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CORPORATIONS AND MARKETS ADVISORY COMMITTEE: ISSUES PAPER ON ASPECTS OF MARKET INTEGRITY

Thank you for the opportunity to make a submission on the CAMAC Issues Paper on Aspects of Market Integrity.

This submission relates primarily to the topics raised in the Issues Paper which concern insider trading.

In summary, this submission contains the following comments and recommendations:

(a) it is unlikely that the sale by a lender of shares subject to margin loan arrangements as a result of an unsatisfied margin call on those shares amounts to insider trading by the director who owns those shares, even where that director possesses inside information;

(b) listed companies should be permitted to make their own determinations of any conditions to be placed on directors entering into margin loans, and any such conditions should be disclosed by the company in its trading policy, developed in accordance with Recommendation 3.2 of the ASX Corporate Governance Principles and Recommendations;

(c) greater transparency should be introduced into "black-out" trading by directors by incorporating specific recommended "black-out" periods for listed company trading policies pursuant to Recommendation 3.2 of the ASX Corporate Governance Principles and Recommendations; and

(d) record-keeping recommendations for analyst briefings should be introduced into the ASX Corporate Governance Principles and Recommendations.

1. Margin Lending to Directors

It is understood that the Hon Senator Nick Sherry, the Minister for Superannuation and Corporate Law ('the Minister') has raised concerns about the practice of directors of listed companies using margin lending arrangements to acquire company shares. From the outset, it should be acknowledged that it is commonly accepted that when directors hold shares in a company, the interests of the director and company's shareholders are considered to be aligned.[1] Accordingly, the introduction of provisions or requirements that would make the holding of shares in a listed company less attractive to, or more onerous for, its directors should be approached with caution.

It is suggested in the Issues Paper that a forced sale of shares subject to a director's margin loan could result in a breach of Australian insider trading laws by that director. In such circumstances, the six essential elements of insider trading <u>may</u> be satisfied. Insider trading by a director will be found to occur where:

(i) the director possesses information;
(ii) the information is not generally available;[2]
(iii) the information is material;[3]
(iv) the director knows (or ought to know) that the information is not generally available;
(v) the director knows (or ought to know) that the information is material; and
(vi) the director trades in the relevant financial products, or <u>procures</u> such trading.

The final element requires some further consideration to determine if the director will actually trade or procure trading if shares he or she holds, subject to margin lending arrangements, are sold by the lender after a margin call. Pursuant to the terms of s1043A(1) of the *Corporations Act 2001* (Cth) ('the *Corporations Act')* the prohibited action is to, as principal or agent:

(c) apply for, acquire, or dispose of relevant financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant financial products; or

(d) procure another person to apply for, acquire, or dispose of relevant financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant financial products.

The Issues Paper suggests that when listed company shares which are the subject of a margin loan are sold by the lender because the director has failed to honour a margin call, the director can be argued that the director procured the disposal of the securities. Section 9 of the *Corporations Act* provides that "procure" includes "cause" and it is suggested that a director <u>causes</u> securities to be sold by not honouring a margin call (by failing to repay part of the loan or provide additional security) since the sale of the securities could have been avoided if such action were taken.

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[1] See, for example, Investment and Financial Services Association Limited, "*Blue Book – Corporate Governance: A Guide for Fund Managers and Corporations*", Guideline 11 – Equity Participation by Non-Executive Directors; Investment & Financial Services Association Ltd, "*Executive Equity Plan Guidelines*", Principle 3.1; Australian Securities Exchange, "*ASX Corporate Governance Guidelines*", 3. Equity-based remuneration; Australian Council of Super Investors Inc, "*Corporate Governance Guidelines*", 14.1 – Remuneration Practices, 14.8 – Other Aspects of Long-term Incentive Schemes, 14.14 – Director Remuneration and Share Ownership.
[2] As defined in s1042C of the *Corporations Act.*
[3] As defined in s1042D of the *Corporations Act.*

However, it is more likely that "causation" sufficient to amount to an act procuring will require an active step be taken rather than resulting from inaction. Section 1042F of the *Corporations Act* now provides a more extensive definition of "procure", which states that if a person incites, induces or encourages an act or omission by another person, the first person is taken to procure the act or omission by the other person. Whilst this definition is expressed to be without limitation, the positive acts expressed by the terms "incite, induce and encourage" connote the taking of active steps and do convey a meaning unlikely to be satisfied by mere inaction (such as the failure to take other steps). Accordingly, it is strongly suggested that the better view is that there is no procuring of trading and therefore no insider trading, where a director fails to honour a margin call and, as a result, the lender elects to sell the shares subject to margin lending arrangements, even if the director possessed inside information at the relevant time. Additionally, a suggestion that a director could have avoided the sale of the shares by making repayment on the margin loan or providing additional securities pre-supposes that the director has the necessary means and resources to take such alternative action.

Additionally, regulation 9.12.01 provides that s1043(1) of the *Corporations Act* does not apply in relation to a sale of financial products under a mortgage or charge of the financial products.[4] This regulation is not expressed to exclude the application of the insider trading prohibition to the actions of the lender only, and arguably also protects the owner of the financial products – in the circumstances under discussion, the director with shares held under margin lending arrangements – from liability under s1043.

Accordingly, no change to the law is recommended as a result of any perceived issues of insider trading. It would be contrary to the spirit of the prohibition on insider trading to determine that a director breaches the prohibition as a result of the actions of a lender who is not in possession of the relevant inside information. The better view appears to be that no such infringement arises, due to the operation of regulation 9.12.01 and the extended definition of "procure" in s1043F of the *Corporations Act*.

On the question as to whether conditions should be placed on the circumstances in which directors of listed companies can enter into margin loans relating to the company's own shares, it is most appropriate for the relevant company be permitted to make such a determination. In order that the market and all other interested parties are aware of any conditions which may be imposed, it is recommended that this issue be dealt with pursuant to the ASX Corporate Governance Principles and Recommendations ('Corporate Governance Principles'). Recommendation 3.2 of the Corporate Governance Principles provides that listed companies should establish a trading policy, which should then be publicly disclosed. If a company were to place conditions on directors entering into margin loans, it would be appropriate for such conditions to form part of such a trading policy.

2. Blackout Trading by Company Directors

It is understood that the Minister has raised concerns about directors trading in company shares during "blackout periods", at times when such trading is supposedly precluded. Such trading clearly has significant potential to result in breaches of insider trading laws.

[4] Regulation 9.12.01(e)(i) of the *Corporations Regulations*

Obviously, trading which occurs during “blackout periods” (commonly the period elapsing between the closing of a company’s books of account and the release of the company’s financial results to the market) will not necessarily amount to insider trading. As noted above, insider trading only occurs where the six essential elements are present. However, trading during such periods is likely to have a negative impact on perceptions of the integrity of Australia’s securities markets.

It is not appropriate to prohibit or restrict trading by directors or other designated officers of a company during any particular periods. This would be contrary to the approach taken under Australian insider trading laws, which draw no distinction between primary and secondary insiders, relying on an “information-connection” rather than a “person-connection”.[5]

However, in order that there is greater transparency and to better preserve confidence in market integrity, this issue would be best dealt with by amendments to the Corporate Governance Principles. As noted above, Recommendation 3.2 provides that listed companies should establish a trading policy, which should then be publicly disclosed. Although the Corporate Governance Principles currently recommend that the trading policy identify whether trading windows or black-outs are used, it does not specify recommended black-out periods. The Issues Paper has described various discrepancies and variations in black-out periods adopted by Australian listed companies. It is suggested that the Corporate Governance Principles be amended to specify recommended black-out periods to be used, so that a company with a trading policy which adopts different black-out periods would be required to specify this, so that the market and other interested parties are aware which black-out periods apply for that company. Additionally, where a clearance is available for trading by restricted parties during the black-out period, any clearances given should be disclosed in the company’s annual report, setting out details of the relevant director, the shares traded and the reason the clearance was granted.

3. Corporate Briefings to Analysts

It is understood that the Minister has raised concerns about the practice of listed companies providing corporate briefings to analysts on the basis that it may have a negative impact on perceptions of the integrity of Australia’s securities markets.

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[5] Most overseas jurisdictions make a distinction between the position of “primary” insiders and “secondary” insiders – see, for example: *See for example*, Canada (Securities Act, 1990, s 76(5)(a) to (d), s 76(5)(e) (Ontario)); the European Union (Directive 2003/6/EC, Insider Dealing and Market Manipulation (Market Abuse), Article 2 and Article 4*);* Germany (Securities Trading Act, 1994, s13(1) and s14(2) (Germany)); New Zealand (Securities Amendment Act, 1988, s3(1) (NZ)); Singapore (Securities Industry Act, 1986, s203(c) to (f) (MAS); South Africa (Insider Trading Act, 1998, s1(viii)(a) and s1(viii)(b) (South Africa)); the United Kingdom (Criminal Justice Act, 1993, s57(2)(a), s57(1) and (2)(b) (UK)); the United States (Dirks v. SEC, 463 US 646 at 655(1983); Shaw v. Digital Equipment Corp, 82 F.3d 1194 (1996); United States v. O’Hagan, 117 S Ct 2199;and SEC v. Falbo, 14 F.Supp 2d (1998)). The relevant tests vary between jurisdictions but, in general terms, primary insiders are those who possess inside information because of some connection with the relevant company (for example, directors, shareholders, employees and those who have a professional relationship with the company) and who have derived the inside information by virtue of that connection. Secondary insiders are those who possess inside information but have no particular connection to the relevant company. Most jurisdictions require that a secondary insider knowingly receive the relevant information directly or indirectly from a primary insider. Prior to 1991, a distinction between primary and secondary insiders existed in Australia, but this was abolished in the reforms which followed the Griffiths Report.

There is a risk that company officers providing corporate briefings to analysts may breach the insider trading prohibition due to "tipping" – s1043A(2) of the *Corporations Act* provides that a person in possession of "inside information" must not, directly or indirectly, communicate the information, or cause it to be communicated, to another person if they know (or ought reasonably to know) that the other person would be likely to trade in the relevant financial products or procure another person to do so.

It is widely recognised that a major difficulty in enforcing the prohibition on insider trading relates to the difficulty of proof.[6] In the case of corporate briefings to analysts, it may be difficult to prove after the event that inside information was in fact provided to analysts (as distinguished from information which is already generally available). As "tipping" is already a criminal offence and may be the subject of civil penalty proceedings under the *Corporations Act*, amendment to the law is not recommended, but instead it is suggested that the Corporate Governance Principles be amended to introduce recommendations for record-keeping for private briefings.

Such record-keeping recommendations could be included in Recommendation 3.2 of the Corporate Governance Principles. As is noted above, Recommendation 3.2 provides that listed companies should establish a trading policy, which should then be publicly disclosed. Recommendation 3.2 could include recommendations for record-keeping when private briefings are held, which listed companies must then either comply with, or explain any non-compliance in each annual report. On this basis, a listed company would then be required to disclose whether it has a trading policy which incorporates the record-keeping recommendations, explain any departure from the recommendations, and make the resulting recordings or transcripts of private and public briefings available on its website – or explain why it has not done so.

The introduction of such record-keeping recommendations would assist in:

(a) the provision of evidence of the nature and content of information provided to analysts;

(b) better enabling the prompt public dissemination of any information provided to analysts, if not previously released; and

(c) maintaining public confidence in the integrity of Australia's securities markets.

Thank you for the opportunity to make a submission on the Issues Paper.
Yours sincerely

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[6] See, for example, the Explanatory Memorandum to the Financial Services Bill 2001 (Cth), para 2.78 to 2.79; Roman Tomasic & Brendan Pentony, "*The Prosecution of Insider Trading: Obstacles to Enforcement*" (1989) 22 *Australian and New Zealand Journal of Criminology* 65; Roman Tomasic, "Casino Capitalism? Insider Trading in Australia", (1991) Australian Institute of Criminology.