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Thank you for the opportunity to comment on the issues raised in CAMAC's Issues Paper on "Aspects of Market Integrity". RiskMetrics (formerly Institutional Shareholder Services) is the world's largest proxy voting advisory firm, providing governance research to more than 1700 institutional investors in Australia and around the world.

We have focused on those parts of the Issues Paper that deal with margin loans to, and share trading by, directors.

Regulation of margin loans to directors

We agree with CAMAC that having directors hold shares in the companies on whose boards they sit generally advances shareholders' interests. The ownership of shares – which gives directors a personal financial stake in the company – acts, in principle, to align the interests of directors with those of the shareholders by providing an incentive for directors to make decisions that serve shareholders' interests, as opposed to decisions that place the self-interest of the directors ahead of shareholders' interests. Share ownership on the part of the directors can therefore be a useful adjunct to other corporate governance mechanisms for addressing the agency problems that occur in the case of listed public companies with a widely-dispersed shareholder base.

The Issues Paper focuses on only one of the ways in which directors can acquire shares in their companies: the margin loan. Another – and more common – way for this to occur is where the company itself facilitates or effects the acquisition of shares by its directors. This latter mechanism is routinely encountered in the context of remuneration arrangements. As CAMAC is aware, executive – including directorial – remuneration is now the subject of a vigorous debate in Australia. For the purposes of the present Issues Paper, we wish simply to point out that the putative corporate governance benefits flowing from directors holding shares in their companies can be undermined severely by poorly designed remuneration arrangements.

The principal constraints on directors entering into margin loans and using those loans to acquire shares are:

- The insider trading laws which prohibit directors (and others) in possession of confidential, price-sensitive information from, among other things, acquiring shares; and
- The duties imposed on directors at general law and under the Corporations Act 2001.

There are two key aspects to these constraints, in the context of the Issues Paper:

- Directors profiting from the trading of shares, including shares whose acquisition has been financed using a margin loan; and

- Directors allowing their conduct to be influenced by the fact of their personal exposure to the financier of the margin loan.

The first aspect raises the question as to whether the insider trading prohibitions and sections 182 and 183 of the Corporations Act (and their general law counterparts) require supplementation. This question is addressed in the next section of our submission.

The second aspect concerns the duty of directors to act in the best interests of the company and the requirement to subordinate their self-interest to the interests of the company. The alignment of interests (between the director and the company's shareholders) that the director's holding of shares is designed to achieve can be eroded by the director allowing his or her conduct to be improperly influenced by his or her personal exposure in respect of the margin loan. The director may, as CAMAC notes, be more concerned to instigate or approve corporate conduct that lessens the likelihood of a call being under the margin loan on the director and that particular conduct – while it may have the short-term effect of supporting or even increasing the price of the shares – may not necessarily be in the best interests of the company. The alignment of interests here is illusory and the benefits to the company from the director's conduct unsustainable.

We therefore support CAMAC's "Option 3" (page 10), namely the mandatory disclosure of *all* the material details of the margin loans that the directors have entered into.

The Corporations Act already contains a mechanism for the mandatory disclosure to the company by directors of personal interests that might influence their judgment. The relevant provision is section 191 which requires directors to disclose details of the nature and extent of any "material personal interest" that they may have in the "affairs of the company". We believe that the mandatory disclosure to the company of margin loans can be effected by a more rigorous interpretation of section 191.

We note that ASIC and the ASX have indicated that all margin loans should be disclosed under that section. This view[1] is not, however, free from doubt. The qualifying words "material" and "affairs of the company" may act to exclude margin loans that are viewed as being unlikely to influence the decision-making of a director in relation to the affairs of his or her company. The materiality of the director's interest and whether that interest relates to the affairs of the company will fall to be determined, in particular, by two factors: the size of the loan relative to the personal wealth of the director (and any guarantor of the loan); and the price at which a call on the loan will be triggered relative to the current price of the shares. We therefore believe that it is necessary to "expand" section 191 or "introduce a separate provision" (which are among the proposals being considered by CAMAC).[2]

This approach is consistent with section 205G which requires directors of a listed public company to notify the ASX of their interests in the company's shares and also details of contracts to which the directors are parties and which confer a right to call for or deliver shares. Again, we believe that section 205G is sufficiently wide to apply to margin loans (given that such a loan constitutes a contract to which the director is a party and which confers on the financier the right to call for the shares). As with section 191, this matter can be rendered free from doubt through a clarifying amendment. The application of section 205G to margin loans is also consistent with ASIC's stated

[1] See ASIC and ASX, 'Disclosure Guidance for Listed Entities', *Media Release*, 29 Feb. 2008.

[2] Thought will also need to be given to the operation of section 195, as the existence of a sufficiently large margin loan or one with a trigger price sufficiently close to the current share price could preclude a director from voting on any matter (as all such matters before the board will relate to the affairs of the company). This could be resolved by permitting a director, who has made full disclosure of the margin loan and obtained the company's permission to enter into the loan, to vote.

rationale for that section which is that shareholders are entitled to know whether directors are buying or selling shares.[3]

We also agree with IFSA and ACSI – as regards Option 1 (page 7) – that all companies should have policies in place regulating the entry into margin loans by their directors (and executives), in analogous fashion to the share-trading policies maintained by companies. Nonetheless, at a minimum, the changes in relation to section 191 discussed above will ensure that companies are in possession of all material information relating to margin loans entered into by their directors.

A final point in relation to margin loans relates to the company's obligations to pass on information about such loans to the ASX under LRs 3.1 and 3.19A.[4] The rationale for requiring disclosure to the market of margin loans is, in our opinion, equivalent to the rationale for requiring disclosure to the market of short positions. In both instances, the information provides investors with a more accurate picture of the level of risk involved in trading the shares, including sentiment about the shares and the pressures that the share price may be subject to.[5] That being the case, we support the disclosure of margin loans relating to non-trivial parcels of shares. A suitable threshold for disclosure is not the higher 5% threshold that is imposed by the substantial shareholding disclosure provisions of the *Corporations Act* but the lower threshold that has been recommended for the disclosure of short positions (ranging from 0.25% to 1%).[6]

Blackout trading by company directors

We believe that improper share trading by directors is best dealt with under the current insider trading prohibitions and sections 182 and 183. Nonetheless, those provisions can be usefully supplemented by *ex ante* mechanisms:

- All listed companies should, consistent with IFSA and ACSI's position on margin loans, have in place blackout policies. This is also consistent with the approach of the ASX Corporate Governance Council's 'Corporate Governance Principles and Recommendations';
- It would be useful if the ASX could provide guidance as to key minimum requirements (along the lines detailed on page 21) such as in relation to the persons (directors and others) who should be subject to the blackout policy, the minimum adequate period for a trading blackout, when waivers will be granted by the company, and the appropriate person within the company to grant such waivers. The UK FSA Model Code is, as noted by CAMAC, a useful benchmark for these requirements;
- Blackout policies need to be supported by a disclosure regime that mandates the timely disclosure of information about share trading by directors and their companies to the ASX. We agree with CAMAC that the 14-day notification period in section 205G should be reduced (to 2 days as earlier recommended by CAMAC).

As will be seen from the above, the critical factor is the extent to which margin loans and share trading may adversely impact upon the discharge by directors of their statutory and general law duties to their companies. We believe that this can be addressed by the imposition of mandatory disclosure requirements on margin loans (which already has the considerable backing of ASIC and

[3] See ASIC, 'Notification of Directors' Interests in Securities – Listed Companies', *Regulatory Guide 193*, June 2008, para 3.
[4] We note that the application of the Listing Rules to margin loans is also supported by ASIC and the ASX: see ASIC and ASX, 'Disclosure Guidance for Listed Entities', *Media Release*, 29 Feb. 2008.
[5] See Treasury, 'Short Selling Disclosure Regime', *Consultation Paper*, March 2009, p. 2.
[6] See Treasury, 'Short Selling Disclosure Regime', *Consultation Paper*, March 2009, p. 4.

the ASX in terms of how the relevant statutory provisions and Listing Rules should be interpreted) and fine-tuning the current rules relating to blackout policies.

Please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail. Thank you once again for the opportunity to comment on the issues raised in your discussion paper.

Yours sincerely

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