Submission to Corporations and Markets Advisory Committee
Aspects of Market Integrity

Margin Lending to Directors

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The use of margin loans by directors

The Minister's letter and press release seek guidance on how margin lending by directors should be disclosed, if at all.

Corporate governance theory and practice generally accepts that the remuneration of directors and officers should be structured to build and maintain enterprise value.1 This is traditionally seen as aligning the interests of directors and officers with those of the shareholders. On this view, a central problem for corporate regulation is how to efficiently manage and reduce the agency costs that arise between the shareholders as providers of capital and the directors who supervise the management of that capital.2 One mechanism that is commonly used is to provide equity-based compensation to directors and company executives. The underlying assumption is that directors and officers (as managers of capital provided by shareholders) will have an incentive to promote the overall success of the business because this will increase the value of holding shares in the business (both through capital gains in share price and through dividend distributions over time). The theory of executive compensation is particularly concerned with avoiding executive focus on the company's short-term share price.3 It is therefore important to structure remuneration so that it promotes the medium and long-term prosperity of the corporation.4

Aside from the incentive to promote corporate value over individual rent seeking, equity compensation packages also provide a useful signalling mechanism to the capital markets which acts to reduce agency costs and thereby lower the cost of outside debt and equity.5 Large share sales by directors send a signal (whether intentional or not) to the market that the director/manager believes there is more value in selling the company's shares than keeping them for the long

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1 See ASX *Corporate Governance Principles and Recommendations*, 2nd ed, 2007, Principle 8.

2 Michael Jensen and William Meckling, Theory of the firm: managerial behaviour, agency costs and ownership structure (1976) 3 *Journal of Financial Economics* 305.

3 Recent corporate collapses such as Enron and One.Tel, and the even more recent problems associated with the development and distribution of risky complex financial instruments, demonstrate the problems with pursuing short-term share price gains and economic bonuses without due regard to long-term performance.

4 For a detailed discussion see Michael Jensen and Kevin Murphy, Remuneration: where we've been, how we got to here, what are the problems and how to fix them, (2004) *Finance Working Paper ECGI*. This paper can be downloaded without charge from http://ssrn.com/abstract=561305

5 See Michael Jensen and William Meckling, Theory of the firm: managerial behaviour, agency costs and ownership structure (1976) 3 *Journal of Financial Economics* 305, which argued that the cost of raising outside debt and equity would be determined in direct proportion to the risk of default by the internal managers as agents of the holders of new outside equity. Therefore, as insiders maintain a greater proportion of the firm's equity, this limits the risk of default as the adverse economic consequences of default are shared in greater proportions by the insiders. For a discussion of signalling theory and its application to executive compensation see Hamid Mehran, Executive incentive plans, corporate control and capital structure (1992) 27 Journal of Financial and Quantitative Analysis 539.

term.6 That is, by voluntarily holding shares in the company directors and officers send a signal to the capital markets that their view is that the future value of capital gains and dividend payments will provide greater personal utility than the value that can be obtained by selling the shares immediately. This signalling mechanism is based on the assumption that directors and managers have inside information that the market does not have.7 Concerns about abuse of this inside information provide the basis for insider trading laws and continuous disclosure laws.

However, although directors and officers are generally encouraged to hold equity stakes in their corporations they also face difficult financing decisions by doing so. This is derived from the perspective of modern portfolio theory and the capital asset pricing model (CAPM). Using these perspectives, by holding large equity stakes in their corporations directors and officers leave too much of their wealth portfolio under the risk of the company failing. As directors and officers have already placed their human specific capital at risk by maintaining employment with the company, they arguably put too much of their wealth at risk by holding a large proportion of their wealth in the same company by significant proportions of shares. Whilst having 'skin in the game' is a key motivational factor designed to drive executive performance, individual directors and officers should have similar opportunities for risk diversification as ordinary shareholders and creditors, who are equally exposed to the risk of the company collapsing. This is justified on the basis that the ultimate success or failure of any individual company is unlikely to be significantly affected by any one individual person. Therefore, directors and officers may face financial ruin as a result of adverse external factors impacting on the company which are beyond their substantial control. The ability to use shareholdings in the company as security to obtain loan finance provides directors and officers with the ability to diversify their risk by using such funds for other investments. This in no way reduces the investment of human capital that they have made in the company. **On these grounds we do not advocate a universal ban on the ability of directors and officers to take out margin loans over their company shareholdings. However, we do argue that some measure of regulation is needed to promote an efficient market in the company's shares and allow investors to make appropriate decisions about the risks associated with investing in the company's securities.** We therefore make several recommendations on how the law could be amended to provide for more efficient capital markets with respect to the issue of director and officer margin loans.

Recommendation 1

1.1 Public companies listed on a licensed financial market should be required by law to develop an internal policy regarding the use of any facility by a company director or officer that enables that individual to divest themselves of the full and unrestricted beneficial interest in owning shares or other securities in the company.

1.2 The use or prohibition of margin loans by directors and officers, including any limitations on the size of margin loans (if any), should be a matter for each company and its board of directors to determine in accordance with the policy developed under Recommendation 1.1 and should not be subjected to legislative prescription.

1.3 Listed public companies should be required to disclose the existence of their internal policy as part of their periodic disclosure obligations in LR 4.10.

Recommendation 2

2.1 Directors and officers should be required by law to disclose information to the company that is relevant for the effective operation and enforcement of the company's policies regarding margin loans or other facilities that allow for the disposition of the beneficial interest in the company's securities by directors and officers.

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6 The signalling value of director trades is recognised by the ASX Listing Rules (LR 3.19A) which require disclosure of such trades.

7 For a discussion of the role of signalling and informational asymmetry see Stephen Ross, The determination of financial structure: the incentive-signalling approach (1977) 8 Bell Journal of Economics 23; Milton Harris and Artur Raviv, The theory of capital structure (1991) 46 Journal of Finance 297.

2.2 This information would include, the existence of a margin loan or other transaction or facility that allows the individual to divest themselves of the full or partial beneficial interest in the company's securities held in their name or by an associate for their benefit. Secondly, where an event occurs which triggers a potential obligation to transfer those securities to a third party, such as a financier under a margin call, that fact should be disclosed to the company immediately or as soon as is reasonably practicable. Thirdly, where the director or officer has made a decision that affects whether the securities will be transferred to a third party, such as the decision to provide funds to meet a margin call rather than allow the financier to sell securities covered by the margin lending facility, that decision should be notified to the company immediately or as soon as is reasonably practicable.

2.3 We suggest that this new provision be inserted as a new s 191A, not as an amendment to s 205G.

Implications and justification of these recommendations

Recommendation 1.1

Currently there is uncertainty about whether or not companies have to disclose margin lending arrangements under the continuous disclosure rules. The joint press release in February 2008 by the ASX and ASIC assumes that companies may be required to do so. This recommendation therefore advocates imposing a statutory obligation on companies to develop systems to enable them to comply with this information where necessary.8 Maintaining an internal policy against which director and officer conduct can be benchmarked provides a useful enforcement mechanism for both the company in relation to its external disclosure obligations and also for ASIC in investigating trades by company directors for potential insider trading and market manipulation.

Recommendation 1.2

In our view, the corporation (in consultation with its individual directors and officers) is the most appropriate body to determine how to find an appropriate balance between the desirability of directors being able to enter into margin loans and the ramifications of being in a position where the Corporation needs to disclose a margin call or similar facility under ASX LR 3.1. As a policy is used the number of shares or other securities that can be subject to margin loans etc may be specifically covered by the company so that appropriate safeguards can be put in place to minimise any adverse impact on the company. Of course, the company's directors and officers will continue to be bound by their duties to the company in respect of informing the company about any material personal interests (s 191) and to act in good faith and to avoid conflicts of interest (ss 181, 182). Furthermore, the setting of arbitrary limits or benchmarks on disclosure would not be beneficial as margin loans or other arrangement affecting the beneficial ownership of the securities may be material to the market assessment of those securities in some cases but not others. There are various factors that will contribute to the materiality of such information, including the number of the securities held by the individual, the proportion of those securities that are subject to the arrangements, the trading volumes in the company's securities, the dispersed or concentrated nature of the company's security holders and the company's capital structure.

Recommendation 1.3

This is a compliance measure designed to ensure that companies are putting in place mechanisms to deal with the peculiar corporate governance and capital market regulatory issues that these arrangements pose.

Recommendation 2.1

This is a compliance measure designed to ensure that individuals provide the company with sufficient information that it needs to implement and maintain its internal policies and its external disclosure obligations to the market. By installing this requirement in the Corporations Act 2001 (Cth) it sends a clear message to corporate managers that these disclosure

8 See also the obligation under ASX LR 3.19B.

issues are important to the market and are not merely matters of personal preference and privacy. This issue is discussed further below in the conclusion.

Recommendation 2.2

In our view, it is important not to limit disclosure to the use of margin lending facilities alone. The use of such facilities is a symptom of the broader governance issue of aligning the interests between managers and the long-term prosperity of the company by giving those managers access to any future benefits through the ownership of securities in the company. As noted by other submissions (see for example Allens Arthur Robinson), the policy of such alignment is frustrated if directors and officers are able to use sophisticated derivative instruments or other techniques to maintain legal ownership whilst divesting themselves of beneficial ownership of the securities.9 The key governance tool is to align these interests through access to the economic benefits that flow from owning shares and other securities in the company, not from merely owning the legal title to those securities. Therefore, disclosure obligations should not be limited to margin loans only but should include other arrangements that pose similar governance issues.

Furthermore, we recommend that the Act require directors and officers to disclose certain key information to the company. This is a compliance measure that will assist the company with complying with its disclosure obligations. We have specifically targeted those events that are the most likely to generate issues for the company, that is entering into the arrangement, when a margin call is made and what the individual's intention is in responding to the margin call.

Recommendation 2.3

We argue that any amendment to the Act to impose further disclosure obligations on company directors should be inserted in Pt 2D.1 of the Act. Section 205G appears in Pt 2D.5 which is concerned with public information about directors. Our proposals do not include directors making public disclosure, but rather directors making limited disclosure to the company, which the company can-if it believes it is material-disclose to the broader market.

Conclusion

There is an argument that directors' financial arrangements for holding securities are not issues that arise in their capacity as directors of the company, but rather in their personal capacity. On this view, the existence of margin lending is not an issue for the company any more than the financial arrangements of other non-insider shareholders. However, directors and officers occupy a special position within the company and their holdings in the company's securities pose special issues that do not apply to outsiders, as noted above. In our view, this position of trust and confidence, and the strong signal that director trades send to the market makes the sale of directors' and officers' securities through margin lending or similar facilities an issue that the company should be aware of. If large numbers of directors' or officers' securities are being sold by a margin lender then the company has a right to know why its shares are trading at such volumes. Similarly if a director or officer has divested themselves of the beneficial to their shares which are supposed to act as a bonding mechanism, the company has a right to know. Any potential conflicts of interests which arise can then be dealt with under the company's internal policies.

Some have argued that disclosure of margin lending arrangements will target particular companies for the attention of hedge funds and short sellers. Examples have been raised from previous months including ABC Learning and Allco. However, one problem with both these examples (and no doubt many others) was that the market was kept uninformed about the reasons for increased trading volumes. Given that listed companies have continuous disclosure obligations, the recommendations above will provide those companies with the information that they need to comply with those disclosure obligations, if and when the nature of margin lending arrangements becomes material to the market. It may be that most cases of margin loans by directors will not be material to the market because of the nature of the arrangements, the size

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9 See the extensive literature on the phenomenon of hidden ownership and empty voting: Henry Hu and Bernard Black, The new vote buying: empty voting and hidden (morphable) ownership (2006) 79 Southern California Law Review 811.

of the holding of securities involved and/or the company's trading conditions. Where the price starts falling 30% or more in a single day, and the market wonders why significant volumes of the company's securities are changing hands, it is important that the company understand why and explain to the market if it is material. The privacy of directors should not necessarily prevent a properly informed market from trading.