CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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Dear John

Market integrity

Chartered Secretaries Australia (CSA) is the independent leader in governance, risk and compliance. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency. We influence thinking and behaviour in Australia in the evolving area of governance, and provide expert commentary on the proper exercise of authority in organisations. We also proactively encourage federal and state governments to create legislative frameworks that foster sound practices in stewardship, accountability and transparency, as well as ethical behaviour.

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 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 issues referred to the Corporations and Markets Advisory Committee (CAMAC).

General comments

We welcome the opportunity to comment on the issues referred to CAMAC by the Minister for Superannuation and Corporate Law, Senator the Hon Nick Sherry, in November 2008, as set out below:

- the use and disclosure of margin lending by company directors
- trading in shares during corporate 'black-out' periods
- 'rumourtrage', or the intentional spreading of false corporate and market rumours, and
- the issue of the disclosure of price-sensitive information at closed company briefings.

The issues referred to CAMAC have been discussed and examined at great length by our members during the past 18 months and our comments on the following pages are the outcome of those robust discussions, and the experience of our members in dealing with these issues.

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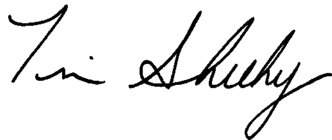
We have been calling for law reform on the first issue (disclosure of margin loans) for most of 2008, with written and verbal submissions made throughout the year to the Australian Securities Exchange (ASX), the Australian Securities and Investments Commission (ASIC), the Department of Treasury and the Minister.

In relation to the second issue, in 2008 we published a Good Governance Guide on board share trading policies, that provides a policy position on trading in shares during corporate black-out periods. We have attached this as Appendix A.

We have also encouraged companies to involve retail shareholders in media and analysts' briefings during the course of last year, on which we comment in further detail below.

Our comments on the following pages are offered within the context of seeking a framework that balances the needs of an informed market and confidence in market integrity with the need to ensure that regulation is enhanced rather than being added to for the sake of it. It is the quality of regulation that counts, not the quantity.

Yours sincerely



Tim Sheehy
CHIEF EXECUTIVE

The use and disclosure of margin lending by company directors

Background

Early in 2008, CSA became concerned that investors were being subjected to wild swings in share prices resulting from margin calls on loans to directors in an environment where ordinary investors and the market were not informed in a timely manner of the creation or existence of these security interests and third-party rights. We began advocating for reform, calling for the disclosure to the market of security interests or third-party rights over directors' shareholdings to be mandated.

We recognised, and continue to recognise, that the issue of whether or not disclosure of security interests or other third-party rights in directors' shareholdings should be regulated is complex. For example, concern has been expressed 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 lose control of their stock. It has been argued that such disclosure could advantage one class of shareholder over another, with hedge funds that have greater company analysis at their disposal targeting companies in which directors have borrowed to buy shares.[1] On this basis, the argument against disclosure is that it could operate against the company's and shareholders' best interests.

CSA's consideration of whether disclosure should be mandated 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. Our consideration also took into account the need not to exacerbate volatility in the market by giving information to short sellers and others that would allow them to target particular companies or directors.

CSA does not consider it good governance for directors to enter into substantial financial arrangements that if disclosed could place their company in jeopardy, and accordingly, we do not accept that this is a compelling argument of itself against disclosure. CSA believes that shareholders and the market need to know about such substantial financial arrangements, so that they can make their own assessment of whether there is potential for the market to move downwards sharply and quickly enough to trigger the third-party right, as happens when there is a margin call. Otherwise the market is uninformed or, potentially, misinformed.

CSA has not called for and does not call for the prohibition of margin loans to directors or regulation imposing conditions on directors before they can enter into margin loans concerning the company's shares. CSA does not support such a prohibition or imposition of limitations. CSA accepts that 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. CSA believes that it should be left to individual companies to set the conditions under which directors can enter into margin loans or grant security over their stock.

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 CSA considers this to be a beneficial outcome.

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[1] AICD Policy & Advocacy Position Paper No. 9, *Director Margin Loans*, June 2008

CSA continues to call for disclosure by directors to the company and by the company to the market in order to ensure that an informed market exists. Investors should have access to information that funds raised may involve directors losing control of their stock. CSA has considered at great length the arguments put forward by various parties against disclosure, but we have not been persuaded by these arguments and we continue to call for disclosure being mandated.

CSA's consideration of alternative approaches to regulation

When considering the issue in 2008, and within the context of seeking a good governance outcome, that is, keeping the market informed, CSA considered three alternative approaches to the disclosure of margin loans. These options were:

1. **maintaining the status quo**, that is, there would be no obligation on directors to disclose to the company any security interest or third-party right in their shareholdings, and there would be no obligation on the company to disclose to the market 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

2. **requiring 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

3. **requiring directors, under legislation, 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 then be required under the ASX Listing Rules 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.

CSA has re-examined each of these options.

1 Maintain the status quo

CSA continues to oppose maintaining the status quo. Market volatility continues to show that the market and ordinary investors are not fully informed as to the risks affecting particular stocks when the market is not fully informed as to security and third-party interests granted by directors. Where directors enter into financial arrangements that provide third-party rights over their shareholdings (for example, stock lending) there can be very material impacts on share prices, even when the director concerned is not in any way in default of their own obligations.

We also note that it has been argued that, following the spate of margin calls on directors in 2008, directors no longer hold margin loans on shares in the companies which they govern or no longer are party to such substantial financial arrangements that a forced sale could lead to negative market activity affecting their company's shares. CSA considers this to be unlikely. As the market navigates its way through the worst financial crisis since the 1930s, directors who would not have considered themselves at risk of receiving a margin call have, and may continue to receive margin calls.

Indeed, CSA notes that data published by the Reserve Bank of Australia (RBA) in March 2009 showed margin calls in the December 2008 quarter soared to a fresh high. The average number of margin calls per day rose to 9.77 per day per 1,000 clients in the final quarter, more than doubling from the third quarter and surging 12-fold from the December 2007 quarter. As noted above, it is unlikely that directors are not included in these statistics.

CSA notes that when the market observes a director selling shares, even when it is a forced sale, the market may perceive such a sale as representing inside knowledge of the prospects and performance of the company. CSA points to the inherent risk of misinterpretation by the market that directors are seeking to exit their investment. This perception problem is ameliorated if investors know that directors have financial arrangements in place that could lead to a forced sale, as disclosure provides notice to investors that such arrangements exist, and on what portion of the stock, thereby allowing investors to make up their own minds about the impact such arrangements could have on the share price and providing clarity as to the forced nature of the sale should it occur.

2 Uniform disclosure

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. There is no materiality test attached to directors' obligation to disclose these relevant interests on the basis that the market should be informed of all dealings by directors in the shares of their companies.

A requirement to provide for the disclosure of whether any of the company securities in which directors have a relevant interest is subject to margin loans, other security interests (mortgage, charge, lien etc) or stock lending arrangements would be a relatively small and easily implemented addition to an existing obligation. Indeed, the CAMAC paper notes that it is arguable that s 205G of the Corporations Act may already require uniform disclosure by directors of transactions in shares of the company including information on when they have entered into margin loans and the details of those loans.

However, on consideration, CSA continues to believe that 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. Therefore, while CSA can see the merit in uniform disclosure, CSA continues to support a materiality threshold, as set out below.

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

CSA believes that 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.

CSA notes that the ASX/ASIC joint Companies Update 02/08 stated that:

> Where a director has entered into margin loan or similar funding arrangements for a *material* number of securities, ASX advises that listing rule 3.1, in appropriate circumstances, may operate to require the entity to disclose the key terms of the arrangements, including the number of securities involved, the trigger points, the right of the lender to sell unilaterally and any other material details. Whether a margin loan arrangement is material under listing rule 3.1 is a matter which the company must decide having regard to the nature of its operations and the particular circumstances of the company. [The emphasis is CSA's.]

There has been support for such disclosure remaining a matter of a company's continuous disclosure obligation rather than requiring additional regulation, noting that 'it provides the necessary flexibility for boards and companies to decide when margin loan arrangements may be material and therefore require market disclosure. In volatile trading conditions, a judgment of materiality may fluctuate frequently'.[2]

However, CSA contends that 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. CSA also notes that unless the director has informed the company of the margin loan (which may not necessarily be the case), the company is not in a position to, and is not obliged to, disclose under Listing Rule 3.1.

The advantage of tying disclosure to a clear materiality threshold, therefore, is that boards and their secretaries are not placed in the invidious position of enquiring into directors' personal financial arrangements and circumstances to determine whether a particular margin loan or other arrangement is material, which might involve an inappropriate degree of scrutiny of directors' personal finances. Tying the disclosure to a materiality threshold provides greater privacy to directors than board assessment as to whether directors' financial arrangements could have a material impact on the share price. Furthermore, an additional advantage is that if the disclosure obligation is placed on the director rather than the company, the issue of whether or not the director has provided information to the company does not negate the director's obligation to disclose.

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.

CSA notes that it has been argued that substantial shareholders could have security arrangements in place that have the same potential to cause a material impact on the share price as directors' arrangements. However, CSA notes that substantial shareholders who are not directors do not have a fiduciary duty to act in the best interests of the company, and nor do they have access to the same inside information or capacity to influence company decisions that directors do. Accordingly, we do not feel that this argument can support non-disclosure.

We are also aware that concerns have been expressed that substantial financial arrangements entered into by directors can give rise to a conflict of interest between the director and the company. Regardless of whether a conflict of interest exists or not, the obligation to disclose should remain.

United Kingdom

CSA notes that in January this year, the Financial Services Authority, in its role as the UK Listing Authority, clarified its position relating to disclosure obligations in respect of transactions by persons discharging managerial responsibilities, such as directors, and their connected persons, who grant security over their shareholdings. The FSA confirmed that granting security over a shareholding is classified in the Model Code as an action that requires market disclosure, under Annex 1 to Chapter 9 of the Listing Rules. 'The Code makes it expressly clear that 'dealing' includes 'using as security, or otherwise granting a charge, lien or other encumbrance over the securities of the company' (paragraph 1(c) (v)).'

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[2] AICD Policy & Advocacy Position Paper No. 9, *Director Margin Loans*, June 2008

CSA points to the UK obligation to disclose to the market as support for our call for disclosure, noting, however, that in the Australian context we support a materiality threshold rather than uniform disclosure.

CSA recommendation

Recommendation
Having considered again the advantages and disadvantages of each option, **CSA recommends** disclosure if a director holds five per cent or more (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). Further disclosure would be required on movements of one per cent or more. However, there should be no requirement to disclose the details of the security arrangements or trigger prices.

Implementation
CSA believes that there are two steps involved in implementing this recommended reform:

1. The CAMAC paper notes that it is arguable that s 205G of the Corporations Act may already require uniform disclosure of transactions by directors in shares of the company including information on when they have entered into margin loans and the details of those loans. Where in the past we have recommended that this section be amended to impose a statutory obligation on directors to inform the company of any security interests that are created or discharged, in light of the uncertainty regarding interpretation of this section, **CSA recommends** that s 205G be amended to *clarify* that directors have a disclosure obligation that extends to the disclosure of security interests in their shares. CSA also recommends that ASIC provide guidance on this issue. CSA notes that clarifying that directors have an obligation under statute to disclose shareholdings subject to security interest or other third-party right to the company is one step only. In order to ensure an informed market, there should be a second step: an obligation on the company to disclose to the market those interests.

2. The ASX Listing Rules should be amended to require the company to notify the market of security and other third-party interests affecting shares in which directors have a substantial relevant interest. **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.

CSA's recommendation for statutory amendment clarifies that the obligation to disclose to the company rests with the director, and obviates a reliance on directors informing companies of their arrangements and any requisite arrangements between directors and companies that this may entail.

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.

Trading in shares during corporate blackout periods

The Corporations Act prohibits 'insider trading' generally and the ASX Listing Rules require notification of directors' dealings. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*, against which listed entities must report in their annual report, contains Recommendation 3.2, which states that: 'Companies should establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy', and Box 3.2, which provides 'Suggestions for the contents of a trading policy'.

CSA notes that different companies and different circumstances require different trading policies, but that irrespective of the terms of a company's policy on trading in company securities, the policy is subject at all times to the law on insider trading.

CSA believes that sufficient guidance is available to companies on the issues to address in a trading policy and that no further guidance is required in the ASX Corporate Governance Council guidelines.

For example, in 2008, CSA published a Good Governance Guide: *Issues to consider in developing or reviewing the policy on trading in company securities* (attached as Appendix A). This Good Governance Guide is a companion to an earlier one published: *Trading in company securities: summary of issues* (attached as Appendix B).

The 2008 Good Governance Guide sets out the:

- legal and regulatory context for a policy on trading in company securities
- purpose of a policy
- issues to address in a policy, including the prohibition on insider trading; directors' interests notification; clearance to deal procedures; awareness of and compliance with the policy; restrictions on trading; and the role of the company secretary.

The Good Governance Guide also notes that:

- a company's policy needs to explain how the company restricts trading in company securities that is in breach of legal and regulatory requirements; and the company's policy
- the board, senior executives and other internal or external persons who have access to inside information relating directly or indirectly to the entity need to be clear as to the risks that the entity's policy is meant to address and what consequences attach to directors, executives and employees from the company's perspective if the policy is breached.

CSA also notes that a company policy on trading needs to address whether exemptions of any kind will apply and in what circumstances. CSA believes that such circumstances should not extend beyond genuine hardship (CSA does not believe that a potential tax liability constitutes genuine hardship) or a court order or similar requirement. Furthermore, CSA believes that exemptions need to be approved by the board or the chairman but that if an exemption for genuine hardship or a court order or similar does not apply, the policy must not be silent on the issue but must state that any exemption is at the chairman's discretion.

The section on 'Restrictions on trading' in CSA's Good Governance Guide *Issues to consider in developing or reviewing the policy on trading in company securities* states that:

> Restrictions on trading in trading policies can be expressed as either black-out periods, or trading windows (see Good Governance Guide 3.1: *Trading in company securities: summary of issues*). Regardless of which approach is decided by the company, it is good governance to ensure that the company clarifies which restrictions on trading are in place. A policy that does not include either a trading windows or a black-out approach to restrictions will give rise to reputational risk, as the perception could arise that trading is permitted at certain times despite legal prohibitions on insider trading.

CSA supports the use of either trading windows or black-out periods and does not support a more interventionist approach to either. CSA notes that a windows trading approach would usually result in a ban on trading in black-out periods. Therefore, a windows trading approach should be just as effective as a black-out approach in the period from the end of a financial period to the release of results for that period. CSA believes that it is for the company to decide which approach is more suitable to the circumstances of the company.

However, CSA notes that any policy must clarify that, irrespective of whether trading occurs in a trading window or outside a black-out period, no trading can occur if it involves the use of inside information.

CSA believes that the ultimate issue is compliance with the law and that policies can assist the board, senior executives and employees to understand their compliance obligations and adhere to them. CSA does not support the adoption of requirements in the form of regulatory guidelines as set out in the Model Code issued by the UK Financial Services Authority. Under the Model Code, a 'restricted' person must not 'deal' in any 'securities' of a listed company at any time, whether or not during a black-out period, without obtaining in advance a 'clearance to deal'. A 'restricted' person is anyone discharging managerial responsibilities concerning the company, being directors and senior executives.

CSA notes that the requirement set out in the Model Code are aligned with the guidance provided by CSA in its Good Governance Guide. However, CSA believes that such matters should remain as guidance and not be regulated.

CSA also welcomes the attention by ASX on directors' trading in the shares of their companies during black-out periods. CSA notes that this attention has resulted in improvements in compliance and supports an ongoing review by ASX of this issue to enforce its importance.

CSA recommendations

CSA recommends that no further guidance on directors' trading in black-out periods should be required in the ASX Corporate Governance Council guidelines.

CSA recommends that it is for the company to decide whether trading windows or black-out periods are more suitable to the circumstances of the company. **CSA opposes** any further intervention in this regard.

CSA opposes the adoption of requirements in the form of regulatory guidelines as set out in the Model Code issued by the UK Financial Services Authority.

'Rumourtrage', or the intentional spreading of false corporate and market rumours

CSA does not believe that any changes are required to the Australian regulatory framework in relation to 'rumourtrage'. CSA believes that the current provisions relating to the dissemination of materially false or misleading information that is likely to induce trading or affect the price of trading; market manipulation; false trading and market rigging; dealing in a financial product using false or misleading information; and engaging in dishonest conduct in relation to a financial product or financial service are adequate to deal with the intentional spreading of false corporate and market rumours.

CSA also does not believe that any further guidance on this issue is required from either ASIC or ASX. There is considerable guidance available already that is easily accessible.

CSA agrees that ss 1041E, 1041F and 1041G should attract civil penalties as well as criminal penalties. CSA notes that the burden of proof of breach required to attract a criminal penalty is such that offences can be difficult to prosecute. CSA believes that, if civil penalty provisions are introduced, it provides additional enforcement capability and the lower civil standard of proof of breach could also encourage greater compliance with the existing regulatory regime.

CSA also recommends that, while considered in the context of rumour mongering, a global review of the provisions in Division 2 of Part 7.2, many of which cover similar but not identical ground, would be beneficial in order to rationalise these provisions and the consequences of a breach (rather than a single factual circumstance giving rise to multiple contraventions and potentially different consequences).

CSA recommendations

CSA recommends that no change be undertaken to the current regulatory framework, as CSA believes the current provisions relating to the intentional spreading of false corporate market rumours are adequate.

CSA recommends that no further guidance on this issue should be required from ASIC or ASX.

CSA recommends that ss 1041E, 1041F and 1041G should attract civil penalties as well as criminal penalties and that the overlapping nature of these provisions (and other related provisions in Division 2 of Part 7.2) would benefit from a review and rationalisation.

The issue of the disclosure of price-sensitive information at closed company briefings

At present, the continuous disclosure provisions (s 674) of the Corporations Act and the requirement under Listing Rule 3.1 to disclose any information that is material and price-sensitive are in place to keep the investing public informed of events and circumstances that could affect the price or value of a company's securities. Continuous disclosure regulation is designed to ensure that investors have timely and equal access to price-sensitive information in relation to traded securities.

Any information, therefore, that could have a material impact on the price of the company's shares that is disclosed in a company briefing, be it private or public, *must* be disclosed by a company to the market immediately. CSA does not believe that further guidance is required to ensure that companies understand their obligations under the continuous disclosure regime.

CSA notes that webcasting information provided in a public or private briefing could be an effective way of expeditiously disclosing such information, regardless of whether it is price-sensitive or not. CSA encourages all companies to provide either a live webcast or an archive of a private or public briefing, to ensure a large range of shareholders have access to the information. However, CSA does not recommend that webcasting should be mandated, as CSA notes that issues of cost may prevent companies from taking up webcasting at this point in time, and forcing additional costs on companies affects shareholder value. CSA does believe that webcasting of public and private briefings is best practice for large companies with large shareholder bases, and notes that such companies are able to sustain the costs attached to webcasting.

CSA notes that, while it is good practice for records to be maintained of private briefings, such record-keeping should not be mandated. CSA points to the difficulty inherent in regulating the detail of such records, which will vary according to company and circumstance.

CSA notes that the continuous disclosure regime prohibits selective disclosure by providing for the disclosure of *any* information that could have a material impact on the share price. On this basis, CSA sees no reason to introduce an equivalent of SEC Rule 100 *Selective disclosure and insider trading* and does not support such a move. CSA also notes that fairness or equal access concerns are already addressed in Listing Rule 3.1.

CSA believes in the general principle of ensuring that there is no restriction on access to information provided by a company, but does not see a role for further regulation in this area. For example, CSA has previously called for the media briefings following company AGMs to be open to all shareholders. On this basis, CSA encourages companies to provide access to any briefing of analysts, by, for example, telephone, to ensure shareholders have access to the information provided at such briefings. In large part, this would dispel the mystique attached to such briefings and reduce the misperception that analysts are granted access to information that is withheld from shareholders. However, again, CSA does not recommend that the provision of such access be mandated.

CSA notes that analysts have raised concerns that their intellectual property rights could be infringed by making analysts' briefings available to all shareholders. While CSA notes that analysts' questions are likely to be more sophisticated than those asked by retail shareholders, any response from the company that contains information that is material and price-sensitive must be disclosed to all investors. Selective disclosure cannot be justified on the basis of sophisticated questions being posed to a company.

CSA recommendations

CSA recommends that companies be encouraged to webcast public or private briefings, but that such dissemination should *not* be mandated.

CSA recommends that it is good practice for records to be maintained of private briefings, but that such record-keeping should *not* be mandated

CSA recommends that an equivalent to SEC Rule 100 Selective disclosure and insider trading should not be introduced, as the current continuous disclosure regime prohibits selective disclosure by providing for the disclosure of *any* information that could have a material impact on the share price.

CSA recommends that companies be encouraged to provide a feed to analysts' briefings but that this should *not* be mandated.