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Sandy Halley asks, should there be more, better or different corporate governance disclosure rules?

Drastic share price falls caused by margin calls on directors' undisclosed loans for shares in the companies on whose board the directors sit has opened a vigorous debate on the need, or not, for greater disclosure and controls of directors' investments. The questions are: should there be more, better or different regulation? If so, what? If not, are other measures required and if so, what would work?

'Regulation' is usually used to refer to statute or other government controls. The OECD identifies a triangle of corporate governance scrutiny, with government regulation, market direction and self discipline making up its sides. Business organisations lobby relentlessly for minimisation of government intervention, holding tight to Adam Smith's 'invisible hand'. Shareholder representatives, independent corporate governance experts, ethics bodies and media scrutiny point to the lack of enforcement of controls of all kinds and argue for stronger controls and diligent enforcement.

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The Australian Institute of Company Directors (AICD) is opposed to new regulation. In its submission to the Commonwealth Treasurer's Financial Services and Credit Reform Green Paper, the AICD, speaking on behalf of its 23,000 members and as the "principal professional body representing directors in Australia" says, "there has been some recent focus by regulators on the use of (margin lending) arrangements by directors of listed companies because they have duties at law and greater access to company information… Although there have been alleged recent abuses of margin lending arrangements, AICD considers that no fundamental overhaul of the regulatory oversight of such transactions is required, just incremental improvement."

The AICD position is that "margin lending plays an important role in the purchase of shares" and that there is now a "nationally consistent regime for margin loans for companies" governed by:

- The Corporations Acts provisions for insider trading and fiduciary responsibilities
- The ASX Corporate Governance Principles concerning directors trading in company securities
- Corporations Act and ASX Listing Rules on continuous disclosure which, when updated in February 2008 required directors to disclose transactions for a 'material' number of listed securities; determination of 'materiality' being a matter for boards to determine.

The 'incremental improvement' AICD suggests is that its members adopt a policy of requiring disclosure to the board or a committee of the board and that materiality criteria to determine market disclosure could be:

- Number of shares to be sold
- Likely impact on "marketing trading patterns"
- The "manner in which a financier might force disposal of the shares".

The AICD published in the July 2008 issue of its national monthly magazine, *Director*, a cover story entitled "Lessons from ABC: Sallyanne Atkinson's views on what went wrong at ABC Learning Centres". The article did not include any mention of margin loans.

In March 2008 Company Secretaries Australia (CSA) conducted a survey of its members on the adequacy of margin loans disclosure regulation (Table 1).

In June 2008, CSA issued a press statement calling for an amendment in the ASX Listing Rules to "require directors to notify the company if they have a 5 per cent stake or more in the company in issued securities subject to margin loans… The company would then be required to inform the market." This short-term measure should be followed by an "amend(ment) to the Corporations Act making it mandatory for directors to comply with this disclosure requirement… giving (ASIC) much tougher enforcement powers." Clearly, company secretaries (who can be fairly seen as honest brokers in the bargaining for balance in the boardroom) do not think that self regulation and market controls are sufficient nor that current legislation is adequate.

The 5 per cent stake rule would prevent single large divestments. But in large companies the sale of much smaller holdings, especially by a number of directors at once, could easily have a 'Henny Penny' effect on the share price.

Todd Davies, Australian Institute of Internal Auditors' Technical and Policy Director and member of the ASX Corporate Governance Council says: "On face value, aligning directors' interests with those of shareholders through share ownership sounds sensible. But margin lending and other leveraged approaches introduce other considerations which can result in a focus on short-term share price performance instead of long-term shareholder interest. We don't have to look very far back in time to see examples of this – this was at the heart of the largest fraud in corporate history, MCI-WorldCom."

In her book, *Extraordinary Circumstances,* whistleblower and former WorldCom internal auditor Cynthia Cooper explains that in 2005 the Compensation Committee, without reference to the board, lent the CEO $400 million for margin calls. If he had not paid, the bank would have sold off some or all of his stock and the share price would have been badly affected. Other directors were stock holders as were lenders, brokers and senior operatives in other agencies supplying and advising WorldCom.

Launching her book in Australia recently, Cooper said that the boardroom atmosphere is rarefied and the distinction between right and wrong behaviour is

Table 1: The question is…

1 Should directors and executives be required to disclose if their shares are subject to margin lending? **Yes: 63%, No: 37%**

2 Should the privacy of directors' and executives' personal finance be respected and disclosure of a margin loan only be required when a margin position may be material to the company's share price? **Yes: 65%, No: 35%**

3 Does the disclosure of shares held by directors and executives being subject to margin loans increase the vulnerability of the company's shares to short selling by hedge funds? **Yes: 82%, No: 18%**

4 Should the disclosure of directors' and executives' financing arrangements be required where failure to disclose might give a false impression of the degree of confidence the directors or executives have in the company or the amount of their personal wealth that they have committed to the company? **Yes: 67%, No: 33%**

5 Does your company have a share trading policy for directors and executives in place? **Yes: 100%, No: 0%**

6 Does your company have in place a process for tracking compliance with share trading policy? **Yes: 81%, No: 19%**

7 Is tighter control required in relation to short selling and stock lending? **Yes: 82%, No: 18%**

Source: Company Secretaries Australia survey, March 2008 more cloudy than it is down on the street. She said the air became very clear very quickly when she entered her office to find it full of FBI agents with guns.

Speaking as an internal auditor, Davies says: "As a profession which relies heavily on having independent directors on the board, we would encourage boards to ask whether directors with margin loans in their own company can be independent and therefore can serve in independent director roles. I suspect that in many cases the answer will be 'no'."

Some Australian-listed companies have independence criteria beyond those required by law for non-executive directors. For example, the Macquarie Group requires non-executive directors to sign, annually, an independence statement which prohibits:

- Executive employment in any company in the group
- Advisers, suppliers or customers whose business with the group exceeds 5 per cent of their own operations
- Directorship of more than two boards in the group
- Substantial shareholding in the group, a company holding more than 5 per cent of voting securities or an officer of the latter
- Any interest or relationship affecting independent directorship in the best interest of the group.

Australian Shareholders' Association (ASA) CEO Stewart Wilson says: "Significant margin loans should be reported to the market via the ASX and all loans should be disclosed to the audit and risk management committees because any large margins loans pose an extra risk to the company share price." On materiality,

"Margin lending focuses on short-term share price performance instead of long-term shareholder interest"
TODD DAVIES

Wilson says that "in most cases a holding of less than 5 per cent could influence the share price. Of particular concern are small companies whose shares are traded in small numbers, day to day."

The ASA does not accept the 'we didn't see it coming' argument which has become a common board defence and was used most recently in the Opes Prime/ANZ debacle. "Several directors had margin loans greater than 5 per cent but the board said they never thought the share price would get low enough for a margin call. What is risk management if it is not to identify risk? If the potential is there, the risk must be reported," Wilson says.

In addition to government regulation and market controls, boards discipline themselves via a range of commitments which are generally published in their annual reports and on their websites. These

Two-speed approach

A 2008 Corporate Governance Reporting review by business advisory specialist Grant Thornton tracks a clear gulf opening between businesses at the top end of town and smaller listed firms. Research shows that more than half of the ASX 300 are still not fully observing governance principles, with the ASX 201-300 showing particular drift from best practice standards.

High-profile disclosure issues dividing the ASX include the structure of the board and the question of executive pay:

- 39 per cent of the 201-300 segment did not have a majority of independent directors on the board, compared to 17 per cent of the top 100.
- 43 per cent of the 201-300 companies did not have an independent director as chairperson. In comparison, 85 per cent of the top 100 firms were led by an independent chair.
- 21 per cent of the 201-300 did not follow shareholder-approved thresholds when finalising equity-based executive remuneration. Only 6 per cent of the top 100 did not pay in accordance with shareholder-set ceilings.

"A 'one size fits all' approach to disclosure isn't always practical, and we understand that smaller listed companies may not face the same operational issues as the larger caps," says Peter Moloney, Director, Business Risk Services at Grant Thornton. "However, the

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Should there be stronger controls?

YES

Obvious:

The Allco, Babcock and ABC Learning crises plainly show that the existing regulations don't work when it counts.

Fundamental:

Acting in the best interests of the company is the responsibility of a company director and any factor which may interfere with that duty must be disclosed and addressed.

Inherent risk:

The formal statement of risk management responsibilities of a board must include any risks imposed by directors themselves.

Oversight:

The risk imposed by margin loans has only become apparent in a falling market; exposing a loophole which can and should be easily remedied by a minor change to regulation.

Culpability:

Directors should be punished for acting in their own interests against the interest of the company; this goes beyond the current statutory provisions for fiduciary responsibilities and against insider trading.

Enforcement:

Sanctions are not being imposed on directors committing margin loan abuses nor on board chairs presiding over margin lending practices.

Impact:

Directors selling shares to raise the capital to pay margin calls show their lack of confidence in the stock recovering in the short term. Once sniffed by the market, large investors, especially hedge funds, short-sell the stock and the price cascades.

ASX 201-300 members are still all sizeable enterprises which makes it surprising that we should see such pronounced disparities.

"From the review we've conducted, we believe that some organisations are still reporting by rote, rather than reporting in order to act and address areas of concern."

Even where the ASX's principles have been met, the report states that many compliance statements lack commercial bite, with companies signing up to recommendations in principle rather than practice. Risk management is an area of particular concern: only 73 per cent of the ASX 201-300 businesses assessed were able to verify that their financial statements were founded on a sound and effective system of risk management and internal compliance.

Grant Thornton analysed the 2007 annual report disclosures made by 290 of the ASX top 300 companies against the Principles of Good Corporate Governance and Best Practice Recommendations ('The Governance Principles') used by the ASX Corporate Governance Council to assess corporate governance levels and trends across the largest listed Australian firms.

The findings follow the ASX's own review in June, which gave an overall benchmark of compliance levels against its Governance Principles (90.5 per cent), but did not offer a detailed snapshot of reporting against individual recommendations. According to the Grant Thornton Report, only 45 per cent of companies in the top 300 implemented all of the Governance Principles in their 2007 annual report disclosures.

NO

Unnecessary:
There is plenty of relevant and effective regulation already.

Over-reacting:
Shares financed by margin loans amount to less than 3 per cent of market capitalisation in Australia.

Intrusive:
Disclosure of directors' private investments is an invasion of privacy.

Harmful:
Director investment shows director confidence in the company and personal alignment with and commitment to its business.

Unfair:
Regulation of director loans disclosure could create differential classes of shareholders, those with and those without access to company analysis.

Useless:
Regulation could easily be evaded by directors transferring loans into the names of family members.

Destructive:
Entrepreneurship would be discouraged by further disclosure by private individuals financing and founding new ventures

Damaging:
Discouraging director investment could reduce market capitalisation and shareholder value.

Interfering:
Prime Minister Rudd's self-definition as an 'economic conservative' would be sullied, resulting in a fall in business confidence in the Australian economy and in the Government's management of it.

The 10 principles that were in effect for the period covered by this review are:

1 **Lay solid foundations for management and oversight:** Recognise and publish the roles and responsibilities of board and management.

2 **Structure the board to add value:** Have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.

3 **Actively promote ethical and responsible decision-making.**

4 **Safeguard integrity in financial reporting:** Have a structure to independently verify and safeguard the integrity of financial reporting.

5 **Promote timely and balanced disclosure of all material matters concerning the company.**

6 **Respect the rights of shareholders:** Respect and facilitate the effective exercise of those rights.

7 **Recognise and manage risk:** Establish a sound system of risk oversight and management and internal control.

8 **Encourage enhanced performance:** Fairly review and actively encourage enhanced board and management effectiveness.

9 **Remunerate fairly and responsibly:** Ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined.

10 **Recognise the legitimate interests of stakeholders:** Recognise legal and other obligations to all legitimate stakeholders.

now include charters, codes of conduct, ethics statements, disclosure of pecuniary interests, confidentiality agreements and board performance reviews.

The St James Ethics Centre cites evidence of codes of ethics being more effective in producing good corporate governance and bottom lines than prohibitive laws. This is explained by laws provoking people to find ways around them whereas ethics statements encourage people to examine options and choose to do the right thing. While the positive and real (shareholder) value of establishing a board culture of ethical behaviour is compelling, individual directors intent on doing the wrong thing would seem to be unlikely to be persuaded by or even interested in ethical considerations.

"Margin lending plays an important role in the purchase of shares" AICD

Having professed its economic conservatism from the outset, the Rudd Government is between a rock and a hard place on corporate governance regulation. It has inherited 12 years of Howard 'hands off' that the business community expects to continue. However, the recent corporate crises in Babcock & Brown, Allco, ABC Learning and Opes Prime demand revision of corporate governance disclosure rules, if nothing else.

The Office of the Minister for Superannuation and Corporations Law will not be drawn on the government's intentions. With a view to "getting the balance right", Minister Sherry has directed Treasury to jointly conduct, with the AICD, a survey of 600 S&P/ASX-200 companies to "consider the current obligations under the *Corporations Act 2001* and the sanctions which apply for misconduct under Australian law. The Government expects the survey results to assist in developing future reform proposals to address both corporate and director misconduct." The Minister's office did not identify any other stakeholders being consulted.

Meantime, shareholders are wondering who is in charge, whose interests are being cared for and whether their money is safe.

Corporate adviser **Sandy Halley** BSW, MTCP, MBA, FAICD has been CEO of billion dollar corporations and a director and chairman of boards in the public, private and community sectors for over 25 years.

Corporate governance: How it works

Government laws and regulations

Authority:
Federal Government[1]

Aspects of governance:
Federal Government[2]
State Governments[3]
Local Governments[4]

Market controls

Authority:
ASX, professional and industry bodies

Aspects of governance:
Share trading prices, licensing and authorisation, membership conditions

Self-regulation

Authority:
No formal authority. Standards established by professional membership bodies for directors and company secretaries

Aspects of governance:
Disclosure of pecuniary interests; board charter, board code of ethics; board confidentiality agreements; board committees – audit, compliance and risk management; annual report; board performance reviews; triple bottom line reporting

1 ASIC – Corporations Act; ACCC – Trade Practices Act; APRA – APRA Act and FMA Act; Dept. Employment & Workplace Relations; Australian Tax Office

2 Corporate conduct and reporting; competition and consumer protection; finance industry regulation including; fiduciary duties of directors; working conditions; tax

3 Occupational health and safety; environment protection; consumer protection; trading practices

4 Public health; premises