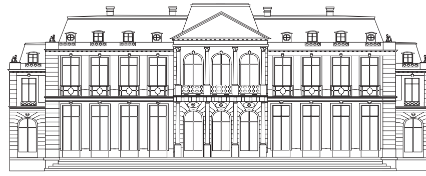
Organisation for Economic Co-operation and Development



Organisation de Coopération et de Développement Économiques

in co-operation with

the Korea Development Institute

and with the co-sponsorship of the Government of Japan and the World Bank

Conference on

"CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE"

The World Bank

CORPORATE GOVERNANCE IN MALAYSIA AN ASSESSMENT

Seoul, 3-5 March 1999

DRAFT

NOT FOR QUOTATION WITHOUT PERMISSION

CORPORATE GOVERNANCE IN MALAYSIA AN ASSESSMENT

I INTRODUCTION

II CORPORATE FINANCING & CORPORATE GOVERNANCE

III CORPORATE GOVERNANCE STRUCTURES & ISSUES – WITH REFERENCE TO CONTROL & CASHFLOW RIGHTS

IV INSIDER CONTROL, EXTERNAL FINANCING, RISKS & REWARDS – SOME PRELIMINARY FINDINGS

V THE LEGAL & REGULATORY FRAMEWORK

a. Introduction
b. Disclosure & Transparency
c. Shareholder Rights
d. Management Oversight
e. Other Internal Mechanisms

VI GOVERNANCE BY LARGE CREDITORS & CREDITOR RIGHTS

VII OPTIONS FOR STRENGTHENING CORPORATE GOVERNANCE

SCHEDULES

I Schedule of Pyramiding & Cross-Holdings of Selected Companies
II International Accounting Standards Adopted for Application in Malaysia
III Malaysian Accounting Standards Issued by MIA, MACPA & MASB
IV A Comparison of International Standards on Auditing (ISAs), The Old International Auditing Guidelines (IAGs) & Their Issue Dates in Malaysia

Copyright © OECD All rights reserved

01-ias.doc

Copyright © OECD All rights reserved

I INTRODUCTION

Where a firm relies only on internal finance, there is no separation between management and financing or between ownership and control. Corporate governance is not an issue as control and cashflow rights are perfectly matched.

Designing an appropriate corporate governance system becomes a problem where the firm places reliance on external finance. This will make for a separation between management and financing thus giving rise to an agency problem. This will also lead to a mismatch between control and cashflow rights with the mismatch greater the more dispersed the shareholding or the more marked the separation between ownership and control. The manager or controlling shareholder, dubbed the insider in the literature, may end up having an enormous discretion about what is done with the funds, often to the point of being able to expropriate much of it.

"…….. the principal practical question in designing a corporate governance system is ……. how to introduce significant legal protection of at least some investors so that mechanisms of extensive outside financing can develop." ([8], p 4)

There is a view that we should not worry about governance, since, in the long run, product market competition would force firms to minimise costs, and as part of this cost minimisation to adopt rules, including corporate governance mechanisms, enabling them to raise external capital at the lowest cost. While agreeing that product market competition is probably the most powerful force toward economic efficiency in the world, Schleifer and Vishny (See [8]) are skeptical that it alone can solve the problem of corporate governance. "One could imagine a scenario in which entrepreneurs rent labour and capital on the spot market every minute at a competitive price, and hence have no resource left over to divert to their own use. But in actual practice, production capital is highly specific and sunk, and entrepreneurs cannot rent it every minute. As a result, the people who sink the capital need to be assured that they get back the return on this capital. The corporate governance mechanisms provide this assurance. Product market competition may reduce the returns on capital and hence cut the amount that managers can possibly expropriate, but it does not prevent the managers from expropriating the competitive return after the capital is sunk. Solving that problem requires something more than competition." ([8], p 3).

The corporate governance mechanism should be designed primarily to protect shareholders and creditors and not employees or community members. The investments by shareholders, for instance, are largely sunk, and further investment in the firm is generally not needed from them. This is much less the case with employees or community members. "The employees, for example, get paid almost immediately for their efforts, and are generally in a much better position to hold up the firm by threatening to quit than the shareholders are. Because their investment is sunk, shareholders have fewer protections from expropriation than the other stakeholders do." ([8], p 13). To induce them to invest in the first place, they need stronger protections in the form of shareholder voting rights supplemented by an affirmative duty of loyalty of the managers to shareholders. Managers have a duty to act in shareholders' interest and the courts in the developed countries have generally accepted the idea of manager's duty of loyalty to shareholders.

There is a possibility for raising finance without governance, that is without giving suppliers of capital any control rights in return for their funds. Then financing will be based on reputations of managers or on excessively optimistic expectations of investors about the likelihood of getting their money back. The sizeable equity financing in the rapidly growing East Asian economies may be

Copyright © OECD All rights reserved

based in part on investor optimism about near-term appreciation. In part investors may be counting on reputation in the short run and legal protection in the longer run when the firm's needs for continued access to capital markets can be relied on to sustain its good behavior until the requisite institutions and legal protection are put in place. Financing without governance, however, cannot be sustained in the long-run.

There are two basic approaches to financing with governance. The first approach, based on dispersed ownership, is to give investors power through legal protection from expropriation by managers. Protection of minority rights and legal prohibitions against managerial self-dealing are examples of such mechanisms. The second approach, based on concentrated ownership (or ownership by large investors), is to match significant control rights with significant cashflow rights. With concentrated ownership – through large share holdings, takeovers and large bank finance – corporate governance is typically exercised by the large investors. These large investors still rely on the legal system but they do not need as many rights as the small investors to protect their interests. They have both the interest in getting their money back and the power to demand it. Although large investors are very effective in solving the agency problem, they have the potential to expropriate other investors and stakeholders in the firm. But large investors are not diversified and hence bear excessive risk. Where a large investor is family-based, management may not be professionalised. This is more likely to be a problem when family fortunes pass on to the descendants of the founder-entrepreneurs.

II CORPORATE FINANCING & CORPORATE GOVERNANCE

a. An Overview of Financial System & Development of Markets

Malaysia boasted the largest debt market and the largest equity market in ASEAN in the mid 90s. Nonetheless, banks in Malaysia have become even more dominant. The share of domestic debt of banking system increased from 62% in 1986 to 75% in 1997 whereas that of the debt market decreased from 38% to 25% over the same period.

To gauge the reliance of firms on the debt and equity markets, the only data that is available is on the supply of funds. In terms of net funds raised, the share of the banking system increased from 50 to 58% between 1986 and 1997 that from the domestic debt market declined from 33% to 11%, that from the equity market increased from 13 to 14% and that sourced from external borrowings increased from 3 to 16%.

The over-dependence on banks in Asia have been caused by the over-protection of anks (in particular of locally-owned banks) and the over-regulation of capital markets. This has led to the under-development of non-bank financial institutions, of capital markets, of risk management products, of risk intermediaries as well as of trading and market making.

An over-dependence on banks can become catastrophic when the high-risk banking industry operates under a regime of pegged exchange rate and open capital flows or under inconsistent macro-economic policies. Asia's experience during the 90s provides ample evidence to substantiate this conclusion.

Copyright © OECD All rights reserved

The high-risk nature of banking (versus for instance the fund management industry) arises from its high gearing, massive asset-liability mismatches which creates an incentive for risky or imprudent banking.

b. Trends in Corporate Financing

Debt-equity ratio can be evaluated either using book or market values.[1] Both book and market-value debt-equity ratios of companies listed on KLSE increased between 1990 and 1996.

	1990	996
Main Board Companies:		
Average book value	0.85	1.12
Average market value	0.27	0.35
Second Board Companies:		
Average book value	0.89	1.55
Average market value	0.19	0.19

Dr Gan Wee Beng finds that the sharp increase in leverage was most marked among the most indebted Second Board Companies. The 90th percentile debt-equity ratio increased from 1.9 in 1991 to 3.2 in 1996. Only moderate increase in debt-equity ratios was found among the Main Board Companies at different levels of leveraging.

As a result of the regional financial crisis and the sharp fall in the market value debt-equity ratio, Dr Gan found that the proportion of companies falling into the insolvent category rose from 19.5% (valued at year end 1996 prices) to 47% (valued at year end 1997 prices). The proportion of companies regarded as healthy declined from 58% to 34%.

By disaggregating the 1996 data Dr S. Suseela Devi found that while the debt-equity ratio of 30 of the largest companies (excluding privatised entities) on the KLSE was 0.71, that of the 30 most debted companies (based on absolute debt amounts) was 1.16 whereas that of the 30 companies with the largest debt-equity ratio was 2.79.[2]

There is to-date no study on the extent to which internal capital markets are operating within large firms or conglomerates. Inter-company advances and borrowings from or by a parent to or from its subsidiaries are permitted under Malaysian law but not directly between subsidiaries or between associates. Inter-company advances or borrowings have often been encouraged by the big divergence between deposit and lending rates. Because of minority interests cross-subsidies are not common

[1] See Gan Wee Beng, Debt and Insolvency Risk in the Malaysian Corporate Sector, 1990-1996, (Mimeograph).

[2] See S Suseela Devi, A Malaysian Financial Sector Study. A Review of the Implications of the Crisis for the Private Sector Financing Patterns, (Mimeograph). There are differences in the numbers given in the studies by Dr Gan and Dr Suseela Devi but no attempt has been made to examine what has caused these differences. For instance, the debt equity ratio was estimated by Dr Suseela at 0.66 in 1996 for the Main Board Companies and 0.77 for the Second Board Companies.

Copyright © OECD All rights reserved

unless there is mispricing or unless such advances have been made on a clean basis. Contingencies including guarantees given to third parties or companies within the group amounted to 9.5% of total debt for the listed companies as a group, based on data given in the study by Dr Suseela Devi. This percentage was 10.3% for the 30 largest companies, 13% for the 30 most indebted companies but only 2.9% for the 30 companies with the highest debt-equity ratios.

b. Dynamics of the Equity Market

The ratio of market capitalisation (of the Malaysian equity market) to money GDP was 3.23 in 1996 whereas it was only 1.36 in 1997. On the other hand the ratio of total market turnover to market capitalisation was 0.59 in 1996 and 1.13 in 1997.

The listing requirements for an IPO include minimum thresholds regarding the number of shareholders and the value and volume of public shares, earnings and balance sheet criteria over a number of years; an assessment of the potential of the firm and industry it belongs to; qualitative criteria regarding corporate governance; and credible documentation of compliance with the above criteria.

From the mid 90s, a disclosure-based regulatory regime has been gradually replacing a merit-based system in deciding on which companies be permitted for listing. Merit reviews are judgements by regulatory bodies on IPOs, not on the quality of the disclosures, but on the merit of the prospective investment. Under a merit system, the regulatory authorities, hence, replace investors in the investment decisions. Merit type systems usually also include a strong role for the regulatory institution in setting prices and allocating rights for IPOs. Under the phased implementation of the disclosure-based regime, the pricing of corporate offers in Malaysia was to be fully determined by market forces from the beginning of 1998. As a result of the regional financial crisis, there has been a shift of the target date (but the exact date has not been announced).

The requirements for continued listing are not clearly spelt out in Malaysia. The authorities are now working on the criteria for a company to qualify for continued listing with reference to such considerations as the adequacy of its scale of operations, the satisfactoriness of its financial condition, the public shareholding spread as well as its corporate governance practices.

Unlike the Anglo-Saxon world, there is concentration in ownership in Malaysia (as elsewhere in Asia). For instance, the three largest shareholders owned some 54% of the shares of the ten largest non-financial private firms and 46% of the shares of the ten largest firms in Malaysia. The average for the Asian countries (i.e. India, Indonesia, Malaysia, Pakistan, Philippines, Sri Lanka and Thailand) was 50% and 46% respectively.

Data is not readily available on the pattern and spread of shareholding when the shareholding of the largest shareholders is excluded. Foreign fund managers was an active group, certainly far more active than domestic fund managers. Domestic institutional investors have emerged as a significant force in the equity market, but easily the most important are Perbadanan Nasional Berhad (PNB) and the Employees Provident Fund (EPF). Insurance companies have not made their presence felt on account of the investment restrictions they face. The popular perception is that retail investors as a group may own more shares than the domestic institutional investors.

The foreign fund managers were reported to account for almost 50% of the turnover of the blue chip companies during the early and mid 90s. Both the foreign fund managers as well as most domestic institutional investors have opted to play only a passive role in corporate governance. Foreign fund managers have been more active in monitoring firm performance, if one goes by the number of client calls made. Local institutional investors have been more reliant on third party research, primarily

Copyright © OECD All rights reserved

that by brokerage houses. However, this does not apply to PNB which is often a sizeable minority shareholder, is represented on boards and therefore, is often an insider and tends to play a more active role in performance monitoring and even in corporate governance.

There were at least two major and glaring cases of corporate governance breakdowns during the 1997-1998 period involving UEM and KFC. EPF had a sizeable minority stake of 10% or more in both the entities. The Government Investment Corporation of Singapore (SGIC) had a similar stake in KFC. Both did not initiate any corporate governance actions against the two companies, in spite of the big sell-down in their shares as a result of certain major irregularities.

The concentration of shareholding in Malaysia implies that there is no market for corporate control. Thus there is little or no role for hostile takeovers to play a disciplinary role on insiders who are not working towards the maximisation of shareholder value. However, share price movements exercised through the exit route or a sell-down of shares, do provide an avenue for disenchanted or aggrieved shareholders to discipline errant insiders. This is evident from an examination of foreign shareholding in and share price movements of UEM and KFC, which companies had been viewed by the market as blue chip companies before the announcement of the major breakdown in their corporate governance practices in 1997. The foreign shareholding in UEM, (represented by some of the top names from the world of institutional investors), amounted to 54.2% at year end 1996 versus Renong's shareholding (which was the controlling shareholder) of 32.6%. The announcement of the corporate governance irregularities in November 1997 led to a 48% decline in the UEM share price and foreign shareholding in UEM contracted to 35.1% by year end 1997. The disclosure of the corporate governance irregularity by KFC in June 1998 also led to a sharp fall in its share price of 48% (a surprising coincidence). Foreign shareholding had fallen from 34.3% to 15% between 1996 and 1997 and the corresponding number for 1998 is still not available. It is not clear what caused the sharp fall even before the public disclosure of the irregularity – the perceived problem of insiders or under performance. For a sample of 75 public listed companies (see Section IV), the weighted average of foreign shareholding had in fact increased marginally from 24% to 24.2% over the 1996-1997 period.

c. Credit Market Dynamics

Banking is relationship-based and not transaction-driven. But governance is exercised by large shareholders and not large creditors. And banks are prohibited from lending to related parties. There are no chapter 11 provisions.[3] Therefore, creditors have been able to pursue their rights without serious handicaps or bias but in recent years, the courts have become slower in resolving disputes between creditors and debtors.

As against this, the prevalent Government view that economic and corporate hardships have been caused by currency speculators and stock market raiders have enabled the problem borrowers to bargain for more time from their bankers to settle their loans. The relaxation of rules with respect to recognition of interest income and loan provisioning has encouraged this tendency. There is no evidence that more loans are being pumped in (on an indiscriminate or imprudent basis) to "rescue" financially weak borrowers. However, loan restructuring is being permitted a little more liberally. Under the old rules, even if the borrower services the restructured loan without default, it will continue to be classified as a non-performing loan for a period of 12 months before it is reclassified. It appears that now a more liberal approach has been adopted and the period for reclassification has been reduced to 6 months.

[3] But there are now proposals for introducing US style anti-creditor rights into the Malaysian bankruptcy code.

Copyright © OECD All rights reserved

There has been a great deal of talk on the need to introduce chapter 11 provisions in Malaysia. Apparently, such provisions are in a Bill which is being reconsidered by the Government.

Under the current law, creditors have a variety of legal protections, including the right to grab assets that serve as collateral for the loans, the right to liquidate the company when it does not pay its debts, the right to vote in the decision to reorganise the company, and the right to remove managers in reorganisation.

If chapter 11 is introduced, it will allow companies unimpeded petition for reorganisation, give companies the right of automatic stay of creditors, and let managers to keep their job in reorganisation thus enabling managers to keep at bay creditors even after having defaulted, as in the US which is deemed as one of the most anti-creditor common law countries. Protection of creditor rights is necessary for ensuring a steady flow of external finance in the form of bank and other credit to businesses and households. More complete bankruptcy laws are necessary in countries such as Malaysia where courts may not be as reliable as in the developed countries.

e. Relationship between banks, big companies and the Government

Of the 37 commercial banks only a few are part of a conglomerate. But prohibition on loans to related parties and its stringent enforcement by the central bank has greatly reduced opportunities for business groups to avail themselves of easy loans through their tie-ups with banks.

The relationship between firms, government and banks cannot be described as cozy as in certain other Asian countries. There was no overt or covert "policy of directed lending" as such and to that extent one cannot say that the financial constraints on big firms were weak.

Nonetheless, there were certain discernible weaknesses. The government's commitment to a high growth policy based on a high ratio of investments to GDP led eventually to the promotion and support of certain mega projects, implicit assumption by lenders that the government will not let these projects fail and to lending decisions by bankers based on collaterals and implied government support and not just on project cashflows. Such over-investment led aggregate demand to outstrip aggregate supply and to mounting or persistent external deficit. It also led to lower returns and poorer cashflows and to more problem loans.

The government's active pursuit of privatisation during the period enabled Malaysia to emerge as a leader in privatisation within the developing world with some brilliant success stories. Privatisation reduced the role of government and increased reliance on markets. But the apparent use of privatisation to attain certain non-economic goals (e.g. the promotion of bumiputra businessmen) have caused problems. This led to more reliance on negotiated tenders and hence to lower efficiency. The desire to control output prices and to minimise subsidies led, in some cases, to government support of privatisation deals via approvals for special property development projects. This has and can lead to an over-supply of properties. And reliance on management or leveraged-buyouts to attain the government's distribution goal biased government policy towards supporting the stock market. Hence, it compromised conduct of monetary policy. It also made the stock market as well as the banking industry, with its over-exposure to share financing, vulnerable to the regional financial crisis.

III CORPORATE GOVERNANCE STRUCTURES & ISSUES WITH REFERENCE TO CONTROL & CASHFLOW RIGHTS

To examine the strengths and weaknesses of corporate governance in Malaysia, it is useful to categorize the companies listed on the KLSE into four groups based on the relationship between the control and cashflow rights of the parties who control the companies:

Copyright © OECD All rights reserved

Group A: management-controlled companies with dispersed shareholding where the managers have control rights with little or no cashflow rights.

Group B: shareholder-controlled companies where the controlling shareholder has a direct majority stake with control rights more closely aligned with cashflow rights. As many decisions only require a majority vote, the controlling shareholder may end up in practice exercising outright control.

Group C: shareholder-controlled companies where the controlling shareholder has a direct but a substantial minority stake with his control rights aligned with his cashflow rights (probably to a lesser degree than for Group B companies) and

Group D: shareholder-controlled companies where the controlling shareholder has only an indirect stake, either through a pyramid-structure or a cross-holding, as a result of which the control rights of the indirect owner is well in excess of its cashflow rights.

In Malaysia, there are at most a few companies on the KLSE which falls into Group A, namely a company which is characterized by dispersed ownership with the manager exercising control rights and having little or no cashflow rights. On the other hand, there are many companies that fall into Groups B and C, which are companies with large shareholders who exercise both control as well as cashflow rights. These large shareholders are typically families or government-owned or promoted institutions. No banks have emerged as large shareholders in keeping with the Ango-Saxon model of banking practiced in Malaysia. There are also many publicly quoted companies that fall into Group D, which are companies where the controlling interest is indirect and where the control rights far exceed the cashflow rights of the controlling shareholder. Group D companies include public quoted companies which are subsidiaries or associates of other listed companies, which in turn are controlled by a controlling shareholder. In Malaysia as elsewhere in Asia, minority shareholders in Group D companies run the highest risk of being expropriated. Unfortunately, the Group D form of companies are not uncommon.

There are many public-quoted companies in Malaysia and elsewhere in Asia which are family-dominated. In meeting the interest of the small or outside shareholders they have been viewed unfavorably in relation to the management-controlled companies of many countries in the OECD world. Large shareholders are certainly in a position to expropriate the small shareholders given their control rights. But the managers in companies with dispersed shareholding also have similar powers given the effective control rights they exercise. Whether an expropriation or squandering of a company's resources will take place will depend on shareholder rights including the rights of large shareholders vis-à-vis small shareholders and how these rights are enforced in practice.

Before we examine how Malaysia fares in this regard, we first explore the incentive for the maximization of shareholder value in a company which is controlled by a large shareholder (i.e. a Group B or C company) compared to one which is controlled by a manager with dispersed shareholding. In a company with concentrated ownership, as there is a better matching of the control

Copyright © OECD All rights reserved

rights of the dominant shareholder with its cashflow rights, there will be a greater incentive for that control to be exercised in maximizing shareholder value. Therefore, the incentive of the controlling shareholder is more likely to be aligned to the interest of other shareholders. On the other hand, as a manager has control rights with little or no cashflow rights, he has less incentive to maximize shareholder value. It is to deal with this problem that a manager is given an incentive contract in the form of share ownership or a stock option to align his interests with those of investors. Even with such incentive contracts the mismatch between control and cashflow rights will still be large in a management-controlled company.[4] Therefore, a company with concentrated ownership, where the mismatch between control and cashflow rights are much less, is likely to promote shareholder value much more than a management-controlled company. In this context, it is useful to note that the use of incentive contracts has been limited by difficulties in the optimal design of incentives, by fear of self-dealing or by distributive politics.

In respect of a company where the controlling interest is indirect (i.e. a Group D company) there will be a mismatch between the control and cashflow rights of the controlling shareholder. Therefore, the incentive of this controlling shareholder with an indirect stake will be less aligned with the interest of the other shareholders. Even then, other things remaining equal, there is likely to be a greater coincidence of interest between the incentive of such a controlling shareholder and his fellow shareholders than between the incentive of the manager and his shareholders (in a management-controlled company).

IV INSIDER CONTROL, EXTERNAL FINANCING, RISKS & REWARDS – SOME PRELIMINARY FINDINGS

To identify the nature and level of insider control as well as the scope and extent of interlocking ownership and implicit guarantees between financial intermediaries and firms as well as between firms and other firms (such as those belonging to a conglomerate), we have examined the situation with respect to 50 out of the 383 (or 13.1%) of the public listed companies (PLCs) in the non-financial sector on the Main Board of the KLSE and 9 out of the 66 (or 13.6%) of the Main Board PLCs in the financial sector. The PLCs examined are the larger or more reputable ones accounting for 50.73% and 53.10% of the market capitalisation respectively of the two sectors in 1996 and for 62.11% and 45.86% in 1997.

Out of the 50 non-financial enterprises, 13 were foreign-controlled with a share in market cap of 7.67% (1996:4.71%) and 5 were public sector controlled with a share in market cap of 29.41% (1996:21.59%). Of the 9 FIs, one was public sector controlled with a share in market cap of 25.17% (1996:24.04%) and another was foreign-controlled but with a share in market cap of only 0.66% (1996:0.65%).

[4] In this regard it is interesting to note that "legal protection of creditors is … more effective than that of the shareholders since default is a reasonably straightforward violation of a debt contract that a court can verify". [(8), p 13]. On the other hand, to make incentive contracts for managers feasible, "some measure of performance that is highly correlated with the quality of the manager's decision must be verifiable in court." [(8), p 7].

Copyright © OECD All rights reserved

In the sample of 59 companies we examined, there were at most six companies whose largest shareholder had shareholding of 25% or below. In fact, the shareholding of the largest shareholder in two was around 15%, in one it was 20%, in another two it was 23.5% and in the sixth it was 25%. These PLCs can be deemed to have more dispersed shareholding compared to the rest and therefore came closest to being considered as management-controlled. And yet all of them had substantial foreign shareholding. The largest shareholder in three of the six was foreign. Excluding the shareholding of the largest shareholder (where it was foreign), the shareholding of the foreign institutional shareholders in these companies ranged between 28.6% to 52.6% in 1996. In four out of the six companies including Renong Berhad, the foreign shareholding increased in 1997, in one it registered a marginal decline whereas in the other, namely KFC Holdings, there was a more substantial decline from 34.3% to 15.0% (the latter because of a questionable transaction). The interesting question is not why there was a decline. But rather what explains the spread and in particular the large foreign shareholding? Is it that minority shareholder rights are well protected in Malaysia, or that the investors were over-optimistic about prospects or that the shareholders could count on the managers to be concerned about reputation and therefore, could expect the managers to work in the larger interest of all shareholders? Or is it that the large foreign shareholding was held by one or two large investors who worked in concert with the largest shareholder in each company?

Reputational consideration will count if the managers need to go back to the shareholders for additional capital. Over the last four years, the only company from this set which went back to the shareholder was Renong. Therefore, it is not clear if reputation would have been a strong enough consideration for shareholders to place their trust in management.

Over-optimism could have played a role but this implies minority shareholders are prepared to part with their money without an assurance that their rights are protected.

In the six companies examined, the equity stake of the largest foreign shareholder[5] was 10% or less. Even if one assumes that this shareholder was working in concert with a company's largest shareholder, the share of foreign shareholding of the institutional variety was still large. In Carlsberg, the second largest shareholder was a local group and together with the largest shareholder, the two had a 50% stake in the company. But this may point to concentrated holding if the two or three largest shareholders are deemed to be working jointly. The incidence of substantial minority shareholding in the face of concentrated shareholding in the hands of the controlling party or parties is a phenomena that requires explanation and this is attempted in Chapter V.

Unlike the six, in 45 of the companies in the sample, where the largest shareholder exercised control either directly or through a PLC it controlled, the controlling stake was significantly higher. In 28 of the companies the controlling shareholding exceed 50%, in nine it was between 40 and 50% and in eight it was between 30 and 40% (of which for four it was 39%). Where the controlling shareholder exercised control in a PLC through its control of another PLC, its effective interest was significantly lower thus causing a big divergence between its control and cashflow rights. For instance, Tan Sri Halim Saad was the controlling shareholder of Renong Berhad with a direct stake of 23.5%, which in turn controlled UEM Berhad with an interest of 37.1%. Therefore, Tan Sri Halim Saad's effective interest in UEM Berhad was only 8.6%, but he exercised control over it.

Unlike the two subset of companies considered above, one subset which is characterised by more dispersed shareholding and the other subset which has more concentrated shareholding, the third subset of companies in the sample (but numbering only eight) entails ownership and control that is exercised through a chain listing or a pyramid-structure and through cross-holdings. For instance, as

---

[5] Or second largest, if the largest shareholder was also a foreign shareholder.

Copyright © OECD All rights reserved

shown in Schedule I, the Estate of Tan Sri Yahya owned 65.3% in Gadek Malaysia through a cross-holding which in turn controlled Hicom and Proton, the latter through Hicom. The Yahya Group's effective interest in Proton was only 4.6%. Cross-holdings (but not an extended chain listing) is also evident in the William Cheng and Kuok Group of companies.

Based on our sample, the incidence of inter-locking ownership is almost mild compared to Japan or Korea. Pyramid structures are not pronounced. Where the manager or the major shareholder exercises control over a PLC through a pyramid structure or cross-holding and where there is a significant divergence between control and cashflow rights, the risk is higher of the insider engaging in activities which maximise his private benefits of control or which expropriate minority shareholders.

Given the risks indicated above, let us examine to what extent minority shareholders and specifically foreign institutional shareholders, took such risks into account in their equity investment decisions. It is interesting to note that in the operating subsidiaries of the Yahya Group, namely Proton and EON, in which the effective interest of the controlling shareholder was almost negligible and therefore in which companies the risks were correspondingly higher, foreign shareholding was not only substantial but also increased from 28.2% in 1996 to 34.6% in 1997 in respect of Proton and from 22.0% to 34.3% in EON. On the other hand, in respect of the two holding companies where the risks were lower, the foreign shareholding which were significantly lower declined from 25.7% to 21.4% in Gadek but increased marginally from 11.2% to 12.5% in DRB. Another interesting case was the Halim Saad Group. We had noted that the foreign shareholding in Renong in fact increased from 14.3% to 22.1%. In the case of UEM, where foreign shareholding stood at the incredible level of 54.2% in 1996, it declined to 35.1% in 1997 but it is not clear if this was entirely due to the unexpected announcement that the then cash-rich UEM had acquired a 33% stake in Renong without proper disclosures or even approvals.

In spite of the obvious risks, it is useful to enquire what factors encouraged even sophisticated investors such as the foreign fund managers to be invested substantially in companies such as EON, Proton and UEM. To what extent was this encouraged by the legal protection of minority shareholders vis-a-vis the controlling shareholder is examined in Chapter V.

A large investor may be rich enough that he prefers to maximise his private benefits of control (including investments in unrelated activities, whether for diversification or for the purpose of empire building), rather than maximise his wealth. Unless he owns the entire firm, the large investor will not internalise the cost of these control benefits to the other investors. This will then be reflected in the failures of large investors to force their managers or companies to maximise profits and pay out the profits in the form of dividends.

An examination of the foreign controlled companies, especially those which have a clear majority shareholder, shows that these companies have been paying out a high proportion of their profits in the form of dividends (and not reinvesting the profits in diversified or empire-building activities). Such high dividend payout ratios may have been facilitated by the more healthy relationship between the control rights of the majority shareholder with its cashflow rights.

In the case of locally-controlled companies, the control rights were usually well in excess of the cashflow rights of the controlling shareholder, usually because of the pyramid structure of companies in the same group. This could explain their much lower dividend payout ratios and their greater propensity to reinvest their profits even in unrelated activites, at least in part to maximise the insider's private benefits of control.

Copyright © OECD All rights reserved

An examination of the financials of EON and Proton vis-a-vis Gadek and DRB show that the operating entities of the Yahya Group had better dividend-payouts ratios. This was however, not the case with respect to UEM.

The higher dividend payout ratios of the Yahya Group should not come in as a surprise. In the operating entities we are reviewing, the Yahya Group was in joint venture with a foreign or a locla party or both. These joint venture partners could have acted as a check and balance. In UEM there were only institutional investors and no joint venture partners.

Under Malaysian law, a corporate cannot lend to or issue a guarantee on behalf of a director-related entity, unless that entity is a subsidiary. Therefore, the issue of guarantees between firms and other firms (such as those belonging to a conglomerate) is not a serious problem in Malaysia. A recent study[6] for the year 1996 has found that the total contingent liabilities reported by the listed companies on the Main Board (including corporate guarantees given to banks on behalf of subsidiaries credit facilities), amounted to RM15.9 billion versus their debt of RM168.1 billion. The corresponding numbers for Second Board companies were RM2.5 billion and RM11.4 billion.[7] The highest amount of contingent liabilities was reported by the industrial and trading sectors which also has a higher ratio of short-term bank borrowings.

V THE LEGAL AND REGULATORY FRAMEWORK

A INTRODUCTION

The operation of companies in Malaysia and thus their governance is affected by laws, regulations and standards in the following areas – company law; securities laws and regulations (including prohibitions on insider trading); exchange listing requirements; financial accounting standards, insolvency laws and regulations and on a wider level, contract, labour, employment, commercial laws and regulations and consumer protection laws. This study evaluates what we term as “core corporate law” (i.e. company law, securities laws, exchange listing requirements, accounting standards and insolvency laws and regulations) and its impact on governance arrangements in companies.

Corporate law in Malaysia is primarily set out in the Companies Act 1965 (No.125) which is based on the British Companies Act 1948 and the Australian Uniform Companies Act 1961. Major subsidiary legislation includes the Companies Regulation 1966, Companies (Winding Up) Rules 1972. In respect of public listed companies the following legislation and also regulatory directives apply - the Securities Industries Act 1983, the Securities Commission Act 1993, the Malaysian Code on Takeovers and Mergers, 1987, the Guidelines on the Regulation of Acquisition of Assets, Mergers and Takeovers (commonly referred to as the FIC Guidelines) and the KLSE Listing requirements and Practice Notes.

The Malaysian Companies Act 1965, administered by the Registrar of Companies, sets out requirements for the birth, death and existence of companies. It identifies fundamental rules

[6] S. Susela Devi, A Malaysian Financial Sector Study: A Review of the Implications of the Crisis for the Private Sector Financing Patterns, 1998.

[7] The database used to compute these numbers have not captured some companies’ information on contingent liabilities. The study does not attempt to quantify the extent of the omission.

Copyright © OECD All rights reserved

governing procedures for incorporation, the basic constitutional structure and the cessation of existence of companies. The Act imposes minimum requirements on the way in corporations are incorporated consistent with the Malaysian contractualist system of company law where the control structure is left to be determined by the promoters and the company through the Memorandum and Articles of Association of a company. [8]

The Memorandum essentially sets out the company's structure and aims. Section 18(1) Companies Act sets out the minimum information to be set out in the memorandum – i.e. name of the corporation, the promoters, the amount of share capital, a statement of objects etc. Other clauses that may be included in the memorandum include for example, clauses prohibiting the alteration of articles, limitation on the number of members etc. The significance of inclusion of a clause in the memorandum is that the memorandum may not be altered except in accordance with the Act.[9]

The Articles Of Association ("Articles") of a company set out the internal regulations for the company and they are the principal means of determining the division of powers between the board and the body of shareholders at the general meeting.[10] In contrast to the memorandum, the contents of Articles are not prescribed by the Act. A company may choose to include whatever it wishes in the Articles.[11]

It is therefore possible to draw a constitution that provides for greater powers to shareholders. For example, there is nothing to prevent insertion of articles that provide for directors to be subject to a more objective standard of care and diligence than those set out by common law. Additionally, directors can be made subject to specific contractual arrangements with the body of shareholders. This form is normally insisted upon by foreign joint venture parties making a major investment in the jurisdiction.[12]

---

[8] Section 33 of the Companies Act 1965 sets out that the corporation's memorandum and articles are a statutory legal contract under which the parties to the contract (the company and the members and members *inter se*) are bound by legally enforceable contractual duties to comply with the provisions of the corporate constitution. Certain features of this contract is worth noting. From corporate governance viewpoint, it is important to note that section 33 does not provide a contract between shareholders and the management. The significance is essentially that a shareholder may enforce his right to have the provisions of the memorandum and the articles observed by injunction against another shareholder or the company but not against the directors of the company.

[9] Section 21(1) Companies Act 1965. But note section 21(1A, which allows deletion or alteration of clauses contained in the memorandum that might have been included in the articles.

[10] Article 73 of Table A, Companies Act 1965 provides for wide-ranging powers to be conferred on management. e.g.:-
"*The business of the company shall be managed by the directors ... and may exercise all such powers of the company as are not, by the Act or by these regulations required to be exercised by the company in general meeting*". Note: Companies Act 1965 provides for a common form of Articles of Association e.g. Table A which companies have the option to adopt, and may make such variations as they see fit, subject to the provisions of the Act.

[11] However, Part 8 Kuala Lumpur Stock Exchange (Main Board) Listing Requirements does in respect of its listed companies mandate the inclusion of certain clauses in the Articles of those companies.

[12] In principle, provisions in the company's constitution may also affect a variety of non-shareholders such as employees, creditors, suppliers and other stakeholders. Although not usual, such stakeholders may contract with the corporation to adjust their constitution to take account of risks suffered from non-standard terms in the company's constitution. For example, financial institutions may insist on certain provisions being inserted into the corporate constitution.

Copyright © OECD All rights reserved

In contrast to the memorandum, the articles of association may, subject to the Companies Act 1965, be freely altered or added to.[13] This power of alteration by special resolution[14] can affect the pattern of rights and duties to the prejudice of a member's rights. In practice, there have been a variety of devices which have been employed to entrench member's rights and duties. Shareholder agreements, and voting arrangements can be entered into providing various procedural and substantive arrangements that delineate the lines of power and entitlements. Insertion of these provisions in the memorandum may also have an entrenchment consequence. Founding share agreements are fairly common in family based entreprises. In certain privatised entities (e.g. the Malaysian Airlines system (MAS)), the government also holds a golden share that enables the government to veto any management decision which it deems fit.

There are nevertheless some restrictions to the power to alter articles. First, when voting to alter the articles, a member must act *"bona fides for the benefit of the company as a whole".*[15] Although in general a shareholder may exercise his vote as he pleases in his own interest, this rule is subject to the common law principle that the majority may not oppress or treat the minority unfairly.[16] Where the capital of the company is divided into different classes of shares and there is a provision in the memorandum or articles authorising the alteration only upon the consent of some specified proportion of shareholders of that class, an alteration of articles to affect class rights may be restrained under section 65 Companies Act 1965. Also Rule 324 of Part 8 of the KLSE Listing requirements prohibits its listed entities from deleting, amending, or adding to the articles which have previously been approved by the Exchange unless it has sought and obtained the written approval of the Exchange.

The Companies Act 1965 does on occasion, restrict the contractual freedom described above, by reserving to the general meeting certain decision-making authority. This check against the broad powers conferred on the board relies on shareholders voting requirements. And in this respect, there has been a discernible trend in Malaysia to increase the range of matters requiring shareholder approval, and it should be remembered that while they may be more effective, they are also more costly than board level protections. Matters requiring shareholder approval include the following:-

- altering the memorandum and articles
- altering the authorized share capital
- consolidating or subdividing the shares
- altering rights to shares
- altering company's status
- residual power to act when the board is unable to

[13] Section 31(1) Companies Act 1965 provides that "subject to the Act and to any condition in the memorandum, a company may by special resolution alter or add to the articles."

[14] The Companies Act 1965 essentially provides for two types of resolutions: ordinary and special. The predecessor to the Companies Act provided for an extraordinary resolution as well but a requirement for such a resolution is now treated as calling for a special resolution. (Section 152(8) Companies Act 1965). An ordinary resolution is a resolution passed by a simple majority of those present and voting while a special resolution must be passed by 3/4ths majority of those present and voting at the meeting.

[15] Per Lindley MR in Allen v Gold Reefs of West Africa Ltd. [1900] I Ch 656

[16] Re Petrotech Logistics Pte. Ltd. (1982) CSLR V[1]

Copyright © OECD All rights reserved

- transactions involving large acquisitions or disposals of company property or undertakings[17]
- share issuance by directors.[18]

Also, bearing in mind the broad powers that are conferred by the articles on boards, the Companies Act 1965 also offers board level protection by regulating their conduct and imposing on them, extensive duties which include "trustee – like" fiduciary duties and the duty to exercise care, skill and diligence. These duties also emanate from case law. The Companies Act 1965 also mandates certain disclosures by directors for example, where they are interested in a transaction.[19] The Companies Act 1965 also sets out mechanisms and processes for shareholders to enforce their rights in Court.

Securities laws have increasingly made inroads into areas traditionally within the domain of company law, though these are generally in the context of public listed companies. The thrust of securities laws by contrast is directed at laying the infrastructure necessary to promote sound and transparent capital markets and therefore better investor protection.[20] Increasingly these laws lay down an onerous regime for information disclosure. Examples include the new Malaysian Code on Takeovers and Mergers 1999 and amendments to insider trading legislation earlier this year.

Some of the recent amendments to securities laws have introduced duplication in regulation. For example the new section 99B Securities Industry Act 1983, introduced early 1998, imposes duties on chief executives and directors of public listed companies to disclose their interests in the company or any associated company to the Securities Commission. A person who fails to make this disclosure commits an offence and is liable on conviction to a fine of one million ringgit or to imprisonment for a term not exceeding 10 years or both.[21] The Securities Industry (Substantial Shareholding Regulations) 1998 now requires reporting of substantial shareholding to be made to the Securities Commission.[22] Companies are now additionally required to submit certain information to the Commission which include –

[17] Section 132C Companies Act 1965

[18] Section 132D Companies Act 1965

[19] Section 131 Companies Act 1965 - though it stops short of mandating that they abstain from voting on the transaction.

[20] Very broadly, the Securities Commission Act 1993 sets out the regulatory requirements for primary market regulation while the Securities Industry Act 1983, for secondary market regulation including continuing disclosure obligations.

[21] A similar provision may be found in section 135 Companies Act 1965 except that the disclosure is to be made to the company for purposes of the register of director's shareholding under section 134 Companies Act 1965. Also the penalty for failure to comply is considerably lighter – Imprisonment for three years or a fine of fifteen thousand ringgit.

[22] Reporting of substantial shareholding is already required under the Companies Act 1965 to the company under section 69E and the Kuala Lumpur Stock Exchange under section 69I. The penalty for breach has been recently revised upwards too. Also the threshold for reporting has been reduced to 2%

Copyright © OECD All rights reserved

- A copy of the company's audited annual accounts and interim and periodic financial reports;

- Any change in the registered business address of the listed entity;

- Any change in the chief executive or directors of the company.

Notably, the Commission now has the power to apply to court for disqualification of chief executives and directors of listed companies where he has been convicted of offences under securities laws or has had an action taken against him for breach of listing rules or civil action for breach of the insider trading or market manipulation provisions.[23] But while these amendments have introduced some duplication in company regulation, the amendments may be justified on grounds that they facilitate the Securities Commission's enforcement of securities laws.

There are nevertheless matters that are generally and rightly regarded as being part of securities laws that continue to remain within the domain of company law for example, the regulation of fundraising in Malaysia. The requirements for disclosures in prospectuses are found in the Companies Act 1965 despite the fact that every company issuing securities would have to seek approval of the Securities Commission under section 32 Securities Commission Act 1993. There is certainly scope for this fragmentation in regulation to be rationalised.

The listing requirements of the Kuala Lumpur Stock Exchange also regulate the affairs of public listed companies. In fact their rules are not merely confined to keeping fair and informed markets through the various disclosure requirements. With the increasing participation of Exchanges around the world in corporate governance issues, listing rules increasingly provide prescriptions that directly affect the conduct of a company's affairs, for example the size of independent director participation on boards or the requirement for audit committees. The recent announcement for the introduction of rules restricting directorships of directors of public listed companies by the Kuala Lumpur Stock Exchange is yet another example of this trend.

The legislative provisions and exchange requirements co-exists with rules of common law and equity emanating from judicial decisions from our own Malaysian Courts and also Singapore, Australia, Canada, New Zealand and the United Kingdom. Aside from setting out extensive duties on directors (which is alluded to above), rules of common law and equity are

[23] Contrast approach of section 130 Companies Act 1965 which prohibits a person who is convicted of offences relating to the promotion or management of a company, offence involving fraud or dishonesty or offences for breach of duty from acting as director, promoter or participate in the management of a company within a period of 5 years from his conviction or after release from prison without leave of the Court. The Registrar has the power to oppose application for leave. Note also that section 130A gives the Registrar of Companies and the Official Receiver the power to apply to court to disqualify directors of insolvent companies.

Copyright © OECD All rights reserved

also a major source of provisions for shareholders to enforce their rights in court.

B DISCLOSURE AND TRANSPARENCY

An investor in a publicly quoted company always has the option to quit by selling his shares. Given the availability of this exit route, the business judgement rule that governs the attitude of courts on the separation of management and financing (and hence towards the agency problem), keep the courts out of corporate decisions except on matters of executive pay, self-dealing and protection of shareholders against expropriation by an insider.[24] If equity markets are active and liquid, then a shareholder can rely on the exit route to protect himself against managerial inefficiencies or abuses which are not kept down by the courts. These abuses include the consumption by managers of perquisites, such as plush carpets and company airplanes, as well as managers expanding the firm beyond what is rational (where they are engaging in empire-building or pursuing pet projects). For a shareholder to rely on the exit route to protect himself and to recover his investments, the regulatory regime must ensure that all material information that investors need to make decisions are disclosed on a full and timely basis, that there are safeguards against anti-competitive behaviour and other forms of abusive behaviour by market participants (who may play a key role in regulation and enforcement), that investors are protected from the insolvency of financial intermediaries and that there are adequate controls for systemic risk.

Until 1995, Malaysia had used a merit-based regulatory regime in deciding on the suitability of a company for listing and the pricing of new issues was usually based on the need to protect the interest of minority shareholders.[25] From 1995, a disclosure-based regulatory regime is being implemented on a phased basis. This will require firms to disclose all material information at the time of new listings, as well as on a periodic or continuing basis thereafter depending on the nature of the information to be disclosed. In countries with more developed capital markets firms rely on market practice and due diligence obligations to ensure the disclosure of all material information. In Malaysia, as the markets are less developed, the regulators are playing a more active role in recent years in defining and enforcing specific accounting, financial reporting and disclosure standards. To reinforce market incentives, the regulators are strengthening due diligence and fiduciary obligations of both financial intermediaries as well as of directors, managers, accountants and auditors.[26]

Good corporate governance based on transparency and the exit route is critically dependent on a country's accounting, auditing, financial reporting and disclosure standards and practices. These standards and practices are examined at some length in this section.

---

[24] Given that this exit option is not available to minority shareholders of private companies, the burden placed on the courts to protect the interest of such shareholders, will be much greater. If the courts are not able to meet this demand, then there will few or no such minority shareholders.

[25] The need to promote certain special interests also led to the use of this regime. The fixing of new issue prices often at levels well below market prices, led to massive over-subscription, harmed issuers and in fact restricted the size of new issue activity.

[26] Under KLSE regulations, listed companies are required to file their annual accounts and reports within 90 days of close of balance sheet. Market observers say that as at August 1998, there were more than 50% of the companies who are not in compliance with this regulation. If true, this is indeed staggering and warrants close scrutiny by the Government.

Copyright © OECD All rights reserved

1. What aspects of financial and operational performance must be disclosed to all shareholders, on what schedule and in what details?

To increase transparency, the Malaysian regulatory framework mandates disclosure and dissemination to potential and existing investors timely, accurate and material information on corporate performance, affairs and events. Such disclosures are mandated at the initial public offering (IPO) of the securities and thereafter on a periodic or continuous basis depending on the information disseminated.[27]

An enterprise is mandated to disclose two types of information at the IPO phase. First, information that allows the prospective investors to assess the underlying state of the offeror, including its risk characteristics, its prior performance, strength of its management and an assessment of the potential of the issuer and the industry it belongs to. Second, more specific information about the IPO: the size of the offering, its intended purpose, dilution, the offer price and its determination, as well as the market-making activities with respect to the underwriting, placement, distribution or pricing of the issue. The information for the IPO has to be distributed to the public in the form of a prospectus.

With respect to the periodic disclosure and reporting requirements, a listed company is required to publish:-

- interim or half yearly reports not later than 3 months after the end of the half yearly financial year

- preliminary financial statements not later than 3 months after the end of the financial year setting out prescribed information

- and issue to the shareholders the printed annual report together with the annual audited financial statements as well as the auditors' and directors' reports within a period not exceeding 6 months of the close of the financial year of the listed company and

- explanations for any differences between the audited accounts and any forecasts, projections previously made.

---

[27] The KLSE maintains and enforces corporate disclosure policy under Part 10 of the Listing Requirements. The policy is to ensure the perpetuation of a fair and orderly market, and the exchange requires all listed companies to:-

- make available to the public information necessary to informed investing
- All those invest must have equal access to such information.

The exchange adopted 6 specific policies:

- All listed companies must "make immediate public disclosure of all material information concerning its affairs, except in exceptional circumstances". A list of exceptional circumstances are found in the rules.

Copyright © OECD All rights reserved

The interim financial statements are consolidated but not audited and are to present fairly the financial performance of the company (with comparative figures for the previous year) but not its financial position or cashflows. The required disclosures on financial performance are almost similar to those that are set out in the income statement which is one of the components of the annual financial statements.

The annual financial statements are to present fairly the financial position, financial performance and the cash flows of the company. The statements are to be prepared before and after consolidation. The complete set of financial statements (with effect from financial year commencing 1.1.1999) include the following components:-[28]

a) balance sheet
b) income statement
c) a statement showing either:-
    i) all changes in equity; or
    ii) changes in equity other than those arising from capital transactions with owners and distributions to owners;
a) cash flow statement; and
b) accounting policies and explanatory notes.

A company has to determine, based on the nature of its operations, whether or not to present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet. When a company chooses not to make this classification, assets and liabilities are presented in order of their liquidity.

As a minimum, the face of the company's balance sheet are to include line items which present the following amounts:-

a) property, plant and equipment;
b) intangible assets;
c) financial assets (excluding amounts shown under (d), (f) and (g);
d) investments accounted for using the equity method;
e) inventories;
f) trade and other receivables;
g) cash and cash equivalents;
h) trade and other payables;
i) tax liabilities and assets as required by IAS 12, Income Taxes;
j) provisions;
k) non-current interest-bearing liabilities;
l) minority interest; and
m) issued capital and reserves.

A company is also required to disclose the following, either on the face of the balance sheet or in the notes:

a) for each class of share capital:-
    i) the number of shares authorised;

[28] The statement of all changes in equity or of non-owner movements in equity (such as exchange gains and losses, revaluations and their tax effects) are currently captured in notes to the account.

Copyright © OECD All rights reserved

ii) the number of shares issued and fully paid, and issued but not fully paid;
iii) par value per share, or that the shares have no par value;
iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the year;
v) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
vi) shares in the enterprise held by the enterprise itself or by subsidiaries or associates of the enterprise; and
vii) shares reserved for issuance under options and sales contracts, including the terms and amounts;

a) a description of the nature and purpose of each reserve within owners' equity;
b) when dividends have been proposed but not formally approved for payment, the amount included (or not included) in liabilities; and
c) the amount of any cumulative preference dividends not recognised.

As a minimum, the face of the income statement is to include line items which present the following amounts:-

a) revenue;
b) the results of operating activities;
c) finance costs;
d) share of profits and losses of associates and joint ventures accounted for using the equity method;
e) tax expense;
f) profit or loss from ordinary activities;
g) extraordinary items;
h) minority interest; and
i) net profit or loss for the period.

Additional line items, headings and sub-totals are to be presented on the face of the balance sheet and income statement when required by the approved accounting standard, or when such presentation is necessary to present fairly the company's financial position and performance.

A company has to present, either in the face of the income statement or in the notes to to the income statement, an analysis of expenses using a classification based on either the nature of expenses or their function within the company.

Companies classifying expenses by function has to disclose additional information on the nature of expenses, including depreciation and amortisation expense and staff costs.

A company has to disclose, either on the face of the income statement or in the notes, the amount of dividends per share, declared or proposed, for the period covered by the financial statements.

A company has to present, as a separate component of its financial statements, a statement on changes in equity showing:-

a) a net profit or loss for the period;

Copyright © OECD All rights reserved

b) each item of income and expense, gain or loss which, as required by other Standards, is recognised directly in equity, and the total of these items; and
c) the cumulative effect of changes in accounting policy and the correction of fundamental errors dealt with under the Benchmark treatments in IAS 8.

In addition, a company has to present, either within the statement or in the notes:-

d) capital transactions with owners and distributions to owners;
e) the balance of accumulated profit or loss at the beginning of the period and at the balance sheet date, and the movements for the period; and
f) a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and the end of the period; separately disclosing each movement.

The notes to the financial statement of an enterprise has to:-

a) present information about the basis of preparation of the financial statements and the specific accounting policies selected and applied for significant transactions and events;
b) disclose the information required by the International Accounting Standards that is not presented elsewhere in the financial statements; and
c) provide additional information which is not presented on the face of the financial statements but that is necessary for a fair presentation.

The accounting policies section of the notes to the financial statements should describe the following:-

a) the measurement basis (or bases) used in preparing the financial statements; and
b) each specific accounting policy that is necessary for a proper understanding of the financial statements.

The company has to make the following other disclosures if not disclosed elsewhere in information published with the financial statements:-

a) the domicile and legal form of the enterprise, its country of incorporation and the address of the registered office (or principal place of business, if different from the registered office);
b) a description of the nature of the enterprise's operations and its principal activities;
c) the name of the parent enterprise and the ultimate parent enterprise of the group; and
d) either the number of employees at the end of the period or the average for the period;[29]
e) information on subsidiaries;
f) segment reporting by products;
g) segment reporting by geographical areas;
h) restrictions on the title to assets;
i) security given in respect of liabilities;

[29] The disclosure for item (d) will be from 1.1.1999.

Copyright © OECD All rights reserved

j) the methods of providing for pensions and retirement plans;
k) contingent assets and contingent liabilities, and;
l) amounts committed for future capital expenditure.

The financial statements are to be prepared and presented in accordance with the approved accounting standards of the Malaysian Accounting Standards Board and the 9th Schedule of the Companies Act, 1965.

Under the KLSE's continuous disclosure requirements, a listed company is required to make immediate public disclosure of all material information concerning its affairs, except in exceptional circumstances. The company is required to release the information to the public in a manner designed to ensure fullest possible public dissemination.

Part 2 of KLSE's Listing Requirements sets out the requirements expected in relation to announcements. It imposes an obligation on listed companies to immediately divulge any information as is necessary to avoid a false market in the trading in securities. Listed companies are to make disclosures, in particular to the KLSE and the market where:-

- it intends, or does not intend, to recommend a dividend;
- call for meetings to pass ordinary and special resolutions;
- receives notices of substantial shareholders or changes in substantial shareholders;
- effects changes in directors, company secretary or auditors;
- proposes to amend its M & A;
- acquires shares in an unquoted company which results in the latter becoming a subsidiary or where the consideration exceeds 5% of the net assets of the listed entity;
- acquires more than 10% of the paid up capital of another listed company, or where the consideration exceeds 5% of the net asset of the listed entity;
- sells any shares in another company which would result in the latter ceasing to be a subsidiary, or where its shareholding falls below 10% if the other company is a listed entity;
- any application filed with court to wind up the company or any of its subsidiaries;
- undertakes a revaluation of its assets and/or those of its subsidiaries (unless it is in the ordinary course of business and in accordance with the Guidelines of the SC);
- proposes to issue new securities exceeding 10% of the nominal value of that same class or which would effect a transfer of a controlling interest;
- proposes either a rights or a bonus issue;
- proposes to allot shares to its directors or to implement an employee share option scheme.

Other regulatory initiatives are supportive of this orientation for immediate public disclosure and thorough public dissemination of material information. For instance, clarification or confirmation of rumours and reports – whenever a listed company becomes aware of a rumour or report, albeit true or false, that contains information that is likely to have, or has had, an effect on the trading of the company's securities or would be likely to have a bearing on investment decision, the company is required to publicly clarify the rumour or report as promptly as possible. Further, response is required to unusual market action – whenever unusual market action takes place in a listed company's securities, the company is expected to make inquiry to determine whether rumours or other conditions requiring corrective action

Copyright © OECD All rights reserved

exists, and, if so, to take whatever action is appropriate. A listed company should refrain from promotional disclosure activity which exceeds that which is necessary to enable the public to make informed investment decisions.

The policy on insider trading prevents insiders from trading on the basis of material information which is not known to the investing public. Normal trading by insiders are subject to disclosure.

1. What requirements exist to assure that an independent external auditor certifies a company's financial statement on a regular basis?

The Companies Act requires, as per S169 (4), the profit and loss account and the balance sheet of a company to be duly audited before they are laid before the company at its annual general meeting.

A company is required under the Act to appoint, at each annual general meeting (AGM) an approved auditor to hold office for the ensuing financial year. The auditor is to audit the accounts and issue a report to the shareholders (for deliberations at the next AGM) on the company financial statements, other records and its registers.

The auditor's report is to clearly state the auditor's opinion as to whether the accounts give a true and fair view (or are presented fairly, in all material aspects), in accordance with applicable approved accounting standards and whether the accounts comply with statutory requirements. Where the accounts have not been drawn up in accordance with a particular applicable approved accounting standard, the auditor is required to quantify the financial effects on the accounts of the failure to so draw up. If in his opinion, the accounts would not, if so drawn up, give a true and fair view, he is to state the reasons for holding that opinion, state if the directors have quantified its financial effects on the accounts and further give his opinion on the quantification.

In the case of consolidated accounts, an auditor is required to state:-

a) the names of the subsidiaries (if any) of which he has not acted as auditor;
b) whether he has considered the accounts and auditor's report of all subsidiaries of which he has not acted as auditor;
c) whether he is satisfied that the accounts of the subsidiaries that are consolidated with other accounts are in form and content appropriate and proper for the purposes of the preparation of the consolidated accounts, and whether he has received satisfactory information and explanations as required by him for those purpose; and
d) whether the auditor's report on the accounts of any subsidiary was made subject to any material qualification, and, if so, particulars of the qualification.

The auditor is also required to report on any defect or irregularity in the accounts or consolidated accounts without regard to which a true and fair view of the matters dealt with by the accounts or consolidated accounts would not be obtained, and if he is not satisfied as to any matter, his reasons for not being so satisfied.

Under the Companies Act, it is also the duty of an auditor of a company to form an opinion as to each of the following matters:-

a) whether he has obtained all the information and explanations that he required;

Copyright © OECD All rights reserved

b) whether proper accounting and other records (including registers) have been kept by the company as required by the Act;

c) whether the returns received from branch offices of the company are adequate; and

d) whether the procedures and methods used by a holding company or a subsidiary in arriving at the amount taken into any consolidated accounts were appropriate to the circumstances of the consolidation,

and he is required to state in his report particulars of any deficiency, failure or shortcoming in respect of any matter referred to in this subsection.

Under the Companies Act, an auditor of a company has a right of access at all reasonable times to the accounting and other records (including registers) of the company, and is entitled to require from any officer of the company and any auditor of a related company such information and explanation as he desired for the purposes of audit.

Unlike the UK Companies Act, the Malaysian Companies Act does not require an auditor to give an opinion as to whether the information given in the Directors' Report is consistent with the audited accounts. And unlike the listing rules of the London Stock Exchange, there are no KLSE rules requiring directors to agree with auditors on the content of preliminary announcement of financial results. There are now moves to bring about these changes.

If an auditor, in the course of the performance of his duties as auditor of a company, is satisfied that:-

a) there has been a breach or non-observance of any of the provisions of the Companies Act; and

b) the circumstances are such that in his opinion the matter has not been or will not be adequately dealt with by the directors of the company,

he is required forthwith to report the matter in writing to the Registrar. The penalty for a breach of this provision is imprisonment for two years or thirty thousand ringgit or both.

The obligation to report is triggered when the auditor is satisfied that a breach of the Act has occurred and where he has no confidence that the directors will deal adequately with the matter. This introduces a subjective element to the duty to report. There is now a move to amend the section to enable an auditor to report matters that in "his professional opinion" constitute a breach of the Companies Act thus providing the auditor an objective standard on which to base his decision to or not to report. The amendment should be such as to protect auditors from defamation suits in respect of this reporting obligation.

An officer of a corporation who refuses or fails without lawful excuse to allow an auditor of the corporation or an auditor of a corporation who refuses or fails without lawful excuse to allow an auditor of its holding company access, in accordance with this section, to any accounting and other records (including registers) of the corporation in his custody or control, or to give any information or explanation as and when required under this section, or otherwise hinders, obstructs or delays an auditor in the performance of his duties or the exercise of his powers, is guilty of an offence under the Act. The penalty for this breach is imprisonment for two years or thirty thousand ringgit or both.

Copyright © OECD All rights reserved

Aside from the above requirements of the Companies Act, the Malaysian Institute of Accountants imposes certain minimum standards of professional conduct on all practicing accountants and auditors.

The MIA, requires the auditor:-

a) to conduct the audit in accordance with approved auditing standards,
b) plan and perform the audit so as to obtain reasonable assurance that the financial statements are free of material misstatements,
c) examine, on a test basis, evidence to support the financial statement amounts and disclosures,
d) assess the accounting principles used in the preparation of the financial statements,
e) assess the significant estimates made by management in the preparation of the financial statements, and
f) evaluate the overall financial statement presentation.

The responsibilities of the auditor in Malaysia under the reporting framework of approved auditing standards and the Companies Act requires an auditor to state whether the identified financial statements are properly drawn up to give a true and fair view. Reports other than a qualified report are unqualified reports. Qualified reports are required to be given if the auditor is unable to report affirmatively on those matters required of him under the reporting framework.[30]

1. What accounting and auditing standards are required of companies when preparing their financial statements?

Malaysia has been adopting, starting from the late 70s, accounting standards that are generally consistent with those issued by the International Accounting Standards (IASs) Committee. The approved accounting standards, which constitute the Malaysian Generally Accepted Accounting Principles (GAAP), comprise IASs adopted in Malaysia and Malaysian Accounting Standards (MASs) issued in Malaysia. MASs cover topics not dealt with in IASs or topics where particular features of the Malaysian environment warrant a domestic standard written specifically to address those features.

By the beginning of 1998 Malaysia had adopted 25 of the 31 extant IAS standards.[31] Only six of the remaining IASs had not been adopted in Malaysia but these can be accounted for. Of these six IAS standards, two deal with the accounting treatment of inflation, which are therefore not material, a third is on accounting for business combinations for which MAS standards exist. The fourth is on computing Earnings Per Share for which a MAS standard has been available from 1984. For the fifth on accounting for financial institutions BNM has drawn up its own standard format of financial reports. The sixth is on disclosure and presentation of financial instruments for which the standard is

[30] The approved auditing standards in Malaysia which are based on the International Standards on Auditing (IASs) have suggested wording to express a qualified opinion depending on whether the matters under consideration affect or do not affect the Auditor's opinion and whether there is any limitation on the scope of the audit or any disagreement with management. See AI 700 on Auditor's Report on Financial Statements.

[31] One of the IAS standards, i.e. S 3, had been superceded by two other standards (namely by S 27 & S 28) and another i.e. S 6 had been withdrawn. By mid 1998, the revised S 1 will replace the original S 1 as well as S 5 & S 13. MASB's exposure draft for the revised S 1 will come into force from 1.1.1999.

Copyright © OECD All rights reserved

to come into force from 1.1.1999. Schedule III enumerates the IASs which have been adopted for application in Malaysia. Schedule IV sets out the various Malaysian Accounting Standards.

The Malaysian GAAP is inferior to the best practices recommended by IASC to the extent that Malaysia has been a little slow in adopting the revised IASs. Comfort can be drawn from a review of Schedule III. It shows that for financial year commencing from 1.1.98 only two of the revised IAS standards would not have been adopted for financial reporting in Malaysia, namely with respect to the standards for income taxes and segment reporting. Interestingly, even the IAS standard with respect to the disclosure and presentation of financial instruments will have been adhered to from financial year 1.1.1999.

Malaysia has not only been adopting good standards but has also been trying to strengthen actual accounting and auditing practices. The professional accounting bodies in the country review the published financial statements annually on a random basis to ensure compliance by their members with the accounting standards and statutory disclosure requirements.

In line with what is happening in certain jurisdictions, the Malaysian Accounting Standards Board (MASB) was established under the Financial Reporting Act 1997 (the Act) as the sole authority to set accounting standards for Malaysia. MASB became operational during the second half of 1997.

The MASB recognised, at its inception, that a body of accounting standards was in existence which had been issued by the Malaysian Institute of Accountants (MIA) and the Malaysian Association of Certified Public Accountants (MACPA) and which had been generally applied in the preparation of financial statements. As a transitional arrangement towards the establishment of a new financial reporting regime under the Act, MASB therefore announced on 5 January 1998 the adoption of 24 of the extant accounting standards as approved accounting standards for the purposes of the Act. These standards, which continue to be known as International Accounting Standards and Malaysian Accounting Standards as the case may be, have been accorded the status of approved accounting standards for the purposes of the Act until each of the standards is reviewed and revised, or replaced by new accounting standards issued by MASB to be known as MASB standards.

The remaining eight accounting standards issued by MIA and MACPA were not adopted by the MASB. But MASB announced that these eight standards will continue to be promulgated by MIA and MACPA as applicable standards in the preparation of financial statements until each of those accounting standards is reviewed and adopted as approved accounting standards, or relevant new accounting standards are issued. MASB stated that the eight accounting standards which had not been adopted by the MASB require further research and wider consultation and that accordingly they have been ranked as priority projects in MASB's work programme.

The MASB acknowledged that the extant accounting standards issued by MIA and MACPA represented a valuable starting point in the establishment of the new financial reporting regime in Malaysia. However, to carry out its own due process so as to satisfy itself that the standards are appropriate and reflect the input of its constituency, MASB embarked on a programme to review all extant accounting standards for consistency with the latest developments in International Accounting Standards, statutory and regulatory reporting requirements, and to evaluate the practical aspects relating to the application of the accounting standards.

Copyright © OECD All rights reserved

Since its commencement, the MASB has established 43 working groups to execute its programme of action, including the review of all extant accounting standards issued by the MIA and MACPA as well as the development of new accounting standards and guidelines to address emerging issues. A special working group has been entrusted with the responsibility to develop a framework to set out the accounting concepts based on Syariah principles. As shown in Schedules III and IV, todate MASB has issued eight exposure drafts which will come into force from 1.1.1999 as well as one foreword, one discussion paper, two draft statements of principles and two technical releases. MASB has been a little cautious in adopting some of the revised IAS standards. This may be explained by its desire to go through a thorough due process in order not to run ahead of its constituency.

The Council of the Malaysian Institute of Accountants (MIA) has determined that Approved Standards on Auditing for members comprise:-

a) International Standards on Auditing (ISA) designated as AI and approved by the MIA and
b) Malaysian Standards on Auditing (MSA) designated as AM issued by the MIA.

In addition to these promulgated standards, all statements issued by the Council relating to recommended practices, including guidelines on auditing are to be regarded as opinions on best current practice and thus form part of Generally Accepted Auditing Practices (GAAP).

INTERNATIONAL STANDARDS ON AUDITING

The MIA has adopted the International Standards on Auditing (ISAs) issued by the International Auditing Practices Committee of the International Federation of Accountants (IFAC) as the basis for approved standards on auditing and related services in Malaysia. MIA prepares an explanatory foreword on the status on each approved ISA that is adopted. In the event that an ISA contains guidance which is significantly different from Malaysian law or practice, the explanatory foreword to an approved ISA provides guidance on such differences. The ISAs which have been adopted in Malaysia are set out in Schedule V. The International Auditing Guidelines (IAGs) which were replaced by the IASs in mid 1998 are set out in the same Schedule.

MALAYSIAN STANDARDS ON AUDITING

Copyright © OECD All rights reserved

MSAs are produced and issued by the MIA as part of its efforts to define standards of auditing and harmonise auditing practices in Malaysia.

MSAs are issued to augment ISAs approved by the MIA. MSAs are intended to cover topics not dealt with in an ISA or topics where particular circumstances of the Malaysian environment warrant a domestic standard written specifically to address those circumstances. When necessary, further guidance will be issued to members.

Presently there is only on MSA in force, namely AMI entitled Auditor's Reports: Forms and Qualifications.

COMPLIANCE WITH APPROVED STANDARDS ON AUDITING

The Council expects members who assume responsibilities as independent auditors to observe approved Standards on Auditing in the conduct of their audits under all reporting frameworks as determined by legislation, regulation and promulations of the Malaysian Institute of Accountants and where appropriate mutually agreed upon terms of reporting.

The onus is on members to use their best endeavours to ensure that such standards are also observed by those persons who assist them in their work.

An audit report has to contain a positive statement to the effect that the audit has been conducted in accordance with Approved Standards on Auditing issued by the Malaysian Institute of Accountants.

The Council has determined that the principles and spirit of the standards must be observed and the application of the standards in totality is recommended.

The Council reserves the right to inquire into apparent failures by members and those persons under their supervision to observe approved Standards on Auditing and generally accepted auditing principles. Any failure to observe approved Standards on Auditing could be regarded as conduct discreditable to the profession of an accountant and might lead to disciplinary action being taken against the member or members concerned. To date the accounting profession has not directed as much attention to strengthening auditing practices as it has devoted to strengthening accounting practices.

Members have also been advised that a court of law may, when considering the adequacy of the work of an auditor, take into account any pronouncements or publications which it thinks may be indicative of good auditing practice. Approved Standards on Auditing are likely to be so regarded.

1. What requirements exist for disclosure regarding the composition of a firm's equity ownership?

Copyright © OECD All rights reserved

The Annual Returns of Companies, which a company has to make to the Registrar of Companies under Section 165 – Part II of the Eighth Schedule of the Companies Act 1965 (CA) requires a disclosure of a company's equity ownership.

The CA and the Securities Industry (Reporting of Substantial Shareholding) Regulations 1998 (SC Regulations 1998), defines any person having 2% or more of the nominal value of the voting shares of the company as a substantial shareholder. A substantial shareholder has to notify the exchange, the listed corporation and the SC:-

- of his substantial shareholding and of any changes thereto;
- the date of the change of interest;
- circumstances giving rise to the change;
- the number of securities acquired or disposed of, both in absolute terms and expressed as a percentage of the issued capital;
- amount of consideration received or paid for the securities, and
- the number of securities held before and after the change, both in absolute terms and expressed as a percentage of the issued capital.

Notices are required to be given within 14 days from the date on which a person becomes a substantial shareholder, or there is a change in circumstances, or he ceases to be a shareholder, as the case may be. A change in circumstances, with respect to a substantial shareholder, also takes into account his deemed interest in shares. Under section 6A(4) of the Companies Act 1965, a person is deemed to have an interest in shares where a body corporate has an interest in shares and:-

- the body corporate is, or its directors are accustomed, or is under an obligation, whether formal or informal, to act in accordance with the directions, instructions or wishes of that person in relation to that share;
- that person has a controlling interest in the body corporate;
- that person, or associates of that person or that person and associates of that person are entitled to exercise or control the exercise of not less than 15% of the votes attached to the voting shares in that body corporate.

Failure to report as required subjects the defaulter to a penalty of Ringgit Malaysia 5,000/- with a default penalty of RM500/- only. However, the courts have powers with respect to defaulting substantial shareholders.[32] The penalty for a contravention of the court order, is RM3,000/- with a default penalty of RM500/-.

The Securities Industry (Reporting of Substantial Shareholding) Regulations which came into effect on the 1st of May 1998 now require that any person who is a substantial shareholder of a public company (whether listed or not) is to provide notice of such interest to the Securities Commission. It should be noted that while these disclosure requirements mirror those which are provided under the Companies Act, breach of these regulations entail a fine of RM500,000 or imprisonment for a term not excluding 5 years or both. This is a substantially higher penalty than that provided for under the Companies Act.

The listing requirement of the KLSE requires a statement from a listed company to be made up to a date not earlier than 6 weeks from the date of issue of its annual audited accounts and indicating the date of such statement and setting out

[32] Section 69N of the Companies Act 1965.

Copyright © OECD All rights reserved

- names of substantial shareholders and their equity interest
- number of holders of each class of equity securities and voting rights attached to each class
- number and percentage distribution of shareholders by size of shareholding of each class
- a statement of the percentage of the total holding of the 20 largest holders of each class of equity securities and
- the names of the 20 largest holders of each class of equity securities and the number of equity securities of each class held.

The listing manual also requires the shareholding spread to be set out in a particular format at a date no earlier than 6 weeks from the date of the issue of the audited annual accounts.

The CA also requires any options to take up unissued shares granted during a financial year to be disclosed in the Directors' Report for that year. The Report has to state

- the name of the person to whom the option has been granted;
- the number and class of shares in respect of which the option has been granted;
- the date of expiration of the option;
- the basis upon which the option may be exercised; and
- whether the person to whom the option has been granted has any right to participate by virtue of the option in any share issue of any other company.

Each report has to specify

- particulars of shares issued during the period to which the report relates by virtue of the exercise of options and
- the number and class of unissued shares of the company under option as at the end of that period as well as the price or method of fixing the price of issue of those shares.

The above requirements do not hold where the option to take up shares has been granted generally on all the holders of a class of shares.

In order to ensure the timeliness of disclosures, the 14 day period for reporting the fact of, or changes in substantial shareholding, should be reduced. As a corollary to the reduction of this period, consideration may have to be given as to whether the reporting obligation should be based on knowledge by the shareholder that he has reached the 2% reporting threshold.[33]

1. ***What requirements exist for disclosure of the identity, compensation, equity ownership and background of directors and senior managers, and of any relationships between a director, the company and managers?***

[33] In jurisdictions such as the UK, the number of days in which the person must report a substantial shareholding is two days. This may give rise to difficulty where the shareholder is not able from time to time determine whether his shares constitute the percentage which triggers off the reporting obligation, in particular where the share capital is changed. In the UK, provisions make the obligation to notify based upon knowledge.

Copyright © OECD All rights reserved

The KLSE listing manual requires the following disclosures about all directors and executive officers in the prospectus for any new issue of shares:-

- the person's name, address, age and position or occupation;
- his business experience in the past 5 years or the principal business of the corporation he is employed in;
- any other directorships held;
- the nature of the family relationship between the directors and executive officers and
- whether he or his employer is a bankrupt, whether he has been convicted or is facing any criminal action and whether he has been ordered or restrained by a court from engaging in any business practice or activity;
- aggregate remuneration paid or distributed to directors for all services rendered to the company or its subsidiaries during the last financial year;
- details of all options (to subscribe for securities) that were received or exercised during the last financial year as well as;
- particulars of material contracts involving the interests of directors or executive officers.

The listing manual does not require a director to declare if he is an independent non-executive director or has any conflicts of interests, either at the time of new issues or on a periodic basis. There is also no requirement for the director to disclose his personal particulars or his financial standing on a periodic basis. It only requires an annual return on who the directors are with a requirement for a disclosure of any changes in directorships.

However, the Companies Act requires a periodic disclosure in the annual report of the shareholding interest of each director in the company or in a related corporation, the total number of securities bought and sold by him during that financial year, as well as particulars of material contracts involving directors' interests, either still subsisting or entered into during the financial year. The aggregate remuneration paid or distributed to directors for all services rendered during a financial year are also disclosed in the annual report for that year.

Section 99B of the Securities Industry Act 1983 now provides that a chief executive and a director of a listed company must disclose to the SC of his interest in securities of the listed corporation of which he is a director or chief executive or of his interest in an associated corporation of the listed company. The consequence of a breach of this provision is criminal sanction of up to RM1 million or imprisonment of up to 10 years or both.

The principle that a director or a chief executive must disclose all interests which may be in conflict with the interests of the company is recognised in the Securities Industry Act 1983 (SIA) and/or the CA.[34] Conflicts of interest may arise through either a personal interest or a duty to some third party. These situations include:-

[34] Section 99B of the Securities Industry Act 1983 now provides that a chief executive and a director of a listed company must disclose to the Commission of his interest in securities of the listed corporation of which he is a director or chief executive or of an associated corporation of the listed company. The consequence of a breach of this provision is criminal sanction of up to Ringgit Malaysia 1 million or imprisonment of up to 10 years or both.

Copyright © OECD All rights reserved

- Holding of any other office in another company including being a nominee director of that company;[35]
- Possession of any property; and
- An interest in a contract with that company.[36]

Under such circumstances, directors are required to notify the company.

The position at common law is that the director will not be allowed to be interested in transactions involving the company or derive any profit from his position, unless he declares the nature of his interest and the shareholders in general meeting release him from the application of this principle. A breach of this principle would entitle the company to consider the transaction voidable, and the company may recover all benefits derived by the director. The purpose is not only to prevent financial loss to company, but also to ensure integrity of management, which would have more information than others with respect to the company.

6. What are the requirements for disclosure of related party transactions?

A related party means a director, substantial shareholder and/or person connected with a director or substantial shareholder.

Under the Companies Act, only Section 132G recognises the concept of a substantial shareholder in related party transactions but such transactions are prohibited. Section 132E only embrace transactions with directors or persons connected with directors. These transactions require disclosure and approval of shareholders.

Until 1997, the KLSE listing rules only covered transactions involving the interests of directors and substantial shareholders, direct or indirect. As a result of the review of the rules after the UEM-Renong debacle, the rules now cover transactions involving the interests, direct or indirect, of persons connected with directors or substantial shareholders.

In 1995, the Securities Commission set out its special requirements for related-party transactions but these are in the nature of guidelines and not regulations. The new KLSE rules are modeled on these guidelines and therefore, they are binding on listed companies.

Under the Securities Commission guidelines and the KLSE rules, a listed company is required to make a public announcement, send a circular and seek the approval of shareholders on all material[37] related party transactions with the following disclosures:-

---

[35] Subsection 131(5) of the Companies Act 1965 provides that every director who holds any office or possesses any property whereby directly or indirectly duties or interest *might be created in conflict with his duties and interests as directors*, shall declare at a meeting of the board of directors, the fact, nature and extent of the conflict. There are criminal sanctions for breach of this provision, also under subsection 131(8) of the Companies Act 1965. The effect of this subsection is that directors may create interests and duties in conflict with their duties and interests as directors, provided that this is declared at a board meeting.

[36] Section 131(1) of the Companies Act 1965 provides that every director of a company who is in any way interested in a contract or proposed contract with the company shall, as soon as practicable after the relevant facts have come to this knowledge, disclose the nature of his interest at a directors meeting. The consequences of a breach of this provision are criminal sanctions under section 131(8) of the Companies Act 1965 – (7 years or 150,000 or both). It is not clear whether this affects the enforceability of the contract (except where it is clear from the articles of association).

Copyright © OECD All rights reserved

a) the date of the transaction, the parties thereto and a description of their relationship, and the nature and extent of the interest of the related party in the transactions;
b) particulars and purpose of the transactions;
c) the total consideration, together with the basis of arriving at the consideration, and how it is to be satisfied;
d) the effects of the transaction on the company including any benefits which are expected to accrue to the said company as a result of the transaction;
e) an opinion by an independent corporate adviser, as to whether the transaction is fair and reasonable so far as the shareholders are concerned, which opinion must set out the key assumptions made and the factors taken into account in forming that opinion;
f) a statement by the directors (other than any director who is a related party in respect of the transaction) that the transaction is fair and reasonable so far as the shareholder are concerned, and that, if applicable, the directors have been so advised by an adviser and
g) a statement that the related party will abstain from voting on the relevant resolution.

International accounting standard S24 on related party disclosures which has been adopted as an approved accounting standard in Malaysia require financial statements to give disclosures about certain categories of related parties.

In broad terms, the Standard requires the following disclosures:-

a) Related party relationships where control exists[38] is required to be disclosed irrespective of whether there have been transactions between the related parties;

---

[37] A transaction is deemed as material if its value exceeds 5% of any one of a select set of variables such as profits, equity, market capitalisation and assets.

[38] S24 defines a related party as follows:-

"Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party, to the extent that it prevents the other party from fully pursuing its own separate interest, in making financial and operating decisions."

In a jurisdiction such as Malaysia which requires a prior approval of related party transaction by shareholders who are not interested in the transaction, the risk of significant related parties and the transactions remaining undetected by the auditor can be high. The International Standard on Auditing with respect to related parties i.e. AI 550 states that the auditor should obtain sufficient appropriate audit evidence as to whether these related party transactions have been properly recorded and disclosed. The Standard requires the auditor to obtain a written representation from management concerning:-

a) the completeness of information provided regarding the identification of related parties; and
b) the adequacy of related party disclosures in the financial statements.

If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor is required to modify the audit report appropriately.

Copyright © OECD All rights reserved

b) If there have been transactions between related parties, the reporting enterprise is required to disclose the nature of the related party relationships as well as the types of transactions and the elements of the transactions necessary for an understanding of the financial statements.

c) Items of similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

Specifically, under the Standard, attention is focussed on transactions with the directors of an enterprise, especially their remuneration and borrowings, because of the fiduciary nature of their relationship with the enterprise. In addition, International Accounting Standard 5, Information to be Disclosed in Financial Statements, calls for disclosure of significant intercompany transactions and investments in and balances with group and associated companies and with directors. International Accounting Standard 3, Consolidated Financial Statements, requires in such statements a list of significant subsidiaries and associated companies, and, for unconsolidated subsidiaries, intra-group balances and the nature of transactions with the remainder of the group. International Accounting Standard 8, Unusual and Prior Period Items and Changes in Accounting Policies, requires disclosure of unusual items.

The following are examples of situations where related party transactions may lead to disclosures by a reporting enterprise in the period which they affect:-

- purchase or sales of goods (finished or unfinished)
- purchase or sales of property and other assets
- rendering or receiving of services
- agency arrangements
- leasing arrangements
- transfer of research and development
- license agreements
- finance (including loans and equity contributions in cash or in kind)
- guarantees and collaterals
- management contracts.

Under the Standard, disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the parent and subsidiaries as a single reporting enterprise. Transactions with associated enterprise accounted for under the equity method are not eliminated and therefore, require separate disclosure as related party transactions.

Although under the Standard, disclosure of transactions between the parent and its subsidiaries is unnecessary in consolidated financial statements, this is inconsistent with the 9th Schedule requirement for the disclosure of significant transactions with related corporations. Therefore, an amendment of the 9th Schedule is in order to remove this anomaly.

1. How are external auditors appointed and removed?

The external auditor is appointed by shareholders by resolution of a company at a general meeting. Section 172 (4) Companies Act provides that an auditor may only be removed from office by resolution at a general meeting, of which special notice has been given.

Subsection 172 (5) requires such special notice to be sent to the auditor as well as the Registrar of Companies (ROC). The auditor is then given the right to make representations in writing to the

Copyright © OECD All rights reserved

company and request that copies of the representation are sent out to every member prior to the meeting at which the resolution is to be considered, be heard orally or require that his representations are read out at the meeting. Once removed, the company must notify the ROC in writing of the removal. As the provisions of the Act do not require the company to furnish to the ROC a copy of the written representations, made by the auditor, a suggestion has been made for amending the Act to require the company to forward a copy of the written representations to aid the ROC in his enforcement activities and not for reinstating the auditor.

Under S172 (15) Companies Act, directors are required to call a general meeting as soon as it in practicable upon receipt of notice in writing from its auditor that he desires to resign. The meeting is for the purpose of appointing another auditor and there is no requirement that the circumstances surrounding the auditor's decision to resign be disclosed.

It has been suggested that the Companies Act and the SIA be amended requiring an auditor to inform the ROC and the KLSE of the reasons for his resignation or for declining to seek reappointment, and that a rule be introduced into the KLSE Listing Manual requiring a company to circulate to shareholders the auditors's representations on the matter.

C SHAREHOLDER RIGHTS

Ownership of shares in a company confers on a shareholder several basic rights which include the following – first the right to secure methods of ownership registration, the right to convey or transfer shares, the right to obtain relevant information on the corporation on a regular basis, the right to participate and vote at general shareholders meetings, the right to elect members of the board and the right to share in the residual profits of the corporation.

Shareholder's right to secure methods of ownership registration

Malaysian law, provides these basic rights to shareholders, consistent with its strong common law background. The law sets out a comprehensive body of provisions on how shares are to be registered, the identity of member(s), the amount, date of entry and cessation, date of allotment, location of register, register of index of members, openness for inspection, and entitlement for copy upon request.[39] Section 358 Companies Act 1965 provides that if there is default in compliance with the keeping, closing or allowing inspection of the register, the company and every officer in default is guilty of an offence. Any agent who causes the company to commit specified breaches will be liable to the same penalties as if he were an officer of the company.[40]

The Malaysian Central depository operates a system that enables securities transactions to be effected electronically without the need for physical delivery of shares scrips. This is done through a system that effects the transfer of ownership of securities through computerized book entries rather than by physical delivery and execution of instruments of transfer. **With effect from 1st November 1999 it became mandatory for securities of companies listed on the KLSE to be deposited with the Central depository.[41]** Under section 107B of the Companies Act 1965, any name that appears on the record of depositors maintained by the central depository under section 34 of the Securities Industry central Depositories Act 1991 shall be deemed to be a member of the company. A depositor will not be regarded as a member of a company entitled to attend, speak or vote at the general meeting unless his name appears on the record of depositors not less than three market days before

[39] Sections 158-161 of Companies Act 1965

[40] Sections 358, 161 of Companies Act 1965

[41] Securities Industry (Central Depositories) (Amendment) (No.2) Act 1998.

Copyright © OECD All rights reserved

the general meeting.[42] Crucially any rectification of the register of depositors must be made to the Court and the Court's discretion to rectify is limited to the circumstances set out in subsection 107D (2) Companies Act 1965.

Shareholder's right to freely transfer shares

The nature of shares as personal property is recognized in Malaysia. Shares may be freely transferable as provided by the Articles of Association and are also capable of being inherited or transmitted by operation of law. Section 98 Companies Act 1965 provides that shares are subject to the general law relating to ownership and dealing in property.[43] The principle of free transferability of shares is fundamental to listed shares. The Listing requirements of the KLSE are clear that the Articles contain no restriction on the transfer of fully paid securities, which are quoted on it.[44]

Shareholder's right to information

The Act makes provision for members to have access to various records and registers that the company must maintain in order to enable the shareholders of a company to be kept fully informed of what is happening in the company. These include –

- the register of members;
- the register of directors, secretaries, managers and auditors;
- the register of directors' shareholdings;
- the register of substantial shareholdings;
- the register of debenture holders;
- the register of charges;
- the register of holders of participatory interests.

---

[42] Section 107B(3) Companies Act 1965

[43] Note however that section 103 (1) provides that notwithstanding anything in the Articles a company may not register a transfer of shares, debentures or interest unless a proper instrument of transfer has been delivered to the company. There is therefore no automatic transfer e.g. by way of death of shareholder. Non use of prescribed form will render transfer void: sec 103(1A). By virtue of section 107C securities that have been deposited with the Central depository shall be by way of book entry and a company is precluded from registering or effecting a transfer.

[44] The law permits free transferability of shares with some exceptions. It must however be noted that if the sale and transfer of shares involved that of a corporation that requires the approval of a Minister then there could well be inhibitions as to free transferability or even sale by private treaty. In one case the High Court set aside an injunction restraining a vendor from selling shares to any other person other than the plaintiff purchaser as it was disclosed that the shares involved shares in a financial institution that requires the approval of the Minister where more than 5 % is involved.(*Tunku Kamariah Aminah Maimunah Iskandariah bte Sultan Iskandar v. Dato James Ling Beng King(1989) 1MSCLC 90,209.*
In private companies the problem arises as to the directors being vested with a right to refuse to register a share.
In one High Court decision it was held that since the decision to refuse registration of transfers is a collective one by the board of directors the fact that one director has acted in bad faith will render the refusal null and void. Bad faith is evidenced by presence of conflict.: *Allied Properties Sdn Bhd.v. Semua Holdings Sdn Bhd & Ors (1988) 1 MSCLC 90,146*
Also it would appear that if directors refused to register a transfer on grounds that such refusal is done primarily to endorse the government's policy of encouragement of active Bumiputra(indigenization) participation in private business : *Mohan a/l Paramsivam v. Sepang Omnibus Company Sdn Bhd (1988) 1MSCLC 90,146*

Copyright © OECD All rights reserved

- A copy of the last audited profit and loss accounts[45], the auditor's report[46] and the directors' report[47] on the accounts.[48]

Shareholder's right to vote

The right to vote is one of a member's fundamental rights. It is recognised in Malaysia as a proprietary right and every member has an unfettered right to exercise his votes as attached to the shares.[49] The principal right of shareholders in respect of their right to vote is their right to vote on the election of directors, on amendments to the constitutional documents of the company, and on key corporate transactions which include transactions where an insider has an interest in the transaction, sale of all or a substantial part of a company's assets, mergers and liquidations. This limits the discretion of the insiders on these key matters.

In this respect the one-share-one vote rule with dividend rights linked directly to voting rights is taken as a basic right in corporate governance. The one-share-one-vote rule is entrenched and observed strictly in Malaysia. Section 55 Companies Act 1965 provides in the case of public companies and their subsidiaries that each equity share (and this includes preference shares with voting rights) may carry only one vote thereby prohibiting the existence of both multiple voting and non-voting of ordinary shares and does not allow firms to set a maximum number of votes per shareholder in relation to the number of shares he owns. The idea behind this basic right is that, when votes are tied to dividends, insiders cannot appropriate cashflows to themselves by owning a small share of the company's share capital but by maintaining a high share of voting control. In LLSV's cross country study, Malaysia was found to be one of only 11 countries out of 49 which impose a genuine one-share-one-vote-rule.

There is a common law recognition that the right to vote is proprietary in nature and so strong is that recognition that a shareholder is entitled to vote in his own interest without any regard of other interest.[50] Therefore when a shareholder votes, he exercises a proprietary right and not a fiduciary power. The proprietary nature of the right to vote is so well ingrained that even if directors who are also shareholders are bound as directors to take a particular course of action, they are not bound as shareholders to vote in the same manner. The boundaries of freedom end where the conduct of the majority of shareholders deprives the company of its

[45] 170(1) Companies Act 1965

[46] 170(2) Companies Act 1965

[47] 169(5) Companies Act 1965

[48] But note that a member has no access to the accounting records of the company. Access is available only to the directors and the auditors.

[49] Section 148(1) Companies Act 1965 provides that every member shall have the right to vote on any resolution notwithstanding anything to the contrary in the company's memorandum and articles of association. The member's right to vote may be suspended by the articles in two instances: first when the member has not paid any calls or other sums payable by him in respect of his shares; secondly if the shares in question are preference shares. In respect of the latter, the Act recognises two classes of shares – equity and preference shares. Preference shares are defined under the Companies Act 1965 to mean a share which does not entitle the member, *among other things*, the right to vote at a general meeting. An equity share in this respect is defined as any share other than a preference share. The significance of the distinction is that all equity shares are subject to the one share-one-vote rule embodied in section 55 Companies Act 1965.

[50] Re Calvary Charismatic Center LTD (1991) 1 MSCLC 95,465

Copyright © OECD All rights reserved

rights or expropriates rights that the minority is entitled to enjoy or to share.[51] To that extent however their right to vote is limited. The justification for judicial interference with this right is based on the principle that a company and its minority shareholders have rights of their own which the majority cannot deprive them.[52]

The ease with which a shareholder is able to exercise his right to vote is also of crucial significance. Voting in Malaysia may be by show of hands or on poll, i.e. a written ballot. Each member is entitled to one vote on a show of hands unless the articles of a company provide otherwise.[53] But on a poll, a member will have as many rights as his shareholding entitles him. The right to demand a poll is therefore an integral right as a member has then the opportunity to realise his full voting power.[54] The chairman is also not permitted to refuse a demand for a poll nor can he exercise his power in a manner that protects the control of management power by the incumbent directors.[55] There being no statutorily prescribed mode of polling, it is normal for the use of a ballot. The manner and procedure as to the poll taken is set out in the articles, in absence of which it will be prescribed by the Chair. [56] It is the practice for public listed companies to appoint an independent firm of chartered secretaries or accountants to conduct polls thus ensuring their independence.

A member may appoint a proxy to vote on his behalf. Section 149 Companies Act 1965 provides for a statutory right for the appointment of proxies. The statutory provisions as contained in the Companies Act 1965 are aimed at curbing undue restrictions that may be inserted in articles of associations against voting by proxy.[57] A proxy has a right to speak at a meeting, in the absence of a contrary provision in the articles. Otherwise a proxy may only vote on a poll.[58] And the proxy may demand a poll.[59] The articles of associations of

---

[51] In the context of Malaysia, these boundries are mainly set out under case law.

[52] Loh Siew Cheang in Corporate Powers – Controls, Remedies and Decision making sets out on page 96 examples of advantages or rights belonging to a company and minority shareholders. The rights belonging to a company are for example corporate opportunities, the right to sue, the right to issue shares. The rights of the minority shareholder may be divided into two groups. First, personal rights such as the right to property in shares, the right against unwarranted dilution of the existing pattern of equity control in a company. Second, derivative rights which are essentially derived from the individual title of the company to property, rights and advantages in respect of which the minority are entitled to share or participate with the majority – for example the right to reap benefits or potential benefits from undertakings.

[53] Section 147(1)©(i).

[54] The Companies Act 1965 preserves the right of a member to demand a poll by –

- Any five or more members having the right to vote at a meeting; or
- A member or members representing at least 10% of the total voting rights of members at the meeting; or
- A member or members holding voting shares on which are paid up in aggregate not less than 10% of the total amount paid up on all the shares conferring the right to vote at the meeting.

[55] Dominion Mining N.L. Larbelistier (1971-1973) CLC 40-048.

[56] Section 146(1) Companies Act 1965

[57] A peculiar feature of section 149 is that the proxy must be a member of the company or an advocate, approved company of auditors or persons approved by the Registrar of Companies. This limitation is regarded by some quarters as unnecessary for its existence tends to limit the freedom of choice on the part of shareholders to appoint persons who are not members as their proxies - Siew Cheang, Loh – Corporate Powers – Controls, Remedies and Decision- making MLJ 1996 at page 529.

[58] Note however that Rule 302 of Part 8 [KLSE Main Board Listing Requirements] provides that the articles of a listed company must allow for a proxy to vote on a show of hands at any general meeting.

[59] Section 146(2) Companies Act 1965

Copyright © OECD All rights reserved

companies generally require proxy forms to be deposited with the company some time before the meeting to facilitate checking and validation of the forms. But any provision requiring forms to be deposited more than 48 hours before the meeting is void.[60] And while this does facilitate shareholders exercising their voting rights, it nevertheless still requires the proxy to attend shareholders' meetings to be able to vote.

The law as it stands does not recognise voting by mail whether by a member or his proxy. Voting by mail certainly makes it easier for shareholders to cast their votes. It overcomes several practical difficulties associated with having to attend general meetings. First from the point of view of retail investors (which dominate the Malaysian investing landscape), who may be dispersed all over the country, voting by mail is a cheaper and more efficient method of enabling them to exercise their right to vote. Second, the argument takes on greater force in the context of institutional investors, namely foreign institutional investors and empowers them to take a greater role in the company's affairs, rather than voting with their feet. Finally many companies hold their annual general meetings within the same time period, which makes it difficult for shareholders to exercise their right to vote unless they go through the legal procedure of designating their proxies at the meeting. Provisions allowing for voting by mail must be supplemented with provisions mandating reasonable notice periods and sufficient disclosure of information to give shareholders the opportunity to decide how they should vote. The objective of broadening shareholder participation suggests the law should consider favorably the enlarged use of technology in voting, including electronic voting.

Another crucial area in increasing the effectiveness of the shareholder's right to vote is in terms of improving the quality and timeliness of information that gets out to shareholders before shareholders meetings. Companies start the visible process of preparing for AGMs by sending shareholders the notice of AGM Section 145(2) Companies Act 1965 requires at least 14 days notice of meetings other than for a meeting to pass a special resolution (21 days) [61] or for one requiring special notice (28 days)[62]. This means that there must be 14 clear days between the issue of the notice and the date of the meeting. This applies to both AGMs as well as EGMs. Notice of meetings must be given to every member.[63] The company's auditor is also entitled to notice of meetings.[64]

---

[60] Section 146 (1) (c) Companies Act 1965. If the article does not have such a prescription then a proxy may be lodged at the meeting itself. *Case :* TSS a company applied for the discharge of various injunctions obtained by LHP , a shareholder in TSS. The injunctions restrained TSS from proceeding with or holding its EGM for the purposes of altering its Articles of Association and its management in implementing and /or exercising their powers to effect certain resolutions which had been passed at the AGM. It was contended inter alia that LHP has no locus standi to maintain the proceedings and that TSS was right in excluding LHP's proxy from attending the AGM as the proxy holder was not a member. The High Court held that LHP has locus standi and that the Articles of Association of TSS which provided that only member s can become proxies is overridden statutorily by sec. 149(1). It further held that the act of excluding LHP's proxy is not a mere procedural irregularity but an illegality that amounted to abuse of power or oppression of minority which vitiated and rendered null and void the AGM and all resolutions passed thereto.*(Lim Hean Pin v. Tean Seng Co. Sdn Bhd & Ors (1992) 2 MSCLC 90,085.* It can be seen that the Court has a correct view of the importance of the proxy provisions and appreciated its rationale as substantive of shareholders' rights and not purely procedural.

[61] 21 days – Section 152(1)CA

[62] Meetings in respect of removal of directors and auditors

[63] Section 145(4) read together with section 148(1)CA.

[64] Section 174(7)CA

Copyright © OECD All rights reserved

Foreign shareholders have at times been disadvantaged by this notice period. It is customary for the registered address of service to be that of the custodian. There have been problems expressed with the fact that the notice of meetings do not get to these shareholders on time because of the additional layer of persons that it has to go through. This fact suggests that a longer circulation period may be necessary. A quick comparison with the position in the UK reveals that companies in the UK are subject to a longer notice period in respect of AGMs – a 21 day notice period for AGMs and a 14 day period for EGMs.

The notice generally sets out the date, time and venue of the AGM and gives details of the business to be transacted. In practice the notice essentially sets out a series of resolutions for approval by members. The Companies Act 1965 does not regulate the contents of notice of meetings. The KLSE Listing Rules[65] set out basic requirements that apply to its listed companies – the notice is to state the date, time and venue of the meeting.[66] However under common law, the notice calling a meeting must contain sufficient information to enable a prudent member to decide whether or not he will attend a meeting. Otherwise a member may be able to invalidate any resolutions passed. In the context of election or re-election of directors, in practice too few boards currently make any real effort to persuade shareholders of the merits of directors nominated for election or re-election. There is certainly scope for improvement in the information that accompanies notice of meetings. For example the Singapore Stock Exchange Listing Manual requires the following additional information as regards director's appointments to be included –

- Shareholding in companies and subsidiaries of companies;
- Family relationship with directors and substantial shareholders;
- Any conflicts of interest that he may have with the listed entity;
- List of convictions for offences.

Shareholder's right to requisition a meeting

The Companies Act 1965 provides that a meeting may be requisitioned by members not holding less than 10% of such paid up capital of the company as carries voting rights. If the directors do not convene a meeting within 21 days after the receipt of the requisition, the requisitionists may convene the meeting themselves;[67]in this case the meeting must be held within three months of the date of deposit of the requisition.

Crucially any reasonable expenses incurred by the requisitionists in calling the meeting are to be paid by the company, which may reimburse itself out of any sums due to the defaulting directors by way of fees or other remuneration. Members also have an independent power to convene an extraordinary general meeting under section 145(1) Companies Act 1945 which essentially provides that two or more members holding not less than1/10th of the company's issued share capital may call a meeting of the company. A requisition under section 144 Companies Act 1965 however is probably the more common course that is followed as most members seldom have the means or the wherewithall to call a meeting themselves. The majority of cases which have come before the court in which section 144 Companies Act

[65] Rule 26 KLSE Main Board Listing Requirements -

[66] However where the notice calling for the meeting is to consider resolutions regarding material transactions, the KLSE rules do require circulars to be issued to shareholders in addition to the notice that is given. All circulars are vetted by the KLSE.

[67] Section 144(3) Companies Act 1965

Copyright © OECD All rights reserved

1965 is invoked is in cases of removal of directors prior to the expiration of the term of their office.

Shareholder communications

A number of developed economies have focused efforts on increasing the quality of shareholder communications, namely through the AGM, for it gives all shareholders, whatever the size of their shareholding direct and public access to boards. Attendance at AGMs in Malaysia is poor and dominated by retail investors. The idea should be to increase its effectiveness so institutional shareholders see value in attending the meetings.

Some effort has been taken to improve the quality of AGMs by way of best practices, not unlike those developed by the Institute of Chartered Secretaries in the United Kingdom which basically establishes and defines best practices for the conduct of AGMs and the rights of shareholders in relation to them.[68] However there may be scope for statutory intervention in several critical areas –

- Member’s resolution
- The right to ask questions at AGMs

Member’s resolutions - Section 151 Companies Act 1965 sets out the right of shareholders wishing to submit proposals to the general meeting. Under this section, shareholders holding in aggregate of not less than 1/20th of the total voting rights, or 100 shareholders holding shares in a company on which there has been paid an average sum per member of not less than RM500, may requisition the company to give to the members entitled to receive notice of the next annual general meeting, notice of any resolution which may properly be moved and circulate a statement of not more than 1000 words on any matter refereed to in the resolution on any business to be transacted.

The biggest deterrent to circulation of shareholder resolutions is that all expenses involved would have to be borne by the shareholder. There is also the 1000 word limit, the difficulty in obtaining sufficient requisitionists and the inability to accompany these circulars with proxies in their own favour. Also from a tactical point of view, the board will obtain advance information about the dissenting shareholder’s case and be able to send out at the same time a circular in reply.

The issue of whether a shareholder should be allowed to circulate resolutions at the company’s expense is a difficult one. In the case of a listed company, for example, the cost of giving notice of resolution by means of a separate mailing could be considerable depending on the size of the share register. A simple amendment transferring the costs to a company irrespective of circumstances could burden companies with a considerable bill which may be unfair to the general body of shareholders for it cannot be assumed that those requisitioning a resolution would constitute the majority. They may in fact represent a tiny fraction of the share register and an even smaller part of the voting equity capital. As this issue will have tremendous impact on companies in terms of cost it should only be introduced after careful research and with extensive feedback.

Shareholder’s right to ask questions at the AGM **-** For shareholders, especially retail shareholders, lacking direct access to the board enjoyed by institutions, the ability to ask

[68] See – “A guide to Best Practices for Annual General meetings” – ICSA 1996

Copyright © OECD All rights reserved

questions is an important source of information on the performance of the company. There may be a case for inclusion of a statutory provision in the Companies Act 1965 requiring companies to make provision for it at the annual general meeting. The alternative of course is to include a statutory provision that gives every shareholder the specific right to table a question to be asked at the AGM in addition to the current ability of the shareholder to ask questions under the " any other business" item of the AGM. This would enable a shareholder to raise a serious point of concern for discussion at the AGM after seeing the reports and accounts but without the need to contemplate a resolution. A statutory question unlike the resolution would not require any advance notice to be given to the other shareholder, and so an additional circulation to shareholders would not become necessary. But such a right could give rise to substantial procedural drawbacks. The AGM would become unmanageable if every shareholder had an unconditional right to have his or her question answered at the meeting.

Shareholder asset protection provisions/ Related party/ Interested party transactions

Given ownership concentration in Malaysian and elsewhere in Asia, these basic rights and improvements suggested above will not sufficiently address minority shareholder protection concerns and their fair treatment. Investor confidence that the capital they provide will be protected from misuse or misappropriation by controlling shareholders, managers and directors is an important factor in capital markets. Malaysia has a number of provisions designed to curb abusive behaviour by interested, related or connected parties, which range form provisions requiring shareholder approval upon disclosure to absolute prohibitions in some cases

- Loans to directors or director-related parties are prohibited (Sections 133 and 133A read with 122A) unless they are subsidiaries
- the approval for disposal by directors of company's undertaking or property (Section 132C)
- the approval for issue of shares by directors (Section 132D)
- substantial property transaction involving directors and persons connected to directors (sec.132E read with sec.132F and Section 122A)
- prohibition of certain transactions involving shareholders and directors (sec 132G)
- substantial shareholding and changes in substantial shareholding requires disclosure to both the company and the Exchange (sections 69E and 69I, and the substantial shareholding regulations 1998). Appendix 1 sets out sections 132C, 132E, 132G, 133 and 133A Companies Act 1965.

However some broad comments may be made on the areas requiring improvement.

- The related party provisions that require shareholder approval, while requiring the interested party or related party to disclose his interests in the transaction, do not require the related party to abstain from voting on the transactions. While it is accepted that a shareholder's right to vote is a right in property, there are limits to the majority voting power in common law. The Courts have essentially sought to control the exercise of majority voting power through the equitable doctrine, that the law will not permit the fraudulent exercise of a power. Therefor there is existing legal basis for imposing on controlling shareholders a duty of fair dealing which would require the transaction to be authorised in advance by disinterested shareholders (i.e. shareholders who have no interest in the transaction) following full disclosure of the extent and nature of the interest. For example,

Copyright © OECD All rights reserved

sections 132E and 132C which while requiring shareholder approval, do not require the interested shareholder from abstaining from voting in a transaction.

- The law should require all substantial or interested party transactions to obtain the prior approval of shareholders. This would overcome the very real problem associated with undoing transactions that are entered into on the condition of subsequent approval by shareholders. For example, section 132E of the Companies Act 1965 which allows substantial property transactions between directors and persons connected to directors to be ratified by the company at a general meeting. In substantial transactions such as that set out in section 132E, ratification is sometimes the only option for the shareholders due to costs associated with turning back or unwinding a substantial transaction. And certainly in the case of substantial transactions, the need to make speedy decisions must give way to protection of shareholders interests generally.

- The provisions on interested or related party transactions in the Companies Act 1965, save for section 132G do not embrace transactions between a company and a substantial shareholder or persons connected with a substantial shareholder. Section 132E for example only embrace transactions between a company and directors and persons connected to the director. This is potentially a very serious omission for not all substantial shareholders sit on boards and more importantly the law does not prevent a controlling shareholder from effecting a related party transaction to the detriment of the company.

- The laws should be clear as to the circumstances that require shareholder approval. For example, section 132C has given rise to uncertainty as to the scope of meaning of "undertaking" "property" and "substantial value" leading to doubts as to whether in any one transaction approval of general meeting is needful. Furthermore, it is arguable that only acquisition/disposal which materially and adversely affects the performance or financial position of the company would require the approval of the general meeting. There is ambiguity in construing in any one case whether the transaction is adverse to the company performance or financial position. Section 132E is also ambiguous as to whether it precludes the board from executing a conditional agreement given the wide language of the provision. Rules 111-120 of Part 4 of the Main Board Kuala Lumpur Stock Exchange Listing requirements set out a better defined criteria for regulation of related party transactions, which sees the introduction of tests such as the assets test, profits test, consideration tests, consideration to market capitalization test and equity or capital outlay tests. The guideline for materiality under the Companies Act 1965 should be formulated in the same manner as laid out in the Kuala Lumpur Stock Exchange rules.

- The penalties for breach of the legal provisions in relation to substantial and connected party transactions should be increased. The increase may for example be by reference to a multiple of gains made by the offenders (as is now the case for insider trading) or allowing investors to seek full compensation for loss from offenders.

- On efficiency grounds a strong case can be made for removing absolute prohibitions of certain related party transactions. Instead such transactions should be

Copyright © OECD All rights reserved

made subject to shareholder approval with interested parties required to abstain from voting.[69]

Enforcement of shareholder rights

Private enforcement rights

The Companies Act 1965 provides statutory remedies for shareholders unhappy with acts of the company. Shareholders may currently choose the route of section 181 or section 218 of the Companies Act 1965.

Section 181 Companies Act 1965 provides for a statutory remedy against oppression. It embodies the member's personal right to be treated fairly. It entitles a member to make an application to court for appropriate orders where the member is oppressed, prejudiced or unfairly discriminated against or his interests disregarded. The underlying element is one of unfairness to the shareholder concerned. Shareholders generally favor the section 181 route as it accords them a wider range of remedies. The *locus classicus* in Malaysian law was a decision by the Privy Council in *Re Kong Thai Sawmill (Miri Sdn Bhd* (1978) 2 MLJ 227 where it was judicially recognized that the section 181 provision is wider than its equivalent in the United Kingdom. Conduct caught under section 181 encompasses autocratic conduct by the board, the appropriation of business, property or corporate opportunity at the expense of the company or its minority shareholders, unjustifiable failure to pay dividends, or the director's neglect of the duty of care skill and diligence. The case also recognises that the Court has unfettered discretion to give relief and to safeguard the rights of minority that may have been trampled upon. The Court's discretion to choose from a wide range of remedies may include the following –

- Prohibiting, canceling, varying a transaction or resolution;
- Regulating the conduct of affairs of the company in future;
- Providing for the purchase of the shares of the company by other members of the company or the company;
- Altering the articles or the memorandum of the company;
- Providing for the winding up of the company

Section 218 Companies Act 1965 gives the holder of fully paid up shares in a company the right to petition the Court for a winding up order. The Court would grant the order in a specified range of circumstances including –

- Where the company is insolvent;
- The director's have acted in their own interests instead of the interests of the members; or acted unfairly or unjustly to other members in the company; and
- If the Court is of the opinion that it is just and equitable for the company to be dissolved.

[69] Section 132G is riddled with difficulties of interpretation which (although there is no empirical study made on it) has a definite effect of thwarting some deals. The scope to be attributed to "the shares" "assets of another company" and the notoriously difficult phrase "first held the shares" has caused much debate amongst both corporate players, practitioners and the regulatory authorities. The costs of transaction have certainly been raised; and whether there are gains to be made by this provision has yet to be demonstrated from a macro-perspective. The section may result in more parties executing transactions through more layers of nominees.

Copyright © OECD All rights reserved

Remedies at common law

There are three forms of actions that are capable of being brought by a shareholder:

i i) Personal action;
ii ii) Representative Action and
iii iii) Derivative Action.
iv
v In a personal action a shareholder takes action in circumstances where his personal rights as a shareholder has been infringed and he seeks relief on his own behalf. It could also take the form of an action to enforce compliance of the Company's memorandum and Articles of Association, general law, the provisions of the Companies Act 1965 (e.g. to enforce the right to inspect the register of members without charge – section 160 Companies act 1965) and personal contracts. The defendant in a personal action is the company.

vi In a representative action a shareholder takes action on behalf of him and other persons to seek remedy against infringement of their collective personal rights. A Court decision will bind all persons represented. The rationale behind representative actions is to avoid duplication of court actions in cases where one action would serve to determine the rights of a number of persons in question. Detailed rules are set out in the Rules of High Court.[70] The biggest drawback to representative actions is that the relief sought cannot be a recovery of damages. In cases where relief sought is damages, the plaintiffs only have recourse via Order 15 rule 4, which allows for joinder of parties or alternatively the Court may grant declaratory relief. Practically this means that once the plaintiff in his representative capacity has established his claim to the declaratory relief sought, it will be necessary for each member of the class to bring his own action to establish damage suffered by him within the limitation period.[71]

vii In a Derivative Action an action is taken where a minority shareholder who is desirous of enforcement of the company's rights against the majority. A Court 's judgment or ruling would be given in favor of the company. The Company is made a party to the proceedings. It should be noted in this respect that the director's fiduciary and statutory duties as well as their common law duties of care, skill and diligence are owed to the company and not the individual shareholders. Also, the power to institute action in the company's name generally rests with the board. It is practically very difficult to cause the company to commence action against the defaulting director especially where he controls the board. So it is not uncommon to find that a company commences action after there has been a change in management or where the defaulting director has left the company. The avenue for minority shareholders to institute action in the company's name is through a derivative action. But to do so the minority shareholder would have to fall within one of the exceptions to the rule in Foss v Harbottle. Malaysia recognizes the exceptions in that if there are –
viii
ix - Ultra vires acts or illegality

[70] Essentially, a representative action in Malaysia may only take either the form permitted under Order 15 rule 12 or rule 13, Rules of the High Court Malaysia. The former is appropriate where every member of the class can be ascertained, where else the latter deals with representative actions involving parties which cannot be ascertained or cannot be readily ascertained.

[71] Civil procedure in the United States is much more facilitative of class actions as set out in Federal Rule on Civil Procedure [23] Notably there is no procedural bar against recovery of damages. The general rule is that differences in the amount of damages claimed by the class member would not defeat class certification so long as damages are readily calculable on a class wide basis. Each member of the class is entitled to a pro-rata share of the damages recovered in the action.

Copyright © OECD All rights reserved

- Fraud on the minority
- There has been a denial of individual rights of membership,[72]

A single shareholder may act to enforce the rights of the company. Also, the practical costs of funding an action as well as the complexities of both the substantial and procedural requirements have proven to be almost insurmountable to the minority. There is also considerable uncertainty whether ratification by some shareholders of a director's breach of duty would result in denying other shareholders, the right to bring a derivative action to protect the company.

There has been some debate whether a statutory derivative action should be provided. The Singapore Companies Act[73] has introduced provisions to that effect in 1993 but has excluded the operation of such a statutory remedy from listed public companies. It is evident that shareholder litigation is costly and involves a fair amount of monies. If the action is derivative in nature the benefit reside with the company. The incentive to engage in such litigation is minimal whilst the disincentives are prohibitive. [74]The Corporate Law Economic Reform Programme in Australia (CLERP) argues for the introduction of a statutory derivative action.[75]

Public enforcement

The discussion here will focus on the following bodies –

The Registrar of Companies is the enforcer of Companies Act 1965 and regulations made thereunder) – The penalties set out in the Act are essentially criminal. The Registrar does not have the power to institute civil action on behalf of an investor suffering loss or damage. In this respect the most of the penalties set out in statute are due for updating. For example the maximum penalty for breach of section 132E, a related party provision involving directors is thirty thousand ringgit. In contrast section 11 of the Securities Industry Act 1983 empowers the Kuala Lumpur Stock Exchange empowers the Commission to impose a fine of up to one million ringgit.

---

[72] There has been suggestion of another exception i.e. in the interests of justice . It is unclear that such an exception is an independent one and whether Malaysian Courts recognize it.

[73] Sections 216A and 16B

[74] There is a judicial attempt to forge a solution to the costs issue in respect of a derivative action.. The Court of Appeal in *Wallersteiner V. Moir* (No2) (1975) 1. All.E.R. 849 it was held that if the minority shareholder had reasonable ground for bringing the action in that it was a reasonable and prudent course to take in the interests of the company "then the minority may be able to excuse himself from paying the costs of the other side, " but the company itself should be liable, because he was acting for it and not for himself. In addition, he should himself be indemnified by the company in respect of his own costs even if his action fails." Notwithstanding this valiant attempt it is clear that such a grant of indemnity is seldom available . For example ,if the suit is representative in nature or to seek remedies against an abuse of fiduciary powers then it would not be proper to apply such an indemnity. Furthermore such an order cannot be given ex parte but that the company must be joined as a party and be able to put before the Court relevant facts: *Re Sherborne Park Residents Co.* (1986) 2 BCC 99,528; Smith & Ors v. Croft & Ors (1986) 2BCC 99,010.

[75] It views its introduction, not as imposing a new form of liability on directors, but rather removes uncertainty and therefore provides for a more effective means by which director's duties to a company may be enforced. This it suggests would increase in the long run, private enforcement and reduce the need for public or regulatory interference. In this respect, CLERP does look at the statutory derivative action as a valuable tool to enhance corporate governance and maintain investor confidence.

Copyright © OECD All rights reserved

The Securities Commission – (as the enforcer of securities laws and the regulator of the Exchange) – The Securities Commission's jurisdiction over public companies stems from the Securities Commission Act 1993 where all public companies seeking to issue or offer securities are to submit their proposal to the Securities Commission for approval. The penalties for failure to submit the proposals for approval or for submitting false and misleading information in connection with the application is severe - fine of 10 million ringgit or a term of imprisonment of 10 years. The Securities Commission also administers the insider trading provisions under the Securities Industry Act 1983 and amendments to the provisions in early 1997 now allow the Commission to institute civil action against the insider the recover the profit or loss avoided by the insider and to impose a civil penalty of up to RM500,000. The powers of enforcement and investigation of the Commission have been enhanced by the introduction in early 1997, of new sections 99A, 99B, 99C and 99D Securities Industry Act 1987. Section 99A now allows the Commission to require a person to disclose the names of persons on whose behalf any dealings in securities are carried out. Section 99B makes it a duty of the chief executive and the directors of a corporation to disclose their interests in securities to the Commission. Section 99C allows the Commission to apply to the Court to disqualify a Chief Executive or director who has been declared a bankrupt or who has contravened a provision of securities laws or who has been convicted of a crime by a Court of law. Section 99D enables the Commission to require a listed corporation to submit its annual audited accounts and periodic financial reports to the Commission.[76]

The Kuala Lumpur Stock Exchange is the primary enforcer of its listing requirements. Section 11 of the Securities Industry Act 1983 alters the contract between the Exchange and listed entity by empowering the Exchange to enforce its rules, not merely against the listed entity, but includes the directors of the listed entity and any person to whom the listing rules are directed at[77]. The section also sets out a very impressive range of actions and penalties the Exchange may impose for breach. They include one or more of the following actions –

- Directing the person in default to comply with or give effect to the rules;
- Impose a penalty which shall be commensurate with the gravity of the offence but the penalty shall not exceed one million ringgit;
- Reprimand the person in default.

The section also empowers the Securities Commission to enforce the listing requirements of the Exchange directly.

[76] **Enforcement data for the Securities Commission.** The Securities Commission's Annual Report for 1996 reports that a "few big cases involving public listed companies and companies going for public listing were successfully investigated. A company going for public listing had its listing on the Exchange revoked for giving a misleading statement to the public regarding its Bumiputera shareholding. In another case, the Managing director as well as the listed company itself were charged in Court with issuing a false and misleading statement to the public regarding its profit forecast". Significantly the Securities Commission instituted the country's first criminal prosecution for the offence of insider trading with unsuccessful results. The case is currently pending appeal.

The Securities Commission's Annual report 1997 refers to one case being investigated under section 32 of the Securities Commission Act 1993 for false or misleading submissions to the Commission. There were a total of 26 complaints received for improper conduct by public listed companies out of which three cases were closed and one referred to other agencies. The statistics do not say how many of those resulted in prosecution or whether any action was taken. The description of prosecution action however does not indicate that any criminal action was commenced for improper conduct by public listed companies.

The investigation and prosecution data for 1997/98 is not available at the time of writing.

[77] Section 11(2)(e) Securities Industry Act 1983

Copyright © OECD All rights reserved

D MANAGEMENT OVERSIGHT

In Asia ex Japan, dispersed shareholding and management control is uncommon. Ownership concentration is the order of the day. The issue of board oversight over management takes on greater meaning, for when one talks of the oversight role of the board, it is with reference to its ability to form an effective check not only against management (as in the executives and officers of the company) but mainly against abuses by controlling shareholders who are inevitably the managers of the company or who are in a position to control management.

There are several mechanisms or structures that are in place to ensure that management and controlling shareholders act prudently to use investor's assets in the best interests of the company or that shareholders do not abuse their control powers against the interests of minority shareholders of a company. Perhaps the most significant mechanism or structure may be found in the provisions that vest certain decision making authority in the general meeting of shareholders. This check against the broad powers conferred on the board, relies on shareholders voting requirements and this is utilised particularly in the context of related party transactions. Shareholder level protections are generally more effective than board-level protections but more costly. But the more effective the board is in serving shareholder interests, the fewer the decisions that should require shareholder action. Towards this extent there are provisions in Malaysia that attempt to strengthen the effectiveness of the board's oversight function through basic prescriptions on board structure and composition including prescriptions mandating the presence of independent elements on the board, provisions relating to the appointment and removal of directors and the imposition of strict and onerous duties of directors.

Board structure and composition

By way of background, Malaysian boards are essentially unitary in nature. The proposed Malaysian Code of Corporate Governance stresses this point when it sets out as the first principle of corporate governance - *"Every listed company should be headed by an effective board which should lead and control the company."* This stresses the dual nature of the board. Boards are generally made up of a combination of executive directors and non-executive - the latter are meant to exercise independent judgement on the board. And in this respect, there is no requirement (or practice) to represent stakeholders (other than shareholders) on boards, such as employees, creditors or major clients/suppliers. The Kuala Lumpur Stock Exchange/Price Waterhouse corporate governance survey indicates a reasonably proportionate mix of independent non-executive directors, non-executive directors and executive directors. Almost all (90%) of companies have at least in name, 2 independent directors of which half (49%) have two independent directors and nearly a quarter (23%) have 3 independent non-executive directors.

There is very little regulation of the structure and composition of boards. The Companies Act 1965 requires every company to have at least 2 directors. The KLSE Listing Requirements essentially require of two independent directors on boards of every public listed entity. Rule 9 the Listing rules sets out the criteria for independence –

" The composition of the board of directors should reflect the ownership structure of the company. Every listed company should have independent directors, that is, directors who are not officers of the company; who are neither related to its officers nor represent concentrated or family holdings of its shares; who in the view of the company's board of

Copyright © OECD All rights reserved

directors, represent the interests of all public shareholders, and are free of any relationship that would interfere with the exercise of independent judgement."

The term independence in the listing rules refers to two crucial aspects. First independence from management and second, independence from a significant shareholder. The purpose of this constraint on a significant shareholder's ability to elect the board, is to ensure at least in general terms that there is a component of the board, at least in numbers, generally reflecting the investment of the public or the minority shareholders in the company, which is not related to the significant shareholder.

The Kuala Lumpur Stock Exchange is currently considering a proposal to expand the definition of independence as embodied in Rule 9 to exclude substantial shareholders.[78] There is a risk however that this proposal may disenfranchise the very group of people who have the most incentive (because of their large shareholding) to ensure that their rights are not abused.

Beyond this there is very little regulation of board composition, not unlike the position in most other jurisdictions. In fact, countries with Codes of Best Practices deal with this issue as a matter of best practice. The corollary is that directors should be prepared to disclose in the annual report as well as the notice of meetings embodying the resolution for their re-election, which of the directors are considered to be independent and be prepared to justify their view if challenged. The proposed Malaysian Code on Corporate Governance adopts that approach. It introduces a form of proportional representation by requiring that 1/3rd of the board should comprise independent directors, and in fulfilling this requirement, the board should include a number of directors, which fairly reflects the investment in the company by the shareholder other than the significant shareholder.

This is supplemented with a requirement for the board to disclose on an annual basis whether 1/3rd of the board is in fact independent and whether board composition fairly reflects the investment of minority shareholders of a company. This essentially leaves it to the market to judge the composition and effectiveness of the board. It relies on investors to take a positive interest in the composition of boards of directors, whether there are appropriate checks and balances, and to the appointment of a core of non-executives of the necessary calibre, experience and independence.

Board committees

Again boards are essentially free to set up whatever committees they see fit to facilitate the management and supervision of the committee. The only committee that is mandated is the audit committee. The Listing rules of the KLSE require all listed companies to have audit committees comprising 3 members of whom a majority shall be independent. The rules also set out the minimum functions of the audit committee. The proposed Malaysian Code on Corporate Governance fleshes out the specific best practices within the general KLSE rules. The Kuala Lumpur Stock Exchange/Price Waterhouse Survey provides some insight into the profile of audit committee members set out in the following table –

Table

[78] Substantial shareholding is a defined term in Malaysia and recent revisions to the Companies Act 1965 (Companies (Amendment No.2) Act 1998 now define a "substantial shareholder" as a persons who has interests in 2% of the voting shares in a company.

Copyright © OECD All rights reserved

Representation	Majority	About Half	Minority	None	No Answer
Financial professionals	20%	17%	37%	21%	5%
Legal professionals	6%	8%	23%	52%	11%
Retired Industry Leaders	7%	6%	17%	61%	9%
Retired Senior Government Officials	9%	6%	32%	45%	8%

Some listed companies in Malaysia have an internal audit function though law does not mandate this. The Price Waterhouse/ KLSE survey suggests that about 68% of companies that responded to the survey have internal audit functions and 33% out of those have outsourced this function.

In addition to the audit committee, typical issues to be delegated to committees of larger public companies include nominating directors (this is alluded to below) and the compensation and remuneration of directors and senior management. While the concept of a remuneration committee is said to be relatively new in Malaysia, the results of the KLSE/Price Waterhouse survey on corporate governance indicates that one in 5 companies already have remuneration committees in Malaysia. No data is provided on the membership of these committees. The proposed Malaysian Code on Corporate governance, stresses the need for companies to establish a formal and transparent procedure for developing policy on executive remuneration and suggests in this respect the setting up of remuneration committees, comprising wholly or mainly of non-executive directors to recommend to the board the remuneration of executive directors in all its forms drawing from outside advice if necessary. The membership of the remuneration committee should be disclosed in the director's report. The proposed Code also requires companies to disclose in the annual report, the details of remuneration of each director.

Appointment and removal of directors

Appointment of directors - The process for appointment of directors in Malaysia is essentially controlled by directors. The articles of association of a company essentially govern the process of appointment and removal of directors. Directors may be appointed by shareholders at a general meeting or by the board of directors. In practice most directors are appointed by directors themselves for filling a casual vacancy or as an additional director by virtue of the powers granted to them under Article 68, Table A of the Companies Act 1965. Any directors so appointed shall hold office only until the next following AGM and shall then be eligible for re-election. Further rule 305 of the Listing Rules requires that any director appointed by the Board to fill a casual vacancy shall hold office until the next AGM and shall be eligible for re-election. Despite the requirement to take all "in between

Copyright © OECD All rights reserved

appointments" to the general meeting, boards essentially control the selection of directors, unless the company is controlled by a significant shareholder, in which case he controls the board.

In every appointment there are forms that are required to be lodged with the Registrar of Companies. In the case of listed companies, Rule 30 of the KLSE Listing Requirements require KLSE to be notified of the appointment as soon as practicable. Section 99D(2)(c) Securities Industries Act 1983 now requires notification of appointments of directors and Chief executives of a company to the Securities Commission. It is evident therefore that while the law sets out notification requirements for the appointment of directors to the relevant authority, it does not prescribe the selection process.

The proposed Malaysian Code on Corporate Governance attempts to strengthen the selection process somewhat by recommending that non-executive directors should be selected through a formal and transparent process. The suggested formal process - a nomination committee, with the responsibility for proposing to boards any new appointments, whether of executive or non-executive directors. The proposed nomination committee should have a majority of independent non-executive directors and should be chaired by such a director. The Executive summary of the KLSE/Price Waterhouse corporate governance survey indicates that only about 20% of companies that responded to the survey had a structured process for selecting independent non-executive directors, and amongst them, the majority (81%) involved the Board as a whole.

Removals of directors - Section 128 Companies Act 1965 preserves the right of shareholders to remove directors. It allows members to remove directors any time during his term of office regardless of provisions to the contrary in the memorandum or articles of association of a company. Special notice is required of any resolution to remove a director or to appoint someone else in his place. While this provision is crucial, the law does not safeguard against capricious removals by significant shareholders. While the company removing a director is required to notify the KLSE of the removal, it is not bound to give reasons for the removal. Additionally the rule should require the company to forward to the KLSE a copy of the written representations of the director, not for purposes of re-instating the director BUT to act as a valuable source of information to the KLSE in its enforcement efforts. Similarly the listing rules should state clearly the right of a resigning director or a director declining to stand for re-election to bring to the notice of the KLSE the circumstances which that resigning director or director declining to stand for re-election thinks ought to be made known to the authorities. This would act as a check against capricious removals by controlling shareholders for while the law encapsulates the fundamental right of a shareholder to remove a director, it does not insulate an independent director from capricious removals.

There are further provisions in companies and securities legislation that allow for the Registrar of Companies and the Securities Commission to apply to court to disqualify a director. Section 130A of the Companies Act 1965 provides for disqualification of directors

Copyright © OECD All rights reserved

of insolvent companies. An application for disqualification may in this respect be made by the Registrar of Companies or the Official receiver. Section 99C of the Securities Industry Act 1983 allows the Securities Commission to commence disqualification proceedings against a director where the director has been convicted of an offence under securities laws or has had civil action taken for breach of certain provisions of the Securities Industries Act or any action as set out in the Act for breach of the provisions of the listing rules. This provision came into effect 1st quarter of 1998 and has not been utilised as yet.

Critique

All of the provisions directed at board composition and structure are designed to introduce structural constraints (against the ability of management and the board to act opportunistically and at the expense of minority shareholder rights). There is certainly an increased reliance on independent directors to provide the necessary checks and balances when board powers of management are conferred on these directors. There are three potential areas for improvement in this context –

- The criteria for independence
- The methodology or proposed methodology to achieve independent board representation
- Finally the extent of empowerment of these independent directors - i.e. are they empowered sufficiently on boards or to put it in another way, are they vested with sufficient authority to approve corporate transactions, which could include, for example, self interested transactions by interested directors.

The criteria for independence - The proposal by KLSE to exclude substantial shareholders from independent participation on boards can have the effect of disenfranchising a significant group of persons with a strong incentive (as a result of their large shareholding) to ensure that their rights are not aggrieved by the conduct of the controlling shareholder. Collective action problems preclude effective monitoring by small shareholders. But large shareholders, in defending their own self interests will often defend the interests of small shareholders as well. Therefore to exclude these persons or their nominees from the definition of independence and thereby from the various board committees that mandate the presence of an independent majority seriously erodes the ability of large outside shareholders to make it harder for the insiders of a company to ignore or deceive a minority shareholder.

The methodology - The proposed method under the Malaysian Code essentially requires a nominating committee comprised of a majority of independent members to select board members and then leaves it to the marketplace to judge the effectiveness of board composition and independent participation on the boards. This pre-supposes an active and critical shareholding community that is able to evaluate and judge governance disclosures by

Copyright © OECD All rights reserved

companies. Its effectiveness turns to a considerable extent on the policing ability of investors, namely institutional investors. However institutional activism in Malaysia is still at very infant stages and their ability to evaluate these sort of governance disclosures and take a view as to their level of independence, while it should be developed, may not be sufficiently mature.

Some countries allow for cumulative voting for directors, which in principle gives more power for minority shareholders to put their representatives on the board of directors. Malaysian law does not provide for cumulative voting.[79] Under cumulative voting a shareholder is allowed to cast all their votes for one candidate standing for election on the board of directors. It is described as a critical feature in linking shareholder level and board level constraints for it allows large minority shareholders to elect their representatives onto the board. Black and Kraakman in their article – A Self Enforcing Model of Corporate Law endorse cumulative voting suggest that the "presence of some outside directors who truly represent shareholders' interest can, over time, influence how all directors understand their role in the corporate entreprise…cumulative voting is part of a broader effort in the self enforcing model [of corporate law] to promote behavioral norms that have served developed countries well."

It must be noted that whilst cumulative voting can strengthen the monitoring power of large minority shareholders, it is of little direct help to retail shareholders. The idea however is that by electing their representatives onto boards, this mechanism is able to offer partial protection to small shareholders. All shareholders benefit if large minority shareholders are able to monitor management performance and control self-dealing by controlling shareholders. Bearing in mind the heavy reliance on independent directors to take the lead in management oversight, there is a strong case for statutory intervention to strengthen the process by which independent directors are given a presence on boards.

The extent of empowerment of independent directors - Section 131 Companies Act 1965 requires every director of a company to disclose to a meeting of the directors any interest, direct or indirect, which they may have in a contract or proposed contract with the company. Section 131 requires disclosure only to the meetings of the directors and not to the general meeting. The interested director must disclose not only that he was interested, but also the nature of his interest. The amount of detail required to be disclosed depends on the nature of the contract or arrangement proposed and the context in which it arises. The disclosure should be made 'as soon as practicable after the relevant facts have come to' the knowledge of the interested directors. To supplement the statutory requirement of disclosure, the articles of a company may prohibit a director from voting on any contract or proposed contract with the company in which he is interested.[80] The secretary of the company must

[79] But note however that the proposed Malaysian Code on Corporate Governance attempts to introduce a form of proportional representation. It does not mandate proportional representation but aims to require companies to disclose the extent of compliance with the prescriptions of the Code and in this context, with its prescription that 1/3rd of the board should be independent of management and a significant shareholder.

[80] The articles of a company may also provide that the office of a director shall become vacant if he is directly or indirectly interested in any contract or proposed contract with the company and fails to declare the nature of his interest in manner required by the Act.(See Table A 72(g))

Copyright © OECD All rights reserved

record every declaration in the minutes of the meeting at which it was made: s 131(7). Failure to disclose by a director under s 131 is an offence that carries with it a heavy penalty: s 131(8).[81]

Therefore while directors are required to make disclosures, the law does not mandate that they abstain from voting. The advantage of bolstering the level of independence of the board and the ability of independent directors to effectively scrutinise board decisions is that it may be an effective alternative to check the tendency to increasingly vest in the shareholders. There is therefore a strong case for the existing legal provisions to require an interested director to abstain from voting in transactions that he has an interest in.

Duties and responsibilities of directors

Section 132 (1) Companies Act 1965 imposes upon directors, the general duty "**to act honestly and use reasonable diligence in the discharge of the duties of his office**". The phrase "act honestly" in section 132 has been defined in the Victorian case of Marchesi v Barnes & Keogh[82] as follows –

'To "act honestly" refers to acting bona fides in the best interests of the company in the performance of functions attaching to the office of the director.'

Directors are also subject to a myriad of general law duties. Subsection (5) of section 132 preserves all of the common law and equitable duties relating to directors. These form the

[81] On the issue whether a contract entered in contravention of s 135 will be void or voidable. In *Tan Bok Seong v Sin Bee Seng & Co (Port Weld) Sdn Bhd & Ors[1995]CSLR vi* the High Court rejected the argument that contravention of s 131(1) and (5) would render an agreement void under s 24 of the *Contracts Act* 1950.

'To my mind, it is manifestly clear that in enacting s 131(1) and (5) of the Companies Act 1965, Parliament had intended for criminal sanctions to be levied against the directors without providing civil remedies thereunder. This meant that the common law remedy would be available to the company. Under the common law, the contract would be voidable at the option of the company.'

The learned judge went on to hold that the contract would stand even under the following conditions :-
(1) where it is not possible to restore the asset or cash passed under the contract to the company;
(2) where the company has been indemnified against any loss; and
(3) where a third party has acquired rights for value without notice of the prohibited contract and thereby suffer by the avoidance.
Having found that the company did not at all time avoid the contract, it was held that the agreement remained valid. No steps were taken by the company to rescind the agreement and the company allowed that agreement to continue for at least five years. This very act of condoning the existence of the agreement would now serve as an estoppel by conduct. It is now too late in the day and it is not open to the defendants to say that the agreement is now void. It is now settled law that a contract can only be rescinded if the parties can be put in status quo.

[82] [1970] VR 434,438 per Gowans J (Supreme Court of Victoria)

Copyright © OECD All rights reserved

bulk of the directors' duties to the company. These can be categorised into two broad categories– fiduciary duties and the common law duties of care skill and diligence. Other sources of duties include duties arising out of the articles of association of companies and contract.

Scope of directors' fiduciary duties

The law imposes on directors, certain "trustee – like" duties. These can be broadly classified into the duties to act in the best interests of the company, the duty to avid conflicts of interest with the company and the duty to act for a proper purpose.

Duty to act in the best interests of the company - The duty of the director to act in the "best interests of the company" has been alluded to above. Essentially the term "best interests of the company" refers to acting in the best interests of the body of shareholders as a whole and not the individual shareholders. In practice, nominees of shareholders who sit on the board are essentially there to further the interests of the shareholder responsible for their election onto the board. However a crucial aspect of the duty of the nominee is that he is not entitled to sacrifice the interests of the company in favour of that of his principal.[83] This however appears to be an area of general confusion. There are some directors who erroneously believe that if a particular shareholder is responsible for their election, the director should represent the best interests of that shareholder in his or her corporate decision making. While the term best interests of the company should not be defined to allow for flexibility in interpretation and judicial creativity, there is nevertheless scope for strengthening of the nominee's position through perhaps a statutory requirement requiring that the nominee act in the best interests of the company and not in the interests of the shareholder responsible for his election.

There is also a well established body of law common law to say that the interests of a company may at times include the "interests of creditors" especially where a company is insolvent or approaching insolvency.[84] With respect to employees, unlike the English Companies Act 1985[85] or the Singapore Companies Act[86], our Act does not expressly provide that the directors of a company are to have the interests of the company's employees' in the performance of their functions.

[83] See in this respect, Winslow J's dicta in Raffles Hotel Ltd. v Rayner [1965] 1 MLJ 60 – when he said,

"A company is entitled to the undivided loyalty of its directors. A director who is the nominee of someone else should be left free to exercise his best judgement in the interest of the company he serves and not in accordance with the directions of his patron."

[84] West Mercia v Dodd, Kinsela v. Russell Kinsela Pty Ltd. [1986] 4 ACLC 215

[85] The English *Companies Act* 1985, s 309 provides, inter alia, that:-
'(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.'

[86] Section 159 Singapore Companies Act 1965

Copyright © OECD All rights reserved

No conflict rule - As fiduciaries, directors must not, as a matter of general rule, put themselves in a position where their duties to the company conflict with that of their personal interest. A company has a right to the services of its directors as an entire board. A director who has entered into a contract with his company in breach of his fiduciary duty still remains accountable to the company for any profit that he may have realized by the deal.

The application of the no-conflict rule may be modified by statute. The provisions of section 131 Companies Act 1965 are designed to achieve such a modification by allowing a company to enter into transactions with directors provided that the interest is first disclosed to the board. [87]

There are several embodiments to no-conflict rule.

- *First the duty not to make secret profits.* Because a director is in a fiduciary position, he must not obtain profit out of corporate assets, information and opportunities[88]. The rule is very strict; it is irrelevant that the company itself would not be able to obtain the profit. In the case of *PJTV Densen (M) Sdn. Bhd. & Ors v Roxy (Malaysia) Sdn Bhd(1980)2MLJ 136*, a company entered into a contract to purchase a piece of land for $15,000 and had paid a deposit of $5,000. Subsequently, the land was registered in the names of two of its directors in equal shares. Raja Azlan Shah CJ (Malaya) (as his Majesty then was) in delivering the judgment that that the directors were trustees and they held land in trust for the company since they stood in a fiduciary position to the company. His Lordship then considered and applied the decision in *Regal Hastings v. Gulliver* and held that the allegation that the company lacked the fund to purchase the land and that the directors bought the land with their own money as members of the public was a travesty of the facts. The directors could, had they wished had protected themselves by a resolution of the

[87] It further provides that no disclosure of interest is required where the interest of the director consists only of being a member or creditor of a corporation which is interested in a contract or proposed contract with the first-mentioned company if the interest of the director may properly be regarded as not being a material interest. In addition, a director is not deemed to be interested or to have been at any time interested in any contract or proposed contract by reason only:-

(1) in a case where the contract or proposed contract relates to any loan to the company - that he has guaranteed or joined in guaranteeing the repayment of the loan or any part of the loan; or

(2) in a case where the contract or proposed contract has been or will be made with or for the benefit of or on behalf of a corporation which y virtue of s 6 is deemed to be related to the company - that he is a director of that corporation. s 131(3).

In *Tneu Beh v Tanjong Kelapa Sawit Sdn Bhd & 3 Ors[1995] 1 CLJ 741*, Siti Norma Yaakob J (as her Ladyship then was) suggested that where all the directors knew about the interest of a director in a contract, the duty to disclose under s 131 could be avoided since the purpose of s 131 was to make all the directors aware of the interests which one or more directors might have in a contract entered into with the company.[87] It was said, “one cannot think that equity requires a ritual of formalities in which the fiduciary must ceremonially confess his sin in order to be able to receive absolution.”

[88] Corporate opportunity is also regarded as a corporate asset which the directors cannot appropriate to their own use.

Copyright © OECD All rights reserved

shareholders in general meeting. In default of such approval, the liability of the directors to account must remain.

- *Second - Directorship in rival companies -* Generally speaking, a fiduciary without the consent of the beneficiary will be strictly precluded from competing with him. At common law, it appears, that in the absence of any provisions in the memorandum or articles or any express agreement to the contrary, a director of a company is generally at liberty to be a director of a competing company. The common law position is slightly modified by our Act, s 131(5), provides, inter alia, that:-

'(5) Every director of a company who holds any office whereby whether directly or indirectly duties or interests might be created in conflict with his duties or interests as director shall declare at a meeting of the directors of the company the fact and the nature, character and extent of the conflict.'

The liberty of a director to hold similar office in a rival company does not apply where there is prohibition in the memorandum or articles restricting a director from having holding offices involving duties or interests in conflict with his duties or interests as a director.[89] If the director acts in breach of the prohibitions not to hold competing directorship, it appears that an interim injunction may be obtained restraining him from dealing with the company's confidential information or trade secrets. In any case, when one is a director of two rival companies, it is difficult to envisage how he could discharge his duties in complete good faith to both. He is walking a thin line and is at risk of breaching his fiduciary duty to act in the best interests of a company if he subordinates the interests of the one company to those of the other.

***Duty to act for a proper purpose*.**

It is plain law that director are under a duty to act bona fide in the interest of the company as a whole and not for any collateral purpose. Where directors are conferred with discretion, the particular purpose for which the discretion is being exercised must be one of those purposes for which it was conferred. The majority of the cases in this area involved the directors issuing new additional shares in an attempt to defeat take-over bids. But the powers of the directors to issue new shares are qualified under section 132D Companies Act 1965 which provides that, notwithstanding any provisions in the memorandum or the articles of a company, directors must not issue new shares without the prior approval of members in general meeting.

[89] Section 131(8) Companies Act 1965

Copyright © OECD All rights reserved

Directors' duties of skill, care and diligence

There is a striking contrast between a director' heavy fiduciary duties and their relatively light obligations of skill and diligence. Unlike the robust approach when adjudicating on questions of loyalty and good faith, courts display a reluctance to interfere with a director's business judgement and take a lenient view of their duties of care, skill and diligence. Courts are also perhaps conscious of substituting their hindsight for a director's foresight and are therefore unwilling to condemn directors, though events have proved their decisions to be wrong. Section 132(1) Companies Act 1965 sets out the duty of the director to "use reasonable diligence in the discharge of the duties of his office." The common law spreads the requirement wider with its duty of skill and care as set out in the landmark decision of Romer J in *Re City Equitable Fire Insurance Co Ltd [1925] Ch 407*:-

Duty of skill – Basically, a director need only to exhibit the degree of skill that is reasonably to be expected form a person with his knowledge and experience. This comprises both of an objective and subjective test. The benchmark is that of a reasonable person with his knowledge and experience.

Duty of care – While it may be unfair to expect an unqualified person to show much skill in the performance of his duties as director, there is no excuse however for a person who accepts the post as director not to be careful. The following general principles may be gleaned form the cases –

- A director must take trouble to discover what his rights and obligations are under the articles and the law.

- A director must delegate their powers and trust their delegatees, in the absence of circumstances that would excite the suspicion of a reasonable man. If the directors of a company are not able to distribute the day to day business function to the officers whom they can trust, the business of the company could not go on and they would be incapable of taking more abstract, important decisions at board level. A director is justified in trusting officers of the corporation to perform all duties that having regard to the exigencies of business, may properly be left to such officers.

- A director is generally not responsible for the acts and omissions of his co-directors even if he did not attend board meetings. He is not responsible for loans made in his absence or things done in his absence from board meetings generally.

Copyright © OECD All rights reserved

Duty of diligence – While directors are generally not responsible for acts or omissions of his co-directors at times when he does not attend board meetings, he may nevertheless be liable under his duty to exercise diligence when performing his duties. Romer J in *Re City Equitable Fire Insurance* stated that a director was not bound to attend all but had qualified the statement by saying that a director ought to attend board meeting 'whenever, in the circumstances, he is reasonably to do so. There is authority which illustrates that continuous non-attendance at meetings may render a director guilty of the breaches of trust which are committed by others. Table A, article 72(f) provides that the office of a director shall become vacant if the director for more than six months is absent without permission of the directors from meetings of the directors held during that period.

Strengthening of duty of care, skill and diligence

There has been a heightening of duty of care and skill as judges are more aware of the growing complexities of modern commerce and also the importance of interest of a well managed corporation. In *Commonwealth of Australia v. Friediech* (1991)5 ACSR 115;9ACLC 946 the Court suggested that it would be incumbent for directors to be capable and able to understand the company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity. In one English decision a high court judge held that it is expected that a trained accountant had to take a special care when signing cheques. Notwithstanding this development it is nonetheless the legal position that a director need display no special skill and that the policy of law continues to permit a wide range of persons to be appointed on the boards of directors. In Malaysia these judicial trends will not go unnoticed and may find its application when the Courts are asked to decide on analogous cases and circumstances.

Other statutory duties of directors

Directors are also subject to various other disclosure obligations under law. Section 135 Companies Act 1965 sets out the general duty of directors to make disclosures. These include disclosures with respect to the directors interests in the company or a related company, any changes in those interests, to name a few. The consequences for breach of this provision is criminal and the penalty, imprisonment for a term of 3 years or a fine of fifteen thousand ringgit. Section 99B of the Securities Industry Act 1983 similarly provides that a chief executive and a director of a listed company must disclose to the Securities Commission, his interest in the securities of a listed entity or any related corporation of the listed entity. This provision carries much stiffer penalties – imprisonment for a term of up to 10 years and a fine of up to RM 1 million.

Critique

Copyright © OECD All rights reserved

And while directors are subject to all of these duties, there is room for strengthening and clarification of these duties. Critical areas in this connection would include –

1. ***Clarification of the duty to act honestly*** – The duty to act "honestly" should be reformulated to require a director to act "bona fides in the best interests of the company." The problem with the existing formulation of the duty to act honestly is that it could be misconstrued by some to require some element of wrong doing or fraud.

2. ***Clarification of the position of nominee directors*** – essentially a person who has a major stake in a company will appoint someone whom he trusts onto the board to keep an eye on his investments. However a crucial aspect of the duty of the nominee is that he is not entitled to sacrifice the interests of the company in favour of that of his principal.[90] This however (as suggested above) appears to be an area of general confusion. There are some directors who erroneously believe that if a particular shareholder is responsible for their election, the director should represent the best interests of that shareholder in his or her corporate decision making. It is suggested that there should be legislative clarification that a nominee's duty to his principal is always subject to his duty to act in the best interests of the company.

3. ***Codification of the fiduciary duty of directors to avoid conflicts of interests*** – There have been numerous criticisms leveled against the practices of directors that give rise to conflict. For example the practice of operating businesses in competition with the listed entity, taking advantage of contracts belonging to the listed entity, disposition of non-performing assets to the listed entity while taking over performing assets at below market value, the practice of interested parties voting on transactions in obvious conflict of interest. These practices have played a significant role in undermining confidence in the Malaysian capital markets. And while there are numerous fiduciary principles under common law to deal with these abuses the problem with common law is that it is difficult to distil a clear set of rules for directors to operate by. The rules operate by reference to the particular facts of the case in question.[91] There are several provisions in the Companies At 1965 which reinforces the common law obligations.[92] But these do not cover the full range of common law duties and obligations. Codification of this duty would set out a clear set of provisions for directors to operate by. Such a provision should set out minimum procedures that directors should adopt in conflict situations which should

[90] See in this respect, Winslow J's dicta in Raffles Hotel Ltd. v Rayner [1965] 1 MLJ 60 – when he said,

"A company is entitled to the undivided loyalty of its directors. A director who is the nominee of someone else should be left free to exercise his best judgement in the interest of the company he serves and not in accordance with the directions of his patron."

[91] To quote Laskin J in Canadian Aero Services Ltd. v O'Malley – "new fact situations may require a reformulation of an existing principle to maintain its vigour in the new setting."

[92] For example section 132E prohibits a director from entering into substantial property transactions with a company, without the approval of members, section 131 makes certain disclosures of interest mandatory, section 133 prohibits companies other than (exempt private companies) from making loans to its directors.

Copyright © OECD All rights reserved

include, full disclosure of the conflict, the interested director should abstain form voting and that the ability of the Court to enquire into the fairness of a transaction should be preserved at all times.

4. ***Strengthening enforcement*** *of fiduciary duties*- As a general rule directors do not owe fiduciary duties to shareholders. For this reason a member cannot sue to enforce a company's right against the directors. The power to institute action in the company's name generally lies with the board. It is practically very difficult for a shareholder to cause the company to commence an action against a defaulting director especially where he controls the board and the company. So typically a company commences action against such a director where there has been a change in management or where he has left the company, which in most instances is unlikely. There is an avenue for minority shareholders to initiate action in the company's name but the practical realities such as the legal costs of funding the transaction as well as the substantive and procedural requirement to institute such an action are generally insurmountable for the minority shareholder. Codification of the fiduciary duties coupled with stringent penalties would go some way towards addressing this problem. Also the threat of statutory enforcement by regulators should prove to be more of an incentive for directors to take their duties seriously. However there is further room to strengthen civil enforcement by shareholders and the recommendation made earlier for the introduction of a statutory derivative action should strengthen the avenue for civil enforcement action.

Copyright © OECD All rights reserved

E OTHER INTERNAL MECHANISMS

Company secretaries

Every company in Malaysia must have one or more company secretaries who must be resident in Malaysia.[93] Section 139(3) provides that the company secretary shall be appointed by the directors. The Companies Act also requires all company secretaries to be a member of a professional body prescribed by the Minister for Domestic Trade and Consumer Affairs and licensed by the Registrar of Companies.[94]

Section 4 Companies Act 1965 deems a company secretary to be an officer of the company.[95]The company secretary is therefore subject to liabilities as an officer, which include, among other things, liability under section 132(2) Companies Act 1965 for misuse of corporate information and section 132A of the same for insider trading. The company secretary is however not part of management and has no power therefore to make commercial decisions on the company's behalf.

The role of a company secretary is not an easy one to describe, for there are great variances. Their duties are to a large extent not fixed by law but are generally those assigned to them by the articles or contracts of employment. Also it is not uncommon for legal officers, finance officers and in some instances corporate finance officers of a company to double up as company secretaries, In smaller companies directors may concurrently act as company secretaries.

At its core, the secretary's function is basically to handle all the paperwork and procedural matters that running an incorporated company involves. They essentially undertake the company's responsibilities for keeping the registered office open and accessible

There is also the developing role of the company secretary in terms of advising the board and chairman of their compliance obligations. The Cadbury Committee for example looked to company secretaries to advise the chairman and the board on issues pertaining to implementation of the Code of Best Practice. The proposed Malaysian Code of Best Practices certainly takes this line by requiring that all directors should have access to the advice and services of a company secretary. This may in time facilitate a gradual and incremental shift towards increasing their range of responsibilties towards a wider advisory function. This then follows through to a crucial role in encouraging compliance with the law. Certainly what could "kick start" the process is if directors are obliged by law to inform themselves, to the extent they deem appropriate of the subject matter before them.

Independent share registrars

The law does not mandate the existence of an independent share registrar in the sense that they are required to be independent of the company or that they cannot be simply removed. However while the risk of abuse exists, to date the performance of share registrars in companies has generally been satisfactory.

External auditors;

---

[93] Section 139(1) Companies Act 1965

[94] Section 139B Companies Act 1965

[95] Directors are also officers under section 4.

Copyright © OECD All rights reserved

External auditors are meant to provide an external and objective check on the way in which financial statements have been prepared and presented. However, the framework under which auditors operate is not well designed. For instance, accounting standards and practice allow boards too much scope for presenting facts and figures in a variety of ways. Whilst shareholders formally appoint auditors and the audit is carried out in their interests, shareholders have no effective say in audit negotiations and no direct link with auditors. Auditors instead work closely with management. Breaking out of the closeness of the relationship is difficult, as auditors have no easy line of communication with the shareholders to which they report. Audit firms also compete for audit work. There is, therefore, a significant amount of pressure for an auditor to reduce the scope of the audit to the minimum necessary. The situation is made worse by the apparent use by some auditors of "lowballing" or "predatory pricing" practices using audit as a loss leader for other more lucrative non- - audit services.

Steps have been taken to improve the audit system. The Financial Reporting Foundation and its Associated body, the Malaysian Accounting Standards Board have been set up to improve and tighten accounting standards, to give these standards the force of law and to facilitate enforcement of these standards through companies. This is a very important step for accounting standards provide important reference points against which auditors exercise their professional judgement. Certain other aspects of the framework that could be strengthened include the following –

There should be full disclosure of fees paid to audit firms for non-audit work. The problem with non-audit work is that where auditors undertake non-audit services, it will increase the value of the firm to the auditorship and thus make the auditors more reluctant to do any thing which will render it likely that the board of directors will seek to get rid of them as auditors. Full disclosure of fees will enable the relative significance of the company's audit and non-audit fees to be assessed. As such subparagraph 1(q) of the 9th Schedule Companies Act requirements in respect of disclosures in profit and loss accounts, should be extended to include disclosure of fees paid in respect of non- audit work.

Auditors as watchdogs

The primary responsibility for prevention and detection of fraud or other illegal acts on the part of the company rests with the board as part of its fiduciary responsibility for protecting the assets of the company. The auditor's responsibility is essentially to properly plan, perform and evaluate his audit work so as to have reasonable expectation of detecting material misstatements in financial statements. Subsection 174(8) CA places a statutory duty on an auditor to report in writing to the Registrar of Companies, where in the course of performance of his duties an auditor of a company **he is satisfied** that;

That there has been a breach or non-observance of any of the provisions of the Act;

The circumstances are such that in his opinion the matter has not been or will not be adequately dealt with by comment in his report on the accounts or consolidated accounts or by bringing the matter to the directors of the company or if the company is a subsidiary, of the directors of the holding company.

Failure to do so carries the penalty of imprisonment for two years, or thirty thousand ringgit or both. The obligation to report is triggered when the auditor **is satisfied** that a breach of the

Copyright © OECD All rights reserved

Act has occurred and where he has no confidence that the directors will deal adequately with the matter.

There are several problems associated with this duty. The term "he is satisfied" introduces a subjective element to the duty to report. Also on a practical level, breaches of the law and especially in cases of fraud, if it involves forgery, collusion or management override of control systems is hard to detect. Also where they suspect that top management or the board itself is implicated in a illegal act but they do not have the necessary evidence to back up their suspicions, they are not in a strong enough position to confront the management or executive directors, nor have they a case to report to the authorities, as they only have a suspicion of wrongdoing and not that a breach has taken place.

There is a strong case for the section to be amended to enable auditors to report matters that in **his professional opinion** constitute breach of the CA. This provision should be supplemented with a provision in the SIA placing a similar obligation on auditors in respect of breaches of securities laws and listing requirements of Exchanges. The advantage to this phrasing is essentially that auditors are held to a more objective standard by which a decision to or not to report is assessed against.

VI GOVERNANCE BY LARGE CREDITORS & CREDITOR RIGHTS[96]

As in Germany and Japan, banks in Malaysia play a dominant role in lending. But the Malaysian banks do not play a role in governance, (with respect to the appointment of managers or directors or the choice of investments), because they do not control or vote significant block of shares or sit on boards of directors. As a rule, they vote the7 equity of other investors, namely of their clients, but only under their express instruction.

The banks in the country do play a major governance role in insolvencies. They appoint receivers or liquidators. But for companies which are not insolvent but illiquid and which require to be restructured or rehabilitated, the procedures for turning control over to the banks (including the rules for them to change managers and directors) are not well established. Nonetheless, the legal environment, until recently, was more favourable to the creditors. And in the absence of well-established rules for the rehabilitation of companies, this may have caused firms suffering from illiquidity to be driven into insolvency.[97]

Banks do not play a role in governance save in bankruptcies. But there are some who are in favour of promoting in Malaysia governance based on banks or even state enterprises as large shareholders as an alternative to our current arrangements.

I have some doubts about this recommendation. Banks in Malaysia as well as in Asia are hardly able to take care of themselves. Therefore, it will not be advisable to entrust them with a key role in the governance of listed companies. The loss of focus is likely to make matters even worse. Furthermore, the incentive of a bank in governance is likely to be severely distorted, as its primary interest is in lending. Where it is a significant minority shareholder and exercises control over a

[96] I wish to acknowledge my debt of gratitude to Mr Arun Gupta of the World Bank for educating me to the basics of corporate debt restructuring and reorganisation.

[97] The banks as large creditors combine substantial cashflow rights with the ability to interfere in the major decisions of the firm. This is because of a variety of control rights they receive when firms default or violate debt covenants and in part because they typically lend short term, so borrowers have to come back at regular, short intervals for more funds.

Copyright © OECD All rights reserved

company by voting these shares and the shares of others for which it acts as a proxy, its main interest is in enhancing its own income from its lending and other related activities and not in enhancing shareholder value. Empirical findings in Japan and Germany attest to this and are highlighted by Shleifer and Vishny in their survey article. [8] Where a state enterprise, through its shareholdings in a listed company, plays a role in governance, here too the incentive is likely to be distorted because of the complete divergence between the control and cashflow rights of state enterprise managers. This point is also made very strongly by Shleifer and Vishny.

Malaysia has five options for dealing with financial distress in the corporate sector from outright liquidation to debt restructuring and reorganisation of the company as an ongoing concern. Two of the options have always existed in the Companies Act but the other three options have emerged only this year.

Winding Up Under Companies Act 1965 (Act 125)

Part X (Sections 212 through 318) of the Act deals with winding up of companies. This part deals essentially with a terminal procedure where the intention is to liquidate and close the company. Under these provisions creditors can petition the High Courts to wind up a company because of failure to pay its debts. The Act provides for appointment of a liquidator/receiver, defines the powers of the liquidator, establishes the priority and ranking of debt between and within different classes of creditors. The provisions under this part are extensive and provide a clear basis for winding-up.

Schemes of Arrangement and Reconstruction Under Companies Act 1965 (Act 125)

Part VII (Sections 176 through 181) of the Act deals with rehabilitation and restructuring of companies as ongoing concerns. Under this part of the Act, the High Court can permit a compromise or arrangement between a company and its creditors subject to a majority in number representing three-fourths in value of the creditors or class of creditors must agree to a reorganisation/compromise plan. The Court can also issue summary orders temporarily restraining creditors from proceeding against the company.

The option embodied in Section 176 to Section 181 is to permit the preservation of the company as an ongoing concern while enabling creditors to recover monies under compromise and reorganisation arrangements that have legal sanction from the Courts. However, according to experts, there are no well-defined Judicial Management procedures for managing schemes of compromise and reconstruction. Unlike other jurisdictions on which Malaysian company law is based, such as UK, Australia and Singapore, in Malaysia there are no specific provisions or guidelines, the process is cumbersome and the courts have limited experience in supervising reorganisation plans. Some experts have made a case for Malaysia to adopt the regulations in place in similar jurisdictions and to strengthen the capacity within the court system to manage corporate restructuring on an ongoing basis.

During the course of 1998 some companies have misused the provisions of Section 176 to seek from the Courts temporary relief from creditors[98] for periods of up to nine months on a unilateral basis without the company being required to initiate a process of dialogue with its creditors and without the creditors being given a chance to present their case to the court before the relief is granted. As there is a high risk that the company could use Section 176 to pre-empt creditors and strip the company of

[98] By August 1998, 32 companies have sought and received summary relief from creditor actions. During the entire mid 80s economic, corporate and banking crisis, the number of companies accorded unilateral temporary relief was in the single digit.

Copyright © OECD All rights reserved

assets, the Government has now introduced a Bill requiring that a company need the consent of creditors representing at least 50% of its debts before it can apply for court protection and requiring that it submit a list of its assets and liabilities with the application.

The courts have been granting temporary relief from creditors not only to the debtor companies but also to their guarantors. This has been so even where the guarantees have been issued by banks, and even where the bank guarantees require payment on demand. This has disadvantaged the bond holders as many had invested in certain bond issues on the strength of the bank guarantees.[99] This can seriously undermine the credibility of bond markets and undermine its development.

CORPORATE DEBT RESTRUCTURING COMMITTEE (CDRC) PROCESS

Repossessing assets in bankruptcy is often very hard even for the secured creditors. With multiple, diverse creditors who have conflicting interests, the difficulties of collecting are even greater, and bankruptcy proceedings often take years to complete. Because bankruptcy procedures are so complicated, creditors often renegotiate outside of formal bankruptcy proceedings both in the US and in Europe. The situation is worse in developing countries, where courts are even less reliable and bankruptcy laws are even less complete.

Accordingly, from mid August 1998, a CDRC has been established under the aegis and with the secretarial support of Bank Negara Malaysia (BNM), to provide a framework to enable creditors and debtors to arrive at schemes of compromise and reorganisation on a voluntary basis without resorting to legal processes. The aim of this scheme, based on the “London Approach” is to tackle the complex cases of indebtness with outstanding debt of at least RM50 million and with more than three creditors.

The key features of the CDRC framework have been worked out but guidelines which are viewed as credible, transparent and consistent have to be developed to encourage the use of the voluntary process. To assist in this process, and in the absence of a long tradition of cooperation between participants, the CDRC has to first concentrate on those cases which will help it to develop and set these guidelines and which can then be used even for the more complex or controversial cases. All

[99] As at end August 1998, the Rating Agency of Malaysia (RAM) published ratings to the tune of RM46.24 billion. Of this amount, close to 40% or RM17.07 billion are bank guaranteed and of the papers guaranteed, about half (i.e. RM8.15 billion) are issued by less credit worthy companies or what RAM considers as having below investment grade ratings on a stand alone basis.

Also by end August 1998, RAM had 13 outstanding issues totalling RM1.48 billion by 12 different issuers under Section 176 protection. Of these, 10 are bank guaranteed, two are corporate guaranteed and one is a non-guaranteed mortgage bond. These companies include those that have applied for and obtained a direct restraining order and those that have its subsidiaries included in its court orders.

See RAM, “Section 176: An Impact Analysis”, RAM Focus, Issue No. 9, September 1998.

Copyright © OECD All rights reserved

efforts must be taken to ensure that there is full disclosure and sharing of information with all creditors.

There are also several specific issues that warrant further deliberations by BNM and the CDRC. To motivate creditors and debtors to use this voluntary process, its legal basis has to be established. For instance, the CDRC process provides for a "standstill" period of 60 days during which a moratorium is imposed on recall of loans and enforcement of security interests. The question is, can the CDRC impose this in a legally binding manner? Another key issue is, what majority rule would be used to reach an agreement over the restructuring plan and who would be eligible to vote? Further, the restructuring process may entail a change in the capital structure (for example a debt-equity conversion), a change in ownership and control (such as a removal of existing directors, injection of outside equity and management), a change in activities or may involve a merger. A number of laws will thus have a bearing on the restructuring process. To prevent the problem of overlapping and multiple jurisdictions and to prevent a restructuring from being incompatible under a particular law, the Government must undertake a review of the various rules and regulations or be prepared to remove any inconsistencies.

ASSET MANAGEMENT COMPANY OR DANAHARTA

Danaharta has been established in 1998 to acquire non-performing loans from banks and assets from distressed companies to minimise the problem of a credit crunch as well as to facilitate an orderly payment/write-down of debts. It will have the same claims as the original creditors and will rely on a number of asset disposal methods (including private placements, public auctions and public tender offers) to recover its claims.

The legal process to be followed by Danaharta aims to compensate for the absence of a well-defined scheme of Judicial Management of corporate restructuring under the Companies Act.[100] The goal is to expedite and shorten the legal procedures and to bring to bear professional expertise in design and implementation of reorganisation plans. The operations of Danaharta are covered under a special act that confers on it broad ranging powers to acquire and manage assets.

---

[100] Danaharta can appoint Special Administrators (SA) that would have a legal mandate to manage and oversee all operations of the distressed enterprise. On the appointment of the SA a moratorium for a period of 12 months (can be extended if necessary) will take effect over winding-up petitions, enforcement of judgements, proceedings against guarantors, re-possesion of assets, applications under Section 176 of the Companies Act.

During this period the SA will prepare a plan for disposal of assets. The plan would be presented to Danaharta who would seek the opinion of an independent advisor as regards the reasonableness of the proposal and the manner in which the proposal safeguards the interest of creditors. Once the approval of the corporation has been received, the SA would convene a secured creditors meeting, seek a majority approval vote and then implement the plan. Plan options could range from restructuring of debts and reorganisation of the borrower as an ongoing concern to disposal of assets through liquidation.

Copyright © OECD All rights reserved

RESTRUCTURING OF SMALL BORROWERS

For corporate borrowers with total outstanding debt of less than RM50 million, the Loan Monitoring Unit at BNM would provide assistance in enabling these borrowers to continue to receive financial support while restructuring their operations. In addition, these borrowers could also use the Danaharta route.

We conclude this section by examining creditor rights in Malaysia based on the LLSV study. Like shareholders, creditors have a variety of legal protections, which also vary across countries. These may include, in line with the analysis of Shleifer & Vishny, the right to grab assets that serve as collateral for the loans, the right to liquidate the company when it does not pay its debts, the right to vote in the decision to reorganise the company and the right to remove managers in reorganisation.

Creditor rights are enumerated in Table V. According to the LLSV study, the protection of creditor rights are more common than the protection of shareholder rights but we state the position of Malaysia only in relation to the common law countries sampled in the LLSV study. Common law countries offer creditors better legal protections against managers. They most frequently (71% of the sample countries including Malaysia and this thanks to the introduction of the recent bill) preclude managers from unilaterally seeking court protection from creditors; they have the lowest (29%) incidence of allowing automatic stay on assets (and Malaysia too does not allow an automatic stay on assets; with one exception (and that exception is New Zealand and not Malaysia) they guarantee that secured creditors are paid first; and they have far and away the lowest (24%) incidence of managers staying on the job in reorganisation proceedings and in Malaysia as well management is replaced by a party appointed by the court or the creditors. According to the LLSV study, the US is actually one of the most anti-creditor common law countries. It allows unimpeded petition for reorganisation, permits automatic stay on assets and lets managers keep their job in reorganisation.

VIIOPTIONS FOR STRENGTHENING CORPORATE GOVERNANCE

1. The advantage of ownership concentration as an approach to governance is that there is a better matching of the control rights of the dominant shareholder with its cashflow rights. Thus there will be a great incentive for that control to be exercised in maximising shareholder value. Therefore, the incentive of the controlling shareholder is more likely to be aligned to the interest of other shareholders. On the other hand, the advantage of dispersed shareholding as an approach to governance is that it enables large wealth holders to minimise risk through diversification. It also makes for more efficiency through the hiring of the best manager. The fact that both approaches to governance is thriving in the developed world suggest that choosing between the two alternatives can be a difficult task.

2. In Asia the more serious problem arises not from large shareholdings but from the more widespread practice of pyramidding and cross-holdings. This causes a major divergence between the control and cashflow rights of insiders. Therefore, the incentive is for insiders to maximise their private benefits of control and not necessarily that of shareholder value. There is thus a higher probability that minority shareholders run the risk of being expropriated or squandered.

3. The managers or controlling shareholders in a company are in a position to expropriate minority shareholders:

Copyright © OECD All rights reserved

- by selling to a connected party the output or an asset of the company at below market price,
- by buying from a connected party an input or an asset at above market price and
- by acquiring an interest in a company connected with a related party at above market price.

1. A sample of the more reputable or larger of the listed companies (comprising 13% of the total in number and over 50% in market capitalisation) showed that the incidence of concentrated shareholding (even as measured by the shareholding of the largest shareholder) is very pronounced in the Malaysian market. The incidence of dispersed shareholding is uncommon. The incidence of interlocking ownership and cross-guarantees between firms in the same conglomerate is low compared to the situation in Japan or Korea. However, concentrated shareholding through a pyramid structure is more widespread. The number of layers between the controlling shareholder and the most distant subsidiary is three, nonetheless it still makes for a significant divergence between control and cashflow rights of the controlling shareholder.

2. A large investor may be rich enough that he prefers to maximise his private benefits of control (including investments in unrelated activities, whether for diversification or for the purpose of empire building), rather than maximise his wealth. Unless he owns the entire firm, the large investor will not internalise the cost of these control benefits to the other investors. This will then be reflected in the failures of large investors to force their managers or companies to maximise profits and pay out the profits in the form of dividends.

6. An examination of the foreign controlled companies, especially those which have a clear majority shareholder, shows that these companies have been paying out a high proportion of their profits in the form of dividends (and not reinvesting the profits in diversified or empire-building activities). Such high dividend payout ratios may have been facilitated by the more healthy relationship between the control rights of the majority shareholder with its cashflow rights.

1. In the case of locally-controlled companies, the control rights were usually well in excess of the cashflow rights of the controlling shareholder, usually because of the pyramid structure of companies in the same group. This could explain their much lower dividend payout ratios and their greater propensity to reinvest their profits even in unrelated activites, at least in part to maximise the insider's private benefits of control.

2. To prevent the abuse of minority shareholders by the controlling shareholders and other insiders, there are legal and regulatory provisions requiring the approval of shareholders on substantial and connected party transactions. However, there are still weaknesses which must be addressed as expeditiously as possible to reduce ownership concentration and increase the reliance of companies on external finance. Therefore the first critical area for reform would be to strengthen the related party provisions in the Companies Act 1965.

Reform of Companies Act 1965 provisions on related party transactions

9. It should be stated at the outset that the Kuala Lumpur Stock Exchange rules on related party transactions are much tighter and better defined, especially the new rule which came into force in July 1998. Reliance on just the KLSE Rules, however, is not satisfactory for the following reasons –

Copyright © OECD All rights reserved

- The range of penalties open to the KLSE to take while impressive, cannot compare with that of the statutory regulator. Section 11 of the Securities Industries Act 1983 provides that in addition to any other action a stock exchange may take under its rules, the Exchange can take the following actions – directing the person in default to comply with the rules, impose a penalty, the quantum of which shall commensurate with the gravity of the breach, provided that it does not exceed one million ringgit and finally reprimand the person in default. The Exchange may under its listing rules also suspend or de-list a company and where the companies are punished through suspension or delisting, one may end up compounding the losses of the injured parties, namely the minority shareholders.

- There have also been doubts expressed as to the extent to which the Listing rules of the KLSE may restrict a shareholder from voting his shares in respect of a transaction that he is directly interested in. The KLSE rules it is felt cannot deny a shareholder that fundamental property right.[101]

- The KLSE does not have the enforcement infrastructure available to a statutory regulator, which would include for example the statutory right to require information, rights of search and seizure that would make its enforcement exercise more effective.

10. The first weaknesses in the Companies Act 1965 provisions with respect to a substantial acquisition or disposal which requires shareholders approval is the definition of what constitutes a substantial acquisition or transaction. The KLSE Rule on a substantial transaction, and in particular, the new rule which came into force from July this year, is more clearly defined. It makes sense for the relevant provisions in the Companies Act to be redefined in a similar manner with respect to such tests as the assets test, profits test, consideration test, consideration to market capitalisation test, and the equity or capital outlay test.

11. The provisions on related party transactions in the Companies Act only requires the transactions to be disclosed and approved by shareholders but the interested parties are not required to abstain from voting. The KLSE Rules, in particular the new Rules, do not suffer from the same deficiency. Therefore, the Companies Act should be amended to require the interested parties to abstain from voting on a connected party transaction.

12. A substantial or interested party transaction should have the prior approval of shareholders. It is not advisable to let a company to enter into a transaction on a conditional basis where approval of shareholders is obtained subsequent to the event. This is because, in the fast-moving or more volatile market environment of today, undoing a transaction (if prior approval is not obtained) may be impossible or may encounter considerable difficulties.

13. With the recent amendments to the Securities Industry Act, penalties for insider trading have been increased to three times the insider's gain. The new civil penalties also allow investors to seek full compensation for loss from the offenders. As substantial and connected party transactions have the potential to inflict more harm on minority shareholders then even insider trading, as amply demonstrated by recent events, the penalties for the breach of legal

[101] Recent amendments to the Securities Industry Act 1983 (Securities Industry (Amendment)(no.2) Act 1998) may now have strengthened the ability of the KLSE to take action the company insider and not merely the listed company, where now the Exchange has the statutory right under section 11(2)(e) to take action against any person to whom the rules or listing requirements of the stock exchange are directed at.

Copyright © OECD All rights reserved

provisions with respect to such transactions should be reviewed and substantially increased. There is also a pressing need for improving the quality of legal enforcement against the breaches of such provisions. The existing penalties against breaches of the KLSE Rules on substantial and connected transactions (which breaches are easier to determine given the greater clarity of the KLSE Rules) do not act as a sufficient deterrent on the offenders. Reliance on some of these penalties may have the unintended consequence of compounding the losses of the injured parties.

14. The provisions on interested or related party transactions in the Companies Act 1965, save for section 132G do not embrace transactions between a company and a substantial shareholder or persons connected with a substantial shareholder. Section 132E for example, only embraces transactions between a company and directors and persons connected to the director. This is potentially a very serious omission for not all substantial shareholders sit on boards and more importantly the law does not prevent a controlling shareholder from effecting a related party transaction to the detriment of the company.

15. On efficiency grounds, a strong case can also be made for the removal of existing prohibitions on certain related party transactions. (e.g. 132G). Instead such transactions should be made subject to the prior approval of shareholders with the interested parties required to abstain from voting.

Facilitating the shareholder's ability to exercise his right to vote

16. A second area for reform, it is suggested is to strengthen the ease with which a shareholder is allowed to vote by providing for voting by mail whether by member or by proxy. Voting by mail overcomes several practical difficulties associated with having to attend general meetings[102]*, not to mention that it is a cheaper and more efficient manner of enabling shareholders to exercise their right to vote. This should be supplemented with provisions mandating longer notice periods and sufficient disclosure of information to give shareholders the opportunity of deciding how they should vote.*

Strengthening the effectiveness of independent director representation on boards

17. There has been a discernible trend in Malaysia to increase the range of matters where decision making authority is reserved to the general meeting of shareholders. But while shareholder level protections may be more effective, they are also more costly than board level protections. But the more effective the board is in serving shareholder interests, the fewer the decisions that should require shareholder decision. In Malaysia there appears to be increasing reliance on independent directors to strengthen the necessary checks and balances when broad powers of management are conferred on

[102] Shareholders may be dispersed all over the country not to mention foreign institutional investors, who may not be based in the country, so that attendance at general meetings would be difficult and costly. Also companies may hold annual general meeting within the same time period which makes it difficult for shareholders to exercise their right to vote unless they go through the legal procedure of designating proxies at the meeting.

Copyright © OECD All rights reserved

directors. There are broadly three areas of improvement that one may suggest to the position of independent directors –

- That any attempt to exclude large shareholders (albeit minority shareholders) from participating as independent board members can have the effect of disenfranchising a significant group of persons with a strong incentive (as a result of their large shareholding) to ensure that their rights are not aggrieved by the conduct of the controlling shareholder.

- One way of harnessing the ability of these large minority shareholders to put their representatives on the board is for the law to provide for cumulative voting for directors. Bearing in mind the heavy reliance on independent directors to take the lead in management oversight and control self dealing by controlling shareholders, a strong case may be made for strengthening the process by which independent directors are given a presence on boards.

- Once on boards, the law should ensure that the independent directors are empowered sufficiently to ensure that they are able to participate effectively. There is scope therefore for section 131 Companies Act 1965 to be strengthened to require an interested director to abstain from voting in respect of transactions that the director has an interest in.

Strengthening the enforcement capability of statutory regulators

18. Another critical area for improvement in lies in strengthening the effectiveness of enforcement action by the regulators. There has been considerable criticism of the speed and effectiveness of enforcement efforts by the various regulators. Critical areas for improvement include –

- Strengthening the autonomy of powers granted to regulators to enforce laws – consistency in enforcement of laws and regulations ensures a level playing field for all participants;

- Rationalisation of the regulatory framework – Fragmentation obstructs enforcement in two critical ways. First it confuses jurisdiction over laws that often lead to regulators struggling to react to situations and often in uncoordinated enforcement activity. A fragmented framework relies heavily on arrangements between regulators. Second, it causes confusion with the public, which then leads to unwarranted but inevitable blame being laid on a regulator, not responsible for regulating that activity, thus further entrenching the perception that regulators are not enforcing the law.

- Modernising the range on enforcement powers of regulators which would include the introduction of a general power that allows the regulator to institute civil action on behalf of an investor to recover damages suffered by the investor as a result of transgressions. This right should be extended to investors to enhance their private enforcement capabilities.[103]

[103] Sections 90 and 90A Securities Industry Act 1983 now provide for the recovery losses caused by insider trading, by way of civil actions instituted either by the Securities Commission or the investor. Contrast the general power given to the Australian Securities Commission under the Australian Securities Commission Act 1989,which allows the Commission to take action in a person's name, where as a result of the investigation, it

Copyright © OECD All rights reserved

- Developing the right experience and skills in enforcement - Priorities should be altered from market development to supervision and enforcement.

- Enhancing the accountability and transparency of regulators – Disclosure of details of enforcement activity and action taken allows the public to evaluate the extent to which the regulators are enforcing laws and the effectiveness of action taken which creates the right incentives for regulators to be pro-active in its enforcement efforts.

Strengthening the private enforcement capacity of investors

19. There is a major deficiency in the ability of investors to institute action against directors for breach of their fiduciary duties. The existing common law provisions on derivative actions have several practical and substantive difficulties that have proven to be almost insurmountable to minority shareholders. There is also considerable uncertainty whether ratification by some shareholders of a director's breach of duty would result in denying other shareholders, the right to bring a derivative action to protect a company. The introduction of a statutory derivative action provides for a more effective means by which a director's duties to a company may be enforced. This would increase private enforcement in the long run and reduce the need for public or regulatory interference. The Australian Corporate Law Economic reform programme views the statutory derivative action as a valuable tool to enhance corporate governance and enhance investor confidence.

20. The five areas set out above, are critical areas for reform in the immediate term. In the medium to long term, the following paragraphs set out key actions to be taken.

21. The development and implementation of a Code of Best Practices. The Finance Committee report on corporate governance sets out the Malaysian Code on Corporate Governance, which sets out principles and best practices for good corporate governance. The report also sets out the intention of the Committee to have the Code backed by listing rules of the Exchange. Essentially, the listing rules are to require companies to disclose their extent of compliance with the Code. This then leaves it to the market to judge the effectiveness of the company's governance practices.

22. It is not intended to suggest by this that self-regulation is sufficient. The case has been made above that the strong arm of the law in necessary to prevent controlling shareholders from maximising their private benefits of control. However the significance of a Code for Malaysia is that it will require companies to make the relevant governance disclosures which then introduces more information about how boards function in Malaysia. Another fairly significant feature about Codes is the aspirational and evolutionary way in which these Codes influence the expectations of society that are eventually reflected in the law. The attention generated by the various Codes of Best Practices have already had an impact on evolving judicial interpretations of director's duties.[104] Certainly the Code also acts as a valuable guide to boards by clarifying their responsibilities and providing prescriptions strengthening the control exercised by boards over their companies.

---

appears to be in the public interest for a person to begin or carry proceedings for the recovery of damages for fraud, negligence, default, breach of duty committed in connection with a matter related to the investigation or for recovery of property of the person.

[104] See for example the Australian case of Daniels v Anderson (1995) 37 NWSLR 438 which is a clear instance of directors being increasingly held to a higher standard of care.

Copyright © OECD All rights reserved

23. However a necessary pre-requisite to successful and effective implementation of the Code is for shareholders to take an active interest and apply pressure to hasten the wide spread adoption of the Code. To put it in another way, the introduction of a Code on Corporate Governance must be in tandem with efforts to build shareholder activism in Malaysia.

24. A case can therefore be made for the setting up of a Minority Shareholder Watchdog Group to monitor and combat abuses by insiders against minority shareholders and to evaluate governance disclosures by companies including issues such as board composition. The Employee Provident Fund of Malaysia, as major institutional investor can take the initiative to set up and organise such a Watchdog group with technical assistance from the ADB or the World Bank. Representatives from the Malaysian Institute of Corporate Governance, the Malaysian Association of Investors and the Malaysian Association of Asset Managers should be invited to participate in the Group. As the growth of the fund management industry in Malaysia gathers momentum, through a decentralisation of EPF's investment activities, these fund managers can play a more active role in this Watchdog Group.

25. Banks in Malaysia do not have a governance role, save in bankruptcies. But there are some who are in favour of promoting governance based on banks or even state enterprises (as large shareholders) as an alternative to our current arrangements. There are problems with this recommendation. Banks in Malaysia as well as in Asia are hardly able to take care of themselves. Therefore, it will not be advisable to entrust them with a key role in the governance of listed companies. The loss of focus is likely to make matters even worse. Furthermore, the incentive of a bank in governance is likely to be severely distorted, as its primary interest is in lending. Where it is a significant minority shareholder and exercises control over a company by voting these shares and the shares of others for which it acts as a proxy, its main interest is in enhancing its own income from its lending and other related activities and not in enhancing shareholder value. Empirical findings in Japan and Germany attest to this and are highlighted by Shleifer and Vishny in their survey article.[105] Where a state enterprise, through its shareholdings in a listed company, plays a role in governance, here too the incentive is likely to be distorted because of the complete divergence between the control and cashflow rights of state enterprise managers. This point is also made very strongly by Shleifer and Vishny.

Improving Transparency, Monitoring & Policy Environment

The accounting, auditing, financial reporting and disclosure standards have witnessed significant improvements in Malaysia in recent years. By adopting good standards, strengthening actual accounting practices and enforcing due diligence and fiduciary obligations of both financial intermediaries as well as of directors, managers, accountants and auditors, market incentives can be reinforced. Investors can then increase their reliance on markets and on the exit route to protect themselves against the inefficiencies or abuses of controlling shareholders and other insiders which are not kept down by the courts. These abuses include the consumption by managers of perquisites, (such as plush carpets and company airplanes) as well as managers expanding the firm beyond what is rational (where they are engaging in empire-building or pursuing pet projects). If the financial markets are to play a more effective role as a signalling and monitoring device in Malaysia to allocate capital and monitor corporate insiders, there is a need for more timely and continuous disclosure of information, including information about asset-liability mismatches, credit risk, liquidity risk and market risk. Given the ownership concentration in Malaysia, a strong case can in

[105] Andrei Shleifer & Robert W Vishny, "A Survey of Corporate Governance", Journal of Finance, 1997, Vol.52

Copyright © OECD All rights reserved

fact be made for a quarterly reporting of financial results and for companies to issue warnings whenever earnings, debt or risk profiles are likely to differ significantly from analysts' expectations or the companies own forecasts. This is to ensure that the investing public do not trade under false expectations and that the insiders do not have too much time to trade on price-sensitive information which the market does not have. Surprise news on debt levels, risk profiles or prospective earnings in the 1997 Annual Reports of blue chips companies such as Magnum and Kulim released during the course of this year have battered their share prices. Investors should not be forced to wait for the reporting season to learn about such surprises. It is preferable to issue warnings about such surprises on a timely basis in order not to disadvantage the ordinary investors vis-à-vis the insiders. Many listed companies are not complying with the KLSE ruling with respect to the filing of annual accounts and report within the stipulated period. This warrants the close scrutiny of regulators.

The concentration of shareholding in Malaysia implies that there is no market for corporate control. Thus there is little or no role for hostile takeovers to play a disciplinary role on insiders who are not working towards the maximisation of shareholder value. However, share price movements exercised through the exit route or a sell-down of shares, do provide an avenue for disenchanted or aggrieved shareholders to discipline errant insiders.

REFERENCES

1. Asian Development Bank & The World Bank, Managing Global Financial Integration in Asia: Emerging Lessons and Prospective Challenges (Mimeograph), 1998

2. Bank Negara Malaysia, Annual Reports, various years.

3. Black,B. and R. Kraakman, "A Self-Enforcing Model of Corporate Law", Harvard Law Review, 1996, 109, 1913-1980.

4. Brian R Cheffins, Company Law – Theory, Structure and Operation, Clarendon Press, Oxford 1997.

5. Philip T N Koh, Principles, Practice and Prospects of Corporate Governance: The Malaysian Legal Framework, Asian Centre for Professional Development Sdn Bhd, 1997.

6. Rafeal L Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W Vishney, Law And Finance, July 1996, NBER Working Paper 5661.

7. ____________________, "Legal Determinants of External Finance", The Journal of Finance, Vol VII No 3, July 1997.

8. Jonathan R Hay, Andrei Shleifer & Robert W Vishny, "Toward a Theory of Legal Reform", European Economic Review, 40 (1996).

9. Andrei Shleifer & Robert W Vishny, "A Survey of Corporate Governance", Journal of Finance, 1997, Vol 52.

10. Stephen Prowse, Corporate Governance in East Asia: A Framework for Analysis, (Mimeograph), June 1998.

11. The World Bank, Private Capital Flows to Developing Countries: The Road to Financial Integration, Oxford University Press, 1997.

Copyright © OECD All rights reserved

DISPOSAL OF UNDERTAKING OR PROPERTY UNDER S 132C

General prohibitions. Unless with the approval of the company in general meeting, the directors must not, notwithstanding anything in a company's memorandum or articles, carry into effect any proposal or execute any prohibited proposal or transaction which would materially and adversely affect the performance or financial position of the company. These prohibited proposals or transactions are:-

(1) the acquisition of an undertaking or property of a substantial value; or
(2) the disposal of a substantial portion of the company's undertaking or property: s 132C.(See *AMMB v City Properties Sdn Bhd*[1992]1AMR 373

Both the terms 'undertaking or property of a substantial value' and 'substantial portion of the company's undertaking or property' are not defined in the Act. However, it is clear that the mere acquisition of an undertaking or property of a substantial value does not make the acquisition or disposal falling straight into the prohibition. The acquisition or disposal must 'materially and adversely affect the performance or financial position of the company'. Unfortunately, the legislature did not see it fit to provide definitions for the term. For example, it is unsure at what point in time the performance or financial position of the company must be materially and adversely affected by the acquisition or disposal. A member may apply to the court for a declaration that a purported general meeting which will be called to approve an acquisition of an undertaking under s 132C on the basis that the information given in the notice of the general meeting is not frank, not open ,not clear and not in any way satisfactory: *Dato Mohd Tahir bin Abdul Rahim & Ors v Sharikat Permodalan Kebangsaan Bhd & Ors* [1991] 2 CLJ 1155.

Consequences of contravention.

(1) criminal. Any director of a company who contravenes the provision of s 132C shall be guilty of an offence and liable to an imprisonment for five years or RM30,000 fine or both.

(2) civil. On the application of any member of the company, the court may make an order restraining the directors from entering into a transaction in contravention of the above: s 132C(2). A transaction entered into in contravention of s 132C(1) is valid in favor of any person dealing with the company for valuable consideration and without actual notice of the contravention: s 132C(3). In *Chan Thiam Teng v Ban Swee Heng Sdn Bhd[1994]2MLJ 583* a board resolution of the defendant company had approved the sale of a piece of the defendant's property and its chairman was authorized to grant options to interested parties who wished to purchase the property. It was not disputed that no approval of the defendant in a general meeting for the sale of the property was obtained and hence sec. 132C(1) had been contravened. The chairman granted an option to the plaintiff and entered into an agreement on behalf of the defendant to sell the property to the plaintiff. On the facts, the court found that the plaintiff had no notice of the contravention in sec. 132C(1), and since the sale and purchase of the property was for valuable consideration, the transaction was valid under sec. 132C(3).

Exceptions. The prohibition under sec 132C does not apply to proposals for disposing of the whole or substantially the whole of the company's undertaking or property made by:-

(1) a receiver and manager of any part of the undertaking or property of the company appointed under a power contained in any instrument; or
(2) a liquidator of a company appointed in a voluntary winding up: sec. 132C(4).

Any director of the company who contravenes sec. 132C shall be guilty of an offence against the Act and on conviction liable to an imprisonment for five years or a fine of RM30,000 or to both: sec. 132C(5).

SUBSTANTIAL PROPERTY TRANSACTIONS UNDER Sec. 132E

Copyright © OECD All rights reserved

General prohibitions. Subject to an approval in general meeting and certain exceptions, sec. 132E forbids a company to enter into any arrangement or transaction with certain prohibited persons to acquire from or dispose to such prohibited persons any 'non-cash assets' of the requisite value. These prohibited persons are:-
(1) a director of the company;
(2) a director of the company's holding company; or
(3) a person connected with such a director.
The company is allowed to enter into an arrangement or transaction as aforesaid if prior approval of the company in general meeting is obtained. In addition, if the director or connected person is a director of the company's holding company or persons connected with such a director, a resolution of the holding company in general meeting is required: sec. 132E. An acquisition or disposal of a non-cash asset includes the creation or extinction of an estate or interest in, or a right over, any property and also the discharge of any person's liability, other than a liability for a liquidated sum: sec. 132E(8).

Persons connected with directors. A person is deemed to be connected with a director if he is:-
(1) a member of that director's family; or
(2) a body corporate which is associated with that director; or
(3) a trustee of a trust under which that director or a member of his family is a beneficiary. This does not apply to a trustee for an employee share scheme or pension scheme; or
(4) a partner of that director or partner of a person connected with that director: sec.122A(1).
The term 'member of that director's family' has an extended meaning and it includes the director's spouse, parent, child (including adopted child and step-child), brother, sister and spouse of his child, brother or sister: sec. 122A(2). A body corporate is associated with a director if:-
(1) the body corporate is accustomed or is under an obligation, whether formal or informal, or its directors are accustomed, to act in accordance with the directions, instructions or wishes of that director; or
(2) that director has a controlling interest in the body corporate; or
(3) that director *or* persons connected with him or that director *and* persons connected with him, are entitled to exercise, or control h exercise of , not less than 15% of the votes attached to voting shares in the body corporate: sec. 122A(3).

'Non-cash asset' and 'requisite value'. A 'non-cash asset' means any property or interest in property other than cash, and 'cash' includes foreign currency: sec. 132E(7). Section 132E(5) provides that a 'non-cash asset is of the requisite value if:-

' ... at the time of the arrangement or transaction for the acquisition or disposal of the asset, its value is not less than ten thousand ringgit but (subject to that) exceeds two hundred and fifty thousand ringgit or ten per centum of the company's asset value, ... '

It is not easy to discover the true meaning of that subsection. Thus, under sec. 132E(5), a non-cash asset is of the requisite value if at the time of the arrangement or transaction for the acquisition or disposal of the asset, its value exceeds:-
(1) RM250,000 or
(2)10% of the *company's asset value* (subject to a minimum of RM10,000) whichever is the lesser.
The amount of the *company's asset value* is the value of its net assets as determined by reference to the accounts prepared and laid under Part VI in respect of the last financial year prior to the arrangement or transaction; or where no accounts have been so prepared and laid before that time, the amount of the company's called-up share capital: sec. 132E(5)(a) and (b). The burden of proof that a non-cash asset exceeds the requisite value lies on the person who alleges it.
Consequences of contravention.

Copyright © OECD All rights reserved

(1) criminal. The Act makes a director of a company or of its holding company, or a person connected with such a director who enters into an arrangement or transaction with the company in contravention of sec. 132E liable to a criminal offence. The criminal liability extends to a director of the company who authorized the arrangement or transaction. A convicted person may be liable to be imprisoned for five years or fined of RM30,000 or to both: sec. 132E(8).

(2) civil. An arrangement entered into in contravention of sec. 132E and any transaction entered into in pursuance of the arrangement is voidable at the instance of the company. This statutory right of the company is lost, if the arrangement and transactions are ratified by the company in general meeting within a reasonable time. Similar ratification must also be made by the holding company in general meeting if the arrangement and transaction are for the transfer of an asset to or by a director of the company's holding company or a person who is connected with such a director: sec. 132E(2).

In addition to the above liability, the prohibited person who has entered into an arrangement or transaction in contravention of sec. 132E, is liable:-

(1) to account to the company for any gain which he had made directly or indirectly by the arrangement or transaction; and

(2) jointly and severally with the other prohibited person to indemnify the company for any loss or damage resulting from the arrangement or transaction: sec. 132E(3).

A member of the company may apply to the court for an order to restrain the company from entering into an arrangement or transaction in contravention of sec. 132E(1): sec. 132E(4).

Exceptions. The prohibitions contained in sec.132E does not apply to an arrangement or transaction for the acquisition or disposal of a non-cash asset entered into:-

(1) by a company -

(a) and any of its wholly-owned subsidiaries; or

(b) and its holding company which holds all the issued shares of the company; or

(c) which is a wholly-owned subsidiary of a holding company and another wholly-owned subsidiary company of that same holding company; or

(2) by a company which is being wound up, unless the winding up is a members' voluntary winding up; or

(3) by a company which is an acquisition or disposal of an asset in the ordinary course of business of the company and is on terms not more favorable that those generally available to the public or employees of the company; or

(4) by a company if such arrangement or transaction does not involve transfer of cash or property and which shall have no effect unless approved at a general meeting or by a relevant authority: sec. 132F.

ACQUISITION OF SHARES OR ASSETS INVOLVING SUBSTANTIAL SHAREHOLDERS UNDER SEC. 132G

General prohibitions. Subject to certain exceptions, a company ("acquiring company") must not enter into any arrangement or transaction to acquire the shares or assets of another company ("target company") in which a shareholder or director of the acquiring company, or a 'person connected to such shareholder or director' has a 'substantial shareholding' as defined in s 69D. It is irrelevant that the arrangement or transaction is for the benefit of such shareholder, director or connected person or for any other person: sec. 132G. The prohibitions in sec. 132G apply notwithstanding to those provisions of Ss 132C and 132E.

The words 'person connected with a shareholder or a director' in this section have the same meaning as that assigned to a 'person connected with a director' in sec. 122A, save that a reference to a member of that shareholder's or director's family shall be limited to that shareholder's or director's spouse and child (including adopted child and step-child). A reference to a shareholder of an

Copyright © OECD All rights reserved

acquiring company is a reference to a shareholder who has a substantial shareholding, as defined in sec. 69D in the acquiring company.

The effects of sec. 132G were considered by Abdul Aziz Mohamad J in *Re Actacorp Holdings & Anor[1993]1MLJ246*. There the court was asked to consider the validity of an arrangement entered into by a public company, Actacorp Holdings Bhd ("Actacorp") on 7 October 1992 to acquire from one Ong Say Kiat ("Ong") of his 490,000 ordinary shares in a private company known as V-Pile System Sdn Bhd ("V-Pile"). Ong was at the material times a director of Actacorp and also a director of V-Pile. Ong was a substantial shareholder in V-Pile pursuant to s 69D since 2 May 1989, whilst Actacorp were substantial shareholders in V-Pile since 10 July 1991. Ong and other persons connected with Ong held more than 15% of the voting rights in Actacorp. The court considered the following main issues:-

(1)whether sec. 132G applied to an arrangement to acquire the shares in a private company (V-Pile) since it is not a type of company defined by s 69B(2); and

(2)whether Actacorp being substantial shareholders of V-Pile, were 'persons connected' with Ong under sec. 122A, and therefore the arrangement was prohibited by s 132G.

In respect of the first issue, the learned judge held that the prohibition in s 132G applied to an arrangement to acquire the shares in a private company notwithstanding the fact that a private company was not a type of company defined by sec. 69B(2). His Lordship was of view that the word 'company' appearing in sec. 132G, whether in relation to an acquiring company or target company, applied to any type of company. According to his Lordship, if the legislature had intended to limit an acquiring company or target company to the type of companies or bodies as prescribed under sec. 69B(2), it would have say so expressly. On the second issue, his Lordship having examined the effects of sec. 122A with care, held that Actacorp was not 'persons connected' to Ong for the purposes of sec. 132G. As a result, the fact that Ong and other person persons connected with Ong held more than 15% of the voting right in Actacorp did not make Actacorp a person connected to Ong for the purposes of sec. 132G. Thus, the fact that Actacorp was a substantial shareholder in V-Pile did not give rise to such a prohibition under s 132G.His Lordship had earlier opined that the phrase 'first held the shares' in sec. 132G(1) referred to the point in time when the director or a person connected with such a director first became the substantial shareholder in the target company.

Consequences of contravention.

(1) criminal. If there is any contravention of sec. 132G, the acquiring company and every director of the acquiring company is liable to an offence under the Act: sec. 132G(5). It is interesting to note that the target company and its directors are not liable under this section The penalty carries an imprisonment for three years or a fine of RM50,000 or to both.

(2) civil. An arrangement or transaction entered into in contravention of sec. 132G(1) shall be void: sec. 132G(2). Any consideration given for the shares or assets shall be recoverable accordingly: sec. 132G(2).

Exceptions. The prohibitions in sec. 132G do not apply in the following cases:-

(1) if the arrangement or transaction was entered into three years after such shareholders, director or connected person, as the case may be, first held the shares in the target company or after the assets were first acquired by the target company, wherever relevant: sec. 132G;

(2) subscription of new shares in a company for cash consideration: sec. 132G(6)(a);

(3) an arrangement or transaction for the acquisition of shares or assets entered in to by a company -

(a) and any of its wholly-owned subsidiaries;

(b) and its holding company which holds all the issued shares of the company; or

(c) which is a wholly owned subsidiary of a holding company and another wholly-owned subsidiary company of that same holding company: sec. 132G(6)(b);

(4) an acquisition of any asset, other than shares, by a company from another company where the sale of the relevant asset is part of the ordinary course of business of the second-mentioned company: sec. 132G(6)(c);

Copyright © OECD All rights reserved

(5) an acquisition of shares or assets by a company made in pursuance of a scheme of compromise or arrangement approved by the court under s 176: sec. 132G(6)(d); or
(6) an aquisition of shares made by a company in connection with a take-over offer made in accordance with the relevant law applicable to such offers: sec. 132G(6)(e).

As can be seen there are an impressive array of asset protection provisions under the Companies Act . this is also augmented in the KLSE Listing requirements.

LOANS TO DIRECTORS UNDER SS 133 AND 133A

General prohibitions. Subject to certain exceptions a company must not:-
(1) make a loan to a director of the company or of a company which by virtue of s 6 is deemed to be related to that company; or
(2) enter into any guarantee or provide any security in connection with a loan made to such a director by other person: sec. 133.

Also, under sec. 133A(1), a company must not make a loan to any person connected with a director of the company or of its holding company; or enter into any guarantee or provide any security in connection with a loan made to such person by any other person. The types of transaction which are prohibited under both sec. 133 and sec. 133A are confined to a 'loan', 'guarantee' and 'security'. Though the prohibited transactions are of different nature, but the ultimate effect is the same, that is the statutory prohibition is aimed at protecting the funds or assets of a company from being depleted by directors through misuse. It is a section the self-evident purpose of which is to protect companies and the shareholders and creditors of the companies.

Our sec. 133 can be traced to sec. 190 of the United Kingdom *Companies Act* 1948 which was enacted based on the recommendation made by the Cohen Committee in 1945. The Cohen Committee had expressed strong objection and the undesirability that directors should borrow from its company. According to the Cohen Committee:-

'If the director can offer good security, it is no hardship to him to borrow from other sources. If he cannot offer good security, it is undesirable that he should obtain from the company credit which he would not be able to obtain elsewhere.'

'Loan', 'guarantee' and 'security'. The statutory prohibition, as noted above, is directed against the provision of 'loan', 'guarantee' and 'security' by a company to its director or persons connected with the director. The word 'loan' is not defined by the Act. In its ordinary dictionary meaning, it means a sum of money lent for a time to be returned in money or money's worth. Therefore, mere indebtedness by a director to a company may not necessarily amount to a loan. A loan of money, in essence, is the payment of a sum of money on condition that at some future time and equivalent amount will be repaid. A loan is not necessarily a loan of money, for it would also include money's worth, for example, a trade bill or advances on letters of credit (*See Dart Sum Timber(Pte)Ltd. V. Bank of Canton Ltd [1992]2MLJ101 CA* (S'pore). What is important is to look at the substance of each transaction and not at the form or the label subscribed to it by the parties involved. So, Lord Delvin in *Chow Yoong Hong v Choong Fah Rubber Manufactory[1962]MLJ 74* remarked:-

'But if a court comes to the conclusion that the form of the transaction is only a sham and that what the parties agreed upon was a loan which they disguised, for example, as a discounting operation, then the court will it by is name and act accordingly.'

Copyright © OECD All rights reserved

This decision of the Privy Council demonstrate that Courts are willing look at the substance of a transaction rather than the mere form.

The other two prohibited transactions are 'guarantee' and 'security'. The word 'guarantee' is not defined in the Act, but its legal meaning can be found in sec. 79 of the Malaysian *Contracts Act* 1950:-

'A "contract of guarantee" is a contract to perform the promise, or discharge the liability, of a third person in case of his default.'

The prohibition applies when guarantee or provision of a security is prohibited by a company to its director must be 'in connection with a loan' made to such a director.

Consequences of breach.

(1) criminal. Where a company contravenes sec. 133, any director who authorizes the making of any loan, the entering into of any guarantee or the providing of any security contrary to the section will be guilty of an offence.: sec. 133(4). Similar criminal liability is imposed for contravention of sec. 133A: sec. 133A(4). Both the offences carry a fine of RM10,000 each.

(2) civil. A purported contract which was entered in contravention of sec. 133 or sec. 133A will not prevent the company which has provided the loan, guarantee or security from recovering:-

(1) the amount of the loan; or
(2) the amount for which the company becomes liable under the guarantee entered into or in respect of any security given: sec. 133(5) and sec. 133A(3).

The main problem regarding civil consequences is whether the lender is able to recover from the company in respect of a purported contract entered in contravention of sec. 133 or sec. 133A. The Act is silent on this point. The initial feeling was that the lender would be unable to recover the loan, on the principle that where legislation expressly prohibits a contract, the contract will be taken to be void and unenforceable unless the prohibiting legislation itself saves the contract. This principle was illustrated in *Che Wan Development Sdn Bhd v Co-Operative Central Bank Bhd[1990]2MLJ265* vis-a-vis sec. 133. The plaintiff in that case was a private company and the defendant was a co-operative society. In 1986, a director of the plaintiff obtained a loan of RM $20 million from the defendant. The loan was secured by a charge on the plaintiff's lands in favor of the defendant. The plaintiff had sought for a declaration that the charge created in favor of defendant was void and unenforceable for contravening sec. 133

His Lordship held that the charge which was created by the plaintiff in favor of the defendant to secure an illegal loan made by the defendant to a director of the plaintiff 'was illegal and therefore void and enforceable' by the defendant as it had contravened the prohibition in s 133.

The decision of NH Chan J was ,however, held to have been 'wrongly decided' by the recent Federal Court in *Co-operative Central Bank Ltd (in receivership) v Feyen Development Sdn Bhd* [1995]3 MLJ 313. The main facts in *Feyen Development* was that the appellant was a co-operative society ("chargee society") registered under the *Co-operative Societies Act* 1948 and the respondent ("chargor company") was a private company. One Lim Kon Kwee ("the borrower") who was a member of the chargee society as well as a director in the chargor company obtained a loan of RM 3 million from the chargee society. The chargor company created two charges over its own lands in favor of the chargee society as security for the loan. The Federal Court had inferred from certain evidence that the loan of RM 3 million was ultimately received by the chargor company. The chargor

Copyright © OECD All rights reserved

company filed a separate proceeding to declare the charge as illegal, void and unenforceable under sec. 133.

The High Court granted the declaration. However, on appeal, the Federal Court reversed the lower Court decision.

His Lordship held that to apply sec. 133 so as to produce a result which would exempt the chargor company from the obligations incurred by it thereunder would be tantamount to applying it to commercial transactions which were free from the taint of corporate abuse which the section was designed to counter. His Lordship concluded by holding the case of *Che Wan* 'was wrongly decided' .

The fact that the loan obtained by the borrower in the case was in reality for the use of the chargor company does not appear to disturb the Court. The practice of using a 'nominee' borrower to obtain loan from a co-operative society secured by a third party charge on the property of a company was not perceived as abnormal. A co-operative society registered under the *Co-operative Societies Act* 1948 was allowed to grant loan only to its members, which by definition only confined to individual persons and not to a corporation. There is nothing objectionable about such a practice: *Realvest Properties Sdn Bhd v The Co-operative Central Bank Ltd (under receivership)* [1996] 3 CLJ 823, 829, FC. It is unsure whether the Federal Court will come to the same conclusion if the loan obtained by the borrower was for his own personal use. However the Federal Court was indignant that NH Chan J refused to followed the reasoning of Feyen decision.The general principles governing the enforceability of a contract entered in contravention of a statute were also comprehensively considered by the Supreme Court in *Chung Khiaw Bank Ltd v Hotel Rasa Sayang Sdn Bhd & Anor* where it was held that a lender was not able to enforce the securities given by a company who had given financial assistance for the purchase of its own shares in contravention of sec. 67(1). The operative wordings contained in s 67(6), prior to its amendment, and sec. 133(5) were the same. After the decision in *Chung Khiaw Bank* case and other cases involving sec. 67, the legislature saw it fit to amend sec. 67(6) by adding the words 'or any person' thereto.
The differing judicial viewpoints between the Federal court and the Court of Appeal does not admit of easy reconciliation.
Exceptions. There are several exceptions under the Act where a company may make loans to its directors.
(1) exempt private company. The prohibitions relating to the provisions of loans, guarantee or security are relaxed in respect of an exempt private company: sec. 133(1). It means to say, unless restricted by its memorandum or articles, an exempt private company may make a loan to its director or person connected with a director or enter into any guarantee or provide any security in connection with a loan made to that director or person connected with that director.

(2) 'company'. The prohibitions in ss 133 and 133A limit its application to a 'company'. By sec. 14(2) a company may be (a) a company limited by shares; (b) a company limited by guarantee; (c) a company limited both by shares and guarantee or (d) an unlimited company. It seems that the prohibitions do not operate against a foreign company registered under the Act.

(3) loan required to perform duties. Again, the prohibitions are not breached, if the loan is made to provide the director with funds to meet expenditure incurred or to be incurred by him:-
(1) for the purposes of the company; or
(2) for the purpose of enabling him properly to perform his duties as an officer of the company: sec. 133(1)(a).
It is pertinent to note that the making of a loan to a director for the above purposes is subject to the fulfillment of the conditions specified in sec. 132(2), in that:-

Copyright © OECD All rights reserved

(1) prior approval of the company is given at a general meeting at which the purposes of the expenditure and the amount of the loan or the extent of the guarantee or security, as the case may be, are disclosed; or
(2) if the approval of the company is not given as aforesaid, at or before the next following annual general meeting, the loan shall be repaid or the liability under the guarantee or security shall be discharged, as the case may be, within six months from the conclusion of that meeting: sec. 133(2).

Where the approval of the company is not given as required, the directors authorizing the making of the loan or the entering into the guarantee or the provision of the security shall be jointly and severally liable to indemnify the company against any loss arising therefrom: sec.33(3).

(4) loan to purchase home. The scope of the prohibitions is further relaxed if the loan is given to the director who is engaged in the full-time employment of the company, or its holding company with funds to meet expenditure incurred or to be incurred by him in purchasing or otherwise acquiring a home: sec. 133(1)(b). The provision in this sub-section is, again, subject to fulfillment of those conditions specified in sec. 133(2).

(5) loan given under an approved scheme. The prohibitions do not apply in the case of a loan made to a director who is engaged in the full-time employment of the company or its holding company, where the company has at a general meeting approved of a scheme for the making of loans to employees of the company and the loan is in accordance with that scheme: sec. 133(1)(c).

01-ias.doc

Copyright © OECD All rights reserved