Australian Government

Corporations and Markets
Advisory Committee

INSIDER TRADING REPORT

November
2003

Corporations and Markets **Advisory Committee**

Insider Trading Report

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Introduction

Background

Australia has one of the broadest prohibitions of insider trading in financial products in the world. While there is wide support for a firm approach in this area, and some concern that the present laws may not be effective enough, there is less clarity about what should be prohibited. Moreover, some tensions in the application of the insider trading provisions have arisen from amendments in March 2002 that considerably extended the range of financial products covered by those laws.

Current law

Under the *Corporations Act 2001* Part 7.10 Division 3, anyone who possesses 'inside information' is prohibited from trading or procuring trading, or communicating that information where trading is likely to take place, in relation to relevant financial products, subject to various exceptions and defences. 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.

Until March 2002, the insider trading prohibition was confined to transactions in securities (whether of public or private entities), interests in managed investment schemes and futures contracts that related to the securities of a body corporate or the price of those securities. Since then, the prohibition has been extended. The financial products now covered by the prohibition are:

- securities, including options over unissued shares
- derivatives
- interests in a managed investment scheme
- debentures, stocks or bonds issued or proposed to be issued by a government
- superannuation products (other than prescribed products), or
- any other financial products that are able to be traded on a financial market.

Breach of the insider trading provisions is a serious criminal offence, carrying a maximum penalty of five years imprisonment as well as substantial fines and possible liability under the civil penalty provisions. There are other significant consequences, such as disgorging any profits made or losses avoided in the transactions and prohibiting an insider-trader from acting as a company director or otherwise managing a corporation.

Unlike the position in some other countries, it is not necessary for the prosecutor to prove that the accused has relied on or otherwise used the relevant information: possession of the information when trading is sufficient. Likewise, it is not necessary to show any connection between the accused and an 'inside' or otherwise privileged source of the information, such as the company whose securities are traded.

Scope of the review

The Advisory Committee has reviewed the insider trading provisions in the light of experience since their current structure was formulated in 1991. The Committee has identified a number of respects in which those laws could be strengthened and clarified in order better to achieve their objective. The Committee has also identified potentially serious problems that stem from the marked expansion in 2002 of the markets and products to which the insider trading prohibition applies, and puts forward proposals to tailor the prohibition better to the circumstances of those markets.

Rationale for the prohibition

The generally stated rationale for the prohibition of insider trading relates to market fairness and market efficiency. The Parliamentary Committee that in 1989 reviewed earlier insider trading legislation emphasised the need to guarantee investor confidence in the integrity of the securities markets and confirmed the following principles adopted in the 1981 Report of the Committee of Inquiry into the Australian Financial System (the Campbell Committee) as a basis for prohibiting insider trading:

> The object of restrictions on insider trading is to ensure that the securities market operates freely and fairly, with all participants having equal access to relevant information. Investor confidence, and thus the ability of the market to mobilise savings, depends importantly on the prevention of the improper use of confidential information.[1]

The Government's policy view was summarised in the Explanatory Memorandum to the 1991 amendments as being that it was 'necessary to control insider trading to protect investors and make it attractive for them to provide funds to the issuers of securities, for the greater and more efficient development of Australia's resources'.

The elements of market fairness and market efficiency are relatively easy to identify in the context of the public securities exchange market conducted by the Australian Stock Exchange (ASX). There are clear expectations that certain relevant information will be made available to all participants in the ASX market on an equal basis, rather than being used to the trading advantage of individuals who through position or circumstance have access to that information in advance of the market generally. Trading by a party who is aware of information that should ultimately be, but has not yet been, made available to all participants in that market undermines perceptions of the fairness of that market and confidence in its overall integrity.

The public interest in maintaining a fair and informed securities exchange market is also underwritten by the various requirements of the Corporations Act and the ASX Listing Rules for companies to disclose information on a transactional, periodic or continuous basis.

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[1] Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Fair Shares for All: Insider Trading in Australia* (October 1989) para 3.3.6.

The position is less clear where financial products are traded on other financial markets, which may have different expectations about disclosure and therefore what constitutes fairness and efficiency in those markets. For instance, there is generally no expectation or procedure in over-the-counter (OTC) markets for the centralised disclosure or dissemination of material price-sensitive information in the same manner as in the ASX market. Instead, it is generally left to the contracting parties in OTC markets to agree on the level of disclosure.

Likewise, the trading of securities in private companies is generally conducted on the basis of direct negotiation between parties known to each other. While any disparity in the knowledge of relevant information held by contracting parties might be regarded as unfair in a general sense, it does not raise the same fairness concerns as in an anonymous securities exchange market that is held out as providing a platform for trading on an equally informed basis. From a public policy perspective, trading securities in a private company may be more akin to trading goods or non-financial products, where the concept of insider trading generally does not apply.

Discussion Paper

The Advisory Committee published its *Insider Trading Discussion Paper* in June 2001. That Paper set out a framework for general debate, as well as raising specific issues, on the appropriateness of the insider trading provisions for Australian financial markets. It also contained a detailed legal analysis of insider trading laws in overseas jurisdictions. The Paper is available on the CAMAC website **www.camac.gov.au**.

Proposals Paper

The Advisory Committee published its *Insider Trading Proposals Paper* in September 2002. That Paper discussed the implications of the March 2002 amendments to the Corporations Act, which extended the insider trading provisions to a much broader range of financial markets and products. It also presented various policy options on how the provisions should apply to these markets. The Advisory Committee also took the opportunity to outline, and seek any further comments on, its response to the issues in the Discussion Paper and some other matters raised by respondents. The Paper is available on the CAMAC website **www.camac.gov.au**.

This Report responds to all the substantial matters and policy options raised in the Discussion Paper and the Proposals Paper.

Submissions

The Advisory Committee received submissions on its Discussion Paper and Proposals Paper from various respondents, as well as comments from a number of overseas regulators. A list of respondents is set out in Appendix 2 to this Report.

The Advisory Committee thanks all respondents for the very high quality of their submissions and the detailed information that they contained. The responses greatly assisted the Committee in developing and refining its views.

In the interests of brevity, this Report contains only a concise summary of the submissions on each of the issues raised. However, submissions can be obtained on the CAMAC website www.camac.gov.au.

Outline of this Report

Structure

This Report adopts a different chapter order than the Proposals Paper. For instance, the matters discussed in Chapter 1 of the Proposals Paper are now dealt with in Chapter 4 of this Report. However, each of the issues discussed in this Report is cross-referenced to relevant paragraphs in the Discussion Paper and the Proposals Paper. All three documents can therefore be read in conjunction on each particular issue.

The format generally adopted in discussing each of the issues in this Report is as follows:

- a statement of the issue
- a summary of the current law (where appropriate, given that the detailed legal analysis in the Discussion Paper is not repeated in this Report)
- a summary of the submissions
- a statement of the recommendation
- reasons for the recommendation.

The section numbering of the Australian insider trading legislation found in the Discussion Paper was changed under the March 2002 amendments. A comparison of the pre- and post-March 2002 numbering is found in Appendix 1 to the Discussion Paper.

Majority and Minority positions

On some recommendations in this Report, a Majority of the Advisory Committee takes a different position from the Minority of the Advisory Committee.

The Chairman of the Australian Securities and Investments Commission and, in some instances, another member comprise the Minority.

Chapter 1. Matters that should change

In this chapter, the Advisory Committee makes a number of recommendations to strengthen the insider trading legislation and related disclosure requirements and to overcome some apparent anomalies. On two other matters, relating to the definition of generally available information and the exercise of option rights, there is a Majority and Minority position.

Chapter 2. Carve-outs

In this chapter, the Majority recommends carve-outs from the insider trading provisions for various securities issues, buy-backs, individual placements and transactions under non-discretionary trading plans. The Minority opposes these carve-outs.

Chapter 3. Matters that should not change

In this chapter, the Advisory Committee supports retaining the existing law and practice in various areas that it considers are soundly based in principle and appear to be working satisfactorily.

Chapter 4. Application to different financial markets

This chapter deals with the extended application of the insider trading provisions since March 2002 to financial products and financial markets. The Advisory Committee canvasses various options for addressing problems that may flow from this extension.

The Majority supports a proposal to focus the insider trading prohibition on information that the market expects should be disclosed to all participants on an equal basis. In consequence of tightening the ambit of this prohibition, a new simplified test of when information is 'generally available' could be introduced. The Minority considers that the current law should not be changed. Instead, any identified problems should be dealt with by specific defences or carve-outs for particular markets or products.

Recommendations

In this Report, the Advisory Committee makes 38 recommendations. Appendix 1 to this Report contains a list of these recommendations.

Further copies

Further copies of this Report are available on the Advisory Committee's website **www.camac.gov.au**.

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The Advisory Committee

Functions

The Corporations and Markets Advisory Committee is constituted under Part 9 of the *Australian Securities and Investments Commission Act 2001*.

Section 148 of that Act sets out the functions of the Advisory Committee:

> CAMAC's functions are, on its own initiative or when requested by the Minister, to advise the Minister, and to make to the Minister such recommendations as it thinks fit, about any matter connected with:
>
> (a) a proposal to make corporations legislation, or to make amendments of the corporations legislation (other than the excluded provisions); or
>
> (b) the operation or administration of the corporations legislation (other than the excluded provisions); or
>
> (c) law reform in relation to the corporations legislation (other than the excluded provisions); or
>
> (d) companies or a segment of the financial products and financial services industry; or
>
> (e) a proposal for improving the efficiency of the financial markets.

Advisory Committee members

The members of the Advisory Committee are selected by the Minister in their personal capacity from throughout Australia on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The members of the Advisory Committee are:

- Richard St John (Convenor)
- Elizabeth Boros—Professor of Law, Monash University, Melbourne
- Barbara Bradshaw—Chief Executive Officer, Law Society Northern Territory, Darwin
- Philip Brown—Emeritus Professor, University of Western Australia, Perth
- Berna Collier—Commissioner, Australian Securities and Investments Commission (alternate to David Knott)
- Susan Doyle—Chairman, PSS and CSS Boards, Canberra (until October 2003)
- Greg Hancock—Managing Director, Hancock Corporate & Investment Services Pty Ltd, Perth
- Merran Kelsall—Company Director, Melbourne

- David Knott—Chairman, Australian Securities and Investments Commission
- John Maslen—Chief Financial Officer and Company Secretary, Michell Australia Pty Ltd, Adelaide
- Louise McBride—formerly Partner, Deloitte Touche Tohmatsu, Sydney
- Marian Micalizzi—Chartered Accountant, Brisbane
- Ian Ramsay—Professor of Law, University of Melbourne
- Robert Seidler—Partner, The Seidler Law Firm, Sydney
- Nerolie Withnall—Consultant, Minter Ellison, Brisbane.

Legal Committee members

In preparing this Report, the Advisory Committee has been assisted by the legal analysis and advice it has requested from its Legal Committee. The members of the Legal Committee are selected by the Minister in their personal capacity from throughout Australia on the basis of their expertise and experience in corporate law.

The members involved in the insider trading review are:

- Nerolie Withnall (Convenor)—Consultant, Minter Ellison, Brisbane
- Elspeth Arnold—Partner, Blake Dawson Waldron, Melbourne
- Elizabeth Boros—Professor of Law, Monash University, Melbourne
- Suzanne Corcoran—Professor of Law, Flinders University, Adelaide, and Professorial Fellow, Australian National University, Canberra
- Damian Egan—Partner, Murdoch Clarke, Hobart
- Brett Heading—Partner, McCullough Robertson, Brisbane
- Francis Landels—Chief Legal Counsel, Wesfarmers Ltd, Perth
- Laurie Shervington—Partner, Minter Ellison, Perth
- Anne Trimmer—Partner, Minter Ellison, Canberra
- Gary Watts—Partner, Fisher Jeffries, Adelaide.

The members subsequently appointed are:

- Ashley Black—Partner, Mallesons Stephen Jacques, Sydney
- Jennifer Hill—Professor of Law, University of Sydney
- Duncan Maclean—Partner, Cridlands Lawyers, Darwin.

Executive

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Thaumani Parrino—Executive Assistant.

1 Matters that should change

1.1 Overview

Clear and effective insider trading laws and appropriate obligations to make information generally available are necessary to protect and guide Australian financial markets. Insider trading may undermine confidence in the fairness of a market and therefore its broader economic function. Also, unclear insider trading laws can result in reduced compliance as well as unproductive uncertainty for market participants. These laws need to be strong and fully enforceable without at the same time impeding or discouraging legitimate market activity.

The Advisory Committee recommends that the legislation be strengthened by:

- enhancing the provisions requiring directors to notify trading in securities of their companies or any related companies and extending that disclosure requirement to senior executives
- restricting the on-selling exemption for underwriters
- repealing the exemption for external administrators
- clarifying that the relevant time for determining liability when trading takes place through an intermediary is when the informed person instructs the intermediary to undertake the transaction
- permitting courts to extend the range of civil claimants beyond the insider's immediate counterparty.

The Committee also recommends legislative changes to overcome apparent anomalies in the current law by:

- extending the Chinese Walls defence to procuring
- extending the equal information defence to civil proceedings
- extending the 'own intentions' defence to anyone trading on behalf of a takeover bid consortium
- protecting uninformed procured persons from civil liability where the procurer receives no direct or indirect benefit.

A majority of the Advisory Committee also recommends:

- replacing the test of generally available information
- permitting the exercise of physical delivery option rights.

1.2 Strengthen the reporting requirements for directors

[Discussion Paper paras 4.1–4.12, Proposals Paper paras 3.3–3.7]

1.2.1 The issue

Are the current requirements under s 205G for directors to notify the ASX of any changes in the relevant interests they hold in securities of their companies, or any related companies, satisfactory?

1.2.2 Advisory Committee view in the Discussion Paper

The Advisory Committee considered that the market has a legitimate interest in being promptly informed of transactions by directors and senior executives of listed companies in their company's securities. One benefit of such disclosure is that it reduces the opportunity for any particular director to engage in insider trading in those securities without detection. However, the current statutory disclosure obligations require strengthening. The Committee put forward a series of proposals in the Discussion Paper to achieve this objective.

1.2.3 Submissions

The submissions generally recognised that the current s 205G does not ensure that the market is sufficiently and promptly informed about directors' transactions in their own companies. Various respondents favoured strengthening the provision to require more comprehensive and expeditious disclosure.

Recommendation 1

Section 205G should be amended as follows:

- the provision should apply to all listed entities. However, exempt foreign entities should be taken to have complied with the provision if the directors of those foreign entities have complied with the disclosure requirements of their incorporating jurisdiction
- the disclosure obligation should 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
- 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
- where a director or senior executive has resigned from that position, the disclosure obligation should cover any relevant transactions that occurred before that resignation and within one month thereafter
- with off-market transactions, a copy of the contract should also be disclosed
- the obligation should be to disclose the closest approximate number of securities whenever it is not reasonably possible to know the exact number

- 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 information to be disclosed under this provision should not include changes that have arisen from transactions that have applied equally to all shareholders, and without individual shareholder election, such as capital reconstructions or bonus issues. These pari passu changes should only be subject to any applicable periodic or annual disclosure obligations.

The Committee does not support a materiality threshold that would permit senior executives to deal in small quantities without disclosure.

1.2.4 Reasons

Complete and prompt disclosure by directors and senior executives of their trading in their company's securities is material to a fully informed securities market. It also constrains insider trading by persons who are the most likely to have access to price-sensitive confidential information about their companies. Prompt reporting is not unreasonable, given the potential sensitivity of this trading information for that market.

While the Advisory Committee supports the disclosure obligation extending to senior executives, it has not attempted to define the concept of 'senior executive' in the limited context of s 205G. It would be preferable to develop this concept for general application in the Corporations Act.[2]

In relation to reducing the disclosure period to two business days, the Advisory Committee notes that the US Public Company Accounting Reform and Investor Protection Act 2002 (the Sarbanes-Oxley Act) reduces the mandatory period for senior executives and principal shareholders of US public companies to disclose changes in ownership of their company's securities to two business days after the changes occurred. A two business day disclosure period is also consistent with the substantial shareholding requirements in Chapter 6C of the Corporations Act.

1.3 Restrict the on-selling exemption for underwriters

[Discussion Paper paras 2.159–2.166, Proposals Paper paras 3.34–3.37]

1.3.1 The issue

Should the current exemption permitting an underwriter to on-sell to uninformed counterparties securities or managed investment products taken up under an underwriting agreement be retained?

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2 The HIH Royal Commission Report, *The failure of HIH Insurance* Vol I (April 2003) paras 6.4.1–6.4.4, analysed some difficulties with the definitions of 'executive officer' and 'officer' in consequence of the March 2000 amendments to the Corporations Act. The Report of the Australian Law Reform Commission, *Principled Regulation: Federal Civil & Administrative Penalties in Australia* (ALRC 95, December 2002) Recommendation 8-1 proposes various tests for determining when an individual is concerned in or takes part in the management of a corporation.

1.3.2 Submissions

Some submissions supported confining the on-selling exemption to sales to other underwriters/sub-underwriters. Other respondents argued that to confine the exemption in any way may increase underwriting risk and underwriting fees and reduce the availability of underwriters.

> **Recommendation 2**
>
> The exemption permitting the on-selling of securities and managed investment products under an underwriting agreement should be confined to sales to other underwriters/sub-underwriters.

1.3.3 Reasons

Underwriters and sub-underwriters can negotiate disclosure terms between themselves. In all other circumstances, an uninformed counterparty should continue to have the protection of the insider trading provisions. The theoretical possibility of increased underwriting costs if the on-selling exemption is confined in the manner recommended does not justify continuing to give underwriters a trading advantage over all other market participants.

1.4 Repeal the exemption for external administrators

[Discussion Paper paras 2.167–2.171, Proposals Paper paras 3.38–3.41]

1.4.1 The issue

Should the current exemption from the insider trading provisions for trading by some classes of external administrators in the exercise of their official powers be extended or repealed?

1.4.2 Submissions

The submissions were divided. Some submissions supported the current statutory exemption, and its extension to other external administrators, arguing that these persons do not make any personal gain from such transactions and that being subject to the insider trading provisions may impede their administration tasks. Other submissions argued that the interests of an external administrator, or the beneficiaries of the administration, should not prevail over those of other market participants.

> **Recommendation 3**
>
> There should be no exemption for any class of external administrators.

1.4.3 Reasons

The rationale for the current exemption for liquidators, personal representatives of deceased persons and trustees in bankruptcy is not readily apparent. The exemption can be seen as contrary to the principles of market fairness and market efficiency, even

though these persons would not normally gain personally from securities trading while holding inside information. Similarly, it is questionable whether administrators, scheme managers or receivers and managers should have any equivalent exemption.

An external administrator who is aware of inside information could choose to disclose that information, either generally or to the counterparty, before transacting or, alternatively, seek a court direction, for instance under s 424 or s 447D, to sell affected financial products.

1.5 Clarify the relevant time for liability when trading through an intermediary

[Discussion Paper paras 2.172–2.182, Proposals Paper paras 3.42–3.46]

1.5.1 The issue

Persons may have inside information at the time, or after, they instruct a broker or other professional intermediary to deal on their behalf. At what point does liability arise?

1.5.2 Policy options

There are at least three options for determining the time when persons with inside information who deal through an intermediary incur liability:

- *when the client instructs an intermediary.* A client would be liable if at this time the information known to that person was inside information. Conversely, a client who at that time was not aware of inside information would not breach the legislation, even where the client became aware of any inside information before the intermediary had fully carried out the instructions

- *when an offer is made on a financial market.* A client who received inside information in the period between instructing the intermediary and the offer being placed would be obliged to take all reasonable steps to withdraw the offer to avoid breaching the legislation. This would reflect the pre-1991 provision, which provided that an insider 'shall not deal in relevant securities', with the term 'deal' including making an offer

- *when the offer is accepted by another market trader.* This would reflect the decision in the *Mt Kersey* case [*Discussion Paper para 2.175*]. In consequence, a client who received inside information in the period between instructing the intermediary and the offer being accepted by the counterparty would be obliged to take all reasonable steps to withdraw the offer to avoid breaching the legislation.

1.5.3 Submissions

The submissions were divided on which of the three options to adopt. Those supporting the first or second option argued that instructing an intermediary to trade by, for instance, placing an offer on SEATS may in itself lead to market distortion and pose a risk to market integrity. Submissions that supported the third option argued that liability should not arise until a transaction has taken place, notwithstanding that this option would require a person who becomes informed only after giving instructions to the intermediary to take all reasonable steps to countermand the instructions.

Recommendation 4

The legislation should clarify that an informed person cannot be liable for insider trading when acting through a professional intermediary unless a transaction takes place.

That being so, the relevant time for determining when that person will be taken to 'enter into an agreement' to deal in Division 3 financial products under s 1043A(1) and (2) should be when the person instructs the intermediary.

1.5.4 Reasons

To avoid any uncertainty for market participants, the legislation should clearly identify a definite time for determining liability where trading takes place through an intermediary.

There are possible merits in each of the three options outlined above. However, the Advisory Committee considers that the first option is the most appropriate, provided that the legislation also stipulates that no liability will arise unless there has been a subsequent transaction. In this context, the client, by giving the instructions, was intending to trade with inside information.

Adopting the first option would also overcome practical problems, particularly in the third policy option, which would require persons who are unaware of inside information at the time they instruct their intermediaries to take all reasonable steps to countermand any unexecuted instructions if they later obtain inside information.

1.6 Extend the Chinese Walls defence to procuring

[Discussion Paper paras 2.190–2.195, Proposals Paper paras 3.58–3.62]

1.6.1 The issue

Should persons who satisfy the Chinese Walls defence (ss 1043F, 1043G, 1043K) be protected against the offence of procuring, as well as trading? The current Chinese Walls statutory defences do not apply to the prohibited conduct of procuring another person to deal in a regulated financial product.

1.6.2 Submissions

All the submissions on this matter supported an amendment to remove the procuring anomaly. The ASX proposed that the statutory Chinese Walls defences be amended to require that intermediaries 'establish, maintain and enforce policies and procedures' for effective Chinese Walls.

Recommendation 5

The Chinese Walls defence should cover the procuring offence.

1.6.3 Reasons

The current law is clearly the result of a legislative oversight and should be remedied. The ASX proposal could be further considered in the context of any future review of the Chinese Walls defence.

1.7 Permit bid consortium members to acquire for the consortium

[Discussion Paper paras 2.209–2.111, Proposals Paper paras 3.63–3.65]

1.7.1 The issues

Should the 'own intentions' exemption in ss 1043H–1043J cover a person in a takeover bid consortium who acquires on behalf of that consortium, but not through the intended bid entity, in the period before the market is aware of the consortium's bid intention? Currently, this exemption only applies to the entity that subsequently conducts the takeover bid. Also, should individual members of the bid consortium be permitted to acquire on their own behalf with the consent of other consortium members?

1.7.2 Submissions

Most submissions that commented on this issue supported any insider trading exemption applying only to pre-takeover bid announcement purchases on behalf of the bid consortium collectively. Individual consortium members should not otherwise have an exemption. A contrary view was that, as market fairness and efficiency are not impaired by a consortium buying ahead of its bid, it is difficult to see how these principles would be impaired by individual consortium members buying on their own behalf.

Recommendation 6

The 'own intentions' exemption should be amended to make clear that members of a prospective bid consortium can acquire on behalf of that consortium prior to the market becoming aware of the intended bid. However, these persons should not be entitled to trade on their own behalf before the market becomes aware of the bid, even with the consent of other bid consortium members.

1.7.3 Reasons

Allowing bid consortium members to acquire on behalf of the consortium before the market becomes aware of the bid is consistent with the policy of the current exemption, namely to promote takeover bids, which may benefit all shareholders. However, bid consortium members who trade on their own behalf before the market is aware of the takeover bid are not furthering the bid, and therefore should not have any comparable exemption.

1.8 Protect uninformed procured persons from civil liability

[Discussion Paper paras 3.13–3.17, Proposals Paper paras 3.66–3.69]

1.8.1 The issue

Under the current insider trading law, uninformed persons who are procured by insiders to trade may be required to return any profit made or loss avoided in their transactions. Should they be exempt from this obligation and, if so, in all or only in some circumstances, for instance if the insider did not benefit directly or indirectly?

1.8.2 Submissions

Most submissions supported an exemption, provided that the insider did not directly or indirectly benefit. However, the submissions differed on how to establish lack of any benefit to the procurer.

Recommendation 7

An uninformed procured person should not be required to return any profit made or loss avoided by that person from a transaction if that person establishes that the insider who procured that person did not receive any direct or indirect benefit from that transaction.

1.8.3 Reasons

The insider trading civil recovery regime should not apply to an uninformed trader, where the informed procurer receives no direct or indirect benefit.

The legal onus should be on the procured person to show, on the balance of probabilities, that the insider did not gain, directly or indirectly, from that transaction. It could be unduly difficult for a plaintiff to establish that the insider has received some direct or indirect benefit.

The Committee does not support the proposal in one submission that the requirement to return the profit made or loss avoided also apply where a benefit to the insider was intended, but did not eventuate. This would unduly complicate the legislation for little benefit.

1.9 Extend the equal information defence to civil proceedings

[Discussion Paper paras 3.18–3.23, Proposals Paper paras 3.70–3.73]

1.9.1 The issue

Should the equal information defence that currently applies in criminal proceedings also apply in civil proceedings?

1.9.2 Submissions

All submissions that commented on this matter supported the equal information defence being available in civil as well as criminal proceedings.

Recommendation 8

The insider trading legislation should provide an equal information defence in civil proceedings similar to the defence that applies in criminal proceedings, namely that the counterparty to the transaction 'knew or ought reasonably to have known' of the inside information.

1.9.3 Reasons

The principle of equal information being a defence is as valid for civil as for criminal proceedings. It is also inappropriate that an informed counterparty could have a statutory civil remedy.

The Committee has considered the implications of Recommendation 8 in a case where a board of directors, with, say, positive confidential information about their company, authorises the issue of their company's options to a director, priced according to the current exchange-quoted price. This price does not take into account the as-yet-unpublished positive information. Those transactions would not constitute insider trading, given the equal information defence (as the knowledge of the board of directors is also the knowledge of the issuing company). However, the directors may be breaching their fiduciary obligations to act in the best interests of the company, given their knowledge that the options were being issued by the company at an undervalue.

1.10 Permit courts to extend the range of civil claimants

[Discussion Paper paras 3.24–3.41, Proposals Paper paras 3.74–3.77]

1.10.1 The issue

Who should be entitled to seek compensation for insider trading? Some jurisdictions provide compensation for 'contemporaneous traders' in an anonymous market, being persons who traded on the opposite side of that market at or about the time the insider traded in that market, whether or not their orders were matched with those of the insider.

1.10.2 Submissions

Some submissions supported contemporaneous market traders having a right of compensation, thereby overcoming the problem of random matching of buy and sell orders on an anonymous market. However, some other respondents argued that including contemporaneous traders could unduly complicate the determination of who were eligible civil claimants and result in claimants obtaining insignificant damages, depending on the number of eligible persons involved.

Recommendation 9

The legislation should enable a court to extend the range of civil claimants who have traded in the market beyond the insider's immediate market counterparty, using the concept of 'aggrieved persons'.

1.10.3 Reasons

The courts can determine when it is appropriate to extend the range of eligible civil claimants beyond the immediate market counterparty of an insider who is trading in an anonymous exchange market. To amend the legislation to include specific categories of 'contemporaneous traders' may unduly complicate the law and may still result in artificial or anomalous outcomes in some instances.

Permitting the courts to extend the range of eligible civil claimants is not inconsistent with providing an equal information defence in civil proceedings (as put forward in Recommendation 8). That defence applies when there is an identified counterparty. Recommendation 9 covers the case where an insider is trading on an anonymous market and the matching of any particular counterparty is purely arbitrary.

1.11 Amend the test of generally available information

[Discussion Paper paras 2.1–2.50, Proposals Paper paras 3.8–3.24]

1.11.1 The issue

One of the elements of insider trading is that the information not be generally available. Currently, information is generally available, and therefore holders of that information can lawfully trade, if it is either published information or a readily observable matter. Should these tests be reformulated?

1.11.2 Current law

Published information

This Report adopts the term 'published information' for information that comes within the current s 1042C(1)(b)(i), namely information that 'has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in Division 3 financial products of a kind whose price might be affected by the information'.

As explained in paras 2.4–2.6 of the Discussion Paper, the published information test applies differently to:

- *uninformed persons*, that is, persons who become aware of the information solely as a result of the information having been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in relevant Division 3 financial products (s 1043M(2)(a)), and
- *informed persons*, that is, persons who become aware of the information earlier, or through a different means, than uninformed persons.

Uninformed persons can trade as soon as they become aware of any published information. No dissemination period is required.

Informed persons can trade on published information only after a reasonable period has elapsed for that information to be disseminated to investors generally.

Interpreting the test. There is no case law on the published information test. In theory, it could be interpreted in either of two ways:

- *the broad interpretation:* published information covers all information that would or would be likely to be brought to the attention of investors generally, even where this still requires one or more further steps, provided that those steps are reasonably likely to occur
- *the narrow interpretation:* published information is confined to all information that would or would be likely to come into the public domain without the need for any further steps.

The latter test is more consistent with the apparent intention of the provision.

Readily observable matter

The legislation does not define a 'readily observable matter'.

1.11.3 Submissions

Most of the submissions acknowledged that these tests should be clarified, particularly in light of a number of recent judicial decisions. However, views differed on whether the readily observable matter test should be retained and, if so, the appropriate criteria for that test.

Two of the respondents, the Australian Securities and Investments Commission (the first approach) and the Law Council of Australia (the second approach), differed on how to apply the three elements of the readily observable matter test raised in the Discussion Paper, namely:

- observable to whom
- how observable, and
- where observable.

Their approaches also differed on whether the readily observable matter test should require a dissemination period.

Observable to whom. On the first approach, the matter must be observable by a cross-section of investors. On the second approach, it would suffice if the matter either is disclosed in a public area or can be observed by the public without infringing rights of privacy, property or confidentiality.

How observable. On the first approach, the matter must be readily observable without resort to technical assistance beyond that likely to be used by a cross-section of investors. For instance, information on the Internet would satisfy the test, but not information visible only through an electron microscope. On the second approach, a matter is readily observable even if other users of the market cannot obtain it because

of limitations on their resources, expertise or competence or it is only available on payment of a fee.

Where observable. On the first approach, the matter would have to be observable at least by investors in Australia. On the second approach, a matter is readily observable even if it is only available overseas.

Dissemination period. On the first approach, a readily observable matter must have been readily observable for a reasonable period to allow dissemination. On the second approach, there should be no change to the current law, which permits persons to trade immediately when they become aware of a readily observable matter.

Recommendation 10

The Majority has elsewhere put forward a Proposal (Recommendation 38), part of which involves replacing the current published information and readily observable matter tests with a new test of when information is generally available.

The Minority opposes the Proposal and considers that the current published information and readily observable matter tests of when information is generally available should remain, subject to changes to the latter test.

1.11.4 Majority reasons

The elements of the recommended new test of when information is generally available, and how that test forms part of the Majority Proposal in Recommendation 38, are further discussed in Chapter 4. Set out below are the reasons for departing from the current published information and readily observable matter tests of when information is generally available.

Published information

The published information test can create considerable uncertainty about when persons may lawfully trade. It applies only to information that 'has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest' in the relevant financial products. When, or how, information can be 'made known' in that manner can be difficult to determine in particular instances. Also, it is unclear how many investors are contemplated in the expression 'persons who commonly invest'. Does it require that a cross-section of investors be informed? Would it suffice if the information was known to a particular group of investors, such as a group of brokers, persons working on a confidential planned takeover bid or subscribers to a research newsletter?

Informed persons who have this information cannot trade until after 'a reasonable period for it to be disseminated amongst such persons has elapsed'. Views may reasonably differ on how long that period would be in different contexts.

Uninformed persons may trade immediately. However, this may give an undue advantage to people who are involved in the very early stages of the publication process and could trade before the market has a realistic opportunity to learn of the information. This may be contrary to the concept of market fairness that underlies the insider trading provisions.

Readily observable matter

The reason given in the Explanatory Memorandum to the 1991 amendments for introducing the readily observable matter test was to overcome the perceived difficulties and limitations of the published information test. However, the ambit of the readily observable matter test is even more uncertain. Under the current law, as reflected in *R v Firns* (2001) 38 ACSR 223 (see further Discussion Paper paras 2.14–2.24), the test has the potential to cover information that could not, on any reasonable view, be described as being generally available to persons who commonly invest in relevant financial products. The two approaches put forward in submissions could either greatly narrow or indefinitely widen the readily observable matter test, without in either case necessarily creating any greater precision in how that test would apply in particular instances.

One possible alternative to the current law would be to retain the readily observable matter test, but exclude certain persons, say corporate directors and other senior officers, from relying on it. In effect, this would remove the right of these corporate officers to rely on the precedent of *R v Firns*. However, this approach could itself create anomalies or avenues for avoidance. An example might be a corporate insider who discloses a 'readily observable matter' to an outsider, who in turn discloses that to a third party, who trades. Should the liability of the third party depend on whether this person knows from whom the information originally came? If so, the recipient of such information would have a strong incentive not to ascertain its source before trading. If not, how could anyone who is informed of a readily observable matter ever be sure when they could lawfully trade?

1.11.5 Minority reasons

The Minority notes that the proposed repeal of the readily observable matter test is contingent and dependent upon the introduction of the Proposal, as discussed in Chapter 4. The Minority opposes the Proposal and would prefer the current tests of when information is generally available to be retained, subject to modifying the readily observable matter test so that the matter must be observable:

- by a cross-section of Australian investors
- without resort to technical assistance beyond that likely to be used by a cross-section of those investors, and
- for a reasonable period of time.

1.12 Permit the exercise of physical delivery option rights

[Discussion Paper paras 2.117–2.132, Proposals Paper paras 3.47–3.57]

1.12.1 The issues

There are two related issues.

- *Informed party exercising option rights.* Persons may, when they are not aware of inside information, lawfully enter into option contracts under which they may buy (call options) or sell (put options) particular securities within, or at the end of, a

specified period for a fixed price. Should they be permitted to exercise their physical delivery call or put rights (against the counterparty or the clearing house) if at the time of exercising those rights they hold relevant inside information?

- *Uninformed party requiring the exercise of option rights.* Should an uninformed counterparty to a person who has become aware of inside information in the period following entry into the option contract be permitted to require the informed person to satisfy that contract by physical delivery (that is, by purchasing or selling securities)?

1.12.2 Current law

The current insider trading provisions prohibit exercise of physical delivery option rights in both situations. However, informed persons may still lawfully cash-settle options (where the options provide for this alternative) instead of taking, or being required to make, physical delivery, as the insider trading provisions only cover acquisitions and disposals of financial products.

1.12.3 Submissions

Informed party exercising option rights

Some respondents acknowledged that to permit informed persons to exercise their option rights may give them an advantage over uninformed persons with the same rights. However, the insider trading provisions should not seek to deal with this advantage, given that the informed person only obtained the material price-sensitive information after entry into the fixed exercise price option contract. Also, in some instances, informed persons may have a fiduciary duty not to publicly release the inside information at the time they must choose whether to exercise or forgo their option rights.

Another respondent proposed that option holders be prohibited from exercising particular option rights unless, say, five days' advance notice of the exercise was given.

Uninformed party requiring the exercise of option rights

All respondents that commented on this issue supported uninformed counterparties being able to exercise their physical delivery option rights.

Recommendation 11

The Majority considers that persons who, in good faith, enter into fixed exercise price physical delivery option contracts when they are not aware of inside information should be entitled to exercise their physical delivery rights, even where they hold inside information at the time of exercise.

The Minority does not support this exemption.

1.12.4 Majority reasons

Option holders should be entitled to the benefit of rights for which they contracted in good faith and before they became informed persons. Any trading advantage they may have over uninformed market participants does not justify the imposition of the insider trading provisions, for the reasons set out in the submissions. Also, the current prohibition could act as an undue disincentive for some people to participate in the options market.

The requirement that the exercise price be fixed at the time of entry into the option contract removes any incentive for the option holder to withhold material price-sensitive information from the market.

The Majority has considered whether the recommendation could create opportunities for abuse where directors or other corporate officers receive from their employer company free or low-cost fixed exercise price physical delivery options over the company's own securities (often as part of a remuneration package). Informed executives who exercise their option rights against the company under these private arrangements do not breach the current insider trading legislation where the relevant information is also known to the company that issued the options, given the equal information defence. Recommendation 11 does not change this outcome.

The Majority does not support requiring option holders generally, or any limited classes, such as directors and senior officers, to notify the market before exercising their physical delivery option rights over any of their company's securities. This advance information may be of interest to other market participants, but could be misleading, as the market may incorrectly guess the reasons for the foreshadowed exercise of the options. Rather, directors and senior officers will be required promptly to disclose their trading under the disclosure obligations in s 205G (see Recommendation 1, supra).

Recommendation 12

Uninformed parties to any option contracts, whether or not fixed price, should be entitled to require their informed counterparties (that is, anyone who holds inside information at the time of exercise) to honour their physical delivery obligations.

1.12.5 Reasons

Uninformed persons should not be prevented from exercising their physical delivery option rights because the counterparty holds inside information. To do so could unduly prejudice their legitimate contractual rights.

2 Carve-outs

2.1 Overview

The Advisory Committee Majority recommends that the insider trading provisions not apply to:

(a) a company making a general securities issue or conducting a share buy-back where the company is subject to a statutory disclosure regime for that issue or buy-back

(b) issuers making placements to wholesale investors and any placees in an individual placement

(c) transactions under non-discretionary trading plans where particular prerequisites to protect against possible abuse have been satisfied.

The effect of (a) and (b) would be to return the insider trading legislation to the generally understood pre-March 2002 position in relation to issues, buy-backs and placements. The purpose of (c) is to allow corporate directors and other officers legitimately to plan for their future dealings in their companies' securities.

The Minority does not support any of these proposed carve-outs from the insider trading legislation.

2.2 Entity making a general securities issue

[Discussion Paper paras 2.99–2.106, Proposals Paper paras 2.2–2.9]

2.2.1 The issue

Should entities making a general securities issue and/or offerees under those issues remain subject to the insider trading provisions?

2.2.2 Current disclosure laws

An entity that intends to make a 'general issue' (being either an offer of new securities to the market generally or an offer to its existing securities holders under a rights issue) is subject to the fundraising disclosure obligations in Chapter 6D of the Corporations Act, as well as the continuous disclosure obligations for disclosing entities. For instance, a prospectus must contain all information that investors and their professional advisers would reasonably require to make an informed assessment of the matters identified in the legislation. This information includes the assets and liabilities, financial position and performance, profits and losses and prospects of the issuer.

There is a range of criminal and civil liabilities under Part 6D.3 for breach of the fundraising provisions, including for any misstatements in, or omissions from, the

disclosure document. Also, action may be taken against the issuer under s 1041E for any false or misleading statements likely to induce persons to subscribe for securities.

2.2.3 Current insider trading law

Issuers

In consequence of amendments to the Corporations Act in March 2002 (ss 761E and 1043A(1)(c)), the insider trading provisions apply to issuers of new securities, including under a general issue. These amendments override the earlier decisions in *Hooker Investments Pty Ltd v Baring Bros (No 2)* (1986) 10 ACLR 524 and *Exicom Pty Ltd v Futuris Corporation Ltd* (1995) 18 ACSR 404, that the insider trading provisions do not apply to an issuer of new securities.

Offerees

The insider trading prohibition applies to any offeree who is aware of inside information affecting the value of the relevant financial products that is not known to the issuer (for instance, an offeree who is aware of a third party's confidential premium-priced pending takeover bid for the issuer).

2.2.4 Submissions

Some respondents argued that the insider trading provisions should continue to apply to issuers, to complement the statutory fundraising disclosure obligations and ensure that potential investors are fully informed. Their view was that the insider trading rules would pose no barrier to a securities issue where the issuer has fully complied with the statutory fundraising disclosure obligations.

Other submissions argued for excluding the insider trading regime. The current prospectus and other disclosure requirements for securities issues cover the same conduct as insider trading. These disclosure laws should deal comprehensively with this conduct, without the insider trading provisions having to supplement them or fill any perceived gaps. If necessary, the criminal and civil penalties and remedies under Part 6D.3 of the Corporations Act should be adjusted to take into account that the insider trading provisions no longer apply.

Recommendation 13

Issuers

The Majority considers that issuers making a general issue should not be subject to the insider trading provisions.

The Minority does not support this exemption.

Offerees

The Advisory Committee considers that offerees who subscribe for new issues when aware of inside information not known to the issuer should remain subject to the insider trading provisions.

2.2.5 Reasons

Issuers: majority reasons

Companies making general issues are subject to the prospectus and other disclosure requirements in Chapter 6D of the Corporations Act. These provisions are specifically designed to ensure that prospective investors are fully informed, with civil and criminal consequences for persons involved in preparing disclosure documents if material price-sensitive information is not included. Excluding issuers from the additional insider trading regime overcomes regulatory duplication without weakening these important investor protection disclosure requirements and remedies.

Prior to March 2002, the general understanding was that the insider trading provisions did not also apply to general issues. This did not appear to result in any abuse. However, the March 2002 amendments, which applied the insider trading provisions to these issues, could unduly increase the cost of corporate compliance without providing any additional protection for investors. Also, any monetary penalty imposed on an issuer for insider trading would reduce its assets, to the detriment of its innocent shareholders.

Overseas jurisdictions reviewed in the Discussion Paper do not generally apply their insider trading laws to issuers. For instance, the categories of persons who can be insiders under the UK, German and South African laws do not include corporate issuers. The fiduciary duty principle underlying US insider trading law could in theory extend those laws to issuers, though an alternative, and more likely, course would be to prosecute an issuer for providing materially misleading or incomplete information to offerees. Thus, excluding issuers from the insider trading regime would not result in Australian insider trading law being out of step with overseas regulation or expectations.

Offerees

The insider trading provisions should continue to apply to informed offerees, as they are not subject to the same disclosure regime, with its criminal sanctions and civil remedies, as issuers.

2.3 Entity making an individual securities placement

[Discussion Paper paras 2.99–2.106, Proposals Paper paras 2.10–2.19]

2.3.1 The issue

Should an entity offering its new securities to individual investors and/or the placees remain subject to the insider trading provisions?

2.3.2 Current disclosure laws

An entity making an offer of its new securities must comply with the fundraising disclosure requirements in Chapter 6D of the Corporations Act, except for small scale offerings (up to 20 investors for no more than $2 million, in any 12 month period) or offers to various categories of wholesale investors, being sophisticated investors (s 708(8)), experienced clients of licensed dealers (s 708(10)) or professional investors (s 708(11).

2.3.3 Current insider trading law

Issuers

In consequence of amendments to the Corporations Act in March 2002 (ss 761E and 1043A(1)(c)), the insider trading provisions apply to issuers of new securities, including under a private placement. These amendments override the decision in *Exicom Pty Ltd v Futuris Corporation Ltd* (1995) 18 ACSR 404, and the earlier case law on which it relied, to the effect that the insider trading provisions do not apply to an issuer of new securities.

Placees

The insider trading provisions apply to any placee who has material price-sensitive information unknown to the issuer. An example would be a placee who is aware of a premium-priced confidential takeover bid being planned for, but unknown to, the issuing company.

2.3.4 Submissions

Some respondents argued that an issuer acting in good faith could nevertheless have difficulty in making individual placements without breaching the insider trading provisions. An example might be an issuer who is involved in confidential contractual negotiations that, if successful, will boost the value of its securities. These negotiations may be prejudiced by any advance disclosure to prospective placees, notwithstanding that the placees would benefit if they take up the securities and the negotiations are subsequently successful.

Rather, the regulation of individual placements could be left to:

- the continuous disclosure requirements for disclosing entities
- the contractual disclosure requirements negotiated between the issuing entity and the placee (covering, for instance, any matters falling within the continuous disclosure carve-outs)
- Part 7.10 Div 2 of the Corporations Act, which, inter alia, prohibits any false or misleading statements likely to induce persons to subscribe for securities and any misleading or deceptive conduct.

Other submissions argued that the insider trading provisions should continue to apply to private placements. They would complement the disclosure requirements and make up for any deficiencies in them. In consequence of continuing to apply the insider trading law, an issuer would have to make full disclosure to the placee of material price-sensitive information that is not generally available, even though the general fundraising disclosure requirements do not apply.

Recommendation 14

The Majority considers that neither issuers making placements to wholesale investors, nor any placees in an individual placement, should be subject to the insider trading provisions.

The Minority considers that the insider trading provisions should continue to apply to all issuers and placees.

2.3.5 Majority reasons

Wholesale investors who are offered placements by a public listed company can supplement information that has been made available under the continuous disclosure requirements by negotiating additional disclosure requirements with the issuer. Likewise, the issuer under any placement, be it to a wholesale investor or under a small-scale offering, can require the placee to disclose any material price-sensitive information affecting the placement not known to the issuer. Also, there are statutory prohibitions on making false or misleading statements to counterparties.

Prior to March 2002, the general understanding was that the insider trading provisions did not apply to new issues of securities, either by way of general issues or individual placements. This did not appear to result in any abuse, or generate calls for further protection for wholesale investors taking up individual placements.

Overseas jurisdictions reviewed in the Discussion Paper do not generally apply their insider trading laws to issuers making private placements. For instance, the UK legislation only applies to transactions that occur on a regulated market or where the person dealing is or relies on a professional intermediary. The categories of persons who can be insiders under the German and South African laws do not include corporate issuers making placements. Thus, excluding issuers making individual placements to wholesale investors (be they Australian or overseas investors) from the insider trading regime would not result in Australian insider trading law being out of step with overseas regulation or expectations.

2.4 Share buy-backs

[Discussion Paper paras 2.107–2.116, Proposals Paper paras 2.20–2.27]

2.4.1 The issue

Should companies making share buy-back offers and/or offerees remain subject to the insider trading provisions?

2.4.2 The current buy-back law

On-market and off-market share buy-backs are regulated under Part 2J.1 Div 2 of the Corporations Act. An entity that wishes to make a buy-back offer, other than some offers of up to 10% of the company's shares in a 12 month period, must obtain the prior approval of shareholders, based on full disclosure to them of all information known to the company that is material to the decision whether to accept the offer, including information within the continuous disclosure carve-outs. There are criminal and civil liabilities for breach. ASX Listing Rule 3.8A (and Appendix 3C to that Listing Rule) also imposes disclosure obligations on companies making on-market buy-back offers.

2.4.3 Current insider trading law

Buying back entities

Exicom Pty Ltd v Futuris Corporation Ltd (1995) 18 ACSR 404 has been treated as authority for the proposition that entities that buy back their own securities are not subject to the insider trading provisions, as a company cannot be an insider in relation to its own securities (though this case dealt with a placement, not a buy-back, some of the reasoning in the case is questionable and the case is clearly overridden in relation to issues of securities).

The Corporations Act s 1043B exempts buy-backs by registered managed investment schemes from the insider trading provisions, provided the buy-back price is calculated pursuant to the scheme constitution and by reference to the underlying value of the scheme assets.

Offerees

The insider trading prohibition applies to any offeree who is aware of material price-sensitive information affecting the value of the shares that is unknown to the buying back entity (for instance, a shareholder, but not the company, is aware of a still-confidential technological development by a competitor that, once introduced, will significantly threaten the company's market share).

2.4.4 Submissions

A number of respondents argued that the insider trading provisions should not apply to share buy-backs, given the continuous disclosure requirements and the obligation of buying-back entities to disclose material information to shareholders under Corporations Act Part 2J.1 Div 2. Any perceived shortcomings in the statutory buy-back disclosure requirements, or the penalties for breach, should be remedied by appropriate reform of those provisions, without having to rely on the insider trading laws to make up for any identified deficiencies.

Some other respondents argued that the insider trading laws complement the current buy-back provisions. The buying-back entity is the party most likely to possess inside information and is therefore best placed to disclose it. Also, the disclosure exemption for some smaller buy-backs may enable the company and its controllers to profit indirectly from any undisclosed positive inside information by causing the entity to buy back its own shares at a reduced price, thereby increasing the value of the remaining shares, including those held by those informed persons.

Recommendation 15

Buy-back entities

The Majority considers that the insider trading provisions should apply to an entity buying back its own shares, except where the buy-back legislation requires that the entity make full prior disclosure of material information to shareholders.

The Minority considers that the insider trading provisions should apply to a buy-back entity in all circumstances.

> ***Offerees***
> The Advisory Committee considers that the insider trading provisions should continue to apply to offerees under share buy-backs.

2.4.5 Reasons

Buy-back entities: majority reasons

Full disclosure by buy-back entities is important, as failure to disclose any material information may disadvantage non-selling [selling] shareholders, if that information is detrimental [beneficial] to the financial position of the company and therefore the price or value of its shares.

In consequence, the insider trading provisions should apply to a buying back entity except where the buy-back provisions require prior full disclosure of material information to shareholders and their approval (ss 257C(2), 257D(2)). The rationale for this limited exemption is the same as for entities making a general issue, namely that the Corporations Act sets out the necessary disclosure requirements. Any concern that may arise about ensuring full investor protection could be dealt with by reviewing whether the penalties for breach of the statutory disclosure obligations for buy-back entities are sufficient.

Where a buy-back does not require prior disclosure to shareholders and their approval, it is not sufficient to rely on the continuous disclosure requirements, given their carve-outs. In these circumstances, the insider trading rules should remain.

Offerees

Offerees under buy-backs should continue to be subject to the insider trading legislation for the same reason as offerees under general issues, namely that they are not subject to any disclosure regime backed by criminal and civil sanctions.

2.5 Private transactions in exchange-tradeable financial products

[Discussion Paper paras 2.93–2.98, Proposals Paper paras 2.28–2.35]

2.5.1 The issue

Should all or some private transactions be excluded from the insider trading provisions? Private transactions are here defined as principal-to-principal transactions, other than placements, effected off-market. They would not include ordinary or special crossings, which should be treated as on-exchange transactions.

2.5.2 Advisory Committee position

This matter is dealt with in Chapter 4 of this Report. Under the Majority Proposal in Recommendation 38, private transactions would be caught only if the informed person had relevant disclosable or announceable information. The Minority would retain the current law, which applies the insider trading prohibition to these transactions.

2.6 Transactions under non-discretionary trading plans

[Discussion Paper paras 2.148–2.152 and Appendix 6, Proposals Paper paras 2.36–2.43]

2.6.1 The issue

Should persons be able to deal under non-discretionary trading plans, notwithstanding that they have relevant inside information at that time?

2.6.2 Current Australian Law

A person with inside information is prohibited from trading, even under a non-discretionary trading plan that was entered into prior to that person obtaining the information.

2.6.3 US exemption for non-discretionary plans

The US Securities and Exchange Commission (SEC) Rule 10b5-1, introduced in October 2000, permits persons to transact under trading plans, notwithstanding that they are aware of relevant inside information, provided they devised these plans before becoming so aware and they have no discretion to alter those plans once so aware, other than to terminate them. The Rule is set out in full in Appendix 6 of the Discussion Paper.

The US Rule applies to trading plans involving either the purchase or sale of financial products. Also, the Rule draws no distinction between on-market and off-market transactions. It can apply in both circumstances.

The SEC Commentary gives the following example of how Rule 10b5-1 would apply:

> an employee wishing to adopt a plan for exercising stock options and selling the underlying shares could, while not aware of material nonpublic information, adopt a written plan that contained a formula for determining the specified percentage of the employee's vested options to be exercised and/or sold at or above a specific price. The formula could provide, for example, that the employee will exercise options and sell the shares one month before [a particular date (eg when her son's college tuition is due)] and link the amount of the trade to the cost of the tuition.

The US rule does not require registration of the plan or regulate its period of operation or level of detail. However, to protect against possible abuse, the exemption from the insider trading provisions only applies where:

- the trading took place in accordance with a plan entered into when the person was not aware of any inside information
- there are no discretions under the plan, other than to terminate it (given that under US law, as under Australian law, any person with inside information may lawfully decide not to trade). A person could not activate a trading plan, nor change its terms, during that time
- the plan was entered into in good faith and not as part of a scheme to evade the insider trading prohibitions.

2.6.4 Submissions

Most submissions supported the principles underlying the US Rule.

Recommendation 16

The Majority considers that there should be an exemption from the insider trading provisions for trading under non-discretionary plans where:

- the trading takes place in accordance with a plan entered into when either the person was not aware of any inside information or any information of which the person was then aware was no longer inside information when any trading under the plan took place
- there are no discretions under the plan, other than to terminate it, and
- the plan was entered into in good faith and not as part of a scheme to evade the insider trading prohibitions.

The person seeking to rely on the exemption should have the legal onus of establishing the above elements, rather than merely an evidential onus to raise them.

The Minority does not support any exemption.

2.6.5 Majority reasons

One consequence of the current law is that those directors and other persons involved in management who are regularly being exposed to inside information may be deprived of reasonable opportunities to deal in their company's securities, even at pre-determined dates under a non-discretionary trading plan. The practice adopted by many companies of encouraging their officers to limit trading in the company's own securities to a 'trading windows' period (for instance, a limited period after release of a company's financial statements) will not assist officers who nevertheless hold inside information at that time. A total prohibition on trading by these persons when they are informed may work against the general interest of shareholders in having corporate officers exposed to the risks and opportunities associated with ownership of shares in the company.

There is a need for flexibility to permit these persons, or anyone else exposed to inside information, to plan ahead in good faith, when either they have no inside information or that information would no longer be inside information when any subsequent dealings take place under the plan.

Requiring any person relying on the non-discretionary plan exemption to prove compliance with the requisite elements of that exemption on the balance of probabilities would deal with possible abuse, without the need for more prescriptive requirements concerning the detail in, or period of, the plan. An example of such a legal onus is found in the defences to insolvent trading, which require a defendant to prove the existence of certain matters at the time when the relevant debt was incurred (s 588H).

The recommendation provides only for an exemption from the insider trading provisions. Companies may still choose to impose 'trading window' controls over trading by their personnel in the company's shares.

2.7 Transactions in unlisted entities

[Discussion Paper paras 2.93–2.98, Proposals Paper paras 2.44–2.51]

2.7.1 The issue

Should all or some transactions in the financial products of unlisted entities be excluded from the insider trading provisions?

2.7.2 Advisory Committee position

This matter is now dealt with in Chapter 4 of this Report. Under the Majority Proposal in Recommendation 38, transactions in unlisted entities would be caught only if the informed person had relevant disclosable or announceable information. The Minority would retain the current law, which applies the insider trading prohibition to these transactions.

3 Matters that should not change

3.1 Overview

The current Australian insider trading legislation goes further in some respects than measures adopted in other countries. The Advisory Committee has reviewed these areas and endorses the current approach in relation to:

- *who is an insider:* whether a person is an insider should continue to depend on the information that the person holds (the 'information connection' approach), rather than the person's direct or indirect relationship with the company (the 'person connection' approach)
- *application to entities:* entities as well as natural persons should continue to be subject to the insider trading prohibition
- *use of inside information:* it should not be an element of the insider trading offence that an informed person has used the inside information in trading, nor should there be a defence of non-use
- *trading contrary to inside information:* the insider trading prohibition should continue to apply even where the insider trades contrary to the price implications of the inside information.

Features of one or more overseas laws that the Advisory Committee does not see as necessary for Australia are:

- rebuttable presumptions that senior company officers are aware of certain inside information
- derivative civil liability for those with authority over persons who engage in insider trading
- specific legislation to prohibit speculative trading or 'short swing profit' trading by corporate decision makers.

The Advisory Committee also supports retaining the existing law and practice in various other areas, which it considers are soundly based in principle and appear to be working satisfactorily. In summary:

- informed persons who lawfully disclose inside information should not be required to inform the recipient that the information is inside information
- there should be no requirement that inside information be specific or precise
- decisions not to trade should continue to be excluded from the insider trading provisions
- the current communication and subscription exemptions for underwriters should remain

- intermediaries should remain liable for aiding and abetting when acting for clients whom they know (rather than merely suspect) have inside information
- the current prohibition on informed intermediaries acting on behalf of uninformed clients, even on an execution-only basis, should remain
- there is no need to adjust the insider trading provisions for directors or white knights of takeover target companies
- there should be no requirement for exchanges to publish any information about any referrals they make to the Australian Securities and Investments Commission (ASIC) on suspected insider trading
- there should be no move to confine criminal sanctions to fiduciaries and other connected persons, with anyone else being subject only to civil penalty liability
- the current rules for assessing compensation in civil proceedings should remain
- companies whose securities are traded should continue to have civil remedies.

Also, while the Committee does not make any recommendation concerning whether ASIC should have a power to impose administrative penalties for insider trading, any future review of this matter should take into account the Report of the Australian Law Reform Commission, *Principled Regulation: Federal Civil & Administrative Penalties in Australia* (ALRC 95).

3.2 Regulate entities as well as natural persons

[Discussion Paper paras 1.48–1.56, Proposals Paper paras 4.3–4.5]

3.2.1 The issue

The insider trading provisions apply to all 'persons', whether natural persons or any other entity (including corporations and partnerships). Should those provisions be confined to natural persons, as occurs in some overseas jurisdictions (see Discussion Paper para 1.50)?

3.2.2 Submissions

The submissions generally supported the provisions continuing to apply to entities as well as natural persons.

Recommendation 17

The definition of insider should continue to include entities as well as natural persons.

3.2.3 Reasons

Limiting the prohibition to natural persons could undermine any incentive for entities to control the flow of information within their organisations.

3.3 Maintain 'information connection' only approach

[Discussion Paper paras 1.57–1.74, Proposals Paper paras 4.6–4.9]

3.3.1 The issue

Should the current 'information connection' test (under which an insider is anyone who possesses inside information) remain or should there be an additional 'person connection' test (which, for the most part, would require some direct or indirect connection or relationship to the source or owner of the material price-sensitive information)?

3.3.2 Submissions

Some respondents who supported the additional 'person connection' test argued that the insider trading legislation should only operate where there is a misuse of privileged access to confidential information. A 'person connection' test would also increase market efficiency by permitting persons who obtain inside information through their own skill and effort unaided by any 'connection' to the relevant company to trade without the restrictions imposed by the insider trading provisions.

Other submissions favoured retaining the 'information connection' only test, without any additional 'person connection' test, arguing that:

- the person connection concept is a remnant of the misappropriation or fiduciary rationales for the prohibition of insider trading. The relevant factor under the (more appropriate) market fairness and market efficiency rationales is equal level of access to information, regardless of one's relationship to the source of that information
- the requirement to establish a connection between the insider and the entity whose financial products are traded may unduly complicate enforcement, especially where there are separate tiers of insiders, for instance, if the prosecution must establish that a secondary insider knew that the source of the information was a primary insider
- a person connection test may increase the difficulty of proving knowledge of each of the elements of an accessorial liability offence
- the person connection test may create greater opportunities to avoid the prohibition by disguising any connection between the secondary insider and the source.

Recommendation 18

The 'information connection' approach, without any additional 'person connection' test, should be retained.

3.3.3 Reasons

The 'information connection' approach better reflects the market fairness and market efficiency rationales that underpin the insider trading legislation. It is also more conceptually straightforward than the 'person connection' approach. It therefore assists

market participants to understand the insider trading laws, while avoiding many of the complexities, uncertainties and gaps in coverage that can arise under the additional 'person connection' approach.

3.4 Not introduce rebuttable presumptions

[Discussion Paper paras 2.133–2.141, Proposals Paper paras 3.25–3.33]

3.4.1 The issue

Should senior company officers be subject to rebuttable presumptions that they:

- were aware of any inside information emanating from within, or otherwise known to, their companies, and
- were aware that the information was not generally available?

These matters were raised for consideration in the Discussion Paper, which noted that obtaining corroborative evidence that a person was subjectively aware of inside information can be one of the most difficult aspects of insider trading law enforcement.

3.4.2 Submissions

The submissions were divided. Some submissions supported rebuttable presumptions for directors, officers and other connected persons, taking into account their role and responsibility in the company. However, other submissions strongly opposed any presumptions, arguing that they would be contrary to the presumption of innocence.

Recommendation 19

There should be no rebuttable presumptions.

3.4.3 Reasons

Statutory rebuttable presumptions are contrary to the generally accepted requirement for the prosecution to prove all the elements of an offence. Also, a defendant may face considerable evidential problems in proving the absence of knowledge, namely that he or she was unaware of any inside information known to the company or was unaware that the information was not generally available.

3.5 No extension to decisions not to trade

[Discussion Paper paras 1.75–1.107, Proposals Paper paras 4.10–4.14]

3.5.1 The issue

Currently, an insider may lawfully use inside information to refrain from trading, may disclose this information to any other persons for that purpose or may procure another person not to trade. Should the legislation prohibit any of these actions?

3.5.2 Submissions

Some submissions favoured a blanket prohibition on disclosing inside information, or procuring, without a lawful excuse, even where the recipient did not trade. A recipient may receive a benefit by deciding not to trade or cancelling a trading order. Also, transactions that may otherwise have occurred could be averted, thereby disadvantaging potential counterparties to those transactions.

Most submissions, however, favoured a continuation of the current law, which, in effect, permits communication of information, or procuring, to discourage trading. They argued that, where no trading has taken place, no market participant would have gained an advantage or suffered any disadvantage.

Recommendation 20

Decisions not to trade, disclosing inside information for that purpose and procuring another person not to trade, should continue to be excluded from the insider trading legislation.

3.5.3 Reasons

Without a trade there is no actual counterparty to be disadvantaged. The mere fact that an informed person benefits from deciding not to trade, or a potential counterparty misses out on the possible benefit that would have accrued if trading had taken place, should not attract criminal liability.

An informed person who advises others not to trade may not necessarily avoid some liability. For instance, this advice could breach fiduciary duties of confidentiality. Also, a person who discloses inside information is at risk of breaching the insider trading provisions if the recipient decides to trade in affected financial products, rather than merely abstain from trading. The test of liability in these circumstances is whether the informant 'knows or ought reasonably to know' that the recipient would trade in affected financial products, rather than simply decline to trade.

3.6 No requirement to inform recipients that they are receiving inside information

[Discussion Paper paras 1.75–1.107, Proposals Paper paras 4.15–4.19]

3.6.1 The issue

Should the insider trading legislation require a person lawfully disclosing inside information to inform the recipient that the information is inside information?

3.6.2 Submissions

The submissions that supported a requirement to inform recipients argued that this would better ensure that recipients cannot exploit this information for their own benefit. It would also guard against actual or inadvertent misuse of inside information.

Other submissions opposed any such requirement as being commercially unworkable.

Recommendation 21

There should be no obligation to inform recipients that information is inside information.

3.6.3 Reasons

Any obligation to inform recipients could unduly complicate commercial communications. Parties would constantly have to check that they were not disclosing any inside information in their commercial dealings without clearly indicating that this was the case. It suffices that informed persons are liable if they in fact communicate inside information and 'know or ought reasonably to know' that the recipient will trade in affected financial products.

3.7 Inside information need not be specific or precise

[Discussion Paper paras 2.51–2.61, Proposals Paper paras 4.20–4.22]

3.7.1 The issue

Should the Australian legislation require that inside information must be specific or precise?

3.7.2 Submissions

Most submissions opposed any requirement that the inside information be specific or precise, arguing that:

- the additional requirement would make the proof of a contravention to a criminal standard more difficult. In some instances, it is not possible to identify the precise information that a defendant possesses. Rather, the prosecution may need to rely on evidence of the defendant's access to information and inferences from that person's conduct
- the need to establish under the current definition of 'inside information' that a reasonable person would expect that the relevant information, if generally available, would be materially price-sensitive avoids the need for any further requirement that the information be specific or precise.

Recommendation 22

There should be no requirement that inside information be specific or precise.

3.7.3 Reasons

To introduce this requirement could unduly narrow the application of the legislation and create artificial distinctions between what does and what does not constitute inside information.

3.8 No use requirement

[Discussion Paper paras 2.142–2.151, Proposals Paper paras 4.23–4.28]

3.8.1 The issue

Should it be a prerequisite for criminal liability that a person holding inside information have used (relied on) that information in trading? Alternatively, should a person have a defence that he or she did not use the information (that is, that the person would have so traded even without the information)?

3.8.2 Submissions

Most submissions opposed any use requirement. Any requirement to prove that the non-public information, and not some other reason, was the predominant motivation for a trade would be unproductive. It would create a significant additional hurdle to effective enforcement of the insider trading law and be contrary to at least the appearance of fairness in the capital markets.

Some submissions favoured a defence of non-use, for instance, where persons inadvertently obtain inside information that inhibits their ability to undertake or continue legitimate hedging or other market transactions.

However, other submissions opposed a defence of non-use, arguing that it may enable defendants to disguise their real motivation for trading.

Recommendation 23

The Advisory Committee elsewhere recommends an exemption for informed persons trading pursuant to a pre-existing non-discretionary trading plan (Recommendation 16). Subject to this limited exception, the insider trading legislation should not have a use requirement or a defence of non-use.

3.8.3 Reasons

Awareness of inside information should suffice to attract the insider trading prohibition. The motivation for trading should be irrelevant. Experience from US case law points to the great difficulties that a prosecutor may face in proving that a defendant actually used inside information in entering into a particular transaction.

A defence of non-use may enable individuals to erect plausible screens to disguise their real motivation for trading. It may be a simple matter for a trader, with the benefit of hindsight, to suggest numerous reasons for trading other than the possession of inside information. This defence may also create unjustified anomalies, for instance, two persons selling when armed with the same inside information, with one of them arguing that, unlike the other, he or she was obliged to sell in any event because of, say, pressing financial commitments and therefore had not ‘used’ the inside information in trading.

3.9 No exemption for trading contrary to inside information

[Discussion Paper paras 2.153–2.158, Proposals Paper paras 4.29–4.32]

3.9.1 The issue

Should an insider be permitted to trade contrary to the inside information that he or she holds, for instance, by selling [buying] particular securities while holding positive [negative] inside information concerning them?

3.9.2 Submissions

The submissions on this matter opposed a statutory exemption permitting an informed person to trade contrary to inside information, arguing that:

- it would simply complicate an already complicated offence
- the regulator, in determining whether to prosecute, and the courts, in determining any penalty, can best decide how to deal with anyone who trades contrary to inside information
- an insider should not be permitted to derive windfall gains, even when contrary to expectations
- in some situations it is difficult to determine how the inside information will affect the price of securities.

Recommendation 24

There should be no defence that an informed person traded contrary to inside information.

3.9.3 Reasons

There is a risk of any such defence being manipulated by persons with inside information claiming that, despite trading profitably, they did not expect to receive a profit (or avoid a loss) through their trading. Also, some confidential inside information may clearly be materially price-sensitive, without the holder being able to determine, or with the holder incorrectly assessing, whether it will increase or decrease the price of the securities. A defence of this nature may prove fortuitous for an insider who traded on what turned out to be that person's incorrect assumption about the price impact of the inside information, when later made public. It may allow insiders to argue their own trading incompetence as a defence.

3.10 Retain the communication and subscription exemptions for underwriters

[Discussion Paper paras 2.159, 2.161–2.164, Proposals Paper paras 4.33–4.36]

3.10.1 The issues

Should a company or an underwriter continue to be permitted to communicate inside information solely for the purpose of procuring a person to enter into an underwriting agreement?

Should an underwriter continue to be permitted to subscribe for securities pursuant to an underwriting agreement before inside information given to that person becomes generally available?

3.10.2 Submissions

All submissions that commented on this issue supported the current exemption that permits companies or underwriters to communicate inside information for the purpose of procuring a person to enter into an underwriting agreement. This right of communication was essential to enable underwriters to perform their functions properly.

Submissions also generally supported underwriters with inside information being able to subscribe for securities under their underwriting agreements. One respondent, while noting that this exemption may not be strictly necessary in view of the existence of the equal information defence, supported its retention to minimise any disruption to the practices of the underwriting industry.

Recommendation 25

The communication and subscription exemptions for underwriting should be retained.

3.10.3 Reasons

Without these exceptions, underwriters could not effectively function. Companies may need to disclose inside information to prospective underwriters, who in turn may need to disclose it to their sub-underwriters. Likewise, it is for the company and the underwriters to negotiate what disclosures should precede a subscription. In both instances, unlike on-selling (Recommendation 2, supra), there would be no disadvantaged arm's-length counterparty.

3.11 Intermediaries to remain subject to aiding and abetting laws

[Discussion Paper paras 2.183–2.188, Proposals Paper paras 4.37–4.39]

3.11.1 The issue

Should intermediaries remain criminally liable for aiding and abetting if they carry out a client's instructions to trade in particular financial products when aware that the client holds inside information, notwithstanding that the intermediary may not profit from the trade (except by receiving a commission for executing the client's orders)?

3.11.2 Submissions

The submissions generally supported prohibiting a broker who is aware that a client has inside information from trading in affected financial products on behalf of that client.

Recommendation 26

An intermediary who is aware that a client holds inside information should remain liable for aiding and abetting by trading in affected financial products for that client.

3.11.3 Reasons

This approach reinforces the market fairness and market efficiency rationales of insider trading laws.

3.12 No exemption for informed intermediaries acting for uninformed clients

[Discussion Paper para 2.189, Proposals Paper paras 4.40–4.43]

3.12.1 The issue

Should an intermediary who has been informed of inside information by one client be entitled to transact for uninformed clients in affected financial products on an 'execution-only' basis? Currently, an informed intermediary would be prohibited from dealing on behalf of any client.

3.12.2 Submissions

Some submissions favoured permitting an informed intermediary to act for any uninformed clients on an execution-only basis, arguing that any refusal by the intermediary to trade may signal the possession of inside information.

Recommendation 27

There should be no exemption for informed intermediaries acting for uninformed clients.

3.12.3 Reasons

In practice, it would be difficult for many brokers to execute contracts on behalf of their clients without the expectation that the broker would advise the client on the transaction. Conversely, informed brokers, if permitted to execute the instructions of their uninformed clients, might risk actions by their clients alleging breach of fiduciary duty to act in their interests. Also, an informed broker who does not wish to act could refer the client to a colleague on the other side of a Chinese Wall. The current law provides a very strong incentive to maintain effective Chinese Walls within an organisation.

In relation to the 'signalling' argument, the refusal of a broker to act does not necessarily indicate that the broker possesses inside information or whether any possible information is positive or negative.

3.13 No derivative civil liability for controllers

[Discussion Paper paras 2.196–2.208, Proposals Paper paras 4.44–4.47]

3.13.1 The issue

Should a person who is in a position to control or supervise the activities of another person be subject to a specific derivative civil liability for the insider trading of that other person?

3.13.2 Submissions

Some submissions supported derivative civil liability, arguing that controllers or supervisors have an interest in maintaining and enhancing confidence in the financial markets and should accept appropriate responsibility for their influential role in those markets.

However, other submissions opposed derivative civil liability, arguing that it may act as a strong disincentive for supervisors or controllers to assist investigations and may encourage civil suits against them merely because of their perceived 'deep pockets'.

Recommendation 28

There should be no derivative civil liability provision.

3.13.3 Reasons

In some instances, firms or individuals could be liable for aiding and abetting insider trading by another person, depending upon their level of knowledge of, or participation in, the unlawful behaviour. However, beyond that, controllers and supervisors should not be subject to a separate derivative civil liability. Instead, these persons could risk considerable reputational damage if the persons they control or supervise engage in insider trading.

3.14 No exemption for directors or white knights of takeover targets

[Discussion Paper paras 2.212–2.225, Proposals Paper paras 4.48–4.54]

3.14.1 The issues

Target company directors

Should directors of target companies who are aware of a pending hostile takeover bid not yet known to the market have some exemption from the insider trading provisions if they provide inside information to a 'white knight' to defend against that bid?

White knights

Should white knights be permitted to purchase issued target company shares when aware of any inside information affecting those shares?

3.14.2 Submissions

Target company directors

Some submissions supported the legislation permitting target company directors to communicate inside information to a white knight where they take all reasonable steps (for instance by obtaining a non-trading undertaking from the white knight) to ensure that the white knight does not purchase target company shares from any uninformed counterparty before the information becomes generally available.

Another view was that there should be no specific allowance for target company directors selectively to disclose inside information to white knights.

White knights

Most submissions opposed any statutory exemption for white knights, arguing that buying from an uninformed vendor has an adverse effect on market fairness, efficiency, integrity and confidence.

> **Recommendation 29**
>
> There should be no specific exemption for target company directors in communicating inside information to white knights.

3.14.3 Reasons

A statutory exemption could be open to abuse, given the uncertainty of its ambit. Also, target company directors who obtain no-trading enforceable undertakings before providing white knights with inside information may already be protected. Liability for communicating inside information only applies where the insider 'knows or ought reasonably to know' that the recipient would be likely to trade or procure another person to trade (s 1043A(2)).

Recommendation 30

There should be no statutory exemption for white knights of takeover target companies.

3.14.4 Reasons

Persons should not be immune from the insider trading provisions merely because they are acting as white knights. Any immunity may create significant avenues for abuse, as well as being detrimental to the interests of counterparties to those white knights.

3.15 No obligation on exchanges to publish their insider trading referrals

[Proposals Paper paras 4.55–4.57]

3.15.1 The issue

Should exchanges be required to publish information about each referral of an insider trading matter to ASIC?

3.15.2 Submissions

One view was that there may be a public interest in an exchange disclosing the fact that it has referred a possible breach to ASIC. The information published could be limited to the securities, the period of trading, the pattern of trading and the size of the potential profits involved. Suspect individuals would not be named.

Most submissions, however, opposed any mandatory disclosure obligation, pointing to concerns about natural justice for affected persons and possible market overreaction.

Recommendation 31

Exchanges should not be obliged to publish any details of their referrals to ASIC of suspected insider trading.

3.15.3 Reasons

Mandatory publication could breach procedural fairness and privacy principles. Also, the market may draw inappropriate and unjustified conclusions about the identity of particular traders or the nature of the information. Furthermore, publication could prematurely alert possible suspects, who could then destroy evidence or otherwise impede the investigative process.

3.16 No differing criminal and civil insider trading regimes

[Proposals Paper paras 4.58–4.60]

3.16.1 The issue

Should criminal liability for insider trading be confined to fiduciaries and other persons connected with an entity whose financial products are traded, with any other persons in breach being subject only to civil penalty liability?

3.16.2 Submissions

Some respondents raised the possibility of confining criminal liability to persons who have some fiduciary obligation to the entity whose financial products are traded or who are otherwise 'connected' to that entity. The category of connected persons could include professional firms, banks, financiers, public relations firms and printers. Action could be taken against other insiders under the civil penalty regime.

Other respondents opposed any move to confine the categories of persons who may be criminally liable. There are many factors, apart from a person's fiduciary or other connection with a company, that may be highly relevant in determining whether a matter is sufficiently serious to be criminally prosecuted.

Recommendation 32

There should not be different criminal and civil insider trading regimes.

3.16.3 Reasons

To limit the categories of persons who might be criminally liable to those with a fiduciary or other connection with a company could introduce additional complexities and anomalies. A variety of other factors, including market impact, could be relevant to determining whether a breach warranted criminal prosecution. Some insider trading could seriously distort the market, even though the perpetrator did not fall within any fiduciary or connected person test. The criminal courts have a discretion over penalties, which can take into account the circumstances in which the person obtained the information.

3.17 No immediate reform of ASIC's enforcement powers

[Discussion Paper paras 3.1–3.12, Proposals Paper paras 4.61–4.64]

3.17.1 The issue

Should ASIC have the power to impose administrative penalties for insider trading?

3.17.2 Current law

ASIC may undertake civil penalty proceedings for insider trading, with the court having the power to make various civil penalty orders, including a pecuniary penalty order. However, unlike the UK Financial Services Authority, ASIC does not itself have the power to impose administrative penalties.

3.17.3 Submissions

ASIC and ASX pointed out that giving the regulator the power to impose administrative penalties for insider trading may be more effective and timely in some cases than having to resort to litigation. However, other submissions argued that administrative penalties should not be considered until there has been sufficient time to assess the extension of the civil penalty regime to insider trading under the March 2002 amendments.

3.17.4 Australian Law Reform Commission Report

The Report of the Australian Law Reform Commission (ALRC), *Principled Regulation: Federal Civil & Administrative Penalties in Australia* (ALRC 95, December 2002), made a number of recommendations to ensure procedural fairness in any administrative proceedings.[3]

Recommendation 33

The Advisory Committee does not put forward a formal recommendation on whether ASIC should have a power to impose administrative penalties for insider trading. However, any further consideration of whether ASIC should have this power should take into account the recommendations in the ALRC Report, *Principled Regulation: Federal Civil & Administrative Penalties in Australia*, that deal with procedural fairness and review of administrative decision making.

3.17.5 Reasons

The ALRC Report contains a detailed analysis of the procedural fairness requirements that should accompany any power given to a regulator to impose quasi-penalties.

3.18 No change to compensation assessment rules

[Discussion Paper paras 3.24–3.43, Proposals Paper paras 4.65–4.67]

3.18.1 The issue

Currently, an insider has a maximum potential civil liability of the actual profit made, or loss avoided, assessed as the difference between the transaction price and the notional price if the inside information had been generally available at the time of trading. Should this test be changed?

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[3] See, in particular, Chapters 14–23.

3.18.2 Submissions

Submissions generally preferred the current method of assessing compensation to the formula used in the Canadian legislation, which requires the court to use an 'average market price' formula to assess compensation to each eligible claimant, being:

- if the claimant is a purchaser—the price paid by the claimant for the security less the average market price of the security in the 20 trading days following general disclosure of the inside information
- if the claimant is a vendor—the average market price of the security in the 20 trading days following general disclosure of the inside information less the price received by the claimant for the security.

Recommendation 34

The existing rules for assessing the profit made or loss avoided should remain.

3.18.3 Reasons

The alternative Canadian average price formula test would run the risk of the price being influenced by external factors occurring within the 20 trading day period.

3.19 Retain civil remedies for companies whose securities are traded

[Discussion Paper paras 3.44–3.52, Proposals Paper paras 4.68–4.71]

3.19.1 The issue

Should a company whose securities are traded in breach of the insider trading provisions continue to be entitled to compensation, even where the company is not a party to the transaction involving the insider?

3.19.2 Current law

A company can recover any profits made or losses avoided by insiders in any transactions involving its securities, even where it is not a counterparty to those transactions.

3.19.3 Submissions

Submissions generally favoured the current law permitting companies to recover compensation. A company has an interest in maintaining an orderly market in its own securities.

A few submissions opposed this right for companies, in the absence of their suffering actual loss.

Recommendation 35

The existing law, under which companies whose financial products are traded are entitled to compensation, should remain, even where those companies have suffered no loss or damage.

3.19.4 Reasons

This right of recovery may provide an incentive for companies to monitor trading in their own securities.

3.20 No speculative trading provision

[Discussion Paper paras 4.13–4.19, Proposals Paper paras 4.72–4.75]

3.20.1 The issue

Should there be controls over 'speculative trading' by directors and other corporate decision makers in the securities of their companies, similar to those found in Canadian law? Currently, there is no specific provision dealing with speculative trading.

3.20.2 Submissions

Some submissions favoured controls over speculative trading, arguing that:

- the right of directors to trade freely in the entity's securities must be balanced against the reputational damage to the entity if the market perceives its directors to have interests which conflict with those of the entity and its security holders
- directors would otherwise have an incentive to misuse inside information or even to create circumstances conducive to their speculative trading positions.

However, other submissions opposed these controls, noting that directors were already subject to fiduciary duties. They argued that a better approach would be to encourage listed entities to adopt corporate governance policies on trading by executives and officers, for instance, by requiring listed entities to disclose their policies on this subject.

Recommendation 36

There should be no new statutory prohibition on speculative trading.

3.20.3 Reasons

The current law on the fiduciary duties of directors adequately regulates this matter.

3.21 No short swing profit provision

[Discussion Paper paras 4.20–4.30, Proposals Paper paras 4.76–4.78]

3.21.1 The issue

Should there be a ‘short swing profit’ prohibition for corporate decision makers, similar to that found in US corporate law? Currently, there is no specific Australian provision dealing with short swing profits.

3.21.2 US law

Subject to some exemptions, the US legislation gives an issuer of securities (or a shareholder of the issuer in a derivative action) the right to seek recovery of any profits made by any corporate directors, executive officers or substantial shareholders of that issuer from any purchase and sale (or sale and purchase) of the issuer’s equity securities (or securities convertible into equity) in any six month period.

3.21.3 Submissions

Most submissions opposed this prohibition, arguing that it assumes that directors and executive officers always and inevitably possess unpublished price-sensitive information. This assumption, if taken to its logical conclusion, would justify prohibiting any dealing by directors and executive officers in their company’s securities, irrespective of whether they possessed unpublished price-sensitive information. The US period of six months is entirely arbitrary.

Recommendation 37

There should be no specific statutory prohibition on short swing profits.

3.21.4 Reasons

Any statutory prohibition would have major implications, as outlined in the submissions. The question of company executives speculating in their companies’ securities is essentially a corporate governance issue. Also, the proposed strengthening of the directors’ disclosure requirements (Recommendation 1, supra) would reduce the possibility of their engaging in undetected insider trading in their own companies’ securities.

4 Applying the insider trading legislation in different financial markets

4.1 Issues under the current law

The Advisory Committee has considered whether some adjustment to the insider trading law is required to ensure that it works effectively and appropriately in the various financial markets to which it now applies, as well as for off-market transactions. The current law gives rise to some significant issues.

4.1.1 Financial Services Reform Act

The March 2002 amendments to the Corporations Act, introduced by the Financial Services Reform Act (FSRA), extended the insider trading legislation from securities and equity-related futures products (as well as interests in managed investment schemes) to a range of quite different types of financial products traded on other financial markets that do not operate under the same disclosure principles or expectations as securities exchange markets. The additional products now regulated include commodity products, reciprocal purchase agreements (repos), negotiable instruments, forward rate agreements, interest rate swaps and options, foreign exchange and electricity contracts.

The amendments primarily reflected the harmonisation objectives of the FSRA to apply uniform laws to financial products. However, it is not clear to what extent the particular impact of the insider trading provisions on non-securities markets, such as over-the-counter (OTC) markets, was considered. There was no discernible call from OTC market participants to have the insider trading law apply more generally to OTC markets, nor was there any generally expressed view that more extensive laws were necessary to support confidence in these markets.

4.1.2 Directly negotiated transactions

There is a difficulty in principle with applying insider trading laws (backed by criminal penalties) to all instances of asymmetry of material price-sensitive information between parties to directly negotiated transactions merely because those contracts involve financial products. This is particularly the case with transactions on OTC markets and transactions in the securities of unlisted entities.

Many OTC transactions are bilateral risk transfer contracts, with the parties typically negotiating their own disclosure covenants and warranties to deal with any informational asymmetry. Similarly, parties to transactions in the securities of proprietary companies and other unlisted entities can negotiate their own disclosure terms. In addition, contracting parties have legal remedies for any misrepresentation or false or misleading statements by a counterparty.

The insider trading legislation intervenes further in these bilateral contracts by making it a criminal offence for contracting parties to fail to disclose to their counterparties all

information known to them, but not their counterparties, that could materially affect the price or value of the contract. This criminal liability remains even if the parties have fully complied with the disclosure requirements of the contract, or the contract states or acknowledges that one party may have material price-sensitive information unknown to the counterparty.

Breach of the insider trading law also has significant civil consequences. A party to a commercial contract might seek to void the contract by arguing that the counterparty, although fully complying with the contractual terms, has nevertheless breached the insider trading legislation. Such challenges could undermine confidence in the certainty of bilaterally negotiated contracts.

4.2 The Proposals Paper

Chapter 1 of the September 2002 Advisory Committee Proposals Paper (available on the CAMAC website www.camac.gov.au) describes key features of various financial markets, the impact of the March 2002 amendments on each of them, and possible policy alternatives for applying the insider trading legislation to them in future.

4.3 Submissions on the Proposals Paper

ASIC and the Commonwealth Director of Public Prosecutions submitted that the insider trading provisions should continue to cover all transactions in financial products, unless the circumstances of the particular market or transaction justified a particular exemption or defence tailored to those circumstances.

Various other submissions argued that the March 2002 amendments, in extending the insider trading provisions to a wider range of markets and financial products, lacked a sound policy basis, in light of the fundamental differences between a securities exchange market and other financial markets. The 2002 amendments to the 'own intentions' defence overcame some specific problems, but did not solve the inherent difficulty in applying the current insider trading provisions to the range of financial product transactions on OTC and other financial markets.

Some respondents proposed a return to the pre-March 2002 position, so that the insider trading provisions would only apply to equity (including managed investment) and equity-linked products. Some other respondents sought exemptions for particular classes of transactions, such as OTC electricity derivatives, though one respondent argued that there is currently a material information imbalance favouring suppliers over retailers in the OTC electricity market.

Other submissions favoured linking the insider trading provisions more directly to the disclosure standards in various markets. However, ASIC and the Commonwealth Director of Public Prosecutions were concerned that adding some new general element to the test for insider trading in an attempt to address perceived problems in the smaller OTC markets would run the serious risk of making insider trading less enforceable in larger markets, such as those conducted by the Australian Stock Exchange and the Sydney Futures Exchange.

4.4 Possible approaches

In light of the analysis in the Proposals Paper and the submissions received, the Advisory Committee has considered three possible approaches to the application of the insider trading provisions in Australian financial markets. These are:

- return the legislation to the pre-March 2002 position
- retain the current law, but with the possibility of introducing specific defences or carve-outs for particular markets or categories of transactions where the circumstances of the particular market or transaction justify a particular exemption or defence tailored to those circumstances (Carve-outs approach), or
- tighten the ambit of the legislation by focusing the prohibition on information that the market expects should be disclosed to all participants on an equal basis. This amendment would also enable a new simplified test of when information is generally available to be introduced (the Proposal).

For the reasons given below, the Majority supports the Proposal, while the Minority supports the Carve-outs approach.

4.5 First policy option: return to the pre-March 2002 position

The principal argument for this option is that it would overcome the concerns raised, particularly by OTC market participants, about imposing in OTC markets the same requirement that applies in securities exchange markets for informed persons either to disclose all confidential materially price-sensitive information known to them or abstain from trading.

The Advisory Committee considers, however, that the first policy option would be inconsistent with the general objective of the FSRA to include all financial products and markets within one overall regulatory scheme. This policy option could result in insider trading laws inappropriately favouring certain categories of transactions over others, unduly discriminating between different facilities for trading Division 3 financial products or providing possible opportunities for market arbitrage.

The insider trading provisions should continue to apply to all markets and financial products regulated under the Corporations Act including OTC and emerging markets, with adjustments for differences between these markets where necessary. The second and third policy options reflect different approaches to making these adjustments.

4.6 Second policy option: retain the current law with appropriate defences and carve-outs

The Minority supports this option and opposes the third policy option.

The principle underlying the second policy option is that the current approach to insider trading—a broadly expressed offence subject to particular carve-outs—is neither untenable nor unworkable. Instead, any problems still facing the OTC or other markets following the introduction of the FSRA could be remedied by:

- additional specific defences in appropriate cases, for instance, further extension of the 'own intentions' defence
- possible carve-outs for particular markets in appropriate cases, and
- possible carve-outs for particular transactions of specified and appropriate types.

The possible defences or carve-outs could be introduced on a case-by-case basis where the justification for the defence or carve-out was apparent. Any particular features of the relevant market or transaction that justify the carve-out can be specified in it. This incremental approach would avoid any weakening of the insider trading provisions that may arise from the third policy option.

4.7 Third policy option: the Proposal

The Majority supports the Proposal and prefers it to the second policy option.

4.7.1 Principle underlying the Proposal

The Majority supports amending the insider trading legislation as it applies to all financial markets and financial product transactions, rather than relying on additional, so far unidentified, defences or carve-outs. The focus of the insider trading prohibition should be on information that the market expects should be disclosed to all participants on an equal basis. To permit trading in these circumstances could give the informed person an unfair advantage over other market participants and undermine confidence in the fairness and integrity of financial markets.

By contrast, the current insider trading provisions are much broader in scope. They apply to anyone trading with confidential price-sensitive information concerning a financial product, even where there is no expectation that the information should be generally disclosed. Maintaining fair and efficient markets does not require that the legislation be cast so widely. It may capture transactions that, reasonably, should not give rise to a criminal offence.

4.7.2 Summary of the Proposal

The Proposal seeks to implement the underlying principle by:

- *focusing the insider trading prohibition.* The insider trading prohibition should apply only to confidential price-sensitive information that should be generally disclosed or will be the subject of a public announcement. This is a development of the concept underlying the disclosable information element as discussed in Chapter 1 of the September 2002 *Proposals Paper*
- *introducing a new test of generally available information.* In consequence of tightening the ambit of the insider trading prohibition, a new simplified test of when information 'is generally available' could be introduced. This test would overcome complexities and ambiguities in the current test (including the indeterminate breadth of the 'readily observable matter' concept).

4.7.3 Focusing the insider trading prohibition

The insider trading prohibition should apply only to disclosable information or announceable information. This can be achieved by adding the following paragraph to both s 1043A(1) and s 1043A(2):

> ‘(ba) the inside information is disclosable information or announceable information;’.

In support of these new paragraphs, the following definitions should be added to s 1042A:

> ‘disclosable information’ means information that:
>
> (a) has to be disclosed either now or in the future pursuant to any legal or regulatory requirement (other than a requirement for disclosure only to a counterparty), whether or not that obligation is complied with, or
>
> (b) would come within paragraph (a) were any person subject to the legal or regulatory requirement to be aware of the information, or
>
> (c) would come within paragraph (a) or paragraph (b) if the subject matter of the information came to fruition (whether or not it does so);’
>
> ‘announceable information’ means information, other than disclosable information, that:
>
> (a) will become the subject of a public announcement, or
>
> (b) would come within paragraph (a) if the subject matter of the information came to fruition (whether or not it does so);’.

Notes in the Explanatory Memorandum or in the legislation could indicate that:

- the reference to ‘information’ in the definitions of disclosable information and announceable information includes information that may eventually be announced or otherwise disclosed, albeit in some different form. An example would be material changes to the pattern of a company’s income and expenses, which may eventually be reported only in some statistical form
- the reference in paragraph (a) of the definition of disclosable information to ‘now or in the future’ indicates that this definition is not confined to information that must be disclosed immediately. It includes, for instance, information that may at some time have to be disclosed under the continuous disclosure or takeover requirements, but is currently exempt from immediate disclosure, such as information about an intended, but as yet confidential, takeover bid
- the reference to ‘legal or regulatory requirement’ in paragraph (a) of the definition of disclosable information would extend beyond statutory obligations to any disclosure requirement that a market provider may impose on participants in that market. It would include, for instance, statute-backed disclosure requirements (as under ASX Listing Rule 3.1) and other disclosure requirements (under either the ASX Rules or those applicable in any other financial market). This would ensure that the insider trading provisions adjust to, and reinforce, disclosure requirements as they develop over time in financial markets

- the purpose of paragraph (b) of the definition of disclosable information is to make clear that the person with the information need not be the person who has to disclose it. Also, information may be inside information, even though the person who would have the disclosure obligation is not yet aware of the information. It places beyond doubt that the insider trading legislation applies to the type of situation that arose in *R v Evans and Doyle* (the Mt Kersey case) (Discussion Paper para 1.41). The information does not have to come from within the company whose financial products are being traded

- the purpose of paragraph (c) of the definition of disclosable information, when read in conjunction with the definition of 'information' in s 1042A, which covers inchoate matters, is to make clear that the definition applies to information about a possible future event, whether or not it takes place. It would apply, for instance, to a person who trades with confidential information about a planned takeover bid, even where that bid does not subsequently eventuate

- the reference to 'a public announcement' in paragraph (a) of the definition of announceable information would include any announcement by any government or government agency of relevant policies, budgets or monetary or fiscal measures or changes. It would also include changes to published credit ratings of listed companies or changes to the constituents of a financial market index. The phrase 'will become' would cover ad hoc announcements in the ordinary course of an agency's regulatory functions, as well as periodic announcements

- the purpose of paragraph (b) of the definition of announceable information, when read in conjunction with the definition of 'information' in s 1042A, which covers inchoate matters, is to make clear that the definition applies to information about a possible future announcement, whether or not it takes place.

No market arbitrage

The Proposal contemplates the insider trading prohibition operating whether an informed person deals on the financial market to which the disclosure requirement applies or elsewhere. It would ensure, for instance, that an informed person could not bypass the prohibition on securities trading by dealing off-market or in a related OTC or futures exchange equity derivative.

Announceable information can apply to any financial market. It would include, for instance, a person entering into an OTC interest rate contract when aware of a pending, but still-confidential, public announcement by a monetary authority that will materially change interest rates.

Practical effects of the Proposal

Set out below are some examples of how the Proposal would avoid overreach of the current insider trading provisions in relation to:

- OTC market trading
- trading in the financial products of unlisted entities.

OTC market trading. A party to an OTC electricity swap contract has specific information known only to itself that it knows would materially affect the price or value of the derivative contract.

Under the current law, that party would have inside information.

Under the Proposal, the transaction would come within the insider trading provisions if, say, the information was required to be disclosed to the market pursuant to the current market disclosure obligations under the electricity legislation. In other circumstances, the counterparty may have contractual and other civil remedies for non-disclosure.

This outcome reflects what the Proposal seeks to achieve in OTC markets. The insider trading law would therefore adjust to the disclosure obligations from time to time in an OTC market. Also, that law can reinforce any changes to the statutory market disclosure obligations in an OTC market.

Trading in the financial products of unlisted entities. A purchaser buys shares in an unlisted company through a private contract when aware of material price-sensitive information affecting those shares known only to himself.

The transaction would come within the current insider trading provisions. It makes no difference that the company is unlisted.

The transaction would come within the Proposal only if the information was disclosable or announceable information. This turns on the nature of the information. Assume, for instance, that the unlisted company is a holding company of a listed company and the price-sensitive information that affects the unlisted company would also materially affect the price or value of the listed company's securities, thereby having to be disclosed by the listed company under the continuous disclosure requirements (either now or in the future) if the listed company was aware of it. In those circumstances, the information would be disclosable information under paragraphs (a) and (b) of the proposed definition. In other circumstances, particularly in transactions involving privately owned companies, the information would probably not be disclosable information, and the insider trading provisions would not apply.

4.7.4 New test of generally available information

The definition of 'inside information' in s 1042A requires that the information not be generally available.

Confining the insider trading prohibition to disclosable or announceable information enables the test of when information is generally available to be greatly simplified.

Under the Proposal, the current test found in s 1042C(1) would be repealed and replaced with the following provisions:

> 1042C(1) For the purposes of this Division, information 'is generally available' only if it:
>
> (a) is accessible to most persons who commonly invest in Division 3 financial products of a kind whose price or value might be affected by the information, or
>
> (b) consists of deductions, conclusions or inferences made or drawn from any information referred to in paragraph (a).
>
> 1042C(1A) Information is deemed to satisfy paragraph (1)(a) if it is disclosed pursuant to any prescribed disclosure procedure.

> The defence in s 1043M(2)(a), which is part of the published information test, should be repealed.

Accessible to most persons who commonly invest

A note in the Explanatory Memorandum or in the legislation could:

- state that information satisfies paragraph (1)(a) only if it either can at that time be obtained by most investors without resort to technical assistance beyond that likely to be used by those investors or comes within subsection (1A)
- list examples of information that satisfies paragraph (1)(a), including, for instance, any information that has been published in widely circulated print or broadcast media
- indicate that posting information on the Internet will not make the information accessible under paragraph (1)(a) unless the information has been disclosed through a prescribed Internet disclosure procedure under subsection (1A).

Prescribed disclosure procedures

Market and regulatory disclosure. For the purpose of subsection (1A), the prescribed disclosure procedures could be listed in the regulations. The ASX continuous disclosure procedure, and other periodic reporting procedures under the Corporations Act, could be included from the outset. Other financial market operators or participants could apply for particular disclosure mechanisms to be prescribed. The application could be approved only if the method or platform for publicly disseminating the information was judged satisfactory. This would avoid operators of new financial markets being able to determine unilaterally what disclosure methods satisfy the test of making information generally available. The list of prescribed disclosure procedures could therefore be augmented over time, as communication technology develops or as different markets provide new methods of disseminating information to their participants.

Internet disclosure. The prescription process under subsection (1A) could also be used to set out more clearly how the insider trading legislation will operate for information available on the Internet. The current s 1042C lacks specific guidance about when information posted on the Internet becomes generally available.

Abolition of the readily observable matter and published information tests

The proposed test of when information is generally available does not include the readily observable matter or published information tests.

The problems with the current tests are discussed in Section 1.11.4.

Under the Proposal, the concept of readily observable matter is unnecessary. The Explanatory Memorandum to the 1991 amendments gave the example of excess stocks in a company's holding yard as the reason for introducing the readily observable matter concept. The existence of excess stocks would rarely be disclosable information or announceable information. Indeed, if, exceptionally, it did satisfy either of those tests, the informed person should be subject to the insider trading prohibition.

The abolition of the readily observable matter concept would also overcome the uncertainties about its ambit, as reflected in the *Firns* case (discussed in paras 2.14–2.24 of the Discussion Paper).

4.7.5 Impact of the Proposal on enforcement

The provisions in Part 7.10 Div 3 of the Corporations Act would remain, subject to the changes recommended in this chapter and elsewhere in this Report.

In consequence, for a person to be convicted of insider trading under the Proposal, each of the following elements (which are the same as under the current law except where noted) would have to be established:

- the person 'possessed' (was aware of) information
- that information came within the statutory definition of 'inside information', namely that it was materially price-sensitive and was not generally available (the current law and the Proposal have different tests of when information is generally available)
- the person knew or ought reasonably to have known that the information was inside information
- the information was in fact disclosable or announceable information (this element is only required under the Proposal), and
- at any time that all of the above were satisfied, the person traded or procured trading in affected financial products or disclosed the information to persons who the informer knew, or ought reasonably to have known, would so trade or procure.

Recommendation 38

The Advisory Committee supports the application of the insider trading legislation to all currently regulated financial markets and financial products. However, there is a difference of view within the Committee on whether there should be any consequential amendments to meet the circumstances of different financial markets.

Majority Proposal

Section 1043A should be amended by adding new paragraphs (1)(ba) and (2)(ba) as follows:

> '(ba) the inside information is disclosable information or announceable information;'.

The following definitions should be added to s 1042A:

> **'disclosable information'** means information that:
>
> (a) has to be disclosed either now or in the future pursuant to any legal or regulatory requirement (other than a requirement for disclosure only to a counterparty), whether or not that obligation is complied with, or
>
> (b) would come within paragraph (a) were any person subject to the legal or regulatory requirement to be aware of the information, or

(c) would come within paragraph (a) or paragraph (b) if the subject matter of the information came to fruition (whether or not it does so);'

'announceable information' means information, other than disclosable information, that:

(a) will become the subject of a public announcement, or

(b) would come within paragraph (a) if the subject matter of the information came to fruition (whether or not it does so);'.

The current s 1042C(1) should be replaced with the following provisions:

1042C(1) For the purposes of this Division, information 'is generally available' only if it:

(a) is accessible to most persons who commonly invest in Division 3 financial products of a kind whose price or value might be affected by the information, or

(b) consists of deductions, conclusions or inferences made or drawn from any information referred to in paragraph (a).

1042C(1A) Information is deemed to satisfy paragraph (1)(a) if it is disclosed pursuant to any prescribed disclosure procedure.

The defence in s 1043M(2)(a), which is part of the published information test, should be repealed.

Minority position

The Minority opposes the Proposal. Any particular problems that arise in specialist OTC markets and the like should be addressed by the introduction of defences and/or carve-outs that are justified by, and tailored to, the circumstances of the case.

Appendix 1 List of recommendations

Chapter 1. Matters that should change

Recommendation 1: Strengthen the reporting requirements for directors

Section 205G should be amended as follows:

- the provision should apply to all listed entities. However, exempt foreign entities should be taken to have complied with the provision if the directors of those foreign entities have complied with the disclosure requirements of their incorporating jurisdiction
- the disclosure obligation should 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
- 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
- where a director or senior executive has resigned from that position, the disclosure obligation should cover any relevant transactions that occurred before that resignation and within one month thereafter
- with off-market transactions, a copy of the contract should also be disclosed
- the obligation should be to disclose the closest approximate number of securities whenever it is not reasonably possible to know the exact number
- 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 information to be disclosed under this provision should not include changes that have arisen from transactions that have applied equally to all shareholders, and without individual shareholder election, such as capital reconstructions or bonus issues. These pari passu changes should only be subject to any applicable periodic or annual disclosure obligations.

The Committee does not support a materiality threshold that would permit senior executives to deal in small quantities without disclosure.

Recommendation 2: Restrict the on-selling exemption for underwriters

The exemption permitting the on-selling of securities and managed investment products under an underwriting agreement should be confined to sales to other underwriters/sub-underwriters.

Recommendation 3 Repeal the exemption for external administrators

There should be no exemption for any class of external administrators.

Recommendation 4: Clarify the relevant time for liability when trading through an intermediary

The legislation should clarify that an informed person cannot be liable for insider trading when acting through a professional intermediary unless a transaction takes place.

That being so, the relevant time for determining when that person will be taken to 'enter into an agreement' to deal in Division 3 financial products under s 1043A(1) and (2) should be when the person instructs the intermediary.

Recommendation 5: Extend the Chinese Walls defence to procuring

The Chinese Walls defence should cover the procuring offence.

Recommendation 6: Permit bid consortium members to acquire for the consortium

The 'own intentions' exemption should be amended to make clear that members of a prospective bid consortium can acquire on behalf of that consortium prior to the market becoming aware of the intended bid. However, these persons should not be entitled to trade on their own behalf before the market becomes aware of the bid, even with the consent of other bid consortium members.

Recommendation 7: Protect uninformed procured persons from civil liability

An uninformed procured person should not be required to return any profit made or loss avoided by that person from a transaction if that person establishes that the insider who procured that person did not receive any direct or indirect benefit from that transaction.

Recommendation 8: Extend the equal information defence to civil proceedings

The insider trading legislation should provide an equal information defence in civil proceedings similar to the defence that applies in criminal proceedings, namely that the counterparty to the transaction 'knew or ought reasonably to have known' of the inside information.

Recommendation 9: Permit courts to extend the range of civil claimants

The legislation should enable a court to extend the range of civil claimants who have traded in the market beyond the insider's immediate market counterparty, using the concept of 'aggrieved persons'.

Recommendation 10: Amend the test of generally available information

The Majority has elsewhere put forward a Proposal (Recommendation 38), part of which involves replacing the current published information and readily observable matter tests with a new test of when information is generally available.

The Minority opposes the Proposal and considers that the current published information and readily observable matter tests of when information is generally available should remain, subject to changes to the latter test.

Recommendation 11: Informed party exercising option rights

The Majority considers that persons who, in good faith, enter into fixed exercise price physical delivery option contracts when they are not aware of inside information should be entitled to exercise their physical delivery rights, even where they hold inside information at the time of exercise.

The Minority does not support this exemption.

Recommendation 12: Uninformed party requiring the exercise of option rights

Uninformed parties to any option contracts, whether or not fixed price, should be entitled to require their informed counterparties (that is, anyone who holds inside information at the time of exercise) to honour their physical delivery obligations.

Chapter 2: Carve-outs

Recommendation 13: Entity making a general securities issue

Issuers

The Majority considers that issuers making a general issue should not be subject to the insider trading provisions.

The Minority does not support this exemption.

Offerees

The Advisory Committee considers that offerees who subscribe for new issues when aware of inside information not known to the issuer should remain subject to the insider trading provisions.

Recommendation 14: Entity making an individual securities placement

The Majority considers that neither issuers making placements to wholesale investors, nor any placees in an individual placement, should be subject to the insider trading provisions.

The Minority considers that the insider trading provisions should continue to apply to all issuers and placees.

Recommendation 15: Share buy-backs

Buy-back entities

The Majority considers that the insider trading provisions should apply to an entity buying back its own shares, except where the buy-back legislation requires that the entity make full prior disclosure of material information to shareholders.

The Minority considers that the insider trading provisions should apply to a buy-back entity in all circumstances.

Offerees

The Advisory Committee considers that the insider trading provisions should continue to apply to offerees under share buy-backs.

Recommendation 16: Transactions under non-discretionary trading plans

The Majority considers that there should be an exemption from the insider trading provisions for trading under non-discretionary plans where:

- the trading takes place in accordance with a plan entered into when either the person was not aware of any inside information or any information of which the person was then aware was no longer inside information when any trading under the plan took place
- there are no discretions under the plan, other than to terminate it, and
- the plan was entered into in good faith and not as part of a scheme to evade the insider trading prohibitions.

The person seeking to rely on the exemption should have the legal onus of establishing the above elements, rather than merely an evidential onus to raise them.

The Minority does not support any exemption.

Chapter 3: Matters that should not change

Recommendation 17: Regulate entities as well as natural persons

The definition of insider should continue to include entities as well as natural persons.

Recommendation 18: Maintain 'information connection' only approach

The 'information connection' approach, without any additional 'person connection' test, should be retained.

Recommendation 19: Not introduce rebuttable presumptions

There should be no rebuttable presumptions.

Recommendation 20: No extension to decisions not to trade

Decisions not to trade, disclosing inside information for that purpose and procuring another person not to trade, should continue to be excluded from the insider trading legislation.

Recommendation 21: No requirement to inform recipients that they are receiving inside information

There should be no obligation to inform recipients that information is inside information.

Recommendation 22: Inside information need not be specific or precise

There should be no requirement that inside information be specific or precise.

Recommendation 23: No use requirement

The Advisory Committee elsewhere recommends an exemption for informed persons trading pursuant to a pre-existing non-discretionary trading plan (Recommendation 16). Subject to this limited exception, the insider trading legislation should not have a use requirement or a defence of non-use.

Recommendation 24: No exemption for trading contrary to inside information

There should be no defence that an informed person traded contrary to inside information.

Recommendation 25: Retain the communication and subscription exemptions for underwriters

The communication and subscription exemptions for underwriting should be retained.

Recommendation 26: Intermediaries to remain subject to aiding and abetting laws

An intermediary who is aware that a client holds inside information should remain liable for aiding and abetting by trading in affected financial products for that client.

Recommendation 27: No exemption for informed intermediaries acting for uninformed clients

There should be no exemption for informed intermediaries acting for uninformed clients.

Recommendation 28: No derivative civil liability for controllers

There should be no derivative civil liability provision.

Recommendation 29: No exemption for directors of takeover targets

There should be no specific exemption for target company directors in communicating inside information to white knights.

Recommendation 30: No exemption for white knights of takeover targets

There should be no statutory exemption for white knights of takeover target companies.

Recommendation 31: No obligation on exchanges to publish their insider trading referrals

Exchanges should not be obliged to publish any details of their referrals to ASIC of suspected insider trading.

Recommendation 32: No differing criminal and civil insider trading regimes

There should not be different criminal and civil insider trading regimes.

Recommendation 33: No immediate reform of ASIC's enforcement powers

The Advisory Committee does not put forward a formal recommendation on whether ASIC should have a power to impose administrative penalties for insider trading. However, any further consideration of whether ASIC should have this power should take into account the recommendations in the ALRC Report, Principled Regulation: Federal Civil & Administrative Penalties in Australia, that deal with procedural fairness and review of administrative decision making.

Recommendation 34: No change to compensation assessment rules

The existing rules for assessing the profit made or loss avoided should remain.

Recommendation 35: Retain civil remedies for companies whose securities are traded

The existing law, under which companies whose financial products are traded are entitled to compensation, should remain, even where those companies have suffered no loss or damage.

Recommendation 36: No speculative trading provision

There should be no new statutory prohibition on speculative trading.

Recommendation 37: No short swing profit provision

There should be no specific statutory prohibition on short swing profits.

Chapter 4: Applying the insider trading legislation in different financial markets

Recommendation 38: Focus the prohibition

The Advisory Committee supports the application of the insider trading legislation to all currently regulated financial markets and financial products. However, there is a difference of view within the Committee on whether there should be any consequential amendments to meet the circumstances of different financial markets.

Majority Proposal

Section 1043A should be amended by adding new paragraphs (1)(ba) and (2)(ba) as follows:

> '(ba) the inside information is disclosable information or announceable information;'.

The following definitions should be added to s 1042A:

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>
> (a) has to be disclosed either now or in the future pursuant to any legal or regulatory requirement (other than a requirement for disclosure only to a counterparty), whether or not that obligation is complied with, or
>
> (b) would come within paragraph (a) were any person subject to the legal or regulatory requirement to be aware of the information, or
>
> (c) would come within paragraph (a) or paragraph (b) if the subject matter of the information came to fruition (whether or not it does so);'
>
> **'announceable information'** means information, other than disclosable information, that:
>
> (a) will become the subject of a public announcement, or

(b) would come within paragraph (a) if the subject matter of the information came to fruition (whether or not it does so);'.

The current s 1042C(1) should be replaced with the following provisions:

> 1042C(1) For the purposes of this Division, information 'is generally available' only if it:
>
> (a) is accessible to most persons who commonly invest in Division 3 financial products of a kind whose price or value might be affected by the information, or
>
> (b) consists of deductions, conclusions or inferences made or drawn from any information referred to in paragraph (a).
>
> 1042C(1A) Information is deemed to satisfy paragraph (1)(a) if it is disclosed pursuant to any prescribed disclosure procedure.
>
> The defence in s 1043M(2)(a), which is part of the published information test, should be repealed.

Minority position

The Minority opposes the Proposal. Any particular problems that arise in specialist OTC markets and the like should be addressed by the introduction of defences and/or carve-outs that are justified by, and tailored to, the circumstances of the case.

Appendix 2 List of respondents

Respondents to the Discussion Paper

- Allan Hodgson & Michael J Whincop, Griffith University
- Australian Financial Markets Association
- Australian Institute of Company Directors
- Australian Securities and Investments Commission
- Australian Stock Exchange
- Bundesaufsichtsamt für den Wertpapierhandel [Federal Supervisory Office for Securities Trading]
- Commonwealth Bank of Australia
- Commonwealth Director of Public Prosecutions
- Chartered Secretaries Australia
- Deborah A DeMott, David F Cavers Professor of Law, Duke University School of Law
- International Banks and Securities Association of Australia
- Law Council of Australia
- Najmeh Habili
- NSW Young Lawyers Business Law Committee
- Ontario Securities Commission
- Robert E Forbes & Ralph L Simmonds, Murdoch University
- The Institute of Chartered Accountants in Australia and CPA Australia
- UK Department of Trade and Industry
- US Securities and Exchange Commission
- Westpac Banking Corporation

Respondents to the Proposals Paper

- ANZ Bank
- Attorney-General's Department
- Australian Financial Markets Association
- Australian Financial Markets Association, Energy and Electricity Committee
- Australian Institute of Company Directors
- Australian Securities and Investments Commission
- Australian Stock Exchange

- Chartered Secretaries Australia
- Commonwealth Bank of Australia
- Commonwealth Director of Public Prosecutions
- Deutsche Bank
- Edison Mission Energy
- Electricity Supply Association of Australia Limited
- Energy Australia
- Ian Cochrane
- IG Group
- International Banks and Securities Association of Australia
- JBWere Limited
- Law Council of Australia
- Legislative Review Task Force of the Commercial Law Association
- Loy Yang Power
- Macquarie Generation
- Shaun Ansell
- Southern Hydro
- Snowy Hydro Limited
- Stanwell Corporation Limited
- Sydney Futures Exchange
- The Institute of Chartered Accountants in Australia and CPA Australia
- TXU