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Conflicts of interest: How would one know?

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Over the last few weeks, we have covered various aspects of conflicts of interest: why it is important, how directors need to fully disclose any conflicts and act appropriately, and the differences between Interested Persons Transactions and Related Party Transactions.

The key challenge that directors and companies face before even making the necessary disclosures is this: how would they know that a conflict even exists in a particular situation? Answering this question requires not just an understanding of the situations in which a conflict can arise, but also having a process that identifies a conflict. These two elements may appear to be the same, but they are not.

When a conflict arises

The general test of a conflict of interest is whether the impartiality of a director can or is perceived to be undermined due to a potential clash between the director's and the company's respective self-interests. As this test can be quite subjective, directors are generally advised to avoid getting into such situations in the first place, and to make full disclosure to the board or shareholders even when there is a doubt that a conflict actually exists.

That said, the rules – specifically Section 156 of the Companies Act, Chapter 9 of the Listing Rules, and Singapore Financial Report Standards 24 - do spell out certain situations where a conflict of interest is deemed to have occurred and how they should be addressed.

For example, the Listing Rules identify the kind of transactions that must be announced and approved by shareholders, and which transactions are specifically included (for example, provision or receipt of financial assistance or services that exceeds certain threshold), or excluded (for example, open market transactions of marketable securities).

More challenging is Chapter 9's definition of "interested persons": a director, the CEO, a 15 per cent shareholder (deemed to be a "controlling shareholder") or a person who, in fact, exercises control over an issuer and their associates. "Associates" are broadly defined to be:

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- The interested person's immediate family (i.e. spouse, child, adopted child, step-child, sibling or parent), or
- The trustees of any trust of which the person or his immediately family is a beneficiary or, in the case of a discretionary trust, is a discretionary object, or
- Any company in which the interested person and his immediate family together (directly or indirectly) have an interest of 30 per cent or more.

This definition of associates can be problematic for directors. How would a director know that his sibling, or even spouse for that matter, is transacting with the company? How does one maintain the privacy and confidentiality of trusts and investment vehicles?

Identifying conflicts

A sound process for identifying conflicts of interest is important for ensuring that the necessary disclosures are made. Such a process should distinguish between the duties of the individual director and the company.

Given the importance and complexity of the subject, different practices have evolved.

One common practice is for directors, the CEO and controlling shareholders to declare upfront in writing to the company all their "associates" and other potential interested persons. This declaration is refreshed annually and updated when interested persons change. It can also serve to satisfy the requirements of Section 156(5) for a general notice to the board of the director's possible interest in a future transaction with the company.

This declaration puts the onus on the company to have a sound internal system to track all potential transactions against this list of interested persons. Where there might be a conflict of interest, the company secretary refers the matter to the audit committee and the board for review for discussion and approval.

When a specific transaction comes before the board or a committee, the conflicted director must comply fully with the company's conflict of interest procedures. The latter usually require him to formally disclose the conflict, to recuse himself from all discussions, and to not vote on the transaction.

Even if the company fails to identify a conflict of interest, a director who is, or should reasonably be, aware that he is conflicted in a matter, should make the necessary disclosures and act accordingly.

Privacy concerns

Of course, a director may wish to protect the privacy and confidentiality of his personal or family investments and finances whether in Singapore or overseas. However, if he does not make a full disclosure or provide a full list of associates to the company, he makes it difficult for the company to comply with Chapter 9.

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Ultimately, companies should develop clear and appropriate conflict of interest rules and policies that address the privacy concerns of its directors and ensure that no Interested Persons or Related Party Transactions slip through the net.

It is for this reason that some companies require directors, CEO and controlling shareholders to make an annual declaration to the effect that "to the best of my knowledge, I am not aware of any transaction between the company and me and/or my associates that has not been declared to the company". This may mitigate the company's failure to identify any transactions with the declared interested persons. It also effectively places the onus on the director to be forthcoming.

Notwithstanding all the policies and processes that are in place, a director still needs to have the integrity, care and diligence to identify and declare his conflicts of interest. In the event of any breach, the extent of his culpability will depend on the precautionary measures he has taken to avoid it.

The writer is the treasurer of the Singapore Institute of Directors. This article first appeared in BTInvest, <http://www.btinvest.com.sg/specials/boardroom/conflicts-of-interest-how-would-one-know/>