Improving corporate governance in Asia

Regulators across Asia are trying to boost shareholder value by addressing some longstanding corporate governance issues. But are we seeing genuine improvements at the company level or a tick box approach? Haonan Wu examines the evidence.

Setting the scene

At its core, corporate governance relies on the right arrangement of checks, balances, and incentives. The purpose is to prevent one group from expropriating the cash flows and assets of others, and to provide a structure to support long-term value creation. History is littered with examples of company collapses arising from poor corporate governance practices. Poor governance impedes economic growth and increases financial market volatility.

A lack of focus on shareholder value, conflicts of interest, limited board independence and poor internal controls have contributed to high-profile scandals in South Korea and Japan, but attempts to reform both markets are now underway.

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Japan's stock market hit a record high in February after a lengthy 34-year wait as exuberant investors flooded back. The recovery in the market following years in the doldrums has been partly driven by optimism that corporate governance reforms will finally unlock value.[1] Perhaps unsurprisingly, South Korea responded by unveiling its own reforms in February, hoping to eradicate the stubborn Korea discount.[2] Expectations are high that regulators are starting to grapple with some longstanding issues that have stymied company performance. But will these measures herald genuine change or will vested interests in South Korea prevent real progress?

The Asian financial crisis of the late 1990s served as a previous watershed moment, prompting a profound re-revaluation of corporate governance practices across the region. As economies grappled with widespread financial turmoil and corporate failures, policymakers and market participants recognised the urgent need for comprehensive reform to address underlying weaknesses in governance structures. In the aftermath of the crisis, governments, regulatory bodies,

1 Japanese reforms ignite investor optimism | Federated Hermes Limited (hermes-investment.com)
2 South Korea unveils reforms to unlock value of listed companies (ft.com)

and industry stakeholders embarked on initiatives aimed at enhancing transparency, accountability, and investor protection within Asian companies.

We have engaged directly with companies on corporate governance since the early 2000s and as part of the Asian Corporate Governance Association (ACGA). Over this period, we have witnessed an evolution in regulation and best practice in Asia. Across the region, regulators have tried to improve board independence and diversity, particularly in Japan, South Korea and Greater China. However, this has also raised the risk of companies taking a "tick box" approach, with board effectiveness potentially lacking the substance to ensure long-term value creation. How well is each market doing and where could they improve? And what role could investors play in this?

Japan

The strong executive influence on the board of directors is a noticeable feature of Japan's corporate culture. Boards often consist mainly of employees who have spent their entire careers at the company, with a combined board chair and CEO still the norm. The widespread practice of cross-shareholding, where companies hold shares in each other, can lead to the entrenchment of management and a reduced accountability to shareholders. Japanese companies often prioritise the interests of other stakeholders over shareholder value creation, which can dilute the focus on maximising returns for investors

Our engagement: Olympus

EOS has been engaging with optical equipment manufacturer Olympus since 2011, when a massive accounting fraud was exposed in which investment losses had been hidden for years.[3] The scandal highlighted the importance of effective board governance and curtailing the influence of a CEO.

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Almost 80% was wiped from the company's stock market value, six banks sued for compensation[4] and Olympus was threatened with delisting.

We urged the company to improve its board composition by adding more independent directors, but also by introducing concrete measures to enhance board functions and oversight. This included establishing key committees such as a nomination and remuneration committee, increasing transparency in the selection process of outside directors, and carrying out a review of the company's governance structure. We also encouraged a move towards at least a majority of independent directors on the board.

The company acknowledged our concerns and appointed a majority-independent board at the 2012 EGM. Olympus also moved to a three tier committee structure in 2019, consisting of an audit, nomination, and remuneration committee. In addition, three non-Japanese directors were appointed to the board.

[3] Olympus scandal - Wikipedia
[4] Japan's Olympus sued by six banks over accounting fraud - BBC News

Reforms

Japan's Corporate Governance Code was established in 2015 and revised in 2018 and 2021. Board size and cross-shareholdings have now significantly reduced, and board independence at prime market listed companies has increased. The appointment of at least one female director to the board is expected, and in June 2023, the government adopted a policy for women to account for over 30% of directors on the boards of Japanese companies listed on the Tokyo Stock Exchange's prime market by 2030.

The regulator has also taken steps to boost shareholder value, with companies urged to achieve a price-to-book ratio of above one. This approach has led to a genuine drive by many companies to improve capital management practices, as evidenced by an increase in share buybacks by companies with inefficient balance sheets.[5]

EOS has been engaging with the regulator in Japan since 2010. Most recently we joined in-person meetings organised by ACGA with the Financial Services Agency (FSA), Tokyo Stock Exchange (TSE) and the Ministry of Economy, Trade and Industry (METI). We expressed our expectations for improved capital allocation practices, board independence and director skills. We also co-signed an open letter pushing for higher requirements on board gender diversity, which was followed by a change in policy.

South Korea

In South Korea, family-controlled companies known as chaebols wield significant influence in the economy. The complex ownership structures and interlocking business relationships can lead to conflicts of interest and undermine transparency and accountability. Ensuring fair treatment of minority shareholders and reducing chaebol dominance remains a challenge.[6] The continued scandals generated by chaebols have cemented our concerns about corporate governance and shareholder rights in South Korea.

Our engagement: Samsung Electronics

EOS has been engaging with Samsung Electronics since 2013 on governance and we escalated our engagement following the bribery and embezzlement conviction of the Samsung heir Lee Jae-yong in 2016.[7] During the engagement, we urged the company to establish a board-driven anti-bribery and corruption culture, and to strengthen the resources and influence of the corporate social responsibility (CSR) committee and sustainability team. We maintained the pressure on the board as the scandal continued to unfold at the company.

The company created a risk management council within the CSR board committee to make sure that sufficient resources were being dedicated to making practical improvements on CSR. In 2018, after our continued engagement on board composition, we welcomed the significant improvements that the company had made to its board. These included the appointment of three new independent directors - one woman and two men with the relevant industry and international experience, in line with our requests.

Reforms

The latest iteration of South Korea's Corporate Governance Code in 2022 introduced several amendments to strengthen board independence, and enhance transparency and disclosure. We have seen an increase in companies with a majority-independent board and the appointment of women to boards, which is now a requirement for large companies.

Recent proposals to address the Korea discount by initiating a "Corporate Value-up Programme", and a requirement for stricter disclosure obligations on a company's handling of treasury shares, demonstrate positive momentum. It is not yet clear whether regulatory initiatives in South Korea will be sufficient to drive a sustained improvement in corporate governance practices and therefore a lessening of the Korea discount, but what is clear is that Japan provides South Korea with a blueprint for instigating meaningful change.

EOS has been engaging with the regulator in South Korea since 2010, discussing a range of topics including poison pills, the corporate governance regulatory framework, and disclosure requirements. We will continue to engage with the regulator on director training requirements, effective capital management (encompassing treasury shares) and what we consider to be the sub-optimal level of dividend pay-outs.

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[5] Japan firms' share buybacks expanded to a record $65bn in 2023 - Nikkei Asia
[6] The unpersuadables? | Federated Hermes Limited (hermes-investment.com)
[7] Lee Jae Yong: Samsung heir gets prison term for bribery scandal - BBC News

Greater China

The Chinese corporate landscape is dominated by state-owned enterprises (SOEs), introducing complexities in governance. State interference may compromise decision-making independence, leading to inefficiencies and opacity. The protection of shareholder rights, particularly those of minority shareholders, remains a contentious issue in China with dual-class share structures at some companies, and shareholders unable to vote on director elections.

Our engagement: JD.com

EOS began engaging with JD.com in 2017, focusing on the company's governance structure, as the CEO/founder held 80% of the voting rights despite only holding an economic interest of 15%. In addition, as the company is registered under Cayman Islands law, there was no requirement to hold an annual shareholder meeting. We also raised our concerns about board composition, board diversity and the inability to give structured feedback.

We intensified our engagement on board governance, composition and diversity following a scandal regarding alleged sexual misconduct by founder Richard Liu in 2018. The case was settled out of court; founder Liu denied any wrongdoing.[8] Between 2018 and 2020, we had eight interactions with the company raising our concerns about shareholder rights, board composition and diversity. In 2021, the company held its first shareholder meeting and appointed its first female board director. It appointed a female CEO in 2023.

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Reforms

Changes in corporate governance practices in China and Hong Kong have been aimed at enhancing transparency, and strengthening investor confidence. The Chinese Securities Regulatory Commission has identified the improvement of corporate governance as a priority, and the development and revision of the Company Law in China has helped to address the issues of related-party transactions and effective board governance. The publication and revision of the Corporate Governance Code in Hong Kong has also contributed to the increase in independent board directors and women on boards, with one-third independence a requirement.

Progress assessment

Although we have seen significant changes and improvements on corporate governance in Asia, it is still widely viewed as an area of structural weakness, when compared with European and North American markets. The increase in independent directors is a positive trend, but in some instances we continue to face challenges in getting access to these directors for engagements.

The lack of relevant business expertise or sufficient knowledge in key areas among some independent directors raises concerns about their effectiveness. As executive directors often hold more power on boards in Asia, we require more effective independent directors to act as a counterbalance and to challenge the executive team. We will continue to encourage companies to build a corporate culture and business strategy that will support long-term value creation.

Our key expectations

- Board member skillsets and experience must be aligned with a company's strategic priorities, and each director should educate themselves on the sector and the company. Evidence suggests that diverse boards enhance the overall performance of a company in the long term.
- We expect independent directors to take an unbiased approach when making decisions, rather than simply agreeing with management. They should also have the behavioural attributes to enable them to contribute to board functionality. Tension and conflict play an essential role in effective boardrooms. Robust debate, open dialogue and tackling uncomfortable issues head-on can benefit a board's decision-making and serve as a supervisory function to company management. A board culture that promotes independent thinking is critical, but independent directors must aim to fulfil their duties and exercise sound judgement even in the absence of such a culture.
- Independent directors should extend their contribution beyond boardroom deliberations by engaging with employees, investors, and wider stakeholders to ensure sound governance practices and long-term value creation.

The company, at its core, is about people, and the key to exercising effective governance is having the right people on the board with the relevant skills and experience. This should be coupled with the right culture to enable each of them to contribute effectively, while incorporating the opinions of wider stakeholders.

[8] JD.com's billionaire founder settles rape lawsuit two days before planned US trial | CNN Business

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