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Mr John Kluver
Executive Director
Corporations & Markets Advisory Committee

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

Dear John

Aspects of Market Integrity: Issues Paper

ASX welcomes the opportunity to comment on the Market Integrity Issues Paper. All four issues present a challenge to identify whether there is a market failure problem that needs to be addressed, and if so, what is the appropriate regulatory response. We comment on the four issues in turn below.

Margin Lending to Directors

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.

[1] See ASX Media Release 29 February 2008, at http://www.asx.com.au/about/pdf/mr20080229_asx_asic_disclosure_update.pdf

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 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.

'Blackout' trading by company directors

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.

Spreading false or misleading information

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.

Corporate briefings to analysts

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.

Please do not hesitate to contact me if you require further information.

Yours sincerely

Malcolm Starr

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