

# Shareholder activism in Asia What more can be done?

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At

PNB Corporate Summit 2019  
"Rebooting Corporate Malaysia"  
Kuala Lumpur,  
30 October 2019

# Working within the control structure

- Most markets have a predominance of controlling shareholders, often with different objectives and perspectives.
- Family controllers can be conservative, and often have other interests that compete for their attention or at worst, engage in connected transactions with the ListCo. Family are usually also executives with a conflict of interests on pay.
- Government controllers can have other objectives, such as implementing industrial/social policy, employment, consumer prices and perceived national security.
- Minority shareholders often have little say except when approving connected transactions or privatisations.
- If a company has no controller (rare in Asia), then activists can take a more direct role in pushing for change to add shareholder value and help companies to reform. Otherwise, gentle persuasion, naming and shaming is the best one can hope for.
- Direct engagement and activism works in non-control situations to add shareholder value (on average). Otherwise activist funds would underperform and lose assets under management.

# Top-down activism: improving the framework

- Within a controlled-company market, improvements can come from legal and regulatory reform to strengthen shareholder rights and internal controls.
- Company/securities law, Listing Rules and Takeovers Codes are part of this framework.
- Investors rationally pay more for stock, lowering cost of capital, if the framework is more trustworthy, giving them a fairer share of returns and improving corporate performance.
- A lower cost of capital makes an economy more competitive, domestically and internationally.
- Institutional investors in particular should take the lead in engaging with policy-makers to reform frameworks, but doors, eyes and ears must be open to this. Capital votes with its feet.
- Rules on: board governance and election procedures, shareholder voting facilitation, capital discipline and pre-emptive rights all play a role.
- When all else fails, access to justice with legal remedies must be available, prompt and feasible.

# INEDs

# Role of INED includes:

- Opining on whether transactions with a controller/director are “fair and reasonable”, including acquisitions, disposals, subscription of shares, grant of share options, ongoing purchase of materials or sale of goods, deposits with parent finance companies etc.
- Opining on whether a privatisation offer is fair and reasonable
- Opining on highly dilutive placements and open offers/rights issues
- Acting as the audit committee, including reviewing accounts (prepared by EDs) and internal controls
- Acting on the nominating committee
- Acting on the remuneration committee to set the pay of directors, often including controlling shareholders
- Thinking without regard to the special interests of controlling shareholders

# INEDs

- Most markets require independent non-executive directors, but only in name
- If the controlling shareholder can vote on INED elections, then the INEDs are dependent on the controller, not independent of it
- Consequently, INEDs are often just rubber stamps for proposals by the controlling shareholder
- INEDs serve at the pleasure of the King, and are only as “independent” as the King wants them to be
- INEDs cannot be removed even if all votes cast by public shareholders are against them
- All the roles of INEDs in the Listing Rules and Takeovers Code, acting as a check and balance, fail.
- HK pretends to have INEDs, but about 90% of firms have a controlling shareholder who elects the entire board
- With no controller, the system works – I was elected to HKEX in 2003 on a 2-share nomination and 3 incumbents were ejected (but only 6/13 of HKEX directors are elected by shareholders – the Government is *de facto* controller).

# The all-INED audit committee of a typical HK board





# Solution: making INEDs independent

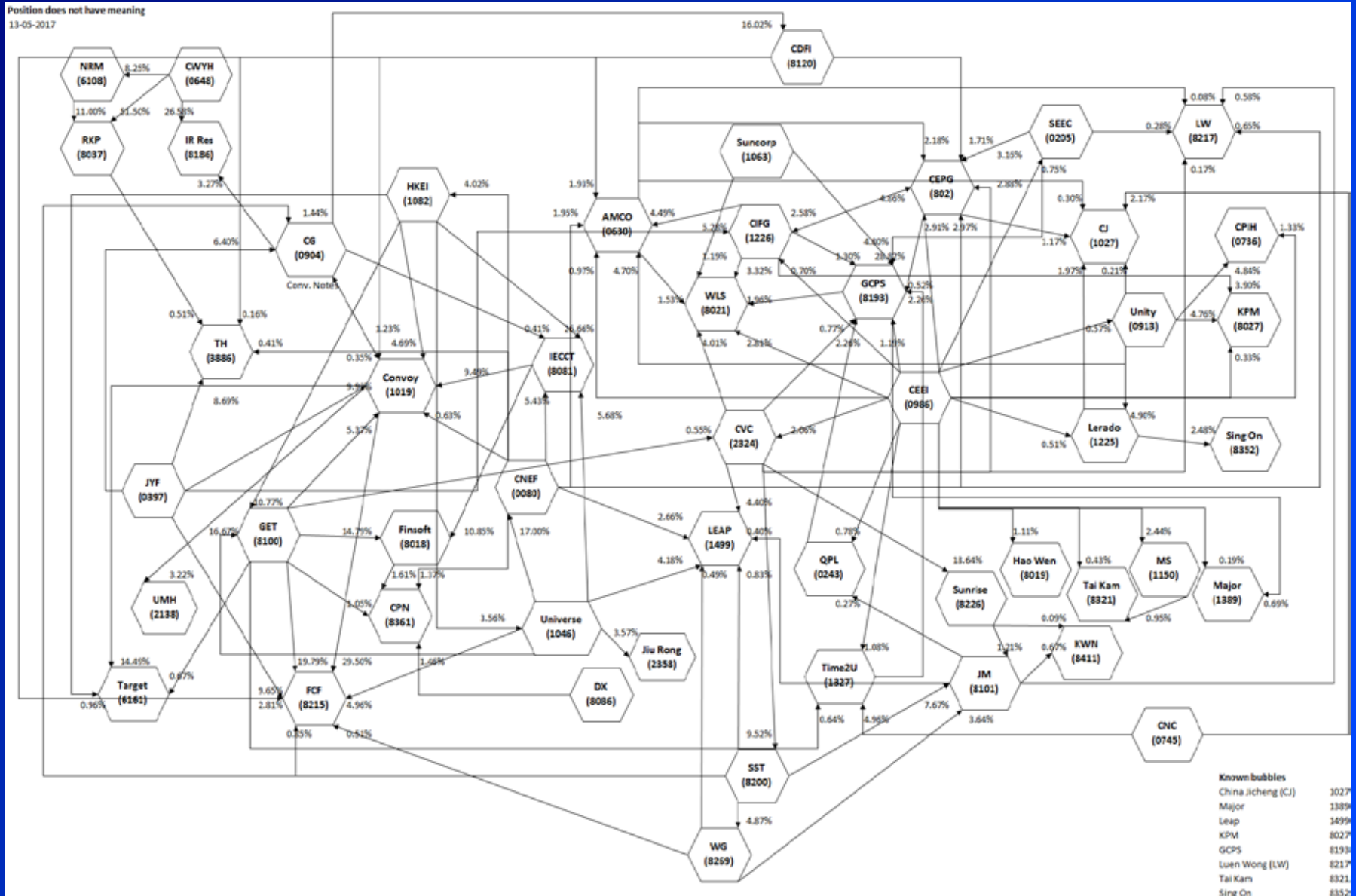
- Independent directors should be elected by independent shareholders in General Meetings. Controlling shareholders and other directors must abstain.
- Boards could still nominate candidates, but candidates would have to be acceptable to independent shareholders, who could alternatively nominate their own.
- INEDs would have a real mandate, and be held accountable at the next election
- An INEDs' report in the annual report should include confirmation of whether the INEDs are *each* satisfied with the corporate governance during the year, giving reasons if not.
- This is about moving from a 1-party state in the boardroom, to representative democracy and accountability for capital
- Alternatively, scrap the requirement to have INEDs rather than provide false comfort. Stop pretending. Boards would either be credible or not.



# NOT a solution:

- Fiddling with the Rules to somehow make controllers elect more “independent” INEDs without addressing the election system.
- *Requiring* boards to say why they think their candidates are independent, not too busy, and sufficiently diverse. We, the independent shareholders, will be the judge of that, and it is up to boards to persuade us.
- Requiring boards to “disclose a diversity policy”. Actions and data speak louder – independent shareholders will judge.
- Setting regulatory limits on number of seats held: independent shareholders can judge a candidate’s suitability
- Hoping that companies will just behave better
- Requiring INEDs to have particular qualifications – independent shareholders would not normally elect incompetent INEDs but let them judge!
- Deflecting the issue with distractions like requiring new committees, rearranging the deck-chairs on the Titanic.

# The Enigma Network: 150 INEDs hard at work



# Directors per HK-listed company, 21-Oct-2019

No. of dirs	No. of cos	Share of cos	Mean age in 2012	Cumulative cos
20	2	0.10%	64.3	2
19	1	0.00%	74.5	3
18	2	0.10%	65.6	5
17	8	0.30%	59.8	13
16	1	0.00%	64.1	14
15	30	1.20%	55.9	44
14	30	1.20%	57.3	74
13	26	1.10%	58.4	100
12	65	2.70%	54.9	165
11	122	5.10%	57.1	287
10	90	3.70%	56.3	377
9	424	17.60%	54.4	801
8	379	15.80%	54.1	1180
7	523	21.80%	53.8	1703
6	439	18.30%	53.0	2142
5	231	9.60%	51.0	2373
4	16	0.70%	51.4	2389
3	9	0.40%	55.3	2398
2	3	0.10%	52.0	2401
0	2	0.10%	-	2403

# INEDs per HK-listed co, 21-Oct-2019

No. of INEDs	No. of Cos	Share of Cos	Total INED seats	Cumulative Cos	Cumulative seats
14	1	0.0%	14	1	14
10	4	0.2%	40	5	54
9	1	0.0%	9	6	63
8	1	0.0%	8	7	71
7	9	0.4%	63	16	134
6	25	1.0%	150	41	284
5	131	5.5%	655	172	939
4	395	16.4%	1580	567	2519
<b>3</b>	<b>1786</b>	<b>74.3%</b>	<b>5358</b>	<b>2353</b>	<b>7877</b>
2	36	1.5%	72	2389	7949
1	4	0.2%	4	2393	7953
0	10	0.4%	0	2403	7953

Average INEDs per company: 3.31. Requirement:  $\geq 1/3$ , minimum 3

# INED seats per person, 21-Oct-2019

No. of INED seats	No. of people	Female	Cumulative people	Cumulative female	Cumulative seats	Cumulative female seats
16	1	0	1	0	16	0
14	1	0	2	0	30	0
13	1	0	3	0	43	0
12	1	0	4	0	55	0
11	3	0	7	0	88	0
10	5	0	12	0	138	0
9	2	0	14	0	156	0
8	8	0	22	0	220	0
7	8	0	30	0	276	0
6	30	1	60	1	456	6
5	57	2	117	3	741	16
4	104	6	221	9	1157	40
3	199	20	420	29	1754	100
2	672	50	1092	79	3098	200
1	4855	703	5947	782	7953	903

# Voting systems

- Institutional shareholders generally have high voting rates, as long as they are given sufficient time to transmit votes via multi-level custodians.
- Retail investors often find barriers. There are plenty of online dealing services, but very few online voting systems.
- In HK, banks and brokers hold clients' stock but have no regulatory obligation to seek client voting instructions. So they don't build systems for it, and retail turn-out is very low. Regulators can fix this by imposing that obligation.
- In privatisations or connected transactions, low retail turn-outs allow approval of bad proposals, with management-friendly votes in the public float, particularly in small- and mid-caps with fewer institutional investors. For PRC issuers, government-controlled asset managers can also vote.
- Checks and balances can fail without high levels of voter turnout.
- Procedures for requisitioning shareholder meetings, and for placing items on the agenda at AGMs, must be efficient, low cost and actionable.



# Capital discipline

- Joint-stock companies were initially established to pursue a specific enterprise set out in the “objects” clause of the Memorandum of Association of the members.
- Over decades and centuries, that has morphed into an “anything we want” provision, subject to laws and regulations.
- Controlled companies tend to hoard surplus capital and may abuse it.
- Listing Rules can re-establish capital discipline. We propose a “Cash Shell Test”:
  1. If a (non-bank) company proposes a disposal which would leave over half its net assets in net cash, then that disposal must be conditional on distribution of the surplus.
  2. No fund-raising could put it into that position.
  3. If the annual balance sheet shows that position, then a resolution to distribute the surplus must be proposed at the AGM, for minority shareholder approval, with controllers and directors abstaining.
  4. “Net cash” includes marketable securities, net of debt.
- Greater capital discipline will improve cross-market returns on equity and investor trust. If companies aren’t using their capital, it should be returned. In short, “use it or lose it”.

# Access to Justice

- As a last resort, investors must have prompt, enforceable legal remedies against oppression and fraud. Justice delayed is often justice denied as assets are depleted without injunctions.
- Auditors must be liable to investors, and not just to the companies they audit, for negligence, because investors rely on the accounts.
- Prospectus liability (for directors and promoters) must extend to secondary-market purchasers, not just initial subscribers.
- A true opt-out class-action system (not just representative group actions) provides legal certainty to defendants and unifies fragmented plaintiffs to share costs, increasing the deterrent effect.
- Litigation financing must be allowed, along with contingent legal fees. Medieval laws against “champerty and maintenance” (profiting from, or funding, litigation) must be abolished. England did so in 1967.
- The loser-pays-costs system will deter frivolous and vexatious actions.
- Australia provides a successful example of a class action system with litigation finance companies.

# A government's role in economic success

- Economies do best when they are allowed to function freely and fairly to all participants, with minimal intervention and central planning.
- Any direct government ownership of business should be avoided, as it tends to distort competition with implicit debt guarantees, the ability to allocate capital from taxation, and the ability to shape policy and legislation to favour that business or sector against others.
- The ownership of companies doesn't affect the ability to tax and regulate them, so to if the objective is to maximise national prosperity, then constraints such as foreign ownership limits (or domestic ownership requirements) will produce sub-optimal outcomes.
- Good competition laws should have pre-merger controls, to prevent market-corning, particularly when finite resources (such as mobile spectrum or airport slots) form barriers to entry.
- Governments should provide essential, non-commercial public infrastructure (with outsourced management where feasible), a strong and universal education system and a means-tested social safety net for the less fortunate or able, funded out of balanced-budget taxation.
- In an era of increasing automation with artificial intelligence, educating every child to their maximum potential, and retraining displaced labour, will be key to economic success.
- The rule of law, protection of property and contract rights, and a reliable, well-funded judiciary are essential to investor confidence.

# A government's role in economic success

- Governments should resist the temptation to direct economic resources or shape policies around chosen sectors or new technology. Provide a level playing field to all sectors and let the market optimize the result. History is littered with counter-examples.
- Taxation should be simple, fair and efficient, not skewed or used as a subsidy, even for SMEs. Nobody will be deterred from setting up a business and making a profit by the prospect of paying a standard rate of tax. It's a nice problem to have.
- Tax profit, not turnover. If a person isn't generating a profit from an activity, then don't tax it unless to recover an external cost (e.g. public healthcare costs of tobacco).
- Stamp duty, for example, taxes asset transfers, not profits, and throw sand in the wheels of the economy, inhibiting reallocation of capital. It was introduced to England in 1694 as a temporary 4-year tax, and they still have it! New Zealand abolished it in 1999.
- VAT (effectively a gross-profits tax) or GST (on final sales) are unnecessary, complicated, regressive and costly to administer. Assuming a reliable accounting and audit system, just tax profits (after expenses) and salaries (after personal allowances) at a flat and equal rate. Each taxpayer then has just one tax bill.
- Don't duty imports – it just protects uncompetitive domestic players from fair competition, unless the import is subsidized at source. Be a freeport.



# A government's role in economic success

- For optimization, land use should be determined by market forces. Grant freehold (subject to eminent domain) or very long leases, and don't pre-set usage with lease conditions, but set the plot ratio and let the market optimize usage, now and in the future. Clusters will naturally appear where co-location generates synergy, and land will be repurposed by the market.
- There's nothing wrong with car ownership as long as you don't drive it on the road, so tax fuel to recover the damage of air pollution, toll the roads, and use congestion pricing to ration roads and shift demand, but don't tax car sales.
- Help the needy, not the needless. Welfare is for people, not companies, and should be targeted and not sprayed, to avoid driving up budgets, raising taxation and deterring investment.
- Rental vouchers can support those who cannot afford to rent a home, but a government doesn't need to be their landlord.
- Home-ownership shouldn't be a policy. Just look at the mess of the 2007-8 global financial crisis to understand why. Governments over-leveraged their populations, set capital inadequacy rules for banks, implicitly guaranteed mortgages (in the US, via Fannie/Freddie) and bailed out banks.

# And in conclusion...

- A trustworthy framework attracts investors who will pay more, and issuers who are willing to sign up to high standards for a lower cost of capital.
- A lower cost of capital means a more competitive economy.
- Good governance starts at the top, with good policy, good law-making and a trust in the power of markets to optimize results, without government direction or participation.
- Free and fair markets, low and simple taxation, a talented and educated workforce and efficient public infrastructure will provide the ingredients of economic growth, attracting inward investment in a virtuous circle.



Terima kasih!

# About Webb-site

- Founded in 1998. Free, not-for-profit, partly funded by speaker fees, but mostly by me. The site and related activity takes about half my time. The other half, I research and invest in HK small-caps, currently holding >5% of 20 listed companies
- Corporate horror stories end up in *Webb-site Reports* (time permitting), while under-valued well-governed companies go into my portfolio, and hopefully not *vice versa*
- Also covering economic governance, advocating transparency, accountability, civil liberties, electoral reform, tax reform, land lease reform, minimal intervention and economically-rational policy-making
- Frequent news flow from courts, tribunals, ICAC, HKICPA, SEHK, SFC and others
- Over 28,000 subscribers to a free newsletter, opt-in/out
- Opinion polling
- *Webb-site Who's Who* covers all HK-listed directors, auditors, advisers since 1990; legislators, district councils, statutory/advisory bodies, CE election committee, relationships between them. Covers all SFC licensees, and all UK company directors and LLP partners
- *Webb-site Total Returns* series – since 1994, all HK stocks including delisted
- CCASS Analysis System for stock movements since 2007
- Directors' share dealings since 2003
- Basic data on all HK-incorporated companies. Still waiting for HK to move to open data and drop the paywall.