



→ **Position paper
– Director and
executive share
trading**



Requiring directors¹ to promptly disclose their trading in company securities to investors and prohibiting insider trading is important in protecting investor confidence.

The rationale for requiring directors to disclose their trading activities is to improve market efficiency. Investors are able to make decisions based on directors' own trading behaviour. Without this knowledge, the suspicion insiders are able to trade on information not known to the market is damaging. Rational investors who are not insiders are reluctant to trade knowing they are competing against investors who may have 'inside' information.²

The perception of insider trading however can be just as damaging as the reality. Such perceptions harm the interests of all investors as they can drive people from the market and from particular companies, reducing liquidity and returns.

Australian legislators and market operators have adopted a two-fold approach to preventing insider trading. The approach has prohibited insider trading and requires disclosure of changes in the interests of directors in company securities shortly after the change occurred.

To manage the systemic and company-specific risk associated with director and executive trading, S&P/ASX 200 companies should:

- have, and disclose, a policy on trading in company securities by directors, executives and other employees potentially in possession of inside information
- ensure such a policy includes details on how it is enforced by the company
- promptly inform the market of the reason behind major sales by directors and executives
- have procedures in place to ensure that changes in director interests are promptly notified to the market in accordance with contractual obligations.

¹In the US and New Zealand, trades by executives are also required to be disclosed.

²This 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, accessed 18 July 2005.

In Australia, research commissioned by institutional investors has found that S&P/ASX200 companies and directors may not be doing enough to prevent perceptions of insider trading arising.¹

The research found that 15% of all trades by S&P/ASX200 directors — 432 out of 2936 trades in total in 2004 — were not notified to the market within the five business days required by the ASX Listing Rules. This is despite these Rules creating a contractual obligation for ASX-listed companies. In some cases, directors informed the market of their initial interest in a company more than six months after joining a company board.²

Background

All OECD countries, including Australia, have laws prohibiting insider trading. Australia also requires directors to notify the market of any changes to their interests in company securities, as do many other countries including the US, the UK and NZ. The rationale for such laws in Australia is:

The object of restrictions on insider trading 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.³

In Australia, the Corporations Act prohibits trading on information not generally known to the market,⁴ while requiring directors to inform the market of changes in their interests in company securities within 14 days.⁵ 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.⁶

Regulators over the past decade have also shown that they are willing to litigate to enforce insider trading laws, successfully prosecuting six individuals on criminal insider trading charges.

The ASX Listing Rules impose a stricter test, requiring directors of ASX-listed companies to notify the market of any changes to their interests in company securities within five business days. The Listing Rules form an enforceable contract between listed companies and the ASX.

Under the Listing Rules, ASX-listed companies are also required to disclose on an 'if not, why not' basis the extent to which their corporate governance practices match the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations. The Council recommends listed companies disclose a policy on trading in company securities by directors, executives and employees.⁷

This disclosure is also matched by investor interest in director and executive trading. Business journalists regularly report on changes to director's interests as advised to the ASX, while specialist services exist to inform investors when directors have traded, and in what quantities.⁸

This web of regulation, market supervision and public interest exist because of the real potential risks that stem from insider trading. There have also been calls for the insider trading laws to be tightened in certain respects, with a proposal for directors being required to notify changes to their interests within two business days of the change occurring.⁹

1_The research was performed by the BT Governance Advisory Service on behalf of the PSS/CSS, the Catholic Superannuation Fund, VicSuper, the NT Government & Public Authorities Superannuation Scheme & Emergency Services Super.

2_The figure 432 also includes instances where a notice of a change of interests should have been given to the market under ASX Listing Rules 3.19A1 & 3.19A3 (initial or final directors' interests notices) but where no notice was given in 2004.

3_Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs,

Fair Shares for All: Insider Trading in Australia (October 1989) para 3.3.6.

4_Part 7.10, Division 3, ss1042A — 1043O.

5_s205G.

6_ss182-183.

7_Recommendation 3.2, Principles of Good Corporate Governance and Best Practice Recommendations, March 2003, p. 26.

8_In Australia for example see <http://www.theinsidetrader.com.au/>.

9_See [http://www.camac.gov.au/camac/camac.nsf/by-Headline/PDFFinal+Reports+2003/\\$file/Insider_Trading_Report_Nov03.pdf](http://www.camac.gov.au/camac/camac.nsf/by-Headline/PDFFinal+Reports+2003/$file/Insider_Trading_Report_Nov03.pdf).

The risks from poor governance of trading in company securities by directors and executives are largely at the systemic, rather than the company level. These include:

Community/market risk

The major risk from director and executive share trading is community and market-driven. Market perceptions that directors and executives are able to profit from trading on inside information can be fatal to investor confidence, creating the perception of an ‘unlevel playing field’ where certain investors are able to profit at others’ expense. Late notification of director share trades may have a similar effect on investor confidence as it removes an investor’s ability to profit from observing director behaviour. Research exists suggesting liquidity improves in emerging markets following the first announcement of the enforcement of insider trading laws.¹ The corollary is that in the absence of such enforcement, investors may be unwilling to trade. Reduced market liquidity and lower share prices as a result damage all investors but particularly those such as superannuation funds that are permanently exposed to the market.

Litigation risk

There is minimal litigation risk to companies from director and executive share trading. Insider trading is a criminal offence, although ASIC has the option to pursue directors using civil penalty provisions. Any litigation is most likely to fall on the individuals concerned meaning the risk is not so relevant to institutional investors except where it impacts companies’ reputations.

Regulatory risk

For investors the major regulatory risk is that the regulation of director share trading becomes so cumbersome that it acts as a disincentive to potential directors. The burden of complying with the director trading notifications and avoiding insider trading at present falls largely on individuals and in any case, the direct costs to shareowners of further tightening of laws on director and executive share trading is likely to be minimal.

Governance of director and executive trading in S&P/ASX200 companies

There are significant risks from poor governance of director and executive trading. Research shows governance of these risks — and the prompt disclosure investors rely on to keep them informed of directors’ trading activities — may be lacking.

Among the findings of the research were:

Selected research area	Number of S&P/ASX200 companies
Did not disclose existence of share trading policy	3
Do not confine director/executive trading to nominated windows	95
Did not disclose change of directors’ interest within five business days	123
Sales of securities by directors two months prior to earnings downgrade	3
Purchases by directors two months prior to earnings upgrade/takeover bid for company	23
Directors have traded between end of a results period and results announcement	20
Trade by director appears in breach of company policy	11
Sale by director of shares worth more than 1% of company market capitalisation not explained within one business day	10

Note 1_Some companies appeared across more than one category and some companies had multiple instances of the same behaviour.

¹Bhattacharya, 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/utpa1.pdf>.



BT GAS will engage 46 companies on behalf of the PSS/CSS, Catholic Super, the NT Government & Public Authorities Superannuation Schemes, the NT Police Supplementary Benefit Scheme, VicSuper & Emergency Services Super to encourage behaviour in line with the behavioural objectives on page 1.

Methodology

The BT Governance Advisory Service reviewed the share trading policies of all S&P/ASX200-listed companies as of May 2005. These policies were assessed on the following criteria, with an equal weighting given to each:

- 1_Does the company have a policy on dealing in company securities?
- 2_Is this policy publicly available?
- 3_Is there a policy or a section of this policy specific to directors/key executives that are likely to have more privileged information than other staff?
- 4_Does the policy extend to related parties of the director such as family members, business associates, etc?
- 5_Does the policy specify what information will be considered price sensitive, over and above the definition laid down in the Corporations Act?
- 6_Are there procedures in place to approve trading?
- 7_In the case of directors, is approval required at board level?
- 8_Does the trading policy contain details of trading windows?
- 9_Does it identify situations where permission to trade will be refused?
- 10_Does the policy deal with trading on inside company information in entities outside of the company (eg takeover targets)?

Every director trade notified to the ASX for these 200 companies in 2004 was also reviewed. Each of 2936 changes of director interests was assessed on six criteria:

- Was the trade a sale of securities up to two months before the company announced an earnings downgrade?
- Was the trade a purchase of securities up to two months before the company announced an earnings upgrade or before a takeover bid was announced for the company?
- Was the trade made between the end of a results period and the results announcement?
- Was the trade in apparent breach of the company's own stated trading policy?
- Was the trade an unexplained sale of more than 1% of the company's market cap? If there was explanation, was it provided within one business day of the sale?
- Was the trade notified to the market within five business days of it occurring, as required by the ASX Listing Rules?

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

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