

## Discussion Paper

### Director Share Trading: Disclosure and Market Integrity

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#### Abstract

*Australian legislation and Australian Stock Exchange Listing Rules adopt a two-fold approach to preventing insider trading and ensuring market integrity. Insider trading is prohibited and legislation mandates that disclosure of changes in the interests of directors in company securities occurs within specified short periods after the change. Existing institutional research commissioned by Australian superannuation funds documents widespread breach of these disclosure requirements, even for S&P/ASX200 companies. This project will undertake a detailed analysis of the level and nature of compliance / non-compliance with disclosure requirements, and examine the implications of that compliance / non-compliance for market integrity.*

#### Project Outline

Requiring directors to promptly disclose their trading in company securities is a vital component of a well-functioning market. Disclosure is integral to preventing insider trading and ensuring market integrity and investor confidence. The objective of laws pertaining to disclosure of trading and the prohibition of 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 mobilize savings, depends importantly on the prevention of the improper use of confidential information.”<sup>3</sup>

Without this knowledge, the suspicion that 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 that the counterparty to the trade may have “inside” information.

The perception of insider trading may be as damaging as the reality. Such perceptions damage the reputation of Australian capital markets with adverse consequences for the Australian Stock Exchange (ASX), companies and investors.<sup>4</sup>

Australian legislation and Australian Stock Exchange listing rules adopt a two-fold approach to preventing insider trading and ensuring market integrity. Insider trading is prohibited and legislation mandates that disclosure of changes in the interests of directors in company securities occurs within specified short periods after the change. The Corporations Act requires directors to inform the market of changes in their

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<sup>3</sup> See Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, (1989), “Fair Shares for All: Insider Trading in Australia”, para. 3.3.6.

<sup>4</sup> The effects of insider trading regulations on liquidity and market risk have been examined by Bhattacharya and Daouk (2002), Brockman and Chung (2003), Easley and O’hara (2004) and Gelos and Wei (2005).

interest in company securities within 14 days, and prohibits directors and executives from using information gained in their capacity as directors and executives for their own advantage.<sup>5</sup>

ASX Listing Rules require notification within five business trading days of changes in directors' interest in company shares. These listing rules constitute an enforceable contract between listed companies and the ASX.

In addition to legislative requirements, the *Principles of Good Governance and Best Practice Recommendations* issued by the ASX in March 2003 provide that companies should:

- have, and disclose, a policy on trading in company securities by directors, executives and other employees potentially in possession of information concerning the company's financial position, strategy or operations, which, if made public, would be likely to have a material impact on the price of the company's securities
- ensure such a policy includes details on how it is enforced by the company
- promptly inform the market of the reason behind major trades by directors and executives, and
- have procedures in place to ensure that changes in director interests are promptly notified to the market in accordance with contractual obligations.

Under the ASX Listing Rules, companies are required to disclose the extent to which their corporate governance practices match these recommendations.

Disturbingly, research commissioned by six leading Australian superannuation funds (the Public Sector / Commonwealth Superannuation Scheme, the Catholic Superannuation Fund, the Northern Territory Government Public Authorities Superannuation Scheme, VicSuper, the Northern Territory Police Supplementary Benefit Scheme and Emergency Services Super) and undertaken by BT Financial Group documents widespread breach of these disclosure requirements. This research was limited to trades made by directors of S&P/ASX 200 companies in 2004. Even for these companies, fifteen percent of all trades by directors (432 out of 2936 trades) were not notified to the market within the five business days stipulated by the ASX Listing Rules.

A summary of the BT findings follows.

<b>Policy / Action Investigated</b>	<b>Number of S&amp;P/ASX200 companies</b>
Did not disclose existence of share trading window	3
Do not confine director / executive trading to nominated window	95
Did not disclose change of directors' interest within five business days	123
Sale of securities by directors within two months of an earnings downgrade	3
Purchase of securities by directors within two months of takeover bid for company or earnings upgrade	23
Directors traded in the period between the end of the reporting period and the announcement of results	20
Trade by a director appeared to be in breach of promulgated company policy	11
Sale by director of shares worth more than one percent of the company's market capitalization not explained within one business day	10

<sup>5</sup> It has been recommended that directors be required to disclose changes in their interests within two business days of the change occurring. See Corporations and Markets Advisory Committee, (2003), *Insider Trading Report*.

While important, the research undertaken by BT is partial in two important respects. First, it is limited to S&P/ASX 200 companies and covers only the Year 2004. Investor confidence requires an examination of companies outside these largest and prima facie likely to be better-governed companies. Secondly, no examination was undertaken of whether these directors traded at times that allowed them to earn above normal returns, either by selling prior to the release of bad news or purchasing prior to the release of good news.<sup>6</sup>

This project will undertake a detailed analysis of the level and nature of compliance / non-compliance with disclosure requirements, and examine the implications of that compliance / non-compliance for market integrity. Data will be collected from 2003 to 2005 on all notifications of trades by directors and executives for the S&P/ASX 500 companies.

Further, consistent with the BT study, the share trading policies of all of these companies will be examined to determine:

- ❖ Whether the company has a publicly available policy on dealing in company securities
- ❖ Whether there is a policy specific to directors and / or key executives that are likely to have more privileged information than other staff
- ❖ Whether the policy extends to related parties such as family members or business associates
- ❖ Whether the policy specifies what information should be considered price sensitive, over and above the definition provided in the Corporations Act
- ❖ Whether there are procedures in place to approve trading
- ❖ Whether, in the case of directors, approval is required at Board Level
- ❖ Whether the trading policy stipulates trading windows
- ❖ Whether the policy details conditions when permission to trade may be refused, and
- ❖ Whether the policy includes provisions relating to inside information relating to other companies (as may be obtained, for example, during a takeover).

By examining and highlighting the level and nature of disclosure compliance and non-compliance, the study will focus awareness of the necessity for disclosure and increase confidence in the Australian market. Further, analysis will be extended beyond S&P/ASX200 companies to the wider market. Such analysis is necessary to ensure market integrity and investor confidence. Outcomes will be promulgated via papers in quality international journals as well as in industry and business publications. Further, the findings will be presented at both international academic conferences and at industry funded conferences.

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<sup>6</sup> Existing research suggests that this is likely to be the case. See, for example, Anand, Brown and Watson (2002), Brown and Foo (1998), and Seyhun (1992).

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