31 March 2009

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
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Dear John

Aspects of Market Integrity

CPA Australia, the Institute of Chartered Accountants in Australia and the National Institute of Accountants (the Joint Accounting Bodies) thank you for the opportunity to comment on the above Issues Paper.

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 Joint 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 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 Joint Accounting Bodies recommend that s205G 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.

Our comments and recommendations are contained in the attached paper.

If you have any queries, in the first instance, please contact John Purcell, Policy Adviser Corporate Regulation CPA Australia on (03) 9606 9826; Kerry Hicks, Head of Reporting Institute of Chartered Accountants in Australia on (02) 9290 5703; or Peter Goujon Manager Member Integrity the National Institute of Accountants on (03) 8665 3114.

Yours sincerely

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Michael Carmody
Chief Executive Officer
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Margin lending to directors (Issues Paper - section 1)

Background – the rationale of director equity participation

Section 198A[1] 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[2] 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'[3] 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[4] 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."[5]

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

- possible conflicts with self-interest and fiduciary duties,
- whether executives/directors are placed in an untenable position under the insider trading regime,
- 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 executive/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 executive/director funds his or her equity participation.

The corporate governance objectives of market disclosures

Considering the aspect of an executive/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[6] and 183[7]. 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."[8]

1 Powers of Directors
2 Effect of Constitution and Replaceable Rules
3 Refer s 124 Legal Capacity and Powers of a Company
4 Ford's Principles of Corporate Law, Butterworths, 13th ed 2007 at 7.620 & 7.630
5 Ibid at page 320
6 Use of position
7 Use of information
8 Hospital Products Ltd v United States Surgical Corporation (1984) 156 CLR 41

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 executives/directors 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 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[9], deals generally with aspects of conflicts of interests, though having at its origins concerns around the damaging effect 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."[10]

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 transactions and arrangements 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 an executive/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 List 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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9 Public Information about Directors and Secretaries
10 Ford's Principles of Corporate Law, Butterworths, 13th ed 2007 at 9.610 p 511

‘Blackout’ trading by company directors (Issues Paper, section 2)

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 the use of position and/or information operate as the primary source of intervention against such misconduct, a sound corporate policy through which a trading ‘blackout’ applies provides an appropriate adjunct for guiding executives/directors, protecting their companies and safeguarding market integrity. It is to this end that we suggest that Principle 3[11] of the 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 trading ‘blackout’. If deemed appropriate, the description of the underlying law and the governance rationale could be expanded upon and 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 difficulties in both drafting and enforcement, offering little, if any, commensurate benefit to companies and the market.

Spreading false and misleading information (Issues Paper, section 3)

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[12] 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 is excessive.

Corporate briefings to analysts (Issues Paper, section 4)

As with our above comments concerning the spreading of false and misleading information, whilst the activity of briefings to analysts may have the affect of undermining market integrity, putting in place an effective regulatory framework would not only be impossible , but 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.

Summary of recommendations and major conclusions

- Section 205G be amended to require directors to disclose margin loans which correspond with notifiable shareholdings.
- Clarification of the requirement of disclosure of margin lending arrangements be given in both s 191 and ASX List Rule 3.1.
- 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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[11] Promote ethical and responsible decision-making
[12] Market misconduct and other prohibited conduct relating to financial products and financial services

- 'Blackout' trading by directors is a highly desirable practice, but for the time being should be dealt with through individual company governance procedures. It is to this end that we suggest that Principle 3 of the ASX CGC Principles and Recommendations offers the most suitable avenue.
- The Accounting Bodies support amendment to ss 1041E, 1041F and 1041G to attract civil as well as criminal penalties.
- Compulsory recording of telephone conversations and other forms of electronic communications in the context of the spreading of false and misleading information is excessive.

The conduct of private and public briefings is best under existing rules though may be more specifically addressed in the ASX's Guidance Note 8 which operates in conjunction with Listing Rule 3.1