



Why Do Chinese Companies Need a D&O Policy?

Directors & Officers liability (or simply “D&O”) insurance provides essential cover for a company’s senior leadership against claims that may arise against them. D&O insurance primarily covers defense and settlement costs related to regulatory investigations or an action brought against a company by a group of shareholders.

As the role of the board and corporate governance has evolved, D&O insurance has become an important and widely-used risk management tool for company leaders. D&O cover gives boards the flexibility and confidence to pursue those strategies that deliver the best outcomes for shareholders.

D&O insurance is still in its relative infancy throughout Asia, but this is likely to change, especially in China. Risks and liabilities that didn’t exist in past years loom large for growing Chinese businesses as they become bigger, and more importantly, geographically broader and more complex enterprises that require sophisticated corporate governance standards. The risk of a shareholder action in Australia, a discrimination suit in Europe, a cyber-attack in

Malaysia or a securities investigation in Hong Kong are real issues that boards need to mitigate.

Without D&O insurance, the financial consequences of such an event could be catastrophic for the company, and devastating to the directors themselves at a personal level. Here are 8 reasons why Chinese companies need start thinking seriously about D&O.

1. EXPANDING CHINESE COMPANIES FACE EXPANDING LIABILITIES.

Chinese companies are fast becoming some of the largest multinational conglomerates in the world. In the first three quarters of 2016, Chinese companies spent over US\$141bn on foreign acquisitions, predominately in Western Europe and the United States.

But only about 10% of Chinese listed companies in the A share stock exchange have D&O insurance. This is a major corporate governance concern as Chinese companies expand around the world.

Particularly in Western Europe and the US, Chinese companies need to be prepared to manage the costs related to a regulatory investigation or a class action shareholder lawsuit, which are much more common sources of D&O claims than in Asia-Pacific. The costs related to investigations or litigation can skyrocket quickly – the securities settlement paid to claimants in the largest US shareholder action, Enron, was over US\$8bn. Defense costs alone related to hedge fund manager Och Ziff Capital Management into bribery allegation in Africa have exceeded US\$100 million.

2. LIABILITIES, LEGISLATION AND PRACTICES ARE DIFFERENT IN EVERY MARKET.

Chinese companies are becoming multi-national corporations in their own right, not just through transformational M&A deals but also through organic expansion into other markets around Asia with groundbreaking products and services. But even within Asia, countries vary widely in their regulatory approach. Some common law jurisdictions such as Hong Kong and Singapore have established and predictable legal frameworks as well as a highly competitive market for D&O insurance.

Operating in other Asian markets can present a variety of unique challenges and liability questions. For example, who bears responsibility for an industrial accident in Vietnam? How can a company settle a claim by US or UK authorities that they have violated anti-bribery legislation? Who will pay for defense costs around a regulatory investigation in the Philippines? How will the company defend itself against a workplace discrimination claim in Indonesia?

D&O insurance protects companies when they find themselves in uncharted waters. This will be especially relevant as Chinese companies step to the infrastructure forefront as part of the country's official *One Belt, One Road* initiative.

3. SHIFT IN REGULATORY APPROACH AROUND IPOs POSES TEST CORPORATE GOVERNANCE AT COMPANY BOARDS.

China's planned shift from an "approval-based system" to a "registration-based system" for IPOs on Chinese stock exchanges is likely to pose new challenges for listed company governance at the board level.

The current approval-based system relies primarily on detailed review and approval by the regulator for every proposed IPO. Because of the level of scrutiny needed, this process can take years and require several rounds of regulatory review. A registration system, by contrast, aims to simplify this review process by shifting the emphasis to the quality, integrity and sufficiency of information disclosure made by the listing company in, for example, its IPO prospectus so prospective investors can make fully informed decisions.

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A registration-based system tends to put greater emphasis on the sufficiency of information disclosure by listed companies, so this planned move by the regulators is likely to see greater scrutiny on the sophistication of governance processes at listed companies and the accountability of its directors. This scrutiny and enhanced accountability at the board level means there is a greater risk of liability to directors. D&O insurance can address and manage this liability.

4. RISKS ARE ALWAYS EVOLVING AND RARELY PREDICTABLE.

Directors & officers face difficult decisions every day in the course of their business, and they must navigate evolving risks in real time based on the best information available to them. But even in the course of fulfilling their fiduciary duties, they can be exposed to errors due to forces outside of their control.

Take cyber risks as one example. Just a few years ago, theft of physical assets was the most pressing security issue facing most companies – today, cybercrime is a threat that can destroy an entire business. Putting in place requisite cyber resilience measures to address such threats, and having business continuity mechanisms in place, is increasingly becoming a governance issue and making its way into regulatory guidelines for boards. Amidst these challenges, D&O insurance affords company executives the peace of mind to pursue what is best for the company, not just the safest option.

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In the past, it was sometimes suggested that having D&O insurance created a perverse incentive for boards to neglect their duties of care. This is simply not the case. In fact, the reverse has proven to be true. Good directors know their obligations and liabilities and, in an environment of increasingly complex regulation, should not (and often do not) serve unless a D&O policy in place. The presence of D&O insurance demonstrates a company with good governance and strong leadership at the highest echelons.

5. INVESTORS ARE UNLIKELY TO STAY PASSIVE FOREVER.

Shareholder suits and class action litigation are currently uncommon phenomena around Asia. This is attributable to a variety of factors, including a developing and fragmented regulatory climate that does not set clear legislation around class action litigation. The experience of Australia over the past decade reveals that this can change rapidly.

Outside of the US, Australia is now the jurisdiction in which a corporation is most at risk of facing class action litigation. Investor or shareholder class actions increased in Australia by 31% between 1992 and 2004, and by over 50% between 2004 and 2016.

Risks arising from shareholder activism are also evolving rapidly. Activist investors began targeting Korean conglomerate Samsung in 2014 to dispute a merger between related companies Samsung C&T and Cheil Industries; today, under pressure externally, Samsung Electronics is on the verge of compromising with investors to re-structure the company and return more free cash flow to investors.

These trends highlight the increasing likelihood of shareholder actions throughout corporate Asia. Expect corporate governance to be under the microscope from shareholders in the years ahead, and the likelihood of a D&O claim to increase.

6. LISTING IN THE US PRESENTS A WIDE RANGE OF RISKS AND LIABILITIES TO DIRECTORS & OFFICERS.

Listing in the United States is a common way for Chinese companies to gain access to international capital. While companies tend to consider carefully the regulatory compliance burden of a US-listing, they tend to under-appreciate the considerable risk of a shareholder or class action.

Chinese companies listed in the US have been major targets for class actions suits. This trend peaked in 2011 when 31 class actions were filed against Chinese reverse mergers.

The preponderance of shareholder suits in the US has made it the largest single market for D&O insurance premiums and claims – in fact, settlements and costs related to shareholder and class action suits accounts for about 90% of claims paid. Any company looking to list in the US should be acutely aware of this significant risk.

7. HONG KONG-LISTED CHINESE COMPANIES ARE UNDER INCREASING RISK OF INVESTIGATION BY THE SECURITIES & FUTURES COMMISSION.

The Hong Kong SFC has made it clear that it's taking a vigilant approach to supervision and regulation of market participants and listed companies. Director Tom Atkinson said in November 2016 that "fraud and misconduct at the corporate level" have cost the Hong Kong stock market HK\$200bn. Fraud and misuse of powers by directors and officers of listed companies "pose one of the greatest threats to the investing public and the integrity of Hong Kong markets".

The SFC's budget for FY2017 is estimated at HK\$1.9bn, a near-threefold increase since FY2008. The bulk of this expenditure increase is due to staff costs, with headcount nearly doubling since FY2008 to 917. The focus of the SFC's headcount increase is in its Enforcement and Intermediaries Divisions. According to SFC's own figures, in FY 2016 the regulator commenced 515 investigations, less than the 553 in FY2015 but still almost double the FY2009 figure of 275. SFC proceedings have also nearly doubled since FY2009, up to 105 in FY2016.

Over 40% of the Hong Kong Stock Exchange's market capitalisation is comprised of Chinese companies. Nearly

every listed company in Hong Kong has D&O insurance, but it is not necessarily sufficient to cover the defense costs around a regulatory investigation.

8. REGULATORS AROUND ASIA ARE LIKELY TO FOLLOW HONG KONG'S LEAD.

Securities and governance regulation around Asia remains fragmented, but Hong Kong's SFC is one of the most respected regulatory agencies in the region. Other major capital markets and corporate centres are likely to follow suit.

The Monetary Authority of Singapore is also stepping up its own enforcement activities, most notably in relation to anti-money laundering regulations targeting 1MDB as well as Swiss private banks BSI and Falcon. Directors & officers at Singapore branches of international banks will need to take careful consideration of their responsibilities and liabilities in this new context.

Hong Kong and Singapore have historically set the tone for capital markets and corporate governance regulation for the whole of the region. The coming years should see other Asia-Pacific markets adopt a similarly firm enforcement approach.

CONCLUSION

Like their Western peers, Chinese companies have a daunting task ahead in navigating global risks. With shareholders looking to maximise their investment returns and regulators expected to aggressively pursue their interest in protecting the integrity of the capital markets, companies will need smart policies that protect their businesses from financial liabilities across markets and cultures. Meanwhile, Chinese companies will increasingly find that a comprehensive D&O policy will help them attract the best directors to lead their growing businesses.