1st draft (3.6.99)
2nd draft (27.6.99)
Final draft (16.7.99)

CORPORATE GOVERNANCE & RESTRUCTURING IN MALAYSIA

- A Review of Markets, Mechanisms, Agents & The Legal Infrastructure

by

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(Paper prepared for the joint World Bank/OECD Survey of Corporate Governance arrangements in a selected number of Asian countries.)

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ABBREVIATIONS

BNM	-	Bank Negara Malaysia
CA	-	Companies Act (1965)
DRB	-	Diversified Resources Berhad, a PLC
EON	-	Edaran Otomobil Nasional Berhad, a PLC
EPF	-	Employees Provident Fund
FRA	-	Financial Reporting Act
IAS	-	International Accounting Standards
IASC	-	International Accounting Standards Committee
IFAC	-	International Federation of Accountants
IPO	-	Initial Public Offering
KFC	-	Kentucky Fried Chicken Berhad, a PLC
KLCI	-	Kuala Lumpur Composite Index
KLSE	-	Kuala Lumpur Stock Exchange
LTAT	-	Lembaga Tabung Angkatan Tentera (Armed Forces Fund)
MACPA	-	Malaysian Association of Certified Public Accountants
MASB	-	Malaysian Accounting Standards Board
MGO	-	Mandated General Offer
MIA	-	Malaysian Institute of Accountants
PLC	-	Public Listed Company
PNB	-	Permodalan Nasional Berhad (National Investment Corpn)
ROC	-	Registrar of Companies
SC	-	Securities Commission
SIA	-	Security Industries Act (1983)
UEM	-	United Engineers Malaysia Berhad, a PLC

An Overview

Unlike the dispersed shareholding of the Anglo-Saxon world, Malaysia and Asia ex-Japan is characterised by concentrated shareholding. Non-competitive product markets or weak legal protection have made for concentrated shareholding, for governance by large controlling shareholders and not by managers, for reduced opportunities of specialisation by management and for lack of diversification of one's investments as well as for an increased risk of expropriation of outside shareholders by controlling shareholders. Banks or institutional investors have not to date played a role as corporate governance agents to check the power of the controlling shareholders or to offset or minimise the potential loss of value from inadequate monitoring and control by small shareholders.

In a company with concentrated ownership, there is a better matching of the control rights of the dominant shareholder with its cashflow rights. There will therefore be a greater incentive for that control to be exercised in maximising shareholder value. Thus the incentive of the controlling shareholder is more likely to be aligned to the interest of other shareholders. However, given that in an environment of concentrated shareholding, the board of directors and the market for corporate control are likely to be weak, there is a higher probability of expropriation of minority shareholders.

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 the insiders in such companies 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 the more pronounced this divergence.

The dominant voting rights of the controlling shareholders in Asia can make for a weak board and for a weak market in corporate control. As such, external financiers require more rights to protect their interest. Thus shareholders in Malaysia have been given, for many years now, more powers to limit the discretion of insiders on key corporate matters. There are also restrictions placed by the Kuala Lumpur Stock Exchange (KLSE) on the voting rights of controlling shareholders to vote on related or interested party transactions. In this regard, it is interesting to note that the powers of the KLSE have been substantially embellished by the recent amendments in 1998 to the Securities Industry Act (SIA) which now strengthens KLSE's ability to take action against directors and anybody to whom its listing rules are directed at, whereas it was previously confined to the listed entity. With this increase in its powers, more reliance on the KLSE has been advocated to enforce the rule on large and related party transactions. As a self-regulatory organisation, KLSE is likely to be more flexible in adapting its Rules to the changing conditions in the business world. There is great merit in this argument provided that KLSE's Rule that restricts an interested shareholder's voting rights is binding, as is now the case with the recent amendments to the SIA.

Apart from the basic voting rights based on the one-share-one-vote rule, shareholders require certain "anti-director rights" that support the voting mechanism against interference by the insiders. Malaysian shareholders only enjoy three of the six anti-director rights identified by La Porta et al, namely that shareholders are not required to deposit their shares prior to a general meeting (GM), that an oppressed minorities mechanism is in place and that the minimum percentage of share capital that entitles a shareholder to call a GM is only 10%. If shareholders are accorded full pre-emptive rights to new stock issues, this will improve minority rights. If cumulative voting is permitted, this will increase the probability of outside

directors. If proxy by mail is permitted, as recommended by the high-level Finance Committee (FC) on Corporate Governance, then this can reduce the cost of shareholder voting and enhance the ability of outside shareholders to limit the discretion of owner-managers. Recent amendments to insider trading rules and the takeover code have strengthened the position of minority shareholders.

To strengthen the role of the board as a check and balance on the owner-manager, the new Code of best practice on corporate governance proposed by the FC recommends that one-third of the board be made up of independent directors and that independent board committees be set up for audit, remuneration and nomination of directors. Rather than decreeing this, it is best to increase the presence of independent directors by allowing shareholders to mail their proxy vote and to cast their votes for one candidate (through cumulative voting) thereby increasing the probability of outside directors.

The Finance Committee has called for more codification as well as for the introduction of statutory derivative action to strengthen civil enforcement action. Aside from codification of a director's fiduciary duties, it also recommends codification of the minimum functions of boards of public limited companies (PLCs). This move towards codification has been motivated by a desire to clarify the law or (as some speculate) to make judgements more consistent, reliable and predictable. It is impossible for the law to be written up to cover all contingencies. Some element of discretion should always be preserved. However, any reform in the law should not be at the cost of the time-honoured business judgement rule that keeps the courts out of corporate decisions. The rule of law requires an efficient, independent and impartial judiciary as well as an independent bar. There has been a growing perception of a decline in the standards to which the rule of law has been upheld in recent years. As the rule of law is a critical determinant of economic growth and as justice must be seen to be done there is a need for the government to address what has led to this adverse trend or perception.

Banks in Malaysia are poor governance agents because they are weak or have distorted incentives. Domestic and foreign institutional investors have a sizeable presence. They can be encouraged to be more vigilant especially in checking abuses by owner-managers. Institutional investors who choose to exercise their voting rights on related party transactions can have a marked effect as only non-interested parties are allowed to vote on such matters. These institutional investors can also have a significant impact on the election of directors who are independent of the controlling shareholders, provided cumulative voting is permitted, the number of directors is below 10 and that their election is not on a staggered basis. Minimising on conflicting objectives or perverse incentives will always remain a major challenge in the exercise of such voting rights by the institutional investors.

An outside investor can vote with his feet if the insider is not maximising shareholder value. But this requires good disclosure rules and an efficient market infrastructure. There is still a great deal of room for improving disclosures on risk exposures and mark-to-market rules. We must not compound the problem by imposing unnecessary controls on trading, as happened in the second half of 1997.

Equally important, restrictive practices on licensing and imports have made for monopolistic tendencies in certain industries and hence for concentrated shareholding. The continued opening up of markets is essential to increase incentives for dispersed shareholding and hence for improved governance practices.

Part I: Introduction

In the Anglo-Saxon world competitive markets have reduced the incentive for concentrated shareholding. But in an environment of dispersed shareholding governance is exercised by the manager. The separation of ownership from management gives rise to the agency problem. We cannot rely on shareholder voting to limit managers' discretion because of the collective action and free-rider problems. And yet there is a heavy reliance on external financing from outside shareholders as attested to by its well-developed public markets in equities. The outsiders have been prepared to provide the finance because the corporate governance mechanisms in place have enabled them to maximise the return on their investments by hiring the best managers (i.e. through a separation of management from financing), to minimise their risk through diversification and to minimise the potential loss in value due to inadequate monitoring.

The corporate governance mechanisms which have enabled heavy reliance on external financing in the Anglo-Saxon world are as follows:-

a) First, there are good disclosure rules and an efficient market infrastructure for an active and liquid financial market and hence for the outside investor to monitor and vote with his feet if the insider is not maximising shareholder value.
b) Second, there is a satisfactory legal framework and enforcement machinery. This machinery supports an internal corporate governance mechanism that minimises abuses by the insiders but maximises business flexibility.[1]
c) Third, the Board of Directors who are elected by shareholders monitor and exercise management oversight and hence act as a check and balance on managers on behalf of shareholders with the assistance of the auditor and
d) Fourth, there is a well-developed market for control of corporate assets, through contested takeovers, mergers and acquisitions, restructurings and bankruptcies, which throws out entrenched insiders who have captured the boards of directors and who are maximising their private benefits of control and not shareholder value. It also throws out incompetent managers who are misusing corporate resources.[2]

Given the well-developed infrastructure on disclosure and market for corporate control as well as a well-functioning legal enforcement machinery and judicial system in the Anglo-Saxon world, the rights that shareholders require are voting rights and the rights that support the voting mechanism against interference by the insiders. These rights dubbed as anti director rights by La Porta et al (1998a) are as follows:-

a) that shareholders are allowed to mail their proxy vote,
b) that shareholders are not required to deposit their shares prior to the general shareholders meeting,
c) that cumulative voting is allowed
d) that an oppressed minorities mechanism is in place
e) that shareholders have pre-emptive rights to new stock issues and,

[1] For instance, the legal and judicial system in the Anglo-Saxon world recognises that outside shareholders need stronger protections in the form of shareholder voting rights supplemented by an affirmative duty of loyalty of the managers to shareholders. 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 the insider.

[2] Where the boards are captured, the internal control mechanisms of corporate governance do not provide the necessary check and balance on insider excesses.

f) that the minimum percentage of share capital that entitles a shareholder to call for an extraordinary general meeting is reasonable i.e. 10% or less.

In an environment of dispersed shareholding, if the board and the market for corporate control are weak, then the potential loss of value from inadequate monitoring and control by small shareholders will not be minimised. By concentrating shareholding, the problem can be minimised as a large shareholder will have the incentive and the power to monitor and limit managers discretion. And in a bank-centered system of corporate governance such as that obtaining in Germany and Japan, the monitoring of managers by the bank as a large and informed investor encourages investments by the outsiders. An institutional investor also has the incentive to take on the task of monitoring managers to minimise the agency problem and this can also encourage investments by outsiders. Monitoring the monitor and conflicts of interests that distort incentives are the problems which face these approaches to governance. These problems can be minimised by promoting competition. And by developing the market for corporate control as an alternative governance mechanism, (but which is a costly one for preventing abuses), we can rely on it to check extreme abuses which are not held in check by the other governance mechanisms.

This country study on corporate governance and restructuring will review the extent to which the markets and mechanisms which have enabled heavy reliance on external financing in the Anglo-Saxon world are present in Malaysia. It will also explore the opportunities and risks that an outside investor faces in an environment of concentrated shareholding where governance is exercised by an owner-manager. There is also an assessment of the role played by banks, domestic institutional investors and foreign fund managers as governance agents and of the reforms required for increasing reliance on external financing.

The focus of the country study is on the structures and practices of corporate governance of major listed companies. A peculiarity of some Asian economies is that many major companies rely more on debt markets rather than on equity markets in corporate financing (so as not to dilute control), such that the size of stock market are relatively small compared with mature western economies. Accordingly, there is a brief review of the role of debt market and debt-holders in enforcing financial discipline and in having a "voice" in corporate governance in Malaysia.

To give a better appreciation of the corporate governance practices in the country there is an extensive discussion of the corporate governance environment in Malaysia and its impact on corporate performance and finance in Part II. In this regard, Part II also provides certain salient information on the financial system in Malaysia, the development of markets as well as trends in corporate financing and serves as a backdrop to the discussion of corporate governance issues in the country. In the discussion on the equity and credit markets, there is a quick review as to whether these markets perform any "disciplinary" functions over listed firms. There is also a review as to whether there is a cosy relationship between banks, big firms and the government to determine the ways and extent to which financial constraints on big firms may be weak due to overt and covert "policy of directed lending" or creditor passivity.

Part II: The Corporate Governance Environment in Malaysia and its Impact on Corporate Performance and Finance

1. The General Economic Context

a. A Review of the Economy Before & After the Asian Crisis

At the outbreak of the Asian financial crisis in mid-1997, the Malaysian economy had been registering high growth for a decade of 8.5% p.a. There was over full employment, with the unemployment rate at 2.6% (versus 8.8% in 1986) and with continued upward pressure on wage rates (and this inspite of the huge pool of foreign labour). The economy was over-invested with a massive over-supply in properties[3] and even in infrastructure facilities and this had exposed the economy to the risk of a boom-bust cycle. The inflation rate was around 2.5% p.a. (and under 4% for the ten year period). The external current account deficit had been persistently high throughout the nineties (above 6% of nominal GNP with a high of 10% in 1995). The service sector was over-regulated and over-protected causing its GDP share to be still below 45%.[4]The economy had become more open with international trade at twice the size of GNP whereas it had been about the size of GNP in the early 80s. The exchange rate in USD terms had appreciated from the 2.70 level in the late 80s to the 2.50 level in the mid 90s.

At the outbreak of the crisis the government was running a fiscal surplus (and the stance of fiscal policy had been prudent from the late 80s). But the stance of monetary and exchange rate policy in the mid 90s was in fact unsound (with a near-pegged exchange rate regime and excessive growth in money supply and credit). Growth was generally prioratised over distribution. But over-reliance on privatisation to achieve a distributional goal undermined efficiency and increased macroeconomic vulnerabilities.

Excessive risk-taking had also caused the regional financial crisis. Asia including Malaysia had taken too much credit risk. There were also huge mismatches between the assets and liabilities of the banks which had led them to assume excessive liquidity risk, interest rate risk or currency risk. This excessive risk-taking was caused partly because the Asians loved to take risk and partly because there were not enough opportunities to hedge risk. Given the love of Asians to take risk the problem should have been addressed by requiring mandatory disclosures to forewarn investors and depositors but the disclosure regime was underdeveloped. To provide adequate opportunities to price and hedge risk active and liquid markets are necessary but markets were not allowed to develop because of the over-regulation of markets and the over-protection of the banking industry.[5]

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[3] According to the 1998 Bank Negara Annual Report the average occupancy rate in the Klang Valley in the office space market continued to decline to around 79% at end-1998 from 95% at end-1997and that in retail centres fell to 65.7% from 90.5%. The situation will deteriorate further given the new supply coming into the market and weak demand. More telling rentals have fallen at least by 50% from their recent peaks.

[4] The prolonged rapid growth of the economy over long periods should have made for a higher GDP share of services but infact it had declined form 43.9% in 1985 to 42.7% in 1995. Over the corresponding period the share of primary production in GDP had declined from 31.2% to 21.0% whereas on the other hand the share of manufacturing had increased from 19.7% to 33.1%.

[5] For an alternative explanation see Raghuram et al 1998. According to Raghuram, transactions in a market based model are based on market generated price signals and requires an infrastructure which facilitates private contracting.

On the other hand, in a relationship-based model markets are under-developed or over-regulated. The prices thrown up by these shallow or illiquid markets serve as poor indicators for coordinating economic activities. Invariably transactions (e.g. borrowing-lending) are based on relationship considerations with the rights and obligations of the parties based on the membership norms of the "family" or "group" to which they belong and not on private contracting (because of poor and weak enforcement of laws).

In an environment where the infrastructure for contracting is weak, investment decisions based on the relationship model need not go sour so long as the supply of capital relative to investment opportunities is limited. This will mean that the investments undertaken are more likely to be productive and profitable.

The initial response to the crisis was to tighten the stance of macro policies to restore market confidence. And judging by the stringent credit control introduced, this led to an overkill. These policies and the contagion plunged the economy into a deep recession.Anti-market pronouncements and an unwillingness to consider a market solution aggravated the crisis. These policies were replaced by a new regime of capital controls in September 1998 and a limited easing in macro policies.
Before we end this sub-section by a quick review of how the economy has performed since then, it is useful to look at the state of the economy and the stance of policy at the time of the imposition of the new regime.

The economy was then in deep recession with rising unemployment [6] and a deterioration in government finances into negative territory. [7]But inflation had peaked (though still in single digit) and was moderating. And there was a rapid build-up in external current account surplus. The interest rate was high but falling (with the 3 month inter-bank rate declining to 9.5%) The RM was weak trading between 4.00 and 4.20 against the USD but the stock market composite index had slipped below 300.[8]There was a banking crisis with mounting non-performing loans (NPLs) with the optimists projecting it at 15% and the pessimists at 30% by end 1999. There was also a corporate crisis with many businessmen (and in particular several prominent bumiputra businessmen) driven into bankruptcy. But more controlling

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However, the investment decisions are likely to go wrong where there is a plentiful supply of capital relative to investment opportunities. And given the weak contracting infrastructure, lenders will face difficulties if they try to recover their loans and minority shareholders run the risk of being expropriated by the controlling shareholders.

East Asia was characterised by a weak contracting infrastructure and massive capital inflows in the 1990s. To protect their interest, the foreign lenders invariably made short-term loans and relied on the threat of not rolling over the loans to ensure that the borrowers serviced their loans. When the Asian crisis struck, the decision of some lenders to call back the loans or of some investors to pull out their investments made others to do the same thus causing a stampede of capital outflows. This was a rational response and not a panic. It did not make sense for the lenders or investors to take their time in going to the courts to enforce their rights given the poor laws and weak enforcement.

[6] The initial situation of over full employment and opportunities for repatriating guest workers made the problem of unemployment less acute.

[7] Although the government deficit was still small, its expected contingent liabilities was escalating on account of its implicit guarantee of bank deposits and infrastructure projects as well as the explicit guarantee of the principal (and of a minimal return) to investors/contributors of the large unit trusts and providend funds.
In respect of those infrastructure projects for which the government had guaranteed traffic volumes, this had ceased to be a problem. But in respect of others it had step-in rights if the concessionaires ran into financial difficulties. But these were not obligations. As the government was not prepared to let the projects be auctioned off to the highest bidders, these step-in-rights became obligations.

[8] There was a difference of opinion whether RM was stabilising or still vulnerable. My considered view was that it was significantly under-valued vis-a-vis the key currencies. It was unclear when the correction will take place but RM was probably stabilising as it was trading close to 4.00 inspite of mounting political uncertainties, falling interest rate and the Prime Minister's call to be prepared for shocks. These factors had more impact on the stock market but even then it is inconceivable that it could have continued its free fall given the lows it had reached. The shock of the sacking of the then Deputy Prime Minister had the potential to depress the markets further. But it may have been discounted given the early warning by the Prime Minister.

shareholders were broke than companies. The economy was still facing a liquidity crisis and was getting into the grip of a credit crunch.[9]

The stance of policy at imposition of the new regime of capital controls was mildly reflationary from mid-98 but the stance of monetary policy was still contractionary. The government was prepared to liberalize and deregulate the economy but only within limits. It was not prepared to open up the service sector which may have provided for a more efficient utilisation of surplus capacity (especially in property and infrastructure sectors). Corporate restructuring was slow.[10]

For 1998 as a whole the Malaysian economy contracted by 6.7%, inflation was registered at 5.3% , the unemployment rate climbed marginally to 3.9%, the 3 month inter-bank rate declined to 6.5% and the external current account recorded a surplus of 13.7% in terms of GNP. The stance of fiscal policy was mildly expansionary, with the federal government running a deficit of –1.9% as a % of GNP in 1998 compared to the surplus of 2.5% in 1997. The stance of monetary policy was contractionary with the growth rate in broad money (ie M3) declining from 18.5% in 1997 to 2.7% in 1998. Credit growth registered an equally steep decline from 26.5% in 1997 to 1.8% in 1998. And the exchange rate was pegged at 3.80 to the USD and has remained at that level from September 1998.[11]

With the aggressive buying of NPLs by the Asset Management Comany and the prompt recapitalization of financial institutions by the Bank Recapitalization Agency, the threat of a credit crunch from the lack of bank capital has been significantly reduced in Malaysia. However, the continued slow growth in credit suggest that bankers are still suffering from risk aversion or loan demand is weak or the stance of monetary policy is still tight as may have been the case until recently. Corporate restructuring however, has been slow, probably because it is not entirely market-driven.

Many observers had expected the imposition of the new regime of capital control to be accompanied by an aggressive easing in macro policies. If this had happened and had continued for any length of time it could have bankrupted the economy. This has in fact not happened. The out-turn of macro policies have continued to be tight, partly because of the anti-inflation bias of policy makers in the conduct of monetary policy and partly because the government machinery was not geared up to cope with the increased spending that had been envisaged in the 1999 Budget unfolded in October last year.

The increased domestic liquidity from the imposition of capital controls as well as weak demand has led to significantly lower interest rates as well as a marked uptick in activity in the stock market and to an extent in the property market. The perception that the exchange rate is undervalued and that capital controls are temporary (fostered at least partly by the

[9] In the first half of 1998, 782 winding-up petitions were filed under the Companies Act – nearly equal to the number of cases filed during all of 1997 – and courts issues 248 winding-up orders.

[10] In respect of banks and infrastructure projects renationalisation may have been preferred to liquidation or auction to the highest bidder. The Government was not prepared to contemplate even this. Rescue of the captains and corporates may have been its preferred option then, for instance, through the issue of government guarantees, to save the government's distributional programme. But as at mid 1999 that has not happened.

[11] In its 1998 Annual Report, Bank Negara had projected the economy to grow at 1% in 1999 with government deficit at 6% of GNP, inflation at under 4% but with the external current account surplus at 11% of GNP. By May 1999, the 3 month inter-bank interest rate had fallen below 4% and many analysts have revised the growth rate upward to 3%. So long as capital controls remain, the long-term growth rate however is not likely to exceed ¾ th of its potential even if conduct of macro policies remains prudent.

country's history and the flexible manner in which the controls have been imposed) have not led to any serious flight in capital through such activities as re-invoicing. However, this is not likely to remain so if there is a risk of capital controls becoming more permanent or if re-pegging of the currency or unexpected shocks cause the currency to become over-valued.

b. 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 banks (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.

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

c. Dynamics of the Equity Market

The ratio of market capitalisation (of the Malaysian equity market) to money GDP was 2.59 in 1995, 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.[12]

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,

[12] Stock market capitalisation as a % of GDP are as follows for the various periods: 1975-79 – 45.2%, 1980-84 – 89.5%, 1985-89 – 101.1% and 1990-94 – 198.8%. the % was 114% in 1990, 122% in 1991, 166% in 1992, 375% in 1993 and declined to 261% in 1994.

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 to 1.1.2001.

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. See Table 8.

The concentration of shareholding in Malaysia imposes a severe constraint on the 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 48.2% decline in the UEM share price (versus a decline in the KLCI index of 14.5% over the corresponding period)[13] 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 47.6% (versus a decline in the KLCI index of 6.1%).[14] 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 Table 10), the weighted average of foreign shareholding had in fact increased marginally from 24% to 24.2% over the 1996-1997 period.

d. 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.[15] 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.

[13] The period referred to is from November 17 to 24, 1997.
[14] The period referred to is from June 8 to 19, 1998.
[15] But there are now proposals for introducing US style anti-creditor rights into the Malaysian bankruptcy code.

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.

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. Monitoring by large creditors may encourage minority shareholders to invest even in companies with concentrated shareholding.

e. Relationship Between Banks, Big Companies and the Government

Foreign-owned banks have a 20% market share. Government-owned or controlled banks, (which included the largest bank in the country, a public limited company), account for 30% of the market share. Many of the leading locally-owned banks are PLCs, but each with a dominant shareholder, either a government institution or a private family interest. All the other local banks were not PLCs and were directly or indirectly controlled by private family interests.

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 "policy of directed lending" to big firms 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.

2. The Corporate Governance Characteristics in Malaysia and their Relevance to the Financial Crisis

a. The Corporate Governance Agents

The Malaysian corporate sector's attempts to access the external market in equities has an early history, as witnessed by the formation of a formal stock brokers association in the 1930s and the setting up of a formal stock exchange in 1960. During that period, the country was dominated by its plantation and mining industries. The large British-controlled companies engaged in plantation, mining and/or trading were listed on the London Stock Exchange. Some of these companies went for a secondary listing on the Malaysian or Singapore stock exchanges in the 60s given the increasing interest of Malaysian and Singapore investors in these companies. Acquisition of the controlling interest in such companies, first by Malaysian private sector interests and later by Government agencies, led to the transfer of their domicile to Malaysia from the 70s.

The initial public offerings by home-grown family-controlled companies as well as domestic market-oriented foreign-controlled companies in manufacturing, trading, construction and services, led to the significant growth of the Malaysian stock market from the 60s. This growth in market capitalisation was further boosted from the 80s by the privatisation of key state enterprises in the transport sector, gaming and utilities. These newly listed entities continued to be characterised by concentrated shareholding either by family interests or the state.

The concentrated shareholding in public listed companies, PLCs, (which are not state-controlled) has been attributed to weaknesses in shareholder rights or the poor enforcement of these rights. In certain activities, restriction on competition has led to higher returns or lower risk thus reducing the incentive of the controlling shareholders to share these benefits with other shareholders.[16]

[16] There are several manufacturing industries in Malaysia with just a few producers accounting for the bulk of the output in the country. Even if there is only one domestic producer in an industry, so long as there are no restrictions on imports or on the entry of new players, the industry cannot be said to be non-competitive as it is

Shareholding in Malaysian PLCs is concentrated and not dispersed but the shareholding is not as concentrated as believed by many. Stijn Claessens et al have analysed the distribution of ultimate control among five broad ownership groups and by the size of ultimate control of each owner at four cut-off levels as set out in Table 1. At the 20% cut-off level of ultimate shareholding for a block shareholder, the benchmark used both by Berle & Means (1932), La Porta et al (1998), as well as Stijn Claessens et al (1999), 10.3% of the PLCs are widely-held in that none of these PLCs have a shareholder whose ultimate holding is 20% or more. At the cut-off levels of 30% and 40%, the percentage of widely-held companies of course increases and quite dramatically to 41.2% and 77.3% respectively. As is to be expected, at the 10% cut-off level only 1% of the PLCs are widely-held. [17]

The dominant shareholder in PLCs with concentrated shareholding is the family. At the benchmark 20% cut-off level, 67.2% of the PLCs are in family hands. The percentage of family-controlled PLCs is 45.6% at the 30% cut-off level and 57.7% at the 10% cut-off level but it drops to 14.7% at the 40% cut-off level.

The next important category of dominant shareholder is the state. The number of state-controlled PLCs is the highest at the 10% cut-off level and declines to 13.4% at the 20% cut-off level. It drops further to 8.2% and 4.2% at the 30% and 40% cut-off levels respectively.

Widely-held financial institutions exercise control over 12.5% of the PLCs at the 10% cut-off level and 2.3% of the PLCs at the 20% cut-off level. There are no PLCs which are controlled by widely-held financial institutions at the 30% and 40% cut-off levels.

The widely-held corporation is a more important category of block shareholder than the widely-held financial institution. The widely-held corporation exercised control over 11% of the PLCs at the 10% cut-off level, 6.7% of the PLCs at the 20% cut-off level, 5% of the PLCs at the 30% cut-off level and 3.8% of the PLCs at the 40% cut-off level.

There is an increase in the importance both of widely-held PLCs as well as state-controlled PLCs if the distribution of ultimate control is measured on a weighted basis in terms of market capitalisation of the PLCs and not just on a unweighted basis, that is, by accounting for the PLCs only in terms of their numbers. At the benchmark 20% cut-off level, the percentage of PLCs which are widely-held in terms of market capitalisation increases from

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exposed to the threat of actual or potential competition. It is restrictive import or licensing arrangements that make for monopolistic tendencies and hence profiteering.

In industries such as iron & steel and cement, which historically had been subject to restrictive imports and licensing in Malaysia, a quick research by the Federation of Malaysian Manufacturers shows that the number of domestic producers has increased over time as can be ascertained from reading [4]. In the rolling of iron and steel, the number of players in the market has increased from three in the 1960s to ten by 1993 and the largest producer in the sixties had dropped to the third position in terms of market share in 1993. In the steel making industry, the number of players had also increased from one in the 1960s to six in 1993. Malayawata, which was the leading steel maker until 1976, had dropped to the fifth position by 1993. In the pipe making industry, the number of players in the industry had increased from a single producer in the 1960s to seven in 1993. For the hydraulic cement industry, the number of producers had increased from two in the sixties to five by 1993.

These data clearly show that the concentration of market power has declined over time in Malaysia. Further liberalisation of licensing as well as of imports is required to improve the competitive position even more and thus reduce the opportunities for profiteering.

[17] A company which has a block shareholder with an ultimate shareholding of close to 30% cannot be viewed as a widely-held company. This will apply even more forcefully to companies where the blockholder has close to 40%.

10.3% to 16.2%, the state-controlled companies increases even more dramatically from 13.4% to 34.8% whereas the family-controlled companies decreases from 67.2% to 42.6% (See Table 2).

The average number of firms per controlling family, as set out in Table 4, was 1.97. In terms of market capitalisation that families control at the 20% cut-off level, the market capitalisation controlled was 7.4% for the top one family, 17.3% for the top five families, 24.8% for the top ten families and 28.3% for the top fifteen families.

Concentration of shareholding varies significantly with firm size, as shown in Table 3 for the benchmark 20% cut-off level. 30% of the largest 20 PLCs were widely-held whereas this was so only for 10.3% of all firms. Similarly, 30% of the largest 20 PLCs were state-controlled compared to 13.4% of all firms. Accordingly, the family was the dominant shareholder only amongst 35% of the largest 20 PLCs compared to 67.2% for all firms. The pattern of ownership for the middle 50 PLCs was not significantly different from that for all firms. However, amongst the smallest 50 PLCs, 84% of the firms was in family hands and 5% under state-control. Although none of the smallest 50 PLCs were widely-held, 11% were controlled by widely-held corporations or financial institutions.

We had noted that shareholding in PLCs is concentrated. At the benchmark 20% cut-off level, it has been found that 37.4% of the PLCs had only one dominant shareholder with the individual shareholding of all other shareholders falling below the 10% level. More interestingly, 85% of the PLCs had owner-managers in that the post of the CEO, Board Chairman or Vice-Chairman had been filled by a member of the controlling family or an employee drawn from the ranks of the controlling shareholder.

The concentration of ownership and hence of votes leverages up legal protection of the large shareholder.[18] Voting rights, which are the principal rights of shareholders, are of limited value unless they are concentrated. And the large shareholder can enforce its rights by relying on relatively simple legal interventions, which are suitable even for poorly informed and motivated courts. Therefore, large investors with a direct interest in a company do not need any special arrangements to establish effective corporate control. But there are investors without large direct shareholding interests who can enhance their control through the use of dual-class shares with different voting rights (i.e. shares which are not based on the one-share-one-vote rule), pyramid structures[19] or cross-holdings.[20]

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[18] The small shareholders as well as the courts do not become actively involved in corporate matters. Voting rights, which are the principal rights of shareholders, are of limited value unless they are concentrated. The free rider problem faced by individual investors makes it uninteresting for them to learn about the firms they have financed or even to participate in the governance. And further contacting and persuading a large group of small shareholders through the proxy mechanism is difficult and expensive. In line with the business judgement rule that keeps the courts out of corporate decisions, the courts are very unlikely to second guess managers' business decisions. And even in the Anglo-Saxon world with its excellent infrastructure for private contracting, courts would interfere only in cases of management theft and asset diversion and if managers diluted existing shareholders through an issue of equity to themselves but are less likely to interfere in cases of excessive pay (given the difficulties involved in detailed contract enforcement). The principal advantage of large investors is that they rely on relatively simple legal interventions, which are suitable for even poorly informed and motivated courts.

[19] A pyramid structure has been defined in Berle and Means (1932) as a ownership pattern which involve the owner "owning a majority of the stock of one corporation which in turn holds a majority of the stock of another – a process that can be repeated a number of times".

[20] A pattern of cross-holdings is said to occur "where a company down the chain of control has some shares in another company in her chain of control".

The use of these devices will enable these shareholders to exercise control or voting rights which are in excess of their cashflow rights. The study by Stijn Claessens el al (1999b) shows that there are shareholders or corporate groups in Malaysia which have resorted to such devices. Their study has shown that the average minimum % of the book value of common equity that is required to control 20% of the vote in Malaysia is 18.11% (versus the average of 19.91% for Singapore and 19.23% for the nine East Asian countries that their study had covered).[21] In 39.3% of the PLCs (versus 55.0% for Singapore and 40.8% for the East Asian Nine as a whole), the controlling shareholder exercised effective control through a pyramid structure. In 14.9% of the companies (versus 15.7% for Singapore and 8.7% for the East Asian Nine), control was exercised through cross-holdings.

As a result of the use of these control devices, the ratio of cashflow rights to ultimate control rights in Malaysia (See Table 6) was 0.853 (versus 0.794 in Singapore and 0.746 for the East Asian Nine).[22] The standard deviation of this ratio measure was 0.215 for Malaysia (versus 0.211 and 0.321 for Singapore and the East Asian Nine respectively).

There are many public-quoted companies (PLCs) 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.

It is useful to explore, on a priori basis, the incentive for the maximization of shareholder value in a company which is controlled by a large shareholder 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 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.[23] 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.

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[21] Stijn Claessens et al (1999b) note that they may have actually exagerated the extent of deviations from the one-share-one-vote rule as their findings (because of the lack of access to company charters) were not based on company-specific voting caps. See p 11.

[22] Stijn Claessens et al (1999b), Table 6, p 29.

[23] 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". [(10), 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." [(10), p 7].

In respect of a company where the controlling interest is indirect exercised through a pyramid structure or cross-holdings 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).

As in Germany and Japan, banks in Malaysia play a dominant role in lending. But Malaysian banks do not play a role in governance (with respect to the appointment of managers or directors or in the choice of investments or on any corporate matters) because they do not or are not permitted to control or vote significant block of shares or sit on boards of directors.[24] As a rule, they vote the 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. 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.[25]

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 as large shareholders as an alternative to our current arrangements.

This recommendation is flawed. 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 (1997) in their survey article.

Within a period of about 10 years the country has faced two banking crisis. This is only partly due to weak supervision. At least part of the blame has to be attributed to the ambitious promotion of local banks and local managers (often at the expense of local corporates and tax payers) as well as the aggressive pursuit of economic growth and distributional goals. Implicit government guarantee of deposits and high gearing compounded the problem by creating an incentive for risky or imprudent banking.

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[24] The Banking and Financial Institutions Act permits FIs only to make portfolio investments in non-financial businesses up to a maximum of 20% of an FI's shareholders funds and up to 10% of the issued share capital of a company in which the investment is made. The FI is not allowed to assume any management role or take up a board position. The shareholders funds so invested must be excluded from an FI's capital for purposes of computing its required capital ratio for conducting its banking business.

[25] The banks as large creditors combine substantial cashflow rights with the ability to interfere in the major decision 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.

The central bank attempts to maintain a tight control over banks both local and foreign. Appointment of directors as well as chief executives requires its approval. Given the central bank's multiple goals in economic management as well as in supervision of banks and given the constraints it faces in its hiring and firing policy as well as in setting compensation, the central bank has a lot of room for improving its performance as an economic manager or as a bank supervisor.

The provident and pension funds, the insurance funds and the unit trusts are emerging as a significant force in the Malaysian financial markets. As at end 1998, the size of the provident and pension funds was RM173 billion, of which 86% was accounted for by the EPF. About 20% of the provident and pension funds was invested in equities, accounting for 9% of market capitalisation. The corresponding size of the insurance funds was RM39.4, of which about 20% would have been invested in equities (equivalent to 2% of market capitalisation). The net asset value of the unit trusts, predominantly invested in equities, was RM38.7 billion accounting for 10.3% of market capitalisation. Of this the government-sponsored funds, controlled primarily by Permodalan Nasional Berhad, had a net asset value to KLSE market capitalisation of 8.6% versus that for private funds of 1.7%.

The insurance companies are permitted to invest 20% of their funds in equities. The corresponding ratio for EPF is 25% but only 18% of its total funds were invested in equities at year-end 1998.

EPF had an equity interest concentrated in the 5-15% range in many blue chip companies on the 1st Board of the KLSE. (See Table 9). PNB is also invested in many blue chip companies both on the 1st and 2nd Boards with an equity interest concentrated in the 5 to 20% range. There are also other major local institutional investors whose pattern of investments are shown in the same Table.

The local institutional investors including the EPF play only a passive role in corporate governance and rely on third party research, primarily that by brokerage houses. However, this does not apply to PNB and LTAT which often have sizeable minority or even controlling interests, are represented on boards and are therefore often insiders and tend to play a more active role in performance monitoring and even in corporate governance.

In an environment of dispersed shareholding with no large institutional investors, we cannot rely on shareholder voting to limit managers' discretion because of the collective action problem and the free rider problem. In an environment of concentrated shareholding, we cannot rely on the market for corporate control (whether it is through hostile takeovers, mergers or acquisitions), to limit managers' discretion because no such market may exist given the existence of large controlling shareholders. However, where there are large institutional investors, proxy by mail is allowed and cumulative voting for directors is also allowed, then we may be able to rely on shareholder voting to limit managers discretion provided the institutional investors do not suffer from a conflict of interest.

Most institutional investors, (e.g. corporate pension funds, bank trust funds and insurance funds), will suffer from a conflict of interest between their desire to maximise shareholder value (which may then require them, where necessary, to vote against corporate managers)

and their desire to retain or solicit business from corporate managers (which may then induce them to vote with the managers).[26]

On the other hand, public pension funds, (and this would include the Employees Provident Fund, or EPF), and mutual funds (to an extent), do not solicit business from corporate managers and therefore face no constraints on how they can vote. Their incentives for maximum effort on their beneficiaries' behalf are still limited, since the beneficiaries get the upside,[27] but at least those incentives are not perverted by direct conflicts. But public fund managers do have conflicting incentives between the need to be good political operators or good money managers and can be subject to public pressure to support social responsibility proposals or invest in local enterprises at the expense of investment returns. Such conflicts will be minimised to the extent that these funds are accountable to individual contributors but will be enhanced to the extent that their returns are government-guaranteed.

In Malaysia we have noted that the EPF is a large domestic institutional investor. However the EPF has captured a large chunk of national savings and its investment management is centralised. Conflicts and perverse incentives from its funds management and corporate governance activities can be minimised not by breaking up the EPF but by parceling its funds for management on a passive and active basis, with the passive portfolio managed in-house and the active portfolio managed (largely if not wholly), by external fund managers. It should be readily apparent why passive management will minimise conflicts and perverse incentives. The operation of its externally managed funds will not cause any conflicts or perverse incentives only if the mandate for such management is based strictly on commercial considerations. This is more likely if the external funds are managed for the account of individual contributors.

Presently, EPF's decision to invest its funds is on a portfolio basis and it does not seek any board positions. This stance cannot be faulted. If it actively seeks a position on the boards of companies in which it invest and monitors its nominees, then it runs the risk of becoming an insider thus adversely affecting its short-term trading opportunities in these companies.

EPF can of course choose to exercise its voting rights on related party transactions. This can have a telling effect where only non-interested parties are allowed to vote. It can also have a significant impact on the election of directors who are independent of the controlling shareholders, provided cumulative voting is permitted. Minimising on conflicting objectives or perverse incentives will always remain a major challenge in the exercise of such voting rights.

EPF has to be ever vigilant against abuses of minority shareholder rights by the insiders. Although it held 10% of the shares in UEM and 14% in KFC, it failed to initiate any actions against the insiders in these companies whose apparent disregard of minority interests led to a steep fall in the shareholder value of these companies.

A case can be made for the setting up of a Minority Shareholder Watchdog Group to monitor and combat abuses by insiders against minority shareholders. Initially EPF as the major

[26] The institutional investors are managed by money managers who are themselves imperfectly monitored agents, that is who have imperfect incentives at best and significant conflicts of interest at worst.

[27] "Institutional fiduciaries have strong incentives to avoid legal risks, because they face personal exposure if the risk comes to pass, while their beneficiaries get most of the upside. They care less about the conduct that legal rules, read narrowly, might permit, than about what those rules, read broadly, might prohibit". [(1), p 523].

institutional investor can take the initiative to set up and organise such a Watchdog Group with the technical assistance of the World Bank or the Asian Development 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 then play a more active role in this Watchdog Group.

If institutional investors take actions against insiders who have violated the trust that ought to be accorded to minority shareholders, then this will send a clear signal and insiders are likely to engage less in dealings which are detrimental to minority shareholders.

Foreign investors are an important force on the KLSE. We have examined (See Table 10) the situation with respect to 75 out of the 383 (or 19.6%) of the public listed companies (PLCs) in the non-financial sector on the Main Board of the KLSE. The PLCs examined are the larger or more reputable ones accounting for 68.0% of the market capitalisation of the sector in 1996 and for 74.4% in 1997. Out of the 75 non-financial enterprises, 10 were foreign-controlled with a share in market cap of 8.0% (1996:4.8%). The weighted average of foreign shareholding in these companies including that by foreign institutional investors or fund managers in fact increased marginally from 24% to 24.2% over the 1996-1997 period.

The foreign fund managers like certain domestic institutional investors have opted to play a passive role in corporate governance. But foreign fund managers are more active in monitoring firm performance through research and client visits.

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.

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 local 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.

We have noted from Tables 1 to 3 that there are many state-controlled companies, especially among the largest entities. Where a state enterprise, through its shareholdings in a listed company, plays a role in governance, the incentive to maximise shareholder value will be distorted because of the complete divergence between the control and cashflow rights of state enterprise managers.

b. Corporate behaviour, finance and restructuring[28]

A study of nine East Asian countries on corporate diversification and efficiency at the company level by Stijn Claessens et al (1998b) revealed that 70% of the firms in Malaysia were multi-segment firms in that they operate in more than one two-digit SIC code industries. This number was second only to that of Singapore whose share was 72% as compared with an average figure of 65% for all nine countries. There is no comparable study at the level of the corporate group, but the setting up of different companies at a group level can be taken as further evidence of diversification. Corporate groups are, within the private sector, amongst the most prominent business houses in Malaysia and often operate across a diversified range of activities within a sector as well as across many sectors as diverse as plantation, manufacturing, trading, services, construction and property development. As stated in the preceding section, control within a corporate group is exercised either through cross-holdings or a pyramid structure. While the incidence of cross-holdings is high according to the measure used by Stijn Claessens et al (1999a), however, the extent of inter-locking ownership is not as pronounced or complicated as in Japan or Korea. The exercise of control through the use of a pyramid structure is more widespread. Usually the controlling shareholder exercises control over a listed operating subsidiary through a listed intermediate holding company. The divergence between control and cashflow rights is more pronounced the greater the number of layers of listed companies between the controlling shareholder and a listed subsidiary. Amongst the prominent corporate groups, Yahya Ahmad, Lim Thian Kiat, Khoo Kay Peng and Vincent Tan used a pyramid structure consisting of two layers of listed companies to control a third layer of listed companies. The divergence between their control and cashflow rights is given in Table 7. Yahya Ahmad, Lim Thian Kiat, Khoo Kay Peng, William Cheng and Kuok Brothers had used cross-holdings to exercise control over certain listed companies. The divergence between their control and cashflow rights is also given in Table 7.

According to the study by Stijn Claessens et al (1998b), the extensive diversification of corporates has led to the misallocation of capital investment possibly even in Malaysia towards less profitable and more risky business segments. And this in spite of the fact that the diversified groups may have emerged to provide an internal capital market (to compensate for weaknesses in external financial markets) as well as to capture scarcity rents arising from practices such as restrictive licensing that usually characterises a hybrid economy (with transactions based partly on markets and partly on relationships).

Michael Pomerleano (1998) has examined, based on data for the period 1992-96, the corporate roots of the financial crisis in East Asia. For some Asian economies, especially

[28] I wish to acknowledge my debt of gratitude to Arun Gupta of the World Bank for educating me on the basics of corporate debt restructuring, which is dealt with later in this sub-section.

Indonesia, Korea and Thailand, clear evidence emerged of a rapid and unsustainable build up of investment in fixed assets financed by excessive borrowing. The East Asian investment spending spree resulted in poor profitability, reflected in low and declining returns on equity and on capital employed. The study concluded that at the core of the corporate crisis were financial excesses that inevitably led to financial distress.

In the case of Malaysia, the debt-equity ratio was on a rising trend and the level of profitability had started to decline but these variables were still at reasonable levels. However, the rapid build up of investment in fixed assets and weak risk management practices had made the corporate balance sheet vulnerable to the crisis as a result of the sharp depreciation in currency value, escalation in interest rate and collapse in demand.

The pre-tax return on capital employed or on assets (ROCE)[29] was 12% in 1992 and declined to 10% in 1996 to give an average return of 11% over the period. ROCE captures the efficiency with which a company uses all its capital resources. By comparing this number against the cost of capital, defined as the interest rate, and taking the difference as the economic value added (EVA), Pomerleano assessed the extent to which Asian corporates had created shareholder value. The EVA reading for Malaysia over the period was 3%, compared to 12% for Hong Kong, 2% for Singapore, 4% for USA, -9% for Indonesia, -2% for Korea and –8% for Thailand (but the reading generally showed a deterioration over the period across the board with the exception of USA).

Pomerleano's study pointed to a rapid build up of fixed assets in Asia. The average change in tangible fixed assets during 1992-96 was 20% in Malaysia, versus 33% in Indonesia, 29% in Thailand and 17% each in Hong Kong and Korea. The risk of rapid business growth is that it can overwhelm managerial capacity as well as distribution and marketing channels.

A study by JD Abendroth (1997) on Malaysian Corporate Capital Structure covering 272 non-financial public listed companies gives the pattern of corporate finance flows over the period 1992-96. Of the total funds used, 28.1% was derived from retained earnings, 27.3% was mobilised from new equity issues and 44.6% from borrowings, (of which 26.6% was short-term debt and 18.0% was long-term debt). The author drew attention to the resemblance of Malaysia's debt financing levels during this period with those of the US during the 1970s of 45%, of which 24% represented short-term debt and 21% long-term debt. However, of the balance, retained earnings accounted for 52% of the funds mobilised compared to 3% from new equity issues. No data is available for corporate financing levels during the post-crisis period. External financing, whether in the form of debt or new equity issues, dried up in 1998 and the first quarter of 1999.

An estimate of the domestic and foreign currency borrowings of the Malaysian corporate sector including of private limited companies is given in Table 11. The capital expenditure of

[29] ROCE is defined as Operating Profit divided by Capital Employed, where Operating Profit = Revenues – Cost of Sales – Selling expenses – General administration expenses – Research and Development expenses – Restructuring expenses +/- Other income/expenses and where Capital Exmployed represents the necessary operating capital derived from the balance sheet assets, i.e. balance sheet total minus financial items and fiscal items which are not considered as necessary operating capital. ROCE gives a comprehensive information about the economic performance of the business, since both operating and non-operating results (e.g. proceeds from sale of property) are accounted for. An added advantage is that it permits a comparison between businesses, without regard to accounting convention (e.g. depreciation), and different capital mobilisation and financing strategies, since the operating profit is viewed in relation to the total funds employed. ROCE shows the rate of return on capital employed for the period, and captures the efficiency in the total use of capital resources.

all limited companies financed by foreign borrowing was 17.8% in 1995, 6.8% in 1996, 12.7% in 1997 and 8.9% in 1998.

Malaysia's debt-equity ratio – which indicates how much borrowed money the corporate sector is using relative to its equity, rose from 31% in 1992 to 62% in 1996 whereas that for Indonesia had risen from 59% to 92%, that for Thailand from71% to 155% and that for Korea had risen from 123% to 132% (in 1995).

To analyse debt sustainability, Pomerleano had calculated the interest cover – that is the ratio of companies' operating cashflows (operating income before interest, taxes and depreciation) to their annual interest payment on loans. For Malaysia the interest cover had declined from 9.1 to 6.7 whereas that for Indonesia had increased from 0.03 to 2.44, that for Korea had declined from 1.42 to 1.07 and that for Thailand had deteriorated from 4.6 to 1.9.

Based on its own data base for the actual financial information of non-financial listed companies for 1996 and the first-half 1997, Goldman Sachs (as quoted in Pomerleano) had projected the operating results and financial position of these companies for 1997 and 1998 under certain assumptions about average interest rates, sales growth etc. The interest cover for Malaysian corporates, according to these estimates, was expected to fall from 6.7 in 1996 to 4.0 in 1998.

From the same data base, Goldman Sachs also estimated the number of companies with EBITDA/Interest expenses under 1. Assuming a close correspondence between the percentage of non-performing loans and distressed corporates, Goldman Sachs estimated a rapid increase in the percentage of loans (and companies) in distress in Malaysia from 8.3% in 1996 to 11.2% in 1997 and 18.5% in 1998.[30] The precent of insolvent or distrssed corporates in 1998 in Indonesia was estimated by Goldman Sachs at 45.6% and that in Korea at 31.5%.

Malaysia has registered significant progress in restructuring its banking system but progress is still limited in corporate restructuring. Danaharta, the government's asset management company (AMC) which was set up in July 1998, had acquired from or was managing (in terms of gross value) RM14.7 billion of non-performing loans (NPLs) of the banking system and had acquired an additional RM5.0 billion from Malaysian-owned or controlled offshore banks and development finance institutions.[31] With the removal of the these NPLs from the banking system, (accounting for 20% of its NPLs), the net NPL ratio of the banking system based on the 6-month classification (which includes all loans whose interest are in arrears for more than 6 months) declined from 8.1% as at end September 1998 to 7.6% as at end December 1998.[32]

Banking institutions with gross NPL ratio exceeding 10% or which required recapitalisation from Danamodal, (the Bank Recapitalisation Agency, BRA, set up in August 1998 by the government to ensure that banks were well-capitalised), are required to sell all their eligible NPLs (of RM5 million and above) to Danaharta. Burden sharing in the recapitalisation exercise is based on the "first-loss" principle where existing shareholders are required to

[30] Based on the sharp fall in the market value debt-equity ratio, Dr Gan Wee Beng (1998) has estimated that the proportion of listed 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%.

[31] The corresponding numbers as at March 15, 1999 was RM15.1 billion and RM6.6 billion respectively.

[32] Based on the 3-month classification, the net NPL ratio as at end 1998 was 13.2%. The net NPL ratio is the ratio of NPL less interest-in-suspense (IIS) and specific provisions (SP) to gross loans less IIS and SP.

absorb all losses to insulate Danamodal's capital against past and existing losses. Both Danaharta and Danamodal have brought forward their bank restructuring plan by six months to complete it by mid 1999.

The Corporate Debt Restructuring Committee (CDRC), which was set up in July 1998 to enable creditors and debtors to arrive at schemes of compromise and reorganisation on a voluntary basis without resorting to legal processes, had received by March 15, 1999, 48 applications for debt restructuring, involving debt of RM22.7 billion. Two restructuring plans are under implementation thus far and 26 Creditor Committees have been formed to oversee the restructuring efforts.

With the setting up of Danaharta, Danamodal and CDRC, the full menu of restructuring options are now available in Malaysia – marked-based, government facilitated and government financed.

Part X (Section 212 through 318) of the Companies Act provides for a purely private and market-based arrangement for creditors to recover their monies through a winding-up of the company and by liquidating its assets. The Act, which provides for the appointment of a liquidator or receiver, defines their powers and establishes the priority and ranking of debt between and within different classes of creditors, is extensive and lays a clear basis for winding-up.

Part VII (Sections 176 through 181) of the Act provides a market-based approach for the preservation of the company as a going concern and for recovery of loans which have the legal sanction of the courts. However, there are no well-defined judicial management procedures for managing schemes of compromise and reconstruction. There are no guidelines, the process is cumbersome and the courts have limited experience in supervising reorganisation plans. Some 32 companies had misused these provisions in 1998 to obtain temporary relief from their creditors on a unilateral basis without following up with a well-defined reorganisation plan. This had unsettled creditors given the risk of asset stripping to which they were exposed. To restore the credibility of this option, Section 176 of the Act was amended in late 1998 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. Since then no relief orders have been obtained.

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 Europe. The situation is worse in developing countries, where courts are even less reliable and bankruptcy laws are even less complete.

Hence, in mid-August 1998, the CDRC was 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. Even in these voluntary restructuring exercises Danaharta is expected to use public funds to buy out debts, in a strategic manner, with the aim of facilitating agreements between creditors and debtors.

The CDRC process depends on cooperation between lenders and while the onshore banks may have an incentive to cooperate, it is not clear if the offshore banks and smaller creditors have a similar incentive. There is therefore, a risk that local banks may land up bearing a higher burden of the restructuring cost. Given the key role the central bank is playing in this government facilitated restructuring process and given the potential conflict of interest between its supervisory role and its role in the work-out-process, the central bank has to bend backward to ensure that the process remains a voluntary one.

The government-financed restructuring option revolves around Danaharta and Danamodal. Danaharta was 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 Mangement of corporate restructuring under the Companies Act.[33] 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.

For corporate borrowers with total outstanding debt of less than RM50 million, the Loan Monitoring Unit at Bank Negara Malaysia 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.

With the amendment to Section 176 of the Companies Act, the incentives for market-based restructuring has increased. But the government has taken the initiative to intervene or guide the restructuring of banks as well as of large companies. As the government owns the only AMC and as large financial resources are available to it and to the BRA, and as an exit strategy is yet to be articulated, this may diminish pressures for the operational and management restructuring of the ailing companies. A strong case can therefore be made for greater reliance on the market-based approach to restructuring and on banks or other private parties to establish AMCs.

To increase reliance on the market-based approach, the remedies available under the Companies Act should be used for resolving the more straight forward cases of corporate distress as those entailed in bilateral creditor-debtor relationships. Use should also be made more of the secondary markets for quick disposal of assets. In fact it should be easy to

[33] 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-possession 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.

dispose off individual properties or pools of real estate given that there is a good and well-functioning secondary market in properties backed by a well-developed land and property registry system. In such cases, the restructuring could be left to banks to be carried out under existing laws governing enforcement of security measures.

The overwhelming role of Danaharta and the inadequate reliance on the market-based approach will be a cause for concern so long as Danaharta's asset warehousing and disposal strategy is not clearly articulated. According to the 1998 Central Bank Annual Report, Danaharta is expected to have a life span of 7 to 10 years. Further, all the bonds Danaharta has issued to date have a five year tenor and it has an option to extend the tenor of these bonds by another five years. This gives the impression that the assets acquired by Danaharta may remain in its warehouse for an indefinitely long period, as has been the case with the Mexican AMC.

Danaharta has given the assurance that it will not function as a warehousing agency and that in fact it will start on its assets disposal programme from the second half of 1999. This is indeed a key issue for the government. The slower the pace at which the assets are disposed off, the greater the overhang in the market place. And so long as there is this overhang, and so long as asset prices are above their market clearing levels, this can severely hamper new development activities and hence the pace of economic growth. Danaharta should also be cautious in the use of its funds in supporting partially completed projects. It is best for Danaharta, by relying on the auction process, to let the market decide on the fate of these projects.

A comprehensive restructuring exercise would require the judicious use of debt-equity conversions. The resulting change in ownership structure and management can create the right incentives for efficient behaviour by all stakeholders. To date there have been few corporate restructurings and hence few ownership and management changes at the corporate level.[34] The bank restructuring has led to the purging of NPLs, the recapitalisation of banks and some new appointees as directors or managers but without necessarily removing the old directors or managers. This is unlike what happened in the aftermath of the last banking crisis in the mid 80s. There were then no Danaharta or Danamodal. The Central Bank sacked the board and management of the ailing banks, appointed a new board and management, wrote down the loans and recapitalised the banks so that they can start all over again. To the extent that the old directors and managers are not removed and to the extent that bank deposits continue to be government-guaranteed the right incentives are not being created to rid the banking industry of the moral hazard problem and of a future banking crisis.

In respect of the corporate sector, if Danaharta ends up as a warehousing agency or if it does not impose proper burden sharing on stakeholders of the corporations that are restructured through its intervention, then the right incentives will not be created to rid the corporate sector of the moral hazard problem in that sector.

Part III: The Regulatory Framework and the Role of Policy

[34] Liberalisation of ownership conditions led to two major foreign equity investments in 1998 – a 30% investment by British Telecoms which increased the capitalisation of Bina Riang and an outright acquisition by Blue Circle of Kedah Cement. These deals, which were market-driven, greatly improved the competitive position of the two enterprises. To date there are no companies in corporate distress which have attracted outside equity investments in any significant quantity. The liberalisation also enabled two cellular phone companies to attract majors from Europe to take a sizeable minority stake after the outbreak of the crisis.

1. Equitable Treatment of Shareholders and Other Stakeholders

a. Shareholder protection

The adequacy of investor protection in Malaysia can be examined in relation to the rights of shareholders, the protection that shareholders enjoy against abuses and expropriation by insiders as well as the quality of law enforcement.

Ownership of shares in a company confers on a shareholder several basic rights which include the following – the right to a secure method 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 on key corporate matters, the right to elect members of the board and the right to share in the residual interest in the profits of the corporation. See Table 12 for more details.

The principal right that shareholders have is the right to vote on the election of directors, on amendments to the corporate charter as well as on key corporate matters such as the sale of all or a substantial part of the company's assets, mergers and liquidations thus limiting the discretion of insiders on these key matters.

In determining how well Malaysia fares as regards this principal right of shareholders, we have to examine the voting rights attached to shares as well as the rights that support the voting mechanism against interference by the insiders (dubbed anti-director rights by La Porta et al, (1998a) in their cross-country study of Law and Finance in 49 countries).

The one-share-one-vote rule with dividend rights linked directly to voting rights is taken as a basic right in corporate governance. This rule obtains when the law prohibits the existence of both multiple-voting and non-voting ordinary shares and does not allow firms to set a maximum number of votes per shareholder irrespective of the number of shares owned. 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 La Porta's cross-country study, Malaysia was found to be one of only 11 countries out of the 49 which impose genuine one-share-one-vote rule.

La Porta et al have identified six anti-director rights which essentially describe how easy it is for shareholders to exercise their voting rights. These rights and the findings, as set out in Table 13, are as follows:-

g) that shareholders are allowed to mail their proxy vote,
h) that shareholders are not required to deposit their shares prior to the general shareholders meeting,
i) that cumulative voting is allowed (whereby shareholders are allowed to cast their votes for one candidate thereby increasing the probability of outside directors),
j) that an oppressed minorities mechanism is in place (whereby minority shareholders are granted either a judicial avenue to challenge the management decisions or the right to step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes e.g. mergers),
k) that shareholders have pre-emptive rights to new stock issues and,

l) that the minimum percentage of share capital that entitles a shareholder to call for an extraordinary general meeting is reasonable i.e. 10% or less.

In their cross-country study La Porta et al found that the average score for the sample as a whole was 3.0 whereas it was 4.0 for the English common law countries, 2.33 for the French and German civil law countries and 3.0 for the Scandinavian civil law countries. This index aggregating shareholder rights was formed by adding 1 to each of the anti-director rights as specified above and 0 otherwise (with the index ranging from 0 to 6). Malaysia was scored at 4 as proxy by mail and cumulative voting are not allowed.[35] The score was 4 for Singapore, 3 for Philippines and 2 for Thailand and Indonesia.

In Malaysia, as in many other common law countries, shareholder voting rights are supplemented by an affirmative duty of loyalty of managers to shareholders i.e. managers have a duty to act in shareholders' interest. The most commonly accepted element of the duty of loyalty are the legal restrictions on managerial self-dealing, such as outright theft from the firm, excessive compensation or issues of additional securities (such as equity) to the management and its relatives. The courts would interfere in cases of management theft and asset diversion, and they would surely interfere if managers diluted existing shareholders through an issue of equity to themselves. However, courts are less likely to interfere in cases of excessive pay and in line with the business judgement rule (that keeps the courts out of corporate decisions) are very unlikely to second guess managers' business decisions, including the decisions that hurt shareholders (e.g. empire-building). Shareholders in Malaysia, as in the United States, have the right to sue the corporation using class action suits that get around the free rider problem, if they believe that the managers have violated the duty of loyalty. However, civil procedure in Malaysia is less facilitative of class actions and contingent fees are prohibited.[36]

In addition to measures of investors' legal rights, the La Porta study also examined the measures or proxies for the quality of enforcement of these rights, namely estimates of "law and order" in different countries compiled by credit risk agencies. Of the five measures studied, namely efficiency of the judicial system, rule of law, corruption, risk of expropriation and likelihood of contract repudiation, the authors noted that only the first two pertain to law enforcement proper and the last three deal more generally with the government's stance toward business.

The study emphasized the role accounting plays in corporate governance.[37] Accordingly, in inaddition to the rule of law variables, the study used an estimate of the quality of a country's

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[35] Shareholders in Malaysia do not enjoy pre-emptive rights on new stock issues given that companies may be required to make special issues to Bumiputras. If this is so then Malaysia's score on anti-director rights is 3 and not 4.

[36] Civil procedure in the United States is much more facilitative of class actions. 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 damages recovered in the action. In Malaysia, on the other hand, once a plaintiff in his representative capacity has established his claim to the damages, each member of the class has to bring his own action to establish damage suffered by him within the limitation period.

[37] "For investors to know anything about the companies they invest in, some basic accounting standards are needed to render company disclosures interpretable. Even more important, contracts between managers and investors typically rely on some measures of firms' income or assets being verifiable in court. If a bond convenant stipulates immediate repayment when income falls below a certain level, this level of income must be verifiable for the bond contract to be even in principle enforceable in court. Accounting standards might then be necessary for financial contracting, especially if investor rights are weak." [(7), p 28].

accounting standards. Like the rule of law measures, the study used a privately constructed index based on examination of company reports from different countries as a measure of accounting standards.

The specification in the study of the indices for the two law enforcement variables and for accounting standards are set out in Table 15. For the variable "efficiency of judicial system", Malaysia was scored at 9 (which is surprisingly high). The average score for countries with a legal system of English origin was 8.15, of French origin 6.56, of German origin 8.54 and Scandinavian origin 10.00. Australia, Hong Kong, New Zealand, Singapore, UK and US which are all common law countries registered a perfect score of 10 each whereas Thailand was scored at 3.25, Indonesia at 2.50 and Philippines at 4.75.

With respect to the "rule of law" variable, Malaysia was scored at 6.78 as against an average of 6.46 for countries with a legal system of English origin, 6.05 for French origin, 8.68 for German origin and 10 for Scandinavian origin. Australia, New Zealand and the US had a perfect score of 10 with the scores for Hong Kong at 8.22, Singapore at 8.57 and UK at 8.57. The scores for Thailand, Indonesia and Philippines were 6.25, 3.98 and 2.73 respectively.

For the rating on accounting standards, (See Table 15), Malaysia was scored at 76, as compared to the average only of 69.62 for countries of English origin, 51.17 for French origin, 62.67 for German origin and 74.00 for Scandinavian origin. Malaysia was behind Singapore and UK which had a score of 78 whereas it was ahead of Australia at 75, Hong Kong at 69, New Zealand at 70 and the US at 71. Malaysia was way ahead of Thailand's 64 and Philippines' 65. Indonesia was not scored.

From the preceding discussion, it is clear that Malaysia was one of only 11 countries out of a sample of 49 countries which impose a genuine one-share-one-vote rule. However, in respect of the exercise and enforcement of these voting rights, there is still a significant room for improvement in Malaysia. The authorities should actively consider allowing proxy by mail and cumulative voting for directors to strengthen the position of minority investors vis-à-vis the controlling shareholders.

The La Porta study did not examine the laws in place for the protection of minority shareholders against insider expropriation or abuses. But this has been attempted in a recent joint study of the Asian Development Bank and the World Bank (1998) for certain selected Asian countries. Table 14 sets out the findings of the study.

From a review of the table, one can infer that Malaysia stands out on the positive side in respect of safeguards against insider abuses. Shareholder approval of major as well as interested transactions is mandatory. Reporting by large shareholders and connected interests is also mandatory. Loans to directors or shareholders are prohibited. Stiff penalties against insider trading, provisions on takeovers and a mandatory independent audit committee minimises abuses by insiders and protects minority interests. However, a close review of existing legislation reveal several weaknesses:-

Firstly, there are outright prohibitions on certain related party transactions. On efficiency grounds, such transactions should be made subject to shareholder approval with the interested parties required to abstain from voting.[38]

[38] Many observers would agree that the outright prohibition in 132G of the Companies Act (CA) on the acquisition of shares or assets in a shareholder or director-related company should be revised but not sections 133 and 133A which deal with loans to directors or persons connected with directors. There is a fairly widely

Secondly, Section 132E of the CA as presently drafted, only embrace transactions with directors or persons connected with directors. It does not embrace transactions between a company and a substantial shareholder or persons connected with a substantial shareholder. Only section 132G (See Footnote 35) recognises the concept of a substantial shareholder in related party transactions. Therefore, the ambit of the section should be extended to cover substantial shareholders and persons connected to substantial shareholders.

Thirdly, Section 132E only requires the related party transactions to be disclosed and approved by shareholders but it does not prohibit the related party from exercising its voting rights on such transactions. Amendments should be considered to require the related parties (and in particular when the ambit of the section is expanded to cover substantial shareholders) to abstain from voting on interested party transactions.

Fourthly, there are also weaknesses in existing legal provisions with respect to a substantial acquisition or disposal which requires shareholders approval.[39] The KLSE Rule on a substantial transaction, and in particular, the new rule which came into force from July 1998, 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.

Fifthly, there were also some serious weaknesses in insider trading rules in Malaysia. With the recent amendments to the Securities Industry Act (SIA), which came into effect this year, the law against insider trading has been greatly improved. Insiders are no longer defined as persons with fiduciary duty or duty of confidentiality namely directors, managers, advisors and agents but include all persons who have in their possession material non public information. A tippee who uses such information will also fall into this group. The law which only provided for criminal action has now been expanded to enable the regulator or any person who has suffered loss or damage from insider trading (or market manipulation) to institute civil action against the offenders, thus heralding a new era in Malaysian securities industry regulation. Penalties for insider trading have also been increased to include civil penalties with provision for the regulator to recover three times the insider=s gain or loss avoided. The new civil penalties also allow investors to seek full compensation for loss or damages from the offenders.

Lastly, there was a serious weakness in respect of the Takeover Code. There are provisions in the Code for the protection of shareholders such as special disclosure thresholds and the obligations to extend a tender offer to all shareholders. However, parties who are involved in an acquisition or a takeover were allowed to apply to the Foreign Investment Committee (FIC) of the Economic Planning Unit for a waiver from making a general offer on “national

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held view that the section should be widened to embrace quasi-loans or other financial benefits or arrangements, gifts or quasi-gifts received or receivable. Also outright prohibitions against loans to directors are not uncommon (unlike the prohibition in 132G which is peculiar to Malaysia) and may be found both in UK and Australia.

[39] See Philip T N Koh, (1997), who contends that ASection 132C has given rise to uncertainty as to the scope of meaning of Aundertaking≅, Aproperty≅ and Asubstantial 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. It can be debated in anyone case whether the transaction is adverse to the company performance or financial position.

interest" grounds or to the Securities Commission if it meets its criteria with respect to the restructuring of a group of companies. Since 29th August, 1997, the FIC in fact granted, subject to certain specific conditions, exemptions to several trust agencies, majority shareholders, individuals and public companies from the obligation to extend a mandatory general offer (MGO) so as to facilitate the acquisition of shares in certain identified companies in order for them to stabilise share prices. These exemptions were poorly received by the market. The market reception became more violent when UEM, one of the entities given the waiver, was given a further exemption, and this despite the MGO being triggered by a breach of the initial approval conditions.

In response to the adverse reaction the SIA was amended in December 1998 to make the SC the sole authority to grant exemptions from provisions of the Code. The amendments now subjects the discretionary exemptive powers to a clear and transparent criteria as stipulated in statue so that the authority that exercises such discretionary power can be checked by investors who would have recourse to Court if the power has been arbitrarily exercised.

Unlike the weaknesses in the Companies Act on a related party transaction, the listing rules of the Kuala Lumpur Stock Exchange (KLSE) requires that a circular be sent to shareholders on a material transaction affecting a director or a substantial shareholder and that their prior approval of the transaction be sought in general meeting and further may require that the interested party abstain from voting.[40]

Reliance on the KLSE Rules, however, was not adequate as the KLSE had powers only to penalise or punish the listed companies and not the insiders committing the offence. Doubts had been expressed as to the extent to which the Rules restrict a shareholder from voting his shares in respect of a transaction that he is directly interested in. The KLSE Rules it was felt cannot deny a shareholder that fundamental property right. In this regard, it is interesting to note that the powers of the KLSE have been substantially embellished by the recent amendments in 1998 to the SIA which now strengthens KLSE's ability to take action against directors and anybody to whom its listing rules are directed at, whereas it was previously confined to the listed entity.

With this increase in the powers of the KLSE, it has been suggested that it is preferable to rely on the KLSE to enforce the rules on related party transactions. This on the ground that KLSE, as a self-regulatory organisation, is likely to be less inflexible in adapting the Rules to the changing conditions in the business world. There is great merit in this argument provided that it can be established that a shareholder, with the recent amendments to the SIA, cannot in fact challenge KLSE's Rules that restrict his voting rights. However, it is important to note that the KLSE still does not have the enforcement infrastructure of a statutory regulator (which includes the statutory right to require information as well as the rights of search and seizure).

The purchases by UEM, a blue chip company with a strong balance sheet, of a one-third interest in a related company but with a weaker balance sheet, namely Renong Berhad, without proper disclosures or prior shareholder approval, as well as controversy over the waiver granted to UEM from making a mandatory general offer under the Takeover Code, led to a big shakeout in investor confidence in the Malaysian stock market in late 1997 and early 1998. This had come soon after the market had succumbed to the regional financial

[40] The old rule 118 only covered transactions involving the interests of directors and substantial shareholders, direct or indirect. The new rule also covers transactions involving the interest, direct or indirect, of persons connected with directors or substantial shareholders.

crisis in mid 97 and the attempt of the government to regulate trading which had unsettled the market further. UEM was penalised for its non-disclosure but not any of its directors. The fine imposed was the maximum but it was a paltry sum in relation to the billions that were lost in market capitalisation. As noted earlier the waiver from the MGO unsettled the market a great deal. On a strict interpretation of the law then the transaction may have required the approval of shareholders only as a large transaction but not as a related party transaction. With the changes to the law made since then, such a transaction, if it were to happen now, would require the prior approval of disinterested shareholders.

Apart from the quality of legal protection, the quality of law enforcement also matters for a system of good corporate governance. The La Porta study adopted the rule of law variable as a proxy for the quality of law enforcement. Going by this measure, Malaysia only ranked 9th amongst the 17 common law countries which were covered by the study. Of the 11 German and Scandinavian civil law countries, only one, namely South Korea registered a lower score than Malaysia for this variable. Even amongst the French civil law countries, there were 7 countries which had a better quality of law enforcement than Malaysia. In the light of the UEM-Renong debacle, Malaysia's record on the quality of enforcement may in fact be worse than what is suggested in the La Porta study. Therefore, it is clear that there is considerable room for Malaysia to improve its record on matters related to law enforcement.

Prior to 1965, minority shareholders had to rely on common law doctrines to check abuse of powers by directors or majority shareholders. There are several difficulties with the common law doctrines.[41] Responding to these inadequacies, the legislature in 1965 introduced S181 of the Companies Act 1965 providing for relief against oppressive conduct or conduct in disregard of interests and unfairly discriminatory or prejudicial conduct.

Section 181 according to Loh Siew Cheang, "is a superior course of law for checking the abuse of powers and in providing remedies when compared with the common law doctrines. Under this section, the rule in *Foss V Harbottle* has no application and the courts are free of common law precedents developed under the doctrine of fraud on the minority when interpreting the scope of the section. Further, once the court is satisfied that the conduct complained of is established, the court has a wide discretion as to the relief which it may grant, such relief including an option to wind up the company".[42]

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[41] Foremost, according to Loh Siew Cheang (1996), aggrived shareholders have first to overcome the rule in *Foss V Harbottle*. Secondly, the difficulty involved in trying to bring the impugned conduct within certain categories of conduct which the courts would readily recognise as being culpable or wronglful. Thirdly, the range of remedies available to aggrieved minority shareholders is limited, p124.

[42] In a decision by the Privy Council in *Re Kong Thai Sawmill (Miri Sdn Bhd* (1978) 2 MLJ 227 (See Thillainathan et al 1999), 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, a second statutory remedy for shareholders, 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.

b. Creditor Protection

A measure of creditor rights and the efficacy of the judicial system in protecting creditor rights, as computed by Claessens et al (1999c), is set out in Table 16.

In constructing the index of creditor rights, Claessens et al have used the methodology in La Porta et al (1997). This index is an average of four indicators of creditor strength. First, the timeliness of rendering a judgement whether to liquidate or restructure once a bankruptcy petition has been filed. For example, the bankruptcy codes in Indonesia, the Philippines and Thailand do not have a specified timetable for rendering a judgement.[43] The remaining six countries impose a timetable, such as 60 working days in Hong Kong and Japan and 180 working days in Malaysia. Second, whether the incumbent management remains in control of the company during reorganisation or bankruptcy. This is the case only in Indonesia and the Philippines. Third, whether the creditor is barred by an "automatic stay" from taking action against the debtor's assets during the pendancy of the bankruptcy. This is the case only in Indonesia, Japan and the Philippines. Fourth, whether secured creditors have the first priority of claims to the debtor's assets. This is the case in Hong Kong, Japan, Korea, Malaysia, Singapore and Taiwan. Based on these indicators of creditor rights, Hong Kong, Singapore and Taiwan were scored at the maximum of 4, Japan, Korea and Malaysia were scored at 3, Thailand at 2 and Indonesia and Philippines at 0.

Claessens et al have constructed their index of the efficacy of the judicial system based on data from a 1999 Asian Development Bank study of Insolvency Law Reform in selected Asian countries. The study reports the expense, difficulty, efficiency and speed of liquidating or restructuring an insolvent corporate borrower. As shown in Table 16, Singapore had the highest ranking at 7 based on the average of the scores of its liquidation and restructuring processes, as against the maximum of 8. Korea was scored at 6.5. Hong Kong, Japan and Thailand (a surprise) were scored at 5.5 as against Malaysia at 4.5, Indonesia and Taiwan at 3.5 and Philippines at 2.0.

Claessens et al state that the individual country surveys on which the above computations are based use similar methodology and were conducted by teams of legal experts in each country and reviewed by a regional team to ensure the comparability of results. Nonetheless, based on casual empiricism, it is my considered view that the score for Malaysia vis-a-vis that of Thailand appears to be low. There has been a reform of the Thai bankruptcy law no doubt but this has been more than compensated by the establishment in Malaysia of Danaharta whose operations are covered under a special act. This act confers on Danaharta broad ranging powers to acquire, manage and dispose assets. It also compensates for the absence of a well-defined scheme of judicial management of corporate restructuring under the Companies Act.

[43] For Indonesia, Claessens et al refer to the law before the bankruptcy reform in August 1998.

c. The Role of the Board of Directors[44]

Malaysian boards are unitary in nature. The average size of the board of Malaysian PLCs is 8. Of this, 2.6 members are made of independent non-executive directors, 2.6 are non-executive directors and 2.8 are executive directors. (KLSE/PriceWaterhouseCoopers 1999). There is no requirement or practice to represent stakeholders (other than shareholders) on boards, such as employees, creditors or major clients or suppliers. Interlocking directorships occur in companies belonging to the same corporate group. No limit has been placed on this practice save to restrict (with effect from 1999) the number of directorships an individual director of a PLC can hold in other PLCs as well as in private limited companies. As a rule individuals belonging to a particular corporate group (whether they are owners, directors or managers) do not sit on boards of companies belonging to other groups. But there are directors who are independent of significant shareholders or management who sit on boards of different corporate groups or companies, provided these companies are not competing with each other.

There has been minimal regulation of the structure and composition of boards. The Companies Act requires every company to have at least two directors. The KLSE listing rules require two independent directors on boards who are neither related to its officers nor represent concentrated or family holdings of its shares. The KLSE is currently considering a proposal to expand the definition of independence to exclude substantial shareholders. A substantial shareholder is now defined (i.e. wef 1998) as a person who has interests in 2% of the voting shares. This is a source of concern given that the new Malaysian Code on Corporate Governance, which was adopted in early 1999,[45] requires that one-third of the board should comprise independent directors. To fulfill this requirement, the Code simply states that the board should include a number of directors, which fairly reflects the investment in the company by the shareholders other than the significant shareholder. The proposed KLSE rule and the new Code, taken together, may have the unintended effect of disenfranchising the very group of people who have the most incentive (because of their large shareholdings) to ensure that their rights are not abused.

There is therefore, an urgent need for KLSE to reconsider its proposal. Otherwise, given concentrated shareholding, the two or three largest shareholders in a company (See Table 9) may end up accounting for two-thirds of the appointees on boards with the balance one-third representing the retail investors without any representation from intermediate groups such as institutional investors who have, by virtue of their large shareholding, an incentive to monitor the managers or owner-managers of the companies in which they have invested.

Presently cumulative voting is not permitted in that a shareholder is not allowed to concentrate and cast its votes on behalf of a single candidate. Also appointment to the board is on a staggered basis, with approximately one-third of the directors coming up for re-election once in three years. If there is cumulative voting with non-staggered boards and the number of directors is in the single digit, then this is likely to see the election of large shareholders as directors who are independent of managers or owner-managers, such as institutional investors. This is a more market-friendly and effective way of ensuring independent directors on boards then what is envisaged even by the new Code. In the

[44] This section is based largely on the study of Thillainathan et al (1999).

[45] This Code was drawn up by a joint-working group of the public and private sector referred to as the Finance Committee and was incorporated into its Report on Corporate Governance. See Government of Malaysia (1999). The Listing Rules of the KLSE are to be amended to incorporate the key provision of the Code.

absence of cumulative voting and given concentrated shareholding, it will be more difficult to ensure a board which is not a captive of the owner-managers.

The new Code 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 nomination committee is to comprise a majority of independent non-executive directors and is to be chaired by such a director. The Executive summary of the KLSE/PriceWaterhouseCoopers 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. Again it is not clear if this process is superior to cumulative voting for ensuring the election of independent directors.

The boards are essentially free to set up whatever committees they see fit to facilitate the management and supervision of the company. The only committee that is mandated is the audit committee. The Listing rules of the KLSE currently 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.[46]

The new Code sets out an additional function of the audit committee, i.e. to consider and where it deems necessary to investigate any matter referred to it or that it has come across in respect of a transaction, procedure or course of conduct that raises questions of management integrity, possible conflict of interest or abuse by a significant or controlling shareholder. The Code further recommends that where upon reporting its findings to the board, the board fails to take any action, the directors of the committee should be required under the Listing rules of the Exchange to report the matter directly to the Exchange.

In addition to the audit committee, typical issues to be delegated to committees of larger public companies include nominating directors (alluded to above) 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/PriceWaterhouseCoopers survey on corporate governance indicates that one in five companies already have remuneration committees in Malaysia. No data is provided on the membership of these committees. The 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 form drawing from outside advice if necessary. The membership of the remuneration committee has to be disclosed in the

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[46] These are as follows:-

- review with the auditor, the audit plan, the auditor's evaluation of the system of internal accounting control, the audit report;
- review the assistance given by company officers to the auditors;
- review the scope and results of internal audit procedures;
- review the balance sheet and profit and loss account of the company;
- review any related party transactions that may arise within the group; and
- nominate the auditors of the company.

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

director's report. The Code also requires companies to disclose in the annual report, the details of remuneration of each director. Presently the remuneration of directors are disclosed on an aggregate basis.[47]

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 avoid 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 – S132 of the Companies Act 1965 (CA) sets out the director's duty to act honestly. This has been interpreted through case law to mean the "best interests of the company". 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.

There is also a well established body of 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. With respect to employees, unlike the English Companies Act 1985 or the Singapore Companies Act, the Malaysian 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.

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 S131 CA 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.

Duty to act for a proper purpose - directors 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 S132D CA which provides that, notwithstanding any provisions in the company's charter, directors must not issue new shares without the prior approval of members in general meeting.

There is a striking contrast between directors 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 perhaps conscious of substituting their hindsight for a director's foresight. S132(1) CA 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.

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[47] The compensation of executive directors and managers include stock options. The rules require disclosure by directors of the shares and options they hold and of the trading in such instruments on an annual basis in the company's Annual Report.

Directors are also subject to various disclosure obligations under the law. S135 CA 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, and any changes in those interests. 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. S99B of the SIA 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.

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

1. ***Clarification of the duty to act honestly*** – The duty to act "honestly" should, according to the FC, 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. 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. The FC Report has 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. And while there are fiduciary principles under common law to deal with these abuses the problem with common law, according to the FC 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. There are several provisions in the CA which reinforces the common law obligations. But these do not cover the full range of common law duties and obligations. Accordingly the FC argues for the Codification of this duty setting out minimum procedures that directors should adopt in conflict situations which should include full disclosure of the conflict, the interested director should abstain from voting and 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. Accordingly the FC has opined that Codification of the fiduciary duties coupled with stringent penalties would go some way towards addressing this problem, that provision be made, as in Australia, for the regulator to institute civil action on behalf of an investor to recover damages suffered by the investor as a result of transgressions and that statutory derivative action be introduced to strengthen the avenue for civil enforcement action by shareholders. Sections 90 and 90A Securities Industry Act, with the recent amendment, now provide for the recovery of losses caused by insider trading, by way of civil actions instituted either by the Securities Commission or the investor.

In Malaysia it is clear that a company is a separate legal entity from its membership but the corporate veil can be lifted (and hence limited liability can be disregarded) in appropriate circumstances. However, according to Chan and Koh (1998), the instances where the court has disregarded the doctrine follow no consistent principles. The court has a discretion to lift the corporate veil for the purpose of discovering any illegal or improper purpose and have indeed pierced it when a fraud has been committed. The court has also not allowed the doctrine to be used by a contracting party to circumvent its contractual obligations lawfully owed to a counter party. The court has denied the existence of a general principle that a parent company and a subsidiary are to be regarded as one. This means that a parent company may not sue to enforce the rights belonging to its subsidiary company and the holding company is not liable for the debt of its subsidiary company.[48] An exception is to establish the agency rule but in the absence of an explicit agency contract between a parent and a subsidiary one cannot be said to be an agent of the other. And in the present state of the law it is difficult to ascertain when a court will imply such an agency. If liability is to be fixed as principal, evidence of agency has to be established substantially and cannot be inferred from the holding of a director's office and by the control of shares alone. It appears that piercing of the corporate veil on agency grounds has not been fully considered by the Malaysian courts.

The exceptions to be found in common law to the doctrine of independent legal entity and limited liability have been supplemented by certain provisions in the written law of the country. These are as follows:-

1. If the number of members of a company falls below the statutory minimum of two, then a sole remaining member, where it is not a holding company, may be liable for the payment of the company's debts if it carries on business for more than six months.
2. The privilege of a member's limited liability may be lost if he is convicted of providing financial assistance for purchasing, dealing in or lending money on its own shares.[49]
3. If any officer of a company signs, issues or authorises any negotiable instrument wherein the name of the company is not so mentioned, he is liable to the holder for the amount due thereon.
4. S132D prohibits the directors to issue shares without the prior approval of the shareholders. A director who contravenes this provision is liable to pay compensation to any adversely affected party.

[48] This is partly because each company in a group may not have identical creditors with identical claims.
[49] Under a recent amendment PLCs are now allowed to buy back their own shares in certain prescribed circumstances.

5. An officer who is a party to the contracting of a debt by a company which is subject to any proceedings such as a winding up action (and which debt the company is unable to repay) may be required to repay the debt without any limitation of liability.
6. The privilege of limited liability is lost if any business of the company has been carried on with intent to defraud creditors.
7. Where any dividend is paid out of share capital and not out of profits every director or manager of the company who pays the dividend will be liable to the creditors up to the extent of the difference and
8. Where companies are related to each other, the law sets aside the independent legal entity doctrine by requiring a consolidated profit and loss account of the holding company and of its subsidiaries.

2. The Importance of Transparency & Disclosure

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.[50] 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.[51] 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

[50] 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 be few or no such minority shareholders.

[51] 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.

market incentives, the regulators are strengthening due diligence and fiduciary obligations of both financial intermediaries as well as of directors, managers, accountants and auditors.[52]

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.

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.

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 (eg. its risk characteristics) and second, more specific information about the IPO (eg. the size of the offering).

With respect to the periodic disclosure and reporting requirements a public listed company (PLC) is now required to publish quarterly financial statements within two months after the end of each financial quarter starting from the third quarter of 1999 (versus half yearly reports within three months previously) and annual audited accounts, auditors' and directors' reports within four months (versus six months previously) from the close of each financial year. Unlike the half year reports which focused only on the financial performance of a PLC and not on its financial position, the new quarterly reporting requirement will be more stringent entailing the release of a balance sheet, income statement and explanatory notes. The annual reports will continue to report on a PLC's financial performance, financial position as well as its cashflows. These reports are also required to disclose the extent of compliance of companies with the Malaysian Code on corporate governance, which Code has the backing of KLSE's listing rules.

Under the continuous disclosure requirements, a PLC is required to make immediate public disclosure of all material information (including non-financial 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 the fullest possible public dissemination.[53]

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[52] Under KLSE regulations, listed companies are required to make timely disclosure of material financial and corporate information. From January 1, 1998 to February 18, 1999, based on data supplied by the KLSE,

- sanctions ranging from a private reprimand to a fine of RM100,000 were imposed on 7 public listed companies for breaches of the Listing Requirements relating to non-disclosure of material transactions and

- sanctions ranging from a private reprimand to a fine of RM100,000 were imposed in 27 instances on public listed companies for the failure to submit financial statements within the periods prescribed in the Listing Requirements.

[53] Other regulatory initiatives are supportive of this orientation for immediate public disclosure and thorough public dissemination of material information. For instance, whenever a PLC 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, whenever unusual market action takes place in a PLC's securities, the company is expected to make inquiry to determine whether rumours or other conditions requiring corrective action exists, and, if so, to take whatever action is appropriate. A PLC is to

Malaysia has been adopting, starting from the late 70's accounting standards that are generally consistent with the standards issued by the International Accounting Standards Committee, IASC, (dubbed IAS's). This process had been spearheaded and supervised by the Malaysian Institute of Accountants (MIA) and the Malaysian Association of Certified Public Accountants (MACPA), the two professional accountancy bodies in the country.
By the beginning of 1998 Malaysia had adopted 25 of the 31 extant IAS standards. 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 not material, in the current economic environment, a third is on accounting for business combinations for which local standards exist. The fourth is on computing Earnings Per Share for which a local standard has been available from 1984. For the fifth on accounting for financial institutions the central bank (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 to come into force from 1.1.1999.

Malaysia has been somewhat slow in adopting some of the revised IASs and to that extent accounting practice in Malaysia has not kept pace with the international best practice. This has become a little more marked after the Malaysian Accounting Standards Board (MASB) was established in 1997 under the Financial Reporting Act (FRA) as the sole authority to set up accounting standards for Malaysia. This is no doubt because MASB has embarked on its own due process as a pre-condition to the establishment of its financial reporting regime for the country. In the interim MASB adopted in January1998, 24 of the extant accounting standards as approved accounting standards for purposes of the Act. The remaining eight accounting standards issued by the professional bodies were not adopted by the MASB. But MASB announced that these eight standards will continue to be promulgated by the professional bodies as applicable standards in the preparation of financial statements until each of these accounting standards is reviewed and adopted as approved accounting standards, or relevant new accounting standards are issued. Based on its current work programme MASB's standards are expected to differ from the IASs primarily to reflect the statutory and regulatory reporting requirements in Malaysia. Seven of MASB's new standards are expected to come into force in July 1999.

Malaysia has not only been adopting good standards but according to the World Bank it 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. The professional accounting bodies have the power to reprimand only their own members for any non-compliance. However, under the FRA the PLCs themselves are now liable to prosecution for non-compliance with approved accounting standards. And the power of enforcement rests with the Securities Commission for PLCs, with the Central Bank for licensed financial institutions and the Register of Companies (ROC) for non listed companies.

The major differences between Malaysian approved accounting standards which are currently in force and IASs are as follows:-[54]

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refrain from promotional disclosure activity which exceeds that which is necessary to enable the public to make informed investment decisions.

[54] The standards chosen for comparison are as per the OECD questionnaire.

1. Current asset investments has to be carried at the lower of cost and market value and not at market value as in IAS25.
2. Goodwill arising on acquisition can be immediately written-off to reserves in the year of acquisition, retained as a permanent item on the balance sheet subject to provision for permanent diminution in value or recognised as an intangible asset on the balance sheet and amortised over its estimated useful life. On the other hand, IAS22 requires goodwill to be recognised as an intangible asset and amortised to zero over its useful life but not exceeding 25 years.
3. IAS32 on the Disclosure and Presentation of Financial Instruments which became operational in 1996 has not been adopted in Malaysia.[55] This means that there is currently no disclosure of terms, conditions and accounting policies for financial instruments (including derivatives), interest rate risk and credit risk data, and the fair value of on-and-off balance sheet financial instruments.
4. There is a reporting requirement to consolidate financial statements in Malaysia which is consistent with IAS27 in all material respects but classifies a subsidiary not by using the criterion of control as in IAS27 but by ownership interest (of more than 50%).[56]
5. On accounting for investment in associates, under current practice in Malaysia, some reporting enterprises recognise associates on the basis of ownership interests of between 20% to 50% and not on the criterion of "significant influence" as per IAS28.

MASB has adopted (but only with effect from 1.7.2001) the revised standard on the effects of changes in foreign exchange rates (i.e. IAS21) which requires all exchange gains or losses arising on translation of long-term monetary items to be recognised as income or as expenses in the period they arise. MASB's transitional provisions permit the deferral of unrealised exchange gains or losses on long-term monetary items provided no recurring exchange losses on the items are expected in the future.

IAS10 on contingencies and Post Balance Sheet Events which was adopted in 1980 became operational in Malaysia on the same date. The accounting treatment of research and development costs in Malaysia is consistent with IAS9. IAS24 on Related Party Disclosures which came into force in 1988 became operational in Malaysia only in 1997.[57]

We have noted the existence of corporate groups and ownership links where a controlling shareholder exercises control via pyramid structures and cross-holdings and where the divergence between control and cashflow rights can lead to the potential expropriation of minority shareholders. The threshold for substantial shareholding reporting has been lowered from 5% to 2% and the period of reporting has also been shortened from 14 to 7 days. The penalties for failure to make the required disclosures have been increased from a fine of RM5,000 to a fine of RM500,000 or imprisonment for a term not exceeding 5 years or both. With these changes, the data base on substantial shareholders will be much better for the analysis of control and cashflow rights and of their implications for violations of minority shareholder rights.

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[55] IAS 32 has been adopted by MIA to come into force w.e.f. 1.1.99. MASB is expected to issue the Standard as an exposure draft in 1999.

[56] In countries where there was no reporting requirement to consolidate financial statements, this had allowed some firms to hide debts on the books of affiliates, preventing lenders and shareholders from discovering the firm's real exposure to high levels of debt.

[57] The following are examples of situations where related party transactions may lead to disclosures: purchase or sale of goods, property and other assets, rendering or receiving of services, agency, leasing and license agreements, finance (including loans and equity contributions), guarantees and collaterals as well as management contracts.

Steps have also been taken to achieve transparency of ownership. Amendments to the Securities Industry Central Depositories Act in October 1998 now prohibit persons from hiding behind their nominees by introducing the concept of an authorised nominee and prohibiting global accounts (an authorised nominee may only hold securities for one beneficial owner in repect of each account) and by requiring a beneficial owner of securities to make a declaration that he is the beneficial owner of the securities. This new restrictive rule which prohibit global accounts and which require a fund manager to open accounts and maintain records in the name of each and every one of its individual clients, (apparently for improving transparency), has increased the cost and decreased the level of private fund management activity and hence aggravated the problem of concentrated shareholding in Malaysia. Given the reporting requirement on substantial shareholders with its reduced threshold, it is not necessary to prohibit the operation of global accounts for the alleged purpose of improving transparency.

The Companies Act requires the financial statements 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 responsibilities of the auditor in Malaysia under the reporting framework of MIA's approved auditing standard and the Companies Act required an auditor to conduct his audit in accordance with international best practice and to clearly state whether the accounts have been drawn up to 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.

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.

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. An officer of a corporation who hinders, obstructs or delays an auditor in the performance of his duties is guilty of an offence under the Act. The penalty for this breach is imprisonment for two years or thirty thousand ringgit or both.

The external auditor is appointed and may only be removed by shareholders. The auditor is given the right to make representations by circulars and be heard orally at a meeting of shareholders convened for the purpose of considering his removal. 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.

Where an auditor desires to resign, the Companies Act provides for the convening of a meeting for the purpose of appointing another auditor but there is no requirement that the circumstances surrounding the auditor's decision to resign is disclosed. It has been suggested that the law 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.

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. The Companies Act places a statutory duty on an auditor to report in writing to the ROC, where in the course of performance of his duties an auditor of a company **is satisfied** that there has been a breach or non-observance of any of the provisions of the Act.

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.

Auditors are required to observe approved Standards on Auditing as promulgated by MIA and an audit report has to contain a positive statement to the effect that the audit has been conducted in accordance with these standards. MIA has adopted the International Standards on Auditing issued by the International Auditing Practices Committee of the International Federation of Accountants (IFAC) as the basis for its approved standards on auditing. Any failure to observe the standards can expose a member to the risk of disciplinary action by the MIA. To date the accounting profession has not directed as much attention to strengthening auditing practices. This is changing now that MASB is the sole authority to issue accounting standards and government regulatory agencies have been entrusted with the responsibility for enforcing these standards against companies which are not observing them. Members of MIA have also been advised that a court of law may, when considering the adequacy of the work of an auditor, take into account the approved standards on auditing as indicative of good auditing practice.

Part IV: Conclusions

At the outbreak of the Asian crisis, there were certain weaknesses in the corporate governance mechanisms for protecting investors vis-a-vis the insiders. And yet on a relative basis, the public equity market was very sizeable. This is partly because Malaysia, with its common law tradition, (which it had inherited from Britain), had a satisfactory reputation for the protection of minority shareholder rights, partly because investors were optimistic about

prospects, partly because the shareholders could count on the managers to be concerned about reputation and therefore could expect the owner-managers to work in the larger interest of all shareholders and partly because a good market infrastructure that facilitated active trading provided the shareholders with the option to exit by selling their shares. The crisis exposed certain glaring cases of corporate governance breakdowns arising from related party transactions which had worked against the interest of minority shareholders. There were only a few cases of such breakdowns among bluechip companies in which the foreign and local funds or institutions had invested. But these breakdowns became very glaring not only because of certain weaknesses in the law but more because (perceived or otherwise) of the weak enforcement of minority shareholder rights as well as the failure of the regulators to take strong actions or impose the required penalties against the violators. Inadequate disclosures of risk exposures (because of weaknesses in the disclosure regime), some shortcomings in the accounting and financial reporting standards (because of non-adherence to international best practice on the mark-to-market rules) and the imposition of restrictions on trading at the height of the crisis had compounded the problem.

In response to the crisis, the most comprehensive corporate governance reform exercise in Malaysia was announced by the Minister of Finance in March 1998 which saw the establishment of a high level Finance Committee (FC) comprising both government and industry representatives. The FC was established to provide a comprehensive report on measures to improve corporate governance. After consultation with selected industry bodies (namely those bodies not represented on the FC) a revised report was re-submitted to the government in February 1999. The recommendations of the FC essentially seek to strengthen the statutory and regulatory framework for corporate governance, enhance the checks and balances and self regulatory mechanisms towards good governance and identify training and education programmes to ensure success in the implementation of its recommendations.

Key recommendations of the FC in the context of the law or rule reform proposals include recommendations for restrictions in voting rights of controlling shareholders in related or connected party transactions to be codified in the Companies Act, codification of the fiduciary duties of directors, strengthening the position of nominee directors, introduction of a statutory derivative action, voting by mail to name a few. The FC's Code on Corporate Governance, to be incorporated into the KLSE's Listing Manual, sets out the extent of independent director participation on boards, use of board committees, and includes proposals for the setting up of remuneration and nominating committees, etc. A key proposal in the context of training and education is to subject all directors of companies seeking listing on the Exchange to undergo mandatory training.

In spite of these comprehensive reforms, minority shareholders are still exposed to considerable risk so long as they operate in an environment of concentrated shareholding. This is so because the independent directors who are to exercise oversight over the owner-managers are liable to capture by these owner-managers. These reforms may prove to be futile unless they are effectively enforced. Too narrow an interpretation or too rigid an enforcement of the reforms may have the unintended effect of curbing business flexibility. What is probably more important is to ensure an efficient and impartial judiciary to which aggrieved parties can turn to redress their grievances. In spite of the country's good heritage in this direction, there is a growing perception in recent years of a decline in the standards of the judiciary. There is of course a need to arrest this trend so as to ensure that the independence, impartiality and integrity of the judiciary is maintained beyond doubt at all times. Equally important the presence of restrictive licensing practices have made for monopolistic tendencies in certain industries and hence for concentrated shareholding. The

continued opening up of markets to competition is essential to reduce the incentives for ownership concentration and therefore to increase the incentives for dispersed shareholding, risk diversification at the level of individual or family wealth holders and hence for improved governance practices.

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Table 1: Control of Public Traded Companies (%) By Type of Shareholder & Level of Ultimate Shareholding of a Substantial or the Controlling Shareholder (Unweighted)

Level/Type	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation
10%	1.0	57.7	17.8	12.5	11.0
20%	10.3	67.2	13.4	2.3	6.7
30%	41.2	45.6	8.2	0.0	5.0
40%	77.3	14.7	4.2	0.0	3.8

Source : Stijn Claessens et al (1999a)

Notes :

Stijn Claessens et al analyze the control pattern of companies by studying ultimate shareholdings. In the majority of cases, the principal shareholders are themselves corporate entities, not-for-profit foundations or financial institutions. The authors then identify the owners of these entities, the owners of their owners, etc and use the family group as the unit of analysis but do not distinguish among individual family members. Corporations are divided into those with ultimate owners and those which are widely-held i.e. those which do not have any owners who have significant control rights. Ultimate owners are further divided into four categories: families including individuals who have large stakes, the state, widely-held financial institutions such as banks and insurance companies and widely-held corporations.

The distribution of ultimate control among the five ownership groups identified has been computed by studying all ultimate shareholders who control over 20% of the shares or votes – the benchmark cut-off level used both by Berle and Means (1932) and La Porta, Lopez-de-Silanes, and Shleifer (1998) – as well as at alternative cut-off levels of 10%, 30% and 40%. The distribution of ultimate control has been computed by reference to a simple average as well as a weighted average where the weights are based on market capitalisation.

Given the above definition of ultimate control, a firm can have more than one significant owner at a given cut-off level and the ultimate owner can change at a different cut-off level. For example, if a firm has three owners – a family which controls 20%, a bank which controls 10% and a widely-held corporation which controls 10% - it is only 1/3 controlled by the family at the 10% level, but is fully controlled by the family at the 20% level. The firm is widely-held at higher cut-off levels.

Table 2: Control of Publicly Traded Companies By Type of Shareholder for Base Case (where an Ultimate Shareholder Controls Over 20% of the Shares)

	Widely Held	**Family**	**State**	**Widely Held Financial**	**Widely Held Corporation**
Unweighted	10.3	67.2	13.4	2.3	6.7
Weighted by Market Capitalisation	16.2	42.6	34.8	1.1	5.3

Source: Stijn Claessens et al (1999a)

Notes: As in Table 1.

Table 3: Control of Publicly Traded Companies By Type of Shareholder & Size of Firm (Based on Market Capitalisation) for Base Case

	Widely Held	**Family**	**State**	**Widely Held Financial**	**Widely Held Corporation**
All Firms	10.3	67.2	13.4	2.3	6.7
Largest 20	30.0	35.0	30.0	0.0	5.0
Middle 50	12.0	69.0	10.0	4.0	5.0
Smallest 50	0.0	84.0	5.0	2.0	9.0

Source: Stijn Claessens et al (1999a)

Notes: As in Table 1.

Table 4: How Concentrated is Family Control?

1.	Number of companies listed on KLSE	621
2.	Number of companies in Sample	238
3.	Share of total market capitalisation	74%
4.	Average number of firms per family	1.97
5.	% of total market cap that families control	
	a. Top 1 Family	7.4%
	b. Top 5 Families	17.3%
	c. Top 10 Families	24.8%
	d. Top 15 Families	28.3%

Source: Stijn Claessens et al (1999a)

Notes: The average number of firms per family refers only to firms in the sample.

Table 5: Means of Enhancing Control (Full sample, % of total)

1.	Cap = 20% V[a]	18.11
2.	Pyramids with Ultimate Owners[b]	39.30
3.	Cross Holdings[c]	14.90
4.	Controlling Alone[d]	37.40
5.	Owner Management[e]	85.00

Source: Stijn Claessens et al (1999a)

Notes:

a. Cap = 20% V is the average minimum % of the book value of common equity required to control 20% of the vote;

b. Pyramids with Ultimate Owners (when companies are not widely held) equals 1 if the controlling owner exercises control through at least one publicly-traded company, 0 otherwise;

c. Cross-Holdings equals 1 if the company has a controlling shareholder and owns any amount of shares in its controlling shareholder or in another company in her chain of control, 0 otherwise;

d. Controlling Owner Alone equals 1 if there does not exist a second owner who holds at least 10% of the stock, 0 otherwise;

e. Management equals 1 if the CEO, Board Chairman or Vice-Chairman are from the controlling family, 0 otherwise.

Table 6: Concentration of Cashflow Rights and Ultimate Control By Largest Control Holder

	Mean	**Std. Deviation**	**Medium**	**1st Quartile**	**3rd Quartile**
Cashflow Rights	23.89	11.68	19.68	14.00	30.00
Control Rights	28.32	11.42	30.00	20.00	30.42
Ratio of Cashflow to Control Rights	0.853	0.215	1.000	0.733	1.000

Source: Stijn Claessens et al (1999b)

Notes:

The study by Stijn Claessens et al also distinguishes between control (or voting) rights and cashflow rights. Suppose, for example, that the family owns 11% of the stock of publicly-traded Firm A, which in turn has 21% of the stock of Firm B. We would say that the family controls 11% of Firm B – the weakest link in the chain of voting rights. In contrast, we would say that the family owns about 2% of the cash flow rights of Firm B, the product of the two ownership stakes along the chain. To make the distinction between cashflow and control rights, the authors document pyramiding structures for each firm, cross-holdings among firms, and deviations from one-share-one-vote rule.

Table 7: Control & Cashflow Rights of Selected Malaysian Corporates[1]

		Control Rights	Cashflow Rights
I	Khoo Kay Peng		
	MUI	0.29	0.13
II	Kuok Brothers		
	Perlis Plantations	0.39	0.39
	Shangri-La Hotels (M)	0.70	0.55
	Federal Flour Mills	0.53	0.34
III	Lim Thian Kiat [2]		
	Multi-Purpose Holdings	0.09	0.03
	Magnum Corporation	0.09	0.01
IV	Vincent Tan		
	Berjaya Group	0.41	0.41
	Berjaya Sports Toto	0.41	0.20
	Berjaya Singer	0.41	0.30
V	Yahya Ahmad Estate		
	Diversified Resources	0.66	0.66
	Gadek Malaysia	0.65	0.54
	Hicom	0.32	0.17
	EON	0.32	0.06
	Proton	0.26	0.05
VI	William Cheng		
	Amsteel Corp	0.70	0.58
	Lion Corp	0.59	0.59

Source: Data extracted from SBC Warburg Dillon Read: Malaysia Connections, January 1998.

Note:

1. Methodology used in computing control rights are as laid down in Stijn Claessens (1999a).
2. T K Lim's family company owned 8.8% of Kamunting Corporation and Malaysian Plantations owned 37.2%. In turn, Kamunting owned 25.2% of Malaysian Plantations. Therefore, actual control rights of T K Lim in Kamunting is probably above 8.8%. Kamunting held a 30.5% stake in Multipurpose Holdings which in turn held a 23% stake in Magnum Corporation.

Table 8: Ownership Concentration in Ten Largest Firms

	All Firms (2)	Private (3)		All Firms (2)	Private (3)
ASIA			**LATIN AMERICA**		
India	38%	40%	Argentina	50%	53%
Indonesia	53%	58%	Brazil	31%	57%
Korea	23%	20%	Chile	41%	45%
Malaysia	46%	54%	Colombia	63%	63%
Pakistan	26%	37%	Mexico	64%	64%
Philippines	56%	57%	Venezuela	Na	51%
Sri Lanka	60%	60%			
Thailand	44%	47%			

Notes:

(1) The average percentage of common shares owned by the three largest shareholders in the ten largest non-financial firms.
(2) Excluding the public share.
(3) Largest 10 firms with no public ownership.

Source: La Porta et. al. (1998)

Table 9: Substantial Shareholding (%) of Key Domestic Institutional Investors[1] in Public Companies Listed on The Kuala Lumpur Stock Exchange

% OF SHAREHOLDING	EPF	KH	LTAT	LUTH	PNB
1st Board					
5 – 10	40	4	9	16	22
10 – 15	10	-	3	6	10
15 – 20	2	1	-	4	3
20 – 30	2	-	4	2	2
30 – 50	-	1	1	-	5
> 50	-	1	2	-	2
2nd Board					
5 – 10	-	-	1	4	28
10 – 15	-	-	-	-	5
15 – 20	-	-	-	-	12
20 – 30	-	-	1	-	4
30 – 50	-	-	-	-	1
> 50	-	-	-	-	-

Source: Data extracted from SBC Warburg Dillon Read, Malaysia Connections, January 1998.

Notes: [1]
EPF - Employees Provident Fund
KH - Khazanah Holdings
LTAT - Armed Forces Fund
LUTH - Pilgrims' Fund
PNB - Perbadanan Nasional Berhad (National Investment Corporation)

Table 10: Company Profile - Weightage of Foreign Shareholding

No.	Company Name	1997	
		Market Capitalisation	%
		RM 'Bil	
1.	Telekom Malaysia Berhad	34.48	11.77%
2.	Tenaga Nasional Berhad	25.73	8.78%
3.	Sime Darby Berhad	8.70	2.97%
4.	Petronas Gas Berhad	15.96	5.44%
5.	United Engineers Malaysia	2.57	0.88%
6.	Resorts World Berhad	7.15	2.44%
7.	Genting Berhad	6.85	2.34%
8.	Renong Berhad	4.00	1.36%
9.	Perusahaan Otomabil Nasional	2.06	0.70%
10.	YTL Corporation Berhad	8.63	2.94%
11.	Rothmans of Pall Mall Berhad	8.64	2.95%
12.	HICOM Holdings Bhd	2.33	0.79%
13.	Malaysian International Shipping Corporation Berhad	4.98	1.70%
14.	Magnum Corporation Berhad	3.51	1.20%
15.	Berjaya Sports Toto Berhad	5.72	1.95%
16.	Edaran Otomobil Nasional Berhad	1.80	0.62%
17.	Malaysia Resources Corporation Berhad	0.87	0.30%
18.	Malaysian Airlines System Berhad	2.40	0.82%
19.	Sarawak Enterprise Corporation Berhad	1.91	0.65%
20.	Nestle (Malaysia) Berhad	4.22	1.44%
21.	Kuala Lumpur Kepong Berhad	5.95	2.03%
22.	Kumpulan Guthrie Berhad	2.50	0.85%
23.	Golden Hope Plantations Berhad	4.52	1.54%
24.	HUME Industries (M) Berhad	1.01	0.34%
25.	Tanjong PLC	2.42	0.83%
26.	Multi Purpose Holdings Berhad	0.80	0.27%
27.	TR Industries Berhad	1.74	0.59%
28.	OYL Industries Berhad	1.23	0.42%
29.	Cahya Mata Sarawak Berhad	0.76	0.26%
30.	Oriental Holdings Berhad	1.54	0.52%
31.	Jaya Tiasa Holdings Berhad	1.81	0.62%
32.	IOI Corporation Berhad	1.06	0.36%
33.	UMW Holdings Berhad	0.78	0.27%
34.	Land & General Berhad	0.36	0.12%
35.	Innovest Berhad	0.20	0.07%
36.	New Straits Times Press (M) Berhad	0.96	0.33%
37.	Perlis Plantation Berhad	2.02	0.69%
38.	Tan Chong Motors Berhad	1.14	0.39%
39.	Malakoff Berhad	1.90	0.65%
40.	Konsortium Perkapalan Berhad	0.35	0.12%
41.	Ekran Berhad	1.41	0.48%
42.	Sime UEP Properties Berhad	0.84	0.29%
43.	Petronas Dagangan Berhad	1.32	0.45%

Table 11: Sources of Funding of Capital Expenditures of Limited Companies

(RM Million)

	1995	**%**	**1996**	**%**	**1997**	**%**	**1998***	**%**
Total	12725	100	12344	100	25915	100	25896	100
Financed from own funds	8412	66.11	9050	73.31	15733	60.71	15891	61.36
Financed from local borrowing	2053	16.13	2455	19.89	6893	26.60	7705	29.75
Financed from foreign borrowing	2261	17.77	839	6.80	3290	12.70	2299	8.88

Source: Department of Statistics, Business Expectation Survey of Limited Companies, various years.

Note: * Estimated

Table 12: Basic Rights of Shareholders in Malaysia

1.	Right to a secure method of ownership	The Malaysian 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. 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. With effect from 1st November 1998 it became mandatory for securities of companies listed on the KLSE to be deposited with the Central depository. 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 the general meeting. 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.
2.	Right to freely transfer shares	The nature of shares as personal property is recognised 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. 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. The Malaysian Central depository has been operating starting in 1992, a system that enables securities transactions to be effected electronically without the need for physical delivery of shares scripts. This is done through a system that effects the transfer of ownership of securities through computerised book entries rather than by physical delivery and execution of instruments of transfer.
3.	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; - 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 interest. - A copy of the last audited profit and loss accounts, the auditor's report and the directors' report on the accounts.
4.	Right to vote at shareholders meetings	The right to vote is one of a member's fundamental rights. It is recognised in Malaysia as a proprietary rights and every member has an unfettered right to exercise his votes as attached to the shares. The principal right of shareholders in respect of their right to vote is their right 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.
5.	Right to make proposals at shareholders meetings	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 referred to in the resolution on any business to be transacted. Shareholder resolutions are not popular. 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 of shareholders 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.

Source : R Thillainathan et al (1999)

Table 13: Rights that Support the Voting Mechanism Against Interference by the Insiders

	VARIABLE	DESCRIPTION
i)	Proxy by mail	9 countries from the sample allowed voting by mail whereas others allowed voting only by the shareholder in person or his authorised representative. Malaysia does not allow proxy by mail.
ii)	Blocking of shares before meeting	14 countries required that shareholders deposit their shares prior to a general meeting of shareholders thus preventing them from selling those shares for a number of days. Malaysia is not one of them.
iii)	Cumulative voting for directors	13 countries allowed shareholders to cast all of their votes for one candidate thus increasing the probability of outside directors but Malaysia is not one of them.
iv)	Percentage of share capital to call an emergency shareholders meeting	38 of the countries required 10% or less thus facilitating better shareholders' control. Malaysia's requirement is 10%.
v)	Oppressed minorities mechanisms	26 of the countries granted minority shareholders either a judicial venue to challenge the management decisions or the right to step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes, such as mergers, assets disposition and changes in the articles of incorporation. Malaysia is one of them.
vi)	Preemptive rights on new stock issues	26 countries required preemptive rights which protects against dilution of minority shareholders and prevents insiders altering ownership structure. Malaysia is one of them. [1]

Source: R.L Porta et al (1998)

Note: [1] The directors may make a special issue of shares of up to 10% of a company's paid-up capital to the general public or to any class of investors if they have obtained the general authority of the shareholders to do the same at a general meeting. Special issues to Bumiputras may also be required during new listings. This can pose a serious problem when the new issue prices differ from the market prices. With the recent move to a disclosure-based regulatory regime and the concomitment freeing of the new issue prices, this is less of a problem. On a strict interpretation, given special issues to Bumiputras, existing shareholders do not enjoy pre-emptive rights in Malaysia.

Table 14: Safeguards Against Insider Abuses in Selected Asean Countries[1]

NO.	VARIABLES	DESCRIPTION/EFFECT	MALAYSIA	THAILAND	PHILIPPINES	INDONESIA
1.	Mandatory shareholder approval of major transactions	Protects against abuse by insiders. Protection can be enhanced through supra-majority voting.	Yes	Yes	Yes	Yes
2.	Mandatory independent board committees	If composed of independent directors, audit and remuneration committees protect against insider abuse.	Yes	Yes		
3.	Mandatory disclosure of non-financial information	Both financial and non-financial information data are important to assess a company's prospects.	Yes	Yes		Yes
4.	Mandatory reporting by large shareholders	Disclosure of transactions by large shareholders protects against abuse by insiders.	Yes	Yes	Yes	
5.	Mandatory disclosure of connected interests	To protect against abuse by insiders.	Yes	Yes	Yes	
6.	Mandatory shareholder approval of interested transactions	Protects against abuse and squandering of company assets by insiders.	Yes	Yes	Yes	Yes
7.	Prohibition of loans to directors [2]	Protects against abuse by insiders; prevents squandering of company assets.	Yes	Yes	Yes	
8.	Penalties for insider trading	Protects against use of undisclosed information at the expense of current and potential shareholders.	Yes	Yes	Yes	Yes
9.	Provisions on takeovers legislation	Protects against violation of minority shareholders' rights.	Yes	Yes	Yes	

Source : 1. Asian Development Bank & World Bank (1998), Managing Global Financial Integration in Malaysia: Emerging Lessons and Prospective Challenges.
2. World Bank 1998.

Notes: [1] A blank means that it was not possible to establish whether the legal/regulatory framework included the shareholder protection variable in question. This has been rectified for Malaysia.

[2] Loans to Directors are prohibited unless the loans are part of the standard benefit package for employees.

Table 15: Specification of Variables for Law Enforcement & Accounting Standards

VARIABLE	DESCRIPTION	SOURCES
Efficiency of judicial system	Assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" produced by the country-risk rating agency *Business International Corporation*. It "may be taken to represent investors' assessments of conditions in the country in question". Average between 1980 – 1995. Scale from 0 to 10, with lower scores for lower efficiency levels.	Business International Corporation.
Rule of law	Assessment of the law and order tradition in the country produced by the country-risk rating agency *International Country Risk* (ICR). Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for less tradition for law and order.	International Country Risk Guide
Accounting Standards	Index created by examining and rating companies' 1990 annual reports on their inclusion or omission of 90 items. These items fall into 7 categories (general information, income statements, balance sheets, funds flow statement, accounting standards, stock data and special items). A minimum of 3 companies in each country were studied. The companies represent a cross-section of various industry groups where industrial companies numbered 70% while financial companies represented the remaining 30%.	International Accounting and Auditing Trends, Center for International Financial Analysis & Research, Inc.

Source: La Porta et al (1998).

Table 16: Legal Origin, Creditor Rights and Efficacy of the Judicial System

Country	Legal Origin	Creditor Rights	Judicial Efficacy
Hong Kong	Anglo-Saxon	4	5.5
Indonesia	French	0	3.5
Japan	Germanic	3	5.5
Korea	Germanic	3	6.5
Malaysia	Anglo-Saxon	3	4.5
Philippines	French	0	2.0
Singapore	Anglo-Saxon	4	7.0
Taiwan	Germanic	4	3.5
Thailand	Anglo-Saxon	2	5.5

Sources: Claessens et al (1999c). Creditor Rights and Efficacy of Judicial System are constructed by the authors based on data from a Asian Development Bank study of Insolvency Law Reform (1999).

The Creditor Rights index is the summation of four dummy variables, where the highest possible score is 4: TIME, equal to 1 if the timetable for rendering a judgement is less than 90 days, 0 otherwise. MANAGER, equal to 1 if incumbent management does not stay during a restructuring or bankruptcy, 0 otherwise. STAY, equal to 1 if there is no Automatic Stay on assets, 0 otherwise, CREDITOR, equal to 1 if secured creditors have the highest priority in payment, 0 otherwise.

The Judicial Efficiency index is the average of 8 variables, the ranking (0-2) of expense, ease, efficiency, and speed for RESTRUCTURING and LIQUIDATION. For Example, we assign 0 points if Restructuring is Very Slow, 1 if Slow, 2 if Quick. Similar ranking is constructed for expense, easy and efficiency. The maximum score is 8 each for Restructuring and Liquidation. We take the average of those scores.