Asian Roundtable

Task Force on

Related Party Transactions

Session 3: Decision-making process: Role of the Shareholders Meetings

Mr Lee Kha Loon,
Market Integrity, Asia Pacific

Manila, 5-6 February 2009
Related Party Transactions
Decision Making process – Role of Shareholders
Meeting

5th Feb 2009

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Related Party Transactions

Decision Making Process – Role of Shareholders Meeting

- Bail out related companies
- Cross Guarantees and Loans to Affiliates
- Privatization and sale of assets
- Transfer of wealth schemes

- Board and Shareholder Approval
  - Types of transactions that need approval
  - How to determine right thresholds
  - Shareholding voting process
  - RPT disclosure policies
The Chinese Grid: Ownership in China Construction Bank after its IPO in 2004

- **HuiJin**
  - 100%
  - JianYin 61.48%
  - State Grid 9.21%
  - Shanghai Baosteel 1.34%
  - Yangtze Power 1.34%
  - Bank of American 0.89%
  - Temasek 8.52%
  - AFH 5.88%
  - Others 11.34%

- **China Construction Bank (BBC)**
  - 100%
  - Jian Xin Bank Limited 100%
  - Sino-German Bausparkasse Corporation Limited 75.1%
  - CCB Principal Asset Management 65%
  - Joseph Fan 30%
View From the Top: *How Li Ka-Shing controls Hong Kong’s most valuable conglomerate*
I Own You, You Own Him, He Owns Me: The Lee Family’s Samsung Dynasty
Chairman Raju (Majority Shareholder) proposed to BOD to buy two related companies (in property and construction) for USD1.6 billion on 16 Dec 2008.

They seek only Board Approval – shareholder approval not required. BOD approved the deals.

At Analyst briefing later that day –

- Investors questioned the deal – why invest in unrelated business?
- Independent valuation of the RPT deals not presented to investors, Chairman refused to even give name of the valuer
- Investors prefer distribution of cash as dividends
- Investors sold Satyam immediately; and the price fall resulted in margin calls and selling of shares.
## SK Corp: A Series of Unfortunate Events

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>27 Feb 03</td>
<td>Prosecutors announce USD 1.2 billion inflated profits by SK Global (now SK Network). SK Chairman was charged on account manipulation</td>
</tr>
<tr>
<td>16 Apr 03</td>
<td>Sovereign discloses its expanded interest of 14.99% in SK Corp.</td>
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<tr>
<td>10 Jun 03</td>
<td>Hermes Pension petitions court for voting right suspension of three directors.</td>
</tr>
<tr>
<td>13 Jun 03</td>
<td>Chey Tae-Won, chairman of SK Corp., sentenced to three years in jail.</td>
</tr>
<tr>
<td>14 Jun 03</td>
<td>Hermes’ court petition succeeds.</td>
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<tr>
<td>15 Jun 03</td>
<td>SK Corp.’s board approves bailout of SK Network including a USD 800m debt-to-equity swap.</td>
</tr>
<tr>
<td>22 Sep 03</td>
<td>Chey released on bail.</td>
</tr>
<tr>
<td>20 Nov 03</td>
<td>Sovereign announces its plan to oust three directors at AGM.</td>
</tr>
<tr>
<td>22 Dec 03</td>
<td>Local minority shareholder groups declare support for Sovereign.</td>
</tr>
<tr>
<td>26 Dec 03</td>
<td>SK Corp. sells 10% treasury shares to friendly parties. Share price declines reflecting end of proxy fight; chairman had acquired enough support at the forthcoming AGM.</td>
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</tbody>
</table>
## SK Corp: A Series of Unfortunate Events

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<tr>
<td>9 Jan 04</td>
<td>Son Kil-Seung, CEO of SK Corp., arrested on misappropriation of SK Shipping’s corporate fund.</td>
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<tr>
<td>30 Jan 04</td>
<td>SK Corp. proposes to increase outside directors to over half of the board.</td>
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<tr>
<td>30 Jan 04</td>
<td>SK Corp. announces 2003 results – net earnings declined by almost 90% due to losses of affiliates.</td>
</tr>
<tr>
<td>2 Feb 04</td>
<td>Templeton and Wellington each disclosed 5% stakes. Foreigners owned more than 50% of SK Corp.’s shares.</td>
</tr>
<tr>
<td>22 Feb 04</td>
<td>SK Corp. proposes six new directors. Outside directors make up 70% of board.</td>
</tr>
<tr>
<td>12 Mar 04</td>
<td>Sovereign loses at AGM; ask for Chey to resign.</td>
</tr>
<tr>
<td>26 Mar 04</td>
<td>SK Corp. establishes a special committee to improve corporate governance.</td>
</tr>
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</table>
Case Study: CNOOC. In 2004, shareholder approval was sought to deposit RMB6.6 billion cash to parent company for a 3 year period. This amounts to 16.6% of NTA. It was approved as there was a very tight period (over a Easter holiday) for shareholders, especially foreign institutional shareholders to file the proxies.

(A similar proposal in 2007 was voted down when the loan expired)

Issue: How can voting mechanisms be improved such that investors are made aware of the issues on time, and more importantly, that the votes are proportional to their interests (i.e., voting is not enough – mandatory one share one vote vs. voting by show of hands)? CNOOC won in 2004 because it was voting by hand, not poll. Therefore it is not enough for major shareholders to abstain.
Case Study: CNOOC. CNOOC holds exclusive rights to PRC offshore oil and natural gas exploration rights as stated in prospectus when listed. CNOOC’s parent gave CNOOC a non compete undertaking at time of listing. In 2005 CNOOC sought minority shareholder approval to give consent to the parent to engage in competing business, both onshore and offshore. Minority Shareholders rallied and voted it down by 59.08%.

Issue: Role of INEDS and IFA are critical. The 5 INEDS recommended in favor of the proposal to minority shareholders. The IFA offers nothing to justify the proposal, except that recent listings did have a “get out “ clause; but CNOOC did not. The independence of a IFA is questionable and a key issue for discussion.
Kun-hee Lee
Chairman

Inheritance TAX of 1.6 Billion WON

Inheritance (1995) 6 Billion WON

S-One

IPO in 1996

35.7 Billion WON

Samsung Engineering

IPO in 1996

23 Billion WON

Convertible Bond 23 Billion WON

SDS

Convertible Bond 1.8 Billion WON

Cheil Communication

Convertible Bond converted to 31.9% equity

Convertible Bond 45 Billion WON

Samsung Everland

Purchase Share

Converted to equity

Samsung Life Insurance

15.3 Billion WON

Convert to equity

Samsung Electronics

Source: Sony vs Samsung
by Sea-Jin Chang
Case Study – A Forensic Study of Daewoo’s Corporate Governance – By Joongi Kim

Related companies pressured employees to purchase Daewoo automobiles. Executives personally marketed cars with sales results linked to performance evaluations. In August 1998 KFTC fined Daewoo Corp USD3.6million for providing interest free loans to employees that purchased Daewoo cars through Daewoo Motor Sales between April 1997 – May 1998.

In 1998 Korean Fair Trade commission, KFTC discovered substantial, improper affiliate subsidization among chaebols. In the case of Daewoo, six companies improperly supported seven affiliates for USD329 million. Daewoo Corp and Daewoo Heavy Industries provided financial support to affiliates on non market terms by refraining from collecting receivables, purchase bonds and commercial paper under unfavorable conditions. KFTC fined Daewoo a modest USD9.5million.
Case Study – A Forensic Study of Daewoo’s Corporate Governance – By Joongi Kim

Related party transactions were also used for asset swaps among Daewoo subsidiaries at exaggerated values. Stronger affiliates would prop up weaker companies by purchasing overvalued assets at above market prices.

In 1998 and 1999, Seoul Investment Trust Management (Daewoo controlled company) used 38% of its funds to buy USD2.4 billion of bonds and commercial paper issued by various Daewoo Affiliates to support these Daewoo affiliates.
Question 1: What types of RPTs are required to be approved by Boards and / or Shareholders?

Are current list of transactions reported sufficient? What other types of transactions should we be looking at?

Family owned companies – transfer of wealth to next generation – without having to pay estate duty. Example – son or daughter of Chairman set up a private company in IT business that service the entire group of companies.

Family members – salary, benefits and compensation. Potential abuse by having generous pay schemes and benefits that may not require disclosures. This is especially for the medium and smaller size companies. Disclosure rules on executive compensation in Asia Pacific is weak.
Examples of related party transactions under FASB and IASB.

<table>
<thead>
<tr>
<th>FASB</th>
<th>IASB</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Services received or furnished, such as accounting, management, engineering and legal services;</td>
<td>• Rendering or receiving of services;</td>
</tr>
<tr>
<td>• Sales, purchases and transfers of realty and personal property;</td>
<td>• Leases;</td>
</tr>
<tr>
<td>• Use of property or equipment by lease or otherwise;</td>
<td>• Purchases or sales of property and other assets;</td>
</tr>
<tr>
<td>• Borrowings and lendings;</td>
<td>• Purchases or sales of goods;</td>
</tr>
<tr>
<td>• Guarantees;</td>
<td>• Transfers of research and development;</td>
</tr>
<tr>
<td>• Maintenance of bank balances as compensating balances for the benefit of another;</td>
<td>• Transfers under license agreements;</td>
</tr>
<tr>
<td>• Inter-company billings based on allocations of common costs;</td>
<td>• Transfers under finance agreements (including loans and equity contributions in cash or in kind);</td>
</tr>
<tr>
<td>• Filings of consolidated tax returns.</td>
<td>• Provisions of guarantees or collateral;</td>
</tr>
<tr>
<td></td>
<td>• Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.</td>
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</tbody>
</table>
Case Study – A REITS listing in Singapore

CITYSpring Infrastructure Trust – The Manager of the REIT put into IPO prospectus a formula for fees based on share price performance. Within 3 months the share price shot up substantially. For the first financial period to 31 Mar 07 the REIT registered a loss of S$52 million after paying fees of S$63 million to the Manager.

Issue. Who is supposed to look after investors’ interest in ensuring that the fee schedule is reasonable? Is the manager carrying out his fiduciary duty by taking fees of S$63 million on a newly listed REIT when revenue is only S$47 million? What is the relationship between the Manager and the REIT? Is this a related party transaction?
Question 2. What is the difference between board and shareholder approvals?

Value thresholds determine when an RPT is to be voted on by directors or shareholders. Is there a “right” threshold?

What is the right benchmark (i.e., net asset value, net tangible assets, book value or percentage of revenues)?
<table>
<thead>
<tr>
<th>China</th>
<th>India</th>
<th>Indonesia</th>
<th>Hong Kong</th>
<th>Singapore</th>
<th>Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value exceeding 300 million RMB or 5% of NAV must be approved by independent directors and discussed by the board.</td>
<td>None specified. Board of directors consent required for contracts for sale, purchase or supply of goods, materials or services.</td>
<td>No specific thresholds, but law provides that RPTs be deliberated on by directors, excluding interested-party directors.</td>
<td>Continuing related transactions are to be approved by the board of directors.</td>
<td>No thresholds specified. By-laws often give blanket approval for directors to deal with company subject to disclosure to, and approval of, the board.</td>
<td>A single RPT exceeding 1% of annual revenues or total assets – or a set of RPTs with a combined total in excess 5% of revenues or total assets.</td>
</tr>
<tr>
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<tr>
<td>If number of independent directors deciding on the RPT is less than three.</td>
<td>Loans to directors, and the provision of facilities or office spaces to a relative of a director.</td>
<td>No specific thresholds, but law requiring RPTs to be approved by independent shareholders.</td>
<td>Value greater than HK$10 million or 3% of book value.</td>
<td>Value equal to or more than 5% of group’s audited NTA.</td>
<td>No shareholder approval required, only notification after board approval.</td>
</tr>
</tbody>
</table>
Question 3: What procedures does the Board use to monitor RPTs?

In Malaysia internal audit is required to report to Audit committee related party transactions under the listing rules.

In HK the CG code requires internal controls to be in place but not specified on reporting RPTs to the Audit Committee or Board.
Question 4: Are Directors who have an interest in RPT required to disclose that interest to the Board and prohibited from voting on the RPT?

“Interested director” not allowed to vote in Singapore, India and Thailand
In China, independent directors approve the RPT after BOD discussion.

Given lack of director independence, should ALL RPTs of a certain value be put to a vote? Given the dominant-shareholder ownership model among Asian companies, how effective are director approvals in preventing controlling shareholders from pursuing transactions that might be abusive to minority investors?

The CNOOC shareholder proposal in 2004 and 2007 relating to loans to CNOCC finance, the parent and the 2007 shareholder proposal to give up offshore rights back to the parent are two good cases to review.
Question 5: When a shareholder vote is required, do “interested” shareholders vote or abstain?

**China** - Related shareholders cannot vote  
**Indonesia** – Related shareholders cannot vote  
**Hong Kong** – Connected persons cannot vote  
**Singapore** – Connected persons cannot vote

May OECD discussion group agreed that both interested directors and shareholders should abstain from voting.
Question 6: Are companies required to develop policies and procedures (and make it public) for approval of RPTs?

India – A proposed law change that will require companies to maintain a register of RPTs and open to inspection by shareholders. The register is required to be signed by all the directors at Directors meeting. (pg 21, India report)

China – requires a separate committee on RPT. However SSE survey in 2008 shows that only 4.6% have complied. (pg18, China report)

Korea case – Sovereign Asset proposed setting up a RPT committee to oversee SK Corp operations in 2004.

Malaysia - a separate circular is tabled at AGM that has two lists of RPT, one for revenue and recurring items; and a second one for capital items.

The Connected Transaction Control Committee comprises 4 members; Two EDs and two INEDs, chaired by INED. The committee is responsible for
• formulating policies and procedures for RPT
• identifying and examining RPTs according to Chinese laws and regulations.

The CTCC met 4 times in 2005 and conducted an in depth study of RPT transactions. The annual report also has a separate section that details the types of RPT.
### A sampling of related-party transactions disclosed to the Hong Kong Exchange

<table>
<thead>
<tr>
<th>Listed company</th>
<th>Nature of disclosed transaction</th>
</tr>
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<tbody>
<tr>
<td>C Y Foundation Group Ltd</td>
<td>Acquisition of 100% of a company owned by chairman and his spouse</td>
</tr>
<tr>
<td>Wo Kee Hong (Holdings) Ltd</td>
<td>Purchase of a unit of vintage Ferrari from a director and controlling shareholder</td>
</tr>
<tr>
<td>Great Wall Motor Co Ltd</td>
<td>Acquisition of companies in China</td>
</tr>
<tr>
<td>China Resources Logic Ltd</td>
<td>Acquisition of China Resources Gas Ltd</td>
</tr>
<tr>
<td>Sino Union Petroleum &amp; Chemical International Ltd</td>
<td>Acquisition of HK$600 million worth of shares from the Chairman of the Board</td>
</tr>
<tr>
<td>Central China Real Estate Ltd</td>
<td>Acquisition of 100% of CCRE Forest Peninsula from a connected person</td>
</tr>
<tr>
<td>Lippo China Resources Ltd</td>
<td>Joint announcement of continuing connected transactions (tenancy agreement)</td>
</tr>
<tr>
<td>Hong Kong Chinese Ltd</td>
<td>Continuing connected transactions (sales and purchases framework agreements)</td>
</tr>
<tr>
<td>Honghua Group Ltd</td>
<td>Continuing connected transactions (product sales, technology transfer and software licensing)</td>
</tr>
<tr>
<td>Advanced Semiconductor Manufacturing Corp Ltd</td>
<td>Continuing connected transactions (sales of products and raw materials)</td>
</tr>
<tr>
<td>Zhongda International Holdings Ltd</td>
<td>Continuing connected transactions (sales of products and raw materials)</td>
</tr>
</tbody>
</table>
The Way Forward - A Collective Effort by....

- Investors
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- Advisors
- Regulators
- Markets