Regnan Submission to CAMAC in response to
"Aspects of Market Integrity Issues Paper"
10th March 2009

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1 Introduction

1.1 Regnan is a specialist governance research and engagement entity operating in Australia. It is owned by eight leading institutional investors. At the time of this submission, Regnan is retained by 13 institutional investors with a mandate to proactively identify potential governance risks and engage companies in relation to these risks.

1.2 Regnan clients invest around A$37 billion in S&P/ASX200 companies as at 31st December 2008.

1.3 This submission reflects the views of Regnan and does not necessarily represent its client organisations.

2 Margin lending to directors

2.1 Legislation should prohibit margin loans to directors

2.1.1 Regnan is opposed to directors holding margin loans over shares in their own company, and believes that this practice should be prohibited under legislation. 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.

2.1.1.1 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 this) can trigger or contribute to a series of events that do cause lasting damage to a company. Damaging events which may be caused by a 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.

2.1.1.2 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 2.1.1.1.

2.1.1.3 While 2.1.1.1 – 2.1.1.2 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.

2.1.1.4 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 as outlined in 2.1.1.1 – 2.1.1.3 above.

2.1.1.5 The argument that prohibition of 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.

2.1.1.6 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.

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

2.2.1 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. 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.

2.2.1.1 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 where 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 in 2.1. 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.

2.2.1.2 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 in 2.1) 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.

3 'Blackout' trading by company directors

3.1 Negative implications of blackout trading for market integrity

3.1.1 Share trading by directors, particularly active[1] share trading, during blackout periods as defined by the ASXMS[2] are detrimental to the company at hand and market integrity because of the perception risk of insider trading that accompanies such director share trade.

3.1.1.1 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 possessed by 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 the

[1] "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.
[2] The period between the close of a company's books and release of half-year or full-year results.

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 periods, it is only necessary for investors to assume this 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.

3.1.1.2 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.

3.1.1.3 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.

3.2 High frequency of active share trading by Australian listed company directors

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

3.2.1.1 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

3.2.1.2 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 8.3% increase on the annual figure for 2007 (see 3.2.1.1 above) despite 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%).

3.3 ASX Corporate Governance Council guidance

3.3.1 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 3.1.1), and outline the expectation that directors will refrain from actively trading in company shares during these times.

3.3.2 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 3.1.1.1 – 3.1.1.3), 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 3.2.1.2).

3.4 ASIC Involvement

3.4.1 Regnan believes that the risk to market integrity posed by directors actively trading during blackout periods (see section 3.1), combined with the evidence of this behaviour's increasing frequency (see section 3.2), 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.

3.4.1.1 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.

3.5 Disclosure requirements in relation to directors' trading

3.5.1 Regnan does not believe tightening of S205G of the Corporations Act requiring changes in director interests to be reported within two business days instead of the current 14 calendar days should take place.

3.5.1.1 Regnan research has demonstrated a high level of non-compliance by S&P/ASX200 companies with both ASX Listing Rule 3.19B[3], and with S205G 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 S205G 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 S205G of the Corporations Act).

3.5.1.2 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	% director trades in breach of ASX Listing Rule 3.19B	% director trades in breach of S205G of the Corporations Act

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

Listed Entities		
2008 Q3 – 3mths to 30th September	13%	7%
2008 Q1 - 3mths to 31st March	6.4%	2.7%

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

3.5.1.3 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 in director interests. If non-compliance continues, then this should be addressed by better enforcement of the existing rules.

3.5.2 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 section 3.4.1.1) 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.

3.5.2.1 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.

3.5.2.2 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.

3.5.2.3 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.

4 Corporate briefings to analysts

4.1 Public briefings

4.1.1 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.

4.1.2 Regnan has elsewhere argued that certain reforms would improve the ability of the Annual General Meeting to effect information flow (see Regnan Submission on AGM Reform[4]).

4.2 Private briefings

4.2.1 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.

4.2.2 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
- Publish information *about* private briefings (for instance, date and participants at each meeting) even where they do not provide content.
- Hold briefings for small groups of analysts from different organisations while declining to hold one-on-one briefings.

[4] http://www.csaust.com/AM/Template.cfm?Section=Discussion_papers&Template=/CM/ContentDisplay.cfm&ContentID=11124

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.

4.2.3 Significant concerns exist regarding equitable access to information, including the opportunity to direct questions to areas of interest. However as outlined above (see section 4.2.2), Regnan does not regard a legislative requirement to publish content as likely to increase market integrity, and sees strengthening of normative guidance as an appropriate step given current practices.