Australian Council of Super Investors Inc.

# DISCLOSURE IMPLICATIONS FOR EXECUTIVE HEDGING OF LONG TERM INCENTIVES

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## EXECUTIVE SUMMARY

1. Executive pay comprises fixed, short term and long term incentive components. Executive incentives arrangements are a key component of the corporate governance mosaic comprising of shareholders, directors and executives and at least in theory should aid in limiting the agency costs associated with the separation of shareholders as owners of listed companies and those that are delegated the authority to run the company by aligning executive interests to shareholders with pay.

2. However, as recent press coverage has highlighted some executives may be negating the downside risks of such long-term incentives through hedging. This turns what should have been 'at risk' pay into a fixed guaranteed outcome, which is contrary to the intention of such incentive schemes. This may also indicate that executives are using information to undertake transactions that is not immediately available to all shareholders and may create the perception of insider trading.

3. A range of Corporations Act, Accounting Standards and Australian Stock Exchange (ASX) Listing Rule provisions govern the reporting of share trading applicable to executives, directors and officers of corporations. The requirements in these provisions differ depending on whether the person dealing in the securities is a director, an executive or another relevant officer of the company.

4. The rationale for requiring disclosure of share trading activities is to improve market efficiency, and the need to guarantee investor confidence in the integrity of the securities markets so that investors are able to make decisions based upon a director's or executive's own trading behaviour.

5. Following the media articles highlighting the fact that hedging of long-term incentives could occur, the Australian Council of Super Investors (ACSI) wrote to the ASX/S&P 200 companies to enquire whether their company had a policy that permitted employees to trade in securities and associated products, which operate to limit the economic risk of those securities that form part of long term incentive schemes. Clarification was also sought as to whether any company policy also extended to hedging of options after vesting.

6. 120 responses were received to ACSI's inquiry. Eighty-six respondents explained that they had a share trading policy i.e. 72%. Of those, sixty-three covered the issue of hedging and 22 of those in particular would allow hedging of incentives after they vest. However, the general position was that this would still be subject to the share trading policy and trading windows etc. Unsurprising no company commented that they allowed hedging prior to vesting.

7. To gain a broader perspective on this issue specific consideration is given to the legal provisions in Australia in relation to share trading disclosure and insider trading provisions and a brief overview is provided in relation to the comparative provisions in the United States and the United Kingdom.

8. In terms of the existing disclosure regime Australian disclosure laws do not explicitly cover the issue of hedging of incentives.

9. This paper argues for the prohibition on hedging of unvested incentives.

10. In terms of executives hedging their incentives after they vest, the issue then becomes that if executives hedge, why are they hedging, when are they hedging, on what basis are they hedging and most importantly when and how is the market informed about this transaction?

11. It is strongly recommended that Section 205G of the Corporations Act and ASX Listing Rule 3.19A be amended to capture the issue of hedging of vested incentives.

12. The existing disclosure requirements **only applies to directors** and not to executives or other officers in terms of change of relevant interests. It is insufficient that changes in shareholdings by executives are only disclosed annually in the Annual Report as required by the accounting standards.

13. This paper therefore considers and ultimately endorses some of the recommendations contained in an earlier report by the Corporations and Markets Advisory Committee (CAMAC) on Insider Trading published in November 2003. Specifically section 205G of the Corporations Act (14 days) and ASX Listing Rule 3.19A (5 days) should be extended to apply to Key Management Personnel (KMP) i.e. those personnel likely to have access to insider information and the timing of disclosures be reduced to 2 business days.

14. There has been some alignment of definitions of Key Management Personnel between Section 300A of the Corporations Act and AASB 124 in relation to related party transactions. However, the same cannot be said for definitions contained within the ASX Listing Rules and ASX Corporate Governance Council's 'Principles of Good Corporate Governance and Best Practice Recommendations'.

15. ACSI also recommends a revision to section 300A of the Corporations Act to extend a company's annual disclosure obligations to require the disclosure of whether a relevant director and executive has utilised a financial instrument to hedge their vested long term incentives.

16. This paper and the findings of a previous study by BT Financial Group illustrate the need for listed companies to have a share trading policy in place and to ensure that it is a live document that is appropriately monitored both by the companies and where necessary by the regulators.

17. This study has not identified if there have been any insider trading breaches in those companies which permit executives to hedge vested incentives. Perhaps this is an avenue best left to the trading regulators, both ASIC and the ASX to investigate.

# 1. INTRODUCTION

A range of Corporations Act, Accounting Standards and Australian Stock Exchange (ASX) Listing Rule provisions govern the reporting of share trading applicable to executives, directors and officers of corporations.[1] The requirements contained in these provisions generally differ depending on whether the person dealing in the securities is a director, an executive or another relevant officer of the company.

This paper considers whether the above mentioned disclosure regime is adequate to identify situations where executives or other officers hedge their long term incentives, which would be counter productive to the purpose of these incentives to align executives interests with shareholder interests.

According to the ASX Glossary of Sharemarket Terms, to hedge means "A transaction which reduces or offsets the risk of a current holding."[2] Hedges might include selling short or buying long in a particular security and typical hedges for this paper's purpose would include share futures and options. Therefore such an instrument aims to minimise the downside risk of a diminution of share price that could ultimately impact on share option values.

The findings of an inquiry conducted by Australian Council of Super Investors (ACSI)[3] into the practices of the ASX/S&P 200 with regards to hedging of securities by executives, together with other recent studies in this and related areas, demonstrates that more needs to be done in terms of improved disclosure of executives and other officers share trading practices and the monitoring of compliance with share trading policies by companies and the relevant regulators.

[1] See Appendix A for further detail on the relevant laws.
[2] ASX, 'Glossary of Sharemarket Terms', <http://www.asx.com.au/webmcq/servlet/com.webmcq.glossary.Glossary?cid=0&word=hedge&alt=1>at 27 July 2006
[3] The Australian Council of Super Investors (ACSI) is a not for profit organisation that provides independent research and advisory services on the corporate governance practices of Australian listed companies to superannuation funds. ACSI now has 38 members together they are responsible for managing over $170 billion in investments.

Questions are raised about the circumstances of when and where directors and executives must disclose share trading related to their company and the extent to which these reporting obligations in fact cover executives (who are not directors) and or officers. To gain a broader perspective on this issue, specific consideration is given to the legal provisions in Australia in relation to share trading disclosure and insider trading provisions and a brief overview is provided in relation to the comparative provisions in the United States and the United Kingdom.

This paper argues for the prohibition on hedging of unvested incentives. In terms of hedging of incentives that have already vested, greater and timelier disclosure is required. As such this paper considers and ultimately endorses some of the recommendations contained in an earlier report by the Corporations and Markets Advisory Committee (CAMAC) on Insider Trading published in November 2003. Specifically section 205G of the Corporations Act (14 days) and ASX Listing Rule 3.19A (5 days) should be extended to apply to Key Management Personnel (KMP) i.e. those personnel likely to have access to insider information.

This study has not identified if there have been any insider trading breaches in those companies which permit executives to hedge vested incentives.

## 2. BACKGROUND

On 4 March 2006 Michael West, of "The Australian" broke a story about executives in the top 50 ASX/S&P companies hedging their long-term incentives. Mr West noted that 'Under loopholes in the Australian Stock Exchange rules, executives can secretly cash in their performance pay – in some cases before the shares and options have even vested.' The investigation by The Australian found that the majority of companies in the top 50 ASX/S&P did not have a policy on the issue and some admitted that they wouldn't even know if their executives were even doing it.

Executive pay comprises fixed, short term and long term incentive components. In 2004 the average top 100 ASX/S&P CEO took home $3.19m in remuneration, 19.7% of which represented the long-term incentive component of this remuneration.[4] It is the long-term "at-risk" component that is under question and whether this incentive can be adequately aligned with shareholder interests when the incentive can be hedged.

[4] ISS Proxy Australia, *CEO Pay in the Top 100 Companies: 2004* (Research prepared for ACSI) (2005) 6.

Executive incentives arrangements are a key component of the corporate governance mosaic comprising of shareholders, directors and executives and at least in theory should aid in limiting the agency costs associated with the separation of shareholders as owners of listed companies and those that are delegated the authority to run the company by aligning executive interests to shareholders with pay.

Investors, particularly institutional investors, rely heavily upon these incentive mechanisms to mitigate agency costs and to gain a tangible insight into the effectiveness of boards at retaining and motivating senior staff. However, the recent press coverage has highlighted that some executives may be negating the downside risks of such incentives through hedging.[5] This turns what should have been 'at risk' pay into a fixed guaranteed outcome, which is contrary to the intention of such incentive schemes. This may indicate that executives are using information to undertake transactions that is not immediately available to all shareholders and may create the perception of insider trading.

In response to Mr West's article, ACSI wrote to the ASX/S&P 200 companies to enquire whether their company had a policy that permitted employees to trade in securities and associated products, which operate to limit the economic risk of those securities that form part of long term incentive schemes. Clarification was also sought as to whether any company policy also extended to hedging of options after vesting. "What we are doing here," said ACSI Executive Officer Phillip Spathis, "is applying the blowtorch to the claim that executive remuneration is aligned to shareholder interests." [6]

ACSI's stated position is that corporations should not allow their executives to remove the risk associated with share options in their remuneration package through hedging. This is because this practice negates the rationale for variable remuneration schemes that should apply when executives have contributed to above average corporate performance.[7]

[5] Michael West, 'Execs hedge incentives to protect pay', *The Weekend Australian*, Australia, 4 March 2006, 033.
[6] Michael West, 'Super council turns up the heat on corporate elite over options hedging', *The Australian*, Australia, 29 May 2006, 025.
[7] ACSI, *Corporate Governance Guidelines: A Guide For Superannuation Trustees to Monitor Listed Australian Companies* (2005), 20.

## 2(a) ACSI Inquiry Background

120 responses were received to ACSI's inquiry. Eighty-six respondents explained that they had a share trading policy i.e. 72%. Of those, sixty-three covered the issue of hedging and 22 of those in particular would allow hedging of incentives after they have vested. However, the general position was that this would still be subject to the share trading policy and trading windows etc.

Not all-together surprising was the fact that no company commented that they allowed hedging prior to vesting. The issue of unvested and vested incentives is considered further at Section 4(a), (b) and (c). Of those that had a policy covering hedging 34% permitted or were of the view that hedging of incentives after they have vested should be permitted. For further detail regarding the feedback to ACSI's inquiry see Section 4.

## 2(b) Senate Inquiry

In response to the press coverage Senator Penny Wong, through the Senate Estimates Committee[8] raised the issue as to whether the Australian Securities and Investment Commission (ASIC) had any concerns about the practice of executives hedging their remuneration options. These questions were addressed to Mr Jeffrey Lucy, Chairman, and Mr Jeremy Cooper, Deputy Chairman of the ASIC on 31 May 2006.

In answer to Senator Penny Wong's questioning Mr Cooper noted that "you really have to look at every single one on its own merits. In other words, what were the shareholders told? What is the nature of the long term incentive? How does the hedging work? Have the shareholders been told about the hedging? When does the hedging take place? In other words, does it take effect after the vesting of the securities? There are many, many issues that bear on whether there is in fact a problem. It is a relatively recent and complex issue. There is not a silver bullet solution."

Senator Wong asked whether the ASIC officers believed that the current remuneration "…disclosure regime adequately covers those issues? In other words, is there sufficient information required such that hedging is a transparent issue or a disclosed issue…" In response Mr Lucy noted that it is an area that had been talked about generally within ASIC but it was not one where they had a definitive position.

[8] Evidence to Senate Economics Legislation Committee Estimates (Budget Estimates), Parliament of Australia, Canberra, 31 May 2006, Proof Hansard E99-E102 (Jeffrey Lucy and Jeremy Cooper).

According to a Company Law & Governance Update by Blake Dawson Waldron Mr Cooper also suggested that if a company holds out that its executive remuneration arrangements align "at risk" pay to rewards and its executives hedge unvested options with the knowledge of the board, the directors could be in breach of their duty to act in good faith.[9]

In terms of a proposed solution Mr Cooper said "…Is it right to re-look effectively at the prescriptive black letter rules in the accounting standards, or is the solution in the directors' duties area? There are complex and myriad ways that you could do this. Maybe the directors' duties solution is that with any arrangement that seeks to obfuscate the level of risk, there are three ways you can deal with it. There is false or misleading conduct happening in relation to what the shareholders are being told. There is the directors' duties issue. Another way to fix it is to rework disclosure in the accounting standards."

In responding to Senator Wong's inquiries Jeremy Cooper advised that ASIC had begun a review of the hedging of executives options the first step of which has been to gather market intelligence on options hedging overseas before it formed a policy position.

Senator Wong also took the opportunity to raise the issue with Mr David Boymal, Chairman, Australian Accounting Standards Board at a subsequent Senate Estimates Hearing.[10] Surprisingly, Mr Boymal, was of the opinion that there was no issue in relation to disposing of options after vesting as in his view it is their business what they do with them.

Whilst a number of companies indicated support for Mr Boymal's position in response to the ACSI inquiry there remains some problems with the disclosure regime even if executives hedging incentives after they vest is a generally accepted practice. In summary, the questions that remain outstanding are if they hedge, at what point are they hedging and on what basis are they hedging and most importantly when and how is the market informed about such transactions? Is it sufficient that changes in shareholdings by executives are only disclosed annually in the Annual Report as required by the accounting standards? And do these and other standards adequately cover situations where an executive or other officer who has access to inside information might hedge their incentives?

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[9] Blake Dawson Waldron, 'To Hedge or Not to Hedge?…That is the Question' (2006) *Company Law & Governance Update* <http://www.bdw.com.au/> at 7 July 2006.

[10] Evidence to Senate Economics Legislation Committee Estimates (Budget Estimates), Parliament of Australia, Canberra, 1 June 2006, Proof Hansard E11 - E12 (David Boymal).

**2(c) Overview of Australian share trading and insider trading disclosure laws**

This paper considers the following key aspects of Australian disclosure and other applicable laws with regard to share trading and insider trading–

(a) AASB 1046 – Director and Executive Disclosures by Disclosing Entities[11]

(b) AASB 124 – Related Party Disclosures

(c) Section 181 – requires directors and other officers to discharge their duties in good faith.

(d) Sections 182(1), 183(1) and 184(2) - deals with the issue of improper or dishonest use of position or information by a director, officer or employee for their own gain

(e) Section 205G of the Corporations Act 2001 relates to disclosures by Directors only

(f) Section 296 of the Corporations Act 2001 - sets out the requirements for compliance with the accounting standards and regulations

(g) Part 7.10, Division 3, ss 1042A – 1043O prohibits trading on information not generally know to the market

(h) ASX Listing Rule 3.1 – continuous disclosure obligations

(i) ASX Listing Rule 3.19A – requires the disclosure of a notifiable interest by Directors only

(j) Recommendation 3.2 of the ASX Corporate Governance Council's *'Principles of Good Corporate Governance and Best Practice Recommendations'* relates to disclosure of share trading policies.

It is contended that the regulators (including the ASX in its monitoring capacity) should not focus solely on the above mentioned accounting standard requirements but also on companies compliance with the spirit of Recommendation 3.2 of the ASX Corporate Governance Council's *'Principles of Good Corporate Governance and Best Practice Recommendations'* in relation to disclosure of share trading policies. Whilst it may be commendable for a listed company to have a share trading policy in place, such a policy is only useful if it is a live document that is appropriately applied and monitored.

[11] AASB 124 replaced AASB 1046 for years ending on or after 31 December 2005 for the purposes of s296(1) for the Corporations Act 2001, but not for the purposes of s300A(1)(c). ASIC subsequently issued class order [CO 06/105] in which ASIC stated its view that because AASB 124 doesn't specify a basis for measuring remuneration, it would be possible to make both the disclosures under s300A(1)(c) and the new AASB 124 using the measurement basis in AASB 1046 for years ending 31 December 2005 to 31 March 2006. ASIC intends to cease providing relief in relation to the disclosure of director and executive remuneration when the regulations are amended.

This paper will therefore highlight the lack of uniformity of disclosures depending on whether the person dealing in the securities is a director or an executive or other relevant officers and the need for greater monitoring of share trading in particular hedging of incentives.

## 3. THE ROLE REMUNERATION OF EXECUTIVE'S PLAY IN CORPORATE GOVERNANCE

In order to consider the issue of share option hedging thoroughly it is worth considering this issue in the context of the corporate governance framework.

**What is corporate governance?**

"*Corporate governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised.*

*Good corporate governance structures encourages companies to create value (through entrepreneurism, innovation development and exploration) and provide accountability and control systems commensurate with the risks involved.*"[12]

Figure 1 below illustrates the separation of ownership and control by management. Management are delegated with the day-to-day decision making powers to run and grow the company in the best interests of its owners. An agency relationship can be defined as "…a contract under which one or more person (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision – making authority to the agent."[13]

[12] ASX Corporate Governance Council 'Principles of Good Corporate Governance and Best Practice Recommendations' (2003), 3.

[13] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' from Journal of Financial Economics (1976) in Thomas Clarke (ed), *Theories of Corporate Governance The Philosophical Foundations of Corporate Governance* (2004) 58, 59.

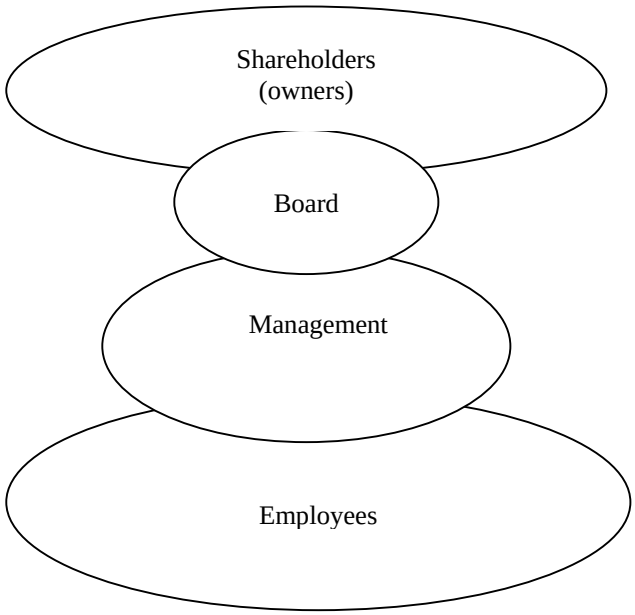


Figure 1[14] **Separation of Ownership and Control**

"Agency costs are incurred by the principals when the interests of the principals and agents diverge, because given the opportunity, agents will rationally maximize their own utility at the expense of their principals." [15]

"Control of agency problems in the decision process is important when the decision managers who initiate and implement important decisions are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions. Without effective control procedures, such decision managers are more likely to take actions that deviate from the interests of residual claimants."[16]

The interests of a CEO and senior management may not always be aligned with that of the shareholders and opportunities for conflict of interest can arise which give rise to the term 'agency cost'. As Thomas Clarke succinctly put it "…shareholders are the principals in whose interest the corporation should be run even though they rely on others to do this."[17]

[14] Institutional Analysis and the Centre for Corporate Law and Securities Regulation, *Corporate Governance: The Role of Superannuation Trustees*, A report prepared for the Australian Institute of Superannuation Trustees (2000).
[15] James H Davis, F David Schoorman and Lex Donaldson 'Toward a Stewardship Theory of Management' in Thomas Clarke (ed), *Theories of Corporate Governance The Philosophical Foundations of Corporate Governance (* 2004) 118, 119.
[16] Eugene F Fama and Michael C Jensen 'Separation of Ownership and Control' in Thomas Clarke (ed), *Theories of Corporate Governance The Philosophical Foundations of Corporate Governance (*2004) 64, 65.
[17] Thomas Clarke (ed), *Theories of Corporate Governance The Philosophical Foundations of Corporate Governance* (2004) 55.

There are a number of corporate governance mechanisms that can be utilised to align these two interests. One such common mechanism is through the utilisation of the long-term incentive scheme.

**Aligning the incentives of executives with those of owners is the most direct way to mitigate the agency problem.**[18] Shareholders particularly institutional shareholders such as superannuation fund trustees do focus on executive remuneration when considering how to exercise their non-binding vote on remuneration report items and the grant and issuing of long-term share and incentive based remuneration that form part of the agenda at Annual General Meetings.

The ACSI Corporate Governance Guidelines state "A significant proportion of a typical superannuation fund's investments is held in domestic and overseas equities. Therefore, the success and long-term viability of publicly listed Corporations have a direct impact on the value of superannuation funds' investments and, ultimately, members' retirement income. It has been widely accepted that poor governance practices pose a threat to corporate performance, thus potentially destroying shareholder value and jeopardising members' financial interests."[19]

There is no doubt that CEO's and senior executives influence the direction of companies, which ultimately affects shareholder return as such executive remuneration should promote superior performance of a company. So when it comes to remuneration shareholders trust directors to attract and retain executives, by paying them well and to use pay in order to properly motivate them.

Share and share option schemes are an important component of executive remuneration. Executive pay comprises fixed, short-term and long-term incentive components. In 2004 the average top 100 ASX/S&P CEO took home $3.19m in remuneration, 19.7% of which represented the long-term incentive component of this remuneration.[20] In order for shareholders to rely on the aim of these long term incentives to align their interests with that of the CEO and other senior executives, where executives are permitted to hedge their incentives appropriate and timely disclosures are needed.[21] See Section 5 for further discussion regarding the Australian laws relating to disclosure of share trading.

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[18] Brian J Hall and Jeffrey B Liebman, *'Are CEOs Really Paid Like Bureaucrats?'*, (1998) XCIII Quarterly Journal of Economics Issue 3, 653, 654.
[19] See above n 7, 1.
[20] See above n 4, 17.
[21] For further discussion about other institutional investors position in this area see IFSA, *Corporate Governance A Guide for Fund managers and Corporations* (2002) 26 and CGI, *Remuneration Guidelines for Institutions and Listed Companies* (2003) 7.

## 4. ACSI INQUIRY RESPONSES

Following Michael West's article in The Australian of 4 March 2006, ACSI wrote to the top 200 ASX/S&P companies to clarify whether these companies had a policy that permitted employees to trade in securities and associated products, which operate to limit the economic risk of those securities.

The top 200 ASX/S&P were chosen for this purpose for two main reasons 1) firstly, ACSI wished to broaden the sample size from the top 50 as used by The Australian in its original investigations, and 2) the ASX S&P 200 represents approximately 89% of total market capitalisation and therefore covers a significant proportion of the Australian equity market.[22]

On 15 March 2006 ACSI wrote to 198 Companies/Trusts in the ASX/S&P 200 and a subsequent reminder letter was sent on 10 July 2006.

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| As at 9 August 2006 120 responses were received from top ASX/S&P 200 listed companies i.e. a 61% response rate. |
| 86 respondents explained that they had a share trading policy i.e. 72%. Of those 64 covered the issue of hedging and 22 of those in particular would allow hedging of incentives after they have vested. However, the general position was that this would still be subject to the share trading policy and trading windows etc. |
| 22 didn't have a policy covering hedging of which 18 either said that they would develop one or would consider the issue further. ACSI will contact the remaining four companies in due course to clarify their position. |
| 27 stated that it was not applicable to their incentive scheme and therefore didn't advise about their share trading policies generally. It should be acknowledged that this was not the focus of the inquiry. |
| 7 companies contacted ACSI to say that they would give this further consideration and would respond in due course. |

None of the respondent companies commented that they allowed hedging prior to vesting.

[22] Aegis Equities Holdings Pty Limited, "Indices Analysis" <https://www.shareanalysis.com/asp/search/indicesearch.asp> at 14/07/2006.

### 4(a) Vesting

Traditionally when a CEO or other senior executive is granted a long-term incentive in the form of shares or options there is a period of time - 'the vesting period' - when executives are not permitted to exercise or deal in these shares or options. The vesting period is used to align the interests of the executives with the shareholders and in general the vesting will only occur on satisfaction of a performance hurdle such as the achievement of a stated Total Shareholder Return against a peer group of companies over a given period.[23] Therefore during the vesting period the executives' long-term incentives are at risk.[24]

By way of an example the following extract is from the Commonwealth Bank of Australia's (CBA) Directors' Report within the 2005 Concise Annual Report in the box below:

**Long Term Incentive (LTI) Arrangements**[25]

Under the Bank's Equity Reward Plan (ERP), LTI grants to Executives are delivered in the form of ordinary shares in the Bank that vest in the Executive if and to the extent that a performance hurdle is met.

LTI grants are made to Executives who are able to directly influence the generation of Shareholder wealth and thus the Bank's performance against the relevant hurdle. Participation is thus restricted to Executives who, in a reporting sense, are no more than three levels removed from the CEO.

The quantum of grants made to each Executive depends on their level within the organisation and has regard to the desired mix between fixed remuneration, short term and long term incentive as well as the performance and potential of the individual Executive.

No value will accrue to the Executive unless the Bank's Total Shareholder Return (TSR) (which is calculated by combining the reinvestment of dividends and the movement in the Bank's share price) at least meets the 50th percentile of a peer comparator group of companies over a three to five year period. The percentage of shares vesting in the Executive rises with increased performance. To receive the full value of the LTI grant, the Bank's performance must be in the top quartile of the peer group.

[23] There are other circumstances where and long-term incentive might vest including retirement, resignation or change of corporate control.
[24] P U Ali and G P Stapledon, 'Having Your Options and Eating Them Too: Fences, Zero-Cost Collars and Executive Share Options' (2000) 18 *Company and Securities Law Journal*, 277-28.
[25] Commonwealth Bank of Australia, Annual Report 2005 <http://www.commbank.com.au/shareholder/2005annualreport/directors_report_cr.asp> at 15 July 2006.

**4(b) Unvested Hedging**

While it appears from those companies that did respond to the inquiry that none supported the use of hedging of incentives prior to vesting this needs to be countered with the comments received that some companies would not know if such hedging transactions took place.

*"We believe that equity incentive schemes should be at risk and that is why "[…] Share Trading Policy prohibits an executive from dealing in derivatives to protect shares or options held under an […] executive equity incentive scheme. As you would know, derivatives are traded in an over the counter market, and therefore […] is not in a position to know who might trade in these products. Consequently we rely on an honour system supported by the fact that executives are well informed about this policy and receive periodic reminders."* **Company A**

Similarly, there are limitations to the conclusion that can be drawn regarding the prevalence of hedging of incentives given that to date only 61% of the top 200 ASX/S&P companies have responded. Concern however remains about what policies and practices apply with respect to those companies that have not responded.

**4(c) Vested Hedging**

Of those companies that had a policy covering hedging 34% permitted or were of the view that hedging of vested incentives should be permitted. The argument in favour of hedging vested incentives is that executives have met the performance conditions to have the incentive vest, it should be at their discretion at that point on how to deal with them; executives in this regard should have the same rights as other shareholders. However, the sting in the tail is that these executives are privy to information at times when shareholders are not.

Predominantly these companies noted that any such trading would be subject to the Companies Trading Policies, trading windows and disclosure obligations either to the Company Secretary, CEO, Chairman to the ASX and in the Annual Report. The "chain of command" for disclosure is dependent upon whether it was an executive or director undertaking the trading.

Examples of the responses that support hedging after incentives have vested are outlined below.

*"It was the view of the Board that this policy would only apply to shares and options that have not vested with the Executive. The rationale behind this decision was that performance shares and options are issued to Executives to incentivise them to achieve performance targets. Once these targets have been met and performance shares and options have vested, then it is at the Executive's discretion to deal with them, subject of course to the restrictions imposed by the Company's Securities Trading Policy."* **Company B**

*The Company's Insider Trading Policy provides for very limited trading windows, this combined with the timing uncertainty that applies to hedging arrangements, makes it most unlikely that an individual will engage in such action. The Company ensures that these limitations and the associated risks are understood by executives…where there is any share or option transaction by an executive, Company policy requires the individual to notify the Company Secretary in writing within five days. Furthermore, as required by Listing Rules, the company would notify the ASX within five business days of any instance where a executive director has dealt in company securities."* **Company C**

*"…a director or employee may deal in "financial product which operates to limited the economic risk of a holding in […] securities,… however unvested securities are excluded from that arrangement…any such arrangement is subject to the following requirements under the Policy;*

- *transaction must be **approved** by the Chairman (for directors) or the CEO (for employees);*
- *only **full vested** shares can be used;*
- *directors and employees may only enter into such transactions when they are not in possession of **price sensitive information**.*

*…[….] securities entered into by its directors and senior management, including Collars, are reported to the board and in the case of directors, transaction are also reported in ASX announcements platform."* **Company D**

*"The policy does not preclude executives from hedging of equity incentives that have vested or the hedging of shares acquired upon the exercise of options. The ability to hedge these holdings (using instruments that are generally available to other shareholders) allows executives to retain their holding as well as meet their funding and tax liabilities. The rationale behind allowing such hedging is to encourage executives to retain their holdings beyond the exercise of their options. We do not believe that the use of such hedging instruments reduces the incentive value of options in fact, enables an extension of the incentive value of options beyond the time of their exercise."* **Company E**

While it appears that based on the responses to the ACSI inquiry and the comments referred to in Senate Estimates Hearings in late May and early June 2006 that there is some support for the ability for executives to hedge their incentives after they have vested the questions that remain are at what point are executives hedging, and when and how is the market being informed about this transaction? Is it sufficient that changes in shareholding/options etc by executives are only disclosed annually in the Annual Report as required by the accounting standards? And do these and other standards adequately cover situations where an executive might hedge their incentives?

**4(d) Examples of Share Trading Policies**

Outlined below are two high standard Share Trading Policies that would be acceptable to ACSI that are aligned with ACSI member interests and deal with the issue of hedging which were provided in response to the ACSI inquiry.

The first is the Coca-Cola Amatil (CCA) Policy on Trading in CCA's shares. It appears that CCA has come a long way since a case that was settled on hedging in 1997 – see page 29 for further detail. The policy applies to Country Managing Directors, the first line reports to the Group Managing Director, Chief Financial Officer and Country Managing Directors and other personnel who are likely to receive price-sensitive non-public information in the course of their positions of employment.

**Extract from Coca-Cola Amatil Policy on Trading in CCA's Shares**[26]

**Speculative Trading**

Under no circumstances should Directors or senior management engage in short-term or speculative trading in the Company's shares. Whilst it is impractical to provide a precise definition of what is short-term or speculative trading the guiding principle should be that at the time of purchase the person should not intend to resell the shares within 12 months with the aim of realising a capital gain.

The prohibition on short-term or speculative trading includes direct dealings in the Company's shares and transactions in the derivative markets involving exchange traded options, share warrants and similar instruments.

The entering into of all types of "protection arrangements" for any CCA shares (or CCA products in the derivatives markets) that are held directly or indirectly by Directors or senior management (including both in respect of vested and unvested shares in any Director or employee share plan) are prohibited at any time, irrespective of whether such protection arrangements are entered into during trading windows or otherwise.

The second example is the ASX Limited's 'Dealing Rules for Employees and Directors' as updated in April 2006.[27]

[26] Coca-Cola Amatil, 'Policy on Trading in CCA's Shares' (2006) <ttp://www.ccamatil.com/files/1/ShareTradingPolicy_May2006.pdf> at 16 July 2006.
[27] ASX Limited's ''Dealing Rules for Employees and Directors' (2006) <http://www.asx.com.au/about/pdf/dealing_rules_april_2006.pdf> at 16 July 2006.

**Extract from ASX Limited's 'Dealing Rules for Employees and Directors' as updated in April 2006.**

**4.2 Short term dealing prohibited**

You must not engage in short term dealing in ASX shares. "Short term dealing" means to deal in ASX shares in a manner which involves frequent and regular trading activity.

**4.3 Prohibition on financial products issued over ASX shares by third parties**

You are **not** permitted to deal at any time in financial products such as options, warrants, futures or other financial products issued over ASX shares by third parties such as banks and other institutions traded on either ASX markets or any other market. The exception applies where ASX shares form a component of a listed portfolio or managed fund or index product.

If you are a participant in the ASX Executive Share Plan or the ASX Long Term Incentive Plan, you are prohibited from entering into transactions in financial products which operate to limit the economic risk of your conditional entitlement or performance right to ASX shares under these schemes.

**4(e) No policy**

A handful of companies responded that they did not have a policy in place regarding this issue and nor did they intend to.

*'We do not have policies precluding entry by executives into risk management arrangements of the type described and would expect some to have done so. We do not track whether such risk management products have been used and do not make any disclosures in annual report or elsewhere.'* **Company F**

In terms of the example above it should be noted that this company is in the process of merging with another listed company, which does have a policy on this issue.

*"There is no need for executives to hedge against the downside risks you refer to given the non-recourse nature of the loans."* **Company G**

*"This issue is not relevant as […] is externally managed by a wholly owned subsidiary of […]."* **Company H**

It should also be noted that not all securities have a secondary market and therefore in some circumstances an incentive would not be able to be hedged.

*"Our securities do not have associated products available (e.g. quoted derivative exchange traded options) and having regard to the long term incentive component of our executives' remuneration, we consider it unlikely and difficult for our executives to hedge against downside risks."* **Company I**

The most surprising response received was *"In response to your query, I advise that we have no interest in proceeding with this matter."* **Company J**

## 5. REGULATION OF SHARE TRADING DISCLOSURE IN AUSTRALIA

Appendix A contains an overview of the key legal provisions in relation to director and executive share trading disclosure.

From this overview the following can be extracted –

(A) Listed companies are only required to disclose **executives** (Key Management Personnel – KMP's) options, rights and other equity holdings held at the start and end of the reporting period i.e. annually in the annual report. It does not appear from these provisions that the law prohibits KMP's from entering into transactions in associated products, which operate to limit the economic risk of their security holdings in the company. Any **disclosure** in this regard falls with the remit of the Recommendation 3.2 of the ASX Corporate Governance Council's *'Principles of Good Corporate Governance and Best Practice Recommendations'*. To illustrate the application of these provisions further one respondent to the ACSI inquiry noted –

*"The terms of issue of share rights to executives prohibit trading in equities that have not fully vested. Our executives cannot pre-sell, mortgage, lend or put any kind of encumbrance over un-vested equities. Hedging activity, if any, is subject to our share trading policy, which requires prior approval and immediate disclosure by a director as we did with […]. Executive deals do not require disclosure but changes in holdings are disclosed annually."*
**Company K**

(B) Timely disclosures such as those required under Section 205G of the Corporations Act (14 days) and ASX Listing Rule 3.19A (5 days) in terms of changes in directors' interests **only apply to directors**.

(C) Recommendation 3.2 of the ASX Corporate Governance Council's 'Principles of Good Corporate Governance and Best Practice Recommendations' recommends that companies disclose its policy concerning trading in company securities by directors, officers and employees. It is also suggested that companies should consider introducing appropriate compliance standards and procedures to facilitate implementation of any code of conduct and trading policy adopted, and an internal review mechanism to assess compliance and effectiveness. This review may involve an internal audit function.

Given some of the responses to the ACSI correspondence namely that Boards would not know if such trading occurs; and the extent of non-compliance with the existing disclosure obligations that will be referred to in the next section; the question arises to what extent are share trading activities being effectively monitored both by listed company boards and the regulators?

(D) There has been some alignment of definitions of Key Management Personnel between Section 300A of the Corporations Act and AASB 124 in relation to related party transactions. However, the same cannot be said for definitions contained within the ASX Listing Rules and ASX Corporate Governance Council's 'Principles of Good Corporate Governance and Best Practice Recommendations'.

Consideration has previously been given to the appropriateness of the disclosure regime in relation to insider trading. In November 2003 the Corporations and Markets Committee (CAMAC) released an Insider Trading Report, which included a number of suggested amendments to Section 205G of the Corporations Act. For this purpose, of particular interest were the following proposals to strengthen the reporting requirements namely:

Section 205G should be amended as follows:

- the disclosure obligation should extend to apply to all directors and senior executives including the chief executive officer. The disclosure obligation on these persons should cover any direct trading and any trading through related parties. However, the paper did not attempt to define the meaning of 'senior executive'.

- directors and senior executives of any entity that substantially manages the affairs of a listed entity should disclose any trading by them in the securities of that listed entity.

- the disclosure period should be reduced from 14 days to 2 business days, except for changes arising under dividend (distribution) re-investment plans, where the period should remain at 14 days. The reason provided for this change by the Committee was that this change would be consistent with the US Public Company Accounting Reform and Investor Protection Act 2002 (the Sarbanes-Oxley Act) for US public companies to disclose changes in ownership of their company's securities to two business days after the changes occurred and would also be consistent with the substantial shareholding requirements in Chapter 6C of the Corporations Act as it relates to takeovers.

It is understood from a discussion held with a representative of CAMAC that Treasury did not respond to this 2003 discussion paper.

## 6. COMPARABLE PROVISIONS IN OVERSEAS JURISDICTIONS

A brief overview is provided in relation to the comparative provisions in the United States and the United Kingdom.

**6(a)(1) United States (US)**

Outlined below is a brief overview of the US laws particularly in relation to insider trading.

Since the introduction of the Sarbanes Oxley Act 2002 in the US, under Section 16 of the Securities Exchange Act of 1934, directors and officers of public companies are required to publicly report transactions in their company stock (including derivative and hedging transactions) within **two business days** of the transaction. Section 16(a) defines "insiders" as ten percent owners, directors, and "officers" of the issuer. The reports are filed electronically with the Securities and Exchange Commission (SEC) using a "Form 4".

Under Australian law only directors are required to report their trading activity within 5 and 14 days under ASX Listing Rules and the Corporations Act requirements, which do not extend to officers who are not directors.

In addition, US companies are required to publicly report within **four business days** on adoption of material compensation (remuneration) arrangements. Those electronic reports are made on a Form 8-K and include compensation plan adoption, employment contracts and similar arrangements.[28]

The SEC has also recently proposed that new executive compensation reporting rules should require companies to include disclosures of whether they have a policy on insider hedging of the economic risk of equity positions.[29] The disclosures would be in a new compensation discussion and analysis report in the annual proxy statement. It is anticipated that the SEC will issue their final rule in the coming weeks.[30] A similar provision is currently under consideration in Australia.

[28] SEC, 'Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction' (RELEASE NOS. 33-8400A; 34-49424A; File No. S7-22-02, 23 August 2004).
[29] See s. 229.402(b)(2)(xi) SEC, 'Executive Compensation and Related Party Disclosure; Proposed Rule' (2006) Vol 71 No 26 *Federal Register* 6542 , 6611.
[30] Email from Keith L Johnson of Reinhart Boerner Van Deuren s.c. to Rosalind McKay, 15 July 2006.

An additional requirement in the US is that a Form 144 is to be filed when an insider intends to sell shares in the near future. No similar provisions exists under Australian law. In the US corporate executives often receive "restricted stock" which is stock given as part of their remuneration. "After a one-year holding period, insiders can sell this restricted stock—but only if they file a Form 144 on or before the date of the actual sale. When insiders file a Form 144, they have 90 days to sell the specified shares, or else they need to submit a new Form 144. When the shares are actually sold, the insider must then file a Form 4."[31]

It has been previously argued in one academic study by David Schizer that there is less opportunity for option hedging (as opposed to stock hedging) in the US due to (1) U.S. tax laws, and (2) Section 16 of the Securities Exchange Act.[32] However, the author argued in this study that tax laws should not be used for this purpose and further needed to be done in terms of more effective contractual and securities law hedging limits.

Schizer also notes that a 1996 SEC release clarified that insiders must disclose the most straightforward hedges —single-stock hedges whose value is explicitly based on the employer's stock price. Interestingly, the study also found that perception among derivatives dealers and their advisors that the disclosure obligations for derivatives are not always honoured. [33]

**6(a)(2) Recent developments in the US**

Notwithstanding the fact that disclosure notifications in the US are closer to real time than in Australia, the US has its own problems with stock option awards. On 20 July 2006 Federal prosecutors filed the first criminal charges against an executive who allegedly manipulated stock option awards in order to give his employees a bigger payday and conceal corporate expenses.[34] Just one week earlier the U.S. attorney's office in San Francisco, formed a task force looking into corporate backdating of stock-option grants.

[31] Morning Star Report, 'Stock Market Definitions' <http://quicktake.morningstar.com/DataDefs/StockInsiderTradeHistory.html> at 15 July 2006.
[32] David M Schizer, 'Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility' (2000) 100 *Columbia Law Review* 440, 440-504.
[33] Ibid 32.
[34] SEC, 'SEC Charges Former Brocade CEO, Vice President and CFO in Stock Option Backdating Scheme' (Press Release, 20 July 2006) see also Carrie Johnson, "Charges Filed in Options Probe", Washington Post, 21 July 2006, D01.

An academic study released in July 2006 by Randall A. Heron of the University of Indiana Business School and Erik Lie of the University of Iowa College of Business,[35] has found that approximately one-fifth of the option grants they reviewed were not reported in a Form 4 filing within two business days of grant, as is now required by law. They also found that late grant disclosures appeared to be associated with company return patterns that suggested potential backdating of the awards. Despite the tighter reporting requirements there appears to be a compliance problem in the US.

In light of the recent backdating scandal in the US a proposed new SEC executive compensation reporting rule would require disclosure of the timing of option grants in coordination with the release of material non-public information ("spring-loading"), and the selection of exercise prices that differ from the underlying stock's price on the grant date.[36]

**6(b) United Kingdom (UK)**

The Rules that relate to the announcement of directors and officers share dealings and the restrictions placed on their ability to deal are covered by the Financial Services Authority (FSA) Listing Rules (generally), FSA Disclosure Rules (Chapter 3) and the Model Code (appended to Chapter 9 of the FSA Listing Rules).

In addition s324 to s328 of the Companies Act 1985 requires directors' dealings to be notified to an issuer.

Sections 51 to 58 of the Criminal Justice Act 1993 sets out the offence, defences, the securities to which this applies and relates to anyone who has information as an insider and then deals in securities that are price-affected securities in relation to the information.

[35] Randall A Heron and Erik Lie 'Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?' Journal of Financial Economics (forthcoming) <http://home.kelley.iupui.edu/rheron/grantsfinal.pdf> at 16/7/2006 see also Indiana University Kelley School of Business Indianapolis, 'Study Finds Backdating of Options Widespread' (2006) <http://kelley.iupui.edu/home/NewsItems_Story.cfm?ID=150> at 15 July 2006.
[36] Thaddeus C Kopinski, Staff Writer, ISS Governance Weekly 'SEC's Final Pay Rules Lauded', 28 July 2006.

The FSA has produced a Code of Market Conduct relating to types of market abuse. Section 118(2) Financial Services and Markets Act 2000 relates to insider dealing. It sets out actions, which point to whether there might be market abuse, before considering whether there is some reason why the behaviour concerned is not abusive. The Code of Market Conduct applies to all persons in relation to qualifying investments admitted to trading on a prescribed market.

Under the Model Code, Listing Rule (LR) 9.2.8 a listed company must require that every person discharging managerial responsibility, including directors and every employee of the company with access to inside information; to comply with the Model Code and to take all proper and reasonable steps to secure their compliance.

FSA Disclosure Rule (DR) 3.1 requires that a "Person Discharging Managerial Responsibility" (PDMR) i.e. listed company director and the senior executives who have access to inside information relating, directly or indirectly, to the issue; and has power to make managerial decisions affecting the future development and business prospects; must notify the issuer of the occurrence of all transactions conducted on their own account in the shares of the issuer, or derivatives or any other financial instruments relating to those shares within **4 business days** of the day on which the transaction occurred i.e. 2 business days later than what is required in the US.

The PDMR definition is similar in some respect to the definition of KMP's under the Corporations Act and the Australian Accounting Standards except that it explicitly covers the issue of having access to inside information.

Under DR 3.1.4 the issuer then must notify the market via regulatory information service "no later than the end of the business day following the receipt of the information by the issuer". The rules also apply to persons connected to a PDMR as well as employee insiders (i.e. their name is on an insider list).

Under the FSA DR 2.8 "An issuer must ensure that it and persons acting on its behalf or on its account draw up a list of those persons working for them, under a contract of employment or otherwise, who have access to inside information relating directly or indirectly to the issuer, whether on a regular or occasional basis." The Rules also set out the content of these lists and that it must be maintained. Under DR 2.8.3 the insider list must be made available to the FSA on request.

The concept of an insider list has some merit; however as it is only made available on request to the FSA, it may not necessarily be a helpful tool in identifying irregular trading activity.

## 7. REVIEWS OF DISCLOSURE OF DIRECTOR AND EXECUTIVE SHARE INTERESTS

This section looks at regulatory activity and prior research in relation to compliance of directors and executives in disclosing their share interests.

The rationale for requiring disclosure of share trading activities is to improve market efficiency, and the need to guarantee investor confidence in the integrity of the securities markets so that investors are able to make decisions based upon a directors or executives own trading behaviour.[37] As indicated in a key research paper into insider trading by BT Financial Group (see below for further detail) "the perception of insider trading can be just as damaging as the reality."[38]

There has been one reported settled case on hedging. In 1997 the Australian Securities Commission (ASC) announced that it had reached an agreement with Mr Muhtar Kent,[39] the former managing director of the European Division of Coca-Cola Amatil Limited (CCA), following an investigation into alleged contraventions of the insider trading provisions of the Corporations Law. The case involved the short sale of 100,000 CCA shares on 15 November 1996. This was at a time when confidential information relating to CCA's recent trading results had not been made public.

More recent actions by the regulators are covered below.

### 7(a) 2000/01 Regulatory Activity

On 5 July 2000 ASIC advised directors that they would be undertaking a further compliance review of directors' disclosure of their share trading. This follows a review in 1999 where 26% of notices

[37] CAMAC, '*Insider Trading Report*' (2003), ii.
[38] BT Financial Group, '*Position Paper – Director and Executive Share Trading*' (2005) <http://www.pss.gov.au/pss/news/PositionPaper_Director%20Share%20Trading_November%202005.pdf> at 7 July 2006.
[39] ASC, 'Insider Trading Investigation of "Coke" Executive' (Press Release, Monday 22 December 1997).

that were lodged with the ASX later than they should have been. In addition 13 directors lodged notices, which had been outstanding until the ASIC review bought it to their attention.[40]

In 2001 ASIC targeted over 80 directors for failing to lodge notifications in compliance with the Corporations Act. As a consequence, 99% subsequently lodged notices with the ASX. ASIC has also seen many instances of late lodgement ranging from days to months.[41]

Subsequent to this the ALP released its policy position on corporate governance which included the proposal for more prompt disclosure of details of directors' share trading and an examination of other initiatives, including share trading windows, directed at ensuring a fair market.[42]

Notwithstanding the attention that disclosure of director share trading interests received in 2000 and 2001, disclosure in this area does not appear to have improved as a study in 2005 by the BT Financial Group on behalf of PSS/CSS (and another four funds) found[43] –

- 60% of top 200 companies did not meet the ASX listing rules requirement to notify any change of interest within five business days.
- 47% companies did not confine directors and executives to nominated trading 'windows'.
- In spite of ASIC's earlier review of this area 15% of the 2936 notifications were late, ranging from a few days to more than four years late.
- Directors at 20 of Australia's largest companies traded during the period between the end of a company's reporting period and the announcement of results (the trading blackout period) where directors and executives are likely to be privy to unreleased information regarding a company's performance.
- Directors at 11 companies breached their company's stated trading policy.
- Directors at 10% of companies purchased shares shortly before the announcement of an earnings upgrade or takeover bid.

[40] Professor Ian Ramsay (ed), 'ASIC Warning – Listed Company Directors Must Disclose Share Interests' (2000) 35 *Corporate Law Electronic Bulletin* 2 (A) <http://cclsr.law.unimelb.edu.au/bulletins/archive/Bulletin0035.htm> at 8 July 2006.
[41] ASIC, 'ASIC and the ASX urge directors to notify market operators of shareholdings' (Press release, 19 October 2005) 05-324.
[42] Professor Ian Ramsay (ed), 'ALP Releases Policy on Corporate Governance' (2001) 44 *Corporate Law Electronic Bulletin* 1 (C) <http://cclsr.law.unimelb.edu.au/bulletins/archive/Bulletin0044.htm> at 16 July 2006.
[43] BT Financial Group, '*Lagging Director Share Trading Governance A Risk For Australian Investors*' (Press Release, 11 November 2005) <http://www.pss.gov.au/pss/news/share_trading.html> at 7 July 2006.

- Directors in 10 companies sold shares worth more than 1% of the company's market capitalisation and did not explain the reasons behind the sale to the market within one business day.
- Three companies did not have a share trading policy.

**7(b) Recent Regulatory Action**

In part in anticipation of the BT Financial Group Report, ASIC and ASX released further information regarding compliance with the disclosure obligations.[44] The ASX in its release noted the courses of action it would take where they were aware of non-compliance with ASX listing Rule 3.19A.

In addition on Wednesday 19 October 2005 ASIC advised that it and the ASX were undertaking a joint campaign to increase awareness among listed public company directors of their obligations under the Listing Rules and the Act, and to ensure a high level of compliance with the requirement to notify their interests, or changes in their interests, to the market under the Listing Rules and the Corporations Act 2001 (the Act).[45]

Other regulatory developments include the announcement on 15 December 2005 by the ASX that a new structure would be put in place which would include ASX Markets Supervision with three separate units of market oversight: This change in structure also includes a dedicated insider trading unit.[46]

In discussions with a representative of the ASX the following issues were identified from this discussion –

The ASX conducts surveillance in three key areas 1) Continuous Disclosure, 2) Insider Trading and 3) Market Manipulation.

[44] ASX, '*Action on non-disclosure of directors' interests'* (2005). <http://www.asx.com.au/resources/newsletters/companies_update/archive/CompaniesUpdate_20051019_1105_HTML.htm> at 7 July 2006.
[45] See above n 41.
[46] ASX, 'Developments at ASX' (2006) Winter 2006 *Compliance in Focus* <http://www.asx.com.au/supervision/pdf/2006_winter_compliance_in_focus.pdf> at 16 July 2006.

The ASX Markets Supervision Insider Trading Unit monitors company announcements and media articles for possible insider trading breaches. The SMARTS (Securities Market Automated Research Trading and Surveillance) is used which monitors all real-time trading information and highlights any price or volume in stock movements. In particular, following the release of certain announcements, the Insider Trading Unit will, review trading in the stock and any derivatives that occurred prior to the announcement. If any concerns are raised and further explanation is required then further enquiries are made of company or relevant broker.

Notwithstanding the electronic technology used to detect any trading irregularities, from the discussion it was deduced that it would not necessarily be possible to distinguish between general over counter transactions (OTC) such as trades generally conducted by investment banks and brokers as opposed to hedging arrangement for a particular executive. Unless, someone who knew of an irregular trade notified the ASX, any irregular hedging arrangement may go undetected. This discussion highlighted in particular the difficulty in monitoring compliance with insider trading provisions and hedging transactions.

On 22 May 2006 the ASX provided an update on the ASX's review of compliance with the ASX Corporate Governance Principles and Recommendations. The report notes significant improvement in corporate governance disclosures and it appears that there was almost 80% compliance with Recommendation 3.2 of the ASX Corporate Governance Council's *'Principles of Good Corporate Governance and Best Practice Recommendations'* in relation to disclosure of share trading policies. [47]

While the review was largely positive about the extent of listed companies' compliance with the level of reporting on governance, the ASX also provided some suggestions to further enhance reporting. Of particular interest was the observation that there was a need for greater clarity when providing corporate governance information in relation to share trading. This finding was based on the results of a User Survey of professional and private investors conducted by the Council in late 2005 and released in March 2006.[48]

[47] ASX, '2005 Analysis of Corporate Governance Practice Disclosure' (2006).
[48] ASX 'Corporate Governance (Market Research Project) Key Highlights' (2006).

## 8. RECENT DEVELOPMENTS

As a consequence of the recent media coverage and to some extent in response to the BT Financial Group Study Treasury, the ASX, Investment and Financial Services Association (IFSA) and the Australian Institute of Company Directors (AICD) are considering what changes may be needed to a range of legal requirements to facilitate better regulation of director and executive share trading. Further details of proposals being considered by each of these organisations is provided below.

Treasury

On Monday 17 July 2006 a press article alluded to the fact that Treasury was considering proposals to require the disclosure of hedging of stock options as part of a broader review of regulation that aims to reduce the amount of regulation.[49]

Following discussion with a Treasury representative it is understood that Treasury is considering including an amendment to the Corporations Act requiring companies to include disclosure in their remuneration reports about hedging. In particular it is understood that companies would need to specify their policy on whether executives and directors are able to hedge their exposure to the share price. Companies would also need to disclose how the policy is enforced. If ministerial approval is given to this proposal it is anticipated that treasury will make an announcement on the issue in mid to late August 2006. The proposed position appears similar to that proposed by the US SEC with regard to new annual compensation reporting rules which covers the issue of hedging.

ASIC

In light of the fact that Treasury is proposing to amend the Corporations Act it is understood that ASIC will not be taking its investigations further without additional evidence that such transactions take place.

[49] Fiona Buffini, 'Pay review targets secret option sales' *The Australian Financial Review*, 17 July 2006, 03.

ASX

Further discussions and recent media coverage have suggested that the ASX Corporate Governance Council's working group would consider proposals to amend the ASX Corporate Governance Principles to recommend that hedging of unvested incentives should be prohibited.

IFSA

It is also understood that IFSA are in the process of amending their Executive Equity Plan Guidelines,[50] and are taking the opportunity to address executive incentive hedging as part of this review. The author has viewed an early draft of the amended document and notes IFSA's proposed position is that companies should have a written and published policy covering the period before and after the vesting of securities where executives might seek to acquire and/or trade in financial products issued over the company's securities by third parties which operate to limit the economic risk of the equity plan.

The draft guidelines suggest that unvested hedging activities should be prohibited and that the company's policy should also require executives to disclose any post-vesting hedging activities to the company. Any breaches of company policy should be treated seriously, and where appropriate, disclosed to the market.

The amendments referred to above are the subject of consultation and therefore subject to change.

AICD

AICD's view on executive option hedging was outlined in the August 2006 Company Director magazine.[51] Hedging of options should be prohibited during the unvested period; more conservative views indicate that companies should disclose hedging arrangements where permitted once the incentives have vested, any current or emerging breaches of policy should be treated seriously and disclosed to the market. It is also understood that the AICD is working on two publications regarding director and employee share trading to be released later in 2006.

[50] IFSA 'Executive Share and Option Scheme Guidelines' were first published as Guidance Note No.12 in May 2000.
[51] Domini Stuart, 'Trading Away Disclosure Responsibilities' (2006) Vol 22 No 7 *Company Director* 24, 24-26.

## 9. CONCLUSION

From an investor perspective the use of financial products to remove the risk associated with long-term incentives is counter intuitive to their intention of aligning the interests of executives and shareholders. This practice negates the rationale for variable remuneration schemes that should apply when an executive has contributed to above average company performance.

Putting to one side the requirements under sections 181 to act in good faith and 182(1), 183(1) and 184(2) of the Corporations Act 2001 in relation to improper or dishonest use of position or information by a director, officer or employee for their own gain, Australian disclosure laws do not explicitly cover the issue of hedging of incentives prior to vesting.

Based on the responses to the ACSI inquiry, market sentiment is that unvested hedging does not occur and nor should it be permitted.

**ACSI would strongly encourage Treasury and the ASX Corporate Governance Council to tighten the Corporations Act and the ASX Corporate Governance Guidelines to prohibit the hedging of unvested incentives.** However, it is understood at present that any amendments to the Corporations Act presently under consideration by Treasury relate solely to annual disclosure and monitoring by companies of policies on the issue of hedging.

Also welcomed is the move by IFSA Executive Equity Plan Guidelines encouraging the promotion of disclosure of hedging of incentives that have already vested. ACSI's guidelines do not differentiate between vested and unvested incentives; however, it is likely that future editions of these guidelines will reflect this issue.

In terms of executives hedging their incentives after they have vested, the issue then becomes that if executives hedge, why are they hedging, when are they hedging, on what basis are they hedging and most importantly when and how is the market informed about this transaction?

The questions raised above highlight the following key deficiencies in the current disclosure regime in relation to share trading and insider trading laws namely:

- Under the Accounting Standards listed companies are only required to disclose Key Management Personnel's (KMP) i.e directors' and executives' options, rights and other equity holdings as at the start and end of each reporting year i.e. annually in the annual report.

- Timelier disclosures such as those required under Section 205G of the Corporations Act (14 days) and ASX Listing Rule 3.19A (5 days) in terms of changes in directors' interests **only apply to directors**.

**It is strongly recommended that Section 205G of the Corporations Act and ASX Listing Rule 3.19A be amended to capture the issue of hedging of incentives after they have vested.**

Consistent with the recommendations of the CAMAC Insider Trading Report of November 2003 it is proposed that Section 205G of the Corporations Act (14 days) and ASX Listing Rule 3.19A (5 days) be extended to apply to KMP i.e. those personnel likely to have access to insider information. It is proposed further that all corresponding definitions of directors, executives and officers be amended to reflect one consistent definition being KMP within the Accounting Standards, Corporations Act and the ASX Listing Rules.

It is also contended that the disclosure period should be reduced from 14 days to 2 business days, except for changes arising under dividend (distribution) re-investment plans, where the period should remain at 14 days. Given the important role executive remuneration plays in aligning shareholders' interests with those of the CEO and other senior executives, appropriate and timely disclosure is needed. This will help guarantee investor confidence in the integrity of the securities markets so that investors are able to make decisions based upon a director's or executive's own trading behaviour. This change would also be consistent with the US position on this issue.

The abovementioned improvements to the disclosure arrangements would provide a more effective and contemporaneous disclosure to shareholders of share trading by executives and directors. In addition, ACSI recommends a revision to section 300A of the Corporations Act to extend a company's annual disclosure obligations on the prescribed details of remuneration, to disclose whether a relevant director or executive has utilised a financial instrument to hedge their vested long term incentives. This revision does not represent an unreasonable and burdensome alteration on disclosure provisions for companies.

There are two further areas of concern that require action from the regulators and these concerns are demonstrated by the following two responses to the ACSI inquiry.

*"As you would know, derivatives are traded in an over the counter market, and therefore […] is not in a position to know who might trade in these products. Consequently we rely on an honour system supported by the fact that executives are well informed about this policy and receive periodic reminders."* **Company A**

*"[…] does not prohibit executives from entering into hedging transactions in relation to vested share options or share rights but are subject to restrictions in dealing with […] securities. There is no general requirement for […] to disclose hedging by Executives of vested share options or share rights."* **Company L**

The responses above, coupled with the BT Insider Trading Study, and the ASX's own reservations about its ability to detect OTC trades with insider dealing implications, highlight the need for greater monitoring of compliance with share trading policies.

It is one thing for a listed company to have a share trading policy in place that covers the issue of incentive hedging; however it is another to ensure that it is in fact being appropriately applied and monitored.

The nature of hedging transactions means that they are difficult to detect and consequently any insider trading breaches implied by such transactions are also difficult to detect. By implication therefore the regulatory regime is not sufficiently equipped to deal with these transactions and any potential breaches.

The proposal by Treasury to require companies to disclose their policies in this area and to disclose how the policy is enforced is welcomed and is likely to be one step in the right direction in terms of monitoring. However, more needs to be done by the regulators.

This study has not identified if there have been any insider trading breaches in those companies which permit executives to hedge vested incentives. Perhaps this is an avenue for further consideration by the trading regulators, both ASIC and the ASX because "the perception of insider trading can be just as damaging as the reality."[52]

[52] See above n 38.

| Law | Description/Application | Timing of Disclosure (where applic.) |
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| AASB 1046 - Director and Executive Disclosures by Disclosing Entities | The Accounting Standard requires disclosure of remuneration details for each 'specified director' and 'specified executive' including options and rights holding and other equity holdings (other than options and rights). A 'specified director' is anyone who was a company director at any time during the relevant reporting period.<br><br>The Accounting Standard defines 'executive' as a person who is directly accountable and responsible for the strategic direction and operational management of the entity. | In the Remuneration Section of the companies Annual Report. |
| AASB 124 – Related Party Disclosures | The new AASB 124 replaces AASB 1046. It applies for years ending on or after 31 December 2005. AASB 124 applies to each entity required to prepare a financial report in accordance with Part 2M.3 of the Corporations Act.<br><br>**Aus25.7.3 and Aus25.7.4** requires the disclosure of options, rights other equity holdings held at the start and end of the reporting period.<br><br>"Key management personnel" replaces specified director and specified executive as noted under AASB 1046 above.<br><br>**Key Management Personnel (KMP)** is defined as those with the authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.<br><br>Due to the similarity in definitions between section 300A in the Corporations Act and KMP in AASB 124, the Board expects the KMP group (or groups) for a listed company will generally include all executives identified by section 300A of the Corporations Act. | Annually in the Directors Report in the Annual Report |

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| Section 300A of the Corporations Act 2001 | Requires the disclosure of the remuneration of directors and senior managers in relation to both the listed company and consolidated entity in the directors' report.<br><br>On 30 January 2006 ASIC issued a class order 'IR 06-03 ASIC relief on remuneration disclosures.' The class order allows listed companies to transfer remuneration information required to be disclosed in the financial report under accounting standard AASB 124 *Related Party Disclosures* into the directors' report. This will enable listed companies to combine the remuneration disclosures required by accounting standards with those already required to be included in the directors' report under s.300A of the Act. | Annually in the Directors Report in the Annual Report |
| Regulation 2M.3.03 and Schedule 5B to the Corporations Regulations | Details the prescribed information on director and executive remuneration that listed companies must disclose in the directors' report.<br><br>ASIC Class Order 06/50 'Transfer of Remuneration Information into Directors' Report' allows listed companies to transfer remuneration information required to be disclosed in the financial report under the revised AASB 124 'Related Party Disclosures' into the directors' report. | Annually in the Directors Report in the Annual Report |
| Section 181 Corporations Act | Requires that a director or other officer of a corporation must exercise their powers and discharge their duties:<br>(a) in good faith in the best interests of the corporation; and<br>(b) for a proper purpose. | |
| Sections 182(1), 183(1) and 184(2) of the Corporations Act 2001 | Deals with the issue of improper or dishonest use of position or information by a director, officer or employee for their own gain. | |

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| Section 205G of the Corporations Act 2001 – Listed Company – director to notify market operator of shareholdings etc | The director must notify the relevant market operator within 14 days after any change in the director's relevant interests. **This provision relates to directors only.**<br><br>'Relevant Interests' – are defined under Section 205G(1) (a) and (b).<br><br>The Basic rule is that relevant interest is holding, or controlling voting or disposal of, securities. | Notify interest within 14 days of appointment or listing of the company (whichever is relevant) and thereafter within 14 days of any change. |
| Section 296 of the Corporations Act 2001 - | Sets out the requirements for compliance with the accounting standards and regulations. | |
| Part 7.10, Division 3, ss 1042A – 1043O | Prohibits trading on information not generally known to the market. Inside information is defined by s 1042A as any information that is not generally available [but] if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products. | |
| Chapter 6C - Takeovers | Information about substantial holdings must be given to company, responsible entity and relevant market operator. This section relates to takeovers. | Within 2 business days after they become aware of the information |
| ASX Listing Rule 3.1 – continuous disclosure obligations | Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information. | Immediate disclosure of material information |

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| ASX Listing Rule 3.19A and 3.19B - | Requires the disclosure of a notifiable interest[53] of a director of the entity (or in the case of a trust, a director of the responsible entity of the trust). The entity must complete Appendix 3 Y and give it to ASX no more than 5 business days after the change occurs. **This provision only applies to directors.**<br><br>ASX published Guidance Note 22 'Director of Interests and Transactions in Securities – Obligations of Listed Entities' in March 2002. Of interest is the following –<br><br>**"OBLIGATION ON LISTED ENTITY – ENFORCEMENT OF AGREEMENT**<br>9. Section 205G places the obligation to disclose on the director, but as the Listing Rules are a contract between ASX and listed entities, rules 3.19A and 3.19B place the primary notification obligation on the entity. In order to be able to make the required disclosure, the entity needs to enter into an agreement with each of its directors under which the director accepts a liability to provide the necessary information to the entity, to enable the entity to comply with the Listing Rules."<br><br>In addition, the guidance note clarifies that where an entity complies with listing rule 3.19A, the obligations of the relevant director under section 205G of the Corporations Act 2001 will also have been satisfied. | 5 business days after the change occurs. |
| ASX Listing Rule 4.10 | Requires companies to provide a statement in their annual report disclosing the extent to which they have followed the ASX Corporate Governance Council's *'Principles of Good Corporate Governance and Best Practice Recommendations'* in the reporting period. Where companies have not followed the recommendations, they must provide reasons why. | Disclose Annually on an if not why not basis |

[53] As defined by Chapter 19 of the ASX Listing Rules.

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| Principle 3 of the ASX Corporate Governance Council's *'Principles of Good Corporate Governance and Best Practice Recommendations'* | **Principle 3** sets out that a company should publish its position concerning the issue of board and employee trading in company securities and associated products which operate to limit the economic risk of those securities.<br><br>Specifically **Recommendation 3.2** requires companies to disclose the policy concerning trading in company securities by directors, officers and employees.<br><br>In the commentary it recommends that companies should consider introducing appropriate compliance standards and procedures to facilitate implementation of any code of conduct and trading policy adopted, and an internal review mechanism to assess compliance and effectiveness. The review may involve an internal audit function.<br><br>**Box 3.2** suggests that the trading policy should specify whether the company prohibits designated officers from entering into transactions in associated products, which operate to limit the economic risk of their security holdings in the company.<br><br>In terms of reporting on Principle 3 it is recommended that the material be made publicly available by posting it on the company's web-site in a clearly market corporate governance section. | Disclose Annually on an if not why not basis |

Table 1.

Denotes disclosure obligation