With the ethics and responsibilities of company boards under critical scrutiny, and as shareholders' meetings more frequently call their directors to account, systems of corporate governance become increasingly important.

Shann Turnbull focuses on directors' share transactions as an area which can have delicate but important implications for reputations. Given directors' potential trading advantages, he writes, their dealings must not only be fair—they must be seen to be fair. Changes in board structures may be an answer.

It is in the interest of all shareholders for their directors to own shares. Directors then become the partners of the shareholders, rather than merely their agents. The difficult question is how directors of publicly traded corporations may acquire shares in a manner that does not enable their integrity to be questioned.

Directors have an advantage over their shareholders in acquiring shares, as they not only have better information but also possess the power to change the future prospects of the company. It may be difficult for directors and other insiders to show that they are not taking advantage of their position ahead of those whom they are supposed to represent as fiduciary agents. Protecting the reputation of directors requires procedures and policies which manage the conflicts of interest in a way that is visible to the investing public—so that directors' dealings are not only fair but are seen to be fair.

The approach may vary, according to whether the shares are purchased on the stock exchange or through a new issue and whether the purchasers are executive directors or non-executive directors.

New issue of shares and options

Any non-pro-rata rights to take up new shares or options dilute the value of the equity held by existing shareholders. The interests of existing shareholders are usually protected by requiring shareholder approval for any non-pro-rata issues. To avoid any suspicion of conflicts of interest, the beneficiaries of non-pro-rata issues cannot become involved in the process of obtaining approval. It follows that if conflicts of interest are to be avoided, then no director or related party can be a beneficiary of a non-pro-rata issue of shares or options.

However, an exception could be made for executive directors where the structure of the board and the process of decision-making were such that there could be no basis for the questioning of the ethics of the directors. That is, the board would need to be seen as being controlled by truly independent non-executive directors. This would mean that no related interest of a non-executive director was the beneficiary of any material business dealing with the company, even if the business relationship was based on “normal commercial terms”.

The goodwill value of doing business on “normal commercial terms” may be not only substantial but highly influential in determining how a non-executive director decides to reward the executives who can sustain such normal commercial relationships.

The disclosure of related-party transactions of directors does not eliminate the conflict. The disclosure of all related-party transactions is re-
The corporate senate

It is apparent that “best practice” for non-pro-rata issue of shares or options to corporate officers would be as shown in the table.

The supervisory board in the table is referred to as a “corporate senate”. The structure and powers of a corporate senate are outlined in my article Wanted: corporate whistle-blowers in the December 1992 issue of JASSA. An example of the contractual details of a senate can be seen in the articles of association of JAC Tractor Limited.

Listed shares

The directors’ access to inside information and their power to change share values give them the opportunity to generate personal profits from the timing of buying or selling shares in their company — an opportunity denied to most other shareholders. However, the law requires directors to represent the interests of all shareholders and not to put their own interests before those of shareholders.

This duty means that directors cannot acquire or dispose of any equity entitlements on terms more favourable than those available to other shareholders.

To ensure this condition is met, directors would have to inform all shareholders of their intention to deal in the company shares before they executed their own orders, thus providing the other shareholders with the opportunity to sell or buy shares ahead of the directors.

To protect investors who may purchase shares being sold by insiders, the public would also need to be informed. There have been a number of instances of directors placing advertisements in the financial press for this purpose.

A more effective and economical method of signalling the intention of directors to deal in the company’s shares would be to give notice to the stock exchange. Not only could the exchange be advised of the intention of insiders to trade, but the company could require all persons buying or selling shares to acknowledge in the transfer documentation that they had received such advice. This would enable the company to protect the reputations of the directors dealing in its shares.

The procedure would require guidelines on the period of notice required and on the reporting of the execution of insider trades. Trades between different insiders may not need the same procedures as trades between insiders and others.

Further, the company could publish all transfers of shares by insiders, as is mandated by the Securities and Exchange Commission in the United States. This published information is used by investment analysts in evaluating the prospects of companies and advising their clients whether to buy, sell or hold.

Another situation in which directors would need to protect their reputations by declaring their arrangements in advance is when they participate in the underwriting of pro-rata share issues. The intention of insiders to participate in underwritings could be influential in the decision of shareholders to take up new shares.

Short selling

The rules of some stock exchanges relating to the sale of shares not owned by the vendor (short-selling) illustrate the type of self-regulating mechanism required to control market exploitation and opportunism.

One example is the rule which allows short sales only when the bid price has increased. As short-selling is only undertaken in the expectation that the shares can be purchased back at a cheaper price in the future, this rule limits the growth in the volume of sell orders, especially from other short-sellers. Without such a rule, short-selling can rapidly destabilise market prices by creating an incentive for further short sales.

An informed market is a stable and fair market. The need for special procedures to allow short-selling parallels the need for special procedures for transactions by directors. The procedures suggested here would enable directors to properly inform their shareholders and the investing public.

Employee share schemes

Employee share ownership plans (ESOPs) may involve the purchase of shares or the issue of new shares. With a unitary board, it would not be ethical for non-executive directors to participate in an ESOP, and the participation of executive directors would
BANK LIQUIDITY

A swap can be used for an interest-rate risk but not a liquidity risk. Similarly, the interest rate on a five-year loan is only hedged by a five-year liability if the interest-rate repricing frequencies are the same. It important that banks do not confuse maturity analysis with repricing analysis. They require completely different responses.

The importance of long-term funding

Regardless of whether the RBA or ratings agencies are monitoring the activities of an institution, it is prudent financial management to ensure a proportion of the liability base is long-term. Advantages include:

- insulation from short term deterioration in a market;
- protection from adverse news directly relating to the institution;
- ensures long-term costs are known;
- avoids the costs of continuously rolling short-term debt.

The attitude of many Australian banks to bedding down long-term funds is remarkably sanguine. Although a high proportion of lending is long-term, including the rapidly growing housing loan portfolios, most Australian banks are infrequent users of long-term bond markets.

Banks such as the Commonwealth, National and Westpac believe their retail networks provide a long-term stable core. Issuing long-term bonds at a margin over the bank bill rate is considered too costly to justify in large volumes. ANZ is more active in bond markets, showing a willingness to pay up to the bank bill rate plus 0.4 per cent for funds out to three or five years.

The second-tier banks are keen to lengthen their liability bases, being less able to be fully confident about the reliability of their retail bases. In recent months, Macquarie Bank, Advance Bank, St George Bank and Bank of Queensland have completed modest long-term borrowing programs, at a cost of 0.50 per cent to 0.60 per cent over the bank bill rate in each case.

Although it seems expensive, it is the price to pay for a better maturity structure. However, due to their limited ability to issue large amounts in long-term markets (where investors are particularly ratings-conscious), these banks can match only a small proportion of long-term loans with borrowings.

What the analyst should look for

Any comprehensive review of a bank must cover liquidity policy in detail. Analysts should question the maturity mismatch and why the bank is satisfied when assets have much longer maturities than liabilities. The range of funding programs, mix of funding between retail and wholesale (short-term and long-term) and extent of reliance on each market should be reviewed. Bank management should have a contingency plan if a major unexpected loss of funds occurs. And any senior bank official who confuses interest-rate risk with liquidity risk does not sufficiently appreciate the business. The maturity transformation of continuously rolling over short-term debt to fund long-term loans may be considered the role of banks. But all financial institutions need to be equipped for the day when investors look elsewhere.

FAIR SHARES

depend on the existence of an ethical governance structure and processes.

ESOPs can both compound and complicate conflicts of interest because shareholders' funds are commonly used to assist in the acquisition of corporate equity by employees. Conflicts are compounded when directors, as trustees for the ESOP, obtain the voting rights of the employees.

ESOPs may not only introduce a cost to shareholders through dilution of their equity, but also result in excessive operating costs in the form of employee remuneration. Evaluation of the cost/benefit to shareholders can be complex, judgmental and dependent on the future performance of the participating employees.

Well designed and managed plans will, of course, produce beneficial outcomes for the shareholders, the enterprise and its employees.

However, there have some examples of employee plans designed to benefit only the top executives. In these, material amounts of shareholder wealth have been diverted to the executives, irrespective of their performance, and in some cases the corporations have failed or become seriously distressed.

These examples have adversely reflected on ESOPs and provide sound reasons for establishing a guide to how share ownership by directors and executives might best be managed.

The establishment of an ethical governance structure becomes a matter of survival for firms which have a large proportion of employee ownership. While employee ownership can give a company a competitive advantage, it can also bring disadvantages. The disadvantages may be not only that the interests of investors are not adequately protected, so increasing the cost of capital, but that the composition of the board is subsequently weakened. There are many examples of excessive control by either executives or employees jeopardising a firm's competitive position.