DANCING THE DERIVATIVE *DEUX PAS*, THE FINANCIAL CRISIS AND LESSONS FOR CORPORATE GOVERNANCE

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I INTRODUCTION

In 2009, financial and capital markets globally continue to be in the midst of a major disruption. The causes of the financial crisis are complex, including the interplay of structured financial products and real economic activity, regulatory gaps, and failure to understand the complexity of systemic risk.

In the banking sector, the shift to self-governance under Basel II resulted in a reduction in overall capital requirements, with commercial banks shifting assets from banking to trading books; reserve banking capital premised on individualised demand; and an asset-based commercial paper market premised on ongoing liquidity, with little attention to systemic risk. The originate and distribute model of lending resulted in less front-end assessment of credit worthiness, as lenders were offloading their risk almost immediately. There has been a tension between short-term returns and long-term sustainability of financial systems, compounded by compensation practices that rewarded high fees and short-term profit. Derivatives also have become a significant factor in the financial landscape. Both credit derivatives and equity derivatives have an important role in managing risk of direct investment. Yet the original objective was overtaken by a speculative market with significant implications for corporate governance.

This paper renews discussion of corporate governance by offering insights on the impact of the proliferation of derivatives counterparties on existing or entrenched corporate governance methodologies and norms, exploring the efficacy of existing corporate governance regimes in a market environment in which legal ownership and control, and economic exposure are no longer aligned.

The paper's title comes from a dance called the *deux pas* or twostep, marked by 'quick, quick, slow' series of steps, forward and back, 'tripping the light fantastic'.[1] Arguably, the rapid development of the derivatives market did not

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1 The *deux pas* or 'twostep' is a dance consisting of a series of chasses, forward or sideways with a skip in each step, to 2/4 or 4/4 time.

allow time for corporate governance norms to develop to deal with the incentive effects associated with the separation of economic interest and legal ownership. Short-term profits generated by derivatives dealers tripping the light fantastic resulted in governance failures and serious negative impact on real economic activity. This paper proposes slowing the dance down to consider the effects of structured financial products, suggesting that some of our corporate governance standards or norms may need retooling in order to be responsive to these changing dynamics. It outlines the standard indicia by which effective corporate governance is currently measured, suggesting that the standard indicia do not take account of the impact of derivatives in terms of the uncoupling of the economic and legal interest in loan assets and equity investments. The paper offers examples of the implications and negative externalities of this 'uncoupling' of interest, including the diminished signalling in the case of credit derivatives and hidden ownership in the case of equity derivatives. The paper then summarises the limited regulatory response in certain jurisdictions to date and explores the concerns identified in the context of the American Insurance Group ('AIG') collapse. Finally, it reflects on some of the governance implications of the global financial crisis, offering some broad principles for effective governance, namely, transparency, accountability and fairness.

Part II starts with a general discussion of accepted norms of effective corporate governance, drawing on principles and indicia drawn from various international sources. Part III then examines the structured financial products markets in terms of how they skew the incentives for corporate conduct. It focuses primarily on the USA and the UK, which account for the vast majority of derivatives based activities globally, but also draws insights from Canada, the EU and Australia. Part IV uses AIG as an illustration of a failure of governance. Finally, Part V suggests principles that should inform further development of good governance practice.

II INDICIA OF EFFECTIVE CORPORATE GOVERNANCE

A fundamental issue for corporate governance is the relationship between directors, officers, shareholders and other corporate stakeholders, whether the corporation or other business entity is privately held or publicly traded.[2] In most jurisdictions, directors and officers are to exercise their business judgment in the best interests of the corporation, subject to limitations imposed by corporate law and, in the case of publicly trading corporations, securities or financial services

2 Stéphane Rousseau, 'Canadian Corporate Governance Reform: In Search of a Regulatory Role for Corporate Law' in Janis Sarra (ed), *Corporate Governance in Global Capital Markets* (2003) 3; Janis Sarra, 'Oversight, Hindsight, and Foresight: Canadian Corporate Governance through the Lens of Global Capital Markets' in Janis Sarra (ed), *Corporate Governance in Global Capital Markets* (2003) 40; Lynne Dallas, 'The Relational Board: Three Theories of Corporate Boards of Directors' (1996) 22 *Iowa Journal Of Corporate Law* 1.

law.[3] Corporate law in many jurisdictions is viewed as facilitative, issuing corporate registrations where relatively few minimum standards are met, regardless of the efficacy of the business plan or structure of the corporation. Directors and officers owe fiduciary obligations to the corporation and, in some jurisdictions or in limited circumstances, to shareholders.[4] As a result, the classic corporate governance framework for many jurisdictions is that in their oversight and management of the company, directors and officers will engage in practices that create wealth for the enterprise and will be responsive to shareholders' economic interests.[5] Directors and officers are also subject to a number of regulatory frameworks in addition to corporate law obligations, including environmental law, employment standards, pension law, labour relations law and tax law, all of which establish baseline requirements for corporate officers in their oversight and operational decisions, and reflect the particular jurisdiction's normative choices about how to value or take account of particular interests.[6]

Corporate governance provides the framework for the setting and achievement of the company's overall objectives: engaging strategic planning and risk management; supervision of corporate officers to prevent shirking or self-dealing transactions; and oversight of the relationship between corporate officers and stakeholders with an interest in the corporation.[7] It includes oversight of regulatory compliance, independent monitoring of audit and operational functions, and corporate responses to market changes.[8] It provides the appropriate incentives for directors and officers to pursue the corporation's best interests. Across multiple business entities, effective corporate governance can enhance economic activity, create long-term employment, and promote healthy capital markets.[9]

Until recently, most aspects of corporate governance were not mandatory.[10] In the wake of US corporate failures and subsequent enactment of the *Sarbanes-Oxley Act* in the United States, the New York Stock Exchange promulgated mandatory corporate governance rules, and the voluntary nature of corporate governance shifted in a number of jurisdictions, particularly those that sought

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3 *BCE Inc v 1976 Debentureholders* (2008) SCC 69 [99].

4 *Peoples Department Stores Inc (Trustee of) v Wise* [2004] 3 SCR 461 (SCC); see generally Ronald B. Davis and Janis P Sarra, *Director and Officer Liability in Corporate Insolvency* (2002).

5 Toronto Stock Exchange ('TSX'), *Where were the Directors? Guidelines for Improved Corporate Governance in Canada* (1994) <http://www.ecgi.org/codes/code.php?code_id=22> at 21 August 2009.

6 See, generally, Helen Anderson (ed), *Directors' Personal Liability for Corporate Fault: A Comparative Analysis* (2008).

7 Sarra, above n 2, 40–5.

8 Governance is multi-faceted, encompassing oversight of human resource management, succession planning, economic sustainability, community investment and engagement, health and safety, human rights and environmental sustainability.

9 Sarra, above n 2, 44.

10 In Canada, the TSX had voluntary guidelines for a number of years. The only mandatory requirement was to disclose annually whether or not the firm was in compliance with the guidelines: TSX, *Toronto Stock Exchange Company Manual* s 474 (now repealed) <http://142.201.0.1/en/pdf/CorpGovCurrentRequirements.pdf> at 21 August 2009

access to US capital markets.[11] Canada's securities law regime was supplemented by new national instruments, including those related to audit committee composition, disclosure of corporate governance practices, and officer certification.[12] Unlike the US, there are not mandatory requirements for most aspects of corporate governance; the focus of Canadian instruments and policies has been transparency, with some independence requirements.

Best practice norms or principles of corporate governance have been largely developed through organisations such as the United Nations Global Compact and the Organisation for Economic Co-operation and Development ('OECD'), aimed at assisting governments in their efforts to improve the institutional and regulatory framework for corporate governance, and providing guidance to corporations, investors and others in developing good corporate governance.[13] The OECD Principles focus on publicly traded financial and non-financial companies, but have application to other business entities.[14] The Equator Principles are another governance indicator, a financial industry benchmark for determining, assessing and managing social and environmental risk in project financing.[15]

The corporate governance framework in any jurisdiction also reflects the legal, regulatory, social and political environment of the particular jurisdiction, including capital structures that may include widely held corporations, state owned enterprises, multiple business entities held in pyramid structures or by controlling families or groups of shareholders, and corporations that grant participation or governance rights to employees. The capital structure significantly influences the corporate governance structure chosen and may influence how effective it is in practice.

A Board Independence and Effective Oversight

The indicia of good governance start with the necessity for board independence, particularly where there is a separation of ownership and control of the business. Independence in this respect includes not only statutory

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11 *Sarbanes Oxley Act of 2002*, Pub L 107–204, 116 Stat 745; New York Stock Exchange Euronext, *Corporate Governance Guidelines 2003,* (2007) <http://www.nyse.com/pdfs/CorpGovGuidelines_4-5-07.pdf > at 21 August 2009.

12 National Instrument ('NI') 51-102 *Continuous Disclosure Obligations* (2004) <www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040402_51-102-cont-disc-ob.pdf> at 21 August 2009; NI 52-110 *Audit Committees* (2008); NI 52-109 *Certification Disclosure in Issuer's Annual and Interim Filings* (2008); NI 58-101 *Disclosure of Corporate Governance Practices*; National Policy 58-201 *Corporate Governance Guidelines* (in force 2005); see also Mary Condon, Anita Anand and Janis Sarra, *Securities Law in Canada: Cases and Commentary* (2005).

13 The United Nations Global Compact is a strategic policy initiative for businesses committed to aligning their operations with principles in the areas of human rights, labour, environment and anti-corruption: United Nations Global Compact <http://www.unglobalcompact.org/AboutTheGC/index.html> at 21 August 2009.

14 OECD Principles of Corporate Governance (2004) <http://www.oecd.org/dataoecd/32/18/31557724.pdf> at 21 August 2009.

15 The Equator Principles (2006), <http://www.equator-principles.com/documents/Equator_Principles.pdf> at 21 August 2009.

definitions of un-relatedness, but standards of conduct that create engaged and independent oversight.[16] Related are effective recruitment and succession planning practices, and ongoing education and development of director skills.[17] The corporate board should review and guide corporate strategy, annual budgets and business plans; set performance objectives; monitor implementation and corporate performance; oversee major capital expenditures or changes; monitor the effectiveness of the company's governance practices; select and monitor key executives; and manage potential conflicts of interest, including misuse of corporate assets and abuse in related party transactions.[18] Independence of directors can ensure that the control by officers is exercised in the company's best interests. Even where there is not a separation of ownership and control, board independence can assist in ensuring that controlling shareholders or officers do not act in a manner that advances their self-interest to the detriment of other shareholders and stakeholders.

B Risk Management

Another indicium of effective corporate governance is risk assessment and management processes. Risk management involves the ability to assess both upside and downside risk to particular decisions and strategies, to assess risks of market failures, and to monitor the capacity of individuals to identify risk and respond appropriately. It is important to ensure the integrity of the corporation's accounting and financial reporting systems, including independent audits, appropriate systems for risk management, financial and operational control, and compliance with relevant standards.[19]

C Disclosure

For publicly traded companies, transparency in disclosure is a key factor in investor confidence in the governance of the business entity. Securities or financial services law require transparency, but different jurisdictions adopt different standards and principles. Numerous jurisdictions require disclosure of material changes to the business and periodic or continuous disclosure of the company's financial status and business plan. Good governance also suggests that rules and procedures governing fundamental changes, such as mergers or acquisition of corporate control, should be clearly articulated so that investors understand their rights and recourse.[20] Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place

16 TSX, above n 5; NI 58-101 *Disclosure of Corporate Governance Practices*; National Policy 58-201 *Corporate Governance Guidelines* (in force 2005).

17 Ibid.

18 OECD Principles, above n 14, 24.

19 *Audit Committees*, (2008); NI 52-109 *Certification Disclosure in Issuer's Annual and Interim Filings* (2008); NI 58-101 *Disclosure of Corporate Governance Practices;* National Policy 58-201 *Corporate Governance Guidelines* (in force 2005).

20 OECD Principles, above n 14, 19–20.

for deciding on the use of their voting rights.[21] Effective governance can enhance transparency.

D Evaluation of Effectiveness and Codes of Conduct

Corporate boards should have established effective means of self-evaluation in order to enhance governance, evaluating effectiveness of the board as a whole, individual directors and board committees.[22] Another indicium is whether the corporate board meets the increasingly robust requirements regarding the composition, role and responsibilities of audit committees.[23] Best practice also suggests that boards adopt a code of business conduct and ethics and ensure its actualisation.[24]

E Recognition of Multiple Interests

The OECD Principles recommend that the corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreement, encouraging active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.[25] There should be effective remedies for violation of stakeholder rights. Where stakeholders participate in the corporate governance process, they should have access to material information on a timely basis and be able to freely communicate their concerns about unethical practices to the board.[26]

F Economic, Social and Environmental Sustainability

A final indicator of good governance is social and environmental sustainability measures, broadly defined.[27] The Global Compact's principles suggest that businesses should respect the protection of internationally proclaimed human rights; give effective recognition to the right to collective bargaining; support elimination of all forms of forced labour; promote greater environmental responsibility; and work against corruption in all its forms.[28] The OECD has observed that if countries are to attract long-term 'patient' capital, corporate governance arrangements must be credible, well understood across borders, and adhere to internationally accepted principles.[29]

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21 Ibid.

22 Sarra, above n 2.

23 Section 407 of the *Sarbanes-Oxley Act of 2002* requires public companies to disclose whether or not at least one 'financial expert' serves on the audit committee.

24 OECD Principles, above n 14, 19–20.

25 Ibid, 21.

26 Ibid.

27 Janis Sarra and Vivian Kung, 'Corporate Governance in the Canadian Resource and Energy Sectors 43 *Alberta Law Review* (2006) 4. It can include sustainable technologies, engagement and community outreach, ethics and human rights.

28 Global Compact, above n 13.

29 OECD Principles, above n 14, 13.

The indicia are highly integrated, creating a synergistic notion of how governance can be effective in advancing economic activity and social wellbeing. These norms and best practices have developed over time through industry and public debate. Governance initiatives are aimed at enhanced transparency in terms of corporate activities, many considering social and environmental risks and impacts of financial or business activities on local communities. In part, they are aimed at tempering shareholder wealth maximisation as the rough and sole measure of business effectiveness. Many attempt to discern practical differences between governance in countries where there are strong legal frameworks to temper the most egregious activities of corporate decision makers and governance where such frameworks have not yet developed or are just emerging.

The indicia of effective governance are premised on the fundamental notion that creditors and equity investors have an economic interest in corporate decisions and activities, shareholders as the residual claimants of the financially solvent company and creditors as fixed claimants of solvent companies and as the residual claimants at the point of insolvency.[30] As the discussion in the next part illustrates, it is the economic interest that in a number of cases has become uncoupled from legal status, raising new questions for some of the underlying premises of corporate governance norms.

III STRUCTURED FINANCIAL PRODUCTS AND THE IMPACT ON CORPORATE GOVERNANCE

There were many shifts in financial products markets that factored in the current financial crisis. Equity derivatives and credit derivatives have experienced an exponential growth in the past decade, offering new challenges for both corporate governance and financial services oversight.[31] The products are complex, ever changing and, in some cases, have considerable impact on corporate governance.

A Credit Derivatives

Credit derivatives were developed as a tool for banks to manage their credit risk in respect of entities in which they had directly invested through their lending activities, diversifying their risk on loan default. In this respect, credit derivatives were effective in cushioning the commercial banks' losses in notable

30 Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvency Corporations* (2001) ch 2.

31 For a discussion of credit derivatives, see Janis P Sarra, 'Credit Derivatives Market Design, Creating Fairness and Sustainability' *Social Science Research Network* (2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1399630> at 21 August 2009.

cases such as Enron and Parmalat. The market grew in less than two decades to an estimated USD 62 trillion in credit default swaps alone at the end of 2007.[32]

There are numerous kinds of credit derivatives, such as credit default swaps, collateralised debt obligations ('CDO'), full and index trades, and credit-linked notes. Credit derivatives are classified as either single name credit derivatives, targeted on the credit worthiness of a single reference entity, or basket derivatives, hedging the risk of clustered defaults in a portfolio.[33] A credit derivative can be a privately negotiated agreement that explicitly shifts credit risk from one party to the other or it can be collateralised and housed within a special purpose vehicle that resells debt contracts in various tranches at differing prices, quality and risk. CDO can be cash flow based, whereby the vehicle issues its own financial instruments to finance purchase of debts of different corporate entities, ensuring a fixed flow of loan repayments that are used to pay investors in the various tranches; or CDO can be synthetic, whereby the entity does not directly purchase debts but rather enters into credit default swaps with a third party, creating synthetic exposure to the debt of a number of corporate entities.[34]

The most common credit derivative is a credit default swap ('CDS'), a contract in which one party, the 'protection buyer', pays fees periodically to a 'protection seller', whose obligation to pay arises on the occurrence of a credit event, which is most frequently the reference entity's failure to pay, bankruptcy or restructuring.[35] The protection buyer that is a creditor of the reference entity hedges the risk of default by that entity in respect of its loan. The protection seller acquires the default risk of the reference entity. Unlike insurance, the amount of compensation that can be claimed under a CDS is not related to the actual losses suffered by the protection buyer. CDS do not require either the protection seller or protection buyer to actually hold an interest in the referenced asset or entity. Therefore the protection purchased by the protection buyer can be more than, less than, or completely unconnected to its underlying exposure.

Market participants on both the buy side and sell side have varying reasons for involvement in the credit derivatives market. Protection buyers may use credit derivatives to manage portfolio uncertainties, including to hedge over concentrations in loan portfolios, free up economic or regulatory capital, and avoid sales of bond holdings. Protection sellers may be in the market to diversify

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32 International Swaps and Derivatives Association ('ISDA'), 'Market Activity 2008' (Press release, 24 September 2008) <http://www.isda.org/press/press092508.html> at 17 September 2009; see also ISDA, 'ISDA Publishes Year-End 2008 Market Survey Results' (Press release, 22 April 2009) <http://www.isda.org/press/press042209market.html> at 17 September 2009.

33 Elizabeth Murphy, Janis Sarra and Michael Creber, 'Credit Derivatives in Canadian Insolvency Proceedings, "The Devil will be in the Details"', in *Annual Review of Insolvency Law 2006* (2006) 187–234.

34 ISDA (2006) <https://www.isdadocs.org/index.html> at 21 August 2009.

35 The reference entity is not a party to the credit default swap.

investment portfolios, enhance relative value of trades, exploit yield alternatives and provide capital arbitrage.[36]

1 *A Shifting Market*

Since 2002, three significant changes occurred in the CDS market. The original objective of managing risk of direct investment under lending portfolios was overtaken by a speculative market for buying and selling derivatives in multiples of the value of the underlying reference assets or entities, resulting in a significant trading market involving a greater number of market participants. Counterparty risk was heavily concentrated among the top 20 global banks and broker dealers, including Bear Sterns, Lehman Brothers, AIG and The Royal Bank of Scotland.[37] Hedge funds went from three per cent to five per cent of the market on the buy and sell side in 2000 to 30 per cent market share in 2006.[38] Those derivatives were then hedged in further credit derivatives in multiples of the value of the originating reference entities. To maintain returns, hedge funds shifted to more speculative investment grades and unrated exposures. Global credit derivatives exposures by ratings shifted downward. In 2002, 36 per cent of all credit derivatives globally were rated at AA or AAA, whereas only eight per cent were rated as below investment grade. Just four years later, only 17 per cent of credit derivatives globally were rated at AA or AAA, and 31 per cent were now rated as below investment grade.[39] Together, these changes altered the credit derivatives market significantly, without any jurisdiction seriously assessing the public policy implications.

Derivatives have been found to be covered by financial services or securities legislation where they trade in public markets in some jurisdictions, but have been most often viewed by regulators as part of the exempt market, assuming sophistication of parties. Other jurisdictions, such as the United States, did not have any regulatory control over CDS or other swaps.[40] There is no obligation to disclose material adverse risk on either the buy or sell side of protection.

Many outstanding derivative contracts can aggregate 10 times or more the amount of creditor claims. When the financial markets began to seriously deteriorate, the CDS exposures of counterparties became evident, with a major

36 Most credit derivative transactions, including most CDS, are not funded but may be subject to margin and collateral arrangements depending on the counterparty. The ISDA standard form CDS is silent on obligations of the protection buyer regarding its knowledge of material adverse information in regard to the reference entity. While one appeal of CDS is ostensibly that they can be tailored to the individual contract, the reality is that most are now off-the-shelf standardised products with industry wide standard terms developed by the ISDA.

37 Murphy, Sarra and Creber, above n 33.

38 British Bankers Association, *Credit Derivatives Report 2006* <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=341&a=7673> at 21 August 2009; Sarra, above n 31.

39 Fitch Ratings, discussed in Murphy, Sarra and Creber, above n 33.

40 Except under anti-fraud powers where they are considered securities: Christopher Cox, 'Testimony Concerning Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions before the Committee on Banking, Housing, and Urban Affairs, United States Senate', 23 September 2008; *Securities Exchange Act 1934*, 15 USC 78.

crisis in the ability of protection sellers post additional cash collateral on outstanding CDS obligations due to overexposure.

2 *Assumptions of Solvency*

Equally significant, CDS purchasers rely on the financial viability of the protection seller to meet their claims at the point of a credit event, yet there is no disclosure requirement that the protection seller has the capacity to settle the derivatives. In this respect, credit derivatives differ from other bilateral contracts where the credit worthiness of counterparty is typically dealt with through negotiated credit controls, including collateral requirements, covenants, representations and warranties, and the oversight of a credit officer.[41] In order to facilitate their liquidity, many such oversight and monitoring terms are not negotiated in CDS.[42] They also differ from insurance, whereby insurance regulation in many jurisdictions imposes rigorous capital adequacy requirements to meet anticipated claims.

The use of credit derivatives means that traditional lenders can fully hedge the risks associated with their loans through purchase of cash-settled CDS or other derivatives, leaving them with a legal claim against the assets of the borrowing company, but no economic interest.

B Equity Derivatives

The operating corporate law framework in many jurisdictions is that effective corporate governance advances the interests of shareholders, whether indirectly through maximisation of corporate wealth or directly through dividends to shareholders. In some jurisdictions, directors and officers may owe a duty of care to shareholders in their oversight and managerial activities.

Equity derivatives originally developed to hedge risk of equity investment. Equity derivatives are generally over-the-counter structured financial products, and include equity swaps, options and futures. An investor can purchase shares, and then shed the economic risk by purchasing equity derivatives, retaining voting power over the shares in a number of instances. In many cases, the investor does not have to disclose the nature of economic interest at risk or, in the case of a fully or over-covered derivative, the lack of any economic interest or risk. Different jurisdictions use different terms. For example, what Canada and

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41 Sarra, above n 31.

42 The ISDA has observed that swaps and related OTC derivatives combine characteristics of loans with those of traded capital market instruments. The swap transaction creates a credit relationship between the counterparties, the terms of which are documented just as the terms of a traditional loan, but unlike a loan, swaps are traded in the market and renegotiation of credit terms for each transaction would be costly in a system of repeated interaction between counterparties. Consequently, the ISDA Master Agreement contains the 'non-economic' terms such as representations and warranties, events of default, and termination events, leaving counterparties to negotiate only economic terms such as rate or price, notional amount, collateral, and close-out netting: ISDA, above n 32.

the US refer to as 'equity swaps' are called 'contracts for differences' ('CfD') in the UK.[43]

The traditional notion of share ownership is that shareholders have a bundle of interrelated rights and responsibilities that reflect their status as residual economic claimants of the corporation, including voting rights, particularly in respect of fundamental changes; election of directors and approval of financial statements; appraisal rights; rights to disclosure; rights to any dividends declared; the ability to trade or sell shares; the ability to bring personal or derivative claims for personal harms or harms against the corporation; and on wind-up of a financially solvent company, the right to a proportional share of the economic value of the company.[44] Voting rights are premised on the basic notion that shareholders have the greatest economic incentive to monitor managerial conduct.

1 *Economic Interest and Legal Rights*

The bundle of shareholder rights assumes a direct link between the shareholder's legal interest and economic interest, as the degree of interest is traditionally viewed as commensurate with the amount invested. Yet derivatives challenge that fundamental notion. A shareholder of record can, through derivatives or securities borrowing arrangements, acquire voting rights while having no economic stake in the issuer, or even having an economic interest contrary to the issuer's, yet seek to influence the outcome of a shareholder vote. While equity derivatives can serve as an effective risk management tool, the disconnection brings with it new incentive effects in the behaviour of both institutional and other significant shareholders and corporate officers, posing questions for governance both on the officer side and investor side of the corporate governance relationship. Just as credit derivatives detach economic interest from legal claim, equity derivatives detach economic interest and legal claim, challenging a fundamental notion of shareholders as special stakeholders in the corporate structure.

For cash settled equity swaps, the shareholder retains the shares but is paid out the cash value of the swap on the occurrence of certain events. Thus, for example, in a takeover situation or other fundamental transaction for which shareholders are given a vote, the shareholder may hold five per cent of the votes as registered owner, but may have no economic interest as it has hedged its risk through the purchase of equity swaps. It can also have a negative economic interest by over-hedging, purchasing a swap of greater value than the underlying shares on which the swap is based. Where economic interest is fully covered by a

43 Canadian regulators use the term 'equity monetisation' to refer to a variety of sophisticated derivative-based strategies that permit investors to dispose of equity risk without transferring ownership.

44 See, eg, *Canada Business Corporations Act* RSC 1985, c C-44 (the '*CBCA*'), as amended.

swap or CfD, the only economic interest may be the cost of purchase of the swap contract.[45]

Equity swaps are often not considered securities and are thus not subject to disclosure and investor protection provisions in a number of jurisdictions, unless they fall within materiality requirements in issuer disclosure obligations or management disclosure and analysis ('MD&A') requirements for corporate insiders.[46] While these disclosure requirements capture a number of transactions that may influence voting power, they often fail to cover the uncoupling of economic interest from voting rights.

For physically settled equity swaps, on the occurrence of a specified event, the ownership of shares changes and the shareholder is required to disclose specified percentages of share concentrations held in the company. However, even here, there can be some issues in respect of an investor holding a sizeable number of swaps on the sell side. With settlement, the corporation finds it has a very significant new shareholder, of which the company was previously unaware. If one norm is that shareholders and officers should know who holds the economic interest in the company, this practice is contrary to that norm. Securities or financial services legislation in many jurisdictions requires disclosure of incremental changes in equity ownership through the threshold

45 Hu and Black have called investors that have substantially greater voting power than economic interest or ownership 'empty voters': Henry Hu and Bernard Black, 'Equity and Debt Decoupling and Empty Voting II: Important Extensions' (2008) 156 *University of Pennsylvania Law Review* 625, 642, 708–9.

46 NI 51-102, pt 5. In Canada, all reporting issuers are required to provide an MD&A of financial condition and results that accompanies the financial statements. The objective of the MD&A is to provide a descriptive analysis of the information contained purely in accounting form in the financial statements, and to provide insights into how the issuer is likely to perform on a going forward basis (in the future). The requirements for MD&A are set out in NI 51-102, pt 5. Although MD&As were originally required to be prepared only by larger issuers, NI 51-102 is aimed at much broader application. MD&A disclosure is particularly important for junior companies that do not have a history of profitable operations that might otherwise give investors assurance about the company's long-term prospects. The MD&A offers an opportunity to provide investors and others that review the information with management's view of how the issuer has performed and how that performance will likely affect future plans. It allows investors and potential investors to assess underlying value in making their decisions about continued or new investments in securities of the issuer. The MD&A is important for retail investors, especially those who may not be able to readily understand the financial statements alone, without the context provided by the MD&A. In an MD&A, management must disclose the nature of changes in the issuer's performance during the reporting period and management's opinion as to the reasons for the change; discuss both positive and negative developments and any material changes from the last reporting period; discuss whether or not the issuer achieved significant milestones and its projections for achieving them in the future; disclose any pending legal proceedings and contingent liabilities; the nature and purpose of related party transactions; any management changes; and discuss any regulatory approval required or obtained for a particular transaction. The MD&A should discuss future financial and operating plans and, importantly, any risks to solvency. See generally Condon, Anand and Sarra*,* above n 12, ch 6.

disclosure requirements, yet the transparency sought by such requirements is negated by this increasingly common practice.[47]

In some instances, where the investor holds the economic benefit of the shares but not the voting rights, it can unwind the swap as per a prior agreement with the dealer and acquire voting rights or it can, in some cases, instruct the dealer how to vote the shares.[48] Where there are formal rights to unwind a swap or to direct the dealer to vote a particular way, the shareholder will likely come within the disclosure requirements of securities or financial services law.[49] But where the voting rights are not legally enforceable, and more relational based or implicit, there is often no requirement for disclosure.[50]

One recent example was a 'two-step going private' transaction in Canada where a shareholder, Pershing, owning five per cent of shares, was able to unwind cash-settled derivatives and vote almost 12 per cent of shares.[51] The finance arm of the holding company that was seeking to have its subsidiary go private had purchased four million shares of the subsidiary to partially hedge its risk in relation to equity swap transactions it had entered into. The Ontario Securities Commission ('OSC') held that there was no evidence to support a finding that Pershing and its swap counterparties had an understanding that the shares would be returned to be voted so that Pershing could be said to exercise 'control or direction' over the shares within the meaning of securities law. Pershing did not have legal ownership and there was insufficient evidence to support a finding that its conduct in respect of the swaps was abusive of the

47 For example, in Canada shareholders must disclose when they have reached a threshold ownership level of 10 per cent (five per cent during a takeover process); in the United States shareholders must disclose when they own five per cent of the ownership: sch 13D or 13G, form 13F; in Switzerland the threshold is also 5 per cent: Haig Simonian, 'Victory Jitters Strike Swiss Industrialists' *Financial Times* (London), 19 March 2007.

48 Hu and Black, above n 45, 635, what they call 'hidden (morphable) ownership'.

49 An example is the *Securities Exchange Act of 1934* (2000) 15 USC §78m, s 13D.

50 The arrangement also can bypass prohibitions in some jurisdictions in respect of vote buying in situations where there is not an intrinsic fairness associated with the objective of the transaction: see R C Clark, 'Vote Buying and Corporate Law' (1979) 29 *Case Western Reserve Law Review* 776; *Schreiber v Carney* (1982) 447 A 2d 17 (Del. Ch.).

51 *Re Sears Canada Inc,* 2006 LNONOSC 1044 22 BLR (4th) 267 (Ont. Securities Commission). In Canada, on a going private transaction, a corporation must first prepare a formal valuation in accordance with detailed rules; the formal valuation must be prepared by a qualified and independent valuator. The valuation must value the securities in which the interests of the holder will be terminated. The corporation must also comply with a *majority of the minority* test, securing the approval of a majority of outside shareholders. This requirement is waived if the controllers hold 90 per cent of the shares and statutory appraisal rights are available. There can be a 'two-step going private' transaction where an offer for shares is first made, with disclosure that a second offer will take the company private. The shares tendered to the corporation in the first step takeover bid may be included for the purposes of computing the majority of the minority in the second step freezeout transaction if the intent to eliminate minority shareholders was disclosed when the offer was made. In some circumstances securities regulators will require a two-thirds majority, for example, where the consideration is less than the value indicated in the valuation. R Yalden, et al, *Business Organizations, Principles, Policies, and Practice* (2007) ch 11.

capital markets so as to invoke the regulator's public interest jurisdiction.[52] In the same case, a bank's finance arm agreed to vote for the offer, based on its business relationship with the holding company. The Commission did not find anything improper in the commitment by the bank to vote shares in which it had little or no economic interest because it had hedged its risk.[53]

There are a variety of other strategies that currently uncouple legal and economic interest in equity investment, such as share lending, which is a widespread practice in the United States.[54] Share lending raises some of the same challenges in respect of governance. Issuers and insiders may be able to employ these strategies to temporarily place securities with friendly parties to influence how the securities are voted. The party holding these kinds of shares are often derivatives dealers or banks, allowing the hidden owner to avoid disclosure of its interest in the corporation and avoid other regulatory requirements such as mandatory bids rules.[55]

The OECD Principles suggest that the corporate governance framework should protect and facilitate the exercise of shareholders' participation and voting rights.[56] The Principles also observe that capital structures that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.[57] Yet they are silent on the capacity of shareholders to engage in voting and other control transactions where they have no remaining economic interest in the business entity.

The extent of the equity derivative market is unknown as it is largely unregulated and in many jurisdictions there are no disclosure requirements, nor is there sufficient public information on the pricing of such derivatives such that an assessment can be made as to whether the costs facilitate or deter the uncoupling of equity investors' legal rights and economic interest.

52 The Commission noted, however, there might well be situations in the takeover bid context, where the use of swaps to park securities in a deliberate effort to avoid reporting obligations could constitute abusive conduct. Ibid *Re Sears Canada* [110], [111].

53 Ibid [246]. It did find that the support agreements between the holding company and the banks gave greater value to the banks than to other investors and ordered a remedy in that respect.

54 Hu and Black observe that the market for share lending includes 20 per cent or more of all the outstanding shares of most large US corporations, which can be readily borrowed, observing that such practices have become prevalent on a low cost and large scale basis, Hu and Black, above n 45, 642. Hu and Black observe that in the second quarter of 2007 alone, US$3.6 trillion of US equities were available for borrowing from 16 banks, citing RMA Securities Lending Industry Composite, *Averages for the Period, Second Quarter, 2007* <http://rmahq.org/NR/rdonlyres/77B9BCC6-5FB2-4961-884D-BAAB3ADAED2B/0/Survey2ndQtr2007.xls> at 21 August 2009.

55 Hu and Black suggest this 'soft parking' of shares means that shares are held in friendly hands that have voting rights but no economic ownership, but provide access to shareholder rights when desired under an informal arrangement to vote as directed or under an arrangement that allows transfer of the shares back to the hidden owner: Ibid, Hu and Black, 639. They also discuss 'record date capture', in which the investor borrows the shares in the stock loan market just before the record date and returns the shares afterwards, when the investor has no economic interest at risk but has acquired voting rights for the purpose of the particular meeting or transaction: Ibid, Hu and Black, 708.

56 OECD Principles, above n 14, 17–18.

57 Ibid, 35–36.

2 *Dancing the TwoStep, Agency Costs, Externalities and Implications for Corporate Governance*

For both credit derivatives and equity derivatives, recent practice raises important questions for corporate governance. The abovementioned indicia assume a level of economic and legal interest for shareholders and creditors, with the focus primarily on incentives for director behaviour. While corporate governance engages notions of controlling agency costs, it does not address situations where there is an uncoupling of interest.

One way of controlling agency costs is monitoring by secured and operating lenders. Traditionally, a creditor's interest in a company was to receive return of its capital plus interest and fees, often premised on encouraging an ongoing credit relationship with the business enterprise. Historically, there were positive externalities associated with commercial bank lending.[58] Banks assisted in correcting governance problems of firms, such as managerial slack, through their monitoring activities, given their superior access to information under loan covenants, and through direct intervention with corporate officers or exiting the relationship, signalling to other creditors that there were problems with the debtor company.[59] The positive externality for corporate stakeholders was that they could be confident that the bank was engaged in a measure of monitoring and oversight of the firm's solvency, an important benefit for trade suppliers, employees and others that did not have the bargaining power to extract disclosure and default control rights.[60] To the extent that the bank's monitoring deterred company misconduct, it reduced the risk on the firm's entire debt.[61]

(a) Misalignment of Interests

The introduction of credit derivatives in some instances has created a misalignment between the creditors' and the company's interests. A creditor can lend an amount to a company and then purchase one or more CDS many times the value of the underlying reference asset or entity. Thus the creditor has an incentive to have the debtor company fail, triggering a credit event in which the value to the creditor from settlement of the CDS is greater than repayment of the loan. Some of the previous willingness by lenders to not enforce covenants for a limited period in order to allow a financially troubled debtor company time to

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58 Externalities occur when an economic activity causes an external benefit or cost to third party stakeholders that were not directly involved in the transaction: Sarra, above n 31.

59 See generally George Triantis and Ronald Daniels, 'The Role of Debt in Interactive Corporate Governance' (1995) 83 *University of California Law Review* 1073.

60 Ibid 1081.

61 Ibid. For companies that relied increasingly on the public debt markets, while the indenture trustee often had limited responsibility to monitor compliance, issuers were frequently required to back their commercial paper with lines of credit from banks, with the banks serving a similar governance role: Ibid 1084, 1088–9.

devise a business plan may be less likely now that the lender is not only fully hedged, but over hedged.[62]

There are agency issues that arise with tranches of creditors under originate and distribute lending. Securitisation of debt through CDO and other derivatives creates incentives for the originating lender not to be duly diligent in its lending decisions.[63] There are few incentives for the originating lender to exact protective covenants or undertake monitoring on an ongoing basis, given that the risk of default is borne by other parties.[64] The reselling of risk, in tranches that moved progressively down the rating scale, to purchasers with little or no information of the underlying risk of the derivative, created a serious disconnection between the value of the reference entity and its assets and the derivatives written on them. CDO arguably also affect corporate governance as the incentive for lenders to monitor that good governance practices are in place to protect their investment are reduced. Directors and officers, aware of these changing interests, may alter their behaviour, in some cases shirking or engaging in self-dealing.[65]

(b) New Externalities

The exponential growth in the use of credit derivatives has shifted the externalities in a way that may contribute to market destabilisation. First, the disconnection between economic interest and residual control rights can create new incentives to reduce oversight and monitoring. Originating lenders may be less willing to expend the time and resources to undertake due diligence in undertaking credit arrangements, as risk is laid off through derivatives under the originate and distribute model.[66] While arguably this managing of risk frees up capital for other market participants seeking to borrow, the previous reliance that creditors had on banks to engage in such monitoring and the resultant signalling of a firm's financial health, have diminished considerably. The signalling to the market that occurred with the decision to lend is no longer reliable as a measure of the firm's value.[67] Second, in the purchase and sale of credit derivatives, parties have frequently given up the negotiation of terms and conditions, including monitoring, restrictive covenants and default control rights, because they know that they will offset their own risk through other structured financial products.[68] Hence the prior positive externality may be lost as senior creditors no longer undertake monitoring and strategic intervention. When the firm begins to

62 Hu and Black, above n 45, 2, 19. They observe that there can also be 'hybrid' decoupling, whereby investors short their shares, buying protection with credit default swaps or use a long equity position to hedge a short debt position.

63 The subprime mortgage lending in the United States and consequent crisis is an example of this agency problem.

64 Elsewhere I have suggested that these incentives shift credit decisions away from the merits of a company's business plan and create risks for less senior creditors: see Sarra, above n 31.

65 There is another agency aspect of the derivatives market, in respect of synthetic derivatives, which needs to be addressed, and specifically the credit ratings associated with such products.

66 Sarra, above n 31.

67 Ibid.

68 Ibid.

slide into financial distress, corporate stakeholders no longer share a common goal of maximising firm value and constraining managerial slack because the originating lender has hedged its risk through its derivatives, and multiple subsequent counterparties have done the same.[69]

Stakeholders that could previously rely on the governance role of banks can no longer do so, yet given the diverse nature of their interests, information asymmetries and collective action problems, they are unlikely to be able to fill this governance gap.[70] It may no longer be feasible for the bank or other traditional operating lender to take a lead in restructuring negotiations, given that they have little or no remaining economic interest due to their credit default swaps. The signalling that occurred through exit or other creditor reactions to the debtor's decisions is diminished because banks and other significant lenders may be fully hedged. Yet that fact is not transparent to other stakeholders, who may still look for such signalling.

Multiplied many times through complex derivative transactions and multiple swaps, previous positive externalities are lost and new negative externalities are created, creating more systemic risks across the market.[71] Given the global nature of credit derivatives, the externalities may create systemic problems that require more broad based intervention than merely improving disclosure.[72]

(c) Misalignment of Equity Interest and Control

In respect of equity derivatives, the assumption that voting power reflects economic interest is no longer valid in a number of instances. Equity derivatives can create a misalignment between the shareholders' and the company's interests. A shareholder can invest and then purchase a swap or other equity derivative to hedge its risk. For smaller investors, this strategy does not really have an impact on corporate governance. However, for larger institutional investors, the disconnection between legal ownership of the shares and economic risk creates disincentives for the shareholder to act to monitor the activities of directors and officers. Shareholders with significant shareholdings are in a position to potentially influence the decisions of directors and officers because of their voting power even though they may have no economic risk. Where formal votes are required, for example, in respect of fundamental transactions, this disconnection may skew results as the vote will not truly represent the wishes of the entire body of shareholders with an economic interest. The OECD Principles suggest that good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders.[73] Such a recommendation assumes that the status

69 Ibid.

70 Ibid.

71 Ibid.

72 There may be additional externalities. Credit derivatives may result in heavier reliance on liquidity and the ability to refinance, given the inability to negotiate terms with creditors, in turn increasing systemic financial risk: Hu and Black, above n 45, 2.

73 OECD Principles, above n 14, 11.

of shareholder carries with it an economic interest such that shareholder interests align with that of the business entity.

Aside from formal voting power, significant shareholders are in a position to informally influence directors and officers, through meetings, media statements and policy positions. Where they have little or no economic interest, this influence may not be in the best interests of shareholders or the corporation. Where a shareholder has fully hedged its interest and has an economic interest in a competitor company, it may actively press for a decision that advances its economic interests in that other entity. Directors and officers that seek to engage in dynamic and responsive governance practices may find it difficult to communicate and persuade those investors, creating potential disadvantage to shareholders that truly have an economic interest in the corporation.

There are also implications for potential takeovers. Currently, the laws in many jurisdictions require disclosure of holdings above specified thresholds so that corporate stakeholders are alerted to the fact that a company is 'in play'.[74] The required disclosure means that an offeror cannot expect that bargain prices for the target's shares will continue after the first disclosure. However, equity derivatives that allow for conversion into shares allow an investor to collect shares without technically falling under securities law disclosure requirements in a number of jurisdictions. When the investor is ready to make a bid for the company, it exercises its options or informal agreements to physically settle the derivative, acquires the percentage of shares it wishes to make the takeover bid and at that point, is required to disclose. There can be considerable amassing of shares before corporate officers or other investors are aware that there is a new significant shareholder. While the Canadian judgment discussed above suggested that in some circumstances the regulator's public interest authority may be engaged, such use of swaps, absent other evidence, was found not to violate securities law as long as the party disclosed its shareholding when it formally met the requisite threshold.[75] Yet more than 80 cases of use of equity derivatives to skew corporate behaviour in the takeover context have been documented across the globe.[76]

(d) Implications for Monitoring

For equity derivatives, smaller or less sophisticated shareholders, who could previously rely on the monitoring and governance role of institutional shareholders, will not be aware that their incentives to monitor have reduced. Where sophisticated shareholders have fully hedged their economic risk, they may be less willing to expend the resources to engage in such monitoring, but the

74 In Canada, an offeror must disclose when he, she or it has acquired 10 per cent of the target's voting shares, that threshold becoming five per cent when there is a takeover bid process engaged: see, eg, *Securities Act* RSO 1990, s 101. The investor must thereafter disclose each time an additional two per cent of the voting shares are purchased, up to a total of 20 per cent of the stock.

75 See the discussion above regarding *Re Sears Canada Inc,* 2006 LNONOSC 1044 22 BLR (4th) 267 (Ontario Securities Commission).

76 Hu and Black, above n 45*,* 658.

lack of transparency in this respect may create negative externalities in respect of smaller shareholders. The previous signalling by institutional shareholders, either from their proxy activities, media statements or shifting of significant investment, may no longer be reliable, and remove an important part of the synergistic aspects of investor oversight of the activities of directors and officers. These positive externalities have allowed investors who did not have the time, resources or capacity to monitor the governance activities of the company, to rely on the monitoring and advocacy of larger shareholders. Coupled with a similar trend in respect of credit derivatives and operating lenders, there may be considerable new risks to smaller investors from the disconnection between legal interest and economic interest of creditors and shareholders that they could previously rely on to signal in respect of the financial and governance health of the company.

3 *Director and Officer Incentive Effects*

The uncoupling that occurs through derivatives can create new agency issues for directors and officers. Given the fact that both types of derivatives avoid many disclosure requirements, these transactions can occur rapidly, in successive waves, and with minimal transparency. The corporation and its directors and officers may have little sense of where the true economic investment in their business lies. If so, they may be governing with a view to the shareholders with legal voting interests, but little or no economic risk. As directors and officers become more aware of the disconnection between legal voting rights and economic interests, it may affect their incentives to act in the best interests of the corporation or its shareholders or creditors, as the likelihood of being held accountable may diminish.

In respect of their own purchase of equity derivatives, directors and officers are required to disclose such activities in many jurisdictions, as it is material information that may be significant to the decision making of these insiders. A director or officer in possession of material undisclosed information, although prohibited from trading in securities of the issuer, may be able to profit improperly from such information by entering into derivative-based transactions that mimic trades in securities of the reporting issuer. While equity derivatives offer a risk diversification strategy for directors and officers, the purchase of derivatives may diminish the underlying purpose of granting stock as part of the compensation package, to align the interests of directors and officers with shareholders. Here, the alignment may now occur with shareholders that have hedged their risk with equity derivatives, rather that aligning with the general body of shareholders that have an economic interest in the success of the company.

4 *Limited Regulatory Response*

The use of derivatives raises issues of transparency and governance. With respect to credit derivatives, there has been little regulatory response to date, save for establishing counter-party clearing facilities in some jurisdictions.[77] Industry resistance to any regulatory oversight of derivatives has been well organised and well funded.

With respect to equity derivatives, some regulators have begun to address the transparency issue through new disclosure requirements under securities or financial services law. While transparency measures address one aspect of corporate governance, other aspects of corporate governance have not yet been addressed. In a takeover bid context, a principal means of protecting the bona fide interests of shareholders of target companies is by ensuring that they are provided with information that might reasonably affect their decision to accept or reject a bid for their shares.[78] Disclosure also provides a signal to the marketplace that competing bidders may be interested in making a formal bid. In response to the use of equity derivatives in takeover bid situations, regulators have taken steps to increase transparency. The UK Takeover Panel changed its disclosure requirements to include cash settled derivatives in its takeover regulation, requiring disclosure of economic ownership of one per cent or more in a target company, including cash-settled CfDs during the pendency of a takeover bid.[79] The UK Financial Services Authority ('FSA') announced a general disclosure regime for long CfD positions as the 'most effective means of addressing concerns in relation to voting rights and corporate influence', effective 1 June 2009.[80] Existing share and CfD holdings, in the same company, are to be aggregated for disclosure purposes.[81] A person must notify the issuer of the percentage of voting rights that he, she or it holds as shareholder or holds or is deemed to hold through direct or indirect holding of financial instruments, including derivatives.[82] A person must make a notification in accordance with the applicable thresholds in respect of any qualifying financial instruments that the person or entity holds, directly or indirectly, which result in an entitlement to

77 See, eg, European Central Counterparty Limited ('EuroCCP'), which was established to provide clients lower cost, lower risk clearing and settlement services on a pan-European basis, clearing trades in more than 5,000 stocks in 15 European markets: EuroCCP <http://www.euroccp.co.uk/about/index.php> at 21 August 2009.

78 *Re Maple Leaf Sports & Entertainment Ltd* (1999) 22 OSCB 2027; *Beringer Properties Inc* (1993) 18 BCSC Weekly Summary 18, 22; and *Re Standard Broadcasting Corp Ltd* (1985) 8 OSCB 3672 at 3676–7.

79 *UK Takeover Code*, r 8.3 (2006); The Panel on Takeovers and Mergers, *Dealings in Derivatives and Options* (2005) <http://www.thetakeoverpanel.org.uk/new/consultation/DATA/PCP200502.pdf> at 21 August 2009. The Code reflects collective professional opinion about appropriate business standards in takeovers and has a statutory basis in the UK: DTR 8.3 (FSA Disclosure and Transparency Rules).

80 *The Disclosure and Transparency Rules (Disclosure of Contracts for Differences) Instrument 2009* ('*DTR*') FSA 2009/13, in force on 1 June 2009 <http://fsahandbook.info/FSA/handbook/LI/2009/2009_13.pdf. 26 February 2009> at 21 August 2009. Financial Services Authority ('FSA'), *Disclosure of Contracts for Difference – Consultation and Draft Handbook Text* (2007) <http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf> at 21 August 2009.

81 FSA, *Contracts for Difference Policy Update* (2008) <http://www.fsa.gov.uk/pubs/cp/cp07_20_update.pdf> at 21 August 2009.

82 DTR 5.1.2R, DTR 5.11.6R, FSA 2009/13. Certain voting rights are to be disregarded (except at five per cent, 10 per cent and higher thresholds) in specified circumstances: DTR 5.3, 20/01/2007.

acquire shares to which voting rights are attached.[83] Thus the UK has opted for increased disclosure through new regulatory requirements, requiring investors to aggregate their holdings of shares and derivative products where they have unilateral rights to convert those products into voting shares and at thresholds it deems material.

In Australia, the Takeovers Panel issued an *Equity Derivatives Guidance Note* in 2008.[84] Disclosure of positions taken in equity derivatives is now required in 'control' situations. The Panel expects disclosure of all long equity derivative positions or a relevant interest in securities or a combination of both, whether hedged or unhedged, exceeding five per cent of the underlying stock, alone or in combination with physical holdings.[85] Disclosure must include the identity of the taker; relevant security; price, including reference price, strike price, option price where appropriate; entry date; the number of securities to which the derivative relates; type of derivative, such as CfD, cash settled put or call option; any material changes to information previously disclosed to the market; long equity derivative positions and relevant interests held by the taker and its associates; and short equity derivative positions that offset physical positions.[86]

In Switzerland, in response to a number of takeover bids where there was non-transparent acquisition of shares prior to an offer, the Swiss Federal Banking Commission amended its rules, effective 2007, to require disclosure of cash-settled call options.[87] The Swiss Parliament adopted legislation to reduce the threshold for disclosure to three per cent and to broaden the definition to require disclosure of any financial product that would enable the holder to acquire voting rights with respect to a potential takeover.

In Canada, the Canadian Securities Administrators ('CSA') have proposed Canadian securities instrument National Instrument ('NI') 55-104 *Insider*

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83 DTR 5.3.1, 20/01/2007. Transferable securities, and options, futures, swaps, forward rate agreements and any other derivative contracts are considered to be qualifying financial instruments provided that they result in an entitlement to acquire, on the holder's own initiative under a formal agreement, shares to which voting rights are attached, already issued of an issuer whose shares are admitted to trading on a regulated market or a UK prescribed market: DTR 5.3.2, 20/01/2007. A 'formal agreement' means an agreement that is binding under applicable law: Directive 2004/109/EC (TD). The instrument holder must enjoy, on maturity, either the unconditional right to acquire the underlying shares or the discretion as to his, her or its right to acquire such shares or not. The holder of qualifying financial instruments is required to aggregate the holdings for purposes of disclosure obligations: DTR 5.3.4.

84 Australia Takeovers Panel, *Guidance Note: Equity Derivative* (2008) <http://www.takeovers.gov.au/content/DisplayDoc.aspx?doc=guidance_notes/current/020.htm&pageID=&Year=> at 21August 2009.

85 It excludes, however, index derivatives and derivatives over a broadly-based basket of securities: Ibid.

86 Ibid.

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> On 1 December 2007 the SFBC will put into effect some changes in the Stock Exchange Ordinance-FBC regarding disclosure obligations of holdings in listed companies. The modifications stem in part from a change in Article 20 of the *Stock Exchange Act,* and in part from experience with disclosures as well as from the *Collective Investment Act* in effect since 1 January 2007. This publication serves as preliminary information for the affected market participants. There may be some changes later in terms of language and wording.

Swiss Federal Banking Commission, 'New Provisions Regarding the Disclosure of Shareholdings' (Press Release, 7 November 2007) <http://www.finma.ch/archiv/ebk/e/archiv/2007/aktuelles2007.html> at 17 September 2009.

Reporting Requirements and Exemptions, which will set out the main insider reporting requirements and exemptions for insiders of reporting issuers, harmonising disclosure requirements, to be in effect 31 December 2010.[88] The rationale is that market efficiency may be impaired if the market is deprived of important information such that the insider's publicly reported holdings no longer reflects the insider's true economic position. The rule does not prohibit insiders from entering into monetisation transactions, but does require that insiders disclose them to the public, so that investors can make their own determination as to their significance.[89]

The above examples illustrate that many of the regulatory responses to date have addressed the problem of equity derivatives and insider information and/or the takeover context. The UK has moved directly towards a broader disclosure regime that attempts to create transparency in the nature of economic and voting interest. Canadian regulators have initiated a process of public comment to consider these issues. The focus is the extent to which disclosure should be required; however another question is how corporate governance norms may need adjusting.

The next part offers a concrete illustration of how corporate governance norms need some retooling. It examines how derivatives were a major factor in the collapse of AIG and in particular, how a business group that ostensibly had good governance structures in place was nevertheless ill-equipped to deal with the incentive effects of its derivatives activities. AIG's financial distress also points to the tension between the notion of the separate legal personality and the highly integrated nature of business enterprise groups.

IV AMERICAN INTERNATIONAL GROUP, GOVERNANCE MISSTEP AND IMBALANCE

American International Group, Inc., a Delaware corporation listed on the NYSE, is a holding company with operations in 130 countries. Its primary activities include general insurance, life insurance and retirement services

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88 Proposed NI 55-104 *Insider Reporting Requirements and Exemptions*, and Companion Policy; 55-104 CP *Insider Reporting Requirements and Exemptions* and Related Consequential Amendments, 2008. The proposed instrument and policy would replace the following instruments currently in effect: NI 55-101 *Insider Reporting Exemptions*; Companion Policy 55-101CP *Insider Reporting Exemptions*; Multilateral Instrument 55-103 *Insider Reporting of Certain Derivative Transactions (Equity Monetization)*; Companion Policy 55-103CP *Insider Reporting of Certain Derivative Transactions (Equity Monetization)* (2004). It is aimed at making it easier for issuers and insiders to understand and comply with their obligations, and for other market participants to analyse the reported information.

89 CSA, 'Notice and Request for Comment – Proposed NI 55-104 *Insider Reporting Requirements and Exemptions*, Companion Policy 55-104CP *Insider Reporting Requirements and Exemptions*, and Related Consequential Amendments (31 OSCB 12117, 8 December 2008) <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/csa_20081218_55-104_roc-insider-rpt.pdf> at 17 September 2009. The CSA proposes to narrow the focus of the insider reporting requirement to a core group of insiders with the greatest access to material undisclosed information and the greatest influence over the reporting issuer by introducing a new concept of a 'reporting insider'.

operations, financial services and asset management.[90] AIG provided insurance protection to more than 100 000 entities, including small businesses, municipalities, 401(k) plans, and companies that together employ over 100 million and had 30 million policyholders in the United States.[91] In addition to its longstanding insurance business, AIG entered the derivatives market in the late 1990s. AIG operated its CDS business through its UK subsidiaries AIG Financial Products and AIG Trading Group ('AIGFP'). The CDS business consisted largely of selling protection on super-senior risk tranches of diversified pools of loans and debt securities. The CDS unit's revenue rose to US$3.26 billion in 2005. Operating income at the unit also grew, rising to 17.5 per cent of AIG's overall operating income in 2005, compared with 4.2 per cent in 1999. In 2007, AIG had US$1 trillion in assets and US$95.8 billion in shareholder equity. AIG's high credit rating and healthy balance sheet assisted with market confidence in its CDS activities.

A AIG's Financial Distress

AIG's collapse was caused largely by its US$526 billion portfolio of CDS.[92] AIG ran out of cash as a result of CDS written on multi-sector CDO. Its dominant derivatives business had been selling plain vanilla products such as interest rate swaps, however it had moved into more complex products in recent years. It held US$61 billion on sub-prime residential mortgage loans.[93] In late 2007, as the US residential mortgage market began to deteriorate, the valuation of these securities declined severely and AIG recorded substantial unrealised market valuation losses, especially on AIGFP's CDS portfolio, leading to significant cash requirements.[94] At the same time, AIG reported large unrealised losses in its short-term loans of certain securities it owned to generate revenues by investing in residential mortgage-backed securities, suffering sharp losses in value. In September 2008, AIG's credit ratings were downgraded, triggering additional collateral calls and cash requirements in excess of US$20 billion, creating a liquidity crisis.[95] The financial pressure was increased because AIG investment had loaned US$76 billion in securities to US companies, and many companies sought return of their collateral as they became concerned about

90 AIG, *Annual Report 2008* (2009) 5 <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MTQ4OHxDaGlsZElEPS0xfFR5cGU9Mw==&t=1> at 21 August 2009.

91 U.S. Department of the Treasury, 'Statement for the Treasury Borrowing Advisory Committee Of the Securities Industry and Financial Markets Association' (Press Release, 2 February 2009), < http://www.treas.gov/press/releases/tg08.htm> at 17 September 2009.

92 Federal Reserve Board ('FRB') (Press Release, 16 September 2008), <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm> at 26 September 2009.

93 AIG, above n 90.

94 Ibid 1.

95 Ibid.

AIG's cash position.[96] When AIG's large write downs and collateral posting obligations became known, those companies sought the cash collateral that they had posted with AIG in exchange for lent securities, demanding their collateral be returned. AIG lacked sufficient funds to satisfy these obligations and was forced to transfer billions in cash to pay out borrowers.[97] AIG subsidiaries also suffered from the collapse of the commercial paper market.

B Government Bailout

On 16 September 2008, the US Federal Reserve Board and Department of the Treasury announced that the Federal Reserve Bank of New York ('NY Fed') would bail out AIG through an US$85 billion revolving credit facility ('Fed Credit Facility') to facilitate a sale process of AIG businesses in an orderly manner with the least possible disruption to the overall economy.[98] The credit facility required AIG to issue 100 000 shares of preferred stock to a new AIG Credit Facility Trust, established for the benefit of the US Treasury.[99] Thus the two-year emergency loan of US$85 billion was in exchange for 80 per cent equity ownership of the company through preferred stock.[100] The Credit Facility contains numerous covenants, including that AIG is to use all reasonable efforts to cause the composition of its board of directors to be satisfactory to the Trust and a prohibition against AIG entering into CDS except consistent with policies approved by the NY Fed.[101] The NY Fed is not required to loan AIG funds under the Fed Credit Facility unless it is reasonably satisfied with AIG's corporate governance.[102] In addition, four AIG subsidiaries had borrowed US$15.2 billion under the Commercial Paper Funding Facility to make voluntary repayments on the Fed Credit Facility.[103]

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96 AIG, Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before S. Comm. on Banking, Housing and Urban Affairs, 111th Cong 5 (2009) (written testimony of Eric Dinallo) <http://banking.senate.gov/public/_files/DinalloTestimonyAIG3509.pdf> 42–4 at 21 August 2009.

97 AIG, *June 2008 Quarterly Report*, (2008) <http://media.corporate-ir.net/media_files/irol/76/76115/reports/Q210Q.pdf> at 17 September 2009.

98 FRB, above n 92.

99 AIG, 'Credit Facility Trust Agreement' (2009) <http://www.newyorkfed.org/newsevents/news/markets/2009/AIGCFTAgreement.pdf> at 21 August 2009; The Federal Reserve Bank of New York, 'Statement Regarding Establishment of the AIG Credit Facility Trust' (Press Release, 16 January 2009), <http://www.newyorkfed.org/newsevents/news/markets/2009/an090116.html>.

100 AIG, above n 99.

101 Ibid s 4.11 33; s 6.10 49; s 6.12, 50.

102 s 4.01(e) 33. As of 30 September 2008, AIG had borrowed US$11.5 billion under the Credit Facility to meet the liquidity needs of its securities lending program and by 5 November 2008, AIG owed the NY Fed US$19.9 billion under the agreement: AIG, above n 97, 144.

103 Established to provide a 'liquidity backstop' to US issuers of commercial paper through a special purpose vehicle ('SPV') that will purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers: FRB (Press Release, 7 October 2008), <http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm> at 21 August 2009. See AIG, *Second Quarter 2008 Quarterly Report* (2008) 53 <http://media.corporate-ir.net/media_files/irol/76/76115/reports/Q210Q.pdf> at 17 September 2009.

On 10 November 2008, AIG and the NY Fed announced a comprehensive plan to address AIG's liquidity issues, including the creation of two financing entities, Maiden Lane II and Maiden Lane III, to acquire AIG's securities lending assets and the multi-sector CDO that were guaranteed by AIGFP's CDS.[104] The entities were funded primarily by the government, with a subordinated capital contribution by AIG. In addition, the US Department of the Treasury purchased, through the Troubled Asset Relief Program ('TARP') under the *Emergency Economic Stabilization Act of 2008*, US$40 billion of newly issued AIG perpetual preferred shares, the proceeds of which were used to pay down a portion of the government loan.[105] Although Maiden Lane II and III and the government's equity injection relieved some liquidity pressures, AIG's losses continued to mount due to credit market deterioration, particularly in mortgage-backed securities and charges related to ongoing restructuring activities, with a net loss for 2008 of US$99.3 billion.[106] As the global financial crisis continued, potential purchasers faced their own lack of access to capital. AIG's core business, the life insurance sector, saw a substantial decline in stock market value. On 2 March 2009, AIG, the US Treasury and the Federal Reserve agreed in principle to develop additional strategies to strengthen AIG's capital base. The terms of the US Treasury's preferred stock investment in AIG was to be modified to make the preferred securities more closely resemble common equity, improving AIG's capital structure. The US Treasury also agreed to provide AIG with a new five-year standby equity capital facility, allowing AIG to raise up to US$30 billion of capital by issuing non-cumulative preferred stock to the US Treasury from time to time.[107] The Fed Credit Facility was modified to allow AIG to repay amounts owed under it with preferred equity interests in two newly formed special purpose vehicles ('SPV').[108] In addition, AIG announced that it expected to transfer to the NY Fed embedded value of up to US$8.5 billion, representing securitisation notes of certain of its US life insurance businesses in return for a further reduction in its outstanding senior secured credit facility balance.[109]

The scope of the bailout is breathtaking, amounting to almost US$200 billion to date. AIG's financial influence in the United States was viewed as so significant that it could not be allowed to fail. One issue, however, is whether the

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104 FRB, above n 103. Under the terms of the agreements, the majority of any appreciation in the securities held by the entities would go to the government, but a portion would be retained by AIG.

105 Pub. L. 110-343, Div. A (2008): AIG, above n 103, 51. AIG was required to use the proceeds from the issuance to pay down the Credit Facility.

106 AIG, above n 103, 51.

107 Ibid 3.

108 AIG, *2008 Annual Report Form 10-K* (2008) <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Mjg0NHxDaGlsZElEPS0xfFR5cGU9Mw==&t=1> at 17 September 2009.

109 On 2 March, AIG announced its intention to form a general insurance holding company, composed of its Commercial Insurance Group, Foreign General unit, and other property and casualty operations, to be called AIU Holdings, Inc. The new holding company will have its own board of directors, management team; American International: Ibid 2.

terms of the bailout respond to governance deficiencies. Currently only some of the information on governance is available to be assessed against the abovementioned indicia of effective governance.

C Governance Structures Failed to Account for Incentives Created by Derivatives

AIG had well defined corporate governance structures and a detailed corporate governance policy. AIG reported adherence to the NYSE corporate governance rules and its own governance policy. It had all the board committees suggested by corporate governance norms: Finance, Compensation and Management Resources, Audit, Public Policy and Social Responsibility, Regulatory, Compliance and Legal, Nominating and Corporate Governance.[110] AIG was a well-known seasoned issuer ('WKSI') accelerated filer in the US, which carried with it the legitimacy of the Securities and Exchange Commission ('SEC') compliance stamp of approval as a seasoned issuer accepted in the market. It had disclosure systems in place and met officer certification requirements under securities law.

The AIG board had previously been dominated by insiders, with five executives serving as directors.[111] However, in 2005, a major institutional investor, the American Federation of State, County and Municipal Employees ('AFSCME') Pension Plan, had complained that insider influence on the AIG board had prevented it from effectively monitoring its business practices and providing needed checks on management.[112] It launched a proposal for more independent directors and after a hard-fought campaign the board was altered to two-thirds independent directors with a lead independent director and a detailed code of conduct for directors.[113]

It appears, however, that there was a disconnection between the parent board and management of its structured financial products unit. The governance structure did not transfer into effective governance strategies in respect of the CDS subsidiary. AIG's small CDS unit of 377 employees operated in a climate of lax oversight, operating with almost complete autonomy, contrary to the more established governance practices of the insurance side of AIG's business activities. The derivatives business was given free reign and little monitoring because of the tremendous returns in the derivatives portfolio.

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110 AIG, *Corporate Governance* <http://www.aigcorporate.com/corpgovernance/index.html> at 21 August 2009.

111 As well as another director whose organisation has received more than US$2 million from a foundation run by the AIG Chair and CEO: American Federation of State, County and Municipal Employees ('AFSCME') Employees Pension Plan Shareholder Proposals, *Proxy Access* (2005) <http://www.afscme.org/press/6838.cfm?print=1> at 21 August 2009.

112 Ibid.

113 AFSCME, 'ADSCME Pension Plan Calls for Reform at AIG', (Press Release, 9 May 2005), <http://www.afscme.org/press/6784.cfm> at 21 August 2009.

D Where were the Directors?

Arguably, the directors failed to exercise the care, skill and due diligence in the best interests of the company when they failed to understand or question the nature and extent of the corporate group's exposure under its derivatives portfolio. There was a lack of financial expertise among directors to fully understand the derivatives activities. AIG viewed itself as a market leader in derivatives yet the directors did not understand the nature and risk of the CDS and related structured financial products. The directors appear to have failed to challenge management when there was a lack of transparency and understanding of the derivatives products. A 'no risk of failure' attitude predominated. Joseph Cassano, a former executive, was reported to have stated in August 2007: 'It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those (CDS) transactions.'[114]

There was also a failure to make the appropriate changes to the governance structure after problems with accounting were identified. The SEC charged AIG with accounting fraud in early 2006, alleging that the company materially falsified its financial statements from 2000 to 2005, where AIG materially misstated its financial results through sham transactions and entities created for the purpose of misleading the investing public, and reported materially false and misleading information about its financial condition in order to mask that its reserves were declining.[115] AIG commenced an internal investigation that eventually led to a restatement of its prior accounting for approximately 66 transactions or items. In its restatement, AIG admitted that its accounting for certain transactions had been improper and that the purpose behind some of those transactions was to improve financial results.[116] The SEC announced the filing and settlement of charges that AIG committed securities fraud, the settlement being part of a global resolution of federal and state actions under which AIG was to pay in excess of US$1.6 billion to resolve claims related to improper accounting, bid rigging and practices involving workers' compensation funds.[117]

114 Gretchen Morgenson, 'The Reckoning Behind Insurer's Crisis, Blind Eye to a Web of Risk', *The New York Times* (New York), 28 September 2008, <http://www.nytimes.com/2008/09/28/business/28melt.html?ref=business&pagewanted=print> at 21 August 2009. As a result of the government bailout AIG, in May 2009, announced six new independent director nominees would stand for election at the AIG 2009 Annual Meeting scheduled for 30 June 2009, reconfiguring the board to include a majority of new independent directors with extensive experience with large complex organisations and in the areas of financial services, accounting and restructuring This change reflects the need for more sophisticated financial expertise on the board: AIG, 'AIG Announces Six New Independent Director Nominees to Stand for Election at 2009 Annual Meeting', (Press Release, 19 May 2009) , <http://ir.aigcorporate.com/phoenix.zhtml?c=76115&p=irol-newsArticle&ID=1290039&highlight=> at 21 August 2009.

115 SEC, 'Litigation Release No 19552: SEC Charges One AIG and Four Gen Re Executives for Aiding in AIG Securities Fraud' (Press Release, 2 February 2006) <http://www.sec.gov/litigation/litreleases/lr19552.htm> at 27 September 2009.

116 As a result of the restatement, AIG reduced its shareholders' equity at 31 December 2004 by approximately US$2.26 billion or 2.7 per cent.

117 SEC, above n 115.

The US District Court for the Southern District of New York entered a final judgment against AIG in 2006, under which AIG paid US$700 million in disgorgement and US$100 million in penalties.[118] The CDS unit maintained that its risk assessments were reliable, however in February 2007 AIG's auditors identified problems in the firm's swaps accounting. On 19 May 2009 the SEC announced that the Federal Court had approved the distribution of more than US$843 million to more than 257 000 harmed AIG investors from a Fair Fund that the SEC established after the company's settlement of the SEC enforcement action.[119]

As part of the settlement of the fraud case, AIG agreed to certain undertakings designed to assure the SEC that future transactions would be properly accounted for and that senior AIG officers receive adequate training concerning their obligations under federal securities laws. AIG's remedial measures included appointing a new CEO and CFO; putting forth a statement of philosophy committed to achieving transparency with all stakeholders through effective corporate governance, a strong control environment, high ethical standards and financial reporting integrity; establishing a Regulatory, Compliance and Legal Committee to provide oversight of AIG's compliance with applicable laws and regulations; and enhancing its Code of Conduct and mandating that all employees complete special formal ethics training. These reforms addressed some of the governance issues, although it is unclear whether AIG put in place any measures to evaluate their effectiveness. It appears that these changes did not address the potential risks of its derivatives activities.

E Systemic Risk Management

In terms of internal risk control as another indicium of effective governance, AIG had an Audit Committee Charter that satisfied NYSE and SEC rules for internal risk control. It had implemented a new risk system after the securities charges discussed above. Yet the new system did not address systemic risk. It was premised on the notion that there would be a liquid market for residential mortgages and other asset backed commercial paper. The lessons of risk prior to 2007 appear to have gone largely unheeded. The deficiencies and fraud in accounting did not appear to deter AIG in its market activities. Nor does it appear to have signalled to the directors that it was appropriate to take a closer look at all the accounting, financial and risk management practices of the business group to better understand and reduce the systemic risk associated with highly interrelated entities within a global operation. The new risk management system may have failed because of a gap between governance structures and good governance

118 AIG consented to the judgment without admitting or denying the allegations. The US District Court for the Southern District of New York entered an order on 14 June 2007.

119 SEC, 'SEC Announces US$843 Million Fair Fund Distribution to Harmed AIG Investors' (Press Release, 19 May 2009) <http://www.sec.gov/news/press/2009/2009-115.htm> at 21 August 2009. Under the Fair Funds provisions of the *Sarbanes-Oxley Act*, the SEC has authority to help harmed investors.

practice. In terms of corporate culture, there appears to have been unquestioning reliance on advisors and market norms.

F Incentive Effects of Officer Compensation

Moreover, AIG's compensation practices were structured to reward short-term returns. From 2001 to 2008, the small derivatives unit AIGFP paid its employees US$3.56 billion.[120] The bonus plan for the unit called for US$220 million in retention pay for the employees, of which US$55 million was paid in December 2008 and the remaining US$165 million paid in March 2009.[121] The government bailout failed to place conditions on continuing high bonuses unconnected to actual financial stability or performance.[122] AIG's position was that it was legally bound to honour the incentive contracts aimed at retaining AIGFP employees. Yet it appears evident that no effort was made to tie accessibility to bailout funding to compromise of those claims, which would have occurred had AIG entered Chapter 11 bankruptcy proceedings. Only after considerable public and media pressure did a number of AIGFP executives agree to return part of the retention bonus payments.[123]

The compensation practices before and after AIG's financial distress indicate that compensation aligned to service fees and immediate returns does not translate to officer behaviour in the long-term interests of the corporate group or its economic viability. There were no negative consequences to managers for their failure to properly assess and address systemic risk. There was no accountability for the financial distress created.

There was also a lack of transparency as to how AIG has spent the bailout money, and only after considerable media and public pressure, in March 2009, AIG released the information regarding the financial companies that received multibillion-dollar payments. The list included 80 major banks and dealers,

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120 Morgenson, above n 114.

121 'American International Group Inc', *The New York Times* (New York), 4 August 2009, <http://topics.nytimes.com/topics/news/business/companies/american_international_group/index.html> at 21 August 2009. E L Andres and P Baker, 'Bonus Money at Troubled A.I.G. Draws Heavy Criticism', *New York Times* (New York), 15 March 2009, <http://www.nytimes.com/2009/03/16/business/16aig.html?_r=2> at 17 September 2009, reporting that '[t]he retention plan also calls for another US$230 million in bonuses for 2009 that are due to be paid by March 2010. Combined with the 2008 bonuses, it would bring the total retention pay for financial products executives to US$450 million.'

122 The highest bonus to executives at the CDS subsidiary was US$6.4 million. Six other employees received more than US$4 million, 15 received bonuses of more than US$2 million, and 51 people received bonuses of US$1 million to US$2 million. 11 who received 'retention' bonuses of US$1 million or more were no longer working at AIG, including one who received US$4.6 million. Louise Story, 'Cuomo Details Million-Dollar Bonuses at A.I.G', *The New York Times,* (New York), 18 March 2009, <http://www.nytimes.com/2009/03/18/business/18cuomo.html?pagewanted=print> at 21 August 2009.

123 For AIG's top seven executives, there will be no annual bonus for 2008 and no regular salary increase through 2009. In addition, these executives gave up their right to receive severance and did not accept payments from their deferred compensation accounts: Ibid 4.

companies and municipalities that AIG owed largely through its securities lending activities.[124]

AIG illustrates that an otherwise viable business enterprise with a history of relatively effective governance and very healthy economic performance in its insurance business, can fail because the governance measures in place were not responsive to changing markets, developing financial products and the incentive effects created by their use. On paper, AIG's governance met the indicia discussed above yet, in practice, its governance failures precipitated one of the largest failures and government bailouts in history. AIG's financial distress also points to the tension between the notion of the separate legal personality and the highly integrated nature of business enterprise groups. Although the CDS subsidiary was a separate legal entity, cross-guarantees brought the entire corporate group down. Corporate governance needs to account for the interrelated financial and control nature of such businesses, even where the legal structure of the corporation is one of separate legal entities.

V ENHANCING PRINCIPLES OF EFFECTIVE GOVERNANCE

Although the governance principles articulated by a number of organisations have offered helpful direction on effective corporate governance, they need some refinement and enhancement to respond to governance issues raised in the current financial market. The principles and norms currently focus on governance problems associated with the separation of ownership and control, but do not address the separation of ownership and real economic interest. This part suggests that the governing principles for retooling corporate governance should be transparency, accountability and fairness, and that all three are essential factors in addressing the challenges posed by derivatives activity and in engaging in a renewed consideration and policy debate in respect of corporate governance.

The exercise of legal rights in the absence of economic interest is a 'moral hazard' to the conduct of the business enterprise. Both the theoretical models and regulatory design of corporate law are based on the incentives to monitor managers that arise from having a real economic interest at risk. Where that is absent, the models need revision. The fact that financial markets for these products are opaque and appear counter to our previously understood norms leads to problems of fairness to other stakeholders who have an economic interest in the business enterprise that is formally aligned with those of the hedged investors, when unbeknownst to them a conflict of economic interest may exist. The corporate law model based on everyone having an interest in the economic

124 Including Goldman Sachs (US$12.9 billion), Merrill Lynch (US$6.8 billion), Bank of America (US$5.2 billion), Citigroup (US$2.3 billion) and Wachovia (US$1.5 billion). Société Générale of France and Deutsche Bank of Germany each received nearly US$12 billion; Barclays of Britain received US$8.5 billion; and UBS of Switzerland received US$5 billion. Sachs and Société Générale were exposures under AIG's derivatives portfolio and others, such as Barclays and Citigroup, were the result of AIG's securities lending program: Ibid.

success of the enterprise, with legal rights accordingly, no longer exists, creating an issue of real fairness.

The specifics of any changes need considerable public policy debate and a clear understanding of what outcomes are sought before regulatory intervention is undertaken, implemented and assessed for effectiveness. However, this part offers some broad starting principles for effective governance, having regard to the issues raised above. The principles include transparency, accountability and fairness.

A Transparency

Transparency as a general principle is important to corporate governance as it enhances confidence in financial products and capital markets and reduces information asymmetries. It allows equity and debt investors to make informed choices about investment, allows corporate directors and officers a clear understanding of who the economic claimants to the business entity are, and can reduce some of the worst vagaries of systemic risk.

1 *Point of Purchase Disclosure*

As a principle, transparency requires that participants with an interest in a business entity have sufficient material information such that they can assess and price risk of investment, decide to exercise any shareholder or creditor rights that may be available, and decide the extent to which they have the information, resources or willingness to engage in monitoring of the activities of directors and officers. There must be sufficient disclosure of material information to allow market participants to make informed choices about credit derivative investment and investment in firms that have derivatives portfolios. The transparency principle could address in part the governance issues raised in respect of derivatives. With respect to the new issues arising from the separation of ownership and economic interest, transparency will expose the moral hazards and permit a debate on what public policy responses should be to this separation.

Purchasers of CDS should be required to disclose, at the time of purchase, any material adverse risk in the reference entity of which they are aware, in order that protection sellers can appropriately price the contract. Materiality in this respect could be based on a standard of whether the facts in respect of the adverse risk would reasonably be expected to have a significant effect on the protection seller's valuation or pricing of the derivative.[125] Protection sellers could be required to disclose any material adverse risk to their financial health at the time of the sale and/or renewal of a derivative contract, and could have an

125 Sarra, above n 31, 8.

ongoing disclosure requirement regarding material adverse change to their ability to settle the derivative at the point of a credit event occurring.[126]

However, disclosure alone may not assist if it is buried in thousands of pages of derivatives documentation. Some jurisdictions such as the EU have moved to summary sheets in their securities law disclosure. Similar summary warnings could be placed on the front of derivatives documents, with a right of action by counterparties where there is a misrepresentation or failure to disclose material information, or the ability to enforce by regulators where the misrepresentation is contrary to the public interest.

2 *Continuing Disclosure Requirements*

Publicly traded companies should be required to disclose the effect of credit derivatives on their risk exposure, including how their credit risk has affected valuation of derivative liabilities and any resulting gain or loss included in earnings statements, and any known information on how counterparty credit risk may have affected their valuation of, or ability to collect on, derivative assets. While some jurisdictions may now require such disclosure as part of their financial services requirements, it should be more broadly and consistently available. The outcome sought by this recommendation is to reduce the potential for unnecessary and unfair financial loss for market participants through greater transparency regarding material risk. It would require plain and timely disclosure of such information as an investor protection measure.

More generally, corporations need to make more transparent the nature of their derivatives exposure, including ongoing assessment and disclosure of more systemic market based risk. For publicly traded companies, that means sufficient disclosure of material information in a timely, accessible and meaningful form that allows investors to make informed choices to buy, sell or hold shares or loans. For privately held companies, state owned enterprises and other business entities, that transparency must be available to their direct equity and credit investors.

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126 Elsewhere I have suggested targeted intervention in the credit derivatives market, including increased transparency and a price for participation in the market, with transaction fees placed in a fund to be available to counterparties that had been unfairly harmed by failure to disclose or other misconduct by market participants. On insolvency, such a claim by the fund would be eligible for debt to equity conversion along with other creditors' claims. Such a strategy would spread the cost of misconduct across parties most actively buying and selling CDS and other derivatives, would allow cost recovery against specific counterparties in some cases, and would diminish the risk of unfair losses to end purchasers. The fund could possibly be empowered to then impose risk-based levies on the counterparties causing the losses, in an attempt to partially recover where the counterparty was solvent: see generally Sarra, above n 32. There are two further public policy issues that need consideration: the first is how mark-to-market accounting has influenced and been influenced by the credit derivatives market and second, there should be public policy discussion as to whether any regulatory intervention should distinguish between sophisticated and less sophisticated derivatives market participants. Arguably, more sophisticated purchasers can price risk in future derivatives agreements or bargain particular governance and monitoring controls: see Janis Sarra, 'Restructuring of the Asset-Backed Commercial Paper Market in Canada'(Speech delivered at the Annual Review of Insolvency Law 2008, Vancouver, 13 February 2009).

3 *Responsibility of Parties Developing New Products*

Financial institutions and other parties that create new derivatives products should be required to disclose underlying material risks to the derivatives to counterparties. Counterparties and retail investors purchasing derivatives should have enforceable remedies for the failure of these entities and individuals to disclose material adverse risks at the point of sale of the derivatives. Such a requirement would enhance transparency regarding new products as they develop, allowing market innovation while aiming to ensure that there is sufficient information in the market to assess and price risk, and to ensure that those making the products available are providing a type of indemnification in respect of the product in terms of assurances that the material adverse risks are known at the time of purchase and sale.

Credit rating and other entities that recommend derivatives products should meet a due diligence standard in examining and disclosing material adverse risk in the derivative products being sold in the public market. Credit rating agencies should be required to disclose all fees associated with a rating, as well as consulting and other fees received from the bank or other entity selling the derivatives. More important, the fees structure of largely unregulated credit rating agencies needs a major overhaul, because fees are currently paid by the firms that are being rated, creating a clear conflict of interest. There should be effective remedies for purchasers and other market participants from failure of those individuals and entities recommending or rating derivatives to meet due diligence and disclosure obligations. Such measures would create appropriate incentives for credit rating agencies and others that recommend investment in credit derivatives to undertake diligent examination and assessment of products, including ascertaining and disclosing material risk, and reducing their conflicts of interest.

4 *Transparency of Economic Interest*

In respect of equity derivatives, the ability to mask the accumulation of shares creates incentives for investors to use equity derivatives to avoid requirements of securities regulation, defeating the public policy objectives at which such disclosures are aimed. As discussed above, some regulators have moved to address some of the most pressing issues in respect of disclosure of equity derivatives, particularly in the takeover context and with respect to insiders. However, outside of these two circumstances, there has been little regulatory consideration of equity derivatives. There is a need for transparency to allow all corporate stakeholders to understand where the economic interest is located and how it motivates particular behaviour.

5 *Regulatory Initiatives*

Regulators should consider requiring public disclosure of ‘no economic interest at risk’ derivatives and prohibiting actions by these derivatives holders that lead to default events or inappropriate voting, in order to address the moral hazard issues of financial products imperilling the real economy. The outcome sought by this recommendation is to reduce incentives for those holding derivatives products to engage in actions that precipitate credit events, control transactions or governance change where they have no economic interest at risk. Many insurance statutes require the insured have at least a factual expectation of loss if the object of the insurance suffers pecuniary damage, loss or destruction; and the factual expectation requires a lawful or substantial economic interest in the preservation of the insured property. The same approach should be considered for derivatives in terms of requiring that a creditor or shareholder that has hedged its claims through a derivative discloses the real quantum and nature of its remaining economic interest, if any, before it has decision or control rights in proceedings involving the reference company.

Any central derivatives exchange and/or counterparty clearing facility that is being created needs to be subject to regulatory oversight, and work towards standardised transparent trading procedures, consistent standards of conduct and disclosure, and transparency in the valuing and settlement of derivatives. The purpose of an exchange or clearing facility is to manage systemic risks to the derivatives market. The US Treasury has observed that the introduction of the first central counterparty clearing facilities are aimed at increasing transparency and are a means of imposing necessary risk controls such as robust margin requirements and necessary risk controls to hinder the accumulation of large and uncollateralised CDS positions.[127] The SEC is lobbying for legislative change that will authorise the Commodities and Futures Trading Commission (CFTC) and SEC to impose recordkeeping and reporting requirements for over-the-counter derivatives and to develop a system for timely reporting of trades and prices but, to date, the transparency aspects are not clearly defined. Moreover, disclosure agreements for central counterparty clearing facilities (CCP) currently appear to allow only for disclosure of aggregated data, based on the argument that it would slow incentives to engage in the derivates market. Yet there is a legitimate public policy discussion to be had in respect of whether support for the speculative aspects of the market is sufficient reason to not require greater transparency.

More generally, credit derivatives documentation should be made public, either through a common database of trading information, a central registry or public disclosure vehicle similar to exchange disclosure requirements in UK and elsewhere. There should be public reporting of credit default swaps, including trading and position reporting by OTC dealers and credit default swap clearing data.

Transparency is an essential starting principle, requiring disclosure in a form that is meaningful for interested stakeholders. Arguably, transparency principles extend beyond corporate directors and officers to other stakeholders involved in the business entity's activities, in terms of making clear their real economic interest in the business. One could design a system that still preserves the right not to disclose the extent of hedged risk and empty voting rights, except perhaps

127 US Department of the Treasury, 'Regulatory Reform Over-The-Counter (OTC) Derivatives' (Press Release, 13 May 2009), <http://www.ustreas.gov/press/releases/tg129.htm> at 21 August 2009.

to the regulator or other centralised information facility, but the quid pro quo would be that the investor could not exercise voting or other default control rights in respect of the business entity.

B Accountability

Corporate governance norms should be highly dynamic, developing continually to respond to new challenges in respect of corporate activity and oversight. The separation of formal voting rights and economic interest through the purchase of equity derivatives may create agency issues and negative externalities in respect of corporate decision making, as explored above. Yet an important principle is that directors and officers are accountable to equity owners for the profitability of the enterprise, and arguably, to other stakeholders for due consideration of their interests in the best interests of the business enterprise. The separation between equity ownership and economic interest raises the question of whether this model of accountability still accomplishes the public policy goals of corporate law.

For different types of business entities, accountability in respect of derivatives means different things. For businesses engaged in securitisation and/or other derivatives activities, one could require that a portion of exposure be left on the originating lender's balance sheet or that the debt require seasoning for a period of time before it can be repackaged and resold. The exposure required to be retained would have to be significant in order to enhance accountability, or the amount would merely be viewed as a nominal price for participation in the market to shed risk.

In respect of their corporate governance activities, corporate officers may use derivatives strategies to facilitate insiders or friendly third parties to vote shares with little or no economic exposure as a strategy to defeat changes in control.[128] Officers can create incentives for the voting shareholder to vote with their interests, but do not directly have that control as it would run afoul of corporate and securities laws in a number of jurisdictions. Even where derivatives arrangements have not been made, these friendly relationships, such as between officers and pension fund managers, can skew voting in favour of management. Greater accountability suggests development of new practices that respond to these challenges and create forward-looking alternatives.

Best practices standards must be developed for OTC derivatives through collaboration between regulators and market participants, including in respect of counterparty credit risk management, oversight, liquidity management, capital adequacy and netting. The outcome sought is to reduce counterparty risk, and move towards the creation of shared definitions of derivatives standards and overarching principles, given the global nature of the market. The development of standards could be joint state and market driven initiatives. The market is able to more quickly adapt standards and measurements of risk to new product developments, but solely industry-dominated standard setting has failed to

128 Hu and Black, above n 45, 642.

adequately assess risk, and in the future may create somewhat self-serving standards given the closed nature of the industry and conflicts of interest arising from compensation practices that do not take systemic risk creation into account. State driven regulatory initiatives may fail to appreciate the intricacies of the derivatives market, but in collaboration with broad types of stakeholders they could ensure public policy initiatives that address accountability concerns. Current initiatives by industry participants could be enhanced by participation of regulatory authorities and investor protection or other NGOs, in order to ensure public interest concerns are included in the development of standards.

Financial services regulatory authorities also have an accountability role. They need to expand their consideration of public policy implications of any regulatory choices to recognisse that financial and capital markets directly influence real economic activity and real communities; hence they need to commence thinking about how, in meeting their statutory goals of investor protection and efficient markets, they give consideration of where those goals fit within broader public policy goals.

1 *New Risk Management Strategies*

Directors and officers should be required to undertake new modelling for risk, recognising the multidimensional nature of credit, liquidity, systemic and agency risk, including continuous reassessment of risk models. They need to have a better understanding of how different directors and officers have different capacities to identify, assess and respond to risk. The governance structure must recognise the inherent and direct conflicts of interest in directors and officers hedging decisions. This issue speaks to the independence indicia discussed above. Independence means that directors ensure that there are effective risk assessment systems in place, not just acceptance of minimum standards. The financial viability of credit derivatives had been questioned for several years, but directors and officers did little to assess whether current risk management systems accounted for systemic risk.

A more focused accountability structure needs to shift derivatives from opaque financial reporting to a clear discussion by directors and officers in MD&A and elsewhere of the risk of such derivatives in both stable and unstable markets and their role in the strategic plans of management.

Just as general corporate governance norms have developed, arguably there is an opportunity to encourage processes that develop new best practices in respect of derivatives and encourage a culture of compliance with any norms and practices developed. For example, stakeholders could decide that an effective governance practice would be to develop a capacity to monitor unwinding of swaps or share lending, ensuring that the parties acquiring voting rights generally meet good governance standards, or at least do not intend to use the shares to advance interests contrary to those of the lending company and its shareholders. Ideas such as that of the Hedge Fund Working Group in the UK, which has recommended a ban on the use of borrowed shares for empty voting purposes, should be considered through informed public discussion.[129] Arguably it is also timely to consider greater democratisation of shareholder voting, in the sense of enhancing opportunities for investor participation where they do hold an economic interest.

2 *Significance in the Takeover Context*

In the takeover context, in additional to mandatory disclosure requirements, there needs to be innovative consideration of how to establish best practices and accountability in the context of takeover transactions. In this respect, the courts can also contribute to these norms by examining processes developed, such as independent directors' committees, and determining whether they fall within best practices or legal requirements, and whether they meet broader public policy objectives of fairness in takeover transactions.

3 *Restricting Ability of Insiders to Hedge Risk*

Directors and officers should not be permitted to shed their own economic exposure through purchase of equity swaps or CfD, as the risk of non-transparent self-dealing is high. While they should be able to diversify their own personal financial risk, such diversification can come from their investing their personal wealth in other portfolios, not from essentially 'betting' against the firm. Any hedging that a jurisdiction does permit should be subject to rigorous and timely disclosure so that directors and officers are accountable for decisions in respect of the business that may accrue to their economic benefit. Prohibitions on such purchases could be accomplished through securities regulation, or by amendment to corporate law that would allow shareholders to adopt such prohibitions in their corporate constating documents.[130]

To bolster the alignment of management and shareholder interests, in 2009 AFSCME proposed that AIG executives and executives at other firms in which it is an investor be required to retain a significant percentage of shares acquired through equity compensation programs for two years past their termination of employment, in order to reward performance based on long-term value creation for shareholders.[131] This proposal could apply to derivatives holdings as well, if an outright prohibition is found to be too intrusive. Such strategies would realign executive compensation practices with the economic interests of the business entity.

There needs to be discussion of how one preserves the risk management features of equity derivatives, which arguably assist the flow of capital in the

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129 Hedge Fund Working Group, *Hedge Fund Standards Final Report* (2008) 61 <http://www.deloitte.com/dtt/cda/doc/content/UK_FS_UKHedgeFundStandards.pdf> at 21 August 2009.

130 Constating documents refer to the documents set out in corporations laws that specify the capital structure, powers of directors and officers, etc. for the corporation. In some jurisdictions they are corporate articles, in others memoranda of incorporation, etc. Canada uses the word 'constating' document to cover these documents which differ in different jurisdictions.

131 AFSCME, 'AFSCME Employees Pension Plan Announces 2009 Shareholder Proposals' (Press Release, 27 January 2009) <http://www.afscme.org/press/24815.cfm?print=1> at 21 August 2009.

market, and at the same time consideration of how such derivatives may skew voting results, control rights, or the ability of investors to properly price shares and creditors can price credit risk.

4 *Aligning Governance Indicia to Recognise Restructured Economic Interest*

Indicia of good corporate governance reflect currents of thought in respect of governance, and they coexist with statutory standards such as fiduciary obligation and duty of care, a baseline standard that is given content by the courts in the context of specific transactions. For example, the Supreme Court of Canada in *Peoples Department Stores v Wise* held that 'best interests of the corporation' should not be read simply as the 'best interests of shareholders' and that from an economic perspective the best interests of the corporation means maximising the value of the corporation.[132] The Supreme Court held that various factors and various stakeholder groups may be relevant in determining what directors should consider in soundly managing with a view to the best interests of the corporation. 'Deference should be accorded to business decisions of directors taken in good faith and in the performance of the functions they were elected to perform by the shareholders'.[133] These insights continue to resonate, but they must recognise the changes in incentives and the externalities created by the derivatives market.

There is also need to grapple with the more fundamental notion that shareholders can vote as they choose and corporate law does not intervene to require disclosure of their reasons for voting a particular way when shareholders may have no economic interest or a negative economic interest in the firm. Any policy decisions that temper rights to vote must align with reasons for such nonintervention historically. Any introduction of new limits on shareholder activity, such as restricting shareholder voting where there is a negative economic interest, should only be adopted after a process of debate and thinking through the objectives, principles and outcome sought.

Perhaps corporate law needs to be amended to recognise a new form of business entity that is expressly categorised as having investors that have no remaining economic interest. That way, other investors and creditors would know, at the point of deciding to invest or lend, that the incentives in respect of governance may be skewed.

Another accountability option would be simply to prohibit the purchase of derivatives where the purchaser has no direct economic interest in the reference entity. Where there was a direct interest, the purchase of an equity swap or CDS could be limited only to the value of the investment in the firm. In essence, derivatives would operate as insurance rather than as a speculative market. These requirements would end the speculative market and return derivatives to their original risk management function. Moreover, to treat the derivatives markets as insurance could subject them to regulatory oversight similar to insurance,

132 *Peoples Department Stores v Wise* [2004] 3 SCR 461, [42].
133 *BCE Inc v 1976 Debentureholders* (2008) SCR 560.

imposing capital adequacy requirements on protection sellers to ensure that they can meet demands to settle, even where there are mass demands for settlement of the derivatives.

Finally, the accountability principle invites us to reconsider in whose interest the corporation is being operated. Shareholder primacy advocates have long rationalised their position based on the collective action problems and economic risks faced by shareholders. When economic interest is removed, shareholders fall into the same category as employees (those without outstanding credit claims for compensation) and community members, who have an interest in the corporation but not a direct economic claim. The derivative governance puzzle invites us to think about the broader social and economic responsibilities of the corporation and the impact of business failure on the lives of ordinary citizens. This issue engages both accountability of corporate directors and officers, but also fairness considerations in respect of governance of the business and its impact on stakeholders.

C Fairness

The third broad principle for governance reform is fairness. It is not fair that people who have legal control over the corporation have little or nothing at risk. When you add the opaque nature of the derivatives market, the unfairness is compounded, because people are investing without the necessary information. Any ensuing public policy discussion must address this issue. Reform of best corporate governance practices needs to account for new economic incentives created by equity and credit derivatives. Consideration should be given to restricting voting where economic interest and legal interest are disconnected during insolvency proceedings. There must be more monitoring of risk-generating behaviour, addressing agency and moral hazard issues. Fairness arguably engages notions of recognising the interests of multiple stakeholders that have an economic stake in the corporation's long term economic and social sustainability.

1 *The Need for Policy Choices*

One question in respect of fairness is whether there should be a prohibition on the voting of shares where there is no economic interest or limiting voting to particular thresholds above real economic interest. Before regulatory intervention, there needs to be a discussion of what the public policy objective sought is, what social goals it may be advancing, what harms are likely from no regulatory intervention and, if intervention is warranted, what is the outcome sought and whether any principles for conduct meet those objectives or more detailed is regulation required. Examples of policy questions to be addressed are: should any intervention being facilitative, such as allowing companies to change their constating documents to prohibit voting of shares where there is no economic interest; or is it fairer to stakeholders to impose the same standards across all companies?

Another question is how to create incentives for institutional shareholders to vote their shares rather than lend them to other parties. Is this question of good governance norms or the need to create protection for such shareholders from pressure to maximise short term return? Disclosure of voting practice may or may not be a sufficient policy tool such that such shareholders are likely to vote their economic interests, based on the fact that their principals would become more aware of their empty voting practices. Regulatory intervention could take the form of allowing parties to place restrictions in their constating documents in terms of lending shares or purchase of derivatives, or it could impose more broad based standards. Should good governance practice suggest that shareholders bargain the corporation's ability to unwind swaps or recall loaned shares for a particular vote, or bargain restrictions on how those votes can be voted in terms of the interests of their beneficiaries; or is this question one that may require a regulatory response? What policy options create fairness for those equity investors that do have a continuing economic interest in the corporation?

Scholars have argued that banks, broker-dealers and derivatives dealers should be restricted in their lending of shares to empty voters as such parties often have little or no economic ownership of the underlying shares and thus no interest in how their borrower votes, whereas investors that lend shares who have an economic interest may lend to those whose interest align or who may have fewer conflicts of interest.[134] Another option would be to have either a standard that imposes some obligation on the record holder to have the requisite number of shares on the record date so that it can give effect to instructions by the shareholders with an economic interest. Either of these options could enhance fairness in respect of all stakeholders.

2 *Development of New Norms of Fairness*

In respect of swaps or CfD, are there new norms that should be developed that respect the risk management aspects, but provide fairness such that there are social, moral or reputational pressures to vote the shares in the interests of the economic owners? Fairness suggests that shareholders that are fully hedged should disclose their lack of economic interest where they seek to exercise voting rights. Perhaps that lack of interest coupled with an interest with an economic competitor should result in removal of default control rights. Is this question a regulatory concern, or perhaps not of concern to the public interest aspect of corporate and securities law at all?

Finally, there needs to be a broader public policy discussion in respect of fairness in corporate governance and derivatives activity in respect of its overall impact on economic and social activities in various jurisdictions. The financial markets do not operate in isolation, and the recent economic distress of whole economies attests to the profound implications of governance failures on ordinary people. It would seem that scholars and policy makers could draw on much broader interdisciplinary notions of fairness to rethink how corporate governance can serve societal economic interests in a manner that allows directors and

134 Ibid 713.

officers to be responsive to these needs which at the same time continuing to meet their fiduciary and other obligations to the corporation.

VI CONCLUSION

Globally, we are not yet clear of the mess created by the recent shifts in financial markets. The past year has illustrated that financial markets and economic activity are integrally connected and that the speculative activities of derivatives counterparties has a significant negative impact on the lives of ordinary working people not engaged in that market because of the depth and breadth of derivatives exposure that can affect real economic activity. The incentives created by the widespread use of both credit derivatives and equity derivatives has removed or reduced some of the most important governance and accountability mechanisms that we have in place to ensure effective corporate governance.

Arguably, dancing the derivative *deux pas* did not allow time for corporate governance norms to develop to deal with the incentive effects associated with the separation of economic interest and legal ownership. Short-term profits generated by derivatives dealers tripping the light fantastic resulted in governance failures and serious negative impact on real economic activity. Now is the time for more careful reflection on the effects of structured financial products. There needs to be a fulsome public policy debate on the governance steps to retain and those that need to be redesigned to ensure long term economic and social sustainability. Now is the time to revise broadly accepted governance principles to account for a radically different make-up of economic interests at stake with the viability of corporations. Basic principles of transparency, fairness and accountability are the starting point, but these principles need to be developed to offer a clear, meaningful revision to corporate governance practices such that the objective of long-term and sustainable business entities are once again a realisable public policy objective.