Building Value in Asia

Corporate Governance and Compliance for a New Era

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The firm regularly advises a number of leading business and financial institutions on an international basis and one way in which the firm aids its clients in staying ahead is through its e-mail based notification LawNow, which keeps clients up-to-date with the latest developments in the law, as they happen. Canham has written numerous articles and is a regular lecturer at the Hong Kong Institute of Directors on the role and duties of company directors. The firm’s website can be visited at www.cmck.com.
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Gannon was closely involved in the establishment of the Hong Kong Monterey Authority in 1993 and has been its general counsel and an executive director since. His office advises on all aspects of the Monetary Authority's functions including monetary operations, reserves management, banking supervision and policy, and international law. In recent years, he has been involved in various projects including the establishment of the Hong Kong Institute for Monetary Research; the real time gross settlement systems for HK dollars and US dollars; and the provision of a statutory scheme of regulation for smart cards.
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Before establishing Makes & Partners, Makes headed the corporate finance teams of three other major Indonesian law firms.

Makes is active in the business community and is involved as a member of a number of important corporate and business bodies, including the Indonesian Public Listed Companies Associates (member of the board of experts) and the National Committee on Corporate Governance (member and advisor to the Indonesian Chamber of Commerce).
Hubert Neiss

Hubert Neiss was appointed to the position of chairman, Asia, in Deutsche Bank's Asia Pacific head office in April 2000, following a career of over 30 years with the International Monetary Fund in Washington DC. There he spent his first six years in the European department and then moved to the Asian department where he became department director in 1991. During the Asian crisis, as director of the Asia and Pacific department, he was the IMF's most visible executive in the region and was intensively involved in negotiating and monitoring emergency programs.

Neiss obtained an undergraduate degree in business in Vienna, Austria, and then went on to achieve his masters degree in economics from the University of Kansas. He returned to Vienna to complete his doctorate in economics and business. Before joining the IMF he worked in the Austrian Institute of Economic Research in Vienna.

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Young-Moo Shin is the founder and managing partner of Shin & Kim, Korea's second-largest law firm. He is a pioneer in Korean securities law and has advised Korean institutions including the Ministry of Finance and Economy, the Securities and Exchange Commission and the Korea stock exchange. As a young lawyer he specialized in securities law at Coudert Brothers in New York. Shin is a graduate of Seoul National University College of Law and holds a Doctor of Juridical Science degree from Yale University. As the Korean securities market has opened, Shin has also advised several foreign institutional investors on shareholder rights and corporate governance issues.
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Prior to taking up his present position, Dean served as the firm's director of services-Asia Pacific, deputy chairman in China, managing partner of the Taipei Consulting Practice, national director of Coopers and Lybrand's Japan programme in the US, and the managing partner of the firm's Tokyo tax practice. Dean, who has masters' degrees in both business and taxation, is a certified public accountant. He specializes in a number of industries and product areas, including financial services, structuring of cross-border acquisitions and transactions, and real estate taxation.

In 1998, 1999 and 2000, he was named as one of the top tax advisors in Japan by the International Tax Review. Dean is a frequent public speaker on corporate issues and has written over 20 articles since 1996 on a range of topics relating to business and M&A in Asia. He is frequently quoted in the Wall Street Journal, New York Times, International Herald Tribune and other business publications.
The aftermath of the 1997 financial crisis has prompted much-needed restructuring throughout south-east Asia and Japan. In China, a major restructuring of state banks has started. In other countries, including India, Hong Kong and Singapore, measures have been taken to strengthen local banks in the face of global competition.

While the danger of a systemic banking crisis in south-east Asia and Japan has passed and the rehabilitation of the financial industry is proceeding, efforts need to be maintained, as financial institutions enter a new era, driven by technological advances and intensified global competition.

The crisis ought to have made clear the value of protecting financial institutions from cyclical downturns and changes in investor sentiment. The building blocks to accomplishing this are a strengthening of the capital base and the improvement of governance in a broad sense.

The capital base has largely been rebuilt through vast injections of government funds and, to some extent, through recourse to the private capital market. The recapitalization has put a high financial burden on governments, and ultimately on taxpayers, but was indispensable to restore the banking system. Governments now have to strike the right balance between achieving adequate capitalization of the banking system on the one hand, and meeting international standards for return on capital on the other. However, adequate bank capitalization is a necessary rather than a sufficient condition to make institutions more resistant to future crisis – recapitalization must be complemented by the improved role of governance.

History can teach us some important lessons. Governance and supervision of financial institutions was generally weak. Loans were frequently made without proper attention to risk, sometimes because of political interference, and external borrowing was conducted without regard to prudential norms. There was limited disclosure and financial transactions were rarely transparent. As the boom ended and these weaknesses were exposed, confidence changed and the crisis was triggered by mass withdrawals of foreign borrowing and sporadic runs on banks by local depositors. The resulting drastic fall in exchange rates damaged corporate balance sheets, caused an interruption of debt service and other payments, and a sharp recession followed (because of the absence of a foreign exchange crisis in Japan, the impact of the loss of confidence in the banking system was milder).
In retrospect it is obvious that weak governance was a key factor in the run-up to the Asian crisis, which was essentially a banking crisis. The need for strong governance becomes even more imperative in an era where global liberalization, intensified competition and technological advance are fuelling an industry trend towards consolidation, so leading to bigger banks that are harder to control. Improvements in governance are, therefore, a priority. They should be guided by best international practices and will need to focus on a large number of issues. In particular:

- risk assessment and risk control;
- credit evaluation;
- loan definitions and provisioning;
- prudential norms;
- accounting standards;
- disclosure and transparency;
- standards for managers through fit and proper tests; and
- rights of shareholders.

A conducive competitive and regulatory environment is needed for improved governance in these areas to become effective. In most countries, efforts to achieve this are underway. Competition will need to be intensified through deregulation, withdrawing privileges of certain institutions, removing barriers to entry, including limitations to foreign ownership, and increasing the role of rating agencies. Regulations must be revised in line with international practice and supervisory authorities are strengthened or newly created. These authorities need to be politically independent and require staff that are technically competent and incorruptible. In several countries it will take time to adequately staff the regulating agencies.

In some of the more developed Asian nations, regulators are shifting from one-size-fits-all regulation towards a more supervisory approach based on the evaluation of banks' management quality and processes, risk management and control systems. They are also playing a role in ensuring corporate governance standards by endorsing the services of external rating agencies to raise bank disclosure standards and improve transparency. They are similarly promoting the employment of professional management in banks where families are still significant shareholders.
In many Asian countries improvements in the operation of the judicial system, particularly with respect to foreclosure and bankruptcy, are also crucial for the strengthening of governance. Again, the adequate staffing of commercial courts in several countries needs a longer-term effect.

But ultimately, the success depends on whether financial institutions can internalize good governance practices, and international best-practice operating standards. That will happen if managers and owners are convinced that high standards of governance are indispensable to attract capital and top personnel, to create value, and to survive in a fast changing global financial environment.
Introduction to corporate governance and compliance

by Stefan Gannon
Hong Kong Monetary Authority

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. In relation to the banking industry in particular, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their board of directors and senior management. It also provides the structure through which the objectives of the institution are set, the strategy of attaining those objectives is determined and the performance of the institution is monitored.

Given their performance in the recent regional financial crisis, banks in Hong Kong are self-evidently well managed by international and regional standards. However, that crisis has reinforced the argument that leadership and control by the board of directors as the guiding mind of the institution is essential if authorized institutions (banks, restricted licence banks and deposit-taking companies) are to navigate their way safely through difficult market conditions.

In recent years, the banking industry has had to cope with a changing business environment. Many of those changes are due to the development of electronic communications. While this has brought financial centres closer together and has opened up new business opportunities, it has also brought new challenges. We are all more likely now to be directly affected by shocks in markets on the other side of the world and there has been a significant increase in competition. I believe there is a general feeling among bankers that they will have to work harder in future to earn a profit.

These and other challenges of which you will all be aware are of a strategic nature. The directors of a bank are its strategic planners. Who else if not the directors are to analyze the big picture, identifying objectives and focusing the institution's resources on achieving them? They can only do so if the basic data to plan strategy is available to them and they have the necessary analytical skills to make the best use of it.

Corporate governance is not just important for banks. Hong Kong's Financial Secretary has recognized this by announcing in his budget speech earlier this year that he had asked the Secretary for Financial Services, with the assistance of the Standing Committee on Company Law Reform, to conduct a comprehensive study on corporate governance in Hong Kong. The objective is to plug any gaps in the corporate governance regime and to become a benchmark in the region. Market bodies, professional organizations and regulators have
been asked to help in this task.

Sound corporate governance is, however, particularly important for banks. Unlike other companies, most of the funds that they use come from depositors. Partially as a result of this, the failure of a bank has the potential not only to affect its stakeholders but to have a systemic effect on the stability of other banks. The Monetary Authority has a particular interest in this as its principal function is to promote the general stability and effective working of Hong Kong's banking system. Some may question why we are so concerned with the corporate governance of banks. The answer is that the legislation which directs us requires us to be concerned with these issues.

After consultation with the banking industry the Monetary Authority issued guidelines on the corporate governance of locally incorporated authorized institutions. In finalizing the requirements of the guidelines, the Authority carefully considered comments received from the industry as well as the particular circumstances of Hong Kong. As a result of the consultation exercise, a number of changes to the draft guidelines that were circulated have been made to address or clarify issues raised. The guidelines have been endorsed by industry associations and advisory committees.

The reader will be relieved to know that I do not propose to refer to the guidelines in detail here. However, I would make the point that it is rooted in the existing legal obligations of directors and, in my view, incorporates practices that most able and reasonable directors will find acceptable. The guidelines are a recognition and endorsement of the importance of directors and an encouragement to their empowerment. Far from being an instrument to weaken the influence of directors, it is an acknowledgement of the continuing need for their special expertise and a confirmation of their responsibilities and powers.

Corporate governance is an important issue. I welcome this publication as a means of disseminating views and providing a forum for discussion of corporate governance and compliance generally in Asia.
From Canada to Korea, the Kyrgyz Republic to Kenya, the number of new codes, policies and regulations on corporate governance has risen exponentially. It began as a trickle with the Cadbury Report in the UK in 1992. A couple of years later it widened into a stream with the publication of the General Motors board guidelines. Now it has become a raging torrent.

In Asia, three-quarters of the region's major economies have a code of best practice or are developing one (Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Singapore and Thailand all have codes; China, the Philippines and Taiwan do not). Although this process started before the financial crisis in some common law jurisdictions in Asia, it was the recession that opened the floodgates to a fundamental rethink of how companies should be governed in future.

Asian managers seeking guidance on how to implement corporate governance are spoilt for choice. The place to start, clearly, is with the local rules and codes produced by the relevant national securities regulator, stock exchange or society of accountants. But to grasp international best practice – increasingly important for firms seeking an overseas listing or other forms of foreign capital – it is necessary to refer to another dozen or so seminal documents (see the box below). Many of these can be downloaded or ordered from the internet, so accessing them should not be too difficult.

What may be more problematic is putting these new ideas into perspective.

**INTERNATIONAL BEST PRACTICE - SEMINAL DOCUMENTS**

**Official and quasi-official statements**

- The Combined Code, June 1998 (UK)
- Blue Ribbon Report on Audit Committees, February 1999 (USA)
- OECD Principles of Corporate Governance, May 1999
- Commonwealth Association for Corporate Governance, Principles for Corporate Governance in the Commonwealth, November 1999.
Institutional investor statements

- TIAA-Cref, Policy Statement on Corporate Governance, October 1997 (US)
- Council of Institutional Investors, Corporate Governance Policies, March 1998 (US)
- CalPERS, Corporate Governance Market Principles, April 1998 (US)
- International Corporate Governance Network, Statement on Global Corporate Governance Principles, July 1999

Corporate statements

- General Motors, Corporate Governance Guidelines, January 1994 (revised 1995 and 1997)
- CLP Holdings, Corporate Governance - CLP Principles & Practices, August 2000 (Hong Kong)

Source: Asian Corporate Governance Association

Code convergence in Asia

Before discussing developments in Asia, it is necessary to define certain terms. Broadly speaking, corporate governance can be divided into two basic types. One is called the Anglo-American or outside model. This refers to diversified ownership of corporations (i.e., many small shareholders, no dominant owners), a single board of directors, an emphasis on shareholder value as the proper focus of corporate activity and a recognition that institutional investors have a vital role to play, as large minority shareholders, in keeping boards and managers on their toes.

The other type is the continental European or inside model: concentrated ownership (by families or banks), a mostly two-tier board system, an emphasis on nurturing relationships with all stakeholders (shareholders, employees, customers, society at large) and limited recognition that minority shareholders have a right to influence management decision-making.

Before the Asian crisis, countries with legal systems influenced mostly by the common law – Hong Kong, India, Malaysia and Singapore – took the Anglo-American model as a reference point in devising their systems of governance. Those following more the civil law tradition – China, Japan, Korea and Taiwan – tended to adopt the European approach.

This neat division into two camps should not be overstated, however. Some countries,
Regulatory overview

such as Japan, show traces of both models. It borrowed from 19th century German law in the development of its company law, but its securities law was imported from the US after the Second World War. Despite the influence of English law, places such as Hong Kong, India and Malaysia display corporate ownership structures that more closely resemble the European family type than the Anglo-American diversified structure – as do the vast majority of Asian firms. And no Asian country has ever wholly followed either model. Rather, they have imported only the parts they have needed.

Fast-forwarding to the present, the interesting contradiction of corporate governance reform in Asia is that it is the Anglo-American model that is gaining as a result of globalization (and the strength of the US as a provider of capital). While Asian countries are not moving towards identical systems of governance, there is a striking agreement among the proponents of reform in each country – mainly market regulators, central banks and international investors – on the centrality of certain principles (see Table 1). These include:

## Table 1

### Points of convergence

<table>
<thead>
<tr>
<th>Country</th>
<th>Enhancement of shareholder value</th>
<th>Independent directors</th>
<th>Higher levels of financial disclosure</th>
<th>Independent board committees</th>
<th>Codes of best practice</th>
<th>Importance of institutional investors</th>
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Test: Does the country subscribe to the principle and apply it to domestically listed firms, or does it have plans to do so?

"Country" refers mainly to official bodies, but also includes business/professional associations involved in corporate-governance standard setting.

Note 1: These principles have been recognized as important by the China Securities Regulatory Commission.

Note 2: Banks in the Philippines are required to have independent committees for remuneration and audit.

Source: Asian Corporate Governance Association

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• enhancing shareholder value as a primary focus of companies and upholding or extending shareholder rights (this is accepted, even in places like China, as a fundamental prerequisite for the development of capital markets);
• the need for non-executive and independent non-executive directors to provide an outside view on strategic direction and to counterbalance the executives on the board (or to help strengthen the supervisory board in relation to the management board in two-tier systems);
• the usefulness of board committees responsible for audit, nomination and compensation, and comprising a majority of independent or non-executive directors;
• the importance of higher levels of financial disclosure from listed companies and much improved auditing practices; and
• allowing or encouraging institutional investors to act as a check against management and a lever for enhancing board independence.

Some of these principles have been incorporated into laws and regulations governing companies and securities trading, or have been expressed in the listing rules of stock exchanges. Most are now included in codes of best practice developed over the past two years and may or may not be mandatory.

A salient example of convergence concerns audit committees. Singapore mandated them for listed companies as early as 1991 – following the collapse of a major conglomerate and a market crisis in the 1980s – and stated that they must comprise a majority of independent directors. Malaysia followed suit in 1994, along with Thailand in December 1999 and, in the same year, Korea (where they are mandatory for listed companies with assets of 2 trillion won ($1.8 billion) or more). Audit committees are not compulsory for main board companies in Hong Kong, but they must now disclose whether or not they have them (a rule in force since January 1999). They are mandated for companies listed on Hong Kong’s second board, the Gem market. Audit committees have also been voluntary in India, but will become a requirement for the 150 most actively traded companies in March 2001.

Hence, despite variation in the implementation of audit committees in Asia, there has been convergence in policy direction and this convergence has grown over time. A similar theme runs through the other areas where convergence is occurring.
... AND DIVERSITY
But convergence does not imply total uniformity – some key differences remain. One fault line involves the stakeholder concept, which defines the corporation as having broad social, as well as commercial, responsibilities. As Table 2 shows, five Asian countries explicitly subscribe to this principle: China, Indonesia, Korea, Japan and Thailand. Two others, Singapore and Malaysia, explicitly recognize the social importance of corporations, but do not make shareholders a primary focus of their governance regimes. Singapore relies on other means, mainly legislation, to protect employees, creditors and customers (as do most countries for that matter). Malaysia encourages boards to be "responsible for relations with stakeholders", but stresses that they are "accountable to the shareholders", according to a high-level report on corporate governance published in February 1999. The report goes on to say: "To define board responsibilities to act in the interests of a broader group than the company's

**Table 2**
Points of divergence

<table>
<thead>
<tr>
<th>Country</th>
<th>Stakeholder focus</th>
<th>Single-tier board</th>
<th>Two-tier board</th>
<th>Size of code</th>
<th>Scope of Code</th>
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Notes:
1. Malaysia recognizes the importance of stakeholders, but argues that boards can only be made accountable to shareholders.
2. Singapore has a stakeholder concept (i.e., corporations play a social role), but it protects workers through legislation.
3. Singapore's current code focuses solely on audit committees, but it is working on a more comprehensive code.

Source: Asian Corporate Governance Association
shareholders would confuse board responsibilities and significantly undermine the accountability of the board. However, in making decisions to enhance shareholder value, boards must develop and sustain these stakeholder relationships.

A second difference concerns board structure: whether companies have single-tier or two-tier boards. Most countries have single-tier. Interestingly, Korea, despite the historic influence of Japan, does not have two-tier boards.

A third point of divergence relates to differing legal and commercial cultures. Both Hong Kong and Singapore have small codes, which are limited in scope. Hong Kong's code is about a page and a half long and is extremely general. Singapore's current code is a similar length and only focuses on audit committees. At the other end of the scale is Korea's comprehensive new code, which runs to about 40 pages. These differences can partly be explained by the contrast between common-law pragmatism and civil-law idealism. But they are also founded in the need in Hong Kong and Singapore to strike a balance, as international financial centres, between commercial freedom and investor protection. Too much of the latter (in the form of new regulations) may damage the investment environment and, some fear, lead to moral hazard issues (i.e., irresponsible investor behaviour). Alec Tsui, former chief executive of the Stock Exchange of Hong Kong, said in 1999 that regulators must strike a balance between over- and under-protecting investors. "Regulators in some developed markets have perhaps erred in the direction of acting too much as nanny to the market, or of inhibiting commercial flexibility with copious rules and regulations. Our philosophy in Hong Kong is to adopt a practical and non-bureaucratic approach, as far as this is possible." Korea, on the other hand, needs a comprehensive new code because not only is the gap between its pre-crisis company law and international best practice much wider, but it must satisfy the IMF and international investors that it is serious about reforming its poorly managed and highly opaque chaebols.

**Local Adaptation of Global Principles**

While there may be a growing consensus among governments and institutional investors in Asia as to what constitutes the core principles of corporate governance, how best to implement them is a question that each government is grappling with. This process is not carried out in isolation, but usually involves negotiation with domestic corporations, local investors and foreign institutional investors. Depending on the economy, it may also involve the IMF, World Bank and the Asian Development Bank.
Regulatory overview

The issues can be quite complex. What is the right balance between mandatory rules, self regulation by companies and market mechanisms (e.g., pressure from institutional investors)? Should the new rules be applied to all companies or, at least initially, just the largest listed ones? What social obligations can legitimately be imposed on companies? Should best practices like world-class financial disclosure, independent directors and audit committees be implemented all at once or phased in? What are the implications for national competitiveness if reform occurs too slowly and investors lose confidence? What complementary institutional building is required to ensure that best practices do not become mere window dressing (e.g., a new institute of directors to train directors and inculcate the meaning of independence)?

These questions represent just the tip of the iceberg and indicate the difficulties involved in implementing a new governance regime. Given that no two countries are alike, no two governance regimes will be entirely alike either.

Differences in priority are already apparent at the national level following the recent spate of reforms. China expects its overseas-listed state enterprises to meet a much higher standard of governance than domestically listed companies. In March 1999 the China Securities Regulatory Commission released a new set of measures designed to "deepen reform" among its overseas-listed companies. Korea sets a higher standard for the proportion of independent directors on the boards of its largest listed companies and banks than other listed companies, and has made audit committees mandatory for the largest listed firms. Hong Kong, as noted above, is bucking the regional trend by not making audit committees mandatory (except for Gem companies). It does, however, use a mixture of official arm-twisting and peer pressure to persuade listed firms to implement them. Thailand's stock exchange, which produced a new code of best practice in March 2000, echoes Hong Kong-style pragmatism by stating that governance reform must be practical and take into consideration the "Thai operating context".

The really interesting question is whether Asian countries will develop original ideas in the process of adapting international best practice to their specific circumstances. Although reform has just begun, it is already apparent that some Anglo-American solutions, designed as they are for a different corporate system, may not function effectively in Asia— at least over the short term. Can we realistically expect relatively young and inexperienced independent directors to stand up to incumbent management in the average Asian company? Will audit committees, made up of such people, provide adequate checks and
balances? The problem is not that the concept of independent directors is inapplicable to Asia – it has to be or how else will most minority shareholders be represented on the board – but that the Anglo-American way of nominating and electing such directors (the board nominates, the shareholders elect at the annual general meeting) may be insufficient to ensure the system works in the family controlled Asian firm. Perhaps minority shareholders need to be given a greater say in the nomination of their representatives?

**INTERNATIONAL ACCOUNTING AND AUDITING DEVELOPMENTS**

Reform of board structures is not the only corporate governance issue brewing worldwide - a parallel move is underway to raise standards of accounting and auditing to world-class levels. Indeed, the pressure for improvement in this latter area has been especially intense following the unforeseen collapse or near collapse of major corporations and financial companies in recent years, such as Peregrine in Hong Kong and LTCM in New York, and the appalling implosion of emerging markets. Andrew Sheng, chairman of Hong Kong’s Securities and Futures Commission, puts it succinctly: “bad accounts equals bad statistics equals bad policies equals bad risk management equals financial crisis”.

In addition to the World Bank and the IMF, the key players in the drive to improve accounting and auditing standards include:

**International Accounting Standards Committee (IASC)**, a London-based organization comprising members from 153 professional accounting bodies in 112 countries. Formed in 1973 to harmonize accounting principles around the world, it is the author of the International Accounting Standards (IAS).

[www.iasc.org.uk](http://www.iasc.org.uk)

**International Federation of Accountants (Ifac)**, a New York-based organization representing a similar range of professional accounting bodies as the IASC. IFAC is the author of the International Standards on Auditing, which have become the national auditing standard in 34 countries and are followed with only slight modification in another 35.

[www.ifac.org](http://www.ifac.org)
International Forum on Accountancy Development (Ifad), a body set up by IFAC with assistance and encouragement from the World Bank in June 1999. One of its primary aims is to "help harness funds and expertise to build accounting and auditing capacity in developing countries". Ifad was formed following criticism from the World Bank that the international accountancy profession was not doing enough to foster professional development in emerging markets.

www.ifad.net

International Organization of Securities Commissions (Iosco), the umbrella body for financial regulators from more than 100 countries. At its recent annual conference, held in Sydney in May 2000, Iosco approved and recommended the use of IAS standards for cross-border listings.

Financial Stability Forum, a grouping of central banks, national treasuries, international financial institutions (ie, IMF, World Bank, etc) and international regulatory and supervisory organizations (eg, the Basel Committee on Banking Supervision, Iosco) formed by the G7 countries in the first half of 1999. It aims to assess vulnerabilities in the international financial system and improve coordination among responsible authorities. One of its activities was to set up a taskforce to examine how to promote the implementation of international standards "relevant to strengthening financial systems". The taskforce identified 12 key standards as being the most relevant. They include the IASC's International Accounting Standards, Ifac's International Standards on Auditing, and the OECD's Principles of Corporate Governance.

www.fsforum.org

Asia is very much part of this interlocked process. Not only are all major Asian economies represented in the IASC, Ifac and Iosco, but Hong Kong and Japan play a leading role in the International Forum on Accountancy Development. Andrew Sheng, Hong Kong's securities chief, chairs the Financial Stability Forum's task force on implementation. And Asian countries are under pressure not just to upgrade their standards in line with the IAS and ISA rules (which many have done), but to ensure they are properly enforced (something the Asian crisis showed was seriously lacking).
EMERGENCE OF A CORPORATE GOVERNANCE INDUSTRY

Pressure for reform in Asia is coming from below as well as above. A schematic description of the variety of actors promoting corporate governance in Asia (see Chart 1) reflects a high level of interest among non-governmental organizations, academics, professional bodies, consultants and the media as well as official bodies, investors and the multilateral financial institutions. Indeed, a broad industry has emerged that is seeking to build much of the intellectual and institutional infrastructure necessary to facilitate improvements in accounting, auditing, director performance and minority shareholder participation.

CHART 1

The corporate governance industry in Asia: an expanding dialogue

Academia  
NGOs*  
Professionals/ media

Governments  
Corporations  
Investors

Multilaterals (World Bank, IMF, etc)

*Non-governmental organizations

New institutes of directors (IoDs) were established in the Philippines, Singapore and Thailand in 1999, while the Hong Kong IoD has been revamped in the past couple of years. The Asian Corporate Governance Association, a private-sector initiative formed by business leaders from around Asia in mid-1999, was set up to educate Asian companies about the commercial benefits of higher standards of governance and assist them with implementation (see box). Also in 1999, the Pacific Economic Cooperation Council formed a core group on corporate governance comprising mainly academics and officials from around the region, including Australia. This initiative is being led by a former finance minister of the Philippines, Jesus Estanislao, who is also the driving force behind his country’s new Institute of Corporate Directors.
Regulatory overview

In Indonesia, a relatively new non-governmental organization, the Indonesian Society for Transparency, is working on the creation of the Indonesian Institute for Corporate Governance. In Korea, another civil rights group, People's Solidarity for Participatory Democracy formed a shareholder activist organization in 1997 that has led the defence of minority shareholder rights there. And in Japan, the Corporate Governance Forum produced the country's first code of best practice in 1998.

Two other trends worth noting include the rapid formation of formal alliances and informal networks between many of these groups, and between these groups and governmental bodies and investors; and the equally rapid development of training programmes, academic courses, conferences and publications. Much of this has been greatly enhanced by the internet and its offer of cheap communications.

The financial crises in emerging markets over the past two years have led to a fundamental rethink about the way in which both national financial systems and companies should be governed. All major Asian economies are participating in this process and, in their own way, are converging towards a global set of corporate governance best practices. Implementation of these principles will vary from country to country, but international providers of capital (and in future domestic ones as well), the multilateral banks and national regulators in Asia all expect corporations to meet certain minimum standards of governance. Modern corporate governance is a new lingua franca for international business. Asian companies operating across borders will find it increasingly important.

Jamie Allen is the founding secretary general of ACGA. The views expressed in this article are his own and do not necessarily reflect those of the ACGA.
ASIAN CORPORATE GOVERNANCE ASSOCIATION

The Asian Corporate Governance Association (ACGA) is a not-for-profit organization formed in August 1999 by a group of business leaders from across Asia. It is a private-sector initiative that advocates the commercial and economic value of higher corporate governance standards to Asia. ACGA engages in original research and publication, information dissemination, seminar organization and commentary. Its board members and staff are regularly invited to speak at regional and international conferences, and it is increasingly being seen as a central resource for information on corporate governance reform in Asia.

ACGA’s founding sponsor is Lombard / APIC (HK), a private equity fund management company based in Hong Kong and investing in Asia. Lombard places a high value on corporate governance and actively works to raise standards of transparency and accountability in its investee companies. Its parent company is Lombard Investments of San Francisco. Other major sponsors include Good Morning Securities, one of Korea’s largest securities firms, and the Housing Development Finance Corporation, India’s largest residential mortgage lender.
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Many Hong Kong companies are majority owned by a single shareholder or a group of family members. Consequently there is a danger that management effectively represents the interests of these shareholders over and above the interests of minority shareholders.

Corporate governance in Hong Kong is therefore driven by the need to guard against any potential conflicts of interest between the majority and minority shareholders, and the desire to ensure that the management is held accountable to – and acts in the interest of – the company, rather than any individual shareholder. This article will focus on companies listed on the main board, as opposed to those listed on the Growth Exchange Market (Gem).

The Hong Kong stock exchange – which monitors and regulates listed companies on behalf of the Hong Kong Securities and Futures Commission (SFC) – does not impose stringent standards of corporate governance on listed companies, but instead provides broad guidelines.

Hong Kong’s main source of authority for regulating the directors of companies listed on the exchange is the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

In the early 1990s, the listing rules were more concerned with the regulation of potential conflicts of interest between the controlling shareholder and the company as a whole rather than the role and responsibilities of the management board. But in 1992 the exchange began its Corporate Governance Project. The first working group was formed in 1993 to analyze and consider matters covered by the UK Cadbury Report on corporate governance, published in December 1992. As a result the first version of the Code of Best Practice for listed companies in Hong Kong was introduced in November 1993 as Appendix 14 to the listing rules. More recently, following its UK counterpart, the Code requires the appointment of an audit committee with a majority of non-executive directors and with an advisory function assisting the executive management on the financial reporting process and internal control system.

The Listing Rules
Most of Hong Kong’s listed companies are incorporated offshore, in jurisdictions such as Bermuda and the Cayman Islands. These companies are therefore, to a large extent, not subject to the Hong Kong Companies Ordinance (Cap 32 of the Laws of Hong Kong), although
the common law position in these jurisdictions is very similar to that in the UK and Hong Kong. As a result, apart from common law, the listing rules are an important source of authority through which the exchange and the SFC regulate the conduct of directors of listed companies in Hong Kong.

The listing rules codify the directors' duties under the common law and require a director of a listed company to fulfil fiduciary duties of skill, care and diligence to a standard at least commensurate with the standard established by Hong Kong law. In particular, Rule 3.08 of the listing rules requires directors to:

- act honestly and in good faith in the interest of the company or its assets;
- act for proper purposes;
- be answerable to the company for the application or misapplication of its assets;
- avoid actual and potential conflicts of interest and duties;
- disclose fully and fairly their interest in contracts with the company; and
- apply a degree of skill, care and diligence as may reasonably be expected of people of their knowledge and experience, and holding their position within the company.

Directors of a listed company must satisfy the exchange that they have the character, experience and integrity, and are able to demonstrate a standard of competence commensurate with their position as a director of such a company (Rule 3.09 of the listing rules). As set out in the exchange's standing requests (issued on February 7 1996), the exchange expects this requirement to be satisfied on a continuing basis.

Directors are also required to undertake to the exchange that, among other things, in the exercise of their power and performance of their duties as a director, they will comply to the best of their ability with the listing rules and use their best endeavours to ensure that the company will so comply (Appendix 5B of the listing rules).

**CODE OF BEST PRACTICE**

The Code was first introduced in November 1993 as an appendix to the listing rules. The Code sought to increase the accountability of directors and contains guidelines considered by the exchange to be the minimum standard that all listed companies should meet in regard to the conduct of good corporate governance, such as conduct at board meetings, the role and the rights of independent non-executive directors, conflict of interest issues involving
substantial shareholders or directors, continuous education for directors and the appointment of an audit committee.

In this respect, the exchange tends to advocate self-regulation and aims to provide broad guidelines only. The listing rules expressly provide that the Code is not intended to be a set of rules which are to be rigidly adhered to and companies are encouraged to devise their own code of practice in the interests of the board of directors as a whole. The listing rules, however, require that companies which do not comply fully with the Code must disclose reasons for non-compliance in all interim and annual reports.

**Directors' Education**

A recent introduction under the Code in May 1998 is that every director is required to keep abreast of their responsibilities as a director of a listed company. Education is vital to raising standards of corporate governance and the exchange believes it is important that directors should thoroughly understand their duties and obligations under the listing rules – and other relevant laws and regulations – to enable them to perform satisfactorily their duties and to earn the confidence of their shareholders. The exchange has, over the years, taken an active role in providing such education, including the publication of books on directors' duties and the exchange's disciplinary procedures, regular distribution of informative materials (including practice and guidance notes on the listing rules from time-to-time) and organizing courses and seminars on corporate governance topics.

**Audit Committees**

The audit committee guideline is another recent development under the Code. In many countries including the US, UK, Canada, Australia, Singapore and Malaysia, audit committees are a feature of good corporate governance for listed companies, many of which are of a mandatory or regulatory nature. The growing importance of this feature is founded on the need for better corporate accountability. Hong Kong has followed this international standard since May 1998 in response to the recommendation of the Fourth Working Group of the exchange formed in 1996, which comprised representatives from the exchange, the SFC and various professional bodies. Similar to the UK and Australian approach, Hong Kong audit committee requirements under the main board's listing rules are introduced as best practice under the Code, rather than as mandatory rules. On the Gem board, however, audit committees are mandated because companies listed there are typically without a track record.
of profitability due to their emerging nature and so more stringent financial accountability
and corporate governance requirements are appropriate.

Members of an audit committee should be appointed from among the non-executive
directors and a majority of them should be independent.

The function of an audit committee is to assist the management in providing an
independent review of the effectiveness of the financial reporting process and internal
control system of companies, and the Code refers to the recommended guidelines provided
in the publication A Guide for the Formation of an Audit Committee issued by the Audit
Committee Task Force of the Hong Kong Society of Accountants Corporate Governance
Working Group in December 1997, which companies may adopt in establishing their audit
committees.

The guide suggests that the audit committee should, among other things:

- consider and review carefully areas where exact figures in the company's accounts are
  not available and the management have made estimates, and to make sure that the
  judgments made by management are reasonable, and where appropriate, it may
  challenge whether an alternative basis of calculation would be relevant or where further
  support details should be obtained before a conclusion is reached;
- consider whether all the relevant items have been adequately disclosed in the financial
  statements, and whether any inconsistencies exist within the financial statements; and
- review any areas of discussion or dispute between the management and the auditors.

The guide also recommends that the audit committee should monitor management's
strategy for ensuring that the company has appropriate and functioning controls in place
on business risk management, and should monitor internal and external audit coverage to
ensure all key risk areas are considered.

The guide also suggests that the duties of the audit committee be extended to include
reviewing the company's compliance with regulations, including the listing rules and other
regulatory, industry or legal requirements, and the company's wider obligations to the
community in which it operates, and of the social or ethical codes that exist within the
business.

The exchange expects that audit committees will serve to contribute significantly to
increasing public confidence in the creditability and objectivity of financial statements -
and of the board of directors as a whole – and to create a climate of discipline and control to reduce the opportunity for fraud.

**Non-executive directors**

The role of non-executive directors has also become more important in the context of corporate governance and in July 2000 the Hong Kong Institute of Directors published *The Guide for Independent Non-Executive Directors*. This guide contains basic guidelines and suggests that non-executive directors should, among other things:

- act towards the company and the members of the company as a whole at all times with honesty and integrity, and use due care, skill and diligence at all times in the consideration of any courses of action affecting the company;
- understand the composition of the board and the diverse role they play as a non-executive director;
- be able to devote a sufficient amount of time to fulfilling this role as well as to learning generally about the company, the business, any competitors and the environment in which the company operates; and
- actively participate in board decisions and help to determine the direction and strategy of the company, as well as supervise the management and act as a sounding board where necessary.

Above all non-executive directors should exercise independent judgment formed after a fair consideration of all relevant information and made free from any personal influence. Certain tests of independence can be found in Rule 3.11 of the listing rules and in Rule 2.8 of the Hong Kong Code on Takeovers and Mergers. These tests generally concern the existence of certain personal and professional relationships, any direct or indirect interests in businesses related to the company on whose board the director sits and the significance or importance of such interests to the non-executive director's own business or situation.

**Disclosure of information**

Disclosure of information on a company is an important part of corporate governance and one which lies in the hands of the directors.

Under paragraph 2 of the Listing Agreement, which every listed company must enter
into with the exchange, a company is required to keep the exchange, members of the company and other holders of its listed securities informed as soon as reasonably practicable, of any information relating to the company and its group which:

- is necessary to enable them and the public to appraise the position of the group;
- is necessary to avoid the establishment of a false market in its securities; and
- might be reasonably expected materially to affect market activity in and the price of its securities.

In May 2000 the exchange issued additional guidance on this general obligation which includes, among other things, the requirement to disclose any change in the company’s financial condition, in the performance of its business or in the company’s expectation of such performance, if knowledge of the change is likely to lead to substantial movement in the price of its listed securities.

Listed companies are also required under Chapter 14 of the listing rules to disclose publicly details of any significant acquisition and disposal transactions. Different requirements apply to different classes of transaction based on the ratio of the size of the asset acquired or disposed of to the size of the company on various bases relating to asset value, profits and amount or value of consideration paid.

More importantly perhaps in Hong Kong, where the management is typically controlled by a single major shareholder with potential conflict of interests with that of the public minority shareholders, any transaction between a listed company and its connected persons (which includes a substantial shareholder, a director or chief executive of the listed company or any of its subsidiaries or an associate of such director, chief executive or substantial shareholder) will, unless otherwise exempted as prescribed under the listing rules, be subject to full disclosure and shareholders’ approval, and any connected person interested in the transaction must abstain from voting at the relevant general meeting. Also, an opinion is required by an independent expert acceptable to the exchange as to whether the transaction is fair and reasonable, which must set out the reasons for and the factors taken into account in forming that opinion.
OBLIGATIONS RELATING TO DEALINGS AND INTEREST IN SECURITIES

A listed company is required to adopt rules governing dealings by directors in the company's listed securities. The Model Code For Securities Transactions by Directors of Listed Companies in Appendix 10 to the listing rules sets out a minimum standard of good practice for directors dealing in securities of their own company.

Directors who are aware of price sensitive information should not deal in the company's shares until the information becomes public. This is in line with the basic prohibition under the Securities (Insider Dealing) Ordinance (Chapter 395 of the Laws of Hong Kong) that persons in possession of confidential price-sensitive information must refrain from dealing or procuring dealing in securities listed on the exchange. Contravention of the Securities (Insider Dealing) Ordinance may result in being banned from acting as a director or manager of a listed company for up to five years.

Also, under the Securities (Disclosure of Interests) Ordinance (Chapter 396 of the Laws of Hong Kong), directors are obliged to disclose to the exchange and the company all their interests in shares of the company and any associated company, and any dealings they may have in those shares.

Under the new composite Securities and Futures Bill, which was gazetted in April 2000, the existing legislative provisions discussed here, together with other existing securities related legislation, are to be consolidated into a single ordinance, with the aim of creating a consistent and simple regulatory framework capable of effective enforcement by the SFC and with which market users (including listed companies and their directors) and intermediaries will be able to comply efficiently. The new composite bill was subject to public consultation until the end of June 2000 and is expected to be enacted by April 2001.

DUTIES OF DIRECTORS OF COMPANIES IN FINANCIAL DIFFICULTIES

The good faith and accountability of directors is of particular importance for companies in financial difficulties and becoming insolvent. The Companies Ordinance imposes criminal liability for various kinds of misconduct by directors and other company officers in relation to insolvent companies. These offences include:

- fraudulent trading (Section 275 of the Companies Ordinance);
- effecting transactions to defraud creditors (Section 273 of the Companies Ordinance);
- not keeping proper books and accounts (Section 274 of the Companies Ordinance); and
• effecting transactions constituting fraudulent or unfair preference to a creditor (Sections 266 and 266B of the Companies Ordinance).

In cases where a liquidator determines that a director has caused the downfall of the company concerned, a director may be disqualified from acting as a director for up to 15 years (Sections 168G and 168H and generally, Part IVA of the Companies Ordinance).

**Disciplinary powers of the exchange and the SFC**

In the event that a listed company director is in breach of the listing rules, the exchange may, among other actions set out in Rule 2A.09 of the listing rules, in the case of a wilful or persistent failure by a director to discharge their responsibilities under the listing rules, state publicly that in the exchange's opinion the retention of office by the director is prejudicial to the interests of investors, and in the event that a director remains in office following the making of such public statement, the exchange may suspend or cancel the listing of the company's securities or any class of its securities. The exchange may also require a breach to be rectified or other remedial action to be taken within a certain period of time including, if appropriate, the appointment of an independent adviser for the minority shareholders.

The SFC also has a supervisory function and will normally be involved if:

• it is requested to do so by the exchange; or
• the SFC has information that suggests a serious breach of the listing rules, a breach of the Hong Kong Codes of Takeovers and Mergers and Share Repurchases or other statutory misconduct under the Securities (Disclosure of Interests) Ordinance or the Securities (Insider Dealing) Ordinance.

**Additional shareholder protections**

While corporate governance and regulation through the exchange and the SFC is a highly effective means of protecting the interests of minority shareholders against abuses of power by majority shareholders, there are additional protections to be found both in common law and statute.

Under Section 168A of the Companies Ordinance, any member of a company who complains that the company has been unfairly prejudicial to their interests, or the interests of the members generally, may make an application to the court for an order of unfair prejudice. If the court, in its discretion, concludes that unfair prejudice has occurred, it may:
make an order to restrain the continuation of the offending conduct;
• order such proceedings as it deems fit to be brought in the name of the company against
  the offending party;
• appoint a receiver or manager of the whole or a part of the company’s property or
  business; or
• make any such other order as it may deem fit.

Other such remedies include an application by the minority shareholder to the financial
secretary for the appointment of an inspector to investigate the affairs of the company or in
certain extreme circumstances the court may exercise its discretion and call for the winding
up of the company if it believes that it is just and equitable to do so.

**OUTLOOK**

Corporate governance has become a key theme in modern corporate development which
stresses transparency and accountability, and is essential to enhancing the prosperity and
integrity of a company.

(The quality of corporate governance in a jurisdiction is closely linked to the
development of its securities market and with its international reputation and
competitiveness as a financial centre, Hong Kong has developed a good corporate
governance framework, regulating company directors through market self-discipline and
various non-statutory rules and codes of behaviours administered by the exchange and the
SFC. It also has adequate statutory backing from various legislative provisions which are to
be consolidated and enhanced following the enactment of the Securities and Futures Bill,
expected in early 2001. Hong Kong has its place as a leading international financial centre,
and it is fair to say that the good corporate governance regime in Hong Kong contributes
significantly in securing its position with a first-class investor protection framework.)
Corporate governance has emerged as a key component in the regulation of India's securities market. It is also benefiting companies and has developed as a significant tool to ensure legal compliance.

A major overhaul of the stock exchanges' listing agreements (Listing Agreement Amendments) has improved the corporate governance standards of India's publicly traded companies. The Securities and Exchange Board of India (Sebi) implemented amendments to the listing agreements that companies enter into with the stock exchanges on which they list their securities, following the recommendations of the Kumaramangalam Birla Committee, an independent group appointed by Sebi to review the regulations.

Issues of corporate governance have been discussed in some form or other since the days of the charter companies (the precursor of the modern company). Today, the term has come to mean different things. Narrow definitions restrict corporate governance to the structure and functioning of the board of directors and the rights and responsibilities of the directors of a company with respect to the shareholders. These definitions are often challenged by those who view the company as more than the shareholders and management—this wider definition refers to the various internal arrangements that exist, questions of control and the allocation of risk and returns.

Given that the title of this publication distinguishes a link between corporate governance and legal compliance, it would perhaps be more appropriate to provide a flavour of the wider definition of corporate governance.

**The Basic Premise**
Any analysis of corporate governance, particularly in India, requires an understanding of the nature of the company. Indian law has traditionally subscribed to the multi-stakeholder conception of the company. The Indian Companies Act, 1956, has detailed provisions helping governmental and quasi-judicial bodies to ensure that management of companies—and shareholders—take into consideration the interests of the various stakeholders in the company. The Supreme Court of India, while granting approval to a proposed merger held that the term "company", given the statutory framework, would include not just the shareholders and employees, but the public interest as well. It may be noted that the government is proposing to amend the Companies Act (Amendment Act) incorporating certain corporate governance requirements.
The multi-stakeholder conception has been under attack over the last few years, with different stakeholders looking to protect their interests. This attack has spilled into the deliberations of some committees established to look into issues of legal reform. The attack is based on a view that the shareholders, as owners of the company, are its primary stakeholders. In the UK Cadbury Report, the shareholders of the company are primarily understood to be the shareholders of the company. Prior to the recommendations of the Birla Committee, the Confederation of Indian Industry formulated a corporate governance code, which viewed shareholder interests as being paramount. Corporate governance therefore is seen as essential to the enhancement of shareholder value.

However, the Birla Committee report acknowledged the multi-stakeholder conception of the company. The Committee defined the goal of corporate governance as the enhancement of long-term shareholder value, while simultaneously protecting the interests of the other stakeholders; suppliers, customers, creditors, bankers, employees, the government and society.

**The Challenge of Corporate Governance**

The Indian legal system has responded to the challenges (the same as those faced in the developed markets of the world) of corporate governance through various statutory and regulatory innovations. The challenges arise from the separation of ownership and control, resulting in the vulnerability of small investors who have no control over the company; the lack of management responsibility in corporate decision making with regard to the stakeholders of the company; the need to ensure that stakeholders do not have to face the consequences of corporate failure; and the risks created by the twin concepts of company law, ie separate legal identity and limited liability of the members of the company. These challenges, when seen in the context of inadequate funding and poor quality management, are addressed in the following ways:

- an emphasis on disclosure requirements;
- improving the quality of the board of directors (for example the appointment of non-executive directors and independent directors);
- responsibility of the board of directors;
- self regulation through an audit committee of the board of directors;
- self regulation through a remuneration committee of the board of directors; and
- restrictions on market control mechanisms.
The Listing Agreement Amendments need to be implemented by all publicly traded companies before March 31, 2001. However, some of the changes require amendments to existing law (like the introduction of postal ballots for shareholders to vote on certain fundamental issues) and therefore are non-mandatory.

**Emphasis on Disclosure Requirements**

The Disclosure and Investor Protection Guidelines 2000, a detailed and comprehensive supplement to the provisions of the Companies Act, tightened disclosure requirements for companies listing on stock exchanges. Mis-statements in an offer document can have civil as well as criminal consequences, in accordance with the provisions of the Companies Act.

Continuous and continuing disclosure by publicly traded companies is mandatory through the publication of an annual report — the contents of which are determined by the Companies Act and rules prescribed by the government — and as a requirement of the listing agreements with the stock exchanges. The annual report contains, among other things, a detailed report by the board of directors of the company, a detailed report by the statutory auditors of the company, the balance sheet and profit and loss account of the company, and details about high-earning employees. Similar information needs to be included for the subsidiaries of the company, a requirement which can be easily overcome due to the limited nature of the definition of a subsidiary under Indian law. Companies are specifically required to disclose the steps taken with respect to conservation of energy, technology absorption and foreign exchange earnings and outgoings.

The Listing Agreement Amendments now require publicly traded companies to include the following in their annual reports, which were not required earlier:

- a detailed report on corporate governance containing details on the board of directors, the audit committee, shareholder meetings and general information for shareholders;
- a detailed compliance report on the mandatory requirements of the Listing Agreement Amendments;
- a certificate from the statutory auditors of the company regarding the same; and
- a management and discussion analysis report to be included with the director's report referred to above.
IMPROVING THE QUALITY OF THE BOARD OF DIRECTORS

Under the Companies Act, the directors of a company are normally appointed by a majority of shareholders at a general meeting of the company. No individual can hold more than 20 directorships, though there are moves afoot to cut that to 15. While the Act itself does not stipulate any significant requirements, the listing agreements now require that publicly traded companies comply with the following:

• not less than 50% of the directors of the company should be non-executive directors (those not in the employment of the company);
• in the case of a company with an executive chairperson, the number of independent directors (directors who apart from their remuneration have no material relationship with the company, its promoters, its management or its subsidiaries, which in the opinion of the board may affect their independence of judgment) should be half; else the number of independent directors can be one-third;
• companies should supply directors with a detailed list containing information on annual operating plans and budgets, capital budgets, quarterly results, significant impending litigation, fatal or serious accidents, dangerous occurrences, material effluents or pollution problems, material defaults in financial obligations to and from the company, product liability claims, significant labour problems, intellectual property issues, details of mergers and acquisitions, joint ventures and certain investments;
• any issue of non-compliance of any regulatory or statutory nature needs to be brought to the notice of the board of directors. This requirement has interesting implications. A number of statutes in India cast criminal responsibility on the directors and management for acts of the company. Directors and management can defend themselves if they can establish that they had exercised diligence or did not have any knowledge. Since all issues of non-compliance would now be brought to the notice of the directors, the efficacy of this defence is substantially reduced — thereby casting a greater responsibility on directors;
• directors are prohibited from becoming members of more than 10 committees or from acting as chairperson of more than five committees across all companies in which they are directors.

In the hope that shareholders will exercise a greater control over the appointment of directors, the Listing Agreement Amendments now require companies to provide a bio-
data of the directors offering themselves for appointment or re-appointment. The Listing Agreement Amendments have effectively ensured that there are independent non-executive directors on the board — which would help in achieving a better standard of self-regulation and transparency.

It may be noted that pursuant to the Listing Agreement Amendments, all the directors of some Indian companies have resigned to pave way for the appointment of new directors keeping in mind corporate governance requirements. This development augurs well for improving the professional standards of directors, particularly in the context of family controlled companies.

Responsibility of the Board of Directors

While the board of directors is empowered to exercise all the powers of the company and do everything the company is authorized to do, the law seeks to ensure that board and management is accountable, among other things, through the following mechanisms:

- sensitive corporate transactions need shareholder approval;
- certain other important corporate decisions, such as the right to make calls, issue debentures and borrow funds, can be decided only at meetings of the board of directors;
- subject to limited exceptions, transactions with companies or firms in which a director or his relative is a member or partner require the consent of the board of directors;
- in certain cases, loans to directors need the prior consent of the government;
- directors who are interested in a transaction of the company are required to disclose their interest to the board and refrain from participating in discussion or voting on any resolution connected with such transactions;
- Sebi has prescribed detailed regulations prohibiting insider trading and fraudulent and unfair trade practices in the context of the securities market;
- as highlighted above, the annual report of the company needs to include a director’s report and a report on corporate governance;
- the Listing Agreement Amendments requires the disclosure of all pecuniary relationship or transactions of the non-executive directors with the company in the annual report. Similarly, disclosures on materially significant “related party” transactions need to be disclosed in the report on corporate governance;
- the Listing Agreement Amendments provide that with respect to executive directors, all
remuneration details, contract details, and stock options need to be disclosed in the report on corporate governance;

- there are a variety of statutory obligations, including detailed provisions with respect to criminal responsibility, which cast responsibilities on directors; and
- the Amendment Act seeks to make a director's "responsibility statement" mandatory. Directors would be required to certify that applicable accounting standards had been followed in the preparation of the financial statements of the company; the accounting policies have been applied consistently and judgments and estimates are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company; that the directors have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of law and for prevention and detection of fraud and other irregularities.

Directors are also cast with fiduciary responsibilities towards the company, which have a number of facets, including:

- the liability for breach of trust: Section 88 of the Indian Trusts Act 1882, requires that any pecuniary benefit that accrues on account of breach of the fiduciary character needs to be held for the benefit of the person to whom the fiduciary responsibility is owed;
- the duty to act honestly and exercise such degree of skill and diligence as would amount to reasonable care, which an ordinary man might be expected to take;
- the duty to disclose any personal interests or potential conflict of interest that may arise; and
- the duty not to compete with the company.

**Audit Committees**

The self-regulatory approach is considered supportive of innovation and enterprise, unlike external regulation. This formed the basis of the recommendations of the Cadbury Committee and would appear to be the basis of the recommendations of the Birla Committee. The Indian legal system is rapidly moving towards the establishment of independent regulators and a greater emphasis on self-regulatory structures. In keeping with this trend, the Listing Agreement Amendments have made an audit committee a mandatory requirement for all
India

publicly traded companies. The committee, appointed by the board of directors, must be independent and qualified, and:

- have a minimum of three members, all being non-executive directors with the majority being independent directors (including the chairperson). At least one of these directors should have financial and accounting knowledge;
- hold meetings three times a year, with one meeting before finalization of annual accounts; and
- have a quorum for meetings of the audit committee set at one-third or two, whichever is higher. However, a minimum of two independent directors is essential to constitute a quorum.

The functions of the audit committee include: oversight of the company’s financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient, and credible; recommending the appointment and removal of the statutory auditor of the company; reviewing with management the financial statements of the company prior to submission to the board of directors; reviewing the internal audit function; review of the findings of the statutory auditor; pre-audit and post-audit discussions with the statutory auditor; review of the company’s financial and risk management policies.

The Amendment Act has proposed to make audit committees mandatory for public companies (whether listed or unlisted), which have a paid up capital in excess of Rs50 million ($1 million). The proposed amendment sets out the powers and functions of the audit committee.

**Remuneration Committees**

The Listing Agreement Amendments include a non-mandatory recommendation that companies establish a remuneration committee of the board of directors, comprising at least three directors. All of these directors should be non-executive with the chairperson being independent. The terms of reference of this committee would include determination of the company’s policy on remuneration packages for executive directors.

While companies are not required to establish a remuneration committee, the Listing Agreement Amendments make it mandatory for the board to decide on the remuneration packages of non-executive directors. In addition, as highlighted earlier, it is mandatory that all elements of remuneration of all the directors be disclosed in the report on corporate governance.
Restrictions on Market Control Mechanisms

Indian law contains a number of statutory and regulatory provisions that restrict market control mechanisms:

- Acquisition of more than 5% of the shares of a publicly traded company, directly or indirectly and with persons acting in concert, requires detailed disclosures to be made by the acquirer to the company and by the company to the stock exchanges;
- Acquisition of 15% or more of the shares of a publicly traded company, directly or indirectly and with persons acting in concert, or a change in control of the company, requires a public offer to be made to the investors of the company for a minimum of 20% of the total shareholding of the company;
- Indian law prohibits a variety of restrictive trade practices and unfair trade practices in the conduct of business by a company; and
- The Report of the Competition Policy and Law Committee appointed by the government has made recommendations with respect to the regulation of anti-competition practices. It is expected that the government of India would proceed with the formulation of an appropriate legislation.

From Corporate Governance to Corporate Ecology

Indian companies are looking to the global markets to raise capital, and in the process are finding themselves up against standards of corporate governance not seen in India so far. The Listing Agreement Amendments have gone a long way in prescribing the mechanisms and procedures (as well as disclosure requirements) needed for effective corporate governance. However, corporate governance is not just about procedural requirements and the time has come for a well thought out amendment to the Companies Act to ensure that Indian corporate law meets global standards on issues like quorum and corporate control within a group context.

Ever since the process of opening the Indian economy to the global economy began in 1991, there have been a number of committees established by the government and Sebi to examine various aspects of Indian corporate law. Perhaps indicative of larger developments and the challenge to the multi-stakeholder conception of the company, the membership of these committees has not always been representative of the various stakeholders. This matter has not been highlighted so far, perhaps because there appears to be a broad economic
consensus among the main political parties in India. Consequently, Indian corporate law is at the threshold of significant changes over the next few years.

The picture is not entirely rosy however. Examples of the friction between the various stakeholders already exist. So far, dominant shareholders, management and creditors have worked together to reduce the bargaining position of employees. The government has committed itself to an ambitious agenda of privatization of a number of public sector units, raising the shackles of the trade unions. At the same time, dominant shareholders, management and employees are at loggerheads with the right of the financial institutions (the main creditors) to appoint nominee directors, albeit for different reasons. The dominant shareholders and management are opposed to the concept of nominee directors due to a potential conflict of interest. Their presence is also seen as restrictive on the decision-making capacity of the board of directors. Employees however believe that nominee directors have a responsibility to all the stakeholders as financial institutions lend public money — and that nominee directors have not always discharged this responsibility. The Amendment Act had contemplated an ingenious provision wherein small investors would have the right to appoint one director on the board. This effectively meant that small investors were seen as a different stakeholder from the controlling shareholders. However, press reports indicate this provision has since been withdrawn.

Given the established traditions of democracy in India, it is possible that in the near future a debate will arise on whether the multi-stakeholder conception of the company is really in conflict with a liberalized economy. The arguments for and against shareholder primacy and indeed the multi-stakeholder conception of the company are many and involve a number of theoretical issues. Some of these issues would be:

- Are shareholders in publicly traded companies owners of the company?
- What constitutes shareholder value?
- Does one evaluate the enhancement of shareholder value in terms of the net worth of the company, potential of the company, the record of the company in paying dividend as per the provisions of the Companies Act or the ability of the company to plough back its profits into the business or the price of the share on the stock exchange?
- What is the best methodology or mechanism to overcome conflicts or differences of view between the various stakeholders?
- What is the role of the dominant shareholders in relation to the company?
What is the role of management and the nature of accountability of management?

How do you solve issues of risk and control in relation to the various stakeholders?

What ought to be the nature and extent of regulation? For example, employees would be more in favour of external regulation while management and controlling shareholders would prefer self-regulation.

There is considerable academic writing, both in India and abroad, which has explored the idea that a company operates within the social realm and its goal is the increase of societal wealth as against shareholder wealth.

The role of corporate governance within the constitutional framework of India may assume great proportions in the years to come. To use the parlance of international human rights law, the Indian Constitution recognizes a number of first generation human rights and provide a direction to the state with respect to a number of second and third generation human rights. Under the Indian Constitution, the first generation human rights are known as “fundamental rights” and are judicially enforceable while the second and third generation human rights are known as “directive principles of state policy”, which are not judicially enforceable, though are to be taken into consideration in the functioning of the state.

Indian constitutional law has seen two significant developments, both spearheaded by the judiciary. Firstly, the content and scope of a number of fundamental rights is being expanded to include principles found in the directive principles of state policy. Secondly, the Supreme Court has laid down (in very few cases) guidelines that need to be complied with and followed by not just the state but also private organizations. If these developments were to enter the realm of corporate law (a possibility that cannot be ignored given the activism shown by the Indian judiciary), the result would be a totally different approach to corporate governance.

As and when the debate on the relevance of the multi-stakeholder conception of the company in a liberalized economy operating within a constitutional framework arrives at a conclusion, corporate governance in India will make significant strides in creating an environment of legal compliance. The pattern of relations between the stakeholders and the company as a whole would give rise to an ecology of legal compliance.

Nishith Desai & Associates is committed to advancing the debate regarding corporate ecology and welcomes your input. Please forward any comments to www.nishithdesai.com

The author would like to acknowledge the assistance of Deanne D'Souza-Monie in the preparation of this article.
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- with Skadden, Arps, Slate, Meagher & Flom;

(ii) **Europe, Asia and Australia** – with Advoc, an alliance of independent business law firms in Europe and the Asia Pacific region; and

(iii) **International trade dispute matters** - with Sandler, Travis & Rosenberg.

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English; Indonesian; Mandarin

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The Indonesian economy was particularly hard hit by the Asian economic crisis. Most
Indonesian companies were caught by the crippling effects of a severe economic downturn
and international markets lost confidence in Indonesia's fundamental governance systems,
intensifying the downward spiral of the economy.

Indonesian companies are now focused on the rebuilding process. For most companies
this first involves financial, shareholding and asset restructuring, and then consolidation of
business operations with a view to stepping up performance and regaining sustainable
profitability.

The resultant debt restructuring process, together with the global market profile
ascribed to Indonesia after the economic crisis, requires that Indonesian companies make
important changes both to their shareholding profile (in many cases family controlled) and
the way they manage and operate their businesses if they are to regain the confidence of
international markets and move forward in the global economy.

THE INDONESIAN CODE FOR GOOD CORPORATE GOVERNANCE
Traditionally, Indonesian corporations have not viewed good corporate governance as
essential. In the past, companies considered that connections and Indonesia's impressive
and steady economic growth underpinned reliable business performance.

This lack of good corporate governance practices exacerbated the effects of the
economic crisis for many companies.

Recognizing this fact, the IMF's support package to the Indonesian government was
conditioned upon the introduction to Indonesia of good corporate governance practices.
This led to the establishment of the National Committee for Corporate Governance Policies
(NCGC).

The Indonesian government's coordinating minister for the economy, finance and
industry established the NCGC in August 1999. The committee comprises 22 members from
senior government positions, private sector business, finance, accounting and law.

The NCGC was tasked with formulating a national framework for the implementation
of good corporate governance principles. Specifically, this involved the preparation of the
Code for Good Corporate Governance and recommendations for appropriate regulatory
reforms, and the accompanying institutional framework required to implement the Code,
The Code represents a model for good corporate governance for the Indonesian business community.

The Code is a dynamic document which the NCGC expects will be reviewed from time to time and enhanced as changes take place in the Indonesian business sector. The NCGC issued the first edition of the Code in March 2000. The March edition is in the process of review and the revised edition is expected to be issued in September 2000.

The Code aims to help Indonesian corporations to develop improved corporate governance structures, maximizing corporate and shareholder returns on investment while facilitating the rebuilding process in Indonesia in the wake of the economic crisis.

The provisions of the Code are founded on the fundamental principles of fairness, transparency, reliability and accountability. The principles are designed to encourage shareholders to decide upon corporate actions as socially responsible and good corporate citizens.

The Code encourages the establishment of management systems, which take into account the interests of all stakeholders through progressive and strategic decision making.

In recognition of Indonesia's economic circumstances — in the short term — the target of the Code is publicly listed companies, state-owned companies and other companies that raise funds from the public such as banks, other financial institutions and other companies that issue financial instruments to public investors.

The Code adopts internationally recognized governance principles while specifically addressing the unique two-tier corporate structure to be maintained by Indonesian companies — i.e. the board of commissioners and the board of directors.

The approach of the Code is to provide a series of guidelines for good governance rather than a set of regulations having the force of law. It is expected however that the acceptance of the principles of governance set down in the Code will lead to the implementation of regulatory reforms and the enactment of laws and regulations in support of such principles.

The NCGC considers that this approach provides for more constructive and flexible application of the principles set forth in the Code, appropriate to a corporation's circumstances.
Regulatory reforms arising out of the Code will nonetheless apply across a range of existing laws and standards, including but not limited to:

- company law – which is currently in the process of revision to adopt among other matters a simpler approval process and registration system;
- company registration law – which is in the process of establishing a central registry to allow efficient and reliable access to corporate data;
- capital markets law and securities regulations – being amended to establish Bapepam (the Capital Markets Supervisory Board) as an independent body. The Jakarta stock exchange listing rules have already been amended to require the appointment of independent commissioners and the implementation of corporate governance by public listed companies;
- banking industry laws; and
- accounting standards – to ensure timely financial disclosure.

The Code is structured so as to separately address the good corporate governance principles and guidelines applicable to the three primary organs of the company (namely the general meeting of shareholders, the board of directors and the board of commissioners), the audit system, the corporate secretary, stakeholders, disclosure requirements, confidentiality and inside information (see box).

**CODE FOR GOOD CORPORATE GOVERNANCE**

**Shareholders rights**

In general terms, the Code recognizes that shareholders rights should be protected, in particular:

- the right to attend and vote at any general meeting of shareholders on a one share one vote basis;
- the right to obtain information concerning the company in a timely manner, helping shareholders to make informed decisions about their investment; and
- the right to receive dividends or other distributions in proportion to their respective shareholding in the company.
The Code prescribes mechanisms for the protection of those rights. Shareholders must have the ability to exercise their rights through appropriate procedures adopted by the company. There must also be fair and equitable treatment of shareholders in accordance with the percentage and class of shares held by them.

The principal mechanism by which shareholders may exercise their rights is the general meeting. The Code acknowledges the general meeting's critical function and sets down procedures to be adopted at such meetings to facilitate meaningful shareholder participation.

Shareholders should have a role in the appointment of, and determination of, remuneration for members of the board of directors (BoD) and the Board of Commissioners (BoC) and participate in the review of the performance of members of the BoC and BoD.

**Boards and audit committees**
The Code reaffirms the principles behind Indonesia's two-tier corporate structure, namely that:

- the BoD is responsible for the overall management of the company; and
- the BoC is responsible for supervising the policies and actions of the BoD.

The Code further sets out key criteria for the appointment of members to the BoD and BoC, procedures for the conduct of meetings of the BoD and BoC, and standards to be maintained by members of the BoD and BoC in actively performing their respective functions in the company. More specifically:

- directors and commissioners should be of good character, have appropriate experience and actively manage the company in the best interests of the company and its shareholders, mindful of the interest of the company's various stakeholders;
- depending on the characteristics of the company, the BoD should have at least 20% of its members as independent members to ensure no conflict of interest with the major shareholders of the company;
- both the BoD and BoC should hold regular meetings. In the case of the BoC this should be at least every month and in the case of the BoD, at least every week. This is to ensure that members of the BoD and BoC are active in performing their respective duties;
• meetings must be properly recorded and members of the BoC and BoD should be provided with a copy of minutes of meetings;
• directors and commissioners should have timely access to all information of the company. In the case of directors this is particularly important so that the directors have sufficient information to properly discharge their duties to the company

Audit systems
• The company must engage appropriately qualified and licensed independent external auditors. The general meeting of shareholders must adopt mandatory internal regulations to govern all aspects of audits.
• The BoC may establish a special audit committee.
• Both internal and external auditors should apply appropriate standards of confidentiality and diligence to their respective roles.

Other matters
The Code touches on and addresses other matters appropriate to good corporate governance practice such as:

Corporate secretary
Public listed companies must appoint a corporate secretary with appropriate qualifications, responsible for investor relations, legal compliance and maintenance of corporate documents.

Stakeholders in the company
The rights of the company’s stakeholders, such as employees, must be protected by the company and stakeholders must be helped to monitor and provide input as to the management of the company for mutual benefit.

Disclosure
Companies should not only disclose matters required under law but also matters which would be of material importance to shareholders, creditors, stakeholders and institutional investors in their decision making with respect to the company.

Stakeholders and shareholders should be made aware of the company’s corporate
governance systems and compliance with those systems so that such parties are well placed to assess the company's performance against appropriate benchmarks.

Expanding upon legal requirements regarding the disclosure of key information in the company's annual report, the Code recommends that the report also contain explanations of, among other things, the following:

- business goals and strategies;
- management assessment of the business climate and risk factors and degree of compliance with good corporate governance practices;
- information on executives and employees including remuneration systems for internal and external auditors and executives; and
- evaluations of the company by external auditors, credit rating agencies and others.

**Confidentiality and inside information**

Confidential information obtained by directors and commissioners in their respective capacities within the company must remain confidential unless such information must be disclosed under law or such information enters the public domain.

Directors and commissioners, and other persons, must not use inside information to their advantage in dealing in the company's shares.

**Corporate Governance in Reality**

Long-term funding is crucial for those Indonesian companies undergoing a restructuring and consolidation process after the economic crisis, i.e., the majority of Indonesian companies. Without it, their futures are very bleak indeed.

As stated in the Code, the NCGC's objective is to provide direction for better corporate governance procedures, enabling soundly managed Indonesian companies greater domestic and overseas credibility, which it hopes will enhance their transparency and managerial efficiency.

In the main, the guidelines are designed for voluntary application although some of the guidelines will have mandatory application through incorporation in laws and regulations passed in support of the Code's guidelines.

The author believes that voluntary adoption of the guidelines will be most beneficial, allowing companies to adopt guidelines in accordance with their real needs and capabilities,
and in keeping with the corporate characteristics of the company. The adoption of the guidelines would in effect be market driven and the author considers that this offers the best prospect for widespread adoption of good corporate governance practices by Indonesian companies.

In practice, some companies, mostly large public companies or financial institutions, have taken it upon themselves to adopt good corporate governance programs.

As a consultant to PT Astra International in the development of its corporate governance programme, the author saw first hand how the voluntary take up of good corporate governance practices can be an important stepping stone on the path to rebuilding Indonesian companies.

Astra was the first non state-owned public company to formally adopt a system for good corporate governance. The company's management had a vision for the future and realized that the success of the company's debt restructuring – and further participation by financiers and investors in the company's future plans – would require the implementation of good corporate governance practices by the company.

In the case of companies working with the Indonesian Bank Restructuring Agency (Ibra) to restructure their commitments to Ibra, it is a requirement in the restructuring of the company's debt, such companies (as borrowers) must adopt good corporate governance practices in the management of their business affairs.

While required as a term of most restructurings, borrower companies invariably voluntarily develop corporate governance programmes as part of the restructuring process.

In taking the carrot-and-stick approach to the implementation of the Code, the focus should be on the carrot.

Enforced compliance takes time and money, particularly in a climate where attitudes to legal enforcement are in the process of change. Indonesia's current commercial environment will be best served by relying on Initiative and market sentiment to promote broad acceptance of the need for good corporate governance practices.

**THE FUTURE OF GOOD CORPORATE GOVERNANCE**

As part of the rebuilding process after the economic crisis, Indonesia is experiencing exceptional and fundamental sociological changes. In particular, Indonesia's governmental system is embarking on an era of greater democratic freedom, encouraging transparency and accountability in public organizations. These principles support the introduction of good corporate governance to Indonesian business.
Direct and indirect foreign investment must play a critical role in the restructuring of the Indonesian economy. The Code adopts internationally recognized governance principles to provide Indonesian companies with essential direction in the establishment and implementation of good corporate governance practices. It is hoped that through the implementation of good governance, Indonesian companies will develop important overseas credibility as well as deriving other substantive and material benefits.

Notwithstanding such renewed nationalist sentiment, Indonesia must be realistic about the time it will take to achieve an economic recovery.

The crisis highlighted the fundamental absence of mechanisms to encourage and support the broad adoption of good corporate governance practices in Indonesia's business community. The challenge for Indonesia's lawmakers is not only to develop effective laws which support the implementation of the principles adopted in the Code, but also to encourage compliance.

In the past, the government agencies' questionable enforcement practices have created an environment in which business considers that regulatory systems are not enforced and therefore need not be complied with.

Looking to the history of Indonesian corporate behaviour therefore, the carrot-and-stick approach will rely heavily on the carrot presented to Indonesian business.

Companies must recognize the real value in encouraging a good corporate governance culture within their organizations. The effectiveness of any good governance system within a company will be linked with the practices of its employees. Employees should be encouraged to strive to adopt and maintain good corporate governance principles set by the company through incentive schemes such as employee share option programmes.

Ultimately, it is not only business leaders, but also grass roots employees that must support good corporate governance programs for them to be successful. The challenge for Indonesia therefore goes beyond convincing the business sector that good corporate governance is a prerequisite to sustainable, economic growth. The speed at which Indonesia recovers will depend on its people, the processes adopted and implemented to stimulate economic recovery, and broad acceptance across the Indonesian business community and eventually society for such processes.

The Code for Good Corporate Governance is an important plank in the platform upon which Indonesian business will build its case for acceptance again by global markets and investors.
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Japan's corporate governance system has evolved very differently from that in many other industrialized countries. In particular, corporate traditions such as the role and composition of the board of directors, the importance of employees as stakeholders, the extent of cross-shareholdings and the main bank system, combined with opaque and limited financial disclosure, have led to shareholders taking a secondary role in corporate Japan.

However, the 10-year stagnation of the Japanese economy is forcing a rethink about the merits of the old ways. Shareholder rights, increased transparency and disclosure have moved up the agenda, both as a reaction against the excesses of the past, as well as a mechanism to invigorate the economy. These changes are leading to an upsurge in merger and acquisition activity in Japan, a trend which is sure to continue.

**Jobs for the Boys**

Japanese employees have traditionally been well looked after thanks to the structure of the board of directors. In theory, the board is legally responsible to the shareholders, but in practice, its primary focus is the welfare of employees. Directors are normally promoted from within the company and are primarily regarded as leaders of the employees, unlike in the US where a majority of the directors are appointed from outside to monitor the operation of the company on behalf of shareholders.

In effect, Japanese directors are leaders of the insiders, whereas US directors are outsiders representing the shareholders. Japanese directors act as if they own the company, whereas US directors act as the agents of the principals, the shareholders. This kind of principal-agent relationship, central to the western model of capitalism, has until recently had few adherents in Japan.

Additionally, the boards of most Japanese companies tend to be large, averaging around 20 members for listed companies. The number of board members also tends to increase over time as new members are appointed as a reward for loyal service to the company. Boards of such a size become unwieldy — there is inevitably a dilution of personal responsibility and a tendency to turn the board into a mere rubber stamping operation for decisions taken by middle managers.

Linked to the nature and structure of the board is the role of employees as stakeholders. In some countries, such as Germany, the employees' stake in a company is institutionalized
in the corporate governance structure by granting them formal representation on the board of directors. There is no legal requirement in Japan's commercial code for the board to consider the interests of employees. In practice, however, partly because of custom and societal expectations, and partly because the directors themselves have been promoted from the insider employee pool, employee considerations weigh more heavily in directors' minds than those of shareholders.

**BUSINESS RELATIONS - A WICKED WEB**

A typical Japanese company has upwards of 70% of its shares held by other corporations or financial institutions. Of these, nearly two-thirds are held by domestic financial institutions, with the remainder held by non-financial corporations. Among the financial institutions, banks hold about half, amounting to over 20% of all stocks. The second largest proportion is held by life assurance companies.

Corporate and institutional investors tend to have reciprocal business partner relationships with the company, creating a complex web of cross-shareholding throughout corporate Japan. The system began with the primary aim of raising capital while preventing hostile takeovers.

Because cross-shareholding has a strategic purpose and symbolizes long-term relationships between the parties, the shares in these arrangements have generally not been disposed of without mutual agreement, resulting in the relatively stable ownership structure of Japanese corporations. As a result of these interconnecting business relationships, the interests of cross-shareholders are not necessarily the same as those of shareholders with pure investment intentions.

Further muddying the waters is the role of a company's main bank. Typically the largest creditor, the main bank has a close business relationship with the company and, in principle, monitors its operation in place of an active capital market discipline through the takeover mechanism. A company will ask its main bank for credit when it needs external finance and the bank will arrange the required credit, often on favourable terms and without robust scrutiny of the company's cash flows. At the same time, the bank is usually a shareholder, as part of a cross-shareholding relationship, and the main provider to the company of financial services.
There is little doubt that these characteristics of the corporate governance system in Japan have contributed to an environment that has been less than supportive to robust M&A activity. For example:

- the boards have not seen maximizing shareholder value as an objective;
- many shareholders themselves have not seen shareholder value as paramount, or even important, preferring instead to focus on their other business relationships and dealings with the company;
- employees', rather than shareholders', considerations have been paramount; and
- companies have not been reliant on the capital markets for funding and so have not felt the pressure to perform financially as a prerequisite to obtaining funds.

The environment continues to be rather negative towards hostile takeovers. The Japanese word used to describe a hostile takeover, nottori, is the same word that is used to define hijacking. The Japanese have viewed companies as much more than parcels of financial assets. Instead they have been thought of as a whole collection of stakeholder interests, which are not for sale. Management pride is at stake and a takeover is seen as an admission of failure, which must be avoided at all costs to preserve face or integrity.

This view was confirmed in the 1980s and early 1990s by the failure of a number of high profile takeover bids by foreign and domestic investors, the most famous of which were the failed attempt by T.Boone Pickens to acquire Koito Manufacturing, a Japanese automotive parts manufacturer and a domestic takeover attempt by the bearings manufacturer Minebea to acquire Sankyo Seiki Manufacturing, an electrical machinery company. These, and other failures, clearly sent out the message that corporate Japan was not for sale.

However, Japan is changing. One of the implications of these changes is that the traditional barriers to takeovers are fast disappearing.

**FORCES FOR CHANGE**

Before the collapse of the bubble economy few in Japan argued against the prevailing system of corporate governance. It appeared to work well, in contrast to the perceived failings of so-called Anglo-Saxon capitalism and its obsession with short-term performance, financial engineering and M&A.
Since the bubble economy's collapse, however, Japan has experienced a lost decade of growth and has found itself in the humiliating position of being transformed from one of the fastest to one of the slowest growing economies in the industrialized world. There is a growing realization that one of the foundations of the present strength of the US economy has been the focus on shareholder value. This has forced managers to concentrate on the identification of performing assets and the disposal of non-performing assets, often to new owners better able to unlock value from them.

As a result, traditional corporate governance practices as well as other characteristics of Japanese management have come under increasing scrutiny. In response, major changes and reforms in the corporate governance structure are underway. Attitudes to shareholder rights are evolving. Management accountability is growing. Financial statement disclosure requirements are becoming more stringent. The Japanese system is moving closer to that of other industrial countries, with implications of importance for M&A in Japan.

Untangling the Web
As the recession continues, corporations and financial institutions are seriously questioning the value of cross-shareholding. It is increasingly considered as non-commercial and inefficient to lock up cash in depreciating assets that pay little in the way of dividends and expose the shareholder's profit stream to share price volatility. In particular, several banks such as Sanwa, Sakura and the Industrial Bank of Japan have unveiled plans to step up dramatically the sale of their portfolio investments.

In the same way as companies have had to closely examine the practice of cross-shareholding, institutional investors have had to re-examine their passivity in relation to challenging the management of the firms in which they own shares. Insurance companies, trust banks and pension funds have come to realize that unless they significantly increase their investment returns, they will not be able to meet their own obligations towards their policy holders and pensioners. Similarly the growth of investment trusts has led to a growth in the number of active investors in the market who demand comprehensive and accurate information, and a sensible business strategy from management.

Overseas investors' holdings of Japanese shares are increasing. For example, Sony has reported that about 45% of the firm's shares are held by non-Japanese owners. In total, about 10% of publicly traded Japanese equities are held by non-Japanese. Moreover, these investors are demanding their rights. This is perhaps best exemplified by the current activities
of California Public Employees' Retirement System, which invests heavily in Japan and has published its five-point plan for good corporate governance in Japan, centering around accountability and transparency, and of the American Chamber of Commerce in Japan, which is lobbying the Japanese government in relation to its review of the Japanese Commercial Code.

The lack of disclosure by Japanese companies has been a key barrier to takeover activity in Japan. Opaque accounting rules have often masked the true financial state of potential acquisition targets. Acquirers have been discouraged and turned their attention to more investor friendly and transparent markets. The Japanese corporate sector has been robbed of the opportunity to benefit from the new skills, management techniques and approaches that a new entrant foreign firm could have brought. However, a combination of pressure from shareholders for greater disclosure and the adoption of new accounting rules based on internationally accepted accounting standards is changing the landscape.

There is now increased emphasis on consolidated financial reporting and the requirement to value stocks and other financial instruments at market value at the close of accounting periods, recognizing unrealized gains or losses in income statements. These new rules apply to cross-shares for the first time in fiscal 2001 and will undoubtedly boost the trend of unwinding such cross-holdings. Moreover, the disclosure of the full extent of the underfunding of corporate pension schemes is now required for the first time. This accounting change alone is expected to add ¥80 trillion (over $700 billion) of additional liabilities to the balance sheets of companies listed on the first section of the Tokyo stock exchange. This will force companies to take action to strengthen their balance sheets as well as, paradoxically, encouraging foreign interest, because bidders will have more confidence in the accuracy of the financial statements produced.

The corporate structure of large Japanese companies is extraordinarily complicated with large numbers of frequently dissimilar ventures, partnerships and subsidiaries. However, the steady deterioration in the performance of many Japanese corporations has forced many of them to seek to streamline their operations and shed non-core, non-performing businesses. This formed the background to the lifting of the ban on pure holding companies in 1997. Daiwa Securities led the way, deciding in 1999 to create a pure holding company structure. Other large companies such as Toshiba have also moved in this direction. The holding company structure will make it easier for Japanese companies to trade business units.
Largely as a result of the collapse of the bubble economy, Japanese banks have suffered from extensive bad debts and a consequential erosion of their capital base. In response they have been squeezing their balance sheets, creating a credit crunch in the economy. This has undermined banks legitimacy as corporate guardians in the eyes of many companies (who have in any event been relying more on the corporate bond market). The high profile failures of Yamaichi Securities, The Long Term Credit Bank and more recently the department store group Sogo, whose wild and reckless borrowings appear to have been endorsed by its main bank, have shattered the Japanese public's confidence in both the legitimacy and effectiveness of the main bank system as a check on the operations of corporate Japan. Other shareholders are being asked to step into the breach.

There are some common themes that can be drawn out from all these factors. Most notable among them that market forces are seriously eroding the stakeholder model of capitalism in Japan.

Companies are realizing that to survive in today's global marketplace they need to focus much more on profits and value, for without them there is no chance to offer security to the employee stakeholders. And without an increase in returns from shareholding, pension funds and insurance companies will be unable to meet their liabilities. They must also satisfy an increasingly demanding shareholder community, which is becoming both more diversified and more vocal in speaking out for its interests.

Moreover, moves towards greater accountability and transparency are irreversible. They are also self reinforcing. Recent studies have shown evidence that shareholders are willing to pay a premium for good governance. Companies will see it is in their interests to reform.

THE COMING M&A BOOM

There is no doubt going to continue to be a large upsurge in M&A activity in Japan in the coming years. Indeed by Japanese standards an M&A boom is already underway. Yet the value of M&A activity last year amounted to an equivalent of only about 7% of stock market value, compared to around 14% in the US. So we are nowhere near the limit of potential activity.

Foreign participation is growing strongly. There were well over 100 foreign acquisitions of Japanese companies in 1999 (up from only around 50 in 1997) with a total transaction value of nearly $25 billion. This trend is self reinforcing. As more foreign companies enter...
Japan others will be encouraged to do so; and as more Japanese companies fall prey to foreign acquirers so the stigma attached to such sales among Japanese management circles will fall and more potential targets will come into view.

Recent high profile deals, such as the takeover of International Digital Communications (IDC) by UK-based Cable and Wireless, against the initial wishes of the IDC management who sought a cozy deal with NTT, and the takeover of SS Pharmaceutical Company by Boehringer Ingelheim, have showed conclusively that shareholders are prepared to sell, if the price is right. With around 200 listed Japanese companies trading at a discount to net cash and unrealized gains in financial and other assets, there are bargains to be had by the wise investor.

It is certainly an exciting time to be involved in M&A in Japan. Every month brings with it a further opening of the market and undiscovered opportunities. There is an historic shift taking place in the Japanese economic and corporate worlds, away from the Japan Inc model that underpinned the Japanese economy in the post-war period, towards something that is more suited to today's global marketplace.

This is a trend that will have great benefits for Japan. The world has changed and is changing, and corporate Japan needs to change with it. One of the forces which will propel this movement is capital market discipline, enforced through the threat and occurrence of takeover. There is no more efficient allocator of resources than the market and probably no advanced industrialized country that needs its resources re-allocated more than Japan. Changes to the corporate governance system and M&A are set to play a key role in this process.
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Corporate
D. S. Kim, S. G. Kim

Corporate Restructuring
D. S. Kim, W. S. Song, Y. S. Park

Securities
C. B. Hur, W. S. Song, I. S. Shim

Banking and Finance
C. B. Hur, W. S. Song, B. S. Choe

Mergers and Acquisitions
C. B. Hur, D. S. Kim, W. S. Song

Telecommunications
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Labour and employment law
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Environment
J. H. Oh

Intellectual Property
J. K. Park, G. S. Park

Tax
Y. S. Park, J. W. Lee

Information Technology
G. S. Park, Y. S. Yun

LANGUAGES SPOKEN
Korean, English, Japanese
At the onset of the Asian financial crisis in mid-1997 the large business groups known as chaebol, and Korean listed companies more generally, were characterized by opaque decision-making, unaccountable senior managers and significantly higher debt-equity ratios than their principal international competitors.

The crisis in Korea quietly started before the pan-Asian economic crisis, beginning with the failures of Hanbo Steel and Kia Motors in early 1997. Straining under the weight of those two major corporate failures, confidence in the Korean economy evaporated in the wake of the mid-1997 currency crisis in Thailand and south-east Asian countries. When the Korean won tumbled after the other Asian currencies, foreign investors and financiers withdrew support for the Korean markets.

As summarized by one commentator: "The corporate insolvency problem translated into a domestic financial crisis and ultimately caused an external liquidity crisis. The exchange rate fell dramatically and Korea’s foreign exchange reserves were depleted. The combined effect of high leverage (and so low interest coverage ratios), lower profits and a lower valued won left firms and banks that had borrowed in foreign currency unable to pay their foreign debts. Much of this debt was short-term and foreign creditors burned by losses in Thailand and south-east Asia were unwilling to roll over corporate credit lines. Domestic banks, desperate for cash to shore up reserves, began to call in loans. Credit within the economy dried up and the economy was thrown into an 18-month period of severe recession.

Economic hardship brought the need for corporate reforms to the fore. The Korean government, along with leading Korean and international institutions, began to pay close attention to the problems of Korean corporate governance and its impact on Korean economic relations. From September 1999 to May 2000 Shin & Kim, Coudert Brothers, Bernard S Black of Stanford Law School and the International Development Law Institute, conducted a study comparing Korean corporate governance standards and practices to international norms, reviewing reforms already enacted in response to the crisis, and recommending further reforms to relevant laws. The results of this study have been published and are under consideration in policy circles. This article draws heavily from the results of that study.

In early 1999 a flurry of corporate governance reforms were enacted to address certain perceived failings in the Korean corporate governance system. As with many Korean reform efforts, these reforms were targeted primarily at the practices of the chaebol, although the reforms
Reforms

The reforms give the board of directors a central role as the organ responsible for a company’s major decisions and enhance the role of independent directors in policing management actions, especially when those actions involve a potential conflict of interest. Currently, independent directors must constitute at least one-quarter of the members of the boards of listed companies and, for the largest listed companies, banks and most non-bank financial institutions, at least one-half of the members. At least two-thirds of the members of the audit committee and at least one-half of the members of the outside director nominating committee must be independent directors.

However, Korea has traditionally had rubber-stamp boards of directors, firmly under the thumbs of controlling shareholders, and experience with independent directors has been limited. Most have been lawyers, accountants, academics and retired government officials. Critics have expressed concerns about the effective independence of many independent directors and about their lack of business experience. Newly appointed independent directors often complain about lack of access to the information they consider necessary for informed decision-making.

The reforms also expand shareholders’ procedural rights to participate in corporate decision-making, their ability to police controlling shareholders and management, and the remedies for violations of applicable laws, regulations or a company’s articles of incorporation. The effectiveness of these reforms depends on a reasonable level of shareholder activism.

There are some signs of such activism in Korea in the activities of Chamyoyundai (the People’s Solidarity for Participatory Democracy), a public interest group which has initiated derivative lawsuits and obtained representation on the boards of directors of several listed chaebol companies. To date, other groups have not become involved in corporate governance issues relating to particular companies or chaebol and there is little activism by individual shareholders. There has been some activism by foreign institutional investors, most visibly at SK Telecom. It remains to be seen if shareholder activism (whether based on civic group activities or on institutional investors) will give life to the shareholder voting and litigation tools which recent legislative and regulatory reforms have made more accessible.
Another key goal of the reforms was to increase the accountability of controlling shareholders and directors by making explicit the legal standards applicable to directors, extending those standards to shadow directors and increasing the accountability of company executives to the board of directors and the accountability of executives and directors to the company’s shareholders. The effectiveness of these reforms depends on the effectiveness of independent directors and the extent of shareholder activism.

Disclosures, particularly for listed companies, will be improved under the reforms by upgrading accounting standards, improving audits (through the use of audit committees and procedures to enhance the independence of statutory auditors), increasing the penalties for fraudulent audit reports, and increasing the frequency of reporting to shareholders.

In addition, the reforms have sought to decrease, and improve the fairness of, intra-group transactions and to encourage the development of a market for corporate control by facilitating takeovers.

**Contents of Specific Reforms**

Post-crisis amendments to the principal Korean legislation and regulations relating to corporate governance include:

- The Securities and Exchange Act was amended to require that, for all companies listed on the Korea stock exchange, at least one-quarter of the members of their boards of directors be independent, "outside directors." For the largest listed companies (with assets greater than 2 trillion won), at least one-half of the members of their boards of directors must be independent, outside directors. (Securities and Exchange Act (SEA) Article 191-16(1) and the Presidential Decree thereunder, Article 84-23(1))
- Among the top 30 chaebol, new intra-group guarantees have been prohibited and existing guarantees were to be eliminated by March 2000. (Monopoly Regulation and Fair Trade Act, or MRFTA, Article 10-2)
- The Act on External Auditing of Joint Stock Companies (AEAJSC), was amended to require preparation of "combined" financial statements for the 30 largest chaebol, to increase penalties for fraudulent audit reports and to revise selection procedures for external auditors.
- The Regulation on Securities Listing granted to the Korea Stock Exchange enhanced powers to ensure the independence of listed companies' external auditors. (Regulation...
Accounting standards for companies subject to the AEAJSC were revised by the Financial Supervisory Commission and the Securities and Futures Commission, to bring them into substantial compliance with International Accounting Standards or US Generally Accepted Accounting Principles.

- Listed companies must file quarterly reports in addition to the annual and semi-annual reports previously required. (SEA, Article 186-3)
- Shareholders may propose matters for consideration at a general shareholder meeting. (Commercial Code, Article 363-2)
- Shareholders can demand cumulative voting, unless precluded by the company’s articles of incorporation. (Commercial Code, Article 382-2)
- The minimum shareholding level required for shareholders to assert rights has been reduced for (i) demanding removal of directors and auditors for wrong-doing (Commercial Code, Articles 385(2) and 415), (ii) seeking an injunction against a director who violates applicable law or a company’s articles of incorporation (Commercial Code, Article 402), (iii) initiating a derivative lawsuit (Commercial Code, Article 403), (iv) convening a general shareholder meeting (Commercial Code, Article 366), (v) inspecting a company’s account books (Commercial Code, Article 466), (vi) applying to court for appointment of an inspector to investigate the company’s actions (Commercial Code, Article 467), and (vii) demanding the removal of a liquidator (Commercial Code, Article 539(2)). These levels were further reduced for listed companies and yet further reduced for the largest listed companies (with paid-in capital of not less than 100 billion won). (SEA, Article 191-13)
- An explicit fiduciary duty has been established, requiring directors to “perform their duties faithfully for the good of the company” in accordance with applicable law and the company’s articles of incorporation. (Commercial Code, Article 382-3)
- Shadow directors, persons who instruct directors on the conduct of the company’s business or conduct such business in the name of a director or using a senior executive title, are subject to the same duties and liabilities as directors. (Commercial Code, Article 401-2)
- The Securities Investment Trust Business Act was amended to allow securities investment trust companies to vote shares they hold in their investment trust business. (Securities Investment Trust Business Act, Article 25)
- To facilitate corporate takeovers, the requirement that a shareholder and related parties acquiring 25% of the shares of a listed company must tender for a majority of the
company's shares was eliminated by an amendment of the SEA.

- Companies are authorized to provide in their articles of incorporation for the granting of stock options to directors, statutory auditors and employees, and standards have been established for their grant and exercise. (Commercial Code, Article 340-2)

- Shareholders may elect at each general meeting of shareholders the chairman to preside at such meeting (Commercial Code, Article 366-2) and may vote in writing at a general meeting of shareholders, without attending the meeting in person or by proxy. (Commercial Code, Article 368-3)

- Videoconference meetings of the board of directors have been authorized. (Commercial Code, Article 391(2))

- Standards have been established for the minutes of meetings of the board of directors and for shareholders to inspect and copy these minutes. (Commercial Code, Article 391-3)

- Companies may provide in their articles of incorporation for their boards of directors to establish committees and to delegate certain powers to such committees. Committee resolutions are to be notified to each director and are subject to reconsideration by the full board at the request of any director. (Commercial Code, Article 393-2)

- Companies may establish audit committees (in place of statutory auditors), two-thirds of whose members are to be independent. (Commercial Code, Article 415-2). Companies listed on the Korea stock exchange with assets of at least 2 trillion won must have such an audit committee. (SEA, Article 191-17 and the Presidential Decree thereunder, Article 84-24)

- Nominating committees for the nomination of independent directors are required for listed companies having assets of at least 2 trillion won and at least one-half of the members of such committees must be independent directors. (SEA, Articles 191-16(3) and 54-5(2))

- Resolutions proposed by shareholders for consideration at the annual general meeting of a listed company are deemed timely if submitted six weeks before the anniversary date of the previous year's annual general meeting, even if notice of such meeting has not yet been given. (Presidential Decree of the SEA, Article 84-21(2))

- Board approval and public notice are required for certain intra-group related-party transactions by a company belonging to one of the 10 largest chaebol. (MRFTA, Article 11-12 and the Presidential Decree thereunder, Article 17-8)
Effects of Reforms Enacted to Date

In every country, effective corporate governance depends on a combination of regulations and market institutions. Recent events in Korea give rise to questions whether the legal and regulatory reform has gone far enough in addressing this economy’s peculiar features. In the late spring of 2000, after the government had pronounced corporate reforms completely achieved, a palace coup for control of Hyundai Motor broke out between the sons of Hyundai founder Chung Ju-Yung.

Despite the fact that the Chung family holds a small minority of Hyundai shares, one of Chung’s sons was able to install himself and his faction in control of Hyundai Motor, disregarding the board of directors and the shareholders. The Hyundai group’s leadership succession struggle shows that unless corporate actors are subject to legal and market discipline, adoption of toothless legal and regulatory reforms will do little to change the habits of the chaebol.

But all is not dark in Korea. The development of greater transparency and accountability within Korean companies will go hand-in-hand with the development of more professional management and the adoption of more efficient, technology-based management systems. In recent years, the principal multinational companies with which the chaebol compete in the international marketplace have expanded significantly through mergers, often financed by stock-for-stock exchanges. Today, Korean companies cannot complete comparable transactions outside Korea. They have neither the international confidence in their corporate governance practices to persuade other companies’ shareholders to accept a stock-financed acquisition, nor the unused debt capacity to pay for a major acquisition with cash. These weaknesses and the continued gradual opening of Korean markets in accordance with WTO rules, will add the market discipline that has been lacking until now. Gradually, albeit not without strife and struggle, corporate governance practices will remedy these weaknesses, else Korean corporations will be unable to compete in the new market environment.

Future Reforms

In considering further corporate governance reforms in Korea, it must be recognized that Korea differs from most of its principal competitors in the high degree of concentration in the corporate economy, the strength of control by corporate founders and their families, and the high levels of intra-group related party transactions. Modern corporate law and securities laws, whether founded on a civil law tradition or a common law tradition, focus
principally on the individual company as a legal entity and lack wholly satisfactory regimes for dealing with corporate groups and intra-group related party transactions. The effort to deal with corporate groups has involved, in various jurisdictions, the development of consolidated financial accounts, broad concepts of control for securities law and accounting purposes, concepts such as piercing the corporate veil (in common law jurisdictions), and concepts such as Konzern (in German law, including contractual Konzern utilizing control agreements and profit transfer agreements and de facto Konzern).

The concentration of Korea's economy in a small number of chaebol heightens the urgency of corporate governance reform. When a company or corporate group fails elsewhere, that is not a tragedy. In contrast, when Daewoo failed, its failure became a crisis for all of Korea. Korea needs reforms that protect it against another major chaebol failure. A good corporate governance system provides checks against bad management, without interfering with good management. Independent directors, if well chosen, can intervene if a company gets into trouble and exercise only gentle guidance when its prospects are bright. Shareholders will use cumulative voting to elect directors when a company is performing poorly, not when it is performing well. This is how independent directors and shareholders behave in other countries and how Korea can expect them to behave as well.

The Shin & Kim and Coudert Brothers consortium recommended additional reforms to corporate governance. To ensure the success of the corporate governance reforms enacted over the past two years and to build further on these reforms, it was suggested that a number of problem areas must be addressed:

- the role of the board of directors must be strengthened. Despite the board of directors' theoretical role as a central decision-making body in the Korean corporation, in reality it has been a weak institution, seldom meeting, seldom openly discussing corporate strategy and policies, and dominated by controlling shareholders;
- the role of independent directors must be further strengthened. The success of many of the corporate governance reforms enacted to date depends on the effectiveness of independent directors. These directors' independence should be enhanced, they should be ensured effective access to the corporate and financial information necessary for informed decision-making and they should have access to independent professional advice and training. Independent directors must be encouraged to be proactive in their role as directors and must have the information and resources needed to be proactive;
the significant expansion of shareholder rights through legislative amendments over the past two years has resulted to date in only a modest increase in shareholder activism. Further attention is required to the corporate decisions requiring shareholder approval, the procedural rights of shareholders, and the obstacles facing shareholders who want to challenge corporate actions in the courts and before regulatory agencies; and
despite expanded regulatory monitoring of related party transactions, these transactions require approval by non-interested decision-makers (independent directors and, for large transactions, non-interested shareholders) and also enhanced disclosure, to ensure their commercial reasonableness and that they do not harm minority shareholders.

Many of the recommended further reforms are being seriously considered. It is probable that cumulative voting in shareholder election of directors will be incorporated into the next revision of the Commercial Code and the role of outside directors in management will be further enhanced. Additionally, the National Assembly and the government are studying whether or not to introduce shareholders' class actions to enhance the ability of minority shareholders to oppose chaebol founding families. As may be expected, entrenched interests strenuously object to the prospect of shareholders' class actions. It is not known whether this reform will be adopted in the present session or put off to a future date. Nevertheless, the mere fact that these issues are being seriously studied is a very hopeful sign for great steps forward in Korean corporate governance.

In evaluating further corporate governance reforms, Korea must recognize that the approaches used in other jurisdictions may be inadequate to deal with the entrenched intra-group relationships characterizing the chaebol. The government should be prepared to consider a limited number of reforms for which there is limited precedent elsewhere. Innovation always carries with it uncertainty, but it is also the means by which the leading edge of corporate governance reform is redefined and advanced.
In Hong Kong, even major institutional investors are often minority shareholders. In 1997 just over half of Hong Kong's listed companies were majority owned by a single shareholder or family group. And almost 90% had one shareholder or controlling family owning 25% or more of the issued share capital.

Unsurprisingly, minority shareholders tend to have very little say. Management decisions are typically left to the board, whose decision is taken by majority rule. While domination by controlling members or families does not always translate into dominance of the board, 9% of all listed companies have boards where 50% or more of the directors are related to the controlling members or families. More importantly, although the controlling members in other listed companies may not have legal control over the board, they still exercise effective control, that is to say they can remove directors who do not follow their wishes.

Balancing the competing interests of majority and minority shareholders is not an easy task. Majority rule allows clear and effective decision-making, but is also open to abuse. The interests of the minority shareholders are protected in a number of ways, but each has its limitation. First, there are matters which have to be decided by shareholders in the general meeting by special resolution (which requires 75% of the vote). These cover fundamental matters such as the alteration of the company's name or articles of association, share buybacks, reduction of capital, appointment and removal of the company's auditors and so on.

This gives the minority a certain degree of negative control if it can command 25% of votes at the general meeting, but that is not always possible. Furthermore, many other matters which concern the day-to-day management are typically left to the board of directors.

Secondly, there are matters which are particularly important to every investor, which are therefore regulated by securities laws and regulations such as the Listing Rules or Takeovers Codes. However, the present system of regulation is not entirely satisfactory.

Thirdly, as a last resort, shareholders are given statutory and common law rights to bring actions against the abusers. But taking legal action is not a very attractive option for many shareholders in a listed company, including even an institutional shareholder.

**Shareholder Activism**

It is unlikely that a small investor would want to incur the time and expense of taking on the controlling members. Questions have, however, been asked whether institutional...
shareholders, who are invariably also minority shareholders, could and would play a role in shareholder activism. The short answer is that this is unlikely. One reason for the low rate of activism could be that institutional shareholders still have a very small holding in the listed companies in Hong Kong. In 1999, out of 330 publicly traded companies, 71.5% were controlled by family and only 5.9% were widely held by institutional investors. In addition to the usual problem of shareholder apathy and free-riding, there are many others obstacles including the various problems associated with legal actions that prevent institutional investors from playing a significant role in improving corporate governance practices in Hong Kong.

Institutional investors can exercise their monitoring role either by bringing legal actions against wrongdoers or by voting at the annual general meeting. Insofar as legal action is concerned, there have been no reported cases where institutional investors have successfully challenged or even attempted to challenge the management of the investee companies either by way of derivative action such as that in Prudential v Newman, or unfair prejudice petition under Section 168A of the Companies Ordinance. Indeed, such legal actions would in most cases be futile as it is extremely difficult to bring a derivative action at common law and extremely costly to petition under Section 168A.

In some special circumstances the institutional investors may be able to use their shareholding to exercise negative control through voting. A recent example involves the successful challenge by the minority in Vickers Ballas. This is not a case involving a listed company in Hong Kong, though Vickers Ballas's predecessor was Citicorp Vickers in Hong Kong (which were merged with J Ballas Holdings in Singapore to form Vickers Ballas). Vickers Ballas is Singapore's largest brokerage. A proposal for Vickers Ballas Holdings to be merged with its rival GK Goh Holdings required 75% of its shareholders under Singapore law. The merger would have created south-east Asia's biggest brokerage, with assets of $5 billion ($580 million) and licences to trade stock on markets across East Asia. Its minority shareholder Ong Beng Seng and his family who owns about 20% of Vickers Ballas was opposed to the merger saying that the plan undervalued Vickers Ballas. Its shareholders voted on June 19, 2000, 69.9% in favour, less than the 75% approval required.

But even that sort of behind-the-scene activism is not always likely to be successful. For example, in 1996 when HSBC proposed a new pay scheme for directors, which was thought to be excessively lucrative by certain shareholder pressure groups and institutional investor lobbies such as Pensions Investment and Research Consultants, the votes against such a scheme accounted to only 4.16% of the total group equity.
Another recent example involves an unsuccessful challenge by a minority shareholder, a US fund manager Brandes Investment Partners, which holds 8% of Jardine Matheson Holdings and 2% of Jardine Strategic Holdings, on the Keswick-controlled Jardine empire. Thanks to a defensive cross-shareholding structure, the Keswick family managed to continue its 125-years of control of the Jardine empire. Unhappy with the Jardine groups' economic performance, which was partly caused by the cross-shareholding, Brandes proposed six resolutions including a proposal to abolish the cross-shareholding structure between the two companies. The proposal, if accepted, could leave the companies vulnerable to takeover, according to Jardine Matheson directors. Although the proposal received support from other minority shareholders – including Marathon Asset Management, a London based investment management firm (which holds less than 5% in Jardine Strategic, and a minimal share in Jardine Matheson), Singapore based Brierley Investment (which holds a small non-disclosable shareholding), and Templeton Emerging Markets (which holds 2% in Jardine Matheson, and 0.5% in Jardine Strategic) – it was voted down by the controlling family.

These are only a few rare examples of shareholder activism where the institutional investors are willing to spend time and money to do so. The major problem with shareholder voting is that most small investors do not have a big enough share in the company to have any incentive to spend time and money on agenda setting and voting at the annual general meeting. While the services provided by proxy advisory firms, if subscribed to by all small shareholders (or by the company itself), can reduce the cost of monitoring in this regard, such proxy advisory firms have yet to be established in Hong Kong.

So the short story is that in Hong Kong, it is unlikely that minority shareholders, including institutional investors can have great success under the present law in intervention by legal means or behind the scenes. Indeed, most shareholders are not concerned with good corporate governance, but are short-term speculators hoping to make a quick buck in the stock market. And for the listed companies and the controlling families it is but a relatively cheap way of raising capital.

**Listing rules**

As most public listed companies in Hong Kong are controlled by controlling families, the investing public are the minority shareholders. And yet the law on minority shareholder protection is ineffective to protect the public. The task of protecting the investing public falls on the stock exchange (by means of its Listing Rules) and the Securities and Futures
Commission. A key theme running through these regulations is disclosure to enhance transparency and accountability. With greater transparency, the regulators hope that investors such as minority shareholders could make an informed decision before they invest in a listed company. One major downside of this approach is that shareholders are not given a direct cause of action if things begin to go wrong, leaving them to deal with the problem by selling their stock with no compensation if they suffer a loss in selling.

As we all know, the aim of the Listing Rules is to reflect the best market practices and to ensure investors' confidence in the market. To achieve that, the Listing Rules for the main board require that directors of listed companies act in the interest of the shareholders as a whole, particularly where public shareholders are in the minority. This means that directors must avoid conflicts of interest between their private interests and the interests of shareholders as a whole. The Listing Rules also require that the issue and marketing of securities is conducted in a fair and orderly manner, and potential investors are given sufficient information to enable them to make properly informed investment decisions. Also, the investors and the public must be kept fully informed by listed issuers and, in particular, must receive immediate disclosure of any information which might reasonably be expected to have a material effect on market activity in, and the prices of, listed securities. All holders of listed securities must be treated fairly and equally. All new issues of equity securities by a listed issuer are first offered to the existing shareholders by way of rights, unless they have agreed otherwise. These rules are designed to secure for minority shareholders certain assurances and equality of treatment which the legal position might not otherwise provide. The Listing Rules for the Growth Enterprise Market contain similar requirements.

There are various specific measures to achieve the above objectives, but the real problem lies in the consequences of breaching the Listing Rules. The stock exchange's options are restricted to civil remedies against the recalcitrant for breach of the Listing Agreement and the directors' declaration and undertaking. These are inadequate deterrents. Although the stock exchange can suspend or withdraw a company's listing, this is unlikely to be used in most cases because any suspension or withdrawal is also likely to harm the minority shareholders whose interests the Listing Rules seek to protect. The more practical and effective actions the stock exchange can take against the party in breach are:

- to issue a private reprimand, a public statement of criticism or a public censure
- to report the misconduct to the Securities and Futures Commission or other regulatory
authorities (such as the Financial Secretary etc).

- to ban professional advisers from representing the person in breach for a prescribed period of time
- to require rectification of the breach or remedial action
- to state publicly that the retention of a director who willfully or persistently breaches the Listing Rules is prejudicial to the investors' interests, or
- to prohibit dealers and financial advisers from acting for a company that is willfully or persistently in breach of the Listing Rules.

The Listing Committee also has the power to investigate by conducting a hearing, to which it can call relevant and appropriate people and documents.

Announcements and circulars of listed companies, as required by the Listing Agreement and the Listing Rules, must be approved by the stock exchange and as such the stock exchange has control over the contents of such announcements and circulars, and can require further disclosure or announcements where appropriate. But it is often not clear whether an announcement or circular is required in the first place, and if required, what should go into it, which makes it difficult to police the general obligation to make an announcement or circular. However, where the matter has been leaked to the market, the stock exchange has been willing to require an announcement to be made regarding that matter.

To assist the stock exchange in its investigation, directors are required to make declarations and undertakings that they will co-operate in any investigation conducted by the Listing Committee (including answering questions, producing documents and attending hearings or meetings). The director also undertakes to ensure the listed company complies with the Listing Rules, the Securities (Disclosure of Interest) Ordinance, the Codes on Takeovers and Mergers and Share Repurchases, and all other relevant securities laws and regulations. As the undertaking is executed as a statutory declaration, any false information in it would constitute a criminal offence.

While the Listing Rules cover a wide range of potential abuses by the controlling members and directors, for the minority shareholders, including institutional investors, relying on the stock exchange to prevent majority abuses is not entirely satisfactory. The action by the stock exchange against the recalcitrant is based on the listing agreement, which the minority shareholders are not party to. So, the minority shareholders do not have any direct action themselves either against the company for the abuses, or the stock
exchange for failing to enforce the Listing Rules. Framing an action at common law for breach of Listing Rules is almost impossible. The proposed Securities and Futures Bill seeks to provide shareholders who are materially affected by market misconduct (a new concept which includes insider dealing, market manipulation, false trading, price rigging, disclosure of information about prohibited transactions, and disclosure of false or misleading information inducing transactions) a private cause of action for damages. This will be a very welcome development if enacted.

Further, the stock exchange is in a position of potential conflict of interests as it seeks its revenue from issuers that list and trade with it, and from shareholders when they transact in the shares of these companies. The exchange’s owners, the broking members, also derive their incomes from transaction charges based on trades. So, there is incentive for the exchange not to appear too keen on enforcement lest it deters companies from listing with it. Some improvements have been made recently to deal with this problem. The exchange has recently transferred several of its regulatory functions to the Securities and Futures Commission which has assumed the duties of front-line regulator of exchange participants. It is also responsible for all new investigations and disciplinary matters under the various ordinances, subsidiary legislation, codes of conduct and conduct involving clients. This includes complaints about exchange participants, disputes between them and their clients and their professional standard in handling their clients’ accounts.

However, as the stock exchange is now wholly owned by the new Hong Kong Exchanges and Clearing, which is also listed on the stock exchange’s main board, this itself creates a conflict of interest in that the regulator is regulating itself.

**Takeovers Codes**

Prior to the Takeovers Code, it was often possible in the 1970s for the controlling shareholders to benefit from takeovers to the exclusion of the minority, as there was no obligation to buy the remaining shares from them. It was the controlling shareholders who would negotiate the terms of the takeover and would obtain the best price for their shares to be sold to the offeror. Also, where there was a hostile takeover or management buyout, there was a conflict of interest between the board of directors and the shareholders. The directors would try to frustrate the hostile takeovers, and in the case of management buyout, they may not try their best to get the best price for the shareholders.

The Codes of Takeovers, Mergers and Acquisitions were introduced with the aim of
ensuring fair treatment for all shareholders affected by takeovers. So the offeror has to make a mandatory offer to the minority when any person, or group of persons acting together, acquires shares that carry 35% or more of the voting rights of a company, or when any person or group of persons who together already hold between 35% and 50% of the voting rights acquire an additional 5% of the voting rights in any 12-month period. To prevent shareholders acting in concert, shares purchased in concert with the offeror will be treated as purchased by the offeror, so that the mandatory offer applies. During the course of an offer all shareholders must be given the same information. All shareholders should be given sufficient information, advice and time to reach an informed decision. All persons concerned with the takeover should make full and prompt disclosure of all relevant information and should take every step to avoid the creation of a false market. Rights of control should be exercised in good faith and oppression of the minority is always unacceptable. Directors should have regard to the interests of the shareholders as a whole, and not to their own interests or those derived from personal and family relationship. The board of the offeree company should not take any action (e.g., poison pills) without the shareholders’ approval in general meeting, which could frustrate the offer or result in shareholders not having the opportunity to decide on its merits. So, the board of the offeree company cannot issue any shares, options, or warrants, sell or acquire assets of a material amount, enter into contract (including service contracts) other than in the ordinary course of business, or cause the company or its subsidiary or associated company to purchase or redeem any shares in the company or provide financial assistance for any such purchase.

Sanctions for breach of the Takeovers Code include private reprimand, public statement of criticism, public censure, requiring dealers and advisers not to act for any person who is in breach of the Code, and other action to be taken or not taken as the takeover panel thinks fit. A breach of the Code would also constitute a breach of the Listing Rules.

As with the Listing Rules, the shareholders are not party to the Takeovers Code. So, they do not have the right to enforce the code directly or sue the SFC for failing to enforce the Code.

**INSIDER DEALING**

The fact that most listed companies are controlled by controlling families means that it is easier and more common for insider dealing to take place. Any person connected with a listed company or anyone receiving relevant price-sensitive information about the listed
company from a person connected with the company cannot deal in the company's securities or its derivatives.

There are some problems with the existing legislation, for example, the definition of "relevant information" is too narrow to capture the general misuse of information advantages. It is also questionable whether Section 10(3) is justifiable — it exempts liability where the transaction is entered into for reasons other than making a profit or avoiding a loss. Such a provision is certainly not found in the laws of the US, Japan, Australia, Canada and several European states. The working of the insider dealing tribunal has also been subject to criticisms in terms of its procedure, accountability, speed of delivery of decision and adherence to principles of due process and fairness. Furthermore, it is for the Financial Secretary to bring cases of insider dealing to the tribunal following representations by the SFC; shareholders do not have any criminal or civil remedies against the insiders.

In an attempt to improve the transparency of listed companies by providing the investing public with information on the details of substantial shareholders and the holdings of directors and chief executive officers so that the public knows who are the controlling members and knows of any changes in such control, the Securities (Disclosure of Interests) Ordinance was introduced. It also helps the public to know the dealings of shares by directors and assist the regulator to discover any insider dealing in the company’s shares. Any person who holds 10% or more of the issued share capital of a listed company is under a duty to disclose such interest. Directors and chief executive officers are likewise required to disclose their interests (including their spouses’ and associates’ interests) in the shares of the company. If an interest exceeds 10%, any change in a whole figure percentage point has to be disclosed. Failure to comply with the disclosure requirements is a criminal offence and the attorney general or the SFC may prosecute the offenders.

The current threshold for persons other than directors has been criticized as being too high, and proposal has been made for it to be lowered from 10% to 5%.

**Outlook**

While the Securities and Futures Commission and the stock exchange play a key role in protecting the minority and the investing public in a number of areas mentioned above, doubts have been raised as to their effective enforcement of those regulations. The stock exchange has been criticized for being too lenient in enforcing the Listing Rules. Likewise, the number of successful prosecutions for breach of the disclosure of interest requirement
and market manipulation is very small and the amount of punitive damages imposed on
the offenders are so low that they can be regarded as mere operating costs for the offenders.
Without tougher penalties for breach of these regulations, they will not do the job they are
intended to do.

So the story so far is that minority shareholders' remedies and the enforcement of
securities regulation need to be strengthened. There are however other measures that can
be adopted at the same time.

One way of improving the shareholders' position is by improving the standards of
corporate governance in Hong Kong. The use of independent non-executive directors at
board level and at audit committee, and remuneration committee can promote transparency
and accountability. In this respect the requirement by the Hong Kong stock exchange of a
minimum of two independent non-executive directors to be in the board of a listed company,
and the requirement of voluntary audit committees for all listed companies is a small step in
the right direction. There is much room for improvement however: the board of many listed
companies only meet the minimum requirement, so the controlling members still have
substantial control over the board. There are also doubts as to whether these non-executive
directors can truly be independent, given that they are often drawn from a very small business
circle. Audit committees should be compulsory, as well as remuneration committees.

Listed companies incorporated abroad (of the 700 listed companies as of November
1999, 599 are incorporated abroad) are not governed by the Hong Kong Companies
Ordinance. They are governed by the corporate laws of their home jurisdictions, some of
which have very week minority shareholders protection. One example is the Semi Tech case
where under Bermudan law a company can by its articles of association restrict a registered
shareholder from sending a proxy to vote by show of hands (under Hong Kong law, this
would not be a problem). The proxies can only participate in a balloted vote if they are eligible
to call for such a vote under Bermudan law. This is unfair to many minority shareholders,
particularly institutional investors, who typically register their shares in a listed company in
the name of the Hong Kong Securities Clearing (HKSCC); ie, they only hold their shares in the
central depository. So, in Semi Tech case, Templeton's shares in Semi Tech were deposited
with the HKSCC and as such HKSCC was not allowed to send Templeton as proxy to vote by
show of hands. HKSCC could only send its own corporate representative to vote for all
shareholders who had deposited their shares with it.
**CONCLUSION**

While securities regulations in Hong Kong, such as the Listing Rules and the Takeovers Code, have covered many areas where minority shareholders' interests are to be looked after, and have set the minimal standards for the controlling members and the management, the enforcement of these standards depends on the resources of the stock exchange and the Securities and Futures Commission. The enforcement record of these standards has not been brilliant. Also they do not allow shareholders to play a more direct role in monitoring the company's affairs. Until the problems associated with shareholders' legal remedies by direct legal actions are resolved, many minority shareholders including institutional investors will face many challenges in attempting to play an active role in corporate monitoring.

If Hong Kong wishes to attract international investment, to remain an international financial centre for the east Asia region, and to remain competitive, it will be necessary to strengthen shareholders' protection. The current proposal to strengthen and consolidate its securities legislation and regulation is an essential step. But equally important is to improve the standards of corporate governance and shareholders' remedies.
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