AFMA

10 March 2009

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee

By email: john.kluver@camac.gov.au

Dear Mr Kluver

**Issues Paper – Aspects of Market Integrity**

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comments to the Corporations and Markets Advisory Committee on its issues paper dealing with *Aspects of Market Integrity*.

AFMA represents the interests of participants in Australia's wholesale banking and financial markets. Our members include banks, stockbrokers, treasury corporations, fund managers, traders in specialised products and industry service providers. Their business places them at the centre of the equities market; brokering transactions, arranging and underwriting capital raisings, structuring products, trading and investing.

The following submission is intended to provide initial views and commentary on the issues raised in the paper within the time constraints to which the Committee is subject. AFMA's members consider that the regulatory issues raised, and the possible regulatory interventions being contemplated, could have significant impacts on the efficient operation of the market. They have a close interest in the advice that is presented by the Committee to the Minister. Accordingly, AFMA would welcome the opportunity to have more public time for consultation on the issues raised in this paper.

Please do not hesitate to contact me at dlove@afma.com.au or (02) 9776 7995 if further clarification or elaboration is desired.

Yours sincerely

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## 1. Margin Lending to Directors

### *Regulation of margin loans to directors (Section 1.4)*

(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 (Section 1.5)***

(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 (Section 1.6)***

(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 (Section 1.7)*

(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.

## 2. 'Blackout' Trading by Company Directors

(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.

## 3. Spreading False or Misleading information

### *Initiating rumours (Section 3.3)*

(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[1] 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.

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

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

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 (Section 3.4)*

(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.

### *Recipients of rumours (Section 3.5)*

(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.

## 4. Corporate Briefings to Analysts

(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[2];
- 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

[2] 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.

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.