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December 18, 2008

The Director, Corporate Affairs
Securities & Exchange Commission of Sri Lanka
Level 28, East Tower
Echelon Square
World Trade Centre
Colombo 01

Re: *Consultation Paper 03 – Financial Arrangements with Related Parties*

Dear Sir:
The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre")[1] and CFA Sri Lanka are pleased to comment on the Consultation Paper *Financial Arrangements with Related Parties*, put forward by the Securities and Exchange Commission of Sri Lanka ("SEC") in November 2008. The CFA Institute Centre represents the views of investment professionals to regulators and standard setters worldwide on issues that affect the practice of financial analysis and investment management, as well as the integrity of global financial markets. CFA Sri Lanka represents nearly 100 investment professionals in Sri Lanka, and is a member society of CFA Institute.

We commend the SEC for addressing the issue of related party transactions, and paying particular attention to transactions between listed companies and subsidiaries, associates or other related entities. Investors in Asian companies are prone to the risks of related party transactions for two main reasons. Firstly, a listed company is likely to be part of a larger business group including subsidiaries and affiliates and secondly, ownership of a typical Asian conglomerate is likely to be concentrated to a single group, for example a family or the State. Problems arise for minority shareholders when affiliations formed under the umbrella of common ownership are exploited. As noted in your paper, this structure makes it easy for related party transactions to take place, especially when the entities exist to support the operations of another.

We believe the current investor protection measures against related party transactions in Asia can be strengthened through better disclosure rules, improved internal governance and greater enforcement of regulations. We strongly support the SEC's efforts to increase the level of disclosures in annual reports of listed companies as follows;

The following provisions will be included as "Continuing Listing Requirements" and "Corporate Disclosures";

[1] The CFA Institute Centre for Financial Market Integrity is a part of CFA Institute. With offices in New York and Charlottesville, Virginia, USA, London, Hong Kong, and Brussels, CFA Institute is a global, not-for-profit professional association of more than 99,500 financial analysts, portfolio managers, and other investment professionals in 134 countries and territories, of whom 86,000 hold the Chartered Financial Analyst® (CFA®) designation. CFA Institute membership also includes 136 member societies and chapters in 57 countries and territories.

Suite 3407
Two Exchange Square
8 Connaught Place
Central, Hong Kong, SAR
852 2868 2700 tel
852 2868 9912 fax
infohk@cfainstitute.org
www.cfainstitute.org

1. A disclosure requirement to be included in the Annual Report which would set out the details of investments and/or lending if it exceeds 10% of the equity.

2. A mandatory disclosure if the investment and/or the receivables exceed 10% of equity.

"Equity" is defined as net assets excluding preference shares.

However, disclosure requirements in the Annual Report alone are not sufficient to prevent the abuse of minority shareholders. These disclosures are made to investors long after the transactions are completed. The CFA Institute Centre and CFASL believe that disclosure requirements by listed companies should be an ongoing process once they reached established thresholds and they should be complemented by strong internal governance systems established at the individual company level. We will discuss below the listing rule requirements and practices in other Asian countries and some recommendations in our conclusion to better regulate related party transactions.

1. Comparison of listing rules requirements – Korea, Hong Kong and China

Stock exchange listing rules, together with accounting standards, form the bedrock of governance structure to protect minority shareholders against abusive related-party transactions. While all Asian jurisdictions have a regulatory framework on the disclosure of these transactions, they differ on the threshold values upon reaching which disclosure must be made, and whether independent shareholders' approval is needed. These thresholds are determined by the value of the related-party transaction in relation to a variety of financial factors, such as net tangible assets, book value, market capitalization and revenues.

In Korea, minority shareholders have no direct influence on a listed company's decision to enter into related-party transactions, and in general, they only get to know about such transactions once a year. The listing rules require companies to seek board approval for transactions exceeding 1 percent of annual revenue or total asset value, and to report them to shareholders at a general shareholders' meeting. A set of transactions with a combined value in excess of 5 percent of annual revenue or total asset value is also subject to this regulation.[2] Outside of the listing rules, *chaebols* with assets in excess of 2 trillion won (US$1.7 billion) have a special requirement, made mandatory by the Korea Fair Trade Commission, for related transactions above 10 billion won (US$8.7 million) or 10 percent of book equity to be approved by the board and disclosed to the public. [3] In any case, no prior shareholder approval of related-party transactions is required.

In Hong Kong, independent shareholders are given a key role in approving on substantial related-party deals. The listing rules require all connected transactions valued at or greater than HK$10 million (US$1.28 million) or 25 percent of four percentage ratios – asset,

[2] Sang-Woo Nam, Il-Chong Nam, "Corporate Governance Reform in Asia: Recent Evidence from Indonesia, Republic of Korea, Malaysia and Thailand", Asian Development Bank Institute (October 2004). Pg19

[3] Woo-Chan Kim, Young-Jae Lim, Tae-Yoon Sung, "What Determines the Ownership Structure of Business Conglomerates? On the Cash Flow Rights of Korea's Chaebol," European Corporate Governance Institute – Finance Working Paper (September 2004)

revenue, equity capital, and transaction-value-to-market-capitalization - to be disclosed to the public, approved by the board of directors, evaluated by an independent financial adviser, and subject to independent shareholders' approval.

Companies are required to publicly announce their proposed connected transactions, and issue a circular to shareholders. The circular must provide a clear and adequate explanation of the transaction, its advantages and disadvantages; a letter from the independent board committee explaining its decision on the deal; and a separate letter from an independent financial adviser explaining its evaluation. Approval of shareholders in a general meeting is required before the transaction can proceed, and a connected party with a material interest in the transaction is not allowed to vote on the resolution approving the transaction.[4]

Transactions valued at between HK$1 million (US$128,200) – HK10million or 2.5 percent - 25 percent of the percentage ratios – are not subject to shareholder approval. They are only required to be disclosed to the exchange.

In China, the Shanghai and Shenzhen stock exchanges follow similar standards to Hong Kong. A company engaging in a related-party transaction with a natural person (such as a director or his family member) must make a timely disclosure to the exchange if the deal exceeds RMB 300,000 (US$44,000). Transactions with any related party valued over RMB 3 million (US$440,000), or more than 0.5 percent of the latest audited net assets, must also be disclosed. Those in excess of RMB 30 million (US$4.4 million), or more than 5 percent of the latest audited net assets, must be disclosed and subject to third-party appraisal, as well as to shareholders' approval at the general meeting. All three instances need the approval of independent directors, who must also provide their opinion in the disclosure.[5]

2. **Internal Governance Systems**

Establishing effective internal governance systems to monitor related party transactions is an essential investor-protection mechanism. This includes board and shareholder approval processes and the development of relevant policies and procedures that facilitate the approval and transparency of these transactions.

Most jurisdictions in Asia require board or shareholder approval as an effective way to determine the fairness of related transactions to minority shareholders. To further safeguard minority shareholders the transaction should be approved by a majority of independent non-executive directors who do not have an interest in the transaction. "Interested" shareholders should also abstain from voting when a shareholder vote is required. Currently there are different thresholds applied to trigger board and shareholder approval for related party transactions and these are summarized in Table 2 below.

Table 2: Board/shareholder approval thresholds for related party transactions in Asia

[4] Chapter 14A of the Hong Kong Exchange Listing Manual for Main Board Companies
[5] Chapter 10 of the Shenzhen Stock Exchange Listing Rules

	Board approval	*Shareholder approval*
China	Value exceeding 30 million RMB or 5% of Net Asset Value must be approved by independent directors and discussed by the board.	If the number of independent directors deciding on the transaction is less than three.
India	No specific thresholds. Board of Directors' consent required for contracts for sale, purchase of and supply of goods, materials or services.	Loans to directors, and the provision of facilities or office spaces to a relative of a director.
Indonesia	No specific thresholds. Law provides that transactions be deliberated on by directors, excluding interested party directors.	No specific thresholds. Law requires transactions to be approved by independent shareholders.
Hong Kong	Continuing related transactions are to be approved by the board of directors.	Value equal or greater than HK$10 million or 25 percentage ratio tests
Singapore	No specific thresholds. By-laws often give blanket approval for directors to deal with company subject to disclosure to, and approval of the board.	Value equal to or more than 5% of group's audited Net Tangible Asset.
Korea	A single transaction exceeding 1% of annual revenues or total assets – or a set of transactions with a combined total in excess of 5% of revenues or total assets.	No shareholder approval required, only notification after board approval.

Source: Lee Kha Loon, CFA "Related Party Transactions, Approval by Boards and Shareholders in Asia", presentation at OECD Roundtable, Hong Kong, 13-14 May, 2008.

In addition, there should be greater transparency by companies to disclose related party relationships when they exist. Companies should voluntarily disclose the identities and level of ownership of related parties who own a substantial amount of their shares, including subsidiaries and affiliated companies. This will also help to ensure that "interested" parties can be identified and abstain from voting in a transaction. As best practice, companies should adopt a written "Conflict of Interest and Related Party Transactions Policy" wherein they define "related party", express why they may need to engage with related parties, and outline their internal-control procedures in dealing with conflict-of-interest situations and related-party transactions.

There are other policies that have been developed by different Asian countries to aid disclosure and approval of related party transactions.

- **India**. A law change is proposed that will require companies to maintain a register of related party transactions which is open to inspection by shareholders. The register is required to be signed by all the directors at the Directors meeting[6].
- **China**. Companies are required to have a separate management committee tasked with reviewing related party transactions[7].

Summary and Concluding Remarks

We believe the proposed disclosure requirements recommended by the SEC are a necessary first step to safeguard minority shareholders. However, tighter policies need to be in place to ensure that shareholder rights are not compromised. We believe that related-party transactions (that reach the approval and disclosure thresholds) should be:

1. *Reviewed by an independent advisor*, to ensure that only fair-market valuations are applied;
2. *Approved by "disinterested" directors where Board Approval is required*
3. *Disclosed to investors in a timely manner* – ideally to the local stock exchange; and
4. *If material, approved by shareholders* in a voting by poll with related parties abstaining from the vote.

The CFA Institute Centre for Financial Market Integrity and CFA Sri Lanka appreciate the opportunity to comment on the SEC's Consultation Paper on *Financial Arrangements with Related Parties*. If you have questions or seek amplification of our views, please feel free to contact Lee Kha Loon, CFA, by telephone at +852-3103-9303 or by email at khaloon.lee@cfainstitute.org, or Murtaza Jaferjee, CFA, at 94-11-243-2326 or murtaza.jaff@jb.lk.

Sincerely,

Kha Loon Lee, CFA
Head, Asia Pacific
CFA Institute Centre for Financial Market Integrity

Murtaza Jaferjee, CFA
President, CFA Sri Lanka

Angela Pica
Policy Analyst
CFA Institute Centre for Financial Market Integrity

[6] Sumant Batra, "India: National Experience with Managing Related Party Transactions," prepared for the OECD 2008 Roundtable on Corporate Governance, Hong Kong, 13-14 May 2008. Pg 29

[7] Weidong Zhang, "Related Transactions Based on the Analysis of China's Listed Companies," prepared for the OECD 2008 Roundtable on Corporate Governance, Hong Kong, 13-14 May 2008. Pg 6