The Corporate Governance Trends in Malaysia: February 1999 Finance Committee Report on Corporate Governance

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Introduction

Ladies and Gentlemen

1. Corporate Governance issues have occupied our thoughts in recent times, and in Malaysia, this has resulted in the much-discussed Finance Committee Report on Corporate Governance. The recommendations in the Report will clearly affect the manner in which directors make decisions, and directors have at this initial stage, the formidable task of assimilating a great deal of information regarding these issues.
2. In view of this, I believe that functions like this are very important, to help elucidate some of the intricacies of these issues, and to give directors some direction in terms of the issues that they may need to address in the near future. In this connection, I would take this opportunity to congratulate the organisers, PNB Investment Institute, for organising this very timely Corporate Governance Conference for nominee Directors, and also to thank them for inviting me to participate in today's seminar.
3. In this session, allow me to give you a broad overview of the trends in corporate governance practices in Malaysia. To do so, I will necessarily discuss the recommendations in the Report. However, rather than going through each of the 70 odd recommendations in the report, one by one, I would prefer to firstly give you a very brief background on the workings of the Finance Committee in coming up with the report. This is to give you an idea not only of the extent deliberations and discussion that had taken place but also an indication of the context and framework in which corporate governance practices will be judged. In the course of the discussion, I would describe some of the general trends in terms of "best practices" approach and regulatory reform. In particular, I will highlight some of the more intricate issues that I believe you will be interested in as directors of public listed companies.

Background

4. As a matter of interest, let us look at how the exercise to strengthen corporate governance standards in Malaysia came about. The SC's programme for

disclosure based regulation of the primary markets, began in 1995. This move from merit based to disclosure based regulation, has always been premised on there being high corporate governance standards in Malaysian public listed companies. Thus, even prior to 1997, work in this area had already begun. Similarly, in 1996, the Registrar of Companies had already developed its Code of Ethics for Directors.

5. The crisis of confidence **after 1997** however "fast-tracked" the exercise to enhance corporate governance standards. This resulted in the commissioning of the "high-level Finance Committee on Corporate Governance" in March 1998. In particular, the Committee was asked to -

   - undertake a review of the legal and regulatory infrastructure to evaluate its effectiveness in promoting sound corporate governance standards. This has included a review of laws governing shareholder rights, duties of directors, disclosure provisions and evaluating the effectiveness of present enforcement mechanisms;

   - develop a **Malaysian Code of Best Practices in Corporate Governance**; and

   - identify **training and education** needs of directors, other key corporate participants and investors.

6. This Committee was asked to produce its report by 30th June, 1998, which it did. The Report was subsequently released for consultation in November 1998 to selected industry bodies, that are not represented on the Finance Committee, to ensure that their views were considered.
7. The Report as you know, was publically issued in Malaysia earlier this year - on 25th March, to be precise. A significant matter to note, is that the composition of the members of the Committee reflects a public - private sector co-operative effort. I myself was a member of the Committee, at that time as a representative of a private sector body. This membership structure provided an appropriate balance of representation and views - from regulators and from industry - ensuring good standards and at the same time not unecessarily stifling entrepreneurship.

Preparation of the report

8. The initial work of the Committee was carried out through 2 working groups-

   - There was the **Working group on best practices in corporate governance and training and education (JPK1)** - This working group was entrusted with the task of developing the Malaysian Code on Corporate Governance and identifying training and education

programmes for its participants. Consistent with the approach adopted internationally, where the standard setting process is essentially led by industry, this working group was chaired by the Chairman of the Federation of Public Listed Companies and participants in the main comprised industry bodies and professional associations. Regulators participated in the working group to ensure that self-interest elements were addressed.

- Then there was the **Working group on law reform issues in corporate governance - (JPK 2)**. The task of this working group was to identify and make recommendations for reform of certain key aspects of corporate regulation and identify effective enforcement mechanisms to ensure that the overall legal and regulatory infrastructure is effective in promoting good corporate governance. This working group was chaired by the Securities Commission.

9. So, as you can see, there were 3 important pillars to this study. One was to set up a "best practices" code of governance, which is largely the approach taken in other countries. Secondly, and unlike similar exercises in other countries, the corporate governance reform exercise also included a comprehensive review of the legal framework and enforcement mechanisms. In addition, at this stage of development, the Committee also considered training and education as a means to enhance awareness of corporate governance issues.
10. Based on this, the Finance Committee report thus broadly concentrates on the following areas:

- strengthening laws governing shareholder rights, directors duties and duties of other corporate participants with particular emphasis on related party transactions;

- enhancing disclosure and transparency;

- promoting effective enforcement;

- developing a Malaysian Code of best Practices on Corporate Governance, which seeks to restructure board composition and thereby create effective boards; and

- training and education

"Best Practices" - Developing a Malaysian Code on Corporate Governance

11. The Finance Committee considered that, at this stage of development in our corporate sector, rules and laws are necessary to bring home the significance that the government attaches to corporate governance issues. The extent of law and rule reform that has been recommended will be discussed later.
12. I will first touch briefly on the Code of Best Practices for Malaysia that is incorporated in the Report. While it is not possible to leave the question of corporate governance entirely to self-regulation, the Committee was of the view that there is definitely a role for a Code of Best Practices on corporate governance. In other words, there should be a self regulatory approach to corporate governance driven primarily by the private sector. The significance of a Code is that **it allows for a more constructive and flexible response to raising standards in corporate governance as opposed to the more black and white approach imposed by statute** or regulation.
13. What this is likely to mean in future, as evidenced by past experience, is that codes influence the expectations of society, and are in many cases, eventually reflected in the law. The attention generated on corporate governance issues has for example already had an impact on evolving judicial interpretations of directors' duties in many jurisdictions.
14. In tailoring the measures to suit our local circumstances, the proposed Code contemplates a **prescriptive approach** of the type recommended by the Hampel Committee in the UK. The proposed Code sets out a set of **principles and best practices** for good governance.
15. The recommendations in the Code are directed principally at boards of listed companies. They are aimed at improving board composition (to ensure that there are effective independent elements on the board) and the working of boards. The recommendations are directed at increasing the efficiency and accountability of boards to ensure that its decision - making processes are not only independent but seen to be independent.
16. The significant problem with prescriptive Codes, such as the one we have proposed, is this issue of "box ticking". "Box ticking" simply put, encourages an attitude of form over substance. Only the letter of the rule would be complied with - yes or no, which is an easier option to the diligent pursuit of corporate governance objectives. >/li>
17. For this reason, the Report has also supplemented the best practices in the Code with a **statement of principles**. With principles, **directors must give a narrative account** of how they apply the principles to the particular circumstances of the company.
18. In this context, KLSE will be introducing in its listing requirements a requirement for companies to disclose in their reports and accounts, how they have applied the principles set out in Part 1 of the Code. It must also set out the extent of

compliance with the best practices set out in Part 2 of the Code (with justification for non-compliance) and set dates for coming into force of the Code.

19. This will mean that you, as directors, will need to address your minds to questions such as the following:

    - How are the principles as set out in Part I of the Code addressed in your company? You must be able to explain these in words, in the annual report.

    - You should note that you should also disclose compliance with the best practices set out in Part II of the Code. If you choose not to comply with these prescriptions, you must be in a position to justify this departure to your shareholders.

    - In making the disclosures mentioned above, you would need also, as directors, to consider what means you have to ensure that the standards set out for your company, are actually adhered to.

Legal and administrative framework

20. It is intended that the Code will support the provisions of law. For now, I would like to spend a few moments discussing the relevant legal and administrative framework in Malaysia.
21. Because of its strong common law origins and heritage, Malaysian companies and securities legislation and the rules of the Exchange as you know, contain many provisions that create a legal and regulatory infrastructure in an attempt to ensure good corporate governance. For example:

    - Under companies legislation, there are specific matters that may be carried out by the board after shareholders' approval has been obtained.

    - There are stringent anti-fraud provisions designed to ensure that directors and other officers of a company do not abuse their position.

    - The listing rules of the stock exchange have a number of provisions to provide for checks and balances to enhance corporate governance, including the requirement that there should be independent audit committees.

22. It is clear that that Malaysian directors, officers and companies are subject to a rigorous set of laws and rules governing their conduct. On this score, even before the Committee began its work, **there was a vast body of laws and rules providing for shareholder rights.**

23. Why then, you may ask was there a need to make recommendations for amendment to laws, rules and regulations?

Governance Pratices in Malaysian Listed Companies

24. Well, there has been evidence over the years of numerous lapses in corporate governance practices. Deficiencies in corporate governance are thought to be attributable to the following main factors:

- Firstly, ownership concentration. As with probably most other Asian economies, the corporate governance issue in Malaysia is quite different from those in most industrialised nations. Unlike those countries, it is not the general separation of management and control that poses problems but the fact that there are many companies with large shareholders who exercise control rights where the risk of the minority shareholders being expropriated exists.

- Second, there is a general perception that boards of directors may not be as effective as required. There is general scepticism about the ability of boards and in particular, independent non-executives to monitor management by controlling shareholders. Control rights secured by the largest shareholder, are often disproportionately greater than actual ownership holdings.

- Third, shareholder passivity - Both foreign fund managers and most domestic institutional investors have opted to play only a passive role in demanding better corporate governance practices in Malaysian public listed companies. They nevertheless have the potential to provide significant incentive to companies to take corporate governance issues seriously.

- Fourth, enforcement - In addition, and importantly, it has been found that the mechanisms for ensuring compliance and enforcement have been generally deficient and that the penalties for breach, insufficient as a deterrent, particularly in times of economic stress on these companies.

- Fifth, lack of awareness of responsibilities. Many of the listings arose from the public flotation of smaller private companies with good growth prospects. Owners of these small, previously private companies, became overnight directors of a public listed company and subjected to a considerable number of complex common law and statutory responsibilities, the significance of which they may not have fully understood.

Strengthening laws

25. The approach that the Committee has taken is to attempt to enhance and modernise the existing foundation on which the existing corporate governance framework is premised. This has included the reform of laws - including companies and securities legislation - and the listing rules of Exchanges. The proposals of the Finance Committee Report in terms of reform of laws and regulation and rules have a two-fold purpose, namely:

    - to update laws, regulations and rules to keep up with commercial reality; and

    - to bring the standards of corporate governance up to internationally acceptable standards.

26. While aware of the difficulties that are posed by the existence of owner concentration, the Committee does not recommend the dilution of ownership concentration as a measure to deal with the difficulties. Instead the Committee attempts to ensure that checks and balances against abuses should be made more effective. In particular, recommendations have been made towards strengthening the law on related party transactions. For example, interested parties in a related party transaction are currently required to disclose their interest in a transaction when obtaining shareholder approval. Our recommendations introduce an additional check by requiring that interested party to abstain from voting in such transactions.
27. In reviewing the laws in this area, the Committee sought to clarify the responsibilities of key corporate participants, in such a way, that they are readily understood by those to whom they apply. In some circumstances, this has involved codification of their duties and responsibilities.

Directors

28. In relation to directors, in the course of its review, the Committee found that there were many laws applicable to directors. However, it was found that these laws were scattered in many sources. These include, for example, legislation, rules, case law on fiduciary duties, and the law of negligence. The Committee therefore concluded that the extent of these duties was not readily apparent to "persons without legal training". It was also found that, to some extent, ineffectual enforcement also perpetuated the ignorance of laws.
29. In relation to directors, it was found that directors were most aware of laws that are embodied in legislation. As such many of the recommendations in relation to directors are aimed at statutorily codifying minimum principal functions and duties of the directors and the board as a whole.

30. Thus, many of the recommendations relating to directors essentially spell out the duties of the directors in legislation so that directors can be clear on their duties and obligations at law. For example:

i.There is to be statutory clarification of the collective duty of the board to oversee management in the event that they delegate their management powers. This is in recognition of the commercial reality that directors, particularly of large companies, place the real power of management with its executive officer while the board deals with more strategic issues.

ii. There is to be statutory codification of the other minimum functions of the board, while permitting flexibility in board-executive relationships.

iii. There is to be a reformulation to impose the general duty on directors to:"... act bona fide in the best interest of the company."This last proposal is intended to dispel the possible misconception that the existing duty to act "honestly" can only be breached if there is some element of wrongdoing or fraud.

iv. Perhaps of particular relevance to those present, is the proposal for statutory clarification of the role of the nominee director. One major difficulty often faced by nominee directors is that they are often the employees of the person nominating them, and have to run the business of the company, thus giving rise to many situations of conflict. To deal with this issue, there will be statutory clarification of the fact the primary duty of a nominee director is to act in the best interests of the company, and that his duty to his principal is subject to this duty and not to the person nominating them.

v.Finally there will also be statutory codification of what the duties of the directors are in relation to conflicts of interests.There is currently a fiduciary duty imposed on directors to avoid conflicts of interests found largely in case law, while certain provisions, in the Companies Act such as section 132E (substantial property transactions), section 131 (mandatory disclosures of interest), section 133 (loans to directors), section 132(2) (misuse of information) also deal with such issues. However, the Committee also found gaps in the law, such as in relation to directors taking advantage of contracts and operating in competition. The Committee therefore proposed that common law fiduciary duty to avoid conflicts of interest will thus be statutorily codified, to set out clearly the obligations of directors in conflict situations. There should thus be full disclosure of the conflict of interest as well as the material facts of the transaction. The transaction must also be authorised following disclosure

concerning the conflict of interest and the transaction by disinterested directors. This recommendation was considered important by Committee in order to address problems such as:

- Operating business in competition with the company;
- Disposal of non-performing assets;
- Voting by interested party

vi. There would also be statutory codification of the duties of care, skill and diligence of directors.
Subsection 132(1) Companies Act sets out the duties of the directors to "use reasonable diligence in the exercise of the duties of his office." At common law, the directors should exercise the degree of skill that is reasonably expected from a person with his knowledge and experience. The basic principles are that:
- Directors must discover his rights and obligations at law and in articles
- Directors may delegate in the absences of suspicious circumstances
The proposal in relation to this is to amend the provision is to clearly set out the common law duties into statute, so that directors must exercise reasonable skill and care, in addition to their duty to use reasonable diligence.

Strengthening disclosure and transparency

31. In addition to codification of the roles of the directors, the recommendations of the Committee also concentrated on measures to strengthen disclosure and transparency. This included calls for a rationalised regime for prospectus regulation, the introduction of civil actions for insufficient disclosures, additional reporting by directors on the state of internal controls and going concern status of a company, to name a few.

Monitoring and enforcement

32. Another key element of the recommendations of the committee include actions to enforce laws, regulations and rules against infringing companies, directors, shareholders and other participants.
33. While the effectiveness of regulators in enforcing good governance is crucial, and certainly a number of recommendations have been made to enhance their effectiveness, all potential methods of providing a greater degree of monitoring and enforcement are also being considered. This includes the roles that may be played by shareholders and other corporate participants, such as independent

directors, company secretaries, internal auditors, corporate advisors and other private institutions for instance, the rating agencies in Malaysia.

34. The role of investors in ensuring good governance, is also considered, and it is thought that there should be measures to enhance their ability to participate in voting and enforcing their rights, by making voting and legal procedures simpler and more accessible. In this connection, the Committee also considered measures to enhance the quality of general meetings so that shareholders see value in attending such meetings. Finally, we considered the effectiveness of the existing avenues for shareholders to enforce their rights and make recommendations towards increasing the effectiveness of shareholder enforcement mechanisms which include the introduction of a statutory derivative action and simplifying the procedures for class actions.
35. After the draft report was circulated to selected industry groups for comments, the Committee also accepted a proposal made by one of the groups, for the setting up of an Institutional Shareholder Watchdog Committee to monitor and combat abuses by company insiders against minority shareholders as a means of encouraging shareholder activism in Malaysia. This is a very important recommendation and would be a first step towards encouraging shareholder activism in Malaysia. The Employee Provident Fund (EPF) as the largest institutional shareholder in Malaysia, has been asked by the Ministry of Finance to organise and to drive the setting up of such a Watchdog Group. In my opinion the Watchdog Group has the potential to play an a valuable advisory role to institutional shareholders, which in turn will facilitate informed voting. Such advice would have had the benefit of the Watchdog Group's constant monitoring and tracking of a company's corporate governance policies and compliance track record. The Watchdog Group could also be empowered by the particular minority shareholder in question to vote on behalf of that shareholder. This makes general meetings more meaningful and the board and management therefore more accountable. It is my understanding that the scope of work of such a Minority Shareholder Watchdog Group is still at an exploratory level. However the principal idea is that united, minority shareholders become a dominant force for any company to reckon with.

Training and education

36. A comprehensive code together with "state-of-the-art" legislative provisions, will not achieve much by way of enhancing standards of corporate governance unless company directors, shareholders, senior management, members of audit committees are aware of their roles and responsibilities.
37. Hence a consistent and systematic approach towards training and education is absolute necessary. One of the most important elements in the Finance Committee recommendations lies in its emphasis on training and education. This will be targetted in particular towards directors, members of audit committees and company secretaries.

38. For example, one of the recommendations of the Committee introduces compulsory education programmes for directors of a company seeking listing as a pre-requisite to listing. In addition the Report proposes mandatory accreditation for all existing directors of listed companies. Continuing education in approved courses will be made a condition of accreditation. So Ladies and Gentleman, in the very near future, directors will be going back to school. Of course appropriate programmes are being developed. Agencies targeted to carry out such training programmes include RIIAM, SIDC, MICG, IBBM and other professional associations such as MAICSA, MACPA and MIA.

Implementation

39. A report is only as good as the paper it is written on until and unless concrete measures are taken to implement its recommendations and thereafter to monitor its implementation. The Committee will continue to oversee implementation of recommendations and to secure policy approval for its recommendations from highest levels of government.
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41. Detailed implementation of the recommendations of the Committee is being undertaken through an Implementation Project Team a subset of the committee comprising the SC, ROC, KLSE and the Federation of Public Listed Companies.
42. Its worth pointing out that some of the recommendations of the Committee have in fact already been implemented, through actions taken by the various agencies, etc. quite independently of the work of the Committee.

Conclusion

43. Before I conclude, I would allude to the performance vs. conformance debate. The issue is whether the call for enhancement and compliance excessive in terms of costs in view of the need not to unduly burden corporates with regulatory and compliance requirements?
44. This is the most fundamental issue that the Committee had to deal with and the Committee sought to strike the appropriate balance between the often competing objectives of facilitating commercial activity and investor protection. The Report indeed reflects the Finance Committee's attempt to strike the right balance.
45. 45. The mission of the Committee is **".. to promote high standards of corporate governance in the interest of strengthening investor protection (and in doing so, restore confidence in the fairness and transparency of the Malaysian capital markets) and enhancing the standing of Malaysian public listed companies".** As such, there would appear to be a call for greater requirements with regard to compliance.
46. One has to remember that this mission was developed against the backdrop of the Asian financial crisis of 1997/98. Standards of corporate governance were

perceived to be insufficient largely because of the adverse publicity in relation to acts of certain corporates. As such, whilst the Committee has been very mindful to ensure that the push for conformance does not distract the corporate sector in terms of its performance objectives, it also saw a great need to enhance investor confidence by asserting more authority over these corporates.

47. I would suggest that the answer to this debate is as follows. The higher the standards of corporate governance practised by companies, the less the need for Government to impose more costly rules and regulations.
48. In addition, as we have seen over the course of the crisis, investors are suspicious creatures by nature. The misdeeds of a small number of corporates are sometimes attributed, fairly or unfairly, to the market as a whole. In particular at a time when funds are beginning to flow back into the country, you as directors, appear to have a rather heavy responsibility, that is, to work towards dispelling this notion that corporates within Malaysia have inadequate governance practices.
49. With that, Ladies and Gentlemen, I would like to express my confidence that you will rise to the challenge, and thank you for your attention.