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“Friend or Foe?” Cautions CFA Institute on Related-Party Transactions

Study recommends investors to be more vigilant in monitoring related party transactions when investing in Asia

Hong Kong, February 2, 2009 – “The Satyam fraud case illustrates that where there is little separation of ownership and control, minority shareholders need to voice their opinion or run the risk of having their rights significantly compromised,” said Lee Kha Loon, CFA, Asia Pacific head of the CFA Institute Centre for Financial Market Integrity, with the release of its study titled “[Related-Party Transactions: Cautionary Tales for Investors in Asia.](#)”

The recent Satyam scandal in India which ended with the resignation of the chairman after admitting to fraud and falsifying accounts, started to unravel after the chairman tried to pass an abusive related-party transaction as a deal that would “deliver greater shareholder value.” Satyam did not take the proposal to buy the two related companies in question to shareholders, but rather the deals were unanimously approved by the board of directors which consisted of nine members, six of which were supposedly independent. Investors, not having a say in the deals, punished the stock after the announcement and the company withdrew the deals.

The Related-Party Transactions study highlights the prevalence of related party transactions in the region and shows how they can affect the interests of minority shareholders. Focusing on Hong Kong, mainland China, and South Korea, the study discusses the nature and motivation of these transactions which vary according to different ownership structures. Using cases as examples, the study identifies circumstances where related-party transactions have compromised minority shareholders, and explores the effectiveness of current regulations aimed at protecting shareholders’ interests. The study also proposes ways to better protect shareholders from abusive related-party transactions.

“Related-party transactions can serve legitimate, practical purposes as long as they are done on an “arms-length” basis. However in Asia, corporate custom and structures can often result in related-party transactions that are significantly conflicted and that negatively impact unwitting investors,” said Lee. “Connected transactions in Asia and elsewhere have been known as a common tool by which a controlling shareholder can expropriate wealth from minority investors,” added New York-based Kurt Schacht, CFA, managing director of the CFA Institute Centre, which advocates fair and efficient capital markets for investors globally.



The study finds that Asian companies are prone to engaging in related-party transactions because of their concentrated ownership structure. The risk to minority shareholders is always present as a result. For example, in Hong Kong and Korea, family ownership and control is common, and a key motivation to undertake related-party transactions is to transfer wealth to the next generation. The prominence of these transactions and the weaknesses in the mechanisms that govern them indicates that greater effort needs to be placed on protecting investors' rights.

The study highlights the following recommendations to protect investors against abusive related-party transactions.

- **Investor vigilance:** Investors should try to engage controlling shareholders when transactions are disclosed and they should be more vigilant in examining them when they are put up for a vote.
- **Effective approval and disclosure:** Upon determination of fairness by an independent advisor, transactions should be approved by “disinterested” directors and disclosed to investors in a timely manner. If a transaction is material, it should also be approved by shareholders.
- **Corporate board independence:** In situations where managers are also majority shareholders, independent directors have a greater onus in exercising their duties to protect the interests of independent shareholders.
- **Greater transparency:** Companies should voluntarily disclose the identities and the level of ownership of related parties, and also the policies in place to monitor and report such related party transactions.
- **Statutory backing of regulations:** Given the extent of losses minority shareholders could suffer from abusive transactions, one assurance that their interests are protected is to make companies legally liable when they violate regulations.

Details of these findings and recommendations are available from the full report available on the [website of CFA Institute](#).

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