Australian Government

Corporations and Markets Advisory Committee

ASPECTS OF MARKET INTEGRITY

Collated Submissions

June 2009

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About this document

All submissions received on the issues paper *Aspects of market integrity* (February 2009) have been published on the CAMAC website (www.camac.gov.au) under **Submissions**.

The first chapter of this paper collates the general comments of respondents.

Chapters 2 to 5 of this paper collate views on each of the matters that the Committee was asked to review. At the beginning of each chapter, there is a reference to the sections of the report where the submissions are summarised.

List of respondents

Accounting Bodies (The Institute of Chartered Accountants in Australia, the National Institute of Accountants and CPA Australia Ltd)

Michael Adams & Marina Nehme, University of Western Sydney

Allens Arthur Robinson

Janet Austin, Lecturer, Business Law and Taxation, Australian School of Business, University of NSW

Australasian Investor Relations Association (AIRA)

Australian Bankers' Association Inc. (ABA)

Australian Employee Ownership Association

Australian Financial Markets Association (AFMA)

Australian Institute of Company Directors (AICD)

Australian Securities and Investments Commission (ASIC)

Australian Securities Exchange (ASX)

Australian Shareholders' Association (ASA)

Jim Berry

Business Council of Australia (BCA)

Chartered Secretaries Australia (CSA)

David Morrison

Financial Services Institute of Australasia (Finsia)

Jason Harris, University of Technology, Sydney

HopgoodGanim Lawyers

Investment & Financial Services Association (IFSA)

Law Council of Australia, Corporations Committee of the Business Law Section

Michael Legg & Alex Steel, University of New South Wales

Juliette Overland, University of Sydney

Regnan

RiskMetrics Australia

Securities & Derivatives Industry Association (SDIA)

1 General comments

Law Council of Australia

Support for Ministerial reference to CAMAC

The [Corporations Committee of the Business Law Section of the Law Council of Australia] (the Committee) commends the Minister for Superannuation and Corporate Law, the Hon. Senator Nick Sherry's decision to refer these issues to CAMAC for review. The Committee believes it is highly desirable that the market be given an opportunity to comment on proposals to change corporate law before the Government determines whether there should be any regulatory or legislative change. By means of referrals of this kind, decisions about regulatory and legislative change can be made on mature reflection, taking into account all implications, and the Committee considers that this will lead to better laws, avoiding errors which are made when decisions are taken in the heat of a current issue. The Committee hopes that this example will continue to be followed.

Caution concerning comparative law examples

The Committee notes that a term of the Minister's reference was to take account of the way in which some of these issues are being handled overseas. The Committee acknowledges that comparative analysis is often helpful for the purposes of identifying issues for discussion. However, the Committee cautions that any decision to 'cherry pick' from other regimes should be taken only after taking full account of differences between the totality of the regime from which they are taken and Australia's corporate law system. Some elements of foreign regimes make sense in the context of the whole regime, and they can have unintended consequences when grafted onto another system. Further, the Committee considers that the Australian corporate laws referred to in the paper are, for the most part, effective in combating wrongdoing and generally operate well. Central to these are the continuous disclosure regime and the role played by the ASX Corporate Governance Council, both of which are peculiar to the Australian system and assist Australia to address appropriately issues which other countries have addressed in other ways.

Need for review of market manipulation laws

The Committee advocates a review of Part 7.10 Division 2 (the market manipulation provisions)of the Corporations Act. Many of the issues addressed in the discussion paper and others (for example concerns around short selling) which have arisen in recent years are symptoms rather than causes. The underlying issue is the difficulty of enforcement of our market manipulation laws and the fact that they have failed to keep pace with developments in the marketplace since many of them were introduced (many after the market failures of the 1970s). Appropriate changes to this regime would better place ASIC to combat not only issues relating to the spreading of false or misleading information through rumourtrage but a range of other issues which have had currency in recent times.

Summary of the Committee's position on issues addressed in the reference

The Committee does not believe it is necessary to amend the existing laws regarding margin lending, trading in blackout periods or corporate briefings to analysts.

The Committee would support the ASX Corporate Governance Council reviewing whether there is greater scope for guidance on trading during black out periods.

The Committee supports the extension of the civil penalty regime in Part 9.4B of the Corporations Act to sections 1041E to 1041G.

It is the Committee's view that the Australian corporate regulatory regime has proved robust in recent market turbulence. The Committee therefore advocates changes only in those areas of the law that are ineffective and poorly drafted to suit their purpose: there is a pressing need for review of Division 2 of Part 7.10 of the Corporations Act.

AIRA

AIRA members believe in a fair market for their company's securities, and would support appropriate action to drive deliberate rumour mongering from the market.

With its members in the front line of dealing – day to day – with analysts and investors, AIRA appreciates the difficulties of balancing a proper understanding of companies' prospects among analysts and investors, with the need for simultaneous disclosure.

In both areas, AIRA believes that each situation of rumours and analyst contacts is different. Consequently no 'one size fits all' rules can be developed. AIRA has therefore developed best practice guidelines, based on many years of day to day experience, to assist in this process, and would encourage CAMAC to recognise these guidelines as industry best practice.

Business Council of Australia

The BCA commends the government for referring the issues of market integrity to CAMAC for review. The BCA considers that regulatory intervention in markets should only occur where there is a clearly identifiable problem to be addressed and the costs of the regulation do not outweigh the benefits to the community and business. Accordingly, the BCA is supportive of a public consultation process that enables consideration of the issues and appropriate responses.

The aim of the discussion paper is to focus on aspects of market integrity including margin loans, rumourtrage and analyst briefings. This submission addresses those three elements of the inquiry in turn below.

The BCA considers that in general, the Australian corporate governance environment is already effectively regulated, through a number of mechanisms such as corporations laws, ASX Listing Rules and ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (ASX Governance Principles). Whilst the BCA recognises that there may be market problems in some areas such as rumourtrage, it is important to ensure that any response to these concerns is effective in addressing them and does not impose administrative or regulatory costs which are disproportionate to the problem be addressed. Inefficient and costly regulation affects all Australians through higher costs and is a major barrier to our continued economic growth and prosperity.

The Australian corporate governance regime is unique. For example, a flexible 'if not, why not' system operates in conjunction with regulation. This system has positioned Australia comparatively well, providing an efficient and flexible regime for company operations. CAMAC has stated that it will *'continue to review relevant law and practice in overseas jurisdictions and welcomes any information that respondents* *may wish to provide.'* Whilst it may be useful to seek comparisons from overseas, they must be considered in the context of their applicability to the Australian environment, an environment which has proven to be robust in comparison to many competitors.

Conclusion

In general, the BCA does not support additional regulatory burdens or requirements being imposed on market participants in the areas of the market integrity inquiry discussed above, particularly if a sufficient problem has not been evidenced. In addition, any intervention in markets must be proportionate to the problem and avoid unintended consequences. Additional guidance in the areas indicated above should be considered as an alternative to regulatory intervention.

ABA

The ABA commends the Federal Government for examining these issues and resisting the urge to take legislative or regulatory action without having a thorough understanding of the complexity of these issues, particularly in the context of the global financial crisis. Rushed decisions can often result in errors or unintended consequences.

Maintaining the integrity of our markets is paramount to ensuring efficiency and preserving confidence of investors. It is important for Australia to maintain a strong and effective regulatory and corporate governance framework for Australia's listed companies, reporting entities, market participants and the business community to ensure investor, shareholder and stakeholder confidence. It is our view that Australia's regulatory and corporate governance framework has proven to be robust in the recent difficult economic and market conditions.

Transparency and accountability is critical to market integrity. Market participants, investors or others that deliberately spread false information to negatively affect a share price should not be tolerated and should be prosecuted. Therefore, we support measures that go to improving transparency and accountability and addressing actual and perceived practices and behaviours that may undermine the integrity of the market.

The ABA believes:

1. It is unnecessary to amend the existing laws regarding margin lending to directors, 'blackout' trading by directors or corporate briefings to analysts. However, we support a review of the law to ascertain whether it is appropriate to apply civil penalties to contraventions of the market manipulation provisions.
2. The ASX Corporate Governance Council should review its *Corporate Governance Principles and Recommendations* with a view to: (1) providing additional guidance specifically on margin lending to directors and 'blackout' trading by directors; and (2) ascertaining whether further guidance on corporate briefings to analysts is required to supplement existing guidance by ASIC and the ASX. However, it is important to ensure that any changes balance enhancing disclosure practices and information for investors with minimising regulatory burden and compliance costs for companies. It is vital that Australia's market remains efficient and orderly and the cost of raising capital remains competitive.

Adams and Nehme

The observations of Adams and Nehme can be summarised in the following manner:

- In relation to margin loans to directors, we support a self regulatory model;
- The ASX Corporate Governance Council should provide further guidance to companies about their approach to blackout trading;
- Rumour-mongering is a destructive force within the securities markets akin to market manipulation; and
- Public and private briefings are of great importance to ensure the integrity of the market.

The global financial crisis has caused many securities markets and capital markets to review the concept of *market integrity*. This Issues Paper (February 2009) reflects some of the current issues of debate on a global basis and we have tried to express the need for tighter regulation but on an efficient and effective basis. The lessons learnt from the rush of legislation post-Enron/WorldCom collapses (such as SOX legislation) that a huge cost burden being imposed on corporations for very little measurable public benefit. Our comments focus on a self-regulatory scheme, but all attempts to prevent market manipulation are worthy of a detailed examination to maintain the Australian securities markets integrity.

Jim Berry

The Reference to CAMAC by the Minister includes:

- 'the lack of transparency and accountability surrounding some of these practices'…
- 'that Australia's system of corporate law and regulations is sufficiently robust to provide investors with confidence that they are able to make fully informed decisions'.

Transparency is most important as investors should be able to view and have access to the information necessary to make effective decisions. A high level of transparency will aid in providing investors with confidence in the information which is provided to the market.

Set out in this submission are a set of simple provisions which will increase transparency and therefore would improve investor confidence.

IFSA

IFSA strongly believes that it is important that any legislative framework and requirements remain principles based. The requirement for all IFSA members to conform to rigorous industry standards and guidance will support the use of principle based legislation by Government, and will promote market confidence and adherence to the principles of the legislation.

As major shareholders, IFSA members are in a position to promote improved company performance that provides positive benefits to all shareholders and the economy as a whole. While shareholders are not involved in the day to day management of companies, the Corporations Act, ASX Listing Rules and industry best practice provide many opportunities for shareholders to monitor and influence company decision making which drives ultimate company performance.

Originally published in 1995 and further revised on five occasions, IFSA's Guidance Note No. 2 'Corporate Governance: A Guide for Fund Managers and Corporations' (hereafter 'Blue Book') assists IFSA members to promote improved company performance by ensuring Australian companies have sound corporate governance structures.

These Guidelines were first developed by fund managers to address some of the corporate excesses during the 1980s and early 1990s. While IFSA's Guidance Notes are not mandatory for members, the Blue Book has become widely accepted by the investment and corporate community as providing best practice guidance for Corporate Governance.

A copy of IFSA's current Blue Book is available at:

http://www.ifsa.com.au/documents/IFSA%20Guidance%20Note%20No%202.pdf

I note that the current edit of the Blue Book is currently under review and an updated 2009 version will be released shortly.

Australia continues to be well regarded in the region for the strength of its regulatory regime and market integrity. Sound corporate governance practices increase investor confidence in the integrity and efficiency of the Australian capital market, and in turn enhance the competitiveness of Australia as a leading financial centre and support the Australian economy more generally.

Consistent with the ASX Corporate Governance Council we believe that before any change to the law or further guidance is provided, the proposals proposed should be carefully considered against the following factors:

- Is there clear evidence of a continuing market failure; and
- If so, what measures are appropriate to address the market failure without unintended consequences or market distortions.

Australia has a diversified and sophisticated capital market. Companies should have the flexibility to develop governance and operating polices (supported by principles stipulated in various statutes, ASX rules and IFSA Guidance) that are consistent with their particular circumstances.

The industry and investors will benefit from a market that has an internationally competitive governance framework and principles based regulatory framework.

Accounting Bodies

On the premise that market integrity embraces the characteristics of efficiency, transparency and stability, this can be achieved by a number of means ranging from the highly mandated through to relatively unfettered reliance on the good conduct of participants. The Accounting Bodies are of the view that, by-and-large, Australia's securities market and its underpinnings in corporate law and market operation rules provides a high level of confidence for participants and the wider community.

Amongst the matters canvassed in the Issues Papers there are a limited number of problems warranting reforms either by minor incremental statutory amendment or development of guidance within the framework of the ASX Corporate Governance Principles and Recommendations.

We have focused in particular on the issues of margin lending to directors as this has been the major issue of contention outlined in the Minister's reference. Moreover, margin lending amongst the four issues considered is the one most suitably addressed through legislative reform. The Accounting Bodies recommend that s 205G be amended to require directors to disclose margin loans which correspond with notifiable shareholdings. It is also suggested that the updating notice period be aligned with the company requirement under Listing Rule 3.19A.

The other elements considered in the Issues Paper, we believe, are best addressed though non-statutory policy development and understanding of the adequacy of existing statutory rules.

David Morrison

(1) There are many factors that impact upon the integrity of the financial marketplace. It is a shame that this is not an issue that is addressed as a matter of course on a regular basis, rather than one that becomes pressing because of a particular unintended effect of the market, namely the Global Financial Crisis (GFC) and its expected impact upon ordinary investors and retired superannuants

(2) My submission is primarily interested in the disclosure aspects that the Issues Paper raises; principally the idea that disclosure is required for a modicum of market efficiency

(3) Market efficiency per se is not something that can be achieved by regulation. Corporate regulation of a market, by definition, reduces efficiency. This is an economic reality, yet there lies a tension between ideal economic policy, and political risk associated with the presumptions around inadequacy of regulation

(4) Attempts to marry the ideals of economics and the perceived need for complex corporate regulation have been made via the Corporate Law Economic Reform Program (CLERP)

(5) The object of CLERP 'is to ensure that business regulation is consistent with promoting a strong and vibrant economy… to promote business and market activity leading to important economic outcomes including increased employment, by enhancing market efficiency and integrity and investor confidence… [within] a clear and consistent framework'

(6) The summary statement of principle for the (CLERP) highlights the deficiency in approach by seeking to achieve, via regulation, inconsistent goals:

'The focus of the reform agenda is to ensure that business regulation facilitates economic activity and job creation. The key principles underlying this review are as follows: market freedom… investor protection… information transparency… cost effectiveness… regulatory neutrality and flexibility… business ethics and compliance'

(7) Whilst the CLERP ideals are noble, one is stretched to opine that they have in fact been achieved, since by definition one cannot simultaneously have for example investor protection and market freedom, there must be a compromise

(8) Compromise by its very nature suggests a lack of perfection – given the strong political imperative for investor protection however vague that concept is in practice, the best means for ensuring protection, if it must be sought, is to insist on disclosure of all relevant information that might impact on an investor's decision to invest and the disclosure of all relevant information that might impact on an investor's ongoing decision to remain invested – this seems to be a reasonable compromise

(9) It is not recommended that the specifics of what is to be disclosed be outlined – such an effort will only encourage ways around disclosure – instead a reasonableness/objective test is suggested whereby a suitable arbiter determines whether or not the relevant information ought to have been disclosed (see (20)-(23) below)

(10) Research around the regulation of corporate fundraising (CLERP) (iii) suggests that 'changes in litigation risk affect the level but not the quality of disclosure… also suggest that the reforms' objectives of reducing fundraising costs while improving investor protection, have been achieved'

(11) What appears absolutely necessary is an increase in the amount of empirical research around changes to corporate regulation whereby variables such as 'disclosure' and 'investor protection' are defined, modelled and tested in at least an attempt to understand whether previous changes to the law have been effective. This might then go some way to determining the direction of future change

(12) Since the Australian regime has experienced difficulty in properly understanding, other than by way of opinion, anecdotal evidence and interest group lobbying behaviour, the precise ambit of an effective economic approach to regulation, it seems very dangerous to make comparative comparisons with other jurisdictions for answers to the disclosure issue that this submission seeks to address – it is essential that the Australian system is objectively understood and where possible empirically verified before comparisons are made with other jurisdictions – at this stage, it is submitted that such comparison would hinder the inquiry

(13) On this basis then, it is difficult to imagine, in the absence of a breach of duty or potential conflict, why directors ought not to be able to purchase shares in the company of which they serve and following on from that – why it is necessary to limit the means by which directors finance the acquisition of those shares. Indeed it appears to be an anomaly to only limit the means by which directors finance a margin loan or margin call as distinct from a company loan for another purpose

(14) Any attempt to somehow limit the manner that a director makes a personal investment decision is difficult to understand – surely, given the widely accepted agency problem, the stronger the separation of ownership and control of the organisation is, the greater the need for effective stewardship – whilst there is an abundance of literature and opinion as to the most effective means of ensuring that directors act in the best interests of the company of which they are stewards, director compliance with shareholder preference, is to place no obstacles in the path of a director having a significant portion of their personal wealth invested in the company that they serve

(15) So long as director interests are disclosed to the public in full, there can be no harm in directors having a holding of company shares, acquiring shares or disposing of shares – full disclosure would be a very effective means of understanding the extent of alignment of shareholders' interests with those of the company's directors and would also assist the regulator in understanding and more properly determining whether a breach of the law has occurred

(16) The risk that may arise, if disclosure is ultimately required, is that directors will utilise more private arrangements (for example acquisition by a trust or superannuation fund) to make acquisition of company securities – nonetheless this

might be easily required by regulation (to include related third parties) but be equally difficult to enforce

(17) It is therefore desirable for directors of publicly listed companies to properly disclose the extent that they are exposed to the fortunes of the companies they serve. This might also contemplate the inclusion of contracts, arrangements or understandings that benefit a director where the director has control (in a direct or indirect (related party) sense. It is difficult to imagine that the requirement of disclosure would result in an exodus of director talent from the market place and therefore, in the absence of empirical testing/understanding, ought to be trialled – section 205G ought therefore to be amended to a wider position that includes margin trading activity as contemplated by the Issues Paper and any other relevant behaviour that affects investors – in short, there are a range of reasons why share prices move (and how investor confidence is shaken) and opportunistic behaviour by directors and/or shareholders will not be halted by a particular regulation (or prohibition) around margin lending

(18) Where regulations are effectively implemented to ensure that full disclosure is made, the market mechanism, together with a properly resourced regulator, will ensure that director behaviour is monitored and understood more fully by the marketplace. It therefore follows that there is no need for 'blackout' trading by directors – note the proviso that the regulation is sufficiently funded to ensure that it is effective. It might also be worth considering the Australian Stock Exchange (ASX) Listing Rules in this context (particularly the continuous disclosure requirement of 3.1 that requires 'timely disclosure' of information impacting upon 'security values… investment decisions, and information in which security holders, investors and ASX have a legitimate interest')

(19) There is one other aspect that might be worth noting, namely the matter of individual shareholder responsibility – in the current state of the GFC there is a large amount of discourse on the responsibilities of directors and of government in ensuring that investor funds are safe. One of the risks of over-regulating, is the natural tendency of the person protected to seek greater protection or to relax their own need for due inquiry

(20) It seems apparent that where disclosure is required and is adequate, the tendency to induce reliance by investors becomes less of a problem thereby diminishing the need to protect an investor in a particular set of circumstances. This seems to be important since the likely circumstances for difficulties to arise are not often predicted with any degree of certainty thus resulting in ex post regulation that has much less impact.

(21) At some point it seems that the tide of complex regulation must slow down and, where that is seen to be desirable, reversed. It is therefore an important step to see disclosure as a means to that end – namely that adequate disclosure precludes the need for more comprehensive regulation around particular behaviour

(22) The regulation of particular behaviour usually occurs after a problem has arisen – it is therefore ad hoc in nature and does not necessarily contemplate (due to design, omission or sheer impossibility for complexity reasons) unintended outcomes/complications with the existing law. It seems that a move away from particular provisions might be more useful and importantly more generically applicable – that is a move to a more 'fuzzy' stance on important issues such as

disclosure, might enhance the position for investors and regulators and ultimately companies.

(23) A 'fuzzy' approach might also allow for codes of conduct to be taken more seriously since they more naturally fit within an atmosphere of voluntary compliance with general rules than a mandatory regulatory setting specifying particular rules

(24) It might be that investors en masse determine that they do not like one particular aspect of director behaviour that becomes disclosed in the course of events by more than one company – this might result in less interest from an investor point of view – the result might be changes to the affected company's constitutions (for example requiring disclosure by directors of margin loan arrangements or changes thereto) or the behaviour of the company directors – both of these possibilities of course occur in the absence of corporate regulation and are driven by investor demand.

2 Margin lending to directors

The submissions in this chapter are summarised in Sections 2.4.3, 2.5.3, 2.6.3, 2.7.2-2.7.4 and 2.8.1-2.8.2 of the report.

Australian Securities and Investments Commission

(1) The implications for market integrity of margin loans to directors

Margin lending has provided a valuable source of funds to support corporate growth, especially for smaller companies and those in 'rapid expansion' mode who are heavily reliant on funding from promoters. As noted in Senator Sherry's letter of reference to CAMAC, margin lending also facilitates investors' access to finance and, in particular, the acquisition by directors and senior executives of significant shareholdings in their company. These shareholdings may in turn serve to align the interests of directors and senior executives (i.e. 'officers' and 'senior managers', as defined in the *Corporations Act 2001*) and their companies.

However, directors' and, to a lesser extent, senior executives' margin loan arrangements may adversely impact market integrity by creating conflicts of interest, and this potentially reduces market confidence in their companies and the market generally.

Entry into margin loans can create conflicts of interest. The director or senior executive has a personal interest in maintaining the security price at a certain level to avoid a margin loan call and that may drive short term corporate decisions, or a reluctance to disclose some material information to the market (e.g. details of margin loan arrangements or information that may depress the price of the company's securities). These types of conflicts become more of an issue when share prices are going down and personal finances are under pressure.

In certain circumstances, confidence in a company and in market integrity can be severely affected if the company's directors or senior executives have entered into margin loan arrangements. The reasons for this include:

- The company's securities may be heavily sold in the market as a result of margin calls on directors and senior executives. In a falling market the momentum for sales becomes self-perpetuating. This was evident in the Australian market early in 2008. Shareholders perceive that the problem lies with directors' or senior executives' conduct rather than with corporate problems.
- A widespread perception that directors' and senior executives' real interests are not fully disclosed can have an adverse impact on market integrity. Shareholders should know when a price fall relates to a margin call and determine if the price fall is simply due to short-term trading turbulence. Shareholders should also know about their directors' equity position and dealings, as that may itself reflect value and confidence in a company. Currently this information is sometimes not being fully disclosed to the market.
- There is also a question about market integrity where directors or senior executives can, or are required to, sell under a margin call even when they have confidential price sensitive information.

(2) Should there be specific regulation of the process of entering into margin loans by directors?

ASIC does not consider legislative bans or large scale restrictions on the ability of directors or senior executives to enter into margin loans are warranted at this time. Margin lending is a bona fide method of funding investments in companies and can be used to support corporate growth.

However, this is not to say that the practice should not be restricted in any way. As a matter of best practice some restrictions should be imposed on margin lending to deal with the conflicts of interest and other impacts on market integrity referred to above. As set out below [under **Disclosure by directors to the company**], ASIC also believes there should be mandatory disclosure of margin loan arrangements by directors to the board at the time of entry into those arrangements.

ASIC thinks that the appropriate restrictions on directors' and senior executives' margin loans depend on the circumstances of the individual company and the nature of the margin loan (e.g. what is appropriate for a larger company will likely not be appropriate for a smaller company; e.g. a loan over less than 1% of the company's shares will have less potential to damage a company than a loan over a 5% interest). The company's board is in the best position to assess the company's circumstances and the nature of the loan and set the appropriate conditions.

ASIC considers that it is very important for boards of listed companies to have clear policies on the circumstances where directors' and senior executives' margin loan arrangements are permitted—including restrictions on loan terms such as LVR exposure, and total equity that may be exposed per individual and amongst all senior executives collectively. Policies on when the company will make disclosure to the market of the existence of loans (and in certain cases loan terms or trigger events) should also be required.

ASIC considers that as a matter of best practice, directors and senior executives should disclose proposed margin loan arrangements to the board before they enter into them and agree not to enter into the loan unless the board approves their entry into the loan.

In deciding whether to approve a margin loan the board should consider issues such as:

- whether the nature of the proposed loan is such that it might lead to concentrated selling of the company's securities in the event of a market downturn (if a margin loan call is made) and whether the board is prepared to accept the risk that this may impact on the market's confidence in the company; and
- whether the loan may, in future situations, require disclosure to the market of material information about the loan under Listing Rule 3.1 and how this disclosure will affect the company.

As a matter of best practice, directors and senior executives should also be required to obtain board approval of any material changes to existing margin loan arrangements and to notify the board of any significant developments under their margin loan arrangements (e.g. if a margin call has been made and the director's or senior executive's proposed response to the margin call).

The board's policies in relation to margin loans (e.g. about when they will approve margin loans and when they will disclose them) should be transparent. They should be made readily available to investors by posting on the company's website with other corporate governance policies.

ASIC considers that the ASX Corporate Governance Council should develop principles and recommendations to guide listed entities on these policies. This approach would ensure listed entities adopt appropriate policies on directors and senior executives' margin loans or disclose why they have chosen not to do so. ASIC would be happy to assist the ASX Corporate Governance Council.

If the ASX Corporate Governance Council does not develop these principles and recommendations, consideration should be given to law reform that would at a minimum require pre-approval by the board of entry into a margin loan.

Disclosure by directors to the company

(3) Should there be requirements for directors to disclose to the board that they have entered into margin loans?

ASIC calls for law reform to require directors to disclose to the board that they have entered into a margin loan, and relevant details of the margin loan (e.g. key terms of the arrangements, including the number of securities involved, the trigger points, the right of the lender to sell unilaterally and any other material details). Directors should also be required to disclose changes to their margin loan arrangements. This will enable the board to be in a position to give disclosure to the market where material.

Early last year, it was said in the market that a number of companies were sold short in the belief that directors or substantial shareholders had significant margin loan exposures. On 29 February 2008, ASIC and ASX issued a media release (MR 08-37 'Disclosure guidance for listed entities') highlighting the need for disclosure of all material price sensitive information known to a company to the market and ASIC's expectation that all directors would have disclosed margin loan information to the board under s 191 of the Corporations Act.

However, there is a view that disclosure of directors' margin loan arrangements is not required under s 191 because the loan does not relate to the affairs of the company and/or because the loan is not material. ASIC does not agree with this interpretation of s 191, but considers law reform is necessary to put the issue beyond doubt. It is in the interests of directors, companies and the market generally that the scope of s 191 is clarified in this way.

It is important that the board have relevant information about directors' margin loans so that they are aware of conflicts of interests and can act appropriately in light of this knowledge. Disclosure of margin loans under s 191 will enable the board to take this information about margin loans into account when deciding whether information has to be disclosed to the market and, therefore, contributes to a fully informed market.

In this context ASIC notes that it has also been argued that a company does not have information about a margin loan that it may be obliged to disclose under Listing Rule 3.1 because directors only know about their margin loans in their personal capacity rather than due to performance of their duties as an officer and that knowledge does not flow to the company except by specific advice. Amending s 191 to make it clear that margin loans must be disclosed to the board would ensure that this argument is not available and will lead to a better informed market.

In light of the above, ASIC supports an amendment to s 191 to clarify that directors must disclose to the board if they have entered into a margin loan and provide relevant details of the margin loan. It should also be clarified that directors and officers must disclose to the board if there are changes to their margin loan arrangements.

Adopting the same reasoning, s 191 should also be amended to make clear that directors must disclose all their interests in securities of the company, including economic interests such as CFDs, options and other derivative instruments, of whatever amount.

Section 191 deals with directors' interests, not interests of other senior executives. As stated above [under **(2) Should there be specific regulation of the process of entering into margin loans by directors?**], ASIC believes corporate best practice would be for companies to require all senior executives to make the same disclosures, under their contract terms.

Disclosure to the market

(4) Should there be specific requirements for directors to disclose to the market that they have entered into margin loans?

Listing Rule 3.1 is the principal mechanism for ensuring that the market is informed about price sensitive information. The continuous disclosure obligation under Listing Rule 3.1 extends to material information about margin loans which the company is aware of.

On the basis that the law reform requiring disclosure to the board under s 191 is effected and best practice guidelines about entry into margin loans are developed, ASIC supports leaving market disclosure to a company as a result of the application of Listing Rule 3.1. That is, provided that companies are aware of the details of margin loan arrangements, ASIC thinks it is appropriate for the decision about what needs to be disclosed to be left to companies. This is because it is difficult to be prescriptive about the level of information that the market requires about margin loan arrangements – this will vary according to the circumstances of the company and the details of the particular margin loan. ASIC considers that, as for continuous disclosure generally, companies are best placed to determine what must be disclosed under Listing Rule 3.1 in relation to margin loans.

As stated above (see [under **(2) Should there be specific regulation of the process of entering into margin loans by directors?**]) as a matter of best practice, the company's policy on when and what it will disclose should be clearly stated and available on the company's website.

Finally, ASIC notes that the extent to which s 205G requires disclosure of margin loan arrangements by the director to the market is debateable. In part it will turn on the nature of the security interest held by the lender. ASIC does not press for specific amendment to s 205G to require disclosure of margin loan arrangements to the market, as long as the above proposals, and those that follow below, are implemented. (We comment further on s 205G in [the second paragraph under **Generic approach to disclosure**] below.)

(5) Should directors be required to disclose to the market (or to the company, which would then disclose to the market) particular events that have occurred since entry into the margin loan?

As stated above ([under **(3) Should there be requirements for directors to disclose to the board that they have entered into margin loans?**]), ASIC thinks that the director should be required to disclose full details of the margin loan to the board, and major developments or amendments. The board should then decide what events should be disclosed to the market in order to comply with the continuous disclosure obligation in Listing Rule 3.1 (see [the first two paragraphs under **(4) Should there be specific requirements for directors to disclose to the market that they have entered into margin loans?**]). What should be disclosed to the market will vary depending on the circumstances of the company and the relevant loan.

(6) Should the market disclosure requirements apply to all directors or only to those directors who are also substantial shareholders?

ASIC thinks the relevant principles apply to all directors. As stated above (in (see [the first two paragraphs under **(4) Should there be specific requirements for directors to disclose to the market that they have entered into margin loans?**])) what is disclosed to the market under Listing Rule 3.1 will vary depending on the individual circumstances of the company and the relevant loan. These circumstances could include the size of the directors' shareholding.

Generic approach to disclosure

(7) Should directors be generally obliged to disclose to the company their interests or arrangements regarding their shareholding, or other equity-linked interest in the company, including financing agreements?

The potential conflicts associated with margin loans over securities could also arise in connection other equity-linked interests in the company. ASIC is of the view that the proposals regarding entry and disclosure of directors' interests (i.e. the best practice guidelines and the proposed amendments to s 191 discussed [above under **(2) Should there be specific regulation of the process of entering into margin loans by directors?** and **(3) Should there be requirements for directors to disclose to the board that they have entered into margin loans?**] should extend to:

- the acquisition by directors and senior executives of any interests or securities the return on which is linked to the performance of the company and includes securities that are hedged into the quoted securities market ('economic interests in securities').

In our view, s 205G should also be extended to require disclosure by directors to the market of economic interests in securities that do not give rise to a relevant interest (e.g. cash settled equity derivatives). ASIC considers that this would support the principle that the market should be informed if a director of a company has entered into a transaction relating to the company's shares or the value of those shares.

(8) Should a company be required to disclose to the market all information concerning those interests/arrangements of directors that investors would reasonably require?

Listing Rule 3.1 requires companies to disclose market sensitive information about the types of interests and arrangements of directors that are discussed in [the first paragraph under **Generic approach to disclosure**] above and of which the company is aware. Provided that disclosure of these interests and arrangements to the board is supported by the amendments to s 191 and the best practice guidelines discussed above, ASIC thinks that Listing Rule 3.1 should be the primary mechanism for disclosing such information into the market.

ASIC also notes that the suggested amendment to the scope of s 205G to cover all economic interests in securities would promote disclosure to the market of these type of interests.

Additional Issues—Section 1

ASIC also believes that law reform is needed to remove some inconsistencies in the application of the insider trading and substantial holding disclosure laws to margin loans.

Insider trading

Regulation 9.12.01(e) exempts the 'sale of financial products under a mortgage or charge of the financial products' from the insider trading provisions (s 1043A(1)). This provides insider trading protection to borrowers and lenders.

This exemption from insider trading can result in inequity when a director's or senior executive's securities are sold in a falling market. The director or senior executive can realise a better price than other shareholder sellers by exiting at the (then) top of the market and so obtain a financial benefit. A person with inside information may not relay that information to a lender, but could acquiesce to a margin call without posting additional security with little risk of breaching the insider trading rules. ASIC would not ordinarily expect to rely on silence alone to constitute a claim for procuring a sale in breach of these rules.

It has become market practice for company financiers to also provide significant margin loan facilities to directors and senior executives of the company. As company financiers, the lender will commonly have price sensitive information in moments of financial stress. ASIC's view is that no person with inside information about a security should be able to deal in that security. It is unfair that a financier who is in possession of inside information is able to take advantage of that information by selling securities to a person who is not aware of that information.

For this reason, ASIC recommends law reform to ensure that borrowers and lenders are subject to the insider trading provisions, by removing this regulation. Lenders should be able to manage facilities despite holding inside information by the use of appropriate information barriers. This amendment may prompt lenders to restrict their willingness to provide margin loans, but more importantly it will remove an unfair advantage that they may have over other creditors or persons dealing in the securities. This amendment will increase the level of confidence in market integrity.

Substantial holding disclosure

Most margin lenders under standard loan arrangements are not subject to the substantial holding disclosure requirements in s 671B. There is presently an exemption from these requirements for lenders whose interest in securities arises solely because of a mortgage, charge or security taken by them in the ordinary course of their business (s 609(1)). ASIC believes that consideration should be given to removing this exemption for any lenders who have an absolute power to sell securities on the occurrence of a market event, such as margin lenders. The substantial shareholding provisions are designed to establish the controllers of shares (including those who can control their disposal), and the interest of a margin lender is no different than any other person's interest in that respect, and is distinguishable from a standard loan facility.

ASX

The incidence of directors having margin loan exposures which could cause difficulties for the companies of which they are a director has arguably lessened considerably since the problem was highlighted by the existence of certain substantial exposures in 2007/08. On balance, we take the view that the incidence of directors taking out margin loans over a significant proportion of the company's securities has receded and that there is no immediate imperative for a legislative response. If, however, CAMAC obtains evidence to the contrary, then it will presumably wish to consider whether the appropriate response is one which Boards can take or whether, instead, there is a case for legislative intervention.

The following analysis is designed to assist CAMAC in the event that it either:

- is presented with evidence, contrary to our understanding from anecdotal feedback, that there is a continuing high incidence of directors taking out margin loans in circumstances where disclosure issues may arise; or
- concludes that the interaction of the various tests established under company trading policies, Corporations Act provisions and listing rules still leaves companies and/or individual directors in an invidious position in determining how best to satisfy all relevant obligations and norms.

The difficulty to which a director with a margin loan may contribute is one arising from (a) the need for directors to consider their existing disclosure obligations to the company and (b) in the event of those obligations being triggered, from the need for companies to consider their existing continuous disclosure obligations to the market.

Subsequent to the problem being highlighted, and notwithstanding the release of joint ASX-ASIC guidance,[1] it is apparent that directors and companies have some difficult judgments to make where a director wishes to take a margined shareholding in a company of which they are a director.

Directors need to (and in light of events, do now) consider refraining from taking out margin loans secured over a proportion of the company's securities which is so significant (both in relation to the director's financial position - for purposes of the directors judgment - and in relation to the size of the company - for purposes of the company's judgment) that the continuous disclosure obligation might be triggered.

We have difficulty seeing any countervailing considerations which would justify directors taking substantial positions in the companies of which they are directors if the only way that this can be achieved is by entering into margin loan arrangements, given the known potential for this to result in the interests of the company being adversely impacted, should the company form the view that it must disclose details of the margin loan to the market in order to meet continuous disclosure obligations. Putting a company to the inconvenience associated with forming a view as to whether

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1 See ASX Media Release 29 February 2008.

continuous disclosure obligations would be triggered is something which a director might prudently avoid. It is also appropriate to note that company boards can act to preclude such action by individual directors by incorporating restrictions in the company's share dealing/trading policy.

Against this background, the following questions require consideration:

- Has the incidence of directors taking out margin loans (to fund substantial positions in the companies of which they are directors) receded to such an extent as to obviate the necessity for intervention?
- If further intervention is required, should this take the form of action at the company level (i.e. a trading policy that clearly sets out what are acceptable circumstances/thresholds for directors to enter into a margin loan), or is legislative intervention required?

It may well be that there is a simple solution to any problem faced by directors whose personal interests may put their companies in an invidious position: i.e. reconsider taking such a substantial position by means of a margin loan or other form of financing. Similarly, at a company level, it could be anticipated that trading policies which do not already address this issue will provide more detail on circumstances under which a director can enter into a margin loan, and when the company must be notified of that loan.

Given the ability of directors to prevent disclosures by directors creating a need for difficult judgments to be made by the company (as to whether continuous disclosure obligations have been triggered), the case for creating new legislative 'safe harbours' from such obligations, specifically relating to directors' share financing arrangements, does not seem to us to be very strong. There does not appear to be a case for any other form of legislative intervention in relation to this issue.

RiskMetrics

We agree with CAMAC that having directors hold shares in the companies on whose boards they sit generally advances shareholders' interests. The ownership of shares – which gives directors a personal financial stake in the company – acts, in principle, to align the interests of directors with those of the shareholders by providing an incentive for directors to make decisions that serve shareholders' interests, as opposed to decisions that place the self-interest of the directors ahead of shareholders' interests. Share ownership on the part of the directors can therefore be a useful adjunct to other corporate governance mechanisms for addressing the agency problems that occur in the case of listed public companies with a widely-dispersed shareholder base.

The Issues Paper focuses on only one of the ways in which directors can acquire shares in their companies: the margin loan. Another – and more common – way for this to occur is where the company itself facilitates or effects the acquisition of shares by its directors. This latter mechanism is routinely encountered in the context of remuneration arrangements. As CAMAC is aware, executive – including directorial – remuneration is now the subject of a vigorous debate in Australia. For the purposes of the present Issues Paper, we wish simply to point out that the putative corporate governance benefits flowing from directors holding shares in their companies can be undermined severely by poorly designed remuneration arrangements.

The principal constraints on directors entering into margin loans and using those loans to acquire shares are:

- The insider trading laws which prohibit directors (and others) in possession of confidential, price-sensitive information from, among other things, acquiring shares; and
- The duties imposed on directors at general law and under the Corporations Act 2001.

There are two key aspects to these constraints, in the context of the Issues Paper:

- Directors profiting from the trading of shares, including shares whose acquisition has been financed using a margin loan; and
- Directors allowing their conduct to be influenced by the fact of their personal exposure to the financier of the margin loan.

The first aspect raises the question as to whether the insider trading prohibitions and sections 182 and 183 of the Corporations Act (and their general law counterparts) require supplementation. This question is addressed in the next section of our submission.

The second aspect concerns the duty of directors to act in the best interests of the company and the requirement to subordinate their self-interest to the interests of the company. The alignment of interests (between the director and the company's shareholders) that the director's holding of shares is designed to achieve can be eroded by the director allowing his or her conduct to be improperly influenced by his or her personal exposure in respect of the margin loan. The director may, as CAMAC notes, be more concerned to instigate or approve corporate conduct that lessens the likelihood of a call being under the margin loan on the director and that particular conduct – while it may have the short-term effect of supporting or even increasing the price of the shares – may not necessarily be in the best interests of the company. The alignment of interests here is illusory and the benefits to the company from the director's conduct unsustainable.

We therefore support CAMAC's 'Option 3' (page 10), namely the mandatory disclosure of *all* the material details of the margin loans that the directors have entered into.

The Corporations Act already contains a mechanism for the mandatory disclosure to the company by directors of personal interests that might influence their judgment. The relevant provision is section 191 which requires directors to disclose details of the nature and extent of any 'material personal interest' that they may have in the 'affairs of the company'. We believe that the mandatory disclosure to the company of margin loans can be effected by a more rigorous interpretation of section 191.

We note that ASIC and the ASX have indicated that all margin loans should be disclosed under that section. This view[2] is not, however, free from doubt. The qualifying words 'material' and 'affairs of the company' may act to exclude margin loans that are viewed as being unlikely to influence the decision-making of a director in relation to the affairs of his or her company. The materiality of the director's interest and whether that interest relates to the affairs of the company will fall to be

[2] See ASIC and ASX, 'Disclosure Guidance for Listed Entities', *Media Release*, 29 Feb. 2008.

determined, in particular, by two factors: the size of the loan relative to the personal wealth of the director (and any guarantor of the loan); and the price at which a call on the loan will be triggered relative to the current price of the shares. We therefore believe that it is necessary to 'expand' section 191 or 'introduce a separate provision' (which are among the proposals being considered by CAMAC).[3]

This approach is consistent with section 205G which requires directors of a listed public company to notify the ASX of their interests in the company's shares and also details of contracts to which the directors are parties and which confer a right to call for or deliver shares. Again, we believe that section 205G is sufficiently wide to apply to margin loans (given that such a loan constitutes a contract to which the director is a party and which confers on the financier the right to call for the shares). As with section 191, this matter can be rendered free from doubt through a clarifying amendment. The application of section 205G to margin loans is also consistent with ASIC's stated rationale for that section which is that shareholders are entitled to know whether directors are buying or selling shares.[4]

We also agree with IFSA and ACSI – as regards Option 1 (page 7) – that all companies should have policies in place regulating the entry into margin loans by their directors (and executives), in analogous fashion to the share-trading policies maintained by companies. Nonetheless, at a minimum, the changes in relation to section 191 discussed above will ensure that companies are in possession of all material information relating to margin loans entered into by their directors.

A final point in relation to margin loans relates to the company's obligations to pass on information about such loans to the ASX under LRs 3.1 and 3.19A.[5] The rationale for requiring disclosure to the market of margin loans is, in our opinion, equivalent to the rationale for requiring disclosure to the market of short positions. In both instances, the information provides investors with a more accurate picture of the level of risk involved in trading the shares, including sentiment about the shares and the pressures that the share price may be subject to.[6] That being the case, we support the disclosure of margin loans relating to non-trivial parcels of shares. A suitable threshold for disclosure is not the higher 5% threshold that is imposed by the substantial shareholding disclosure provisions of the *Corporations Act* but the lower threshold that has been recommended for the disclosure of short positions (ranging from 0.25% to 1%).[7]

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3 Thought will also need to be given to the operation of section 195, as the existence of a sufficiently large margin loan or one with a trigger price sufficiently close to the current share price could preclude a director from voting on any matter (as all such matters before the board will relate to the affairs of the company). This could be resolved by permitting a director, who has made full disclosure of the margin loan and obtained the company's permission to enter into the loan, to vote.

4 See ASIC, 'Notification of Directors' Interests in Securities – Listed Companies', *Regulatory Guide 193*, June 2008, para 3.

5 We note that the application of the Listing Rules to margin loans is also supported by ASIC and the ASX: see ASIC and ASX, 'Disclosure Guidance for Listed Entities', *Media Release*, 29 February 2008.

6 See Treasury, 'Short Selling Disclosure Regime', *Consultation Paper*, March 2009, p 2.

7 See Treasury, 'Short Selling Disclosure Regime', *Consultation Paper*, March 2009, p 4.

Chartered Secretaries Australia

We have been calling for law reform on the first issue (disclosure of margin loans) for most of 2008, with written and verbal submissions made throughout the year to the Australian Securities Exchange (ASX), the Australian Securities and Investments Commission (ASIC), the Department of Treasury and the Minister.

Background

Early in 2008, CSA became concerned that investors were being subjected to wild swings in share prices resulting from margin calls on loans to directors in an environment where ordinary investors and the market were not informed in a timely manner of the creation or existence of these security interests and third-party rights. We began advocating for reform, calling for the disclosure to the market of security interests or third-party rights over directors' shareholdings to be mandated.

We recognised, and continue to recognise, that the issue of whether or not disclosure of security interests or other third-party rights in directors' shareholdings should be regulated is complex. For example, concern has been expressed that disclosure of the level of security interests or other third-party rights over directors' shareholdings can incite hedge funds to sell the stock, create pressure on the share price and force those directors who have security interests on their holdings to lose control of their stock. It has been argued that such disclosure could advantage one class of shareholder over another, with hedge funds that have greater company analysis at their disposal targeting companies in which directors have borrowed to buy shares.[8] On this basis, the argument against disclosure is that it could operate against the company's and shareholders' best interests.

CSA's consideration of whether disclosure should be mandated took into account the need to keep the market informed, the administrative burden of implementing any enhanced disclosure requirements (including the need to balance the benefits against the costs of any such enhanced disclosure requirements) and the legitimate interest of directors in the privacy of their personal financial affairs. Our consideration also took into account the need not to exacerbate volatility in the market by giving information to short sellers and others that would allow them to target particular companies or directors.

CSA does not consider it good governance for directors to enter into substantial financial arrangements that if disclosed could place their company in jeopardy, and accordingly, we do not accept that this is a compelling argument of itself against disclosure. CSA believes that shareholders and the market need to know about such substantial financial arrangements, so that they can make their own assessment of whether there is potential for the market to move downwards sharply and quickly enough to trigger the third-party right, as happens when there is a margin call. Otherwise the market is uninformed or, potentially, misinformed.

CSA has not called for and does not call for the prohibition of margin loans to directors or regulation imposing conditions on directors before they can enter into margin loans concerning the company's shares. CSA does not support such a prohibition or imposition of limitations. CSA accepts that funding arrangements where a director grants security over their stock can be very useful to companies

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8 AICD Policy & Advocacy Position Paper No. 9, *Director Margin Loans*, June 2008.

whose founders seek to maintain material ownership as the capital base increases. CSA believes that it should be left to individual companies to set the conditions under which directors can enter into margin loans or grant security over their stock.

However, CSA does not accept that it is good governance for a director to enter into substantial financial arrangements which if disclosed to the market could lead to significant volatility in their company's share price. If the effect of requiring disclosure is to limit arrangements of this kind CSA considers this to be a beneficial outcome.

CSA continues to call for disclosure by directors to the company and by the company to the market in order to ensure that an informed market exists. Investors should have access to information that funds raised may involve directors losing control of their stock. CSA has considered at great length the arguments put forward by various parties against disclosure, but we have not been persuaded by these arguments and we continue to call for disclosure being mandated.

CSA's consideration of alternative approaches to regulation

When considering the issue in 2008, and within the context of seeking a good governance outcome, that is, keeping the market informed, CSA considered three alternative approaches to the disclosure of margin loans. These options were:

1. **maintaining the status quo**, that is, there would be no obligation on directors to disclose to the company any security interest or third-party right in their shareholdings, and there would be no obligation on the company to disclose to the market unless (a) it is 'aware' of the information in the sense defined in the Listing Rules, that is a director or executive officer has come into possession of the information in the course of the performance of their duties; and (b) the information is discloseable under the ordinary operation of Listing Rule 3.1
2. **requiring directors to disclose whether any of the company securities in which they have a relevant interest are subject to margin loans**, other security interests (mortgage, charge, lien etc) or stock lending arrangements. There would be no requirement to disclose the details of the security arrangements or trigger prices
3. **requiring directors, under legislation, to disclose to the company** if any of the company securities in which they have a relevant interest are subject to margin loans, other security interests (mortgage, charge, lien etc) or stock lending arrangements. **The company would then be required under the ASX Listing Rules to disclose to the market if a director held more than five per cent (substantial shareholder notice level of materiality)** of the company's issued securities subject to security interests or other third-party rights. Further disclosure would be required on movements of one per cent or more. There would be no requirement to disclose the specific details of the security arrangements or trigger prices.

CSA has re-examined each of these options.

1 Maintain the status quo

CSA continues to oppose maintaining the status quo. Market volatility continues to show that the market and ordinary investors are not fully informed as to the risks affecting particular stocks when the market is not fully informed as to security and third-party interests granted by directors. Where directors enter into financial arrangements that provide third-party rights over their shareholdings (for example, stock lending) there can be very material impacts on share prices, even when the director concerned is not in any way in default of their own obligations.

We also note that it has been argued that, following the spate of margin calls on directors in 2008, directors no longer hold margin loans on shares in the companies which they govern or no longer are party to such substantial financial arrangements that a forced sale could lead to negative market activity affecting their company's shares. CSA considers this to be unlikely. As the market navigates its way through the worst financial crisis since the 1930s, directors who would not have considered themselves at risk of receiving a margin call have, and may continue to receive margin calls.

Indeed, CSA notes that data published by the Reserve Bank of Australia (RBA) in March 2009 showed margin calls in the December 2008 quarter soared to a fresh high. The average number of margin calls per day rose to 9.77 per day per 1,000 clients in the final quarter, more than doubling from the third quarter and surging 12-fold from the December 2007 quarter. As noted above, it is unlikely that directors are not included in these statistics.

CSA notes that when the market observes a director selling shares, even when it is a forced sale, the market may perceive such a sale as representing inside knowledge of the prospects and performance of the company. CSA points to the inherent risk of misinterpretation by the market that directors are seeking to exit their investment. This perception problem is ameliorated if investors know that directors have financial arrangements in place that could lead to a forced sale, as disclosure provides notice to investors that such arrangements exist, and on what portion of the stock, thereby allowing investors to make up their own minds about the impact such arrangements could have on the share price and providing clarity as to the forced nature of the sale should it occur.

2 Uniform disclosure

Companies and directors currently have an obligation under the Corporations Act and the Listing Rules to disclose to the market any relevant interests of directors in the securities of the company, with details of the number of securities held. The obligation extends to disclosure of contracts that confer a right to call for or deliver shares in the company. There is no materiality test attached to directors' obligation to disclose these relevant interests on the basis that the market should be informed of all dealings by directors in the shares of their companies.

A requirement to provide for the disclosure of whether any of the company securities in which directors have a relevant interest is subject to margin loans, other security interests (mortgage, charge, lien etc) or stock lending arrangements would be a relatively small and easily implemented addition to an existing obligation. Indeed, the CAMAC paper notes that it is arguable that s 205G of the Corporations Act may already require uniform disclosure by directors of transactions in shares of the company including information on when they have entered into margin loans and the details of those loans.

However, on consideration, CSA continues to believe that the risk to the market is questionable where directors have a relevant interest that is subject to security interests or other third-party rights where the shareholding is immaterial relative to the company's overall issued capital. Therefore, while CSA can see the merit in uniform disclosure, CSA continues to support a materiality threshold, as set out below.

3 Disclosure of security interests and other third-party rights to the company with market disclosure in the case of substantial shareholdings

CSA believes that the market should be informed if a director's shareholding subject to a security interest or other third-party right is sufficiently large that its forced sale would be likely to have a material effect on the price of the company's securities. From the perspective of investors, price sensitivity is the key issue.

CSA notes that the ASX/ASIC joint Companies Update 02/08 stated that:

> Where a director has entered into margin loan or similar funding arrangements for a *material* number of securities, ASX advises that listing rule 3.1, in appropriate circumstances, may operate to require the entity to disclose the key terms of the arrangements, including the number of securities involved, the trigger points, the right of the lender to sell unilaterally and any other material details. Whether a margin loan arrangement is material under listing rule 3.1 is a matter which the company must decide having regard to the nature of its operations and the particular circumstances of the company.

There has been support for such disclosure remaining a matter of a company's continuous disclosure obligation rather than requiring additional regulation, noting that 'it provides the necessary flexibility for boards and companies to decide when margin loan arrangements may be material and therefore require market disclosure. In volatile trading conditions, a judgment of materiality may fluctuate frequently'.[9]

However, CSA contends that companies would often be unable to determine materiality without examining the financial arrangements of directors and, furthermore, would often not have access to such information. For example, a director's shares in one company may form part of a larger portfolio to which the security interest applies, and judging materiality would involve examination of the entire portfolio. CSA also notes that unless the director has informed the company of the margin loan (which may not necessarily be the case), the company is not in a position to, and is not obliged to, disclose under Listing Rule 3.1.

The advantage of tying disclosure to a clear materiality threshold, therefore, is that boards and their secretaries are not placed in the invidious position of enquiring into directors' personal financial arrangements and circumstances to determine whether a particular margin loan or other arrangement is material, which might involve an inappropriate degree of scrutiny of directors' personal finances. Tying the disclosure to a materiality threshold provides greater privacy to directors than board assessment as to whether directors' financial arrangements could have a material impact on the share price. Furthermore, an additional advantage is that if the disclosure obligation is placed on the director rather than the company, the issue of whether or not the director has provided information to the company does not negate the director's obligation to disclose.

Moreover, the five per cent materiality threshold (substantial shareholder notice) is fully accepted in the market and this would be a natural extension of that disclosure.

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9 AICD Policy & Advocacy Position Paper No. 9, *Director Margin Loans*, June 2008.

CSA notes that it has been argued that substantial shareholders could have security arrangements in place that have the same potential to cause a material impact on the share price as directors' arrangements. However, CSA notes that substantial shareholders who are not directors do not have a fiduciary duty to act in the best interests of the company, and nor do they have access to the same inside information or capacity to influence company decisions that directors do. Accordingly, we do not feel that this argument can support non-disclosure.

We are also aware that concerns have been expressed that substantial financial arrangements entered into by directors can give rise to a conflict of interest between the director and the company. Regardless of whether a conflict of interest exists or not, the obligation to disclose should remain.

United Kingdom

CSA notes that in January this year, the Financial Services Authority, in its role as the UK Listing Authority, clarified its position relating to disclosure obligations in respect of transactions by persons discharging managerial responsibilities, such as directors, and their connected persons, who grant security over their shareholdings. The FSA confirmed that granting security over a shareholding is classified in the Model Code as an action that requires market disclosure, under Annex 1 to Chapter 9 of the Listing Rules. 'The Code makes it expressly clear that 'dealing' includes 'using as security, or otherwise granting a charge, lien or other encumbrance over the securities of the company' (paragraph 1(c)(v)).'

CSA points to the UK obligation to disclose to the market as support for our call for disclosure, noting, however, that in the Australian context we support a materiality threshold rather than uniform disclosure.

CSA recommendation

Recommendation

Having considered again the advantages and disadvantages of each option, **CSA recommends** disclosure if a director holds five per cent or more (substantial shareholder notice level of materiality) of the company's issued securities subject to security interests or other third-party rights (margin loans, other security interests (mortgage, charge, lien etc) or stock lending arrangements). Further disclosure would be required on movements of one per cent or more. However, there should be no requirement to disclose the details of the security arrangements or trigger prices.

Implementation

CSA believes that there are two steps involved in implementing this recommended reform:

1. The CAMAC paper notes that it is arguable that s 205G of the Corporations Act may already require uniform disclosure of transactions by directors in shares of the company including information on when they have entered into margin loans and the details of those loans. Where in the past we have recommended that this section be amended to impose a statutory obligation on directors to inform the company of any security interests that are created or discharged, in light of the uncertainty regarding interpretation of this section, **CSA recommends** that s 205G be amended to *clarify* that directors have a disclosure obligation that extends to the disclosure of security interests in their shares. CSA also recommends that ASIC provide guidance on this issue. CSA

notes that clarifying that directors have an obligation under statute to disclose shareholdings subject to security interest or other third-party right to the company is one step only. In order to ensure an informed market, there should be a second step: an obligation on the company to disclose to the market those interests.

2. The ASX Listing Rules should be amended to require the company to notify the market of security and other third-party interests affecting shares in which directors have a substantial relevant interest. **CSA recommends** that this be done by requiring companies to state on each Form 3X and Form 3Y lodged with respect to a director's relevant interests whether or not, and if so how many of, the relevant securities are subject to a substantial security or third-party interest (that is, more than five per cent). There would be an additional requirement to lodge a Form 3Y where a director's relevant interests have not changed but security interests are created or discharged. This would be binding on companies and relatively simple to administer. The onus would be on directors to properly inform the company of their arrangements, as is currently the case with respect to directors' share trading.

CSA's recommendation for statutory amendment clarifies that the obligation to disclose to the company rests with the director, and obviates a reliance on directors informing companies of their arrangements and any requisite arrangements between directors and companies that this may entail.

CSA recommends that ASX issue a guidance note detailing what information is being sought and for what purpose by the addition of the new box on Forms 3X and Form 3Y requiring details about the security or other third-party interests applying to the number of shares to be inserted in the box. The guidance note could highlight that companies are free to provide further explanation as to why the box on these forms has been ticked, if desired.

Law Council of Australia

The Committee agrees broadly with the statements and conclusions made by Ewen Crouch in his paper *Director's Margin Loans: Disclosure Issues* given last year.[10]

That paper highlighted that the issue of disclosure of margin loans is already contemplated and effectively dealt with by a combination of ASX Listing Rule 3.1 (regarding continuous disclosure), sections 191 (directors' disclosure of a material personal interest) and 205G (director to notify ASX of shareholdings) of the Corporations Act and the substantial shareholder provisions (s 671B and Chapter 6D more generally). As that paper highlighted, '…there is far more machinery available in the law as it is today than has been appreciated by the marketplace…'.[11] This matrix allows appropriate account to be taken of a range of factors such as the size of the loan, the loan to valuation ratio, the market capitalisation of the company, the number of shares to which it relates and the liquidity of the companies' securities (to name but a few) in a way which a law specifically directed at margin loans could not.

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10 Crouch, E, *Director's Margin Loans: Disclosure Issues* in Austin RP (Ed.) 'The Credit Crunch and the Law' (2008), Ross Parsons Centre of Commercial, Corporate and Taxation Law, Sydney.

11 Ibid, p 1.

The Committee agrees that s 205G could be extended to synthetics. This would be an acceptable extension of the law, and the Committee considers that this should form part of the announced Treasury review regarding extending disclosure under Chapter 6C. The Committee would also support bringing down the time for directors' disclosure under section 205G to the 5 day period currently provided for under the Listing Rules.

Business Council of Australia

The BCA does not believe that additional regulation is currently needed in relation to margin lending in the context of director's or other officer's holdings.

Evidence of a problem

Some specific instances of margin loans supporting substantial shareholdings of directors and executives were highlighted as a problem around late 2007 and during 2008. Companies and directors acted quickly to deal with this issue, and it is likely that the incidence of margin loans supporting significant shareholdings has now diminished. ASIC and the ASX also released an update in February 2008 to assist companies to deal with their obligations with respect to margin loans. In general therefore, the problem seems to be less urgent than it may have been when this issue arose in 2007 and 2008.

There are a number of existing regulatory requirements that operate in combination to effectively deal with the issue of margin loans, including:

- the continuous disclosure regime under ASX Listing Rule 3.1;
- substantial shareholding provisions in the Corporations Act;
- director disclosure of material personal interests under section 191 of the Corporations Act; and
- director disclosure to ASX of shareholdings under section 205G of the Corporations Act.

In addition to regulatory requirements, other practices deal with margin lending. These include:

- Recommendation 3.2 of the ASX Governance Principles which requires listed companies to establish a policy concerning trading in company securities by directors, senior executives and employees and to disclose that policy or a summary of that policy to the market.
- An update released by ASIC and ASX in February last year which highlighted that certain circumstances may require disclosure of details of a director's funding arrangements under Listing Rule 3.1. The update highlighted that an assessment of materiality and therefore extent and timing of disclosure of such information is a matter for the board to decide in the circumstances of the individual company.

Costs and benefits of intervention

Margin loans and other funding arrangements facilitate the purchase of shares in a company. Undue restrictions on borrowing to acquire shares should be avoided. It is important to encourage share ownership by directors and officers in their companies. For example, share ownership and remuneration in the form of shares is an important mechanism for tying the interests of directors and officers to the company's interests.

Additionally, start-up companies may require funding by founder directors in the company. Hindering such investments could be detrimental to innovation or shareholder value.

There is a risk in going beyond a flexible regime and for example mandating public disclosure of specific details of funding arrangements. Mandatory requirements for public disclosure could put companies or individuals in a vulnerable position. If specific details such as trigger points for margin calls are disclosed, this may encourage some market players to target vulnerable companies to manipulate share prices.

Possible response

Additional guidance in the ASX Governance Principles could be developed to assist companies in dealing with their trading policy under Recommendation 3.2. The guidance could cover a range of issues associated with company trading policies, including:

- trading policies could detail the circumstances under which a director or officer can take out a margin loan; or
- trading policies could mandate disclosure to the board by a director or officer of details about a margin loan. Such disclosure will enable the board to assess in a timely way, the details of a margin loan for the purposes of ASX Listing Rule 3.1, whilst also allowing the boards continued flexibility to make decisions of materiality.

AICD

AICD notes that there has been a discrete focus on directors' margin loans in the current market leading to this reference, rather than a focus on the broader issue of circumstances that might lead directors to sell down a sizeable parcel of company shares thereby putting downward pressure on the company's share price. Be that as it may, AICD considers that the current regulatory regime regarding the discrete issue of directors' margin loans does not require fundamental overhaul, as the existing continuous disclosure obligations imposed on listed companies provide appropriate regulatory oversight.

It is widely accepted that shareholders expect directors to hold shares in the listed companies of which they are a director, in order to align the directors' interests with those of the company and shareholders generally. Margin lending arrangements play an important role in enabling directors to purchase such shareholdings. The prohibition of or introduction of overly onerous regulation of director margin loans may create a significant disincentive for directors planning to purchase such shareholdings.

AICD believes that introducing blanket regulation of directors' margin loans is inappropriate. In many cases, the mere fact that a director has a margin loan arrangement in place over their shareholding is, in itself, information of limited value or interest to the market (for example, where the size of the director's shareholding in the company is insignificant). The unnecessary disclosure of a director's personal financial affairs should be avoided unless absolutely necessary. Accordingly, a blanket requirement forcing all directors to disclose details of any margin loan arrangements in all instances is not appropriate.

AICD considers that the existing continuous disclosure regime is sufficient in requiring a company to determine whether it is aware of information in relation to margin loan arrangements that is 'material' or 'price sensitive' and therefore requiring disclosure to the market.

Boards should be left to determine the appropriate level of 'internal regulation' of director margin loans by putting in place internal policies that are appropriate for the company's particular circumstances. These policies may, for example, prohibit directors from entering into margin loans, set conditions on which directors can enter into margin loan arrangements or require directors to disclose details of such arrangements to the company including when a margin call might be made and cannot be met by the director. In addition, ASX Guidance Note 8 could be updated to include guidelines specifically dealing with directors' margin loans.

AFMA

Regulation of margin loans to directors

(1) the implications for market integrity of margin loans to directors

There has been long standing support for the principle that share holdings by directors in their own companies promotes market efficiency by directly aligning their interests with that of shareholders. Margin loans have provided the means by which founding directors have been able to maintain significant shareholdings while the capital base of their companies have grown. These arrangements do not appear to cause problems during periods of normal trading volatility.

The area of concern surrounds whether margin loans to directors damage the interests of other shareholders during periods of very high volatility, such as that flowing from the global financial crisis. AFMA does not consider that there is a demonstrated case of market failure resulting from margin loans to directors.

The argument, that knowledge by third-parties of directors' shareholdings in their own companies, which are supported by margin loans creates points of vulnerability that can be exploited by selling stock to create pressure on those directors to sell their shares, does not appear to be supported by evidence that there is a general market integrity problem. While particular examples of failing companies can be pointed to where there were margin loans to directors, the vulnerabilities in these companies and the consequent fall in their share prices appears to be due to a recognition by investors that there were problems with their financial fundamentals and management that were far more significant in their failure than whether directors were using margin loans.

Accordingly, AFMA does not consider that a market failure problem has been demonstrated that would warrant additional regulation.

(2) should there be specific regulation of the process of entering into margin loans by directors? If so:

- **should it be left to individual companies to set the conditions under which directors can enter into margin loans**
- **should the legislation require prior company approval before directors can enter into margin loans**
- **should the legislation impose limitations on margin loans to directors**
- **should the legislation prohibit margin loans to directors**

As there is not a threat to market integrity from margin loans to directors, there is not a demonstrated need for additional regulation, which would impose additional costs and burdens without any clear benefit. Excessive regulation in this area could deter directors from holding meaningful shareholdings in companies, particularly those companies where founding directors wish to maintain significant share positions as the capital base grows.

The ASX Governance Council Principles (Principles) provide an existing framework to cover conduct in relation to margin loans to directors. AFMA supports all listed companies following the recommendations in the Principles (Recommendation 3.1) and establishing a code of conduct and disclosing the code or a summary of the code as to:

- the practices necessary to maintain confidence in the company's integrity;
- the practices necessary to take into account their legal obligations and the reasonable expectations of their stakeholders; and
- the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.

A code could include content on the appropriate handling of directors' margin loans as part of following Recommendation 3.2. This would mean putting in place a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy.

Disclosure by directors to the company

(3) should there be specific requirements for directors to disclose to the company that they have entered into margin loans? If so:

- **should it be left to individual companies to set the disclosure requirements**
- **should the legislation require disclosure of entry into a margin loan**
- **should the legislation require disclosure of the details of a margin loan.**

This is an area where the adoption of a code of conduct as recommended by the Principles can provide an appropriate mechanism for indicating how disclosure should be made by directors to a company.

Recommendation 3.2 of the Principles currently suggests the following as recommended content:

> 3. Require designated officers to provide notification to an appropriate senior member of the company, for example, in the case of directors, to the chair, of intended trading, including entering into transactions or arrangements which operate to limit the economic risk of their security holdings in the company. No prior notification is needed for participation in dividend reinvestment plans and other corporate actions open to all shareholders.

This recommended content in the Principles could be supplemented by specific reference to providing notification that a director's shareholding is supported by a margin loan.

Disclosure to the market

(4) should there be specific requirements for directors to disclose to the market that they have entered into margin loans? If so, what information should be disclosed (for instance, that the director has a margin loan, the number of shares subject to the loan or other details of the loan such as the circumstances in which a margin call could be made)

This is another area where the adoption of a code of conduct, as recommended by the Principles, can provide an appropriate mechanism for indicating how disclosure should be made by a company of their directors' loans.

Disclosure can be carried out in the context of the continuous disclosure obligations in conformance with Recommendation 5.1 of the Principles. This recommendation notes that companies should establish written policies designed to ensure compliance with ASX listing rule disclosure requirements and to ensure accountability at a senior executive level for that compliance and disclose those policies or a summary of those policies.

The content of the policy should address the roles and responsibilities of directors, officers and employees of the company in the disclosure context; in particular, who has primary responsibility for ensuring that the company complies with its disclosure obligations and who is primarily responsible for deciding what information will be disclosed.

Disclosure of the existence of a margin loan to the market should be decided on the basis of whether it is material information that falls within the scope of a company's continuous disclosure obligations.

(5) should directors be required to disclose to the market (or to the company, which would then disclose to the market) particular events that have occurred since entry into the margin loan and, if so, what events (for instance, that a margin call has been made or that the market share price was within a certain percentage of the margin call strike price)

Reference is made to the response to question (4). With regard to the content of the disclosure, a balance needs to be struck between personal privacy of the directors and informing the market. The appropriate balance in disclosure can be struck by deciding on disclosure on the basis of whether it is material information that falls within the scope of a company's continuous disclosure obligations.

(6) should the market disclosure requirements apply to all directors or only to those directors who are also substantial shareholders

The question of whether a disclosure obligation should apply to all directors is a matter of judgment where the particular circumstances and the materiality of the shareholding can be taken into account. This is again a matter that can be appropriately handled under a code of conduct that is suited to a particular company's circumstances.

Generic approach to disclosure

(7) should directors be obliged to disclose to the company their interests or arrangements regarding their shareholdings or other equity-linked interests in the company, including financing arrangements?

This is area where the adoption of a code of conduct as recommended by the Principles can provide an appropriate mechanism for indicating how disclosure should be made by directors to a company.

Reference is made again to the content of the code under Recommendation 3.2 of the Principles.

> 3. Require designated officers to provide notification to an appropriate senior member of the company, for example, in the case of directors, to the chair, of intended trading, including entering into transactions or arrangements which operate to limit the economic risk of their security holdings in the company. No prior notification is needed for participation in dividend reinvestment plans and other corporate actions open to all shareholders.

The recommended content in the Principles could be supplemented by specific reference to providing notification of a director's shareholding or other equity-linked interests in the company, including financing arrangements.

(8) Should a company be required to disclose to the market all information concerning those interests or arrangements of directors that investors would reasonably require?

Reference is made to the response to question (4). With regard to the content of the disclosure a balance needs to be struck between personal privacy of the directors and informing the market. The appropriate balance in disclosure can be struck on the basis of whether it is material information that falls within the scope of a company's continuous disclosure obligations.

Juliette Overland

In summary:

(a) it is unlikely that the sale by a lender of shares subject to margin loan arrangements as a result of an unsatisfied margin call on those shares amounts to insider trading by the director who owns those shares, even where that director possesses inside information;

(b) listed companies should be permitted to make their own determinations of any conditions to be placed on directors entering into margin loans, and any such conditions should be disclosed by the company in its trading policy, developed in accordance with Recommendation 3.2 of the ASX Corporate Governance Principles and Recommendations.

It is understood that the Hon Senator Nick Sherry, the Minister for Superannuation and Corporate Law ('the Minister') has raised concerns about the practice of directors of listed companies using margin lending arrangements to acquire company shares. From the outset, it should be acknowledged that it is commonly accepted that when directors hold shares in a company, the interests of the director and company's shareholders are considered to be aligned.[12] Accordingly, the introduction of provisions or requirements that would make the holding of shares in a listed company less attractive to, or more onerous for, its directors should be approached with caution.

It is suggested in the Issues Paper that a forced sale of shares subject to a director's margin loan could result in a breach of Australian insider trading laws by that director. In such circumstances, the six essential elements of insider trading <u>may</u> be satisfied. Insider trading by a director will be found to occur where:

(i) the director possesses information;

(ii) the information is not generally available;[13]

(iii) the information is material;[14]

(iv) the director knows (or ought to know) that the information is not generally available;

(v) the director knows (or ought to know) that the information is material; and

(vi) the director trades in the relevant financial products, or <u>procures</u> such trading.

The final element requires some further consideration to determine if the director will actually trade or procure trading if shares he or she holds, subject to margin lending arrangements, are sold by the lender after a margin call. Pursuant to the terms of s 1043A(1) of the *Corporations Act 2001* (Cth) ('the *Corporations Act')* the prohibited action is to, as principal or agent:

(c) apply for, acquire, or dispose of relevant financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant financial products; or

(d) procure another person to apply for, acquire, or dispose of relevant financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant financial products.

The Issues Paper suggests that when listed company shares which are the subject of a margin loan are sold by the lender because the director has failed to honour a margin call, the director can be argued that the director procured the disposal of the securities. Section 9 of the *Corporations Act* provides that 'procure' includes 'cause' and it is suggested that a director <u>causes</u> securities to be sold by not honouring a margin call (by failing to repay part of the loan or provide additional security) since the sale of the securities could have been avoided if such action were taken.

However, it is more likely that 'causation' sufficient to amount to an act procuring will require an active step be taken rather than resulting from inaction. Section 1042F of the *Corporations Act* now provides a more extensive definition of 'procure', which states that if a person incites, induces or encourages an act or omission by another

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12 See, for example, Investment and Financial Services Association Limited, *Blue Book – Corporate Governance: A Guide for Fund Managers and Corporations*, Guideline 11 – Equity Participation by Non-Executive Directors; Investment & Financial Services Association Ltd, *Executive Equity Plan Guidelines*, Principle 3.1; Australian Securities Exchange, *ASX Corporate Governance Guidelines*, 3. Equity-based remuneration; Australian Council of Super Investors Inc, *Corporate Governance Guidelines*, 14.1 – Remuneration Practices, 14.8 – Other Aspects of Long-term Incentive Schemes, 14.14 – Director Remuneration and Share Ownership.

13 As defined in s 1042C of the *Corporations Act.*

14 As defined in s 1042D of the *Corporations Act.*

person, the first person is taken to procure the act or omission by the other person. Whilst this definition is expressed to be without limitation, the positive acts expressed by the terms ‘incite, induce and encourage’ connote the taking of active steps and do convey a meaning unlikely to be satisfied by mere inaction (such as the failure to take other steps). Accordingly, it is strongly suggested that the better view is that there is no procuring of trading and therefore no insider trading, where a director fails to honour a margin call and, as a result, the lender elects to sell the shares subject to margin lending arrangements, even if the director possessed inside information at the relevant time. Additionally, a suggestion that a director could have avoided the sale of the shares by making repayment on the margin loan or providing additional securities pre-supposes that the director has the necessary means and resources to take such alternative action.

Additionally, regulation 9.12.01 provides that s 1043(1) of the *Corporations Act* does not apply in relation to a sale of financial products under a mortgage or charge of the financial products.[15] This regulation is not expressed to exclude the application of the insider trading prohibition to the actions of the lender only, and arguably also protects the owner of the financial products – in the circumstances under discussion, the director with shares held under margin lending arrangements – from liability under s 1043.

Accordingly, no change to the law is recommended as a result of any perceived issues of insider trading. It would be contrary to the spirit of the prohibition on insider trading to determine that a director breaches the prohibition as a result of the actions of a lender who is not in possession of the relevant inside information. The better view appears to be that no such infringement arises, due to the operation of regulation 9.12.01 and the extended definition of ‘procure’ in s 1043F of the *Corporations Act*.

On the question as to whether conditions should be placed on the circumstances in which directors of listed companies can enter into margin loans relating to the company’s own shares, it is most appropriate for the relevant company be permitted to make such a determination. In order that the market and all other interested parties are aware of any conditions which may be imposed, it is recommended that this issue be dealt with pursuant to the ASX Corporate Governance Principles and Recommendations (‘Corporate Governance Principles’). Recommendation 3.2 of the Corporate Governance Principles provides that listed companies should establish a trading policy, which should then be publicly disclosed. If a company were to place conditions on directors entering into margin loans, it would be appropriate for such conditions to form part of such a trading policy.

Allens Arthur Robinson

Regulation of margin loans to directors

We are against any prohibition of margin lending to directors, or any limitation that directors may only enter into margin loans if they can demonstrate the financial capacity to repay the loan without recourse to the pledged securities.

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15 Regulation 9.12.01(e)(i) of the *Corporations Regulations*.

The Issues Paper raises three issues in relation to the use of margin loans by directors. These are:

- possible conflicts of interest;
- directors may put themselves in an untenable position under insider trading laws; and
- material security holdings in the company may be dumped on the market where a margin call is made under a director's margin lending arrangements, resulting in a material fall in the security price.

While the Issues Paper raises these three issues, the letter from the Minister seems more concerned with the third point.

Dealing with the third point, we do not consider this to be a reason to ban or impose limitations on margin lending to directors for a number of reasons, including:

(a) often directors' security holdings will not be material, so that even if all of the securities subject to the margin loan were sold by the lender following a margin call, there would be no market impact;

(b) if margin lending to directors is banned, they will simply be able to structure their financing arrangements in another way, such as by borrowing against the security of their place of residence. Unless it is proposed to ban all financing arrangements under which directors buy securities in the companies of which they are a director, there is little sense in singling out margin loans for prohibition or limitation;

(c) as noted in the Issues Paper, it is in security holders' interests to encourage directors to have an ownership interest in the companies they direct, rather than discourage it; and

(d) some of the examples which are given to support calls for bans on margin lending, such as the sale by margin lenders to Allco Principals Trust of securities in Allco Finance Limited would not necessarily have been prevented by a prohibition on margin lending to directors, as the trust arrangements there did not appear to be under the control of any particular director. It also appears, from press reports (which may or may not be accurate), that many of the beneficiaries of the relevant trusts were management below board level.

We do not consider that the fact that directors may find themselves with an interest to maintain the price of the company above the trigger for a margin call is sufficient to warrant prohibition of margin loans. Obviously, in this regard the interests of the directors will generally be aligned with the interests of security holders.

The fact that directors may, if the margin loan is called, put themselves in breach of insider trading laws is an issue that directors need to take advice on before they enter into the arrangement, and may point to a need for amendment of the insider trading provisions to include an exception for non-discretionary trading (although we note the SEC's view is that the exception would not be available on a sale under a margin loan). But these are not arguments for banning margin loans outright or permitting them only when directors can demonstrate that they have the financial capability to repay without resort to the pledged securities.

Disclosure by directors to the company

There is a need for greater disclosure by directors of margin lending arrangements. We think that investors in listed companies have a legitimate expectation that directors will have informed the company (and that the company will then have informed the market) if their securities are subject to margin lending arrangements and are therefore at risk of forced sale in the event of a decline in the security price. However, there is no need for a separate disclosure regime for margin loans – this should be achieved by amending the flaws in the existing disclosure regime, section 205G of the Corporations Act.

We believe that disclosure of margin lending arrangements is only one of the issues which needs to be addressed in relation to disclosure of directors' interests in the securities of publicly listed companies. As important in any rewrite of section 205G is making sure that the disclosure extends to any arrangements with third parties under which the directors' economic interest in the securities is reduced. This was an issue for ASX some years ago, where a director could, through derivative instruments, sell the economic interest in their securities, while retaining a relevant interest for disclosure purposes. This had the effect of creating the impression in the market that the relevant director's interest was fully aligned with other security holders, when this may not have been the case.

We think that section 205G should be redrafted to cover the following:

(e) in addition to requiring disclosure of the director's relevant interests in securities in the company and the circumstances giving rise to the relevant interest, it should require disclosure of any third party's relevant interests in those same securities. For this purpose, relevant interests of third parties which would otherwise be disregarded under section 609(1) (money lending and financial accommodation), section 609(6) (market traded options and derivatives) and section 609(7) (conditional agreements) should not be disregarded. Removing the application of section 609(1) for the purposes of section 205G would mean that security interests over the securities under any financing arrangements would need to be disclosed;

(f) the disclosure of security interests over the relevant securities would result in disclosure of the fact that the securities are subject to margin lending arrangements. However, we do not think that the disclosure needs to go beyond identifying the third party with the relevant interest, the nature of the relevant interest and a short description of the agreements under which it arose. We do not think that it should be necessary for the director to have to disclose the price triggers at which margin calls can be made because, as noted in the Issues Paper, this will simply give the short sellers a price point at which to aim and encourage market manipulation. It should also not be necessary to disclose the initial amount advanced, as it would be possible for short sellers to back-solve the price triggers for margin calls if they know the LVR for the security. While perhaps not perfect disclosure, the market would trade on the basis of a known uncertainty, namely, that the securities held by the director could possibly be sold in the future under security arrangements;

(g) require disclosure of any agreement, arrangement or understanding under which any third person has an economic interest in the relevant securities, even if such agreement, arrangement or understanding does not give rise to a relevant interest in the securities;

(h) the requirement in section 205G(1)(b) to disclose contracts to which the director is a party, or under which the director is entitled to benefit, and which confer a right to call for or deliver securities, should extend to agreements, arrangements or understandings to which the director or any entity under his or her control is a party or entitled to benefit. This would then catch margin loans structured as securities lending arrangements where the director holds the securities through his or her family company or family trust. Those arrangements would not necessarily be caught under sub-paragraph (e) above as the financier (ie, the securities borrower) will not necessarily have a relevant interest in the securities where they have on-lent them; and

(i) the time limit for disclosure under section 205G(3) should be reduced from 14 days to two business days to make it consistent with Chapter 6C.

Adams and Nehme

(1) The implications for market integrity of margin loans to directors

Margin loans to directors are an issue of policy and disclosure. As a consequence, clarity in relation to directors' margin loans impacts on market integrity.

(2) Should there be specific regulation of the process of entering into margin loans by directors? If so:

- Should it be left to individual companies to set the conditions under which directors can enter into margin loans?

Yes, we support this option for it is the most cost effective and efficient way to administer directors' margin loans. The reputation of the company dominates the individual benefits that arise from margin loans. Ultimately, it is the company's credibility that may be affected by margin loans to directors. Companies can develop risk management strategies to deal with such issues.[16]

Further, ASX/ASIC Companies Joint Update (29 February 2008) noted that a director of a company that is entering into a margin loan for a material number of listed securities may have to consider ASX Listing Rule 3.1 (Continuous Disclosure) which may operate to require disclosure of the key terms of the arrangements.

- Should the legislation require prior company approval before directors can enter into margin loans?

No, at this point in time, the cost of compliance does not warrant specific legislation in this area. The current rules dealing with directors' duties and continuous disclosure are enough to protect the interest of the company.

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[16] Michael Adams and Thomas Clark, Final Report: Changing Roles to Company Boards and directors (September 2007), 48, <http://www.ccg.uts.edu.au/project_changingroles.htm>.

- Should the legislation impose limitations on margin loans to directors?

No, there should not be any legislation imposing limitations on margin loans to directors.

- Should the legislation prohibit margin loans to directors?

There is no evidence that the majority of directors are abusing margin loans. Further, there is no cost benefit analysis to prove that margin loans are bad for stock market or individual corporate entities.

Further, there is a risk that a margin loans may lead a director to commit insider trading without even realising it. The legislator should take this into account when considering insider trading rules and may introduce a new defence dealing with margin lending, where an automated sell of securities is required due to the terms and conditions of the margin loan.

Disclosure by directors to the company

(3) Should there be specific requirements for directors to disclose to the company that they have entered into margin loans? If so:

- Should it be left to individual companies to set the disclosure requirements?

It should be left to companies to set the disclosure requirements needed in relation to margin loans.

- Should the legislation require disclosure of entry into a margin loan?

No, the legislation should not introduce a specific disclosure requirement dealing with entry into a margin loan. The protection provided under s 191 should be enough. Further, the broad application of ASX Listing Rule 3.1 may cover such a situation. If a company is aware that a substantial holding of its director is subject to a margin loan, this may result in disclosure under Rule 3.1.

The ASX Listing Rule 3.19A states that a listed company has to notify the ASX of ‘notifiable interests’ which a director has in the company. A clarification may be introduced to ensure that ‘notifiable interests’ includes margin loans to directors.

- Should the legislation require disclosure of the details of a margin loan?

No, the legislation should not require disclosure of the details of a margin loan for the abovementioned reasons.

Disclosure to the market

(4) Should there be specific requirements for directors to disclose to the market that they have entered into margin loans? If so, what information should be disclosed (for instance, that the director has a margin loan, the number of shares subject to the loan or other details of the loan such as the circumstances in which a margin call could be made)?

As part of the ASX listing rule, there should be specific guidelines relating to disclosure of directors’ margin loans.

Disclosure of directors’ margin loans to the listed company they are working for is important to allow the company to disclose the margin loans to the ASX. Without such disclosure, the ASX rule 3.19A would not be applied as the ASX Guidance Note states that 'an entity is not required to notify ASX of any information which it does not have, and thus would not be in breach of the Listing Rules in such a case.'[17]

(5) Should directors be required to disclose to the market (or to the company, which would then disclose to the market) particular events that have occurred since entry into the margin loan and, if so, what events (for instance, that a margin call has been made or that the market share price was within a certain percentage of the margin call strike price)?

Yes, there is a need for directors to disclose to the company (which leads to a disclosure to the market) of particular events that have occurred since entry into the margin loan.

(6) Should the market disclosure requirements apply to all directors or only to those directors who are also substantial shareholders?

The market disclosure requirements should apply to all directors of listed companies.

Generic approach to disclosure

(7) Should directors be obliged to disclose to the company their interests or arrangements regarding their shareholdings or other equity-linked interests in the company, including financing arrangements?

Yes, the directors of public listed companies should be obliged to disclose their interests regarding their shareholdings or other equity linked interest in the company.

(8) Should a company be required to disclose to the market all information concerning those interests or arrangements of directors that investors would reasonably require?

Yes, a company should disclose such information to ensure the transparency of the market.

HopgoodGanim Lawyers

The implications for market integrity of margin loans to directors

A critical tenet of market integrity is proper and accurate disclosure by those participants. Market integrity will not be served by blanket disclosure of interests and arrangements entered into by directors. The emphasis should be on disclosure of material interests and arrangements which may potentially affect the share price of the company.

Should there be specific regulation of the process of entering into margin loans by directors?

If so:

Should it be left to individual companies to set the conditions under which directors can enter into margin loans?

The ASX and ASIC in their joint companies update 02/08 sets out that ASX Listing Rule 3.1 'in appropriate circumstances, may operate to require the entity to disclose the key terms of the arrangements, including the number of securities involved, the

[17] ASX, *ASX Guidance Note 22: Director Disclosure of Interests and Transactions in Securities - Obligations of Listed Entities*, para 8.

trigger points, the right of the lender to sell unilaterally and any other material detail. Whether a margin loan arrangement is material under listing rule 3.1 is a matter which the company must decide having regard to the nature of its operations and the particular circumstances of the company'.

A company's share price could potentially be affected by a directors' margin loan where a margin call has been made. In this respect individual companies should have the ability to comment or otherwise have input on the conditions under which directors can enter into margin loans. We suggest that this can be achieved by encouraging companies to set out in writing its policies relating to how it will set the conditions under which directors can enter into margin loans and what factors will be relevant to setting such conditions for example, trigger events etc. This may be achieved through ASX requiring such written policies as part of the ASX Corporate Governance Principles and Recommendations.

Should the legislation require company approval before directors can enter into margin loans?

No, such a legislative requirement would be overly burdensome on companies in terms of compliance with a statutory requirement to disclose personal affairs of directors. Companies should have written policies on margin loans by directors which should give guidance to directors on matters such conditions of margin loans etc.

Should the legislation impose limitations on margin loans to directors?

No, it should be left to the individual companies to decide any pre-requisites or limitations that directors should be mindful of when entering into margin loans. This should be set out in a written policy by the company on margin loans by directors as part of their broader adherence to good corporate governance practices. Individual companies would be best placed to decide appropriate pre-requisites and limitations having regard to its operations and particular circumstances.

Should the legislation prohibit margin loans to directors?

No, allowing directors to hold shares in the company is an acceptable way to incentivise director performance. Prohibition of such a practice would remove a measure available to companies to incentivise their directors.

Disclosure by directors to the company

Should there be specific requirements for directors to disclose to the company that they have entered into margin loans?

If so:

Should it be left to individual companies to set the disclosure requirements?

Yes, it should be left to companies to set the disclosure requirements in respect of directors' margin loans. In addition to the clarification in ASIC/ASX companies update 02/08 in respect of directors' margin loans, companies should be encouraged to set out in writing their policies for dealing with margin loans by directors as part of their broader adherence to good corporate governance.

Should the legislation require disclosure of entry into a margin loan?

No, there is no need to introduce legislation to this effect. ASIC/ASX companies update 02/08 is instructive in this regard. The emphasis should be placed on disclosure of material information and not just the mere entry of a director in a margin loan.

Should the legislation require disclosure of the details of a margin loan?

No, this should be left to individual companies to decide the disclosure requirements and whether the details of a directors' margin loan are material and therefore should be disclosed and we refer to the clarification in the ASIC/ASX companies update 02/08. Regulators should balance disclosure against concerns such as disclosing information that would enable short selling of a company's securities and the disclosure of a director's personal affairs. A company's decision to disclose details of a margin loan will be based on materiality having regard to the company's operations and circumstances.

Disclosure to the market

Should there be specific requirements for directors to disclose to the market that they have entered into margin loans? If so, what information should be disclosed (for instance, that the director has a margin loan, the number of shares subject to the loan or other details of the loan such as the circumstances in which a margin call could be made)?

No, this should be left to individual companies to formulate a policy by which the company will decide whether the terms of a margin loan by a director are material and therefore should be disclosed.

Should directors be required to disclose to the market (or to the company, which would then disclose to the market) particular events that have occurred since entry into the margin loan and, if so, what events (for instance, that a margin call has been made or that the market share price was within a certain percentage of the margin call strike price)?

We agree that there should be disclosure of particular events which have occurred such as a margin call, however this should be left to individual companies to formulate a policy by which directors are required to disclose to the company material events to be disclosed to the market for example such events which have occurred which could potentially affect the share price. The level of detail which will need to be disclosed needs to be considered carefully. Guidance from the ASX would be instructive.

Should the market disclosure requirements apply to all directors or only to those directors who are also substantial shareholders?

The market disclosure requirements should only apply to those directors who are substantial shareholders of the company or who otherwise hold such number of securities in the company that its sale in response to a margin call could materially affect the market price of the company's shares. The criteria should be enumerated and set out in a company's policy on directors' margin loans.

Where market disclosure requirements are to apply to all directors, this could significantly add to the compliance cost of companies.

Generic approach to disclosure

Should directors be obliged to disclose to the company their interests in or arrangements regarding their shareholdings or other equity-linked interests in the company, including financing arrangements?

Yes, however we would suggest that in order to provide clarity to companies there should be guidance on what thresholds will trigger such an obligation to disclose. There should be an emphasis on an obligation to disclose such interests or arrangements which may potentially affect the share price of the company, if the interest is insignificant or does not have the potential to affect the share price of the company than there is little value in its disclosure to the company and the market. Guidance from ASIC and ASX in this respect would be instructive. Section 205G of the *Corporations Act* requires a director to notify the market operator of his or her shareholdings. This could provide the basis for any further appropriate disclosure that will need to be made.

Should a company be required to disclose to the market all information concerning those interests or arrangements of directors that investors would reasonably require?

Yes, but as above, we would suggest that there should be guidance in respect of what will trigger the requirement for directors to disclose.

Regnan

Legislation should prohibit margin loans to directors

Regnan is opposed to directors holding margin loans over shares in their own company, and believes that such a practice should be prohibited under legislation. Regnan holds this position because directors holding margin loans over their own shares detracts from market integrity in two ways. First, the propensity for large director share holdings to be liquidated by margin calls has been shown to drive share prices down to artificially low and fundamentally damaging levels. Second, a director's ability to act in the best interests of the company, i.e. fulfilling their fiduciary duty, may be compromised when there is an incentive to manage the share price upward such that a margin call is avoided regardless of the size of the share parcel.

Some may argue that the temporary drops in share prices associated with director margin calls over large parcels of shares do not cause lasting damage to shareholder investments in a company, because over time the share price will return to a level that reflects the fundamental value of a company. This may be true of temporary price drops in isolation. However several examples in 2008 (for example Babcock & Brown, ABC Learning Centres) have demonstrated that temporary price drops resulting from margin calls being made on large director share holdings (or even the threat of price drops resulting from margin calls being made on large director share holdings) can trigger or contribute to a series of events that do cause lasting damage to a company. Damaging events which may be caused by temporary price drop resulting from a margin call over a large parcel of director shares include; A fall in investor confidence in a company's directors and/or management if investors perceive senior executives or directors giving priority to their own finances over the best interests of the company by allowing themselves to be margin called, A fall in investor confidence in a company's directors and/or management if investors perceive that senior executives or directors are reckless in their personal financial affairs, Banking covenants may be triggered if a company's share price drops below a certain level regardless of the reason behind the drop.

In addition, investors with a short-term focus may seek to profit from short term price drops associated with margin calls over large director share holdings, and deliberately drive down a company share price in order to trigger a margin call. The unfortunate result of this short term profit by a single investor is long term damage to a company's fundamental value as detailed above in [the previous paragraph].

While [the previous two paragraphs] outline the risk to long term company interests posed by directors holding margin loans over large share holdings, it also needs to be acknowledged that margin loans of any size also pose a threat by compromising a director's ability to carry out their fiduciary duty to the company. The proposition that it is beneficial for directors of a public company to hold shares because of the alignment of interest between directors and other shareholders is valid. However the extension of this argument used to justify the use of margin loans to facilitate directors increasing their exposure to the company is not valid. The 'cliff-face' nature of margin loans, whereby if the share price falls below a certain level then a margin call is triggered, in fact acts to misalign directors with other shareholders. This is because of the conflict of interest that then exists between a director's personal financial affairs and the interests of the company (and by extension other shareholders). It is reasonable to expect that a director with a margin loan over company shares may feel pressure to manage a company share price upward in the short term to avoid a margin call. In particular, this pressure may consciously or unconsciously affect a director's willingness to disclose negative information to the market and enthusiasm for disclosing positive information to the market.

The extent to which directors would be restricted in their shareholders as a result of not being able to increase their exposure via margin loans is considered appropriate, given the additional risks that such holdings carry and as outlined in [the previous three paragraphs] above.

The argument that prohibition of a director margin loans is an unacceptable impact on their freedom to invest is not compatible with the premise that a director must abide by their fiduciary duty to the company. This fiduciary duty also distinguishes the situation of a director holding a margin loan over company shares from that of another investor holding a margin loan over company shares – the key difference being that the director has a fiduciary duty to act in the best interests of the company while the other investor does not.

It must also be recognised that while directors continue to hold margin loans over their own company shares, then the uncertainty surrounding margin calls from an insider trading perspective remains. There have been observed instances in 2008 where directors' shareholdings were allegedly subject to margin calls immediately prior to the company releasing bad news, which raises the question of who initiated the sale of shares. Were it the directors themselves who initiated the sale then they would by definition be guilty of insider trading under Australia's Corporations Act. It has also been anonymously suggested that some directors in 2008 'talked down' their own share price to deliberately trigger margin calls allowing directors to exit their exposure to a company without having to take responsibility for the sale. This second scenario still has the potential to carry with it the crime of insider trading under

Australian law because the downward management of the share price can be argued to have been a form of procurement.

In the event that legislation does not prohibit margin loans to directors

Should directors holding margin loans over shares in their own company not be prohibited via legislation, then it is Regnan's view that it should be legislated that directors must seek company approval at board level prior to entering into any margin loans, during which full details must be disclosed to the board to enable an assessment of whether such a margin loan materially threatens a company's share price or compromises a director's ability to carry out their fiduciary duties. In addition, companies should also be required to disclose margin loan details of individual directors to the market (including # of shares lodged as security) minus details on the trigger price.

If margin loans to directors are allowed, then it is appropriate that legislation require a company board to consider the risks outlined above in 2.1 and only approve margin loans in circumstances that the board considers company interests are not materially impacted. This is because board deliberation will assist in protecting a company against individual directors' errors of judgement which may lead to a realisation of the risks outlined above [under **Legislation should prohibit margin loans to directors**]. Legislation requiring full disclosure of <u>all</u> details of directors' planned margin loan arrangements is essential to this process, because without all details a company board cannot effectively assess all risks posed to company interests by a director margin loan.

It is also appropriate that the company then disclose to the market details including the director concerned, and the number of shares lodged as security, for all margin loans held by directors. A period of five days from entry into the margin loan is considered a suitable timeframe within which companies should be required to notify the market (consistent with ASX Listing Rule 3.19B). This should enable all investors to assess associated risks to the company (as outlined [under **Legislation should prohibit margin loans to directors**]) without providing the trigger price necessary for short-term focused investors to launch a sophisticated 'attack' on the share price in an attempt to trigger a margin call.

Jim Berry

Companies need to make arrangements with directors under ASX Listing Rule 3.19B to ensure the all directors discloses to the company all the information on the director's trading required under ASX Listing Rule 3.19A. This was introduced in September 2001 and caused, over a period of several years, a dramatic improvement to the quality and timeliness of director's trading information disclosed to the market.

A requirement that the Company makes arrangements with its directors that the Company must authorise a director entering into any margin loan or mortgage involving the company's securities, would ensure that the company takes responsibility for the issue.

A provision that the notifiable interest of a director was the subject of a mortgage or margin loan could be added to the Appendix 3X, Y and Z of the Listing Rules. The forms could also provide details of when the Board approved the arrangements. These details would provide information to the market if a director's notifiable interest were the subject of a lien. I have not given consideration as to whether ASX would agree to such a change.

It seems strange that the market is not currently informed when a lender exercises his lien and sells the securities. A lender exercising his lien may seek to sell in quite a different manner to a director selling securities. The control of the sale instructions is exercised by the lender and not the director. Surely this is information that investors require in order to understand market transactions. Accordingly, amending Appendix 3X, Y and Z to advise when a lender exercises his right to sell securities would be beneficial.

A carve out for the director against a charge of insider trading should be created where a lender exercises his right to sell the securities.

If a director receives notification that a lender has or intends to exercise his right to sell securities, a requirement is needed that the market be informed within 24 hours.

Australian Employee Ownership Association

The disclosure of margin loans by directors should be a requirement of the corporate constitution approved by the regulator not by the company, a securities exchange or by the law.

Full disclosure of any and all equity related arrangements is desired to both the company and the market as would be accepted and desired by members of an Employee Share Ownership Plan (ESOP).

ABA

Shareholdings by directors has long been held to promote market efficiency by directly aligning the interests of directors with those of the company's shareholders. We believe that margin lending and other funding arrangements can form an important part of share purchase arrangements. Therefore, directors should not be prohibited from borrowing to purchase shares in their company. However, directors are in a unique position in that they have a legal obligation to exercise care and diligence and act in the best interests of the company[18] as well as they can have access to company information, including price sensitive information.

The ABA notes that in February 2008, ASIC and the ASX issued an update reminding companies that where a director of a company has entered into a margin loan or similar funding arrangement for a material number of securities, ASX Listing Rule 3.1 may operate to require the company to disclose the key terms of the arrangements, including the number of securities involved, the trigger points, the right of the lender to sell unilaterally and any other material details. Furthermore, the update emphasised that whether a margin loan arrangement is material is a matter which the company must decide having regard to the nature of its operations and the particular circumstances of the company.[19]

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18 Sections 180 and 181 of the Corporations Act.

19 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/MR%2008-37.pdf/$file/MR%2008-37.pdf

The ABA believes:

- Directors of the company must disclose to the Board any material personal interest they may have in a matter that relates to the affairs of the company.[20]
- Directors of the company must disclose to the Board their relevant interests in the company, including shareholdings, other equity-linked interests, and margin lending and other funding arrangements, as well as provide all details concerning the operations of those interests. Boards and companies must possess all relevant information about the margin loan or similar funding arrangement to assess whether it constitutes a substantial shareholding. Boards should determine when margin loan arrangements are material to the company and therefore warrant disclosure to the market.
- Companies should have a policy on trading by directors in their company's shares.[21] The policy should oblige directors to disclose to the company the necessary information required for the company to assess whether a margin loan or other funding arrangement constitutes a substantial shareholding. The policy should also include details of any specific restrictions or conditions a company may impose on its directors entering into margin loans or other funding arrangements.[22] The policy should also include procedures to ensure adequate mechanisms for oversight and compliance with the policy. The policy or a summary of the policy should be made public (i.e. disclosed on the company website and/or in the company annual report).
- Companies must disclose to the market any substantial interests held by a director in the company's shares and any material changes to those interests or arrangements.[23] Companies should disclose to the market a statement as to whether a director has a margin loan or other funding arrangement that is material to the company as well as information concerning those interests or arrangements.[24]

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20 Section 191 of the Corporations Act.

21 The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* state that companies should establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy (Recommendation 3.2).

22 Companies should disclose in their policies whether margin loans are prohibited or restricted by directors, for example, a company may impose a restriction on the use of the company's shares as security for the loan unless the director can demonstrate financial capacity to repay the loan or meet a margin call without resorting to the forced sale of the pledged shares.

23 ASX Listing Rule 3.19A requires disclosure within 5 business days. The ABA notes that section 205G of the Corporations Act requires disclosure within 14 days. The ABA also notes that section 671B of the Corporations Act requires disclosure of substantial shareholdings within 2 business days. The statutory obligations and ASX Listing Rules should be aligned to 2 business days, with the exception of dividend reinvestment plans (DRPs) where the obligation should remain at 14 days.

24 Boards should exercise judgment in deciding whether the shareholding and margin loan arrangement is material in the particular circumstances, and accordingly, how the company is to meet its disclosure obligations under the law.

It is important to balance informing the market about margin loans by directors and maintaining the privacy of directors. The disclosure requirement should align with the substantial shareholder regime (section 671B of the Corporations Act).

- Companies must immediately disclose information that a reasonable person would expect to have a material effect on the value of the company's shares.[25]

The ABA does not believe it is necessary to impose additional legal or regulatory obligations through the Corporations Act. Rather the ASX Corporate Governance Council should amend its *Corporate Governance Principles and Recommendations* to explicitly include guidance on companies establishing a policy concerning margin lending and other funding arrangements by directors and senior executives. We suggest that Recommendation 3.2 and commentary be amended.

This approach would ensure that Boards and companies have the flexibility to decide what is material to the company, which is particularly important in volatile market conditions. This approach also recognises that Boards are best placed to judge whether a margin loan or other funding arrangement is material giving consideration to the circumstances of the company and the nature of its operations. This approach also ensures that Boards are able to apply the guidance appropriately to their company, yet does not compromise a consistent approach across listed companies.

However, this approach would not require companies to disclose to the market certain specific details about the margin loan or other funding arrangement of its directors and senior executives. Certain specific details being disclosed to the market (e.g. circumstances in which a margin call could be made) may have adverse and perverse affects. It is important to balance enhanced disclosure of margin loans by directors with providing too much information, which could be exploited and result in manipulative trading.[26]

The ABA believes that standards applied to directors should also apply to senior executives of companies and similar persons in similar entities, including listed managed investment schemes.

With regards to margin lending by directors, the ABA notes the following:

- Commentary on directors' margin loans made by the Australian Institute of Company Directors (AICD);[27] and
- Commentary on directors trading and margin loans made by the Investment and Financial Services Association (IFSA) and the Australian Council of Superannuation Investors (ACSI).[28]

ASA

The ASA identified a need to address the issue of the implications of margin lending by directors and executives of listed corporations in early 2008. Several high profile cases involving directors of listed corporations which have subsequently failed bought this issue to the attention of retail shareholders.

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25 ASX Listing Rule 3.1.

26 The ABA notes that if the market price of the shares that would trigger a margin call is known to the market, certain traders could target a company where a director has a margin loan or other funding arrangement to deliberately force the share price down to trigger a margin call and potential sale of the shares.

27 *Position Paper No 9: Director margin loans*. 21 July 2008.

28 *Joint Statement by IFSA and ACSI on Market Integrity and Efficiency*, 28 March 2008.

In June 2008 the ASA released its policy, *Margins Loans: Directors and Executives* which is appended to this submission (Appendix A). Many of the responses raised in the CAMAC issues paper were considered at the time, including imposing a regulatory requirement for disclosure of margin loans relating to holdings over a specified proportion of the issued capital of the corporation.

Chartered Secretaries Australia suggests a threshold of a 5% holding, at which not only directors but other substantial shareholders would be required to disclose their holdings. The ASA consider such a requirement to be arbitrary and not directly linked to the materiality of the lending.

The ASA policy is best reflected by part 1.7 of the issues paper, with directors to disclose their equity interests including any financing to the company, with the company then responsible for deciding whether those interests and arrangements need to be disclosed to the market. ASA policy extends requirement not only to directors, but also to executives of the corporation.

Appendix A: ASA Policy Statement

Margin Loans: Directors and Executives

Background

Margin lending is a form of gearing whereby the shares purchased with the loan are the subject of a mortgage in favour of the lender. Because shares are more volatile than other property, margin lenders limit the level of gearing to a set percentage (known as the Loan-to-Value Ratio or LVR) of the value of the shares. Commonly, LVRs are set at a maximum of 70%. The difference which is known as the 'margin' is made up by the borrower's own collateral.

Company directors and executives are not restricted from entering into margin loans with respect to the stock of that company. However ASX Listing Rule 3.1 requires an entity to disclose information with regard to margin loans that 'a reasonable person would expect to have a material effect on the price or value of the entity's securities'.

Disclosure of margin loans to directors and executives might cause companies to become prey to opportunistic buying and selling. However failure to disclose could mean that information about specific loans becomes insider information circulating amongst a minority in the market, allowing those insiders to obtain an advantage over other investors.

In the event of a margin call it is likely that some underlying performance issue, real or rumoured, has already caused the value of the company to decrease. These losses of value however are given further momentum by the increased supply of shares caused when a director or executives significant share holding is sold to meet a margin call.

There are risks, which are largely outside of the control of the company, inherent in allowing margin borrowing by executives and directors over the company's stock. The benefits which accrue to shareholders from this practice are small. Although there may be virtue in tying directors/executives financial fortunes to the company in some circumstances, this can and should be achieved without entering into margin loans.

The ASA Position

1. Full details of any margin loans entered into by directors and executives, including triggers for margin calls, should be disclosed to the board. The

board must, if circumstances demand, meet its appropriate disclosure obligations in accordance with ASX Listing Rule 3.1.

2. Listed companies should have a policy with regard to directors and executives entering into margin loans. In formulating such a policy the board should consider the risks which may arise as a result of the duty to publicly disclose information about such loans, the short and long term business environments in which the company operates and the size of potential holdings the subject of any loan.

3. Directors and executives need to take into account both the duty to disclose and the potential negative effects which could arise from margin calls being made when deciding whether it is appropriate to enter into a margin loan over company securities.

Finsia

It is difficult under the current regulatory regime to know the exact extent of margin lending to directors in respect of shares in the companies of which they are directors. Without accurate information about the extent of margin lending, it is not possible to assess realistically the impact a prohibition would have on directors' share acquisition behaviour. While prohibition would remove one means for a director to finance the acquisition of the company's shares, it would not prevent other financing arrangements.

Finsia favours greater disclosure and clearer legislative obligations in this area. In particular, the current ambiguity about whether s 191 and s 205G impose disclosure obligations in relation to margin lending arrangements should be resolved. Finsia supports requiring all directors to disclose to the company (and listed companies to the market), within two to five business days, the entry into a margin loan and the number of securities subject to the loan. Subsequently, the fact that those securities have ceased to be subject to the margin loan should also be disclosed, whether due to (third party or personal) disposal of the securities, paying out the loan, or otherwise.

IFSA

Margin lending is a long established practice available to directors and investors. Where used as part of an investment strategy margin loans can provide various advantages and consequent benefits to directors. However, utilising a margin loan facility is, like any investment, not without its risks.

Public confidence in a company can be eroded if there is insufficient disclosure and monitoring of trading and exposures relative to company shares by parties who may be viewed as 'insiders'. Companies must develop, enforce and monitor policies on director and executive trading in accordance with the Corporations Act 2001 and which reflect their own circumstances. The policies should include appropriate restrictions and disclosure regarding margin-lending arrangements over the company's stock.

Companies, directors and senior management must comply with the Corporations Act 2001 regarding use of insider information while trading in company shares. Disclosure of director trading must also be in accordance with the law and the ASX Listing Rules.

We note that there is ongoing concern regarding the disclosure of executive and director share trading, including margin lending. Companies must develop, monitor and enforce their policies on director and executive trading. The policies should be available to shareholders on request and should be disclosed on the company website. Companies must ensure that there is a high level of transparency regarding director and executive trading to ensure that inappropriate behaviour is not taking place or perceived to be taking place. Inappropriate trading behaviour, or the perception of such behaviour, has the ability to undermine shareholder confidence and impact on company performance.

The Company share trading policy should also specifically provide guidance regarding restrictions and disclosure about all directors and executives entering margin lending or other lending arrangements over the company's stock, particularly where the holdings and/or exposures are material and when these arrangements should be publicly disclosed. This should also include guidance regarding suitable margin lenders (i.e. not related parties) and managing trigger points for margin calls or forced sales.

These requirements are all stipulated in IFSA's forthcoming 2009 Blue Book.

IFSA recommendation

Given the current requirements included in the Corporations Act 2001, IFSA Blue Book, ASX listing rules and governance principles we believe that the current principles based regulatory approach to margin lending by directors is adequate.

Harris & Legg

The use of margin loans by directors

The Minister's letter and press release seek guidance on how margin lending by directors should be disclosed, if at all.

Corporate governance theory and practice generally accepts that the remuneration of directors and officers should be structured to build and maintain enterprise value.[29] This is traditionally seen as aligning the interests of directors and officers with those of the shareholders. On this view, a central problem for corporate regulation is how to efficiently manage and reduce the agency costs that arise between the shareholders as providers of capital and the directors who supervise the management of that capital.[30] One mechanism that is commonly used is to provide equity-based compensation to directors and company executives. The underlying assumption is that directors and officers (as managers of capital provided by shareholders) will have an incentive to promote the overall success of the business because this will increase the value of holding shares in the business (both through capital gains in share price and through dividend distributions over time). The theory of executive compensation is particularly concerned with avoiding executive focus on the company's short-term

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29 See ASX *Corporate Governance Principles and Recommendations*, 2nd ed, 2007, Principle 8.

30 Michael Jensen and William Meckling, Theory of the firm: managerial behaviour, agency costs and ownership structure (1976) 3 *Journal of Financial Economics* 305.

share price.[31] It is therefore important to structure remuneration so that it promotes the medium and long-term prosperity of the corporation.[32]

Aside from the incentive to promote corporate value over individual rent seeking, equity compensation packages also provide a useful signalling mechanism to the capital markets which acts to reduce agency costs and thereby lower the cost of outside debt and equity.[33] Large share sales by directors send a signal (whether intentional or not) to the market that the director/manager believes there is more value in selling the company's shares than keeping them for the long term.[34] That is, by voluntarily holding shares in the company directors and officers send a signal to the capital markets that their view is that the future value of capital gains and dividend payments will provide greater personal utility than the value that can be obtained by selling the shares immediately. This signalling mechanism is based on the assumption that directors and managers have inside information that the market does not have.[35] Concerns about abuse of this inside information provide the basis for insider trading laws and continuous disclosure laws.

However, although directors and officers are generally encouraged to hold equity stakes in their corporations they also face difficult financing decisions by doing so. This is derived from the perspective of modern portfolio theory and the capital asset pricing model (CAPM). Using these perspectives, by holding large equity stakes in their corporations directors and officers leave too much of their wealth portfolio under the risk of the company failing. As directors and officers have already placed their human specific capital at risk by maintaining employment with the company, they arguably put too much of their wealth at risk by holding a large proportion of their wealth in the same company by significant proportions of shares. Whilst having 'skin in the game' is a key motivational factor designed to drive executive performance, individual directors and officers should have similar opportunities for risk diversification as ordinary shareholders and creditors, who are equally exposed to the risk of the company collapsing. This is justified on the basis that the ultimate success or failure of any individual company is unlikely to be significantly affected by any one individual person. Therefore, directors and officers may face financial ruin as a result of adverse external factors impacting on the company which are beyond their

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31 Recent corporate collapses such as Enron and One.Tel, and the even more recent problems associated with the development and distribution of risky complex financial instruments, demonstrate the problems with pursuing short-term share price gains and economic bonuses without due regard to long-term performance.

32 For a detailed discussion see Michael Jensen and Kevin Murphy, Remuneration: where we've been, how we got to here, what are the problems and how to fix them, (2004) *Finance Working Paper ECGI*. This paper can be downloaded without charge from http://ssrn.com/abstract=561305

33 See Michael Jensen and William Meckling, Theory of the firm: managerial behaviour, agency costs and ownership structure (1976) 3 *Journal of Financial Economics* 305, which argued that the cost of raising outside debt and equity would be determined in direct proportion to the risk of default by the internal managers as agents of the holders of new outside equity. Therefore, as insiders maintain a greater proportion of the firm's equity, this limits the risk of default as the adverse economic consequences of default are shared in greater proportions by the insiders. For a discussion of signalling theory and its application to executive compensation see Hamid Mehran, Executive incentive plans, corporate control and capital structure (1992) 27 Journal of Financial and Quantitative Analysis 539.

34 The signalling value of director trades is recognised by the ASX Listing Rules (LR 3.19A) which require disclosure of such trades.

35 For a discussion of the role of signalling and informational asymmetry see Stephen Ross, 'The determination of financial structure: the incentive-signalling approach' (1977) 8 *Bell Journal of Economics* 23; Milton Harris and Artur Raviv, 'The theory of capital structure' (1991) 46 *Journal of Finance* 297.

substantial control. The ability to use shareholdings in the company as security to obtain loan finance provides directors and officers with the ability to diversify their risk by using such funds for other investments. This in no way reduces the investment of human capital that they have made in the company. **On these grounds we do not advocate a universal ban on the ability of directors and officers to take out margin loans over their company shareholdings. However, we do argue that some measure of regulation is needed to promote an efficient market in the company's shares and allow investors to make appropriate decisions about the risks associated with investing in the company's securities.** We therefore make several recommendations on how the law could be amended to provide for more efficient capital markets with respect to the issue of director and officer margin loans.

Recommendation 1

1.1 Public companies listed on a licensed financial market should be required by law to develop an internal policy regarding the use of any facility by a company director or officer that enables that individual to divest themselves of the full and unrestricted beneficial interest in owning shares or other securities in the company.

1.2 The use or prohibition of margin loans by directors and officers, including any limitations on the size of margin loans (if any), should be a matter for each company and its board of directors to determine in accordance with the policy developed under Recommendation 1.1 and should not be subjected to legislative prescription.

1.3 Listed public companies should be required to disclose the existence of their internal policy as part of their periodic disclosure obligations in LR 4.10.

Recommendation 2

2.1 Directors and officers should be required by law to disclose information to the company that is relevant for the effective operation and enforcement of the company's policies regarding margin loans or other facilities that allow for the disposition of the beneficial interest in the company's securities by directors and officers.

2.2 This information would include, the existence of a margin loan or other transaction or facility that allows the individual to divest themselves of the full or partial beneficial interest in the company's securities held in their name or by an associate for their benefit. Secondly, where an event occurs which triggers a potential obligation to transfer those securities to a third party, such as a financier under a margin call, that fact should be disclosed to the company immediately or as soon as is reasonably practicable. Thirdly, where the director or officer has made a decision that affects whether the securities will be transferred to a third party, such as the decision to provide funds to meet a margin call rather than allow the financier to sell securities covered by the margin lending facility, that decision should be notified to the company immediately or as soon as is reasonably practicable.

2.3 We suggest that this new provision be inserted as a new s 191A, not as an amendment to s 205G.

Implications and justification of these recommendations

Recommendation 1.1

Currently there is uncertainty about whether or not companies have to disclose margin lending arrangements under the continuous disclosure rules. The joint press release in February 2008 by the ASX and ASIC assumes that companies may be required to do so. This recommendation therefore advocates imposing a statutory obligation on companies to develop systems to enable them to comply with this information where necessary.[36] Maintaining an internal policy against which director and officer conduct can be benchmarked provides a useful enforcement mechanism for both the company in relation to its external disclosure obligations and also for ASIC in investigating trades by company directors for potential insider trading and market manipulation.

Recommendation 1.2

In our view, the corporation (in consultation with its individual directors and officers) is the most appropriate body to determine how to find an appropriate balance between the desirability of directors being able to enter into margin loans and the ramifications of being in a position where the Corporation needs to disclose a margin call or similar facility under ASX LR 3.1. As a policy is used the number of shares or other securities that can be subject to margin loans etc may be specifically covered by the company so that appropriate safeguards can be put in place to minimise any adverse impact on the company. Of course, the company's directors and officers will continue to be bound by their duties to the company in respect of informing the company about any material personal interests (s 191) and to act in good faith and to avoid conflicts of interest (ss 181, 182). Furthermore, the setting of arbitrary limits or benchmarks on disclosure would not be beneficial as margin loans or other arrangement affecting the beneficial ownership of the securities may be material to the market assessment of those securities in some cases but not others. There are various factors that will contribute to the materiality of such information, including the number of the securities held by the individual, the proportion of those securities that are subject to the arrangements, the trading volumes in the company's securities, the dispersed or concentrated nature of the company's security holders and the company's capital structure.

Recommendation 1.3

This is a compliance measure designed to ensure that companies are putting in place mechanisms to deal with the peculiar corporate governance and capital market regulatory issues that these arrangements pose.

Recommendation 2.1

This is a compliance measure designed to ensure that individuals provide the company with sufficient information that it needs to implement and maintain its internal policies and its external disclosure obligations to the market. By installing this requirement in the Corporations Act 2001 (Cth) it sends a clear message to corporate managers that these disclosure issues are important to the market and are not merely matters of personal preference and privacy. This issue is discussed further below in the conclusion.

Recommendation 2.2

In our view, it is important not to limit disclosure to the use of margin lending facilities alone. The use of such facilities is a symptom of the broader governance issue of aligning the interests between managers and the long-term prosperity of the company by giving those managers access to any future benefits through the ownership of securities in the company. As noted by other submissions (see for

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36 See also the obligation under ASX LR 3.19B.

example Allens Arthur Robinson), the policy of such alignment is frustrated if directors and officers are able to use sophisticated derivative instruments or other techniques to maintain legal ownership whilst divesting themselves of beneficial ownership of the securities.[37] The key governance tool is to align these interests through access to the economic benefits that flow from owning shares and other securities in the company, not from merely owning the legal title to those securities. Therefore, disclosure obligations should not be limited to margin loans only but should include other arrangements that pose similar governance issues.

Furthermore, we recommend that the Act require directors and officers to disclose certain key information to the company.

This is a compliance measure that will assist the company with complying with its disclosure obligations. We have specifically targeted those events that are the most likely to generate issues for the company, that is entering into the arrangement, when a margin call is made and what the individual's intention is in responding to the margin call.

Recommendation 2.3

We argue that any amendment to the Act to impose further disclosure obligations on company directors should be inserted in Pt 2D.1 of the Act. Section 205G appears in Pt 2D.5 which is concerned with public information about directors. Our proposals do not include directors making public disclosure, but rather directors making limited disclosure to the company, which the company can - if it believes it is material - disclose to the broader market.

Conclusion

There is an argument that directors' financial arrangements for holding securities are not issues that arise in their capacity as directors of the company, but rather in their personal capacity. On this view, the existence of margin lending is not an issue for the company any more than the financial arrangements of other non-insider shareholders. However, directors and officers occupy a special position within the company and their holdings in the company's securities pose special issues that do not apply to outsiders, as noted above. In our view, this position of trust and confidence, and the strong signal that director trades send to the market makes the sale of directors' and officers' securities through margin lending or similar facilities an issue that the company should be aware of. If large numbers of directors' or officers' securities are being sold by a margin lender then the company has a right to know why its shares are trading at such volumes. Similarly if a director or officer has divested themselves of the beneficial to their shares which are supposed to act as a bonding mechanism, the company has a right to know. Any potential conflicts of interests which arise can then be dealt with under the company's internal policies.

Some have argued that disclosure of margin lending arrangements will target particular companies for the attention of hedge funds and short sellers. Examples have been raised from previous months including ABC Learning and Allco. However, one problem with both these examples (and no doubt many others) was that the market

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37 See the extensive literature on the phenomenon of hidden ownership and empty voting: Henry Hu and Bernard Black, 'The new vote buying: empty voting and hidden (morphable) ownership' (2006) 79 *Southern California Law Review* 811.

was kept uninformed about the reasons for increased trading volumes. Given that listed companies have continuous disclosure obligations, the recommendations above will provide those companies with the information that they need to comply with those disclosure obligations, if and when the nature of margin lending arrangements becomes material to the market. It may be that most cases of margin loans by directors will not be material to the market because of the nature of the arrangements, the size of the holding of securities involved and/or the company's trading conditions. Where the price starts falling 30% or more in a single day, and the market wonders why significant volumes of the company's securities are changing hands, it is important that the company understand why and explain to the market if it is material. The privacy of directors should not necessarily prevent a properly informed market from trading.

Accounting Bodies

Background – the rationale of director equity participation

Section 198A[38] of the Corporations Act 2001 provides that 'the business of the company is to be managed by or under the direction of directors'. This section, along with s 140[39] concerning the contractual effect of a company's constitution, establishes a clear division in corporate powers. Underlying this statutory formality is the notion that the company is a 'real-thing'[40] separate from its owners and controllers (the directors). This in turn, clearly allows, unless precluded by statute or the corporate constitution, the latter group having both an ownership and a management relationship with a corporate entity. Indeed Austin and Ramsay[41] note shareholding by managers/directors amongst fifteen mechanisms of corporate governance which operate with the objective of aligning the behaviour of directors with the interests of the company and its shareholders.

The contrast of views around the efficacy and the potential for perverse incentives of both executive remuneration and director shareholding is captured, in Austin and Ramsay's following remarks:

> Some commentators suggest that increasing managers' and directors' shareholdings in their companies provides them with the incentive to improve corporate performance. Other commentators suggest that high levels of such share ownership may simply entrench managers and directors.[42]

Over and above this controversy are more substantive matters pointed to in the Issues Paper at page 5, though there directed at the impact of margin loans:

- possible conflicts between directors self-interest and their fiduciary duties
- whether directors are placed in an untenable position under the insider trading regime

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38 Powers of Directors.

39 Effect of Constitution and Replaceable Rules.

40 Refer s 124 Legal Capacity and Powers of a Company.

41 *Ford's Principles of Corporate Law*, Butterworths, 13th ed 2007 at 7.620 & 7.630.

42 ibid at p 320.

- whether companies themselves are adequately informed of such arrangements, and in turn
- whether the market is adequately informed under the continuous disclosure regime.

Central to these issues is the extent to which established rules concerning director material personal interests, along with the numerous rules around remuneration and related-party transactions, can or should extend to the distinct factor of one specific, though controversial, means by which a director funds his or her equity participation.

The corporate governance objectives of market disclosures

Considering the aspect of a director's fiduciary relationship with their companies as a starting point, these are identified as part of general duties and powers; respectively under Corporations Act 2001 sections 182[43] and 183.[44] Whilst these duties are well understood, it is worth reiterating here the underlying general law or equitable character of these duties, particularly in terms of their enduring nature notwithstanding constantly evolving business practices. One of the more often referred to judicial descriptions of a fiduciary relationship is that provided Mason J:

> The principle is that the fiduciary cannot be permitted to retain a profit or benefit which he has obtained by reason of his breach of fiduciary duty. A fiduciary is liable to account for a profit or benefit if it was obtained (1) in circumstances where there was a conflict, or possible conflict of interest and duty or (2) by reason of the fiduciary position or by reason of the fiduciary taking advantage of opportunity or knowledge which he derived in consequence of his occupation of the fiduciary position.[45]

In general then, a fiduciary is a person who is under an obligation to act in another's interest to the exclusion of the fiduciary's own interest. A fiduciary cannot use their position, knowledge or opportunity to the fiduciary's own advantage, or have a personal interest in, or inconsistent engagement with a third party, unless fully informed and free consent is given. Against this well established understanding of the general law and how it is reflected in the law of directors' duties, the character of margin lending, and the triggering of trading, does present potential for conflict of interest damaging to both the company concerned and confidence in the market.

Outside of the Corporations Act 2001 Pt 7.10 prohibitions on trading by those possessing inside information, the treatment of a director's personal interests has tended away from seeking formalised consent, emphasising rather the attributes of timely and comprehensive disclosure to either other directors or members, and where appropriate, the wider market.

In the above context, adoption of *Option 2* (Prior company approval as a prerequisite of margin loans) described under 1.4.2 (Possible further initiatives) of the Issues Paper would seem, in our view, as being out-of-step with the manner in which rules have developed to contend with other aspects of directors' involvements with their

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43 Use of position.

44 Use of information.

45 *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41.

companies. Similarly, such response, it is urged, cannot be considered in isolation from the wider context of director and executive remuneration.

Minor amendment of section 205G

Absent compelling evidence that a blanket prohibition on margin loans to directors is warranted (1.4.2 *Option 4*), the most appropriate policy response, in our view, is that of incremental development or clarification of applicable market disclosure arrangements. The Issues Paper's discussion of s 205G in this regard is highly commendable and the following brief comments are made.

It is noteworthy that s 205G whilst falling within Pt 2D.5,[46] deals generally with aspects of conflicts of interests, though having at its origins concerns around the damaging affect of insider trading on individual companies and markets. As Austin and Ramsay observe:

> The Cohen Committee Report (1945) disapproved insider trading but recommended only a limited measure of control in the form of provisions to ensure that there would be publicity for transactions by a director in securities of the director's company. Those recommendations gave rise to legislation from which s 205G is derived.[47]

Whilst there has been only limited judicial and secondary commentary on s 205G, it is fair to conjecture that it is capable of being adapted to cover types of transaction and arrangement not directly contemplated at the time of its enactment, or the enactment of its antecedent legislation. Clearly if the 'notifiable interests' shareholdings are reportable to the market operator by a director, it is a reasonable incremental step for the underlying character of the financing arrangement to be likewise reported. Such development, we believe, is protective of the interests of both the company and its members, and will contribute to a better informed market.

It is suggested also that as part of achieving consistency across the various related parts of the corporate law and the continuous disclosure regime, corresponding clarification of the requirement of disclosure of margin lending arrangements be given in both s 191 and ASX Listing Rule 3.1.

Over and above minor amendment to s 205G to extend the interpretation or definition of notifiable interest to cover margin lending arrangements, it is further suggested that the s 205G(3) and (4) notification periods of fourteen days be significantly shortened – perhaps to two days to directly align with the counterpart company market disclosure requirement under ASX Listing Rule 3.19A.

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[46] Public Information about Directors and Secretaries.

[47] *Ford's Principles of Corporate Law*, Butterworths, 13th ed 2007 at 9.610 p 511.

3 'Blackout' trading by company directors

The submissions in this chapter are summarised in Section 3.5 of the report.

Australian Securities and Investments Commission

(1) The implications of blackout trading for market integrity

The issue of directors trading in securities in the blackout period has attracted the attention of commentators who have linked the practice to insider trading and called for the banning of trading by directors in the blackout period. Trading during the blackout period certainly creates a perception that directors are trading on the basis of inside information. It is this perception of unfairness that would appear to impact the overall confidence in integrity of the market.

However, the very fact that a director trades in securities during the blackout period does not mean that the director is engaging in insider trading. It is possible for the market to be fully informed during the blackout period, though audited figures have not been released. It is possible for a non-executive director not to have all the price sensitive information that the company has.

As noted in the CAMAC issues paper, the ASX has conducted a detailed analysis of trading by directors during blackout periods, based on disclosures by companies to ASX of directors' dealings. Of the significant number of trades reported in the blackout periods last year, only a relatively small number were conducted in breach of the company's blackout trading policy and to date none have been referred to ASIC for possible breach of the insider trading rules.

ASIC and ASX inquire into suspicious trading at or before the time of significant announcements to the market, whether or not they occur during a blackout period. ASX and ASIC will then investigate whether the trader is an insider. These reviews are more effective for identifying potential illegal trading activity by directors, than reviews of blackout trading.

(2) Would it be beneficial if the ASX Corporate Governance Council provided further guidance to companies about their approach to blackout trading and, if so, what guidelines might be appropriate

ASIC endorses the adoption of trading policies by companies, as recommended in the ASX Corporate Governance Principles and Recommendations. Clear and comprehensive disclosure of these policies would directly address market perceptions that directors are freely allowed to trade during this period whilst in possession of inside information.

One specific area where the ASX Corporate Governance Principles and Recommendations could be modified is to encourage greater disclosure to shareholders about when waivers from any blanket prohibitions on trading during the blackout period would be granted. The less discretion attached to the ability to grant these waivers, the less likely that there will be a perception of waivers being granted purely to give a director a trading advantage.

(3) Should a more interventionist approach be adopted

The adoption of a more interventionist approach raises a number of significant issues, as set out in Section 2.5.2 of the CAMAC issues paper. The questions raised by adopting a more interventionist approach (such as banning blackout trading or adopting the rules in the Model Code) are:

- whether the perception issues raised by blackout trading can only, or most effectively, be addressed through the adoption of such an approach; and
- whether the benefits of adopting such an approach outweigh any costs or disadvantages associated with it.

ASIC believes that these decisions are essentially decisions of policy, that are more appropriately made by Government.

ASX

ASX Market Supervision (ASXMS) announced in June 2008 that it would carry out reviews of trading by directors during Q1 and Q3 of each year. The rule framework created by listing rules 3.19A and 3.19B requires listed entities to disclose directors' interests in securities and transactions in securities within five business days. This framework complements the director notification requirements of Section 205G of the Corporations Act, under which a director has fourteen days in which to disclose relevant trading.

Using the data from the reviews of directors' trading, ASXMS also conducted reviews of trading by directors during the period between the close of books and the release of the entity's half-year and full-year results (defined as the 'blackout' period). This exercise was undertaken notwithstanding that there are no specific listing rules or legislation in relation to blackout trading.

Disclosure of directors' trading is primarily a matter of good corporate governance. Investor confidence in directors and the market can be undermined when there is active trading in contravention of the entity's publicly disclosed trading policy. Such trading may be indicative of breaches of other Corporations Act provisions, such as insider trading and directors duties, although this is not necessarily the case.

In respect of blackout trading, a careful reading of the publicly available data released by ASXMS does not support a conclusion that there is a high degree of non-observance with company trading policies. As stated in ASX's 11 December 2008 media release, ASXMS reviewed 1,418 trades during the relevant period (July - Sept quarter). Of these, 718 were identified as active trades occurring during the 'blackout' period. Of these trades, ASXMS identified 95 (13.2%) trades as potentially contravening the trading policies of the companies concerned. ASXMS wrote to 46 entities to ascertain whether a contravention of the trading policy occurred. The majority of responses indicated that the transactions did not breach the relevant trading policy because appropriate approval for the trade had been given. Only 15 (1%) trades contravened the company's trading policy.

A key outcome of ASXMS's review has been heightened interest in, and awareness of, the issues associated with directors who trade during blackout periods in contravention of their company's trading policy. However, the very small number of trades which actually contravene the company policy suggests that there may not be a market failure problem that needs to be addressed. Instead, there may simply be a need for companies to assess whether there is scope for more fulsome disclosure of the circumstances in which approvals have been given, pursuant to trading policies, to trade during blackout periods. ASX would welcome use of the appendices under ASX

Listing Rule 3.19A as an appropriate instrument through which to make these more fulsome voluntary disclosures.

Law Council of Australia

It is the Committee's view that no law reform is required in respect of company directors trading during blackout periods.

The ASX Corporate Governance Principles and Recommendations, together with the already established regulatory framework (e.g. prohibitions on insider trading, improper use of corporate position or information and market misconduct) adequately deal with this issue. Having said this, the Committee would support review by the ASX Corporate Governance Council of guidance currently given about trading during blackout periods.

Companies should be left to formulate their own policies (in accordance with the relevant ASX Corporate Governance Principles and Recommendations) which are appropriate to the size, structure and nature of the individual company. There are numerous and substantial difficulties (outlined in Section 2.5.2 of the Issues Paper) regulators would face in attempting to find a 'one size fits all' solution.

The Committee supports the ASX initiative of conducting quarterly reviews of directors' trading in the shares of their companies during blackout periods. This type of surveillance puts companies on notice that the ASX is actively monitoring directors trading patterns, prompting companies to advise directors to ensure they comply with the company's trading policies. The Committee encourages the ASX to continue this review process and regularly monitor and publish directors trading patterns during blackout periods.

Issues for consideration

What are the implications of blackout trading for market integrity?

It is the Committee's view that any perception that blackout trading has the potential to negatively impact on market integrity is readily overcome by the various ASX Corporate Governance Principles and Recommendations, ASX Listing Rules, statutory prohibitions and disclosure requirements that effectively regulate the issue of blackout trading. The Committee would like to point out that the 2008 ASX quarterly reports on directors trading during blackout periods was misreported in the media and that this report actually found that problem areas only account for a very small percentage of the relevant trades by directors in shares of their companies.

Would it be beneficial if the ASX Corporate Governance Council provided further guidance to companies about their approach to blackout trading and, if so, what guidelines might be appropriate? (Section 2.5.1)

The Committee would support the ASX Corporate Governance Council reviewing its guidance on trading policies and blackout periods to see if more useful guidance could be given. At present, the only reference to trading windows and blackout periods in the Corporate Governance Principles and Recommendations is a suggestion in section 3.2 that companies should '*identify whether trading windows or black-outs are used and if so, details of their application*'. The Committee would not object to a recommendation that companies adopt trading windows and black-out periods, with appropriate carve-outs and disclosures, for instance, by suggesting that companies should disclose when a director has been given a waiver to permit trading during a blackout period.

Should a more interventionist approach be adopted and, if so:

(a) how might that approach deal with the issues set out in Section 2.5.2

(b) should all or some of the requirements set out in the Model Code issued by the UK Financial Services Authority be adopted (Section 2.5.2)?

No, the Committee does not support a more interventionist approach. Further regulatory reform is not necessary for the reasons outlined above. The issues set out in Section 2.5.2 of the Issues Paper highlight the difficulties a more interventionist approach would encounter and provide support for the view that further regulatory reform is not appropriate. It is the view of the Committee that no international market has formulated a more effective legislative framework to deal with the issue of company directors trading during blackout periods.

Chartered Secretaries Australia

In relation to the second issue, in 2008 we published a Good Governance Guide on board share trading policies, that provides a policy position on trading in shares during corporate black-out periods. We have attached this as Appendix A.

The Corporations Act prohibits 'insider trading' generally and the ASX Listing Rules require notification of directors' dealings. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*, against which listed entities must report in their annual report, contains Recommendation 3.2, which states that: 'Companies should establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy', and Box 3.2, which provides 'Suggestions for the contents of a trading policy'.

CSA notes that different companies and different circumstances require different trading policies, but that irrespective of the terms of a company's policy on trading in company securities, the policy is subject at all times to the law on insider trading.

CSA believes that sufficient guidance is available to companies on the issues to address in a trading policy and that no further guidance is required in the ASX Corporate Governance Council guidelines.

For example, in 2008, CSA published a Good Governance Guide: *Issues to consider in developing or reviewing the policy on trading in company securities* (attached as Appendix A). This Good Governance Guide is a companion to an earlier one published: *Trading in company securities: summary of issues* (attached as Appendix B).

The 2008 Good Governance Guide sets out the:

- legal and regulatory context for a policy on trading in company securities
- purpose of a policy
- issues to address in a policy, including the prohibition on insider trading; directors' interests notification; clearance to deal procedures; awareness of and compliance with the policy; restrictions on trading; and the role of the company secretary.

The Good Governance Guide also notes that:

- a company's policy needs to explain how the company restricts trading in company securities that is in breach of legal and regulatory requirements; and the company's policy
- the board, senior executives and other internal or external persons who have access to inside information relating directly or indirectly to the entity need to be clear as to the risks that the entity's policy is meant to address and what consequences attach to directors, executives and employees from the company's perspective if the policy is breached.

CSA also notes that a company policy on trading needs to address whether exemptions of any kind will apply and in what circumstances. CSA believes that such circumstances should not extend beyond genuine hardship (CSA does not believe that a potential tax liability constitutes genuine hardship) or a court order or similar requirement. Furthermore, CSA believes that exemptions need to be approved by the board or the chairman but that if an exemption for genuine hardship or a court order or similar does not apply, the policy must not be silent on the issue but must state that any exemption is at the chairman's discretion.

The section on 'Restrictions on trading' in CSA's Good Governance Guide *Issues to consider in developing or reviewing the policy on trading in company securities* states that:

> Restrictions on trading in trading policies can be expressed as either black-out periods, or trading windows (see Good Governance Guide 3.1: *Trading in company securities: summary of issues*). Regardless of which approach is decided by the company, it is good governance to ensure that the company clarifies which restrictions on trading are in place. A policy that does not include either a trading windows or a black-out approach to restrictions will give rise to reputational risk, as the perception could arise that trading is permitted at certain times despite legal prohibitions on insider trading.

CSA supports the use of either trading windows or black-out periods and does not support a more interventionist approach to either. CSA notes that a windows trading approach would usually result in a ban on trading in black-out periods. Therefore, a windows trading approach should be just as effective as a black-out approach in the period from the end of a financial period to the release of results for that period. CSA believes that it is for the company to decide which approach is more suitable to the circumstances of the company.

However, CSA notes that any policy must clarify that, irrespective of whether trading occurs in a trading window or outside a black-out period, no trading can occur if it involves the use of inside information.

CSA believes that the ultimate issue is compliance with the law and that policies can assist the board, senior executives and employees to understand their compliance obligations and adhere to them. CSA does not support the adoption of requirements in the form of regulatory guidelines as set out in the Model Code issued by the UK Financial Services Authority. Under the Model Code, a 'restricted' person must not 'deal' in any 'securities' of a listed company at any time, whether or not during a black-out period, without obtaining in advance a 'clearance to deal'. A 'restricted' person is anyone discharging managerial responsibilities concerning the company, being directors and senior executives.

CSA notes that the requirement set out in the Model Code are aligned with the guidance provided by CSA in its Good Governance Guide. However, CSA believes that such matters should remain as guidance and not be regulated.

CSA also welcomes the attention by ASX on directors' trading in the shares of their companies during black-out periods. CSA notes that this attention has resulted in improvements in compliance and supports an ongoing review by ASX of this issue to enforce its importance.

CSA recommendations

CSA recommends that no further guidance on directors' trading in black-out periods should be required in the ASX Corporate Governance Council guidelines.

CSA recommends that it is for the company to decide whether trading windows or black-out periods are more suitable to the circumstances of the company. **CSA opposes** any further intervention in this regard.

CSA opposes the adoption of requirements in the form of regulatory guidelines as set out in the Model Code issued by the UK Financial Services Authority.

Juliette Overland

In summary, greater transparency should be introduced into 'black-out' trading by directors by incorporating specific recommended 'black-out' periods for listed company trading policies pursuant to Recommendation 3.2 of the ASX Corporate Governance Principles and Recommendations.

It is understood that the Minister has raised concerns about directors trading in company shares during 'blackout periods', at times when such trading is supposedly precluded. Such trading clearly has significant potential to result in breaches of insider trading laws.

Obviously, trading which occurs during 'blackout periods' (commonly the period elapsing between the closing of a company's books of account and the release of the company's financial results to the market) will not necessarily amount to insider trading. As noted above, insider trading only occurs where the six essential elements are present. However, trading during such periods is likely to have a negative impact on perceptions of the integrity of Australia's securities markets.

It is not appropriate to prohibit or restrict trading by directors or other designated officers of a company during any particular periods. This would be contrary to the approach taken under Australian insider trading laws, which draw no distinction between primary and secondary insiders, relying on an 'information-connection' rather than a 'person-connection'.[48]

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48 Most overseas jurisdictions make a distinction between the position of 'primary' insiders and 'secondary' insiders – see, for example: *See for example*, Canada (Securities Act, 1990, s 76(5)(a) to (d), s 76(5)(e) (Ontario)); the European Union (Directive 2003/6/EC, Insider Dealing and Market Manipulation (Market Abuse), Article 2 and Article 4*);* Germany (*Securities Trading Act*, 1994, s 13(1) and s 14(2) (Germany)); New Zealand (*Securities Amendment Act, 1988*, s 3(1) (NZ)); Singapore (*Securities Industry Act, 1986*, s 203(c) to (f) (MAS); South Africa (*Insider Trading Act, 1998*, s 1(viii)(a) and s 1(viii)(b) (South Africa)); the United Kingdom (*Criminal Justice Act, 1993*, s 57(2)(a), s 57(1) and (2)(b) (UK)); the United States (*Dirks v SEC*, 463 US 646 at 655(1983); *Shaw v Digital Equipment Corp*, 82 F.3d 1194 (1996); *United States*

However, in order that there is greater transparency and to better preserve confidence in market integrity, this issue would be best dealt with by amendments to the Corporate Governance Principles. As noted above, Recommendation 3.2 provides that listed companies should establish a trading policy, which should then be publicly disclosed. Although the Corporate Governance Principles currently recommend that the trading policy identify whether trading windows or black-outs are used, it does not specify recommended black-out periods. The Issues Paper has described various discrepancies and variations in black-out periods adopted by Australian listed companies. It is suggested that the Corporate Governance Principles be amended to specify recommended black-out periods to be used, so that a company with a trading policy which adopts different black-out periods would be required to specify this, so that the market and other interested parties are aware which black-out periods apply for that company. Additionally, where a clearance is available for trading by restricted parties during the black-out period, any clearances given should be disclosed in the company’s annual report, setting out details of the relevant director, the shares traded and the reason the clearance was granted.

Allens Arthur Robinson

We do not see any need to implement the concept of ‘blackout’ trading into law. We consider that security trading by directors is sufficiently regulated by existing, comprehensive and well-developed insider trading laws, disclosure requirements and directors' duties.

We consider that a ‘blackout’ trading requirement would not enhance the operation of existing regulations. Our view is that ‘blackout’ trading should remain a function of company policy. The circumstances of each company are different, so it is inevitable that a one-size-fits-all scheme will require the development of exceptions for those companies that do not fit. Section 2.5.2 of the Issues Paper highlights the complexities involved in attempting to draft ‘blackout’ trading periods into law.

We consider that a well-funded ASIC, supported by ASX, is best-placed to monitor and enforce existing insider trading laws, disclosure requirements and directors' duties in relation to security trading by directors. As noted in Section 2.4 of the Issues Paper, ASX conducts regular surveillance of directors’ trading in the securities of their companies during the period between the close of each company’s books and the release of its periodic financial results to the market. This surveillance reveals a very low level of contravention of security trading regulations.

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v O’Hagan, 117 S Ct 2199;and *SEC v Falbo*, 14 F.Supp 2d (1998)). The relevant tests vary between jurisdictions but, in general terms, primary insiders are those who possess inside information because of some connection with the relevant company (for example, directors, shareholders, employees and those who have a professional relationship with the company) and who have derived the inside information by virtue of that connection. Secondary insiders are those who possess inside information but have no particular connection to the relevant company. Most jurisdictions require that a secondary insider knowingly receive the relevant information directly or indirectly from a primary insider. Prior to 1991, a distinction between primary and secondary insiders existed in Australia, but this was abolished in the reforms which followed the Griffiths Report.

AFMA

(1) the implications of blackout trading for market integrity

'Blackout trading' sits within the context of insider trading and market manipulation regulation. The trading by directors in their own company's shares during sensitive periods and any other time must be in accordance with law in this area. Section 205G of the Corporations Act, together with the prohibitions on insider trading and market manipulation, are all directed to maintaining a fair and orderly market. Breaches of the law in this area are serious because they affect market integrity. It is important that there is effective enforcement of the law in this area and it is universally observed by market participants.

A perception by investors that there may be breaches of the law occurring because of trading during sensitive periods by directors, regardless of whether there is substance to such suspicions, damages the reputation of the market as a whole and undermines market integrity.

Given the existing level of stringent law regarding trading during sensitive periods, additional black letter law intervention is not warranted. However, more industry based guidance could assist directors in determining the best way to conduct trading in their own company's shares and provide reassurance to investors that appropriate systems are in place to consider justifiable reasons as to why approvals should be granted to directors to trade during blackout periods.

(2) would it be beneficial if the ASX Corporate Governance Council provided further guidance to companies about their approach to blackout trading and, if so, what guidelines might be appropriate (Section 2.5.1)

As noted in response to question (1) it is important that the reputation of the market is protected. The Principles can play a role in providing more assistance to market participants around blackout trading.

(3) should a more interventionist approach be adopted and, if so:

- **how might that approach deal with the issues set out in Section 2.5.2**
- **should all or some of the requirements set out in the Model Code issued by the UK Financial Services Authority be adopted (Section 2.5.2)?**

As noted in response to question (1) there is already stringent law governing trading by directors in their own company's shares. The Principles can play a role in providing more assistance to market participants around blackout trading. The FSA Model Code could be taken into account when framing appropriate industry based guidance that is consistent with the Corporations Act.

HopgoodGanim Lawyers

What are the implications of blackout trading for market integrity?

The implications of company directors and senior officers of publicly listed company's trading during 'blackout periods' can be far-reaching but this is often dependent upon the circumstances that surround such trades. As such, it is difficult to assess the impact and implication that trading during a blackout period has on a generic one size fits all basis. Furthermore, there may be circumstances that predicate trading during a blackout period and make it reasonable in the circumstances for directors and senior officers to trade during blackout periods, for example, the take up of entitlements under a rights issue or other offer.

Would it be beneficial if the ASX Corporate Governance Council provided further guidance to companies about their approach to blackout trading and, if so, what guidelines might be appropriate?

We believe there is some merit in the ASX's corporate governance guidelines offering guidance as to the acceptable behaviour with respect blackout trading particularly with respect to the following:

- The period of time which constitutes a blackout period and whether there are any forbidden/prohibited periods of trade;
- What individuals within the company are required to comply with blackout trading guidelines;
- What criteria and procedures do companies, its directors and senior officers need to satisfy before they can undertake a trade during a blackout period;
- What securities are affected by a blackout trading guidelines;
- What individuals within the company are permitted to grant waivers or approvals to trade;
- What the consequences of trading during a blackout period are from a regulatory perspective;
- What constitutes acceptable trading during blackout periods;
- What constitutes unacceptable trading during blackout periods.

It would be useful to offer companies further guidance as to how ASX intend to interpret trades undertaken during blackout periods and the procedures that companies can adopt to ensure compliance with ASX Corporate Governance Principles and Recommendations guidelines.

Should a more interventionist approach be adopted and, if so how might this approach deal with the issues set out in section 2.5.2.?

We agree with CAMAC that the ASX's Corporate Governance Councils voluntary approach together with the insider trading provisions and other market misconduct legislative provisions in the Corporations Act 2001 (Cwlth) which, are designed to deal with any underlying impropriety, are for the most part adequate to deal with inappropriate market trades. However, as noted above, greater guidance over acceptable blackout trading would be of assistance but a more interventionist approach should be approached with caution.

We have addressed some of CAMAC's questions raised in section 2.5.2 of the Issues Paper below:

Should all, or some, publicly listed companies be obliged to have a blackout trading policy?

If the ASX guidelines are sufficient the requirement for all publicly listed companies to have formally adopted and implemented blackout trading policies on a uniform basis seems unnecessary. Particularly, when the instance of blackout trading may not arise for all publicly listed companies.

The current administration of 'blackout' policies, as regulated by ASX Recommendation 3.2 appears to offer a pragmatic approach to the issue. More specifically, by recommending, rather than insisting, that publicly listed companies establish a blackout trading policy recognises that the requirements and resources of listed entities differ. Additionally, as noted in the Honourarable Nick Sherry's letter to CAMAC dated 19 November 2008, a company is required, in accordance with ASX Listing Rule 4.10.3, to address in its annual report any deviation from the Corporate Governance Principles and Recommendations including, the reason behind any such deviation. In our opinion this is a common sense approach to the issue and subject to the implementation of more prescriptive guidelines should be sufficient to monitor blackout trading together with the regulatory provisions in the Corporations Act which deal with any underlying impropriety.

Should the content of blackout trading policies be standardized?

As noted above, we believe there is some merit in having more prescriptive guidelines with respect to blackout trading and having more defined parameters with respect to points a) to e) above would be of assistance. However, forcing all publicly listed companies to implement standardised blackout trading policies ignores the differing circumstances of all the publicly listed companies.

The ASX should be sufficient to monitor corporate governance of its publicly listed companies and where warranted refer any corporate malfeasance to ASIC.

The legislation surrounding insider trading and market misconduct are adequate responses to share trading transactions which can affect market integrity. Any regulatory reform of blackout trading should support the existing legislative framework and not seek to supersede or replace it. A measured approach to this issue would the utilisation of 'please explain' letters by ASX in instances where there maybe questions with respect to a directors or senior officers of publicly listed companies that have traded during a 'blackout' period. If the trade in question falls within the prescriptive guidelines then the matter need not be taken further. If however, there are still questions over the trade that have taken place then ASX in conjunction with ASIC should rely on the existing legislative framework to handle such instances.

As such if a 'please explain' letter were to be issued it would not be unreasonable for companies to expect certain assurances from ASX that when issuing a response that these would not automatically get posted on the ASX platform as this could have unwarranted detrimental affects on the company at large. Particularly, where the trade in question arose due to the financial hardship of a director which may not have direct correlation to the companies financial position.

Should all or some of the requirements set out in the Model Code issued by the UK Financial Services Authority be adopted?

The prescriptive nature of the Model Code issued by the FSA appears to offer a common sense and pragmatic approach to the issue of blackout trading. Transplantation into the ASX's Corporate Governance Principles and Recommendations of some of the Model Codes use prescriptive guidelines with respect to the following would be of assistance:

Definitions of:

- Close periods;

- What constitutes dealing;
- Prohibited Periods;
- Dealings that are not subject to the guidelines – this in particular should offer significant guidance over what constitutes permitted trading during blackout period. It would also provide a fairer assessment of 'blackout' trading by distinguishing between acceptable and unacceptable blackout trading. Particularly, where the trade arose due to any one of the following:-
  - Take up of entitlement under a rights issue;
  - Acceptance of a takeover offer;
  - Transfer of Shares arising out of employee share scheme; and
  - Dealing where the beneficial interest does not change.
- Recommendation to use a 'clearance to deal' system – whilst it may not be necessary to go to the same lengths used in the Model Code the internal governance encouraged by the 'clearance to deal' system would benefit companies and regulators alike. It would assist companies by encouraging greater board transparency, which in the majority of publicly listed companies is actively undertaken already.
- Outlining what constitutes 'exceptional circumstances' – the recognition that directors should not be unduly burdened in circumstances of personal financial hardship is sensible.

The clarity offered by the prescriptive nature of the Model Code could be transplanted into the ASX's Corporate Governance and Principal Recommendations with respect to blackout trading.

AICD

Directors who trade with the benefit of inside information, in breach of the prohibition on insider trading, should be appropriately and swiftly dealt with under the existing law. However, the mere fact that a director has traded during a 'blackout' period will not necessarily indicate that the director has breached the prohibition on insider trading. There can be legitimate reasons why a company director would need to trade shares during a 'blackout' period and should be able to do so provided that the director does not possess inside information. For example, a director may need to dispose of shares during a 'blackout' period where they are experiencing financial hardship, or if the director is required to exercise an option during a 'blackout' period because the option expiry date falls during that period.

AICD considers that the existing continuous disclosure regime and insider trading prohibitions adequately deal with the issue of directors trading during 'blackout' periods and that further regulation of this area is not required.

AICD supports the introduction of a mechanism similar to the US SEC Rule 10b5-1 which allows directors and officers to structure future trading plans for non-discretionary share purchases (for example, the exercise of an option or receiving shares pursuant to a share plan) without those purchases being caught by the continuous disclosure regime or insider trading prohibitions (provided, of course, that the director or officer was not aware of price-sensitive information at the time that the plan was implemented).

AICD also supports the adoption of a Model Code by the ASX (similar to that issued by the UK Financial Services Authority but with amendments to reflect current Australian practices).

In accordance with Recommendation 3.2 of the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations, many listed companies have established share trading policies that restrict trading by directors and other persons who are likely to be in possession of 'inside information' by specifying trading 'windows' or 'blackouts' or both. Such policies may provide the board with a discretion to allow trading during restricted periods where a director's particular circumstances justify doing so.

AICD suggests that when boards exercise their discretion to allow a director to trade during a restricted period, companies should announce to the market that the discretion has been exercised. ASX should also consider requiring disclosure of such information, for example, by including an additional question in the ASX Appendix 3X (Initial Director's Interest Notice), Appendix 3Y (Change of Director's Interest Notice) and Appendix 3Z (Final Director's Interest Notice) Forms:

- Were the shares in question traded during a period where trading would not normally be permitted under the company's trading policy? and
- If yes, did the board exercise its discretion to allow the trade to proceed during the restricted period?

This disclosure would provide the market with comfort that the trade had taken place in accordance with the company's trading policy (even if the trade occurred during a 'blackout' period or outside of a trading 'window') and that the board had recognised that legitimate reasons existed to warrant the exercise of its discretion under the trading policy.

Regnan

Negative implications of blackout trading for market integrity

Share trading by directors, particularly active[49] share trading, during blackout periods as defined by the ASXMS[50] are detrimental to the company at hand and market integrity because of the perception risk of insider trading that accompanies such director share trade.

It is reasonable for investors to expect that between the close of a company's books and the release of half-year or full-year results, that directors would be in possession of inside information. Inside information in possession of directors during this time could range from general knowledge about the strength in performance of different divisions of the company, through to draft financial results. Even where a company's draft financial results are in line with investor expectations, a director's intimate knowledge of a company's performance can provide them with a conviction that the rest of the market is lacking. Although some may argue that it is not always certain that directors would be in possession of such inside information during blackout

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[49] 'Active' share trading being any instance where a director has made a deliberate decision to trade (either buy, sell or enter into contract), as opposed to 'passive' share trading where a trade has occurred as a result of a pre-determined plan such as a dividend re-investment plan or regular share purchase plan.

[50] The period between the close of a company's books and release of half-year or full-year results.

periods, it is only necessary for investors to assume that it is likely for directors to hold such inside information for perception risk of insider trading to arise. To argue that it is not likely for directors to hold such inside information regarding their own company during this time is false, because it implies that directors are uninformed about their own company. Were directors to be uninformed in such a manner, then investors would alternatively have a right to be concerned about the competence of those directors with whom they have charged the responsibility of overseeing their capital investment.

Perception risk of insider trading is damaging firstly to the company in which directors are actively trading during blackout periods. Such companies face reputational risk when they cannot convince the market of their integrity and commitment, and their directors' integrity and commitment, to good corporate governance practices.

More significantly from a market perspective, perception risk of insider trading is detrimental to market integrity because of the effect it can have on investor confidence; where market perceptions that directors and executives are able to profit from trading on inside information can damage investor confidence, creating the perception of an 'unlevel playing field' where certain investors are able to profit at others' expense. The resultant reduced market liquidity and lower share prices damage all investors, but particularly those such as superannuation investors who through large super funds remain exposed to the entire market over periods as long as forty years.

High frequency of active share trading by Australian listed company directors

ASX Market Supervision (ASXMS) and Regnan research have both highlighted the high frequency of Australian listed company directors.

Regnan research focusing on S&P/ASX200 company directors' trading in the 12 months to 30th September 2007 found a 15% increase in active director trading behaviour between 2004 and 2007 (see results below in Table 1).

Table 1 **Regnan Research on S&P/ASX200**	**# active S&P/ASX200 director trades during blackout periods**	**# S&P/ASX200 companies with active director trades during blackout periods**
2007 - 12mths to 30th September	48	23
2004 - 12mths to 31st December	42	20

More recently, ASXMS studies focusing on the first quarter (Q1) and third quarter (Q3) of the 2008 calendar year have shown that the behaviour of active share trading by company directors during blackout periods has continued to increase. Although the Q3 2008 results show an absolute decrease in directors actively trading shares during blackout periods from 795 down to 718, ASXMS point out in their own media release that this represents a relative increase from 42.7% to 50.6% of all active share trades by directors during the quarter (see results below in Table 2).

Table 2 ASXMS Research on all ASX Listed Entities	# active director trades during blackout periods	# companies with active director trades during blackout periods
2008 Q3 – 3mths to 30th September	718 (50.6%)	331
2008 Q1 - 3mths to 31st March	795 (42.7%)	381

When looking at the S&P/ASX200 subset analysis of ASXMS' research, 2008 Q1 alone contained 52 active S&P/ASX200 director trades during blackout periods. This represents an <u>8.3% increase</u> on the annual figure for 2007 (see [the first paragraph under **High frequency of active share trading by Australian listed company directors**] above) <u>despite</u> the fact the 2008 Q1 period only captures half the blackout periods captured by Regnan's 2007 study. Unfortunately ASXMS' 2008 Q3 report does not disclose the S&P/ASX200 subset results, so a proper comparison between Regnan's 2007 study and ASXMS' 2008 study cannot be performed.

It is also worth noting the severity of some of the active director trading during blackout periods found by ASXMS. The number of active director trades during blackout periods that ASXMS viewed as potentially contravening the relevant company's own share trading policy increased from 57 (7.2% of all active share trades during the quarter) in 2008 Q1 to 95 (13.2% of all active share trades during the quarter) in 2008 Q3. Following further investigation by ASXMS via contact with companies, confirmed contraventions of company share trading policies by directors were six in 2008 Q1 (0.7%) and 15 in 2008 Q3 (2.1%).

ASX Corporate Governance Council guidance

The ASX Corporate Governance Council *Corporate Governance Principles and Recommendations* Recommendation 3.2 should be extended to include a definition of blackout periods consistent with ASXMS' definition (see [the first paragraph under **Negative implications of blackout trading for market integrity**, above]), and outline the expectation that directors will refrain from actively trading in company shares during these times.

Regnan believes the above addition to Recommendation 3.2 is necessary to address the threat to market integrity posed by active director share trading during blackout periods (see [the second to fourth paragraphs under **Negative implications of blackout trading for market integrity**, above]), because a strong message to both companies and directors is needed to discourage this behaviour. It is not enough that weaker measures such as public comments by the ASX or other stakeholder groups on their own will be sufficient, given that active director share trading during blackout periods has been on the increase since 2004 and has continued to grow even after ASXMS began monitoring and commenting publicly on the matter (see [the third paragraph under **High frequency of active share trading by Australian listed company directors**, above]).

ASIC Involvement

Regnan believes that the risk to market integrity posed by directors actively trading during blackout periods (see [the section headed **Negative implications of blackout trading for market integrity**, above]), combined with the evidence of this behaviour's increasing frequency (see [the section headed **High frequency of active share trading by Australian listed company directors**, above]), requires the ASX to refer all instances of directors actively trading during blackout periods on to ASIC for investigation. In addition, ASIC should place a reverse burden of proof on to the directors themselves to demonstrate that they have not traded in their own company's shares whilst in possession of inside information.

Directors would be able to present their case by referring to their company's own compliance records, to demonstrate the governance exercised by the company prior to the trade for the purpose of providing assurance that the director was not in possession of inside information. Governance exercised may include a board-level review of the trade prior to approval being granted under a company's share trading policy.

Disclosure requirements in relation to directors' trading

Regnan believes tightening the s 205G of the Corporations Act to require changes in director interests be reported within two business days instead of the current 14 calendar days should not take place.

Regnan research has demonstrated a high level of non-compliance by S&P/ASX200 companies with both ASX Listing Rule 3.19B,[51] and with s 205G of the Corporations Act (see Table 3 below).

Table 3 **Regnan Research on S&P/ASX200**	**# S&P/ASX200 companies in breach of ASX Listing Rule 3.19B**	**# S&P/ASX200 companies in breach of s 205G of the Corporations Act**
2007 - 12mths to 30th September	97 (48.5%)	70 (35%)
2004 - 12mths to 31st December	123 (61.5%)	

However, as can be seen above slow progress is being made on improving compliance by companies (as obliged under ASX Listing Rule 3.19B) and directors (as obliged under s 205G of the Corporations Act).

ASXMS research focusing on Q1 and Q3 of the 2008 calendar year has also illustrated an improvement in compliance by companies and directors, as can be seen in Table 4 below.

Table 4 **ASXMS Research on all ASX Listed Entities**	**% director trades in breach of ASX Listing Rule 3.19B**	**% director trades in breach of s 205G of the Corporations Act**
2008 Q3 – 3mths to 30th September	13%	7%
2008 Q1 - 3mths to 31st March	6.4%	2.7%

Not only has there been a demonstrated improvement in the timely disclosure of changes in director interest since 2004, but the rationale of tightening a rule to address

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[51] ASX Listing Rule 3.19B requires changes in director interests to be disclosed within five business days.

existing non-compliance is flawed; if companies and directors are struggling to lodge changes of interest within five business days, surely non-compliance would only increase under a two business day regime.

Ultimately, Regnan believes five business days (as per ASX Listing Rule 3.19B) is an appropriate timeframe within which companies and directors should be required to lodge changes of interest. If non-compliance continues, then this should be addressed by better enforcement of the existing rules.

Another element of disclosure of changes in directors interests that needs to be addressed is the usefulness of existing disclosure to both investors, and to companies and directors. Regnan believes that the Appendix 3Y form should be revised to include a section that prompts the company to describe the governance exercised by the company (see [the second paragraph under **ASIC Involvement**, above]) and, in the case of atypical trades which would be most likely to be exposed to perception risk of insider trading, the rationale for the trade.

This disclosure would greatly assist in reducing perception risk of insider trading for all director share trading activities. Not only would investors (and ASIC) be better assured that companies are exercising appropriate governance over the share trading activities of its executives and directors, but a clear opportunity is provided to the director and the company to explain why certain trades (which from the outside otherwise appear egregious) have taken place. This is a practice that some directors and companies already abide by, however there are many instances where director trades are needlessly exposed to perception risk of insider trading when there is otherwise a perfectly reasonable explanation.

While it is understood that there may be privacy concerns around disclosing the rationale for the trade, directors and companies would remain free to determine when rationale is disclosed and what level of detail is disclosed. The more a trade is likely to be perceived as insider trading, the more a director and company might choose to disclose contextual information. Regnan can see no reason why there would be any sensitivities around disclosing the governance a company has exercised over share trading by its directors.

Regnan believes that the 'Nature of Change' box in the Appendix 3Y form could be altered to prompt for this extra information regarding governance exercised, and rationale for the trade.

Adams and Nehme

(1) The implications of blackout trading for market integrity

Blackout trading does have an impact on market integrity and helps to ensure that there is transparency in the market. It serves a similar goal to the continuous disclosure regime.

(2) Would it be beneficial if the ASX Corporate Governance Council provided further guidance to companies about their approach to blackout trading and, if so, what guidelines might be appropriate (Section 2.5.1)

Yes, this is reinforced by continuous disclosure regime and the ASX Listing Rule 3.1 and the three years study conducted by Professor Michael Adams and Professor Thomas Clark in relation to the 'Changing Roles to Company Boards and directors'.[52]

(3) Should a more interventionist approach be adopted?

No, there should not be a more interventionist approach.

RiskMetrics

We believe that improper share trading by directors is best dealt with under the current insider trading prohibitions and sections 182 and 183. Nonetheless, those provisions can be usefully supplemented by *ex ante* mechanisms:

- All listed companies should, consistent with IFSA and ACSI's position on margin loans, have in place blackout policies. This is also consistent with the approach of the ASX Corporate Governance Council's 'Corporate Governance Principles and Recommendations';
- It would be useful if the ASX could provide guidance as to key minimum requirements (along the lines detailed on page 21) such as in relation to the persons (directors and others) who should be subject to the blackout policy, the minimum adequate period for a trading blackout, when waivers will be granted by the company, and the appropriate person within the company to grant such waivers. The UK FSA Model Code is, as noted by CAMAC, a useful benchmark for these requirements;
- Blackout policies need to be supported by a disclosure regime that mandates the timely disclosure of information about share trading by directors and their companies to the ASX. We agree with CAMAC that the 14-day notification period in section 205G should be reduced (to 2 days as earlier recommended by CAMAC).

As will be seen from the above, the critical factor is the extent to which margin loans and share trading may adversely impact upon the discharge by directors of their statutory and general law duties to their companies. We believe that this can be addressed by the imposition of mandatory disclosure requirements on margin loans (which already has the considerable backing of ASIC and the ASX in terms of how the relevant statutory provisions and Listing Rules should be interpreted) and fine-tuning the current rules relating to blackout policies.

Australian Employee Ownership Association

(1) Trading blackouts are inconsistent with providing a fully informed market or liquidity for insiders and their financiers who may have financed their shareholdings that could include an ESOP.

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52 Michael Adams and Thomas Clark, Final Report: Changing Roles to Company Boards and directors (September 2007), <http://www.ccg.uts.edu.au/project_changingroles.htm>.

(2) The current trading blackout practices in Australia and overseas are based on the false premise that there is no asymmetric information when insiders are allowed to trade shares. Current practices do not recognise that the identity of who is trading shares can be price sensitive information that should be subject to continuous disclosure. For Trustees of an ESOPs to carry out their fiduciary responsibilities with due diligence they need to know the identity of any insider trading including those with business relations with the company like their own beneficiaries, other suppliers, contractors and customers, who have an intention of trading shares. All such stakeholders should be required as a condition of doing business with the company inform the company when they intend to trade its shares so that the market can be informed with their broker informing the counter party of any trade at the time any trade is to be made. All such stakeholder trades should then be on the public record by the time of settlement (3 days).

Jim Berry

It is quite evident that inside information varies greatly from company to company. Blackout periods often work on the incorrect assumption that the price sensitiveness commences upon the preparation of the financial statements. Instead, the regular preparation of management reports on revenue on a periodical basis (daily, weekly or monthly) is concrete information upon which the results of a company may be able to be calculated with some accuracy.

I believe recent events demonstrate that the blackout assumption is flawed. Revenue in many businesses appears to have rapidly slowed in September and October 2008 as the Global Financial Crisis rolled from one industry to another. Downgrading profits in February 2009 when revenue was under pressure 5 months earlier points out the frailty of a set blackout period. This example shows it is inappropriate to codify blackout periods as it provides false security to directors.

One of the key responsibilities of the Chairman should be to authorise or refuse securities transactions. This will require him to make enquiries at certain times as to whether trading should be approved.

A requirement that the Company makes arrangements with its directors that the Company must authorise all trading by directors involving the company's securities, would ensure that the company takes responsibility for properly monitoring trading by directors.

Appendices 3X, Y and Z may be modified to record when and who approved the transaction.

All trading approvals should be ratified by the board at the next available meeting.

In my experience some director's notices (Appendices 3X, Y and Z) are deficient or lack clarity in only a minor way, but the deficiency makes examination of the trading difficult. An example of this would be trading in small parcels at the end of trading on several days which is only disclosed on the director's notice as one purchase. These deficiencies erode investor confidence.

Some examples of this lack of clarity include

- The dates on the Notice do not accord with turnover reported on that date.
- Sales and purchases are combined into a net amount without separate disclosure.

- Prices on Notices are not in accord with transactions reported for that date.
- Amalgamation of several or many days trading onto one contract note which is not properly described on the Notice.
- Contract notes are delayed because the order is incomplete.
- Several brokers are used.

The problem is compounded as ASX does not publish Register of Sales (or Course of Sales) with broker IDs except to data providers after 3 days. As a result, an ordinary investor or the media cannot obtain trading data with broker ID from ASX in which to carry out enquiries.

Therefore, consideration should be given to require trading data including broker ID to be disclosed to investors or their advisors at a minimal cost.

A method to provide transparency to a director’s trading would be to amend Appendices 3X, Y and Z to require that broker IDs are provided for each group of transactions. The notice should detail for each trading date, the volume, price, consideration and broker IDs.

If ASIC or ASX notes that any Notice is confusing, deficient or defective then ASIC or ASX might have power to require the company’s auditors to provide corrected notices showing the corrected information. A request to complete new notices should be immediately disclosed to the market.

ABA

Banks and other companies have adopted trading policies for ensuring compliance with the insider trading laws and market manipulation provisions. Recommendation 3.2 of the *Corporate Governance Principles and Recommendations* requires a listed company to publish its policy concerning trading in the company’s shares by directors, officers and employees. Furthermore, while trading during ‘blackout’ periods may not be explicitly prohibited in the law, trading by directors may contravene the insider trading laws, market manipulation provisions, and statutory and fiduciary obligations for directors not to improperly use their position or company information for personal advantage.

Directors trading during ‘blackout’ periods could undermine the integrity of the market. A perception by investors that there may be breaches of the law can undermine investor confidence and the reputation of the market. Therefore, it is important to ensure that companies have in place policies that promote practices that maintain confidence in the governance of the company, including practices for addressing actual or potential incidences of illegal and unethical behaviours.

Directors that trade on price sensitive information and contravene the insider trading laws or market manipulation provisions should not be tolerated and should be prosecuted. However, a director trading during a ‘blackout’ period may not constitute a breach of the law. In exceptional circumstances, directors that do not possess price sensitive information should be able to trade. Exceptional circumstances could include:

- Where the director would suffer severe personal financial hardship;
- Where a court order is issued relating to the financial position of the director;

- Where the director participates in an employee share scheme or dividend reinvestment plan (DRP); and
- Where the director undertakes a transaction involving the exercise of an option or the uptake of qualification shares.

The ABA believes:

- Directors of the company that possess price sensitive information, or a person related to them, must not trade the company's shares or linked financial products during 'blackout' periods.
- Companies should have a policy on trading by directors in their company's shares. The policy should clearly identify what constitutes a 'blackout' period, prohibit trading during a 'blackout' period for those in possession of price sensitive information, and outline any exceptional circumstances and procedures for discretionary decisions by the Board. The policy should also include details of procedures to ensure adequate mechanisms for oversight and compliance with the policy. The policy or summary of the policy should be made public (i.e. disclosed on the company website and/or in the company annual report).
- Boards should determine when trading may be permitted due to exceptional circumstances.[53]
- Companies must disclose to the market any substantial interests held by a director in the company's shares and any material changes to those interests or arrangements. Companies should disclose to the market a statement as to whether the Board has exercised its discretion in allowing a director to trade during a 'blackout' period.

The ABA does not believe it is necessary to impose additional legal or regulatory obligations through the Corporations Act. Rather the ASX Corporate Governance Council should amend its *Corporate Governance Principles and Recommendations* to explicitly include guidance on companies establishing a policy concerning trading windows and 'blackout' periods.[54] We suggest that Recommendation 3.2 and commentary be amended.

The ABA notes that the ASX should continue to conduct reviews of trading by directors during 'blackout' periods.

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[53] The ABA notes that investors must have assurances that appropriate systems are in place to make sure that proper approval and adherence procedures are maintained. Any exceptions available for directors should also be made available for other officers and employees that are otherwise subject to similar trading restrictions.

[54] Additional guidance should seek to build on existing obligations with regards to the insider trading laws and market manipulation provisions, for example, identify proper approval and adherence procedures and exceptional circumstances where trading may be permitted by directors, senior executives and other employees that have access to company information. The ABA notes that the Model Code issued by the Financial Services Authority (FSA) in the United Kingdom and Rule 10b5-1 made by the Securities and Exchange Commission (SEC) in the United States could be given consideration in terms of enhancing guidance in this area, especially with regards to exceptional circumstances relative to ensuring compliance with legal obligations in this jurisdiction.

ASA

Retail shareholders have long been concerned insider trading by directors and executives. In the past the Association's position has bean that the laws prohibiting insider trading should be sufficient regulation of this activity. However research done by governance consultants, Regnan over a number of years, the ASA's own research carried out in the first half of 2008 and the ASX's research in 2008 (quoted in the issues paper) have left the Association increasingly concerned that the current laws do not act as a sufficient deterrent to insider trading.

In the current situation it is within the discretion of each company what, if any, period is a blackout/trading window, whether there is a process of granting exceptions and the instances when approval will be given by the chair to trade during the black out. The ASA sees a number of problems with the current regime:

- There is uncertainty amongst investors as to what is allowed
- Corporations do not have any duty to explain why trades took place during a black out, so there is a lack of transparency
- Any knowledge by the market of a potential inside trade is retrospective as is any investigation and action which can be taken by the regulator.

The ASA have noted several high profile instances in 2008 where the suspicion that a director has traded on inside information has not been abated by explanations provided by the corporation. Retail shareholders have lost confidence in boards and are frequently looking to the regulators to play a more active role. Given that approximately 46% of Australian adults own shares[55] and successive Governments have encouraged investment by ordinary Australians both directly and indirectly in the capital markets, maintaining the confidence of these investors in the system should be a fundamental consideration of Government and regulators.

The ASA would ideally see trading by directors and executives regulated in a similar manner to that which applies in the UK through the FSA Model Code. This would include a blanket prohibition against trading during prescribed periods and a process of ASIC providing approval of any exceptions, which would be limited to financial hardship. These changes would be additional to the current laws on insider trading.

The ASA accepts that there would be costs involved in this proactive approach both for industry and regulators. However the current procedure of regulators investigating and querying trades also involves considerable resources.

There are benefits not only for investor confidence but also for directors and executives who would be able to point to clearance from the regulator as an answer to accusations of impropriety. The clearance process would provide certainty for corporations in circumstances where there is ambiguity and remove the responsibility for decision making and for potential conflict from chairs and company secretaries.

Finsia

In Finsia's view, as long as there is no specific sanction (legislative, by ASX, or by the company) against a director for breaching a company's trading policy, lack of compliance with company trading policies can be expected to continue. Bringing

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55 ASX Australian Share Ownership Study 2006.

about greater compliance with internal policies would require a more interventionist approach with some form of external sanction.

Finsia notes that breach of a company's trading policy does not necessarily involve insider trading or other misconduct, although any trading by persons internal to a company, during a routinely-occurring period when external persons are inevitably not privy to the same corporate information, is likely to raise that suspicion. Changes in this area could focus on enhancing the ability of regulators to identify and prove trading misconduct. Tightening the requirements around the existence of, content of and compliance with listed companies' internal trading policies may assist, if contraventions are followed up externally.

IFSA

IFSA is opposed to the practice of director and executive trading during a designated 'blackout' period. Consistent with our comments above, companies must develop, monitor and enforce their policies on director and executive trading. This should specifically include activity within any trading windows and 'blackout' trading periods.

The implementation and enforcement of a trading policy acts as an instrument to minimise the potential for any perception that directors or executives are dealing in the entity's securities while in procession of inside information.

Along with CAMAC, we recognise that any underlying impropriety in blackout trading is dealt with by the insider trading and other market misconduct provisions. Companies should have the flexibility to develop a trading policy which suits their own circumstances and include what period the blackout period will operate, whom the policy applies to and whether any exemptions from blackout trading can be granted.

This policy should be publicly disclosed.

<u>IFSA recommendation</u>

The market supervisor and companies (via the Board of Directors) should actively continue to monitor, enforce and report on trading within any trading windows and 'blackout' trading periods.

Accounting Bodies

The Accounting Bodies clearly acknowledge that directors and officers because of their close involvement in the conduct of financial reporting and disclosure are potentially in possession of information affecting the market assessment of corporate performance, and are thus, subject to an incentive to actively trade their shares in the period between the close of a company's books and the release of either half-year or full-year results.

Whilst the insider trading regime and statutory rules related to use of position and use of information operate as the primary source of intervention against such misconduct, a sound corporate policy through which a 'blackout' of trading is implemented provides an appropriate adjunct for guiding directors, protecting their companies and safeguarding market integrity. It is to this end that we suggest that Principle 3[56] of the

56 Promote ethical and responsible decision-making.

ASX CGC Principles and Recommendations offers the most suitable avenue. The content of Box 3.2 ‘Suggestions for the content of a trading policy’ contains a number of elements, point 5 in particular, which pertain to a ‘blackout’ of trading. If deemed appropriate, the description of the underlying law and the governance rationale could be expanded upon and the company policy specifically elevated to an ‘if not, why not’ type disclosure.

More regulatory-based interventionist approaches that would operate across all listed entities, we believe, would present difficulty in both drafting and enforcement, offering little, if any, commensurate benefit to companies and the market.

4 Spreading false or misleading information

The submissions in this chapter are summarised in Sections 4.3.3, 4.4.6 and 4.5.3 of the report.

Australian Securities and Investments Commission

Initiating rumours

(1) The implications for market integrity of rumour-mongering

In an efficient market, participants rely on the flow of reliable material information to establish prices for securities. A rumour, or unverified information about an entity or affecting an entity, will lead to inefficiencies in this pricing mechanism. In an environment of high market turbulence, the dissemination of unverified information has the potential to further destabilise markets and undermine market integrity.

The problems caused by rumours are most obvious in falling markets, and there has been repeated analysis of the laws restricting short selling and spreading of false information since 1929. However false rumours can also be used to falsely promote a security price.

Since January 2008 there has been concern that some individuals are deliberately spreading false or misleading information about listed securities in order to artificially provoke sales of securities, in some instance to reduce their market price and profit from short selling activities in the stocks. On 6 March 2008, ASIC posted media release MR 08-47, 'False or misleading rumours', expressing its concerns with this issue and initiated investigations into market manipulation. ASIC announced on 17 September 2008 that it was extending its enquiries on the question (MR 08-202, 'Enquiries into market manipulation'). ASIC has also conducted discrete investigations into conduct by individuals involving the initiation and spreading of rumours.

ASIC's Project Mint, investigating the integrity of the Australian markets and the impact of false rumours and collusion is still underway. Among other things, that work has contributed to a deeper understanding that conduct which may be classified as 'rumourtrage' or 'rumour-mongering' may take a wide variety of forms. Originating or initiating false or unverified information is caught by the current law, so long as the information is material. Simple on-communication or dissemination of that information may also be caught. In some cases it is difficult to distinguish between an opinion and a rumour, and in other cases a 'rumour of an opinion' may be originated and disseminated. In some cases a rumour has no basis in fact. In other cases it may be based, in varying degrees, on an element of truth or verified information. In that instance the information may also be inside information for the purpose of s 1043A. Some or all of these elements may combine in unusual ways. As noted in more detail below, the current legislative framework could be better adapted to this wide variety of conduct.

(2) and (3) Should all or some of s 1041E, 1041F and 1041G be civil penalty provisions as well as attracting criminal liability and should any of the elements of any of these three provisions be amended, and if so, in what manner?

Each of sections 1041E to G are important parts of ASIC's armoury in ensuring the origination and dissemination of unverified information does not affect market integrity. They are currently criminal offences. We also consider s 1041H, imposing civil liability only, plays a role in this respect.

However, the regulatory options provided by ss 1041E to G are limited in ways that other provisions focussed on market integrity (sections 1043A and 674 in particular) are not, because they are not civil penalty provisions. We think it important that those limitations are removed to ensure ASIC has access to the full range of regulatory options (administrative, civil, civil penalty and criminal), in responding to conduct affecting market integrity. This will assist ASIC to ensure that the range of conduct that can constitute 'rumourtrage' is met by a scaleable response on ASIC's part.

For example, some conduct may be appropriately dealt with by administrative action (that is, banning or licensing action) by ASIC based on s 1041H (inter alia). Other conduct may have had such a detrimental effect on market integrity, and be capable of proof to the criminal standard, that a criminal prosecution is the appropriate regulatory response. However, at least some of the conduct will fall between those two extremes. Where the criminal standard of proof is not able to be met, but market integrity is fundamentally affected, we consider administrative action alone to be an inadequate regulatory response. On that basis, ASIC supports law reform so that ss 1041E-G of the Corporations Act constitute civil penalty provisions, as well as criminal offences.

We note that the Revised Explanatory Memorandum to the Financial Services Reform Bill 2001, in relation to the application of the civil penalty regime to the insider trading and some market misconduct provisions (ss 1041A, 1041B, 1041C and 1041D) stated:

> '2.79 Another major problem that exists in relation to the market misconduct and insider trading provisions, is the difficulty ASIC has in successfully prosecuting a breach of the provisions. As the existing provisions are offence provisions, the criminal burden of proof (beyond reasonable doubt) applies. ASIC has found it difficult to prove elements of the offences beyond reasonable doubt, as many elements refer to the defendant's state of mind. This difficulty may result in cases not being pursued even where there has been a breach of the provisions. This is undesirable as it casts the law into disrepute, and also threatens the integrity of financial markets.
>
> 2.80 It is therefore proposed to make the market misconduct and insider trading provisions civil penalty provisions. The application of the civil burden of proof (balance of probabilities) will facilitate the bringing of actions for breaches of the provisions. The application of civil penalties is likely to act as a deterrent to market misconduct. Another option is to redraft the offence provisions to make them easier to prosecute. However, significant objections to such a proposal may be anticipated given that criminal sanctions would apply to contraventions.
>
> 2.87 Breaches of the market misconduct and insider trading provisions must be punished to ensure the integrity of Australian financial markets. ASIC's ability to enforce these provisions will be enhanced by making them part of the civil penalty regime.'
>
> We consider this reasoning also applies to ss 1041E-G.

If ss 1041E–G become civil penalty provisions, we suggest that the approach adopted by the legislature in respect of ss 1041A through C be followed and the 'fault' element from the existing provisions removed. For example, when sections 1041A and 1041B became civil penalty provisions, the element of 'intent' was removed from these provisions.

The maximum prison penalty for the major market integrity offences (ss 1041A-G, s 1043A and s 674) is 5 years imprisonment. CAMAC may wish to consider if there is merit in lifting the maximum to 10 years, in line with the proposed penalty for illegal cartel activity.

(4) Should some form of compulsory recording of telephone conversations and other electronic forms of communication, such as SMS, be introduced

In ASIC's opinion compulsory recording of telephone conversations and other electronic forms of communication would help to deter rumour mongering and other market abuses – partly by making it logistically more difficult for traders. To maximise effectiveness, any compulsory recording of communications would need to be accompanied by reform banning the use on trading floors of mobile phones and any other devices that cannot be recorded or taped.

As noted by the FSA in Policy Statement 08/01, investigating and prosecuting market abuse matters is very difficult and good quality recordings would help in detection of this conduct. We acknowledge that participants who wish to engage in illegal conduct could evade detection by using secure alternative communication channels.

The cost of implementing these measures would be very significant. We have not attempted to quantify these costs as they are best estimated by industry. It is a matter for Government whether the benefits outweigh these costs.

(5) Any other steps to facilitate the detection and prosecution of rumour mongering

ASIC has no additional regulatory proposals at this stage. ASIC has established a number of initiatives to seek early information about the flow of rumours in sufficient detail for them to be traced to the originator.

Target response to rumours

(6) and (7) Would there be benefit in ASIC or the ASX providing further guidance on how companies should deal with market rumours affecting their securities and in that context, would it be beneficial to adopt any of the principles of the FSA Market Abuse Directive Instrument

ASIC has published guidance for companies on dealing with rumours (Regulatory Guide 62 *Better Disclosure*). The principles enunciated there remain valid. We accept that companies do not want to be drawn into a situation where they are practically obliged to respond to every rumour, particularly as the substance nears the truth and a simple 'no' is not sufficient. It is clear however that simply ignoring rumours is not appropriate in this market.

We will consider whether the principles need to be refreshed in conjunction with the guidance work we are undertaking mentioned immediately below.

Recipient of rumours

(8) Would it be beneficial to develop best practice guidelines on how to deal with rumours received

ASIC is currently developing and will shortly proceed with consulting with the industry on 'good practice' guidelines to assist market participants (brokers and fund managers) who are the recipients of rumours. We plan to complete this work in the next 3 months. Our work in this area will take into account the detailed guidance the

FSA published in November 2008 on rumours and will involve a discussion on origination, rules for balanced dissemination of established rumours, and house rules for handling information, and acting on it. We will also look at practices in the US market. As noted above 'rumourtrage' and 'rumour-mongering' conduct may occur in a wide variety of forms.

Additional Issues—Section 3

In addition to support for a civil penalty regime targeted at this conduct, we suggest some amendments to other provisions of the Act that will enhance ASIC's administrative powers in this area. Those enhancements will assist ASIC to ensure that all varieties of the conduct that affect market integrity are able to be the subject of regulatory action.

AFS Licensee general obligations

We recommend that s 912A(1) is amended to specifically require AFS licensees who are market participants or who deal in or advise in securities to have guidelines to ensure responsible discussion of information about listed entities. Including a specific obligation of this type ensures that it dealt with by all licensees (similar to the specific obligation regarding conflicts in s 912A(1)(aa)). We consider that the implementation of arrangements to prevent the initiation and spreading of rumours is complementary to the requirement to ensure that the financial services provided by the licensee or its representatives are provided efficiently, honestly and fairly (refer s 912A(1)(a)), and accordingly, the primary responsibility for implementing these arrangements should rest with the licensee.

Banning powers

We recommend s 920A(1) is amended so that ASIC can make a banning order against a person if they contravene the licensee's guidelines on rumourtrage discussed above.

We consider that the rules of conduct imposed by licensees on their employees and representatives to ensure that they comply with the financial services laws are an important means by which the objects of Chapter 7 of the Act are achieved. It should be made clear that ASIC can use its banning power where conduct by an employee or representative breaches a licensee's internal guidelines. The amendment we suggest in conjunction with the amendment we suggest to s 912A(1) above, would provide ASIC with an additional administrative remedy which would ensure ASIC could appropriately deal with rumourtrage conduct by the range of persons associated with financial services licensees.

Extension of s 1309

We note that s 1309(1) of the Act provides, among other things, that an officer or employee of a corporation who makes available, or gives information, or authorises or permits the making available or giving of information to an operator of a financial market, is guilty of an offence. The relevant market operator at the present time is ASX. We consider that this offence should be extended to false information made available to the clearing or settlement operators, presently Australian Clearing House Pty Ltd ('ACH') and the ASX Settlement and Transfer Corporation Pty Ltd ('ASTC'). Treasury and the Reserve Bank of Australia (with ASX) are currently preparing rules and regulations requiring disclosure of short selling transactions to ASX and to ASTC of equities securities lending transactions. Rumourtage is said to benefit short sellers, and it is therefore important that ASIC and ASX/ASTC/ACH have reliable information on short selling activity. Expanding s 1309 in the manner proposed would encourage accurate reporting.

ASX

The existence or otherwise of a market failure problem in respect of this issue turns on:

- the adequacy of the existing provisions and enforcement options available; or
- an assessment of the performance of market supervisors and market regulators in giving effect to those provisions.

In respect of the first point, ASX would not object to market manipulation provisions attracting civil penalty provisions if there is clear evidence that there is an enforcement problem attributable to the evidentiary burden of the current criminal provisions. If a problem exists elsewhere (for instance in the wording of the provisions themselves) then there is arguably little merit in simply adding a new enforcement tool.

In respect of the second point, we note CAMAC's question relating to the introduction of some form of compulsory recording of telephone conversations and other electronic forms of communication. An appropriate starting point when considering this issue would be to determine the class of potential market users who should have to submit to whatever is involved in the new restriction (such as monitoring of all verbal and electronic communications by certain employees). For instance, we feel there is little value in only targeting the conduct of a sub-set of Australian Financial Service Licence (AFSL) holders (eg ASX Participants), as this is likely to produce a number of market distortions and may encourage conduct designed to circumvent the requirements.

To illustrate the above point, we note that it has been alleged that overseas-based hedge funds are one source of false market rumours in Australia. It is unclear how these entities, if not licensed in Australia, would be discouraged from undertaking such illegal activities unless there was recording of telephone conversations originating from the hedge funds (difficult to see how this would be achieved), or recording of all possible recipients of such information in Australia, including all AFSL holders and media outlets (difficult to see how this could be justified). Another unintended consequence may be the acceleration of the movement of advisory activities from ASX Participant entities to related (or non-related) non-ASX Participants, thereby resulting in ASX participants becoming execution only direct market access providers and circumventing the objectives of the proposal. We suggest that the practical difficulties in achieving an appropriately targeted regulatory outcome should be a key consideration for Government when deciding whether to introduce new restrictions of the type outlined by CAMAC.

The fact that a truly comprehensive solution may be impractical because of these jurisdictional considerations suggests that if any new obligations are imposed on those entities which do clearly come within the practical reach of the Australian law, namely AFSL holders, they might best be expressed in principle-based terms.

For example, CAMAC may wish to give further consideration to the feasibility of amending the Corporations Act or AFSL licence conditions to require an AFSL holder to:

- have in place, and give effect to, controls and procedures reasonably designed to give effect to their obligation to ensure that their representatives do not spread false or misleading statements (section 1041E of the Corporations Act);
- identify any conduct contrary to the obligations of its representatives pursuant to section 1041E of the Act; and
- report to ASIC any conduct contrary to the obligations of its representatives pursuant to section 1041E of the Act.

This approach would leave it open to all AFSL holders how they give effect to the obligation which may, or may not, include monitoring of all verbal and electronic communications by certain employees.

AICD

AICD supports the lowering of the evidentiary thresholds that currently apply to the provisions under the Corporations Act relating to the generation and spreading of false or misleading information about securities. As suggested in the Issues Paper, this can be achieved by making sections 1041E, 1041F and 1041G civil penalty provisions in addition to attracting criminal liability.

Otherwise, AICD considers that the existing laws and the ASIC and ASX policies are appropriate and sufficient to deal with the spreading of false or misleading information and no further regulation is required. In particular, AICD does not support the introduction of any form of compulsory recording of telephone conversations and other electronic forms of communication, such as SMS as they are an inefficient evidentiary mechanism. We note that similar provisions in relation to the recording of calls during takeovers were repealed in 2007 on the basis that they had not increased the protection of security holders and imposed significant costs on the parties involved.

AIRA

A key part of what Investor Relations officers do for their companies is to seek a fair valuation for the company's shares. By definition rumours detract from that aim, in that they are not fact. Rumours are an inevitable consequence of a free market, but rumours spread deliberately should be driven from the market.

One part of the solution is in deterrence, and ensuring that regulators have the right options for prosecution is important. Equally, clarity on how companies should handle rumours is important and guidance is helpful. No two events are the same, and writing hard coded rules applicable in all situations is almost impossible. AIRA guidance on rumours is that

> 'Listed companies should develop a written policy for dealing with rumours and market speculation. Generally, companies are encouraged not to comment on rumours and market speculation. Companies should set out their policy with regards to working with the ASX in instances in which market or media speculation on material information has occurred.'

Specific questions.

Initiating rumours

(1) the implications for market integrity of rumour-mongering

AIRA agrees with CAMAC that malicious rumour-mongering with intent, is a serious concern, and action to counter it is needed. Unchecked, rumour mongering can lead to price volatility, to inefficient price formation, and ultimately undermine trust in the markets themselves. Especially at the moment, with the likely rise in companies using rights issues for their capital needs, those companies are especially vulnerable during the offer period.

(2) should all or some of ss 1041E, 1041F and 1041G be civil penalty provisions as well as attracting criminal liability

Prosecutions are difficult to progress, but are effective in raising the profile of the issue. For example, the significant rise in market abuse actions brought by the UK's Financial Services Authority in the last 2 years has been noted. Many have been brought under a civil regime, not criminal, with the civil offences (see below) having a lower burden of proof.

AIRA believes that it is the fact of a prosecution, as well as the penalty, that is a significant deterrent, so would support the creation of a regime which maximises the chances of a successful prosecution.

(3) should any of the elements of any of these three provisions be amended and, if so, in what manner

See answer to question 7.

(4) should some form of compulsory recording of telephone conversations and other electronic forms of communication, such as SMS, be introduced

AIRA does not support the compulsory recording of telephone and other electronic forms of communication. If one channel of communication were subject to recording, this would have the likely effect of driving communications to those means/forms that are not recorded.

We also note the growth of dark pools of liquidity, with an estimated 20% of the markets liquidity. Many of these do not offer transparency of the potential counterparties. We would encourage CAMAC to consider how transparency of dark and light transactions could be achieved.

(5) any other steps to facilitate the detection and prosecution of rumour-mongering

One of the challenges is in identifying the rumour in the first place. We note the growth in social media tools and expert investor sites and the 'rumour mills' which exist to capture the views of a community. A number of companies use third party electronic media monitoring type services to monitor these and other similar sites for potential rumours.

(6) would there be benefit in ASIC or the ASX providing further guidance on how companies should deal with market rumours affecting their securities

We agree that guidance (rather than regulation) of how to deal with rumours would be welcome. The CAMAC Issues Paper provides an extensive list of guidance, all of which tries to identify conditions where a disclosure should be made. These include:

> ‘Where the media comment appears to be reporting in specific detail a material change in strategy or that a material transaction is to occur, the source of the comment appears referrable to those involved, and there is an apparent or likely movement in the share price or volume, ASX is likely to take the view that an announcement would be required’.
>
> ‘Policies on responding to rumours should aim for consistency: saying 'we do not respond to market rumours' on some occasions and at other times indicating there is no substance in a rumour may send a signal to the market’
>
> ‘The litmus test …is the false market’
>
> ‘when the market moves in a way that appears to be referrable to the comment or speculation’

These extracts from guidance notes are not contradictory, but they do place different emphases on when a disclosure is required. Review of this guidance, in conjunction with AIRA’s own best practice guide, would be helpful.

(7) in that context, would it be beneficial to adopt any of the principles in the FSA Market Abuse Directive Instrument

As the Committee of European Securities Regulators has identified, the implementation of the Market Abuse Directive varies across Europe, especially in so far as penalties are concerned. However the FSA implementation referenced in the Issues Paper, is comprehensive. Between Financial Services and Markets Act Sections 118 and 397, a balance of criminal and civil penalties are open to authorities, and used effectively, can make a difference.

Recipients of rumours

(8) would it be beneficial to develop best practice guidelines on how to deal with rumours received

See answer to (9) below

(9) if so, what should be the content of those guidelines, who should develop them and how should they be monitored or enforced?

We welcome the email link established by ASIC on its public website, to receive reports on false rumours heard by listed companies in the market. In many markets, listed company whistle blowing solutions also exist, but we should steer clear of a regulatory approach along the lines of Section 301(4) of the Sarbanes Oxley Act.

SDIA

It is important to make clear at the outset that ‘rumour mongering’ is taken to refer to the circulation of rumours which are either false or misleading, whether deliberately or recklessly, or which may be materially price sensitive, as opposed to merely passing on rumours as such that have been heard in the market.

It is difficult to prevent people talking about rumours. It is an inherent part of human nature. It is unlikely that legislation would ever be effective to prevent people engaging in gossip and passing on rumours generally. As far as the markets are concerned, gossip and rumours are regarded as part of market ‘colour’. A client who is discussing a stock with their broker will consider the broker duty-bound to tell them everything they have heard about the stock, within the bounds of legal obligations, and not withhold information from them.

The focus of legislation and guidelines should be (as it currently is) on prohibiting the dissemination of rumours which are false or misleading, either knowingly or recklessly, or which may be materially price sensitive and where the rumour has some credibility e.g. as a result of knowing the source of the rumour.

Notwithstanding the recent coining of the term ‘rumourtrage’ and the allegations of that the practice has been widespread in recent months, the spreading of false or misleading information regarding securities is not a new phenomenon. The classic case of *R v De Berenger*, often referred to in legal texts, involving the individuals who dressed in military uniform and spread false reports that Napoleon had been killed in battle and that Wellington had reached Paris, in order to profit from the inevitable rise in the market for government securities, is an excellent example in distant history.

Existing legislation adequate. The prohibitions currently in the Corporations Act have evolved over time to address such practices, both specifically and generally. The various sections are cited in the Issues Paper, including sections 1041A-G.

In SDIA’s view, the existing legislation provide a formidable arsenal to the regulator to deal with market manipulation generally, and rumourtrage/false and misleading statements in particular, and there is no pressing need to change the laws. There have been a number of cases over the years where instances of market manipulation have been the subject of successful enforcement action by ASIC and by ASX in cases of quite complex market scenarios, indicating that the legislation can be quite effective. Significant fines have been imposed in a number of cases, indicating the robustness of the existing regime.

There is an argument that the provisions would benefit from being reviewed. The sections have been derived from various sources and have evolved in a piecemeal way over time, and there is a considerable amount of overlap between some of the sections. The sections may benefit from being reviewed to remove this overlap. However, it is important that in making any changes to streamline the sections, no new element of uncertainty is created as a result of the language that is used.

There is also no reason why sections 1041E, 1041F and 1041G should be on a different footing to the other market misconduct provisions, so we can see no grounds to argue those sections should not be made civil penalty provisions in line with the other provisions.

Better enforcement needed. In SDIA’s view, what is needed is greater and more effective enforcement of the provisions that exist. ASIC needs to make greater efforts to be closer to the markets and to employ a better market surveillance and intelligence program. In our view, if the markets perceived that ASIC was policing this area to a greater degree, then the incidence of ‘rumourtrage’ would not be seen as so prevalent. There is evidence that the increased attention devoted by ASIC recently in response to the perceived incidence of ‘rumourtrage’ has already had an impact on the level to which that conduct is perceived to be occurring in the market.

Mandatory telephone recording not justified. SDIA does not believe that the introduction of a mandatory requirement for brokers to tape telephone lines would make a material impact on the ability of ASIC to bring successful enforcement action. SDIA notes that the CAMAC Issues Paper quotes the UK FSA, which is about to introduce this requirement, as saying that ‘This requirement will have a limited effect on the detection of rumour-mongering.’

There are a myriad of means of other communication available to any person who was intent on spreading false information and/or inside information, and it would not be a difficult matter to communicating with a broker using a means other than a taped telephone line.

As against this, the cost of introducing mandatory telephone taping would be considerable. Quite apart from the infrastructure costs, it is also necessary to factor in the cost of storage of the tapes for what is likely to be a considerable period of time, and the cost of retrieval to satisfy regulatory query. The total costs would be significant, and in our view will far outweigh any potential benefit. Introducing costs of this magnitude at a time when the securities industry is under severe financial pressure due to the economic downturn, and at a time when other additional compliance and IT costs are being imposed, including the costs of introduction of short sale and stock lending reporting, and additional capital requirements, would be onerous.

Therefore, SDIA believes that mandatory taping would be a disproportionate reaction to the prevailing situation.

In relation to rumours which may involve the dissemination of price sensitive information, such as where the rumour contains sufficiently definite information or where the identity of the source provides credibility to the information, this is an area where the operation of the existing insider trading provisions is widely understood. A person to whom a rumour is passed in these circumstances is potentially an insider, and would be precluded from dealing in the securities the subject of the rumour and from passing on the rumour. SDIA does not believe that any additional requirements or legislative change is needed to deal with this scenario.

On the question of the response by Targets to rumours, SDIA considers that the practice most commonly followed by target companies of not responding to rumours is the appropriate one in our view, provided that this satisfies the Target's obligations under the Continuous Disclosure regime are met. No further Guidelines for responding to rumours by Target companies is in our view necessary.

Chartered Secretaries Australia

CSA does not believe that any changes are required to the Australian regulatory framework in relation to 'rumourtrage'. CSA believes that the current provisions relating to the dissemination of materially false or misleading information that is likely to induce trading or affect the price of trading; market manipulation; false trading and market rigging; dealing in a financial product using false or misleading information; and engaging in dishonest conduct in relation to a financial product or financial service are adequate to deal with the intentional spreading of false corporate and market rumours.

CSA also does not believe that any further guidance on this issue is required from either ASIC or ASX. There is considerable guidance available already that is easily accessible.

CSA agrees that ss 1041E, 1041F and 1041G should attract civil penalties as well as criminal penalties. CSA notes that the burden of proof of breach required to attract a criminal penalty is such that offences can be difficult to prosecute. CSA believes that, if civil penalty provisions are introduced, it provides additional enforcement capability and the lower civil standard of proof of breach could also encourage greater compliance with the existing regulatory regime.

CSA also recommends that, while considered in the context of rumour mongering, a global review of the provisions in Division 2 of Part 7.2, many of which cover similar but not identical ground, would be beneficial in order to rationalise these provisions and the consequences of a breach (rather than a single factual circumstance giving rise to multiple contraventions and potentially different consequences).

CSA recommendations

CSA recommends that no change be undertaken to the current regulatory framework, as CSA believes the current provisions relating to the intentional spreading of false corporate market rumours are adequate.

CSA recommends that no further guidance on this issue should be required from ASIC or ASX.

CSA recommends that ss 1041E, 1041F and 1041G should attract civil penalties as well as criminal penalties and that the overlapping nature of these provisions (and other related provisions in Division 2 of Part 7.2) would benefit from a review and rationalisation.

Janet Austin

This submission only relates to the issues raised in Section 3.3 of the Issues Paper**: Initiating rumours**

(1) the implications for market integrity of rumour-mongering.

The spreading of rumours impacts on market integrity as it runs contrary to one of the fundamental principles of securities laws that the market should be fair, efficient and transparent.[57] Sections 1041E, 1041F and 1041G of the *Corporations Act 2001* (Cth) (Corporations Act) already prohibit the spreading of false or misleading rumours. The spreading of rumours which are true is also of concern as it suggests insider trading and/or companies failing to comply with their continuous disclosure obligations. The recent problems with rumour-mongering suggest that the existing laws are not operating effectively. The reason seems to be, not generally with the wording of the statute (although some suggested improvements are set out below), but with a failure to enforce these prohibitions. With limited enforcement the law is not acting as an effective deterrent to engaging in this type of behaviour.

Accordingly the solution would seem to lie in enhancing enforcement of the existing prohibitions. A number of studies have shown that effective enforcement of securities laws is fundamental to market integrity.[58] Effective enforcement may also result in more dispersed equity ownership, greater stock price accuracy and greater liquidity.[59]

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[57] IOSCO Objectives and Principles of Securities Regulation (May 2003) at para 4.1, available online at www.iosco.org.

[58] See for example Bhattacharya, U. and H. Daouk, 2002, 'The World Price of Insider Trading', *Journal of Finance* 57 and Hail, L. and C. Leuz, 2005, 'International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?', (ECGI - Law Working Paper No. 15/2003) http://ssrn.com/abstract=641981.

[59] LN Beny, 'Insider Trading Laws and Stock Markets Around the World; An Empirical Contribution to the Theoretical Law and Economics Debate' (2007) 32(2) *Journal of Corporation Law* at 237.

(2) Should all or some of ss 1041E, 1041F and 1041G be civil penalty provisions as well as attracting criminal liability

For consistency with other market manipulation provisions in the Corporations Act Section 1041E should be a civil penalty provision. This would give ASIC the flexibility to bring civil penalty action if it does not believe that it can prove the mental element of the offence.

Furthermore the knowledge element in s 1041E(c) should be removed as it is unnecessary given the application of the *Criminal Code 1995* (Cth) (the Code) to the Corporations Act. As the Code applies the prosecution would have to prove intention, knowledge or recklessness in relation to each of the physical elements of this prohibition to prove this as a criminal offence.[60]

Section 1041F should also be amended, removing dishonesty and making it a civil penalty prohibition. For example it could provide:

> A person must not induce another person to deal in financial products:
>
> (a) by making or publishing a statement, promise or forecast which is false, misleading or deceptive;
>
> (b) by the concealment of material facts; or
>
> (c) by recording or storing information which is false or misleading in a material particular if;
>
>> (i) the information is recorded or stored in, or by means of a mechanical, electronic or other device; and
>>
>> (ii) when the information was so recorded or stored, the person had reasonable grounds for expecting that it would be available to the other person, or class of persons that includes the other person.

Again with the application of the Code to the Corporations Act the prosecution would have to prove intention, knowledge or recklessness in relation to each of these physical elements to prove this as a criminal offence.

Section 1041G should remain a criminal offence given central 'moral blameworthy' element of dishonesty in this offence. However the test for dishonesty prescribed in s 1041G should be removed. This is because this test, derived from the UK case of *R v Ghosh* [1982] QB 1053, is inconsistent with the test for dishonesty in other provisions in the Corporations Act and inconsistent with the application of the Code to the Corporations Act. No other provision in the Corporations Act which contains dishonesty as an element, except for s 1041F and s 1041G, has a test for dishonesty prescribed within the section.[61]

In relation to those provisions in the Corporations Act where no test for dishonesty is prescribed, the test is similar, but not identical to, the *Ghosh* test. Dishonesty is a 'physical element' under the Code, being a 'circumstance' in which conduct occurs.[62] Although the Code does not make it clear, presumably as a result of the test set out by the High Court *Peters v The Queen* (1998) 192 CLR 493, the finder of fact (a jury or magistrate) would have to find that the conduct was dishonest in accordance with the

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60 *Criminal Code* (Cth) ss 5.4 and 5.6.

61 For example, *Corporations Act* 2001 (Cth) s 588G(3), s 260D(3) and s 256D(4).

62 *Criminal Code* (Cth) s 4.1(1).

standards of ordinary, decent people. In addition, as with any physical element where the Code applies, there is a prescribed 'fault element', in this case recklessness.[63] Accordingly the finder of fact would also have to find that the defendant must either have known that the conduct would be dishonest in accordance with the standards of ordinary people, or was at least aware that there was a substantial risk that the conduct would be dishonest in accordance with the standards of ordinary people.[64]

(3) Should any of the elements of any of these three provisions be amended and, if so in what manner

See response to issue 2 above.

(4) Should some form of compulsory recording of telephone conversations and other electronic forms of communication, such as SMS, be introduced

Compulsory recording of telephone conversations and other electronic forms of communication should not be introduced. Introducing such a system would be costly and limited to certain lines. In order not to contravene the provisions of the *Telecommunications (Interception and Access) Act 1979* (Cth) (TI Act), it would have to be made clear to the parties to the conversation that they were being recorded.[65] Accordingly it is unlikely that those persons spreading false rumours would use telephones on which they know they are being recorded.

A more effective mechanism would be to amend the TI Act to allow ASIC to obtain a warrant to intercept telephone or other electronic communications in relation to an investigation into the market misconduct and insider trading provisions in Part 7.10 of the Corporation Act. Interception without a warrant is prohibited by s 7 of the TI Act. The power to apply for such a warrant is contained in s 39 of the TI Act. Under this section an 'enforcement agency', as defined, can apply to a Judge of the Federal Court or a member of the Administrative Appeals Tribunal (AAT) for a warrant in respect of a particular telecommunication service or in respect of services which may be used by a particular person. ASIC is not however an 'enforcement agency' within the definition contained in s 5 of the TI Act. Nor is it possible for any of the enforcement agencies listed within that definition, such as the Australian Federal Police, to obtain a warrant in respect of any of the relevant market misconduct offences in the Corporations Act. This is because s 46 of the TI Act provides that the Judge or AAT member may issue a telecommunications interception warrant on the application of an agency only when they are satisfied that information would be likely to be obtained to assist in connection with the investigation of a 'serious offence'. None of the market misconduct offences currently fall within the definition of 'serious offence' in s 5D of the IT Act.

The government has recently introduced legislation into Parliament which would allow the Australian Competition and Consumer Commission (ACCC) to obtain such interception warrants in relation to the investigation of the new provisions to be introduced in the *Trade Practices Act 1974* (Cth) which make it a criminal offence to form a cartel. The stated reason why this power is needed is that:

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[63] *Criminal Code* (Cth) s 5.6(2).

[64] *Criminal Code* (Cth) s 5.4.

[65] See s 6 of the *Telecommunications (Interception and Access) Act 1979* (Cth).

> Cartels are generally covert arrangements. Discovery and proof of the existence of a cartel is more difficult than other forms of corporate misconduct, justifying such powers to penetrate the cloak of secrecy.[66]

Market manipulation (including the spreading of false rumours) and insider trading are also usually undertaken under a cloak of secrecy with the perpetrators difficult to identify. It can be difficult to detect and there may be no documentary trail.

If ASIC was able to obtain a warrant to intercept electronic communication this may result in very significant evidence. In the absence of such evidence ASIC is often left in the exceptionally difficult position of having to try and make out a circumstantial case where it may be able prove that telephone calls were made, but has no evidence as to what was said.

Furthermore granting ASIC the power to seek a warrant under the TI Act would act as a better deterrent than compulsory recording of telephone conversations as perpetrators would not be aware or able to find out if their conversations, on any line, were being recorded.

(5) Any other steps to facilitate the detection and prosecution of rumour-mongering

Another possible mechanism that has been suggested to facilitate the detection and prosecution of market manipulation is granting immunity for participants in offences who 'blow the whistle' on the activity.

The ACCC currently has a policy whereby an individual or a corporation who is involved in a cartel can be granted immunity from civil proceedings provided they are the first person to report the activity to the ACCC, they are not the leader of the cartel and they did not coerce others to join the cartel.[67] On 1 December 2008 the ACCC and the Commonwealth Director of Public Prosecutions announced a Memorandum of Understanding which has the effect that the same criteria will apply to criminal prosecutions when the new cartel offence provisions are enacted.[68]

In a recent article 'An immunity policy of Insider Trading and Market Manipulation'[69] Brent Fisse considered whether an immunity policy similar to the ACCC should be introduced by ASIC for market offences. He argues it is difficult to justify why, if such a policy is available for cartel offences it should not be available market offences:

> It is difficult to distinguish insider trading from cartel conduct on the basis that the conduct is easier to detect. Market manipulation may be easier to detect given the record of trades from which patterns of manipulation may be discerned but difficulty nonetheless arises.

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66 *Media Release* 27 October 2008 by Hon Chris Bowen MP Assistant Treasurer 'Rudd Government to Introduce Legislation Criminalising Cartels'.

67 See *ACCC Immunity Policy for Cartel Conduct*, 26 August 2005.

68 'ACCC and CDPP Outline Arrangements for Cartel Conduct Immunity' 1 December 2008, and draft 'Memorandum of Understanding between the Commonwealth Director of Public Prosecutions and the Australian Competition and Consumer Commission regarding Serious Cartel Conduct'.

69 B Fisse, 'An Immunity Policy for Insider Trading and Market Manipulation?' LCA Corporations Workshop 20-21 September 2008.

> Nor does it seem plausible to attempt a distinction on the basis of the actual or likely harm to market integrity is less significant in impact than the actual or likely harm to competitive markets from cartel conduct.[70]

Fisse also points to the fact that the US Securities Exchange Commission has a leniency policy and the UK Financial Services Authority has a policy of considering cooperation in deciding whether or not to prosecute an individual for market misconduct.[71]

Whilst such a leniency policy may result in the detection of more market misconduct, by itself, it may prove to be an imperfect mechanism to foster successful enforcement action by ASIC. Without adequate corroboration, it is doubtful that evidence given by the person granted immunity (who would in other circumstances be a co-accused) as to the involvement of another will be sufficient for ASIC to be able to establish a prima facie case. Furthermore, in criminal trials the value of such evidence is lessened by the fact that a jury is likely to be given a warning that such evidence may be unreliable, be told the reasons why it may be unreliable and that the jury must exercise caution in using it to convict an accused.[72] Even if ASIC brings civil penalty proceedings, instead of a criminal prosecution, courts have repeatedly stressed that given the seriousness of the consequences for a defendant in such proceedings, a high level of satisfaction is required to find such a contravention.[73] Evidence of a co-offender without adequate corroboration is unlikely to satisfy this test.

Nevertheless an immunity or leniency policy should be considered to ensure that ASIC is equipped with equivalent powers and tools to those used by equivalent regulators around the world to ensure a more consistent and coordinated enforcement response. In addition if there is an immunity or leniency policy and ASIC is given telephone intercept powers, ASIC may be able to use telephone intercepts to obtain the corroboration necessary to secure a conviction. This combination of investigation techniques has the potential to become a powerful tool for ASIC to fight market misconduct.

Business Council of Australia

The BCA is concerned about the incidence of false and misleading information being spread in the market ('rumourtrage') particularly given the impact that this has had on the integrity of the market in the current economic climate.

Evidence of a problem

Regulators must be able to, as far as possible, detect and take action against inappropriate market behaviour. However, it appears that there may be some current difficulty in regulators being able to detect where rumourtrage is being originated and in holding those responsible to account.

Even if such a problem has been demonstrated, a targeted and proportionate response must be taken if the problem is to be addressed and unintended consequences avoided.

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70 Fisse, n 69 at 6.

71 Fisse, n 69 at 2.

72 See for example *Evidence Act 1995* (NSW) s 165.

73 See for example *Adler v ASIC* (2003) 46 ACSR 505 at 534; *ASIC v Loiterton* [2004] NSWSC 172 at [10]; *ASIC v Vines* [2002] NSWSC 1223 at [20].

Costs and benefits of intervention

The proposal for compulsory recording of telephone conversations and other electronic forms of communication must be considered in context of whether it will enhance the ability for regulators to combat rumourtrage. As with any regulatory intervention, the benefits must outweigh the costs.

There are a number of costs and risks associated with compulsory recording of conversations. Compulsory recording may for example divert significant resources away from more effective investigation by regulators towards time consuming activities like reviewing large amounts of non-material information. Indeed, prior experience with compulsory recording in Australia resulted in it being disbanded because of the undue costs associated with the program. CAMAC's discussion paper highlights that the requirements to record telephone conversations during a takeover bid were repealed *'on the basis they did not increase the protection of security holders and imposed significant costs on the parties involved'*.

In addition to the costs and risks, it is unclear how the proposal will in practice increase the regulator's ability to investigate and take action against inappropriate behaviour. For example, only certain regulated market participants in Australia will be captured by the recordings. If overseas or unregulated market participants are spreading rumours, they may not be captured by the compulsory recording regime. It is likely that alternative methods of behaviour will be employed by individuals to avoid the recording regime (for example, face to face meetings).

Possible response

There may be some merit in undertaking a more specific review of the market manipulation provisions of the Corporations Act, to ensure they are simpler, less conflicting and able to be effectively applied by the regulators. However, a more detailed analysis (with longer periods for consultation and analysis) would be required for such a review.

Recognising that regulators may be having difficulty in identifying and taking action against those spreading false and misleading rumours, the BCA considers that any proposals to deal with rumourtrage must be given due consideration to ensure responses are targeted, proportionate and avoid unintended consequences.

AFMA

Initiating rumours

(1) the implications for market integrity of rumour-mongering

The timely release of material price-sensitive information is necessary to ensure that the same information (in both content and detail) is available to all investors, and to act as a deterrent to selective disclosure and insider trading, to counter market distortion through rumours and speculation and above all, to enable investors to make informed investment decisions.

False rumour mongering is most effectively combated by a continuous disclosure regime that recognises the need for the market and all investors to have fair access to price-sensitive information (positive and negative) on an equal footing. It requires listed companies to disclose, in a timely manner, to all market participants all relevant information which may affect security values or influence investment decisions.

The basic premise of corporate disclosure is that the greater the quality, detail and timeliness of material disclosure made by a company in relation to its business operations and performance, the greater the market confidence and the lower the risk for investors in evaluating the company's investment potential, thereby promoting market efficiency.

Disseminating material information as and when it occurs is the most effective way to mitigate the potential for negative surprises and to advance the interests of investors and cut off the opportunity for rumours to have effect.

(2) should all or some of ss 1041E, 1041F and 1041G be civil penalty provisions as well as attracting criminal liability

There does not appear to be any compelling evidence to indicate that the law is deficient in providing criminal penalties for breaches of sections 1041E, 1041F and 1041G of the Corporations Act.

With regard to whether or not more enforcement action would be undertaken if a civil penalty was also available in relation to these provisions, as the civil standard of proof is also high it is doubtful that enforcement teams would make different judgments on whether to proceed with civil cases instead of criminal cases. In the absence of evidence that the criminal standard has been a significant barrier to pursuing such breaches, we suggest that civil penalty provisions are unlikely to increase the prospects of successful regulatory action and to that extent any benefit would prove to be illusory.

There is a continuing lack of clarity with respect to the interaction of the Criminal Code and the Corporations Act where civil and criminal penalties both apply to market manipulation provisions, particularly in relation to section 1041B. Under subsection 1041B(2), a defendant could incur civil and criminal liability for transactions that were entered into for legitimate purposes and which did not create a false or misleading appearance. Consideration of whether civil penalty provisions should apply as well as criminal liability need to be considered in the context of the broader Review of Sanctions[74] that was conducted by the Government in 2007.

(3) should any of the elements of any of these three provisions be amended and, if so, in what manner

Consideration of whether civil penalty provisions should apply as well as criminal liability need to be considered in the context of the broader Review of Sanctions that was conducted by the Government in 2007.

(4) should some form of compulsory recording of telephone conversations and other electronic forms of communication, such as SMS, be introduced

While taping phone calls or retention of electronic communications of some market participants might seem to be a possible way to increase the chance of detection, the range of channels of communication available outside broker dealing systems militates against this. In the context of an infinite range of channels of possible communication, including media, mobile phones, other electronic communications and external meetings, the regulatory effectiveness of recording only one channel of communication is difficult to see.

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[74] Review of Sanctions for Breaches of Corporate Law, The Treasury, 2007.

If one channel of communication were to be recorded this would have the likely effect of driving communications by a rogue intent on breaking the law to those means/forms that are not the subject of monitoring.

If recording were mandated, the question of how long the retention period for records should be becomes a difficult one to resolve. The longer the period, the more costly this will be for brokers and this also adds another layer of complexity to a broker's normal document retention practices. In firms where conversations are currently being recorded this is done by brokers to assist in resolving trading errors/disputes and hence they are retained for a short period of time (eg T+3). Retention for longer periods is unnecessary for good civil legal risk management practice.

If the net is cast too wide, a different type of detection problem may occur. Rather than having a lack of information to review, regulators will be faced with the opposite problem of too much information to review. It then could become an exercise in searching for the 'needle in the haystack'; which can result in matters either being overlooked and/or significant delay in completing an investigation. It could significantly add to the cost of regulation as teams of ASIC officers will be required to engage in time intensive review of large volumes of information. This would detract from the good principle that regulatory action is more effective when it is timely.

A rigorous cost benefit analysis would need to be conducted to assess whether such a requirement would produce any compliance benefit. As compulsory recording of telephone and other electronic forms of communication would result in significant additional costs being imposed on industry. Requiring the taping and retention of calls is unlikely to assist in detection but will add significantly to costs for industry and regulators with little demonstrable benefit. An estimated cost for installation of a telephone taping system for an equities trading desk is estimated to be $390,000 to $470,000 once off to install and $36,000 to $50,000 per year to maintain voice recording records. At the 2008 ASIC Summer School, the SEC Commissioner, Kathleen Casey noted that a very small amount of their success rates regarding insider trader investigations were the result of telephone records.

The compliance value of such compulsory recording has previously been considered in the context of the imposition and later removal of requirements from the Corporations Act to record telephone conversations during takeovers. The lessons from this previous law reform exercise should be taken into account in considering new measures of this type.

(5) any other steps to facilitate the detection and prosecution of rumour-mongering

AFMA notes that ASIC has recently set up a mechanism to assist in the reporting of false market rumours. Information can be sent to ASIC by email or by telephone. This facilitative measure will assist monitoring and compliance activities by the regulator.

Overall, the importance of ensuring timely reporting to the market is emphasised in response to this question as the most effective way to address market rumours.

Target response to rumours

(6) would there be benefit in ASIC or the ASX providing further guidance on how companies should deal with market rumours affecting their securities?

AFMA considers that it would be appropriate for industry and ASIC to review together the current guidance documentation, particularly ASIC's 1999 'Heard it on the grapevine' guidance to develop a fresh guidance package which includes both guidance from the regulator and good industry practice. Such a combined package should be developed holistically so that both the regulator's view and industry guidance on good practice complement each other.

Attention should be directed in this review beyond the role of brokers to the wider field of market participants and commentators using blogs, chat sites and the media.

(7) in that context, would it be beneficial to adopt any of the principles in the FSA Market Abuse Directive Instrument

The relevance of the FSA Market Abuse Directive Instrument should be considered as part of the collaborative review between industry and ASIC on updating guidance as proposed in answer to question (6) above.

The relevance of the FSA Market Abuse Directive Instrument should be considered as part of the collaborative review between industry and ASIC on updating guidance as proposed in answer to question (6) above.

Recipients of rumours

(8) would it be beneficial to develop best practice guidelines on how to deal with rumours received

This question should be considered as part of the collaborative review between industry and ASIC on updating guidance as proposed in answer to question (6) above.

(9) if so, what should be the content of those guidelines, who should develop them and how should they be monitored or enforced?

This question should be considered as part of the collaborative review between industry and ASIC on updating guidance as proposed in answer to question (6) above.

Australian Employee Ownership Association

Rumour-mongering would be discouraged and its problems mitigated by the disclosure provisions set out in the responses to [blackout trading].

Allens Arthur Robinson

ASIC's Project Mint has since March 2008 been actively reviewing documentary records of, and conducting interviews with, market participants to attempt to gather evidence for a successful prosecution of the market manipulation provisions in sections 1041A to 1041F. This process clearly has some way to run, but we suspect that ASIC will continue to struggle to successfully prosecute persons for spreading false or misleading information. Rumourtrage has been a particular issue over the last 18 months when combined with short selling in relation to particular securities.

Because of the difficulties faced by ASIC in successfully prosecuting market manipulation and misconduct offences, we would support making sections 1041E to 1041H civil penalty provisions.

We are also aware that some commentators consider that the market manipulation and misconduct sections of Part 7.10 of the Corporations Act are overlapping and confusing, and have called for those sections to be redrafted under a single clear general market misconduct provision. While we have no problem with this, we do not believe that the drafting of the existing provisions has been an impediment in the past to successful prosecution for offences under the provisions. Having a well funded and active regulator (ie ASIC) and making sections 1041E to 1041H civil penalty provisions is much more important.

We would not support the introduction of compulsory recording of telephone conversations and other forms of electronic communication, in addition to those that are already recorded, for the purpose of regulating rumourtrage. We consider that it is unlikely that persons participating in rumourtrage would use the forms of communication that would be recorded under such a regime, and where the few who do use those forms of communication for rumourtrage are successfully prosecuted, the cost to implement compulsory recording, in our view, would far exceed the benefit.

We would not oppose the development of best practice guidelines by ASIC, ASX or the appropriate industry bodies.

Law Council of Australia

The Committee considers that there is a pressing need for a wholesale review of the existing provisions dealing with market manipulation in Division 2 of Part 7.10 of the Corporations Act.

To the extent that the current provisions apply to market disclosure and the dissemination of information, the provisions are overlapping and confusing. They are also inadequate for the prosecution of manipulative trading offences. They have failed to keep pace with changes in the market place. Section 1041E is derived from recommendations of the Rae Committee and section 73 of the *Securities Industry Act 1970* (NSW). Section 1041F is derived from the *Prevention of Fraud (Investments) Act 1958* (England) and is similar to section 1041E. All of these sections were enacted at a time when the trading floors in Australia were state based, open outcry. They therefore predated electronic trading of securities, mobile phones and the internet.

The complexity and inaptness of these provisions to market structure explain why there has been so little enforcement history in Australia and no attempt has been made to resolve uncertainties derived from UK case law based on similar provisions as to the culpability basis of the sections.[75] Sections 1308 and 1309 also now cover very similar territory in a slightly different way.[76] The intersection with the civil remedy in section 1041H is also overlapping and confusing.

The Committee advocates the adoption of a single general antifraud sanction (to use US jargon) that applies to statements that relate to dealings in securities. This would be in the interests of simplification and clarification of this important policy underpinning of Australia's securities laws.

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75 See the difference in approach between *R v Bates & Russell* [1952] 2 All ER 842, *R v Grunwald* [1953] 1QB 150 and *R v Mackinnon* [1959] 1QB 150. See also *Pollard v DPP* (1992) 8 ACSR 813. In the UK the uncertainty was resolved in 1963 by section 21 of the Protection of Depositors Act 1963 (England).

76 Apparently derived from s 375 of the *Companies Act 1961*.

An important element of that debate is to fix a culpability requirement for the prohibition. The Committee would support a fraud standard for criminal liability and a negligence standard with a due diligence defence for civil liability.[77]

The Committee supports the extension of Part 9.4B civil penalty liability to these provisions for the reasons enunciated to support the introduction of that regime for certain sections specified in the Corporations Act.[78]

The Committee is also of the view that telephone recording will not work as an effective remedy to stamp out 'rumourtrage' as rumourtrage will then merely take place outside dealing room floors. At best, telephone monitoring practices might operate as a disincentive to wrongdoing. However, this perceived enforcement benefit needs to be balanced against invasion of privacy, the cost of such intercepts and the often huge investigative resources taken up in reviewing hours of telephone taping product. There have been some public suggestions that telephone intercept powers should be given to ASIC in this area. While this might address some issues around the use of mobile telephones, the existence of prepaid telephones which are often difficult to trace makes this also a blunt instrument and magnifies the downsides addressed in relation to telephone taping.

Adams and Nehme

Initiating rumours

(1) The implications for market integrity of rumour-mongering

Rumour-mongering has a very negative effect on market integrity for it is contrary to the fundamental principles and objectives stated by the International Organisation of Securities Commissions (IOSCO): fairness, efficiency and transparency of the market. Today, fairness, efficiency and transparency of the market are incorporated into the *Corporations Act 2001* (Cth). In short, rumour-mongering may lead to market manipulation which is prohibited by the law due to its negative impact on market integrity.

(2) Should all or some of ss 1041E, 1041F and 1041G be civil penalty provisions as well as attracting criminal liability?

Before making any changes to the current laws, a look at s 1041I is needed. Section 1041I notes that 'a person who suffers loss or damage by conduct of another person that was engaged in the contravention of section 1041E, 1041F, 1041G or 1041H may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention […].' Since civil liability is possible, civil penalty provisions should also be introduced in relation to these sections. This will also ensure consistency with other market manipulation provisions in the *Corporations Act*. This will also provide ASIC with flexibility to bring civil penalty actions in relation to such breaches without the need to prove the mental element.

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77 This was broadly the recommendation of the Jenkins Committee in 1962 when reviewing the antecedent of s 1041F - see paragraphs 253-255 of Cmnd 1749.

78 As enunciated in the recommendations of the 1989 Cooney Committee Report.

(3) Should any of the elements of any of these three provisions be amended and, if so, in what manner?

Strict liability needs to be introduced in relation to proving the existence of certain elements.

(4) Should some form of compulsory recording of telephone conversations and other electronic forms of communication, such as SMS, be introduced?

Yes, compulsory recording should be introduced for listed companies only. Such companies would afford the cost that would be generated from compulsory recording telephone conversation and other electronic forms of communication. However, it needs to be made clear that such communications are being recorded so not to contravene the *Telecommunications (Interception and Access) Act 1979* (Cth).

ASIC may also be provided with powers to issue a warrant to intercept telephone or other electronic communication in case it suspect that market manipulation or insider trading are taking place. This will require the amendment of the *Telecommunications (Interception and Access) Act 1979* (Cth). Section 6C of the Act limits the issue of warrant on the application of 'an agency or an officer of an agency, or on an application by an eligible authority of a State'. An inclusion of ASIC in the list of agencies requires an amendment of s 5 (the interpretation section) to include ASIC into the list of 'enforcement agencies'.

(5) Any other steps to facilitate the detection and prosecution of rumour-mongering

Another step to facilitate the detection of rumour-mongering is through whistle-blowing and granting immunity to participants involved in market manipulation who blow the whistle on the activity. Further, the improvement of the continuous disclosure regime would improve detection of rumour-mongering.

Target response to rumours

(6) Would there be benefit in ASIC or the ASX providing further guidance on how companies should deal with market rumours affecting their securities?

No comment.

(7)In that context, would it be beneficial to adopt any of the principles in the FSA Market Abuse Directive Instrument?

No comment.

Recipients of rumours

(8) Would it be beneficial to develop best practice guidelines on how to deal with rumours received?

Yes, this would be very beneficial. It will protect investors and it will enhance transparency of the markets.

(9) if so, what should be the content of those guidelines, who should develop them and how should they be monitored or enforced?

In our opinion, the ASX Corporate Governance Council would be an ideal body to develop such guidelines.

Jim Berry

Submission on Section 3.5 Recipients of Rumours

The phrase ‘does not care’ in s 1041E(1)(c) needs to be explained. If it means that if you pass on a rumour without establishing whether it is true or not, you are guilty of an offence, then that needs to be made very clear.

A requirement that ALL license holders were required to record all phone conversations would help in insider trading and manipulation investigations. In addition, it would clarify facts in any investigations into possible breaches of false or misleading statements.

ABA

Market rumours can have a significant impact on the efficiency and integrity of the market. We are concerned about false information being deliberately spread across the market – referred to as ‘rumourtrage’ – especially recently during the global financial crisis and market turbulence. Rumourtrage, coupled with aggressive short selling, can distort the market and have destructive consequences for share prices, and with regards to bank stocks, can have serious consequences for the stability of banks and the banking system.

The ABA notes that the Federal Government, ASIC and the ASX have recently taken actions to address concerns about abusive short selling in Australia’s market, for example, enhancing disclosure of short selling data. However, disclosure of short sales does not address concerns regarding potentially collusive behaviour, predatory trading, rumourtrage and false information being deliberately spread across the market. These are challenging regulatory issues – in particular, establishing what constitutes a rumour and finding the evidence of this market misconduct in Australia and overseas can be extremely difficult.

The ABA observes that some recent examples of rumourtrage, information that has been, or could have been, seriously damaging to a company’s reputation and share price, has allegedly been spread by market commentators or others that could claim the information to be a matter of opinion. It is important to bear in mind that a rumour may not simply be information that is factually incorrect, but also information that is baseless, yet equally able to have adverse consequences for the company’s shares as well as the efficiency and integrity of the market.

The Corporations Act prohibits a person in this jurisdiction or elsewhere from making a statement or disseminating information if the information is false in a material particular or is materially misleading and where the statement or information is likely to induce persons in this jurisdiction to trade.[79] It is important for regulators to have adequate powers and remedies to detect and take action against inappropriate market behaviour. Criminal offences and civil penalties should apply to the most egregious behaviour and severe contraventions in the law.

The ABA notes that in March 2009, the Financial Services Authority (FSA) in the United Kingdom introduced an obligation on stock brokers to record, and retain for six months, certain electronic communications. While there may be some appeal in introducing a similar obligation in Australia, we are uncertain as to the effectiveness

79 Section 1041E of the Corporations Act.

of such a measure. Recording communications of stock brokers would likely result in capture of an incredible amount of information that would likely lead to inefficient investigations. Having said that, it is unlikely to capture all communications (e.g. only relating to execution of client orders, not general discussions about market conditions or company/sector performance) and it is unlikely to apply to communications of all persons that may be in a position to initiate and/or spread rumours. Abusers are likely to find other ways to get around the law. Recording of communications also raises privacy issues. It should also be noted that the requirement to record conversations during a takeover bid were recently repealed from the Corporations Act.

The ABA believes it is important for companies to make sure they have procedures in place for dealing with market rumours. ASIC and the ASX have both issued guidance for companies to use in responding to rumours or speculation to ensure that the market is fully informed.[80] While existing guidance is helpful in assisting companies meet their legal obligations, we observe that in some cases the rumour is not clearly linked to a piece of information or supposedly single fact – that is, some assertions may be very general, yet still able to have adverse consequences for the company's shares. In these cases it is difficult for companies to respond and issue information to the market to counteract the rumour.

The ABA believes:

- The Government should conduct a review of Part 7.10 Division 2 of the Corporations Act (market manipulation provisions). Further consideration should be given to the offences relating to market misconduct and manipulation with a view to assessing the adequacy of current prohibitions, offences and defences and the difficulties of detection, investigation of suspected contraventions of the law and associated practices (i.e. collection of evidence) and enforcement, especially in light of the emergence of electronic communications.[81]
- The Government should give further consideration to: (1) how rumours may spread across the market, including by commentators that may, or may not be market participants, financial service providers, or directors, officers or employees of a listed company; and (2) culpability for initiating and/or spreading rumours, so that a targeted response to market rumours can be implemented.[82]
- ASIC, ASX and industry representatives should review existing guidance with a view to developing a new guidance package that promotes good

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80 *Heard it on the Grapevine* issued by ASIC and Guidance Note 8 issued by the ASX.

81 The ABA notes that in 2007 the Government commenced a review of sanctions for breaches of corporate law. This review should give specific consideration to the market manipulation provisions.

82 The ABA notes the description of market manipulation as contained in the EU *Market Abuse Directive*. This description explicitly refers to the use of the media or Internet to spread false and misleading signals as to financial instruments. The current provision in the Corporations Act is silent as to the way false and misleading statements may be spread. We consider that it is not necessary to explicitly identify some forms of communications, as this risks that as new technologies develop there may be some uncertainty with regard to the application of the provision to those new forms of communications. However, it would be reasonable for ASIC and the ASX to provide guidance on how persons, technologies or facilities may be used to spread false and misleading statements.

industry practice, industry and market awareness of market misconduct and the consequences, and good disclosure to investors.

The ABA notes that ASIC has recently established a facility for the reporting of rumours and other false information. This facility will hopefully assist the regulator monitor and take action against rumourtrage.

ASA

The view of the ASA is that the only effective mechanism in preventing the spreading of false and misleading information is in ensuring that there is a significant risk that offenders will be caught and ensuring that the penalties bear a relation to the offence. Guidelines for best practice and other well meaning, but essentially self regulatory measures cannot address a practice, at the heart of which lies an intention to breach the law.

The ASA would support measures which would allow ASIC to successfully pursue a greater number of prosecutions. There is a suggestion that the taping of phone conversations could assist. Obviously the relationship between the costs to industry and regulators and the benefits that could be gained must be considered.

Long-lasting penalties, such as banning brokers, must provide a greater deterrent than fines. Assisting the regulator to make a case by attaching civil penalty provisions to those relevant sections of the Corporations Act 2001, must also act as a greater deterrent.

Ensuring that ASIC is properly resourced to investigate and prosecute is extremely important.

Finsia

In relation to the initiation of false rumours, Finsia supports amending the Corporations Act to provide for civil penalty provisions in addition to the existing criminal liability under s 1041E, s 1041F and s 1041G. However, Finsia considers that the other measures discussed in the Issues Paper would not significantly assist in preventing or proving ‘rumourtrage’.

IFSA

As noted in the issues paper, the making of or misleading statements is an area which is adequately covered in varying degrees by provisions in the Corporations Act 2001 and ASX’s Operating Rules.

<u>IFSA recommendation</u>

While the current regulatory framework is adequate, we would be happy to work with government and industry representatives on further investigating the extent of ‘rumourtrage’ and whether the existing regime should be enhanced.

Legg, Harris and Steel

1. Introduction

The modern share market operates based on the efficient market hypothesis that share prices fully reflect all available information and that requiring mandatory disclosure of price-sensitive information, that may otherwise remain private, promotes the accuracy of share prices.[83] Equally, false or misleading information may be used to artificially effect share prices and as a result market confidence. Despite reliance on the efficient market hypothesis, irrational behaviour by investors has been found to occur, particularly in times of uncertainty, providing a strong justification for regulatory intervention.[84]

An efficient market is supported by disclosure requirements and prohibitions on misleading information. The main aim of continuous disclosure is to enhance confident and informed participation by investors in secondary securities markets.[85] Continuous disclosure is also fundamental to corporate governance and investor protection through preventing insider trading and market manipulation.[86]

International Organization of Securities Commissions (IOSCO) in its Objectives and Principles of Securities Regulation states:

> The regulation of trading in the secondary market should prohibit market manipulation, misleading conduct, insider trading and other fraudulent or deceptive conduct which may distort the price discovery system, distort prices and unfairly disadvantage investors. Such conduct may be addressed by direct surveillance, inspection, reporting, product design requirements, position limits, settlement price rules or market halts complemented by vigorous enforcement of the law and trading rules.[87]

The IOSCO Public Document No. 103, Investigating and Prosecuting Market Manipulation, IOSCO Technical Committee, May 2000 goes into further detail including:

> Public confidence in the fairness of markets enhances their liquidity and efficiency. Market manipulation harms the integrity of, and thereby undermines public confidence in, securities and derivatives markets by distorting prices, harming the hedging functions of these markets, and creating an artificial appearance of market activity.[88]

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83 See Entcho Raykovski, Continuous Disclosure: Has Regulation Enhanced the Australian Securities Market? (2004) 30 (2) *Monash University Law Review* 268 at 270 and Angie Zandstra, Jason Harris and Anil Hargovan, Widening the net: Accessorial liability for continuous disclosure contraventions (2008) 22 *Australian Journal of Corporate Law* 51 at 54-55 explaining the theoretical basis of continuous disclosure.

84 Entcho Raykovski, Continuous Disclosure: Has Regulation Enhanced the Australian Securities Market? (2004) 30 (2) *Monash University Law Review* 268 at 272.

85 Companies and Securities Advisory Committee, *Report on an Enhanced Statutory Disclosure System*, September 1991 pp 6-7 and Corporate Law Economic Reform Program, *Corporate Disclosure: Strengthening the Financial Reporting Framework*, Paper No 9 (2002) p 129.

86 Corporate Law Economic Reform Program, *Corporate Disclosure: Strengthening the Financial Reporting Framework*, Paper No 9 (2002) p 129 and Belinda Gibson, Commissioner, ASIC, ‘Improving confidence and integrity in Australia’s capital markets’, Presentation to the Committee for Economic Development of Australia (CEDA), Sydney, 8 July 2008 at 2.

87 International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* (May 2003) p 43.

88 IOSCO Public Document No. 103, Investigating and Prosecuting Market Manipulation, IOSCO Technical Committee, May 2000 (‘IOSCO No. 103’) at 1.

> …
>
> A number of [market manipulation] methods used include:
>
> Dissemination of false or misleading market information through media, including the Internet, or by any other means. The dissemination is done in order to move the price of a security, a derivative contract or the underlying asset in a direction that is favorable to the position held or a transaction planned by the person disseminating the information.[89]

The activity of rumour-mongering has an adverse effect on market integrity.

2. Possible amendment of sections 1041E, 1041F and 1041G

The CAMAC discussion paper observed that 'this is an area where there are practical problems in uncovering evidence and in proving each of the elements of an offence beyond reasonable doubt'.[90] There is some suggestion that the existing provisions may be rendered easier to prove through making the sections civil penalty provisions or by making the elements of the section easier to prove regardless of whether the criminal or civil standard of proof applies.

It is important in regulation, as in law generally, to send clear messages about acceptable and unacceptable conduct. One important distinction the law draws is between behaviour that exposes one to liability to compensate victims and behaviour that is morally condemned by society generally: that is between civil and criminal liability. A fundamental principle of criminal liability is that the wrongness of criminal behaviour lies in the mental state with which a person does the act. Justice Brennan in *He Kaw Teh v R* observed that 'The requirement of mens rea avoids "the public scandal of convicting on a serious charge persons who are in no way blameworthy".'[91]

Degrees of wrongness are seen to often lie in the different forms of intention or knowledge offenders have at the time the act is committed. The degree of criminality can at times also lie in the acknowledged harm that the activity can cause.[92] In instances where the harm is severe and there is no social utility in the doing of the act, less emphasis may be placed on the mental state and the act still be seen as criminal. For example, homicide is considered in most instances to be an abhorrent act with no social utility. If the offender causes a death intentionally or with recklessness as to death or serious injury the crime of murder is committed.[93] However, given the severe harm represented by death liability can also exist if the offender acts without any mental awareness that they may cause death, provided the act is sufficiently negligent.[94]

On the other hand, if the act that constitutes the crime is one that is socially beneficial in some circumstances,[95] or the act is one that is regularly committed with no real

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89 IOSCO No. 103 at 6.

90 Corporations and Markets Advisory Committee, Aspects of market integrity (2009) p 25.

91 *He Kaw Teh v R* (1985) 157 CLR 523, 565 citing *Sweet v. Parsley* [1970] A.C. 132. 150.

92 For nuanced discussion of these issues see Stuart Green, *Lying, Cheating and Stealing: A Moral Theory Of White-Collar Crime* (2006) and Caron Beaton-Wells, 'Capturing the Criminality of Hard Core Cartels: The Australian Proposal' (2007) 31 MULR 675.

93 See eg *Crabbe v R* (1985) 156 CLR 464

94 See eg *R v Lavender* (2005) 222 CLR 67

95 Such as sexual intercourse.

harm caused,[96] the emphasis in determining criminal liability rests strongly on the mental intentions and knowledge of the accused. This is particularly important in a business setting.

The nature of the conduct that is under consideration, the spreading of false rumours, is a form of behaviour that is in general terms central to financial markets. That is, the communication of information about businesses, shares, and financial products is at the very core of a market. In modern electronically mediated markets, information and share trading occur at extremely fast rates, and often information is passed that is less than perfect or fully researched. It would be highly stifling if participants in a market felt that they were prohibited from passing on information that was not extensively checked for veracity.

In these circumstances, there is not a clear dichotomy between truth and rumour. Instead there is a sliding scale of reliability of information. At one end the reliability becomes so thin that is can be characterised as a rumour, but that point is liable to be not easily demarcated, other than when the information is clearly not verifiable.

Similarly, the falsity of information operates on a sliding scale from information that is totally false to information that contains elements of a misleading nature. In order to deal with this the criminal law requires that communication that is sufficiently false to raise the possibility of criminal liability must be false in a 'material particular', as do sections 1041E and 1041F. This materiality is determined objectively, but importantly from the perspective of the recipients not the communicator.[97] Thus information can be found to be false even though the communicator strongly believes it to be true.

Because of these considerations it is important to strike an appropriate balance between protecting the integrity of market information and also acknowledging that market participants regularly pass on information that may be speculative or that they wrongly believe to be accurate.

The current regulation of information sharing in the Corporations Act seeks to strike that balance. It recognises that individual fault aside, participants in a market should be able to expect that information is accurate. As such, the Act provides for a broad basis for civil compensation for loss in s 1041H. Liability under section 1041H is relatively easy to establish because:

- The conduct may be directed to an unidentified group of people so that a representative member of that group must be determined by the court to ascertain if the conduct is misleading or deceptive.[98] The ordinary or reasonable representative of that group may be an unsophisticated retail level investor or a person without experience in dealing with shares, which increases the likelihood that they may be misled.[99]

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96 Lying through exaggeration in social interaction could be an example.

97 Cf *ASC v Macleod* (2000) 18 ACLC 424.

98 *Campomar Sociedad, Limitada v Nike International Ltd* (2000) 202 CLR 45, 85: followed in *National Exchange Pty Ltd v Australian Securities and Investments Commission* (2004) 49 ACSR 369, [18]–[19] in relation to s 1041H(1).

99 *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452, 467; *Downey v Carlson Hotels Asia Pacific Pty Ltd* [2005] QCA 199 (Unreported, Queensland Court of Appeal, Williams and Keane JJA, Atkinson J, 10 June 2005) [65].

- The connection between a misleading statement and a share so as to attract the operation of section 1041H of the Corporations Act can be indirect or less than substantial.[100]
- Intention is irrelevant. The provisions are drafted so as to be concerned with consequences and not the contravener's state of mind.[101]

However, section 1041H is not a civil penalty provision. It grounds civil liability only. ASIC is able to seek an injunction to prevent or stop a person from contravening section 1041H and in addition or in substitution seek damages.[102] ASIC may also pursue compensation orders on behalf of persons who suffered or are likely to suffer loss or damage because of the contravention of section 1041H.[103] ASIC cannot seek a pecuniary penalty order pursuant to section 1317G.

The existence of such a civil basis for compensation means that any justification for criminal liability is not based on a need to provide any indirect avenue for compensation of victims. Instead, criminal liability is only required to express social denunciation of behaviour that is seen to be so far from acceptable that it deserves criminal sanction.

As will be seen, the authors do not consider that there are forms of behaviour that fall outside of the current offences that would justify an action by ASIC via civil penalty provisions.

(a) Section 1041E

As a default, criminal liability for the spreading of false rumours should only arise if the offender deliberately passes on false information with an intention to induce a person rely on that information to their detriment, or to the offender's benefit. This is the form of behaviour that the Minister's letter is concerned about and is at the crux of the Committee's enquiry. Such behaviour clearly falls within the current ss 1041E, 1041F and 1041G.

It is also generally accepted that because of the known harms that can be caused by the spreading of information that criminal sanction should extend to any person who spreads the information with a knowledge that there is a substantial risk that it might be false and that it is unjustifiable to take that risk (that is, recklessly, as defined under the Criminal Code s 5.4). Currently such an awareness can form the basis of liability under s 1041E. However recklessness is expressed in the terms 'does not care'. **Consideration should be given to re-wording the recklessness element of s 1041E to be in conformity with recklessness under the Criminal Code to ensure a consistent approach to the mental state throughout Commonwealth law. This is particularly the case in light of the use of 'reckless' in s 1041F**.

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100 *Australian Securities and Investments Commission v Narain* (2008) 66 ACSR 688, [9], [76].

101 *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre Ltd* (1978) 140 CLR 216, 228, (Stephen J): 'As I read s 52(1) ... it is concerned with consequences as giving to particular conduct a particular colour. If the consequence is deception, that suffices to make the conduct deceptive'; *Brown v Jam Factory Pty Ltd* (1981) 53 FLR 340, 348; *Australian Securities and Investments Commission v Online Investors Advantage Inc* [2005] QSC 324 (Unreported, Supreme Court of Queensland, Moynihan J, 26 October 2005) [138] dealing with section 1041H(1) of the *Corporations Act* and section 12DA(1) of the *ASIC Act*.

102 s 1324(1) and (10).

103 s 1325.

However, the section also extends liability in some circumstances to a person who unwittingly passes on false information. Those circumstances are when the communicator 'ought reasonably to have known'. This form of liability is unusual in criminal law, but can be justified if the harm caused by the activity is so great that any person engaging in it has a responsibility to take care.[104] The minimum standard for liability under s 1041E is thus one of negligence. It is based on the fact that the offender does in fact not know the information is false, but should have realised this. This can be justified in this instance because of the levels of responsibility borne by, and trust placed in, those who deal in financial products both to the market and its regulators but also to the public and others involved in the market.

Below this minimum level of criminal liability are only situations where a person passes on false information in circumstances where no reasonable person could have been expected to know that the information was false. Such instances do not form a principled or necessary basis for criminal liability. If liability were extended to these instances, any penalty that would be applicable would be minimal as a court would be required to sentence on the basis that no other reasonable person in that situation would have done otherwise. Unless knowledge was contested, it would be unlikely that ASIC would pursue prosecution.

Similarly there is no need for any civil penalty provision to be coupled to this offence. Given that the minimum fault requirement for breach of s 1041E is an objective test of reasonableness, a civil penalty would not act to make proof easier except in two instances. The first would be where the falsity was not to be reasonably known, and the second would be whether there was doubt as to whether the defendant was the person who had disseminated the information. In both cases, it would be inappropriate to impose penalties.

It is submitted that there is no need or justification for any amendment to s 1041E.

(b) Section 1041F

This section contains a number of fault elements. Making or publishing a statement etc requires recklessness as defined in the Criminal Code s 5.4. Concealment of facts requires dishonesty as defined in the Criminal Code s 130.3. Recording information requires knowledge.

It is submitted that this is unfortunate and a consistent fault element be required for all three forms of behaviour. The Criminal Code uses recklessness as the default fault element for offences where the physical element involves circumstances or results (s 5.6(2)). As this offence requires the result of an inducement, recklessness is the appropriate fault element. Similarly, the falsity of information is a circumstance and consequently recklessness as to the existence of such falsity is appropriate.

It is submitted that the fault elements for s 1041F be recklessness as defined in the Criminal Code.

Given that the appropriate fault element for s 1041F is recklessness there may be scope to introduce a civil penalty offence to complement the section. The difficulty with so doing would be the need to consider the extent to which liability would be strict. For example it might be seen to be overly heavy-handed to expose to liability

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[104] An example of this is the offence of negligent driving.

persons who had not intended nor were reckless as to whether their actions would induce dealing in the financial product.

Because of the overlap between ss 1041E and s 1041F(1)(a) any civil penalty provision should probably expressed to only cover those forms of dealing outside of the scope of s 1041E(2). Indeed it may be questionable whether those forms of dealing have potential to affect the market in the same way as inducing application and disposal of financial products, and if so, whether civil penalties are necessary.

Given the ability of internet based information to spread rapidly and widely, it might be appropriate to create a civil penalty regime for s 1041F(c). However, it is arguable that electronic storage of information that is accessible via the internet amounts to dissemination of information, and thus would fall within s 1041E, reducing the strength of any case for a civil penalty for this behaviour.

It is submitted that there is not a clear case for amending s 1041F to include civil penalty provisions.

(c) Section 1041G

It is unfortunate that the use of dishonesty in the Corporations Act is not uniform. While dishonesty in sections 1041F and 1041G are defined in terms of the Criminal Code adoption of the test derived from *R v Ghosh*,[105] the use of dishonesty in s 184 is not so defined. Indeed s 184(1) requires a compound concept of intentional dishonesty. It is submitted that for consistency any use of dishonesty in the Corporations Act should conform to the Criminal Code definition, as s 1041G currently does. It is a failure of the current form of the Corporations Act that this is not uniformly the case, and has the potential to create considerable uncertainty of interpretation.

The definition of dishonesty in the Criminal Code was the result of a clear decision by the Federal Parliament to reject the approach to dishonesty favoured by the High Court in *Peters v R*.[106] In so doing, the Parliament made clear that dishonesty is a fault element, not a physical element, though there is some academic debate over whether it is a purely fault element of a compound of physical and fault.[107] Analysis of the decision of the High Court in *Peters v R* may suggest that the High Court considered dishonesty when used as an aspect of 'dishonest means' in defrauding applied to a physical element of an offence.[108] If so, it is submitted that the definition of dishonesty in the Criminal Code and in the present s 1041G rejects that characterisation of dishonesty.

Instead s 1041G represents a general offence that prohibits behaviour that is otherwise not clearly prohibited by Part 10, where the offender knows that such behaviour would not be considered acceptable practice by ordinary people. There may be

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105 [1982] QB 1053.

106 (1998) 192 CLR 493. The High Court held that dishonesty was to be tested against the standards of ordinary decent people, but that the awareness of this by the accused was irrelevant. In so doing, they rejected the approach in *Ghosh*.

107 See eg Stephen Odgers, *Principles of Federal Criminal Law* (2007); Ian Leader-Elliott, 'Cracking the Criminal Code: Time for Some Changes' U. of Adelaide Law Research Paper No. 2009-003.

108 See eg Alex Steel, 'Describing Dishonest Means: The Implications Of Seeing Dishonesty As A Course Of Conduct Or Mental Element' (2009) *Adelaide Law Review*.

controversy about the use of such generalised and undefined behavioural standards in business regulation, and this is certainly the case in relation to the proposed Trade Practices Act 1975 cartel offences.[109] Putting that considerable issue to one side, it is clear that the only basis for liability under s 1041G is that the conduct is dishonest. Otherwise the conduct, in the terms of the section, is entirely lawful.

It is therefore not logically possible to either create a lower fault threshold or amend it to a civil penalty provision.

It is submitted that no amendment be made to s 1041G

If CAMAC were minded to introduce a civil penalty provision then the *Financial Services and Markets Act 2000* (UK) provides an example of a regulatory framework where market manipulation may attract both civil penalties and criminal prosecution. The civil penalty may be imposed if the person engages in market abuse ie the behaviour is likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments of the kind in question.[110] Liability is strict, but may be avoided by proof of defences of reasonable mistake or due diligence.[111] Importantly, the burden of proving such defences lies on the defendant. Such a burden would act as an incentive for organisations to maintain effective compliance programs, a matter discussed in more detail below. The scope of any such defences would in practice define the offence, and given that the burden of proof would fall on the defendant, more consideration of the nature of those defences would need to be made before it would be appropriate for CAMAC to form a final view on the matter.

3. Obtaining Evidence

A perceived problem with the provision is that it is difficult to obtain the evidence to prove a contravention. A complaint that appears to have existed since at least 2000.[112] However, it should be noted that the section has been successfully used, for example, *R v Adler* (2005) 53 ACSR 471, *ASIC v Elm Financial Services Pty Ltd* [2005] NSWSC 1020, *ASIC v Preston* [2005] FCA 1805 and *ASIC v Macleod* (2000) 22 WAR 255.

The suggestion for improving the ability of ASIC to prosecute cases is to require the recording of electronic communications similar to that recommended by the FSA.[113] The FSA has estimated that the proposal will give rise to a one-off industry costs of £9-14 million and ongoing annual costs of £6-11 million.[114] The utility of the rules

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[109] See eg the submissions to the Criminal Penalties for Serious Cartel Conduct – Draft Legislation Discussion Paper issued by Treasury in January 2008.

[110] *Financial Services and Markets Act 2000* (UK) sections 118 and 123.

[111] *Financial Services and Markets Act 2000* (UK) section 123(2).

[112] IOSCO No. 103 at 21 ('In many jurisdictions, there is a different standard of proof for civil, administrative, and criminal actions, with the highest standard of proof required for criminal proceedings. In all three types of cases, it will often be difficult for the regulatory authority or prosecutor to obtain direct evidence -- either through documents or testimony -- of manipulation.').

[113] FSA Policy Statement 08/01 *Telephone Recording: recording of voice conversations and electronic communications* (March 2008).

[114] FSA Policy Statement 08/01 *Telephone Recording: recording of voice conversations and electronic communications* (March 2008) 11.

has attracted scepticism[115] and there also appears to be gaps in the rules (ie not applicable to mobile telephones or other handheld electronic devices) that make it easy for the dishonest or intentional contravener to avoid being recorded. The FSA's own report only states that recording communications 'may' increase the probability of successful enforcement.[116]

The authors are not opposed to the recording of electronic communications but a cost-benefit analysis needs to be undertaken before electronic communications recording rules are mandated. Such a study needs to consider the scope of the proposed rules (which markets and which functions in those markets are to be subject to the recording requirement) and the ease with which the requirements could be circumvented.

Consideration should be given to other alternatives to assist in the gathering of evidence. Three options worthy of consideration are:

1. Immunity agreements

2. Requirement to inform ASIC of receipt of rumour

3. Telephone tapping

The FSA has sought the ability to plea bargain or offer immunity to whistle blowers who come forward and report insider trading.[117] Such an approach could also be used in relation to market manipulation. A useful analogy would be the ACCC immunity policy for cartel conduct.[118] The ACCC's immunity policy interpretation guidelines state:

> International experience has demonstrated that an effective immunity policy encourages businesses and individuals to disclose cartel behaviour and this in turn assists the ACCC to stop the harm of the illegal conduct and prosecute participants.
>
> Just as importantly, an immunity policy that provides incentives to businesses and individuals to disclose illegal behaviour is also a powerful disincentive to the formation of cartels, as potential participants will perceive there then exists a greater risk of ACCC detection and court proceedings.[119]

The same reasoning may apply to market manipulation. An individual that engages in rumourtrage will have an incentive to confess to ASIC to avoid prosecution. Equally the possibility that a co-conspirator may seek immunity from ASIC is a powerful disincentive to engaging in market manipulation in the first place.

Consideration should also be given to adopting a requirement that a person who receives a statement or information that is materially false or is materially misleading, ie a rumour, should be obligated to inform ASIC of its receipt and source. This would

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115 See In Principle - A Newsletter from Bingham McCutchen's Financial Regulatory Practice (Autumn 2008) p 16 ('It remains to be seen whether the new rules will deliver tangible results for enforcement for market abuse; the overall view at the moment remains sceptical.') and The Financial Services newsletter from DLA Piper UK LLP (Summer 2008) p 13 ('It is unclear to what extent the FSA is, in reality, being hampered in its investigations by a lack of tape-recorded evidence.').

116 FSA Policy Statement 08/01 *Telephone Recording: recording of voice conversations and electronic communications* (March 2008) 5 and 15.

117 See Margaret Cole, Director of Enforcement, FSA, 'The FSA's Market Abuse Strategy: Prevention & Cure', 29 June 2007 and BBC News, 'Treasury eyes whistleblower plan', 28 March 2008.

118 See ACCC Immunity Policy for Cartel Conduct (26 August 2005).

119 ACCC Immunity Policy Interpretation Guidelines (26 August 2005).

be similar to sections 311 and 601HG in relation to auditors who have an obligation to report to ASIC of a suspected contravention of the Corporations Act.[120] Provision would also need to be made for the extension of a qualified privilege to the person informing ASIC. Although the requirement is stated as applying to a person above, it may be more workable to define the persons who have the obligation more strictly, such as by reference to stock brokers or the holders of an Australian Financial Services Licence.

Market manipulation relies in the misleading information being disseminated, so that multiple people must become involved, and secrecy so that those engaging in rumourtrage are not caught. The immunity and reporting requirement suggestions increase the risk that secrecy cannot be maintained.

Telephone tapping is currently not available for a suspected offence under section 1041E. Market manipulation is currently not classified as a 'serious offence', under the *Telecommunications (Interception and Access) Act 1979* (Cth). It is neither specifically listed as a serious offence nor does it attract the requisite penalty of at least 7 years imprisonment.[121] ASIC is not an 'agency' for the purposes of the Telecommunications (Interception and Access) Act and is unable to apply for or obtain a telecommunications interception warrant.[122] The availability of telephone tapping has been suggested as a way to overcome ASIC's inability to obtain the necessary evidence.[123]

Such a power could be given to either the Australian Federal Police or ASIC. The authors prefer the former as they have a broader responsibility to the public and can weigh the social benefits and costs of such intrusive powers across a broader range of interests. Further, if ASIC were to be granted such powers there would necessarily need to be described limits on the persons and circumstances in which the phone-taps could be granted. No such restrictions need apply if the AFP were able to undertake the interception.

The utility of telephone tapping needs to be considered in greater detail as it will be necessary set out the facts and other grounds on which the application for a warrant is based. The difficulty in obtaining evidence to prosecute the offence may also mean that there will be difficulty in satisfying a judge that a warrant should be issued. Further, it is likely that by the time ASIC (probably through the ASX) becomes aware that rumourtrage may be occurring in relation to a particular security the offending conduct may have occurred before any telephone tapping can take place.

If telephone-tapping were considered necessary, it is submitted that the most appropriate method by which this could be achieved would be to increase the maximum penalty for the offences to 7 years from their current 5. This would then bring the offences within Telecommunications (Interception and Access) Act s 5D(2)(a). In order to obtain a warrant the AFP would further be required by s 5D(2)(v) to establish that the activity amounted to serious fraud. This would both maintain the current regime of seriousness in terms of applicable penalty and also

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[120] See Michael Legg, An Auditor's Obligations to Report to ASIC – Between the Hammer and the Anvil (2005) 23 *Company and Securities Law Journal* 264.

[121] *Telecommunications (Interception and Access) Act 1979* (Cth) s 5D.

[122] *Telecommunications (Interception and Access) Act 1979* (Cth) s 5.

[123] See Andrew Main, ASIC must be given phone tap power, *The Australian*, 3 February 2009.

require that in each application evidence of potentially serious harm would be required.

4. Continuous Disclosure

CAMAC's Issue Paper stated that:

> Rumours can be initiated for various purposes. For instance, they may be created to misinform the market about the true financial position of a company, with the intention of artificially deflating or increasing the market price of its shares. Other rumours may be circulated in an attempt to force a company to acknowledge or disclose market-sensitive information otherwise exempt from disclosure requirements. An example would be a rumour concerning an incomplete proposal or negotiation that up to that point had not been publicly disclosed, in reliance on an exception to the continuous disclosure obligation under ASX Listing Rules.[124]

This submission focuses on the second type of rumour referred to by CAMAC.

The more likely that a rumour may have an element of truth to it, the more harmful that rumour is. A half truth is like a half brick, it travels further and does more damage. It may therefore be useful to reduce the opportunity for rumours to emanate from a source that is most likely to have some semblance of truth to it - the corporation about which the rumour is circulating. This requires a strengthening of confidentiality.

The issue of rumourtrage could be combated by amending the listing rules as follows:

1. the exceptions to disclosure set out in Listing Rule 3.1A can only be relied upon if the corporation has in place a compliance system for providing reasonable assurance that confidential information is indeed kept confidential. The directors must certify that such a compliance system exists in the annual and half-yearly accounts. If such a certification is in place then there is a presumption that the corporation may respond to any rumours in the market by citing the existence of its compliance system. The presumption is rebutted by a showing that the compliance system has failed ie the rumour is from the company or an advisor to the company who received confidential information.

2. if a rumour about a corporation is communicated then there will be a presumption that a false market exists and that the corporation must promptly confirm or deny the rumour. The presumption will not apply if a compliance system for providing reasonable assurance that confidential information is indeed kept confidential.

The requirements for a confidentiality compliance system could be usefully mandated or described by the ASX or ASIC. Equally there could be a requirement for a compliance plan to be registered with the ASX.

The aim here is two-fold. The first aim is to provide an incentive for corporations to take a tougher line on enforcing confidentiality. Just as AFSL holders are required to manage conflicts pursuant to section 912(1)(aa), listed corporations must protect confidentiality. In *ASIC v Chemeq*, Justice French (as he then was) opined:

> Compliance policies and procedures will not be effective unless there is, within the corporation, a degree of awareness and sensitivity to the need to consider regulatory obligations as a routine incident of corporate decision-making. This kind of general sensitivity to the issues underpins what is sometimes called a 'culture of compliance'.

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[124] Corporations and Markets Advisory Committee, *Aspects of market integrity* (2009) p 26.

> It does not require a risk adverse mentality in the conduct of the company's business, but rather a kind of inbuilt mental check list as a background to decision-making.[125]

The above recommendations build on the general sensitivity as to compliance obligations that are currently expected and require systems that promote and protect confidentiality.

Second, remove the incentive for those persons who seek to use a rumour to try and force a corporation to confirm whether a particular transaction is taking place by trying to create a false market or suggest that confidentiality has been lost. If the compliance system works then there should be no 'informed' rumours unless a person deliberately seeks to breach confidentiality. Such a person should be able to be more readily identified if a functioning compliance system is in place as the company should know every person that has had access to the confidential information.

The authors acknowledge that the above approach would require a change to the current ASX approach to confidentiality where once the ASX determines that confidentiality is lost, even when confidentiality arrangements are in place and/or the information has come from a source other than the entity, disclosure must follow.[126]

As for the suggested recording of electronic communications recommendation, there should be a cost-benefit analysis of lifting the bar for non-disclosure.

Accounting Bodies

The Accounting Bodies acknowledge the damaging affect on markets of the dissemination of false statements, though recognising the challenge for regulatory frameworks to fully eliminate this behaviour. This said, the various statutory measures contained in Pt 7.10[127] offer a comprehensive framework, though we support amendment to ss 1041E, 1041F and 1041G to attract civil as well as criminal penalties. Over and above this change, the range of difficulties alluded to in this part of the Issues Paper are best addressed through the operation of a well resourced regulator. Additionally, the various guidance referred to which have been developed by ASIC and ASX are sound. As a final comment, the possible response of making compulsory the recording of telephone conversations and other forms of electronic communications seems excessive.

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125 *ASIC v Chemeq* [2006] FCA 936 at [86].

126 ASX, *Guidance Note 8 - Continuous Disclosure Listing Rule 3.1* (June 2005) at [34].

127 Market misconduct and other prohibited conduct relating to financial products and financial services.

5 Corporate briefings to analysts

The submissions in this chapter are summarised in Section 5.7 of the report.

Australian Securities and Investments Commission

(1) The role that analysts' briefings play in Australia's financial market and the implications for market efficiency and integrity of these briefings

Analysts' briefings play an important and positive role in increasing the dissemination of accurate information on companies to the market. They enable management to explain the company's financial results, business strategies and outlook and they provide analysts with the opportunity to question and evaluate management. Public and private briefings are an important resource for analysts to gain greater insight on the company and its management and so formulate more knowledgeable recommendations. Informed and critical analysis of company results and management performance promotes a more efficient market and enhances market integrity.

Of course any disclosures at briefings must comply with the laws relating to continuous disclosure and insider trading (particularly the tipping offence which must be engaged when price sensitive information is provided to analysts).

There may be fairness issues (both real and perceived) in relation to the current practice of private briefings with well-connected analysts potentially having access to more detailed and higher quality discussions with management. However, ASIC believes the benefits that the market derives from more informed and critical analysis of companies and management mitigate the fairness issues, provided the law is complied with. In determining whether any briefing is appropriate, management must act for proper purposes and in the best interests of the company.

Public briefings

(2) Whether there should there be greater guidance on what is required to ensure that the information provided in a public briefing is effectively and expeditiously disclosed generally

A briefing is public when 'the content of the briefing, [and any interchange with persons present,] is simultaneously made 'generally available' to the market.' (CAMAC issues paper, page 31)

ASIC believes there should be some common understanding about what should be considered public, and therefore materials presented made available to the market. There is some circularity in the above definition.

In principle, if a company generates materials or provides information or reports that are provided to a number of analysts then those materials should be made available to the market, even if a particular item of information may not be so material and price sensitive that the continuous disclosure requirements are engaged. It may be that the Corporations Act should be amended to require this, supplementing the continuous disclosure provisions.

Many companies ensure that information provided in a public briefing is expeditiously disclosed to the general public by:

- Placing slides and other material presented at analysts' briefings on the company website at the time of the briefing;

- Giving investors access to live broadcasts of analysts' briefings, and making telephone conferencing facilities available to allow investors to listen to briefings; and
- Recording analysts' briefings and placing a transcript or summary of the briefing and questions and answers on the company website as soon as possible after the briefing.

ASIC considers that the law should not be specific on the means by which companies make the information presented at public briefings available generally, though clearly a written record must be provided to the market. Companies are best placed to determine what is the most effective and efficient disclosure mechanism in their particular circumstances. A more flexible approach will also allow companies to take advantage of technological developments.

(3) Whether there are any approaches to public briefings of analysts in overseas jurisdictions that could usefully be adopted in Australia?

ASIC does not believe the adoption of a rule equivalent to the SEC Rule 100 Selective disclosure and insider trading is necessary on the basis that the continuous disclosure and insider trading provisions in the Corporations Act already adequately deal with this issue.

ASIC has no other comments on approaches to public briefings in overseas jurisdictions.

Private briefings

(4) Whether private briefings to analysts increase market efficiency beyond what may be achieved through public briefings

Private briefings, whether in the form of presentations in stockbrokers' offices or private conversations between analysts and corporate officers, enable analysts to directly engage with company management on an informal or one-on-one basis. They are an effective way for analysts to test their views, resolve any misunderstandings and gain a better insight into the company's business and strategies. They also give analysts greater opportunity to challenge management's views and assumptions and hold them to account. However, ASIC believes it is critical that in conducting private briefings, companies strictly comply with the law and that further steps can be taken to ensure and to enable ASIC to monitor this compliance.

(5) Whether particular issues arise in relation to compliance with, and the enforcement of, the insider trading and continuous disclosure provisions, and whether, or in what manner, those issues could be dealt with through further legislative or other initiatives

As noted above, all analyst briefings must be conducted in compliance with the laws requiring continuous disclosure and prohibiting insider trading.

ASIC believes it is not practicable or appropriate to require all private briefings to be recorded and made available to the public for a number of reasons. Firstly, private briefings vary significantly in their degree of formality, from structured group presentations to individual telephone conversations and meetings. Also, many companies conduct a significant number of private briefings. Investor relations personnel in large companies may be involved in hundreds of private briefings each reporting period. Requiring taping and publishing of every briefing would be onerous and for many companies, impractical.

Existing guidelines on best practice investor relations provide companies with processes they can implement to reduce the risk of potential non-compliance with disclosure laws. For example, companies should keep the number of persons authorised to speak on their behalf to a minimum. These persons should be made aware of the information that can and cannot be disclosed before any analyst briefing. Depending on the size of the company, it may be appropriate to have one senior manager overseeing all briefings and other information disclosures. Companies need to develop a disclosure regime that reflects the circumstances of the company and minimises the risk of selective disclosure.

Although mandating the taping of private briefings is not considered appropriate, ASIC recommends that at the least, the ASX Corporate Governance Council develop best practice guidance requiring companies to keep detailed records of all private briefings. The scope of the record-keeping requirement would be a matter for discussion but, as a minimum, it should include:

- all persons present;
- date and timing (length) of the meeting; and
- an outline of the topics discussed.

Record keeping requirements would enable companies to undertake a review procedure following every private briefing, to confirm that no price-sensitive information has been inadvertently disclosed. If price-sensitive information has been inadvertently disclosed, the information should be immediately released to the ASX and posted on the company's website.

The discipline of record-keeping would ensure that companies turn their mind explicitly to the disclosure issue after every private briefing. The keeping of records would also allow ASIC or others to determine retrospectively whether market sensitive information was discussed at a private briefing. It would also be best practice for companies to keep a central record of when analysts' briefings occur that could be easily accessed by the company and regulators.

Law reform to stipulate maintenance of these records may be an appropriate measure.

(6) Whether there should be any restrictions on when companies can conduct private briefings

ASIC does not propose that there should be mandatory restrictions on when companies can conduct private briefings. While it would not generally be appropriate for companies to give non-public briefings in the blackout period prior to the publication of financial results, this may not always be the case for all companies. Given the significant variance in disclosure issues that companies in different industries and circumstances face, companies themselves are in the best position to determine when it is not appropriate to give private briefings. Instead, ASIC supports the development of best practice guidance by the ASC Corporate Governance Council that recommends no private briefings during a company's blackout period.

(7) Whether there are fairness or other equal access concerns with current practices regarding private briefings and, if so, how they might be dealt with

As noted above, there may be fairness issues (both real and perceived) in relation to the current practice of private briefings. While ASIC recognises the benefits of direct, one-on-one access to company management, it is critical for market integrity that the market can be assured of compliance with the law.

Where a company generates a document or other record to provide additional material information to more than one analyst in a private briefing, ASIC believes it is appropriate that the company immediately make the document or record widely available either on the company's website or by other means.

ASIC also considers that the market should be informed in advance of the timing of the publication of a listed company's financial results and any public analysts' briefings. Advance notice should assist in ensuring that investors have equal access to price sensitive information that the company discloses at this time to the market.

(8) Whether any issues of intellectual property rights would arise in any move to require that the content of communications in private briefings to analysts be made available to investors generally and, if so, how they might best be dealt with

ASIC believes that industry participants are better placed to comment on whether any issues of intellectual property rights arise in any move to require the content of private briefings to be made available to investors generally.

(9) Whether there are any approaches to private briefings of analysts in overseas jurisdictions that could usefully be adopted in Australia

At this stage, ASIC has no comment on approaches to private briefings in overseas jurisdictions.

ASX

ASX is not aware of the background to this aspect of the referral or of any new developments that would suggest that there has been an increase in the extent of non-compliance with continuous disclosure obligations or insider trading arising from the activities of executives involved in investor relations activities. We therefore query whether a market failure problem has been identified which requires addressing.

We recognise that the law leaves little room for investor relations executives to do more (outside of structures that distribute new information simultaneously to all investors) than point analysts to information that is already in the public domain, identify issues that are relevant to understanding the company's prospects and clarify analysts' understanding of information that is already in the public domain. We also recognise the difficulties for investors generally in having a basis for confidence as to whether or not communications between investor relations executives and analysts are appropriately confined to communications of this type.

In the absence of breaches coming to light and being vigorously prosecuted, the responsibility to enhance investor confidence on this issue would seem to rest squarely with boards conveying a message of zero tolerance for communications that stray beyond the type of communications outlined above. Provided that investor relations executives are aware that stepping beyond this narrow range of communications will not be tolerated, it is difficult to see the scope for prescriptive responses to the challenges faced by companies in communicating appropriately with investors by assisting analysts in their understanding of the company's business.

Law Council of Australia

The Committee does not consider that there is a need to greater regulate analysts briefings. Corporate briefings to analysts play an important role in Australia's finance market and, in the Committee's view, more information gets to the market as a result of analyst briefings then the market would otherwise receive in the absence of those briefings. While selective briefing has the potential to affect market integrity, the Committee considers that the continuous disclosure regime and insider trading laws, together with the actions of ASIC and ASX in producing guidance through *Heard it on the Grapevine* and *Better Disclosure for Investors* guidance, as well as ASX Guidance Note 8, supported by the ASX Corporate Governance Council's Principles and Recommendations are a sufficient regulatory response and are generally very well understood in the market.

It is the Committee's view that although telephone monitoring of private analysts' briefings may prove a disincentive against companies being selective in their disclosure of price sensitive information, this is a costly and problematic approach which will not stop the problem.

The CAMAC discussion paper makes reference to the operation of Regulation FD (Fair Disclosure) in the United States. A provision such as Regulation FD must be understood in the context of the US regulatory environment. Regulation FD exists in circumstances where the insider trading sanction does not generally extend to information provided to market analysts.[128] Continuous disclosure requirements of US securities exchanges do not found private rights of action and are more limited than in Australia. The US background is therefore quite different.[129] On the other hand the Committee believes there is a proper policy basis in existing Australian law to properly regulate issues surrounding selective disclosure of material information to analysts as mentioned above. The Committee does not consider that recent experience of enforcement of these provisions reflects deficiencies that require legislative remedy.

Issues for consideration

Should there be greater guidance on what is required to ensure that the information provided in a public briefing is effectively and expeditiously disclosed generally?

No. It is the view of the Committee that sufficient guidance on disclosing information provided in analysts' briefings is already available to companies.

Should there be any restrictions on when companies can conduct private briefings, for instance by the introduction of mandatory blackout periods for non-public briefings prior to the publication of periodic financial results?

No. It is the Committee's view that placing restrictions on when companies can conduct analysts' briefings or banning such briefings outright would do a disservice to the market. There are valid reasons for briefing market analysts, even during blackout

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128 See *Dirks v SEC* 463 US 646.

129 For further discussion see *Golding & Kalfus* (2004) 22 C&SLJ 385.

periods, but companies must ensure they comply with all applicable disclosure requirements.

Are there any approaches to public or private briefings of analysts in overseas jurisdictions that could usefully be adopted in Australia?

No. It is the Committee's view that the regulatory framework and corporate governance guidelines currently in place in Australia sufficiently deal with corporate briefings to analysts.

Are there fairness or other equal access concerns with current practices regarding private briefings and, if so, how they might be dealt with. For instance:

- In what, if any, circumstances, would it be appropriate and feasible to require that all or part of the content of communications in private briefings to analysts be made available to investors generally, and
- if that content is to be made available, in what manner
- Should the market be informed in advance of the timing of the publication of a listed company's financial results.

First, it is the view of the Committee that *more* information reaches the market as a result of analyst briefings than the market would otherwise get in the absence of those briefings, as highlighted above.

Second, as highlighted by the paper in section 4, there are already legislative prohibitions on providing certain information to analysts.

Whilst the Committee does not think it is necessary that the public be made aware of the timing of publication of a listed company's financial results, it would not oppose reform in this area.

AICD

The current regulatory regime that applies to the corporate briefing of analysts is, in AICD's view, appropriate in requiring companies to keep the market fully informed and further regulation is not required. AICD has regularly cautioned directors in relation to the company's continuous disclosure obligations in its member communications.

Companies are already well aware of the sensitivities that are involved in giving briefings to analysts, both publicly and privately. In the event of any inadvertent breach of their continuous disclosure obligations during such briefings, companies are, on the whole, quick to act in relation to the breach and, in most circumstances, such incidences do not cause any major detriment to the market.

Many listed companies already conduct corporate briefings publicly (rather than privately) and are circumspect in respect of the information that they provide to analysts at those briefings. The continuous disclosure regime is therefore effective in regulating the conduct of companies and directors at such briefings. In particular, the AICD does not support the proposition that companies be required by law to record all public briefings and make such recordings available to the public.

Chartered Secretaries Australia

We have encouraged companies to involve retail shareholders in media and analysts' briefings during the course of last year, on which we comment in further detail below.

At present, the continuous disclosure provisions (s 674) of the Corporations Act and the requirement under Listing Rule 3.1 to disclose any information that is material and price-sensitive are in place to keep the investing public informed of events and circumstances that could affect the price or value of a company's securities. Continuous disclosure regulation is designed to ensure that investors have timely and equal access to price-sensitive information in relation to traded securities.

Any information, therefore, that could have a material impact on the price of the company's shares that is disclosed in a company briefing, be it private or public, *must* be disclosed by a company to the market immediately. CSA does not believe that further guidance is required to ensure that companies understand their obligations under the continuous disclosure regime.

CSA notes that webcasting information provided in a public or private briefing could be an effective way of expeditiously disclosing such information, regardless of whether it is price-sensitive or not. CSA encourages all companies to provide either a live webcast or an archive of a private or public briefing, to ensure a large range of shareholders have access to the information. However, CSA does not recommend that webcasting should be mandated, as CSA notes that issues of cost may prevent companies from taking up webcasting at this point in time, and forcing additional costs on companies affects shareholder value. CSA does believe that webcasting of public and private briefings is best practice for large companies with large shareholder bases, and notes that such companies are able to sustain the costs attached to webcasting.

CSA notes that, while it is good practice for records to be maintained of private briefings, such record-keeping should not be mandated. CSA points to the difficulty inherent in regulating the detail of such records, which will vary according to company and circumstance.

CSA notes that the continuous disclosure regime prohibits selective disclosure by providing for the disclosure of *any* information that could have a material impact on the share price. On this basis, CSA sees no reason to introduce an equivalent of SEC Rule 100 *Selective disclosure and insider trading* and does not support such a move. CSA also notes that fairness or equal access concerns are already addressed in Listing Rule 3.1.

CSA believes in the general principle of ensuring that there is no restriction on access to information provided by a company, but does not see a role for further regulation in this area. For example, CSA has previously called for the media briefings following company AGMs to be open to all shareholders. On this basis, CSA encourages companies to provide access to any briefing of analysts, by, for example, telephone, to ensure shareholders have access to the information provided at such briefings. In large part, this would dispel the mystique attached to such briefings and reduce the misperception that analysts are granted access to information that is withheld from shareholders. However, again, CSA does not recommend that the provision of such access be mandated.

CSA notes that analysts have raised concerns that their intellectual property rights could be infringed by making analysts' briefings available to all shareholders. While CSA notes that analysts' questions are likely to be more sophisticated than those asked by retail shareholders, any response from the company that contains information that is material and price-sensitive must be disclosed to all investors. Selective disclosure cannot be justified on the basis of sophisticated questions being posed to a company.

CSA recommendations

CSA recommends that companies be encouraged to webcast public or private briefings, but that such dissemination should *not* be mandated.

CSA recommends that it is good practice for records to be maintained of private briefings, but that such record-keeping should *not* be mandated.

CSA recommends that an equivalent to SEC Rule 100 Selective disclosure and insider trading should not be introduced, as the current continuous disclosure regime prohibits selective disclosure by providing for the disclosure of *any* information that could have a material impact on the share price.

CSA recommends that companies be encouraged to provide a feed to analysts' briefings but that this should *not* be mandated.

AIRA

A significant part of the task of a company's Investor relations Officer lies in dealing – proactively and reactively - with analysts and investors.

The relationship between a company and the analysts covering it, is complex and contacts can be extremely frequent. They range from the formal public discussions of results, to the individual discussions sometimes required to ensure the factual accuracy of any analyst's (private or published) research (eg to ensure an analyst has used the correct publicly available data released by the company in his or her model). These contacts may be simple ad hoc 5 minute telephone conversations, or structured meetings, so they do not lend themselves to increased formal regulation.

Because of the complexity of these relationships, AIRA and Finsia (formerly the Securities Institute of Australia) have developed a best practice guide *Principles for Building Better Relations Between Listed Entities and Analysts.* The principles in it aim to assist analysts and listed entities to manage their communications and interactions in a way that reinforces the integrity and efficiency of Australia's markets.

AIRA therefore believes that these guidelines should represent industry best practice.

AIRA notes that the Issues Paper and the Minister's letter refer to the *perception* that some analysts and investors have access to critical information. AIRA believes that the best way to correct this perception is by reaffirming the principles above, helping companies and analysts manage the complex business of dealing with analysts and investors.

Specific questions.

(1) the role that analysts and investors' briefings play in Australia's financial market and the implications for market efficiency and integrity of these briefings

Sell side analysts are a vital channel of communication to the buy side fund managers for listed companies. They create insight into those companies, which helps accurate price formation in the market. This channel supports the direct briefings that companies provide to investors.

Research and analyst insight is provided not only to institutional fund managers, but also in the form of commentary to the media and hence to retail investors.

Public briefings

(2) whether there should be greater guidance on what is required to ensure that the information provided in a public briefing is effectively and expeditiously disclosed generally? For instance, should all public briefings be webcast and/or podcast and in either case should a transcript of the proceedings also be provided

As the Issues paper notes, AIRA's best practice guide recommends that listed companies should consider using conference calls and webcasts.

Our experience is that (since the 2004 research to which the paper refers) with the availability of affordable technology, a majority of listed companies do use widely accessible webcasts and conference calls which are broadcast live and then made available for replay or download as a podcast from an archive section of the investor relations section of the company's website. Many companies also publish a transcript of the proceedings following the event too.

We believe that the regulatory structure of continuous disclosure, together with best practice guidance as to how to achieve it, works well.

(3) whether there are any approaches to public briefings of analysts and investors in overseas jurisdictions that could usefully be adopted in Australia.

See above.

Private briefings

(4) whether private briefings to analysts and investors increase market efficiency beyond what may be achieved through public briefings

Private briefings of analysts and investors (commonly referred to as 'one on one meetings', although more then one person from each organisation is generally present) are a vital part of ensuring accurate valuations. Each analyst and investor may have specific or unique questions linked to their own investment ideas and strategies, which themselves drive volume and stock prices. Private briefings that ensure accuracy of the data and assumptions underlying those ideas are essential if the market is not to be misled.

(5) whether particular issues arise in relation to compliance with, and the enforcement of, the insider trading and continuous disclosure provisions, and whether, or in what manner, those issues could be dealt with through further legislative or other initiatives. In this context:

> ***- should the equivalent of SEC Rule 100 Selective disclosure and insider trading be adopted***

> ***- should there be mandatory record-keeping requirements for some or all private briefings and, if so, of what nature***

AIRA best practice guidance highlights several measures on the conduct of meetings with analysts and investors, including attendance by more than one company representative. (These were highlighted in the UK by the disputed meeting between Sainsbury Plc and Merrill Lynch in 2004, which prompted an FSA investigation).

(6) whether there should be any restrictions on when companies can conduct private briefings, for instance by the introduction of mandatory blackout periods for non-public briefings prior to the publication of periodic financial results.

AIRA best practice guidance is that companies should consider imposing a blackout period, which is we believe observed by almost all companies.

(7) whether there are fairness or other equal access concerns with current practices regarding private briefings and, if so, how they might be dealt with. For instance:

> ***- in what, if any, circumstances, would it be appropriate and feasible to require that all or part of the content of communications in private briefings to analysts and investors be made available to investors generally, and***
>
> ***- if that content is to be made available, in what manner***
>
> ***- should the market be informed in advance of the timing of the publication of a listed company's financial results***

AIRA firmly believes that companies, analysts and investors should be able to have conversations that do not discuss price sensitive information, without the need to disclose their contents. To require public disclosure of them would reduce the usefulness of analyst and investor research and impact accurate price formation.

AIRA supports and encourages listed entities to make an announcement to the ASX and on the company's own website, the date of the release of its financial results or other material event, as well as the timing and details of a webcast and/or conference call.

AIRA does not believe it is practical or appropriate for the contents of any private briefing to be recorded or disclosed to the market. We believe this could lead to a substantial 'clouding effect' in that the ASX company announcements platform would be swamped with relatively unimportant information.

(8) whether any issues of intellectual property rights would arise in any move to require that the content of communications in private briefings to analysts and investors be made available to investors generally and, if so, how they might best be dealt with.

By its nature, analysts' and investors' research is unique, and proprietary to them. Making it public would result either in those discussions ceasing altogether (with a consequent loss of accuracy and misdirection of the market) or in firms giving up providing research. We would also note that only non price sensitive information is discussed during these contacts.

(9) whether there are any approaches to private briefings of analysts and investors in overseas jurisdictions that could usefully be adopted in Australia.

The Guidance contained in the FSA List 9 published on 24th June 2005 offers useful tips.

Regnan

Public briefings

Market efficiency requires that company information be available to the widest possible audience, including the company's interpretation, explanation and context for reported results. Regnan cannot see any reason that entities of scale (for instance, S&P ASX 200 entities) should not make such briefings widely available via low-cost technologies such as webcast, podcast, or the online provision of transcripts, as recommended by the Australian Investor Relations Association.

Regnan has elsewhere argued that certain reforms would improve the ability of the Annual General Meeting to effect information flow (attach this as an appendix).

Private briefings

Regnan recognises the increased information flow that is enabled by private briefings, and its contribution to efficient market pricing of securities. However issues of fairness and integrity, both real and perceived, raise questions about the ***net*** market benefit of private briefings to market integrity and liquidity.

Compliance with and enforcement of insider trading and continuous disclosure provisions are important in relation to private briefings. Regnan regards it as important that entities keep unedited records of all meetings and briefings (including content) with investors/analysts, as a check against continuous disclosure and insider trading breaches.

Regnan regards transparency as beneficial even where this falls short of comprehensive publication of content. For instance, companies could:

- make public the list of questions received from analysts in private briefings, and/or information shared by the company in response.
- make teleconference briefings with groups of investors available to other listeners either in real time or via podcast/audio on website
- Companies could publish information *about* private briefings (for instance, date and participants at each meeting) even where they do not provide content.
- Companies could hold briefings for small groups of analysts from different organisations while declining to hold one-on-one briefings.

All steps towards greater transparency contribute towards mitigating perception risks associated with market efficiency and integrity.

Regnan considers that normative guidance emphasising transparency is currently the most appropriate means to achieve improvements in market efficiency and integrity. Any legislative requirement to publish content of all briefings is likely to sanitise or eliminate one-on-one briefings, reducing market efficiency. Absent monitoring mechanisms, and wherever analysts benefit from information advantages, an unintended consequence of any such legislation could be to drive more detailed discussions underground.

Significant concerns exist regarding equitable access to information, including the opportunity to direct questions to areas of interest. However as outlined above Regnan does not regard a legislative requirement to publish content as likely to increase market integrity, and sees strengthening and of normative guidance as an appropriate step given current practices.

Juliette Overland

In summary, record-keeping recommendations for analyst briefings should be introduced into the ASX Corporate Governance Principles and Recommendations.

It is understood that the Minister has raised concerns about the practice of listed companies providing corporate briefings to analysts on the basis that it may have a negative impact on perceptions of the integrity of Australia's securities markets.

There is a risk that company officers providing corporate briefings to analysts may breach the insider trading prohibition due to 'tipping' – s 1043A(2) of the *Corporations Act* provides that a person in possession of 'inside information' must not, directly or indirectly, communicate the information, or cause it to be communicated, to another person if they know (or ought reasonably to know) that the other person would be likely to trade in the relevant financial products or procure another person to do so.

It is widely recognised that a major difficulty in enforcing the prohibition on insider trading relates to the difficulty of proof.[130] In the case of corporate briefings to analysts, it may be difficult to prove after the event that inside information was in fact provided to analysts (as distinguished from information which is already generally available). As 'tipping' is already a criminal offence and may be the subject of civil penalty proceedings under the *Corporations Act*, amendment to the law is not recommended, but instead it is suggested that the Corporate Governance Principles be amended to introduce recommendations for record-keeping for private briefings.

Such record-keeping recommendations could be included in Recommendation 3.2 of the Corporate Governance Principles. As is noted above, Recommendation 3.2 provides that listed companies should establish a trading policy, which should then be publicly disclosed. Recommendation 3.2 could include recommendations for record-keeping when private briefings are held, which listed companies must then either comply with, or explain any non-compliance in each annual report. On this basis, a listed company would then be required to disclose whether it has a trading policy which incorporates the record-keeping recommendations, explain any departure from the recommendations, and make the resulting recordings or transcripts of private and public briefings available on its website – or explain why it has not done so.

The introduction of such record-keeping recommendations would assist in:

(a) the provision of evidence of the nature and content of information provided to analysts;

(b) better enabling the prompt public dissemination of any information provided to analysts, if not previously released; and

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[130] See, for example, the Explanatory Memorandum to the Financial Services Bill 2001 (Cth), paras 2.78-2.79; Roman Tomasic & Brendan Pentony, 'The Prosecution of Insider Trading: Obstacles to Enforcement' (1989) 22 *Australian and New Zealand Journal of Criminology* 65; Roman Tomasic, 'Casino Capitalism? Insider Trading in Australia', (1991) Australian Institute of Criminology.

(c) maintaining public confidence in the integrity of Australia’s securities markets.

Allens Arthur Robinson

In our view, analysts have a crucial role to play, as financial experts, in publishing informed opinion about the prospects of Australian companies, so we consider that banning private briefings would have a negative effect on the market. Also, our view is that a ban on private briefings would be counter-productive because it would reduce the amount and quality of informed opinion about Australian companies available to security holders and investors.

We do not see any need for further regulation of private briefings to analysts, because we consider that existing insider trading laws and continuous disclosure requirements sufficiently deal with corporate briefings to analysts. We also consider that ASX Corporate Governance Principles and Recommendations, supported by ASX Guidance Note 8, very clearly set out expectations as to the conduct of private briefings to analysts.

We would not oppose the development of mandatory record-keeping requirements for private briefings, so long as those record-keeping requirements are not onerous on the companies conducting briefings.

SDIA

Role of Research Analysts. Research Analysts perform a vital role in the financial markets. As noted in the Minister’s letter quoted in the Issues Paper, analysts keep the market informed. Research analysts critically analyse publicly available information about listed companies and issuers, including accounts and other financial information. They also critically analyse the performance of the company, its management and the company’s sector.

This analysis independent of the management of the company is vital in assisting investors in assessing the true value of a company and its securities and their prospects. Only the largest of institutional investors have the resources to perform such analysis themselves. Even though research analysts generally publish their analysis only to the clients of the firm which employs them, the benefits of broker research does find its way into the market as a whole, which is to the benefit of all investors and potentially informs the share price of the security.

Therefore, we submit that the contribution of research analysts to market efficiency is beyond dispute.

Existing Regulation and Guidance Effective. We note that during the last decade, equity research has been reviewed in great detail in various jurisdictions, including in the course of the ASIC *Heard it on Grapevine* project, without any conclusions to the contrary.

We note that as a consequence of the reviews carried out at that time, various guidelines were issued, including *Better Disclosure for Investors – Guidance Rules* published by ASIC, the *Best Practice Investor Relations: Guidelines for Australasian Listed Entities* published by the Australian Investor Relations Association in May 2006 (‘the *AIRA Guidelines*’), and the *Corporate Governance Principles and Recommendations* published by the ASX Corporate Governance Council. The SDIA produced guidelines for research analysts in conjunction with the Securities Institute, entitled *Best Practice Guidelines for Research Integrity*.

The above guidelines are thorough and well considered, and each resulted from a lengthy process of consideration of issues relating to the release of information by listed companies and communications with research analysts. They are all founded on the fundamental principle that materially price sensitive information should be released to the market generally and should not first be released selectively. They contain a wealth of other guidance on best practice for issuer interaction with the market.

In SDIA's view, the question of potential selective dissemination of materially price sensitive non-public information by issuers is adequately addressed by the existing insider trading provisions of the Corporations Act in conjunction with the ASX Listing Rules (particularly L.R. 3.1 and Guidance Note 8) and as amplified by the abovementioned guidelines. We are not aware of any significant failures that have occurred in recent times that would suggest the need for amendment or addition to existing regulation.

In particular, SDIA also does not support limiting the extent to which issuers are able to communicate with investors, research analysts or financial journalists, as the need arises and in the most efficient and effective manner, whether that be on a large or small group or on a one-on-one basis.

There is in our view a widespread acceptance and implementation of the principles contained in the various Guidelines referred to. There were a limited number of instances in which selective disclosure arose as an issue in around 2002 e.g. Southcorp matter, AMP, in which subsequent remedial action was quickly taken to address the situation and the market kept informed. Since those instances, there have not been any repeat cases that have come to light. In our assessment, these instances served as an education to the market, and there is no indication that there are systematic selective disclosures of price sensitive information occurring in the market at present. If this was commonly occurring, we would have expected that a significant number of instances would be coming to light on an ongoing basis.

Role of Public and Private Briefings. We refer to the *AIRA Guidelines* to which reference is made in the Issues Paper. We note at Page 8 the *AIRA Guidelines* conveniently set out a variety of meeting activities that typically are carried out by a listed company, including media briefings, analyst briefings, media conferences, buy-side lunches, dealing room briefings and domestic/international road shows. The Guidelines also note that analyst and investor briefings may be group Briefings or one-on-one meetings.

This range of different forums of communication have clearly been developed over time to assist issuers to structure the way in which they communicate with all relevant groups with whom they needs to communicate, and in a way which is most efficient, practical and effective to the issuer.

Whilst some of the meetings referred to are group meetings, they may in practice be meetings of only a small group e.g. of investors, dealers, and hence they are similarly selective, even though they are not one-on-one meetings.

Whilst public briefings are likely to be preferable for certain forms of meetings for practical reasons (e.g. efficient time use) and for compliance reasons (to more conveniently monitor for the potential risk of inadvertent selective disclosure of price sensitive information), it would not make sense to limit the flexibility of issuers to communicate with either small groups or with research analysts on a one-on-one basis where needed, and to ‘corral’ the issuer into a series of large scale meetings. This would in our view hinder communication with issuers and the flow of information to the market. An issuer should have the flexibility to hold meetings as circumstances warrant.

It is noted that the Issues Paper at 4.3 quotes sources which confirm the value that companies place on being able to hold one-on-one meetings.

It is important also from the point of view of quality of analyst research that one-on-one briefings not be prohibited. It may not be practical, feasible or efficient for the body of analysts present at a group meeting for each individual analyst to pursue their own lines of questioning within the time constraints of the meeting.

Issues may also arise in between meetings which an analyst may wish to pursue, and which cannot wait until the next group meeting. In particular, an individual analyst may identify a particular issue or line of enquiry as a result of their own analysis and efforts that may not have occurred to other analysts. Analysts should be able to raise these issues with the issuer independently and expeditiously. The market is highly time sensitive, and it is in the interests of market efficiency that such issues are resolved without delay, and not await the next scheduled group meeting.

Provided of course that no non-public information has passed in a one-on-one meeting in response to the analyst’s enquiries, the analyst should also be able to derive the benefit of their analytical efforts and be the first to report their analysis to their clients.

A requirement that the only forum for communicating with a company would be group meetings would mean that all present could free-ride on the work of a particularly astute analyst, which could act as a disincentive to analysts to engage in probing analysis and as a disincentive to broking firms to carry the considerable costs of supporting a research arm. This would not further market efficiency.

It should be noted that financial journalists perform a function not dissimilar to research analysts, and both groups should be free to meet with issuers on the basis of similar principles.

Market fairness considerations. We note the concerns in 4.6.1 of the Issues Paper. SDIA appreciates that questions of market fairness and perceptions of equality of access to information may arise where a company engages in selective including one-on-one briefings, and that these perceptions can be important even where no breach of the law may be occurring.

However, as mentioned earlier, these considerations were equally prominent at the time of the lengthy review of equity research which took place in 1998-2000, including ASIC’s Grapevine project, and SDIA believes that the measured response at the time, including the various Guidelines referred, to remain effective to deal with any such concerns today.

Whether new Rules required. SDIA notes that the various Guidance issued on this subject does not have the force of law, and that this might be seen as unsatisfactory.

As mentioned earlier, SDIA believes that the existing measures operate well and statutory Rules are not needed. In our submission, it is important that the flexibility which is built into the various Guidance notes not be lost, and it is difficult to see how Regulation could be drafted that would not be at the expense of such flexibility.

As regards SEC Rule 100 in particular, we note that the Rule requires that material non-public information should be disclosed publicly by an issuer simultaneously with an intentional selective disclosure and promptly in the case of an unintentional disclosure. The preferable position, in our view, is that disclosure of such information should always first be to the market (as set out in the Australian Listing Rules and other Guidance noted above). Also, we do not see much to be gained by making it a legal requirement to promptly remedy an unintentional disclosure, as it would be hard to see this not happening as a matter of course as a result of the Listing Rules.

If Regulation is seen as essential to attach the force of law to obligations in this area, considerable care is needed in drafting the Rules to ensure that they positively contribute to regulation and that they do not remove much needed flexibility.

Record keeping of briefings. In the current economic climate, additional costs and regulatory burden are a significant issue for listed companies and for brokers. SDIA would argue strongly that any record keeping requirement that might be introduced should be simple and low-cost.

Business Council of Australia

The BCA does not consider that additional regulation or guidance is required in relation to analyst briefings.

Evidence of a problem

Existing regulation and guidance already sufficiently deals with corporate briefings to analysts, including the continuous disclosure regime under Listing Rule 3.1, insider trading laws and ASX Corporate Governance Principles (eg Recommendation 8). The BCA is not aware of any evidence of a problem with respect to the current regime and as such does not believe there is sufficient evidence to justify any regulatory or other intervention in this area.

Analyst briefings play an important part in Australia's financial market by providing shareholders with timely and useful information. The current environment allows companies to develop communication methods on a case-by-case basis, depending on an individual company's shareholder base. This is more likely to be beneficial to shareholders, than imposing prescriptive obligations upon companies. Burdensome requirements might hinder the process and therefore the timeliness and extent of information flow in the market.

Costs and benefits of intervention

a) Public briefings

The BCA does not consider that a proposal for all public briefings to be webcast or podcast or transcripts provided, is necessary.

Many organisations already provide webcasts of significant briefings like annual results and AGMs. However, a prescriptive approach to webcasting of all public briefings may act to the detriment of some organisations that do not already undertake such a process and would find it costly or burdensome to do so.

Most companies also undertake public briefings on a smaller scale, an ad hoc basis and in various different locations. For example, companies may hold annual board or customer dinners where investors and analysts are invited. Executives may be invited to speak interstate or overseas at conferences or briefings. Those sorts of events may be difficult and costly to webcast or to have transcribed.

b) Private briefings

The BCA considers that private briefings to analysts increase market efficiency by increasing the information flow in the market.

A proposal for mandatory record-keeping requirements (eg transcripts or recordings) could be overly restrictive. Open flow of dialogue has proven to be useful for both companies and investors. For example, an investor may wish to express an opinion on leadership styles. Investors should be able to express their views on matters of opinion without the risk of them being made public.

AFMA

(1) the role that analysts' briefings play in Australia's financial market and the implications for market efficiency and integrity of these briefings.

Briefings to analysts are an important and necessary element of a well functioning market. They are invaluable in developing the market's understanding of the corporate and it is up to all parties involved to act responsibly. From a company's perspective, meetings should be properly managed eg run a formal agenda, have the meeting minuted and that a record be kept of the discussion points, questions asked and responses provided. Many companies already do this and we are supportive of this approach which helps to promote greater transparency in the market. Companies must also ensure that they are complying with their continuous disclosure obligations.

Analysts must act responsibly and take appropriate action where they believe they have inadvertently received material non-public information or other sensitive information.

Public briefings

(2) whether there should be greater guidance on what is required to ensure that the information provided in a public briefing is effectively and expeditiously disclosed generally? For instance, should all public briefings be webcast and/or podcast and in either case should a transcript of the proceedings also be provided.

Australia has a well developed and effective regulatory framework to deal with corporate briefings by analysts. The ASX continuous disclosure regime already provides sufficient protections for the market in this area. Listed entities are already required to disclose any material price-sensitive information to the public in a timely fashion. In addition to ASX listing rule 3.1, listing rule 15.7 provides that an entity must not disclose information that is for wider disclosure to the market until it has been released by ASX. Australian issuers are not allowed to make selective disclosure.

Comprehensive guidance is already provided by:

- ASX Guidance Note 8, which incorporates ASIC's Regulatory Guide 62 - Better Disclosure to Investors;[131]

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[131] As ASIC's Regulatory Guide 62 was settled and released in 2000, a review of the guide may be timely in the context of current market conditions.

- the ASX Corporate Governance Council Principles; and
- the Australasian Investor Relations Association.

With regard to the specific suggestions in the question, public briefings should be genuinely public, and could be open to the public in a practical way through webcasts. Transcripts are too cumbersome and would be unnecessary if provided through webcasts and downloadable as podcasts. These are matters of good industry practice and could be addressed through the Principles.

(3) whether there are any approaches to public briefings of analysts in overseas jurisdictions that could usefully be adopted in Australia

We have no observations to make on this question.

Private briefings

(4) whether private briefings to analysts increase market efficiency beyond what may be achieved through public briefings.

Private briefings to analysts are conducted pursuant to ASIC and ASX regulatory guidance. Private analyst briefings may be necessary for a range of reasons, including:

- clarification of points; and
- bringing analysts who are new to an issuer up to speed.

Analysts are more likely to ask probing questions in a private session. Private briefings of analysts are a valuable way by which research report writers can be accurately informed about, or properly understand, information regarding the issuer that is already in the public domain. This in turn assists in keeping the wider market informed.

The prohibitions on insider trading in the Corporations Act are an effective deterrent and do not require amendment. Likewise, as noted above, the continuous disclosure regime supervised by the ASX also works well.

(5) whether particular issues arise in relation to compliance with, and the enforcement of, the insider trading and continuous disclosure provisions, and whether, or in what manner, those issues could be dealt with through further legislative or other initiatives. In this context:

- **should the equivalent of SEC Rule 100 Selective disclosure and insider trading be adopted**
- **should there be mandatory record-keeping requirements for some or all private briefings and, if so, of what nature**.

The Issues Paper considers the US approach to dealing with selective disclosures through SEC Rule 100 (Regulation FD). The continuous disclosure framework is more rigorous and applies more generally across a wider range of information than disclosure requirements in the United States. US listed entities are subject to a disclosure framework that differs in a number of respects to that applying in Australia. For example, where information is disclosed inadvertently in a briefing, SEC Regulation FD merely requires that the information be disclosed ‘promptly’ (as distinct from immediately) once selective disclosure has been made. This is a less onerous obligation than that applying to Australian listed entities.

It is difficult to determine how an additional obligation in a form equivalent to Regulation FD would be of benefit, taking into account the wider operation of the continuous disclosure framework. Conversely the grafting of a Regulation FD type requirement onto the current framework would have the potential to erode the operation of continuous disclosure.

The current blackout requirements that apply in relation to analyst briefings are appropriate and effective in practice.

Mandatory record keeping requirements regarding private briefings including the mandatory disclosure of the content of communications in private briefings is an unnecessary administrative burden. Analysts' briefings are already governed by the Corporations Act prohibition on insider trading. Company management and research analysts are aware of these obligations.

The corollary, if the contents of private briefings to analysts were required to be disclosed, is that it would necessarily extend to any private communications conducted by the company. That is, whenever a company talked to anyone, including shareholders, or potential shareholders, those discussions would have to be published. Company briefings are conducted on both the buy and sell side.

(6) whether there should be any restrictions on when companies can conduct private briefings, for instance by the introduction of mandatory blackout periods for non-public briefings prior to the publication of periodic financial results

Having a blackout period is a matter of good industry practice and could be addressed through the Principles.

(7) whether there are fairness or other equal access concerns with current practices regarding private briefings and, if so, how they might be dealt with. For instance:

- **in what, if any, circumstances, would it be appropriate and feasible to require that all or part of the content of communications in private briefings to analysts be made available to investors generally, and**
- **if that content is to be made available, in what manner**
- **should the market be informed in advance of the timing of the publication of a listed company's financial results**

Private briefings depend on access being given by a company to analysts. The fact that private briefings are being held should be public information. Analysts should be given fair and equal treatment in their access to such briefings.

The content of the briefing can continue to be released within the scope of the continuous disclosure obligation.

This is an area again where good industry practice should prevail and could be addressed through the Principles.

(8) whether any issues of intellectual property rights would arise in any move to require that the content of communications in private briefings to analysts be made available to investors generally and, if so, how they might best be dealt with

Analysts and their employers have intellectual property rights in all aspects of an analyst's work, including notes and discussions which go towards a final report. An analyst's employment is based upon his/her intellectual ability and it is unfair and unrealistic to expect their approach towards an issuer and their discussions with that issuer to be made public. If an analyst chooses to focus on certain aspects of public information about an issuer, or seek clarification on discrete points, that approach is part of the value in the intellectual property rights attributed to the research report. These rights are owned by the firm employing the analyst. If they were made freely available to the public, it would discourage the production and publication of any research. This would in turn, ultimately hurt the entire financial industry in Australia.

(9) whether there are any approaches to private briefings of analysts in overseas jurisdictions that could usefully be adopted in Australia

We have no observations to make on this question.

Adams and Nehme

(1) The role that analysts' briefings play in Australia's financial market and the implications for market efficiency and integrity of these briefings?

Analysts' briefings play an essential role in transmitting information as Australia has one of the world's highest levels of direct and indirect (mostly due to the compulsory superannuation regime) share ownership and thus ordinary investors need pure information. Accordingly, the importance of the existence of a level playing field to give equal access to information, through the use of modern technologies such as the internet and podcasts. Such briefing will keep the market better informed and this helps to achieve a more transparent market.

Public briefings

(2) Whether there should be greater guidance on what is required to ensure that the information provided in a public briefing is effectively and expeditiously disclosed generally? For instance, should all public briefings be webcast and/or podcast and in either case should a transcript of the proceedings also be provided?

Yes, there should be such a greater guidance. We need to use all the tools that are at our disposal to ensure integrity of the market. Greater guidance helps achieve such an outcome.

(3) Whether there are any approaches to public briefings of analysts in overseas jurisdictions that could usefully be adopted in Australia?

No comment.

Private briefings

(4) Whether private briefings to analysts increase market efficiency beyond what may be achieved through public briefings?

There need to be a research in this area: What evidence is there to prove that private briefing would increase market efficiency? Para 4.2.2 and 4.6 of the Issues Paper raised certain legitimate problems with private briefing.

(5) Whether particular issues arise in relation to compliance with, and the enforcement of, the insider trading and continuous disclosure provisions, and whether, or in what manner, those issues could be dealt with through further legislative or other initiatives. In this context:

- Should the equivalent of SEC Rule 100 Selective disclosure and insider trading be adopted?

Such an option may be desired. However further research on the advantages and disadvantages of SEC Rule 100 are desired.

- Should there be mandatory record-keeping requirements for some or all private briefings and, if so, of what nature?

Yes, we agree with the recommendation of the AIRA.

(6) Whether there should be any restrictions on when companies can conduct private briefings, for instance by the introduction of mandatory blackout periods for non-public briefings prior to the publication of periodic financial results?

No comment.

(7) Whether there are fairness or other equal access concerns with current practices regarding private briefings and, if so, how they might be dealt with. For instance:

- in what, if any, circumstances, would it be appropriate and feasible to require that all or part of the content of communications in private briefings to analysts be made available to investors generally, and

- if that content is to be made available, in what manner

- should the market be informed in advance of the timing of the publication of a listed company's financial results

Private briefings are particularly recommended in the case of capital raising.

(8) Whether any issues of intellectual property rights would arise in any move to require that the content of communications in private briefings to analysts be made available to investors generally and, if so, how they might best be dealt with?

The normal laws of intellectual property should provide sufficient protection.

(9) Whether there are any approaches to private briefings of analysts in overseas jurisdictions that could usefully be adopted in Australia?

We are unaware of other jurisdictions' laws in relation to this particular matter.

Australian Employee Ownership Association

No briefings of Analysts should be allowed to be private. Any such briefing should be broadcast on the internet as is becoming common with general meetings with a audio-video recording posted on the web page of the company.

ABA

The ABA recognises that some have the perception that analyst briefings are unfair – this misperception can be damaging to the reputation of the market. We believe analyst briefings play an important role in the market by enhancing information flow for the benefit of all investors. Open communications that take place in a professional manner contribute to pricing efficiency and the orderly functioning of the market.[132] For example, banks have briefings and discussions with analysts and other professionals in order to provide information, and explanation and interpretation of that information. Restricting banks and other companies from conducting briefings (e.g. prior to the publication of periodic financial results) would have adverse consequences for the quality of information in the market.

Many companies conduct public briefings rather than private briefings. During public briefings companies may refer to, or provide research analysts with, any information that is already in the public domain. Companies must not disclose information in a briefing that is intended for the market until it has been released by the ASX.[133]

Companies manage briefings with analysts by keeping a record of discussion points, questions and responses. However, some briefings may inadvertently involve the discussion of commercially sensitive information. In this instance, companies must assess whether the information it disclosed constitutes information that is materially price sensitive, and therefore should be made 'generally available' to the market.[134] It is important that briefings do not inappropriately result in information asymmetries. In this regard, it is our view that the continuous disclosure regime is adequate in these circumstances.

The ABA notes that during briefings, analysts and other professionals may make deductions, interpretations or draw conclusions that are their intellectual property. Companies should not need to disclose or explain those deductions, interpretations or conclusions in meeting its continuous disclosure obligations. Any response made by the company to those deductions, interpretations or conclusions should be treated in the same manner as anticipated disclosures. Furthermore, companies may need to give consideration to the intellectual property of analysts and other professionals in how the company intends to meet its continuous disclosure obligations and/or make briefings available to a wider audience. Public disclosure of analysts' intellectual property may discourage participation by analysts in briefings to the detriment of the efficient and orderly functioning of the market.

In some cases companies conduct private briefings. We believe private briefings are a valuable mechanism for ensuring that analysts and other professionals properly understand the information. Private briefings can be held to enable analysts and other professionals to clarify points and interrogate information that is already in the public domain so that they can produce accurate recommendations, ratings and reports. Some briefings may involve the discussion of commercially sensitive and non-public information. Limiting these types of briefings would have significant and adverse consequences for a fully informed market, the operations of banks and other

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[132] *Principles for Building Better Relations Between Listed Entities and Analysts.* 16 August 2006.

[133] ASX Listing Rule 15.7.

[134] ASX Listing Rule 3.1.

companies, and the quality of information in the market (i.e. credit ratings). In this regard, it is our view that the prohibitions on insider trading are adequate in these circumstances.

The ABA believes:

- Companies should have a policy on ensuring compliance with the continuous disclosure and insider trading laws. The policy should identify how companies will conduct briefings and respond to shareholder enquiries as well as how intentional and non-intentional disclosures during public and private briefings will be managed. The policy should also include details of procedures to ensure adequate mechanisms for oversight and compliance with the policy. The policy or summary of the policy should be made public (i.e. disclosed on the company website and/or in the company annual report).
- Companies should consider ways of making briefings conducted with research analysts and other professionals more broadly available, including via webcasts or posting summaries on the company website concurrently with conducting the briefing or posting a transcript on the company website following the briefing.

The ABA believes existing guidance by ASIC and the ASX on analyst briefings is adequate, and therefore it is not necessary to impose additional legal or regulatory obligations through the Corporations Act. Having said that, the ASX Corporate Governance Council should review its *Corporate Governance Principles and Recommendations* to assess whether its guidance should be amended to further reinforce the principles of fair and equal access as contained in existing guidance by ASIC and ASX.

With regards to corporate briefings to analysts, the ABA notes the following:

- Commentary on analyst briefings and the exchange of information between companies and analysts made by the Australasian Investor Relations Association (AIRA) and Finsia; and
- Commentary on investor relations made by the AIRA.[135]

ASA

The ASA view is that analysts' briefings are sufficiently provided for by 3.1 of the ASX Listing rules and the insider trading provisions of the Corporations Act 2001. Information should not be provided to an analyst that has not been announced to the market as a whole.

Relatively simple and inexpensive technology exists to ensure that briefings can be broadcast live, and even the most technologically constrained listed corporation can ensure that a detailed notice of any information to be given at a briefing is placed in the web prior to the meeting with additional information which may be elicited during the meeting to be published during or immediately after the meeting.

The experience of the ASA is that listed corporations in Australian have generally made reasonable efforts to disseminate information from briefings. The quality of the information varies. Frequently the disclosure is in the form of power point slides or

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135 *Best Practice Investor Relations: Guidelines for Australasian Listed Entities.*

other summary documentation which requires further explanation, which is provided to the briefing but not to the market. There are few listed corporations that could not take the extra step of broadcasting analysts briefings live, and the ASA will be encouraging a situation where this becomes a standard practice.

ASIC have recently begun to attend analyst briefings. Likewise many of the corporations monitored by the ASA invite the ASA representative to attend the briefings.

Whilst there are improvements to be made, the ASA sees this as an area where corporations have been willing to effect change and accordingly neither regulation or further guidance are currently needed.

Finsia

Finsia considers that the current regulatory framework in Australia operates in an effective and fair way, and that significant change is not warranted.

However, to enhance supervision under the current framework, Finsia would support:

- requiring companies to keep (for a period of say, two years) a written record of their private briefings, setting out 'who, when, where' and the topics discussed
- requiring listed companies to give advance notice to the market of the timing for release of their financial results.

IFSA

We strongly believe that companies should manage communications so that no investor or potential investor obtains material or price sensitive insider information that has not been disclosed to the market in accordance with the Corporations Act and the ASX Listing Rules. We fully support the market regulator and supervisor in ensuring these laws and rules are followed at all times.

As noted above, fund managers have an important role in monitoring and influencing company decision making which ultimately drives company performance. While recognising the important role of corporate briefings to analysts, it should not be acceptable to engage in information arbitrage by holding private briefings at which market sensitive information is made available, which gives rise to information asymmetries.

IFSA recommendation

IFSA considers that the current regulatory regime is flexible and sufficient to cover disclosure and governance practices of corporate briefings to analysts.

Accounting Bodies

As with our above comments concerning the spreading of false and misleading information, whilst the activity of briefings to analysts may have the effect of undermining market integrity, putting in place an exhaustive regulatory framework is problematic, and indeed, potentially counter-productive. The Accounting Bodies fully support measures that enhance the flow of quality information within the market. It is to this end that the continuous disclosure regime under Chapter 6CA of the Corporations Act 2001 operates as a vital adjunct to annual and half-year financial reporting. Given the dynamic character of corporate information and the range of interested parties, we suggest that the conduct of private and public briefings might best be addressed through the ASX's Guidance Note 8 which operates in conjunction with Listing Rule 3.1.