Euro – Asia Corporate Governance Dialogue
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Governance of Financial Instruments

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"We pledge to adopt the policies needed to lay the foundation for strong, sustained and balanced growth in the 21st century."

…Yet our work is not done. Far more needs to be done to protect consumers, depositors, and investors against abusive market practices, promote high quality standards, and help ensure the world does not face a crisis of the scope we have seen.

- *…We must take care not to spur a return of the practices that led to the crisis.*

Leaders' Statement: The Pittsburgh Summit

Nigeria’s Corporate Governance Code

PART I: <u>NEED FOR A NEW CODE OF CORPORATE GOVERNANCE</u>

1.0 <u>Introduction</u>

1.1 Financial scandals around the world and the recent collapse of major corporate institutions in the USA and Europe have brought to the fore, once again, the need for the practice of good corporate governance, which is a system by which corporations are governed and controlled with a view to increasing shareholder value and meeting the expectations of the other stakeholders.

Regulatory Emphasis on Financial Instruments

- MiFID, Resolution on Dark Pools in Europe
- Dodd-Frank in the United States
- Swiss Governance code

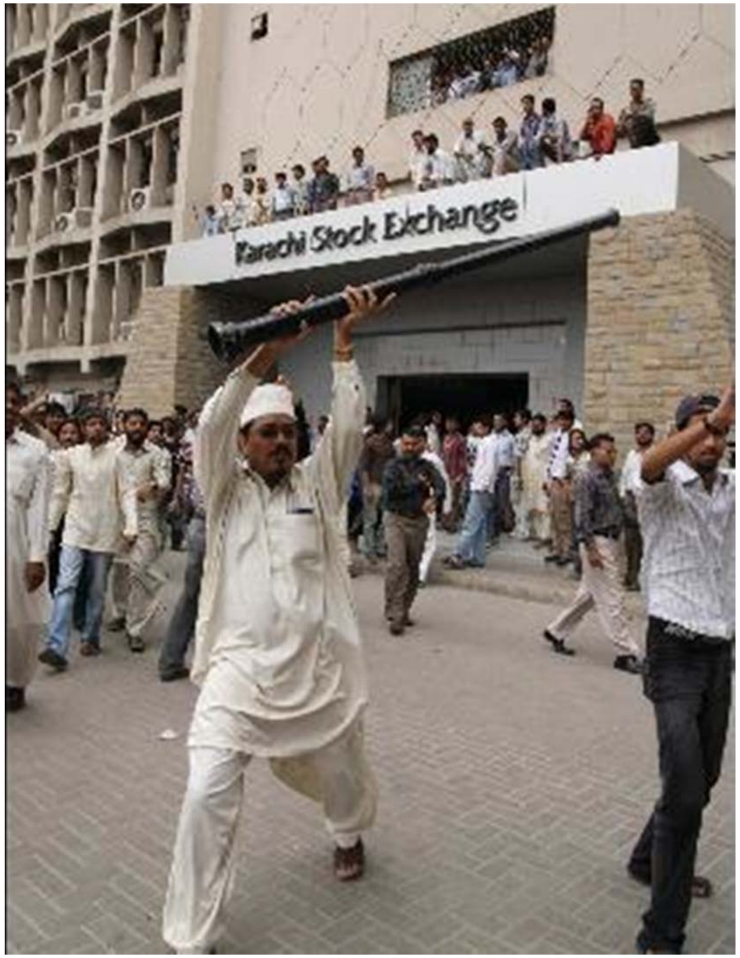
…

Pakistani Stock Market

- All-time high in April, 2008
- Market falls until June 23, when regulators limit price declines to 1% daily and ban short-selling
- Volume collapses
- July 10: Government announces plan to prop up prices by purchasing stocks
- Prices continue to fall until on July 16…

Source: Prof. Owen Lamont, Harvard

An old-fashioned stoning



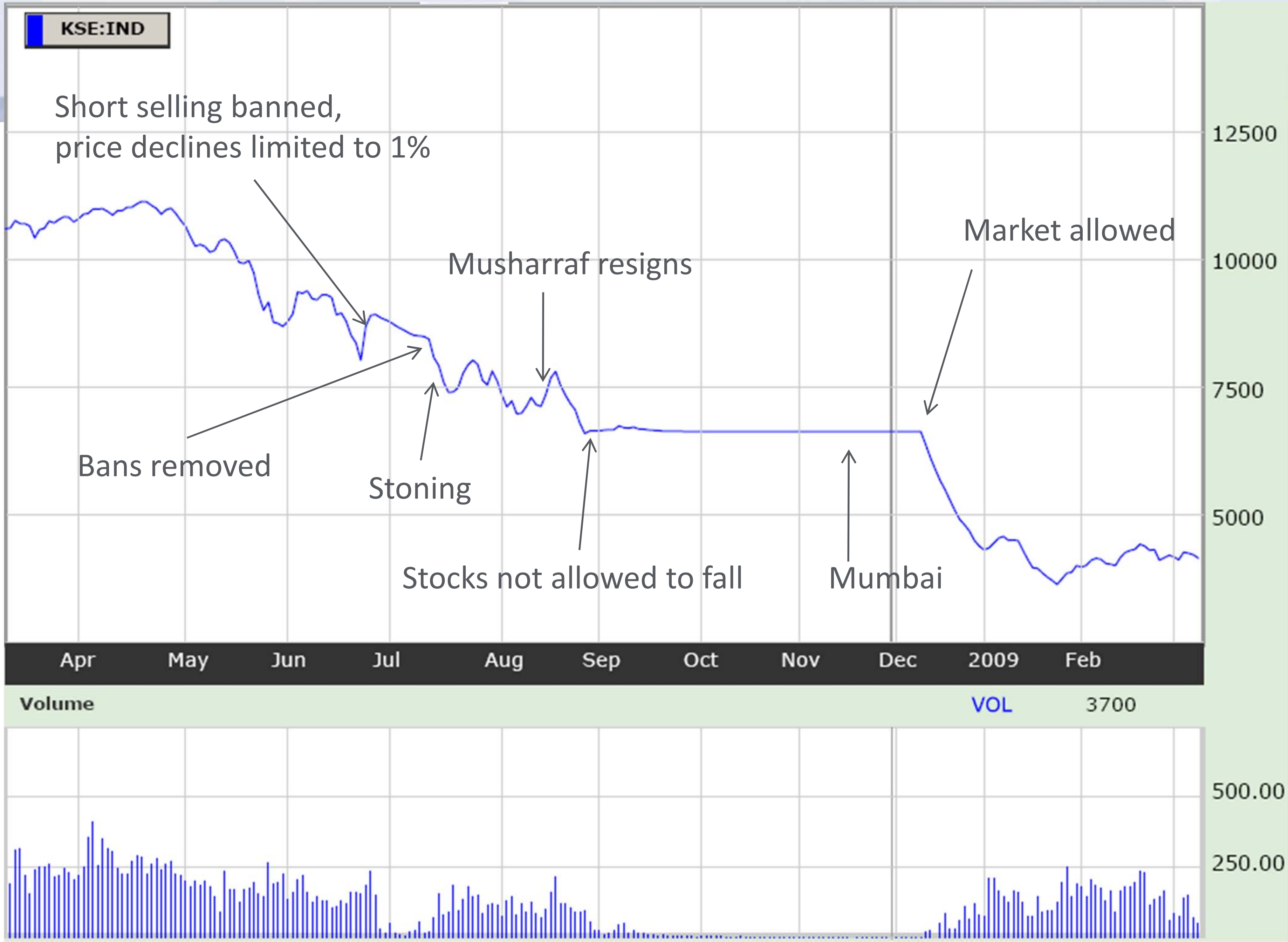
Source: Prof. Owen Lamont, Harvard

Pictures from Bloomberg

Government response

- Instead of banning short selling, Pakistani just ban **selling**:
  - August 27: Pakistani SEC prohibits trading at below the Aug. 27 closing price
  - Trading prohibition eventually ends on December 15
- Prices unable to react to Mumbai bombing

Source: Prof. Owen Lamont, Harvard



Source: Bloomberg

Does it sound familiar?

- Overexpansion, which leads to…
- Increasing leverage, plus…
- A dominant CEO, surrounded by…
- An inefficient Board, poorly educated in business,…
- Using ***sophisticated financial instruments***, which induces…
- Fraud to hide leverage from markets…
- Using controversial accounting rules, but…
- Sanctioned by Auditors that do not perform their due diligence.

Adapted from Prof. Stewart Hamilton, IMD

However…

- The common factor in all corporate failures (financial and not) of recent years is the inability/unwillingness of Board of Directors to act.

- There are several reasons at play:
  - Lack of talent at all levels in organizations
  - Delegation of responsibilities
  - Lack of internal controls
  - CEO (Ch
  - Lack of r
  - Lack of f … nts

This is the most important governance failure that regulation needs to address!!!

Talent on the Board?
The Lehman's Board of Directors

- John Macomber, 80 years old, a former McKinsey & Co. consultant and chief executive of chemical-maker Celanese Corp
- John Akers, 74, former IBM chief
- Thomas A. Cruikshank, 77, chief executive of Halliburton Co.
- Henry Kaufman, 81, former chief economist at Salomon Brothers.
- Sir Christopher Gent, 60, the one-time CEO of Vodafone PLC.
- Roger S. Berlind, 75, theater producer
- Chief Executive Roland Hernandez, 50, former Telemundo Chief Executive Officer.
- Michael Ainslie, 64, former chief executive of Sotheby's Holdings
- Marsha Johnson Evans, 61, one-time head of the Red Cross and a former Navy rear admiral.

The role of the Board of Directors in Lehman's collapse

(3) **Lehman's Board of Directors**

Without exception, former Lehman directors were unaware of Lehman's Repo 105 program and transactions.[3642]

In late 2007 and 2008, management made numerous presentations to the Board regarding balance sheet reduction and deleveraging; in no case was the use of Repo 105 transactions disclosed in those presentations.[3653]

Source: Examiner's Report re: Lehman Brothers Holdings Chapter 11 Proceedings, March 11, 2010

Lack of Finance Skills

Shareholder Report on UBS's Write-Downs

At the same time, the IB also undertook a specific review of the Fixed Income business in conjunction with external consultants. It was recognized in 2005 that, of all the businesses conducted by the IB, the biggest competitive gap was in Fixed Income, and that UBS's Fixed Income positioning had declined vis-à-vis leading competitors since 2002. In particular, the

The consultant also noted that strategic and tactical initiatives were required to address these gaps and recommended that UBS selectively invest in developing certain areas of its business to close key product gaps, including in Credit, Rates, MBS Subprime and Adjustable Rate Mortgage products ("**ARMs**"), Commodities and Emerging Markets. ABS, MBS, and ARMs (in each case including underlying assets of Subprime nature) were specifically identified as significant revenue growth opportunities. The consultant's review did not consider the risk capacity (e.g. stress risk and market risk) associated with the recommended product expansion.

18 April 2008

Lack of Finance Skills that leads to delegation of responsibilities

Relying in part on the Oliver Wyman study, Robert Rubin, then chairman of Citi's executive committee, and Thomas Maheras, head of capital markets, conducted a review of the fixed-income business. […]

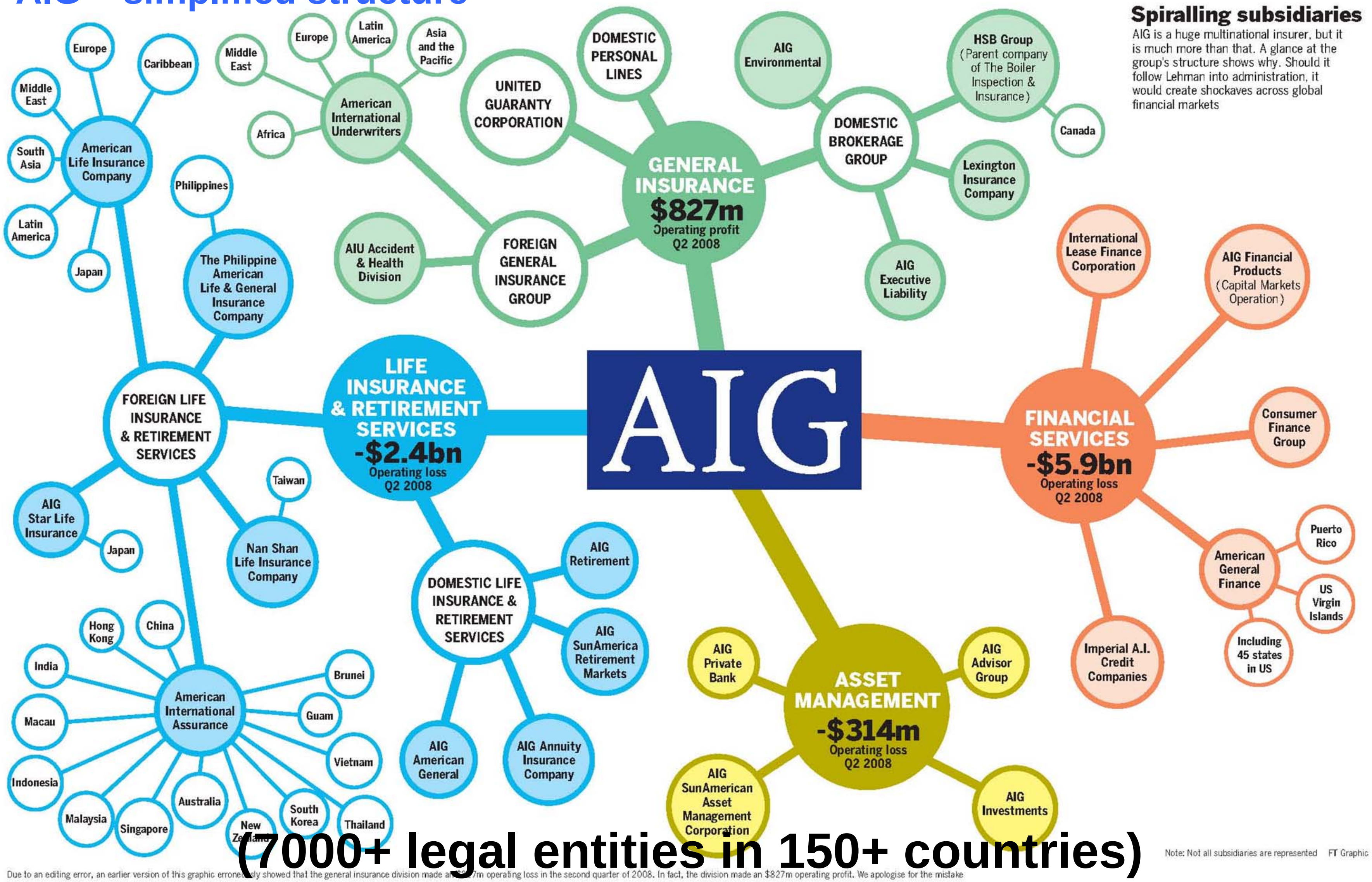
Citi would end up spending more than $300m in 2006 to hire traders, bankers and cutting-edge software systems. CDOs and other structured credit products were a part of that buildout.

"Based in part on a careful study from outside consultants hired by our senior-most management, the company decided to expand certain areas of our fixed income business that we believed at the time offered opportunities for long-term growth," Mr Maheras told the Financial Inquiry Crisis Commission on Wednesday."

Financial Times, April 8 2010

Too Big to Fail

AIG – simplified structure



(7000+ legal entities in 150+ countries)

Basel II marked the emergence of the Credit Derivatives Market

AIG Financial Products ended up insuring $513bn of debt against credit default, using CDS

- $294bn corporate debt
- $141bn European residential mortgages and
- $78bn CDOs including subprime

And those took the Insurance company down…

In its 2007 Annual Report, AIG writes that

> *"approximately $379 billion … of the $527 billion in notional exposure of AIG Financial Products' super senior credit default swap portfolio as of December 31, 2007 represents derivatives written, for financial institutions, principally in Europe, for the purpose of providing them with regulatory capital relief rather than risk mitigation."*

> *(cited in Hellwig, 2010)*

Note the problem: the case of UBS

Prior to the crisis, UBS had equity capital equal to CHF40 bn, with an overall balance sheet of CHF1,600bn.

Losses on subprime-mortgage backed securities and derivatives amounted to well over CHF40 bn. If it hadn't been for recapitalization by the government of Singapore and by the Swiss Confederation, UBS would have had to declare bankruptcy.

Livedoor and Takafumi Horie

- On January 18, 2006, Japanese prosecutors raided the offices of Livedoor and Horie's home on suspicion of securities fraud and money laundering. Livedoor's share price fell 14.4 percent in one day, with sell orders so numerous that trading volume prompted the Tokyo Stock Exchange to close 20 minutes early for the first time in its history

- The Nikkei index lost 465 points, its largest drop in nearly two years; the ramifications were felt in other markets around the world, especially in Asia

Takafumi Horie

- On January 23, 2006, Horie was arrested by Tokyo district public prosecutors, and on January 24 he announced his resignation as CEO. On April 27, 2006, he was released on ¥300 million bail on condition that he refrain from contact with Livedoor or any of its employees.
- Horie's manipulation of Livedoor's stock price was done by a combination of stock splits and the use of Moving Strike Convertible Bonds ("Death Spiral Convertibles")

Takafumi Horie

Japan's Horie sentenced to jail in Livedoor fraud

REUTERS

Fri Mar 16, 2007 9:16 PM IST

By Jonathan Soble

TOKYO (Reuters) - Takafumi Horie, the 34-year-old Internet entrepreneur who rattled corporate Japan with his celebrity lifestyle and brash takeover bids, was found guilty and sentenced to 2-1/2 years in prison on Friday for his role in a securities fraud at his former company Livedoor.

The punishment contrasted with past sanctions meted out to Japanese executives convicted of white-collar crimes, who often receive suspended sentences after pleading guilty and showing remorse.

Experts said the ruling symbolised a new determination by regulators to clamp down on corporate misdeeds, though Horie's defiant insistence on his innocence likely marked him for tougher treatment.

"If he had just sort of shut up and taken his knocks like a 'good Japanese', I don't think he would have been punished as much," said Keith Henry, director of Asia Strategy, a consultancy that advises firms on policy and regulatory issues in Japan.

A dropout from the prestigious University of Tokyo who used savvy marketing and an aggressive string of acquisitions to build a $50,000 start-up into a conglomerate worth $6 billion at its peak, Horie had called the charges "malicious" and blamed his chief financial officer for the accounting mess.

And the lesson is...

"*If you see a loophole and you don't use it, someone else will use it against you.*"

Takafumi Horie

Conclusions

- The (wrong) use of financial instruments is at the center of the governance failures of the recent years.

- We need regulation to prevent misuse, but also internal corporate governance rules to ensure that:

  - Boards understand the products (instruments) their companies use
    - Board education
    - Board composition

  - Internal controls can cope with the complexity of those instruments