CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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Dear Malcolm

Disclosure of shareholdings subject to security interest or other third-party rights

CSA is the peak professional body delivering accredited education and the most practical and authoritative training and information on governance, as well as thought leadership in the field. Our members have primary responsibility in listed companies to deal with the Australian Securities Exchange (ASX) and interpret and implement the Listing Rules. Our members deal on a day-to-day basis with ASX and have a thorough working knowledge of the operations of the markets, the needs of investors and the Listing Rules, as well as compliance with the Corporations Act (the Act).

We have drawn on their experience in our submission on the disclosure of shareholdings subject to security interest or other third-party rights. We have also been acutely aware of the interests of retirees when formulating our views on this issue.

Background

In our 5 May submission to ASX on short selling, we noted that any regulatory response in relation to short selling should not be undertaken in isolation, but should include appropriate regulatory attention to the disclosure of margin loans to executives and directors, as well as stock lending. We also advised that we would make a separate submission on this issue.

CSA has been concerned that investors have been subject to wild swings in share prices driven by margin calls on loans to directors and securities lending arrangements entered into by or on behalf of directors. Ordinary investors and the market have not been informed in a timely manner of the creation or existence of these security interests and third-party rights.

The issue of whether or not disclosure of security interests or other third-party rights in directors' shareholdings should be regulated is complex. Our consideration of this issue took into account the need to keep the market informed, the administrative burden of implementing any enhanced disclosure requirements (including the need to balance the benefits against the costs of any such enhanced disclosure requirements) and the legitimate interest of directors in the privacy of their personal financial affairs. We have also been concerned not to exacerbate the problem by giving information to short sellers and others that would allow them to target particular

companies or directors. However, we do not consider it good governance for directors to enter into substantial financial arrangements that if disclosed could lead to negative market activity affecting their company's shares. Accordingly we do not accept that this is of itself an argument against disclosure.

We are also aware that there may be concerns that such substantial financial arrangements can give rise to a conflict of interest between the director and the company. While security arrangements in respect of other substantial shareholders have the same potential to cause a material impact on the share price, substantial shareholders who are not directors do not have a fiduciary duty to act in the best interests of the company.

Alternative approaches to regulation

Within the context of seeking a good governance outcome, that is, keeping the market informed, CSA considered three alternative approaches. CSA recognises that there are advantages and disadvantages attached to each option.

1 Maintain the status quo

As is currently the case, there would be no obligation on directors to disclose to the company any security interest or third-party right in their shareholdings. There would be no obligation on the company to disclose unless (a) it is 'aware' of the information in the sense defined in the Listing Rules, that is a director or executive officer has come into possession of the information in the course of the performance of their duties; and (b) the information is discloseable under the ordinary operation of Listing Rule 3.1.

Advantage

Although security and third-party interests over directors' shareholdings have recently been under the spotlight and have had a dramatic impact on the share price of a small number of companies, before the recent market volatility there does not appear to have been widespread public concern about directors funding their holdings in this way. It is possible that any expansion of regulation could be a 'knee-jerk' response to particular, limited circumstances, which might impose on all directors and companies an ongoing, unnecessary regulatory burden.

Disadvantage

Balanced against this is the concern that recent market volatility has shown that the market was not fully informed as to security and third-party interests granted by directors and that, as a result, the market and ordinary investors were not fully informed as to the risks affecting particular stocks. As Opes Prime showed, where directors enter into arrangements which provide third-party rights over their shareholdings, there can be very material impacts on share prices even when the director concerned is not in any way in default under a margin loan.

2 Uniform disclosure

This option would require directors to disclose whether any of the company securities in which they have a relevant interest are subject to margin loans, other security interests (mortgage, charge, lien etc) or stock lending arrangements. There would be no requirement to disclose the details of the security arrangements or trigger prices.

Advantage

Companies and directors currently have an obligation under the Corporations Act and the Listing Rules to disclose to the market any relevant interests of directors in the securities of the company, with details of the number of securities held. The obligation extends to disclosure of contracts that confer a right to call for or deliver shares in the company.

Disadvantage

Requiring disclosure of security and third-party interests creates another level of regulatory burden on companies and directors. Directors may also prefer to keep private information concerning their funding of securities. Furthermore, the risk to the market is questionable where directors have a relevant interest that is subject to security interests or other third-party rights where the shareholding is immaterial relative to the company's overall issued capital.

3 Disclosure of security interests and other third-party rights to the company with market disclosure in the case of substantial shareholdings

This option would require directors to disclose **to the company** if any of the company securities in which they have a relevant interest are subject to margin loans, other security interests (mortgage, charge, lien etc) or stock lending arrangements. The company would be required to disclose **to the market** if a director held more than five per cent (substantial shareholder notice level of materiality) of the company's issued securities subject to security interests or other third-party rights. Further disclosure would be required on movements of one per cent or more. There would be no requirement to disclose the specific details of the security arrangements or trigger prices.

Advantage

The market should be informed if a director's shareholding subject to a security interest or other third-party right is sufficiently large that its forced sale would be likely to have a material effect on the price of the company's securities. From the perspective of investors, price sensitivity is the key issue.

The advantage of tying disclosure to a clear materiality threshold is that boards are not placed in the difficult position of enquiring into directors' personal financial arrangements and circumstances to determine whether a particular margin loan or other arrangement is material. Companies would often be unable to determine materiality without examining the financial arrangements of directors and, furthermore, would often not have access to such information. For example, a director's shares in one company may form part of a larger portfolio to which the security interest applies, and judging materiality would involve examination of the entire portfolio.

Moreover, the five per cent materiality threshold (substantial shareholder notice) is fully accepted in the market and this would be a natural extension of that disclosure.

Disadvantage

There is concern that disclosure of the level of security interests or other third-party rights over directors' shareholdings can incite hedge funds to sell the stock, create pressure on the share price and force those directors who have security interests on their holdings to sell their stock. The argument against disclosure is that it could operate against the company's best interests. Furthermore, funding arrangements where a director grants security over their stock can be very useful to companies whose founders seek to maintain material ownership as the capital base increases.

However, CSA does not accept that it is good governance for a director to enter into substantial financial arrangements which if disclosed to the market could lead to significant volatility in their company's share price. If the effect of requiring disclosure is to limit arrangements of this kind then that it is a beneficial outcome.

CSA recommendation

Recommendation
Having considered the advantages and disadvantages of each option, **CSA recommends** disclosure if a director holds more than five per cent (substantial shareholder notice level of materiality) of the company's issued securities subject to security interests or other third-party rights (margin loans, other security interests (mortgage, charge, lien etc) or stock lending arrangements). There would be no requirement to disclose the details of the security arrangements or trigger prices.

Implementation
CSA understands that the ASX Corporate Governance Council has considered this issue and does not see a role for the *Corporate Governance Principles and Recommendations* in providing for disclosure of security interests and third-party rights in directors' shareholdings. On this basis, CSA believes that there are two ways in which our recommended reform can be implemented:

- The ASX Listing Rules could be amended to require directors to notify the company of security and other third-party interests affecting shares in which they have a substantial relevant interest and for the company to notify the market of those interests. CSA recommends that this be done by requiring companies to state on each Form 3X and Form 3Y lodged with respect to a director's relevant interests whether or not, and if so how many of, the relevant securities are subject to a substantial security or third-party interest (that is, more than five per cent). There would be an additional requirement to lodge a Form 3Y where a director's relevant interests have not changed but security interests are created or discharged. This would be binding on companies and relatively simple to administer. The onus would be on directors to properly inform the company of their arrangements, as is currently the case with respect to directors' share trading.
- Section 205G of the Corporations Act could be amended to impose a statutory obligation on directors to comply with this requirement. This would require legislative action but would give ASIC greater enforcement powers in the event of non-compliance.

CSA recommends that ASX issue a guidance note detailing what information is being sought and for what purpose by the addition of the new box on Forms 3X and Form 3Y requiring details about the security or other third-party interests applying to the number of shares to be inserted in the box. The guidance note could highlight that companies are free to provide further explanation as to why the box on these forms has been ticked, if desired.

Conclusion

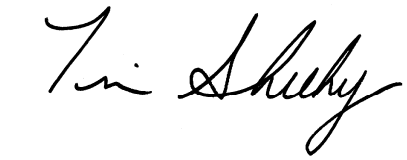
CSA is aware that the issue of whether or not disclosure of security interests or other third-party rights in directors' shareholdings should be regulated is complex. Our members have given considerable thought to this issue, and our recommendations arise from a concern that, at present, good governance outcomes are not being served, as the market is not fully informed.

CSA believes that the issue of the disclosure security interests or other third-party rights in directors' shareholdings can be addressed immediately through action on the part of ASX, while longer-term legislative reform is pursued. CSA also believes that the issue of disclosure

requirements can be addressed while consideration of other complex issues, such as stock lending, continue. CSA would be happy to make a further submission on stock lending should ASX seek additional comment.

CSA would be happy to meet with you to discuss these issues and would welcome the opportunity to be involved in further deliberations.

Yours sincerely



Tim Sheehy
CHIEF EXECUTIVE

cc
The Hon. Senator Nick Sherry, Minister for Superannuation and Corporate Law
Cherie Parker, Market Integrity Unit, Corporations and Financial Services Division, Treasury
Marian Kljakovic, Market Integrity Unit, Corporations and Financial Services Division, Treasury
Belinda Gibson, Commissioner, Australian Securities and Investments Commission