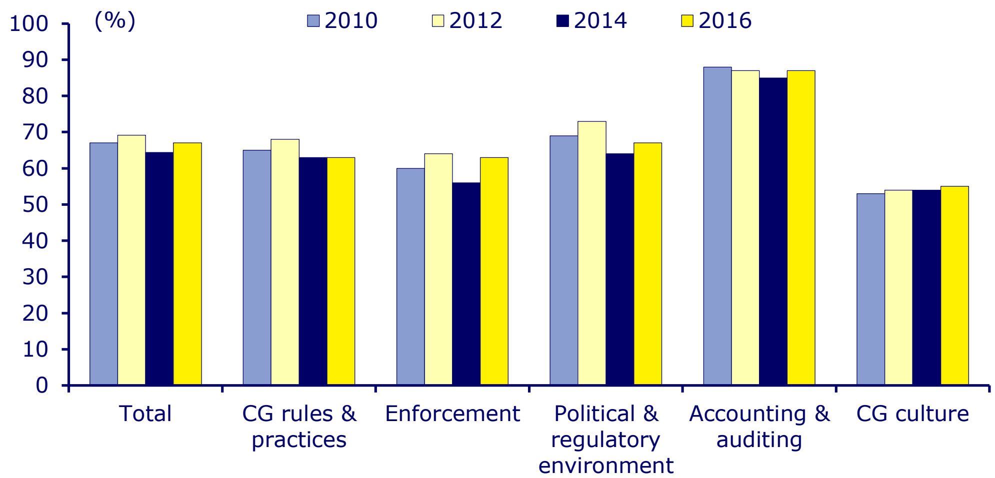
Key issues and trends

- ❑ Revamped securities enforcement strategy, MAS joins with CAD
- ❑ New chief regulatory officer at SGX, signalling more commitment
- ❑ SGX forms three independent committees to bolster regulatory function
- ❑ Mandatory voting by poll finally arrives
- ❑ ACRA introduces eight 'audit quality indicators'
- ❑ Upgrade to takeover regulations
- ❑ SingPost debacle an embarrassment

Overall score rises from 64% in 2014 to 67% in 2016

Figure 84

Singapore CG macro category scores



Source: ACGA

Following a period of reflection, Singapore reinvigorates its CG regulatory regime

Singapore seems to have undergone a period of existential self-reflection about its CG and capital-markets strategy over the past two years. A reinvigorated Monetary Authority of Singapore (MAS) and new regulatory leadership at the Singapore Exchange (SGX) has brought significant tightening in regulation and enforcement and a renewed sense of direction. MAS has substantially rethought its approach to tackling securities crime and joined in a closer partnership with the Commercial Affairs Department (CAD) of the Singapore Police Force. SGX has a new regulatory chief and recently moved its regulatory arm into a separate company, much like the ASX did in Australia in 2010. And regulators are providing greater disclosure of their actions.

But plans for dual-class shares are highly controversial

But as the title of our chapter implies, other developments are starting to cast an unwelcome shadow over all the good progress. SGX refreshed its listing regime in 2015 with the creation of three new independent committees on listing advisory, disciplinary action and appeals, but it is debatable whether this has helped to raise CG standards. In late August 2016, stories appeared in the local media saying that one of the committees, the Listing Advisory Committee, was in favour of dual-class shares and had given SGX the green light to carry out a consultation. While officially this is not a done deal, it is certainly being viewed as such by market practitioners in Singapore and elsewhere; and with just one mainboard listing in 2015, the pressure to drive new foreign listings is strong. SGX has also raised eyebrows by proposing to scrap its own Minimum Trade Price regime and reopened a discussion on whether to do away with quarterly reporting. The stage seems set for some heated public policy debate.

CG rules and practices

Score stays at 63%

Singapore has had quite a busy couple of years since our last *CG Watch* report, with regulation generally (but not always) heading in the right direction. SGX mandated voting by poll in August 2015 (a policy decision made much earlier) and introduced a new *Sustainability Reporting Guide* in June 2016 on a comply-or-explain basis. Meanwhile, MAS amended its takeover code in March 2016, closing a few loopholes and tightening oversight. While scores moved up on some questions in this category, overall they stayed the same because of slight downgrades in relation to the publication of audited annual results in less than 60 days (other markets are moving ahead faster in this area) and on a new question about stewardship codes. While Singapore is preparing one, it had not been published at the time of writing.

SGX under considerable pressure to attract new listings

Areas of concern include the recent ideas from SGX as part of a review of its listing manual to scrap quarterly reporting, and the possible introduction of dual-class shares for listed companies (following a consultation later this year or early next). SGX is clearly under pressure to attract more listings after a barren 2015, which saw just one mainboard listing and tumbling trading volume. While IPOs jumped this year to 17 (as of end-August), they were matched by 18 delistings - and then there was the sad departure of Neptune Orient Lines on 6 September 2016, following its takeover by French shipping group CMA CGM. While we fully understand the commercial pressures on SGX, and empathise with its predicament regarding IPOs, we do not see dual-class shares as any sort of panacea - and it will raise both investment and regulatory risk. It is also likely to be interpreted as an opportunistic and short-term move on Singapore's part following Hong Kong's rejection of the idea in 2015.

Good reporting standards, but practices vary

Singapore generally sets good standards (in regional terms) on corporate reporting, although practices among local companies are more variable with a clear difference in disclosure between large caps (generally of a decent standard) and small caps (much more spotty). The financial reporting surveillance programme initiated by the Accounting and Corporate Regulatory Authority (ACRA), and the subsequent guidance it gave in late 2015, provided interesting insight into the status of financial reporting in Singapore and proved a useful tool for companies. Nonfinancial disclosure among most companies tends to be formulaic, however, and Singapore companies seem to have a blindspot when it comes to making full disclosure of director remuneration.

Singapore implements ESG disclosure requirement

Singapore has also pressed ahead with ESG disclosure. SGX upgraded its sustainability reporting requirement to comply or explain in June 2016, to be phased in from December 2017. Disclosure practices vary among companies, with some clear standout reporters among large caps (CDL, Genting, CapitaLand, Olam and Singtel), then disclosure standards dropping noticeably among smaller companies, with some focusing on philanthropic activities and community projects.

Question marks over genuine independence of INEDs

Minority rights could be strengthened

In other areas of reporting, disclosure requirements on major shareholders, directors' dealings and price-sensitive information remain robust and are generally well monitored. However, regulations for RPTs (known as Interested Person Transactions in Singapore) are not as comprehensive as those in Hong Kong and compliance with the rules can be mixed, especially among smaller cap companies.

Voting by poll is now mandatory for SGX-listed companies (as of August 2015). Independence qualifications for board appointments could be stronger (a one-year cooling off is not enough) and this has a potential knock-on effect on board committees, especially the audit committee, where there are some question marks over the genuine independence of some INEDs.

As with most markets in the region, minority shareholders tend to get shut out when it comes to nominating board members. Pre-emption rights, while slightly better than Hong Kong's, are far from best international practice. The vast majority of companies (94%) do not make our minimum 28 days' notice standard for publishing their AGM notice, with most meeting the local standard of 21 days. Notable exceptions to this are Singapore Airlines, Singapore Press Holdings and SGX, all GLCs.

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SGX to develop better market surveillance/member supervision

The SGX is a self-regulatory organisation. The potential conflict-of-interest SGX faces as both a listing authority/front-line regulator and a for-profit listed company has been a point of contention among some market participants.

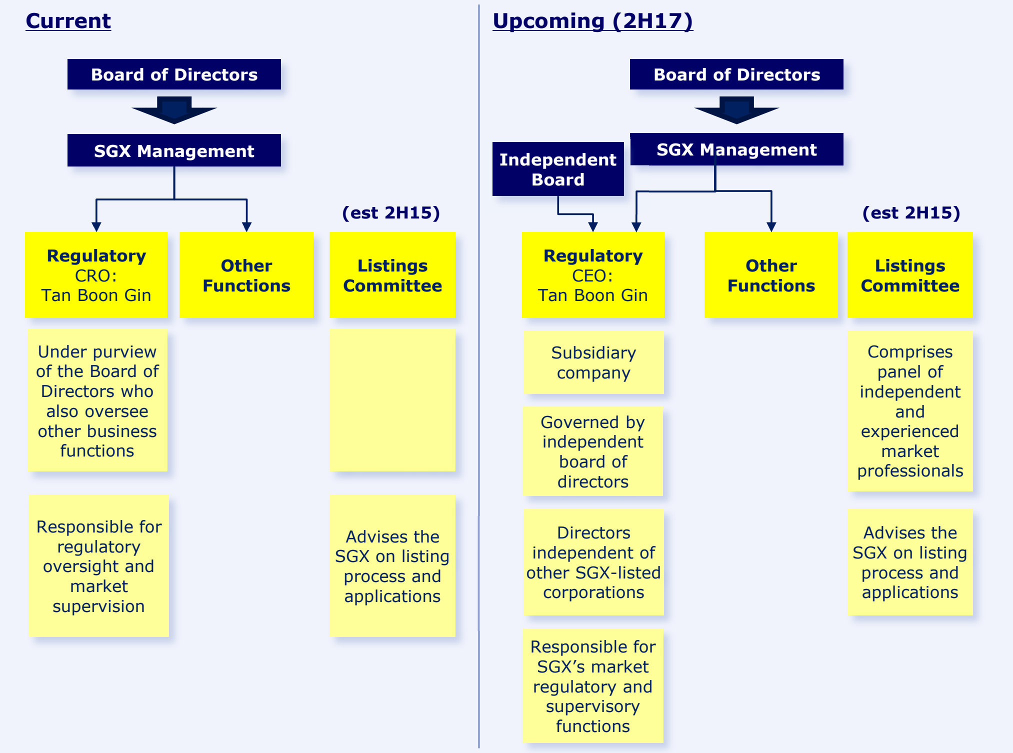
In the wake of the Penny stock issue (discussed below), SGX has pushed out a raft of governance reforms and improvements. One of these is the establishment of a subsidiary by 2H17 to house its market surveillance/member supervision functions. The subsidiary will have a separate board that is majority-independent. All board members will be independent of any SGX-listed companies. SGX's Chief Regulatory Officer will lead the subsidiary, and the MAS will continue to maintain oversight of both the exchange and its regulatory functions.

While MAS deemed the exchange to be an appropriate regulator in its December 2015 review, we believe that SGX's move to further enhance governance is a good compromise.

We do not anticipate substantial changes in regulatory intensity as a result of the change, but the restructuring to remove the conflict of interest is a step in the right direction. The independence and authority of the new subsidiary will be the key in determining its effectiveness.

Mr Tan Boon Gin heads regulation unit at SGX

Mr Tan Boon Gin - SGX Chief Regulatory Officer



Source: CLSA, SGX

Enforcement

Score rises from 56% in 2014 to 63% in 2016

After several years of what we regarded as a regression in enforcement activity by financial regulators, most notably at the SGX, the past two years have seen Singapore get much more serious in this area. After some high-profile embarrassments, including the China Sky fiasco (where a listed S-chips refused to comply with SGX directives) and the penny stocks scandal, it became clear that a more hands-on approach to enforcement was necessary.

MAS and CAD now joined up

In April 2015, MAS and CAD, the principal enforcement agency for the criminal investigation of white-collar crime, announced a new and radically different strategy on joint securities enforcement. While MAS still has only administrative and civil penalty powers, it can now undertake criminal investigations in conjunction with CAD into market misconduct such as insider trading, market manipulation, and false or misleading disclosure. If criminal prosecution is to be brought, this will be done by the Attorney-General's Chambers in the name of the Public Prosecutor; or MAS may undertake civil penalty action in its own name. The new strategy has seen a significant increase in penalties and disgorgement fines for misconduct, especially insider trading, and a more consistent and effective approach to enforcement overall.

New regulatory broom at SGX

Around the same time, and as part of a major management overhaul, SGX appointed a new Chief Regulatory Officer, Tan Boon Gin, in June 2015. An experienced prosecutor and CAD investigator, Tan made an immediate impact at SGX. Enforcement efforts and disclosure have improved significantly. For example, on 30 November 2015, SGX issued a detailed reprimand of a firm called Sunvic Chemical Holdings for breaching listing rules relating to 'interested person transactions' (ie, related-party transactions). Such announcements about listed companies were rare in the past. SGX is also providing greater disclosure on long-suspended companies, publishing its first report on the topic in May 2016. And Tan has made it clear to companies that the exchange will take a keen interest in how they respond to the new *Sustainability Reporting Guide*, saying that ESG risks are real, and he was mulling a 'carrot and stick' approach to fostering good disclosure.

Singapore unusual in housing its securities commission in its central bank

Despite the clear progress, Singapore remains anomalous in our survey as the only market without a separate securities commission; and there is little or no prospect of one ever being established. Our view remains that such a regulatory structure is suboptimal and weakens regulatory efficiency, leaving Singapore behind Hong Kong in its market enforcement.

SGX plans to set up a new subsidiary to handle enforcement

On the other hand, one recent structural step forward was the SGX's decision to transfer its frontline regulatory functions to a new subsidiary company, nominally called 'RegCo', in an effort to address conflicts of interest. As its announcement on 18 July 2016 noted: 'The move aims to further enhance the governance of SGX as a SRO by making more explicit the segregation of its regulatory functions from its commercial and operating activities.' How much difference this new structure brings remains to be seen, but we wish it well. SGX aims to set up RegCo in the second half of 2017.

Institutional investor interaction surprisingly low

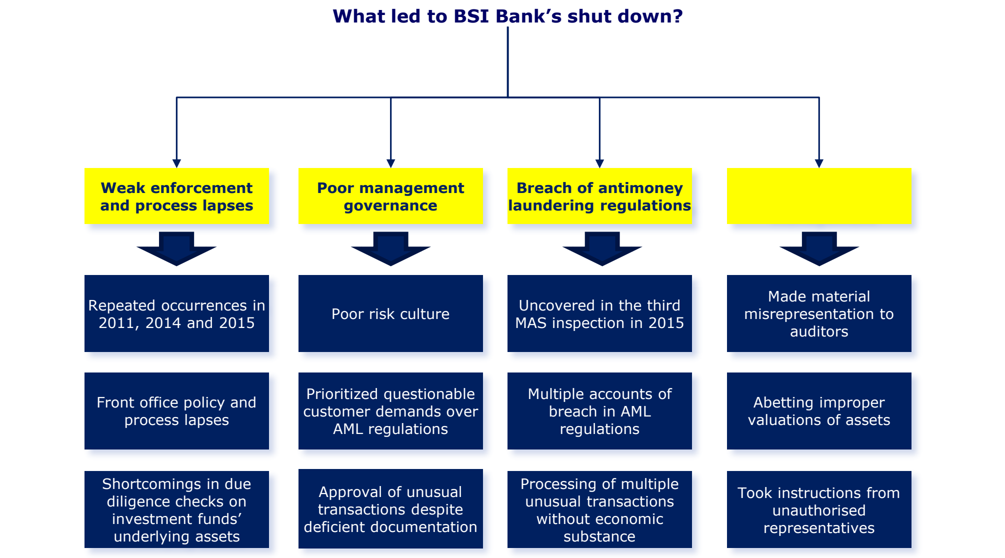
For a relatively sophisticated market, Singapore lacks a truly active institutional investor base: while institutional investors do vote on AGM resolutions and will vote against those they object to, few institutions attend these meetings. That function is left to retail investors, where attendance and engagement has improved of late, led by SIAS, the Securities Investors Association (Singapore), which has done sterling work on behalf of retail investors in recent years.

Minorities rarely take on boards

Investor actions against errant boards and companies remain the exception rather than the rule and lawsuits are rare. Protections for minority investors in takeovers are generally sound, albeit behind Hong Kong's, and improved following a revision of the Takeovers Code by MAS in March 2016.

Figure 85

BSI Bank's misconduct



Source: CLSA

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MAS orders BSI Bank to shut down operations in Singapore

On 24 May 2016, the Monetary Authority of Singapore (MAS) gave notice to BSI Bank, a subsidiary of Swiss BSI SA offering private-banking services in Singapore, that it was withdrawing its merchant-banking status in the republic and imposing financial penalties amounting to S$13.3m. Reasons cited by Singapore's regulatory body were that the bank had 'serious breaches of anti-money laundering (AML) requirements, poor management oversight of the bank's operations, and gross misconduct by some of the bank's staff.'

In MAS's statement, it noted that its decision to shut down the bank took into account repeated control lapses as well as glaring deficiencies in their due-diligence checks it had uncovered since 2011. Specifically, it highlighted that multiple unusual transactions that had no economic substance were processed based purely on faith of client representations despite insufficient documentation.

MAS withdraws BSI banks merchant-banking status for serious breaches of AML requirements

Additionally, six members of BSI's senior management and staff were referred to the Public Prosecutor for evaluation on suspected criminal offences. MAS uncovered evidence of actions by the individuals that put questionable client demands ahead of bank compliance and controls. Other alleged offences included 'making material misrepresentation to auditors, abetting improper valuation of assets, and taking instructions from persons other than customers' authorised representatives'.

MAS highlighted its strict stance on compliance with its AML regulations

In the same statement, MAS took the opportunity to once again highlight its strict stance on compliance with its AML regulations and countering terrorism financing. A quote by Mr Ravi Menon, Managing Director of MAS in the statement read: 'BSI Bank is the worst case of control lapses and gross misconduct that we have seen in the Singapore financial sector. It is a stark reminder to all financial institutions to take their anti-money laundering responsibilities seriously. Controls need to be robust, surveillance vigilant, and the management culture must emphasise professional integrity and risk consciousness.'

Ending off, the regulator sounded a warning to financial institutions that they are conducting supervisory reviews of the sector and bank accounts, and will not have any hesitation to take action against those who have been found to fall short of the required standards.

This has been a clear signal to the market and financial institutions of the renewed efforts to increase oversight and the regulators resolve to enforce existing rules.

Political and regulatory environment

Score rises from 64% in 2014 to 67% in 2016

As a city state that prides itself on business efficiency, it comes as no surprise that Singapore's political and regulatory regimes are closely connected. This extends to CG policy reform, where considerable progress can be achieved quickly given short chains of command and clear political will. Witness the swift progress made by MAS and CAD on enforcement over the past two years, and senior management changes at SGX, once the need was identified. However, Singapore can shift just as quickly in another direction if business dictates. We feel the threat of this happening with the proposed introduction of dual-class shares.

We believe MAS should spin out securities division

MAS describes itself as the 'integrated regulator and supervisor of the financial services sector'. It is also the central bank. As efficient and capable as the authority is, we continue to believe it would be more effective long term if its securities enforcement division was spun out, a point we made in our last *CG Watch*. In the short term, however, we watch with interest the progress being made in its closer partnership with CAD.

MAS flexes its muscles and shuts down Bank BSI

As a bank regulator, MAS is certainly not afraid to flex its muscles, as it did in late May 2016 when it ordered the closure of Swiss private bank, BSI, for serious breaches of anti-money laundering regulations in the wake of the 1MDB scandal in Malaysia. It continues to investigate the fallout from the affair, in collaboration with other international regulators.

ACGA lobbying helps secure multiple proxies

In the area of legislative reform, Singapore has been active in revising its corporate laws in recent years, with company law amendments from 2014 implemented in two phases (2015 and 2016) rather than all in 2015. Following a sustained advocacy campaign initiated by ACGA in 2007 and gaining support from both global investors and local custodian banks, multiple proxies for shareholder meetings finally took effect via a change in the company law in January 2016.

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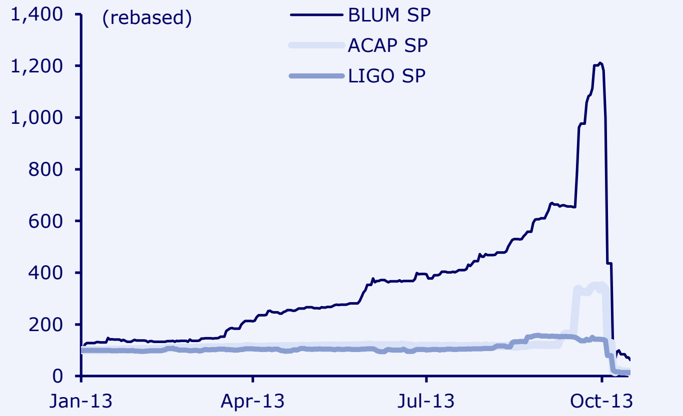
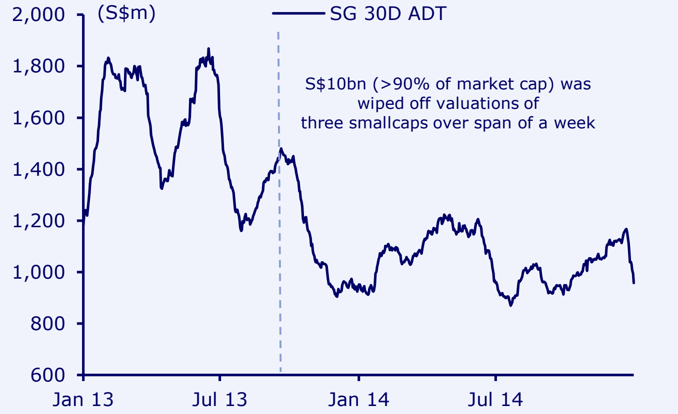
Penny-stock scandal and trade failure in SGX drive governance change

In 2013, three SGX-listed stocks: Blumont, Asiasons and LionGold, almost quadrupled in value between January and September before collectively losing more than 90% of their market capitalisations (S$10bn), over the span of a week in October. There was no apparent reason for either the sizeable rerating or the sharp and sudden derating. This led to a concern about stock-price manipulation. Post-correction, all three stocks were suspended. This was followed by a period of restricted trading. Once trading was stable, SGX removed these curbs. Almost immediately following the crash, SGX, MAS and the Commercial Affairs Department of the Singapore Police launched an investigation into the incident. This investigating is ongoing.

No apparent reason for either the sizeable rerating or the sharp and sudden derating

Sentiment was materially impacted by the penny-stock rout. Since this incident, trading activity has been subdued and there has been a reduction in overall liquidity on the Singapore market. In response to this, a number of market reform proposals were announced. Some of the proposed changes include: a reduction in board lot size, a minimum trading price of 20 Singapore cents for mainboard-listed firms, a move to collateralised trading, new short-position reporting requirements and a shortened settlement cycle. SGX also launched a plan to encourage retail participation in the market, moved to increase transparency with respect to enforcement and regulation and enhanced some of its processes and governance. SGX redesigned its querying process for listed companies in 2014. In 2015, SGX further enhanced the 'trade with caution' alert to be more informative for investors. In 2016, SGX announced it would be setting up a separate subsidiary to house its regulatory functions.

Outside of the SGX, there have also been changes at MAS. Its investigative powers have been broadened such that they are on par with the CAD. The expectation is that this will raise their efficiency and effectiveness.

Three small caps lost >90% of market cap in a week	Activity on the SGX took a hit after the incident
	

Source: CLSA, Bloomberg

Regulators' websites could be better

Both MAS and SGX operate decent websites that work well and are generally fairly easy to navigate, but enforcement data on both sites can be difficult to access and interpret. Meanwhile, the SGX database of historical company data (five years) is inadequate compared with that of HKEx (10-15 years). There seems little excuse for this difference.

Courts are efficient, media competent

Singapore's courts are generally regarded as efficient and impartial with respect to securities cases and the level of understanding among judges of securities law is high. Media report extensively on CG scandals and issues (witness the reportage from the *Business Times* on SingPost) and subject knowledge is good.

Accounting and auditing

Score rises from 85% in 2014 to 87% in 2016

Singapore's accounting and auditing standards are of a high quality and policed by an effective regulator in ACRA (the Accounting and Corporate Regulatory Authority). By 2018, Singapore will introduce a new financial reporting framework that will be identical to IFRS.

ACRA an effective regulator

As the independent audit regulator, ACRA has been seeking enhanced powers over CPA firms for several years and while in the legislative pipeline, the necessary amendments to the Accountants Act have been further delayed. ACRA can take disciplinary action against individual CPAs, but not firms. However, it does have an active programme of inspections and monitoring with regard to firms, like its counterparts in other markets. Indeed, its Practice Monitoring Programme reports continue to be among the best in the region.

Audit quality varies between large and small caps

Accounting and auditing practices among large-cap companies are of a high standard in Singapore (due in large part to the dominance of the Big-Four firms as appointed auditors), but the same cannot be said for smaller-cap companies. ACRA admits it has experienced issues with small CPA firms sometimes preparing accounts for companies as well as acting as the auditor.

ACRA announces eight Audit Quality Indicators

On the issue audit quality, which is rapidly emerging globally as a major area of concern, ACRA issued an initial set of eight Audit Quality Indicators (AQIs) in October 2015 as part of its enhanced oversight of the audit profession. While the issue of AQIs is somewhat controversial internationally - not all audit regulators believe in them on the grounds that the indicators chosen are usually 'too generic and can be gamed' - our view is that this is an experiment worth trying in Singapore. Creating the AQIs has at least started a discussion as to how audit quality can be measured and who should have access to the data. At present, the idea is that the Big Four will only share the information with the company audit committees, if the committees request it. We understand that few audit committees have done so to date, which frankly reflects poorly on board governance practices in Singapore. In future, there also needs to be some way for investors to better understand audit quality.

ACRA seeks views of investors on financial reporting, auditing and CG in Singapore

ACRA also undertook a survey in May 2016 seeking views from investors with respect to financial reporting, audit and CG in Singapore. The survey was extremely detailed and sought investor views on how useful they found financial statements in making investment decisions, what aspects of financial statements they particularly focused on (or ignored), and their views on auditing, including the importance (or not) of choice of auditor, how audit committees should evaluate auditors and how much of this information audit committees should provide to investors.

Investors confirm they are interested in financial reporting and auditing after all!

The survey was undertaken in collaboration with the National University of Singapore (NUS) Business School and the Institute of Singapore Chartered Accountants (ICSA). A total of 33 institutional investors, including analysts, and 171 retail investors participated in the survey - not a bad result for such a specialised topic and given the speed with which the survey was undertaken. A report of the results, tantalisingly titled 'Into the Minds of Investors', can be found on the ACRA website (www.acra.gov.sg). It affirms that investors do rate financial statements as a key source of information (though retail and institutional use them somewhat differently), that investors are interested in quality audits, and that they would like more interaction with audit committees, among many other things. Positively, the report states that:

> *Investors have also indicated that they were more likely to engage auditors with the impending new requirement that auditors indicate Key Audit Matters (KAMs) in financial reports under the enhanced auditor reporting standards from January 2017.*

The new audit report arrives early in Singapore

This refers to the new long-form audit report being introduced globally from December 2016. Early adopters of new report in Singapore include SingTel, UOB and CapitaLand.

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Iceberg Research attacks Noble Group alleging accounting practises

Shortly after Olam, Noble group was the next major commodity trader in Singapore to be on the receiving end of a short-seller's report by Iceberg Research (which was started by an ex-Noble employee) that cast doubts about its accounting methodology and profit booking. This drew a sharp refute from management and even had them engage an independent auditor (PwC) to review their operating and valuation assumptions as part of their validation to both bankers and investors.

While the allegations were never substantiated, what it did was draw increased scrutiny upon its accounting for fair-value gains on commodity contracts. The net value of fair valued commodity contracts was worth over 95% of Noble's equity value in FY15, with the after scaling up by a factor of 600% over a period of seven years.

Olam next Singapore commodity trader featured in short-seller's report by Iceberg

The combination of increased scrutiny and poorer operational performance due to weaker commodity prices and demand took its toll on profitability as management ended up spending significant time and effort defending its accounting policies as well as reassuring both its bankers and customers of their credit worthiness during the period.

This eventually culminated in Noble Group losing its investment grade rating, and dropping out of Singapore's Straits Times Index due to the decline in share price as a reflection of its operational woes.

While this may all turn out to be an entire collection of false allegations in an attempt by a disgruntled ex-employee to get back at the company, what it highlights is that when companies start adopting aggressive accounting policies in their profit accounting, they open themselves to such attacks and in this particular instance, it does not seem to be worth it after all.

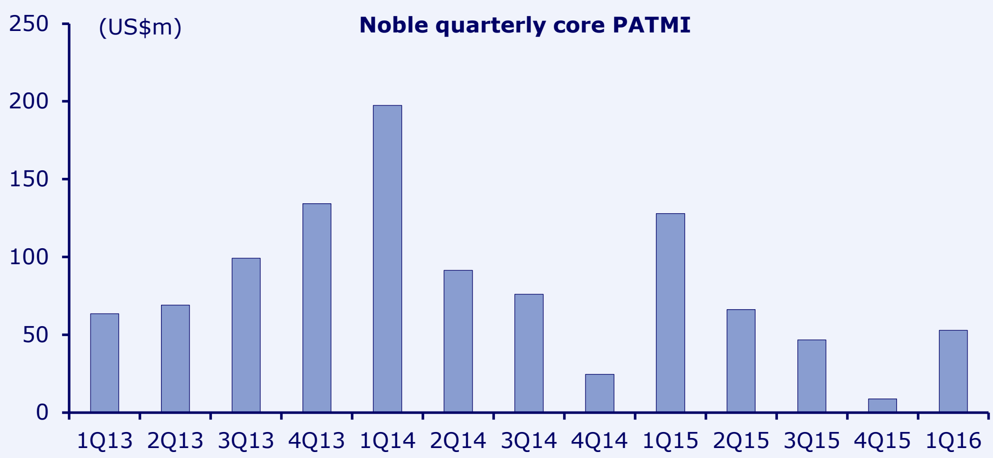
Chart 1: FV assets as % of total assets has been rising YoY

Chart 2: Quarterly NP of Noble is in decline

Chart 3: Share price of Noble has crashed

Allegations and weak commodity prices have pressured profitability since 1Q15

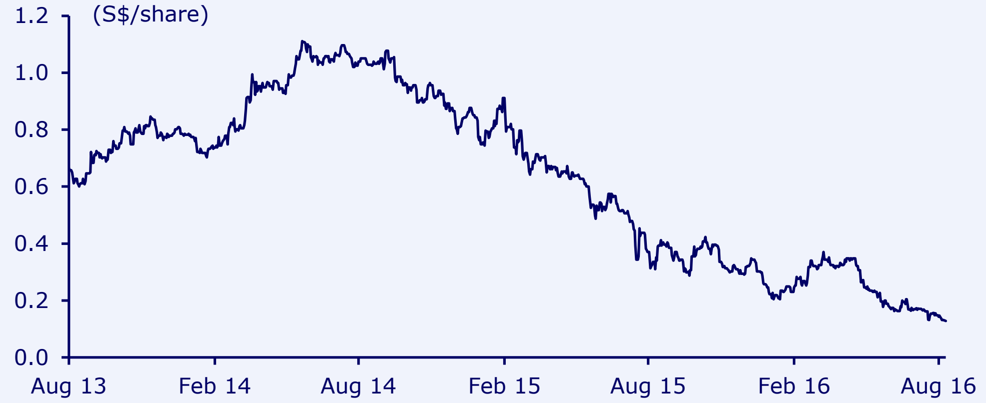
Noble's quarterly core earnings



Source: CLSA

Since the attack, Noble's share price has fallen by >80%

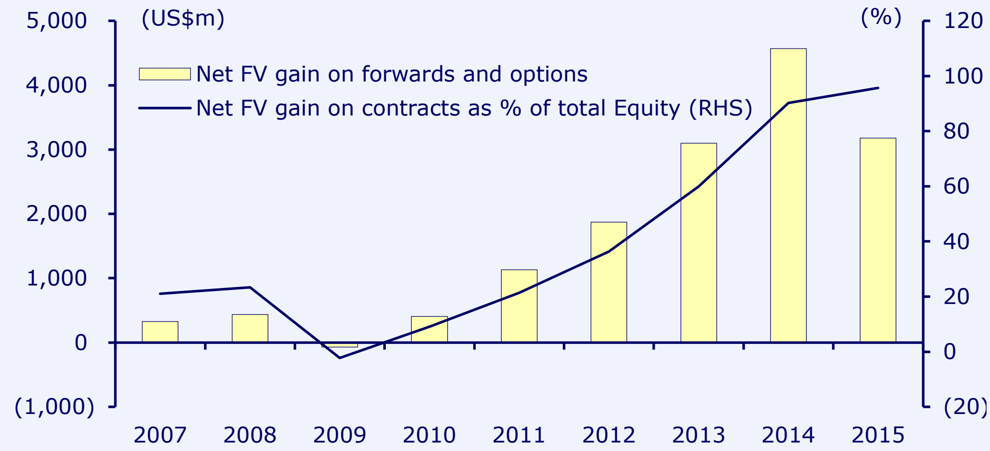
Noble's share-price performance



Source: CLSA, Bloomberg

Due to the recognition of profit from fair value of commodity contracts, as of FY15, Noble's net fair value gain on commodity contracts was equivalent in size to 95% of Noble's shareholder equity

Noble net fair value gain on commodity contracts as % of total equity



Source: CLSA

CG culture

Score rises from 54% in 2014 to 55% in 2016

On balance, we see no major change in CG culture in Singapore over the past two years. Organisations working hard to promote different aspects of CG, such as SIAS, the Singapore Institute of Directors (SID), and the Chartered Secretaries Institute of Singapore (CSIS), which was formerly called SAICSA, all continue to perform at a high level. A small group of dedicated researchers continue to produce interesting studies, including the work done on the Asean CG Scorecard by SID and NUS. Company policies towards CG have been stable - though many areas could improve, especially on nonfinancial reporting. And retail investors continue to take more interest in local CG than their institutional counterparts.

SGX works with company secretaries to try to decluster AGMs

One interesting new initiative, announced in March 2016, is a joint effort by SGX and CSIS to reduce AGM clustering. The two organisations launched an online calendar to allow listed companies to indicate their tentative AGM dates. With 60% of listed companies having 31 December as their financial year-end, and four months in which to hold their AGM, many AGMs are therefore held in the last two weeks of April. This compresses voting times for institutions and reduces the number of meetings investors can attend. The goal is to spread AGMs more evenly across April.

Singapore's institutional investment environment is quite different to most of Asia

One feature of Singapore that is noticeably different to many other markets in Asia is the structure of its institutional-investor industry. Other markets like China, Japan, Korea, Malaysia, Taiwan and Thailand all have significant domestic asset owners, particularly state pension funds, that see a long-term benefit in raising CG standards in their domestic capital markets. Singapore lacks similar large-scale local pension funds, while many of the foreign and domestic asset managers in Singapore use it as a base for investing across the region. This has resulted in less emphasis on domestic-institutional-investor activism in Singapore, much like the state of play in Hong Kong. Although regulators are keen to encourage more investor engagement through the imminent launch of a stewardship code, it remains to be seen how actively this will be implemented.

Where scores went up or down

The higher final score in this section came about through a combination of small changes up or down on a few questions. Scores went down on such things as electronic voting and on a new question relating to board evaluations. They went up on company dialogue with shareholders and the existence of self-funded, non-profit organisations working to promote CG.

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Singapore Post corporate governance issues

Independent director Keith Tay did not disclose his interest when SPSOT embarked on run of M&As

Independent Keith Tay did not disclose his interest in Famous Holdings, FS Mackenzie and Famous Pacific Shipping (NZ) when SingPost acquired the three entities. Tay is a director and shareholder of Stirling Coleman Capital, which acted as the 'financial adviser' for both the FS Mackenzie and the Famous Pacific deal. During the Famous Holding transaction, Stirling Coleman was also the 'arranger' .

According to the Singapore Companies Act, under section 156 (1), a director of a company is required to declare his interest during an acquisition and Tay had a duty to disclose this. In addition, Singapore Post has been accused of not having a prescribed policy and proper process of procedure, evaluation and approval of M&A transactions.

Tay has resigned but ACRA has launched an investigation on the lapse

SingPost did submit a Special Audit report to the Accounting and Corporate Regulatory Authority (ACRA) on May 2016. While SingPost did not disclose the full report, it has released a summary of its Special Audit report, which indicates that investments in the three entities are strategic to SingPost and are part of its business strategy. Tay has decided to relinquish his position as the Lead Independent Director of the company following the completion of the Special Audit. Following this, ACRA announced it is investigating SingPost for possible breaches of the Companies Act. This has shaken investors' confidence and trust in SPOST.

SPOST has taken steps to address investors' confidence and improve corporate governance

To address investors' confidence and improve governance, SPOST adopted all the recommendations from both the Special Audit and the Review with one exception: a recommendation to deem all directors with more than nine years' tenure as non-independent was found to be no longer relevant in view of SPSOT's Board Renewal and Tenure Policy. This has set the maximum tenure of a director at no more than nine years.

We think the resolutions put in place will significantly improve disclosure and addresses the key issues. Concerns will be on SPOST business strategy and how it can improve its e-commerce footprint.

CG issues resulted in derating

Singapore Post - 12 month forward PE

Source: CLSA

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- Introduction of dual-class shares
- Weakening of CG standards to attract listings
- Removal of quarterly reporting requirement
- Slow takeup in sustainability reporting
- Any weakening in regulatory enforcement
- Slow takeup in implementation of new stewardship code
- Audit committees showing continued reluctance to access AQIs
- ACRA still does not have extended powers under Accountants Act

Quick fixes

What to fix

- Companies could improve nonfinancial reporting, especially around remuneration policy, board evaluation and operation of board committees
- SGX to improve and deepen its database of company announcements
- Companies to use new SGX-CSIS online calendar to reduce AGM clustering
- More large caps voluntarily release audited annual results in less than 60 days, in line with regional best practice
- Institutional investor industry to play a more public role in CG policy development

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With contributions from Neesha Wolf

Taiwan - Connecting more of the dots

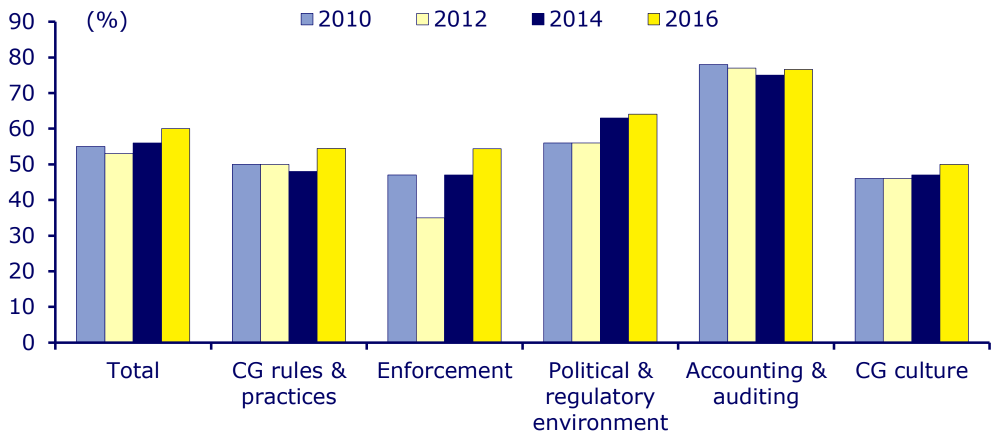
Key issues and trends

- Taiwan's CG system becoming more inter-connected and less fragmented
- Investor stewardship code adopted on a comply-or-explain basis and with signatories
- E-voting and voting by poll increasing by leaps and bounds
- TWSE promotes sustainability reporting
- Corporate reporting, especially CG disclosure, still formulaic
- A colourful two years for enforcement
- Questions linger over judiciary and public prosecutors

Overall score rises from 56% in 2014 to 60% in 2016

Figure 86

Taiwan CG macro category scores



Source: ACGA

Taiwan has successfully sustained its CG reform momentum . . .

In our last survey, *CG Watch 2014,* we commented on the bold steps that Taiwan was taking to improve its CG system and raised its overall score from 53% in 2012 to 56% in 2014. We also described how its previously piecemeal efforts at reform were becoming more coordinated. Our main note of caution was to ask whether the momentum could be sustained.

. . . and now ranks fourth in the region - up from sixth in 2014

Going on the evidence of the past two years, Taiwan has not only maintained its forward movement, but has enhanced its reform efforts. Its total score this year rises to 60% and its ranking finally moves up, from sixth to fourth. Its nearest competitors, Malaysia and Thailand, have dropped in points and ranking, while Taiwan's score is slightly higher than that achieved by the other two markets in 2014.

Strong government support has helped to maintain CG direction

Taiwan has sustained its efforts through a combination of clear government political support, close coordination between key regulatory and support agencies, and the formation of a well-funded Corporate Governance Center at the Taiwan Stock Exchange (TWSE). On a professional level, key officers from financial regulatory bodies and the stock exchange have been allowed to travel to international and regional conferences on CG and CSR/ESG in recent years. The value of this kind of personal interaction with peers and capital market participants around the world cannot be underestimated. It gives the officers in question a broader outlook on global reform trends and new points of comparison against which to judge their own market. How different things were in Taiwan only a few years ago.

Scores across the five categories in our survey remain uneven, however

As the chart above shows, Taiwan's performance in this survey, like most markets, is uneven. Top-down advances in rules and enforcement need to be matched by a bottom-up deepening of CG culture. The score for Political/regulatory is relatively high in regional terms, but masks a range of underlying problems. And foreign investors continue to struggle with some aspects of the share voting system in Taiwan. Nevertheless, more policy and regulatory coherence is apparent today and we hope the momentum continues.

CG rules and practices

Score rises from 48% in 2014 to 54% in 2016

There has been a steady improvement in CG rules and practices across a number of areas in Taiwan over the past two years. Some of these are new, some are the result of reforms made earlier. As the score of 54% for this category implies, however, there are many areas where further improvement is possible.

Taiwan launched a stewardship code for investors in June 2016

The big news so far this year has been the adoption of Taiwan's 'Stewardship Principles for Institutional Investors' on June 30, 2016. The Principles were formally launched at an endorsement ceremony on August 12 and have already been signed by 14 domestic institutional investors, including national pension and investment funds such as the Bureau of Labor Funds, National Development Fund, Chunghwa Post (the national post office) and the Public Service Pension Fund. Local and foreign-owned asset managers have signed up too, while the local investment industry body, the Securities Investment Trust & Consulting Association, is encouraging its members to sign.

Code includes concept of collective investor engagement

As in other Asian markets that have adopted stewardship codes, the Principles follow closely to the model created a few years ago in the UK. It is significant that Taiwan has included the sensitive concept of collective engagement by investors in the document, although it has done so as a subsidiary guideline within the text rather than as a topline principle (a pragmatic decision that follows the approach of Malaysia and Hong Kong and places the issue slightly under the radar screen of anyone likely to object). It is also worth noting that the TWSE led a constructive consultation process and took account of many of the comments received, with the final version of the Principles a marked improvement on the first draft. It looked initially as if the whole exercise was going to be rushed, with an end-Q1 2016 publication deadline. Fortunately, the release was delayed three months and the end result, both in terms of content and signatories, could be judged a success.

Sustainability reporting takes off

Sustainability reporting has exploded in Taiwan

Another significant development over the past two years has been an explosion in sustainability reporting (called 'CSR reporting' in Taiwan) by listed companies. Among TWSE listed companies, there was a 140% increase in CSR reporting over the three years from 2013 (109 reports) to 2015 (262 reports). This means that 30% of them now produce CSR reports, including 82 of the top 100 large caps. According to a recent study by the Business Council for Sustainable Development (BCSD) Taiwan, part of the global BCSD network, the number of CSR reports in Taiwan totalled 406 in 2015 (of which 336 were from listed companies and 70 from other organisations such as unlisted companies, government agencies and non-profit organisations). Almost 86% of the 406 reports were based on GRI G4 guidelines (with 98% of the 262 reports from TWSE-listed companies following GRI 4). Interestingly, 44% of the reports had third-party assurance (with 54% of the TWSE company reports having it).

Government mandated sustainability reporting in 2014

The main factor driving this change has been regulation. While the TWSE began promoting CSR reporting in 2008 and produced a set of *CSR Best Practice Principles* in 2010 (with the GTSM, a board for smaller high-growth firms), it was the introduction of mandatory standards in 2014 that really got the ball rolling. In September of that year, and following safety scandals in the food sector among others, the Financial Supervisory Commission (FSC), the country's peak financial regulator, stated that all listed companies with paid-in capital of NT$10bn or more, as well as certain companies in sectors such as food, chemicals and finance/insurance, must produce a CSR report based on the latest GRI guidelines. Standards were tightened in October 2015, when the paid-in capital threshold was dropped to NT$5bn or more and affected companies required to report from 2017.

Focus now on improving quality of this reporting

While there has been a significant increase in sustainability reporting volume, it is generally recognised that it is still early days for reporting quality in Taiwan. A task force was formed in February 2016 comprising experts from CPA firms and non-profit organisations to help enhance the overall quality of reporting. The BCSD Taiwan study contains useful recommendations for companies, including gaining a deeper understanding of the GRI system, focusing more on material aspects of ESG, and improving the credibility of quantitative data. Meanwhile, the TWSE has undertaken a revision of its *CSR Best Practice Principles* to bring them more into line with OECD standards and is planning to develop a sustainability index.

INEDs and audit committees multiply

Taiwan was late in mandating independent directors and audit committees

A particular feature of CG reform in Taiwan since the early 2000s has been its late adoption of mandatory independent directors (INEDs) and audit committees. The former were initially required only for IPOs and then companies above a certain size. In December 2013, they were mandated for all companies from 2015 onwards. As for audit committees, they were largely voluntary and most companies chose not to have them, preferring instead to continue with the traditional system of supervisors. In December 2013, the FSC began mandating audit committees for public financial institutions and listed companies with paid-in capital of NT$10bn, with implementation over 2015 to 2017 once their board/supervisor terms had ended. A second phase implementation covering listed companies with paid-in capital of NT$2bn will take place over 2017 to 2019.

Most TWSE companies now have INEDs and a third have audit committees

The data tells the story:

- 87% of the 875+ firms listed on the TWSE now have INEDs, with an average per company of less than two
- More than 90% of the 44 largest firms (top 5% by number) have INEDs
- Only 35% of all TWSE listed firms have audit committees
- Almost 85% of the 44 largest firms have audit committees

Board independence still has some way to go

It would be fair to say, therefore, that while the adoption of INEDs and audit committees has been quite rapid, the overall level of independence on boards remains low and the penetration of audit committees is limited - except for the larger firms. It is interesting to see which large caps still do not have audit committees: Hon Hai is one, while China Steel formed its audit committee only in June 2016.

Investors want to know whether INEDs and audit committees are doing their job

Of equal, if not more, interest to investors is how well these new independent directors and audit committees are functioning. Do they understand their roles? Are they adding real value and an independent perspective to board decision-making? While there is no general data to draw on yet, the TWSE says it will conduct a survey on the level of professionalism among INEDs. It is well aware of the need to focus on improving director quality and has been running an active programme of director and company education in recent years, often in collaboration with non-profit organisations such as the Taiwan Corporate Governance Association, Securities and Futures Institute, and BCSD Taiwan, as well as the Big-Four accounting firms.

TWSE is updating its CG code to enhance board independence

The exchange is also working on updating its *Corporate Governance Best Practice Principles,* which apply to listed companies on a comply-or-explain basis. In addition to a new chapter on engagement with shareholders, and enhancements to the section on shareholder protection, the new version of the principles will place more emphasis on board independence and functions. For example, it will recommend that companies appoint a company secretary or someone exclusively responsible for CG affairs, ensure at least one independent director attends shareholder meetings, and will suggest limits on the number of executive directors on boards (not more than one third). The revised principles were submitted to the FSC for approval in June 2016.

Electronic voting sizzles

Taiwan one of only five markets in Asia with an e-voting system

A further area of considerable progress has been electronic voting (e-voting), which refers to the ability of retail and institutional investors to cast votes for a shareholder meeting from their personal computers, and for these votes to be passed quickly and almost directly to a company. In markets without e-voting, votes cast suffer extended delays as they are shuffled along the traditional and inefficient proxy agent-vote tabulator-custodian bank voting chain, with the end result being that shareholders in these markets are under great pressure to vote much earlier. In Asia, only China, India, Japan, Korea and Taiwan have e-voting systems - while Taiwan's is one of the more established and widely used (along with Japan and India).

E-voting has been mandatory for selected companies since 2012

The Taiwan Depository & Clearing Corporation (TDCC) created an e-voting system called StockVote in 2009 and it started becoming mandatory for listed companies to use in 2012. Since that year, when 82 issuers adopted the system, it has steadily been made mandatory for an ever-wider number of companies. Again the data tells the story. According to TDCC:

- The number of listed companies using StockVote has risen from 208 in 2014 to 605 in 2016. Of the latter, 475 were TWSE issuers. (Note: There are around 1,600 listed companies in Taiwan in total, with slightly more than half on the TWSE and the remainder on the smaller Taipei Exchange - formerly called GTSM.)
- The percentage of shares voted electronically at annual meetings increased from 36% of all votes cast in 2014 to 45% in 2016.
- While most of the 605 companies using e-voting in 2016 were mandated to do so, 114 chose it voluntarily. This is a massive increase on the 16 voluntary adopters in 2014.

Voting by poll has expanded alongside

The expansion of e-voting has contributed to a rapid growth in voting by poll, since StockVote automatically counts votes cast and this makes it easier for companies to undertake full polls at their AGMs. Official figures indicate that voting by poll is even more widespread than e-voting: 614 companies listed on the TWSE and 888 in total undertake it and most of them publish detailed results quickly. This represents a dramatic change from five years ago.

Wait, there is more . . .

Taiwan at last adopts director nomination, English on rise, and AGMs being declustered

There is not space to describe in detail all the recent developments in CG rules and practices in Taiwan, so we will briefly highlight three more:

- Adoption of the **director nomination system**, which is designed to create a structured and transparent system for nominating directors to boards (something previously lacking). Interestingly, while a proposed company law amendment has yet to pass, almost half of all TWSE-listed companies have introduced such a system.
- **Use of English** in AGM notices, meeting handbooks, and annual reports has grown rapidly from a low base. In 2014, only around 70-80 companies produced English-language materials. Today, these numbers have doubled or tripled.
- **Annual general meetings:** In addition to voting by poll, most TWSE companies are releasing their final agendas and handbooks at least 28 days before meetings, and about 10% have moved the date of their AGMs from the peak month of June to May. (Note: Taiwan imposes a cap on the number of meetings that can be held each day and reduced this from 200 to 100 in January 2015.)

It is still early days

Much CG reform is still at a nascent stage

Despite the many genuine areas of progress in CG rules and practices in Taiwan, there are inevitably areas of weakness. Some are described or implied above, including the fact that much reform is still in its infancy and will take time to become established. When responding to the new Stewardship Principles, for example, many domestic investors told the TWSE that they did not understand the comply-or-explain concept. They also asked the exchange for sample policy documents, which it rightly refused to do (though it has provided a sample statement for endorsing the principles).

Template disclosure creates boilerplate

The issue of disclosure templates developed by regulators is a difficult one. On the one hand, the regulator wants to provide guidance to companies and a degree of consistency in the information provided to the market. On the other, this approach results in company reports all reading the same and, in some areas, too much boilerplate.

Audit committee reports contain little meaningful information

We reviewed the nonfinancial reporting of a select sample of 25 large and small caps and found a depressing degree of formulaic and legalistic statements on such things as board committees. For example, the terms of reference and attendance statistics for audit committee meetings were presented, but little substantive description as to what the committee had discussed or achieved during the year. Yet many audit committee reports contain empty legalese such as the following:

> *With respect to the execution of cases in which the Independent Directors abstain themselves on the ground of conflict of interest, the name of the Independent Directors, contents of motion, reasons for abstention and participation in voting should be clearly stated*

Since most companies have nothing to report, they simply write: 'None'. This strikes us an unproductive exercise. Would it not be better for companies to simply state they have no conflicts of interest to report and use the space for more informative text?

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Launch of TWSE Corporate Governance 100 Index

TWSE Corporate Governance 100 Index has outperformed TWSE Index

Since Taiwan Stock Exchange's (TWSE) launch of the 'TWSE Corporate Governance 100 Index' on 29 June 2015, the index return since inception has outperformed TWSE index by 3.81% as of 23 August 2016, reflecting the stronger financial and/or operational performances by and investor preferences for the TWSE-listed companies with solid CG.

Adjustments of 26 constituents effective on 20 July

The TWSE just announced the adjustments of 26 constituents of the TWSE CG 100 index after reviewing the liquidity, CG review and three financial indicators (book value per share not lower than par value, net profit after tax ranking and growth rate ranking), as well as screening based on non-quantitative indicators. The adjusted index took effect on 20 July 2016.

Index aims to attract more investment into companies with good CG

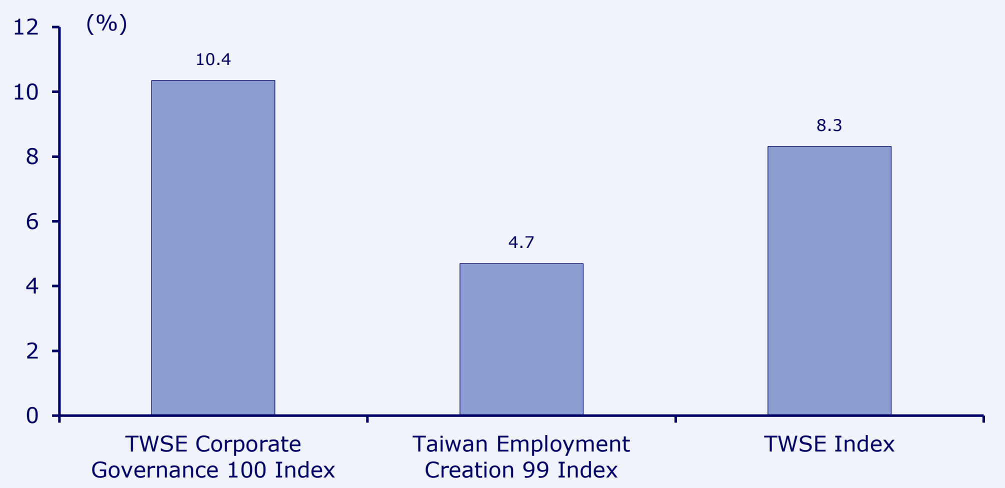
The main objective of the index is to licence its use to major fund-management institutions and investment-trust companies either as an investment benchmark or for issuing index-based passive investment products to attract more investment into companies with good CG, which in turns attract more enterprises to focus on this issue.

Taiwan will launch first CG ETF in near term

Taiwan Index Plus Corporation just signed the authorisation contract with Fubon Investment Trust Company to use TWSE CG 100 Index for planning the issuance of the first Taiwan CG ETF. In addition to TWSE CG100 index, TWSE has also issued Employment 99 index and high-pay 100 index to induce investors' awareness of socially responsible investment (SRI).

TWSE CG 100 Index enjoys highest return among three indices

Index performance of TWSE CG 100, employment 99 vs TWSE index YTD



Source: Bloomberg

Listed stocks added to/delete in TWSE CG 100 index effective in 20 July 2016

Add		Delete	
Code	**Company**	**Code**	**Company**
2204 TT	China Motor	1605 TT	Walsin Lihwa
2207 TT	Hotai	1711 TT	Everlight Chemical
2227 TT	Yulon	1717 TT	Eternal Materials
2311 TT	ASE	2023 TT	Yieh Phui
2354 TT	Foxconn	2104 TT	China Synthetic Rubber
2395 TT	Advantech	2312 TT	Kinpo
2408 TT	Nanya Technology	2402 TT	Ichia
2454 TT	MediaTek	2439 TT	Merry
2610 TT	China Airlines	2451 TT	Transcend
2618 TT	Eva Airways	2480 TT	Stark
2634 TT	Aerospace	2492 TT	Walsin
2801 TT	Chang Hwa Commercial Bank	2603 TT	Evergreen Marine
2812 TT	Taichung Commercial Bank	2606 TT	U-Ming Marine
2820 TT	China Bills Finance	2609 TT	Yang Ming Marine
2823 TT	China Life Insurance	2855 TT	President Securities
2832 TT	Taiwan Fire & Marine Insurance	3036 TT	WT Microelectronics
2838 TT	Union Bank Of Taiwan	3450 TT	Elite Advanced Laser
2845 TT	Far Eastern International Bank	3576 TT	Neo Solar Power
3017 TT	Asia Vital	3704 TT	Unizyx
3023 TT	Sinbon	4994 TT	X-Legend
3231 TT	Wistron	5007 TT	San Shing Fastech
3665 TT	Bizlink	5243 TT	Eson Precision
4733 TT	Swancor	8021 TT	Topoint
4927 TT	Apex	8046 TT	Nan Ya Printed Circuit Board
6176 TT	Radiant	9907 TT	Ton Yi Industrial
9921 TT	Giant	9910 TT	Feng Tay

Source: TWSE

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New York DFS fined Mega Bank for violating anti-money laundering law

A 21-page consent order to require Mega Bank to correct compliance controls

It was considered as serious and persistent in the compliance controls for Mega Bank

DFS fines Mega Bank New York Branch US$180m

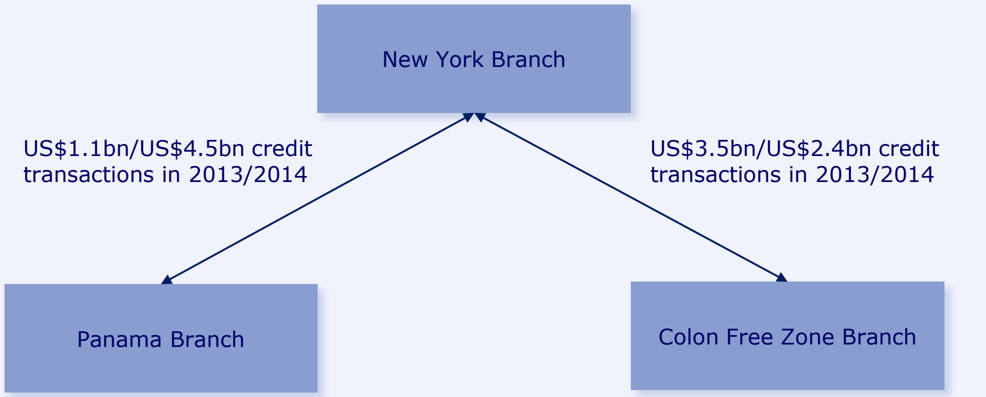
The New York Branch of Mega International Commercial Bank of Taiwan under Mega Financial Holding Company (2886 TT) was fined by the New York Department of Financial Services (DFS) US$180m (or NT$5.7bn) for violating anti-money laundering law on 18 August, 2016. The bank's New York branch is the largest overseas banking unit (OBU) with the longest history in Taiwan's financial industry per local media. DFS assigned a legal compliance consultant within 10 days to supervise the branch. The fine and the consulting fee charge by DFS could result in up to 20% profit contraction for Mega.

DFS issued a 21-page consent order that requires the bank to establish effective compliance controls and to retain independent monitor for two years. DFS found six major issues with the Bank's New York Branch: poor internal controls, including the chief compliance officer had conflicts of interests as she had other operational and business responsibilities; suspicious money transfer with the bank's Panama branches that might involve money laundering; deficient customer due diligence; unclear risk control policy; quarterly audit reports were not submitted to headquarters according to internal policy; and ignorance of the financial audit reports.

The compliance failures found by DFS are considered 'serious and persistent' which reflects the bank's lack of emphasis on building a vigorous compliance infrastructure. Pursuant to the consent order, Mega Bank shall take immediate steps to correct the violations and the serious deficiencies in the bank's compliance programme, as well as the implementation of the anti-money laundering controls.

Mega Bank's credit transactions between New York and Panama branches

Mega's transactions recognised as violating anti-money laundering law



Source: CLSA, New York Department of Financial Service

Enforcement

Score rises from 47% in 2014 to 54% in 2016

Taiwan's performance has continued to improve in this category, although this time it is as much the product of enhanced efforts by institutional investors in share voting and company engagement as more robust regulatory enforcement.

Higher scores for shareholder voting and meeting attendance

We have given slightly higher scores on whether institutions vote their shares, vote against resolutions with which they disagree and attend AGMs. Here we are looking at both domestic and foreign institutions, with the evidence of the past two years suggesting a noticeable uptick in the interest level of domestic pension and investment funds in AGMs and the governance of investee companies generally - and not just because of the new Stewardship Principles. There has also been some ongoing engagement by foreign investors.

Domestic pension and investment funds take a higher profile

Two of the leading domestic state funds in this area include the Bureau of Labor Funds and Chunghwa Post, while Cathay Securities Investment Trust is a local asset manager taking a stronger interest in CG issues. Among the foreign funds and affiliates, those devoting most time to Taiwan include the likes of Hermes EOS, Baillie Gifford and USS of the UK, and PGGM of the Netherlands. It is a small but dedicated group and likely to grow, especially on the domestic side. The new Stewardship Principles have 14 signatories to date and we understand this could rise by another six to 10 in the coming months. SITCA, the Securities Investment Trust & Consulting Association, hopes that at least half of its 38 members will sign and has been arranging discussion meetings on the code.

Insider trading has been in the spotlight

In terms of regulatory enforcement and state prosecutions, it has been an eventful and colourful couple of years. In January 2015, the government lost an important insider-trading case against Frank Huang of Powerchip. At the end of the same year, it won a big victory against Ko Wen-chang of WK Technology Fund in the Green Point case. Ko was sentenced to nine years in prison and fined NT$100m for taking advantage of material nonpublic information relating to a merger between Green Point and a company called Jabil Circuit in 2006. However, the fact that both cases took a decade to resolve indicates the delayed nature of such investigations and prosecutions in Taiwan.

Rebar Group and Wang family back in the spotlight

The past two years have brought several other high-profile prosecution successes against company directors and officials - albeit after long delays. For example:

- In February 2015, the Taipei District Court found 21 parties involved in the huge Rebar Group embezzlement liable for almost NT$50m (about US$1.6m) in compensation. The case dates back to 1998, when the founding Wang family set up the embezzlement scheme and began funnelling billions into their own pockets. This particular court action was brought in 2007 by the Securities and Futures Investor Protection Center (SFIPC), a government entity that holds shares in all listed companies and can take legal action on behalf of investors.

Farglory chairman suffers humiliation . . .

- In March 2015, Chao Teng-hsiung, chairman of Farglory Land Development, was sentenced by the Taipei District Court to four and a half years in prison on corruption charges; and in the same case, Yeh Shih-wen, former deputy commissioner of Taoyuan County, was sentenced to 19 years in prison and fined just over NT$33m (US$1m) for taking bribes worth NT$20m from Farglory.

. . . then is handed a get-out-of-jail card

Such cases typically go to appeal, with punishments sometimes reduced. This happened controversially in the Farglory case in December 2015, when the Taiwan High Court reduced Chao Teng-hsiung's 4.5-year prison term to just two years and then suspended it for five years. He was also fined NT$200m (about US$6m). Many viewed the outcome as a corruption of justice, especially since the official who received the bribes, Yeh Shih-wen, was still sentenced to a long prison term.

FSC gets worried about misleading disclosure

In an interesting enforcement action in mid-2015, the financial regulator took aim at misleading disclosure. In June of that year, the FSC said it would launch an investigation into HTC, the smartphone maker, for possibly misleading the market when it sharply cut its sales forecast just days after its AGM earlier the same month. The company announced a potential loss of NT$8bn (US$259M) a mere three days after its 2 June annual meeting.

Executives prosecuted for tainted oil scandal

More recent court news has included prosecutions flowing from the 2014 tainted oil scandal. Highlights include:

- Executives from suppliers involved in the Ting Hsin tainted oil scandal were found guilty by the Kaohsiung District Court on 26 February and sentenced to prison terms between four months to five years. Fines ranged from NT$4.5m to NT$6m.
- Executives from Cheng I Food and Yu Fa Olein were found guilty of negligence and violating the Act Governing Food Safety and Sanitation for falsifying information about the origin of their materials and selling animal feed oil for processing into cooking oil products for human consumption.

But court finds insufficient evidence against company at centre of the scandal

However, the public remained outraged because executives from the company at the centre of the oil scandal, Ting Hsin International, received not guilty verdicts from the Changhua District Court in November 2015. The ruling said the prosecution had not provided sufficient evidence to back up the claim that the animal feed oil imported from Vietnam was unhealthy.

Insider trading back in the news with the OBI Pharma case, which snares leading academic

March 2016 brought news that one of Taiwan's leading academics, Wong Chi-huey, president of Academia Sinica, had become embroiled in an insider trading probe at OBI Pharma, a biotechnology firm founded by Wong and his associates in 2002. On 21 February 2016, the company announced the results of a cancer drug trial that yielded 'not significant' results, sending OBI share prices into a downward spiral. At the time, Wong reaffirmed his confidence in the company and its prospects. But it was later revealed that on 18 February he had sold 10,000 shares on behalf of his daughter.

In a parallel investigation, OBI Pharma chairman, Michael Chang, was interrogated on suspicion of helping a major shareholder, Alpha Corporate Holdings, a BVI company, sell its shares before results were announced and not reporting the trade. On 20 May, the TWSE fined OBI Pharma NT$1m (US$30,500) for failing to publish information about shareholding changes by major shareholders, including Alpha, in its 2013 and 2014 annual reports.

Prosecutors raid CTBC on suspicion of insider trading, profiteering and illegal fund transfers

Then in June, following a tip-off from a whistleblower to the FSC, a judicial probe was opened into CTBC Financial involving alleged insider trading, profiteering on real-estate transactions, and illegal transfers of company funds. The Special Investigation Division under the Supreme Prosecutors Office raided 58 offices and homes on 8 June and summoned 94 people for questioning. It alleged that CTBC Financial (formerly known as Chinatrust) illegally transferred US$300m into accounts controlled by Jeffrey Koo, Jr, a major shareholder and the *de facto* leader of the company. Prosecutors believe CTBC Financial may have established a shell company to partner with a construction firm to buy a site for an office building, and then sold it to its subsidiary CTBC Bank at a significant markup, with those involved pocketing the difference. Koo has called the allegations a 'misunderstanding'. He is appealing a nine-year prison term handed down in 2010 for illegal transactions involving Red Fire Developments.

Criminal Code amendments finally allow for confiscation of assets illicitly obtained

Meanwhile, an important new law took effect on 1 July 2016 that will free the judicial system from antiquated laws that have long hampered efforts to confiscate assets illicitly obtained through financial crime. Previously, Taiwan law required a conviction before such assets could be seized. Amendments to Article 38 of the Criminal Code now allow for third-party confiscation and independent confiscation orders.

Taiwan previously relied on outdated Qing Dynasty law to recover stolen assets

Before these changes, Taiwan used Qing Dynasty legislation from 1905 that stated assets obtained from a crime could only be confiscated as a form of punishment. This required a guilty verdict before ill-gotten booty could be seized. To avoid seizure, criminals simply transferred the assets to a third party, often a shell company, which could not be convicted of the crime, hence the assets could not be recovered. Furthermore, it was not possible to issue an independent confiscation order when a suspect could not be found. If a suspect disappeared, illicitly obtained assets could not be recovered, even if they were known to be in Taiwan, let alone if they had been spirited abroad. The new law addresses these issues and allows for third-person confiscation and independent confiscation orders. Legal reformers are calling for amendments on detention (to prevent defendants from absconding) and money laundering (to prevent criminals from hiding their proceeds).

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Solar Applied Material Technology delisted for accounting fraud

Solar Applied Material provided fraudulent accounting records since 2011

Solar Applied Material, which specialises in IGZO sputtering target for TFT-LCD, specialty chemical and resource recycling, was delisted on 17 May 2016 after it was found providing fraudulent accounting records since 2011 with deferred cumulative losses of NT$1.7bn. Earlier in March 2016, the company reported 450kg of stolen gold by a departed staff member, which led to NT$510m in losses. Prior to that, Solar Applied Material also reported NT$610m LCM inventory losses. The total cumulative losses by the company could be up to NT$2.8bn. The company chairman, CFO and board supervisor turned themselves in to Ministry of Justice for further legal investigation.

Cover up to NT$1.7bn of cumulative losses

Solar Applied Material was a major supplier of sputtering target to the major TFT-LCD panel makers - Sharp, AUO, Sony and Innolux. Due to poor operational management, delays in new product development, losses from precious metal trades for nonhedge purposes, the company had used fraudulent accounting since 2011 to cover up NT$1.7bn of cumulative losses. In addition, the company's insufficient internal control had allowed its gold trader to obtain 450kg of gold from the company's account for personal disposal.

Solar Applied Material remains under investigation for accounting fraud, improper internal controls and avoidance of Taipei Exchange's (OTC) audit.

Solar Applied Material stock delisted on 17 May 2016

Timeline of Solar Applied Material's accounting fraud

Date	Event
Dec 15	Recognised NT$610m LCM inventory losses
3/31/2016	450kg of stolen gold by a departed staff which led to NT$510m losses
5/12/2016	Two independent directors resigned
5/13/2016	The company's chairman, CFO and board supervisor turned themselves in to Ministry of Justice on providing fraudulent accounting records since 2011 with deferred cumulative losses of NT$1.7bn.
5/17/2016	Solar Applied Material was delisted from Taiwan stock market

Source: CAST, MOPS

Political and regulatory environment

Score rises slightly from 63% in 2014 to 64% in 2016

Taiwan's adoption in December 2013 of a five-year *Corporate Governance Roadmap* has certainly provided clear direction to regulators and the exchange for the setting of policy priorities and objectives. In January of this year, the FSC reiterated support for the *Roadmap* and announced that this year would see the adoption of a stewardship code for investors and amendments to both the CG and CSR best-practice principles from the TWSE, among other things.

Scores dropped on government policy and stock exchange company database

While the overall score for this section has remained largely the same, we have altered scores on a few questions. Downgrades include:

- 'Whether the government has a clear, consistent and credible policy on corporate governance' (C.1): Despite our positive statement above about the *Roadmap,* we have dropped this score slightly because of some uncertainties resulting from the change in government from the KMT to DPP in May 2016, such as current discussions on amending the company law to allow employee representation on boards. Given that board governance is still evolving in Taiwan and most boards lack diversity and a truly independent element, it seems premature to start reserving seats for favoured stakeholders (despite the fact that this model may work reasonably well in other countries). This seems certain to create conflict around board composition, which in turn could impede progress being made on CG generally by companies.

- ‘Does the exchange provide an efficient and extensive database of issuer announcements, reports going back 10 years and in English’ (C.9): A slight downgrade, because while the Market Observation Post System (MOPS) works reasonably well and goes back more than 10 years for some companies, the limited amount of English-language material means it is considerably less useful than the best databases in the region.

Low public trust in the judiciary and prosecutors finally out in the open - and being discussed

An issue that has both positive and negative overtones for public-sector governance in Taiwan is the recent airing of concerns about low levels of public trust in the judiciary and recent cases of corruption among public prosecutors. Rightly or wrongly, there is a perception that the judiciary is not entirely clean and the courts favour the powerful, as in the Farglory case. There have also been some high-profile cases against prosecutors on the grounds of corruption. In one recent case, a former Tainan prosecutor, Sung Tsung-yi, was sentenced to 20 years in prison for bribery and corruption. In general, our view is that sunlight is a good disinfectant and such cases should be out in the open.

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Public opposition on SPIL’s sale to Tsinghua Unigroup

SPIL sought Tsinghua Unigroup to fend off ASE’s hostile takeover

On 11 December 2015, SPIL announced it would sell 1.033bn new shares to Tsinghua Unigroup at NT$55 per share for a 25% stake in SPIL in a bid to fend off a takeover bid by ASE. In response, ASE offered to acquire 100% of SPIL’s existing stake at NT$55/share in cash, matching Tsinghua’s bid and required SPIL to terminate/cancel the Tsinghua Unigroup deal and other transactions that would dilute SPIL’s shares at the expense of shareholders.

Public opposition aroused on the sale of Taiwanese company to mainland

Public opposition on SPIL’s sale to Tsinghua Unigroup rose as it is a sensitive issue to sell a substantial stake to a mainland Chinese company like Tsinghua, which would thus become the largest shareholder of the Taiwanese company. Particularly, Tsinghua has been aggressive in trying to buy into Taiwanese semiconductor companies, which are categorised as a nationally important industry as it is highly related to national defence. Two leading candidates for president of Taiwan at the time voiced opposition to the deal.

SPIL ended Tsinghua Unigroup’s agreement and merged with ASE

After considering the subjective and objective factors of the company and Tsinghua, SPIL ended the agreements regarding share subscription and strategic alliance with Tsinghua on 28 April 2016. After a series of private discussions with ASE’s management, SPIL and ASE jointly announced the signing of letter-of-intent (LOI) to form a holding company that separately owns ASE and SPIL as sibling companies. Ultimately, both company’s board of directors approved to form a holding company, named ASE Investment Holding on 1 July 2016, and the completion of the deal is currently subject to the approval from overseas antitrust regulatory authorities.

A dramatic turn in SPIL's merger development

Timeline of the sale of SPIL

Date	Event
8/21/2015	ASE announced to tender 25% of SPIL shares at NT$45 per share
8/28/2015	SPIL and Hon Hai announced a share swap to fend off ASE's hostile takeover
10/15/2015	SPIL failed to solicit its shareholder's approval on share swap with Hon Hai
12/11/2015	SPIL entered an agreement to sell 25% stake to Tsinghua Unigroup
12/22/2015	ASE announced second tender offer on SPIL to up its stake to 49.7%
3/23/2016	Fair Trade Commission terminated the review on ASE's second tender on SPIL
4/28/2016	SPIL announced to cancel the agreement of Tsinghua Unigroup's private placement
5/30/2016	ASE and SPIL signed LOI to form a holding company that separately owns ASE and SPIL
7/1/2016	ASE and SPIL's board of directors both approved to form a holding company, named ASE Investment Holding

Source: CAST

Scores upgraded for informative regulatory websites and media reporting

Meanwhile, we have upgraded scores as to 'whether regulators provide informative websites with all key regulatory documents easily available' (we note improvement in the TWSE's website in particular) and 'whether the media are sufficiently free and skilled at reporting on CG' (we believe the scope and quality of reporting is on the rise, though the latter still shows room for improvement).

Accounting and auditing

Score rises slightly from 75% in 2014 to 77% in 2016

We do not see any significant change in this category from two years ago. The primary reason for the upward adjustment in score is to correct a mistake we made in *CG Watch 2014* with regard to the FSC's work as an independent audit regulator. We had said that the FSC did not produce a separate report on its inspections of CPA firms and audit engagements, unlike its counterparts in Japan, Malaysia, Singapore and Thailand. This was incorrect: the regulator has published a document called the 'General Inspection Report' on an annual basis since 2009.

CPA firm inspections follow international practice

The latest report covers 2015 and was published in April 2016. It provides some useful statistics on the shape and size of the CPA industry, which not surprisingly is dominated by the Big Four but also comprises a large number of mid-tier and smaller firms (note: single-person CPA firms cannot do public company audits in Taiwan). The report also summarises key inspection objectives, which are similar to those in other markets: reviewing the quality control systems of firms (leadership, independence, client acceptance, HR capabilities, engagement performance and monitoring), and reviewing individual audit engagements selected on a risk-based approach and considering public interest and materiality.

Deficiencies found, as in other markets, in both firm-level systems and audit engagement quality

In terms of scope, the FSC inspected four CPA firms in 2015 and found the following deficiencies at one or other of the firms:

- **Firm quality-control systems**: Failure to establish proper performance-evaluation criteria for personnel; only requiring the firm's partners, not all its auditors, to sign a declaration of impartiality and independence; failure to establish policies and procedures to ensure staff or auditors' independence; poor practices on client acceptance; lack of policies and procedures for monitoring staff workload; failure to conduct engagement quality-control reviews in a timely manner; and so on.

- **Individual audit engagements**: Working papers that lacked some key audit procedures relating to confirmation, materiality, large cash inflows and outflows, asset impairment, and communication with other auditors where this was necessary; failure to execute the audit plan; failure to understand the entity sufficiently and thereby be able to identify risks of material misstatement in the accounts; and so on.

Indeed, what is striking about the FSC's report is how similar it is to reports from counterpart bodies around the region.

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Phison is accused of falsifying its financial statement

On 5 August 2016, Phison Electronics was accused of false transactions to show billions in profit through its three overseas subsidiaries. Prosecutors suspect that chairman KS Pua and other managers manipulated the company's financial statements by selling parent company's products to its subsidiaries and then showing false transactions to inflate company revenue. The company was also accused of failing to disclose material information in Phison's financial statements that would potentially constitute an infringement of shareholder interests and violate the Securities Exchange Act.

Phison is accused of manipulating financial statements through its three subsidiaries

In fact, transacting memory components within subsidiaries and related companies is common for memory suppliers to manage inventory to these 'hub' companies. Memory is commodity so supply/demand dynamics change dramatically and impact the pricing accordingly. When memory prices turn weak, memory suppliers buy more to build inventory and sell for profit when the price soars. Many memory module and IC suppliers have these hubs subsidiaries for inventory management. With this, some of the large unlisted memory module houses may thus stay private to avoid any potential accusation or legal action from the regulator to better manage inventories.

Intercompany transaction is a common way to manage inventory for memory suppliers

We would think Phison's key issue may fall on the insufficient disclosure of all the transaction between parent and subsidiaries, rather than it making up a false financial statement. In this case, there would be no punishment or fine posted on Phison. However, if it turned out to be that the company engages in the making of false statements in the context of financial report and/or accounting fraud, both the company and the chairman and other manager would be facing an administrative fine and criminal sanctions as regulated by the Security Act.

We think Phison's key issue may fall on insufficient disclosure of intercompany transaction

Figure 87

Laws on false statement and insufficient disclosure of intercompany transactions

Event	Related punishment/fines
False statements	1) Administrative fine: According to Security Act Article 14, if the financial report contains misrepresentations or nondisclosures, the chairman, managerial officers and accounting officers shall be punished with a an administrative fine of NT$0.24-2.4m (Security Act, Article 178) 2) Criminal sanctions: According to Security Act Article 174, if the company makes false statements in the context of a financial report, the chairman, managerial officers and accounting officers shall be punished with imprisonment for 1-7 years and in addition thereto a fine of no more than NT$20m may be imposed.
Insufficient disclosure of intercompany transactions	1) No punishment/fines would be posed. 2) Require restatement of financial statement to sufficiently disclose of intercompany transactions

Source: CLST

CG culture

Score rises from 47% in 2014 to 50% in 2016

As the first section of our survey showed, there have been numerous changes in the governance practices of listed companies in Taiwan in recent years. More firms have independent directors and audit committees. There is much greater use of English in company reports and announcements. Better management of AGMs, the adoption of electronic and poll voting, earlier release of detailed agendas. A huge boost in the volume of sustainability reporting. The list can go on.

Positive data points need to looked at from both sides

However, for a more balanced picture of CG in Taiwan, it is worth turning the data on board governance at TWSE-listed companies on its head:

- 65% do not have audit committees.
- 15% of the 44 largest firms do not have audit committees.
- 30% do not vote by poll.

Taking statistics on English-language material among TWSE firms, the picture is even more stark:

- 70% do not file English meeting notices.
- 79% do not file English meeting handbooks.
- 84% do not file English annual reports.

Average quality of CG improvement among big companies may be of little interest to some investors

This perspective helps to give a sense of the challenges ahead and some of the priority areas to focus on (depending on the size and nature of each issuer of course). It also explains why, despite all the positive efforts made in recent years, there is a high likelihood that the specific experience of any individual foreign institutional investor in the Taiwan market is just as likely to be negative as positive. It is cold comfort that the use of English has expanded rapidly if the companies you are following do not translate their reports. Indeed, as one European investor said to us recently, the low level of English reporting by Taiwan mid-caps had directly affected the appetite of certain foreign funds to invest - especially as other markets in the region, such as China, offer a more compelling story. Equally, it is commendable that e-voting and voting by poll have made such impressive strides, but this means little to an investor who has tried and failed to do cumulative voting online in Taiwan (the system currently does not cater for it).

Top-down regulation still the main driver of reform

It is also worth emphasising that the majority of the CG reforms seen to date have been brought about by top-down regulatory action. This is appropriate and necessary given the relatively early stage of CG development in Taiwan. Indeed, without the TWSE taking the lead on assessing companies through its 'CG Evaluation System', introduced in 2014, much of the data we have today would not exist. And without the TWSE taking a lead on CG education through its numerous conferences, seminars, training courses and so on, much of this would not be happening either. We hope the funding for these efforts continue. Over the longer term, we also hope that the stewardship code inspires domestic institutional investors to expand their efforts and demand higher standards of governance from companies.

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Bribery whistleblowing at Formosa Plastics

On 27 July 2016, Formosa Plastics Group (FPG), a top Taiwan manufacturing conglomerate, announced that one of its chief executives had resigned over a multiyear bribery scheme involving a supplier. In what the local media described as the biggest bribery scandal in the firm's 61-year history, 25 employees are suspected of accepting payments from an exclusive plastic-bag supplier. Lin Chen-jung, president and a board director of Formosa Plastics Corp (FPC), the group's core company, had been in the position less than two weeks when the news broke, which triggered his resignation. While there is no word on whether Lin has admitted guilt, some of the accused employees have done so.

FPG erupted multi-year bribery scandal

The scandal came to light because an anonymous letter from a whistleblower called on management to launch an inquiry into the kickback scheme that allegedly began seven years ago. After the scandal broke, FPG revealed that it had been using a strict and transparent procurement system, which some observers say is the reason why the supplier had to resort to bribing employees. FPG said it will now add more layers of fraud-prevention mechanisms, including a new audit team to monitor the terms of exclusive, emergent and designated purchases. Also, a random computer assignment process will be used for future procurement projects. FPC is implementing disciplinary action on those involved, according to company rules, labour contracts and regulations. Meanwhile, the justice ministry's Bureau of Investigation is investigating the case, and the Taipei District Prosecutors' Office reportedly has also launched an investigation.

FPC's key issue may be insufficient fraud-prevention mechanisms and the lack of discipline. If the company has engaged in a bribery scheme, the company, chairman and managers will face an administrative fine and criminal sanctions as regulated by the Securities Act.

FPG's violations of CG/CSG has been hitting the headlines

Recent company specific issues in Formosa Plastics

Date	Event
Jun 15	An anonymous letter from a whistleblower called on management to launch an inquiry into the kickback scheme related to bribery
Jul 15	Lin Chen-jung, the former president and a board director of Formosa Plastics Corp (FPC), has resigned over a multi-year bribery scheme involving a supplier
Apr 16	Ha Tinh Steel- Formosa Plastics' steel mill in Vietnam killed a lot of marine life due to toxic emissions
May 16	The General Department of Taxation asked Hung Nghiep Formosa Ha Tinh to pay VND255bn (USD11.6m) in back taxes.
Jul 16	Formosa Plastics officially admits guilt for mass killing of fish in Vietnam

Source: CLSA

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- ❑ Any delays in the implementation of new audit committees
- ❑ CG and sustainability reporting that continues to be formulaic
- ❑ Any loss of interest among domestic investors in new stewardship code
- ❑ Confusion and/or conflict created by the DPP's idea for mandatory employee representation on boards
- ❑ A slowdown in the progress towards stronger enforcement

Quick fixes

What to fix

- Improved company reporting around board committees and remuneration
- Removal of empty legalistic language in company annual reports (reports should be written in a company's own words)
- Expansion of English-language reports and announcements
- Extension of voting by poll to all listed companies
- A commitment to review the new stewardship code in two years
- Ensure investors can vote cumulatively online if they wish to do so

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Thailand - On the verge?

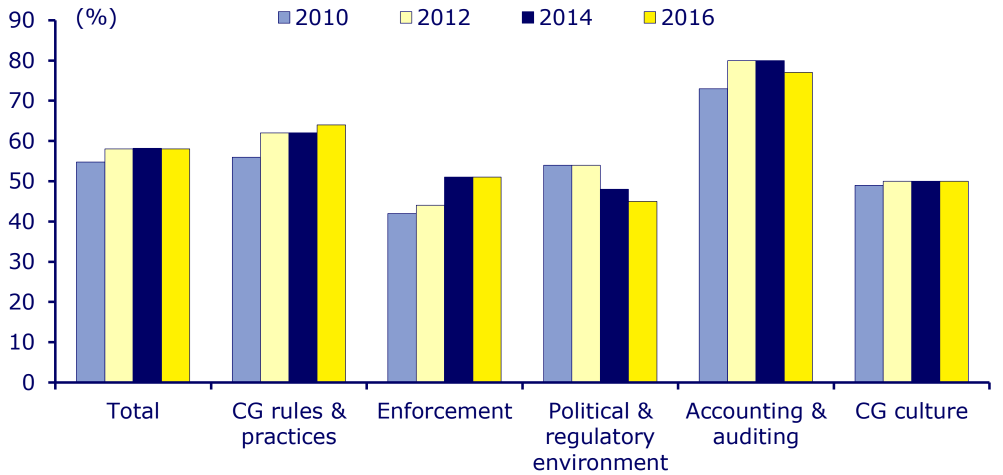
Key issues and trends

- Stepped up activity on enforcement cases
- SEC civil sanction powers draw nearer
- Investors become vocal on governance standards
- Long list of pending reforms
- Class-action law finally implemented
- SET governance structure changed
- Strong disclosure on risk factors, MD&A, large cap sustainability
- Gaps in remuneration disclosure, boilerplate committee reports

Overall score stays the same at 58%

Figure 88

Thailand CG macro category scores



Source: ACGA

Reforms just enough to maintain overall score

Thailand maintained a slow, but steady pace, in implementing CG standards and practices over the past two years, with a few notable bright spots. The legislative process resumed under the military government, which passed some important and long-pending reforms. High-profile insider trading cases in late 2015 and early 2016 galvanised domestic investors into taking public action and brought expressions of outrage from many in the business community. And the Securities and Exchange Commission (SEC), under fresh leadership, has a new lease on life.

Growing legislative protections, regulatory activity on codes

There were a number of legislative reforms including amendments to the anticorruption act and a new class-action law. Stronger private placement controls were brought in. There were also several proposed developments: the SEC is expecting to obtain civil sanctioning powers; there will be enhanced qualification requirements and accountability for CFOs; the public hearing for a revision to related-party rules is complete; a revised CG Code is in the works; a draft stewardship code is in consultation; and there is continued discussion of how to professionalise a number of wholly state-owned enterprises. However, we maintained our policy of not giving a score to proposals that are not yet adopted.

CP All insider trading case galvanises investors

A further brightspot was the SEC's willingness to tackle market misconduct at larger companies and the strong support this received from investors. This was triggered by a notable case at CP All, a bluechip that operates the 7-Eleven franchise in Thailand. It was unusual to see the directors at such a large company receive a sanction for insider trading - and it was the first time institutional investors had publicly expressed concern about directors continuing at a company after committing the offence.

Could Thailand be on the verge of a new era in CG?

If promised reforms eventuate, could Thailand be on the verge of a new era of CG and capital-market regulation? It is a tempting thought. Much is likely to depend on the overall political situation and whether a new system of accountable government can evolve in which corruption is under control. If this happens, the sky seems the limit. But Thailand could just as easily be held back, as it has in recent years, by the dead weight of old practices and vested interests.

CG rules and practices

Score increases from 62% in 2014 to 64% in 2016

The score for regulation and policy increased a small amount. There were incremental improvements in score on nonfinancial reporting practices (aside from remuneration, which we downgraded), on the improved protections for private placements, and for the long AGM notice periods that companies typically provide. But Thailand does not (yet) have a stewardship code - an issue for which we added a new question - and this held back the increase in score for this section slightly.

Decent financial reporting, but no upgrade

As regards financial reporting, generally financial statements are detailed, though we did note some examples of companies that had significant cost items with no breakdown. Companies have to produce reviewed statements within two months of the quarter end and all 25 companies we reviewed complied with this requirement. However, there are still significant concerns over corruption in Thailand, raising questions about whether and how companies are reporting internally. We also heard that there are concerns over the strength of audit committees - that questions asked are not always challenging and they do not always have clear positions on ethics and compliance. Further, there was a case in which PTT Global Chemical delayed informing investors for nearly a month about a significant unscheduled outage at one of its plants, highlighting issues around continuing disclosure practices. Consequently we left the score unchanged.

Risk factor disclosure a notable positive in Thailand

We took a more positive view of nonfinancial reporting at both large and small companies. The disclosure of risk factors is particularly detailed - arguably the best in the region - presenting company-specific risks and the steps taken to mitigate them, including relevant quantitative information in many cases. All of the large companies produced an MD&A for each quarter. The requirement for an MD&A only extends to interims, so we thought this was strong disclosure. Some of the smaller companies did not produce MD&As, or only summaries, after the first quarter. A few companies included details from their board evaluations, which usually presented a highly favourable picture of board performance! And there is often detailed disclosure on training.

Relatively detailed, but static reports from committees

Remuneration disclosure typically provides individual director fees, which is an important positive. However, it was not possible to understand the links between individual and company performance and pay for management for any of the companies. CG statements, audit committee reports, other committee reports, risk statements and internal controls are often detailed.

But these are usually boilerplate with reports that covered the terms of reference and mostly static information.

Decent large-cap ESG disclosure

For sustainability disclosure, which is required, there was a clear difference between the strong disclosure at the larger companies and the weak disclosure at the small companies. For large companies, 10 out of 15 provided detailed information, though these did not always tackle the most strategic issues in the depth of the best international practices. Only two out of 15 had minimal disclosure. The other three either did not have decent enough stats or missed out strategic policy areas. From the small companies, only two provided more than a basic policy. We upgraded the score for disclosure at large companies.

Public hearing underway for significant CG Code revision . . .

Thailand's existing CG Code follows the format of the OECD Principles, which starts with the rights of shareholders, moves on to stakeholders, transparency and disclosure, then closes with the responsibilities of the board. On 2 August 2016, the SEC announced a public hearing on a restructured code, which has been drafted to emphasise board responsibilities, in particular ethical leadership, strategies for sustainability, and board effectiveness. Ambitiously, it is calling the document an 'Integrated Governance Code' that looks at governance more practically, rather than from the point of view of a policymaker, and emphasises the role of the CEO and people management, innovation and responsible operation, as well as good risk management, disclosure and shareholder engagement. It will replace 'comply or explain' with 'apply or explain an alternative' - the same approach as being taken in Malaysia - to try to avoid creating a reactive, compliance mindset in companies. The Commission expects it will take several years to socialise the new code, which it hopes to complete by the end of 2016.

. . . and for a Thai stewardship code

The Investment Governance Code, also scheduled for an end-2016 launch, may have an easier passage. Although stewardship is not a familiar label for investor responsibilities in Thailand, many of the largest funds already have voting guidelines and the CP All case has driven home the point that investors need to take action where companies exhibit poor standards of behaviour. The principles proposed for the code also include a reference to sustainability and they encourage collective engagement (like Hong Kong, Malaysia and Taiwan, but unlike Japan).

Private placement rules upgraded

There were a number of other areas of rule change and public hearing. Significantly, the SEC upgraded disclosure requirements and approval processes for private placements. Essentially issuers have to apply to the SEC for approval where a placement is not at the market price. The SEC provided a list of factors that would trigger a rejection of the application.

CFO qualifications and accountability to rise

There were also rule changes in process, including improvements to financial reporting through the introduction of qualification requirements for CFO and accountants who prepare financial statements, and increasing the accountability of the CFO in signing them. Also there will be an upgrade to Stock Exchange of Thailand (SET) rules on related-party and material transactions. The SEC is reviewing the results of a public hearing on proposed rule changes, which will update technical requirements (size thresholds, definitions and handling of recurring RPTs) and increase the fiduciary duties of the board in providing a fair and reasonable opinion.

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CP ALL case raised widespread collaboration to adopt high CG standards

CP ALL share underperformed badly despite its superior business performance

CP ALL management insider trading

The insider-trading case concerning CP ALL's senior management raised awareness among institutional investors and led to pressure on the company to take action against such unethical practices. It also prompted the SEC to initiate decisive and speedier action in other cases, as well as to improve laws and code of conduct in coming years.

The news broke in early December 2015 that the SEC had fined three senior executives at CP ALL for insider trading, related to a transaction of Siam Makro shares, an entity that CPALL had acquired in April 2013.

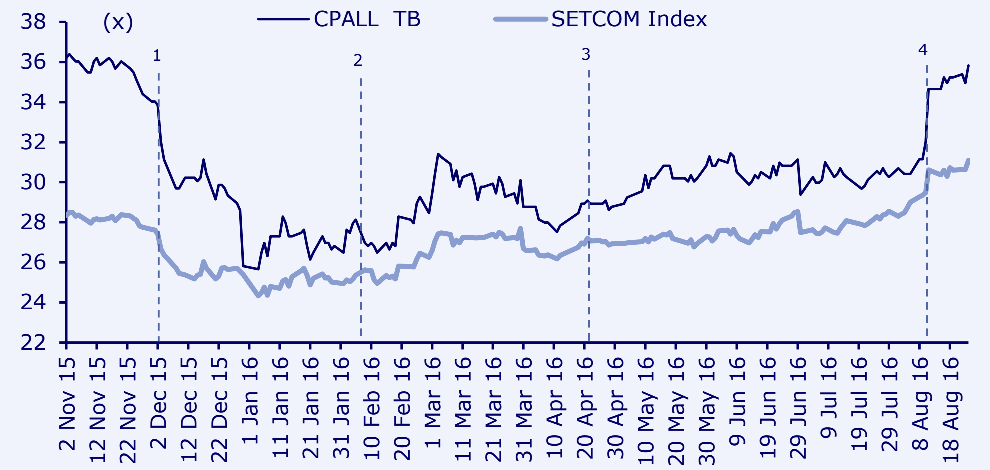
The incident prompted the local institutional-investor community to press CP ALL's board of directors to act against the three executives by selling/freezing their CP ALL investments. However, the board of directors supported the three executives, much to the angst of investors. While the independent directors were re-elected, there was a large numbers of votes against four out of five, resulting in a 31% disapproval rate to reflect their dissatisfaction.

CP ALL's board of directors decided to hire Ernst & Young to review and revise its CG standards and to implement an independent compliance unit. The chairman wrote an open letter apologising to investors regarding the matter, committing the firm to a higher CG standard and compliance. Later in August, all three senior executives decided not to take one-year salary.

The incident also prompted SEC to take harsher measures against pending regulatory breaches and to tighten relevant regulation and ethical codes of conduct relating to inside-information trading and directorship.

Timeline of CP ALL CG issue management

No.	Date	Event
1	2-Dec-15	Insider trading issue raised
2	5-Feb-16	Set up CG committee and appoint EY as a CG adviser
3	22-Apr-16	Local institution voted against renewing 4/5 independent directors
4	10-Aug-16	The company announced 3 executives would not take salary for 1 year



Source: CLSA, Bloomberg

Enforcement

Overall score unchanged at 51%

In recent months, there have been a number of high-profile cases of insider trading and market manipulation that started with the criminal settlement for insider trading at CP All announced on 2 December 2015. This was a clear indication of a more assertive stance from the regulator with larger companies and we upgraded the scores for regulatory effort and treating all companies fairly. We also upgraded for investors showing a greater willingness to vote against resolutions. However, we made tighter assessments in other areas, leaving the overall score for Enforcement unchanged.

Greater willingness to tackle issues at large companies

What makes the recent period interesting for enforcement is that the cases relate to senior executives in major companies and some of the richest families. In addition to the CP Group, companies include Bangkok Insurance, Siam Global House and WHA Corp. In each case a senior member of the company - chair or deputy chair - has had to make a criminal settlement. This process is one in which the offender agrees the offence and pays a fine, rather than going through a long court process.

CP All directors remained in position . . .

The CP All case was noteworthy as the individuals, including the deputy chairman, remained in their positions at the company, despite Thai laws on only trustworthy individuals being allowed to hold such positions. The reason was that while the SEC can ban directors from serving in such cases, its practice with regard to nonfinancial companies has been to settle on first offences and only ban for second offences. In the CP All case, the SEC followed its precedent, relying on social and market sanctions to discipline the company. Indeed, the real, long-term sanction in these cases is likely to be a social one. CP All's reputation is likely to be tarnished for a long time.

. . . leading to an investor outcry

Thai investors took a firm view, refusing to buy more shares and voting against directors standing for re-election at the CP All AGM in late April. The results were close. The four directors that retired and were re-elected by rotation received votes against of more than 30%, with some additional abstentions, even though they themselves were not guilty of any insider trading. In the case of Police General Phatacharavat the vote against was as high as 33.44%.

Regulatory powers still weak . . .

Ultimately the regulator does not yet have effective powers of investigation and sanction. Currently the SEC's options are limited to issuing a criminal settlement - in which the offender accepts the offence and pays a fine - or handing the case over to the Economic Crime Division of the Royal Thai Police or the Department of Special Investigation of the Ministry of Justice. These will then pass the case on to the Office of the Attorney General. Unfortunately, the criminal process is long and tortuous and it is hard to secure convictions - anecdotally, cases do not receive the skilled handling they need to result in convictions.

. . . with upgrades pending . . .

There is a bill working its way through the legislature to provide civil sanctioning powers to the SEC. The proposed upgrades include allowing the SEC to take offenders to court. They will also allow broader types of sanction, including prohibiting offenders from entering the market for up to five years and the power to recover investigation costs. The scope of application includes market misconduct, false statements in securities offerings, and breach of duty of care or loyalty, and includes a nominee whose trading or banking account was used.

. . . but custodial sentences still a long way off

These powers would present a significant upgrade. Nevertheless, even when the SEC is able to use them, the Thai regulators will still be at a disadvantage to some other markets. For example, in Malaysia, the courts are giving prison sentences for market misconduct cases, and these seem to be increasing.

Good regulatory statistics from the SEC

We left the score for regulatory statistics unchanged. The SEC produces very useful information including several years data on enforcement. There is typically useful information about cases for which it issues press releases, but this is not all of them. There is some information on inspections in the audit inspection reports, though limited information about enforcement. Enforcement statistics from the SET are hard to find and often not clear. Its regulatory statistics were only provided for six months in 2016.

Better use of resources to address enforcement backlog

We also downgraded the score for the question of whether there has been investment in human or technological resources in recent years. The SEC's headcount has declined, while there was no discussion of major investments in new IT systems. The SEC appears to be doing more with its current resources given that it is addressing a backlog of cases.

Investor contribution at AGMs typically lacking

Finally, we downgraded the score for institutional investor contribution at AGMs, which is an important area of market enforcement. Notwithstanding the events at CP All, institutional investors typically do not ask questions at AGMs.

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Steel tycoon accused of falsifying accounts of GSTEL and GGLS

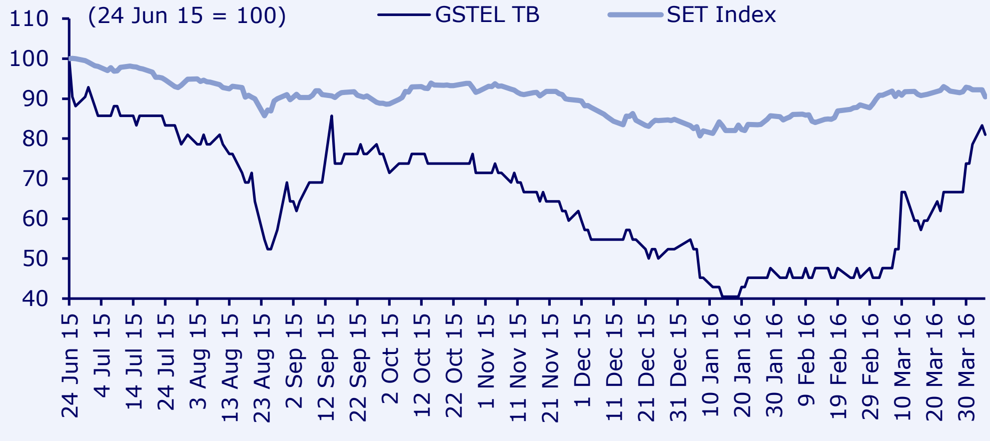
G Steel PCL (GSTEL) and G J Steel PCL (GJS) directors and executives were accused of manipulating the company's payables to avoid reporting a loss during 2008-09. The company defended its accounting of a lower than actual cost to reflect the situation that it was negotiating with the supplier. In total, two companies should have reported Bt10.6bn loss.

Four directors were found guilty by SEC under Sections 312 and 315 of the Securities and Exchange Act B.E. 2535 (1992) and Sections 83 and 86 of the Penal Code. The case was passed to Department of Special Investigation (DSI) as a criminal case. All four were blacklisted from running a public company until they can prove themselves innocent in the criminal court case that can take years.

Share price reacted negatively to news and clearly underperformed for six months

GSTEL share price vs SET index rebase

Date	Event
24-Jun-15	SEC files criminal complaint against GSTEL & GJS directors and executives
25-Jun-15	Director and managements resigned



Source: CLSA, Bloomberg

Political and regulatory environment

Score fell from 48% in 2014 to 45% in 2016

There were once again pulls in both directions on political and regulatory environment, resulting in an overall downgrade for the section. The new class-action law and amended anticorruption act were both strong positives. As noted above, there has been movement on the civil sanctioning powers for the SEC. The government has also taken steps on SOE reform, with a draft bill to set up a national state-enterprise to act as a holding company for major SOEs. Recent media reports state that the Cabinet approved the bill in principle in late August 2016 and forwarded it to the Council of State for consideration. It could become law next year.

SET governance reforms in place

We also noted the announcement on 27 July 2016 of changes to the governance structure of the SET. The exchange will be incorporated and have an 11-member board, four from the brokerage community, six with relevant credentials, and the chairman will make up the eleventh member. The SET will be subject to corporation tax and have to make a contribution to the capital markets development fund. This is an overdue reform and, as one fund manager described it, 'a step in the right direction'.

New class-action law a positive - will it be effective?

We were pleased to see the Class Action Act take effect on 4 December 2015. It was finally passed in April of that year, having been in limbo for around 14 years. The first environmental class-action case came to court in May 2016. Lawyers filed against gold-mining company Akara Resources, a subsidiary of ASX-listed Kingsgate Consolidated, on behalf of hundreds of villagers living around the Chatree gold mine in Phetchabun and Phichit. On 21 June 2016, the SEC and SET co-hosted a seminar on the use of class-action lawsuits to protect investors' interests. We await developments here and will watch the case history unfold with interest.

Challenges in public governance remain

However, we also downgraded in several areas. While the SEC has a strategic roadmap, the government does not have a clear and consistent policy on supporting CG reform beyond its anticorruption programme, in our view. We downgraded on the question of whether the government was making progress in improving standards of public governance. On the one hand, we heard anecdotes suggesting there was less corruption in government and less interference in capital-markets cases. On the other, the lack of transparency over political decision-making has continued. The referendum on the constitution in early August 2016 produced a clear result, but it will take time to implement and for the new system to settle.

Concerns have increased over the skills and independence of the judiciary

We also downgraded the scores for questions on the skills, independence and cleanliness of the judiciary. In terms of capital-markets offences, it is well-documented that cases take an inordinately long time and often do not result in a conviction. We also noted anecdotes about the judiciary making decisions in favour of the military junta, suggesting reduced independence.

Presentation of regulations and English language disclosure still a challenge

Finally, we downgraded the score for the availability and usability of information on regulatory websites. One major challenge in reviewing rule changes is that the Thai version comes out in advance of the English language translation - in some cases there were public hearings without an English-language translation. This makes it difficult for the governance teams at institutional investors without a direct footprint in Thailand to participate in consultations. Beyond this, the structure of SEC laws and SET rules are hard to follow - searching for rules is more a hit and miss game of chance than a logically structured exercise.

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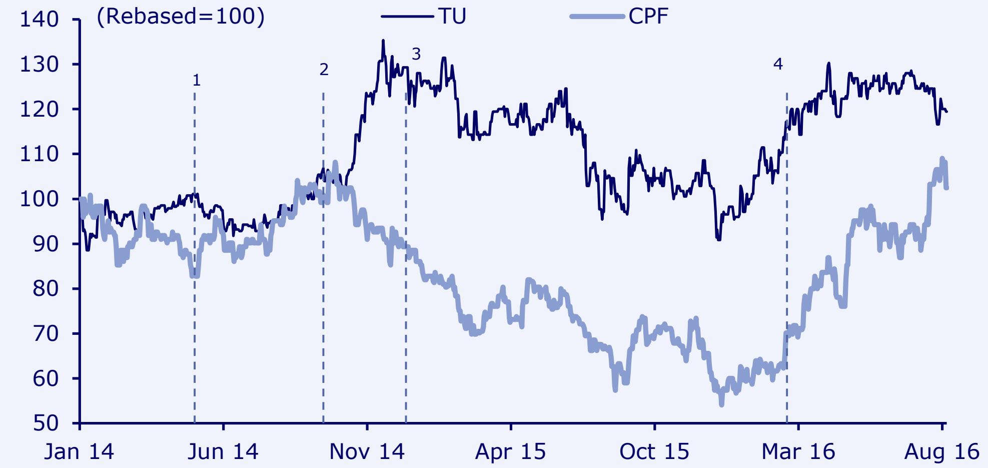
Both US and EU sanctions had negative impact on both TU and CPF, major shrimp exporters

Human trafficking and abuse in fishery and manufacturing industries
The military government has swiftly addressed rising international pressure on Thailand's government to fight human trafficking and abuse in fishery and manufacturing industries. It is forcing closer cooperation from big listed corporations like CP Foods and Thai Union Group.

Both went through their supply-chains to ensure full compliance with the renewed tight standards against such practices. CP Foods is willing to open to clients and third-party NGOs all their processing and suppliers for full audit. On the other hand, Thai Union Group went even further in one case to consolidate all shrimp processing in house and cut down some spurious external suppliers to ensure full compliance of labour regulation.

CPF and TU share-price movement during US and EU sanctions on Thai fisheries

No.	Sanction	Date	Event
1	US TIP	20-Jun-14	US downgraded Thailand to 'Tier 3' from 'Tier 2'
2	EU IUU	Feb 15	EU warned on Yellow Card issuance to Thailand on IUU
3	EU IUU	21-Apr 15	EU issued Yellow Card to Thailand on IUU fishing
4	US TIP	28-Jun-16	US upgraded Thailand to 'Tier 2 watch list' from 'Tier 3'



Source: CLSA, Company data, Bloomberg

Score falls from 80% in 2014 to 77% in 2016

Accounting and auditing

This year we tightened our assessment for some aspects of accounting and auditing standards and oversight, leading to a small overall downgrade. One positive area is that local accounting standards have now essentially converged with international standards. Thai authorities have also confirmed the adoption of the new long-form audit report for accounting periods ending on or after 16 December 2016, and the SEC and Federation of Accounting Professions (FAP) are working together on the New Auditor's Report Educational Project to prepare users and stakeholders for the change. Nevertheless, we marginally downgraded scores for the audit oversight mechanism, effective disciplinary control, and reporting on audit industry capacity.

SEC emphasises need to shift competition for audits towards quality and away from price

The SEC published the 2015 version of its audit inspection report in Thai and provided us a draft translation. This showed an increase in the proportion of audit firms that passed inspections with only minor deficiencies to 50% in 2015 from 25% in 2013 and 2014. There were still deficiencies in audit sampling, audits of revenue recognition when using percentage of completion, audits of inventory and cost of sales, and the process of forming an audit opinion. The SEC cited inadequate or inappropriate risk assessments during the audit planning stages and insufficient fees as the key reasons for deficiencies in audit quality at the firm and engagement level. The SEC, with the FAP, intends to form a group of experienced consultants to guide audit firms and auditors towards higher quality processes. The SEC has encouraged auditors to publish their transparency reports to help shift the basis of competition away from cost and fees and towards audit quality.

Little or no information on investigations, sanctions

The inspections report goes on to provide details of the issues arising from inspections, with some statistical breakdown, and covers many points for remediating them. What was missing was discussion of investigations and sanctions for auditors - beyond noting six auditors failed to obtain approval.

CG culture

Score stayed at 50%

We upgraded scores for two questions and downgraded for two, resulting in no overall change in the score for CG culture. For the three questions that changed there was no change in the overall score.

Leading disclosure of board evaluations

We changed Question E.2 to focus on board evaluation. Of the Thai companies we reviewed, all 15 of the large-cap and eight of the small-cap companies stated that they undertook board reviews. In many cases the companies provided information relating to the evaluation, with scores on the different components of evaluation. These found (unsurprisingly) that the boards were doing a good job. While the self-serving nature of the reports makes it hard to use the information, there is still a detailed level of disclosure and Thailand scored the highest on this measure among Asian markets.

Limited chair independence, no concept of lead independent director

Thai companies fared less well for the presence of an independent chair or lead independent director. Out of the 25 companies we reviewed, none mentioned a lead or senior independent director. We found six chairs that were independent in our view. In one case, a state company had designated as independent a chairman, who was a former minister. In another case, a company claimed that a director who had served on the board since 1984 and subsequently became chairman was independent. We believe this is too long a period over which to classify a director as independent. We also checked the independence of audit committee chairs. We found 16 out of the 25 we assessed that were independent in our view. In two cases there was too little information to make an assessment. We noticed that several of the audit committee chairs were more than 80 years old.

Leading risk factor disclosure

Thai companies typically have strong disclosure of risk factors, including highly specific risks to the company and the steps the company is taking to mitigate them, often with quantified details. For this reason, we increased the score on the question of adequate disclosure of internal controls and risk management.

Pay disclosure still not what investors need

We downgraded the score for disclosure of remuneration. In our last survey we noted that Thai companies had good overall disclosure on director fees in the Asian context, including the amounts for named directors. This remains the case. However, there is very little disclosure of the structure of pay and incentives beyond the occasional high level comment that there are fixed and variable elements of pay, based on targets. There were no companies that provided sufficient disclosure to enable investors to understand the link between individual and firm performance and management pay.

CP All triggered investor action

There was increased activity from domestic fund managers during the period. This was particularly notable in the CP All case. Quite a few fund managers announced that they would not buy more CP All on account of the CG concerns and many voted against the directors up for election at the AGM. However, this is only one company and there has been significant progress on active ownership in a number of Asian markets. Consequently we did not upgrade the score for the question on investors' engagement in promoting better CG practices. However, we did upgrade the score for investors setting up CG funds, noting two ESG fund launches, with more on the horizon.

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PTTGC delayed disclosure on production unit shutdown

On 13 June 2016, PTTGC notified the Stock Exchange of Thailand that its Olefin Unit No.3 (ethylene production capacity of 1,000,000 tonnes per year) had shut down since 17 May 2016 to repair the furnace coils, which were damaged from a power outage and thermal shock within the coil. In its filing, PTTGC noted that it expected the Olefins Unit No.3 'will resume operation at 66% by mid-June 2016.' According to the 2Q16 analyst briefing presentation, which was distributed on 16 August 2016, the Olefins Unit No.3 resumed operations at 66% utilisation on 14 June 2016, a day after PTTGC notified the Stock Exchange of Thailand of the 17 May 2016 unplanned outage incident.

Disclosure came nearly a month after incident took place

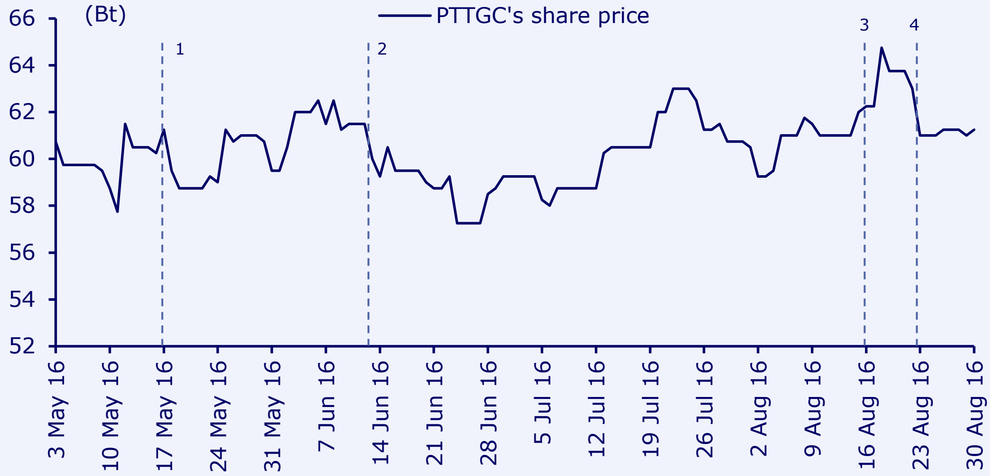
In its May-June 2016 issue of Asia Regional Briefing, the Asian Corporate Governance Association (ACGA) pointed out PTTGC's delayed disclosure of the incident as one that illustrates ongoing issue about continuing disclosure or the lack of it across markets.

On 22 August 2016, when a fire broke out at a waste-water storage tank of PTTGC's subsidiary company, PTT Phenol, the company notified the Stock Exchange of Thailand on the morning of the same day.

PTTGC share movement following two factory accidents

PTTGC share price surrounding the accidents

No.	Date	Event
1	17-May 16	Olefin Unit No.3 experienced unplanned outage
2	13-Jun-16	PTTGC notified SET about the incident
3	16-Aug 16	PTTGC's analyst meeting
4	22-Aug-16	Fire broke out at waste-water storage tank



Source: CLSA, Company data

Downgrade watchlist

Factors that could force the country's score to fall in 2018:

What to avoid

- Failure to proceed with the long list of reforms
- Failure to maintain momentum on enforcement
- Investors do not maintain the new emphasis on stewardship
- No improvement in containing corruption

Quick fixes

What to fix

- Quicker translations of key documents for public hearings - and better accessibility of regulatory documents on SEC/SET websites
- SET to archive company announcements and reports for at least five years
- More informative summaries of regulatory information from SET
- Encourage better ongoing disclosure of price sensitive information
- Investigation and sanction statistics for audit investigations

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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 CG in Asia through independent research, advocacy and education. ACGA engages in a constructive dialogue with regulators, institutional investors and listed companies on key CG issues and works towards making improvements.

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

Membership network

ACGA is funded by a membership base of more than 100 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$25tn 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

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

Founding sponsor

CLSA is one of the original founding corporate sponsors of ACGA and continues to support the association's work.

ACGA foundation sponsor

ACGA is honoured that, starting in 2012, Norges Bank Investment Management (NBIM) of Norway became the first foundation sponsor of the association. NBIM has been a valued member of ACGA for many years and this agreement marks a considerable enhancement of its support for CG improvement in the Asia region.

NBIM
Norges Bank Investment Management

Appendix 2: ACGA market-ranking survey

Evaluation of Asian markets on corporate-governance norms

A	CG rules & practices The following questions are targeted at mainboard-listed companies	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH	AU
1	Do financial reporting standards compare favourably against international standards? (eg, frequency and timeliness of reporting; existence of robust continuous disclosure rules; detailed explanation of P&L, balance sheet, cashflow; and so on)	L	L	L	L	L	L	L	L	L	L	L	Y
2	Do financial reporting practices among large listed companies[1] compare favourably against international best practices? Both in terms of their periodic reports and ad hoc announcements.	S	L	L	S	Y	L	L	L	L	L	L	Y
3	Do financial reporting practices among small- and medium-sized listed companies compare favourably against international best practices?	M	S	S	M	S	S	S	M	S	S	S	L
4	Do nonfinancial reporting standards for CG disclosure compare favourably to international standards? (ie, the MD&A, Report of Directors, CG statements)	M	L	L	S	S	S	L	M	L	S	L	Y
5	Do nonfinancial reporting practices among large listed companies for CG disclosure compare favourably to international best practices?	S	L	L	L	M	M	S	S	L	S	L	Y
6	Do nonfinancial reporting practices among small- and medium-sized listed companies for CG disclosure compare favourably to international best practices?	M	S	M	M	M	M	M	M	S	M	S	S
7	Do nonfinancial reporting standards for ESG/sustainability disclosure compare favourably to international norms? (eg, an ESG/sustainability section in the annual report following the 'comply-or-explain' standard; a separate GRI or sustainability report; disclosure of environmental KPIs; an Integrated Report.)	M	L	L	M	S	S	L	M	L	L	L	Y
8	Do nonfinancial reporting practices among large listed companies for ESG/sustainability disclosure compare favourably to international best practices?	S	S	L	S	Y	Y	S	S	S	S	L	Y
9	Do nonfinancial reporting practices among small- and medium-sized listed companies for ESG/sustainability disclosure compare favourably to international best practices?	M	M	M	N	M	N	N	N	M	M	N	S
10	Do large listed companies report their audited annual financial results within two months or 60 days? (Note: Not to be confused with the annual report, which usually comes out later)	N	M	Y	M	N	S	M	S	S	M	Y	L
11	Do small- and medium-sized listed companies report their audited annual results within two months or 60 days?	N	N	Y	N	N	M	N	N	N	M	Y	S
12	Is quarterly reporting mandatory, is it consolidated and does it provide adequate and credible P&L, cashflow and balance-sheet data (with adequate explanation of the numbers)?	L	N	M	Y	Y	Y	L	Y	Y	Y	Y	S
13	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	S	Y	S	L	Y
14	Do securities laws require disclosure of share transactions by directors and controlling shareholders within three working days?	L	Y	Y	N	N	L	Y	N	Y	M	Y	L
15	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)	M	L	S	M	L	S	S	M	L	S	S	Y
16	Does the regulatory regime require - and enforce - adequate and timely disclosure of related-party transactions (continuing, small, and large transactions)?	S	Y	S	N	L	L	S	M	L	S	S	L
17	Do securities laws provide a credible deterrent against insider trading and market manipulation?	M	L	M	N	S	S	S	N	S	S	M	L
18	Is voting by poll mandatory for all resolutions at general meetings?	L	Y	L	L	Y	N	Y	N	Y	L	L	L
19	Is there an up-to-date national code (or codes) of best practice based on evolving international CG standards?	N	Y	L	L	L	S	L	S	Y	L	L	Y
20	Is there a stewardship code (or equivalent) for institutional investors based on the "comply or explain" standard?	N	S	N	N	Y	N	L	N	N	Y	N	L
21	Is there a clear and robust definition of 'independent director' in the code or listing rules? (ie, one stating independent directors should be independent of both management and the controlling shareholder; that does not make it easy for former employees and former/current professional advisors to become independent directors; and which produces genuinely independent directors)	M	S	M	M	S	S	S	M	S	S	S	L
22	Must companies disclose the exact remuneration of individual directors and senior executives (top-5) by name (or do they)?	S	Y	Y	M	M	L	N	M	L	M	S	Y
23	Are audit committees (or an equivalent) mandatory and implemented?	Y	Y	Y	Y	M	Y	Y	Y	Y	S	Y	Y
24	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	M	M	M	M	N	S	M	S	L
25	Can minority shareholders easily nominate independent directors and are these candidates likely to be elected?	N	N	M	N	N	M	N	M	N	S	N	N
26	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	M	M	L	N	L	Y	Y	Y	Y	Y
27	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	M	N	N	N	S	N	S	M	S	L
28	Do companies release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?	N	Y	L	S	S	S	S	S	S	Y	Y	Y

[1] Main index. Continued on the next page

Evaluation of Asian markets on corporate-governance norms (continued)

B	**Enforcement** **Enforcement covers both 'public enforcement' by regulatory authorities of CG rules and regulations and 'private enforcement' by investors of their rights as shareholders.**	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH	AU
1	Do financial regulators in your country have a reputation for vigorously and consistently enforcing their own CG rules and regulations?	M	L	S	N	S	S	M	N	L	S	S	S
2	Have their efforts improved tangibly in recent years?	L	L	Y	M	L	L	L	S	L	Y	Y	Y
3	Are securities regulators seen to treat all companies and individuals equally?	M	L	S	M	L	S	M	M	L	L	L	L
4	Are the regulatory authorities sufficiently resourced in terms of funding and skilled staff to do their job properly?	M	Y	S	M	L	S	L	S	L	S	L	S
5	Does the main statutory regulator (ie, the securities commission) have effective powers of investigation and sanction?	L	Y	L	M	L	L	L	M	L	L	M	Y
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)	Y	Y	S	M	S	L	S	M	L	S	S	N
7	Has the securities regulator and/or government had a successful track record prosecuting cases of insider trading and market manipulation in recent years?	S	Y	M	N	S	S	S	N	L	S	S	L
8	Does the stock exchange have effective powers to sanction breaches of its listing rules?	M	M	S	N	L	S	L	M	S	M	M	L
9	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years?	L	S	S	N	S	S	S	N	S	S	M	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	L	S	Y	N	L	S	L	Y
11	Do institutional investors (domestic and foreign) exercise their voting rights?	M	L	Y	S	Y	L	L	M	L	L	L	Y
12	Are institutional investors actively voting against resolutions with which they disagree?	M	Y	L	M	Y	S	M	N	Y	Y	L	Y
13	Do institutional investors (domestic and foreign) often attend annual general meetings?	M	M	M	M	S	M	M	M	M	S	M	M
14	Do minority shareholders (institutional or retail) nominate independent directors?	N	N	M	N	N	N	M	N	N	N	N	M
15	Do retail shareholders see the annual general meeting as an opportunity to engage with companies and ask substantive questions?	N	S	M	L	S	M	Y	S	Y	S	Y	Y
16	Are minority shareholders willing to launch lawsuits against companies and/or their directors?	M	M	M	N	L	Y	N	M	N	N	N	S
17	Are minority shareholders adequately protected during takeovers, privatisations, and voluntary delistings?	M	Y	S	M	S	N	L	N	L	L	S	L
C	**Political & regulatory environment** **This section addresses the level of political will within a country to improve CG as well as the nature of the regulatory and legal environment.**	**CH**	**HK**	**IN**	**ID**	**JP**	**KR**	**MY**	**PH**	**SG**	**TW**	**TH**	**AU**
1	Does the government have a clear, consistent and credible policy in support of corporate governance reform?	N	N	M	M	S	N	M	M	M	S	N	N
2	Does the central bank or equivalent financial authority exercise effective regulatory powers over the governance of banks?	L	L	L	L	L	S	S	L	L	S	Y	L
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; without fragmentation and disagreement between different financial and economic regulatory authorities; and where there is a clearly definable securities commission or bureau taking the lead on enforcement)	M	L	M	M	L	M	L	M	L	S	L	L
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	S	S	M	M	N	M	M	N	N	S	S
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)?	M	L	L	M	Y	Y	L	M	L	Y	L	L
6	Has the stock exchange been actively reviewing and modernising its listing rules in recent years (ie, with a view to improving corporate governance)?	M	S	L	N	S	Y	Y	M	Y	Y	M	L
7	Has the securities commission signed the IOSCO multilateral Memorandum of Understanding?	Y	Y	Y	Y	Y	Y	Y	M	Y	Y	Y	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	Y	S	Y
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 10 years and in English)?	L	Y	L	M	S	M	Y	S	S	S	M	Y
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	S	S	N	M	N	L	M	Y
11	Is the judiciary independent and clean (in relation to company and securities cases)?	N	Y	S	N	Y	S	M	S	L	L	N	Y
12	Is the judiciary sufficiently skilled in handling securities cases?	N	Y	M	M	S	S	M	S	Y	S	M	Y
13	Is the media free to report on CG abuses among listed companies?	M	Y	Y	S	Y	L	M	L	L	Y	L	Y
14	Is the media sufficiently skilled at reporting on CG?	S	L	L	S	L	S	S	M	L	S	L	L
15	Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	M	L	M	S	L	S	N	M	Y	S	M	S
16	Is the government making progress in improving standards of public governance?	S	M	S	M	S	S	N	S	S	M	N	L

[1] Main index. Continued on the next page

Evaluation of Asian markets on corporate-governance norms (continued)

D	IGAAP (or Accounting & auditing) **This section addresses the nature of accounting and auditing rules and practices, as well as the regulation of the accounting profession.**	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH	AU
1	Does the government or the accounting standards board have a firm commitment to adopting international (IFRS) accounting standards (and is this being implemented consistently)? ('Adopting' means full implementation of IFRS; less than full implementation is called 'convergence'.)	Y	Y	L	Y	L	Y	Y	Y	Y	Y	Y	Y
2	Are local accounting rules largely in line with international standards?	Y	Y	S	Y	Y	Y	Y	Y	Y	Y	Y	Y
3	Are accounting policies and practices among large companies[1] in line with international standards and best practices? (eg, are accounting policies being followed properly?; do the firms have adequate accounting and financial reporting systems and trained staff?)	L	Y	L	L	Y	L	L	Y	Y	Y	L	Y
4	Are accounting policies and practices among small- and medium-sized companies in line with international standards and best practices?	S	S	M	S	S	S	S	S	S	S	S	S
5	Do the rules require detailed segment reporting?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
6	Is disclosure of audit and non-audit fees paid to the external auditor required, with accompanying commentary sufficient to make clear what the non-audit work is?	S	L	Y	M	S	S	S	S	S	S	S	Y
7	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); and is it being implemented consistently?	Y	Y	L	Y	Y	Y	Y	Y	Y	Y	Y	Y
8	Are local auditing rules fully in line with international standards?	L	Y	L	L	Y	Y	Y	Y	Y	Y	Y	Y
9	Are auditing practices among large companies[1] in line with international best practices? (eg, the auditor does not need to assist in any way with account preparation; audit quality standards are high; audit partners spend sufficient time supervising audits)	L	Y	L	L	L	L	L	L	Y	L	L	L
10	Are auditing practices among small- and medium-sized companies in line with international best practices?	M	S	M	M	S	M	S	M	S	S	S	S
11	Has the government or accounting regulator enacted and enforced effective rules 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; a positive duty for auditors to report fraud; and so on)	S	M	L	M	S	S	S	M	Y	L	S	Y
12	Has the government established an independent audit oversight board with clear, effective and independent powers of registration, inspection, investigation, and sanction (over both auditors and audit firms)?	S	M	M	M	S	S	Y	M	L	S	L	Y
13	Does the audit regulator exercise effective and independent disciplinary control over the audit profession (including disclosure of its enforcement work on a timely basis)?	M	M	N	M	S	S	L	M	L	S	S	L
14	Does the audit regulator publish a report or survey on audit industry capacity (ie, the level of skills and experience in the CPA profession)?	M	N	N	N	Y	M	Y	N	Y	S	L	Y
15	Does the audit regulator and/or the local accounting industry body have an active programme for CPA education?	Y	Y	Y	L	L	Y	Y	Y	Y	Y	Y	Y

[1] Main index. Continued on the next page

Evaluation of Asian markets on corporate-governance norms (continued)

E	CG culture **This section looks at the extent to which corporate governance has penetrated company and market behaviour and decision-making.**	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH	AU
1	Does the average listed company believe that CG will provide tangible benefits? (eg, lower cost of capital, improved share price, better risk management). Look at evidence from individual companies as well as policies/activities of key business associations.	N	N	N	N	N	N	N	N	N	N	N	S
2	Do listed companies typically undertake board evaluations, either internally or using external consultants?	M	M	M	M	M	M	M	M	M	M	S	L
3	Do listed companies typically provide induction and ongoing training to their directors - executive and nonexecutive - and disclose these programmes in their annual reports?	M	L	M	M	M	M	S	S	S	M	S	S
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). Is this disclosure meaningful and honest?	L	Y	L	L	Y	S	S	L	Y	Y	L	Y
5	Are small- and medium-sized listed companies actively seeking to improve their communication and dialogue with shareholders?	S	S	M	S	L	M	M	S	S	S	S	S
6	Do company boards generally have an independent chairman and/or lead independent director?	N	M	M	M	M	M	S	N	M	N	M	Y
7	Do listed companies provide adequate disclosure of their internal-control and risk-management functions in their annual reports? Key issues to look at: A clearly articulated 'risk appetite'? A strategy in line with this risk appetite? Risk committees within the board and senior management? Constant communication by the CEO about the company's risk appetite?	S	L	S	S	S	S	S	S	S	S	L	L
8	Do listed companies provide a detailed explanation of their executive and employee remuneration policies?	M	S	M	M	M	N	N	M	S	M	M	Y
9	Is there a trend towards listed companies voluntarily voting by poll at their AGMs and making the results public afterwards?	Y	Y	Y	Y	Y	N	S	M	Y	Y	Y	Y
10	Has the stock exchange or another organisation developed an open electronic voting platform (straight through processing) for investors?	L	N	Y	N	Y	Y	N	N	N	Y	N	N
11	Do 'reputation intermediaries' (investment banks, accountants and lawyers) or stock exchanges promote high standards of CG in clients about to undergo an IPO?	N	N	N	N	N	N	N	N	N	N	N	M
12	Are institutional investors (domestic and foreign) actively engaged in promoting better corporate governance practices?	N	S	S	N	L	S	S	N	M	S	S	Y
13	Have institutional investors set up any CG 'focus funds'?	N	N	N	N	M	N	M	N	N	N	M	N
14	Are retail investors or non-profit organisations engaged in promoting better CG practices?	N	S	S	N	S	Y	Y	M	Y	Y	L	Y
15	Have retail investors or members of the public formed their own independent (self-funded) shareholder or CG organisations?	N	M	S	N	S	Y	M	S	Y	S	M	Y
16	Is there an institute of directors (or equivalent) actively engaged in director training?	M	Y	M	Y	Y	M	Y	Y	Y	S	Y	Y
17	Are other professional associations of accountants, company secretaries, financial analysts and so on promoting CG training and awareness raising?	L	Y	Y	M	Y	M	Y	S	Y	S	L	Y
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	L	Y
19	Does the media actively and impartially report on CG reforms and developments?	M	L	Y	S	L	L	S	S	L	L	L	L

[1] Main index. CH = China; HK = Hong Kong; IN = India; ID = Indonesia; JP = Japan; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TW = Taiwan; TH = Thailand; AU = Australia. Y = Yes (+ 1 point); L = Largely (+ 0.75 point); S = Somewhat (+ 0.5 point); M = Marginally (+ 0.25 point); N = No (0 point); X = Zero/no data available. Source: ACGA

Appendix 3: CLSA CG questionnaire

Questions in bold carry negative scoring . . .

Discipline (18% weight)

Question number	Range of scores	Question	Guidelines
1	0,1	Does management stick to a clearly defined core businesses?	Core business represent the industries and skill sets a company has shown a clear competence and ideally has competitive advantage in. It is subjective. Tangential acquisitions or new ventures that build on the skills that the company is recognised by the market and customers as holding could be deemed by the analyst to broaden the core business over time (eg, Hyundai Motor acquiring a construction business is not within its core business. Apple moving into the auto industry could be argued as still within its core competence of software and design, based on innovation).
2	0,1	Are you confident management clearly understands its company's cost of capital and uses it as a key input in capital allocation?	Answer 'No' if you have any reason to believe any of the below are true: You cannot find reference to the costs of capital in company's communication material or during interactions with investors The company has a history of continuing to fund businesses which do not earn their costs of capital
3	0,1	Has the company issued any capital (debt or equity) in the past five years which was clearly not in the best interests of shareholders?	Answer 'Yes' if you have any reason to believe the below are true: ❑ There was an expensive acquisition with unconvincing arguments for synergies ❑ It provided inadequate disclosure for the reasons of capital issuance and capital usage ❑ You are concerned about solvency implications of current balance-sheet structure or any recent debt issuance
4	**0,1**	**In the past five years has the company engaged in any type of restructuring which conflicts with shareholder interests?**	**Transactions which conflict with shareholder interests include the following:** ❑ **Spinoff of strategically important or imminently profitable businesses to related parties (eg, the Baidu deal with iQiyi)** ❑ **Mergers or demergers done at material deviations to analysts' estimates of a fair price** ❑ **Transactions which increase voting control of one group at the expense of another without a control premium**
5	**0,1**	**Is the company free from government interference?**	**Answer 'No' if you have any reason to believe any of the below are true:** ❑ **The company faces indirect pressure to alter pricing, hiring investment or any material entity level decisions in any way which would hurt shareholder interests to support government goals** ❑ **This does not include normal regulations which are within the confines of a company's official mandate that allows it to earn an previously agreed upon regulatory return**
06a	0,1	Has management disclosed reasonable return on capital (eg, ROA or ROE or ROIC) targets? If so, please state such in (6b).	The time horizon and specific type of metric is not important. A target which is unnecessarily high and encourages the company to take undue risk should be answered 'No'.
06b			Please state the metric used by the company and the number in metric-number format (eg, ROE-15 or ROA-13 or ROIC-7).

Source: CLSA

Transparency (18% weight)

Question number	Range of scores	Question	Guidelines
7	0,1	Does the company publish its full-year results within two months of the end of the financial year?	The formal regulation is three months for audited annual accounts in most markets, but two months is seen as good practice. Best practice is now one month or less
8	0, 0.25, 0.5, 0.75, 1	Are the financial reports clear and informative?	For every question below answered true take off 0.25 per question (which means four or more questions answered true will result in a score of 0): ❑ If over the past five years there has been occasion when the results announced lacked disclosure subsequently revealed as relevant; ie, restated accounts ❑ If key footnotes to the accounts are unintelligible ❑ If negative factors were downplayed when presenting company results which were important in assessing the business value ❑ If there is inadequate information on the below items: ■ revenue/profit split for different businesses ■ regions/countries ■ product lines ❑ If there is inadequate disclosure and/or inadequate provisions for contingent liabilities, NPLs or likely future losses ❑ If there is inadequate detail of group/related company transactions and the rationale ❑ If there is inadequate disclosure regarding 'other expenses' ❑ If there is an auditor qualification
9	0,1	Are the accounts free of controversial interpretations of IFRS or of dubious accounting policies?	Answer 'No' if you have any reason to believe any of the below are true: ❑ If the company has changed accounting policies, or adopted a controversial accounting practice which boosted its stated earnings ❑ If proforma or unaudited results statements are notably different from actual audited accounts ❑ If expenses have not been sufficiently 'disaggregated' as per IAS 1 ❑ If profits are consistently rising in the face of falling cashflow to the extent analysts are concerned about the number ❑ If the valuation of any assets (eg, biological assets such as forests) does not appear to have a sound basis
10	0,1	Does the company consistently disclose major and price-sensitive information punctually?	Answer 'No' if there have been cases in the past five years when the share price moved noticeably just before a material announcement or results release and in a direction which anticipated the announcement
11	**0,1**	**Do analysts and investors 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**

Source: CLSA

Independence (18% weight)

Question number	Range of scores	Question	Guidelines
12		Is there any reason to doubt the independence of the chairman?	Answer 'Yes' for following the circumstances: ❑ The chairman is a relative of the CEO and or senior executive and there is no established history of prioritising shareholders over family goals ❑ The chairman was formerly a long-term employee of the company and has no history of challenging management decisions (ie, he is only technically 'independent' due to the cooling-off prescriptions in the listing rules) ❑ The chairman is a government appointee and was clearly appointed for political reasons ❑ The chairman has a reputation for being a weak leader
13	0,1	Does the company have an effective and independent audit committee?	Answer 'No' if you have any reason to believe any of the below are uncertain or false: ❑ The audit committee is chaired by a genuinely independent director and more than half its members are independent directors ❑ All members of the committee, including the independent directors, have financial expertise - and one member is a financial or accounting expert ❑ The committee membership also has a range of expertise in relevant industries or service sectors ❑ The committee meets regularly, well before board meetings, and communicates directly with internal auditors (this information, if it exists, should be in the audit committee report in the annual report) ❑ The audit committee report contains substantive information about the financial, accounting and risk issues it discussed during the year (ie, the report is not just a boilerplate description of its terms of reference, membership, director attendance statistics and so on)
14	**0,1**	**Has the company been involved in a scandal in the past five years which raises questions about the independence of external auditors?**	**For example, DSME's losses were delayed from being reporting for several years with auditor endorsement. It was later revealed by regulators, which forced auditors to admit their fault on the matter. Also, Toshiba overstated its operating profit over seven years due to overly aggressive management pressure.**
15	**0, 0.5, 1**	**Do the independent nonexecutive directors on the board act in a genuinely independent way?**	**Here we are looking for analysts to provide their best assessment of the competence and substantive independence of the board. In the past five years has the company provided: 1 = positive evidence of specific action which shows a board has challenged management 0.5 = no negative evidence 0 = if the analyst has any concerns or is aware of negative behaviour Some examples of negative behaviours are: ❑ Approved transactions that analyst believe were unattractive ❑ Approved unreasonable remuneration packages ❑ Failed to take action when the competence of senior executives was questioned by outsiders**
16	**0, 0.25, 0.5, 0.75, 1**	**Does the company vote by poll at AGMs and EGMs for all resolutions and release detailed results the next day (where all votes including those through proxies are given their appropriate weight based on the percentages of shareholding, as opposed to a show of hands)?**	**Score the company based on how many of gold standard questions are answered 'Yes' Give a score of 1 for all 3 questions: 0.75 for having 2 out of 3 questions 0.5 for having 1 out of 3 questions 0.25 if you believe company is doing something on this topic 0 if you believe company is doing nothing Gold standard: 1. All votes are counted on each resolution, including both proxy votes (ie, sent in beforehand, usually from institutional investors) and any votes cast during the meeting (mostly by retail shareholders, but sometimes institutions as well) 2. The company engages an independent third party (eg, a law or accounting firm or share registrar) to scrutinise the vote count 3. The company publishes the detailed results no later than one day after the meeting (detailed results = full disclosure of all votes - For, Against and Abstain - on each resolution, as well as a report on the number of shares eligible to vote at the meeting)**
17	0,1	Does the board composition reflect an attempt to bring diverse talent and backgrounds to the board?	Answer 'No' if the independent directors are mainly retired executives or retired government officials, or if the board is all male

Source: CLSA

Responsibility (18% weight)

Question number	Range of scores	Question	Guidelines
18	0,1	Can you confirm no one with a criminal conviction is sitting on the board or in a senior executive position in the company?	This excludes traffic offences and overtly political convictions
19	**0,1**	**Over the past five years, has the company engaged in any related-party transactions which harm the interests of noncontrolling shareholders?**	**Answer 'Yes' if the company engages in any of the following:** ❑ **Sourcing key materials from a related party, or using a related party which is not part of the listed group as a distribution channel (this does not include related-party transactions (RPT) which are not harmful to shareholder interests; RPTs are not necessarily bad if genuinely done at arm's length and free from conflicts of interest)** ❑ **Placing funds in deposit or for investments in a related parties which meet the following criteria:** ■ **Which are not part of the listed group** ■ **The annual report discussion of related-party transactions runs over two short paragraphs** ■ **The listed company has invested in businesses where the controlling shareholders have interests in the past three years** ❑ **However, the analyst should not consider the economic impact of such transactions as we are focusing on culture and behaviour, not materiality (any RPT which raises red flags should indicate a 'Yes' regardless of size)**
20	**0,1**	**Is the controlling shareholder's primary financial interest the listed company?**	**Answer 'No' if the company is any of the following:** ❑ **A government-controlled entity** ❑ **A listed company where the ultimate shareholder(s) have various other business interests** **Note: if no controlling shareholder put Yes**

Fairness (18% weight)

Question number	Range of scores	Question	Guidelines
21	**0,1**	**Has there been any evidence of conflicts of interest on the board or among senior management in the past five years?**	**Answer 'Yes' if you have any reason to believe there were any of the following:** ❑ **Questionable inter-company transactions** ❑ **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** ❑ **Mergers or demergers took place which disadvantaged minorities**
22	**0,1**	**Has the company issued any securities which decouple voting rights from economic rights?**	**Answer 'Yes' if:** ❑ **Any classes of ordinary shares which disenfranchised their holders** ❑ **They issued any dual-class shares** ❑ **There has been any preferential access to or pricing of any securities which were not offered to all shareholders**
23	**0,1**	**Have there been any controversies/questions over whether share trading by board members, or placements by the company have been fair, fully transparent and well-intentioned?**	**Answer 'Yes' if any of the below are true:** ❑ **Announcements were made to the exchange after three working days** ❑ **Major shareholders did not reveal all transactions including those under nominee names** ❑ **It is believed that the parties related to the major shareholders involved in transactions were not disclosed to the exchange, or were accused of insider trading**
24	0,1	Is remuneration of the board and executive compensation fair?	Answer 'Yes' if any of the below is true: ❑ Is there a clear link between the company's fundamentals and remuneration? ❑ The company does not use asymmetric payoff structures such as long-dated options ❑ Is all remuneration immediately expensed and reported in detail within the primary accounts rather than as footnotes

Source: CLSA

Pru Benett
Blackrock

Appendix 4: Passive investor

BlackRock interview

CLSA has, for more than a decade, rated companies on the quality of their governance, however, no one really rates the research community or investors in their own contributions. Are we being a little hypocritical, should we be evaluating ourselves more?

Evaluating governance is very difficult as it can't be easily quantified

Pru (BlackRock): Evaluating companies on ESG criteria is very different to evaluating companies in financial criteria. Financials results are presented within a universal accounting framework to define what is measured and how. When evaluating governance we have some disclosures but they tend to be boilerplate, they can lack clear definitions and often the output doesn't differentiate between good and bad behaviours. For example, many companies in Asia staff their boards with one-third independent directors and establish audit nomination and remuneration committees. In that sense, their structures are in accordance with various governance codes in the region. However, this of itself doesn't identify which companies are well governed and which are not. That is a far more difficult question. What we really lack are appropriate disclosures that go beyond compliance to convincingly assess the substance of governance regardless of the form. I don't think there is enough qualitative information or analysis on this issue.

We can see this in recent academic research out of Australia looking at the links between independence and performance where similarly timed projects draw completely contradictory conclusions. One key factor that the research typically misses is looking at the competence of the board. It is not just about independence, the demonstration of which often devolves into box-ticking exercises, it is about having a truly competent board of directors. I think this is where research and common practise miss the mark, though I would hasten to add I don't have the solution to this difficult problem.

And how do you think Asian investors are doing in terms of tangible actions to promote positive change?

Activist hedge funds have added a lot of value in Asia in recent years

Pru (BlackRock): I think there are a few active hedge funds like Elliott that have had a big impact in places like Korea for example. Their aggressive challenge of Samsung C&T's proposed merger with Cheil Industries last year really shook up the Korean market. I am actually flying up to Korea soon because a number of investors, including myself, have been invited to come in and meet the board of a Korean company. That's a positive step and a case where one could argue investor actions have actually precipitated tangible and positive changes. To that end, activist investors are probably having the most high-profile impact. But there is also a role for other investors such as BlackRock where our interactions with G Resources (an active long-term holding) demonstrate that we are willing to take public action that goes beyond simply executing within the less visible voting process when we believe the circumstances demand it.

Does that suggest the investment community is relying on small number of active players rather driving change collectively?

BlackRock's approach is about engagement and communication

Pru (BlackRock): We of course can coordinate with other investors and we do that from time-to-time. However, coordination typically requires special circumstances. When considering the day-to-day task of pushing for good governance one of our new tools is our corporate-governance and proxy-voting guidelines. We recently published these for Hong Kong and intend to roll them out throughout the region. We wanted to articulate to our investee companies how we view certain corporate-governance factors. This includes things like how we might engage on succession planning or voting around general mandates. This is important because typically corporate meetings will have a specific agenda and so limit the scope of what can be covered. However, after these meetings we can leave our guidelines with the companies to show them how we view other aspects of corporate governance. We are reluctant to support a request for a general mandate for example if it lacks a specific rationale around why it is needed. If the company puts forward a cogent explanation we will support it. So there is value in calibrating expectations on both sides. Sometimes when questioned on why such agenda items exist, companies respond with 'it has been the standard practice for 15 years' or 'our lawyers told us to put it in'. We are communicating to the company that our purpose is not to dictate how to do conduct business but to reason with them on why we should support it.

Is it the vote action that matters, or engagement over time?

While votes matter engagement is essential

Pru (BlackRock): You must have both. For BlackRock, given the breadth of companies we own positions in, we cannot engage with every company. However, for egregious matters, engagement is more effective than voting. Sometimes just by looking at the agenda it's a no-brainer for us to vote against. However, after engaging with the company there are times where you gain an understanding about why you might support it.

In your governance leadership capacity do you provide guidance to your portfolio management on how to engage?

We focus our attention on controversial proposals

Pru (BlackRock): Most of our investments are passive therefore we prioritise engagement in terms of our exposure (position size) and the importance of the issue itself. Each particular issue also gets prioritised. For example, we were invested in a company that was accused of using slave labour. Despite having a small stake in this company it was clearly a significant issue. As such, we had to work closely with the company to establish the facts and seek to eliminate any related risks. We, of course, also work closely with the portfolio managers and analysts that work in active equities, who generally don't meet with the board as much as we do. So there is a bit of differentiation with their form of engagement. We are more board-focused for governance; active managers are more management focused. However, we work together on issues to get a better outcome from a corporate-governance perspective.

We (CLSA) tend to see Australia as a benchmark for good governance, how does Asian access compare to Australia today?

Australian engagement model is more mature and a benchmark for Asia

Pru (BlackRock): We agree Australia is a benchmark; the engagement model is quite mature there. One of the driving forces was the two-strikes rule and the nonbinding vote on remuneration reports. In contrast, the engagement model is still developing in Asia. Getting access to management where we have a large holding or active holding is usually not a problem. However, access to chairmen is more difficult in Asia. In Australia, most of top-50 company chairman make themselves available once a year on a roadshow to talk exclusively about governance issues. They will typically seek to meet prior to AGM season but this type of culture does not exist in Asia yet. There is a completely different ownership structure here with significantly more SOE and family-controlled companies. These structural differences change the interaction between company agents and capital. If these structural issues were to change, it would impact the rate of transition to a more open-engagement environment that we see in Australia.

What about the trend in access? Has the gap to Australia narrowed or widened over time and what are your expectations for the future?

Asia's gap to Australia will narrow slowly with time

Pru (BlackRock): We expect the gap to narrow. I have worked in corporate governance for 20 years and I can tell you in the late nineties in Australia, companies did not engage with shareholders on corporate-governance issues in the manner they do today. As such, this is positive for the Asian outlook in terms of a precedent. However, Asia will not have a similar trajectory to Australia due to the ownership structure here. SOEs and family account for 70% of listed companies and we should acknowledge that structural difference leads to cultural differences.

Does this suggest the eventual selling down of these stakes leads to better engagement or do we face structurally lower access for Asia?

Reduction of SOE and family ownership can contribute to this

Pru (BlackRock): It will depend on the succession planning that takes place. We should remember there are a number of meaningful companies where the patriarchs are in the eighties and nineties. Some have already brought in external management and others have done a good job of preparing the selected family representatives to take over senior positions. So it will depend on how that process is managed. As a result, I see that the trajectory is in the right direction but it is the slope of the curve that may not match Australia. It is unlikely to be as rapid as Australia's transformation from say 1997 to 2007, when they had the nonbinding vote on remuneration that came in during 2006, which really raised engagement. That was also followed by the two strikes rule in 2011, which then took engagement to another level.

What is the more productive conversation, both from the perspective of investors and companies; board-level discussion or management? Or must investors do both and if so what is the right balance?

BlackRock focuses governance conversation at the board level

Pru (BlackRock): Yes that's correct. Ultimately, it's quite straightforward. The governance issues should be discussed at the board level. If we can't get access to board-level decision makers we ask management to take these issues back to the board for us. Now that is undesirable because it's not effective. Messages can easily be inadvertently lost in transmission or translation. For my mind, there is a clear line between what is an issue for the board and what is an issue for management.

So it sounds like you are saying active managers are more likely to focus on talking with management teams but those specifically responsible for governance should focus their energy more on the board?

Board is the key point of oversight for management

Pru (BlackRock): Yes that's correct from an issues standpoint, but from an overarching process standpoint, they still need to speak to both. If you're an active manager with a small number of positions versus perhaps 1,500 or more for a passive manager, you are likely to know each company very well and have an intimate knowledge of the quality of management. However, they should still meet the board. The board is the body that is providing oversight of management, approving the strategy and measuring the implementation of that strategy. As such, they should be able to identify issues before they devolve into material problems. Their job is to question management, sometimes coach them and to generally increase the probability of success. If portfolio managers exclusively meet with company management they are less likely to get an indication of board quality, which may impact long-term performance, or at a minimum they will naturally get a less objective assessment. This is why you need independent and competent boards to carry out that role.

Is it fair to say that boards are even harder to access than management and would you see that as a missed opportunity not just to improve the quality of the discourse but reduce the direct drain on management time?

Active managers benefit from speaking to both management and the board

Pru (BlackRock): There are a number of issues embedded here. I thoroughly support the idea of talking to the board for understanding corporate culture because it comes from the top. However, we should remember if your discussions with the board are focused on issues specific to the board there is less scope to save management time because you should not be having those discussions with management anyway. When you consider the line between what you take up with the board and what you take up with management many will argue it is blurred, I don't think it is, as I have said before, I think it is very clear. That said, I agree the processes can be complementary, especially for an active manager. I certainly support that speaking to the board can help investors better understand not just how the company is doing but how management is doing in shaping those outcomes.

Isn't meeting investors that sometimes own only basis points of a company (sometimes for quarters rather than years) a waste of management time?

Access is critical but efficiency of access is a relevant consideration for management

Pru (BlackRock): I think providing access is critical and having quarterly calls to answer questions from investors and analysts during that time is a good example of an efficient way for a company to communicate with shareholders. If shareholders decide not to utilise those channels I can agree it becomes more reasonable for management to express reluctance for additional time.

Are the best companies for access the ones that try to think holistically about the most efficient ways to reach the maximum number of investors rather than doing ad-hoc engagements that, by their nature, will tend to favour the larger or more aggressive investors?

We use ad-hoc engagement to address specific issues

Pru (BlackRock): Our ad-hoc engagement is used when we have specific issues to raise. However, periodic governance tours as an example still offer significant value. When we meet with Australian chairman on their annual governance roadshows, we typically do not have specific issues to address. However, more often than not, we are a substantial shareholder and it is important for us to meet, share our views and develop the relationship. This is important because, if an issue arises and we have some specific concerns we know who to talk to and they know us. This immediately leads to more effective and efficient discussions.

In parallel to this, a related development we should consider is that a lot of boards are increasingly meeting with proxy advisors, which can shift their focus. While there are natural efficiencies to proxy-advisor research that we all value, it is nonetheless still important for boards to remember that votes are made by shareholders not by proxy advisors. Occasionally, I will get emails saying that a chairman of a given company is visiting proxy advisors to which I must reply reminding them that I am not a proxy advisor. In this respect face-to-face meetings and exchanging views is a useful forum to bring alive our mutual roles in the process so that board members might better internalise this for their own understanding and decision-making processes.

This raises an important question; has the investment community essentially outsourced the voting process to proxy advisors and does that dilute the value of the process? Also isn't there the potential for conflicts of interest?

Proxy voters are valuable productive tool but ultimately do not vote, shareholder do.

Pru (BlackRock): From a global perspective, there are two key proxy advisors, which are ISS and Glass Lewis. ISS does have a business that conflicts with proxy advice; Glass Lewis doesn't. Glass Lewis does sell its reports for a nominal fee, however it does not do consulting services to companies, which is obviously a big difference between the two firms. That said, ISS clearly states that it has Chinese walls in place to ensure its research is not compromised.

BlackRock uses two proxy advisors in each market so we are not overly influenced by one or the other. We have one of the proxy advisors implement our custom policies because around 70% of proposals are not controversial. We don't seek to review every proposal as our goal is to focus on the remaining 30% that requires our attention. We have systems in place to escalate these kinds of proposals. This is a practical reality around how we can execute the process when we are invested in 5,000 companies in the Asian region. If there are resolutions that are either controversial or not in line with our policies it gets escalated for review. If it is in line with our policy it gets voted automatically. Our policy is on our website and publicly available to the companies.

Some would argue that passive investment is a threat to improving corporate governance. Interestingly the Harvard Business Review recently quoted academic research arguing the opposite? What would be your take on the active versus passive debate for ensuring good governance?

Passive investment can augment active governance effort

Pru (BlackRock): I think they are different and complementary. Passive investors like BlackRock have dedicated teams to address the issue of governance and so do influence and raise the bar in certain markets. However, active managers have an advantage of having the power of selling their shares. McKinsey did some research that well-governed companies attract a higher valuation. We believe good governance can lower your cost of capital. In that respect we see a missed opportunity. This is because a lot of companies in Asia look at governance as a compliance issue and so it is managed from within their legal or compliance departments.

However, we look at it as a strategic issue. Especially for family-controlled companies. We are not arbitrarily saying please make one third of your board independent. We want to see people on the board that we are confident are competent and provide value added oversight of management. The reality is that families in Asia have often built extraordinary companies from nothing over decades. The company will have a particular culture that could be adding a lot of value that we don't want to interfere with. However, as companies keep maturing we believe that there is value in fresh blood and better board processes to keep that growth going. Furthermore, we see this governance evolution as an advantage to the families themselves because they are long-term investors just as we are.

You raise a good point, the debate about independence. In *CG Watch 2016* we actually decided to remove arbitrary questions about the number of independent directors. Should we be looking more at board competence rather than setting arbitrary targets for the number of 'independent' directors, a concept that can be easily gamed in CLSA's view?

A focus on board competence is more value added than independence

Pru (BlackRock): Our standard approach is to assume that directors are not independent unless proven otherwise. Even if they meet the published criteria for independence in a given market it does not mean they are truly independent. For this reason, I think discussions around independence are often not constructive. Some of the most competent directors that I have seen were not independent and vice versa. I would also suggest that some global investors have difficulty understanding the cultural differences in Asia as they haven't lived here. They underappreciate the significance of companies being state-owned or family-controlled, which may have endowed them with certain characteristics or cultures that could have been very important to them becoming such large listed company.

In Japan, for example, there is a different way of doing business. Therefore, to come to Asia and tell the board that they must ensure one third of directors are independent or focusing too much on the concept of independence can be quite ineffective. However, in seeking to transition the focus to the issues of competence, skill depth and diversity on boards we also face significant information challenges. This is because it is only mandatory to release their name, age, and current and former directorships, which do not really tell us anything.

So the core issue is if their actions and goals suggest they are focused on the advancement of the company and if they are competent to achieve that?

Yes, in our models we are more focused on indicators of competence or incompetence rather than data around definitional issues of independence.

What are the top one-to-three things that you think we should be focusing on to improve governance in Asia

'Independent' directors of tightly held companies often misunderstand the fiduciary duties

Pru (BlackRock): We would like to see directors better understand their role in regards to minority shareholders. Often times, they have been voted in by the major block shareholders and as a result typically have a pre-existing relationship with that block shareholders. Naturally it makes sense that these types of directors are more likely to see their responsibilities as primarily aligned to the block shareholder. In this context they can fail to understand their fiduciary duties to minorities. I think this is a very important message that we need to communicate to the director community.

Another very important issue is developing a better understanding how investors operate, and understanding our mutual positions on proxy voting, and where companies should be making their case to investors around why we should support them. As to our response, while voting is important, if we vote against a company, it is critical to communicate with the board about why. Unlike a market like Australia, where the engagement model is more developed, sometimes we cannot gain access to management teams or boards before voting against a resolution in Asia. In these circumstances, follow-up communication is crucial.

So that brings us to another key issue. While collaboration is often the best means of mutual advancement, there will be times when investors must call boards and or management to task? Do you think that is happening enough?

We see some clear example of investors challenging companies in Asia

Pru (BlackRock): Well the Elliott's of this world certainly do and I would argue that BlackRock does as well. We have had a very public disagreement (which is ongoing for that matter) with G Resources. We actually ran a proxy campaign to explain to shareholders why we thought it was very important for them to reject a specific transaction. We had been long-term shareholders since 2009, we had engaged with the company privately, sharing our views. However, we were not getting any response and so felt we had to go public to address the issues. We would do this again if we find ourselves in the same situation.

The best engagement model is a function of the issues at hand and the shareholder structure

If we compare Australia versus Asia, have you seen more of Asia calling out boards or management compared to Australia? Or is this not really comparable as Australia has less contentious behaviours?

Pru (BlackRock): It comes down to shareholder structure. Going public against the board is a costly exercise and it is even more so if there is a 30-40% block shareholder. However, in Australia you have a shareholder structure where institutional holdings are much more dispersed and even a shareholder with only a 1% holding (and perhaps persuasive influence with the broader institutional community) can exert significant pressure on a board. If the structure is such that votes are effectively locked up, regardless of the success of a proxy campaign with minority shareholders, it suggests a public strategy will be ineffective and possibly counterproductive.

Constant communication is the dominant feature of the BlackRock approach

What are the key developments that have taken the bulk of your attention in the last several years?

Pru (BlackRock): The dominant feature of our engagement has been focused on communication. This is why we have a guideline for Hong Kong and it will be rolled out to other jurisdictions. It outlines our expectation of disclosure and communication particularly around our definition of the board and how it operates. I find there are mismatches between our perception of what the board should be doing and what it thinks. We need to communicate this in a constructive and cogent way and build these relationships; especially when we own a significant stake like 5-6%. Here we have significant power, particularly on related-party transactions because related parties cannot vote. Overall, we want the relationship to be cordial, as we are in it for the long term and the nature of our mandate means for much of the funds we can't sell.

BlackRock is most interested in continually enhancing board competence

Thank you so much for your time, any closing comments for us?

Engagement matters. For governance, boards are where it should be focused. Boards matter and the competence of the board is the key. We want strong oversight and active engagement. To that end, board fees are too low in Asia. We would support paying higher fees if it resulted in more qualified, competent and accessible boards. Thank you.

Pru Bennet bio

Pru Bennett, Director, is Head of BlackRock's Investment Stewardship team for the Asia Pacific Region based in Hong Kong. In this role, Pru is responsible for leading BlackRock's stewardship efforts covering engagement and voting in Asia, Japan, Australia and New Zealand on behalf of BlackRock's clients globally and integration of extra financial issues in the investment process.

Pru is an active participant in the public corporate governance, stewardship and responsible investment debate and as such regularly speaks on the importance of these issues for company performance and investment decisions. Pru represents BlackRock on a number of industry and regulatory bodies including the Australian Financial Services Council's ESG Working Group and Hong Kong's Securities and Futures Commission's Public Shareholder Group. In 2013, Pru was named as one of Australia's top 10 Women of Influence in Corporate Governance.

Prior to joining BlackRock in 2010, Pru was head of Corporate Governance at institutional advisor Regnan Governance and Research. From 1998, Pru was a director of Australian proxy advisor Corporate Governance International, which was acquired by Glass Lewis & Co in 2006 and is now known as CGI Glass Lewis. Prior to working in the area of CG, Pru was Investor Relations Manager for Qantas Airways Limited. Pru has a BCom from the University of New South Wales and is a member of the Australian Institute of Chartered Accountants.

About BlackRock

BlackRock is one of the global leaders in investment management, risk management and advisory services for institutional and retail clients. At 30 June 2016, BlackRock's AUM was US$4.89tn. BlackRock helps clients around the world meet their goals and overcome challenges with a range of products that include separate accounts, mutual funds, iShares® (exchange-traded funds), and other pooled investment vehicles. BlackRock also offers risk management, advisory and enterprise investment system services to a broad base of institutional investors through BlackRock Solutions®. As of 30 June 2016, the firm had approximately 12,700 employees in more than 30 countries and a major presence in global markets, including North and South America, Europe, Asia, Australia and the Middle East and Africa. For additional information, please visit the Company's website at www.blackrock.com/hk | Twitter: @BlackRockHK

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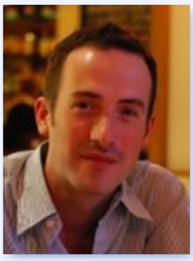

David Smith
Aberdeen

We look at the quality of the company before we look at the valuation

Asia's concentrated ownership means we must assess governance before we invest

The right family ownership can lead to better long-term orientation and outcomes

Appendix 5: Active investor

Aberdeen Asset Management

From previous discussions, one point was made that surprised us. This was that some investors do not see the value of governance. Our understanding is that your process is heavily tied governance. Is this fair?

David Smith (Aberdeen): Yes, our process is such that when we look at a company we look at the quality of the company before we look at the valuation. Quality would include quality of the franchise, management and corporate governance. Asia is a dynamic region in terms of the people you will be co-investing with. We are ultimately co-investors in most companies here and so we want to make sure we are investing with companies that will look out for minority shareholders; with owner-managers that will look out for minority shareholders. We put a lot of emphasis on the quality of governance before we invest. We find that it is best to frontload our governance work. If you take shortcuts at the front end, Asia has a risk of making you pay for it at the back-end. Something might go wrong and then you are going to have to roll your sleeves up to try to extricate yourself.

One explanation offered for the disinterest of some investors in Asia is that, while they understand the intellectual merit of governance, practical application is a challenge because of things like concentrated ownership and government ownership. This introduces complicating political goals that might not match the shareholders goals. So they lose confidence in the cost-benefit of the engagement process. How should we think about those challenges?

David Smith (Aberdeen): With concentrated ownership the emphasis of corporate governance is highlighted. We are investing reasonably chunky investments I would say, a conviction portfolio if you will. We are typically the second-largest investor I suppose in many of our companies behind someone who would have 16-17%. In that kind of situation, the onus is on you as a shareholder to do your research to make sure you are investing with someone who takes corporate governance seriously. To ensure you are finding a likeminded individual or a likeminded family. If you find the right one, then that's a very powerful alignment; someone who's focused on multi-generational wealth creation and transfer. But if you find the wrong one, that can be a much less comfortable position to be in. We certainly think Asia's concentrated ownership puts a lot of onus on us to really think about corporate governance before we invest.

Interestingly academic governance research often finds that family-based companies (and or founder-run companies) often outperform as long as the right conditions exist. Would you agree? What are the right conditions?

David Smith (Aberdeen): That is absolutely right. If you are the type of investor who holds a truly long-term perspective, a long-term view on value creation and on strategy and execution; then finding a major family shareholder can be ideal. This is by virtue of sometimes their similarly large investment at stake but it can also be their outlook. They can be more willing to look at an investment opportunity that may not pay back in the next three or four quarters but they can assess that in two to three years and so, they (and therefore we as a large minority position) will be very well placed. It is tough to make that case in some markets but we are reasonably comfortable with the families that we invest in. They do have that long-term perspective, so we are pleased to be co-investors there.

CLSA has for more than a decade rated companies on the quality of their governance, however, no one really rates the research community or investors in their own contributions, how do you think the Asian investment community is doing in terms of tangible actions to actually precipitate improvement?

Aberdeen sees companies and investors sharing mutual obligations

David Smith (Aberdeen): I guess I can talk about how we view our role. We would say that there are certain responsibilities on companies. They have to comply with certain codes, they should treat shareholders fairly, they should have a long-term view of value creation and generally they should do the right thing. As investors we also have responsibilities to the companies as well. That includes making sure we are there to act as a sounding board for them when they are considering directional decisions for example. I want to stress these are more of high-level discussions, we are not tinkerers. Sometimes we can give some advice from what we see elsewhere in the region. It may be that if we are investing in a company that is relatively small cap then we can add a little bit of value, one would hope, in the discussions we have with management.

One very simplistic example of this is where you have a founder-led company who brings in some professional management and wants to put in place an option scheme. Sometimes founders are great at running companies but less great on the intricacies of stock-option plans. That is where we can say 'look you probably don't need something as complex as A or as longwinded as B, we suggest something that is easier to understand and ties in with your strategic targets as preferable for you and so would propose a scheme that looks like this.' This is based on our experience and also if it aligns with the family's perspective and our own.

Is it the vote action that matters, or engagement over time?

A vote is a culmination of private engagements; it is rare we would use it to first raise a concern

David Smith (Aberdeen): There are some things that investors may take a structural view on, something like a general mandate to issue shares. But for issues that are more strategic I think the vote is typically a culmination of private engagements. It is rare that we would first voice our concerns through a vote at an AGM. So there is lot of engagement that happens during our meetings with management. We will want to convey our views on things like dividends, board compensation or strategic issue. These can go on for some time. We have had engagements that go on for years. If you think that engagement in Asia means initiating an engagement in January and seeing some results in March or April you are going to be quite disappointed! Of course, one of the elevations of engagement is a vote at an AGM. That is where you want to be more vocal in your dissatisfaction but it is certainly not the first option. A lot of engagement goes on behind the scenes before we get to that point.

Do investors have an obligation to demonstration commitment to and knowledge of a company in order to request management facetime?

We think that it is incumbent on us to be responsible and engaged owners

David Smith (Aberdeen): I can't speak for all investors but we see our investments as more of a partnership for a long term position. As I mentioned earlier, we certainly think that it's incumbent on us to be engaged investors and give our views. We don't trade in and out of positions. When we ask for management's time we hope that management also get something out of the meetings. We are not sitting down asking them what their GP margin forecast for the next quarter is. We're hopefully pushing on their strategic challenges, whether they have got the right bench strength, what their balance sheet looks like, how they are thinking about competition, where they would like to drive the business over the next three or four years. Our general feedback is

The changing trends is more access to above the C-suite (the board) and below (business heads)

We are getting more access to board level nonexecutive directors

Speaking to both management and boards is the richest most useful interaction model

that management find our meetings somewhat useful. We are not in the business of peppering management with data point questions. So to our view, we think that it is incumbent on us to be responsible and engaged. We also think if we have capital invested in a company then management should speak to us and pleasingly they do.

We suspect your ability to get access to the management is better due to your scale and style of investment. Within that context, if you reach a certain scale and commitment level is Asian access comparable to the rest of the world, or do gaps exist even for very substantial and long-term holders?

David Smith (Aberdeen): We do believe that our style and long-term view gets us reasonable access to management. Management know we won't ask for quarterly datapoints and I would hope they would expect a valuable discussion. Once a company gets over that hurdle and gets a comfort level then sure, it helps with access in the region. Of course, there are pockets of difference, but on the whole we get good access. Where things are changing, and this is more for the market as a whole not just for Aberdeen; is investors are getting better access to more sub C-suite management. You've seen a lot of reverse roadshows, you are seeing things like business heads being brought out to see investors; so that is changing across the market.

One other pleasing change, I am not sure if this is the case for other investors, is we are getting far more access to board-level nonexecutive directors like the chairman around the region. This has certainly been the case in Australia, Singapore and Hong Kong for example where maybe you didn't get that access 10 years ago when I first moved here. Now we are having reasonably good discussions with chairmen. We have done quite a few of them in Singapore this year for example, where we are able to sit down and say 'we want to talk to you about your view of company strategy and management's execution of that strategy for example. How does the board view progress, how do they view resource allocation?' These are different discussions but certainly good for us as a long-term investors to get a handle onto the people who are overseeing management.

What is the more productive conversation, both from the perspective of investors and the company, a board-level discussion or a management-level discussion? Or must investors do both and if so what is the right balance?

David Smith (Aberdeen): We find them both productive but for different reasons and of course at different points in cycle. The core to our process is interaction with management and we will typically try to meet management two, three or even four times a year. This is not just for financial updates but for strategic updates as well. How are you tracking against your plans for this year, how are you tracking against your strategy. But also we find meetings with the board members useful as well. They can give you a different perspective. Sometimes management will tell you everything is hunky dory and the board will flag certain issues that they are less comfortable with for example. It is also useful when the company is going through turmoil - maybe turmoil is a strong word - a strategic change or the industry is challenged or the company is changing strategy, then discussions with the board are incredibly useful to get a different perspective on that. So both discussions are useful but for different reasons. As investors what we want to do is to understand our companies and their people as well as possible, so it all helps to build that picture.

Are more board interactions a missed opportunity not just to improve the quality of the discourse but reduce the direct drain on management time?

Talking to boards is a fantastic way to build conviction in the governance process

David Smith (Aberdeen): Yes. Whether it reduces the burden on management I don't know. I am not sure if investors would reduce their request for management interaction having met the board because the discussions are by nature different. I think this is a missed opportunity for companies to be able to say 'this is our long-term strategy and go talk to our board, who are the ones that are holding us to account as nonexecutive directors, and see what they think'. They can also highlight the background of the directors and the skills that they bring to the board to give investors some comfort that the corporate governance mechanisms and checks and balances are in place.

Board interaction is far more valuable than reading bland governance disclosures

As investors we get a lot of detail on financials in an annual report but when it comes to corporate-governance disclosures, they tend to be somewhat bland and boilerplate so it is difficult to see if governance is actually working. So you can have quite good discussions with board members. You can talk about what was the focus of the discussions in the last year, the dynamics within the board, the skills that directors think need to be added to the board to meet the challenges of the industry or the company's strategy over the next three to four years. It is quite useful for us to see how governance actually works rather than reading disclosures that can be fairly bland in the annual report.

Isn't meeting investors that sometimes only own basis points of a company (sometimes for quarters rather than years) a waste of management time? Could companies argue that several hours a quarter open to any and all that wish to psychically or virtually attend is enough?

Long-term engaged shareholders are value counterparties but activists can be also

David Smith (Aberdeen): I have a strong view; management's job is to run the company. It's not meeting investors every Thursday. What management need to do is prioritise what types of investors they want to meet through their outreach. Now they need to provide certain information to the market and there will be quarterly briefings that you mention that usually focus around the results. I think if management are looking to engage investors, and I suggest that they do, they really need to look at those investors either on the register or who may come onto their register that share their views on time horizon. Now they can't ask investors how long do you intend to hold the stock; that is a tough question for anyone to answer. But certainly they will see names on the register that will be familiar to them from their style.

Meeting activists, even if they can hold short-term positions, can still be very valuable

They might want to deprioritise investors that they think are traders. However, even that is a tough decision to make because there are some investors that focus on the short term but can provide very good suggestions for strategic tweaks to the company. Activism is rare in Asia but sometimes activists can come onto the register who make very useful suggestions or maybe make the same suggestions that we have been making but are more vocal about it from the get go. It is tough for management to know what to prioritise and who to talk to because they have finite time. But certainly they should be having good conversations with their larger long-term shareholders with whom they think they can have the most useful discussions.

What are the top-three things that you think investors should be doing more of when trying to improve governance in Asia?

Invest in companies who's behaviours suggests they deserve the capital

David Smith (Aberdeen): Firstly, it starts with capital allocation; that is investing in companies that display good corporate governance. I think the problem is that capital markets tend to be fairly short term in memory and capital is allocated to people or projects that should not necessarily have capital allocated to them. I think once you have invested it is incumbent on investors to have a good dialogue with management and make it clear what you expect from them in terms of execution over the next three, four five years. That is not to say investors should micromanage but have a good discussion about strategy and its execution. Investors should also make clear their expectations of what good corporate behaviour or corporate governance looks like. We need to see it as a partnership that can grow and reel discussions away from things like Ebitda or GP margins for the next quarter, more towards longer-term issues. This will help improve governance in the region.

Advocating for positive regulatory change is also helpful

I would add, that there is a regulatory agenda as well. No one invests hoping that the regulator will save your bacon; by the time you need to ask the regulator for something then typically value has already been destroyed. But making sure the regulatory playing field is conducive to long-term investing and reduces avenues to expropriation for example and removes some of those temptations that might be there is also something that investors should be focusing on. There are areas around the region where we think regulators can do more, on the whole they are doing a good job, but there are areas that regulators should focus on and I think if you are a long-term investor then these kind of 'rules of the game' or 'out of bounds markers', call them what you will, are smaller but important parts of the job.

While collaboration is typically the best means of mutual advancement, there will be times when investors absolutely must call boards and or management to task? Do you think that is happening enough? Just to make the question a little bit tougher we found out through this process that the percentage of votes that receive a 'no' can literally be as low as basis points...

It's important to vote your convictions even when the result is already known

David Smith (Aberdeen): So there are several issues here. The first one is what I would call the piping or the regulations around Asia. It can mean that you are investing with a controlling shareholder with 60 or 70% and if you are upset with management's actions it can be challenging to defeat a resolution that's on the agenda. Even if all minority shareholders vote against, it will still pass so that's a structural issue. We think there is value in voting against a resolution if we feel strongly, even if it is going to pass, because then we can show it to management. We can say if you remove the family vote you can see that no one else favours this resolution and that has been particularly useful in the markets like Hong Kong for things like general mandates.

Asian investor can say 'No' more often to poor resolutions

Has there been enough calling of management or boards to account? It's not enough I would say; but that is probably true of most markets. Certainly investors could do more. I think there can be a preference for the Wall Street walk (selling your position). There are always some parts of the market that will say this is just too difficult so let's move on; particularly given the presence of controlling shareholders who will dominate the AGM vote.

In part the director nomination and elections process is the challenge

This is where I have a bit of an issue with the voting structures that we have in Asia. We place a lot of emphasis on independent directors and say they are the ones that should hold management to account. But the reality is that they are recruited by, nominated by, and appointed by, the controlling shareholder who determines their presence of the board. So they do, in effect, serve at the pleasure of the king. So Asia, for the most part, has imported UK-style corporate governance Cadbury codes for AGM election. You can say that Asia should probably take a different approach if we are going to put so much emphasis on independent directors. If you look at the UK experience, the UK has actually amended AGM voting for controlled companies having had that experience recently. Now there are two votes, one by all shareholders and one by just minority shareholders. So the second vote is an advisory vote, I shan't go into details here but it's an interesting situation.

Maybe we need to rethink the way that we elect independent directors

Maybe to help minority shareholders hold management or the board to account more, the voting mechanism needs to change? Because even if you are incredibly unhappy with a director and you vote against, if the controlling shareholder re-elects him and shows a lack of interest in what minorities say, then as a shareholder you are challenged. That goes back to my first point of doing your homework before you invest. It also means that maybe we do need to rethink the regulatory landscape in Asia particularly around how we vote for and appoint independent directors. Most regulatory review, most changes to regulation focuses on independent directors and we're putting more and more onus on them to be arbiters of equity. Is this transaction fair and reasonable? Let's get an independent director's view. But the reality is that these individuals are appointed by controlling shareholders. So maybe in order to hold them to account we need to rethink the way that we elect them.

We have heard much debate about independent directors. You also mentioned earlier the challenges of boilerplate disclosure. Certainly independence is one concept that is easily gamed. It would be very interesting if we went to a world where selecting independent directors was equivalent to a related-party transaction; that would change the game in Asia.

We end up voting for independent directors based on independence rather than competence

David Smith (Aberdeen): Yes, you are absolutely right, and we do say that one share, one vote is holy to investors. And I am sure you will have seen the discussion in Singapore at the moment on dual-class shares. But for certain transactions, we do disenfranchise controlling shareholders like RPTs that you mentioned. So maybe we should do that for independent directors. As you say it is boiler plate at the moment. I think most of the region is somewhat reduced to voting for independent directors based on their independence rather than competence. So are they independent, tick, should we vote for them, well we have no reason not to, I suppose is what the market says.

David, Pru Bennett of Blackrock was saying her bug bear is that she is far more interested in competence than independence insofar as someone might not be independent but if it is clear through their behaviours that they have the long-term interest to the company at heart, then she values their role. However, she's more concerned that they care about long-term outcome and they are competent not if they fit some specific definition of independence.

One of the bigger trends in Asia is that the independence of directors is being gamed somewhat

David Smith (Aberdeen): Yes you are right. We tend to look to competence and to what an individual brings to the board. One of the bigger trends in Asia is that the independence of directors is being gamed somewhat and you've seen a growth in dependent directors that are structurally independent (for example academics) but dependent on the company for their pension so they bring few other skills to the board other that structural independence.

... and their willingness to say 'yes' to the chairman...

If a director challenges management and brings industry experience to the board then that is great

David Smith (Aberdeen): Yes quite. To Pru's point and this is a point that I would make; if someone is able to demonstrate that they challenge management, they provide a counterpoint to management thinking and bring industry experience to the board then that is great. Then the challenge is; do investors get to meet these individuals. This goes back to our earlier conversation. Great access to the board or certainly chairmen would give investors some comfort, even though a company may be one independent director short of compliance with a code, that the board is robust. That there is challenge and that directors are competent because you would much rather have one borderline director who brings great experience than the one who is demonstrably independent but brings no relevant experience to the board.

Remuneration takes an inordinate share of investor time

Are there any other standout issues that have dominated your attention over the last several years that we have not yet discussed?

David Smith (Aberdeen): Our primary focus is always company strategy and management and board competence. That is fundamental. One issue that has taken up too much of our time is remuneration; particularly in markets like Australia. Remuneration reports are too complex, structures are too complex. Companies sometimes struggle to understand what kind of behaviour these schemes are driving. We'd much prefer to have far simpler remuneration schemes that are longer dated in terms of the performance conditions.

'One could almost make an argument that votes on remuneration should not exist'

One could almost make an argument that votes on remuneration should not exist. We should just hold the chairman of a remuneration committee (rem-com) to account, not hold specific votes. We don't have a vote on strategy for example and that is far more important for the company. In a way, remuneration committees are almost outsourcing that work by having this huge consultation with shareholders to say 'what do you want'. We are tweaking it this way and that and it is taking a lot of our time in some markets; I think many investors would agree. Elsewhere, RPTs take a lot of our time as well but this is nothing new in Asia. I don't think there is sort of emerging issues that the market is not focused on. We would like to spend more time meeting boards and directors I think.

We are seeing a select few companies in Asia making boards available

Australia's practise of making board members available to investors seems to have started to come to Asia. That could be very positive moving forward.

David Smith (Aberdeen): Yes you are right. It's common in Australia to get that kind of access and certainly further afield. In the UK, it is more common as well, ahead of an AGM or in mid-year, the chairman of the board or the chairman of the audit committee might do the rounds with 20 or so of the largest investors. So that is certainly a common practise. In Australia ahead of the AGM, of course, you will get a meeting with the rem-com if you want it because everyone is focused on remuneration as it particularly relates to the two-strike vote in Australia now. We are seeing a few companies in Asia making boards available. That may be the board as a whole or individuals; it is a select few companies but the trend is improving.

Let's collaborate, make as much or your team (management) and board available as possible

Thanks so much for your time, any closing comments for us?

David Smith (Aberdeen): For management teams they should continue to make themselves available to investors. In fact, make as much of the team as is practical available to investors. I encourage boards to have more discussions with investors. I think boards can be terrified that we are going to ask them about minute business details like product margins when really margins are the last thing that we want to ask them about in most cases; it is the strategy and how they monitor strategy. So boards should be less hesitant is perhaps the best way to put it. We are not here to hold their feet to the fire when we first meet the board we just want to understand how the board looks at certain issues. We are looking for a constructive and collaborative relationship with boards and management. It is certainly not going to be a hostile experience, one would hope, unless it needs to be. I encourage more boards to make themselves available to investors and hopefully they will find it useful. Our experience from the meetings we have with chairman and boards is that they have found the conversations useful to get an external perspective on their companies.

Let's hope they do! Thanks again.

Daniel Smith
Glass Lewis

Appendix 6: Proxy advisor

Glass Lewis

CLSA has, for more than a decade, rated companies on the quality of their governance, however, no one really rates the research community or investors in their own contributions, Glass Lewis is obviously an integral part of the voting process, how do you think the Asian investment community is doing in terms of tangible actions to precipitate positive change?

Low voting ratio's in Asia make engagement more important

Dan (Glass Lewis): There is definitely some room for improvement. If you look at pure voting levels it's certainly is not high as it could be. Also if you look at the share registers of listed Asian companies many of them are closely held. It can be difficult to affect change solely through voting. You need to appreciate the practical limitation of being a portfolio shareholder. That is why we think engagement with portfolio companies on governance issues not just for typical topics such as financial and strategic issues can be really valuable. Anecdotally many of our clients that have exposure to Asian equities have ramped up their engagement activity in many Asian jurisdictions over the past few years. But again there is still some work to be done in that respect.

What percentages of investors that are eligible to vote actually do and is this a rising or a falling trend? Are there significantly different trends by country?

Global investment houses are almost universally voting, small investment houses are less likely to

Dan (Glass Lewis): It really depends on the type of shareholder. Often they are large investment houses with headquarters in the USA and other developed market where there are legal requirements for US investment companies to vote their shares. If they are already voting in their US jurisdiction it would be inconsistent at a firm level not to vote in other jurisdictions subject to cost restraints on things like power of attorney or share blocking. In that sense certainly with our clients who are large investment houses, they are voting across the region in Asia. Small institutions sometimes don't have the resources to make informed voting decisions and so they delegate those responsibilities to external managers if they are multi-manager funds or asset owners. We came across some local investment firms domiciled throughout Asia that don't always have the same views on the importance of proxy voting relative to the USA, Australia and UK based investment houses.

What do you think is driving these differences in voting behaviours by size of institution and market domicile?

Differing regulatory backgrounds can contribute to voting differences

Dan (Glass Lewis): It's hard to say with a great deal of confidence. If you are talking about US or Australian firms, these are two groups of investors that I have the most familiarity with. There are years and sometimes decades of compliance obligations really baked into voting behaviours. If the Securities and Exchange Commission in the USA tells us we all have to vote then absolutely we are going to vote. So differences in regulatory environment probably contribute to some degree. You can combine that with general differences in ownership composition. If you are a local investment firm based in Singapore or Hong Kong you would probably expect a large portion of your investment universe to be comprised of companies with a controlling or at least a dominating shareholder on the registry. Here you kind of know that you are essentially going along for the ride. When you combine that with an investment thesis predicated on active ownership then, if you have a fundamental disagreement with the board or the management, you would sell your shares. Whereas in the USA, UK and Australia, with the rise of index-based funds and passive investing, where managers may be replicating the market, the ability to sell out becomes limited. So other tools in the toolkit including voting become that much more important as a means of pressuring management on any areas of disagreement.

Is it the vote action that matters, or engagement over time?

Deep consistent engagement is far more valuable than voting alone

Dan (Glass Lewis): If you look at the mechanism, voting is largely a binary decision. You are either supportive of management or against it. Similarly the voting outcome is binary too; either the resolution passes or it doesn't. As a result, voting as a mechanism doesn't tell too much of a story about why the result was cast. It does have a benefit as a signal and that is why sustained engagement, and here we are not talking about once in a blue moon, a consistent regime between management, boards and shareholders over long periods of time to develop mutual understanding and a context of nuance can be really valuable. I think that probably matters more in the long term.

On the engagement front, many investors lament a lack of access to management in Asia. We (CLSA) tend to see Australia as a benchmark for good governance, how does Asian access today compare to Australia today?

Australia's access sophistication makes it almost unfair to compare Asian markets

Dan (Glass Lewis): Australia has a really sophisticated engagement regime. In that sense it is almost unfair to compare Asian markets against Australia. In Australia corporate access is largely not an issue either for an individual equity analyst getting access to management for the investment decision-making process or for the corporate governance or ESG experts to gain access to the board. Those streams of engagement are very effective. We don't see that level of intensity across those multiple streams nearly to the same degree in Asian jurisdictions. It is at a slightly higher level in Singapore, Hong Kong and Japan but again not nearly to the level we see in Australia.

If the regulators and companies across the Asia jurisdictions were trying to think about what a sophisticated model looks like, what are the hallmarks of the Australian model that you think are most valuable?

Australia's process runs separate NDRs (management) and governance roadshow (board)

Dan (Glass Lewis): Again it is important to look at it in two separate streams. One is the traditional access that portfolio managers and equity analysts have to management to ask fundamental questions relating to the finances, strategy and operations of the business. Separate from that stream is the corporate-governance stream. So to what extent do governance specialists who may or may not be equity analysts or portfolio managers themselves have access to the board and to governance experts at the company. Again separate from the CEO and CFO, to ask questions about process and oversight and risk management. In Australia those channels are clearly understood by the largest companies. Boards have built into their quarterly or annual calendars the expectations that they will block out chunks of their time for so called governance roadshows which is different to the typical nondeal roadshows where the CEO and CFO typically meet with portfolio managers.

What is the more productive conversation, both from the perspective of advisors' and the company, a board-level discussion or a management-level discussion? Or must investors do both and if so what is the right balance?

Company secretary can be an excellent way to begin a relationship with the board of directors

Dan (Glass Lewis): It depends on the context, for example, the previous level of engagement that the shareholder has had with management and the company broadly and how involved or receptive the directors are, for that matter. We should also consider what governance issues are going on with the company more broadly. In our experience from interacting with companies who are at varying stages of maturity in terms of governance engagement, the company secretary is often times a really good starting point due to the unique nature of that role. Because they are supporting and effectively reporting to the board but they are still a member of management. They have the ability to translate what is going on from a process and governance point of view to shareholders without getting caught up in spruiking the business. I think what can happen if you are talking with a CEO about governance issues (I am painting with broad brushstrokes here so bear with me) is that often times you get him or her in front of investors and all they want to do is talk about how great the company is.

It can lay a foundation for more targeted and so productive conversations thereafter

If the discussion is on the oversight of the process you are not going to get much out of talking to the CEO. Conversely if you want to talk about that with an independent director who is not comfortable fronting shareholders then you are not going to get much benefit out of that either. That is where having the company secretary at least as a starting point can establish a good foundation. It creates better rapport, they can take the perspective that 'hey, wait a minute investors or proxy advisors are not trying to screw management, they have legitimate issues that they want to discuss and they are receptive to company's point of view'. Building that rapport initially at that level lays the foundation for further discussions down the pike with actual directors.

So it sounds like you would agree with the argument that business issues are for management discussions and governance issue for board discussions?

Board members' style and knowledge should inform what kind of meetings investors' request

Dan (Glass Lewis): Generally, I think that is pretty much on point. Again it depends on how involved the chairman is in the business itself. Often times we chat with chairman and you can see there can be quite stark variances in the types of chairman. Some of them are very hands on and are comfortable getting into the weeds on even operational issues or the mechanics of the execution of the strategy. They can be very happy to front investors or at least proxy advisors on these issues. Other chairman, perhaps their skills are in other areas and so don't feel comfortable going into that level of detail on those matters and so much rather defer to management. And that's okay, we are not saying we have preference either way, but from a shareholder's point of view being able to assess what is a reasonable expectation of who you should be speaking with at the company is useful. You might be barking up the wrong tree depending on who you are trying to get access to.

We often hear about limited access to board members in Asia. Would you see that as a missed opportunity not just to improve the quality of the discourse but reduce the direct drain on management time?

Board members can augment management meetings and improve engagement productivity

Dan (Glass Lewis): Yes, I think there is some legitimacy in that. There is no denying that shareholder engagement regardless of whether it is with investment analysts on financial and strategic issues or government specialist on government-process issues, takes up management time. There is preparation for it and travel time especially when you are doing roadshows. There is no doubt, the board stepping in and taking some of the load on the governance-related discussion with shareholders could effectively help management deploy the scarce resource of their time more effectively.

Isn't meeting investors that sometimes only own basis points of a company (sometimes for quarters rather than years) a waste of management time? Could companies argue that several hours a quarter open to any and all that wish to psychically or virtually attend is enough?

Management can't meet everyone but ultimately they must engage with the providers of capital

Dan (Glass Lewis): That is similar to the preceding question and there is a fair amount of overlap with the one you mentioned prior to our call that says 'do investors have an obligation to demonstrate commitment and knowledge in order to request face time.' I think it is a slippery slope there because by whose definition do you meet certain amount of knowledge, commitment or minimum threshold of shareholding. It is not realistic for management to meet every shareholder or potential shareholder. However, severe restraints can be used as an excuse to deny access to discuss legitimate issues. Shareholders ought to leave it to management's discretion. But to be clear, putting the onus on shareholders to prove they are worth management's time seems to get the issue backward from my point of view. At the end of the day they are the ones providing capital.

Is that really true? If you own five basis points of the company and trade on short holding periods how are you adding any value to management or any real value-add in the true capital allocation function. For some investors surely management have an obligation to say no on the argument that Warren Buffett is right, ultimately you get the shareholder that you deserve?

Companies should consider meetings based the expected quality of the interaction

Dan (Glass Lewis): That is a fair enough point. Then I think it becomes a question of what are the issues that shareholders are wishing to discuss. What is the legitimacy of the types of questions and comments those shareholders want to bring up to management. Instead of talking about how long this investor is going to be on the register or how large of a stake do they have in my business, that is irrelevant. What is more important is, are they pointing out materiality gaps in my disclosures, that through addressing I might be able to potentially rerate my company value in the market. I think there is some resonance there in terms of, if engagement help facilitate better disclosure to all shareholders which allows the market to calibrate a clearer reflection of value in the share price, then the market overall, and company in particular, is better off.

We have heard that for some companies where governance was not particularly strong but they were starting to engage, they were finding the processes uncomfortable but quite valuable. Has this been your experience?

Valuable on engagement becomes most clear after long period of persistence

Dan (Glass Lewis): Yes very much so. This is something we see in Australia where we have very robust engagement regimes and where we reach out to every company in our research coverage and that's about 650 ASX-listed companies. You can imagine we get quite into the micro-caps. Obviously, we don't meet with all of them on a yearly basis but we meet with about a third of them. Over the years, we have developed relationships with directors to get a mutual understanding. When you are sitting across the table from someone for the 10th or 12th or 15th time over the course of the years, you develop a mutual appreciation of each other's perspective. We have certainly seen that anecdotally, and taking a step back to a market-wide level, a translation of that into enhanced disclosure and I think more meaningful disclosure on the key areas of governance matters that we have been focusing on.

What are the top-three things that investors need to do more of when trying to improve governance in Asia?

Keep trying to engage and prepare to ensure high quality engagements

Dan (Glass Lewis): Keep on trying to engage, in other words, don't give up. When you get a meeting, come prepared, know the company's specific context not just your own policy approach. Finally, make sure you clearly articulate the relevance of governance issues to the core investment thesis of your firm.

What is the fundamental role of proxy advisors in your mind? What do you think are the frustrations that investors might have?

Proxy advisors sometimes play the role of foil to help investors say 'no'

Dan (Glass Lewis): I think the proxy advisors play an important role in the governance of companies and as a part of the investment decision-making process and investment-maintenance process. Our research helps investors identify risks in their portfolio companies. Of course, it's their right to determine how best to integrate our research into their decision-making process. For some investors that may mean using our research as a foil, almost like a 'good cop, bad cop' strategy. And that way it potentially allows the investors to avoid losing access to management. We have received specific feedback from some of our clients that they sometimes feel reticent to vote against management lest they be cut out of the corporate-access market.

Couldn't you argue that is a value-added function? While it can be frustrating as proxy advisors yourself in that partly you want investors to own the decision. Especially if the choice to own the decision is more likely to precipitate behavioural change from management. But if we are on a spectrum in a journey when we are waiting for the behaviours and accepted norms to evolve over time; isn't it better to blame the proxy advisors but vote and send a signal. In an Asian context often an indirect message is heard more than a direct one? That way the change process at least begins.

The foil role can help in the journey to better behaviours – engagement is key to make that work

Dan (Glass Lewis): Well you don't stay in the proxy advisor industry for long if you don't have a thick skin. As a service provider to our clients, within constraints, we are happy for them to rely on our recommendations and research as they see fit. If that means we need to jump on some grenades for them then so be it. To be clear the key thing is that we don't want to raise issues for the sake of raising them. We want to identify the core fundamental risk for the long term investment process for that particular company. So it is ultimately for investors to manage how they deal with that. We think it can be quite constructive for an investor to front a board, or a company secretary or and IR officer and say, "hey look Glass Lewis says this and that is a big concern for us, how do you respond to that?" If this facilitates a dialogue that contributes to better outcomes for shareholders even though it causes grief for the company, then so be it. It doesn't have to mean that it ultimately translates to a vote against management. In fact if we had to choose between a vote against management and a positive outcome but the resolution passes, we'd prefer resolution to pass with the discussions behind the scene.

Our understanding is that it is only actually a small percentage of resolution that is ever actually rejected. So the question becomes, is there any evidence that investors are actually saying no and is this behaviour changing?

Investors can vote yes but privately express concerns to constructively affect change over time

Dan (Glass Lewis): I think what happens behind closed doors in the privacy of board rooms and phone discussions is a lot more meaningful than reading the vote results. Even though you don't see as much change as one might expect we don't have any problem at all with that change happening slowly as the result of discussions happening outside of the public domain.

We have consistently heard that Australia has changed dramatically. Does that offer a fundamentally optimistic perspective for Asia, with the core constraint being the concentrated ownership, or is that a naïve perspective. Are we headed for dramatic improvements in governance in Asia or incremental changes that might prove underwhelming in the long term?

Be optimistic about Asian governance long term, but it is about long term

Dan (Glass Lewis): For Asian governance I am quite optimistic for the long-term outlook. But I don't think it will happen at a pace that a lot of developed Western-market players would expect or prefer. In that sense, you have to play the long game. Certainly among our asset-owner clients, especially, and our asset manager clients, who are, in effect, universal owners because of index-based approach, where they can't do the Wall Street walk; they will be invested in these companies for 10, 20, 30 years. Sure their relative weighting might fluctuate on a periodic basis, but otherwise they are in for the long haul. So if you are willing to play the long game, then I think our optimism is well placed.

What are the key developments that have taken the bulk of your attention in the last several years? What should we learn?

Dan (Glass Lewis): Be aware of unintended consequences of regulatory or legislative change when it comes to governance issues.

That is interesting, is there something specific that you have in mind? What might that mean for investors reading this?

Look for unintended consequences of regulations (good and bad)

Dan (Glass Lewis): To use Australia as an example, in 2011 the two-strike regime was introduced. This was legislation regarding voting on executive remuneration. If you get 25% votes against you get a strike, if you get two strikes over two consecutive years, it is a potential board spill (all board members stand for re-election). So the fear at the time was that it will prove a massive destabilising force. In practice, in the five years since its introduction that has not happened. But what has happened is it really helped to ramp up the level of engagement especially between boards and shareholders.

That is an example of unintended consequence. Going back to the USA there is a slightly different example. Back in the early 90s, the Clinton administration introduced legislation on the tax deductibility of executive compensation, such that only certain types of compensation could be tax deductible where incentive pay was tax deductible, but they put in a threshold of a million dollars that would be considered the limit on what could be deducted for tax purposes. Conversely, what happened as a result of the legislation was, basically instead of putting a cap on bonuses, it put a floor on bonuses. Highlighting that it was tax deductible so that companies could write-it off, made them more inclined to bigger bonuses. So again we need to be careful with the knock-on effects of regulations. Often time, things happen outside the realms of conception.

Yes, we saw that in investment banking where they started limiting bonuses relative to bases so the industry raised everyone's base pay.

Dan (Glass Lewis): Exactly. So what we've done as the result, is adapted our focus to addressing the knock on effects of regulatory or legislative changes.

We hope that this report will be read by many investors, historically that has certainly been the case, if you could send a message to your clients about how you would most like to work together to improve outcomes for all stakeholders what would that be?

Be as open and transparent as you can with your proxy advisors

Dan (Glass Lewis): In that regards, we would say to investors, be open and transparent with proxy advisors on what your priorities are. It is not that we have the ability to guarantee making those our priorities. But at least we know where you are coming from.

Is there a message that is relevant to boards or management?

Dan (Glass Lewis): Yes absolutely. What is key for us is that companies and boards should really be telling their story about how their governance supports their business. Governance-related exposures often get shoehorned into compliance, lowest common denominator box-ticking exercises. But if you don't look at it as a compliance exercise but more as a communication exercise, really kind of telling your story, I think that's where companies are finally working out governance has a tremendous ability to really add value to all of their the shareholders.

Thanks so much for your time.

Jun Frank
ISS Corporate Solution

Appendix 7: Corporate consultant

ISS Corporate Solutions (ICS)

CLSA has, for more than a decade, rated companies on the quality of their governance, however, no one really rates the research community or investors in their own contributions. Are we being a little hypocritical, should we be evaluating ourselves more?

investors are the most engaged on governance in Asia

Jun (ICS): Investors' actions vary by market. In Asia, foreign investors who are based in Europe or the USA and invest into Asia are most active. They tend to be pretty engaged in terms of voting. Foreign investors are also more likely to be engaged with the company to push for change and exchange viewpoints. Asian domestic investors in general are less engaged in terms of exercising their rights as shareholders.

Looking at regional differences, there are possibly cultural and institutional elements. For local Asian investment communities one of the simplest ways to break it apart is the pension community versus the rest. Is there any evidence that pension funds are more engaged or becoming more so?

However, there is clear evidence of increasing engagement from Asian pensions

Jun (ICS): There are certainly signs that pension funds are starting to become more engaged. Asset owners and their rising expectations are key drivers in terms of the investment community getting more engaged with companies. If asset owners don't demand better corporate governance, asset managers will not spend the money to do it with conviction. In Japan, GPIF (Government Pension Investment Fund) is pushing for more engagement and exercising of their ownership rights. In Korea, there is some push for it and in Hong Kong we are talking about the stewardship code, which pushes for more engaged asset owners and asset managers. Also, in Malaysia, asset owners are becoming more active. However, compared to institutions like CalPERS in the USA or Norges Bank in Europe, there are still significant gaps between what asset owners in Asia are doing, compared to what the assets owners are doing in other parts of the world.

Do you think part of it is the scale and maturity of the institution in that the bigger you are the greater the expectation from the community that you have the resources to be organised and systematic in executing your governance responsibilities? Also, longer histories allow more time to develop the organisational capabilities. Evidence of that would be if there were signs that some of your clients had been far less engaged 10 or 15 years ago.

Market maturity and ownership structures heavily influence governance

Jun (ICS): Yes, I think the maturity of the funds and the market has a lot to do with it. Also there are differences in mindsets as well. Culture is a strong factor in Asia. When you look at overseas markets with clear active ownership it tends to be more mature markets with longer histories and more established institutional investors. Typically, they will have a few champions within that market who are pushing or voting for better stewardship. I think capital markets in Asia tend to be much younger and institutional investors have shorter histories of active ownership. Also in Asia, confrontation is sometimes taboo, which is further complicated by the fact that ownership in Asia can be highly concentrated with the founding family or the state as the controlling or major shareholder. In these cases, their vote can determine the outcome of meetings. This means there is less incentive to be active or vote because there is a sense that your votes simply don't matter.

Do you think change champions like Elliott and or Dan Loeb at Third Point can play an important role in evolving the Asian governance culture?

Asset owners have a key role to play in improving Asian engagement

Jun (ICS): The role of the champions is very important. However, when I refer to champions in terms of active ownership I am thinking more about champion voices coming more from traditional investors and asset owners like GPIF, PFA (Pension Fund Association) and even their asset managers. Hedge funds often trigger mixed views. Some see them as agents of positive change while, conversely, others view them negatively and see their legacy as controversial. In my estimation, advocates for good governance would like to see mainstream managers and owners taking up the cause, seeing the value in corporate governance and taking actions in line with their view. I believe they would like to see asset owners encouraging managers to vote and engage. In many markets, managers raise awareness of the issues that concern them and encourage other institutions to do so as well. However, I don't think we see as much in Asia compared to other markets.

Conflicts of interest are also an impediment to improving governance

Another significant impediment to more investor-issuer engagement is conflicts of interest. Often times in Asia, asset managers themselves have significant business with or are even owned by the corporations. When an investor has significant business dealings with the listed companies, the institution may become much less willing to challenge management and may not want to exercise voting rights. They are often supporting management when they do vote.

It is interesting you mention explaining the value of corporate governance to institutional investors which might surprise some readers. Are you making a distinction between the intellectual value and real world applications?

Short investment horizons and tight holdings can limit the interest in and impact of governance

Jun (ICS): The value of governance is broadly understood. One consideration is the cost-benefit of engagement. If investors conclude a vote cannot influence the outcome they may opt not to do it. Another important factor is investment horizon, for markets like China there is a higher propensity to trade frequently. For those investors that are trading based on price movements and quarterly earnings, governance is less likely to be an important factor.

What percentages of investors that are eligible to vote actually do and is this a rising or a falling trend? Are there significantly different trends by country?

Data is spotty and range by market is wide but vote participation is rising

Jun (ICS): The data is spotty. A lot of markets do not disclose voting results and or the breakdown of the vote. For those markets, we have no data on voter turnout or approval rates. They are Korea, Malaysia and Thailand. Aggregating markets with robust data we would say the regional trend is improving. In Hong Kong, the voter turnout was roughly 68-69% last year for the companies covered by proxy adviser Institutional Shareholder Services, the parent company of ICS, and this year it went up by 1ppt to around 70%. So it is slowly improving. For some markets like China, the data is less encouraging where the voter turnout is about 55%; however, this data includes the controlling shareholder vote. Therefore the actual turnout for minority shareholders is an extremely small percentage. I believe Japan has the highest turnout in Asia with around 80% among large companies.

So differing degrees of market maturity and investor sophistication by country dictate much of the voter turnout.

Higher institutional ownership leads to higher voting participation

Jun (ICS): Yes, shareholder composition is important as well. Retail investors tend to vote less. So higher institutional ownership will typically lead to greater voter turnout. So for markets like China where significant portion of the market capitalisation is owned by retail investors we see lower turnout.

Looking at how retailers invest, one increasingly popular vehicle is ETFs. Is passive investment good or a bad for governance trends moving forward?

Benefits of passive investment outweigh risks from a governance perspective

Jun (ICS): From a governance perspective passive managers could be well engaged with companies. They have resource constraints so obviously cannot engage with every company, but many vote on the companies they invest in. They also screen companies for problems and engage with management. Because they cannot trade in and out of stocks their risk on corporate governance is greater relative to other investors. Therefore, from a governance perspective I would say it is positive for large passive investors to own a material portion of the market to provide stewardship and enforce good governance behaviours.

Is it the vote action that matters, or engagement over time?

Both have a role depending on the cost and potential benefit at stake

Jun (ICS): I see this as a continuum. Voting, engagement, activism and even shareholder litigation are all ways of exercising your ownership rights. Voting is the method with the lowest cost and risk. For voting you can outsource the process and it is also the least confrontational option. You can be anonymous, you do not have to explain why you voted a certain way and you are only one of many voters. Engagement can be more costly and potentially cause tension with company. To engage you need to research your portfolio to identify the specific issues to address. You need to talk to the companies consuming time and resources. These costs can increase as you escalate an issue with decisions such as proxy battles and litigation. That said, with that escalation comes the potential for greater rewards.

Many investors lament a relative lack of access to management within Asia. We (CLSA) tend to see Australia as a benchmark for good governance, how does Asian access today compare to Australia access today?

Australia offers significantly better access than Asia

Jun (ICS): From an access perspective that is a very easy one to answer. Australia is different from many of other Asian market. It is very common for institutional investors to engage directly with chairmen and C-suite executives but in Asia it is not as easy to get executive-level access. As to whether Australia is an appropriate model for Asia I am less sure. Structural and cultural difference may make it an unrealistic target for Asia.

How is the trend of Asia compared to Australia? Has the gap narrowed or widened and what are your expectations for the future?

There is a clear trend for more engagement, especially in Japan

Jun (ICS): At least in Japan it is getting much better and that is the feedback from my corporate clients. After the introduction of the stewardship code the dynamic of investor and issuer relationships has improved. More investors are asking for engagement with senior management. Furthermore, not only are the companies responding to more requests for engagement but they are making requests themselves and making senior executives more available. We see more CEOs attending IR roadshows and even governance roadshows in key markets where major investors are based. Also, during periodic analyst briefings more senior executives are attending the calls compared to just having the CFO or more junior person run it. So the trend in the last couple years in Japan has been for more engagement from senior executives.

My understanding is that Japanese culture is not a confrontational one at all but we see this huge change. While perhaps not confrontational what's driving the more proactive engagement, is it Abenomics?

Government reform has contributed to improving engagement in Japan

Jun (ICS): Abenomics was a major factor pushing for change. It's also critical to remember that engagement doesn't necessarily have to be confrontational. A lot of the times it is much more cordial. With Abenomics and the Ito Report that was very influential, it became more accepted in the minds of Japanese investors and management to talk about things like capital efficiency, shareholder returns and the strategy for the company. Previously, the discussions only focused on numbers and financial forecasts when investors were able to meet with management.

What is the more productive conversation, both from the perspective of investors and the company, board-level discussion or management? Or must investors do both and what is the right balance?

There is increase demand from investors to meet board members

Jun (ICS): Institutional investors tend to prefer meeting senior executives like the CEO or CFO. A growing trend in the rest of the world, not so much in Asia, is gaining access to independent directors such as independent chairmen or the lead independent director. Shareholders, of course, want to meet with the CEO, but increasingly they also want to speak to independent directors who are actually charged with representing their interests on the board.

One interviewee has argued, when an engagement's sole focus is governance, that discussion should be exclusively with the board. Would you agree?

It makes sense to focus governance question to board level interactions

Jun (ICS): I think it makes a lot of sense. The board is the body responsible for installing proper governance structures and providing checks and balances. They should be the agents of shareholders to monitor management. So I think it makes sense to talk to board members and independent directors about governance issues. However, from the perspective of some companies (especially in Asia) it may be difficult to allow access to nonexecutive directors. There are sensitivities around what information is disclosed for fear that the company may not be able to control the message

Isn't that exactly the point? The board is supposed to be the guardian of governance whereas management's incentive is to control the message and in many respects their continued tenure is based on sustaining the market's approval where messaging plays a key part. Isn't a reduced ability of management to control the message regardless of substance a good thing?

No all directors are comfortable with or trained to communicate with investors

Jun (ICS): Not every director is sufficiently prepared to speak with institutional investors and represent the company. These directors may need training on what is allowed to be disclosed or not. What some companies have done is to assign lead directors or the chairman as the main person who communicates with investors where the company must make sure to provide sufficient support to these directors. So what I mean by controlling the message is that when engaging investors in a private setting there is always the risk of inadvertently leaking insider information. This could prove a significant problem for all parties. Directors must be trained in how to be able to effectively handle these communications and what can be disclosed.

Doesn't this come to the issue of competence? One of the things that we are hearing is that you need competent board members that can demonstrate they have the requisite skills to be value added in their roles. The danger for tightly held companies is that the board can effectively become a façade to create the appearance of appropriate governance structures. Isn't the best way to demonstrate the substance of the board to make them available to those whose job it is to assess the substance of a company's governance?

But investors need to develop this competence and should be available

Jun (ICS): I absolutely agree with that. I think it is reasonable for investors to demand access to these board members to really assess if these board members are truly representing their interests. However, and on a practical basis, agreeing to every request by investors may not be feasible. Directors are busy people with competing demands on their time, so assigning a specific director to engage with investors could be a reasonable compromise for both parties.

Is it fair to say that boards are even harder to access than management and would you see that as a missed opportunity not just to improve the quality of the discourse but reduce the direct drain on management's time?

There is some efficiency to providing access to the board but its more about quality of discourse

Jun (ICS): Usually when directors engage with investors a member of company management, IR or some other company representative is also present. There are some resources that need to be set aside to support director engagement. But absolutely, CEOs and chairmen are very busy people. Having someone else available to engage with investors could reduce the burden on management and help improve the delivery of investor's opinions to the board, which could help them execute their roles. Another opportunity is simply proximity. For Hong Kong for example, a lot of investors are based overseas and some of the board members are based overseas. So it is logistically easier for these board members to meet with investors.

Isn't meeting investors that sometimes own only basis points of a company (sometimes for quarters rather than years) a waste of management time?

Companies should absolutely be strategic about who they meet with and how they do it

Jun (ICS): Companies certainly need to choose with whom they engage. They have limited resources. It may not be the best use of time to talk to someone who will hold your stock for days or months; these investors are also less likely to be interested in talking about governance. Companies should prioritise by both the size of ownership and by type of investor. Of course, companies should seek to be closer to their biggest holders. Also, longer-term investors are likely to offer more mutually beneficial engagement. Companies should also talk to investors who are known for activism to understand what they expect from your company. So absolutely be strategic about engagement.

Is there scope for mutual benefit from engagement?

Management can benefits form engagement as much as investor can

Jun (ICS): The feedback we get from the companies we advise and their investors is that typically engagement is valuable for both sides. Investors can get a better understanding about management, their vision, governance and their execution, while companies gain a better understanding of institutional investors' perspectives. Sometimes they hear good ideas about capital management, for example.

Could companies argue that several hours a quarter open to any and all that wish to psychically or virtually attend is enough?

Quarterly briefing is not enough, private engagement is also required and many actively do it

Jun (ICS): Quarterly analyst briefings do not negate the need for private engagement. The frequency will really depend on the company. Our parent company, ISS, did some research on engagement trends globally. The majority of the companies we surveyed initiated more than six engagements a year, and 26% actually said 25-100 engagements a year. The key takeaway from all of this is that there is a significant portion of the market that understands the value of engagement and does it frequently.

We heard one example where an investor raised objection to a legacy practice and found that management had no idea investors were so displeased.

Even actions as simple as emails can have an impact

Jun (ICS): That doesn't surprise me. Sometimes management are not aware that problems exist. Even something as simple as an email can go a long way to increasing management awareness of issues.

Any tips when engaging with companies?

Engagement does not need to be confrontational

Jun (ICS): The best practice on engagement is to have a constructive discussion. It doesn't have to be confrontational. Also getting access to senior management could increase the impact of your engagement. It doesn't have to be CEO or CFO but it is important to speak directly with C-suite level if not the executive-director level. This can help ensure the fidelity of the message. In Asia, you often only get access to IR officers, therefore you never know if this message is directly related to the CEO as IR managers may screen the messages. Even if the IR manager does not screen the message the impact is diluted if the feedback is not direct.

Management new to engagement are sometimes surprised how useful they find it

I remember one Japanese company CEO who went on a roadshow for the first time and met with a big pension fund in what proved to be a very intense meeting. The IR manager was very nervous and CEO was initially very upset. However, in the end he found the trip in its entirety to be very meaningful to him in that he had no idea about many of the viewpoints and concerns the investors had expressed. Because he learned so much he will continue doing this on a regular basis. So absolutely, engagement can have a significant impact on executive level thinking.

What are the things investors should do less of?

Investors should avoid generic, formulaic questions

Jun (ICS): In Japan, one criticism towards investors we hear from issuers is that they ask too many generic governance questions that come across as box-ticking. While I agree that the form that governance takes can be important to embedding good practices, without explaining why these issues are important, investors can appear to be running through the motions, which can put companies off.

What percentage of resolutions is rejected? Is there any evidence that investors are actually saying no to companies and what is the trend?

The percentage of resolutions that get voted down is extremely low

Jun (ICS): The short answer is resolutions that get voted down are extremely rare. It is something like 0.5% or less in certain markets. Potentially egregious management behaviour often goes unchallenged publicly and privately in Asia. However, there are certain types of resolutions that tend to get voted down more often. In Hong Kong, related-party transactions tend to get voted down more. The big reason for that is because controlling shareholders or interested shareholders are not allowed to vote. So minority shareholders have a much larger say. Also, these transactions can potentially have negative consequences for the investors; there is economic value at stake increasing the incentives to say no. Other resolutions have a higher likelihood of review like amending articles of incorporation or M&A but overall the vast majority, more than 99%, pass resolution without issue.

That's extraordinary! Does that say that, in practically terms, there is basically no true check and balance actually taking place?

Resolution fail rates are too crude a tool to measure governance performance

Jun (ICS): Vote results are not the best standard of measurement to assess checks and balances. The vote outcome is heavily dependent on the shareholder structure. If you have a controlling shareholder no matter how many minority shareholders go against a resolution it will be passed anyways.

In markets like the USA, where there is more dispersed ownership and higher institutional ownership, we see better discipline mechanisms in terms of management resolutions. In Asia, the dynamic is very different. So that's one complication. Another important measure of how effective the checks and balances are (within the structural constraints) is to measure the margin by which a resolution passed. It is especially important to consider, if a majority of minorities voted against a resolution. This is, at a minimum, a powerful indicator to management that something is wrong. Management should then speak to the dissenting investors to address their concerns.

Has the trend for voting 'no', the percentage of institutional investor voting no, has that been going up overtime?

Minority willingness to say 'no' is rising

Jun (ICS): We can only get data for some markets. That said, the general trend, especially in progressive markets like Hong Kong and Japan, the level of dissent is increasing. More investors are voting 'no' to certain resolutions.

Are certain types of voters more likely to vote? Or vote no?

Foreign investors are usually the most willing to say 'no' to companies

Jun (ICS): Retail investors typically are not active on voting. When they vote they typically send in a blank vote. Foreign investors in general tend to vote more often and tend to be willing to go against management if needed. Domestic investors are typically more friendly to management or do not vote at all. There are always market differences as well. In Japan, domestic investors can be even stricter than foreign investors on certain issues

Any closing remarks?

ISS recommends investors vote, engage and where appropriate collaborate more

Jun (ICS): Voting and giving feedback to companies could foster better understanding among companies of value of good governance and help narrow the gap in understanding. Constructive engagements could create positive feedback loop that help enhance corporate governance over the long term. From the company side transparency is the most important thing in Asia in order to have good communication and governance. It's an area that many Asian markets and companies fall behind compared to their Western counterparts. It is the foundation of having accountability. Information access is integral to raising mutual understanding.

Jun Frank is Executive Director at ISS Corporate Solutions (ICS). Jun joined ICS in August, 2015, and is responsible for its North Asian markets, focusing on helping Japanese and Korean companies improve their corporate-governance practices, while supporting issuers in broader Asia. Prior to ICS, Jun headed ISS' Asia ex-Japan research, overseeing proxy advisory service and policy developments for the region. He also served as Director of Asian Proxy Research at Glass Lewis where he managed corporate-governance research on Asian companies since 2005. In 2008, he was named a 'Rising Star of Corporate Governance' by Millstein Center for Corporate Governance and Performance at the Yale School of Management. He holds a BA from the University of California at Berkeley and an MBA with concentrations in corporate finance and investments from the University of Notre Dame.

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Text provided by ISS Corporate Solutions

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1MDB (N-R)
3SBio (1530 HK - HK$8.16 - BUY)[1]
58.com (WUBA US - US$49.25 - BUY)[1]
7-Eleven (SEM MK - RM1.51 - BUY)[1]
a2 Milk (A2M AU - A$1.96 - BUY)[1]
AAC (2018 HK - HK$90.20 - BUY)[1]
ABC-Mart (2670 JP - ¥6,660 - BUY)[1]
Ace Hardware (ACES IJ - RP970 - OUTPERFORM)[1]
Adelaide Brighton (ABC AU - A$5.29 - UNDERPERFORM)[1]
Aditya Birla Nuvo (N-R)
Adlink (6166 TT - NT$60.7 - BUY)[2]
Advantech (2395 TT - NT$287.5 - OUTPERFORM)[2]
AGL Energy (AGL AU - A$17.92 - BUY)[1]
AIA (1299 HK - HK$50.90 - BUY)[1]
Aichi (6345 JP - ¥776 - OUTPERFORM)[1]
AIDC (N-R)
Air Asia (N-R)
Air China (753 HK - HK$5.75 - SELL)[1]
Airmedia (AMCN US - US$3.00 - OUTPERFORM)[3]
Airtac (1590 TT - NT$247.0 - SELL)[2]
AIS (ADVANC TB - BT158.0 - OUTPERFORM)[1]
Alibaba (BABA US - US$102.57 - BUY)[1]
Alphaland (N-R)
ALS (ALQ AU - A$5.75 - SELL)[1]
Amcor (AMC AU - A$15.71 - BUY)[1]
Amorepacific (090430 KS - 399,000 WON - OUTPERFORM)[1]
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AMP (AMP AU - A$5.36 - SELL)[1]
Antonoil (3337 HK - HK$0.74 - SELL)[1]
AP Thailand (AP TB - BT7.1 - OUTPERFORM)[1]
APA (APA AU - A$9.10 - UNDERPERFORM)[1]
Apex (N-R)
Arvind (ARVND IN - RS331.7 - BUY)[1]
Asahi Glass (5201 JP - ¥643 - BUY)[1]
Asahi Group (2502 JP - ¥3,564 - OUTPERFORM)[1]
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Ascott RT (ART SP - S$1.15 - OUTPERFORM)[1]
ASE (2311 TT - NT$38.9 - OUTPERFORM)[2]
Ashikaga (7167 JP - ¥386 - BUY)[1]
Asia Aviation (AAV TB - BT7.0 - BUY)[1]
Asian Paints (APNT IS - RS1,182.6 - SELL)[1]
Asiasons (N-R)
Asics (7936 JP - ¥2,143 - UNDERPERFORM)[1]
ASM Pacific (522 HK - HK$62.60 - SELL)[1]
Astra Agro (AALI IJ - RP16,475 - BUY)[1]
Astra Intl (ASII IJ - RP8,300 - BUY)[1]
Asustek (2357 TT - NT$275.0 - SELL)[1]
ASX (ASX AU - A$49.17 - UNDERPERFORM)[1]
AUO (N-R)
AusNet Services (AST AU - A$1.63 - OUTPERFORM)[1]
AVC (N-R)
Axis Bank (AXSB IB - RS629.2 - BUY)[1]
Ayala Corp (AC PM - P855.00 - UNDERPERFORM)[1]
Ayala Land (ALI PM - P38.60 - BUY)[1]
Baidu (BIDU US - US$187.50 - BUY)[1]
Bajaj Auto (BJAUT IS - RS3,088.7 - OUTPERFORM)[1]
Bangkok Dusit (BDMS TB - BT22.6 - OUTPERFORM)[1]
Bank Mandiri (BMRI IJ - RP11,200 - OUTPERFORM)[1]
Banpu (BANPU TB - BT14.9 - SELL)[1]
BAT Malaysia (ROTH MK - RM50.92 - SELL)[1]
BCA (N-R)
BDO (BDO PM - P111.30 - OUTPERFORM)[1]
BEA (23 HK - HK$32.90 - SELL)[1]
BEC World (BEC TB - BT22.2 - BUY)[1]
Beijing Jinfeite (N-R)
Bekasi Fajar (BEST IJ - RP318 - BUY)[1]
Bellamy's (BAL AU - A$13.45 - OUTPERFORM)[1]
Bharat Forge (BHFC IB - RS878.5 - SELL)[1]
Bharatiya Manila Bank (N-R)
Bharti Airtel (BHARTI IS - RS324.4 - BUY)[1]
Bharti Infratel (BHIN IS - RS357.6 - BUY)[1]
Bizlink (3665 TT - NT$185.0 - BUY)[2]
Bloomberg (N-R)
Bloomberry (BLOOM PM - P5.10 - BUY)[1]
Blue Bird (BIRD IJ - RP2,890 - OUTPERFORM)[1]
BlueScope (BSL AU - A$8.55 - OUTPERFORM)[1]
Blumont (N-R)
BNI (BBNI IJ - RP5,800 - UNDERPERFORM)[1]
BNK Financial (138930 KS - 8,930 WON - OUTPERFORM)[1]
Boral (BLD AU - A$6.40 - BUY)[1]
BPI (BPI PM - P105.00 - BUY)[1]
Brambles (BXB AU - A$12.01 - UNDERPERFORM)[1]
Bridgestone (5108 JP - ¥3,589 - OUTPERFORM)[1]
Brilliance Auto (1114 HK - HK$9.47 - SELL)[1]
BSI Bank (N-R)
BTIM (BTT AU - A$8.55 - OUTPERFORM)[1]
Budgetlane supermarket (N-R)
Bumi Armada (BAB MK - RM0.76 - BUY)[1]
BW Plantation (N-R)
BWX (BWX AU - A$4.70 - BUY)[1]

Cairn India (CAIR IB - RS198.3 - BUY)[1]
CalPERS (N-R)
CalSTRS (N-R)
Canvest (1381 HK - HK$3.72 - BUY)[1]
CapitaLand (CAPL SP - S$3.20 - OUTPERFORM)[1]
CAR (699 HK - HK$7.90 - BUY)[1]
Cathay Pacific (293 HK - HK$11.44 - SELL)[1]
CBA (CBA AU - A$72.06 - SELL)[1]
CCT (CCT SP - S$1.64 - OUTPERFORM)[1]
Central Plaza (CENTEL TB - BT38.3 - OUTPERFORM)[1]
Century Pacific (CNPF PM - P16.92 - BUY)[1]
Chalco (2600 HK - HK$2.95 - SELL)[1]
Challenger (CGF AU - A$9.25 - BUY)[1]
Chang Hwa Bank (N-R)
Cheil Worldwide (030000 KS - 15,950 WON - SELL)[1]
Cheng Shin Rubber (2105 TT - NT$68.0 - BUY)[2]
Cheung Kong Infra (1038 HK - HK$68.80 - UNDERPERFORM)[1]
Chiba Bank (8331 JP - ¥601 - OUTPERFORM)[1]
China Airlines (N-R)
China Bills (N-R)
China Coal (1898 HK - HK$4.02 - SELL)[1]
China Life (2628 HK - HK$20.55 - SELL)[1]
China Life (TW) (N-R)
China Motor (N-R)
China Southern (1055 HK - HK$4.64 - SELL)[1]
ChipMOS (8150 TT - NT$31.4 - BUY)[2]
Chroma (2360 TT - NT$84.1 - BUY)[2]
Cipla (CIPLA IB - RS592.3 - OUTPERFORM)[1]
Citigroup (C US - US$47.79 - BUY)[3]
City Developments (CIT SP - S$9.11 - BUY)[1]
CJ Korex (000120 KS - 199,000 WON - BUY)[1]
CK Property (1113 HK - HK$57.60 - UNDERPERFORM)[1]
CKH Hutchinson (N-R)
ClearView Wealth (CVW AU - A$1.00 - BUY)[1]
CLP (2 HK - HK$80.65 - UNDERPERFORM)[1]
CMS (867 HK - HK$13.28 - BUY)[1]
CNOOC (883 HK - HK$9.63 - SELL)[1]
Coal India (COAL IS - RS332.6 - OUTPERFORM)[1]
Coca-Cola Amatil (CCL AU - A$9.75 - SELL)[1]
Cochlear (COH AU - A$138.00 - SELL)[1]
Colgate India (CLGT IB - RS989.6 - SELL)[1]
Coli (688 HK - HK$26.80 - OUTPERFORM)[1]
Colopl (3668 JP - ¥1,636 - BUY)[1]
Com2us (078340 KS - 112,400 WON - BUY)[1]
ComfortDelGro (CD SP - S$2.87 - SELL)[1]
COSL (2883 HK - HK$6.30 - SELL)[1]
Cover-More (CVO AU - A$1.31 - BUY)[1]
CP All (CPALL TB - BT59.3 - BUY)[1]
CP Foods (CPF TB - BT30.8 - BUY)[1]
CPIC (2601 HK - HK$29.85 - SELL)[1]
CPN (CPN TB - BT57.0 - OUTPERFORM)[1]
CR Beer (291 HK - HK$17.74 - BUY)[1]
CR Gas (1193 HK - HK$26.30 - BUY)[1]
CR Land (1109 HK - HK$23.05 - BUY)[1]
Credit Suisse (N-R)
Cromwell (CMW AU - A$0.99 - SELL)[1]
CSL (CSL AU - A$103.72 - OUTPERFORM)[1]
CSPC Pharma (1093 HK - HK$7.78 - OUTPERFORM)[1]
CSR (CSR AU - A$3.46 - UNDERPERFORM)[1]
CSRC (N-R)
CyberAgent (4751 JP - ¥5,800 - BUY)[1]
CYBG (CYB AU - A$4.78 - BUY)[1]
D&L (DNL PM - P10.78 - OUTPERFORM)[1]
Dabur (DABUR IS - RS298.9 - OUTPERFORM)[1]
Daikin (6367 JP - ¥9,426 - UNDERPERFORM)[1]
DB Corp (DBCL IB - RS412.3 - BUY)[1]
Del Monte Pacific (DMPL PM - P12.20 - BUY)[1]
Deloitte Anjin (N-R)
Deutsche Bank (N-R)
Dexus (DXS AU - A$9.57 - UNDERPERFORM)[1]
DGB Financial (139130 KS - 9,300 WON - OUTPERFORM)[1]
Dialog (DLG MK - RM1.53 - OUTPERFORM)[1]
Dick Smith (N-R)
Digi (DIGI MK - RM5.08 - OUTPERFORM)[1]
Disco (6146 JP - ¥11,810 - BUY)[1]
Dish TV (DITV IB - RS97.5 - BUY)[1]
Domino's (DMP AU - A$72.42 - SELL)[1]
Don Quijote (7532 JP - ¥3,625 - BUY)[1]
Dongfang (1072 HK - HK$6.47 - SELL)[1]
Dr Lal PathLabs (DLPL IN - RS1,127.0 - BUY)[1]
Dr Reddy's (DRRD IB - RS3,186.3 - OUTPERFORM)[1]
DSME (N-R)
DUET (DUE AU - A$2.55 - SELL)[1]
DuluxGroup (DLX AU - A$6.35 - BUY)[1]
Eagle High (N-R)
Ebara (6361 JP - ¥568 - UNDERPERFORM)[1]
Eclat Textile (1476 TT - NT$374.0 - BUY)[2]
eClerx (ECLX IB - RS1,561.5 - SELL)[1]
Eco World (ECW MK - RM1.34 - BUY)[1]
Egco (EGCO TB - BT197.0 - BUY)[1]
Eicher Motors (EIM IS - RS23,419.2 - SELL)[1]
eLaser (N-R)
ELLIOTT (N-R)
Engley (2239 TT - NT$204.0 - BUY)[2]

Ernst & Young (N-R)
Eson Precision (N-R)
Esprit (330 HK - HK$7.00 - SELL)[1]
Estia Health (EHE AU - A$3.18 - SELL)[1]
Eternal Chemical (N-R)
Eunilane Foodmart (N-R)
EVA Airways (N-R)
Evergreen Marine (N-R)
Everlight Chemical (N-R)
Exide Industries (EXID IB - RS192.8 - SELL)[1]
Ezion (EZI SP - S$0.28 - BUY)[1]
F@N Communications (2461 JP - ¥761 - UNDERPERFORM)[1]
FamilyMart (8028 JP - ¥6,990 - UNDERPERFORM)[1]
Famour Holdings Pte Ltd (N-R)
Famour Pacific Shipping (N-R)
Fanuc (6954 JP - ¥17,135 - OUTPERFORM)[1]
Far Eastern Bank (N-R)
Far EasTone (4904 TT - NT$74.5 - OUTPERFORM)[2]
Fast Retailing (9983 JP - ¥36,410 - BUY)[1]
FCT (FCT SP - S$2.14 - OUTPERFORM)[1]
Feng Tay (9910 TT - NT$160.0 - BUY)[2]
FFG (8354 JP - ¥444 - BUY)[1]
Filinvest Land (FLI PM - P1.84 - BUY)[1]
First Lane Super Traders Co (N-R)
First Resources (FR SP - S$1.85 - BUY)[1]
Fletcher Building (FBU AU - A$10.73 - UNDERPERFORM)[1]
Florida State Board of Administration (N-R)
Flytech (6206 TT - NT$110.0 - OUTPERFORM)[2]
Formosa Plastics Group (N-R)
Fosun Pharma (2196 HK - HK$23.95 - BUY)[1]
Foxconn Tech (N-R)
Fraser & Neave (FNN SP - S$2.11 - OUTPERFORM)[1]
FreakOut (6094 JP - ¥3,650 - BUY)[1]
FS Mackenzie (N-R)
Fuji Machine (6134 JP - ¥1,192 - OUTPERFORM)[1]
G Steel (N-R)
GAC (2238 HK - HK$11.46 - SELL)[1]
Gamevil (063080 KS - 66,600 WON - BUY)[1]
Gamuda (GAM MK - RM4.83 - SELL)[1]
General Motors (GM US - US$31.71 - OUTPERFORM)[3]
Genting Singapore (GENS SP - S$0.77 - UNDERPERFORM)[1]
GGLS (N-R)
Giant Mfg (9921 TT - NT$211.5 - SELL)[2]
Glass Lewis (N-R)
Globe Telecom (GLO PM - P1,976.00 - BUY)[1]
GMA (GMAP PM - P6.05 - BUY)[1]
GMO Payment (3769 JP - ¥4,845 - BUY)[1]
Godrej Consumer (GCPL IB - RS1,680.2 - OUTPERFORM)[1]
Godrej Prop (GPL IB - RS355.4 - BUY)[1]
Golden Agri (GGR SP - S$0.37 - SELL)[1]
Golden Eagle (3308 HK - HK$9.66 - UNDERPERFORM)[1]
Goldman Sachs (GS US - US$171.66 - OUTPERFORM)[3]
Goldpac (3315 HK - HK$2.65 - UNDERPERFORM)[1]
Goldtempo Company Inc (N-R)
Goodman (GMG AU - A$7.38 - OUTPERFORM)[1]
Government Pension Investment Fund (N-R)
GrainCorp (GNC AU - A$8.18 - OUTPERFORM)[1]
Grasim (GRASIM IB - RS4,775.6 - SELL)[1]
Great Eagle (41 HK - HK$35.55 - SELL)[1]
Great Wall Motor (2333 HK - HK$8.30 - OUTPERFORM)[1]
Growthpoint (GOZ AU - A$3.22 - UNDERPERFORM)[1]
GSK Consumer (SKB IS - RS6,292.4 - BUY)[1]
Haier Electronics (1169 HK - HK$13.70 - BUY)[1]
Haitian (1882 HK - HK$16.00 - SELL)[1]
Hana Financial (086790 KS - 29,200 WON - SELL)[1]
Hang Lung Prop (101 HK - HK$18.88 - BUY)[1]
Hang Seng Bank (11 HK - HK$138.80 - UNDERPERFORM)[1]
Hankook Tire (161390 KS - 59,800 WON - BUY)[1]
Hansol Chemical (014680 KS - 86,000 WON - BUY)[1]
Hanssem (009240 KS - 147,000 WON - BUY)[1]
Hartalega (HART MK - RM4.60 - UNDERPERFORM)[1]
HCL Tech (HCLT IB - RS773.5 - BUY)[1]
HCM (6305 JP - ¥1,911 - UNDERPERFORM)[1]
HDFC (HDFC IB - RS1,437.3 - BUY)[1]
HDFC Bank (HDFCB IB - RS1,289.5 - BUY)[1]
Henderson Group (HGG AU - A$4.24 - BUY)[1]
Hengan (1044 HK - HK$69.65 - BUY)[1]
Hengdeli (3389 HK - HK$0.90 - SELL)[1]
Hilong (1623 HK - HK$1.02 - BUY)[1]
Hindalco (HNDL IB - RS161.9 - BUY)[1]
Hindustan Unilever (HUVR IB - RS951.5 - UNDERPERFORM)[1]
Hiroshima Bank (8379 JP - ¥435 - BUY)[1]
HIS (9603 JP - ¥2,718 - BUY)[1]
Hiwin (2049 TT - NT$172.0 - BUY)[2]
HK Exchanges (388 HK - HK$198.60 - SELL)[1]
HM Sampoerna (HMSP IJ - RP4,000 - UNDERPERFORM)[1]
HMI (3658 TT - NT$1,355.0 - OUTPERFORM)[2]
HomePro (HMPRO TB - BT9.5 - BUY)[1]
Hon Hai (2317 TT - NT$77.7 - SELL)[1]

Honda Motor (7267 JP - ¥3,167 - BUY)[1]
Honghua (196 HK - HK$0.40 - SELL)[1]
Hotai Motor (N-R)
Hotel Shilla (008770 KS - 67,100 WON - BUY)[1]
HSBC (5 HK - HK$59.30 - UNDERPERFORM)[1]
Hu Lane (6279 TT - NT$155.0 - BUY)[2]
Hua Hong Semi (1347 HK - HK$9.40 - BUY)[2]
Hysan (14 HK - HK$37.90 - OUTPERFORM)[1]
Hyundai BNG Steel (N-R)
Hyundai Heavy (009540 KS - 140,500 WON - BUY)[1]
Hyundai Mipo (010620 KS - 76,000 WON - BUY)[1]
Hyundai Motor (005380 KS - 139,500 WON - OUTPERFORM)[1]
Hyundai Steel (004020 KS - 53,700 WON - BUY)[1]
I.T (999 HK - HK$2.79 - BUY)[1]
IAG (IAG AU - A$5.32 - SELL)[1]
Ichia Tech (N-R)
ICICI Bank (ICICIBC IB - RS276.4 - BUY)[1]
Idea Cellular (IDEA IB - RS84.4 - SELL)[1]
Idea Cellular (N-R)
IDFC (IDFC IB - RS63.8 - BUY)[1]
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IHH (IHH MK - RM6.65 - OUTPERFORM)[1]
IHI (7013 JP - ¥288 - SELL)[1]
IJM Corp (IJM MK - RM3.45 - UNDERPERFORM)[1]
Incitec Pivot (IPL AU - A$2.75 - BUY)[1]
Indiabulls HFC (IHFL IS - RS817.8 - BUY)[1]
Indian Oil (IOCL IB - RS563.4 - BUY)[1]
Indocement (INTP IJ - RP17,400 - UNDERPERFORM)[1]
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Info Edge (INFOE IS - RS841.0 - BUY)[1]
Infosys (INFO IB - RS1,037.9 - OUTPERFORM)[1]
Innocean Worldwide (214320 KS - 72,300 WON - SELL)[1]
Innolux (N-R)
Integral Diagnostics (IDX AU - A$1.56 - SELL)[1]
Inventec (2356 TT - NT$24.9 - BUY)[1]
IOI (IOI MK - RM4.48 - SELL)[1]
Iress (IRE AU - A$11.68 - BUY)[1]
IRPC (IRPC TB - BT4.7 - OUTPERFORM)[1]
Isetan Mitsukoshi (3099 JP - ¥1,043 - BUY)[1]
ISS (N-R)
ITC (ITC IB - RS265.3 - BUY)[1]
J Front Retailing (3086 JP - ¥1,286 - BUY)[1]
Japara Healthcare (JHC AU - A$1.89 - SELL)[1]
Jasa Marga (JSMR IJ - RP4,760 - BUY)[1]
JB Hi-Fi (JBH AU - A$30.60 - BUY)[1]
JD.com (JD US - US$26.86 - BUY)[1]
Jet Airways (JETIN IB - RS547.5 - SELL)[1]
Jiangling Motors (200550 CH - HK$20.10 - BUY)[1]
Jiangnan (1366 HK - HK$1.18 - OUTPERFORM)[1]
Jiangxi Copper (358 HK - HK$9.24 - UNDERPERFORM)[1]
Jollibee (JFC PM - P247.20 - BUY)[1]
JPL (JAGP IB - RS206.8 - BUY)[1]
JPMorgan Chase (JPM US - US$67.25 - BUY)[3]
JSW (5631 JP - ¥465 - SELL)[1]
JTekt (6473 JP - ¥1,561 - UNDERPERFORM)[1]
Kakao (035720 KQ - 81,800 WON - SELL)[1]
Kalbe Farma (KLBF IJ - RP1,755 - UNDERPERFORM)[1]
Kangning Hospital (2120 HK - HK$41.70 - UNDERPERFORM)
Kangwon Land (035250 KS - 39,900 WON - BUY)[1]
Kao (4452 JP - ¥5,610 - BUY)[1]
KB Financial (105560 KS - 39,400 WON - SELL)[1]
KB Kookmin Bank (N-R)
KDB (N-R)
KDDI (9433 JP - ¥3,129 - BUY)[1]
Kepco (015760 KS - 58,700 WON - BUY)[1]
Kepco Plant Service (051600 KS - 63,000 WON - BUY)[1]
Keppel Corp (KEP SP - S$5.49 - SELL)[1]
Keppel DC (KDCREIT SP - S$1.21 - BUY)[1]
Keppel Reit (KREIT SP - S$1.13 - OUTPERFORM)[1]
Kerry Properties (683 HK - HK$23.60 - SELL)[1]
KEXIM (N-R)
Keyence (6861 JP - ¥72,490 - BUY)[1]
KHI (7012 JP - ¥313 - OUTPERFORM)[1]
Kia Motors (000270 KS - 44,200 WON - OUTPERFORM)[1]
King Yuan (2449 TT - NT$29.4 - BUY)[2]
Kinpo Electronics (N-R)
Kirin (2503 JP - ¥1,726 - UNDERPERFORM)[1]
Kiwoom (039490 KS - 75,200 WON - UNDERPERFORM)[1]
Kobayashi Pharma (4967 JP - ¥5,010 - UNDERPERFORM)[1]
Koh Young Tech (098460 KQ - 44,250 WON - BUY)[1]
Komatsu (6301 JP - ¥2,274 - OUTPERFORM)[1]
Konica Minolta (4902 JP - ¥920 - OUTPERFORM)[1]
Korean Air (N-R)
Kossan Rubber (KRI MK - RM6.70 - OUTPERFORM)[1]
Kotak Bank (KMB IB - RS819.4 - OUTPERFORM)[1]
KT&G (033780 KS - 120,000 WON - BUY)[1]
Kubota (6326 JP - ¥1,486 - BUY)[1]
La Chapelle (6116 HK - HK$8.68 - OUTPERFORM)[1]

LandMark (3081 TT - NT$345.0 - BUY)[2]
Larsen & Toubro (LT IB - RS1,538.9 - BUY)[1]
Lawson (2651 JP - ¥7,450 - SELL)[1]
Lee & Man Paper (2314 HK - HK$6.59 - OUTPERFORM)[1]
Lendlease (LLC AU - A$14.14 - SELL)[1]
Lesso (2128 HK - HK$5.76 - BUY)[1]
LG Chem (051910 KS - 248,000 WON - BUY)[1]
LG Corp (003550 KS - 68,500 WON - BUY)[1]
LG Electronics (066570 KS - 51,800 WON - BUY)[1]
LG H&H (051900 KS - 986,000 WON - BUY)[1]
LG Innotek (011070 KS - 81,300 WON - BUY)[1]
LIC Housing Finance (LICHF IB - RS583.6 - SELL)[1]
Lifestyle (1212 HK - HK$11.20 - SELL)[1]
Line (3938 JP - ¥4,620 - BUY)[1]
Link Reit (823 HK - HK$57.65 - OUTPERFORM)[1]
LionGold (N-R)
Livzon Pharma (1513 HK - HK$46.80 - BUY)[1]
L'Occitane (973 HK - HK$15.88 - SELL)[1]
Longfor (960 HK - HK$12.18 - BUY)[1]
Longyuan Power (916 HK - HK$7.17 - OUTPERFORM)[1]
LPN (LPN TB - BT11.6 - SELL)[1]
LTG (LTG PM - P17.04 - SELL)[1]
Lupin (LPC IB - RS1,579.4 - SELL)[1]
Luye Pharma (2186 HK - HK$5.19 - OUTPERFORM)[1]
M&M (MM IB - RS1,489.3 - OUTPERFORM)[1]
M1 (M1 SP - S$2.55 - SELL)[1]
Macquarie (MQG AU - A$81.39 - BUY)[1]
Magellan (MFG AU - A$22.81 - BUY)[1]
Major Cineplex (MAJOR TB - BT27.5 - OUTPERFORM)[1]
Makita (6586 JP - ¥7,360 - SELL)[1]
Makro (MAKRO TB - BT32.5 - BUY)[1]
Man Wah (1999 HK - HK$5.38 - BUY)[1]
Mando (204320 KS - 267,000 WON - BUY)[1]
Maple Leaf Edu (1317 HK - HK$6.54 - BUY)[1]
Mapletree Ind (MINT SP - S$1.79 - OUTPERFORM)[1]
MapletreeLog (MLT SP - S$1.08 - OUTPERFORM)[1]
Marico (MRCO IB - RS300.1 - SELL)[1]
Maruti Suzuki (MSIL IB - RS5,482.4 - BUY)[1]
Matahari Dept Store (LPPF IJ - RP18,025 - UNDERPERFORM)[1]
Max Financial (MAXF IB - RS600.1 - OUTPERFORM)[1]
Maxis (MAXIS MK - RM6.26 - SELL)[1]
Mazda Motor (7261 JP - ¥1,669 - BUY)[1]
McGrath (N-R)
MediaTek (2454 TT - NT$250.5 - SELL)[1]
Medibank (MPL AU - A$2.53 - BUY)[1]
Medytox (086900 KS - 432,100 WON - SELL)[1]
Mega Financial (N-R)
Mega International Commercial Bank of Taiwan (N-R)
Melco Crown (MPEL US - US$15.17 - UNDERPERFORM)[1]
Melco Phils (MCP PM - P3.79 - SELL)[1]
Merida (9914 TT - NT$137.0 - SELL)[2]
Merry Electronics (N-R)
Metcash (MTS AU - A$2.11 - BUY)[1]
MGM China (2282 HK - HK$12.88 - UNDERPERFORM)[1]
MHI (7011 JP - ¥444 - BUY)[1]
Midland (1200 HK - HK$2.56 - UNDERPERFORM)[1]
Minor International (MINT TB - BT38.0 - OUTPERFORM)[1]
Minth (425 HK - HK$29.60 - BUY)[1]
Mirvac (MGR AU - A$2.24 - OUTPERFORM)[1]
Mitra Keluarga (MIKA IJ - RP2,870 - BUY)[1]
Mitsubishi Motors (N-R)
Mizuho Financial (8411 JP - ¥180 - UNDERPERFORM)[1]
Mizuno (8022 JP - ¥537 - SELL)[1]
Momo (8454 TT - NT$217.5 - OUTPERFORM)[2]
Monash IVF (MVF AU - A$2.28 - SELL)[1]
Muddy Waters (N-R)
Myer (MYR AU - A$1.28 - SELL)[1]
MYOB (MYO AU - A$3.76 - UNDERPERFORM)[1]
Nabtesco (6268 JP - ¥2,613 - BUY)[1]
Nanya PCB (N-R)
Nanya Technology (N-R)
Naver (035420 KS - 869,000 WON - BUY)[1]
NCsoft (036570 KS - 279,500 WON - UNDERPERFORM)[1]
NE Bodega (N-R)
Neo Solar Power (N-R)
Nestle (N-R)
NetEase (NTES US - US$221.68 - UNDERPERFORM)[1]
New China Life (1336 HK - HK$33.80 - SELL)[1]
New Oriental Edu (EDU US - US$43.99 - BUY)[1]
Newcrest Mining (NCM AU - A$22.86 - SELL)[1]
NEXTDC (NXT AU - A$4.25 - BUY)[1]
NHN Entertainment (181710 KS - 59,100 WON - SELL)[1]
Niantic (N-R)
Nihon M&A Center (2127 JP - ¥5,780 - BUY)[1]
Nikon (7731 JP - ¥1,508 - OUTPERFORM)[1]
Nippon Kayaku (4272 JP - ¥1,115 - BUY)[1]
Nissan Motor (7201 JP - ¥1,049 - BUY)[1]
Noble Group (N-R)
Novatek (3034 TT - NT$112.0 - SELL)[2]
NTN (6472 JP - ¥370 - UNDERPERFORM)[1]
NTPC (NTPC IS - RS159.8 - UNDERPERFORM)[1]
NTT Docomo (9437 JP - ¥2,601 - BUY)[1]
Oberoi Realty (OBER IN - RS296.6 - BUY)[1]

OCBC (OCBC SP - S$8.87 - SELL)[1]
Oil Search (OSH AU - A$6.51 - OUTPERFORM)[1]
Olam (N-R)
Oneview Healthcare (ONE AU - A$6.50 - BUY)[1]
Orica (ORI AU - A$13.94 - OUTPERFORM)[1]
Origin Energy (ORG AU - A$5.13 - OUTPERFORM)[1]
Orion (001800 KS - 776,000 WON - BUY)[1]
Orora (ORA AU - A$3.07 - OUTPERFORM)[1]
Padini (PAD MK - RM3.01 - BUY)[1]
Pakuwon (PWON IJ - RP635 - BUY)[1]
Parco Supermarkets (N-R)
Pax Global (327 HK - HK$6.13 - BUY)[1]
PChome Online (8044 TT - NT$364.0 - BUY)[2]
Pegatron (4938 TT - NT$77.2 - BUY)[1]
Pepsi-Cola (PIP PM - P3.11 - BUY)[1]
Perpetual (PPT AU - A$46.61 - UNDERPERFORM)[1]
Persistent Systems (PSYS IN - RS609.0 - BUY)[1]
PetroChina (857 HK - HK$5.23 - BUY)[1]
Petronet LNG (PLNG IB - RS351.4 - SELL)[1]
Phison (N-R)
Phoenix Mills (PHNX IN - RS432.8 - BUY)[1]
Ping An (2318 HK - HK$43.30 - OUTPERFORM)[1]
Pitcher Partners (N-R)
Platinum AM (PTM AU - A$5.15 - BUY)[1]
PLDT (TEL PM - P1,869.00 - BUY)[1]
Pola Orbis (4927 JP - ¥8,970 - BUY)[1]
Polaris Investama (N-R)
Poly Culture (3636 HK - HK$20.50 - UNDERPERFORM)[1]
Posco (005490 KS - 231,500 WON - OUTPERFORM)[1]
Posiflex (8114 TT - NT$182.0 - BUY)[2]
Power Assets (6 HK - HK$76.65 - OUTPERFORM)[1]
Prada (1913 HK - HK$23.40 - SELL)[1]
Premier Investments (PMV AU - A$16.40 - OUTPERFORM)[1]
President Securities (N-R)
Prestige Estates (PEPL IN - RS208.7 - BUY)[1]
PricewaterCoopers (N-R)
Pruksa (PS TB - BT23.8 - OUTPERFORM)[1]
PT Danareksa (N-R)
PT Langgam Inti Hibrindo (N-R)
PT Trikomsel (N-R)
Puradelta Lestari (DMAS IJ - RP248 - BUY)[1]
Puregold (PGOLD PM - P44.00 - OUTPERFORM)[1]
Q Technology (1478 HK - HK$3.28 - BUY)[1]
Quality Houses (QH TB - BT2.3 - UNDERPERFORM)[1]
Quanta (2382 TT - NT$62.5 - BUY)[1]
Quindell (N-R)
Radiant (6176 TT - NT$52.3 - SELL)[2]
Raffles Medical (RFMD SP - S$1.53 - SELL)[1]
Rakuten (4755 JP - ¥1,374 - OUTPERFORM)[1]
Ramsay Health Care (RHC AU - A$80.27 - BUY)[1]
Realtek (2379 TT - NT$122.0 - BUY)[2]
Reliance Worldwide (RWC AU - A$3.00 - UNDERPERFORM)[1]
Rizal Commercial Banking Corporation (N-R)
Robinsons Land (RLC PM - P30.35 - OUTPERFORM)[1]
Rockwell Land (ROCK PM - P1.70 - SELL)[1]
Ryobi (5851 JP - ¥449 - UNDERPERFORM)[1]
Ryohin Keikaku (7453 JP - ¥19,420 - BUY)[1]
Sa Sa (178 HK - HK$2.95 - SELL)[1]
Sainsbury's (N-R)
Samchuly Bicycle (024950 KQ - 14,700 WON - OUTPERFORM)[1]
Samsonite (1910 HK - HK$25.40 - BUY)[1]
Samsung Card (029780 KS - 52,500 WON - BUY)[1]
Samsung Electronics (005930 KS - 1,639,000 WON - BUY)[1]
Samsung Eng (028050 KS - 11,100 WON - SELL)[1]
Samsung Heavy (010140 KS - 10,200 WON - SELL)[1]
San Roque Supermarket (N-R)
San Shing (N-R)
Sands China (1928 HK - HK$34.50 - OUTPERFORM)[1]
Santos (STO AU - A$4.08 - UNDERPERFORM)[1]
Sapporo (2501 JP - ¥2,728 - SELL)[1]
Saran Menara Nusantara (N-R)
Sarana Menara (TOWR IJ - RP3,980 - OUTPERFORM)[1]
SBI (SBIN IB - RS267.9 - BUY)[1]
Security Bank (SECB PM - P230.40 - OUTPERFORM)[1]
SEG (2386 HK - HK$6.77 - UNDERPERFORM)[1]
Sega Sammy (6460 JP - ¥1,459 - UNDERPERFORM)[1]
Sekawan (N-R)
Semen Indonesia (SMGR IJ - RP10,050 - BUY)[1]
Seoul Auction (063170 KS - 12,100 WON - BUY)[1]
Septeni (4293 JP - ¥2,926 - BUY)[1]
Sesa Goa (N-R)
Seven & I (3382 JP - ¥4,481 - OUTPERFORM)[1]
SGX (SGX SP - S$7.60 - SELL)[1]
Shanshui Cement (N-R)
Sharp (N-R)
Shenhua (1088 HK - HK$14.94 - OUTPERFORM)[1]
Shenzhou Intl (2313 HK - HK$53.65 - BUY)[1]
Shimano (7309 JP - ¥15,790 - BUY)[1]
Shinhan (055550 KS - 41,050 WON - OUTPERFORM)[1]
Shinsegae (004170 KS - 203,500 WON - BUY)[1]
Shiseido (4911 JP - ¥2,706 - BUY)[1]
SHKP (16 HK - HK$120.80 - OUTPERFORM)[1]

Shree Cement (SRCM IB - RS17,659.0 - SELL)[1]
Siam Cement (SCC TB - BT514.0 - BUY)[1]
Sigma Pharma (SIP AU - A$1.28 - OUTPERFORM)[1]
Siloam (SILO IJ - RP10,800 - OUTPERFORM)[1]
Sims MM (SGM AU - A$9.12 - SELL)[1]
Sinbon (N-R)
SingPost (SPOST SP - S$1.42 - OUTPERFORM)[1]
Singtel (ST SP - S$4.06 - OUTPERFORM)[1]
Singyes Solar (750 HK - HK$4.67 - BUY)[1]
Sino Biopharm (1177 HK - HK$5.24 - BUY)[1]
Sinopec (386 HK - HK$5.70 - BUY)[1]
Sinopec Kantons (934 HK - HK$3.79 - BUY)[1]
Sinopharm (1099 HK - HK$40.05 - BUY)[1]
Sirtex Medical (SRX AU - A$31.52 - BUY)[1]
SK Hynix (000660 KS - 38,700 WON - BUY)[1]
Slater and Gordon (N-R)
SMC (N-R)
SMFG (8316 JP - ¥3,600 - OUTPERFORM)[1]
SMIC (981 HK - HK$0.87 - BUY)[2]
Solar Applied Material Technology (N-R)
Sony (6758 JP - ¥3,411 - BUY)[1]
South China Morning Post (N-R)
Southwest Securities (N-R)
SP Setia (SPSB MK - RM3.43 - OUTPERFORM)[1]
Spark Infra (SKI AU - A$2.38 - OUTPERFORM)[1]
SpeedCast (SDA AU - A$3.85 - BUY)[1]
SpiceJet (SJET IN - RS64.0 - SELL)[1]
SPIL (2325 TT - NT$46.6 - SELL)[2]
Spotless (N-R)
SPT Energy (1251 HK - HK$0.50 - SELL)[1]
St Shine (1565 TT - NT$790.0 - SELL)[2]
Standard Chartered (N-R)
StarHub (STH SP - S$3.45 - SELL)[1]
Stark Technology (N-R)
State of Wisconsin Investment Baord (N-R)
Stecon (STEC TB - BT22.2 - BUY)[1]
Stella International (1836 HK - HK$12.60 - UNDERPERFORM)[1]
Stirling Coleman Capital (N-R)
Sumitomo Mitsui (N-R)
Sumitomo Osaka (5232 JP - ¥463 - UNDERPERFORM)[1]
Summarecon (SMRA IJ - RP1,740 - BUY)[1]
Sun Art (6808 HK - HK$5.37 - SELL)[1]
Sun Hung Kai Properties (N-R)
Suncorp (SUN AU - A$12.69 - BUY)[1]
Sunny Optical (2382 HK - HK$40.60 - SELL)[1]
Suntory B&F (2587 JP - ¥4,315 - OUTPERFORM)[1]
Supalai (SPALI TB - BT22.8 - OUTPERFORM)[1]
Super Retail (SUL AU - A$10.27 - BUY)[1]
Superb Summit (N-R)
Suruga Bank (8358 JP - ¥2,552 - OUTPERFORM)[1]
Surya Citra Media (SCMA IJ - RP3,000 - OUTPERFORM)[1]
Suzuki Motor (7269 JP - ¥3,518 - SELL)[1]
Swancor (N-R)
Swire Pacific (19 HK - HK$87.80 - UNDERPERFORM)[1]
Taichung Comm Bk (N-R)
Taiheiyo Cement (5233 JP - ¥303 - BUY)[1]
Taiwan Fire & Marine (N-R)
Taiwan Mobile (3045 TT - NT$114.0 - OUTPERFORM)[2]
Takata (N-R)
Takeuchi (6432 JP - ¥1,490 - OUTPERFORM)[1]
TAL Edu (XRS US - US$64.02 - UNDERPERFORM)[1]
Tata Consultancy (TCS IB - RS2,321.2 - BUY)[1]
Tata Motors (TTMT IB - RS584.5 - BUY)[1]
Tata Power (TPWR IB - RS77.5 - SELL)[1]
Tata Sons (N-R)
Tata Steel (TATA IB - RS402.9 - SELL)[1]
Tata TM (N-R)
TechnoPro (6028 JP - ¥3,365 - BUY)[1]
Teijin (3401 JP - ¥396 - BUY)[1]
Telkom (TLKM IJ - RP4,160 - BUY)[1]
Telstra (TLS AU - A$5.11 - UNDERPERFORM)[1]
Tencent (700 HK - HK$215.00 - BUY)[1]
Tesco (N-R)
Thai Oil (TOP TB - BT65.3 - BUY)[1]
Thai Union Frozen (TU TB - BT20.2 - UNDERPERFORM)[1]
Thai Union Group (N-R)
Thaicom (THCOM TB - BT21.3 - UNDERPERFORM)[1]
Tianjin Libao (N-R)
Tianrui Group (N-R)
Tiger Asia (N-R)
Timbercorp (N-R)
Time Dotcom (TDC MK - RM7.81 - BUY)[1]
Tingyi (322 HK - HK$8.44 - SELL)[1]
Tisco (TISCO TB - BT51.0 - UNDERPERFORM)[1]
Titan (TTAN IB - RS432.6 - SELL)[1]
Tokyo Electron (8035 JP - ¥9,282 - OUTPERFORM)[1]
Ton Yi Industrial (N-R)
Tongda (698 HK - HK$1.70 - BUY)[1]
Tony Moly (214420 KS - 47,500 WON - BUY)[1]
Top Glove (TOPG MK - RM4.80 - UNDERPERFORM)[1]
Topoint Technology (N-R)
Torrent Pharma (TRP IB - RS1,682.3 - BUY)[1]
Toshiba (6502 JP - ¥336 - BUY)[1]
Toung Loong (4401 TT - NT$100.0 - BUY)[2]

Tower Bersama (TBIG IJ - RP5,575 - OUTPERFORM)[1]
Toyota Motor (7203 JP - ¥6,190 - BUY)[1]
Transcend Info (N-R)
Transurban (TCL AU - A$11.10 - UNDERPERFORM)[1]
Travellers Intl (RWM PM - P3.40 - SELL)[1]
Treasury Wine (TWE AU - A$11.02 - BUY)[1]
Trend Micro (4704 JP - ¥3,620 - OUTPERFORM)[3]
TrueLight (3234 TT - NT$72.6 - SELL)[2]
Tsinghua Unigroup (N-R)
TSMC (2330 TT - NT$183.0 - BUY)[2]
TVS Motor (TVSL IS - RS337.9 - SELL)[1]
UBOT (N-R)
UCPB (N-R)
UEM Sunrise (UEMS MK - RM1.10 - SELL)[1]
UGL (UGL AU - A$2.30 - BUY)[1]
UltraTech (UTCEM IS - RS4,115.4 - OUTPERFORM)[1]
U-Ming (N-R)
UMW (UMWH MK - RM5.88 - SELL)[1]
UMW Oil & Gas (UMWOG MK - RM0.91 - SELL)[1]
Unicharm (8113 JP - ¥2,560 - BUY)[1]
Unilever (N-R)
Unilever Indo (UNVR IJ - RP45,750 - OUTPERFORM)[1]
Uni-President (1216 TT - NT$59.1 - UNDERPERFORM)[2]
Uni-President China (220 HK - HK$6.08 - BUY)[1]
Unique E&C (UNIQ TB - BT16.4 - BUY)[1]
United Spirits (UNSP IB - RS2,357.9 - BUY)[1]
Unizyx (N-R)
UOB (UOB SP - S$18.78 - OUTPERFORM)[1]
Vale Indonesia (INCO IJ - RP2,900 - BUY)[1]
Vanguard (5347 TT - NT$60.9 - SELL)[2]
Vedanta Group (N-R)
Vega Telecom (N-R)
Viatron Technologies (141000 KQ - 26,050 WON - BUY)[1]
Vinda (3331 HK - HK$14.90 - OUTPERFORM)[1]
Vipshop (VIPS US - US$13.78 - BUY)[1]
Virtus Health (VRT AU - A$8.09 - UNDERPERFORM)[1]
Voltas (VOLT IS - RS390.1 - SELL)[1]
Walmart (N-R)
Walsin Lihwa (N-R)
Walsin Technology (N-R)
Want Want (151 HK - HK$5.13 - UNDERPERFORM)[1]
Waskita Karya (WSKT IJ - RP2,640 - SELL)[1]
Weifu High-Tech (200581 CH - HK$16.35 - BUY)[1]
Wemade (112040 KS - 19,700 WON - BUY)[1]
Wesfarmers (WES AU - A$43.11 - BUY)[1]
Westports (WPRTS MK - RM4.42 - OUTPERFORM)[1]
WH Group (288 HK - HK$6.18 - OUTPERFORM)[1]
WHA (WHA TB - BT3.1 - BUY)[1]
Wharf (4 HK - HK$56.45 - SELL)[1]
Wilmar (WIL SP - S$3.21 - OUTPERFORM)[1]
Wipro (WPRO IB - RS473.6 - OUTPERFORM)[1]
Wistron (3231 TT - NT$22.9 - BUY)[1]
Wistron NeWeb (6285 TT - NT$95.3 - BUY)[2]
Wong Weng Foo & Co (N-R)
Wonik IPS (240810 KS - 22,550 WON - BUY)[1]
Woolworths (WOW AU - A$23.27 - SELL)[1]
Woori Bank (000030 KS - 11,350 WON - SELL)[1]
WorleyParsons (WOR AU - A$8.38 - SELL)[1]
WT Microelectronics (N-R)
Xero (XRO AU - A$19.34 - BUY)[1]
Xintai Electric (N-R)
Xinye Securities (N-R)
Xinyi Glass (868 HK - HK$7.53 - BUY)[1]
Xinyi Solar (968 HK - HK$3.36 - BUY)[1]
XL Axiata (EXCL IJ - RP2,760 - UNDERPERFORM)[1]
X-Legend (N-R)
Yahoo Japan (4689 JP - ¥415 - UNDERPERFORM)[1]
Yamaha Motor (7272 JP - ¥2,096 - OUTPERFORM)[1]
Yang Ming (N-R)
Yaskawa Electric (6506 JP - ¥1,510 - UNDERPERFORM)[1]
Yes Bank (YES IB - RS1,330.7 - BUY)[1]
Yieh Phui (N-R)
Yue Yuen (551 HK - HK$34.25 - BUY)[1]
Yulon Nissan Motor (N-R)
Zee Entertainment (Z IB - RS538.7 - BUY)[1]
Zenkoku Hosho (7164 JP - ¥4,075 - BUY)[1]
Zoomlion (1157 HK - HK$2.93 - BUY)[1]

[1] Covered by CLSA; [2] Covered by CAST; [3] Covered by CLSA Americas

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