



# Corporate Governance Case Studies

Volume two

Edited by Mak Yuen Teen

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**CPA**  
AUSTRALIA





# **Corporate Governance Case Studies**

## **Volume two**

**Mak Yuen Teen**

Editor

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## **Corporate Governance Case Studies Volume 2**

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# Foreword

The fast-changing business landscape continues to present many new and ongoing complexities for boards and senior management. Leaders and, especially, directors of corporations need to have the strength, knowledge and flexibility to provide the moral compass for companies to function and excel. Compliance with rules, regulations and standards is only a small part of directors' roles. More importantly, they need to embrace the highest standards of governance and independence to meet the increasing expectations of shareholders and other stakeholders in the new world order.

Singapore has built its reputation as a global financial centre among investors because of its high standards of corporate governance. This model ensures that companies have access to quality capital and investors have utmost confidence in the quality of local business entities. Since the inaugural edition of this Corporate Governance Case Studies Collection was published last year, Singapore's Code of Corporate Governance has been revised by the Monetary Authority of Singapore. While not mandatory, publicly-listed companies are expected to comply with the Code's guidelines which form a principles-based approach to prudent corporate governance.

In publishing Volume 2 of this collection of teaching case studies, CPA Australia hopes to further raise awareness and promote thoughtful discussions on key corporate governance issues in companies across global markets, including Singapore and Asia. Positive feedback suggests that the original format we adopted in Volume 1 was useful in generating thought leadership in issues on governance and transparency. Therefore, the authors have retained the formula of presenting the facts and identifying relevant issues in each case study on board, board committees, ownership structure, corporate governance rules and regulations, auditors and remuneration. Discussion questions follow each case study to facilitate debate aimed at promoting stronger governance standards.

CPA Australia is grateful to Associate Professor Mak Yuen Teen for supervising and editing the case studies produced by students of the NUS Business School. We hope the cases provide a good platform for you to study governance issues that positively contribute to your professional development.

Associate Professor Themis Suwardy FCPA (Aust.)  
Divisional President – Singapore  
CPA Australia

May 2013



# Preface

Last year, CPA Australia and I collaborated to publish the first volume of corporate governance case studies. I had introduced the requirement for students in my Corporate Governance and Ethics course in the BBA (Accountancy) programme at NUS Business School to write a case study as part of their learning. I also felt that there was a dearth of good Asian case studies and that such a project can also benefit others who are teaching or learning the subject, especially in Singapore and the region. We took the decision that we will not profit from this initiative and made this freely available to others, with the soft copy made available on the internet. We imposed minimal restrictions on its use.

Feedback from my past students indicates that they indeed feel that they learn a lot from writing the cases. Our experience with the response to the first volume also justified our belief that others will find the cases useful. The cases are being used in educational institutions and in training of directors and other professionals both here and abroad, including in places such as Australia, Malaysia, Hong Kong, Oman, Philippines and Sri Lanka.

We are therefore pleased to present the second volume of abridged cases. Again, the cases are diverse. Six of these cases involve companies listed in Singapore, five focus on other Asia Pacific companies in Australia, China and Japan, while the remaining five are U.K. and North American-based. As before, the cases are selected to ensure sufficient diversity in terms of issues raised.

The cases are written for the purpose of generating discussion and are intended to be used for analysis. Therefore, they do not include analysis or interpretation of the situations – this is for those using the cases to discuss and debate.

Although the copyright for the cases resides with CPA Australia and me, those who wish to use the cases only have to inform us and acknowledge the source. Only if the cases are being reproduced in a collection sold commercially would we charge a fee, which would be reinvested in this initiative.

I would like to thank CPA Australia for sponsoring of the cost of hiring students to help with the checking and editing of the cases, and producing this volume. I am also grateful to the students who helped in editing these cases and, of course, to the students who helped in preparing the initial cases. They are acknowledged in the first footnote of each case. I would also like to specifically mention the capable support provided by the project manager, Lau Lee Min, a fourth year BBA (Accountancy) honours student at the NUS Business School.

I hope you will find this collection useful.

Mak Yuen Teen, PhD, FCPA (Aust.)  
Associate Professor of Accounting  
NUS Business School  
National University of Singapore

May 2013

# Sky's The Limit: The China Sky Saga

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## Case Overview

In late November 2011, the Singapore Exchange (SGX) issued a directive to China Sky to appoint a special auditor. Several reasons were behind the issuance, namely the exchange's concerns over the Interested Person Transactions (IPTs) between the audit committee chairman, Lai Seng Kwoon, and the company; the aborted acquisition and development of land in China; and the significant repairs and maintenance costs incurred. However, this directive went unheeded by China Sky. On 6 January 2012, the SGX made a rare move to commence legal proceedings against China Sky after it failed to comply with SGX's directives to appoint a special auditor. However, just 10 days after SGX filed the legal proceedings, it withdrew its application. This was the first time a listed company had defied a directive from SGX to appoint a special auditor. China Sky described itself as a 'bullied child' putting up with SGX's unreasonable demands<sup>1</sup>. This objective of this case is to allow discussion of issues such board independence, conflict of interest, and enforcement of listing rules.

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This is the abridged version of a case prepared by Chew Jia Yi, Joanne Chin Kai En, Audrey Low Ying Jun, Thai Wei Ying, Jeremy Ng, Yap Jie Hui, Felix Hadiyanto under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. Consequently, the interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Low Jiemin under the supervision of Professor Mak Yuen Teen.

## Background of Company

China Sky Chemical Fibre Co Ltd was incorporated on 29 March 2005. Its office is registered in the Grand Cayman British West Indies. It was listed on the SGX Mainboard on 3 October 2005.<sup>2</sup>

China Sky specialises in producing high-end nylon fibres which have a wide range of commercial applications, ranging from high-end sportswear and casual wear to consumer products such as curtains, tablecloth, upholstery and decorative materials, shoes, bags, luggages, umbrellas, tents, ribbons and nylon webbings. Its products are sold under the trademark and brand name of “*Tian Yu*”.

Chairing its Board of Directors was Cheung Wing Lin, and CEO Huang Zhong Xuan was an executive director on the board. Huang was also the largest shareholder of China Sky, holding a stake of 37.8%.<sup>3</sup> The other four board members include executive director Song Jian Sheng, non-executive director Wang Zhi Wei, and two Singaporean independent directors, Er Kwong Wah and Lai Seng Kwoon.

The board comprised of three board committees. Both the nominating committee and remuneration committee were chaired by Er Kwong Wah. Er was appointed as an independent director of China Sky in 2005. Er was also one of the few directors in Singapore who served on 10 or more boards, and as of April 2010, He was reported to be on the boards of 12 listed companies in diverse industries<sup>4</sup>.

The audit committee was chaired by Lai Seng Kwoon, another independent director of China Sky with almost 30 years of experience in accounting, tax and finance matters. He runs his own accounting firm, SK Lai & Co<sup>5</sup>.

## The Queries Begin

Before the whole saga began, SGX had issued several queries to China Sky. These included queries in March 2010 regarding the company's announcements relating to its financial year ended 31 December 2009, in August 2010 regarding its results for the second quarter ended 30 June 2010, and in March 2011 regarding its results for the year ended 31 December 2010.

On 22 April 2011, China Sky issued an announcement in response to other SGX queries regarding the following items: interested person transactions, total value of benefits paid to the independent directors, justification for their continuing independence, remuneration received by certain directors from related corporations, grant of options to employees of related corporations, date of grant of options to a director and reasons for non-disclosure of the grant, deposit paid to a third party with respect to acquisition of land use rights, and how the company has complied with best practices relating to dealing in securities under the SGX listing rules. On 25 April and 29 April, the company issued further "clarification" announcements relating to these issues.

On 27 April, Prof Mak Yuen Teen of the National University of Singapore published a scathing commentary regarding Mr Lai's independence in response to the company's announcement dated 22 April<sup>6</sup>. According to him:

*"It has now emerged that Mr Lai's accounting firm, SK Lai & Co, provided significant accounting-related services to China Sky, while Mr Lai was an independent director and chaired the audit committee (AC)... The services relate to assisting in the review of the company's internal, accounting and reporting controls, reviewing quarterly financial statements and results announcements, and providing consultancy and advisory services for various accounting procedures, including the consolidation of a subsidiary. As the AC chairman, Mr Lai has a primary responsibility for overseeing the areas for which his firm is providing accounting-related services, and is therefore put in a position to review his own firm's work. Further, the AC oversees the external auditors, who are expressing an opinion on the financial statements, while his firm is advising management on the controls and accounting procedures which underlie the preparation of these financial statements. The amount of fees involved suggests*

*that the work of his firm was substantial... there is an unacceptable conflict between his role as AC chair and his firm's role in providing accounting-related services. While the company has claimed that the IPTs are conducted at arm's length and that each member of the AC abstained from voting on matters in which he is interested, it still begs the question as to how SK Lai & Co was appointed when there are many accounting firms that can provide such services. Further, the AC is also tasked with reviewing the IPTs, but Mr Lai's firm is the primary (only) beneficiary of the transactions which were reported."*

In addition, Prof Mak further questioned disclosures made in the company's 2010 corporate governance report. The 2010 report stated that the independent directors have confirmed that they do not have any relationship that could interfere, or be reasonably perceived to interfere, with the directors' independent business judgment. He also questioned the board's response to SGX's query, where they continued to assert Lai's independence.

In the midst of the saga, China Sky appointed Yeap Wai Kong as an independent director on 2 May 2011<sup>7</sup> and reshuffled its board committees. Furthermore, China Sky hired Rodyk and Davidson LLP to advise and conduct a review of the company's existing corporate governance procedures through identifying any existing weaknesses and recommending measures to address those weaknesses<sup>8</sup>.

### **16 November 2011 – SGX Orders China Sky to Appoint Special Auditor**

SGX's directive ordering China Sky to appoint a special auditor was a result of issues uncovered by SGX in the course of reviewing annual reports filed by China Sky for financial years 2006 to 2010, including announcements made by China Sky in response to queries by SGX.<sup>9</sup> These issues include those relating to the IPTs between China Sky and its then-audit committee chairman Lai Seng Kwoon and an aborted land acquisition in Fujian province.

### **17 November 2011 - China Sky Trading Suspended on SGX**

China Sky then requested to suspend the trading of its shares on 17 November 2011 - a day after SGX issued the directive ordering China Sky to appoint special auditors<sup>10</sup>.

China Sky stated that a trading suspension for its shares was “necessary to avoid the establishment of a false market, which may result from the SGX directive.”<sup>11</sup> The company felt that distortions in its share price would arise due to investors’ speculation of the uncertainty surrounding the SGX directive. However, by then, China Sky’s shares had already plummeted 40% following SGX’s numerous queries following China Sky’s FY 2010 report and 96% since China Sky’s peak in October 2007.<sup>12</sup>

## **16 December 2011 - China Sky Reprimands for Lack of Compliance**

On 15 December, China Sky issued a statement on SGXNET saying it would not appoint a special auditor as directed by SGX, maintaining that such a move was unwarranted and not in the best interests of the company and its shareholders.

China Sky argued that while the SGX had regarded the transactions as unusual, there had been no express allegations of accounting irregularities or fraudulent practices. Hence, China Sky found that the usual reasons that gave rise to concerns necessitating the appointment of special auditors for companies listed on the SGX were absent and “[accused] the Exchange of taking an intimate interest in the corporate and strategic management and the day to day operations of the Company”<sup>13</sup>.

On 16 December, SGX issued a statement reprimanding China Sky and each of its directors for persistently failing to comply with directives from the exchange “despite every opportunity offered to the company and its board”. This was in response to the queries from the SGX to the company that were met with contradictory statements and disclosures which were not substantiated.<sup>14</sup>

China Sky released a string of responses to SGX’s reprimand on 21 December 2011, saying that the reprimand was “issued without any merit and clearly showed a total disregard of the interests of the shareholders.” China Sky added that it was shocked by this directive, as it had responded to a series of demands for information and queries from the SGX officers since April 2009.<sup>15</sup>

Consequently, China Sky's non-compliance led SGX to decline its request to lift the trading suspension on the 22 December 2011<sup>16</sup>.

### **31 December 2011 - Reconstitution of Board Committees**

The second and final deadline for China Sky Chemical Fiber to appoint a special auditor by 5 January 2012 was fast approaching. In a rare move, the Monetary Authority of Singapore (MAS) threw its weight behind the directive issued by SGX, saying that China Sky should comply with the instruction<sup>17</sup>. In response to MAS' move, China Sky announced a reconstitution of its board committee on 31 December 2011. As of 1 January 2012, the audit committee would be chaired by Er Kwong Wah while Lai Seng Kwong would take over as the new chairman of the nominating committee.<sup>18</sup> However, the company remained silent as to whether it will comply with the directives.

### **5 January 2012 - Resignation of Independent Directors**

China Sky's three independent directors, Er Kwong Wah, Yeap Wai Kong and Lai Seng Kwoon, tendered their resignations on 5 January 2012. All three independent directors stated the company's non-compliance with SGX's directives dated 16 November 2011 as the main reason for their cessation of titles and duties.<sup>19</sup> All three stepped down with immediate effect in the midst of China Sky's continued defiance of the SGX directive.

### **6 January 2012 - SGX Sues China Sky**

SGX commenced legal proceedings against China Sky on 6 January 2012, and applied to the High Court of Singapore for a Court Order to enforce its directives on China Sky. The application was made against China Sky and its directors, Huang Zhong Xuan, Cheung Wing Lin, Song Jian Sheng and Wang Zhi Wei, in pursuant to Section 25 of the Securities and Futures Act (power of courts to order observance or enforcement of the listing rules).<sup>20</sup>



In addition, the resignation of its independent directors led to its non-compliance with Listing Rules 221 and 720(3), which included the need to appoint at least two independent directors resident in Singapore, to obtain the approval of SGX for the appointment of any director onto the board, as well as to fill the vacancy within the audit committee to meet the minimum requirement of 3 members<sup>21</sup>. The matter was then escalated to the High Court to force China Sky and its directors to comply with these listing requirements.

### **16 January 2012 - SGX Withdraws Lawsuit against China Sky**

SGX withdrew the lawsuit on 16 January 2012, which it filed against China Sky earlier. No reasons were given as to the retraction of this lawsuit. The only announcement made on the same day was the fact that lawyers representing both parties have met and that China Sky's lawyer was seeking further instructions from the company.<sup>22</sup>

### **7 February 2012 - Resignation of China Sky's CEO & Financial Controller**

China Sky's CEO, Huang Zhong Xuan, quit on 7 February 2012 for "personal health reasons." Three days later, the group financial controller Hui San Wing resigned, citing a lack of leadership, guidance and support from the CEO and independent directors.<sup>23</sup>

### **16 February 2012 - MAS and Singapore Police Commence Investigations**

On 16 February 2012, a joint announcement made by the Singapore Police and the MAS revealed that SGX had sent in a report detailing possible breaches of the Securities and Futures Act by China Sky and its directors.<sup>24</sup>

MAS had referred the potential breaches to the Commercial Affairs Department for them to investigate the matter. The Commercial Affairs Department is the police unit responsible for investigating corporate crime.

## **9 April 2012 - MAS Seeks Court Order to Freeze Ex-CEO's Funds**

On 9 April 2012, it was reported that MAS sought a court order to freeze the funds of Huang Zhong Xuan.<sup>25</sup> This move by MAS was targeted to restrain Huang, a Chinese national, from taking or sending money out of his Credit Suisse Group AG account in Singapore. This preventive act was done to counter the risk that the monies in the bank account may be dissipated by Huang.

According to court papers, Huang had transferred about \$10 million out of the bank account on 5 March 2012. Subsequently, on 27 March 2012, he had given instructions to move the remaining \$3.7 million out of the account. Credit Suisse provided copies of Huang's account opening forms and banking details from 6 December 2010 to 27 March 2012 to the Commercial Affairs Department, which asked for the details on 26 March 2012, having commenced their investigations on China Sky on 16 February 2012.<sup>26</sup>

## **18 April 2012 - Former Independent Director Takes on SGX**

Yeap Wai Kong sought to overturn the public reprimand issued to him from SGX on 16 December 2011 by applying for a quashing order from the court. Yeap was represented by lawyer Tan Cheng Han, a consultant at TSMP Law Corporation.<sup>27</sup>

At the start of the 3-day hearing, Tan described SGX as being "tyrannous in the use of its power during the High Court sessions." According to Yeap's argument, China Sky had intended to comply with SGX's directives to appoint a special auditor, which is contrary to the bourse's impression. He argued that the delay in compliance with the directive was solely due to the need to understand the basis for appointing the special auditor.<sup>28</sup>

The case was subsequently dismissed by the High Court on 9 May 2012. Justice Philip Pillai ruled that the "SGX had 'fully and substantively' given Mr Yeap Wai Kong a 'fair hearing'."<sup>29</sup>

### **23 April 2012 – Resignation of Auditors**

The company received, on 23 April 2012, a notice from its auditors, Messrs Deloitte and Touche LLP, that it wished to resign with immediate effect. The reason given was “they are unable to discharge their responsibility as Auditors of the company” and “not be in a position to complete the audit” without any independent non-executive directors and independent Audit Committee members since January 2012.<sup>30</sup>

### **11 September 2012 – China Sky Appoints New Management**

China Sky appointed a chief executive officer, a financial controller, two independent directors and a company secretary. Ling Yew Kong was appointed as its CEO and executive director. Lee Chong Ping was appointed financial controller. William Tan Yew Chee was appointed non-executive independent director and will chair China Sky's nominating committee. Former China Sky independent director Er Kwong Wah, was re-appointed as a non-executive independent director and will chair China Sky's audit committee.<sup>31</sup>

## **Recent Developments**

On 25 October 2012, China Sky finally gave in and appointed Stone Forest Corporate Advisory Pte Ltd as its special auditor. Issues to be reviewed included the repairs and maintenance costs incurred in the first quarter of FY 2009, major acquisitions of the Fujian Land and the interested person transactions.<sup>32</sup> The initial defiance of the order was blamed on miscommunication.<sup>33</sup>

The China Sky saga finally came to a temporary end until the release of findings by the special auditor. It may still be a while before the trading suspension on China Sky would be lifted. In the meantime, shareholders can only wait.

## Discussion Questions

1. Comment on the separation (or lack of) between the board, management and shareholders in a company like China Sky, and how that can impact on a company's corporate governance.
2. Given the interested person transactions between Mr Lai and China Sky, comment on the independence of the board of directors.
3. Comment on the multiple directorships held by independent director Mr. Er Kwong Wah.
4. Discuss whether the CEO and independent directors should be allowed to resign without any replacement.
5. Comment on SGX's moves in response to China Sky's non-compliance with SGX's request to appoint a Special Auditor. What else can SGX do to issuers that refuse to comply with its directives?
6. For foreign companies such as China Sky, are existing rules adequate in ensuring good governance? What else, if any, can be done to improve corporate governance of foreign companies?

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# China Hongxing: Where is the Cash?

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## Case Overview

Accounting irregularities noted by China Hongxing Sports Limited's auditors Ernst & Young LLP for the company's financial year 2010 marked the start of yet another S-chip scandal unraveling on the Singapore Exchange (SGX). The irregularities discovered involved cash and bank balances, accounts receivables, accounts payables, and other expenses. The discovery of these accounting irregularities was subsequently followed by trading suspensions and a special audit investigation. The objective of this case is to allow a discussion of issues such as the consequence of directors holding multiple directorships, director's duties and responsibilities, the adequacy of SGX rules in ensuring independent directors discharge their responsibilities, poor corporate governance leading to poor oversight of management, and the implications of a lax listing regulatory environment.

## Background

China Hongxing Sports Limited (China Hongxing) is an investment holding company incorporated in Bermuda in 2005<sup>1</sup>. It was founded by the Wu family and is headquartered in Quanzhou City, China<sup>2</sup>. Similar to many other Chinese

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This is the abridged version of a case prepared by Phyllis Chen Meijie, Cheng Keevin, Leong Sum Yue, Liw Wei Shan, Jason Oh Yongqin, Siow Yi Sheng and Yang Kai-Hui under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Mabel Lynn Leong Jia Jia under the supervision of Professor Mak Yuen Teen.

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companies, it is a family-owned business in which the founding family dominates the management. China Hongxing, along with its subsidiaries, is engaged in the business of designing, manufacturing and selling a range of sports footwear, apparel and accessories<sup>3</sup>. Out of China Hongxing's 7 subsidiaries, only Profitstart Group Limited is directly held<sup>4</sup>. On 14 November 2005, China Hongxing successfully listed on the main board of the SGX<sup>5</sup> through an initial public offering (IPO) priced at 8 cents per share. Many investors jumped on board, and its shares achieved a first week closing price of 8.9 cents per share<sup>6</sup>.

China Hongxing produces around 23.9 million pairs of shoes annually. The company's products are sold under Erke, a well-recognized brand name, which has won the company many awards in China<sup>7</sup>.

China Hongxing sells its products through a network of twenty distributors across China, as well as two export agents handling their sales to the Middle East and Southeast Asia<sup>8</sup>. The distributors are given free rein on mode of distribution, usually setting up specialty stores within their specific designated areas, or delegating the task to third party retailers. By September 2012, China Hongxing had more than 3,800 stores in China<sup>9</sup>.

Erke was awarded the "Top 500 Most Valuable Brands in China" for the 7<sup>th</sup> time in 2010, and "Asia's best 200 under A Billion" of Forbes in 2009. These awards further enhanced China Hongxing's reputation.

## **Board of Directors**

The founding Wu family owns approximately 33% of the total outstanding shares and the rest of the shares are held by the public<sup>10</sup>. Wu Hanjie, one of the founding members with more than 20 years of experience in the shoe manufacturing industry<sup>11</sup>, used to serve as a non-executive Chairman and a member of the Nominating and Remuneration Committee<sup>12</sup>. After he retired on 26 April 2007<sup>13</sup>, Wu Hanjie ceased to hold any position in China Hongxing.

The board of China Hongxing consisted of five directors. Wu Rongguang and Wu Rongzhao, the sons of Wu Hanjie, were the executive directors. Wu Rongguang was also the Group's Chairman after taking over from his father in 2007<sup>14</sup>. As the Chairman, his responsibilities included overseeing the management and operations of the group, and setting the agenda of board meetings. Wu Rongzhao was appointed as the Group's Chief Executive Officer (CEO), and was responsible for the Group's overall management and Finance, Production and Administration<sup>15</sup>.

The other three directors were independent directors Chan Wai Meng, Bernard Tay and Alfred Cheong who respectively chair the Remuneration, Nomination and Audit Committee. Each independent director was also a member of the other board committees<sup>16</sup>. All three independent directors possess substantial accounting and finance experience, as well as certified accounting qualifications<sup>17</sup>. Chan had 30 years of finance, sales and marketing experience. Tay had 30 years of work experience in public accounting firms. Cheong had more than 10 years of experience in the audit and financial consulting services industry. Cheong concurrently held four other directorships in listed companies while Tay and Chan each held five concurrent directorships. Both Chan and Cheong sat together on the board of another Chinese company (S-chip), C&G Industrial Holdings Limited<sup>18</sup>.

## **The Trouble Starts**

China Hongxing managed to achieve annual revenue growth of around 40 percent since its listing on SGX in 2005<sup>19</sup>. Revenue increased steadily from RMB1.41 billion in 2006 to a peak of RMB2.9 billion in 2008<sup>20</sup>.

In 2009, however, revenue dipped by 31 percent to approximately RMB2 billion<sup>21</sup>. This decline in performance was attributed to the global financial crisis and discounts given to distributors to weather the downturn and manage inventory levels in their channels<sup>22</sup>. Earnings per share (EPS) also dropped sharply from RMB0.1766 to RMB0.0474<sup>23</sup>. The board of China Hongxing clarified that “in the view of the uncertain economic environment, it was deemed prudent to maintain its cash position and not declare a final dividend for the year”<sup>24</sup>. The chairman also assured that in spite of the volatile economy, China Hongxing would continue seeking out business opportunities that could help them gain a stronger foothold and increase their competitiveness in the industry<sup>25</sup>.

China Hongxing had a huge pile of cash reserve that was neither used for investments and expansion, nor was it paid out to shareholders. In 2008, despite having RMB1.98 billion of cash, it merely paid out RMB0.015 a share, or RMB38 million in total, during its mid-year payout<sup>26</sup>. In 2009 when China Hongxing had RMB2.98 billion cash, it paid out an interim dividend and a final dividend of RMB0.01 per share, amounting only to a total of RMB56 million<sup>27</sup>. The total dividend payout ratio over cash was approximately 2 percent. Investors eventually raised questions about the existence of the money, given that only a small amount of dividends was paid out in comparison to the huge cash reserve and China Hongxing’s reluctance to increase dividends<sup>28</sup>.

Despite the gloomy economic outlook, the amount of trade receivables nearly doubled from RMB363.4 million in 2009 to RMB684.6 million in 2010. Trade payables, however, was much lower at RMB174 million. This drew the suspicion of some traders as the amount of raw materials bought did not seem to match the amount of goods produced<sup>29</sup>.

In September 2009, it came to light that the company took five months to report a series of share sales by a large investor, JF Asset Management<sup>30</sup>. In its defence, China Hongxing maintained that it did not receive any fax notification on the transaction. However, JP Morgan Asset Management, which owned JF Asset Management, released evidence showing that it had notified China Hongxing within two days of the sales<sup>31</sup>. This event triggered investors to question the quality of China Hongxing’s corporate governance.

## The Auditors Resign

Things started to improve for China Hongxing's businesses. The company's share price rose by 34.7% in July 2010, beating the market gain of 7% in the same period. However, the company continued to face an onslaught of competition from top-end brands and struggled to effectively expand in the lower-end market<sup>32</sup>. Analysts predicted that this might result in it becoming a takeover target<sup>33</sup>.

The situation worsened when the Group's joint auditors for the previous five years, RSM Nelson Wheeler and Foo Kon Tan Grant Thornton LLP, suddenly resigned, two months before the year-end audit was about to commence<sup>34</sup>. In November 2010, Ernst & Young LLP was engaged as the new auditors<sup>35</sup>.

Shareholders did not question the management about the resignation of the auditors when they met on 29 November 2010 to approve the appointment of the new auditors<sup>36</sup>. Net Research Asia Capital executive chairman Kevin Scully commented that China Hongxing's board could have done more to investigate the resignation before issuing a negative assurance in November on the third-quarter results, which stated that nothing 'materially false or misleading' had come to their knowledge or attention<sup>37</sup>.

## New Auditors Discover Irregularities

On 22 February 2011, the company announced that the audit committee had been informed by the auditors that irregularities were found in the cash and bank balances, accounts receivables, accounts payables, and other expenses in their audits of its subsidiary companies, Fujian China Hongxing Erke Sports Goods Co Ltd and Quanzhou Hongrong Light Industry Co Ltd, in China<sup>38</sup>. Ernst & Young were not able to finalize the audit for the financial year ended 31 December 2010<sup>39</sup>. The company requested for a trading halt on 22 February 2011<sup>40</sup>. Its share price had plunged from 16.5 cents about a month before the trading halt to 11.5 cents the day before trading halt<sup>41</sup>.

On 25 February 2011, the company cited audit issues as the reason for the trading halt. This was shortly followed by a request for trading suspension<sup>42</sup>. The board of directors then proceeded to appoint an independent special auditor, NTan Corporate Advisory, on 1 March 2011 to carry out a thorough investigation on the issues raised by the external auditors<sup>43</sup>.

In the meantime, China Hongxing's audit committee said that it would strive to protect the company's assets and ensure that operations could continue smoothly despite the suspension of trading activities<sup>44</sup>. China Hongxing sought a series of time extensions from SGX in order to finalize and report their financial results for financial year ended 31 December 2010<sup>45</sup>.

The trading suspension raised concerns and frustration amongst shareholders, as they could neither sell off nor buy more shares of China Hongxing<sup>46</sup>. David Gerald, President of Securities Investors Association (Singapore), agreed with minority shareholders' suggestions that China Hongxing shares should continue being traded, with restrictions on short selling and a ban on management and controlling shareholders from trading<sup>47</sup>.

## **Findings of Special Auditor**

On 27 February 2012, China Hongxing submitted an initial proposal to SGX to request for a resumption of trading activities<sup>48</sup>. This was followed by a submission of a fuller trading resumption proposal on 25 July 2012 after the special audit report had been finalized and issued on 23 July 2012<sup>49</sup>.

The key findings of the special audit investigations include (1) cash and bank balances of the Group was RMB263 million instead of RMB1,417 million as was presented in the initial FY2010 accounts, (2) the key subsidiaries (Fujian China Hongxing Erke Sports Goods Co Ltd and Quanzhou Hongrong Light Industry Co Ltd, in China) incurred and made payments in excess of actual amounts or without the Board's approval and (3) instances of the key subsidiaries' non-compliance despite established internal control procedures<sup>50</sup>.

Following the release of the special auditor's report, China Hongxing issued an announcement on 25 July 2012 proposing a few key changes that could help remedy the weaknesses in their system, and enhance the management and executive functions of the Group<sup>51</sup>. Some of these changes included appointing a new CEO to replace current CEO Wu Rongzhao, appointing a Finance Director who will supervise the Chief Financial Officer, appointing new internal auditors to conduct a thorough review of the existing internal controls procedure, and the appointment of a professional firm to advise the Group on listing obligations and to ensure compliance with applicable laws<sup>52</sup>.

On 25 September 2012, SGX responded to the trading resumption proposals submitted by China Hongxing, commenting on certain matters that require further consideration by the company as well as additional steps that need to be taken in formulating the proposal<sup>53</sup>. Trading of China Hongxing shares remained suspended pending further announcements by SGX and China Hongxing. However, amidst the accounting scandal, China Hongxing still managed to maintain strong revenue numbers of RMB2.7 billion for financial year ended 31 December 2011, a 11.7 percent growth from 2010<sup>54</sup>.

## **Is Corporate Governance the Root Cause?**

On 1 September 2006, SGX made a set of changes to its listing rules in an attempt to strengthen corporate governance of issuers. One of the changes was a requirement for directors to provide a “negative assurance” confirmation for every announcement of interim quarterly or half yearly financial results<sup>55</sup>. At least two directors would be required to sign and declare that to the best of their knowledge, nothing has come to their attention which may render the interim financial results to be false or misleading<sup>56</sup>.

Despite changes being made to the SGX listing rules, it is arguably still easier for Chinese firms to get listed in Singapore, as compared to Hong Kong, United States or even China itself. Furthermore, in contrast to the United States' Sarbanes-Oxley Act, which is backed by the full force of legislation and carries harsh penalties, the breaching of SGX rules will only attract light punishments such as a reprimand or, at most, a delisting of a company's shares<sup>57</sup>. Due to the

relatively low listing standards and lenient selection process, substandard firms may be attracted to list on SGX. Coupled with other scandals involving S-chips, the value of such companies had been falling and some of the stronger and more promising S-chips were trying to delist themselves from SGX<sup>58</sup>.

SGX has also been criticized for its lack of information with regards to companies that are listed on its boards. Without this information, trading within the exchange would lack the transparency necessary to keep the market fair. Allowing a suspended company to resume trading without providing any regular updates during the suspension could send the company's share price plummeting as the market assumes the worst. Associate Professor Mak Yuen Teen of the National University of Singapore agreed that it is "a prudent practice for SGX to ensure there is adequate information in the market before trading can occur"<sup>59</sup>. However, it appears that SGX's efforts to strengthen corporate governance have fallen short, in light of the rampant problem of S-chip scandals.

Ultimately, is the China Hongxing scandal due to poor corporate governance? To what extent has the lax listing standards of the SGX contributed to such S-chip scandals?

## **Discussion Questions**

1. Discuss the possible red flags that should have been raised prior to the trading halt in 2011.
2. Evaluate the board structure of China Hongxing and its likely impact on the effectiveness of the Board of Directors. Are there concerns with the independent directors?
3. Discuss whether SGX should allow the trading of China Hongxing's shares with restrictions.
4. Are the SGX rules and the enforcement of these rules effective in ensuring good corporate governance, especially for Chinese companies (S-chips)? Explain.

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# Daka Designs Limited – Designers of a Fraud

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## Case Overview

Shortly after Daka Designs Limited (Daka) launched its initial public offering (IPO) on the Mainboard of Singapore Exchange (SGX), it issued profit warnings. This led SGX to seek a special audit by KPMG. The special audit found the non-disclosure of possibly material information, including how capital raised was used and cash drawings and loans made to senior executives. The objective of this case is to allow a discussion of issues such as investor protection in IPOs, effectiveness of the board of directors in protecting minority shareholders, as well as the impact of cross-border listings on investor protection.

## The Beginning

Founded in 1993 by Executive Chairman, Pat Y. Mah, Daka Designs grew to become one of the more prominent design and development companies in Hong Kong. Daka had its main operations in Hong Kong and primarily focused on the design, development and marketing of innovative products for the global consumer market. Daka's drive to innovate culminated in the receipt of numerous awards and accolades<sup>1</sup> since its incorporation.

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This is the abridged version of a case prepared by Ivan Goh Qian Heng, Caryn Loh Jia Ling, Roy Ng Song Min, Ng Xin Rong, Seah Jia Zhi, Vivien Tan Hwee Min and Tan Liang Quan under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lau Lee Min under the supervision of Professor Mak Yuen Teen.

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Daka had plans moving forward to develop its distribution network in order to provide a more integrated and efficient supply chain as well as open up new markets to reach out to customers.

## **Initial Public Offering**

In July 2004, Daka filed for an IPO on SGX with the aim of raising about S\$14 million in net proceeds, 25.5% of the company's enlarged share capital. It planned to use the IPO proceeds to expand its marketing network, product development, and for its expansion in China<sup>2</sup>. In addition, its prospectus stated that the divestment of Daka Industrial Limited (DIL) was a result of Daka's change of focus, from manufacturing to the design and development of products. Finally, the prospectus showed high turnover and profitability.

## **Profit Warnings**

Shortly after its IPO, Daka issued a profit warning for the six months ending 30 September 2004, attributing it to a delay in its marketing network and product development plans. SGX queried Daka on its failure to alert the public prior to the IPO. Daka responded by citing the time lag between the IPO and finalization of the impact on bottom line figures. Consequently, Daka's share price plummeted.

Another problem surfaced after Daka announced the financial results for its first financial year ended 31 March 2005. Daka disclosed that there might be repayment issues with Daka Manufacturing Limited (DML)<sup>3</sup>. DML was wholly-owned by DIL, which was 18%-owned by Daka. DML and DIL were supported by Daka through loans. Daka would then set off these loans against the cost of goods Daka purchased from DML. In Daka's reply to SGX queries on this loan issue, Daka simply explained that it had not foreseen the loans having an adverse impact on Daka.

On 11 October 2005, Daka issued yet another profit warning, stating that reported financial performance may not meet market expectations. This round of profit warning was reportedly due to provisions made against the amount due from its subsidiary, DML. On 14 November, 2005, Daka reported an interim loss of HK\$38.8 million for the six months ended 30 September 2005.

Daka had issued two profit warnings in a short span of just over a year since attaining listing on the Mainboard. This triggered SGX to appoint KPMG on 20 November to conduct a special audit to investigate Daka's financial affairs.

## **Roadblock**

KPMG faced difficulty in performing the special audit as Daka restricted KPMG's access to its financial information and personnel despite KPMG's and SGX's repeated requests for Daka's cooperation.

Raymond Chow, the CEO, was purported to have meticulously taken actions to impede KPMG's review. He allegedly went to the office over the weekend to prevent the auditors from removing computer data<sup>4</sup>. Furthermore, in their attempt to restrict KPMG's access to sensitive company information, employees of Daka communicated through non-Daka web accounts<sup>5</sup> to avoid the auditors' scrutiny.

Despite obtaining limited information, KPMG was still able to derive certain preliminary findings. On 16 January 2006, SGX announced that Daka's trading would be halted because it had breached listing rules<sup>6</sup> by failing to cooperate in the conduct of the special audit.

Following the halt, the audit committee overruled company management's decision to hinder the special audit and granted KPMG access to Daka's financials and other information. Eventually, the CEO and management gave in.

## Special Audit<sup>7</sup>

Daka appointed the consultancy firm A&M Asia to act as interim managers on 22 May 2006 during the course of the special audit. Kelvin Flynn and Eric Thompson were appointed executive director and CEO respectively. On 25 May 2006, Mah, Chow, CFO Kevin Leung and executive director Rose Chow decided to relinquish their managerial positions and took leave of absence from the Board of Directors. This was to prevent further erosion of confidence in the company management and corporate governance of Daka<sup>8</sup>.

In the special audit report released in June 2006, KPMG raised concerns regarding possible breaches of the Securities and Futures Act (Chapter 289) and other laws in Singapore.

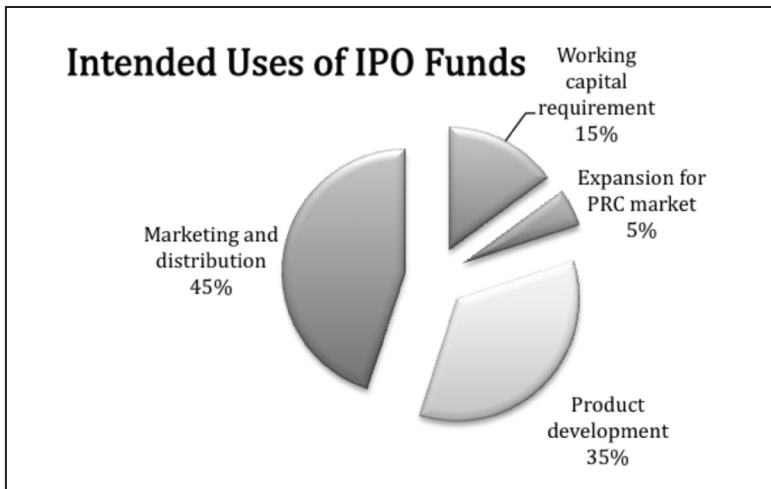


Figure 1

According to its prospectus, Daka had planned to use S\$6.3 million of the IPO proceeds to expand its marketing network, S\$5.6 million for product development and the remainder for working capital and expansion in its PRC market. Instead, it used HK\$64.8 million raised from the IPO - 84% of the capital - to repay existing bank loans. This intention was not disclosed in its prospectus. Since this was material information which could have affected potential investors' perceptions, the non-disclosure was in breach of the listing rules<sup>9</sup>.

Moreover, several large cash drawings and loans from Daka were made by Mah and Chow between 2003 and 2004. The amounts outstanding from the directors as at 31 March 2003 and 30 September 2003 were described in the financial statements of the Daka Group as "non-trade in nature, unsecured, interest-free and repayable within the next twelve months"<sup>10</sup>. No further details on the directors' drawings were revealed in the prospectus, although this information should have been disclosed under the Securities and Futures Regulations<sup>11</sup>.

Daka had been trying to boost profits by recording sales prior to goods being delivered as well as generating fictitious sales as early as 2002. Undelivered goods were also shifted away from the factory to avoid being accounted for in their stock. As a result, HK\$12 million revenue was recorded for Daka in the final month of 2004, despite only earning HK\$8 million in the first 11 months.

In addition, Daka failed to disclose the Group's plan in 2001 to acquire 100% of DIL, as part of its IPO plan. In fact, Daka did acquire a 100% stake in DIL in 2002, by acquiring a certain Lawrence Chan Kam Tong's 50% stake in DIL. Following this acquisition, Daka had sufficient control and influence over DIL and DML (wholly owned by DIL). However, prior to IPO in 2003, Daka chose to divest its stake in DIL to Chan, effectively reducing its interest to 18%.

The conclusion drawn from the special audit was that information provided in the prospectus was completely inconsistent with the firm's actual activities and objectives. KPMG also believed that Daka's true intention of the divestment had been to improve the performance of Daka in anticipation of the IPO.



In addition, Daka staff and management appeared to be involved in the operations and decision-making of DML. The authorised signatories for DIL's bank account were Daka staff, and they were also found to be financing their operations, and maintaining the accounting system and finance function of DIL. On the other hand, Chan, who effectively owned 82% of DIL, had no control over DIL and had assisted DML only at Daka's request. This suggested that DIL was a controlled subsidiary, and the investment in DIL was likely to be more than the prima facie 18%. This should have warranted the need for DIL (and wholly-owned DML) to be consolidated for accounting purposes. Including DML's losses in the consolidated accounts - which was not done - would have reduced Daka's profits by HK\$19.2 million.

## **Navigating Through Murky Waters**

To release Daka from its past liabilities, a proposal was drawn up to sell Daka Group to Daka Direct for HK\$42.5 million<sup>12</sup>. The sale converted Daka into a shell company with only a cash asset of HK\$12 million<sup>13</sup>. Following the sale, Daka was renamed Carats Ltd. In order to remain listed, Carats pursued opportunities for the company to secure new business through a reverse takeover. A reverse takeover seemed to be the best exit option for its minority shareholders since they would be able to have a stake in a viable business and benefit from any upside in share price of the new company. However, several attempts for a reverse takeover failed and Carats was eventually delisted a year later.

## **Epilogue**

The Hong Kong ICAC prosecuted the top three former senior executives, Pat Mah, Raymond Chow and Kevin Leung in September 2009. They were charged for their respective roles in a conspiracy to defraud the SGX and misleading existing and potential investors through the misrepresentation of Daka Designs' true financial position. In view of their serious breach of trust, Mah and Chow were sentenced to 24 months and 38 months in jail respectively in October 2011<sup>14</sup>, and disqualified from taking up any directorships for five years in Hong Kong. This conviction also disqualifies them from holding any directorship in Singapore under the Companies Act Section 154(1).

## Discussion Questions

1. Did the directors breach any laws pertaining to directors' duties?
2. Are the prospectus disclosures adequate for investors? If not, how can they be improved?
3. In this case, divergence of control and cash flow rights occurs because the majority shareholders were able to exercise excess control than their shareholdings. Does this divergence between control and cash flow rights of the majority shareholders result in lower protection for minority shareholders? If that is the case, how can we resolve it?
4. Do you think there exists a conflict of interest between the CEO's position as management of the company and his position on the Board?
5. How might a cross-border listing contribute to the reduction of investor protection? Are Singapore's corporate governance rules geared for fraud perpetrated across borders? What can be done to mitigate this problem?

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- 6 SGX Listing Rule 704(12) stipulates that the 'Exchange may require an issuer to appoint a special auditor to review or investigate the issuer's affairs and report its findings to the Exchange or the issuer's Audit Committee or such other party as the Exchange may direct.' Hindering the work of special auditors constitutes a breach of this rule. <[http://rulebook.sgx.com/en/display/display\\_main.html?rbid=3271&element\\_id=5070](http://rulebook.sgx.com/en/display/display_main.html?rbid=3271&element_id=5070)> accessed 12 December 2012
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# OCBC: A Model For Family Companies And Good Bank Governance?

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## Case Overview

In December 2010, the Monetary Authority of Singapore (MAS) amended its corporate governance regulations and guidelines for banks and other major financial institutions. These changes were in line with global banking reforms introduced in the aftermath of the global financial crisis. The objective of this case is to allow a discussion of issues such as corporate governance of a family-controlled but professionally-managed company, board structure, board independence and the impact of regulatory changes on OCBC.

## Background

Oversea-Chinese Banking Corporation Limited (OCBC) is the longest established Singapore bank, formed in 1932 after the merger of three local banks - the Chinese Commercial Bank (1912), the Ho Hong Bank (1917) and the Oversea-Chinese Bank (1919). OCBC is the second largest financial services group in Southeast Asia by assets and one of Asia's leading financial services groups. Globally, it is renowned as one of the top banks in the world; other than being recognised as the World's Strongest Bank by Bloomberg Markets Magazine in 2011 and 2012, OCBC is also rated Aa1 by Moody's.<sup>1</sup>

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This is the abridged version of a case prepared by Chuah Yiye, Fenny Francisca, Goh Ghee Hie, Julia Anjani, Lim Kher Yang, Rani Hapsari, Samantha Eva Ho and Steffie Wong under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Cynthia Yeo Li Tian under the supervision of Professor Mak Yuen Teen.

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As a listed company, OCBC has to comply with the Singapore Exchange (SGX) listing rules and “comply or explain” against the Singapore Code of Corporate Governance, most recently revised in May 2012. As a bank, it has to comply with corporate governance regulations and guidelines issued by the Monetary Authority of Singapore (MAS).

According to OCBC, one of its core values is integrity, which underscores the importance of fair dealing as the basis for doing business. It has won a number of corporate governance and transparency-related awards, including the following:<sup>2</sup>

- Singapore Corporate Governance Award – Big Cap Category (Merit): SIAS Investors’ Choice Awards 2012
- Internal Audit Excellence (Merit): SIAS Investors’ Choice Awards 2012
- Best Managed Board (Market Capitalisation of S\$1 billion & above) – Gold Award: Singapore Corporate Awards 2012
- Most Transparent Company - Finance Category (Runner-up): SIAS Investors’ Choice Awards 2011
- One of the Top 10 companies in Singapore for Best Corporate Governance, Best Investor Relations, Most Committed to a Strong Dividend Policy & Best Corporate Social Responsibility: FinanceAsia’s 11th Annual Poll of Asia’s Top Companies
- Best Annual Report / Formal Disclosure for 2009 Annual Report: IR Magazine 2010
- Singapore Corporate Governance Award (Merit): SIAS Singapore Corporate Governance Award 2010
- Most Transparent Company Award - Finance Category (Runner-up): SIAS Singapore Corporate Governance Award 2010

## Ownership Structure of OCBC

OCBC Bank's founding Lee family is a substantial shareholder of OCBC, holding a total of 20% of the issued ordinary shares. 3.54% of the shares are registered in the name of Lee Foundation. Moreover, the Lee Foundation is deemed to have an interest in 0.66% ordinary shares held by Lee Pineapple Company (Pte) Limited, 11.96% ordinary shares held by Selat (Pte) Limited (of which 0.51% is Selat (Pte) Limited's deemed interest), 3.68% shares held by Singapore Investments (Pte) Limited and 0.06% ordinary shares held by Peninsula Plantations Sendirian Berhad. The other substantial ordinary shareholders, apart from the Lee Family, are Aberdeen Asset Management PLC with 7.01% of the ordinary shares and Aberdeen Asset Management Asia Limited with 6.19% of the ordinary shares.<sup>3</sup>

The interest of the Lee family is represented on the 14-member board by Lee Seng Wee and Lee Tih Shih, both of whom are non-executive directors of OCBC. They are not independent from substantial shareholders, but are deemed independent from management and business relationships. They are also affiliated with the Lee Foundation and Selat (Pte) Limited. Lee Seng Wee, the second generation of the Lee Family, was first appointed to the board on February 1966 and was a Chairman of OCBC Bank from 1995 to 2003. He is currently a member of the Board's Executive Committee and Nominating Committee. He is the director with the largest interest in the ordinary shares, with a direct interest of 0.22% and a deemed interest of 0.13%.

Lee Tih Shih, the third generation of the Lee Family, is not as closely involved in the banking business as the previous generations even though he has previously served in senior positions at OCBC Bank. He was first appointed to the board on April 2003 and is presently an Associate Professor at the Duke University Medical School in Durham, USA and Duke-NUS Graduate Medical School in Singapore. He has a direct interest of 0.08% in the bank.<sup>4</sup>

## **Board of Directors: Pre-Regulatory Changes**

Based on the 2010 Annual Report (AR), OCBC's Board of Directors comprised of 11 board members – one executive director (CEO David Conner), 5 non-executive non-independent directors who included the board chairman Cheong Choong Kong, and 5 independent directors, making up more than one-third but less than half of the board. There was one female director, Fang Ai Lian, who was an independent director and had joined the board in November 2008.

The board as a group comprised of members with core competencies in areas such as accounting, finance, business and management. Among the independent directors, Patrick Yeoh Khwai Hoh, who had served the board since July 2001 and Colm Mccarthy, who joined the board in November 2008, have experience in the banking industry. The other independent directors included Bobby Chin, a former managing partner of KPMG Singapore who had served on the board since October 2005 and Neo Boon Siong, a business school professor and former dean who joined the board in January 2005.

The Board had five committees - Audit Committee (AC), Nominating Committee (NC), Remuneration Committee (RC), Risk Management Committee (RMC) and Executive Committee (EC). Except for the EC, the other four committees were all chaired by independent directors. The independent directors constituted a majority in the AC and half of the RC. There were no executive directors in the AC, NC and RC.

Within the AC, only Bobby Chin had recent and relevant accounting experience, while Colm Mccarthy had related financial management expertise. For the NC and RC, the members had accounting or financial expertise. In the RMC, only one member, Lai Teck Poh, a non-executive non-independent director, had risk management experience while the other members had banking, financial or business experience.



## **Recent Regulatory Changes and Impact on OCBC**

In December 2010, the MAS issued the Banking (Corporate Governance) (Amendment) Regulations and revisions to the corporate governance guidelines for banks, financial holding companies and direct insurers incorporated in Singapore. The changes had a major impact on OCBC.<sup>5</sup>

### **Director independence**

Directors who are independent from management, business relationships and substantial shareholders will no longer be considered independent after they have served for a continuous period of 9 years on the Board. Based on the 2011 AR, Patrick Yeoh, one of OCBC's independent directors, had served on the Board of Directors for 10 years. He retired at the 2012 Annual General Meeting (AGM).

The circumstances under which banks are expected to appoint a Lead Independent Director (LID) were expanded to include situations where the Chairman has other relationships with the Financial Institution (FI).

The Board Chairman and non-executive director, Cheong Choong Kong, is deemed to have other relationships with OCBC because he receives payments and benefits from consulting for OCBC Management Services Private Limited, a wholly-owned subsidiary of OCBC. Therefore, OCBC should appoint a LID. However, OCBC had not done so as of FY2011 and explained that since the CEO and Chairman of OCBC are separate persons and the Chairman is a non-executive director, the appointment of a LID would unnecessarily diffuse the 14-member OCBC board. They also explained that the NC is chaired by an independent director.

### **Composition of the board and board committees**

MAS regulations state that banks shall not appoint a person who is a member of the immediate family of the Chief Executive Officer's (CEO) as the Board Chairman. OCBC's Chairman is neither an executive director nor an immediate family member of the CEO.

At the end of FY2011, OCBC's Board of Directors comprised 14 board members – 1 executive director, 5 non-executive non-independent directors including the board chairman, and 8 independent directors, making up more than half of the board. After the departure of Patrick Yeoh, who had served for more than 9 years, the board size was reduced to 13 members, with 7 independent directors. Samuel Tsien was appointed Group Chief Executive Officer on 15 April 2012 after the retirement of the former CEO, David Conner. However, Tsien did not join the board as a director. Therefore, OCBC moved to a wholly non-executive board, with a majority of independent directors.

The amended regulations provide that the number of independent directors on the Board, Nominating Committee (NC) and Remuneration Committee (RC) is to be increased from the one-third to a majority.

OCBC's NC comprised of 5 members and is chaired by Fang Ai Lian. At the end of FY2011, there were only two independent directors Fang and Neo Boon Siong in the committee. At the AGM in April 2012, Dato' Ooi Sang Kuang, a former Deputy Governor of Bank Negara Malaysia who was appointed as an independent director on 21 February 2012, was elected. He replaced Lai Teck Poh, a non-executive non-independent director in the NC. With this change, OCBC complied with the requirement of a majority of NC members to be independent. The members have experience in accounting, finance, business and academia.

The RC comprised of 4 members and is chaired by Fang Ai Lian. There were two independent directors, Fang and Neo Boon Siong. On 9 January 2012, Quah Wee Ghee was appointed to the RC, and subsequently elected at the AGM. With the appointment of Quah, the RC comprised of 5 members, of whom 3 were independent directors. Hence, OCBC complied with the requirement of a majority of RC members to be independent. The members have experience in accounting, finance, banking, business and academia.

## **Governance over remuneration framework and practices**

The new MAS guidelines recommend additional components and factors that the RC must consider in the design and operation of the remuneration framework. RCs have to ensure that the remuneration practices are aligned with and in accordance with the remuneration framework, strategic objectives and corporate values.

In FY2011, changes were made to the remuneration structure by the RC. This resulted in an increase in proportion of the deferred remuneration component for senior executives. The CEO and his direct subordinates are identified as “senior management”, while employees with ‘Senior Vice President’ rank and above are identified as “material risk-takers”, and these two groups are deemed to have a major influence on the long term performance of the Bank. The remuneration of employees who are reporting directly to the CEO and are of at least Executive Vice President in rank are approved by the board. The remuneration of other employees in the group of senior executives are approved by the remuneration committee.

The MAS guidelines also recommend that the RC should adopt the Principles for Sound Compensation Practices and Implementation Standards issued by Financial Stability Board (FSB) with regards to remuneration matters. These principles cover effective governance of compensation, effective alignment of compensation with prudent risk taking, and effective supervisory oversight and engagement by stakeholders.<sup>6</sup>

With respect to first principle, staff engaged in financial and risk control should be independent, have appropriate authority, and be compensated in a manner that is independent of the business area they oversee and commensurate with their key role in the firm. It was disclosed in the annual report for FY2011 that the performance of the risk and compliance functions is assessed based on the achievement related to their respective performance measures, independent of the business they oversee. Furthermore, market compensation data on risk and compliance functions are considered for remuneration.

With respect to the second principle, compensation outcomes must be symmetric with risk outcomes. It was disclosed in the annual report for FY 2011 that the Bank's variable bonus pool is fully discretionary and the factors taken into consideration are the Bank's performance, market conditions and competitive market practices. Executives are also remunerated according to their own performance measures, while taking into account market compensation data for their respective job roles.

### **Governance over risk management**

Under MAS regulations, the RMC must comprise at least 3 directors and non-executive directors must make up the majority.

OCBC's RMC was formed in August 2004 although it was not mandated by MAS until 2010. During FY 2011, there were 6 members in the committee, comprising 2 independent directors, 3 non-executive directors and the CEO. However, after the AGM in April 2012, Lai Teck Poh, a non-executive director, replaced retired independent director Patrick Yeoh as the Chairman, with the other members comprising 2 independent directors and 3 non-executive directors, including David Conner who recently retired as CEO. Only Lai has the relevant expertise in risk disciplines while the other members have technical accounting/finance experience and business experience.

Besides the regulations, the amended guidelines also mention that the Board may appoint a Chief Risk Officer (CRO) to oversee the risk management function depending on the scale, nature and complexity of the business. MAS approval for the appointment of CRO is required. Gilbert Kohnke holds the rank of Executive Vice President and has been the Head of Group Risk Management since September 2005. In his capacity as CRO, he reports to both the CEO and RMC and he does not hold other positions in the bank.

## Discussion Questions

1. Comment on the structure of OCBC ownership and control. How does it affect the corporate governance of OCBC?
2. OCBC and UOB both have families as controlling shareholders. How is their corporate governance and management different? What are the pros and cons in the different ways they are governed and managed? Which do you think is the better approach?
3. Evaluate the board structure of OCBC in terms of its size, independence, competencies and diversity. .
4. How have the new MAS regulations and guidelines affected the corporate governance of OCBC, particularly in the areas of board composition, remuneration and risk management? Discuss whether the measures adopted by OCBC are appropriate.

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# UOB: Should Wee Hold On Forever?

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## Case Overview

New regulations and guidelines introduced by the Monetary Authority of Singapore (MAS) in 2005 raised the bar on corporate governance for financial institutions in Singapore. Following the 2008 global financial crisis, the MAS issued revised regulations and guidelines to ensure that the corporate governance standards applicable to banks and large direct insurers in particular are consistent with global standards. The focus on corporate governance has raised questions about the existing corporate governance system of UOB. In particular, issues such as the separation of Chairman and CEO and the remuneration of Wee Cho Yaw, the Chairman and major shareholder of the bank, have been thrust into the spotlight. The objective of this case is to allow a discussion of issues such as the board composition and independence, long tenure of independent directors, relationship between the CEO and Chairman, executive remuneration, and new rules and regulations following the 2008 financial crisis, in the context of a family-controlled and managed bank.

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This is the abridged version of a case prepared by Chen Yee, Cheryl Wai Xinting, Geno Lim Meng Hui, Ho Boon Keat, Luqman Aris, Mui Boon Loong and Victor Soh under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Felicia Lee Sze Lin under the supervision of Professor Mak Yuen Teen.

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## Background

United Overseas Bank (UOB) is the smallest of the three local banks in Singapore in terms of total assets.<sup>1</sup> It was founded on 6 August 1935 by Wee Kheng Chiang, father of the present Board Chairman Wee Cho Yaw, and was originally known as the United Chinese Bank. Wee Cho Yaw, whose name is synonymous with UOB, took over the reins of UOB in 1958.

UOB's growth has been attributed to several key acquisitions; some notable ones being the acquisition of Chung Khiaw Bank in 1971 and Overseas Union Bank in 2001. Although each acquisition had diluted the Wee family's stake, with the Wee family holding only a total stake of about 16.5% as of 8 March 2012, UOB has remained under the family's control through cross-shareholdings.<sup>2</sup>

Although Wee handed over the CEO position in 2007 to his son, Wee Ee Cheong, he continues in his role as the Chairman of UOB's Board of Directors. When Wee reached 70 in 2007, the Monetary Authority of Singapore (MAS), Singapore's central bank, approved his annual reappointment as a director.<sup>3</sup>

## Recent Regulatory Changes

MAS introduced regulatory changes for local banks through amendments to the corporate governance regulations and guidelines in December 2010. Some of the key changes in the regulations include: <sup>4</sup>

- A director who has served more than 9 years cannot be considered independent, although he can still remain as a non-independent director on the Board, as long as composition requirements are met.
- A person who is a member of the immediate family of the CEO should not be appointed as the Board Chairman. Existing Board Chairmen who do not meet this requirement can continue in their role, subject to annual approval by MAS

- The proportion of independent directors on the Board, Nominating Committee and Remuneration Committee was increased from one-third to a majority. However, a single substantial shareholder who holds 50% or more of a locally-incorporated bank can continue to have majority representation on the Board and these committees provided at least one-third of directors are independent directors
- A Board Risk Management Committee, comprising at least three directors with a majority of them being non-executive, must be established.

Key amendments were also made to the “Guidelines on Corporate Governance for Banks, Financial Holding Companies and Direct Insurers Incorporated in Singapore”, including:

- The circumstances under which a lead independent director should be appointed were expanded to cover other business relationships which the Chairman may have with the bank and additional guidance on the role of the lead independent director was provided.
- The Remuneration Committee is responsible in ensuring that the Principles for Sound Compensation Practices and Implementation Standards issued by Financial Stability Board (FSB) are adopted when determining executive remuneration.
- The Risk Management Committee is to comprise at least 2 directors with the relevant technical financial sophistication in risk disciplines or business experience, as the Board determines in its judgment.

## **UOB’s Board of Directors**

Based on the 2011 annual report, UOB’s board comprised of 11 directors, all of whom were men. The Chairman, Wee Cho Yaw, was classified as non-executive and non-independent. His son, Wee Ee Cheong, who is the CEO, was the sole executive director and deputy chairman of the board. The



remaining 9 board members were independent directors, out of whom only one had relevant experience in the banking industry. Several of the independent directors – Cham Tao Soon, Tan Lip-Bu and Philip Yeo - had qualifications in engineering and science, and three of them – Cham, Yeo and Ngiam Tong Dow - had their full-time work experience mostly in senior positions in the public sector and academia. Some had full time positions outside of the UOB group, and all of them sat on boards of listed companies outside of the UOB group, with seven being the highest number of directorships held by a single independent director, Reggie Thein. They retired as a senior partner of one of the major accounting firms in 1999.

UOB had five board committees - the Nominating Committee (NC), Remuneration Committee (RC), Audit Committee (AC), Executive Committee (EXCO) and Board Risk Management Committee (BRMC). The composition of each board committee is shown in **Figure 1**.

Figure 1 UOB Board Committees' Composition

Remuneration Committee	Audit Committee	Nominating Committee	Executive Committee	Board Risk Management Committee
<ul style="list-style-type: none"> <li>• Wee Cho Yaw (Chairman)</li> <li>• Cham Tao Soon</li> <li>• Yeo Liat Koh Philip</li> </ul>	<ul style="list-style-type: none"> <li>• Cham Tao Soon (Chairman)</li> <li>• Yeo Liat Koh Philip</li> <li>• Thein Reggie</li> </ul>	<ul style="list-style-type: none"> <li>• Wong Meng Meng (Chairman)</li> <li>• Wee Cho Yaw</li> <li>• Ngiam Tong Dow</li> <li>• Cham Tao Soon</li> <li>• Franklin Leo Lavin</li> <li>• Wee Ee Cheong (Alternate to Wee Cho Yaw)</li> </ul>	<ul style="list-style-type: none"> <li>• Wee Cho Yaw (Chairman)</li> <li>• Wee Ee Cheong</li> <li>• Ngiam Tong Dow</li> <li>• Cham Tao Soon</li> <li>• Yeo Liat Koh Philip</li> </ul>	<ul style="list-style-type: none"> <li>• Wee Cho Yaw (Chairman)</li> <li>• Wee Ee Cheong</li> <li>• Ngiam Tong Dow</li> <li>• Tan Lip-Bu</li> </ul>

## Tackling the Independence Issue

Although the MAS Guidelines recommend that a lead independent director be appointed if the Chairman and CEO are related by close family ties, UOB did not have a lead independent director on its board. The NC rationalized that all the directors may be approached for assistance and the Bank has an established process for receiving and responding to shareholders' feedback and complaints.<sup>5</sup>

Wee had mentioned that he had been looking for a successor outside the Wee family for the Chairman position to comply with a new rule in the Banking Act that disallows the Chairman and CEO to be immediate family members. If this were to happen, it would be the first time in UOB's history that it would have a Chairman from outside the family.<sup>6</sup>

UOB had a significant number of Independent Non-Executive Directors (INED) who had served on its board for a long period of time. The length of service for each INED as of 31 December 2011 is shown in Table 1. Ngiam, Cham, Wong and Yeo had each served at least 10 years on UOB's board. Wong chaired the Nominating Committee while Cham chaired the Audit Committee.

**Table 1:** Length of Service and Date of Appointment for UOB's Independent Non-Executive Directors

	Ngiam Tong Dow	Cham Tao Soon	Wong Meng Meng	Phillip Yeo	Reggie Thein	Franklin Leo Lavin	Willie Cheng	Tan Lip-Bu	Hsieh Fu Hua
Length of service (years) <sup>1</sup>	10	10	11	11	3	1	1	1	N.A.
Date appointed	1/10/01	4/1/01	14/3/00	26/3/00	28/1/08	15/7/10	15/7/10	15/11/10	16/1/12

In addition, Wong Partnership LLP, at which NC Chairman Wong Meng Meng is a Senior Counsel and the Founder-Consultant,<sup>7</sup> had provided legal services to UOB on several occasions previously.<sup>8</sup> However, the quantum and nature of these business dealings were not disclosed.<sup>9</sup>

The prevailing composition of the board and board committees was poised to change with the new regulatory changes introduced by MAS. The stricter definition of independence to exclude directors who have served for more than 9 years on the board would have a significant effect on UOB's board composition, since four of the existing INEDs (Ngiam, Cham, Wong and Yeo) would no longer be considered independent when the new regulations take effect from financial year 2012.

Ngiam and Yeo decided not to seek re-election at the 2012 Annual General Meeting while Cham and Wong would remain and be considered non-independent directors.<sup>10</sup> Four new directors had been appointed to the board since 2010 - Franklin Leo Lavin, Willie Cheng,<sup>11</sup> Tan Lip-Bu and Hsieh Fu Hua. Lavin had worked in senior finance and management positions in international banks, before taking on various senior U.S. government positions, and is now Chairman and CEO of Export Now and also hold directorships in other companies. Cheng was a former managing partner of Accenture and has a background in accounting, finance and information technology. Tan is President and CEO of Cadence Design Systems, founder and Chairman of a leading venture capital firm, and sits on the boards of four other international corporations. Hsieh was the CEO of the Singapore Exchange from 2003 to 2009.

Wee Cho Yaw was the chairman of three of the four board committees he sat on (RC, EXCO and BRMC) despite the Banking Regulations specifying that the RC Chairman must be an independent director. However, the Banking Regulations allow for an incumbent Board Chairman to be an immediate family member of the CEO, and for the incumbent RC Chairman to be non-independent. Furthermore, the NC was of the view that Wee's vast experience made him the most appropriate person to chair the RC.<sup>12</sup>

## Remuneration Policy

UOB's remuneration policy for senior executives comprises of fixed salary, variable performance bonus, benefits and long-term incentives, according to its risk-reward framework. Although the MAS Guidelines recommend disclosure of the top five key executives' remuneration, UOB does not make such disclosures, citing the keen competition for talent in the banking sector as its reason.<sup>13</sup>

Moreover, the RC which is chaired by Wee, had proposed that the Chairman should receive an additional fee of \$2.25 million as part of his total 2011 remuneration for his valuable advice and guidance provided to Management.<sup>14</sup>

Additional fees of this nature have been part of Wee's remuneration package ever since his appointment as Chairman in 2007. Wee's remuneration as Chairman was the highest among the three local banks as can be seen in **Table 2**, with his remuneration in the range of S\$5.25 to S\$5.5M for 2010 and 2011.

Table 3 shows the CEO remuneration, estimated change in remuneration, and return on equity for the three local banks for 2010 and 2011. The remuneration of the CEO for UOB appears comparable to that for the other two banks.

**Table 2:** Comparison of Chairman's Remuneration for the Three Local Banks in 2010 and 2011

	2011	2010
	Remuneration(SGD)	Remuneration(SGD)
UOB	5.25M to 5.5M**	5.25M to 5.5M**
DBS	946,477	678,538*
OCBC	2.95M	3.23M

Source: UOB, DBS, OCBC Annual Reports 2011, 2010

\* Peter Seah became DBS Chairman only in May 2010

\*\*Includes additional payment for 'valuable advice'

**Table 3:** Comparison of CEO Pay and Return on Equity for the Three Local Banks in 2010 and 2011

	2011			2010		
	Salary (SGD)	% increase from prior year	ROE (%)	Salary (SGD)	% increase from prior year	ROE (%)
UOB	6.5 to 6.75M	-13.70	11.10	8 to 8.25M	41.80	12.90
DBS	8.08M	15.00	11.00	8.04	-20.00	10.20
OCBC	7.08M	2.62	11.10	7.48M	14.80	12.10

Source: UOB, DBS, OCBC Annual Reports 2011, 2010

## UOB's Financial Track Record

UOB's financial performance in terms of net income and return on equity was comparable to its local peers over the past five years, as shown in Tables 4 and 5 respectively. Despite being the smallest of the three banks in terms of total assets, UOB had outperformed its peers based on net income and return on equity in 2010 and in 2008, which was at the height of the global financial crisis.

**Table 4:** Net Profit after Tax attributable to Shareholders (in S\$ millions) of the Three Local Banks

Bank	2007	2008	2009	2010	2011
DBS	2,278	1,929	2,041	1,632	3,035
OCBC	2,071	1,749	1,962	2,253	2,312
UOB	2,109	<b>1,937</b>	1,902	<b>2,426</b>	2,327

Source: Annual Reports, UOB, DBS & OCBC, 2007 to 2011

**Table 5:** Return-On-Equity attributable to Shareholders of the Three Local Banks

Bank	2007	2008	2009	2010	2011
DBS	11.12%	9.73%	8.04%	6.14%	10.54%
OCBC	13.21%	11.02%	10.34%	10.84%	10.24%
<b>UOB</b>	12.17%	<b>12.44%</b>	10.02%	<b>12.56%</b>	10.13%

Source: Annual Reports, UOB, DBS & OCBC, 2007 to 2011

Many attributed UOB's good performance to Wee's foresight and good business acumen. In the Chairman's message from the UOB's 2009 annual report, he predicted that the financial crisis would continue to persist.<sup>15</sup> Hence, UOB had focused on building up a capital cushion to enhance its balance sheet strength during the financial crisis.<sup>16</sup>

“We are very mindful of our funding. We want to make sure that our liquidity position is intact and that we are able to manage our short-term liquidity,” said CEO Wee Ee Cheong during the recent UOB’s FY2011 and 2011 fourth quarter results briefing, highlighting top management’s prudence in managing the Bank.

## **Recent Developments**

In August 2012, Wee Cho Yaw announced his plans to step down as Chairman in 2013. He will be succeeded by the most recently-appointed non-executive and independent director, Hsieh Fu Hua, who has extensive experience in the financial sector. He was also the former CEO of the Singapore Exchange.

At the 2013 AGM, Reggie Thein retired and decided not to seek re-election. Two new directors were appointed, James Koh Cher Siang as an independent director in September 2012, and Ong Yew Huat as a non-independent non-executive director in January 2013. Both were elected at the 2013 AGM. Koh is the Chairman of the Housing and Development Board, and had extensive experience in the civil service, holding appointments such as Controller of Income Tax and permanent secretary positions in Ministries of National Development, Community Development and Education. He has also held directorship positions in several listed companies and is currently a director of CapitaLand. Ong retired as executive chairman of Ernst & Young Singapore in December 2012 and is a director of United Overseas Bank (Malaysia) and Singapore Power.

## Discussion Questions

1. Evaluate UOB's board structure (i.e., board size, leadership, independence, competencies and diversity) as disclosed in its 2011 annual report and after the 2012 and 2013 AGMs. How have the new MAS regulations and guidelines impacted the board structure of UOB? How should the NC undertake this assessment?
2. MAS Regulations require the Nominating Committee ("NC") to conduct an assessment of the skills of the directors on an annual basis. How should the NC undertake this assessment?
3. Comment on the remuneration structure, level and disclosure by UOB. Do you believe they are appropriate/adequate?
4. What is the model of corporate governance that characterizes UOB? Discuss the effectiveness of regulations in improving corporate governance in UOB. Do you think that its current model of corporate governance increases shareholder value? Discuss.

## Endnotes

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# SLOW TRAIN COMING: TRAIN DISRUPTIONS AT SMRT

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*“It is unfortunate that it happened... We are very sorry that this happened... In fact until now, we cannot ascertain why it happened because it has never happened before. It’s not something that we could foresee it could happen... All the energy now is to ensure that it doesn’t happen again.”*

- Saw Phaik Hwa, CEO of SMRT<sup>1</sup>

## Case Overview

On 15 and 17 December 2011, train services on the North-South Line broke down twice, the worst disruptions in SMRT’s 24-year history. Hundreds of thousands of commuters were significantly inconvenienced during these two disruptions and thousands of commuters were left stranded in the stalled trains for hours. These disruptions exposed inadequate contingency plans at SMRT. SMRT also failed to provide trapped commuters and the general public with accurate and timely updates during the disruptions. The matter was made worse when the general public realized that the information that SMRT provided lacked credibility.

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This is the abridged version of a case prepared by Lau Wei Le, Loh Chiew Hong, Thoo Sheng Long, Yan Wenxian, Zhang Yichen, Minnie Bui Hai Minh and Ngo Hsiao Yan under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Rachel Goh Yi Ling under the supervision of Professor Mak Yuen Teen.

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The objective of this case is to facilitate a discussion of issues that may have contributed to the service disruptions at SMRT, such as the emphasis on the interests of shareholders versus stakeholders, factors affecting the effectiveness of the board of directors, and the importance of proper risk management.

## **Tracking SMRT's Roots**

SMRT Corporation is a public transport company incorporated on 6 March 2000 and was listed on the Singapore Exchange on 26 July 2000<sup>2</sup>. Currently, there are only a few public transportation companies in Singapore and SMRT is the second largest public transportation company after Comfort DelGro. Through its wholly-owned subsidiaries, SMRT Corporation operates various business segments that include bus, rail, taxi, and other transport-related services<sup>3</sup>.

SMRT Trains Ltd is a rail operator wholly owned by SMRT Corporation<sup>4</sup>. It was first known as Mass Rapid Transit Corporation (MRTC) when it was incorporated on 6 August 1987. A 10-year License and Operating Agreement (LOA) was obtained in the same year and MRTC began its first Mass Rapid Transport (MRT) service on 7 November 1987, running from Yio Chu Kang to Toa Payoh<sup>5</sup>. In 1976, SMRT incorporated Singapore LRT Pte Ltd as a wholly-owned subsidiary<sup>6</sup>. In 1987, SMRT renewed and signed a 30-year LOA with the Singapore Land Transport Authority<sup>7</sup>. SMRT Trains Ltd currently operates 3 main MRT lines, namely the North-South Line, the East-West Line and the newly-opened Circle Line<sup>8</sup>.

The profitability of SMRT has increased steadily over the years. It had been praised for charging reasonable prices and maintaining high operational efficiency. Previous train mishaps, such as two trains bumping into each other at Clementi MRT station in August 1993<sup>9</sup>, drew mainly sympathy from the public, not the fury and unpleasant comments heard about SMRT today.

## Corporate Governance

SMRT has been widely commended for its corporate governance. This is evident from the number of corporate governance-related awards received by the company in recent years<sup>10</sup>. SMRT was also ranked second in the Governance and Transparency Index in 2010<sup>11</sup> (where the company's corporate governance, transparency, and investor relations were assessed). SMRT was also ranked top in a corporate governance study of 30 companies on the Straits Times Index, conducted by the U.S.-based business consultancy Resources Global Professionals (RGP)<sup>12</sup>. Some of the factors evaluated by the study include compliance with the Code of Corporate Governance, structure of the board, directors' compensation, disclosures, and the company's involvement in community projects and events<sup>13</sup>.

### Board of Directors and Senior Management

As of 2013, SMRT has a board of eight directors<sup>14</sup> with five board committees, namely the Audit Committee, Nominating Committee, Executive Committee, Remuneration Committee, and Board Risk Committee. SMRT places a strong emphasis on board diversity, as it sees that as necessary to bring in new skills and perspectives onto the board. Moreover, board members are constantly changed to ensure an independent and diverse board composition. The board of directors is led by its Chairman, Koh Yuan Guan, who is also Chairman of the Central Provident Fund Board, and a member of the board of the Monetary Authority of Singapore. The board members hold directorships in other Singapore-listed companies.

From 2002 to 2012, the top management at SMRT was led by its President and Chief Executive Officer (CEO), Saw Phaik Hwa, who joined SMRT after 19 years of retail experience at DFS Venture Singapore (Pte) Ltd. In addition to her management role at SMRT, she also served as a board member in various corporations and associations in Singapore, including the Esplanade Co. Ltd, National Environment Agency, Health Promotion Board, Tan Tock Seng Hospital Community Charity Fund, and Youth Business Singapore.

The composition of the board and senior management team at SMRT underwent significant changes over the past few years. According to SGX announcements, eight SMRT senior management members had left the company within a time span of one year since 2010. They held various important positions, such as the Chief Financial Officer, Chief Operating Officer, Vice-President of Maintenance and Senior Vice-President of Corporate Services, and had left for various reasons such as pursuing personal interests, career advancement, and health reasons.

In 2011, two non-executive directors, Halimah Jacob and Ho Kim Wah, stepped down as directors of SMRT. Halimah Jacob stepped down on 21 May 2011 after her appointment as a Minister of State, and Ho Kim Wah stepped down on 8 July 2011 as he decided to retire. In January 2012, SMRT CEO, Saw Phaik Hwa, resigned from her position at SMRT to “pursue personal interests”. There was no additional appointment of directors to replace these directors who had left, and subsequently, SMRT was left with a board size of eight directors.

## **The Growing Unhappiness**

*“People can board the trains – it is whether they choose to.”*

- Saw Phaik Hwa, CEO, SMRT (July 2010)

While SMRT had been seemingly commercially successful over the years, it had its share of problems. The most pertinent issue is the overcrowding in the trains, which has led to increasing public anger. LTA surveys revealed that commuters were very concerned about long waits, erratic bus arrivals, overcrowding, and inconvenient transfers in the public transport system.

Over the years, SMRT also faced rising costs. In an attempt to improve its profitability, SMRT applied to the Public Transport Council in 2011 for a maximum fare adjustment of 2.8%<sup>15</sup>. The previous fare hike was in 2008<sup>16</sup>.

While the general public understood that the fare hikes were inevitable due to inflation, they also expected that the fare increments would bring about service improvements, especially during peak hours<sup>17</sup>. However, the public did not seem to believe that there had been service improvements, in light of the growing public unhappiness.

## **Recent Problems**

On the evening of 15 December 2011, train services on the North South Line from Marina Bay station to Braddell station experienced a major disruption<sup>18</sup>. Four trains stalled, one between the City Hall and Dhoby Ghaut stations, one between the Somerset and Orchard stations, one at Braddell station, and one just before Braddell station<sup>19</sup>. It was discovered that the misalignment between the trains' current collector shoes and the power rail had caused the trains to stall<sup>20</sup>. SMRT immediately dispatched engineers to attend to the fault on-site and subsequently conducted a full inspection of the problem<sup>21</sup>. Bus bridging services were also activated to help commuters travel to stations affected by the disruption<sup>22</sup>.

It was estimated that around 127,000 commuters were affected by the major service disruption which occurred during the peak hours<sup>23</sup>. The situation also caused distress to an estimated 1,000 commuters trapped in the stalled trains, especially since the trains were stuck in the underground tunnel without ventilation<sup>24</sup>. It was reported that two commuters trapped in the stalled trains were sent to hospital for breathing difficulties<sup>25</sup>. The disruption lasted five hours, and train services resumed at 11.40pm.

On 16 December, The Minister of Transport, Mr Lui Tuck Yew said:<sup>26</sup>

*"I spoke to Chairman, SMRT, Mr Koh Yong Guan, this afternoon, to reiterate the government's concerns over the incident and over how the incident was handled...And I told him that the SMRT board and management must make every effort to get to the bottom of this, to improve on their procedures and on how these incidences are managed."*

The next morning, train services were disrupted for the second time<sup>27</sup>. This time, the disruption involved the stalling of five trains between the Ang Mo Kio and Marina Bay stations on the North-South Line<sup>28</sup>. As with the earlier incident, the cause was similarly due to a misalignment between the trains and the power rail. About 94,000 commuters were affected, and the disruptions lasted for a total of seven hours<sup>29</sup>.

In response to the disruption, bus bridging services were activated in the morning, and the frequency of the Circle Line train service was increased to cater to the increasing flow of passengers who were affected by the disruption<sup>30</sup>. Additionally, announcements were made in both English and Mandarin in all stations and trains, as well as through media channels such as radio stations, Channel NewsAsia's tickertape, SMRT's corporate website, and Twitter. Signs were also promptly displayed to inform affected passengers at stations. Finally, SMRT offered a refund to passengers who were unable to complete their journeys due to the disruption.

In light of the two incidents, the Prime Minister of Singapore, Mr. Lee Hsien Loong, ordered a public inquiry to investigate the matter<sup>31</sup>. Overnight checks were conducted by SMRT engineers, who traced the power faults for both disruptions to 21 dislodged "claws", which are components that secure the power rail. Excessive vibrations from the running of trains appeared to be a key contributory factor causing the dislodgement. As a precaution, trains were required to travel at a slower pace between these stations to reduce such vibrations. Plastic cable ties were also used as a temporary measure to secure the claws.

## **The Aftermath**

The following day, train services on the North-South and East-West Lines started later than usual as the checks conducted by the LTA and SMRT staff ran throughout the night<sup>32</sup>. SMRT continued the checks and repairs over the next few weeks, and the damaged trains were returned to service as and when they were ready.

While several measures had been taken by SMRT during the disruptions, they were not very effective. The Minister of Transport, Mr Lui, highlighted several areas where significant improvement were needed, such as communication with commuters, bus bridging services, and coordination between government agencies and transport operators<sup>33</sup>. This was in spite of the improvements in the way SMRT handled the second disruption as compared to the first one<sup>34</sup>. Although bus bridging services were provided, they were ineffective due to its low frequency, poor information dissemination, and poor 'detrainment' procedures by the train staff<sup>35</sup>. This had left many stranded in the affected stations. Furthermore, affected commuters of the first disruption had claimed that, other than announcements conveying apologies for the inconvenience caused, no useful instructions were given to them, leaving them clueless about what was happening<sup>36</sup>.

*"SMRT could have better handled the evacuation of the passengers in the stalled trains to reduce the sense of distress, and provided clearer and timelier information and instructions to the public, instead of leaving commuters confused and apprehensive in already disordered circumstances. That the two incidents have the same proximate cause and happened two days apart also raises concerns about possible systemic shortcomings."*

- Lui Teck Yew, Minister of Transport (January 2012)

Mr. Lui appointed a Committee of Inquiry (COI) to investigate the matters<sup>37</sup>. Mr. Tan Siong Thye, Chief District Judge of the Subordinate Courts, headed the COI, and other members of the committee included Professor Lim Mong King from the School of Mechanical & Aerospace Engineering at Nanyang Technological University, and Mr. Soh Wai Wah, Director of Prisons<sup>38</sup>. The committee was asked to look into the sequence of events leading up to the disruption of train services on the North-South Line on 15 and 17 December. Recommendations to minimize the recurrence of such incidents and suggestions of ways to improve the management of similar incidents were main tasks of the committee.<sup>39</sup>

In addition, SMRT's board of directors commissioned an Internal Investigation Team (IIT) comprising seven independent experts from diverse backgrounds on 3 January 2012<sup>40</sup>. The team was led by Mr. Ong Ye Kung, SMRT's independent director, who was concurrently the Deputy Secretary General of NTUC<sup>41</sup>. The team's main responsibilities were to examine the causes of the disruptions, to evaluate how SMRT responded to the mass disruption events, to suggest actions required to minimise potential recurrence in the future, and enhance SMRT's capabilities in crisis management<sup>42</sup>. In order to gather a holistically well-rounded view on the issue, IIT also sought comments from the general public.

## Moving On

*"As CEO of SMRT, I am naturally responsible. Being responsible does not mean walking away from these faults. It means doing all I can to get the problem fixed."*

- Saw Phaik Hwa, CEO, SMRT (December 2011)

Shortly after the train disruptions, SMRT's CEO, Saw Phaik Hwa, announced that she had no plans to step down, and that she would remain to make everything right<sup>43</sup>.

However, amidst public anger over the two major breakdowns in train services and mounting public pressure for management accountability, she eventually resigned on 6 January 2012<sup>44</sup>. Following her resignation, SMRT's independent director, Mr. Tan Ek Kia, assumed the interim executive responsibility for the management while the board conducted a search for a new CEO<sup>45</sup>.

*"I have had the privilege of leading a group of very committed and loyal staff over the last nine years. I feel it is now time for SMRT to bring in new leadership and take the organisation to the next level."*

- Saw Phaik Hwa, CEO, SMRT (January 2012)



On 29 March 2012, SMRT's IIT completed its investigation into the disruption of train services<sup>46</sup>. The company submitted the report to the SMRT board, which in turn submitted the team's report to the COI. The public hearing began on 16 April 2012, during which the LTA noted that SMRT's maintenance expenditure on trains and tracks did not keep pace with the increase in ridership. In addition, the Chairman of the COI noted that there were certain areas that SMRT should pay attention to in the near future. Among those, he raised his concerns over the ineffectiveness of bus bridging services in dealing with emergency and mass disruption incidents<sup>47</sup>.

In light of the severity and factors surrounding the two major disruptions, SMRT was fined \$2 million, the largest penalty ever imposed on any transport operator<sup>48</sup>.

## **Discussion Questions**

1. Evaluate the events leading up to the train breakdowns. Did SMRT place too much emphasis on shareholders' interests compared to the interests of other stakeholders, especially commuters?
2. Evaluate the effectiveness of the risk management and crisis management procedures in place at SMRT. Have the Board Risk Committee and Risk Management Committee executed their duties effectively?
3. Should the Board of Directors be held responsible for the train disruptions?
4. There were a number of resignations of senior management staff over a very short period of time prior to the train disruptions. What might be potential explanations for the high number of resignations and what impact might they have on SMRT? Should the board monitor the turnover of senior management and staff and should they have been concerned with the high turnover?
5. SMRT appointed their independent director, Mr. Tan Ek Kia, as their interim CEO. What does this suggest about SMRT's CEO succession planning?

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# Yahoo! A Modern Day Tale of Alibaba

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## Case Overview

On 10 May 2011, Yahoo! Inc. (Yahoo!) indicated in its SEC filing that Alibaba Group Holdings Limited (Alibaba) had transferred the ownership of Alipay to a new entity controlled by Alibaba's CEO Jack Ma. Yahoo! said in a press release two days later that it was not informed of the ownership transfer until 31 March 2011, several months after the alleged transfer completion date of August 2010. Alibaba fought back the next day, arguing that the ownership transfer had abided entirely to regulations and the board was informed beforehand of this impending ownership change<sup>1</sup> Yahoo! shares fell as much as 7.3% to \$17.20 on the initial announcement date, and lost more than 10% through the week<sup>2</sup>. While public reactions were divided, some fundamental questions inevitably surfaced in investors' minds: whose side of the story should they trust? Who should take responsibility for the delayed disclosure? Who is trying to mislead the investors? The objective of this case is to allow a discussion of corporate governance issues such as board representation and structure, conflict of interest, board communication, decision making/authority as well as directors' duties.

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This is the abridged version of a case prepared by Andrew Aw De Cai, Felicia Goh Pei Ting, Lin Jiajing, Low Chern Yik, Min Tianzhu, Michelle Yeo Hui Min, Yvonne Tan Yan Qi under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. Consequently, the interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Low Jiemin under the supervision of Professor Mak Yuen Teen.

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# Background

## **Alibaba Group**

Alibaba was founded in 1999 in Zhejiang Province, China. The founder Jack Ma Yun had a vision of connecting every businessman in China through the emerging Internet technology. By 2011, its flagship subsidiary Alibaba.com had grown into the biggest online business-to-business (B2B) marketplace in China, with a market share of approximately 50%. In 2007, Alibaba.com successfully filed for an Initial Public Offering (IPO) on the Hong Kong Stock Exchange. Alibaba also owns Taobao, the biggest consumer-to-consumer (C2C) online shopping platform in China; and Tmall, a dedicated business-to-consumer (B2C) platform.

One of Alibaba's most successful developments was Alipay, a third-party online payment platform launched in 2004. It was initially created as a functional unit within Alibaba.com to provide payment solutions for the company's online portals such as Taobao. By 2011, Alipay had grown to become the world's largest online payment system.

## **The Yahoo!-Alibaba partnership**

In October 2005, Alibaba took over the operations of Yahoo! China and issued 40 percent of its shares to Yahoo! valued at US\$1 billion as part of its strategic partnership with Yahoo!. Prior to September 2012, Yahoo! was a major shareholder of Alibaba, owning 43% of the total shares, followed by Softbank – a Japanese IT firm – with 29% ownership. The remaining 28% was owned by Jack Ma and his management team.

Alibaba's board of directors comprised of four members. In October 2005, Jack Ma, the Chairman of the board, occupied one of the two seats taken by Alibaba's management. Jerry Yang, representative of Yahoo! (subsequently replaced by Tim Morse and later Jacqueline D. Reses), and Sun Zheng Yi (Japanese name: Masayoshi Son), Softbank's representative, each occupied one out of the two remaining seats.

Over time, Alibaba expanded and achieved huge success internationally. However, Yahoo! was losing market share in virtually all areas of its domestic businesses. Consequently, the investment in Alibaba became its crown jewel. This investment allowed the California-based Corporation to bypass the stringent protocols regulating foreign investment in China, and yielded huge profits from the rapid growth of internet usage in China.

## **Alipay Spinoff**

### **The Spinoff Decision**

In 2010, a new regulation termed the Second Ordinance was passed, requiring all online payment systems to be wholly owned by the Chinese in order to retain their operating licenses<sup>3</sup>. Foreign owned systems had to undergo a separate application process, which was much more tedious and difficult. This regulatory change was aimed at addressing national security concerns regarding the collection of private financial information by foreign-owned payment systems. Alipay was deemed to be jointly owned by Chinese and foreign entities and this regulatory change posed a problem for Alibaba.

Before this new regulation, most companies (including Alibaba) had attempted to circumvent these regulations through the creation of Variable Interest Entities (VIE), where the holding company would transfer nominal ownership of a subsidiary but retain economic benefits through contractual cash flows services.<sup>4</sup>

Alibaba arranged for Alipay to be transferred to Zhejiang Alibaba E-commerce Ltd (Zhejiang Alibaba). Zhejiang Alibaba was 80% owned by Jack Ma and 20% owned by Shihuang Xie, the co-founder and a key management executive of Alibaba. The transfer was carried out in two phases; the first involved a 70% ownership transfer in June 2009 and the second a transfer of the remaining 30% in August 2010<sup>5</sup>. Net consideration totaling RMB 330 million was paid<sup>6</sup>.

The VIE structure was retained after the completion of the transfer of ownership. As such, Alibaba still recorded Alipay in its consolidated financial statements for FY2010 as per regulatory requirements. But by the end of the first quarter of 2011, Jack Ma felt that the VIE could no longer bypass the close scrutiny of the Chinese authorities<sup>7</sup>. A formal letter was issued to Softbank and Yahoo! on 31 March, stating that it would spin-off Alipay completely and terminate the VIE structure. As of 31 March, Alipay was no longer consolidated under Alibaba as a wholly owned subsidiary, but accounted for as an affiliate.

## **Delayed Disclosure by Yahoo**

On 10 May 2011, Yahoo! disclosed in its 10-Q filing to the U.S. Securities and Exchange Commission (SEC) that 100% ownership of Alipay had been transferred to Zhejiang Alibaba under Jack Ma's majority ownership. Yahoo! investors subsequently got wind of the news of the disagreement between Yahoo! and Alibaba.

## **Yahoo!'s Side of the Story**

Yahoo! claimed that it did not know about the ownership transfer and deconsolidation of Alipay until 31 March 2011. Furthermore Yahoo! claimed that the board had not approved the decision.

Carol Bartz, CEO of Yahoo! from Jan 2009 to Sept 2011<sup>8</sup>, was believed to have held office for too short a term to have a good understanding of Alibaba's corporate affairs. According to one person familiar with the situation, the Yahoo! board did not blame Ms. Bartz for escalating tensions with Alibaba Group because she was not aware of the Alipay restructuring. The rest of the directors were not pointing fingers at her, said the person. Instead, Yahoo! was "having a battle with the Chinese"<sup>9</sup>.

Yahoo! was entitled to appoint two representatives on the board as stated in the 2005 cooperation agreement. In February 2011, then CFO of Yahoo!, Tim Morse said that the company had yet to take up the extra seat as 'the current situation is good and there [was] no need to break the balance'<sup>10</sup>.



## **Alibaba (Jack Ma's) side of the Story**

Alibaba disputed Yahoo!'s claims and mentioned that the transfer was discussed at virtually all board meetings since as far back as two years ago.<sup>11</sup> Alibaba further claimed that the board gave “informal consent” to the management team to fully deal with Alipay matters in July 2009<sup>12</sup>.

In another interview, Jack Ma stated that in the six years since Jerry Yang and Masayoshi Son joined the Alibaba board, “not one decision [had] been approved by the board”, and that “a lot of things [had] been discussed outside of the board and the board has come to an agreement...in the minutes of [their] meetings” He also mentioned that making a decision through the board was useless since the board directors would not have agreed to it and Alipay may collapse as a result of delayed application for an operating license<sup>13</sup>.

Jack Ma claimed that Sun Zheng Yi avoided discussion about the transfer, citing a lack of time in March 2011. In addition, Ma further added that Sun advised him to lie to the Central Bank about Alipay's foreign ownership instead of transferring the ownership of the company. Although there was no consensus on this matter by the end of March, the deadline for license application, Jack Ma took a unilateral decision to bypass the board and submit the application to the Central Bank with Alipay as a wholly Chinese-owned entity. Consequently, Alipay successfully obtained a license in May 2011<sup>14</sup> to operate locally.

## **Softbank's side of the Story**

Softbank refused to comment on the ownership transfer incident. According to an insider, Softbank “is not a final decision-maker but a participant in the compensation talks”<sup>15</sup> since it only has one seat on Alibaba's board.

## **Stock Market and Investors' Reactions**

In the few months prior to the saga, investors had been bidding up Yahoo!'s shares. This was partly attributable to positive projections of the future value of its Alibaba holdings, with a large portion attributable to Alipay<sup>16</sup>.

After the announcement on 10 May 2011, Yahoo!'s share price plunged by 7.3%<sup>17</sup>, with investors fearing a value erosion of Yahoo!'s stake<sup>18</sup>. Subsequently, its shares dropped to \$16.00, from \$18.55, losing 13.7% within the week.<sup>19</sup>This was largely due to investors questioning why Yahoo! was not in the loop about the transfer, and whether the relationship with Alibaba will be sustainable<sup>20</sup>.

Several lawsuits were filed against Yahoo!. Shareholders claimed they were misled by the non-disclosure, which artificially pushed up Yahoo stock price to a value much higher than what it should be. Others alleged that a proper value recovery proposal (in the case that Alipay might be spun off) should have been in place way before the announcement date as changes should have been anticipated as far back as 2009. Over the period from 10 May to 29 July, Yahoo's shares declined by 29.4%.

## **Analysts' Views**

Analysts were generally in consensus that the manner in which the ownership transfer was done was disputable. Youssef Squali from Jefferies & Co mentioned that even though the ownership transfer is inevitable given the Chinese regulations, 'the way it was done is questionable'<sup>21</sup> since Ma himself admitted that there was no proper board voting procedure for Alipay's transfer.

Walter Price of RCM Capital Management felt that Yahoo! could have better handled the delayed disclosure by holding a press release once they learned about the transfer<sup>22</sup>. In addition, Century Weekly deemed the consideration of RMB330 million too low to be considered as an arm's length transaction. This raised the possibility of a conflict of interest given Ma's control over Zhejiang Alibaba, and whether a management buyout (MBO) was the true incentive for spinning off Alipay.

## **The Settlement**

After months of tense negotiations, Alibaba, Yahoo! and Softbank announced on 29 July 2011 that they have signed an official agreement with regards to the transfer of Alipay.

The key terms of the agreement were as follow<sup>23</sup>:

The holding company of Alipay will pay Alibaba 37.5% of its total equity value from the proceeds of any liquidity event – such as an IPO – subjected to a minimum of \$2 billion and a maximum \$6 billion.

Prior to any liquidity event, the holding company of Alipay will pay Alibaba 49.9% of Alipay’s pre-tax profits, in addition to software licensing fees and royalties.

APN Ltd, an independent Special Purpose Vehicle (SPV), which will exist until the liquidity event, was set up by Jack Ma and Alibaba Group CFO, Joe Tsai, to issue Alibaba a \$500 million, 7 year, interest-free promissory note. To back the promissory note, Jack Ma put 50 million of his own Alibaba ordinary shares into APN Ltd.

## **Analysts’ Reactions to Settlement**

As opposed to the spin-off decision, analysts were split in their opinions of the settlement. Forbes was positive as the settlement lifted the uncertainty over the Alipay transfer as it once deterred investors from buying its shares and projected Alipay to ‘grow very well in the coming years’<sup>24</sup>. The valuable Alipay-Taobao revenue was preserved and kept within the group itself. In addition, non-Taobao or third-party payment processing business can be captured with the new Alipay structure.

On the other hand, analysts from Wells Fargo and Stifel Nicolaus thought that although the agreement may sound reasonable<sup>25</sup>, the actual realization of the settlement plans may not be as optimistic as it looks, citing the uncertainty of the realizable value of the Asian assets as a reason. The short-run outlook of the stock was still ‘fairly murky’ and this was tied to the performance of the core business<sup>26</sup>. The underlying MBO nature of Alipay transfer also exposed how Yahoo!’s fate in Asia is dictated by the whims of Jack Ma.

Some analysts did not see the potential for an IPO for Alipay as there was no clear timeline. Yahoo!'s shareholders might not be happy with the cap of \$6 billion on proceeds.<sup>27</sup> Moreover, they felt that the Chinese government's focus on domestic ownership makes a global IPO unlikely<sup>28</sup>.

Other analysts were neutral on the value of the agreement. A JP Morgan analyst agreed that the agreement provided a definitive range of outcomes for the eventual monetization of Alipay, while also clearing an overhang on Yahoo!'s stock. As a major stakeholder, Yahoo! can force a liquidity event after 10 years", should an IPO remain unlikely<sup>29</sup>.

New speculation about the unspoken plan of the Alibaba IPO arose. Tsai mentioned that there are no current plans, but did not rule out the possibility. From the settlement terms, Alibaba now appears to enjoy more tangible cash flow income from the new Alipay, which would put itself in a better position for any future IPO, benefitting Yahoo! by extension.

## **Investors' Reactions to Settlement**

Some investors had sold their shares in Yahoo! even before the settlement as they were bothered by Yahoo!'s lack of knowledge and the loss of Alipay's value to Alibaba's portfolio. An influential hedge fund manager of Greenlight Capital, [dumped his entire stake in Yahoo](#), saying in a letter to investors that this "wasn't what we signed up for."<sup>30</sup> Shares of Yahoo! initially rose 6% in premarket trade after the agreement was announced. This indicated that the investors were satisfied with the deal. However, the stock price started tumbling between 3 to 8 August which could be attributed to the decline of the broader technology sector<sup>31</sup>. Citigroup analyst Mark Mahaney maintained that, while the agreement "removes some uncertainty, Yahoo! appears to have become a forced seller of one of its key Asian assets."<sup>32</sup>

## Recent Developments

On 20 May 2012, Yahoo! and Alibaba reached an agreement on a comprehensive value realization plan for Yahoo!'s stake in Alibaba.<sup>33</sup> The first step was carried out on 18 September 2012. Alibaba repurchased half of Yahoo!'s stake for US\$7.6 billion.<sup>34</sup> After this transaction, voting rights of Yahoo! and Softbank Corp were diluted to below 50% on the company's board.<sup>35</sup> Yahoo! will be required to sell back half of the remaining stake upon IPO and the other half after IPO.<sup>36</sup>

This agreement provided a win-win situation and is expected to bring to an end what could be the 'longest running global cat fight in Internet history'.<sup>37</sup> 'Alibaba CEO Jack Ma is now in the driver's seat completely'; he has gained control over the company.<sup>38</sup> For Yahoo!, the agreement provides for a staged exit over time, balancing near-term liquidity and return of cash to shareholders with the opportunity to participate in future value appreciation of Alibaba.<sup>39</sup>

On 15 January 2013, Jack Ma announced that he will step down as Alibaba's CEO in May, and become Executive Chairman when his successor takes over.<sup>40</sup>

## Discussion Questions

1. Is the board structure in Alibaba appropriate? Are the shareholders adequately represented on the board based on their ownership?
2. What are the problems you perceive that might exist in Alibaba's board in terms of decision making process, with particular reference to the Alipay case?
3. Have Jerry Yang and Masayoshi Son fulfilled their duties as directors on Alibaba's board? If not, what could be some possible reasons?
4. Is Jack Ma acting in the best interest of the company with regards to the transfer decision, given that Zhejiang Alibaba is 80% owned by himself? What are other possible alternatives?
5. Discuss possible alternatives to the settlement.

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# Another Day, Another Trading Scandal: The Case of National Australia Bank

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## Case Overview

In January 2004, an employee within the National Australia Bank (NAB) revealed that there were cases of unauthorized foreign currency derivatives trading that resulted in total losses of A\$360 million. The NAB trading scandal was one of the largest rogue trading scandals that shook the Australian market. The traders had concealed losses by entering into fictitious one-sided currency transactions. The Australian Prudential Regulation Authority (APRA), the regulatory body for banks, condemned the bank for its lax management, as it had ignored the warning signs of irregular currency options trading practices. The objective of this case is to allow a discussion of issues such as the important elements for good corporate governance, board oversight, internal control and risk management.

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## **Background**

Headquartered in Victoria, Australia, NAB provides personal and business financial services, including credit cards and loans. It has expanded globally and established its presence in New Zealand, Asia, the United Kingdom and United States with over 12 million customers and 50,000 employees<sup>1</sup>.

## **The Corporate and Investment Banking Division**

The Corporate and Investment Banking Division (CIB) was set up to handle large corporate clients, banks, financial institutions and other government bodies. CIB services and products include debt financing, financial risk management products and investor services and products<sup>2</sup>.

Within the CIB, the Market Division provides clients with various traded financial products and risk management solutions, covering foreign exchange, money market, commodities and financial derivative products. The foreign currency trading department operation was split into 2 main trading desks, the spot foreign exchange desk and the currency options desk, where the scandal and foreign exchange loss arose.

The currency options desk at that time operated on a 24-hour basis from two places, Melbourne and London. Trading activities occurred mainly within the interbank market; nonetheless, it also had several non-bank clients. The customer business originated from the Bank's branches and subsidiary banks from around the world and was passed to the currency options desk.

## **The Risk Management and Internal Audit Functions**

The organisational structure of NAB dictated that the risk management responsibility such as the trading, profit and risk responsibility, had to be delegated to the traders with varying layers of supervision, monitoring and reporting procedures to be followed. This risk management philosophy was consistent with the approach widely used by other major financial institutes at that time.

Within the CIB division, the risk management function was disaggregated into smaller units that served the business units. Operations were split into different desks, which reported to CIB management and Group Risk Management separately. The Market Risk and Prudential Control Department (MR&PC) in CIB was responsible for ensuring the compliance of risk strategy.

It was the responsibility of the internal audit function to ensure effective operation and compliance with the bank's policies and procedures. The head of internal audit reported relevant information, problems and recommendations mainly to four parties, namely the Principal Board Audit Committee (PBAC), Central and Regional Risk Management Committees, the CEO and the Group Risk Management.

## **The Methods of Concealment**

Three principal methods of concealment were used. Initially, smoothing of earnings was done through entering incorrect dealing rates into the system. This allowed profits and losses to be shifted from one day or one period to another. Thereafter, two more methods were employed: processing false spot foreign exchange and false option transactions.

The traders discovered that there was a one-hour window between the bank's close-of-day and the review time. The bank's end-of-day close was at 8am and the Operations division (back office) would start reviewing the transactions at 9am. This one-hour period allowed them to manipulate the profits recorded.

The *modus operandi* was to enter genuine spot foreign exchange transactions with incorrect transaction rates. During the one-hour period, this incorrect information would be amended to the actual rates. The profits or losses recorded in the general ledger would be incorrect because they were recorded according to end-of-day valuations. Since the general ledger did not get restated after these amendments, these concealments would go unnoticed<sup>3</sup>.

A second method of concealing losses was the use of one-sided transactions. In September 2003, the traders lost heavily on the bet that the Australian and New Zealand dollars would fall against the US dollar. The traders then entered one-sided transactions to disguise their true loss position. The one-sided transactions with other divisions within NAB worked by first entering a false transaction at only their end of the position, with no offsetting position created in other divisions. These one-sided transactions were subsequently 'surrendered' during the one-hour window before the bank office checks took place<sup>4</sup>.

By 'surrendering' these transactions, the back office checks would not reveal any discrepancies. These figures would still be posted to the general ledger and used for management reports as well as the preparation of financial statements. The accounting entries for transactions that were 'surrendered' were reversed; however, the transactions recorded remained in place. Using this method, the traders were able to record false profits and losses on the same day. When the transactions were surrendered the following day, the false profit was reversed. By creating and surrendering these transactions on a daily basis, the false profit or losses was rolled forward and the real position could be concealed.

Other methods of concealment included the revaluation of the portfolio using incorrect rates and entering false option transactions<sup>5</sup>.

## The Failure of Risk Management and Internal Control

Risk management controls were overridden. NAB required proper approval from Market Risk & Prudential Control (MR&PC) before traders could engage in transactions that involved new products. However, the rogue traders did not seek approval from MR&PC. Despite this concern being raised by MR&PC to their supervisor, no action against the traders was taken. In fact, MR&PC was pressured to approve the options transaction. Although MR&PC eventually did not approve these transactions, they were overridden when the head of global markets gave his approval.

It was also found that the supervisors, such as the General Manager of the Markets Division, had failed to follow through the entire review procedure. Monitoring was simply limited to headline profit and loss statements, suggesting that there was a lack of understanding with regard to the underlying risks undertaken by the traders. In fact, the management simply attributed smooth profit to the successful implementation of the department investment strategy.

Furthermore, the reliability of Value-at-Risk (VaR) was being questioned because there was a conflict of opinion between MR&PC and the currency options desk. This resulted in the VaR currency trading limit breaches being removed from the front page of daily risk reports. At the same time, many VaR limit breaches were committed by the traders and these breaches were simply approved by the trading and global products head. This matter was exacerbated by the little urgency and attention given for the resolution of these differences in opinion. It was only in October 2003 that the issue was included on the agenda of the CIB Risk Management Executive Committee, which was then further postponed to January 2004. This enabled the traders to get away with these limit breaches as the mechanisms in place to monitor risks fell apart. In hindsight, all false one-sided transactions were actually captured by the VaR algorithm, but disregarded.

Finally, in October 2003, MR&PC identified an unusual sale with another bank for a premium of A\$322 million. The traders clarified that this transaction was required to finance some other positions and the issue was not pursued further. The lack of supervision had enabled the traders to exploit the systems in place further.

In its May 1999 report, Internal Audit rated currency options as ‘unsatisfactory’, and highlighted several 3-star issues, which were defined as “Serious matters for the attention of the Managing Director and reportable to the Board Audit Committee”<sup>6</sup>. The weaknesses identified included the inability to reconcile profit and loss between the front and back offices, the exclusion of volatility smile (observed pattern of options) in revaluations and the lack of independent monitoring of risk concentrations. The report further stated that review processes were unsatisfactory, as many of these issues surfaced due to “an inadequate control framework.in currency options”.

In its June 2000 quarterly audit report to PBAC, Internal Audit stated that the weaknesses in May 1999 had been rectified by management. Following this, in the December 2001 audit report, Internal Audit gave an overall rating of ‘adequate’ for the foreign exchange business, including currency options. Two 3-star issues in relation to currency options were identified - limit breaches occurred daily (for 61 out of 61 days), and incorrect VaR numbers produced. The daily limit breaches were not explained, and the incorrect VaR was attributed to the non-usage of volatility smile. At the same time, the Head of Internal Audit introduced a new rating system i.e. a ‘three star plus’ for all issues in the range of A\$5 to A\$30 million in place of the current A\$1 to A\$30 million.” As a result of the new rating criteria, the number of issues for PBAC consideration was reduced from 70 to 21, and the two remaining 3-star currency options issues were not reported to PBAC.

In the January 2003 audit report, no significant matters on currency options were highlighted. However, the report raised a new issue “Currency options desk operating limits need to be reviewed”, rated as 1-star (thus reported only to business unit management). It was evident from the report that the limits were still being breached. NAB held the view that the limit breaches were due to inappropriate design of the limits and not due to a disregard for the limits. NAB also felt that the breaches would be eliminated with better-designed limits.

Due to the low ratings assigned by Internal Audit to the currency options issues (1-star instead of 3-star), PBAC was not alerted to the limit breaches even though it continued to occur in 2001 and up until 2003.

## **Profit-driven Management**

Breaches of higher limits occasionally reached a higher level of management. These transactions would then be approved by the head of global markets, as mentioned previously. The management seemed to have informally consented to these limit breaches by the traders since nothing was done to stop their actions. This cultivated a culture where the traders could flout the standards of the bank and felt free to engage in risky behaviour because there were seemingly no consequences.

Management seemed to focus heavily on the profits and ignore the potential problems. They were keen to protect their bottom line and disregarded the risks and possible slipups in their internal management.

The culture of poor adherence to rules, responsibility shirking and suppression of bad results was partly a consequence of the profit-oriented culture. As such, the risk committee chairman, Graham Kraehe, acknowledged that the board should bear full responsibility for the culture at the bank.

## Where was the Board?

Management simply kept the directors in the dark. Additionally, the directors trusted the management deeply and relied only on information and reports supplied by management.

Collectively, the inaction of both parties allowed the scandal to go unnoticed for a long time. The directors were so trusting that they even failed to ask for the annual management letter from the external auditor when the management did not provide it. The board would have been alerted to the concerns KPMG had with regards to the foreign trading desks, as early as 2001 when it was first noted in the management letter, if they had insisted on reviewing the annual management letter.

The two principal board committees – risk and audit –also failed to probe further and provide sufficient oversight for the audit and risk management activities in the firm. During the Principal Board Risk Committee (PBRC) meeting in November 2003, management assured the committee that the VaR was safely within the limits for the Markets Divisions as a whole. The committee was unaware of the currency option desk’s risk limit breaches. Had the audit and risk committees actively sought information and provided oversight over their areas of responsibilities, they probably would have discovered the warnings from internal audit and the risk management department.

When other Australian banks and the Australian Prudential Regulation Authority (APRA) raised their concerns about the large and unusual currency transactions of NAB in 2002 and 2003, NAB sat on these concerns and no further investigations were conducted by management in response. Moreover, the head of global risk management dismissed APRA’s request to enforce compliance with risk management policies and credit limits. In addition, a letter was sent in to APRA containing misleading information to conceal limit breaches committed in December 2003. All these decisions were made without seeking the advice of the board. NAB’s management downplayed both the market’s and APRA’s warnings, along with other internal warnings from the internal audit and risk management departments.



The feedback from APRA was directed to Chairman Allen. Some key issues that were highlighted included lax approach to limit management, non-adherence to risk management policies, absence of formal model validation, insufficient back-testing for the approved VaR model, and valuation of NAB's portfolio using front office's information. Without consulting the Board or the risk committee, the responsibility for preparing a response to APRA was delegated to the head of global risk management. Although, most of APRA's feedback given was within the Board's area of responsibility, they were not notified. Furthermore, the risk manager's reply to APRA suggested that most of the issues were either insignificant or had been addressed, when in fact, neither the Board nor the Management had done anything.

## **Aftermath**

In January 2004, the firm announced that it had uncovered losses of up to A\$185 million. The majority of the fictitious trades had occurred between October 2003 and mid-January 2004. A revaluation of the options portfolio raised the options losses to A\$360 million.

According to NAB Chief Executive Frank Cicutto, weak internal controls enabled the traders to carry out the fraud. The losses had stemmed from a punt on the value of Australian and New Zealand dollars, and the four traders – Bullen, Duffy, Ficarra and Gray - had sought to cover the losses with unauthorized trades on NAB's account.

## **Epilogue**

The four traders who were involved in the scandal were prosecuted in court and received jail terms of between 16 to 44 months<sup>7</sup>. NAB was also required to comply with 81 special APRA remedial requirements<sup>8</sup>. A new executive committee was put together<sup>9</sup> as the firm looked towards rebuilding its culture<sup>10</sup>.

## Discussion Questions

1. Evaluate the effectiveness of the board at NAB.
2. Were there other aspects of corporate governance at NAB that were problematic?
3. In 2003, the currency option control issues were not reported to Principal Board Audit Committee (PBAC) despite it being a “3-star” problem. The Internal Audit function believed that the monetary value of this issue to be less than A\$5 million threshold. Was the reliance of the PBAC on Internal Audit to screen the firm’s control issues reasonable? Should PBAC only have reviewed issues with a “3-star” and above rating? Discuss the impact of using such a screening mechanism on NAB between 1999 and 2004.
4. In your opinion, what has to be done to improve the corporate governance at NAB?
5. Prior to the NAB trading scandal, rogue trader Nick Leeson’s unauthorised trading led to the collapse of Barings Bank. More recently, Societe-Generale, UBS and JP Morgan also reported massive losses from unauthorised trading. Why do such trading scandals continue to happen in banks? Are banks too complex to govern and manage well?

## Endnotes

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- <sup>2</sup> CIB employed some 2,600 people and generated around A\$1,000 million in net profits before tax.
- <sup>3</sup> Investigation into foreign exchange losses at the National Australia Bank, 12 Mar 2004, *PricewaterhouseCoopers*
- <sup>4</sup> Comanescu, A, An Inquiry into the Nature and Causes of National Australia Bank Foreign Exchange Losses, Nov 2004, retrieved from <<http://qed.econ.queensu.ca/pub/faculty/milne/872/Comanescu%20FinalMA%20paper.pdf>> accessed 20 Dec 2012
- <sup>5</sup> NAB- FX Options, Apr 2009, *PRMIA*, <[http://prmia.org/pdf/Case\\_Studies/National\\_Australia\\_Bank\\_Short\\_Version\\_April\\_2009.pdf](http://prmia.org/pdf/Case_Studies/National_Australia_Bank_Short_Version_April_2009.pdf)> accessed 20 Dec 2012
- <sup>6</sup> Control issues were accorded ratings of 1-star to 4-star, with issues given a higher star rating more serious. Only issues given a 3-star rating or above were reported to PBAC.
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# Call 0 for One.Tel

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## Case Overview

One.Tel was the fourth largest telecommunications company in Australia before its collapse in 2001. The management of One.Tel was able to conceal signs of financial distress in the company, arguably due to poor corporate governance in a number of areas, including board composition, board committees, internal controls, audit, and executive remuneration. The objective of this case is to allow a discussion of issues such as board independence, board committees, executive remuneration, role of auditors and regulatory enforcement.

## One.Tel: the Beginnings

One.Tel was an Australian telecommunications company founded by Rodney Adler, Jodee Rich and Brad Keeling on 1 May 1995. Created soon after the 1993 deregulation of the Australian telecommunications industry, One.Tel positioned itself as a low cost mobile phone service provider. The company successfully launched an initial public offering to sell its shares on the ASX at A\$2 per share, less than three years after it was founded.<sup>1</sup>

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This is the teaching notes of a case prepared by Corine Tay, Krishnasruthi Srivalsan, Tan Huijie, Teng Yun Ting, Yee Guan Wei and Yong Lin Lin under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Low Jiemin under the supervision of Professor Mak Yuen Teen.

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One.Tel's business model was based on reselling excess phone capacity purchased from major telecommunications companies, such as Telstra and Optus. By engaging in predatory pricing, aggressive marketing as well as liberal extension of credit to customers, One.Tel aimed to secure a large market share in terms of number of customers. By the financial year (FY) ended 1997, One.Tel's customer base had increased from 1,000 in 1995 to 160,000, with sales revenue totalling A\$148 million.<sup>2</sup>

One of One.Tel's major revenue drivers was a favourable deal forged with Optus, enabling it to offer discounted mobile phone coverage to customers via the Optus network. Optus promised One.Tel 'loyalty bonuses' of A\$120 for every new customer signup. One.Tel's sales staff were rewarded with hefty commissions. Insiders revealed that these commissions led to employees paying people A\$10 just to sign up with the company.<sup>3</sup> Under its aggressive marketing policy, One.Tel readily took on customers such as the unemployed, teenagers and international visitors, suggesting that it rarely took creditworthiness of their customers into consideration. As a result, One.Tel experienced high default rates. In addition, One.Tel used the relatively high margins on other products to counter its loss-making services. These services were loss-making as One.Tel used price-cutting as a strategy to retain customers.<sup>4</sup>

A dispute later arose between One.Tel and Optus which resulted in the termination of the contract with Optus as their exclusive mobile service provider. One.Tel then decided to create its own mobile telephone network rather than depend on reselling established telephone services.

In 1998, One.Tel launched its 'Global Strategy' to enter the lucrative global market with an expansion into Europe.<sup>5</sup> On 23 November 1999, Lucent Technologies announced a decision to finance One.Tel to build a European mobile network at a cost of US\$20 billion. On the same day, One.Tel was ranked the 30th largest listed company in Australia with a worth of A\$3.8 billion. After a 10-to-1 share split on 10 May 1999, One.Tel shares reached a new high of A\$2.84 on 26 November 1999, with a total market capitalization of A\$5.3 billion.<sup>6</sup>

One.Tel also acquired licenses to build its mobile network in Australia with the assistance of News Ltd and Publishing and Broadcasting Ltd (PBL). In March 2000, they spent A\$523 million on purchasing telecommunication licenses, ten times the amount paid by competitors for acquiring similar licenses.<sup>7</sup>

## **Board and Management Structure**

In 1998, One.Tel had four members on the board: Jodee Rich and Brad Keeling as Managing Directors, and Rodney Adler and John Greaves as non-executive directors. All board members were subjected to election each year, except Jodee Rich. This ensured that as the Chief Executive Officer (CEO), he will not be able to be removed by shareholders.

At the end of June 1999, One.Tel had increased its board size to eight members. Among them, five were non-executive directors. Two of the newly appointed non-executive directors were from the two largest investors in One.Tel, James Packer (Chairman of PBL) and Lachlan Murdoch (Chairman of News Limited). James Packer, Rodney Adler and Jodee Rich were high school mates.<sup>8</sup>

## **Board Committees**

The Finance and Audit Committee, Remuneration Committee, and the Corporate Governance Committee consisted of only two members, Rodney Adler and John Greaves, who had close links with the CEO. This was despite the fact that there were three other non-executive directors. Both Adler and Greaves had business connections with One.Tel, indicating that they were not independent directors. The Finance and Audit Committee met three times a year, while the Remuneration Committee and the Corporate Governance Committee met only once annually.<sup>9</sup>

## Executive Remuneration<sup>10</sup>

In FY1999, remuneration paid to the three executive directors and chairman of the board totalled A\$2.3 million, one-third of the operating profit after tax that year. On 15 February 1999, James Packer and Lachlan Murdoch, through PBL and News Limited respectively, agreed to invest A\$430 million immediately and another A\$280 million in future, in exchange for 40% of One.Tel's shares. Two days before the news broke, One.Tel's share price rose from A\$9.80 to A\$13.55. As a result of the deal, Rich, Keeling and Packer received combined bonuses of \$82.5 million.

For FY2000, One.Tel executives were paid A\$14.2 million in performance bonuses tied to share prices, despite the company making a loss of A\$291 million. In order to avoid public scrutiny, these bonuses were treated as deferred expenditure and setup costs (to be capitalized) associated with One.Tel businesses across Europe and Australia.

One.Tel's directors were also granted options on very easy terms and exercised options regularly. In FY2000, One.Tel's top six executives were granted 8.2 million options valued at A\$15.9 million.

## Financial Reporting and Internal Controls

Jodee Rich relied on other managers to report matters to him instead of reviewing the firm's financial and accounting records himself. Even the finance director, Mark Silbermann seldom reviewed One.Tel's financial and accounting records.<sup>11</sup>

One.Tel also had a higher accrual component in its earnings as compared to competitors of similar size. In 1998 and 1999, One.Tel had large positive accruals amounting to 18% of total assets compared to 7% of competitors' total assets, leading to positive earnings. In contrast, its competitors, Optus and Hutchison, always had negative income-decreasing accruals.

In FY1999, previously expensed costs of establishment for business operations were capitalised and amortised (over a period not exceeding three years). This change in accounting policy helped the company to transform a A\$25.4 million loss to A\$6.9 million profit by capitalizing A\$32.4million of costs of establishment.<sup>12</sup> In FY2000 however, One.Tel had to write off these costs because the Australian Securities and Investments Commission (ASIC) was not agreeable to this accounting policy change, resulting in a loss of A\$291.1 million.<sup>13</sup>

## **External Auditors**

BDO Nelson Parkhill issued an unqualified opinion throughout the years as One.Tel's external auditor. In addition to relatively high audit fees, the firm received additional fees for non-audit services, which accounted for more than 40% of the total fees they received.<sup>14</sup> An investigation by both ASIC and the Institute of Chartered Accountants of Australia (ICAA) discovered that One.Tel had deferred A\$48 million of expenditures and concealed a loss of more than A\$40 million. The audit partner, Steven La Garca, as well as BDO were fined A\$48,000 for breaching the Australian accounting and auditing standards.<sup>15</sup>

In January 2001, One.Tel changed their auditors to Ernst & Young (E&Y) because they wanted 'a big name to sign off the accounts'.<sup>16</sup> However, E&Y's chairman, Brian Long, had a long association with Kerry and James Packer, as well as Packer controlled company, PBL, which had a substantial interest in One.Tel. Long had been the auditor for PBL for nearly nine years.<sup>17</sup>

## **Mayday Calls**

In June 2000, the company recorded a loss of A\$291 million, despite sales revenue doubling to A\$654 million. In October 2000, Merrill Lynch warned that One.Tel was in danger of running out of cash. In February 2001, the company revealed that it had lost A\$132 million in the period from July to December 2000, and Merrill Lynch predicted that they would run out of cash by April 2001. However, during the board meeting on 30 March 2001, directors James Packer and Lachlan Murdoch were informed that 'everything was fine'.<sup>18</sup>



In November 2000, Steven Gilbert resigned from the board after he made A\$85 million. He had lent the company \$60 million in 1998 and then converted his stake into 135.9 million shares at A\$0.35, well below the then price of A\$2.40. He then sold his shares throughout 1999 and 2000.<sup>19</sup> John Greaves resigned from the board in March 2001. Rodney Adler sold more than 5 million shares in October 2000 and another 5 million One.Tel shares in February 2001. He quit the board nine days after Greaves, and dumped another 6 million shares for A\$2.2 million.<sup>20</sup> In the board meeting held on 17 May 2001, both managing directors Jodee Rich and Brad Keeling resigned.<sup>21</sup>

On its last trading day, 25 May 2001, One.Tel's shares closed at \$0.16.<sup>22</sup> On May 28, One.Tel was taken off the Australian Stock Exchange after an ASIC investigation revealed its insolvency. On 29 May, auditors E&Y estimated that One.Tel needed another A\$240 to A\$370 million to stay afloat for the next six months.<sup>23</sup> The next day, One.Tel ceased operations.

## The Last Board Meeting

On 29 May 2001, a board meeting was held together with creditors and equipment supplier Lucent Technologies to negotiate a possible rescue deal. The Board, including Silbermann, unanimously agreed that the A\$132m initially promised by PBL and News Limited at the board meeting on 17 May, would not be enough to keep the company solvent, and agreed not to proceed with it. The A\$132m injection of cash could only have seen the company through for 6 months with a A\$9m buffer. However, News Limited and PBL only agreed to underwrite the issue based on One.Tel needing A\$60m, and the extra A\$72m was meant to be a buffer.<sup>24</sup>

## Legal Action

In 2009, ASIC took legal action against Jodee Rich, Brad Keeling, Mark Silbermann and John Greaves.<sup>25</sup> Keeling was found to have breached his duties as a director by not informing the board of the dire financial state of the company and was ordered to pay A\$92 million in compensation.<sup>26</sup> Greaves, on the other hand, settled the matter out of court.<sup>27</sup> At the same time ASIC was unsuccessful in proving that Rich and Silbermann failed to act with due care and diligence in providing the board with information about One.Tel's financial position.

In the court hearing, it was found that monthly financial reports did not routinely include the cash balance nor provide information on outstanding creditors, trade receivables, or ageing of debtors. The bi-monthly board meeting papers had information on cash balances and monthly cash usage, but unrepresented cheques were not taken into account. Management did not clarify whether these cash balances excluded unrepresented cheques, and directors did not enquire about the exact cash balances. Rich did not review monthly management accounts when he was One.Tel's managing director<sup>28</sup> and relied on the advice of senior executives<sup>29</sup>.

## Recent Developments

James Packer and Lachlan Murdoch and their associated companies are still being pursued by One.Tel's liquidators for nearly A\$400 million for their involvement in the collapse of One.Tel. The lawsuit revolved around their decision to abandon a rights issue to raise A\$132 million capital shortly before One.Tel's collapse in 2001. The case was lodged in June 2012 by a special purpose liquidator, who was appointed in late 2003 by the New South Wales Supreme Court.

The whole liquidation process has already gone on for more than a decade. Liquidators are currently sitting on about A\$15 million in cash. This is all creditors are expected to receive unless the special-purpose liquidator wins the case.<sup>30</sup>

## Discussion Questions

1. What are the factors which contributed to the collapse of One.Tel?
2. Evaluate the independence of the external auditors (BDO Nelson Parkhill) and whether you believe they played a role in the collapse of One.Tel.
3. Evaluate the independence of non-executive directors James Packer and Lachlan Murdoch and whether it contributed to the effectiveness (or lack of) of the board.
4. Comment on the composition of the board committees of One.Tel.
5. One.Tel executives were paid A\$14.2 million in bonuses based on share price performance even when the company was making a loss. Do you think executive bonuses should be paid based on share price, profit or some other basis? Give reasons for your answer.
6. In your opinion, do you think that that ASIC was right in suing the directors? Discuss the importance of enforcement in improving corporate governance,

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# Olympus: Caught in the Act

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## Case Overview

On 14 October 2011, Michael Woodford was removed as CEO and Company President of Olympus Corporation<sup>1</sup>. Olympus' official reason for firing Woodford was that there existed cultural differences between Woodford and the management over the direction and conduct of Olympus' business. Woodford argued that he was removed because he blew the whistle over accounting irregularities associated with several suspicious acquisitions. On 8 November 2011, Olympus admitted to inappropriate accounting practices whereby funds were used to cover investment losses as far back as the 1990s. Shortly after, Kikukawa resigned from his positions as CEO, President and Chairman of Olympus. This incident raised concerns over the usage of "Tobashi" schemes and the weakness of corporate governance in Japan. The objectives of this case are to allow a discussion of issues such as the effectiveness of the board of directors (with reference to independence, long tenure and diversity), whistleblowing, external auditors' relationship with a company, effectiveness of internal audit and shareholder activism.

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This is the abridged version of a case prepared by Cynthia Yeo, Deborah Chew, Grace Chew, Quek Yong Xin, Sophia Soh, Soong Kah Weng, Marie Tan and Teoh Hui Qing under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Cynthia Yeo Li Tian under the supervision of Professor Mak Yuen Teen.

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## Beginning of the Saga (1980s – 90s)

After the signing of the Plaza Accord in 1985 by the G-5 countries, the Yen appreciated sharply against the US dollar. Export prices rose sharply, weakening competitiveness and profits of many exporters, including Olympus. Determined to beef up profits, many Japanese firms started employing “Zaitech”, a speculative investment strategy, whereby firms invested spare cash to compensate for dwindling earnings. Olympus was no exception. This eventually created a bubble economy<sup>2</sup>.

The then President, Toshiro Shimoyama (January 1984 - June 1993), employed aggressive financial management strategies. On 20 May 1987, the management committee decided to pursue “Zaitech”. Together with Hideo Yamada, then Assistant Manager of the Finance Group in the Accounting Department, and Hisashi Mori, who led the investment department, the company invested in domestic and foreign bonds, specified money trusts and other financial instruments.<sup>3</sup>

Consequently, when the bubble economy burst in the early 90s, losses escalated as investments turned sour. The estimated unrealised losses were in tens of billions of yen. Olympus conveniently swept them under the rug and reported false profits<sup>4</sup>.

Matters got worse when Japan moved towards fair value accounting. Companies had to value financial instruments on a mark-to-market basis instead of acquisition cost basis by 1999. Olympus would have had to take a huge valuation loss of ¥95 billion under the new accounting rules<sup>5</sup>. Eventually, the losses were of such great magnitude that Olympus had no choice but to continue with its fraudulent accounting practices in order to hide the losses.

Together with senior management of Olympus, the team manipulated the balance sheet figures through “Tobashi” schemes. “Tobashi” literally means to “fly away” with the losses<sup>6</sup>. This was a covert affair that was handled only by a select few. Yamada and Mori would submit periodic status reports on the losses to key management figures<sup>7</sup>.

## **The Reign of Tsuyoshi Kikukawa (2000s)**

Both President Masatoshi Kishimoto (June 1993 to June 2001) and President Tsuyoshi Kikukawa (June 2001 to 2011) were found to be aware of the “Tobashi” schemes. Kikukawa gave his stamp of approval and instructed Yamada and Mori to continue suppressing the matter<sup>8</sup>.

Yamada served multiple positions - as Head of (Internal) Audit Office, Corporate Auditor, Head of Administration Management Division, as well as Officer in Charge of Audits<sup>9</sup>. Mori served as Executive Vice President and Compliance Officer among other positions. The duo had also held appointments as Corporate Centre Managers for many years.

Having vast knowledge of financial management, they were able to monitor the losses from their positions in the Finance Department<sup>10</sup>. Over a period of 13 years<sup>11</sup>, they hid losses, booked overstated goodwill and manipulated the financial statements.<sup>12</sup>

## **The Board of Directors**

Before the revelation of the scandal, the Board of Directors consisted of 15 male members, including Kikukawa (Chairman and CEO), Woodford (President and COO), Mori and three outside non-executive independent directors.<sup>13</sup> The number of outside directors was considered high in Japan. The only person on the Board with substantial experience and background in finance and accounting was the director in charge of finance and accounting himself.<sup>14</sup> The presence of the three independent directors was considered to be above the average of a Japanese company because the Company law<sup>15</sup> in Japan did not stipulate a minimum number of independent directors. A typical Japanese-style board of directors is usually composed of internally promoted directors. Olympus had such a board, with many directors having served many years as employees in the company, coupled with the lack of job rotation.<sup>16</sup>



There were other corporate bodies established in addition to the Board of Directors. Before a management structure revision in 2001, there were the Management Committee (MC) and the Board of Managing Directors (BOMD).<sup>17</sup> The MC comprised all members of the BOD and the Board of Auditors (Audit Committee). The MC deliberated on the policies that were to be decided on by the BOMD and key management issues in the area of operations. Items requiring resolutions to be passed had to be raised to the BOMD. The BOMD was composed of persons above Managing Directors and were seen to be ranked higher than those in the normal BOD. They were in charge of all the most important decisions. In essence, the Board and the Management Committee had become underlings of the BOMD, making the BOMD the highest decision-making body within Olympus for day-to-day execution of operations.

The Management Implementation Committee (MIC) was formed in 2001 following the revision which eliminated the MC and the BOMD. The MIC had an average of 7 to 8 members and comprised of the Chairman of Olympus Corporation, president, vice-president, group presidents (presidents of subsidiaries and related companies), as well as centre managers. Likewise, the MIC was established to isolate the execution of daily operations from the BOD. They decided on agenda items that were not to be resolved by the BOD. The purpose was to discuss on key management items together, thus preventing the president of the corporation from being the sole decision maker<sup>18</sup>.

Directors may voice their opinions at Board meetings but Kikukawa always had the final say. He also decided the appointments of directors and management executives and the remuneration of individual directors. When the issue of extraordinary losses being posted was brought up during the 780<sup>th</sup> Board of Directors Meeting, questions were raised. However, because Kikukawa approved the posting, objections were not voiced out and the resolution was passed successfully. Any concerns with regards to acquisitions were also not acted upon once Kikukawa showed his approval, with the go-ahead given without much deliberation<sup>19</sup>. The corporate culture in Japan is such that one places significant trust and dependence on his leader. Critics have long felt that this would result in a domineering behaviour of leaders over employees, creating a “Yes” culture<sup>20</sup>.

## The “Tobashi” Scheme Revealed

The “Tobashi” scheme was used widely in Olympus. To make it work, Olympus first had funds set up in Europe, Singapore and Japan. Thereafter, Olympus would deposit funds in the form of bonds to various banks in these countries. These banks would then extend loans to Olympus’ funds. Subsequently, these funds purchased bad assets off Olympus’ balance sheet<sup>21</sup>. Gross overpayment of acquisition deals was then used to circulate money spent on these deals back into Olympus to close out the missing values.

In 2008, Olympus bought Gyrus Group, a medical equipment maker in Britain, at a cost of US\$2.2 billion<sup>22</sup>. The amount was equivalent to almost 5 times its turnover and 27 times the EBITDA of Olympus for FY2008<sup>23</sup>. Furthermore, an acquisition fee of US\$687 million, equivalent to approximately 36.1% of the purchase price, was disbursed to two small companies, Axes America LLC (US\$17m) and Axam Investments Ltd (US\$670m), which were incorporated in USA and Cayman Islands respectively. In contrast to the usual 1 to 2 percent fees for mergers and acquisitions (M&A), this was the highest M&A fee ever disbursed<sup>24</sup>. Three months after receiving the final payment from Olympus in June 2010, Axam was struck off Cayman Islands’ company registry for non-payment of registration fees.<sup>25</sup>

During that year, Olympus also spent US\$773m on the acquisition of three other small venture firms that were unprofitable and seemingly unrelated to the core competencies of Olympus – Altis, Humalabo, and NewsChef. Subsequently, these investments were written down by US\$586m to only 25% of the value.<sup>26</sup> The gross overpayment for assets and generous fees worked out to be at least US\$1.5b for the acquisitions of Gyrus and the three unprofitable companies<sup>28</sup>. Olympus’ revelations recall the practice of concealing impaired investments known as “Tobashi” that became widespread in Japan in the late 1980s.<sup>27</sup>

## **Black October – When Things Started to Crumble (2011)**

With Woodford's ascension to the position of CEO in Olympus, the company became one of the rare Japanese companies to have a foreigner at its helm<sup>28</sup>. This was big news and various rumours spread. Given the fact that Woodford could not speak Japanese<sup>29</sup>, dissenters said that he was appointed CEO because he would be “easy to control” by Kikukawa<sup>30</sup>.

Woodford was kept in the dark about various major decisions despite being the CEO. Two weeks into office, several suspicious acquisitions made by Olympus were made known to him through his German colleagues, instead of executives or directors in Tokyo. His German colleagues had emailed him about an article in a little known Japanese business journal called Facta Magazine. The article highlighted the extraordinarily high payments and acquisition fees for the acquisition of Gyrus and the three small domestic companies<sup>31</sup>.

From 23 September to early October, Woodford sent several letters to the Board asking about the questionable accounts. At the same time, he provided PricewaterhouseCoopers (PwC) with the necessary documents and asked them to investigate the acquisition of Gyrus shares. On 11 October 2011, when PwC came back with the interim report concluding that there is a “possibility that improper acts took place”<sup>32</sup>, Woodford sent letters to Kikukawa, Mori, external auditors Ernst & Young (EY), and the general counsel requesting the resignation of the officers responsible for the improper acts, namely Kikukawa and Mori<sup>33</sup>.

## **A Dramatic Exit**

On 14 October 2011, the directors held a special Board of Directors' meeting, which was supposedly regarding the acquisitions<sup>34</sup>. However, the agenda was quickly replaced to discuss Woodford's removal from his posts of president, representative director and CEO, with Woodford not allowed to vote since he was an interested party. Approval was unanimous with Olympus' official reason for firing Woodford being existing cultural differences with Woodford as he was a foreigner, and that his management style clashed with the other Japanese executives<sup>35</sup>. Woodford had to clear his desk and leave Japan immediately.

After his departure from Olympus, Woodford blew the whistle on the acquisitions to the UK's Serious Fraud Office (SFO) with all the evidence he had. Investigations by the SFO, and subsequently the FBI, triggered the Tokyo Stock Exchange (TSE) to demand full disclosure of the deals in late October 2011, which heightened the fears of investors. As a result, Olympus set up a panel to examine the allegations on 1 November 2011. The company's share price tumbled by as much as 80%<sup>36</sup> since the start of the scandal, hitting an all-time low of US\$9.05 on 8 November 2011<sup>37</sup>.

On 8 November, Olympus finally admitted to using the various acquisitions to cover up losses<sup>38</sup>. On 24 November, the company announced the resignation of Yamada, Mori and Kikukawa - who had been reinstated as President and CEO after the Woodford's dismissal - from their management and board positions. Shuichi Takayama took over as President and CEO after Kikukawa's resignation.

## **Whistleblowing Policy**

A whistleblowing 'Help Line' and whistleblower system had been in place in Olympus since November 2005, after the whistleblower protection law was passed in Japan in 2004<sup>39</sup>. The Help Line seemingly ends at the Compliance Office, headed by Compliance Officer Mori<sup>40</sup>.

However, the culture in Olympus was one where employees did not dare to express opinions different from those at the top. Employees did not dare to express their opinions against their superiors, especially since Mori also helmed the Compliance Office<sup>41</sup>. Although the Help Line accepted cases reported anonymously, investigations could only commence if the identity of the whistleblower is revealed for matters that required investigations<sup>42</sup>. Unsurprisingly, there were cases withdrawn after employees were informed of this policy.

## **The Fight was over before it Began**

On 30 November, Woodford resigned from the Olympus board and prepared for a proxy fight to reform the board and restructure the management of the company<sup>43</sup>. Despite the resignations of those involved in the accounting malpractices, the other directors could retain their positions.<sup>44</sup>

It turned out to be an uphill battle. Ownership of the company was very diffused, with 49.68% of the shares held by domestic financial institutions and 27.71% held by overseas institutional investors. The largest institutional shareholder was Nippon Life Insurance Co., which held 8.26% of the shares.<sup>45</sup> Woodford failed to win the support of any of the local financial institutions. This was attributed largely to the corporate practices of Japan, where major institutional investors do a great deal of business with companies they invest in and are collectively linked to various keiretsu or have many cross-shareholdings<sup>46</sup>. Thus, they are hesitant to offend management with whom they have strong relationships<sup>47</sup> with and shareholder activism is frowned upon<sup>48</sup>. On 6 January 2012, Woodford gave up his fight<sup>49</sup>.

## Watchdog or Lapdog?

KPMG AZSA LLC (KPMG) was Olympus' appointed auditors from November 1974 to June 2009 and Ernst and Young ShinNihon LLC (EY) replaced KPMG as auditors for the year ended 2010<sup>50</sup>. Although accounting manipulations started years before the scandal was exposed, Olympus had always received clean opinions<sup>51</sup>. An independent panel set up to investigate the scandal had, however, concluded that both auditing firms did not contravene any legal obligations<sup>52</sup>.

The audits, however, were not always without conflicts. On many occasions, KPMG battled with the company's top management. In fact, KPMG discovered traces of Olympus' manipulative accounting treatment as early as 1999 after persistent questioning, but management had come up with excuses to shrug off the auditors' concerns<sup>53</sup>. Later, as the schemes grew wilder, Olympus impeded proper audits by providing incomplete documents and falsified statements<sup>54</sup>. Meetings over accounting matters related to the high advisory fee of US\$687 million for the Gyrus acquisition and steep payments for the three domestic companies were held in 2009, but KPMG was not able to establish Olympus' relationship with Axam Investments<sup>55</sup>. Olympus then decided to replace KPMG with E&Y. In July 2009, when E&Y took over, they similarly had queries about Gyrus and Axam<sup>56</sup>. Again, due to insufficient evidence, they were unable to ascertain whether Axam was a related party.

The complexity of the transactions and the intentional smokescreen put up by management fettered KPMG's ability in doing its job, such that the independent panel ruled that they have carried out all relevant testing and had not neglected anything which they could possibly do<sup>57</sup>. The conclusion for E&Y, which had only audited Olympus for a short period, was similar<sup>58</sup>.

## Recent Developments

Following the series of investigations on the home front and abroad which are still ongoing, Olympus sued 19 former and current executives in February 2012<sup>59</sup>. Furthermore, three Olympus top executives<sup>60</sup> and four other bankers involved in the scheme were charged with fraud.<sup>61</sup> The Tokyo Stock Exchange did not delist Olympus because it did not reach the maximum ratio of liabilities to assets in the listing rules. Instead, it fined Olympus ¥10m (about US\$125,000) and put Olympus on 'security on alert' designation, giving Olympus three years to improve its corporate governance before facing potential delisting<sup>62</sup>.

An EGM was held on 20 April 2012 to appoint the new directors and management team.<sup>63</sup> However, Woodford regarded the change as insufficient since the new management team could have a major influence in board decisions. The new Chairman is Yasuyuki Kimoto, a former executive from Sumitomo Mitsui Financial Group, the main lender of Olympus.<sup>64</sup>

On 22 May, Olympus introduced new compliance measures. A new external helpline was introduced and headed by an independent attorney at law, who had no vested interest in the company. Moreover, a Compliance Committee was also established, comprising an external chairman, an external director and an external attorney. The committee's role is to advise the Board on new policies and methods related to compliance.<sup>65</sup>

With regards to its future, Olympus faces various uncertainties, and there is huge scepticism as to whether the new board and management can help Olympus recover. What is certain, though, is that Olympus faces a Herculean task to rebuild its previously excellent reputation so as to restore the confidence of people in Japan and around the world. Whether Olympus can succeed in restoring public confidence remains to be seen.

## Discussion Questions

1. What are the characteristics of an effective board of directors? Evaluate Olympus' board during the period when the accounting fraud was perpetuated against these characteristics.
2. What are some unique features of the corporate governance of a Japanese company like Olympus? How do they affect the quality of corporate governance?
3. Olympus had a whistleblowing system since 2005. What were the factors which may have limited its effectiveness? Would the changes introduced recently be sufficient to encourage whistleblowing in Olympus?
4. Discuss the role played by the external and internal auditors in the scandal. Could they have done a better job, and if so, how?
5. Why did the proxy fight waged by Woodford, fail? Under what conditions are such proxy fights more likely to succeed?



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# Woefully Unprepared: TEPCO and the Japanese Earthquake and Tsunami Disaster

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## Case Overview

A radiation disaster was triggered at Tokyo Electric Power Company (TEPCO)'s Fukushima Daiichi nuclear plant after a huge earthquake and tsunami hit Japan on 11 March 2011. This left TEPCO facing an imminent threat of bankruptcy as it was left saddled with compensation and clean-up costs, with figures that were in trillions of yen. In the face of a bankruptcy threat, its main bank and the Japanese Government swiftly stepped in to offer financial support. This sense of urgency contrasted greatly with the apathy of Masataka Shimizu, the Chief Executive and President of TEPCO. Shimizu did not even participate in the meetings of the top-level crisis management team or formally transfer his responsibility to a deputy. The objective of this case is to allow a discussion of issues such as board structure, board responsibilities, stakeholder versus shareholder capitalism model, and the significance of the external environment on the corporate governance of companies.

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## A Promising Start

TEPCO was founded in 1951. It soon expanded its services throughout the Kanto region, Yamanashi Prefecture and the eastern portion of Shizuoka Prefecture. When nuclear energy became a national strategic priority in 1973, TEPCO was well-positioned to capitalise on this new market opportunity. Fossil power plants for peak load supply were built around Tokyo Bay and nuclear reactors for base load supply were built in Fukushima and Niigata Prefectures. It had also expanded into the field of Liquefied Natural Gas, which reduces surplus generation capacity and increases capacity utilisation by developing pumped storage hydroelectric power plants.

Despite these developments, TEPCO posted its first ever loss of US\$1.44 billion in the year ended 31 March 2008 following the 2007 Niigata Chuetsu-Oki Earthquake,<sup>1</sup> when it had to close down its Kashiwazaki-Kariwa nuclear power plant.<sup>2</sup> At that time, TEPCO was the largest energy company in Japan in terms of total assets and the fourth largest in the world, with market capitalisation of over US\$38 billion and 38,000 employees.<sup>3</sup>

As of March 2011, TEPCO had 192 power stations in total, ranging from hydroelectric, geothermal, and nuclear to fossil fuels, with a total capacity of 64.988GW and a market share of 34.9% in Japan with US\$66 billion sales turnover.<sup>4</sup> However, a serious turn of events led to the downfall of TEPCO.

## The Unfolding of the Crisis

Disaster hit the east coast of Japan on 11 March 2011 at 14:46 Japan Standard Time in the form of an 8.9-magnitude earthquake, one of the largest in recorded history, and triggered a tsunami.<sup>5</sup> This resulted in close to 16,000 deaths, 27,000 injured and 3,000 missing<sup>6</sup>.

At the Fukushima nuclear plant, the tremors caused by the earthquake led to an automatic shutdown of nuclear power reactors 1, 2 and 3 at the Fukushima Daiichi nuclear plant and units 1 to 4 at Fukushima Daini. After the earthquake, the first tsunami struck the Fukushima Daiichi plant, and a 14-metre tsunami breached the seawall of 5.7 metres designed to protect the power plant. This knocked out the back-up diesel and emergency power supply, resulting in the power loss that caused the cooling pumps to malfunction. Despite this, early ministry and TEPCO reports insisted that there was no radioactive leak.<sup>7</sup> However, the danger level of the crisis at the Fukushima Daiichi nuclear plant was raised to seven the following day.<sup>8</sup>

Evacuation of citizens began and TEPCO began pumping seawater into the plant to cool the reactors down.<sup>9</sup> However, this caused the central cores of reactors to become irreparably damaged, and the situation worsened when fires broke out and aftershocks hit the power plant.

Over just three days, shares in TEPCO nosedived by 57%.<sup>10</sup> It lost US\$24 billion in market value. The ratio of sell orders to buy orders was 5:1. This happened despite the Bank of Japan announcing that it would inject US\$183 billion into TEPCO's banking system.<sup>11</sup>

## **TEPCO's Main Bank to the Rescue<sup>12</sup>**

When Sumitomo Mitsui faced liquidity problems in 1997 due to the Asian Financial Crisis, TEPCO, a company with the highest credit rating, pulled together close to US\$2 billion of funds financed at low rates from Western banks. This long-standing favour could finally be repaid to TEPCO, and the bankers wasted no time in offering a US\$27.4 billion emergency loan to the company.<sup>13</sup> Relief of this magnitude reflected the strong backing of banks and the government for the company and this led to an 18.3% recovery in Tepco's stock price.



## Missing in Action

Although about 300 workers struggled hard to cool down the nuclear reactors, Masataka Shimizu, the chief executive and President of TEPCO, did not even visit the crippled power plant.<sup>14</sup> Insiders reported that he did not join meetings of a top-level crisis management team established by the company and the government, or visit the team's offices inside TEPCO's central Tokyo headquarters.<sup>15</sup> Furthermore, he had not formally transferred responsibility to a deputy.<sup>16</sup> After the company reported a net loss of US\$15 billion attributable to the disaster at the Fukushima Daiichi nuclear plant, Shimizu resigned to take responsibility for the disaster.<sup>17</sup> This was the greatest loss ever reported in Japan by a non-financial company.<sup>18</sup>

## Mounting Debt and Government Bailout

There were increasing doubts as to whether TEPCO had the ability to pay compensation claims to the thousands of households and businesses adversely affected by the radiation leaks, leading to talks about the bankruptcy of the company.

TEPCO's liabilities were estimated to range between US\$49 billion and US\$306 billion. This meant that the liabilities could well exceed its assets of US\$186 billion. Moreover, the company also owed US\$96 billion to bondholders and bank creditors, accounting for a hefty 8% of Japan's total domestic debt market. If TEPCO went into bankruptcy, these debt holders would take precedence over the victims of the disaster.<sup>19</sup> Following news reports of the US\$7 billion loss expected in the financial year of 2011,<sup>20</sup> TEPCO's shares plummeted by 27.6%, a record-low which led to fears of the delisting of TEPCO and the consequent huge losses weighing down on shareholders.<sup>21</sup>

A bill was submitted to Japan's Parliament on 14 June 2011 which aimed to bail TEPCO out, ensuring that the disaster-stricken victims would receive compensation. This was quickly met with a highly positive market response, which sent the stock price soaring by 25%.<sup>22</sup> Apart from the provision of a safety net to TEPCO approved by the Cabinet, the increase was also bolstered by the short sale and margin rule restrictions imposed on 14 March 2011.

## **Nationalisation Rumours**

On 3 July 2011, it was revealed that TEPCO might potentially face the nationalisation of its nuclear operations.<sup>23</sup> But the government reassured the general public that there were no such plans.<sup>24</sup> Fears of the nationalisation were again renewed in December after the need of a government bailout became increasingly certain.<sup>25</sup>

## **Internal Governance Structure and Practices**

TEPCO's Board of Directors met monthly to decide on strategic issues and oversee directors' performance.<sup>26</sup> Its Board of Managing Directors met weekly. Out of the 20 directors who made up the Board, 18 were insiders and the utility had never appointed any outsider for the top job.<sup>27</sup> Besides the absence of independence in the Board, it also had little diversity in terms of age, gender as well as nationality.

TEPCO's Remuneration and Corporate Ethics Committees were deemed to be affiliated to, but not part of, the Board of Directors. Despite having a Remuneration Committee, remuneration was decided by the Board.

The task of overseeing management was assigned to the Board of Auditors,<sup>28</sup> a legally separate and independent body, which comprised of both corporate and accounting auditors elected by the shareholders.<sup>29</sup> Lastly, there were many internal committees below the board level which were usually headed by senior TEPCO executives from the various offices and group companies.<sup>30</sup>

It was not the first time that TEPCO was subjected to intense regulatory scrutiny and strong public censure. In 2002, a former employee blew the whistle on its supplier. It was revealed that there were falsifications of safety reports for several of its reactors. In 2007, it was discovered that incidents which occurred in the nuclear plants had gone unreported.<sup>31</sup> Later in the year, an earthquake caused a fire and radiation leak at TEPCO's Kashiwazaki Kariwa nuclear plant that was located near a faultline, which TEPCO knew about.<sup>32</sup> The company executives also permitted the construction of Fukushima Daiichi plant despite tsunami warnings because it was thought that the calculations were "provisional estimates" which were based on academic theories that were not then widely accepted.<sup>33</sup>

## **Japan's Institutional Environment**

In Japan, companies are allowed to choose between the more favoured option of having a board of corporate auditors<sup>34</sup> or the committee system. Although charged with the oversight of the board and set up as an independent body, the corporate auditors are commonly connected to the company and very rarely take actions.<sup>35</sup>

Moreover, "stakeholder capitalism"<sup>36</sup> is deeply ingrained in the country. Instead of individuals, Japanese companies are largely owned by other companies and by financial institutions, most notably large commercial banks. Institutional investors held 61.9% of TEPCO's shares. Its major shareholders were all financial institutions, accounting for 30% of its shares.<sup>37</sup> They have a central role in corporate governance as they determine the fate of companies. Should a failing firm be deemed to be a profitable customer of the main bank, it would often attempt to rescue it.<sup>38</sup> Managers of listed companies were entrusted not only with control of operations, but also with guardianship of the interests of key stakeholders.<sup>39</sup> Firm survival, not profit, is the key to Japanese managers.<sup>40</sup>

Whereas institutional investors are often the most vocal advocates of corporate governance in the West, Japanese institutional investors tend to rubber-stamp management decisions and re-elect board members even in the face of poor performance.<sup>41</sup> Director selection is based on top executives who have risen through the corporate ranks<sup>42</sup> and the market for CEOs is virtually non-existent.<sup>43</sup> Japan is the only major market in Asia that does not mandate some degree of board independence for listed companies.<sup>44</sup>

The regulation of the nuclear industry is characterized by extremely close ties. It was common for bureaucrats to parachute straight from their ministries into the utilities. Former employees of the utilities also formed a significant portion of the regulatory agency's inspectors.<sup>45</sup> In addition, the Ministry of Economy, Trade and Industry (METI), lacked the necessary knowledge and expertise in the area of nuclear energy. The minister is forced to rely on nuclear scientists sponsored by the utilities which it was charged with monitoring.<sup>46</sup> METI was responsible for safety issues but was also charged with promoting the nuclear industry.<sup>47</sup> Nuclear operators often sought to extend their reactors' use beyond the 40-year statutory limit because of the difficulties in building new power plants. Officials greenlight these requests because they were also charged to expand the use of nuclear energy and reduce the reliance on imported fossil fuels.<sup>48</sup>

The kisha (press) club system, which forms a part of every ministry, has fostered an intimate relationship between the bureaucracy and mainstream media. The latter is given restricted access to the government in exchange for a direct line of communication with the outside world.<sup>49</sup> TEPCO was one of the biggest contributors to the media with an annual advertising budget exceeding US\$150 million.<sup>50</sup> As the crisis unfolded, the media downplayed the severity of the disaster as compared to the foreign media in the hope of calming the public,<sup>51</sup> allowing TEPCO to be shielded from media scrutiny.<sup>52</sup>

Consequently, victims of the crisis were worried that inadequate compensation will be paid by TEPCO due to the lack of pressure from the press.<sup>53</sup>

## The Aftermath

In the summer of 2011, after the immediate crisis was dealt with, Vice President Sakae Muto resigned from the company that he had worked for 37 years. On 14 March 2012, standing before a Diet committee, Muto acknowledged that TEPCO was partly to blame for the nuclear disaster triggered by the March 11 tsunami.

Following the 2002 scandal, the company had already made changes to its corporate governance practices. What exactly could be done to prevent this from happening again?

## Recent Developments

In May 2012, the government agreed to inject ¥1 trillion of fresh capital into TEPCO, which effectively nationalized the firm<sup>54</sup>. With the capital injection, TEPCO's management and operations were forced to reform. One such reform was the replacement of its former chairman by Kazuhiko Shimokobe, who was chosen by the bailout fund. Eighteen months after the disaster, in October 2012, TEPCO admitted for the first time that the disaster could have been avoided. In a follow-up news conference session in December 2012, Takefumi Anegawa, the head of Tepco's company reform taskforce admitted that TEPCO's lack of safety culture and bad habits were the driving forces behind the accident<sup>55</sup>. In November 2012, TEPCO launched its Intensive Reform Implementation Action Plan which aims to improve safety measures, lower costs and provide better management controls to ensure that the disaster does not happen again<sup>56</sup>.

Moreover, the Japanese Government announced plans to reduce the use of nuclear power within 30 years. This move will shift the utility companies such as TEPCO towards the use of renewable energy<sup>57</sup>

## Discussion Questions

1. Comment on TEPCO's internal corporate governance arrangements, including its Board of Directors as well as its various committees.
2. Did TEPCO's Board of Directors carry out its responsibilities effectively and did poor corporate governance contribute to the Fukushima disaster? Explain.
3. Discuss the "stakeholder capitalism" model in Japan with regards to the globally accepted corporate governance practices. Explain whether it contributed to TEPCO's crisis.
4. Evaluate the extent to which institutional weaknesses in the nuclear industry was a contributing factor to the Fukushima crisis. Suggest measures the Japanese government should undertake to address these issues.

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# Berkshire Hathaway: The Fall of David Sokol

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*“Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless.”*

- Warren E. Buffett, Chairman and CEO of Berkshire Hathaway<sup>1</sup>

## Case Overview

In 2011, Chairman and CEO of Berkshire Hathaway, Warren Buffett, announced the sudden resignation of David Sokol in a press release, citing personal reasons for the decision. The news shocked many, as Sokol had long been considered as a leading candidate to succeed Buffett’s leadership position in Berkshire Hathaway. Sokol’s resignation raised further questions by stakeholders when it was revealed that Sokol had purchased shares in Lubrizol, shortly before he proposed the company to Buffett for acquisition. Amidst allegations of insider trading and front running, Sokol has maintained that his Lubrizol purchases were not unlawful in any way. The Sokol incident also caused some observers to question Berkshire’s corporate governance practices, and dented the company’s once stellar reputation. This objective of this case is to facilitate a discussion of issues such as ethics, insider trading, the trust-based governance system in Berkshire Hathaway, factors affecting the effectiveness of monitoring by the board of directors, and the importance of succession planning.

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This is the abridged version of a case prepared by Chan Ying Ying, Grace Foo Mao Jia, Rachel Goh Yi Ling, Lui Wing Kee, Sebastian Joseph Widodo, Tan, Francis de Jesus, Annis Teo Zhen Ni under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. Consequently, the interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Rachel Goh Yi Ling under the supervision of Professor Mak Yuen Teen.

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## **Berkshire Hathaway**

Berkshire Hathaway Inc. is a multinational conglomerate holding company that originated from a merger between Berkshire Fine Spinning Associates and the Hathaway Manufacturing Company in 1955<sup>2</sup>. In 1962, Warren Buffett began to purchase Berkshire's stock (which he believed was underpriced) and by 1967, became the majority owner of the company. After the discontinuation of its textile operations, Buffett used Berkshire as his investment vehicle to purchase various companies, most notably in the insurance industry. The company has since expanded, owning a diverse range of businesses<sup>3</sup>. Its share returns have consistently outperformed the market during the period from 1965 to 2011<sup>4</sup>, and the company also ranked 16th in Forbes' 2012 list of most reputable companies in the U.S.<sup>5</sup>.

## **Trust-Based Governance<sup>6</sup>**

Despite its sheer size, Berkshire has a relatively simple governance structure. The basic principle underlying Berkshire's governance is trust - a principle that is not surprising because Buffett has always believed that the company is a huge partnership operating based on trust among its partners. This trust-based governance is manifested in some corporate practices unique to Berkshire Hathaway.

Capital allocation in Berkshire is centralised at its headquarters; decisions on how to reinvest free cash flows generated by business units are made entirely by Buffett, and at times after consulting his long-time partner Charlie Munger, but never vetted by any committees. There is no formal investment committee to perform due diligence on capital allocation decisions. Operating decisions are made entirely by managers of each business unit without much consultation with the headquarters; they are not required to submit budgets or long-term plans for review. Such procedures indicate that a huge amount of trust is placed by corporate headquarters on its managers to act with integrity.

Furthermore, Berkshire has few, if any, internal controls within the company. No due diligence is conducted before Berkshire commits to an acquisition and the board seldom reviews purchase decisions; most acquisition decisions are made under the sole discretion of Warren Buffett.

Commenting on this trust-based system, Munger described the governance system of Berkshire as “a seamless web of deserved trust,” and credited it as instrumental in helping the company grow from a market capitalisation of \$10 million in 1965 to \$200 billion in 2011<sup>7</sup>.

## **The Rise of David Sokol**

David Sokol’s relationship with Berkshire began in 1999 when Berkshire acquired MidAmerican Energy, a company in which Sokol was the CEO<sup>8</sup>. From 1999 until his abrupt resignation in 2011, Sokol displayed exceptional managerial performance, fuelling wide speculation that he was the candidate with the greatest potential to succeed Buffett as Berkshire’s CEO. Under Sokol’s stewardship, underperforming divisions Johns Manville and NetJets had gone back on track, further enhancing Sokol’s image as one of the “star players” within the company<sup>9</sup>. Sokol also played an integral role in the selection of some of Berkshire’s acquisition targets. In 2010, Sokol was encouraged to shortlist companies that could serve as potential acquisitions for Berkshire<sup>10</sup>. This subsequently proved to be catastrophic for Sokol as it became the starting point of a series of events that eventually culminated to his controversial resignation in 2011.

## Acquisition of Lubrizol<sup>11</sup>

The Lubrizol deal began in late 2010, when a group of investment bankers from Citigroup provided Sokol with a list of potential target chemical companies that Berkshire might be interested in. From that list, Sokol selected Lubrizol as the only company of interest. Sokol then conveyed Berkshire's possible interest in acquiring the company, as Citigroup had connections with Lubrizol's CEO. On Sokol's request, Citigroup subsequently arranged a meeting between Lubrizol's CEO, James Hambrick, and Sokol who was acting as a Berkshire representative.

In the middle of January 2011, Sokol proposed Lubrizol for acquisition to Buffett and also informed him of his opportunity to meet the CEO of Lubrizol. During this conversation, Buffett enquired how Sokol had learnt of Lubrizol, Sokol replied that he had owned the company's shares. However, Sokol did not disclose the amounts and timings of his purchases. On 25 January 2011, Sokol met with Hambrick, and updated Buffett on what transpired in the meeting the following day. Slightly more than a week after, Buffett met with Hambrick to negotiate the terms of the acquisition, and on 14 March 2011, Berkshire and Lubrizol announced the merger agreement. Berkshire had agreed to purchase Lubrizol for \$9 billion in cash.

When a Citigroup representative came forward to congratulate Buffett on the merger, he revealed the role of Citigroup in the acquisition process. This prompted further investigation which eventually revealed that Sokol had gained a hefty \$3 million profit for his purchase of Lubrizol shares just days before Berkshire's acquisition proposal<sup>12</sup>. Public accusations of insider trading thus ensued as many felt that Sokol had abused his position in Berkshire by using privately-held information to obtain an unfair profit.

## David Sokol's Defence

In a bid to defend his reputation amidst speculation surrounding the circumstances of his resignation, Sokol agreed to an interview with CNBC's Squawk Box on 31 March 2011. In the interview, he raised the following points in his defence<sup>13</sup>.

First, the shares were purchased based on his personal decision and prior to his recommendation of the potential acquisition opportunity to Buffett. Second, he bought Lubrizol's shares without the knowledge that Berkshire was interested in acquiring the company. Furthermore, he argued that he did not utilise any private information provided by Citigroup's bankers; he emphasised that the list of companies provided by the Citigroup bankers was public information, and his decision to purchase Lubrizol's shares was purely to better manage his family's wealth. Finally, Buffett had the sole discretion over investment decisions in Berkshire Hathaway. Hence, he felt it unfair to be accused of insider trading as he had no control over Berkshire's acquisition decision of Lubrizol.

## Audit Committee Report

Following Sokol's resignation, Berkshire's audit committee decided to investigate the affair and publish an official view of the company regarding Sokol's resignation. In an 18-page report published at the end of April 2011<sup>14</sup>, Berkshire's audit committee criticized Sokol's decision to purchase Lubrizol's shares and outlined the following reasons as to why Sokol's purchase of Lubrizol shares constituted a breach of Berkshire's policies and state laws.

First, the transaction violated Berkshire's *Insider Trading Policies and Procedures*, which forbid the trading of securities of public companies when the trader possesses material information relating to them. Even though there was significant uncertainty as to whether Buffett would support the acquisition, Sokol should have abstained from trading Lubrizol's shares from the day he selected it from Citigroup's list of companies and initiated acquisition talks.

In addition, the share purchases violated Berkshire's Code of Business Conduct and Ethics since Sokol purchased Lubrizol's shares when he already knew that Lubrizol's board would consider Berkshire's interest, hence increasing the possibility of a successful merger between the two companies. Even if this information was not material, it was clearly confidential, and the Code prohibited Sokol from trading on it. Furthermore, the Code was also violated when Sokol took the opportunity from a potential Berkshire acquisition and profited personally. Sokol's pre-merger purchases may even have hurt Berkshire, since it sullied the firm's reputation for not making hostile acquisitions and could have undermined the trust between the latter and potential partners.

Finally, Sokol failed to fulfill his duty of full disclosure under Berkshire's Code as well as under the Law of Delaware, which was applicable to Berkshire due to its place of incorporation. Transactions that could be reasonably expected to give rise to a conflict of interest and personal gain should be fully disclosed.

## **Succession Challenges for Warren Buffett**

David Sokol's resignation has since triggered a wave of criticism about Berkshire's corporate governance practices and the sustainability of its governance system. On top of that, another issue had been repeatedly raised – its succession planning.

The issue of succession planning at Berkshire has become a major cause of concern for investors since Sokol had been widely viewed as a frontrunner in the line of potential candidates to succeed Buffett<sup>15</sup>. With his resignation, questions surrounding Buffett's potential successors and the effectiveness of the selection process have been raised. Although Buffett has often reassured the public that Berkshire is prepared for succession<sup>16</sup> and has identified an internal candidate as well as two back-up candidates, the issue of succession at Berkshire is still a cause of anxiety for many. This is because the self-proclaimed robustness of Berkshire's succession planning has yet to be seen, and the elderly 82-year-old Buffett had been diagnosed with prostate cancer



on 11 April 2012<sup>17</sup>. On 5 May 2012, a shareholder proposal for the disclosure of a written and detailed succession policy was voted down<sup>18</sup>, after the board argued that there was no benefit in formally publishing its succession plans.

A clear succession plan is essential for good governance - the real challenge for Berkshire's succession planning would be to effectively select and execute a seamless transition of power to a competent and viable candidate capable of at least fitting into Buffett's shoes while also ensuring that the corporate culture that helped Berkshire excel remains in place.

## **The Next Step for Berkshire Hathaway**

The David Sokol scandal has highlighted several questions for Buffett and Berkshire's directors regarding the company's corporate governance system. Should Berkshire's overall governance structure be changed? Should more internal controls be introduced within the company? Has Sokol or other executives engaged in similar trading previously, but these were simply undetected due to Berkshire's lack of internal controls? Does Berkshire need to reform the board and confer real power upon it to monitor the CEO and his decisions?

Given such concerns, it is imperative for Buffett and his board to act fast in order to safeguard Berkshire Hathaway's reputation. After all, it takes 20 years to build a reputation but only five minutes to ruin it.

## **Recent Developments**

In early January, the U.S. Securities and Exchange Commission (SEC) dropped its probe into David Sokol. According to Sokol's lawyer, Sokol has been "completely cleared" as there was no evidence against him.<sup>19</sup>

## Discussion Questions

1. Has David Sokol committed an unethical act? In light of the SEC's dropping its probe, was Sokol unfairly treated by Berkshire Hathaway and commentators?
2. Did current corporate governance practices in Berkshire Hathaway play a part in the events leading to the incident? How can these practices be improved to prevent such situations from recurring?
3. How can firms strike an appropriate balance between the amount of freedom allotted to and the extent of monitoring over star executives like David Sokol?
4. Why do investors worry about Berkshire's succession planning? How can the board of directors address such issues?

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# Galleon: A Case of Insider Trading

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## Case Overview

The Galleon insider trading case is one of Wall Street's largest cases, involving confidential information leakage of esteemed global corporations Goldman Sachs and Procter & Gamble. It led to the fall of two well-known business leaders in the US, Rajat Gupta and Raj Rajaratnam. Rajat Gupta, once a highly-respected and influential businessman, suddenly found himself falling from grace as he faced one count of conspiracy and five counts of securities fraud



The objective of this case is to allow a discussion on issues such as insider trading, duties of directors and directors holding multiple directorships..

## Who is Rajat Kumar Gupta?

Rajat Kumar Gupta (Gupta) is a renowned Indian American businessman, best known for being the first Indian-born managing director of McKinsey & Company<sup>1</sup>, a prestigious management consultancy group. Despite coming from a humble background, Gupta excelled in his studies and went on to obtain an MBA from Harvard Business School<sup>2</sup>. Gupta joined McKinsey & Company in 1973 and became the managing director in 1994, during which he co-founded the Indian School of Business, the American India Foundation, as well as

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Scandent, a broad-based technology solution company<sup>3</sup>. It was also during this time that he came into contact and built relationships with wealthy Wall Street investment bankers<sup>4</sup>. Raj Rajaratnam (Rajaratnam), his alleged partner-in-crime, later claimed that Gupta was in the “hundreds-of-million-aire’s circle”, but he wanted to be in the “billionaire’s circle”<sup>5</sup>.

Gupta sat on many boards such as Goldman Sachs, Procter & Gamble, AMR Corporation, Genpact Limited and Harman International Industries<sup>6</sup>. He also sat on the boards of educational institutions and non-profit organisations including Harvard Business School and the Gates Foundation<sup>7</sup>. At the same time, he remained a “senior partner emeritus” at McKinsey & Company<sup>8</sup>.

## The Friendship

Unlike Gupta, Rajaratnam came from a wealthy family in Sri Lanka. He received English education since young before going to Wharton Business School to pursue his MBA<sup>9</sup>. He founded Galleon Group, which was one of the largest hedge fund management firms in the world before it was wound down in October 2009<sup>10</sup>. He was the Managing Member of Galleon Management LLC, general partner of Galleon Management and a portfolio manager for the Galleon Tech Fund<sup>11</sup>. Like Gupta, Rajaratnam was a prominent name on Wall Street.

Gupta and Rajaratnam quickly became close friends and business partners through their investments and joint ventures in private-equity firms Taj Capital and New Silk Route Partners LLC in 2006<sup>12</sup>. Gupta visited Rajaratnam’s office regularly<sup>13</sup>, indicating close ties between the two.

During the period when the insider trading case allegedly took place, Rajaratnam appointed Gupta as Chairman of Galleon International and gave him an ownership stake<sup>14</sup>. Gupta also had \$10 million invested in at least two other Galleon funds<sup>15</sup>.

# The Chain of Events

## **12 March, 2007**

Gupta attended a Goldman Sachs' audit committee meeting from Galleon's premises through a conference call<sup>16</sup>. During the call, there was a discussion regarding Goldman Sachs' first quarter earnings which was due to be announced the next day. The earnings had exceeded analysts' forecasts.<sup>17</sup> Approximately 25 minutes after this call, Rajaratnam had one of his funds buy about 350,000 Goldman Sachs shares<sup>18</sup>. The next day, after Goldman Sachs' earnings announcement, its shares rose by more than \$2 per share from the previous close, reaping profits for Galleon funds<sup>19</sup>.

## **10 June, 2008**

Gupta allegedly tipped off Goldman Sachs' quarterly earnings to Rajaratnam after learning from the firm's CEO Lloyd Blankfein that its second quarter results would exceed analysts' consensus forecasts substantially<sup>20</sup>. In the morning of 11 June, 2008, Rajaratnam instructed Galleon funds to buy 7,350 out-of-the-money call options on Goldman Sachs stock as well as 350,000 Goldman Sachs shares, minutes after the open of the market<sup>21</sup>. When Goldman Sachs announced its second quarter earnings on 17 June, 2008, Rajaratnam sold his positions, making about US\$19 million for Galleon<sup>22</sup>.

## **29 July, 2008**

Gupta had a phone conversation with Rajaratnam, disclosing confidential information from a Goldman Sachs' board meeting in which the directors considered the possibility of purchasing either commercial bank Wachovia or the American International Group<sup>23</sup>.

## **23 September, 2008**

Gupta participated in a Goldman Sachs board meeting call using his phone. During the call, Goldman Sachs board approved a US\$5 billion investment by Berkshire Hathaway in Goldman Sachs at the height of the financial crisis<sup>24</sup>. Barely 16 seconds after the meeting, at about 3.54pm, Gupta made a call to Rajaratnam to divulge this information to him<sup>25</sup>. Shortly after, Rajaratnam instructed a number of Galleon funds to buy about 217,200 Goldman Sachs shares for a total of approximately US\$27 million at 3.58pm, about 2 minutes before the markets closed<sup>26</sup>.

After the market closed, Goldman Sachs made a public announcement of the Berkshire Hathaway investment<sup>27</sup>. The next morning, Goldman Sachs shares opened at US\$128.44, more than US\$3 per share higher than the pre-announcement closing price of US\$125.05 the day before<sup>28</sup>. Galleon then sold the 217,200 Goldman Sachs shares the same day, earning a profit of about US\$840,000<sup>29</sup>.

### **23 October, 2008**

Gupta attended a conference call with the Goldman Sachs board, where the senior executives updated the board about quarterly financial results<sup>30</sup>. According to Goldman Sachs' internal financial analyses, the firm lost almost US\$2 per share for the quarter ending November 28, 2008, which was significantly worse than the market expectations, and was the first time in the company's history as a public-listed firm that a loss was made<sup>31</sup>. This time, it took Gupta 23 seconds to call Rajaratnam and inform him of Goldman Sachs' negative interim financial results<sup>32</sup>. As soon as the market opened the next day, Galleon Tech Funds started to dispose of its entire long position in about 150,000 Goldman Sachs shares, avoiding a loss of several million dollars.<sup>33</sup>

### **29 January, 2009**

Gupta attended an Audit Committee meeting of the Procter & Gamble Board of Directors at around 9 am, the day before Procter & Gamble's quarterly earnings was to be released<sup>34</sup>.

The draft of the earnings results stated, amongst other things, that the company expected its organic sales to grow by 2 to 5% for the fiscal year, a forecast that fell short of the previous publicly announced forecast by Procter & Gamble<sup>35</sup>. Gupta allegedly then called Rajaratnam at 1.18pm with the news<sup>36</sup>. Shortly after that, at 2.52pm, some Galleon funds started shorting about 180,000 Procter & Gamble shares<sup>37</sup>, booking a profit of more than US\$570,000<sup>38</sup>.

### **1 July, 2010**

Gupta became the Chairman of the International Chamber of Commerce. The Wall Street Journal revealed that in April 2010, Gupta was under federal scrutiny. This, however, did not deter organisations from keeping him on their Boards of Directors. Gupta still remained on the Boards of Procter & Gamble, American Airlines, Harman International Industries, and others<sup>39</sup>.

### **1 March, 2011**

The U.S. Securities and Exchange Commission (SEC) filed an administrative complaint against Gupta for insider trading in relation to Rajaratnam's trial<sup>40</sup>. Gupta vigorously denied the SEC allegations and filed a countersuit claiming that the charges were unfair and violated his constitutional rights<sup>41</sup>. On 4 August, 2011, the SEC withdrew its complaints against Gupta<sup>42</sup>.

### **13 October, 2011**

Rajaratnam was sentenced to 11 years in prison for the biggest insider trading case in decades<sup>43</sup>. He was also ordered to pay a fine of US\$10 million and forfeit US\$53.8 million<sup>44</sup>.

### **26 October, 2011**

Gupta was arrested after he surrendered to the FBI. He was charged with one count of conspiracy and five counts of securities fraud, which carry a potential penalty of 105 years in prison<sup>45</sup>. Prosecutors later added another securities fraud charge based on the 12 March, 2007 discussion with the Goldman Sachs audit committee allegedly from Galleon's premises<sup>46</sup>.

Gupta pleaded not guilty to all of the charges and was freed on a US\$10 million bail and travel restrictions, while awaiting trial<sup>47</sup>. His lawyer maintained that he was innocent of all the charges<sup>48</sup>.



## The Resignations

### **Goldman Sachs**

Prior to the SEC administrative complaint, Rajat Gupta decided not to stand for re-election to Goldman Sachs Board of Directors in March 2010<sup>49</sup>. In a Goldman Sachs' press release, Lloyd C. Blankfein, Chairman and CEO, said that Gupta's "independent advice, keen understanding of the issues and belief in [Goldman Sachs] culture has had a tremendous impact on [the] firm"<sup>50</sup>. Yet, Blankfein later admitted as a witness in Rajaratnam's trial that he "had an inkling" of Gupta's connection to the Rajaratnam case prior to Gupta's resignation but only found out more after Gupta had stepped down<sup>51</sup>. Despite this "inkling", Goldman Sachs did not take any action.

### **Procter & Gamble**

Procter & Gamble announced through its regulatory filing and press release that Rajat Gupta voluntarily resigned from the company's board on 1 March, 2011 "to prevent any distraction to the P&G Board and [its] business"<sup>52</sup>.

Procter & Gamble and its Board of Directors were aware of the planned SEC civil action against Rajat Gupta "a few weeks" in advance<sup>53</sup>. Although Gupta had submitted written assurances to the company that the allegations had no merit, Procter and Gamble decided not to inform shareholders of the matter, claiming that it was in the best interest of its shareholders, and that the company was not required to disclose the information as it is not material<sup>54</sup>.

### **AMR Corporation and Harman International**

After his resignation from the Procter & Gamble Board, Gupta remained a director in American Airlines and Harman International Industries, and when questioned, spokesmen at these companies said they had no comments<sup>55</sup>.

On 7 March, 2011, Rajat Gupta voluntarily resigned from AMR Corporation Board, its subsidiary American Airlines<sup>56</sup>, as well as the board of Harman International Industries<sup>57</sup>.

## **McKinsey & Company**

Even though Gupta had remained a “senior partner emeritus” in McKinsey with his own office and assistant, a McKinsey spokesman said in a statement after the insider trading case became public knowledge that “Our firm no longer has a professional relationship with Rajat Gupta”<sup>58</sup>.

## **Genpact Limited**

Genpact Limited, where Gupta was the Chairman, remained supportive of him. Genpact issued a statement saying Gupta “has made invaluable contributions to Genpact, and has always sought to hold Genpact to the highest standards of integrity and corporate governance”<sup>59</sup>. Besides confirming that Gupta would continue to be Chairman of Genpact Board, Genpact said they had no further comment<sup>60</sup>. However, on 4 March, 2011, Gupta notified Genpact of his resignation from the board<sup>61</sup>.

## **Indian School of Business**

Similar to Genpact Limited, Indian School of Business (ISB), expressed their support towards Gupta despite the ongoing investigation. ISB had said that it “is confident that Rajat Gupta will be vindicated” and that “he [Rajat Gupta] continues to be the Chairman of the ISB executive board”<sup>62</sup>. This support created controversies both within and outside India, as Rajat Gupta resigned from the boards of American institutions but remained a director for Indian institutions<sup>63</sup>. Despite the support, Gupta resigned from the ISB Board on 21 March, 2011<sup>64</sup>.

By April 2011, Rajat Gupta has resigned from all of the boards that he was involved in.

## Another One Bites the Dust

Gupta's trial started on 22 May, 2012<sup>65</sup>, and on 15 June, he was found guilty on three out of five counts of securities fraud and one count of conspiracy<sup>66</sup>.

On 24 October, Gupta was sentenced to two years in prison and was also ordered by the court to pay a US\$5 million fine<sup>67</sup>. After being convicted of insider trading, Gupta's reputation as a director and a respected businessman has been irrevocably damaged. This could mark the tragic end to an otherwise brilliant career that Gupta has built for himself over the years.

## Discussion Questions

1. Comment on Rajat Gupta's directorships and chairmanship on various Boards of Directors.
2. Assuming that the allegations by the SEC are factually correct, comment on Rajat Gupta's actions with regards to his duties as a director.
3. Discuss the issue of voluntary versus forced resignation when a director faces litigation and charges.
4. Discuss the companies' reactions to the SEC's accusations towards Rajat Gupta. Are their reactions really in the best interest of shareholders? On what basis should companies decide whether or not to disclose such information to shareholders and the public?
5. If the Galleon/Rajat Gupta case had occurred in your country, what laws and regulations would have been broken (if any), and what are the possible sanctions against the individuals concerned?

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# Can You Hear Me? News Corporation and the Phone Hacking Scandal

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## Case Overview

On 10 July 2011, News of the World (NoW) ended its 168 years of existence when it published its final edition. The paper was one of the many casualties of the phone hacking scandal which engulfed News Corporation (News Corp). Investigations have shown that the newspaper's practice of phonehacking started as early as 2005. The matter was closed when there was no evidence to suggest that it was more than an isolated event. Subsequently, other newspaper publications alleged that the victims of phone hacking included many other celebrities and politicians. It was also alleged that NoW's senior management was aware and condoned these activities. This prompted shareholders to question whether the Board was doing their job. In October 2011, many News Corp investors voted against the re-election of James and Lachlan Murdoch at the annual general meeting. However, they were re-elected onto the Board because of News Corp's dual-class share structure, which gave the Murdoch family 40% of the votes even though they owned only 12% of the total outstanding shares. The objective of this case is to allow a discussion on issues such as ethics and tone at the top, dual-class share structures, board independence and effectiveness, and shareholders' activism.

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This is the abridged version of a case prepared by Cao Feiya, Jean Chang Tingting, Sharine Chew Xin Lin, Juan Kusuma, Kylie Seah Hsueh Chin, Ma Tianbo and Clement Yee Hong Wei under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Lau Lee Min under the supervision of Professor Mak Yuen Teen.

# The Making of an Empire

Rupert Murdoch was born in Melbourne in 1931. Young Murdoch inherited his first newspaper, The Adelaide News, from his father in 1952<sup>1</sup>. Murdoch initially focused on the Australian market, by starting up new publications and acquiring several newspapers and television channels in Australia. In 1968, Murdoch entered the United Kingdom (UK) market by buying News of the World Organization for £26 million, which owns News of the World and several other publications. He was quoted saying, “We see opportunities to participate in media developments across Europe.” Then in 1973, Murdoch entered the United States (US) market. After acquiring and buying a string of newspapers during the 1970s in the US and in the 1980s in Australia, Murdoch established News Corp as a global holding company. In February 1981, News International plc (NI), the UK newspaper publishing division of News Corp, was established<sup>2</sup>.

In early 2011, News Corp was valued at about US\$48.29 billion, and its product portfolio includes newspapers, magazines, books, movies, sporting events, websites, cable programming and satellite television<sup>3</sup>.

## Corporate Governance

### Shareholding Structure

Despite the Murdoch family collectively owning only about 12% of News Corp’s shares, they effectively control News Corp due to the dual-class share structure which News Corp had adopted. Under this dual-class share structure, the Murdoch family owned 40% of the Class B shares which have voting rights, even though Class B shares only made up 30.4% of the total outstanding News Corp shares<sup>4</sup>.

## **Board Composition**

The Board of Directors comprised of 16 directors, 8 of whom were classified as independent. Murdoch is the Chief Executive and Chairman, while his sons, Lachlan and James, were also on the board. James was also the Deputy CEO. Four of the other directors were executive directors. The independent directors included an opera singer named Natalie Bancroft, and Jose Maria Aznar, the former Spanish Prime Minister. Only two of the independent directors have media industry experience, and both had worked for companies belonging to the media conglomerate during their careers. The independence of News Corp's directors complied with the listing rules of NASDAQ, which News Corp was listed on<sup>5</sup>. In 2011, James Breyer replaced Tom Perkins as an independent director on the Board. Perkins, who sat on News Corp's Board for 15 years, had previously resigned from the Hewlett Packard Board in protest against an unethical leak investigation ordered by the then Chairperson. Perkins was dubbed as "the closest thing to a truly independent director" on the Board of News Corp and the "best hope" for improving its governance by a columnist at Reuters. Another independent director who left the Board in 2011 was Kenneth Cowley, a long-time director and chairman of an Australian clothing firm.

## **Board Committees**

The Board consists of three committees – the audit committee, compensation committee and the nominating and corporate governance committee. None of the audit committee members is a Certified Public Accountant, have significant experience in accounting, or risk management expertise.

According to a 2011 interview with Nell Minow, the co-founder of The Corporate Library, which rates companies on their corporate governance, News Corp had received an F grade for the past six years "only because there is no lower grade"<sup>6</sup>.

## Origins of the Phone Hacking Scandal

In 2000, Rebekah Brooks, Rupert Murdoch's top aide was appointed as the editor of NoW. During her tenure at NoW, she reported on the case of Milly Dowler, a 13-year-old girl who was kidnapped and murdered. The murder was described as one of the most notorious of the decade<sup>7</sup>.

Brooks was subsequently promoted to be the first female editor of the tabloid The Sun in 2003, and was later promoted to chief executive of NI in September 2009. At the same time, Andy Coulson, Brooks' deputy editor since 2000, replaced her as the editor of NoW.

NoW's phone hacking practice was first detected in November 2005, when Clive Goodman, NoW's royal editor, wrote a story about Prince William's knee injury. The leakage of this confidential information prompted complaints by royal officials about voicemail messages being intercepted. It was reported that Goodman hired a private investigator, Glenn Mulcaire, to tap phone lines, and paid him more than £100,000 a year for his services<sup>8</sup>. In 2007, Goodman and Mulcaire were jailed for four and six months respectively.

The Press Complaints Commission, the newspaper regulation watchdog, published a report in May 2007, saying that no evidence of wrongdoing was found at NoW. Moreover, a review of internal emails between Coulson and executives showed that they were not aware of Goodman's action. It subsequently led to the conclusion that the royal family phone hacking case was strictly a one-off event which was orchestrated by the duo. Furthermore, Coulson accepted full responsibility for the scandal and resigned as the editor of NoW. He was later appointed by David Cameron as his communications chief.

## The Unravelling of the Scandal

Everybody in News Corp thought the worst was over. That was hardly the case when James Murdoch, CEO of News Corp's European and Asian Operations, reportedly made a dubious payment of £700,000 to Gordon Taylor (a former English professional footballer) in April 2008. This was made in exchange for a confidentiality agreement. It was revealed later that Taylor's phone was hacked by NoW reporters, and the agreement barred Taylor from reporting the phone hacking to the authorities.

The Guardian, a competitor newspaper publication in the UK, revealed that there were other victims, many of whom were also paid off in exchange for confidentiality agreements. It also alleged that these victims included many other celebrities and politicians and that NoW's senior management was aware of and condoned the phone hacking. However, NoW's senior management denied knowledge of such activities.

Two months after Coulson's repeated denial of the knowledge of widespread phone hacking in NoW, Sean Hoare, an ex-NoW reporter, admitted to a New York Times reporter that phone hacking was encouraged at the tabloid and Coulson had actually asked him to do it. Soon after, another ex-NoW reporter Paul McMullan also confessed to The Guardian that other illegal reporting techniques were also prevalent in NoW<sup>9</sup>.

In January 2011, British police opened a new investigation into the allegations of phone hacking at the tabloid, called "Operation Weeting"<sup>10</sup>. The truth was eventually exposed when Mulcaire was ordered by the High Court to provide more information regarding the people behind the scenes<sup>11</sup>. Three former NoW journalists - Edmondson, chief reporter Neville Thurlbeck and senior journalist James Weatherup - were arrested in April 2011 on suspicion of conspiring to intercept mobile phone messages and unlawfully accessing voicemail messages.

NoW had no choice but to admit its role and apologise for its actions. NI set up a website for compensation seekers and made several compensation payments to victims who were involved in the scandal<sup>12</sup>. Upon further investigation, some 300 NoW emails from NI solicitors Harbottle & Lewis were given to Scotland Yard<sup>13</sup>. They allegedly showed that Coulson had authorised payments to police officers.

In July 2011, The Guardian revealed that NoW had hacked Milly Dowler's phone to gain access to more information about her kidnap. Subsequently, Brooks reaffirmed her stand that she would steer the company in the right direction and ensure that they would appropriately resolve the issue<sup>14</sup>.

Rupert Murdoch, who had hitherto remained silent about the controversy since British politicians called for an investigation, broke his silence one day after Brooks made her statement. He called the hacking accusations "deplorable and unacceptable" and vowed to cooperate with any police inquiries<sup>15</sup>. On the same day, he appointed his advisers, Joel Klein (an executive director of News Corp) and Viet Dinh (an independent director of News Corp) to investigate the phone-hacking allegations<sup>16</sup>. He continued to back Brooks to lead NI<sup>17</sup>.

## **The Descend from the Gutter to the Sewers**

*"This is the most humble day of my life<sup>18</sup>."*

– Rupert Murdoch

Many years have passed since the first phone hacking incident before Murdoch decided to initiate a formal investigation into the allegations. These actions were taken too late. On 7 July 2011, James Murdoch announced that NoW will publish its last paper on 10 July after 168 years of circulation<sup>19</sup>. Within the first two weeks of July, the market responded with a massive sell-off of News Corp's shares. The share price fell by about 13% and the volume of shares traded during this period spiked as well.

The next day, Coulson was formally arrested on suspicion of conspiring to intercept communications and of making illegal payments to police officers. At a separate South London police station, Goodman was also re-arrested for questioning on corruption. Both arrests came after NI handed a series of emails to police in June which allegedly detailed illegal payments made to Scotland Yard officers for sensitive information<sup>20</sup>. A letter from Goodman to NI executives revealed that phone hacking had been widely discussed in the daily editorial conference, until explicit reference to the phone hacking was banned by the editor.

Since News Corp is listed in the US, it was required to comply with US laws and rules. The payments made may have violated the Foreign Corrupt Practices Act<sup>21</sup>. Members of Congress urged the US government to hold investigations on these payments as well as the alleged purchase of phone records of 9/11 victims<sup>22</sup>.

Bogged down by the phone hacking scandal, News Corp had to give up the proposed acquisition of satellite broadcaster BSkyB. It had already owned 39 percent of the shares and wanted to make a bid for full ownership of the broadcaster. Unexpectedly, on news of the failed bid, shares in News Corp rose 3.8% in New York<sup>23</sup>.

After repeated calls for Brooks to take responsibility for the scandal, she finally bowed to pressure and resigned as the CEO of NI on 15 July 2011. The share price fell by 4% in the next 3 days. Brooks was subsequently arrested.

On 19 July 2011, Rupert and James Murdoch were questioned by British Members of Parliament over the phone hacking scandal. Rupert Murdoch reportedly told the MPs: "I am not responsible". He claimed that he was not aware of the extent of phone-hacking and had been misled by staff. Similarly, James Murdoch was "surprised and shocked" when he learnt that NI had still been paying the legal fees of Mulcaire – the private investigator that was involved in the royal family phone-hacking scandal<sup>24</sup>.

The Parliamentary Select Committee cited the event in April 2008 where James Murdoch reportedly made dubious payments to Taylor and two other footballers<sup>25</sup>, in exchange for barring them from reporting the phone hacking cases to the authorities. This revelation suggests that senior management knew of the pervasiveness of phone hacking within NoW.

To reassure the public, Viet Dinh (an independent director) issued the following statement on behalf of the independent directors of News Corp on 20 July:

*“The News Corporation Board of Directors was shocked and outraged by the allegations concerning the News of the World, and we are united in support of the senior management team to address these issues. In no uncertain terms, the Board and management team are singularly aligned and committed to doing the right thing.”*<sup>26</sup>

The following month, Rupert Murdoch endorsed deputy chairman Chase Carey as his successor rather than James Murdoch<sup>27</sup>. In September 2011, amendments and extensions were made to a lawsuit initiated in March 2011 against News Corp’s acquisition of Murdoch’s daughter’s company, due to the development of the phone hacking scandal<sup>28</sup>. The shareholders accused the Board of not doing their job properly and said that these revelations showed a culture that ran amok within News Corp and a Board that provided no effective review or oversight<sup>29</sup>.

Thereafter, the Murdoch family faced increasing pressure and disapproval from shareholders. On 25 October 2011, one third of News Corporation shareholders voted against allowing James and Lachlan Murdoch to continue serving on Board, while 14% cast ‘no’ votes against Rupert Murdoch<sup>30</sup>. Newscorp’s share price rose by 5% over the next three days.

Matters worsened in February 2012, when court documents revealed that NoW journalists had actually asked Mulcaire to hack phones. In total, the number of phone hacking incidents amounted to 2,226 within a period of five years<sup>31</sup>. James Murdoch also eventually resigned as NI’s Chairman<sup>32</sup>.



## Recent Developments

Since the scandal, many arrests have been made under Operation Weeting<sup>33</sup> and Operation Elveden – the investigation into police officers accepting inappropriate payments<sup>34</sup>. In total, US\$224 million in legal and related professional fees had been incurred for the year ended 30 June 2012 in relation to the scandal<sup>35</sup>. In July 2012, News Corporation confirmed that it will be split into two separate companies, with Murdoch serving as Chairman in both companies but only as Chief Executive in one<sup>36</sup>. During the shareholders' meeting held in October 2012, a shareholder proposal demanding that Murdoch step down as Chairman of News International was defeated. Despite their unhappiness, shareholders were still unable to force significant changes in the corporate governance of News Corp. The impetus for change may have been lost as the share price had risen 44% during 2012<sup>37</sup>.

Brooks and Coulson have been formally charged with conspiracy<sup>38</sup>. Both have denied these allegations and insist that they were unaware of the phone hacking incidents. It was estimated that the prosecution process will last for at three years<sup>39</sup>. Other publications under NI are also under fire, with 21 of The Sun journalists being arrested. This has stirred the fear of arrest amongst the remaining journalists – especially the investigative journalists – who are now unwilling to take on investigative stories<sup>40</sup>. Finally, this issue has sparked debate about the need for media plurality – reducing the concentration of media power in the hands of a few. However, the issue of media plurality will ultimately be decided by the British Parliament<sup>41</sup>.

## Going Forward

With mounting public anger over its unethical practices, Murdoch had to make a swift decision to conduct further internal investigations to determine the pervasiveness and severity of the unethical conduct in the organisation as part of damage control. Concurrently, the embattled organisation faces a daunting task in rebuilding its faltering public image. Many have expressed their optimism that News Corp will be able to weather the storm eventually, but the important question is, at what cost? Nobody, not even Murdoch, has an answer to that, at least for now.

## Discussion Questions

1. Discuss the importance of the tone at the top and corporate culture in influencing a company's standard of conduct. What do you think is News Corp's tone at the top and corporate culture? How has this affected ethical standards, implementation and enforcement of the code of conduct at News Corp?
2. Do you think a whistleblowing policy would have helped to reduce the prevalent illegal reporting techniques? If you were to recommend a whistleblowing policy for News Corp, how should it be implemented?
3. Analyse the role of the Board in handling the phone-hacking scandal. Do you believe it was adequate? What should the board have done to prevent an escalation of the scandal?
4. Comment on the true independence of News Corp's Board. Is it sufficient to just follow the guidelines in corporate governance codes? Should there be a deeper review of the threats to a director's independence?
5. Although News Corp is a public multinational corporation, the decision-making processes of the company seem to lie solely in the Murdochs' hands. Why is this so? How does this affect the level of involvement of other shareholders in monitoring News Corp's performance?
6. What are the pros and cons of a dual-class share structure? On balance, do you believe that regulators should permit such structures for publicly-listed companies?

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# HSBC: Who's the Boss?

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## Case Overview

In September 2010, the business world was shocked by a public boardroom debacle at HSBC. Incumbent Chairman, Stephen Green, had announced his pre-mature departure from HSBC ahead of schedule, putting HSBC's succession plan into the spotlight. An unforeseen and public power struggle ensued, with speculation as to whether incumbent CEO Michael Geoghegan or one of several other possible candidates would get the top job. The chaotic succession process undermined HSBC's stellar reputation for smooth management succession, and damaged the credibility of the board. The objective of this case is to allow a discussion of issues such as the importance of board and senior management succession planning and what it entails, the difference between a Chairman's and CEO's roles, attributes of a good Chairman, and whether former senior executives should become board chairmen.

## HSBC: A Model of Smooth Succession

HSBC has a long history of smooth board and senior management succession underpinned by clear succession plans. Regular review of these plans by independent non-executive directors also serves to strengthen its robustness.

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This is the abridged version of a case prepared by Apple Goh, Chidambara Thanu, Mabel Koh, Lew Karxieu, Oh Kai Li and Song Huizhen under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or management. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Rachel Goh Yi Ling under the supervision of Professor Mak Yuen Teen.

The succession process for the Board Chairman position involves extensive benchmarking against external candidates to ensure its internal candidates are up to standard and not simply chosen by virtue of their insider status. This seeks to ensure that the best candidate is chosen - one who has the capacity for strategic thinking, authority to run the board, and personal standing to represent HSBC externally. Institutional shareholders are consulted with respect to the succession plan, in addition to an independent search process for potential candidates.

HSBC's past successions for the Board Chairman position have been low key, without major disruptions to the business or public outcry. Successions have also been traditionally consensus-driven, with the succession receiving unanimous support from the board of directors.

## **Overhauling HSBC's Model of Succession**

In May 2006, Michael Geoghegan replaced Stephen Green as CEO of HSBC, while Green was promoted to Chairman. Despite executing another smooth CEO-to-Chairman hand-over<sup>1</sup>, HSBC was criticized for its tradition of promoting its CEO to Chairman, as this was perceived to impair the Chairman from independently and objectively monitoring the company. The handover was thrown into focus in part due to a climate of growing focus on corporate governance.

The roles at HSBC had traditionally been such that the Chairman functioned more as a CEO, while the CEO served as the deputy. Following the handover, Green concurred with governance critics that the operational management and oversight roles should be separate and distinct. He spent the next few years of his term as Chairman taking significant steps to re-define these two roles<sup>2</sup>, transferring the responsibility for strategy development from Chairman to CEO in 2009 and taking on more of a monitoring and ambassadorial role as Chairman. Besides paving the way to a more palatable corporate structure within the bank, these actions emphasised HSBC's renewed commitment to corporate governance.



## The End of an Era of Smooth Succession

In late May 2010, news that Green was to step down as Chairman of HSBC within a year leaked out in various media reports. According to these reports, HSBC's board was prepared for the transition and had spent the past three years putting together a succession plan<sup>3</sup>. This involved ceasing the tradition of promoting the CEO to Chairman, and naming possibly the bank's first non-executive Chairman successor – John Thornton - a HSBC non-executive director who was also a former Goldman Sachs partner. However, these rumours were refuted by HSBC.

Four months later, on 7 September 2010, an official HSBC announcement confirmed that Green had agreed to become the U.K. Minister of State for Trade and Investment<sup>4</sup>. Following the announcement, the bank revealed that it had always intended “to approve a successor to Mr. Green before the end of the year, and that timetable remains on schedule”<sup>5</sup>. However, Green had initially announced in May that he would stay on as Chairman until at least the spring of 2011<sup>6</sup> but he had suddenly decided to leave before the year-end<sup>7</sup>, leaving the bank with just three months to appoint a replacement. His premature departure forced HSBC's board to come to a swift decision regarding the succession.

As Green was highly regarded as a modern influence on the 145-year-old bank and had led it admirably through the 2003 U.S. subprime division crisis as well as the 2008 global financial turmoil, it came as no surprise that HSBC's share price plunged when news of Green's leaving first leaked in May 2010 - investors viewed his departure as the loss of a major asset for the bank.

With no official word from HSBC on the candidates to succeed Green, there was widespread speculation in the media.

It was reported that, within HSBC, many wished for the bank to maintain its tradition of promoting the CEO to Chairman. CEO Geoghegan was a hardworking “banker's banker”<sup>8</sup> who had held posts within HSBC all around the world in his 37 years with the bank, a decisive and quick-thinking CEO who had earned the

respect of many of his staff. However, certain factors hampered Geoghegan's appointment. First, it seemed that his aggressive management style did not sit well with investors, who did not see his adversarial ways as suited to leading the board<sup>9</sup> and performing the ambassadorial role of a Chairman. Second, and perhaps more significantly, corporate governance guidelines since 2003 had recommended that British companies should not elevate CEOs to Chairmen<sup>10</sup>. HSBC appeared inclined to abandon its tradition of promoting the CEO to Chairman and appoint a non-executive Chairman as a more independent check on the CEO-led business. This would leave Geoghegan out of the race.

Given this turn of events, the board's final decision on chairmanship was very much unpredictable to observers. This was apparent from the extensive list of potential candidates generated through public speculation.

Other frontrunners for the role included John Thornton, a non-executive director who was more well-received by investors<sup>11</sup> because of his independence from bank management, but an unpopular choice internally due to his harsh management style developed from his stint at Goldman Sachs. Another candidate was Douglas Flint, HSBC's Finance Director, who was viewed as a "compromise candidate"<sup>12</sup> to placate both investors and management, although he had perceivably less showmanship and experience at HSBC than Green and Geoghegan<sup>13</sup> and faced the same question on independence. Media reports also mooted the idea of a temporary Chairman<sup>14</sup>, with Simon Robertson (a senior independent director at HSBC) taking the role. However, this was widely viewed as unlikely given Robertson's role as Chair of the Nomination Committee, designated to appoint Green's successor, and his existing duties at Rolls-Royce.

With seemingly no clear successor at the time of Green's announced departure, and a myriad of potential candidates that appeared to leave the public and internal stakeholders divided, the succession looked poised to be the most chaotic that HSBC had seen for a long time.

## Power Struggle in the Boardroom

To add to HSBC's troubles, news leaked on 21 September 2010 in *The Financial Times* that Geoghegan had threatened to resign after being informed at a meeting that the board did not intend to give him the position of Chairman<sup>15</sup>. HSBC's executives commented that Geoghegan could be unhappy at the possibility of being passed over in favour of Thornton. HSBC eventually followed up with a strongly-worded denial of the incident<sup>16</sup>. However, the damage had been done – the information leakage had given the public an insight into the boardroom power struggle. The picture of a fractured board and rifts over HSBC's succession were thrust into public spotlight.

Even though the official stance of HSBC and its top management suggests that Geoghegan's threat to resign might have been exaggerated and sensationalised<sup>17</sup>, what the public saw at that point in time was an extremely disorganised and poorly conveyed succession plan within HSBC, which is ill-befitting of a large global bank. Naturally, many questions arose. If this leadership transition had indeed been planned for, why did stakeholders and in particular, Geoghegan, not seem aligned to the plan prior to the announcement, leading to internal confusion and the subsequent uproar? It was clear from an external viewpoint that HSBC had not conveyed the plan and managed expectations well, both internally and externally. The pressure was intensified for HSBC to achieve a resolution as swiftly as possible, in order to assuage investors' discontent, prevent divisiveness within the organisation on candidate selection, and restore its public image.

## The Dilemma

In selecting a new Chairman, the Nomination Committee's dilemma was obvious. Geoghegan was a long-serving HSBC banker with a wealth of intimate knowledge on HSBC's operations. With Green already leaving, the loss of Geoghegan would be a double-whammy. Yet, condoning Geoghegan's appointment and promoting him would undermine shareholders' wishes, and impede HSBC's effort to keep up with changes in the governance landscape.

It seemed like no resolution would be able to completely reconcile the interests of shareholders and management. The need and urgency for the board to arrive at a resolution in keeping with the best interests of the company and to quell public speculation on the internal rift was pressing, while external perceptions of an ill-conceived and ill-conveyed succession plan continued to plague HSBC<sup>18</sup>.

## **The Resolution**

On 24 September 2010, just three days after the reported spat between Geoghegan and the board, HSBC unveiled a new leadership team<sup>19</sup>. After consideration of numerous factors, the board made a unanimous decision to appoint Douglas Flint to succeed Green as Chairman. Stuart Gulliver was appointed Group Chief Executive, while Sir Simon Robertson remained the senior independent non-executive director and assumed the concurrent role of Deputy Chairman. Geoghegan would continue to serve in an advisory capacity until 31 March 2011, after which he would formally retire.

John Thornton stayed on as HSBC's non-executive director. The appointment of Robertson as Deputy Chairman was aimed at countering investors' discontent<sup>20</sup> about the newly-installed, predominantly executive leadership team.

## **Investors' Reaction**

Investors' reaction to the new leadership team was generally positive. On the day the leadership changes were announced, HSBC shares increased by 0.4 percent to 666.4 pence.

General investor sentiment was that despite the infighting, "the right men have ended up in the right jobs"<sup>21</sup>. However, many institutional investors remained upset at the poorly executed succession, and their disapproval manifested in numerous calls for HSBC's non-executive directors to be replaced, to take responsibility for the "bloody mess"<sup>22</sup>.

## Discussion Questions

1. What is the purpose of a succession plan and what are the components of a comprehensive succession plan?
2. How is succession planning for the board and senior management different for companies with controlling shareholders?
3. Identify the problems that arose as a result of HSBC's Chairman succession. What was lacking in HSBC's succession plan?
4. What is the impact of poor succession planning on HSBC and its stakeholders?
5. What are the roles of the Chairman and the CEO? How are they different? What are the attributes of a good Chairman?
6. What are the pros and cons of having the CEO becoming the Chairman? In your view, has HSBC addressed the concerns of the CEO becoming Chairman by appointing the Finance Director as Chairman?
7. How should a company balance its needs against the expectations of external stakeholders with respect to compliance with good practice?
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# Sino-Forest: Sigh, No Forest?

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## Case Overview

On 2 June 2011, Muddy Waters, a short-seller, released a report alleging that Sino-Forest had fraudulently inflated its assets and earnings<sup>1</sup>. Sino-Forest's stock tumbled 60% on the release of the report<sup>2</sup>. The objective of this case is to allow a discussion of issues such as listings through reverse takeovers, director's duties, the effectiveness of external auditors and the Audit Committee, risk management, and form versus substance of corporate governance.

## The Roots Of Sino-Forest

In 1994, Sino-Forest Corporation, a forest plantation company was founded by Allen Chan, a Hong Kong entrepreneur, and Kai Kit Poon, a former Forestry Bureau official. Chan became the firm's public face, raising billions of dollars from Canadian and international investors. As a former Forestry Bureau official, Poon had the *guanxi* with government forestry officials, connections that are vital to doing business in China<sup>3</sup>.

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This is the abridged version of a case prepared by Chen Zi Yang, Clara Goh Shu Fen, Lam Hua Yuan, Lee Shi Jie, Tan Wei Ying, Thia Li Yun and Vanessa Chew Wen Yi under the supervision of Professor Mak Yuen Teen and Dr Vincent Chen Yu-Shen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Mabel Lynn Leong Jia Jia under the supervision of Professor Mak Yuen Teen.

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The firm's first major deal was to provide timber to a fibre board factory, which was jointly owned by Sino-Forest and the Leizhou Forestry Bureau, an arm of the Chinese government. The Leizhou deal helped Sino-Forest gain a listing on the Alberta Stock Exchange in 1994 through a reverse takeover of a dormant shell company<sup>4</sup>. Chan and his business associates chose to list Sino-Forest in Canada because they reasoned that Canadian investors are more familiar with the forestry sector. Sino-Forest eventually shifted its listing to the Toronto Stock Exchange (TSX) in 1995<sup>5</sup>.

Sino-Forest's main revenue stream comes from their Wood Fibre operations in the People's Republic of China (PRC)<sup>6</sup>, where Sino-Forest purchases standing timber plantations. They will hold the trees for two to three years to get fibre growth, then sell them to buyers through middlemen known as "authorized intermediaries (AIs)"<sup>7</sup>.

## **Sino-Forest's Prominent Figures**

### **Allen Chan**

Chan was the company's Chief Executive Officer (CEO) and Chairman<sup>8</sup>, and he raised almost C\$3 billion from Canadian and international investors since Sino-Forest's public listing<sup>9</sup>. While there are currently no rules, only guidelines, for the separation of the CEO and Chairman positions in Canada<sup>10</sup>, this separation has been increasingly common and accepted as a corporate governance best practice.

### **Simon Murray**

Simon Murray is the most high profile independent director on Sino-Forest's Board, being the ex-Managing Director of Hutchinson Whampoa. He joined the Board in 1999 and remains on it as of December 2012<sup>11</sup>. He consistently had attendance problems over the years. In 2010, Murray was present for only 2 out of 16 Board meetings, and none of his committee meetings<sup>12</sup>. This may be due to his busy schedule since he sat on five other boards<sup>13</sup>.

On 3 August 2010, Sino-Forest took majority control of Greenheart, a forestry company, and Murray co-invested in the deal<sup>14</sup>. Murray's position as an independent director became contentious as he had become such close business partners with Sino-Forest after this transaction.

## **Problems Arising from the Leizhou Venture**

Between 1994 and 1997, Sino-Forest reported US\$60 million in sales from the Leizhou venture<sup>15</sup>. However, regulatory documents from the PRC painted a different picture about the joint venture's profitability. The joint venture's 1995 PRC Capital Verification Report (a regulatory filing requirement in PRC) showed that the venture lost US\$1.1 million (RMB 8.7 million)<sup>16</sup>. However, these losses were never disclosed to Sino-Forest's investors. In fact, management reported in its 1996 Annual Report that the Leizhou venture completed 3 years of profitable operations. Sino-Forest's management had never explained the discrepancy between its 1996 Annual Report and its PRC regulatory filings for the same period.

In 1998, the Leizhou Forestry Bureau accused Sino-Forest of making improper payments to an external party for no commercial purpose, and wanted to end the joint venture. The failure of the Leizhou joint venture did not affect Sino-Forest's profitability and growth, as its profits and assets continued to grow steadily. Much of this profit and asset growth was attributed to Sino-Forest's new business model of trading through "authorized intermediaries" ("AIs"), which started in 2003.

## Rising from the Ashes

Sino-Forest reported strong net income growth from US\$18.6 million in 2001 to US\$395.4 million in 2010. The share price also grew strongly from C\$1.19 in 2001 to C\$23.29 in 2010<sup>17</sup>. Many rating agencies also gave good ratings and Fitch gave Sino-Forest the best non-investment grade rating<sup>18</sup>. Daryl Swetlishoff who is ranked by StarMine as one of Canada's top stock pickers described Sino-Forest as a "strong buy," saying it is "an undervalued stock"<sup>19</sup>. For 15 years, from 1994 to 2010, Sino-Forest's auditors Ernst & Young LLP (E&Y) and BDO Limited gave clean audit opinions on Sino-Forest's financial statements<sup>20</sup>. At its peak, 31 March 2011, Sino-Forest had a market capitalization of C\$6.2 billion<sup>21</sup>.

## The Bombshell – Muddy Waters calls Sino-Forest a 'Stratospheric Fraud'

On 2 June 2011, Muddy Waters shocked investors by issuing a negative research report on Sino-Forest by alleging that their assets and revenues were overstated<sup>22</sup> and that the auditors were ineffective. This set off a sharp sell-off in shares, resulting in a drop in share price from an opening price of C\$18.21 on 2 June 2011<sup>23</sup> to a closing price of C\$5.23 on 3 June 2011<sup>24</sup>.

### (i) Overstatement of Forest Plantation Assets

Muddy Waters alleged that Sino-Forest had overstated its timber assets through a misleading use of an outside forestry valuator, Poyry. Poyry was allowed access to only 0.3% of Sino-Forest's purported timber holdings<sup>25</sup> for its valuation estimation and had made it clear that its valuation report could not be relied on as due diligence since the report was based on information provided by Sino-Forest<sup>26</sup>. However, Sino-Forest did not disclose this fact in its annual reports, which may have misled investors into thinking that Poyry had certified ownership of Sino-Forest's assets. This was a breach of Canadian securities law that requires directors and officers to disclose all material facts that would affect securities prices<sup>27</sup>.

## **(ii) “Authorised intermediaries” (AIs) and Revenue Recognition Issues**

Due to PRC’s strict regulatory restrictions on foreign enterprises, Sino-Forest, which was incorporated in the British Virgin Islands, is restricted from selling standing timber directly to end-customers. Thus, Sino-Forest had to conduct sales through their AIs, pursuant to “entrusted sales agreements”<sup>28</sup>.

These AIs will purchase logs and deliver them to a chipping facility and they assume risks and obligations throughout the process, from purchase to sale, with the exception of the period where the logs are waiting to be chipped. During this period, risks and obligations fall on Sino-Forest<sup>29</sup>. Sino-Forest is given a percentage of AI’s net profit after taxes<sup>30</sup>. Thus, the AIs, serving both as Sino-Forest’s suppliers and customers are obliged to deduct and remit all of the applicable taxes on behalf of Sino-Forest<sup>31</sup>.

Muddy Waters alleged that the usage of anonymous AIs allowed Sino-Forest to fabricate sales transactions without leaving proper paper trails of value-added tax (VAT) tax records, which are the mainstay of China audit work<sup>32</sup>. Muddy Waters also questioned the incredibly high gross margin that was given to Sino-Forest by the AIs, as all operating activities were performed by AIs and Sino-Forest neither had risk capital nor moved any physical goods<sup>33</sup>.

Furthermore, Muddy Waters revealed that the only AI disclosed by Sino-Forest in April 2011 was a connected party to Sino-Forest<sup>34</sup>. Thus, Muddy Waters was suspicious that the sales revenues generated by Sino-Forest were not from genuine arms-length transactions, but instead undisclosed transactions with connected parties.

## **(iii) Long Distance (Audit) Relationship**

### **a. Competency of Audit Committee (AC) questioned**

The Audit Committee as at 31 December 2010 consisted of James Hyde (Chairman), William Ardell, James Bowland and Garry West, all of whom are “independent” and “financially literate”<sup>35</sup>. However, their competency and financial literacy were questioned by Muddy Waters as all 4 members lacked industry, political, and cultural knowledge of the PRC<sup>36</sup>. Their understanding of Sino-Forest’s complex accounting issues was also questioned.

## **b. “The Retirement Club”**

Out of Sino-Forest’s five independent directors, two were retired partners from E&Y - James Hyde and Garry West - and they both sat on the Audit Committee<sup>37</sup>. James Hyde was also the Audit Committee Chairman<sup>38</sup>. Since the recommendation of the external auditor is a responsibility of the Audit Committee, it raised suspicion of the true independence of E&Y given that Hyde and West could still possess connections and social networks with their former audit firm. This could potentially reduce independence and impede audit effectiveness.

## **c. External Auditors 12,500km away from Sino-Forest<sup>39</sup>**

The geographical distance between external auditors based in Canada and Sino-Forest’s main PRC operations<sup>40</sup> might have reduced the effectiveness of the audit. Furthermore, Canadian audit firms have to rely on local partners who, while licensed to audit in China, may not have the competency to meet Canadian standards<sup>41</sup>.

E&Y was quiet on the issue of accounting fraud and their only statement was released in June 2011<sup>42</sup>, which stated that they were unable to comment due to ongoing special committee work and professional obligations. Whether E&Y took reasonable care and diligence in their audit work will remain a mystery for the time being.

# **The Fallout**

## **3-6 June 2011**

Sino-Forest immediately responded by setting up a Special Committee of independent and financially qualified directors to investigate Muddy Waters’ allegations, and reported to the board material matters that were reviewed<sup>43</sup>. Meanwhile, Sino-Forest’s share price had dropped to a closing price of C\$5.23 on 3 June 2011. On 6 June 2011, PricewaterhouseCoopers (PwC) was appointed as an independent accounting firm to assist with the investigations<sup>44</sup>.

## **8 June 2011**

The Ontario Securities Commission (OSC) stepped in and commenced investigations of the allegations against Sino-Forest<sup>45</sup>.

## **26 August 2011**

OSC accused Sino-Forest of fraud, stating that Sino-Forest appeared to have misreported its revenues and assets and hence, it suspended trading of the firm's stock<sup>46</sup>.

## **28 August 2011**

In the face of mounting allegations<sup>47</sup>, Allen Chan voluntarily stepped down as Chairman and CEO and William Ardell, the lead independent director, succeeded him. Chan was installed into the new role of Founding Chairman Emeritus<sup>48</sup>.

# **Special Independent Committee's (IC) Findings**

## **(i) Existence of AIs**

The IC commented that there was limited information on the nature and scope of the relationship between AIs and Sino-Forest. There was no documentary support to show if the business transactions between Sino-Forest and AIs existed. The arrangements where Sino-Forest's payables from AIs were set-off by AI's receivables from the sale of timber could not be verified. Furthermore, even if interviews were arranged, little verifiable information would be forthcoming as third parties feared that information would fall into the hands of the Chinese government authorities and they would be questioned "for tax reasons", amongst other reasons<sup>49</sup>.

## **(ii) Existence of Timber assets**

The IC which consisted of foreigners, was unable to verify Management's assertions regarding forestry maps, because such information were classified as state secrets which foreigners had no access to. Additionally, the IC was unable to obtain Plantation Rights Certificates from local government authorities. Instead, they had to sought confirmations from local forestry bureaus to acknowledge Sino-Forest's rights to the standing timber. However, such confirmations are not officially recognized documents, nor are they titled documents. These confirmations were issued at the request of the company, Sino-Forest, and the IC were not entirely comfortable with the manner in which these confirmations were obtained<sup>50</sup>.

## **(iii) Cultural issues leading to weak internal control**

The IC stated that Sino-Forest's business model relied heavily on personal relationships. This caused an over-dependence on a small group of management who were integral to the maintenance of customer relationships, resulting in a concentration of authority and lack of segregation of duties. The management handled asset acquisitions and was in charge of both accounts receivables and accounts payables. This situation created risks in the areas of measurement and completeness of transactions, which may lead to the possibility of inaccurate financial reporting. The documentation of contractual arrangements was often incomplete, reducing verifiability<sup>51</sup>.

## **The House of Cards Collapses**

*"If you build a house of cards, the wind blows and the house collapses, you can't blame the wind that you built a house of cards"*

– Carson Block, founder of Muddy Waters Research on Bloomberg TV

On 30 March 2012, Sino-Forest filed for bankruptcy protection, nine months after it was accused of fraud by short seller Muddy Waters<sup>52</sup>. Less than a week later, its long-standing auditor, E&Y, resigned<sup>53</sup>.

The next day, Sino-Forest received a notice from the OSC, alleging that it had engaged in conduct contrary to the province's securities act. The document cited sections of the act relating to fraud, market manipulation and fabrication of untrue or misleading statements<sup>54</sup>. Such letters are usually issued by the commission close to the end of an investigation and before possible formal proceedings<sup>55</sup>.

Sino-Forest delisted its ordinary shares from the TSX on 9 May 2012<sup>56</sup>. The delisting was because Sino-Forest had failed to meet continued listing requirements and failed to file its interim and annual audited financial statements on a timely basis. Meanwhile, on 3 December 2012, the OSC accused E&Y of "failing to conduct a proper audit" of Sino-Forest, just days after E&Y reached a US\$117 million settlement deal with Sino-Forest shareholders which had yet been approved by the courts<sup>57</sup>.

Although OSC's allegations of fraud against Sino-Forest and its former executives are still ongoing at the moment, it seems almost certain that Sino-Forest had committed accounting fraud.

This case makes one wonder, was Sino-Forest indeed a fraud since day one?



## Discussion Questions

1. Was the listing of Sino-Forest through a reverse takeover a significant contributor towards its problems?
2. Discuss how the relationship-based (i.e. guanxi) business model affects corporate governance.
3. Comment on the potential risks of Sino-Forest's Audit Committee Board having retired partners from their current external auditor.
4. Assuming that Sino-Forest operated in a legitimate fashion, what could have been done to prevent such a fall in their stock price?
5. Is Sino-Forest's disclosure and compliance with the Code of Corporate Governance a true reflection of good corporate governance?
6. Recently, Muddy Waters also shorted the shares of Olam International and released a highly negative report on the company. Do you believe that short sellers such as Muddy Waters are a positive or negative force for good governance?

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## About the Editor

Mak Yuen Teen was founding director of the Corporate Governance and Financial Reporting Centre (CGFRC) and Associate Professor of Accounting at the NUS Business School at the National University of Singapore. He holds First Class Honours and Master degrees in accounting and finance and a PhD in accounting, and is also a

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Prof Mak is a member of the OECD Asian Corporate Governance Roundtable. He has served on key corporate governance committees involved in developing and revising codes of governance in both the corporate and charity sectors in Singapore and chaired the subcommittee which developed and revised the code of governance for charities.

He co-chaired the Singapore Corporate Governance Awards between 2003 and 2009 and currently chairs the judging panel for the Investor Relations Award under the Singapore Corporate Awards organized by Business Times and the Singapore Exchange.

Prof Mak developed the Governance and Transparency Index (GTI) which rates the corporate governance of listed companies in Singapore. He is the Singapore representative in the development of the ASEAN Corporate Governance Scorecard and Ranking, an initiative driven by regional regulators.

His report on improving the implementation of corporate governance practices in Singapore, commissioned by the Monetary Authority of Singapore and Singapore Exchange, was published in June 2007. His book "From Conformance to Performance: Best Corporate Governance Practices for Asian Companies" was published by McGraw-Hill in 2005. His primer on governance for social enterprises in Singapore, commissioned by the Social Enterprise Association, was published in 2012.



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