Countering **complacency**

What impact will Singapore's recently-revised regulations have on the corporate governance landscape?

James Thomas speaks with **Professor Mak Yuen Teen**

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Singapore is currently leading the way in corporate governance practice within Asia, having overtaken Hong Kong in the most recent ACGA / CLSA corporate governance survey[1]. Recent years have brought improvements to the regulatory enforcement regime in Singapore – in particular around fraud, corruption and insider trading – which is strong relative to much of the region. The country also enjoys a robust regulatory framework, sound listing rules and a solid system of securities law. Moreover, it is aligned with international accounting standards and follows the US model of regulatory oversight of auditors, which includes auditor registration, practice monitoring and so forth.

However, despite being a leader within the region, there are areas in which Singapore's corporate governance practice could be improved, and, according to Mak Yuen Teen, Associate Professor at the National University of Singapore: "The latest challenge for Singapore is avoiding complacency." As the ACGA / CLSA report states: "Even the best Asian markets – Singapore and Hong Kong – have a long way to go before they can claim to be truly international" – there is therefore some work to be done in raising standards across the region to a level at which it can be considered world leading.

Balancing interests

Much of the difficulty of achieving such change within Singapore lies in managing the tension which exists between the desire to encourage companies to list on the local exchange and the need to ensure the protection of investors through a robust regulatory framework. For example, the exchange itself is a listed company with a regulatory role and therefore there is an inherent conflict between its regulatory and commercial objectives. "Balancing the interests of issuers who are seeking capital and the investors who are providing it is a perennial problem," explains Prof. Mak, "and perhaps we think too much about the issuers' interests and not enough about those of the investors. We want companies to list here, without considering whether regulators are able to enforce rules or investors are able to enforce their rights if anything goes wrong. More could be done in terms of investor protection; for example, through better screening of companies."

He cites as evidence of this trend the example of the many Chinese companies which have chosen to list in Singapore, and questions whether such decisions are motivated by a perceived leniency in the corporate governance requirements on the island. "The determining factors for any company in choosing to list within a jurisdiction are usually liquidity, proximity to

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operations, and proximity to customers," he explains. "However, many Chinese companies currently listing in Singapore would probably find better liquidity in Hong Kong or some of the major markets, and they are certainly not bringing themselves closer to customers or operations through listing here as most of their operations are in China anyway. The concern, then, is whether we are attracting the lower quality companies."

Part of the attraction for such companies, historically, has been Singapore's relatively modest requirements around the composition of companies' Boards of Directors. The persistence of the "old boys' network" has resulted in some Directors sitting on many – sometimes up to 13 or 14 – boards, and the independence of boards and the commitment of Directors to the companies is therefore sometimes open to question. There are related concerns over whether some independent Directors who are serving on boards have the relevant expertise and experience. For boards of financial services firms there is also the question of whether there is adequate financial industry experience, risk management expertise and executive compensation expertise amongst the independent Directors in light of the heightened expectations following the financial crisis. This situation has been perpetuated by low levels of Director accountability, with Directors rarely being charged for breaches of duties let alone prevented from sitting on too many boards.

Shareholder in-activism

A further weakness in Singapore's corporate governance regime is the fact that it is difficult for shareholders to exert any corrective influence on company behaviours, and therefore shareholders very rarely take action. As Prof. Mak continues: "In recent years, there have been numerous cases of companies, often based in China but listed in Singapore, in which fraud has occurred. Because these companies are based in China, regulators in Singapore are unable to take action because, even though strictly speaking they are breaking Singapore law, we don't have extradition treaties with China and therefore can't bring the individuals responsible over here to charge them. Needless to say, it will be even more futile for shareholders to take action to enforce their rights, especially given the legal costs involved." With roughly 45% of the companies listed in Singapore being based overseas – and about half of that number being from China – it is routine to find that, when things go awry with such companies, neither regulators nor shareholders are able to achieve a suitable outcome.

The legal system in Singapore creates further restrictions on shareholder activism. "Here shareholders rarely take action because there is no class action of the kind that you see in the US," explains Prof. Mak. "The contingency fee system of litigation in the US, in which if you sue and you lose you are not required to pay the legal fee, means that people are very willing to take action. By contrast, a shareholder who decides to sue here will face very high legal costs and may not recover all of those fees even if they are successful. Compounding this, the likelihood of punitive damages is also very small."

Changing requirements

To counter concerns over standards of corporate governance in the Singapore financial services sector, the Monetary Authority of Singapore (MAS) has recently introduced revised regulations on corporate governance, which are mandatory for banks, financial holding companies and direct life insurers incorporated in Singapore with assets over $5bn, while additional guidelines apply on a "comply or explain" basis for those with assets under $5bn. The regulations place particular focus on the areas of board composition and Director accountability.

For example, MAS has tightened the definition of "independence" of Directors, meaning that after nine years as a Director one can no longer be considered "independent". Moreover, firms are now required to have a Chief Risk Officer, and a risk management committee. In common with developments in jurisdictions such as the UK, MAS is also placing greater scrutiny on remuneration throughout financial institutions, with closer attention being given to how key officers who perform controlled functions are paid, rather than simply focusing on senior management and Directors' remuneration.

The requirements also place new demands on financial services firms around the appointment of Directors, and aim to ensure that Directors have the appropriate level of expertise. When appointing Directors, financial institutions should target individuals with financial industry experience, risk management experience and compensation experience, in light of what is expected of a risk management committee and remuneration committee. This approach is broadly consistent with the recommendations of the Basel Committee and the UK Walker Review. However, these requirements are not without their problems. For example, filling boards with such individuals could prove a challenge in the short term, believes Prof. Mak. "Taking the requirement for financial experience," he argues, "most financial institutions in Singapore have individuals on the board who have worked in a financial institution before, but it is very different working in a bank, say, just 10 years ago than it is today. You've got to ask how relevant their experience is to today's market." >>

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The requirement for risk management expertise is equally problematic, he suggests. MAS has left it to the financial institutions themselves to determine what kind of risk management expertise is required on the board, but some guidance and clarity would be welcome. "In requiring risk management expertise, does MAS mean that we must have 'quant-types' on boards, i.e. those who are very good at financial risk management?" asks Prof. Mak. "If so, you have to wonder whether such types would have the wider skills to make good Directors, and the worry is that companies will simply end up appointing individuals who have recently been employed in a risk management capacity." MAS has also not imposed requirements for independent Directors on the risk management committee, preferring to focus on risk management expertise. Both independence and expertise are important.

Meanwhile, compensation expertise also throws up some problems, not least because, traditionally, very few board members have come from a human capital background, and the pool of such individuals may not be large enough to satisfy demand.

Taken in sum, these requirements for additional expertise also introduce the potential for boards to grow to an unwieldy size due to the difficulty of finding individuals who possess more than one of these skills. However, with only three listed banks and a handful of large insurance companies, the hope is that identifying such individuals will not prove a challenge too far.

Effectiveness

Instead, perhaps a more pressing question is how these regulations will apply in practice and whether they will have the desired effects of improving board composition and behaviour, and promoting good corporate governance, or whether they simply address the physical form of boards rather than the substance of how they act.

On the face of it, the regulations do appear to be addressing substance rather than form. "I always feel that MAS is very serious about raising standards," says Prof. Mak, "and if you look carefully at the regulations, MAS is definitely trying to put more pressure on nominating committees to appoint the right kind of people." Significantly, the regulations require firms to document the entire nomination process as well as their assessment of whether Directors are independent. MAS, being a supervisor, will be able to inspect those minutes and Prof. Mak believes that this ability will ensure that standards of behaviour are raised.

Much, then, will depend on the willingness of MAS to actually enforce the regulations, through conducting thorough governance reviews of financial institutions and scrutinizing the records of discussions that take place at committee meetings. Prof. Mak believes that, having required firms to document such discussions, it seems likely that the regulator will, in due course, demand access to them.

On a less positive note, while there is much in the regulations aimed at correcting board composition and behaviour, there is little focus on promoting increased shareholder activism, and indeed Prof. Mak believes that, in not extending the mandatory requirements further, the shortcomings resulting from an inactive shareholder base could persist. "The 'comply or explain' approach has been applied in many jurisdictions, but I feel it has not worked in Singapore, in part because we don't have the level of institutional shareholder activism that you see for example in the UK," he explains.

It remains to be seen whether these regulations have the desired effect of elevating Singapore's corporate governance regime on the global league tables, but it is nevertheless hugely positive that – despite leading the way within the region – Singapore is continuing to push towards higher standards.

IN Detail

1. "CG Watch 2010", Credit Lyonnais Securities Asia in collaboration with the Asian Corporate Governance Association