



**Senator the Hon Nick Sherry  
Minister for Superannuation and Corporate Law**

19 NOV 2008

Mr Richard St John  
Convenor  
Corporations and Markets Advisory Committee  
GPO Box 3967  
SYDNEY NSW 2001

Dear Mr St John

As a result of the global financial crisis and the related turbulence in Australian financial markets, the effect on the market of a number of practices has given rise to a significant degree of concern in the business, and broader, community.

I am concerned that the lack of transparency and accountability surrounding some of these practices could mean that there is potential for damage to the integrity of the market and investor confidence. In my view, the Corporations and Markets Advisory Committee, as a statutory source of independent advice to the Australian Government on issues relating to corporations and financial markets law and practice, is the correct forum to provide advice on the effect of these practices.

**Directors' interests in listed securities and margin lending**

Margin lending refers to the practice of providing loans that are secured over an asset held by the borrower, with a condition that if the ratio of the asset's market value to the amount of the loan falls below an agreed level, the borrower may become subject to a 'margin call'. If this occurs the borrower must reduce the level of indebtedness or increase the value of the security pledged, commonly by selling part of the security to pay down the loan. Margin loans are commonly utilised to enable investors to acquire financial products which are then used as the collateral.

Margin lending plays an important role in the market. It facilitates investors' access to finance and their ability to pledge assets as security. Any restriction on margin lending has the potential to distort investment decisions and interfere with the efficient allocation of capital.

Margin lending can provide a means of facilitating the acquisition of meaningful shareholdings by directors, which may contribute to the alignment of directors' and companies' interests and act as an inducement to good performance. The leveraging of shareholdings may magnify a director's gain or loss from those shareholdings.

However, following financial market events in early 2008, some analysts have suggested that there may be a significant adverse impact on the market price of a company's shares where a director is required to divest large parcels of shares as a result of a margin call.

In particular, concerns have been directed at the level of disclosure to the market of margin lending arrangements.

### *Regulation of margin lending*

ASX listing rule 3.1 provides that, once a company becomes aware of information concerning it that a reasonable person would expect to have a material effect on the value of the company's securities, the entity must immediately inform the ASX.

On 29 February 2008, the ASX and ASIC jointly issued *Companies Update 02/08* which clarified that, where a director's relevant and material shareholding is subject to a margin loan (or similar funding arrangement), listing rule 3.1 may, in 'appropriate circumstances', require an entity to disclose the key terms of the arrangements (including the number of securities involved, the trigger points, the rights of the lender to sell unilaterally, and any other material details). This disclosure obligation operates in conjunction with section 191 of the *Corporations Act 2001* which arguably obliges a director to disclose their substantial shareholdings that are subject to loan arrangements. This provision obliges a director with a material personal interest in a matter relating to the affairs of the company to give the other directors notice of that interest.

Notwithstanding the companies update required under ASX listing rule 3.1 and section 191, some uncertainty may remain as to the nature of directors' obligations to disclose margin loan arrangements to their boards, and the obligations of companies to disclose margin loan arrangements to the market.

There is also a question as to whether the current disclosure obligations in respect of margin lending arrangements best address the various competing policy considerations involved.

Better disclosure to the market will improve the ability of market participants to assess the risk of divestiture of material shareholdings by directors. However, some commentators have suggested that the provision of specific details of loan arrangements, such as trigger prices, may encourage market manipulation by short sellers of the company's stock.

The frequency, nature and extent of any mandatory disclosures may also impact on the regulatory burden imposed on companies. Generally, greater disclosure increases the costs and complexity of compliance. Improving the clarity and certainty of the test to be applied in determining whether disclosure is required may reduce complexity, the costs of compliance, and costs resulting from erroneous non-compliance.

The current regime should also be assessed in terms of the effect on directors as well as on the company itself. Rules that impose costs upon directors may act as a disincentive to directors acquiring a material shareholding in companies which employ them. The extent to which any rules require the disclosure of the personal affairs of directors or their associates may have a similar effect.

In regards to this issue, I refer you to the work previously undertaken by Chartered Secretaries Australia (*Disclosure of shareholdings subject to security interest or other third-party rights — submission to ASX*, 13 June 2008) and the Australian Institute of Company Directors (*Position paper no. 9 – Directors' Margin Loans*, 21 July 2008).

Having regard to all the above matters, I request that CAMAC:

- (i) examine how overseas jurisdictions regulate the disclosure of directors' shareholdings subject to margin loans or similar funding arrangements, and compare and contrast overseas regulation with that of Australia; and
- (ii) advise whether changes are required to Australia's regulatory framework and if so what form they should take.

### **'Blackout' trading by company directors**

A 'blackout' period refers to the time when a company's officers are prohibited by the policies set by the company from trading in the company's securities. These periods generally occur prior to the release of annual or half-yearly results. 'Blackout' trading is when officers trade during a 'blackout' period.

The obligation to have a 'blackout' policy is regulated by Recommendation 3.2 of the *ASX Corporate Governance Principles and Recommendations*. This 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'. Under ASX Listing Rule 4.10.3, a company is required to provide a statement in its annual report disclosing the extent to which it has followed the *Corporate Governance Principles and Recommendations*. If the company has not followed a recommendation, it must provide reasons for its non-compliance.

'Blackout' trading is not against the law, however, individuals who trade with information which is not generally available are subject to the insider trading prohibitions in Part 7.10 of the Corporations Act. Additionally, section 183 of the Corporations Act imposes a prohibition on directors improperly using company information to gain a personal advantage, and section 205G of the Corporations Act and ASX listing rule 3.19A impose disclosure obligations in respect of the holding, or alteration, by directors of certain interests they have in the company.

Both the ASX and Regnan have recently reviewed trading by directors and found a significant lack of compliance with regard to not trading in the 'blackout' period. ASX Markets Supervision Pty Limited (ASXMS) also conducted a review which examined rule 3.19A notifications via the Companies Announcements Platform between 1 January 2008 and 31 March 2008. That review found that of the 1,863 active trade notifications lodged, 43 per cent occurred in the period between the close of books and the release to the market of the relevant entity's half-year and full-year results. Both reviews also identified significant levels of late compliance or non-compliance by directors with their obligations under section 205G and rule 3.19A.

I note that ASIC published Regulatory Guide 193 - *Notifications of directors' interests in securities - listed companies* on 25 June 2008. This document provides some clarification of the notification obligations of directors and sets out the criteria taken into account by ASIC when assessing whether regulatory action should be taken.

I am concerned that active trading by directors between the close of books and the release of results has the potential to affect confidence in the integrity of Australia's markets. From a policy perspective, such confidence is central to maintaining Australia's attractiveness as an investment destination.

I request that CAMAC:

- (i) examine how overseas jurisdictions regulate 'blackout' trading, and compare and contrast overseas regulation with that of Australia;
- (ii) while noting the already extensive insider trading prohibition, advise whether changes are required to Australia's regulatory framework to provide for greater confidence in the integrity of the market, specifically relating to directors' trading activity; and
- (iii) advise what form any such changes should take if they are required.

### **Spreading false or misleading information**

During the recent market turbulence, concerns have been raised that some market participants may have been spreading false or misleading information in respect of certain securities in order to take advantage of artificial changes in their price. This practice is sometimes referred to as 'rumourtrage'.

Section 1041E of the Corporations Act prohibits the dissemination of false information that is likely to have a negative effect on the price of any securities in circumstances where the disseminator knew, or ought reasonably to have known, the information was false.

In parallel to this provision, there are prohibitions on market manipulation (section 1041A), false trading and market rigging (section 1041B and 1041C), and inducing a person to deal in a financial product using false or misleading information (section 1041F). Additionally, section 1041G of the Corporations Act prohibits a person carrying on a financial services business from engaging in dishonest conduct in relation to a financial product or financial service.

On 7 March 2008, the Australian Securities and Investments Commission initiated an investigation into the allegations of market manipulation by false rumours and collusive behaviour (Project Mint). In light of the concerns that have been raised regarding rumourtrage, it is appropriate to review the regulatory regime governing market manipulation, with specific focus on the spreading of false information.

I request that CAMAC:

- (i) examine how overseas jurisdictions regulate the spread of false or misleading information, and compare and contrast overseas regulation with that of Australia; and
- (ii) advise whether changes are required to Australia's regulatory framework, and if so what form they should take.

### **Disclosure of market-sensitive information**

Analysts, and the research they perform, play an important role in Australia's financial markets, by keeping the market informed. Briefings are sometimes provided by companies to analysts on a confidential basis to assist in the pricing of securities in the market and to assist with research.

Under the continuous disclosure obligations in the Corporations Act and the ASX Listing Rules, price-sensitive information must be provided to the market once the company becomes aware of it. Continuous disclosure both ensures that the market is fully informed and contributes to market fairness and efficiency. Alternative ways in which market-sensitive information may be distributed include press briefings and posting information on the company's website.

There are concerns, however, that confidential briefings are being provided to analysts which create the perception that some analysts have access to critical information that is not available to other analysts, shareholders and the general public. These perceptions can lead to a lack of confidence in the integrity of Australia's financial markets and potentially create opportunities for insider trading.

I request that CAMAC:

- (i) examine the role that analysts' briefings play in Australia's financial market, including whether their role is a positive one that leads to greater market efficiency; and
- (ii) advise whether changes may be required to Australia's regulatory framework; and if so, what form they should take.

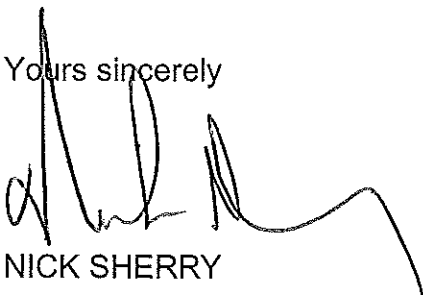
### **Referral and resourcing**

It is important to ensure that Australia's system of corporate law and regulation is sufficiently robust to provide investors with confidence that they are able to make fully informed decisions. I therefore seek CAMAC's advice on the corporate law aspects of the matters set out in this letter.

In order to assist in this task, I have approved the payment of \$100,000 to CAMAC. I would appreciate CAMAC's advice by 30 June 2009. Due to the nature of the issues contained in this referral, I believe it is important that this timeframe is adhered to, although I also note the complexity of these matters and as such I request that CAMAC keep Treasury informed of any factors that might impact on the delivery of your advice within this timeframe.

The Government values the expertise and insights that CAMAC brings to corporate law policy development and looks forward to receiving its report.

Yours sincerely

A handwritten signature in black ink, appearing to read 'NICK SHERRY', with a long horizontal flourish extending to the right.

NICK SHERRY