Chapter Three – Improving information flows

3.1 This chapter examines the communication and information side of shareholder engagement, while those issues related to shareholder decision-making and accountability mechanisms are discussed later in Chapter Four. In particular, this chapter examines issues relating to the communication channels between companies and their shareholders, including the following:

- Facilitating communication and information flows between companies and institutional investors, particularly in the context of complex share ownership arrangements;
- Addressing the difficulties for retail investors in accessing company information and communicating with company boards; and
- Potential improvements to disclosure on short selling and margin lending activities.

Institutional investor issues

3.2 Institutional investors are generally large investment vehicles with the ability to buy and sell securities in large quantities. In Australia, they are typically superannuation funds and other managed funds investing on behalf of their members. The committee was informed that while these entities increasingly want to engage with companies, complex share ownership arrangements and uncertainty over certain legal obligations was hindering communication between companies and their institutional shareholders.

Willingness and capacity to engage

3.3 Institutional investors determine the extent of their engagement as shareholders on the basis that its cost will be outweighed by the benefits that accrue from engaging, namely improved investment returns.

3.4 Evidence to the committee suggested that the level of shareholder engagement by institutional investors is increasing. For instance, Riskmetrics held the view that institutional investors 'are increasingly involved in the governance of the companies in which they invest'.[1] This had been assisted by companies, in turn, becoming increasingly willing to discuss with, and listen to, concerns and queries from shareholders on corporate governance issues.[2]

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1 Riskmetrics, *Submission 13*, p. 3.

2 Riskmetrics, *Submission 13*, p. 3.

3.5 They suggested that institutional investor participation may be extrapolated, albeit imperfectly, from voting levels and the outcomes of votes at company meetings:

> Since 1999, when a study found only 35% of all available shares were voted on director re-election resolutions at top 100 ASX-listed companies, turnout on all resolutions at top 100 companies has increased to 58.2% of all available shares in 2006. It is also worth noting that institutional shareholders are also increasingly willing to vote against management – in 2006, the average level of dissent by shareholders from the board recommendation on controversial resolutions was 21.2% for top 200 companies, up from 8.2% in 2005. Equally importantly, however, the increased level of constructive dialogue between company directors and managers, and shareowners, is evidenced in the decline in the number of controversial resolutions put to shareholders, from 20% of all resolutions put to top 200 company shareholders in 2004 to 8.9% in 2006.[3]

3.6 The Business Council of Australia (BCA) indicated that institutional investors preferred to influence corporate governance outcomes through discussion with the board, rather than expressing their views by casting negative proxy votes.[4] The committee notes that this description of preference is probably accurate, but is difficult to quantify.

3.7 Nowak and McCabe submitted that institutional investors are well placed to engage with the companies in which they invest. They outlined the following relevant factors:

- the availability of dedicated resources to monitor and analyse individual company and industry performance;
- the services of corporate investor relations specialists; and
- access to company management through formal communications and informal meetings.[5]

3.8 Despite their capacity to do so, Nowak and McCabe argued that institutional investors would determine their level of engagement on the basis of costs and benefits:

> …the calculation for the institutional investor remains one of balancing the information and transaction costs of active engagement against the benefits of doing so. The benefits are more likely to outweigh the costs of engagement where their holding of shares in a particular corporation is

3 Riskmetrics, *Submission 13*, p. 3. Statistics come from Riskmetrics annual Voting Outcome reports. Controversial resolutions are deemed to be those where one or more features deviate from accepted standards of good governance, eg ASX Corporate Governance Council.

4 Business Council of Australia, *Submission 29*, p. 8.

5 Nowak and McCabe, *Submission 5*, pp 2 – 3.

> significant in the context of their portfolio and/or overall market trading volumes in that corporation. Nevertheless our research finding was that a number of institutional investors adopted a policy of non-engagement and the proponents of this approach argued that engagement would be a distraction from their primary focus.[6]

3.9 The Association of Superannuation Funds of Australia Ltd (ASFA) indicated that anecdotal evidence suggested 'growing engagement and more active involvement of superannuation funds in voting'.[7] However they commented that superannuation funds are limited in their capacity to engage with the companies in which they invest:

> ...on some issues funds may seek to engage whereas at other times their involvement may not be as active. Given that superannuation funds in total have engagement with just about every company listed in Australia, it is difficult for individual trustee boards to engage on every issue with every fund. The trustees of each fund have responsibilities with regard to a number of matters, and just one part of it is the engagement with companies and participation in the voting processes.[8]

3.10 Australasian Investor Relations Association also held the view that superannuation funds do not want to engage directly with companies:

> Companies find it very difficult to actually engage directly with their major beneficial shareholders in the case of superannuation funds. To be fair, the reason given for why they do not want to engage directly with companies is purely a resourcing issue. I think that is something that needs to be borne in mind if you are going through a health check of shareholder engagement and participation. There are many superannuation funds in this country, but most are not terribly large, and even the largest industry superannuation funds, for example, are not set up themselves to engage directly with companies.[9]

3.11 The role of the intermediaries used to undertake this task is discussed in the following section.

3.12 In the following chapter, the committee discusses the importance of institutional shareholders engaging on corporate governance matters by exercising an informed vote on important company resolutions.

The intervening role of custodians

3.13 Although institutional investors are increasingly involved with governance issues, the capacity issues mentioned above usually makes their engagement with

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6 Nowak and McCabe, *Submission 5*, p. 3.

7 Mr Ross Clare, ASFA, *Committee Hansard*, Canberra, 15 April 2008, p. 25.

8 Mr Ross Clare, ASFA, *Committee Hansard*, Canberra, 15 April 2008, p. 23.

9 Mr Ian Matheson, Australasian Investor Relations Association, *Committee Hansard*, Sydney, 16 April 2008, p. 69.

companies indirect. In their submission to the inquiry, ASFA indicated that it is reasonable for funds to delegate responsibility for shareholder engagement to their fund managers, as long as this policy is adequately disclosed.[10]

3.14 The ownership arrangements institutional investors enter into affect their engagement with the companies they have an interest in. Superannuation funds for example, which comprise the majority of institutional investors, often delegate responsibility for managing their investment portfolio to an external fund manager. The funds are the beneficial owners of the shares, but their investments are often managed externally, particularly with smaller funds, and the securities are invariably registered in the name of a custodian. Fund managers are not necessarily the registered owners of the shares either, though; this responsibility usually rests with entities that specialise in providing custodian services, typically investment banks.

3.15 The interactions between funds, investment managers and custodians varies, which is reflected in the myriad ways and extent to which beneficial share owners either directly or indirectly engage with the companies in which they invest, if at all. Funds' policies on corporate governance engagement outline the fund managers' role in monitoring corporate governance and the circumstances in which managers are required to exercise their own discretion on voting, or consult with the fund on a voting position. IFSA told the committee that it encourages fund managers to establish direct contact with company boards and senior management.[11]

3.16 The role of intermediaries on voting, including advice from proxy advisory services, is discussed in the following chapter.

3.17 The committee was advised that the main difficulty with these complex arrangements is with companies struggling to identify, and thus engage with, the beneficial owners of shares. According to Australasian Investor Relations Association, listed companies are increasingly seeking to identify and establish direct contact with beneficial share owners, usually fund managers, so they can engage with their institutional shareholders.[12] Despite sound intentions though, evidence suggested that the task of identifying beneficial share owners behind custodial arrangements remained problematic. ACSI told the committee that:

> …the companies say to us that we are not really aware of which superannuation funds own how much of what because you are all in there as custodially owned. We are in favour of them having as much transparency as possible without having to spend money to find out exactly who their institutional shareholders are and who the ultimate beneficiaries are. [We are] in favour of unpacking the institutional side.[13]

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10 ASFA, *Submission 2*, p. 2.

11 Mr John O'Shaughnessy, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 3.

12 Australasian Investor Relations Association, *Submission 12*, p. 3.

13 Mr Michael O'Sullivan, ACSI, *Committee Hansard*, Canberra, 15 April 2008, p. 61.

3.18 It added that companies having a clearer understanding of their shareholder base would improve superannuation funds' capacity for engagement.[14]

3.19 Some organisations contended that the tracing provisions in section 672 of the Corporations Act, which enable companies to direct the registered owners of shares to disclose information about those with relevant interests in the shares, do not work as effectively as they could. AICD suggested that the tracing provisions needed to be bolstered and recommended that section 672 of the Corporations Act be amended to provide for the following:

> - Imposing an administrative obligation on the registered holder of shares or scheme interests to create, maintain and update a register of relevant interests where that interest exceeds, say, 1% of all shareholdings in the company.
> - Requiring that a copy of that Register be provided on written request to the company, scheme or ASIC.
> - Should third parties desire to have access to such information for bona fide reasons, they may make application via ASIC in the same manner that they can now in the terms of S.672A(2) of the Corporations Act.[15]

3.20 They proposed that this would align the tracing provisions with the substantial holding provisions in s671B of the Corporations Act.[16]

3.21 ASX Limited also highlighted the role of custodial ownership in constraining 'genuine intentions on the part of [companies] to engage with their investors'. They wrote:

> A practical impediment to effective shareholder engagement is the difficulty sometimes encountered by companies in seeking to identify their shareholders. A lack of transparency as to ultimate shareholder identity may result from the understandably widespread use by shareholders of custodians through which to hold their investments. The use of trading techniques involving equity derivatives and short selling may also make ultimate economic ownership of securities difficult to establish.[17]

3.22 Australasian Investor Relations Association suggested that section 672 was deficient because it applies to ordinary shares only, without extending to interests held via derivatives instruments such as equity swaps and contracts for difference. Their submission provided the following example:

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14 Mr Michael O'Sullivan, ACSI, *Committee Hansard*, Canberra, 15 April 2008, p. 62.

15 AICD, *Submission 35*, Attachment 1, p. 2.

16 AICD, *Submission 35*, Attachment 1, p. 2.

17 ASX Limited, *Submission 14*, p. 3.

> One of our members recently informed us that they became aware that a foreign based hedge fund had acquired an economic interest in their company to the value of AUD700 million via a contract for difference. This was not able to be discovered through the operation of the beneficial ownership tracing process as provided for in s.672.[18]

3.23 They recommended that section 672 of the Corporations Act be amended to capture derivative instruments.[19]

Committee view

3.24 The committee recognises that institutional shareholders' inevitable use of intermediaries is making it difficult for companies to know the identity of beneficial share owners of companies. To alleviate this problem the committee joins IFSA in urging institutional investors to make direct contact with company boards to assist them in having this information. The committee, however, does not support AICD's suggestion for custodial share owners to be required to hold a register of interests, as it does not think the benefits would justify the administrative burden created.

3.25 The use of derivative instruments presents a more significant problem, given the evidence the committee received in regard to the application of the Corporations Act tracing provisions. The committee recognises the complexity of these arrangements and the practical difficulty of tailoring the legislative framework to ensure companies can obtain accurate information regarding ownership at any given time. However, the committee is of the view that the government should at least investigate the implications of extending section 672 of the Corporations Act to include derivative instruments.

Recommendation 1

3.26 The government should examine the implications of amending the tracing provisions in section 672 of the Corporations Act to include derivative instruments.

The increasing significance of responsible investment

3.27 Responsible investment for institutional investors refers to taking an active approach to share ownership to engage with companies on environmental, social and governance (ESG) issues. The basis for this investment approach is the recognition of the importance of ESG issues to ensuring long term sustainability and thus minimising long term investment risks.

3.28 Responsible Investment Consulting told the committee that long term issues are highly relevant to superannuation fund members who may be investing over a 50

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18 Australasian Investor Relations Association, *Submission 12*, p. 3.

19 Australasian Investor Relations Association, *Submission 12*, p. 4.

year period. Those companies that invest responsibly will be seen to represent a lower risk, thus attracting 'a premium in terms of their shareholder value'.[20]

3.29 Responsible Investment Consulting stated:

> [Environmental, social and governance issues] tend to be long-term issues that can have an impact on investment returns. One of the problems therefore is that for disclosure obligations around materiality, it is very difficult for an investor to be able to argue that it will influence the share price on a day-to-day basis. Climate change for instance will have an impact; we all know that. How a company responds to climate change will have an impact, but will that impact happen in a day, a month, two months or two years? We are arguing that we need a broader debate about disclosure.[21]

3.30 Regnan emphasised the importance of ESG issues to institutional investors that spread their risk across the entire investment spectrum:

> Because universal owners own cross-sections of the economy, they inevitably find that some of their holdings are forced to bear the cost of other sectors' or firms' externalities. This creates an incentive for universal owners to minimize negative externalities and maximize positive ones across portfolio holdings.[22]

3.31 Responsible Investment Consulting suggested that investors need to be more demanding of companies for sustainability reporting, rather than having additional reporting being mandated. It indicated that the greatest barrier to engagement on ESG issues is cost:

> Everyone is focused on their investment returns, and in a down market that becomes more so. The problem is that, whilst we all know that environmental and social issues are here to stay—in particular that climate change is here to stay—the short-term temptation is to focus on our investment returns today and not invest in the research, because the research may cost us a few basis points.[23]

3.32 Interestingly, Regnan suggested that small companies have greater exposure to ESG issues than large ones and were therefore not disadvantaged in bearing the cost of engaging with shareholders about them. The reason, they suggested, is that large companies are more diversified and better able to absorb the consequences of an ESG risk coming to fruition:

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20 Mr Gordon Noble, Responsible Investment Consulting, *Committee Hansard*, Sydney, 16 April 2008, p. 38.

21 Mr Gordon Noble, Responsible Investment Consulting, *Committee Hansard*, Sydney, 16 April 2008, p. 33.

22 Regnan Governance Research, *Submission 22*, p. 7.

23 Mr Gordon Noble, Responsible Investment Consulting, *Committee Hansard*, Sydney, 16 April 2008, p. 36.

> Large companies are so large that they are exposed on a variety of fronts—health and safety, natural environmental interface, social licence to operate et cetera. In mining, for example, the consequences of a health and safety breach are much more material for a small company than for a large company. For a large company, they will be absorbed from a financial perspective. If BHP Billiton have a breakdown in one part of their business, they are unlikely to have a trading halt if production has dropped as a result of that particular incident, because they are a diversified entity. Smaller businesses are far more exposed to more narrow elements of ESG.

3.33 Both Responsible Investment Consulting and Regnan told the committee that companies may be concerned about potential liability issues relating to selective market disclosure. They requested that regulatory guidance be provided to remove lingering concern about the potential liability that may accompany communicating ESG information to shareholders.[24] Regnan proposed an amendment to the Corporations Act giving 'safe harbour' to companies undertaking this kind of engagement in good faith.[25]

3.34 Regnan also suggested that governments, when investing, do so 'within the platform of the UNPRI'.[26]

3.35 The Australian Institute of Company Directors (AICD) suggested that, given the evolving nature of sustainability reporting, it would be preferable to allow practices to develop for another two years before contemplating mandatory requirements or an 'if not, why not' regime.[27]

Committee view

3.36 The committee strongly supports and encourages companies adopting ESG reporting on a voluntary basis. The committee recognises that ESG reporting is in its early stages and companies should continue to be given the opportunity to determine the best way to approach the task free of government regulations. However, investors are increasingly pressing for ESG reporting and companies should respond to this demand accordingly. If companies cannot, by the end of the current decade, show that they have done this in a manner acceptable to shareholders then it is the view of the committee that the government should consider regulating in this area.

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24 Mr Gordon Noble, Responsible Investment Consulting, *Committee Hansard*, Sydney, 16 April 2008, p. 35; Mr Erik Mather, Regnan Governance Research, *Committee Hansard*, Sydney, 16 April 2008, p. 47.

25 Mr Erik Mather, Regnan Governance Research, *Committee Hansard*, Sydney, 16 April 2008, p. 48.

26 United Nations Principles of Responsible Investment. Mr Erik Mather, Regnan Governance Research, *Committee Hansard*, Sydney, 16 April 2008, p. 44.

27 Mr Kevin McCrann, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 64.

3.37 Companies should be encouraged to adopt ESG reporting and engage on ESG issues without being concerned that it may contravene their continuous disclosure obligations. Accordingly, the ASX should clarify the scope of Listing Rule 3.1 as it applies to engagement on ESG matters.

Recommendation 2

3.38 The ASX should clarify the scope of continuous disclosure requirements as they apply to engagement on ESG issues.

Legal uncertainty over engagement

3.39 The committee also received evidence outlining potential legislative disincentives for institutional investors to engage with companies. In particular there remains some doubt as to whether trustees may, in the course of undertaking normal shareholder engagement practices, be contravening aspects of the Corporations Act.

3.40 Regnan raised specific concerns relating to the responsibilities of superannuation fund trustees under the sole purpose test contained in section 62 of the *Superannuation Industry (Supervision) Act 1993*. In general terms, the provision stipulates that regulated superannuation funds must be maintained for the purpose of providing retirement benefits to members.[28] Regnan told the committee that the sole purpose test needed to be clarified to ensure that trustees engaging on ESG issues, where relevant to financial returns, fell within its scope.[29]

3.41 The committee discussed the sole purpose test in this context in its 2006 report on corporate responsibility. It did not accept a narrow interpretation of the provision that would constrain trustees from researching and considering environmental and social performance, but did recommend that the Australian Prudential Regulation Authority (APRA) clarify the matter.[30] At the time of writing, a government response to the committee's report had not been provided.

3.42 The potential 'dampening effect on institutional investors acting collectively' with the Corporations Act takeover provisions was also raised. ACSI submitted that:

> …there are certain sections of the Corporations Act (namely section 606 and Part 6C.1) which when combined with the very broad definitions of "relevant interest" and "associate" have a dampening effect on institutional investors acting collectively. Institutional investors could unintentionally

28 Australian Prudential Regulation Authority, 'The sole purpose test', *Superannuation Circular No.III.A.4*, February 2001, accessed on 22 May 2008 at http://www.apra.gov.au/Superannuation/upload/III-A-4-The-Sole-Purpose-Test.pdf

29 Mr Erik Mather, Regnan Governance Research, *Committee Hansard*, Sydney, 16 April 2008, p. 44.

30 Parliamentary Committee on Corporations and Financial Services, *Corporate responsibility: Managing risk and creating value*, June 2006, p. 74.

> breach these sections if they seek to act collectively, especially if they act outside the context of an upcoming company meeting.

3.43 They warned that the Australian Securities and Investment Commission's (ASIC) attempt to remove this potential impediment to engagement was too narrow, as the relevant Class Order only applies to circumstances where institutional investors enter into an agreement on matters relating to a general meeting. ACSI contended that collective engagement often occurred outside the context of company meetings, and recommended that ASIC revise its guidance accordingly.[31]

Committee view

3.44 The committee is of the view that where institutional investors are concerned that shareholder engagement may contravene their regulatory obligations, ASIC should take the appropriate measures to clarify the scope of the Corporations Act as it applies to collective actions under the takeover provisions.

Recommendation 3

3.45 ASIC should clarify the position of institutional investors engaging collectively with companies outside company meetings in terms of the Corporations Act.

Retail investor issues

3.46 Retail investors are essentially those shareholders who are not institutions. As a category, they range from a person holding a handful of shares in a single company to private investors with substantial, diverse shareholdings.

Willingness and capacity to engage

3.47 Retail shareholders are faced with essentially the same question as institutional investors on the question of whether to actively engage with the companies in which they invest: is engagement worth it and do I have the ability to do it?

3.48 AICD told the committee that many shareholders have no interest in engaging with the companies they invest in.[32] Professor Margaret Nowak and Dr Margaret McCabe from the Curtin University of Technology suggested that the costs of engagement to small retail investors are often not worth the benefits:

> Cost (especially in time) relative to the benefits from accessing and analysing comparative industry and market information to make judgments on relative firm performance, is a major factor. ASX research shows that direct investors spread their portfolio across industry sectors and that 40%

31 ACSI, *Submission 11*, pp 4-5.

32 Mr Kevin McCann, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 58.

> have a spread across three or more sectors. This compounds the cost of acquiring and analysing the information to facilitate active engagement.[33]

3.49 They added that the powerlessness felt by individual investors over company decision-making and board composition compounded the disincentive to engage.[34]

3.50 Nowak and McCabe questioned the reasonableness of any expectation for retail shareholders to be engaged with companies, proposing instead that 'rational apathy … is often optimal'. When dissatisfied with company performance or direction, retail investors selling their shareholding remains the most effective option.[35]

3.51 Treasury framed the issue of retail investor apathy as a 'free rider' problem:

> The free rider problem … encourages shareholders to refrain from undertaking acts of management oversight because it is in their interest for someone else to undertake these acts (allowing them to reap the benefits without bearing the costs).[36]

3.52 Dr Shann Turnbull of the International Institute for Self-governance proposed that companies need to better harness the efforts of shareholders who are willing to engage to overcome the free rider problem. He suggested that company constitutions allocate governance powers to a 'shareholder watchdog committee' to facilitate a self-regulatory approach from companies. This would in turn enable government to reduce its own regulatory burden on companies. [37]

Simplifying company information for retail investors

3.53 The relationship between the information available to shareholders about companies and their ability to engage and make informed assessments on the basis of that knowledge was briefly outlined in Chapter Two. The most important primary source of this information is contained in the annual reports companies provide investors in accordance with their obligations under section 314 of the Corporations Act. However a common complaint amongst contributors to the inquiry was that the overwhelming and inaccessible nature of corporate reporting information has become a major hindrance to shareholders' capacity or willingness to engage with companies.

3.54 The CLERP 9 reforms helped to alleviate the problem, for both shareholders and companies, of the requirement to send shareholders hard copies of mandated company reports. These reforms to the Corporations Act have allowed shareholders to choose whether they are sent the inevitably bulky company annual report or be left

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33 Nowak and McCabe, *Submission 5*, p. 1.

34 Nowak and McCabe, *Submission 5*, p. 1.

35 Nowak and McCabe, *Submission 5*, pp 1-2.

36 Treasury, *Submission 17*, p. 5.

37 Dr Shann Turnbull, *Submission 23*, p. 2, p. 6.

with the option of accessing it via the internet.[38] Unfortunately, this measure has not necessarily addressed the reason why shareholders do not, or cannot, read annual reports.

3.55 Contributors to the inquiry maintained the view that mandated company information remains inaccessible to ordinary retail investors.[39] For instance, the Australian Shareholders' Association said that:

> The difficulty with giving shareholders too much information is that they will not read any of it. This is what frequently seems to happen with documents that are sent to shareholders to communicate with them: they are too voluminous, the language is legalistic. Shareholders look at them but give up before reading them.[40]

3.56 Chartered Secretaries Australia (CSA) stated that company reports have become inaccessible as a consequence of mandated disclosure 'bolt-ons' in the Corporations Act.[41] While supporting the continued availability of mandated information to those wishing to access it, CSA suggested that companies should have greater discretion when determining the most appropriate way to communicate with their shareholders.[42] They also encouraged companies to utilise interactive technology to make the online annual report more relevant.[43]

3.57 CSA recommended removing the Corporations Act requirement for companies to provide a 'concise report' to shareholders, due to its conciseness having been eroded by additional regulation:

> As more and more companies become more sophisticated in portraying the information electronically, the easier it will be for shareholders to access it. The concise report has had its day, and any further tampering with it would be a waste of time.[44]

3.58 AICD indicated that it would prefer to see a principles-based, rather than 'black-letter', approach to company reporting.[45] Their submission advocated greater emphasis on providing meaningful information by focussing on 'performance rather

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38 Sections 249J and 314 of the Corporations Act; see for example McConvill, J. *An introduction to CLERP 9*, LexisNexis Butterworths, 2004, pp 151-152.

39 See for example Chartered Secretaries Australia, *Submission 8*, p. 5; AICD, *Submission 25*, p. 49.

40 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 21.

41 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, pp 6-7.

42 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 9; CSA, *Submission 8*, p. 5.

43 Chartered Secretaries Australia, *Submission 8*, p. 15.

44 Mr Tim Sheehy, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 10. See section 314(2) of the Corporations Act.

45 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 63.

than conformance', encouraging companies to provide voluntary company reviews in a comprehensible form.[46] According to AICD, voluntary 'shareholder-friendly' reporting should be characterised by the following:

- a balanced view of company performance written in plain English; and
- clear explanations of the relevant financial results.[47]

3.59 The Institute of Chartered Accountants stated that 'reporting and communications are the mechanism through which a company drives effective engagement and participation'. They criticised the 'tool-kit' approach to reporting for not containing the sort of information that investors desire:

> In their current form, these reports do not address the company's strategy, its success or failure in implementing it, or insights into what future performance might look like if the strategy is well executed.
>
> …
>
> … there is little meaningful information available about how the objectives of the company are set, how risk is monitored and assessed, how performance is optimised and whether a company has the ability to create value through entrepreneurialism, innovation, development and exploration, providing accountability commensurate with the risks involved.[48]

3.60 The Institute of Chartered Accountants suggested a more 'holistic' approach to corporate performance reporting and recommended that the committee conduct a separate, detailed inquiry into the issue.[49] Australasian Investor Relations Association emphasised that investors increasingly preferred to access company information via electronic media and suggested that the opt-in for hard copies of the annual report should be extended to other forms of statutory communication, such as the notice of meeting.[50] ASA, however, opposed this proposal on the basis that shareholders may mistakenly opt out of notification of a meeting they have an interest in attending.[51]

Committee comment

3.61 The committee acknowledges that while the CLERP 9 reforms on the electronic provision of annual reports may have saved a considerable amount of paper,

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46 AICD, *Submission 25*, p. 49.

47 AICD, *Submission 25*, p. 50.

48 Institute of Chartered Accountants, *Submission 7*, pp 2-3. They also emphasised that the importance of effective reporting also applied to institutional shareholders.

49 Institute of Chartered Accountants, *Submission 7*, pp 4-5.

50 Australasian Investor Relations Association, *Submission 12*, p. 5. CSA also recommended that all statutory information should be allowed to be provided electronically. See CSA, *Submission 33*, p. 2.

51 ASA, *Submission 38*, p. 6.

the information that companies must legally provide shareholders is so dense as to be incomprehensible to most people. Evidence to the committee suggests that the concise report, which was intended to overcome some of these problems, has failed to serve its purpose. The absence of a report from companies outlining their performance and objectives in plain English represents a major barrier to retail investors engaging with companies.

3.62 The committee is of the view that the ability of shareholders to access company reports on the internet has made the concise report much less relevant than it once was. The electronic provision of company reports now allows shareholders to access specific aspects of company reports that are of interest to them, making the necessity to provide a concise report increasingly obsolete. Therefore, companies' obligation to provide it under section 314(2) of the Corporations Act should be removed. This would hopefully encourage companies to produce a plain, comprehensible statement of company performance and direction that is better suited to the requirements of shareholders.

Recommendation 4

3.63 The government should amend section 314 of the Corporations Act to remove the requirement to produce a concise financial year company report.

The usefulness or otherwise of AGMs

3.64 The requirement for publicly listed companies to hold an annual general meeting (AGM) is included at section 250N of the Corporations Act. These meetings provide an important opportunity for retail shareholders to engage directly with company boards and executive management. However, the committee heard a number of claims that the relevance of the forum is diminishing, an argument supported by falling AGM attendances. There was, however, support for reviving the AGM and the committee received a number of suggestions on how it might be made more relevant.

3.65 The voting process as it relates to AGM attendees is discussed in the following chapter; the focus of the following discussion is the AGM's deliberative function.

3.66 CSA suggested that the original purpose of the AGM had been overtaken by technological advances, making it less relevant to shareholders:

> …the AGM was created in an era of horse and coach; pen and ink; limited printing and a fledgling postal service, all of which dictated that members would physically meet with directors annually. It is now an era of advanced technology: mobile telephones; cameras and text messaging; the internet; webcasting; powerful portable computers and geographically dispersed shareholders.
>
> …

> …the information that is dealt with at an AGM is available many months before the AGM is held and that this affects attendance.[52]

3.67 They informed the committee that AGM attendances for the top 200 ASX-listed companies were falling steadily, continuing a long term trend. The results of their biannual survey of governance practices reported:

- the proportion of top 200 company AGMs attracting more than 300 shareholders falling from 35.7 per cent in 2001 to 11.1 per cent in 2007; and
- the proportion of top 200 company AGMs attracting fewer than 100 shareholders increasing from 23.2 per cent in 2001 to 41.3 per cent in 2007.[53]

3.68 CSA suggested that recent strong company results may partly explain falling attendances.[54] However, they also expressed the view that AGMs no longer appeal to shareholders due to the absence of a deliberative purpose, with votes determined by proxy before the start of the meeting. Further, continuous disclosure has removed the informative role AGMs once served.[55] AICD also emphasised the diminishing importance of physical meetings in a technologically advanced society, highlighting the constant information available to investors in the financial media.[56]

3.69 AICD further claimed that shareholder activism had 'diverted attention away from the traditional agenda of the annual meeting'.[57] This view was supported by the Business Council of Australia, who expressed the view that special interest groups were dominating company meetings.[58]

3.70 Despite falling attendances, both AICD and CSA maintained that retail shareholders still relied on company meetings as a forum for engagement.[59] AICD stated that:

> Despite its limitations many still believe that the annual general meeting provides an invaluable opportunity for shareholders – particularly retail shareholders – to raise issues, question the board and management and personally express their views on company performance.

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52 Chartered Secretaries Australia, *Submission 8*, p. 11. See also AICD, *Submission 25*, p. 44.

53 Mr Tim Sheehy, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 2.

54 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 5.

55 Mr Tim Sheehy and Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 5.

56 AICD, *Submission 25*, p. 44.

57 AICD, *Submission 25*, pp 44-45.

58 Business Council of Australia, *Submission 29*, p. 6.

59 Chartered Secretaries Australia, *Submission 8*, p. 12.

> The meeting provides a forum for personal appraisal of new candidates for election to the board and the way in which the meeting is conducted conveys to shareholders something of the culture of the board and the chairman's character.[60]

3.71 CSA proposed improving the relevance of the information gleaned at the AGM by separating its formal voting and informal information/dialogue functions.[61] This would be achieved by keeping voting open beyond the close of the meeting to enable shareholders to exercise their vote having had the benefit of discussion and questioning during the AGM.[62] This proposal is discussed further in the following chapter from paragraph 4.43.

3.72 CSA also questioned the requirement for small companies - those outside the ASX top 300 - to hold an AGM every year when direct voting can be used instead.[63] ASA disagreed that small companies should be exempted:

> The AGM is the only forum for shareholders to directly question the board with regard to the management of the company. It is the one opportunity for directors to hear directly the views of shareholders and is an important part of shareholder participation and engagement. In the experience of the ASA, companies within the ASX 200 are generally better at communicating with shareholders. It is those companies the CSA seek to exclude where shareholders most need this forum.[64]

3.73 In its discussion paper, 'Rethinking the AGM', CSA also posed other potential changes:

- mandating a minimum time for discussion and questions at AGMs;
- extend the statutory timeframe for holding AGMs by a month to ameliorate the crowded AGM season; and
- encourage chairs of board committees to answer shareholders' questions at the AGM.[65]

3.74 A potential option for improving the relevance and accessibility of AGMs is to utilise technology to enable participation from remote venues. Boardroomradio, for example, strongly advocated the benefits of companies having the option to host

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60 AICD, *Submission 25*, p. 47.

61 Chartered Secretaries Australia, *Submission 8*, p. 12.

62 CSA, 'Rethinking the AGM', *Discussion Paper*, 2008, p. 9. They suggested that this should not extend to unlisted public companies such as not-for-profit companies.

63 Chartered Secretaries Australia, *Submission 8*, p. 13.

64 ASA, *Submission 38*, p. 4.

65 CSA, 'Rethinking the AGM', *Discussion Paper*, 2008, pp 12-13.

'virtual' AGMs over the internet.[66] However CSA told the committee that a major concern with this idea was the reliability of current technology to transmit meetings in real time; querying whether such meetings would be deemed to be invalid if a technological failure restricted participation. They also raised the logistical issues that eventuate when trying to equitably manage a meeting with questioners in multiple locations.[67]

3.75 Mr Stephen Mayne also made a number of suggestions to improve AGMs. These included:

- maximising attendance by holding meetings at more convenient times for those with work responsibilities;
- allowing the press to ask questions at the meeting; and
- limiting the time available to individual shareholders speaking at AGMs to prevent them being hijacked.[68]

3.76 The Business Council of Australia noted that some companies found it useful to invite shareholders to submit questions prior to the AGM, though the limited resources of small companies may not permit this.[69]

Committee view

3.77 The committee is of the view that although technology has replaced the informative purpose company AGMs once served, they are still a useful engagement forum for retail investors. These are shareholders who are not generally invited to the private briefings accorded to institutional investors, and the AGM is their only chance for a face-to-face meeting with the company board. Companies should therefore endeavour to hold AGMs at convenient times and allow reasonable time for questions and discussion with shareholders. They should also broaden participation by allowing investors to submit questions to the board and by transmitting the meeting online. The committee agrees with CSA, though, that online participation is potentially unwieldy and unfair to those attending the meeting in person.

3.78 The committee does not support exempting small companies from holding AGMs.

3.79 The relevance of AGMs to modern shareholder requirements clearly needs to be addressed. The current legislative framework does not prevent the AGM from facilitating shareholder engagement, but the attitude and culture of some company

66 Boardroomradio, *Submission 30*, p. 7.

67 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, pp 16-17.

68 Mr Stephen Mayne, *Submission 18*, pp 2-5.

69 Business Council of Australia, *Submission 29*, p. 9.

boards has meant that AGMs do not always represent a forum that best serves that purpose. The committee is therefore of the view that ASIC should carefully examine this area in preparation for establishing a comprehensive set of guidelines or principles for companies holding an AGM. These should include ways to improve the participatory aspect of meetings through discussion and questions, including questions on notice to the board, as well as maximising shareholder attendance. The guidelines should also outline best practice for managing conflicts of interest at company meetings, particularly with respect to the Chair maintaining control over procedural matters where a conflict exists, and the handling of discretion over voting undirected proxies.

3.80 Best practice guidelines have worked well to improve corporate governance generally and the committee is of the view that guidelines on AGMs would encourage companies to adopt a better approach to this important forum for shareholder engagement.

Recommendation 5

3.81 ASIC should establish best practice guidelines for company annual general meetings.

3.82 The committee is also of the view that companies should be encouraged to simplify their reporting to shareholders in this way.

Recommendation 6

3.83 ASIC should establish best practice guidelines for clear and concise company reporting.

The 100 member rule

3.84 Section 249D(1) of the Corporations Act stipulates that:

(1) The directors of a company must call and arrange to hold a general meeting on the request of:

(a) members with at least 5% of the votes that may be cast at the general meeting; or

(b) at least 100 members who are entitled to vote at the general meeting.

This is usually referred to as the '100 member rule'.

3.85 A significant history of opposition to the 100 member rule was reinforced during the inquiry, with the general tone of complaint continuing to be that the rule is open to abuse. For instance, Treasury stated that ability of relatively small groups of shareholders to impose the cost of an extraordinary general meeting (EGM) on

companies gave them 'significant and undue leverage when negotiating with large companies'.[70]

3.86 The ACTU disagreed, suggesting that the 100 member threshold was large enough to prevent meetings being called 'on a vexatious basis'.[71]

3.87 The Exposure Draft of the Corporations Amendment (No. 2) Bill 2006 proposed to abolish the 100 member rule and leave the five percent requirement, which would have brought Australia's law into line with comparable jurisdictions.[72] The committee also notes its previous recommendation in support of abolishing the rule.[73] However, Treasury indicated that attempts to modify the rule had failed to garner the support of state attorneys-general. It told the committee that the new government was attempting to have the matter reconsidered:

> Recently, the minister, Senator Sherry, indicated at the last meeting of MINCO that he would like this issue reconsidered. He has asked Commonwealth officials, in consultation with our state counterparts, to put together a discussion paper that identifies all the options and the pros and cons of those options and that will, hopefully, move the debate forward.[74]

3.88 CSA gave their support for a five per cent threshold of voting entitlements, while retaining a 100 member rule for proposing resolutions at AGMs. They told the committee that the purpose for calling a special meeting should have substantial enough support to justify the expense borne by the company:

> …if you are asking a company to convene a special meeting and go through the expense, there should at least be some likelihood of that resolution passing, so we turn to the five per cent of shareholders as being the trigger. Then at least there are enough people so that it has a likelihood of succeeding.[75]

3.89 AICD offered conditional support for this proposal:

> …it [would have] to be a resolution that is in accordance with the business of the meeting. We would be concerned if there were a multitude of frivolous resolutions, which would serve to disrupt the conduct of the business of the meeting.[76]

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70 Treasury, *Submission 17*, p. 7.

71 ACTU, Submission 24, p. 7.

72 Explanatory Memorandum, Exposure Draft Corporations Amendment Bill (No. 2) 2006, p. 5; Treasury, *Submission 17*, pp 6-7.

73 The committee made an exception in the case of mutuals. See for example, Parliamentary Joint Committee on Corporations and Financial Services*, Inquiry into the Exposure Draft of the Corporations Amendment (No. 2) Bill 2005*, June 2005, pp 3-9.

74 Mr Matthew Brine, Treasury, *Committee Hansard*, Canberra, 15 April 2008, p. 73.

75 Mr Tim Sheehy, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 12.

76 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 63.

Committee view

3.90 Although no significant abuse of the 100 member rule has occurred, the committee is again of the opinion that it has the potential to be abused and should be replaced. The government should continue to negotiate with state attorneys-general to achieve this outcome.

Recommendation 7

3.91 The government should continue to negotiate with the states to have the 100 member rule abolished.

Disclosing material information equitably

3.92 The committee heard mixed reports about the equitable distribution of company information to different classes of shareholders. In particular, concerns were raised that the practice of companies offering private briefings to institutional shareholders disadvantaged retail investors and may breach their continuous disclosure requirements.

3.93 Chapter 6CA of the Corporations Act outlines companies' obligations to disclose in accordance with the ASX Listing Rules. ASX's principles on which the Listing Rules are based include the following:

> Timely disclosure must be made of information which may affect security values or influence investment decisions, and information in which security holders, investors and ASX have a legitimate interest.[77]

3.94 ASX Listing Rule 3.1 states:

> Once an entity is or becomes aware of any information concerning it that a reasonable person would expect would have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.[78]

3.95 ASA told the committee that a disincentive for retail investors to engage is a perception of an uneven playing field with respect to disclosure.[79] Boardroomradio argued that there is a divergence of information available to different classes of investors. For instance, market information disclosed to professional investors in selective briefings may not be appropriately reflected in the company's disclosure to the market at large in accordance with the ASX Listing Rules. They claimed that retail investors are at a disadvantage by not having timely access to market information of a

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77 ASX, *ASX Listing Rules*, 'Introduction and objectives', accessed on 19 June 2008 at http://www.asx.com.au/ListingRules/chapters/Introduction.htm

78 ASX, *ASX Listing Rules*, Chapter 3 – Continuous disclosure, accessed on 19 June at http://www.asx.com.au/ListingRules/chapters/Chapter03.pdf

79 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 20.

material nature.[80] Boardroomradio proposed that companies should be required to maintain up-to-date shareholder email lists to allow instant dissemination of important company information.[81]

3.96 Boardroomradio also suggested that audio transmissions of such briefings should be provided to all investors, via the internet, and should fall within the terms of the ASX's continuous disclosure requirements.[82] AICD also recommended that the information provided in these briefings should also be posted on company websites.[83]

3.97 Responsible Investment Consulting complained that the present ad hoc approach to companies' engagement with shareholders was inefficient for companies and inequitable for shareholders:

> From a company perspective the demand for engagement, whether it be to supply additional information, or to communicate views places pressure on a company's resources.
>
> Where a company does respond to an engagement request there is no mechanism for the response to be distributed to other market participants beyond making an announcement to the market. This is a highly inefficient practice and can result in a company entering multiple dialogues on similar issues, wasting valuable company resources. It is also counter to the principle that market participants should have equal and timely access to material information.[84]

3.98 They proposed a system of 'questions on notice' to companies, whereby both questions and responses would be available to registered market participants.[85]

3.99 Treasury told the committee that any company that selectively disclosed price sensitive information would be in breach of the listing rules and the Corporations Act.[86]

3.100 AICD defended the practice of offering private briefings:

> These briefings give institutional investors opportunities to question the board and management on more detailed matters, often financial, than might be raised at annual general meetings. Such briefings are not a means for giving some shareholders inside information and anything significant

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80 Mr John Murray, Boardroomradio, *Committee Hansard*, Canberra, 15 April 2008, pp 14-15.

81 Boardroomradio, *Submission 30*, p. 9.

82 Mr Bill Gair, Boardroomradio, *Committee Hansard*, Canberra, 15 April 2008, p. 19.

83 AICD, *Submission 25*, p. 28.

84 Responsible Investment Consulting, *Submission 4*, p. 4.

85 Responsible Investment Consulting, *Submission 4*, p. 5.

86 Ms Marian Kljakovic, Treasury, *Committee Hansard*, Canberra, 15 April 2008, p. 74.

> should be reported immediately to all investors. The company may not divulge any exclusive information or anything that is price sensitive.[87]

3.101 They rejected assertions that such briefings contravened ASX Listing Rule 3.1 and indicated that prudent retail investors would check the ASX website for new information releases.[88] Australasian Investor Relations Association also rejected claims that selective disclosure was occurring during private briefings to certain investors.[89]

Committee view

3.102 The committee supports companies holding private briefings with institutional investors conducted within the parameters established by ASX Listing Rule 3.1. ASIC should carefully monitor the effect of these briefings on share prices to ensure companies are not selectively disclosing material company information.

3.103 The committee also considers that companies should post the information contained in private briefings on their websites. If possible, this information should be available at the same time as the briefing itself and shareholders should be forewarned of its pending availability to provide the most equitable access.

Recommendation 8

3.104 ASIC should selectively or periodically monitor and enforce company information disclosure in private briefings to institutional shareholders to ensure compliance with their continuous disclosure obligations.

The public share register: concerns about privacy and predatory offers

3.105 Presently, section 173 of the Corporations Act allows anyone to inspect a register of shareholders kept pursuant to section 168 of the Act. The unrestricted nature of this provision and the associated lack of privacy it affords shareholders was the subject of strong criticism to the committee.

3.106 In their evidence to the inquiry, CSA strongly advocated legislative changes to protect the privacy of retail shareholders. They described the current legislative arrangements as an 'anachronism', mostly utilised nowadays for the nefarious purpose of making under-priced offers in an attempt to exploit uninformed shareholders. In their submission CSA wrote:

> Modern technology makes the disclosure of shareholders' particulars vulnerable to predatory behaviour, in a way that is not possible with other forms of wealth holdings such as bank accounts and superannuation.

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87 AICD, *Submission 25*, p. 28.

88 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 59.

89 Mr Ian Matheson, Australasian Investor Relations Association, *Committee Hansard*, Sydney, 16 April 2008, p. 69.

> CSA notes that Australians understand their right to privacy, as embodied in legislation, and increasingly query why they have no right to privacy as investors. With the growth of the numbers of shareholders in Australia, the question of providing privacy and protection to them has become more urgent.[90]

3.107 They suggested that companies releasing their share register details to predatory parties served to further disengage shareholders, some of whom assume the offers are supported by the company.[91]

3.108 Both ACSI and CSA recommended that a 'proper purpose' test be applied, enabling companies to test the bona fides of those seeking access to the personal details of their shareholders.[92] ACSI recommended that a proper purpose could include:

- shareholders wishing to contact other shareholders about issues relating to a general meeting resolution;
- shareholders checking their details have been correctly recorded;
- a request from an executor; and
- a request from a regulatory agency.[93]

3.109 In response to a question on notice from the committee, CSA offered its support for a proposal to amend the Corporations Act to allow companies to keep two separate registers. One would contain all shareholders, whose details would only be disclosed to other shareholders and those making offers as part of a takeover bid in accordance with Chapter 6 of the Corporations Act. The other register, available publicly, would only include the details of those with a substantial shareholding – over five per cent. This would align the public register with the substantial shareholding provisions in section 671B of the Corporations Act.[94]

3.110 ASA disagreed that access to share registers should be restricted:

> Whilst the ASA is mindful of the fact that shareholder registers can be misused, it would not support moves to restrict this information. On balance the importance of the legitimate reasons to access to register outweigh the privacy arguments. Shareholders are aware that they are investing in a public company. That the registers are open to abuse by predatory share

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90 Chartered Secretaries Australia, *Submission 8*, p. 17.

91 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 3.

92 Mr Peter Abraham, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 3; Chartered Secretaries Australia, *Submission 8*, p. 18; ACSI, *Submission 11*, p. 8.

93 ACSI, *Submission 11*, p. 9.

94 CSA, *Submission 33*, p. 3.

> offers is clear, but the solution to this problem should not be found in restricting the legitimate rights of shareholders to identify and contact each other.[95]

3.111 ASA and ASX Limited both stressed that improving financial literacy is the most effective way to protect unsophisticated investors.[96]

3.112 The committee notes the work of the Financial Literacy Foundation in developing a number of programs aimed at improving Australians' financial knowledge.[97]

Committee view

3.113 The committee agrees that universal access to shareholder registers is inconsistent with the privacy of personal information generally. Further, the details of those who invest in funds that manage shares on their behalf are not accessible as the details of those who invest directly. The financially illiterate have been exposed to predatory share purchase offers, while shareholders who mistakenly believe the company is complicit in making the offer may avoid engagement with the company as a consequence. The committee supports proposals to amend the Corporations Act to limit access to the personal details of shareholders, in line with acceptable privacy standards.

Recommendation 9

3.114 The government should amend section 173 of the Corporations Act to limit access to the details of shareholders with non-substantial holdings, subject to a proper purpose test to allow access on certain conditions.

Obligations on small companies

3.115 Finally, the committee recognises concerns that the substantial corporate governance requirements imposed by the Corporations Act may impede small, closely held, entities from incorporating. The thrust of this disquiet is that the one-size-fits-all approach best suited to regulating large financial entities is not necessarily suitable for small businesses without a diverse group of equity investors to protect.

3.116 Family Business Australia called for an amendment to the 50 shareholder rule in section 113 of the Corporations Act, which provides that companies with more than this number of shareholders are required to become unlisted public companies. It claimed that family companies with successive generations of shareholders could exceed 50 shareholders; unfairly forcing them to relinquish family control as well as

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95 ASA, *Submission 38*, p. 4.

96 ASX Limited, *Submission 14*, pp 7-8; ASA, *Submission 38*, p. 4.

97 Treasury, *Submission 40*, p. 2.

triggering reporting obligations unsuited to family-run companies. It instead suggested a threshold of 300 shareholders.[98]

3.117 Treasury informed the committee that companies with more than 50 shareholders had a sufficiently diverse ownership base to justify greater governance requirements. They also noted that proprietary companies classified as 'large' due to their economic significance still face similar reporting obligations to unlisted public companies. Treasury did not accept that there is a 'compelling rationale' for amending the restriction.[99]

Committee view

3.118 A slight increase in the 50 shareholder limit for proprietary companies would address the difficulty some family businesses face when new generations acquire an interest in the company. The committee does not believe increasing the limit to 100 would have any deleterious regulatory consequences and suggests that this change be implemented.

Recommendation 10

3.119 The government should amend section 113 of the Corporations Act to raise the limit for shareholders in a proprietary company to 100.

3.120 The committee is also of the view that the broader issue of the framework for regulating small, closely held companies needs to be reviewed. The one-size-fits-all approach of the Corporations Act may be appropriate for large publicly listed companies with a diverse shareholder base with a considerable equity investment, but it places a significant regulatory burden on small companies and not-for-profit organisations for which the protection offered to investors by the Corporations Act is not as appropriate.[100] The government should therefore begin to investigate an alternative regulatory framework for small incorporated companies and not-for-profit organisations.

Recommendation 11

3.121 The government should investigate an alternative regulatory framework for small incorporated companies and not-for-profit organisations.

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98 Mr Christopher Johnston, Family Business Australia, *Committee Hansard*, Canberra, 15 April 2008, pp 36-37.

99 Treasury, *Submission 40*, p. 1.

100 This idea is explored in detail in a paper by Senator Andrew Murray titled 'A proposal for simplifying the legal form and regulation of small for-profit businesses and not-for-profit entities', April 2008.

Potential disclosure improvements

3.122 During the committee's inquiry the Australian equities market was undergoing a period of volatility and the practices of short selling and margin lending attracted considerable public attention. There was a widespread view that these activities are not subject to sufficiently rigorous disclosure requirements to ensure shareholders remain adequately informed.

Short selling

3.123 Short selling describes the technique of obtaining profit from the falling value of a stock by selling it at current market price with the intention of re-purchasing it at a lower price and retaining the difference. This allows investors to profit by trading shares they consider to be overvalued. 'Covered' short selling describes the practice where the shares being traded are borrowed, usually from fund managers or custodial owners holding shares on behalf of institutions. The shares are lent subject to a contractual agreement that they will be returned at an agreed time, for a premium. Typical stock borrowing agreements formally involve the borrower actually purchasing the securities from the lender and contracting to re-sell at an agreed time or on demand.[101] If within that time the short seller can re-purchase the shares at a lower price, then a profit is made. If they are re-purchased at a higher price then a loss is incurred.

3.124 'Naked' short selling differs in that it involves agreeing to sell a stock that is not held - neither owned nor borrowed - and subsequently buying it at a lower price, within the brief window of time that enables settlement obligations to be met. In other words, the later share purchase at a lower price needs to be completed soon enough to enable the seller to meet the original undertaking to sell the stocks that were not held at the time the agreement was made.

3.125 Lending stock for the purposes of short selling potentially enables fund managers and trustees to maximise shareholder returns; they can benefit not only when the value of their shares is increasing, but also when they are in decline. However, the practice has also been associated with nefarious activities such as insider trading and spreading mischievous market rumours.[102] For example, company insiders may offload stock prior to the announcement of a profit forecast downgrade and re-purchase soon after the price has fallen; or short sellers may seek to drive a share price down by spreading false rumours about a company's financial position. The judiciousness of lending a stock to somebody seeking deterioration in its value can also be questioned.

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101 ASX, 'Short Selling', *ASX Public Consultation*, 28 March 2008, accessed 9 May 2008 at: http://www.asx.com.au/about/pdf/short_selling_public_consultation_paper.pdf, p. 5.

102 See for example, Goldwasser, V. *Stock Market Manipulation and Short Selling*, Centre for Corporate Law and Securities Regulation, CCH Australia, 1999, pp 18-19.

3.126 While the committee notes that the ASX benefits from increased trading volumes generated by the practice, ASX has described short selling as 'a legitimate and worthwhile trading technique which contributes to market liquidity, efficiency and price discovery'.[103] This latter point refers to the capacity of the market to respond quickly to restore equilibrium where a stock has been overvalued.

3.127 In evidence to the committee, ASA commented that companies significantly affected by short selling have often been subjected to some 'initial distress' that caused them to be targeted.[104] They told the committee that:

> Per se, short selling is not a problem, but it depends upon what basis it is done and what other activities are going on around it. If you short sell because you genuinely believe that a company is overvalued, and it is, and the price drops then that is an effective way of correcting overvaluation. If you short sell because you have insider information or you have spread a market rumour, which is untrue, and then you trade off of that then obviously that is to the disadvantage of all other shareholders.[105]

3.128 In the context of shareholder engagement, two main areas of concern relating to short selling were raised with the committee:

1. The knowledge of shareholders (and the market generally) that shares in a particular company had been lent; and

2. Institutions' monitoring and control of stock lending by interposed entities and its disclosure to fund members; and the appropriateness of obtaining fund member consent.

Market disclosure of stock lending

3.129 The committee heard concerns about a lack of transparency of stock lending for covered short sales, rendering the undesirable practices that sometimes complement short selling difficult to regulate.[106] It should be emphasised that concerns raised during the inquiry related to disclosure, rather than the activity itself. The committee recognises that no widespread campaign to have short selling prohibited entirely exists.[107] However, disclosure is critical to regulators being able to

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103 ASX, 'Short Selling', *ASX Public Consultation*, 28 March 2008, accessed 9 May 2008 at: http://www.asx.com.au/about/pdf/short_selling_public_consultation_paper.pdf, p. 4.

104 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 23.

105 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 24.

106 See for example, Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 24.

107 The Australasian Investor Relations Association is amongst those that have called for naked short selling to be banned. See Durkin, P. 'Cover up: call for end to naked shorts', *Australian Financial Review*, 8 May 2008, p. 4.

identify and prosecute instances of insider trading and the dissemination of untrue rumours that may be associated with short selling.[108]

3.130 While the Corporations Act requires naked short sales to be disclosed to the market, ambiguity in the definition of short selling in section 1020B of the Corporations Act has allowed covered short selling to occur undisclosed. Australasian Investor Relations Association suggested that the Corporations Act be amended to provide for the mandatory disclosure of covered short selling, adding that the ASX should disclose stock lending through the CHESS clearing and settlement mechanism.[109] They stated that with up to 40 per cent of a company's stock on loan at any given time, engagement with those with an interest in the company is difficult.[110] This issue was discussed in more detail at paragraph 3.13.

3.131 AICD agreed that disclosure of stock lending for the purpose of short selling is appropriate.[111]

3.132 On 28 April 2008, the Minister for Superannuation and Corporate Law, Senator the Hon. Nick Sherry, stated that he considered short selling to be 'an important financial tool in promoting market efficiency and encouraging true stock prices'. He did reiterate, however, that the loophole would be addressed:

> In the interests of transparency, the Government will pursue legislative change to the Corporations Act to address any ambiguity around covered short selling and the requirement for disclosure.
>
> Treasury and ASIC are currently investigating the best legislative option to address these issues.[112]

3.133 In conjunction with the government's decision to close the covered short selling loophole, the ASX released a consultation paper on 28 March 2008 inviting comment on a range of improvements to the Listing Rules, including:

- facilitating the transparency of short selling volumes pending legislative change; and
- deterring irresponsible naked short selling by increasing the fee attached to a failure to deliver shares on time.[113]

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108 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 24.

109 Mr Ian Matheson, Australasian Investor Relations Association, *Committee Hansard*, Sydney, 16 April 2008, p. 68.

110 Australasian Investor Relations Association, *Submission 39*, p. 1.

111 Mr John Story, AICD, *Committee Hansard*, Sydney, 16 April 2008, p. 64.

112 Senator the Hon. Nick Sherry, 'Corporate governance in today's volatile market condition', *Speech to Riskmetrics Group*, Melbourne, 28 April 2008, accessed 9 May 2008 at: http://minscl.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2008/010.htm&pageID=005&min=njs&Year=&DocType=

3.134 With respect to addressing problems in the long-term, the ASX also recognised the need to address the 'definitional ambiguity' referred to during the committee's inquiry:

> The legislative definition of the transactions which need to be reported as short sales should capture both sell orders submitted when the seller does not own the amount of securities being offered and sell orders submitted when the seller only owns the securities through a borrowing agreement and is subject to a contractual obligation to return the securities to the lender.
>
> The legislative gap or loophole that currently exists in relation to short selling is that the prohibition is widely considered not to extend to sales of securities at a time when the seller owns such securities, even if the seller only owns them by virtue of having entered into a typical stock borrowing arrangement.[114]

3.135 Australasian Investor Relations Association advised the committee that the beneficial owner tracing provisions under section 672 of the Corporations Act were not typically able to be used to identify instances where stock has been lent.[115]

The role of institutions

3.136 Although the complex share ownership arrangements institutions enter into (discussed above at paragraph 3.13) mean that they do not directly lend their shares, institutional investors still have the authority to direct fund managers as to whether they want their stocks lent or not. This decision is taken in the context of trustees' legal authority to manage the assets of the fund on behalf of their members and their responsibility to perform this task for the benefit of fund members; that is, to maximise returns on members' investments. ASFA explained that share lending is undertaken responsibly on the basis of risk/reward calculations in accordance with these obligations.[116]

3.137 Treasury also advised that share lending must comply with trustees' legal obligations:

> [Superannuation funds] are under fiduciary and statutory obligations to deal with the funds in a way which best promotes the ultimate beneficiaries, the investors in the super funds. We would argue that that fiduciary obligation would involve trustees reviewing the appropriateness of investment

113 ASX, 'Public Consultation on Short Selling', *Media release*, 28 March 2008, accessed 9 May 2008 at: http://www.asx.com.au/about/pdf/mr280308_shortselling_consultation.pdf

114 ASX, 'Short selling', *ASX Public Consultation*, 28 March 2008, p. 4, accessed 9 May at: http://www.asx.com.au/about/pdf/short_selling_public_consultation_paper.pdf, pp 4-5.

115 Mr Ian Matheson, Australasian Investor Relations Association, *Committee Hansard*, Sydney, 16 April 2008, p. 70.

116 Mr Ross Clare, ASFA, *Committee Hansard*, Canberra, 15 April 2008, p. 32.

> practices, such as scrip lending, and redetermining those policies from time to time as market conditions change.[117]

3.138 AFSA explained that approaches to stock lending varied between funds; some engaging in the practice and others not. They also indicated that, as beneficial owners, the funds were subjected to minimal risk:

> …the whole issue is one whereby superannuation funds, in terms of their individual situations, have been reviewing what they have been doing and what the risk-return structure is for them in how they do it. Generally, superannuation funds do not have direct dealings with the ultimate borrowers of the stocks. Often the arrangements are through their custodians, so their counterparty risk is with the custodians. It has been an activity with very minimal risk for the superannuation funds. Whether individual funds undertake such activity has been a matter for individual funds.[118]

3.139 The question of whether fund trustees should obtain the consent of their members before lending stock was raised at the committee's hearings. ASFA indicated that the present arrangement, whereby fund members delegate management authority to trustees, does not require consent to be provided. They added:

> Whether it should be is basically a matter for parliament to decide. The mechanics of getting that informed consent, either in general or on specific issues, would be challenging.[119]

3.140 The Investment and Financial Services Association (IFSA) supported this view of the fiduciary approach:

> What flows from that is that you have basically given that right to the person who is acting as the fiduciary in that capacity to exercise and to make those day-to-day decisions on your behalf in your best interest.[120]

3.141 ASA emphasised the benefits of disclosure in this area. They told the committee that in addition to observing their fiduciary obligation to maximise returns to members, institutional investors should disclose their lending policies:

> …institutional shareholders should have a clear policy about securities lending, which can be accessed, and they should also be clearly considering the relationship between risk and return when lending those securities and only take that decision if it fits with their policy in terms of their appetite for risk.[121]

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117 Mr Matthew Brine, Treasury, *Committee Hansard*, Canberra, 15 April 2008, p. 76.

118 Mr Ross Clare, ASFA, *Committee Hansard*, Canberra, 15 April 2008, p. 27.

119 Mr Ross Clare, *Committee Hansard*, Canberra, 15 April 2008, p. 33.

120 Mr Martin Codina, IFSA, *Committee Hansard*, Canberra, 15 April 2008, p. 8.

121 Ms Claire Doherty, ASA, *Committee Hansard*, Sydney, 16 April 2008, p. 26.

Committee view

3.142 The committee is of the view that while short selling is a legitimate trading tool, it is necessary to ensure it is appropriately disclosed to the market to ensure that undesirable practices that potentially accompany short sales can be identified by regulators. Further, the committee does not oppose institutional investors lending their stocks to maximise returns, but considers that funds should be required to disclose their stock lending practices or policies to members.

3.143 The committee also notes that the Australian Government is examining this issue with a view to implementing legislative change to address disclosure matters.

Margin lending

3.144 Concerns associated with company directors holding shares tied to margin loans were also topical during the course of the inquiry. In basic terms, margin lending refers to the technique of borrowing to invest, thereby increasing returns when shares increase in value. The risk attached to margin loans is that borrowers also increase their exposure to losses; the potential for increased profits is accompanied by increased risk. If the value of the shares borrowed against declines to a specified level, lenders will intervene and make a margin call. This requires the holder of the loan to reduce debt as a proportion of the value of their shareholding by injecting cash to reduce borrowings, or to purchase additional shares.

3.145 A potential problem with margin lending arises when shareholders are unaware of situations where directors are facing possible margin calls on their own shareholding in the company, which can often be substantial. Such information has the potential to provide a trading advantage to those who are aware of it, while ordinary shareholders remain oblivious until it is too late. Thus, a company director's undisclosed exposure to margin loans significantly increases the potential for insider trading.

3.146 On 29 February 2008 the ASX released a statement on director-shareholder margin loans, which stipulated that such arrangements may be of material significance under Listing Rule 3.1 and subject to market disclosure requirements:

> Where a director has entered into margin loan or similar funding arrangements for a material number of securities, ASX advises that listing rule 3.1, in appropriate circumstances, may operate to require the entity to disclose the key terms of the arrangements, including the number of securities involved, the trigger points, the right of the lender to sell unilaterally and any other material details. Whether a margin loan arrangement is material under listing rule 3.1 is a matter which the

> company must decide having regard to the nature of its operations and the particular circumstances of the company.[122]

3.147 CSA informed the committee that this guidance was inadequate:

> …there is a call from the market for greater clarity as to when a director or an executive should disclose when they hold shares tied to a margin loan. It appears that the current continuous disclosure definition of materiality under listing rule 3.1 is inadequate and that the market requires greater clarification.[123]

3.148 The committee notes reports that the Australian Government has prepared a green paper proposing that ASIC takes over the regulation of margin lending practices.[124]

Committee view

3.149 The committee does not consider that leaving an assessment of the materiality of a director's margin loan arrangements to the company itself is sufficient. The government's corporate governance green paper should clarify this important disclosure issue.

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122 ASX, *Companies Update*, No. 02/08, 29 February 2008, accessed 9 May 2008 at: http://www.asx.com.au/resources/newsletters/companies_update/archive/CompaniesUpdate_20080229_0208_HTML.htm

123 Mr Tim Sheehy, CSA, *Committee Hansard*, Sydney, 16 April 2008, p. 1.

124 Taylor, L. 'ASIC to police margin lending', *The Australian*, 23 April 2008, p. 1; Drummond, M. 'ASIC shifts to closer watch on markets', *Australian Financial Review*, 9 May 2008, p. 3.