KEY CONSIDERATIONS IN MANAGING SHAREHOLDER INVOLVEMENT IN THE BUSINESS: EFFECTIVE PRINCIPLES OF THE ROLE OF SEPERATION

THE ANNUAL GOVERNANCE & ETHICS CONFERENCE

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What are Shareholders Concerns

Governance	Management	Ownership
• Limited board independence, • Insufficient attention to investor proposals or concerns, • History of reporting, accounting and/or governance issues	• Diminished investor confidence, • Lack of accountability and strategic direction despite issues, • Excessive executive compensation	• Heavy institutional concentrations, • Limited insider ownership, • Large founding family holdings potentially looking for exit

What are Shareholders Concerns

Financial	Operational	Event-Driven
• High cash balance, • Stable cash flow, • Low debt levels, • Low book-to-market ratio	• Underperforming line(s) of business, • Underutilized assets, • Uncertain or unclear strategy	• Change in CEO, • Restructurings, • Cyclical downturns, • Consolidation

Shareholder Limitations

- **Shareholders suffer from two primary limitations:**
- **Free-rider problem**. Shareholder actions are expensive. Although all shareholders enjoy the benefits, a few bear the costs. This provides a disincentive to act.
- **Indirect influence**. Since shareholders do not have direct control over the company, they tend to exert influence via the following:
  - Communicating their concerns
  - Withholding votes from directors
  - Waging a proxy contest to elect an alternative board
  - Voting against company proxy items
  - Sponsoring their own proxy items
  - Selling their shares

Why separation: Agency Problem

The agency problem arises when the interests of principals and agents are non-aligned ie **<u>in conflict</u>**

Agency Theory – agency relationship

Agency Theory – Separation of ownership and management

- Expansion of business needs more capital which is sourced externally
- Increasing complexity in business activities needs professional agents
- The agency/corporate governance problem arises when the interests of principals and agents are not aligned

RECENT CG FAILURES- GLOBAL

Mismanagement of $1.6 b Customer Funds

Racial discrimination, misrepresenting market tests, manipulating earning and disrupting long-term contractual arrangement with distributors.

Money Laundering

Risk Management & Internal Control Failures– $7B trading scandal

Embezzlement

Weak Governance systems

Unauthorized trading fined ($475,797,475

Failure of governance on climate risk

RECENT CG ISSUES- KENYA

Conflict of interest, role of Chairman

CMC Holdings Limited

Conflict of interest, role of Chairman, Board wrangles

Gross board misconduct leading to collapse

Insider Trading. Over 477 Million in penalties and sanctions against select Kestrel Capital management on role

Conflict of interest, insider dealing

Penalised for lax forex checks

Poor governance, heavy borrowing and investments in projects that never gave returns

IMPACT OF CRISES & SCANDALS

- Trillion dollar losses
- Unprecedented bailouts of firms and nations
- Systemic unemployment
- Collapse in asset values
- Loss of investor confidence
- Suspensions and de-listings
- Banks unwilling to lend
- Countries on the verge of insolvency
- Social unrest

CAUSES OF GOVERNANCE FAILURES

- Failure to understand value of good corporate governance
- Failure to understand, identify, mitigate and control risk
- Lack of co-ordinated international policy making
- Poor corporate governance legal frameworks
- Poor regulatory structures
- Lack of effective regulatory tools and sanctions
- Failure to provide effective regulatory oversight and enforcement
- Lack of remedies and sanctions to deal with deficiencies

CAUSES OF THE CRISIS

- Large global macro-economic imbalances
- An increase in commercial banks involvement in risky trading activities
- Growth in securitized credit
- Increased leverage
- Failure of banks to manage financial risks
- Inadequate capital buffers
- Misplaced reliance on complex math and credit ratings in assessing risk

INVESTOR PROTECTION-SUMMARY OF CASES AS AT June 2019

YEAR	PBC	PUI	PAKA	ENFORCEMENT	FINALISED	NFPA	TOTAL
2014	5	20	3	2	3		22
2015	6	22	4	-	4		36
2016	6	10	2	1	5		25
2017	4	13	2	2	0		21
2018	7	14	5	1	14		40
2019	3	16	2	1	11	2	35

PBC - Pending before court
PUI - Pending under investigation
PAKA - Pending arrest of known accused
ENFORCEMENT - Referred to Directorate of Market Operations for consideration and action
FINALIZED - The files that have been closed after judgement from court
NFPA - No further Police action

INVESTOR PROTECTION-SAMPLE OF SACTIONS AGAINST LISTED COMPANIES TO PROTECT SHAREHOLDERS

Kapchorua Tea Kenya	Late Publication of Half Year Interim Financial Statements for the Period ending September 30, 2017 and failure to publish the financial statements	Warning issued against the Company in September2018.
Athi River Mining (ARM) Company Limited (In Administration)	Publishing information to Shareholders and the Public without the approval of the Authority contrary to Regulation 63(7) of the Capital Markets (Licensing Requirements) (General) Regulations (2002) and publishing Information to shareholders that is misleading contrary to Section 34(b) of the Capital Markets Act.	Regulatory Caution Issued against the Company in November 2018.
Bamburi Cement Limited	Publishing Profit Warning without the approval of the Authority contrary to Regulation 63(7) of the Capital Markets Licensing Requirements) (General) Regulations (2002).	Regulatory Caution Issued against the Company in December 2018.
Equity Bank Limited	Late Publication of change in Book Closure Date in two Daily Newspapers of National Circulation contrary to Regulation 19(2) of the Capital Markets (Securities)(Public Offers, Listing and Disclosures) Regulations (2002) which requires issuers of securities to make immediate public disclosure of information which might reasonably be expected to have material effect. Equity Bank Limited failed to make an immediate disclosure to the shareholders of the change in its book closure date from April 14, 2017 to May 05, 2017.	In January 2019, the Company was directed to pay Mr. Imran Dhanji Kshs. 60,000/= being dividends due tohim based on the book closure date of April 14, 2017 pursuant to Section 11(3)(cc) and Section 25A(2) and (3) of the Capital Markets Act.
Atlas Financial Group	Carrying on business of an Investment Advisor without holding a valid license contrary to the provisions of Section 23(1) of the Capital Markets Act.	Notice to Cease and Desist issued against the Company in September 2018.

Shareholder Value

Factors that impact shareholder value:

Corporate Governance
- Board Size & Independence
- Shareholder Rights
- Executive Compensation

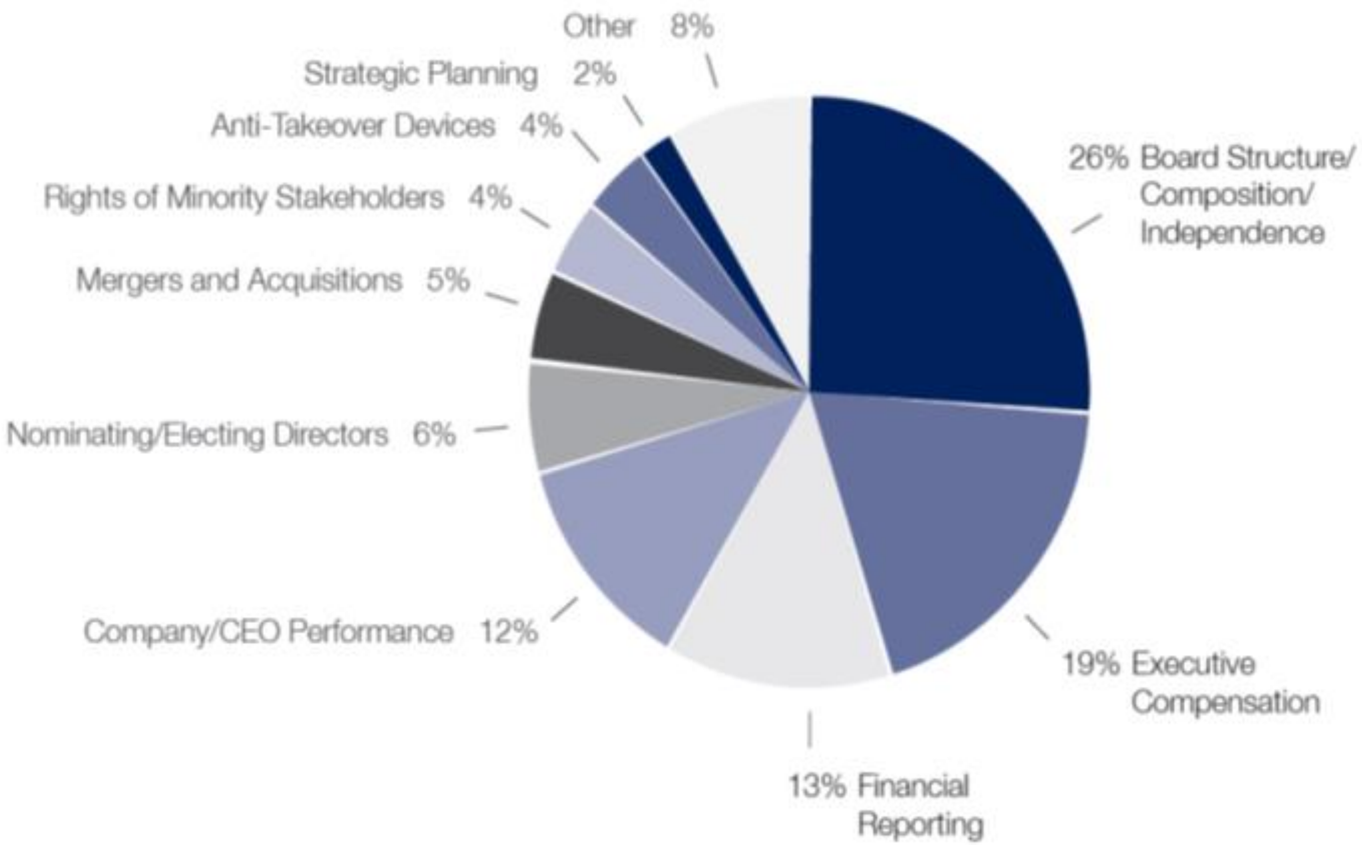
Business Strategy
- Growth
- Segments & Subsidiaries
- Mergers & Acquisitions
- Public vs. Private Decision

Operational
- Production Efficiency
- Business Processes
- Personnel Issues

Financial
- Capital Efficiency & Capital Structure
- Dividend Policy
- Share Buybacks & Cancellations

Investor Relations
- Analyst Coverage
- Investor Interactions
- Forecast Accuracy
- Credibility with Markets

RELATIVE IMPORTANCE OF BOARD IN BUSINESS



Source: RiskMetrics Group, Inc.

Corporate governance

- Most countries have developed and implemented corporate governance codes – Kenya, UK, Malaysia, Australia, Brazil, Canada, China, France, Germany, Ghana, India, Japan, Nigeria, South Africa, Tunisia, among others.
- Corporate governance is now seen as an essential building block of stable economies.
- Corporate Governance Code as well as the Stewardship Code is aligned to Capital Market Master Plan and globally accepted corporate governance standards.
- The Corporate Governance Code encourages a change of attitude from mechanical box-ticking to adoption and application of the corporate governance standards.

Key Elements of Corporate Governance code

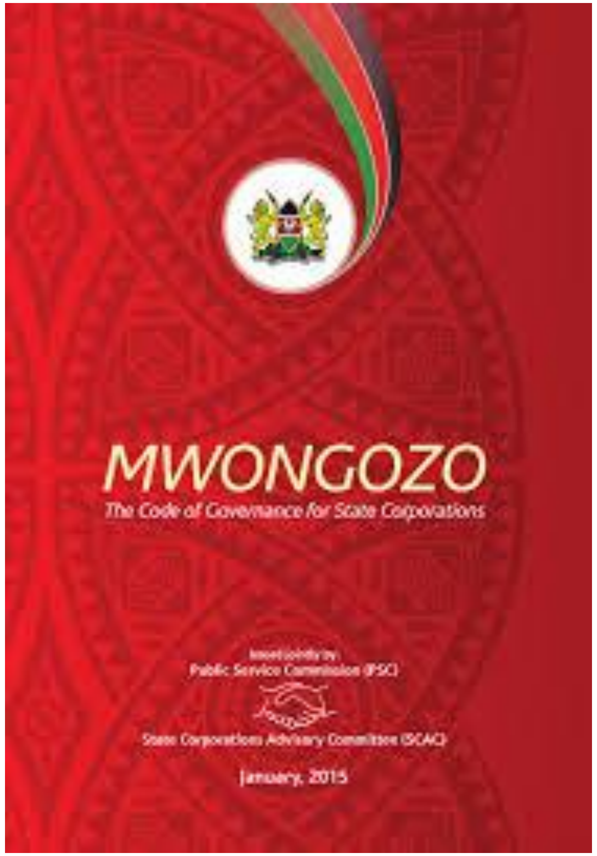
- **Remuneration of directors linked to corporate performance**
  - Ensures maximization of shareholder value
  - Ensures that appropriate incentives are set out based on performance
- **Effective stakeholder relations**
  - Effective management of stakeholders positively impacts a company's strategy and long-term growth
  - Stakeholders include shareholders, customers, suppliers, employees, creditors, regulators, media, auditors and potential investors
  - Board to recognize the rights of stakeholders and encourage co-operation in creating wealth and sustainable businesses
- **Focus on sustainability**
  - Ensures that the company is able to conduct its operations in a manner that meets existing needs without compromising future needs.
  - Board to ensure that the company's strategies promote sustainability
  - Key considerations be on environmental, social and governance (ESG) matters
  - Sustainability promotes long-term success leading to increased shareholder value
  - Integrated reporting a useful tool for reporting on the company's sustainability strategies
- **Governance and legal audits**
  - Corporate Governance Code requires companies to undertake governance and legal audits annually
  - Audits key in checking the level of compliance with the law and sound governance practices

Key Elements of The Sterwardship Code

The development of a Stewardship Code for Institutional Investors is one of the critical pillars under the Corporate Governance Code for Public Listed Companies.

- ✓ It also seeks to ensure that institutional investors foster sustainable value, wealth maximization and long term success of investee companies.
- ✓ Seeks to ensure that the shareholders receive maximum value for their holdings through engagement with investee companies.
- ✓ "Apply or Explain" principle where provisions of the Code should be applied by institutional investors and an explanation given for any departure or non-adherence.
- ✓ Institutional investors will be required to take up the role of stewardship as the representatives of their clients or investors in listed companies (they are a voice for shareholders)..
- ✓ They are also encouraged to communicate with management/board on their voting decisions and report on its voting record to the clients.
- ✓ For clarity, institutional investors are pension funds, private pension scheme providers, insurance companies, takaful operators, investment trusts and collective investment schemes.
- ✓ There are two categories of institutional investors, firstly asset owners who collect and manage funds by way of investing in equities and other capital markets products on behalf of their beneficiaries or clients
- ✓ Main principles are Monitoring companies held in investment portfolios, Active and informed voting practices, Engagement, escalation and collaboration with other institutional investors, Conflicts of interest, Focus on sustainability issues including environmental, social and ethical factors and Public disclosures and client reporting.

MWONGOZO CODE



- Code of Governance for Government Owned Entities developed by the Implementation Committee, in conjunction with SCAC and the Institute of Certified Secretaries (ICS) in consultation with World Bank.
- Provides a framework embodying Board charters, Codes of conduct, professional ethics, and performance management. Addresses matters of effectiveness of Boards, transparency and disclosure, accountability, risk management, internal controls, ethical leadership and good corporate citizenship.
- It further provides a platform for addressing shareholder rights and obligations and ensuring more effective engagement with stakeholders.
- More importantly, MWONGOZO ensures that sustainability, performance and excellence become the hallmark of our Government Owned Entities.

CORPORATE GOVERNANCE REFORMS BENEFIT MULTIPLE STAKEHOLDERS

Who benefits	How?	The results
Investors	• Protection from abuse • Increased shareholder value	▪ Good corporate governance systems encourage global and local equity (and debt) investors. Increasing portfolio investment in emerging economies and driving change.
Companies	• improved access to finance (both equity and debt) • Higher valuations • Better decision-making	▪ Investors more likely to provide capital at a lower rate ▪ Sustainable wealth creation within the private sector can only be brought about through good management, entrepreneurship, innovation, and better allocation of resources. ▪ Better corporate governance adds value by improving the performance of companies through more efficient management, better asset allocation, and improvements in productivity.
Regulators & supervisors	• A first line of prudential defense • Increased financial stability	▪ Investors less likely to flee well-governed countries / companies in times of crisis. ▪ Companies with good corporate governance practices will have better risk-management systems than those without. ▪ key component of the governance and anti-corruption agenda
Markets	• Higher market capitalization and liquidity	▪ Markets can grow by improving their corporate governance standards and enforcement mechanisms.
Economies	• More sustained economic growth • Increased financial stability • Increased competitiveness	▪ More “champion” companies that can compete and grow internationally ▪ Higher economic growth

ROLE OF SHAREHOLDERS IN RUNNING A COMPANY

Principle	Consideration
Board composition and appointment of board members	Shareholders play a critical role in the appointment of board members. To improve this, shareholders should be involved in the nomination of board members, ask relevant questions on appointment while making sure that the nomination process ensures that the board is representative, diverse and competent.
Stewardship responsibilities of institutional investors	The Stewardship Code for Institutional Investors, 2017 calls on institutional investors to actively participate in the oversight of issuers. The Code requires institutions investors to engage companies, have comprehensive voting policies and sustainability. Institutional investors to play a more proactive rather than reactive role in the oversight of companies.
Stakeholder relations	The Corporate Governance Code for issuers calls on issuers to identify and engage their stakeholders. Shareholders should ensure that companies have effective stakeholder engagement policies that go beyond the AGMs.
Transparency and disclosure	Shareholders to proactively engage companies and ensure that they remain transparent while disclosing all the relevant information necessary for informed decisions. This includes shareholders asking for more relevant, timely and balanced information.
Collaborations amongst shareholders	Shareholders have a stronger voice when they come together and share their issues, feedback and concerns rather than individually.
The place of governance audits and the role of shareholders	The Corporate Governance Code requires issuers to undertake independent governance audits once every two years. The governance audits play a critical role in assessing the state of governance of issuers. Currently, governance audit opinions are published in the issuer’s annual reports. There is work ongoing to have the governance audit report as an agenda during AGMs. This will enable shareholders understand the state of governance and ask relevant questions.

INVESTOR PROTECTION

- ✓ The Authority published the first Corporate Governance Scorecard. The issuers weighted overall score in the application of the Code was **55%.**

- ✓ It is an encouraging start and can be compared against the ASEAN Corporate Governance Scorecard Country Reports and Assessments 2014 which indicated that Indonesia, Malaysia, Philippines, Singapore,Thailand, and Vietnam scored 43.29%, 62.29%, 48.90%,55.67%, 67.66% and 28.42% respectively.

MINORITY SHAREHOLDERS

- ✓ Minority shareholders can generally be outvoted by the majority in relation to important decisions of a company and can therefore suffer prejudice.
- ✓ Much however depends on whether actions have been taken to deliberately prejudice the minority shareholder or shareholders as against the legitimate power and influence which can be used

MINORITY SHAREHOLDERS PROTECTION

- ✓ Minority shareholders in firms registered in Kenya can breathe a sigh of relief following the signing into law of the Business Laws (Amendment) Bill, 2019.
- ✓ The Amendment act lifts the threshold for compulsory acquisition/sell-out rights for company shareholders involved in a take-over from 50% to 90%.
- ✓ Therefore, for companies listed at the Nairobi Securities Exchange, the new law will ensure the protection of minority shareholders.

ROLE OF ACCOUNTANTS IN CORPORATE GOVERNANCE

- ✓ Accountants are the gatekeepers of governance and financial reporting.
- ✓ By more effectively communicating corporate governance structures from the top down, organizations can facilitate more accurate and ethical information.
- ✓ Arguably, a large percentage of all governance issues with listed companies could have been avoided had the accounting sections scrutinized transactions more.

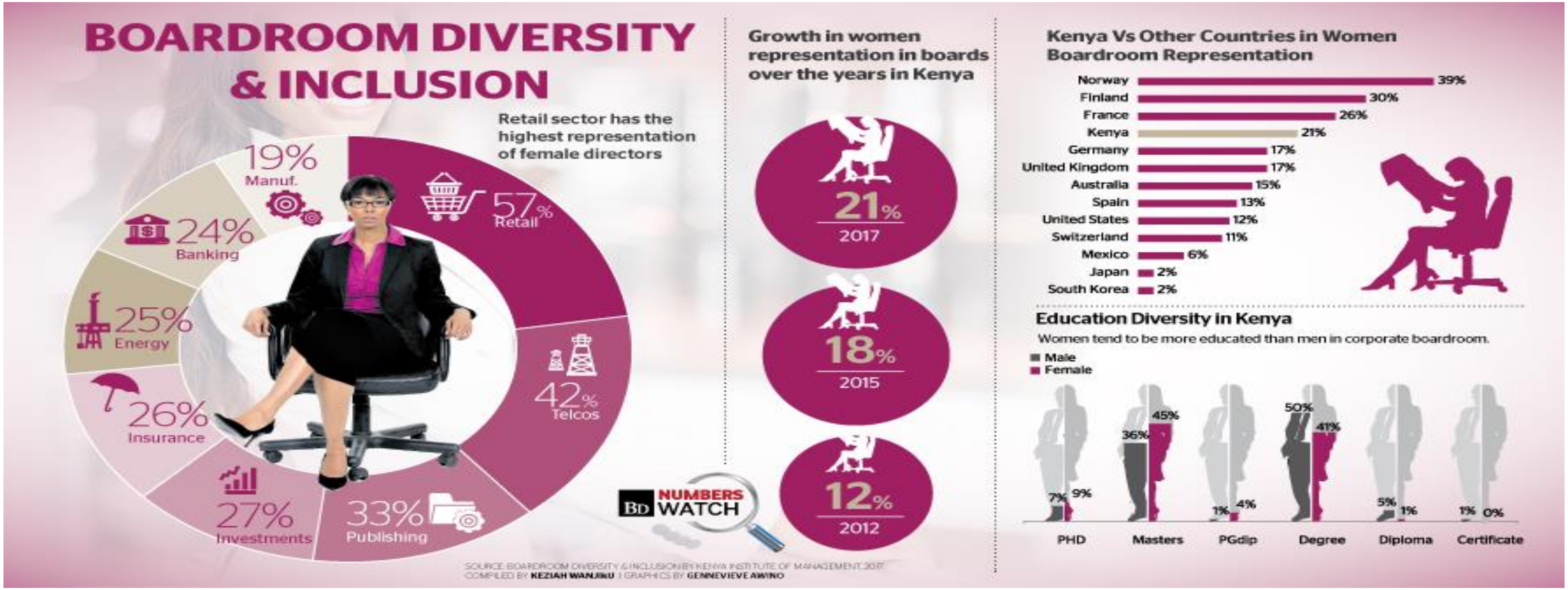
HOW DO A CORPORATION'S SHAREHOLDERS INFLUENCE ITS BOARD OF DIRECTORS

- ✓ Individual shareholders who do not possess large share price influence, or less than 1% of outstanding shares for example, must mobilize others to have real strategic influence.
- ✓ Collective of shareholders can exert significant influence to bring about desired changes in the direction of the firm in both the short- and long-term.

SO? AS AN INVESTOR:

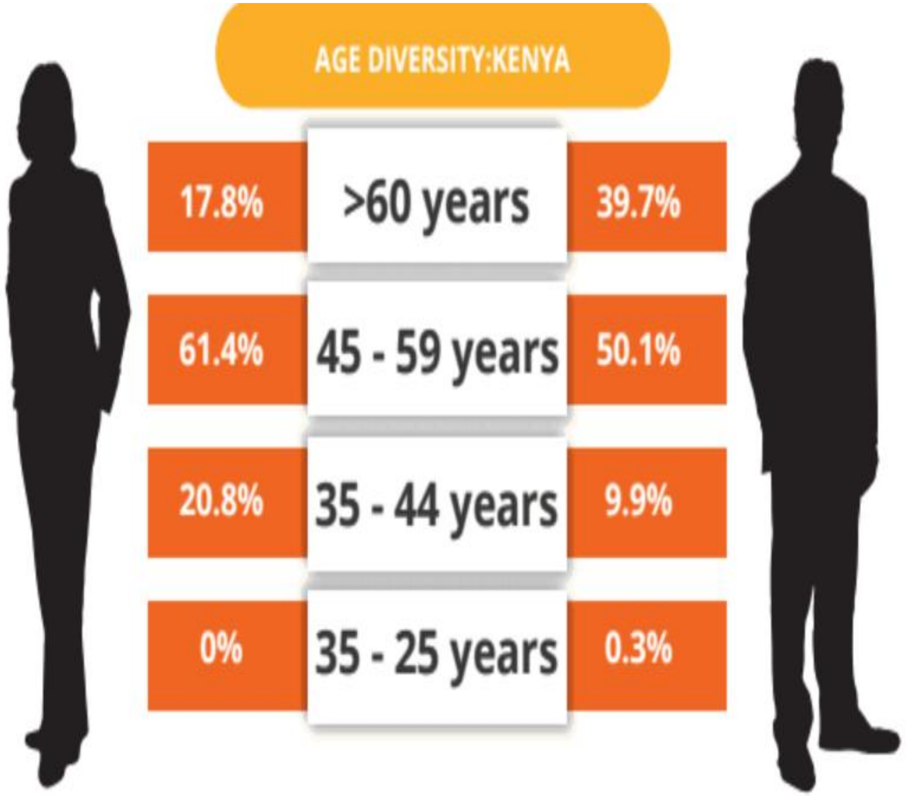
- HOW DO YOU:
  1. EVALUATE BOARDS/GOVERNANCE BEFORE INVESTING?
     - ✓ Reports analyses (incl. CMA)
     - ✓ Board members track records
     - ✓ Personal contact/interviews
     - ✓ Consult experts

Board Diversity (1)



Report on diversity by Kenya Institute of Management and Nairobi Securities Exchange (2017)

Board Diversity (2)



- Board diversity is a critical factor that determines the board's effectiveness.
- currently, there are at least six (6) women who are CEOs/MDs of issuers of securities to the public in Kenya.
- Additionally, at least three (3) issuers chaired by women.

SO? AS AN ENTREPRENEUR:

- HOW DO YOU FORM A GOOD BOARD?
  1. Persons of integrity
  2. Committed
  3. Competent
  4. No special interest

NEXT STEPS ON THE IMPLEMENTATION OF GOOD CORPORATE GOVERNANCE PRACTICES IN KENYA – CONT'D

➢ **Listed companies to-**

- engage with institutional investors
- establish investor relations function
- provide sufficient disclosure on governance and sustainability
- provide training to management and board members on stewardship

➢ **CMA to-**

- champion the Code and monitor its application
- encourage institutional investors to become signatories
- report on application of the Code
- periodically review the Code

• **Key Recommendations**

- Need for awareness forums for all stakeholders to ensure success of the Code
- Better engagement between listed companies and institutional investors
- CG commensurate with size of business entity instead of the current one size fits all model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