SPECIAL REPORT:

CORPORATE GOVERNANCE

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As they expand into global markets, it is crucial that Asian companies stay abreast of local laws

ALL AROUND THE WORLD, capitalism is under scrutiny and good governance is edging up the agenda. The public, bruised by economic worries, scandals and the perceived excesses of a crooked corporate elite, are demanding action. Further, governments are more willing to act on the public's behalf, applying more force in the process.

Good governance is becoming a major issue for companies in Asia, according to Steve Tunstall, risk and insurance management expert and director of Singapore-based Tunstall Associates. "In the past few years, one way or another, the management teams at many companies has somehow stepped outside of what they should be doing and started doing things that their shareholders wouldn't like," he says.

"This is a long-winded way of saying that people have been misbehaving – and they have been facing the full force of the law when they are in jurisdictions that are motivated to bring actions against them, particularly in the US, where some fines have been truly eye-watering."

Increasingly, Asian firms are moving into those jurisdictions and coming up against risks that challenge their governance structures. Fines imposed on Asian companies by US authorities increased from US$428m between 1995 and 2004 to US$5.1bn between 2005 and September 2014 – amounting to 77% of the total fines for such offences – according to a report published in October by the Korea Chamber of Commerce & Industry.

Japanese companies were affected hardest, with fines totalling US$3.3bn; South Korean companies received US$1.2bn and Taiwanese ones US$868m.

Despite this, a major survey by the insurer AIG revealed that many companies in South-East Asia still view corporate governance as more of a compliance issue than anything else (see 'Corporate governance survey results' pp30-31).

"At a high level, the concern is that risk management practices of the region are taken with a view from the rear-view mirror," says Jason Kelly, head of Asia financial lines at AIG. "Risk exposures are rapidly evolving, and having good corporate governance practices in place will help mitigate these exposures. Simply put, merely being compliant with local laws and regulations is a not a strong risk management model."

> *'Many companies in Asia have grown extremely fast in the past 15 years and are now in a position I'm not sure they really understand. They have a lot of learning to do'*
> **Steve Tunstall,** Tunstall Associates

Rapid growth

In one sense, Asian companies are victims of their own success. Tunstall says: "Many companies in Asia have grown extremely fast in the past 15 years, expanded rapidly and are now in a position I'm not sure they really understand.

"They have a lot of learning to do and governance questions are not always a front-of-mind issue in Asia.

"[Companies] need to bear in mind that as they grow and expand from local to regional, regional to national and national to global, they are moving into some different jurisdictions that have a different perspective on good and bad behaviour."

In many ways, this is the reverse of the advice that has traditionally been given to Western companies moving into Asia. "As [Asian companies] move from a sheltered and protected backwater, they need to be really careful. Looking at the most recent cases from the US, eight out of 10 of those companies that were fined were international, not US firms, and Asian businesses need to be aware of that risk," says Tunstall.

Owen Hawkes, a partner in forensic services at KPMG Singapore, agrees. "Asia is a global growth engine. However, governance has not necessarily caught up with that growth. Investors are therefore striking a balance between growth opportunities and avoiding the opportunities for loss," he says.

"Another major factor driving governance by Asian and Western multinational corporations is the significant uptick in enforcement for governance failures, corruption and anti-competitive practices."

One result has been a mass of new laws aimed at correcting corporate behaviour and defending customers and shareholders.

"I have heard estimates that, in 2012, there were more than 75,000 pieces of new business legislation in

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Asia alone," says Tunstall. "You can ask your counsel: 'Are we compliant with everything?' and, of course ,they will say: 'Yes.' However, in reality, that is almost impossible to achieve unless you have unlimited resources. Not only is understanding this fire-hose of legislation a problem, but the enforcement of the legislation is mixed and always changing."

For example, in China, statutes that the authorities have mostly ignored in the past are now being enforced with the full force of the law. Across the world, there is an increasing level and complexity of regulation.

"This is always a challenge for companies – and for directors on an individual basis – to grapple with," says Wilson Ang, a partner at Norton Rose Fulbright (Asia) LLP. "There has also been an increasing aggression in enforcement activity across Asia-Pacific."

Crime and punishment

A key trend is the shift towards scrutiny of individuals and, in particular, senior management.

"The public has seen the fallout of financial crises and corporate meltdowns, as well as the violation of serious laws, including corruption and money-laundering; and they have seen large fines being levied against corporations," says Ang. "However, what they want is people being punished as well. In various corruption cases, people have been prosecuted, but they tend to be the rank and file who are caught red-handed handing over cash or negotiating corrupt deals. There seems to be a perception that members of the C-Suite are not being brought to account. These people can be just as aware, with just as much or even more responsibility, for improper business practices.

"There have been cases where the entire board has been changed. There have also been cases where board members have had to step down.

Look out for rogue agents… before they land your board of directors in court

Good governance needs to extend into the supply chain. A good example is bribery and corruption, an area that has seen increased scrutiny in recent years, with accountability for the corrupt actions of second- or third-tier sales agents now reaching up to board level in some jurisdictions.

"[It is important to] know who you are dealing with and what they are doing, especially where it is common practice to use a local agent or where the market is new or where it is in fact compulsory to use a local agent," says Wilson Ang of law firm Norton Rose Fulbright.

"Companies need to conduct proper due diligence on these agents and then make sure they find out as much as possible about what they are doing.

"There is a limit to what can be done, but it is useful if they can be contractually obliged to allow you to inspect their books or produce documents showing what expenses have been incurred."

Such is the risk, says Ang, that firms should ask themselves whether there is a genuine business case for having an agent. "If there is, can they really provide value, can they do the work and do they have a track record?" he adds. "By track record, I mean their reputation as well. Do they have convictions, are they subject to any investigations, do they have a criminal past? Contracts need proper clauses that forbid agents to undertake certain tasks; to make sure as much as possible that they do not do anything illegal."

The difficult part is getting to know who the agent is. "It is a question of fact and substance and in some jurisdictions this can be hard to establish," says Ang. "Some employees may try and finesse relationships to bypass the companies' compliance programmes – they will work to make it look as though a certain agent is not working for a company or supplier when in fact they are – and this can bring a level of risk exposure with it."

Corporate governance survey results

AIG hosted corporate governance seminars in 2014 in six Asian countries (Hong Kong, Vietnam, Indonesia, Malaysia, Singapore and the Philippines) with participants from listed companies and broker houses. A survey was carried out with chief financial officers, risk managers or general counsel from these listed companies to gain insights into their corporate governance practices. Here are some of the key findings of the survey.

Preparedness

THERE IS LITTLE DOUBT AMONG THOSE SURVEYED THAT CORPORATE GOVERNANCE IS important. But is enough being done within companies across the region to ensure this pressing issue is being managed effectively? The survey revealed that although most companies have compliance, legal review and IT/data security practices in place, many still have some alarming shortcomings. The absence of a risk committee, a dedicated risk manager, policies and guidelines regarding interactions with regulators and government officials and, in 22% of cases, a lack of independent board members, should be cause for concern for many firms.

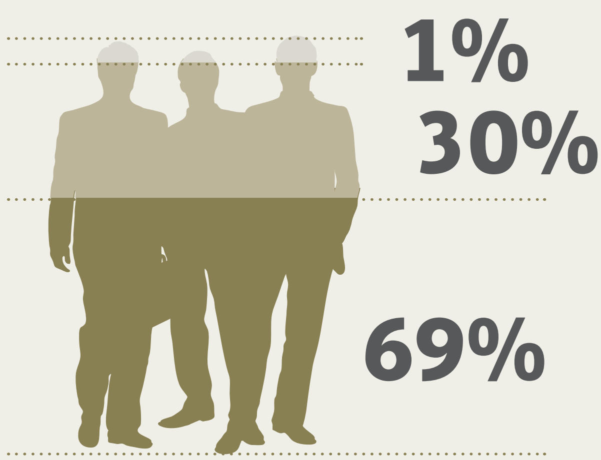
How important is corporate governance?

Almost all (99%) respondents claim that corporate governance is important. Close to 70% considered the subject very important, especially from those companies that have a risk committee or risk manager in place.

Neither

Somewhat important

Very important



What measures are being taken?

Organisational structure: more than 40% of companies surveyed do not have a risk committee and 22% do not have an independent board.

Independent board members	78%
Risk manager	71%
Risk committee	60%

Policy: only 60% of respondents work in companies that have policies and guidelines regarding interactions with regulators and government officials.

Entertainment and gift policies	76%
Policies and guidelines regarding interactions with local regulators and policymakers	60%

Training: generally, related training for employees is not common practice, except for compliance.

Compliance training for employees	81%
IT/data security training for employees	70%
Risk training for employees	66%

Base: total respondents (N=95) | Q. Please identify whether the following applies to your company

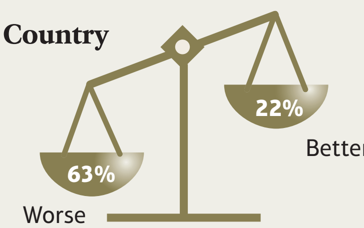
Top of mind

MOST COMPANIES SURVEYED consider changes in or compliance with regulations to be their top risk priorities. Yet many of the emerging risks faced by business are beyond the reach of simple 'tick the box' compliance. Despite the increasing incidents and exposures in the areas of cyber crime and data breach, listed companies do not consider them top risk priorities.

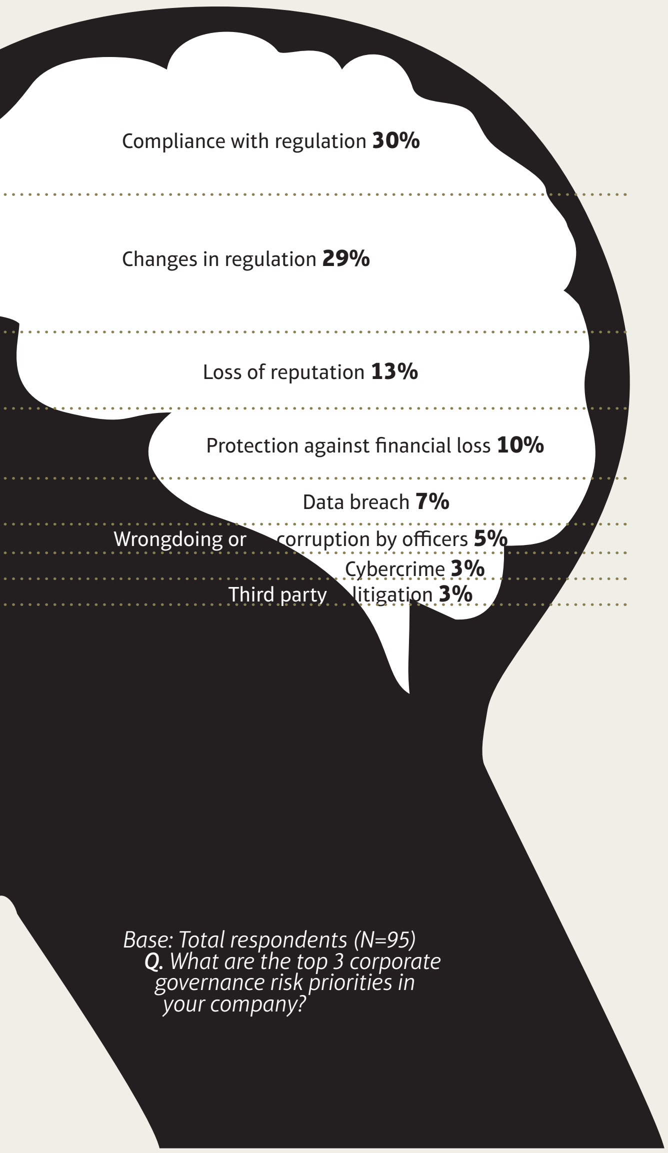
Bribery and corruption

Alarm bells are sounding in boardrooms across Asia as certain previously acceptable commercial practices have become taboo in the region. However, although awareness may be increasing, incidents of bribery and corruption appear to be on the rise. The majority of respondents surveyed believe bribery and corruption have become worse in their country or industry. The concern is higher at a country level, compared to an industry level.

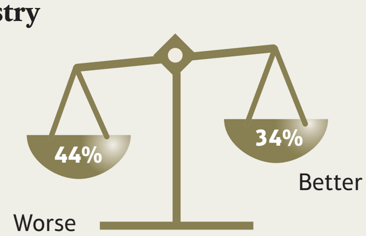
Country



Base: total respondents (N=79)
Q. Does your company consider bribery and corruption an issue….?



Industry



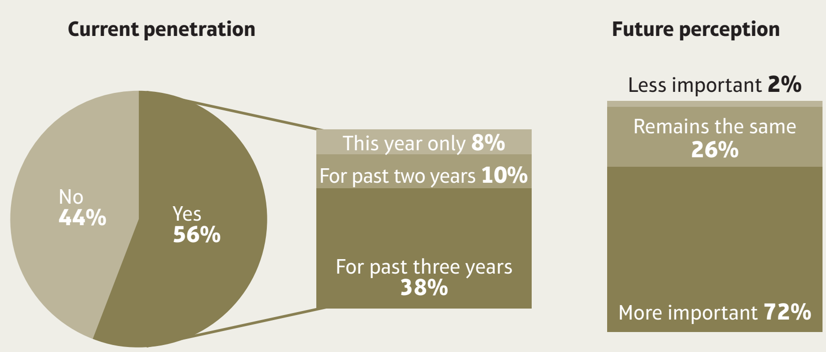
Base: total respondents (N=81)

Insurance

TOUGH ECONOMIC CONDITIONS, and a rise in insolvencies and securities actions have increased D&O insurance penetration in the US and Europe. Will the rise in regional regulation, regulatory enforcement and the expansion of Asian businesses overseas drive take-up in Asia? Although more than half of respondents to the survey indicate that their company had a D&O policy, almost three-quarters think D&O cover will become increasingly important in the future.

D&O: policy penetration

Fifty-six percent of respondents indicate that their company has a D&O policy and 72% believe that D&O insurance will become increasingly important in the future.

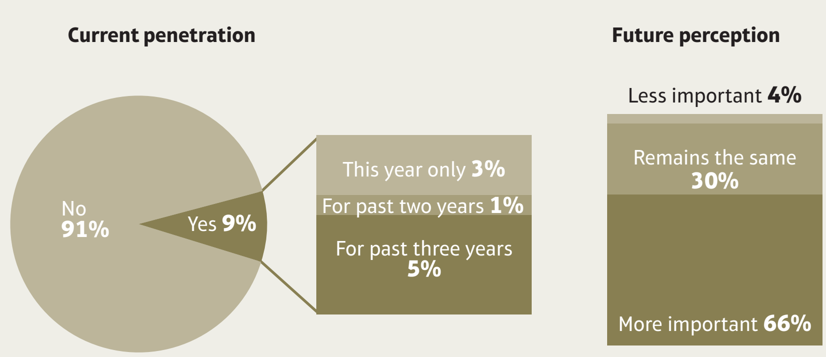


Base: total respondents (N=78) *Base: TotalRespondents (N=81)*

Q. *Does your company have the following insurance coverage? How do you see the role of the following insurance policy for your company in the next few years?*

Cyber insurance

Penetration of cyber insurance is extremely low within public companies surveyed although two-thirds of respondents claim it will be of increasing importance.



Base: total respondents (N=73) *Base: total respondents (N=70)*

Q. *Does your company have the following insurance coverage? How do you see the role of the following insurance policy for your company in the next few years?*

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However, I believe prosecutors are looking as though they want senior executives to be charged and brought to account."

This is taking place across Asia, but to different degrees. In some countries, enforcement can be politically motivated; elsewhere, it is economically driven. In other countries, which are signatories to various international treaties and conventions, one motivation comes from a need to improve because they are under review. "The international community will level criticism against jurisdictions that don't enforce these standards," says Ang.

Hygiene factor

Singapore is one jurisdiction that has been pushing the corporate governance agenda hard for many years now, with implications for those who aspire to operate there.

Hawkes says: "Countries that do not have a strongly established corporate governance culture increasingly realise that this is a 'hygiene' factor that could exclude them from benefiting from the investment into the region.

"Equally, in some economies, the biggest governance risk might be nepotism, while in others it might be an undisciplined government sector seeking bribes or favours. It is essential to do due diligence on its business environment before investing in a company or drawing up a governance framework."

Although all sectors need to improve, the companies that depend on high-manpower, lower-value work will tend to find it harder to impose governance and controls than their peers, because of the larger pool of lower-paid staff and higher staff turnover.

"International co-operation between regulators now means that if something goes wrong in one country it might spread to other countries," says Ang. "Regulators are improving their channels of communications and companies are operating in different countries; their employees are moved around. The business model they adopt in one place might be adopted in another and this is why certain companies and banks are getting into trouble in different jurisdictions. This is what I would call a contagion effect."

One of the challenges for Asian firms trying to adapt to this new environment with better governance and risk management is that their corporate structures and business environments are often characterised by informal arrangements.

"There is a much higher proportion of family or founder-run firms, many of which are listed in Asia rather than in the West," says Hawkes. "Accordingly, investors and business partners may lack confidence in a firm that appears opaque or informally arranged.

"The companies themselves may have poor internal control frameworks, which leave them vulnerable to some of the key risks in Asia such as bribery and corruption, financial reporting fraud and minority investor oppression."

Complacency

With founder or owner-managed firms, there may be a sense that they have achieved success without spending too much time on corporate governance. "They may also feel that they know their business better than anyone so they can manage the risks inherent in their activities," says Hawkes. "In others, there may be a degree of complacency. However, many firms – including family-run businesses – do commit time to ensuring that their company is able to weather storms and govern itself objectively."

All firms need to ensure governance standards, and key to addressing their exposure is implementing proper protocol through formal risk management structures and procedures. "Companies need to address their risk from the top down with a strong enterprise risk management structure," says Ang.

"They need to understand relevant laws and have a strong compliance system that can track changes across various territories."

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Wilson Ang, Norton Rose Fulbright (Asia) LLP

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Owen Hawkes, KPMG

To do this, there needs to be a clear, overarching strategy of global alignment that also takes account of the conditions in specific commercial contexts. “On a top group level, umbrella policies are necessary that are applicable across the board,” says Ang. “Multinationals need to look at local regulation and nuances and determine how these might influence implementation.

“They need to look at local culture, local language and elevate their rules to a more stringent level accordingly – not bring their standards down to the lowest common denominator.”

Hawkes agrees. “Companies then need to assess the risks inherent in the environment in which they operate; they have to do their due diligence and understand practices in the relevant country,” he says. “Otherwise, they risk being blind-sided by practices they may never have known existed.”

He argues that companies need to take three key steps to protect themselves when addressing fraud and corruption risks. First, they should assess the risks inherent in their business and their country of business. Second, they need to put in place controls to prevent, detect and respond to those risks when they arise. Third, they should ensure that their employees and management are educated on the expectations of the company, the risks faced by the organisation and their role in mitigating those risks.

“They also need to make sure that their employees, management and even business partners understand and meet the expectations of the organisation,” says Hawkes. “Boards, management and employees all have a vital role to play. The board has to ensure that a corporate governance framework is in place and exercise oversight to ensure that it is being operated effectively.”

Management must dedicate sufficient time and resources to addressing risks and engage with issues at a sufficiently granular level when they arise, he adds.

Feedback

“Employees have a huge advantage in assisting a company with identifying risks and how to mitigate them,” he concludes.

“Because they are on the ground, they can see how business activities are undertaken, what risks arise and how controls are operated in reality. Employees can feed back information on threats, control failures and unusual or anomalous activities, provided they are trained and empowered to do so.” **SR**

THOUGHT LEADERSHIP

What a strong corporate governance ethos really means

As 2014 comes to an end, risk managers will be looking forward to the challenges of 2015 and thinking about implementing the right risk management strategies to protect the company balance sheet, the company brand and of course, its directors and officers. Technology will undoubtedly be a part of that thinking process.

However, when thinking about what corporate governance is and its relationship to risk management practices, it is important to remember that corporate governance is a dynamic set of relationships between the board of directors, the senior management team, company employees, shareholders, customers and other third parties.

It is this set of dynamic relationships that can add value to the organisation or liability to the company and its directors and officers in the daily management of company affairs.

When it comes to the exposures faced by directors and officers and their involvement in the corporate governance process, one item high on their list is meeting the requirements of local regulators.

This is the case whether the issue is compliance with local listing standards, managing third-party data or having proper procedures in place with regard to the US Foreign Corrupt Practices Act or its local equivalent.

With technology rapidly evolving, the ability to use it to enhance internal controls might be equally offset by the technology used to get around well-designed safeguards.

It might even create a false sense of security that good controls are in place simply because of large investments in a new technology platform.

Once a hacker cracks the security protocol or an employee in a faraway subsidiary breaches a law, no amount of insurance purchased or money spent on technology can completely remove the exposures faced by the organisation and its senior management team.

The best risk management controls can come only from a strongly embedded ethos of good corporate governance.

Good corporate governance is about having proper oversight of the business functions, implementing proper procedures in risk controls (which are regularly reviewed and tested), having regular engagement with staff, customers and the regulators and listening when things are not going to plan.

Directors and officers have never faced more challenges than today in meeting the demands of company stakeholders and advancing their companies’ business goals while also complying with regulations.

Jason Kelly, vice president at AIG Insurance Hong Kong

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