

PROXY *Governance*, Inc.

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

Presentation to



[October 2010]



PROXY Governance

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

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

Source: *Shareholder Rights Across Markets: A Manual for Investors*, CFA Institute, 2009

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

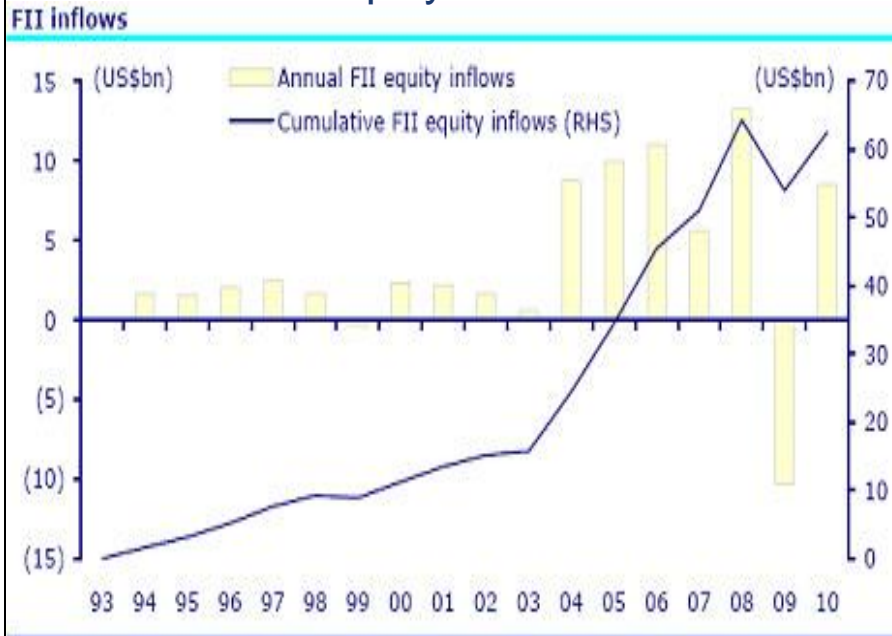
How Asia Compares

- 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.

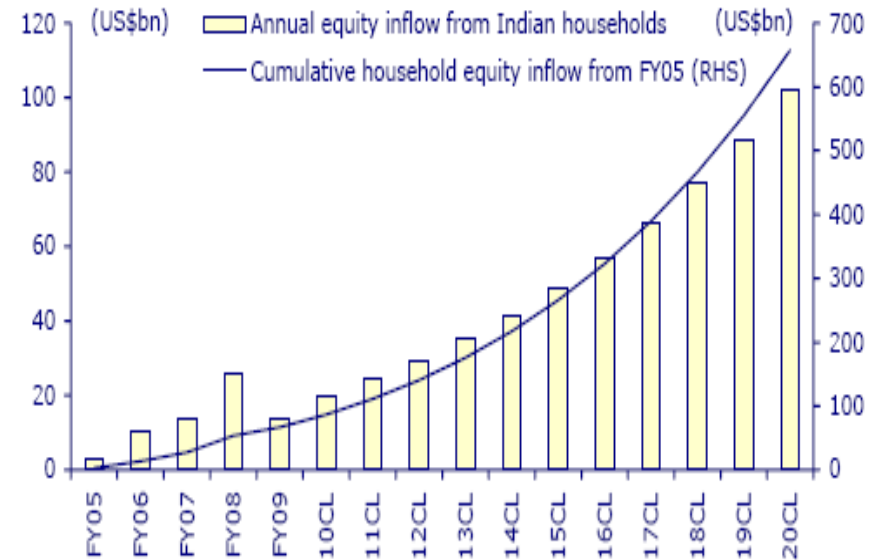
- FII own about 16% of Indian equities (worth US\$147bn) and account for 10-15% of the equity



Source: Sebi, CLSA Asia-Pacific Markets

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

Equity inflow from Indian households



Note: Priced on 27 October 2009. Source: CLSA Asia-Pacific Markets

Consequences of Poor Disclosure cont'd

- 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.



THE PREMIER STRATEGIC PARTNER FOR CORPORATE GOVERNANCE AND PROXY VOTING SERVICES

Rakhi Kumar
Senior Research Analyst
8180 Greensboro Drive, 8th Floor
McLean, VA 22102
Tel : (703) 245-5800
Fax : (703) 245-4800
www.proxygovernance.com

