



## >> Position Paper – Director and Executive Security Trading

Updated 1 April 2008



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Effective protection against insider trading is critical to market confidence and, over time, liquidity. For a company, failing to demonstrate a working governance system to prevent insider trading not only poses risks for the company but also for the broader Australian listed securities market.

This paper deals with the key company and market risks associated with poorly governed director and executive security trading<sup>1</sup>. It constitutes a call to action by ten major Australian institutions, which together invest more than A\$ 65 billion<sup>2</sup> in S&P/ASX200 companies. It is based on recent market research undertaken by Regnan, a governance research and engagement firm.

### Overview

All OECD countries, including Australia, have laws prohibiting insider trading. Australia requires directors to also notify the market of any changes to their interests in company securities, as do many other countries including the US, UK and New Zealand. This regulation exists because of the risks that stem from insider trading.

Poor compliance with existing security trading rules and poor director security trading behaviour can severely undermine investor confidence. A lack of transparency or late notification of director and executive security trading to the market, combined with director security trades occurring during times where investors could reasonably assume that those directors are in possession of inside information, can have a financially damaging effect: It obscures directors' behaviour and increases the risk that shareholders perceive an 'uneven playing field' where a privileged few are able to profit unduly from trading on inside information (perception risk of insider trading).

**If investors cannot be confident that equitable conditions exist for all security holders, they may avoid certain securities and ultimately threaten security value.**

**Furthermore, overseas investors may be discouraged from the Australian listed securities market as a whole by a perception of an uneven playing field.**

<sup>1</sup> For the purposes of Regnan's research and this position paper, security trading is defined as extending to all transactions that involve listed securities including shares, units, stapled securities and certain derivatives over those securities.

<sup>2</sup> At 1 January 2008.

In Australia, the Corporations Act prohibits trading on information not generally known to the market,<sup>3</sup> while requiring directors<sup>4</sup> to inform the market of changes in their interests in company securities within fourteen calendar days.<sup>5</sup> It also prohibits directors and executives from using information gained in their capacity as directors and executives for their own advantage, or for that of another person.<sup>6</sup>

Australian Securities Exchange (ASX) Listing Rules impose an even stricter regulatory regime, requiring directors of ASX-listed companies to notify the market of any changes in their interests in company securities within five business days. These Listing Rules form an enforceable contract between listed companies and the ASX and are matched by investor interest in director and executive trading.

## Call to Action

The institutions represented by Regnan are investing for the long term, and fiduciary duty requires them to be vigilant over risks within their portfolio. These investors therefore regard governance of security trading risks as relevant to their portfolios' long-term performance.

The institutional investors represented in this position paper believe that ensuring effective disclosure of director trading in securities should be an imperative for companies.

Public scrutiny works as a safeguard against the illegitimate personal enrichment of those who have access to inside company information. It also strengthens confidence in an orderly market, in which effective controls are crucial to ensure efficient outcomes for all investors.<sup>7</sup>

Consequently, the institutional investors represented by Regnan expect S&P/ASX200 companies to evidence their efforts in preventing inappropriate security trading by:

- Having, and disclosing, a policy on trading in listed company securities by directors, executives and other employees who are likely to possess market-sensitive inside information;
- Ensuring that such a policy includes details on how the company endeavours to achieve directors', executives' and other employees' adherence to the Corporations Act and ASX provisions against insider trading;

<sup>3</sup> Part 7.10, Division 3, ss1042A – 10430.

<sup>4</sup> In the US and New Zealand, trades by executives are also required to be disclosed.

<sup>5</sup> S205G.

<sup>6</sup> S182-183.

<sup>7</sup> This is the rationale underpinning regulation requiring disclosure of trades by directors and executives and the prohibition of insider trading. See the preamble to EU Council Directive 89/592 Coordinating Regulations on Insider Trading, 1 Common Mkt Rep. or Newkirk, T.C. & Robertson, M.A., 19 September 1998, Speech by SEC Staff: Insider Trading – A US Perspective at [http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm#FOOTBODY\\_19](http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm#FOOTBODY_19) accessed 18<sup>th</sup> January 2008.

- Having procedures in place that ensure changes of director interests are promptly notified to the relevant market operator in accordance with contractual obligations;
- Disclosing the rationale (and governance applied) behind any change in director interests in the company which might be publicly perceived as insider trading;
- Eliminating inappropriate security trading by directors, i.e. security trading which poses a high perception risk of insider trading and is not accompanied by highly transparent governance processes.

## Summary of Results

Continuous investigation by Regnan on behalf of major Australian institutional investors over the past three years has found unacceptably high levels of companies breaching existing market regulations regarding disclosure of director security trading.

During the year ended September 2007 almost half (97) of S&P/ASX200 companies failed to notify public capital markets of changes in director interests within five business days as required by the ASX Listing Rules. And more than a third (70) of S&P/ASX200 companies also breached the 14 calendar day rule stipulated by the Corporations Act<sup>8</sup>.

Furthermore, research suggests that security trading behaviour by Australian company directors has significantly deteriorated during the past three years:

- In 32 companies, directors were actively purchasing shares within eight weeks prior to a material earnings upgrade or takeover announcement – a 40 % increase from 2004 (23 companies).
- In 23 companies, directors were actively trading shares during the period following books-close until the day results were released – a 15 % increase from 2004 (20 companies). In 8 of these 23 companies the directors actively traded on the same day as results were released, leaving the market no time to digest the results.

Regnan research shows a decrease in the number of companies with directors actively selling shares before a material earnings downgrade with just one company in 2007 (2004: 3 companies). Fewer company directors have sold large tranches of shares without explanation with 3 companies in 2007 (2004: 10 companies). Given the generally low number of incidents in both areas of trading governance, the striking degradation of directors' security

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<sup>8</sup> Corporations Act, Part 2D.5, s205G



trading integrity in the high-volume areas outweighs these minor improvements.

These results underpin a disappointing failure of a number of Australian companies to improve security trading behaviour. This leaves a significant number of company directors exposed to the perception risk of insider trading.

The findings also suggest that – despite public campaigns by the ASX and the Australian Securities and Investment Commission (ASIC) to improve compliance, as well as Regnan’s<sup>9</sup> continuous confidential engagement with poor performers – a large number of companies and their directors still fail to recognise disclosure provisions as a valuable governance tool to minimise perception risks related to insider trading.

As part of its mandate by leading Australian institutional investors, Regnan will now re-embark on its confidential engagement campaign with 54 companies from the S&P/ASX200 to encourage behaviour in line with reasonable governance practice.

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<sup>9</sup> Much of the engagement was carried out by Regnan’s predecessor – the BT Governance Advisory Service.

## Appendix

### Regulatory Background

Australian legislators and market operators have adopted a two-fold approach to prevent insider trading: a black letter law prohibition and a disclosure requirement. The rationale for such laws in Australia is:

*... to ensure that the securities market operates freely and fairly, with all participants having equal access to relevant information. Investor confidence, and thus the ability of the market to mobilise savings, depends importantly on the prevention of the improper use of confidential information.<sup>10</sup>*

Besides the legal provisions stipulated in the Corporations Act, the Australian Securities Exchange has established an additional set of Listing Rules, which are binding on all companies listed in Australia and which impose even stricter security trading notification standards.

Following an 'if not, why not' approach, the ASX requires companies to disclose their compliance with the ASX's own Corporate Governance Principles and Recommendations. The ASX Corporate Governance Council recommends listed companies establish and disclose a policy on trading in company securities by directors, senior executives and employees.<sup>11</sup>

Furthermore, there is a high public interest in director and executive trading. Business journalists regularly report on changes to directors' interests as advised to the ASX, while specialist services directly inform investors on directors' trading routines.<sup>12</sup>

As market understanding and awareness increase, issues of security trading governance become more and more the centre of public debate.<sup>13</sup> Calls have already been made for insider trading laws to be tightened<sup>14</sup> and that, for example, senior executives be subject to the same disclosure requirements as directors under the Corporations Act.<sup>15</sup> Another proposal is for the Corporations Act notice period of fourteen calendar days to be shortened to two business days for all non-dividend reinvestment plan trades.

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<sup>10</sup> House of Representatives Standing Committee on Legal and Constitutional Affairs, 1989, Fair Shares for All: Insider Trading in Australia (October 1989), para 3.3.6.

<sup>11</sup> Recommendation 3.2, Corporate Governance Principles and Recommendations.

<sup>12</sup> For example, GoldmanSachs JBWere in Australia include prominent director securities trade notifications in their 'Daily Cable' publication, which is a daily electronic publication.

<sup>13</sup> In March 2007, the previous Federal Coalition Office of the Parliamentary Secretary to the Treasurer announced support for a CAMAC recommendation put forth in November 2003 to extend trading disclosure requirements to Australian listed company executives. Adoption of such a recommendation by the new Labor Federal Government would bring Australia in line with the US and New Zealand in requiring both directors and executives to disclose trading activities to investors.

<sup>14</sup> Under recommendations originally issued in 2003 by the Corporations and Markets Advisory Committee (CAMAC).

<sup>15</sup> S205G.

## Risks of Insider Trading

Companies that fail to establish an effectively working security trading governance regime face considerable risks. Not considering these risks can result not only in reputational damage, but also real devaluation of stock prices.

### *Community/market risk*

The greatest risk related to director and executive security trading is community and market-driven. Market perceptions that directors and executives are able to profit illegitimately from trading on inside information (perception risk of insider trading) can be fatal to investor confidence and lead to unwillingness to trade.<sup>16</sup> Especially, companies that cannot convince the market of their commitment to good corporate governance risk reputational damage. More importantly, they expose themselves to significant financial risks if shareholders decide to avoid the stock. This would likely result in lower share prices and reduced market liquidity. The damage would affect all investors, yet superannuation funds with their universal exposure to markets would be most affected.

### *Litigation Risk*

Insider trading is a criminal offence, although ASIC has the option to pursue directors using civil penalty provisions. However, there is minimal litigation risk to companies from director and executive security trading. As evidentiary hurdles are significant, it is difficult for ASIC to successfully prosecute in this area. In the event of litigation this is most likely to fall on the individuals concerned. Institutional investors are still exposed to risk of loss because any litigation is likely to have a negative impact on a company's reputation and stock market value.

### *Regulatory Risk*

Another major risk for companies and investors is that the regulation of security trading could become so cumbersome that it might hamper boards in their efforts to attract new members. There is a risk that, given current high levels of non-compliance with existing rules on director trade notifications, investors push for stricter regulation. Investors who are likely to have only minimal direct costs by enforcing tighter laws could unintentionally be faced with long-term costs, if a higher regulatory burden for companies acted as a disincentive to the attraction of new directors.

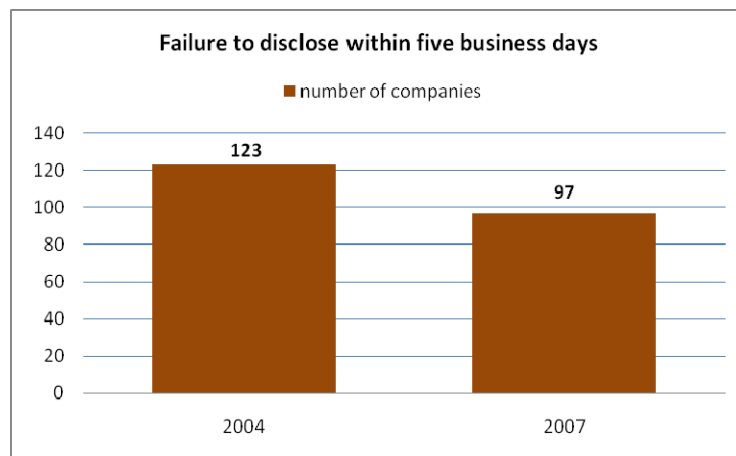
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<sup>16</sup> Research in emerging markets suggests that liquidity improves with the introduction of insider trading laws. The corollary is that in the absence of such legal provisions investors may be unwilling to trade. See: Bhattacharya, U. & Daouk, H. The World Price of Insider Trading. Forthcoming in The Journal of Finance, accessed at <http://www.e.u-tokyo.ac.jp/cirje/research/workshops/macro/macropaper04/utpal1.pdf>.

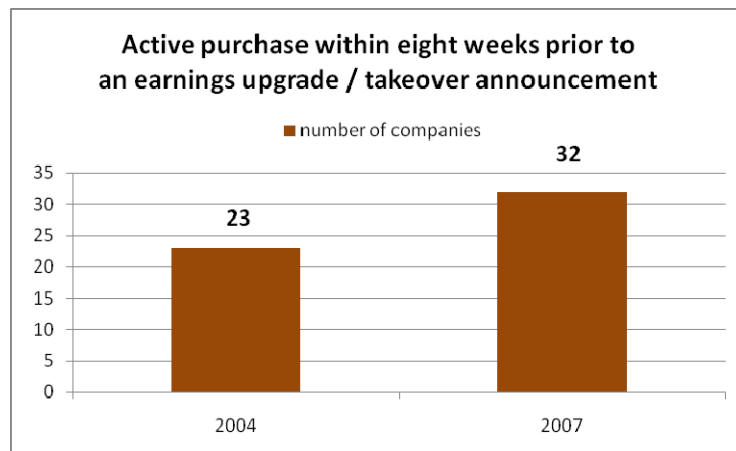
## Regnan Research Findings

The research has found limited improvement in compliance with ASX Listing Rule 3.19A, which requires notification to the market of director trades<sup>17</sup> within five business days and which forms a contractual obligation<sup>18</sup> for ASX-listed companies.

- In 2004, 15 % of all trades by S&P/ASX200 directors were not notified to the market within the five business days. In 2007, still 11 % of all trades by S&P/ASX200 directors were not notified to the market within five business days. In 2007, it took an S&P/ASX200 director 10 business days on average to notify a trade to the market – twice as long as required by the Listing Rules.



- The number of S&P/ASX200 companies with directors who actively purchased shares within 8 weeks prior to a material earnings upgrade or takeover announcement increased significantly by 40 % between 2004 and 2007.

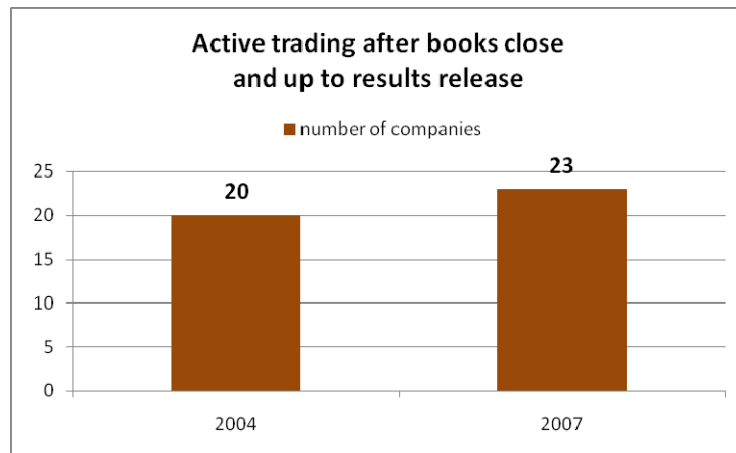


<sup>17</sup> Trades assessed in this context include initial and final director interest notices as per sections 3.19A.1 and 3.19A.3 of ASX Listing Rule 3.19A.

<sup>18</sup> ASX Listing Rule 3.19B.

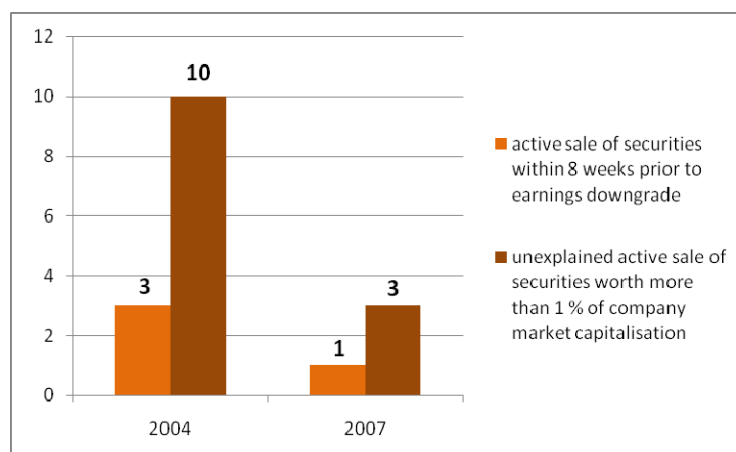
By far the most concerning behaviour involves the active trading after the end of a results period and up to the day of the results announcement. Directors are increasingly trading actively during these sensitive periods:

- The number of companies with directors who actively purchased shares during the period following books-close until the day results were released rose by 15 % between 2004 and 2007.



There has been an improvement in the number of S&P/ASX200 companies with directors actively selling interests in company securities within eight weeks prior to the announcement of a material earnings downgrade. Also, research found a decrease in the number of companies with directors who actively sold more than 1 % of the company’s market capitalisation without explanation. However, these behaviours are not regarded as key concerns, as research shows that these behaviours have been infrequent over recent years. This is not surprising given the strength of the share market throughout the research period and will be of greater interest in a declining market environment.

The highly concerning deterioration of previously discussed high-volume areas of misbehaviour outweighs these improvements.



## Methodology

Analysis of the security trading behaviour of company directors was first conducted in 2005 by BT Governance Advisory Service, Regnan's predecessor. In October 2007, Regnan reviewed the security trading policies of all S&P/ASX200 companies adding two new guidance parameters to the original methodology of ten parameters.

Company security trading policies were assessed on parameters in the following three groups:

- Existence and availability of security trading policies to investors;
- Guidance to directors, executives and employees on how to comply with the Corporations Act insider trading provisions and avoid the perception risk of insider trading;
- Discipline that the company requires of its directors, executives and employees when trading shares (with special focus on the use of trading windows or blackout periods, and approval procedures).

Regnan reviewed every director trade notified to the ASX for S&P/ASX200 companies between 1 October 2006 and 30 September 2007 for compliance with notification requirements. Each of the 3,255 changes of director interests were assessed on the following two criteria:

- Was the trade notified to the market within five business days of it occurring, as required per ASX Listing Rules?
- Was the trade notified to the market within 14 calendar days of it occurring, as required by the Corporations Act?

In search of behavioural traits which most likely expose a director to the perception risk of insider trading, Regnan reviewed all active trade decisions by S&P/ASX200 company directors notified to the ASX between 1 October 2006 and 30 September 2007. A trade was deemed to be the result of an active trade decision when no link to appointment/resignation events, share purchase plans, dividend re-investment plans or other innocuous trades was found. **Passive trades such as those resulting from dividend reinvestment plans, director and executive share plans were excluded.**

Each of the 956 active director trades was assessed on the following four criteria:

- Was the active trade a sale of securities within 8 weeks prior to the company announcing an earnings downgrade?
- Was the active trade an acquisition of securities within 8 weeks prior to the company announcing an earnings upgrade or takeover?

➤ Was the active trade made after the end of a results period (6-months end or 12-months end) and before or on the day the results were announced to the market?

➤ Was the active trade a sale of more than 1 % of the company's market capitalisation, which was not explained through public disclosure within one business day of the trade occurring?

These four criteria were chosen as being instances where a trade made by a director may have been made on inside information or may be perceived to have been made using inside information.



## Regnan Clients

When conducting engagement on security trading governance, Regnan represents the following institutional investors, which at 1 January 2008 invested about A\$ 65 billion in S&P/ASX200 companies (nearly one in six institutional dollars in the Australian share market):

- BT Investment Management
- Catholic Super
- Hermes Investment Management Limited (managed for the BT [formerly British Telecom] pension scheme)
- HESTA Super Fund
- Northern Territory Government and Public Authorities Superannuation Scheme (NTGPASS)
- NSW Local Government Superannuation Scheme
- NSW State Super (SAS Trustee Corporation)
- Vanguard Investments Australia Ltd
- VicSuper
- Victorian Funds Management Corporation (VFMC)
- Westscheme

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