PROXY Governance, Inc.

Roundtable on Abusive Related Party Transactions in Asia: Shareholder’s Perspective

Presentation to

OECD

[October 2010]
Outline

- Kinds of related-party transactions requiring shareholder votes.
- Framework for evaluating related-party transactions.
- How Asia compares.
- Consequences of poor disclosure.
- Suggestions for improvement.
Most Related Party Transactions not Subject to Shareholder Approval

- **Most transactions classified as day-to-day business transactions**
  - Transfer Pricing
  - Intercompany Loans and Guarantees
  - Leasing or Licensing Agreements between related companies
  - Loans to directors and officers (if allowed)

- **No reporting due to materiality disclosure threshold**
  - Often does not apply to consolidated financial statements as the consolidated statements present information about the holding and its subsidiaries as a single reporting enterprise.

- **Director approval adequate for most transactions from regulatory perspective**
Related Transactions that Require Shareholder Approval

- **Sale of Company/ Asset**
  - Requirement in most jurisdiction

- **Purchase of Asset with stock**
  - No shareholder approval required if all cash transaction in most jurisdictions

- **Capital Raising or Restructuring of Capital**
Not all Related-Party Transactions are Bad

- Very common in Asia; Results from ownership structure – family and state control.
- Red flag when economic interest not aligned to controlling interest.
- Should be an arm-length transaction: deal terms favorable to minority shareholders?
- The process of approval and transparency regarding deal terms is also key for gaining shareholder approval and trust.
Evaluating the Overall Framework

- Regulatory framework for disclosure of related-party transactions.
- Quality of oversight provided by regulator.
- Legal liabilities of directors and quality of judiciary system – class action lawsuits.
- Internal controls and audit quality.
- Disclosure of company policy on related-party transactions.
- Financial press coverage and analysis.
PGI Framework for Evaluating the Review Process

- Quality of directors and overall independence of company board.

- Disclosure document should address:
  - Deal Terms - nature of transaction, amounts involved, financing methods;
  - Process of oversight provided by independent directors;
    - Appointment of independent special committee,
    - Advice sought from independent financial advisors,
    - Related-parties abstain from discussion and voting.

- Market reaction to deal.

- Company history with regard to related-party transactions.
## Related-Party Transactions Framework in Asian Countries

<table>
<thead>
<tr>
<th>Criteria</th>
<th>China</th>
<th>HK</th>
<th>India</th>
<th>Indon.</th>
<th>Malay</th>
<th>SK</th>
<th>Taipei</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of publicly traded company with controlling shareholder</td>
<td>69%</td>
<td>56%</td>
<td>45%</td>
<td>80%</td>
<td>26%</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>% of companies that report RPTs (1% of revenue or more) in last 3 yrs</td>
<td>53%</td>
<td>38%</td>
<td>17%</td>
<td>0%*</td>
<td>7.4%</td>
<td>53%</td>
<td>16%</td>
</tr>
<tr>
<td>Are class-action suits common?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Are derivative suits common?</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Supermajority vote for mergers?</td>
<td>Yes^</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Often</td>
<td>Yes</td>
<td>Yes^</td>
</tr>
</tbody>
</table>

*Disclosure threshold high- 10% of revenues or 20% of equity; ^ requires two-thirds of votes casts*

Source: Shareholder Rights Across Markets: A Manual for Investors, CFA Institute, 2009
How Asia Compares

- Insufficient information provided to shareholders to make informed decisions, though some better than others, such as Hong Kong, Singapore and Malaysia.

- Shareholder proxy reforms needed in some markets such as India and Hong Kong.
  - Voting in AGM’s is by show of hands, unless poll demanded – one person vote, instead of one share, one vote.
  - In Hong Kong, since March ‘04 voting by poll mandatory for related-party transactions.

- Class action lawsuits should be encouraged.
Consequences of Poor Disclosure

- Changing face of minority shareholders in EM countries: Foreign and domestic institutional investor participation in equity markets increasing.

- FII own about 16% of Indian equities (worth US$147bn) and account for 10-15% of the equity.

- Growth of MFs, domestic investments in equity mrkt to grow to about US$ 100 billion in 2020.

*Note: Priced on 27 October 2009, Source: CLSA Asia-Pacific Markets*
These shareholders (esp. foreign investors) expect comparable disclosure in English, have developed voting policies on related-party transactions, maybe required by law to vote shares.

Often, lack of information results in withhold or abstain vote recommendations by proxy advisory firms, which could increase votes against management proposals.

Increased transparency about related-party transactions and the review process employed by company is beneficial to shareholders and the company.
Suggestions for Regional Improvement

- Enhance and streamline materiality limits and disclosure requirements for related-party transaction across Asian countries.

- Develop best practice guide for controlled companies with significant related-party transactions that would require, for example:
  - Independent board level committee to review related-party transactions for companies with multiple transactions.
  - Appointment of independent financial advisors to review fairness of terms and valuations used.
  - Enhance disclosure formats that provide relevant information to shareholders in a timely manner.
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