24 April 2002

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

Initially by email to: john.kluver@asic.gov.au

Dear John

CAMAC Insider Trading Discussion Paper

The Australian Financial Markets Association (AFMA) would like to thank the Corporations and Market Advisory Committee (CAMAC) for its encouragement to make a submission for its inquiry into insider trading. Also, thank you for presenting at the AFMA Seminar "FSR: An Industry in Transition" on Thursday 11 April. The date was chosen to be one month after the implementation date of the FSR laws, and it is clear that your presentation was well received.

AFMA represent the participants in the over-the-counter (OTC) financial markets, a new industry sub-sector to the ongoing Insider Trading debate. AFMA and our members are coming to grips with the effects of the unilateral widening of the Insider Trading offences through FSR to all OTC transactions which took effect without transition on 11 March 2002. The turnover of the OTC financial markets dwarfs that of the exchange markets in overall size and growth. In the fiscal year to 30 June 2001, OTC financial markets contributed A$31 trillion, or 72%, of all financial markets turnover. The growth in the OTC markets was 13.5%. A summary of all Australian financial markets turnover is attached in the Appendices.

The FSR insider trading provisions put this vibrant and healthy sector of Australian financial markets at risk of flight to more favourable jurisdictions. Where trading cannot move overseas, there is a strong possibility that the efficiency of the OTC financial markets will be impaired by laws designed for public retail access markets. Accordingly, the issue of insider trading is very important to Australian OTC financial markets and dealers.

We believe that the FSR formulation of insider trading laws – particularly to the over the counter (OTC) markets - is unique in the world. We believe that the laws, which have application to global trading which occurs in Australia, are very different in scope to those applicable in other jurisdictions and will expose Australia to the scrutiny in view of the experimental nature of the approach being adopted. The world's financial services regulators, particularly those in our timezone who look to Australia for leadership, will be watching to see what affect the Laws will have on market efficiency, enforceability, market abuse, and market participants.

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The Australian Financial Markets Association submits the following solutions for consideration:

1. Limit insider trading to prescribed financial markets (such as FSR Regulation 7.1.01); and,
2. Limit insider trading to listed products; and,
3. Re-define what constitutes inside information for the purposes of different markets (particularly OTC financial markets).

These proposals are not inconsistent with the UK FSA Code of Market Conduct, which recognizes the differences between different markets and participants.

It is particularly difficult to combat all the issues and legacy of insider trading, as it applies to OTC trading in a single submission. The FSR Task Force would be pleased to provide further supplementary submissions to assist in CAMAC's deliberations. Additionally, the members of the AFMA FSR Task Force have indicated their willingness to meet directly with CAMAC or the CAMAC legal committee to discuss any matter relevant to this submission. One subject that is too vast to write into a submission, but may be worthwhile for CAMAC is the operations of the OTC financial markets and the differences between the OTC and the traditional licensed financial markets.

This submission also includes as appendices:

- Members of AFMA
- Members of the AFMA FSR Task Force
- Selected comments on the issues raised in the CAMAC Insider trading Paper

The Electricity trading members of AFMA are preparing a special submission on the application of FSR Insider Trading laws to electricity derivatives trading, and particularly by the producers of electricity. That submission is nearing completion.

Please feel free to contact me on the numbers listed below.

Yours sincerely

John R Rappell
Director, Policy & FSR Consulting

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Postscript:
"Mit Geduld und Zeit ,wird sich der tiefe Geistigernebel über Insiderhandel auflösen"

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"The amendments (to the Insider Trading Laws) demonstrate the Government's willingness to refine the law where unintentional barriers to business may have emerged. We are set on having a flexible, pro-business approach without compromising the integrity of the legislation and making sure implementation goes smoothly for all stakeholders."

Senator Ian Campbell, Parliamentary Secretary to the Treasurer, 25 March 2002

Introduction

The Australian Financial Markets Association (AFMA) is of the view that it is appropriate for different types of markets to have different rules depending upon the nature of the market, it's participants and the products traded. In the case of OTC financial markets the participants are predominantly sophisticated institutions which have an intimate knowledge of the market, it's risks and other participants. It is crucial to note that insider trading has not been considered an issue in respect of OTC financial markets prior to implementation of FSRA in Australia or elsewhere. As you are aware, prior to implementation of FSRA, OTC financial markets (other than bonds) were not subject to insider trading laws. The general lack of insider trading laws for OTC financial markets prior to FSRA did not result in a perception that insider trading occurred in OTC financial markets or was a problem in any way. By contrast it is generally accepted that insider trading can be a problem and ought to be regulated in exchange traded environments where retail participants have significant involvement. Some of the reasons why insider trading is not a significant issue for OTC financial markets include that participants on OTC financial markets are usually highly sophisticated, understand the way in which the markets work (including in some circumstances the existence of information asymmetry), often have ongoing commercial relationships which depend on maintaining positive reputations and place a premium on maximum flexibility in their markets. In other words, participants in OTC financial markets generally choose to accept less regulation in exchange for speed and flexibility, in this regard I refer to the comments about transparency levels made under the heading "Market Microstructure Research" below.

In simple terms AFMA's view is that insider trading was not an issue for OTC financial markets prior to FSRA. Consequently, the imposition of insider trading laws on OTC financial markets is the equivalent of applying a remedy where there is no ill. If the application of insider trading laws to OTC financial markets merely solved no problems, AFMA would not object, however, there are also negative consequences of the application. Negative consequences, include additional compliance costs, the potential for markets to close down if key players can not trade for certain periods and the creation of a perception by global firms that Australia is a difficult jurisdiction in which to operate. For example, most OTC financial markets do not have any centralised information distribution infrastructure, therefore once inside information is received it would be difficult to make it public in an effective manner, so if a participant receives inside information when it holds open positions, is a market maker or otherwise would have been trading, the participant would be required to cease operations and potentially incur significant damage until it is able to cleanse itself. In the absence of any offsetting benefits from the application of the insider trading laws to OTC financial markets, these negatives have the potential to make Australia a disadvantageous jurisdiction in which to operate.

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Application of insider trading to the pre-FSR laws

The AFMA FSR Task Force has considered the application of Insider Trading to OTC financial markets in the pre-FSR Corporations Law.

While it can be argued that the pre-FSR insider trading laws included OTC transactions, we believe that such a position is an overly literal interpretation of the laws. Any inclusion of OTC financial transactions in the Insider Trading provisions would have been unintended and incidental and not in response to any policy setting of which we are aware. The pre-FSR Insider Trading laws were formulated without any consideration of OTC transactions, and were never challenged by industry as they were never considered to apply OTC transactions. It is arguable that they were never prosecuted because:

1. There were no offenders or offences brought to the attention of the regulator which required prosecution (which would indicate requirement for no further regulation); or,
2. There was no intention to prosecute OTC transactions because of their unintended and incidental inclusion; or,
3. The insider trading laws were not enforceable in the OTC markets, as they were designed for authorized markets.

OTC financial markets with no requirement, or mechanism, for disclosure.

One criticism of the FSR Insider Trading laws regards Insider Trading as an information question. In other words, the critique approaches the concept of insider trading from an alternate position. That position is one where Insider Trading is an offence against the normal operations of a disclosure regime, which is understood and expected by the market participants. The issue with the FSR insider Trading laws is that it has extended the laws that relate to the retail public access, exchange-based disclosure regime to products, participants, and markets that do not have a disclosure regime. It is inappropriate to have an offence for not disclosing in markets that have and expect to have no disclosure requirement, and no disclosure mechanisms.

The OTC market does not have a mechanism to ensure that material information is disclosed to the market on a timely basis as is the case with a listed exchange such as the Australian Stock Exchange which has a CAP platform. Therefore if a participant has inside information there is no mechanism available to ensure that information which should have made generally available can be made available to the market. This would result in a breach of the insider trading regime.

The case for excluding over the counter financial markets and products from the insider trading law

The members of the AFMA FSR Task Force consider that the FSR insider trading provisions may not be pro-market efficiency for the purposes of OTC financial markets transactions between non-anonymous, private non-retail parties. It is arguable that the FSR Insider Trading Laws are anti-efficiency for the participants of the OTC markets, as they have the potential to discourage participation or active risk management.

The issue with the FSR laws, and their application of functionally uniform regulation, is that only one market microstructure has been considered – that of a retail-transparency based public-access markets – such as the Australian Stock Exchange. The former Chapter 7 provisions have been applied to the public-access futures markets and all other financial

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markets. The concept of "able to be traded on a financial market" has been extended from the pre-FSR formulation relevant to authorized markets, to all financial markets regardless of whether the financial market is operated centrally or not; and regardless of whether the financial market requires licensing or not.

Market Microstructure research

The market microstructure research of Professors Maureen O'Hara, Vernon Smith, and Charles Plott, uphold the FSA Code of Market Conduct where it says:

> "The extent to which market users may reasonably expect to have access to information differs between different markets."[1]

These researchers are internationally renowned economists and game-theorists. We would consider it appropriate to consult economists when the objective of the FSR insider trading laws is market efficiency. It would be appropriate for economists and market microstructure experts to have a greater say in the public policy formulation. We have supplied list of readings that may assist in the Appendix.

The research and evidence shows that pro-efficiency measures in markets that have retail access differ from pro-efficiency measures for non-retail access markets. For example, wholesale participants will migrate towards lower transparency markets, while retail participants will migrate towards higher transparency markets. This is a readily observable fact of the Australian financial markets.

The specific issue of OTC credit derivatives

Banks are increasingly using a variety of techniques to actively manage loan portfolios and to maximise their performance, including through the purchase or sale of physical loans and credit derivatives. APRA and international prudential regulators actively encourage management of credit portfolios by ADIs. Counterparties in this market are invariably sophisticated domestic and international institutions. Extension of the insider trading provisions to credit derivatives entered into by ADIs, as part of their portfolio management activities is not necessary either on the grounds of efficiency or public policy.

Firstly, it is anomalous that one can trade in the physical loan market with no insider trading implications, but not the credit derivative market, which simply makes the process of transacting more efficient and adds market depth.

Secondly, even if it is considered that these market participants need protection, it is submitted that such protection is afforded under the current misleading and deceptive conduct provisions, and that it is not appropriate to also bring this market within the criminal offence provisions. This argument may be applied more generally to the OTC markets as well.

[1] FSA Handbook, Chapter 1, Code of Market Conduct, Section 1.4.3, December 2001

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The regulatory outcomes of the FSR insider trading laws are different from the rest of the FSR laws. (Also Part 7.10 has no regulation or policy level modification)

The Insider Trading laws are directed towards Market efficiency or market fairness. These are concepts that require economic interpretation. With the exception of some the other Part 7.10 Market Misconduct offences the remainder of the financial services reforms were directed primarily to (retail) consumer protection.

The application of new offences and penalty provisions, the changes in burden of proof and intent, while assisting with the prosecution of the offences are not necessarily germane to market fairness, and have also added further confusion to a debate which has had no resolution in over a decade.

Hidden consumer protection in the insider trading provisions – “front running”; “scalping”; “piggy backing”

The FSR Insider Trading provisions have a number of implicit consumer protection measures against “abuse of relationship” between the client and the broker or counterparty. The abuse of relationship relates to the fiduciary or stewardship responsibility that a broker has for its client, or a OTC trader where an order cannot be executed immediately due to the clients instructions (examples: Stop-loss, on-close, etc).

These abuses, while requiring regulation, should not be hidden within the provisions of the Insider Trading laws, which are apparently designed for market efficiency and fairness. They require, and should have, their own consumer protection-style laws and remedies designed accordingly.

There should be separate market misconduct provisions, applicable to OTC markets, to ensure that participants act with integrity and to provide consumer protection. The FSR Market Misconduct provisions may be the appropriate avenue for the hidden consumer protection aspects of the insider trading laws.

The concerns of the FSR Civil Penalty provisions

The best view of the new FSR civil penalties would be to encourage participants in the market participants to take direct action against each other. This is a serious concern for the Directors and officers of our Members, including the AFMA Executive Committee (the association equivalent of a Board).

Another consequence of the FSR Insider Trading provisions relating to OTC trading activity is that there are very few “actual insiders”. The targets of the laws are the intermediaries – particularly those who deal in derivatives or make markets.

This consequence was recognized in the legislative changes, which passed through the houses on 21 March 2002. In his press release, the Parliamentary Secretary to the Treasurer explained the late changes to the Insider Trading Laws in the following manner:

> "They will ensure that the insider trading provisions do not jeopardise the capacity of over the counter market makers to manage risk through the use of derivative products," Senator Campbell said.

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The Senators comments reflect that an unintended consequence of the FSR Insider Trading Laws was that bona fide trading by OTC participants could be considered Insider Trading. The target of the FSR Insider Trading laws is the AFS licensee, the persons who will collectively be supplying market liquidity. AFS Licensees could be viewed as "actual insiders" in areas where they are also "producers" (such as credit, mergers and takeovers advice, etc), but not in the course of their day-to-day business as intermediaries. Unfortunately, the FSR Insider trading laws makes no distinction between "actual insiders" and incidental or accidental insiders

The application of the insider trading rules to the OTC market ignores the fundamental difference between exchange traded and OTC markets. An OTC contract is a bilateral principal to principal contract executed at a negotiated price. The contract can be tailored to a client's needs in terms of product structure, settlement terms, and dealing method. Conversely, a transaction conducted on a listed exchange is subject to fixed terms and conditions that are dictated by the exchange and which indiscriminate of counterpart. Inherent in an OTC market participants ability to provide a price *is* that the participant will have information which others in the market do not have. Therefore OTC price makers may inherently be in breach of the insider trading regime when pricing OTC contracts

The case for commending the approach taken in the UK FSA Code of Market Conduct

The UK FSA Code of Market conduct applies to qualifying investments traded on a prescribed market. AFMA recommend that the Australian law should examine this approach, and prescribe what markets the Insider Trading laws apply to. The FSA Code of Market Conduct prescribes markets, for example: London Stock Exchange, AIM, LIFFE, LME, IPE. The Australia laws could prescribe markets such as the Australian Stock Exchange and Sydney Futures Exchange. Through this mechanism the law would preserve the policy basis of the pre-FSR laws, and ensure a closer analogue with international best practice.

This could be achieved in the current law by defining the term "able to be traded on a financial market". The current definition of that phrase is non-inclusive and leaves a number of questions unanswered, particularly in relation to OTC financial markets. An alternate to defining that phrase would be to replace it with "able to be traded on a licensed market", such as that used in s.1043K.

The FSA's Code of Market Conduct accepts that insider trading must relate to and reinforce the accepted disclosure regime of each unique market structure. The FSA Code also recognises that different markets differ in information that is expected by the participants in that market.

Public policy, market efficiency, and ethical regulatory environment. Can they be all optimised simultaneously?

AFMA is concerned that the application of the law is efficacious when viewed from the perspective of public policy and market efficiency. This paper includes examples that illustrate that an inappropriate doctrinaire approach is being used as the basis for "policy". A good example is the overriding doctrine of uniform regulation of functionally similar financial products. That principle is very suitable for the purposes of (retail) consumer protection for which it was designed. It enables consumers to more easily compare the advantages and disadvantages of different products. It also results in the providers of retail products being treated in a more evenhanded manner. However, this principle of uniform regulation is not

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appropriate for achieving the additional objective of the financial services reforms – market integrity. Attention needs to be given to the very different nature of the markets and in particular the OTC markets. Reinforcing this point are the FSR Regulations which differentiate between transactions on a licensed exchange and those transacted over-the-counter. While it is the case that functionally similar regulation was an objective, the implementation of that objective needed to be adjusted in its application to different financial markets.

A third aspect, which is very important to AFMA, as a self-regulating association, is that of appropriate ethical balance in the laws. It is very difficult to encourage effective self-regulation in the context of laws that transparently display an attachment to a doctrinaire approach in place of an appropriate balancing of regulatory interests. For example, AFMA is of the view that it is both inefficient and unethical to devise laws that are unenforceable, or which give rise to unintended consequences, which would have been uncovered with a careful regulatory impact study.

In the case of insider trading, AFMA believes that there has been insufficient review of the so-called policy decisions made during the CLERP process. This is most clearly illustrated in the FSR Act Revised Explanatory Memorandum:

> Feedback from consultations: There were very few comments on the proposed changes to market misconduct and insider trading provisions, and no objections to the proposal to make a single set of provisions apply to all financial products that may be traded on a financial market[2][3]

While industry did not understand the scope of the Part 7.10 offence provisions until after they were passed into Law, it is clear that there are many objections to applying the Insider Trading laws to a wider range of products and a wider range of financial markets.

[2] Revised Explanatory Memorandum 2.84

[3] AFMA do not agree with the comment in the same section regarding “Costs/Benefits: Industry will benefit from the consistent regulation of functionally similar products, as they can be certain about the type of behaviour that is prohibited in relation to all relevant financial products” Explanatory Memorandum 2.82

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Appendix: Some useful readings of OTC market efficiency, fairness, and transparency

Easley, D., Kiefer, N., O'Hara, M., & Paperman, J., 1995, "Liquidity, Information, and Infrequently Traded Stocks", Working Paper, Cornell University.

Bloomfield, R., & O'Hara, M. 1996, "Market Transparency: Who wins and who loses?", Working Paper, Johnson Graduate School of Management, Cornell University.

Bloomfield, R., & O'Hara, M. 1997, "Can Transparent Markets Survive?", Working Paper, Johnson Graduate School of Management, Cornell University.

Brown-Hruska, S. & Laux, P., 1997, *The Role of EFPs in Futures Markets - An old dog does new tricks"*, Research Paper, Catalyst Institute.

IOSCO Technical Committee Working Party on the Regulation of Secondary Markets, 1992, *Transparency on Secondary Markets - a synthesis of the IOSCO debate*, International Organization of Securities Commissions, Milano, Italy.

Lamourex, C., & Schnitzlein, C., 1997, "When its not the only game in town: The effect of bilateral search on the quality of a dealer market", *Journal of Finance*, 683-712.

Lyons, R., 1996, "Optimal transparency in a dealership market with an application to foreign exchange", *Journal of Financial Intermediation*, 5.225-254.

Madavan, A., 1996, "Security Prices and Market Transparency", *Journal of Financial Intermediation*, 5.255-283.

O'Hara, M., 1995, *Market Microstructure Theory*, Blackwell Publishers, Cambridge, MA.

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Appendix: EXAMPLES OF COMMON TRADES, WHICH WILL BE IMPACTED BY INSIDER TRADING LEGISLATION

A member bank sought independent legal opinion on four common or everyday OTC transactions (It was also assumed that all trades in the scenarios provided may “materially” move the market). Based on the Act, Regulations and amendments/updates as at the end of March the **draft legal advice** received is that only in one scenario is the situation clear cut as to whether the bank has breached the insider trading provisions.

Scenario 1 – Clarified as not in breach

Client A telephones Bank X for a firm quote on a seven year Australian dollar interest rate swap in A$250m which the client accepts. Bank X then commences hedging the swap in the markets using a mixture of swaps, physical bonds and bond futures.

Before Bank X has completed hedging Client B calls and asks for a firm quote on A$150m. The price quoted to Client B reflects the risk held by the Bank from the previous transaction.

The view is Bank X would be exempt from the insider trading provisions under regulation 9.12.03 (íts “own intentions”). Further, the amendments to the Act would also exempt Bank X under s1043I(1) and (2).

Scenario 2 – Unable to clarify based on current law

Client A telephones Bank X seeking a firm quote on a seven year Australian dollar interest rate swap in A$250m. The client indicates that they are seeking quotes from three banks and want the quote-held firm for 2 minutes.

The dealer at Bank X is aware that the relationship manager is keen for the bank to win the business. The dealer quotes competitively but this can only be done on the basis of him pre hedging part of the risk even though he may be out bid on the quote. (If the quote is unsuccessful there is no guarantee that the dealer will be able to unwind the hedge profitably.)

The view is that in this scenario Bank X has a piece of information which is exempted by the regulations, i.e. it proposes to enter a transaction with the client. However, there is another piece of information regarding the client’s intention to enter into a transaction. The Bank therefore has knowledge of the client’s trading intentions as well as its own, and those intentions may not involve the Bank.

Based on amendments to the Act, Bank X will be exempt under s1043I(1) and (2) in relation to the information that it proposes to enter a transaction with the client. The issue with regard to the information of the client’s intention is still present.

Scenario 3– Unable to clarify based on current law

Client A telephones Bank X seeking an indicative quote on a seven year Australian dollar interest rate swap in A$250m. The dealer at Bank X concludes that the client will deal today, if not with Bank X then with another Bank and buys bond futures to reduce his current risk position which will lose money if the trade goes ahead and materially impacts the market.

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Scenario 4– Unable to clarify based on current law

As for scenario 3 but dealer has no open position when taking the call but buys bonds to benefit if the trade should proceed and materially move the market.

For both scenarios 3 and 4 the relevant information is what Client A might do (i.e. there is a possibility of activity). If this knowledge is sufficient to move the market and the approaches to banks by Client A have not been sufficient to make it generally available information, then there may be a breach of the insider trading provisions in the absence of any other defence.

The following are "real" examples where the FSR laws have unintended consequences by outlawing regular OTC financial market activity which would be considered regular activity by OTC financial market participants. The AFMA FSR Task Force with ABA and IBSA has collated these examples.

Example – "producers" risk management - Electricity Hedging

The only risk management transaction available for retailers or generators of electricity is to enter into bilateral electricity "swap" contracts. A derivative under FSR.

It is arguable that one or both could have inside information, that would not be able to be managed using a Chinese Wall. Generators may have some information about generation capacity and their bidding in the National Electricity Market. Retailers may have information about load, curtailability of load and demand side management. This is illustrated by a certain asymmetry that is mandated by the NEC which requires generators to publicly pre-notify generation capacity to NEMMCO, where there is no obligation on retailers as regards the demand side, load curtailability etc.

Example – Portfolio Management

Banks with a loan portfolio seek to maximise the performance of the portfolio by actively managing it, by buying and selling a variety of instruments, including physical loans, fixed interest securities, options and credit derivatives.

The decision to buy or sell a corporate credit could be driven by a variety of factors, including:

- a desire to free up credit limits to allow more business
- the view of a sector or country
- perceived credit issues, which could be based either on public or non-public information
- a desire to balance a portfolio between geographic regions and economic sectors
- capital attribution issues associated with internal or external credit ratings (ie more capital is required to support a loan with a lower credit)
- large credit exposure policies or other policy considerations.

The area responsible for the decision to buy or sell a credit would not usually be aware of any inside information relating to the credit in question. However, a transaction decision could be tainted by inside information which is contained in other parts of the organisation in circumstances where there was no intention to profit from that information.

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Putting the portfolio management area behind a chinese wall would not protect the process because transaction decisions need to take into account internal risk ratings and other credit requirements which are set by credit areas who must by definition be on the client side of the chinese wall. So even if a credit decision or rating is based on non-price sensitive factors (eg economic/sector/large credit exposure policies, etc) if at that time the credit area has inside information, then it could be said that the Bank is at risk of committing insider trading (under section 1043A(1)(d)) if any aspect of the credit process can be said to have influenced the transaction decision (which will often be the case), even where that decision was made by a person behind a chinese wall.

This inhibits the bank from carrying out bona fide risk management and portfolio management activities that are strongly supported by prudential regulators. It also creates an anomaly in that the same exposures could theoretically be obtained in the physical market with no insider trading concerns, subject to the additional inefficiencies that this would create (note however that transaction cost and the lack of liquidity in the physical market militates against this).

Example - effect of S. 1042G

The CEO of an existing major client calls on the MD of a bank. The CEO informs the MD that his company is experiencing trading difficulties and asks for some modification of its credit terms. Assuming this met the definition of insider information under S.1042A, then it would also mean that the bank would be taken to possess this information under S. 1042G. (It should be noted in passing that the bank has no mechanism for publicly disclosing this information, nor indeed may it do so without breaching client confidentiality. If information is market sensitive, it is the client's responsibility to disclose - not its bankers).

Six floors below and quite incidentally (ie. without knowledge of the MD's meeting with the client nor of its content) and as part of his normal trading activities a trader buys credit protection on the client from counterparty A (another bank). Six months later, the client suffers a rating downgrade, thereby increasing the value of the protection significantly. A sues for damages on the basis that the bank has traded on insider information.

The bank's only defence would be to rely on S1043F ("Chinese Wall arrangements by bodies corporate"). Thus it would have to demonstrate to the satisfaction of the court that Chinese Wall "arrangements" existed between the MD and the Trader and also between any intervening person between the MD and the Trader. Presumably, these arrangements would need to be substantive, identifiable and auditable to satisfy the provisions of 1043F. This effectively means that contact between the MD and the Trader, and anyone else either of them would come into contact with inside the organisation, has to be carefully circumscribed.

The position is even more fraught with difficulty because a bank is awash with credit information – the reason being that providing credit is its core business. Furthermore, that information may emerge in, or pass to, various departments of the bank such as Tax, Finance, Legal, Credit Assessment and a host of others as well as the normal line banking centres. In this context the footnote #265 to Paragraph 2.192 of the Discussion Paper is germane to this issue, except that in the footnote's example the trader procures a client to trade, whereas in the circumstances described above it is the bank itself that is trading. The conclusion is that the law forces the bank to institute a multitude of Chinese Walls within the organisation, making the monitoring of compliance a nightmare undertaking - a clearly impractical outcome.

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A solution is to exempt credit providers from the provisions of S.1042G whereby insider information relating to the credit worthiness of an existing client is imputed to the organisation as a whole merely because one of its officers receives that information in the course of his duties.

This example and the proposed solution does not preclude a wider exclusion of derivatives from the insider trading provisions of the FSRA. Arguments for that outcome are included elsewhere in this submission.

Example – orders that cannot be executed immediately:

Large client orders not "at market", that is, at the prevailing price. Examples include stop-loss, good 'til done at a price, "take profit", etc. These are the so-called "book" orders.

May be inside information and material, but what if the "orders" are not at the current price. That is they may or may not be material in the future, but that would have to be assessed contextually. Therefore can the Bank deal now with knowledge of the client's future trading intentions, even though they are probably going to deal with the Bank?

Example – Credit event of a client trading

LargeMiningCo had entered into a series of FX and silver derivatives with approximately 30 different banks. These banks constituted all the market makers for FX and silver in Australia. LargeMiningCo then experienced financial difficulties – the 30 banks involved were all aware of this. This information was price sensitive with respect to Australian FX and silver prices. Consequently, the banks involved had insider-trading information, but not as a direct result of their trading or market making activities.

The FSR own transaction exemption would not have been available in this example. The Chinese walls exemption would also not given relief as each of the Banks needed to draw on the expertise of different parts of their organisations, and would have breached a Chinese wall. It may also be an issue where there is only a single dealer able to trade a particular product (say, silver).

If this had occurred under the FSR regime, all 30 banks would have been barred from participating in the Australian FX and silver markets while they had this information. There may have been a serious reduction in the efficiency of the Australian FX or silver markets while the situation continued.

Whilst it may be possible to argue that this is an rare incident, the same principle applies whenever a syndicate of banks is involved with a large corporation, and the corporation puts the syndicated banks on notice that it is going to do something which would affect an OTC market. This includes informing the syndicate banks that the corporation has plans to move offshore, has takeover plans or is in financial distress.

(Note: many firms would not allow the knowledge of financial difficulties to reach the traders. That information would be behind the Chinese Wall with Credit and senior mgmt as necessary to assess our exposures. If necessary due to expertise we would bring a trader over the wall but in the knowledge that they could not trade. Also it is sometimes possible to obtain the necessary expertise from a person without giving them the specific circumstances etc.)

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Appendix: Members of AFMA as at April 2002

FULL MEMBERS
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AMP Henderson Global Investors
AMP Services Limited
Arab Bank Australia Limited
Australia and New Zealand Banking Group Limited
AWB Limited
AXA Australia
BA Australia Limited
Bank of China
Bank of Queensland
Bank of Tokyo-Mitsubishi Australia Ltd
Bank of Western Australia Limited
Bank One, NA
Barclays Bank PLC
Bendigo Bank Limited
BNP Paribas
BOS International (Australia) Limited
Citigroup
Commonwealth Bank of Australia
Country Energy
Credit Agricole Indosuez Australia Ltd
Credit Suisse First Boston Limited
Credit Union Services Corporation (Australia) Limited
CS Energy Ltd
Delta Electricity
Deutsche Bank AG
Dresdner Bank AG, Australian Branch
Duke Energy Australia Trading & Marketing Pty Ltd
EdgeCap Pty Ltd
Energex Retail Pty Ltd
Eraring Energy
Ergon Energy Pty Ltd
Energy Australia
Enertrade
Enron Australia Finance Pty Ltd
Goldman Sachs Australia Pty Limited
HSBC Bank Australia Limited
Hydro-Electric Corporation
ICAP Australia Pty Ltd
ING Bank (Australia) Limited
ING Bank NV Sydney Branch
InterGen (Australia) Pty Ltd
Integral Energy Australia Corporation
J B Were Capital Markets
JPMorgan Chase Bank
Loy Yang Power Management Pty Ltd
Macquarie Bank Limited
Macquarie Generation
Merrill Lynch (Australia) Pty Ltd
Mizuho Corporate Bank Ltd, Sydney Branch
N M Rothschild & Sons (Australia) Limited
National Australia Bank Limited
National Power Australia Pty Ltd
Nomura Australia Limited
Northern Territory Treasury Corporation
NRG Flinders
NSW Treasury Corporation
OCBC Bank
Origin Energy
Prebon Yamane Money Markets (Australia) P/L
Primary Industry Bank of Aust. Ltd
Queensland Investment Corporation
Queensland Treasury Corporation
RBS (Australia) Pty Ltd
Royal Bank of Canada
SG Australia Limited
Snowy Hydro Trading Pty Ltd
South Australian Government Financing Authority
Southern Hydro Partnership
St. George Bank Limited
Stanwell Corporation Limited
Sumitomo Mitsui Finance Australia Limited
SUNCORP-METWAY Ltd
Tarong Energy Corporation Limited
Tasmanian Public Finance Corporation
Telstra Corporation Limited t/as Telecom Australia Limited
TFS Australia Pty Ltd
The Australian Gas Light Company
The Toronto Dominion Bank Australian Branch
Treasury Corporation of Victoria
Tullett & Tokyo Liberty Pty Ltd
TXU Trading
UBS Warburg Australia Limited
UFJ Australia Limited
United Overseas Bank Limited
Western Australian Treasury Corp.
WestLB Sydney Branch
Westpac Banking Corporation
Yallourn Energy Pty Ltd
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Reserve Bank of Australia

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Appendix: Members of the AFMA FSR Task Force

First Name	Last Name	Organisation
Michael	Cleland	Australia and New Zealand Banking Group Limited (VIC)
Bill	Fuggle	Baker & McKenzie
Helen	Bakoulis	Citigroup (NSW)
Victoria	Weekes	Citigroup (NSW)
Debra	Cass	Commonwealth Bank of Australia
Peter	Green	Commonwealth Bank of Australia, Sydney
Andrew	Lumsden	Corrs Chambers Westgarth
Anastasia	Economou	Credit Suisse First Boston Australia Limited, NSW
Charmaine	Byrne	Credit Suisse First Boston Australia Limited, NSW
Andrew	Robertson	Deutsche Bank AG (NSW)
Scott	Carran	JPMorgan
Camille	Blackburn	Macquarie Bank Limited
Julie	Abramson	National Australia Bank Limited (Vic)
Terence	Keefe	National Australia Bank Limited (Vic)
Scott	Mannix	NSW Treasury Corporation
Doug	Clark	Securities & Derivatives Industry Association
Sean	Rahilly	SG Australia Limited
Astrid	Gates	St George Bank Limited
James	Andrae	Tarong Energy Corporation Limited
Euan	Macallan	Treasury Corporation of Victoria
Tracy	Hudson	Westpac Banking Corporation
David	Pearson	Westpac Banking Corporation, Sydney
Orla	Fisk	Zurich Capital Markets Australia Ltd
John	Rappell	Australian Financial Markets Association
Alexandra	Johnson	Australian Financial Markets Association

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Appendix: OTC vs exchange traded turnover data: Australian Financial Markets Report

1.1: The Australian Financial Markets - Summary of Total Market Turnover						
	Annual Turnover (AUD billion)a					
	1996-97	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**% Changeb**
OTC Financial Markets						
Government Debt Securities	1,387	1,102	1,054	1,043	1,019	(2.3)
Non-Government Debt Securities	62	82	150	205	257	25.2
Negotiable & Transferable Instruments	1,334	1,599	1,872	2,063	2,448	18.7
Repurchase Agreements	2,413	3,117	3,918	5,498	5,017	(8.8)
Swapsc	410	451	577	868	1,470	69.4
Forward Rate Agreements	518	498	527	1,060	1,675	58.1
Interest Rate Options	71	66	53	51	52	1.7
OTC Equity Derivatives			8	11	15	37.3
Credit Derivatives				18	28	53.3
Foreign Exchange	15,320	17,249	19,131	15,942	18,181	14.0
Currency Options	334	569	655	606	909	50.1
Total OTC Financial Markets	**21,849**	**24,763**	**27,945**	**27,365**	**31,071**	**13.5**
Exchange Traded Markets						
Equities						
ASX Shares	211	243	282	362	418	15.4
ASX Options	98	74	91	104	133	27.7
Total Equities Markets	309	317	373	466	551	18.1
Futures						
SFE Futures	7,396	8,703	9,428	9,753	10,709	9.8
SFE Options	1,316	964	752	556	450	(19.1)
Total Futures Markets	8,712	9,668	10,180	10,309	11,159	8.2
Total Exchange Traded Markets	**9,021**	**9,985**	**10,553**	**10,775**	**11,709**	**8.7**
All Financial Markets	**30,870**	**34,718**	**38,498**	**38,140**	**42,781**	**12.2**
OTC Electricity Derivatives				133	203	52.7
				million megawatt hours		

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1.2: The Australian Financial Markets - Summary of Total Market Turnover

	Annual Turnover (AUD billion)					
	1996-97	**1997-98**	**1998-99**	**1999-00**	**2000-01**	**% Change**
Debt Markets						
Physical Market Turnover						
Government Debt Securities	1,387	1,102	1,054	1,043	1,019	(2.3)
Non-Government Debt Securities	62	82	150	205	257	25.4
Negotiable & Transferable Instruments	1,334	1,599	1,872	2,063	2,448	18.6
Sub-Total	2,783	2,783	3,076	3,311	3,724	12.5
Off Balance Sheet Turnover						
Repurchase Agreements	2,413	3,117	3,918	5,498	5,017	(8.8)
Swaps	410	451	577	868	1,470	69.3
Forward Rate Agreements	518	498	527	1,060	1,675	58.1
Interest Rate Options	71	66	53	51	52	1.9
Credit Derivatives				18	28	49.7
SFE Interest Rate Futures and Options	8,483	9,388	9,839	9,884	10,810	9.4
Sub-Total	11,895	13,520	14,914	17,379	19,052	9.6
Total Debt Markets	**14,678**	**16,303**	**17,990**	**20,690**	**22,776**	**10.1**
Multiple of Off-Balance Sheet Activity						
to Physical	4.3	4.9	4.8	5.2	5.12	
Currency Markets						
Physical Market Turnover						
Spot Foreign Exchange	5,887	7,156	8,312	5,805	5,315	-8.4
Sub-Total	5,887	7,156	8,312	5,805	5,315	-8.4
Off Balance Sheet Turnover						
FX Swaps	8,811	9,173	9,688	9,165	11,602	26.6
Forward Foreign Exchange	622	920	1,131	972	1,264	30.0
Currency Options	334	569	655	606	909	50.1
Sub-Total	9,767	10,692	11,474	10,743	13,775	28.2
Total Currency Market	**15,654**	**17,818**	**19,786**	**16,548**	**19,090**	**15.4**
Multiple of Off-Balance Sheet Activity						
to Physical	1.7	1.5	1.4	1.9	2.6	
Equities Market						
Physical Market Turnover						
ASX Shares	211	243	282	362	418	15.5
Sub-Total	211	243	282	362	418	15.5
Off Balance Sheet Turnover						
ASX Options	98	74	91	104	133	27.7
OTC Equity Derivatives			8	11	15	43.0
SFE Equity Futures and Options	229	280	341	425	349	(17.9)
Sub-Total	327	354	440	540	497	(7.9)
Total Equities Market	**538**	**597**	**722**	**902**	**915**	**1.4**
Multiple of Off-Balance Sheet Activity						
to Physical	1.5	1.5	1.6	1.5	1.2	
All Financial Markets	**30,870**	**34,718**	**38,498**	**38,140**	**42,781**	**12.2**
OTC Electricity Derivatives				133	203	52.8
				million megawatt hours		

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Appendix: Responses to selected Issues raised by CAMAC

CHAPTER 1

1.11 (p. 13) Identifying the reasons for prohibiting insider trading is fundamental to the appropriate development and application of insider trading laws. Is the jurisprudential basis for the current Australian legislation satisfactory?

No Comment

Issue 1. (p. 19) Are the current market fairness and market efficiency rationales for the Australian insider trading legislation appropriate?

Yes. AFMA would consider that these two rationales are appropriate and would lead to three considerations:
1. that insider trading would be limited to financial products that are traded on a licensed market, or capable of being traded on a licensed market. The rationales of market integrity and efficiency based on licensed markets are unhelpful to OTC financial market trading.
2. that fairness and efficiency are further defined or their dimensions understood
3. that the balance between civil, criminal, and statutory remedies reflects these rationale(s)

1.36 (p. 19) Should insider trading laws cover only non-public price-sensitive information derived from within the entity whose securities are traded (the narrow approach) or any non-public price-sensitive information affecting particular securities that is not available to the market, regardless of its source (the broad approach)?

The narrow approach is more appealing from the view of enforcement and also the rationale established above. While the Broad approach may be appealing on paper it has two critiques:

1. is more difficult to see the causality of broad information to the rationale(s); and,

2. it is far more difficult to confine the manner of information. For example, a rate-cut by the RBA will affect all tradeable financial products.

1.37 (p. 19) Also, should the definition of inside information be confined to information that relates to a company or its securities, while excluding information that relates only to securities generally or to issuers of securities generally?

Our response is similar to that above for section 1.36 of the discussion paper. We would recommend that the information is confined to that relating directly to the specific company or security, and not to companies or securities generally.

There is a further issue on the subject of issuers – particularly in the new FSR regime, where some dealers are deemed issuers – particularly in derivatives transactions. Examples: the advising stockbroker is a deemed issuer for the purpose of exchange traded derivatives, the OTC AFS licensee is the deemed issuer for the purposes of any OTC derivative including the vast majority of foreign exchange. Accordingly, the scope of the term issuer requires

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closer attention and definition to ensure that "deemed" issuers are not confused with initial issuers or persons regulated under Chapter 6. This approach has been adopted for ASX warrant issuance and trading.

Two aspects of issuance that require further investigation relate to the scope of products where an entity is the issuer, but not subject to the provisions of the Corporations Law – government bonds are an example. There is a possibility of a non-level playing field or breach of the principals of competitive neutrality. Related is the scope of the FSR products definitions where government bonds include bonds "proposed to be issued". FSR s.764A1(j).

Issue 2. (p. 21) Is the current Australian broad approach to the definition of inside information appropriate? Should the legislation exclude information that relates only to securities generally or to issuers of securities generally?

See above.

Issue 12. (p. 55) Should the range of financial products covered by the insider trading provisions of the Financial Services Reform Bill exclude indices, derivatives over commodities and/or any other financial products?

The insider trading laws should exclude all transactions and products traded exclusively in the OTC financial markets. Insider trading laws should apply to products which are is capable of being traded on a public or licensed market.

The FSR definition of "able to be traded on a financial market" is insufficiently prescriptive and creates uncertainty – particular when applied to non-licensed markets.

2.93 (p. 55) Should the insider trading legislation be limited to financial products that are traded or tradeable on a public market?

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Issue 13. (p. 57) Should the insider trading legislation apply to any trading or only transactions that are or can be carried out on a public market?

The Australian Financial Markets Association strongly agrees with a proposal that insider trading legislation be limited to transactions and products that are or can be carried out on a public market. AFMA believe that the insider trading laws are part of a regulated disclosure regime. The OTC markets do not have the requirement, or the mechanism, or the participant expectation for public (or even participant) disclosure. Further, our submission indicates that the application of insider trading laws to non-public markets is untried and will have unintended consequences. Those consequences could include a reduction in liquidity, participation, and overall efficiency of an OTC market. We would content that this is the reverse of what is intended with insider trading laws.

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The Australian Institute of Company Directors

The Australian Institute of Company Directors (AICD) is the peak organisation representing the interests of company directors in Australia. Current membership is over 16,000, drawn from large and small organisations, across all industries, and from private, public and the not-for-profit sectors. Membership is on an individual, as opposed to a corporate basis.

The AICD is a federation of seven State divisions, each of which is represented on a National Council. Overall governance of the AICD is in the hands of its National Council which is comprised of the seven division Presidents, plus a National President, two National Vice-Presidents and a National Treasurer. AICD has several national policy committees, focusing on issues such as law, accounting and finance, environment, taxation and economics, and national education, along with task forces to handle matters such as corporate governance.

The key functions of AICD are:

- to promote excellence in director's performance through education and professional development

- to initiate research and formulate policies that facilitate improved director performance

- to represent the views and interests of directors to government, regulatory bodies and the community

- to provide timely, relevant and targeted information and support services to members and, where appropriate, government and the community

- to maintain a member's code of professional and ethical conduct

- to uphold the free enterprise system

- to develop strategic alliances with relevant organisations domestically and internationally to further the objectives of the AICD

AICD appreciates the opportunity to make submissions on the Discussion Paper ("**DP**"), and commends CASAC for reviewing Australia's insider trading legislation in the light of corresponding legislation of comparable countries, a valuable summary of which is contained in DP Appendix 2.

AICD comments on the issues raised in the DP follow the DP's grouping of those issues into:

- matters that should not be changed
- matters that may require legislative change
- other possible changes for consideration.

Matters that should not be changed

Who are insiders?

The DP notes in para 0.17 that "in almost every respect, the Australian insider trading laws are stronger in their terms than comparable overseas laws". That observation is particularly pertinent to the definition of an *insider*. Whereas the law of almost every comparable jurisdiction requires an *insider* to have some kind of connexion with the relevant company, in much the same way as Australian legislation did before 1991, present Australian legislation makes a person an insider merely by the possession of price-sensitive information that is not generally available, howsoever obtained, regardless of:

- any connexion or lack of connexion with the relevant company
- the propriety or lack of propriety in obtaining the information.

AICD submits that CASAC should re-consider whether Australian legislation should, in that respect, be brought more into line with that of almost all of the other jurisdictions as outlined in DP Appendix 2. AICD would draw the attention of CASAC to the following considerations:

- the target of the prohibition against insider trading is the improper use of information by persons having a privileged access to information: that, if anything, is what the notion of *market fairness* is all about
- it is unfair to prohibit a person from profiting from information obtained by the person's own discovery and not derived "from within [the relevant] company."
- it does not advance the government's professed objective of making Australia a major financial market in the world by casting its insider trading legislation in a mould which, in this regard, would be seen to be unfair in comparison with that of other comparable jurisdictions

In its definition of an *insider*, Australian legislation - as the DP appears to see it - contemplates a market that is both *efficient* and *fair* in the sense of being a market in

which all participants are in possession of all relevant information at any relevant time. No market in the real world functions, or is capable of functioning efficiently on that basis.[1]

One does not have to go all the way with Professor Henry Manne in taking that point what he sees as its logical conclusion: that, far from prohibiting *insiders* from trading, they should be encouraged to do so to promote market efficiency. One cannot, however, close one's eyes to the reality that the objective notion of *market efficiency* and the subjective notion of *market fairness* are to a degree in conflict. Very arguably, Australia's present legislation pursues unduly the objective of *market fairness* at the expense of *market efficiency*. AICD therefore submits that consideration be given by CASAC to recommending the re-definition of an *insider* along the lines recommended by Professor Philip Anisman in his report to the NCSC *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives.*[2]

Such a definition would:

- confine the notion of *insider* to a real insider including, be it said, a director of the relevant company and a tippee from a real insider
- bring Australia's insider trading law more or less into line with comparable jurisdictions
- strike an acceptable compromise between the notions of *market efficiency* and *market fairness*
- avoid the complexity of the pre-1991 requirement of *connexion*, which so troubled the Griffiths Committee whilst at the same time meeting its fundamental point that "The offence of insider trading must have its genesis in the use of information derived from within a company."

Underwriting exemption

The Institute supports retention of the exceptions for underwriters presently contained in CA s1002J for:

- communication of information to underwriters
- subscription of underwriters
- on-selling by underwriters

The DP supports retention of the first two, but questions retention of the third. Removal of the third exemption would necessarily increase underwriting risk and would consequently increase underwriting fees or decrease underwriting availability. AICD therefore supports retention of the on-selling exemption and notes that it does not appear to have caused any trouble since its introduction in 1991.

[1] See, for example, F. A. Hayek *The Use of Knowledge in Society*.
[2] AGPS Canberra 1986

Matters that may require legislative change

Information covered

The Institute supports an amendment to exclude information that relates only to securities generally or to issuers of securities generally.

Generally available information

The DP's concern about the decision of the NSW Court of Criminal Appeal in *R v Firns*[3] that a judgment of an open Papua New Guinea court is *readily observable matter* for the purposes of Australian insider trading legislation is understandable, but the Institute fears that the cure proposed by the DP, viz:

> *giving priority to the publishable information test by confirming the readily observable matter test to anything not capable of falling within the publishable information test*

could prove to worse than the supposed defect. And it would certainly do violence to the legislative intention of the *readily observable matter* arm of the definition of generally available information, expressed in paragraph 326 of the explanatory memorandum for the current insider trading legislation as follows:

> Concern was expressed that in consequence of the adoption of the definition [the publishable information test] in the exposure draft, information directly observable in the public arena would not be regarded as generally available, as it has not been "made known". It was considered that a person could be liable for insider trading where he/she traded in securities on the basis of, for example, an observation that the body corporate had excess stocks in a yard. This was not the intention of the provision.

Is such an observation "capable of falling within the publishable information test? If so, who would publish it and how?

Transactions covered

AICD supports:

- introduction of a rule similar to SEC Rule 105b5-1 to permit persons to deal in securities in accordance with securities trading plans entered into without possession of unpublished price-sensitive information

- permitting an option holder who becomes aware of unpublished price-sensitive information after entering into the option contracts to exercise the option to buy or sell, provided that the option contract stipulates a fixed exercise price

[3] [2001] NSWCCA 191: (2001) 38 ACSR 223

Internal controls over insiders

As already noted, AICD supports retention of the *Chinese Wall* exception for corporations and partnerships. AICD also supports extension of the exception to the procuring offence.

Director notification of shareholdings

It is imperative that there be no inconsistency in the notification provisions of the Corporations Act and the ASX Listing Rules. If a legislative change is to be made, it should clearly override and supplant the ASX Listing Rules on director notification. The worst outcome for Directors would be to have two slightly different notification obligations.

Other possible changes for consideration

Liabilities of insiders

AICD does not support amending the legislation to:

- prohibit insiders from disclosing inside information without a lawful reason, even where the purpose or result of the disclosure is that the recipient does not trade
- require a person lawfully disclosing inside information to inform the recipient that the information is inside information
- impose liability on insiders for procuring if, on the basis of inside information, they "discourage or stop" another person from dealing in affected securities

The first two of those proposals would be seen by many to amount to an unwarranted assault on freedom of speech. The third does not strike AICD as very logical. As the DP points out at para 1.77, an *insider* may lawfully use inside information for the purpose of refraining from trading. Why, therefore, should it be an offence to communicate inside information to encourage someone else to refrain from trading?

Transactions covered

The *Financial Services Reform Act* 2001 ("**FSRA**") re-enacts existing insider trading legislation presently in Part 7.11 Div 2A with little change, apart from extending its operation beyond *securities* to *Division 3 financial products*, defined in s1042A as meaning:

- securities
- derivatives
- managed investment products
- superannuation products, other than those prescribed by regulation
- any other financial products that are able to be traded in a financial market

AICD agrees with the DP's suggestion that the legislation be confined to securities and other financial products that satisfy any of the following tests:

- they are traded or are capable of being traded in a financial market
- they give an indirect interest in a tradeable financial product
- they involve a financial services provider

As the DP points out, insider trading does not apply to trading in commodities, and it would therefore be anomalous to apply it to derivatives over commodities.

Subjective elements

AICD opposes the DP's suggestion that the legislation could introduce a rebuttable presumption that directors and other managers are aware of any confidential price-sensitive information derived from within their companies or a rebuttable presumption that they are aware that information of that kind is "inside" information. Such presumptions would often be factually incorrect and would be inherently unfair.

To say that such presumptions would assist insider trading prosecutions is much the same as saying that a presumption of *mens rea* on the part of the accused would assist murder prosecutions.

Exemptions

Contrary to the position taken by the DP, AICD believes not only that the present exemption for liquidators, personal representatives and trustees in bankruptcy should be retained, but also that it should be extended to other external administrators. An external administrator's task is quite difficult enough without having to worry about insider trading legislation and, as the DP notes, an external administrator does not make any personal gain from transactions entered into in that capacity.

Derivative civil liability

AICD opposes the suggestion in the DP that a person who is in a position to control or supervise the activities of another person be civilly liable where that other person on his or her own behalf breaches the insider trading provisions.

The DP points to US legislation which imposes such derivative civil liability - in some circumstances. Whatever the merit or otherwise in the US of that approach, it must be remembered that US law requires a person to have a fiduciary or similar duty to the relevant company, a matter which could be expected normally to be known to a controller or supervisor. To impose such liability under Australian law, with its egregious notions of *insider* and "inside" information would be most unjust.

Takeovers

AICD agrees with the suggestions in the DP that:

0.49 Any exemption for pre-bid buying by a consortium contemplating a takeover bid might only apply to any purchases made on behalf of that

consortium. Individual consortium members should not otherwise have an exemption.

0.50 Target company directors could have a defence to the disclosing and procuring offences if they show that they communicated any inside information merely for the purpose of encouraging a person to be a white knight and took all reasonable steps to ensure that the white knight did not transact an issued target company shares before that information became generally available.

Regulator's remedies

AICD opposes the introduction of a provision for recovery of a multiple of the profit gained or loss avoided in insider trading, or giving ASIC power to impose administrative penalties.

As the DP points out (para 3.4) the FSRA has made the insider trading provisions civil penalty provisions, empowering the court to make various civil penalty orders, including:

- a declaration of contravention
- a pecuniary penalty order of up to $200,000
- a compensation order for any person who has suffered loss or damage through a contravention

AICD does not consider that further measures should be put forward until it appears clearly that the new civil penalty regime is inadequate.

Liability of procured persons

The FSRA replaces the civil liability provisions in CA 1013 with a new s1043L. The position of a person who is unknowingly procured to buy or sell by an *insider* is in principle unchanged: that person remains under potential civil liability. The essential unfairness of such liability leads AICD to support the DP's suggestion of relieving a person in that situation from civil liability, provided that the *insider* did not receive any direct or indirect benefit from the transaction.

Compensation rights

The DP (paras 3.36 - 3.43) points out the difficult questions arising from giving compensation rights for insider trading. As AICD sees it, the questions have been pre-empted by the new civil penalty regime introduced by the FSRA, which allows compensatory orders for any person who has suffered loss or damage through a contravention of, *inter alia*, the insider trading legislation. The legislature has left it to the courts to grapple with the difficult questions, and further legislation should therefore await the courts' work on the task entrusted to them.

Speculative trading by insiders

The DP raises the suggestion that *directors and other corporate decision makers* should be prohibited from short selling their companies' securities or transacting in options over them.

The suggestion arises from Canadian legislation to that effect (DP paras 4.15 - 4.18). AICD finds difficulty, having regard to Australia's different legislation both on insider trading and short selling, in seeing justification for such legislation.

Prohibition on short selling profits

The DP suggests that *directors and executive officers* should be required to disgorge any profits received form buying and subsequently selling their company's securities with a six month period.

This suggestion is prompted by US legislation to that effect. It assumes that directors and executive officers are always and inevitably in possession of unpublished price-sensitive information, an assumption which is not legitimate. This assumption if taken to its logical conclusion, would justify prohibition of any dealing by directors and executive officers in their company's securities irrespective of possession of unpublished price-sensitive information. The suggested period of six months is entirely arbitrary.

CHARTERED SECRETARIES AUSTRALIA

Keeping good companies

10 October 2001

Mr John Kluver
Executive Director
Companies and Securities Advisory Committee
GPO Box 3967
SYDNEY NSW 2001
BY EMAIL

Dear Mr Kluver,

INSIDER TRADING DISCUSSION PAPER

Chartered Secretaries Australia (CSA) welcomes this opportunity to comment on the above Discussion Paper.

CSA has been at the forefront of improved compliance and corporate governance for many years. With over 8,000 members throughout Australia, CSA has representatives in a wide cross section of Australian businesses, including in particular, listed companies.

Generally CSA endorses the Committee's support for the principles underlying the Australian insider trading legislation, and most of its existing provisions, as expressed in paragraph 0.17 of the Introduction to the Discussion Paper.

However, while also supporting adjustments in a number of areas, CSA is concerned that the Committee's views may not give adequate recognition to those persons who develop their own independent knowledge base. We make the following comments:

Chapter 1: Rationale and overview of insider trading regulation

Issue 1 - Are the current market fairness and market efficiency rationales for the Australian insider trading legislation appropriate?

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www.CSAust.com

Subject to the qualifications expressed in this response, yes.

Issue 2 - Is the current Australian broad approach to the definition of inside information appropriate? Should the legislation exclude information that relates only to securities generally or to issuers of securities generally?

CSA sees no difficulties in all the situations under 1.40 being caught. However, as expressed above, CSA is concerned by suggestions that the law should also seek to limit or restrict persons transacting on the basis of their own research or deduction, where the information on which that conduct is based is not derived from within the Company, its officers or advisors. It follows that as a minimum, CSA would support the legislation excluding information that only relates to securities generally or to issuers of securities generally.

Issue 3 - Should the current Australian definition of insider, which includes entities as well as natural persons, be maintained or be confined to natural persons?

CSA supports retention of the current Australian definition of insider.

Issue 4 - Should the Australian definition of insider continue to take an "information connection" approach only or require an additional "person connection" element?

The type of exemption envisaged by CSA under the above paragraphs would not alter the position discussed in footnote 85. However, it would require clarification of what is meant by "information" under 1.62. Provided "information" in that context was intended to mean "real" information as distinct from opinion or deduction, CSA would support the continuation of an "information connection" only approach, without any additional "person connection" element.

Issue 5 - Should the insider trading legislation:

- **prohibit any person holding insider information from disclosing that information without a lawful reason, even where the purpose or result of the disclosure is that the recipient does not trade:** Yes.
- **require a person lawfully disclosing inside information to inform the recipient that the information is inside information:** Yes.
- **impose liability on persons holding inside information if they "discourage or stop" another person from dealing in affected securities?** No, for the reasons expressed in 1.107.

Chapter 2: Details of regulation

Issue 6 - Should the test of generally available information:

- **give priority to the publishable information test**
- **expand the application of that test**
- **extend the circumstances where a reasonable dissemination period is required under that test?**

Issue 7 - Should the readily observable matter test be clarified? If so, in what manner?

The facts of R v Kruse and R v Firns are an excellent illustration of the concerns CSA has in this area. In the opinion of CSA, a distinction should be drawn between the defendants, who were both officers of the appellant company (and this should include their professional advisors), and those who had no connection with the company. With respect to the outcome, CSA is surprised that the Court appeared to accept as legitimate any delay in notifying the Australian Stock Exchange of the Court's decision. In CSA's opinion, there should have been a complete prohibition on any dealings by persons within or associated with the company until ASX had been notified of the outcome. In CSA's opinion, the ASX disclosure test, as amended under 2.32, should be paramount. This would also confirm that the requirement exists irrespective of the location of the event giving rise to the Continuous Disclosure obligation.

The wider question is whether a casual observer should be placed in the same position as the corporate officers or their advisors? Using the example quoted under 2.43, A should not be liable, particularly as in that event, B itself may not be aware of the deposit or its consequential value.

Issue 8 - Should the Australian legislation require that inside information must be specific or precise? No.

Issue 9 - Do the current insider trading and continuous disclosure provisions properly complement each other?

CSA supports both the Overseas law position as expressed in 2.65, and the Advisory Committee's view expressed in 2.66, that the insider trading provisions should be wider than the existing Listing Rule 3.1. To the extent that it is necessary, for the reasons expressed above, CSA also believes that the insider trading provisions should redress the decisions in R v Kruse and R v Firns.

Issue 10 - What, if any, amendments are necessary to take into account research and analysis?

CSA shares the Advisory Committee's view about Dirks v SEC. In CSA's opinion, as the source of that information was corporate employees, the defence should not have been allowed. CSA's concern is that research based upon sources external to the Company should not be penalised, even though the information upon which that research is based may not be regarded as being generally available (the 2.43 situation above).

Issue 11 - What, if any, amendments are necessary to take into account trading before release of one's own research?

CSA considers that in the context of <u>professional advisors or researchers</u>, the decisions reported in 2.79 and 2.80 should be regarded as correctly representing the law, and that the contrary argument expressed by the Committee in 2.82 should prevail. Private research where there is no obligation to publish should be treated differently, and should only be attached where all or part of the information has been made available by the Company or its officers.

Issue 12 - Should the range of financial products covered by the insider trading provisions of the Financial Services Reform Bill exclude indices, derivatives over commodities and/or any other financial products? No.

Issue 13 - Should the insider trading legislation apply to any trading or only transactions that are or can be carried out on a public market?

CSA supports the Advisory Committee's view set out in 2.96: at this stage it should not extend further as canvassed under 2.97.

Issue 14 - What, if any, amendments are needed to enable companies to issue their own securities without breaching the insider trading provisions, while properly protecting investors?

CSA supports the concern expressed under 2.101 that the reasoning in the Exicom case is questionable, and sees no justification in excluding new issues from the insider trading provisions.

Issue 15 - What, if any, amendments are needed to enable companies to buy back their own securities without breaching the insider trading provisions? Nil.

Issue 16 - What, if any, amendments are needed to enable informed persons (that is, persons who only receive inside information in the period between entry into and exercise of an option contract) to exercise their physical delivery of option rights without breaching the insider trading provisions?

CSA supports the concluding words under 2.126 that an exemption should only exist where the exercise price is fixed on entry into the original option contract.

Issue 17 - What, if any, amendments are necessary to enable uninformed counterparties to informed persons (that is, persons who only receive inside information in the period between entry into and exercise of an option contract) to exercise their physical delivery options?

CSA supports the respective positions expressed under 2.129 and 2.131.

Issue 18 - Should any amendments be made to the current awareness test? and Issue 19 - Should any amendments be made to the current knowledge test?

No. CSA supports the current Australian position under 2.134.

Issue 20 - Should the Australian legislation deal more specifically with the use requirement issue and, if so, in what manner?

CSA supports the recommendation of the Griffiths Report set out in 2.143 and stresses that in cases of criminal liability as distinct from civil liability, both tests should apply.

Issue 21 - Should the legislation permit an informed person to trade contrary to inside information?

CSA supports the retention of the current statutory prohibition on trading (2.154).

Issue 22 - Should the underwriting exemptions be reformulated and, if so, in what manner?

CSA supports the current law (2.161).

Issue 23 - Should the rules regulating transactions by external administrators be amended and, if so, in what manner?

CSA would support an amendment to the existing law so that administrators, scheme managers, receivers, and receivers and managers receive the same statutory protection as afforded under 2.168.

Issue 24 - Should persons with confidential price-sensitive information be liable when they instruct a broker to trade, when that broker places the offer on the

market, when that offer is accepted by a counterparty broker or at some other time?

As Stock Exchange systems become increasingly automated, offer and acceptance will become virtually instantaneous. CSA therefore supports the second bullet point under 2.180 - when an offer is placed on a stock exchange trading system.

Issue 25 - Should the legal position of intermediaries acting for clients who they know have inside information be clarified and if so, in what manner? and Issue 26 - Should intermediaries who have been informed by clients that they have inside information be restricted in acting for other clients?

CSA supports the Advisory Committee's view as expressed in 2.188 and 2.189.

Issue 27 - Should the Chinese Walls defence be amended and, if so, in what manner?

CSA agrees that protection should be afforded to the Bank in the example provided in footnote 265, and that the legal position should be as set out in 2.195.

Issue 28 - Should a derivative civil liability provision be included in the Australian legislation? Yes.

Issue 29 - How should the Australian legislation deal with consortium bidders?

As set out in 2.211.

Issue 30 - Do the Australian provisions need any modification for target company directors in the context of takeover bids?

CSA supports the two restrictions test proposed in 2.219.

Issue 31 - Should white knights be permitted to purchase issued shares when aware of a pending price-sensitive hostile bid not known to the market?

No, the law should remain as set out in 2.221.

Issue 32 - Should white knights be permitted to purchase issued shares when aware of any other inside information affecting those shares? No.

Chapter 3: Remedies

Issue 33 - Should the regulator be given any additional powers to deal with insider trading?

No, nor would CSA support a multiple factor at this time.

Issue 34 - In what circumstances, if any, should uninformed procured persons not be civilly liable for the profit made or loss avoided by an insider trading transaction?

In the circumstances, and to the extent provided in 3.16 and 3.17.

Issue 35 - Is any amendment to the equal information defence necessary?

While CSA believes a distinction should continue to be drawn between civil and criminal proceedings, it is supportive of the amendment proposed in 3.23.

Issue 36 - Should there be a right of compensation for insider trading? If so, who should be eligible claimants and how should compensation be assessed?

As evidenced by the breadth of matters discussed under these headings, these are most complex issues. In the absence of a more specific view expressed by the Committee, CSA is of the view that compensation rights should be left as is under 3.25, and that the suggestion included in 3.32 provides the most focused outcome.

Issue 37 - In what circumstances, if any, should companies whose securities are affected by insider trading be entitled to compensation?

CSA supports the retention of the existing Australian law as set out in 3.45 and 3.46. CSA would have no objection to a power similar to 3.49 being included in the Australian legislation, but remains opposed to any multiple of profit as envisaged under 3.48.

Chapter 4: Other provisions

Issue 38 - In what manner should the director notification requirements be amended?

CSA believes that these matters are adequately covered by the ASX Listing Rule amendments which became effective on 30 September 2001.

Issue 39 - Should the Australian legislation introduce controls over speculative trading by corporate decision makers in the securities of their companies?

As part of its submissions to ASX relating to Listing Rule amendments, CSA has supported the adoption by Listed Companies of policies governing dealings in the company's shares, with details of the policy to be set out in the Annual Report. In this respect, CSA would support a prohibition on conduct of the type covered by the Canadian legislation under 4.15.

Issue 40 - Should the Australian legislation include a "short swing profit" prohibition? If so, who should be subject to the prohibition?

CSA believes this prohibition should be addressed under Issue 39 as part of a wider control over speculative trading by both Directors and Executive Officers.

We would be happy to meet with members of your Committee to discuss these comments after you have had the opportunity to consider them.

Yours sincerely

Tim Sheehy
CHIEF EXECUTIVE

[To be typed on Business Law Section letterhead]

John Kluver,
Executive Director,
Companies & Securities Advisory Committee,
GPO Box 3967,
Sydney, NSW 2001.

15 November 2001

Dear John,

Insider Trading Discussion Paper

I enclose a submission prepared by the Corporations Committee of the Business Law Section of the Law Council of Australia in response to your Insider Trading Discussion Paper.

The Committee believes that it is very timely for Australia's insider trading regime to be subject to a comprehensive review. As your Discussion Paper notes, Australia adopted its own unique approach to the regulation of insider trading 10 years ago and the Committee believes it is now appropriate to review this approach in light of both our own experience and international devlopments in the intervening period. This is so even though our insider trading rules were recently rewritten by the Financial Services Reform Act because the new provisions were not exposed for comment as part of the original FSR Bill and attracted little public attention when they were finally introduced into Parliament.

Against this background, the Committee congratulates CASAC for the work it has undertaken in preparing its Discussion Paper. The Discussion Paper is very comprehensive and thoughtful document. It also identifies very clearly the key issues which need to be considered in any review of insider trading and provides a very good basis for a discussing the competing considerations which shape the law in this area.

The Committee has prepared the enclosed submission in response to the 40 issues identified in the Discussion Paper. As you will see, the Committee agrees with some of the provisional views expressed by CASAC, but disagrees with others. In particular, the Committee believes that the rationale for insider trading regulation should be more narrowly defined – focusing more on the misuse of privileged information than the mere use of information that is not generally available - and that this should shape the framework of the prohibition. The Committee also sees some merit in the adoption of different civil and criminal regimes along the lines of the recent UK reforms.

We trust the enclosed submission assist CASAC in its deliberations. In addition, if you would find it useful, members of the Committee would be happy to meet with you to discuss aspects of the submission in more detail.

Yours sincerely,

Insider Trading

Discussion Paper

June 2001

Submission by the Corporations Committee, Business Law Section, Law Council of Australia

Issue 1: Are the current market fairness and market efficiency rationales for the Australia insider trading legislation appropriate?

The Committee agrees that "identifying the reasons for prohibiting insider trading is fundamental to the appropriate development and application of insider trading laws".

The Issues Paper identifies four main rationales that have been put forward from time to time:

- fiduciary duty
- misappropriation
- market fairness
- market efficiency.

In general, the Committee supports CASAC's view that the market fairness and market efficiency rationales are more appropriate because they focus on the broader market implications of insider trading and its economic repercussions. However, the Committee does not believe that market fairness or market efficiency require a strict "disclose or abstain" rule that prohibits any person in possession of material, non-public information from dealing in securities.

As the Issues Paper acknowledged, no financial market other than Australia (and Malaysia) has such a rule and it is difficult to believe that there are unique features of the Australian (and Malaysian) markets which require a regime which is fundamentally different from those operating everywhere else. It is also difficult to believe that "investor confidence" requires such a different regime if that requirement has not been manifested in New York, London, Tokyo, Frankfurt, Paris, Hong Kong or any other major financial market.[1]

While the report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, "Fair Shares For All: Insider Trading in

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[1] We acknowledge that the Proposal for a Directive of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) presented by the Commission of the European Communities earlier this year adopts a similar approach to the Australian regime. However, this has not met with universal acclaim and, until such time as it becomes clear that the proposed approach will be reflected in a final directive, we do not believe this should carry much weight.

Australia" ("Fair Shares For All") clearly stated that the basis for the Australian prohibition on insider trading should be the need to guarantee investor confidence, the Committee is of the view that "Fair Shares For All" does not provide a sufficient justification for a "disclose or abstain" rule when that rule has been rejected in every other leading financial market.

In these circumstances, the Committee believes that any revised insider trading legislation in Australia should reflect a more careful balancing of the conflicting factors that need to be taken in to consideration in this area. These were clearly stated in the United Kingdom when the Financial Services Authority ("FSA") issued its initial consultation draft Code of Market Conduct in 1998 (CP10 "Market Abuse. Part 1: Consultation on a draft Code of Market Conduct). This explicitly recognised that:

> "there will always be times where certain persons will have access to relevant information that is not available to others. Such persons may have an opportunity to take advantage of that information by trading on the basis of it, thereby realising a profit or avoiding a loss. Although the person may therefore have benefited, it is not necessarily against the wider interest of the market that he does so. Where the benefit is taken through a trade the market will reflect that person's sentiments and hence indirectly the information. In all markets, a balance has to be struck between often conflicting factors: the desire to bring all information to bear upon the price, through trading and disclosures; the need to reward properly those who research or analyse; and the damage that can be done to efficient pricing if people fear those with whom they are trading have some informational advantage over them." (see paragraph 74)

The Committee wishes to emphasis that, in balancing these considerations, it does not support the arguments of Professor Henry Manne in defence of trading by corporate insiders on the basis of their privileged access to information[2]. The Committee accepts that such trading undermines investor confidence in the fairness of financial market and that this outweighs any arguments that such trading enhances market efficiency. However, the Committee does not believe that investor confidence is harmed by all trading undertaken by people who have information that is not generally available. Indeed, to the contrary, it believes the market expects and benefits from such trading, which fulfils one of the primary functions of any market – namely price discovery – and contributes to overall market efficiency.

In the Committee's view an appropriate balance of these considerations is now reflected in the final version of the UK Code of Market Conduct ("FSA Code"), which provides that misuse of information will only amount to market abuse if all four of the following circumstances are present:

[2] Manne "Insider Trading and the Stock Market" (1966).

- a person deals or arranges deals in any qualifying investment or product based on information;
- the information is not generally available;
- the information is likely to be regarded by a regular user as relevant when deciding the terms on which transactions in the investments of the kind in question should be effected; and
- **the information relates to matters which the regular user would reasonably expect to be disclosed to users of the particular prescribed market. (see paragraph 1.4.4)**

The fourth of these conditions makes it clear that the essence of the abuse is the misuse of privileged information rather than merely trading on the basis of an informational advantage. Other jurisdictions adopt a very similar approach by incorporating a "person connection" test into their laws (as discussed in relation to Issue 4 below).

The Committee's comments on the "person connection" test are set out in more detail below. However, the Committee recommends that any stated rationale for revised legislation explicitly recognises that an essential element of insider trading is the misuse of privileged information and not merely the possession of price sensitive information.

In this context, the Committee also recommends that CASAC give consideration to the possibility of establishing different regimes for criminal and civil liability in this area. In the United Kingdom, criminal laws apply only to a relatively narrow range of very serious misconduct where there is a clear intention to abuse the market and other users. However, the civil regime covers a much broader range of misconduct which may adversely affect market confidence, integrity and efficiency. The civil regime also provides for the FSA to issue a code giving appropriate guidance as to the behaviour which may be regarded as constituting "market abuse".

While it is too early to judge the United Kingdom's experience with this regime, it does appear to offer a number of significant benefits:

- the definition of "market abuse" in the civil regime can be framed in more general terms than would be appropriate in a provision giving rise to criminal liability;
- the code of market conduct allows the regulator to give more specific guidance in relation to specific practices than is possible in legislation;
- the code is also more flexible and can be adapted to suit changing market practices and different expectations in different markets; and
- the criminal regime can be confined more narrowly to serious and intentional misconduct without condoning abusive practices

Clearly, the adoption of a similar regime in Australia would require extensive market consultation. Nevertheless, if there is to be a reform of the law in this area, the Committee believes that the adoption of a similar regime would merit serious consideration.

Issue 2: Is the current Australian broad approach to the definition of inside information appropriate? Should the legislation exclude information that relates only to securities generally or to issuers of securities generally?

The Committee believes that the current Australian broad approach to the definition of inside information is appropriate. However, the Committee believes it would be helpful to exclude information that relates only to securities generally or to issuers of securities generally. The Committee also believes that safe harbours should be established to permit trading on the basis of certain trading information.

The Committee notes the suggestion in paragraph 1.40 of the Issues Paper that information in relation to trading activities and the operation of markets may constitute price sensitive information under current Australian law.

In this regard, it is notable that FSA Code has specific safe harbours which permit trading on the basis of such information (see paragraphs 1.4.26 and 1.4.28). While authorised firms may have other regulatory or legal obligations governing behaviour such as "front-running", the FSA explicitly recognised that:

> "while trading information will be unavailable to other market users and may also be relevant in deciding the terms in which transactions should be effected, behaviour based on this information is not regarded as amounting to market abuse. Other users of the market would not expect to have equal access to such information, and behaviour based on this information would not constitute a failure to observe the standard of behaviour reasonably expected by a regular user" [FSA 59 "Market Abuse: A Draft Code of Market Conduct", paragraph 6.50].

After public consultation, the safe harbours proposed in FSA59 were further widened.

The Committee believes that similar safe harbours should be established in Australia.

The Committee also notes the commentary in paragraph 1.41 of the Issues Paper in relation to the issues which arose in the case of *R v Evans and Doyle* [1999] VSC 488. The Committee believes these issues are more appropriately dealt with in the context of Issue 4, but doubts whether "regular users" in Australia would have expected the information allegedly

possessed by Mr Evans in that case to have been disclosed to the market. Accordingly, it does not believe that Australian law should prohibit a person trading while in possession of such information.

Issue 3: Should the current Australian definition of insider, which includes entities as well as natural persons, be maintained or be confined to natural persons?

The Committee supports the current Australian definition of insider, which includes entities as well as natural persons if, but only if, an appropriate Chinese wall defence remains in place. (refer to Issue 27)

The Committee notes that under current Australian law a body corporate may be guilty of an offence if it deals in securities when an officer of the body corporate possesses price sensitive information even though that information has not been communicated to the persons who made the decision to deal. The defence under Section 1002M may not be available even though paragraphs 1002M(a) and (c) are both satisfied if the body corporate's "chinese wall" does not satisfy paragraph 1002M (b). This seems an unjust situation and one which would be avoided if the law only applied to natural persons. The extension of the law to bodies corporate complicates the law by requiring rules dealing with the attribution of knowledge to a corporate entity and the availability of "chinese wall" defences.

If Australia were to adopt differentiated criminal and civil regimes along the lines discussed under Issue 1, the Committee would support the criminal offence being confined to natural persons to avoid these complications.

In any event, the Committee does not agree that limiting the legislation to natural persons would undermine incentives for entities to control the flow of information within their organisations (cf paragraph 1.55 of the Issues Paper). The natural persons in charge of an entity's affairs would continue to have very strong incentives to implement such controls. This is clearly evident from the experience in the United Kingdom.

The Committee comments on the topic raised in paragraph 1.60 in the context of Issue 14.

Issue 4: Should the Australian definition of insider continue to take an "information connection" approach only or require an additional "person connection" element?

The Committee does not believe that the Australian definition of insider should continue to take an "information connection" approach only. While we do not advocate a return to an approach which requires a formal "person connection" element, we do support a modified approach which

recognizes that insider trading is characterised by the misuse of privileged information rather than merely the use of information which may not be available to the market as a whole.

As the Issue Paper notes, Malaysia is the only other jurisdiction in the world which has a criminal offence of insider trading without a "person connection" requirement While the UK civil regime governing market abuse does not have a specific "person connection" requirement it is much closer to the rest of the world than Australia. Indeed, the FSA Code reflects many features of the US fiduciary duty and misappropriation rules.

While it is always possible that there are unique features of the Australian markets which require a different regime from the rest of the world, the Committee believes a fundamentally different regime should only be retained if a strong and convincing rationale is put forward for so doing. The Committee does not agree with the comments in paragraph 1.73 of the Issues Paper that "market fairness and efficiency" require this result. In the Committee's view, these comments give insufficient weight to the points noted in paragraphs 1.20 – 1.22 of the Issues Paper that recognise the market does not expect all informational advantages to be eliminated.

While "Fair Shares for All" clearly concluded that Australia's previous "person connection" test was too restrictive, it also concluded that "the offence of insider trading must have its genesis in the use of information derived from within a company" (see paragraph 4.3.5). This was consistent with the arguments of the National Companies and Securities Commission and the Committee of Inquiry into the Australian Financial System, which were cited with approval in paragraphs 3.1.10 and 3.3.6. At no point does "Fair Shares for All" provide a clear or cogent rationale for extending the insider trading prohibition to people who are not "insiders" and do not have "inside information". If the prohibition is to continue to be so extended, the Committee believes such a clear and cogent rationale is required. That rationale should also squarely address the countervailing arguments that have been accepted in all other major financial markets.

The Committee recognises that the "person connection" approach is less straightforward than the "information connection" only approach. The Committee also recognises that the "person connection" test found in the laws of many jurisdictions (and previous Australian law) may be too narrow to capture every circumstance in which a person may possess privileged information that the market would expect to be disclosed before any dealing. The Committee believes this is a further argument for adopting the UK approach in which the criminal offence is more narrowly defined (with a formal "person connection" test) whilst the civil regime has a more flexible approach that is guided by a regulatory code of conduct.

Issue 5: Should the insider trading legislation:

- **prohibit any person holding inside information from disclosing that information without a lawful reason, even where the purpose or result of the disclosure is that the recipient does not trade;**

  The Committee notes that the FSA Code (which is referred to in the Issues Paper as an example of such a prohibition) does not "prohibit" disclosure of inside information without a lawful reason, but rather provides guidance as to the circumstances in which selective disclosure of such information may be regarded as "encouraging" another person to deal. The FSA Code also lists an extensive range of circumstances in which such disclosure will not be regarded as encouraging others to deal (see paragraphs 1.8.6 and 1.8.7 of the FSA Code). Notably, these provisions are identified as "examples of disclosure for a legitimate purpose" and are not stated to be exhaustive. The Committee would support similar provisions in a similar code in Australia, but opposes any such prohibition being introduced in to Australia's insider trading legislation.

- **require a person lawfully disclosing inside information to inform the recipient that the information is inside information;**

  Once again, the relevant provision in the FSA Code forms part of the guidance as to whether selective disclosure may be regarded as encouraging another person to deal. The Committee would again support a similar prohibition in a similar Code but opposes any such requirement being introduced into Australia's insider trading legislation.

- **impose liability on persons holding inside information if they "discourage or stop" another person from dealing in affected securities?**

  The Committee believes that insider trading legislation should not impose liability on persons if they discourage or stop another person from dealing in affected securities.

  Most companies which have policies restricting trading in their securities by directors or officers typically seek to extend those policies to relatives, family trusts and similar entities. Clearly, the law should not prohibit a director from discouraging or stopping their spouse from buying securities when the director is in possession of favourable information (or selling securities when the director is in possession of unfavourable information).

  While current law leaves open the possibility that a director may discourage their spouse from buying securities when the director is in possession of unfavourable information (or selling securities when the director is in possession of favourable information), this

has limited adverse effects on the market. It would also be very difficult to identify such non-trading or to bring any meaningful enforcement action. In these circumstances, the Committee believes that the insider trading legislation should not impose liability in these circumstances.

Issue 6: Should the test of generally available information:

- **give priority to the publishable information test;**
- **expand the application of that test; or**
- **extend the circumstances where a reasonable dissemination period is required under that test?**

The Committee does not believe that the test of generally available information should:

- give priority to the publishable information test;
- expand the application of that test; or
- extend the circumstances where a reasonable dissemination period is required under that test.

The Committee believes that the framework it has proposed in relation to Issues 1 and 4 would provide a more coherent basis for dealing with the issues.

It may well be inappropriate for a corporate officer (or other connected person) to be prohibited from trading (or from encouraging others to trade) on the basis of privileged information they have gained in relation to a material decision of a foreign court which affects their company and has not been disclosed to the market. However, the Committee does not believe it would be appropriate to prohibit an analyst from providing a recommendation based upon their diligence and effort in monitoring such a decision ahead of an announcement. Unless the prohibition incorporates a "person connection" test, the analyst in such a circumstance would be treated as an "informed person" who could not avail themselves of the defence in section 1002T (2) (a).

The Committee believes that Australian law should encourage people to use information they have obtained by research, analysis or other legitimate means. The proposals in the Issues Paper would stifle legitimate research and analysis and harm Australia's financial markets.

Issue 7: Should the readily observable matter test be clarified? If so, in what manner?

The readily observable matter test should be clarified. In line with the FSA Code, information should be regarded as readily observable:

- if it is discussed in a public area or can be observed by the public without infringing rights of privacy, property or confidentiality;
- even if other users of the market cannot obtain it because of limitations on their resources, expertise or competence;
- even if it is only available overseas; and
- even if it is only available on payment of a fee.

Issue 8: Should the Australian legislation require that inside information must be specific or precise?

No.

The FSA Code does **not** "require inside information to be specific or precise". Rather, the "extent to which… information is specific or precise" is one of many factors to be considered in determining whether information is "relevant information" (see paragraphs 1.4.9 – 1.4.11). All of these factors would be useful and relevant if a similar code were adopted in Australia.

Issue 9: Do the current insider trading and continuous disclosure provisions properly complement each other?

The Committee supports the continuation of existing exemptions from the continuous disclosure requirements and agrees that the insider trading previsions should continue to apply to price sensitive information that falls within these exemptions.

Issue 10: What, if any, amendments are necessary to take into account research and analysis?

The committee refers to its comments in response to Issues 1, 4, 6 and 7.

While the Committee does not support the approach adopted in *Dirks v SEC* 463 US 646 (1983), it notes that the activities of the analyst in that case were crucial in uncovering and exposing an infamous corporate fraud. The analyst initially reported that fraud to the company's auditors and sought to have it reported in the press, but they declined to act. Others reported it to regulators (including the SEC) who also failed to act. It was only when the analyst discussed his findings with his clients and their selling prompted a fall in the share price that regulators acted and uncovered the fraud.

This clearly demonstrates the beneficial effects of research and analysis, which will be lost if the insider trading prohibition is too restrictive.

The Committee accepts that analysts must not be freely allowed to trade or publish research on the basis of inside information sourced from corporate management. However, the law should not deter analysts from questioning corporate managers or from publishing research which is not based on privileged information.

Issue 11: What, if any, amendments are necessary to take into account trading before release of one's own research?

The Committee believes this issue is better dealt with by requiring full disclosure of any such trading.

Analysts are invariably involved in providing advice to clients on an ongoing basis, while research reports are published only at intervals (and, even then, are not usually made generally available). Consequently, there will always be circumstances in which some people will be dealing on the basis of an analyst's views when others do not have access to those views. This is inevitable and unobjectionable. If an analyst engages in "pump and dump" or other objectionable conduct, this is more appropriately dealt with as market manipulation.

Issue 12: Should the range of financial products covered by the insider trading provisions of the Financial Services Reform Bill exclude indices, derivatives over commodities and/or any other financial products?

The Committee notes that the Financial Services Reform Act has now been enacted in terms which will extend the new insider trading prohibitions to "Division 3 financial products", including derivatives and other financial products that are able to be traded on a financial market.

The Committee shares the concerns noted in paragraphs 2.88 to 2.92 of the Issues Paper that the extension of the insider trading prohibition (as currently framed) to derivatives over commodities could unduly restrict the ability of people who deal in the underlying commodities (and may, as a consequence, have price sensitive information in relation to those commodities) in engaging in derivative transactions. Most commodity producers engage in hedging strategies using derivatives and we believe that it is undesirable to prevent them from doing so simply because the information they have gained from participation in the commodity market may be price sensitive in the derivative market. We do not believe that derivatives should be subject to a different regime from the underlying commodity.

We note the suggestion that one way of dealing with this issue would be to allow commodity producers to hedge physical positions but to prohibit overhedging or profit taking. However, we believe this would an extremely difficult distinction to make in practice because hedging

strategies are often complex and involve a range of different derivatives that may not be precisely matched against physical positions even when the primary aim is to hedge underlying exposures in the physical market.

If the primary insider trading prohibition were recast along the lines suggested earlier in this submission, these problems may well be less acute. Derivative trading by a commodity producer on the basis of its knowledge of the physical market would, we suggest, not be regarded as involving the misuse of privileged information. In contrast, the example given in paragraph 2.90 of the Issues Paper of an executive of a mining company who takes a short position in gold futures contracts on the basis of confidential information about the discovery of a large gold deposit by that company almost certainly would involve the misuse of privileged information. This highlights the difficulties which flow from the failure to refine the primary definition of what constitutes insider trading.

Issue 13: Should the insider trading legislation apply to any trading or only transactions that are or can be carried out on a public market?

The Committee believes that the insider trading legislation should be confined to public markets[3].

In the Committee's view, people who transact in private markets do not expect to have equivalent access to information. This is reflected in the lack of any continuous disclosure regime. Typically, they rely on contractual representations and warranties instead.

The Committee believes it is anomalous that insider trading laws might apply when a major company sells securities in a private subsidiary to another major company (especially if the disclosures regarding the subsidiary are negotiated at arm's length).

Issue 14: What, if any, amendments are needed to enable companies to issue their own securities without breaching the insider trading provisions, while properly protecting investors?

The Committee believes that a company's disclosure obligations in relation to an issue of securities should be regulated by prospectus laws and not insider trading laws. For example, a listed company should be free to make a placement without needing to disclose information that has been exempted from disclosure under the continuous disclosure regime.

[3] It may be appropriate to treat all ED securities as being subject to the insider trading regime and not limit the regime to quoted securities.

Issue 15: What, if any, amendments are needed to enable companies to buy back their own securities without breaching the insider trading provisions?

Likewise, the Committee believes this subject should be regulated by share buy-back laws and not the insider trading legislation.

Issue 16: What, if any, amendments are needed to enable informed persons (that is, persons who only receive inside information in the period between entry into and exercise of an option contract) to exercise their physical delivery option rights without breaching the insider trading provisions?

Generally speaking, the Committee believes that people should be free to exercise contractual rights or perform contractual obligations if they acquire those rights (or assume those obligations) without breaking the insider trading laws. However, we note that this may have some anomalous consequences. For example, if an investment banker were to buy out of the money call options over shares in a company perceived as a potential takeover target and that investment banker were then engaged to advise another company in relation to a bid for the target, it would seem strange that the banker could exercise the call options (which may still be out of the money but below the proposed bid price) on the basis of information gained as an adviser to the bidder.

Issue 17: What, if any, amendments are necessary to enable uninformed counterparties to informed persons (that is, persons who only receive inside information in the period between entry into and exercise of any option contract) to exercise their physical delivery options?

See Issue 16

Issue 18: Should any amendments be made to the current awareness test?

No.

Issue 19: Should any amendments be made to the current knowledge test?

No.

Issue 20: Should the Australian legislation deal more specifically with the use requirement issue and, if so, in what manner?

The law should permit people to enter into securities trading plans along the lines permitted by the SEC. Otherwise, no change is necessary.

Issue 21: Should the legislation permit an informed person to trade contrary to inside information?

No.

Issue 22: Should the underwriting exemptions be reformulated and, if so, in what manner?

See the Committee's comments in relation to Issue 14.

Issue 23: Should the rules regulating transactions by external administrators be amended and, if so, in what manner?

The Committee agrees that the rationale for the current exemption is not clear. However, to the extent an external administrator has an obligation to deal in securities in order to perform their duties, it may be appropriate for this duty to prevail over the insider trading prohibition. Otherwise, the people who have the underlying economic interest in the relevant securities may be prejudiced by the accident that the person who happens to have been appointed as external administrator possesses price sensitive information.

Issue 24: Should persons with confidential price-sensitive information be liable when they instruct a broker to trade, when that broker places the offer on the market, when that offer is accepted by a counterparty broker or at some other time?

The Committee believes that the relevant time is when the trade is executed. However, consistently with our comments in relation to Issues 16 and 17, the Committee believes that a person should not breach the prohibition if they become aware of relevant information after they have given binding instructions to their broker.

Issue 25: Should the legal position of intermediaries acting for clients who they know have inside information be clarified and if so, in what manner?

The Committee supports the views expressed in the Issues Paper.

Issue 26: Should intermediaries who have been informed by clients that they have inside information be restricted in acting for other clients?

See Issue 25.

Issue 27: Should the Chinese Walls defence be amended and, if so, in what manner?

The Chinese Walls defence should be amended to apply to both the trading offence and the procuring offence.

The Chinese Walls defence should not be removed. It is available in all other jurisdictions and, if it were removed in Australia, all (or almost all) major market participants would effectively be excluded from Australian financial markets.

Issue 28: Should a derivative civil liability provision be included in the Australian legislation?

No.

The Committee notes that Part 2.5 of the Criminal Code has deliberately not been extended to the insider trading regime.

Issue 29: How should the Australian legislation deal with consortium bidders?

The Committee believes that individual consortium members should be free to trade with the consent of all other members of the consortium.

The law currently permits a bidder to trade ahead of their bid. Members of a possible bidding consortium are in no different position from a single bidder and should not be treated differently even if not all members of the consortium wish to buy a pre-bid stake.

Issue 30: Do the Australian provisions need any modification for target company directors in the context of takeover bids?

Target company directors should be permitted to disclose price sensitive information to a bidder or potential bidder if they make disclosure on terms which prohibit dealings until the relevant information has been made generally available (or ceased to be price sensitive). The market is not adversely affected by the disclosure of the information if it is adequately informed prior to the dealing.

Issue 31: Should white knights be permitted to purchase issued shares when aware of a pending price-sensitive hostile bid not known to the market?

No.

Issue 32: Should white knights be permitted to purchase issued shares when aware of any other inside information affecting those shares?

No.

Issue 33: Should the regulator be given any additional powers to deal with insider trading?

The Committee believes that any change should await the Australian Law Reform Commission's review of civil and administrative penalties.

Issue 34: In what circumstances, if any, should uninformed procured persons not be civilly liable for the profit made or loss avoided by an insider trading transaction?

Uninformed procured persons should not be civilly or criminally liable.

Issue 35: Is any amendment to the equal information defence necessary?

The equal information defence should be retained but should apply to both civil and criminal proceedings. It should also be made clear that the communication of information to a person in order to allow a dealing with that person under the equivalent information defence does not violate the "tipping" provisions.

The Committee also believes that it may be useful to clarify that shares, options and securities may be granted to, and exercised by, employees under employee share and option plans (or individual employment arrangements) even though the employees may be in possession of price sensitive information.

Issue 36: Should there be a right of compensation for insider trading? If so, who should be eligible claimants and how should compensation be assessed?

The Committee regards insider trading as an offence as against the market rather than a violation of the rights of individual participants in the market. An insider does not normally induce other people to trade – the counterparties to an insider's trades are usually people who have voluntarily decided to enter the market and who would most likely have transacted with other uninformed market participants if the insider had abstained from dealing.

In these circumstances, any civil remedy for insider trading should be viewed primarily as a further deterrent to the offence rather than a compensation regime. Of course any remedies arising as a result of an

officer's breach of duty or as a result of any misrepresentation or other misleading or deceptive conduct should remain available in accordance with their terms.

Against this background, the Committee opposes the extension of civil claims to all people who deal contemporously.

The Committee also questions whether direct counterparties suffer any loss as a consequence of their orders being matched with those of an insider.

While the Committee does not have a concluded view, it believes it may be more appropriate for either the company or the regulator to have a right to recover a multiple of the insider's profit and to give the Court a discretion over the distribution of the funds recovered along the lines of the New Zealand legislation.

Issue 37: In what circumstances, if any, should companies whose securities are affected by insider trading be entitled to compensation?

See Issue 36.

Issue 38: In what manner should the director notification requirements be amended?

The Committee questions whether a statutory regime is required in light of the recently revised ASX Listing Rules

Issue 39: Should the Australian legislation introduce controls over speculative trading by corporate decision makers in the securities of their companies?

The Committee does not have a view on this. The Committee does, however, believe that it would be desirable to encourage listed entities to adopt policies on trading by executives and officers. That might be done by requiring listed entities to disclose their policies on this subject.

Issue 40: Should the Australian legislation include a "short swing profit" prohibition? If so, who should be subject to the prohibition?

The Committee does not have a view on this, but opposes any suggestion that substantial shareholders should be subject to such a regime simply by virtue of their shareholding. The Committee notes that a person may become a substantial shareholder as a result of making a takeover bid and may then sell their stake if they are over-bid by a counterbidder. The

Committee does not believe this should attract any short-swing profits regime.

Subject: Comments on Insider Trading Discussion Paper

Submission to:

Companies and Securities AdvisoryC ommittee

Comments on Insider Trading Discussion Paper

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October 10, 2001

We appreciate the opportunity to review and comment upon the Insider Trading Discussion Paper (the "Paper"). We have tried to be as succinct as possible, and to restrict our comments to the topics listed below, where there were specific issues which

we wished to raise, orw here we agreed or disagreed strongly with the positions taken in the Paper.

We do hope that these comments will prove useful. We would, of course, be happy to discuss any of the comments, should the need arise.

<u>Comment #1</u>- "Information Connection" Approach

This seems to be an essential preliminary issue to inside trading regulation. It appears to us to be valid to begin regulation with an "information connection" approach, effectively catching any person or entity with undisclosed material price-sensitive information about a company, without regard to the relationship of such person to the company, or the source of such information. We also agree with the proposed strengthening of the "generally available information" provisions. The broader focus of an "information connection" would correctly sweep into the insider trading net activities such as "front running" and "scalping", since the information on which these activities would be made profitable is itself material price-sensitive information not sourced in the company whose securities are being traded.A dapting such an approach will require consideration of a broader range ofr elationships which must be exempted from regulation, since the approach will automatically sweep into the regulatory prohibition a number of relationships which, arguably, should not be caught. This approach appears to us to be marginally preferable to regulation through a "people connection", where itw ould be necessary to define the connections to a company that will bring the possessor of information within the scope of the regulation, instead of defining the situations which require exclusion under the "information connection"a pproach. This is because the "information connection" approach should be more flexible, and should catch a broader array of misuses of non-public information. However, since failure to comply with this regulation is meant to have criminal or quasi-criminal repercussions, it may be overly-protective and too inflexible to catch all possible future uses of inside information, no matter how developed, unless exempted by future legislation.

This issue becomes more significant in the context of comparison with insider trading regulation in other major capital markets, and the increasing globalization of international equity markets. As the Paper points out, allo ther markets, with the exception of Malaysia, (the Province of Quebec, Canada is another example) have a "people connection" component to insider tradingr egulation. It may become a disincentive to inter-listing of internationale quities on the ASX if Australian insider trading laws were seen to criminalize behavior related to trading activities when these same activities would not be caught in jurisdictions having a "people connection" test, and may be sensibly excluded.

While we tend to favour the "information connection" approach, we do have a lingering concern about catching in the broader trading net activities which should not be caught, and are not caught in other jurisdictions. We wonder if this perceived

difficulty might not be addressed by some broad regulatorye xempting power in the hands of ASIC, which could be used, prospectively and retrospectively, to exempt types or varieties of trades as future circumstances require.

Comment #2- **Clear Deliniation of the Prohibition**

It is always difficult to advise in an area where the boundries of prohibited activity are imprecise, particularly so when the prohibition carries criminal or quasi-criminal sanctions for breach. The Paper recognizes this issue in itsi ntroduction (section 0.5), where it is stated that "Insider trading laws also need to be clear and workable, so that all parties know where they stand." Yet the basis for responsibility for insider trading involves trading while inp ossesion of something as imprecise as "material price-sensitive information". It is not hard to imagine that corporate insiders will always be in possesion of some non-public information, even after announcement of the latest financial period results. This will cause some measure of uncertainty with these individuals trading, even under the best of circumstances, lest after the fact it be argued that such information was materially price-sensitive because its announcement would have moved the market by some small percentage.

We believe it would be helpful if some indication was given as to the magnitude of what is "material" price-sensitive information. This would at least give some comfort to consciencious insiders in affecting ordinary trades, and make advising in such circumstances marginally easier.

Along a similar line of thought, it would be helpful if some guidance could be given as to what is a "reasonable dissemination period" following which an informed person can trade after public disclosure. Again, the issue is giving comfort to the conscientious insider, or advising such insider. Possibly, the answer is that an informed person can trade as soon as the market re-opensf ollowing release of confidential information. Yet, the insider has had time to digest more fully the impact of the announced change, and thus may still have an advantage on the market for some unknown period. Some "bright-line" guide as to what is a reasonable dissemination period would be very helpful, yet would not seem to be at odds with any regulatory objective.

Comment #3- Application to Non-Publicly Trade Securities

It is hard to see the rationale for extending the reach of insider trading to securities that are not publicly traded. Certainly, there can be no need to protect the integrity of capital markets in prohibiting such trades. To a business venture, one of the costs of access to public markets is the accompanying duty of public disclosure. We wouldn't have thought that if there is no duty of continuousm aterial change disclosure, there is any

need to have insider trading implications for selling non-traded securities without disclosure.

Sales of significant interests in private companies are normally attended by heavily-negotiated disclosure provisions, coupled with indemnities forb reach. These are normal commercial provisions which are privately negotiated. Causing insider trading ramifications to flow from such transactions wouldc reate in effect a positive duty of disclosure on the seller, as the only way of obtaining a suitable equal knowledge defence. This seems to us to be an unwarranted interference in private commerce, with no corresponding publics ecurities regulation policy objective being served.

Comment #4- New Issues Of Securities

Similar to comment #3, it is difficult to understand why insider trading rules should be extended to new issues of securities. When new issues are undertaken through prospectus, the purchasers have a whole separate set of rights flowing from incomplete prospectus disclosure,i ncluding rights against the issuer, its directors, and others. The need for additional penalties under the insider trading rules seems doubtful at best.

If securities are being issued in a private placement transaction,w ithout benefit of a prospectus, the assumption has to be that private placees can negotiate their own sets of representations and indemnities to guard against the risks that they consider material. Even if a need was felt to exist to protect purchasers in prospectus-exempt transactions, it would seem more compatible to the scheme of securities regulation generally to give such purchasers private rights of action for incomplete disclosure (based on some less formal disclosure document such as an offer information statement, offering memorandum or circular) then to apply the full range of insider trading provisions to such private failures of disclosure.

It must be remembered that insider trading is a very serious default, with criminal and quasi-criminal consequences. It would seem inappropriate that such dramatic results should flow from disclosure failures in a share issuancet ransaction, where other more appropriate remedies exist.

Comment #5 - Tipping/ Procuring

It would probably be simpler and more effective to prohibit all tipping of inside information, whether there is or is not a reasonable expectation of trading, unless the tipping was in the necessary course of the business of the company for which the information is price- sensitive. This exception would, of course, have to be carried through to the permitted uses that can be made of price-sensitive information derived from outside a company (i.e. developed by analysts). The requirement that the tipping

of price-sensitive information be accompanied by a disclosure that the information is non-public and cannot be used to trade would certainly improve the ability to track the party in the chain responsible for misuse, that being either thep erson who traded after receiving disclosure that the information was non-public, or the person who tipped and failed to disclose that the information was non-public and price-sensitive.

Consistent with the above, a procuring offence should be made out simply by the advising by the person with the special knowledge to trade or not tot rade, whether a trade occurs or whether the person informed is aware that the advisor possesses inside information. It may be that it will be difficult to prove the procuring when no trade occurs, either because the actual advise is not accepted or the advice is not to trade. However, the wrongful use of inside information still exists in these circumstances, and the clean articulation of the prohibition should act as a deterrent in most cases. In at least some situations, the offence will still be provable, as where the person who receives the advice is prepared to speak.

As to the responsibility of the person procured, that person should be an insider, with separate responsibility, if he or she knows, or should reasonably know, that the advisor possesses inside information (whether the exact detail is known), but should have no actual or implied responsibility if there is nok nowledge of any wrong being committed by the advisor

We suggest that the above is a cleaner and simple set of rules morec onsistent with the general concepts of an "information connection" system.

<u>Comment #6</u>- Take- Over Bids and White Knights

Consistent with the above comment, we believe that a company should be able to convey material price- sensitive information to a white knight to induce a rival take- over bid, and that this tipping would be in the necessary course of the company's business. That information would have to be conveyed subject to an indication that it wasm aterial undisclosed information, and could only be used to make an all-shares offer through which the substance of the insider information would be conveyed by the bidder. We believe that these disclosure procedures are already normal for such transactions, and would probably be the only basis upon which directors and officers of the targetc ompany could meet their fiduciary obligations to act in the best interest of the company and all of its shareholders in disclosing valuable proprietaryc orporate information.

The more difficult question in this area is whether either an original bidder or a white knight should be able to make pre- bid purchases under an" information connection" insider trading regime. A credible argument can certainly be made that the fact that a bid is intended is itself material price-sensitive information. If that is so, why should either bidder be allowed to use such information to acquire shares in advance of a bid

in a regime which attaches significance to the possession of price- sensitive information, however generated?

Of course, regulating pre-bid accumulations by a bidder would be contrary to market practice in other jurisdictions, and may cause serious issues forb idders in inter-listed shares, in a manner similar to that mentioned in Comment #1. If a bidder is allowed to bid, an explicit exemption would appear to be necessary. If this approach is taken (and we think that consistency to international standards here is probably preferable top urity with the "information connection" concept), there would seem to be little justification to extending it to permit purchases by individual bidding syndicate members, rather than exempting purchases only on behalf of the bidding syndicate. As a final matter, there should be no impediment to the white knight making pre-bid purchases as well, as long as the white knight has not received advice that it has been given material non-public price-sensitive information about the target company. It would only be the receipt of such information which should disqualify pre-bid purchases, and not the status alone of being a second bidder in a take- over battle.

It could even be argued that the receipt by the white knight of information that another bid was expected might not disqualify the white knight from making market purchases if it has already agreed with the company to make its own bid. Presumably, the white knight's bid will have to be higher than the original proposed bidder to be successful, and thus the news of the original bidder's intention would not appear to be material. Allowing the white knight to accumulate would level the playing field between the bids, by letting botha ccumulate, to the ultimate benefit of all shareholders, who would presumably have the benefit of the full inter-bid competition.

Comment #7 - Exemptions

In a system based on "information connection", which sweeps up all holders of price-sensitive information, creating the right balance of exemptions, or carving out types of information which may well not be regarded as material price- sensitive information, is probably the most difficult issue of all.

As set out above, we believe that on a balance of interests, an exemption for take- over bidders who do not have non-public material information, other than their own intention to bid, makes most sense, and perhaps can even bee xtended. Also, the underwriting exemption makes sense if new share issues are to attract insider trading implications, despite our Comment #4. The sense of this exemption would have to be that the underwriter has been informed about the non- public information and thus there is an equality of information between vendor and purchaser. An exemption for risk passage from the underwriter to a sub-underwriter, on the basis that the underwriter wouldd isclose prior to contract, also makes sense. In each of these cases, the assumption would have to be that the required tipping by the company to the underwriter, and from the underwriter to the sub-underwriters, would be permissible as in the necessary course of the company's business, and would be accompanied by non- trading

warnings, permitting trading only after delivery of the disclosured ocument which would accompany the ultimate sale and which would contain the until then non- public information.

On the other hand, we agree that an exemption for scheme managers,r eceivers, administrators and liquidators makes no sense. If these entities actually possess material non-public information, they should not be permitted to trade until disclosure has been made. There would seem to be no conceivable public market rationale for preferring thei nterests of the creditors of the company to the interests of participants in the public capital markets.

We also agree that the "did not make use" defence is inappropriate in that it can give rise to exemptions that are not based entirely on reality. Trading decisions can result from more than one factor, including the non- public information. Engaging in an examination of whether the non- public information or another reason is the predominant motivation for a trade is unproductive, and probably contrary to at least the appearance of fairness in the capital markets. A more rigid exemption based upon a non-d iscretionary trading programme, implemented prior to receipt of the material non- public information, makes more sense.

We also agree with the position that an exemption for trading based on an analyst's report should be limited to research resulting from deduction, conclusions and inferences made or drawn from generally available information. If the analyst's report is based on access to corporate secrets, either verbal or documentary, the report should be considered as tipped information, and thus unusable without insider trading implications. Trading in front of the release of an analyst's report should also be prohibited on the basis that the report, even if based on generally available information, may itself be material non- public information. The difficulty with this last conclusion is that if it is correct, then the release of the report to a selected dealer's client list, for solicitation of trading orders, would also have to be tipping. If so, the analyst could never engage in analysis which could be valuable to the dealer's trading clientele until after broad disclosure. Perhaps the answer here is in fact a specific provision making this" scalping" activity into insider trading, but specifically exempting the conveying of the recommendations to clients, and subsequent trading by these clients.

We believe that insider trading should apply to more than individuals (i.e. it should apply to a corporation or partnerships trading on its own behalf, or tipping or procuring), and that it should be presumed that information contained in one part of an organisation is available in another part of an organisation which then trades, advises or procures. The obvious conclusion from the above is that a Chinese Wall defence is still necessary. The problem with Chinese Walls is that more and more, there is scepticism as to whether the Wall really works tos egregate the non- public information from those who trade. The way in which S.1002M and S.1002N are currently drafted grants the exemption only if "the information was not soc ommunicated and no such advice was so given". Thus, the organisation wishing to rely on the exemption would appear to have the onus of proving that the Wall actually works if a situation deserving

of testing should arise. It appears to us that this statement of the exemption sufficiently protects a truly functioning Wall, and still allows for attack on the leaky Wall. We thus think that no change needs to be made here, other than specifically addressing procuring activity to ensure that it also is protected as long as the Wall works.

Comment #8 - Civil Liability To Market Participants

We believe that the criticism is rightly made that the current civila ction by a market participant against an insider trader is not useful. This is because of the difficulty in matching trades to the insider, and also because any matching is fortuitous. We do not, however, see any real virtue in moving to a regime that allows forc ompensation to be paid to those who are contemporaneous traders in the market. Again, the fact that these participants were in the market in the period contemporaneous with the insider is purely fortuitous. One has to assume that these people were buyers or sellers in any event and would have transacted with someone else at the same price if the insider was not in the market, unless the insider was running the market up or down (which seems highly unlikely, as the insider would then be clearlyb egging to be caught). Thus, there would appear to be little utility in such compensation. Any deterrent factor from the threat of compensation would appear to be unnecessary as the activity is already criminal, and subject to heavy civil penalty. The other problem with contemporaneous matching is the potential sheer magnitude of the liability. Consider the office worker who uses inside information to purchase 500 shares. On an order- matching civil liability, this person's civil liability would fit the magnitude of the offence. What would be thel iability potential for this offender under a contemporaneous trading regime?

Similarly, it is hard to imagine real utility in the company itselfh aving rights to pursue a civil action. One would assume that to do so, the company would have to establish its own losses, which, as the Paper points out, are difficult to imagine as existing.

Comment #9 - Insider Reporting

We believe some care should be taken in extending insider reporting obligations too far, unless some "material change" threshhold is applied. In many modern organisations, mid- level management individuals are often given titles such as "vice-president" as am eans of recognition, but without the title conveying the sense of someone in continuous possession of real inside information. Occasionally, such people may actually possess inside information, but more routinely they do not.

As often, the remuneration package of these mid- level managers includes option or share compensation entitlements, and if the company is doing well, those equity assets may be the individual's largest source of wealth accumulation. It is only with a great deal of actual embarrassment that these individuals can liquidate ap ortion of their holdings, for very valid personal reasons, and without any hint of inside trading, if a

reporting obligation is involved. As more "juicy" information becomes available in public insider reports, the gossip side off inancial reporting will run newspaper columns reporting which insiders have sold. This then becomes an issue for the mid- level manager, both inside the organisation where he or she may be seen as not believing in the cause, and outside, where personally sensitive information is made public.

The point to this is that there may be little marginal utility to extending insider reporting to these levels, but quite significant personald is benefit to the individual. Either the reporting obligation should be kept to real senior officers, or a "material change" level should be put into the reporting obligation in order to balance the reporting benefit with the obligation on the insider.

Comment #10 - Short Swing Profit Rule

This is a provision of American securities laws that would best be left where it is. The Rule is simply a great annoyance to shareholders and executives of public companies, with arguably no utility to the market. It presupposes that buys and sells in a six-month period must be improper, which clearly is not necessarily so. The only utility to the Rule lies in the American willingness to permit private enforcement actions, which allows securities bounty- hunters to perform searches to try to be first to identify a possibly unintentional infringement of the Rule, for personalp rofit to the securities sleuth. It is hard to imagine why Australia would want to import this, possibly the worst of American securities regulation.