Submission to the Corporations and Markets Advisory Committee in response to its Issues Paper on Aspects of Market Integrity

Introduction

1. Allens Arthur Robinson is pleased to provide this submission to the Corporations and Markets Advisory Committee in response to its Issues Paper of 10 February 2009 on Aspects of Market Integrity.

Margin lending to directors (Issues Paper, section 1)

Regulation of margin loans to directors

2. 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.

3. 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.

4. 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.

5. 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.

6. 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

7. 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.

8. 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.

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

(a) 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;

(b) 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;

(c) 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;

(d) 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 (a) 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

(e) 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.

'Blackout' trading by company directors (Issues Paper, Section 2)

10. 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.

11. 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.

12. 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.

Spreading false or misleading information (Issues Paper, Section 3)

13. 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.

14. 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.

15. 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.

16. 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.

17. We would not oppose the development of best practice guidelines by ASIC, ASX or the appropriate industry bodies.

Corporate briefings to analysts (Issues Paper, Section 4)

18. 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.

19. 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.

20. 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.

Contact details

21. Please contact any of the following if you would like to discuss our submission or have any queries in relation to it:

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