

Financial Market Integrity

-Do Ethics and Corporate Governance Matter?

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CFA Centre Mission

To be a leading voice for investors on issues of fairness, efficiency, and investor protection in global capital markets

To promote high standards of ethics, integrity and professional excellence within the investment community.

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Ethics & Business?

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“OK, honesty is the best policy.

Let’s call that option A.”

**“Ok honesty is the best policy.
Let’s call that option A.”**

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Do Ethics Matter?

THE NEW YORK TIMES, SUNDAY, DECEMBER 12, 2004

How Consultants Profit From Pensions

Continued From Page 1
 ant is based on trust," said David R. Eichenlaub, finance officer and chairman of the general pension plan for the city of Chattanooga. "To the extent that Phillips breached that trust, we thought it was important for the pension fund to do everything possible to hold him accountable for the results."

Pension experts say the Chattanooga case is hardly rare among retirement funds. The Securities and Exchange Commission is concerned enough about conflicts of interest among consultants who advise pension funds on asset allocation, selection of money managers and other investment matters that it is conducting an industry-wide inquiry. The results of the S.E.C.'s investigation are expected soon, and enforcement actions may follow.

Aubrey Harwell, a lawyer for Mr. Phillips, declined to make him available for this article. Mr. Harwell said: "No, I

ingly large role in the world of pension consulting. Merrill Lynch, Smith Barney and Morgan Stanley are all big in this field.

The potential for conflicts is greatest at firms with brokerage or trading operations, pension authorities say, and it almost always involves how the consultants are compensated.

The trouble is, much of a consultant's pay can be hidden from view. The Chattanooga complaint said Mr. Phillips and his colleagues controlled and manipulated the information given to the pension board, keeping it in the dark about excessive fees and conflicts inherent in the recommendations they made to the fund. Mr. Phillips's reports on the pension fund's performance were misleading, the complaint said, because they did not take into consideration all of the fees and commissions it paid.

Only when the Chattanooga board began con-



Stephanie Bruce/The Tennessean

William Keith Phillips faces questions over his role as a consultant to the general pension fund for the city of Chattanooga, Tenn.

the execution of those trades as a firm that is competing for the business. Execution costs can skyrocket.

A letter sent to a public pension client last January by Rittenhouse Asset Management Inc., a money manager in Radnor, Pa., described the

panies. But mutual funds often discount their commissions on larger trades, so if the fund had put all \$10.4 million into one of the international mutual funds, Merrill Lynch Consulting would have received 0.69 percent.

"Sunrise, not Merrill Lynch, selected the money managers from recommendations we provided," said Mark Herr, a Merrill spokesman. "During the five years we provided consulting services, Sunrise finished in the top quartile or quintile for results when compared to its peers."

Brokerage commissions are not the only source of revenue for many pension consultants. They also receive payments from money managers who attend annual conferences at luxurious resorts set up by the consultants. The conferences are billed as opportunities for money managers to meet pension plan officials, but critics describe them as pay-to-play mechanisms. They contend that the money managers recommended by consultants to pension funds tend to be only those who paid to attend the conferences.

Earlier this year, CRA RogersCasey, an investment consultant in Chicago, held two conferences, one at the American Club in Kohler, Wis., near two famous golf courses, and the other at the Kingsmill Resort in Williamsburg, Va. Celebrities often appear at CRA RogersCasey conferences: past speakers have included Gen. H. Norman Schwarzkopf, James Carville, the political consultant, and Robert B. Reich, the former

financial adviser, has consultant's resignation payments Callan has money managers it had to the fund.

For example, Ms. one of the money managers by Callan has years of experience in finance ranking in the cent of its peers nationwide she questioned the tion did it emerge that significant economic with the money manager. Callan's spokeswoman performance of the pension fund spoke for its years ended Sept. 30, Diego was in the top 1 public fund universe top third in each of the She added that in a ty than half the investm recommended by Callans.

But Ms. Shipione sa to-play practices are consultant's advice a the form of an object, dation, but in reality it sult of self-serving e Pension trustees nee about the business consultants and their enue. It would at least mation with which to t ant's objectivity."

Are consultants putting their interests ahead of their clients'?



Centre for Financial Market Integrity

Do Ethics Matter?

Recent enforcement actions by Securities and Futures Commission

Date	Company/Name	Actions
18 Oct 2005	Lee Sing Wai, Stephen	Stephen Lee Sing Wai Sentenced to Six-month Imprisonment for Failure to Attend SFC Interview During His Three-year Suspension Period
13 Oct 2005	<ul style="list-style-type: none"> Rexcapital Partners Incorporated Tees Corporation TingKong-RexCapital Holdings Limited 	SFC Prosecutes TingKong-RexCapital Holdings Limited, Rexcapital Partners Incorporated and Tees Corporation for Contravening Part XV of the Securities and Futures Ordinance
7 Oct 2005	Lee Sing Wai, Stephen	SFC Prosecutes Stephen Lee Sing Wai for Not Attending SFC Investigation Interview
7 Oct 2005	<ul style="list-style-type: none"> Lam Ho Chu Wilson TISCO Securities Hong Kong Limited Yam Shun Hung 	SFC Reprimands TISCO Securities Hong Kong Limited and Suspends Lam Ho Chu Wilson and Yam Shun Hung for Breaching the Code of Conduct
7 Oct 2005	Lau Pak Tong	SFC Suspends Lau Pak Tong for Breaching the Know-Your-Client Rule
6 Oct 2005	Chu Yat Lam	SFC Prosecutes Chu Yat Lam for Contravening Part XV of the Securities and Futures Ordinance
5 Oct 2005	Lau Yin Mei Carmela	SFC Reprimands and Fines Lau Yin Mei Carmela for Short Selling and Other Misconduct
3 Oct 2005	<ul style="list-style-type: none"> Chan Ka Lok Cuthbert Han Sze Chao Richard Lippo Securities Limited Yeung Angie 	SFC Reprimands Lippo Securities Limited and Suspends Han Sze Chao Richard, Chan Ka Lok Cuthbert and Yeung Angie
29 Sep 2005	Chow Wai Ho	SFC Prosecutes Chow Wai Ho for Making Unsolicited Calls
29 Sep 2005	Kong Kwok Yee	Kong Kwok Yee Convicted of Misleading the SFC
29 Sep 2005	Cheung Ngai Yi Charlotte	SFC Reprimands Cheung Ngai Yi Charlotte for Breaching the



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Do Ethics matter?

Breach of trust results in:

- Risk aversion
- Higher cost of capital
- Unneeded volatility & cost for:
 - Client
 - Firm
 - Investment manager
- Over Regulation

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Investor Trust is Essential

Capital Markets Are Built on Trust.

Investors must have confidence in:

- Corporate Leaders
 - Accountants & Auditors
 - Security Analysts
 - Investment Advisors
 - Portfolio Managers
 - Fund Managers

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A Business of Confidence

Between...

- Client and advisor
- Client and consultant
- Analyst and advisor
- Issuer and investors
- Issuer and analyst

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Key Drivers of CG Changes

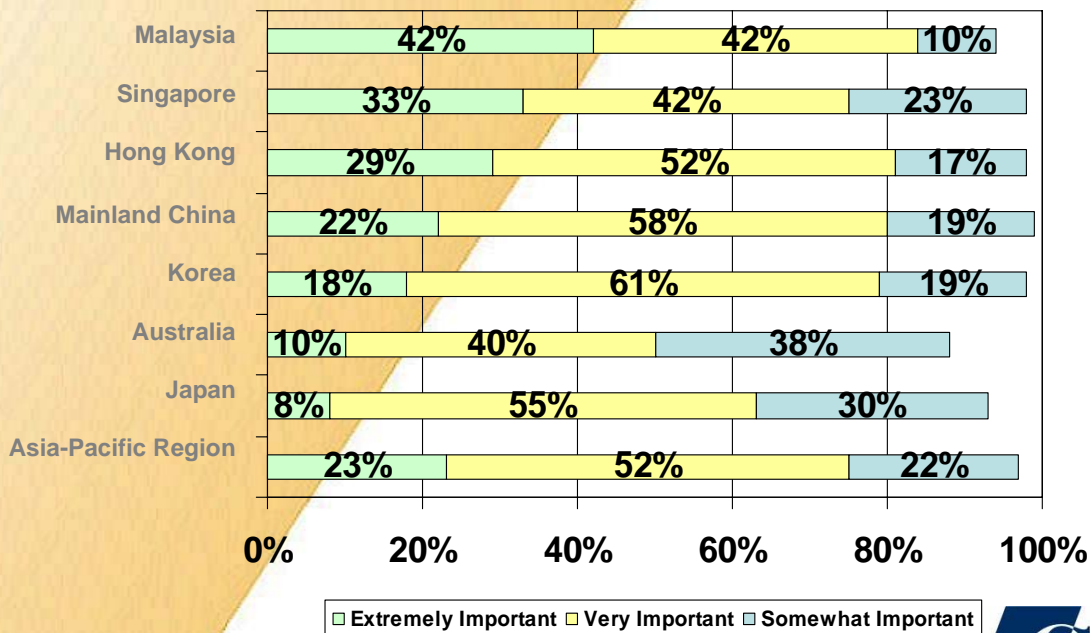
- Directors/ Senior Management
- Institutional Investors
 - CALPERS, GO European Focus Fund, Lazard Korea CG Fund.
- CG Advocates – David Webb
- CG Associations and Rating Agencies
 - ACGA annual country rating reports
 - GMI Study linking ROE and CG Ratings

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Governance Practices: Importance to Decision Making

“How Important Are Companies’ Corporate Governance Practices
to Your Investment Decisions?”

In Descending Order of “Extremely Important” Rating



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Directors and Senior Management

- MINDSET Change is key
- Regulators and Stock Exchanges provide the rules
- A number of companies in Asia are setting the pace.
- Internal acceptance of good CG practices and detail disclosure and transparency is the key

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Active Investor Impact

CALPERS

- PEMA-Permissible Equity Market Analysis
- Factors used in analysis:
 - Political Stability
 - Productive Labor Practices
 - Transparency
 - Market Liquidity and Volatility
 - Market Regulation, Legal System, & Investor Protections
 - Capital Market Openness
 - Settlement/Transaction Costs

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CALPERS Permissible Equity – 2005 rating

		Politic	Trans- parency	Productiv e Labor	Market Liquid & Volatility	Regs & Legal	Market Open	Trans- action Costs	Score
	Weighting	17.0%	16.0%	17.0%	12.5%	12.5%	12.5%	12.5%	
1	Poland	3	3	3	3	3	3	3	3.00
2	Israel	2	3	3	3	3	3	3	2.83
3	S. Korea	3	3	3	3	3	2	2	2.75
4	Chile	3	3	3	2	2	3	2	2.63
5	CzechRep	3	3	3	2	2	3	2	2.63
6	S. Africa	3	3	3	3	2	3	1	2.63
7	Taiwan	3	3	2	3	3	2	2	2.58
8	Hungary	3	3	3	1	2	3	1	2.38

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CALPERS Permissible Equity

		Politic	Trans- parency	Productiv e Labor	Market Liquid & Volatility	Regs & Legal	Market Open	Trans- action Costs	Score
	Weighting	17.0%	16.0%	17.0%	12.5%	12.5%	12.5%	12.5%	
9	Mexico	2	3	1	3	2	3	3	2.37
10	Malaysia	2	3	1	3	2	1	3	2.12
11	Brazil	2	3	2	1	2	1	3	2.04
12	India	2	2	2	3	1	3	1	2.02
16	Philippines	2	3	1	3	3	1	1	2.00
17	Thailand	2	3	1	3	2	1	2	2.00
18	Sri Lanka	1	3	2	2	1	2	3	2.00
19	Argentina	1	2	2	2	2	3	2	1.96

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CALPERS Permissible Equity

		Politic	Trans- parency	Produc tive Labor	Market Liquid & Volatility	Regs & Legal	Market Open	Trans- action Costs	Score
	Weighting	17.0%	16.0%	17.0%	12.5%	12.5%	12.5%	12.5%	
17	Turkey	1	2	3	2	2	1	2	1.96
20	Venezuela	1	3	2	2	1	2	2	1.87
21	China	2	1	1	3	2	1	2	1.67
22	Morocco	1	2	2	1	2	2	1	1.58
24	Indonesia	1	3	1	2	2	1	1	1.57
25	Russia	1	3	1	2	2	1	1	1.57
26	Egypt	1	1	1	3	1	1	3	1.50
27	Pakistan	1	1	1	2	2	1	3	1.50

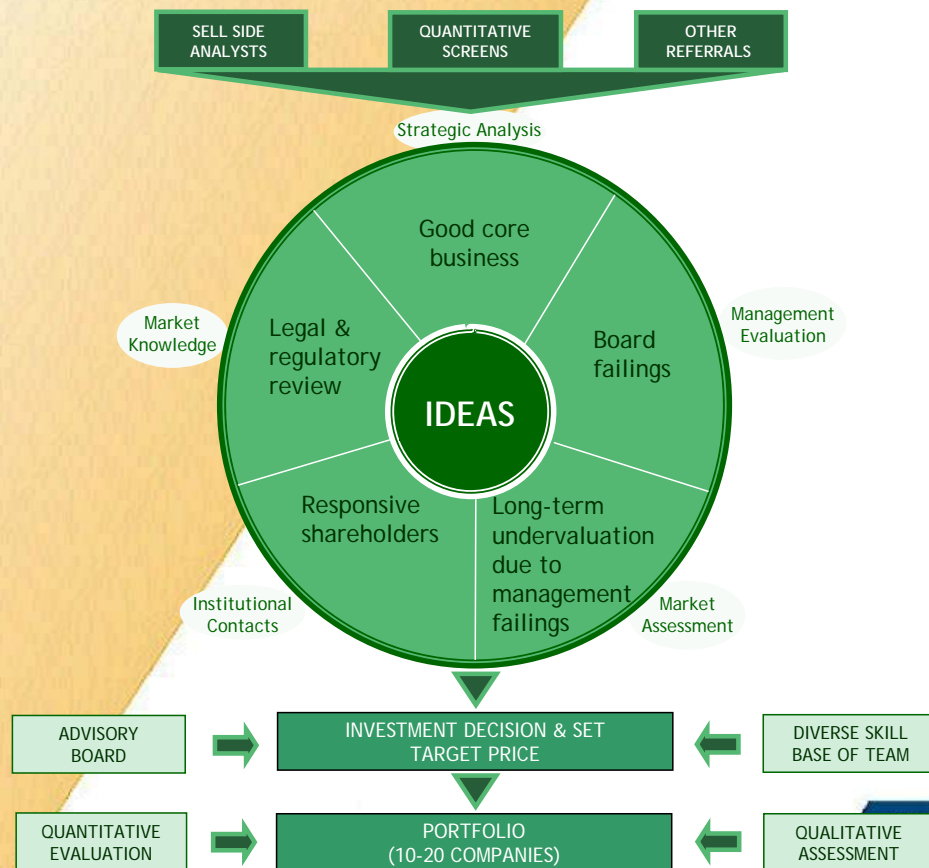
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GO European Focus Fund

- GO's investment philosophy is based on our belief that companies with involved and informed share owners are worth more over the long-term

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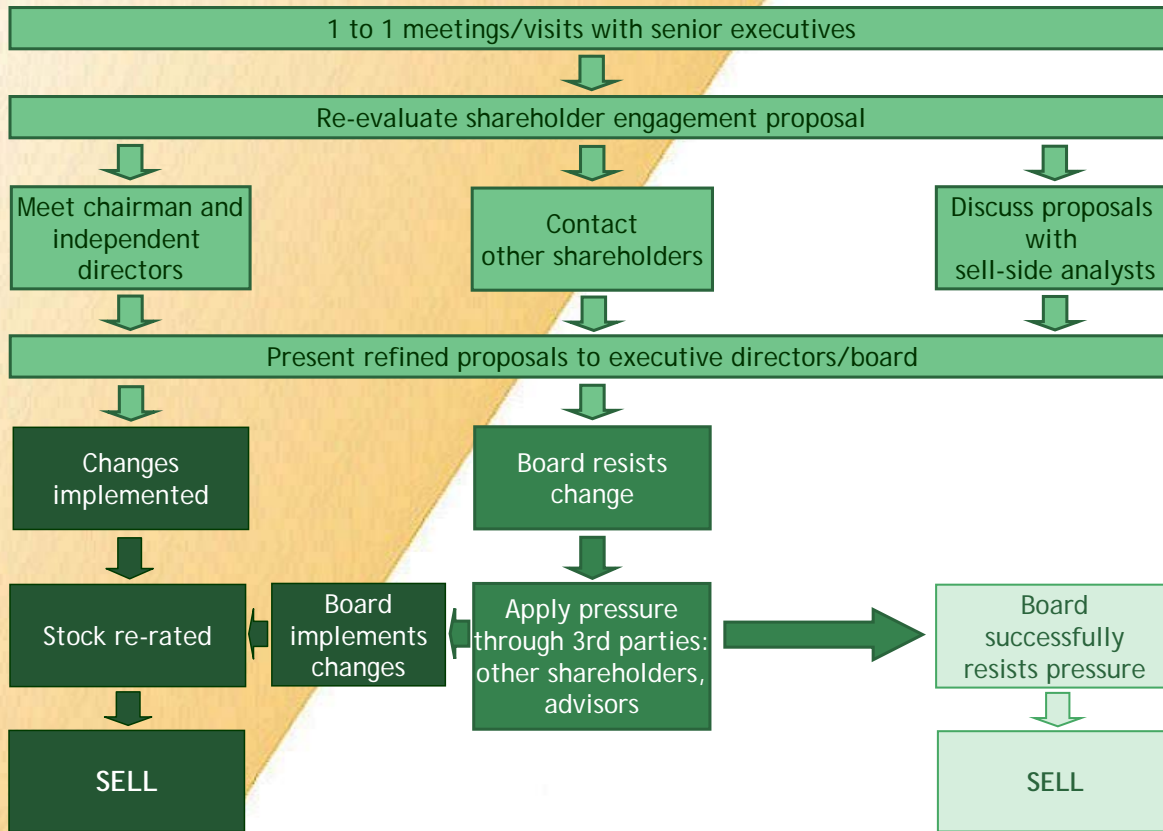
GO European Focus Fund Investment Process



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Warning: Portfolios with 10 to 20 companies can have a high portfolio risk and a high tracking error to a benchmark index.

GO European Focus Fund Engagement Process



Matters on which GO engages

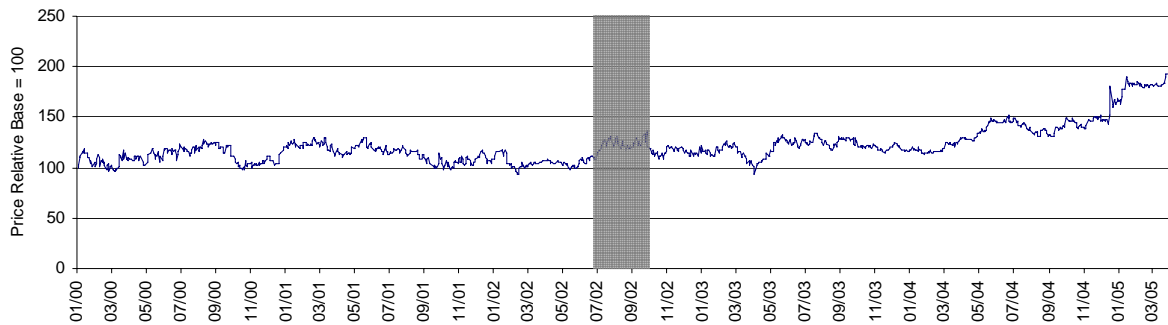
- Board composition
 - Strategy
 - Capital structure
- } Strategic governance
-
- Internal controls
 - Executive remuneration
 - Corporate responsibility
- } Structural governance



But owners must not micro-manage

Galerias Lafayette

Galerias Lafayette Price Relative



Pre- investment

- Retail and Financial Services conglomerate
- Family control
- Poor return on capital
- Lack of financial discipline for store portfolio
- Impending option to realise Monoprix stake

Engagement proposal

- Separate real estate assets from retailing
- Assess economic returns from store portfolio
- Exit non-performing stores
- Realise Monoprix option

Post Investment

- Separation of real estate from retail
- Rationalisation of store portfolio
- Monoprix option extended
- Potential bid from family interests

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Shareholder-rights Activists

David Webb

- Project Poll
- Voting by show of hands common in Asia
- Family owned companies – control agenda and voting process at AGM
- one share one vote – global standard

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ACGA annual report card

- ACGA and CLSA produces an annual report card for 10 Asia Countries
- The 5 areas covered are
 - Rules and regulations
 - Enforcement
 - Political and regulatory climate
 - IGGAP
 - CG culture

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Governance and Performance

Study by Governance Metrics International

GMI rates 3,458 companies worldwide

- The areas covered are
- board accountability, financial disclosures and internal controls, Shareholders rights, executive compensation, takeover defenses, etc

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GMI ratings v Return on Equity

- Groupings by GMI ratings
- Top 10% worldwide
- Average
- Bottom 10 % worldwide
- Return on Equity
- 5 years to June 2006
- 14.35
- 10.44
- 9.20

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Corporate Governance Issues in Asia

- **Financial Reporting and Disclosures**
 - Accuracy and reliability
 - Need for quarterly reporting
- **Analyst Retaliation and Research Objectivity**
 - How can analysts be protected?
- **Ownership Structure**
 - Impact on independent directors and minority shareholder rights
- **Executive Compensation**
 - Is pay linked to performance of company

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CFA Centre – Asia Pacific Corporate and Financial Disclosure - Survey Key Findings

- **Quality is improving**
- **Average of 3.2 on a five-point scale**
- **Quarterly financial reports is a global best practice and should be made mandatory**
- **Disclosure practices and financial statement quality and corporate governance practices as either “very” or “extremely” important when making investment decisions**
- **The cash flow statement, income statement, footnotes and balance sheet were ranked as the most important information sources**

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Quarterly Reporting

- **Singapore and China require it**
- **Hong Kong and Australia do not**
- **Debate is whether mandatory quarterly reporting benefits investors or encourage short term thinking by both investors and management.**

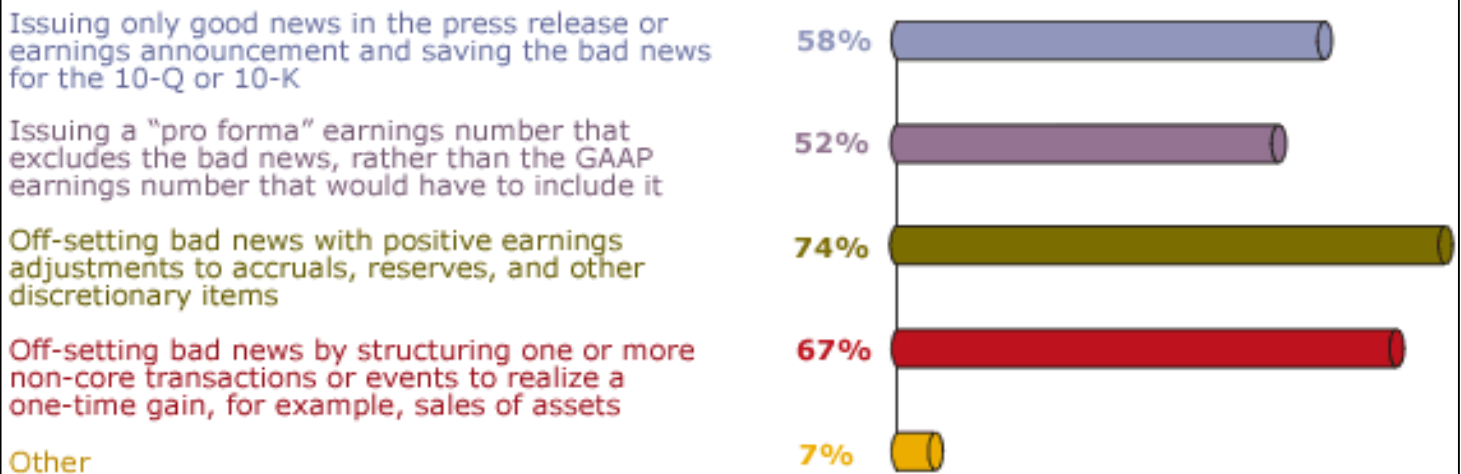
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Companies hiding bad news?

- Do you believe that companies hide bad news about earnings from investment professionals in their quarterly releases?



If you answered "yes," please indicate how they do so (select all that apply):

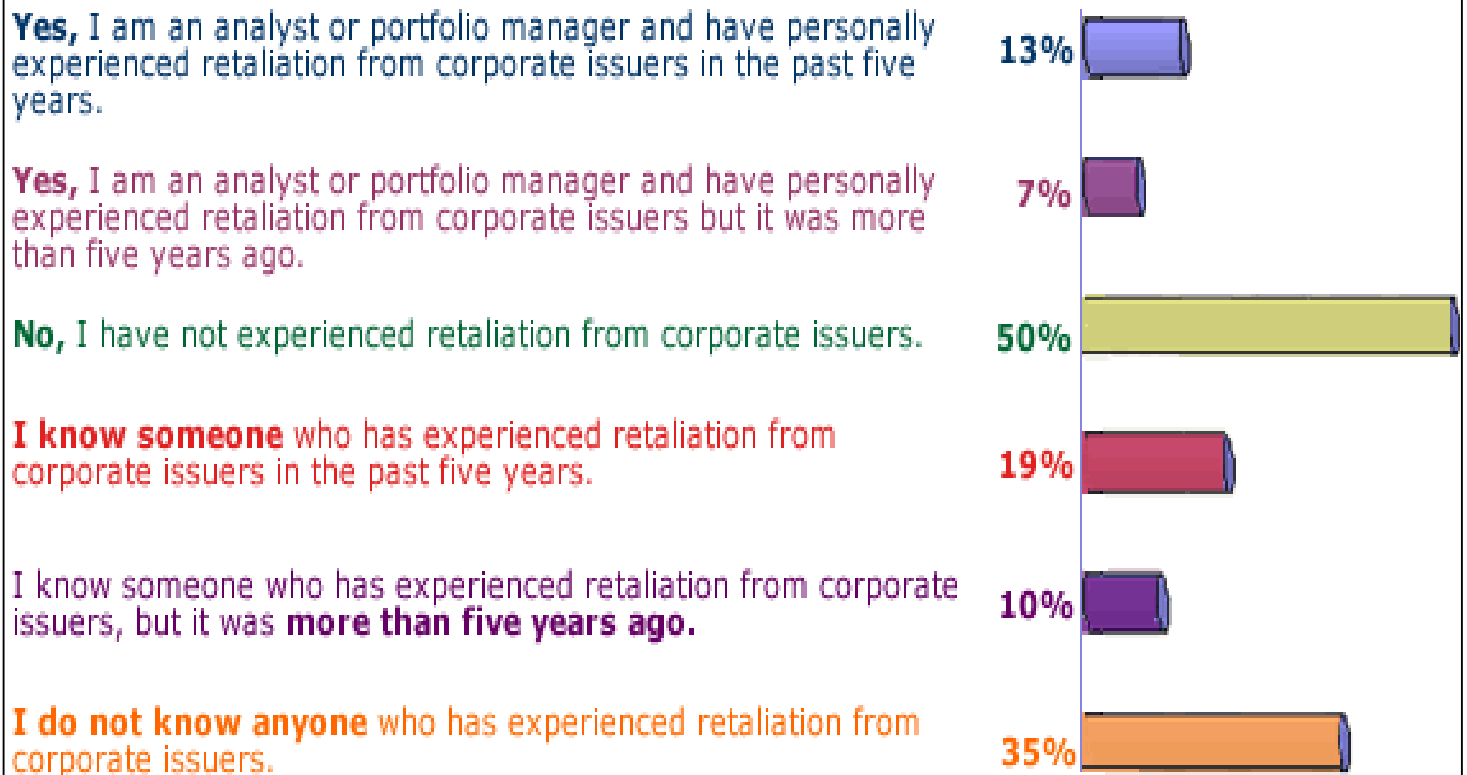


Improving Communications and Transparency between Analysts and Issuers

- Capital Markets need free flow of information to improve transparency
- Analyst Retaliation – how prevalent is it?
- Relationship between Issuers and Analysts cannot be regulated
- Need for best practice guidelines

Company retaliation on analysts and fund manager

Have you experienced retaliation from corporate issuers?



Analyst-Corporate Issuers Relations Guidelines

Issues addressed in the guidelines include:

- Information flow between analysts and corporate issuers.
- Analysts' conduct in preparing and publishing research reports and making investment recommendations.
- Corporate issuers' conduct in providing analysts with access to corporate management.
- Review of sell-side analyst reports by corporate issuers.
- Research that is solicited, paid or sponsored by the issuer.

Ownership Structure – Western model

- US and UK – Broad based institutional ownership –
- CG System designed to eliminate or mitigate conflicts of interest particularly those between 1. managers and shareowners and 2. directors and shareowners

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Types of conflict of interests

Manager – shareowner conflicts

- Self projection/ job security/ power vs Long term wealth creation for shareowners
- Short term gains and long term vulnerability vs Long term risk adjusted growth
- Rewarding senior management through issue of stock options

• Director – shareowner conflicts

- Identifying with managers' interest vs shareowners' interest
- Are the independent directors really independent?

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Ownership Structure – Asian Model

- Wide institution based ownership is generally absent
- Two types of ownership dominate
 - Family Owned / tightly held companies
 - Government owned companies

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Ownership Structure – Asian Model

- Government controlled companies
 - National industries and dominate local capitalization
 - Used by governments to develop and implement CG practices
 - Served as a model for others, improve image of country to outsiders
 - Independent directors, high levels of disclosures in annual reports and compliance with local CG codes

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Executive Compensation

CEO of Tyco used corporate funds to buy home decorating items including a \$17,000 traveling toilette box, a \$445 pin cushion and \$15,000 umbrella stand. Also borrowed from company's loan program to buy \$270mn worth of yachts, art, jewelry vacation estates. In capacity of CEO he then forgave these loans!

According to estimates his excesses cost the shareowners \$600mn in all.

To top it all, in legal proceedings he claimed that it was not illegal for him to do what he did!

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Executive Compensation

- Pressure for Greater Disclosure of CEO, directors and CEO compensation.
- Singapore CG Code recommends linking pay to performance. Top 5 executives compensation to be disclosed in bands.
- Hong Kong requires disclosure of directors total remuneration on a named basis.
- Debate over appropriate level of pay for non-executive directors

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The Manual: Needed Education

- Created *by* investors *for* investors
- Insight on how companies define governance structure
- Lists & identifies what investors should look for
 - Board practices
 - Management practices
 - Shareowner rights
- Takes a global perspective
- Written in plain English
- Does NOT advocate best practices or a single system
- Free to investors on our website

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Application of the manual - What investors should look for?

- Board composition and independence
- Whether the chairman of the board is independent
- The qualification of the directors
- Election of directors on an annual or staggered basis
- Board self assessment practices
- Frequency of separate sessions of independent directors
- Audit committee and audit oversight
- Compensation committee and compensation awards to the management
- Use of/ or lack of it of independent legal and expert counsel
- Statement of Governance Policies

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Conclusion

- Corporate Governance in Asia is evolving
- There is no one size fits all model for CG practices globally
- CG manual can be a tool for us to better understand and analyze the impact of CG in our investment decision making process.