Guide on Fighting Abusive Related Party Transactions in Asia

OECD

Guide on Fighting Abusive Related Party Transactions in Asia

SEPTEMBER 2009

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.

Issued under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the OECD member countries.

© OECD 2009

Foreword

Abusive related party transactions – where a party in control of a company enters into a transaction to the detriment of non-controlling shareholders - are one of the biggest corporate governance challenges facing the Asian business landscape. This *Guide on Fighting Abusive Related Party Transactions in Asia* provides policymakers, enforcement authorities, private institutions, shareholders and other stakeholders with options for monitoring and curbing such abusive related party transactions, focusing on disclosure and the board/shareholders approval system. It also looks into the role of auditors and independent directors. A case study is provided in an Annex, featuring a six-step approach to analysing related party transactions and assessing potential for abuse.

A major contributing factor is that many Asian enterprises are part of a large business group, or owned by a controlling shareholder (*e.g.* family or state) with a large network of personal interests. In the current global economic environment, effective monitoring and curbing of abusive related party transactions remains high on the agenda of corporate governance reform in Asia.

While much progress has been achieved over the past decade in developing an effective legal and regulatory framework in Asia, remaining challenges to enforcement and inadequate board oversight have facilitated abusive related party transactions. The challenge of fighting abusive related party transactions is as much about implementation and enforcement as the policy framework itself.

This Guide aims to help build consensus among policy-makers and practitioners on the direction of reforms in Asia, cutting across the areas of regulation, implementation and

enforcement. This is a lofty challenge, but worth attempting. Looking ahead, the Guide will be widely disseminated. It will also be actively used. OECD will closely follow developments through policy dialogue and exchange of experience among not only Asian Roundtable member jurisdictions but also OECD member countries and other regions.

Acknowledgements

The OECD would like to thank all members of the Asian Roundtable Task Force on Related Party Transactions for dedicating their time and expertise to developing this *Guide on Fighting Abusive Related Party Transactions in Asia*. Special thanks are due to experts and organisations who prepared earlier drafts of the Guide, notably David Smith, and insights or comments on previous drafts from Leo Goldschmidt, Patrice Aguesse, Sidharta Utama, Selvarany Rasiah, Jonathan Juan Moreno, Kha Loon Lee, Charles Canfield, Sumant Batra, Marcello Bianchi and Charles Grieve as well as the participants in the 2007 and 2008 Asian Roundtable on Corporate Governance meetings held in Singapore and Hong Kong, China. The OECD would also like to extend sincere gratitude to our partners, the Government of Japan, the International Finance Corporation, the Asian Development Bank and all Asian institutions supporting the Roundtable's work. Thanks also to the participants in the 2009 Asian Roundtable meeting in Manila, Philippines who endorsed and launched this Guide.

Table of Contents

Key Recommendations 7

1. Background 9

1.1 Introduction – Why Asia, Why Now? 9
Box 1 – Related Party Transactions' Prevalence in China 10
Box 2 – An example: the Satyam Case 12
1.2 Structure of the Guide 13

2. Definition of Related Party Transactions 14

2.1 Ownership and Control in the Asian Context 14
2.2 Definition of Related Parties 16
Box 3 - Related Parties under Indian AS 18 17
Box 4 - Related Parties under IAS 24 19
2.3 Types of Transactions 19
Box 5 - CNOOC Ltd: Related Party Financial Transactions 20
Box 6 - Examples of other Related Party Transactions 21
2.4 Summary 22

3. Legislative and Regulatory Approaches 23

Box 7 – An Example of RIA Applied to Related Party Transactions 24
3.1 Ex-Ante Protection: Disclosure and Shareholder Approval 25
Disclosure 27
Box 8 - General Mandate for Related Party Transactions (Singapore) 26
Shareholder Approval 27
Box 9 – Interested Party Abstentions in Malaysia 28
Box 10 - Shareholder Approval in China 28
Reporting 29
Thresholds 29
Box 11 - Sample Approaches to Thresholds for Disclosure and Shareholder Approval 30
3.2. Ex-post Enforcement and Shareholder Redress 32
Box 12 – Shareholder Redress in China and Indonesia 32
3.3 Summary 35

4. Board Oversight and Approval 36

4.1 Role of Independent Directors 37
Box 13 – Related Party Transaction Committee in Belgium 38
Box 14 - Broad Independent Criteria 40
Recruitment and Election 41
Ongoing Training 42
Remuneration 43
4.2 Auditors..43
4.3 Communicating Auditor Quality...45

Notes...47

Annex: Case Study - How to Assess Related Party Transactions in Six Steps...51

Who are the Parties on Either Side of the Transaction?.................................52
What Asset is being Transferred? 53
How is the Asset Priced?..53
Box 15 – Pricing of Finished Goods 55
What Compensation is Involved? 55
Are any of the Parties Conflicted? 56
Why is the Asset Being Transferred? Why Now?...57

Task Force Members 59

Bibliography 62

Key Recommendations

1. *The legal definition of "related parties" should refer to control and be broad enough to capture relevant transactions that present a risk of potential abuse. It should be sufficiently harmonised with respect to different bodies of law such as company law, listing rules and accounting standards in each jurisdiction to avoid misunderstanding and an excessive regulatory burden, thereby underpinning better implementation and enforcement.*

2. *The legal and regulatory framework for "related party transactions" should provide appropriate and effective threshold-based tiers, referring to materiality for disclosure and shareholders' approval and/or board approval of related party transactions according to the risk of potential abuse. It should also take into account regulatory efficiency, weighing the potential cost and benefits.*

3. *A company should develop and make public a policy to monitor related party transactions that should be subject to an effective system of checks and balances as well as a disclosure process. This can include the possibility for non-controlling shareholders to review the independence of directors in a timely manner.*

4. *The external auditor should be independent, competent and qualified in order to provide an assurance to the board and shareholders that material information concerning related party transactions is fairly disclosed and alert them to any significant concerns with respect to internal control. The policy framework should support this role effectively.*

5. *Independent directors should play a central role in monitoring related party transactions, such as designing board approval procedures, conducting investigations and having the possibility for obtaining advice from independent experts. Their role should be supported by the policy framework.*

6. *Objective judgement in the decision-making process of the board should be ensured. This would include giving non-controlling shareholders sufficient influence over the nomination and election of directors, in particular independent directors, and the design of their incentive structures, such as remuneration policy.*

7. *Where reliance is placed on shareholders' approval, a voting system should be established with a majority of disinterested shareholders for the approval of related party transactions at Shareholders Meetings.*

8. *The legal and regulatory framework should ensure that legal action, including specialized courts and alternative dispute resolution, does not prohibit minority shareholders from seeking legal redress quickly and cost-effectively.*

9. *A coherent regulatory system dealing with related party transactions, particularly disclosure, board oversight and shareholder approval should be established in each jurisdiction to facilitate implementation and enforcement efforts.*

1. Background

The OECD-Asian Roundtable on Corporate Governance (Roundtable) serves as a regional hub for exchanging experiences and advancing the corporate governance reform agenda in Asia. Established in 1999, the Roundtable supports decision-makers in their efforts to improve corporate governance in the region, using the OECD Principles of Corporate Governance (OECD Principles) as a reference. In 2007, the Roundtable resolved to address one of the biggest corporate governance challenges facing the Asian business landscape – related party transactions.

The Task Force on Related Party Transactions (Task Force) was established by the Roundtable in Hong Kong, China in May 2008 with the aim to develop a guide on monitoring and curbing abusive related party transactions.[1] This Guide on Fighting Abusive Related Party Transactions in Asia (Guide), developed by the Task Force, seeks to provide policymakers, enforcement authorities, private institutions, shareholders and other stakeholders with key recommendations and analysis of the core issues. The Guide, focusing on publicly traded companies in Asia, may also be useful to technical assistance agencies working on these issues.

1.1 Introduction – Why Asia, Why Now?

Although not unique to Asia, family (or state-run) business groups and the informal nature of business relationships typical of the Asian business landscape facilitate related party transactions. In many cases such transactions are perceived as being inevitable, useful, and recurring in ongoing operations. This is particularly the case with diversified business groups: while an upstream coal processing plant may be providing coal to a

downstream power station, it is equally likely that a financial services company is providing deposit services to a manufacturing company under related ownership, or – in the case of DBS Group Holdings Ltd in Singapore - the purchase of airline tickets from Singapore Airlines Ltd.[2]

Most related party transactions are not abusive. However, under certain conditions the transactions can allow controlling shareholders or executives of a company to benefit personally at the expense of non-controlling shareholders of the company. Abusive related party transactions have increasingly become a challenge to the integrity of Asian capital markets. The costs of abusive transactions are high, whether in the form of one-off material expropriations of wealth, or the slow expropriation of wealth via continuous operational transactions. Therefore, effective monitoring and curbing of these transactions has come to the forefront of reforming the Asian corporate governance landscape.

Box 1 - Related Party Transactions' Prevalence in China

Year	***Frequency of RPTs***	***Proportion of companies with RPTs (percent)***	***The total trade volume of RPTs (billion Yuan)***
2000	473	26.2	53.89
2001	1582	55.1	151.77
2002	2190	57.4	165.86
2003	1602	49.2	131.75
2004	1151	43.9	73.85
2005	1104	37.8	107.98
2006	1066	38.7	174.57
2007	1105	37.7	360.09

Source: Zhang. (2008)

Abusive related party transactions are often accompanied by a loss of business opportunity for the listed entity, overpayment of an asset, or simply making use of financial services in a way that places the listed entity at risk. Often termed 'tunnelling' (Cheung *et al*., 2007), these transactions could also include selling an asset at an inflated price to the listed entity, purchasing an asset at a reduced price from the listed entity, or the controlling shareholder securing a loan guarantee from the listed entity (Berkman *et al*., 2008).

The increase of centrally-administered, group affiliated financial entities in some Asian countries, for example, means that the potential for intra-group loans made by this central finance company increases the risk to listed entity in the group.[3] Indeed, in recent years abusive related party transactions have drawn market participants' and policy makers' attention to the systemic risks that may damage market integrity.

Regardless of the shape abusive related party transactions take, the commonality is that they are in many cases accompanied by a misrepresentation of a listed company's financial situation. Some cases have demonstrated a pursuit of private benefits by a controlling shareholder, such as extracting wealth from the listed company at the expense of public shareholders. Other cases show management misrepresenting their financial statements, including by means of related party transactions, in order to meet market expectations under strong pressure from shareholders. In any event, abusive related party transactions damage market integrity considerably.

The influence of abusive related party transactions on entire capital markets is significant. Abusive related party transactions may lead to a 'national' discount to the country's market as a whole. While not all related party transactions are abusive, there is a view that related party transactions are a high risk factor that investors would pick up prior to investing. For example, Cheung, Rau, and Stouraitis (2006) found that the announcement of a connected transaction alone resulted in negative abnormal stock returns for Hong Kong-listed companies. Even if a company has no history of abusive

related party transactions, investors might put a risk premium for abusive related party transactions based on observable behaviour across a market.

Box 2 – An example: the Satyam Case

The case of Satyam Computer Services in India has been well documented and serves to highlight some of the risks in Asia. On December 16, 2008, the board of directors of Satyam (now Mahindra Satyam) approved the acquisition of Maytas Properties and Maytas Infrastructure for $1.3 billion and $300 million, respectively. Both Maytas Properties and Maytas Infra were entities related to B. Ramalinga Raju, the founder and chairman & CEO of Satyam. Concerns over valuations of the two entities, the timing, method of payment, and alleged concerns around the deal from independent directors led to greater scrutiny of Satyam by investors and termination of the proposed acquisition deals. Following this, four independent directors resigned and on January 7, 2009, Raju revealed a $1 billion accounting fraud and resigned as chairman & CEO of Satyam, admitting that for the past several years he had been inflating cash reserves and overstating revenues.

While abusive related party transactions may not be the underlying cause of the fraud, the terms and nature of the transactions focused attention on the company, and resulted in the exposure of the accounting fraud. While not necessarily causal, the existence of an abusive related party transaction may draw attention to financial accounts, in turn assisting investors and regulators in uncovering other inappropriate behaviour. In the case of Satyam, the situation focused attention on corporate governance standards in India, the process for approving related party transactions, and illustrates the broader impact that abusive related party transactions have on national economies and perception of market integrity.

More importantly, this challenge is as much about changing corporate culture as it is about laws and regulations. There are also systemic issues in many jurisdictions that need to be addressed concurrently in order to improve corporate governance and especially the equitable treatment of shareholders:

- the election, compensation, and training of independent directors in order to facilitate their independent mindset on the board;
- an insufficient number of independent and qualified (external) auditors capable of effectively monitoring related party transactions in many jurisdictions weakens their role; and
- an insufficient number of experienced, independent, and qualified judges, lawyers and securities market regulators in some jurisdictions.

1.2 Structure of the Guide

The Guide seeks to highlight the definition of related parties and related party transactions, in order to capture those that present a real risk of potential abuse. It raises key issues about control, consistency and materiality. The Guide then moves on to consider legislative and regulatory approaches to monitoring and curbing abusive related party transactions, including suggestions for improving the legal and regulatory approach to disclosure and shareholders' approval based on thresholds and a voting system with a majority of disinterested shareholders. The Guide comments on the roles of (external) auditors and independent directors, providing suggestions on how to enhance the effectiveness and credibility of independent directors.[4] The Guide does not attempt to define precisely what constitutes an "abusive" transaction; this may be best left to national legal traditions. Annexed is a 6-point case study to assist shareholders, regulators and other stakeholders with critically assessing related party transactions.

2. Definition of Related Party Transactions

This section first provides some further background on the ownership and control dynamics of Asian companies. Secondly, it discusses options for defining related parties, and the various types of related party transactions that are observed in Asia.

2.1 Ownership and Control in the Asian Context

A recurrent theme in discussions of related party transactions is the ownership structure of many Asian companies. Two broad control structures are commonly observed in Asia:

- Simple majority ownership; and
- Complicated network ownership.

The first type of ownership structure often involves either i) a family, or ii) the state (or a state-owned enterprise) forming a holding company that in turn owns a significant portion of a listed company. The consolidated ownership portion may for example convey effective control through a blocking minority (often 25 percent to 33 percent) or absolute control (more than 50 percent and above). The family or state is often represented at many levels of senior management, and other executive directors will often retain some connection with the family or state. The companies often have a combined Chairman/CEO.

In the second type of ownership structure, a nexus of shareholder agreements or interlinked boards grant effective control over the listed company to a founding family. Indeed, it is not uncommon for Asian companies to be controlled via a pyramid of

entities owned by the controlling shareholders of the listed company that is often only a part of that pyramidal structure. Korean *Chaebols* are examples of this complex network ownership structure.[5] In such cases, identifying related party transactions presents a significant challenge. On this issue, the Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance (OECD Methodology)[6] states that:

> *"…the potential for abuse is greater where the legal system allows, and the market accepts, controlling shareholders to exercise a level of control which does not correspond to the level of risk that they assume as owners through exploiting legal devices to separate ownership from control. Such abuse may be carried out in various ways, including through inappropriate related party transactions, amongst others"*

The implication of both the simple majority shareholder structure and the complicated network ownership structure is that decision-making may be unilateral, and robust discussion lacking on the board. The controlling shareholder is able to recruit and nominate directors who will serve at the pleasure of the controlling shareholder, with other shareholders having limited or no influence on director selection. In the case of a family-owned entity, non-executive directors are often family members; in the case of state-owned enterprises, directors are often political appointees or have links to the state. In such circumstances, the CEO/patriarch makes a decision on an agenda item at a board meeting, debate is absent, and the decision is implemented. Given that in many cases the controlling shareholder may have private interests outside of the listed company, the risk of abusive related party transactions is significant.[7]

It is essential to note that concentrated (state or family) ownership is not *a priori* negative. While concentration may create an agency problem between majority and minority shareholders, it provides majority owners with the means and incentive to monitor management in the interest of all.

For example, in China the 'wrapper' (or financial packaging, *cai wu bao zhuang*) method of listing state-owned enterprises saw large SOEs carve out profitable portions of their operations and list shares in those business units (Aharony *et al*., 2000). In many cases the private SOE carved out profitable and attractive business units for listing, retaining significant ownership positions in the listed entity and full ownership of other units in a private holding company (either directly or through a subsidiary).[8] However, it must also be recognised that in such circumstances controlling shareholders play a significant role in the recruitment and election of directors, and that consequently board effectiveness and accountability to other shareholders may be hindered.

2.2 Definition of Related Parties

The starting point for monitoring and curbing abusive related party transactions is an appropriate definition of 'related parties'. In the absence of a strong definition, measures such as improving disclosure, shareholders' approval process, enhancing the role of auditors/independent directors or the legal and regulatory framework are not likely to have an impact. The OECD Methodology offers:

> *"The definition of "related party" is sufficiently broad to capture the kinds of transactions in the jurisdiction that present a real risk of potential abuse, it is not easily avoided and is effectively enforced."*

When monitoring abusive related party transactions, it is important to understand what constitutes control, both direct and indirect. Inconsistent definitions, spread across various laws and regulations in a jurisdiction, may both cause confusion for those implementing and enforcing them (including external auditors, independent directors, and regulators) and impose an unnecessary regulatory burden.

Box 3 - Related Parties under Indian AS 18

Indian AS 18[9] defines related parties as including:

(a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

(b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

(c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;

(d) key management personnel and relatives of such personnel; and

(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

Indian AS 18 explicitly excludes the following parties from related party status:

(a) two companies simply because they have a director in common, notwithstanding paragraph 3(d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings);

(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

(i) providers of finance;

(ii) trade unions;

(iii) public utilities;

(iv) government departments and government agencies including government sponsored bodies.

In determining relatedness, thresholds for control could be developed. For example, where a shareholder has a significant holding such as 10 percent or more interest in a listed company, which potentially involve control, the interest becomes material. Where that shareholder also has 10 percent or greater interest in a counterparty, that transaction would constitute a related party transaction. At the same time, associates or relatives of that controlling shareholder (in the case of associates, determined by some interest and materiality threshold) would also be considered related parties. However, common directors would not necessarily infer that two companies are related (that director may, however, be conflicted during board discussions on this topic).

Relatedness could also extend both horizontally and vertically around the ownership relationship. In terms of an individual, a controlling shareholder might have direct influence, yet his/her relatives could also be classified as being related parties. Here, the regulatory framework may provide several threshold tiers of family relationships:

- At the first level, spouse, brother, sister, mother, father, son, daughter, or equivalent;
- At the second level, cousins, in-laws, aunts, uncles, or equivalent; and
- At the third level, grandparent, grandson, or equivalent.

It must be recognised that, in countries where family ownership is common, complex inter-generational relationships with diverse interests make such distinctions challenging. As such, in distinguishing between these layers of relatives, the regulatory framework could establish a principles-based approach to determine relatedness.

Where the controlling shareholder is a holding company, related parties could include the holding company, sister companies that share a common controlling shareholder, and associated companies that have some other common linkage. Non-wholly-owned-subsidiaries (including subsidiaries jointly owned by the listed company and the holding company) could similarly be included in the list of related parties:

- At the first level, the parent/holding company;

- At the second level, associates of the holding company; and
- At the third level, associates of the listed entity.

Box 4 - Related Parties under IAS 24

Pursuant to IAS 24.9, a party is related to an entity if:

(a) directly, or indirectly through one or more intermediaries, the party:

  (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

  (ii) has an interest in the entity that gives it significant influence over the entity; or

  (iii) has joint control over the entity;

(b) the party is an associate of the entity;

(c) the party is a joint venture in which the entity is a venturer;

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

The aim of this process is not to be prescriptive, but to include both notions of absolute interest, and principles of interest. The legal framework on related parties might serve to highlight control and/or influence rather than a narrow focus on the relationship. The latter could be ineffective, leading to companies complying with the letter of the law, but not its spirit. In many cases, influence is divorced from economic interest, and by

referring only to economic interest regulation runs the risk of being too narrow in focus. IAS 24.9 provides a broad definition of related parties that has been accepted in many jurisdictions as being comprehensive (see Box 4 - Related Parties under IAS 24).[10] An accelerated adoption of IAS 24 amongst Asian countries, and a consensus on the parties that can be classed as being related, would be a significant achievement and development.[11]

2.3 Types of Transactions

The legal and regulatory approach to monitoring and curbing abusive related party transaction may be different depending on whether it is a continuing transaction[12] or non-recurring transaction.

In a continuing transaction, companies engage in ongoing transactions with related parties for the provision of services such as ancillary services or inputs such as coal by one entity to the other. They can also include the provision of financial services (see Box 5 - CNOOC Ltd). These contracts tend to be multi-period (*e.g.* for a period of three years), and are in some cases limited by an annual cap as to the level of fees that may be paid to the counterparty. It may be a significant challenge to aggregate these recurring related party transactions; a company could establish a policy for this purpose.

Box 5 - CNOOC Ltd: Related Party Financial Transactions

At an extraordinary meeting of the company in March 2007, Hong Kong-listed CNOOC Ltd sought authorization to deposit funds for three years with sister company CNOOC Finance Ltd., controlled by CNOOC Ltd's state-owned parent China National Offshore Oil Corporation. Shareholders were concerned that the deposits were unsecured, and that intra-group lending could expose them to the risk of losses from non-controlled entities. At the meeting, over 52 percent of independent shareholders voted against the resolution, forcing the company to claw back monies already deposited with CNOOC Finance Ltd.

As for non-recurring transactions, for example, a holding company might acquire an asset from a listed subsidiary, or vice-versa. In Asian companies, the assets to be transferred are often land and/or property.

Box 6 (Examples of other Related Party Transactions) provides a non-exhaustive list of the many forms of related party transactions occurring in Asia and the rest of the world. The provision of guarantees to related parties (including major shareholders, subsidiaries, and sister companies), and the provision of loans to directors are also common related party transactions.[13] On the subject of loans to directors, the OECD White Paper on Corporate Governance in Asia (White Paper) recommends that:

> *"Asian policy-makers should consider prohibiting listed companies from engaging in certain types of related-party transactions, such as personal loans to directors, officers, controlling shareholders and other insiders."*[14]

Box 6 - Examples of other Related Party Transactions
Transactions involving the sale or purchase of goods
Transactions involving the sale or purchase of property and/or assets
Transactions involving the lease of property and/or assets
Transactions involving the provision or receipt of services or leases
Transactions involving the transfer of intangible items (*e.g.* research and development, trademarks, license agreements)
Transactions involving the provision, receipt, or guarantee of financial services (including loans and deposit services)
Transactions involving the assumption of financial/operating obligations
Transactions that include the subscription for debt/equity issuances
Transactions that involve the establishment of joint-venture entities[15]

2.4 Summary

This section has proposed a few, simple guideposts for defining related parties, control and/or influence to capture relevant transactions that present a risk of potential abuse. Consistent definitions are vital in avoiding misunderstandings and an excessive regulatory burden. In addition to providing clarity to commercial operators and investors, consistency between the different laws and regulations governing related party transactions (such as company law, listing rules and accounting standards) are important to auditors, (independent) directors, regulators and courts.

3. Legislative and Regulatory Approaches

Legislative and regulatory approaches to monitoring and curbing abusive related party transactions vary throughout Asia. The Guide highlights key issues to be considered when attempting to improve the framework, its implementation and its enforcement. This includes a need to balance more effective regulation of the markets with the necessity to avoid an un-necessary burden on companies, shareholders, auditors, regulators and markets. This section provides thoughts on an effective policy framework, particularly with regard to disclosure and shareholders' approval, and shareholders' redress.

Disclosure is fundamental – transparent and consistent reporting of related party transactions allows shareholders to better understand the rationale for, and nature of related party transactions. Principle V.A.5 of the OECD Principles recommends that "disclosure should include, but not be limited to, material information on related party transactions", and the annotations to the Principle note that "it is essential for the company to fully disclose material related party transactions to the market, either individually, or on a grouped basis, including whether they have been executed at arm's-length and on normal market terms".

At the same time, it is important that regulation is efficient, meaning that it does not unduly increase the regulatory burden and that it is accompanied by strong enforcement. In general, additional disclosure requirements on related party transactions may unfairly impose a regulatory burden on the companies that conduct their business in an equitable and transparent manner, in other words, indirectly imposing a cost on shareholders. Balancing these interests is vital and a Regulatory Impact Assessment (RIA) weighing the regulatory costs and benefits would provide useful analysis to legislators/regulators when defining their approaches to monitoring and curbing abusive related party

transactions. A concrete example from an OECD member country is provided in Box 7 (An Example of RIA Applied to Related Party Transactions). It needs to be noted that in this case the regulator has the authority and information to determine who is a controlling shareholder. This task could in principle be executed by other official agencies.

Box 7 – An Example of RIA Applied to Related Party Transactions

The Italian regulator CONSOB (Commissione Nazionale per le Società e la Borsa) recently evaluated three regulatory options pertaining to approval of related party transactions:

1. the endorsement of Corporate Governance Code recommendations that would serve to enhance the role of the board of auditors as a supervisory body to oversee effective implementation and enforce regulations, with the board of auditors' power to sanction endorsed by CONSOB;
2. the enhancement of the role of independent directors as central actors in the process, (approval of procedures, conduct of negotiations, approval of the transaction, and the possibility of obtaining advice from independent experts at all stages) with the award of decision-making power to the board of directors; and
3. the requirement that material related party transactions be examined and eventually approved at shareholders meetings.

Ultimately, as a result of the cost and impact analysis, CONSOB decided on option (ii), stating that option (i) would be of limited effect, and that while option (iii) might be highly effective, it would impose excessive burdens on listed companies.

The lessons from this are important – CONSOB sought a balanced way that would sufficiently mitigate the risk of abusive related party transactions, while trying to avoid imposing a burden on the company and market. Every jurisdiction will undoubtedly face its own challenges. Often, the lack of a coherent legal and regulatory framework with responsibility shared or spread across multiple agencies overseeing company law, securities legislation, disclosure regulation and listing rules can present obstacles to effective enforcement. A coherent regulatory system, particularly concerning disclosure and board oversight, would be important.

3.1 Ex-Ante Protection: Disclosure and Shareholder Approval

From the perspective of investors the two main concerns about related party transactions are, first, how well are investors able to monitor such transactions and, secondly, what options for ex-ante action and ex-post redress exist if these transactions are perceived to be abusive. If disclosure is timely, comprehensive and accurate, shareholders could be able to monitor adequately abusive related party transactions by themselves. However, requiring all related party transactions to be approved by shareholders may not be feasible in the case of ongoing transactions, or where multiple transactions are small in number and would require multiple approvals. Where a size carve-out alone exists, the risk is that issuers will separate large transactions into multiple, smaller transactions so as to avoid shareholder approval requirements.

One approach would be to define thresholds for disclosure and shareholder approval. In Hong Kong, China for example, Rule 14A.16 of the SEHK Listing Rules breaks transactions into the following categories:

- connected transactions exempt from the reporting, announcement and independent shareholders' approval requirements;
- connected transactions exempt from the independent shareholders' approval requirements;
- continuing connected transactions exempt from the reporting, announcement and independent shareholders' approval requirements;
- continuing connected transactions exempt from the independent shareholders' approval requirements; and
- connected transactions, including continuing connected transactions, not falling under any of the categories set out in rules 14A.16(1) to (4).

Box 8 - General Mandate for Related Party Transactions (Singapore)

In addition to the *de minimis* waiver, Singapore-listed companies are able to seek from shareholders a General Mandate for recurrent transactions of a revenue or trading nature. Specifically, Chapter 9 of the Listing Rules (Rule 920(1)) states that:

"An issuer may seek a general mandate from shareholders for recurrent transactions of a revenue or trading nature or those necessary for its day-to-day operations such as the purchase and sale of supplies and materials, but not in respect of the purchase or sale of assets, undertakings or businesses. A general mandate is subject to annual renewal."

When requesting approval for a General Mandate for Related Party Transactions, the issuer must make reference to:

- (i) the class of interested persons with which the entity at risk will be transacting;
- (ii) the nature of the transactions contemplated under the mandate;
- (iii) the rationale for, and benefit to, the entity at risk;
- (iv) the methods or procedures for determining transaction prices;
- (v) the independent financial adviser's opinion on whether the methods or procedures in (iv) are sufficient to ensure that the transactions will be carried out on normal commercial terms and will not be prejudicial to the interests of the issuer and its minority shareholders;
- (vi) an opinion from the audit committee if it takes a different view to the independent financial adviser;
- (vii) a statement from the issuer that it will obtain a fresh mandate from shareholders if the methods or procedures in (iv) become inappropriate; and
- (viii) a statement that the interested person will abstain, and has undertaken to ensure that its associates will abstain, from voting on the resolution approving the transaction.

Following the granting of this General Mandate, issuers must disclose the value of transactions entered into under the General Mandate in the annual report.

Disclosure

Allowing related party transactions below a *de minimis* threshold to be exempted from disclosure[16] could minimise the costs for companies and reduce the regulatory burden.[17]

Related party transactions that exceed a certain threshold would be disclosed, along with the terms and conditions of the transactions. For example:

- the transaction date;
- the parties to the transaction;
- the relationship between the parties;
- a description of the transaction;
- the rationale for entering into the transaction;
- the total consideration and terms of the transaction; and
- the extent to which the related parties or company will benefit economically from the transaction.

Shareholder Approval

Related party transactions that exceed a certain threshold would be subject to shareholder approval.[18] The related party transactions could take two forms: i) small, recurring transactions in the ordinary course of business, and ii) specific, one-off transactions. The issue of aggregation or grouping comes up in the case of recurring related party transactions, both in order to ascertain what transactions are effectively "material" and also to help non-controlling shareholders improve their monitoring (see Box 8 - General Mandate for Related Party Transactions (Singapore)). It would also be beneficial for shareholders to request independent (*i.e.* non-conflicted) directors for their opinion on the transaction. Directors with a conflict of interest in the transaction would abstain from making a recommendation to shareholders (see Box 9 – Interested Party Abstentions in Malaysia).

Box 9 – Interested Party Abstentions in Malaysia

In relation to the abstention of voting by interested parties, the Bursa Malaysia Listing Rules (Chapter 10) provide that:

"In a meeting to obtain shareholder approval -

(a) the interested director, major shareholder or person connected with a director or major shareholder with any interest, direct or indirect ("interested major shareholder" or "interested person connected with a director or major shareholder"); and

(b) where it involves the interest of an interested person connected with a director or major shareholder, such director or major shareholder,

must not vote on the resolution approving the transaction. An interested director or interested major shareholder must ensure that persons connected with him abstain from voting on the resolution approving the transaction."

Source: Bursa Malaysia Listing Requirement 10.08(7).

Available at: http://www.bursamalaysia.com/website/bm/regulation/rules/listing_requirements/downloads/bm_mainchapter10.pdf

Box 10 - Shareholder Approval in China

As with all markets, two types of related party transactions are commonly seen in China – the non-recurring transaction, and the recurring service provision agreement. With respect to the former, companies must gain shareholder approval for sales of assets, or any pledge of assets as guarantee, equal to or greater than 30 percent of the total value of the company's assets. Moreover, shareholders representing two third of the votes in attendance at a meeting must approve the resolution (CL, §§122, 123, & 145). Independent directors must ratify any related party transaction amounting to more than 5 percent of assets or RMB 3 000 000 (around US$415 000), and here related parties must abstain from voting. With respect to the latter type of transaction, the CSRC Code prescribes that prices for related party transactions should be roughly equal to that which an independent third party might charge (CSRC Code, §13).

It may also be useful for directors to ask for advice from independent experts. The expert's opinions can be reproduced in the circular to shareholders, if independent directors consider it is necessary.

In terms of voting at the shareholders meeting, the legal and regulatory framework could require that interested shareholders (and their associates – see Section 2) abstain from voting on the transaction.[19] Moreover, when a vote on a related party transaction is mandated, it would be beneficial for votes to be taken by a poll (as opposed to a show of hands). Many international shareholders are unable to attend extraordinary general meetings; a vote by poll would ensure that they are consulted on material transactions.

Reporting

Based on defined thresholds, the legal and regulatory framework could require that related party transactions be disclosed to shareholders in a timely fashion, at least in annual reports. These disclosures may see similar *de minimis* transactions grouped for ease of presentation. However, transactions within the above defined threshold would be disclosed, including the values of the transactions entered into after shareholder approval was received, the names and relationships with the counterparties, and the nature of the transaction. These would sit within the audited financial statements, and auditors would be responsible for providing assurance that the figures presented are accurate.

Thresholds

The above approach relies on thresholds for disclosure and approval, as well as the recognition of the existence of *de minimis* transactions. While the regulatory framework may offer different thresholds, a very simple approach to this could be an option discussed in Box 9 - Sample Approaches to Thresholds for Disclosure and Shareholder Approval.

Box 11 - Sample Approaches to Thresholds for Disclosure and Shareholder Approval

	The Ratio Approach	**Hybrid Approach**
De minimis	Where the transaction is less than or equal to 0.099 percent of net assets	Where the transaction is less than or equal to 0.099 percent of net assets OR where the transaction is between 0.1 percent of net assets and 2.49 percent of net assets but is less than $75 000
Disclosure	Where the transaction is between 0.1 percent of net assets and 2.49 percent of net assets	Where the transaction is between 0.1 percent of net assets and 2.49 percent of net assets OR Where the transaction represents 2.5 percent of net assets and above but is between $75 000 and $150 000
Approval Requirement	Where the transaction represents 2.5 percent of net assets and above	Where the transaction represents 2.5 percent of net assets and above OR is worth $150 000 or more

This suggested approach uses Net Asset Value as an example, although the regulatory framework may make use of a) alternative thresholds, and/or b) alternative approaches which would see the transaction benchmarked against a different ratio, including revenue or profit as a base of calculation. Singapore Stock Exchange, for example, makes use of Net Tangible Assets (NTA) as the benchmark. Listing Rule 905 requires any transaction greater than 3 percent of NTA be disclosed to the market, whilst Listing

Rule 906 requires any transaction greater than 5 percent of NTA be approved by shareholders.

In addition to a single threshold approach, there is another approach using a number of different ratios rather than specifying just one, so as to be sure that a broad spectrum of transactions is assessed. Furthermore, there is a hybrid threshold approach. The option discussed below includes an absolute value component so as to be applicable to a broad spectrum of companies (including those with low level of net assets).

Again, the figures contained in Box 11 are for illustrative purposes only –alternate thresholds can be defined by each jurisdiction according to their specific context. Most important is that the legal and regulatory framework governing related party transactions include clauses allowing for discussion of materiality. Although some related party transactions may appear to be less than a certain threshold, a materiality test may prove that they are material to one or more related counter-parties, and as such might be submitted for either disclosure or shareholder approval. One further approach is to provide two distinct thresholds – one for ongoing/recurring transactions, and one for non-recurring transactions.

It is important to emphasise the need for an aggregation clause. Where disclosure thresholds are in place the risk is that listed companies will structure transactions so as to qualify for *de minmis* treatment. Similar related party transactions need to be aggregated appropriately and made subject to disclosure and, if stipulated by laws or regulations, made subject to shareholders' approval. In response to this challenge, for example, paragraph 10.12 of Bursa Malaysia Securities Bhd Listing Requirements grants Bursa Malaysia Securities the power to aggregate separate transactions and treat such transactions as if they were one transaction if the terms of such transactions were agreed upon within a period of 12 months (Practice Note 14 provides guidance on this).[20] When determining thresholds, market consultation can be helpful to ensuring credibility. Ongoing dialogue among relevant stakeholders would be important to keeps checks on the adequacy of the threshold, and adjust when appropriate.

3.2. Ex-post Enforcement and Shareholder Redress

Enforcement actions to curb abusive related party transactions can be both ex-ante and ex-post. Ex-ante actions to deter abusive related party transactions include board oversight and shareholders' approval. Ex-post, ensuring effective ways for shareholders to obtain legal redress would have significant influence on deterring abusive related party transactions. The OECD Principles (Principle III.A.2) recommend that:

> *"Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress."*

Box 12 – Shareholder Redress in China and Indonesia

The 2006 Company Law revision significantly strengthened shareholders' rights in China. Pursuant to the revised Company Law, any shareholder (or group of shareholders) holding 1 percent or more of more of the company's shares for 180 consecutive days is able to bring a suit against senior management, directors or supervisors in their own name on behalf of the company where those persons have caused a loss to the company (§152). Moreover, shareholders are able to bring actions on behalf of the company against a director or senior manager deemed to have damaged shareholder interests by violating a law, articles of association, or other administrative regulation (CL, §153). In addition, shareholders are able to bring action against a controlling shareholder who has caused losses to the company (§20). These provisions remain relatively untested, but their existence has added legislative support for shareholder rights and redress in China.

In Indonesia, Corporation Law gives shareholders the right to file a lawsuit against a company if they incur loss as a result of unfair treatment without reasonable justification arising from decisions made by the Shareholders General Meeting, commissioners or directors (§62). Moreover, the Capital Market Law also states that any person who suffers losses arising from violations of this law and or its implementing regulations can sue for compensation, either jointly or severally with other persons with similar claims, against the person or persons responsible for such violations (§111).

In reality, minority shareholders in Asian jurisdictions often lack suitable ways of obtaining effective redress. The enshrinement of fiduciary duties (the duty of loyalty and duty of care) by directors would go a long way to facilitating shareholders' redress by focusing attention on the responsibility of directors. For example, the recently revised Company Law in China represented a move towards legal mechanisms and systems similar to common law systems, including privately enforceable shareholder rights. It also introduced for the first time duties of loyalty and diligence for senior officers (§148), whilst prohibiting "…acts that are inconsistent with the obligation of fidelity to the company" (§149.viii). Where there is no legal recognition of fiduciary duties, shareholders' redress may be more challenging.

The two main legal means of shareholder redress are: i) class action suits, or ii) derivative suits. In a number of jurisdictions derivative suits are permitted, but class action suits are not. This is, for example, the case in both China and Hong Kong, China.

Moreover, while a derivative suit provides some redress for shareholders, monetary awards stemming from a successful outcome would belong to the company and not shareholders directly, making derivative suits unattractive – not least where the solvency of the concerned enterprise may be in doubt (given that shareholders are the last to benefit from any monetary awards, subordinate to creditors, bondholders etc). In addition, the risk of the free-rider problem (*i.e.* that a lead claimant's efforts would be shared equally by all shareholders) adds to the challenges for shareholders to take legal action.

Obstacles remain, however, to an effective class action/derivative suit mechanism - access to proper information, shareholder sophistication, and cost are all factors that may impede the active use of these mechanisms. Moreover, the wording of the law with regard to the burden of proof is of central importance given that the burden of proof emphasis will decide whether minority shareholders make use of the mechanism judiciously, or are discouraged from doing so depending on the regulatory wording.

Broadly, however, shareholders need to have the power to:

- petition a court to prohibit an abusive related party transaction from occurring (*i.e.* obtain an injunction);

- petition a court to instruct directors to cease undertaking an abusive related party transaction; and

- petition a court to ensure that profits derived from an abusive related party transaction are repaid to the company.

Implementing such legislation is a key as well as training of the judiciary, although here questions of their independence, competence, and experience arise. Minority shareholders may doubt the judiciary's expertise in handling such cases. Ensuring that the judiciary is trained, independent and well-versed in complex financial transactions is an important role for governments.[21]

It is also imperative for minority shareholders to be able to co-ordinate and consult with others. Although minority shareholders may feel aggrieved over a certain action undertaken by the company, co-ordination (especially in large jurisdictions) can be challenging and resource-intensive. A central minority shareholders' group (for example, the *Minorities Shareholders Watchdog Group*[22] in Malaysia, or Singapore's *Securities Investors Association (Singapore)*[23]) allows for some co-ordination. It may also allow coordination of expenses when legal action is required. Without such bodies, minority shareholders may struggle to make use of their rights in a cost-effective and coordinated manner.

3.3 Summary

This section has proposed some key issues that could improve the legal and regulatory framework for ex-ante checks on related party transactions, notably on disclosure and shareholder approval, based on a threshold approach, and ex-post redress aggrieved shareholders. Protection of minority shareholders would be supported by ensuring i) a requirement that shareholder meetings approve material related party transactions with a majority of disinterested shareholders' votes; and ii) quick and cost-effective legal redress, including through specialized courts and alternative dispute resolution.

In most Asian jurisdictions, the lack of knowledge and experience within the judiciary still forms a serious constraint for solving corporate governance related disputes. Therefore, there remains a clear need to further develop the capacity to adjudicate corporate governance related disputes, either through specialised courts or alternative dispute resolution

All of the above, however, is predicated on regulators being sufficiently resourced with the capacity to set priorities effectively. Where regulators are well-intentioned but underfunded, regulation will be inconsistent and enforcement challenging. Sufficient funding could be directed to regulators in order to ensure that they have staff with adequate expertise to ensure that regulation is efficient and constructive. Inter-authority coordination between regulators in each jurisdiction would encourage policy-makers and regulators to make better use of limited resources.

4. Board Oversight and Approval

The board is charged with making decisions in the interests of all shareholders. Within the decision making process of the board, independent directors, the audit committee, and internal/external auditors are all required to play a significant role in monitoring and curbing abusive related party transactions. Indeed, Principle VI.D.6 of the OECD Principles recommends that the board should fulfil certain key functions, including:

> *"Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions."*

Members of the board and key executives would need to have an obligation to inform the board in advance of any related party transaction causing material conflicts of interest, conclude the transaction with the approval of the board through an effective monitoring system, including of their performance. Furthermore, in some cases, it may be appropriate for companies to prohibit directors from engaging in such transactions. In order for non-controlling shareholders to check whether the board effectively monitors and approves related party transactions, the company might develop and disclose a policy/guide to monitoring related party transactions.

Independent directors have a central task in helping the board fulfil the above function.[24] Their role has become progressively more important to shareholders.[25] Evidence of the role played by independent directors to participate in curbing related party transactions is also apparent; in a study with a sample of 782 publicly traded firms with a dominant shareholder from 22 countries, Dahya, Dimitrov and McConnell (2007) found that "…a

higher proportion of independent directors are associated with a lower likelihood of related party transactions."[26]

This section will look at ways in which the role of independent directors can be strengthened, how they can be developed and trained so as to be better placed to monitor and curb abusive related party transactions, and on the recruitment and compensation process of independent directors.

4.1 Role of Independent Directors

Independent directors play a crucial role in monitoring abusive related party transactions.[27] While all directors are required to discharge fiduciary duties to all shareholders, inviting directors with a conflict of interest in discussions on related party transactions may be counter-productive. Independent judgement is critical to monitoring related party transactions and to ensure that agreed transactions are in the interests of the company and all shareholders. While the Guide has recommended the threshold approach to disclosure and approval at the shareholder level, all related party transactions require board oversight (with interested parties abstaining from both discussions or voting on the transaction).

The Guide recommends that only non-conflicted directors discuss and decide on a related party transaction, and this could be included in the company's policy about a board approval procedure. A number of jurisdictions currently enforce similar requirements (see Box 13 – Related Party Transaction Committee in Belgium), including India which requires as part of the company's Listing Agreement that the audit committee approve all related party transactions and that the firm disclose "materially significant" related party transactions to shareholders (Batra, 2008). Moreover, the Guide recommends that, where transactions require shareholder approval, independent directors may wish to:

- retain an independent expert to offer professional advice to independent directors on the fairness of the transaction; and
- make a recommendation to shareholders.

Box 13 – Related Party Transaction Committee in Belgium

In Belgium, the Company Code (*Code des Sociétés*) (§524) requires that intra-group transactions be approved by a committee composed of three independent directors. This committee must retain an independent expert (remunerated by the company) to deliver advice, with the committee considering the nature of the transaction, as well as any potential gain or prejudice for the company and its shareholders.

Following this, the Board of Directors as a whole discusses the proposed transaction making reference to the committee’s report, with an external auditor providing a fairness opinion on the data contained within the committee’s report. The Board’s minutes reflect the final decision plus any justification for deviating from the committee’s advice. Finally, the committee's decision (along with excerpt of the board's minutes and the auditor's fairness opinion) is included in the company's management report.

Source: Goldschmidt (2009)

A particular challenge when discussing the role of independent directors is that doubts remain over their independence from a controlling shareholder in many Asian jurisdictions. The controlling shareholder often identifies recruits, nominates, and elects these directors, and hence their loyalty is - in many cases – to that party. Although most Asian jurisdictions require independent directors on boards, they are usually a minority on boards.

Many Asian jurisdictions require a board to include at least three independent directors. While Singapore’s Code of Corporate Governance recommends that “There should be a

strong and independent element on the Board, with independent directors making up at least one-third of the Board", in Hong Kong, China the Code of Corporate Governance Practices suggests, *as a recommended best practice*, that independent directors should represent at least one-third of the board. Rule 3.10 of the SEHK Main Board Listing Rules requires only that at least three independent directors be appointed to boards of listed companies.[28] In China, the 2001 'Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies' (the 2001 Guidelines) require boards to be one-third independent by 30 June 2003. The Company Law review in 2006 gave statutory backing to the introduction of independent directors in China (Company Law, §123). The 2001 Guidelines state that independent directors should be "…especially concerned with protecting the interests of minority shareholders from being infringed" (2001 Guidelines, I.2).[29]

In some jurisdictions, relations with controlling shareholders are deemed not to be material and transitions from executive to independent roles are rarely covered by independence criteria. It is not the objective of the Guide to prescribe absolute levels of independence required. However, the legal and regulatory framework could be enhanced to ensure that an independent mindset is reflected in the decision-making process of the board. For example, non-controlling shareholders might have sufficient influence over the nomination and election of directors, in particular independent directors, and their incentive structures, such as remuneration policy.

Many jurisdictions have developed rules to determine independence, with jurisdictions having different requirements depending on their business environment, culture, and legal system. There are, however, certain universal characteristics of independence. The policy framework and corporate practices would need to treat implementation of independence criteria fairly when reviewing the qualification of independent directors.

Box 14 - Broad Independent Criteria

Examples of relationships that may jeopardise the independence of a director might include:

- where that director has served as an executive director of the company in the past three years;
- where that director is a substantial shareholder of the company;
- where that director is a director of a substantial shareholder of the company;
- where that director has (or is a director/partner of a firm that has) received compensation from the company greater than *e.g.* $20 000 in the most recent year;
- where that director is related to a substantial shareholder, or executive director of the company; and
- where that director has served as an independent director for a certain period of time.

Independence requirements could include scope for companies to provide a full explanation of why they feel that a director is independent despite not meeting certain formal independence criteria. Despite the criteria suggested above, what is of most importance are the following:

- a director of independent mind;
- a director who is willing to challenge other directors and/or management; *and*
- a director who has time to devote to the board (*i.e.* does not serve on numerous boards and associated committees).

The first two criteria are difficult for shareholders outside of the boardroom to assess. The latter can be approached by developing guidelines around a maximum number of boards that a director can serve on. However, there are challenges associated with this approach.

Some directors may be conflicted by a certain transaction (*i.e.* may be related to the other party), and as such it would be inappropriate to assume that the directors would be able to discharge their fiduciary duties to multiple parties in the transaction. Where a related party transaction is subject to shareholder approval, disinterested shareholders could ask for an opinion from independent directors.

Recruitment and Election

In many cases a director may appear independent, yet may not possess the capability to exercise independent judgement. Developing relevant expertise and competence is critical for board members. While definitions of financial expertise are broad, the United States Regulation S-K[30] (item 407(d)(5)(ii)) defines an audit committee financial expert as a person possessing the following attributes:

i) an understanding of generally accepted accounting principles and financial statements;

ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;

iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;

iv) an understanding of internal control over financial reporting; and

v) an understanding of audit committee functions.[31]

A related issue is that of the recruitment process for independent directors. In many cases, independent directors are nominated and elected by the controlling shareholder; the use of a nomination committee, consisting of majority-shareholder-recruited directors, is not necessarily sufficient to avoid a 'rubber stamping' culture. To this end, cumulative voting may provide non-controlling shareholders with a way to support independence on a company's board. Cumulative voting relies, to some extent, on the organisation of non-controlling shareholders, and on multiple nominees being proposed for board seats (assuming elections are decided by simple majority vote).[32] While consensus on the effectiveness of cumulative voting has not been reached in Asia, it represents one option for non-controlling shareholders to enhance independent judgement in the decision making process of the board. In some cases, a voting system with a majority of non-controlling shareholders can be an alternative method.

Ongoing Training

An issue that is frequently raised is whether independent directors possess sufficient experience and knowledge to effectively monitor related party transactions. One solution is to introduce compulsory, ongoing training for independent directors.[33] This may add cost on a systematic basis, but empowering independent directors with the ability to monitor abusive related party transactions is vital, and will provide assurance to shareholders that adequately qualified directors are stewarding the company, as well as improving market integrity. At the outset, directors might attend a company orientation programme for new directors organised by companies.[34] Ongoing training might be provided to directors. These courses could be run by the stock exchange, or a third party external body such as an Institute of Directors.[35] Training might be disclosed to shareholders as part of the annual report, although not necessarily audited, and might be funded by the company. Such training could be rigorous, relevant, and recurring – continuous professional development requirements for directors may be introduced where they are not currently in place.

Remuneration

Another fundamental issue to support directors' independent judgement is aligning their remuneration with the longer-term interests of the company and its shareholders. Often, independence might be questioned if they receive considerably high compensation or some form of market-linked compensation (*e.g.* stock option rights). Perhaps a more effective approach to enhance a director's independent mindset is to focus on the incentive structures to facilitate the longer-term interests of the company and its shareholders. Excessively high compensation of an independent director might impair their independent mindset (and hence be less likely to challenge management). The remuneration policy needs to be linked to long-term performance. One solution might be to grant long-vesting shares. Independent directors would be granted a certain portion of their annual fees by way of shares in the company, with these shares subject to a 3-5 year vesting period. In this case, independent directors have an interest in ensuring that value is created, sustained, and not destroyed via abusive related party transactions.[36]

4.2 Auditors

Principle V.C of the OECD Principles recommends that:

> *"an annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all respects."*

The complexity of group structures and the inter-connectedness of enterprises (most notably under the 'complicated network ownership' structure) means auditors face significant challenges in being sceptical of material information on related party

transactions in Asia. The fact that, for the most part, external auditors are reliant on information provided by management magnifies this challenge.

Auditors' ability to be alert to transactions that raise concern (*e.g.* a large number of transactions for cash, lack of receipts, bill-and-hold transactions) is central to their profession. This extends to understanding the counter-party to these transactions. In many cases, abusive related party transactions are not disclosed on a simple peer-to-peer basis; they may involve a number of holding companies, offshore entities, and third parties. Management may, in some cases, be constructing complicated networks for such transactions in order to conceal their existence. In such cases, auditors might be prepared to examine in great detail such counterparties. This is no simple task – companies can often have a large number of customers. However, a 'nose' for curiosity might help auditors triage the most likely candidates for examination.

They might also enquire whether these are disclosed accurately to shareholders. It is proposed that such disclosures are made part of financial accounts presented to shareholders and that such information be subject to audit scrutiny. This is currently a requirement in a number of jurisdictions, including France[37] and Indonesia where related party transactions are disclosed in annual and semi-annual reports, and audited (Bapepam-LK Rule IX.E.1).[38]

However, while external auditors play an important role, there remain concerns over the ways in which listed companies and their shareholders can ensure the independence of auditors. Ultimately, market participants must remain cognizant of the fact that auditors are retained by the company they audit. Broadly, listed companies and their shareholders would need to ensure that the auditors retained:

- are truly independent;
- have adequate quality control procedures; and
- are properly discharging their responsibilities and performing requisite procedures as required by relevant standards.

An effective 'whistle blower' mechanism may be established by management as an internal control mechanism, assessed by internal auditors. Such mechanisms are in many cases under the remit of the audit committee, and the internal auditor might assess the robustness of such mechanisms. In particular, internal auditors might consider whether employees are able to anonymously relate concerns over transactions. In some cases whistle-blower mechanisms and procedures are in place, but fall down on fundamental flaws; they may request the whistle-blowers to identify themselves, for example, or may route the whistle-blower hotline direct to the CEO and/or Chairman (who may be the counter-party of concern). Many effective mechanisms make use of external bodies, ensuring anonymity and allowing for an uninhibited disclosure. Regulators and legislators may seek to provide statutory protection for whistle blowers, protecting these parties from court action where a report was made in good faith.

4.3 Communicating Auditor Quality

It is in the interests of market operators, regulators, companies, and auditors themselves that auditors are of a high quality, and that information on auditor quality is communicated to the market.[39]

Auditors have a clear interest in ensuring a systemic trust in the audit profession. To that end, auditors might seek affiliation where it exists, and governments and regulators might ensure that regulatory oversight bodies are established to regulate the audit profession. These bodies might be independent and distinct from the profession they regulate. Auditors themselves might aim to adhere to promulgations of the International Federation of Accountants (IFAC),[40] including International Standards on Auditing (professional standards for the performance of financial audit of financial information)[41] and the IFAC Code of Ethics for Professional Accountants.[42]

There is, however, arguably little that auditors can do when faced with a determined and resourceful controlling shareholder. The role of auditors is one that complements that of

the board in this area – it does not replace the board. While that may be true, issues of auditor liability will continue to be discussed in situations where auditors have failed to recognise related party transactions that need to be reported to shareholders.

Notes

1. Throughout this Guide, Hong Kong and China are used as short-form for the Hong Kong Special Administrative Region (HKSAR) of the People's Republic of China, and the People's Republic of China, respectively.

2. In the course of FY2008, DBS Group Holdings Ltd (DBS) purchased SGD 5.8 million worth of air tickets from Singapore Airlines Ltd. The entities are related by virtue of a common shareholder – Temasek Holdings (Pte) Ltd. Source: DBS Group Holdings Ltd FY2008 Annual Report, p46.

3. In this example, a listed company makes an unsecured deposit with a central finance company, owned by the listed company's controlling shareholder. The finance company also takes deposits from private entities owned by the controlling shareholder, and is able to make loans to private entities owned by the listed company's controlling shareholder. Where deposits are unsecured, the default of a private entity would jeopardise deposits made by the listed company. The default may also impact the credit rating of the listed company.

4. Note that a number of board structures exist within Asia and users of this Guide are encouraged to understand that fact when considering these board dynamics. Indonesia, for example, operates a two-tier board system that includes both directors and commissioners. Here, Independent Commissioners are equivalent in name and role to Independent Non-Executive Directors in markets that operate a unified board structure.

5. See Kim, Lim, & Sung (2004) for a detailed discussion of *Chaebols*, ownership structure, and cash-flow rights.

6. OECD (2006), "Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance". Available at: http://www.oecd.org/dataoecd/58/12/37776417.pdf.

7. Moreover, and while this is beyond the remit of this Guide, there exists a risk of deprivation of wealth generating opportunities – the ownership entity (family or state) is able to take advantage of the economic opportunities that the listed entity is able to create, on a private basis, thus depriving shareholders of wealth generating opportunities.

8. In a large number of cases, ongoing related party transactions are commonplace in order to support the functioning of the listed entity (*e.g.* trading of input goods, provision of logistical support etc). In other cases, one-off asset transfers are seen where the private holding company either purchases assets from, or sells assets to, the listed entity.

9. Accounting Standard (AS) 18 (issued 2000): Related Party Disclosures". Available at: http://www.icai.org/resource_file/262accounting_standards_as18new.pdf.

10. Some progress has been made with regard to broad adoption of IFRS in Asia. Hong Kong Financial Reporting Standards (HKFRS) are compliant with IFRS, whilst in China the introduction of the ASBE in 2007 (consisting of one 'Basic Standard' and 38 specific standards applicable to all listed Chinese companies) substantially brought China into line with IFRS (although deviations from IAS 24 still exist, notably around treatment of State-owned Enterprises). Indian Accounting Standard (AS) 18 (prescribed by the Institute of Chartered Accountants of India (ICAI)), is broadly similar to IAS 24, albeit with several key deviations. In Korea, the Korea Accounting Standards

Board (KASB), resolved in 2006 to make full adoption mandatory for all listed companies from 2011, whilst The Indonesia Financial Accounting Standard Board plans to adopt IAS 24 in 2010.

11. Where there is a difference on interpretations of related parties, there is a risk of 'regulatory arbitrage', whereby listed companies seek the lowest burden for compliance and actively seek out low levels of corporate governance requirements. Harmonizing definitions of related party transactions, to the extent possible, would mitigate this risk within Asia and beyond.

12. With respect to the ongoing, continuing, or recurrent transaction, an understanding of timeframe for such definitions is important. For example, the Bursa Malaysia Securities Bhd Practice Note No. 12/2001 (Paragraph 4.1.1) states that "A transaction which has been made or will be made by the listed issuer at least once in 3 years in the course of its business will be considered recurrent." Available at: http://www.bursamalaysia.com/website/bm/regulation/rules/listing_requirements/downloads/BM_LR_PN12.pdf.

13. Many jurisdictions have restrictions on the provision of loans - for example, section 133A of the Malaysian Companies Act-prohibits the provision of loans to persons connected to directors.

14. OECD (2003), "White Paper on Corporate Governance in Asia", Available at: http://www.oecd.org/dataoecd/4/12/2956774.pdf.

15. IAS 31 (Interests in Joint Ventures) describes a joint venture as including i) jointly controlled operations; (ii) jointly controlled assets; and (iii) jointly controlled entities.

16. Note that, as recommended in later sections of the paper, board approval (with interested parties not participating in discussions and votes) would still be required.

17. In Singapore, for example, *de minimis* transactions are considered to be those less than SGD 100 000.

18. The Asian White Paper stated that "the company should at least be required to disclose related party transactions and to seek the approval of a majority of disinterested directors or approval or ratification by an appropriate majority of disinterested shareholders".

19. In Singapore, Listing Rule 919 requires that "In a meeting to obtain shareholder approval, the interested person and any associate of the interested person must not vote on the resolution."

20. Bursa Malaysia Securities Bhd Practice Note No. 14/2002 (Requirements on Transactions and Related Party Transactions), Available at: http://www.bursamalaysia.com/website/bm/regulation/rules/listing_requirements/downloads/BM_LR_PN14.pdf.

21. Similarly, governments need to ensure that delineation between regulators is clear, and that overlaps are minimized. Sprawling regulators with overlapping responsibilities can contribute to a problem and hinder the remedying of that problem. Whilst a single super-regulator is challenging to implement (and not necessarily the most efficacious solution), the number of regulators might be streamlined so as to prevent duplication.

22. See: http://www.mswg.org.my/

23. See: http://www.sias.org.sg/

24. Principle V*I.E.*1 of the OECD Principles recommends that "Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest".

25. The list of requirements for independent directors is at times not practical; they must be able to provide independent judgment in the decision-making process of the board, preferably with useful knowledge such as auditing/accounting and/or experiences concerning the industry in which they operate.

26. Of the 22 counties considered, five (Hong Kong, India, Japan, Korea, and Malaysia) were from Asia.

27. Note, however, that in most jurisdictions directors have fiduciary responsibilities to all shareholders, not just minority shareholders.

28. This is important distinction – the requirement for one-third independent in Singapore is subject to a ‘comply or explain’ requirement under Rule 710 of the SGX Listing Manual. In Hong Kong the status of one-third independence as a recommended best practice means that companies need not disclose non-compliance with recommended best practices.

29. Shen and Jia (2005) note that independent director fees range from RMB 1 000 to RMB 80 000, and an average fee of between RMB 40 000 and RMB 50 000 per annum.

30. Standard Instructions for Filing Forms under the Securities Act of 1933, Securities Exchange Act of 1934, and Energy Policy and Conservation Act of 1975. Available at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=20c66c74f60c4bb8392bcf9ad6fccea3&rgn=div5&view=text&node=17:2.0.1.1.11&idno=17#17:2.0.1.1.11.5.31.7.

31. Regulation S-K also provides that such a person may have acquired such attributes through: i) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions; ii) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or iv) other relevant experience.

32. Note that where a nominee receives more negative votes than positive votes, the net result will be a negative vote for that nominee. In such circumstances, that director will in many jurisdictions not be voted in, and one board seat may remain open. However, market participants remain aware that cumulative voting represents an opportunity for non-controlling shareholders to ensure independent judgment in the decision making process of the board, but does not solve the problem of weak board effectiveness.

33. It might be added that ongoing training for all directors is important. However, this recommendation recognizes the centrality of independent directors to the approval process.

34. Regulators may also wish to introduce pre-IPO training for new directors (including executive directors) on the nature being a director of a listed company (including discussion of fidelity and fiduciary duties). It is perhaps preferable that such training not be provided by a sponsoring investment bank, but instead be provided by an external service provider of an independent body such as an Institute of Directors. Attendance at such training/orientation could be reported in the prospectus and annual report, along with details of the training provided.

35. For example, the Institute of Directors in the United Kingdom offers a Chartered Director course which results in official accreditation and recognition (via the use of the post nominal letters CDir). See: http://www.iod.com

36. The risk, of course, is that such a structure dis-incentivises INEDs from speaking up towards the end of their tenure, or towards the end of their tranche's vesting periods. Nonetheless, some form of long-term alignment must be found.

37. Article L225-88 of the French commercial code and Introductory Speech on Related Party Transactions, Mr. Xavier Tessier (Head of International Affairs, Autorité des marchés financiers, French Securities Regulator), OECD Conference on 14 May 2008, Hong Kong. Available at: http://www.oecd.org/dataoecd/17/48/41815520.pdf.

38. Bapepam-LK Rule IX.E.1, Transactions Involving Conflict of Interests. Available at: http://www.bapepam.go.id/pasar_modal/regulasi_pm/peraturan_pm/IX/IX.E.1.pdf.

39. See IOSCO Public Document No. 134, "Principles of Auditor Oversight", IOSCO Technical Committee (October 2002).

40. See: http://www.ifac.org/

41. The revised "2009 Handbook of International Standards on Auditing and Quality Control" (effective December 15, 2009) draws together both the International Standards on Auditing and the International Standard on Quality Control into one document. Available at: http://www.ifac.org/Members/DownLoads/2009-handbook-of-internatio.pdf.

42. Available at: http://www.ifac.org/Members/DownLoads/2005_Code_of_Ethics.pdf.

Annex: Case Study - How to Assess Related Party Transactions in Six Steps

This section aims to provide market participants (shareholders, auditors, directors, regulators, etc) with a Guide to understanding abusive related party transactions. It highlights a number of key red-flags that these parties could look for when examining a transaction, and ways that controlling shareholders seek to conceal either the extent of the transaction, or whether the transaction is with a related party. In doing so, it makes use of a very simplified transaction – an unlisted parent holding company acquires an asset from a listed subsidiary. The process builds on the recommendations developed during this Guide, and illustrates the ways in which they can be built into the assessment process. The following relies on the fact that the transaction is disclosed as being with a related party – admittedly a key impediment to identifying abusive related party transactions – but nonetheless, allows market participants to determine the extent of abuse, if any, which is occurring. Similarly, this process relies on both the listed company and its management and controlling shareholder making available relevant and appropriate information to independent directors as and when they request it.

In this transaction, HoldCo is proposing to acquire 100 percent of a property asset from ListCo. ListCo is being advised by AdviceCo, a local brokerage firm. For ease of reference, AdviceCo is charged with making a recommendation to independent shareholders on the fairness of the deal. HoldCo holds 51 percent of ListCo, and a number of the non-independent directors sit on both boards. ListCo's board retains the market minimum number of independent directors. ValueCo is providing the market valuation for the property assets to AdviceCo, and in turn independent shareholders. The

deal is all-cash, with a down-payment made on initial agreement, and a balloon payment made following a successful EGM.[1]

The step-by-step guide is by no means exhaustive. It includes a number of the commonly observed traits of abusive related party transactions as part of a six-step guide to spotting key red-flags for analysts, regulators, auditors, and independent directors alike.[2] Throughout this step-by-step guide reference is made to analysts – this reference can be taken to include any market participant analysing a transaction.

Who are the Parties on Either Side of the Transaction?

In our simplified transaction, it was disclosed that HoldCo is acquiring the assets from ListCo. However, in many cases such disclosure is incomplete. Whilst in this example the relationship between HoldCo and ListCo is not complex (HoldCo holds 51 percent of ListCo), in other cases two parties may initially appear unrelated. HoldCo may have established 4 offshore subsidiaries (BVICo I, II, III, and IV) to each acquire 25 percent of the property assets. In some cases, HoldCo may control only 33 percent of each of BVICo I, II, II, and IV, with various third parties controlling the remaining 67 percent of each offshore company. These single-layer complexities class ListCo as an indirect, non-wholly-owned subsidiary. However, there may be double-layer complexities. Each of BVICo I, II, III, and IV could in turn have wholly or non-wholly owned subsidiaries. HoldCo could in turn own some portion of these second level subsidiaries. This latter scenario is common in property transactions, with special purpose entities often established for the purpose of holding one particular property, with controlling shareholders and listed companies often each owning 50 percent of the joint venture company.

1. As with many transactions of this kind, a successful EGM is a prerequisite for the deal to be completed. A fully refundable deposit is repaid if the EGM is not successful.

What Asset is being Transferred?

In some cases the asset is identifiable, and tangible. In this example, 100 percent of a property asset is being transferred. Market participants could, however, seek to understand whether ListCo has the full ownership of the property to be transferred, and whether the deed of ownership can be located and verified. In other cases a portion of the asset is being transferred. It may be that a wholly-owned subsidiary of a listed company is selling 51 percent of a property asset to an associate of the parent holding company, or vice-versa. In other cases, the asset being transferred is actually a service or an input (often continuing related party transactions). The service may be central administration, provision of a central finance service, and so on. In the case of an input, it may be the provision of coal to a downstream power station. It may be a guarantee over a loan to a subsidiary by a third party, or it may be the assumption of a loan to a subsidiary.

Fundamentally, market participants may seek a full understanding of the asset being transferred, or in the case of a service, the parameters of the service to be provided, and the length of time the service is to be provided for. In the case of a loan guarantee or assumption of loan, market participants might seek to ascertain ownership interests of the subsidiary.

How is the Asset Priced?

The valuation of an asset is a key aspect for analysts to understand. In our simplified example, ValueCo is providing a valuation of the property assets. In a transaction such as this, a property valuation company may use comparable properties as a basis for valuation, and may have conducted site visits in order to understand the property and its

2. Here, market participants (including shareholders, auditors, and regulators) are collectively referred to as analysts for ease of reference.

environs. A thorough valuation report might provide some discussion of this. Market participants may, however, be alert to valuation companies that:

i) appear to have no track record when it comes to property valuation;

ii) appear to have used inappropriate comparable properties when providing the valuation;

iii) have used inappropriate projections for value growth over time as a basis for valuation; *or*

iv) make no discussion of even a cursory site visit;

v) provide minimal information on how valuations were arrived at, and present minimal financial information to shareholders.

Market participants might subject the valuation company's report to particular scrutiny; where one of the above red flags is raised, market participants might seek clarification from the company. In many cases the scrutiny of a transaction is concerned with whether the offer price meets the valuation; a more sophisticated approach considers how that valuation was determined.

In the case of service provision, these services or inputs are often priced on a market price, or cost-plus basis. In the case of the former, the agreement would ordinarily state that services (*e.g.* ancillary support services) are to be provided at a price no greater than can be sourced from the market by an independent service provider. In the case of the latter, the agreement may state that the input to be provided (*e.g.* the provision of coal to a downstream power factory) is to be provided at cost price plus a 10 percent margin.

There are potential red-flags here. Market participants, when assessing these transactions, could ensure that some price discussion is included in the agreement, including a "terms no worse" clause where appropriate. Upper limits on price and a discussion of how the price was agreed (market trends, expected capacity/utilisation etc) might also be included.

Box 15 – Pricing of Finished Goods (Aluminum Corporation of China Limited)

The Chalco FY2008 Annual Report* describes a number of related party transactions with the parent company (Aluminum Corporation of China, or Chinalco) and its associated companies and related parties. These transactions include sales of materials and finished goods, provision of utility services, provision of engineering, construction, and supervisory services, purchases of key auxiliary materials, provision of social service and logistics services, provision of utilities services, and rental expenses for land use rights and buildings. With respect to each of the above, Chalco discloses in theFY2008 Annual Report the pricing policy attached to the sale or purchase of assets or services. For example, with respect to the sales of materials and finished goods, the pricing policy is as follows:

(i) Adoption of the price prescribed by the PRC government (“State-prescribed price”);

(ii) If there is no State-prescribed price then adoption of State-guidance price;

(iii) If there is neither State-prescribed price nor State-guidance price, then adoption of market price (being price charged to and from independent third parties); and

(iv) If none of the above is available, then adoption of a contractual price (being reasonable costs incurred in providing the relevant services plus not more than 5% of such costs).

* Aluminum Corporation of China Limited FY2008 Annual Report, Note 33, pp246-249.

What Compensation is Involved?

A key component of understanding whether a transaction is abusive involves examining the nature of the compensation to be paid for the asset. Our simplified transaction sees a pure cash payment, funded from cash-on-hand, in two instalments: one on the agreement between HoldCo and ListCo, and one on the obtaining of shareholder approval at the EGM.

However, in some cases the deal is funded by some other method. Payment via an asset-swap is not uncommon. Here, there is a double valuation issue – who has valued the asset to be tendered? In some case, where the asset to be used as currency is property, a valuation can be fairly readily obtained. In other cases, the currency may be shares in a third party. This is an important area for analysts to explore in greater detail. Where a ListCo, for example, is transferring shares of a third-party to a HoldCo, market participants might ask why the shares are being transferred out of their ownership. What are the prospects for the third party? If they are good, why is the ListCo disposing of the shares? Are the shares fully tradable? In some cases, the shares may be subject to a trading lock-up period which would depress the price of the shares. If that lock-up expires soon, why would the ListCo transfer those shares?

Are any of the Parties Conflicted?

Perhaps the most obvious area where abusive related party transactions are involved is whether the directors/advisers involved at the company are conflicted themselves. In some cases, this may be easy to ascertain: a director of both ListCo and HoldCo in our simplified example would be conflicted; ValueCo may receive financial gain if a transaction is approved. However, there may be more indirect conflicts. A director of ListCo may also be a director of ValueCo or AdviceCo; he may be a director of the bank that is providing financing to HoldCo. In all of these cases, the director would be conflicted. Whilst the scope of conflicts of interest is broad, areas which may lead a party to be conflicted include the following:

i) where the party has a pecuniary interest which are in conflict with those of the company;

ii) where the party's objective professional judgment to act in the best interest of the company and its shareholders is compromised.

However, in determining such conflicts, attention must be given to:

i) the size of the transaction;

ii) the overall financial position of the director;

iii) the director's interest in the transaction; and

iv) the significance of the interest, the benefit to the company and to the relevant interested party, and other terms of the transaction.

Many jurisdictions have requirements that such directors neither vote on the transaction nor advise non-controlling shareholders on how to vote. Nonetheless, market participants might be aware that there are a number of ways in which the director may be conflicted. As a matter of course, market participants could research biographical backgrounds of directors of the listed company, looking out for red-flags that may highlight conflicts.

Why is the Asset Being Transferred? Why Now?

Understanding the why now? question is an often over-looked, but similarly useful aspect for identifying abusive related party transactions. If an abusive related party transaction sees a counterparty benefit to the detriment of the listed company, shareholders might enquire of all transactions as to:

- why is the asset being traded? In many cases, assets are traded for reasons of 'diversification' of the listed entity;
- why the listed company is 'diversifying' into an asset that is – by coincidence - owned by a parent company;
- why now is the best time to undertake this transaction;

- why now - if the market is depressed - is the best time to sell an asset to a related party. Waiting for six months might potentially see the company obtain a higher valuation for the entity.

Of course, this is not an exact science – predicting valuations and market timing is challenging, and directors do in the majority of cases act in the interest of all shareholders. In many cases timing influences abusive related party transactions because related parties may have incurred losses on a separate entity or business venture, and may be keen to 'inject' assets into that entity to prevent a breach of debt covenants. It may be that on a personal level he/she has incurred losses associated with the stock market and needs funding. In any of these cases, the alignment of interests may be absent. As such, an understanding of the timing of transactions is crucial to analysts.

Task Force Members

Mr. Leo GOLDSCHMIDT
Director
European Corporate Governance Institute (ECGI)
Belgium

Mr. Héctor LEHUEDÉ
Advisor to the Minister
Ministry of Finance
Chile

Ms. Serena Shiau-Huei HUANG
Junior Associate
Listing Promotion Department
Taiwan Stock Exchange
Chinese Taipei

Mr. Daniel Cheng-Hua YUAN
Manager
Listing Promotion Department
Taiwan Stock Exchange
Chinese Taipei

Ms. Hsiu-Ling, LEE
Section Chief of Security and Futures, Securities and Futures Bureau
Financial Supervisory Commission
Chinese Taipei

Mr. Patrice AGUESSE
Director
Regulatory Policy Division
French Securities Exchange Commission (AMF)
France

Professor Stephen CHEUNG
Chair, Professor of Finance, Department of Economics and Finance
City University of Hong Kong
Hong Kong, China

Mr. Charles GRIEVE
Senior Director
Corporate Finance Division
Securities and Futures Commission
Hong Kong, China

Ms. Jennifer LEE KEI FONG
Associate Director, Corporate Finance
Securities and Futures Commission
Hong Kong, China

Mr. Sumant BATRA
Managing Partner
Kesar Dass B & Associates,
Corporate & Commercial Lawyers
India

Mr. Arif BAHARUDIN
Head of Accounting and Disclosure Standards Bureau
Indonesian Capital Market and Financial Institutions Supervisory Agency
Indonesia

Dr. Sidharta UTAMA
Chairman
Indonesian Institute for Corporate Directorship (IICD)
Indonesia

Mrs. Evie SULISTYANI
Head, Policy Development of Corporate Governance Sub Division
Indonesian Capital Market and Financial Institutions Supervisory Agency
Indonesia

Dr. Marcello BIANCHI
Chair, OECD Steering Group on Corporate Governance and Head of the Regulation Impact Analysis Office Economic Regulation Division
Commissione Nazionale per le Societa e la Borsa (CONSOB)
Italy

Professor Hasung JANG
Dean and Professor of Finance
Korea University, Business School
Korea

Mr. Anil Joshi HARI CHAND
Assistant General Manager
Regulatory Services (Advisory & Reform)
Securities Commission Malaysia
Malaysia

Mrs. Selvarany RASIAH
Chief Regulatory Officer
Bursa Malaysia Bhd
Malaysia

Mr. Weidong ZHANG
Senior Research Fellow
Research Centre, Shanghai Stock Exchange
People's Republic of China

Mr. Lixin ZHAO
Deputy Director General
Department of Listed Company Supervision
China Securities Regulatory Commission (CSRC)
People's Republic of China

Mr. Nestor A. ESPENILLA Jr.
Deputy Governor
Supervision and Examination Sector
Central Bank of the Philippines
Philippines

Dr. Jesus ESTANISLAO
Chairman
Institute of Corporate Directors
Philippines

Mr. Jonathan Juan MORENO
Vice President & Head, Corporate Governance Office
Head of the Corporate Governance Division
The Philippine Stock Exchange
Philippines

Dr. Piman LIMPAPHAYOM
Assistant Director
Academic Development
Sasin GIBA of Chulalongkorn University
Thailand

Mr. Kengkla RUCKPHAOPUNT
Director
Industry Development Center
Capital Market Development Fund (CMDF)
Thailand

Mr. Suraphon BUPHAKOSUM
Good Governance Development & Alliance Department
Industry Development
Capital Market Development Fund (CMDF)
Thailand

Mr. Jaseem AHMED
Director
Governance, Finance, and Trade Division
Asian Development Bank (ADB)

Mr. Kha Loon LEE
Head, Asia Pacific
CFA Institute Centre for Financial Market Integrity

Mr. Charles CANFIELD
Senior Corporate Governance Officer
IFC East Asia & Pacific Department
Corporate Governance
International Finance Corporation

Dr. David SMITH
Head
Asian Corporate Governance Research
RiskMetrics Group

<u>OECD Task Force Secretariat</u>

Mr. Kenji HOKI
Outreach Advisor
Corporate Affairs Division
Directorate for Financial and Enterprise Affairs
OECD

Ms. Fianna JESOVER
Senior Policy Analyst
Corporate Affairs Division
Directorate for Financial and Enterprise Affairs
OECD

Ms. Lya VILLASUSO
Project Co-ordinator
Corporate Affairs Division
Directorate for Financial and Enterprise Affairs
OECD

Bibliography

Aharony, J., Lee, J. & Wong, T.J. (2000), “Financial Packaging of IPO Firms in China”, *Journal of Accounting Research*, 38 (Spring), pp103-126

Bapepam-LK (2008), “Rule IX.E.1, Transactions Involving Conflict of Interests” (Benturan Kepentingan Transaksi Tertentu). Available at: http://www.bapepam.go.id/pasar_modal/regulasi_pm/peraturan_pm/IX/IX.E.1.pdf

Batra, S. (2008), “India: National Experience with Managing Related Party Transactions,” prepared for the OECD 2008 Roundtable on Corporate Governance, Hong Kong (13–14 May 2008)

Berkman, H., Cole, R.A. & Fu, L.J. (2008), "Expropriation through loan guarantees to related parties: Evidence from China,” *Journal of Banking & Finance*, 33(1)

Bursa Malaysia Securities Bhd Listing Requirements, Chapter 10. Available at: http://www.bursamalaysia.com/website/bm/regulation/rules/listing_requirements/downloads/bm_mainchapter10.pdf

Bursa Malaysia Securities Bhd Practice Note No. 12/2001 (Recurrent Related Party Transactions of a Revenue Nature). Available at: http://www.bursamalaysia.com/website/bm/regulation/rules/listing_requirements/downloads/BM_LR_PN12.pdf.

Bursa Malaysia Securities Bhd Practice Note No. 14/2002 (Requirements on Transactions and Related Party Transactions). Available at: http://www.bursamalaysia.com/website/bm/regulation/rules/listing_requirements/downloads/BM_LR_PN14.pdf.

CFA Institute Centre for Financial Market Integrity (2009), Related-Party Transactions - Cautionary Tales for Investors in Asia. Available at: http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n1.1.

Cheung, Y.L., Jing, L., Rau, P.R. & Stouraitis, A. (2006), "Tunnelling, propping, and expropriation: evidence from connected party transactions in Hong Kong", *Journal of Financial Economics*, 82(2)

Cheung, Y.L., Jing, L., Rau, P.R. & Stouraitis, A. (2007), "How does the grabbing hand grab? Tunneling assets from Chinese listed companies to the state", *City University of Hong Kong Working Paper*

Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control - Integrated Framework*. Available at: http://www.coso.org/IC-IntegratedFramework-summary.htm

Council of the Institute of Chartered Accountants of India (2000), "Accounting Standard (AS) 18 (issued 2000): Related Party Disclosures". Available at: http://www.icai.org/resource_file/262accounting_standards_as18new.pdf

Dahya, J, Dimitrov, O & McConnell, J.J. (2006), "Dominant Shareholders, Corporate Boards and Corporate Value: A Cross-Country Analysis", *ECGI - Finance Working Paper No. 99/2005*

Dahya, J,& McConnell, J.J. (2007), “Board Composition, Corporate Performance, and the Cadbury Committee Recommendation,” *Journal of Financial and Quantitative Analysis*, 42

Deng, J., He, J. & Gan, J. (2008), “Privatization, Large Shareholders' Incentive to Expropriate, and Firm Performance”, AFA 2008 New Orleans Meetings Paper.

Goldschmidt, L. (2009), “Related Party Transactions in Belgium”, A Background Paper for the OECD Asian Task Force on Related Party Transactions, Manila, 5-6 February 2009

Interests in Joint Ventures, International Accounting Standard No. 31 (International Accounting Standards Bd. 2009), available at: http://www.iasb.org (last visited 19 June 2009)

International Federation of Accountants (2009), “2009 Handbook of International Standards on Auditing and Quality Control” (effective December 15, 2009). Available at: http://www.ifac.org/Members/DownLoads/2009-handbook-of-internatio.pdf

International Federation of Accountants (2006), “Code of Ethics for Professional Accountants”, Available at: http://www.ifac.org/Members/DownLoads/2005_Code_of_Ethics.pdf

Khanna, VS & Black, BS (2007), “Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India”, *Journal of Empirical Legal Studies*, 4

Kim, W., Lim, Y., & Sung, TY (2004), “What Determines the Ownership Structure of Business Conglomerates?: On the Cash Flow Rights of Korea's Chaebol”, *ECGI - Finance Working Paper No. 51/2004; KDI School of Pub Policy & Management Paper No. 04-20.*

OECD (2007), “OECD Economic Surveys: Korea”, Volume 2007/6, June 2007

OECD (2006), “Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance”. Available at: http://www.oecd.org/dataoecd/58/12/37776417.pdf

OECD (2004), “OECD Principles of Corporate Governance”, available at: http://www.oecd.org/dataoecd/32/18/31557724.pdf

OECD (2003), “White Paper on Corporate Governance in Asia”, Available at: http://www.oecd.org/dataoecd/4/12/2956774.pdf

Related Party Disclosures, International Accounting Standard No. 24 (International Accounting Standards Bd. 2009), available at: http://www.iasb.org (last visited 19 June 2009)

Shen, SB & Jia, J. (2005), “Will the Independent Director Institution Work in China?”, *Loyola of Los Angeles International and Comparative Law Review*, Vol. 27

Tessier, X. (2008), “Introductory Speech on Related Party Transactions” OECD 2008 Roundtable on Corporate Governance, Hong Kong (13–14 May 2008). Available at: http://www.oecd.org/dataoecd/17/48/41815520.pdf.

Zhang, W. (2008), “Background Document,” prepared for the OECD 2008 Roundtable on Corporate Governance, Hong Kong (13–14 May 2008)

Corporate Governance Series

Guide on Fighting Abusive Related Party Transactions in Asia

Abusive related party transactions – where a party in control of a company enters into a transaction to the detriment of non-controlling shareholders - are one of the biggest corporate governance challenges facing the Asian business landscape.

This Guide on Fighting Abusive Related Party Transactions in Asia provides policymakers, enforcement authorities, private institutions, shareholders and other stakeholders with options for monitoring and curbing such abusive related party transactions, focusing on disclosure and the board/ shareholders approval system. It also looks into the role of auditors and independent directors.

September 2009