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Shadow Equity - The Darker Side of Insider Trading

A look at the insider trading prohibition in section 1043A of the Corporations Act in the context of derivatives and proposed ASX listing rule amendments to company trading policies

As global capital markets improve, a number of insider trading charges brought by ASIC, together with recent warnings by the ASX, serve as a timely reminder of the tough stance being taken on those who trade securities with knowledge of undisclosed price-sensitive information. In addition, senior executive remuneration has never been subjected to more intense public and political focus.

It is in that context that many may not realise that the insider trading prohibition is not simply limited to trading in what are regarded as traditional securities, such as shares or options. This FocusPaper looks at how the prohibition can affect dealings in quasi-security interests – also known as “shadow” or “virtual” equity.

The insider trading prohibition

The general insider trading prohibition is found in section 1043A of the Corporations Act 2001 (Cth) (**Act**). That section provides that if:

- (a) a person (the *insider*) possesses insider information; and
- (b) the insider knows, or ought reasonably to know, that the elements to the definition of inside information are satisfied in relation to the information¹;

the insider must not (whether as principal or agent):

- (c) apply for, acquire or dispose of, a *relevant Division 3 financial product* [emphasis added]; or
- (d) procure another person to apply for, acquire or dispose of, a relevant Division 3 financial product.

¹ Inside information is information that is not generally available and, 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.

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A breach of section 1043A gives rise to a maximum penalty of \$1,100,000 for a body corporate and \$220,000 and/or 5 years imprisonment for an individual. However, on 28 January 2010, the Government announced proposed changes that will:

- increase the penalties for market misconduct to \$500,000 or three times the profit made or avoided (whichever is greater) and up to 10 years imprisonment for an individual and, for a corporation, \$5 million, three times the profit made or loss avoided or 10% of the annual turnover of the corporation in the relevant period;
- give ASIC greater power to use telephone interception to obtain direct evidence of suspected breaches of insider trading and market misconduct provisions; and
- expand ASIC's search warrant powers.

The Government is expected to release an exposure draft of the proposed changes later this year.

Relevant Division 3 Financial Products

The definition of a "relevant Division 3 financial product" is very wide and captures shares (whether listed or unlisted), options, derivatives, interests in a managed investment scheme, debentures, stocks, bonds, certain superannuation products and any other financial product that is able to be traded on a financial market.

Interests or contractual rights that are linked to the price of a security – commonly referred to as "shadow", "virtual" or "ghost" equity – are likely to come within the definition of a "derivative"² and hence constitute a relevant Division 3 financial product. This is often overlooked by many who associate insider trading as being focused only on the trading of "vanilla" securities such as shares and options.

The key characteristic of a "derivative" is that the amount of consideration or value that can be realised from the derivative is determined by reference to the value or amount of something else including, for example, an asset, a rate, an index or a commodity.³

What is Shadow Equity?

Shadow equity is essentially a contractual right to receive certain commercial or financial benefits normally associated with value or price movements in issued equity, but without actually holding that underlying equity. A holder of shadow equity will typically be granted rights to receive a monetary payment that is determined by reference to some level of corporate financial performance or movement in a share or option price. In some cases, it is the holder of those rights who is entitled to select a date or period on, and/or in respect of, which the value of those rights are determined. However, the shadow equity holder is usually not entitled to attend or vote at shareholders' meetings or receive the benefit of dividends or other shareholders' rights under the Act or the constitution of the relevant company.

As the value of the entitlements attaching to shadow equity is derived from the value of something else (i.e. the real equity to which the shadow equity value-formula relates), it is

²Section 761D(1), Corporations Act 2001 (Cth).

³Note that this is merely an inclusive, and not an exhaustive definition.

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likely that shadow equity will normally constitute a relevant Division 3 financial product. Accordingly, any person who from time to time is an “insider” must be especially mindful when considering the exercise of his or her rights under any shadow equity. The person must always first consider whether he or she has any price-sensitive information that has not been publicly disclosed.

Where the determination of the value of the shadow equity occurs without any action, omission, collusion or other material involvement by the holder of that shadow equity, the threat of a breach of the insider trading regime is of less concern.

Director Payments and Shadow Equity

A common type of shadow equity comes in the form of bonus payments made to directors or other senior management members. Many companies grant their executive directors a right to receive a bonus payment that is often calculated by reference to the performance in the company’s share or option price.

For instance, a bonus payment calculated with reference to the company’s share price on a day or over a period of time in the future that can be selected by the director, is likely to constitute a relevant Division 3 financial product for the purposes of section 1043A. Such an arrangement could expose a director to liability for breach of the insider trading regime – brought about by the director’s decisions in relation to such matters as the timing of the exercise date or his or her selection of the share valuation period, whilst that director was in possession of inside information.

The following example illustrates how a director could breach section 1043A as a result of an exercise of his right in relation to a bonus payment arrangement:

- A director of ABC Co has a right to receive a cash bonus payment that can be exercised at any time between 1 July 2009 and 31 December 2009 (**Exercise Period**).
- The bonus payment is calculated with reference to a formula whereby the director can select any five day VWAP⁴ of the company’s shares during the Exercise Period. The higher the VWAP, the higher the director’s bonus payment.
- On 7 August 2009, the director:
 - becomes aware that XYZ Co is likely to announce an attractive takeover bid for ABC Co, which has not yet been publicly disclosed; and
 - subsequently selects the dates of 10 August 2009 to 14 August 2009 for the purposes of calculating the five day VWAP for his bonus payment.
- On 10 August 2009, XYZ Co publicly announces the takeover bid.

In a recent example of shadow equity dealt with by the writers, an executive of a public company was entitled to a payment determined by the excess (if any) by which the ten day VWAP of that company’s shares over a period selected by that executive, exceeded a fixed value of the shares, multiplied by the number of shadow equity units held by that executive.

⁴ Volume Weighted Average Price

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Companies and directors can avoid the risk of contravening the insider trading prohibition or allegations of such contraventions, through making arrangements that do not allow a director to control or affect the “disposal” of the relevant Division 3 financial product. For example, a bonus payment that is calculated with reference to a company’s VWAP over a period in the future that is prescribed at the time of issuing the shadow equity and which is not selected and cannot be varied by the director, should not (of itself) facilitate a breach of the insider trading regime.

That arrangement may still constitute a relevant Division 3 financial product. However, because the director has no control over or involvement in how the value of the bonus payment is derived or the timing of disposal of his shadow equity, the exercise or disposal of the shadow equity would be unlikely to constitute a contravention of section 1043A, even if at the time of that exercise, the director was in possession of inside information.

Proposed changes to ASX Listing Rules

ASX-listed companies and their directors should be aware of recently proposed changes to the ASX Listing Rules. On 4 December 2009, the ASX released a public consultation paper⁵ outlining proposed changes which will require listed entities to adopt and disclose a trading policy which sets out rules for the trading of an entity’s securities by its key management personnel (which includes directors).⁶

Under the proposal, an entity’s trading policy will need to include at least the following information:

- the entity’s “prohibited period” (often referred to as a “blackout period”), being the period(s) of time when the entity’s key management personnel are prohibited from trading in the entity’s securities;
- the restrictions on trading that apply to the entity’s key management personnel;
- any exceptional circumstances in which the entity’s key management personnel may be permitted to trade during a prohibited period with prior written clearance from the entity. ASX expects that exceptional circumstances would generally be limited to passive trades and severe financial hardship; and
- the procedures for obtaining prior written clearance from the entity for trading in the entity’s securities.

The proposed definition of “trading policy” refers only to the entity’s *securities* (emphasis added). Accordingly, under the proposed rules as currently drafted, a trading policy will not need to provide rules for dealing in any other relevant Division 3 financial products such as shadow equity. However, it may be prudent from a compliance perspective that an entity’s trading policy nevertheless deals with other relevant Division 3 financial products. Indeed, it is contemplated in the commentary on Recommendation 3.2 of the ASX Corporate

⁵ “Listing Rule Amendments – Company Policies on Trading Windows and Blackout Periods”, ASX Public Consultation, 4 December 2009 (**Consultation Paper**).

⁶ Recommendation 3.2 of the ASX Corporate Governance Council’s Principles and Recommendations (**Guidelines**) states that companies should establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy. However, unlike the ASX Listing Rules, this recommendation is not mandatory.

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Governance Council's Principles and Recommendations that an entity's trading policy may specify whether the entity prohibits trading in financial products issued or created over the entity's securities or trading in associated products.⁷

A director of an ASX-listed company is currently required to lodge an Appendix 3Y if there is any change in his or her relevant interest in any securities of that company. Under the proposed changes, the Appendix 3Y will require directors to advise whether their trade occurred during a prohibited period and if so, whether written clearance was provided for the trade.

The general intention of the proposed amendments is to reduce the likelihood of directors and senior management from trading in their companies' securities whilst in possession of undisclosed price-sensitive information. This, in turn, is expected to improve the public perception and integrity of the market. Many listed companies already have trading policies which state that directors and employees who hold shares in the company must not trade during blackout periods. Blackout periods are generally the period between finalising the financial accounts and public release of those accounts to the market. However, the listing rules do not currently set out any mandatory rules for trading policies.

ASX's proposed amendments follow a survey conducted by ASX Market Supervision which found that 33% of all active trades by directors during the first quarter of 2009 occurred during the period between close of books and release of financial results.⁸

Assuming the amendments come into force, ASX-listed entities should:

- adopt new trading policies or review their existing trading policies;
- advise directors of the new Appendix 3Y requirements;
- advise directors and employees of the requirements under the entity's trading policy; and
- establish systems to manage compliance with the entity's trading policy by directors, officers, employees and other "potential insiders" of the company.

The public have until 26 February 2010 to make submissions to ASX regarding the proposed amendments. It is anticipated that the proposed changes will come into effect in late 2010 or early 2011.

⁷ ASX Listing Rule 4.10.3 requires listed entities to disclose in each annual report the extent to which they have followed the Guidelines during the reporting period. If an entity has not complied with a recommendation, it must explain why. ASX Listing Rule 12.7 requires the top 500 listed entities to have an audit committee, and the top 300 to have an audit committee that is composed in accordance with recommendation 4.2 of the Guidelines. In addition ASX Listing Rule 19.2 requires all listed companies to comply with the "spirit, intention and purpose" and to look "beyond form to substance" when seeking to comply with the Listing Rules.

⁸ paragraph 14, page 5 of the Consultation Paper.



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